

ABSOLUTE ADVANTAGE THEORY

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ABSTRACT

The theory also assumes that exchange rates are stable which in reality it is seldom. In the current economic world exchange rates changes rapidly. This can cause major loss to some country if they trade in a wrong time. This is because exchange rates play a major role in trade market. A country with absolute advantage can produce a good at lower marginal cost (fewer materials, cheaper materials, in less time etc.) This means that, the country should implement specialization in the production of such goods. Specialization of good can be made by Research and Development which leads to improvement of existing products or procedures.

INTRODUCTION

A country is said to have an absolute advantage over another country in the production of a good or service if it can produce that good or service using fewer real resources. Equivalently, using the same inputs, the country can produce more output. The concept of absolute advantage can also be applied to other economic entities, such as regions, cities, or firms, but we will focus attention on countries, specifically in relation to their production decisions and international trade flows. The fallacy of equating absolute advantages with cost advantages is a never-ending source of confusion. Deviations between the two are caused by the fact that real resources may receive different remunerations in different countries.

In reaction to the mercantilist literature of the 17th century (which advocated state regulation of trade to promote wealth and growth), a doctrine of free trade emerged at the end of the 18th century, culminating in 1776 in Adam Smith's (1723-1790) masterpiece *An Inquiry into the Nature and Causes of the Wealth of Nations*. Drawing upon the work of others, Smith was able to put many different arguments and elements together in a coherent and systematic framework, organized using a few general principles, and thus providing a new way of thinking about political economy (Douglas A. Irwin, 1995). Smith thus provided the first analysis of economic reasons for advocating a policy of free trade and according to Joseph A. Schumpeter (1954, p. 374): "seems to have believed that under free trade all goods would be produced where their absolute costs in terms of labor are lowest."

Origin of the theory

The main concept of absolute advantage is generally attributed to Adam Smith for his 1776 publication *"An Inquiry into the Nature and Causes of The Wealth of Nations"* in which he countered mercantilist ideas. Smith argued that it was impossible for all nations to become rich simultaneously by following mercantilism because the export of one nation is another nation's import and instead stated that all nations would gain simultaneously if they practiced free trade and specialized in accordance with their absolute advantage. Smith also stated that the wealth of nations depends upon the goods and services available to their citizens, rather than their gold reserves. While there are possible gains from trade with absolute advantage, the gains may not be mutually beneficial. Comparative advantage focuses on the range of possible mutually beneficial exchanges.

In the early 18th century, David Ricardo followed the 'Theory of Absolute Cost Advantage given by Adam Smith' and took it a step further, by emphasizing that cost advantage is not a mandatory condition for trade to take place, between two countries. This is because, the countries can still gain from international trade, even when one country is able to produce all the goods with less labour cost than another country. In the book *"Principles of Political Economy"*, Ricardo indicated

that it is beneficial for a nation to specialize in the production of those goods, which it can produce with maximum productivity, and minimum wasted effort and expense and to import those goods from other nations which it produces inefficiently.

In international trade, countries specialize in producing a good to service the rest of the world. Suppose two countries want to exchange resources, and they both have absolute advantages over the other in the goods they're offering. The trade between them would be helpful to both countries because they gained a resource they couldn't previously access.

Theory of Absolute Cost Advantage

Adam Smith, the father of economics, thought that the basis of international trade was absolute cost advantage. According to his theory, trade between two countries would be mutually beneficial if one country could produce one commodity at absolute advantage (over the other commodity) and the other countries could, in turn, produce another commodity at an absolute advantage over the first.

In other words, the principle of absolute advantage refers to the ability of a party (an individual, or firm, or country) to produce a greater quantity of a good, product, or service than competitors, using the same amount of resources. Adam Smith first described the principle of absolute advantage in the context of international trade, using labor as the only input. Since absolute advantage is determined by a simple comparison of labor productiveness, it is possible for a party to have no absolute advantage in anything; in that case, according to the theory of absolute advantage, no trade will occur with the other party. It can be contrasted with the concept of comparative advantage which refers to the ability to produce specific goods at a lower opportunity cost. Examples of factors that fuel absolute advantage include:

Geography: A country's location in the world can grant proximity to natural resources, which can give it an absolute advantage over other countries. For example, nations in the Middle East can produce oil more quickly and cost-effectively than countries in North America, empowering them with absolute advantage.

Technology: Advanced technology can enable professionals to produce goods more quickly than competitors. Companies might have machines that can process and package products at more efficient rates than employees can by hand.

Wealth: With high-income levels, a country or company can devote financial assets toward producing goods or offering services. They can also develop technology and hire more professionals, which grants them an absolute advantage over entities with less wealth.

Education: Education can teach employees how to practice technical skills, which they can use to design products. A skilled workforce can streamline production for a company, offering an absolute advantage over a company whose employees have different expertise.

Examples of absolute advantage

The Canadian economy has an absolute advantage in agricultural goods relative to most other countries globally. This because land is relatively abundant in Canada, as well as low cost.

The United States has an absolute advantage in the production of copper wire. Copper is a natural resource in both the United States and U.S. producers have manufacturing technology that allows them to make a foot of copper wire

Taiwan is the world's leading manufacturer of one of the most crucial industrial technologies—semiconductors. Indeed, a single Taiwan-based firm, Taiwan Semiconductor Manufacturing Company, controls more than 60% of global capacity for the most advanced chips.

China, Thailand, and Vietnam, on the other hand, produce and export low-cost manufactured goods. These three countries have an absolute advantage because of their considerably lower unit labor costs.

Saudi Arabia, the ease with which it can reach its oil supplies, which greatly reduces the cost of extraction, is its absolute advantage over other nations.

Italy was the leading producer of wine in 2021, and had the highest export volume of wine in that year, at 20.8 million hectoliters. The other two top wine producers were also the top exporters. Spain exported 20.2 million hectoliters and France, 13.6 million.

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Assumptions of the Absolute Advantage Theory

- ✓ Smith assumed that the costs of the commodities were computed by the relative amounts of labor required in their respective production processes.
- ✓ He assumed that labor was mobile within a country but immobile between countries.
- ✓ He took into consideration a two-country and two-commodity framework for his analysis.
- ✓ He implicitly assumed that any trade between the two countries considered would take place if each of the two countries had an absolutely lower cost in the production of one of the commodities.

Key Differences Between Absolute and Comparative Advantage

1. Absolute advantage is when a country or business enterprise is impeccably more efficient at a production of a commodity than any other country or business enterprise, then the country is said to have an absolute advantage in the production of that commodity. On the other hand, comparative advantage is when a country or business enterprise is comparatively more efficient, in the production of a commodity than another country or business entity, then that country is said to have a comparative advantage in the production of that particular commodity.
2. In absolute advantage, we study the productivity of nations, in the production of a commodity, which is better than its competitors who use the same resources. As against, in comparative advantage, we study how efficiently a country uses its resources, to produce goods at a lower opportunity cost than its competitors.
3. While the absolute advantage is used to determine resource allocation, trade pattern and trade volume. Conversely, comparative advantage helps in ascertaining the direction of trade and international production.
4. In absolute cost advantage theory, trade is not considered mutual and reciprocal. In contrast, in comparative advantage theory, trade between the countries is considered as mutual and reciprocal.
5. Cost is the primary factor in absolute advantage. On the contrary, the opportunity cost is the basic factor in comparative advantage.

Pros of Absolute Advantage

Cost Advantage

It allows countries to specialize on a task where they're most productive. Specialization of labor, or division of labor, results in a significantly higher productivity per unit of labor, and in turn, a lower cost of production. Smith also used the concept of "Economies of Scale" to explain the lowering of production costs, as a higher output due to labor diversification would significantly reduce production costs.

Natural Advantage

A country should produce those goods that are naturally favoring its climatic environment. The presence of lots of natural resources would significantly provide an advantage to such a country while producing the goods.

Acquired Advantage

Acquired advantage includes advantages in technology and level of skill development.

Criticisms

Adam Smith, theory has certain weaknesses.

Firstly, this theory assumes that each exporting country has an absolute cost advantage in the production of a specific commodity. This assumption may not hold true, when a country has no specific line of production in which it has an absolute superiority. Most of the backward countries with inefficient labour and machinery may not be enjoying absolute advantage in any line of activity. So the principle of absolute cost advantage cannot provide complete and satisfactory explanation of the basis on which trade proceeds among the different countries. Secondly, Adam Smith simply indicated the fundamental basis on which international trade rests. The absolute cost advantage had failed to explore in any comprehensive manner the factors influencing trade between two or more countries. Thirdly, the 'Vent for Surplus' doctrine of Adam Smith is not completely satisfactory. This doctrine can have serious adverse repercussions on the growth process of the backward countries. These countries do not sell their surplus produce in foreign markets but are constrained to export despite domestic shortages for the reasons of neutralizing their balance of payments deficit.

CONCLUSION

In a nutshell, absolute advantage creates many benefits for a country. However, there are certain limitations to this theory that a country will have to face. Firstly, it does not consider the transportation cost of moving the products from one country to the other. This is because, transportation cost are counted in final selling price of the product. As transportation cost is also a factor in production price sometimes trading can be a loss to a country. Next, the theory also assumes that exchange rates are stable which in reality it is seldom. In the current economic world exchange rates changes rapidly. This can cause major loss to some country if they trade in a wrong time. This is because exchange rates play a major role in trade market.

RECOMMENDATION

A country with absolute advantage can produce a good at lower marginal cost (fewer materials, cheaper materials, in less time etc.) This means that, the country should implement specialization in the production of such goods. Specialization of good can be made by Research and Development which leads to improvement of existing products or procedures. For example, to increase the Agricultural productivity Scientist such as Biologist and Chemists will need to develop technologies which may eventually lead to more production. For example, if a country has an absolute advantage on producing wheat, farmers of that country has to balance the environmental concerns to meet the need in a sustainable way. In overall, Research and Development helps the countries with absolute advantage to specialize and maximize the productivity.

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