

# Introduction to Economics – Principles of Economics



## Lecture 2

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# Today's agenda

Objective of households, firms and the government

Some diagrams. Very important!!!

Circular flow model

Production Possibility Frontier

10 Principles of Economics

## Objectives of households

What is your objective as a household?

Money?

More money?

Good job?

New premium class car?

New flat or house?

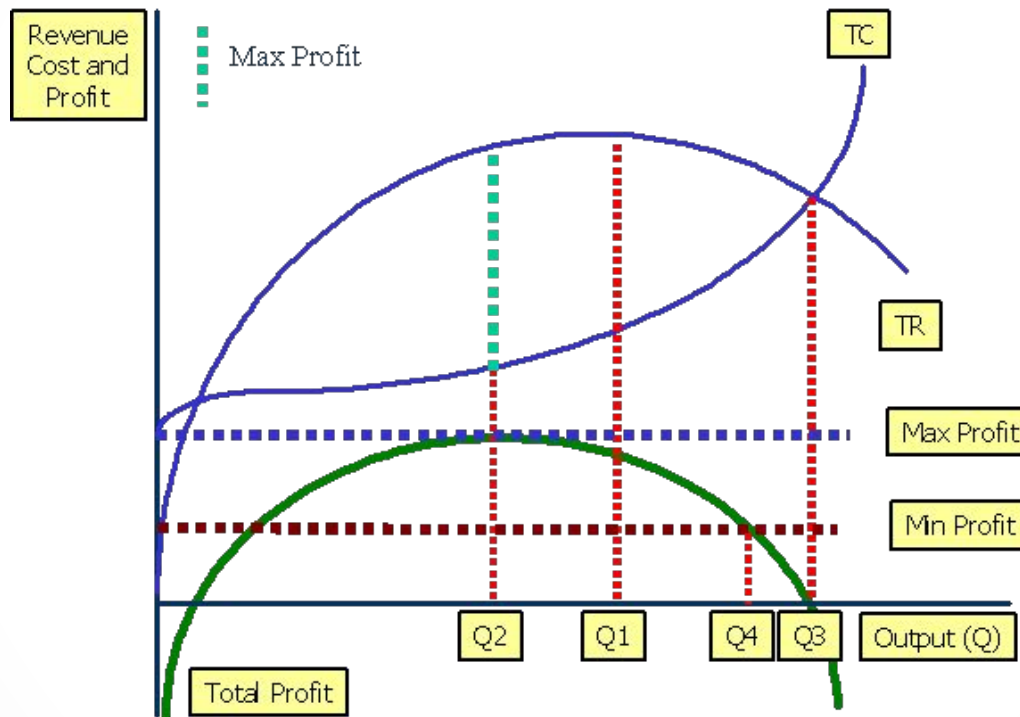
If you said YES to all these questions, then you're RIGTH!!!

But economists use term "utility" all these aspects of human life

Therefore, households' objective is to maximise their utility from consumption

# Objectives of firms

In economic theory we assume that main objective of firms is to **maximise profits**



Is there any problems with such assumption?

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## Objectives of firms

If “Yes”, then why it might be so?

There are many aspects that influence firms decisions about their objectives

Revenue maximisation

Sales maximisation

Divorce between ownership and control

# Objectives of the government

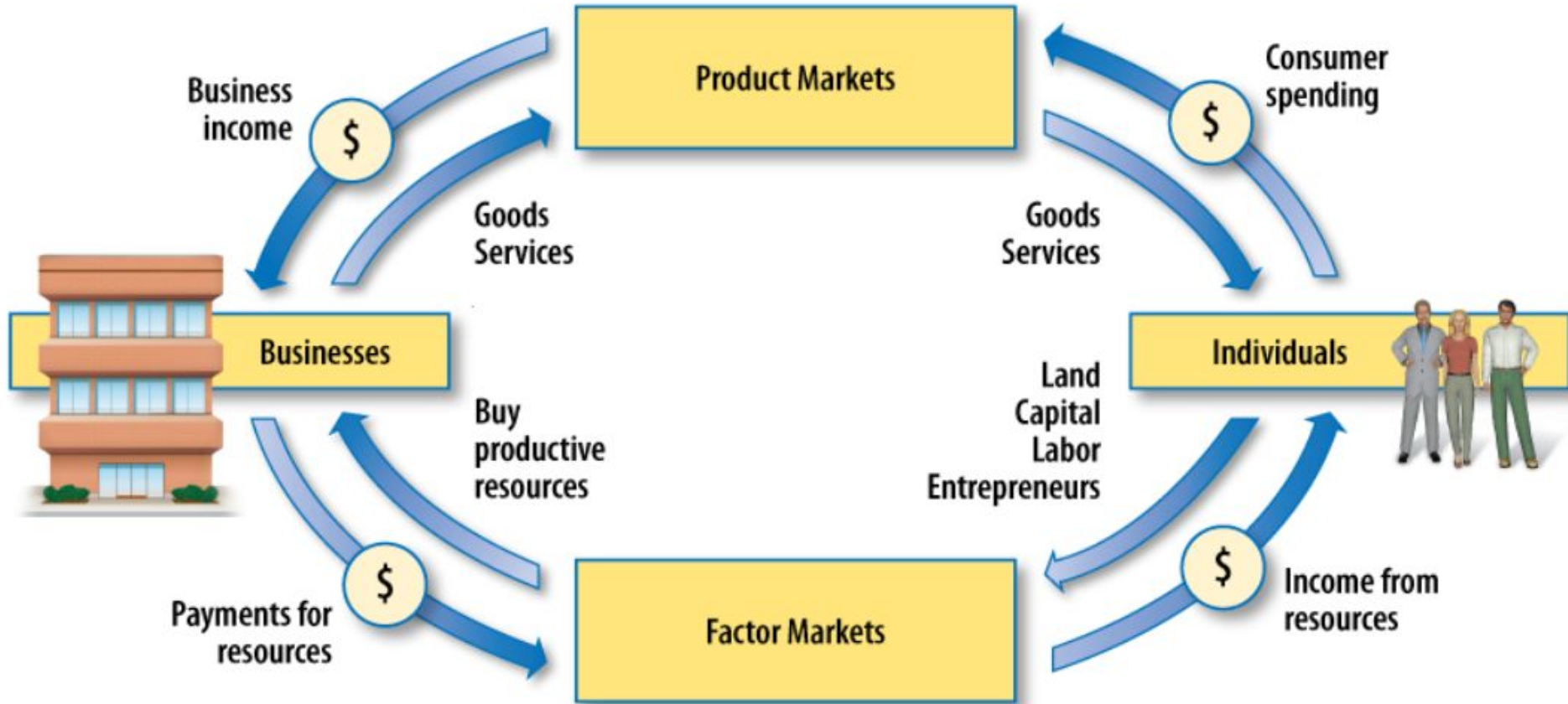
Four main targets:

- ❖ Low unemployment
- ❖ Low and steady inflation
- ❖ Sustainable economic growth (GDP)
- ❖ Positive balance of payment (more export than import)

Additional objective:

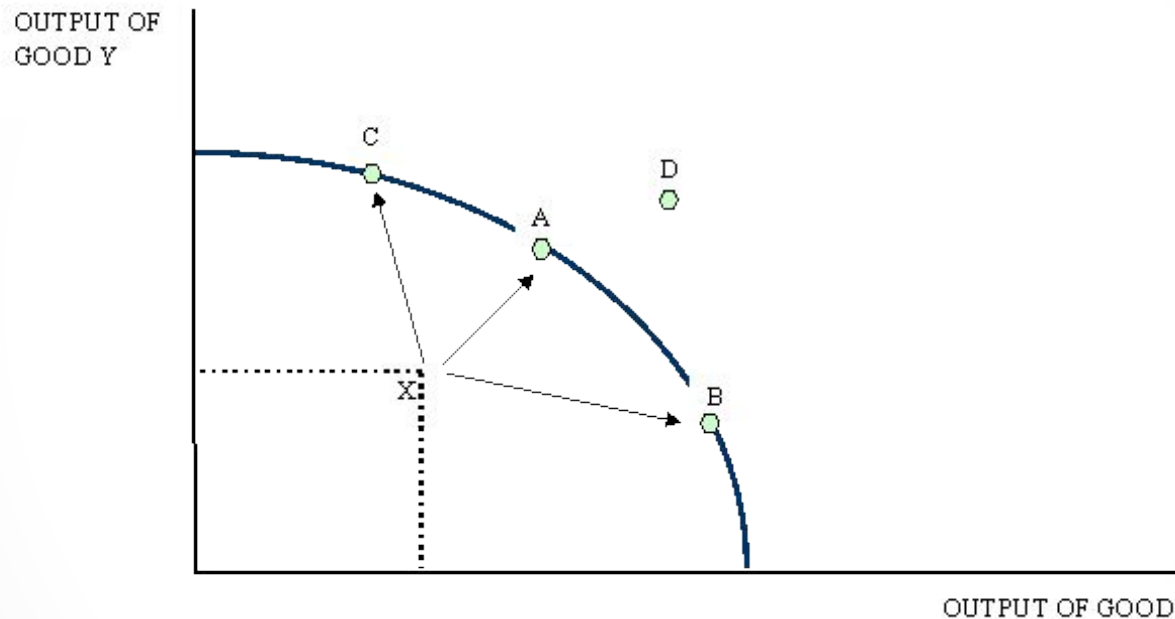
- ❖ Reduce inequality and increase peoples' welfare
- ❖ Protect the environment

# Circular flow model



# Production Possibility Frontier

A PPF shows the different combinations of goods and services that can be produced with a given amount of resources in their most efficient way  
Any point inside the curve – suggests resources are not being utilised efficiently  
Any point outside the curve – not attainable with the current level of resources



Note that PPF is drawn concave to the origin – principle of diminishing returns




## Principle #1 – People face trade-offs!

There is now such thing as FREE LUNCH!

A student who studies both Finance and Economics

Studying Economics	Studying Finance
Two more hours of studying Economics	Giving up two hours of studying Finance



The same dilemma with equality and efficiency

Redistributing income leads to a reduction in incentives to work hard  
e.g. redistributing income via progressive tax regime where rich pays more  
and poor pays less.

## Principle #2 – The cost of something is what you give up to get it

Concept of opportunity cost

Consider a student who is deciding whether to go to college or not

Going to college	Cost: Tuition fees Room rent costs Books and Food
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Does it represent what you give up to spend a year in a college?

## Principle #3 – Rational people think at the margin

**Rational people** – who systematically and purposefully do the best they can to achieve their objectives given their opportunities

Rational decision-maker takes an action **if and only if** marginal benefit of the action exceeds marginal cost. Thus, rational decision-makers make decisions comparing marginal benefit and marginal cost

Marginal benefit is a benefit of having one extra unit of something, while marginal cost is a one extra unit of cost to individual or a firm of having or producing something

Water is necessary to survive, while diamonds are not really necessary for living

Then why water is cheap, while diamonds are expensive?

## Principle #4 – People respond to incentives

Incentive is a thing that motivates or encourages one to do something

If benefits from taking economic activity are greater than costs, then there is an incentive to do so

The logo for Chocolife.me features the word "Chocolife" in a dark brown, sans-serif font, followed by ".me" in a smaller font size. A red heart shape is positioned behind the ".me" text.The logo for BeSmart features the word "BeSmart" in a bold, orange, sans-serif font with a slight 3D effect. Below it, the Russian phrase "умные покупки" (smart purchases) is written in a smaller, white, sans-serif font. The entire logo is set against a blue rectangular background.

## Principle #5 – Trade can make everyone better off

**Absolute advantage** - The ability of a country, individual, company or region to produce a good or service at a lower cost per unit than the cost at which any other entity produces that good or service.

**Comparative advantage** exists when a country has a 'margin of superiority' in the production of a good or service i.e. where the **marginal cost of production is lower**

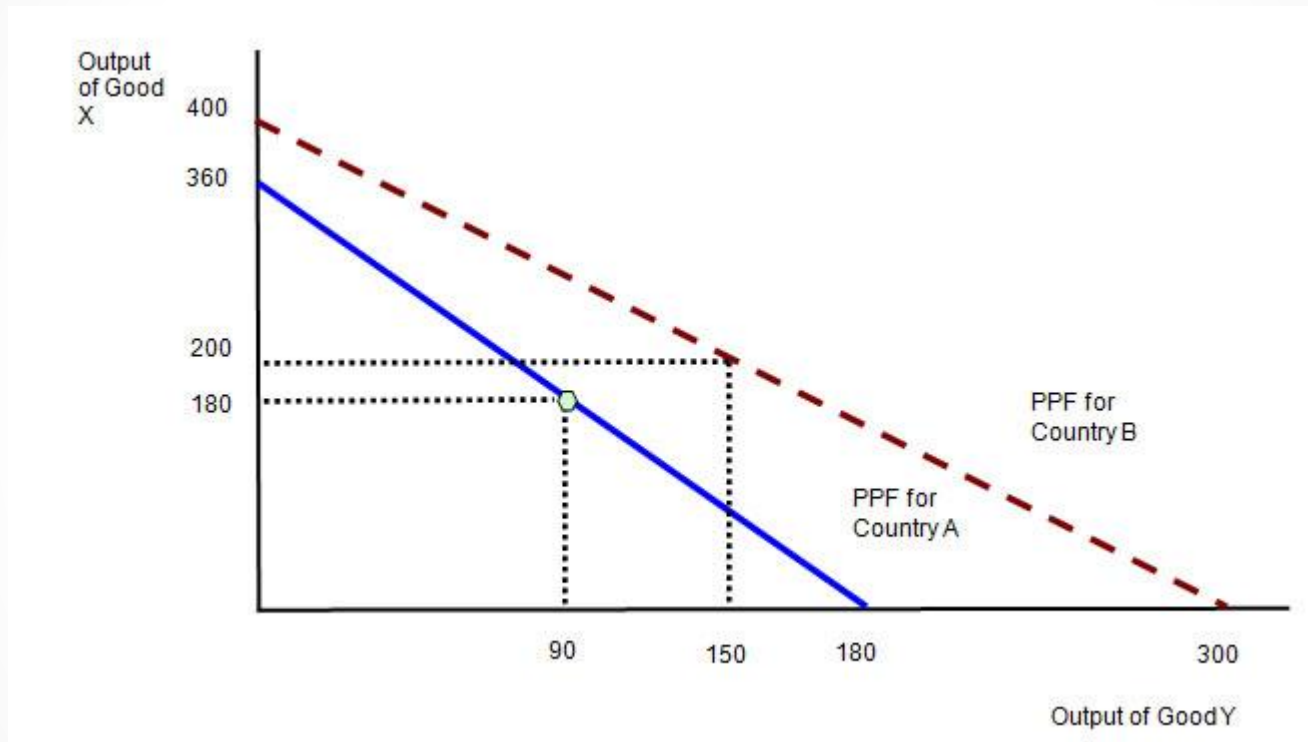
Two countries are producing two products (X and Y). With a given amount of resources:

	Output of X	Output of Y
Country A	180	90
Country B	200	150

Hence, Country A should specialise in producing good X, while B better off by specialising in good Y

# Principle #5 – Trade can make everyone better off

You can show it on a diagram



## **Principle #6 – Markets are usually a good way to organise Economic Activity**

Planned economy is one where government decides which goods and services to be produced, how much goods and services to be produced and who produced these goods and services

Why is free-market economy is better way to organise economic activity?

Government does not know business environment in the market

Government does not know tastes of consumers and how much they want to demand goods and services

Government does not know what price would prefer consumers

Government may not have knowledge about which goods and services are needed

Invisible hand brings efficiency?

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## **Principle #7 – Governments can sometimes improve market outcomes**

Why do we need government if “the invisible hand” is so powerful?

To ensure property rights

Reduce impact of externalities on social well-being

Ensure that players in the market do not use their market power in not socially responsible way or do not have enough market to influence markets

Reduce inequality via economic instruments such taxes



## **Principle #8 – A country's Standard of Living Depends on its ability to produce goods and services**

In 2008 average income of a household in USA was \$47 000, while in Nigeria it was only \$1 400

There is a fundamental relationship between productivity and standards of living

Productivity is how much products and services can be produced from each unit of labor

## **Principle #9 – Prices rise when the government prints too much money**

Inflation is an overall increase in prices within the economy

When government creates large quantities of money, the value of money falls

We shall come back to this at later stages of our course

## **Principle #10 – Society faces a short-run trade off between Inflation and unemployment**

What happens when the government injects money into the economy?

Increasing the amount of money in the economy stimulates more spending and therefore the demand for goods and services

Higher demand over time gives firms incentive to increase their prices, but in the meantime it also encourages firms to hire more workers reducing unemployment

## Practice questions

Name a way that your family interacts in the factor market and a way that it interacts in the product market.

Name one economic interaction that isn't covered by the simplified circular-flow diagram.

## Practice questions

An economy consists of three workers: Larry, Moe, and Curly. Each works ten hours a day and can produce two services: mowing lawns and washing cars. In an hour, Larry can either mow one lawn or wash one car; Moe can either mow one lawn or wash two cars; and Curly can either mow two lawns or wash one car.

Calculate how much of each service is produced under the following circumstances, which we label A and B

- All three spend all their time mowing lawns. (A)
- All three spend all their time washing cars. (B)
- All three spend half their time on each activity.

## Practice questions

Maria can read 20 pages of economics in an hour. She can also read 50 pages of sociology in an hour. She spends 5 hours per day studying.

- a. Draw Maria's production possibilities frontier for reading economics and sociology.
- b. What is Maria's opportunity cost of reading 100 pages of sociology?

# HOMEWORK!

For lecture 1:

Read Chapter 1 in Mankiw

Problems and applications Q2 and Q3

For lecture 3:

Read Chapter 2 and 3 in Mankiw

Chapter 2: Questions for review Q6

Problems and applications Q1 and Q2 parts a and b

Chapter 3:

Questions for review Q1

Problems and applications: Q1