

TABLE 2.2
Comparative Advantage
(output per unit of labor)

	<u>Steel</u>	<u>Silver</u>
Mexicana	1	3
Americana	7	6

To illustrate the gains from trade, assume Americana can exchange 7 kg of steel for 7 kg of silver. If Americana chooses to shift 1 unit of labor out of the production of silver and into the production of steel, it could produce an extra 7 kg of steel. This extra steel could be traded for 7 kg of silver. As only 6 kg less silver was produced, Americana would gain 1 unit of silver compared to its no-trade position. Mexicana would also gain because the 7 kg of steel it received for its silver would have taken 7 units of labor time to produce. Mexicana could now use that labor effort to produce 21 kg of silver, trading 7 kg of this extra silver production for an extra 7 kg of steel. Hence it would have the same quantity of steel and an extra 14 kg of silver by specializing and trading. Mexicana gains more (14 kg of silver) than Americana (1 kg of silver), but they both have gained by specializing and entering into trade with one another. This is the fundamental (and somewhat counterintuitive) lesson of the theory of comparative advantage. The potential for exploiting gains from trade arising from comparative advantage remains the most popular justification for trade liberalization to this day.

While classical theories of trade focused on the benefits to be gained from trade, they did not answer the question, "What determines comparative advantage?" Classical economists suggested that the quality of natural resources or differences in climate led to differences in the efficiency of labor. While this provided a reasonable explanation when trade consisted largely of agricultural and resource-based commodities, it did not seem relevant in the case of industrial goods.

In the 1930s, a new *neo-classical* theory of trade was developed to explain how comparative advantage could arise (Ohlin 1933). Neo-classical theory assumed, in