

What determines A's trade patterns?

Two facts from before:

1. Country A Exported F and Imported C

2.
$$\frac{a_{LF}}{a_{LC}} = \left(\frac{P_F^A}{P_C^A} \right)^{\text{autarky}} < \frac{P_F^W}{P_C^W}$$

Deductions:

There is a country B that Imports F and Exports C

$$\Rightarrow \frac{P_F^W}{P_C^W} < \left(\frac{P_F^B}{P_C^B} \right)^{\text{autarky}} = \frac{b_{LF}}{b_{LC}}$$

$$\Rightarrow \frac{a_{LF}}{a_{LC}} < \frac{b_{LF}}{b_{LC}} \text{ or equivalently } \frac{a_{LC}}{a_{LF}} > \frac{b_{LC}}{b_{LF}}$$

Opportunity Cost of F is lower in A than in B

Opportunity Cost of C is higher in A than in B

A country *exports* a good if the opportunity cost of that good in the country is *lower* than in other countries

A country *imports* a good if the opportunity cost of that good in the country is *higher* than in other countries

The Principle of Comparative Advantage

A has a comparative advantage in food (F) and B has a comparative advantage in clothing (C).

Comparative advantage

-Says nothing about *absolute* productivity.

uses information only on $\frac{a_{LF}}{a_{LC}}$ relative to $\frac{b_{LF}}{b_{LC}}$

-It says nothing about a_{LF} relative to b_{LF}

It's possible that:

$$a_{LF} < b_{LF} \text{ and } a_{LC} < b_{LC}$$

i.e. labor in A is more productive than labor in B
or A has an *Absolute Advantage* in both sectors

If that is the case:

Real wage in A > Real wage in B

(in both autarky and free trade)

(under *Perfect Competition*, a factor must be paid equal to its *Productivity*)

Important Conclusions:

Absolute Advantage determines relative Real Wages

Comparative Advantage determines Trade Patterns

Use this distinction to examine one of the most common incorrect arguments against trade, the "cheap labor" argument.

Usual form of argument:

- our industries cannot compete against countries with low wages
- the industries of low wage countries will flood us with cheap goods and ruin our industries
- so we cannot open our borders to trade with these "cheap labor" countries

But:

- reason for low wage is low productivity (absolute advantage)
- low wage has nothing to do with *relative* productivities (comparative advantage)

even if wages are very low in the rest of the world:

- one of A's industries will thrive and export
- workers in A will receive higher *real* wages after trade

Conclusions

- Differences in opportunity costs between countries provide the basis for trade
- This difference in opportunity costs is due to differences in technology
- Principle of comparative advantage
- A country specializes in production of the good in which it has the lower opportunity cost relative to other countries; it exports that good and imports the other good
- All countries can gain from trade
- Low wages result from low productivity
- Low wages in the foreign country do not change the benefits from international trade