The Economist as Scientist

Economists play two roles:

1. (                      ): try to explain the world
2. Policy advisors: try to improve it

In the first, economists employ the (                      ),
the dispassionate development and testing of theories about how the world works.
Assumptions & Models

- Assumptions simplify the complex world, make it easier to understand.

- Example: To study international trade, assume two countries and two goods. Unrealistic, but simple to learn and gives useful insights about the real world.

- (Model): a highly simplified representation of a more complicated reality. Economists use models to study economic issues.

Some Familiar Models

A road map
Some Familiar Models

A model of human anatomy from high school biology class

Some Familiar Models

A model airplane
Some Familiar Models

The model teeth at the dentist’s office

Don’t forget to floss!

Our First Model: The Circular-Flow Diagram

- The **Circular-Flow Diagram**: a visual model of the economy, shows how dollars flow through markets among households and firms

- Two types of “actors”:
  - ( )
  - firms

- Two markets:
  - the market for ( )
  - the market for “factors of production”
Factors of Production

- ( ): the resources the economy uses to produce goods & services, including
  - labor
  - land
  - capital (buildings & machines used in production)

FIGURE 1: The Circular-Flow Diagram

Households:
- Own the factors of production, sell/rent them to firms for income
- Buy and consume goods & services

Firms:
- Buy/hire factors of production, use them to produce goods and services
- Sell goods & services
Our Second Model: The Production Possibilities Frontier

- The **Production Possibilities Frontier (PPF)**: a graph that shows the combinations of two goods the economy can possibly produce given the available resources and the available technology

- Example:
  - Two goods: computers and wheat
  - One resource: labor (measured in hours)
  - Economy has 50,000 labor hours per month available for production.
### PPF Example

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

<table>
<thead>
<tr>
<th></th>
<th>Employment of labor hours</th>
<th>Production</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Computers</td>
<td>Wheat</td>
</tr>
<tr>
<td>A</td>
<td>50,000</td>
<td>0</td>
</tr>
<tr>
<td>B</td>
<td>40,000</td>
<td>10,000</td>
</tr>
<tr>
<td>C</td>
<td>25,000</td>
<td>25,000</td>
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<tr>
<td>D</td>
<td>10,000</td>
<td>40,000</td>
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<tr>
<td>E</td>
<td>0</td>
<td>50,000</td>
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</tbody>
</table>

**Diagram:**

**Think like an Economist**

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**PPF Example**

<table>
<thead>
<tr>
<th>Point on graph</th>
<th>Production</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Computers</td>
</tr>
<tr>
<td>A</td>
<td>500</td>
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<tr>
<td>B</td>
<td>400</td>
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<tr>
<td>C</td>
<td>250</td>
</tr>
<tr>
<td>D</td>
<td>100</td>
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<tr>
<td>E</td>
<td>0</td>
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</tbody>
</table>
A. On the graph, find the point that represents (100 computers, 3000 tons of wheat), label it F. Would it be possible for the economy to produce this combination of the two goods? Why or why not?

B. Next, find the point that represents (300 computers, 3500 tons of wheat), label it G. Would it be possible for the economy to produce this combination of the two goods?

**ACTIVE LEARNING 1**

**Points off the PPF**

- Point F: 100 computers, 3000 tons wheat
- Point F requires 40,000 hours of labor. Possible but not efficient: could get more of either good w/o sacrificing any of the other.

**ACTIVE LEARNING 1**

**Answers**
The PPF: What We Know So Far

Points on the PPF (like A – E)
- possible
- efficient: all resources are fully utilized

Points under the PPF (like F)
- possible
- not efficient: some resources underutilized (e.g., workers unemployed, factories idle)

Points above the PPF (like G)
- not possible
The PPF and Opportunity Cost

- Recall: The ( ) of an item is what must be given up to obtain that item.
- Moving along a PPF involves shifting resources (e.g., labor) from the 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.

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.
In which country is the opportunity cost of cloth lower?

**FRANCE**

**ENGLAND**

*England*, because its PPF is not as steep as France's.
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.

![Economic growth shifts the PPF outward.](image)

The Shape of the PPF

- The PPF could be a straight line, or bow-shaped
- Depends on what happens to opportunity cost as economy shifts resources from one industry to the other.
  - If opp. cost remains constant, PPF is a straight line.
    (In the previous example, opp. cost of a computer was always 10 tons of wheat.)
  - If opp. cost of a good rises as the economy produces more of the good, PPF is bow-shaped.
Why the PPF Might Be Bow-Shaped

As the economy shifts resources from beer to mountain bikes:

- PPF becomes steeper
- opp. cost of mountain bikes increases

Why the PPF Might Be Bow-Shaped

At point A, most workers are producing beer, even those that are better suited to building bikes. So, do not have to give up much beer to get more bikes.

At A, opp. cost of mtn bikes is low.
Why the PPF Might Be Bow-Shaped

At B, most workers are producing bikes. The few left in beer are the best brewers. Producing more bikes would require shifting some of the best brewers away from beer production, would cause a big drop in beer output.

THINKING LIKE AN ECONOMIST

Why the PPF Might Be Bow-Shaped

- So, PPF is bow-shaped when different workers have different skills, different opportunity costs of producing one good in terms of the other.

- The (      ) would also be bow-shaped when there is some other resource, or mix of resources with varying opportunity costs (E.g., different types of land suited for different uses).
The PPF: A Summary

- The PPF shows all combinations of two goods that an economy can possibly produce, given its resources and technology.

- The PPF illustrates the concepts of tradeoff and opportunity cost, efficiency and inefficiency, unemployment, and economic growth.

- A bow-shaped PPF illustrates the concept of increasing opportunity cost.

Microeconomics and Macroeconomics

- **Microeconomics** is the study of how households and firms make decisions and how they interact in markets.

- ( ) is the study of economy-wide phenomena, including inflation, unemployment, and economic growth.

- These two branches of economics are closely intertwined, yet distinct – they address different questions.
The Economist as Policy Advisor

- As scientists, economists make **positive statements**, which attempt to describe the world as it is.

- As policy advisors, economists make **(normative statements)**, which attempt to prescribe how the world should be.

- Positive statements can be confirmed or refuted, normative statements cannot.

- Govt employs many economists for policy advice. *E.g.*, the U.S. President has a Council of Economic Advisors, which the author of this textbook chaired from 2003 to 2005.

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**ACTIVE LEARNING 3**

Identifying positive vs. normative

Which of these statements are “positive” and which are “normative”? How can you tell the difference?

- a. Prices rise when the government increases the quantity of money.

- b. The government should print less money.

- c. A tax cut is needed to stimulate the economy.

- d. An increase in the price of burritos will cause an increase in consumer demand for video rentals.
### Answers

**a.** Prices rise when the government increases the quantity of money.

*Positive – describes a relationship, could use data to confirm or refute.*

**b.** The government should print less money.

*Normative – this is a value judgment, cannot be confirmed or refuted.*

**c.** A tax cut is needed to stimulate the economy.

*Normative – another value judgment.*

**d.** An increase in the price of burritos will cause an increase in consumer demand for video rentals.

*Positive – describes a relationship. \textit{Note that a statement need not be true to be positive.}*
Why Economists Disagree

- ( ) often give conflicting policy advice.
- They sometimes disagree about the validity of alternative positive theories about the world.
- They may have different values and, therefore, different normative views about what policy should try to accomplish.
- Yet, there are many propositions about which most economists agree.

CHAPTER SUMMARY

- As scientists, economists try to explain the world using models with appropriate assumptions.
- Two simple models are the Circular-Flow Diagram and the Production Possibilities Frontier.
- Microeconomics studies the behavior of consumers and firms, and their interactions in markets. Macroeconomics studies the economy as a whole.
- As policy advisers, economists offer advice on how to improve the world.