Principles of Economics

Chapter 1

Nature and Scope of Economics

Learning objectives

Understanding Scarcity:

Decision-making agents in the economy:

Objects of choice and economic activities:

Macroeconomics vs. Microeconomics:

Three problems of every economy:

Economic models:

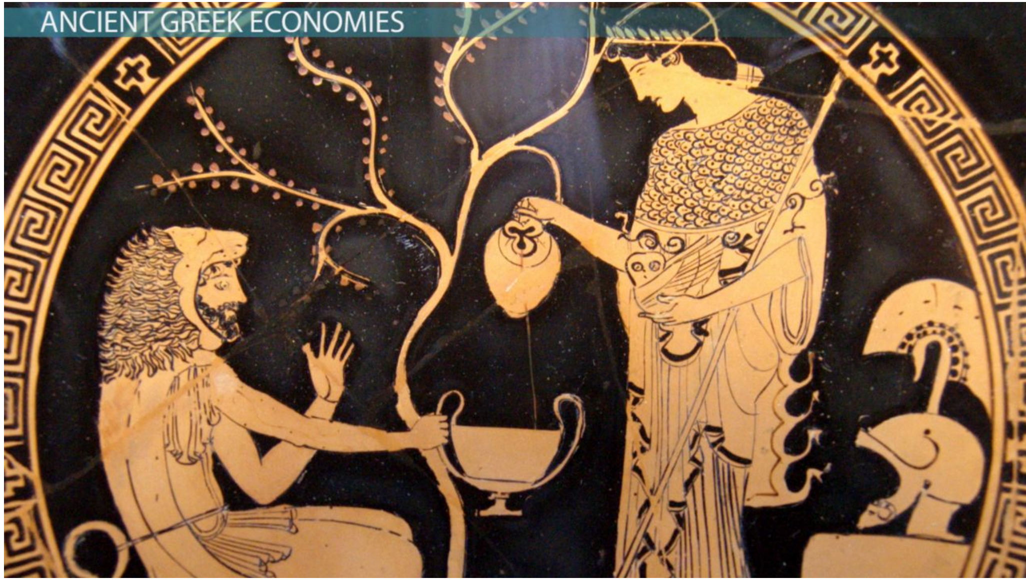
Basic economics typically revolve around understanding fundamental economic concepts, principles, and theories that help individuals comprehend how economies function.

Introduction

The word economy comes from the Greek word oikonomos, which means “one who manages a household.”

Households and economies have much in common.

A household faces many decisions. a household must allocate its scarce resources (time, dessert, car mileage) among its various members, taking into account each member’s abilities, efforts, and desires.



Introduction

Economics is the study of how society manages its scarce resources. The behavior of an economy reflects the behavior of the individuals who make up the economy.

Economists study how people make decisions: how much they work, what they buy, how much they save, and how they invest their savings. Economists study how people interact with one another.

Economists analyze the forces and trends that affect the economy as a whole, including the growth in average income, the fraction of the population that cannot find work, and the rate at which prices are rising.

Economic concepts

Scarcity

- The problem of unlimited want and limited resources
- How we decide who gets what

Equity

- Everyone gets exactly the same treatment
- the property of distributing economic prosperity uniformly among the members of society

Efficiency

- Allocate optimally, generate as much happiness as possible
- the property of society getting the most it can from its scarce resources

Equity or efficiency?

Economic concepts

Scarcity means that society has limited resources and therefore cannot produce all the goods and services people wish to have.

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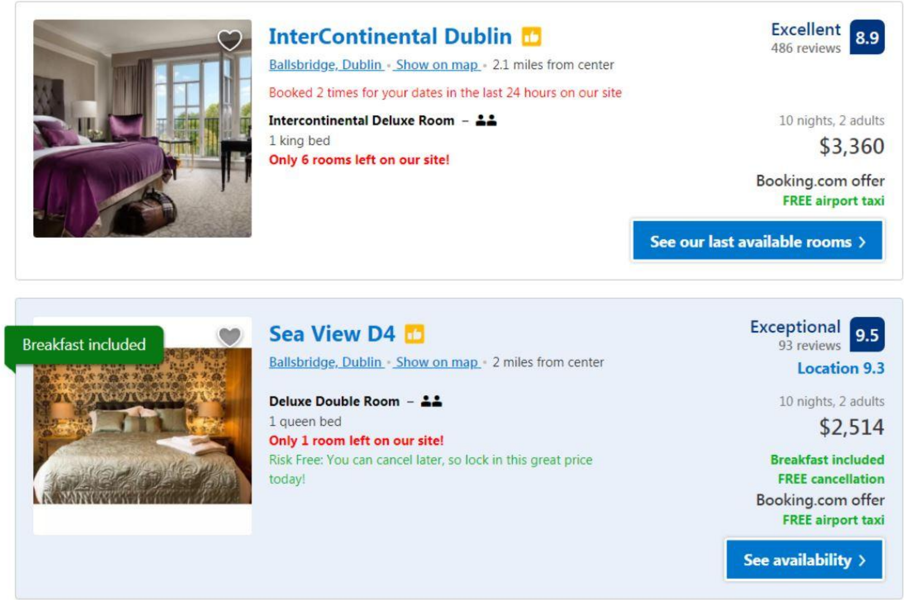
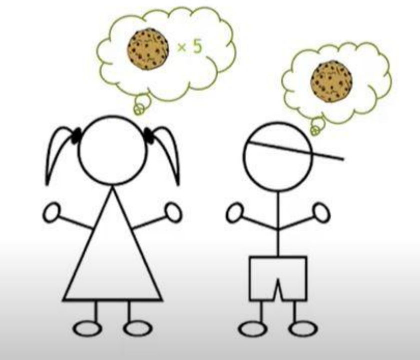
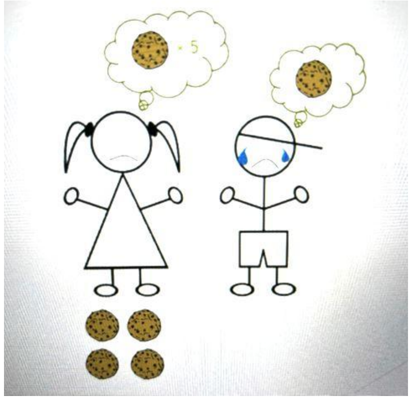
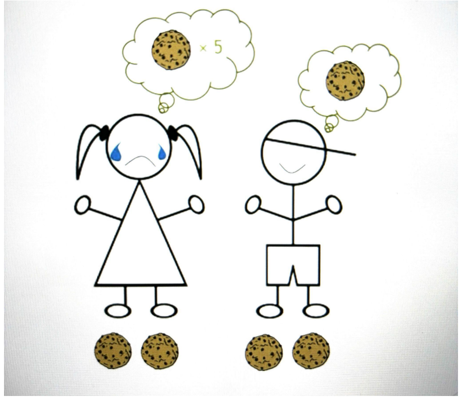


Equity or Efficiency







Rational thinking, trade-offs, cost of something you give up to get it

Non-economics people: " Is this call more important than listening to lectures?"

Principles of Economics: " Is the marginal benefit of this call greater than the marginal cost?"

At dinnertime, you do not ask yourself-"Should I fast or eat like a pig?"

Instead, you will be asking yourself "Should I take that extra spoonful of rice?"

When exams roll around, your decision is not between blowing them off and studying 24 hours a day but whether to spend an extra hour reviewing your notes instead of watching TV.

Rational thinking, trade-offs, cost of something you give up to get it

The **"Guns or Butter" model** is a simple economics concept that describes **the tradeoff governments face in spending on national defense or on domestic programs.**

The model is meant to highlight the spending constraints faced by governments – **they must choose between the two**.

Territory or Energy

OR

Economic (decision-making) agents

Economic agents are individuals, entities, or groups that participate in economic activities by making decisions regarding the allocation of resources, production, consumption, and investment.

Households:

- **Role**: Households are groups of individuals living together and sharing resources.
- **Function**: They are consumers of goods and services, provide labor to firms, and make decisions about consumption, saving, and investment.

Economic (decision-making) agents

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Firms (Businesses):

- **Role**: Firms are entities engaged in the production and sale of goods and services.
- **Function**: They hire labor, acquire capital, and make decisions about what to produce, how to produce, and how much to produce. Firms also make pricing and investment decisions.

Economic (decision-making) agents

Economic agents are individuals, entities, or groups that participate in economic activities by making decisions regarding the allocation of resources, production, consumption, and investment.

Governments:

- **Role**: Governments at various levels (local, regional, national) play a regulatory and interventionist role in the economy.
- **Function**: They collect taxes, provide public goods and services, regulate economic activities, and implement fiscal and monetary policies.

Economic (decision-making) agents

Economic agents are **individuals**, **entities**, or **groups** that participate in economic activities by making decisions regarding the allocation of resources, production, consumption, and investment.

Function: They facilitate the flow of money and credit in the economy by providing loans, managing deposits, and offering investment services.

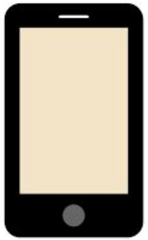
Function: They make decisions about employment, negotiate for better working conditions, and contribute to the production process. Labor unions advocate for the rights and interests of workers.

Individuals combine for collective consumption choices

Objects of choice and economic activities

In economic activity, individuals and organizations make choices about how to allocate scarce resources to satisfy their needs and wants. Commodities are called the objects of choice.

Goods are tangible products that have a physical presence and provide utility or satisfaction to consumers.



Services are intangible activities or tasks that are performed by one party for another, providing value or benefit without the transfer of a physical product.

Objects of choice and economic activities

In economic activity, individuals and organizations make choices about how to allocate scarce resources to satisfy their needs and wants. There are three types of economic activities.

Consumption is a fundamental economic activity that refers to the use of goods and services by individuals, households, or entities to satisfy their wants and needs. It is a critical component of the overall economic process and is often analyzed in the context of microeconomics, which focuses on the behavior of individual economic agents.

Production is a fundamental economic activity that involves the transformation of inputs (resources) into outputs (goods and services) to satisfy human wants and needs. It is a key element in the economic process, contributing to the creation of wealth and the overall growth of an economy.

Exchange is a fundamental economic activity that involves the transfer of goods, services, or assets between individuals, businesses, or governments. It is a core concept in economics and plays a crucial role in the allocation of resources, the formation of prices, and the functioning of markets.

Microeconomics and Macroeconomics (scope of economics)

Microeconomics is a branch of economics that focuses on the study of individual economic units, such as households, firms, and markets. It examines how these entities make decisions regarding resource allocation, production, consumption, and pricing in the context of supply and demand.

Macroeconomics is a branch of economics that studies the behavior, performance, and structure of an entire economy as a whole. Macroeconomics looks at broader aggregates, such as national income, employment, inflation, and overall economic output.

Ten principles of economics

How People Make Decisions
1: People Face Trade-offs
2: The Cost of Something Is What You Give Up to Get It
3: Rational People Think at the Margin
4: People Respond to Incentives

How People Interact
5: Trade Can Make Everyone Better Off
6: Markets Are Usually a Good Way to Organize Economic Activity
7: Governments Can Sometimes Improve Market Outcomes

How the Economy as a Whole Works
8: A Country's Standard of Living Depends on Its Ability to Produce Goods and Services
9: Prices Rise When the Government Prints Too Much Money
10: Society Faces a Short-Run tradeoff between Inflation and Unemployment

What would you (as a policy maker) trade off for?

What would you (as a policy maker) trade off for?

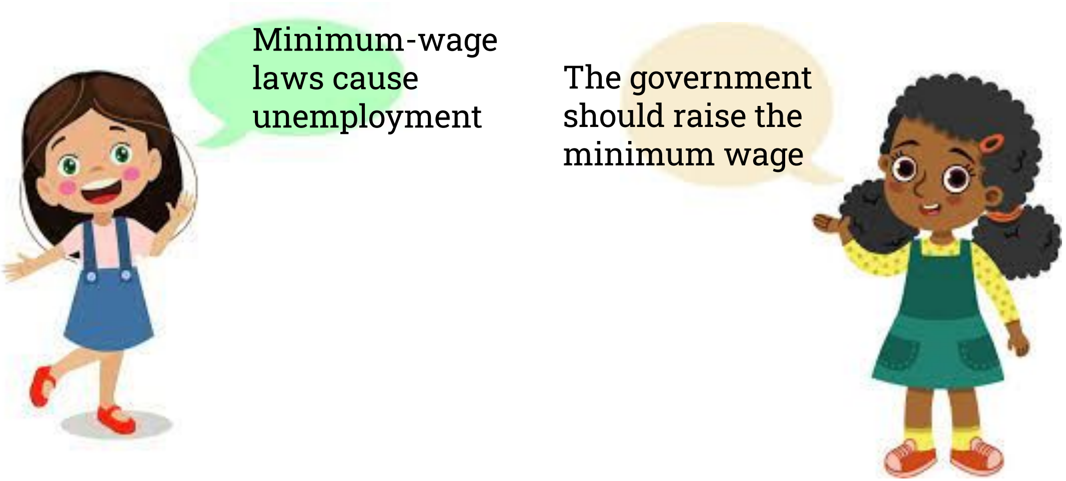
The Economist as policy advisor

- Economists trying to explain the world (**as scientists**)
- Economists trying to help improve the world (**as policy advisors**)

Who is talking like a scientist and who like a policy advisor?

The Economist as policy advisor

- Economists as scientists and as policy advisors use two languages: **positive and normative**
- **Positive (objective) statements** claims that attempt to describe the world as it is (using facts and figures, past and present comparison, description and explanation).
- **Normative (subjective) statements** claims that attempt to prescribe how the world should be (recommendations, ethical considerations, cannot be tested).



Who is making a positive statement and who a normative one?

The Economist as policy advisor

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The Economist as policy advisor

Who is making a positive statement and who a normative one?

Who is talking like a scientist and who like a policy advisor?

Central problems of the economy

WHAT TO PRODUCE	HOW TO PRODUCE	FOR WHOM TO PRODUCE
This question addresses the issue of resource allocation and decision-making regarding the goods and services to be produced in an economy. It involves choices about what types of products and services should be prioritized based on the needs and wants of the society.	This question focuses on the methods and technology used in the production process. It involves decisions about the most efficient and cost-effective ways to produce goods and services. Different economies may employ various production methods, and the choice can impact factors such as labor, capital, and technology utilization.	This question revolves around the distribution of goods and services among the members of society. It considers issues of income distribution, wealth inequality, and the criteria used to determine how resources are allocated to individuals or groups. Economic systems may differ in their approaches to addressing this question, ranging from market-based systems to centrally planned economies.

Economic Models: Circular flow diagram

Circular-flow diagram: a visual model of the economy that shows how dollars flow through markets among households and firms.

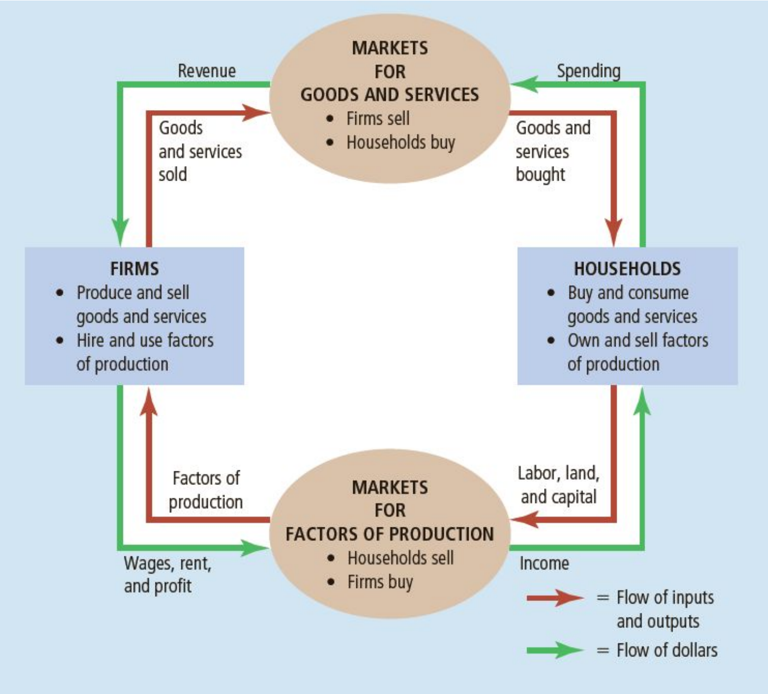
Households and firms interact in two types of markets: goods market and market for factors of production.

In the markets for goods and services, households are buyers, and firms are sellers.

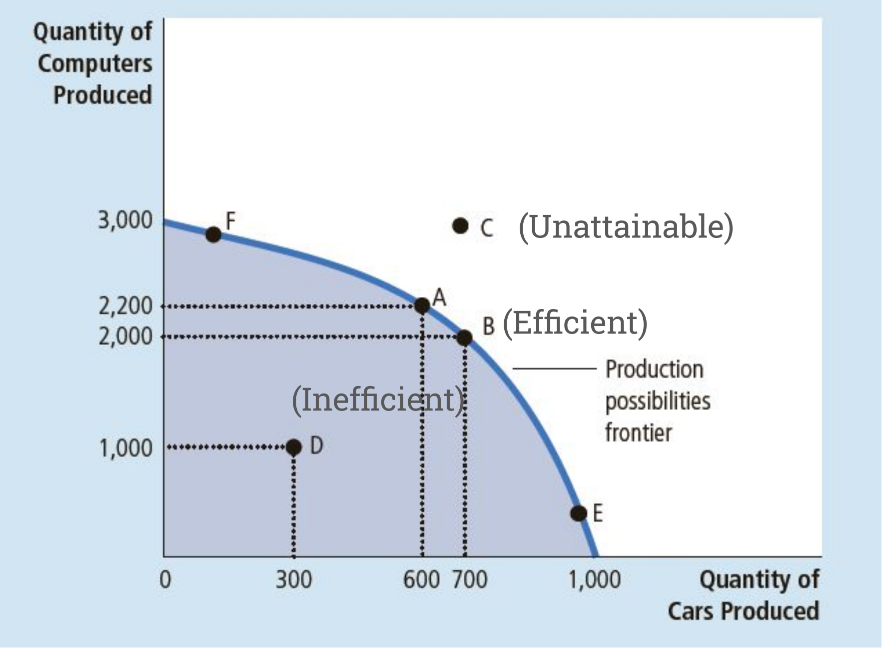
In the markets for the factors of production, households are sellers, and firms are buyers.

The inner loop represents the flows of inputs and outputs.

The outer loop of the diagram represents the corresponding flow of dollars. The households spend money to buy goods and services from the firms. The firms use some of the revenue from these sales to pay for the factors of production



Economic Models: The Production Possibilities Frontier



The production possibilities frontier shows the combinations of output—in this case, cars and computers—that the economy can possibly produce.

The economy can produce any combination on or inside the frontier.

Points outside the frontier are not feasible given the economy's resources.

The slope of the production possibilities frontier measures
the opportunity cost of a car in terms of computers.

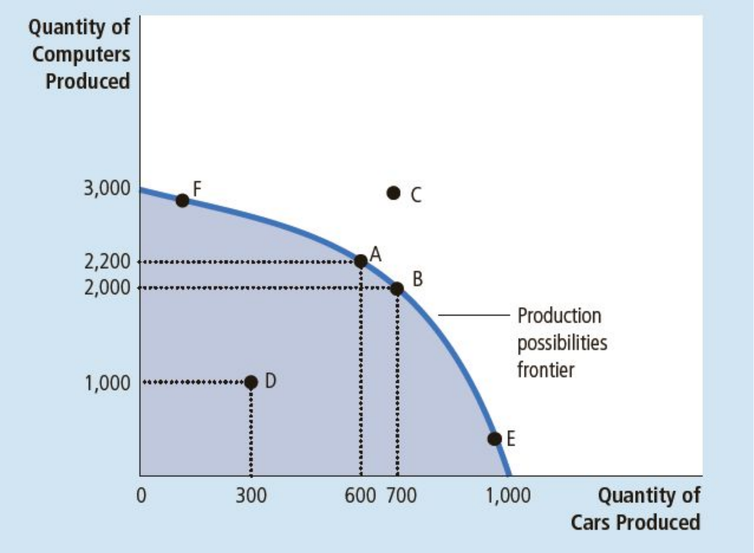
This opportunity cost varies, depending on how much of the two goods the economy is producing.

Efficient point: When the economy is producing at such a point, say point A, there is no way to produce more of one good without producing less of the other.

Inefficient point: the economy is producing less than it could from the resources it has available

Unattainable: when the economy does not have enough resources to produce the outputs, given the technology level.

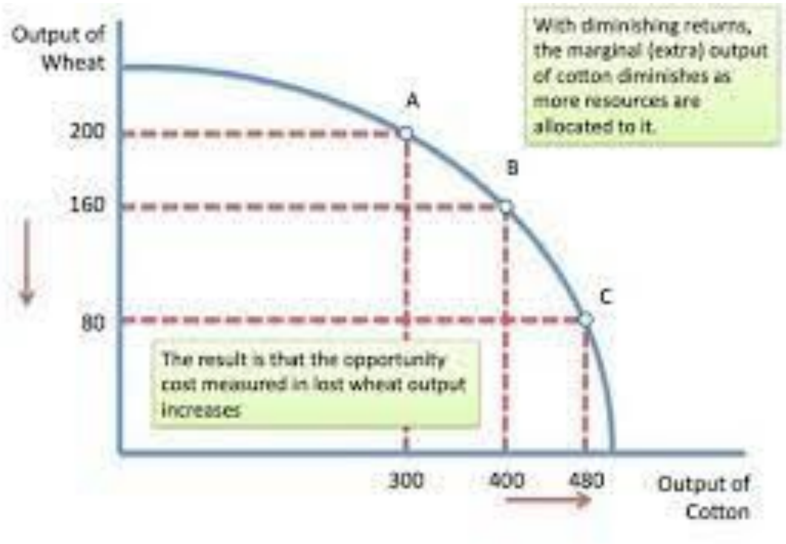
Economic Models: The Production Possibilities Frontier



When the economy is using most of its resources to make computers, the resources best suited to car production, such as skilled autoworkers, are being used in the computer industry. Because these workers probably aren't very good at making computers, increasing car production by one unit will cause only a slight reduction in the number of computers produced. Thus, at point F, the opportunity cost of a car in terms of computers is small, and the frontier is relatively flat.

By contrast, when the economy is using most of its resources to make cars, such as at point E, the resources best suited to making cars are already at work in the car industry. Producing an additional car means moving some of the best computer technicians out of the computer industry and turning them into autoworkers. As a result, producing an additional car requires a substantial loss of computer output. The opportunity cost of a car is high, and the frontier is steep.

Economic Models: The Production Possibilities Frontier



As the economy moves down the production possibilities frontier, it experiences *increasing marginal opportunity costs*.
As more resources are diverted (shifted) from wheat to cotton, the production of cotton will increases, but by smaller and smaller amounts (it is increasing at a decreasing rate). At the same time, more and more wheat is lost. The production of wheat is declining by greater and greater amounts: the opportunity cost is increasing.

From points A to B, additional 100 unit of cotton is produced giving up 40 units of wheat (slope 0.4).
From points B to C, additional 80 units of cotton are produced giving up 80 units of wheat (slope 1).

Economic Models: why increasing marginal opportunity cost

Study additional hour in the morning! Yes, you still have plenty of time to hang out by the river. **Opportunity cost is low.**

Study additional hour in late afternoon! Aww, it’s going to be dark soon. Can you go now? **Opportunity cost is high.**


every story has an end
but in life
every end is a new beginning