**TOPIC 2**

**Theories of international trade: Mercantilism, Absolute and Comparative advantage.**

**(A) Mercantilism:** Mercantilism as developed in the 16th century was one of the earliest efforts of economists towards an economic theory. The theory states that what determines the wealth of a country is the amount of its gold and silver holdings. The central message of mercantilism is that a country should increase its holdings of gold and silver by promoting exports and discouraging imports.  What this means, therefore, is if the residents of other countries buy more from you (exports) than they sell to you (imports), then they have to make up the difference in gold and silver.  Hence, the objective of each country is to have a trade surplus, which meant more Silver and Gold. To achieve a trade surplus, the nation-states promoted exports and imposed restrictions on imports; a strategy referred to as **protectionism**. Nations built larger armies and national institutions to help them gain a trade advantage over other nations. Sometimes such gains are achieved through military conquest (this explains the origin of colonialism and annexation). Nations expanded their wealth by acquiring and using their colonies around the world to control more trade and amass more riches. The British colonial empire was one of the more successful examples. It increased its wealth by using raw materials from places like the present day the Americas, India, and Nigeria. In addition, France, the Netherlands, Portugal, and Spain were also successful in building large colonial empires that generated extensive wealth for their governing nations. Although mercantilism is one of the oldest trade theories, it remains part of modern thinking. Countries such as Japan, China, Singapore, Taiwan, and even Germany still favour exports and discourage imports through a form of neo-mercantilism in which the countries promote a combination of protectionist policies and restrictions and domestic-industry subsidies. Nearly every country, at one point or another, has implemented some form of protectionist policy to guard key industries in its economy. While export-oriented companies usually support protectionist policies that favour their industries or firms, protectionism affects other companies and consumers adversely. Import restrictions lead to higher prices for consumers, who pay more for foreign-made goods or services. However, Free-trade advocates highlight how free trade benefits all members of the global community, while mercantilism’s protectionist policies only benefit select industries, at the expense of both consumers and other companies, within and outside of the industry.

**(B) The theory of absolute advantage:** Adam Smith proposed the theory of absolute advantage in his 1776 epoch-making book -The wealth of nations. The theory questioned the existing mercantile theory. In Smith’s An Inquiry into the Nature and Causes of the Wealth of Nations, he focused on the possibility of a nation having the ability to produce a good more efficiently than another nation. As a laisse faire proponent, Smith advocated that trade between countries should not be regulated or restricted by government policy or intervention but should be allowed to flow naturally according to market forces (forces of DD & SS also called the invisible hand). This theory is an extension of the principle of division of labour to the sphere of foreign trade. According to Adam Smith, a country should specialise in those commodities, which it can produce at a lower absolute cost than other countries. The term 'absolute cost' means the entire cost of production in terms of workforce, which the theory assumed is the only factor required for the production of a commodity. More output from a unit of labour indicates fewer costs and vice versa. When we explain gains from trade by comparing absolute differences in costs, we refer to it as an **absolute advantage.** A country X has an absolute advantage over another country Y in the production of a particular commodity when an equal quantity of resources (labour) can produce more of the commodity in X than in the other country Y. The term reciprocal absolute advantage is used between two countries, where each country produces one commodity more cheaply than the other does. Assume that two countries - X and Y use two units of resources each to produce the quantities of cocoa and lace as shown in table 1 below:

**Table 1: Outputs of Cocoa & Rice by Countries X & Y**

|  |  |  |
| --- | --- | --- |
| **Country** | **Units of Resource (Labour)** | **Output** |
| **Cocoa** | **Rice** |
| X | 2 | 40 | 12 |
| Y | 2 | 10 | 35 |
| Total | 4 | 50 | 47 |

Country X has an absolute advantage over Y in the production of cocoa while Country Y has an absolute advantage over X in the production of Rice. The reason is that a unit of resources (labour) produces 40 tons of cocoa in country X while it produces 10 tons of cocoa in Country Y. There is an absolute difference in costs. Country A produces cocoa at an absolute lower cost of production than country B since its output per unit labour is higher. On the other hand, 35 tons of rice is greater than 12 tons of rice, hence country Y produces rice at an absolute lower cost of production than country X. Trade between the two countries will benefit both if they should specialize, using their units of resources in the production of the commodity that they have an absolute advantage. Such action will lead the world total output to increase as shown in table 2 below and mutual trade can exist between the two countries.

**Table 2: Outputs of Cocoa & Rice by Countries X & Y**

|  |  |  |
| --- | --- | --- |
| **Country** | **Units of Resource (Labour)** | **Output** |
| **Cocoa** | **Rice** |
| X | 2 | 80 | - |
| Y | 2 | - | 70 |
| Total | 4 | 80 | 70 |

In table 2 above, country X specialized in the production of cocoa while country Y specialized in the production of rice. With specialization, the world output of cocoa increased by 30 tons (i.e., 80-50) while the output of rice increased by 23 tons (i.e. 70-47).

**(C) The theory of Comparative advantage:** The challenge to the idea of absolute advantage theory was that some countries might be better at producing both goods (X & Y) and, therefore, have an advantage in many areas while on the other hand; another country may not have any useful absolute advantages. Hence, the emphasis by Adam Smith on absolute differences in costs between two countries is not realistic. First, most underdeveloped and developing countries engage in trade even when they do not possess an absolute advantage in the production of commodities. Second, a developed country that has an absolute advantage over another in the production of two commodities still engage in trade since the margin of advantage differs in the two commodities. In response to these challenges, David Ricardo introduced the theory of comparative advantage in 1817. Ricardo reasoned that even if Country X had the absolute advantage in the production of both cocoa and rice, specialization and trade could still occur between the two countries. Comparative advantage occurs when a country cannot produce a product more efficiently than the other country; however, it can produce that product better and more efficiently than it does other goods. As a result, comparative advantage focuses on the relative productivity differences in products, whereas absolute advantage looks at absolute productivity differences between countries. According to Ricardo, What matters in international trade is a comparative advantage and not an absolute advantage. Unlike the absolute advantage derived by comparing the absolute costs (i.e., the total cost of production in terms of labour) in the two countries, comparative advantage is obtained from relative costs. This is the cost of producing a commodity in terms of the other. This cost is the same as the marginal cost (MC) which in a competitive market is equal to the price. The study of gains from trade by considering comparative differences in costs (relative costs) gives rise to comparative advantage. A country has a comparative advantage when it sacrifices less in the production of a given commodity than in the other. The country may have an absolute advantage in the production of both commodities, but a comparative advantage in the production of one commodity than in the other. In table 3 below, country X has an absolute advantage in the production of both cocoa and rice.

**Table 3: Outputs of Cocoa & Rice by Countries X & Y**

|  |  |  |
| --- | --- | --- |
| **Country** | **Units of Resource (Labour)** | **Output** |
| **Cocoa (tons)** | **Rice (tons)** |
| X | 2 | 50 | 30 |
| Y | 2 | 10 | 15 |
| `Total | 4 | 60 | 45 |

This does not mean that it should not engage in trade. We can see that its margin of advantage differs in the two commodities. A unit of labour used in country X produced 50 tons of cocoa that are five times greater than the 10 tons it produced in country Y. In contrast, a unit of labour in country X produced 30 tons of rice, which is twice greater than the 15 tons it produced in Country Y. If country X produces 50 tons of cocoa, it sacrifices 10 tons of cocoa that it would have imported. However, if it produces 30 tons of rice, it sacrifices 15 tons of rice it would have imported from country Y. The sacrifice that country X makes by engaging in cocoa production is less than what it should have made if engaged in rice production. Therefore, it is cheaper for it to import rice than cocoa. From the above illustration, country X has a comparative advantage in the production of cocoa but a comparative disadvantage in the production of rice. On the other hand, country Y has a comparative disadvantage in the production of the two commodities but it has a better comparative disadvantage in the production of rice. Consequently, it should specialize in the production of rice and import cocoa from country X.

An alternative explanation to the illustration above is to look at what each country sacrifices by not producing the other commodity. This involves opportunity cost. A country has a comparative advantage in the production of a good if it can produce that good at a lower opportunity cost relative to another country. The opportunity cost of producing any commodity is calculated by the use of the formula:

**Opportunity cost = Forgone quantity/Obtained quantity**

Using the formula above on the data contained in table 3, the opportunity cost of producing:

50 tons of Cocoa = 30/50 = 0.6 of rice

10 tons of Cocoa = 15/10 = 1.5 of rice

30 tons of rice = 50/30 = 1.67 of Cocoa

15 tons of rice = 10/15 = 0.67 of Cocoa

Represented in the table4 below, are the output and the opportunity costs they gave based on the above calculations?

**Table 4: Output and Opportunity cost of Cocoa & Rice in Countries X & Y**

|  |  |
| --- | --- |
| **Country** | **Output and Opportunity cost** |
| **Cocoa (tons)** | **Rice (tons)** |
| X (Ghana) | 50 (0.6 of Rice) | 30 (1.67 of Cocoa) |
| Y (Nigeria) | 10 (1.5 of Rice) | 15 (0.67 of Cocoa) |

In table 4, the figures in bracket are the opportunity cost of the output written before it. Country X sacrifices much (1.67 > 0.67) in producing Rice while Country Y sacrifices much (1.5 > 0.67) in producing cocoa. Country X should specialize in the production of cocoa while country Y should specialize in the production of rice.

Assignment1: **Summarize the Assumptions of the theory of comparative advantage.**