Institutional developments	World Bank and IMF (1944)/ COMECON (1947)/ PL-480 (1954)/ GATT (1964)/ Group of 77 (1964)/ US$ as reserve currency/ Eurodollar and offshore $ market	Group of 7 (1975) / GATT Uruguay Round (1986)/ NAFTA (1994)/ WTO (1995)/ Group of 20 (2003) Offshore banking/ Structural Adjustment Loans/ Glasnost and Perestroika/ IMF and World Bank 'governance' loans

Week 2 – Free trade and its consequences

1. **Comparative and absolute advantage**

   Comparative advantage: a country has comparative advantage in the production of good x if the opportunity cost of producing a unit of x, in terms of other goods foregone, is lower in that country than abroad
   - Comparative advantage measured in opportunity cost of forgoing production of other goods
   - e.g. Britain vs Portugal in production of cloth and wine; Smith says Portugal is better in both so Britain should purchase both; Ricardo says Portugal and Britain should produce what they're comparatively better at
   - Each country should produce the good that is relatively cheaper compared to the cost of producing the other good in another country

   Absolute advantage: a country has absolute advantage in the production of good x if it costs fewer resources to produce a unit of x in that country than abroad
   - Developed by Adam Smith
   - "If a foreign country can supply us with a commodity cheaper than we ourselves can make it, better buy it of them with some part of the produce of our own industry employed in a way in which we have some advantage"
   - Important exceptions such as national defence

2. Assumptions of comparative advantage theory

- Perfect competition: number of buyers and sellers, homogenous products, rational maximising behaviour by agents, no entry or exit barriers
- Constant returns, i.e. the rate of output growth relative to factor inputs: in modern industry increasing returns may be the norm, meaning trade could be not universally beneficial (Keen 2001 ch3.)
- No learning effects: assumes that protected industries will not improve their efficiency when this is not the case

- External immobility of factors: assumes that factors of production do not need to move internationally: Post-Keynesian theorists argue that mobile factors means trade switches to absolute rather than comparative advantage because TNC capital can shape production costs in host countries; absolute advantage-based trade makes exploitation-based trade more likely
- Internal mobility of factors: assumes that factors can move to new employment so smoothly that cost of free trade does not outweigh the benefits, however capital can sink and workers can find it hard to get new jobs at equivalent pay (Prasch 1996)
- Full employment: lost profits, long-term unemployment and reduced wages are social costs that can outweigh gains from trade (Dunkley 2000, 116, 152, 289)
- Lump-sum compensation: structural adjustment assistance for free trade from the winners is not monitored
- No externalities: prices often do not reflect costs such as environmental destruction or labour exploitation
- Voluntary, arm's-length trade: assumes that trading transactions are voluntary, in fact influenced by debt-induced exchange, IMF-WB pressure or intra-firm exchange
- The good consumer: more opportunity for consumption does not necessarily equal increased welfare, some groups could get more gains than others (Krugman and Obsfeld 1994, 204)
- Gains to locals: in age of globalisation, people may spend more of their money on imports or send money overseas; also free trade redistributes benefits from government and local firms to individuals and exporters, therefore inherently privatising and not equal to public good
- Forcing structural change is good and inevitable
- Material goals: assumes that the key goals of economic policy are income maximisation and rapid economic growth

Two major implications of assumptions: (Dunkley 2004)

- Free trade may be less beneficial than claimed to an extent which depends on the number and degree of failures
- Countries may differ in their degree of assumption failure and thus in their capacity to gain from trade

Comparative advantage

Production possibility frontier

- Describes how much of the two goods the country can produce, shows the combination of outputs potentially available if resources are used optimally
- An increase in a country's resources would shift the PPF outwards
- If the opportunity cost of importing a good is less than that of producing it in the home country, trade is the optimal solution (e.g. the opportunity cost of locally producing 1 bicycle is 2 coats due to the time that a worker would spend producing the bicycle. If the import cost of a bicycle is 1.5 times the cost of a coat, then the import opportunity cost is less)
- The exact quantity exported by each country must equal the quantity imported by the other (i.e. suppply = demand), world prices adjust so that this is true
- Efficiency differences create wage differences between countries

Table 13.2 **Wages, costs and prices in a simple trade model**

	Labour units to produce 1 unit		Wage ($)	Unit cost of production ($)		World price ($)	
	bicycles	coats		bicycles	coats	bicycles	coats
Home	1	0.5	400	400	200	300	200
Foreign	2	2	150	300	300	300	200

- Any firm attempting to produce bicycles in Home would make a loss
- Any firm producing coats would make a loss
- Therefore trade follows comparative advantage

Countries gain from trade
- Economies can consume more than they previously could because without trade you can only consume what you produce
- Total gains exceed total losses
- However, both countries do not gain equally; e.g. in above example foreign wages are lower

National specialisation → ↑ optimal use of resources
↑ individual and global wealth

↑ consumer choice and ↓ prices

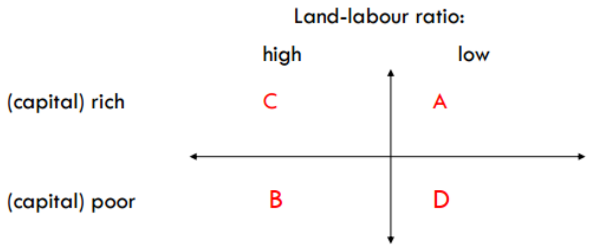
↑ competition and efficiency in domestic markets

↑ international spread of technology and know-how
→ ↑ chance of 'catch up'

↑ interdependence → peace and harmony amongst nations

Sources of comparative advantage
- Differences in technology (only if able to continually keep ahead of technological race)
- Differences in endowments (the stocks of labour, capital and other resources, i.e. factors of production), may change over time

Heckscher-Ohlin theory of trade
- Based on 2 observations: economies differ in relative quantities of different factors of production, production of different goods requires the use of factors of production in different proportions
- Predicts that countries will have a comparative advantage in the production of goods that are relatively intensive users of factors of production with which they are well endowed
- Not much empirical support
- Trade will tend to bring about convergence of factor prices across countries (if one country imports unskilled-labour intensive goods, the demand and therefore price of its unskilled labour will go down)



countries:	A	B	C	D
Population density (people/km^2)	98	23	3	95
GDP/capita ($US)	39,400	10,200	38,400	10,200

countries:	Austria	Brazil	Canada	Dominica
Population density (people/km^2)	98	23	3	95
GDP/capita ($US)	39,400	10,200	38,400	10,200

w	x	y	z
Iron Ore	Soap	Petrol	Cars
Petrol	Bananas	Cars	Car parts
Soya	Toothpaste	Gas	Medicines
Sugar	Paint	Car parts	Electricity
Cars	Sand	Goods vehicles	Engines

countries:	A	B	C	D
Population density (people/km^2)	98	23	3	95
GDP/capita ($US)	39,400	10,200	38,400	10,200

Which groups are likely to support (✓) or oppose (x) free trade?

	A	B	C	D
capital	✓	x	✓	x
land	x	✓	✓	x
labour	✓	x	x	✓

Winners and losers in trade

- Relatively abundant factors of production in a country will gain from trade while relatively scarce ones may lose (Stolper-Samuelson theorem)
- E.g. NAFTA - owners of capital and skilled labour in the US and unskilled workers in Mexico will be in favour because those factors are relatively abundant and will therefore be in demand, causing incomes to rise. Unskilled workers in the US will be opposed because then they will no longer be relatively scarce and their incomes will go down
- A less developed country is likely to have a comparative advantage in unskilled labour intensive products and would therefore benefit from trade
- Wage imbalances between two countries can be narrowed by either Mexicans moving to the US to take jobs (migration) or the development of labour-intensive industry in Mexico selling into the US (trade). Narrowing of gap in wages through trade may reduce Mexican immigration pressures on the US.

Stolper-Samuelson theorem extended

- External changes can have the same effect as trade or protection changes (e.g. when a nation's ecternal transport becomes dearer or its trade less secure, the effect is the same as if it had raised tariffs)
- Global changes in transportation must have benefited relatively abundant factors of production and harmed relatively scarce ones
- Four types of economies: (1) capital rich, land rich and labour poor (2) capital rich, land poor and labour rich (3) capital poor, land rich and labour poor (4) capital poor, land poor and labour rich
- Economically advanced - capital rich

FIGURE 1 Four Main Types of Factor Endowments

	Land-Labor Ratio: High	Land-Labor Ratio: Low
Economy Advanced	ABUNDANT: Capital, Land SCARCE: Labor	ABUNDANT: Capital, Labor SCARCE: Land
Economy Backward	ABUNDANT: Land SCARCE: Capital, Labor	ABUNDANT: Labor SCARCE: Capital, Land

FIGURE 2 Predicted Effects of Expanding Exposure to Trade

	Land-Labor Ratio: High	Land-Labor Ratio: Low
Economy Advanced	CLASS CLEAVAGE: Land and Capital free-trading, assertive; Labor defensive, protectionist	URBAN-RURAL CLEAVAGE: Capital and Labor free-trading, assertive; Land defensive, protectionist **Radicalism**
Economy Backward	URBAN-RURAL CLEAVAGE: Land free-trading, assertive; Labor and Capital defensive, protectionist **U.S. Populism**	CLASS CLEAVAGE: Labor free-trading, assertive; Labor and Capital defensive, protectionist **Socialism**

FIGURE 3 Predicted Effects of Declining Exposure to Trade

	Land-Labor Ratio: High	Land-Labor Ratio: Low
Economy Advanced	CLASS CLEAVAGE: Labor assertive, Land and Capital defensive **U.S. New Deal**	URBAN-RURAL CLEAVAGE: Land assertive, Labor and Capital defensive **W. European Fascism**
Economy Backward	URBAN-RURAL CLEAVAGE: Labor and Capital assertive, Land defensive **South American Populism**	CLASS CLEAVAGE: Land and Capital assertive, Labor defensive **Asian & East European Fascism**

Possible objections to political extension of S-S theorem

- Could be less pertinent in countries that depend only slightly on trade; however, S-S obtains at any margins, expansion of trade in autarkic economies still devastating
- Winners can compensate the losers; however, natural tendency is for winners to ignore losers
- Rational people disinvest from losing factors and therefore cleavages are eliminated; adaptation may be delayed, however technology makes factors more mobile and adaptation more predictable

Lecture

History

- Empire and political power, coercion, imperial expansion are key to trade (historically)
- Initially extensive state support of trade in the development of British empire, as empire extended free trade became more common (abolishment of Corn Laws, Central Navigation Act (banned foreign vessels from using British colonial ports), signed a free trade agreement with France)
- Interwar period, increased barriers to trade, declining trade volumes
- Post-war-1970s: GATT, trade dominated by USA-Europe-Japan, state-led development in poorer countries, rich countries still practiced discrimination in terms of who they traded with
- Post 1970s: increased in trade to GDP ratio 28% (1970) to 58% (2010), US in trade deficit, Asian countries in surplus

Why did trade expand post 1970s?

- Washington Consensus (poorer countries must reduce protections to receive aid/financial benefits)

  Influence of WTO
- General Agreement of Trade in Services (GATS)
- Trade-Related Intellectual Property Rights (TRIPs)
- Trade-Related Investment Measures (TRIMs)
- Constrains developing countries more than in does developed countries, but BRICs countries have in some cases been able to flaunt those rules

Organising principles

- Most Favoured Nation (countries that sign up to WTO must treat all other members equally)
- National treatment (governments gave to treat their imports the same as they treat national industry; no protectionism)
- Reciprocity (must do in return whatever the other country did to your imports)

Safeguards

- Anti-dumping duties (stop countries selling large amounts of goods at below-market prices to undercut competition)
- Countervailing duties (if another country subsidises their exports, you can do the same)

NAFTA

In America

- Reduction of factory-based production
- Increase of corporate headquarters
- Firms have increased their exports to Mexico
- NAFTA reduced costs for companies to transport goods to and from Mexico
- Consumers benefit from more products, better quality, lower prices

Late Victorian Holocausts

- Introduction of capitalism during famines in 1800s in India, China, Brazil, Vietnam
- Laissez faire economic ideology
- India was supplying a fifth of Britain's wheat consumption, financed British military supremacy in Asia (25% of India's budget)
- During the famine of 1899–1900, when 143,000 Beraris died directly from starvation, the province exported not only thousands of bales of cotton but an incredible 747,000 bushels of grain
- During 1876 Lytton, widely suspected to be insane, ignored all efforts to alleviate the suffering of millions of peasants in the Madras region and concentrated on preparing for Queen Victoria's investiture as Empress of India
- did nothing to check the huge hikes in grain prices
- Economic "modernization" led household and village reserves to be transferred to central depots using recently built railroads. Much was exported to England, where there had been poor harvests
- Telegraph technology allowed prices to be centrally co-ordinated and, inevitably, raised in thousands of small towns
- Relief funds were scanty because Lytton was eager to finance military campaigns in Afghanistan
- as believers in Malthusianism, thought that famine was nature's response to Indian over-breeding.

Week 3 – State building & restrictions on trade

1. Hamilton and List – opposition to free trade

List's point

- If all nations could unite into one free-trading state then they would all become richer
- But that union doesn't exist yet
- Need protection to further true freedom of trade (allowing developing countries to catch up)
- Reality of one free-trading state without protectionism is that countries would turn inwards in terms of manufacturing and then all other states would become unimportant and subjugated to Britain

List - productive power

- Comparative advantag ususally seen as best for raising global output, trade surplus, trade gain distribution, productivity
- Productive power starts from position that capital accumulation and division of labours specialisation are products of economic development (Shaefaddin 2005 48)
- Developing countries shouldn't focus on increasing sum of ecxchangaebla values but productive power that allows them to produce high-skills goods
- Lack of productive power = country doomed to import goods of higher value than it exports, leading to debt and underdevelopment
- Productive power = natural, material and mental capital
- Specialisation only comes once you have education, infrastructure, communication and transport organized by state