Trading example

For complete specialization: Portugal trades all of its wheat and the UK trades how many cars?

Exchange rate: 1 c for = 4.5w or 44.44 cars for 200 wheat.

After trade:

**UK** has: **200** wheat and **55.56** cars left over. Each car has a minimum value in the UK of 4 wheat so these cars have a value of 222.24 (55.56 x 4) + 200 wheat traded with Portugal = 422.24 total wheat value

**Portugal**  has: **44.44** cars = whea value of 1 c = 5w. See Box D. ( 44.44 x 5 = 222.24) Portugal pays only 4.5 in trading instead of 5)

**Therefore:**

Portugal gets a car for 4.5w and UK gets 4 wheat for 1 car. **Both countries gain from Trade.**

Note: this diagram shows the possible output of the UK in RED and the trading (im)possibility for trading 100 cars for 422.24 wheat. Is 422.24 Wheat possible? What exchange rate would work between cars and wheat using a barter system?

422.24

What are the costs for each country to produce wheat + cars?

Calculate opportunity cost values.

**Answers:**

1. C (uk) = 4 w
2. 1c (por) = 5w
3. 1w (uk)=0.25 c
4. 1w (por) = 0.2 c

**Can the UK + Portugal gain from specialization + trade?**

**Task 1:**

Cauculate opportunity cost of:

1. 1 car (uk)
2. 1 car (por)
3. 1 wheat (uk)
4. 1wheat (por)

Note:Each country uses 10 x on wheat + 10 x on cars

Note: These are complicated examples that will most likely not be asked in HP2 but if you work your way through the examples you will see that specialization + trade works for full and partial specialization. The trading partners (the firms in reality) need to find the trading possibilities so that both stakeholders WIN!

**May 2008 HP 1 Q3 (a)**

**Explain the principle of comparative advantage and the benefits which might arise from free trade. (10 marks)**

**May 2007 HP 2 Q 6**

**Using the principle of comparative advantage, explain why economic theory suggests that countries should specialize and trade with each other.**

NOTE: 50 % of resources used for each product.

Syllabus Weight: 4

Syllabus Item: 134

Webnote 315



**D**

e.r.= 1c:4.5w

100 cars = max UK output without trade.

450 wheat = max return if exchange rate for 1 car = 4.5 wheat. UK can acquire 404.5 wheat as per the example below in box D.

***Webnote***

***401* (HL)**

# Syllabus Reference-Section4.1: Comparative advantage