

Gains from Trade

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Gains from Trade in Classical Model

- Under autarky a country produces both goods though it has comparative advantage in the production one commodity.
- If country A has advantage in the production of X commodity then we have $a_{LX} < a_{LY}$
- Condition for participating in trade by country is

$$\frac{P'_X}{P'_Y} > \frac{a_{LX}}{a_{LY}}$$

Gains from Trade in Classical Model

- As trade opens up the country will produce only X and exchanges X for Y as relative price of X in international market is higher than that under autarky.
- With one hour of labour the country can produce $\frac{1}{a_{LX}}$ units of X.
- With one hour of labour it can produce $\frac{1}{a_{LY}}$ units of Y.

Gains from Trade in Classical Model

- Indirect production of Y by one unit of labour through importing from other country is

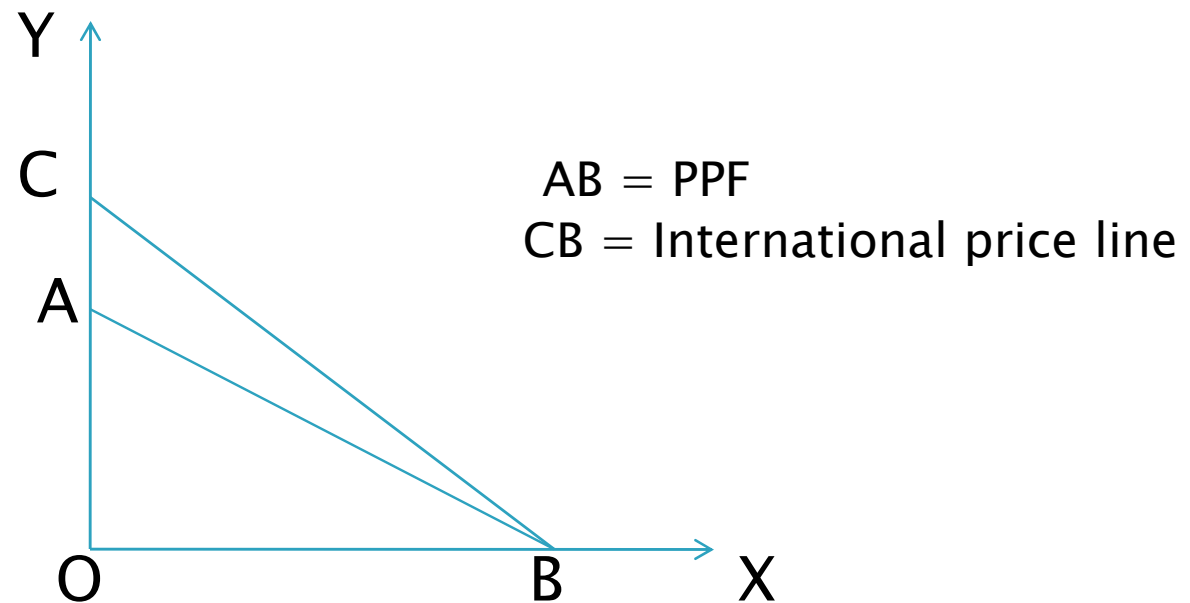
$$\frac{1}{a_{LX}} \frac{P'_X}{P'_Y}$$

- As $\frac{P'_X}{P'_Y} > \frac{a_{LX}}{a_{LY}}$, we get, $\frac{1}{a_{LX}} \frac{P'_X}{P'_Y} > \frac{1}{a_{LY}}$

- Thus, trade offers the country a better use for labour-hours.

Gains from Trade in Classical Model

- ▶ Secondly, gains from trade can be shown with the help of PPF and price line.



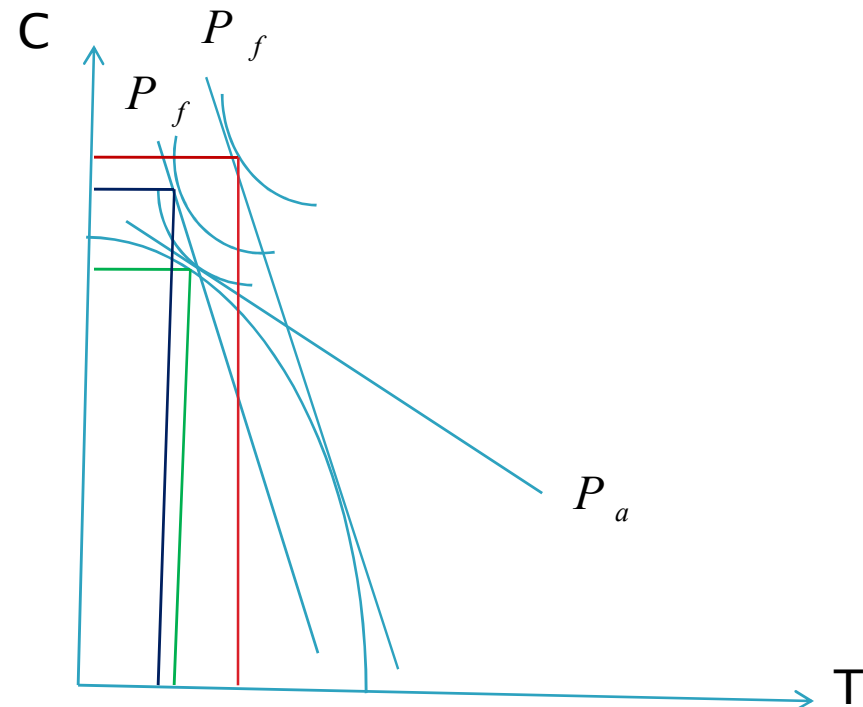
Gains from Trade in Classical Model

Gains from trade for a country arise due to

- More productive use of labour–hours available
- Consumption of larger bundle of goods

Gains from Trade in Neo-classical Model

- Let us assume that factors are immobile, so production point is fixed after trade.
- But producers can take the advantage of increase in the relative price of X in international market.
- Through such exchange the country gains as there is a shift from lower to higher IC.



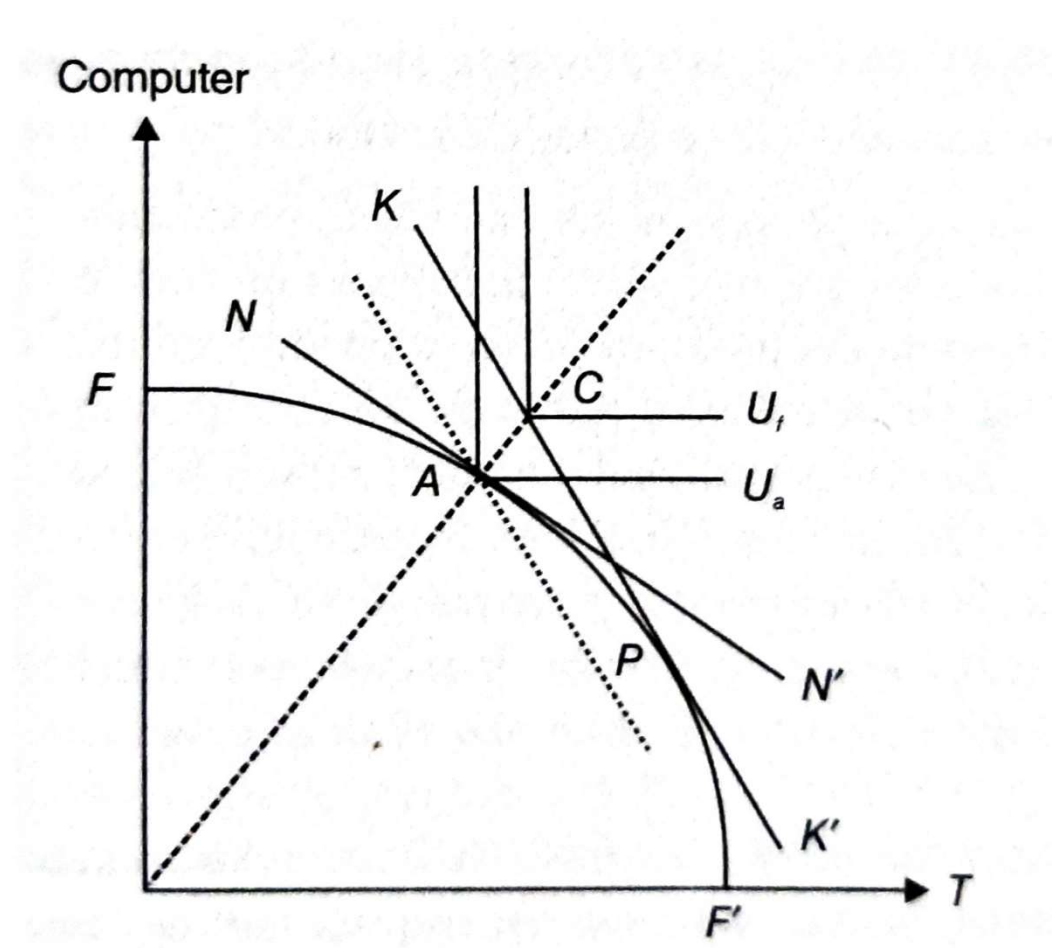
Gains from Trade in Neo-classical Model

- This gain is called gains from exchange.
- Now if the factors are assumed to be mobile across sectors and goods are substitutable in consumption then specialization in production occurs.
- Then the country moves to more higher IC. This movement occurs due to gains from specialization.

Gains from Trade in Neo-classical Model

- If factors are immobile in the economy then the country only gets gains from exchange.
- If the commodities are not substitutable in consumption then the country gets only gains from specialization.

Goods are not substitutable in consumption



References

- ▶ Krugman and Obstfeld
- ▶ Caves, Frankel and Jones
- ▶ Reed and Soderston