

Macroeconomics: Principles and Applications
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Lesson 1 Recap

Q1- What is the study of economics?

First of all, the study of economics is the study of decision making about how to allocate our scarce resources. What are the scarce resources? Those are: land, labor, capital, and entrepreneurship. *Note that in economics, when I say capital, I specifically mean machines and factories.*

Q2- What are three ways people in the past follow in this decision-making process?

Government, tradition, and the market. It is important to know that all countries on earth uses all three methods from one extent to the other. Each method has its advantages and shortcomings.

Q3- How do economists decide how to allocate resources?

This brings up three important questions: (1) What goods and services should we produce given our limited resources? It is not so much of a question of whether we should produce tables or chairs- of course, we need both! But how many of each? (2) How should we produce those goods and services? What kind of technology should we use? Where? (3) For whom should we produce it? Who are our customers?

Q4- Precisely, how do we determine the cost of a decision?

There is no such thing as a free lunch! All decisions come with a cost. That is what we called- Opportunity Cost. **Opportunity cost is what you would be doing now if you weren't doing what you're doing!** (definition credit to Peter J. Simon) That is quite confusing. Let's put it in the real world. Instead of sitting here and read my lecture notes, you can watching YouTube. And that is the Opportunity Cost of you reading my lecture notes. That doesn't mean much. Sometimes we need to put it in terms of outcome. The O.C. in that case would be happiness. You are less happy because you lost your YouTube time. **Please note that it is not a list of things that you COULD be doing, but it is ONE THING that you would do.** In economics, the opportunity cost of using all my machines to produce tables is the money gained for selling chairs. What is important to know here is that ALL CHOICE comes with a COST.

Q5- How do we determine Opportunity Cost in terms of another thing?

The Production Possibility Curve! Figure 1 below shows the PPC of sodas and pizzas. Anywhere along the curve I am allocatively efficient while at point a there is unemployment. Point c is unachievable since I am producing beyond my available resources. What about opportunity cost? What if I want to SHIFT point b leftwards along the curve to produce more sodas and less pizzas? My opportunity cost would be the pizzas I give up. A better example would be in figure 2: if I want to shift from point A to B, my O.C. would be the 40 tones of wheat I give up.

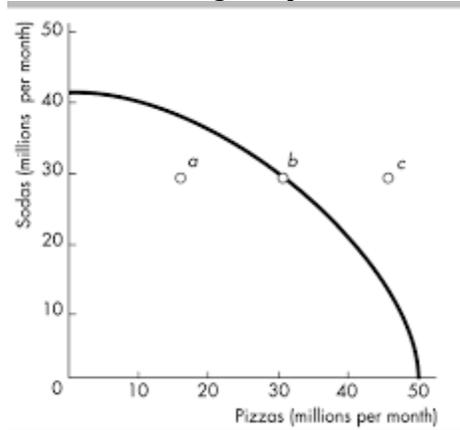


Figure 1

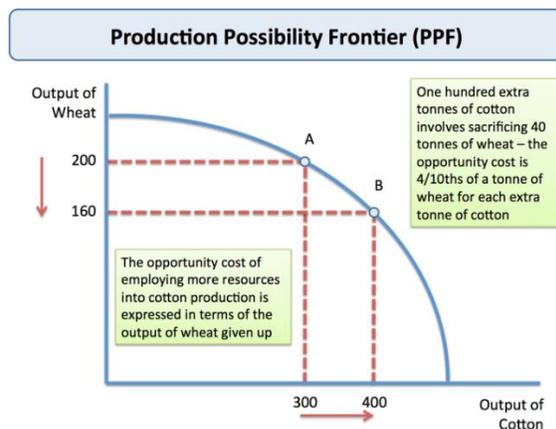


Figure 2

Q6- Why isn't the PPC a straight line?

You can probably tell, not all resources are equally productive in the production of the same good. You would give up the worst study time to watch Netflix because it yields the lowest O.C. Eventually, you will find yourself giving up time that is better for studying! That is what we called the Law of Increasing Opportunity Cost!

Q7- How does the market system operate?

Based on the Supply and Demand Graph! (Figure 3). On y-axis, there is always price. On the x-axis, it is always quantity.

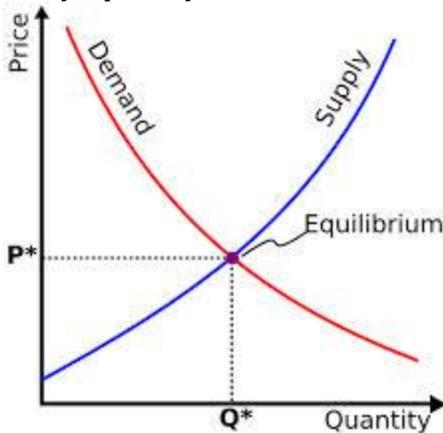


Figure 3

Q8- Why is the demand curve sloping downwards?

Because consumer's QUANTITY DEMAND for a good decreases as price increases. Similarly, we are willing to buy more when the price is lower. When the price increases, we can find substitution. If my income increases, I can buy more. And also, there is the Law of Diminishing Marginal Utility. That is a fancy way of saying for each additional unit of good we add; our satisfaction will not be as much as the previous unit. "Blue jeans for example, the less each additional pair raises your happiness so the less you're willing to pay for yet another pair." (credit to Peter J. Simon, Principles of Macroeconomics)

Figure 1 Credit

https://www.google.com/search?biw=1280&bih=578&tbm=isch&sa=1&ei=HyMiXbWfAY-k_Qblh67IAQ&q=production+possibilities+curve+of+pizza+and+test+score&oq=production+possibilities+curve+of+pizza+and+test+score&gs_l=img.3...21716.24878..24983...0.0..0.194.1937.14j6.....0....1..gws-wiz-img.....35i39.8UnGyimFx8Y#imgrc=rAukd1EIAzVbQM:

Figure 2 Credit

https://www.google.com/search?biw=1280&bih=578&tbm=isch&sa=1&ei=OSMiXZaUMIfv_QaPzi3ABQ&q=production+possibilities+curve+and+opportunity+cost&oq=production+possibilities+curve+and+opportu&gs_l=img.3..0.0i24.206043.207644..208299...0.0..1.320.1440.5j4j1j1.....0....1..gws-wiz-img.....0i8i30.qe8_NoQig2A#imgrc=CFQHPLm21ophVM:

Figure 3 Credit

<https://economics.stackexchange.com/questions/5706/what-do-supply-demand-curves-really-look-like>

Credit

Chen, Alexander- Principles of Macroeconomics

Simon, Peter- Principles of Macroeconomics

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