Global economy and Global economic Governance Intro

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Lecture 2. **Basics of the Word trade theory**

Understanding international trade

- The core areas for understanding international trade:
- - the reasons for trade
- - explanation of trade patterns
- - the gains from trade
- - or losses from restricting trade.
- - empirical evidence supplements the theoretical treatment. The European Union (EU), World Trade Organization (WTO) and the United Nations Conference on Trade and Development (UNCTAD) are institutionally involved in trade policy issues and their major concerns are included in the subjects to be studied

2. Basics of the Word trade theory

- The starting point for studying international trade:
- Why do countries trade with each other?
- How do countries gain from international trade?
- What determines the international pattern of specialization and the commodity and composition of trade?

Adam Smith

- Adam Smith had shown the gains of trade in the presence of *absolute advantage*;
- each country will benefit from specialization in those commodities in which it has an absolute advantage (i.e. can produce at lower real cost than another country),
- that is, the situation in which a country is more efficient in producing a good than another country.
- "Real cost," for Smith, meant the amount of labor time required to produce a commodity.

Adam Smith

- = Appears a reason for trade
- = if the good is cheaper in another country – the reason to buy it, if it is more expensive – the reason to sell it.
- As simple as that
- The concept compares productivity in a sector for a product.

David Ricardo model

- Ricardo's model shows that *mutual gains* from trade (and specialisation) arise even when one of the countries is less efficient in the production of all goods.
- Although the poor country may be less efficient overall, and thus not have an absolute advantage, it may still have a relative efficiency, giving it a *comparative advantage*.

The assumptions of the Ricardian model

- Each good is produced with the aid of one factor of production -labor.
- Labor works with land and capital but these other factors are suppressed in the model and the assumption is that the unit of labor works with fixed other inputs

Comparative advantage

England is more efficient at the production of both goods. Less labor is required to produce either good in England than in Portugal. Still Portugal has a comparative advantage in shoes, whereas UK has a comparative advantage in cloth

Days of labor	Portugal	UK
A pair of shoes	4	2
Cloth	12	4

The Ricardian model

- Developed by David Ricardo in the early nineteenth century to provide intellectual support for the abolition of Corn Laws in Great Britain – to promote the benefits of free trade in grain
- Ricardo's numerical example uses two countries, Portugal and England, and the production and trade of two products, namely wine and cloth.
- The Ricardian model remains the starting point of the international trade theory 200 years after Ricardo originally developed it.

Opportunity cost

- Example of two countries –USA and Colombia. And 2 products roses and PCs
- Some politicians denounced the growing imports of flowers into the United States, which they claimed were putting American flower growers out of business.
- And it was true that a growing share of the market for winter roses in the United States was supplied by imports from Colombia
- But was that a bad thing?

Opportunity cost

- In the USA the flowers must be grown in heated greenhouses, at great expense in terms of energy, capital investment, and other scarce resources.
- Those resources could be used to produce other goods.
- Inevitably, there is a trade-off. In order to produce winter roses, the U.S. economy must produce fewer of other things, such as computers.

Opportunity cost

- Suppose that the United States grows 10 million roses and that the resources used to grow those roses could have produced 100,000 computers instead.
- Then the opportunity cost of those 10 million roses is 100,000 computers.
- Conversely, if the computers were produced instead, the opportunity cost of those 100,000 computers would be 10 million roses.

Opportunity cost

- Colombian workers are less efficient than their U.S. counterparts at making sophisticated goods such as computers
- which means that a given amount of resources used in computer production yields fewer computers in Colombia than in the United States.
- So the trade-off in Colombia might be something like 10 million winter roses for only 30,000 computers.

Opportunity cost

- The opportunity cost of roses in terms of computers is the number of computers that could have been produced with the resources used to produce a given number of roses.
- The opportunity cost of the roses would be less in Columbia
- Opportunity cost for computers in the USA is lower.
- A given amount of resources used in computer production yields fewer PCs in Columbia than in the US
- This difference in the opportunity cost offers the possibility of the mutually beneficial rearrangement of the world production.

Comparative advantage. Gains of specialization

- Let the US stop grow roses and start produce more PCs
- Let Columbia grow roses
- If the US will devote resources to PCs instead of roses the USA and the world as a whole will produce more
- If specialization is according to comparative advantage, the total world production of both goods can be greater than under autarky.

Change in production

	M roses	Thousand PCs
USA	-10	+100
Colombia	+10	-30
Total	0	+70

Comparative advantage. Gains of specialization

- More generally, it can be shown that free trade, and hence specialization according to comparative advantage, will expand production and consumption possibilities in both countries.
- it is also possible to raise the standard of living

Gains from trade

- The reason that international trade makes an increase in world output is that it allows each country to specialize in producing the good in which it has a comparative advantage.
- A country has a comparative advantage in producing a good if the opportunity cost of producing that good in terms of other goods is lower in that country than it is in other countries.
- Two countries can trade to their mutual benefit even when one of them is more efficient than the other at producing everything
- Producers in the less efficient country can compete by paying lower wages

Importance of trade

- Trade brings not only benefits of choosing lower priced goods in another country
- Trade determines specialization
- It is an indicator to people, cos. and countries of what to produce in a more efficient way

Testing the model

- The empirical evidence validates the predictions of the Ricardian model that:
- 1. Except when labor inputs are equal across countries, gains from trade exist
- 2. A country exports the commodity in which it has a comparative labor cost advantage and imports the commodity in which it has a comparative disadvantage

The models and reality

- We need to be careful when applying the Ricardian model, or any other model.
- Leamer and Levinsohn provide the following sobering advice:
- 1. Don’t take trade theory too seriously.
- 2. Don’t take trade theory too casually.
- The Ricardian model, like all economic theory, is not meant to be taken literally. It is a simplified version of reality, meant to elucidate certain key points, not to describe it exhaustively.
- It is useful to establish how important comparative advantage is, rather than showing that it is not always exactly true.