

## Section I Review

## Summary

## The Study of Economics

1. Everyone has to make choices about what to do and what *not* to do. **Individual choice** is the basis of **economics**—if it doesn't involve choice, it isn't economics. The **economy** is a system that coordinates choices about production and consumption. In a **market economy**, these choices are made by many firms and individuals. In a **command economy**, these choices are made by a central authority. **Incentives** are rewards or punishments that motivate particular choices, and can be lacking in a command economy where producers cannot set their own prices or keep their own profits. **Property rights** create incentives in market economies by establishing ownership and granting individuals the right to trade goods and services for mutual gain. In any economy, decisions are informed by **marginal analysis**—the study of the costs and benefits of doing something a little bit more or a little bit less.
2. The reason choices must be made is that **resources**—anything that can be used to produce something else—are **scarce**. The four categories of resources are **land, labor, capital** and **entrepreneurship**. Individuals are limited in their choices by money and time; economies are limited by their supplies of resources.
3. Because you must choose among limited alternatives, the true cost of anything is what you must give up to get it—all costs are **opportunity costs**.
4. Economists use economic models for both **positive economics**, which describes how the economy works, and for **normative economics**, which prescribes how the economy *should* work. Positive economics often involves making forecasts. Economics can determine correct answers for positive questions, but typically not for normative questions, which involve value judgments. Exceptions occur when policies designed to achieve a certain prescription can be clearly ranked in terms of efficiency.
5. There are two main reasons economists disagree. One, they may disagree about which simplifications to make in a model. Two, economists may disagree—like everyone else—about values.
6. **Microeconomics** is the branch of economics that studies how people make decisions and how those decisions interact. **Macroeconomics** is concerned with the overall ups and downs of the economy, and focuses on **economic aggregates** such as the unemployment rate and gross domestic product, that summarize data across many different markets.

## Introduction to Macroeconomics

7. Economies experience ups and downs in economic activity. This pattern is called the **business cycle**.
8. With respect to the business cycle, economists are interested in the levels of **aggregate output, unemployment** and **inflation**.
9. Over longer periods of time, economists focus on **economic growth**.
10. Almost all economics is based on **models**, “thought experiments” or simplified versions of reality, many of which use analytical tools such as mathematics and graphs. An important assumption in economic models is the **other things equal (*ceteris paribus*) assumption**, which allows analysis of the effect of change in one factor by holding all other relevant factors unchanged.

## The Production Possibilities Curve Model

11. One important economic model is the **production possibilities curve**, which illustrates the **trade-offs** facing an economy that produces only two goods. The production possibilities curve illustrates three elements: opportunity cost (showing how much less of one good must be produced if more of the other good is produced), **efficiency** (an economy is efficient in production if it produces on the production possibilities curve and efficient in allocation if it produces the mix of goods and services that people want to consume), and economic growth (an outward shift of the production possibilities curve).
12. There are two basic sources of growth in the production possibilities curve model: an increase in resources and improved **technology**.
13. There are **gains from trade**: by engaging in the **trade** of goods and services with one another, the members of an economy can all be made better off. Underlying gains from trade are the advantages of **specialization**, of having individuals specialize in the tasks they are comparatively good at.

## Comparative Advantage and Trade

14. **Comparative advantage** explains the source of gains from trade between individuals and countries. Everyone has a comparative advantage in something—some good or service in which that person has a lower opportunity cost than everyone else. But it is often confused with **absolute advantage**, an ability to produce more of a particular good or service than anyone else. This confusion leads some to erroneously conclude that there are no gains from trade between people or countries.