Module 1

1.1 Ten Principles of Economics

Economics is the study of how society manages its scarce resources. In most societies, resources are allocated not by an all-powerful dictator but through the combined actions of millions of households and firms. Economists therefore study how people make decisions: how much they work, what they buy, how much they save, and how they invest their savings. Economists also study how people interact with one another. For instance, they examine how the multitude of buyers and sellers of a good together determine the price at which the good is sold and the quantity that is sold. Finally, economists analyze forces and trends that affect the economy as a whole, including the growth in average income, the fraction of the population that cannot find work, and the rate at which prices are rising.

How People Make Decisions

Principle 1: People Face Trade-offs
Principle 2: The Cost of Something Is What You Give Up to Get It
Principle 3: Rational People Think at the Margin
Principle 4: People Respond to Incentives

How People Interact

Principle 5: Trade Can Make Everyone Better Off
Principle 6: Markets Are Usually a Good Way to Organize Economic Activity
Principle 7: Governments Can Sometimes Improve Market Outcomes

How the Economy as a Whole Works

Principle 8: A Country's Standard of Living Depends on Its Ability to Produce Goods and Services
Principle 9: Prices Rise When the Government Prints Too Much Money
Principle 10: Society Faces a Short-Run Trade-off between Inflation and Unemployment

Principle 1: PEOPLE FACE TRADEOFFS: To get something one has to sacrifice other things. For example, a country can spend its maximum resources for its defense but at the same time, it has to sacrifice the maximum spending for the country's welfare. A society also faces tradeoffs between Efficiency and Equity. The government generally taxes rich people so that it can get the money from them and use it for the welfare of the poor people; this brings the equity but reduces the efficiency.

Principles 2: THE COST OF SOMETHING IS WHAT YOU GIVE UP TO GET IT: Since we do tradeoffs, the people generally find out the cost and benefits that their action is going to incur. For an action, one has to sacrifice something. For example: I have come here to do post-graduation but I had to sacrifice my server administrator job. A cost that is given up to get something known as the opportunity cost. My opportunity cost is server administrator job, money, and time, which I had given up for the post-graduation.

Principle 3: RATIONAL PEOPLE THINK AT THE MARGIN: One always makes small changes in their plan of action to achieve maximum benefits from the process. This small change is known as the marginal change as it takes place around edges. For example: A student who is

enrolled for 1 year of education, if he/she adds one more year to its study, they will be able to apply for permanent residency which incur additional benefits but with this come the additional costs of college fees, time etc. Comparison of marginal benefits and marginal cost will be able to help you in taking the decision.

Principle 4: PEOPLE RESPOND TO INCENTIVES: Behavior of any person or firm changes according to the environmental variables like benefits or cost changes. For example: If the cost of the orange increases then the consumer will shift towards apples, as the cost of orange is high.

Principle 5: TRADE CAN MAKE EVERYONE BETTER OFF: Trade is taking place between the products that countries own not between the countries. Trading between parties makes goods cheaper. For example: Trade between country A and country B will help both the countries to get goods from one another and help them to expertise in what they are good at producing.

Principle 6: MARKETS ARE USUALLY A GOOD WAY TO ORGANIZE ECONOMIC ACTIVITY: Market Economy is the concept where a centralized judgment planner is substituted by judgment of millions of households and firms. The place where the households and firms can communicate with each other for services and goods is known as the market and it takes place under the influence of the price and self-interest, which helps them to make decisions. For example: Taxes that are imposed by the government always change the price of goods and the decisions of producers and consumers.

Principle 7: GOVERNMENTS CAN SOMETIMES IMPROVE MARKET OUTCOMES: When a market fails to distribute the resources efficiently, it is known as market failure, which decreases efficiency. Government imposes some rules to improve the market.(Mankiw,2003,p.11) For example: When the Australian government imposes a carbon tax on the emission of the carbon, which will make the firm emit less carbon, which results in less pollution.

Principle 8: A COUNTRY'S STANDARD OF LIVING DEPENDS ON ITS ABILITY TO PRODUCE GOODS AND SERVICES: The living standard in the country depends upon the country producing capacity. In countries where more goods and services are produced in a unit time, their standard of living is high as compared to the people with less productivity. For example: Living standard of a U.S. citizen is better than the living standard of Mexican and Nigerian citizens as a U.S. citizen earn more than those two citizens.

Principle 9: PRICES RISE WHEN THE GOVERNMENT PRINTS TOO MUCH MONEY: Inflation is the state in which the price level increases in the economy. Inflation occurs when the supply of the money, which is under the hood of the government, increases drastically in comparison to the accessibility of services and goods in the markets.When the government produce high quantity of a nation's money, then it has lost its value. For example: When in Germany the average price of the commodity is tripling every month so the production of money is also tripling every month.

Principle 10: SOCIETY FACES A SHORT-RUN TRADEOFF BETWEEN INFLATION AND UNEMPLOYMENT: Policy that is making, to reduce the inflation led to increase in unemployment and policy to reduce unemployment led to increase in inflation this properly describe in Philip curve. This concept ended in 1970 when inflation and unemployment co-existed at their maximum peak. The relationship between inflation and unemployment is temporary.