Model Building and Gains from Trade

Models

Economists use models to understand real-world economy.

Models - simplified versions of reality
- built with assumptions
- good if useful for purpose they were designed for

Ceteris paribus : assumption that all other variables are constant while studying the change of one variable
- isolates the effect of the single variable

meaning: other conditions remaining the same

start simple, then observe, then can increase complexity

Endogenous factors - controlled variables inside model
- ceteris paribus

Exogenous factors - uncontrollable variables unaccounted outside model

Danger of faulty assumptions - it is necessary to often examine and re-evaluate the assumptions in models.

Production Possibilities Frontier - what society can produce if all resources are used effectively

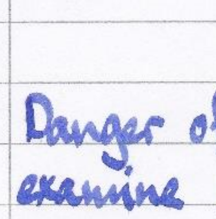
illustrates benefits of trade and describes ways to grow the economy

Anything inside is inefficient. Wasting resources

e.g. Assumptions - technology fixed
- resources fixed
- simplified analysis of 2 goods

Pizza

Anything outside is unattainable



PPF negative due to if pizza prod↑, chicken prod↓, scarcity and limited resources

Chicken

+ exogenous factors e.g. workers slacking off

Highest-valued alternative ← (Recall Opportunity cost) = slope of PPF

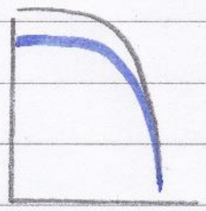
As pizza prod ↑, workers + tech more for pizza, so harder and harder if want to produce chicken

More realistic PPF. No constant slope
Opportunity costs not constant

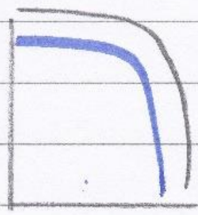
Law of increasing relative cost: As prod ↑, cost of prod ↑
Produce ↑ of good A, giving up ↑ of good B

If PPF expands e.g. more resources and or technology

1) Affect production of one good



2) Affect production of both goods



<u>Specialization and Trade</u> (absolute advantage)
Improvements in technology and more resources can make an economy more productive.
Also creates gains for society

As long as the terms of trade are between the opportunity costs of the trading partners, the trade benefits both sides.
(comparitive advantage)

<u>Growth</u>
Consumer goods - for current consumption food, clothes, housing, etc
Capital goods - that help produce other goods buildings, cars, comps, etc
Investment - resources to make new capital

e.g. A

Short-run PPF

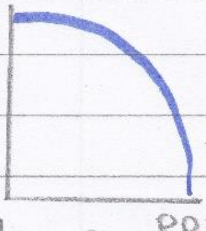
→

Long-run PPF

e.g. B (more balanced)

Short-run PPF

→



Long-run PPF