Econ 340
Lecture 3
Comparative Advantage and the Gains from Trade

Outline: Comparative Advantage and the Gains from Trade
• Why Countries Trade
  – Price Differences
  – Supply and Demand
  – Determinants of Prices
• Ricardian Model of Trade
  – Examples
  – Wages and Prices in the Ricardian Model
  – Lessons from the Ricardian Model
• Generality of the Gains from Trade
• Identifying Comparative Advantage
• Critiques of Comparative Advantage

Why Countries Trade
• Price differences
  – If prices differ by more than transport costs
    • Buyers in high-price country will import
    • Sellers in low-price country will export
    • Anybody in any country can profit by doing both:
      – Buying in low-price country
      and
      – Selling in high-price country
Why Countries Trade

Thus, in all cases:

\[ P_A < P_B \]
may lead to: trade \( A \rightarrow B \)
that is, \( A \) exports
\( B \) imports

\[ P_A < P_B \]
will lead to: trade \( A \rightarrow B \)
if \( P_B - P_A > t \)
\( t = \text{trade cost} \)

Why Countries Trade: Supply and Demand

"Autarky" = No trade

Autarky price in country A

Autarky price in country B

Free Trade = No barriers to trade

\( P_F \) is defined by these two distances being equal.
Why Countries Trade: Supply and Demand

Note that price need not be half way between.

Use areas to measure gains and losses.

Loss of Consumer Surplus

Gains and losses from trade:
A’s demanders lose
Gains and losses from trade:
A’s demanders lose
- \( a \)
A’s suppliers gain
\(+ (a+b)\)
→ Country A gains
\(+b\)

Gains and losses from trade:
A’s demanders lose
- \( a \)
A’s suppliers gain
\(+ (a+b)\)
→ Country A gains
\(+b\)
B’s demanders gain
\(+ (c+d)\)

Gain of Consumer Surplus
A's demanders lose \(-a\)
A's suppliers gain \(+(a+b)\)
Country A gains \(+b\)
B's demanders gain \(+c+d\)
B's suppliers lose \(-c\) → Country B gains \(+d\)

Gains and losses from trade:

Country A

Country B

World gains \(+ (b+d)\)
What Determines Prices, and Thus Trade?

• Prices determined by
  – Productivity of labor (and other factors)
  – Price of labor (w=wage)
  – Exchange rate (E) (i.e., prices of currencies)

• Since w and E are largely common to all sectors
  – The main determinant of how individual sectors trade (i.e., whether they export or import) is Productivity in sectors
  – High (relative) productivity, i.e., output per worker
    • Implies low (relative) price
    • And hence export

Adjustment Mechanism

• What if all of a country’s prices are too high for it to export at all?
  Then either:
  – Exchange rate (value of currency) will fall
    • Because otherwise nobody would buy its currency.
  Or:
  – Wages will fall
    • Because nobody would hire its labor
  ➔ Either of these will lower the country’s prices

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Ricardian Model of Trade

- Due to David Ricardo (1772-1823)
- Assumptions:
  - Production uses only labor
  - Technology:
    - Constant unit labor requirements (labor per unit of output)
    - Or equivalently, constant labor productivities (output per unit of labor)
      (“constant” here means “does not vary with output”)

Example 1 (Absolute Advantage):

<table>
<thead>
<tr>
<th>2 goods</th>
<th>Food</th>
<th>Cloth</th>
</tr>
</thead>
<tbody>
<tr>
<td>2 countries</td>
<td>A=US</td>
<td>B=UK</td>
</tr>
</tbody>
</table>

- Data:
  - Labor requirements per unit
    - Food (hr/lb) | US | .01 | UK | .02 |
    - Cloth (hr/yd) | US | .02 | UK | .01 |
  - Labor endowment (workers) | US | 10 | UK | 10 |

Autarky Equilibrium (Example only)

| Labor allocations | Food | 4 | 6 |
| Cloth | 6 | 4 |

Production = Consumption

\[ \frac{4}{0.01} = \frac{6}{0.02} \]
Ricardian Model of Trade

- **Trade**
  - If countries had the same currency and same wage = $10/hr, then
  
  \[ P_{Food}^{US} = \$0.10 \]

  - Thus
    - US produces Food
    - UK produces Cloth
  - Suppose that they both completely specialize
    - (i.e., US produces only food and UK only cloth)

Ricardian Model of Trade

- **Trade Equilibrium**
  
  \[
  \begin{array}{c|cc}
  & US & UK \\
  \hline
  Food & .01 & .02 \\
  Cloth & .02 & .01 \\
  Labor & 10 & 10 \\
  \end{array}
  \]

  \[
  \begin{array}{c|cc}
  Production & Food & Cloth \\
  Possible Consumption & Food & Cloth \\
  \end{array}
  \]

Ricardian Model of Trade

- **Compare consumption in autarky and trade:**
  
<table>
<thead>
<tr>
<th>Consumption in Autarky</th>
<th>Food</th>
<th>Cloth</th>
</tr>
</thead>
<tbody>
<tr>
<td>Food</td>
<td>400</td>
<td>300</td>
</tr>
<tr>
<td>Cloth</td>
<td>300</td>
<td>400</td>
</tr>
</tbody>
</table>
Ricardian Model of Trade

- Compare consumption in autarky and trade:

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<th>Food</th>
<th>Cloth</th>
</tr>
</thead>
<tbody>
<tr>
<td>Food</td>
<td>400</td>
<td>300</td>
</tr>
<tr>
<td>Cloth</td>
<td>300</td>
<td>400</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Consumption with Free Trade</th>
<th>Food</th>
<th>Cloth</th>
</tr>
</thead>
<tbody>
<tr>
<td>Food</td>
<td>500</td>
<td>500</td>
</tr>
<tr>
<td>Cloth</td>
<td>500</td>
<td>500</td>
</tr>
</tbody>
</table>

- Trade permits consumption to be higher, of both goods, in both countries!
- Both countries gain from trade

Example 2 (Comparative Advantage):

- Data:
  - Labor requirements (US, UK, UK')
    - Food (hr/lb): .01, .20
    - Cloth (hr/yd): .02, .10
  - Labor endowment (workers): 10, 100

Now US has absolute advantage in both goods, i.e., it needs (a lot) less labor
Ricardian Model of Trade

• Does this matter for production, consumption, or trade? NO!
  – In autarky, UK could produce 300 food and 400 cloth, by allocating 6 workers to food and 4 to cloth.
  – So can UK′: by allocating 60 workers to food and 40 to cloth.

• How does this happen? Through prices and wages
  • Suppose initial wage is $10 in both US and UK′.
  • Then prices are:
  
<table>
<thead>
<tr>
<th></th>
<th>US</th>
<th>UK′</th>
</tr>
</thead>
<tbody>
<tr>
<td>Food</td>
<td>$.10</td>
<td>$2.00</td>
</tr>
<tr>
<td>Cloth</td>
<td>$.20</td>
<td>$1.00</td>
</tr>
</tbody>
</table>

  • Disequilibrium!
    – Nobody would buy from UK′
    – At least to $2.00
    – No labor demand in UK′
    – At most to $0.50
    – Wage in UK′ must fall

Ricardian Model of Trade

  – With trade, UK could produce 1000 cloth by allocating all 10 workers to cloth.
  – So can UK′, by allocating all 100 workers to cloth.
  – With trade, UK could consume 500 food and 500 cloth, by exporting 500 cloth.
  – So can UK′, by trading as before!
Lecture 3: Comparative Advantage

Ricardian Model of Trade

One possible trade equilibrium for US and UK′

<table>
<thead>
<tr>
<th>Wage of Labor</th>
<th>US</th>
<th>UK′</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>$10.00</td>
<td>$1.50</td>
</tr>
</tbody>
</table>

This works! Free trade prices

<table>
<thead>
<tr>
<th>Gains from trade</th>
<th>Wage in units of</th>
<th>US</th>
<th>UK′</th>
</tr>
</thead>
<tbody>
<tr>
<td>Food</td>
<td>100</td>
<td>100</td>
<td>5</td>
</tr>
<tr>
<td>Cloth</td>
<td>50</td>
<td>67</td>
<td>10</td>
</tr>
</tbody>
</table>

What the wage can buy

Ricardian Model of Trade

• Implications for Fears of Trade
  – Low productivity country (UK′) can still compete, because of its low wage
  – High wage country (US) can still compete because of its high productivity

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Gain from Trade in General

- This is a very simple model
- But it does generalize to less restrictive assumptions (trust me!)
  - Many goods (not just 2)
  - Many countries (not just 2)
  - Many other assumptions can also be relaxed

Gain from Trade in General

- Sources of gain from trade
  - Most sources of gain are analogous to how individuals gain from trade
  - Comparative advantage focuses on
    - Differences in ability to produce goods
  - Other sources of gain, not in this model
    - Differences in tastes
    - Economies of scale

Gain from Trade in General

- What trade does not do:
  - Trade does not help everybody
    - There are losers from trade
      - See Giles
      - We’ll see later in the course who they are
  - Trade does not reduce inequality
    - At least not necessarily; it could, in some cases
    - But there are also good reasons why it may increase inequality
Gain from Trade in General

• What trade does not do:
  – Trade may not cause countries to grow faster
    (There is debate on that. See Giles.)
  – Trade certainly does not fix all problems
    • Weak or corrupt government
    • Failure to save
    • Poor technology
      (Look at UK. It gains from trade, but it is still very poor.)

Gain from Trade in General

• Implications for Trade Policies
  • Autarky is not realistic, but “protection” (i.e., tariffs, quotas, etc.) is very realistic
  • Result that there is gain from trade does extend to reducing protection
    – There are exceptions – we’ll see later
    – But in most cases, countries (as a whole) do gain from reducing their tariffs
      • Even if other countries do not reduce tariffs
    – Countries also gain when other countries liberalize

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Identifying Comparative Advantage

- Definition: A country has a comparative advantage in a good, relative to another good and another country, if its relative cost of producing the good is lower than the other country's.

(This comparison should be done in autarky, i.e., when they do not trade, because costs may change as a result of trade.)

Identifying Comparative Advantage

- If \( C_{c} \) is the cost of producing 1 unit of good \( g \) in country \( c \), then country 1 has a C-A in good 1 (compared to good 2 and country 2) if

\[
\frac{C_{11}}{C_{21}} < \frac{C_{12}}{C_{22}}
\]

Here, Peru has C-A in ham because

\[
\frac{7}{14} < \frac{6}{9} \quad \text{i.e.,} \quad \frac{1}{2} < \frac{2}{3}
\]

And Iran has C-A in eggs because

\[
\frac{9}{6} < \frac{14}{7}
\]

Examples

- Given data on unit labor requirements, since cost is proportional to these, look for where these are relatively low:

<table>
<thead>
<tr>
<th>Labor per unit output</th>
<th>Country</th>
<th>Iran</th>
<th>Peru</th>
</tr>
</thead>
<tbody>
<tr>
<td>Good</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Ham</td>
<td>6</td>
<td>7</td>
<td></td>
</tr>
<tr>
<td>Eggs</td>
<td>9 14</td>
<td></td>
<td></td>
</tr>
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Identifying Comparative Advantage

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<td>9</td>
<td>14</td>
<td></td>
</tr>
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</table>

- In this example, you could also compare across countries:
  - Although Peru's labor requirement is higher than Iran's in both goods,
  - it is only 1/6 higher in Ham and it is 5/9 (>1/6) higher in Eggs

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<tr>
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<td>7/6</td>
</tr>
<tr>
<td>Eggs</td>
<td>14/9</td>
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</tbody>
</table>

Is the Theory of Comparative Advantage Correct?

- It's not easy to test, for reasons explained in Dizikes article
  - Model says countries don't produce at all where they have no comparative advantage; so how can you measure productivity there?
  - Economists Costinot and Donaldson get around this with data on land characteristics
  - They find support for the theory
Is the Theory of Comparative Advantage Correct?

- Problem: Comparative Advantage is defined in terms of autarky prices
  - These normally cannot be observed
  - Bernhofen & Brown do observe them from historical Japan, which was closed to trade prior to 1859
  - They found:
    - "Japan exported products with relatively low prices during autarky and imported products that had relatively high autarky prices."
    - Gains were 7% of GDP

How Large Are the Gains from Trade?

- Costinot and Rodriguez-Clare use a model to estimate the gains from trade
  - Their estimate for the US today ranges from 2% to 8% of GDP
  - Why the large range?
    - It depends crucially on the "elasticity of demand for imports"
    - This determines how easily consumers are able to substitute domestic goods for imports
    - If low, then we need imports more than if high

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Critiques of Comparative Advantage

• Some argue that Ricardian assumptions no longer hold
  – Some say the Ricardian Model assumes
    • Factors are freely mobile within countries
    • Factors are immobile between countries
  – Without these assumptions, they say, countries lose from trade
  – NOT TRUE! Relaxing either assumption does not interfere with the gains from trade

Critiques of Comparative Advantage - Bivens

• See reading by Josh Bivens
• Writes from Economic Policy Institute, which is often critical of free trade
• He doesn’t question that there are gains from trade
• What he questions is the size of the gains
  – He cites authors at the Peterson Institute who quote figures that he says are way too large
  – (Peterson bases its estimates on study by Brown, Deardorff, and Stern)

Critiques of Comparative Advantage - Bivens

• Bivens’s objects to high estimates of gains from trade, because
  – Much of the gain comes from expanded trade in services
    • Estimates on trade barriers in services are very uncertain (Yes!)
    • Thus he says we should not expect gains from service trade (No!)
  – Estimates ignore the effects of trade on the distribution of income (Yes)
Critiques of Comparative Advantage - Prestowitz

- Prestowitz cites a study by 3 very respected (by me) economists
  - They measure losses from increased trade with China
  - Find them to be significant
- Prestowitz concludes that US may have lost from this trade
  - Yes, there are both losses and gains
  - Large losses, yes, but even larger gains

Critiques of Comparative Advantage - Prestowitz

- Prestowitz also claims that the case for the gains from trade assumes:
  - Perfect competition, No economies of scale
  - No cross-border flows of investment, technology, or people
  - Full utilization of all resources, No costs of adjustment
  - Fixed exchange rates
  - That losers from trade (who exist, but whose losses are temporary) will be compensated by the winners
- And that these assumptions do not hold.
- He’s:
  - Right that these assumptions do not hold
  - Wrong that the gains from trade require them

Conclusion

- Bottom line from all this
  - Yes, there are losers from trade
  - Gains from trade, especially from comparative advantage, outweigh the losses
  - Note also (see Brooks) that countries have done much better with trade than without, and not just in income – also reduced child mortality and increased education
Next Time

• Modern Theories and Additional Effects of Trade
  – Other theories of trade that are more realistic than the Ricardian Model
  – Effects of trade on other things, such as wages
  – How some will lose from trade