

Theory of International Trade

Comparative Cost Advantage Theory – Part 6

Comparative Cost Advantage Theory

VI. Wage Rate between Two Countries

- Though the wage taken for the two countries above may be arbitrary, the wage rate in the two countries will be in the range determined by the productivity of labour.
- For example, if wage in B is Rs.400, then wage in A cannot be more than 800 (because the productivity in A is double or 100% more than that in B).

Comparative Cost Advantage Theory

- **Upper limit of wage** is fixed by ratio of productivity of comparative cost of A in wine to comparative cost of B in wine (highest productive sector in one country to lowest productive sector of another country) (e.g., $A/B = 20/10$).
- **Lower limit of wage** is determined by ratio of productivity of comparative cost of A in cloth to comparative cost of B in cloth (lower productive sector in country A to higher productive sector of country B) (e.g., $A/B = 20/16$).

Comparative Cost Advantage Theory

- **Upper limit of wage** = If wage rate in B is 400, then in A can't be more than 800

$$\text{i.e. } \left(\frac{20}{10} \times 400 = 800\right).$$

- **Lower limit of wage** = If wage rate in B is 400, then in A can't be less than 500

$$\text{i.e. } \left(\frac{20}{16} \times 400 = 500\right)$$

Hence, wage in A will be between Rs. 500 to Rs. 800.

Comparative Cost Advantage Theory

- If it is 800, no export from A but only import from B, → causing deficit in balance of payment of country A, → outflow of gold from A, → rise in money supply in B and decrease in A, → increase in price and wage in B and decline in A, → and eventually direction of trade will be same as before and comparative advantage will reassert itself with narrow range of trade and gain than before.

Comparative Cost Advantage Theory

- Similarly, wage in A cannot be less than 500, otherwise things will move in opposite direction and comparative cost theory will again assert itself.
- From the cost data alone, exact wage cannot be determined, only range.
- Exact term of trade between the countries cannot be inferred, only range within which rate may lie.
- Only definite inference is that the wage rate will be higher in more productive country by more than least cost advantage but less than greatest cost advantage.

Comparative Cost Advantage Theory

- **J. S. Mill:** By introducing principle of ‘the equation of reciprocal demand’ pointed out that exact ratio of wage and terms of trade will be determined by the conditions of demand, by the fact that both the countries experience balance in their balance of trade i.e. each country’s exports must be equal to its imports.

To be continued

Comparative Cost Advantage Theory

THANK YOU