

. . . The word *economy* comes from a Greek word for “one who manages a household.”

A household and an economy face many decisions:

- Who will work?
- What goods and how many of them should be produced?
- What resources should be used in production?
- At what price should the goods be sold?

Society and Scarce Resources:

- The management of society’s resources is important because resources are scarce.
- *Scarcity*. . . means that society has limited resources and therefore cannot produce all the goods and services people wish to have.

***Economics* is the social science concerned with the efficient use of scarce resources to achieve the maximum satisfaction of economic wants.**

How people make decisions? (First four principles)

- People face tradeoffs.
- The cost of something is what you give up to get it. (Opportunity Cost)
- Rational people think at the margin: Choosing little more or less.
- People respond to incentives.

How people interact with each other? (next 3 principles)

- Trade can make everyone better off through specialization.
- Markets are usually a good way to organize economic activity.
- Governments can sometimes improve economic outcomes.

The forces and trends that affect how the economy as a whole works. (last three principles)

- The standard of living depends on a country's production.
- Prices rise when the government prints too much money.
- Society faces a short-run tradeoff between inflation and unemployment.

Principle #1: People Face Tradeoffs.

“There is no such thing as a free lunch!”

To get one thing, we usually have to give up another thing.

- Food v. clothing
- Leisure time v. work
- Efficiency v. equity

Efficiency means society gets the most that it can from its scarce resources.

Equity means the benefits of those resources are distributed fairly among the members of society.

Making decisions requires trading off one goal against another.

Principle #2: The Cost of Something Is What You Give Up to Get It.

- Decisions require comparing costs and benefits of alternatives.

Whether to go to college or to work?

Whether to study or go out on a date?

Whether to go to class or sleep in?

The opportunity cost of an item is what you give up to obtain that item.

LA Lakers basketball star Kobe Bryant chose to skip college and go straight from high school to the pros where he has earned millions of dollars.

Principle #3: Rational People Think at the Margin.

- Marginal changes are small, incremental adjustments to an existing plan of action.

People make decisions by comparing costs and benefits at the margin.

Suppose Department of Economics offers you a master degree if you take three more classes at the end of your college: Not bad deal!!!

Principle #4: People Respond to Incentives.

- Marginal changes in costs or benefits motivate people to respond: Comparisons of ***marginal benefits*** and ***marginal costs***.

When price of apple rises, people decide to eat more pears and fewer apples.

Discounts and Sales

- The decision to choose one alternative over another occurs when that alternative's marginal benefits exceed its marginal costs!

Principle #5: Trade Can Make Everyone Better Off.

- People gain from their ability to trade with one another.
- Competition results in gains from trading.
- Trade allows people to specialize in what they do best.

Principle #6: Markets are usually a good way to organize Economic Activity.

A market economy is an economy that allocates resources through the decentralized decisions of many firms and households as they interact in markets for goods and services.

- Households decide what to buy and who to work for.
- Firms decide who to hire and what to produce.

Adam Smith made the observation that households and firms interacting in markets act as if guided by an “*invisible hand*.”

Invisible hand = prices

- Because households and firms look at prices when deciding what to buy and sell, they unknowingly take into account the social costs of their actions.
- As a result, prices guide decision makers to reach outcomes that tend to maximize the welfare of society as a whole.

Principle #7: Governments Can Sometimes Improve Market Outcomes.

- *Market failure* occurs when the market fails to allocate resources efficiently.
- When the market fails (breaks down) government can intervene to promote efficiency and equity.

Market failure may be caused by

- an *externality*, which is the impact of one person or firm's actions on the well-being of a bystander.

A factory polluting air near residential area

- *market power*, which is the ability of a single person or firm to unduly influence market prices.

Monopoly: higher prices: lower consumer welfare

Principle #8: The Standard of Living Depends on a Country's Production.

Standard of living may be measured in different ways:

- By comparing personal incomes.
 - By comparing the total market value of a nation's production.
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- Productivity is the amount of goods and services produced from each hour of a worker's time.
 - Almost all variations in living standards are explained by differences in countries' productivities.

Principle #9: Prices Rise When the Government Prints Too Much Money.

- Inflation is an increase in the overall level of prices in the economy.
- One cause of inflation is the growth in the quantity of money.
- When the government creates large quantities of money, the value of the money falls.

Principle #10: Society Faces a Short-run Tradeoff Between Inflation and Unemployment.

- The Phillips Curve illustrates the tradeoff between inflation and unemployment: $\uparrow \text{Inflation} \Rightarrow \text{Unemployment} \downarrow$

It's a short-run tradeoff!

Summary

- When individuals make decisions, they face tradeoffs among alternative goals.
- The cost of any action is measured in terms of foregone opportunities.
- Rational people make decisions by comparing marginal costs and marginal benefits.
- People change their behavior in response to the incentives they face.
- Trade can be mutually beneficial.
- Markets are usually a good way of coordinating trade among people.
- Government can potentially improve market outcomes if there is some market failure or if the market outcome is inequitable.
- Productivity is the ultimate source of living standards.
- Money growth is the ultimate source of inflation.
- Society faces a short-run tradeoff between inflation and unemployment.

Thinking Like An Economist

- Every field of study has its own terminology:
 - *Mathematics*: integrals ❖ axioms ❖ vector spaces
 - *Psychology*: ego ❖ id ❖ cognitive dissonance
 - ***Economics***: supply ❖ opportunity cost ❖ elasticity ❖ consumer surplus ❖ demand ❖ comparative advantage ❖ deadweight loss

The economic way of thinking: a-) involves thinking analytically and objectively b-) makes use of the scientific method.

The Scientific Method: the systematic pursuit of knowledge through the formulation of a problem, collection of data, and the formulation and testing of hypotheses.

It consists of a number of elements:

- *Observation of facts (real world data)*
- *The formulation of possible explanations of cause and effect (hypotheses)*
- *The testing of these explanations (hypothesis)*
- *The acceptance, rejection or modification of the hypotheses.*
- *As favorable results accumulate, the hypotheses evolve into theory (sometimes referred to a model).*

Theoretical Economics: involves establishing economic theories by gathering, systematically arranging, and generalizing from facts. It is the process of deriving and applying economic theories and principles.

Generalizations:

Economic Theories, principles, and laws are generalizations relating to the economic behavior or to the economy itself.

Economic Principles are expressed as the tendencies of typical or average consumers, workers, or business firms.

For ex: *Consumer spending rises when personal income increases.*

Some HH may save all of an increase in their incomes. But on average, spending goes up.

The Role of Assumptions:

- Economists make assumptions in order to make the world easier to understand.
- The art in scientific thinking is deciding which assumptions to make.
- Economists use different assumptions to answer different questions.

Ceteris Paribus (Other Things Equal): *It is assumed that all other variables except those under immediate consideration are held constant for a particular analysis.*

Policy Economics: is the application of theories and data to formulate policies that aim to resolve a specific economic problem or achieve an economic goal.

Formulating Economic Policy:

- *State the goal* e.g. low inflation
- *Determine the policy options*
e.g. fiscal policy, monetary policy
- *Implement and evaluate the policy that was selected.*
e.g. Did a specific change in the money supply alter the inflation?

Economic Goals

- **Economic Growth**
- **Full Employment**
- **Economic Efficiency**
- **Price-Level Stability**
- **Economic Freedom**
- **Equitable Distribution of Income**
- **Economic Security**
- **Balance of Trade**

Tradeoffs across goals: To achieve one, sometimes we must sacrifice the other: For ex: *Efficiency & Equity*.

Microeconomics and Macroeconomics

- *Microeconomics* focuses on the individual parts of the economy.
 - How households and firms make decisions and how they interact in specific markets
- *Macroeconomics* looks at the economy as a whole.
 - Economy-wide phenomena, including inflation, unemployment, and economic growth

POSITIVE VERSUS NORMATIVE ANALYSIS

- *Positive statements* are statements that attempt to describe the world as it is.
- *Normative statements* are statements about how the world should be.
- Called prescriptive analysis (hint: ought to be, should)

Positive or Normative Statements?

1. An increase in the minimum wage will cause a decrease in employment among the least-skilled.
2. State governments should be allowed to collect from tobacco companies the costs of treating smoking-related illnesses among the poor.
3. Higher federal budget deficits will cause interest rates to increase.

