

INTRODUCTION TO ECONOMICS

The Economy and Economic Systems

WHAT IS ECONOMICS

Economics involves an exchange of goods and money, which are used as a medium from buyers and sellers. Individuals purchase goods and services for final consumption and provide the inputs into production, and all these individuals are collectively known as “**households**”.

The organizations which buy these factors and use them to produce goods and services are referred to collectively as “**firms**”.

The **amount of interaction** between households and firms the **economic activity**, which is the quantity of buying and selling that goes on in the economy over a period.

Households and firms engaging in **production** and **exchange** are referred to as the **economy**.

The economic process is usually characterized by households which **purchase** final goods and services for final consumption and provide the inputs to land, labour and capital for producing.

THE ECONOMIC PROBLEM

Economies have **resources** at their disposal which are classified as:

- **land** → all the **natural resources** of the earth such as oil and gas.
- **labour** → the **human effort** both mental and physical, that goes into production.
- **capital** → **equipment** and **structures** used to produce goods and services as machinery in factories.

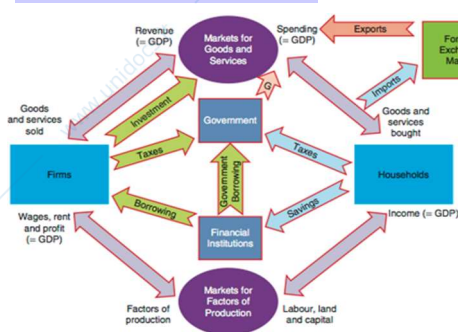
SCARCITY AND CHOICE

Resources are scarce in relation to the **demand** for them and demand for these wants and needs is generally greater than our ability to satisfy them.

Scarcity means that society has **limited resources** and therefore cannot produce all the goods and services households demand, and economics is used to study **how society manages its scarce resources**.

Because of the tension between people’s wants and needs, for this reason decisions must be made by households and firms about how to **allocate** incomes and resources to meet societies’ wants and needs.

THE CIRCULAR FLOW DIAGRAM



Households buy goods and services from firms.

Firms use money to pay for resources purchased from households.

When households receive **income**, some of the income is:

- **saved** (S) → providing funds for financial institutions;
- **taxed** (T) → used by the government in making purchases.

Products and services may be:

- **purchased** from other countries as **Imports** (M)
- **sold** abroad as **Exports** (X)
- used by businesses to **invest** (I) them in new **capital**.

How People Make Decisions

PEOPLE FACE TRADE-OFFS

Households and firms must make **choices**. Making choices involves **trade-offs**. A trade-off is the **loss** of the benefits from a decision to forego or sacrifice one option, balanced against the benefits incurred from the choice made.

An important trade-off is that one between:

- **efficiency** → deals with the **maximum** that society can get from a small resource.
- **equity** → deals with the **distribution** of resources fairly between society’s members.

OPPORTUNITY COST

Making decisions requires **comparing** the costs and benefits of alternative courses of action, and the **opportunity cost** introduces the concept of **profit** and of **costs** where, in economic choices, people compare costs with benefits, comparing the **value** of what they get and what they lose.

It's important to understand which costs are useless and which are not, because the opportunity cost of a choice is represented by a **lost used to obtain a benefit**.

$$\text{Opportunity cost of good } y = \frac{\text{Sacrifice of good } x}{\text{Gain in good } y}$$

Opportunity cost is the cost expressed in terms of the next **best alternative sacrificed**, so what must be given up in order to acquire something.

THINKING AT THE MARGIN

Thinking at the margin make people decide by comparing costs and benefits at the margin, which describe **small incremental adjustments** to an existing plan of action.

Marginal analysis is based around an assumption that economic agents are seeking to **maximize** or **minimize** outcomes when making decisions.

Consumers may be assumed to seek to maximize the satisfaction they gain from their incomes, and firms to maximize profits and minimize costs.

The **marginal change** is a tiny concept and a technical approach which use analytical tools, that doesn't change the initial meaning, but **can marginally change its sense** by incrementing.

Thinking at the margin means that decision-makers choose a course of action such that the marginal cost is equal to the marginal benefit, and to do the best they can with their existing resources they use **rationality**, which is the **assumption** that decision-makers can make consistent choices between alternatives.

PEOPLE RESPOND TO INCENTIVES

A marginal change **motivates** anyone choices, motivating in a good or in a bad way people and their decisions. People make decisions by comparing costs and benefits, it is logical to assume that their behaviour may change when the costs or benefits change.

Economics decisions affect con people behaviour, so **people respond to incentives**.

How People Interact

TRADE CAN MAKE EVERYONE BETTER OFF

Trade is not something in which a part gains and the other loses, but it allows anyone to gain by motivating people to **specialize** in what they do best.

Trade between economies can make **all better off**.

Households, firms and countries have different resource endowments; individuals have talents and skills that allow them to produce some things more efficiently than others.

Trade allows individuals, firms and countries to specialize in the activities **they do best**. With the income they receive from specializing they can trade with others who are also specializing and can improve their **standard of living** as a result.

In an economic point of view the concept of **comparative advantage** stays on the concept of **specializing** in something which benefits are greater, because it's useless to spend time in activities which can't produce something convenient.

Specializing in something that can become an opportunity cost and not in something that can transform itself in a loss is one of the main points of economics.

THE CAPITALIST ECONOMIC SYSTEM

An **economic system** is the way in which resources are organized to **provide for the needs** of an economy's citizens.

A **capitalist economic system** incorporates the **principles of the private ownership** of factors of production to produce goods and services which are exchanged through a price mechanism.

The **profit** motive provides an incentive for entrepreneurs to **take risks** to organize factors of production.

MARKETS OFTEN ARE AN EFFICIENT WAY TO ORGANIZE ECONOMIC ACTIVITY

A market economy is an economic system in which there is an **allocation of resources** that decentralize decisions of different firms and household as they interact in markets for services.

The role of markets in capitalist economic systems is **central**.

In a market economy economic problems are addressed 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, while firms decide what to produce.

In a pure market economy (one **without any government intervention**) no one is considering the economic well-being of society as a whole, in fact in economic choices no one decides for the well-being of the whole society, but just for **personal interests**.

In 1776 Adam Smith observed that firms and household interact in economy just for their **own gain**, led by an "invisible hand" which guides self-interest into promoting society's economic well-being.

Market prices reflect the value of a product to customers and the cost of the resources used to produce it because firms and household look at both prices when deciding what to buy and what to sell.

The consumers base their ration on the prices of the costs and the value, cause prices reflect costs and benefits.

When there are government interventions the prices are not always pure, because they are contaminated by the price control, like **imposes taxes**, in these cases households and firms' decisions are inefficient.

GOVERNEMENTS CAN SOMETIMES IMPROVE MARKET OUTCOMES

Markets are a good way to organize economic activity, but sometimes the government can intervene to **promote equity and efficiency**.

Sometimes markets fail, and a market failure is caused by a **wrong allocation of resources** which is not efficient. The market failure can be generated by:

- an externality → actions of consumption or production impact of the well-being of **third party** non-involved, as pollution.
- a market power → the ability of a single economic agent (or small group of agents) to have a substantial **influence on market** prices or output.

How The Economy as a Whole Works

MICROECONOMICS AND MACROECONOMICS

The field of economics has been divided into two broad subfields:

- Microeconomics is the study of how households and firms **make decisions** and how they **interact** in specific markets.
- Macroeconomics is the study of **economy-wide phenomena**, including inflation, unemployment and economic growth.

AN ECONOMY'S STANDARD OF LIVING DEPENDS ON ITS ABILITY TO PRODUCE GOODS AND SERVICES

A key concept in macroeconomics is the "economic growth" which is the **increase** in the number of goods and services produced in an economy over a period of time.

One **measure of the economic well-being** of a nation is given by gross domestic product (GDP) per capita (per head) of the population.

The GDP is represented by the market value of all final goods and services produced within a country in a period of time divided by the population of a country.

The growth of the GDP is given by the **economic growth**, which is the increase in the amount of goods and services in an economy over a period.

The **average income** is reflected in various other measures of the quality of life and standard of living, which is welfare based on the amount of good and services that a person can buy with his own income, calculated on the real income per capita of the population.

Living standards are different from country to country because of its productivity.

The relationship between productivity and living standards also has profound implications for public policy, because if the policy makers **improve** education and training and invest in technology, **productivity increases**.

PRICES RISE WHEN THE GOVERNMENT PRINTS TOO MUCH MONEY

Inflation is an increase in the overall level of prices in the economy, which is usually caused by the **growth of quantity of printed money**.

High inflation is a problem because it **imposes** various costs on society, keeping inflation at a low level is a goal of economic policymakers around the world.

In these cases, when a government creates large quantities of the nation's money, without any corresponding increase in output or productivity, money lose value, and the prices increase, imposing society higher costs.