

Suggested additional literature

- Sachs, J. & F. Larrain: Macroeconomics in the Global Economy, 2001
- Krugman, P. & M. Obstfeld: International Economics – Theory and Policy, 7. Ed., Boston 2006, chapters 2-7 (also available in German as “Internationale Wirtschaft – Theorie und Politik der Außenwirtschaft”)

Misconceptions About Comparative Advantage

1. Free trade is beneficial only if a country is more productive than foreign countries.
 - But even an unproductive country benefits from free trade by avoiding the high costs for goods that it would otherwise have to produce domestically.
 - High costs derive from inefficient use of resources.
 - The benefits of free trade do not depend on absolute advantage, but on comparative advantage: specializing in industries that use resources most efficiently.

Misconceptions About Comparative Advantage

1. Free trade is beneficial only if a country is more productive than foreign countries (*examples*).
 - “No need to reinvent the wheel”
 - Cell phones, Internet, technology in general
 - This technology can in turn be used for local production

Misconceptions About Comparative Advantage (cont.)

2. Free trade with countries that pay low wages hurts high wage countries.
 - While trade may reduce wages for *some* workers, thereby affecting the distribution of income within a country, trade benefits consumers and other workers.
 - Consumers benefit because they can purchase goods more cheaply.
 - Producers/workers benefit by earning a higher income (by using resources more efficiently and through higher prices/wages).

Misconceptions About Comparative Advantage (cont.)

2. Free trade with countries that pay low wages hurts high wage countries (*examples*).
 - Steel industry in the US → Highly subsidized and unionized
 - Protection for some at the expense of:
 - Higher prices
 - Less consumption
 - Higher income for some but less overall
 - Pollution!

Misconceptions About Comparative Advantage (cont.)

3. Free trade exploits less productive countries.
 - While labor standards in some countries are less than exemplary compared to Western standards, they are so with or without trade.
 - Are high wages and safe labor practices alternatives to trade? Deeper poverty and exploitation (e.g., involuntary prostitution) may result without export production.
 - Consumers benefit from free trade by having access to cheaply (efficiently) produced goods.
 - Producers/workers benefit from having higher profits/wages—higher compared to the alternative.

Summary

- Comparative advantage:
 - Consumers react to **price** differences and buy from lower price foreign producers the goods in which their country does not have comparative advantage (gains from exchange).
 - Producers react to **price** differences and allocate resources to industries where relative productivity is higher, exporting those goods (gains from specialization).
- Every country always has an industry in which it has a *comparative* advantage and it is competitive in world markets for that industry.

A country has **Comparative Advantage** in a given good if its **relative productivity** in that good is higher than in other goods (lower *opportunity cost*)

Specialization according to **Comparative Advantage** creates **value**, by increasing output.

Does the decentralized international **market** achieve this pattern of specialization? How?

Who benefits and who loses from international trade in the free-market?

Among individuals within a country?

Among countries?

Summary: Policy implications

1. If countries are permitted to trade freely (and actually, even if that trade is restricted), and if they have competitive, undistorted markets, then they will export the good or goods in which they have comparative advantage and import those in which they have comparative disadvantage.

2. Under the same conditions, all countries will gain from trade, in the sense that those individuals who gain from trade within each country will gain enough that they could potentially fully compensate those individuals who lose, within the same country, and still remain better off than in autarky.

Reasons for absolute and comparative advantages I

- (Non-) availability [Kravis]

Trade results from objective non-availability of certain goods in some countries (e.g. raw material) or the prohibitive cost of production.
- Differences in productivity [Ricardo]

Differing production functions cause international differences in production possibility functions.
- Factor endowments [Heckscher / Ohlin]

Differing relative factor endowments of countries result in differing factor prices and thus differences in production cost for labor intensive and capital intensive products.

Reasons for absolute and comparative advantages II

- Technological gap [Posner] and product life cycle [Vernon]

Industrial countries have advantages for high-tech production. Technology diffusion gives rise to production of the goods in other countries.
- Domestic demand [Linder]

Specific domestic demand preferences may cause economies of scale and thus production cost advantages.
- Large scale economies and differentiated products [Helpman and Krugman]

A high potential of large scale economies (e.g. high R&D cost) results in first mover advantages. In differentiated markets this cost advantage may be sustainable and self-enforcing, as competitors may not reach a sufficient demand and output

Empirical Evidence

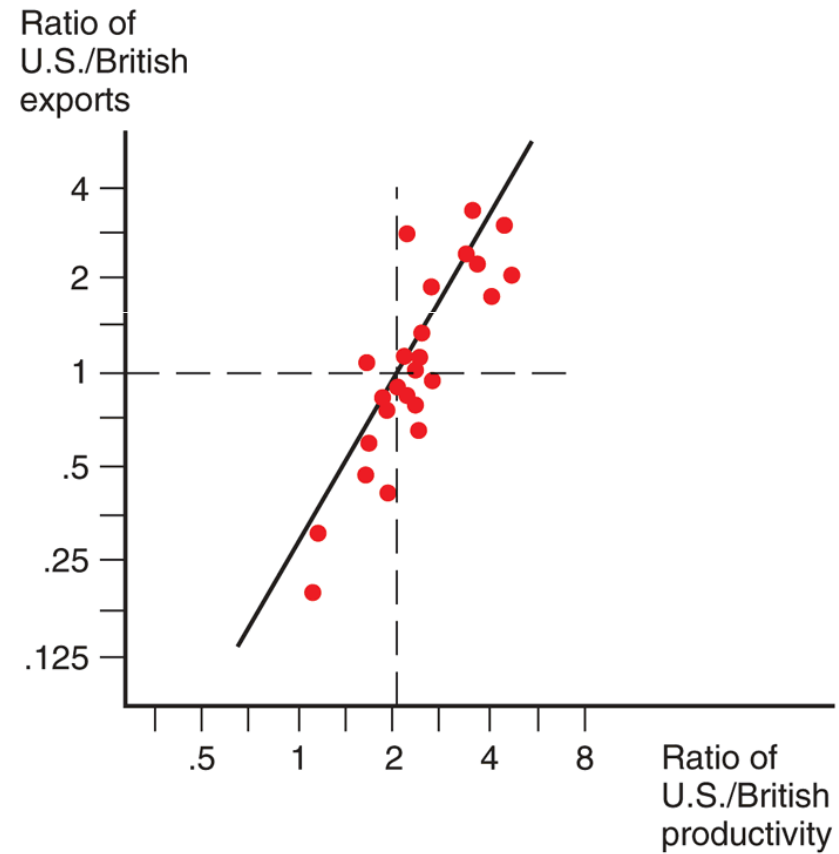
- Do countries export those goods in which their productivity is relatively high (Ricardo)?
- The ratio of US to British exports in 1951 compared to the ratio of US to British labor productivity in 26 manufacturing industries suggests yes.
- At this time the US had an absolute advantage in *all* 26 industries, yet the ratio of exports was low in the least productive sectors of the US.

Empirical Evidence (cont.)

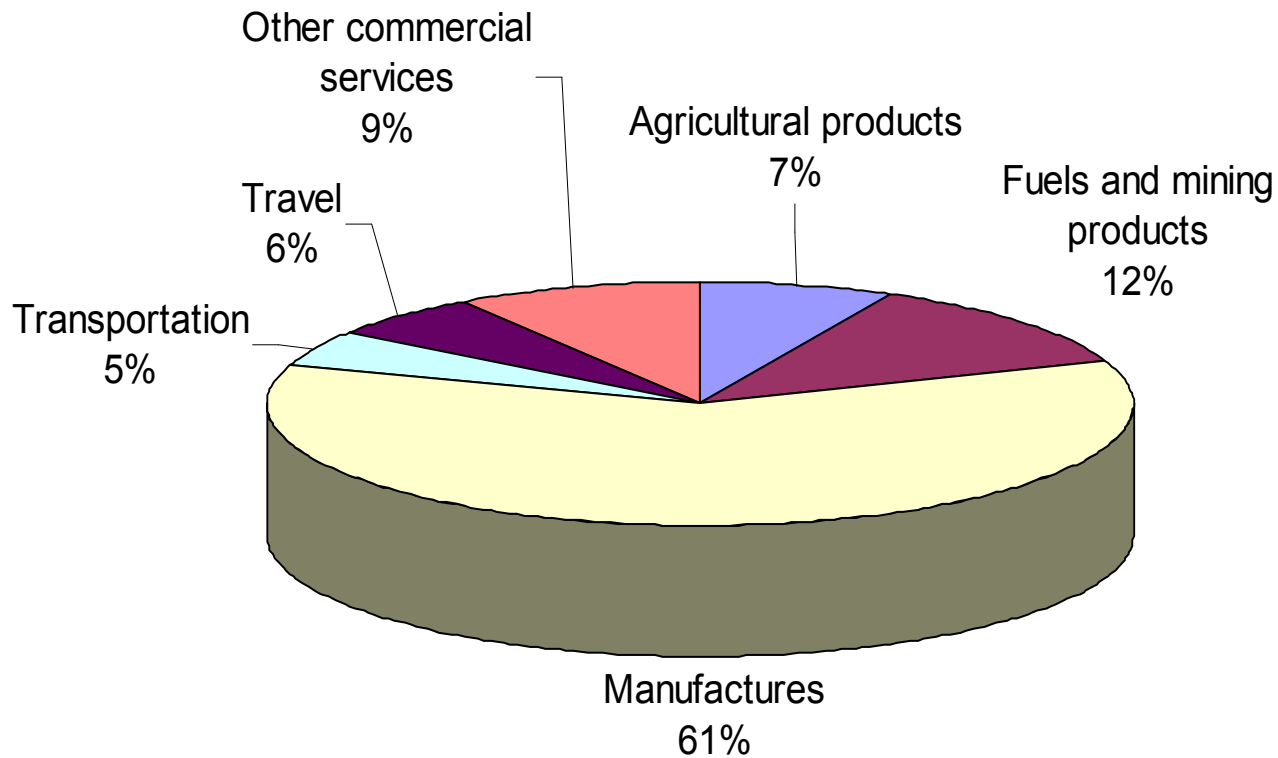
Figure 3-6

Productivity and Exports

A comparative study showed that U.S. exports were high relative to British exports in industries in which the United States had high relative labor productivity. Each dot represents a different industry.



The structure of world trade



Data source: WTO 07