

Classical Trade Theories: Part I

Adam Smith and
Comparative Advantage

Comparative Advantage

- By mid-18th century, mercantilism out
- Adam Smith
 - Nations should act like households/individuals
 - Specialization allows all trading parties to gain
 - Amount of Specialization – depends on market size (ex. General Motors)
 - Specialization based on differences in ability

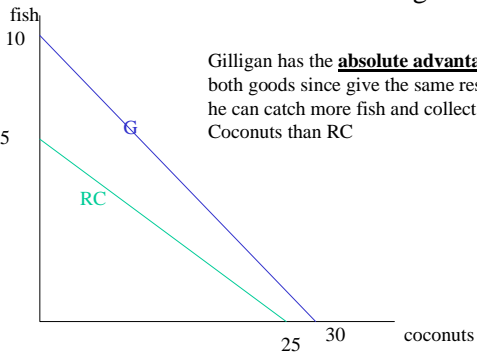
Specialization and Trade

- We are still producing on each PPF, but now have the ability to CONSUME outside the PPF of each country.
- But, how are we able to get the goods that the other country produces?
- DEFINITION The terms of trade tell us the rate at which a country can trade domestic products for imported products.

Comparative Advantage Example

- 2 people: Robinson Crusoe (RC), Gilligan (G)
- Each works 5 hours/ day
- RC: can catch 5 fish or collect 25 coconuts
- G: 10 fish or 30 coconuts

PPF and Absolute Advantage

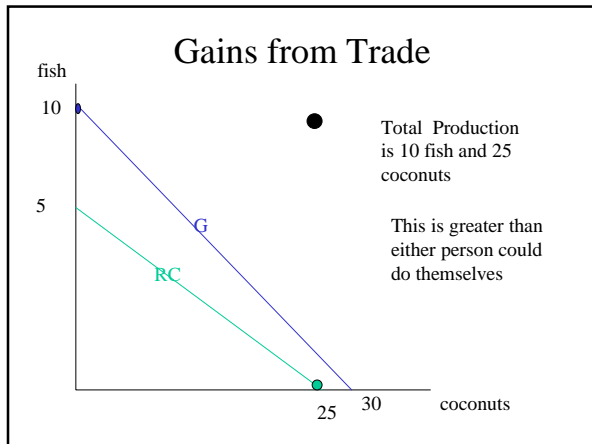


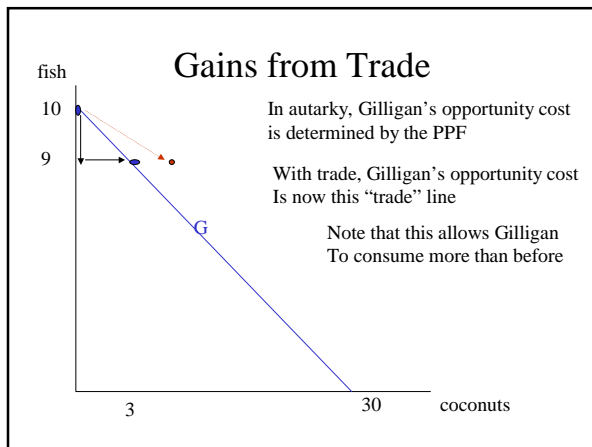
Opportunity Cost and Terms of Trade

- This is an opportunity cost chart for RC and G

	<u>1 fish</u>	<u>1 coconut</u>
RC	5 coconuts	1/5 fish
Terms of Trade		
Gilligan	3 coconuts	1/3 fish

So what would be a good terms of trade (fish per coconut?)





Terms of Trade

Another example:

- Japan - can produce 10 computers for every 1 tractor
- China - can produce 4 tractors for every 1 computer

Terms of Trade

Note:

- 1) There can be more than 1 terms of trade that will benefit both countries.
- 2) Even if you have an absolute advantage, there can still be gains from trade - trade is determined by specialization and comparative advantage, NOT absolute advantage.

More Examples

- Canada: Can produce 50 cars or 100 bushels of corn
- United States: 200 cars or 200 bushels of corn

- 1) Draw the PPFs for each country.
- 2) Determine the domestic opportunity costs for each country.
- 3) Determine who has the absolute and comparative advantages For each good.
- 4) Find a terms of trade (international opportunity cost) that allows both countries to benefit from trade.
