CHAPTER ONE

BASICS OF ECONOMICS

The Basics of Economics

- Outline:
  - Definition of economics
  - Scope of economics
  - Scarcity, choice, opportunity cost and PPF
  - Basic economic questions
  - Economic system
  - Decision making agents (circular flow model)

Cont'd

- *Two fundamental facts (scarcity: limited resource and unlimited want).*
- Economics is a social science which studies about efficient allocation of scarce resources so as to attain the maximum fulfillment of unlimited human needs.
- As economics is a science of choice, it studies how people choose to use scarce or limited productive resources (land, labour, equipment, technical knowledge and the like) to produce various commodities.

Scope of Economics

- **Microeconomics:** Studies the behaviors of individuals within an economy: Consumers and producers in particular markets.

Examples of microeconomic concepts:

- The Automobile market in Switzerland,
- The market for movie tickets in Zurich

- **Macroeconomics:** Studies the total effect on a nation's people of all the economic activity within that nation. The four main concerns of macroeconomics are:

- total output of a nation,
- the average price level of a nation

Positive Vs Normative Economic concepts

- **Positive economics:**
- It is concerned with analysis of facts and attempts to describe the world as it is.
- It tries to answer the questions
- what was…?
- what is…? or
- what will be…?
- It does not judge a system as good or bad, better or worse.

Cont’d

- **Normative economics:**
- It deals with the questions like,
- what ought to be…?
- Or what the economy should be…?
- It evaluates the desirability of alternative outcomes based on one‘s value judgments about what is good or what is bad.
- In this situation since normative economics is loaded with judgments, what is good for one may not be the case for the other.
- Normative analysis is a matter of opinion (subjective in nature) which cannot be proved or rejected with reference to facts.

Scarcity, choice, opportunity cost and production possibilities frontier

- Have you ever faced a problem of choice among different alternatives?
- If ***yes***, what was your decision?
- What is scarcity? Do you think that it is different from shortage? Why?
- **Scarcity**
- The term scarcity reflects the imbalance between our wants and the means to satisfy those wants.
- **Shortage**
- When people are unable to get the amount they want at the prevailing or on going price.
- ***So shortage is the specific and short term phenomenon while scarcity is a universal phenomenon.***

Choice

- If resources are scarce, then output will be limited.
- If output is limited, then we cannot satisfy all of our wants.
- Thus, choice must be made.
- In short, ***scarcity implies choice*.**
- ***Choice, in turn, implies cost*.**
- That means whenever choice is made, an alternative opportunity is sacrificed.
- This cost is known as opportunity cost

Opportunity cost

- Opportunity cost is the amount or value of the next best alternative that must be sacrificed (forgone) in order to obtain one more unit of a product.

NOTE :

- When we say opportunity cost, we mean that:
  - It is measured in goods & services but not in money costs
  - It should be in line with the principle of substitution

The Factors of Production

Land	Labor	Capital	Entrepreneurship
Land resources are those things that are "gifts of nature". The soil in which we grow food, wood, minerals such as copper and tin and resources such as oil, goal, gas and uranium are scarce	Labor refers to the human resources used in the production of goods and services. Labor is the human work, both physical and intellectual	Capital refers to the *tools and technologies* tha t are used to produce the goods and services we desire.	This refers to the innovation and creativity applied in the production of goods and services.

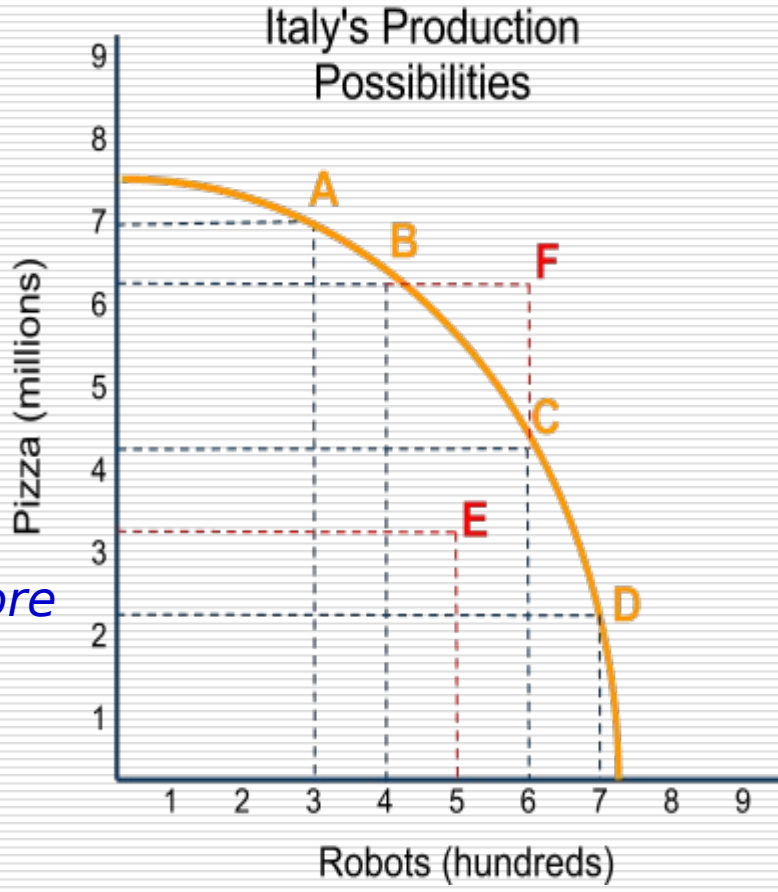
The Production Possibilities Frontier or Curve (PPF/ PPC)

- **PPF:**
- Is a curve that shows the various possible combinations of goods and services that the society can produce given its resources and technology.
- The PPF describes three important concepts:
- i) The concepts of scarcity: - the society cannot have unlimited amount of outputs even if it employs all of its resources and utilizes them in the best possible way.
- ii) The concept of choice: - any movement along the curve indicates the change in choice.
- iii)The concept of opportunity cost: more of one good requires sacrificing some of another product

Consider the hypothetical PPC for the country of Italy

This model shows that Italy can produce:
- Either 7.5 million pizzas,
- OR 750 robots
- Note, however, that Italy can **NOT** produce 7.5 million pizzas AND 750 robots

Italy faces a tradeoff in how to use its scarce resources of land, labor and capital. As the country moves along its PPC from point A to point D:
- *It gives up more and more pizza to have more robots*
- *It gives up current consumption of food for production of robots, which themselves are capital goods, and therefore will assure that Italy's economy will grow into the future.*

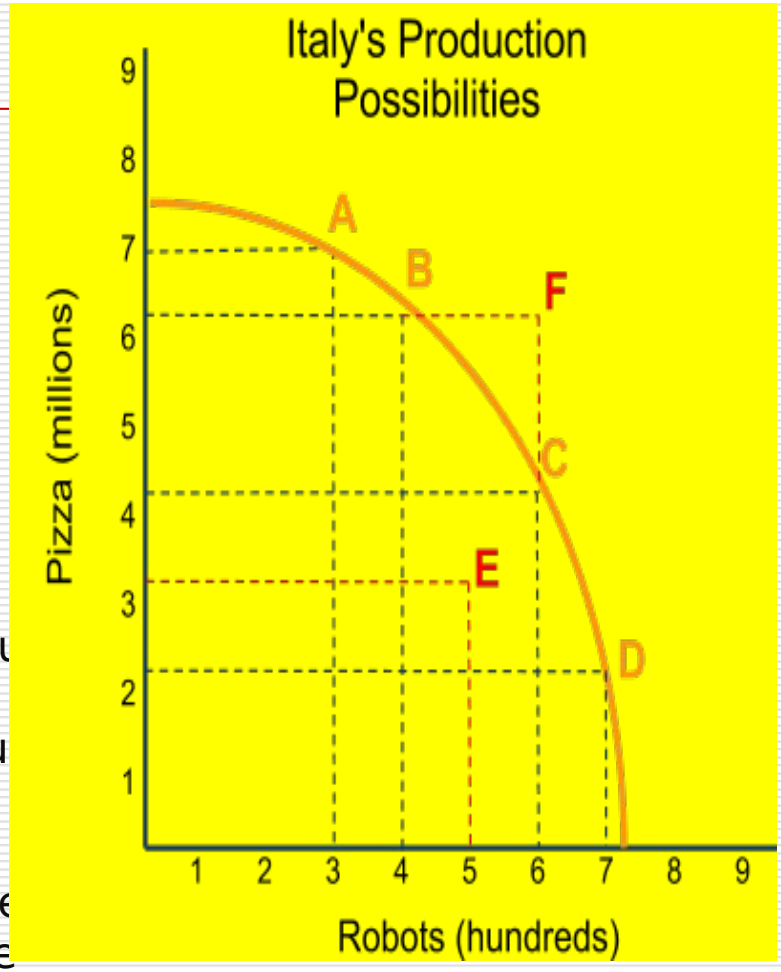


Assumptions about the PPC:

- ***A point ON the PPC is attainable only if a nation achieves full-employment of its productive resources***
- ***The nation's resources are fixed in quantity***
- ***The economy is closed, i.e. does not trade with other countries***
- ***Represents only one country's economy***

Observations about points on or within the PPC

- Points ON the PPC are attainable, and desirable, since a country producing on the line is achieving fu employment and efficiency
- Points inside the PPC (such as E) are attainable bu undesirable, because a nation producing here has unemployment and is inefficient
- Points outside the PPC (such as F) are unattainable because they are beyond what is presently possible given the country's scarce resources. But such points are desirable because they mean more output and consumption of both goods.



Basic Economic Questions

- *What to Produce?*
- This problem is also known as the problem of allocation of resources.
- *How to Produce?*
- This problem is also known as the problem of choice of technique.
- *For Whom to Produce?*
- This problem is also known as the problem of distribution of national product

Basic Economic Systems

- *Market (capitalist) Economy*: Most production and distribution decision made by private sector
- market play every role and government intervention is minimum
- *Command economy*: Production and distribution are owned and controlled by the state.
- *Mixed economy*: Hybrid.
- It incorporates some of the features of both and allows private and public sectors to co-exist.

Decision making units and the circular flow model

- Three agents (decision making units) in the economy:
- *i) Household*: A household can be one person or more who live under one roof and make joint financial decisions.
- Households make two decisions.

a) Selling of their resources, and

b) Buying of goods and services.

- *ii) Firm*: A firm is a production unit that uses economic resources to produce goods and services.

Agents in the economy

Firms also makes two decisions

a) Buying of economic resources

b) Selling of their products

- *iii) Government:* A government is an organization that has legal and political power to control or influence households, firms and markets.
  - Government also provides some types of goods and services known as public goods and services for the society.
  - May play supervisory role

Circular flow

- The three economic agents interact in two markets:
- **Product market:** it is a market where goods and services are transacted/ exchanged.
- That is, a market where households and governments buy goods and services from business firms.
- **Factor market (input market):** it is a market where economic units transact/exchange factors of production (inputs).
- In this market, owners of resources (households) sell their resources to business firms and governments.

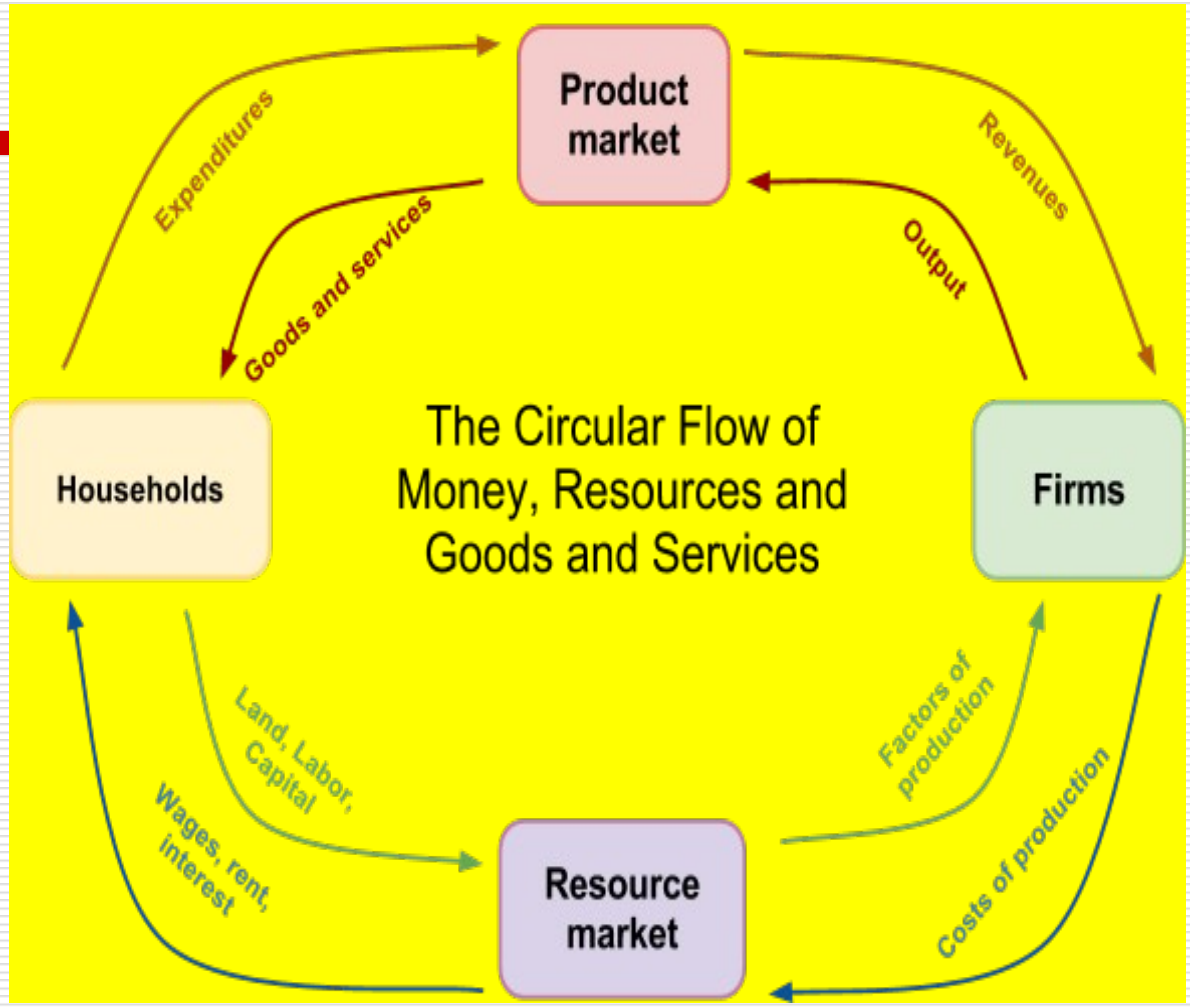
Circular flow

- Thus the circular-flow diagram is a visual model of the economy that shows how money (Birr), economic resources and goods and services flows through markets among the decision making units.

The Circular Flow (TWO SECTOR)

Market economies are characterized by a circular flow of money, resources, and products between households and firms in resource and product markets. Notice:

- ***Money earned by households in the resource market is spent on goods and services in the product market***
- ***Money earned by firms in the product market is spent on resources from households in the resource market***.



The incentives of Households: *Maximize Utility*

The incentive of Firms: *Maximize Profits!*

READING ASSIGNMENT

- The three sector circular flow model

- What is the basic difference with the two sector model?

Review Questions

- Define scarcity, choice and opportunity cost. Can you link them in your day to day lives?
- What do you understand by *positive economics* and *normative economics*?
- Explain why economics deals with allocation and efficient utilization of scarce resources only?
- Describe the four categories of economic resources. Which category of resources you and your family owned?
- What is a production possibility curve?

THE END!

THANK YOU FOR YOUR ATTENTION!