Three key economic ideals:
- **Market –** A group of buyers and sellers of a G/S and the institution or arrangement by which they come together to trade
- **Studying how people make choices:**
    1) **People are rational**
        - Economics assume that consumers/firms use all information available in order to make the best decision
    2) **People respond to economic incentives**
        - Economics emphasis that consumers/firms respond to economic incentives e.g. PBS
    2) **Optimal decision are made at the margin**
        - Economists reason that the optimal decision is to continue any activity up to the point where the marginal benefit equals the marginal cost (MB=MC)

Scarcity, trade-offs and the economic problem that every society must solve:
- **Trade-offs –** The idea that, because of scarcity, producing more of one good or service means producing less of another G/S
- **Opportunity cost –** The loss of potential gain, as available resources are invested into the next best alternative
- **Three fundamental economic questions**
    1) What good and services to produce?
    2) How to produce the goods and services?
    3) For whom to produce the goods and services for?

Centrally planed economies versus market economies:
- **Centrally planned economy –** An economy in which the government decides how economic resources will be allocated
- **Market economy –** Economy in which the decisions of households and firms interacting in markets allocate economic resources
    - **Consumer sovereignty –** Occurs as firms must produce goods and services that meet the wants of consumers or the firms will go out of business e.g. market economy

The Modern mixed economy:
- **Mixed economy –** An economy in which most economic decision result from the interaction of buyers and sellers, but in which the government plays a significant role in allocating resources
- While Aust operates under a market economy there is still intervention form the government. For example government provide those products that firms don't such as roads, street lights, pensions

Efficiency and equity:
Productive efficiency – When a good or service is produced using the least amount of resources
Allocative efficiency – Occurs when production reflects consumer preferences and resources are allocated throughout the economy to produce what consumers demand
Dynamic efficiency – Occurs when new technologies and innovations are adopted over time
Voluntary exchange – Occurs in a market when both the buyer and seller of a product are made better off by the transaction

Equity – The fair distribution of economic benefits between individuals and between societies
- Some people support taxing people with higher income allowing for a more equal distribution of income. However this reduces the incentive for people to work hard and get ahead, therefore there is a trade-off between the two.

Economic models/theory:
- **Models –** Simplified versions of reality which are used to help analyze real world problems
- **To develop a model, economists generally follow these steps:**
  1) Decide on the assumption to be used in developing the model
  2) Formulate a testable hypothesis
  3) Use economic data to test the hypothesis
     - **Positive analysis –** Concerned with 'what is' and involves value free statement that can be checked by using facts e.g. whether reduction in tax leads to increased spending
     - **Normative analysis –** Analysis concerned with 'what ought to be' and involves making value judgments which cannot be tested e.g. individuals should receive tax reductions as they are able to decide how to spend money to max their satisfaction
  4) Revise the model if it fails to explain well the economic data
  5) Retain the revised model to help answer similar economic questions in the future

Microeconomics and Macroeconomics:
- **Microeconomics –** The study of how households and firms make choices, how they interact in markets and how the government attempts to influence their choice
- **Macroeconomics –** The study of the economy as a whole, including topics such as inflation, unemployment and economic growth

Week 2 – Measuring total production, income and economic growth (Ch. 4 P.G. 88- 101)

Economic growth – The expansion of society's productive potential. Economic growth is usually measured by the rate of growth in real GDP.
Unemployment rate – The percentage of the labour force that is unemployed
Business cycle – Alternating periods of economic expansion and economic contraction relative to trend growth
Expansion – The period of a business cycle during which total production and total employment are increasing above trend growth
Contraction – The period of a business cycle during which total production and total employment are falling below trend growth
Recession – The period of a business cycle during which total production and total employment are decreasing
Inflation rate – The percentage increase in the general price level in the economy from one year to the next

Gross domestic product (GDP) measures total production:
- **GDP –** The market value of all final G&S produced in a country during a period of time
  - **Final G&S –** A new G&S which is the end product of the production process that is purchased by the final user. Some

G&S are used in the production of other G&S, **Intermediate G&S** – A G&S that is an input into another G&S. E.g. car tyres produced by a separate company and sold to BMW is only counted one in GDP measure otherwise it would be double counted
- GDP is measured quarterly

Measuring GDP using the value added method:
- **Value added –** Refers to the additional market value a firm adds to a product and is equal to the difference between the price the firm sells a good for and the price it paid other firms for intermediate goods

Other measures of total production and total income:
- **National income accounting –** Refers to the methods the ABS uses to keep track of total production and total income in the economy. The table containing this information is referred to as The Australian System of National Accounts.
- **ABS also calculates these measures:**
  - **Net Domestic Product (NDP) –** Is calculated by measuring GDP and subtracting the value of depreciation on capital equipment
  - **Gross National Income (GNI) –** Is Australia's GDP, plus income generated overseas by Australian residents and firms, minus the income generated in Australia by non residents and foreign firms

Methods of measuring GDP:
- **The production methods –** The sum of the value of all G&S produced by industries in the economy in a year minus the cost of G&S used in the productive process, leaving the value added by the industries
- **The expenditure methods –** The sum of total expenditure on final G&S by households, investors, govt and net exports (the value of exports minus the value of imports)
- **The income method –** The sum of the income generated from the production of G&S, which includes profit, wages and other employee payments, income from rent and interest earned

Transfer payments – Payments by the government to individuals for which the government does not receive a good or service in return

Circular flow diagram:
- Illustrates the flow of spending and money in the economy. Firms sell G&S to households/firms/government. To produce G&S firms use labour, capital, natural resources, entrepreneurs. Households supply factors of production to firms in exchange for income e.g. wages, interest, profit, rent. Firms make payment to households in exchange for hiring workers. Households also use their income to pay tax and save. Govt borrow this money from household. We can measure GDP either by calculating the total value of expenditure on final G&S or by calculating the value of total income.

Components of GDP:
- **Y = C + I + G + NX**
- **Consumption –** Spending by households on G&S, not including spending on new houses

- **Investment** – Spending by firms on new factories, office building, machinery and inventories, plus spending by households on new houses
- **Government** – Spending by federal, state and local government on G&S
- **Net export expenditure**

Does GDP measure what we want it to measure?
- **Shortcomings of GDP as a measure of total production:**
    - **Household production** – Cooking, gardening, child care are not counted in GDP around the house
    - **The underground economy/black-market** – Buying and selling of goods and service that is concealed from the government to avoid taxes or regulation or because the goods and services are illegal
- **Shortcomings of GDP as a measure of wellbeing**
    - **The distribution of GDP** - GDP may not take into account parts of the population who's economic wellbeing may be unchanged
    - **The value of leisure is not included in GDP** – While leisure time may be enjoyed it is not calculated in GDP
    - **The level and quantity of health care and education** – Takes no account of the composition of G&S produced, limited health care services lower wellbeing
    - **GDP not adjusted for pollution or negative externalities** – Manufacturing plants pollute yet GDP is not adjusted to deal with pollution
    - **GDP is not adjusted for changed in crime and other social problems** – An increase in crime may decrease wellbeing but may increase GDP if it mean more police

Real GDP versus Nominal GDP:
- **Real GDP** – A measure of the volume of final G&S, holding prices constant (not inflation/deflation)
- **Nominal GDP** – The market value of final G&S evaluated at current year prices

Calculating the economic growth rate:
- **Economic growth rate** – The rate of change of real GDP from one year to the next
    - Growth rate in 2008/09 = $1,195,707, Growth rate 2009/10 = $1,222,802
    - 1,222,802 – 1,195,707 = $27,095
    - $\dfrac{27,096}{1,195,707} \times 100 = 2.27\%$

The GDP deflator:
- **Deflator** – A measure of the price level, calculated by dividing nominal GDP by real GDP and multiplying by 100

    - GDP deflator = $\dfrac{\text{Nominal GDP}}{\text{Real GDP}} \times 100$