

## Chapter 4 Notes:

- Use 'economy' to talk about the economic or financial state of society.
  - Study of the financial welfare of an economy and how an economy operates.
  - How people and organizations individually and collectively. Create and spend income
  - How a society acquires and uses its financial capital, real capital, and human capital
- **Microeconomics** studies the economic behavior of individuals and organizations. **Macroeconomics** looks at how individuals and organizations come together to operate as an economy.
- Major components of the economy:
  - **Income**- receive in exchange for labor or producing something that others want; incentive; measure of total products produced and sold by a society
  - **Employment**- full employment is when everyone who wants a job has a job; jobs are created by supply and demand
  - **Capacity**- deals with the resources that an economy processes or its ability to acquire those resources; creates productivity; this is done by **factors of production (labor, knowledge, money, and natural resources)**.
  - **Prices**- in/deflation is when the prices of products go up/down; deflation will occur when supply > demand, inflation will occur when demand > supply.
- Many different types of unemployment:
  - **Seasonal unemployment**: demand for employees varies depending on the time of year ex: water skis shop
  - **Structural unemployment**: structural barriers that prevent employers and employees from coming together. Ex: the more qualified employees must move to the location of the company
  - **Transitional unemployment**: employee desires to make a change. Ex: change jobs
- Factors of Production:
  - Labor: people
  - Natural resources: minerals, water, land, and other elements found in nature
  - Money: financial capital; medium of exchange
  - Knowledge: insights and expertise of the people
- Price change:
  - Price changes can artificially and unfairly **redistribute wealth**
  - Price changes can **create uncertainty** and thus affect how people behave
- Causes of Price changes:

- **Demand-pull inflation:** occurs when demand for a product exceeds the available supply of the product
- **Cost-push inflation:** occurs when the cost of an item goes up without an increase in demand; typically happens when supply is artificially and suddenly limited
- Two forms of income:
  - **Nominal income:** the measure of income for individuals, businesses, and nations in current-year dollars w/o adjusting for inflation/deflation
  - **Real income:** we adjust nominal income for inflation/deflation
    - **We use economic indices to adjust the nominal income.**
- **Economic Index:** measures the relative change of an economic factor over time. Example: something that was worth \$1 last year, can be worth \$1.25 today...this is a 25% increase or valued at 125%.
  - **Consumer Price Index (CPI):** estimates how the average price (retail prices) of consumer goods has changed in a given period
  - **Producers Price Index (PPI):** estimates how the prices (wholesale prices) of products sold between businesses have changed in a given period.
  - **GDP deflator:** estimates how the prices of all items have changed in a given period.

#### Free Markets:

- Adam Smith wrote An Inquiry into the Nature and Causes of the Wealth of Nations.
  - An economy would best prosper if people were free to own property such as a business; businesses were free to compete for customers, and customers were free to choose between competing products and businesses.
  - Competition= Invisible hand (past term)= **Multiplier effect (current term)**.
    - Multiplier effect states that if you spend money then you create income for someone else. This cycle continues and everyone wins
  - Smith believed in Free market systems; nowadays called **capitalistic economies**
- **Markets are free to set the price for any given product**
- **Price is the market's assessment of an item's value**
  - Function of supply and demand
- Higher prices create lower demand
- Lower prices create higher demand

- **Equilibrium point/ Market Price:** where demand and supply meet on the S&D curve; the price where buyers (demand) and sellers (supply) agree to an exchange
- When demand and supply react to price changes, we say the demand and supply functions are **price-elastic**.
  - Happens when the customers **have alternate choices**
- When demand and supply do not react to price changes, we say the demand and supply functions are **price-inelastic**.
  - Happens when customers must have the product NOW and **do not have alternate choices**

#### Economic Power

- Perfect competition in a free market economy because buyers and sellers share economic power.
  - When monopolies and oligopolies are created, perfect competition cannot exist
- Monopoly: happens when one business controls the entire supply of a product
- Oligopoly: occurs when a few businesses control the supply of a product
  - Collusion: when competing businesses get together and set prices
- Alternatives to Free Markets:
  - **Socialism:** economic system in which the **govt owns selected businesses**; govt decides what will be produced, price, and who can or cannot purchase these products ex: Banks, Transportation companies, oil; when the govt owns a business it is said that the business is **nationalized**.
    - Uses taxes and profits from nationalized businesses to pay for social welfare: education, healthcare, transportation
  - **Communism:** no private ownership; all things are owned by everyone; there is no free market because the government decides everything
  - **Controlled or regulated economies:** an economy in which businesses are privately owned but heavily regulated by govt; govt tells a businesses what they can and cannot do; Russia is an example
  - **Mixed economies:** dominated by free markets but selectively use socialism or regulation; USA is an example
- Economic cycle/ business cycle
  - Peak: income, employment, prices, and the utilization of capacity are high
  - We measure economic cycles by income; **we measure an economy's income by its GDP**

#### GDP

- Value of goods and services produced in an economy in a given year
  - **Nominal:** current price of goods and services