**Lecture 2**

ECON 252

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**Mercantilism:**

* The wealth of a nation is measured by its stocks of precious metals (gold, silver etc.).
* Trade is a zero sum game
  + A country can only gain gold if another loses it
* Exports encouraged, imports restricted by most countries, in order to acquire more gold

**Adam Smith and the true wealth of nations:**

* The wealth of a nation depends on productivity, not on gold stocks
* Trade is *not* a zero sum game
  + Both sides can benefit from trade due to specialization
  + Gains from trade the result of absolute advantage
    - Absolute advantage: being able to produce a good using fewer inputs than another producer

**Gains from trade example (absolute advantage):**

|  |  |  |
| --- | --- | --- |
|  | Wheat | Cheese |
| England | **6 hours to produce one unit** | **4 hours to produce one unit** |
| France | **4 hours to produce one unit** | **6 hours to produce one unit** |

Notice that England as an absolute advantage in cheese. France has an absolute advantage in wheat.

Suppose England wants a unit of cheese and France wants a unit of wheat.

England could spend 6 hours producing a unit of wheat and France could spend 6 hours producing a unit of cheese.

Alternatively, England could spend 4 hours producing a unit of cheese and France could spend 4 hours producing a unit of wheat. England could then trade its unit of cheese for France’s unit of wheat.

In both cases, England gets a unit of wheat and France gets a unit of cheese.

With trade, both country’s needed to use 2 hours less of labor in order to achieve this.

Each country has been made better off by specializing in the good for which they have an absolute advantage.

**Gains from trade example (comparative advantage):**

|  |  |  |
| --- | --- | --- |
|  | Wheat | Cheese |
| England | **3 hours to produce one unit** | **4 hours to produce one unit** |
| France | **4 hours to produce one unit** | **6 hours to produce one unit** |

In this example, England has an absolute advantage in both goods. Can trade still benefit both countries? Adam Smith says no.

The Ricardian viewpoint says yes, both countries can still benefit by specializing in the good for which they have a comparative advantage.

**Comparative advantage:** Producing a good at a lower opportunity cost than another producer.

England has an opportunity cost of producing a unit of wheat of 3/4 a unit of cheese.

England has an opportunity cost of producing a unit of cheese of 4/3 a unit of cheese.

France has an opportunity cost of producing a unit of wheat of 2/3 a unit of cheese.

England has an opportunity cost of producing a unit of cheese of 3/2 a unit of cheese.

England has a comparative advantage in cheese. France has a comparative advantage in wheat. Ricardo says both sides can benefit from trade by specializing in the good for which they have a comparative advantage.

Thus we expect England to produce cheese, and trade for any wheat it needs. Trading for wheat doesn’t help England unless they can do so using less than 3 hours of labor. In 3 hours, England can produce ¾ of a unit of cheese. Thus England benefits if they can trade 3/4 of a unit of cheese (or less) for one unit of wheat.

Similarly, France should produce wheat and trade for cheese. They do not benefit unless they can get enough wheat to trade for cheese with fewer than 6 hours of labor. In 6 hours, France can produce 3/2 a unit of wheat. So France benefits from trade if they can trade 3/2 (or less) of a unit of wheat for a unit of cheese. Said another way, France benefits if they can trade 1 unit of wheat for 2/3 of a unit of cheese (or more).

Therefore both countries will benefit from trade whenever one unit of wheat can be traded for between 2/3 and 3/4 of a unit of cheese.

**Note:** In this simple two good two country example, it is impossible for one country to have a comparative advantage in both goods.

**Note:** It is possible for neither country to have a comparative advantage in either good. This occurs only when one row of the labor requirements is a multiple of the other. In this case beneficial trade can’t occur.

In our framework, trade makes both countries better off almost all of the time. Why then do some people oppose free trade? Three common arguments:

* The assumption that a worker can easily switch what he produces is unrealistic. If England only produces cheese, an English wheat farmer may be unemployed short term, and may have to buy new equipment or learn new skills to be able to find a job producing cheese.
* In the long run, the number of jobs is unaffected by trade. However, the mix of jobs available will change. Certain industries are often argued to be critical for all countries to be active in, even if they do not have a comparative advantage in these goods. For example, it is often argued that every country should have some agricultural presence, even if this is not where their competitive advantage lies, as the country should not risk starving if trading for food is no longer possible.
* Income inequality can be altered by trade. If a country imports a good that is made by low skill workers, and exports a good that requires high skill workers, we would expect high skill workers to earn even more and low skill workers to earn even less, widening the gap between the two. The desirability (or lack thereof) of an increase in income inequality is a matter of opinion however.