Misconceptions About Comparative Advantage

- Productivity and Competitiveness
  - Myth 1: Free trade is beneficial only if a country is strong enough to withstand foreign competition.
    - This argument fails to recognize that trade is based on comparative not absolute advantage.

- The Pauper Labor Argument
  - Myth 2: Foreign competition is unfair and hurts other countries when it is based on low wages.
    - Again in our example Foreign has lower wages but still benefits from trade.
Misconceptions About Comparative Advantage

- Exploitation
  - Myth 3: Trade makes the workers worse off in countries with lower wages.
    - In the absence of trade these workers would be worse off.
    - Denying the opportunity to export is to condemn poor people to continue to be poor.
## Misconceptions About Comparative Advantage

### Table 2-3: Changes in Wages and Unit Labor Costs

<table>
<thead>
<tr>
<th></th>
<th>Compensation per Hour, 1975 (US = 100)</th>
<th>Compensation per Hour, 2000 (US = 100)</th>
<th>Annual Rate of Increase in Unit Labor Costs, 1979–2000</th>
</tr>
</thead>
<tbody>
<tr>
<td>United States</td>
<td>100</td>
<td>100</td>
<td>1.1</td>
</tr>
<tr>
<td>South Korea</td>
<td>5</td>
<td>41</td>
<td>.07</td>
</tr>
<tr>
<td>Taiwan</td>
<td>6</td>
<td>30</td>
<td>3.6</td>
</tr>
<tr>
<td>Hong Kong</td>
<td>12</td>
<td>28</td>
<td>NA</td>
</tr>
<tr>
<td>Singapore</td>
<td>13</td>
<td>37</td>
<td>NA</td>
</tr>
</tbody>
</table>

Comparative Advantage with Many Goods

- Setting Up the Model
  - Both countries consume and are able to produce a large number, N, of different goods.

- Relative Wages and Specialization
  - The pattern of trade will depend on the ratio of Home to Foreign wages.
  - Goods will always be produced where it is cheapest to make them.
    - For example, it will be cheaper to produce good i in Home if \( wa_{Li} < w^*a^*_{Li} \), or by rearranging if \( a^*_{Li}/a_{Li} > w/w^* \).
## Comparative Advantage with Many Goods

### Table 2-4: Home and Foreign Unit Labor Requirements

<table>
<thead>
<tr>
<th>Good</th>
<th>Home Unit Labor Requirement ($a_{Li}$)</th>
<th>Foreign Unit Labor Requirement ($a^*_i$)</th>
<th>Relative Home Productivity Advantage ($a^*<em>i/a</em>{Li}$)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Apples</td>
<td>1</td>
<td>10</td>
<td>10</td>
</tr>
<tr>
<td>Bananas</td>
<td>5</td>
<td>40</td>
<td>8</td>
</tr>
<tr>
<td>Caviar</td>
<td>3</td>
<td>12</td>
<td>4</td>
</tr>
<tr>
<td>Dates</td>
<td>6</td>
<td>12</td>
<td>2</td>
</tr>
<tr>
<td>Enchiladas</td>
<td>12</td>
<td>9</td>
<td>0.75</td>
</tr>
</tbody>
</table>
Which country produces which goods?

- A country has a cost advantage in any good for which its relative productivity is higher than its relative wage.
  - If, for example, $w/w^* = 3$, Home will produce apples, bananas, and caviar, while Foreign will produce only dates and enchiladas.
  - Both countries will gain from this specialization.
Determining the Relative Wage in the Multigood Model

- To determine relative wages in a multigood economy we must look behind the relative demand for goods (i.e., the relative derived demand).
- The relative demand for Home labor depends negatively on the ratio of Home to Foreign wages.
Comparative Advantage with Many Goods

Figure 2-5: Determination of Relative Wages

Relative wage rate, \( \frac{w}{w^*} \)

Relative quantity of labor, \( \frac{L}{L^*} \)

Apples

Bananas

Caviar

Dates

Enchiladas

RS

RD

0.75

2

3

4

8

10
Adding Transport Costs and Nontraded Goods

There are three main reasons why specialization in the real international economy is not extreme:

- The existence of more than one factor of production.
- Countries sometimes protect industries from foreign competition.
- It is costly to transport goods and services.

The result of introducing transport costs makes some goods nontraded.

In some cases transportation is virtually impossible.

- Example: Services such as haircuts and auto repair cannot be traded internationally.
Empirical Evidence on the Ricardian Model

Figure 2-6: Productivity and Exports

Ratio of U.S./British exports

Ratio of U.S./British productivity
Summary

- We examined the Ricardian model, the simplest model that shows how differences between countries give rise to trade and gains from trade.

- In this model, labor is the only factor of production and countries differ only in the productivity of labor in different industries.

- In the Ricardian model, a country will export that commodity in which it has comparative (as opposed to absolute) labor productivity advantage.
The fact that trade benefits a country can be shown in either of two ways:

- We can think of trade as an indirect method of production.
- We can show that trade enlarges a country’s consumption possibilities.

The distribution of the gains from trade depends on the relative prices of the goods countries produce.
Summary

- Extending the one-factor, two-good model to a world of many commodities makes it possible to illustrate that transportation costs can give rise to the existence of nontraded goods.

- The basic prediction of the Ricardian model—that countries will tend to export goods in which they have relatively high productivity—has been confirmed by a number of studies.