

Smith and Ricardo: The case for international specialization and Free Trade

- <http://www.youtube.com/watch?v=siu6JYqOZ0g&feature=youtu.be>

#### I.Quotes of the Day

- "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." --Wealth of Nations Book IV
- "...the mean rapacity, the monopolizing spirit of merchants and manufacturers, who neither are, nor ought to be, the rulers of mankind, (though it cannot perhaps be corrected) may very easily be prevented from disturbing the tranquillity of anybody but themselves..." --Wealth of Nations Book IV

#### II.The Progress of ideas: Changes in the meaning of wealth and value

- A. Intrinsic value
- B. Labor theory of value
- C. Mercantilist idea of value

#### III. Smith's objections

- A. Gold and silver are durable.....but so are pots and pans....we don't need more than we can use!
- B. To produce goods that others can produce more efficiently is wasteful
  - a. Scottish wine example

#### IV.Plato was the first advocate of free trade – did Smith borrow his idea about the division of labor?

- A. " Then, as we have many wants, and many persons are needed to supply them, one takes a helper for one purpose and another for another; and when these partners and helpers are gathered together in one habitation the body of inhabitants is termed a State..... And they exchange with one another, and one gives, and another receives, under the idea that the exchange will be for their good.
- B. Smith: "The tailor does not attempt to make his own shoes, nor the shoemaker his own clothes: and countries too should make what they can make cheaper, and buy in what would cost them more to produce."

#### V.Theory of Comparative Advantage

- A. **David Ricardo (1772-1823)**
- B. **FREE TRADE VS PROTECTIONISM**
- C. **Production without specialization and division of labor (see table)**
- D. **Production with specialization before trade (see table)**
- E. **Production with specialization and trade (see table)**
- F. **Opportunity costs**

The "lost opportunity" of doing A is the value of any benefit given up by not doing B



A certain good should always be produced in the country which has the lowest opportunity cost



If a country can choose between producing two goods it should choose the one where it is most

#### **EFFICIENT**

#### G. **Two important principles**

- 1) Efficiency produces wealth
- 2) Trade is necessary to be efficient, because through competition all countries grow = there is an absolute gain

#### H. Assumptions of Ricardo's Theory

- 1)Assumes static givens in a country's economy ...
- 2)... and doesn't discuss technology as a factor of production.
- 3)Labor theory of value

## I. Labor Theory of Value (Smith)

The real price of every thing, what every thing really costs to the man who wants to acquire it, is the toil and trouble of acquiring it. What every thing is really worth to the man who has acquired it, and who wants to dispose of it or exchange it for something else, is the toil and trouble which it can save to himself, and which it can impose upon other people. (*Wealth of Nations* Book 1, chapter V)

## J. Heckscher-Ohlin-Samuelson and Krugman modernize Ricardo

- 1) This model maintains that a nation's comparative advantage is determined by the relative abundance and most profitable combination of its several factors of production, such as capital, labor, resources, management, and technology.
- 2) Krugman expands on Heckscher-Olin and wins Nobel Prize
- 3) Krugman noticed that the accepted model economists used to explain patterns of international trade did not fit the data.
- 4) The Hecksher-Ohlin model predicted that trade would be based on such factors as the ratio of capital to labor, with "capital-rich" countries exporting capital-intensive goods and importing labor-intensive goods from "labor-rich" countries.
- 5) Mr. Krugman noticed that most international trade takes place between countries with roughly the same ratio of capital to labor.
- 6) The auto industry in capital-intensive Sweden, for example, exports cars to capital-intensive America, while Swedish consumers also import cars from America.
- 7) Paul Krugman Defends Free Trade
  - a) "Ricardo's Difficult Idea,"
  - b) People will specialize in producing the goods and services in which they have a comparative advantage.
  - c) The result is that we never need to worry about low-wage countries competing us out of jobs;
  - d) the most they can do is change those goods and services in which we have a comparative advantage.
  - e) **Free Trade leads to growth in Exports**
  - f) **Krugman: Free Trade is the cause of economic development in poor countries**

"The raw fact is that every successful example of economic development this past century--every case of a poor nation that worked its way up to a more or less decent, or at least dramatically better, standard of living--has taken place via globalization; that is, by producing for the world market rather than trying for self-sufficiency." (Krugman in Slate 1999)

## J. Free trade = absolute gain ... but relative loss?

### 1) Comparative Advantage is Dynamic

2) While the United States has long imported oil and other raw materials from the third world, we used to import manufactured goods mainly from other rich countries like Canada, European nations and Japan. But recently we crossed an important watershed: we now import more manufactured goods from the third world than from other advanced economies. That is, a majority of our industrial trade is now with countries that are much poorer than we are and that pay their workers much lower wages (Krugman 2007)

## K. Sum: Effects of Free Trade

- 1) Efficiency → Growth → Good life for everyone
- 2) Harmonious International Relations
- 3) Role of the State: To let producers produce most efficiently—to separate politics and economics:

4) the key actors for liberals are firms and consumers, not states.

5) Commerce → Peace Why?

a) Efficiency should be the basis of all political relations

b) Does Free Trade make the state obsolete?

## Production without specialization and division of labor

	Wine	Cloth	Total
England	3	5	8
Portugal	9 (Absolute Advantage)	6	15
Total goods produced			23

## Production with specialization before trade

	Wine	Cloth	Total
England	1	10	11
Portugal	16	0	16
Total goods produced			27

*Before trade: Resources put where they are most efficient (specialization)*

*Note: Efficiency increases total number of goods available, from 23 to 27*

**Without  
specialization  
and trade:**

	Wine	Cloth	Total
England	3	5	8
Portugal	9	6	15
Total goods produced			23

**With  
specialization  
and trade:**

	Wine	Cloth	Total
England	5	6	11
Portugal	12	4	16
Total goods produced			27