MODULE 14
GLOBALIZATION AND TRADE

Over time, the world has become a smaller place. Globalization is the process by which the world, previously isolated through physical and technological distance, becomes increasingly interconnected. Globalization happens through the increase in interaction between peoples around the world that involves the sharing of ideas, cultures, goods, services and investment.

As globalization increases over time, individuals, firms, institutions, and politicians work within and across countries to define exactly how "open" they want to be. It is natural for people to want to protect their own products through tariffs or trade restrictions, while having open access to foreign markets. But if one country protects its products, its trading partners are likely to do the same. One thing is for sure, protection and openness to international trade both have income distribution effects. The key question is who reaps the benefits and who carries the burden of the system adopted by a given country.

We live in a global marketplace. The food on your table might include fresh fruit from Chile, cheese from France, and bottled water from Scotland. Your wireless phone might have been made in Taiwan or Korea. The clothes you wear might be designed in Italy and manufactured in China. The toys you give to a child might have come from India. The car you drive might come from Japan, Germany, or Korea.

Absolute and Comparative Advantage

Absolute advantage is when a producer can produce a good or service in greater quantity for the same cost, or the same quantity at a lower cost, than other producers. Absolute advantage can be the basis for large gains from trade between producers of different goods with different absolute advantages.

A country has an **absolute advantage** over another country if it can produce a given product using fewer resources than the other country needs to use. For example, if Canada can produce 100 pounds of beef using two ranchers, while Argentina needs three ranchers to produce 100 pounds of beef, Canada has an absolute advantage over Argentina in beef production.

Comparative advantage is an economy's ability to produce a particular good or service at a lower opportunity cost than its trading partners. A comparative advantage gives a company the ability to sell goods and services at a lower price than its competitors and realize stronger sales margins.
For example, oil-producing nations have a comparative advantage in chemicals. Their locally-produced oil provides a cheap source of material for the chemicals when compared to countries without it. A lot of the ingredients are produced in the oil distillery process. As a result, Saudi Arabia, Kuwait, and Mexico are competitive with U.S. chemical production firms. Their chemicals are inexpensive, making their opportunity cost low.

What happens when a country has an absolute advantage in all goods?

What happens to the possibilities for trade if one country has an absolute advantage in everything? This is typical for high-income countries that often have well-educated workers, technologically advanced equipment, and the most up-to-date production processes. These high-income countries can produce all products with fewer resources than a low-income country. If the high-income country is more productive across the board, will there still be gains from trade? Good students of Ricardo understand that trade is about mutually beneficial exchange. Even when one country has an absolute advantage in all products, trade can still benefit both sides.

Trade and Incomes

Incomes depend on labor productivity. A country with an absolute advantage in some product has higher labor productivity than another country does in the production of that product. If a country has an absolute advantage in producing both goods, it has higher labor productivity in both and its workers will earn higher incomes than those in the other country. Thus, the average income in a country depends on its average labor productivity.
Now consider comparative advantage. If a country specializes production in the product in which it has a comparative advantage, it raises its average labor productivity and raises its average income. Thus, comparative advantage is more important than absolute advantage in understanding which country should trade which product in order to maximize the standard of living in both countries.

Intra-Industry and Inter-Industry Trade

Intra-industry trade refers to the exchange of similar products belonging to the same industry. The term is usually applied to international trade, where the same types of goods or services are both imported and exported. Intra-industry trade represents international trade within industries rather than between industries. Such trade is more beneficial than inter-industry trade because it stimulates innovations. Intra-industry trade occurs when a country exports and imports goods in the same industry.

Inter-industry trade is a trade of products that belong to different industries. For instance, the trade of agricultural products produced in one country with technological equipment produced in another country can be classified to be an inter-industry trade.

The international trades raise the standard of living for participating countries. Indeed, free trade maximizes the gains from international trade. While each country is better off through international trade, that doesn't mean that all individuals are better off.

Free trade is a policy and like every policy, there are winners and losers. The winners are consumers and workers, managers and owners of firms that produce goods whose demand increases through international trade. The losers are workers, managers and owners of firms whose demand decreases as a result of international trade.