Comparative Advantage and Specialization

TRADE

We have learned enough about production that we can now begin our explanation of trade.

TRADE
- Assumptions

Let’s assume there are two products (Food

TRADE

the main question:

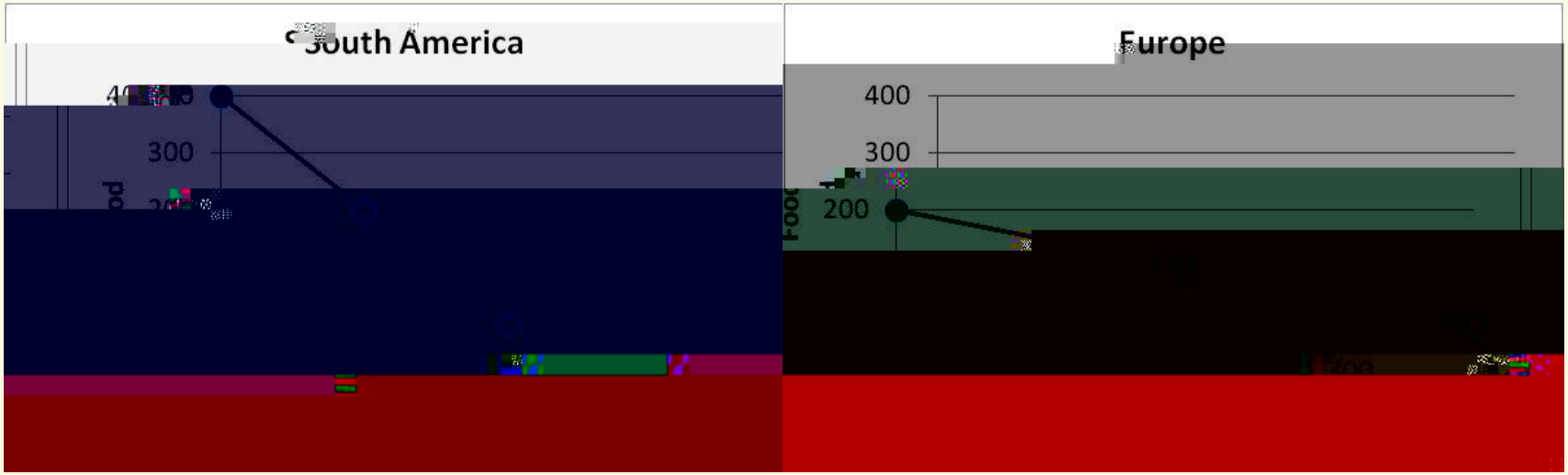
To be self-sufficient and produce everything we need

To cooperate with the other country &

TRADE

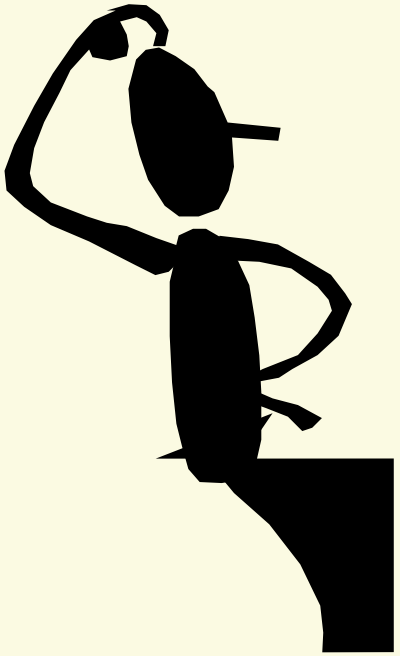
Trade is beneficial if one can only produce food while the other can only produce computer.

Computers	Food	Computers	Food
200	0	400	0
100	200	200	100
0	400	0	200



TRADE

But what happens if one is much better in producing both computers and food?

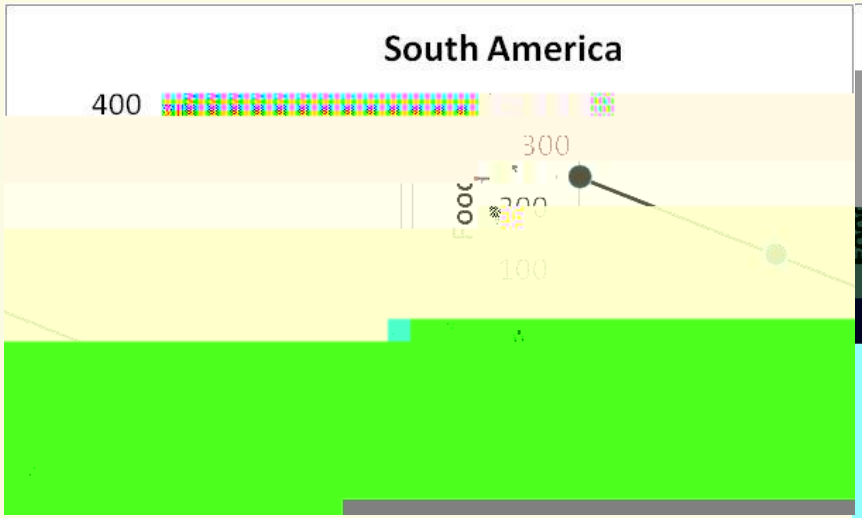


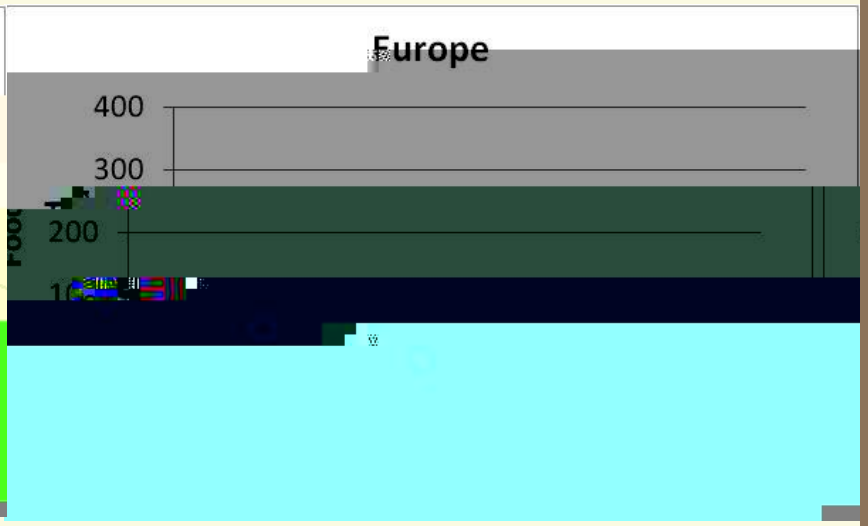
A different example

Computers	Food
250	0
125	125
0	250

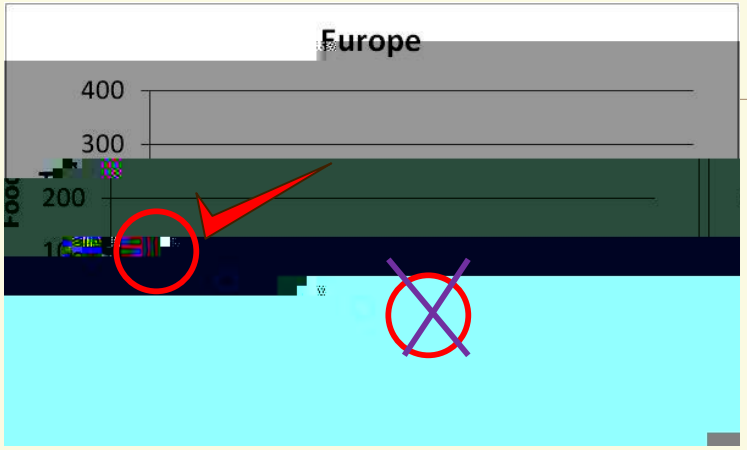
Computers	Food
200	0
100	50
0	100

They can still benefit from trade as long as opportunity costs are different.





Opportunity Costs



What is the opp. cost of 1 food in Europe?

If you pick to produce 100 units of food …

you give up producing 200 computers.

100

vs.

200

Opportunity Costs

100

So the opportunity cost of units of food is computers.

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So, what are opportunity costs in South America?

South America could produce a maximum of 250 food units. BUT to do so they have to give up 250 units of computer.

So, the cost of 250 units of food is 250 computers.

Or, the opportunity cost of 1 food is 1 computer.

Opportunity cost of a computer in South America?

South America could produce a maximum of 250 computers. BUT to do so they have to give up 250 units of food.

So, the cost of 250 computers is 250 units of food.

That means that the opportunity cost of each unit of 1 food is 1 computer.

So, what are opportunity costs?

Specialize in what your opportunity cost is

Absolute vs. Comparative Advantage

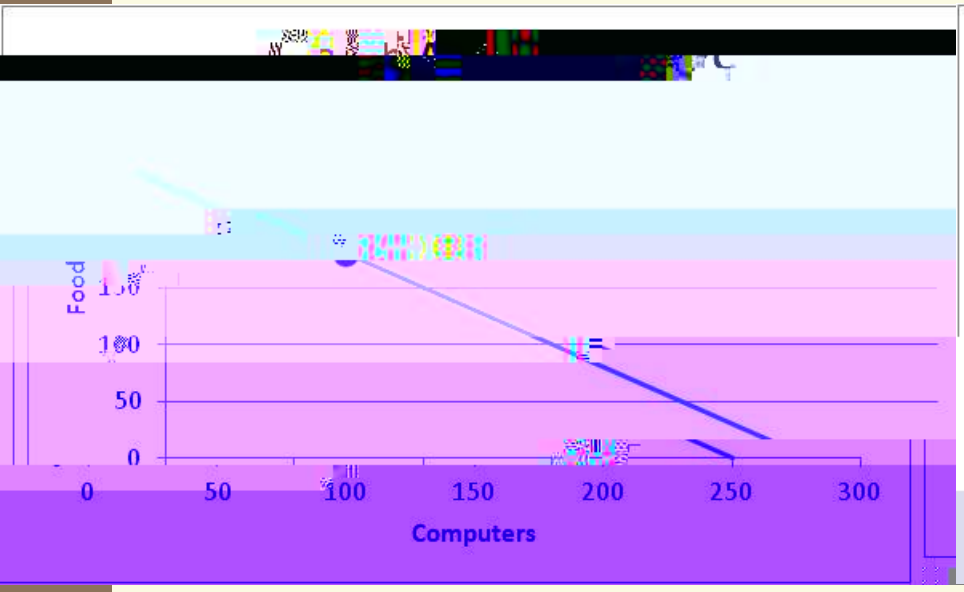
The ability of an individual, firm, or country to produce more of a good or service than competitors using the same amount of resources.

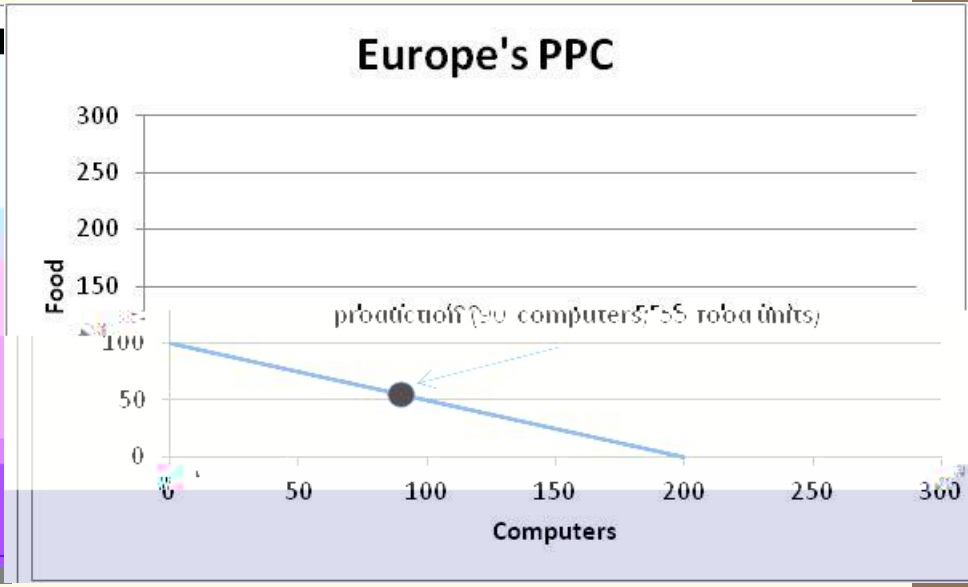
The ability of an individual, firm, or country to produce a good or service at a lower opportunity cost than other producers.

TRADE

What if there is no trade?

		South America		Europe	
		Computer	Food	Computer	Food
NO Trade	Production	70	180	90	55
	Consumption	70	180	90	55





TRADE

Let's introduce trade instead.

Specialize and trade 66 units of food for 99 computers.

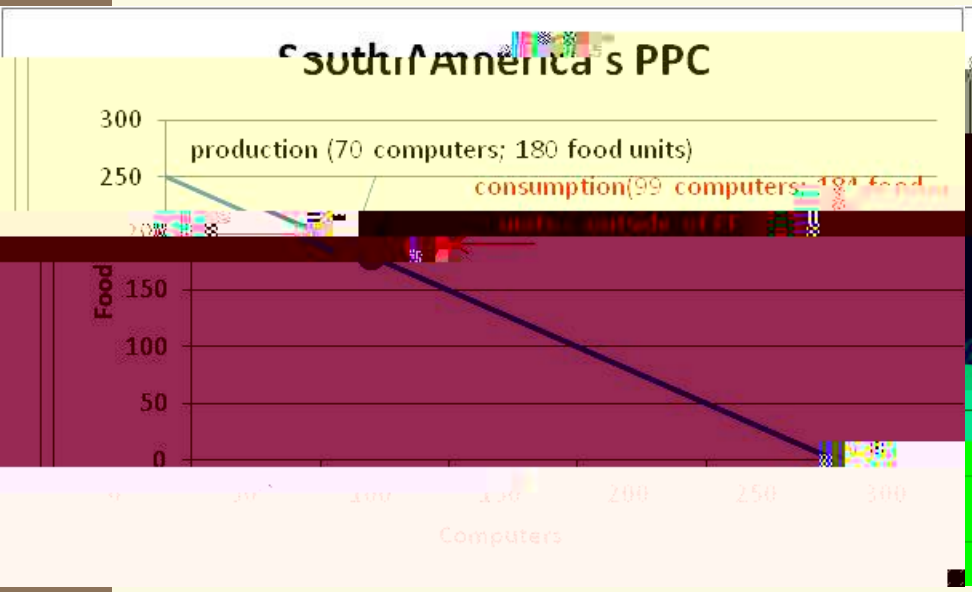
		South America		Europe	
		Computer	Food	Computer	Food
[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
99	184	101	66	Trade	Consumption

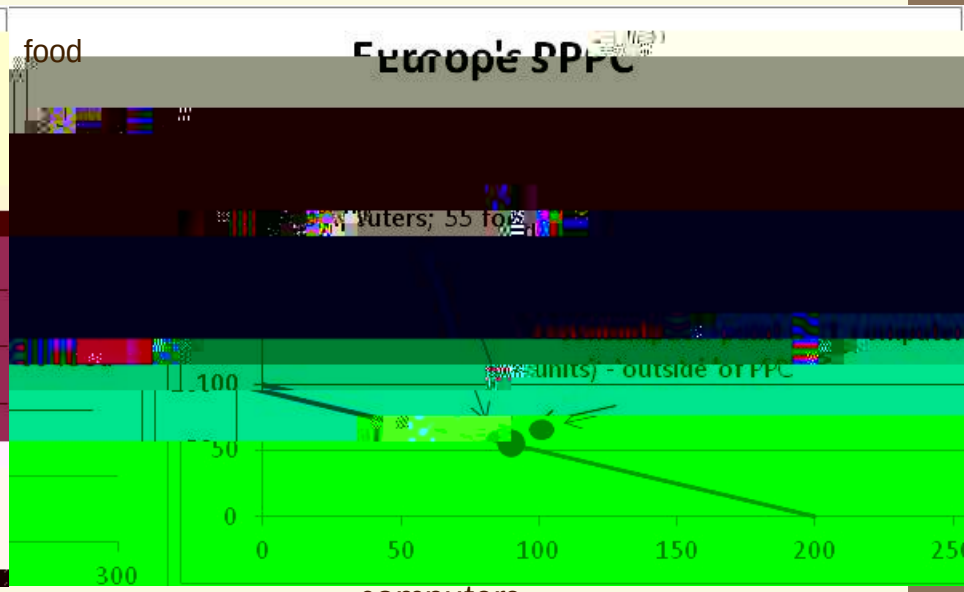
Gains from TRADE

		South America		Europe	
		Computer	Food	Computer	Food
NO Trade	Production	70	180	90	55
	Consumption	70	180	90	55

		South America		Europe	
		Computer	Food	Computer	Food
With Trade	Production	0	250	200	0
	Consumption	99	184	101	66

Gains from TRADE with Graphs





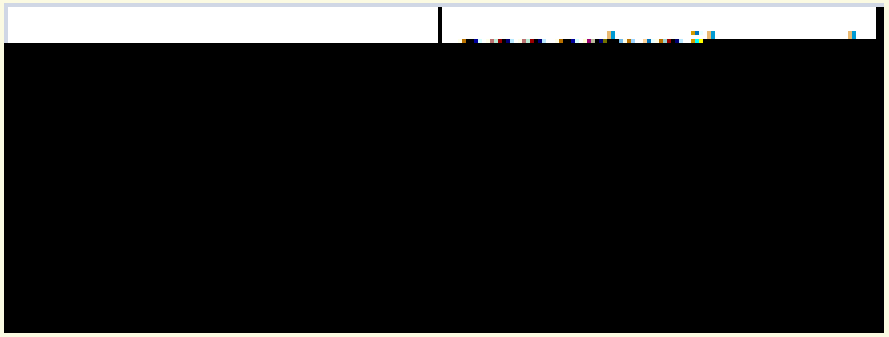
Trade

You may now ask: “But where did you come up with that they should trade 66 food units for 99 computers?”

Excellent question.

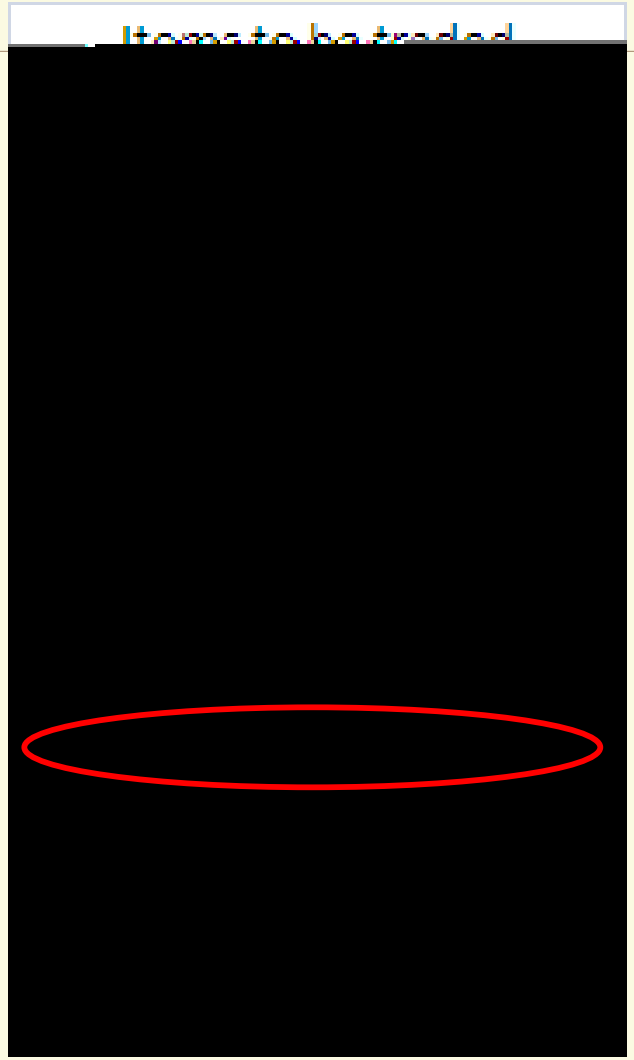
66 Food units for 99 computers is equivalent to each 1 food for 1.5 computers, right? Right.

And that comes from the opportunity cost table.



Trade will only make both countries better off if the ‘price’ in trade is between the two opp. costs.

Trade pattern



Should the United States trade with other countries?

As we all know Americans enjoy a lot of goods produced by other countries.

Imports: goods produced abroad and sold domestically.

Exports: goods produced domestically and sold abroad.