Topic 2: Specialization & Trade

It takes two to make an island paradise…

Three Basic Questions

- Every society must answer

1.

2.

3.

One Person Economy (Island)

- 2 goods:
  - Fish
  - Rope

- How will this society answer 3 questions?

The Answer depends on:

1. Tastes
   -
2. Technology:
   -

Production Table

Output Per Day	
Fish	Metres Rope
0	6.5
10	6.0
20	5.2
30	3.8
40	0

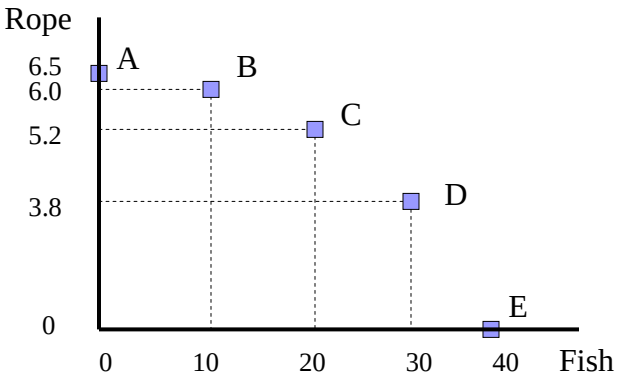
Why does the opportunity cost increase?

Principle of Increasing Costs:

- As the production of one good expands, its opportunity cost generally increases
- Inputs tends to be specialized
  -
- Initially fishing will be quite lucrative
  -
  -
- Eventually start to use time that is not very productive in fishing
  -

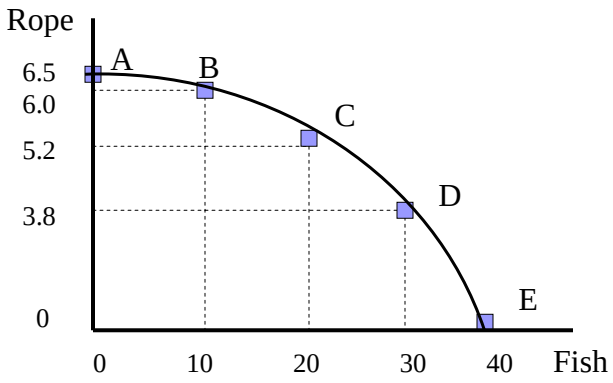
Production Possibilities Frontier

- Plots the combination of goods that can be produced given technology and resources



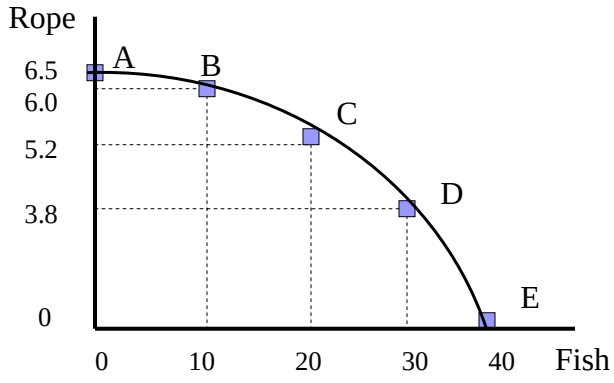
PPF Continued...

- Slopes down
- Slope represents opportunity cost



Shape of the PPF

- The PPF is bowed outward
- Result of the principal of increasing cost



Back on Track

How do we answer the questions

(1) What is produced?

(2)How is it produced?

Technology (skills): determines how resources can be combined.

-
-

Tastes: determine the combination of fish and rope chosen

Tastes and Efficiency

- We know that points on the PPF are efficient in terms of production
- However, some points on the PPF may not be efficient in terms of product mix
  -
-

Two or More Person Economy

Complications

a.

b.

c.

- We'll discuss **a** and **c** later in the course
- Now we'll deal with **b**

Specialization and Exchange

- Suppose there are now two people on the island
- Tom and Wilson

Scenario 1:

- Tom is better than Wilson at fishing
- Wilson is better than Tom at weaving rope
- Obviously, Tom should fish all the time and Wilson should weave rope
- They are both better off if they specialize and exchange

Example: Comparative Advantage

Scenario 2:

- Tom is better at both fishing and rope weaving

	Rope(m.)/day	Fish/day
Tom	6	8
Wilson	4	2

- *Should they specialize and exchange?*
- Tom -
- Wilson -
-

Comparative Advantage Continued

	Rope(m.)/day	Fish/day
Tom	6	8
Wilson	4	2

Opportunity cost of 1 metre of rope:

- Tom –
- Wilson –
-

- We can show that both would be better off if they specialize and exchange

Specialization and Exchange

- Suppose they do not trade and each spends 5 days a week fishing and 2 days making rope

	Without Trade		*With Trade*	
	Rope	**Fish**	**Rope**	**Fish**
Tom	12	40		
Wilson	8	10		

- If they specialize total production will be:
  - Tom:
  - Wilson:

How do Systems Coordinate?

I Command Economy (Old Russian, China)

- Centrally planned
  -
  -
- Big task

II Free Market System “Laissez Faire”

- Limited government involvement
- Agents act on self-interest
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