Basic Principles

- We all have comparative advantages
- We are all made better off by specializing in our comparative advantage
- Economists refer to this as gains from trade.

Where do you find Specialization?

- Within a business
  - Different employees do different tasks
- With a country
  - Firms tend to buy a lot of inputs from other specialized firms.
  - Miller’s Pizzeria does not make its own flour or cheese.
- Between nations

The Growth in Trade

- Transportation and communication costs have fallen, making it profitable to ship many items around the world.
- A series of trade agreements has resulted in significantly lower tariffs (taxes on imports) and other barriers to trade. These include
  - The European Economic Community
  - NAFTA
  - ASEAN
  - The World Trade Organization

The Case for Trade

- The case for International Trade is the same as the case for domestic trade.
  - We can all gain by specialization, and the principle can easily be extended to the international arena.
  - After all, do I personally care whether my car comes from Detroit, Atlanta, or Japan?

A Little History

- Adam Smith and The Wealth of Nations
- Mercantilism
  - Stressed self-sufficiency
  - Measures well-being in terms of gold.
- Smith stressed standard of living
An Example

<table>
<thead>
<tr>
<th>Output Per Day of Work</th>
<th>T-shirts</th>
<th>Music CDs</th>
<th>Relative Cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>United States</td>
<td>20</td>
<td>10</td>
<td>2:1</td>
</tr>
<tr>
<td>Mexico</td>
<td>5</td>
<td>1</td>
<td>5:1</td>
</tr>
</tbody>
</table>

Key Points

- American workers are more productive than Mexican workers and will have higher wage rates.
- The workers of each nation have a comparative advantage.
  - In the CD industry, Americans are ten times as productive as Mexicans are.
  - In the T-shirt industry, American workers are only four times as productive.

The Gains from Trade

- If they trade, both parties will gain, despite
  - The American Worker’s fear of competing with "cheap foreign labor".
  - The Mexican Worker’s fear of competing against more productive workers.

The price of a t-shirt

- Absent International Trade
  - In the US, a Music CD costs two T-shirts, for that is the opportunity cost of producing a Music CD.
  - In Mexico, a Music CD costs five T-shirts, for that is the opportunity cost of producing the Music CD.

The price of a t-shirt

- With International Trade
  - The price of a Music CD, in terms of a T-shirt, the terms of trade, must be the same in both countries.
  - The price must be between 2 and 5 t-shirts; just what depends on supply and demand
- We will assume (so that we can get on with this example) that the actual price is 3:1.
The Gains from Trade

• Suppose 10 Americans switched from producing t-shirts to music CDs. Then
  – US T-shirt production declines by 200 t-shirts per day
  – US Music CD production rises by 100 music CDs per day.
• The US can trade the music CDs for 300 Mexican t-shirts for a net gain of 100 t-shirts in the US.

The Gains from Trade

• The Mexicans also gain. If 60 Mexicans switch from producing Music CDs to t-shirts, then
  – Mexican music CD production declines by 60 per day.
  – Mexican t-shirt production rises by 300 per day.
  – Mexicans can trade the t-shirts for music CDs for a net gain of 40 music CDs to Mexico.

A Tabular Presentation

<table>
<thead>
<tr>
<th></th>
<th>US</th>
<th>Mexico</th>
</tr>
</thead>
<tbody>
<tr>
<td>T-shirt Production</td>
<td>-200</td>
<td>300</td>
</tr>
<tr>
<td>CD-Production</td>
<td>100</td>
<td>-60</td>
</tr>
<tr>
<td>T-shirt imports</td>
<td>300</td>
<td></td>
</tr>
<tr>
<td>CD-imports</td>
<td></td>
<td>100</td>
</tr>
<tr>
<td>Net Gains</td>
<td>100 t-shirts</td>
<td>40 CD’s</td>
</tr>
</tbody>
</table>

Summary

• Whenever nations or individuals have comparative advantage, they gain from trade.
  – There are always comparative advantages.
• Other issues:
  – What causes Comparative Advantage
  – Objections to Free Trade
  – A history of trade policy

End

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