

Assumption and Models

Assumption

Assumption simplify the complex world.

Ex. For studying trade, we can assume only one seller and one buyer,

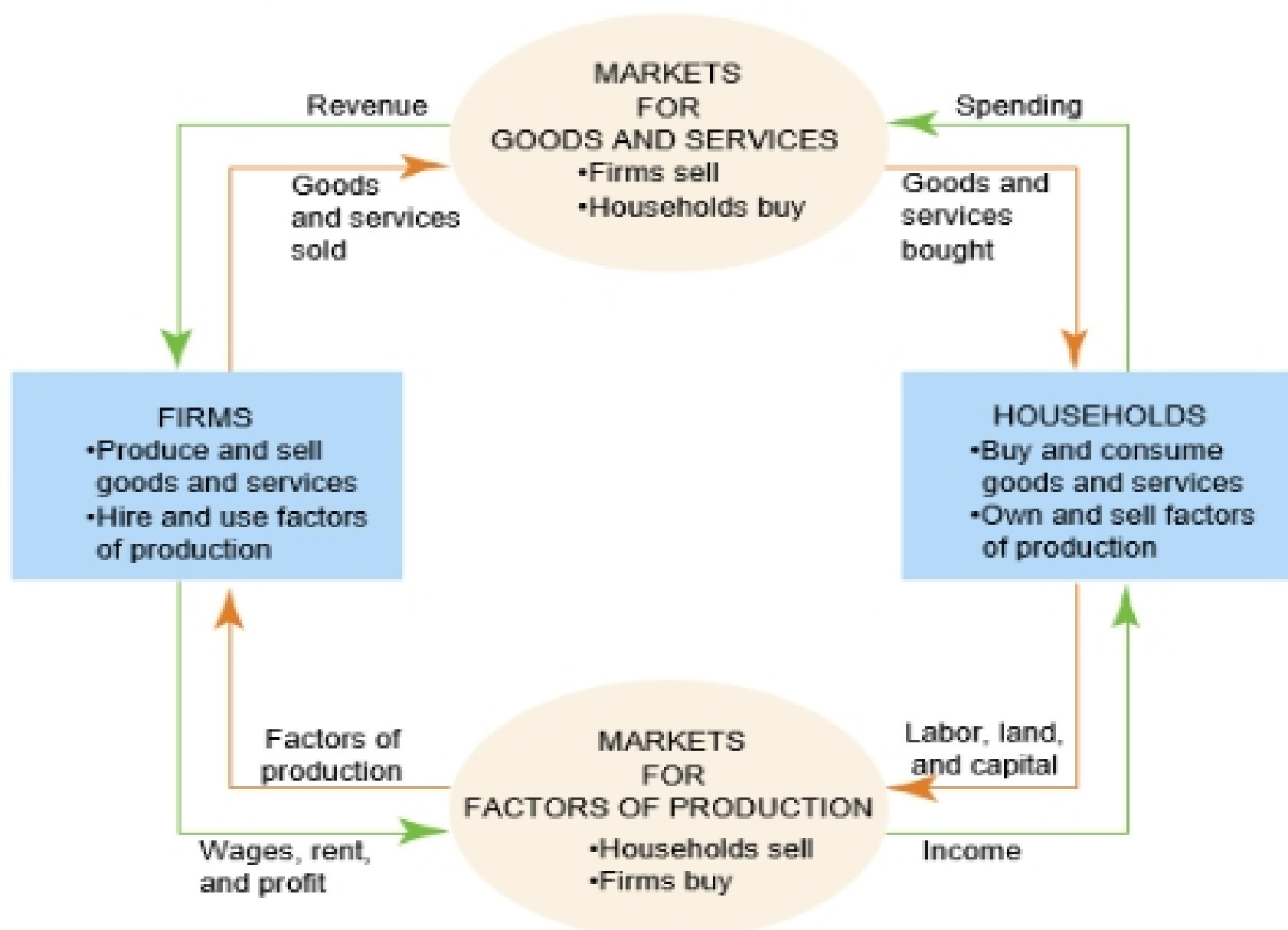
Unrealistic but easier to understanding

Model

Highly simplified representation of world with assumption.

The first model: **Circular-Flow Diagram**

- ✓ Two actor: households & firms
- ✓ Two market: good & services market, “factor of production” market



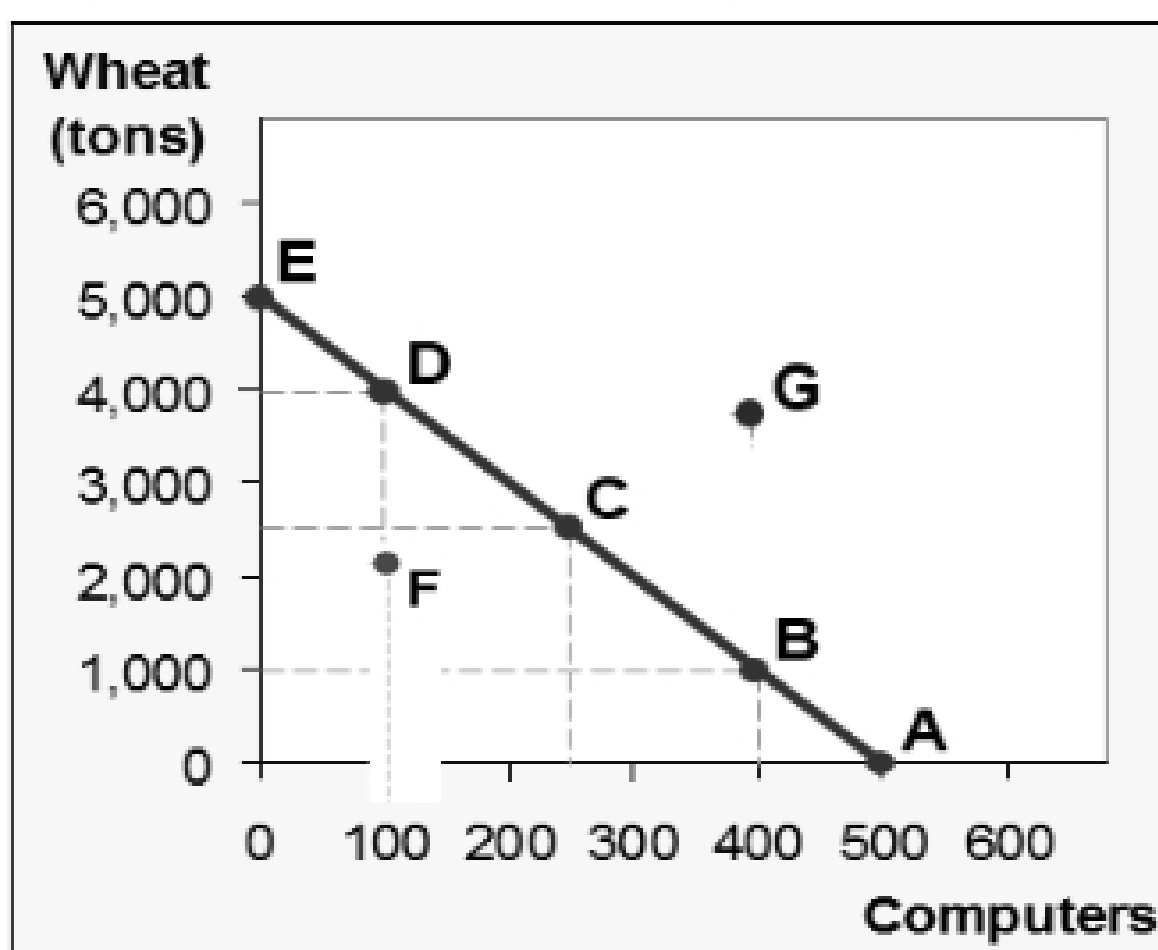
The second model: **Production Possibility Frontier**

✓ PPF is a graph shows the combinations of output that the economy can possibly produce given the available factors of production and the available production technology.

✓ Ex. Goods: computers and wheat

Resource: labor: 50,000 labor hours per month.

Point on graph	Production	
	Com-puters	Wheat
A	500	0
B	400	1,000
C	250	2,500
D	100	4,000
E	0	5,000



Points on the PPF (like A – E)

✓ Possible and efficient: all resources are fully utilized

Points under the PPF (like F)

✓ Possible but not efficient: some resources underutilized

(workers unemployed, factories idle)

Points above the PPF (like G)

✓ not possible yet

(Technology and economy development could shift PPF outward)

The PPF and Opportunity Cost

Opportunity cost of an item is what must be given up to obtain that item. Moving along a PPF involves shifting resources from the production of one good to the other.

Tradeoff: getting more of one good requires sacrificing some of the other. The slope of the PPF tells you the opportunity cost of one good in terms of the other.

The Shape of PPF

PPF is a **straight line** if opp. cost remains constant,

Ex. computers vs. wheat [see last topic]

PPF is **bow-shaped** if opp. cost of a good rises as the economy produces more of the good.

Ex. Beer vs. Mountain bikes

Assume the resource is labor [workers].

Not every worker good at making bikes, so shifting resources to mountain bikes, increases opp. cost of bike.

