[Frequently Asked Questions]

[Absolute, Equal and Comparative Cost Differences]

Subject:	Business Economics
Course:	B.A., 5th Semester, Undergraduate
Paper No. & Title:	Paper – 541 International Economics
Unit No. & Title:	Unit - 1 International Trade Theory
Lecture No. & Title:	1: Absolute, Equal and Comparative Cost Differences

Frequently Asked Questions

(1) Who give the concept of absolute cost differences?

A. The concept of absolute cost differences is given by Adam Smith.

(2) What is the main reason of international trade according to Adam Smith?

A. The main reason of international trade is division of labor according to Smith.

(3) Why nation has the natural advantage in production of a particular commodity?

A. Nation has the natural advantage in production of a particular commodity because of natural monopoly. Some nations have the natural monopoly over natural resources and therefore they have the natural advantage in production of a particular commodity.

(4) Which cost differences do not induce international trade?

A. Equal cost differences do not induce international trade.

(5) Why international trade is not possible in case of equal cost differences?

A. International trade is not possible in case of equal cost differences because trade is not beneficial to the nations.

(6) Who propounded the theory of comparative cost differences?

A. The theory of comparative cost differences was propounded by David Ricardo.

(7) Explain the assumptions of comparative cost difference theory.

A. The assumptions of comparative cost difference theory are as followes:

(a) <u>2*2 model:</u>

There are two nations and two commodities. This We assume that there are two nations X and Y and two commodities A and B.

(b) <u>Perfect competition:</u>

There is a perfect competition in the market. Which means that product is homogenous and there are large number of buyers and sellers in the market.

(c) <u>Mobility of factors of production:</u>

All the factors of production are mobile within the nation but perfectly immobile between two nations.

(d) <u>Production cost:</u>

The production cost considered as labor cost. There is only one factor of production i.e. labor. How many labor hours are used in the production of a commodity is very important.

(e) <u>Constant cost:</u>

It was assumed that production will take place under the constant cost condition. It means that the output level cannot affect the cost of production.

(f) <u>Transportation cost:</u>

The theory assumes that there are no transportation charges. This is impractical but theory assumes because transportation cost affects the prices of the commodity.

(g) No trade restrictions:

The international trade is not restricted by tariffs and other instruments. The international trade is free from all barriers.

(h) Size of the nation:

Both nations are of equal size. It means that there is no huge difference between two nations regarding their respective natural resources.

(i) **Taste of the consumers:**

There are no differences in the tastes of the consumers in both nations.

(j) Trade cycle:

There is no trade cycle in both nations. Economy of both nations is stable.

(8) Give the limitations of Ricardo's theory of international trade.

A. The limitations of Ricardo's theory are:

(a) The theory considers only two nations and two commodities. In practical world more nations are involved in international trade with more than two commodities.

(b) Ricardo measures cost in terms of labor hours. It is very difficult to measure the cost in labor hours because it is quite subjective. Normally, cost is measured in money.

(c) This theory assumes perfect competition. This assumption is also far from reality.

(d) This theory ignores the demand side. Ricardo considers only supply side to explain the theory.

(e) This theory assumes that factors are mobile within the country only. Factors cannot move from one nation to another nation. This assumption is again far from reality.

(f) Ricardo makes assumption of free trade. It means that there is no obstruction to international trade. But in real world, countries impose tariffs, quota etc. and creates barrier to trade.

(g) This theory explains complete specialization. It explains that one country produces only one commodity after having trade. This is not true in the real world.

(9) Which cost differences is most important in international trade theory?

A. The concept of comparative cost differences is most important in the theory of international trade.

(10) Why international trade arises?

A. International trade arises because of following reasons:

(1) Human wants are unlimited. One nation cannot produce everything that it demands. Nation has to depend on the other nation.

(2) The quality of factors of production in different nations is different.

(3) Natural resources are unevenly distributed among various nations.

(4) Technological developments in different countries differ.

(5) International trade is a result of division of labor and specialization. The division of labor in each country is also different.

(6) The factor endowment in different nations differs because the quality of factors of production in different nations is different.