Session 2. General equilibrium trade analysis

3. General equilibrium trade modeling: Ricardian 2 x 2 x 1 trade model
   3.1 Key concepts and theoretical significance
      3.1.1 Contributions of Adam Smith: specialization, absolute advantage, gains from trade
      3.1.2 Contributions of David Ricardo: comparative advantage
   3.2 Model specifications and assumptions of the model
      3.2.1 General equilibrium analysis
      3.2.2 Model specifications: 2 countries, 2 goods, and 1 factor (labor, L)
      3.2.3 Assumptions of the model
          [1] Identical goods and labor factor
          [2] Competitive markets in goods and factor
          [3] Perfect mobility of the labor factor between the two sectors
          [4] Immobility of labor across national borders
          [5] No transactions/transportation costs
          [6] No government intervention
          [7] Countries have different labor endowment
          [8] Different technology: different L use per unit produced
          [9] Constant opportunity cost in production: linear production possibilities curve
          [10] Preferences may or may not be identical across countries
   3.3 Modeling of trade
      3.3.1 Example 1. Both countries have an absolute advantage in production of one good

Goods	Production possibilities in:		Closed market equilibrium: Q = C		Pre-trade prices (bread in terms of wine or wine in terms of bread)		World price or terms of trade (TOT)
	North	South	North	South	North	South	
Bread	100	20	60	10	1B = ½ W	1B = 5 W	1B =
Wine	50	100	20	50	1W = 2 B	1W = 1/5 B	1W =

Step 1. Production possibilities and supply-side analysis
Step 2. Closed economy equilibrium: supply and demand analysis
Step 3. Determination of domestic (pre-trade) prices
Step 4. Determination of a world price: terms of trade
Step 5. Adjustment process: change in relative prices
Step 6. Trade and welfare implications: gains from trade

Pre-trade general equilibrium   Free trade general equilibrium