

Chapter 3

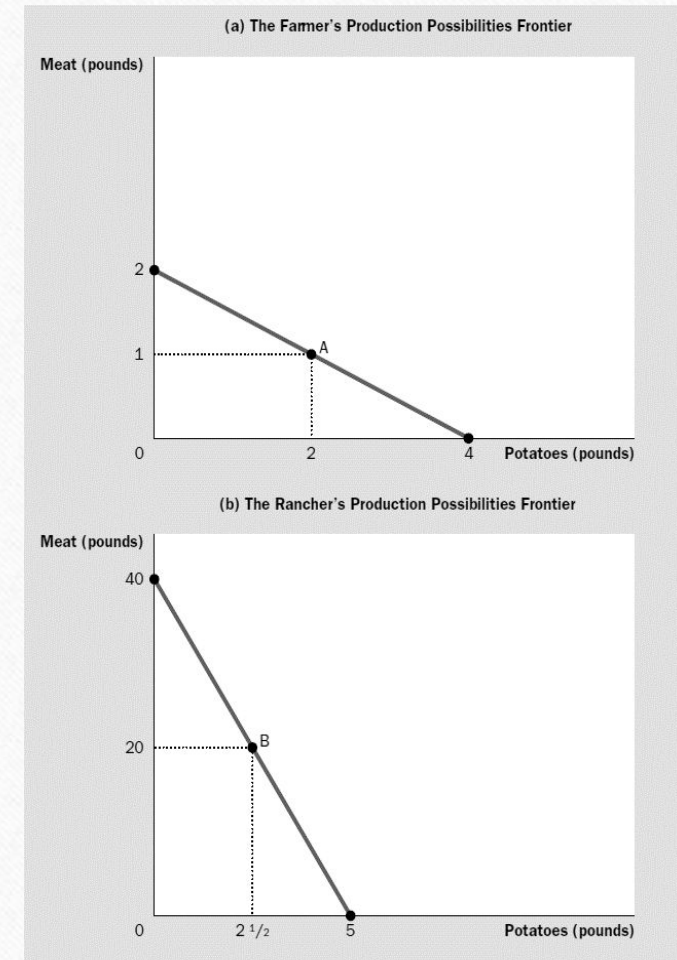
Interdependence and the Gains from Trade

Introduction

- A primitive society has gained from trade, and so we are
- Producers are not doing charity
- Cattle rancher and potato farmer: when is the trade beneficial?

Production possibilities

	Hours needed to produce 1 pound of:		Amount produced in 40 hours	
	Meat	Potatoes	Meat	Potatoes
Farmer	20 hours	10 hours	2	4
Rancher	1 hour	8 hours	40	5



Specialization and trade

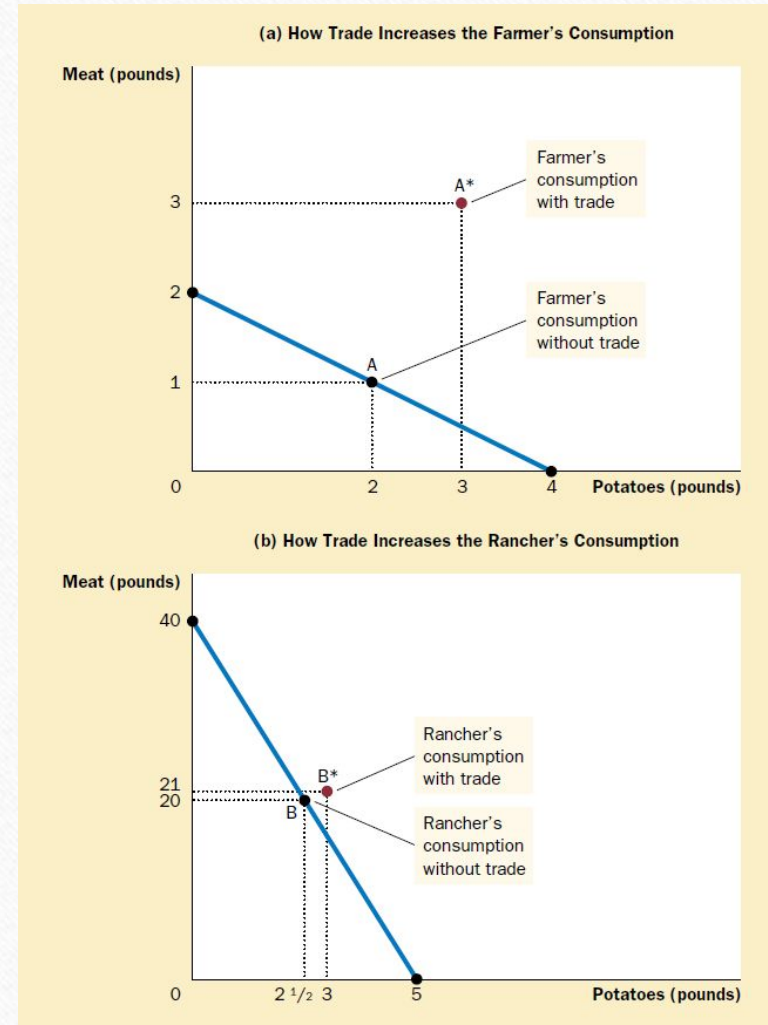
Rancher to farmer:

1. You produce only potato
2. I will cattle for 24 hours and produce potatoes for 16 hours
3. You give 1 potato and I will give you 3 meats

	Autarky		Post-trade		Point A &B	
	Meat	Potato	Meat	Potato	Meat	Potato
Farmer	0	4	3	3	1	2
Rancher	24	2	21	3	20	2.5

Cont...

- Both are well-off in point A* and B*, compared to previous situation
- This is possible because of trade and specialization



Puzzle

- If the rancher is able to produce both at a cheaper cost why is he interested in trading?
- Absolute advantage and comparative advantage

	Hours needed to produce 1 pound of:		Amount produced in 40 hours	
	Meat	Potatoes	Meat	Potatoes
Farmer	20 hours	10 hours	2	4
Rancher	1 hour	8 hours	40	5

Absolute Advantage and Comparative Advantage

	Absolute cost		Opportunity cost	
	Meat	Potatoes	Meat	Potatoes
Farmer	20 hours	10 hours	2 potatoes	$\frac{1}{2}$ meat
Rancher	1 hour	8 hours	$\frac{1}{8}$ potatoes	8 meats

How is it beneficial?

- Farmer's opportunity cost of meat is 2 lbs potatoes without trade, and it comes down to $1/3$ by trading
- If rancher's trade he is giving 3 meats for 1 potato but if he produces, his he has to forgo 8 potatoes
- Specialization helps produce more

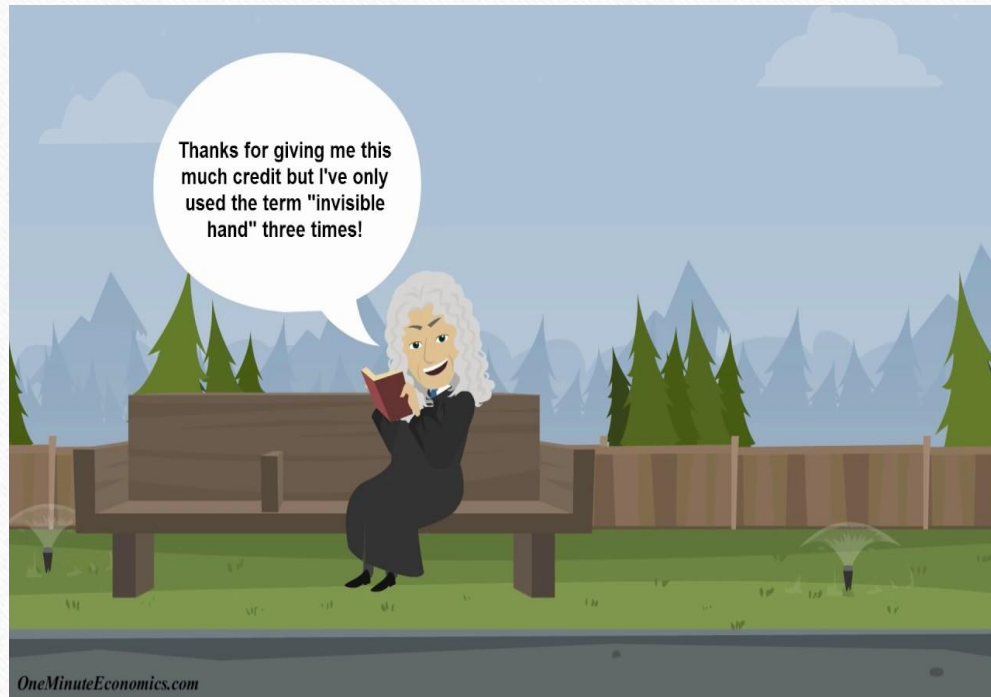
Explained but trapped



"Senator, I'd like to ask you about the economy."

"Talk to the invisible hand,"

Why Invisible?



Examples

- Sehwag can finish the match before a Ranji player but...
- The U.S and Japan produce 1 car per month but the former produce 2 tons of food and the latter produce 1 ton. Japan should produce car and the U.S should produce food