

### Chapter 3: Interdependence and the Gains from Trade

Everyday you rely on people whom you have never met → produce goods and services you enjoy

- Interdependence is possible because people trade with one another
  - They get something in return

#### A PARABLE FOR THE MODERN ECONOMY

Everyone can benefit from trade → specialize in what you do best and trade with what you don't

#### **Production Possibilities**

Shows the possible outcomes and all others in between for production

- Production possibilities are useful in showing the trade-offs that the groups face
  - Doesn't show what they will actually choose

#### **Specialization and Trade**

Trade allows each of them to specialize in doing what they do best

- Spend more time growing product
- Each party can consume more product without doing more trade

#### COMPARATIVE ADVANTAGE: THE DRIVING FORCE OF SPECIALIZATION

##### **Absolute Advantage**

**Absolute Advantage** – The ability to produce a good using fewer inputs than another person

- Absolute advantage to the producer who requires a smaller quantity of inputs

##### **Opportunity Cost and Comparative Advantage**

**Opportunity Cost** – whatever must be given up to obtain some item

- **Comparative Advantage** – The ability to produce a good at a lower opportunity cost than another producer
  - Reflects relative opportunity cost
  - Possible for one producer to have absolute advantage in all products
  - Impossible for one producer to have comparative advantage in all products
    - Each producer will have comparative advantage in one good and will produce that good

##### **Comparative Advantage and Trade**

Gains from specialization and trade → based on comparative advantage

- Specialize in product of comparative advantage

- Total production in economy rises
- Increase in size of economic pie
  - Total production increases, producers share the benefits
  - Obtain good for a price lower than their opportunity cost
- Trade can benefit everyone in society

### **The Price of the Trade (Terms of Trade)**

There are gains from specialization and trade

- For both parties to gain from trade, the price at which they trade must lie between the two opportunity costs
  - Falls in between otherwise both parties would want to be buyer of low opportunity cost and seller of high opportunity cost products
  - How far can someone push up price of product before no one wants to buy

In a contract of meat and potatoes

- 5 oz of meat for 15 oz of potatoes
  - 1 oz meat = 3 oz potatoes
  - 1 oz potatoes = 1/3 oz meat
- Farmer: sells P, buys M
  - Farmer wants to buy meat for less than his opportunity cost for making his own meat
    - Buy meat for less than 4 oz of potatoes
      - Max price farmer would pay for M is 4P
      - Min price R would accept for M is 2P
- Rancher: sells M, buys P
  - Rancher wants to buy potatoes for less than his opportunity cost for making his own potatoes
    - Buy potatoes for less than 1/2 oz of meat
      - Max price rancher would pay for P is 1/2 M
      - Max price farmer would accept for P is 1/4 M

### **APPLICATIONS OF COMPARATIVE ADVANTAGE**

The principle of comparative advantage explains interdependence and the gains from trade

#### **Should Tom Brady Mow His Own Lawn**

Tom Brady is an extremely talented football player

- Can also mow his lawn faster than anyone else can
  - Should he mow his lawn himself?
- Brady has absolute advantage in mowing lawn faster
  - Neighbor has comparative advantage because Brady could spend time making commercial that would earn a lot more money than neighbor could

- Brady can earn 20,000 and neighbor can earn 40\$
  - Brady should pay neighbor between 40-20,000 to mow lawn
    - Tremendous gains form trade → both are better off

### **Should the United States Trade with Other Countries**

Populations in different countries can also benefit from specialization and trade

- **Imports** - Goods produced abroad and sold domestically
- **Exports** - Goods produced domestically and sold abroad

Eg: America and Japan → food and car

- Both produce 1 car a month, America produces 2 tons of food/japan only 1
  - Japan has comparative advantage in producing cars
  - US has comparative advantage of producing food
    - Trade → both countries can have more food and cars
- Allows all countries to achieve greater prosperity
  - But, some individuals can be worse off while country is better off