

Addis Ababa Science & Technology University
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Department of Economics

Introduction to Economics (Econ 1101)

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- **Scope and Methods of Economic Analysis**

- **The concept of economic **theory****

- A **theory** is a framework that helps us to understand the **relationships between cause and effect** and the **implications** of each type of relationships in the economic process.
 - Should be powerful for prediction & explanation
 - Theory constructs and utilizes the concept of models for prediction and analysis of economic phenomena
 - Note: theory holds true in general

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- A model is a simplified representation of a real situation. It includes the main features of the real situation which it represents.

Definition of economics, What is Economics?

- **Economics** is a social science which studies about **efficient** allocation of **scarce** resources so as **to attain unlimited** human needs.
 - Economics is a science of **choice**. land, labor, .
 - Scarce resources-land , labor, capital & entrepreneurship
- There is **scarcity** of these resource-everything cannot be produced
- Therefore **efficiency** (how to get the most from these resources) in prodn, consn, distribn & exchange of g & s.

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Branch of economics

- **There are two branches of economics**
 - **Microeconomics**: focuses on the individual parts of the economy.
 - A person, hhs, a firm, etc
 - **Macroeconomics**: deals with the effects and consequences of the aggregate behavior of all decision making units in a certain economy.
 - Economy as a whole, economy wide phenomena focusing on issues like
 - Inflation, Unemployment, GDP etc
- **Note**: Both microeconomics and macroeconomics are **complementary** to each other.

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Economics can also be analyzed from two perspectives:

- **Positive economics:** description of the world as it is.
- **Normative economics:** includes value judgment,

Methods of economic analysis: Two methods

- **Inductive method**
- **Deductive method**

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The Fundamental Economic Problems

Scarcity and the problem of choice

Choice involves trade off -----there is **opportunity cost** in making choice

Opportunity Cost is “The best alternative that we give up, or forgo, when we make a choice or decision”.

Question: What is the opportunity cost of education for you?

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- Therefore, society faces the following fundamental economic problems
 1. **What to produce:** Product mix choice decision
 2. **How to produce:** Technology/technique choice decision
 3. **To whom to produce:** distribution choice decision

Every decision made at each point in time involves opportunity cost for you, so must decide on an alternative with the lowest o.c.

Opportunity cost can be best explained by the tool of production possibility frontier/curve (PPF/PPC)

What is PPF/PPC?

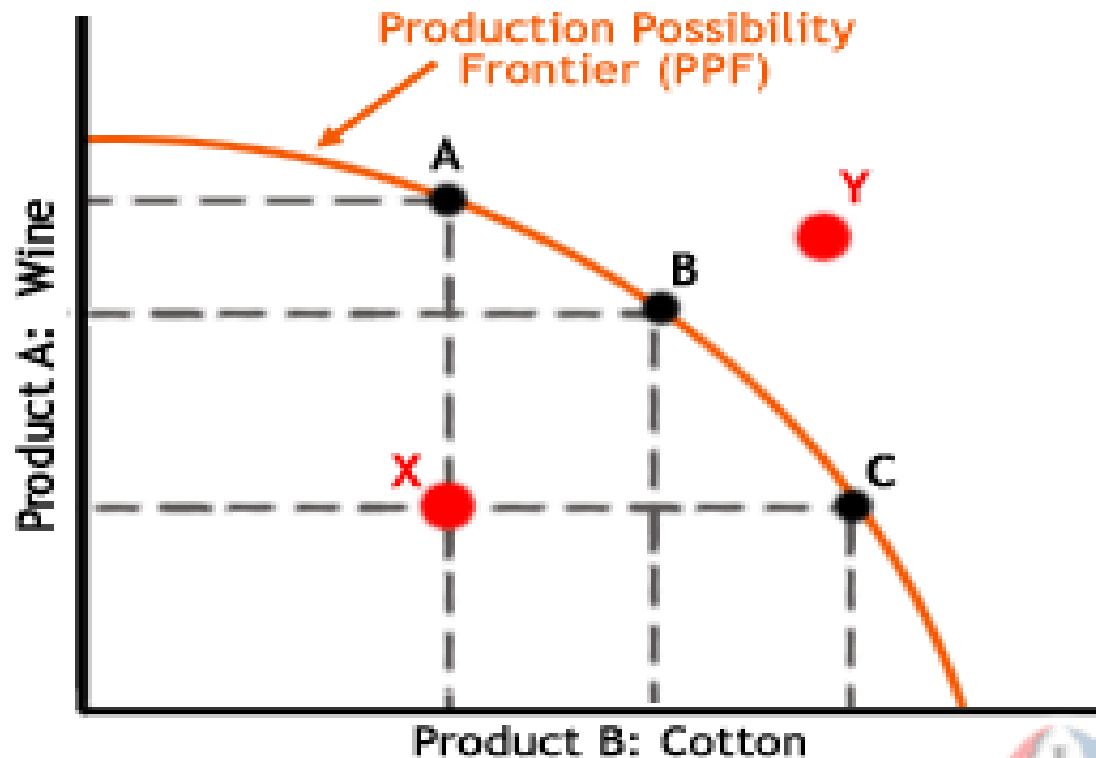
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- production possibility frontier/curve (PPF/PPC/PTC) depicts a curve showing different technically efficient combinations of various (two) goods that can be produced from a given amount of resources.

The PPF illustration assumes that
production of only two goods
resources are fixed for a period of time
technology assumed fixed in the short run
full employment of resources

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The PPF/PPC/PTC



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● Opportunity Cost

Remember that O.C is the value of what is forgone in order to have something else.

The O.C of shifting production from A to B is given as:

$$\frac{\Delta Y}{\Delta X} = \frac{\text{Change in the amount of Wine}}{\text{Change in the amount of Cotton}}$$

Note that O.C increases as we go down the ppc b/c the shape is concave.

Question: why do you think the shape is concave?

O.C is person specific

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Decision making units and circular flow of economic activities

The three most important decision making units are:

Households: owners and suppliers of resources
demanders of g & s

Business firms: decide on the demand side of resources

decide on the ss side of g & s

Government: regulatory role from legal and political power

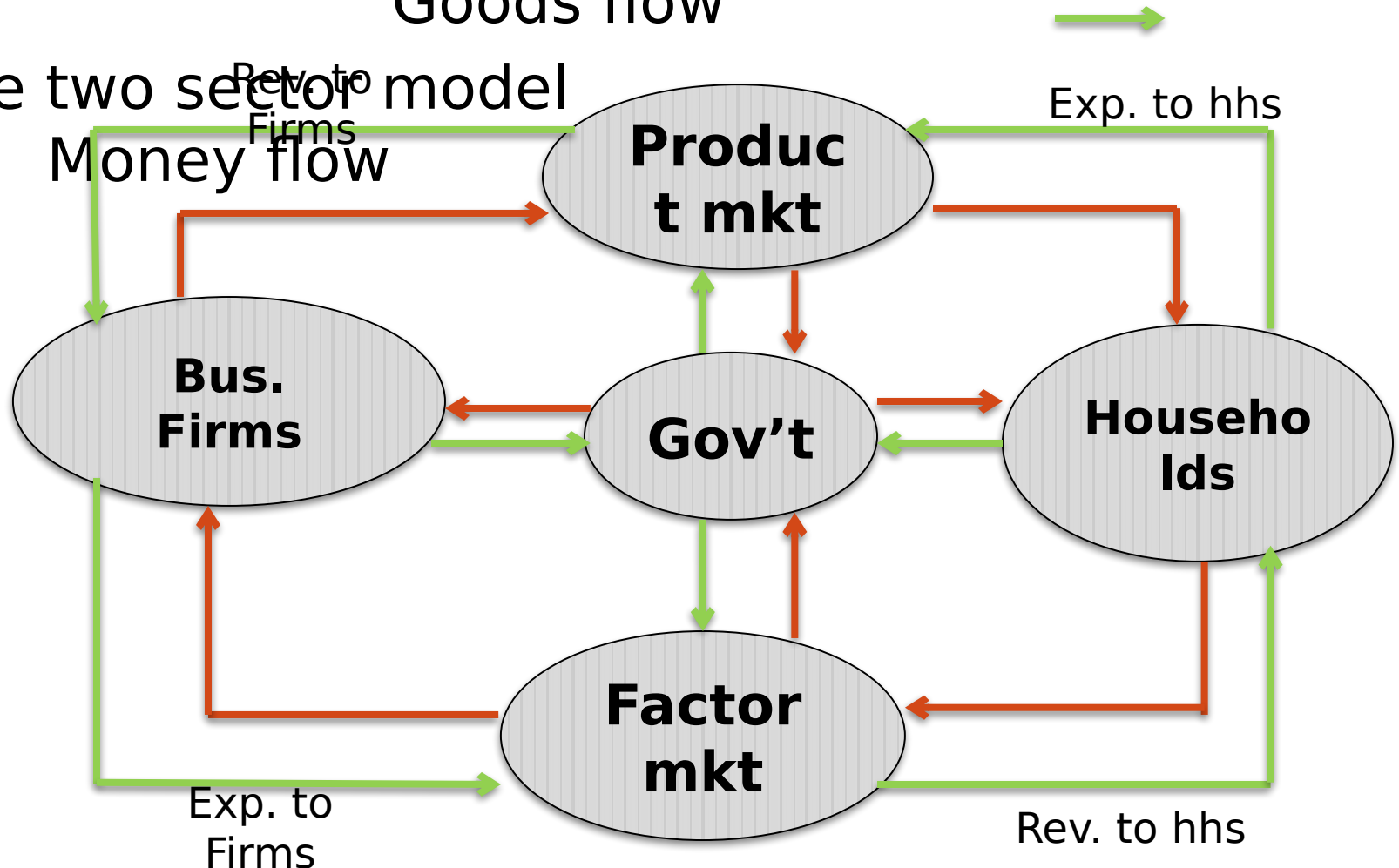
● These actors interact both in the factor and product

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- The **circular-flow diagram** is a visual model which shows the interaction of these decision makers

Goods flow

- The two sector model



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Alternative economic systems

An economic system is defined as a network of decisions and actions of economic and political players in production, distribution and consumption process in a country.

There are 4 general alternative economic systems

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1. **Free-market economy (Capitalism):**

- private sector (market) led economy
- minimum gov't
- high competition ---high efficiency
- distribution is unfair

2. **Command economy (Socialism):**

- maximum gov't and no market resource allocation
- central planning approach
- very low competition-----very low efficiency
- distribution is fair

3. **Mixed economy:**

4. **Traditional economy:**

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Please attempt the review questions at
the end of the chapter

-----End of Chapter one-----