

## ECN – Chapter 2

### Thinking like an Economist

#### The Economist as Scientist

- Economists play 2 roles:
  - Scientists: try to explain the world
  - Policy advisors: try to improve it

#### *The Scientific Method: Observation, Theory, and More Observation*

- Economists employ the scientific method, the dispassionate development and testing of theories about how the world works

#### *The Role of Assumptions*

- Assumptions simplify the complex world, make it easier to understand
- Ex. to study international trade, assume 2 countries and 2 goods (unrealistic but simple to learn)

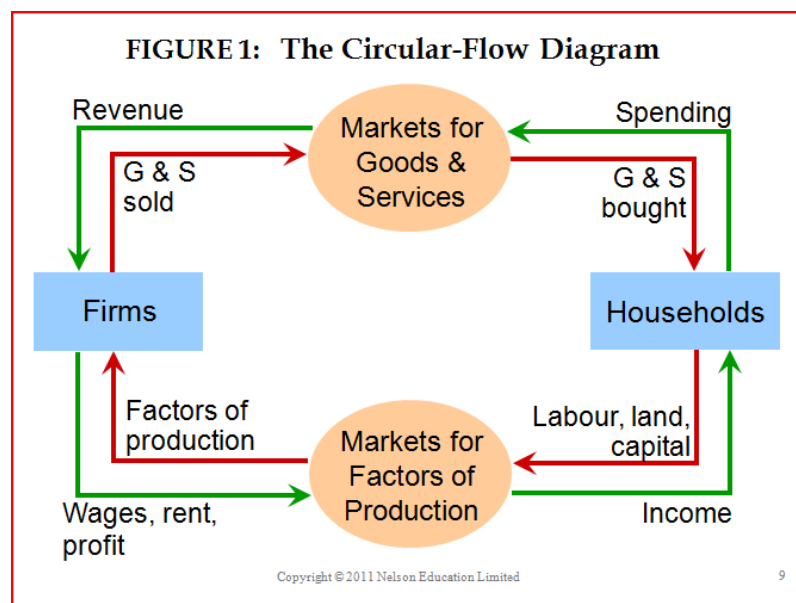
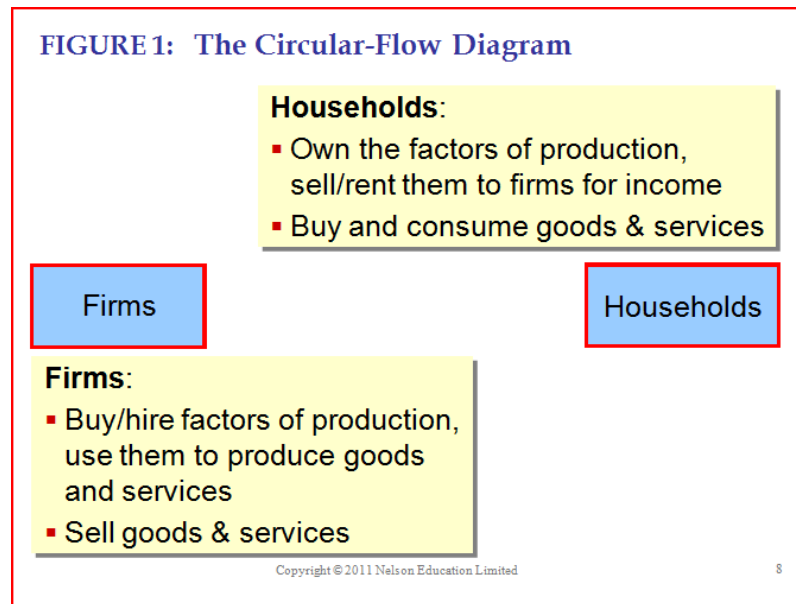
#### *Economic Models*

- Model: a highly simplified representation of a complicated reality
  - Composed of diagrams and equations
  - Economists use models to study economic issues

#### *Our First Model: The Circular-Flow Diagram*

- Circular-flow diagram: a visual model of the economy that shows how dollars flow through markets among households & firms
- Two types of decision makers (“actors”):
  - Households
  - Firms
- Two markets:

- The market for goods and services
  - Households are buyers and firms are sellers
- The market for factors of production
  - Households are sellers and firms are buyers
- Factors of production: the resources the economy uses to produce goods & services
  - Includes: labour, land, capital (building & machines used in production)



*Our Second Model: The Production Possibilities Frontier (PPF)*

- Production possibilities frontier: a graph that shows the combinations of 2 goods the economy can possibly produce given the available resources and the available technology
- Ex. two goods: computers and wheat
  - One resource: labour (hours)
  - Economy has 50,000 labour hours per month available for production

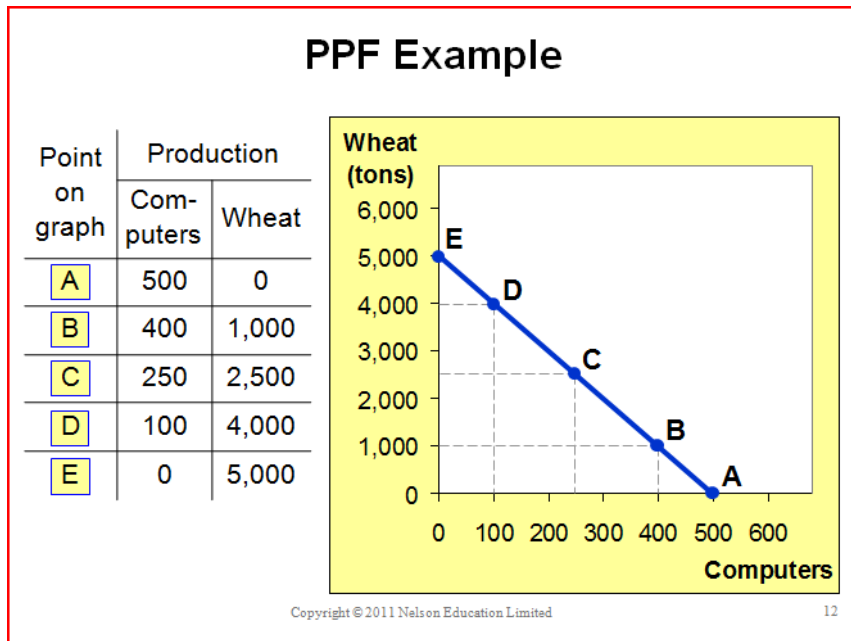
### PPF Example

- Producing one computer requires 100 hours labour.
- Producing one ton of wheat requires 10 hours labour.

	Employment of labour hours		Production	
	Computers	Wheat	Computers	Wheat
A	50,000	0	500	0
B	40,000	10,000	400	1,000
C	25,000	25,000	250	2,500
D	10,000	40,000	100	4,000
E	0	50,000	0	5,000

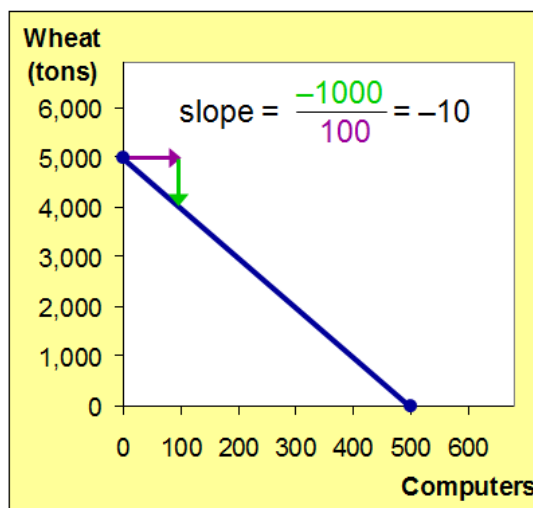
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- Recall: the opportunity cost of an item is what must be given up to obtain that item
- Moving along a PPF involves shifting resources (ex. labour) from production of one good to the other
- Society faces a tradeoff: getting more of one good requires sacrificing some of the other
- The slope of the PPF tells you the opportunity cost of one good in terms of the other (rise/run)

## The PPF and Opportunity Cost



The slope of a line equals the “rise over the run,” the amount the line rises when you move to the right by one unit.

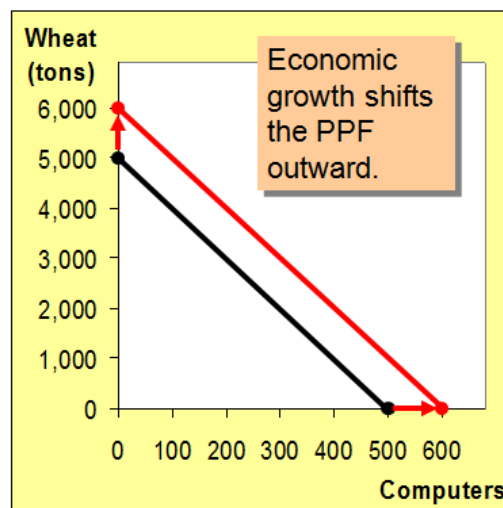
Here, the opportunity cost of a computer is 10 tons of wheat.

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## Economic Growth and the PPF

With additional resources or an improvement in technology, the economy can produce more computers, more wheat, or any combination in between.



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- The PPF could be a straight line or bow-shaped
  - If opportunity cost remains constant, PPF is a straight line
  - If opportunity cost of a good rises as the economy produces more of the good, PPF is bow-shaped
- Why the PPF might be bow-shaped:
  - PPF is bow-shaped when different workers have different skills, different opp. costs of producing one good in terms of the other
  - PPF would also be bow-shaped when there is some other resource, or mix of resources w/ varying opp. costs (ex. different types of land suited for different uses)
- PPF summary:
  - Shows all combinations of 2 goods that an economy can produce (given resources and technology)
  - Illustrates concepts of tradeoff, opportunity cost, efficiency and inefficiency, unemployment, and economic growth
  - A bow-shaped PPF illustrates concept of increasing opp. Cost

### *Microeconomics and Macroeconomics*

- Microeconomics: study of how households and firms make decisions and how they interact in markets
  - Microeconomist might study effects of rent control on housing in Toronto
- Macroeconomics: study of economy-wide phenomena (inflation, unemployment, and economic growth)
  - Macroeconomist might study effects of borrowing by the federal gov't
- These two are intertwined but distinct (different questions and models)

### **The Economist as Policy Adviser**

#### *Positive versus Normative Analysis*

- As scientists, economics make positive statements:

- Positive statements: attempt to describe the world as it is
- As policy advisors, economists make normative statements
  - Normative statements: attempt to prescribe how the world should be
- Positive statements can be confirmed or refuted, normative statements cannot (involves values and facts)
- The Gov't of Canada (like other gov't's) relies on advice of economists

### **Why Economists Disagree**

- Economists often give conflicting policy advice
- May disagree about the validity of alternative positive theories about the world
- May have different values, and, therefore different normative views about what policy should try to accomplish

### **Some Propositions about Which Most Economists Agree (and percentage)**

1. A ceiling on rents reduces the quantity and quality of housing available (93%)
2. Tariffs and import quotas usually reduce general economic welfare (93%)
3. Flexible and floating exchange rates offer an effective international monetary arrangement (90%)
4. Fiscal policy (ex. tax cut and/or gov't expenditure increase) has a significant stimulative impact on a less than fully employed economy (90%)
5. If the federal budget is to be balanced, it should be done over the business cycle rather than yearly (85%)