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Cambridge IGCSE™ and O Level

Economics

Third Edition

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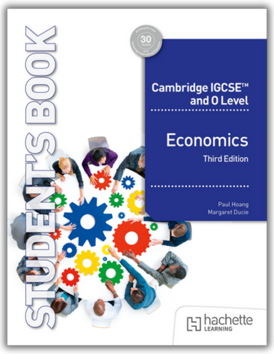

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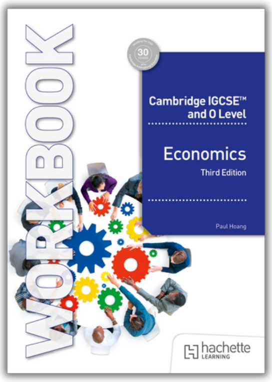

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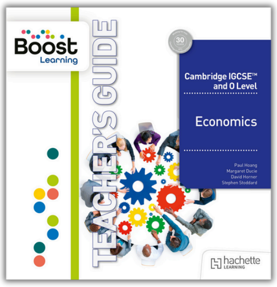

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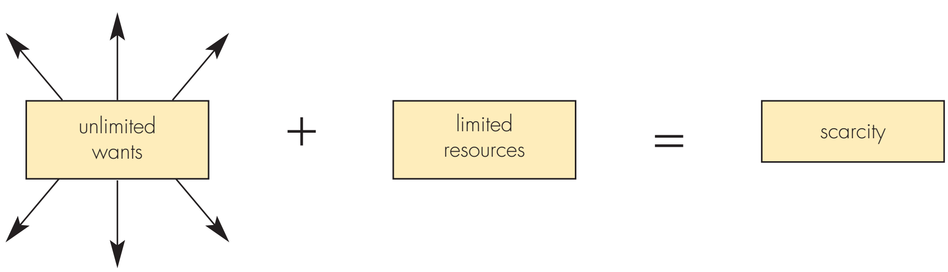
Contents

1 The nature of the basic economic problem

- ★ a definition of the basic economic problem
- ★ the concept of scarcity
- ★ examples of the basic economic problem in the context of consumers, workers, producers/firms and governments
- ★ the three basic economic questions which determine resource allocation
- ★ the differences between economic goods and free goods.

The basic economic problem: finite resources and unlimited wants

In every country, resources are limited. Governments, firms (businesses) and individuals have to make decisions about how to allocate scarce resources to satisfy their unlimited needs and wants. This is known as the **basic economic problem**, which exists in every economy: how best to allocate scarce resources to satisfy people's unlimited needs and wants. Essentially, economics is the study of how scarce resources (see Chapter 2) are allocated to satisfy the unlimited needs and wants of individuals, governments and firms in an economy.



▲ **Figure 1.1** The cause of the basic economic problem

The three main **economic agents** (or decision-makers) in an economy are:

- » consumers (individuals or households)
- » firms (businesses which operate in the **private sector** of the economy)
- » the government.

Firms and individuals produce goods and services in the private sector of the economy and the government produces goods and services in the **public sector**. For example, the government might provide education and healthcare services for the general public. All economic agents (governments, firms and individuals) produce and consume goods and services.

Workers are affected by the number of available jobs in the economy, which may be limited compared to the number of people seeking employment. This scarcity of job opportunities forces workers to make choices about accepting lower-paying jobs, relocating to other areas, or investing in further education to improve their employment prospects. (See Chapter 17 for more on workers.)

Definitions

The **basic economic problem** is concerned with how best to allocate scarce resources in order to satisfy people's unlimited needs and wants.

Economic agents are households (private individuals in society), firms that operate in the private sector of an economy and the government (the public sector of an economy).

Private sector refers to the economic activity of private individuals and firms. The private sector's main aim is to earn profit for its owners.

Public sector refers to economic activity directly involving the government, such as the provision of state education and healthcare services. The public sector's main aim is to provide a service.

Resource allocation and the three basic economic questions

The three basic economic questions addressed by economic agents are:

1 What to produce?
2 How to produce it?
3 For whom to produce it?

Economic agents respond to these questions based on the needs and wants of a particular society.

Definitions

Goods are physical items such as tables, cars, toothpaste and pencils.
Services are non-physical items such as haircuts, bus journeys, telephone calls and internet access.
Needs are goods and services that are essential for survival.
Wants are goods and services that are not necessary for survival but are demanded by economic agents to fulfil their desires.

Activity

Discuss how a private firm producing running shoes would answer the three basic economic questions.

Goods are physical items that can be produced, bought and sold. Examples are furniture, clothing, toothpaste and pencils. **Services** are non-physical items that firms provide and customers pay for. Examples are haircuts, bus journeys, education, concerts, telephone calls and internet access.

Activities

1 Make a list of the goods and services provided by the public sector of your economy.
2 Identify the goods and services which are free to individuals and those for which you have to pay.
3 List which goods/services could be provided by a private firm as well as by the public (government) sector.
4 Compare and contrast the aims and objectives of a government-funded swimming pool and a private health and leisure club.

Needs are the essential goods and services that humans need for survival. These include nutritional food, clean water, shelter, protection, clothing and access to healthcare and education. All individuals have a right to have these needs met. This is stated in Articles 25 and 26 of the United Nations Universal Declaration of Human Rights, drafted in December 1948.

Article 25 states:
Everyone has the right to a standard of living adequate for the health and well-being of himself and of his family, including food, clothing, housing and medical care and necessary social services, and the right to security in the event of unemployment, sickness, disability, widowhood, old age or other lack of livelihood in circumstances beyond his control.

Article 26 states:
Everyone has the right to education. Education shall be free, at least in the elementary and fundamental stages. Elementary education shall be compulsory. Technical and professional education shall be made generally available and higher education shall be equally accessible to all on the basis of merit.

Wants are goods and services that are not necessary for survival but are human desires – that is, things we would like to have. Wants are unlimited, as most people are rarely satisfied with what they have and are always striving for more. Wants are a matter of personal choice and are a part of human nature.

According to the World Bank, in 2022, 648 million of the world's people were living on less than $2.15 per day.

Source: 'Half of the global population lives on less than US$6.85 per person per day' by Marta Schoch, Samuel Kofi Tetteh Baah, Christoph Lakner, Jed Friedman, 8 December 2022, World Bank Blogs website: worldbank.org.

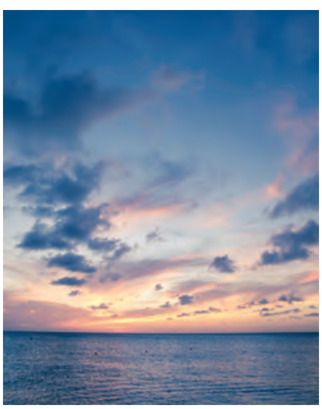
A handful of the richest people on the planet have as much wealth as the poorest half of the world's population. The study of economics can help to explain why this happens and offer possible solutions to the basic economic problem.

Activities

1 Make a list of your top 10 wants and needs.
2 Is there anything in your list of needs that you could actually survive without?
3 Is there anything in your list of wants that might be considered as a need?
4 Identify a shortage of any good or service in your economy. Explain why the shortage has occurred.

Definitions

Economic goods are those which are limited in supply.
Free goods are goods which are unlimited in supply. Hence, there is no opportunity cost in terms of their output.
Opportunity cost is the cost of the next best opportunity forgone when making a decision.



▲ **Figure 1.2** Examples of free goods (seawater and air)

Economic goods and free goods

An **economic good** is one which is limited in supply, such as oil, wheat, cotton, housing and cars. It is scarce in relation to the demand for the product, so human effort is required to obtain an economic good.

Free goods are unlimited in supply, such as the air, seawater, rainwater, sunlight and (to some extent) public domain web pages. There is no **opportunity cost** in the production or consumption of free goods.

A free good is not the same as a good that one can obtain without having to pay (such as education or healthcare services provided by the government). For education and healthcare services, and similar, there is an opportunity cost (the money could have been spent on the provision of other goods and services) and such services are funded by taxpayers' money.

Activity

Make a list of 10 goods which are limited in supply (economic goods) and a second list of goods which are unlimited in supply (free goods). How many goods did your class think of that are unlimited in supply?

Practice questions: multiple choice

1 What is the basic economic problem faced by all societies? [1]
- A achieving happiness
- B an inefficient economic system
- C rewarding factors of production
- D scarcity of resources

2 Which product is **most** likely to be classified as a free good? [1]
- A birthday presents
- B public transportation
- C seawater
- D state (government-funded) education

Chapter review questions

1 What is economics the study of?
2 What is the difference between a need and a want?
3 What is meant by the basic economic problem?
4 What is meant by economic agents?
5 What are the three fundamental questions that all economies face?
6 What is the difference between goods and services?
7 How do economic goods differ from free goods?

Revision checklist

- ✔ Economics is the study of how resources are allocated to satisfy the unlimited needs and wants of individuals, governments and firms in an economy.
- ✔ The basic economic problem is concerned with how best to allocate scarce resources in order to satisfy people's unlimited needs and wants.
- ✔ Three fundamental questions arise from the basic economic problem: what to produce, how to produce it and for whom to produce it.
- ✔ Economic agents comprise consumers (individuals and households), businesses (firms) and the government.
- ✔ Firms and individuals produce goods and services in the private sector, whereas the government operates in the public sector.
- ✔ Goods are physical items that can be produced, bought and sold. Services are non-physical items that can be provided by firms and governments and are usually paid for by customers.
- ✔ Needs are the essential goods and services required for human survival.
- ✔ Wants are goods and services that are not necessary for survival but are human desires. These are infinite due to human nature.
- ✔ Economic goods are limited in supply, whereas free goods are unlimited in supply and so have no opportunity cost in terms of output and consumption.

2

The factors of production

This chapter will cover:

★ a definition and examples of factors of production
★ the rewards for factors of production
★ the causes of changes in the quantity and quality of factors of production.

Defining factors of production

Definition

Factors of production are the resources required to produce a good or service, namely land, labour, capital and enterprise.

To produce any good or service, one needs resources. These resources are known as the **factors of production** and they are divided into four categories:

- **Land** – the natural resources or raw materials required in the production process, such as oil, coal, water, wood, metal ores and agricultural products.
- **Labour** – the human resources required in the production process, including skilled and unskilled labour.
- **Capital** – the manufactured resources required in the production process, such as machinery, tools, equipment and motor vehicles.
- **Enterprise** – the skills a businessperson requires to combine and manage successfully the other three factors of production.

▲ Factors of production: land, labour, capital and enterprise

For example, the factors of production required to produce cans of Coca-Cola are as follows:

- **Capital** – factory buildings, machinery, computers, tools and delivery trucks to transport the drinks to warehouses and retailers.

Study tip

The first letter of each of the four factors of production spells the word CELL. This is a useful way of remembering the four factors of production.

- **Enterprise** – the risk-taking and business skills necessary to organise the production process successfully, and to motivate workers so they work to the best of their ability, in the pursuit of profit for the company.
- **Labour** – people to work on the production line, perform administrative tasks, promote the drinks effectively to customers and manage the company.
- **Land** – the natural resources required to make Coca-Cola, such as sugar, water and caffeine (from cacao beans).

Activities

1 Consider the resources (factors of production) required to deliver an International GCSE Economics lesson.

▲ What resources are used to deliver a lesson?

2 Discuss whether it is possible to know which of the four factors of production is the most important for economic activity.

Activity

In class, discuss why all four factors of production are required in the following cases:

a For the construction of roads.
b To provide haircuts to clients.

Factors of production and their rewards

As the factors of production are productive resources, each has a reward for its use in the production process:

- The reward for land is called **rent.** Rental income comes from the ownership of property, such as physical and related assets, and is paid by the tenants of the land resources.
- The reward for labour is called **wages and salaries.** Wages are paid to workers on an hourly basis, such as those who earn a national minimum wage (see Chapter 17). Salaried staff are paid a fixed amount per month.

- The reward for capital is called **interest**. If the interest rate (see Chapter 24) is high, it becomes less worthwhile for businesses and households to borrow money for production purposes because the cost of borrowing is high, and vice versa.
- The reward for enterprise is called **profit**. This is the return for the entrepreneur's good business ideas and for taking the risks in starting up and running the organisation. Profit is what remains after all business costs are paid, including payment to the other factors of production.

Collectively, the four rewards for the factors of production are known as **income**.

Causes of changes in the quantity and quality of factors of production

The quantity and quality of factors of production will change if there is a change in the demand for and/or supply of land, labour, capital or enterprise. Possible changes include the following:

- Changes in the **costs of factors of production** – for example, if labour costs increase because of an increase in the national minimum wage (see Chapter 17), this would tend to reduce the demand for labour.
- Government policies can affect the **costs of production**, such as through taxes and subsidies (see Chapter 14). For example, lower income taxes can help to create incentives for people to work, thus increasing the quantity of labour resources. If a business has to comply with regulations, this will tend to increase costs of production. By contrast, subsidies help to reduce production costs, thereby increasing output of goods and services.
- **New technologies**, such as automation or artificial intelligence (AI), allow firms to increase output. Higher productivity also enables firms to cut their average costs of production (see Chapter 19).
- **Net migration of labour** (see Chapter 17) will affect the quantity of labour in the economy. If there are more people migrating to a country than there are people emigrating from that country, the quantity of labour in that country will increase, **ceteris paribus** (Latin for 'all other things remaining equal').
- **Improvements in education, training and healthcare** will improve the quality of labour as workers become more valuable to firms. This helps to boost production.
- **Unfavourable weather conditions** (such as severe droughts or flooding) will reduce the supply of agricultural products. Conversely, good weather conditions will increase supply, thus increasing agricultural output.

Activity

Use the internet to investigate global employment opportunities in selected countries around the world.

Practice questions: multiple choice

1 Which option is **not** an example of capital as a resource? [1]
A computers
B factory
C machinery
D natural resources

2 Which event is **most** likely to cause an increase in the average cost of labour? [1]
A a decrease in the national minimum wage
B an increase in the national minimum wage
C government tax policies
D net migration of labour into the country

Chapter review questions

1. What is meant by factors of production?
2. What are the four factors of production?
3. What are the various rewards for factors of production?
4. What is the collective name for the four returns on the factors of production?
5. What are the various causes of changes in the quantity and quality of factors of production?

Revision checklist

✔ Factors of production are the resources required to produce a good or service, namely land, labour, capital and enterprise.
✔ The return on the four factors of production are rent (land), wages and salaries (labour), interest (capital) and profit (enterprise). Collectively, the rewards are called income.
✔ The quantity and quality of factors of production will change if there is a change in the demand for and/or supply of land, labour, capital or enterprise. This could be due to changes in the costs of factors of production, government policies, new technologies, migration of labour, changes in educational levels of the labour force and even climatic conditions.

3 Opportunity cost

This chapter will cover:

- ★ a definition of opportunity cost, with examples
- ★ the influence of opportunity cost on decisions made by consumers, workers, producers/firms and governments.

Defining opportunity cost

Opportunity cost is the cost of the next best opportunity forgone (given up) when making economic decisions. Every choice made has an opportunity cost because in most cases there is an alternative.

Some examples of opportunity cost are as follows:

- The opportunity cost of choosing to study International GCSE Economics is another International GCSE subject you could be studying instead.
- The opportunity cost of visiting the cinema on Saturday night could be the money you would have earned from doing casual work instead of going to the cinema.
- The opportunity cost of building an additional airport terminal could be using the same government funds to build public housing for low-income families.
- The opportunity cost of a school purchasing 100 laptops for use in classrooms might be the science equipment that the school could not buy as a result.
- The opportunity cost of going to university to study for a degree is the loss in income that would have been earned if the undergraduate student had chosen to work instead during that time.

Case study: US federal government spending

According to the Federal Ministry of Finance, the US federal government announced spending of over $6.75 trillion in 2024 on the following:

- 21% on social security
- 14% on healthcare services
- 13% on Medicare (federal health insurance program)
- 13% on national defence
- 13% on federal debts (interest repayments)
- 10% on income security
- 5% on veterans' benefits and services
- 5% on education, training, employment and social services
- 2% on transportation
- 1% on community and regional development
- 3% on other items of expenditure.

Source: 'How much has the US government spent this year?'
US Treasury, 2024, US Fiscal data website

The government raises a finite amount of taxation revenue and must decide how much of the budget to allocate to each area of public spending. There is an opportunity cost attached to the decisions made, as increased spending in one area may lead to decreased spending in another.

Activity

Investigate the major components of government spending in your country or a country of your choice. Be prepared to share your findings with others in the class.

The influence of opportunity cost on decision-making

Opportunity cost directly influences the decisions made by consumers, workers, producers (firms) and governments. Referring to the basic economic problem (see Chapter 1), there are competing uses for an economy's scarce resources. Thus, there is an opportunity cost when the aforementioned economic agents allocate scarce resources.

- **Consumers** have limited incomes, so whenever they purchase a particular good or service, they give up the benefits of purchasing another product.
- **Workers** tend to specialise (see Chapter 17) – for example, as secondary school teachers, accountants, doctors and lawyers. By choosing to specialise in a particular profession, workers give up the opportunity to pursue other jobs and careers.
- **Producers** (firms) need to choose between competing business opportunities. For example, Toyota has to decide how best to allocate its research and development expenditure in terms of developing either its hybrid cars or its electric vehicles.
- **Governments** constantly face decisions that involve opportunity cost. If a government chooses to spend more money on improving the economy's infrastructure (such as improving its transportation and communications networks), it has less money available for other uses (such as funding education and healthcare).

In general, decision-makers will choose the option that gives them the greatest economic return. For example, a government might prioritise welfare benefits in order to improve economic well-being.

Activities

1 Discuss whether quantitative or qualitative factors play a bigger role in economic decision-making.
2 To what extent does the concept of opportunity cost apply to your own decisions about post-16 and university education?

Practice question: structured question

The opportunity costs for a farmer in terms of corn and wheat production are shown in the following table.

Corn production (units)		Wheat production (units)
65	plus	30
55	plus	35

Calculate the opportunity cost for the farmer of producing 1 unit of wheat. [2]

Practice questions: multiple choice

1 Juke bought a new games console for $295 but has never used it. The second-hand value of his console is $195. What is the opportunity cost of Juke owning the games console? [1]

A $0
B $100
C $195
D $295

2 What is the opportunity cost to the economy if the government decides to build a new motorway (highway)? [1]

A the cost of relocating and compensating residents in order to build the motorway
B the money spent on building the motorway
C the other projects that could have been undertaken had the motorway not been built
D the overall cost to taxpayers of financing the motorway project

Activity

Discuss the costs and benefits of the government building a new airport. What are the key opportunity costs of such a decision?

Chapter review questions

1 How is opportunity cost defined?
2 What might be the opportunity cost of a student studying International GCSE Economics?
3 Why do consumers face opportunity costs in decision-making?
4 Why do workers face opportunity costs in decision-making?
5 Using an example, explain why producers (firms) face opportunity costs in decision-making.
6 Using an example, explain why governments face opportunity costs in decision-making.

Revision checklist

✔ Opportunity cost is a very important concept in the study of economics, as it affects the decision-making of consumers, workers, producers (firms) and governments.
✔ Opportunity cost is the cost of the next best opportunity forgone when making a decision.
✔ Opportunity cost arises because economic agents have to make competing choices regarding what to do with their finite resources. Thus, there is an opportunity cost when economic agents allocate scarce resources.

4 Production possibility curve diagrams

This chapter will cover:

- ★ a definition of production possibility curves (PPC)
- ★ how to draw and interpret appropriate PPC diagrams
- ★ the significance of the location of production points on PPC diagrams
- ★ the causes and consequences of movements along a PPC and shifts of a PPC.

Definitions

The **production possibility curve (PPC)** represents the maximum combination of goods and services which can be produced in an economy, i.e. the productive capacity of the economy.

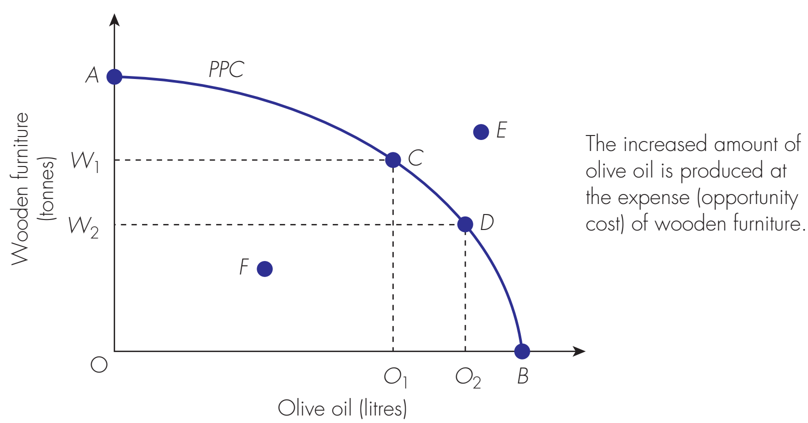
A **PPC diagram** is a graphical representation of the maximum combination of the amounts of two products that can be produced in an economy, per period of time.

Defining production possibility curve

A **production possibility curve (PPC)** shows the maximum combination of any two categories of goods and services that can be produced in an economy, at any point in time. Essentially, it shows the productive capacity of the economy.

Interpreting PPC diagrams

Assume a country can only produce two types of goods: wooden furniture and olive oil. It has a limited amount of land, labour and capital. In Figure 4.1, if producers wish to increase production of olive oil from O_1 to O_2, then the amount of wooden furniture manufactured will have to decrease from W_1 to W_2. The opportunity cost of producing the extra O_1 to O_2 litres of olive oil is therefore W_1 to W_2 tonnes of wooden furniture.



▲ **Figure 4.1** A PPC diagram

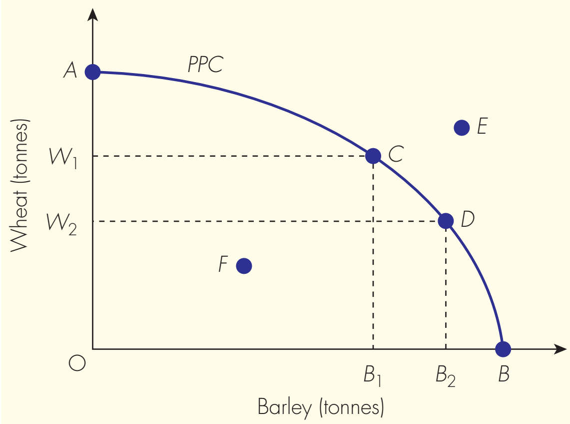
The production points in Figure 4.1 are as follows:

- Point *A* – all resources are dedicated to the production of wooden furniture.
- Point *B* – all resources are dedicated to the production of olive oil.
- Point *C* – W_1 tonnes of wooden furniture are produced along with O_1 litres of olive oil.
- Point *D* – W_2 tonnes of wooden furniture and O_2 litres of olive oil are produced.
- Point *E* – this point is beyond the production possibility curve. It lies outside the productive capacity of the economy, so it is currently unattainable.

- Point *F* – this point is within the productive capacity of the economy. This means that the production of both olive oil and wooden furniture can increase without any opportunity cost, as some factors of production are currently not being used.

Practice questions: multiple choice

Study the diagram below, which shows the PPC for Country Y. It produces only two products: wheat and barley.



1 If Country Y wishes to increase the production of wheat from W_2 to W_1, what is the opportunity cost? [1]
A a reduction in barley production from B_2 to B_1
B an increase in barley production from B_1 to B_2
C an outward shift of the PPC towards point *E*
D *C* to *D*

2 At which point is there spare capacity in the economy? [1]
A point *C*
B point *D*
C point *E*
D point *F*

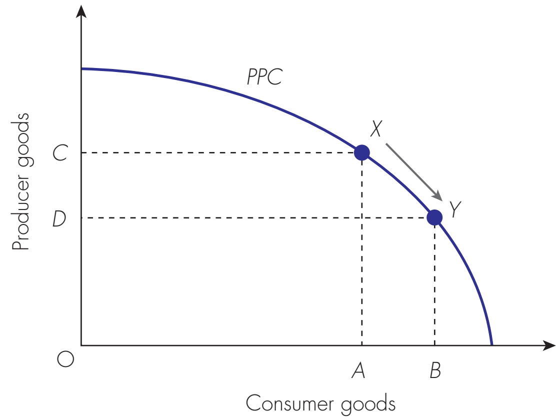
Causes and consequences of shifts and movements of the PPC

Movements along a PPC and opportunity cost

For a country to be on its PPC, two conditions have to be met:

- All resources are used – there is no unemployment of factors of production.
- There is efficiency in the use of resources – factors of production are allocated to their best use/purpose.

A movement along a PPC results in an opportunity cost. This means that if a country wants to produce more of one product, it has to produce less of another product. In Figure 4.2, a movement along the PPC from point *X* to point *Y* means more consumer goods are produced (from *A* to *B*). However, this comes at the expense of producer goods, as fewer producer goods are produced (from *C* to *D*).



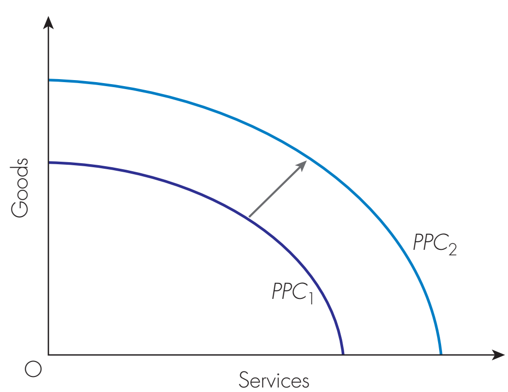
▲ **Figure 4.2** Movement along the PPC

Shifts of the PPC in terms of an economy's growth

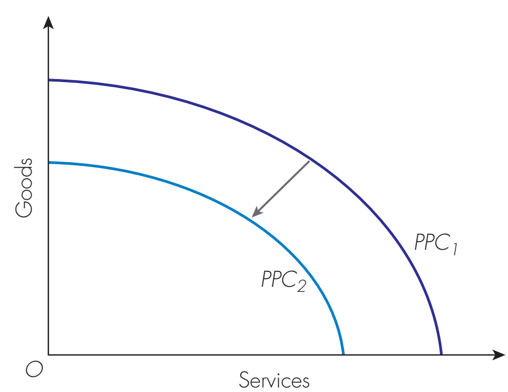
For a country to shift its PPC outwards, as shown in Figure 4.3, there must be economic growth (see Chapter 26). This can come about in the following ways:

- An increase in the **quality** of factors of production (see Chapter 2), such as more highly skilled labour achieved through investments in education, research and training. Technological advances and improved production techniques can also lead to increased productivity.
- An increase in the **quantity** of factors of production, such as the discovery of new resources, the reclamation of land or net migration of labour into a country.

In Figure 4.3, economic growth causes an outward shift of the PPC from PPC_1 to PPC_2. This means the economy can produce more goods and services, without necessarily incurring an opportunity cost.



▲ **Figure 4.3** An outward shift of the PPC



▲ **Figure 4.4** An inward shift of the PPC

Economies strive to increase their productive capacity. For example, advances in technology will result in higher productivity and output for an economy. This means that even with the same amount of factors of production, more goods and services can be produced, resulting in an outward shift of the PPC.

By contrast, detrimental changes can cause the PPC to shift inwards. These changes might include a major natural disaster, the outbreak of a pandemic, or a war that destroys a large proportion of the economy's farmland, factories and infrastructure. In Figure 4.4, the PPC shifts inwards from PPC_1 to PPC_2. This represents a decrease in the productive capacity of the economy.

Activity

Low-lying areas of Bangladesh are prone to flooding each year. Crops are lost and thousands of people lose their homes. During times of severe flooding, roads and railways are damaged and farmers find it impossible to get their dwindled crops to market.

a Draw a PPC diagram and explain the impact of flooding on the productive capacity of Bangladesh.
b On the diagram, draw and label a point where some of the factors of production will be idle.
c On the diagram, draw and label a point that is unattainable.

Chapter review questions

1 What is meant by the productive capacity of an economy?
2 What does a PPC diagram show?
3 How is the concept of opportunity cost shown on a PPC diagram?
4 Which two conditions must hold for an economy to be operating on its PPC?
5 What does a movement along a PPC mean?
6 What are the causes of an outward shift of a PPC?

Practice questions: multiple choice

1 Which is **most** likely to cause an inwards shift of a country's production possibility curve (PPC)? [1]
A a natural disaster in the economy
B an increase in the quantity of factors of production
C better quality factors of production
D higher opportunity costs of production

2 Which best describes a movement along an economy's PPC? [1]
A a decrease in the labour force due to a major natural disaster
B a shift from producing more of Good A to producing more of Good B
C a technological improvement in the production of both goods and services
D an increase in the resources available to the economy

Practice question: structured question

Country Y has decided to reallocate resources from the production of capital goods to consumer goods.

a Draw a PPC diagram for Country Y before and after the reallocation of resources. [2]
b Explain how the reallocation of resources affects the position on the PPC for Country Y. [2]
c Explain the potential long-term impact of this decision on economic growth in Country Y. [2]

Activity

Using real-world examples, discuss why an outwards shift of the PPC is not always good for the economy.

Revision checklist

- ✔ A PPC shows the maximum combination of any two categories of goods and services that can be produced in an economy. It shows the productive capacity of the economy.
- ✔ A PPC diagram is a graphical representation of the maximum combinations of two products that can be produced in an economy, when all resources are used efficiently.
- ✔ For a country to be on its PPC, two conditions have to be met: full use of all factors of production (there are no unemployed resources) and efficient use of all resources (all factor inputs are put to their best use).
- ✔ Movements along a PPC incur an opportunity cost.
- ✔ Economies strive to increase their productivity capacity, as shown by an outward shift of the PPC.
- ✔ Detrimental changes, such as natural disasters or war, can cause the PPC to shift inwards.

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