CIE Economics AS-level

Topic 4: The Macroeconomy

f) Principles of absolute and comparative advantage

Notes

The distinction between absolute and comparative advantage

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.

Countries can specialise where they have comparative advantage. This increases economic welfare.

Free trade area

This is where countries agree to trade goods with other members without protectionist barriers. For example, the North American Free Trade Agreement (NAFTA) is a free trade area.

They allow members to exploit their comparative advantages, which increases efficiency.

Customs union

Countries in a customs union have established a common trade policy with the rest of the world. For example, they might use a common external tariff.

Monetary union

This is sometimes called a currency union. Members of a monetary union share the same currency. This is more economically integrated than a customs union and free trade area. The Eurozone is an example of this.

Full economic union

This is made up of a common market with a customs union. The members have common freedom of movement of goods, services, capital and labour, as well as a common external trade policy. The EU is an economic union.

Economic unions with common currencies are called **economic and monetary unions.**

Trade creation and trade diversion

Trade creation occurs when a country consumes more imports from a low cost producer, and fewer from a high cost producer.

Trade diversion occurs when trade shifts to a less efficient producer. Usually, a country might stop importing from a cheaper producer outside a trading bloc to a more expensive one inside the trading bloc.

Trade diversion is more likely to occur where external tariffs are high, which results in goods produced within the trading bloc becoming cheaper to import than goods produced outside the trading bloc.

The benefits of free trade, including the trading possibility curve

Free trade is the act of trading between nations without protectionist barriers, such as tariffs, quotas or regulations.

Free trade provides the following benefits:

- Countries can exploit their comparative advantage, which leads to a higher output using fewer resources and increases world GDP. This improves living standards.

- Free trade increases economic efficiency by establishing a competitive market. This lowers the cost of production and increases output.

- By freely trading goods, there is trade creation because there are fewer barriers. This means there is more consumption and large increases in economic welfare.

- More exports could lead to higher rates of economic growth.

- Specialising means countries can exploit economies of scale, which will lower their average costs.

According to comparative advantage, specialising minimises the opportunity cost for countries. The assumptions of the **Trade Possibilities Curve** are:

- Two nations produce two goods and there is a trade-off
- There are constant costs in producing each good. This assumes the possibilities curve is a straight line.
- The two nations face different costs of production.