Lesson 1: Basic Terminology, Absolute and Comparative Advantage

Benefits from trade:

- Countries gain from exchange and specialization as trade enables them to receive a higher price for their exports (which increases profits) and pay a lower price (relative to the cost of goods produced domestically) for their imports.
    - International trade results in more efficient resource allocation as countries can reduce domestic production of goods that they cannot produce efficiently (and instead import them) and increase production of goods that they are more efficient at producing (and export them).
    - Specialization enables production and consumption of larger quantities of goods, which increases welfare.

- Domestic companies gain access to global markets and customers, which leads to increased exchange of ideas and greater awareness of changing consumer tastes and preferences.

- Capital intensive industries gain access to much larger markets, enabling them to reap the benefits of economies of scale.

- Domestic households are able to choose from a wider variety of goods and services.

- Increased foreign competition reduces monopoly power of domestic firms and forces them to continuously strive to become more efficient.

- Trade liberalization can lead to higher inflation-adjusted GDP as a result of a more efficient allocation of resources, learning by doing, knowledge spillovers and improved productivity.

Costs:

- Companies that are less efficient than international firms may go out of business if foreign firms are allowed to enter the market. This will lead to higher (structural) unemployment. These unemployed workers would need to be retrained for jobs in expanding industries.

- The counter argument is that despite the short and medium term costs and unemployment, these resources will eventually be reemployed in more efficient industries.

Absolute advantage refers to a country's ability to produce a good at a **lower cost** or using fewer resources than its trading partners.

Comparative advantage refers to a country's ability to produce a particular good at a **lower opportunity cost** than its trading partners. Example 1, should help clarify these concepts.

Example: Absolute and Comparative Advantages

Suppose there are only two countries, Germany and Bangladesh. These countries trade regularly with each other. Output per worker per day for cars and cloth is shown below:

	Cars	**Cloth (yards)**
Germany	8	16
Bangladesh	4	32

Based only on the information given, answer the following questions:

1. Which country has an absolute advantage in the production of:
   a. Cars
   b. Cloth

2. Which country has a comparative advantage in the production of:
   a. Cars
   b. Cloth

3. Illustrate the gains for each country from trading based on comparative advantage.

	Production	Consumption
Germany		
Cars	100	100
Cloth	200	200
Bangladesh		
Cars	50	50
Cloth	400	400
Global aggregates		
Cars	150	150
Cloth	600	600

The Ricardian Model and the Heckscher-Ohlin Model attempt to explain the sources of comparative advantage for countries. The Ricardian Model focuses on differences in technology across countries, while the Heckscher-Ohlin Model focuses on differences in factor endowments.

Ricardian Model

- Assumes that labor is the only variable factor of production.
- A country gains a comparative advantage in the production of a good based on differences in labor productivity, which reflect underlying differences in technology.
- Differences in technology are the key source of comparative advantage.
- Technological gaps between countries can decrease over time, leading to shifts in comparative advantage.

Heckscher-Ohlin Model (also referred to as the factor-proportions theory)

- Assumes that both capital and labor are variable factors of production, so a good can be produced with varying combinations of the two.

- Technology is the same in each industry across countries, but it varies across different industries.

- Differences in factor endowments are the primary source of comparative advantage.

- A country has a comparative advantage in a good whose production requires intensive use of a factor with which it is relatively abundantly endowed.
    - For example, if a country has large quantities of labor (relative to capital), it would specialize in goods whose production is more labor-intensive and export them.

- Allows for redistribution of income through trade as it assumes that more than one factor of production is variable.
    - Specialization and trade increase demand for the factor that is used in the production of goods that the country exports, and decrease demand for factors used in the production of goods that the country imports.
    - For an economy with abundant labor, increased demand for labor-intensive goods results in an increase in wages.
    - Over time, income is redistributed from capital to labor in such economies.

- Theoretically, free trade should eventually result in equal prices of goods and services and equal prices of factors of production across countries.
    - However, in the real world trade only results in a tendency for factor prices to converge in the long run.