Fundamental Economics Concepts

Economics is study of how individuals make choices about how to allocate and distribute scarce resources (scarcity) and how they interact with each other.	Assume people make rational choices by comparing opportunity costs and choosing greatest net benefit.
Opportunity cost is what we give up by making an economical choice.	Trade should make everyone better off.
Positive economics uses analysis to describe and make predictions under certain contexts.	Normative economics uses analysis to evaluate merits of different contexts.
Pareto efficiency is when goods are maximally efficient, and any change will result in a negative outcome for somebody.	Main branches of economics are microeconomics (individual) and macroeconomics (society).

Microeconomics

Interaction of supply and demand is central topic.	A market is all the buyers and sellers of a particular good or service.
A perfectly competitive market includes: large number of buyers/sellers, all participants are informed of market price, and highly standardized good/service.	Equilibrium occurs when no market participant has any reason to alter behavior (where supply and demand meet on the graph).
Demand curve shows quantity of a good/service that consumers are willing/able to purchase, and has a negative slope.	Position of demand curve depends on: income, prices of related goods, tastes, expectations, and number of buyers.

Microeconomics (cont)

Supply curve shows quantity of a good/service that producers are willing to supply at each price, and has a positive slope.	Position of supply curve depends on technology used in production, prices of inputs used in production, expectations, and number of sellers.
Competitive market equilibrium maximizes total surplus (combined benefits) of market participants.	Elasticity provides an independent measure of responsiveness of supply and demand to price changes.
Government interventions include: setting price ceilings/price floors, imposing taxes on transactions to raise revenue for essential services.	Trade makes people better off, generally, and international trade increases total surplus.

Microeconomics (cont)

Firms supply goods/services by combining: labor, capital, raw materials, and other inputs, while seeking to maximize profits.	Perfectly competitive markets aim for firms to make zero economic profits.
Imperfect markets include: monopoly (single supplier), oligopoly (small number of suppliers), and monopolistic competition (many suppliers of similar but differentiated products).	Imperfect competition arises because of barriers to entry into the market.
Imperfect competition causes lower equilibrium quantities and higher equilibrium price, causing total surplus to be lower than it would be in a competitive market.	Profits from imperfect competition arise from new methods of production, new markets, and/or new goods/services.

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Microeconomics (cont)

Market failures arise when breakdowns in private property system causes market outcomes to deviate from socially efficient outcome.	Externalities occur when important economic decisions occur outside of the market. Possible solutions include creating a market for those interactions, and/or government regulation.

All goods/services can be classified along two dimensions: extent rivalry in consumption, where consumption for one means less for another, and ease of excludability, where who controls the good. There are 4 categories of good/service: private goods, common resources, collective goods, and public goods.

Governments are distinguished from private organizations through their ability to enforce taxes and their monopoly on legitimate force.	Pork barrel politics and rent seeking are sources of inefficiency of government programs, as everyone pays for them, but one area gains the benefit.

Macroeconomics

Macroeconomics is concerned with: (1) What determines long-run growth, and (2) what are the causes and consequences of short-run fluctuations in economic activity, employment, and inflation.	Total output of economy is measured using Gross Domestic Product (GDP), which is the market value of all final goods/services produced within a country during a specified period of time.
In US, output has grown much faster than population since 1900 (40x vs 4x).	Business cycle is the alternation between recessions (distance between peak and trough) and expansions (distance between trough and peak).

Macroeconomics (cont)

Labor force is total of all individuals who are either working or fit for work but unemployed.	Unemployment is categorized into three subtopics: 1)frictional (unemployment by choice), 2) structural (technology shift in industry), or cyclical (due to business cycle).
Consumer Price Index (CPI) and Gross Domestic Product Deflator are two measures of inflation (prices in economy are all increasing).	GDP is a measure of production, but at the level of the economy, production = expenditures = income.
4 categories of expenditures: 1) consumption, 2) investment, 3) government purchases of goods/services, and 4) net exports.	Labor productivity depends on quantities of physical and human capital, natural resources, technological understanding, and political/legal environment.

Macroeconomics (cont)

Savings is a term for income not spent on consuming goods/services, while investments is a term for purchase of new capital equipment.	Financial markets are the institutions through which individuals who have money they want to save can supply these funds to persons or companies who wish to borrow money to invest.
In a closed market, savings must equal investments. In an open economy, savings must equal investments plus net capital outflows.	In financial markets, interest rate is adjusted to equate the supply of saving to the demand of saving.

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Macroeconomics (cont)

Money serves the following functions: 1) medium of exchange, 2) unit of account, and 3) a store of value.	Monetary value is compared using M1 (liquid assets such as cash, checkable deposits, and traveler's checks) and M2 (not very liquid assets such as M1 plus savings/time deposits, certificates of deposits, and money market funds).
Federal Reserve is central bank of the US, was established in 1913, consists of 12 district banks located throughout the country and the Federal Reserve Board, located in Washington, D.C.	The Federal Reserve controls the supply of money in the economy and acts as lender of last resort for the banking system.

Macroeconomics (cont)

Effects of increasing the supply of money: 1) short term effects include credit conditions and influence on the level of economic activity, and 2) long-term effects include changing prices but no real effect on the economy.	Output gap is used to analyze short-term variations in economic activity, and is calculated by the difference between actual output and potential output.
Economy's output is determined by its potential output, but is also determined by aggregate demand, as short-term prices influence demand outside of potential output values.	When potential output and actual output do not align, deviations cause them to equate. Monetary and fiscal policies are used to help the recovery from deviations.

Economics of Technology and Innovation

"Great Enrichment" refers to periods of industrialization since the 1800s indicated by advances in material living standards, connectedness through transportation and information networks, and health/safety.	Primary drivers of industrialization include technology revolutions - mechanization of factories/farms, materials for manufacturing/construction, agricultural productivity, new sources of energy, powered transportation, electronic communications, and better health through sanitation, vaccines, and antibiotics.

Economics of Technology and Innovation (cont)

US spends 2.5% GDP on research (largest supplier in the world), contributing to 1% annual growth in total factor productivity, a common way to measure technological progress. Estimates show that for every $1 spent on R&D, $3.60 is made in social value.	Private companies tend to underinvest, as they are worried competitive companies may benefit from information spillover. Business employ imperfect strategies to mitigate this - secrecy, intellectual property, lead time, and complimentary assets.
Innovation is also supported by government and non-profit investments in scientific research.	Institutions are main factor connecting investors with inventions.

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