

The Gains From Specialization

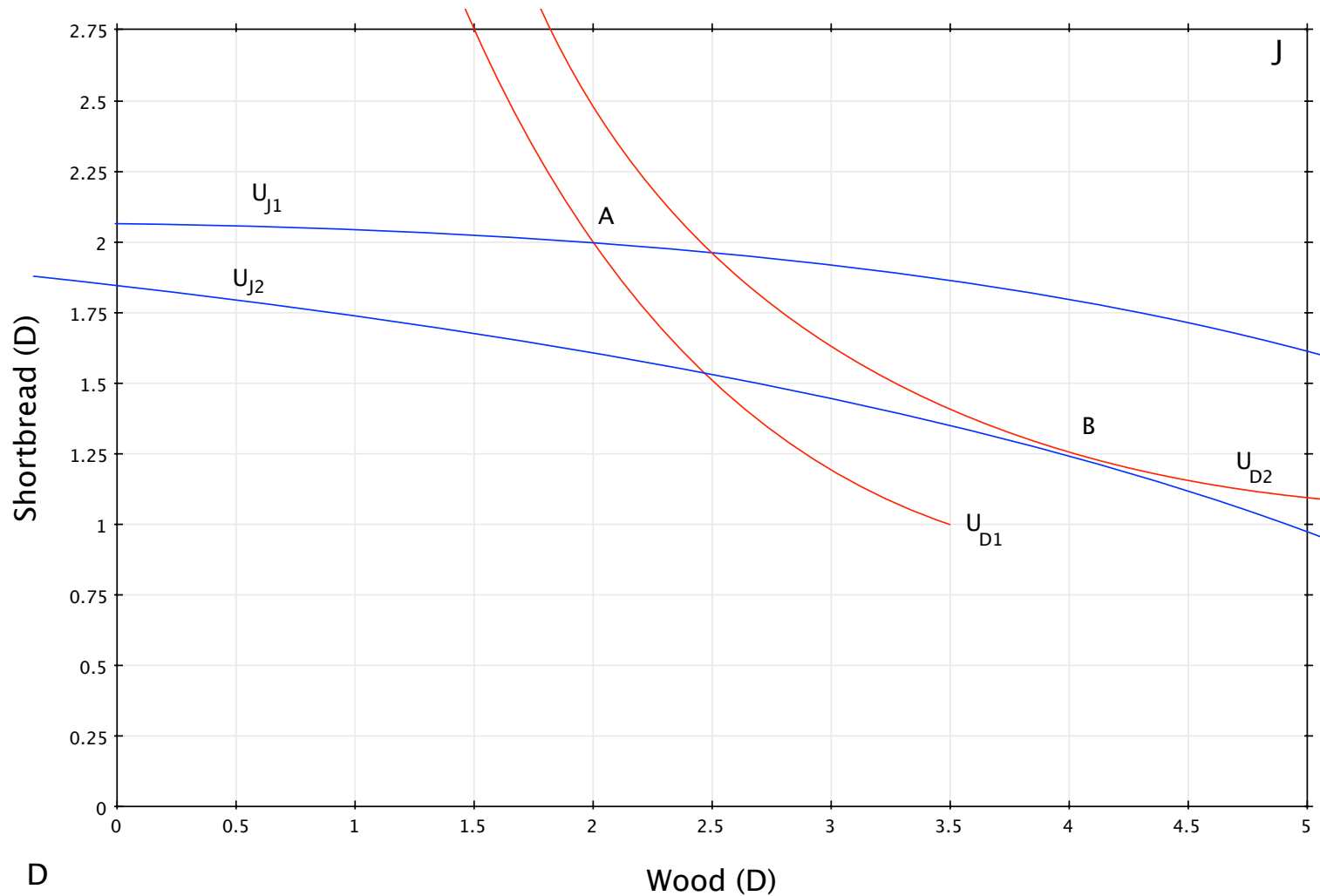
Last Wednesday's equilibrium;

David gets
(4, 1.25)

John
(1, 1.5)

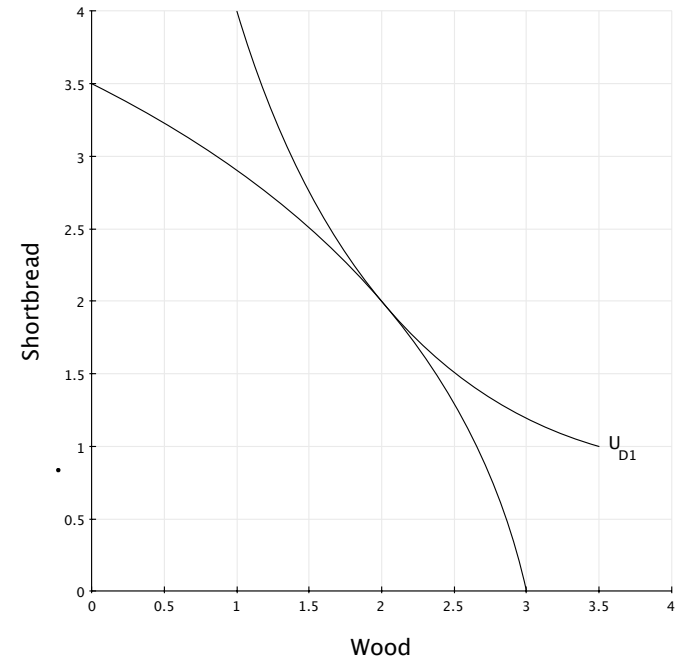
The
exchange,
hence the
mutual gain
in welfare, is
entirely
voluntary

The economy
produces
(5, 2.75)



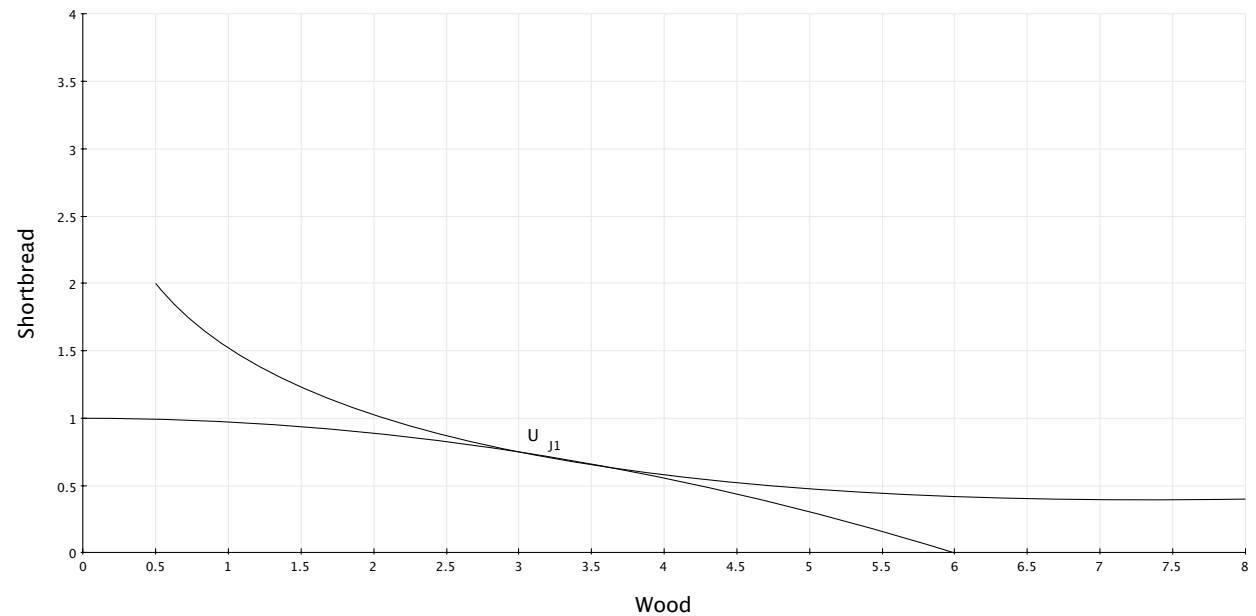
John and David can be better off if they recognize that each has different opportunity costs in production. David is relatively better at producing shortbread and John is relatively better at producing wood.

David

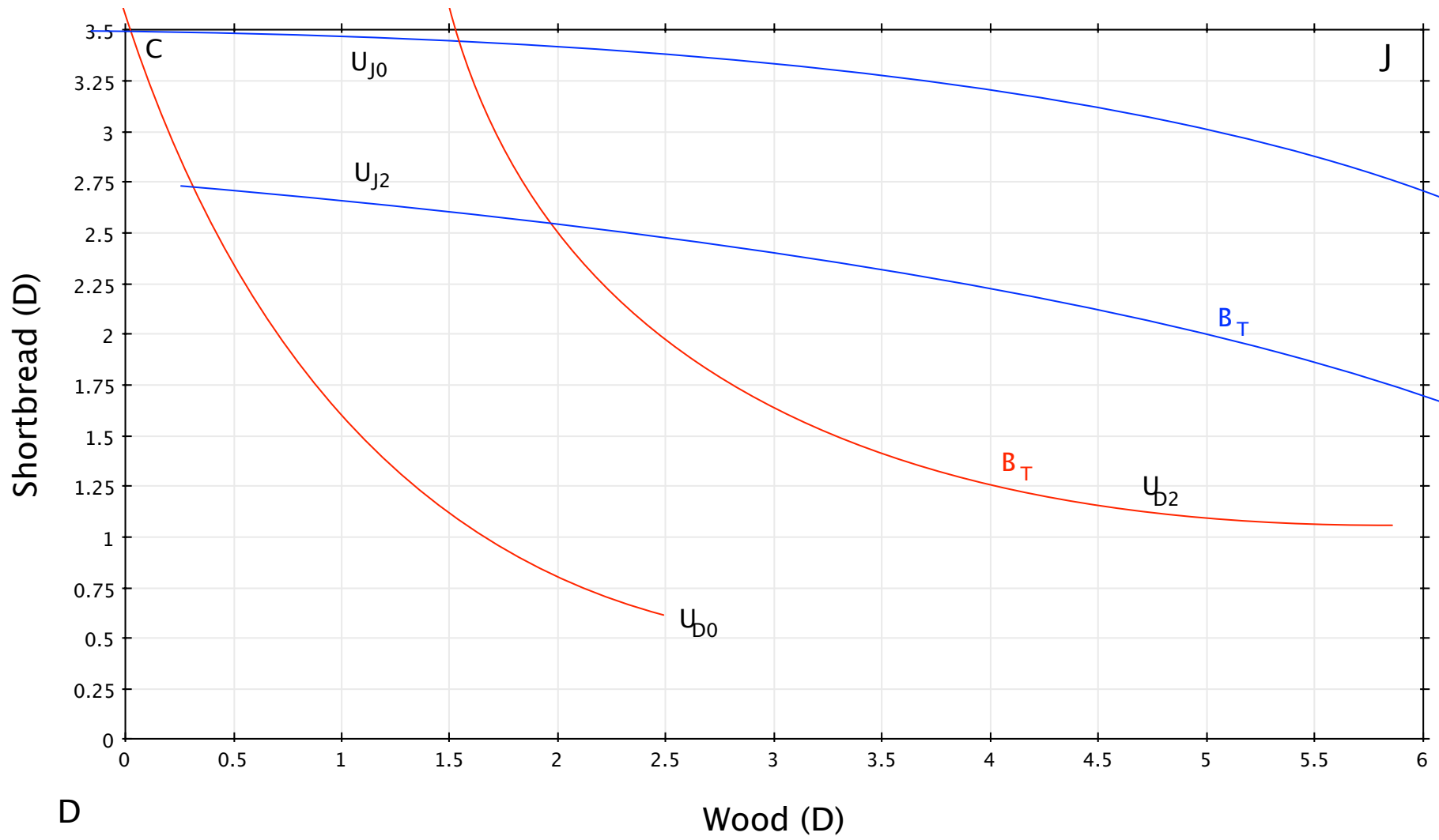


John

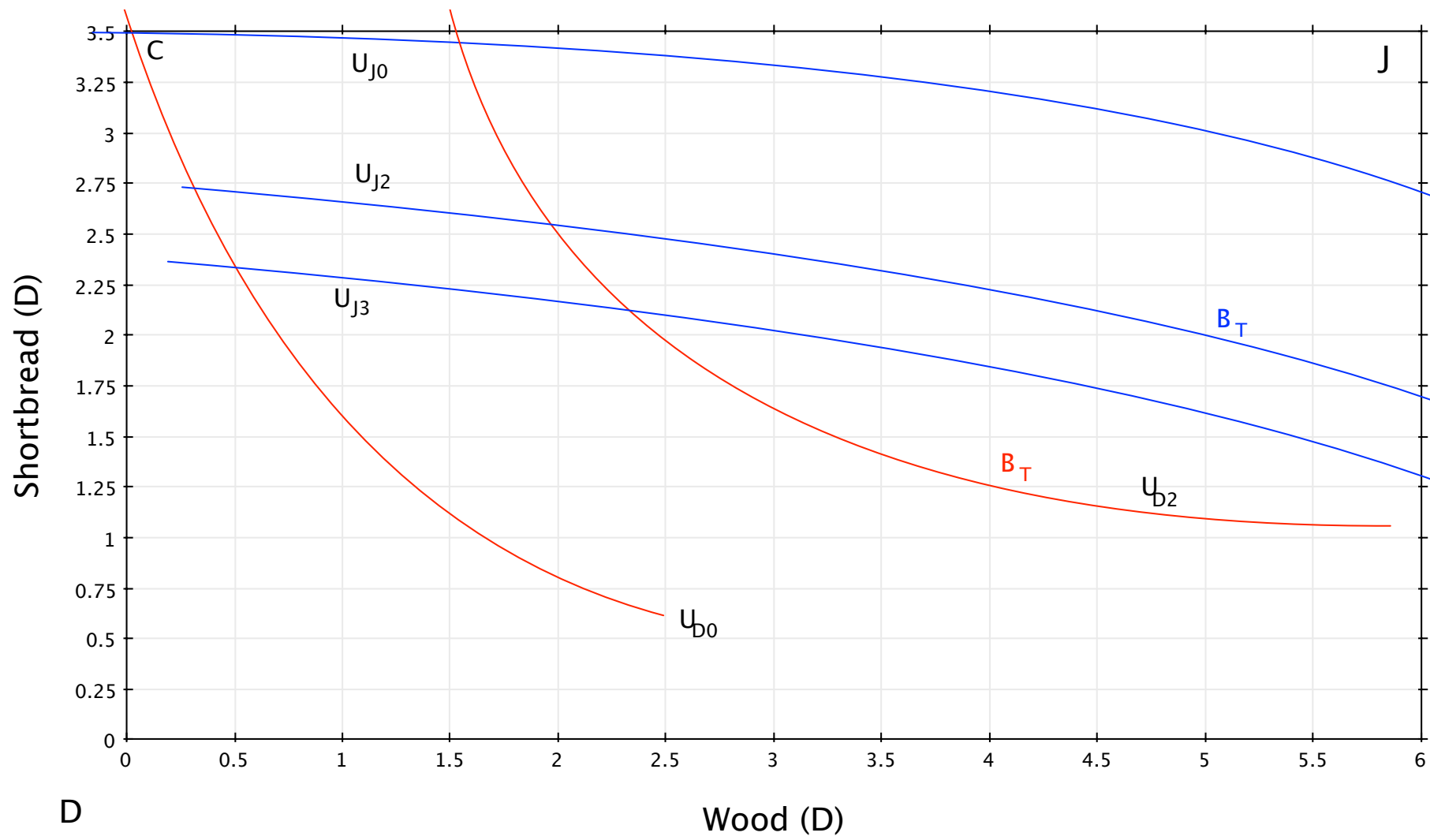
If John specializes in producing wood, and David in shortbread, then they can move from a (5, 2.75) economy to a (6, 3.5) economy and both be better off.



If John is producing 6 cords of wood and David 3.5 dozen shortbread cakes, now there is a lens of trading opportunities between the consumption bundles (hence utility levels) they achieved through their previous bargain which left David at (4,1.25) and John at (1,1.5)



John could move to indifference curve U_{J3} by persuading David to trade more shortbread for wood.



An exchange equilibrium for this economy has David producing 3.5 dozen shortbread cakes, John producing 6 cords of wood, David consuming 4.5 cords of wood and 20 shortbread cakes (1.75 dozen), and John consuming 1.5 cords of wood and 16 shortbread cakes (1.25 dozen)

