FIGURE 8.2

(a) No trade

Price

No-trade equilibrium

CS

P^A .... A

PS

S

D

Q_0 **Quantity**

(b) Free trade

Price

S

a

P^A ....

b
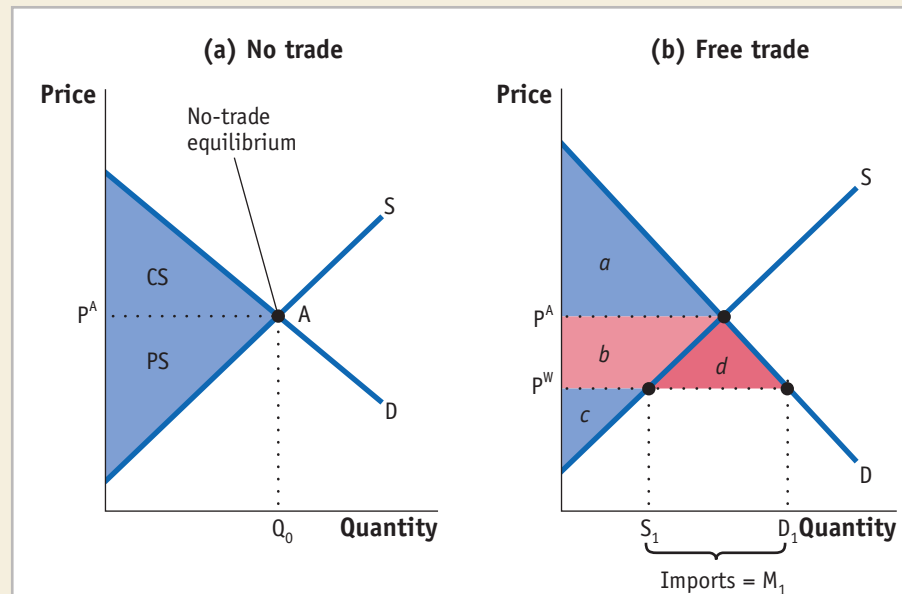
P^W .... d

c

D

S_1 D_1**Quantity**

Imports = M_1

The Gains from Free Trade at Home With Home demand of D and supply of S, the no-trade equilibrium is at point A, at the price P^A producing Q_0. With free trade, the world price is P^W, so quantity demanded increases to D_1 and quantity supplied falls to S_1. Since quantity demanded exceeds quantity supplied, Home imports the $D_1 - S_1$. Consumer surplus increases by the area *(b + d)*, and producer surplus falls by area *b*. The gains from trade are measured by area *d*.

a in panel (b). Producer surplus is the area below the price of P^A and above the supply curve, which is labeled as PS in panel (a) and also shown as area *(b + c)* in panel (b). So the sum of consumer surplus and producer surplus is the area between the demand and supply curves, or CS + PS = area *(a + b + c)*. That area equals Home welfare in the market for this good in the absence of international trade.

Free Trade for a Small Country Now suppose that Home can engage in international trade for this good. As we have discussed in earlier chapters, the world price P^W is determined by the intersection of supply and demand in the world market. Generally, there will be many countries selling on the world market, and many countries buying. We will suppose that the Home country is a **small country,** by which we mean that it is small in comparison with all the other countries buying and selling this product. For that reason, Home will be a *price taker* in the world market: it faces the fixed world price of P^W, and its own level of demand and supply for this product has no influence on the world price.

In panel (b) of Figure 8.2, we assume that the world price P^W is *below* the Home no-trade price of P^A. At the lower price, Home demand will increase from Q_0 under no-trade to D_1, and Home supply will decrease from Q_0 under