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International Economics: Comparative Advantages

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What is International Economics?

- It works on:
 - The exchanges' advantages;
 - The structure of the international commerce;
 - The Balance of Payments;
 - The determination of the exchange rate;
 - The International economics policies coordination;
 - The international capital market coordination.

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The Comparative Advantage

- "it's the best example that I know of an economic principle which is true but not is easy to understand for intelligent people"
- P. Samuleson
 - Absolute advantage and comparative
 - Ricardian Comparative advantage
 - Factor specific comparative advantage
 - Heckscher – Ohlin.

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The Comparative Advantage

- It's based on principles and hypothesis:
- Cost opportunity;
- advantage;
- Decreasing return of production factors;
- Among State.

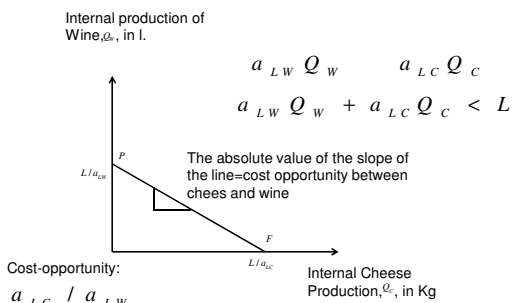
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Ricardian Model

- Different Productivity within factors of production and countries.
- Therefore defining a_{LW} and a_{LC} as unit of workforce applied on, for instance, wine and cheese while L is the total workforce supplied.
- Moreover the labour is free to move within difference sectors in the same countries but not at international level.

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Production Frontier



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Relative prices

- The different Production frontiers represent the different combination of goods an economy can produce, but in order to establish which of them is suitable is based on the price.
- In particular, it's necessary to know the relative prices of the two goods thus the relative prices.
- In this case, just the price of goods since there only is one factor of production, labour.
- Workers use to move from one sector to another according to the salary.
- It means they use to go where the salary is higher.

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Prices determination

- Let P_c and P_w are respectively the prices and a_{LC} are the number of hour of work in order to produce a one Kg of cheese, since there is not other factors of production thus the result of the production is distributed to the labour force.
- therefore, the salary per hour on the cheese sector will be equal to one hour of work:

$$P_c / a_{LC}$$

- and will be the same for the wine sector

$$P_w / a_{LW}$$

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Salary determination

If so then the salary paid on the cheese sector will be higher than the salary paid on the wine sector if :

$$P_c / P_w > a_{LC} / a_{LW}$$

On the other hand, the salary paid on the wine sector will be higher than the cheese sector if :

$$P_c / P_w < a_{LC} / a_{LW}$$

But since all the workers would like to be employed where the salary is higher thus the economy will go on the direction of specialization where the salary is higher.

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Labour Theory value

If it's true what we said then which the meaning of the relationship between the number of hours of work in order to produce a good:

$$a_{LC} / a_{LW}$$

In fact, in an closed economy, all the two goods should be produced but since the two goods could be produced if and only if their cost of opportunity is equal to their prices

$$P_C / P_W = a_{LC} / a_{LW}$$

The cost of opportunity is given by the relationship of input of factors of production per one unit of good.

Then, in syntesis, according to this theory: in closed economy, the relative prices are equal at the number of hours to produce the same goods.

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International Trade

We have two countries *A* and *B*, with only one factor of production *L*, labour, and two goods produced, wine and cheese.

The labour force on country *A* is *L* while in country *B* is *L** so the labour effort to produce the goods is give by a_{LW} and a_{LC}

In country *A* a_{LW}^* and a_{LC}^* on country *B*.

Assume that $a_{LC} / a_{LW} < a_{LC}^* / a_{LW}^*$

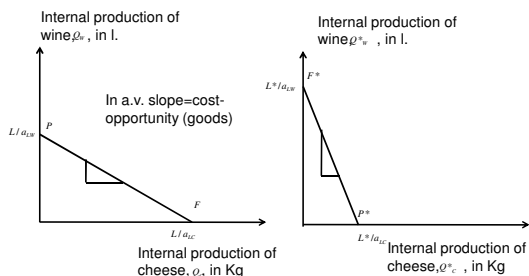
Or that $a_{LC} / a_{LW}^* < a_{LC}^* / a_{LW}^*$

It means that we assume the effort needed to produce the goods in country *A* is minor than in country *B*.

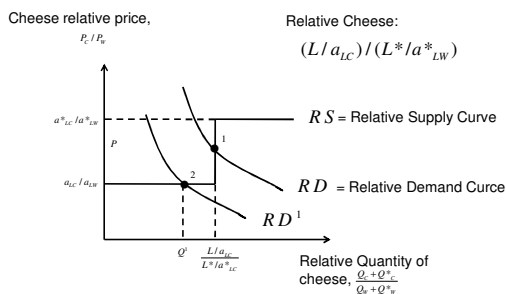
In other words, it means the marginal productivity is higher in country *A* on cheese production. It means Country *A* has a comparative advantage on cheese production.

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Production Frontier in *A* and *B*

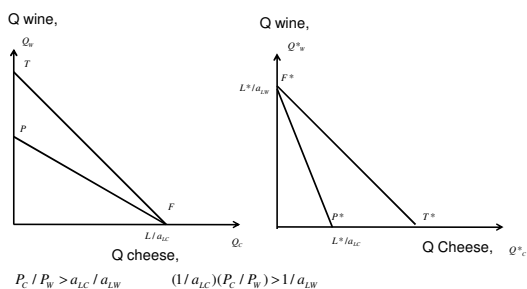


Determination of the relative prices after the exchange



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International Trade gains



Comparative and absolute Advantage

	Cheese	Wine
Country A	$a_{LC} = 1$ h per Kg	$a_{LW} = 2$ hs per l.
Country B	$a_{LC}^* = 6$ hs per Kg	$a_{LW}^* = 3$ hs per l.

1. The price of cheese is given by: P_C / P_W ;
2. It depends by the Demand but it should be within the frontier of the cost of opportunity with the wine in A and B;
3. In A we have $a_{LC} = 1$ & $a_{LW} = 2$; thus the cost of opportunity is given by $a_{LC} / a_{LW} = 1/2$.
4. In B we have 2. The international price of the cheese is $P_C / P_W = 1$

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Regarding International Trade and

- **Productivity and Competitiveness:** gains from international trade is given by the comparative advantage instead by the absolute advantage. The absolute advantage is not necessary and sufficient conditions for a comparative advantage. In fact, even a country has an absolute disadvantage on the production of two goods but it has a higher disadvantage in one sector instead of another. This is a comparative advantage;
- **Low wages:** the fact that a country has a comparative advantage because it has lower wages or higher productivity is not important. It's important that the relative price is lower; it means that count the fact it can buy a good with the value of another good (indirect production);
- **Labour Exploitation:** in reality if we don't have international trade then the salary should be even lower.

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Do the salaries reflect productivity?

	Wage per hour in 1975		Wage per hour in 2000		Rate of growth of LCUP: '79 - '00
	USA = 100	Italy = 100	USA = 100	Italy = 100	
USA	100	137	100	135	1,2
Italy	73	100	74	100	1
South Korea	5	7	41	55	0,07
Taiwan	6	8	30	40	3,6
Honk Kong	12	16	28	38	n.a.
Singapur	13	18	37	50	n.a.
France	71	97	83	112	0
UK	53	73	80	108	2,5
Japan	47	64	111	150	3,2

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Specific Factors and income distribution

- If international trade is good then why there are so many countries and people against it?
- In fact, as said international trade given the theory of comparative advantage gives to all the participants a gain, in terms of countries.
- However international trade and comparative advantage, has a negative feedback on income distribution in each country.
- In fact, the specialization of the country on one product instead the production of all the goods needed given the international trade means there should be a shift of the factors production from less efficient to more efficient sectors of the national economy.
- International trade thus has a great effect on national distribution. First of all, because factors production use to move slowly from one sector to another and their transfer is very expensive. Second, the demand of factors production is different in different sectors of the economy.

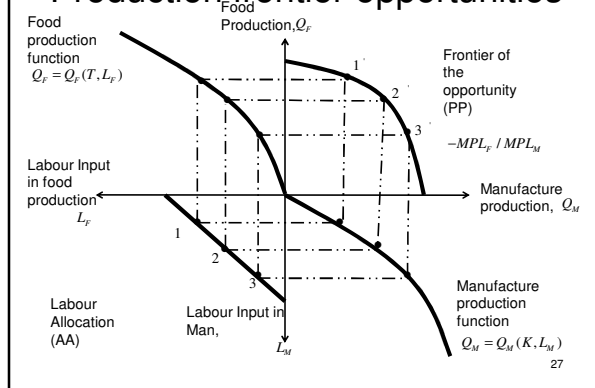
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What does mean specific factors?

- In economy there are three factors production: Land, labour and Capital.
- The model presented is based only on labour.
- In the model of specific factors there are land and capital.
- However, land and capital are highly correlated with the specific production sector compared to labour.
- It's true that in long term perspective they can move as well as but it takes time and it has a high cost (investment).
- Therefore, even land and capital could be considered non specific but on the long run.
- However, this could happen as well as on labour market. In fact, it take time for a worker highly specialized to move from one sector to another. Then specific factors need more time to move from one sector to another.
- Finally, comparative advantage is based on technology, factor endowments, preferences and economies of scale.

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Production frontier opportunities

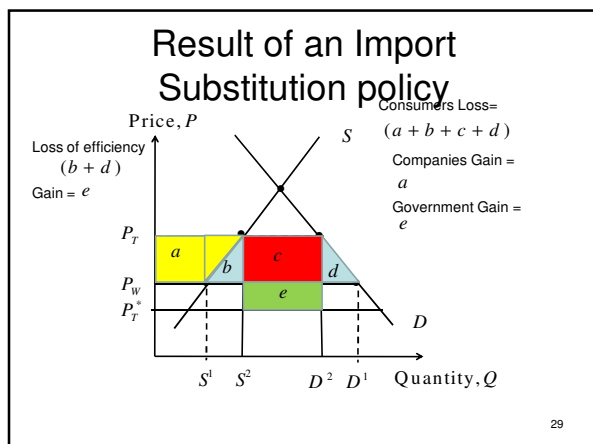


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Import Substitution

- Means unequal treatment of imported goods through tariffs, quotas or exchange rate;
- There is a welfare effect that in a static model works in a different way than in the dynamic one.

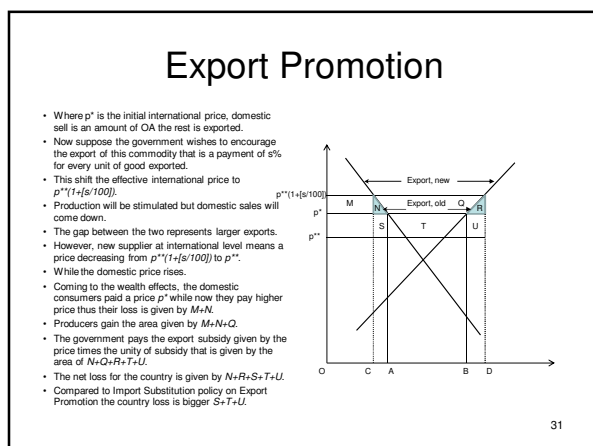
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Export Promotion

- Means promoting national goods (such as non primary exports) through specific international trade policies such as reduced import duties, import quotas for exporters, preferential credit, export subsidy.

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Multilateralism

- GATT (General Agreement on Trade and Tariffs) which is a complex multilateral system of rules and norms aimed at reducing trade barriers among countries on some coordinated, and multilateral bases.
- GATT has been developed on Bretton Woods conference in 1944 and the first round took place in Geneva in 1947 while the last one (the eighth one) closed in Uruguay in 1994 with the foundation of WTO (World Trade Organization) .
- The new one (Doha Round) started in 2001 and is still open.
- The main rule of GATT is the Most-Favored-Nation (MFN) which warmly suggest to the members of the WTO to apply tariffs and quotas to all the WTO member states as lower as to the preferred one.
- This rule during the years "forced" WTO member states to open their country to regional agreement.

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Conclusions (I)

- In every country international trade award more the specific factors on export sector while damages the specific factors of imported sectors. Labour as non specific factor use to gain or loose according to the condition of the specific sector;
- International trade increase the frontier of the opportunity (choice);
- The fact that there are always losers and winners on international trade makes that in each country there are many people against it and few people in favor.

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Conclusions (II)

- The distribution effect of international trade is not a specific aspect of it but it happens in each country and economy when there is a technological shift;
- It should be always better to open the country to international trade and compensate the losers;
- Finally, those against international trade are always better organized than those in favor.
- Finally, loss could happen in case of catching up, capital markets, positive externalities, coordination failure, income and wealth distribution and large country tariffs.

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