International Economics

Chapter 3: Theories of International Trade

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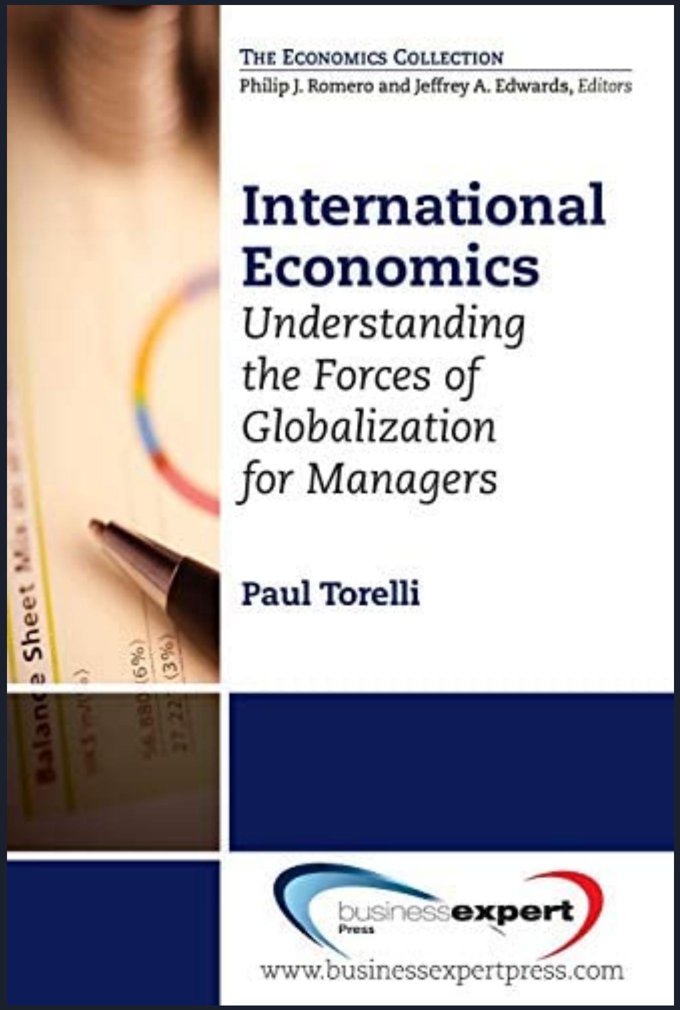
Chapter Overview

- Absolute v. Comparative Advantage
    - Globalization Extensions
    - Factor Proportions Model (Heckscher-Ohlin Model)
    - Gravity Model
- Technology and Human Capital
- Basic Trade Terms
- Key Takeaways



Absolute v. Comparative Advantage

Absolute advantage: Adam Smith believed an international division of labor based on the productive advantages of each country would produce optimal results.

Comparative advantage: David Ricardo argued for comparing production costs and opportunity costs among nations and determining the most effective division of labor.

- Basis for modern trade theory but has applications beyond economics and can be applied to individuals, businesses, and organizations
- Not necessarily a clear division of production when applied to global trade and a global economy (production is more diversified)
  - "The Ricardian model predicts a very high degree of specialization that is not observed in the real world" (Torelli, 2017, p. 72).

Absolute v. Comparative Advantage

Basis	Absolute Advantage	Comparative Advantage
Definition	The ability of a country to produce more goods with the same amount of resources than another country	The ability of the country to produce goods better than another country with the same amount of resources
Benefits	1. Trade is not mutually beneficial 2. Benefits the Country with absolute advantage	1. Trade is mutually beneficial 2.Benefits of both the countries
Cost	The absolute cost of producing goods impacts if the country has an absolute advantage	The opportunity cost of producing goods impact the Country's comparative advantage
Economic Nature	It is not mutual and reciprocal	It is mutual and reciprocal

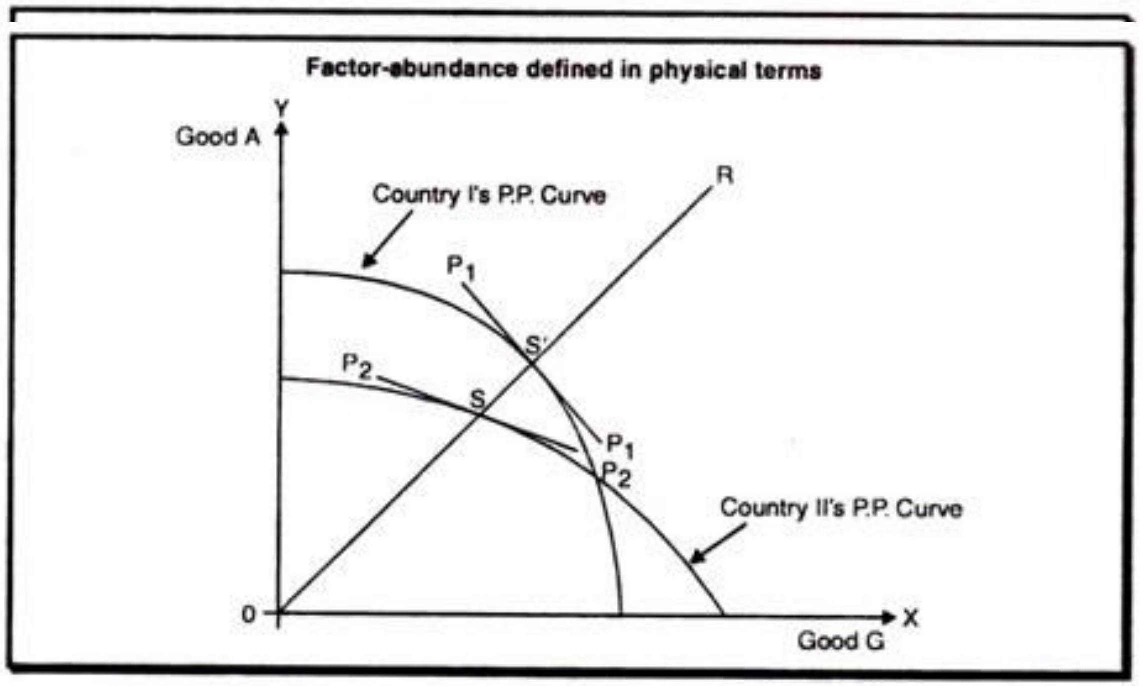
Extensions on Comparative Advantage

Globalization Extensions

- Adds capital and capital investment as a factor which can weaken gains from international specialization
- “In the presence of capital mobility, absolute advantages may erode, and comparative advantages may become less pronounced as well” (Torelli, 2017, p. 72).
- Human capital is missing from the Ricardian model – differences in human capital levels as well as social capital and culture influence comparative advantage

Factor Proportions Model

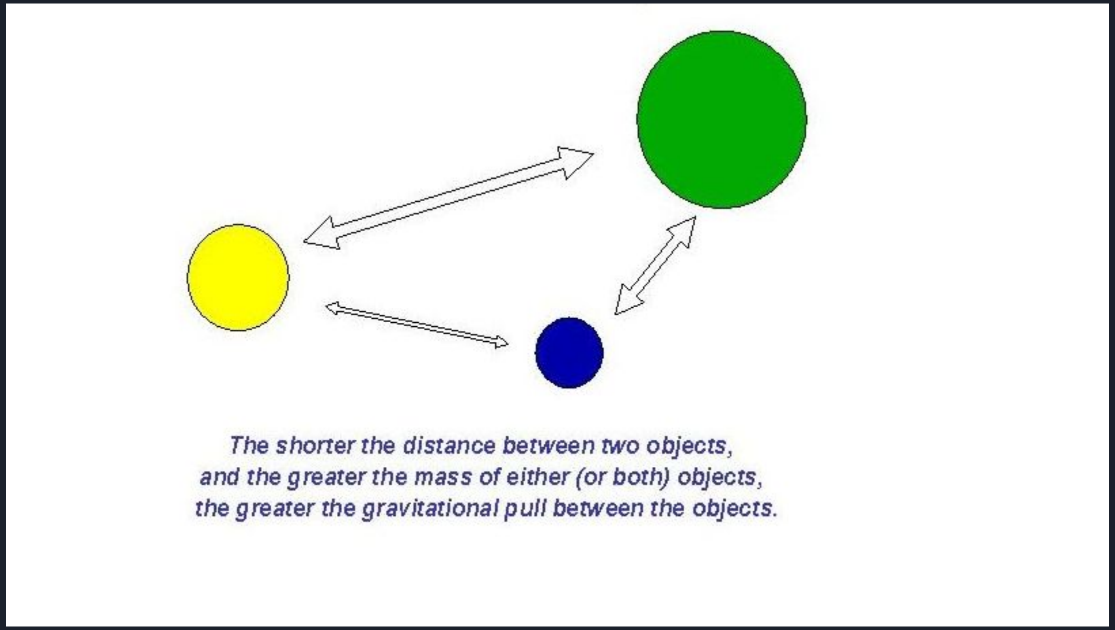
- Also called the Heckscher-Ohlin Model
- Assumes that each economy has a given amount of capital, labor, technology, and other resources
- ”It predicts that the direction of trade between nations will be determined by differences in supply-side factor abundance” (Torelli, 2017, p. 73).
- Each nation will produce the good that makes greater use of the factor of production (capital, labor, technology, etc.) that it has in abundance


Factor-abundance defined in physical terms
Good A
Y
Country I's P.P. Curve
R
P_1
S'
P_2
S
P_1
P_2
Country II's P.P. Curve
0
X
Good G
Fig. 1


Capital abundant country.
Export of capital- intensive goods
Export of labour –intensive goods
Labour abundant country.

Gravity Model

- The amount of trade between two countries is dependent on the product of their economic output and the distance from each other
- Larger economies consume more and are likely to import more goods – stronger gravitational pull
- Due to transportation costs and other barriers, the closer two economies are, the more likely they are to engage in trade
- Supported by a number of modern trade theories



Technology and Human Capital

- Including capital, labor, and technology has implications for how modern trade functions.
- ”Each country’s production in a given sector depends on the level of technology it possesses and the human capital of its work force” (Torelli, 2017, p.77).
- Greater human capital and better technology open more doors for trade but also require more specialized labor and technology, more research, and stronger education requirements within a country.
- Technology changed trade relationships, particularly with human capital and expertise within labor.
    - “Habakkuk hypothesis” claims that technology progressed faster in the US than England because labor was scarce and industrialists were incentivized to develop laborsaving technologies
    - “Porter hypothesis” claims that government environmental regulations trigger the development and implementation of cleaner technologies so there could potentially be a shift toward more innovative and accessible technologies as a result

Basic Trade Terms and Concepts

- **Tariff**: tax on imports – increases the cost of shipping goods to a foreign country
- **Export subsidies**: government payments to exporting firms
- **Free trade**: allows each country to follow its comparative advantage without tariffs which will yield efficient development and growth, lowers prices, and benefits consumers in every country
- **Protectionist trade policy**: supports incomes of specific groups, often advocated for by interest groups
- **Public choice**: analyzes political economy of trade policies and shows that there is disparity between consumers and protected industries
- **Infant Industry Protection**: temporary protection for developing industries from foreign competition – can lead to bribery or corruption, higher prices for domestic consumers, but can also be highly effective (i.e. China's automobile industry, WTO membership)

Key Takeaways from Chapter 3

- Absolute advantage: not mutually beneficial; only benefits the country with absolute advantage
- Comparative advantage: mutually beneficial between multiple countries; benefits both countries through trade
- Factor proportions (H-O) model: nations will produce the good that makes greater use of the factor of production it has in abundance
- Labor and technology have a major influence on the economy and how trade theory is understood and applied
- Gravity model: trade will happen between nations that are closer together as long as their economic needs align

“Comparative advantage implies that each person should follow the career path or line of work which they are best at, to maximize their production and well-being, however measured. Within an organization, each member ought to work according to his or her strengths; within each industry, every company has its own comparative advantage” (Torelli, 2017, p. 69).

Reference

- Torelli, P. (2017). *International Economics, Second Edition: Understanding the Forces of Globalization for Managers* (2nd ed.). Business Expert Press.

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