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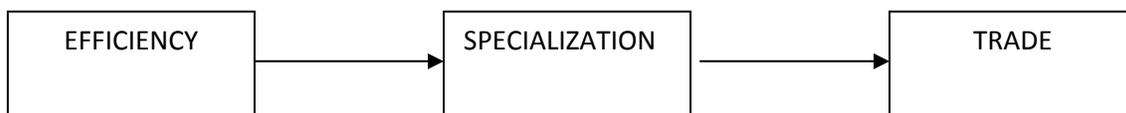
Name:

Lecture 2a: International Trade (Adam Smith and the Theory of Absolute Advantage)

- After this lesson, students must be able to explain, with examples and graphical illustrations, The Theory of Absolute Advantage propounded by Adam Smith.

Absolute Advantage: concerns with the quantities of single product that can be produced using the same quantity of resource in two different countries.

2ai. Efficiency, Specialization and Trade (adapted from Lipsey and Steiner (ed.al). *Economics*) p. 773.



International Trade and the resulting gains from trade arise in response to specialization in production undertaken to increase efficiency. The first arrow shows the link between efficiency and specialization in production; an economy can achieve increased efficiency by specializing in the production of those goods and services that it is relatively good at producing. The second arrow shows the link between specialization in production and the need to engage in international trade. When an economy specializes in the production, its production of most goods and services will not match the desired consumption of its citizens. In order to obtain the desired goods and services for consumption, it must engage in international trade, exporting those goods and services that it produces in excess of desired consumption, and importing those of which desired consumption exceeds domestic production.

Table 1: An Illustrated Example

1a: Before specialization and trade

	Mobile Phones (Units)	MP3 Players (Units)
USA	200	100
UK	100	200
Total Output	300	300

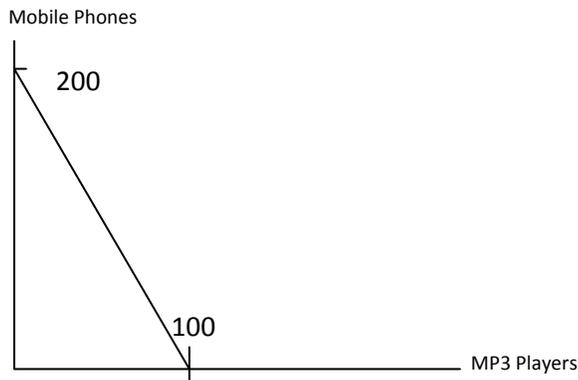
(a) Should there be trade between USA and UK? Yes

Why? Because USA is more efficient in the production of mobile phones and UK, more efficient in the production of MP3 Players.

Detailed explanation:

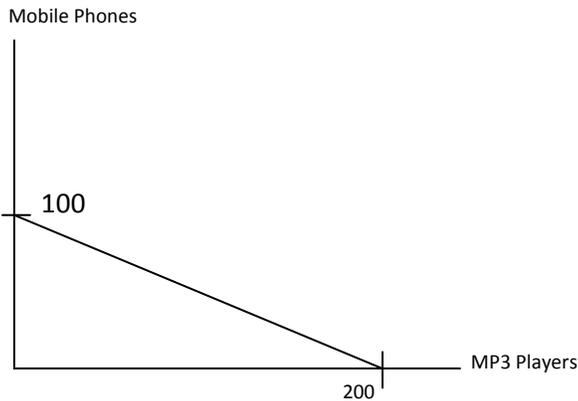
For the case of USA, 1 unit of resource can produce 200 Mobile Phones or 100 MP3 Players (assuming that Americans only require that number of goods.)

Graph 1a: Production and consumption possibilities of USA, before specialization.



Similarly, UK, the same 1 unit of resource can produce 100 Mobile Phones and 200 MP3 Players.

Graph 1b: Production and consumption possibilities of UK, before specialization.



1b: After specialization

	Mobile Phones (Units)	MP3 Players (Units)
USA	400	0
UK	0	400
Total Output	400	400

Therefore we can conclude that, _____ Absolute Advantage in the production of Mobile Phones and _____ has Absolute Advantage in the production of MP3 Players. So, _____ specializes in the production of Mobile Phones and _____ specializes in the production of MP3 Players. When this happens total world production of world of both Mobile Phones and MP3 Players. According to the theory of Absolute Advantage, this entails a rise in average standard of living.

Under what conditions should trade take place? **1:1 exchange (Reciprocal Exchange)**

2a. Scenario

Consider this situation. There are only 2 countries in the world- USA and China. Both USA and China produce 2 types of goods- Jeans and Toys. The production from the two countries and represented in table 2.

Table 2:

	Jeans (units)	Toys (Units)
USA	200	2000
China	100	1500
Total Output	300	3500

- (a) Should there be trade between USA and China?
- (b) Under what conditions?