Intl Trade - Comparative vs. Absolute Advantage

By Troy Segal | Updated June 1, 2018 - 6:00 PM EDT

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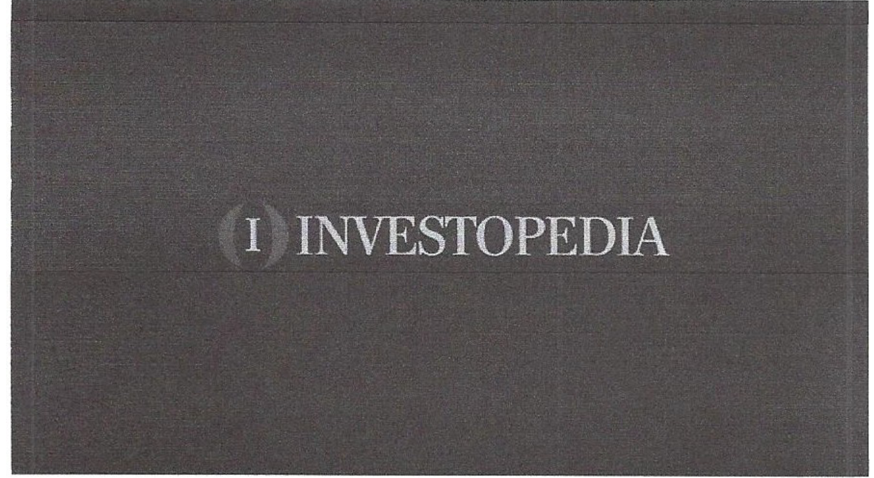

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A: Absolute advantage and comparative advantage are *two* important concepts in international trade that largely influence how and why nations devote limited resources to the production of particular goods. They describe the basic economic benefits that countries get from trading with one another.

Absolute Advantage

Though it is not economically feasible for a country to import all of the food needed to sustain its population, the types of food a country produces can largely be affected by the climate, topography and politics of the region. Spain, for example, is better at producing fruit than Iceland. The differentiation between the varying abilities of nations to produce goods efficiently is the basis for the concept of absolute advantage.

If Japan and the United States can both produce cars, but Japan can produce cars of a higher quality at a faster rate, then it is said to have an absolute advantage in the auto industry. A country's absolute advantage or disadvantage in a particular industry plays a crucial role in the types of goods it chooses to produce. In this example, the U.S. may be better served to devote resources and manpower to another industry *in* which it has *the* absolute advantage, rather *than* trying to compete with the more efficient Japan.

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Comparative Advantage

The focus on the production of those goods for which a nation's resources are best suited is called specialization. When economists refer to specialization, they mean the increase in productive skill that is achieved from focused repetition in producing a good or service. A country specializes when its citizens or firms concentrate their labor efforts on a relatively limited variety of goods. Historically, specialization arose as a result of different cultural preferences and natural resources.

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Given limited resources, a nation's choice to specialize in the production of a particular good is also largely influenced by its comparative advantage. Whereas absolute advantage refers to the superior production capabilities of one nation versus another, comparative advantage is based on the concept of opportunity cost. The opportunity cost of a given option is equal to the forfeited benefits that could have been gained by choosing the alternative. If the opportunity cost of choosing to produce a particular good is lower for one nation than for others, then that nation is said to have a comparative advantage.

Assume that both France and Italy have enough resources to produce either wine or cheese, but not both. France can produce 20 units of wine or 10 units of cheese. The opportunity cost of each unit of wine, therefore, is 10 + 20, or 0.5unitsof cheese. The opportunity cost of each unit of cheese is 20 + 10, or two units of wine. Say Italy can produce 30 units of wine or 22 units of cheese. Italy has an absolute advantage for the production of both wine and cheese, but its opportunity cost for cheese is 30-;.22, or 1.36 units of wine, while the cost of wine is 22+ 30, or 0.73 units of cheese. Because France'sopportunity cost for the production of wine is lower than Italy's, it has the comparative advantage despite Italy being the more efficient producer. Italy's opportunity cost for cheese is lower, givingit both an absolute and comparative advantage.

Since neither nation can produce both items, the most efficient strategy is for France to specialize in wine production because it has a comparative advantage and for Italy to produce cheese. International trade can enable bothnations to *enjoy* both products at reasonable prices because each is specialized in the efficient production of one item.

A Little History

Adam Smith was the first economist to systematically extend the benefits of specialization to separate nations. In his *book,An Inquiry into the Nature and Causes of the Wealth of Nations,* Smith argued that countries should specialize in the goods they can produce most efficiently and trade for those goods they can't produce as well.

Smith only described specialization and international tradeas they related to absolute advantages: England can produce more textiles per labor hour and Spain can produce more wine per labor hour, so England should export textiles and import wine. It wasn't until British economist David Ricardo arrived at the concept of comparative advantage in the early 19th century that thereal benefits of international trade were discovered.

Ricardo, borrowing from an essay written by Robert Torrens in 1815, explained how nations could benefit from trading even if one of them had an absolute advantage in producing everything. In other words, if the United States was more productive in every way thanChina, it would still behoove the U.S. to trade with the Chinese. The reason for this is opportunity cost.

Moreover, Ricardo argued thata country shouldn't specialize in those goods it can produce at a higher total level,but in those goods it can produce with a tower opportunity cost.

Implications of Comparative Advantage

Consider a hypotheticalsituation where the U.S. can either produce 100 televisions or 50cars. China can produce 50 televisions or 10 cars. The U.S. is better at producing bothin an absolute sense, but China is better at producing televisions because it only has to give up one-fifth of a car to make one television; the U.S. has to give up one-half of a car to make a television. Conversely, the U.S. only has to trade two televisions to make a car, while China has to forgo five televisions to make a car.

This example highlights why there is almost alwaysan economic incentive for two entities, including entire nations, to engage in trade.Thisis especially important for less-developed countries, who are not shut out of international markets because they lack the superior technology and capital infrastructure of wealthy nations.

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The Bottom Line

Comparative advantage leads to more income for countries. It's a key argument in favor of free trade. By comparison, restrictions on trade in the form of tariffs or quotas skew comparative advantages. The result is products that should have been imported become more expensive and resources are wasted on activities that don't produce the highest return.

(For related reading, see: *How is comparative advantage used as a justification for free trade policies?*)

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