Study Guide

Chapter 2  Scarcity and Economic Development

1. Adam Smith: Invisible Hand Theorem

3. Production Possibilities Frontier
   a) A producer (or an economy) has the ability to produce any combination that is on and inside the PPF.
   b) Efficiency is achieved when all of resources are fully used in the best way.
   c) Inefficiency occurs when resources are not fully used - combinations inside the PPF, Unemployment
   d) Unattainable – combinations outside the PPF
   e) Opportunity cost – since the resources used to make the two goods are given, when a producer or an economy tries to make more of a good, it has to make less of another good. The amount of goods forgone is the opportunity cost.

   \[
   \text{Opportunity cost per unit of } X = \frac{\text{Units of } Y \text{ given up}}{\text{Units of } X \text{ gained}}
   \]

   f) Consumer goods – for present consumption, usually for personal use.
   g) Capital goods – for future consumption, usually used by business firms and government.
   h) Trade off between the present and the future – since resources are limited, an economy that produce more consumer goods for the present consumption would have to produce less capital goods to make consumer goods for the future consumption. This would lead to a slower economic growth.
   i) Economic growth – the economy that allocates more resource to make capital good at present will grow faster.
   j) Law of increasing opportunity cost -

4. Comparative advantage and the gains from trade
   • Comparative advantage – A producer or a country has comparative advantage over the other in producing a good if its opportunity cost is lower.
   • Self-sufficient economy – people make everything they need for themselves. There is no trade in this economy. People consume what they produce.
   • People are better off with trade than self-sufficiency because people have more goods to consume if they trade.
   • The gains from trade arise from specialization and comparative advantage.
   • The country that has comparative advantage (i.e. lower opportunity cost) in making a product should produce more and export that product;
   • The country that has comparative disadvantage (i.e. higher opportunity cost) in making a product should produce less and import that product.
   • The United States, like any other countries, is benefit from trading with any other nations!
   • Not all individual are better off from international trade. Workers who lost jobs due to imports are losers; workers who find jobs in the exporting sector gains; consumer also gains due to lower prices of imported goods.