

# Economic Systems

- ▶ **Economic Questions and Economic Systems**
- ▶ **Production Possibilities Frontier**
- ▶ **Comparative Advantage**

# Economic Systems

- ▶ 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*

## **Economic Questions and Economic Systems**

- ▶ **Identify 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*

## **Economic Questions and Economic Systems**

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

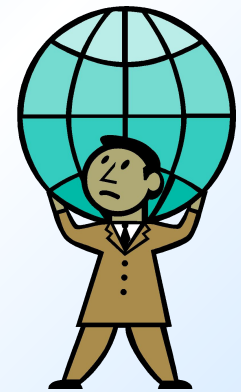


Market place in Cameroon

# Three Economic Questions



- ▶ All economies must answer these 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 economist **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
- ▶ 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*

## **Production**

## **Possibilities Frontier**

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

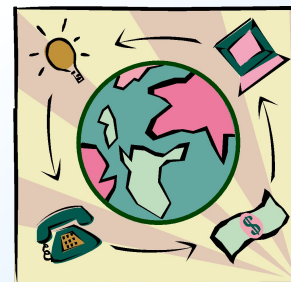
# *Key Terms*

## **Production Possibilities Frontier**

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



# Efficiency and Production Possibilities Frontier



## ▶ PPF model

- ▶ Shows possible combinations of 2 types of goods that can be produced when available resources are used fully and efficiently
- ▶ Figure 2.1

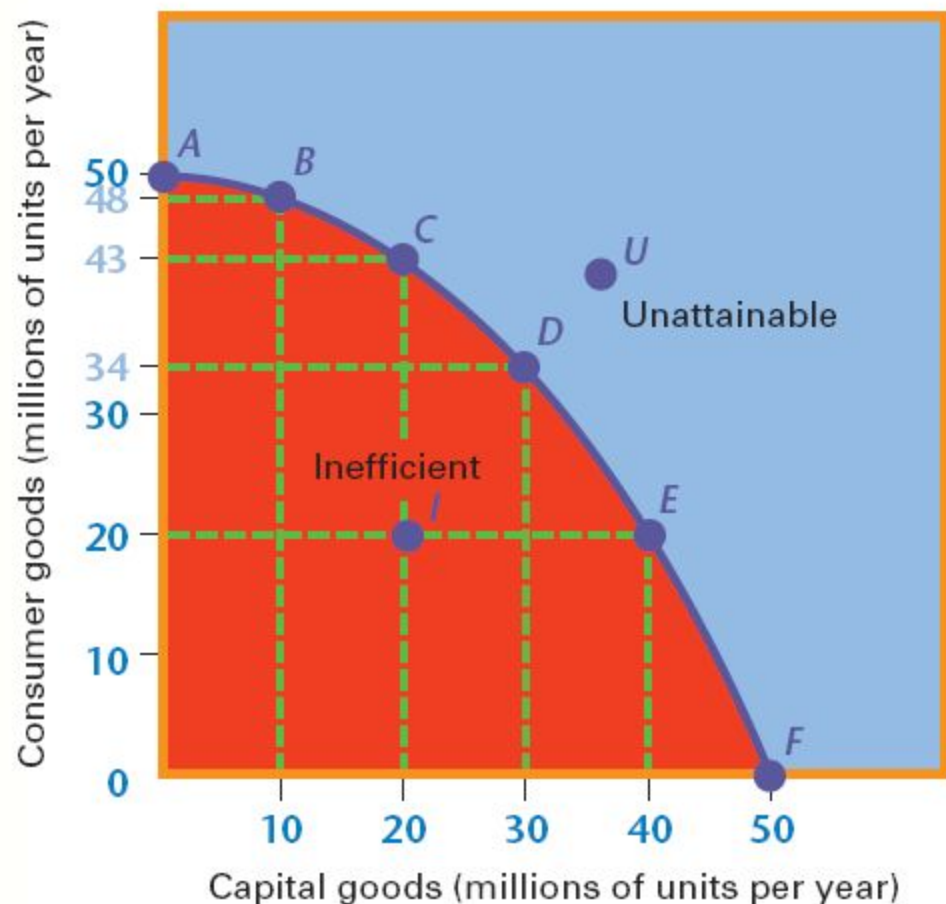
## ▶ Inefficient and unattainable production

- ▶ Point I and U on the curve

## ▶ Shape of the PPF

- ▶ Any movement along PPF involves giving up something

# Production Possibilities Frontier – PPF Figure 2.1



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

# Efficiency and Production Possibilities Frontier

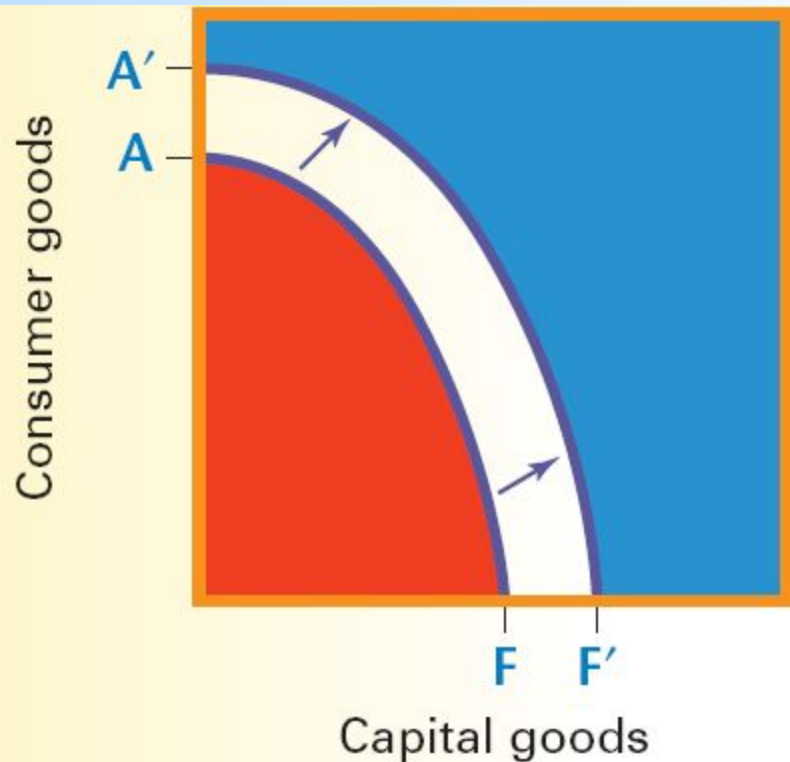
- ▶ The resources in an economy are not all perfectly adaptable
- ▶ **Law of increasing opportunity cost** – each additional increment of one good requires the economy to give up larger increments of other good
- ▶ The **PPF** has a bowed-out shape due to the law of increasing opportunity cost

# Shifts in the PPF

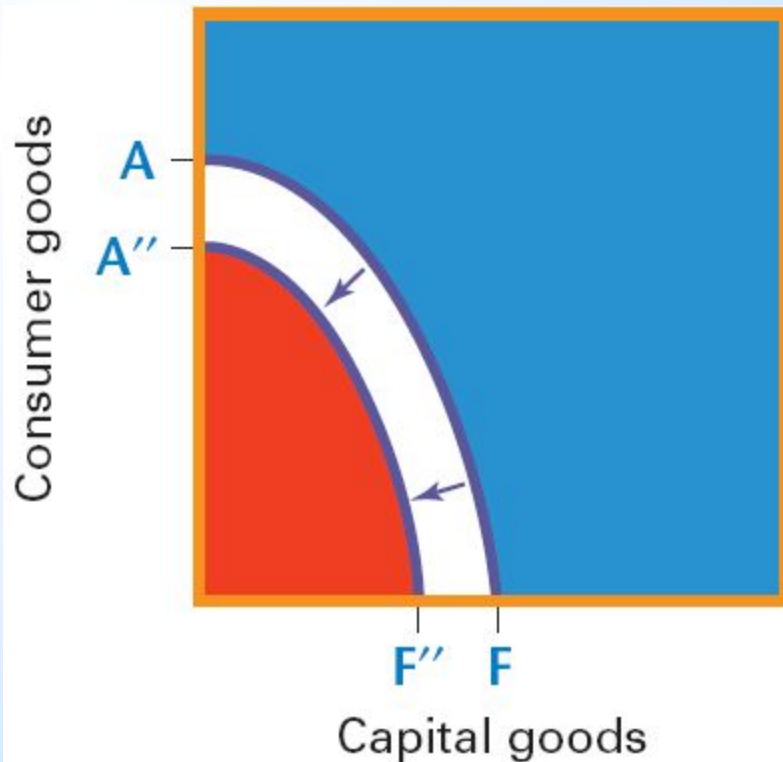
- ▶ **Economic Growth** – an expansion in the economies ability to produce
- ▶ **Changes in resource availability**
  - ▶ Increase (more labor) – PPF shifts outward
  - ▶ Decrease (less resources) – PPF shifts inward
- ▶ **Increases in stock of capital goods**
- ▶ **Technological change**

# Shifts in the PPF

Increase in available resources



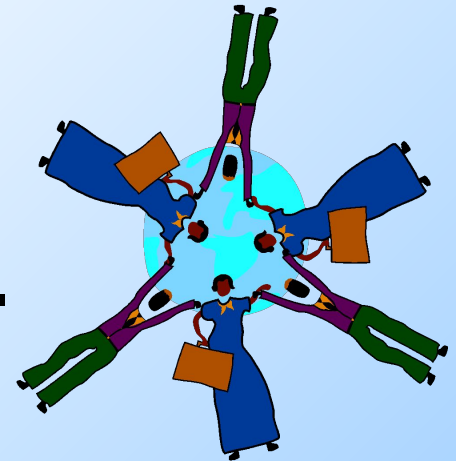
Decrease in available resources



# *Objectives*

## **Comparative Advantage**

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



# *Key Terms*

## **Comparative Advantage**

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



# Comparative Advantage

- ▶ **Absolute advantage** – being able to do something using fewer resources than other producers require
- ▶ **Law of comparative advantage** – the worker with the lower opportunity cost of producing a particular output should specialize in that output





# Specialization

- ▶ **Specialization** – when individual workers focus on single tasks
- ▶ **Gains from specialization**
  - ▶ More efficient and productive
  - ▶ Absolute advantage focuses on who used the fewest resources, comparative advantage focuses on what else those resources could have produced
- ▶ **Exchange**
  - ▶ **Barter** – system of exchange in which products are traded directly for other products
  - ▶ **Money** – medium of exchange

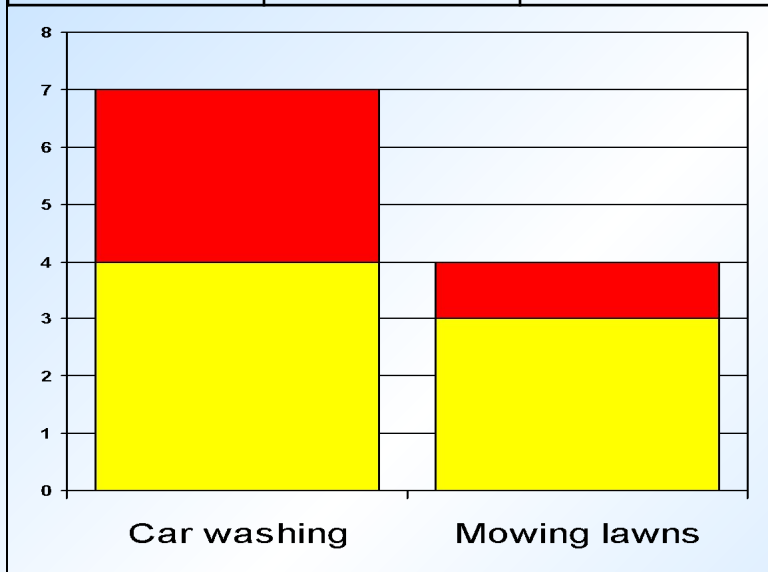
# Specialization



- ▶ Most people consume little of what they produce and produce little of what they consume!
- ▶ **Division of labor** – sorts the production process into tasks to be carried out by separate workers
- ▶ Drawbacks of specialization (Figure 2.2)

# Comparative Advantage and Specialization- Figure 2.2

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

