

# ECONOMICS IN THE REAL WORLD

## STUDENT RESOURCES

### A-LEVEL



ADAM SMITH  
INSTITUTE

Edexcel A-level Economics: 4.1.2 Specialisation and trade, a) Absolute and comparative advantage, b) Advantages and disadvantages of specialisation and trade

AQA A-level Economics: 4.2.6.2 Trade

#### Definition:

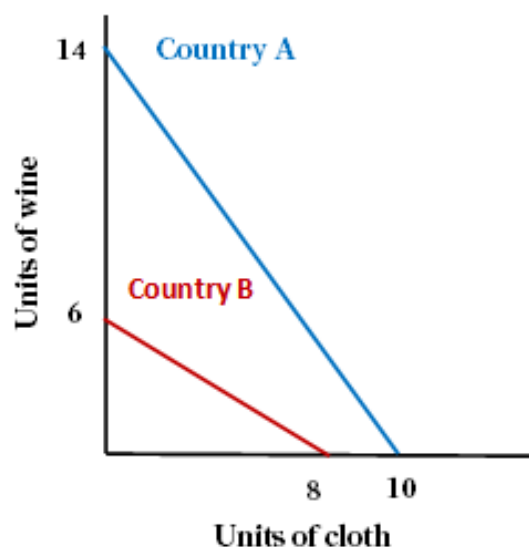
- Absolute Advantage - when a nation can more efficiently produce a good or service than foreign countries
- Comparative Advantage - when a nation can produce a good or service at a lower opportunity cost than foreign countries

The comparative advantage model shows that when nations engage in trade, if each nation specialises in the production of the good or service for which they have lower opportunity cost (a comparative advantage) then total economic welfare will increase.

#### Comparative Advantage Example

In this example we will look at 2 countries  
Country A has an absolute advantage in the production of both cloth and wine.

Despite this country B has a comparative advantage in the production of cloth as for each unit of cloth produced it only sacrifices 0.75 units of wine, whereas country A must sacrifice 1.4 units of wine for each unit of cloth which is produced.



Following the theory of comparative advantage Country A would produce primarily wine while country B would only produce cloth.

# ECONOMICS IN THE REAL WORLD

## STUDENT RESOURCES

### A-LEVEL



ADAM SMITH  
INSTITUTE

#### Quantitative example

Without specialization			Partial specialization			Full specialization		
	Wine	Cloth		Wine	Cloth		Wine	Cloth
Country A	3	4	Country A	11	2	Country A	0	8
Country B	7	5	Country B	0	8	Country B	14	0
Total	10	9	Total	11	10	Total	14	8

The data from the table is taken from the graph above. When both countries fully specialise in the goods which they are most efficient at producing the total quantity of goods produced increases from 19 to 22. However, there is a reduction in the quantity of cloth. To avoid this country A may put some of its resources towards the production of cloth.

Country A is more efficient in the production of both goods. Despite this, when both countries specialise in what they are relatively better at, more goods are produced in total. Therefore, through specialisation and trade total economic welfare can be increased for all countries, even those with an absolute advantage.

#### Assumptions

- **Perfectly mobile factors of production** - factors of production are not perfectly mobile and as such there will be some negatives of specialisation. For example, temporary unemployment will occur due to factors of production switching to the industry in which the nation has a comparative advantage in.
- **No transportation costs** - there are costs associated with transport which would reduce the total efficiency gain from trade.

# ECONOMICS IN THE REAL WORLD

## STUDENT RESOURCES

### A-LEVEL



ADAM SMITH  
INSTITUTE

#### Evaluation

- **Dutch Disease** - the growth of specific industries and trade will lead the countries currency to appreciate. This may force other industries into bankruptcy as they are unable to export at the higher prices. As the economy grows reliant on the only industries which are able to compete internationally, the risk is introduced that the failure of these industries will lead to an economic crisis. Such was the case in Venezuela where the failure of their oil industry lead to total economic collapse.
- **Infant Industries** - small firms in developing industries may be put out of business before they can reach their marginal efficient scale by larger, more cost efficient international competitors.
- **Hysteresis and structural unemployment** - if labour markets are not dynamic enough, the unemployment caused by the shifting of industry due to international trade will lead to longer term structural unemployment and labour hysteresis. This is where those who are unemployed for significant amounts of time gradually lose the skills which make them employable.