Comparative Advantage is not Competitive Advantage

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David Ricardo showed in 1817, in his landmark *Principles of Political Economy and Taxation*. that if each country produces according to its comparative advantage, global output is maximized. When the Polish-American mathematician Stanislaw Ulam challenged American economist Paul Samuelson to name one theory in all of the social sciences that is both true and nontrivial, Samuelson responded (although only after many years had passed) with David Ricardo's theory of comparative advantage. "That it is logically true," Samuelson noted, "need not be argued before a mathematician; that it is not trivial is attested by the thousands of important and intelligent men who have never been able to grasp the doctrine for themselves or to believe it after it was explained to them."

As much of the recent debate on China shows, many important and intelligent men and women – including many economists – are still unable to understand the main insight of David Ricardo's model, which is that trade gains depend on relative cost advantage, not on absolute cost advantage, and that this relative advantage can only be expressed in balanced trade. They continue to believe precisely what David Ricardo set to disprove.

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They often argue, for example, that China's trade surplus reflects its comparative advantage in producing a wide and growing range of manufactured goods. That is why, they argue, that its trade surplus contributes to global growth by maximizing global output.

But that's not true, and that is certainly not what Ricardo showed. China (like most other manufacturing economies that run persistent surpluses) has a competitive advantage, not a comparative advantage, largely for the same reason that it has such weak domestic consumption – government and banks subsidize production across the board at the expense of household consumption through direct and indirect transfers. These are transfers from the household sector to manufacturers, and occur in the form of an undervalued currency, cheap credit, restricted labor, import restrictions, overspending on infrastructure, the provision of land, research and other subsidies to manufacturers, and so on.

By substantially lowering production costs relative to those of their main trading partners, these transfers give China a competitive advantage in producing most manufacturing goods. They allow Chinese manufacturers to produce goods at lower prices than foreign competitors can ever hope to match without similar levels of subsidy and currency and credit support from their own governments.

But this competitive advantage is not the same as a comparative advantage. The former means an economy is able to produce more cheaply than its trade partners. The latter means that the relative "cheapness" with which an economy produces some goods is greater than the relative "cheapness" with which it produces other goods, so that it can only have a comparative advantage in roughly half the goods it produces.

This is because comparative advantage is about relative costs, not absolute costs, and while an economy can have lower absolute costs in

most or even all things, by definition it cannot have lower relative costs in much more than half of what it produces. Ricardo's example shows this very clearly. In his model. Portugal produces both textiles and wine more cheaply and efficiently than England, which means that Portugal has a competitive advantage in all goods, and England a competitive disadvantage in all goods.

But Ricardo did not argue that the world would benefit if Portugal produced both wine and textiles, with England producing neither and acquiring them by running trade deficits with Portugal. Instead, he showed that because the relative "cheapness" with which Portugal produces wine is greater than the relative "cheapness" with which it produces textiles, Portugal only has a comparative advantage in producing wine, and England has a comparative advantage in producing textiles. He showed that if Portugal only produces wine, and exports some of it to England to buy textiles, and if England only produces textiles, and exports some of it to Portugal to buy wine, trade would be balanced and total output would be maximized – and as counterintuitive as it may seem, this is the case even though Portugal can produce textiles more cheaply and efficiently than England.

If we do the math in Ricardo's model, it quickly becomes obvious that global output is maximized only when global trade is balanced. When trade is unbalanced, and Portugal exploits its competitive advantage to run trade surpluses with England, the math doesn't work. Portugal and England collectively produce less than either of them produced before they began trading with each other, although the contractionary impact this unbalanced trade has on collective output can be very unevenly distributed – Portugal may indeed grow more quickly, thereby either forcing more than 100% of the contractionary impact on England or (in the modern retelling of the story), forcing England to make up for net domestic demand leaking out of the economy through trade deficits by raising domestic debt and shifting its total production out of tradable goods and into non-tradables (mainly services).

For global production to be maximized, in other words, countries should not be net exporters of all goods in which they have a competitive advantage. They should be net exporters only of those goods in which they have a comparative advantage, and they should use the proceeds of those export revenues to import those goods in which they have a comparative disadvantage.

What is more, when we allow trade to become persistently unbalanced, we run into the problem that Keynes identified in the 1930s – trade imbalances allow countries that have become more competitive by suppressing domestic demand to export weak domestic demand to the rest of the world. When that happens, either total global production is reduced and unemployment rises, or debt must rise in the deficit country to make up for the weak demand in the surplus country and to prevent unemployment from rising.

It is worrying that even though economists regularly cite David Ricardo's model of comparative advantage as one of the few, great, non-trivial models in economics, so few of them understand the math behind the model. The whole point of Ricardo's model was to make (and prove) the counterintuitive point that competitive advantage is not the same as comparative advantage, and that the world benefits from balanced trade even when one country can produce everything more cheaply.

This becomes more obvious when we realize that just by changing the value of the currency, we can shift competitive advantage from one country to another, whereas comparative advantage is structural, and does not shift so easily. That is why it is surprising that so few academic economists understand that Ricardo's model of comparative advantage is also necessarily a model of balanced trade.

It is worth noting as an aside that a country's comparative advantage is not static and permanent. It can certainly be altered by domestic policies, but mainly over many years by industrial policies designed

specifically to alter it. Alexander Hamilton's "infant industry" model is an obvious case of altering comparative advantage. But the key point remains: however a country seeks to create comparative advantage in one of more industries, comparative advantage should never be confused with competitive advantage.

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Before closing, I should note that some economists have argued that if a country like China wants to subsidize all of its manufacturing at the expense of domestic workers and households, Americans should simply take advantage of this "generosity" by running trade deficits with China and by importing more than they export. This allows them to exploit Chinese subsidies by importing goods more cheaply than they can be manufactured at home which, they claim, maximizes total American welfare by raising total consumption. As I put it in a recent article for the *Financial Times*:

For decades, Americans have been told that low-priced imports are an unalloyed blessing. By purchasing goods produced more cheaply abroad, Americans can stretch their paychecks and raise their living standards.

But, as I argue in the article, this gets the logic backwards. Over the long run, total consumption can only rise in line with total production. Cheap imports only increase total consumption if we assume that total production is increased by running persistent trade deficits.

But of course it isn't. As I have shown elsewhere, trade deficits only boost production when the associated net capital inflows boost domestic investment, which tends to be the case mainly in rapidly-growing developing countries (e.g. the US during much of the 19th Century). In those cases, high domestic investment needs are often constrained by scarce domestic saving and expensive capital, in which

case net foreign capital inflows can be used to boost domestic investment.

But this is unlikely to be the case in advance economies today, like the US and the EU, where much lower investment needs are likely to be constrained not by scarce domestic saving but rather by weak demand and competitive imports. In advanced economies, in other words, trade deficits are much less likely to be balanced by higher domestic investment than by higher unemployment or higher domestic consumption (i.e. a reduction in domestic saving). In that case they must lead either to higher unemployment, as Joan Robinson and John Maynard Keynes explained in the 1930s, or (since the breakdown of Bretton Woods balance-of-payments constraints in the early 1970s) to rising household and fiscal debt.

That is why I argue in the article that American consumers benefit from cheaper imports only under certain conditions, one of which is a broadly balanced trade account:

That's why the simplistic claim that Americans "win" by getting cheap T-shirts from Bangladesh or cheap cars from China misses the point. Americans win from trade not when imports are cheaper, but rather when those imports cause a shift in American production that leads to faster productivity growth. In other words, if trade leads to a more rapid expansion in domestic production, workers will improve their welfare and consume more whether or not imports are cheaper. And if trade doesn't lead to a more rapid expansion in domestic production, they will not improve their welfare even with cheaper imports.

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