## Session 4. General equilibrium trade analysis, continued

- 3. General equilibrium trade modeling: Ricardian 2 x 2 x 1 trade model
  - 3.3 Modeling of trade
    - 3.3.2 Example 2. One country has an absolute advantage in production of both good

|       | Production possibilities in: |       | Closed<br>equilil<br>Q = | Closed market<br>equilibrium:<br>Q = C |  | Pre-trade prices<br>(bread in terms of wine or<br>wine in terms of bread) |                     | World price<br>or terms of<br>trade |  |
|-------|------------------------------|-------|--------------------------|----------------------------------------|--|---------------------------------------------------------------------------|---------------------|-------------------------------------|--|
| Goods | North                        | South | North                    | South                                  |  | North                                                                     | South               | (101)                               |  |
| Bread | 100                          | 30    | 70                       | 20                                     |  | 1B = 1W                                                                   | 1B = 3W             | 1B =                                |  |
| Wine  | 100                          | 90    | 30                       | 30                                     |  | 1W = 1B                                                                   | $1W = \frac{1}{3}B$ | 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

World market of wine in terms of bread







Step 5. Adjustment process: change in relative prices Step 6. Trade and welfare implications: gains from trade



3.4 Law of one price, world price, and terms of trade

- 3.4.1 Define LOOP and TOT
- 3.4.2 Meaning of changes in TOT

3.5 Summary of the general lessons of the 2 x 2 x 1 trade model: specialization, trade and gains