

Chapter 3 A Classical Economic Model

- what determines the economy's total output/income
- how the prices of the factors of production are determined
- how total income is distributed
- what determines the demand for goods and services
- how equilibrium in the goods market is achieved

Economic models

...are simplified versions of a more complex reality

- irrelevant details are stripped away
- assumptions are made

...are used to

- show relationships between variables
- explain the economy's behavior
- devise policies to improve economic performance

Endogenous vs. Exogenous Variables

- The values of **endogenous** variables are determined in the model.
- The values of **exogenous** variables are determined outside the model: the model takes their values & behavior as given.
- In the model of supply & demand for pizza,
endogenous: P, Q^d, Q^s
exogenous: P_m