

Chapter 3

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Interdependence and the Gains from Trade

Exports and Imports

- **Exports:** goods produced domestically and sold abroad
 - To export means to sell domestically produced goods abroad
- **Imports:** good produced abroad and sold domestically
 - To import means to purchase goods produced in other countries

Trade Can make both countries better off

U.S.			
	consumption without trade	consumption with trade	gains from trade
computers	250	270	20
wheat	2500	2700	200
Japan			
	consumption without trade	consumption with trade	gains from trade
computers	120	130	10
wheat	600	700	100

Where do these gains come from?

- **Absolute advantage:** the ability to produce a good using fewer inputs than another producer; it measures the cost of a good in terms of the inputs required to produce it
 - The US has an absolute advantage in wheat: producing a ton of wheat uses 10 labor hours in the US vs 25 in Japan
- If each country has an absolute advantage in one good and specializes in that good, then both countries gain from trade

Opportunity Cost and Comparative Advantage

- **Comparative advantage:** the ability to produce a good at a lower opportunity cost than another producer
 - The *opportunity cost* of a computer is
 - 10 tons of wheat in the US, because producing one computer requires 100 labor hours, which instead could produce 10 tons of wheat
 - 5 tons of wheat in Japan, because producing one computer requires 125 labor hours, which instead could produce 5 tons of wheat
 - Japan has a comparative advantage in computers
- *Absolute advantage is not necessary for comparative advantage!*

Comparative Advantage and Trade

- When each country specializes in the good(s) in which it has a comparative advantage, total production in all countries is higher, the world's "economic pie" is bigger, and all countries can gain from trade.