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ECONOMICS 101

A complete study guide to all topics economics

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UNIT 1: Introduction to Economics

What Is Economics?

- The study regarding how **money** is consumed, produced, and transferred.
- The study of choices that lead to the best possible use of resources in order to best satisfy human needs and wants (of which are constant and unlimited).

Scarcity

- **Fundamental concept** of how economies functions
- Exists because factors of production are **finite**/limited, while human wants are **infinite**/unlimited
- *Not enough* resources to produce everything that human beings need and want
- Human needs and wants are satisfied by **goods** and **services**:
  - Physical objects = goods (food, clothing, cars)
  - Non-physical activities = services (education, health care, banking)
- *There are **3 questions** economies must pose because of scarcity:*
  1. What to produce
  2. How to produce it
  3. Who to produce it for
- **Resource allocation** - to assign resources to specific uses, which are chosen among many choices
  - Includes **reallocation**, **underallocation**, and **overallocation**

Factors of Production

- Resources are the **inputs** used to produce goods + services wanted by people
- These inputs are known as factors of production and are scarce.
- Examples: human labour, machines, metals inside the earth

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The 4 Factors of Production

Factor	What it is	Example
Land *(aka natural capital)*	Natural resources, "gifts of nature"	Oil reserves, forests, mines
Labour	Physical and mental effort contributed	Economist, doctor, teacher
Capital *(aka physical capital or capital good)*	The man made factors that physically produce the output	Tools, factories, buildings, machinery
Entrepreneurship	*Organizes the other 3 factors Special human skill, involves ability to innovate by developing plans to allow business operations to function - Takes on risk or success of the business	Skills, knowledge

Opportunity Cost

- The value of the **next best alternative** and must be given up to gain something else.
- Results from scarcity and having to make a choice

Productions Possibility Model

- A simple model that shows the important economic concepts (scarcity, choice, opportunity costs).
- Represents all efficient combinations of two goods produced
- Bowed out curve = increasing opportunity cost
- Bowed down curve = decreasing opportunity cost

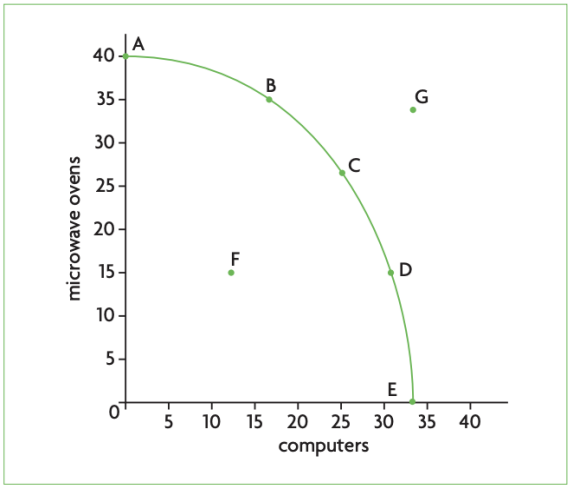
Absolute Advantage

- When a good or service can be produced in a greater quantity and in a given amount of time

Comparative Advantage

- When a good or service can be produced at a lower opportunity cost than another

Example curve:



[1]

Combination of the resources:

Point	Microwave ovens	Computers
A	40	0
B	35	17
C	26	25
D	15	31
E	0	33

[2]

[1] Ellie Tragakes, *Economics for the IB Diploma* (Cambridge: Cambridge University Press, 2020).
[2] Ellie Tragakes, *Economics for the IB Diploma* (Cambridge: Cambridge University Press, 2020).

- Curve represents the production possibilities when resources are allocated for this combination of resources: microwave ovens and computers.

How Do Economists Approach the World?

- **Economists**' objective is to make decisions based on society's best interests.

Economic decision-making:

- Based on assumptions and the outcome of certain decisions, made by posing statements that are positive and normative
- Positive economics:
  - Used to describe, explain, and predict outcomes
  - Based on positive, forward thinking
- Normative economics:
  - Basis of policy-making in government, based on beliefs of what outcomes should be

***These two economic basis of thinking for economist, work together to allow the economy to be successful*

UNIT 2: Microeconomics

WHAT IT IS

➔ **The behaviour of resource owners, firms, and consumers, where they make economic decisions in a market**

Competitive Markets

Market: A term referring to the relationship between sellers and buyers in terms of the exchange of good and services,. (Exists in all industries.)

The meaning of a competitive market:

- Where rivals compete to be able to reach a certain goal
- Example: Two firms may compete to see who can produce more output in a given amount if time.

Supply and Demand

DEMAND:

Law of Demand: the negative relationship between price and quantity demand

-As the price of goods increases, the quantity demanded decreases.

Non-price determinants of market demand:

- Income with normal goods -- Refers to most goods, demand increases as a result of an increase in consumer income

    - Example: shoes
- Income with inferior goods -- Demand falls as consumer income increases, consumers turn to more expensive alternatives
    - Example: used cars, second-hand clothing
- Preferences and tastes -- the good becomes more trendy or popular, demand increases
- Demographic changes -- increaser in the number of buyers causes demand to increase, proves that market demand is the sum of all individual demands
- Price of substitute goods -- two goods that satisfy a similar need, a decrease in the price of one substitute results in a decrease in demand of the other substitutes (rightward shift)
- Price of complementary goods -- two goods that tend to be used together, a decrease in the price of one results in an increase in the demand of the other
- Number of consumers in the market

REMEMBER:

A change in **price = change in the quantity demand = **movement** of demand curve,*

&

A change in a **non-price determinant = change in demand = **shift** of **entire** demand curve*

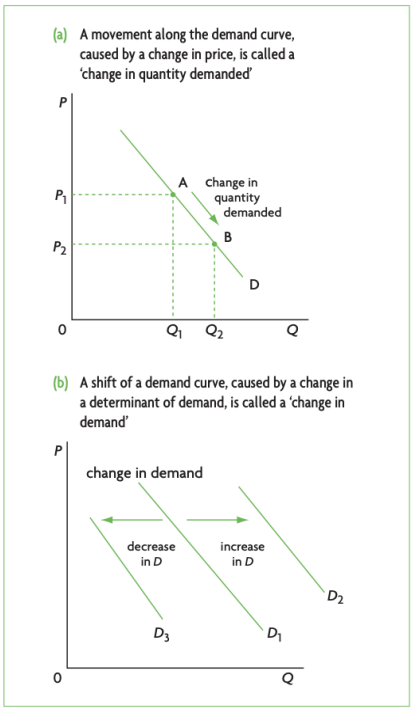


Figure 2.4 Movements along and shifts of the demand curve [3]

SUPPLY:

The Law of Supply: Explains the positive/direct causal relationship between price and quantity supplied. (*As the price of the supplied good increases, the quantity also increases.)*

[3] Ellie Tragakes, *Economics for the IB Diploma* (Cambridge: Cambridge University Press, 2020).

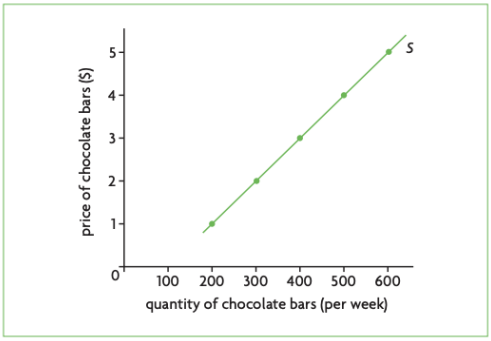


Figure 2.5 Supply curve for a firm [4]

**Higher prices = profit increase = incentive to produce more output*

**Lower prices = lower profitability = incentive to produce less output*

Non-price determinants of market supply:

- Costs of factors of productions
  - Input prices -- land, labour, capital
  - Technology -- better technology = lower costs of production = higher profitability
  - Taxes (government intervention) -- imposes new tax or increases an existing tax = increase in production costs = decreased supply
  - Subsidies (government intervention) -- payment made to a firm by the government, opposite of tax, given to firms to increase production
- Prices of related goods (competitive supply) -- goods competing for the use of the same resources, each firm will end up producing more of one and less of the other
- Number of firms -- increases in number of firms producing the good = increased supply
- Unpredicted events/shocks -- includes unexpected events such as weather or war

[4] Ellie Tragakes, *Economics for the IB Diploma* (Cambridge: Cambridge University Press, 2020).

Market Equilibrium

- **The point at which the quantity of both demand and supply are equal.**

Equilibrium: when quantity supplied is equal to quantity demanded

- Here there is no tendency for the price to change
- Determined at the point where demand curve intersects supply curve
- At this point -- consumers are satisfied and won't make changes

Disequilibrium: excess demand (shortage) or excess supply (surplus)

- At any price other than the equilibrium price, there is a market disequilibrium

Changes in Equilibrium: when the non-price determinants of supply and demand change (There is a shift in the curve and the equilibrium price adjusts.)

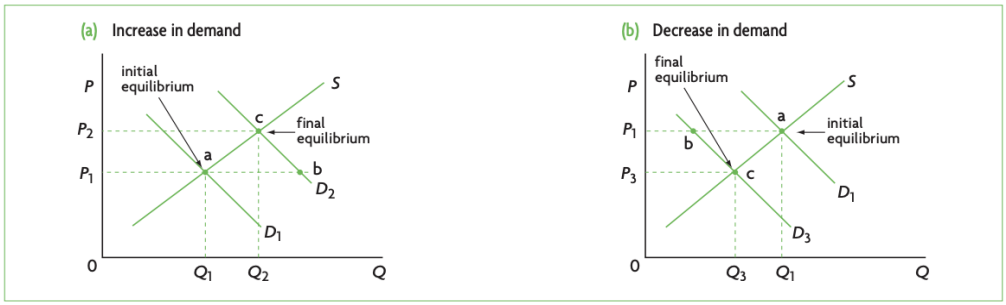


Figure 2.10 Changes in demand and the new equilibrium price and quantity [5]

[5] Ellie Tragakes, *Economics for the IB Diploma* (Cambridge: Cambridge University Press, 2020).

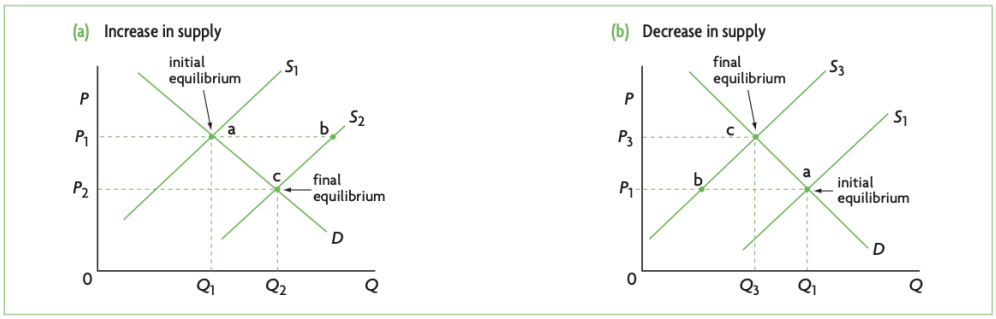


Figure 2.11 Changes in supply and the new equilibrium price and quantity [6]

* { **Shortage --** when quantity demanded is greater than quantity supplied }

{ **Surpluses --** when quantity supplied is greater than quantity demanded } *

Elasticities

PED - Price Elasticity of Demand

- Measures how responsive the demand of a good is to changes in its price

$$\text{price elasticity of demand} = PED = \frac{\text{percentage change in quantity of good } X \text{ demanded}}{\text{percentage change in price of good } X}$$

If we abbreviate 'change in' by the Greek letter Δ, this formula can be rewritten as:

$$PED = \frac{\%\Delta Q_x}{\%\Delta P_x}$$

Simplifying, the above formula can be rewritten as:

$$PED = \frac{\frac{\Delta Q_x}{Q_x} \times 100}{\frac{\Delta P_x}{P_x} \times 100} = \frac{\frac{\Delta Q_x}{Q_x}}{\frac{\Delta P_x}{P_x}}$$ [7]

[6] Ellie Tragakes, *Economics for the IB Diploma* (Cambridge: Cambridge University Press, 2020).

[7] Ellie Tragakes, *Economics for the IB Diploma* (Cambridge: Cambridge University Press, 2020).

- The PED is a negative price because quantity demanded is negatively/indirectly related. THOUGH to avoid confusion, the **minus sign is dropped**.
    - The PED creates several possible values and ranges for it.

PED Values, Characteristics, and What They Means

Value of *PED*	Classification	Interpretation
Frequently encountered cases		
$0 < PED < 1$ (greater than zero and less than one)	inelastic demand	quantity demanded is relatively unresponsive to price
$1 < PED < \infty$ (greater than 1 and less than infinity)	elastic demand	quantity demanded is relatively responsive to price
Special cases		
$PED = 1$	unit elastic demand	percentage change in quantity demanded equals percentage change in price
$PED = 0$	perfectly inelastic demand	quantity demanded is completely unresponsive to price
$PED = \infty$	perfectly elastic demand	quantity demanded is infinitely responsive to price

[8]

Determinants of PED:

1. Number of substitutes - the more there are, the higher the elasticity
2. Necessities vs. luxuries - demand for necessities is less elastic than that of luxuries, *necessities are not as responsive to changes in price since we need and can't live without them
3. Length of time - the longer it takes for purchasing decision to be made, the higher the elasticity
4. Amount of income spent on a good - the more spent from one's income on a good, the higher the elasticity

[8] Ellie Tragakes, *Economics for the IB Diploma* (Cambridge: Cambridge University Press, 2020).

XED - Cross-price elasticity demand

- Measures how responsive the demand of one good is to the change in price of **another good**

$$\text{cross-price elasticity of demand} = XED = \frac{\text{percentage change in quantity demanded of good } X}{\text{percentage change in price of good } Y}$$

$$XED = \frac{\%\Delta Q_x}{\%\Delta P_y}$$

which can be rewritten as:

$$XED = \frac{\frac{\Delta Q_x}{Q_x} \times 100}{\frac{\Delta P_y}{P_y} \times 100} = \frac{\frac{\Delta Q_x}{Q_x}}{\frac{\Delta P_y}{P_y}}$$

[9]

PES - Price Elasticity of Supply

- Measures the responsiveness of quantity supplied of a good to a change in price of the good. (along the supply curve)

$$\text{price elasticity of supply} = PES = \frac{\text{percentage change in quantity of good } X \text{ supplied}}{\text{percentage change in price of good } X}$$

$$PES = \frac{\%\Delta Q_x}{\%\Delta P_x}$$

which can be rewritten as:

$$PES = \frac{\frac{\Delta Q_x}{Q_x} \times 100}{\frac{\Delta P_x}{P_x} \times 100} = \frac{\frac{\Delta Q_x}{Q_x}}{\frac{\Delta P_x}{P_x}}$$

[10]

PED Values, Characteristics, and What They Means

[9] Ellie Tragakes, *Economics for the IB Diploma* (Cambridge: Cambridge University Press, 2020).
[10] Ellie Tragakes, *Economics for the IB Diploma* (Cambridge: Cambridge University Press, 2020).

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[11]

Determinants of PES

1. Length of time - responds to changes in price, adjusts their resources and quantity supplied
2. Mobility of factors of production - with how much ease and the pace at which companies adjust their resources and production
3. Extra capacity of firms - capacity not being used, makes it easier to increase output as a response to price increase of a good
4. Ability to store stocks - will likely have a higher PES than those that can't

Role of Government in Microeconomics

Indirect Taxes

- Imposed on spending of goods and services
- **Paid by consumers to producers**, and then from producers to governments
- Differs from *direct taxes*, which are paid by consumer directly to the government

Excise taxes: on particular goods and services (like gas and alcohol)

Why they are imposed:

[11] Ellie Tragakes, *Economics for the IB Diploma* (Cambridge: Cambridge University Press, 2020).

1. Source of revenue for the government
2. Discourage consumption of goods that harm individuals (such a cigarettes)
3. Used to redistribute income
4. Improves inefficient resource allocation by improving negative externalities

Effects on Stakeholders

Consumers - price increases

Producers - fall in price and quantity output of good sold

Government - positive, only stakeholder that gains from this tax

Workers - less output if fewer workers are needed for production, unemployment

Subsidies

- A way for the government to **assist firms and consumers**
- Through direct cash payments, loans, and more
- Usually a **fixed** amount
- Allocation of resources due to how they affect relative price, **leading to higher production and consumption**

Why they are imposed:

- **Supports** growth of industries
- **Encourages** exports of certain goods
- To encourage production and consumption

Effects on Stakeholders

Consumers - decrease in price and increase in quantity purchased

Producers - positive, high price and larger quantity leading to higher revenue

Government - negative, they take on the burden paying the subsidy

Workers - more workers hired, employment

Market Failure

WHAT IT IS

- **Failure of the market to achieve allocative efficiency - leading to overallocation or underallocation**

Externalities: happen when the producers and consumers give rise to negative and positive side effects who are not part of it (third-parties), come from either consumption or production activities

*Positive - external benefits

*Negative - external costs

MPC, Marginal Private Costs: costs to producers of producing one more unit of a good

MSC, Marginal Social Costs: costs to society of producing one more unit of a good

MPB, Marginal Private Benefits: benefits to consumers of consuming one more unit of a good

MSB, Marginal Social Benefits: benefits to society of consuming one more unit of a good

***Negative Externalities**

Fixing it: Market-based policies to manage negative externalities

- **Tax** - tax on output (per unit), tax on pollutants emitted (per unit) such as **carbon tax**
- **Tradable permits -** policy where polluting is permitted to firms by government

Advantages: these policies work to internalize the externality

Disadvantages: technical difficulties with designing the tax and risk of the effectiveness of the policy

***Positive Externalities**

Positive production externalities

- Underallocation of resources going towards a good with a positive production externality leads to **welfare loss.**
- These losses to society are a result of a **scarcity** of the good being produced.
- **Merit goods:** desired by consumers but are underallocated and underprovided by the producers

Ways of correcting positive production externalities

- Government provisions
- Subsidies

Positive consumption externalities

- Benefits created by consumers, externally and socially
- Welfare loss from this is seen in difference between MSB and MSC

Ways of correcting positive consumption externalities

- Government provision
- Legislation
- Advertising
- Subsidies

***Sustainability with resources**

- **Sustainable resources** are able to reproduce and don't become depleted, because they are used correctly and at the right pace.
- Combines the economy and environment
  - Problem with sustainability - conflict between **economic and environmental goals**

UNIT 3: Macroeconomics

WHAT IT IS

- ➔ **The study of how the economy function as a whole, on a much larger scale**
- ➔ **Looks at specific resource and product markets, and how people behave**
- ➔ **We study the total rather than each individual stakeholder alone**

Main Objectives:

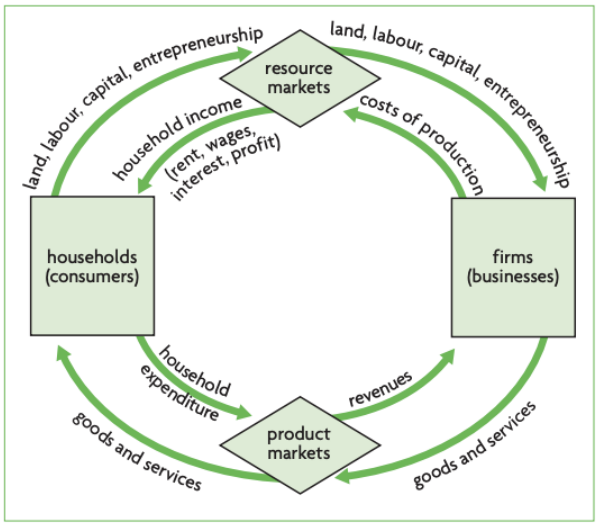
- Full employment

- Stable rising price level
- Economics growth
- Equitable income distribution

Economic Activity

Overall Economic Activity

Circular flow of income simple model (in a closed economy and no government):



[12]

- Shows the concepts and relationships of the **macroeconomy**
- *Shows that the value of output = total income generating in producing the output
- **4 factors of production and their payment methods:**
    1. Rent (for land)
    2. Wages (for labour)
    3. Interest (for capital)
    4. Profit (for entrepreneurship)

[12] Ellie Tragakes, *Economics for the IB Diploma* (Cambridge: Cambridge University Press, 2020).

Income flow: from firms to households

Expenditure flow: from households to firms

Leakages and Injections (withdrawals)

- Paired together, so whatever leaks out can come back through injections

  ***Leakages include**: saving, taxes, imports*

  ***Injections include:** investment, government spending, exports*

Saving: consumer income that isn't spent

Investment: spending of firms in order to produce capital goods

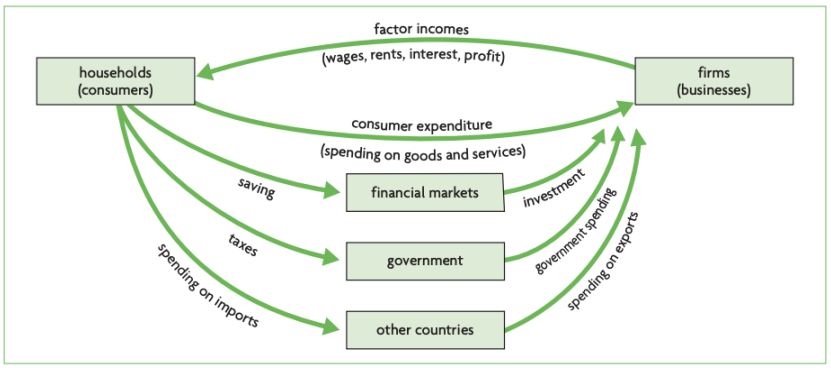
Taxes: paid by households to the government

Government Spending: funds that go towards government expenditures and go back into the expenditure flow

Imports: goods and services produced in other countries, purchased by domestic buyers

Exports: goods and services produced domestically, purchased by foreign buyers

Circular flow of income, including leakages and injections:



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Measuring Economic Activity

- **Assesses economic performance overtime**
- **Compares income and output with other economies**
- **Creates a basis for developing policies to deal with economic issues**

3 ways of measuring aggregate output (all within a country, over a given period of time)**:**

1. **Expenditure approach** - All the spending to buy final goods and services produced within a country is added up.

2. **Income approach** - All income earned by factors of production that lead to production of all goods and services.

3. **Output approach -** The value of all final goods and services produced.

4 components of total spending:

Consumption (C): spending/purchases by a household in a year, except housing

[13] Ellie Tragakes, *Economics for the IB Diploma* (Cambridge: Cambridge University Press, 2020).

Investment (I): spending by firms on capital goods

Government spending (G): spending by government of factors of production

Net Exports (X-M): exports (X) - imports (M)

** { Adding the 4 components, you get GDP:* ***C + I + G + (X-M) = GDP*** *} **

GDP: The **market value** of all final goods and services produced in a country, in a given time period. (usually a year)

GNI: A form of **aggregate output**, which is the value of all final goods and services produced by a country's residents. (*regardless of where it came from)*

Nominal value: A **measure of money value** in terms of the price at the time it was measured.

Nominal GDP: current prices, doesn't account for price changes

Real value: A measure of value that looks at **changes in price over time**, rather than at the time.

Real GDP: price change overtime

***Green GDP** = GDP = value of environmental degradation*

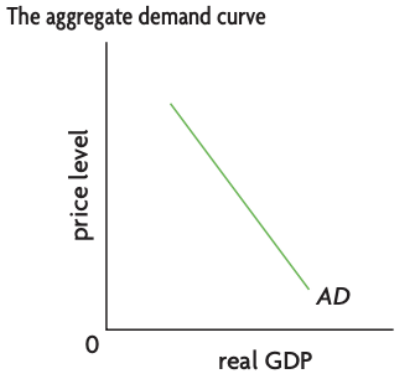
Variations in Economic Activity: Aggregate Demand and Aggregate Supply

From https://simplestudies.edublogs.org

Aggregate Demand and Curve:

Aggregate demand (AD): The total amount of aggregate output/real GDP that output buyers (consumers, firms, government and foreigners) want to buy at each of economy's price levels.

AD Curve: The relationship between total real output demanded by the 4 components and the economy's price level.



[14]

Reasons for negative slope:

- **Wealth effect:** changes in price level affecting people's wealth, price level decrease = more output demanded, leading to downward movement along curve

- **Interest rate effect:** changes in price level affecting interest rates and then aggregate demand, price level increase = higher demand for money = increased interest rates = decreased consumer borrowing and investments, leading to downward movement along curve

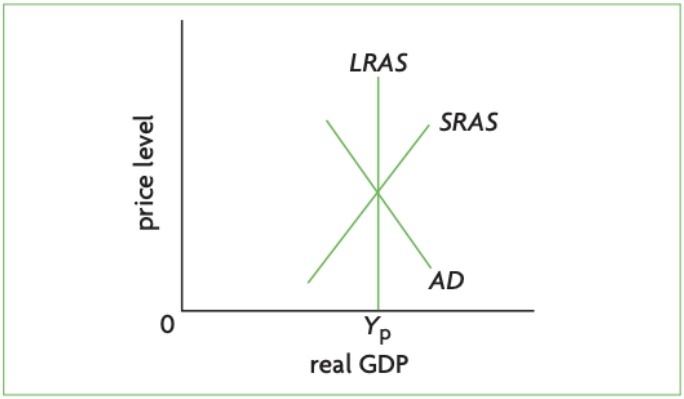
- **International trade effect:** increase in domestic price level while other countries' stays the same = exports to become more expense = less quantity demand, leading to downward movement along curve

[14] Ellie Tragakes, *Economics for the IB Diploma* (Cambridge: Cambridge University Press, 2020).

Aggregate Supply Curves and Changes

Long-run aggregate supply (LRAS): The **long-run** relationship between price level and aggregate output, shown with **LRAS Curve.**

Short-run aggregate supply: The **short-run** relationship between price level and aggregate output, shown with **SRAS Curve.**



[15]

- The LRAS and SRAS curve intersect, occurring at the GDP

Inflationary gap: output gap, actual equilibrium output is **greater** than potential output

Deflationary gap: output gap, actual equilibrium output is **less** than potential output

Inflation and Deflation

Inflation: sustained **increase** in the overall price level

Deflation: sustained **decrease** in the overall price level

Disinflation: when inflation occurs at a **lower rate**, from one year to the other

[15] Ellie Tragakes, *Economics for the IB Diploma* (Cambridge: Cambridge University Press, 2020).

Consumer Price Index (CPI): measures the cost of living for a household compared to a **hypothetical** basket of goods, measured through consumers

Problems:

- Different households experience *different inflation rates* due to different levels of income and consumption of goods and services.
- Different inflation rates *depend on cultural and regional factors.*
- There are changes in..
  - the quality of the goods and services
  - the consumption as a result of discounts, sales, deals
  - the consumption as a result of new products
  - the comparison to other countries around the world

Producer Price Index (PPI): The indices of prices that producers receive at a number of different stages in the production process, and measures level changes **through producers not consumers.**

Consequences of Inflation:

- A rise in inflation rates leads to **risks** and uncertainties with certain stakeholders:
  - ***People with fixed income/wages*** -- as inflation rises, they become worse off
  - ***People with income/wages that increases at a lower rate than inflation*** -- when it doesn't keep up, their income will fall
  - ***Cash holders*** -- as inflation rises, cash value and purchasing power decreases
  - ***Money savers*** -- when rate of interest is lower than rate of inflation, their money goes down in value and results in less savings

An appropriate rate of inflation:

- A low and stable rate, in the rage of 2-3% each year
- **Not a zero rate**, because this is too close to deflation

Causes and Consequences of Deflation:

- ***Deflation*** (like inflation) creates uncertainties for firms because of the decreasing price levels, making it difficult for them to make changes in their prices
- ***Wages of workers don't easily fall*** **--** difficult for firms to lower prices and wages since profit would decrease, so they keep them high
- ***Oligopolistic firms fear price wars*** **--** when one lowers price, the other follows, so firms avoid lowering their prices
- ***Firms want to avoid lowering menu costs*** **--** believe deflation is only for short period of time, and so they keep prices the same

Economics of Inequality and Poverty

Issue of Equity and Income Distribution:

- Because of unequal distribution in areas of factors of distribution, there is inequity when it comes to how income is distributed.
    - Example: People may want to work, but lack skills that firms look for when hiring.

Issue of Poverty

- The inability to satisfy minimal needs of consumption due to a lack of basic financial and other essential resources.

  Absolute poverty: defines minimum income level (poverty line) to sustain a family's basic needs

  Relative poverty: compares income of households and individuals to median incomes and related to how equally incomes are distributed among the population

  Causes:

    - Low income
    - Unemployment

- Low levels of ownership - of capital and land
- Discrimination
- Age
- Demographics
- Inaccessibility of social services

Consequences:

- Low standards of living
- High infant/child mortality rate
- Lack of access to healthcare, aid, and education
- Higher risk of preventable diseases - due to lack of resources and aid
- Unable to reach full potential - in terms of talent, education, career

Demand-Side Policies: Monetary and Fiscal Policy

Fiscal Policy:

Fiscal Policy: The manipulation by the government of its own expenditures, taxes, and spending to influence economic conditions.

Expansionary fiscal policy: for eliminating a deflationary/recessionary gap, works to **expand aggregate demand**

Contractionary fiscal policy: for eliminating an inflationary gap, works to **contract aggregate demand**

These policies can:

- Increases government spending
- Decreases business taxes

- Decreased personal income taxes

Strengths:

- Pulls an economy out of a severe recession/deflation
- Spending of the government directly impacts aggregate demand and is made certain that changes in spending **will** be made
- Affects long-term growth of the economy in terms of potential output

Weaknesses:

- Time lags
- Political pressure and constraints
- Deficit spending
- Unable to deal with instability in terms of supply
- Tax cuts may not increase aggregate demand (risk)

Monetary Policy:

Monetary policy: A policy carried out by banks and regulates money supply, interest and exchange rates, and borrowing in order to achieve macroeconomic goals.

The role central banks play (in every country):

- ***Bankers for the government*** -- (for the government) They hold cash deposits, receive payments, make payments, and manage government borrowing.
- ***Bankers for commercial banks*** -- (for commercial banks) They hold cash deposits and loans.
- ***Conductor of the monetary policy*** -- Responsible for this policy, which involves making changes to money supply, interest and exchange rates, and borrowing.

Chart: Demand-side policies for recessionary and inflationary gaps

Expansionary policy (in recession)

Type of policy	Measures	Effects
Fiscal policy	increase government spending	increase *AD*
	lower personal income taxes → increase consumption spending	increase *AD*
	lower business taxes → increase investment spending	increase *AD*
Monetary policy	increase supply of money → lower interest rate →	
	(i) increase consumption spending	increase *AD*
	(ii) increase investment spending	increase *AD*

Contractionary policy (in inflation)

Type of policy	Measures	Effects
Fiscal policy	decrease government spending	decrease *AD*
	raise personal income taxes → decrease consumption spending	decrease *AD*
	raise business taxes → decrease investment spending	decrease *AD*
Monetary policy	decrease supply of money → raise interest rate →	
	(i) decrease consumption spending	decrease *AD*
	(ii) decrease investment spending	decrease *AD*

[16]

Supply-Side Policies

Supply-side policy: The production and supply side of the economy, specifically to aggregate supply.

Two categories:

1. ***Interventionist:*** relies on government involvement to achieve economic goals
2. ***Market-based:*** relies on competitive markets to achieve economic goals

Interventionist supply-side policies include..

- Investments in human capital (education and healthcare), infrastructure, new technology, industrial policies, and improving the accessibility to healthcare

Market-based supply-side policies include..

1. ***Encouraging competition***
   - Privatisation -- transfer of ownership from public to private sector
   - Deregulation -- eliminating or reducing government regulation of private activities
   - Private financing of public activities

[16] Ellie Tragakes, *Economics for the IB Diploma* (Cambridge: Cambridge University Press, 2020).

2. ***Labour market reforms***
    - Eliminating or reducing minimum wage legislation
    - Weakening power of labour unions
    - Reducing unemployment benefits
    - Reducing job security

3. ***Incentive-related policies***
    - Lowering personal income taxes
    - Lowering business taxes
    - Lowering taxes on capital investments

UNIT 4: International Economics

What is trade?

- It involves buying and selling goods and services internationally.

Globalization: The spread of products, tech, info, jobs across the globe.

- *Main mechanism - international trade*

Absolute advantage (recall): when the country is the only source of a product or is able to make more of a product **using the same or fewer resources than others**

- France has this advantage in wine, though is being challenged by Italy and Spain

Comparative advantage (recall): when a good or service can be **produced at a lower opportunity cost than another**

Opportunity cost (recall): The benefit you miss when one alternative is **chosen over the other.**

Efficiency: The output for a given amount of time and within a given amount of resources.

Balance of trade: The difference in value of a nation's imports and exports during a specific period. *exports-imports*

Balance of payments: The difference between flow of money into the country and flow going out. *includes everything - imports, exports, tourism, loans, foreign aid*

Trade surplus: The selling of **more products than purchasing**, results in favourable balance

Trade deficit: The purchasing of **more products than selling**, unfavourable balance

{ 2 Key Measures of Effectiveness of International Trade }

1. Managing the National Credit Card

- Trade deficits aren't always bad. It's good if the economy is strong enough to keep growing.
- Trade surpluses can be bad possibly for consumers, and the domestic goods prices might get high.

2. Balance of payments

- Having unfavourable balance of payments is bad for the stability of a country's currency. **(esp in long run)**
- Many are worried about the U.S dollar due to this. (They have many negative balances, and to cover the debt, they borrow from other countries.)
  - *U.S imports more than it exports*

Benefits of International Trade

Why Nations Trade:

- *High monetary value for international trade*
- *Different countries produce different products*
- *Economies of scale*
- *Gaining resources needed by a certain country*
- *Free trade*
- *New ideas and technology*
- *Reduces hostility and violence between countries*
- *Increases competition*
- *Greater efficiency in production process*
- *Foreign exchange*

  ~ Overall economic growth ~

Importing: buying products overseas and reselling in one's country

From https://simplestudies.edublogs.org

- For many - this is the **biggest link to the global market**

Exporting: selling domestic products to foreign customers

- Companies can identify an international market and become exporters to get into the global arena.

Factors to consider when deciding between importing and exporting:

1. Cost of labour
2. Knowledge capital
3. Resource availability

International licensing agreement: Allows foreign companies to sell domestic company's products or use its property in exchange for royalty fees.

International franchise: when domestic companies give foreign companies the **right to use its brand and sell its products** (A popular form of global expansion, expanding overseas)

- Example: McDonalds, KFC, hotel chains

Types of Trade Protection

Tariff: The **most common form of trade restriction**, which protects domestic industries from foreign competition and increases revenue for the government.

Effects:

- **Increased quality supplied, decreased quality demanded**
- Domestic consumers are at a disadvantage
- Domestic producers are at an advantage

- Foreign producers are at a disadvantage
- Government earns revenue from the tariffs

Quota: The limit on the amount of goods that can be imported over a certain period of time (usually a year), and the effects are tariffs.

Embargo: **extreme quota**, where imports and exports to a country are banned

Dumping: selling exported goods below the price that producers would normally charge in domestic market

Subsidies (recall): government payments to certain industries to **promote and regulate trade**

Exchange Rates

Exchange rates: value of one currency relative to another

U.S. Dollar

Hypothetical exchange rate between US dollar and Euro:

- Number of US dollars per euro: 1.5 dollars = 1 euro
- Number of euros per dollar: 0.67 euro = 1 dollar

- Estimates 62% of world's currency reserves (IMF), most commonly traded
  - Foreign Currency Reserves: assets held by central banks in foreign currencies
  - Kept as backup funds in in the case where nation currency devalues
- ***Post World War 2*** - currency of western EU, Australia, Japan were pegged by USD
  - Pegged: country maintains its currency value at fixed exchange rate relative to USD

- Relative strength is strong
- Many countries adopted/rely on USD, thus are willing to hold large amounts of it

Strengthening dollar: buys more of another currency

Weakening dollar: buys less of another currency

Changes in Exchange Rate

Appreciation: an increase in the exchange rate for a currency

- Caused by increase in demand or increase in supply
- Requires a **higher amount of the foreign currency** to purchase one dollar
- Dollar is worth more in this case
- More expensive for foreigners to buy exports, cheaper for countries to buy imports

Depreciation: a decrease in the exchange rate for a currency

- Caused by increase in demand or increase in supply
- Requires **less of the foreign currency** to purchase one dollar
- Dollar is worth more in this case
- Cheaper for foreigners to buy exports, more expensive for countries to buy imports

**Both appreciation and depreciation affect imports and exports*

Causes of changes in exchange rate:

- Foreign demand for domestic exports
- **Domestic demands for imports**
- Relative **inflation rates**

- Investment from foreign countries
- Changes in **income**

Effects of changes in exchange rate:

- **Cost-push inflation**
- **Demand-pull inflation**
- Effects **employment**
- Effects economic growth
- Effects on foreign debt

Balance of Payments

1. **Balance of payments:** All transactions between residents of a country and residents of all other countries. (usually over the course of a year)

- **Having unfavourable balance of payments is bad** for the stability of a country's currency, especially for the long term

  (Many are worried about the U.S dollar due to this)

  - They have many negative balances, and to cover the debt, they borrow from other countries

    *U.S also imports more than it exports**

Structure of the balance of payments:

Includes:

1. Balance of trade in goods
2. **Current transfers**
3. **Balance on current amount**
4. Capital account
5. Financial account

Example of balance of payments

Current account	
1. Exports of goods	+40
2. Imports of goods	–65
Balance of trade in goods (items 1+2)	**–25**
3. Exports of services	+25
4. Imports of services	–15
Balance of trade in services (items 3+4)	**+10**
Balance of trade in goods and services (items 1+2+3+4)	**–15**
5. Income (inflows minus outflows)	–6
6. Current transfers (secondary income) (inflows minus outflows)	+1
Balance on current account (items 1+2+3+4+5+6)	**–20**
Capital account	
7. Capital transfers (inflows minus outflows)	+0.7
8. Transactions in-produced, non-financial assets (inflows minus outflows)	+0.3
Balance on capital account (items 7+8)	**+1**
Financial account	
9. Direct investment (inflows minus outflows)	+23
10. Portfolio investment (inflows minus outflows)	–4
11. Reserve assets (official reserves)	+1
Balance on financial account (items 9+10+11)	**+20**
12. Errors and omissions	–1
Balance (sum of all items from 1 to 12)	**0**

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[17] Ellie Tragakes, *Economics for the IB Diploma* (Cambridge: Cambridge University Press, 2020).

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