



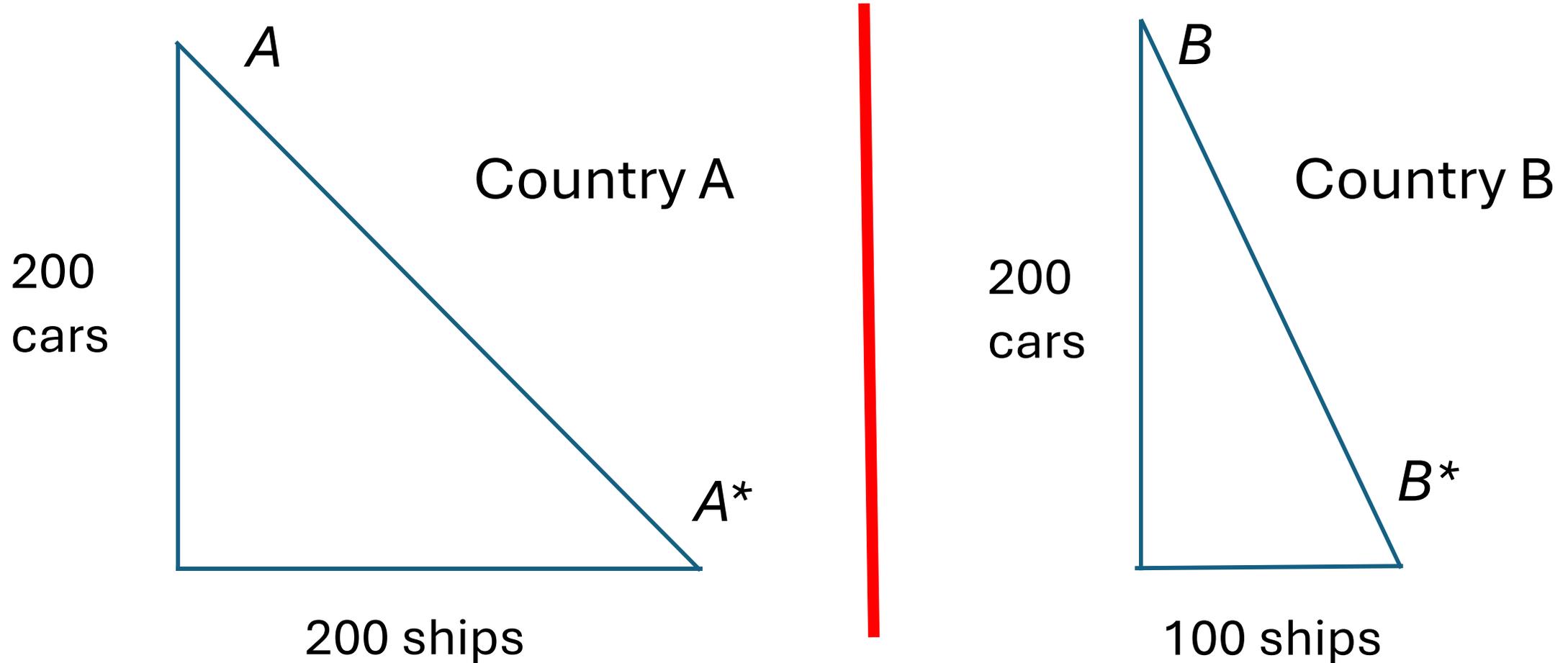
INSTITUTE OF
INTERNATIONAL
MONETARY RESEARCH

Analysis and insight into trends in money and banking,
and their impact on the world's leading economies

The magic of free trade

*A presentation by Professor Tim Congdon CBE,
Chair of the Institute of International Monetary Research,
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Two isolated nations, before trade – with production possibilities frontiers of AA^* and BB^*



Two isolated nations, before trade – with production possibilities frontiers of AA^* and BB^*

- When the countries are isolated, country A can produce and consume 200 cars if all its resources are devoted to car production, or 200 ships if all its resources are devoted to ship production. It is subject to the production possibilities frontier, AA^* .

- Again, when the countries are isolated, country B can produce and consume 200 cars if all its resources are devoted to car production, or 100 ships if all its resources are devoted to ship production. It is subject to the production possibilities frontier, BB^* .

Two isolated nations, before trade – with production possibilities frontiers of AA^* and BB^*

- Suppose in isolated country A, resources are split equally between car and ship production. Plainly, country A can produce *and consume* 100 cars and 100 ships. Similarly, with resources split equally between the two industries in isolated country B, it can produce *and consume* 100 cars and 50 ships.

- Total consumption in the two isolated countries:

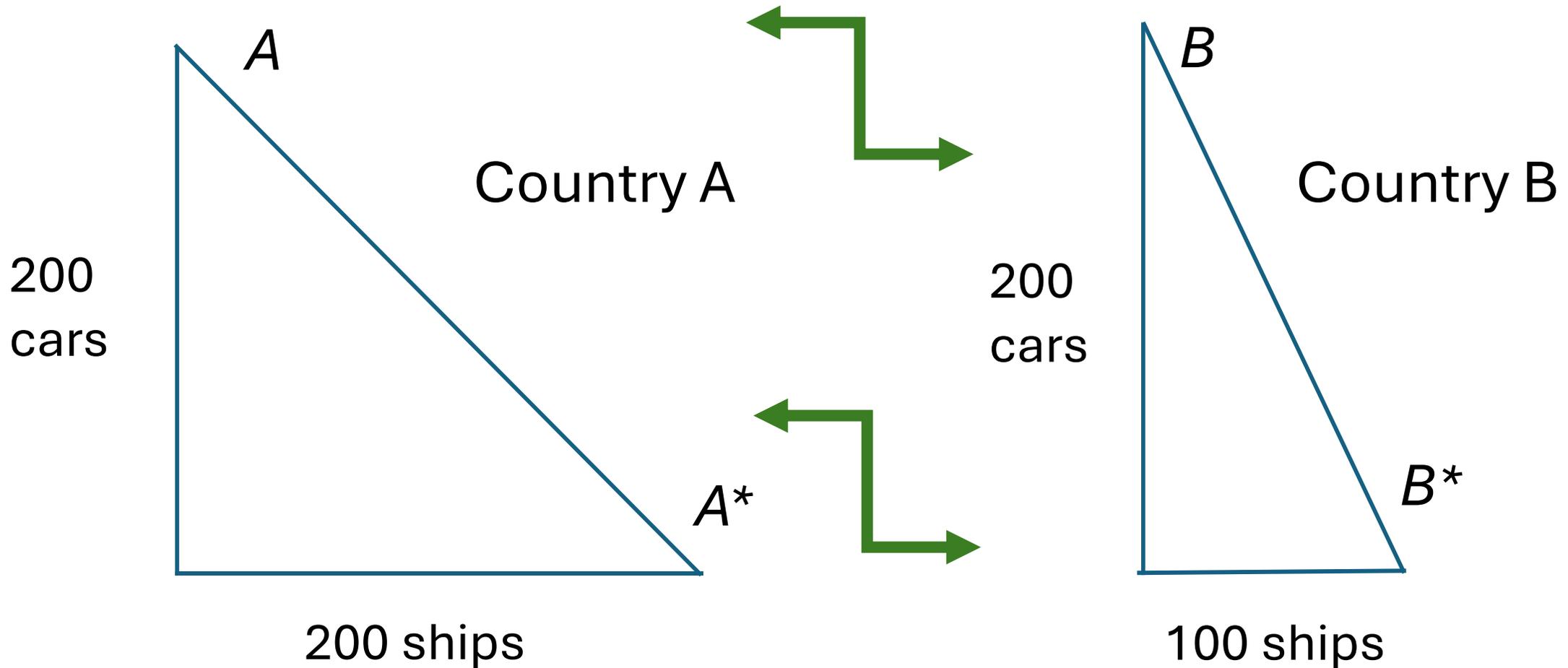
Consumption of cars,

- In country A 100
- In country B 100

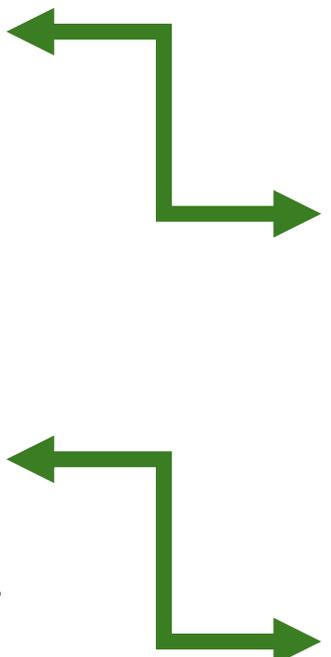
Consumption of ships,

- In country A 100
- In country B 50

People in the two nations start trading – with production possibilities frontiers of AA^* and BB^* in same positions

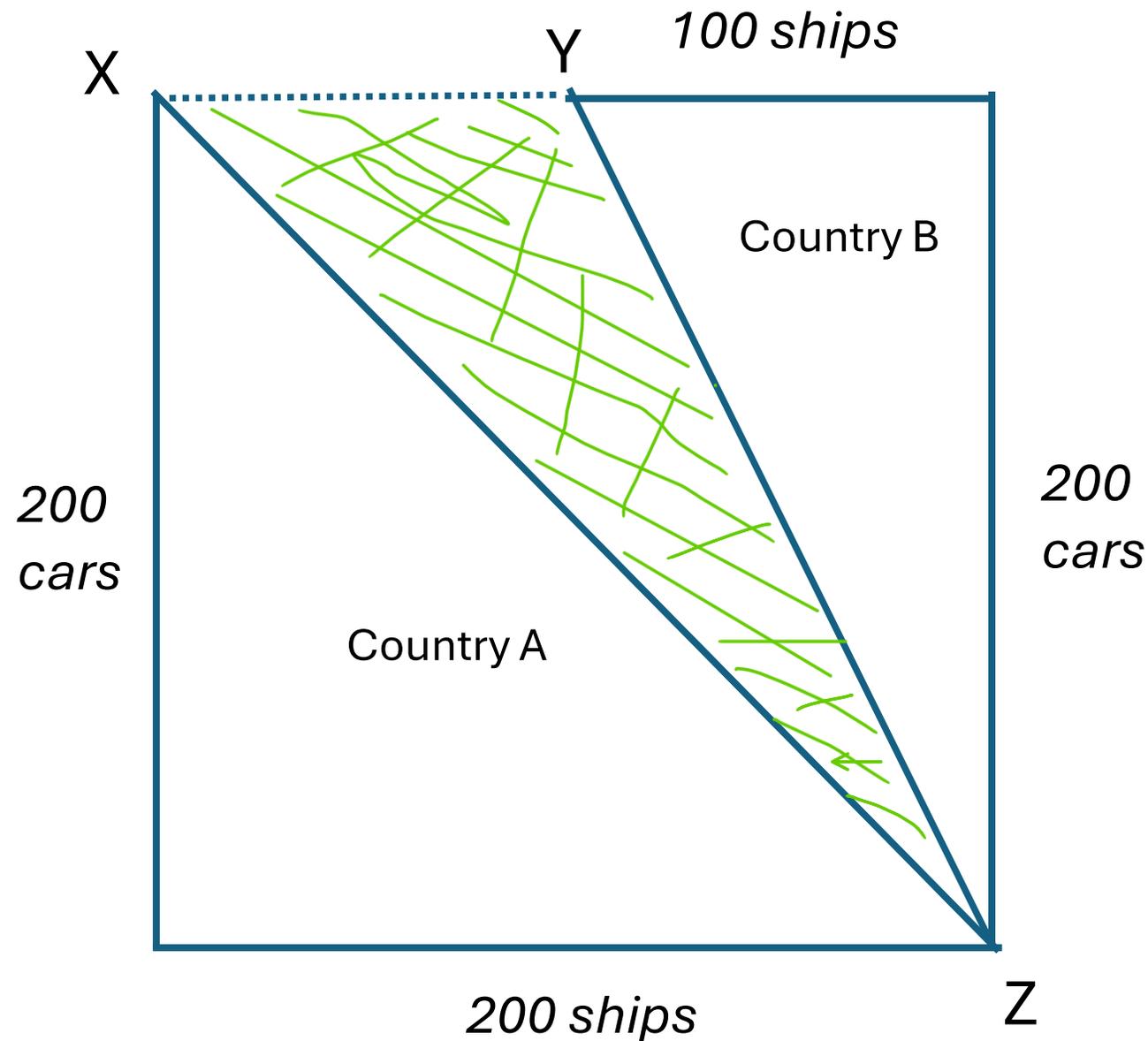


People in the two nations start trading – with production possibilities frontiers of AA^* and BB^* in same positions

- As trading starts, it becomes clear – from relative costs and prices – that country A has a comparative advantage in ships. (If it makes 100 ships, the number of cars lost is 100. This is the so-called ‘opportunity cost’ of making the 100 ships.) Country B has a comparative advantage in cars. (If it makes 100 ships, it loses all its production of 200 cars.)
 - Country A specializes on ships and country B on cars. **In other words, the two countries specialize ‘according to comparative advantage’.** A nation has a comparative advantage in that line of production where the opportunity cost of allocating resources to it is least.
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The magic of free trade

Countries A and B have unchanged production possibilities frontiers, but specialization leads to **extra consumption** shown in the apparently magical XYZ triangle. **Country A makes only ships, and 200 of them, and country B makes only cars, and again 200 of them. Country A sells ships to country B, and country B sells cars to country A.**



The magic of free trade: a simple illustration

Production in the free trade situation, with full specialisation

- **Country A** has a comparative advantage in ship production and specialises totally in that, **making 200 ships**.
- **Country B** has a comparative advantage in car production and specialises totally in that, **making 200 cars**.

Consumption in countries A and B when free trade established

- **Plainly, total global consumption can be 200 cars and 200 ships. The two countries enjoy a potential increase in consumption of 50 ships, because of the specialisation due to trade.**

The magic of free trade – production possibilities frontiers of AA^* and BB^* unchanged, but consumption can increase

- Total consumption in the two isolated countries:

Consumption of cars,

- In country A 100
- In country B 100

Consumption of ships,

- In country A 100
- In country B 50

- Total consumption in the two trading countries, with full specialization:

Consumption of cars in both country A and B,

- 200

Consumption of ships in both country A and B,

- 200.

Specialization results in 50 extra ships...apparently by magic.

The magic of free trade: further arguments

- Free trade in **best-practice, latest-technology capital goods** improves productivity – and hence moves the production possibilities frontier, with a given workforce, outwards.
- Free trade extends production runs and delivers **economies of scale** – and hence again improves productivity and moves the production possibilities frontier outwards.
- With free trade, the government does not favour one sector of the economy over another. Neutral treatment of different sectors encourages self-reliance, **and avoids subsidies, rent-seeking and cronyism**. Market forces determine economic outcomes, not politics, lobbying and the like. (Compare Singapore with almost any African country or compare Chile with most other Latin American nations.)

The magic of free trade: production possibilities frontier ‘moves outwards and to the right’

- The so-called ‘static’ argument for free trade – which turns on the benefits of specialisation according to comparative advantage – assumes no change in different nations’ supply-side capacity.
- **But, in practice, opening to international trade does lead to ‘dynamic’ improvements in nations’ supply-side capacity. In jargon, the production possibilities frontier ‘moves outwards and to the right’.**
- Real-world illustrations of the beneficial power of free trade are numerous, with post-Mao China being perhaps the best illustration in the modern world.
- At Mao’s death, the value of tiny Hong Kong’s exports and imports exceeded those of the Republic of China. (This is true!) With the unilateral trade specialisation pioneered by Deng Xiaoping, China’s imports *and* exports boomed, and China is today the world’s largest exporter of goods.

Suppose the arguments for free trade were true...

- If it were true that free trade were a good idea between two nations, it would also be true that free trade was a good idea between all nations...
- The ultimate end of free trade would be free trade between all nations in every product, i.e., borders between nations would have no effect on trade flows. In this sense, everyone would be ‘a citizen of the world’.
- **The culmination of free trade would be that all nations – in an economic sense – increasingly resembled the ‘free ports’ of Singapore and Hong Kong at present, where incomes per head are a multiple of the world average.**

Suppose the arguments for protection and isolation were true...

- If it were true that protectionism were a good idea between nations, it would also be true that protectionism was a good idea between the regions of a country...
- The ultimate end of protectionism – and indeed its *reductio ad absurdum* – is that all exchanges should cease. If exchanges between nations should cease, but so should exchanges between regions, between town and country, and indeed between everyone...
- **So the culmination would be, well, a return to living in caves. (The tribal societies of the Dark Ages did interact...through gifts.)**

The magic of free trade: two great economists

Adam Smith
1723-1790



- His 1776 *Wealth of Nations* developed the **dynamic** arguments for free trade, emphasizing that specialisation (or ‘the division of labour’) was beneficial and depended on the size of the market.

David Ricardo
1772 - 1823



- First clear exposition of the **static** principle of comparative advantage, which served as background to the case against the Corn Laws, in the then British debate. These laws were abolished in 1846, inaugurating over 80 years of British free trade.