ECON 105 – Principles of Macroeconomics

Chapter 1

Ten Principles of Economics

What Economics Is All About

Everyone everywhere faces one fundamental problem:
resources are scarce.

Resources: anything used to produce something else

- Labour = work done by humans
- Land = natural resources (soil, oil, water, minerals)
- Capital = goods that have been produced in order to be used to produce other goods (buildings, machines, roads, ports).
- Human capital = education, skills, and knowledge
- Time

Scarcity: a resource is scarce if there is not enough to satisfy everyone if it were free.

Economics: the study of how society manages its scarce resources to satisfy people's unlimited wants.

Principle #1: People Face Trade-offs

Because resources are scarce we cannot do or have everything that we want, so we must make decisions or *trade-offs.*

Trade-off = The act of giving up one thing to get more of another.

All decisions involve trade-offs.

"There is no such thing as a free lunch."

Efficiency vs. Equity

Society faces an important trade-off: efficiency vs. equity

- **Efficiency** = getting the most from scarce resources
- **Equity** = distributing resources evenly among members of society

Generally there is a tradeoff between efficiency and equity.

E.g. Taxes—take money from those who are producing consuming to pay for public goods → equalizes resource distribution but discourages production and consumption.

Principle #2: The Real Cost of Something Is What You Give Up to Get It

Opportunity cost: what you must give up to get something

Example: Going to FIC
Opportunity costs:

- **Money used for tuition and books**
- **Income you could be earning by working instead**
- **Forgone time with family and friends at home**

Principle #3: Rational People Think at the Margin

Marginal analysis = analyzing incremental changes in an activity

Rational people make decisions by comparing **marginal benefits** and **marginal costs**.

A marginal benefit (MB) is the extra benefit from one more unit of an activity.

A marginal cost (MC) is the extra cost of one more unit.

People will choose to do one more unit of the activity only if $MB \geq MC$

Exercise

Assume you are selling your 10-year old car. You have already spent $9,000 on repairs.

At the last minute, the transmission fails. You can pay $600 to have it repaired, or sell the car "as is".

In each of the following scenarios, should you have the transmission repaired?

1) Blue book value is $6,500 if transmission works, $5,700 if it doesn't.
2) Blue book value is $6,000 if transmission works, $5,500 if it doesn't.

Answers

Principle #4: People Respond to Incentives

Incentive = something that causes a person to do or not do something, such as a reward or punishment.

Examples:

- FIC offers free pizza on orientation day → students are more likely to attend.
- The cost of speeding ticket increases → more people obey speed limits.

If you want people to change their behavior you must change the incentives that they face.

Principle #5: Trade Can Make Everyone Better Off

Trade = exchange of goods and services

Rather than being self-sufficient, people can specialize in producing things they are better at and exchange for other goods. Through specialization and trade, people have more of all goods to consume.

E.g. In a family one person cooks and one fixes the cars rather than each cooking and fixing their own cars:

Save time, better quality → There are gains from trade for each person.

To be covered in Chapter 3.

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

Market = a group of buyers and sellers of a particular good or service.

"Organize economic activity" means determining

- what to produce
- how to produce
- how much of each good to produce
- who receives which good

A market economy allocates resources through the interaction of supply and demand, or individual producer and consumer decisions. To be covered in Chapter 4.

The milk market

Principle #7: Governments Can Sometimes Improve Market Outcomes

First, governments can help markets by enforcing property rights.

Property rights = when someone owns the property and has the authority to make decisions about that property.

Examples: land, homes, cars, books, ideas (copyrights and patents)
Property rights are protected by police and courts.

- Market works only if property rights are enforced.
- We reply on the government to enforce our rights over the things we produce.

More on Government

Second, governments can help to promote efficiency when there is market failure.

Market failure = when market fail to allocate society’s resources efficiently.

E.g. Government can use policies to stabilize output

More on Government

Third, government may also promote equity.

Tax or welfare policies can change how resources are divided.

In Canada the rich pay more taxes, and the government uses the revenue to pay for schools, hospitals, and roads for everyone.

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

The standard of living depends on *productivity.*

Productivity = the amount of G & S produced from each unit of a worker's time.

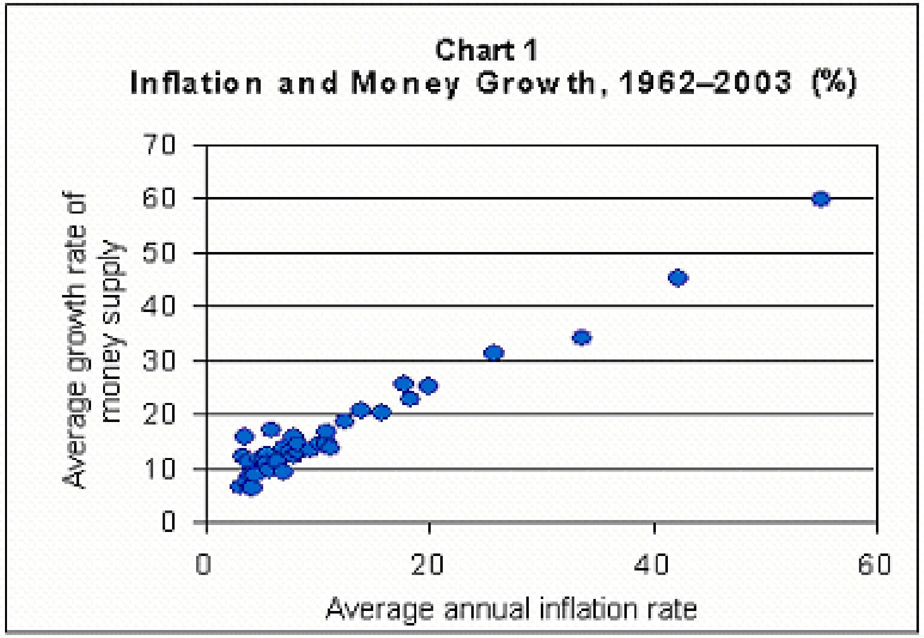
To be covered in Chapter 7.

Principle #9: Prices Rise When the Government Prints Too Much Money

Inflation = increases in the overall level of prices.

In the long run, inflation is almost always caused by excessive growth in the quantity of money.

To be covered in Chapter 10 & 11.



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

The short-run effects of increasing the money supply:

- There is more spending and thus an increase in demand for G & S.
- Higher demand increases prices and encourages more production → firms hire more workers to produce those G & S.
- More hiring means lower unemployment.

To be covered in Chapter 16.