

Trade-offs, Comparative Advantage, and the Market System

Chapter 2

Chapter Outline

- Production Possibilities Frontiers and Opportunity Cost
 - Use a PPF to analyze opportunity costs and trade-offs
- Comparative Advantage and Trade
 - Understand comparative advantage and how it is the basis for trade
- The Market System
 - Explain the basic idea of how a market system works

Production Possibilities Frontiers and Opportunity Costs

- Scarcity –a situation in which unlimited wants exceed the limited resources available to fulfill those wants
- Scarcity → trade-offs
- Opportunity cost –the highest valued alternative that must be given up to engage in an activity

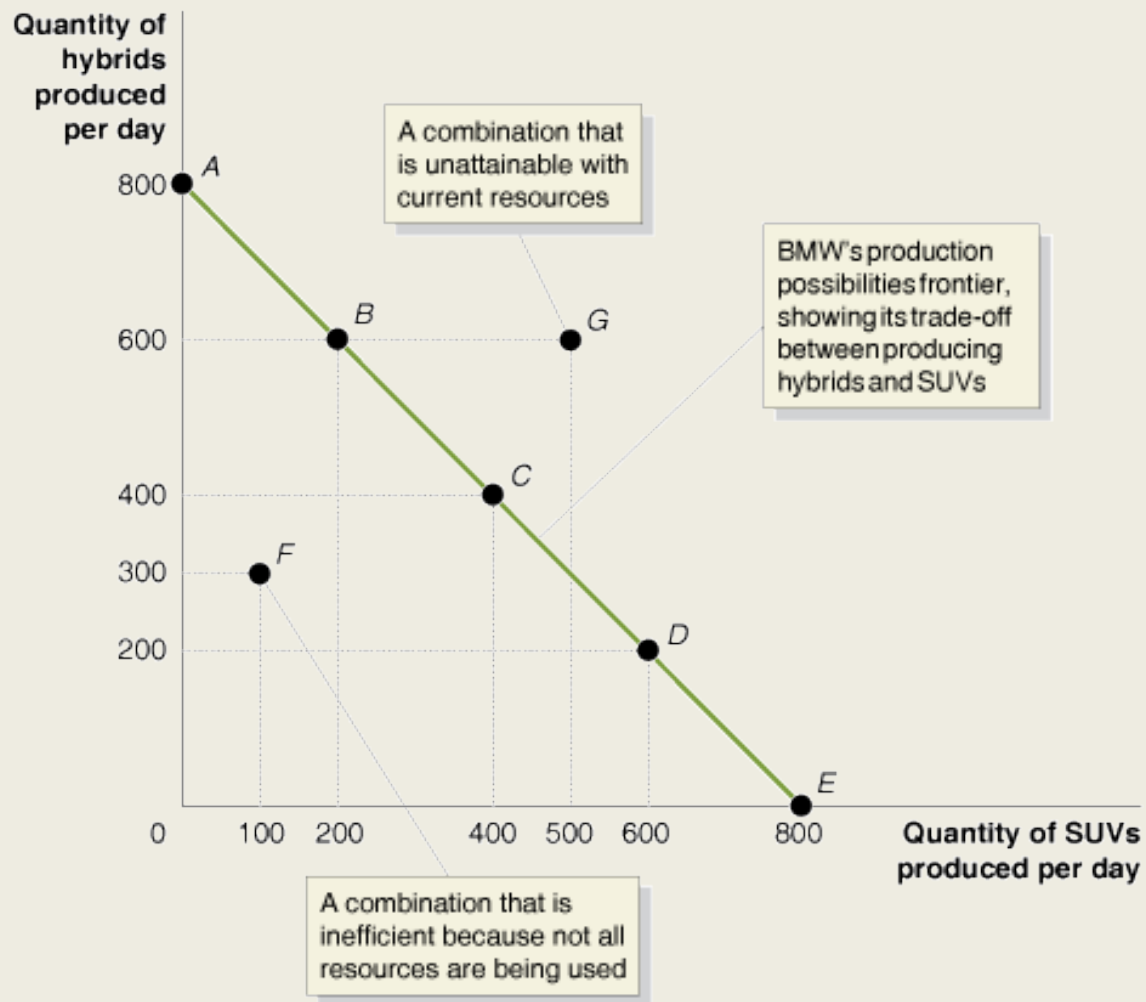
Production Possibilities Frontiers and Opportunity Costs

- PPF = A curve showing the maximum attainable combinations of two products that may be produced with available resources and current technology.

BMW's Production Possibilities Frontier

- BMW faces a trade-off: To build one more hybrid, it must build one less SUV.
- The production possibilities frontier illustrates the trade-off BMW faces.

BMW's Production Choices at Its Spartanburg Plant		
Choice	Quantity of Hybrids Produced	Quantity of SUVs Produced
<i>A</i>	800	0
<i>B</i>	600	200
<i>C</i>	400	400
<i>D</i>	200	600
<i>E</i>	0	800



BMW's Production Possibilities Frontier

- Combinations on the frontier (A, B, C, D, E) or inside the frontier (F) = *attainable* with the resources available
- Combinations on the frontier = *efficient*
 - All available resources are fully utilized, and the fewest possible resources are being used to produce a given amount of output
- Combinations inside the frontier = *inefficient*
 - Maximum output is not being obtained from the available resources
- Combinations outside the frontier = *unattainable* given the current resources

Absolute advantage vs. Comparative advantage

- *Absolute advantage*=The ability of an individual, a firm, or a country to produce more of a good or service than competitors, using the same amount of resources
- *Comparative advantage*=The ability of an individual, a firm, or a country to produce a good or service at a lower opportunity cost than competitors.

Important!!

- Absolute advantage is not necessary for comparative advantage
- Comparative advantage is not necessary for absolute advantage
- *The basis for trade is comparative advantage, not absolute advantage.*

Example

Question 4

The market system

- **Market**
 - A group of buyers and sellers of a good or service and the institution or arrangement by which they come together to trade.
- **Product market**
 - A market for goods—such as computers—or services—such as medical treatment.
- **Factor market**
 - A market for the factors of production, such as labor, capital, natural resources, and entrepreneurial ability.
- **Factors of production**
 - The inputs used to make goods and services.

Thanks