

Chapter two Trade

The Production Possibility Model, Trade, and Globalization 2

Comparative Advantage

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Markets, Specialization, and Growth

- Growth in per capita income during the past 2000 years

| Year | Income |
|------|---------|
| 0 | \$500 |
| 500 | \$600 |
| 1000 | \$700 |
| 1500 | \$800 |
| 2010 | \$5,500 |

- What caused this growth?

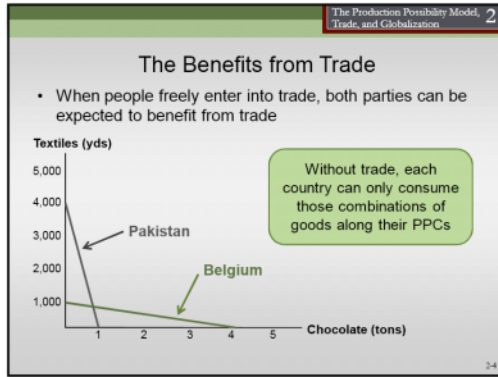
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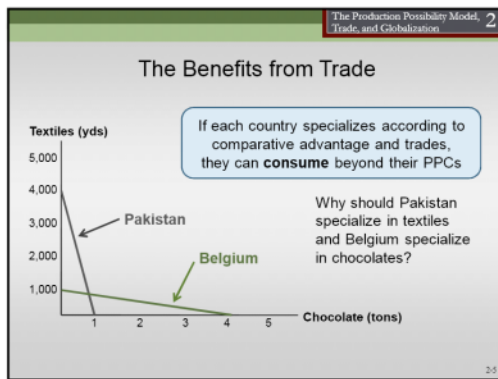
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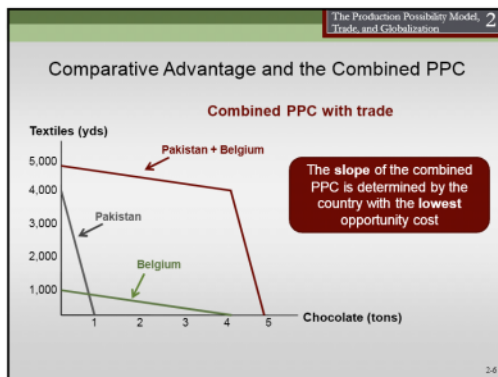
Comparative Advantage

- The reason the opportunity cost of guns increases as we produce more guns is that some resources have comparative advantage over other resources
- A resource has **comparative advantage** if it has the ability to be better suited to the production of one good than another

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Application: 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 textiles
- The *gains* from trade are *higher wages* for workers in Bangladesh and *lower-priced* cloth for U.S. consumers

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Outsourcing, Trade and Comparative Advantage

Outsourcing

- **Outsourcing** is the relocation of production once done in the United States to foreign countries
- Outsourcing occurs because many other countries have a comparative advantage in labor costs
- The U.S. has comparative advantage in technology, institutional structure, and specialized knowledge

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Outsourcing, Trade and Comparative Advantage

Globalization

- **Globalization** is the increasing integration of economies, cultures, and institutions across the world
- A positive effect of globalization is that it provides larger markets than the domestic economy
- The global economy increases the number of competitors and this increased competition can be a negative effect of globalization

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Outsourcing, Trade and Comparative Advantage

Exchange Rates and Comparative Advantage

- The U.S. comparative advantage in innovation results in higher wages in the U.S.
- As industries mature, they move to lower wage countries
- In order to regain our comparative advantage, the U.S. exchange rate will decline and foreign wages will increase to make U.S. exports cheaper and imports to the U.S. more expensive

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Outsourcing, Trade and Comparative Advantage

The Law of One Price

- The law of one price is the wages of equal workers in one country will not differ significantly from the wages of workers in another institutionally similar country
- If the U.S. loses its comparative advantage based on technology and institutional structure, U.S. wages will decrease relative to wages in many other countries

The reality is that the citizens in the U.S. has been living better than it could have otherwise because of trade and outsourcing

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Chapter Summary

- The production possibility curve embodies the opportunity cost concept
- Increasing marginal opportunity cost exists
- Trade allows people to use their comparative advantage and shifts out society's combined production possibility curve
- Efficient, inefficient and unattainable points on the PPC
- Through specialization and trade, countries can increase consumption

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Chapter Summary

- The typical outward bow of the PPC is the result of comparative advantage and trade
- Because many goods are cheaper to produce in foreign countries, production of goods formerly in the U.S. is being outsourced
- Outsourcing is the product of the law of one price
- Globalization is the increasing integration of economies, cultures, and institutions across the world

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