

Exercise walk-through

1.3

Comparative Advantage and Gains from Trade

AP Macroeconomics

Absolute vs comparative advantage

Absolute

make *more* with the same resources

Comparative

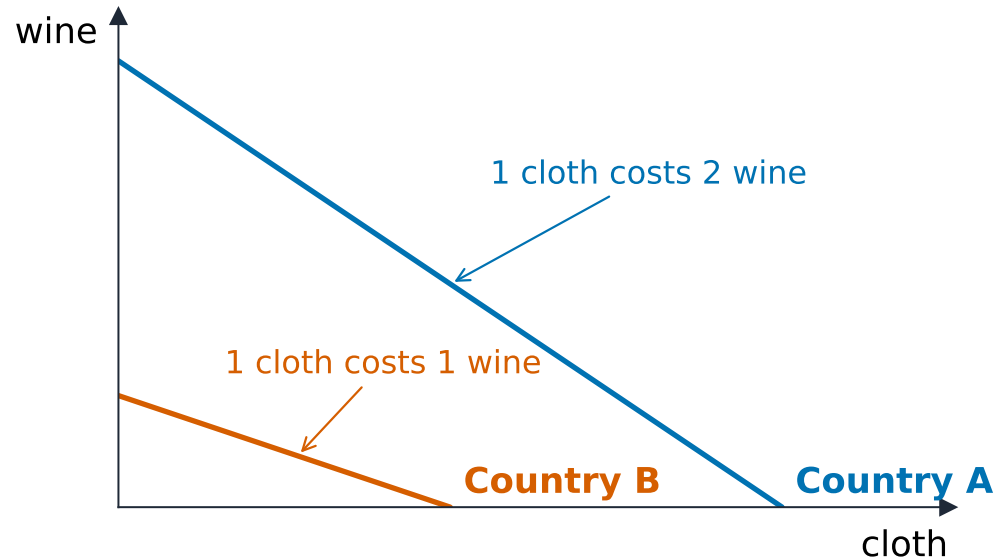
make it at a *lower opportunity cost*



Specialize, then trade – both sides can gain

Both sides gain even if one is better at everything – as long as costs differ.

Comparative Advantage and Gains from Trade



Comparative advantage comes from differently-sloped production possibilities curves

Gains from trade – worked example

per day	wheat	cloth
Country A	12	6
Country B	4	4

A → wheat



B → cloth

Compare opportunity costs

Cost of 1 cloth: $A = \frac{12}{6} = 2$ wheat, $B = \frac{4}{4} = 1$ wheat.

⇒ B is cheaper at cloth

Cost of 1 wheat: $A = 0.5$ cloth, $B = 1$ cloth.

⇒ A is cheaper at wheat

The **terms of trade** must fall *between* the two costs for both to win.

Exercises 2.1-2.3

2.1 State the difference between absolute and comparative advantage. [2]

2.2 Country X can make 20 wheat **or** 10 cloth. Find the opportunity cost of 1 wheat.[2]

2.3 State the basis on which a country should choose which good to specialize in. [1]

Exercises 2.1-2.3

2.1 State the difference between absolute and comparative advantage. [2]

2.1

- absolute advantage is producing more of a good with the same resources; comparative advantage is producing it at a lower opportunity cost

2.2 Country X can make 20 wheat **or** 10 cloth. Find the opportunity cost of 1 wheat.[2]

2.2

- 1 wheat costs $\frac{10}{20} = 0.5$ cloth

2.3 State the basis on which a country should choose which good to specialize in. [1]

2.3

- the good in which it has the **lower opportunity cost** (comparative advantage)

Exercises 3.1-3.2

3.1 A producer has a comparative advantage when it has a lower

[1]

☐

A total output

B opportunity cost

C selling price

D population

3.2 Mutual gains from trade come from

[1]

☐

A absolute advantage

B specialization by comparative advantage

C raising tariffs

D self-sufficiency

Exercises 3.1-3.2

3.1 A producer has a comparative advantage when it has a lower

[1]

☐

- A total output
- B opportunity cost
- C selling price
- D population

3.1 B

- opportunity cost.

3.2 Mutual gains from trade come from

[1]

☐

- A absolute advantage
- B specialization by comparative advantage
- C raising tariffs
- D self-sufficiency

3.2 B

- specialization by comparative advantage.

Exercise 3.3 (a)

3.3 In one hour, Ann makes 4 cakes **or** 8 breads; Ben makes 2 cakes **or** 2 breads.

(a) Find Ann's opportunity cost of 1 cake.

[1]

Exercise 3.3 (a)

3.3 In one hour, Ann makes 4 cakes **or** 8 breads; Ben makes 2 cakes **or** 2 breads.

(a) Find Ann's opportunity cost of 1 cake.

[1]

(a)

- 1 cake costs 2 breads

Exercise 3.3 (b)

3.3 In one hour, Ann makes 4 cakes **or** 8 breads; Ben makes 2 cakes **or** 2 breads.

(b) Find Ben's opportunity cost of 1 cake.

[1]

Exercise 3.3 (b)

3.3 In one hour, Ann makes 4 cakes **or** 8 breads; Ben makes 2 cakes **or** 2 breads.

(b) Find Ben's opportunity cost of 1 cake.

[1]

(b)

- 1 cake costs 1 bread

Exercise 3.3 (c)

3.3 In one hour, Ann makes 4 cakes **or** 8 breads; Ben makes 2 cakes **or** 2 breads.

(c) State who should specialize in cakes, and why.

[1]

Exercise 3.3 (c)

3.3 In one hour, Ann makes 4 cakes **or** 8 breads; Ben makes 2 cakes **or** 2 breads.

(c) State who should specialize in cakes, and why.

[1]

(c)

- Ben – his opportunity cost of a cake (1 bread) is lower than Ann's (2 breads)