

Econ Study Guide Exam 1

CHAPTER 1

Objectives:

1. Know the difference between micro and macro economics
2. Evaluate the role that rational self-interest plays in economic analysis
3. Distinguish between positive and normative economic statements
4. Explain why economics is a science

Economics-is part of the social sciences, and, as such, seeks explanations of real events; it is the study of how people allocate their limited resources in an attempt to satisfy their unlimited wants; is the study of how people make choices

- It is a way of thinking; it is concerned with how people make decisions when faced with scarcity

Resources-things that have value and, more specifically, are used to produce goods and services that satisfy people's wants

Wants-all of the items that people would purchase if they had unlimited income

Economics is divided into two types of analysis: Micro and Macro Economics

1. **Microeconomics**-is the part of economic analysis that studies decision-making undertaken by individuals (or households) and by firms. It is like looking through a microscope to focus on the small parts of our economy
 - a. Example-concerned with effects of changes in gas price relative to that of other energy sources; it examines the effects of new taxes on a specific product or industry
2. **Macroeconomics**-is the part of economic analysis that studies the behavior of the economy as a whole. It deals with economy wide phenomena such as changes in unemployment, in the general price level, and in national income
 - a. Example-issues involving the rate of inflation, the amount of economy wide unemployment, the yearly growth in the output of goods and services in the nation; aka aggregates—total amounts or quantities

Economic System-a society's institutional mechanism for determining the way in which scarce resources are used to satisfy human desires

3 Basic Economic Questions for every nation

1. What and how much will be produced?
2. How will items be produced?
3. For whom will items be produced?

2 Opposing Answers

1. Centralized Command and Control (aka central planning)
 - a. One person or government makes decisions regarding the 3 Q's
 - b. Means of production owned by gov
 - c. Difficult to obtain info that would be captured by prices
2. Price System (aka Market system)

- a. Decentralized decision-making, meaning under a pure price system, individuals and families own all of the scarce resources used in production
- b. Individuals and families own means of production
- c. Prices serve as signals that provide info

Mixed Economic Systems-incorporation of both centralized command and control and a decentralized price system

- A continuum of options for mixing
- Some countries more CCC (China, N. Korea) and others more Price (S. Korea)
- Countries can change how much CCC vs. how much Price system over time (USA: autos, banks)

Economics as a Science

- Economics uses the scientific method using models that simplify the real world
- Economists seek to predict what people will do when faced with certain incentives
- Simplification is necessary. Think about maps. The test of a model is its ability to predict.
- Models must be based on a set of assumptions – tells when model is applicable
- *Incentives matter—they influence behavior in predictable ways*
 - o Direct incentives-easy to recognize
 - o Indirect incentives-secondary change in behavior (unintended consequences)

Ceteris Paribus-“all else equal;” the assumption that nothing changes except the factor or factors being studied

- •Ex: How much of a particular product a family buys is how expensive that product is relative to other products
 - o In addition to relative prices, other factors influence decisions when purchasing something
 - o Some deal with income, tastes, custom and religious belief

Rationality Assumption-assumption that people do not intentionally make decisions that would leave them worse off

- So many ways to be irrational; only one to be rational.
- Studying rationality gives baseline
- Economics focused on outcomes rather than thought process.
 - o 3 rationality assumptions:
 1. Interested only in own satisfaction
 2. Choices always align with long-term interests
 3. Can consider every choice
- Bounded Rationality:

- o People are nearly but not fully rational
- o Sometimes break from the 3 rationality assumptions
- o People use rules of thumb instead of considering all choices

Positive Vs. Normative Economics

- Positive-analysis that is strictly limited to making either purely descriptive statements or scientific prediction
 - o Statements about “what is”
 - o Can be tested proven/disproven
 - o Ex: if gas prices fall, people will buy more gas
- Normative-analysis involving value judgments about economic policies; relates to whether outcomes are good or bad
 - o Statements about “what should be”
 - o Are matters of opinion
 - o Ex: gas prices are too low

CHAPTER 2

Objectives:

1. Understand scarcity
2. Know why economics considers “wants” but not “needs”
3. Discuss why obtaining increasing increments of any particular good typically entails giving up more and more units of other goods
4. Explain why society faces a trade-off between consumption goods and capital goods
5. Distinguish between absolute and comparative advantage

Scarcity—not a shortage, not poverty

- It is a fact of life. Physicists didn’t invent gravity; economists didn’t invent scarcity
- Resources are the inputs used in production of the things we want
- Scarce resources are used to produce products that can be used in consumption

5 Types of Resources

1. Land → natural resource
 - a. Location
 - b. Original fertility and mineral deposits
 - c. Topography
 - d. Climate
 - e. Water
 - f. Vegetation
 - g. Basically, “natural” stuff AKA “gifts of nature”
2. Labor → Productive contributions of humans who work