# Unit 1
# Basic economic concepts

## In accordance with the APT programme objectives of the lecture are to help You to:

- understand the principle of marginal analysis;
- understand that the existence of limited resources along with unlimited wants results in the need to make choices;
- deal with the concepts of opportunity costs and trade-offs, and to illustrate these concepts by using the production possibilities curve;
- understand why and how specialization and exchange increase the total output of goods and services;
- be able to differentiate between absolute and comparative advantage, to identify comparative advantage from differences in opportunity costs and to apply the concept of comparative advantage, in order to determine the basis under which mutually advantageous trade can take place between countries.

# Required reading

Begg, D., R.Dornbusch, S.Fischer. Economics. 8th edition. McGraw Hill. 2005.

**Chapter 1. Economics and the economy.**

**Chapter 2. Tools of economic analysis.**

# What is Economics?

Two ways to define economics:

1) The study of how the society decides what, how and for whom to produce.

2) The study how the society allocates its scarce resources.

Scarcity of resources → Tradeoffs → Opportunity Cost.

Learning to think like an **economist**:

**All social phenomena emerge from the choices of individuals in response to expected benefits and costs to themselves.**

- There are always costs to any choice, because resources are scarce, and having something means having less of something else (trade-offs).
- For a choice to be made, its expected benefits should be at least as great as its costs (Cost-benefit principle).

# Choice: Comparing benefits and costs

In general choose **how much** of an activity to pursue, how much to buy, etc.

Decisions are made on the **margin**.

**Marginal cost** – the increase in total cost that results from carrying out one additional unit of an activity.

**Marginal benefit** – the increase in total benefit that results from carrying out one additional unit of an activity.

# Choice

Economic surplus – total benefit minus total cost.

In order to maximize economic surplus, individuals (firms, society) should add units of activity as long as marginal benefit ≥ marginal cost.

# Opportunity Cost

- Opportunity cost of a good is the quantity of other goods which must be sacrificed to obtain another unit of that good.
- **Opportunity cost** of an activity is the value of the next best alternative that must be forgone in order to undertake that activity.

# Production Possibilities Frontier (Curve)

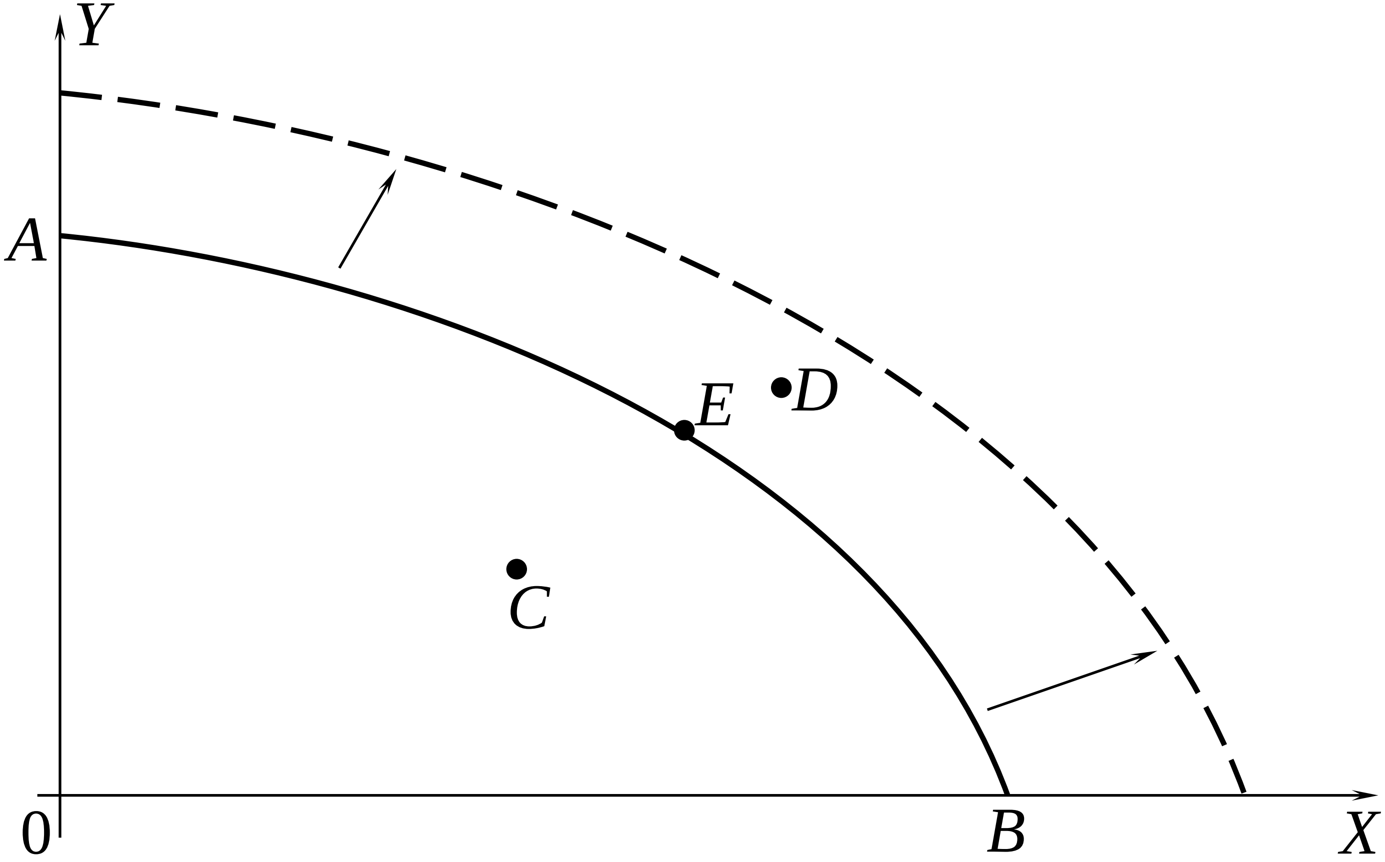
For a given amount of resources, shows the maximum amount of one good that can be produced for every possible level of production of the other good.

PPF for a large economy is convex off the origin (or concave).

The slope measures the returns to producing good 1 (on horizontal axis), which decline with the amount of good 1 (opportunity cost increases) → diminishing returns.

<u>Remember:</u> The total amount of resources is fixed. We only reallocate them (people/hours) to production of one good or the other.

# Production possibility frontier



# Factors that shift PPF

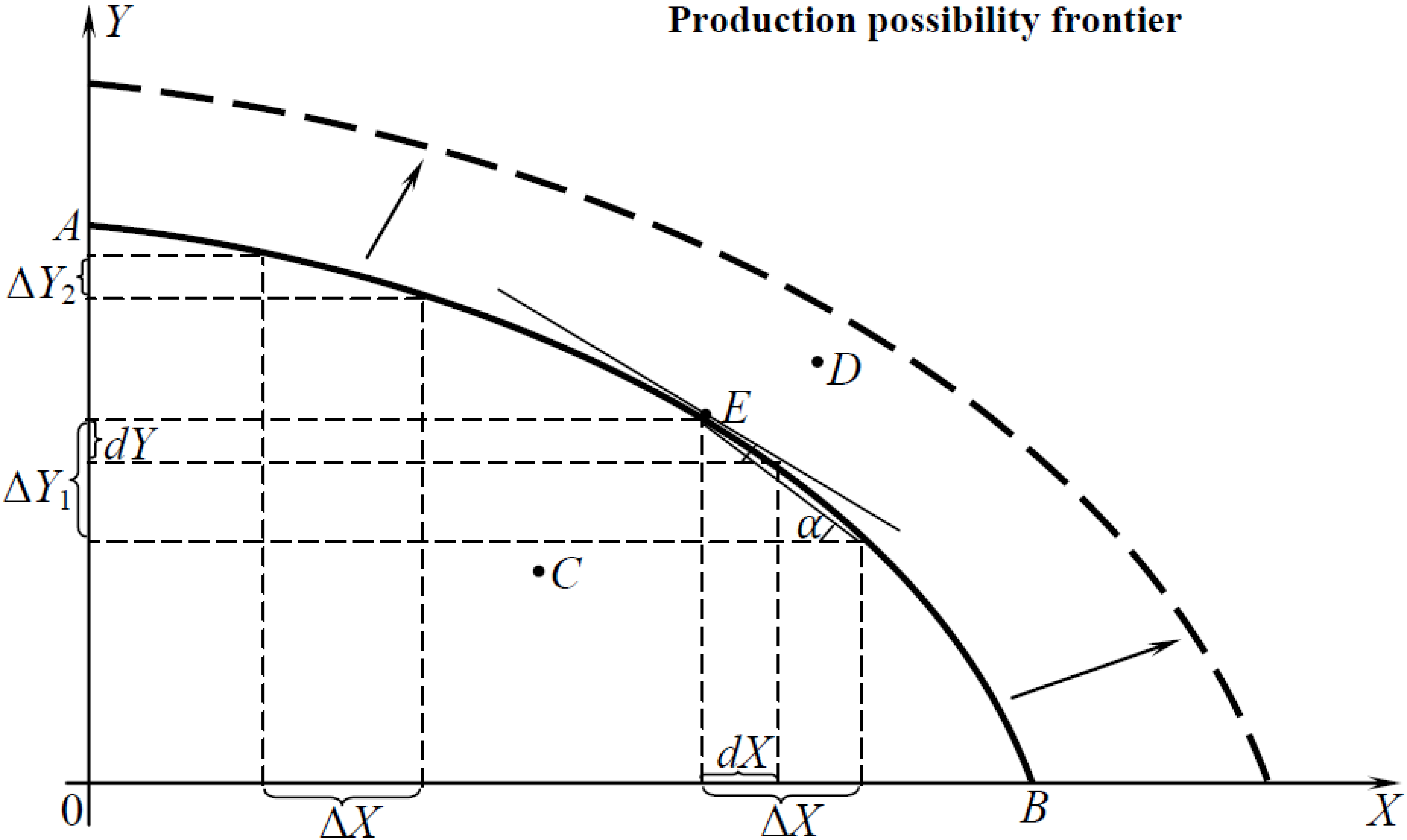
Over time, the total amount of available resources may change

- People
- Land
- Capital
- Knowledge / technology

Increase → outward shift

Decrease → inward shift

**Production possibility frontier**



# Comparative Advantage, Specialization and Trade

An economic agent has a **comparative advantage** over another if his opportunity cost of performing a task is lower than the other agent's opportunity cost.

Both nations and individuals may benefit from specialization and trade due to the increase in total output.

Highest total production is achieved when agents specialize in activities for which their opportunity costs are lowest.

## Comparative advantages, specialization and gains from trade