



POLI 142A: United States Foreign Policy

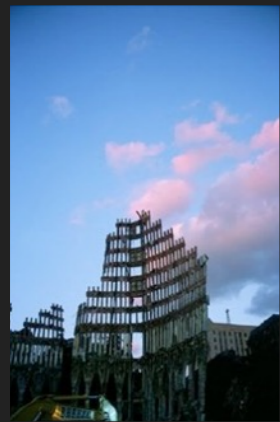


Comparative Advantage

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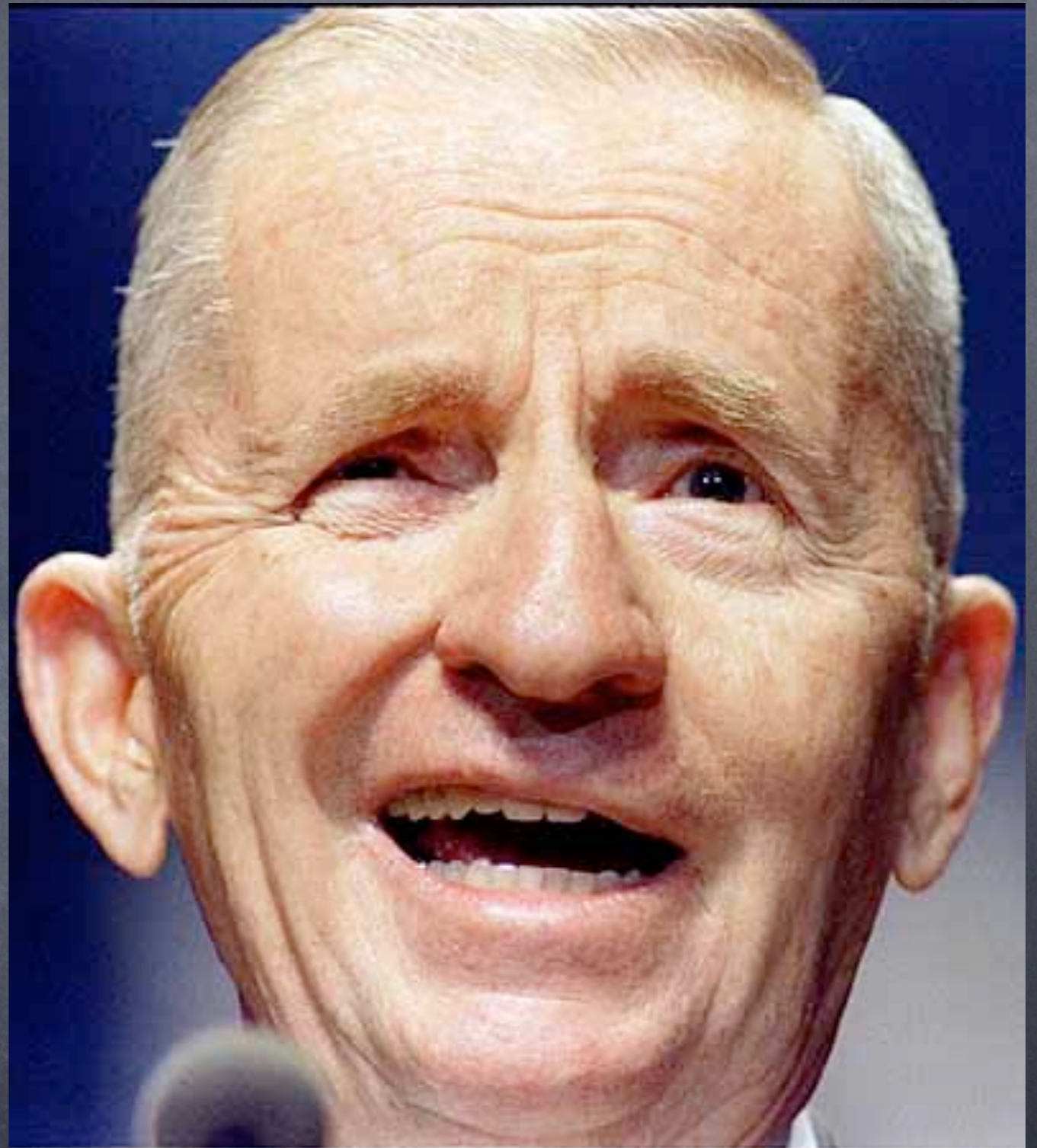
Introduction

- Comparative Advantage is the most important concept in the political economy of trade
- Also most difficult (often misunderstood)
- Cannot decipher debate about free trade without understanding comparative advantage

What's all the yelling about?

- ① Probably no concept in the study of human social behavior over which there is more consensus from experts
- ① Almost every professional economist accepts the basic virtue of freer international trade
- ① And yet there is a basic tension between the logic of free trade as presented by liberals and criticism by economic nationalists. Why?

“NAFTA will
cause a giant
sucking sound as
jobs go south.”





“Free trade has always been an ideology of elites, of academics, scribblers and think-tank denizens. The people never wanted NAFTA, MFN for China or a WTO... When it comes down to who gets the factory and who gets the jobs, us or them, we are almost all economic nationalists, we are almost all America Firsters.”



Op Ed. "Americans know free trade hurts; why doesn't the GOP?"
Miami Herald, February 18 2004

Absolute Advantage

"If a foreign country can supply us with a commodity cheaper than we ourselves can make it, better buy it of them with some part of the produce of our own industry, employed in a way in which we have some advantage."

Adam Smith (Book IV, Section ii, 12)

Absolute Advantage, cont.

- If our country can produce some set of goods at lower cost than a foreign country.
- And if the foreign country can produce some other set of goods at a lower cost than we can produce them.
- Then it would be best for us to trade our relatively cheaper goods for their relatively cheaper goods.
- In this way both countries may gain from trade.

Counterpoint – Infant Industry Hypothesis

“It is well known... that certain nations grant bounties on the exportation of particular commodities, to enable their own workmen to undersell and supplant all competitors in the countries to which those commodities are sent. Hence the undertakers of a new manufacture have to contend not only with the natural disadvantages of a new undertaking, but with the gratuities and remunerations which other governments bestow. To be enabled to contend with success, it is evident that the interference and aid of their own government are indispensable.”

Counterpoint, cont.

- ⑥ Domestic subsidies mean domestic tax payers are paying part of the cost for foreign consumers.
- ⑥ Taken to its logical extreme, Hamilton's argument for protection is indistinguishable from foreign aid.
- ⑥ Increasing exports of goods and services also means increasing imports of foreign currency.
- ⑥ If the foreign country has nothing you want to buy, then their money in payment of goods is worthless!

Comparative Advantage

- David Ricardo (English economist, early 19th Century) is often credited with popularizing the concept of comparative advantage.
- Relaxes the assumption of Smith that free trade requires absolute advantage.
- Trade benefits two states even when one state lacks absolute advantage in any good.

Comparative Advantage, cont.

- As long as the relative cost of production of two goods differs between two countries...
- States benefit by specializing in the good that is relatively cheap domestically (that country's comparative advantage)
- And then trading for the other good.
- Comparative advantage also tells us which

The Ricardian Model

Labor required to produce one unit of given good.

	Cuckoo Clocks	Kuala Bears
Australia	4	2
Austria	1	1

Ricardian Model, cont.

Autarky = no international trade

Labor	Cuckoo Clocks 50%	Kuala Bears 50%
Australia (800 units)	100	200
Austria (400 units)	200	200
World	300	400

Ricardian Model, cont.

Free Trade, specialize in comparative advantage

Labor	Cuckoo Clocks	Kuala Bears
Australia (800 units)	150 (gains 50)	$400 - 200 = 200$
Austria (400 units)	$400 - 150 = 250$ (gains 50)	200
World	$300 + 100 = 400$ (gains 100)	400

Why oppose free trade?

- Ricardian model shows country as a whole is better off specializing and trading ("size of economic pie" grows).
 - But this does not mean that everyone in country is made better off by free trade.
 - Some benefit and some are harmed
- Politics is about distribution (who gets what)
- Since trade policy also affects distribution of benefits,

Oppose free trade?, cont.

• Heckscher-Ohlin theory:

- Think of economies as made up of basic inputs to production (factors: land, labor, capital, etc.)

- Country has comparative advantage in goods and services that make relatively intensive use of the country's abundant factor.

• Factor-price equalization theorem:

- Free trade between two countries will tend to

Oppose free trade?, cont.

- Stolper-Samuelson theory (two factors: land, labor):
 - Free trade tends to raise wages in the labor abundant country (and lower rents on capital)
 - Tends to lower wages in the labor scarce country (while raising rents on capital).
- Political implication: holders or intensive users of the scarce factor should resist free trade - seek protection.

All is well that ends in controversy...

- ① Some confusion in free trade debate is resolved if we:
 - ① Recognize that free trade helps on the whole
 - ① Acknowledge free trade hurts a minority of workers
 - ① Add politics: those harmed have an incentive to seek remedies outside of the market framework
- ① The tradeoffs (efficiency vs. equity)