Absolute and comparative advantage

Absolute advantage

KEY TERM

Absolute advantage: used in the context of international trade, a situation where, for a given set of resources, one country can produce more of a particular product than another country.

	Before specialisation		After specialisation	
	Rice	Coffee	Rice	Coffee
Indonesia	500	200	1,000	
Brazil	200	500		1,000
Total	700	700	1,000	1,000

Table 4.4 Absolute advantage: specialisation

If each country specialises in the product in which it has an absolute advantage and then trades, based on opportunity cost ratios, total output will rise and both countries will be able to consume more products

	Rice (tonnes)	Coffee (tonnes)
Indonesia	700	450
Brazil	300	550
Total	1,000	1,000

Table 4.5 Absolute advantage: specialisation and trade

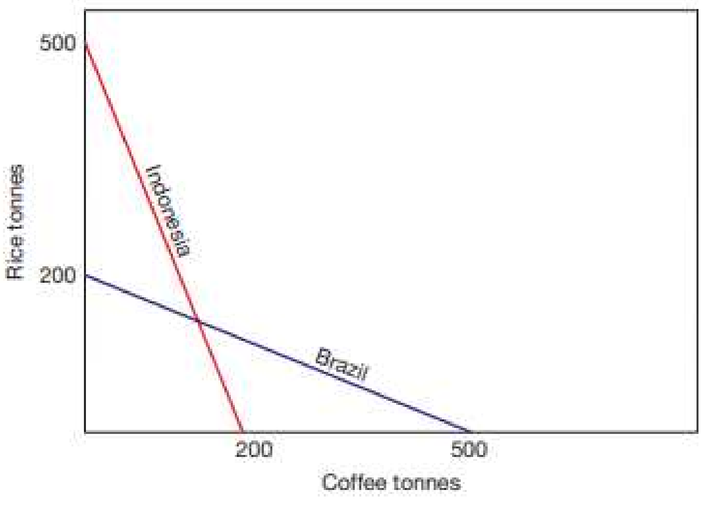

Figure 4.20 Absolute advantage

- Indonesia has the absolute advantage in producing rice while Brazil has the absolute advantage in producing coffee. Figure 4.20 shows simplified production possibilities for the two countries. This is based on each country devoting half of its resources to each of the products

Comparative advantage

KEY TERM

Comparative advantage: used in the context of international trade, a situation where a country can produce a product at a lower opportunity cost than another country.

Some countries buy products from abroad that their own producers would be capable of producing with fewer resources. This is because it enables its producers to concentrate on producing those products they are even better at producing

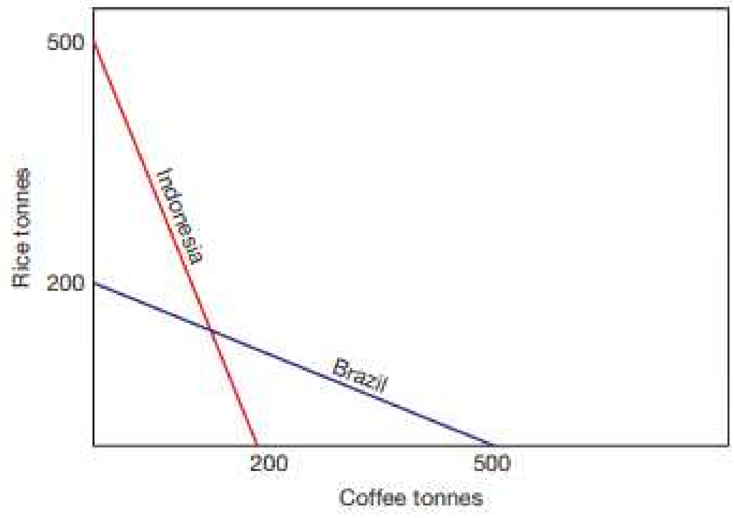

Figure 4.20 Absolute advantage

	Before specialisation		After specialisation	
	Coats	Shirts	Coats	Shirts
USA	4,000	10,000	8,000	
Bangladesh	1,000	8,000		16,000
Total	5,000	18,000	8,000	16,000

Table 4.6 Comparative advantage: the benefits of specialisation

Comparative advantage does not provide a full explanation of the pattern of global trade. Reasons:

- governments may want to avoid overspecialization
- transport costs may off set the comparative advantage
- the exchange rate may not lie between the opportunity cost ratios and other governments may impose trade restrictions.