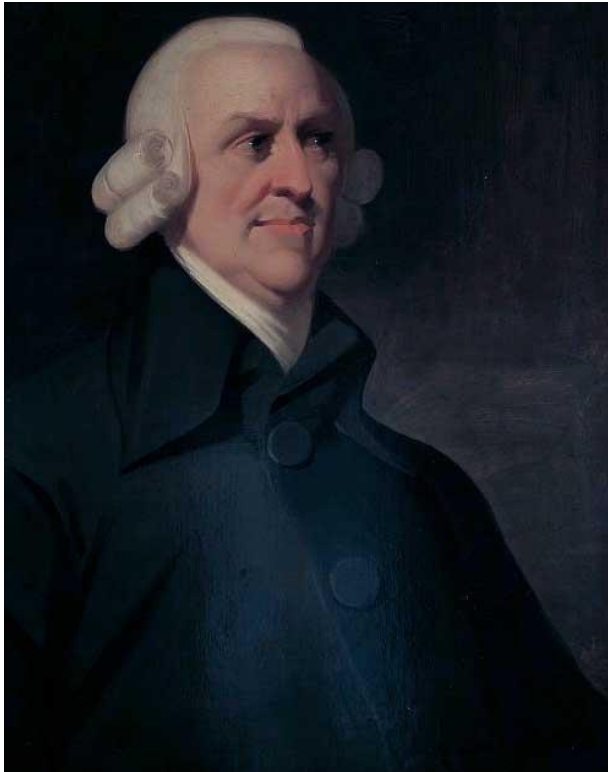


Introduction to economics

Foundation Course Group I

Telangana State Civil Services

Father of Modern Economics



It is not from the benevolence of the butcher, the brewer, or the baker that we expect our dinner, but from their regard to their own interest.

– Adam Smith

Adam Smith (1723 – 1790)

- o Known as father of modern economics
- o Wrote the first and most important books on the subject of economics, *An Inquiry into the Nature and Causes of the Wealth of Nations* (1776)
- o Smith believed in “free market”

(free market is one where consumers may buy what they like and producers may produce what they like, with no government interference)

Smith suggested that a laissez-faire (don't interfere) approach should be followed, leaving customers and producers to make their own decisions

What is Economics?

- Economics is a study of rationing systems
 - Planned Economies
 - Free Market Economies
- It is the study of how scarce resources are allocated to fulfill the infinite wants of consumers

■ **NEEDS:** are the basic necessities that a person must have in order to survive

e.g. food, water, warmth, shelter and clothing

■ **WANTS:** are the desire that people have

e.g. things that people would like to have, such as bigger homes, iphones, etc.

The Economic Problem



A wind farm. Copyright: iStock.com

- Unlimited Wants
- Scarce Resources –
Land, Labour, Capital
- Resource Use
- Choices

The Economic Problem

- o **What goods and services should an economy produce?** – should the emphasis be on agriculture, manufacturing or services, should it be on sport and leisure or housing?
- o **How should goods and services be produced?** – labour intensive, land intensive, capital intensive? Efficiency?
- o **Who should get the goods and services produced?** – even distribution? more for the rich? for those who work hard?

SCARCITY

- The excess of wants resulting from having limited resources (land, labor, capital and entrepreneurs) in satisfying the endless wants of people.
- It is a universal problem for societies – it is not limited to poor countries.
- To the economist, all goods and services that have a price are relatively scarce. This means that they are scarce relative to people's demand for them.

Factors of Production

□ Land

- natural resources available for production
- renewable resources: those that replenish
- non-renewable resources: cannot be replaced

□ Labor

- physical and mental effort of people used in production

□ Capital

- all non-natural (manufactured) resources that are used in the creation and production of other products

□ Enterprise (Entrepreneurship)

- refers to the management, organization and planning of the other three factors of production

Factors of Production

Payments
to factors
of
Production

Land

Labor

Capital

Enterprise

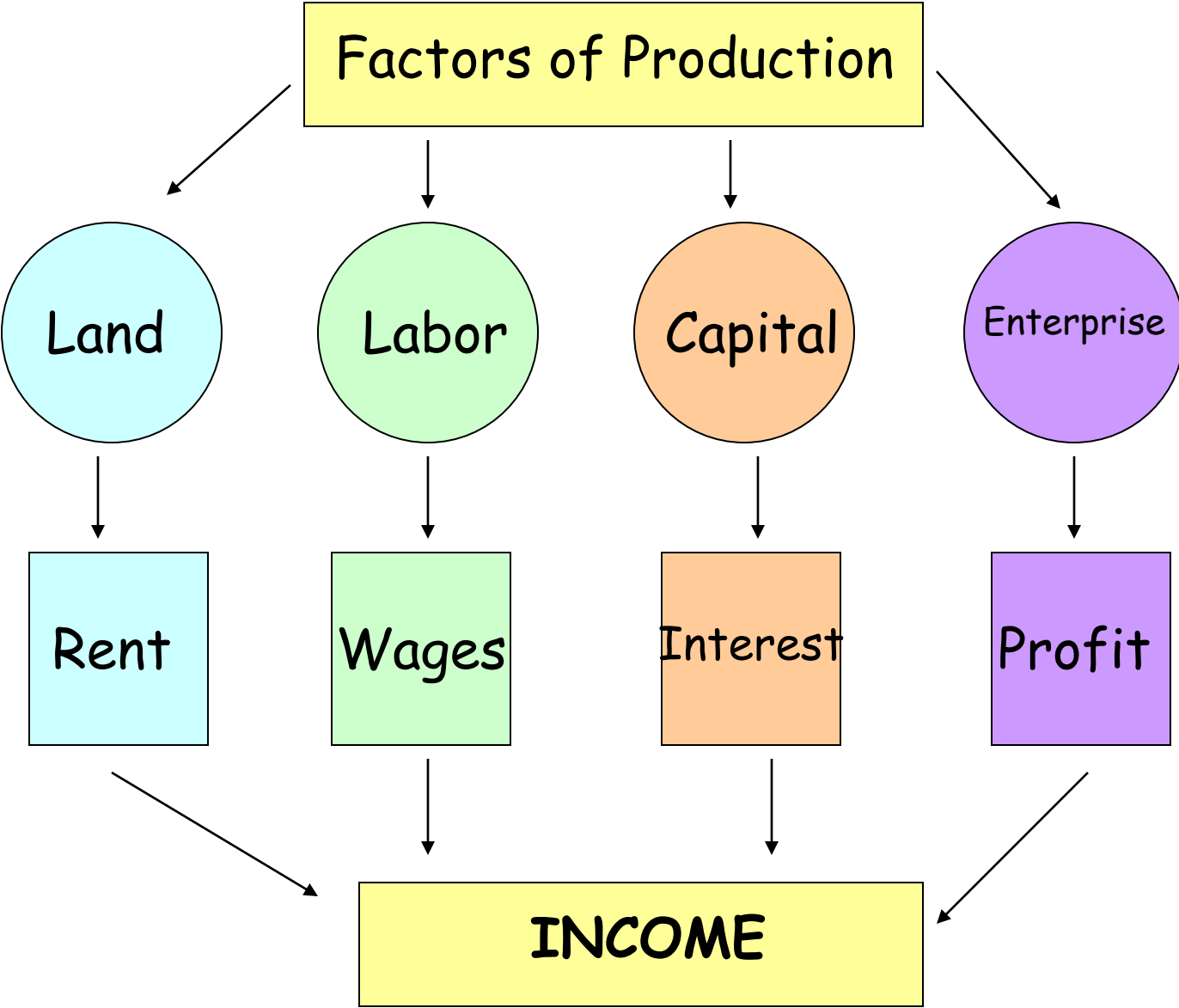
Rent

Wages

Interest

Profit

INCOME



Opportunity Cost

- ▣ Definition – the cost expressed in terms of the next best alternative sacrificed
- ▣ Helps us view the true cost of decision making
- ▣ Implies valuing different choices

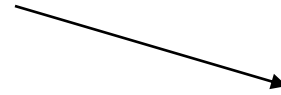
CHOICE

- Since people do not have infinite income, they need to make choices whenever they purchase goods and services.
- They have to decide how to allocate their limited financial resources and so always need to choose between alternatives.
- People wants are infinite; resources are finite, therefore, choices must be made.

Free and Economic Goods



- Does not incur any opportunity costs in its production or when consumed
- Not relatively scarce (not limited in supply)
- Will not have a price



- Has an opportunity cost (goods that use resources which could have been put to use producing something else)
- Uses scarce resources
- Will have a price

Types of Products

□ Consumer goods - products sold to general public

- **consumer durable goods:**

products that last a long time and can be used repeatedly

- **non-durable goods:**

products that need to be consumed very shortly after purchase

- Capital goods or Producer goods - products purchased by other businesses to produce other goods and services

e.g. computers, machinery, tools

- Services - intangible products provided by businesses

e.g. teachers (education),
doctors (health care)

Production Possibility Curves (Frontier) also known as PPF

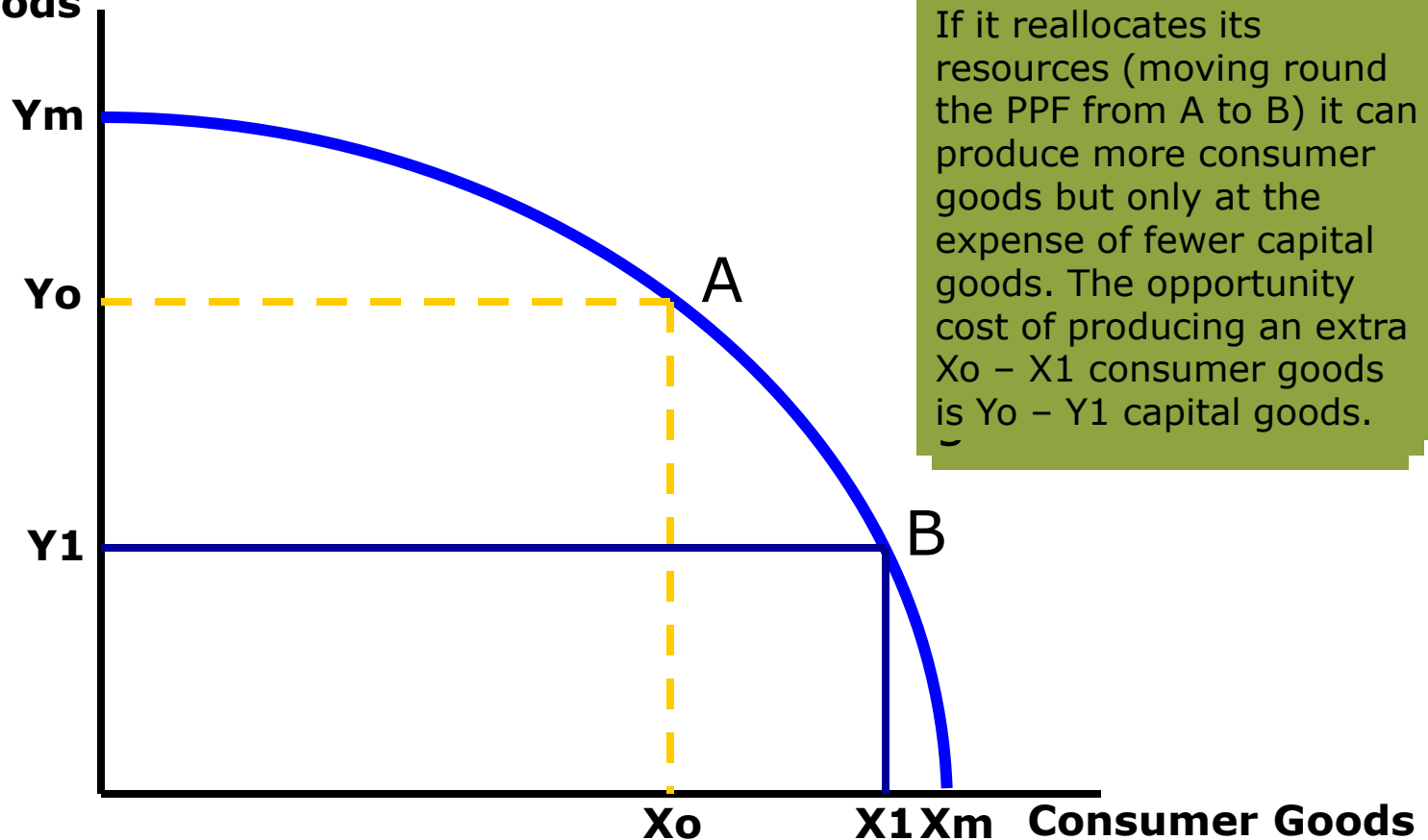
- Production – output of goods and services
- Possibility – maximum attainable amount
- Frontier – border or boundary
- PPF shows the boundary of what is possible and is used as an illustration in economics to show the choices facing all countries in producing goods which use limited factors of production.

Production Possibility Frontiers

- o Show the different combinations of goods and services that can be produced with a given amount of resources
- o No 'ideal' point on the curve
- o Any point inside the curve – suggests resources are not being utilised efficiently
- o Any point outside the curve – not attainable with the current level of resources
- o Useful to demonstrate economic growth and opportunity cost

Production Possibility Frontiers

Capital Goods



If the country is
If it reallocates its
resources (moving round
the PPF from A to B) it can
produce more consumer
goods but only at the
expense of fewer capital
goods. The opportunity
cost of producing an extra
 $X_o - X_1$ consumer goods
is $Y_o - Y_1$ capital goods.

Rationing Systems

■ The basic economic questions:

(1) **WHAT** to produce

(2) **HOW** to produce it

(3) **WHO** shall receive it

Rationing Systems:

Planned Economies

vs.

Free Market Economies

Planned Economies

- Sometimes called
 - = a centrally planned economy or
 - = a command economy
- Decisions as what to produce, how to produce, and who to produce for, are made by a central body, the government.
- All resources are collectively owned.
- The quantity of decisions to be made, data to be analyzed, and factors of production to be allocated are immense. This makes central planning very difficult.

Free Market Economies

- Sometimes called:

 - = a private enterprise economy or

 - = capitalism

- All production is in private hands

- Few cases of surpluses and shortages

{If there are changes in the pattern of demand, then there will be changes in the pattern of supply in order to meet the new demand pattern}

- Is a self-righting system

Mixed Economies

- In reality, all economies are mixed economies
- Some countries have high levels of planning and government involvement in the economy (eg. China)
- Government involvement is deemed essential, since there are some dangers that will exist if the free market is left to operate without interference.

Disadvantages of a Free Market Economy

- ❑ Demerit goods (things that are bad for people, such as drugs or cigarettes) will be over-provided, driven by high prices and thus a high profit motive.
- ❑ Merit goods (things that are good for people, such as education or healthcare) will be underprovided, since they will only be produced for those who can afford them and not for all.

Disadvantages of a Free Market Economy

- ❑ Resources may be used up too quickly and the environment may be damaged by pollution, as firms seek to make high profits and to minimize costs.
- ❑ Some members of society will not be able to look after themselves, such as orphans, the sick, and the long-term unemployed, and will not survive.
- ❑ Large firms may grow and dominate industries, leading to high prices, a loss of efficiency, and excessive power.

Disadvantages of a Planned Economy

- Total production, investment, trade, and consumption, even in a small economy, are too complicated to plan efficiently and there will be misallocation of resources, shortages, and surpluses.
- Because there is no price system in operation, resources will not be used efficiently. Arbitrary decisions will not be able to make the best use of resources.

Disadvantages of a Planned Economy

- ❑ Incentives tend to be distorted. Workers with guaranteed employment and managers who gain no share of profits are difficult to motivate. Output and/or quality will suffer.
- ❑ The dominance of the government may lead to a loss of personal liberty and freedom of choice.
- ❑ Governments may not share the same aims as the majority of the population and yet, by power, may implement plans that are not popular, or are even corrupt.

Microeconomics

- Centers on the forces working at the individual level (e.g. individual firms and consumers)
- Focuses on the needs, desires and buying habits of the individual consumer
- An example: studying how firms react to increasing costs of production by raising the price and subsequently how consumer/household spending is adjusted when the price rises
- Name of the game: Supply, Demand and Markets

Macroeconomics

- The sum total of all micro parts
- Looks at the aggregate (sum or total) of individual markets
- The four main areas of study
 - (1) Growth (increase in total output)
 - (2) Price level (inflation)
 - (3) Labor Markets (unemployment)
 - (4) The balance in the foreign sector (exports/imports, exchange rates)

□ MICRO

Firm's reaction to increased demand for its product

□ MACRO

Studying the effects on all firms in the economy due to a general increase in demand

■ MICRO

Decision of a worker to work less
due to lower wages

■ MACRO

Total hours of labor (and
unemployment)

Definition of Growth

- Growth is the increase in national output within an economy (country or region) during a time period – usually 12 months.

(National output is the sum of all goods and services produced in a country during a given period of time = GDP or GNP)

- This is put in percentage terms to show the annual percentage increase in output.
- It is measured in money terms and usually adjusted for inflation to show real growth.

Definition of Development

- The concept of development is a qualitative variable and thus far broader than any of the variables aimed at describing it.
- It is about having choices: economic and political choices; choice of schools, healthcare; choice of government.
- It is about having opportunities: for education, work, public office, private ownership, leisure.
- It is about freedom: freedom of opinion, speech etc.

Definition of Sustainable Development

- Development that meets the needs of the present without compromising the ability of future generations to meet their own needs.
- Growth that lasts

NOTE: There's an on-going debate about the precise meaning of this term.

Growth in relation to Environment

Debates:

- Environmental damage is caused by Growth
 - due to increase in income and consumption
- Environmental damage is quite often the result of a lack of growth
 - increasing wealth means that there are sufficient resources to improve the method of production and lower pollution levels, use less material and overall make more goods

Demand Curve



Supply Curve



The equilibrium price

