THE GLOBAL ECONOMY EXAM NOTES – Part 1

TOPIC ONE: INTRODUCTION

- Economics is the study of the choices of consumers, business managers and government officials make to attain their goals, given their scarce resources.
- The choices reflect the trade-offs people face because we live in a world of scarcity, which means that although our wants are unlimited the resources available to fulfill those wants are limited
- It is a group of useful ideas about how individuals make choices.
- Economic models are simplified versions of reality used to analyse real-world economic situations.

- A market is a group of buyers and sellers of a good or service and the institution or arrangement by which they come together to trade.

Three key economic ideas:

- **People are rational:**
  - Rational individuals weigh the benefits and costs of each action, and they choose an action only if the benefits outweigh the costs.
  - The assumption of rational behaviour is very useful in explaining most of the choices that people make.
- **People respond to economic incentives:**
  - Consumers and firms consistently respond to economic incentives.
  - Eg. If medicines were free there would be little incentive for patients or doctors to
- **Optimal decisions are made at the margin:**
  - Economists use the word marginal to mean an extra or additional benefit or cost of a decision.
  - Eg. The marginal benefit of watching more television is the enjoyment you receive, while the marginal cost is the lower grade you receive in class from having studied less.
  - Economists reason that the optimal decision is to continue any activity up to the point where the marginal benefit equal the marginal cost.
  - Economists refer to analysis that involves comparing marginal benefits and marginal costs as marginal analysis.

Scarcity, trade-offs and the economic problem that every society must solve:

- Society faces the economic problem that is has only a limited amount of economic resources – such as workers, machines and natural resources.

- Society therefore faces trade-offs. A trade-off is the idea that, because of scarcity, producing more of one good or service means producing less of another good or service.

<u>Trade-offs:</u>

- Trade-offs force society to make choices, particularly when answering the following three questions:
    - **What goods and services will be produced?**
- What will be produced is determined by the choices made by consumers, firms and governments
- Consumers, firms and government face the problem of scarcity by trading off one good for another
- When analysing the decision to choose between the alternative options, economists use the concept of opportunity cost.
- This is one of the most important concepts in economics. The opportunity cost of any activity is the highest-valued alternative that must be given up to engage in activity that activity. (Eg. A lost grade due to watching television rather than studying)
    - **How will the goods and services be produced?**
- Firms choose how to produces the goods and services they sell
- In many cases firms face a trade-off between using more workers and using more machines
    - **Who will receive the goods and services?**
- Depends largely on how income is distributed
- The individuals with the highest income have the ability to buy the most goods and services
- An important policy question, however, is whether the government should intervene to make the distribution of income more equal
- Such intervention occurs in Australia – taxes (people with higher incomes pay a larger fraction of their income.

<u>Centrally planned economies versus market economies:</u>

- A society can have a centrally planned economy in which the government decides how economic resources will be allocated.
- Or a society can have a market economy in which the decisions of households and firms interacting in markets allocate economic resources.
- In a centrally planned economy the government decides what goods to produce, how to produce them and who will receive them.
- Centrally planned economies, like the former Soviet Union have not been successful in producing low-cost, high-quality goods and services. – As a result the standard of living of the average person tends to be quite low.
- All the high-income democracies, such as Australia, the USA, Canada, Japan and many European countries are market economies.
- Market economies rely primarily on privately owned firms to produce goods and services that meet the wants of consumers of the firms will go out of business.
- It is ultimately consumers who decide what goods and services will be produced in market economies. This concept is referred to as consumer sovereignty.

- In a market economy the income of an individual is determined by the payment received of what they have to sell.

The modern 'mixed' economy:

- Beginning in the middle of the twentieth century, government intervention in the economy dramatically increased in every marker economy. The increase was primarily caused by the high rates of unemployment and business bankruptcies during the Great Depression of the 1930's.
- Eg. In 1910, Australia established the Social Security System which now provides government payments to the retired, the disabled, the unemployed and others.
- Some economists argue that the extent of government intervention makes it no longer to accurate to refer to Australia, US, Canadian, etc, economies as market economies. Instead they should be referred to as mixed economies.
- In a mixed economy, most economic decisions result from the interaction of buyers and sellers in markets, but the government plays a significant role in the allocation of resources.

Efficiency and Equity:

- Market economies tend to be more efficient that centrally planned economies.
- There are three types of efficiency:
    - Productive efficiency – occurs when a good or a 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 innovation are adopted over time.
- Markets tend to be efficient because they promote competition and voluntary exchange.
- Voluntary exchange refers to the situation in which both the buyer and seller of a product are made better off by the transaction.
- Although markets promote efficiency, they don't guarantee it.
- Governments sometimes reduce efficiency by interfering with the voluntary exchange in markets. (Eg. many governments limit the imports of some goods from foreign countries)
- Just because an economic outcome is efficient this does not necessarily mean that society finds it desirable.
- Many people prefer economic outcomes that they consider fair or equitable, even if these outcomes are less efficient.
- Equity usually involves a 'fair' distribution of economic benefits.
- There is often a trade-off between efficiency and equity.
- Government policy makers have to confront this trade-off.

Economic models:

- Economists rely on economic theories or models to analyse real-world issues.
- Economic models are simplified versions of reality used to analyse real-world economic situations.
- One purpose of economic models is to make economic ideas sufficiently explicit and concrete to be used for decision-making by individuals, firms or the government.
- Economists often use several models to examine different aspects of the issue.
- To develop a model, economists generally follow these steps:
    - Decide on the assumptions to be used in developing the model
    - Formulate a testable hypothesis
    - Use economic data to test the hypothesis
    - Revise the model if it fails to explain well the economic data
    - Retain the revised model to help answer similar economic questions in the future

The role of assumptions in economic models:

- Any model is based on making assumptions because models have to be simplified to be useful.
- We cannot analyse an economic issue unless we reduce its complexity.
- Assumptions are simplifications – we form a hypothesis based on these assumptions and then we test the hypothesis

Forming and testing hypotheses in economic models:

- A hypothesis in an economic model is a statement that may be either correct or incorrect about an economic variable.
- An economic variable is something measurable that can have different values, such as the price paid for water use.
- An economic hypothesis is usually about a causal relationship.
- Before accepting a hypothesis we must test it
- To test a hypothesis we must analyse statistics on he relevant economic variables.
- Data may be required on other variables as well
- Testing a hypothesis can be tricky – just because two things are correlated – that is, they are associated with each other – does not mean that one caused the other.
- Over a period of time, many economic variables will be changing, which complicates testing hypotheses.
- Hypotheses must be statements that could in principle turn out to be incorrect. (it must be possible to prove or disprove them)
- Economists accept and use an economic model if it leads to hypotheses that can be confirmed by statistical analysis
- Economists often refer to a hypothesis as being 'not rejected' rather than being 'accepted', by statistical analysis.
- If statistical analysis clearly rejects a hypothesis, it may be that an assumption made in the economic model was too limiting or too simple
- Process of developing models, testing hypotheses… scientific method (economic = social science)