

ECON 101: Principles of Economics I

Lecture Note 1

University of Michigan at Ann Arbor

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Lecture 1 Economic Models

Monday, August 29, 2022 11:28 AM

What is economics?

- Economics is the study of the allocation of scarce resources.
This means we study choices.
- Why must we choose?
 - Scarcity: the limited nature of society's resources
- If our resources are scarce, then choosing option B necessarily means not taking option A.
 - Opportunity cost: What you must give up to get some item.

What tools do we use? We use models.

Model - a simplified representation of a real situation that is used to better understand real-life situations

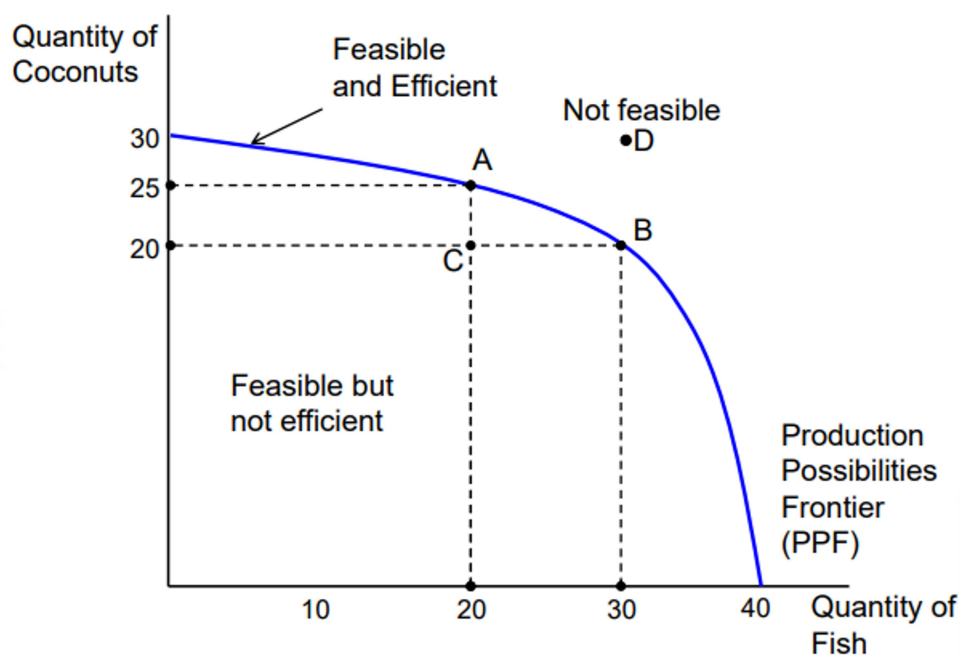
- The "other things equal" assumption means that all other relevant factors remain unchanged.

We use models to describe, predict and make recommendations.

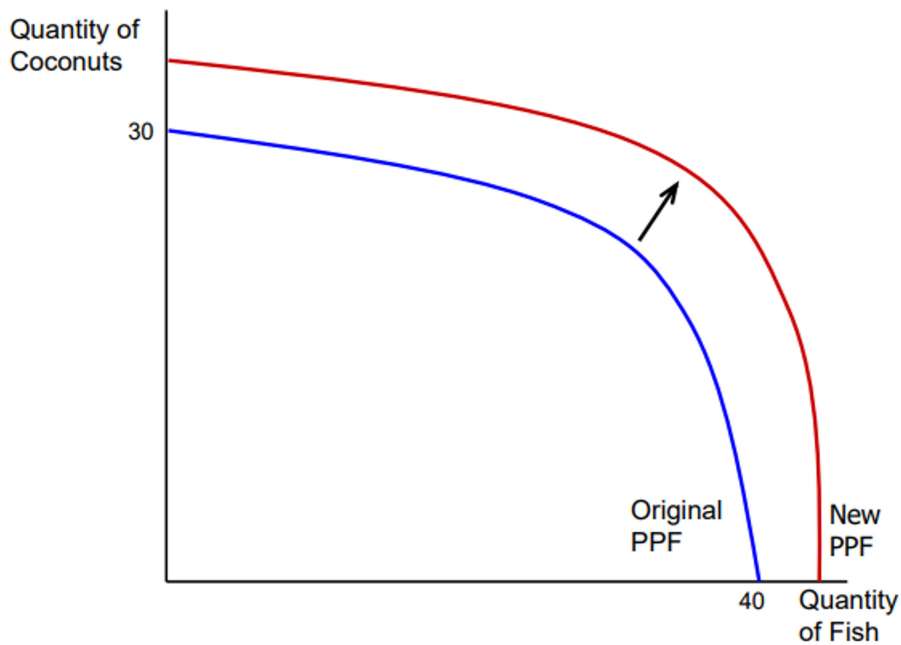
- Positive economics - the branch of economic analysis that describes the way the economy actually works.
- Normative economics - prescriptions about the way the economy should work.

The Production Possibility Frontier (PPF)

The PPF illustrates the trade-offs facing an economy that produces only two goods. It shows the maximum quantity of one good that can be produced for any given production of the other.



Economic Growth

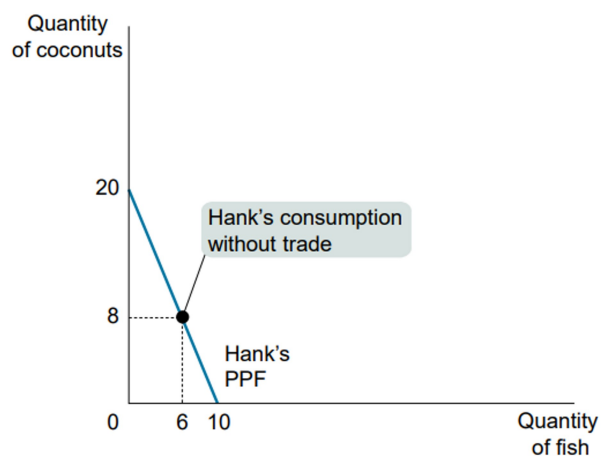
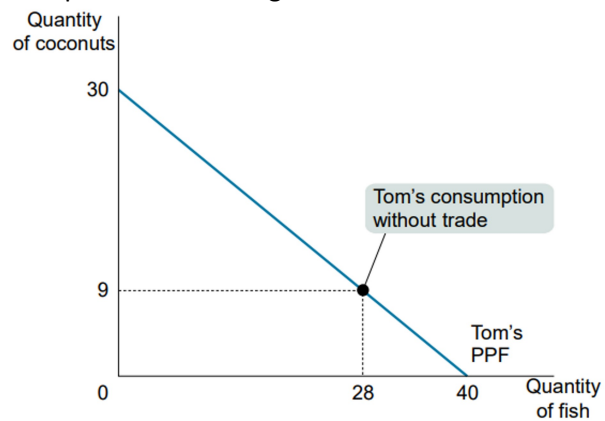


IMPORTANT:

The Production Possibilities Frontier demonstrates that limits of possible production.

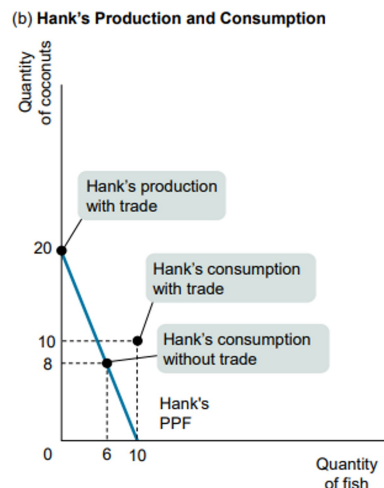
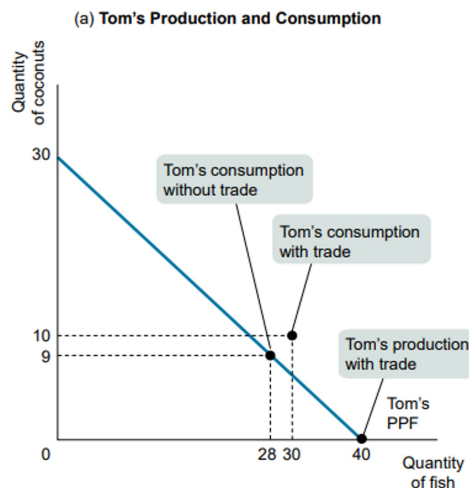
- Producing inside the frontier means that resources are wasted.
 - Feasible but not efficient
- Producing beyond the frontier is impossible
 - Infeasible
- Producing along the frontier requires the use of the entire resource allocation.
 - Feasible and efficient

Comparative Advantage and Gains from Trade



Opportunity costs of fish and coconuts

	Tom's Opportunity Cost	Hank's Opportunity Cost
One fish	3/4 coconut	2 coconuts
One coconut	4/3 fish	1/2 fish



Comparative vs. Absolute Advantage

- Comparative Advantage:
An individual has a comparative advantage in producing a good or service if the opportunity cost of producing the good is lower for that individual than for other people
- Absolute Advantage:
An individual has an absolute advantage in an activity if he or she can do it better than other people

IMPORTANT:

- Opportunity costs affect how we choose to specialize and trade.
- We won't trade at a higher price than our own opportunity cost.
- Comparative Advantage is the basis for specialization and trade.
- We have a comparative advantage when our opportunity cost is lower.
- There are potential gains from specialization and trade.
- We're better off specializing in the goods in which we have a lower opportunity cost.