MICROECONOMICS

CHAPTER 1
10 LESSONS FROM ECONOMICS

Economics: study of the choices people and societies make to attain their unlimited wants, given their scarce resources (i.e. to deal with the problem of scarcity
- Economists study how people interact with each other and analyse forces and trends that affect the economy

Scarcity: where unlimited wants exceed the limited resources available to fulfil those wants

Scarcity > choices (A or B) > tradeoff's between A or B > opportunity cost > comparative advantage > specialise (in the thing we have a comparative advantage in) > trade > create value

3 fundamental questions.
- what goods or services will be produced?
- how to produce those goods and services?
- who will receive those goods and services?

HOW PEOPLE MAKE DECISIONS

1. People face trade-offs

Making decisions requires trading off one goal against another such as a clean environment and a high income
- another trade off is between efficiency and equity.
- Efficiency: the property of society getting the most it can from its scarce resources.
- Equity: the property of distributing economic prosperity fairly among the members of society

2. The cost of something is what you give up to get it

Opportunity cost: the best alternative that must be given up to obtain some item

Definition: The opportunity cost of any production or consumption activity is the value of 'next best' alternative that must be given up to engage in that activity
- (what you have to give up to get)
- Every cost is an opportunity cost

3. Rational people think at the margin

Marginal change: a small incremental adjustment to a plan of action
- A rational decision maker takes an action if and only if the marginal benefit of the action exceeds the marginal cost

Decisions are made comparing costs and benefits at the margin
Optimal decision: MB = MC (additional benefit = additional cost)

4. People respond to incentives

An incentive is something that induces a person to act.
- The influence of prices on the behaviour of consumers and producers is crucial for understanding how the economy allocates scarce resources

HOW PEOPLE INTERACT

5. Trade can make everyone better off

Trade allows people to specialise in what they do best and this lies at the heart of gains from trade allowing them to enjoy a greater variety of goods and services

6. Markets are usually a good way to organise economic activity

Market economy: an economy that allocates resources through the decentralised decisions of many firms and households as they interact in markets for goods and services

- Firms decide whom to hire and what to make. Households decide which firms to work for and what to why with their incomes. These firms and households interact in the marketplace, where prices and self-interest guide their decisions
- Prices are the instrument with which the invisible hand directs economy activity. In any market, buyers look at the price when determining how much to demand, and sellers look at the price when deciding how much to supply. As a result of the decisions that buyers and sellers make, prices reflect both the value of a good to society and the cost to society of making the good.

The invisible hand: the idea that buyers and sellers freely interacting in a market economy will create an outcome that allocates goods and services to those people who value them most highly and makes the best use of our scarce resources

7. Governments can sometimes improve market outcome

The invisible hand can work its magic only if the government enforces the rules and maintains the institutions that are key to a market economy. Markets only work if property rights are enforced so individuals can own and control scarce resources.

There are two broad reasons for a government to intervene in the economy and change the allocation of resources that people would choose on their own: to promote efficiency and to promote equality.

Equity

Even when the invisible hand is yielding efficient outcomes, it can nonetheless leave big differences in economic wellbeing. A market economy rewards people according to their ability to produce things that other people are willing to pay for.

Efficiency

- Although the invisible hand usually leads markets to allocate resources to maximise the size of the economic pie, this is not always the case. Economists use the term market failure to refer to a situation in which the market on its own fails to allocate resources efficiently.

Market failure: a situation in which a market left on its own fails to allocate resources efficiently.

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

Causes of market failure

Externality: the uncompensated impact of one person's actions on the wellbeing of a bystander. A positive externality makes the bystander better off. A negative externality makes the bystander worse off.

Market power: the ability of a single economic actor (or small group of actors) to have a substantial influence on market prices.

HOW THE ECONOMY WORKS AS A WHOLE

8. A country's standard of living depends on its ability to produce goods and services

Almost all variations in living standards is attributable to differences in countries' productivity.

- Productivity: the quantity of goods and services produced from each hour of a workers time

9. Prices rise when the government prints too much money

When a government creates late quantities of the nation's money, the value of the money falls.

Inflation: an increase in the overall level of prices in the economy

10. Society faces a short-term trade-off between inflation and unemployment

Trade-off between inflation and unemployment is called the Phillips curve, after the economist who first examined this relations.
Phillips curve: the short-term trade-off between inflation and unemployment

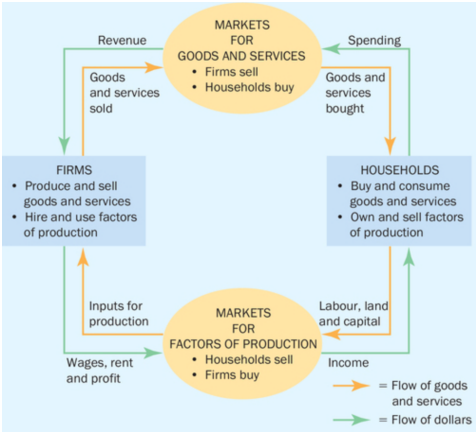
CHAPTER 2
THINKING LIKE AN ECONOMIST

THE ECONOMIST AS SCIENTIST
The scientific method: Observation, their and more observation

EG. high inflation arises when the government prints too much money.
- collect and analyse data on prices and money from many countries
- if variables are completely unrelated the economist would doubt the validity of his theory
- if variable were strongly correlated the economist would gain confidence in his theory

Historical episodes allow us to illustrate and evaluate economic theories of the present.

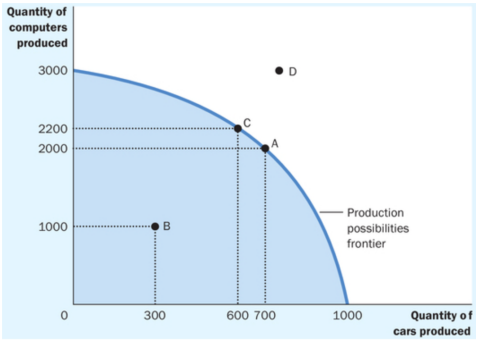
Economic models
The circular-flow diagram: a visual model of the economy that shows how dollars flow through markets among households and firms
- how the economy is organised and how participants in the economy interact with one another.



Firms produce goods and services using various inputs, such as labour, land and capital (buildings and machines). These inputs are called the factors of production. Households own the factors of production and consume all the goods and services that the firms produce.

In the markets for goods and services, households are buyers and firms are sellers. In particular, households buy the output of goods and services that firms produce. In the markets for the factors of production, households are sellers and firms are buyers. In these markets households provide firms with the inputs that the firm uses to produce goods and services. The inner loop of the diagram represents the flow of goods and services between households and firms. The outer loop of the diagram represents the corresponding flow of dollars.

The production possibilities frontier: a graph that shows the various combinations of output that the economy can possibly produce given the available factors of production and the available production technology.



An outcome is said to be efficient if the economy is getting all it can from the scarce resources it has available.

A bowed-out shape means people are specialised
A straight line means people are not specialised

Microeconomic and macroeconomics
Microeconomics and macroeconomics are closely intertwined as changes in the overall economy arise from the decisions of millions of individuals.
Microeconomics: the study of how households and firms make decisions and how they interact in markets
Macroeconomics: the study of economy-wide phenomena, including inflation, unemployment and economic growth

THE ECONOMIST AS A POLICY ADVISOR

Positive versus normative analysis

Polly: minimum-wage laws cause unemployment
Norma: the government should raise the minimum wage

Polly is speaking like a scientist - she is making a claim about how the world works
Norma is speaking like a policymaker - she is making a claim about how she would like to change the world

Positive statement: claims that attempt to describe the world as it is
Normative statements: claims that attempt to prescribe how the world should be

A key difference between normative and positive statements is how we judge their validity. We can confirm or refute positive statements by examining evidence. In contrast, evaluating normative statements involves values as well as facts. Norma's statement cannot be judged using data alone. Deciding whether what is a good or bad policy involves our views on ethic, religion and political philosophy.

WHY ECONOMISTS DISAGREE

- Economists may disagree about the validity of alternative positive theories about how the world works
- Economists may have different values and, therefore, different normative views about what policies should try to accomplish

Differences in scientific judgements

Economics is a young science and there is still much to be learned. Economists have different haunches about the validity of alternative theories or about the size of important parameters.

Difference in values

Policies cannot be judged on scientific grounds alone. Economists give conflicting advice sometimes because they have different values

CHAPTER 3
INDEPENDENCE AND THE GAINS FROM TRADE

THE PRINCIPLE OF COMPARATIVE ADVANTAGE

Absolute advantage

Absolute advantage: the ability to produce a good using fewer inputs than another producer

- Economists use the term absolute advantage when comparing the productivity of one person, firm or nation with that of another. The producer that requires smaller quantity of inputs to produce a good is said to have an absolute advantage in producing that good.

Opportunity cost and comparative advantage

Comparative advantage: the ability to produce a good at a lower opportunity cost than another producer

- Economists use the term comparative advantage when describing the opportunity cost of two producers.
- Although it is possible for one person to have an absolute advantage in both foods, it is impossible for the same person to have a comparative advantage in both goods. This is because the opportunity cost of one good is the inverse of the opportunity cost of the other; if a person's opportunity cost of one good is relatively high, his opportunity cost of the other good must be relatively low.

Comparative advantage and trade
Differences in opportunity cost and comparative advantage creates the gains from trade. When each person specialises in producing the good for which he or she has a comparative advantage, total production in the economy rises. This increase in the size of the economic pie can be used to make everyone better off.

Should a country trade with other countries?
Imports: goods and services are produced abroad and sold domestically
Exports: goods and services that are produced domestically and sold abroad

CHAPTER 4
THE MARKET FORCES OF SUPPLY AND DEMAND

MARKETS AND COMPETITION
Supply and demand are the forces that make market economies work. They determine the quantity of each good produced and the price at which it is sold. Supply and demand refer to the behaviour of people as they interact with one another in competitive markets.

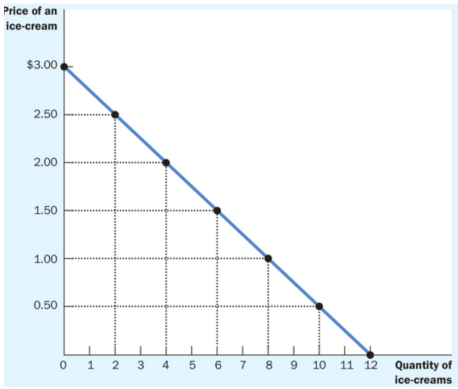
What is a market?
Market: a group of buyers and sellers of a particular good or service.
The buyers as a group determine the demand for the product and the sellers as a group determine the supply of the product. Markets can be highly organised such as the sharemarket or the market for some agricultural commodities. Markets can also be less organised such as the market for ice-cream.

What is competition?
Competitive market: a market in which there are many buyers and many sellers so that each has a negligible impact on the market price
- Each seller has limited control over the price because other sellers are offering similar products.

Perfectly competitive
1. the goods offered for sale are all exactly the same
2. the buyers and sellers are so numerous that no single buyer or seller has any influence over the market price

Some markets have only one seller and this seller sets the price. Such a seller is called a *monopoly*. Such as your local water company.

DEMAND
The demand curve: the relationship between price and quantity demanded
Quantity demand: the amount of a good that buyers are willing and able to purchase
- Because the quantity demanded falls as the price rises and rises as the price falls, we say that the quantity demanded is *negatively* related to the price.



The law of demand: the claim that, other things being equal, the quantity of a good falls when the price of the good rises

Demand schedule: a table that shows the relationship between price of a good and the quantity demanded

Demand curve: a graph of the relationship between the price of a good and the quantity demanded