

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:

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

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.