Theory of International Trade

Comparative Cost Advantage Theory – Part 2

Comparative Cost Advantage Theory

Labour Cost Structure Comparison

Country	Labour Cost of Producing Wine	Labour Cost of Producing Cloth	Exchange Ratio in Each Country (Domestic Term of Trade)
Portugal	80	90	80:90 – i.e. 1 unit of wine (W) = 0.89 unit of cloth (C) (1 W = 0.89 C or 1 C = 1.13 W)
England	120	100	120:100 – i.e. 1 unit of wine (W) = 1.2 units of cloth (C) (1 W = 1.2 C or 1 C = 0.83 W)
Comparative Cost Ratio	80/120 = 0.67	90/100 = 0.90	

Comparative Cost Advantage Theory

i. **Summary of above table:**

- Portugal has absolute advantage in both the products;
- Labour cost of wine 80 < 120 ; Labour cost of cloth 90 < 100
- But comparative advantage in wine as comparative cost of wine is (0.67) which is less than comparative cost of cloth (0.9)

Comparative Cost Advantage Theory

- For one unit of wine, Portugal use only 67% of England's labour cost of wine; whereas for clothes, she uses 90% of England's labour cost of cloth.
- If in country I, the labour cost of producing product A is a_1 and of B is b_1; and in country II, the labour cost of producing product A is a_2 and of B is b_2; then absolute and comparative cost advantage can be algebraically expressed as,

Comparative Cost Advantage Theory

- Algebraically;
- Absolute Cost Advantage of country I over II in product A

$$\frac{a_1}{a_2} < 1 < \frac{b_1}{b_2}$$

- Comparative Cost Advantage of country I over II in product A

$$\frac{a_1}{a_2} < \frac{b_1}{b_2} < 1 \qquad \left(\frac{80}{120} < \frac{90}{100} < 1\right)$$

Comparative Cost Advantage Theory

- England has absolute disadvantage in both the products, but comparatively less disadvantageous in cloth.
- **Ricardo:** Advantageous for both the countries to have trade.
  - England produce cloth and exchange cloth for wine from Portugal.
  - Portugal produce wine and exchange wine for cloth from England.

To be Continued ……….

Comparative Cost Advantage Theory

THANK YOU