Theory of International Trade

Comparative Cost Advantage Theory – Part 4

Comparative Cost Advantage Theory

- So long as England gets more than 0.83 unit of wine for one unit of cloth (gives less than 1.2 units of cloth for one unit of wine), she will be gain. Closer the exchange rate is towards 1.13 units of wine for one unit of cloth, more will be gain to England, and vice-versa.

iii. Terms of Trade between Countries:

- Terms of trade will take place somewhere between 1W = 0.89 C to 1W = 1.2 C

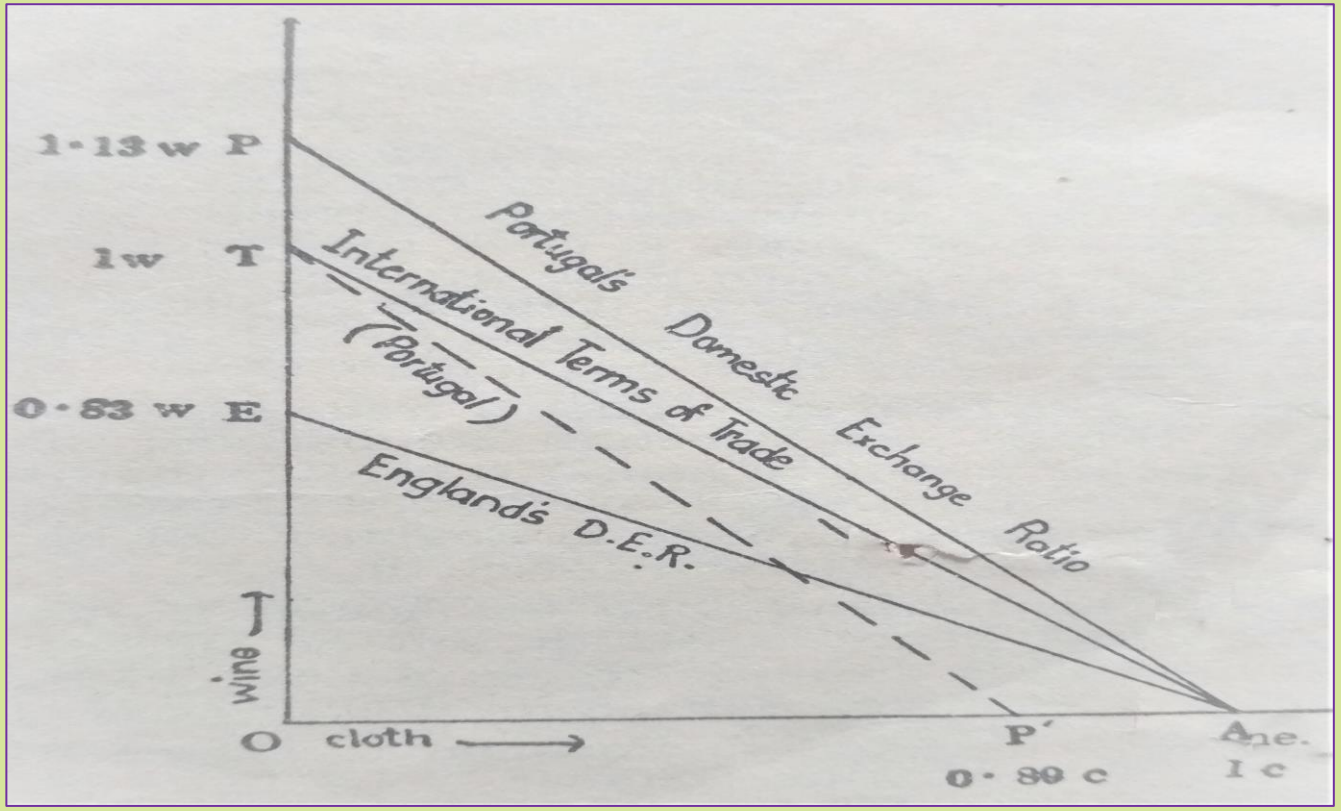
Comparative Cost Advantage Theory

- Suppose exchange rate takes place as 1W = 1C, then
  - Portugal will gain by saving 10 units of labour cost (80 labour instead of 90).
  - England will gain by saving 20 units of labour cost (100 labour instead of 120).

Comparative Cost Advantage Theory

iv. Graphical Representation of Comparative Cost

Diagram: Terms of Trade



Comparative Cost Advantage Theory

- In figure,
- PA – Portugal's terms of trade $\left(\frac{OP}{OA}, or, 1C = 1.13W\right)$
- EA – England's terms of trade $\left(\frac{OE}{OA}, or, 1C = 0.83W\right)$
- TA – International terms of trade $\left(\frac{OT}{OA}, or, 1C = 1W\right)$
- TP', a parallel line of PA showing Portugal's terms of trade (1W = 0.89C)

Comparative Cost Advantage Theory

- Portugal has absolute advantage in both the goods but comparative advantage in wine, while England has comparative least disadvantage in cloth.
- If Portugal specializes in wine and England in cloth, then both the countries will gain.
- If exchange rate is 1W = 1C, then, England gain by 0.17 and Portugal by 0.11 uit than without trade.

To be Continued ……

Comparative Cost Advantage Theory

THANK YOU