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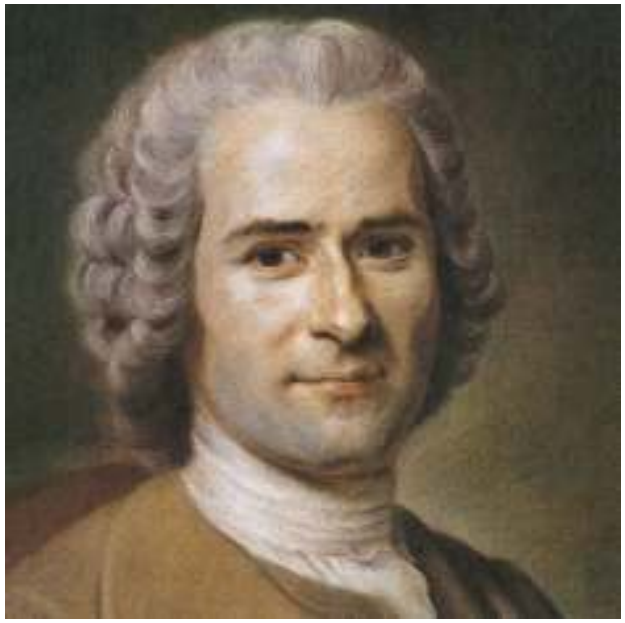
Lecture 3

1. Absolut advantage
2. Comparative advantage
3. International specialization
4. Global value chains
5. Fair trade project



Under p. 1

Laissez-faire (free trade)

the policy of leaving things to take their own course, without state interfering, but is it really possible?

- **Adam Smith** (1723 - 1790) was a Scottish moral philosopher and a pioneer of political economy

- One of the key figures of the Scottish Enlightenment, Adam Smith is best known for two classic works: *The Theory of Moral Sentiments* (1759), and *An Inquiry into the Nature and Causes of the Wealth of Nations* (1776)

- Smith argued that it was impossible for all nations to become rich simultaneously by following mercantilism because the export of one nation is another nation's import and instead stated that all nations would gain simultaneously if they practiced **free trade** and **specialized in accordance with their absolute advantage**

Absolute Advantage exists when a country can produce a good at a lower expense than another country.

- **Capability of one country to produce more of a product with the same amount of input than another country (absolute advantage)**
- **A country should produce only goods where it is most efficient, and trade for those goods where it is not efficient**
- Trade between countries is, therefore, **beneficial**

Absolute Advantage exists when a country can produce a good at a lower expense (lower price) than another country.

Absolute Advantage and Gains from Trade

	Cocoa	Rice	
	Resources required to produce 1 t		
Ghana	10,0	20,0	
Vietnam	40,0	10,0	
	Production and consumption without trade		
Ghana	10,0	5,0	
Vietnam	2,5	10,0	
Total	12,5	15,0	
	Resources required without trade		
Ghana	100	100	Cocoa & Rice
Vietnam	100	100	
Total	200	200	400

How much resources will be needed if Ghana produces the necessary 12,5 t cacao and Vietnam 15,0 t rice?

Ghana	125	0	
Vietnam	0	150	
Total	125	150	275

The gain from trade is 125 units of resources.

2. Comparative advantage

Ricardo showed that there is mutual national benefit from trade even if one country is more competitive in **every area** than its trading counterpart and that **a nation should concentrate resources only on industries where it had a comparative advantage**, that is in those industries in which it has the **greatest competitive edge.**

The example:

Hours of work necessary to produce one unit		
Country	Cloth	Wine
England	100	120
Portugal	90	80

David Ricardo (1772 – 1823)

Contributions:
Ricardian equivalence, labour theory of value, comparative advantage, law of diminishing returns.

England could commit 100 hours of labor to produce one unit of **cloth**, or produce **5/6 units** of wine (100/120).

In comparison, **Portugal** could commit 90 hours of labor to produce one unit of **cloth**, or produce **9/8 units** of wine (90/80).

5/6 (0,833) < **9/8** (1,125)

- Portugal has an ***absolute advantage*** in producing cloth due to fewer labor hours
- England has a ***comparative advantage*** due to lower opportunity cost (5/6 <9/8).

England is more efficient at producing **cloth** than wine, and Portugal is more efficient at producing **wine** than cloth.

So, if each country specializes in the good for which it has a comparative advantage, then the global production of both goods increases, for England can spend 220 labor hours to produce 2.2 units of cloth, while Portugal can spend 170 hours to produce 2.125 units of wine.

Comparative advantage is all about reducing the opportunity cost of a given production strategy. The opportunity cost of producing a particular item is equal to the potential benefit that could have been gained by choosing an alternative.

Criticism

As Joan Robinson subsequently pointed out in reality following an opening of free trade with England, Portugal endured centuries of economic underdevelopment: "the imposition of free trade on Portugal killed off a promising textile industry and left her with a slow-growing export market for wine, while for England, exports of cotton cloth led to accumulation, mechanisation and the whole spiralling growth of the industrial revolution".

Robinson argued that Ricardo's example required that economies were in static equilibrium positions with full employment and that there could not be a trade deficit or a trade surplus.

(1903 – 1983), previously Joan Robinson, was a British economist well known for her work on monetary economics and her wide-ranging contributions to economic theory.

3. International specialization

International specialization was centuries based on the international division of labor. It is a spatial **division of labor** which occurs when the process of production is no longer confined to national economies. Under the traditional **international division of labor**, until around 1970, underdeveloped areas were incorporated into the world economy principally as suppliers of minerals and agricultural commodities.

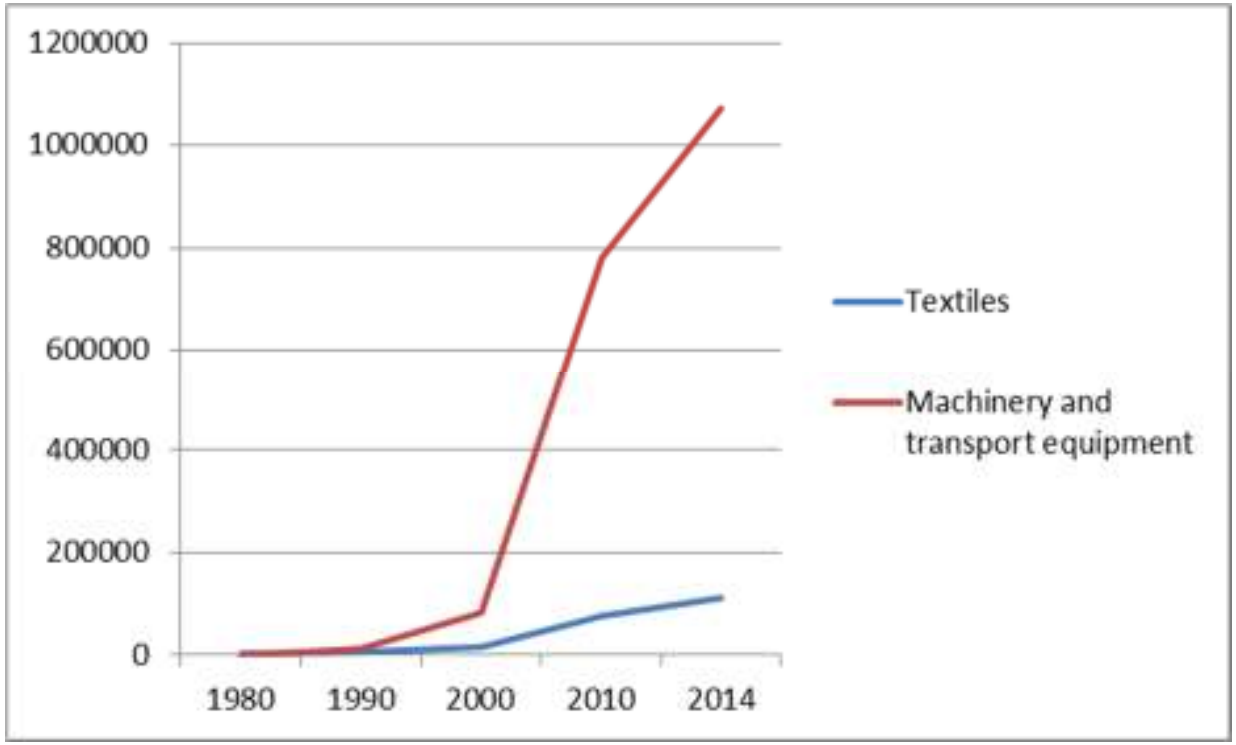
This was realized thanks to the inter-sectoral specialization of individual countries - metropolises and colonies or former colonies.

The engine of this process was international trade!

In the late twentieth century and early twenty-first century inter-sectoral specialization is gradually replaced by intra-sectoral specialization, where a major role plays economy of scale.
Now the engine of the economic process is the free movement of capital.

Best example for the dynamic of the change is the commodity structure of Chinese exports

Mill. USD



Taking into account its static comparative advantages China should specialize in textile industry but thanks to the dynamic of capital flows China is now specialized in electronics and machine building industry.

Balassa Index of Revealed Comparative Advantage

$$ES_{ij} = \frac{\frac{X_{ij}}{X_{wj}}}{\frac{M_{ij}}{M_{wj}}}$$

where ES_{ij} is the export specialization of the country i regarding the product sector j; X_{ij} is the exports of the country i by product sector j; X_{wj} is the world exports by product sector j; M_{wj} is the imports of the country i by product sector j, M_{wj} is the world imports by product sector j.

Dynamics of EU global trade specialization

SITC	Commodity groups	$X_{eu}/X_w : M_{eu}/M_w$				
		2003	2006	2008	2010	2013
0+1+4	Agricultural products	0,98	0,68	0,96	1,00	1,06
2	Mineral row materials	0,82	0,77	0,85	0,84	0,87
3	Fuels	0,47	0,44	0,45	0,45	0,51
67	Iron and steel products	1,14	1,06	1,03	1,13	1,16
5	Chemical products	1,23	1,21	1,20	1,20	1,22
7	Machinery and transport equipment	1,10	1,12	1,15	1,14	1,25
65+84	Textile and cloths	0,83	0,79	0,78	0,74	0,98
8-84	Other manufactured products (sanitary items, furniture, lighting equipment, shoes, medical and optical instruments, watches, photographic equipment, etc.).	1,11	1,08	1,04	1,04	0,91

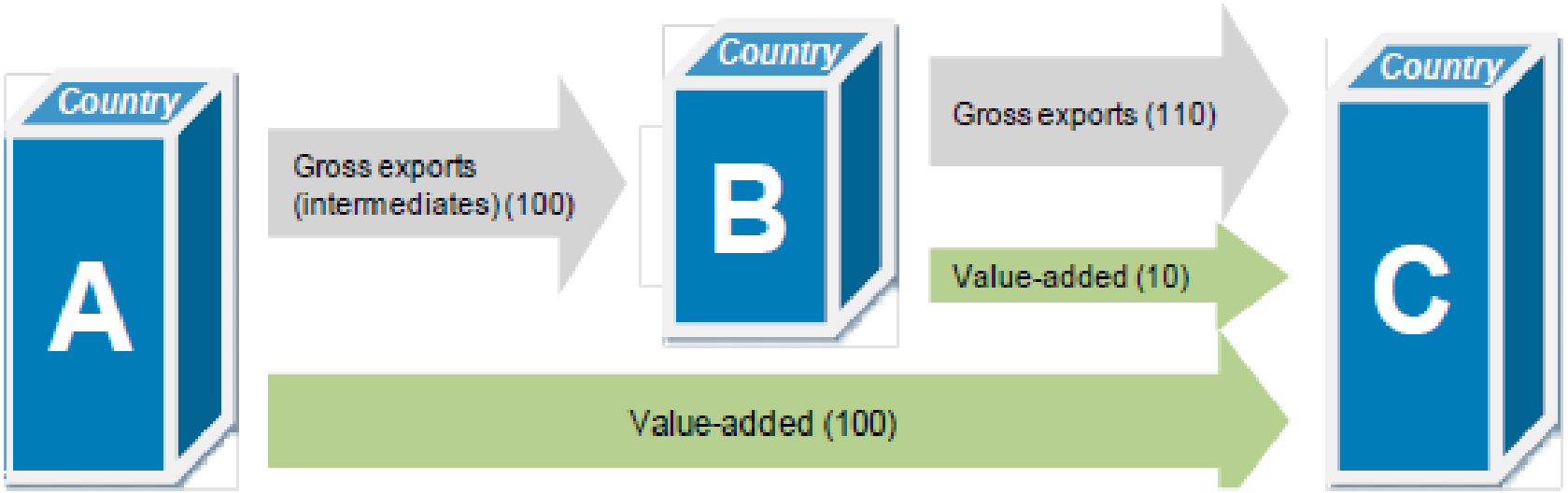
EU in the exports of high-tech products

High-tech groups	Total exports of high-tech products		of which (%)				
	in Million EUR	annual average growth rate 2001-2006	EU-27	US	JP	CN	OTHERS
Aerospace	109 425	-2.5	32.8	46.7	1.2	0.7	18.6
Armament	6 236	2.4	24.3	48.4	1.1	0.5	25.8
Chemistry	32 155	5.5	21.3	17.3	4.6	14.5	42.2
Computers-Office machines	298 243	2.9	8.0	10.8	5.8	33.4	42.0
Electrical machinery	46 328	9.7	10.0	12.9	14.6	9.0	53.5
Electronics-Telecommunication	562 814	6.1	10.5	12.1	9.1	16.0	52.4
Non-electrical machinery	36 775	3.1	27.6	27.8	17.9	2.0	24.7
Pharmacy	49 802	8.2	44.3	20.7	1.9	3.8	29.2
Scientific Instruments	145 100	8.4	20.1	20.4	12.1	10.8	36.6
Total high-tech	1 286 879	4.7	15.0	16.8	8.0	16.9	43.3

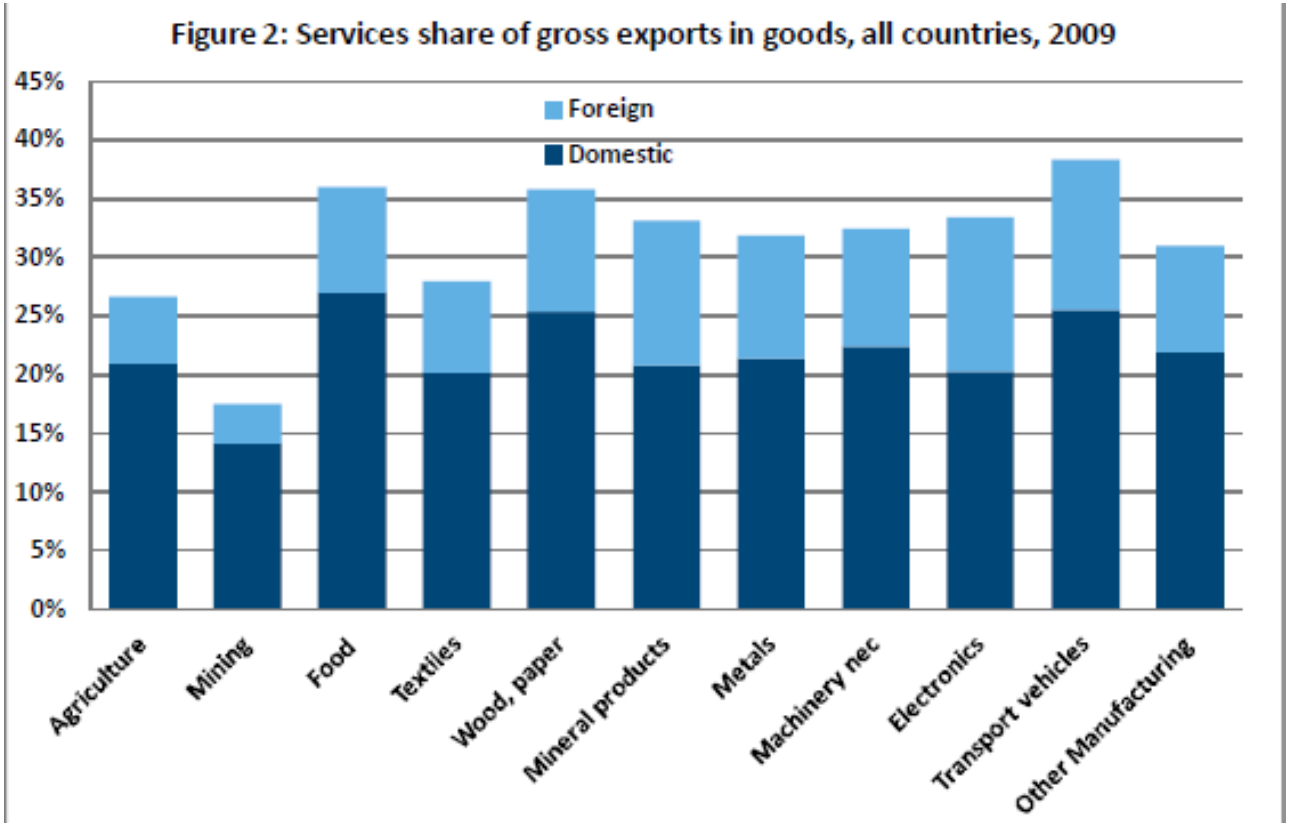
Considering that the EU share of world exports is around 25%, it can be said that the EU's high-tech industries have a global competitive advantage especially in pharmaceuticals - share about 44% of global exports and to some extent in aircraft (33%). With a total share of about 15% the EU lags behind its main competitors - the US and China, whose share is about 17% each.

4. Global value chains

Global value chains (GVCs) have become a dominant feature of today's global economy. This process of international fragmentation, driven by technological progress, cost, access to resources and markets, and trade policy reforms, challenges our conventional wisdom on how we look at and interpret trade and, in particular, the policies that we develop around it. Traditional measures of trade, that record gross flows of goods and services each and every time they cross borders, alone, may lead to misguided decisions being taken.



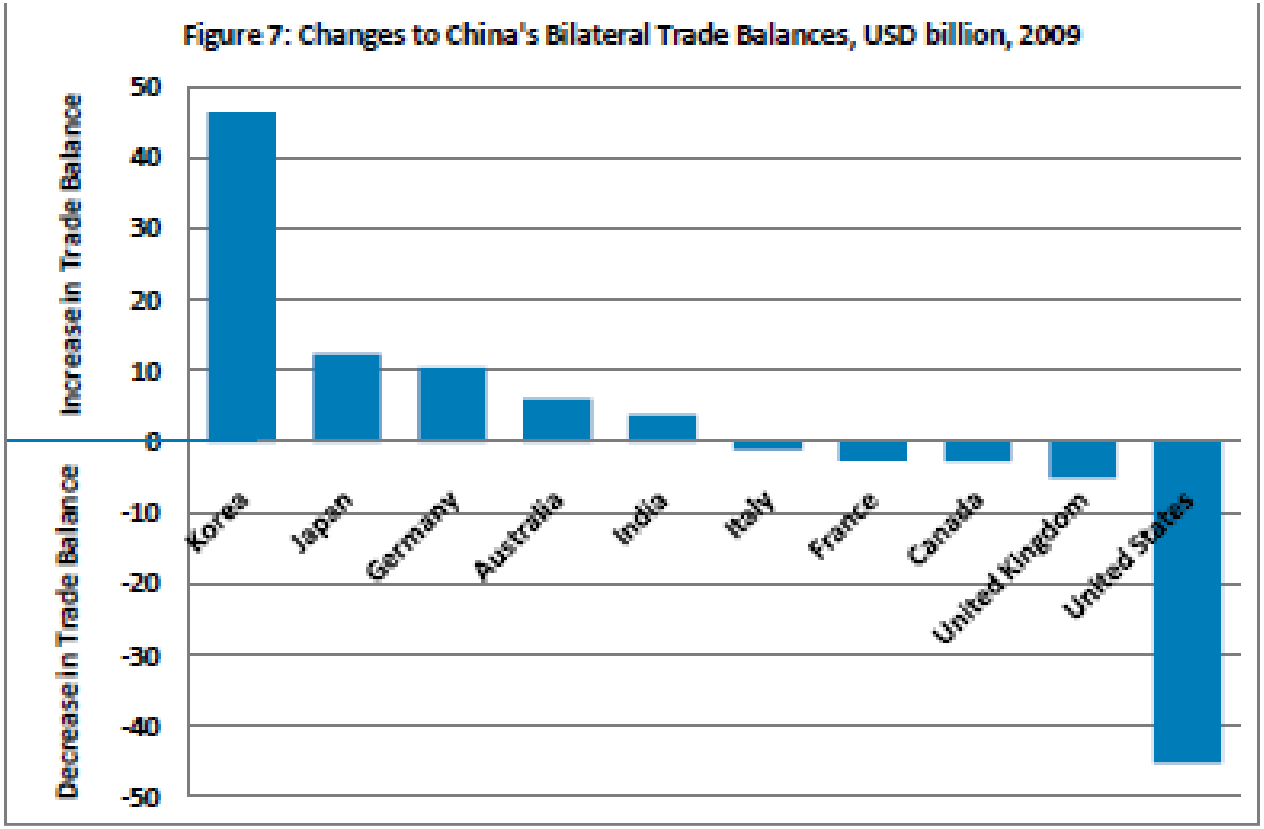
Services comprise about two-thirds of GDP in most developed economies. However, based on gross terms, trade in services typically account for less than one-quarter of total trade. But accounting for the value added by services in the production of goods shows that the services sector contributes over 50% of total exports in the United States, the United Kingdom, France, Germany and Italy and nearly one-third in China



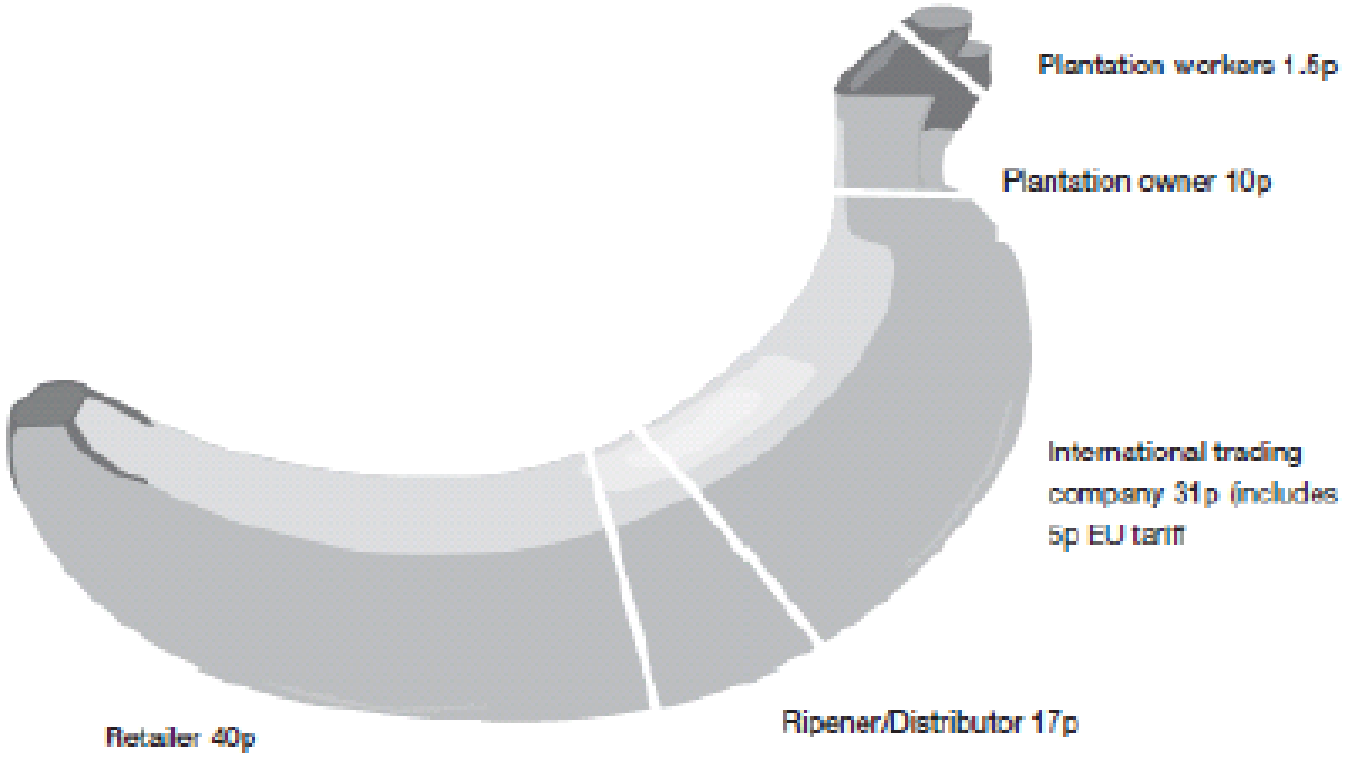
Bilateral trade balance positions can change significantly when measured in value-added terms, although the total trade balance is unaffected. China's bilateral trade surplus with the United States was over US$ 40 billion (25%) smaller in value-added terms in 2009, for example (and 30% smaller in 2005). This partly reflects the higher share of US value-added imports in Chinese final demand (see Figure 7) but also the fact that a significant share (one-third) of China's exports reflect foreign content - the "Factory Asia" phenomenon.

OECD-WTO Database on Trade in Value-Added

Figure 7: Changes to China's Bilateral Trade Balances, USD billion, 2009



DISTRIBUTION OF EARNINGS OF A 1£ RETAIL VALUE OF ECUADORIAN BANANAS



As we can see on this figure, plantation workers receive as remuneration only 1,6% of the earnings. The biggest shares of the earnings go to the retailers (supermarket chains) – 40% and to the international trading companies – 31%. The same picture we can see in the international trade with cacao, coffee, cotton, other agricultural I mineral row materials, clots etc.

5. Fair trade project

http://wfto.com/