# 8. International Economics (Part 1)

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Outline

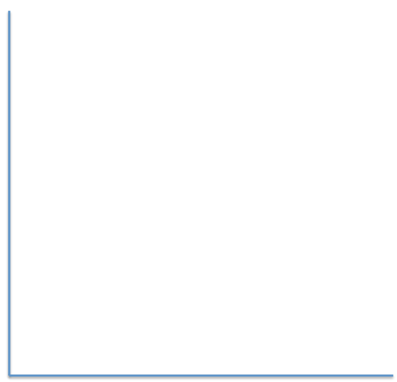
- Introduction to international trade (Part 1)
- Balance of Payments (Part 2)
- Market for foreign exchange (Part 2)
- The effect of exchange rate on economy (Part 2)

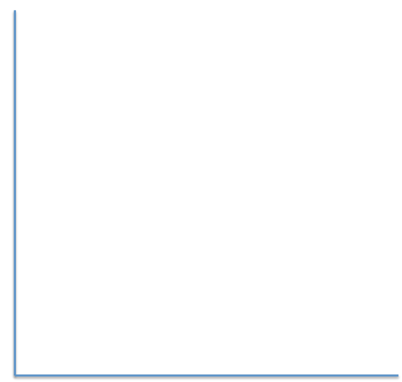
Introduction to international trade

- International trade with the rest of the world
  - dealing with open economy
  - its theory is the extension of individual's exchange
  - Reason for trade
    1. The production cost of the same commodity in each country is not equal
    2. Comparative advantages
  - without international trade, no foreign-made product
  - trade $\Rightarrow$enlarge market size $\Rightarrow$ room for dividion of labour $\Rightarrow$ specialization (increase productivity) $\Rightarrow$ more outputs with the same inputs
- We examine a special case. We assume the world to consist of two products; meat and potatoes.
- There are two producers: A Farmer (Billy) and A Rancher(Helen)
- Each producer has a production possibility frontier: How much of each good can they produce in 40-hours.
- The key to understanding the motivation for trade is defining the difference between absolute advantage and comparative advantage. The latter forms the basis for trade.
- The objective of trade is to improve the standard of living for both producers (consumers).
- Production Possibility Frontier: 2 Producers- 40 hours of labor each yields

| | Amount produced in 8 hours | | Hours needed to make 1 kg of: | |
|---|---|---|---|---|
| | Meat | Potatoes | Meat | Potatoes |
| Farmer | ........kg. | .......kg. | 20 hr./kg | 10 hr./kg. |
| Rancher | ........kg. | ...... kg. | 1 hr./kg | 8 hr./kg. |

- It seems that rancher is more efficient because rancher use less time to produce both goods.
- “Absolute advantage: an agent has an absolute advantage in producing a given good if he is more efficient in producing it than any other agent.”
- Which agent has the absolute advantage in producing cheese and which agent has the absolute advantage in producing bread?
- The Racher has an absolute advantage in producing both goods.
- Draw production possibility frontier





- Consider the Opportunity Costs: : an opportunity cost is the cost of any activity measured in terms of the best alternative foregone.

| | Meat in terms of potatoes given up | Potatoes in terms of meat given up |
|---|---|---|
| Farmer | 2 | $\frac{1}{2}$ |
| Rancher | $\frac{1}{8}$ | 8 |

- So the rancher can produce 1 kg. of meat at a lower opportunity cost
- The farmer can produce 1 kg of potatoes at a lower opportunity cost

- For the rancher – potatoes are more expensive relative to meat
- For the Farmer – meat is more expensive relative to potatoes
- "An agent has a comparative advantage in producing the good for which the cost opportunity is lower."
- Comparative advantage reflects - RELATIVE opportunity cost
- Which agent has the comparative advantage in producing cheese and which agent has the comparative advantage in producing bread?
- Farmer is RELATIVELY more efficient than rancher in producing potatoes.
- Suppose both divide their time equally for these 2 production; 20 hours for meat and 20 hours for potatoes

| | Meat | Potatoes |
|---|---|---|
| Farmer | 1 kg. | 2 kg. |
| Rancher | 20 kg. | 2.5 kg. |

- Without trade,for each individual, if they want to produce and consume more of one goods; they must produce and consume less of the other goods
- Show the production of the farmer and the rancher in PPC graph on the previous page
- How can the two improve their total [consumption] via trade?
- The Rancher's Offer to Farmer: Spend all 40 hours producing potatoes and I'll trade 3 kg of meat for 1 kg of your potatoes.
- So the farmer spends 40 hours producing ........ kg. potatoes
  - With the offer the farmer will exchange 1 kg of potatoes with 3 kg of meat
  - The farmer will have ........ kg of potatoes and ........ kg of meat.
  - The farmer will be better off because the farmer can consume more of both goods which might not be possible without trade
  - Show the consumption of the farmer on PPC graph
- The rancher will allocate more time on meat production and less time on rice prod
- uction by 4 hours
  - The rancher will produce ....... kg of meat and ......... kg of potatoes
  - Then, the rancher will exchange 3 kg of meat with 1 kg of potatoes
  - The rancher will have ........ kg of potatoes and ........ kg of meat.
  - The Rancher will be better off because the farmer can consume more of both goods which might not be possible without trade
  - Show the consumption of the farmer on PPC graph

- The rancher has absolute advantage over the farmer in meat and potatoes production.
- However, the opportunity cost of producing potatoes of the rancher is greater than that of the farmer.
- Therefore, the farmer has a comparative advantage over the rancher in potatoes production.
- When one party has a comparative advantage over the other party, there is a benefit from trade.
- If the rancher had a comparative advantage over the farmer in producing both goods, there would be no benefit from trade.
- Gains from specialization and trade based on comparative advantage .
- Total production in economy rises Increase in the size of the economic pie. Everyone – better off.
- Trade can benefit everyone in society. It allows people to specialize in activities Have a comparative advantage.
- The price of trade Must lie between the two opportunity costs.
- Should Tiger Woods mow his own lawn?
  - Woods Mow his lawn in 2 hours
  - Film a TV commercial and earn $10,000 (2 hours)
- Forrest Gump
  - Mow Woods's lawn in 4 hours
  - Work at McDonald's and earn $20 (4 hours)
- Should Thailand trade with other countries?
  - Imports: Goods produced abroad and sold domestically
  - Exports: Goods produced domestically and sold abroad
- Principle of comparative advantage
  - Each good – produced by the country with smaller opportunity cost of producing that good
- Specialization and trade
  - All countries – greater prosperity
- Two Important Economists' Contributions Adam Smith: (not required)
  - The economic benefits of specialization
  - David Ricardo: The economic benefits of comparative advantage and free trade