

Globalization is about liberalization

- The major economic feature of globalization is the liberalization of barriers to trade in goods and financial services and ownership

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Trade barriers

- Tariffs – taxes on imports
- Quotas – only specified amount allowed from each country
- Anti-dumping tariffs – taxes on countries found to have ‘dumped’ products
- Non-tariff barriers to trade (NTBs) – agricultural regulations, trucking regulations
- Procurement requirements – government must ‘Buy American’
- Foreign investment and other financial restrictions
- Labor movement restrictions

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Ricardo’s theory of comparative advantage

David Ricardo (1772-1823)

Principle of comparative advantage:

Nations always benefit when they allow free trade, because that encourages specialization in the products in which the nation is most productive.

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David Ricardo on comparative advantage:

- To produce the wine in Portugal, might require only the labour of 80 men for one year, and to produce the cloth in the same country, might require the labour of 90 men for the same time. It would therefore be advantageous for her to export wine in exchange for cloth. This exchange might even take place, notwithstanding that the commodity imported by Portugal could be produced there with less labour than in England. Though she could make the cloth with the labour of 90 men, she would import it from a country where it required the labour of 100 men to produce it, because it would be advantageous to her rather to employ her capital in the production of wine, for which she would obtain more cloth from England, than she could produce by diverting a portion of her capital from the cultivation of vines to the manufacture of cloth. [On the Principles of Political Economy and Taxation](#) par. 7.16 (See also pars. 7.13-7.15)

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Define comparative advantage

If there is only one factor of production, and constant costs, then can completely characterize economy by unit labor requirements and labor endowments.

Consider two countries, Benin and Nigeria, that can each produce two goods, groundnuts and kola nuts. Suppose that conditions in each of the countries are such that the unit labor requirements for producing each of these goods are different.

In Benin growing groundnuts is hard, it takes 1 (a_k) unit of labor to grow a ton of groundnuts, whereas it takes only $1/3$ (a_g) unit of labor to gather a ton of kola nuts in the forest.

In Nigeria, on the other hand, it takes $1/3$ (a_k^*) to grow groundnuts, and $1/4$ (a_g^*) to gather a ton of kola nuts in the forest. Notice that in Nigeria it takes less labor to do both- less labor to grow groundnuts, less to gather kola nuts.

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Define comparative advantage

- Representation of the two economies (algebraic)

	Benin	Nigeria
• kola	a_k	a_k^*
• gnut	a_g	a_g^*
• labor endow.	L	L^*

- Representation of the two economies (numerical)

• kola	1/3	1/4
• gnut	1	1/3
• labor endow.	10	20

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Comparative advantage

- Notice that $a_k > a_k^*$ and $a_g > a_g^*$ in the numerical example so Nigeria has absolute advantage in producing both kola and groundnuts.
- Also notice that $a_k^*/a_g^* > a_k/a_g$. We will say that this is the definition of comparative advantage. Nigeria has comparative advantage in groundnuts, Benin in kola, because *even though Nigeria is more productive at both, it is relatively more productive in groundnuts*.
- Notice that the ratio a_k^*/a_g^* is how many groundnuts a self-employed laborer would have to give up to get a ton of kola; or, if the laborer gave up ton of kola, how many groundnuts he or she would get. (A ton of kola requires a_k units of labor, and each unit of labor could have produced $1/a_g$ tons of groundnuts.)

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Comparative advantage

- The ratio of the unit labor productivities simply represents the opportunity cost of kola in terms of groundnuts.
- Saying that a country has comparative advantage in something is the same thing as saying it has a lower opportunity cost of producing that good.
- *It gives up fewer of the other good to get more of the good it has comparative advantage in, compared with the other country.*
- So there is a double comparison involved here, that is what makes it tricky!

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Comparative advantage

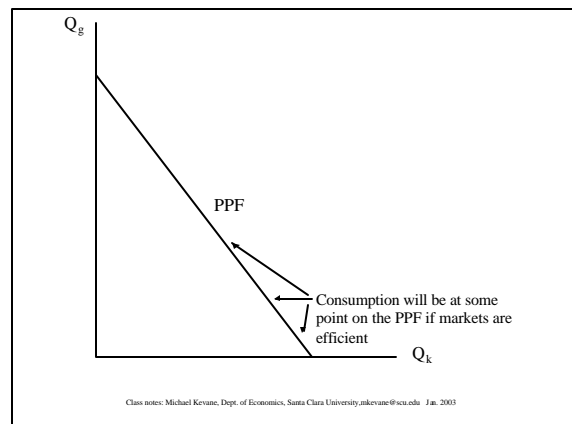
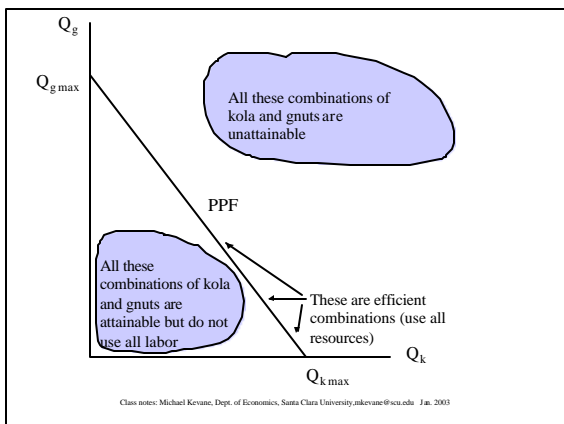
- To see exactly how and why free trade could benefit both the Beninois and the Nigerians, let us represent their economies with a graph of the production possibility frontier. Suppose the total endowment of labor in Benin was L , and in Nigeria L^* . The amount of labor used in the production of groundnuts, plus the amount used in kola nuts, cannot exceed this total (and will be equal to it if there is no benefit from laying around).

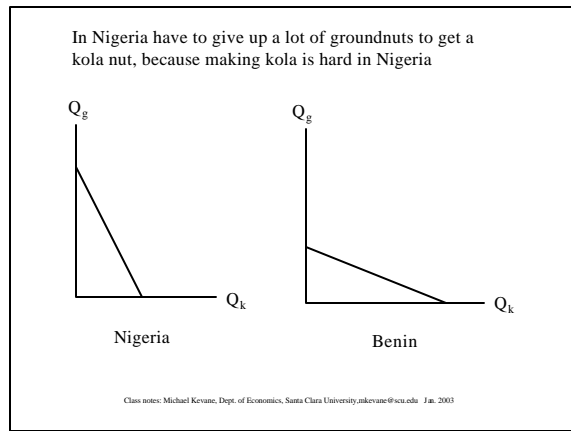
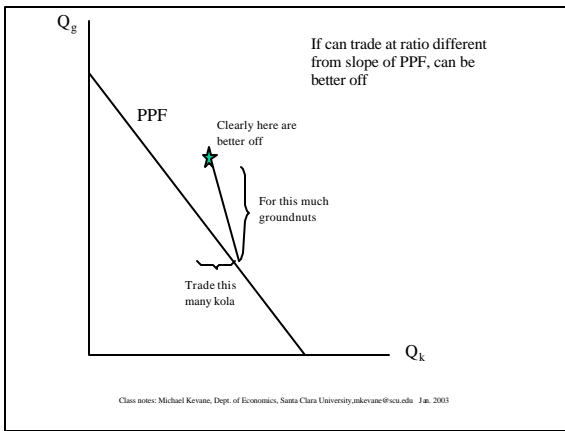
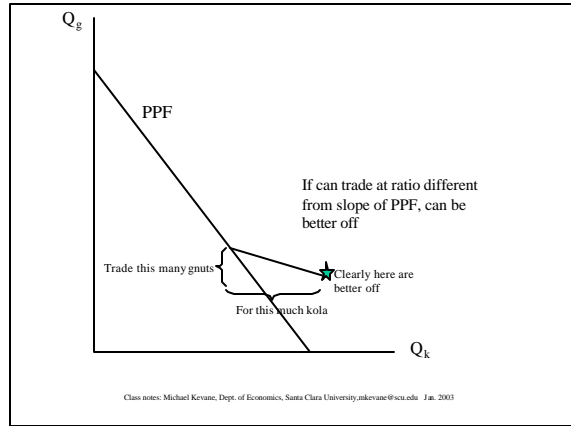
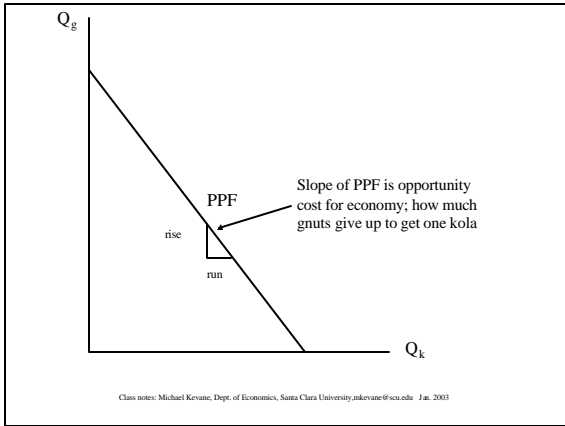
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Comparative advantage

- Therefore, we have the following equality if all labor is being used efficiently:
- $a_k Q_k + a_g Q_g = L$.
- We could graph this line, with the quantities produced measured on the axes.
- $Q_g = (1/a_g)L - (a_k/a_g)Q_k$.

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Comparative advantage

- But remember our premise: the countries will have different opportunity costs
- The countries will have different pre-trade prices
- So countries necessarily better off
- Trade simply expands the set of consumption possibilities

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Is this the whole story?

- Does comparative advantage mean everyone should always have free trade on everything?
- Why don't they?
- Perhaps the model is leaving out some important features of the real world?

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What were the crucial assumptions?

- only one factor of production: no distributional issues
- assumed technology was given, but where does it come from? How does technology change (learning by doing?)
- assumed constant costs, but some industries may have increasing returns
- assumed perfect competition, but sometimes industries are oligopolies- what should trade policy be in that case?

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Bottom line

- Have to understand logic of comparative advantage
- Protection comes at a cost: domestic resources will be used to produce something, when could obtain it with fewer resources if purchased from abroad
- Calls for protection have to be justified

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Think critically?

- Consider the assertions and ideas that follow

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Comparative advantage

- Paul Krugman's parable
 - Suppose a scientist finds a way to turn ordinary fast-growing Eucalyptus trees into cheap sugar; he would be hailed as genius
 - Then it is revealed that he actually is shipping the trees to The Philippines, and exchanging them for sugar!
 - Horrors! We must protect our American sugar industry

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The idea comparative advantage

- Why do countries benefit from trade? What products are countries likely to trade? You already know the basic answers to these questions from intuition-- replace countries with persons, and it is clear that people who are good with computers specialize in computers, and people who are good with the land work on the farms, and they specialize and trade the things they are good at. By analogy, it seems reasonable to say that countries benefit because trade allows them to take advantage of the efficiencies of specialization, and countries specialize in producing and exporting the goods in which they are efficient.

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Motivating the problem

- But what happens if a country trades with another country that is more efficient at producing all goods. This was perennial cry about Japan or Asian Newly Industrialized Countries (NICs, such as Singapore, Taiwan, Korea)- they are going to 'wipe out' America's economy. They will reach a point where they can produce everything cheaper. If the U.S. trades with them, won't we be unable to export? Wouldn't it be better to erect trade barriers to "save our economy"?

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Assertion 1a: Protectionism from low wage economies is good

"If the United States continues to allow free trade with the low-wage economies of Southeast Asia and Latin America we [assume you are both from the U.S.] will be digging our own graves. American firms cannot compete with those economies once they get access to our markets, because with their low wages they will be able to outsell us in every product line. Sooner or later, American firms will go out of business and workers will lose their jobs to low-cost labor from those countries."

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Assertion 1b: Protectionism from high productivity economies is good

"If Latin America and Southeast Asia continue to allow free trade with the high-productivity economy of the United States we [assume you are from L.A. or S.E. Asia] will be digging our own graves. Local firms cannot compete with those economies once they get access to our markets, because with their high-productivity they will be able to outsell us in every product line except low-value added export crops. Sooner or later, our firms will go out of business and workers will lose their jobs to big multinational corporations from those countries."

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