

have two countries (Canadiana and Americana) and two goods (oranges and pencils). By expending one unit of labor, Canadiana can produce one orange. Alternatively, Canadiana could use one unit of labor to produce four pencils. For an equal commitment of labor, Americana can produce five oranges or three pencils. Clearly Canadiana has an absolute advantage in producing pencils, and Americana has an absolute advantage in producing oranges. Assume that people in Canadiana will exchange one pencil for one orange. Americana could shift one unit of labor from producing pencils to producing oranges (it is beginning to specialize in orange production). If Americana can trade five of its oranges for five pencils produced by Canadiana, it will gain two pencils (i.e., by moving one unit of labor from its own production of pencils, three pencils less are produced but five pencils are gained from trading). The five units of oranges Canadiana receives from trading would have required it to expend five units of labor time if they were produced domestically. If Canadiana had used this labor time producing pencils, it could have produced twenty pencils. By specializing and trading, Canadiana can make a net gain of fifteen pencils (twenty minus the five pencils it must trade). Of course, people in Canadiana have given up nothing because the five oranges they are no longer producing have been acquired by trading.