Comparative advantage or sophisticated restrain in the international trade of EU?

Nenovski, Tome and Makrevska, Elena

GLOBUS - Institute of Economic Research

September 2012

Tome Nenovski, PhD
University American College Skopje
nenovski@uacs.edu.mk

Elena Makrevska, MBA
emakrevska@gmail.com

Comparative advantage or sophisticated restrain in the international trade of EU?

ABSTRACT

When David Ricardo set the theory for comparative advantages, he imagined that one day the world will function as an economy without borders, which will be beneficial for every country. Today, the world is still far from the realization of that idea.

However, Ricardo`s theory has in some way become a model for the creation of a common European market, in which member states of the Union trade freely. From the early beginnings of its creation, the European Union was envisaged as free trade area in which the countries can use their comparative advantages. The idea is that a country would specialize in production of the goods which have relatively lower costs of production, and trade them for goods that are costly to be produced at home.

It is the theory of perfect competition, or model of trade without customs and other trade barriers in which the prices will gradually become equal, and the trade between the countries will be based on comparative advantages. That is the model of David Ricardo`s theory, created two centuries ago.

Still, practice opposes to the basic values of Ricardo`s theory because there is no model of perfect competition in the EU, because of the numerous custom and non custom restrains, uneven prices in the trade among the EU member states, different consumer tastes in different countries, high transportation costs and others trade barriers. Such trade barriers in some way give explanation to the high difference in the economic growth of the member countries of EU, i.e. slow the convergence process in the Union.

If the EU really wants to realize the vision “Europe without borders”, then the trade barriers should be removed as soon as possible. If this comes to light, we can say that Ricardo`s theory is really valid in the modern ways of trading.

Key words: Ricardo’s theory; foreign trade; comparative advantages; prices equilibrium; free trade.

J.E.L. classification code:
E6 - Macroeconomic Policy, Macroeconomic Aspects of Public Finance, and General Outlook

Introduction

In the mutual trade, countries should use their comparative advantages. They need to specialize in production and trade of goods that have a relative comparative advantage, i.e. goods that are produced with lower cost in comparison to other countries; and to share them with other countries as well. It is the basis of free trade or trade without restrictions on export and import by the government. In addition, the encouragement of free trade depends on the economy of scale, competition, diversity and number of offered products, efficient allocation of resources and international cooperation.

This is the theory of David Ricardo, one of the founders of classical political economy. Although it was established back in 1817, today that theory forms the basis for explaining the benefits of international trade, i.e. the incentives and motives of national economies to trade with each other. This model on comparative advantages is a model for today's advocacy for free trade. If there is free trade between foreign countries, it is clear that the products will move from areas with lower prices to areas with higher prices. However, the realization of such a theory today does not function in the EU completely.

The fundamental values of the theory of Ricardo are opposed due to numerous limitations and weaknesses in the implementation of this law of comparative advantages. Therefore a question is raised: is the theory of Ricardo valid under the current economic conditions? The opinion on this matter varies with different economists. Most of them think that with some improvements this theory can give the effects that were introduced by great Ricardo two centuries. ago.

1. *Terms of trade*

Theoretically, a closed (autarkic) economy does not communicate with other economies in the world. It is self-sufficient and does not depend on import and export of goods and services. Today, there is no economy with such features and the economies of all countries are open.

Open economy is an economy that freely communicates with other economies in the world. Mutual economic relationships of the modern economies are established in two ways: by buying/selling various goods and services on the world markets and by buying/selling of capital goods on those markets.

The countries export goods and services mainly for two reasons. First, in some cases the domestic market is unable to absorb (to buy) the entire production of certain goods and services. Companies are trying to sell the surplus of those goods and services on the foreign markets where there is inadequacy of such goods and services or there is high demand for them, i.e. a specific country can not cater with their domestic production. Secondly, domestic enterprises can evaluate foreign markets that provide better conditions (prices) for the sale of their products and thus can achieve higher earnings. In that case, the conditions for exchange (trading) are favorable for them. It is called (Nenovski, 2010) microeconomic aspect of monitoring and analyzing the terms of trade (commerce) with foreign countries.

Macroeconomic aspects in terms of international exchange, of course, are wider. They refer to the conditions under which the total national economy trades internationally. Moreover, it is always analyzed under the terms whether the country exports more than it imports, what is the structure of the export and import, what is the coverage of import by export and, finally, what is the cost-effectiveness of foreign trade to the national economy.

The answer to these questions gives the conditions under which the international trade is executed. The terms of trade with foreign countries refer to the quantity of imported goods that a country can get (pay) by the price of the unit export good. They can improve or deteriorate depending on the prices of goods and services exported and/or imported. If prices of imported goods rise and prices of export goods remain unchanged or, perhaps, fall, the trade conditions of the particular economy deteriorate. In such situations the country needs to export more in order to buy the same quantity of import goods and vice versa. The events on the world markets in the period 2007-2008 and in early 2011 testify the significance of the conditions and changes in the terms of trade. Namely, developing countries have been major exporters of primary products for many years, and are faced with adverse terms of trade. The reason for that was the long-term economic stagnation and decline in prices of primary products. That happened with agricultural and food products. This situation reduced the earnings from export and the developing countries needed to export more in order to import products with a high degree of finalization. These countries have faced poor conditions of international exchange in a long period of time.

However, in 2007-2008 and in the early 2011 the conditions changed. Due to various reasons, the demand for certain agricultural and food products (wheat, corn, sugar, etc.) sharply increased. The prices of these products reached extremely high values. Suddenly the countries that produce agricultural products were in much more favorable situation than in the previous decades. Indexes of their export prices became much higher than the indexes of their import prices (Eurostat, 2011). Their terms of trade were significantly improved.

Generally, there are factors that enhance and factors that exacerbate the conditions of trade. They can strongly influence the scope and pace of export of goods and services in some countries. According to professor Mankiw (2009, p. 692-693), the most important factors are the following:

- Tastes and preferences of consumers for domestic or foreign goods and services;
- Domestic and foreign prices of goods and services;

- Exchange rate of national currency;
- Domestic and foreign income of consumers;
- Cost of transporting goods from one country to another;
- The foreign policy of the government.

These variables change over time. Therefore, the conditions in international trade change as well. The previously described developments in the prices of agricultural and food products convincingly confirm this conclusion.

2. Comparative advantage in international trade

In order to exploit the benefits of the terms of trade, a country needs to offer goods and services on the world market in which it is specialized or which can benefit the country. In other words, in order to be a competitive athlete on the world market, the country should offer products that can be sold at competitive prices on the world markets. Simultaneously, the country will participate on the world market by buying at lower prices and selling the products on the domestic market by higher price.

There are differences in the availability of raw materials and other factors of production internationally. This leads to the existence of differences between countries in terms of production costs of individual goods and services. Therefore, countries should produce goods and services with the available resources (that they have in large quantities and at low price) and thus the final products can be sold cheaply (more competitively) on the world markets. To accomplish this, they should at least temporarily sacrifice the production of goods and services which are available to be produced, but have no competitive advantage.

The previous observations lead us to the term opportunity cost of producing a product or supplying a service. Opportunity cost of producing a product or supplying a service is the quantity of other goods and services that are sacrificed (not produced) in order to produce an additional unit of that specific product or service (Fiti, 2006, p. 456). We can take for instance an economy which is closed and which with the given resources can produce only shirts and shoes. The more resources are used to produce the shirts, fewer resources will be used for the manufacturing of shoes. The opportunity cost of the shirts is the amount of shoes that are sacrificed (not produced) in order to produce shirts.

This legitimacy stems from the limitations (rarity) of resources. However, from it, the foundations (structure) of the international trade arise. Namely, if an economy can produce certain goods and services for a shorter period of time and with less expense of other factors of production, it can specialize and concentrate just on the production of those goods and services. Specialization itself will act on reducing the production costs of those goods and services. It will enable the (specialized) country to produce those goods and services in large batches and to realize economy of scale (production of large quantities of a product using the available resources and other factors of production). The economy of scale reduces fixed costs per unit of a product. As a result of specialization and economy of scale, the country is able to produce large quantities of certain goods and services with lower prices and to exchange them for other goods and services which, if produced at home, will cost more. Thus, the opportunity cost for the production of goods and services in the specialized country significantly decreases.

Specialization of certain goods and services for the particular country means getting a comparative advantage in international commerce (Law on comparative advantage). It may occur in the form of absolute or relative form of advantage for the production of certain goods and services. Both benefits have been established and elaborated by the founders of classical political economy, Adam Smith and David Ricardo. Over time, the two theories have evolved (changed) in certain parts, but remained (especially the theory of Ricardo of relative comparative advantages) as economic laws by which countries should act in the international trade in order to get greater benefit. The theory of Ricardo of comparative advantages is one of the basic tenets of the foundation of the single European market - the European Union (EU).

3. *Perfect competition and free trade*

David Ricardo's theory of comparative advantage today is the basis for explaining the benefits of international trade, i.e. the initiatives and motives of national economies to trade with each other. At its core lies the model of perfect competition (at the time of Ricardo, market structures were close to the model of perfect competition). This model is the basis for today's economists that are promoting free trade (with no customs and other restrictions).

The end result of the Ricardo’s model of comparative advantage leads to a gradual flattening of the prices of products and services in the economies that trade with each other, based on comparative advantages. Namely, if there is free trade between countries and relevant economic and political cooperation among the various nations within the EU with positive implications for their economic growth (a realistic assumption within the EU now), it is clear that the products will move from areas with lower prices to areas with higher prices (Nenovski, 2010). France, for instance, has obvious comparative advantage in producing high quality cheese, and Spain has a comparative advantage in producing high quality men's shoes. Countries trade with each other within the single European market, de facto, without customs duties and non-tariff restrictions. Cheese, which is cheaper in France, may be placed on the Spanish market, and men's shoes that are manufactured in Spain may be placed on the French market. So the higher supply of high quality and relatively cheaper French cheeses in Spain will cause drop in the price of the cheeses in this country. Conversely, a rise in imports of high quality men's shoes from Spain to France, and the increased supply of men's shoes on the French market may also cause decline in the price of that product in France.

If that trade relation between the two countries is established, the prices of the products in the markets in those countries will begin to converge and become equal. Use of trade between two countries, thanks to specialization in areas where countries have already gained comparative advantages, will have the citizens of Spain buy and consume less expensive French cheese and citizens of France buy and consume cheaper Spanish men's shoes.

Such arguments are the basis for free or liberal trade, which all EU Member States would benefit. In fact, the validity of the theory of Ricardo of comparative advantages and the assessment of most contemporary economists that all countries participating in foreign trade will benefit if it is free are reasons for intensive exchange of goods and services between EU Member States. The mutual dependence on the economic cooperation of individual national economies within the EU economy becomes more and more important.

4. Trade between the EU Member States

So far, however, such conclusions are not fully realized in the mutual exchange of EU Member States. Analyses of statistical indicators show that the less developed "old" EU member states (like Portugal and Greece), and most of the countries that have joined EU since 2004 (Bulgaria, Czech Republic, Lithuania, Hungary, Poland, Portugal, Slovenia, Slovakia…) (hereinafter referred to as Group countries), are still far from realizing the benefits expected from the activities of the single European market. The low development of some “old” EU member states and the need to meet the Acquis communautaire, as a condition for membership of the "new" countries in the EU, are mostly aiming to remove the various customs and non-tariff barriers in relations with other Member States. That means the need for their integration into the common European market conditions theirs larger openness to the EU. The result of this is a growing size of their foreign trade within the EU.

However, the conditions in the mutual exchange of goods and in the mutual exchange of services between Group 10 and the EU are quite different.

Regarding the exchange of goods, no significant imbalances between export and import have been noted. According to Zamora (2009), EU countries are more open in that part, which indicates that the internal market provides encouraging integration of the markets of goods. In fact, statistics confirm that the internal trafficking of goods accounts for about 18 percent of the EU GDP. Moreover, the Group countries and, especially, the newly admitted EU countries, show greater openness (almost twice as big, about 35 percent of GDP) than the "old" EU member states, which show about 17 percent of GDP in the exchange of goods on the domestic market.

Despite the high openness to trade in goods, the openness of all Member States in the exchange of services is very small (about 6 percent of GDP). Moreover, in the developed part of the EU there is a distinctive orientation towards the much larger import of services from countries outside the EU. They, in particular, demand services from the outside world in the field of financial services, information and IT services and the construction services. A possible reason for this is the higher quality of the services which are obtained outside the EU. However, in various analysis (Zamora, 2009) it is stated that the main reason for such relations in exchange regarding the services are still present high barriers that countries set for imports of services from the EU internal market. Knowing this, the European Commission in 2006 adopted Directive 2006/123/EC on services, which the Member States of the EU should have started implementing by the end of 2009. The main objective of this Directive is to remove barriers from the sharing of services among the EU members, which will be a great benefit to businesses and consumers in all EU countries.

Accordingly, in the commercial relations between Member States there are still a number of limitations that do not allow significant improvement in trading conditions and equal identification of all Member States with a single market.

5. Limitations

In practice these fundamental values of the validity of Ricardo's theory of comparative advantage are often challenged. Actual limitations and shortcomings can be summarized as follows:

a) The model of perfect competition within the EU today virtually does not exist. Today the prevailing market structures limit the competitiveness. For example, today there are oligopolies (more differentiated sellers who agree to act on the market). Such are, for example, clusters of cars, wine, grain, oil, etc. In some areas there are monopolies (the only manufacturer of a product). This is usually the case of phone service or computer software companies. Because of their presence neither the flexibility of prices and wages, nor the mobility of production factors (labor, capital) functions, which are the basic requirements of the model of perfect competition;

b) Although efforts are made to appropriately establish freer international trade, in practice, it remains burdened by numerous restrictions. To protect the economy, many countries used protectionist measures, such as various quantitative restrictions on trade with other countries. The most illustrative example are the various quantitative restrictions which individual Member countries use in order to protect their products from competing products from other Member countries which built powerful and competitive industries, especially based on comparative advantages arising from the relatively cheap and abundant labor.

Simultaneously, in a very common use are the non-tariff barriers that some countries have introduced for the protection and promotion of their products in trade with other Member States. Often the more developed Member States require extremely high safety standards for imported goods or bring much bureaucracy to reduce the volume of goods and services entering the country. For example, unnecessary delays are introduced in the processing of import documentation or very high (often subjectively high) standards for health and safety of the population. Or, to boost exports of their products, some countries grant subsidies which can be public (for example, approving grants or performing other investment incentives), hidden (granting tax breaks for exporters) or exporters can even receive direct financial assistance to export (Nellis H. Parker, 2004, p. 318). The western parts of the EU often do;

c) The theory of comparative advantage puts the EU developing countries in a disadvantage. These countries have comparative advantages in the production of raw materials and products with low degree of industrial processing (finalization). The prices of these products are low compared to the prices of products with a high degree of finalization of production whose comparative advantages are on the side of developed EU Member States. Accordingly, there is an unfavorable relationship between the prices of raw materials and commodity prices with a high degree of processing. In other words, the terms of trade are unfavorable to the less developed member states. In the past decade, terms of trade became worse in less developed countries because the prices of the products with high degree of finalization is faster than the dynamics of growth of prices of raw materials and products with a low degree of processing. That means that less developed countries are forced to supply larger quantities of raw materials to obtain smaller quantities of industrial products. In that case the less developed countries lose as opposed to the claim of the theory of comparative advantages that in the international trade all countries have benefit;

d) The model does not explain how countries trade among themselves to establish a balance in the trading price;

e) The model does not explain how to overcome the different tastes of consumers in different Member States;

f) The original theory of Ricardo of comparative advantage does not explain how to reduce transport costs as barriers to foreign trade, etc.

6. Conclusions: Single Market for European identity

If the theory of Ricardo insists that foreign trade should be with strict observance of the relative comparative advantages, that means the theory actually requires the preservation of present relations, or unchanged status (status quo), which obviously does not suit the less developed countries within the EU. This means that comparative advantages of raw materials for production are on the side of less developed countries and comparative advantages for production of industrial products are on the side of developed countries. Therefore, the theory of Ricardo should be analyzed through its dynamic aspect, i.e. to take into account that the comparative advantages are not given once and for all, but that each country, with reasonable and well-established development policy, should create relative comparative advantages in strictly selected economic sectors.

That, in reality, of course, is possible. Typical examples are the countries of Southeast Asia, which gained comparative advantages in the electronics sector, which previously did not have. Or countries-producers of agricultural and food products, which, as previously stated, fight for higher prices of their products on the world markets, which significantly improved their terms of trade within the outside world.

In addition, to be an equal field for competition for all its members, the European market should be more open than ever, and the measures which will be taken should lead to stimulation of the competition. This is possible with a greater integration of different (national) markets in a single market, and elimination, as much as possible, of the numerous restrictions which are still maintained. In fact, one cannot speak of a fully integrated market if the "economic borders” between individual Member States are not eliminated. This particularly applies to the "old" member states, which by eliminating the remaining foreign trade barriers will contribute to improving the functioning of the internal market in the EU.

The analysis confirms that the Group countries shows a much greater willingness to trade in goods and services with other Member States. But the obvious is still present: the resistances and constraints posed by the advanced (older) member states, especially in the exchanges of various forms of services within the EU. The European economy can be considered to be fully integrated only providing that the internal market guarantees freedom of mutual exchange of services as well.

Elimination of the previously mentioned weaknesses will upgrade the theory of Ricardo and make it valid in the current economic conditions. Within the EU it is possible with further liberalization of the trade in the Member States and further enhancement of their trade integration as a condition for establishing and fostering sustainable economic development of EU integration as a whole. In this case the theory of Ricardo could really be effective in realizing the vision of a Europe without any borders, which would mean strengthening the single market that would be equally identified by all Member States.

References

Eurostat (2011). Agricultural Commodity Price. Available at:
http://appsso.eurostat.ec.europa.eu/nui/show.do?dataset=prc_fsc_idx&lang=en

Fiti, T. (2006). *Ekonomija*. Skopje: Univerzitet Kiril i Metodij - Ekonomski fakultet.

Mankiw, G. (2009). *Principles of Economics*. 5th edition. USA: South-Western College Pub.

Nellis, J., Parker, D. (2004). *Principles of Macroeconomics*. Harlow, England: Pearson Education Limited.

Nenovski, T. (2010). Macroeconomics, second edition, UACS, Skopje, Republic of Macedonia.

Zamora, R.A. (2009). *How is Internal Market Integration Performing*. Brussels: European Commission.

Internal Market and Services DG, Horizontal Policy Development – Impact Assessment, Evaluation and Economic Analysis, Unit B2.