

Specific Factors Problem

Consider a country that can produce two commodities (Cloth and Soy) using three factors (capital, land and labor). The country has fixed endowments of the three factors. The production of Cloth (C) uses capital (K) and labor, while the production of Soy (S) uses land (T) and labor. Therefore labor is a mobile factor while capital and land are specific factors. Production technologies follow the assumptions listed in class. In addition the country has “nice” community indifference curves.

Free Trade:

Assume that the country is trading freely with the rest of the world at **prices** p_S/p_C that are **higher** than the autarky prices.

(1) (6 pts) Show a possible free trade equilibrium (draw a plausible PPF, indifference curves and identify possible production and consumption points). **Please use the horizontal axis for Soy.**

Free Trade at Fixed World Prices after an increase in the world relative price of Soy:

Suppose now that due to global factors the world relative price of Soy increases (i.e. p_S/p_C goes up). In the following questions (2 -6) you are asked to evaluate the qualitative effects of this change.

(2) (10 pts) Use a diagram to show what happens to labor allocation across sectors and to the wage as a result of this change.

(3) (4 pts) What happens to Soy and Cloth output? Justify.

(4) (6 pts) Are workers better off or worse off? Justify.

(5) (8 pts) Are the owners of Capital better off or worse off? Justify.

(6) (8 pts) Are the Owners of Land better off or worse off? Justify.