

CHAPTER 2

Economic Systems and Economic Tools

2.1 Economic Questions and Economic Systems

2.2 Production Possibilities Frontier

2.3 Comparative Advantage

Consider

CHAPTER 2

Economic Systems and Economic Tools

- ▶ Why are economies around the world growing more market oriented?
- ▶ How much can an economy produce with the resources available?
- ▶ Can you actually save time by applying economic principles to your family chores?
- ▶ Why is experience a good teacher?
- ▶ Why is fast food so fast?

Objectives

LESSON 2.1

Economic Questions and Economic Systems

- ▶ Identify the three questions that all economic systems must answer.
- ▶ Describe a pure market economy, and identify its problems.
- ▶ Describe a pure centrally planned economy, and identify its problems.
- ▶ Compare mixed, transitional, and traditional economies.

Key Terms

LESSON 2.1

Economic Questions and Economic Systems

- ▶ economic system
- ▶ pure market economy
- ▶ pure centrally planned economy
- ▶ mixed economy
- ▶ market economy
- ▶ transitional economy
- ▶ traditional economy

Three Economic Questions

- ▶ All economies must answer three questions:
 1. What goods and services will be produced?
 2. How will they be produced?
 3. For whom will they be produced?

Economic System

- ▶ An economic system is the set of mechanisms and institutions that resolves the what, how, and for whom questions.
- ▶ Some standards used to distinguish among economic systems are:
 - ▶ Who owns the resources?
 - ▶ What decision-making process is used to allocate resources and products?
 - ▶ What types of incentives guide economic decision makers?

Pure Market Economy

- ▶ All resources are privately owned.
- ▶ Coordination of economic activity is based on the prices generated in free, competitive markets.
- ▶ Any income derived from selling resources goes exclusively to each resource owner.

Invisible Hand of Markets

- ▶ According to Adam Smith (1723–1790), market forces coordinate production as if by an “invisible hand.”

Problems with Pure Market Economies

- ▶ Difficulty enforcing property rights
- ▶ Some people have few resources to sell
- ▶ Some firms try to monopolize markets
- ▶ No public goods
- ▶ Externalities

Pure Centrally Planned Economy

- ▶ All resources government-owned
- ▶ Production coordinated by the central plans of government
- ▶ Sometimes called communism
- ▶ Use visible central planners

Problems with Centrally Planned Economies

- ▶ Consumers get low priority
- ▶ Little freedom of choice
- ▶ Central planning can be inefficient
- ▶ Resources owned by the state are sometimes wasted
- ▶ Environmental damage

Mixed Economy

- ▶ United States is a mixed economy.
- ▶ It is also considered a market economy.
- ▶ Government regulates the private sector in a variety of ways.

Transitional Economy

- ▶ A transitional economy is in the process of shifting orientation from central planning to competitive markets.
- ▶ It involves converting state-owned enterprises into private enterprises—privatization.
- ▶ The transition now under way will shape economies for decades to come.

Traditional Economy

- ▶ A traditional economy is shaped largely by custom or religion.
- ▶ Family relations also play significant roles in economic activity.

Objectives

LESSON 2.2

Production

Possibilities Frontier

- ▶ Describe the production possibilities frontier and explain its shape.
- ▶ Explain what causes the production possibilities frontier to shift.

Key Terms

LESSON 2.2

Production

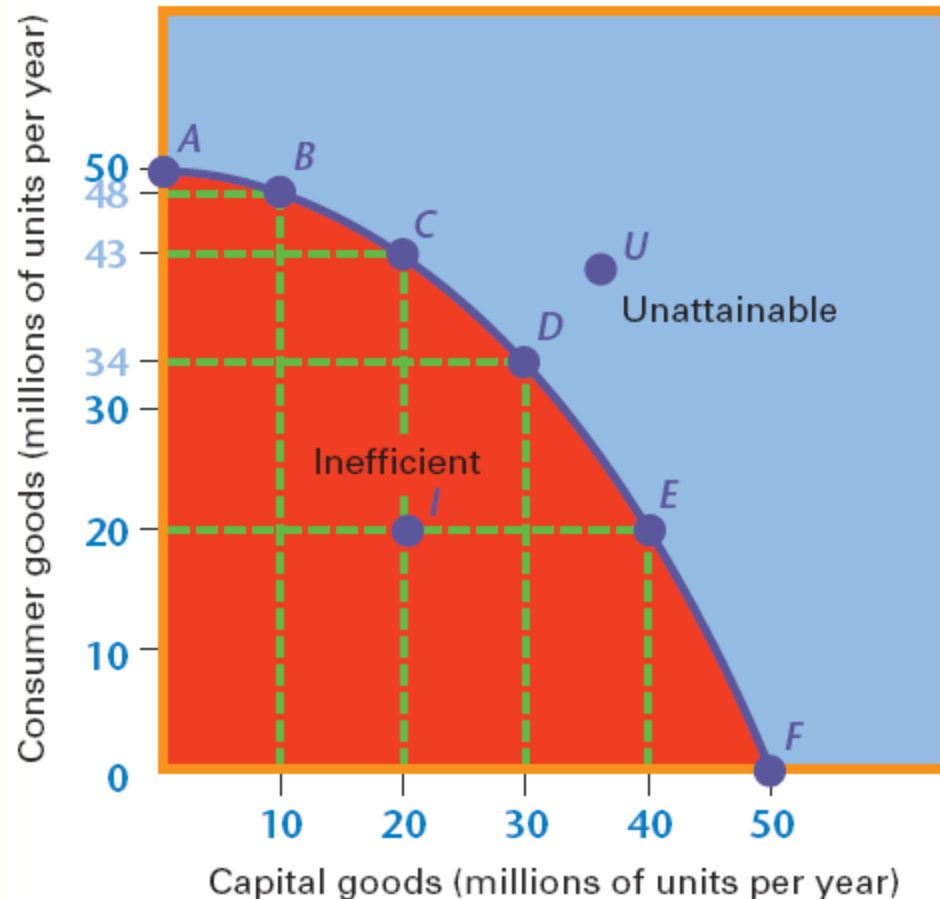
Possibilities Frontier

- ▶ production possibilities frontier (PPF)
- ▶ efficiency
- ▶ law of increasing opportunity cost
- ▶ economic growth

Efficiency and Production Possibilities Frontier

- ▶ Simplifying assumptions
- ▶ PPF model
- ▶ Inefficient and unattainable production
- ▶ Shape of the PPF

Production Possibilities Frontier



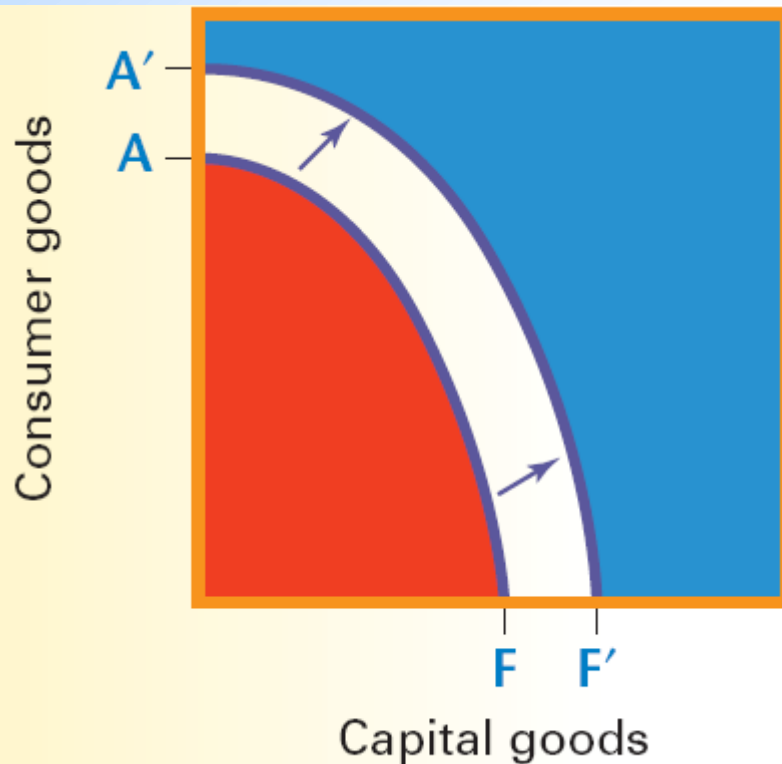
- ▶ **A** through **F** are attainable
- ▶ **I** represents inefficient use of resources
- ▶ **U** represents unattainable combinations

Shifts in the PPF

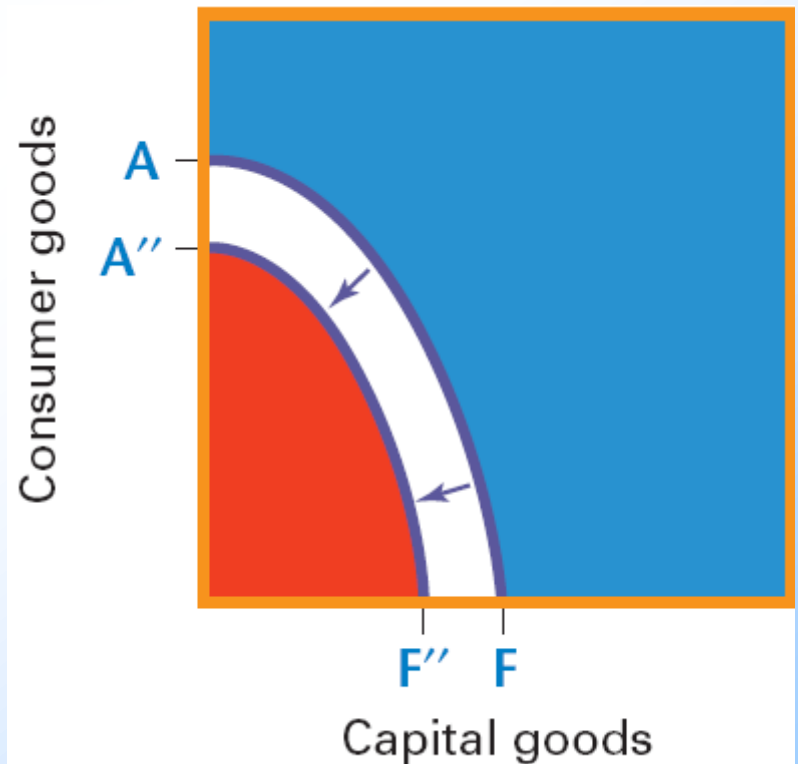
- ▶ Changes in resource availability
- ▶ Increases in stock of capital goods
- ▶ Technological change
- ▶ Lessons from the PPF

Shifts in the PPF

Increase in available resources



Decrease in available resources



Objectives

LESSON 2.3

Comparative Advantage

- ▶ Explain the law of comparative advantage.
- ▶ Understand the gains from specialization and exchange.

Key Terms

LESSON 2.3

Comparative Advantage

- ▶ absolute advantage
- ▶ law of comparative advantage
- ▶ specialization
- ▶ barter
- ▶ money
- ▶ division of labor

Comparative Advantage

- ▶ Absolute advantage
- ▶ Law of comparative advantage
- ▶ Gains from specialization
- ▶ Exchange
 - ▶ Barter
 - ▶ Money
- ▶ Wider application

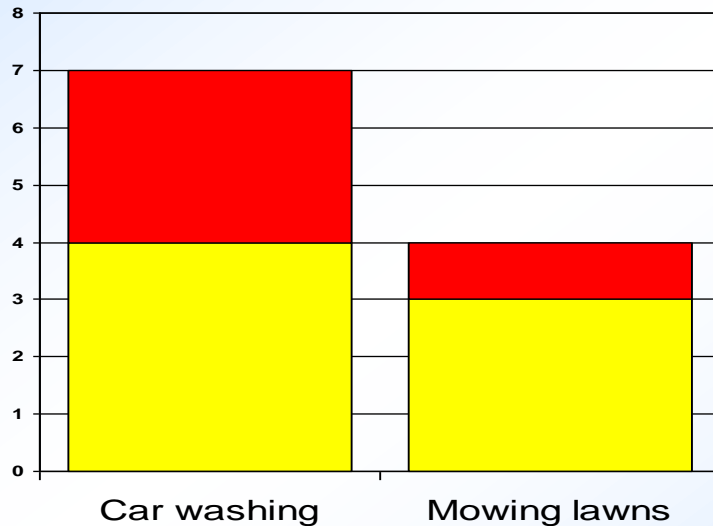
Specialization

- ▶ Division of labor
- ▶ Drawback of specialization

Comparative Advantage and Specialization

Six hours without Specialization

	Car washing	Lawn mowing
■ David	3	1
■ Casey	4	3
	7	4



Six hours with Specialization

	Car washing	Lawn mowing
■ David	6	0
■ Casey	0	6
	6	6

