

Comparative Advantage and Pure Theory

Why trade takes place?

- = Classical economists saw labour as the only factor of production
- = Different labour productivity among countries cause trade.

Why do countries gain by trading

- = The classical economists were of view that so long as cost conditions differ between the countries, at least one and probably both will gain by trading.
- = These questions and answers contain the essence of the theory of comparative advantages.

The Theory of Comparative cost/ advantage

- = This Theory formulated around 1815 by David Ricardo.
- = The period of 17th and 18th centuries was the period of mercantilism. — Highly nationalistic,
- = It viewed the well being of the own nation.
- = It generally viewed foreign trade with suspicion.

Adam Smith :- Absolute Advantage of Trade

- = A country could gain by trading. The tailor does not make his own shoes; he exchanges a suit for shoes.
- = Both will gain

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Smith argued a whole country can gain by trading with other countries.

= If it takes 10 labour units to manufacture 1 unit of good A in Country I but 20 labour units in Country II and if it takes 20 units of labour to manufacture 1 unit of good B in Country I but only 10 labour units in Country II, then both countries can gain by trading.

= If the two countries exchanged the 2 goods at a ratio 1:1 so that 1 unit of good A is exchanged for 1 unit of good B, Country I could get 1 unit of good B by sacrificing only 10 units of labour, whereas it would have to give up 20 units of labour if it is produced itself. Same is the case with Country II.

= The implication is that both countries could have more of both goods by trading.

David Ricardo - Theory of comparative Advantage.

= Ricardo did not object to Smith's analysis rather he analysed the theory on the basis of comparative advantages.

= A great deal of trade is governed by differences in cost of production.

= If United States can produce tea only at very high costs and India can produce computers only at excessive costs it surely benefits both countries to trade tea for computers.

<u>Cost Comparison.</u>		
	<u>1 unit of wine</u>	<u>1 unit of cloth</u>
Portugal -	80	90
England -	120	100