



# Understanding Economics

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2<sup>nd</sup> edition  
by Mark Lovewell and Khoa Nguyen

## Chapter 1

# **The Economic Problem**

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# Chapter Objectives

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- In this chapter, you will:
  - consider the economic problem that underlies the definition of economics;
  - learn about the way economists specify economic choice;
  - examine the production choices an entire economy faces, as demonstrated by the production possibilities model;
  - analyze the three basic economic questions and how various economic systems answer them.

# Economics Defined

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- Economics is the study of how to distribute scarce resources among competing ends.
  - Microeconomics focuses on individual consumers and businesses.
  - Macroeconomics takes a broad view of the economy.

# The Economic Problem

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- Economists deal with the economic problem.
  - Economic agents must continually make choices.
  - Their wants are unlimited.
  - They face a limited supply of economic resources.

# Economic Models

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- Economic models:
  - simplify economic reality
  - show how dependent variables are affected by independent variables
  - include inverse and/or direct relationships
  - incorporate a variety of assumptions such as *ceteris paribus*
  - are classified as part of either positive economics or normative economics

# Economic Choice

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- Economists assume that economic decision-makers maximize their own utility.
  - Decision-makers must keep in mind the opportunity cost of each alternative.
  - Opportunity cost is defined as the utility of the best forgone alternative.

# The Production Possibilities Model

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- The production possibilities model is based on three assumptions:
  - an economy makes only two products
  - resources and technology are fixed
  - all resources are employed to their fullest capacity

# The Production Possibilities Curve (a)

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- The production possibilities curve shows a range of possible output combinations for an economy.
  - It highlights the scarcity of resources.
  - It has a concave shape, which reflects the law of increasing opportunity costs.

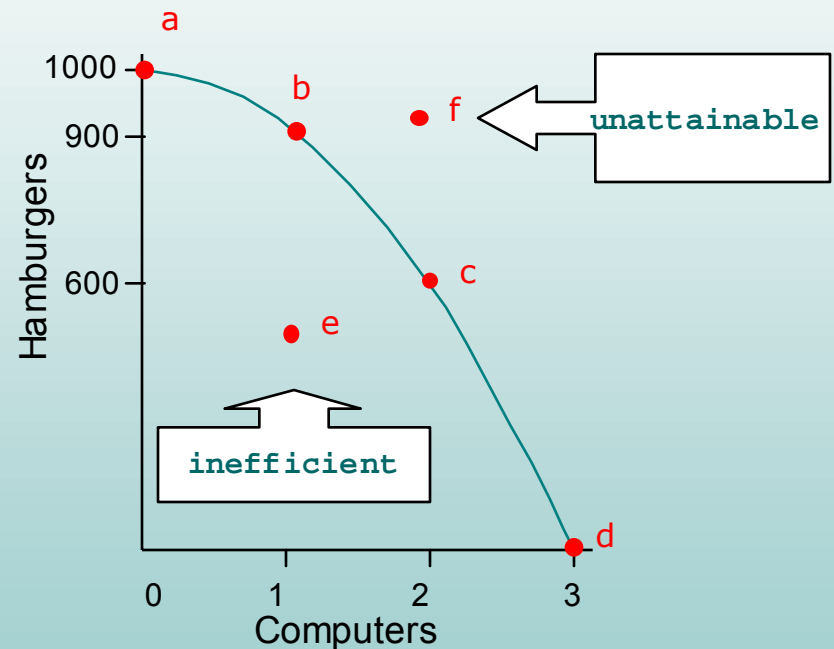
# The Production Possibilities Curve (b)

Figure 1.1, page 8

## Production Possibilities Schedule

Hamburgers	Computers	point on graph
1000	0	a
900	1	b
600	2	c
0	3	d

## Production Possibilities Curve



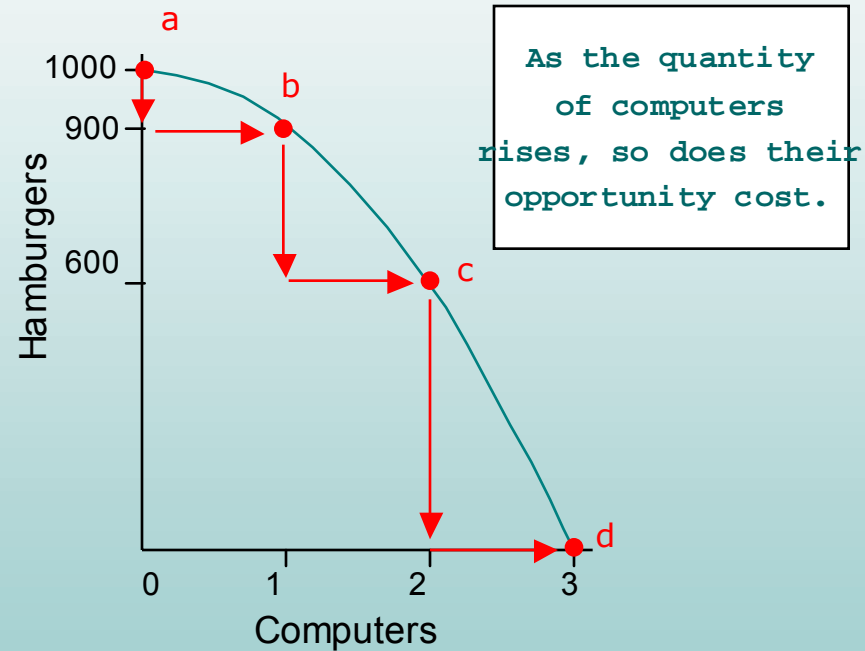
# The Law of Increasing Costs

Figure 1.2, page 9

Production Possibilities Schedule

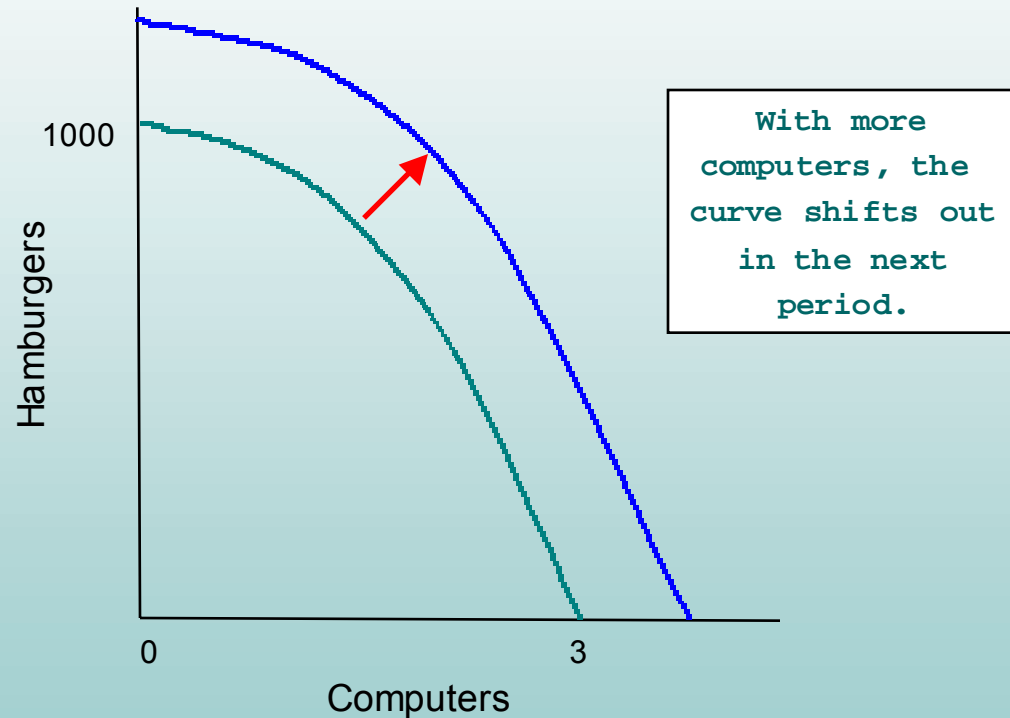
Hamburgers	Opportunity Cost of Computers	Computers	point on graph
1000		0	a
	100		
900	300	1	b
	600		
600		2	c
	600		
0		3	d

Production Possibilities Curve



# Shifts in Production Possibilities

Production Possibilities Curve



# The Basic Economic Questions

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- There are three basic questions any society must answer:
  - what to produce
  - how to produce
  - for whom to produce

# Economic Systems

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- There are three systems to choose from:
  - Traditional economies focus on non-economic concerns and have tight social constraints.
  - Market economies are consumer-centered and innovative but create inequality and instability.
  - Command economies equalize incomes but often have a lack of freedom.

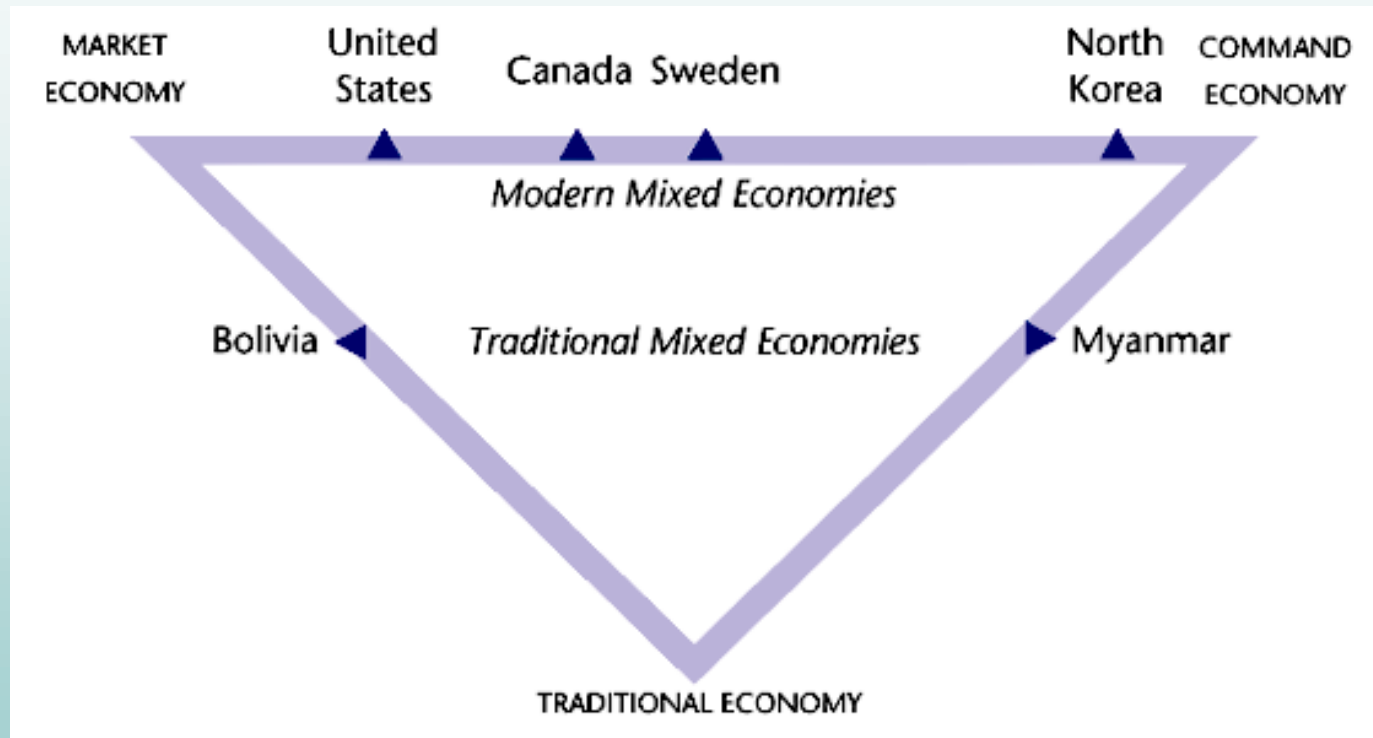
# The Range of Economic Systems (a)

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- Most countries have mixed economies.
  - Modern mixed economies include both private and public sectors.
  - Traditional mixed economies combine traditional sectors with private and/or public sectors.

# The Range of Economic Systems (b)

Figure 1.4, page 15



# Economic Goals

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- There are seven major economic goals:
  - economic efficiency
  - income equity
  - price stability
  - full employment
  - viable balance of payments
  - economic growth
  - environmental sustainability

# Complementary and Conflicting Economic Goals

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- Economic goals may be complementary.
  - An example is the relationship between full employment and economic growth.
- Economic goals may be conflicting.
  - An example is the relationship between price stability and full employment.

# The Founder of Modern Economics

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- Adam Smith:
  - explained how the division of labour increases production
  - argued that self interest is transformed by the invisible hand of competition so that it creates significant economic benefits
  - stressed the principle of *laissez faire*, which means that governments should not intervene in economic activity



# Understanding Economics

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End

## Chapter 1

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