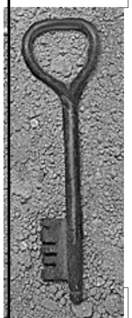
Basic questions and theories of trade

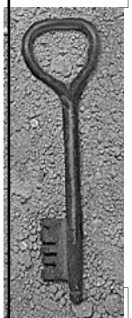


- Why countries trade with each other and should trade be restricted by one country to benefit its residents?
  - Adam Smith’s theory of trade based on absolute advantage. (Productivity differences)
  - Later Ricardo’s theory based on comparative advantage (Productivity differences)
  - Heckscher-Ohlin theory of comparative advantage based on differences in factor endowments, but countries have share the same technology.

Why trade – in general

Main reasons in all theories of International trade:

- Countries engage in international trade because they benefit from doing so.
  - Allows countries to specialize production so that resources are allocated most efficiently.
    - Trade frees each country’s residents from having to consume goods in the same combination in which the local economy can produce them.
  - Benefits from product specialization:
    - Individuals may produce one good (*e.g., teaching economics*) and exchange that for others goods to consume (*e.g., food or clothing*).



Mercantilism

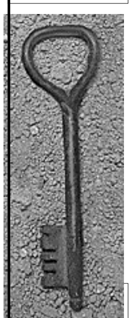
ercantilism represented the dominant attitude toward international trade in the 17th and 18th centuries.

eriod of nation-building.

old and silver served as money.

ymbolized a nation's wealth.

ations encouraged exports and restricted imports as a method to improve inflow of gold and silver.



A. Adam Smith's theory of trade based on absolute advantage

Motivations – to refute the erroneous stand on trade protection of Marcantalism which existed then.
Reading: *Box on Mercantilism on p.23*

Concepts:

- **Absolute Advantage**
- **Labor theory of value**
- **Arbitrage**
- **directions of trade**

Absolute Advantage: Conisder the example

Labor hrs required to make	US	Rest of the World
1 bushel of wheat	2	2.5
1 yd of cloth	4	1.0

Which country has absolute advantage in production of which good?

Us in production of wheat and foreigners in cloth

Labor theory of value: Price in terms of labor content

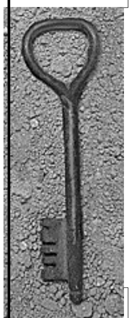
US: Wheat = 2.0, cloth = 4.0
Foreign: Wheat = 2.5, cloth= 1.0

Relative price of wheat in terms of cloth, denoted $p_{w|c}$

In US: $p_{w|c}$ =1/2 yard/bushel,
Foreign countries: $p_{w|c}$=2.5 yard/bushel

Arbitrage:

Arbitrage possibility: Suppose US has 100 units of labor and Produces 20 bu wheat and 15 yd cloth. Similarly, foreigners 20 bu wheat and 50 yd clothes. There is possibility of arbitrage by traders



Ricardian Theory

Concepts:

- ➢Production possibility curve
- ➢Community indifference curve– demand curve for wheat
- ➢Production decision to maximize revenue –supply curve of wheat
  - ✓Autarky equilibrium
  - ✓International trade equilibrium and trade pattern
  - ✓Gains from trade – in terms of income and welfare

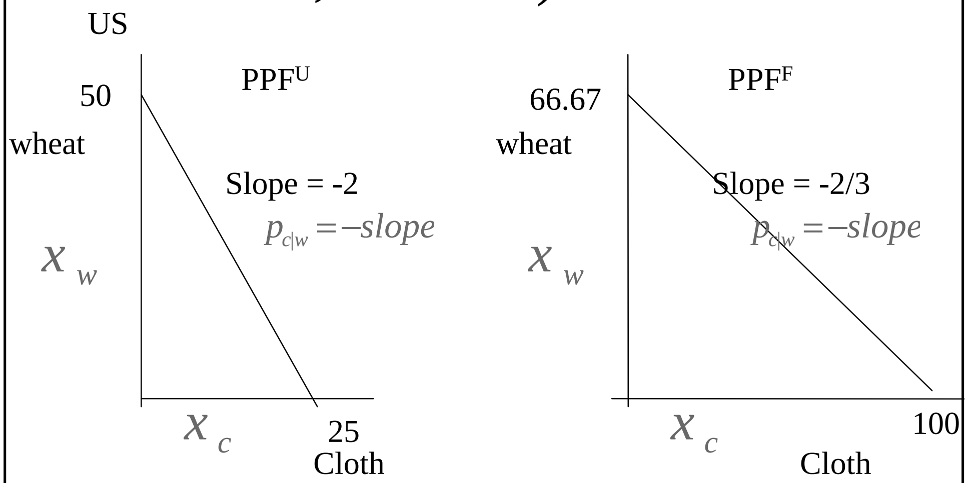
Example

Example modified from Adam Smith Section

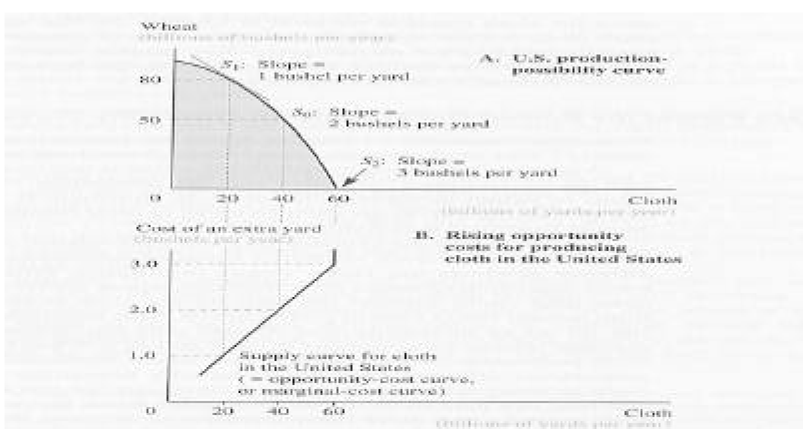
Labor hrs required to make	US	Rest of the World
1 bushel of wheat	2	1.5
1 yd of cloth	4	1.0

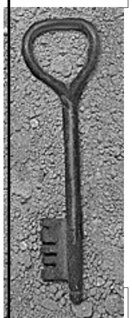
Each country has 100 units of labor.
One country has absolute advantage in production of both goods.
Would the countries benefit from trade?

PPF (Production possibility frontier, or curve)



Increasing marginal cost of production





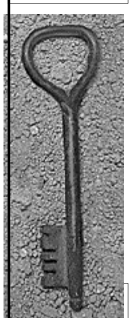
Consumption and Production for the economy

With or without trade:

- Which combinations of goods will be actually consumed by the economy?
- Which combination of goods will be produced in the economy

Answer depends on the prices.

- Community indifference curve, utility maximization, gives demand curve for a good
- Revenue maximization, gives supply function

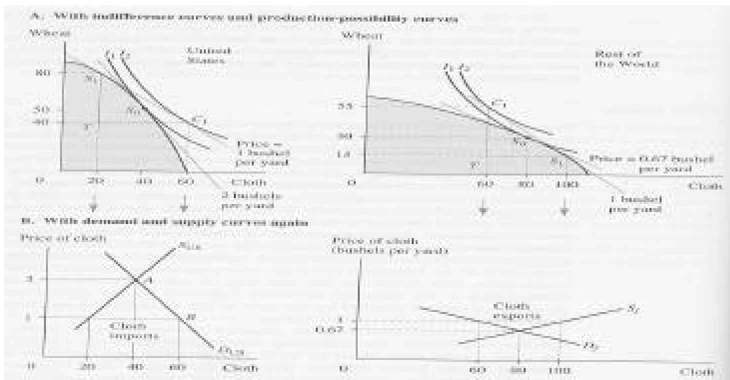


Main concepts

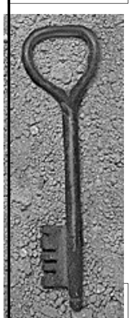
- Community indifference curves, utility maximization, demand curve
- Revenue maximization, and supply curve
- Autarky equilibrium prices (slopes) and quantities consumed in each country
- International price after free trade will be between two autarky prices
- At different prices, trade triangle
- Gains from trade

Figure 3.5

For the US and Foreign, suppose we have the following PPFs and indifference curves



Explain, demand, supply curves, trade triangle, autarky equilibrium
Gains from trade – due to pure trade, and due to specialization



Heckscher-Ohlin Theory

- ♦ Two factors of production: capital and labor
- ♦ Countries have identical technology
- ♦ Labor abundant/capital abundant
- ♦ Labor intensive/capital itensive

<u>Prediction of the theory:</u>

A country exports the product that uses their abundant product intensively

$$\frac{\text{US land supply}}{\text{US labor supply}} > \frac{\text{Foreign land supply}}{\text{Foreign labor supply}}$$