

Notes – Why We Trade
Instructor: Syon Bhanot

Why We Trade

In class game: see freehand notes on the next page for the details

Key terms:

- Absolute Advantage: when a country can produce a goods more efficiently than another country, it has "absolute advantage" over the other country in the production of that good
- Opportunity cost: whatever must be given up to obtain a given item – this can be the inputs, but as we will see it is useful to express the opportunity cost in terms of the other good you could possibly produce!
- Comparative advantage: producer that gives up less of other good to produce given good is said to have comparative advantage in producing that good
- Specialization: focusing energy/resources on the production of a specific good

In-Class Discussion based on readings – some suggested readings:

- **Krugman:** New York Times Op-Ed “Trouble With Trade.”
- **Free vs. Fair Trade:** The Economist online debate, “This house believes that making trade fairer is more important than making it freer.”
- **Reinhardt reading:** Uwe Reinhardt’s “How Convincing Is the Case for Free Trade?” in the New York Times Economix blog.

Why We Trade

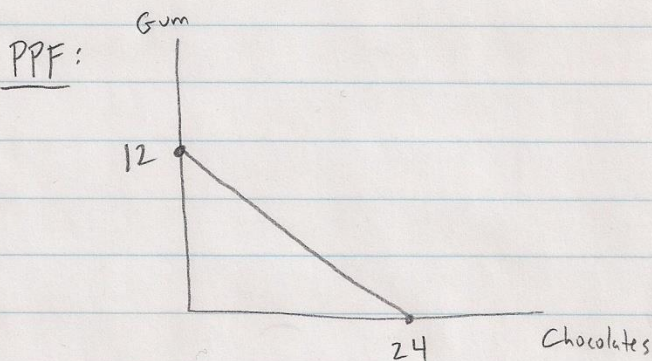
Syon Bhanot notes

In-class example: The Belferlands and Littaverania

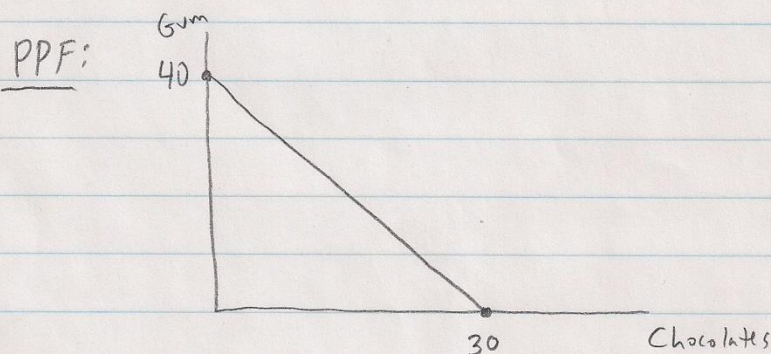
each with 120 "Labor" units

①
"PPFs"

The Belferlands



Littaverania



②
Costs +
opp. costs

	1 gum	1 chocolate
The Belferlands	10 Labor	5 Labor
Littaverania	3 Labor	4 Labor

cost
in
Labor

	1 gum	1 chocolate
The Belferlands	2 chocolates	1/2 gum
Littaverania	3/4 chocolate	4/3 gum

* cost in
other good -
opportunity
cost!

* The Belferlands has comparative advantage in "making" chocolate... Littauerania has comparative advantage in "making" gum.

- this even though Littauerania has absolute advantage in both goods!

Suppose the Belferlands made: 4 gum, 16 chocolates
and that Littauerania made: 20 gum, 15 chocolates



both countries could be better off with trade!



if the Belferlands makes 2 less gum and makes 4 chocolates with that, and Littauerania makes 3 less chocolates and makes 4 gum with that, we get...

- The Belferlands: 2 gum, 20 chocolates

- Littauerania: 24 gum, 12 chocolates



The Belferlands could offer three of the chocolates to Littauerania in exchange for three gum, so we'd have...

- The Belferlands: 5 gum, 17 chocolates

- Littauerania: 21 gum, 15 chocolates

* NOTICE: both countries better off than they began!!

Acceptable trade terms: The Belferlands needs a minimum of $\frac{1}{2}$ gum per chocolate, Littauerania needs a minimum of $\frac{3}{4}$ chocolate per gum: so terms of trade between $\frac{1}{2}$ gum per chocolate and $\frac{4}{3}$ gum per chocolate will see beneficial trade!!