Fourth Stage – Economic Dep. 2022-2023 Microeconomic Studies

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**Scarcity** means that society has limited resources and therefore cannot produce all the goods and services people wish to have. Just as each member of a household cannot get everything he or she wants, each individual in society cannot attain the highest standard of living to which he or she might aspire.

**Economics** is the study of how society manages its scarce resources. In most societies, resources are allocated not by an all-powerful dictator but through the combined choices of millions of households and firms. Economists, therefore, study how people make decisions - how much they work, what they buy, how much they save and how they invest their savings. Economists also study how people interact with one another.

The 10 principles of economics are introduced here to give you an overview of what economics is all about. These 10 principles are mainly distributed into three groups:

1. **How people make decisions**
2. ***People face trade-offs***. You may have heard the saying, 'There's no such thing as a free lunch'. To get something that we like, we usually have to give up something else that we also like. Making decisions requires trading off one goal against another.

Efficiency; the property of society getting the most it can from its scarce resources.

Equity; the property of distributing economic prosperity uniformly among the members of society.

1. ***The cost of something is what you give up to get it***. Because people face trade-offs, making decisions requires comparing the costs and benefits of alternative courses of action. In many cases, however, the cost of some action is not as obvious as it might first appear.

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

1. ***Rational people think at the margin***. Economists normally assume that people are rational.

Rational people who systematically and purposefully do the best they can to achieve their objectives.

Economists use the term marginal change to describe a small incremental

adjustment to an existing plan of action. Keep in mind that margin means 'edge', so marginal changes are adjustments around the edges of what you are doing. Rational people often make decisions by comparing marginal benefits and marginal cost.

1. ***People respond to incentives***. An incentive is something that induces a person to act, such as the prospect of a punishment or reward. Because rational people make decisions by comparing costs and benefits, they respond to incentives.
2. **How people interact**

The first four principles discussed how individuals make decisions. As we go about our lives, many of our decisions affect not only ourselves but other people as well. The next three principles present some key ideas about how people interact with one another.

1. ***Trade can make everyone better off.*** Trade allows countries to specialize in what they do best and to enjoy a greater variety of goods and services. The Chinese, the Japanese, the Germans and the Indonesians are as much our partners in the world economy as they are our competitors.
2. ***Markets are usually a good way to organize economic activity.*** Most countries that once had centrally planned economies have abandoned this system and instead have adopted market economies. In a market economy, the decisions of a central planner are replaced by the decisions of millions of firms and households. Firms decide whom to hire and what to make. Households decide which firms to work for and what to buy with their incomes. These firms and households interact in the marketplace, where prices and self-interest guide their decisions.

So, 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.

1. ***Governments can sometimes improve market outcomes.*** If the invisible hand of the market is so great, why do we need government? One purpose of studying economics is to refine your view about the proper role and scope of government policy. One reason we need government is that the invisible hand can work its magic only if government enforces the rules and maintains the institutions that are key to a market economy. Most important, markets work only if property rights are enforced so individuals can own and control scarce resources. A farmer won't grow food if she expects her crop to be stolen; a restaurant won't serve meals unless it is assured that customers will pay before they leave; and a film company won't produce movies if too many potential customers avoid paying by making illegal copies.

Property rights: the ability of an individual to own and exercise control over

scarce resources.

Consider first the goal of efficiency. Although the invisible hand usually leads markets to allocate resources to maximize 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. One possible cause of market failure is an externality, which is 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. Another possible cause of market failure is market power, which refers to the ability of a single economic actor

(or small group of actors) to have a substantial influence on market prices.

1. **How the economy as a whole works**
2. ***A country's standard of living depends on its ability to produce goods and services***. The differences in living standards around the world are staggering. What explains these large differences in living standards among countries and over time? The answer is surprisingly simple. Almost all variation in living standards is attributable to differences in countries' productivity - that is, the amount of goods and services produced by each hour of a worker's time. In nations where workers can produce a large quantity of goods and services per hour, most people enjoy a high standard of living; in nations where workers are less productive, most people must endure a more meagre existence. Similarly, the growth rate of a nation's productivity determines the growth rate of its average income.
3. ***Prices rise when the government prints too much money.*** This response is defined as inflation, which is an increase in the overall level of prices in the economy.
4. ***Society faces a short-run trade-off between inflation and unemployment.*** While an increase in the quantity of money primarily has the effect of raising prices in the long run, in the short run the story is more complex. Most economists describe the short-run effects of money growth as follows:

• Increasing the amount of money in the economy stimulates the overall level of spending and thus the demand for goods and services.

• Higher demand may over time cause firms to raise their prices, but in the meantime, it also encourages them to hire more workers and produce a larger quantity of goods and services.

• More hiring means lower unemployment. This line of reasoning leads to one final economy-wide trade-off: a short-run trade-off between inflation and unemployment.

Although some economists still question these ideas, most accept that society faces a short-run trade-off between inflation and unemployment. This simply means that, over a period of a year or two, many economic policies push inflation and unemployment in opposite directions. This short-run trade-off plays a key role in the analysis of the business cycle, which is fluctuations in economic activity, such as employment and production.

**Reference: Joshua Gans, Stephen King, Martin Byford, N. Gregory Mankiw. 2021. Principles of Microeconomics, 8th Edition, Cengage Learning Australia Ply Limited.**