Edexcel (A) Economics A-level

Theme 4: A Global Perspective

4.1 International Economics

4.1.2 Specialisation and trade

Notes

Absolute and comparative advantage:

Countries can specialise in the production of certain goods. For example, Norway is one of the world's largest oil exporters. Countries trade to get the goods and services they are unable to produce.

A country has **absolute advantage** in the production of a good or service if it can produce it using fewer resources and at a lower cost than another country.

Comparative advantage occurs when a country can produce a good or service at a lower opportunity cost than another country. This means they have to give up producing less of another good than another country, using the same resources.

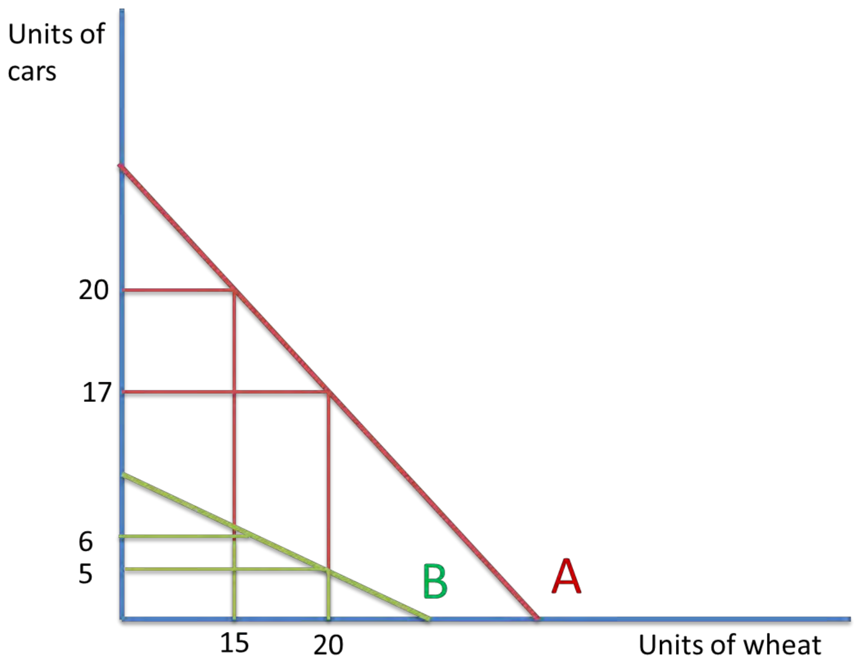
Comparative advantage diagram and numerical analysis

Country A can produce 30 units of wine and 10 units of wheat with their resources, and country B can produce 32 units of wine and 20 units of wheat.

	Wine	Wheat
Country A	30	10
Country B	32	20
Total	62	30

It can be seen that country B has an absolute advantage in producing both products (it can produce more of both with the same resources). The greatest difference between the productions is with wheat, so country B should produce wheat and country A should produce wine.

The opportunity cost of production is reflected in the gradient of the PPF. If more of one good is produced, less of the other good can be produced.



From the diagram, it can be seen that to increase production of wheat by 5 units, A has to give up 3 units of cars (20 to 17). However, B only gives up 1 unit of cars (6 to 5). Therefore, B has a lower opportunity cost of producing wheat, so B should produce wheat (it has a comparative advantage in wheat). For each unit of wheat, the opportunity cost ratio for A is 3/5, whilst for B it is 1/5.

Assumptions and limitations relating to the theory of comparative advantage

The theory of comparative advantages assumes a perfectly competitive market. In reality, this is likely to be different, which results in the full benefit of specialisation not happening. Specialising fully could also lead to structural unemployment, since workers might not gain the transferable skills they need to change between sectors, or they are simply unable to change.

Comparative advantage does not consider the exchange rate when considering the cost of production for both countries. Therefore, if the price of one good increase, it is more worthwhile producing that good, even if the country has a comparative advantage in the other good.

Countries can develop an advantage in the production of a good, such as Vietnam in the production of coffee. It is the largest coffee supplier to the UK and, over the last 30 years, it has become one of the world's largest coffee producers. During this period, Vietnam's market share increased from 1% to 20%.

Moreover, comparative advantage is derived from a simple model with two countries; the global trade market is significantly more complex than this.

It can be argued that comparative advantage is no longer a relevant concept. Countries do not only produce a handful of goods and services, like the theory suggests. Rather, a wide variety of goods and services are produced, and there is very little specialisation. This is helped by the advancement of technology.

Advantages and disadvantages of specialisation and trade in an international context

Advantages:

- Greater world output, so there is a gain in economic welfare.
- There could potentially be higher quality, since production focusses on what people and businesses are best at.
- A greater variety of goods and services could be produced.
- Lower average costs, since the market becomes more competitive.
- There is an increased supply of goods to choose from.
- There is an outward shift in the PPF curve.
- More opportunities for economies of scale

Disadvantages:

- Less developed countries might use up their non-renewable resources too quickly, so they might run out.
- Countries could become over-dependent on the export of one commodity, such as wheat. If there are poor weather conditions, or the price falls, then the economy would suffer.
- There could be more structural unemployment, since production moves abroad.
- Some countries might become stuck in the production of one good or service, so they cannot develop further.