Notes on Chapter 2

Production Possibilities and Opportunity Costs:
We started our discussion with the analysis of Factors of Productions. We talked about Labor, Capital, Land and Entrepreneurship. These are broad categories, please make sure which productive resource belong to what category. For example, the resources of the sea are considered under the land category. A little strange, but that is how the resources are broadly classified.

With the example of Robinson Crusoe, we presented the idea of Production Possibility Frontier (PPF). The book is very good in discussing and presenting this concept, please study it carefully, making sure that you completely understand the idea of Opportunity cost and the Law of Increasing Costs.

What causes the PPF to shift? If there is a natural disaster, what would happen to the PPF of a country? What about scientific innovations which make all resources more productive?

If a country operates somewhere within the PPF (not on the line itself), then this means that there exists underutilized capacity and unemployed/unutilized resources in that country. We consider such a situation to be economically inefficient. On the other hand, if a country operates on any point on the PPF, it signifies efficiency and full utilization of its resources.

Production Possibilities and Economic Specialization:
We thoroughly discussed the concept of Absolute Advantage and Comparative Advantage with help of examples. Under a two country setting, I showed you how to determine which country has absolute advantage / comparative advantage in the production of which commodity. We did that in two different ways, in the first set of examples the tables we used had information about the quantity of the two products that each country can produce in a given amount of time (e.g., the tables in pages 37 and 38). We used that information to find out the opportunity cost of each product in each country and then decided which country had absolute and comparative advantage in what commodity.

In the second type of setup, the table provided information about the labor it is needed to produce a unit of each commodity in question (e.g., practice problem 3 on page 41). We then used this input information to compute the opportunity cost of the commodities in question. Once the opportunity costs were computed, the method of determining the absolute and comparative advantage was the same. Please make sure that you understand how to find out absolute and comparative advantage under both these two methods.