Comparative Advantage

Production Frontiers

There is a trade-off between producing oil and wheat for both the U.S. and Saudi Arabia. They each have their comparative advantages as shown by the production frontiers. By allowing trade, the joint production frontier becomes bigger and the standard of living becomes higher in both countries than with only the national economies. In this model, we assume that this process does not produce unemployment and that the transition costs between industries are low. Trade will not happen, though, if the production frontiers are identical in shape and the two countries have identical production facilities and methods – this never happens, however, so there will always be trade.

Difference between making potato chips and computer chips:

Some argue that the dominant industry doesn’t make difference because microeconomics says that in different industries in a competitive market:
1. Return on Investment of capital (ROIk) is same
2. Wages are the same
So if these two factors are the same – who cares what you are making?

However, this is wrong because this is an equilibrium model, whereas we live in constant disequilibrium. We are moving towards equilibrium but we will never get there because of:
1. Technology changes
2. Economies of scale and learning curves
3. Man-made advantages (in standard model, comparative advantages are fixed, which is not true)
These three things combined are what make the standard model false.

In this setup, there are of course winners and losers. The winners have small gains but have very large numbers while the losers number very few but have huge losses. Consequently, the losers have more political clout because they’re more concentrated and are more sensitive to effects.

Zambia (is an example of a long-term decline)

In currency terms, per capita GDP in 1997 was $90-100/year and going down (pop: 10+ million). At the time, there was a growth rate of 3.7% (!). This alone doomed Zambia as the population growth rate is way too high. The place is so disorganized that there is no more recent data. This
wasn’t always the case – in 1965, per capita income was higher than Asia whereas now it is much much less. So what happened?

These African countries have huge AIDS rates and very low education – an average of 2.6 years of education in 1980 and most certainly around 1.5 now. In 1970, the illiteracy rate was 52% and would be much higher now because the school system is dysfunctional.

African and tropical countries

This is a common theme in tropical countries, which must deal with horrendous disease problems, including malaria and AIDS, which thrive in the tropics (in addition to killing diseases, cold weather is also good for organization). The problem with disease is that infected people don’t die out – they take a long time to die during which time they need to cared for and can spread the disease further. The tropics also have lots of plant diseases that were compounded by the green revolution (which is why rice is so prevalent – because it grows underwater).

Further, drug companies will never work on tropical diseases because there is absolutely no way to turn a profit (the American government has started offering prizes for malaria vaccines but we’ll see if that works). Biotechnology has helped places like India and China but haven’t worked in the tropics.

Singapore was an exception to this trend because they had the ability to get organized – in 1965, Zambia looked much better than Singapore but you can’t grow without social organization.

The environment of African economies

<table>
<thead>
<tr>
<th>Positives:</th>
<th>Negatives:</th>
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<tr>
<td>Lots of natural resources</td>
<td>Not real countries in the historical sense</td>
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<tr>
<td>Potential for rich countries –</td>
<td>just random borders</td>
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<tr>
<td>they are born rich</td>
<td>No national identity (73 groups &amp; 80 lang.)</td>
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<tr>
<td>No civil war or race problems</td>
<td>Trade embargo</td>
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<td>Respected uncrrupt leader</td>
<td>One commodity income</td>
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<tr>
<td>Peaceful transition from a</td>
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<td>colony to a country</td>
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There was also a strong belief that socialism was the route to economic success – this was based on the Soviet model as the USSR went from being poor to a powerhouse. In the 1960s, USSR was say ahead of the USA in economic growth. People also believed that private companies were exploiters just out to get your money.

Other problems included malnourishment, which people with no energy to work and susceptible to disease, and corruption, which was high in Zambia and relates back to socialism.

Commodity economies
With commodities such as copper (which is what Zambia’s economy was based on), you would expect prices to drop in the long-term as technology is developed. If you’re a tech leader, your own costs will drop faster than prices, making it very profitable to stay in the business. If you’re a tech laggard, prices will fall first. That said, low educated countries like Zambia most certainly won’t be tech leaders, which means their economies will eventually collapse.

They tried to form a copper cartel but it didn’t work. This is because in copper, technology makes you a low-cost provider (unlike OPEC where nature made the Persian Gulf a low-cost provider). Also, copper is reusable and it never disappears causing a supply problem as the market became more and more saturated.

Remedies

Zambian government tried to remedy this by taking money from copper and putting it in other industries. However, Zambia was not efficient in these other industries so not only did they fail, but then copper also failed because the money was pulled out of it. Diversification only makes sense if you can execute it.

Farm aid and subsidies are also bad because it destroys local farmers, which prompts them to move to cities and their home villages (which are their insurance policies) start to fail.

What if a country’s debt is five times its GDP? They could never pay it off so there will never be new investments in the country. However, if you relieve the debt (which the IMF does), you allow the debt cycle/corruption to start over again. So what do you do?…