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Study materials for degree part 2

Comparative cost theory of international trade

This theory is developed by a classical economist David Ricardo. According to this theory, the international trade between two countries is possible only if each of them has absolute or comparative cost advantage in the production of at least one commodity.

This theory is based upon following assumption:

1. There are only two countries and two commodities
2. There is no governmental intervention in export and import Only labour is factor of production. Quantity of labour used gives cost of production.
3. There is perfect mobility of labour within the country but not between the countries.
4. There is no cost of transportation between the countries.
5. The law of constant returns to scale operates in production.
6. The units of labour are homogeneous
7. The units of each commodity in both countries are homogeneous

According to comparative cost advantage theory of international trade, each country exports the commodity in which it has cost advantage and imports the commodity in which it has cost disadvantage. This theory can be explained as following:

A**. Comparative cost advantage**

If a country can produce both commodities with less cost than another country but in different ratio, the country is said to have comparative cost advantage.

Country	Labour required to produce clothe	Labour required to produce shoe
Nepal	10	4
India	20	12
ratio	10/20=0.5	4/12=0.33

In the above table, the cost of production of clothe in Nepal is only 50% of cost of production of clothe in India. In case of shoes, the cost of production is only 1/3rd of cost in India. It shows that Nepal can produce both commodities with fewer cots than India. But in order to take advantage, it produces only shoes land let India produce clothe for it. Nepal produces shoes and exports to India. India produces clothe and exports to Nepal. If they do so, both of them can take benefits.

B. Absolute cost advantage:

If a country can produce a commodity with less cost but has to bear more cost in the production of another commodity than another country then the country is said to have absolute cost advantage. In this case, both of the countries produce and export the commodities in which they have absolute cost advantage.

Country	Labour required to produce clothe	Labour required to produce shoe
Nepal	10	8
India	20	4
ratio	10/20=0.5	8/4=2

In the above table, the cost of production of clothe in Nepal is less than in India. But cost of production of shoes is less in India than in Nepal. In this case, Nepal is said to have absolute cost advantage in production of clothe but absolute cost disadvantage in production of shoes. India is said to have absolute cost advantage in production of shoes but absolute cost disadvantage in production of cloth. Therefore, Nepal produces only clothe and exports to India. India produces only shoes and exports to Nepal. Doing it, both the countries can take benefit.

C. No cost advantage:

If a country can produce both commodities with less cost than another country but in equal ratio, the country is said to have no cost advantage.

Country	Labour required to produce clothe	Labour required to produce shoe
Nepal	10	4
India	20	8
ratio	10/20=0.5	4/8=0.5

In the above table, Nepal is shown able to produce both commodities with less cost than India in equal ratio. It means Nepal has no cost advantage. It is loss to the Nepal to import any commodity form India. That's why it decides to produce both goods for itself. Therefore, India too produces both goods for itself. There is no trade between them.

Criticisms

This theory is not applicable if there are more than two countries and more than two commodities

In every country there is more or less government intervention in international trade

There is cost of transportation from one country to another country

The units of labour are not homogeneous and the workers are paid more or less in different countries

There may be increasing or decreasing returns to scale

Labour is not perfectly mobile within the country too. In the modern era, there is mobility of labour from one country to another

The commodities produced in the different countries differ in quality, taste, size, quantity etc.