Microeconomics 1

Comparative Advantage and the Basis for Trade

Definitions

- Absolute advantage: when an agent can carry on an activity with less resources than another agent
- Opportunity cost (OC): the value of the next best alternative to that particular action
  - Calculated by the slope of the PPC
  - OC of y-axis is the inverse of x-axis
- Comparative advantage: when an agent has a lower opportunity cost of carrying an activity than another agent

<u>The Production Possibility Curve (PPC)</u>

PPC: represents maximum output possibilities for two (or more) goods, given a set of inputs (or resources such as time) if inputs are used efficiently

Assumptions of the Model

- There are only 2 possible activities
- There are only 2 individuals
- When trading, there are:
  - No transaction costs (i.e. negotiation costs, transportation costs, etc.)
  - No barriers to trade (i.e. import quotas, tariffs, etc.)

The Principle of Comparative Advantage

- Everyone is better off if each agent specialises in the activities for which they have a comparative advantage in
- Specialisation and gains from trade only occur when OC is different for all
- The gains from trade grow larger as the difference in OC increases

The Principle of Increasing Opportunity Costs (low hanging fruit)

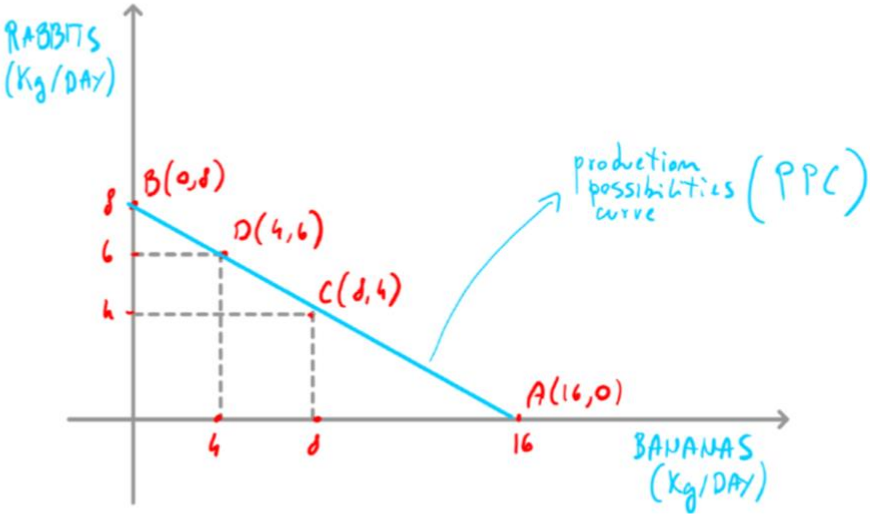
- In the process of increasing the production of any good, first employ those resources with the lowest opportunity cost and only once these are exhausted, turn to resources with higher costs

The main factors that drive economic growth (shifts the PPC outwards) are:

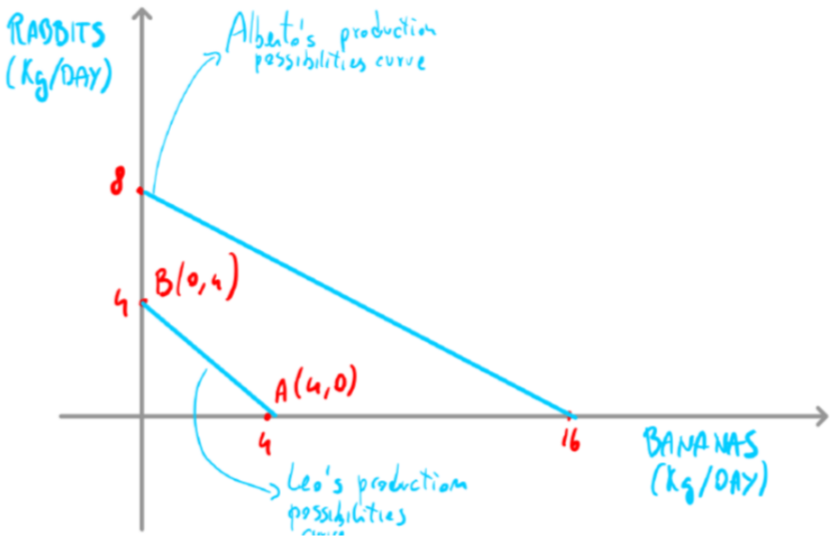
- Increase in infrastructure (e.g. factories and equipment)
- Increase in population (i.e. larger labour force)
- Advancements in knowledge/technology (e.g. education, IT, communications)

Different types of PPCs

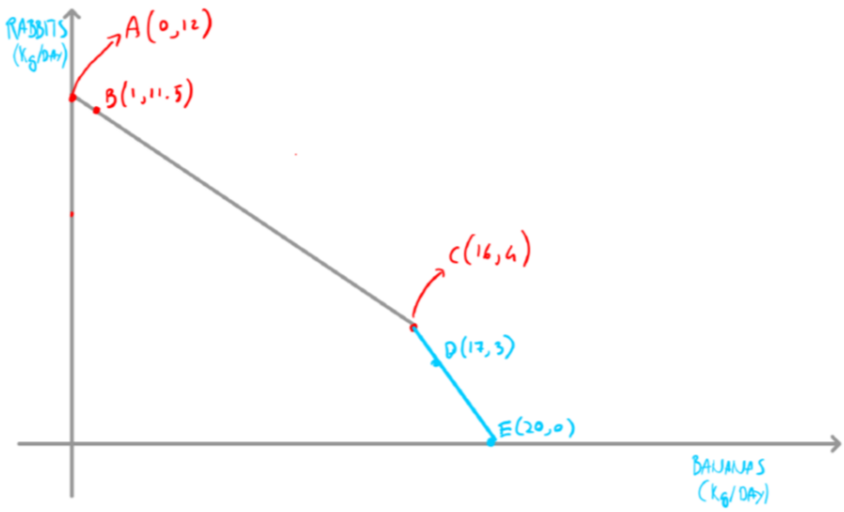
- One agent economy (straight line represents constant productivity)



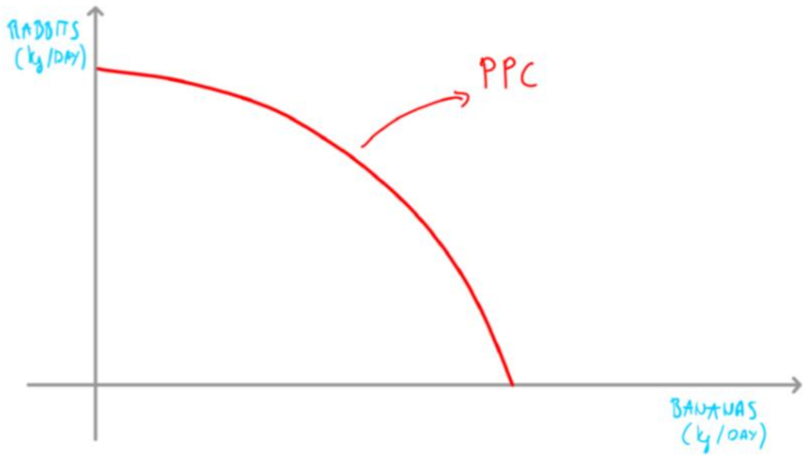
- Two agent economy (straight lines represent constant productivity)



- Aggregate PPC



- Economy wide PPC



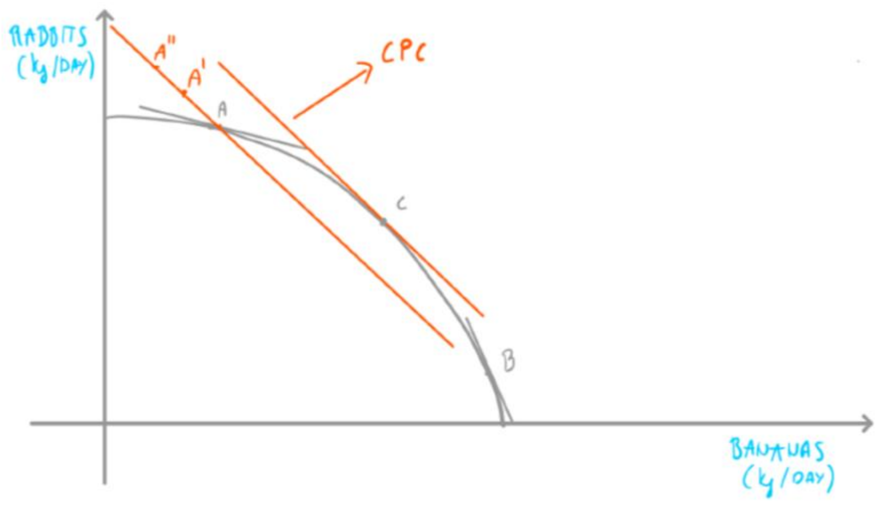
Trading between economies

- Why? A country's economic welfare does not depend on what it produces, but on what it consumes
- At what price? At a price lower than the OC of the buyer, but higher than the production cost of the supplier

<u>The Consumption Possibility Curve (CPC)</u>

CPC: represents all possible combinations of two goods that the economy can feasibly consume when it is open to international trade

- In a closed economy (no trade), the PPC and CPC are identical
- In an open economy, the CPC is to the right and above the PPC



Classic critiques to the Model (we assumed the following)

- No psychological costs associated with performing the same activity the entire day
- No transaction costs connected with trading
- No import quotas or tariffs, which would limit profits
- No change in preferences for G&S

Supply in Perfectly Competitive Markets

Definitions

- Market: the set of all the consumers and suppliers who are willing to buy and sell that good or service at a given price
- Market equilibrium: occurs when the price is such that the quantity consumers want is the same as the quantity that suppliers want to sell
- Marginal benefit: the extra benefit accrued by producing that unit
- Marginal cost: the extra cost of producing that unit (expressed as the OC, not the absolute cost of producing the good)
- Economic surplus: the difference between the marginal benefit and the marginal cost when taking the action
- Quantity supplied: the quantity of a given good or service that maximises the profit of the supplier
- Producer reservation price the minimum amount of money the producer is willing to accept to supply the marginal unit of the good
- Sunk cost: a cost that once paid cannot be recovered
- Fixed factor of production: the factor of production's cost does not vary with the quantity produced
- Fixed cost: a cost associated with a fixed factor of production
- Variable factor of production: the factor of production's cost tends to vary with the quantity produced
- Variable cost: a cost associated with a variable factor of production
- Short run: a period of time during which at least one factor of production is fixed
- Long run: a period of time during which all factors of production are variable
- Elastic supply: when the price elasticity of supply is greater than 1
- Unit elastic supply: when the price elasticity of supply is equal to 1
- Inelastic supply: when the price elasticity of supply is less than 1

A perfectly competitive market has the following characteristics:

- Consumers and suppliers are price-takers i.e. they cannot influence the market price
- Homogeneous goods
- No externality
- Goods are excludable and rival
  - Excludable: suppliers can prevent consumers from consuming a good
  - Rival: goods become unavailable to other consumers once consumed
- Full information available
- Free entry and exit

The Cost-Benefit Principle

- An action should be taken if the marginal benefit is greater than or equal to the marginal cost

<u>The Supply Curve</u>

The supply curve: represents the relationship between the price of a good or service and the quantity supplied of that good or service