

LECTURE # 3 ABSOLUTE ADVANTAGE

Demand and Supply in Domestic Markets in Autarky

Trade between the countries

Gain from Trade

Schematic View of Absolute Advantage

Conclusions

Wealth of Nations

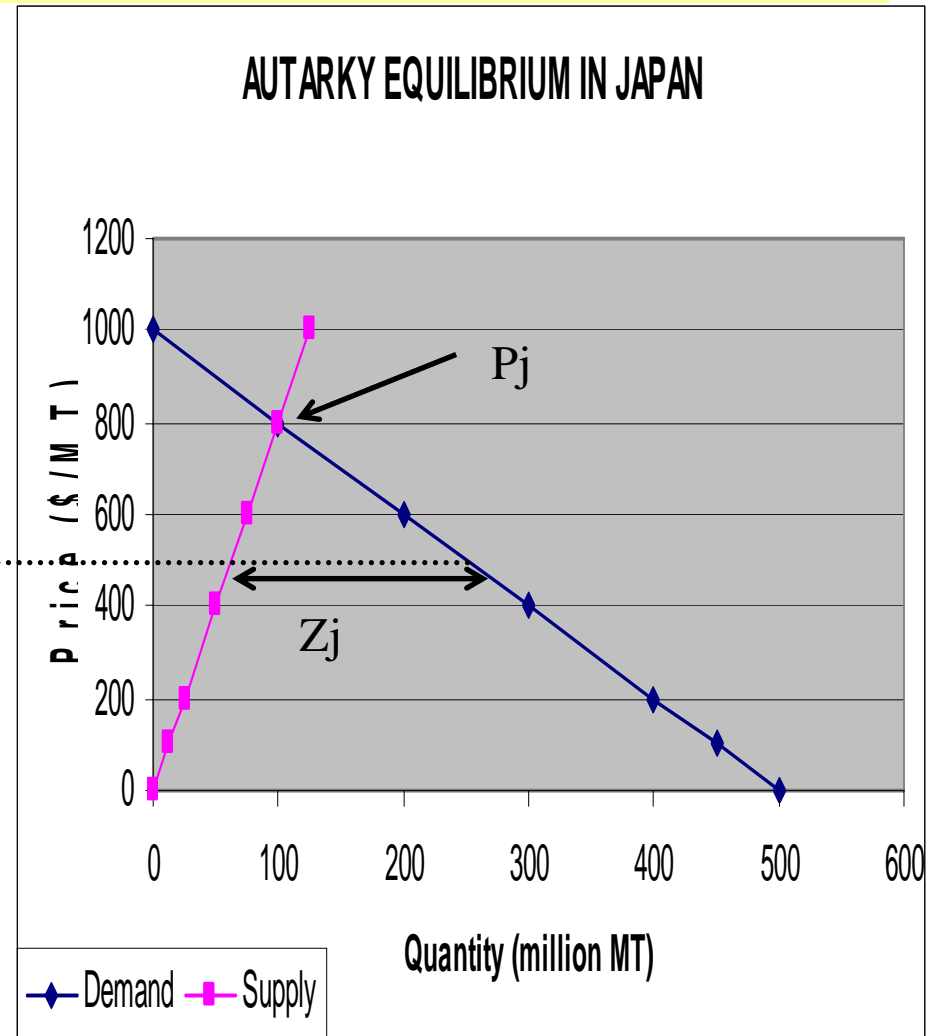
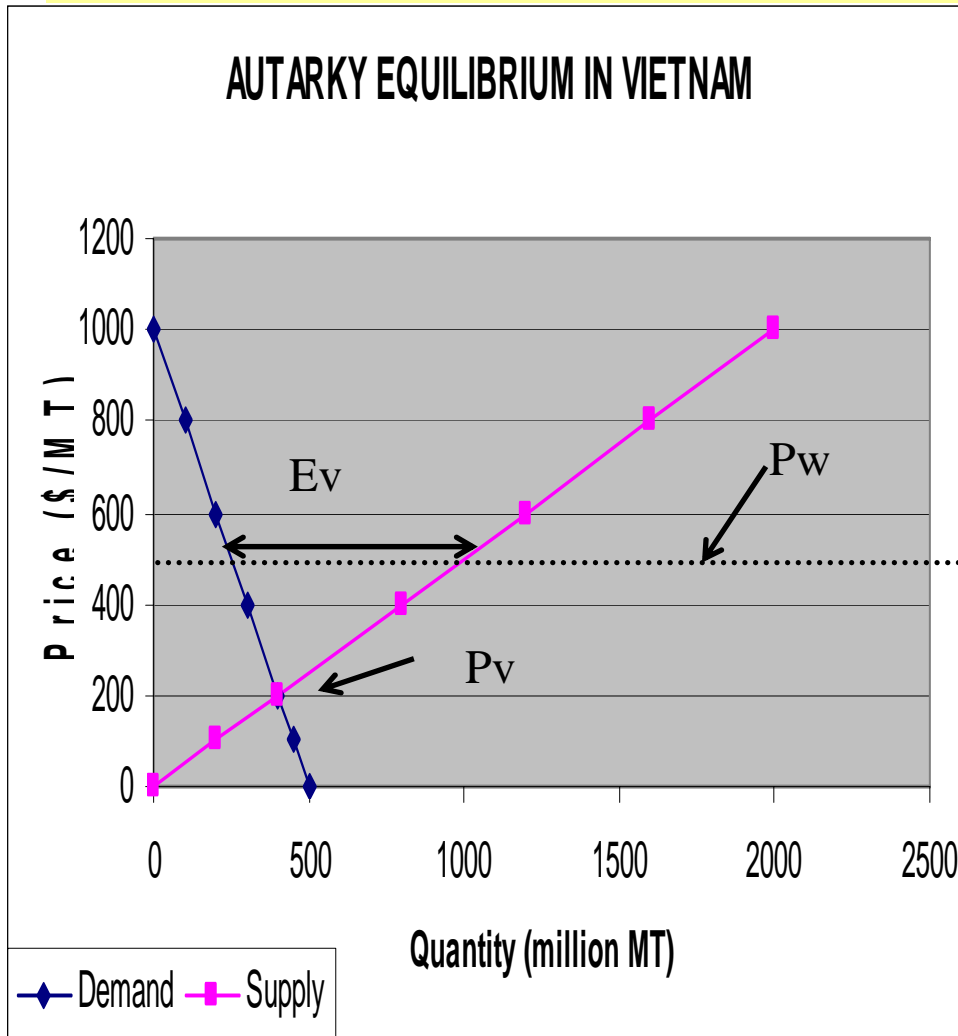
Adam Smith (1723-1790)



Historical development of trade theory

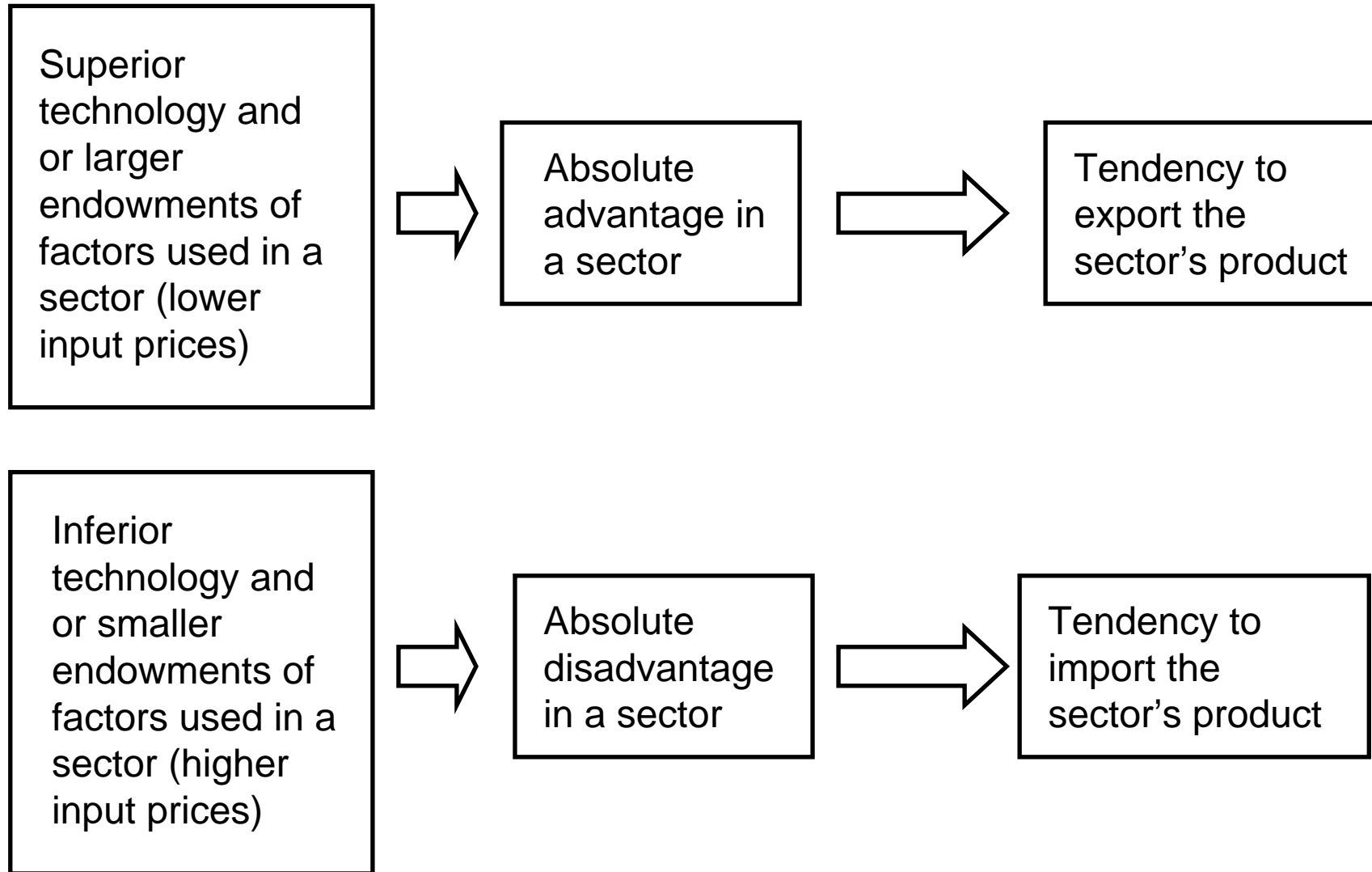
- Mercantilism
 - Regulation to ensure a positive trade balance
 - Critics: possible only for short term; assumes static world economy
- Absolute advantage (Adam Smith)
 - Countries benefit from exporting what they make cheaper than anyone else
 - But: nations without absolute advantage do not gain from trade
- Comparative advantage (David Ricardo)
 - Nations can gain from specialization, even if they lack an absolute advantage

ABSOLUTE ADVANTAGE



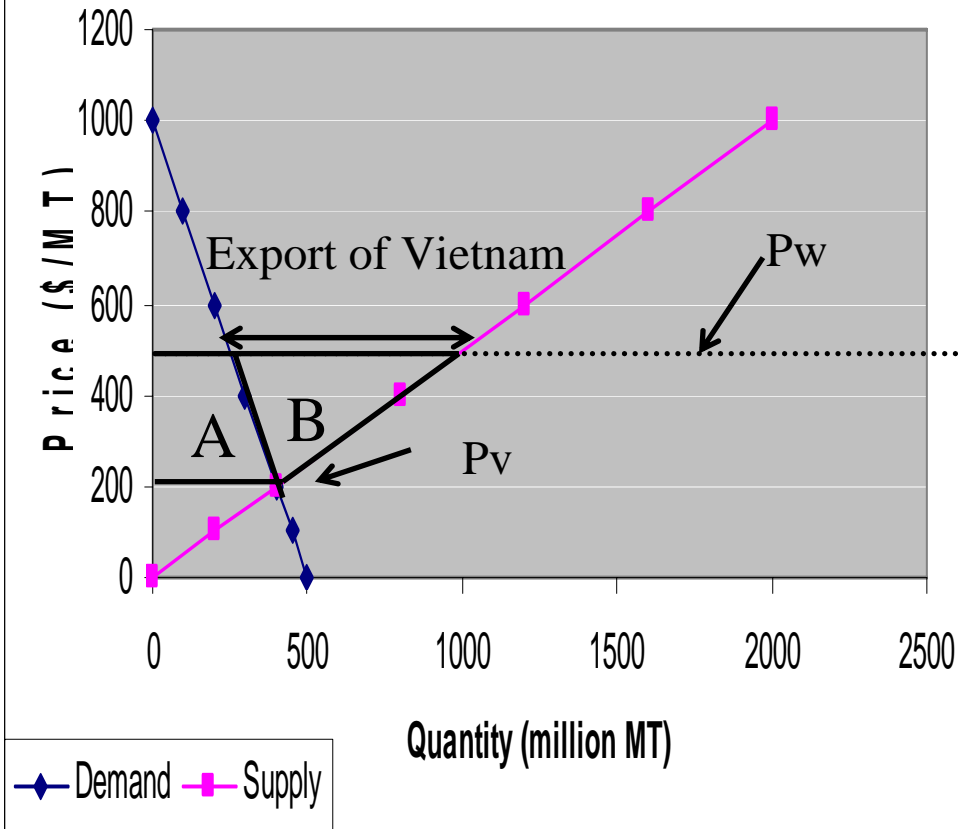
Autarky Price in Vietnam (P_v) < World Free Trade Price (P_w) < Autarky Price in Japan (P_j)

A Schematic View of Absolute Advantage

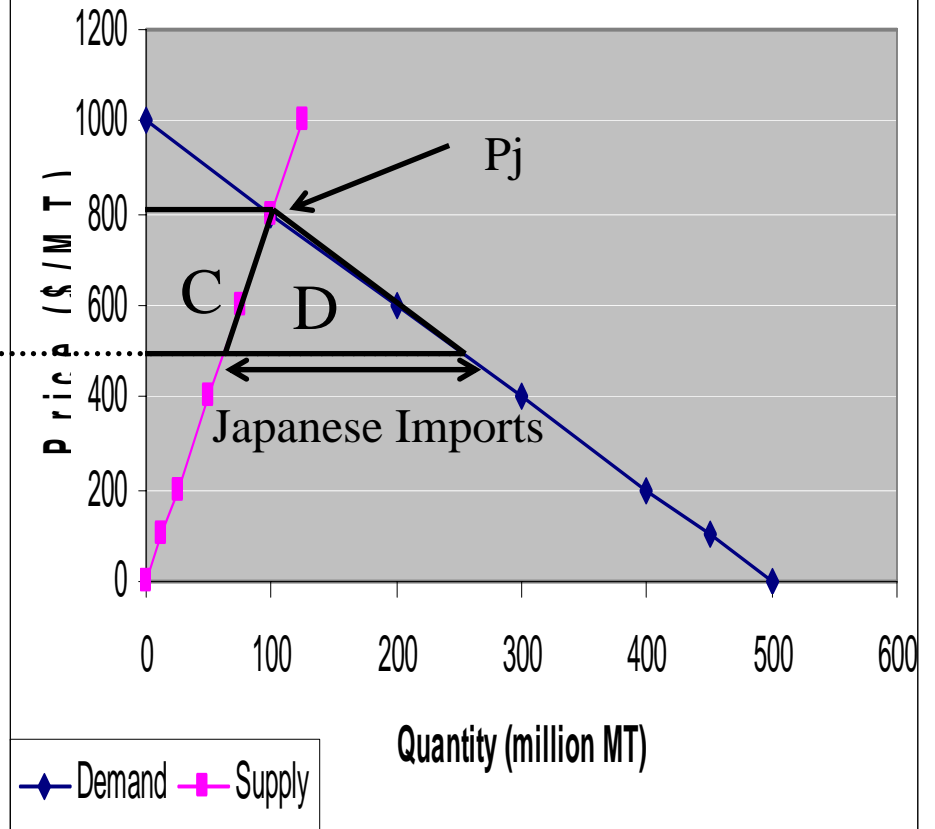


GAINS FROM TRADE

AUTARKY EQUILIBRIUM IN VIETNAM



AUTARKY EQUILIBRIUM IN JAPAN



Country	Change in Producer's Surplus	Change in Consumer's	Gain from Trad
Vietnam	A + B	-A	B
Japan	- C	C + D	D

CONCLUSIONS

Trade can improve overall welfare of the countries involved

Pitfalls

Country without absolute advantage can not export -
Untrue

Seeking gain depends upon TERMS OF TRADE

Everybody does not gain from trade

Producers of Rice in Japan LOOSE

Consumers of Rice in Vietnam LOOSE

Comparative Advantage Model – David Ricardo