

Lecture 9

Economics 181, International Trade

Reviewing HO and the Standard Trade Model

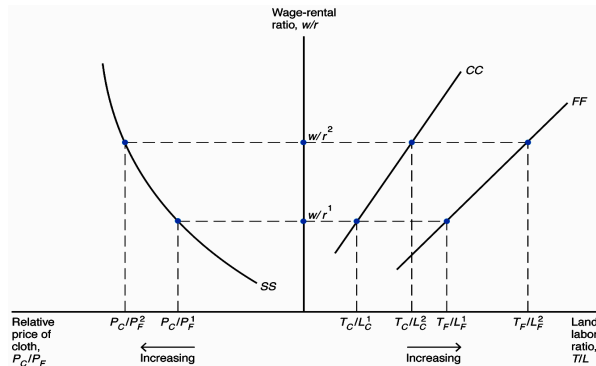
- Assignment #2 Due This Thursday

I. Empirical Evidence on HO

II Reviewing HO

- 1) H-O explains trade in terms of factor endowments. A country will export the good which uses intensively its abundant factor, such as skilled labor in the USA.
- 2) The most useful contribution of the HO approach is the insights it yields into the impact of trade on the distribution of income.
- 3) However, there are a lot of problems with this approach. For example, the USA tends to export skill-intensive, but not capital-intensive goods. This fact is what is known as the Leontief paradox: the USA has generally exported goods which are labor-intensive, not capital intensive. The Leontief paradox is no longer a paradox once we make the distinction between skilled and unskilled intensive goods.
- 4) In addition, the assumption of equal technology applied to each factor across countries does not seem reasonable. Finally, wages do not equalize across countries.
- 5) For a complete picture of where our comparative advantage truly lies, we need to combine both the HO and Ricardo approaches--each yields useful insights.
- 6) These two approaches--HO and Ricardo--provide the basis for our belief in the gains from trade. They form the core of economists' and policy-makers' beliefs in opening up to trade. These approaches are also useful for showing the basis of income differences and the distributional conflicts that arise from opening up to trade.

Tricky issues:



Graph at left shows that if Price of Cloth increases, return to factor used Intensively to produce cloth rises, and both Sectors reduce their use of that factor. Left quadrant illustrates SS; right quadrant Indicates factor intensity and how it changes with changes in factor prices.

III. The Standard Trade Model

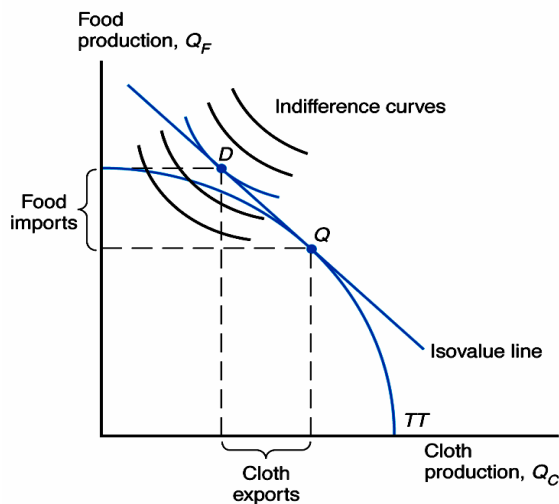
The last part of the first half of the course brings together all three models to present a standard model of trade. So far, all three models that we have studied (Ricardo, Specific Factor, HO) have the following in common:

- (1) PPF summarizes production capacity of economy
- (2) opening up to trade leads to welfare gains and
- (3) PPF determines a country's relative supply schedule
- (4) world equilibrium determined by intersection of world RD curve and world RS curve.

A. The PPF once again: autarky

The PPF for food and cloth can be shown as the diagram below. Economy in autarky produces and consumes at Q, which is where the line with slope $-P_c/P_f$ is tangent to the PPF. How can we prove this?

B. The PPF once again with trade. We draw a general production possibility frontier, with the price line (what is the slope?) tangent to the PPF at point Q. The economy below produces at Q but consumes at D. **The benefit of trade is it allows us to separate consumption and production points.**



C. Terms of trade changes and national welfare.

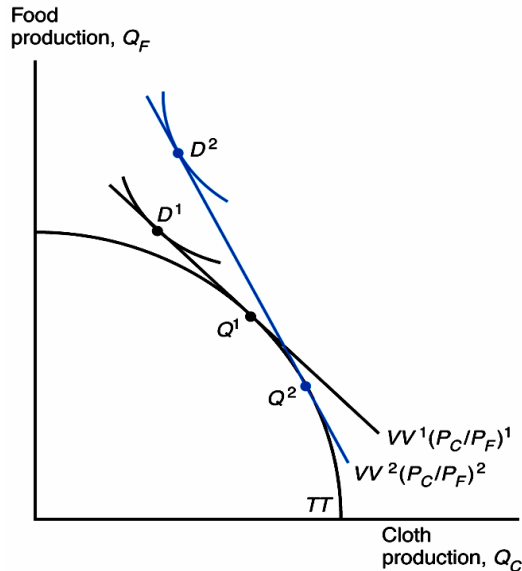
A country's terms of trade are defined as : $TOT = P_{export}/P_{import} = P_e/P_i$

If your TOT rise (ie P_e rises or P_i falls), welfare rises. (ie you are better off).
Below, the country exports cloth. If P_{cloth} rises, what happens?

- (1) The production of cloth rises
- (2) The country's terms of trade improved
- (3) Welfare increased; the country is now on a higher indifference curve.

But trade could also lead to declining terms of trade (ie P_{cloth} falls relative to P_{food}).

Generally, any event that increases export prices will improve your terms of trade, and anything that raises import prices hurts your terms of trade.



We could ask how various factors affect a country's terms of trade (P_{export}/P_{import}). In particular two issues are of interest:

- (1) Did greater competition from NICs hurt industry country terms of trade?
- (2) Have the poorest countries experienced a long term decline in their terms of trade because of the poor performance of commodity prices?

D Relative Supply and Relative Demand

Impact of the following on relative demand and supply:

- (1) Import Tariff :tariff on imports of food reduces demand for food and increases supply of food, which leads to a net fall in relative import prices of food compared to cloth. So a country's terms of trade improve if the country is large. Note these are external (world) prices. In general, the internal price to consumers of the good facing the tariff would rise relative to the other good.
- (2) If effect (1) is BIG enough, a tariff perversely lead to a net fall in import prices facing consumers. This is known as the Metzler paradox.