Elements of Microeconomics

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Week 2

Office Hours Schedule

- Monday: 9:30-11:00 AM
- Wednesday: 10-11:30 AM and 1:30-3:30 PM
- Thrusday: 2:00-4:00PM

- These are subject to change. Please keep an eye for announcements adjusting them.
- If NONE of these work, that is ok. Please email me if you'd like to meet and we can set up a time.

- Last week we bagan a short introduction of trade. This weeek we will dive deeper into trade.

- Remeber the question: Is trade always benefical?
  1. In this class we will not focus on the empirics of this statement as that is for later studies.
  2. By developing the idea *comparative advantage* we will see that trade can make everyone better off.

Absolute and Comparative Advantage

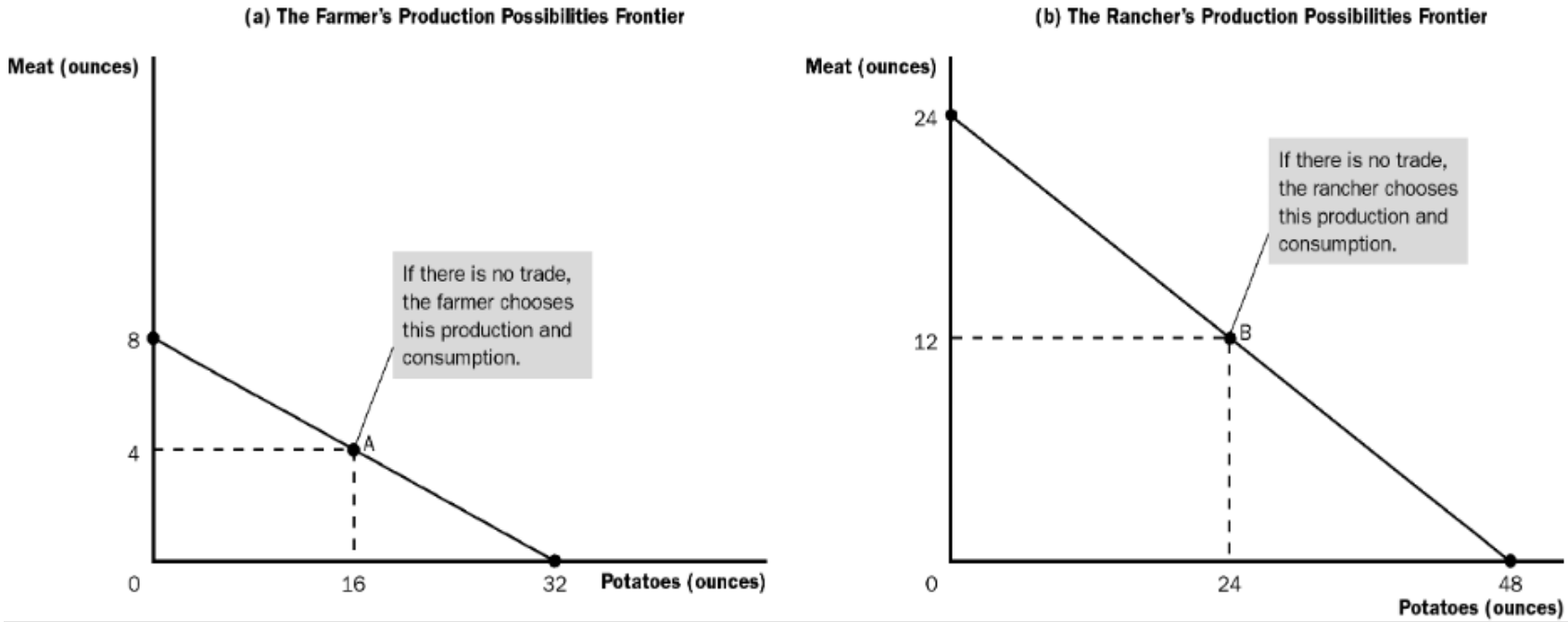
- *Absolute Advantage* - the ability to produce a good using fewer inputs than another producer.

- *Comparative Advantage* - the ability to produce a good at a lower **opportunity cost** than another producer.

- *Opportunity Cost*:
  1. This concept never goes away and relates back to the principle of **trade-offs**.
  2. Formally, OC is defined as: *whatever must be given up to obtain some item*.
  3. Opportunity cost is more than just forgone earnings,, it can also include things such as time.

Back to the PPF

- Let us take a look at two individuals who might seek to engage in trade relations.
- The following PPFs shows us both Ruby and Frank's output of meat and potatoes in an 8hr work day



Determining Trade

- Steps to Determine Trade
  1. Draw the PPFs (you'll have to do this on exams)
  2. Calculate the opportunity costs for producing meat and potatoes respectively for each farmer.
  3. Determine the trade price.
- Using the PPFs and the 8 hour work day we can extract the following information:

	Minutes Needed to Make One Ounce of:		Amount Produced in Eight Hours	
	Meat	**Potatoes**	**Meat**	**Potatoes**
Frank the farmer	60 min./oz.	15 min./oz.	8/1=8 oz.	8/0.25=32 oz.
Ruby the rancher	20 min./oz.	10 min./oz.	8/0.33=24 oz.	8/0.16=48 oz.

Setting the Price of Trade

- To set the price of trade we must first determine the opportunity costs for both goods for both farmers.
    - Knowing the opportunity costs will allow us to determine the **specialization** of each farmer.
- The price of trade **will always line between the 2 opportunity costs** for both parties to gain.

Another Example

Suppose it requires 10 labor hours for The Riverlands to produce 1 computer and 20 labor hours for The Riverlands to produce 1 sandwich. The Vale can produce 1 computer using 25 labor hours and 1 sandwich using 5 labor hours. Both kingdoms are endowed with 100 labor hours.

1. Draw the PPF for both kingdoms
2. Who has the absolute advantage in producing these goods?
3. Who should produce what and how do you know?

Strategy for Approaching Any Trade Problem

1. Figure out the traders and goods.
2. Draw PPF
   - If it is constant OC then PPF is straight line. If not then it is bowed. Be mindful of this.
3. Determine absolute advantage and comparative advantage.
   - This tells you who will trade what.
4. Determine trade price.
   - This is based on the opportunity costs of production for each party. Let the comparative advatnage guide you.
   - Always remember: *the price of trade will always lie between the two countries opportunity costs*.