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Research Paper

Role of Comparative Advantage in International Trade

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ABSTRACT
The conceptual framework for international trade could be traced to the outcome of specialisations, differential skills, diversions in natural resource endowments, geographical proximity and approaches, religious and socio-cultural movement, onslaught of imperialism and entrepreneurial human instinct.
Tracing the formulation of trade policy issue of international business, the theory of mercantilism can be taken as starting point. The mercantilists identified a nation's wealth or well-being with its stock of precious metals. A favourable balance of trade was required, which encouraged aggressive export but restrictive import policies, since the net outflow of goods would be matched by inflow of gold. Secondly, it advocated promotion of manufacturing at home rather than importing manufactured goods, which would displace domestic production and employment. This theory explains the colonial powers trade objective of generating trade surplus with colonial possessions.

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I. INTRODUCTION

The free economies tend to move more faster and steadily then closed economies and is significant in creating more jobs and employment in country. The companies making profits have more employment opportunities and tend to hire more workers in comparison to companies that are making losses. Global economic trades act catalyst for greater efficiency and productivity. This is because companies have access to a wider range of high-quality, affordable inputs. They also have access to technology and quality inputs to boost innovation capabilities and creativity in workplace. Adding to this, prevailing competitions in the marketplace stimulates companies adopting new and better ways with more efficiency and better prices. Input of new ideas and enhanced access to export markets from other countries makes it more productive.

In Mercantilist system, governments tried to increase exports than their import quantities thereby making the trades more balances and favaourable and thus increasing the wealth of the country. Countries engaged in mercantilism increases their wealth by increasing the supply of gold, silver and other metal trades by engaging in a protectionist role in the country-increasing exports and reducing imports, especially with the use of tariffs.

However, mercantilist mis specified the wealth of nation by identifying it with the stock of precious metals rather than by consumption alternatives available to the nation's citizens. Moreover, how other trading partners were to pay for imports without the ability to export, was never explained.

Adam Smith, in his book 'The Wealth of Nations', put forward the theory of absolute advantage, advocating free trade as the best policy for nations of the world. Smith argued that with free trade, each nation could specialize in the production of those commodities in which it has an absolute advantage and import those commodities in which it has an absolute disadvantage. A country may have natural advantage in the form of climatic conditions, access to certain natural resources and abundant labour force or acquired advantage in the form of technology and skill development. This international specialization of factors of production would result in an increase in world output, which would be shared by trading nations. As a result, all nations could gain simultaneously rather than one nation gaining at the expense of other nations.

It implied that a country which had an absolute Adam Smith 's theoretical proposition was drastically modified by the work of David Ricardo whose theory of comparative advantage attempts to provide theoretical basis of modern trade theory and the underlies the basic concept of the present liberalised multilateral trading system based on the WTO. Ricardo's insight can be presented in a simple manner by considering the following example.

Suppose there are two countries A and B, two commodities X and Y, Constant returns to scale and zero transport costs. Further suppose the cost data calculated in terms of labour hours is as follows:

Table 1: Example on Comparative advantage

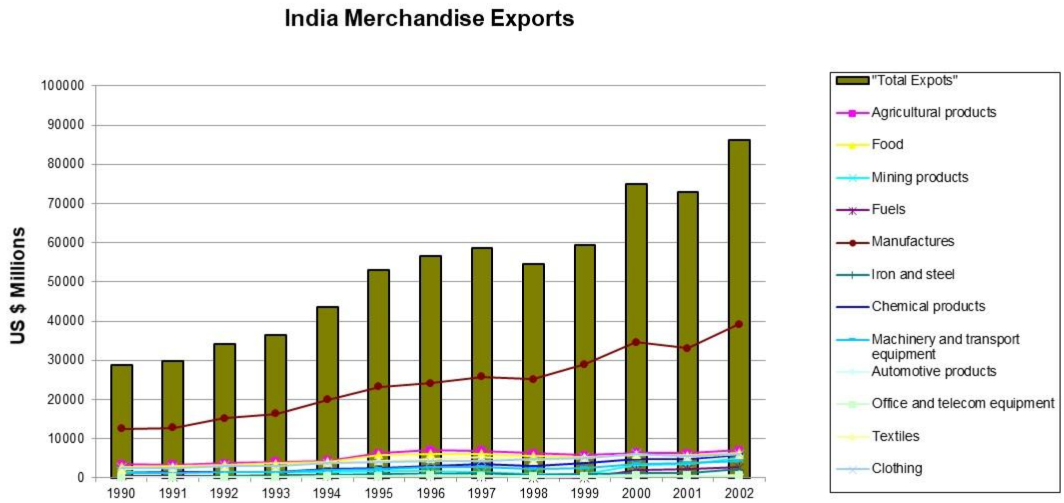
Output per hour of Labour		
Commodities	A	B
X	5	4
Y	10	2

Now country A has an absolute advantage in the production of both the commodities. Under the dispensation of absolute advantage, it will export both the commodities and B will import both the goods, leading to a unidirectional international exchange.

Ricardo pointed out that the price structure of the two commodities in the countries is an important determinant of trade. Thus, in country A the ratio of price of commodity X to the price of commodity Y=2 i.e., X=2Y. In country B the ratio of price of commodity X to the price of commodity Y=1/2 i.e., X=1/2Y.

So, the traders in country A will gain if they export commodity Y to country B and obtaining commodity X in return import it into country A. In this way they can produce 4 times the commodity X which they would otherwise be able to produce without trade. The trade would take place between the two countries with country A exporting commodity Y and country advantage in all commoditise would not import any commodity from abroad and would keep exporting so that there would be a unidirectional trade.

Similarly, a country which had a comparative disadvantage in the production of all goods would be an importer of goods with no exports at all.



The establishment of the world trade organization (WTO) that will have a greater impact in the form of liberalization if it succeeds in increasing the costs or reducing the benefits of those seeking mercantilist profits through trade restrictions.

Over the above the most pernicious fallacy of mercantilism that remain today, is the idea that imports reduce domestic employment. Globally Labor unions have found this argument to justify the reduced imports originating in low-wage countries with a long political and media debate over the implications of offshoring of service sector jobs for national employment. Many researchers have claimed that offshoring of services can reduce employment and puts U. S. jobs at risk. However, there had been no loss on average, jobs simply reallocate among the regions and industries. Another view of mercantilist persists that it is bad to current account deficit i.e. borrowing or selling assets to the world markets in access to the export revenues. But if spending is for expansion or productive purposive that can yield greater returns it will promote economic growth even when this results in an increase of net foreign indebtedness. Many developing countries have run current account deficits for extremely long periods with high rates of return on capital while maintaining rapid growth and solvency. For e.g. USA in nineteenth century was borrowing from the investors and had high international capital flows to build railroads. Furthermore, in a developing countries, persistent surpluses may primarily reflect a lack of viable investment opportunities at home or a growing demand for money, and not a "mercantile" accumulation of international reserves at the expense of the trading partners.

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