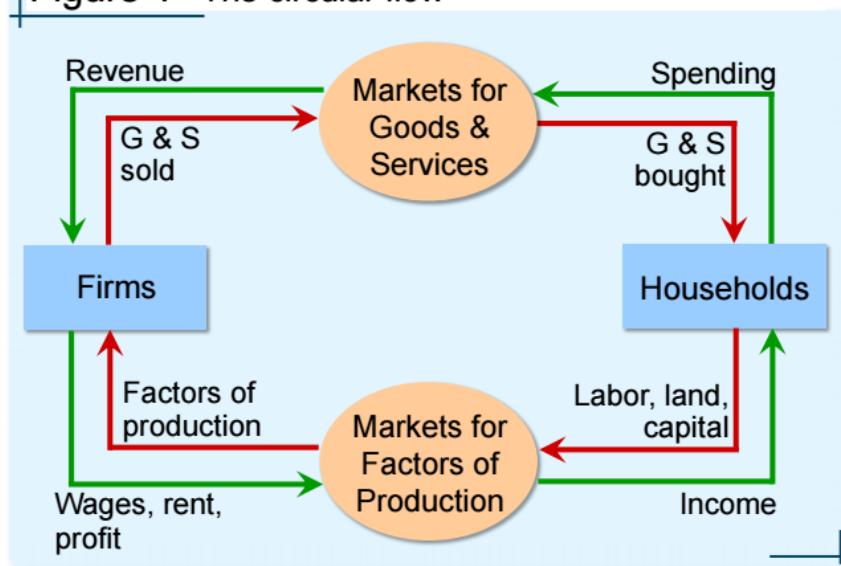


Ch 2. Thinking Like an Economist

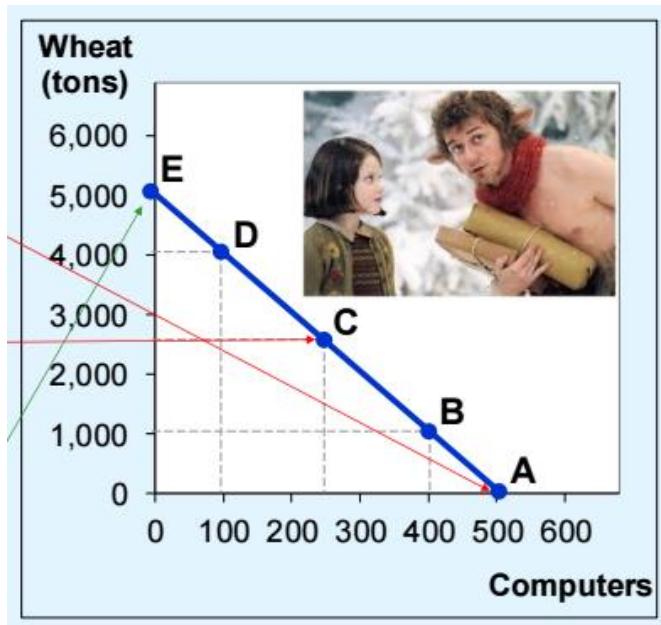
- Economists play two roles, Scientists and/or Policy advisors
 - Economists use assumptions and models to study economic issues
- **1. Circular-flow diagram**
- Visual model of the economy, Shows how dollars flow through markets among households and firms
 - Two decision makers –Firms and Households
 - Interacting in two markets
 - 1) Market for goods and services
 - 2) Market for factors of production (inputs): labor, land, capital

Figure 1 The circular flow



2. Production Possibilities Frontier, PPF

- A graph: combinations of output that the economy can possibly produce
- Given the available factors of production and technology
- Example: Narnia Land
- producing computers and wheat, with one resource(50,0000 Labor hours), Producing one computer requires 100 hours labor.
- Producing one ton of wheat requires 10 hours labor



- Points on the PPF (like A – E): possible & Efficient: all resources are fully utilized
- Points under the PPF (like F): possible but Not efficient: some resources are underutilized (e.g., workers unemployed, factories idle)
- Points above the PPF (like G) – Not possible

- Moving along a PPF
- The slope of the PPF : The opportunity cost of one good in terms of the other
- Economic Growth and the PPF : With additional resources or an improvement in technology, the economy can produce more

- **Shape of the PPF**
- Straight line: constant opportunity cost
- Previous example: the opportunity cost of 1 computer is 10 tons of wheat
- Bowed outward: increasing opportunity cost
- As more units of a good are produced, we need to give up increasing amounts of the other good produced