

Comparative Advantage

Chapter 2-2

Trade and Comparative Advantage

- ▣ The production possibility curve is bowed because individuals specialize in the production of goods for which they have a comparative advantage and trade with others.

Trade and Comparative Advantage

- ▣ To produce on the production possibilities curve, individuals must produce those goods for which they have a comparative advantage.

Trade and Comparative Advantage

- ▣ Adam Smith argued that humankind's proclivity to trade leads to individuals using their comparative advantage.

Markets, Specialization, and Growth

- ▣ The growth in per capita income in the past two millennia has been astonishing.
- ▣ This owes largely to the introduction of markets and democracy.

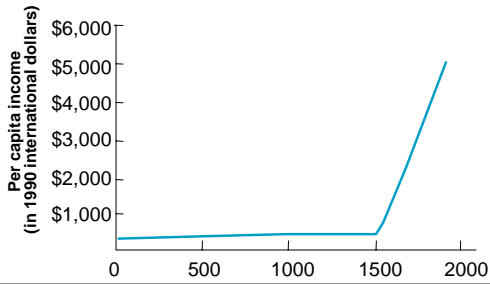
Markets, Specialization, and Growth

- ▣ Markets allow specialization, leading to trade and growth.

Markets, Specialization, and Growth

- As people are allowed to compete and specialize, they get better at what they do, develop new technologies, and the market grows ever larger.

Growth in the Past Two Millennia



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The Benefits of Trade

- When people trade, both parties expect to benefit from the trade.
- Otherwise, why would they have traded in the first place?

The Benefits of Trade

- The argument for the benefits of trade underlies the general policy of laissez-faire.
 - *Laissez-faire* – an economic policy of leaving coordination of individuals' actions to the market.

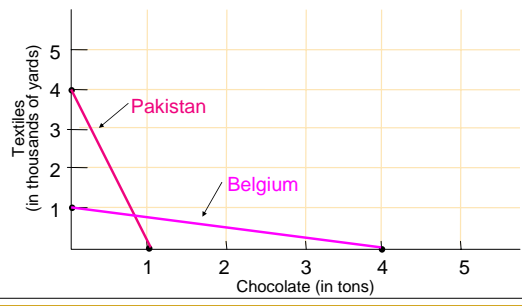
Production Possibilities without Trade

- Pakistan can produce 4,000 yards of textile per day or 1 ton of chocolate per day.
- Belgium can produce 1,000 yards of textile a day or 4 tons of chocolate per day.

Production Possibilities without Trade

- Pakistan has a comparative advantage in producing textiles.
- Belgium has a comparative advantage in chocolate.

Production Possibilities without Trade



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Production Possibilities without Trade

- Pakistan has chosen to produce 2,000 yards of textiles and 0.5 tons of chocolate.
- Belgium has chosen to produce 500 yards of textile and 2 tons of chocolate.

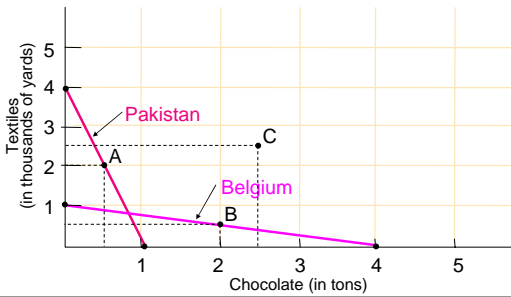
Production Possibilities without Trade

- **Point A:** The combination of textile and chocolate chosen by Pakistan.
- **Point B:** The combination of textile and chocolate chosen by Belgium.
- **Point C:** The joint combination without trade.

Production Possibilities without Trade

Pakistan's and Belgium's Individual Possibilities		
	Textile per day	Chocolate per day
Pakistan	2,000 yards	0.5 ton
Belgium	500 yards	2 tons
Total	2,500 yards	2.5 tons

Production Possibilities without Trade



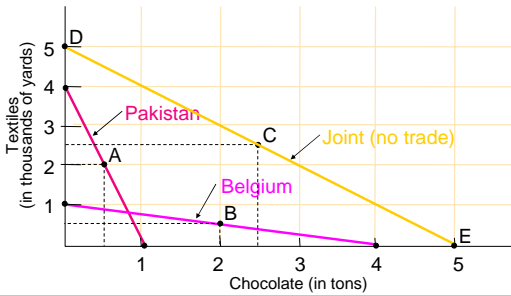
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Production Possibilities without Trade

- ▣ The two extreme combinations are both countries producing only textile (point D) and both producing only chocolate (point E).
- ▣ The combined production possibilities curve with no trade is drawn by connecting these two points.

Production Possibilities without Trade



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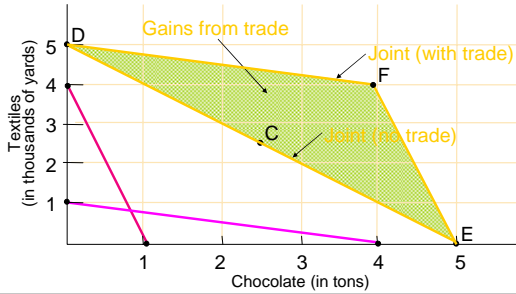
Production Possibilities with Trade

- **Point F:** This is where each nation is focusing on that activity for which it has a comparative advantage.
 - Pakistan produces 4,000 yards of textile.
 - Belgium produces 4 tons of chocolate.

Production Possibilities with Trade

	Combined Production Possibilities		
	No Trade	Specializing and Trade	Gains to Trade
Fabric	2,500 yards	4,000 yards	1,500 yards
Chocolate	2.5 Tons	4 tons	1.5 Tons

Production Possibilities with Trade



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Production Possibilities with Trade

- The combined PPC is bowed out because of Point F – comparative advantage and specialization.

U.S. Textile Production and Trade

- Two hundred years ago, the U.S had a comparative advantage in textile production.
- Now, countries with cheaper labor, such as Bangladesh have the comparative advantage in textile production.

U.S. Textile Production and Trade

- ▣ The gains from trade show up as higher pay for workers in Bangladesh and lower-priced cloth for U.S. consumers.
