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Globalisation, Trade & Comparative Advantage

🌍 Why Do Countries Trade?

Countries trade because they have different:

- Natural resources
- Climates
- Skills and labour
- Technology
- Production costs

No country can efficiently produce everything it wants. Trade allows countries to access a greater variety of goods and services and improve living standards.

☑ Absolute Advantage

Definition

A country has an **absolute advantage** if it can produce more of a good or service using the same quantity of resources than another country.

Example

Country	Cars	Wheat
UK	100	50
France	80	40

The UK has an **absolute advantage** in both cars and wheat because it can produce more of each.

Key Point

Absolute advantage looks at:

Who can produce more?

📊 Comparative Advantage

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Definition

A country has a **comparative advantage** if it can produce a good at a lower opportunity cost than another country.

Comparative advantage focuses on **opportunity cost**, not productivity.

Opportunity Cost

Definition

Opportunity cost is the next best alternative forgone when making a choice.

Example

Country	Cars	Wheat
UK	100	50
France	60	60

UK

Producing 100 cars means giving up 50 wheat.

1 car = 0.5 wheat

France

Producing 60 cars means giving up 60 wheat.

1 car = 1 wheat

✅ The UK sacrifices less wheat to produce cars.

Therefore:

- UK has a comparative advantage in cars.
- France has a comparative advantage in wheat.

Key Point

Countries should specialise according to their **comparative advantage**, not necessarily their absolute advantage.

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✅ Assumptions of the Comparative Advantage Model

The model makes several assumptions:

1. Only two countries exist.
2. Only two goods are produced.
3. Resources are fully employed.
4. There are no transport costs.
5. There are no trade barriers.
6. Factors of production cannot move between countries.
7. Opportunity costs remain constant.

Evaluation

These assumptions make the model easier to understand, but they are unrealistic because:

- There are many countries and products.
- Transport costs exist.
- Trade barriers such as tariffs exist.
- Unemployment often exists.

🎯 Specialisation

Definition

Specialisation occurs when a country focuses on producing the goods and services in which it has a comparative advantage.

Benefits of Specialisation

Higher Efficiency

Resources are used where they are most productive.

Higher Productivity

Workers become more skilled through repetition.

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Economies of Scale

Larger production lowers average costs.

Higher Output

More goods and services can be produced globally.

Gains from Trade

Countries can consume goods they do not produce themselves.

Drawbacks of Specialisation

Dependence on One Industry

Countries may become too reliant on certain sectors.

Vulnerability to Shocks

A fall in demand can have a large impact on the economy.

Structural Unemployment

Workers may struggle to move into new industries.

🏴‍☠️ Terms of Trade

Definition

Terms of trade measure the ratio of export prices to import prices.

It shows how many imports a country can buy using the revenue earned from exports.

Formula

$$\text{Terms of Trade Index} = \frac{\text{Export Price Index}}{\text{Import Price Index}} \times 100$$

Example

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Export Price Index = 120

Import Price Index = 100

$$\frac{120}{100} \times 100 = 120$$

Terms of Trade = **120**

Interpretation

If the Terms of Trade Index is above 100:

✅ Export prices have risen relative to import prices.

✅ The country can purchase more imports with the same quantity of exports.

Improvement in Terms of Trade

Occurs when:

- Export prices rise faster than import prices, or
- Import prices fall relative to export prices.

Benefits

- Increased purchasing power
- Improved living standards
- Greater ability to buy imports

☑ Comparative Advantage and the PPF

What is a PPF?

A **Production Possibility Frontier (PPF)** shows the maximum output an economy can produce using all available resources.

Before Specialisation

Countries produce a mixture of two goods.

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Example:

- Cars
- Wheat

They operate at a point somewhere on their PPF.

After Specialisation

Countries focus on producing the good in which they have a comparative advantage.

For example:

- UK specialises in cars.
- France specialises in wheat.

Result

Total Output Increases

More cars and more wheat are produced worldwide.

Trade Occurs

Countries exchange their products.

Consumption Beyond the PPF

Trade allows countries to consume combinations of goods that would be impossible to produce on their own.

This is one of the main gains from trade.

🌎 Why is Trade Important?

Developed Countries

Examples:

- UK
- USA
- Germany

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Benefits

- Access to larger markets
- Cheaper imports
- Greater consumer choice
- Economies of scale
- Increased competitiveness

Possible Costs

- Job losses in some industries
- Increased foreign competition

Developing Countries

Examples:

- India
- Bangladesh
- Vietnam

Benefits

- Employment creation
- Foreign Direct Investment (FDI)
- Economic growth
- Technology transfer
- Increased export earnings

Possible Costs

- Dependence on exports
- Environmental damage
- Exploitation of workers
- Reliance on multinational corporations

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