

Gov 1780: International Political Economy

Section 7
11 Mar 2021

Agenda

Today we are going to review some of the **fundamentals of trade theory**. These concepts are already *somewhat* familiar to you, but they are SUPER important.

So think of today's session as an opportunity to clear up any points of confusion and get to the level where you could confidently explain these concepts to someone else!

All together:

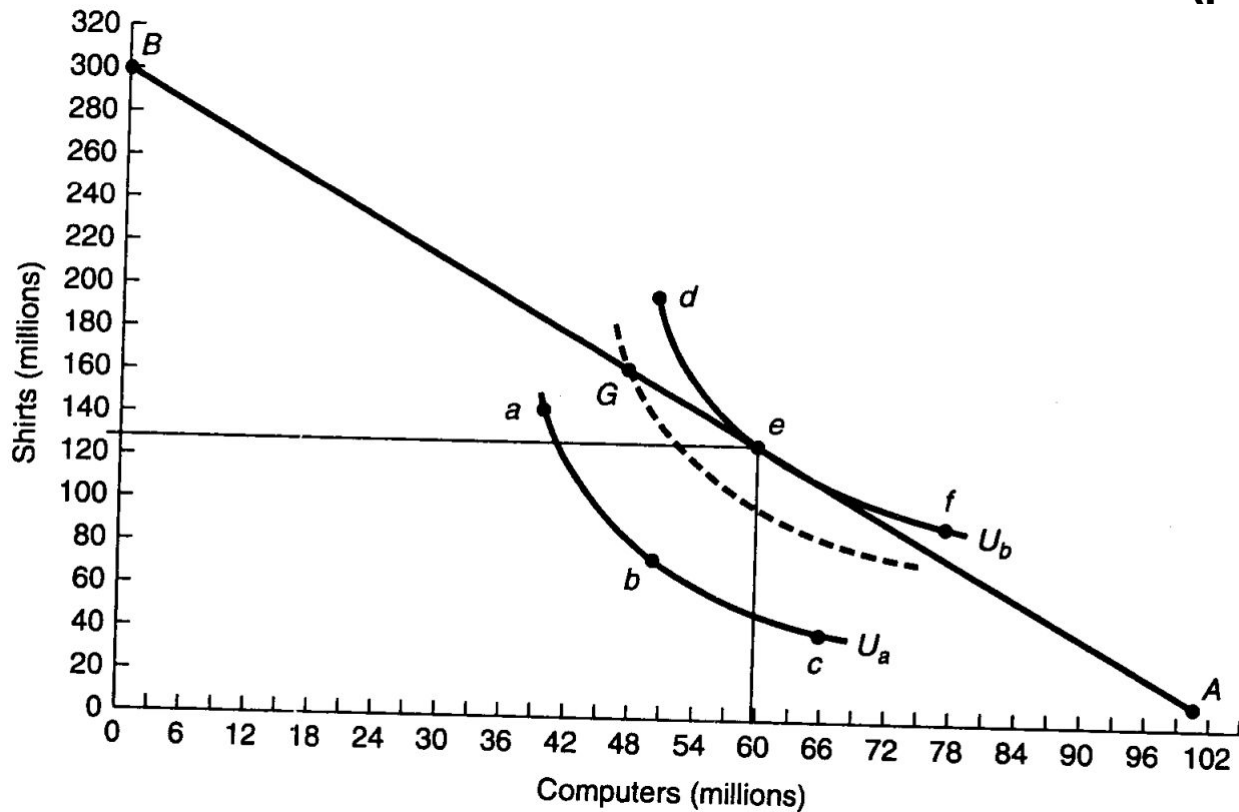
- The logic of comparative advantage

Breakout rooms:

- Heckscher-Ohlin
- Stolper-Samuelson
- Ricardo-Viner

Comparative advantage

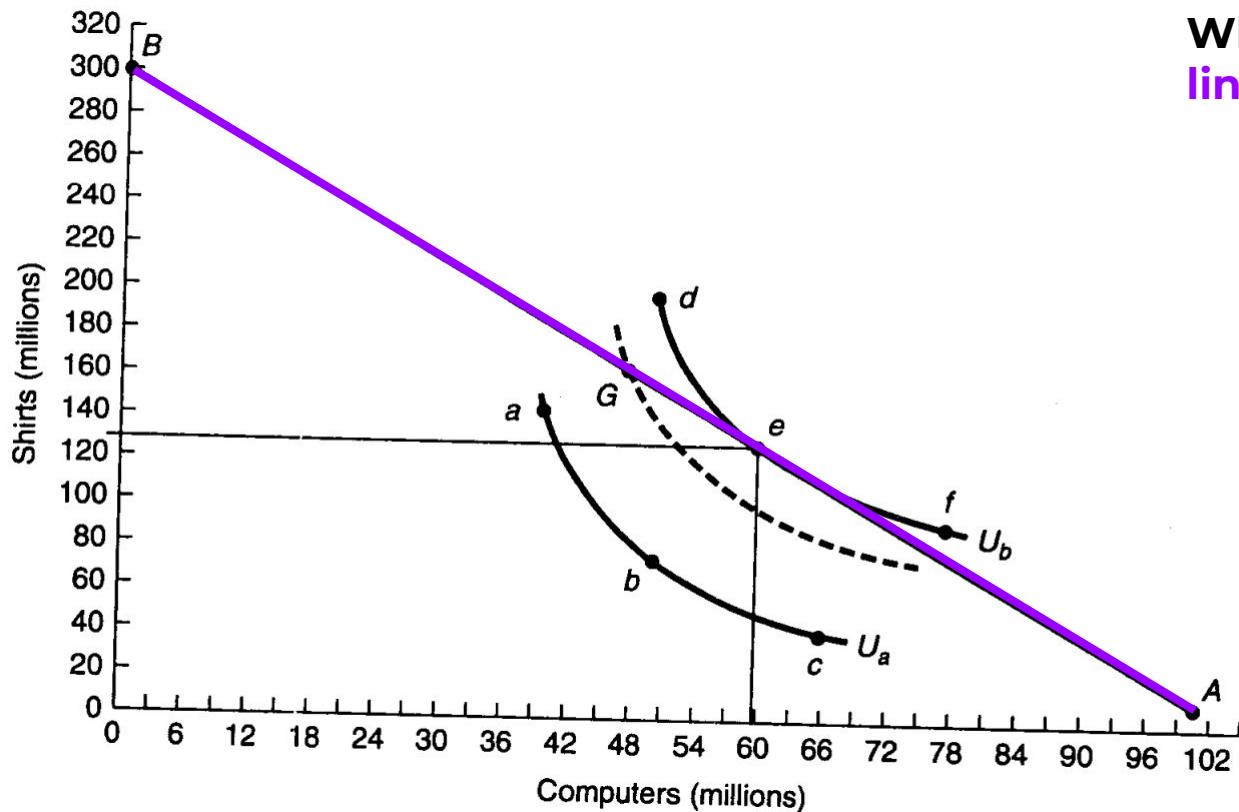
Let's review this
diagram from Oatley
(p.49)



Comparative advantage

Let's review this diagram from Oatley (p.49)

What does the **straight line** represent?

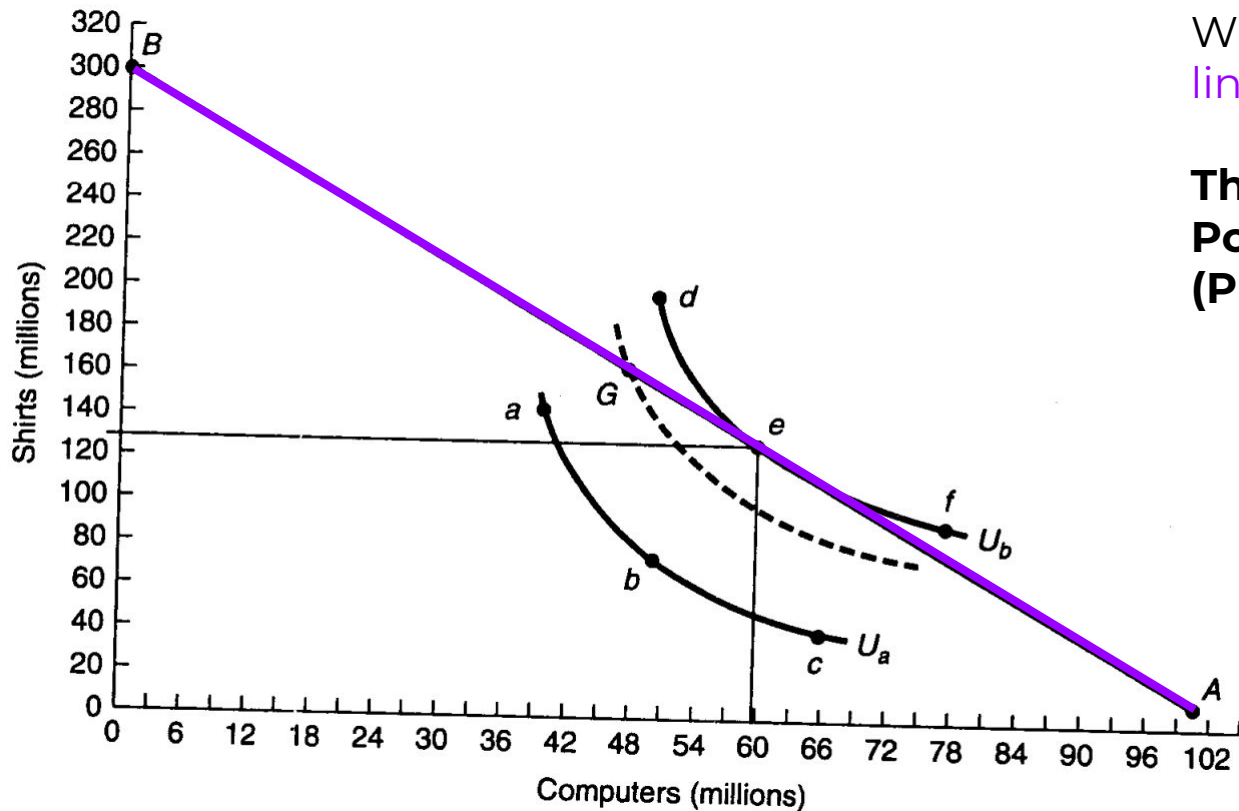


Comparative advantage

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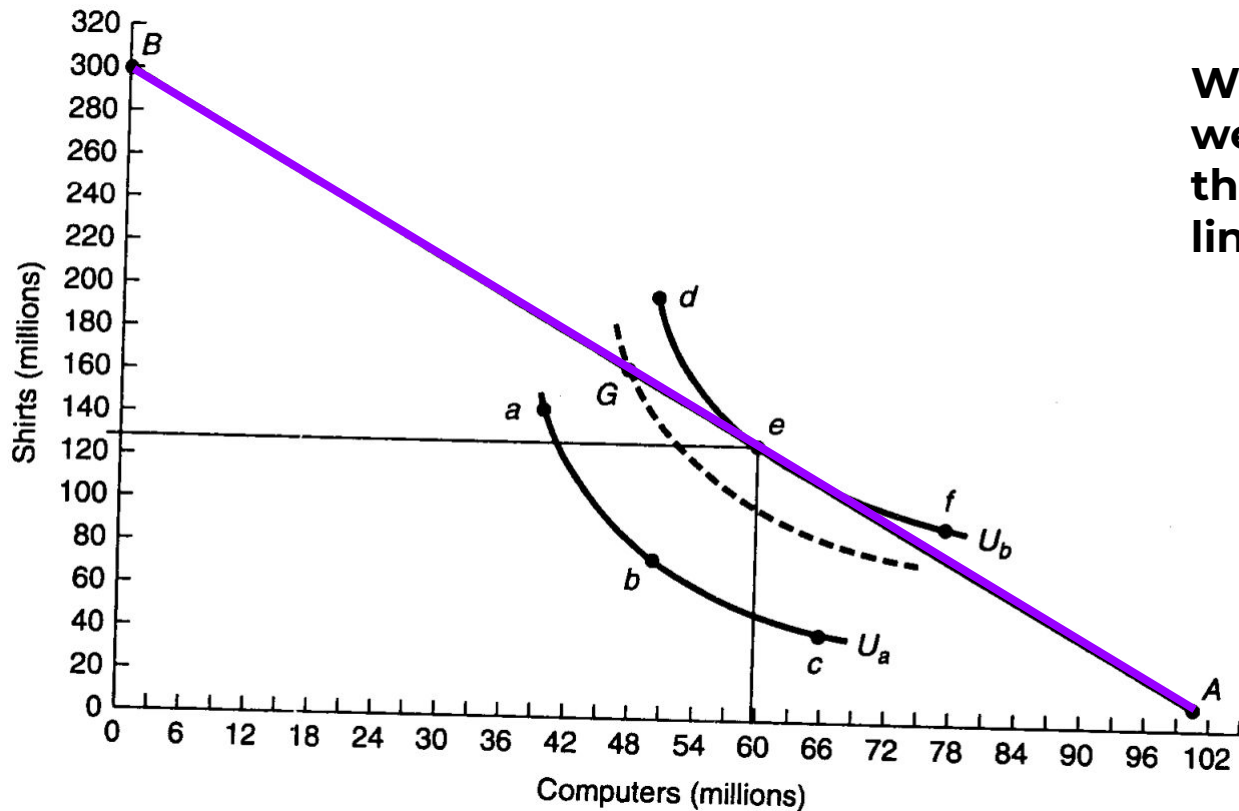
What does the **straight line** represent?

The Production Possibility Frontier (PPF)



Comparative advantage

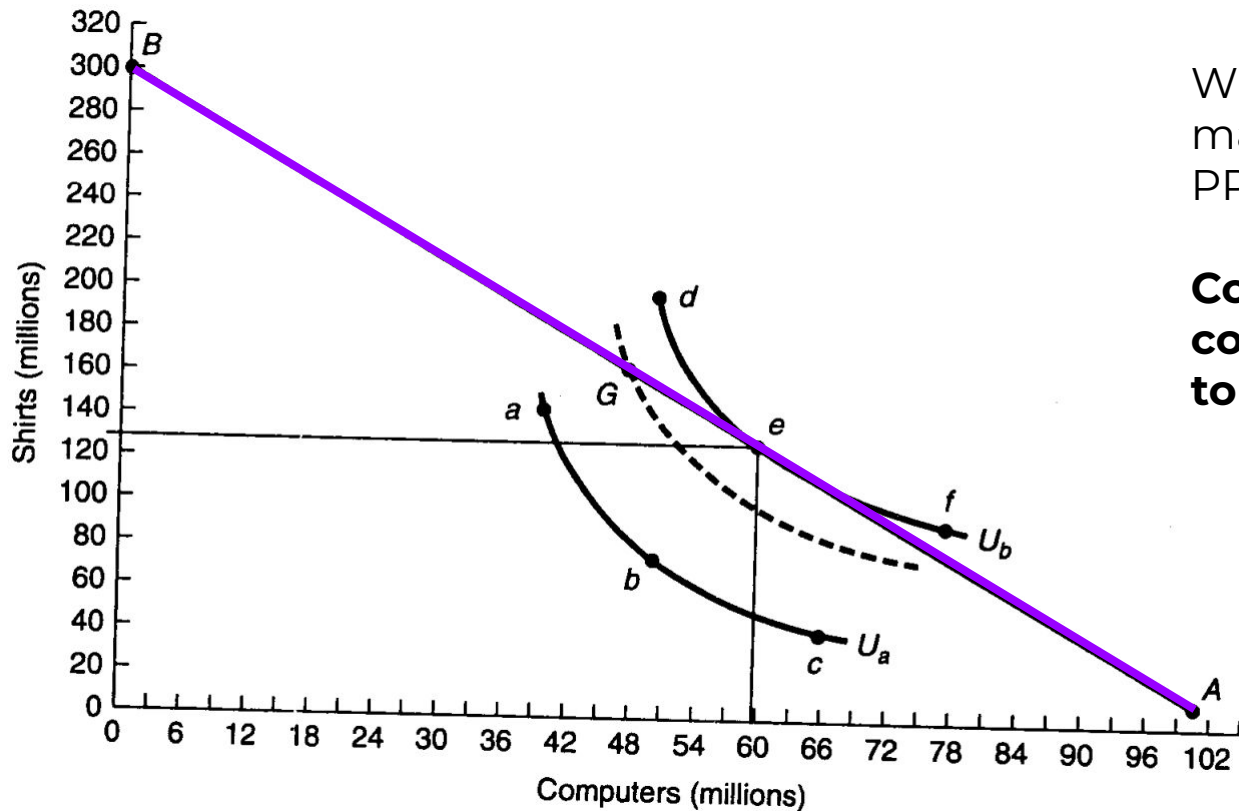
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What assumption are we making by drawing the PPF as a straight line?

Comparative advantage

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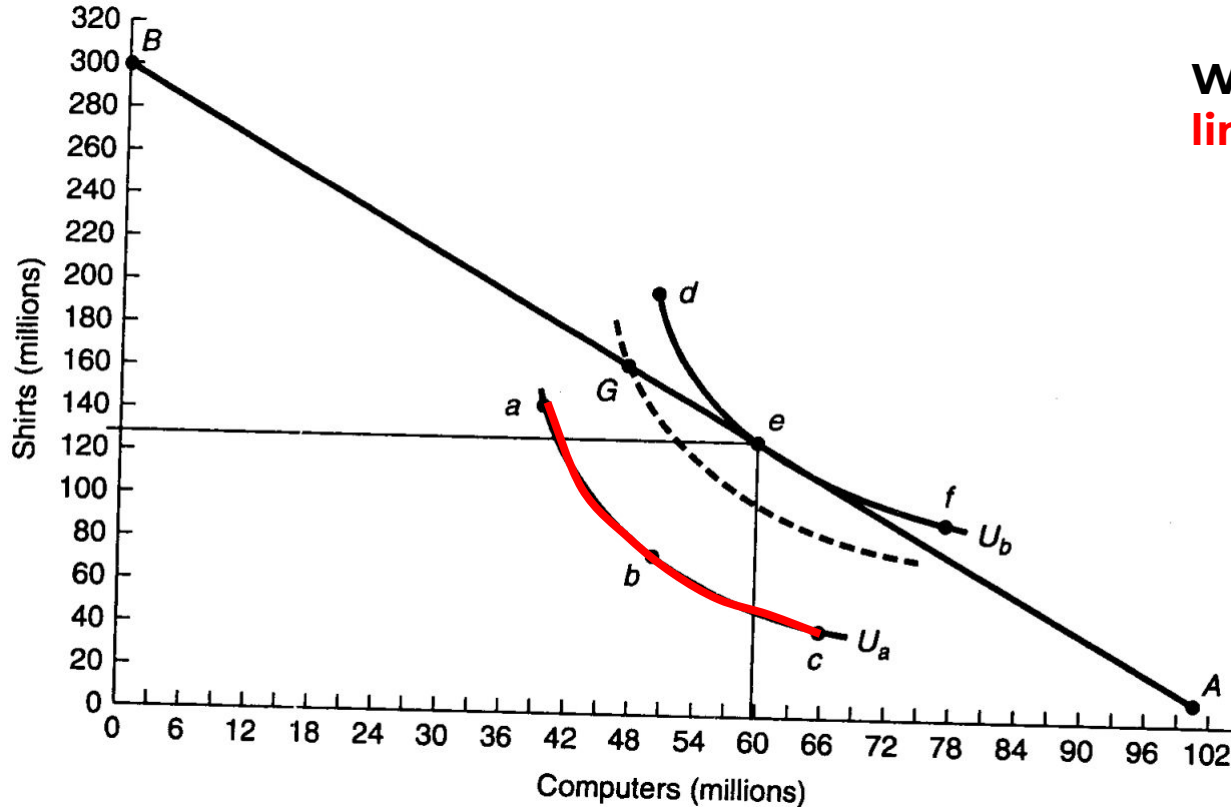
What assumption are we making by drawing the PPF as a straight line?

Constant opportunity costs / Constant returns to scale in production

Comparative advantage

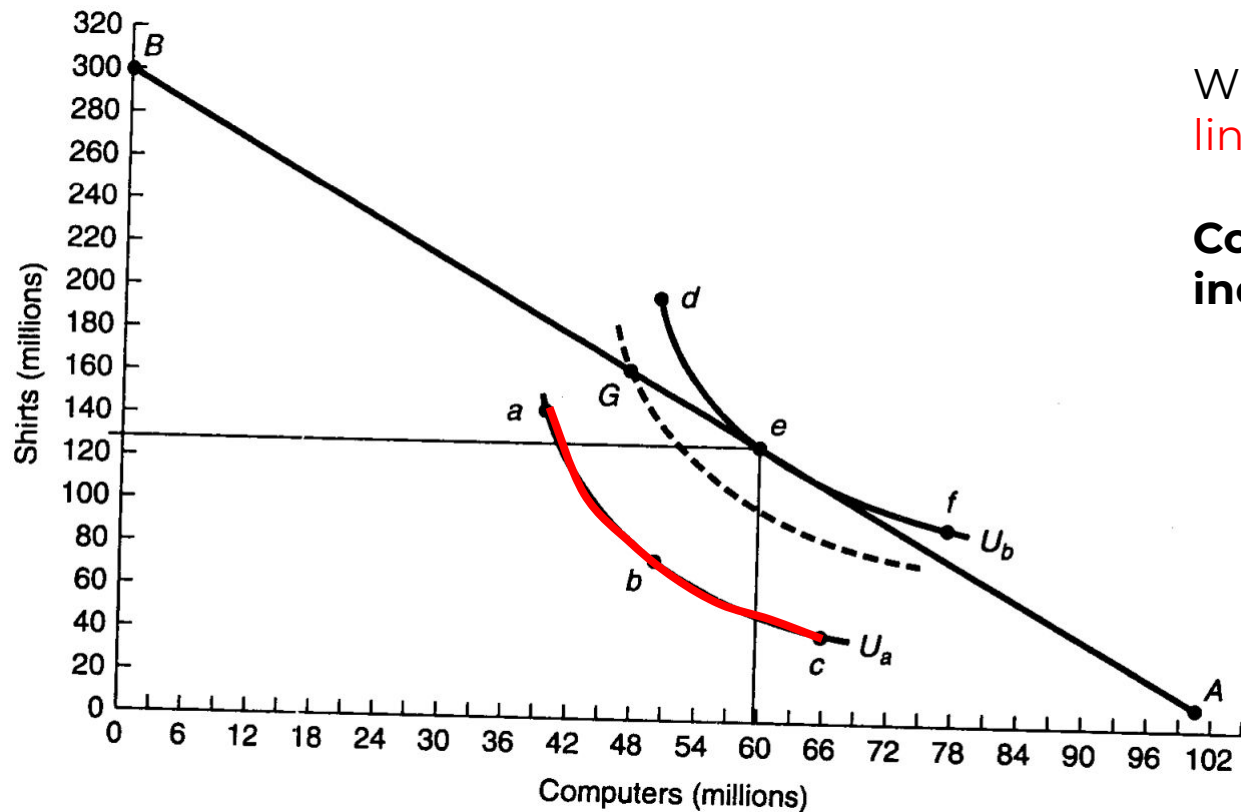
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What are the curved lines?



Comparative advantage

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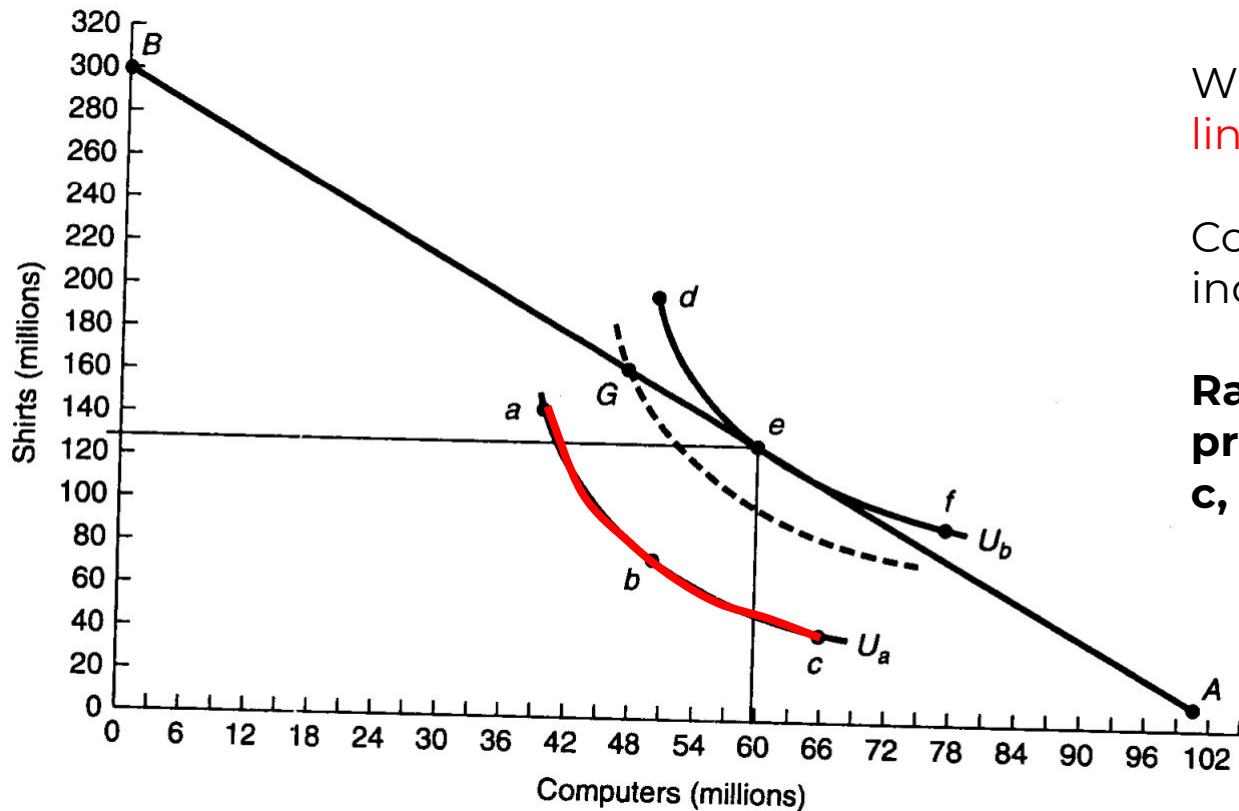


What are the **curved lines**?

**Consumption
indifference curves**

Comparative advantage

Let's review this diagram from Oatley (p.49)



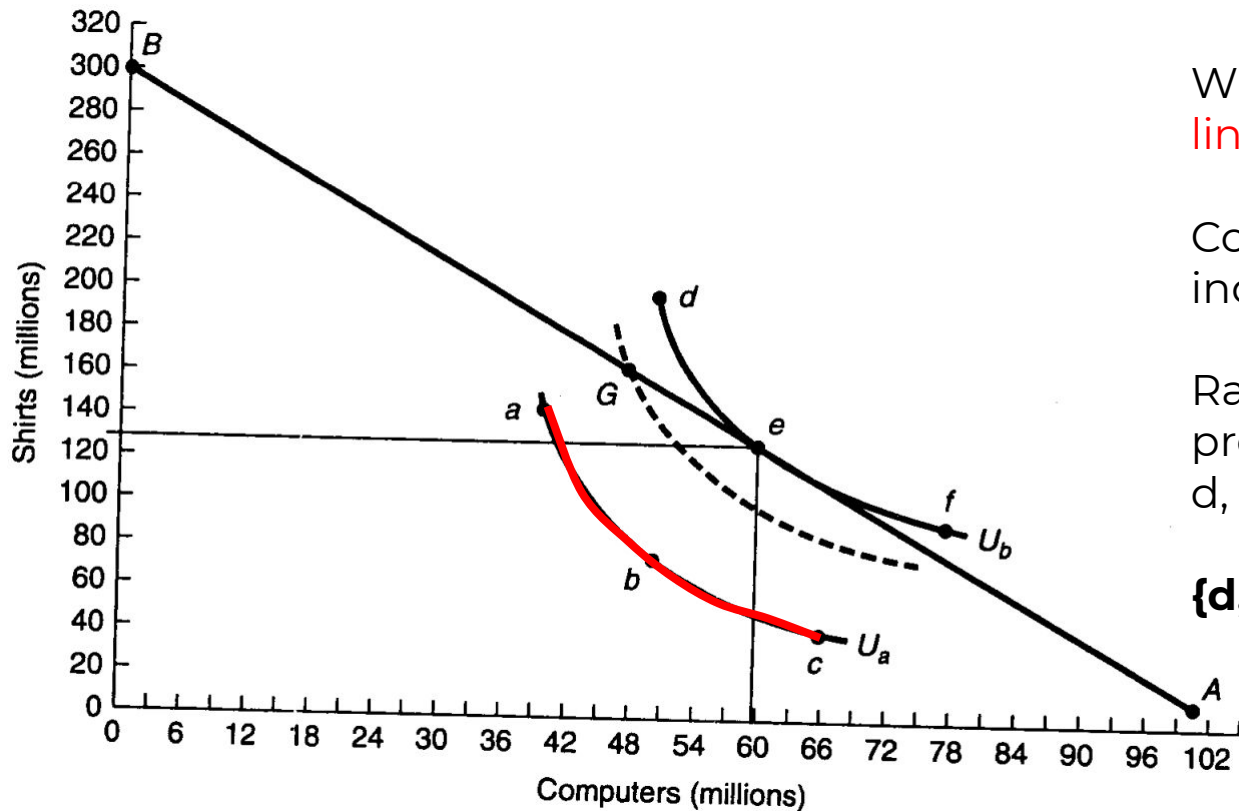
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Consumption
indifference curves

Rank the consumer's preferences over {a, b, c, d, e, f, G}

Comparative advantage

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What are the **curved lines**?

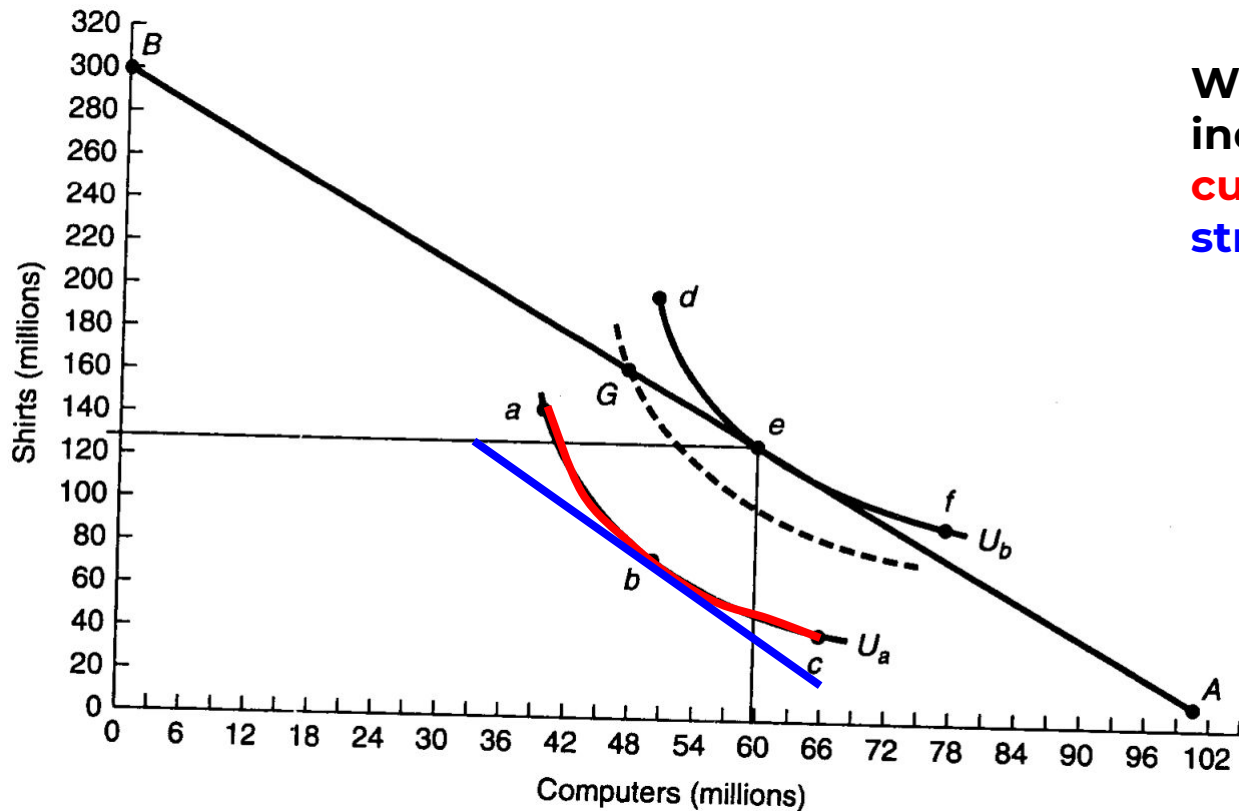
Consumption
indifference curves

Rank the consumer's
preferences over {a, b, c,
d, e, f, G}

{d, e, f} > {G} > {a, b, c}

Comparative advantage

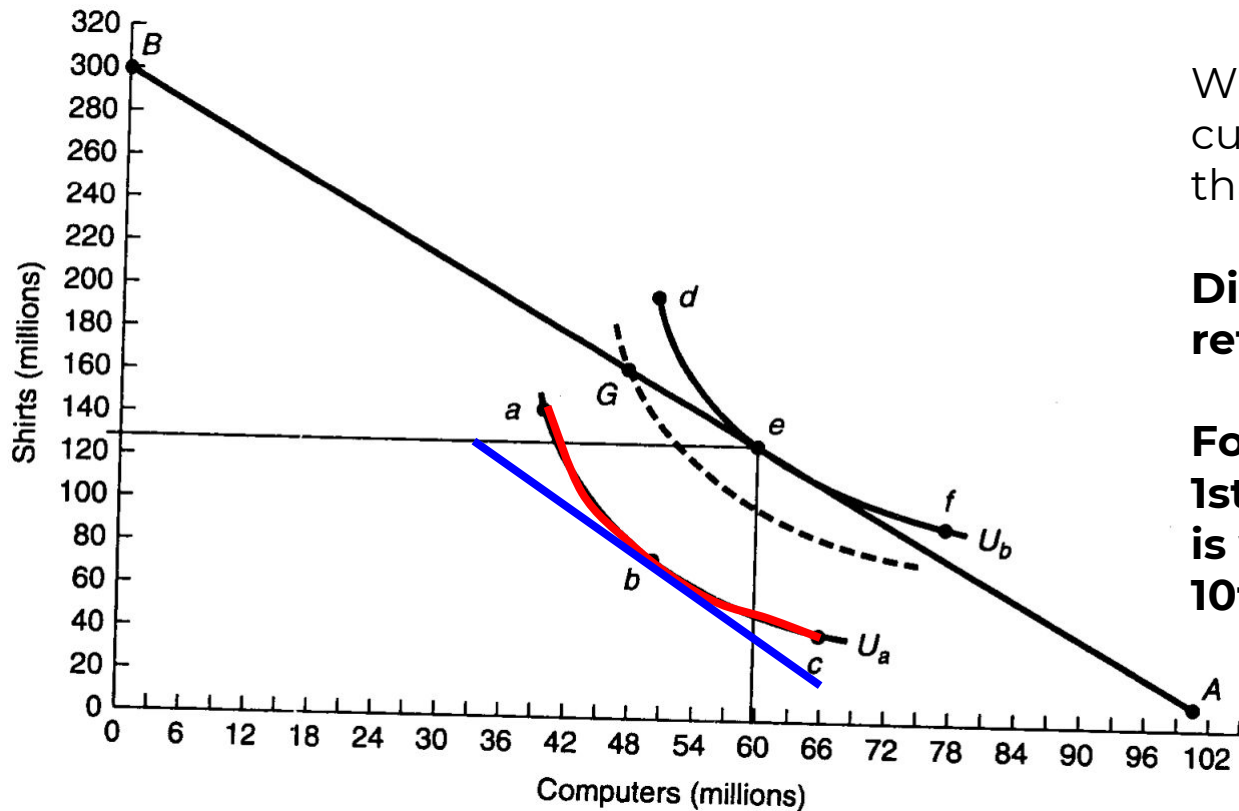
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**Why are the
indifference curves
curved rather than
straight?**

Comparative advantage

Let's review this diagram from Oatley (p.49)



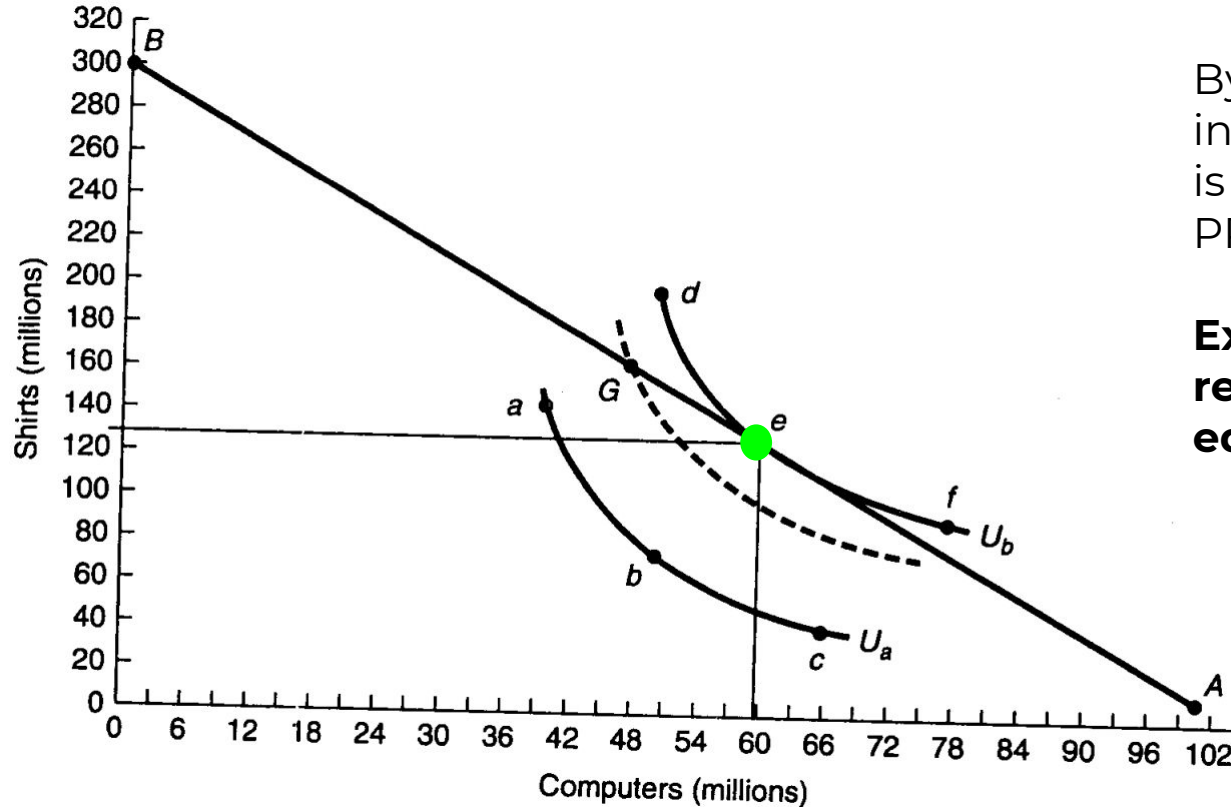
Why are the indifference curves **curved** rather than **straight**?

Diminishing marginal returns.

For the consumer, the 1st computer (or shirt) is worth more than the 10th!

Comparative advantage

Let's review this diagram from Oatley (p.49)

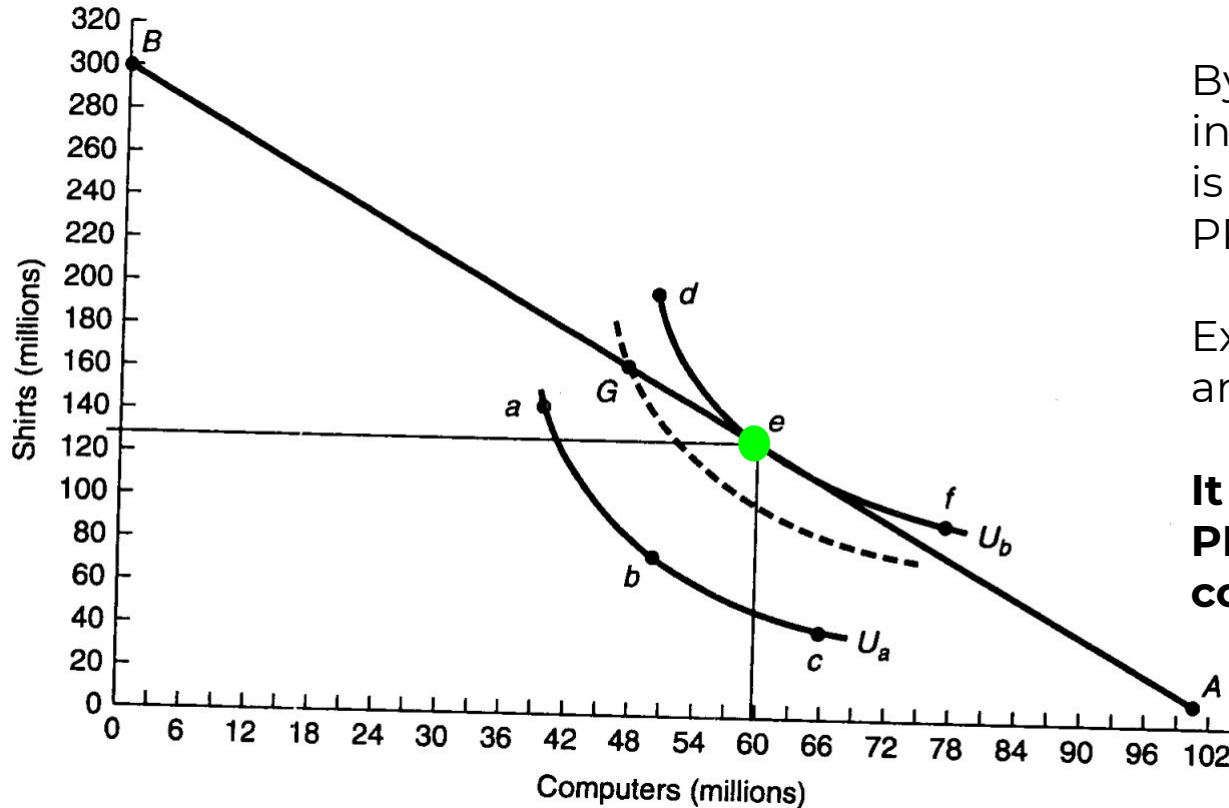


By shifting out the indifference curve until it is at a tangent to the PPF, we arrive at point e.

Explain why e represents an equilibrium.

Comparative advantage

Let's review this diagram from Oatley (p.49)



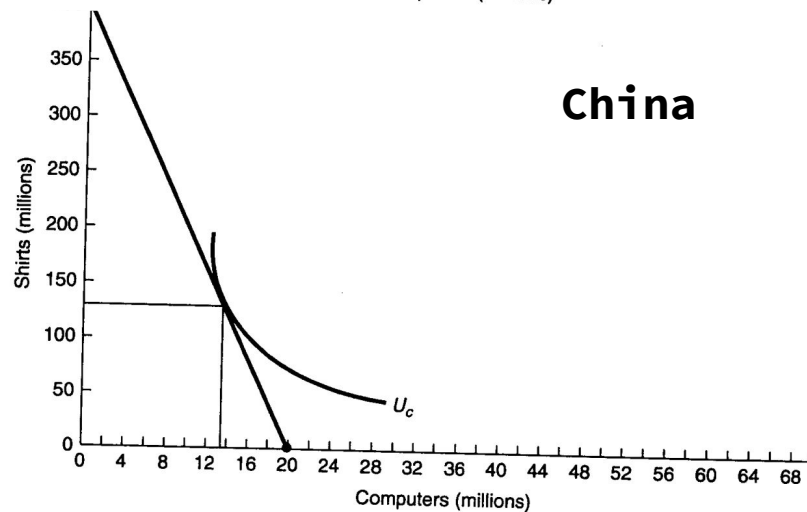
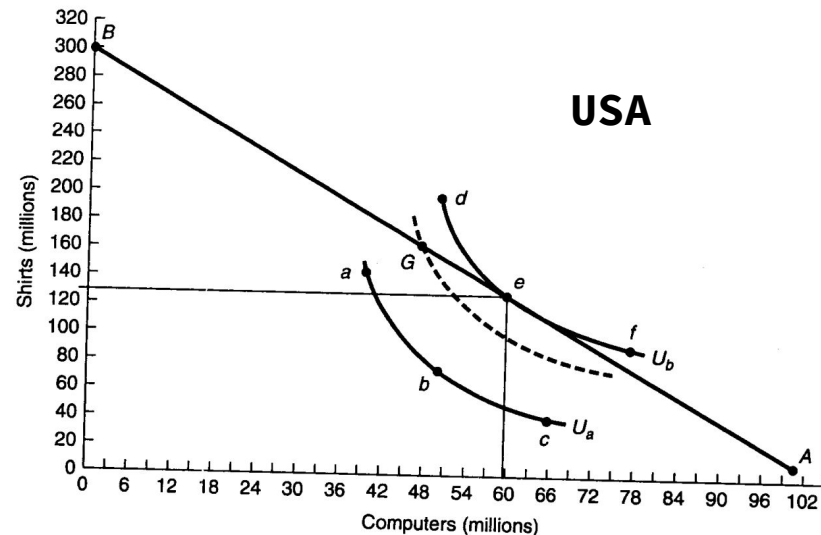
By shifting out the indifference curve until it is at a tangent to the PPF, we arrive at point e.

Explain why e represents an equilibrium.

It is the point along the PPF that maximizes consumer utility.

Comparative advantage

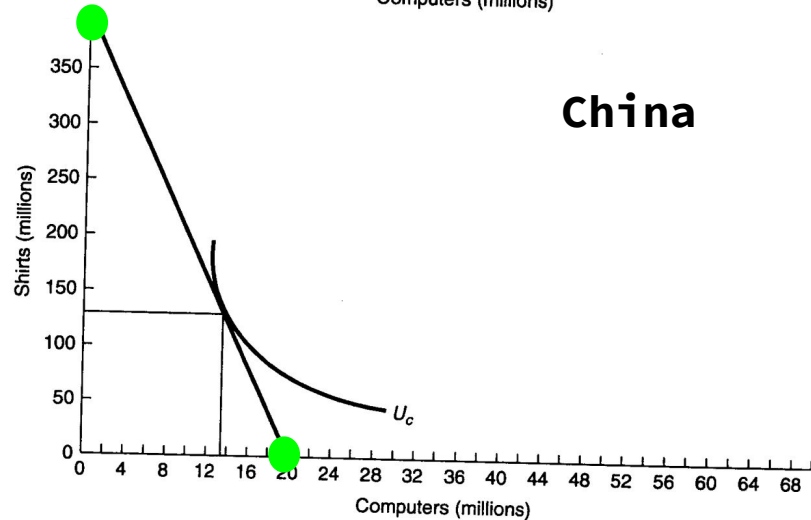
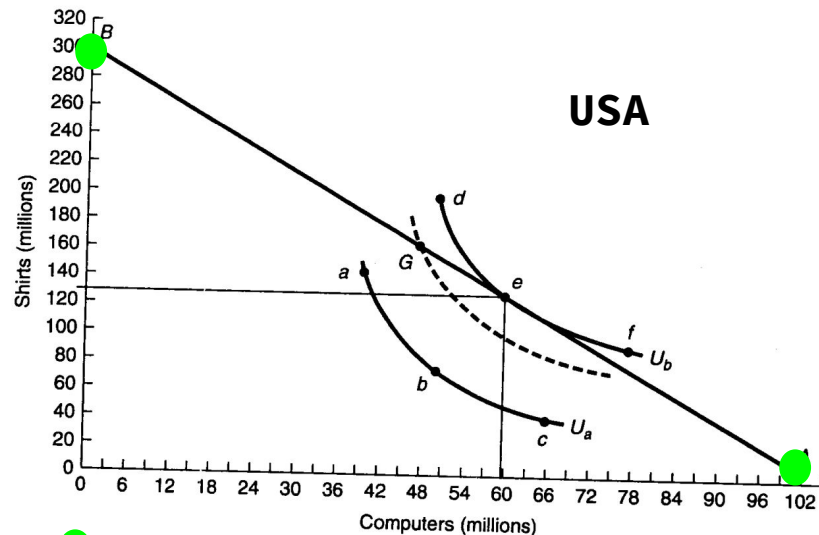
Why is the slope of the PPF steeper in China vs the US?



Comparative advantage

Why is the slope of the PPF steeper in China vs the US?

Look at where the PPF hits the axes. These points represent how many shirts/computers the country could produce if it allocated all factors to producing that good.

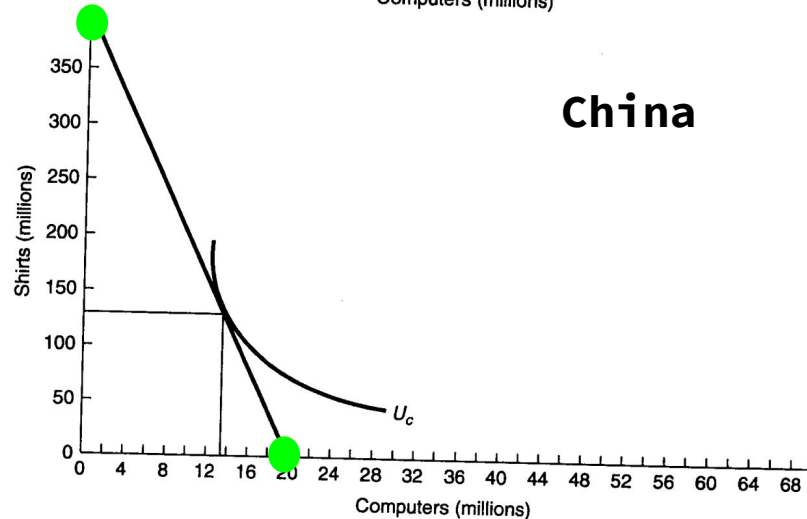
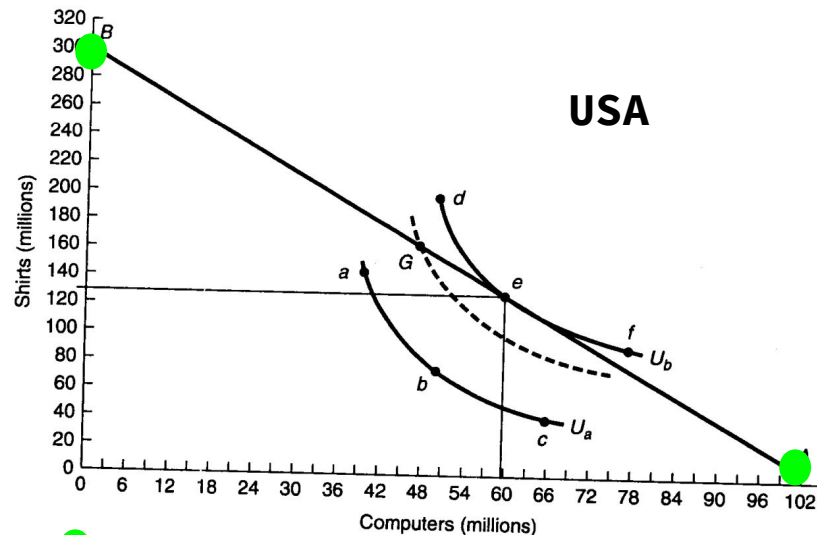


Comparative advantage

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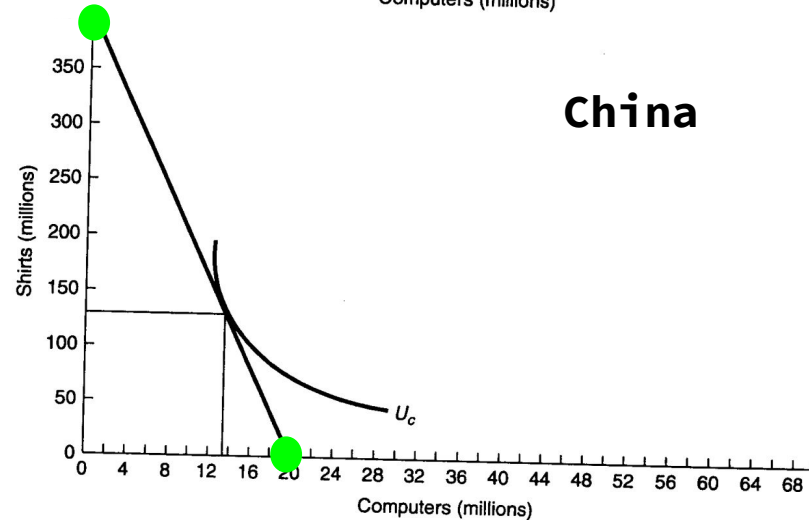
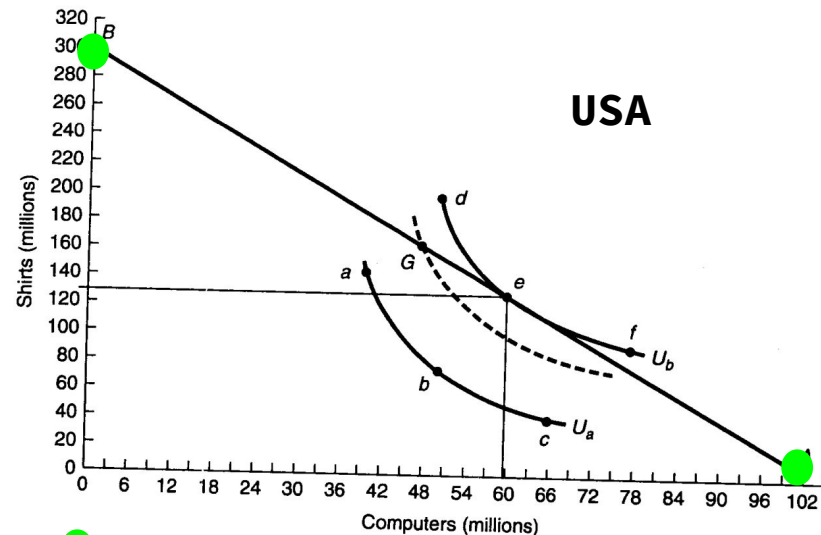
Look at where the PPF hits the axes. These points represent how many shirts/computers the country could produce if it allocated all factors to producing that good.

- The US can produce a maximum of **300m shirts** and **102m computers**.
- China can produce a maximum of **350m shirts** and **20m computers**.



Comparative advantage

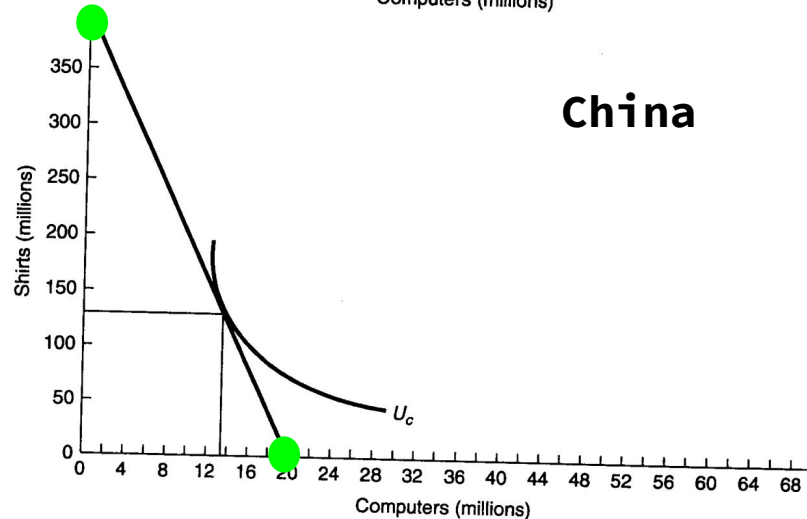
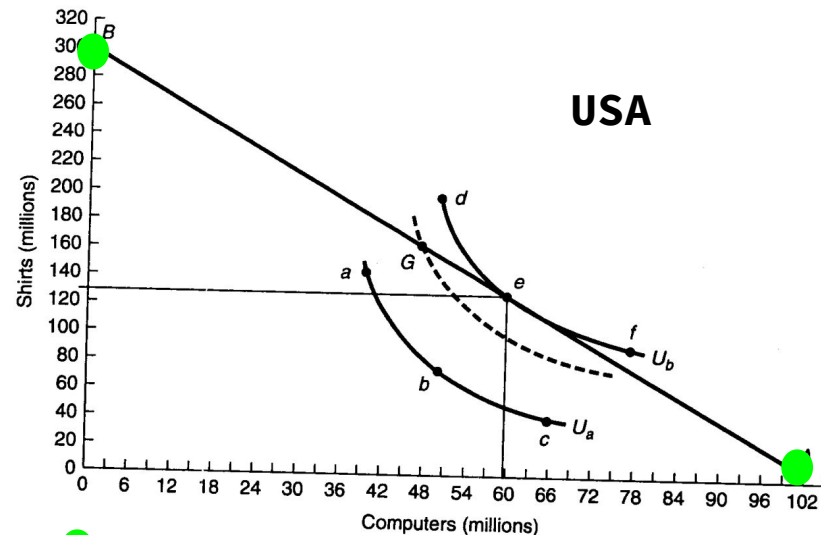
OK so... does China have an *absolute* advantage or a *comparative* advantage in making shirts?



Comparative advantage

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Answer: both!



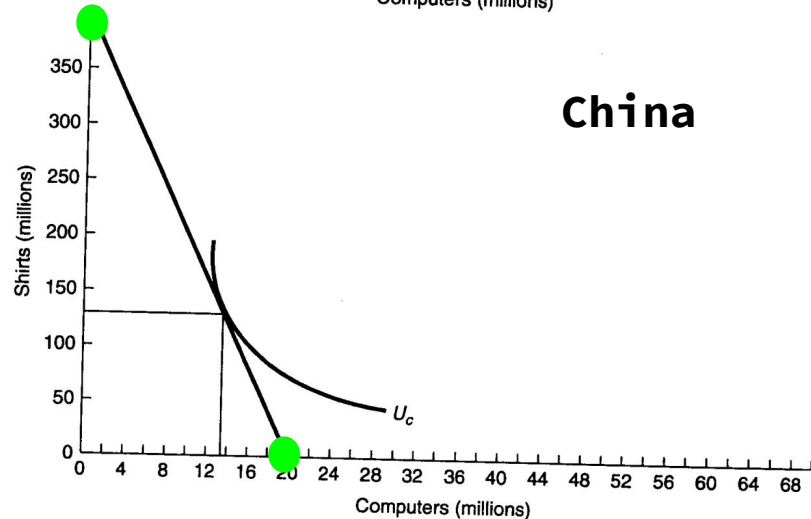
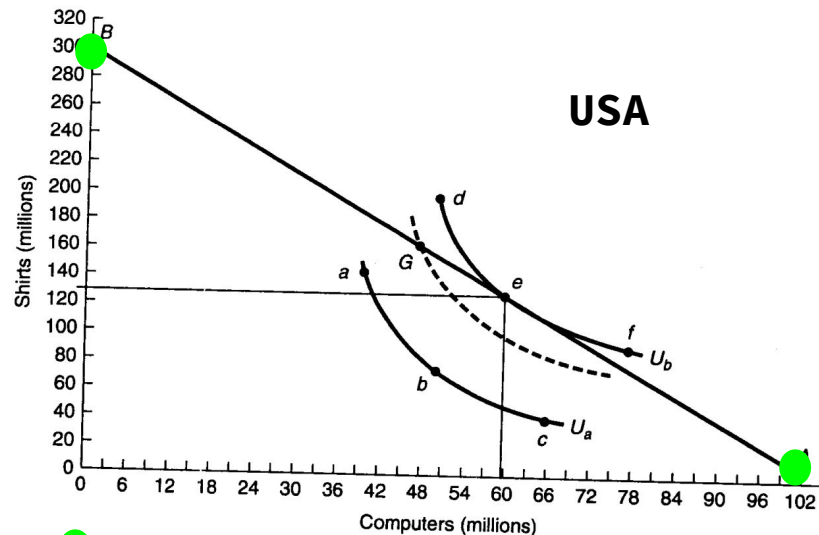
Comparative advantage

OK so... does China have an *absolute* advantage or a *comparative* advantage in making shirts?

Answer: both!

China has an **absolute** advantage in shirts because using all available resources it can produce more than the US (350m > 300m).

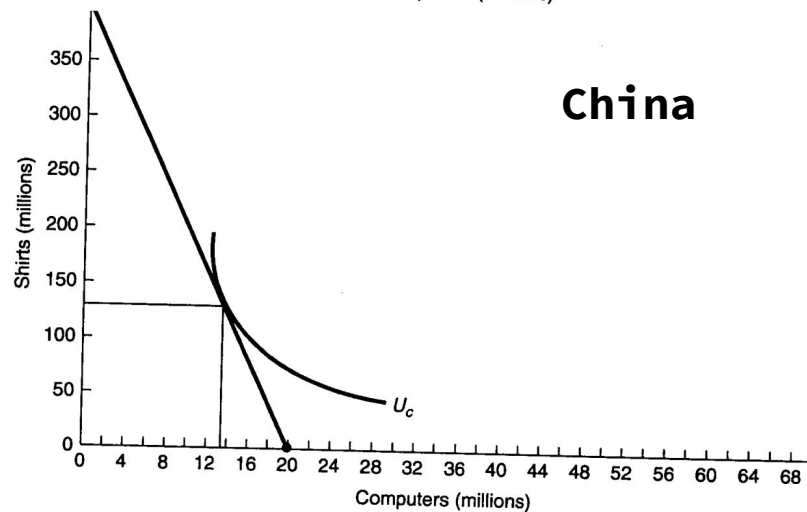
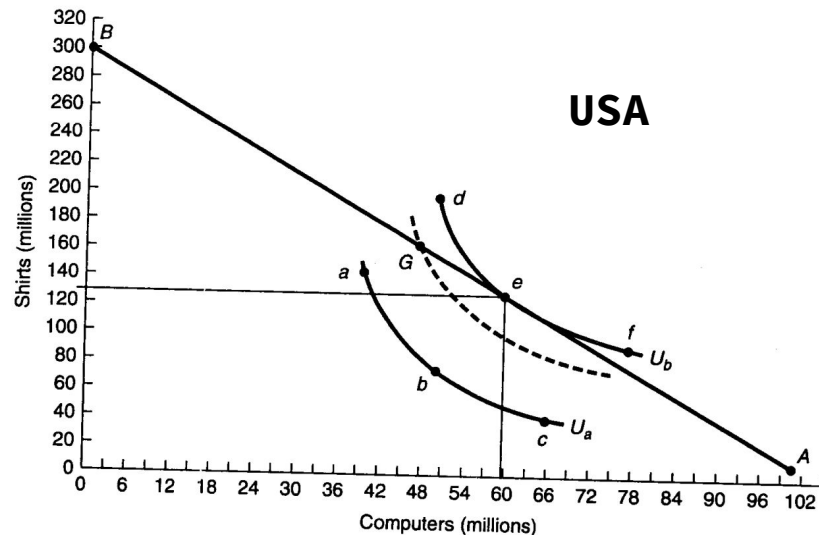
China also has a **comparative** advantage in shirts because it face lower opportunity costs (= the computers that could have been made).



Comparative advantage

So far the diagrams assume that each country is autarkic.

What happens if the two countries can trade with each other?

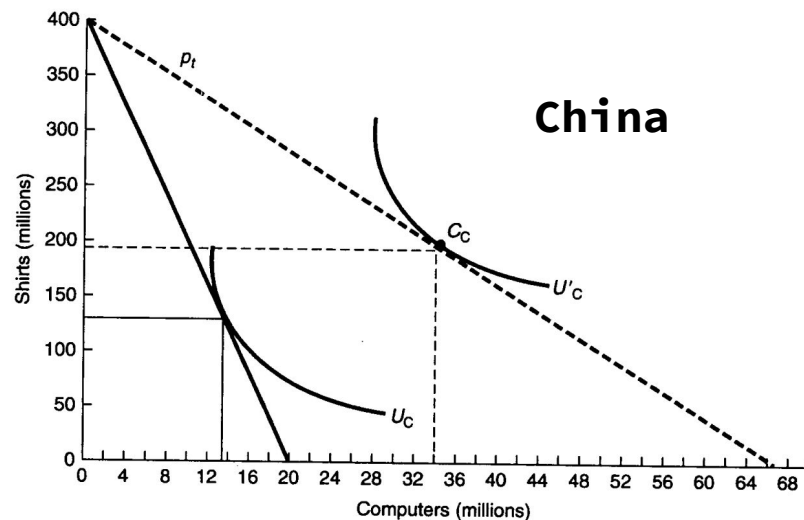
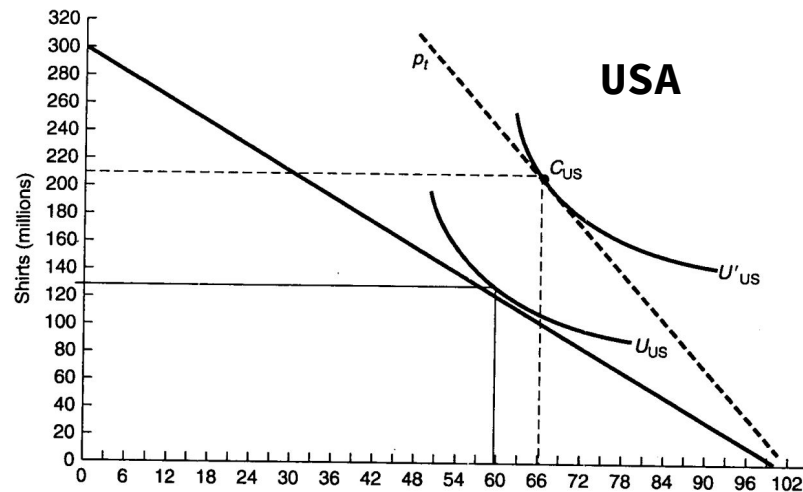


Comparative advantage

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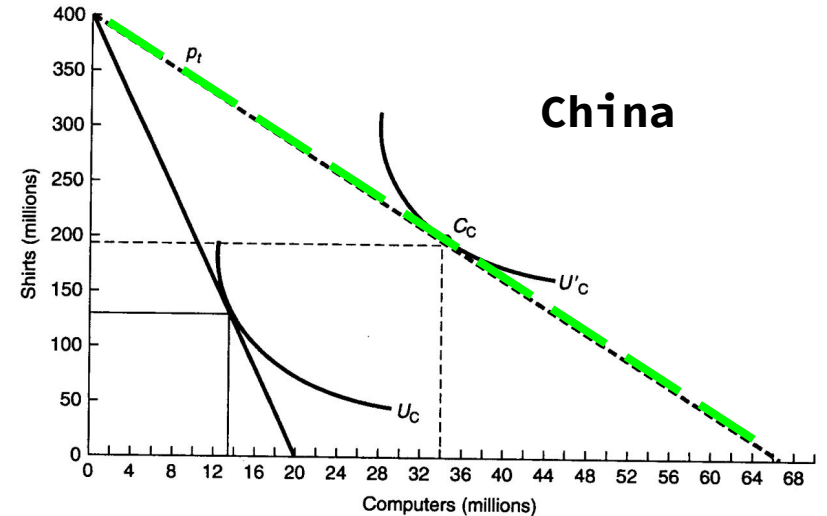
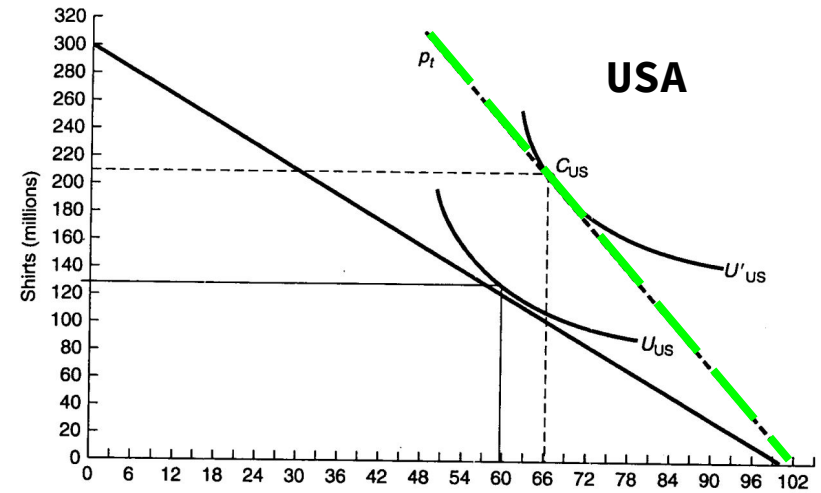
What happens if the two countries can trade with each other?

- USA specializes in producing computers
- China specializes in producing shirts



Comparative advantage

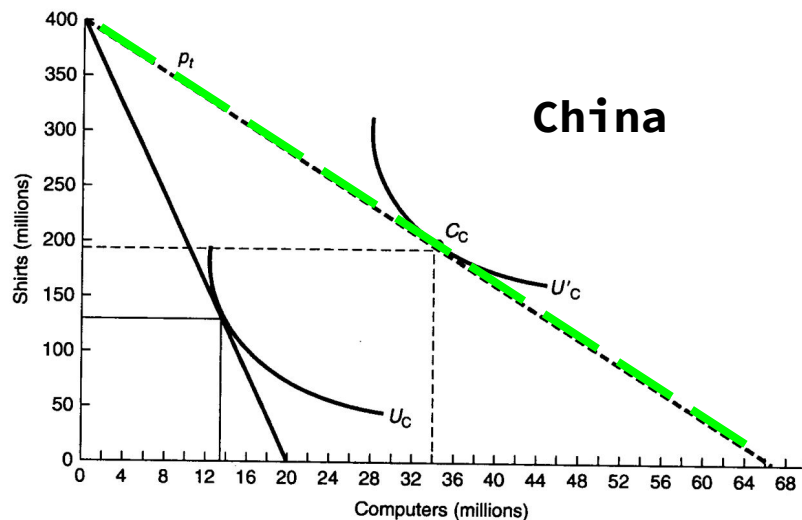
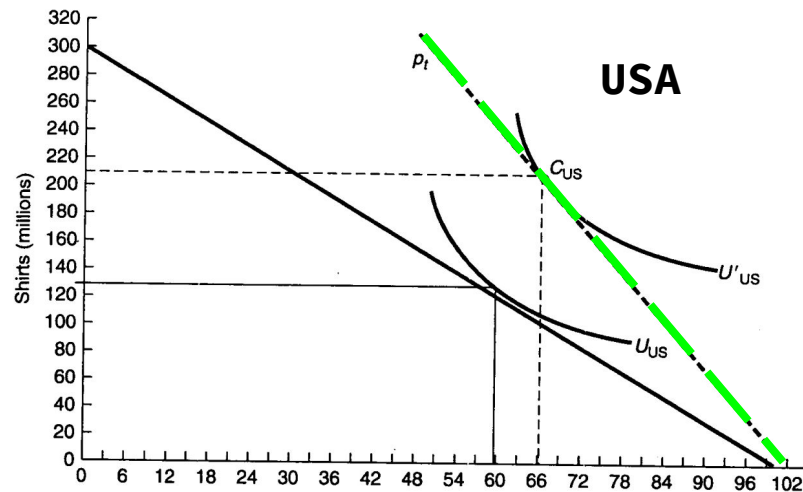
What does the **dotted line** represent?



Comparative advantage

In autarky, one computer costs 3 shirts in the US, but costs 20 shirts in China.

Under free trade, the countries trade at a price somewhere between those two rates. Let's assume: 6 shirts per computer.

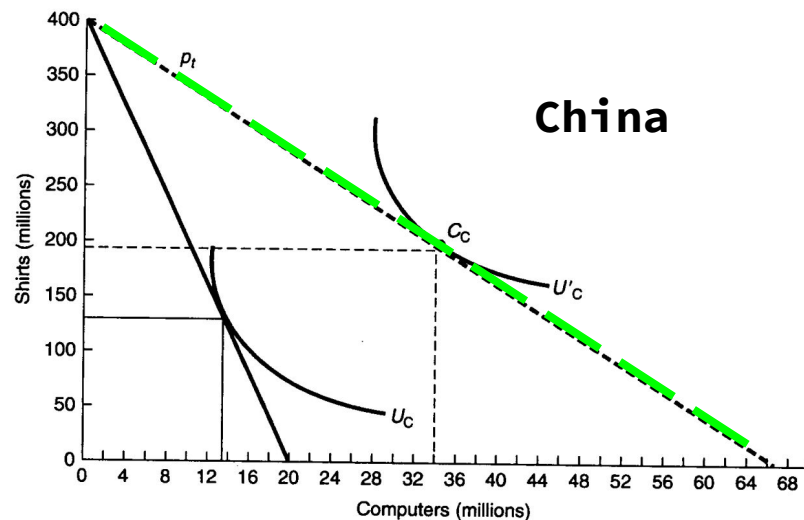
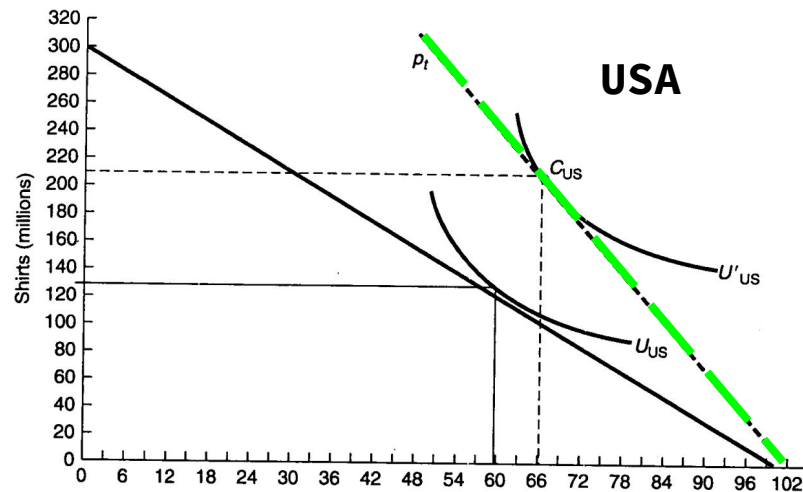


Comparative advantage

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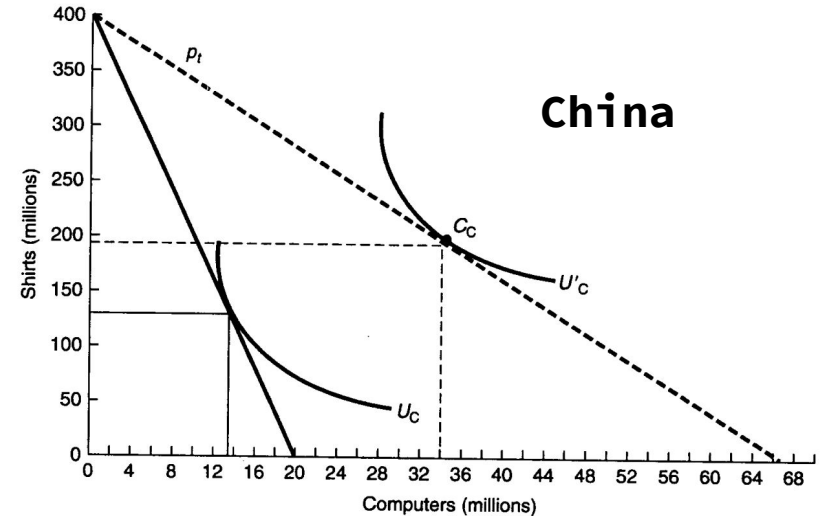
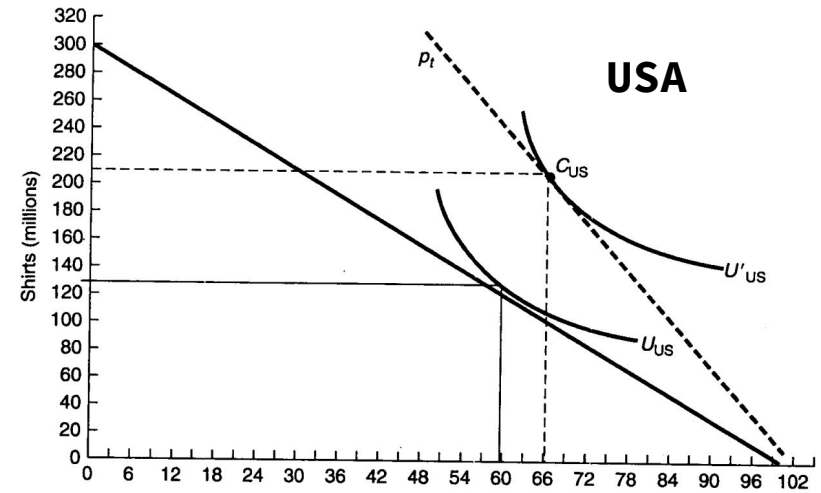
Under free trade, the countries trade at a price somewhere between those two rates. Let's assume: 6 shirts per computer.

- For the US, one computer can now “buy” 6 shirts from China, instead of just 3 shirts in the US.
- For China, one computer costs 6 shirts to buy from the US, as opposed to 20 shirts to produce domestically.



Comparative advantage

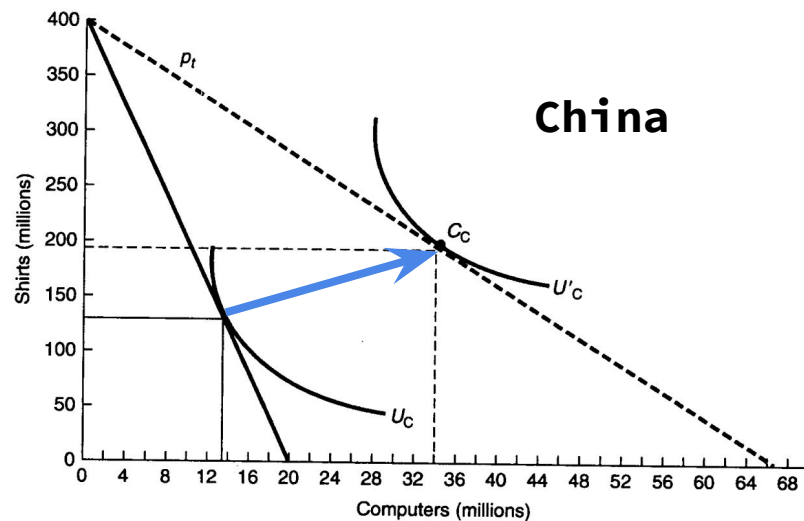
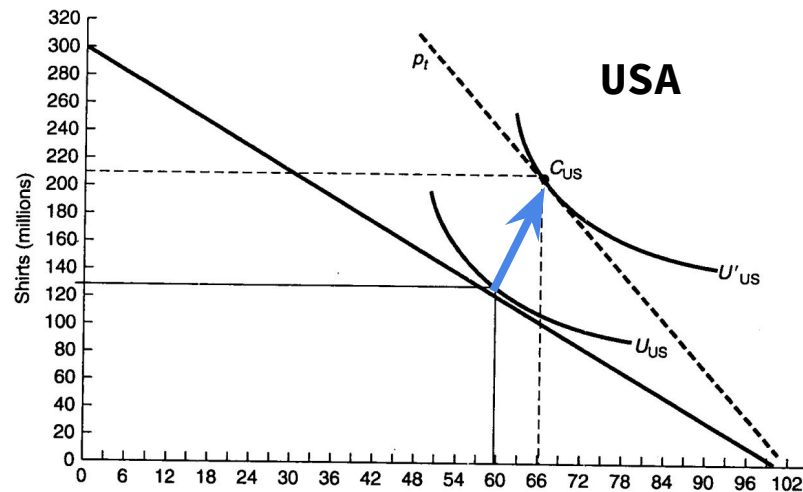
What does this mean for consumers?



Comparative advantage

What does this mean for consumers?

More consumption of *both goods* = higher utility!



Breakout room activity

- 1. Explain the assumptions and results of these models of trade:**
 - a. Heckscher-Ohlin Model
 - b. Stolper-Samuelson Theorem
 - c. Ricardo-Viner Model (aka “Specific factors model”)

- 2. Imagine that you are an intrepid team of empirically-inclined economists:**
 - a. Come up with a research design that would allow you to test which model of trade applies in a particular real-world context.
 - b. List specific hypotheses (e.g., if Heckscher-Ohlin applies, we would expect to see X, but if Ricardo-Viner applies, we would expect to see Y...)

Group 1

— — —

Group 2

— — —

Group 3

— — —