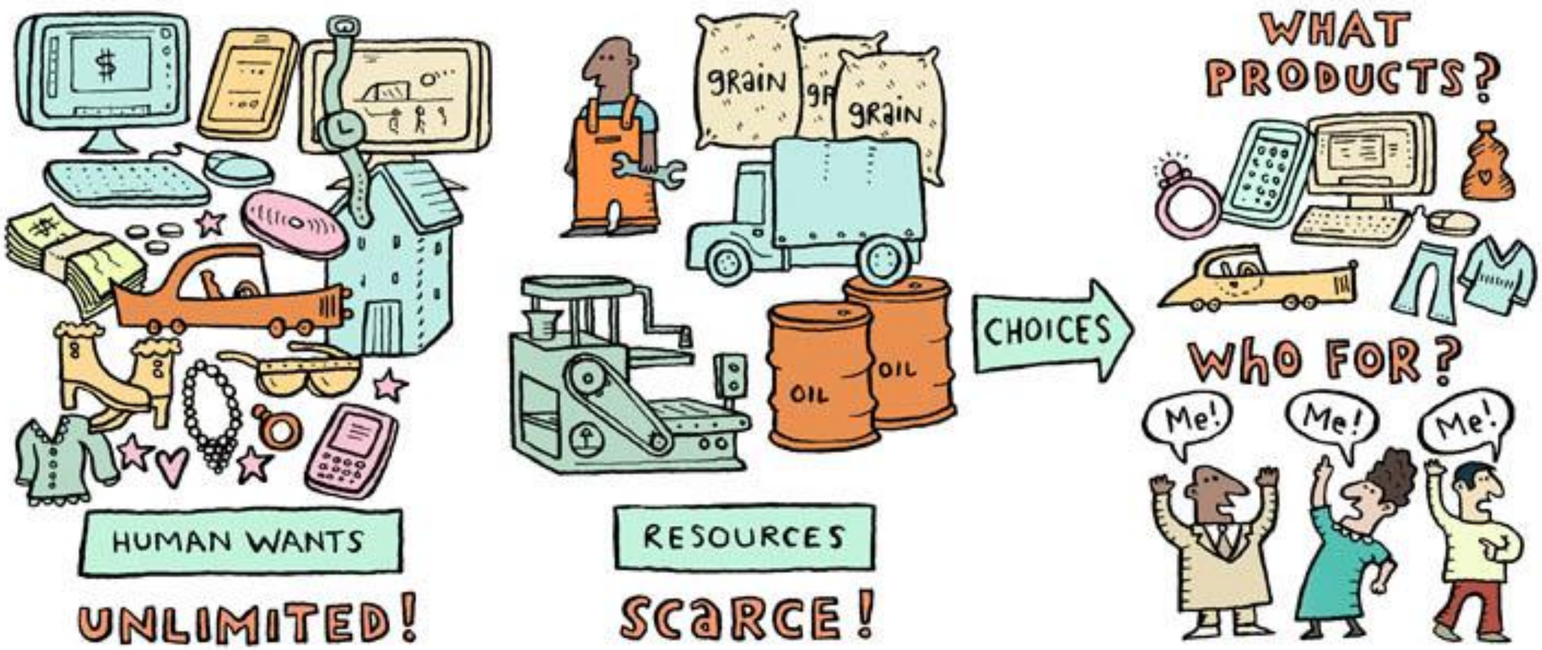
Introduction to Economics

What is Economics?

- What do you think we will cover in this course?
  - What will happen when natural minerals and ores such as oil, zinc, copper and aluminum eventually run out?
  - Why do famous footballers such as David Beckham earn more than most doctors?
  - Why do food and energy prices keep rising but the prices of large-screen T.V’s keep falling?

The basic economic problem

Human wants are unlimited but resources are scarce



Introduction to Economics

What is Economics?

Scarcity - definition: *something is scarce when it is both* desirable *and* limited.

Not all goods are scarce. Some goods that humans consume are infinite... Place the following words under the correct category, Scarce or Not Scarce

Scarce or not scarce?

Murderers
Computers
Swiss francs
factory workers
Water
HIV
Oxygen
Mosquitos
British Pounds
Doctors
Creativity
Nitrogen

Sewing machines
Diamonds
Worms
Happiness
Apartments in Zurich
Love
Clouds
Teachers
Dirt
Football players
Air

Your first economics riddle: The Diamond/Water Paradox

Something to think about:

- Nobody needs diamonds, yet they are EXTREMELY EXPENSIVE
- Everybody needs water, yet it is EXTREMELY CHEAP

Why are diamonds so expensive?

Why is water so cheap?

Free goods and economics goods

What is meant by "goods" in economics?

- Goods are...

the stuff people WANT because it make us feel GOOD!

- *Haircuts, cars, toothbrushes, TVs, movies, happiness, shoes, vacations, friendship, hamburgers, love, jewelry, education, air (to breathe, duh!), fresh water, public transportation, sunshine, etc...*

Some goods are ECONOMIC goods: Scarce resources are used in the production of economic goods.

Some goods are FREE goods: The resources used in the production of free goods are NOT scarce. Usually, free goods are those things you enjoy that you don't have to pay for!

From the list above, identify which are FREE and which are ECONOMICS goods

Free goods or Economic goods

Introduction to Economics

What is Economics?

Economics is about...

Scarcity: Economics is about the allocation of scarce resources among society's various needs and wants.

Resources: Economics is about the allocation of resources among society's various needs and wants.

Tradeoffs: individuals and society as whole are constantly making choices involving tradeoff between alternatives. Whether it's what goods to consume, what goods to produce, how to produce them, and so on.

Opportunity Cost: "*the opportunity cost is the opportunity lost*". In other words, every economic decision involves giving up *something*. NOTHING IS FREE!!

The Basic Economic Problem:

Humans' wants are unlimited, while the resources needed to meet those wants are limited and scarce

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What is Economics?

Economics is about…

Producers (firms) and consumers (households): The economy is made up of these two major groups (there's also government, but that comes later). Most interactions in the marketplace are between households (that's us) and firms (that's the companies who make the stuff we demand)

Supply and Demand: Economics is about supply and demand. We (households) are the demanders and they (firms) are the suppliers. The price we pay is determined by the level of demand and the level of supply of any particular good.

Trade and exchange: Without trade, none of us would be here right now. Economics will help you understand how trade makes everyone better off

Markets: Markets are where all economic transactions take place. There are many different kinds of markets, some more competitive than others

Your first lesson in Economics - SCARCITY EXISTS

All resources are limited, yet human wants are unlimited.

Economics is the science devoted to dealing with the problem of scarcity.

Opportunity cost

Opportunity cost is the cost of choice

- What would you buy with US$10?
- How should the government spend US$250 million?

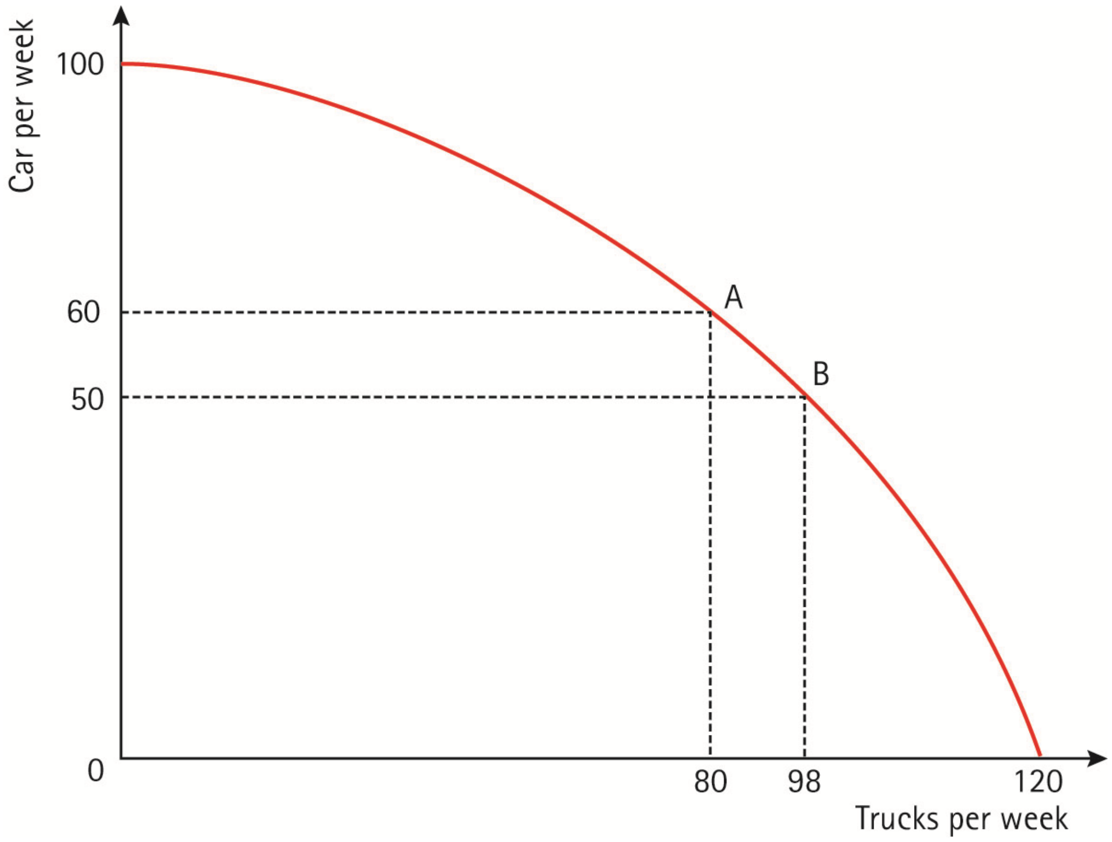
  (Or, should the government cut taxes by US$250 million?)
- What occupation will you choose when you finish your studies?
- How should a new business invest US$20 million?
- Should we conserve more natural resources?

… and what are the next best alternatives foregone?

Production possibility curves

A firm producing cars and trucks

What is the opportunity cost of producing 20 more trucks?



Production possibility curves

- Production possibility curves (PPCs) show the maximum combined output of two or more products a firm or an entire economy can produce with its available resources
- Resources are being used **efficiently** if they are producing their maximum output
- But, because resources are limited, producing more of one product means producing less of another
- PPCs are therefore a useful way of showing the opportunity cost of producing more of one product in terms of how much of another must be given up

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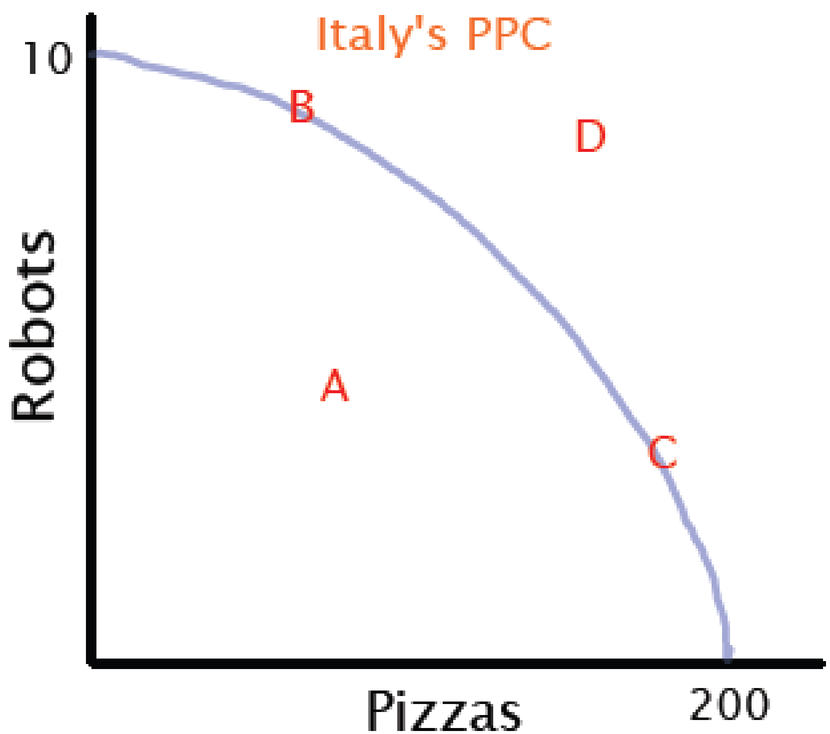
The Production Possibilities Curve

What is the PPC?

The PPC illustrates the possible combinations of goods or services that can be produced by a single nation, firm, or individual using resources efficiently



What does it show?

That nothing is free and that everything has an opportunity cost. If society wants more pizzas, it must give up robots.

What basic economic concepts can it be used to model?

- Scarcity, tradeoffs, opportunity cost, economic growth, efficiency, unemployment.

Understanding the PPC: The graph above shows that Italy can produce EITHER 10 robots OR 200 pizzas, or some combination of the two products, as long as it remains on or within its PPC. A point inside the PPC is attainable but not desirable. A point outside the PPC is desirable but unattainable.

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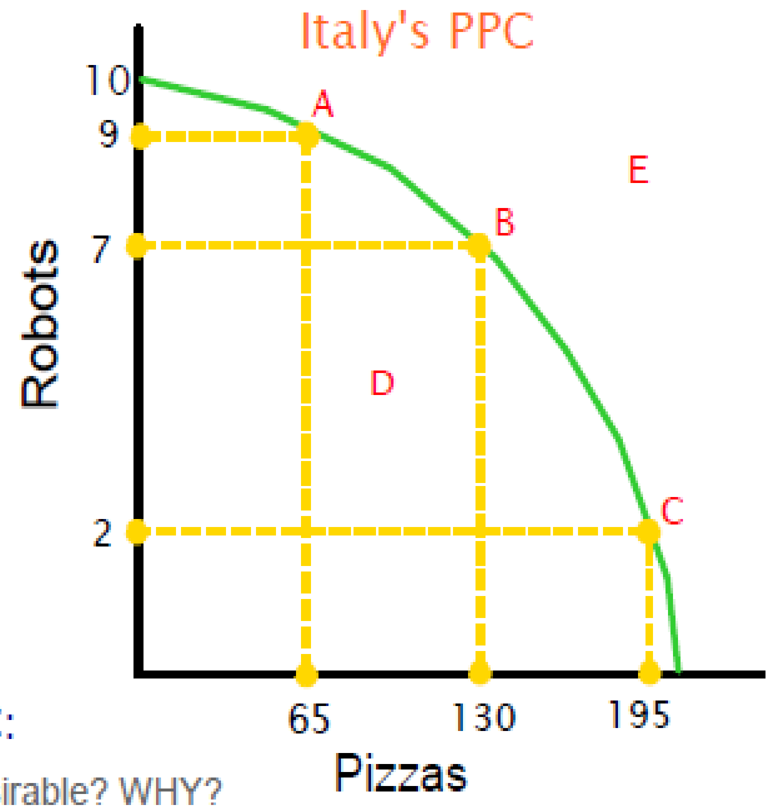
The Production Possibilities Curve

Assumptions about the PPC:

- The PPC is attainable only if a nation achieves full-employment of its productive resources
- The nation's resources are fixed in quantity
- Assumes the nation must chose between only two goods
- The economy is closed, i.e. does not trade with other countries
- Represents only one country's economy



Questions to consider about the PPC:

1) Which point(s) are attainable and desirable? WHY?
2) Which point(s) are attainable but not desirable? WHY?
3) Which point(s) are unattainable? Is this point desirable? Explain.
4) Which point will mean more consumption in the future? Explain.
5) Which point means more consumption now? Explain.
6) Why is the PPC bowed outwards?
7) How does the PPC illustrate opportunity cost? Tradeoff? Scarcity?

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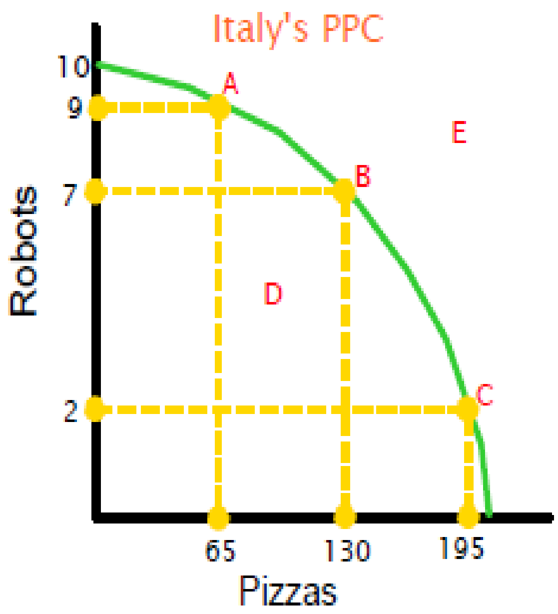
The Production Possibilities Curve



1) Which point(s) are attainable and desirable?

- Points on the PPC (A, B and C) are attainable through full employment, and thus desirable because they represent efficient use of Italy's resources.

2) Which point(s) are attainable but not desirable?

- Point D is inside the PPC, thus represents inefficient use of resources, and most likely high unemployment, and is thus undesirable.

3) Which point(s) are unattainable? Is this point desirable?

- Point E is beyond Italy's production possibilities and is thus unattainable. It is desirable because it represents greater consumption of both pizzas and robots.

4) Which point will mean more consumption in the future?

- Point A represents more consumption in the future, because Robots are a capital good, used to make other products for consumption. If Italy produces more robots now, it may mean more consumer goos in the future.

5) Which point means more consumption now?

- Point C because pizza is a consumer good. Households don't buy and use robots, but they do like to eat pizzas.

6) Why is the PPC bowed outwards?

- The Law of Increasing Opportunity Cost

Introduction to Economics

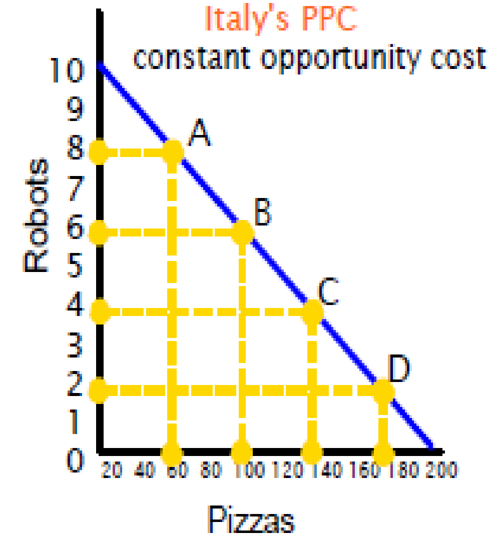
The Production Possibilities Curve

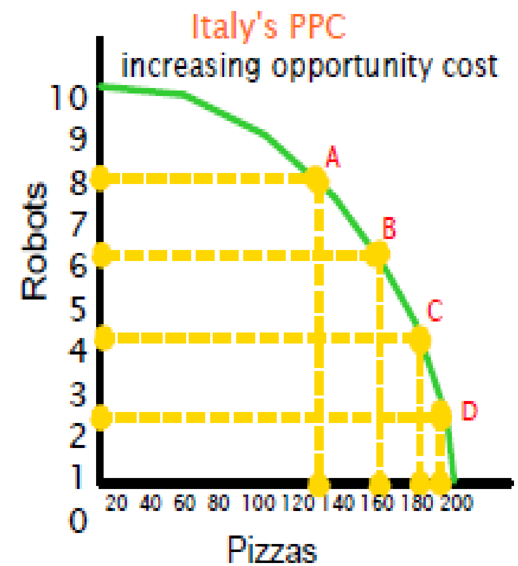
Law of increasing opportunity cost:
As the production of a particular good increases, the opportunity cost of producing an additional unit rises.

Rationale: *Economic resources are not completely adaptable to alternative uses. Many resources are better at producing one type of good than at producing others.*

Pizzas and Robots:

Assume Italy was producing 200 pizzas and 0 robots. Surely, many of the resources (land, labor and capital) being used to make pizzas would be better suited to making robots. As Italy starts making its first two robots it has to give up very few pizzas, since only those resources that are suited for robot production will be used. At first, 2 robots "cost" Italy only 5 pizzas. But as the country makes more and more robots, the opportunity cost increases, because at some point pizza makers will have to build robots. As Italy approaches 10 robots, the opportunity cost of the last two robots is 130 pizzas, as resources better suited for pizza production are employed in robot factories.





Resource allocation

Because productive resources are scarce relative to human wants we must decide:

What to produce?	How to produce?	Who to produce for?
Should we use resources to produce as many consumer goods as possible or allocate some resources, for example, to build new roads or to provide better health care?	What tools and machinery will be needed? How many workers will be required and what skills will they need? Is it cheaper to employ more labour or more machinery?	Should people in the greatest need get the goods and services they require? Or should they be produced for people who can pay the most for them? What price should they pay?

Problem Solving

- Remember the groups of problems you faced as survivors on a desert island
- Copy out the table and write down your solutions posed in each column. The first is completed for you

What to produce?	How to produce?	For whom to produce?
Build shelter	**Everyone helps using large palm leaves**	**Everyone shares a shelter**

Who decides and how they decide the ‘answers’ to these questions in an economy is referred to as the economic system

Economic systems

Who in an economy decides what goods and services to produce, how to produce them and who to produce them for, and how are these decisions are made?

A Pure Market economy	Mixed economy	Planned / Command economy
Who? Private sector firms and consumers *How?* The price mechanism	*Who?* Private sector firms and consumers, and a government *How?* The price mechanism and government planning	*Who?* Government *How?* Government planning

All countries have a government therefore most countries have a mixed economy

Price mechanism is an economic term that refers to the manner in which the prices of commodities affect the demand and supply of goods and services

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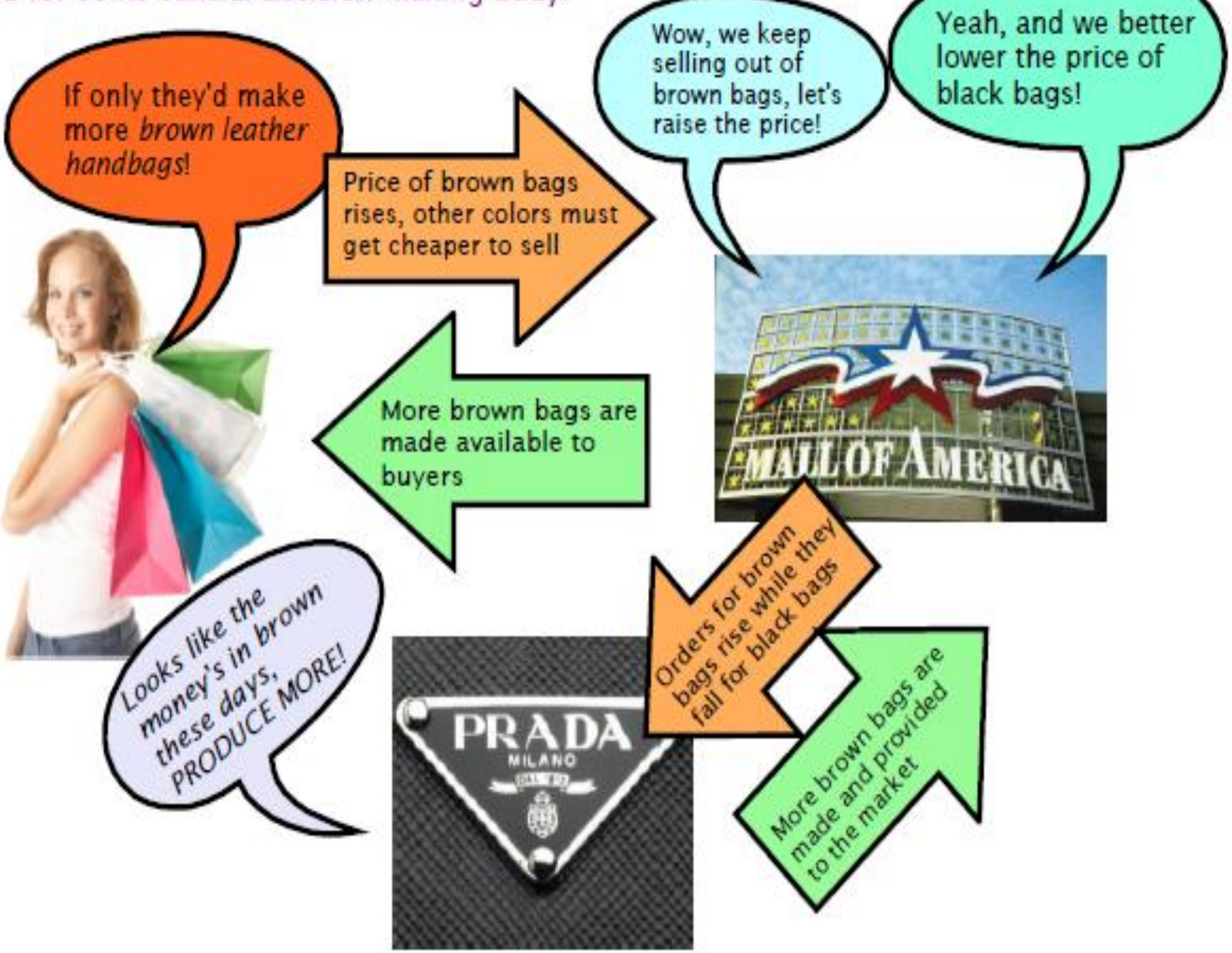
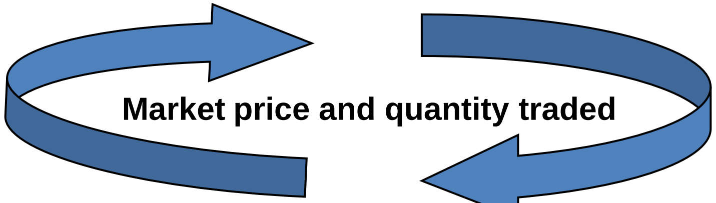
the Price Mechanism

Prices: Prices are *signals* from buyers to sellers. Prices help allocate resources towards their most efficient uses. Through the price mechanism, the wants and needs of man are satisfied *without* the need for some central decision making body.



The price mechanism

A **market** is any set of arrangements that brings together all the producers and consumers of a good or service so that they can engage in exchange.



Consumers consume goods and services to maximize their utility (satisfaction)

Private firms produce goods and services to maximize their profits

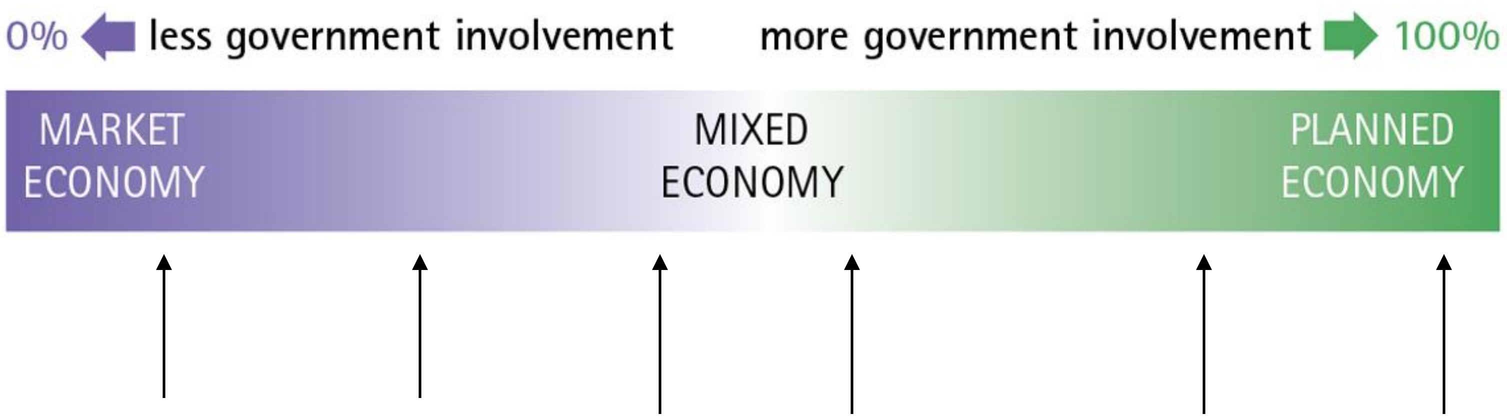
As consumer demand for a product rises — **MARKET PRICE RISES** — Production becomes more profitable, so producers increase output

As consumer demand for a product falls — **MARKET PRICE FALLS** — Production becomes less profitable, so producers reduce output

The price mechanism

- In a market economy, high or rising prices provide firms with important signals about what consumers want and are willing to pay for, and therefore which products will be profitable to make and sell. Likewise if the market price and profitability is falling because consumer demand is falling because is consumer demand shrinking.
- Therefore in the market system it is this price mechanism that guides the many decisions taken by producers and consumers about how scare resources should be allocated.
- The desire by private firms to make profits and the preferences and spending patterns of consumers will determine what goods and services are produced, how they are produced, and who they are produced for.

Economic systems



Bahamas
Singapore

Argentina
Mauritius
Nepal
Paraguay

Denmark
France
Italy
Sweden
UK
Many developed economies

China
Cuba

North Korea

The market economic system

Consumers

Goods and services

Money

Private sector producers

Consumption | **Exchange** | **Production**

In a **free market economic system** all decisions are taken by **private sector** organizations and individuals. There is little or no role for government or a **public sector** and therefore little or no taxation or public spending.

Economic systems

Property rights

Limited government role

Communism

entrepreneurship

Government ownership of property

Freedom of Choice

Socialist

North Korea

Self interest

China

Competition

Profit motive

Central Planning

Capitalist

Rationing system

USA

State owned enterprises

Economic systems

Limited government role

Self interest

Communism

USA

Socialist

entrepreneurship

North Korea

Central Planning

Profit motive

Government ownership of property

Competition

Freedom of Choice

China

Property rights

State owned enterprises

Capitalist

Rationing system

What’s good about the market system?

- A wide variety of goods and services will be produced to satisfy consumer wants
- Firms respond quickly to changes in consumer wants and spending patterns
- The profit motive of firms encourages them to develop new products and use the most efficient methods of production
- There are no taxes

If consumer demand is rising, prices will rise and production becomes more profitable. Entrepreneurs will allocate resources to their most profitable uses

Profits can be increased by increasing sales and/or reducing costs of production

There is no public sector in a totally free market economic system

How the market system can fail

Market failure: when free markets fail to produce goods and services that are worthwhile or when the decisions of producers or consumers result in wasteful or harmful activities

Firms will only produce goods and services if they are profitable	**Firms will only supply products to consumers who are able to pay for them**	**Resources will only be employed if it is profitable to do so**

How the market system can fail

Market failure: when free markets fail to produce goods and services that are worthwhile or when the decisions of producers or consumers result in wasteful or harmful activities

Harmful goods may be produced if it is profitable to do so	**Some producers and consumers may ignore the harmful effects of their activities on others and the environment**	**Some firms may restrict competition, mislead consumers and charge them very high prices**

Firms will only produce goods and services if they are profitable

Firms will only supply products to consumers who are able to pay for them

Resources will only be employed if it is profitable to do so

Harmful goods may be produced if it is profitable to do so

Some producers and consumers may ignore the harmful effects of their activities on others and the environment

Some firms may restrict competition, mislead consumers and charge them very high prices

How the market system can fail

- Using the handout "How can market system fail" describe or demonstrate market failures consistent with those shown in the slide presentation from last class
- Use the market failures from the handout and identify some ways a government might be able to solve them.

Activity: Market Failure

Headline	Type of Market Failure	How govt. intervention might solve the problem
World's top firms…….	Some producers and consumers may ignore the harmful effects of their activities on others and the environment	Introduce regulations and organizations to monitor pollution output.

The mixed economic system

In a **mixed economy** a **government** can intervene in different markets in an attempt to correct the worst market failures:

✓It can provide useful and essential goods and services

✓It can provide goods and services for people in the greatest need

✓It can employ people in **public sector organizations** and provide financial support to private sector firms to boost output and employment

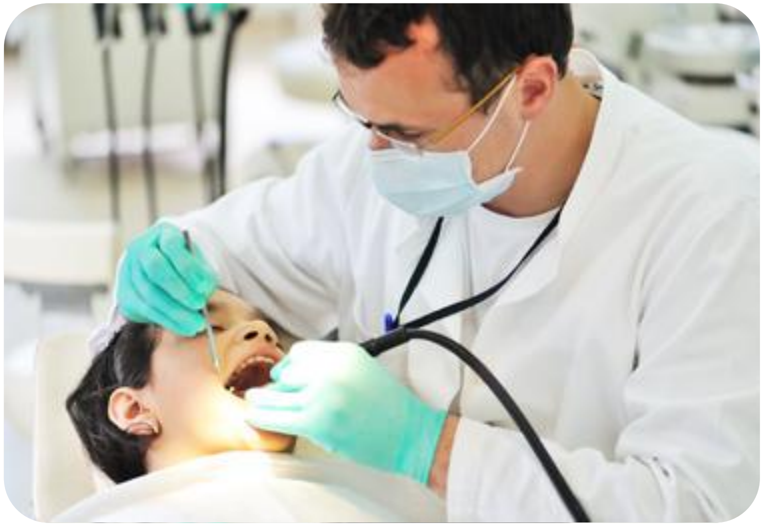
✓It can outlaw the production of harmful goods and dangerous activities

✓It can outlaw business practices that restrict competition or mislead consumers

The mixed economic system

A mixed economy therefore combines the advantages of a market economic system with:

- government ownership and control of some scarce resources
- government interventions to regulate the actions of private sector firms and consumers in some markets



Government intervention: some problems

By correcting failures in some markets, a government may distort the allocation of resources and cause problems in others:

X High taxes on people and firms can distort market price signals and reduce work incentives

X Land regulations can increase production costs and therefore reduce the profitability and supply of some goods and services

X Public sector organizations may be inefficient and produce poor-quality goods and services because they do not have to make a profit

X Some government spending may be for political or even personal gain

Key point summary

- The market for a particular good or service consists of all those producers willing and able to supply it and all those consumers willing and able to buy it.
- Producers use market price signals to determine what is profitable. Rising consumer demand for a product will tend to increase its price and profitability.
- Most private sector firms aim to maximize their profits. Consumers aim to maximize their satisfaction or utility.
- A market economy will profit a wide variety of goods and services IF it is profitable to do so, but only for those with the ability to pay.
- Market failures may cause scarce resources to be allocated to uses that are wasteful or even harmful to people or the environment.
- A government can intervene to provide employment and subsides to allocate scarce resources and services for those in need.
- But government intervention can create its own problems: taxes can reduce incentive to work, regulations can impose costs on firms which reduce output, etc. Plus public sector organizations may be inefficient as they do not have to make a profit.