# Micro Unit I Review

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AP Econ

MHS

# Micro Unit I Study Guide

- Economic Systems
- Economizing Problem
- Circular Flow Model
- Opportunity Costs
- PPCs
- PPC & Economic Growth
- Optimal Allocation (MB = MC)
- Specialization & Trade
- Absolute Advantage
- Comparative Advantage
- Comp. Adv. Questions
  - Output (OREO)
  - Input
- Terms of Trade

# The Economizing Problem

**Wants (Unlimited)**

***vs.***

**Resources (Scarce)**

# ECONOMIC SYSTEMS

## *THE MARKET SYSTEM*

***Pure Capitalism***

***Laissez-faire***

## *THE COMMAND SYSTEM*

***Socialism***

***Communism***

# Economic Systems

- **Economic systems differ in two important ways:**
  - **Who owns the factors of production**
  - **The method used to coordinate economic activity**

# The Market System:

- There is private ownership of resources.
- Markets and prices coordinate and direct economic activity.
- Each participant acts in his or her own self-interest.
- In pure capitalism, the government plays a very limited role.
- In the U.S. version of capitalism, the government plays a substantial role.

# The Command Economy - Socialism or Communism:

- There is public (state) ownership of resources.
- Economic activity is coordinated by central planning.

# The Circular Flow Model for a Market-Oriented System

- There are two groups of decision makers in the private economy (no government yet):  households and businesses.
- Households and business interact in both resource and product markets.

# The Circular Flow Model for a Market-Oriented System

- What happens in the resource markets?
  - Households sell resources directly or indirectly (through ownership of corporations).
  - Businesses buy resources in order to produce goods and services.
  - Interaction of these sellers and buyers determines the price of each resource, which in turn provides income for the owner of that resource.
  - Flow of payments from businesses for the resources constitutes business costs and resource owners' incomes.

# The Circular Flow Model for a Market-Oriented System

- What happens in the product markets?
  - Households are on the buying side of these markets, purchasing goods and services.
  - Businesses are on the selling side of these markets, offering products for sale.
  - Interaction of these buyers and sellers determines the price of each product.
  - Flow of consumer expenditures constitutes sales receipts for businesses.
  - Circular flow model illustrates this complex web of decision-making and economic activity that give rise to the real and money flows

# CIRCULAR FLOW MODEL

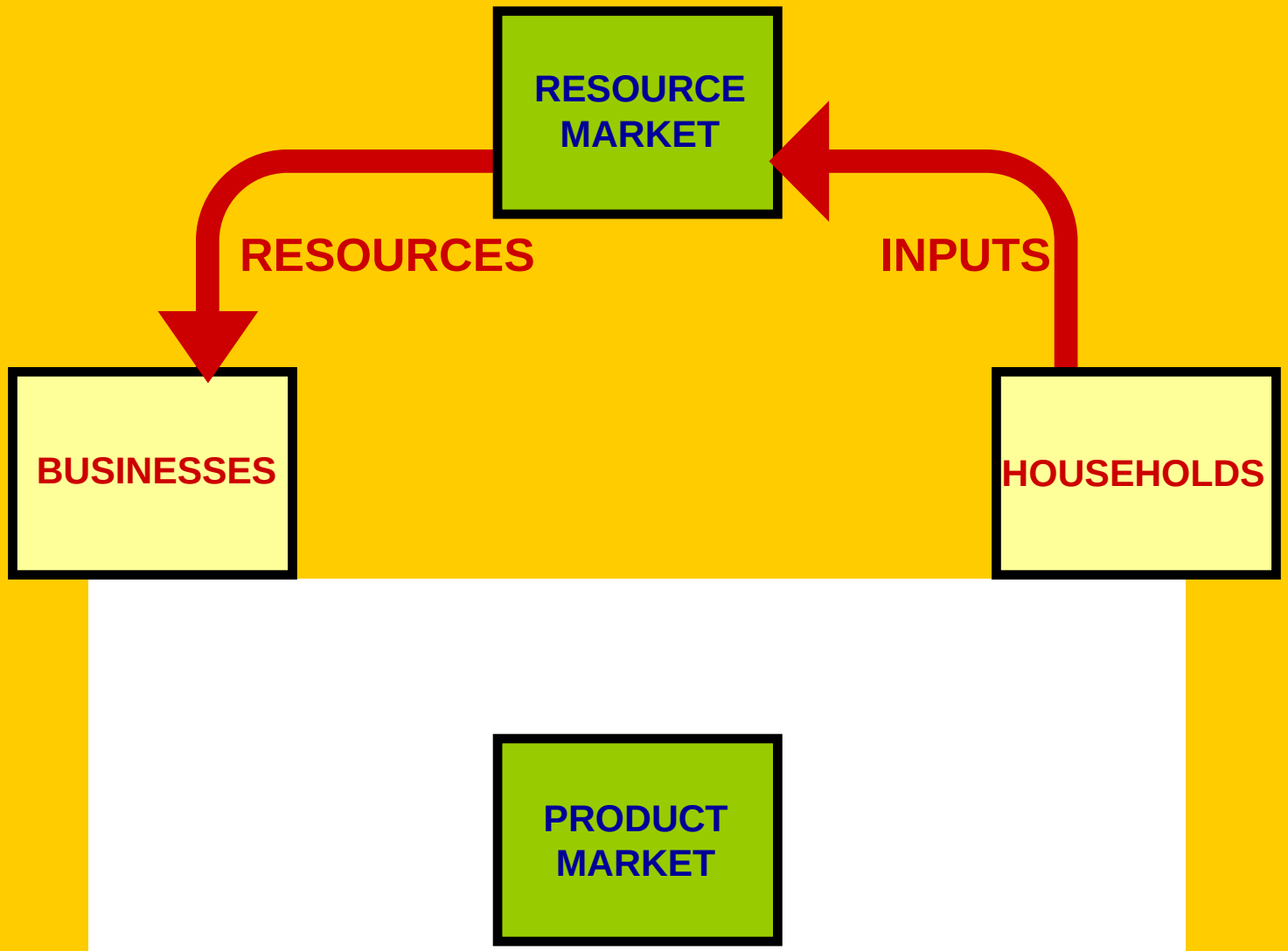
RESOURCE MARKET

BUSINESSES

HOUSEHOLDS

PRODUCT MARKET

# CIRCULAR FLOW MODEL



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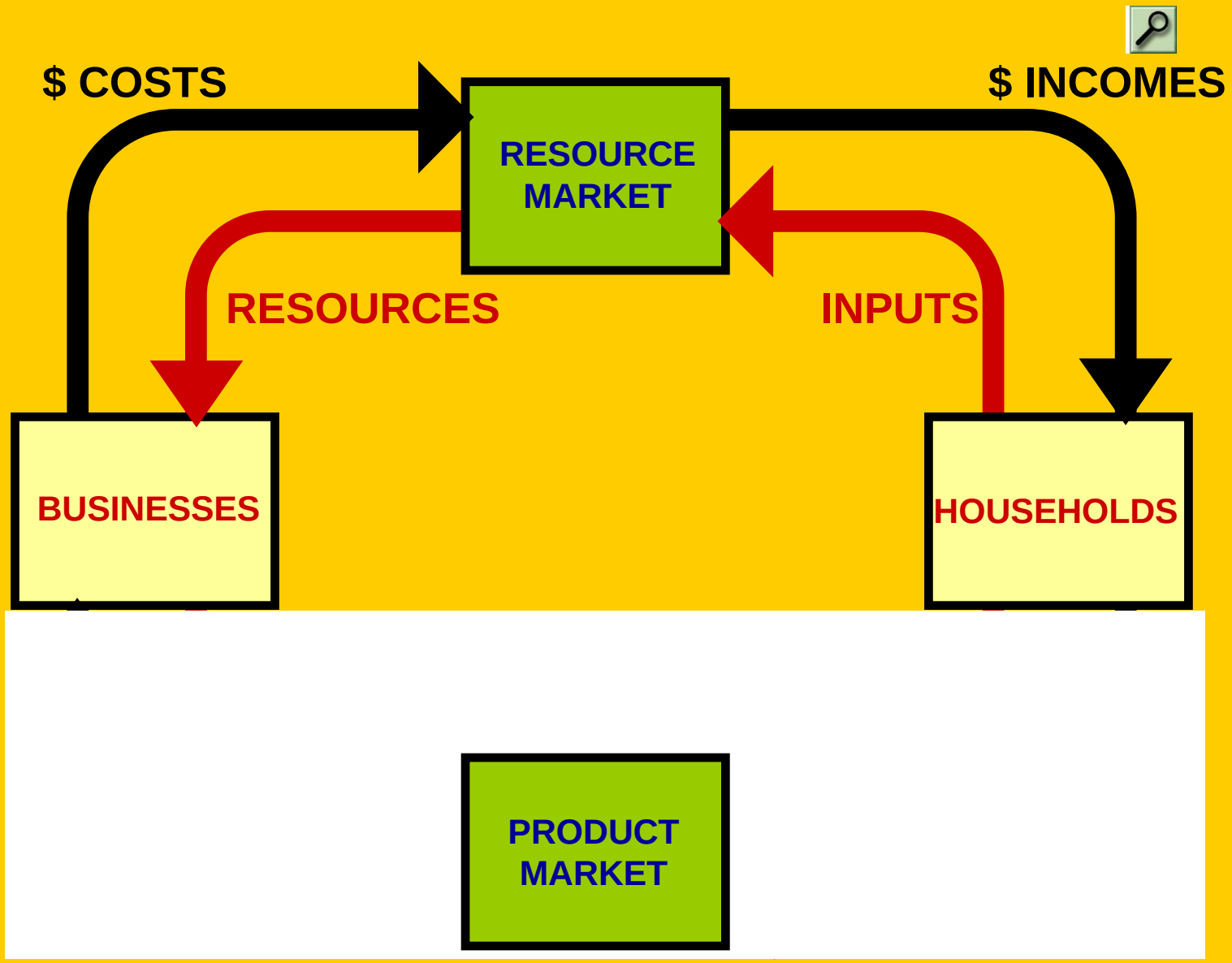

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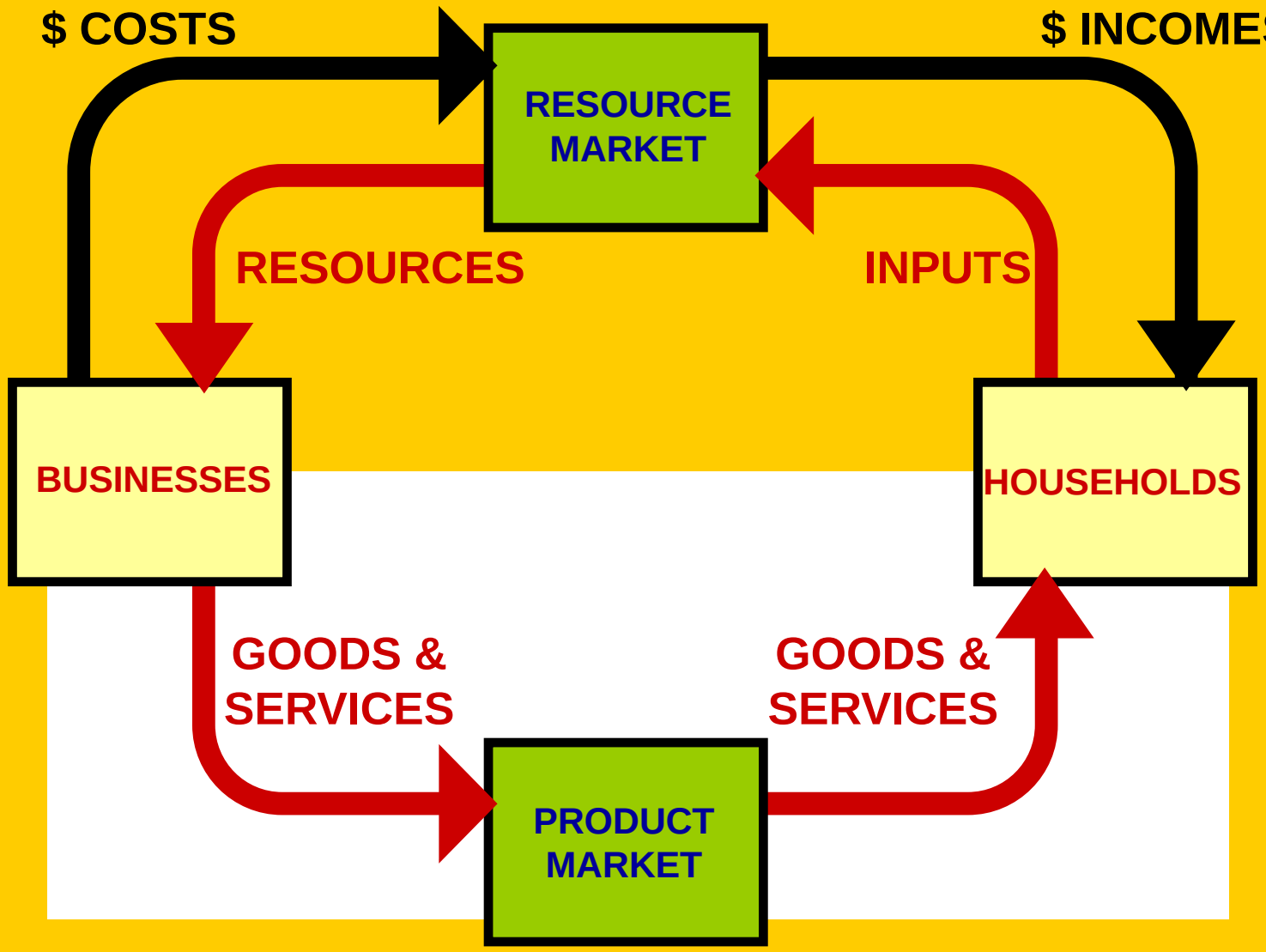

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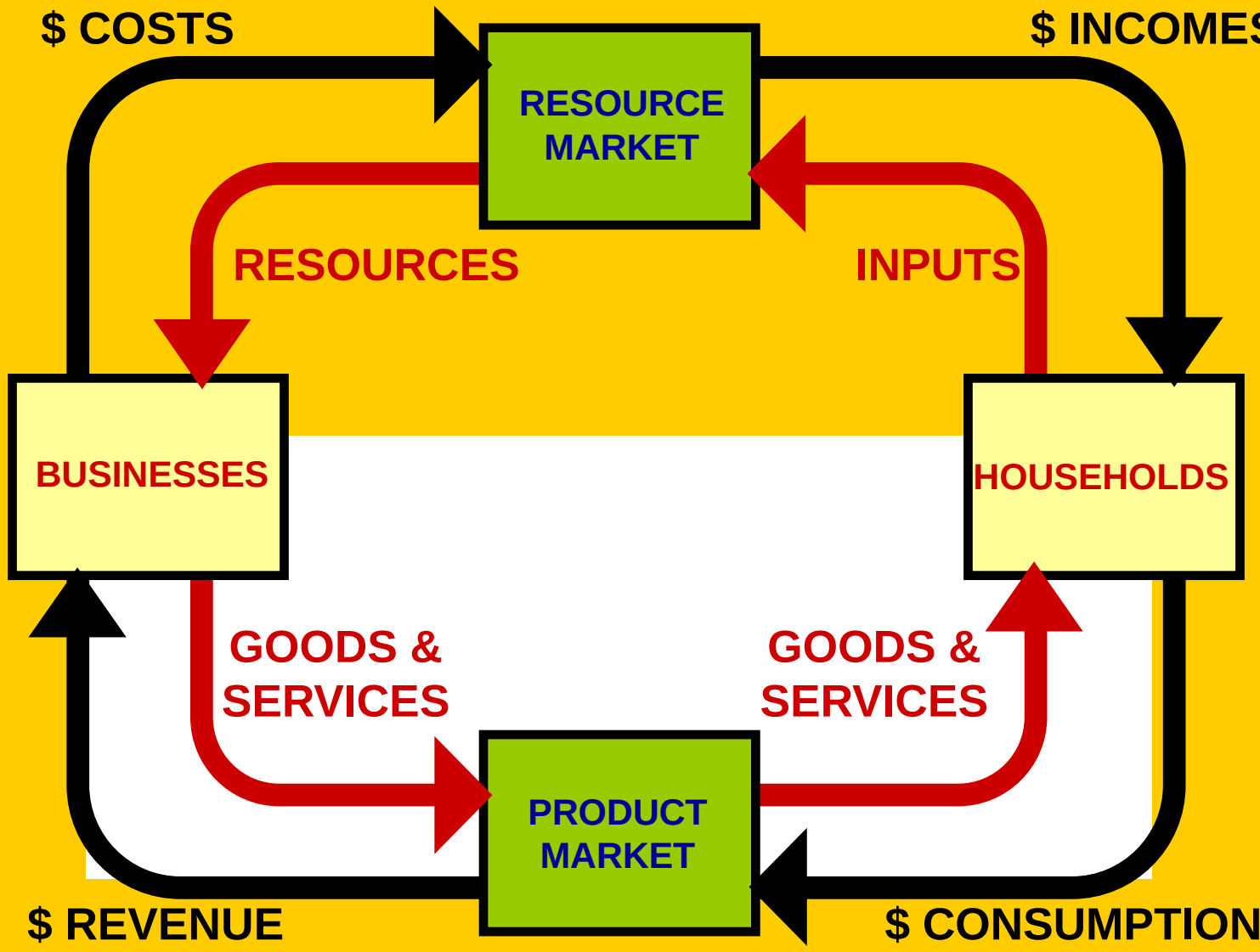

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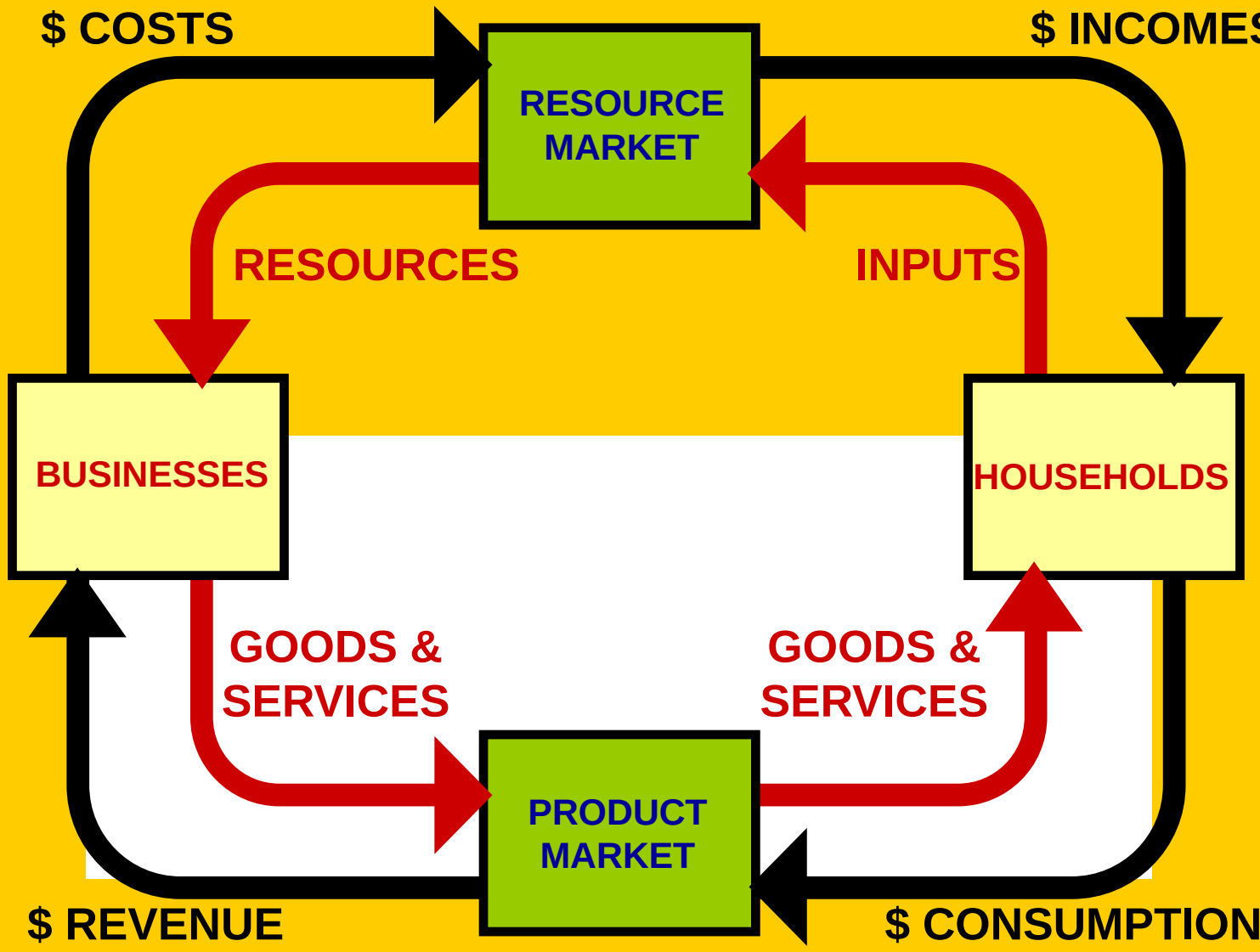


# Limitations of the model

- Does not depict transactions between households and between businesses.
- Ignores government and the “rest of the world” in the decision-making process.
- Does not explain how prices of products and resources are actually determined, but this is explained in Chapter 4.

# Economics: Employment and Efficiency

- Economics is a science of efficiency (absence of waste) in the use of scarce resources.
- Efficiency requires full employment of available resources and full production.
  - Full employment means all available resources should be employed.
  - Full production means that employed resources are providing maximum satisfaction of our economic wants.

# Full production implies two kinds of efficiency

- Productive efficiency: the production of goods in the least costly way
- Allocative efficiency: resources are used for producing the combination of goods and services most wanted by society
  - Allocative efficiency requires that there be productive efficiency.
  - Productive efficiency can occur without allocative efficiency.
- Full production means producing the “right” goods (allocative efficiency) in the “right” way (productive efficiency).

# PRODUCTION POSSIBILITIES

- **Production possibilities tables and curves are devices to illustrate and clarify the economizing problem**.

- **Production Possibilities Curve** = graphical display of the different combinations of goods and services that society can produce in a fully employed economy (assuming a fixed available supply of resources and a fixed level of technology.)

- Every point on the PPC represents a point of productive efficiency.

# PRODUCTION POSSIBILITIES

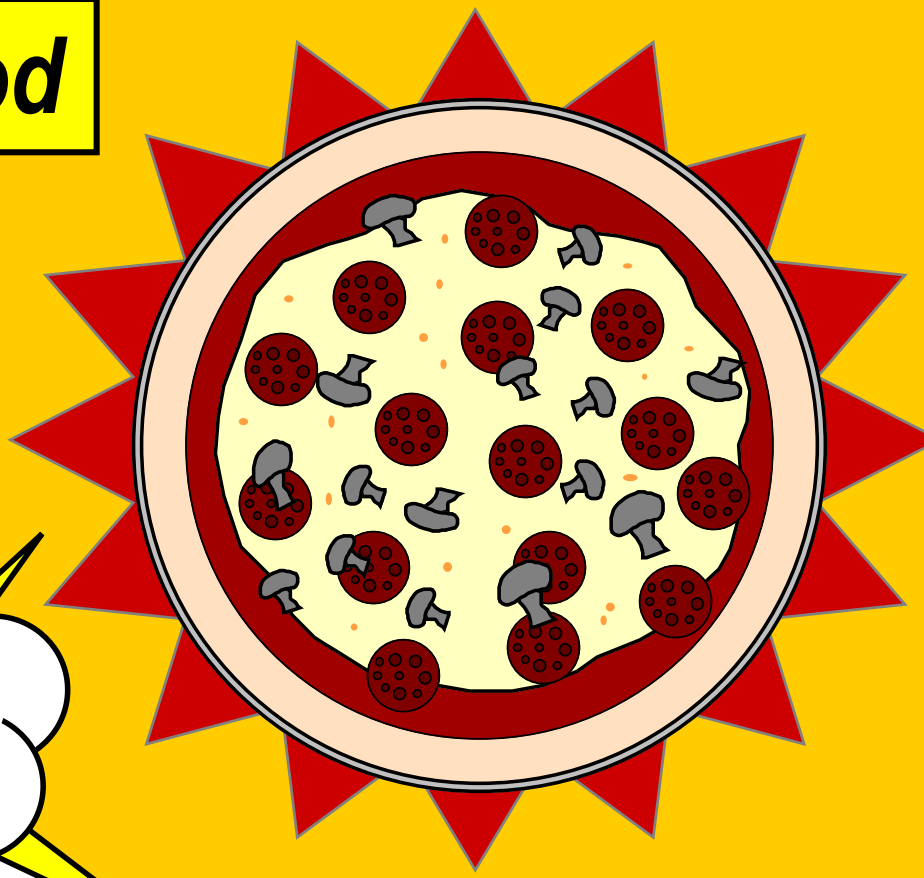
*Assumes. . .*

- **Full Employment**
- **Fixed Resources**
- **Fixed Technology**
- **Two Goods**

*for example. . .*

# PRODUCTION POSSIBILITIES

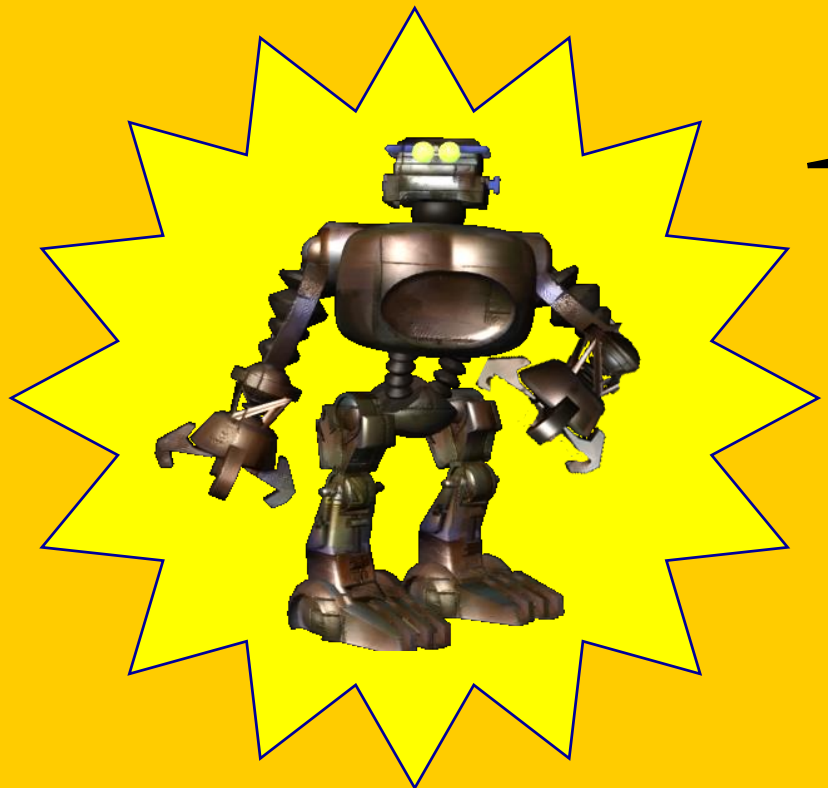
**A Consumer Good**



*for example. . .*

# PRODUCTION POSSIBILITIES

***A Capital Good***



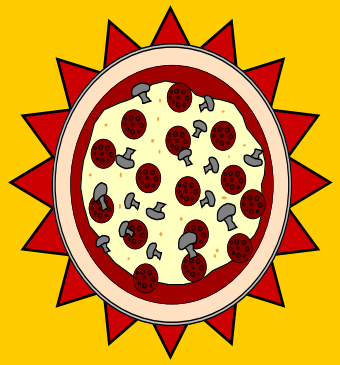
**Robots**

*for example…*

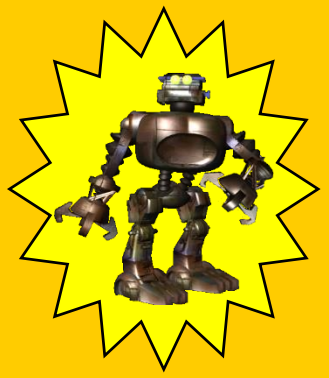
# PRODUCTION POSSIBILITIES

*What if we could only produce . . .*

**10,000 Robots**



***or***



**400,000 Pizzas**

***Using our resources, to get some pizza, we must give up some robots!***

*for example. . .*

# PRODUCTION POSSIBILITIES

*in table form*

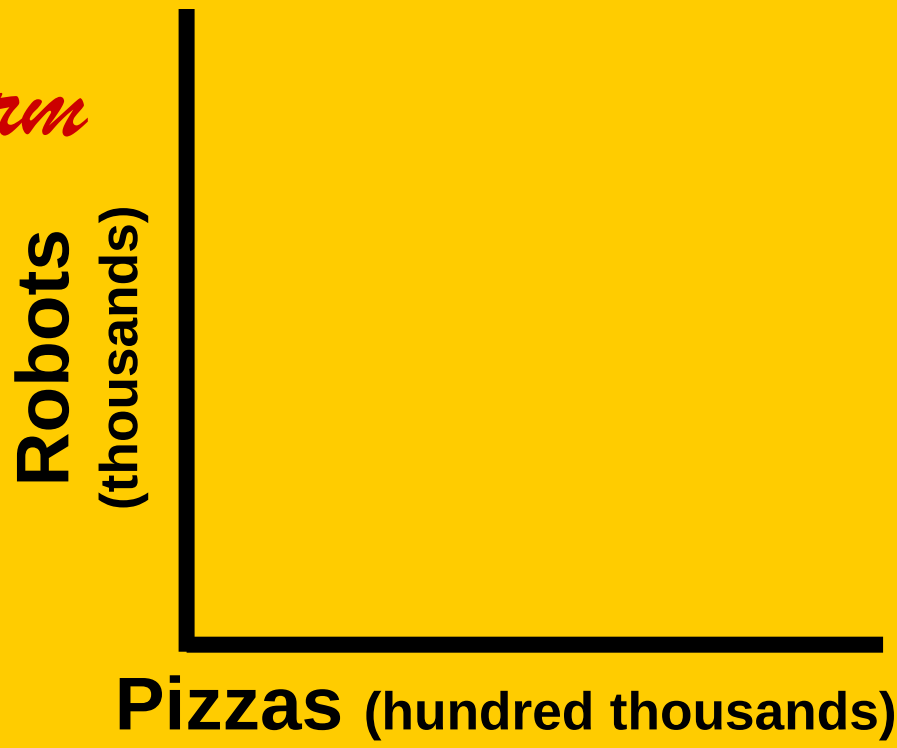
| PIZZA | 0 | 1 | 2 | 3 | 4 |
|---|---|---|---|---|---|
| *(in hundred thousands)* | | | | | |
| ROBOTS | 10 | 9 | 7 | 4 | 0 |
| *(in thousands)* | | | | | |

# PRODUCTION POSSIBILITIES

*in table form*

| | | | | | |
|---|---|---|---|---|---|
| **PIZZA** | **0** | **1** | **2** | **3** | **4** |
| ***(in hundred thousands)*** | | | | | |
| **ROBOTS** | **10** | **9** | **7** | **4** | **0** |
| ***(in thousands)*** | | | | | |

*graphical form*



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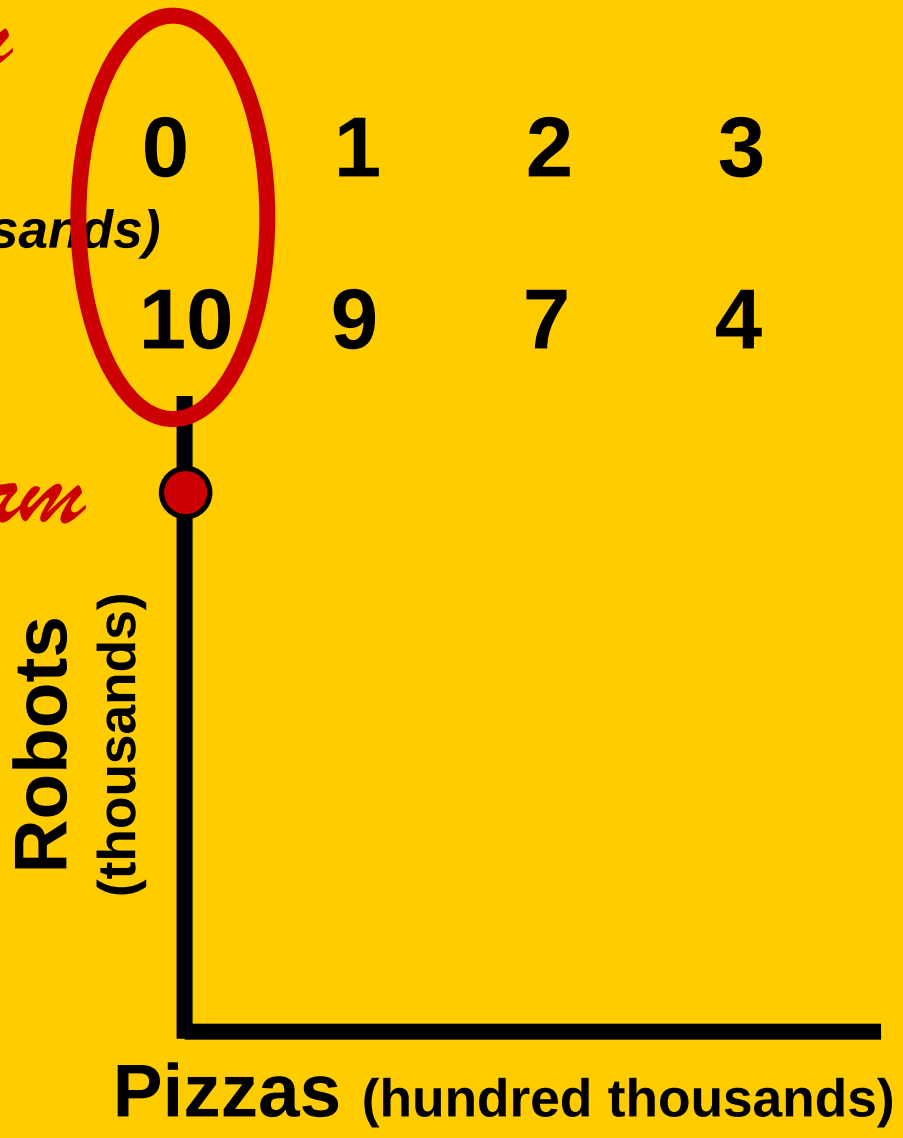

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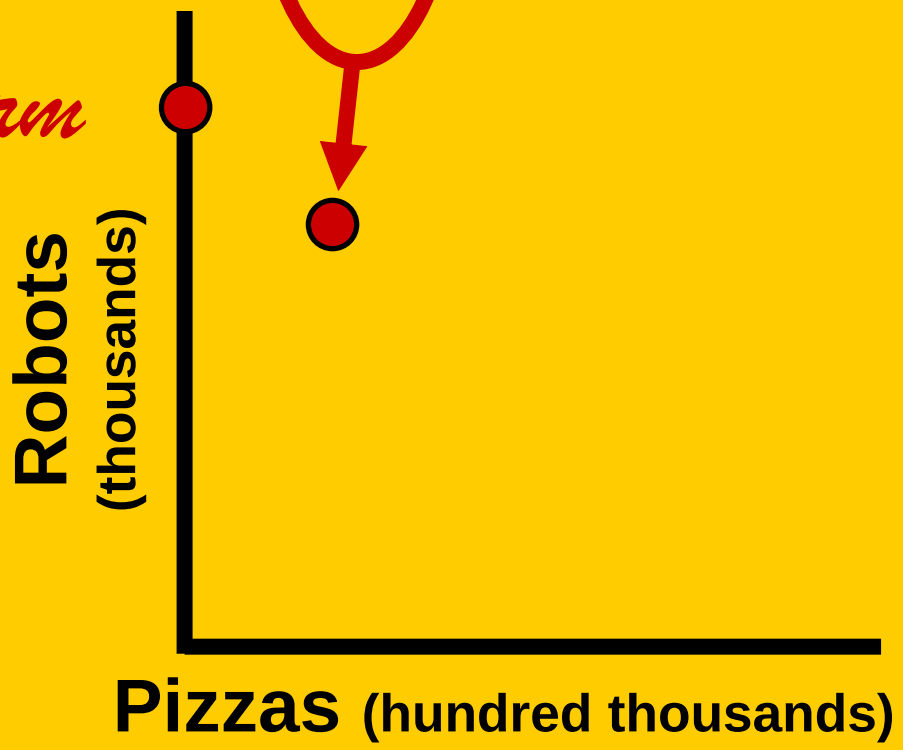

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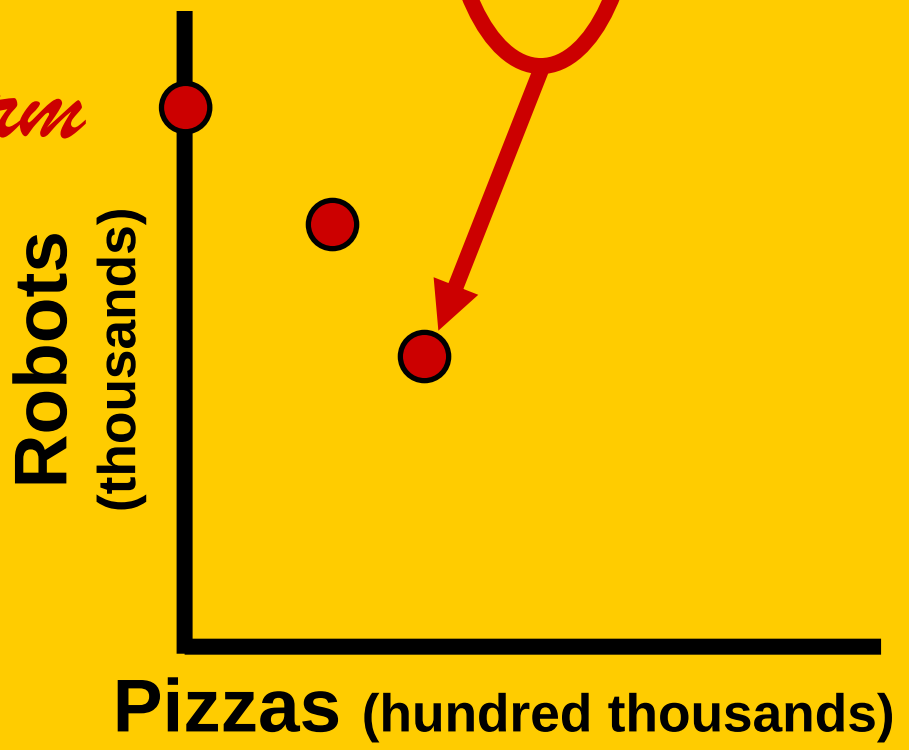

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*in table form*

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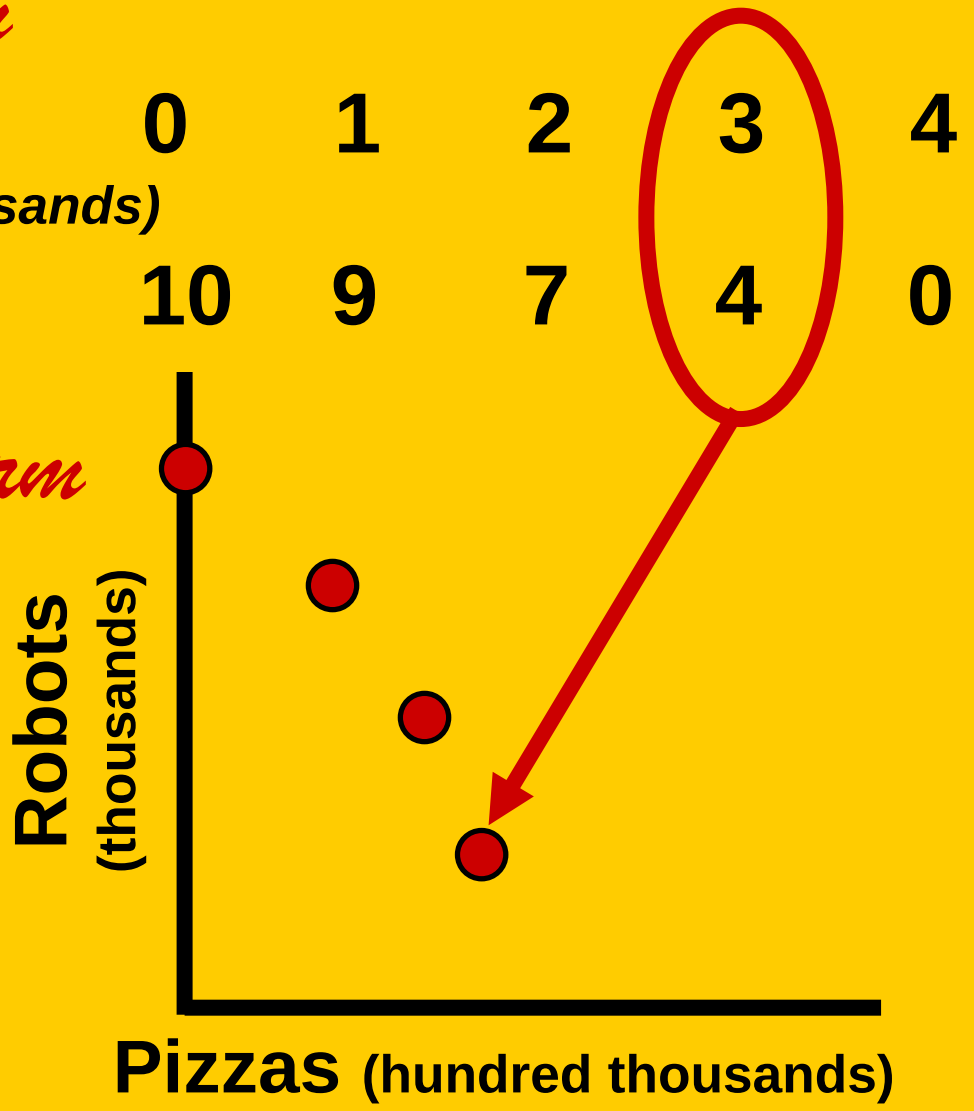

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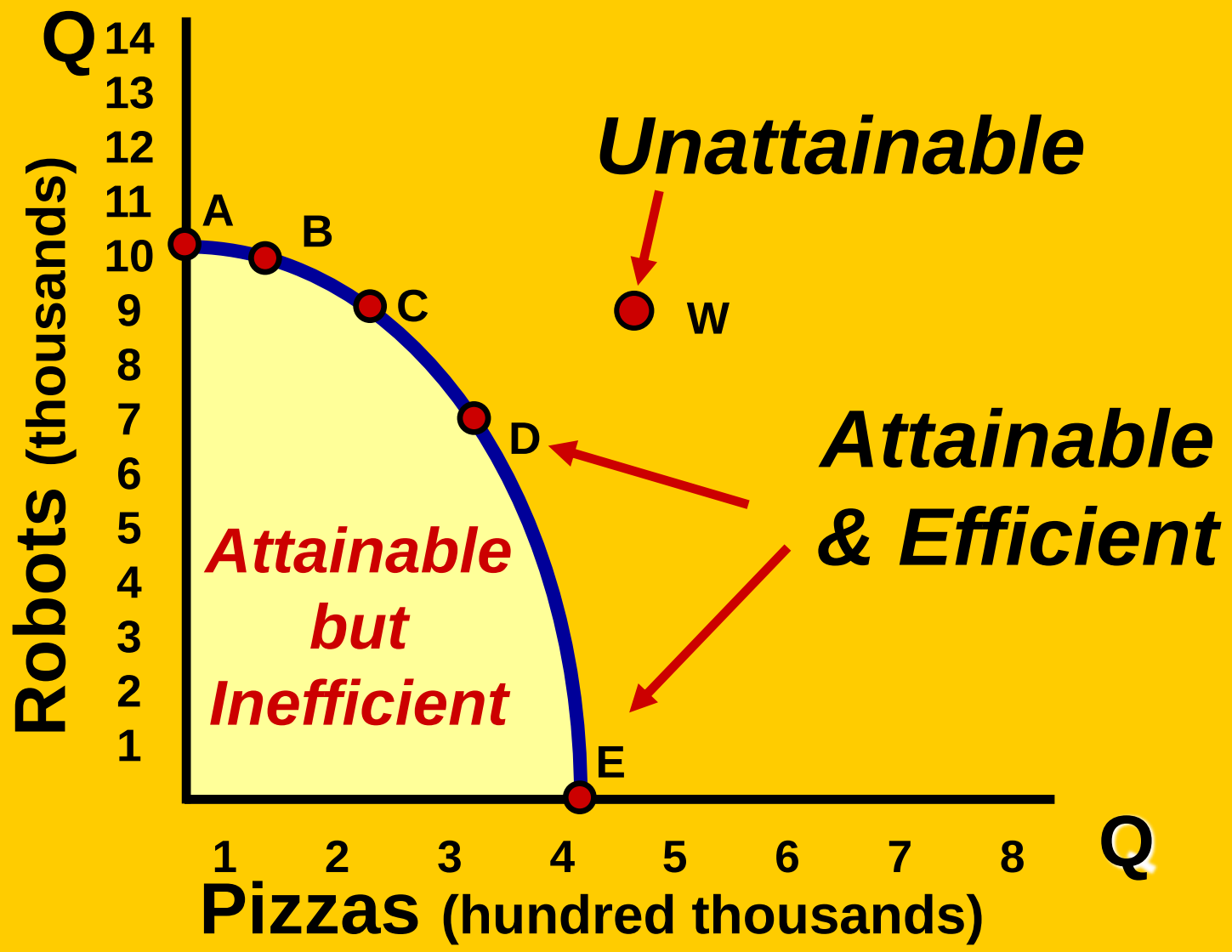

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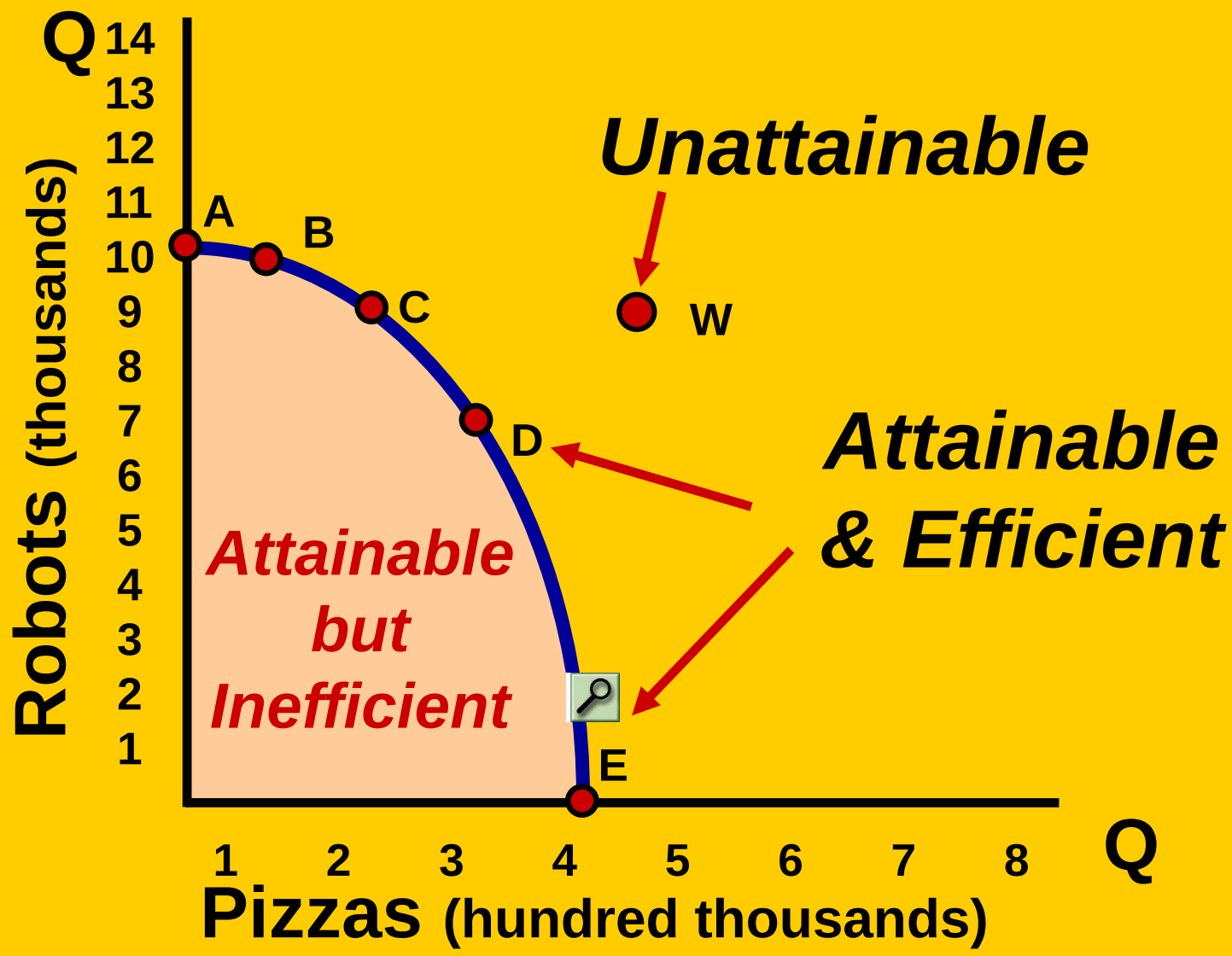


# Notes...

## *LAW OF INCREASING OPPORTUNITY COSTS*

***Opportunity Cost* = the amount of other products that must be forgone or sacrificed to produce a unit of a product.**

**Notes...**

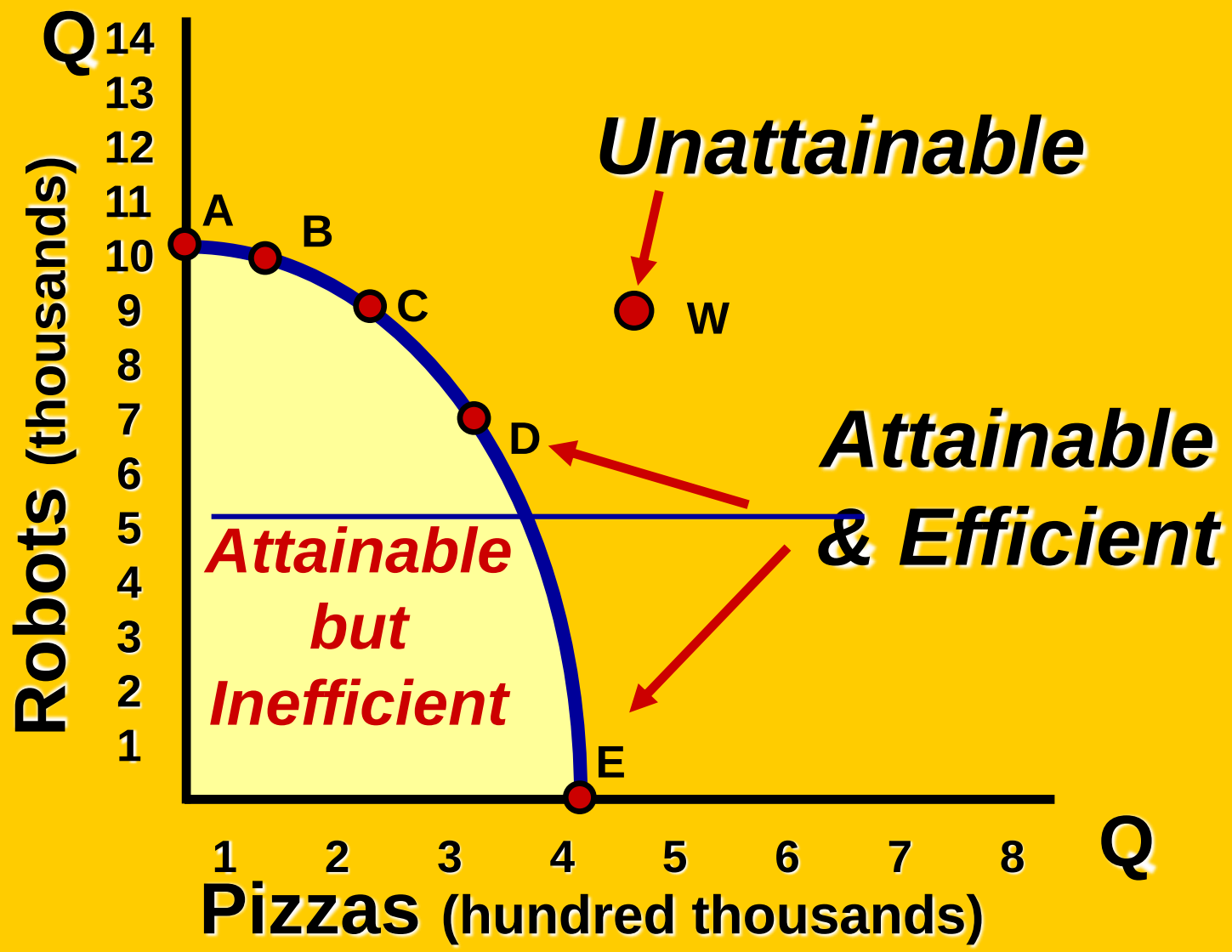
***You can think of opportunity cost as the value of the next best thing forgone.***

# Notes...

***The LAW OF INCREASING OPPORTUNITY COSTS…***

***As the production of a particular good increases, the opportunity cost of producing an additional unit rises.***

# PRODUCTION POSSIBILITIES



# Notes...

## *LAW OF INCREASING OPPORTUNITY COSTS*

***Reflected in the concave shape of the production possibilities curve. The curve is bowed out from the origin of the graph.***

# Notes...

***LAW OF INCREASING OPPORTUNITY COSTS***

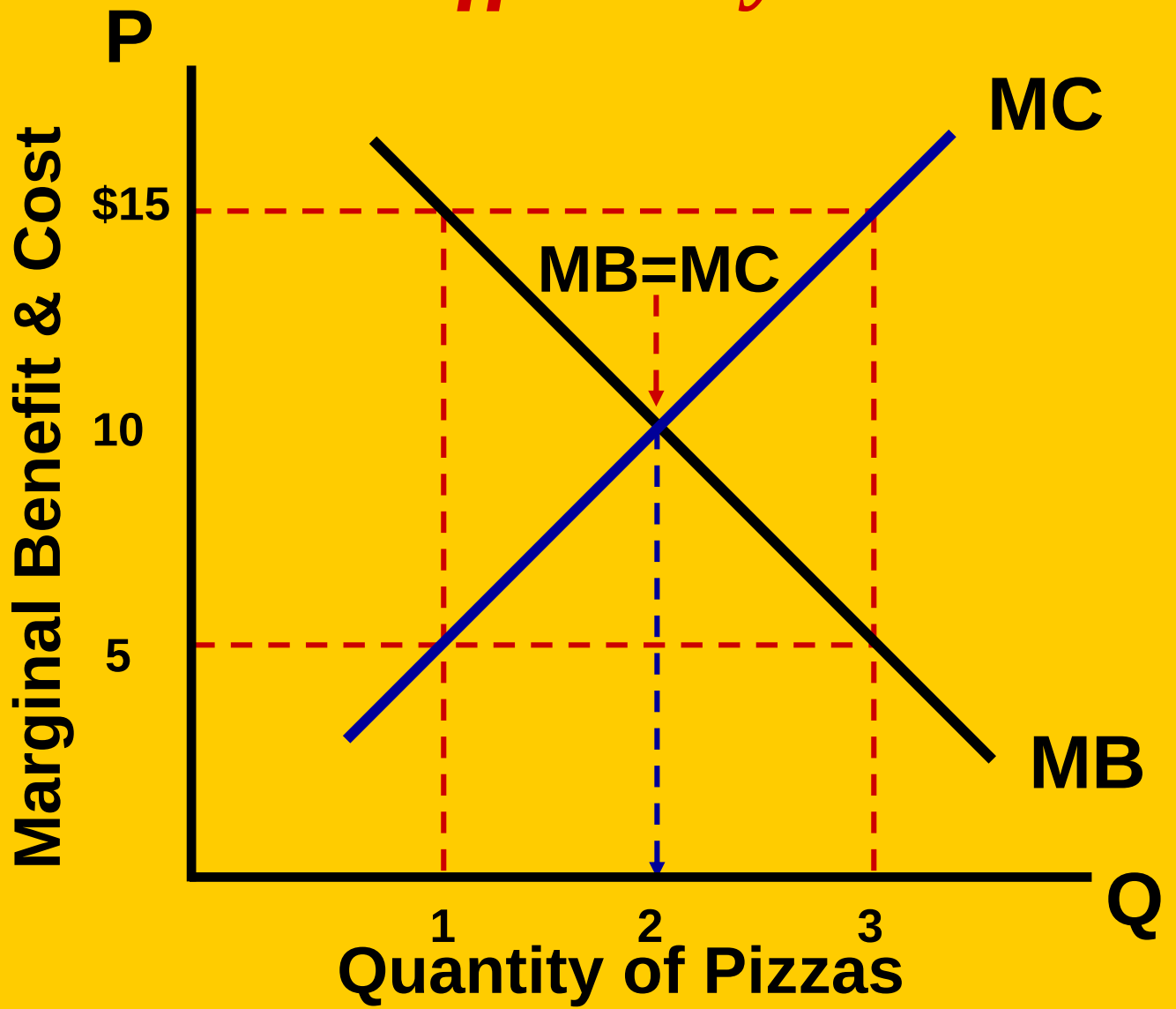
***Based on the fact that economic resources are not completely adaptable to alternative uses (like making pizza or building robots.)***

# OPTIMAL ALLOCATION

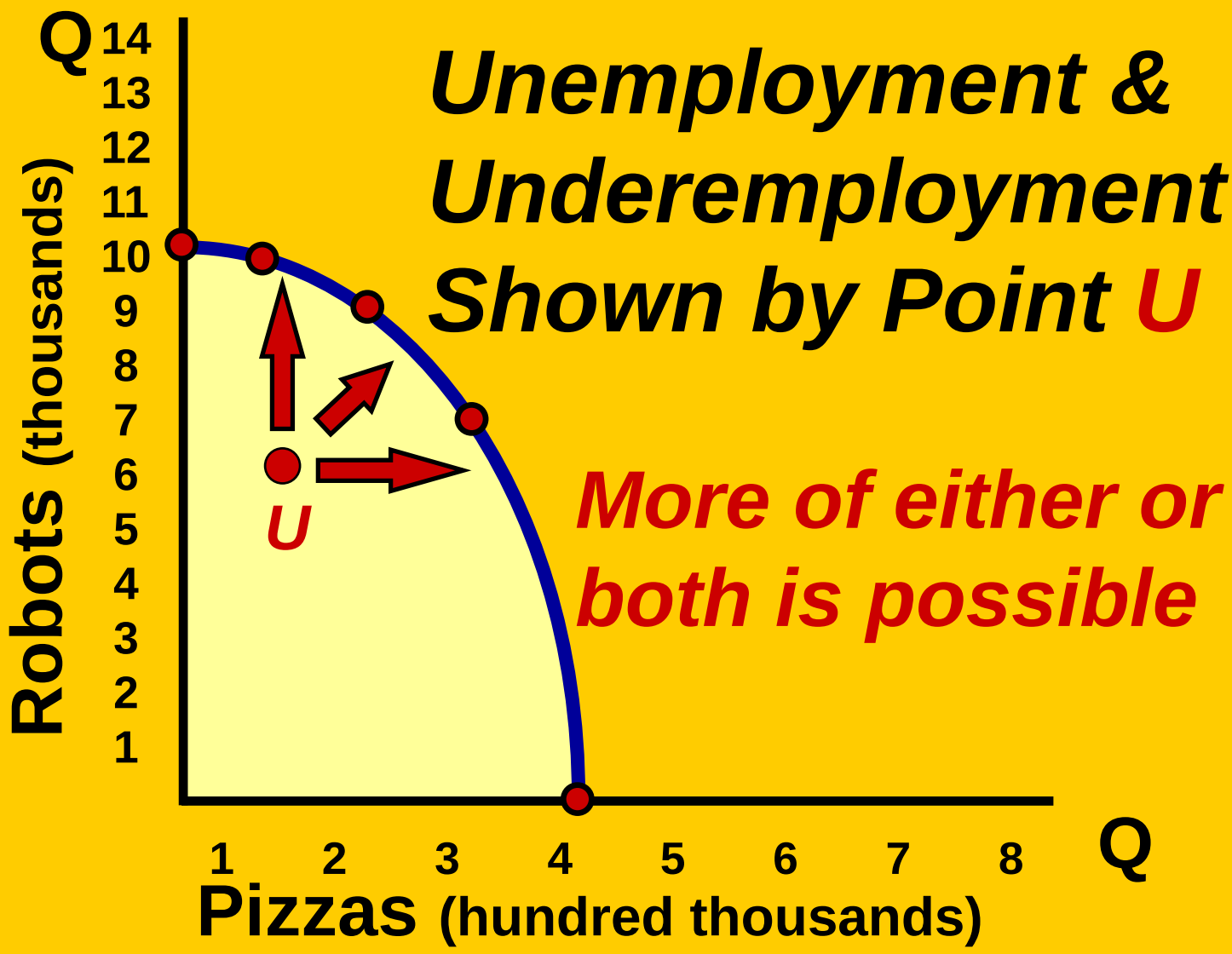
- Economic decisions center on comparisons of marginal benefit (MB) and marginal cost (MC).
- To economists, “marginal” means “additional” or “a change in.”
- The optimal amount of any economic activity occurs where **MB = MC** (whether we are talking about an individual or society in general.)

# OPTIMAL ALLOCATION

## *Allocative Efficiency: MB=MC*



# PRODUCTION POSSIBILITIES




***Unemployment & Underemployment Shown by Point U***

***More of either or both is possible***

Notes...

## *Economic Growth*

**The ability to produce a larger total output… represented by a rightward shift of the production possibilities curve**

# Notes...

***Economic Growth***

**is the result of…**

**1. Increases in supplies of resources**

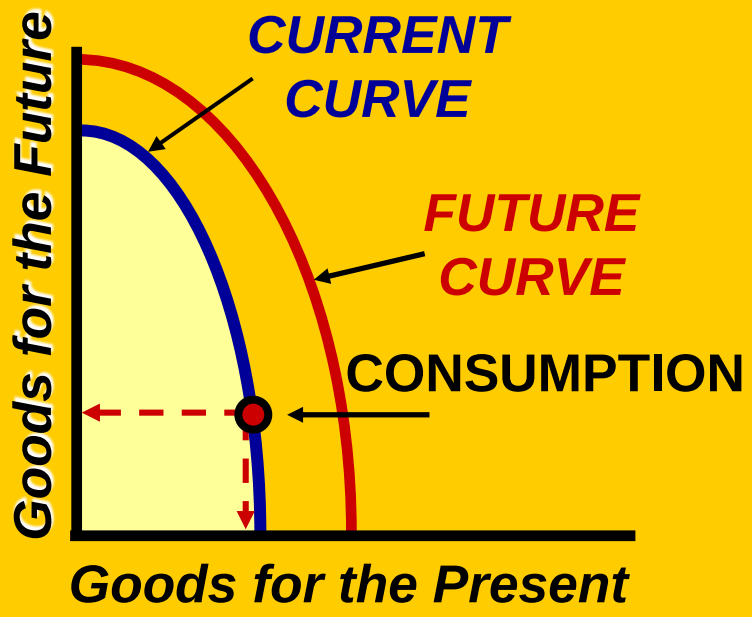
**2. Improvements in resource quality**

**3. Technological advances**

# PRODUCTION POSSIBILITIES

## *Two Examples of Economic Growth*

**NOWTOWN - FAVORS PRESENT GOODS**



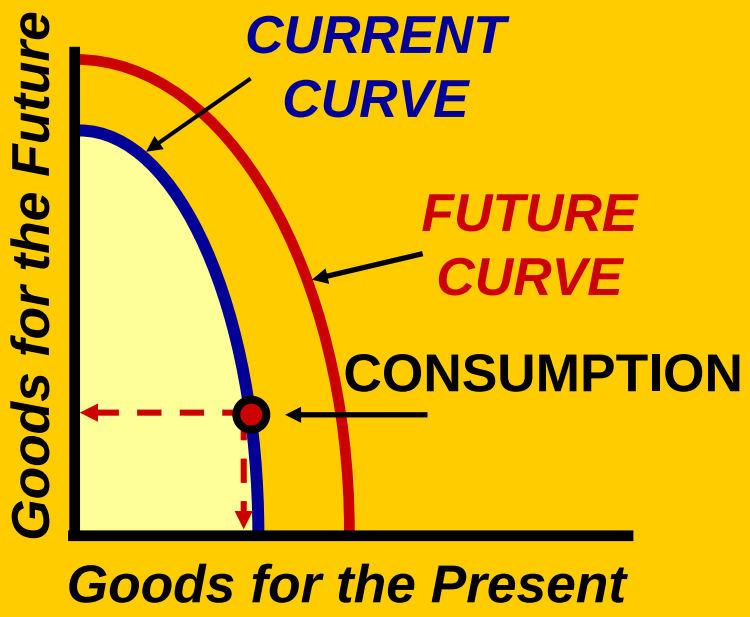

**Nowtown**

# PRODUCTION POSSIBILITIES

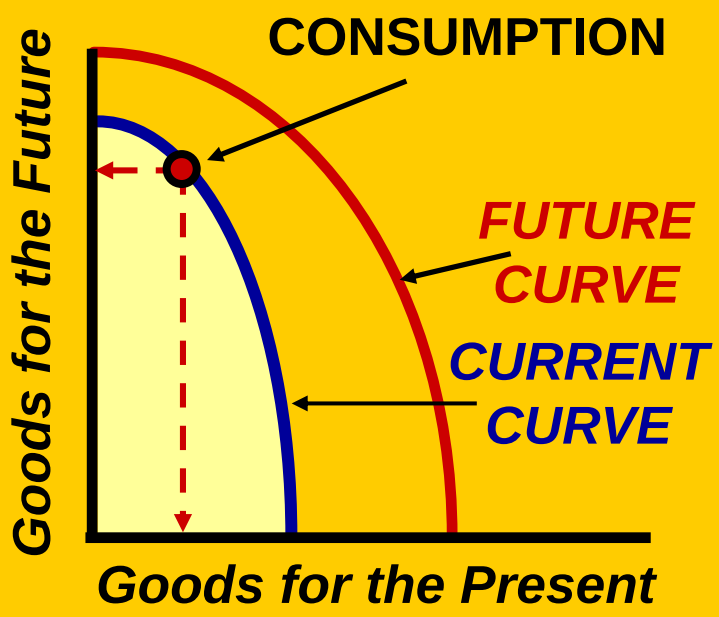
## *Two Examples of Economic Growth*

**NOWTOWN - FAVORS PRESENT GOODS**

**LATERVILLE - FAVORS FUTURE GOODS**




**Nowtown**




**Laterville**

# Markets, Prices, and the Three Coordination Tasks

- Markets $\Rightarrow$ solutions to the three coordination tasks
- Consumers are in control
- Sometimes the solutions are compatible with society's goals, other times not.

# Absolute Advantage

- A person/country has an **absolute advantage** over another person/country in the production of a particular product, if it can produce more of that product from a specific quantity of resources.

# Comparative Advantage

- A person/country has a **comparative advantage** over another person/country in the production of a particular product, if it can produce that product at a lower opportunity cost.

# How To Tackle Comparative Advantage - Oreo

- Output questions tell **how much is being produced** in a given time period.
- Input questions **usually give the amount of time** it takes to produce one unit.

  – Both questions get solved by easy division, but people can get confused as to what gets divided by what.

# How To Tackle Comparative Advantage - Oreo

- Here's a nifty trick:
  - For output questions, use the oreo cookie approach. The opportunity cost of Guns = Butter / Guns. The equation looks like an oreo cookie:

    **G**=B/**G**. [Output = Oreo]
  - For input questions it's just the opposite. The opportunity cost of Guns = Guns / Butter. No oreo format (G=G/B)

# Attack Comparative Advantage FRQs and MCs

- 1st Find absolute advantage
- 2nd Compute opportunity cost to determine comparative advantage
- 3rd Use comparative advantage to determine terms of trade

# Ultimate Tips for Output Comparative Advantage Analysis

- THINK IN TERMS OF TWO PRODUCTION POSSIBILITIES CURVES
- OREO Method: Opportunity cost of S=D/S

# Ultimate Tips for Input Comparative Advantage Analysis

- NO PRODUCTION POSSIBILITIES CURVES
- NO OREO Method: Opportunity Cost of S=S/D
- Typically identified by Hour / Minutes