Higher Level

Absolute advantage Where a country is able to produce more of a particular good or service than other countries for a given amount of inputs	**Comparative advantage** Where a country is able to produce a good or service at a lower opportunity cost than another country.
Theory of comparative advantage Countries will find it mutually advantageous to trade if the opportunity cost of production of goods differs.	**What gives a country comparative advantage?** 1. Factor endowments (natural advantages that a country has) 2. Level of technology
Limitations to the theory of comparative advantage 1. Perfect knowledge – consumers have perfect knowledge of where the least expansive goods can be purchased (in reality, of course, this is not true). 2. No transport costs (in reality, of course, this is not true). 3. Costs are constant - no economies of scale when an economy produces more of a good (in reality, of course, this is not true). 4. Only two economies producing two goods? Not realistic in the real world – although theory can be applied to multiple economies/products. 5. Goods are homogeneous (identical). Again, usually not the case. 6. No tariffs or trade barriers; again often not the case 7.	**A *persistent* Current Account deficit has a number of problems:** 1. (X-M) is negative and so AD will be lower than it would be otherwise. This will result in less economic activity and unemployment. 2. A Current Account deficit means imports are greater than exports. This depreciates a currency. This is not necessarily a bad thing unless it persists into the long term. 3. The deficit needs to be financed. This can be done in a number of ways: * By borrowing from abroad. * By selling domestically owned assets to foreigners. * By attracting foreign direct investment. * By using foreign currency and gold reserves
Problems associated with a current account surplus 1. A surplus means other countries must have deficits. They could use protectionism (tariffs, quotas etc) to try to solve their problem. 2. A surplus (X greater than M) will lead to an appreciation of the currency which will reduce a country's exports competitiveness. 3. A current account surplus suggests a country is living within its means. It would make sense to "invest" the surplus in reducing poverty rather than in buying overseas assets.	**Policies to correct a current account deficit.** These fall into three categories: 1. Expenditure switching policies 2. Expenditure reducing policies 3. Supply sided policies to increase competitiveness
1. **Expenditure switching policies** i.e. switching spending from foreign goods to domestic goods can be achieved by: • Protectionism • Depreciation	**Disadvantages of using protectionism:** • Retaliation • Higher prices for domestic consumers (from tariffs etc) • Loss of economic efficiency • Loss of other benefits of trade