THINK LIKE AN ECONOMIST

Defining Economics

Marginal benefit (MB): The immediate positive impact of a decision.

Marginal cost (MC): The immediate negative impact of a decision.

When MB > MC, it makes sense to select that option. When MC > MB, it makes sense to reject that option.

Rational choice theory has two principles:

1. Economic actors seek to maximize their satisfaction when making decisions.
2. When making a decision, they rationally believe the benefits of the decision will outweigh the costs.

Invisible hand theory: Self-interest motivates buyers and sellers. It drives commerce, guided, as it were, by an "invisible hand."

Asymmetric Information

Asymmetric information: When one party in a transaction possesses better decision-influencing information than the other.

Adverse selection: When asymmetric information causes market failure.

Market failure: A market outcome predicated on flawed information or producing undesirable results.

Moral hazard: When someone takes more risks knowing that another party bears the brunt of those risks.

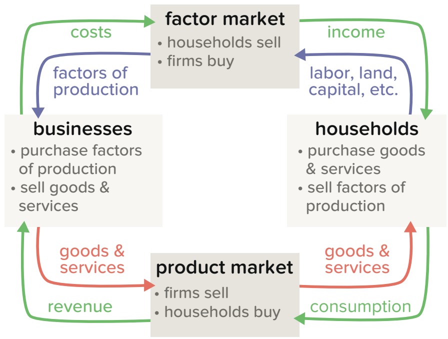
Principal-agent problem: Agents (e.g., employees) can't always be trusted to act in the best interest of their principals (e.g., employers).

Ways to combat asymmetric information:

Screening allows the uninformed party to draw out information from the informed party.

Signaling is the act of revealing private information to the uninformed party.

Theory of Markets



Market forces: The economic drivers behind the exchange of goods and services in a free market (e.g., the collective tendency to buy more of a product when its price is low).

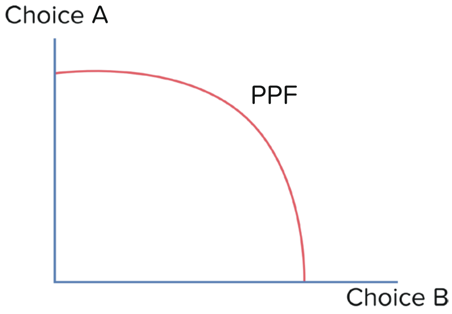
Factors of production: The building blocks of industry, including raw materials, investment capital, and manpower.

The **factor market** is where businesses buy what they need to operate. The **product market** is where they sell goods and services to households.

Producer surplus is the difference between the market price and the minimum amount a business has to charge to make a profit.

Consumer surplus is the amount above the market price that a consumer is willing to pay.

The Production Possibilities Frontier

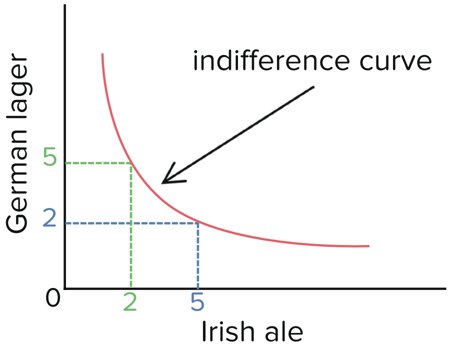


Production possibilities frontier (PPF): A curve representing all the possibilities that exist between choosing only choice A or only choice B.

The slope of the PPF between two points is equal to the opportunity cost for making one decision versus the other.

Constant opportunity cost: When the opportunity cost between two choices is constant, the resulting PPF is a straight line.

Marginal Utility and Budget Lines



Indifference curve (IC): The combinations of two goods on a PPF that yield the same level of utility. The further the indifference curve moves from the origin, the greater the total utility.

Marginal rate of substitution (MRS): The ratio of the tradeoff between two points on the IC.

Budget constraint (BC): The budgetary limitation placed on choices. Utility is optimized at the point at which the BC is tangent to the IC.

Income effect: A drop in prices causes a consumer to feel richer, and buy accordingly.

Substitution effect: A drop in price for one good makes it all the more attractive versus a pricier substitute.

Elasticity and Its Applications

Price Elasticity of Demand (PED): A measure of how demand for a good changes in relation to a change in price.

Perfectly inelastic: Goods with PED = 0. At any price X, the quantity you demand does not change (see DC_1 at right).

Perfectly elastic: Goods with PED = ∞. Any change in price X will cause an infinite change in the quantity demanded (see DC_2).

Necessity goods: Goods with inelastic demand that have PED < 1 . These goods are deemed essential by a consumer and are likely to be purchased regardless of a price change or a change in income (milk, gas, etc.).

Luxury goods: Goods with elastic demand that have PED > 1. These goods are purchased only when the price seems justifiable in the consumer's eyes (jewelry, sports cars, etc.).

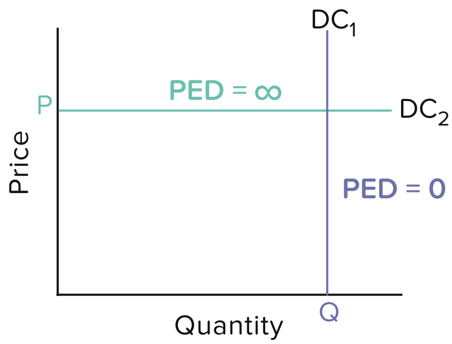
Cross-price elasticity of demand (CPED): The change in price for one good affects the quantity demanded of another.

Income elasticity of demand (IED): A calculation of how a change in a consumer's income affects their purchasing of a good.

Normal goods: Increased income leads one to purchase more. They have positive IED values.

Inferior goods: Increased income leads one to purchase less. They have negative IED values.

Giffen goods: An increase in price causes an increase in demand.



Cross-Price Elasticity of Demand (CPED)

$$\frac{\%\text{ Change in Q (Good X)}}{\%\text{ Change in P (Good Y)}}$$

IED

$$\frac{\%\text{ Change in Q (Good X)}}{\%\text{ Change in Income}}$$

Deadweight Loss

Economic surplus: The sum of consumer surplus (CS) and producer surplus (PS).

Deadweight loss (DWL): The loss of economic surplus due to a market intervention.

Price floor: The minimum price at which a good can be sold legally.

Price ceiling: A legal maximum on the price that sellers may charge, which leads to DWL.

Quota: A legal limit placed on the quantity of a good available to consumers, which leads to DWL.

International Trade at the Local Level

Absolute advantage: The ability of an individual to produce more of a good or service than her competitors.

Comparative advantage: The ability of an individual to produce a good or service at a lower opportunity cost (OC) than her competitors.

Specialization: Focusing production on a good or service made with comparative advantage.

	OC of producing 1 kg of corn	OC of producing 1 kg of soybeans
Igor	1 kg of soybeans	1 kg of corn
Alaina	2 kgs of soybeans	0.5 kg of corn

	Alaina		Igor	
	Corn	Soybeans	Corn	Soybeans
All time producing corn	60 kgs	0 kgs	40 kgs	0 kgs
All time producing soybeans	0 kgs	120 kgs	0 kgs	40 kgs