

chapter:

2

>> Basic Concepts and Economic Models: Trade-offs and Trade

Krugman/Wells
Economics

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WHAT YOU WILL LEARN IN THIS CHAPTER

- The difference between positive economics and normative economics
- When economists agree and why they sometimes disagree
- Why **models**? Simplified representations of reality—play a crucial role in economics
- Two simple but important models: (scarcity / choice)
 - production possibility frontier
 - Comparative advantage model

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Discourses in Economics

- **Positive economics** is the branch of economic analysis that describes the way the economy actually works.
- **Normative economics** makes prescriptions (values/ judgements) about the way the economy *should* work.
- A **forecast** is a simple prediction of the future (*positive economics*).

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Why economists disagree sometimes?

There are two main reasons economists **disagree**:

- Which **simplifications** to make in a model
- **Values** (*normative economics*): Economists can determine correct answers for positive questions, but typically not for normative questions, which involve value judgments.
- [The exceptions are when policies designed to achieve a certain prescription can be clearly ranked in terms of *efficiency*].

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Models in Economics

- A **model** is a simplified representation of a real situation that is used to better understand real-life situations.
 - Create a real but simplified economy
 - Simulate an economy on a computer
- The “**other things equal**” **assumption** means that all other relevant factors remain unchanged.
[*ceteris paribus* assumption]

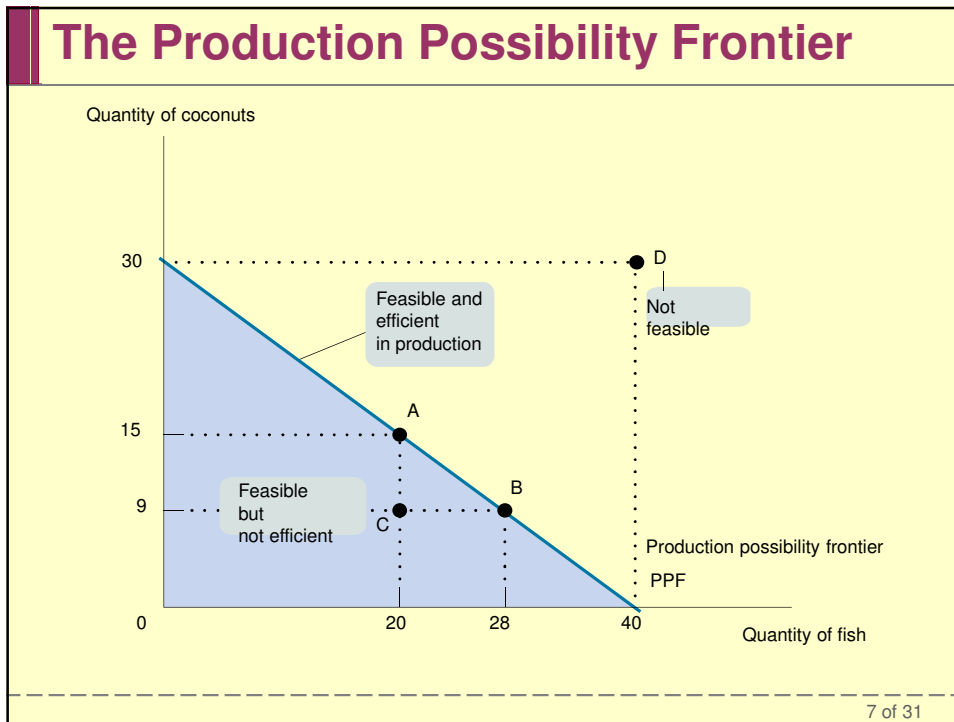
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Trade-offs: The Production Possibility Frontier

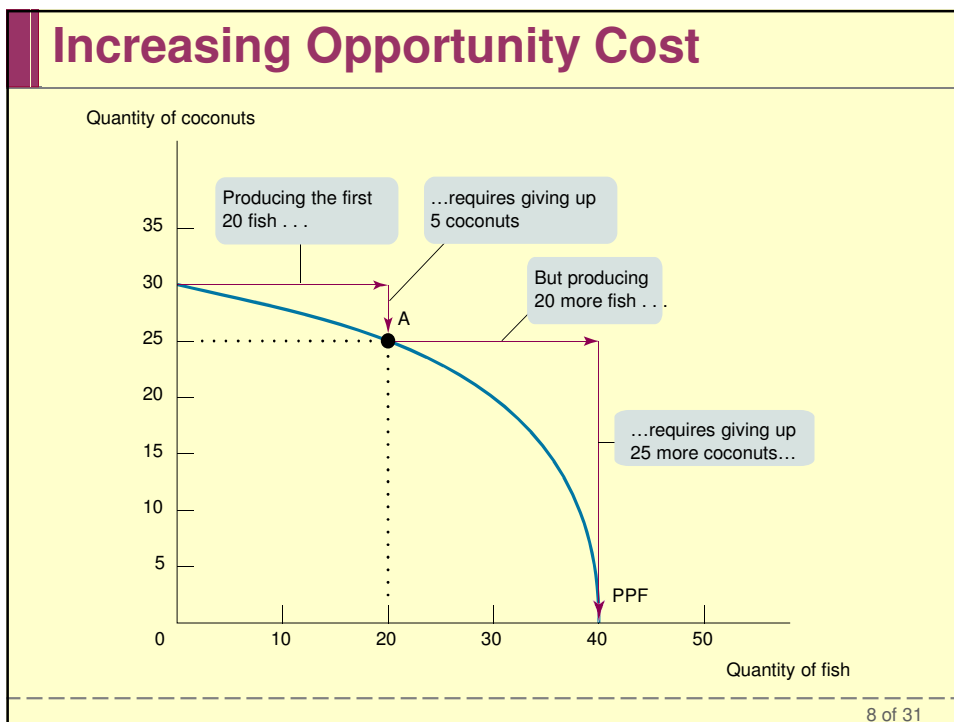
- The **production possibility frontier (PPF)** illustrates the trade-offs facing an economy that produces only two goods. It shows the maximum quantity of one good that can be produced for any given production of the other.
- The PPF improves our understanding of trade-offs by considering a simplified economy that produces only two goods by showing this trade-off graphically.

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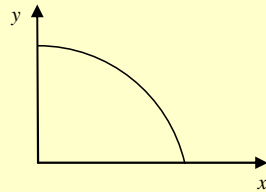
The Production Possibility Frontier



Increasing Opportunity Cost



No domínio contínuo



$y = f(x)$ Expressão analítica da FPP

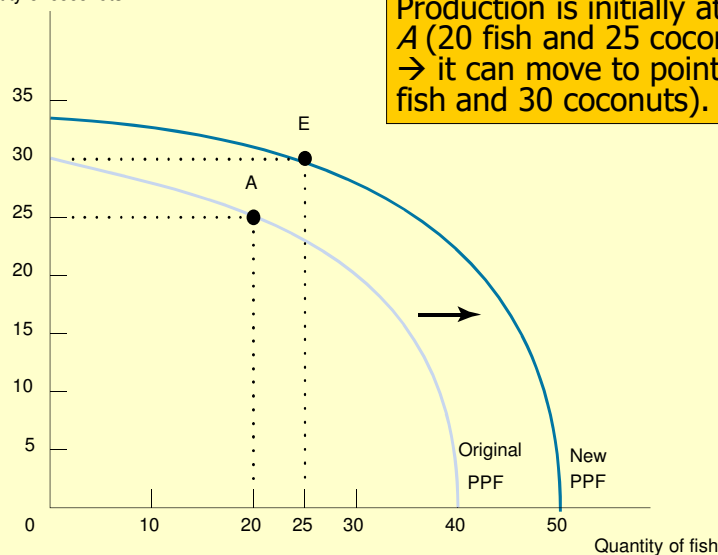
$$CO_{X,Y} = -\frac{dy}{dx}$$

$\frac{d^2y}{dx^2} < 0$ FPP côncava (custo de oportunidade crescente)

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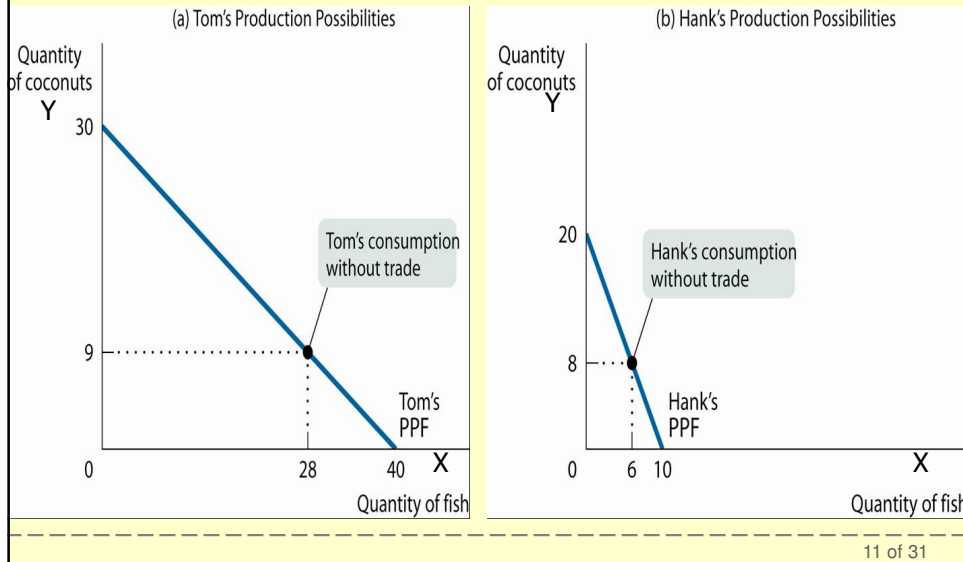
Economic Growth

Quantity of coconuts



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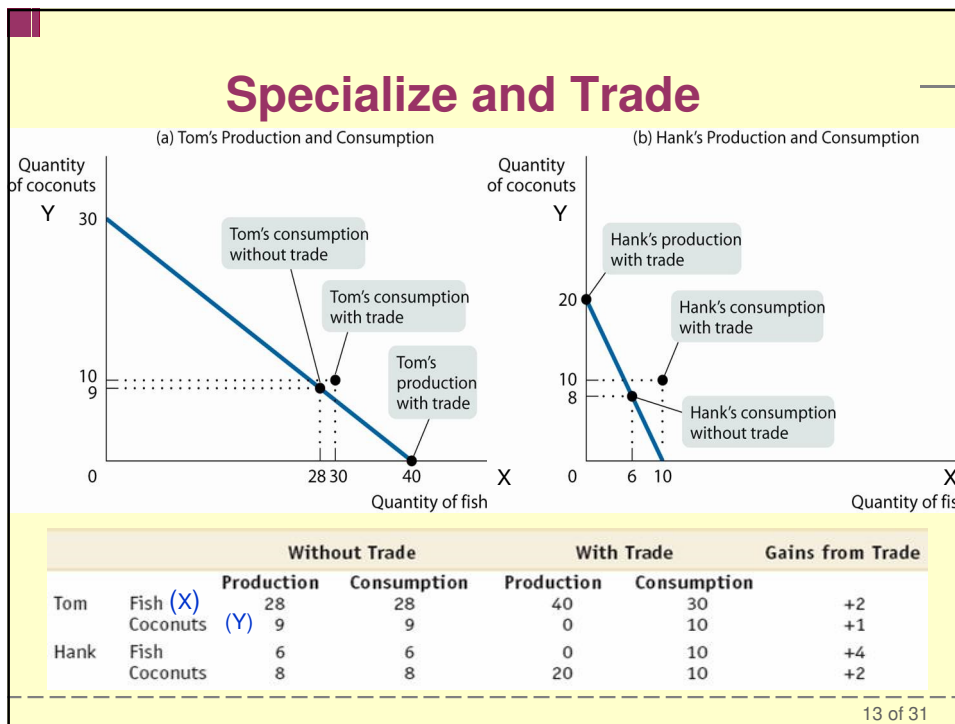
Comparative Advantage and Gains from Trade Ex.: Tom and Hank



Tom and Hank's Opportunity Costs

	Tom's Opportunity Cost	Hank's Opportunity Cost
One fish (X)	3/4 coconut [CO _{x,y}] _{Tom}	2 coconuts [CO _{x,y}] _{Hank}
One coconut (Y)	4/3 fish [CO _{y,x}] _{Tom}	1/2 fish [CO _{y,x}] _{Hank}

Both castaways are better off when they each specialize in what they are good at and trade.



Comparative vs. Absolute 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.
- An individual has an **absolute advantage** in an activity if he or she can do it better than other people. Having an absolute advantage is not the same thing as having a comparative advantage.

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The End of Chapter 2

Coming attraction
Chapter 3:
Supply and Demand