

**ECON 305**  
**INTERNATIONAL ECONOMICS I**  
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**Key to Exercise 02**  
**Comparative Advantage**

1. The following table shows the hours of labor required to produce one unit of each commodity in each country:

	<b>Cloth (hours/yard)</b>	<b>Wine (hours/Gallon)</b>
<b>Portugal</b>	<b>2</b>	<b>3</b>
<b>England</b>	<b>1</b>	<b>1</b>

a. Is there a basis for trade? Explain.

Yes, there is a basis for trade, as though England has absolute advantage in both industries (1 versus 2 and 1 versus 3), her comparative advantage in Wine industry is higher ( $1/3 < 1/2$ ). Hence, we expect Portugal to produce Cloth and England Wine.

b. Which country is expected to specialize in **cloth** production according to David Ricardo? In **wine** production?

We expect Portugal to produce Cloth and England to specialize in Wine.

c. What is opportunity cost of **wine** in terms of **cloth** in England? In Portugal?

In Portugal,  $1W=1.5C$

In England,  $1W=1C$

It is easy to see that Wine is cheaper in England, that makes England competitive.

d. Suppose that terms of trade is  $1W=1.25C$ . Does opening its economy into trade make England better off or not? Show.

Yes, trade (of Wine for Cloth) makes England better off, because each unit of Wine earns  $0.25C$  extra via international trade.

e. Suppose that terms of trade is  $1W=0.75C$ . Which country is worse off by opening its economy into trade? Explain.

England is worse off at this terms-of-trade, as Wine industry makes  $0.25C$  loss in this case.