Economics: Core Concepts Part III

When everybody else is better off, they can buy more, they strengthen demand, strengthen the market, strengthen the country.
-Carlos Slim Helu

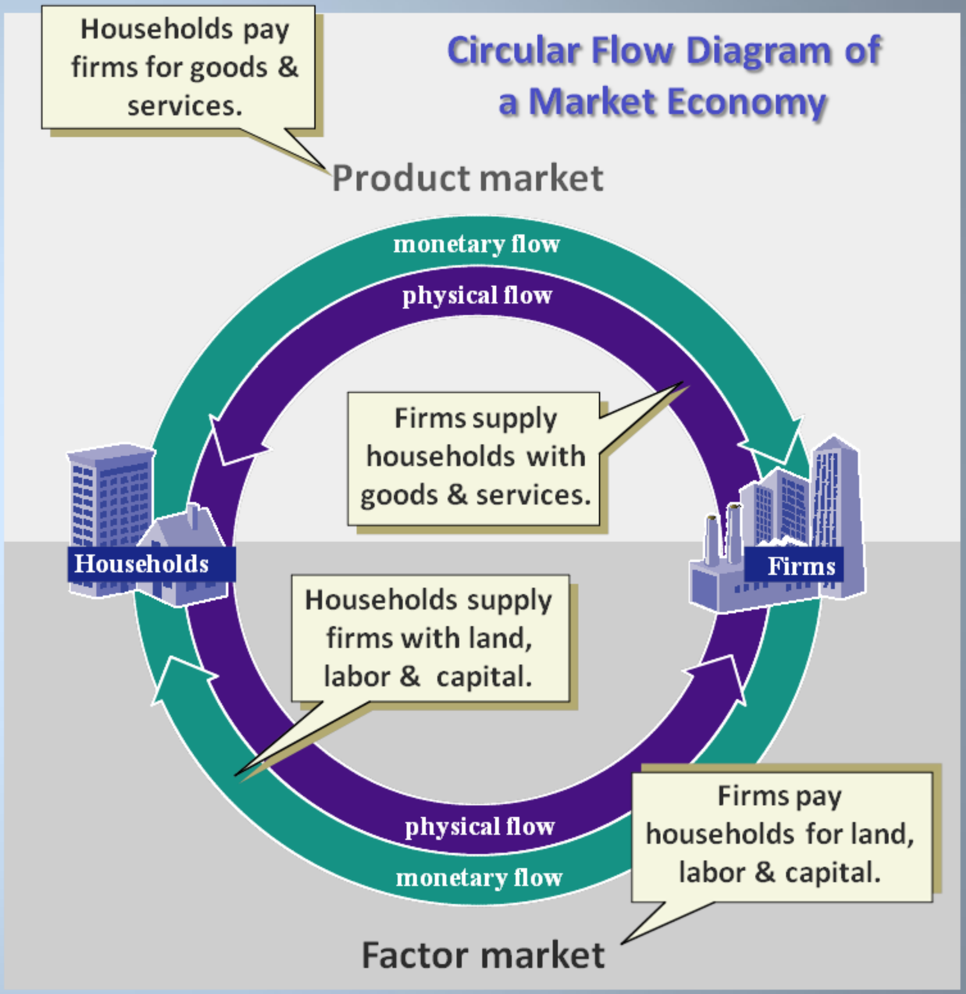
Economic Concept #6: Markets are usually a good way to organize economic activity.

- A ***market economy*** is an economy that allocates resources via the decentralized decisions of many firms and households as they interact in markets for goods and services.
  - Households decide what to buy and who to work for.
  - Firms decide what to produce and who to hire.

The Free Market Economy

In a free market economy, households and firms use markets to exchange money and products.

Households own the **factors of production** and consume goods and services.



Adam Smith

- Adam Smith is often referred to as the father of the market economy. He described a system in which an *invisible hand* maintains the market without government intervention. The government exists merely to protect individual rights.
- Because Smith's study was the most comprehensive study of economics up until that time, his ideas became the basis for all classic economic thought.

Main Ideas of Adam Smith

- ***Laissez faire*** is the doctrine of *leave it alone* … of nonintervention by government in the market mechanism. Government should not intervene in a market economy beyond preserving peace and enforcing property rights.
- Charity, while virtuous, cannot provide all the essentials for living. *"It is not from the benevolence of the butcher, the brewer or the baker that we can expect our dinner, but from their regard to their own interest."*
- The division of labor causes prosperity.

The Invisible Hand of a Market Economy

- The ***market mechanism*** is the use of market prices and sales to signal desired outputs (or resource allocations).
- The market decides the mix of output in an economy.

The Invisible Hand of a Market Economy

- Smith said that if people are allowed to pursue their **self-interest** in free markets, resources will be guided as if by an invisible hand to produce the most efficient level of aggregate (total) output.
  - Because households and firms look at prices to decide what to buy and sell, they unknowingly take into account the social costs of their actions.
  - As a result, prices guide decision makers to reach outcomes that tend to maximize the welfare of society as a whole.

Why Do Markets Exist?

Markets exist because none of us produces all the goods and services we require to satisfy our needs and wants. (And doing so wouldn't be very efficient!)

A ***market*** is an arrangement that allows buyers and sellers to exchange goods and services.

Specialization is the concentration of the productive efforts of individuals and firms on a limited number of activities.

The Market's Self-Regulating Nature

- In every transaction, the buyer and seller consider only their **self-interest**, or their own personal gain. **Self-interest** is the motivating force in the free market.
- Sellers in a free **market** struggle for the dollars of buyers. This is known as ***competition***, which is the regulating force of the free **market**.
- The interaction of buyers and sellers, motivated by **self-interest** and regulated by **competition**, all happens without a central plan … the invisible hand of the **marketplace**.

Advantages of the Free Market

Efficiency

- As a self-regulating system, a free market economy is **efficient**.

Freedom

- Free market economies have the highest degree of economic freedom of any economic system.

Growth

- Because **competition** encourages innovation, free markets encourage growth.

Goods & Services

- Free markets offer a wider variety of goods and services than any other system.

The Market Economy

"All the bad things you hear about markets are true: unemployment, inflation, inequalities of income and wealth, monopoly power, negative externalities and insufficiently supplied public goods. You know, there is only one thing that is worse than the market and that is no market."

Csaba Csaki
Rector of Economics, University of Budapest
August 1990

Economic Concept #7: Trade can make everyone better off.

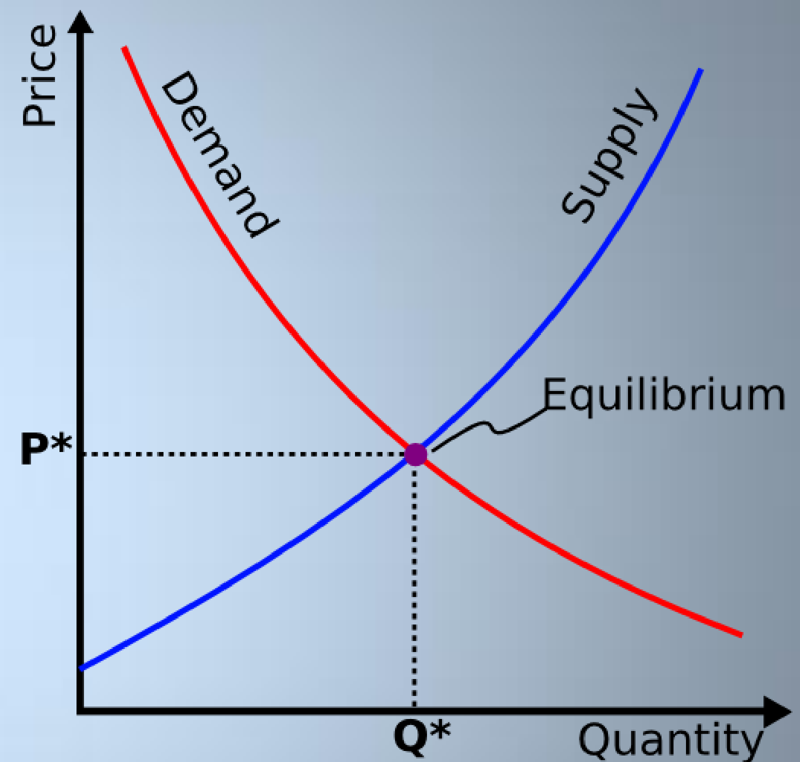
- People gain from their ability to trade with one another.
- **Competition** results in gains from trading.
- Trade allows people to **specialize** in what they do best.

The Advantage of Voluntary Trade

People can produce goods and services at lower **opportunity costs** when they **specialize** in what they do best. Then they can trade what they produce for goods and services that would be more costly for them to produce. In this way, both sides gain.

Demand & Supply

- A market economy has both demand and supply (buyers and sellers).
- ***Demand*** is what people want.
- ***Supply*** is what is available.



When sellers' prices match buyers' demands, the market is at equilibrium … there is no shortage or surplus of the product.

Economic Concept #8: The Law of Demand

- The less of something there is to go around the more buyers are willing to pay for it.
- The more of something there is to go around the less buyers are willing to pay for it.

Economic Concept #9: The Law of Supply

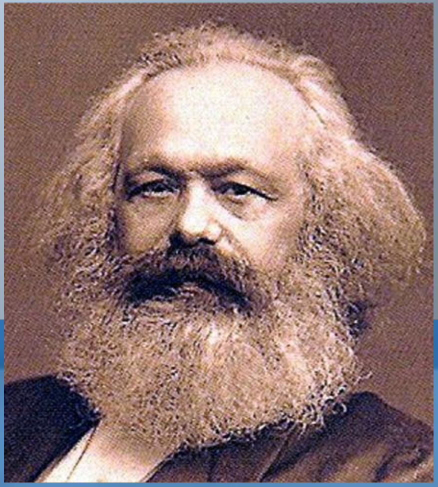
The more buyers are willing to pay for a product the more sellers are willing to make of the product.

Economic Concept #10: Governments can sometimes improve market outcomes.

- ***Market failure*** occurs when the market fails to allocate resources efficiently.
- When the market fails (breaks down) government can intervene to promote **efficiency** and **equity**.

Karl Marx

- Karl Marx argued that the government not only had to intervene but had to own all the **factors of production**.
- **Markets**, he said, permit capitalists to enrich themselves while the proletariat toil long hours for subsistence wages. The proletariate (workers) should rise up and revolt, according to Marx.
- During his lifetime, most of Marx’s ideas were ignored.

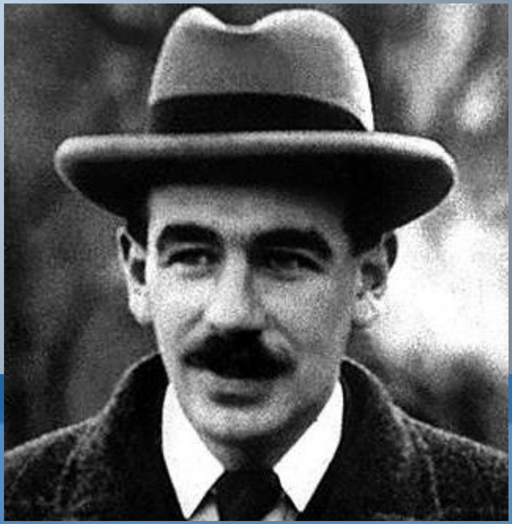


Marx's Main Ideas

- The horrible conditions during the industrial age were the result of the alienation of the workers in capitalist society.
  - The worker is alienated from what he produces. The worker is alienated from himself; only when he is not working does he feel truly himself. People are alienated from each other … in a competitive society people are set against other people.
- To understand human history you must see it as the story of social classes and their struggles with each other.
- Private property leads to inequality and greed.
- "From each according to ability to each according to need" (equal distribution of wealth).

John Maynard Keynes

- John Maynard Keynes offered a less drastic solution than Marx.
- Keynes ideas quickly and permanently changed the way the world looked at the economy. *The General Theory of Employment, Interest and Money* was published during the Great Depression. Many politicians read it and believed in it.



Keynes’ Main Ideas:

- Government should play an active but not an all-inclusive role in managing the economy.
- The government should regulate the economy by stimulating or slowing consumption. This is done by taxing and spending. (Tax more and spend less to slow the economy. Tax less and spend more to stimulate the economy.)
- By increasing aggregate (total) demand the economy will grow (demand-side fiscal (tax and spend) policies).
- During WWII Keynes wrote *How to Pay for The War* which_promoted compulsory saving and rationing to prevent **inflation**.

A Mixed Economy

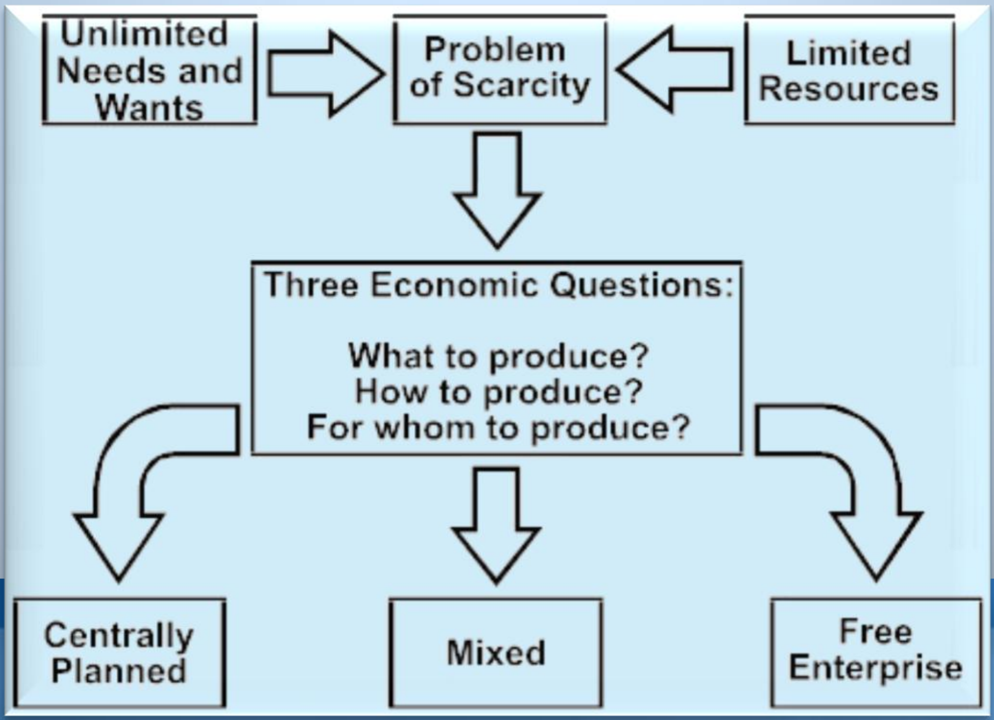
- A ***mixed economy*** is one that uses both market signals and government directives to allocate goods and resources.
- Most economies use a combination of market signals and government directives to select economic outcomes.

Continuing Debates

- The core of most debates is some variation of the WHAT, HOW or FOR WHOM questions.
  - Conservatives favor Adam Smith's **laissez-faire** approach.
  - Liberals tend to think government **intervention** is likely to improve the answers.

Continuing Debates

Countries answer the basic economic questions differently and their answers change over time.



Politics

- Political forces are a necessary ingredient in economic policy decisions.
- Inevitably, political choices must be made.

Market Failure

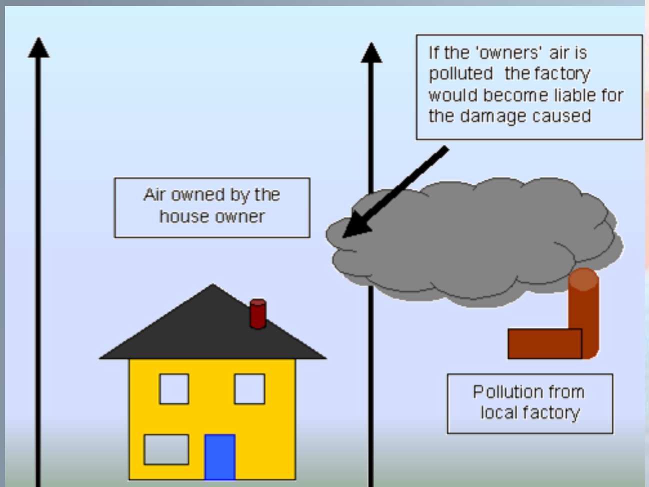
- A **market failure** is an imperfection in the market mechanism that prevents optimal outcomes.
- If the market signals don’t give the best possible answers, we say that the market mechanism has failed.

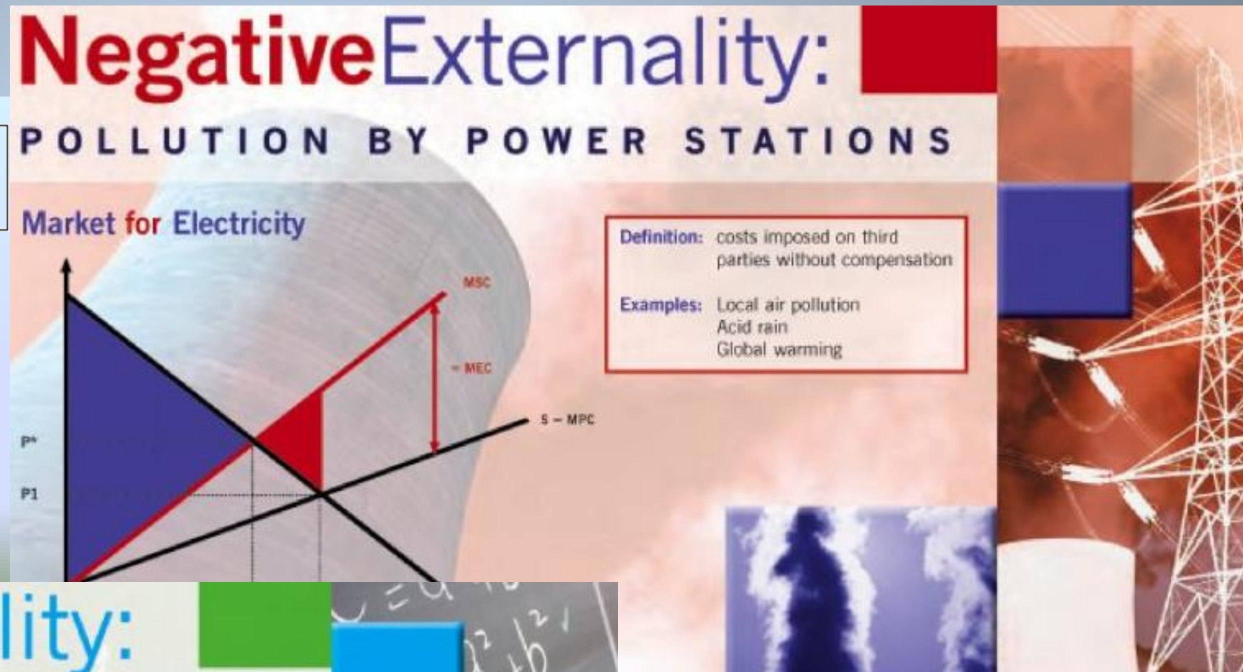
Market Failure

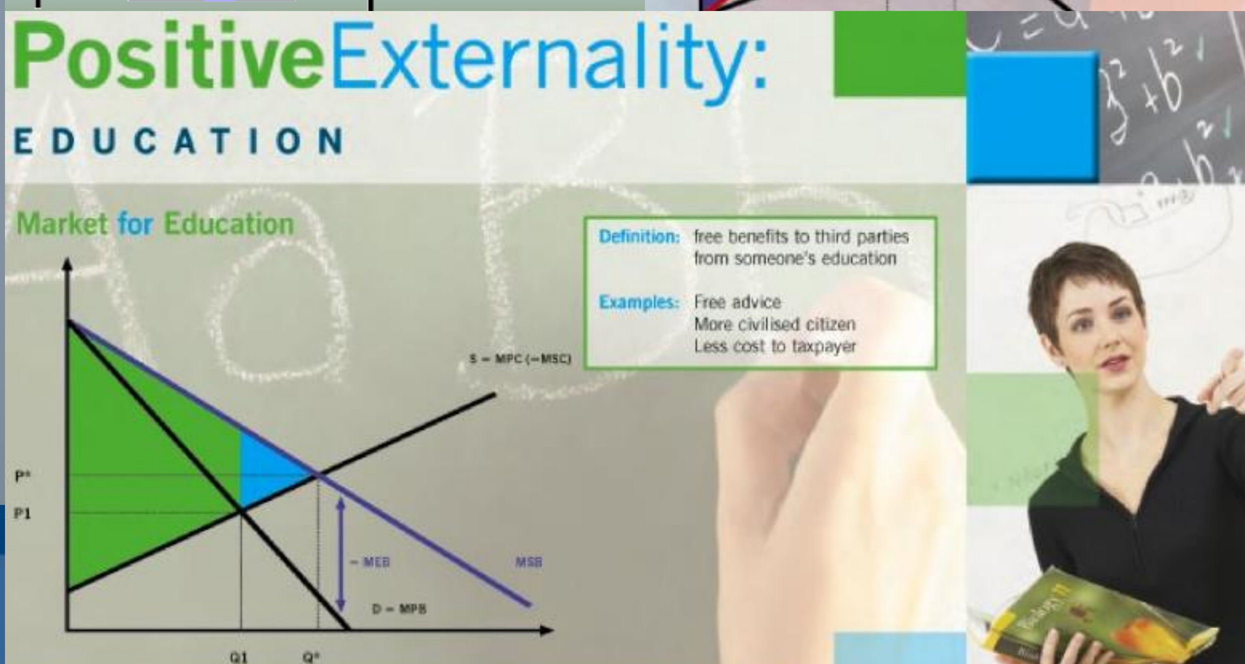
Market failure may be caused by:

- an ***externality*** – The decision-maker does not confront the full **cost** or does not receive the full benefit of an action. When the supply curve fails to include external costs, the equilibrium price is artificially low and the equilibrium quantity is artificially high
- Government Interference through price ceilings or price floors.
- Monopoly power (***market power***) – the ability of a single person or firm to unduly influence market prices

Externalities







The unintentional imposition of a good thing (positive **externality**) or a bad thing (negative **externality**) on an uninvolved 3rd party.

Government Price Controls

- Price Ceilings
  - Rent controls
  - Interest rate ceilings on mortgages or credit cards
- Price Floors
  - agricultural price supports
  - minimum wage

Price Ceilings:
Rent Control

- **Intended consequence**
  - affordable housing for poor
- **Unintended consequence**
  - Increased quantity demanded
  - Severe shortage
  - Reduced housing
  - Owner neglect
- Economic solution
  - Direct subsidies to the poor

Price Floors: Agricultural Price Supports

- **Intended consequence**
  - help farmers, especially the small farmer
- **Unintended consequences**
  - massive surplus
  - storage costs
  - perverse **incentive** of crop disaster aid

Government Failure

- Government intervention may move us closer to our economic goals or it may fail.
- A ***government failure*** is government intervention that fails to improve economic outcomes.

Seeking Balance

The challenge for society is to minimize failures by selecting the appropriate balance of market signals and government directives.

End Versus Means

- Economists don’t formulate an economy’s objectives.
- They focus on the means available for achieving given goals.

Imperfect Knowledge

We may never find an absolute truth, because the inner workings of the economy change over time.

People's choices have consequences that lie in the future.

The important costs and benefits in economic decision making are those that will appear in the future.

The study of economics stresses the importance of making decisions about the future because we can only influence the future. We cannot influence things that happened in the past.

10 Economic Concepts Reviewed

- People are rational.
- People respond to incentives.
- There’s no such thing as a free lunch.
- The standard of living depends on a country’s production.
- Society faces a short-run tradeoff between inflation and unemployment.
- Markets are usually a good way to organize economic activity.

10 Economic Concepts Reviewed

- Trade can make everyone better off.
- The Law of Demand -- The less of something there is to go around the more buyers are willing to pay for it. The more of something there is to go around the less buyers are willing to pay for it.
- The Law of Supply -- The more buyers are willing to pay for a product the more of that product sellers are willing to make.
- Governments can sometimes improve market outcomes

So … Do you have a good grasp of the basic economic concepts we’ve covered so far?

If you’re not sure, give yourself a day or two off and then go through these three core concept presentations again.

You’ll probably find you understand more than you think you do!


The End