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FOUNDATION IN BUSINESS

SELF INSTRUCTIONAL MATERIALS

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FACULTY OF BUSINESS, HUMANITIES & HOSPITALITY

BACHELOR OF COMMERCE (HONS) IN INTERNATIONAL BUSINESS

Topic 10 ▸ Economic (Part 2)

LEARNING OUTCOMES

By the end of this topic, you will be able to:

1. Explain the 10 principles of economics;
2. Explain 4 basic principles of individual decision making that are important in an economic context;
3. Explain 3 principles concerning how people interact with one another; and
4. Explain the 4 phases of an economic cycle.

▸ INTRODUCTION

An economy works by creating a network of markets composed of buyers and sellers. These economic markets allocate scarce resources among the players within that market.

10.1 THE 10 PRINCIPLES OF ECONOMICS

There are 10 basic economic principles that make up economic theory and act as a guide for economists. Aside from standard economic concepts like supply and demand, scarcity, cost and benefits, and incentives, there are an additional 10 principles to follow in the field.

Let's take a look at them more closely as well as some examples to illustrate each principle.

1. People face trade-offs

Everyone faces decisions that put one option above the other. Most decisions, especially economic ones, involve trading off one thing for another.

In society, one of the main trade-offs we experience is between efficiency and equity. Efficiency refers to something we can get the most out of, especially if the resource is scarce. Equity implies that all members of society benefit equally from a resource. The theory is that people will make good decisions if they thoroughly understand both options.

However, what usually ends up happening in life and in economics is that one item, either efficiency or equity, is chosen above the other. For example, the way students decide to spend their time or how governments allocate budgets can be examples of the trade-offs people face.

2. The cost of something is what you give up to get it

Since people face these trade-offs, a decision requires a comparison of the costs against the benefits of alternative courses of action. Sometimes, the most obvious action or answer isn't the first one you would think of.

Each item has an opportunity cost, in other words, what you're giving up to get it. So, when facing a decision, people should understand the opportunity cost involved in that decision and in each action.

For example, some people consider only the cost of an action, but not the time involved. Cooking dinner at home is cheaper than ordering from a restaurant, but takes up a lot more time than calling to place an order.

3. Rational people think at the margin

In general, economists like to assume that people are rational thinkers. Still, they look at marginal changes to describe small adjustments to the plan of action. Another way of looking at this is that people make decisions when they think at the margin, or around the edge of a plan of action.

For example, the decision of whether or not to take an extra class in your semester is an incremental decision that will have you comparing marginal costs and benefits.

When considering marginal changes, we as consumers are looking for the maximum satisfaction on our purchases that fit with our budgets and incomes. So, we look for ways to achieve maximum satisfaction within the constraints of what we are willing to pay for a commodity, and the decisions it takes to get there are influenced by marginal changes and rational thinking.

4. People respond to incentives

This economic principle isn't surprising but makes a lot of sense when we consider the last few principles. Since consumers make decisions by comparing benefits and cost, what happens when that scale changes? That's where incentives play a part.

Incentives inspire consumers to act by offering up an extra reward to those people who will change their behavior. Incentives can also be positive or negative, meaning you can incentivize people to do something or not to do something.

For example, a positive incentive would be offering employees a bonus if they work extra hours. However, a negative incentive can be exemplified by extra taxes governments might put on things like fuel that encourage people to use it less.

5. Trade can make everyone better off

This one seems obvious, but trade can be a positive for all parties involved. It's not like a competition where one side wins and the other loses. In trade, all parties can win by focusing on what they're best at.

The best example of this is countries that benefit from trading with each other. Most countries don't have all the resources they need to function effectively, so they turn to other countries for more or even cheaper resources that they can trade. It also allows for a wider variety of goods to become available in the country, which increases competition on a global scale.

When you think about trade between countries, let's say between the U.S. and Canada, neither side "wins," but both benefit in different ways from a trade partnership.

6. Markets are usually a good way to organize economic activity

A lot of countries used to have a centrally planned economy but are now moving towards market economies.

In a market economy, decisions are made collectively by millions of households and firms that have a stake in the economy. If you think about it, it's like a cycle. Households decide where they'll work, and firms decide who they want to hire and what to produce. These two parties interact in the market economy where decisions are guided by self-interest.

Sometimes, the market economy or aspects of it fail, and that's where governments have to step in to implement policy. But usually, the interaction between households and firms are guided almost automatically, seemingly by an 'invisible hand' that helps direct economic activity.

The result is that households and firms consider prices when looking at what to buy and sell, and they both look at costs and social benefits, which ultimately ends in a society's welfare being increased.

7. Government can sometimes improve market outcomes

We touched on the government interfering in the market in the last economic principle in the form of policy creation, but why does the government need to intervene when we have the invisible hand?

Well, the hand actually relies on the government for protection. The market will only work if certain rights are enforced, and the hand needs help in organizing economic activity within the market, namely, to promote both efficiency and equity.

Markets can fail when they fail to allocate resources efficiently, and this happens as a result of externality, which is when an action produces an impact on the well-being of a bystander, or in this case, of society. An example of this is pollution and the well-being of the

environment. Without the intervention of governments, the market could have a negative impact without even meaning to.

Additionally, the invisible hand might not focus on how to distribute resources equitably and instead may reward individuals based on their production.

8. A country's standard of living depends on country production

As we know, there are different standards of living in different countries, and this is directly correlated to the country's productivity.

Not only that, but the changes over time of standards of living can also be quite significant. For example, even in high-income countries, the Western world has made leaps and bounds in what we consider to be the standard of living. When compared to lower-income countries, the growth of the standard of living is slower.

This growth can be traced back to the goods and services produced in each country. In places where workers are able to produce more goods, the standard of living is higher, and vice versa. To increase the living standard, there need to be public policies that affect it without negatively impacting productivity by way of increasing education and providing better access to tools and technology.

9. Prices rise when the government prints too much money

This one is relatively simple. Prices follow inflation, and a high rate of inflation increases costs, so economic policymakers aim for a lower level of inflation to keep the market moving. In most cases of a high rate of inflation, the cause is that there's too much money in circulation. When governments print more money and there's more available, its value decreases.

10. Society faces a short-run trade-off between inflation and unemployment

Another result that occurs when there's more money circulating is a lower rate of employment. Economists use the Phillips Curve to trace the correlation between the two, which helps them understand market and business cycles. The Phillips Curve aims to push inflation and unemployment in opposite directions.

Policymakers can impact inflation and unemployment by altering how much money is printed, as well as the amount of government taxes. Therefore, the policies that are implemented by governments and policymakers have a direct impact on the market and economy and can severely impact the rates of inflation and unemployment.

SELF CHECK 10.1

1. Choose any 1 of the 10 principles of economics that you have just learnt. Provide a detailed example where it was applied and share this example in Nilai Uni Connect.

10.2 HOW PEOPLE MAKE DECISIONS?

Simply put, an economy is a bunch of people interacting with each other. Therefore, the behavior and decisions people make shape the economy they live in. So, to understand how the economy works, we first have to understand how people work. To do that, we're going to look at four basic principles of individual decision making that are important in an economic context: (1) People face trade-offs, (2) Trade-offs lead to opportunity cost, (3) People think at the margin, and (4) People respond to incentives.

1. People face Trade-offs

We can't always get everything we want in life, so we have to make choices. That means, to get something we like, we usually have to give up something else we like as well. Or as many economists put it, "there ain't no such thing as a free lunch".

To illustrate this, meet Bobby. Bobby has 10 dollars to buy lunch. Like most people, he likes pizza and burgers. For the sake of this example, we'll assume that both of them cost exactly 10 dollars. Now, because Bobby only has 10 dollars to spend, he cannot afford to buy both. Instead, he has to choose either the pizza or the burger. Tough choice, indeed.

It's important to note that every decision involves a trade-off, not just the ones related to money. So even if Bobby was offered a meal for free, he'd still have to choose between the pizza and the burger.

2. Trade-offs lead to opportunity cost

Opportunity cost describes the value of what we have to give up in order to get something else. You can think of it as the price we pay for choosing one thing over another. This is pretty easy to understand if both of these things have a price tag attached to them. However, most decisions involve other non-monetary factors such as lost time, pleasure, or other relevant benefits that must be considered as well.

For example, in the case of our pizza vs. burger example from earlier, Bobby's opportunity cost of buying a pizza is one burger, which is worth 10 dollars. Now, to make this a little more interesting, let's assume that Bobby's friend asks him to skip lunch to help him fix his car instead. If Bobby agrees, he can earn 50 dollars for helping his friend. In that scenario, the opportunity cost increases, because Bobby could leave as much as 50 bucks on the table, depending on his decision.

However, things get even more interesting if we assume that his friend doesn't offer Bobby any financial compensation whatsoever. In that case, Bobby has to compare the costs and benefits of spending time with his friend and helping him to a delicious pizza without any financial reference values. Not an easy task.

3. People Think at the Margin

Most of the choices we face aren't black and white. In most cases, they're some shade of grey in between. That means, most decisions aren't about fundamental choices, but rather about incremental adjustments. Small changes to our current situation that help us to reach a slightly better outcome and to maximize our utility.

For example, when Bobby gets his pizza, he doesn't immediately have to choose between eating the whole thing or nothing at all. Instead, he can just start with the first slice, and then simply eat additional slices until he's full. So the decision he faces is not whether he should eat in general, but whether he should eat that last slice or not… although in the case of pizza, that's almost always a yes.

4. People Respond to Incentives

Because we make decisions based on a cost/benefit analysis, our behavior is likely to change as soon as the costs and benefits of that decision change. That means, we often change our minds even after we have made an initial decision.

Just imagine if the price of pizza had doubled overnight. In that case, Bobby would probably change his mind and get a burger. After all, he likes both and the burger has just become much cheaper compared to the pizza.

Of course, there are many other incentives that can also have an effect on people's decisions, like fashion, new technologies, or social expectations. However, in an economic context, you can assume that – unless stated otherwise – price is the most important incentive. What can I say… once again, it's all about the money.

SELF CHECK 10.2

Does any of these 4 principles in decision making happen at your workplace?

10.3 HOW PEOPLE INTERACT?

Previous four principles showed how individuals make decisions. The next three principles concern how people interact with one another.

PRINCIPLE #5: TRADE CAN MAKE EVERYONE BETTER OFF

Trade allows each person to specialize in the activities he or she does best, whether it is farming, sewing, or home building. By trading with others, people can buy a greater variety of goods and services at lower cost. Countries as well as families benefit from the ability to trade with one another. Trade allows countries to specialize in what they do best and to enjoy a greater variety of goods and services.

PRINCIPLE #6: MARKETS ARE USUALLY A GOOD WAY TO ORGANIZE ECONOMIC ACTIVITY

Today, most countries that once had centrally planned economies have abandoned this system and are trying to develop market economies. In a market economy, the decisions of a central planner are replaced by the decisions of millions of firms and households. Firms decide whom to hire and what to make. Households decide which firms to work for and what to buy with their incomes. These firms and households interact in the marketplace, where prices and self-interest guide their decisions. Economist Adam Smith made the most famous observation in all of economics: Households and firms interacting in markets act as if they are guided by an "invisible hand" that leads them to desirable market outcomes. prices are the instrument with which the invisible hand directs economic activity. Prices reflect both the value of a good to society and the cost to society of making the good.

PRINCIPLE #7: GOVERNMENTS CAN SOMETIMES IMPROVE MARKET OUTCOMES

Although markets are usually a good way to organize economic activity, this rule has some important exceptions. There are two broad reasons for a government to intervene in the economy: to promote efficiency and to promote equity. That is, most policies aim either to enlarge the economic pie or to change how the pie is divided. Economists use the term market failure to refer to a situation in which the market on its own fails to allocate resources efficiently. One possible cause of market failure is an externality. An externality is the the impact of one person's actions on the well-being of a bystander. Another possible cause of market failure is market power. Market power refers to the ability of a single person (or small group of people) to unduly influence market prices.

10.4 HOW THE ECONOMY AS A WHOLE WORKS?

10.4.1 Transactions and Purchase Cycles

Typically, economies go through cycles of booms and busts. The economic activities of a market are subject to cyclical fluctuations. The four phases of upswing, boom, recession and depression characterize the development of various economic variables within an economic cycle. Economic variables include gross national product, gross domestic product, degree of employment, price development and, in this context, rate of inflation.

The economy reflects the overall transaction and purchase cycles of a market. Economic activity can be measured by different variables such as national product,employment levels and price developments.

An economic cycle is divided into four phases:

FOUR PHASES OF AN ECONOMIC CYCLE	
Economic upswing	**Boom**
Recession	**Depression**

The economic cycle covers the entire period in which economic development goes through the individual phases, from one upswing to the next. Overall economic development occurs with a certain regularity. These economic fluctuations follow regular movements, or cycles, which may differ between sectors and industries.

The economy and economic cycle are also influenced by fluctuations in economic variables, such as production rates, employment levels, interest rates and prices.

10.4.2 Types of Economic Cycles

Following are the three main types of economic cycles.

3 MAIN TYPES OF ECONOMIC CYCLES	
Seasonal Cycles	Seasonal cycles or fluctuations are economic trends that last only a few months, but often have a significant impact on an economy. The retail sector, for example, sees an uptick in sales during holidays, from Valentine's Day to Christmas. Characteristics of seasonal fluctuations include: • Seasonal changes in demand • Impact on individual sectors of the economy

	• A certain degree of predictability to which entrepreneurs must adapt
Economic Fluctuations	Cyclical fluctuations usually last several years, and result from a delayed imbalance between the aggregate forces of supply and demand. In contrast to seasonal fluctuations, economic fluctuations affect the entire economy. Economic fluctuations are characterized by: • Periodic (repetitive) highs and lows • Time periods spanning several years • A certain degree of irregularity • Unpredictability • Their influence on the entire economy • The possibility of leading to serious economic crises • Profound changes in demand which often lead to financial crises
Structural Fluctuations	Structural fluctuations are long-term, usually lasting between 40 to 60 years. They are brought about by technical and social innovations and their continued evolution. With technological changes, working capacities are freed up and can be used elsewhere, resulting in more innovations.

10.4.3 Phases of the Economic Cycle

The four phases of an economic cycle are detailed as follows:

Phase 1: Expansion

During the expansion phase, the positive mood of market participants creates optimistic expectations for the future. Usually, this phase comes after a crisis, and it's often the result of economic and monetary stimulus measures employed by governments and central banks. Private demand for consumer goods increases and, among companies, the demand for capital goods. The gross national product also increases during this economic trend, as the production of companies increases and more jobs are created. Similarly, the share prices of listed companies rise. (Note that the stock market rises even when the economy stagnates, and only the central banks are creating money.)

The following characteristics are present during expansion:

CHARACTERISTICS PRESENT DURING EXPANSION
• Declining unemployment rate • Inventories decline as consumption increases • Production once again increases to catch up with rising demand • Stock market prices rise • Prices in general rise steadily • General increases in household consumption

Phase 2: The Boom

The boom is considered to be the second phase of the economic cycle. Production capacities are completely utilized, and companies record impressive profits and sales. During the boom cycle, market participants are positive, yet expectations are negative. The boom and upper turning point in a business cycle display the following characteristics:

CHARACTERISTICS PRESENT DURING THE BOOM
• No further price increases • Stagnation in sales • Smaller companies disappear from markets • Consolidation processes through acquisitions of companies (takeovers, mergers, etc.)

At the height of the boom, the economy overheats, leading to a turnaround. Stagnation occurs as production rates can no longer be increased or sustained. The market becomes saturated, cutting off room for further growth.

Phase 3: Recession

A boom is followed by a recession, characterized by higher costs during the boom as demand slowly falls. The cost pressure on companies increases, and at the same time, profits shrink. Theoretically, this means that share prices are also falling, resulting in unemployment, more part-time (as opposed to full-time) jobs, and income reduction. The downturn is accompanied by a generally negative assessment of the economic situation by market participants. A recession displays the following characteristics:

CHARACTERISTICS PRESENT DURING RECESSION

- High stock prices
- No/hardly any investments made
- Decreased spending
- Labor market decline in overtime work, while the number of part-time jobs increases
- Declining stock market prices
- Potential increase in unemployment rates accompanied by lack of demand in the labor market
- Stagnating prices and fewer wage increases

Phase 4: Depression

In a depression, market participants are consistently pessimistic even as they see positive signals for the future. The depression phase can be described as a special case in the business cycle. It's often accompanied by economic crises, as during the 2008 financial crisis. Companies suffer as their equity capital shrinks. At the same time, interest rates on capital rise, and more companies are forced into bankruptcy. At the height of a depression, the value of money plummets because of low interest rates.

The depression phase can be identified by these characteristics:

CHARACTERISTICS PRESENT DURING DEPRESSION
• Large rise in unemployment • Rapidly falling stock prices • Deflation • Fewer or no investments being made • Interest rates falling to record lows • Growth of the informal economy

Points to Ponder/Takeaways

- There are 10 basic economic principles that make up economic theory and act as a guide for economists.
- There are four basic principles of individual decision making that are important in an economic context: (1) People face trade-offs, (2) Trade-offs lead to opportunity cost, (3) People think at the margin, and (4) People respond to incentives.
- There are three principles concern how people interact with one another.
- Four phases of an economic cycle are economic upswing, boom, recession and depression.

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