

Origin of the Idea

David Ricardo (1772–1823)

Argued against Corn Laws in British Parliament.

Corn Laws: high tariffs on imported grain that protected British landowners.

His *theory of comparative advantage* is still the ideological foundation for free trade.



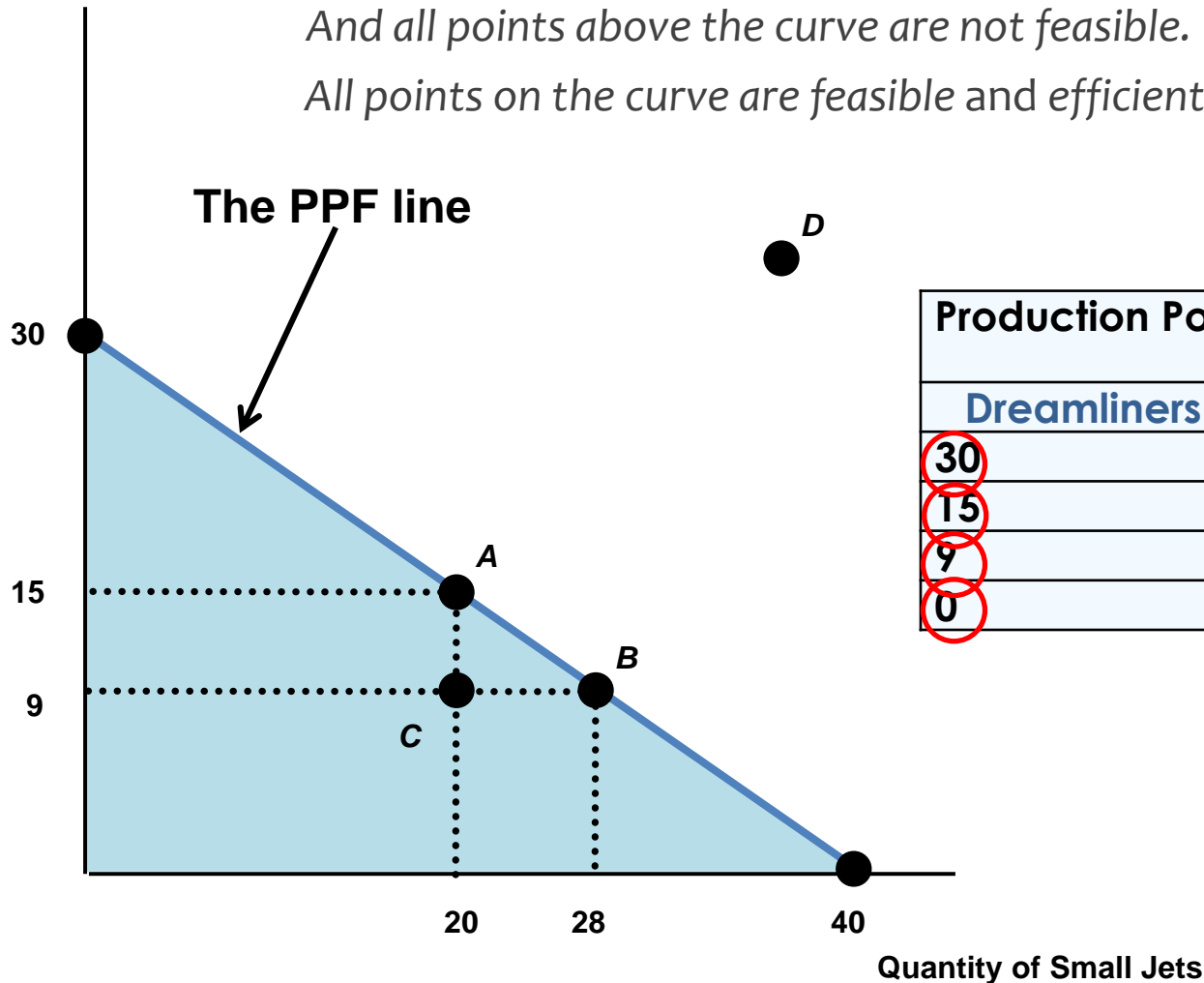
PPF Curve: Production Possibility Frontier

The PPF is
a diagram
that shows the
combinations of
two goods that are possible for a
society
to produce at full employment.

Trade-Offs: The Production Possibility Frontier

Quantity of Dreamliners

All points under the curve are feasible (but not efficient)...
And all points above the curve are not feasible.
All points on the curve are feasible and efficient.



Production Possibilities	
Dreamliners	Small Jets
30	0
15	20
9	28
0	40

What is the opportunity cost of one small jet?
What is the opportunity cost of one Dreamliners?

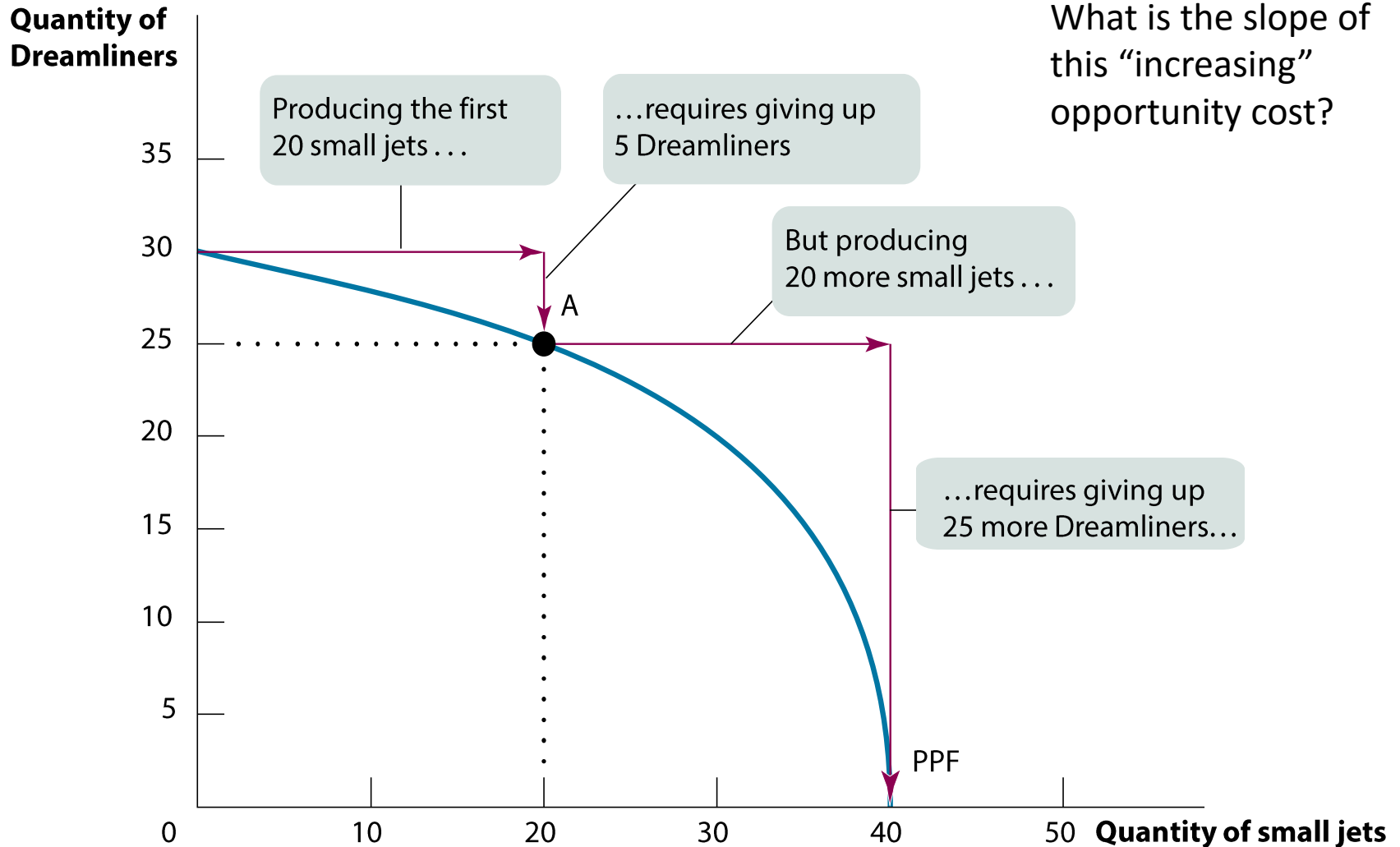
Combination	Number of lamps possible	Number of sofas possible
<i>A</i>	0	1,000
<i>B</i>	50	800
<i>C</i>	125	500
<i>D</i>	200	200
<i>E</i>	225	100
<i>F</i>	250	0

What is the opportunity cost of each lamp?

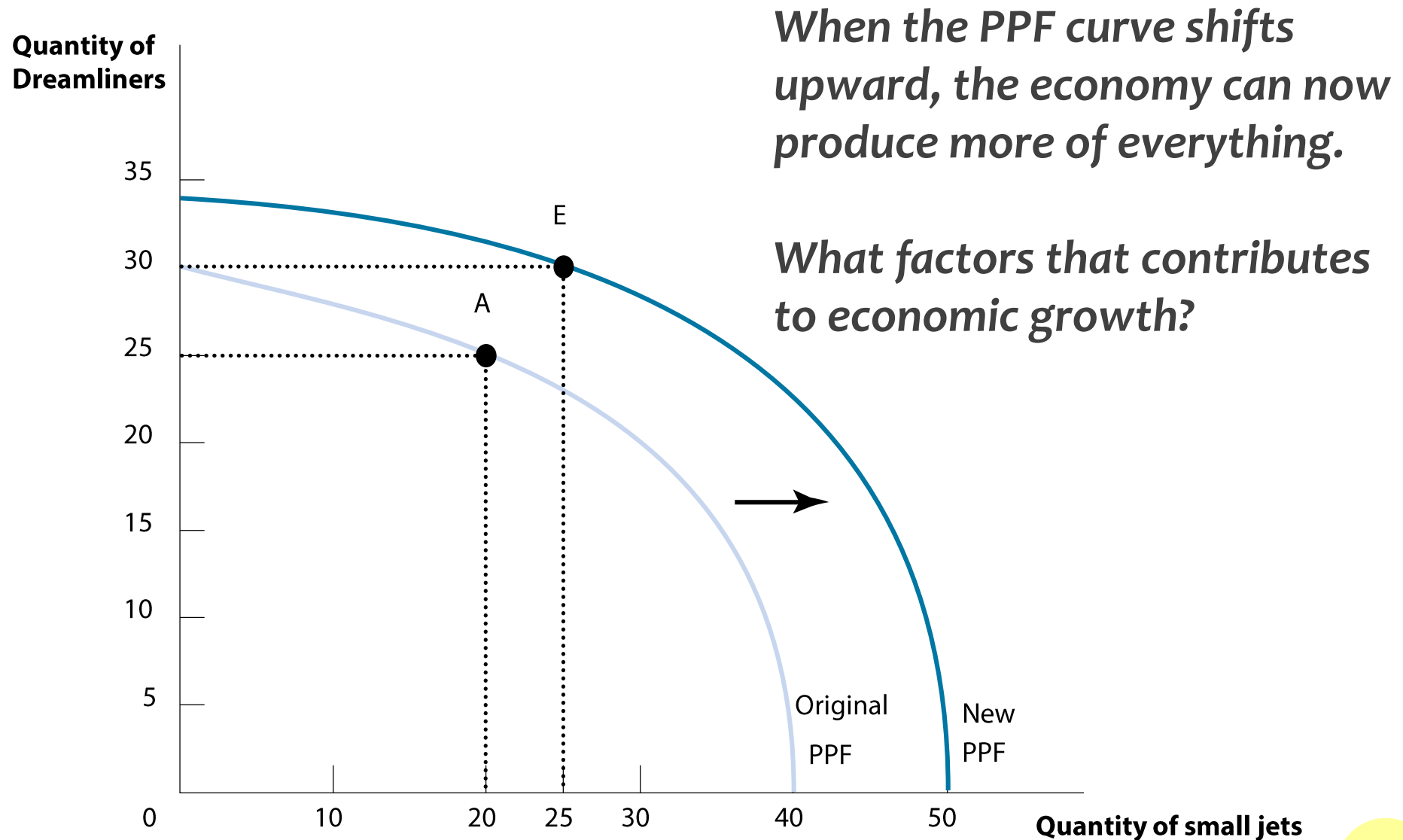
- a) One-fourth of a sofa**
- b) 1 sofa**
- c) 4 sofas**
- d) 200 sofas**

The Law of Increasing Relative Cost

When the Opportunity Cost is “Increasing”



PPF and Economic Growth



Comparative Advantage and Gains from Trade

Theory of Comparative Advantage:

It makes sense to produce the things you're especially good at producing and buy from other people the things you aren't as good at producing.

*The U.S.
imports
bananas
from
Ecuador.*

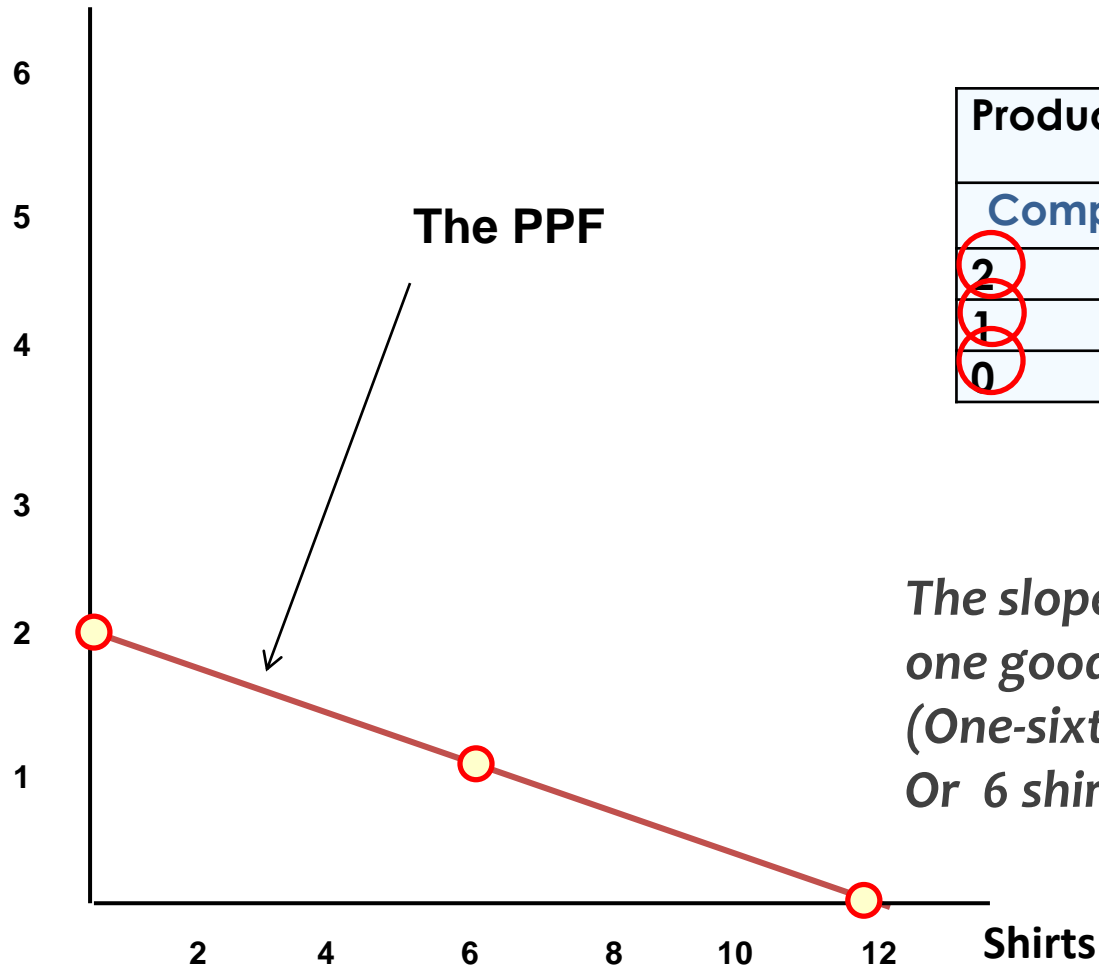


Comparative Advantage and Gains from Trade



Computers

Mexico's Production Possibilities Frontier



Production Possibilities	
Computers	Shirts
2	0
1	6
0	12

*The slope = the trade-off (“cost”) of one good for the other.
(One-sixth of a computer = 1 shirt;
Or 6 shirts “cost” 1 computer.)*

Comparative Advantage: Lower Opportunity Cost

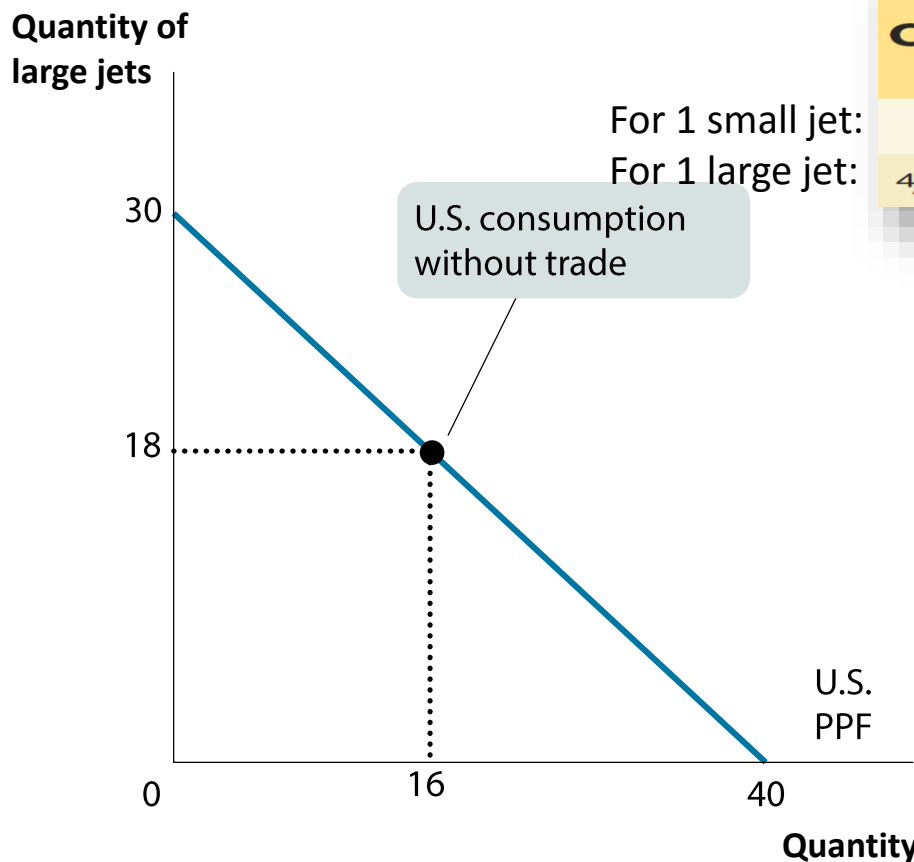
each country has a different opportunity cost for each good.
Take a look at the opportunity costs for computers:



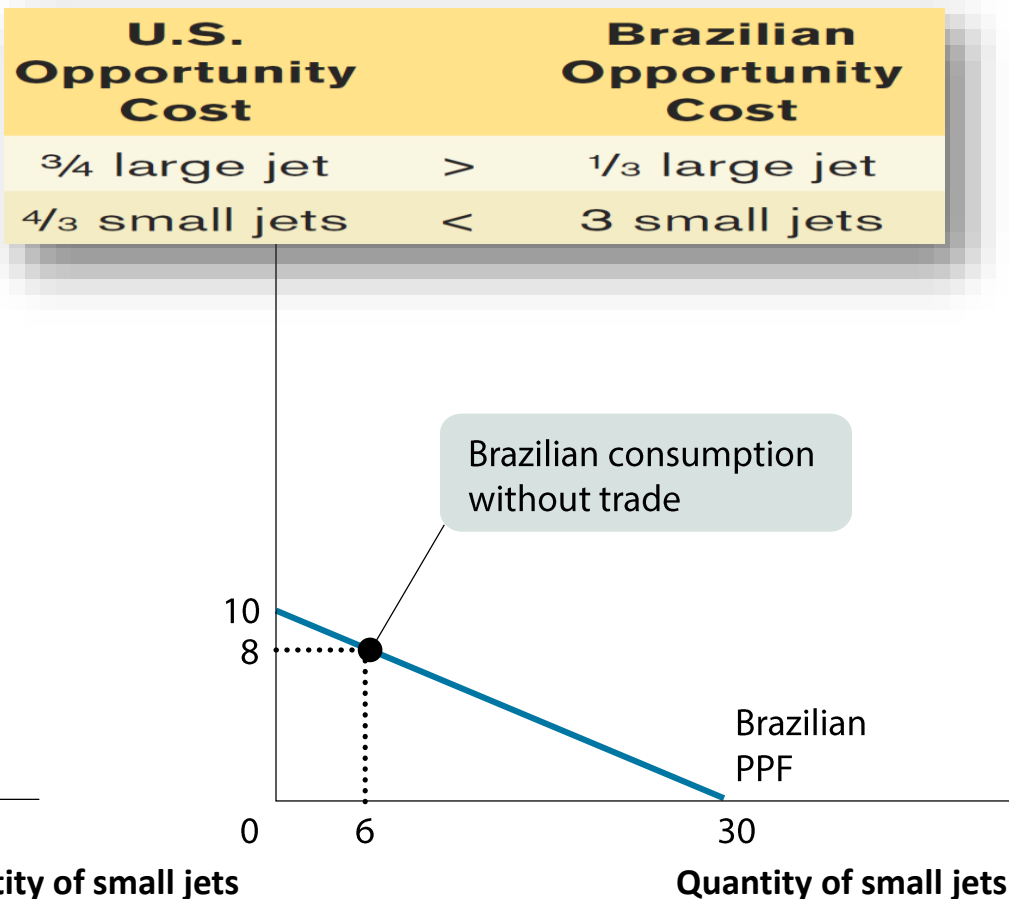
Would there be a benefit to trade?
If so, who should produce what?

Comparative Advantage and Gains from Trade

(a) U.S. Production Possibilities



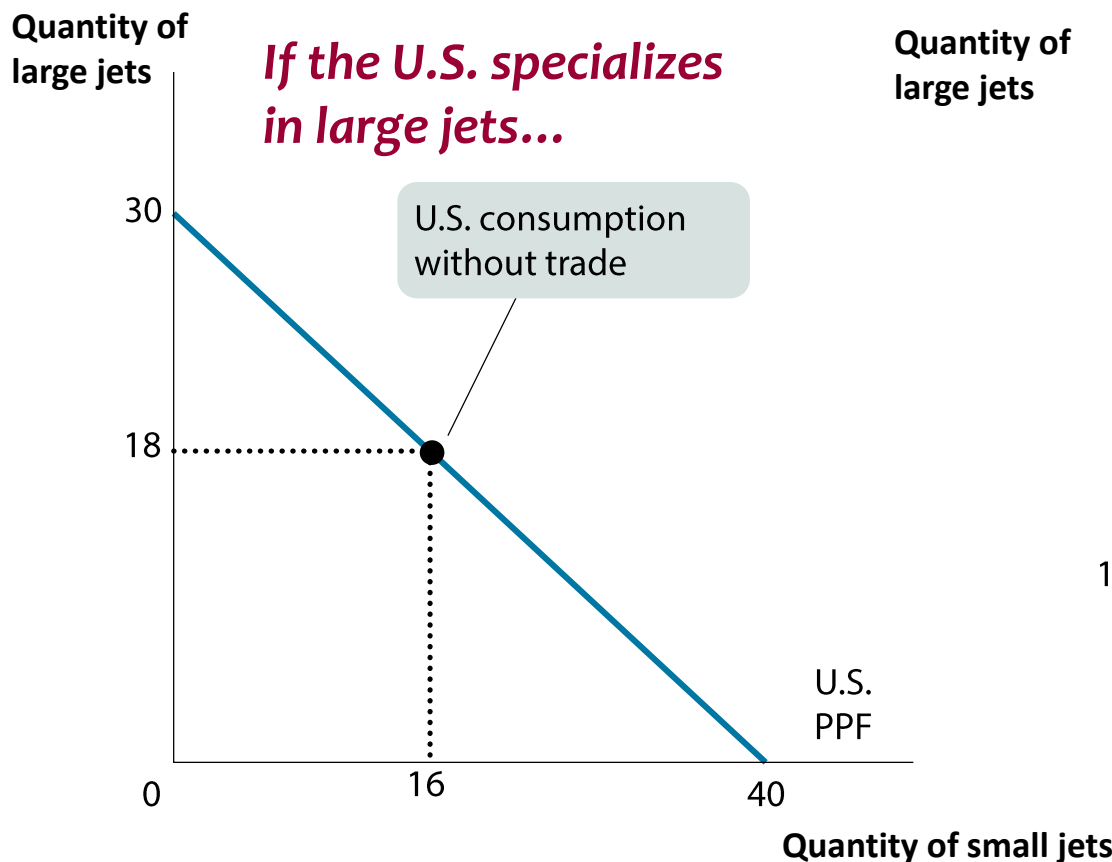
(b) Brazilian Production Possibilities



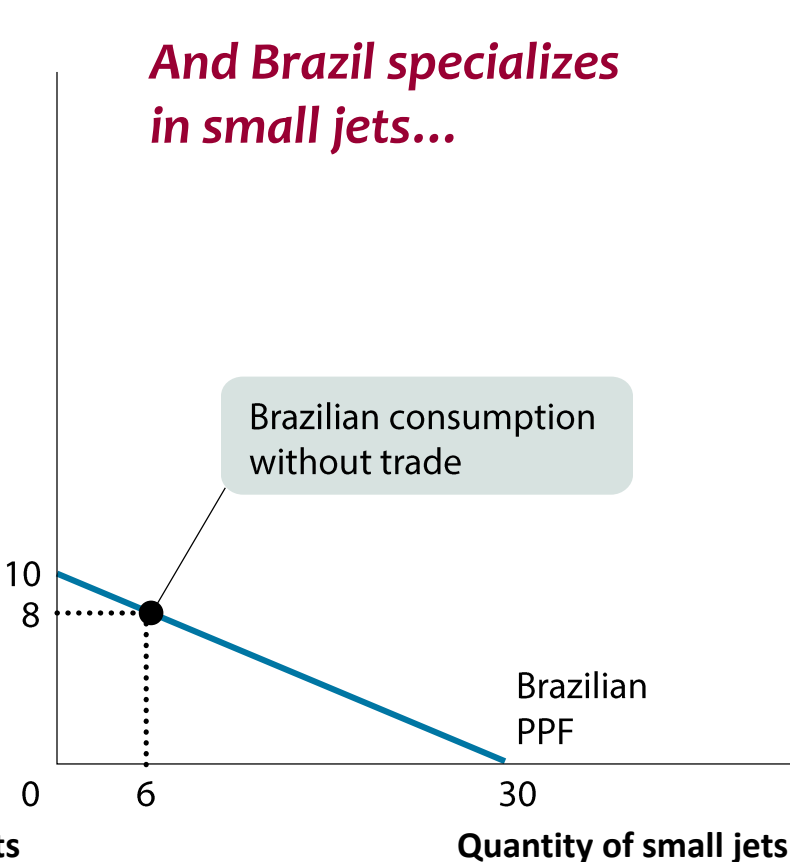
Since each country has a different opportunity cost, it makes sense to specialize and trade...

Comparative Advantage and Gains from Trade

(a) U.S. Production Possibilities

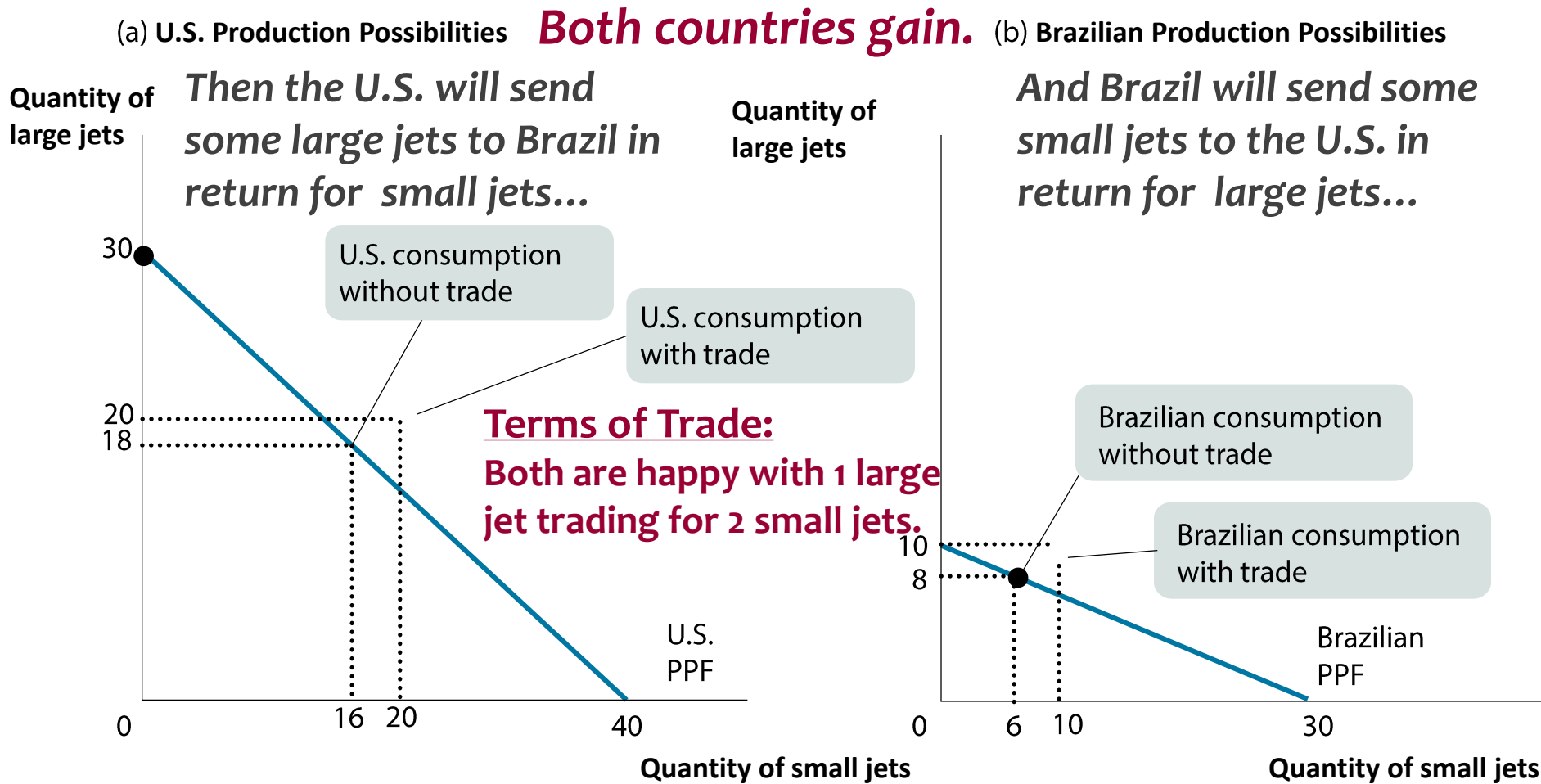


(b) Brazilian Production Possibilities



More airplanes will be produced with the same resources (up from 26 (18 + 8) to 30 large jets and up from 22 (16+6) to 30 small jets).

Comparative Advantage and Gains from Trade

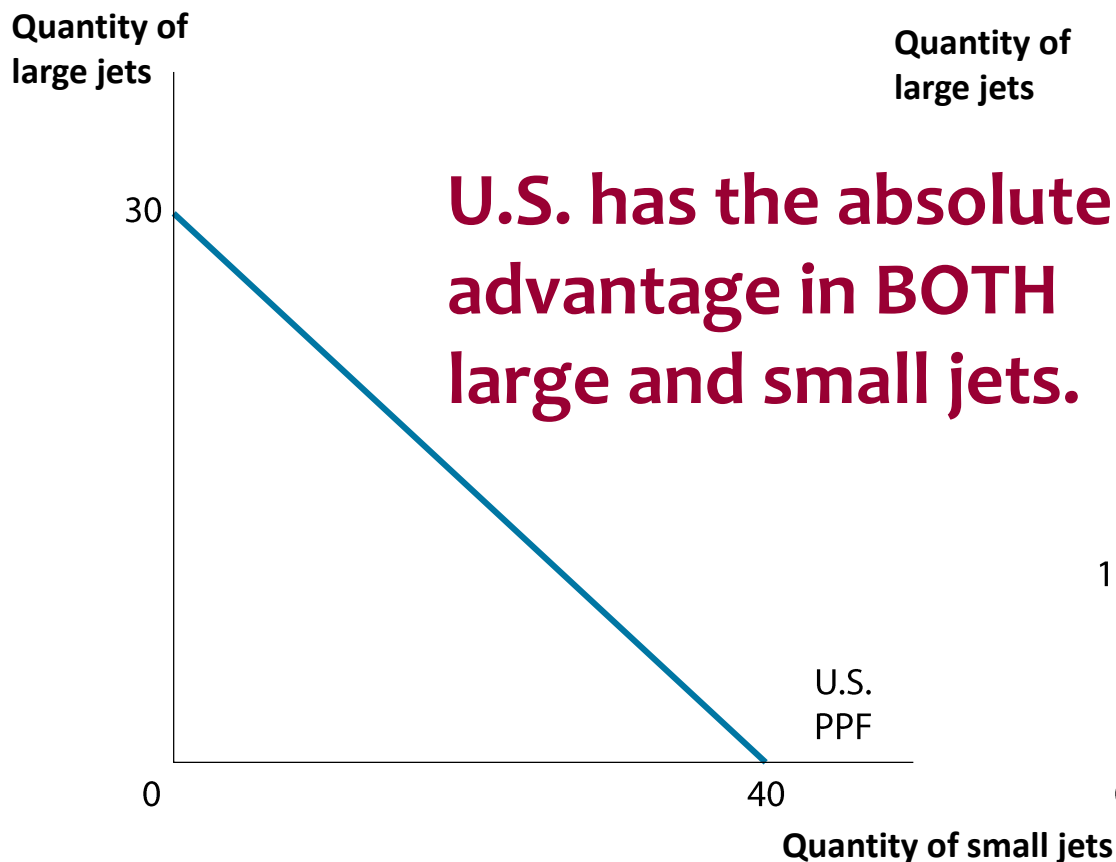


Both countries will be happy to export their goods for any price ABOVE their cost of production and import for any price BELOW their cost of production.

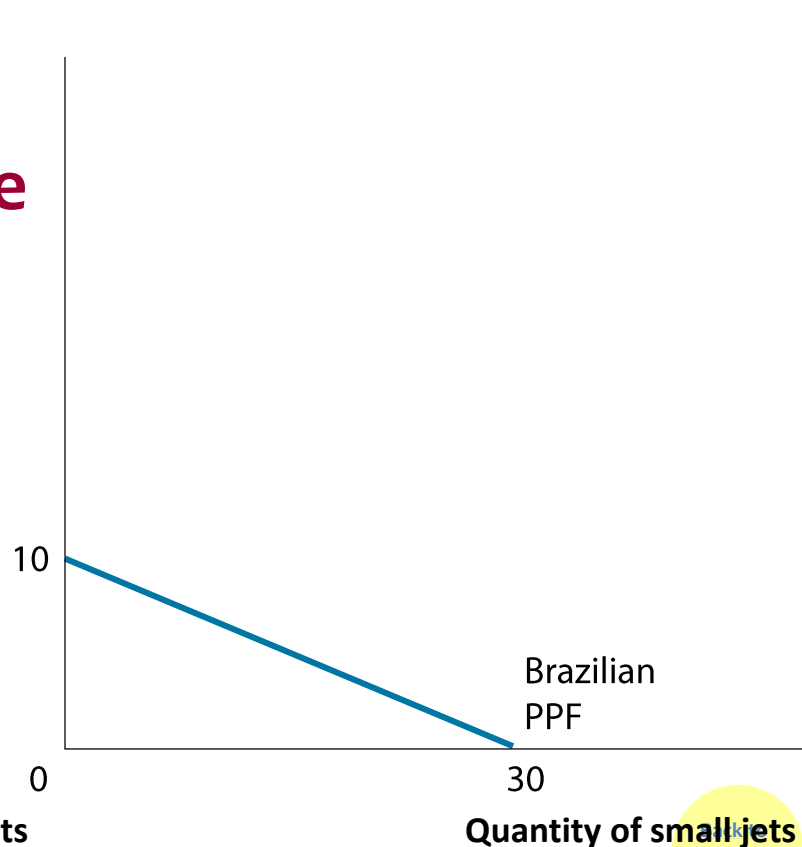
Comparative Advantage vs. Absolute Advantage

Absolute advantage: a country can produce more output per worker than other countries.

(a) U.S. Production Possibilities



(b) Brazilian Production Possibilities



Let's Try This



Suppose that in Australia, it takes 2 hours to harvest 10 bushels of apples and 4 hours to harvest 10 bushels of tomatoes. Suppose a worker in Brazil can harvest 10 bushels of apples in 4 hours or 10 bushels of tomatoes in 5 hours. (hint: “eliminate” the resources, in this case, the “hour”).

- a) Graph the PPF lines for each countries
- b) Determine the opportunity costs of each country in producing a bushel of tomatoes
- c) Which country has the comparative advantage in tomato? In Apple?
- d) Which country has the absolute advantage in tomato? In Apple?

International Trade



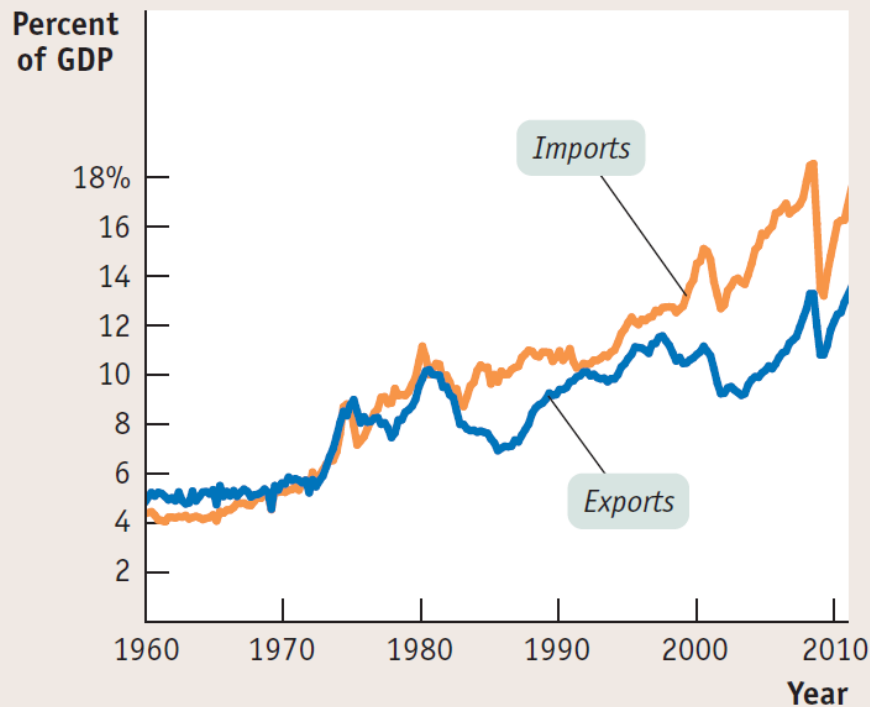
International trade improves the welfare of Mexican auto parts producers as well as American car buyers and sellers.



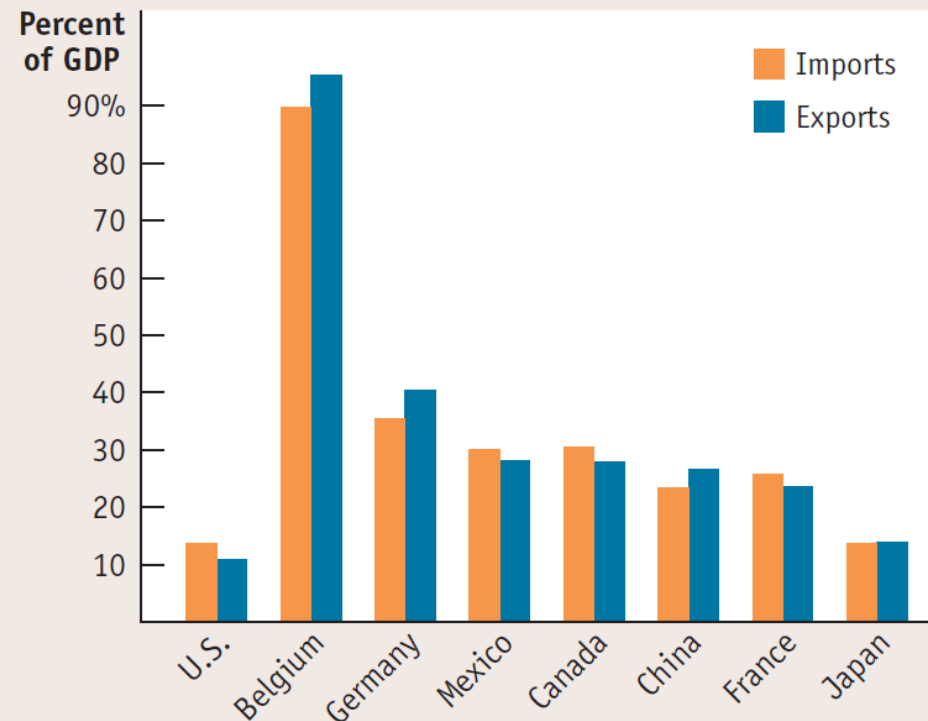
International Trade...

...is more important for the U.S. than it used to be and is more important for some countries than others...

(a) U.S. Imports and Exports, 1960–2010



(b) Imports and Exports for Different Countries, 2009



The Effects of Trade Protection

Policies that limit imports are known as *trade protection* or simply as *protection*.

A *tariff* is a tax applied on imports.

Check wto.org for:

- a list of tariff on various goods.
- a list of trade disputes among economies

The Effects of a Tariff

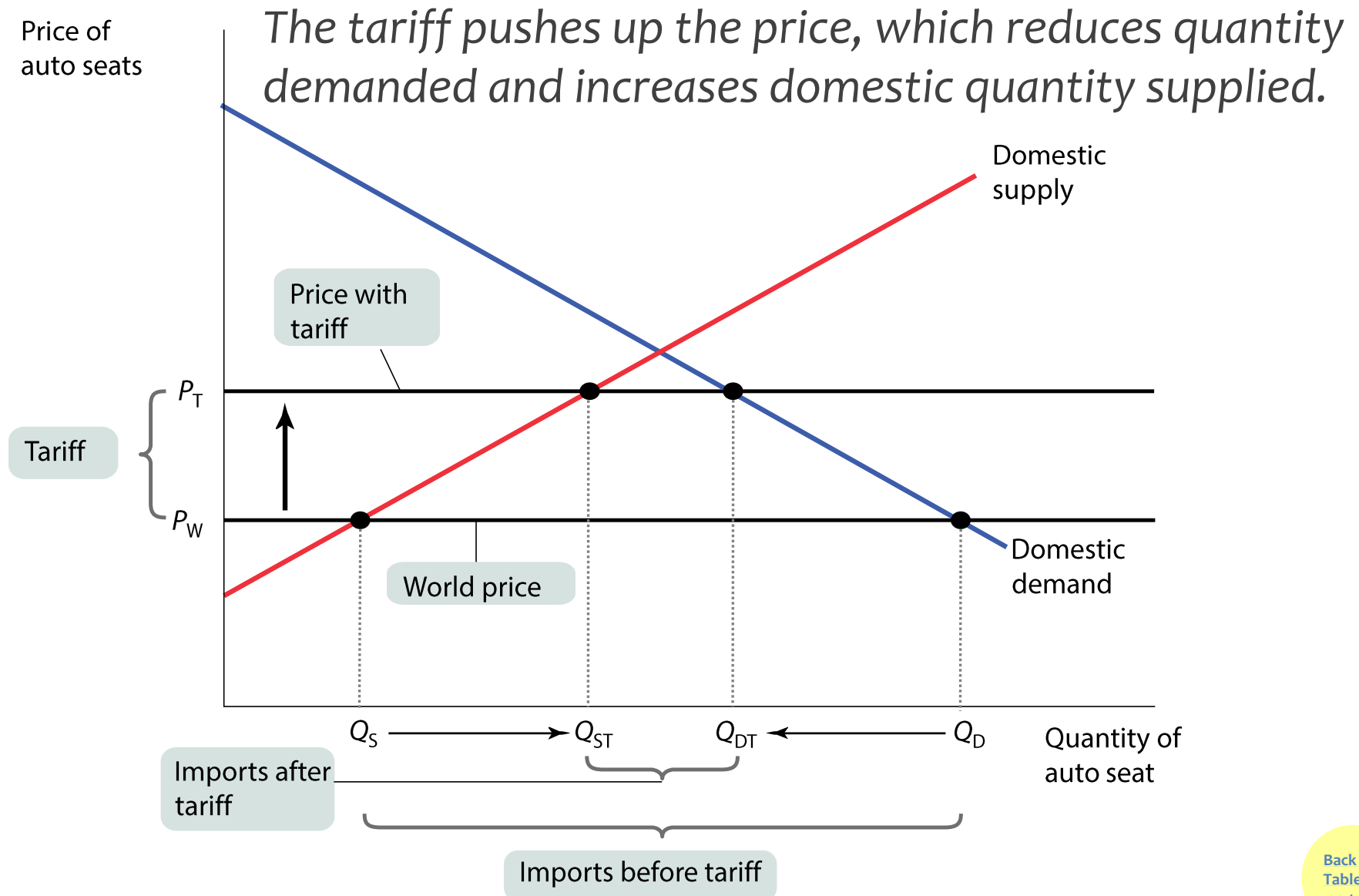
A tariff has **two effects**:

1. \uparrow domestic production, but
2. \downarrow domestic consumption (due to higher price).

There are losses on domestic consumption in terms of quantity (lower) and price (higher), due to Tariff.

How do we measure the value of these losses (wasted resources)?

The Effect of a Tariff



Sources of Comparative Advantage

Differences in technology

Sometimes a country has developed, for many years, a particular technology that explains its comparative advantage.

Swiss watches, for example



Arguments for Trade Protection

1) National Defense

In times of national crisis or war the United States **must be able to rely on key domestic industries:**

Oil

Steel

Defense

Food



Protection is required even during peacetime to ensure their availability.

Arguments for Trade Protection

2) Domestic (un)employment

Globalization will force some firms to lay off workers.

Even so, increased trade usually increases jobs in other industries .

But: for workers who lose their jobs, switching industries can be difficult and time-consuming.

Arguments for Trade Protection

3) The infant industry argument:

Infant industry: New industries need a temporary period of protection to develop.

Critique:

- Hard for government to predict the best emerging technologies.
- Difficult to become competitive when protected from competition.
- Many times politics determine which industries are granted protection.

International Trade Agreements and the World Trade Organization

International trade agreements: treaties in which a country promises to reduce import tariffs in return for a promise by the other country to do the same.

NAFTA (North American Free Trade Agreement): a trade agreement between the United States, Canada, and Mexico.

EU (European Union): a customs union among 27 European nations.

Global trade agreements

WTO (World Trade Organization): oversees international trade agreements and rules on disputes between countries over those agreements.

New Challenges to Globalization

Globalization and Inequality

Offshore outsourcing: hiring people in another country to perform various tasks.

Sweatshop labor fallacy: It's easy to get outraged about the low wages paid to the person who made your shirt; but it's harder to appreciate how much worse off that person would be, if denied the opportunity to work in that industry and sell goods in rich countries' markets.



Discuss: Productivity and Wages Around the World

Write down two factors for each of the following questions:

- a) Why do the wages stay low in poor countries?
- b) Why are the wage differentials important in international trade?
- c) What are other factors, other than wages, important in international trade?

