

ECONOMIC PRINCIPLES

*ECO10004 Essential Course Notes
2016*

- Key Concepts & Market Forces
- Elasticity
- Cost of Production
- Perfect Competition
- Market Power
- Oligopoly and Market Failure
- GDP and Economic Growth
- Unemployment and Inflation

Table of Contents

| | |
|--|----|
| 1 – Key Concepts and Market Forces..... | 3 |
| The Interaction Of Demand And Supply | 5 |
| The demand side of the market →..... | 5 |
| The supply side of the market →..... | 6 |
| Comparative Advantage and Trade | 8 |
| Market Equilibrium | 9 |
| 2 – Elasticity | 11 |
| Price Elasticity of Demand | 11 |
| The Variety of Demand Curves | 11 |
| Other Demand Elasticities..... | 13 |
| Price Elasticity of Supply | 13 |
| The Determinants of the Price Elasticity of Demand..... | 14 |
| The Relationship Between Price Elasticity and Total Revenue..... | 15 |
| Key determinants of the price elasticity of supply | 15 |
| The Relationship Between Price Elasticity and Total Revenue..... | 16 |
| 3 – Cost of Production..... | 17 |
| The Short Run..... | 17 |
| Graphing Cost Curves..... | 19 |
| Typical Cost Curves | 19 |
| Costs In The Long Run | 20 |
| Economic Profit vs. Accounting Profit..... | 21 |
| Summary | 21 |
| 4 – Perfect Competition..... | 22 |
| Market Structures | 22 |
| Perfectly Competitive Market..... | 23 |
| How A Firm Maximises Profit In A Perfectly Competitive Market..... | 23 |
| Revenue For A Firm In A Perfectly Competitive Market..... | 24 |
| Market structure And Profit Maximisation..... | 24 |
| Illustrating Profit Or Loss On The Cost Curve Graph..... | 25 |
| Deciding Whether To Produce Or To Shut Down In The Short Run..... | 25 |
| The Entry And Exit of Firms In The Long Run..... | 26 |
| Efficiency | 27 |

| | |
|--|----|
| 5 – Market Power..... | 28 |
| Market Power And Technological Change..... | 28 |
| Monopolistic Competition | 29 |
| Competition With Differentiated Products..... | 30 |
| Advertising | 30 |
| Brand Names..... | 31 |
| 6 - Oligopoly and Market Failure | 32 |
| The Equilibrium For An Oligopoly | 32 |
| Game Theory And The Economics Of Cooperation | 32 |
| Externality And Efficiency | 33 |
| Government Policies To Deal With Externalities | 34 |
| Market Failure And Government Failure | 35 |
| 7 - GDP And Economic Growth..... | 36 |
| Measuring GDP | 36 |
| Components of GDP..... | 37 |
| Real GDP v Nominal GDP | 37 |
| Economic Growth Rate | 38 |
| Labour Productivity..... | 38 |
| Potential GDP..... | 38 |
| Shortcomings Of GDP As A Measure Of Total Production..... | 39 |
| New Growth Theory..... | 39 |
| Is Economic Growth Good Or Bad?..... | 40 |
| 8 - Unemployment and Inflation..... | 41 |
| Measuring The Unemployment Rate..... | 41 |
| Problems With Measuring The Unemployment Rate..... | 41 |
| Trends | 41 |
| Job Creation And Job Destruction..... | 42 |
| Costs Of Unemployment To The Economy And Individuals | 42 |
| Measuring Inflation..... | 43 |

1 – Key Concepts and Market Forces

Economics: The study of the choices and interactions consumers and societies make in the market in order to satisfy their wants, given their scarce resources.

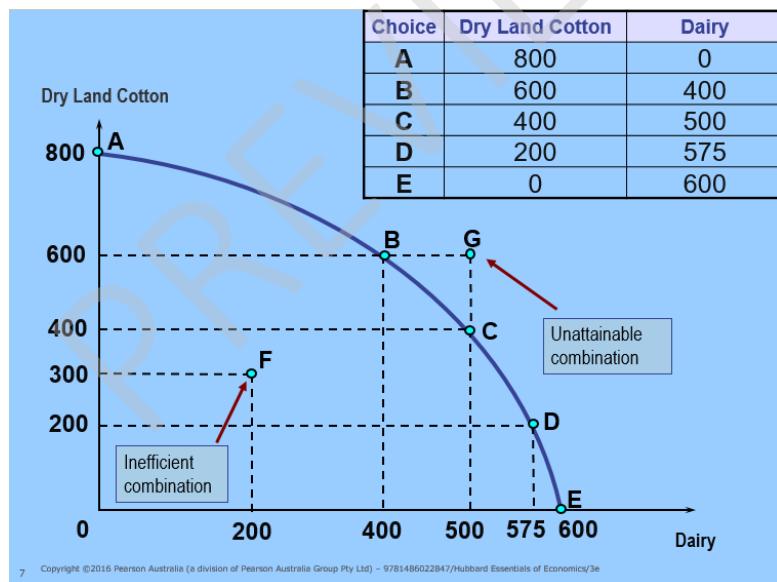
Scarcity: A situation in which unlimited wants exceed the limited resources available to fulfill those wants.

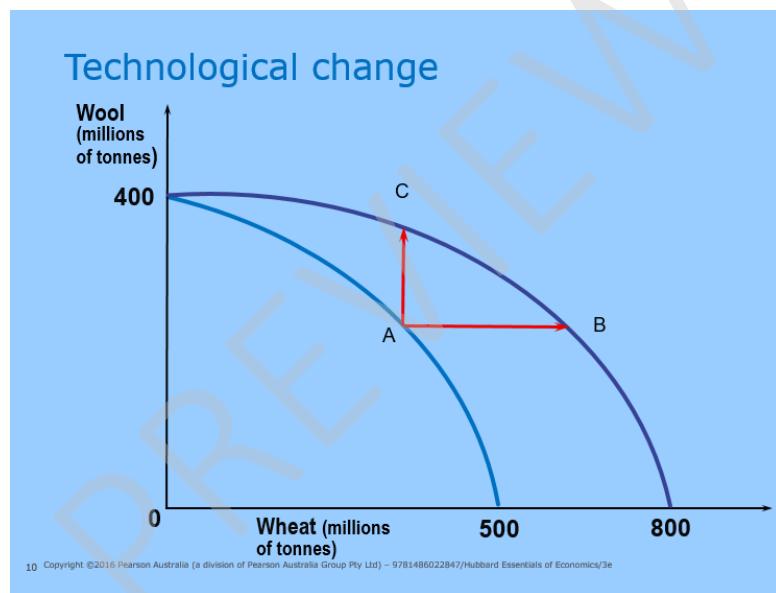
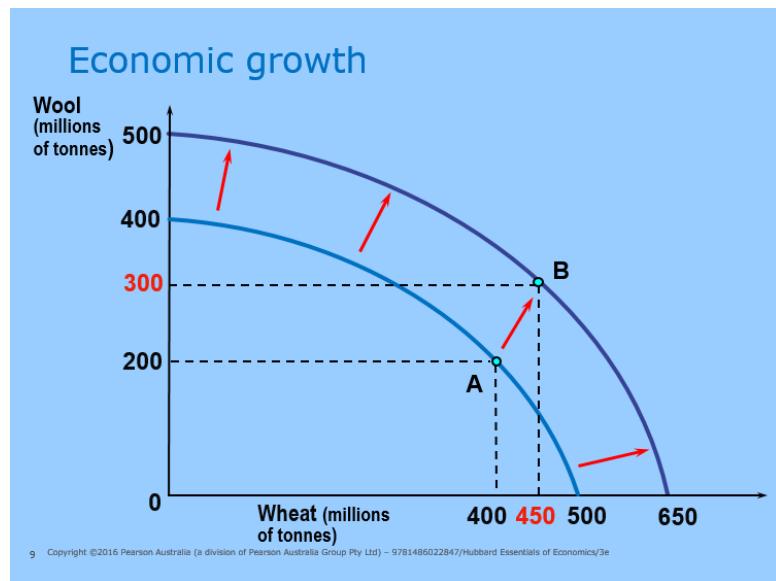
Resources: Inputs used to produce goods and services. Examples include – land, water, minerals, labour, capital and entrepreneurial ability.

Trade-off: The concept that states that due to scarcity, producing more of one good/service means sacrificing another good/service and thus making less of it.

Opportunity Cost: The opportunity cost of any activity is the highest-valued alternative that must be given up in order to engage in that activity.

Production possibility frontier: A curve showing the maximum attainable combinations of making two products at a time with the available resources. The bowed-out shape also reflects increasing marginal opportunity costs – *Thus, the more resources already devoted to an activity, the smaller the pay-off to devoting additional resources to that activity.*



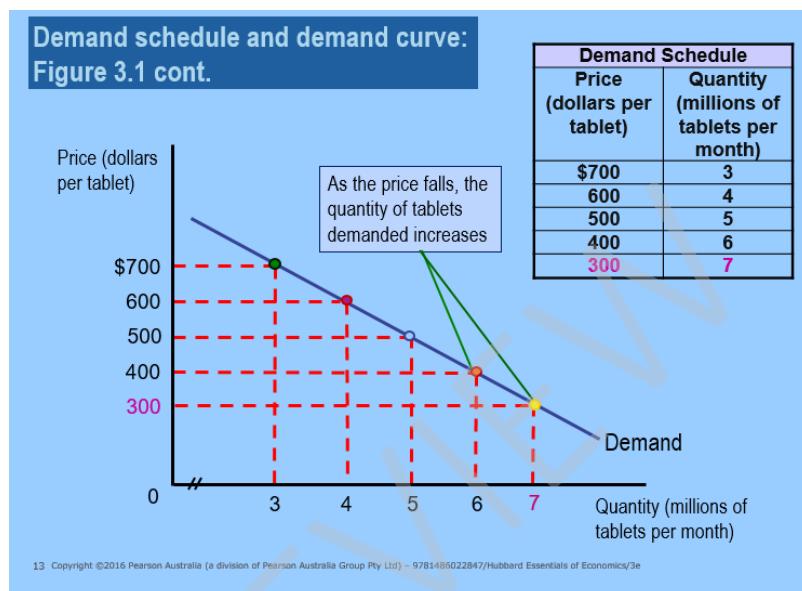


The Interaction of Demand and Supply

The demand side of the market →

Quantity demanded: The amount of a good/service that a consumer is willing and able to buy at a given price.

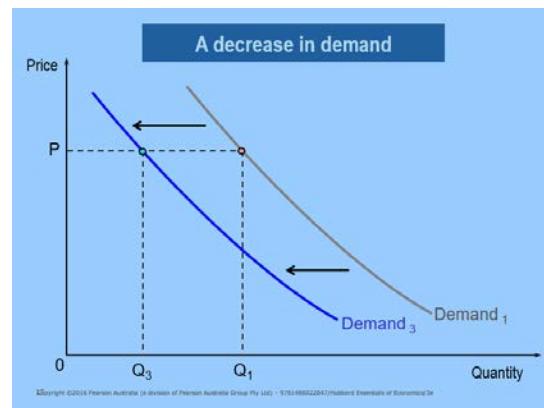
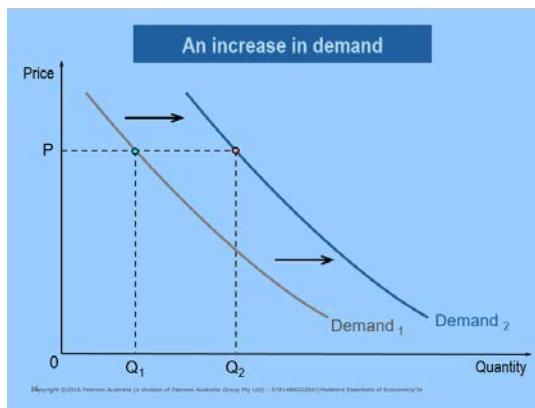
Demand curve: A curve that shows the relationship between the price of a product and the quantity of the product demanded.



The law of demand: (Holding everything else constant) When the price of a product falls, the quantity demanded will increase. Thus, when the price of a product rises, the quantity demanded will decrease.

Variables that shift market demand:

1. Income → Normal good (demand increases as income rises and decreases as income falls) & Inferior good (demand increases as income falls and decreases as income rises)
2. Prices of related goods → Substitutes (goods/services that can be used for the same or a similar purpose) & Complements (goods and services that are used together)
3. Tastes → (broad category that refers to the many subjective elements that can influence a consumer's plans to buy a good or service – etc. season, trends, fashion)
4. Population and demographics → Demographics (changes in the characteristics of a population with respect to age, race and gender)
5. Expected future prices → If consumers expect prices to increase in the future, they have an incentive to increase purchases now, and *vice versa*.



- A *change in the quantity demanded* refers to a movement along the demand curve because of a change in the product's price.
- A *change in demand* refers to a shift in the demand curve (changes quantity demanded at all price levels).
- Occurs due to a change in the variables, other than the product's own price, that affect demand.

The supply side of the market →

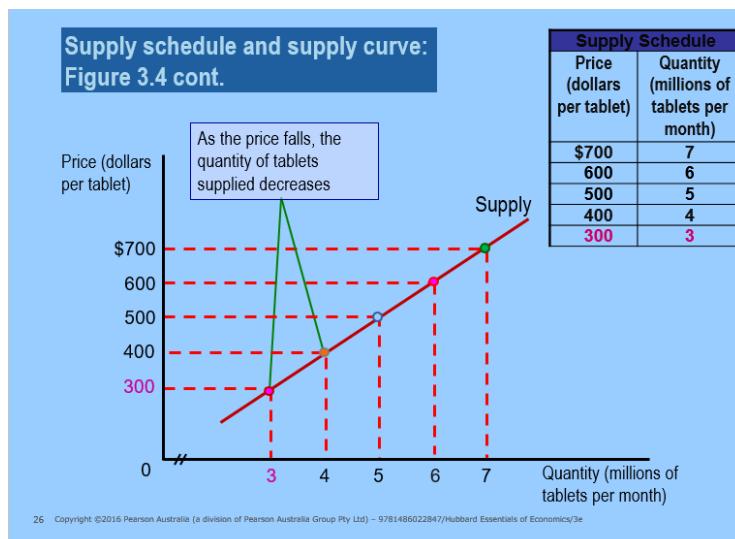
Quantity supplied: The amount of a good or service that a firm is willing and able to supply at a given price.

Supply schedule: A table showing the relationship between the price of a product and the quantity of the product supplied.

Supply curve: A curve that shows the relationship between the price of a product and the quantity of the product supplied.

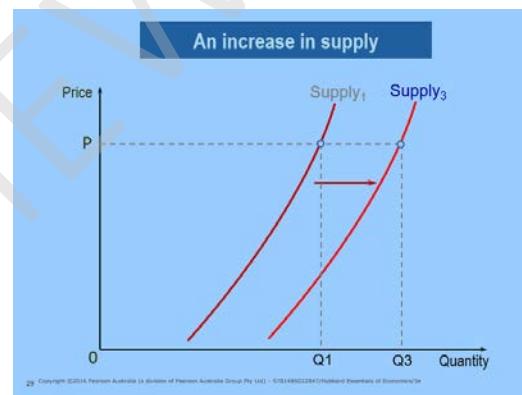
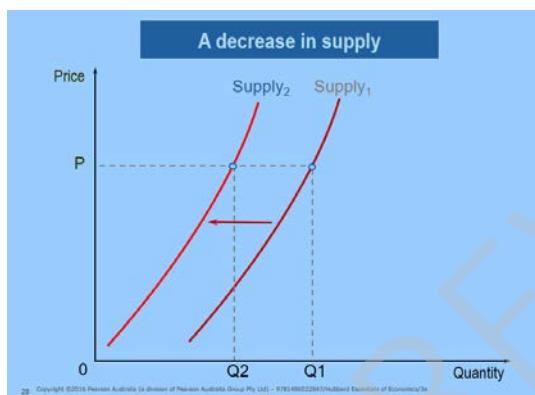
Market supply: The supply by all the firms of a given good or service.

The law of supply: Holding everything else constant, an increase in the price of a product causes an increase in the quantity supplied, and a decrease in the price of a product causes a decrease in the quantity supplied.



Variables that shift supply:

1. Prices of inputs → An increase in the cost of an input increases the cost of production. The firm supplies less. A decrease in the cost of an input decreases the cost of production at every price. The firm supplies more at every price.
2. Technological change → A change in the ability of a firm to produce output with a given quantity of inputs. Technological change allows the firm to produce more outputs with the same amount of inputs.
3. Prices of substitutes in production → An increase in the price of a substitute in production decreases the supply of the initial good, while a decrease in the price of a substitute in production increases the supply of the initial good.
4. Number of firms in the market → When new firms enter the market, supply increases. When firms exit the market, supply decreases.
5. Expected future prices → If firms expect the price of its product will increase in the future they have an incentive to decrease supply now.



- A *change in the quantity supplied* refers to a movement along the supply curve as a result of a change in the product's price.
- A *change in supply* refers to a shift in the supply curve (quantity supplied changes at all price points).
- Occurs due to a change in the variables, other than the product's own price, that affect supply.