
Economic analysis helps us understand the world around us. It helps us understand the functioning of the various sectors in the economy and the choices made by individual decision-making units. **(1) Economic theories** simplify reality so that the underlying cause-and-effect relationships among variables can be understood. **(2) Economic variables** are quantities or dollar amounts that have more than one value. Theories are necessary in order to better understand the complexities of reality. **(3) An economic model** is a simplified way of expressing a theory. It can be expressed verbally, graphically, in tables, or mathematically. Assumptions underlie a theory because theories are **(4) abstractions from** reality, and it is necessary to establish the environment and motivation of people for which the theory holds. Economic models can be used to develop hypotheses. **(5) A hypothesis** is a statement of relationship between two variables that can be tested by empirical verification. Deductive reasoning is used when taking a general body of knowledge or theory and using implications of the theory to construct hypotheses. Hypotheses that have been subjected to repeated empirical verification and have withstood the test of time become **(6) economic principles or laws**. A good model is one that can generate accurate predictions. But even a model that does not predict perfectly can still be useful in helping us understand the causal relationships among variables and the consequence of the assumptions underlying the model. The causal relationships that we want to understand are difficult to isolate unless we make the assumption of **(7) ceteris paribus**.

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