

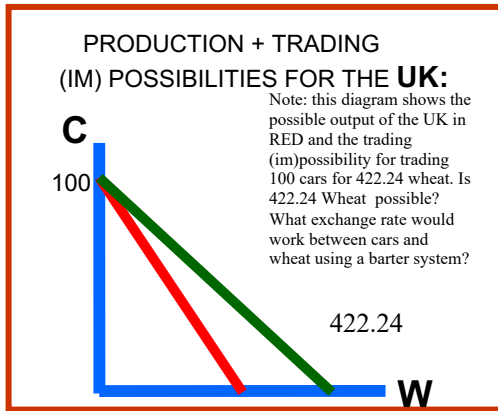
INTERNATIONAL TRADE COMPARATIVE ADVANTAGE

Can the UK + Portugal gain from specialization + trade?

Webnote 424

Syllabus
Weight: 3

Syllabus
Item: 134



A: NO TRADE

UNITS OF OUTPUT PRODUCED WITHOUT SPECIALISATION, UK AND PORTUGAL: ie SELF SUFFICIENCY

UK	+	POR	+	TOTAL
200		100		300
		50		70
		20		

NOTE: 50 % of resources used for each product.

PRODUCTION POSSIBILITIES FOR WHEAT AND CARS, UK AND PORTUGAL:

UK	+	POR	+	TOTAL
20 (4)		10 (5)		30 (9)
		5 (.25)		10 (2.5)
		2 (.2)		

NOTE: UK HAS ABSOLUTE ADV IN BOTH GOODS

B: Full TRADE

UNITS OF OUTPUT PRODUCED WITH SPECIALISATION, UK AND PORTUGAL:

UK	+	POR	+	TOTAL
0		200		200
		0		100

C: Partial TRADE

UNITS OF OUTPUT PRODUCED WITH PARTIAL SPECIALISATION BY THE UK AND FULL SPECIALISATION BY PORTUGAL:

UK	+	POR	+	TOTAL
120 (6x)		200 (20x)		320
		70 (14x)		70
		0		

NOTE: ASSUME EACH COUNTRY HAS 20 X OF RESOURCES

- KEY WORDS:**
- TERMS OF TRADE
 - OPPORTUNITY COST
 - SPECIALISATION
 - ABSOLUTE ADVANTAGE
 - PRODUCTION POSS. CURVE
 - TRADING POSS. CURVE
 - RETURNS TO SCALE: CONSTANT, INCREASING + DECREASING

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TRADING EXAMPLE:
EXCHANGE RATE = 1 CAR FOR 4.5 WHEAT
UK SELLS 41 CARS TO PORTUGAL FOR 184.5 W
THIS LEAVES THE UK WITH 304.5 W AND 29 CARS
PORTUGAL HAS 15.5 W AND 41 CARS
RESULT : BOTH COUNTRIES ARE BETTER OFF AS A RESULT OF SPECIALISATION + TRADE. TOTAL WEALTH HAS INCREASED.

DOMESTIC OPP COST RATIOS
UK = 1 CAR FOR 4 WHEAT
POR = 1 CAR FOR 5 WHEAT
EACH COUNTRY WILL BENEFIT AS A RESULT OF TRADE + SPECIALISATION.
CALCULATE THE SITUATION WITH AN EXCHANGE RATE OF 1 CAR FOR 4.5 KILOS OF WHEAT
NOTE: DRAW ALSO A PRODUCTION + TRADING POSS. CURVE FOR PORTUGAL.

- Task 1:**
Calculate opportunity cost of:
- 1 car (uk)
 - 1 car (por)
 - 1 wheat (uk)
 - 1 wheat (por)

- Answers:**
- C (uk) = 4 w
 - 1c (por) = 5w
 - 1w (uk) = 0.25 c
 - 1w (por) = 0.2 c

What are the costs for each country to produce wheat + cars?
Calculate opportunity cost values.

Trading example
For complete specialization: Portugal trades all of its wheat and the UK trades how many cars?
Exchange rate: 1 c for = 4.5w or 44.44 cars for 200 wheat.

After trade:
UK has: 200 wheat and 55.56 cars left over. Each car has a minimum value in the UK of 4 wheat so these cars have a value of 222.24 (55.56 x 4) + 200 wheat traded with Portugal = 422.24 total wheat value

Portugal has: 44.44 cars = wheat value of 1 c = 5w. See Box D. (44.44 x 5 = 222.24) Portugal pays only 4.5 in trading instead of 5)

Therefore:
Portugal gets a car for 4.5w and UK gets 4 wheat for 1 car. **Both countries gain from Trade.**

May 2008 HP 1 Q3 (a)
Explain the principle of comparative advantage and the benefits which might arise from free trade. (10 marks)

May 2007 HP 2 Q 6
Using the principle of comparative advantage, explain why economic theory suggests that countries should specialize and trade with each other.

Note: These are complicated examples that will most likely not be asked in HP2 but if you work your way through the examples you will see that specialization + trade works for full and partial specialization. The trading partners (the firms in reality) need to find the trading possibilities so that both stakeholders WIN!