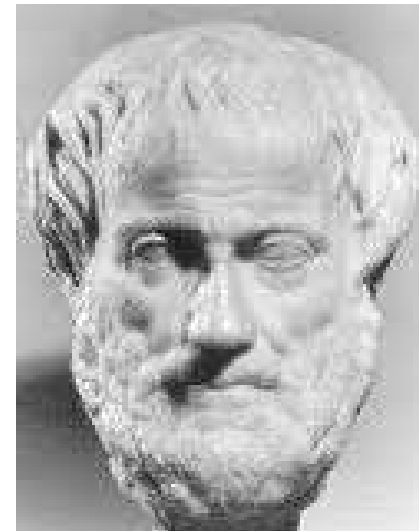


Specialization

"Every work is better done which receives of the sole, and not the divided, attention of the worker."

"We are what we repeatedly do. Excellence, then, is not an act, but a habit."

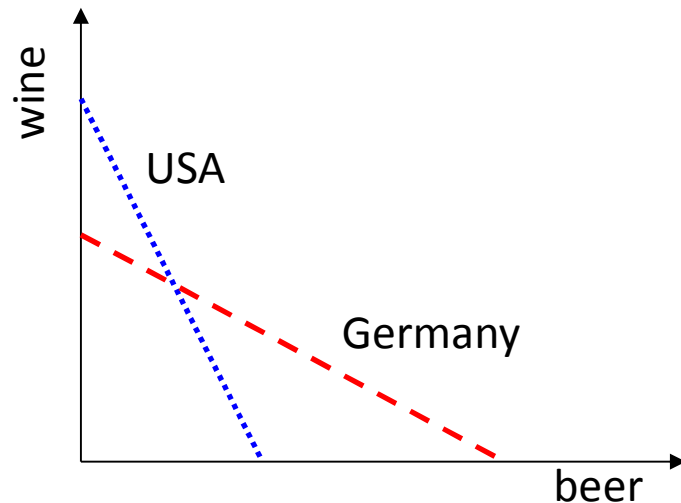
– Aristotle



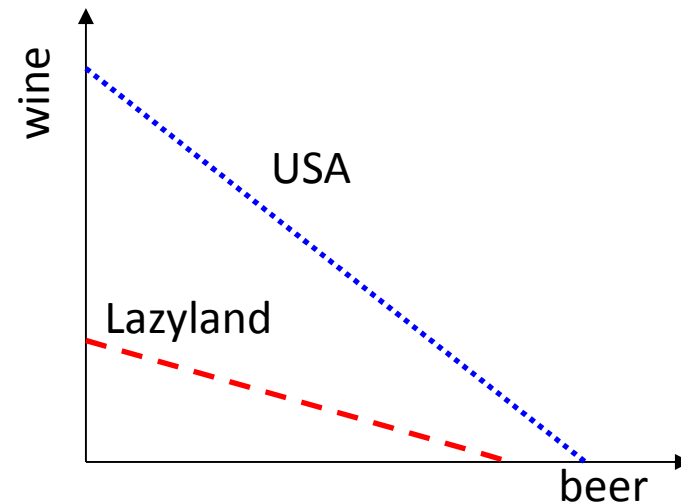
International trade theory in a nutshell

- Specialization and trade results in mutual welfare gains
- Reason: exploitation of absolute and comparative advantages

Production possibility frontiers of two countries in case of *absolute* advantage [Smith]



Production possibility frontiers of two countries in case of *comparative* advantage [Ricardo]



In both cases the USA specialize in production of wine, Germany/Lazyland in beer

Example continued: Wages and prices

- Comparative advantage: specialize and trade
- But, what will induce countries to do that?
 - Answer: prices (wages, in our simple context)
- Assume countries share same currency and wages \$10/hr

Wages and prices in autarky	US	Germany
Labor (\$/hr)	\$10	\$10
Wine (\$/l)	\$0.10	\$0.20
Beer (\$/l)	\$0.20	\$0.10

- We can get prices by multiplying wages by u.l.r. (why?)
- Price difference leads to trade (e.g. wine is cheaper in US)

Example continued: Wages and prices

- Remember that allowing for free trade between the two countries leads to full specialization:

Production under free trade	US	Germany
Wine (l/hr)	1000	0
Beer (l/hr)	0	1000

- We had supposed that they trade half their output

Consumption under free trade	US	Germany
Wine (l/hr)	500	500
Beer (l/hr)	500	500

- By specializing and trading both countries have gained

Example continued: Wages and prices

- Now consider US and Lazyland

Wages and prices in autarky	US	Lazyland
Labor (\$/hr)	\$10	\$10
Wine (\$/l)	\$0.10	\$2.00
Beer (\$/l)	\$0.20	\$1.00

- Both goods are cheaper in the US → *both exported?*
 - No; no way of paying for goods from US indefinitely
 - Wages adjust till “Lazy” workers become competitive
 - In practice: different currencies (exchange rates)
- How far should the wage in Lazyland fall?

Example continued: Wages and prices

- Suppose wages in Lazyland to be \$1.50/hr

Wages and prices under free trade	US	Lazyland
Labor (\$/hr)	\$10	\$1.50
Wine (\$/l)	\$0.10	\$0.30
Beer (\$/l)	\$0.20	\$0.15

- Beer is cheaper in Lazyland and wine cheaper in US
- Under full specialization and free trade, what will prices be?
- The fall of wages in Lazyland seems to have made workers worse off by trade → NO, real wages go up!
- US workers also enjoy the gains of trade
- True, US workers are much better off than “lazy” workers, both in autarky and under free trade → Why?

Some unrealistic features so far...

- What if there are transport costs?
- What if there are more than one factor?
- What if there are more than two goods/countries?
- Will there always be complete specialization?

Transport Costs and Non-tradable goods

- If there are transport costs, the competitiveness edge of a country must more than make up for this transport cost.
- Otherwise, the good will not be traded, even if it is cheaper to produce in one country. This good is called non-tradable.
 - In reality, economies spend large proportions of their income in these type of goods.
- It can become tradable, if transport costs fall or the productivity advantages widen (globalization).

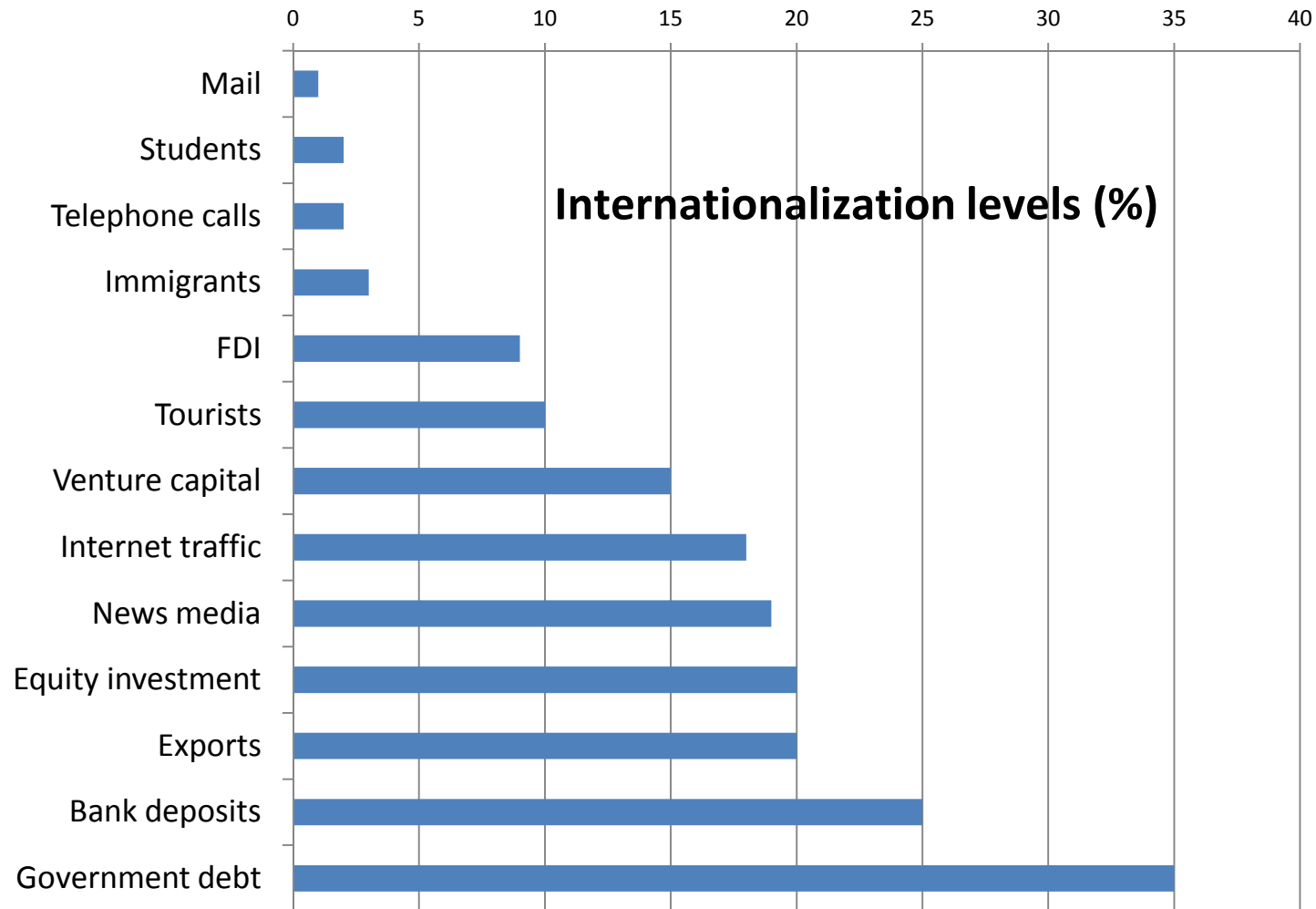
Global markets vs. local markets

TRADABLES and NON-TRADABLES

- Tradable goods can travel across borders and have international markets that set prices.
- Non-tradable goods have their prices set by supply and demand in local markets.
 - Often, the same good exists in different countries because it is produced locally.
- With globalization, many goods and services have become tradable.

	Non-tradables	Tradables
Goods	<ul style="list-style-type: none"> • Cement • Housing • McDonalds Hamburger 	<ul style="list-style-type: none"> • Textiles • Machinery • Almost all goods
Services	<ul style="list-style-type: none"> • Hairdressers • Government services • Auto-repair • Almost all services 	<ul style="list-style-type: none"> • Consulting • Banking • Telecom's • Tourism

Internationalization levels



Source: TK, cited in Ghemanwat "World 3.0".

The Ricardian model: one factor (labor)

- Goods are competitively produced from a single factor of production (*labor*)
- Technologies differ across countries and goods
- Two goods and two countries
- Labor is immobile between countries but mobile within each
- Countries export the good in which they have comparative advantage
- If technologies are the same then NO trade
- Alternative: Heckscher-Ohlin model (multiple factors)