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Thinking Like an Economist



Thinking Like an Economist

Every field of study has its own terminology

- Mathematics

- integrals ❖ axioms ❖ vector spaces

- Psychology

- ego ❖ id ❖ cognitive dissonance

- Law

- promissory ❖ estoppel ❖ torts ❖ venues

- Economics

- supply ❖ opportunity cost ❖ elasticity ❖ consumer surplus ❖ demand ❖ comparative advantage ❖ deadweight loss



Thinking Like an Economist

Economics trains you to. . . .

- Think in terms of alternatives.
- Evaluate the cost of individual and social choices.
- Examine and understand how certain events and issues are related.



THE ECONOMIST AS A SCIENTIST

The economic way of thinking . . .

- Involves thinking analytically and objectively.
- Makes use of the scientific method.
- Uses abstract models to help explain how a complex, real world operates.
- Develops theories, collects and analyzes data to evaluate the theories.

The Scientific Method: Observation, Theory, and More Observation

- Uses abstract models to help explain how a complex, real world operates.
- Develops theories, collects and analyzes data to evaluate the theories.

The Role of Assumptions

- Economists make assumptions in order to make the world easier to understand.
- The art in scientific thinking is deciding which assumptions to make.
- Economists use different assumptions to answer different questions.

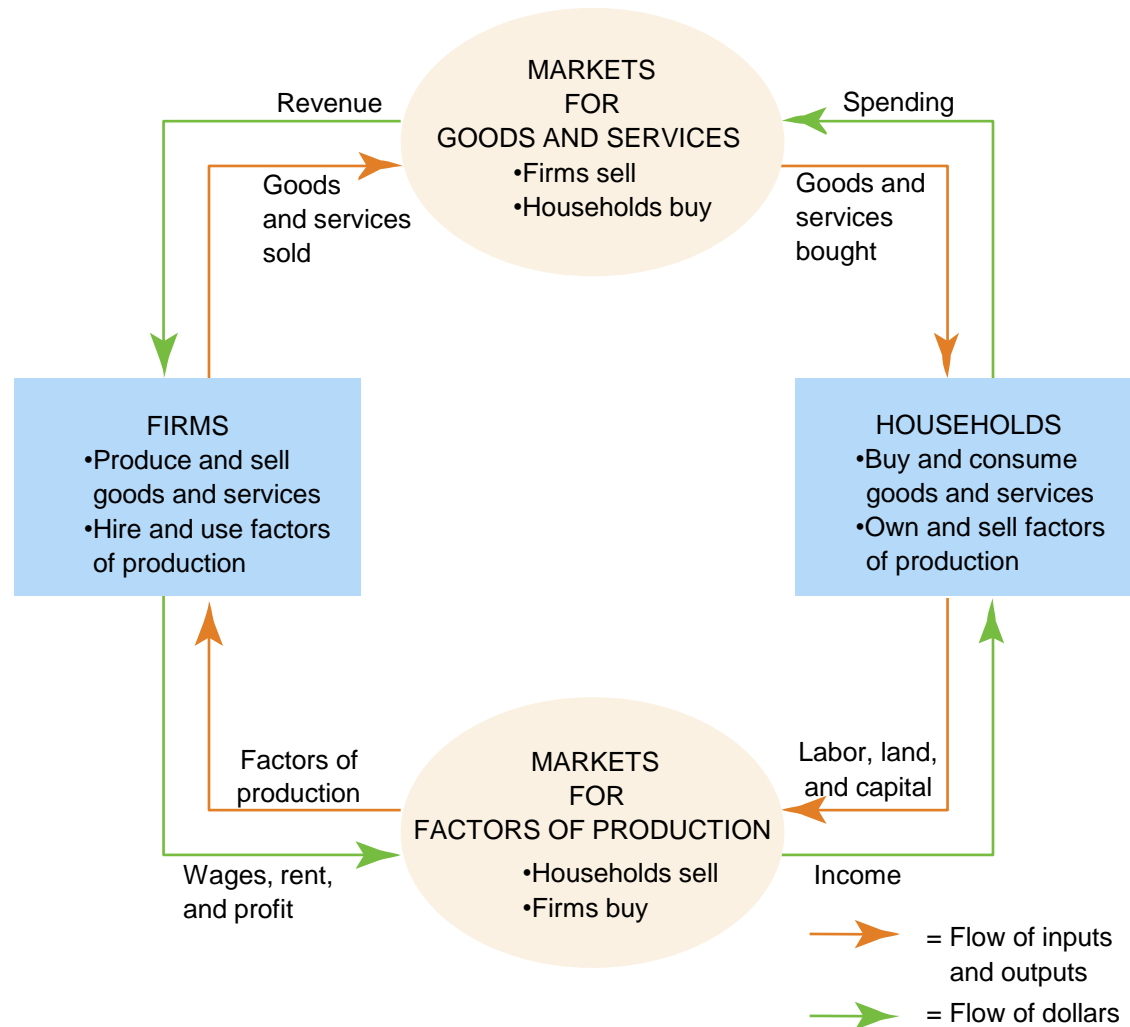
Economic Models

- Economists use models to simplify reality in order to improve our understanding of the world.
- Two of the most basic economic models are:
 - The Circular Flow Diagram
 - The Production Possibilities Frontier

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

- The *circular-flow diagram* is a visual model of the economy that shows how dollars flow through markets among households and firms.

Figure 1 The Circular Flow



Our First Model: The Circular-Flow Diagram

- Firms
 - Produce and sell goods and services
 - Hire and use factors of production
- Households
 - Buy and consume goods and services
 - Own and sell factors of production

Our First Model: The Circular-Flow Diagram

- Markets for Goods and Services
 - Firms sell
 - Households buy
- Markets for Factors of Production
 - Households sell
 - Firms buy

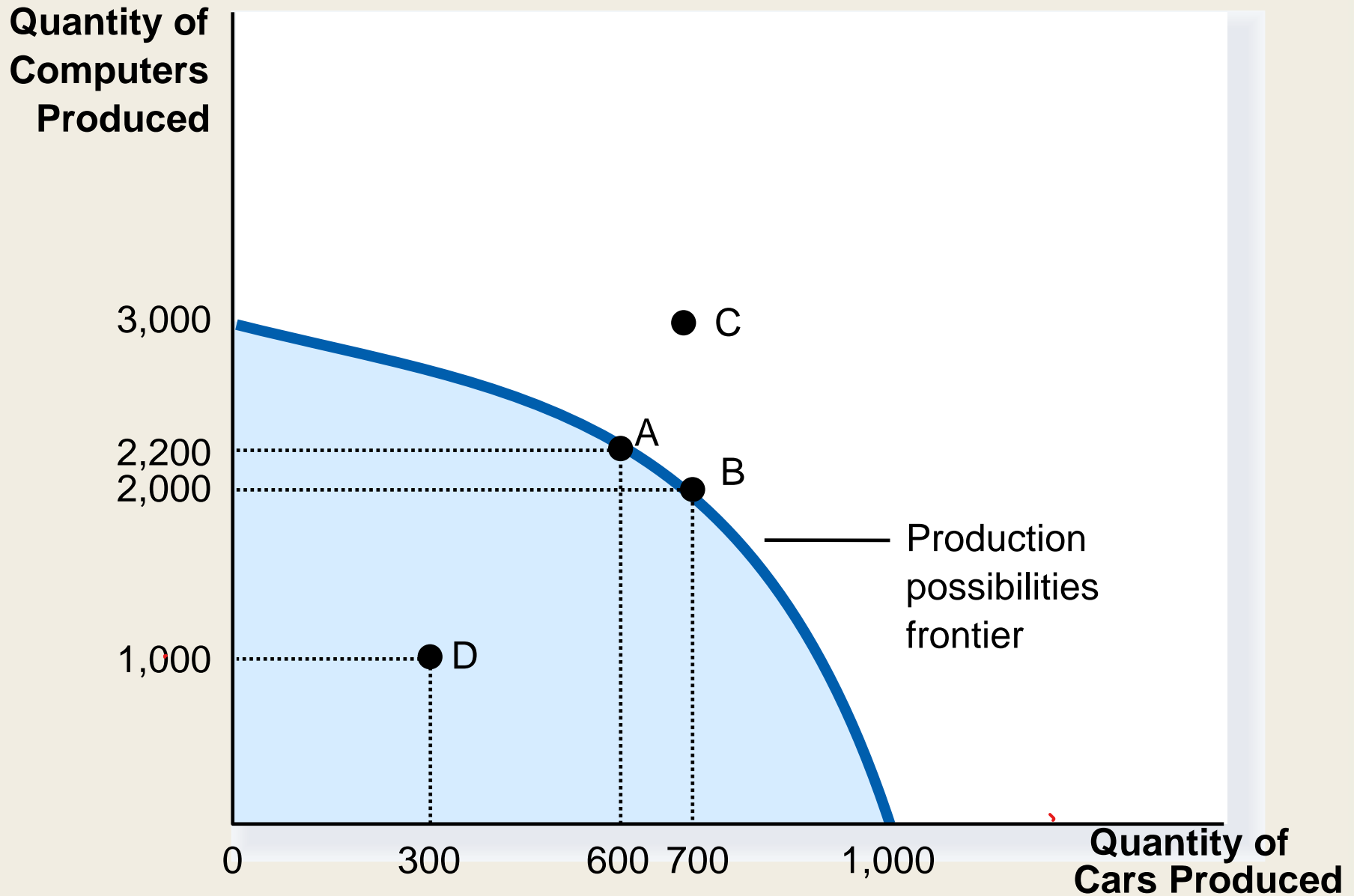
Our First Model: The Circular-Flow Diagram

- Factors of Production
 - Inputs used to produce goods and services
 - Land, labor, and capital

Our Second Model: The Production Possibilities Frontier

- The *production possibilities frontier* is a graph that shows the combinations of output that the economy can possibly produce given the available factors of production and the available production technology.

Figure 2 The Production Possibilities Frontier



Our Second Model: The Production Possibilities Frontier

- Concepts illustrated by the production possibilities frontier
 - Efficiency
 - Trade-offs
 - Opportunity cost
 - Economic growth