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.

The Benefits from Trade

- When people freely enter into trade, both parties can be expected to benefit from trade.

Comparative Advantage and the Combined PPC

- If each country specializes according to comparative advantage and trades, they can consume beyond their PPCs.
- Pakistan specializes in textiles, and Belgium specializes in chocolates.
- Why should Pakistan specialize in textiles and Belgium specialize in chocolates?

The slope of the combined PPC is determined by the country with the lowest opportunity cost.
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.

Outsourcing, Trade and Comparative Advantage

- **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.

Outsourcing, Trade and Comparative Advantage

- **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.

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.

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.

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.
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

Preview of Chapter 3: Economic Institutions

• Define market economy
• Compare and contrast capitalism with socialism
• Describe how businesses, households, and government interact in a market economy
• Summarize briefly the advantages and disadvantages of various types of businesses
• Explain why, even though households have the ultimate power, much of the economic decision making is done by business and government
• State six roles of government
• Explain why global policy issues differ from national policy issues