International Trade Theory

• Increasing <u>wage inequality</u> in the US

– Is international trade the culprit?

- Why study Trade Theory?
 - Provides systematic understanding of the <u>winners and</u> <u>losers</u> of trade policy. Necessary since distribution and redistribution is the stuff of politics.
 - Can predict who will support free trade or protection-groundwork for understanding government policy.
 Helps fill in <u>societal approach.</u>

Classical Trade Theory

- Ricardo and Comparative Advantage
 - A relative concept: countries gain if they specialize and trade the good that they produce most efficiently, relative to other goods they produce.
 - A comparative advantage means that no matter how good (or bad) you are at producing stuff, there's always something that you're best (or least worst) at doing.
 - All countries have a comparative advantage in something.
 - No country can have a comparative advantage in everything.

Trade Theory and International Relations

- Implications for international relations
 - Very optimistic view of international economic relations. Trade makes all nations better off.
 - <u>Global</u> welfare is maximized by free trade.
 - <u>National</u> welfare is maximized by <u>unilateral</u> free trade (a stronger proposition).
- National welfare analysis of a tariff
 - consumer surplus and producer surplus
 - "deadweight" losses
 - rent-seeking

Diagram: Welfare analysis of a tariff



- consumers lose A+B+C+D
- producers gain A
- government gains C
- "deadweight" loss to society B+D
- plus "dynamic" costs
- plus waste of "rent-seeking"

Neoclassical Trade Theory

- Why do countries produce and trade what they do?
 - Key is national differences in endowments of factors of production (e.g, labor, capital, land).
 - Core suppositions: 1) goods differ in factor requirements. 2) countries differ in their factor endowments.
 - <u>Heckscher-Ohlin Theorem</u>: a country will produce and export goods whose production makes intensive use of the factor of production that is relatively abundant (cheap) before trade.
 - <u>Factor-Price Equalization Theorem</u>: trade will diminish cross-national differences in factor prices.