

1. Ten Principles of Economics


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March 8, 2016

Economics

- ▶ Economics is a social science – it provides tools and frameworks with which one can understand society.
 - ▶ It studies how society manages its scarce resources.
 - ▶ It studies the production, distribution, and consumption of goods and services.

Economy

- ▶ Ideal case: Benevolent social planner (dictator or God)
 - ▶ But unrealistic
- ▶ Market economy 
 - ▶ Production, distribution, and consumption are the results of decentralized decisions by many **firms and individuals**
 - ▶ There **is no central authority** telling people what to produce and where to ship it.
 - ▶ Each individual producer makes what she thinks will be most profitable; Each consumer buys what he or she chooses.
- ▶ Command economy
 - ▶ There **is a central authority** making decisions about production, distribution, and consumption
 - ▶ Command economies have been tried, yet didn't work well.
 - ▶ Highly complex; imperfect knowledge; human nature(?) etc.

Economy

- ▶ Market economies however seems to be able to coordinate even highly complex activities
- ▶ Somewhat surprisingly, the unplanned "chaos" of a market economy turns out to be more orderly than the "planning" of a command economy
- ▶ *The Wealth of Nations* (Adam Smith) – "invisible hand"
 - ▶ It usually works fine
 - ▶ But, not always
 - ▶ It is important to understand when and why it does not work
 - ▶ Market Failure

Ten Principles of Economics



Principle 1: People Face Trade-offs

- ▶ "There ain't no such thing as a free lunch."
- ▶ studying economics vs. studying psychology vs. watching TV vs. ...
- ▶ buying food vs. family vacation
- ▶ a clean environment vs. a high level of national income
- ▶ efficiency vs. equality (i.e. size of the pie vs. how it is divided)

Principle 2: The Cost of Something is What You Give Up to Get It

- ▶ "Opportunity cost"
 - ▶ What you must give up in order to get an item you want
 - ▶ The true cost of any item is not just the amount of money it costs to buy, but everything else in addition to money that must be given up in order to get that item
- ▶ Crucial to understand individual choice
 - ▶ Every choice you make means forgoing some other (your next best) alternative


Principle 3: Rational People Think at the Margin



- ▶ "marginal change" – a small incremental adjustment to a plan of action
- ▶ make decision by comparing *marginal benefits* and *marginal costs*



Principle 4: People Respond to Incentives

- ▶ An incentive is something that induces a person to act
- ▶ Incentives are crucial to analyzing how markets work
 - ▶ Because people usually exploit opportunities to make themselves better off, incentives can change people's behavior.
- ▶ Examples
 - ▶ price of gasoline $\uparrow \rightarrow$ switch to smaller cars
 - ▶ price of parking $\uparrow \rightarrow$ fewer people will drive
 - ▶ more generous unemployment benefit \rightarrow less effort to find a job
 - ▶ seat belt law \rightarrow fewer death per accident; more accident 
- ▶ Policy implication: any attempt to change people's behavior that *doesn't* change their incentives is not likely to be successful.
 - ▶ a plan that calls on manufacturers to reduce pollution voluntarily won't be effective; a plan that gives them a financial incentive is more likely to work

Principle 5: Trade Can Make Everyone Better Off

- ▶ Related to the previous principles
- ▶ A family could try to take care of all its own needs.
 - ▶ But it doesn't.
 - ▶ We have an economy instead of self-sufficient individuals
- ▶ Specialization → trade
 - ▶ the starting point for *The Wealth of Nation*
 - ▶ Individuals are better off
 - ▶ The economy, as a whole, can produce more when each person specializes in a task and trades with others.
- ▶ Markets are what allow people specialize and trade.

Principle 6: Markets Are *Usually* a Good Way to Organize Economic Activity

Markets Move Toward Equilibrium

- ▶ Many buyers and sellers of numerous goods and services
- ▶ Decentralized and self-interested decision making, yet market economies have been successful
- ▶ "Invisible hand"
 - ▶ Buyers and sellers look at the price when deciding how much to demand and supply
 - ▶ As a result, market prices reflect both the value of a good to society and the cost to society of making the good
 - ▶ Prices often adjust to leads to desirable outcomes



Principle 7: Government Can Sometimes Improve Market Outcomes

Why do we need government?

- ▶ Government is necessary for markets to work.
- ▶ The invisible hand is powerful, but not perfect; "*market failure*"
 - ▶ externality
 - ▶ market power
- ▶ Equality (or fairness)
 - ▶ equality vs. efficiency
 - ▶ e.g. disabled-designated parking space; NBA player vs. chess player
- ▶ An important part of your education in economics is learning to identify not just when markets work but also when they don't work – and to judge what government policies are appropriate in each situation.

Principle 8: A Country's Standard of Living Depends on Its Ability to Produce Goods and Services

- ▶ Production function



$$Y = F(A, K, L)$$



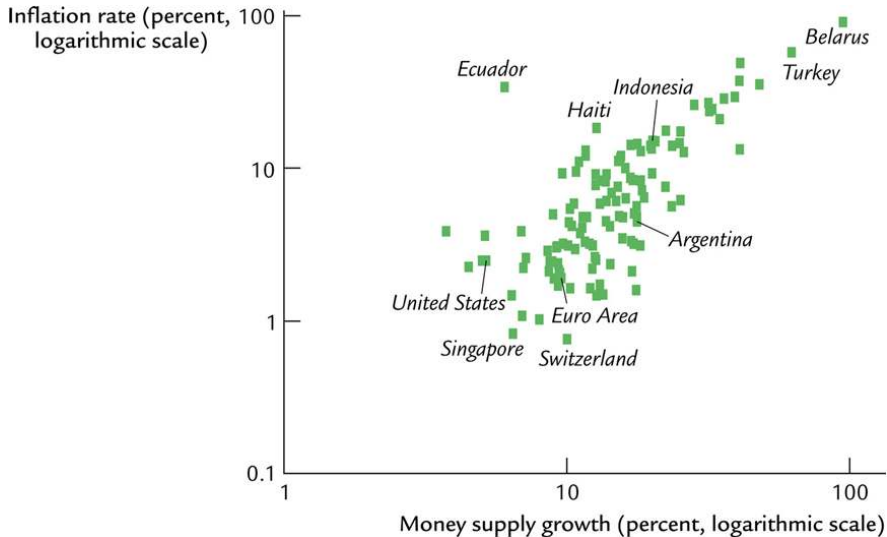
$K = \text{capital}$; $L = \text{labor}$; "factors of production"

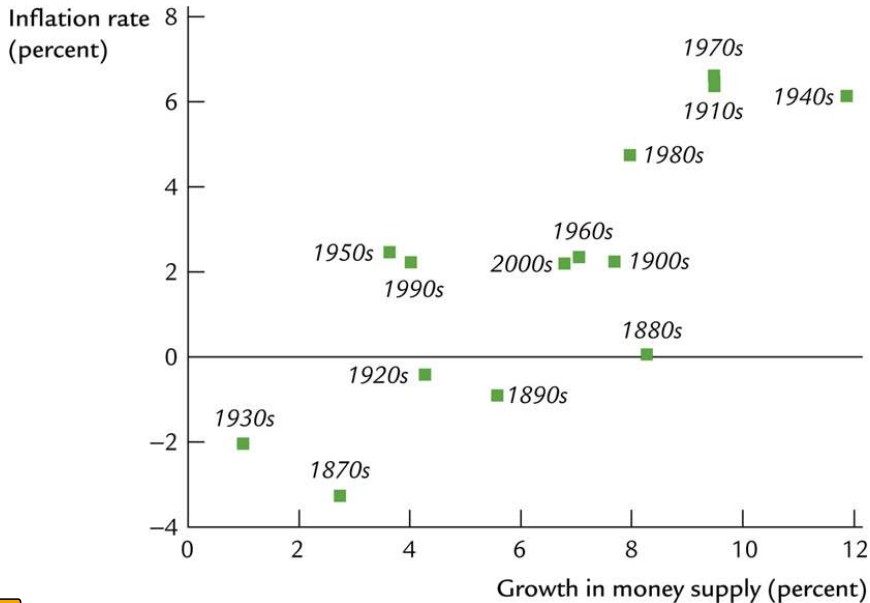
$A = \text{productivity}$

- ▶ Almost all variation in living standard is due to differences in countries' productivity

Principle 9: Prices Rise When the Government Prints Too Much Money in the Long Run

- ▶ **Inflation** - increase in the overall level of prices
- ▶ Germany
 - ▶ 1919: a loaf of bread 0.26 mark
 - ▶ 1923: a loaf of bread 80 billion mark
 - ▶ This massive inflation proved enormously costly to German society
 - ▶ Many people lost their lifetime savings
 - ▶ Many businesses failed
 - ▶ One of the factors that led to the rise of the Nazi movement
- ▶ Many countries of Latin America (1980s and 1990s)
- ▶ Russia (1990s)
- ▶ U.S. (during the Civil War)
 - ▶ the rapid printing of Confederate currency
 - ▶ high inflation in Southern states
 - ▶ the currency was worthless
 - ▶ transactions in the South were conducted largely by barter



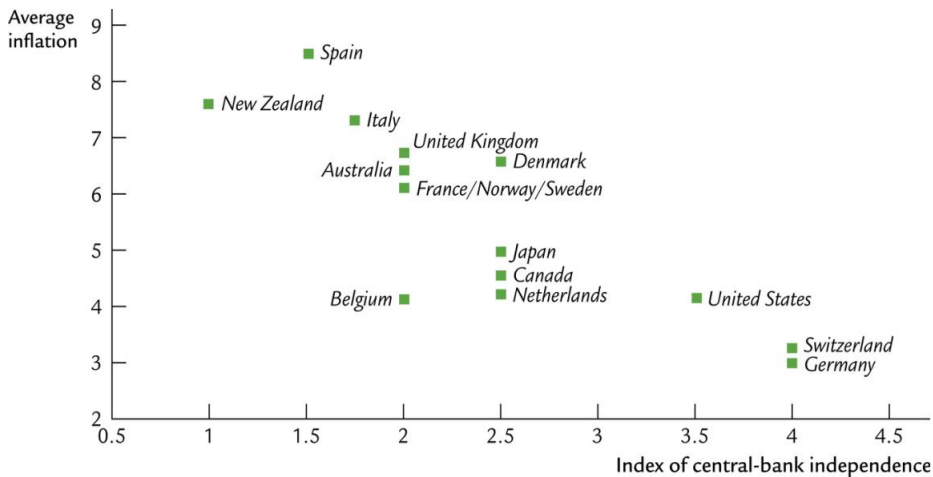


Hyperinflation - Recent episodes



	money growth (%)	inflation (%)
Israel, 1983-85	295	275
Poland, 1989-90	344	400
Brazil, 1987-94	1350	1323
Argentina, 1988-90	1264	1912
Peru, 1988-90	2974	3849
Nicaragua, 1987-91	4991	5261
Bolivia, 1984-85	4208	6515



Inflation and Central-Bank Independence



Principle 10: Society Faces a Short-Run Trade-off between Inflation and Unemployment

- ▶ In LR: printing money → price level increases (and nothing else)
- ▶ In SR: printing money → price level increases (but not as much) & output increases; unemployment decreases  
- ▶ $M \uparrow$
 - ▶ → stimulate the economy; people demand more goods and services
 - ▶ → firms raise their prices, but with higher demand, they produce more by hiring more workers
 - ▶ → more hiring means lower unemployment
- ▶ Gives trade-off for policymakers over the business cycle
- ▶ During the great recession, various stimulus packages → may cause inflation in the near future.

Ten Principles

- ▶ 1, 2, 3, 4 – How People Make Decisions
- ▶ 5, 6, 7 – How People Interact
- ▶ 8, 9, 10 – How the Economy as a Whole Works