

International Trade

Absolute Advantage



SAPIENZA
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International Economic Policy

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From Reinert, K.A. (2012) An Introduction to International Economics, Instructor Materials

Chapter 2: Absolute Advantage

An Introduction to International
Economics: New Perspectives on the
World Economy

Absolute Advantage: Analytical Elements

- Countries
- Sectors
- Factors of production

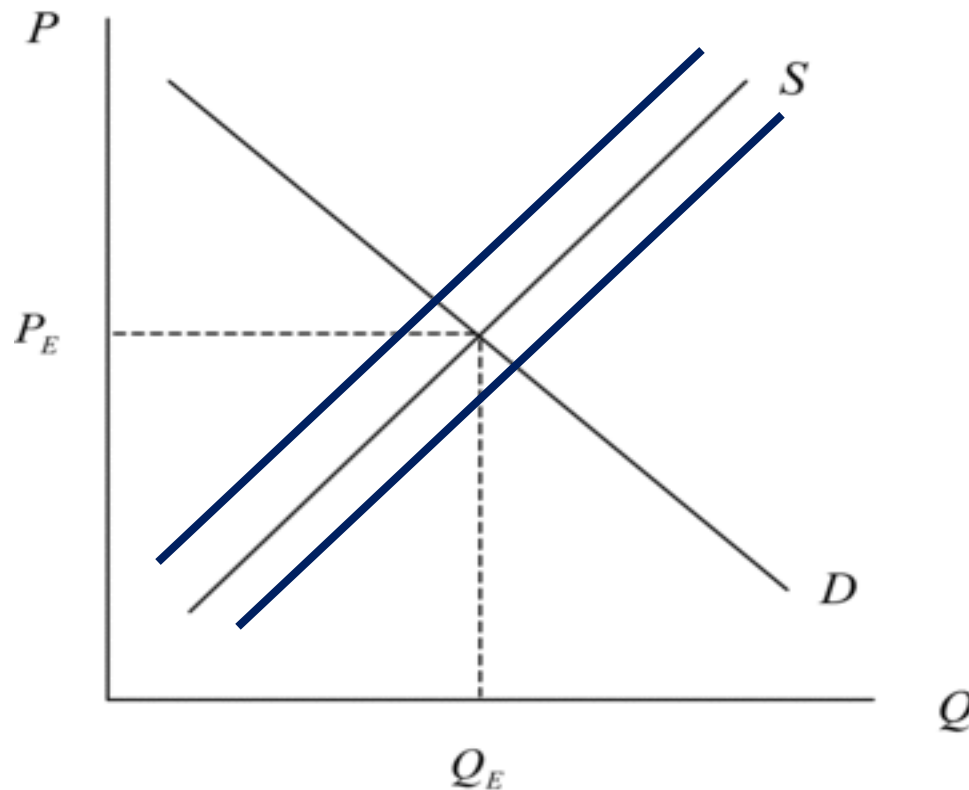
Introduction

- By using the supply and demand diagram this chapter makes a first step in helping you to answer these questions
 - Why does a country export a particular good?
 - Why does it import a particular good?
 - What forces are behind the expansion of world trade that is occurring in the world economy?
- Absolute advantage
 - Possibility that, due to differences in supply conditions, one country can produce a product at a lower price than another country

Supply and Demand in a Domestic Market

- Throughout the world, rice is exchanged in markets
- Supply curve is upward sloping—firms supply more rice to the market as the price increases
 - Changes in price are represented in the diagram by movements along the supply curve—changes in quantity supplied
 - Reductions in input prices and improvements in technology shift the supply curve to the right
 - Increases in input prices and technology setbacks shift the supply curve to the left
 - Known as changes in supply

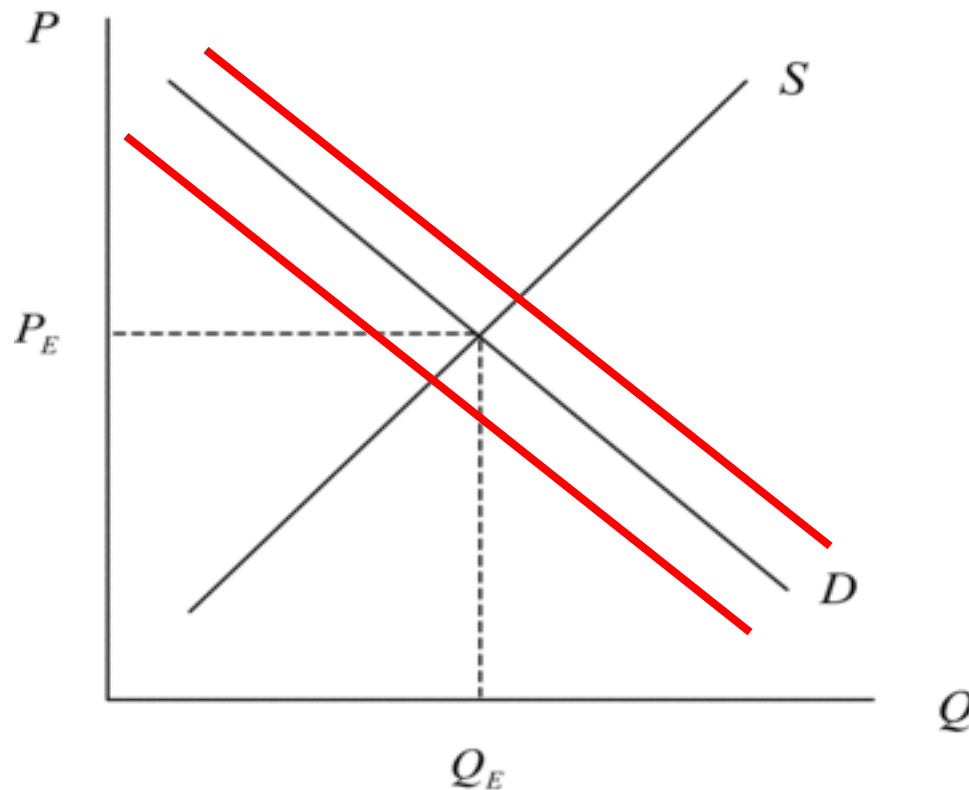
Figure 2.1. A Domestic Rice Market



Supply and Demand in a Domestic Market

- Demand curve is downward sloping—consumers demand less rice from market as price increases
 - Changes in price are represented by movements along the demand curve—changes in quantity demanded
- Additional demand-side factors
 - Incomes and preferences
 - Increases shift demand curve to right
 - Decreases shift demand curve to left
 - Shifts are known as changes in demand

Figure 2.1. A Domestic Rice Market



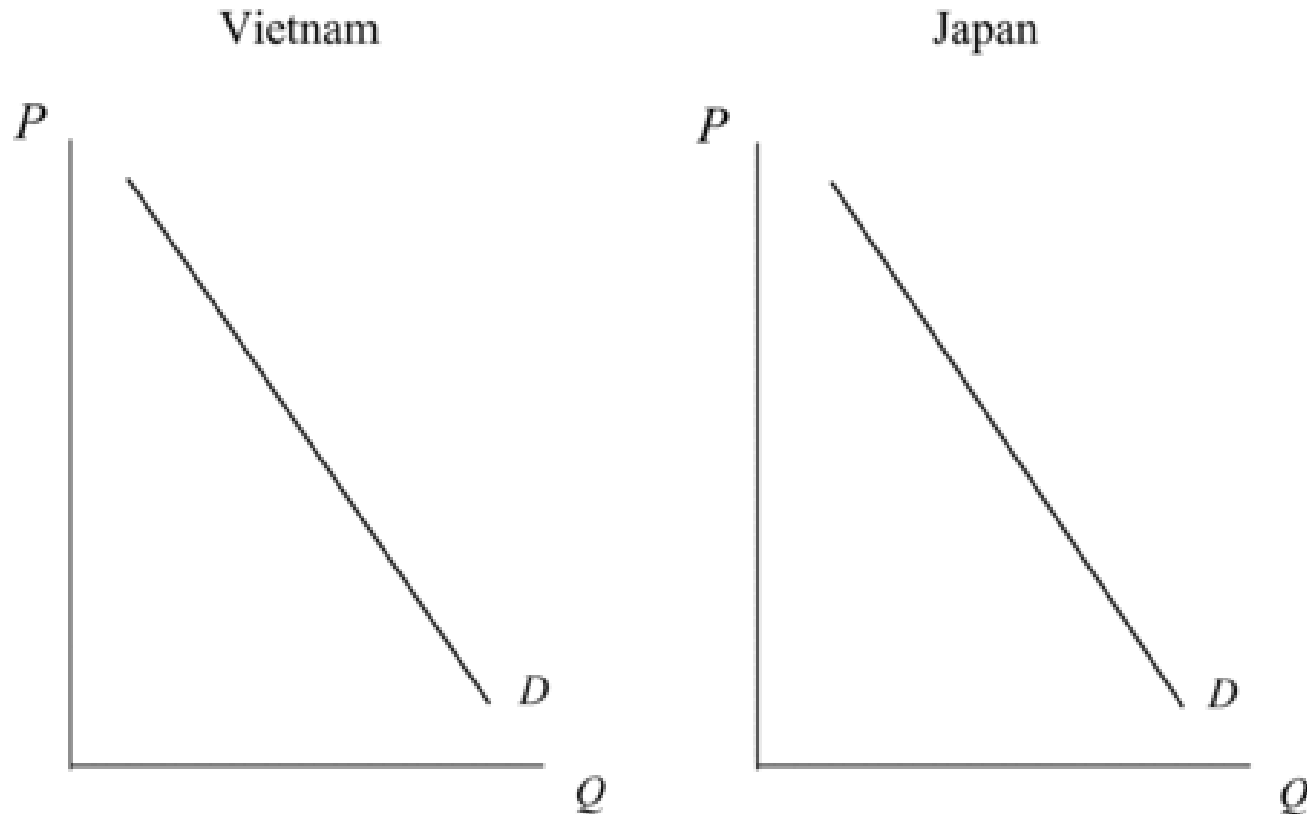
Supply and Demand in a Domestic Market

- Intersection of supply and demand curves determines the equilibrium in the domestic rice market
- Any shifts will change equilibrium price and quantity for rice by shifting the demand or supply curves.
- Rice markets are international
 - Cannot analyze them effectively using Figure 2.1

Absolute Advantage

- Rice is produced in both Vietnam and Japan
- Assume demand conditions are exactly the same in both countries
 - Same preferences, same incomes, same price elasticity of demand
 - Implies demand curves for rice in the two countries are exactly the same

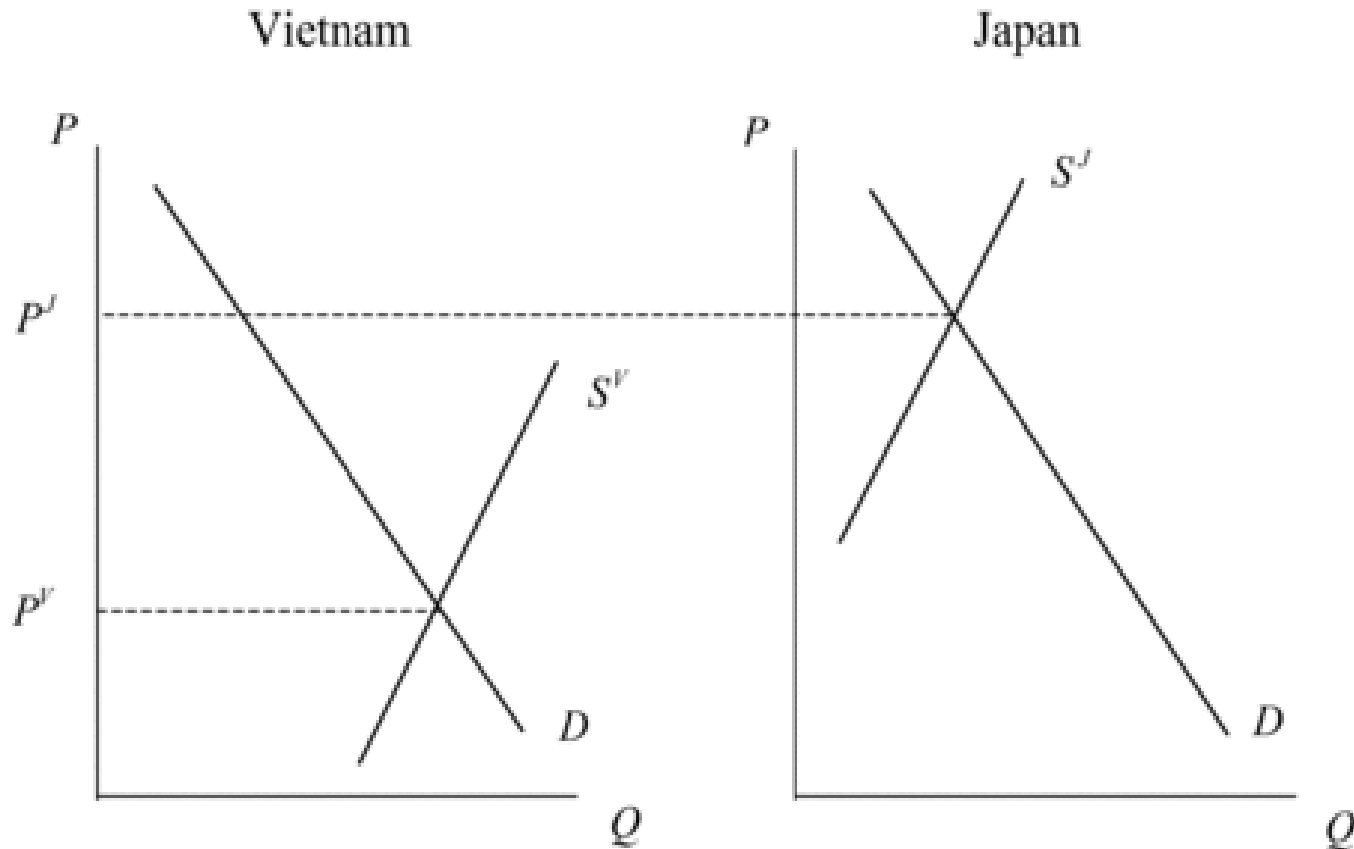
Figure 2.2. Demand for Rice in Vietnam and Japan



Absolute Advantage

- Trade often arises due to differences in supply conditions
 - Assume supply curve for Vietnam is farther to the right than supply curve for Japan
 - At every price Vietnam supplies more rice than Japan
 - Perhaps Vietnam uses superior technology or production inputs are lower in Vietnam

Figure 2.3. Absolute Advantage in the Rice Market



Autarky Price

- Since no trade is involved between Vietnam and Japan
 - These two prices are known in international economics as autarky prices
 - Autarky is a situation in which a country has no economic relationships with other countries
 - Figure 2.3 depicts a situation in which autarky price of rice is lower in Vietnam than in Japan
 - Vietnam has an absolute advantage in the production of rice vis-à-vis Japan

International Trade

- Absolute advantage implies a potential pattern of trade
 - If the two countries forgo autarky and begin to trade
 - World price of rice will lie somewhere between the two autarky prices, or
 - $P^V < P^W < P^J$
 - This situation is depicted in Figure 2.4

Figure 2.4. Trade in the Rice Market

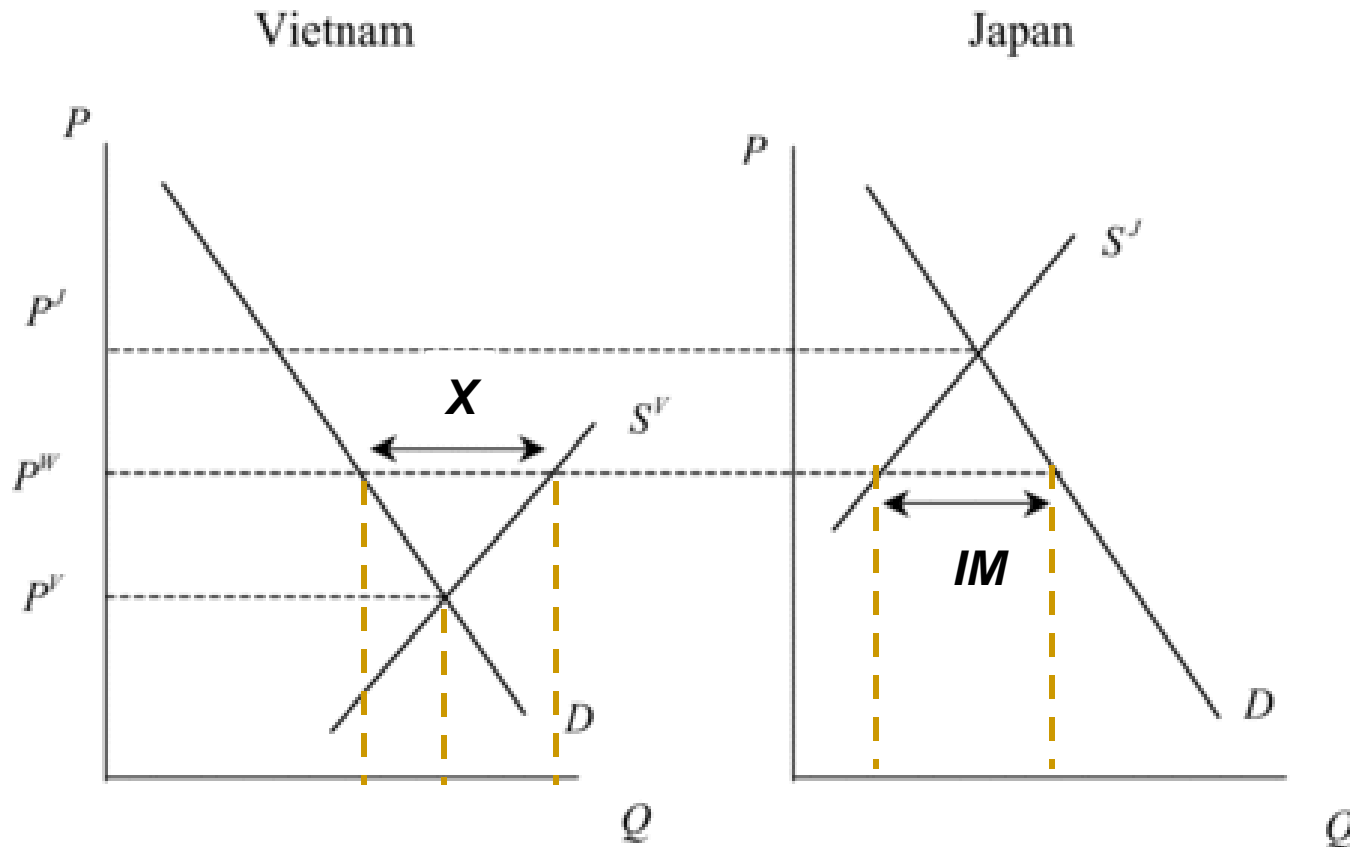
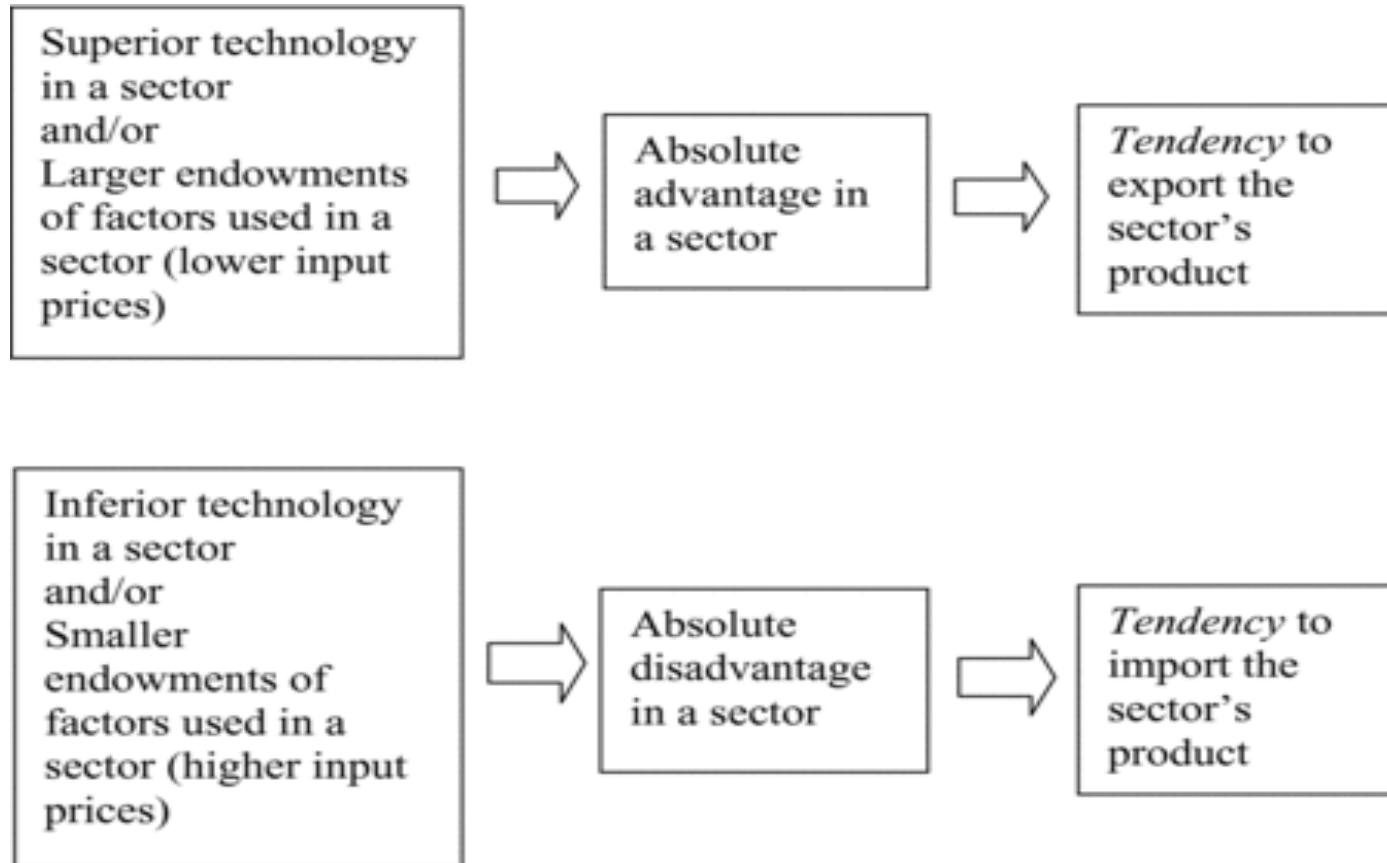


Figure 2.5. A Schematic View of Absolute Advantage



A Question

- What ensures that the amount exported by Vietnam is the same as the amount imported by Japan?
 - If X^V were smaller than IM^J there would be excess demand or a shortage in world market for rice
 - Excess demand causes price to rise
 - As P^W rose, exports of Vietnam would expand and imports of Japan would contract until excess demand in world market disappeared
 - Similarly, if X^V were larger than IM^J , P^W would fall to bring world market back into equilibrium

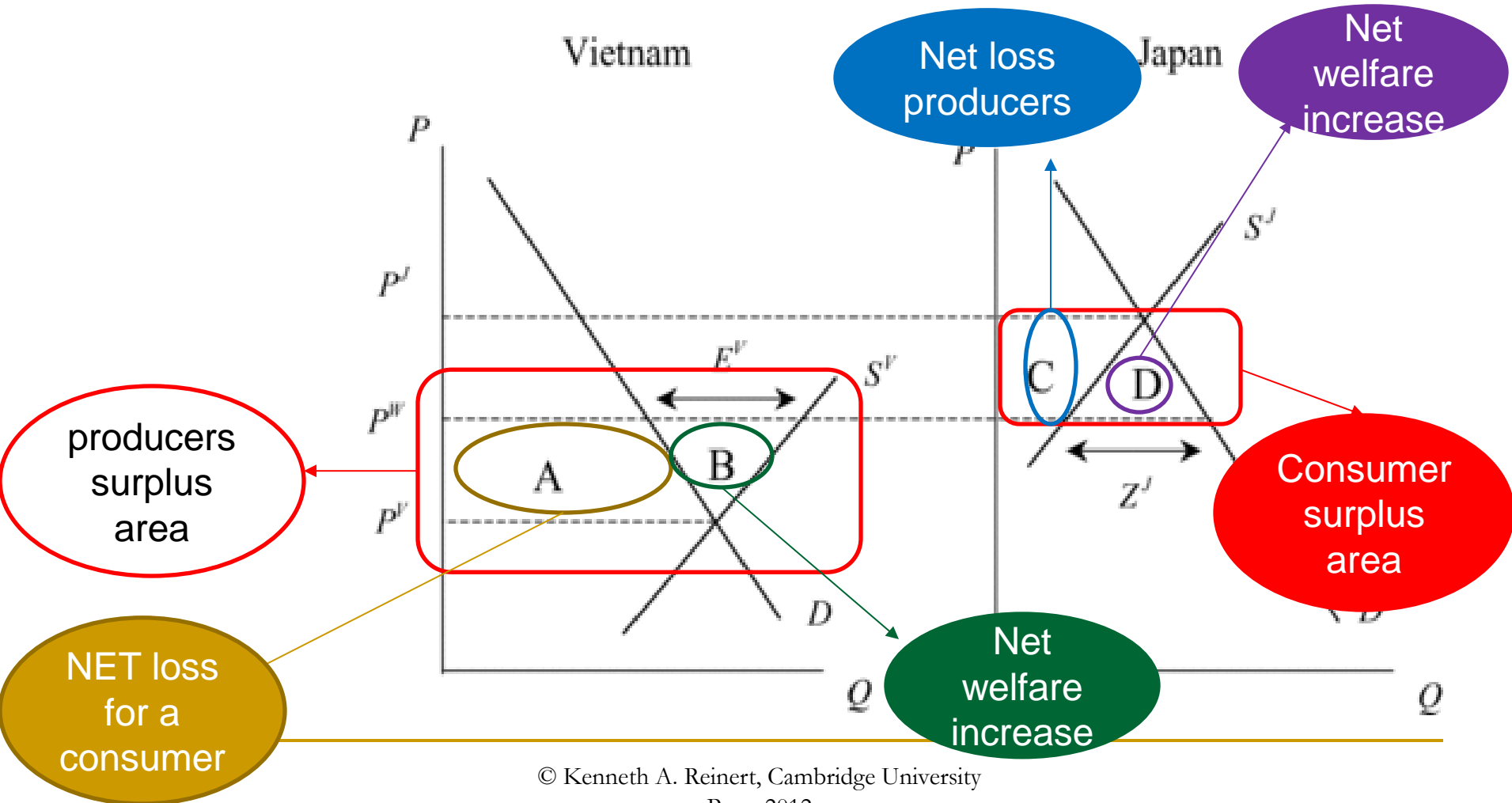
Summary So Far

- Differences in supply conditions among countries rise to complementary patterns of absolute advantage
- These patterns of absolute advantage make possible complementary patterns of international trade

Gains from Trade

- Given a pattern of absolute advantage, it is possible for a country to give up autarky in favor of importing or exporting
 - Japan can import rice, and Vietnam can export rice
- But should a country actually do this?

Figure 2.6. Gains from Trade in the Rice Market



Gains from Trade in Vietnam

- When Vietnam moved from autarky to exporting in the rice market
 - Producers experience both an increase in price and an increase in quantity supplied along the supply curve
 - Should be good for producers
 - Figure 2.6 shows an increase in producer surplus of area A+B as a result of the movement from autarky to trade
 - Consumers experience an increase in price and a decrease in quantity demanded along the demand curve
 - Should harm consumers
 - Figure 2.6 shows a decrease in consumer surplus of area A

Gains from Trade in Vietnam

- What do these effects mean for Vietnam?
 - Producers have gained area A+B
 - Consumers have lost area A
 - Gain to producers exceeds loss to consumers
 - For economy as a whole there is a net welfare increase of area B
 - Vietnam gains from its entry into world economy as an exporter

Gains from Trade in Japan

- When Japan moved from autarky to importing in the rice market
 - Producers experience a decrease in price and a decrease in quantity supplied along the supply curve
 - Should harm these producers
 - You can see in Figure 2.6 that there has been a decrease in producer surplus of area C
 - Consumers experience a decrease in price and an increase in quantity demanded
 - Contribute to an increase in consumer surplus of area C + D

Gains from Trade in Japan

- What do these effects mean for Japan?
 - Consumers have gained C+D
 - Producers have lost area C
 - The gain to consumers exceeds the loss to producers
 - For the economy as a whole, then, there is a net welfare increase of area D
 - Japan gains from its entry into the world economy as an importer

Gains from Trade

- Moving from autarky to either importing or exporting involves a net increase in welfare for the country involved
 - Known as gains from trade
- Many popular writings on the world economy suggest trade relationships are a win-lose proposition for the countries involved
 - The gains from trade idea, however, tells us that trade can be mutually beneficial to countries involved

Limitations

- Trade can improve overall welfare for the countries involved
- Concept has its limits
 - Suggests the possibility that a country could not have an absolute advantage in anything, and would have nothing to export at all
 - This is unlikely

Limitations

- The notion of the gains from trade also has its limits
 - Suggests that countries as a whole mutually gain from trade
 - Does not suggest, however, that everyone within a country will gain from trade
 - Producers of rice in Japan lose from trade, and consumers of rice in Vietnam lose from trade