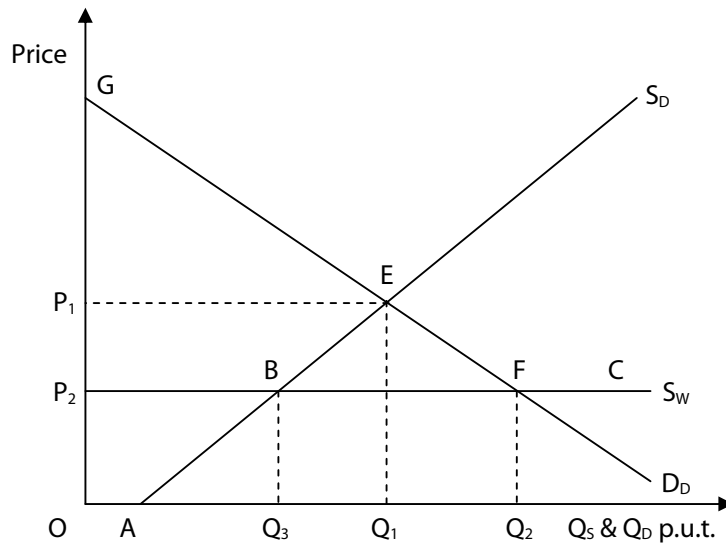


Gains from trade



Autarky

Under autarky, considering a single product, domestic production and consumption create a market equilibrium with price P_1 , and output Q_1 .

Free trade

Under free trade, S_w is the world or external supply curve and is modelled as being perfectly elastic as the economy can purchase as much as it desires as long as it is willing to pay the world market price, P_2 , which is lower than P_1 due to specialisation – those economies with a comparative advantage will supply as they are the lowest cost producers.

OQ_2 represents the higher level of domestic consumption. It would be false to assume there are no efficient producers within the economy, and here the above model suggests a level of output of Q_3 from the efficient domestic producers.

Q_3Q_1 represents the decrease in domestic production as inefficient firms leave the industry and the economy becomes open to free trade. Q_3Q_2 is the imported quantity.

The effective supply curve is therefore ABFC.

The gains from trade are the reduced price, from OP_1 to OP_2 , and the increase in consumption from OQ_1 to OQ_2 .

Welfare analysis of gains from free trade

At a price of P_1 and a level of consumption Q_1 , there is consumer surplus P_1EG . The gains from free trade can be seen as an increase of consumer surplus of P_1EFP_2 .

The net increase for society in economic welfare is BEF, so is another way of expressing the gains from trade.

