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Basics of economics

Educational and methodical manual

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In this educational-methodical manual, the main topical issues of economic theory are considered, the connection of these issues with the practice of managing in conditions of a transition period to market relations is carried out. The manual contains illustrative material that gives a clear and logical understanding of the material.

The educational-methodical manual is intended for students of economic specialties studying in English.

The educational-methodical manual is compiled in accordance with the requirements of SCSE and standard programs of economic specialties.

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CONTENT

Explanatory note

The teaching aid is intended for theoretical and practical studies in the study of the discipline "Basics of economics" for students of economic specialties studying in multilingual groups.

The main part of the manual gives key concepts of modern economic theory and analysis of the practical application of these concepts at different levels of management: people, families, enterprises, national and world economies.

The manual includes the main topics of the course of economic theory, which reveal the content and forms of a market economy. The publication contains control questions for repetition, testing and literature on topics.

The objectives of the course are to learn and to apply in practice the following:

- Key concepts of the economic theory;
- Various methods and theories of economic analysis including the analysis of economic models;
- Various factors influencing the economic activity both at the micro- and macroeconomic level;
- Basic concepts of micro- and macroeconomics;
- Major characteristics of various market structures, their advantages and disadvantages;
- Behaviour of consumers and producers;
- Main forms of business ownership;
- Basics of micro- and macroeconomic policy, economic growth and efficiency;
- Essential economics terminology both in the Russian and in the English languages;
- Skills of academic bilingual competence: reading and speaking comprehension in economics in Russian and in English.

1. ECONOMICS AS A SCIENCE

Keywords
definition – определение
formulate – формулировать
scarce resources – редкие (ограниченные)
ресурсы commodity –товар
distribute – распределять
business executive – управляющий директор, топ-менеджер
causes and consequences – причины и следствия
inflationary – инфляционный
rational – рациональный, разумный
run (abusiness) – управлять (фирмой), руководить (бизнесом)
production and consumption – производство и потребление
particular item – отдельный предмет
behaviour – поведение
level – уровень
methodology – методология
derive (a principle) – выводить(принцип)
applied economics – прикладная экономика
prediction – предсказание
economic theory – экономическая теория
generalization – обобщение
quantitative – количественный
average – средний показатель
household – условная семья
economic model – экономическая модель
deduction and induction – дедукция и индукция
positive and normative statements – позитивные и нормативные утверждения
simplify – упрощать
variable – переменная величина
constant – постоянный
purchase – покупать, покупка
income – доход
assumption – аксиома, допущение
other things being equal – при прочих равных условиях
micro - and macroeconomics – микро-и макроэкономика
management – менеджмент
marketing – маркетинг
finance – финансы и денежное обращение
accounting – бухгалтерский учет
logistics –логистика
research and development (R&D) – НИОКР (научно-исследовательская и опытно-конструкторская работа)

There are many definitions of economics. One of them was formulated by Paul Samuelson, a prominent American economist and the author of textbooks on economics which have been used by economics students all over the world for decades:

Economics is the study of how societies use scarce resources to produce valuable commodities and distribute them among different people.

Economics is a science. However it is of practical value in business. An understanding of the overall operation of the economic system puts the business executive in a better position to formulate policies. The executive who understands the causes and consequences of inflation is better equipped during inflationary periods to make more intelligent decisions than otherwise. Indeed, more and more economists are employed by corporations. Their job? To gather and interpret economic information upon which rational business decisions can bemade.

In spite of its practical benefits, however, the students must be warned that economics is an academic subject. Unlike accounting, advertising, corporation finance, and marketing, economics is not primarily a how-to-make-money area of study.

Production and consumption of goods and services are discussed from the viewpoint of society as a whole, not from the standpoint of one's own personal financialbenefits.

Economics is concerned with the following:

1. The production of goods and services: how much the economy produces; what particular combination of goods and services; how much each firm produces; what techniques of production it uses; how many people itemploys.

2. The consumption of goods and services: how much the population as a whole spends (and how much it saves); what pattern of consumption is in the economy; how much people buy of particular items; how people's consumption is affected by prices, advertising, fashion and otherfactors.

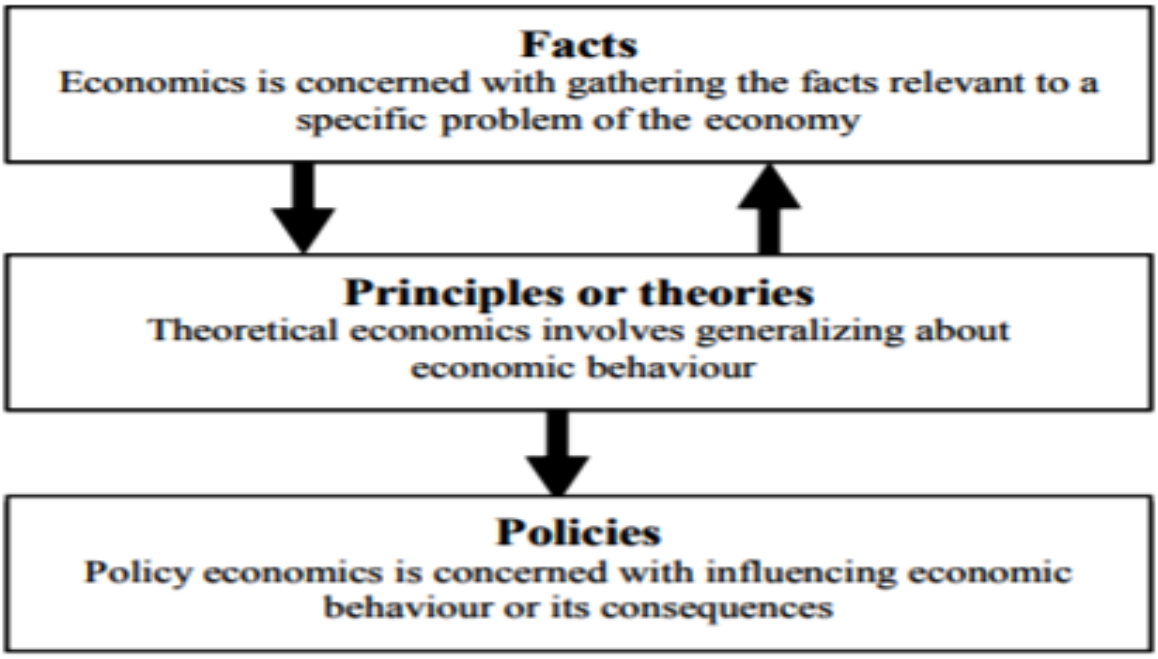
As individuals want more than they can have, this makes them behave in certain ways. Economics studies that behaviour of people as consumers of various goods and services. The society as a whole faces the similar problem, so economics also studies the behaviour of producers (firms), and of governments which can influence the level of production and consumption as a whole.

Methodology

What do economists do? What procedures do they employ? The economist must first gather the facts which are relevant to consideration of a specific economic problem. Then the economics puts this collection of facts in order and summarizes them, and finds out a principle concerning the way individuals and institutions actually behave. Deriving principles from facts is called "economic theory" or "economic analysis". Finally, the general knowledge of economic behavior which economic principles provide can then be used in developing policies for correcting or avoiding the problem. This final aspect of the field is called "applied economics" or "policy economics". In this way economic theory

serves as the basis for economic policy. Economic principles are extremely valuable as predictive devices. If some undesirable event (such as unemployment or inflation) can be predicted or understood through economic theory, we may be able to influence or control the event, or prepare for it. Ability to predict a rainstorm does not give us control over the weather, but it does permit us to prepare for it by carrying a raincoat and an umbrella.

Picture 1.1 Economic analysis.



Economic principles are generalizations and characterized by imprecise quantitative statement. Economic facts are usually diverse; some individuals and institutions act one way and some another way. Hence, economic principles are stated in terms of averages. For example, when economists say that the average household earned an income of $22,390 in 1981, they are making a generalization. It is recognized that some households earned much more and many others much less. Yet this generalization, properly handled and interpreted, can be very meaningful and useful.

Economists try to find economic principles by building models. The predictions of the models form the basis of economic theories. The theories can be tested by comparing the predictions of the models with the facts of the real world.

What methods are used by economists to develop their theories?

Induction and deduction

Induction takes place when accumulated facts are arranged systematically and analyzed so as to permit the derivation of principle. Deriving principles of facts we are describing the inductive or empirical method.

The other method is called deductive or hypothetical. For example, economists may say that it is rational for consumers to buy more of a product when its price is low than when its price is high. Such untested principle is called a

hypothesis. The validity of this hypothesis can be tested by the systematic and repeated examination of relevant facts. Thus, the deductive method goes from the general to the particular, from theory to facts. Most economists view deduction and induction as complementary, rather than opposing, techniques of investigation.

All sciences are careful to distinguish between two types of statements: statements about what is or was or will be – positive statements; and statements about what ought to be – normative statements. Thus, positive economics investigates the ways in which economic agents seek to achieve their goals. It deals with facts and is free from subjective opinions. For example, 'The unemployment rate is 7%'.

Normative economics makes suggestions about the ways in which society's goals might be more efficiently realized. For example, 'The unemployment should be lowered'.

Economic models

When economic science discovers a relationship between two or more things, then a model can be designed. Economics uses economic models to explain economic processes which are so complex in the real economy that models become useful.

A model is a simplified picture of reality that tells how some things influence other things. And various simplifying assumptions are used. For example, "other things being equal" assumption:

In constructing their generalizations, economists as well as other scientists make use of the ceteris paribus (Latin) or 'other things being equal' assumption. That is, they assume all other variables are held constant except the one under consideration. To illustrate: If economists want to focus on "the price of product X – purchases of product X" relationship, they assume that only the price of product X varies, and all other factors which may influence the amount of product X purchased are constant, such as the prices of other products, consumer incomes, tastes, fashion, etc.

Exactly what is an economic model?

An economic model is the same thing as an economic theory or principle or law. Economists talk about the "principle of diminishing marginal utility" and the "law of demand" and the "theory of the firm". All these are models: statements of "what causes what" and "what would happen if…". A model can be represented in three ways:

- verbally (in words)
- graphically (in graphs and diagrams)
- mathematically(equations)

There are two levels of the economic analysis: microeconomics and macroeconomics.

Microeconomics deals with the problems that consumers and firms face in their economic activity. Microeconomics also studies the way that individual markets work and the detailed way that government activities such as regulations and taxes affect individual markets. Much of microeconomics focuses on trying to

understand what factors affect the prices and quantities traded in individual markets.

Macroeconomics deals with the economy as a whole. It is concerned with the economy of a country and regulation of the economy by the governments. In particular, it studies the overall values of output as a whole, of unemployment and of inflation.

The division is useful because what is rational for the individual firm or household is not necessary rational when considering the whole economy.

Applied economics includes the following: management, marketing, finance, accounting, logistics, to name just a few.

1. Answer the following questions:

1. What is economics about?
2. How should we study economics? What is the character of methodology of economics?
3. What specific problems and limitations might we encounter in studying economics?
4. What is meant by an economic theory and how economic theories are developed by building and testing economic models?
5. What is the difference between microeconomics and macroeconomics?
6. How can you distinguish positive and normative statements?

2. Find the correct answer:

1. If all economists were laid end to end, they would not reach a conclusion." Who made this whimsical observation?
a Harry Truman
b. George Bernard Shaw
c. John Maynard Keynes
d. Ronald Reagan

2. Economists sometimes give conflicting advice because
a. graduate students in economics are encouraged to argue with each other.
b. economists have different values and scientific judgment.
c. economists acting as scientists do not like to agree with economists acting as policy advisers.
d. economics is more of a belief system than a science.

3. Almost all economists agree that rent control
a. has no effect on the rental income of landlords.
b. allows the market for housing to work more efficiently.
c. adversely affects the availability and quality of housing.
d. is a very inexpensive way to help the most needy members of society.

4. When economists are trying to explain the world, they are
a. scientists.
b. policy advisers.
c. in the realm of microeconomics rather than macroeconomics.
d. in the realm of normative economics rather than positive economics.

5. Which of the following statements is correct about the roles of economists?
a. Economists are best viewed as policy advisers.
b. Economists are best viewed as scientists.
c. In trying to explain the world, economists are policy advisers; in trying to improve the world, they are scientists.
d. In trying to explain the world, economists are scientists; in trying to improve the world, they are policy advisers.

6. For economists, statements about the world are of two types:
a. assumptions and theories.
b. true statements and false statements.
c. specific statements and general statements.
d. positive statements and normative statements.

7. Normative statements are
a. not usually made by economists.
b. claims about how the world should be.
c. claims about how variables in the economy normally behave.
d. pessimistic interpretations of the economy.

8. Positive statements are
a. prescriptive.
b. claims about how the world should be.
c. claims about how the world is.
d. made by economists speaking as policy advisers.

9. When economists make positive statements, they are
a. speaking as scientists.
b. speaking as policy advisers.
c. making claims about how the world should be.
d. revealing that they are very conservative in their views of how the world works.

10. When economists make normative statements, they are
a. speaking as scientists.
b. speaking as policy advisers.
c. making claims about how the world is.
d. revealing that they are very liberal in their views of how the world works.

3. True/False

№	Rate the following statements	True/False
1	Something that is economical requires a lot of money to operate.	
2	Microeconomics is a branch of economics that studies such variables as unemployment, growth of economy, national incomes, money supply, monetary policy.	
3	Opportunity cost is your limited income.	
4	Entrepreneurship is a function of combining and organizing natural resources, capital goods, labour, assuming the risks of business failure, and providing the creativity and managerial skills necessary for production to take place.	
5	Facts are how individuals and institutions behave in producing, exchanging, consuming goods and services change with time.	
6	Economic relationships can be expressed as equations, graphs, and schedules.	
7	Managerial economics involves the application of economic theory and decision science.	
8	The ultimate test of the value of an economic theory is whether it is based on reasonable assumptions.	
9	The concept of the circular flow of economic activity illustrates the point that all economic activities are interdependent.	
10	The single most important element in managerial economics is the microeconomic theory of the firm.	
11	Economic theory suggests that a cubic function is an appropriate form for an empirical short-run total variable cost curve.	
12	Macroeconomic forecasts are generally based on multiple-equation econometric models.	
13	If an economic relationship is complex, it must generally be expressed as an equation.	
14	Economic profit is an important mechanism for the efficient reallocation of resources in a free-enterprise economy.	
15	Expansions and contractions in the general economy result in seasonal variation.	

2. FROM THE HISTORY OF ECONOMIC THOUGHT

Key words:
emerging nation-states – нарождающиеся национальные государства
enact laws – принимать законы
excess – излишек
European powers – Европейские державы
mainstream economics – главенствующая экономическая теория
era of modern economics – эра современной экономики
laissez-faire – свободная рыночная экономика
contribution – вклад
policy implications – политические выводы
merchant – купец, торговец
source of economic wealth – источник экономического богатства
favorable balance of trade – положительный торговый баланс
trade restrictions – торговые ограничения
circumstance – обстоятельство
benefit society – приносить пользу обществу
outperform competitors – работать лучше конкурентов
make a fortune – сделать состояние
government intervention– правительственное вмешательство
government regulation – правительственное регулирование
self-interest – личный интерес, корысть
division of labour – разделение труда
barriers to trade – торговые барьеры
law of comparative advantage – закон сравнительных преимуществ
abandon a policy of protection – отказаться от политики протекционизма
labor theory of value – трудовая теория стоимости
surplus value – прибавочная стоимость
just economic order – справедливый экономический порядок
negotiations – переговоры
persist – упорствовать
reverse the trend – переломить тенденцию
externalities – экстерналии
environmental pollution – загрязнение окружающей среды
beneficial – благоприятный
lay off – увольнять
food stamps – продуктовые талоны (для мало обеспеченных)
reduce poverty – снижать бедность
inequality – неравенство
money supply – денежное предложение, денежная масса
budget deficit – бюджетный дефицит
environmental issues – природоохранные вопросы

Schools of economic thought and some of the great names

- Mercantilists
- Physiocrats
- Classical Economics: Adam Smith and David Ricardo
- Karl Marx
- Neoclassical Economics
- John Maynard Keynes
- Monetarists: Milton Friedman
- Paul Samuelson

Mercantilists

The first systematic thinkers were the mercantilists of the 16th – 18th centuries. The major emerging nation-states of Europe believed in the economic theory of mercantilism. Mercantilists argued that nations should behave as if they were merchants competing with one another for profit. Accordingly, governments should support industry by enacting laws designed to keep labor and other production costs low, and exports high. In this way the nation could achieve what was called a 'favorable balance of trade', a situation in which exports exceeded imports. The excess, which was like profits to a merchant, would result in an increase in the nation's supply of gold or silver.

To achieve favorable trade balances, the major European powers sought to acquire colonies. Colonies, it was thought, could provide the 'mother country' with cheap labor, raw materials and a market for its manufactured goods.

In an effort to achieve these goals in their American colonies, the British, for example, enacted the Navigation Acts. The Navigation Acts protected British industry by prohibiting the colonies from producing certain goods like hats, woolen products and wrought iron (кованое железо). Protest against the Navigation Acts was so great that they are regarded as one of the principal causes of the American Revolution.

Mercantilist practices inspired numerous ideas. David Hume (1711-1776) suggested his brilliant gold-flow mechanism to demonstrate how the mercantilists' gold inflow would eventually end up raising prices rather than output.

Physiocrats

The group known as the Physiocrats reacted powerfully to the ideas of the French mercantilists. The Physiocrats declared agriculture the only source of economic wealth and attempted to remove trade restrictions from corn and other sectors. In other words, since real wealth came from the land, it followed that the wisest thing government could do would be to keep its hands off business. This idea was expressed in the slogan 'laissez-faire' (`let people do as they choose').

A remarkable depiction of the economy as a circular flow, still used in today's texts, was made by François Quesnay, Louis XIV's court physician. He stressed that the different elements of the economy are as integrally tied together as are the blood vessels of the body.

Classical Economics: Adam Smith

1776, the year that Americans associate with the signing of the Declaration of Independence, also marked the publication in England of one of the most influential books of our time an Inquiry into the Nature and Causes of the Wealth of Nations, known as the Wealth of Nations written by Adam Smith. The book earned the author the title ‘the father of economics’.

Smith objected to the principal economic beliefs of his day. He differed from the physiocrats who argued that land was the only source of wealth. He also disagreed with the mercantilists who measured the wealth of a nation by its money supply and called for government regulation of the economy in order to promote a ‘favorable balance of trade’.

In Smith’s view, a nation's wealth was dependent upon production, not agriculture alone. How much it produced, he believed, depended upon how well it combined labor and the other factors of production. The more efficient the combination, the greater the output, and the greater the nation’s wealth.

The heart of Smith’s economic philosophy was his belief that the economy would work best if left to function on its own without government intervention. In those circumstances, self-interest would lead business firms to produce only those products that consumers wanted, and to produce them at the lowest possible cost. They would do this, not as a means of benefiting society, but in an effort to outperform their competitors and gain the greatest profit. But all this self-interest would benefit society as a whole by providing it with more and better goods and services, at the lowest prices.

To explain why all the society benefits when the economy is free of regulation, Smith used the metaphor of an ‘invisible hand’:

“Every individual . . . neither intends to promote the general interest, nor knows how much he is promoting it. He intends only his own security, his own gain. And he is in this led by an invisible hand to promote an end which was no part of his intention. By pursuing his own interest he frequently promotes that of society more effectually than when he really intends to promote it.’

The ‘invisible hand’ was Smith’s name for the economic forces that we today would call supply and demand, or the marketplace.

His idea of the importance of the division of labour for the efficient production, and other sections dealing with the factors of production, money and international trade are as meaningful today as when they were first written. Smith’s Wealth of Nations contains some of the best descriptions of the principles upon which the market economy is based.

Classical Economics: David Ricardo

David Ricardo (1772-1823) is one of history's most influential economists, from whose thinking both neoclassical and modern economics derive. Born in England, Ricardo made a fortune on the London Stock Exchange. This wealth gave him the time to write and to serve in Parliament's House of Commons. His most famous work, Principles of Political Economy and Taxation (1817), marked him as the greatest spokesman for classical economics since Adam Smith.

One of Ricardo's contributions lay in a thorough analysis of the nature of economic rent – a theory that survives almost intact today. He also presented a careful analysis of the labor theory of value. But his major contribution was his analysis of the laws of income distribution in a capitalist economy.

Ricardo is especially famous in international economics for demonstrating the advantages of free trade. Free trade is a policy in which tariffs and other barriers to trade between nations are removed. To prove his point, Ricardo developed a concept we now call the law of comparative advantage. Comparative advantage enabled him to demonstrate that one nation might profitably import goods from another even though the importing country could produce that item for less than the exporter.

As Member of Parliament, Ricardo pressed the government to abandon its traditional policy of protection. Though he did not live to achieve that goal, his efforts bore fruit in the 1840's when England became the first industrial power to adopt a policy of free trade. There followed 70 years of economic growth during which the nation became the world's wealthiest industrial power.

Karl Marx

Karl Marx (1818-1883) was a philosopher, economists and a revolutionary. The first volume of his Das Kapital was published in 1867 but the rest of his work did not appear until after his death. His theory explains the origin and the historical development of the capitalist economic system. Class analysis, the central component of Marxism, is not peculiar to Marx but was shared by contemporary political economists, such as Adam Smith and David Ricardo.

The center of Marx's economics was the labor theory of value. Marx assumed that it is labor power that gives value to a commodity – both the direct labor and the indirect labor embodied in buildings or machinery used up in the productive process. Marx realized that, under competitive capitalism, market prices would not necessarily equal labor values because capitalists receive an excess in revenues over labor costs – a surplus value by which Marx meant the difference between revenues and total labor costs.

The economic interpretation of history is one of Marx s lasting contributions to Western thought. Marx argued that economic interests lie behind and determine our values. Why do business executives vote for conservative candidates, while labor leaders support those who advocate raising the minimum wage or increasing unemployment benefits? The reason, Marx held, is that people's beliefs and ideologies reflect the material interests of their social and economic class.

Neoclassical Economics

Classical writers worked with horizontal supply curves and ignored the role of demand curves. Around 1870, three scholars independently laid the foundation for modern economics by devising an analysis that could synthesize both demand elements and cost elements. They were W. Stanley Jevons (1835-1882) in England, Carl Menger (1840-1921) in Austria, and Leon Walras (1834-1910) in Switzerland.

The key element in the neoclassical revolution was to understand how consumer preferences (called 'utility') enter the demand for goods. The neoclassical economists provided the missing link in a complete theory of the market mechanism by showing that demand depends upon marginal utility.

Walras discovered how to analyze the economy as a whole – as a general equilibrium of all the labor, land, and product markets. Joseph Schumpeter (1883-1950) used to say that of all great economists, surely Walras was the greatest – for it was he who discovered how all markets interact in a general equilibrium.

Ever since Adam Smith analyzed the harmful effects of government regulation of the market, economists have devised technical tools that could measure the losses that arise from government interferences with a competitive equilibrium; important innovations were the concepts of consumer surplus devised by Alfred Marshall and allocational efficiency introduced by Vilfredo Pareto. But neoclassical economists were not all proponents of laissez-faire. Most of the great economists have been critical of capitalism's inequality.

Even as economics became more 'scientific', it never lost its interest in policy. Most of the great economists were inspired by the idea how to help improve the world. But, however much the neoclassical economics did not have a well-developed macroeconomics to match its microeconomics.

The Keynesian Revolution

In the years after World War I, economists made great contribution to the analysis of the economic world of developed and developing regions. One enormous hole, however, still remained, for neoclassical economics did not have a well-developed macroeconomics to match its microeconomics.

The neoclassical theories of money and the price level earlier developed by Alfred Marshall (1842-1924) and Yale's Irving Fisher (1867-1947) paved the way for the Keynesian concepts of the demand for money.

John Maynard Keynes (1883-1946) stands with Adam Smith and Karl Marx as one of the world's most influential economists. The son of a noted British economist, Keynes made a fortune through speculation in Stock Exchanges. He served the British government as a financial adviser and was a key participant in the negotiations following both World Wars I and II.

Although Adam Smith had written The Wealth of Nations about the time of the American Revolution, by the 1930s little had changed in the thinking of mainstream economists. Most would have agreed with Smith, that the best thing government could do to help the economy would be to keep its hands off. They reasoned that as long as the economy was free to operate without interference, the forces of supply and demand would come into balance. Then, with total supply and demand in equilibrium, everyone looking for work could find a job at the prevailing wage, and every firm could sell its products at the market price.

But the 1930s was the period of the Great Depression. Despite the assurances (уверения) of the classical economists, the fact was that unemployment and bankruptcy had reached record proportions in the United States and the rest of the industrialized world. It was at this time (1936) that Keynes' famous work was

published. The General Theory of Employment, Interest and Money transformed economic thinking in the 20th century, much the way that The Wealth of Nations had in the 18th century.

Keynes demonstrated that it was possible for total supply and demand to be at equilibrium at a point well under full employment. What is more, Keynes demonstrated that unemployment could persist indefinitely, unless someone stepped in to increase total demand. The 'someone' Keynes had in mind was government.

The suggestion that governments abandon 'laissez-faire' in favor of an active role in economic stabilization was regarded as revolutionary in the 1930s. Now, whenever a nation appears to be entering a period of recession or inflation, economists and others immediately think of steps the government might take to reverse the trend.

Monetarism

In the 1950s and 1960s, monetarists, most notably Milton Friedman, began to argue that Keynesian fiscal policy had negative long-run effects. Unlike Keynesians, monetarists insisted that money is neutral, meaning that in the long run, changes in the money supply will only change the price level and have no effect on output and employment. They argued that governments should abandon any attempt to manage the level of demand in the economy through fiscal policy. On the contrary, monetarists focus on the supply and demand for money being the primary means by which economic activity is regulated. They argued that excessive expansion of the money supply is inflationary, and that monetary authorities should focus solely on maintaining price stability.

Paul Samuelson and Milton Friedman

Paul Samuelson and Milton Friedman are two of America's most distinguished economists. In recognition of their achievements, Samuelson was awarded the Nobel Prize in Economics in 1970 and Friedman in 1976. Both spent most of their professional lives on the faculty of major universities (Samuelson at the Massachusetts Institute of Technology, and Friedman at the University of Chicago). Though they have much in common, they hold strikingly different views on economic issues. In particular, they differ on what role the government should play in the economy.

Classical economists had long recognized the need for government to provide goods and services that would not or could not be provided by the private sector (like national defense). But they insisted that this participation should be kept to a minimum.

Samuelson argued that too many of the problems the classical economists wanted to leave to the marketplace were not subject to its influence. These externalities, affecting things like public health, education, and environmental pollution, were not subject to the laws of supply and demand. Consequently, governments have to establish goals for the economy and use its powers to achieve them.

Milton Friedman sees things differently. Like the classical economists of old, he regards supply and demand as the most powerful and potentially beneficial economic forces. The best that government can do to help the economy, in Friedman's view, is to keep its hands off business and allow the market to 'do its thing'. The minimum wage laws are a case in point. Whereas Samuelson advocates minimum wage laws as a means of helping workers at the bottom of the income ladder, Friedman would argue that by increasing labor costs, minimum wage laws make it too expensive for many firms to hire low-wage workers. As a result, those who might otherwise be employed are laid off.

On the one hand, Samuelson is in favour of the concept of government-sponsored programs such as public housing and food stamps as a means of reducing poverty. Friedman, on the other hand, would prefer to give the poor additional income and allow them to use the funds to solve their problems without government interference.

Economics today

Today the giants of modern economics keep one eye on economic analysis and the other upon the policy implications of their theoretical studies. Economists of the late twentieth century study government budget deficit, the money supply, the environment, and poverty not only because they are interested in economic behavior. They also look for ways that the government can promote economic efficiency. Modern economists are far from consensus. Economists are divided between the conflicting schools of thought of monetarism and Keynesianism as to the extent to which governments can influence economies. Contemporary problems in economics center upon the control of inflation, unemployment, and the balance of payments, as well as the stimulation of economic growth.

1. Answer the following questions:

1. What is the basic difference between Mercantilists and Physiocrats?
2. What economic issues raised by Adam Smith secured him the name of the father of modern economics?
3. Which of the neoclassical economists discovered how to analyze the economy as a whole in the general equilibrium?
4. What issues lay the foundation for the dividing line between Keynesians and monetarists?

2. Find the correct answer:

1. Which is NOT one of the three basic economic questions that must be answered in an economy?
a. How to produce
b. What to produce
c. For Whom to produce
d. When to produce

2. What is mercantilism?
a. A system where a mother countries gains money and power from natural resources that come from its colonies
b. Where colonies trade gold and silver with each other
c. Wars that start over money.
d. Plantation colonies trading slaves for money.

3. Under the theory of Mercantilism, how was wealth defined?
a. The amount of gold a country had
b. A nation`s ability to produce
c. A country`s diversity in materials
d. How many colonies it controlled and owned

4. Karl Marx (1818-1883) was a
a. philosopher
b. economists
c. revolutionary
d. all answers are correct

5. The neoclassical theories of money and the price level earlier developed by
a. Alfred Marshall and Yale's Irving Fisher
b. John Maynard Keynes
c. Adam Smith
d. Karl Marx

6. Who is one of history's most influential economists, from whose thinking both neoclassical and modern economics derive?
a. David Ricardo
b. John Maynard Keynes
c. Adam Smith
d. Karl Marx

7. Most of the great economists were inspired by the idea how to help improve the
a. world
b. country
c. city
d. humanity

8. When monetarists, most notably Milton Friedman, began to argue that Keynesian fiscal policy had negative long-run effects.
a. In the 1950s and 1960s
b. In the 1940s and 1950s
c. In the 1930s and 1940s

d. In the 1920s and 1930s

9. Paul Samuelson and Milton Friedman are two of
a. Canada's most distinguished economists.
b. America's most distinguished economists.
c. Spain's most distinguished economists.
d. Italia's most distinguished economists.

10. The Wealth of Nations written by
a. David Ricardo
b. John Maynard Keynes
c. Adam Smith
d. Karl Marx

3. True/False

№	Rate the following statements	True/False
1	The first systematic thinkers were the mercantilists of the 16th – 18th centuries.	
2	The Physiocrats declared agriculture the only source of economic wealth and attempted to remove trade restrictions from corn and other sectors.	
3	1976, the year that Americans associate with the signing of the Declaration of Independence	
4	The heart of Smith's economic philosophy was his belief that the economy would work best if left to function on its own without government intervention.	
5	Karl Marx discovered how to analyze the economy as a whole – as a general equilibrium of all the labor, land, and product markets.	
6	The neoclassical theories of money and the price level earlier developed by Alfred Marshall (1842-1924) and Yale's Irving Fisher (1867-1947) paved the way for the Keynesian concepts of the demand for money.	
7	*Physiocrats* argued that nations should behave as if they were merchants competing with one another for profit.	
8	Adam Smith had written The Wealth of Nations about the time of the American Revolution, by the 1930s little had changed in the thinking of mainstream economists.	
9	Paul Samuelson and Milton Friedman are two of America's most distinguished economists.	
10	David Ricardo (1772-1823) is one of history's most influential economists, from whose thinking both neoclassical and modern economics derive.	

3. BASIC CONCEPTS OF ECONOMICS

Key words
scarcity and choice – нехватка и выбор
satisfy – удовлетворять
housing – жилье
available – доступный
factors of production – факторы производства
input – вводимый ресурс
output – объем произведенной продукции, выпуск продукции
amount – количество
labour – труд (фактор производства)
natural resources – природные ресурсы
capital – капитал
skills – умения, квалификация
equipment – оборудование
productivity - производительность
wage – зарплата
shareholder – акционер
opportunity costs – альтернативные издержки
sacrifice – жертвовать, жертва
weigh up benefits and costs – взвешивать выгоды и издержки
forgo – поступаться
revenues – поступления, доходы
allocation of scarce resources – размещение ограниченных ресурсов
production possibility curve (frontier) – кривая (граница) производственных возможностей
data – данные (datum)
measure – мера, измерять
transfer – переводить, превращать
ever-increasing – всё возрастающий
properties – свойства
suitable – пригодный
unit of a good – единица товара
vertical and horizontal axis – вертикальная и горизонтальная ось координат (axes)
employment – занятость
unemployment – безработица
investment - инвестиции
technological advances – технологический прогресс

The central economic problem is about scarcity and choice. Human wants are virtually unlimited whilst the resources to satisfy our wants are limited. The most pressing wants are food, housing, clothing and warmth. They have to be satisfied

first. Advances in technology, however, have added new wants and brought about new ways of satisfying existing wants. For example, our wants for cars and television sets were unknown to previous generations and the wants to travel, regarded as difficult in the past, can be satisfied easily because of many different types of transport.

At any time people in different countries of the world can produce only a limited amount of goods and services because the available resources are limited, or scarce. These resources or factors of production as they are often called are of three types:

Labour: all forms of human input, both physical and mental, into production. The labor force is limited both in number and in skills.

Natural resources: land and raw materials. They are inputs into production that are provided by nature. The world's land area is limited, as are its raw materials.

Capital: all inputs that have themselves been produced, e.g. factories, machines, transportation and other equipment. All of them are also limited. Moreover, the productivity of capital is limited by the state of technology.

Three fundamental questions of economics arise because of scarcity and the need to choose between alternative uses of scarce resources.

1. What goods and services are going to be produced? For example, how many cars, how much wheat, how many rock concerts, how mush education, etc. The answer depends not only on resources but also on the needs: in Finland consumers need mare warm clothes because of the climate. In China consumers need more rice because it is traditional everyday food there.

2. How are things going to be produced? Resources can be used in different proportions. Labour-intensive production versus capital-intensive production: In Brazil maize is grown with a lot of labour and limited capital, and in the Netherlands tomatoes are grown with a lot of capital and limited labour. In India electronic devices are produced in small workshops with relatively more labour than capital, and in Germany electronic goods are made with more capital and less labour than in India.

3. For whom are things going to be produced? How will the nation's income be distributed? Historically there have been various answers: according to traditions and customs: in the primitive society hunters got the best food; according to the principle of equality: in the former communist-block countries; according to people's ability to pay: in contemporary Russia. In answering this question, modern economics is more focused on the following aspects of the problem: What will the wages of farm workers, builders, accountants, teachers be? How much will pensioners receive? How much will go to shareholders?

Choice and opportunity cost

Choice involves sacrifice. The more food we choose to buy, the less money we have to spend on other goods. The more food a nation produces, the less resources there will be for producing other goods. In other words, production and consumption of one good involves the sacrifice of alternatives. The opportunity

cost of something is what you give up to get it/do it. For example, if a farmer's production is either 1000 tonnes of carrots or 2000 tonnes of potatoes, then the opportunity cost of producing 1 tonne of carrots is the 2 tonnes of potatoes forgone. Another example is from a student's everyday life: the opportunity cost of buying a textbook is a new pair of trainers you also wanted that you will have to go without. Consumers' rational decisions involve choosing those goods that give you the greatest benefit relative to cost.

The same principles apply to firms when deciding what to produce. Rational choices are also needed in production. The problem is associated with the allocation of the limited resources. For example, should a car manufacturer open up another production line? A rational decision will again involve weighing up the benefits and costs. The benefits are the revenues that the firm will earn from selling the extra cars. The costs will include the extra labour costs, raw material costs, costs of component parts, etc.

To sum up, we can say that the basic economic problem is concerned with the *allocation of scarce resources* among competing and virtually unlimited wants of consumers in society. All nations have to decide in some way what, how and for whom to produce.

The production possibility curve

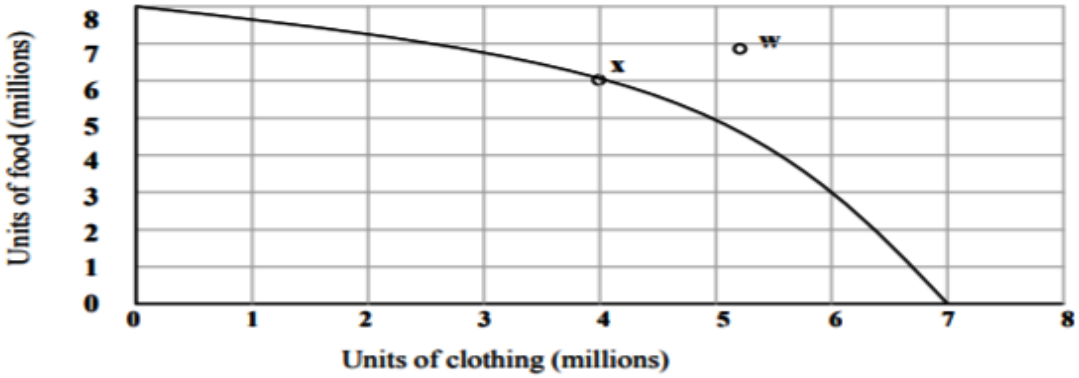
Now let us consider how the economic problem can be illustrated by means of a production possibility frontier, or curve in terms of graphics. This diagram is actually a graph. Like many diagrams in economics it shows a simplified picture of reality. The graph is based on the data shown in Table 2.1. We assume that Country A allocates all its resources – land, labour and capital – to produce just two goods, food and clothing. The table shows allpossible combinations that could be produced over a year.

Table 2.1 Maximum possible combinations of food and clothing that can be produced in a given time period.

Units of food (millions)	Units of clothing (millions)
8.0	0.0
7.0	2.2
6.0	4.0
5.0	5.0
4.0	5.6
3.0	6.0
2.0	6.4
1.0	6.7
0.0	7.0

The information in the table can be transferred to a graph (Figure 2.1): units of food are measured on the vertical axis and units of clothing on the horizontal axis. The curve also shows all combinations of the two goods that can be produced.

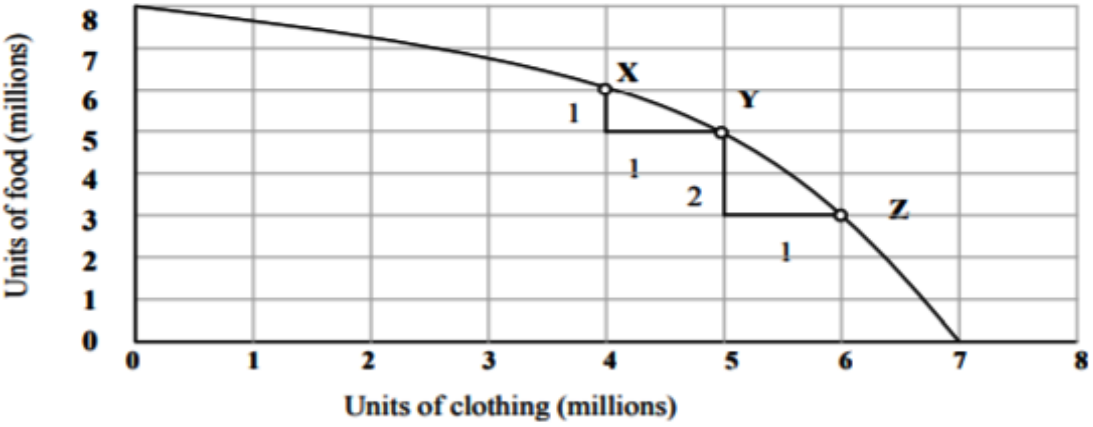
Figure 2.1 A Production Possibility Curve.



For example, production could take place at point x, with 6 million units of food and 4 millions of clothing being produced. Production cannot take place beyond the curve, for example, at point w: there are not enough resources to do this.

The fact that to produce more of one good involves producing less of the other is illustrated by the downward sloping nature of the curve. For example, the country could move from point x to point y in Figure 2.2. In doing so it would be producing an extra 1 million units of clothing, but 1 million fewer units of food. This diagram is to a large degree a simplification, but it still allows important principles to be illustrated. A production possibility curve illustrates the microeconomic issues of choice and opportunity cost. It also illustrates the phenomenon of increasing opportunity costs.

Figure 2.2 Increasing opportunity costs.



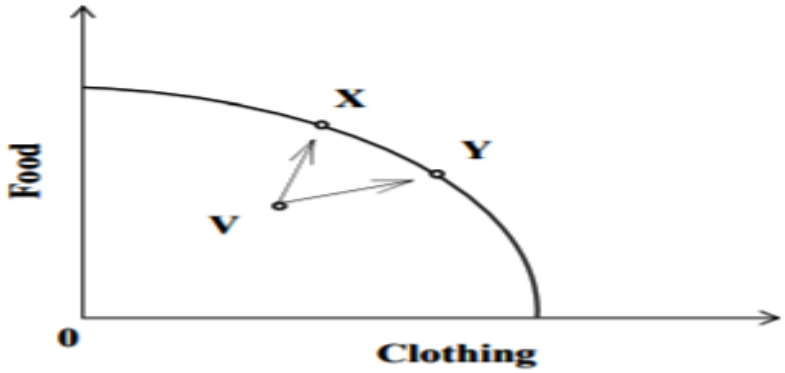
As production moves from point x to y to z, the amount of food sacrificed rises for each additional unit of clothing produced. The opportunity cost of the fifth million units of clothing is 1 million units of food. The opportunity cost of the sixth million units of clothing is 2 million units of food. In other words, as the country produces more of one good, it has to sacrifice ever-increasing amounts of

the other. The reason for this is that different factors of production have different properties. People have different skills. Land differs in different parts of the country. Raw materials differ, and so on. Thus as the nation concentrates more and more on the production of one good, it has to start using less and less suitable resources.

Making a fuller use of the resources

If not all the resources are used in the country, the nation will be producing at the point inside the curve (Figure 2.3), say, point v. The economy is producing less of both goods than it could possibly produce. The reason may be unemployment. By increasing employment the nation could move out on the curve: to point x or y. It means it could produce more clothing and more food (proportions will be different).

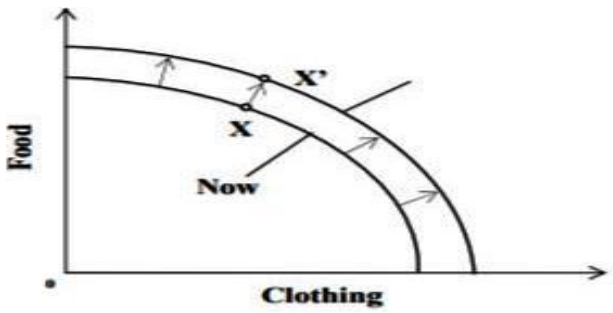
Figure 2.3. Macroeconomics and the production possibility curve.



In Figure 2.3. we are not concerned with the combination of goods produced (a microeconomic issue), but with the issue whether the total amount produced is as much as it could be (a macroeconomic issue).

The production possibilities of a nation are likely to increase over time. For example, investment in a new plant and machinery will increase the stock of capital, new raw materials may be discovered; technological advances are likely to take place. Labour is likely to become more productive through education and training. This growth in potential output is illustrated by an outward shift in the production possibility curve. This will allow actual output to increase: for example from point x to point x1 (Figure 2.4)

Figure 2.4 Shifts in the PPC from now to 5 years later.



1. Answer the following questions:

1. What is the central economic problem faced by all individuals and societies?
2. What are the three fundamental questions of economics?
3. Why is it essential for people to make economic decisions?
4. What is meant by ‘opportunity cost’? How is it relevant when people make economic choices?

2. Find the correct answer:

1. Economists generally support
a. trade restrictions.
b. government management of trade.
c. export subsidies.
d. free international trade.

2. Normative conclusions
a. come from positive analysis alone.
b. are based on ignorance of positive analysis.
c. involve value judgments.
d. reflect the economist's role as scientist.

3. "Prices rise when the quantity of money rises rapidly" is an example of a
a. negative economic statement.
b. positive economic statement.
c. normative economic statement.
d. statement that contradicts one of the basic principles of economics.

4. Which of the following is an example of a normative, as opposed to positive, statement?
a. Gasoline prices ought to be lower than they are now.
b. The federal government should raise taxes on wealthy people.
c. The social security system is a good system and it deserves to be preserved as it is.
d. All of the above are normative statements.

5. Which of the following is an example of a normative, as opposed to positive, statement?
a. If the price of a product decreases, people's willingness to buy that product will increase.
b. Reducing tax rates on the wealthy would benefit the nation.
c. If the national saving rate were to increase, so would the rate of economic growth.

d. The elimination of trade restrictions would increase an economy's standard of living.

6. Which of the following is not an example of a positive, as opposed to normative, statement?
a. Higher gasoline prices will reduce gasoline consumption.
b. Equality is more important than efficiency.
c. Trade restrictions lower our standard of living.
d. If a nation wants to avoid inflation, it will restrict the growth rate of the quantity of money.

7. A production possibilities frontier is bowed outward when
a. the more resources the economy uses to produce one good, the fewer resources it has available to produce the other good.
b. an economy is self-sufficient instead of interdependent and engaged in trade.
c. the rate of tradeoff between the two goods being produced is constant.
d. the rate of tradeoff between the two goods being produced depends on how much of each good is being produced.

8. If an economy is in a trough on the business cycle
a. unemployment is low, real GDP growth is low, and inflation is low (your response)
b. unemployment is high, real GDP growth is high, and inflation is low
c. unemployment is low, real GDP growth is high, and inflation is high
d. unemployment is high, real GDP growth is low, and inflation is low

9. The central economic problem is about
a. clothing and warmth
b. scarcity and choice
c. food and housing
d. land and raw materials

10. These resources or factors of production as they are often called are of
a. three types
b. four types
c. five types
d. six types

3. True/False

№	Rate the following statements	True/False
1	Capital: all inputs that have themselves been produced, e.g. factories, machines, transportation and other equipment.	
2	Labour: land and raw materials.	
3	Choice involves sacrifice.	
4	To sum up, we can say that the basic economic problem is concerned with the allocation of scarce resources among competing and virtually unlimited wants of consumers in society.	
5	Human wants are virtually limited whilst the resources to satisfy our wants are unlimited.	
6	Natural resources: land and raw materials.	
7	Labour: all forms of human input, both physical and mental, into production. The labor force is limited both in number and in skills.	
8	The production possibilities of a nation are likely to increase over time.	
9	Two fundamental questions of economics arise because of scarcity and the need to choose between alternative uses of scarce resources.	
10	Labour is likely to become more productive through education and training.	

4. ECONOMIC SYSTEMS

Key words:
wealth – богатство
set laws – устанавливать законы
govern – управлять
property rights – права собственности
variety – разнообразие
command economy – командно-административная экономика
market economy, or free enterprise, or laissez-faire – рыночная экономика
mixed economy – смешанная экономика
invisible– невидимый
direction – направление, указание
supply – поставлять, снабжать
transmit – передавать
adjust – регулировать
supply meets demand – предложение равно спросу
equilibrium – равновесие
law enforcement – обеспечение соблюдения законов
defence – оборона
fail – терпеть неудачу
social security – социальное обеспечение
justice – правосудие
disposal of chemical and nuclear waste – утилизация химических и ядерных отходов
violence – насилие
government intervention – государственное вмешательство
market forces – рыночные силы (спрос и предложение)
demand curve – кривая спроса
supply curve – кривая предложения
quantity – количество
public good – общественный продукт
broadcasting – радиотрансляция
subsidize export industries – субсидировать экспортные отрасли
monetary policy – кредитно-денежная политика, монетарная политика
fiscal policy – налоговая, фискальная, бюджетная политика

Economics is a social science. An economy is the system according to which the money, industry and trade of a country are organized and its wealth which it gets from business and industry.

The economic system is a network of relations and organizations that implements the following:

• sets the laws and regulations that govern the economic activity;

• determines the property rights and ownership of factors of production;
• distributes the decision-making power over production and consumption;
• determines the answers to the three fundamental questions.

There is a great variety in the way countries organize their economies. But one central theme dominates: Should the economy rely primarily upon the private market or upon government commands to answer the fundamental questions of what, how, and for whom to produce?

Economies fall into three major groups:

1. Command or planned economy
2. Free market economy
3. Mixed economy

In a command or planned economy direction is given by government bureaucracy that determines through a system of planning offices what goods are produced, how they are produced, and who gets the fruits of productive activity. Such planned economy existed in the Soviet Union and in the Soviet bloc countries.

A free market economy, or free enterprise, or laissez-faire (a French word for 'let people do what they choose') is the type when resources are allocated through markets, and governments do not intervene in economic decisions of production and consumption. Under the market system, firms buy factors of production and produce outputs, selecting inputs in order to maximize their profits. Consumers supply factors of production and buy consumer goods to maximize their satisfactions.

The free-market economy is usually associated with a capitalist system, where land and capital are privately owned. Economic decisions are made by households and firms that are assumed to act in their own self-interest.

It is also assumed that individuals are free to make their own economic choices: consumers are free to decide what to buy with their incomes; workers are free to choose where and how much to work; firms are free to choose what to sell and what production methods to use. The resulting supply and demand decisions of firms and households are transmitted to each other through their effect on prices.

A mixed economy.

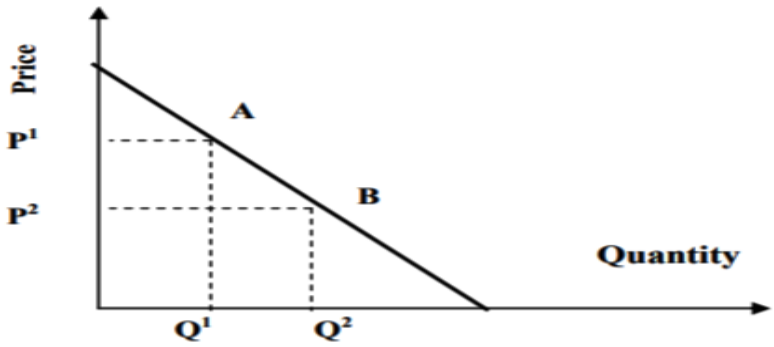
Most modern economies are mixed as they are partly regulated by market forces and partly by governments. When governments influence economic decisions of economic agents, we talk about government intervention in the economy. The degree and forms of intervention differ from country to country.

Adam Smith advocated the principles of a free market economy with no government regulation. He called the market forces – supply and demand – an 'invisible hand' which can regulate the economy better than any governments.

Demand is the willingness and the ability of consumers to buy goods and services. In other words, demand is related to people's unlimited wants and influences consumers decisions what, how much and at what price to buy. The demand curve is a graph which shows the relationship between the price of a good

and the quantity of the good demanded. Price is measured on the vertical axis; quantity demanded is measured on the horizontal axis.

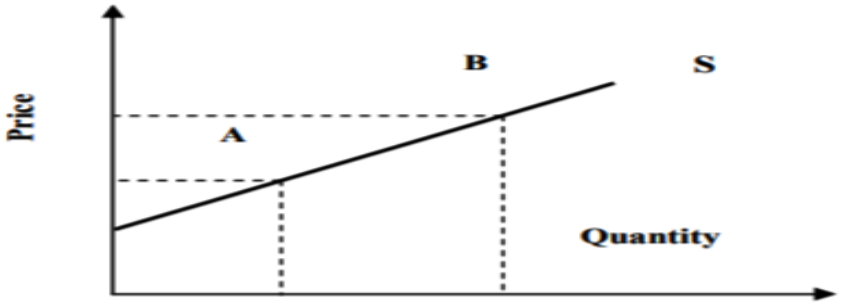
Figure 3.1 Demand curve.



Supply is the willingness and the ability of producers to sell goods and services to consumers. In other words, supply is related to the limited resources that producers use as inputs and influences producers decisions what, how much and at what price to sell.

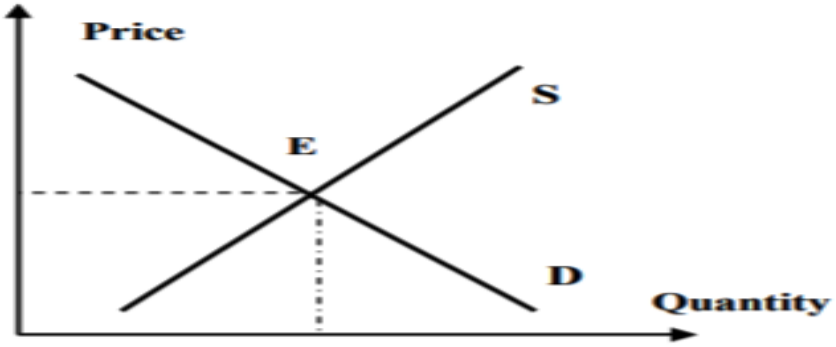
The *supply curve* is used to illustrate the quantity of a good that producers wish to sell at each price. Other things equal, when prices are high, the supplied quantity is high as well. The concepts of demand and supply can be illustrated graphically.

Figure 3.2 Supply curve.



The relationship between demand and supply in the freemarket economy can also be illustrated graphically.

Figure 3.3 Demand and supply curves.



Let us study Figure 3.3. The decisions of consumers (buyers) are represented by the demand curve (D) and the decisions of producers (sellers) are represented by the supply curve (S). Demand and supply are regulated through prices: the lower the price the more goods and services will be bought by consumers (demand curve). The higher the price the more goods and services will be produced by producers (supply curve). Prices and quantities of goods 'adjust themselves' until supply meets demand and then we say that the market is in equilibrium (point E).

The role of the government

In addition to consumers (households) and producers (firms), there is also a third group of decision-makers: a government is an institute that redistributes income and wealth in the society and provides goods and services. The basic service provided by government is laws and a mechanism for their enforcement (courts and police forces). But governments also provide such services as national defence, health services, and many more listed below.

Governments play an important role in modern economies. In particular, they interfere with 'market forces' regulating the areas where the private sector and the market system fail. In particular, governments control the production of public goods, i.e. the goods that would not be provided by the free market. Governments implement and regulate various tasks in the following areas:

- Education
- Health care
- Housing
- Working conditions (working hours, child labour, minimum wages, and so on)
- Social security (unemployment and sickness benefits, old age pensions)
- Defence (the armed services - army, navy, airforce)
- The police, the justice system, prisons, and so on Public transport (trains, buses, and so on)
- Traffic regulations (the driving test, speed limits, seat belts, the alcohol limit, parking restrictions, the size and weight of lorries and trucks, the safety of cars, and so on)
- Health, safety, and cleanliness regulations (concerning factories, shops, restaurants, food, medicines, the disposal of chemical and nuclear waste, and so on)
- The sale of alcohol, drugs, guns, and so on
- The press, broadcasting, the arts, entertainment, and the freedom of expression (concerning sex, violence, politics, and so on)

Moreover, governments help domestic producers to compete with foreign firms by subsidizing export industries and by helping domestic firms to enter new export markets. One of the main tasks of any government is also to implement monetary policy and a fiscal policy. We will study these macroeconomic issues later.

1. Answer the following questions:

1. What are the answers to the fundamental economic questions in a command, market and mixed economies?
2. What are the main economic functions of the state (government) in a modern economy?
3. What instruments does government use to intervene in the economy?

2. Find the correct answer:

1. Which is used to measure economic growth?
a. real GDP
b. inflation
c. interest rates
d. unemployment

2. Assume the U.S. Government's most recent fiscal policy slowly caused the economy to speed up and enter an expansion. Most likely, the Government
a. decreased the discount rate.
b. increased taxes.
c. decreased taxes.
d. increased the reserve requirement.

3. An economy that is at full employment
a. has close to zero frictional and structural unemployment.
b. has only seasonal unemployment.
c. has close to zero cyclical unemployment.
d. has found a job for everyone.

4. If the U.S. economy was in a recession, which fiscal policy would be most appropriate to get out of the recession?
a. decrease taxes, people have more disposable income
b. raise the reserve requirement, banks will have more money to loan
c. decrease government spending, the citizens will have more money to spend
d. buy bonds on the open market, the money supply will increase

5. The unemployment rate, GDP, and CPI can be used to determine
a. if a country uses a market or command economy.
b. which stage of the business cycle and economy is on. (correct answer)
c. how likely a person is to get credit.
d. the supply and demand of a market.

6. A budget surplus means that

government spending is higher than the Federal Reserve spending.
Government revenues are greater than government expenditures.
government expenditures are greater than government revenues.
Federal Reserve spending is higher than Government spending.

7.Regarding GDP, in which way is stagflation different than simple inflation?
a. in stagflation, it is easier to raise GDP
b. with stagflation, GDP increases
c. GDP is ignored under stagflation
d.stagflation means there is decreasing GDP

8. What is the term for an economic system where the government makes almost all the economic decisions?
a. market
b. command
c. traditional
d. capitalist

9. A COMMAND economy is an economy where the economic questions are answered by
a. the government
b. the consumers and producers
c. tradition
d. a foreign country

10. One of the main tasks of any government is also to implement
a. monetary policy and a fiscal policy
b. microeconomic policy
c. macroeconomic policy
d. social policy

3. True/False

№	Rate the following statements	True/False
1	Economics is a social science.	
2	A free market economy is the type when resources are allocated through markets, and governments do not intervene in economic decisions of production and consumption.	
3	An economy is the system according to which the money, industry and trade of a country are organized and its wealth which it gets from business and industry.	
4	Karl Marx advocated the principles of a free market economy with no government regulation.	
5	The demand curve is a graph which shows the relationship between the price of a good and the quantity of the good demanded.	
6	Market forces: supply and demand	
7	The economic system is a network of relations and organizations.	
8	Supply is the willingness and the ability of consumers to buy goods and services.	
9	Most modern economies are mixed as they are partly regulated by market forces and partly by governments.	
10	Demand is the willingness and the ability of producers to sell goods and services to consumers.	

5. FORMS OF BUSINESS OWNERSHIP

Key words

commercial enterprise – коммерческое предприятие
sole proprietorship – индивидуальное предпринимательство
raise money – добывать денежные средства (инвестиции)
settle the debts – улаживать долги
hire, employ – нанимать
employer – работодатель
employee – сотрудник, работник
dissolve – ликвидировать
retire – уходить в отставку, на пенсию
bear the responsibility – нести ответственность
retailing – розничная торговля
maintenance – тех.обслуживание
partnership – товарищество
accountancy – бухгалтерия
real estate – недвижимость
corporation, joint-stock company – корпорация, акционерное общество
fraction – доля
go bankrupt – обанкротиться
Stock Exchange – фондовая биржа
salary – оклад, зарплата
CEO (chief executive officer) – топ-менеджер
double taxation – двойное налогообложение
mismanagement – неэффективное руководство
state-owned corporation – государственное предприятие
appoint – назначать (на должность)
privatize and nationalize – приватизировать и национализировать
private limited companies – закрытое акционерное общество
public limited company – открытое акционерное общество
forward or backward integration – интеграция «вверх» или «вниз»
horizontal or vertical integration – горизонтальная или вертикальная интеграция
expansion – расширение, укрупнение, рост
merger – слияние
takeover – поглощение
acquisition – выкуп, приобретение
limited liability – ограниченная ответственность
shareholder (BE), stockholder (AE) – акционер
bankruptcy – банкротство
property – собственность
profit – прибыль
shares (of stock) – акции

The main types of business organization

Business is a commercial enterprise performing all those functions that govern the production, distribution, and sale of goods and services for the benefit of the buyer and the profit of the seller. The existing forms of business organization enable various branches of industry to adapt to changing conditions and to function more efficiently and profitably. The main three forms of business ownership are sole proprietorship, a partnership, and a corporation.

Sole proprietorship is ownership of a business by a single person. The sole proprietor provides capital to run the business and makes all the decisions. He/she employs other people and is responsible for the success and for the failure of the business. It is the simplest and the oldest form of business ownership.

Advantages:

• It is relatively easy to start this type of business;
• The owner has an incentive to run the firm efficiently as all the profits are his/hers;
• It is a flexible type of business as the owner can quickly respond to changes in the market conditions.

Disadvantages:

• Unlimited liability – in case of bankruptcy the owner may lose all his property including his personal assets including a house/flat, a car, etc. that can be sold to settle the debts of the business;
• A single owner is seldom able to invest as much capital as a partnership or a corporation can obtain;
• Unless the owner has much personal wealth, the business may have difficulty borrowing money in critical times;
• A sole proprietor may also have difficulty hiring and keeping good employees because the business will dissolve when the owner retires or dies.
• The owner faces all the risks, and alone bears all the responsibility for the business.

In many countries this type prevails in such sectors as farming, retailing, repair and maintenance work, personal services (e.g. hairdressing).But in terms of total employment, capital and output this type is relatively unimportant.

A partnership is an association of two or more persons who have agreed to combine their financial assets, labour, property, and other resources as well as their abilities and who carry on a business jointly for the purpose of profit. The agreement the partners usually sign to form an association is known as a partnership contract and may include general policies, distribution of profits, responsibilities, etc.

Advantages are similar to those of sole proprietorship: it is easy to establish a partnership, and this is also a flexible form of business. It is usually easier for partnerships to obtain additional financing because the personal assets of the group are usually larger and the chances of success are higher.

Disadvantages:

• Unlimited liability of each partner for the debts of the business, i.e. complete financial responsibility for losses.
• Partners who wish to retire may find it difficult to recover their investments without dissolving the partnership and ending the business.

Partnerships dominate in such professions as law, accountancy, medical services, real estate business and so on.

A business corporation (AE) is an organization created by law that allows people to associate together for the purpose of profit making. Corporations are also known as joint-stock companies (BE) because they are jointly owned by different persons who receive shares of stock in exchange for an investment of money in the company. Shares represent fractions of the company's assets such as cash, equipment, real estate, manufactured goods, etc.

Though the corporation is more difficult and expensive to organise than other business forms, it has a number of advantages. Most business people form limited companies. In this case shareholders have the liability only for the amount of money they have invested. If the company goes bankrupt, their personal possessions are not in danger, i.e. they cannot be sold to pay the debts of the company (except in criminal cases).

Most companies begin as private limited companies as the founders invest their private capital (or borrow from banks). Successful, growing companies apply to one of the Stock Exchanges to become a public limited company. After that its shares are traded in different financial markets and anyone can buy shares at the market price.

Advantages:

• Limited liability – if the corporation goes bankrupt, shareholders can lose no more than they have invested.

• Money to operate the business is obtained by the sale of stocks to the general public and this enables the corporation to exist independently of its owners.

• The corporation finds it easier to borrow money from banks and it is also a successful means for attracting large amounts of capital and investing the latter in plants, modern equipment and expensive research.

• Salaries large corporations can offer to managers and specialists are high, and that allows corporations to hire professional and talented CEOs and employees.

Disadvantages:

• A double taxation of profits: taxes are first paid on net income, and then shareholders pay taxes on their dividends;
• Numerous financial reports must be sent to various federal regulatory agencies;
• In large corporations shareholders have no real control over the business and as a consequence there is risk of mismanagement that may lead to bankruptcy.

A *state-owned* corporation has no private shareholders. Government owns the business and appoints managers to run it. Profits are used for investments. If this type of business is inefficient, government may sell it, i.e. have it privatized (as it happened with some large state-owned companies in the UK in the 1980s).

The purpose of this type is to run an industry which is important for the national economy. For example, such large nationalized industries in the UK as the Port of London (1909), and the BBC (1927). Another purpose of state-owned corporations is to provide important public services at a reasonable price. For example, the Tennessee Valley Authority in the USA is a federal corporation providing power and irrigation services, and flood control since the 1930s.

Public interest requires organization and operation of business to be subject to governmental regulation. Government regulation, particularly in the USA, attempts to prevent the formation of monopolies that totally control a particular branch of industry such as steel, petroleum, or automobile production.

1. Answer the following questions:

1. What is a firm?
2. Why do people prefer to form limited companies?
3. What are advantages and disadvantages of major forms of business organizations?
4. What types of integration are used by companies?
5. What is special about a state-owned corporation?

2. Find the correct answer:

1. When calculating GDP, the purchase of a new factory is counted as
a. net export
b. government
c. investment
d. consumption

2. Which of the following statements is not correct?
a. Trade allows for specialization.
b. Trade has the potential to benefit all nations.
c. Trade allows nations to consume outside of their production possibilities curves.
d. Absolute advantage is the driving force of specialization.

3. What is a commercial enterprise performing all those functions that govern the production, distribution, and sale of goods and services?
a. Business
b. Proprietorship
c. Partnership
d. Agreement

4. … is ownership of a business by a single person.
a. Sole proprietorship
b. A partnership

c. A corporation
d. no answer

5. … is an association of two or more persons who have agreed to combine their financial assets, labour, property, and other resources.
a. Sole proprietorship
b. A partnership
c. A corporation
d. no answer

6. … is an organization created by law that allows people to associate together for the purpose of profit making.
a. A business corporation
b. Sole proprietorship
c. A corporation
d. A partnership

7. A state-owned corporation has no
a. profits
b. taxes
c. private shareholders
d. dividends

8. Advantages of a sole proprietorship:
a. It is relatively easy to start this type of business
b. The owner has an incentive to run the firm efficiently as all the profits are his/hers
c. It is a flexible type of business as the owner can quickly respond to changes in the market conditions
d. All answers are correct

9. Disadvantages of a sole proprietorship:
a. Unlimited liability – in case of bankruptcy the owner may lose all his property including his personal assets including a house/flat, a car, etc. that can be sold to settle the debts of the business
b. A single owner is seldom able to invest as much capital as a partnership or a corporation can obtain
c. Unless the owner has much personal wealth, the business may have difficulty borrowing money in critical times
d. All answers are correct

10. Partnerships dominate in such professions as
a. law
b. accountancy

c. medical services
d. All answers are correct

3. True/False

№	Rate the following statements	True/False
1	Business is a commercial enterprise performing all those functions that govern the production, distribution, and sale of goods and services for the benefit of the buyer and the profit of the seller.	
2	The main three forms of business ownership are sole proprietorship, a partnership, and a corporation.	
3	A business corporation (AE) is an organization created by law that allows people to associate together for the purpose of profit making.	
4	Sole proprietorship is an association of two or more persons who have agreed to combine their financial assets, labour, property, and other resources as well as their abilities and who carry on a business jointly for the purpose of profit.	
5	A state-owned corporation has no private shareholders.	
6	Unlimited liability - seldom able to invest as much capital as a partnership or a corporation can obtain	
7	Partnerships dominate in such professions as law, accountancy, medical services, real estate business and so on.	
8	Most companies begin as private limited companies as the founders invest their private capital	
9	Salaries large corporations can offer to managers and specialists are high, and that allows corporations to hire professional and talented CEOs and employees.	
10	A partnership is an association of two or more persons who have agreed to combine their financial assets, labour, property, and other resources as well as their abilities and who carry on a business jointly for the purpose of profit.	

6. MARKETS AND COMPETITION

Key words:
circular flow of goods and incomes – кругооборот товаров и доходов
household – условная семья
twin – двойной, двусторонний
top (bottom) half – верхняя (нижняя) половина
expenditure – расходы
flow – перетекать, переходить
reverse – меняться местами
interest – проценты
facilitate – содействовать
insurance – страхование, страховка
factor market – факторный рынок
rent, hire – арендовать, нанимать
interact – взаимодействовать
budget constraint – бюджетное ограничение
compete – конкурировать, соперничать
restricted – ограниченный
perfect competition – совершенная конкуренция
imperfect competition – несовершенная конкуренция
monopolistic competition – монополистическая конкуренция
oligopoly – олигополия
monopoly – монополия
natural monopoly – естественная монополия
fix the price – устанавливать цену
cost price – себестоимость
illegal – противозаконный
differentiated product – дифференцированный продукт
undifferentiated (homogeneous) – недифференцированный
dumping – демпинг
cartel – картель, ценовой сговор
entry into the market – вход на рынок
barriers to entry – барьеры на входе
economies of scale – экономия на масштабе (от масштаба)

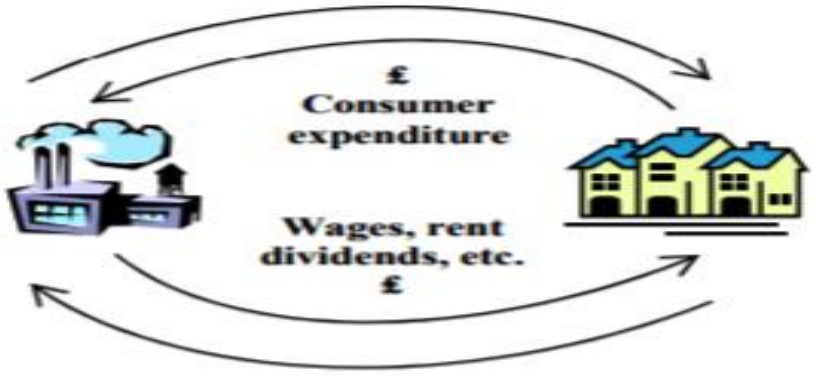
The circular flow of goods and incomes

The process of satisfying human wants involves producers and consumers. The relationship between them is two-sided and can be represented in a flow diagram (see Figure 5.1).

The consumers of goods and services are called ‘households’. Some members of households are also workers, and in some cases they are also the owners of other factors of production, such as land. The producers of goods and

services are called ‘firms’. Firms and households are in a twin ‘demand and supply’ relationship with each other.

Figure 5.1 The circular flow of goods and incomes.



First, in the top half of the diagram, households demand goods and services. In the process, exchange takes place. Firms exchange goods and services for money. In other words, money flows from households to firms in the form of consumer expenditure, while goods and services flow the other way – from firms to households.

This coming together of buyers and sellers is known as a market. There are all sorts of markets: the market for apples, the market for oil, for cars, for houses, for televisions and so on.

Second, firms and households come together in the market of factors of production. This is illustrated in the bottom half of the diagram. This time the demand and supply role are reversed. Firms demand the use of factors of production owned by households –labour, land, and capital. Households supply them. Thus the services of labour and other factors flow from households to firms, and in exchange firms pay households money – namely, wages, rent, dividends and interest. There are also particular factor markets – the market for shop assistants, for hairdressers, for land, etc.

There is thus a circular flow of incomes. Households earn incomes from firms, and firms earn incomes from households. The money circulates. There is also the circular flow of goods and services, but in the opposite direction. Households supply services to firms, which use them to supply goods and services to households.

In addition to two groups of decision-makers and the flows between them, Figure 5.1 shows two groups of markets. In everyday speech, the word ‘market’ means a place where people buy and sell goods such as fruit and vegetables, fish and meat. In economics, ‘market’ has a more general meaning. A market is any arrangement that facilitates buying and selling. For example, the hotel market in London, the EU milk market or the world insurance market. The latter is not a place. It is a mechanism by which consumers (households) and producers (firms) interact: households buy insurance and insurance companies sell it. In this market,

decision makers do not necessary meet physically. They can make deals by telephone, email and via the Internet.

There are two groups of markets: goods markets and factor markets.

Goods markets are those in which goods and services are bought and sold, such as bread or video players or hotel accommodation.

Factor markets are those in which factors of production change hands. Factors as well as goods may be bought, hired or rented. For example, a stadium may rent the land it uses, own the buildings it builds on the land and hire the labour force that works there.

One of the fundamental features of the market is competition, and it is traditional to divide industries into categories according to the degree of competition that exists between the firms within the industry.

Competition is a market condition when there is more than one producer of a specific good or service and consumers are free to choose which product to buy. On the one hand, producers want to maximize profits by selling as much as possible at high prices. On the other hand, buyers having budget constraint want 'the most for the money'. Thus, producers, in order to compete successfully among other producers, seek to use resources efficiently. Thus competition is a market mechanism which encourages technological innovation, modernization, and rationalization.

It is traditional to divide industries into categories according to the degrees of competition: that exists between the firms within the industry. There are four such categories: perfect competition, monopolistic competition, an oligopoly, and a monopoly, the latter three representing imperfect competition. To distinguish between these four categories, the following must be considered:

The number of firms: from one to many.

The nature of the product:

Homogeneous (undifferentiated): an identical product;
Differentiated: a particular brand or model or variety;
Unique: the only product in the market.

Market power: to what extent firms

Freedom of entry into the market can be free or limited.

Table 5.1 Features of the four market structures.

Type of market	Number of firms	Freedom of entry	Nature of product	Market power	Example s
Perfect competition	Very many	Unrestricted	Homogeneous (undifferentiated)	No	Wheat, cabbage
Monopolistic competition	Many/several	Unrestricted	Differentiated	Yes, but limited	Restaurants, builders
Oligopoly	Few	Restricted	1.Undifferentiated or 2. Differentiated	Yes, but limited	1.Cement 2. Cars
Monopoly	One	Restricted or completely blocked	Unique	Yes	Prescription drugs

Perfect competition. Under this condition there is a large number of small firms and they cannot have much influence on the market price. Economists are in favour of perfect competition as with the market mechanism, the price is near equilibrium.

A *monopoly* is an opposite situation: There is one producer, which does not allow competition. As a result, a single producer can fix the price. A natural monopoly is in question when an efficient existence of more than one seller is impossible or uneconomical. For example, electricity, gas and water supply to households and firms.

Monopolistic competition is based on the fact that consumers may have preferences for different brands; so producers can sell products at higher prices than equilibrium. However, the control over the market is limited: if a price is too high, consumers can buy a good from another producer.

An *oligopoly* is a degree of competition when the market is dominated by a few large producers. Each firm is large enough to influence the price and entry of new firms is restricted.

Unfair methods of competition:

1. *Dumping* is selling products at cost price or lower with the purpose to defeat the competitors and later to increase the prices in order to cover the losses.

2. *Cartel* is an agreement by competitors to fix the price at the level which is usually higher than the equilibrium price. Hence the other name of this method, namely, a price-fixing agreement.

The consequences re obviously that under these conditions the market forces – supply and demand – do not produce an equilibrium price and the consumers pay more. Therefore, dumping and cartels are considered illegal practices in many countries. Antidumping and anti-monopoly laws prevent such practices, in particular in the USA.

1. Answer the following questions:

1. What is market?
2. How much competition does a firm face?
3. What determines the degree of market power of a firm?
4. What happens when there are many firms all competing with each other? Is it good for us as consumers?

2. Find the correct answer:

1. Which provides the greatest incentive for entrepreneurs to take risks?
a. interest
b. inflation
c. profits
d. prices

2. Unemployment that occurs as a result of a recession or an economic downturn is
a. seasonal
b. structural
c. frictional
d. cyclical

3. If a country wanted to implement a barrier to trade that would help its producers AND consumers, which option would be best?
a. tariff
b. subsidy
c. embargo
d. quota

4. Sharlee was recently laid off from her job at a manufacturing plant when the company she worked for brought in a machine to replace her. This is classified as what type of unemployment?
a. structural
b. seasonal
c. cyclical
d. frictional

5. A market basket represents a long list of goods and services that the average household buys in a given time period. By dividing a market basket of goods and services from one time period by a market basket from another time period a person can calculate the
a. consumer price index
b. gross domestic product
c. unemployment rate
d. aggregate supply

6. Serena's business is small and was quick to start. Serena retains all of her profits, but is also responsible for all of the debts and legal responsibilities of the business. Based soley on this information, Serena's business is MOST LIKELY a
a. sole proprietorship
b. partnership
c. corporation
d. monopoly

7. For two individuals who engage in the same two productive activities, it is impossible for one of the two individuals to
a. have a comparative advantage in both activities.
b. have an absolute advantage in both activities.
c. be more productive per unit of time in both activities.
d. gain from trade with each other.

8. The gains from trade are
a. evident in economic models, but seldom observed in the real world.
b. evident in the real world, but impossible to capture in economic models.
c. a result of more efficient resource allocation than would be observed in the absence of trade.
d. based on the principle of absolute advantage.

9. Sellers enter a market looking to make as much money as possible by offering a good or service. Buyers enter a market looking to spend as little as possible for a good or service. This interaction determines the
a. productivity of a business.
b. production possibilities curve.
c. economic system of a country.
d. market clearing price of a good.

10. A market condition when there is more than one producer of a specific good or service and consumers are free to choose which product to buy?
a. policy
b. competition
c. system
d. factor

3. True/False

№	Rate the following statements	True/False
1	An oligopoly is a degree of competition when the market is dominated by a few large producers.	
2	Competition is a market condition when there is one producer of a specific good or service	
3	Factor markets are those in which factors of production change hands.	
4	Monopolistic competition is based on the fact that consumers may have preferences for different brands; so producers can sell products at higher prices than equilibrium.	
5	Goods markets are those in which factors of production change hands.	
6	Unique: the only product in the market.	
7	Homogeneous (undifferentiated): a particular brand or model or variety	
8	Freedom of entry into the market can be free or limited.	
9	Cartel is an agreement by competitors to fix the price at the level which is usually higher than the equilibrium price.	
10	Pure competition is characterized by that in the market the big	

	number of the firms which are releasing similar, but not identical products operates.	
11	Easy entry and *exit* of firms from the market are a necessary condition of the pure competition.	
12	In conditions of the pure competition demand for production of branch represents a horizontal line.	
13	Monopolist receives economic profit only in the long-term period.	
14	Demand curve from which the monopolist collides, is less elastic, than a demand curve of competitive firm.	
15	Increase of the prices for the goods at a monopolistic competition is the reason of that manufacturers start, as against conditions of the pure competition, to receive economic profit.	

7. COSTS OF PRODUCTION AND PROFITS

Key words:
inputs – вводимые ресурсы
output –объем произведенной продукции, выпуск продукции
install – устанавливать
fixed factor – постоянный фактор
variable factor – переменный фактор
short run – краткосрочный период
long run – долгосрочный период
obtain – приобретать, принимать
distinction – отличие
distinguish – различать
profit – прибыль
profitability – рентабельность
revenue – доход
opportunity costs – альтернативные издержки
explicit and implicit costs – явные и неявные издержки
marginal costs – предельные издержки
marginal revenue – предельный доход
average total costs – средние общие (валовые) издержки

Factors of production in the short run and in the long run

If a firm wants to increase production, it will take time to obtain a greater quantity of certain inputs. For example, a producer can use more electricity by turning on more switches, but it may take a long time to buy and install more machines, and longer still to build another factory.

If the firm wants to increase output in a hurry, it will only be able to increase the quantity of certain inputs. It can use more raw materials, more tools and possibly more labour. But it will not be able to build a new building or buy additional machines. Thus the factors of production used by the firm can be classified into *fixed factors* and *variable factors*. If a firm cannot obtain more of a certain factor within the period under consideration, the factor is said to be a fixed factor. If the factors can be varied, they are called variable factors. The distinction between fixed and variable factors allows us to distinguish between the short run and the long run.

When we speak of the short run and the long run, we are not referring to definite periods of calendar time. We are referring to certain conditions. We define the short run and the long run in terms of fixed and variable factors. The short run is a situation in which the firm has at least one fixed factor, while the long run is a situation in which all the firm's factors are variable.

The actual length of the short run will differ from firm to firm. If it takes a farmer a year to buy new land, buildings and equipment, the short run is any time up to a year, and the long run is any time period longer than a year. On the other

hand, if it takes a shipping company three years to obtain an extra ship, the short run is any period up to three years, and the long run is any period longer than three years.

Firms seek to maximize their profits, i.e. they attempt to produce as cheaply as possible. Thus, *profit* (π) can be defined in terms of revenue and costs. *Revenue (R)* is what the firm earns by selling goods or services in a given period such as a year. *Costs (C)* are the expenses which are necessary for producing and sellin goods or services during the period. Profit is the total revenue *(TR)* from selling the output minus the total costs *(TC)* of inputs used:

$$\pi = TR - TC$$

where π – a Greek letter 'pi' represents profits.

Profit is an absolute indicator that illustrates how efficient the production of the firm is. If we measure the efficiency of costs per a unit of output, we will know how profitable the firm is, in other words, the profitability = profit / costs. For example, if the profits are 15 money units and costs are 100 money units, then the profitability is 0.15 (15%).

Costs should include opportunity costs of all resources used in production. Opportunity cost of a commodity is the amount obtained by an input in its best alternative use. In particular, costs include the owner's time and effort in running the business. Costs also include the opportunity cost of the financial capital used in the firm.

Factors not owned by the firm are called *explicit costs.* They are direct payments to outside suppliers of inputs, for example, payments for electricity. Factors already owned by the firm are called *implicit costs.* They are the costs that do not involve a direct payment of money to a third party, but which nevertheless involve a sacrifice of some alternative. For example, the firm owns machinery and it does not have to pay for using them. Their opportunity costs are thus implicit costs.

Aiming to get higher profits, firms obtain each output level as cheaply as possible. Firms choose the optimal output level to receive the highest profits. This decision can be described in terms of marginal cost and marginal revenue.

Marginal cost (MC) is an increase in total cost when one additional unit of output is produced.

Marginal revenue (MR) is the corresponding change in total revenue from selling one more unit of output.

As the individual firm has to be a price-taker, each firm's marginal revenue is the prevailing market price. Profits are the highest at the output level at which marginal cost is equal to marginal revenue, that is, to the market price of the output. If profits are negative at this output level, the firm should close down.

An increase in marginal cost reduces output. A rise in marginal revenue increases output. Of course, the optimal quantity supplied is affected by such noneconomic factors as technology, environment, etc.

Other cost concepts are average cost *(AC)* and average total cost *(ATC)*, average fixed cost *(AFC)* and average variable cost *(AVC)*. If *Q* represents the quantity of output produced, these concepts can be defined as follows:

AFC = TFC/Q: AVC = TVC/Q; ATC = TC/Q; ATC = A FC + A

1. Answer the following questions:

1. What is the relationship between inputs and outputs in the short run and in the long run?
2. What is meant by ‘costs’?
3. How are profits measured?

2. Find the correct answer:

1. Assume the United States has absolute advantage over Singapore in the production of all goods. Which statement about trade possibilities between the two countries is correct?
a. The terms of trade will be based on the United States's absolute advantage.
b. They can still arrange a beneficial trade if each one focuses production on a good in which they have comparative advantage.
c. Since the United States has absolute advantage in all goods, it is impossible to reach a trade agreement.
d. Singapore could benefit from a trade with the United States, but the United States would not benefit.

2. Jill is trying to decide whether or not to buy a car. If she is using rational decision making, she should MAINLY consider
a. the marginal costs and marginal benefits.
b. if buying the car will incur any opportunity costs.
c. whether the car will lose value over time.
d. the type of insurance she will need.

3. The opportunity cost of an item is
a. the number of hours that one must work in order to buy one unit of the item.
b. what you give up to get that item.
c. always less than the dollar value of the item.
d. always greater than the cost of producing the item

4. Which BEST describes scarcity?
a. When there is not a lot of something
b. There is a limited amount of a resource to meet an unlimited demand
c. What is given up when a choice is made
d. There is limited demand for an item that is plentiful

5. … is an increase in total cost when one additional unit of output is produced.
a. Marginal cost
b. Marginal revenue
c. Average cost
d. Total cost

6. … is the corresponding change in total revenue from selling one more unit of output.
a. Marginal cost
b. Marginal revenue
c. Average cost
d. Total cost

7. Factors not owned by the firm are called
a. explicit costs
b. implicit costs
c. marginal cost
d. marginal revenue

8. Factors already owned by the firm are called
a. explicit costs
b. implicit costs
c. marginal cost
d. marginal revenue

9. … are the highest at the output level at which marginal cost is equal to marginal revenue.
a. Costs
b. Profits
c. Prices
d. Revenues

10. … is what the firm earns by selling goods or services in a given period such as a year.
a. Costs
b. Profits
c. Prices
d. Revenue

3. True/False

№	Rate the following statements	True/False
1	Investment decisions involve costs and revenues that extend over a number of years.	
2	A firm should continue to increase its level of capital investment so long as the rate of return on the least profitable investment project that the firm undertakes is less than the marginal cost of capital.	
3	In calculating net cash flows, depreciation is treated as a cost.	
4	The firm, as an organizational structure, exists in order to reduce transactions costs.	
5	Economic profit is equal to total revenue minus all implicit costs.	
6	Implicit costs refer to the value of inputs owned and used by a firm.	
7	All costs are variable costs in the long run.	
8	Investment decisions involve costs and revenues that extend over a number of years.	
9	The difference between the external and internal cost of raising equity capital is due to flotation costs.	
10	Economic cost curves define the minimum economic costs of producing various levels of output.	
11	The costs of negotiating and enforcing contracts are transaction costs.	
12	Profit is a constraint on the operation of a firm.	
13	Business profit is generally greater than economic profit.	
14	The expected profit of a strategy is equal to the level of profit realized from the outcome with the highest level of probability.	
15	The idea that profits are a form of reward for the successful introduction of a new product or process is the frictional theory of profit.	

8. DEMAND AND SUPPLY

Key words:
theory of demand – теория спроса
quantity demanded – величина спроса
income – доход
preference – предпочтение
law of demand – закон спроса
consumer demand – потребительский спрос
market demand – рыночный спрос
slope down / up – иметь отрицательный / положительный уклон
determinant – детерминанта, решающий фактор
expectation – ожидание
shift – смещаться, перемещаться, сдвигаться
change in quantity demanded – изменение величины спроса
change in demand – изменение спроса
forecast – прогноз
theory of supply – теория предложения
quantity supplied – величина предложения
output – объем произведенной продукции, выпуск продукции
profit – прибыль
revenue – доход, выручка
costs – издержки, расходы
marginal costs – предельные издержки
marginal revenue – предельный доход
market supply – рыночное предложение
shortage – дефицит, нехватка
surplus – избыток
substitute good – товар-заменитель
complementary good – товар-дополнение
normal good – качественный товар
inferior good – товар низкого качества
signal – сигнал
incentive – стимул
respond – реагировать, отвечать

Theory of demand

Economics is concerned with consumption and production. Another way of looking at this is in terms of demand and supply. In fact, the market forces – demand and supply, and the relationship between them lie at the very centre of economics. We will start with the theory of demand and revise some of the material that we have had in Module 3.

Demand is the willingness and the ability of consumers to buy goods and services. In other words, demand is related to people's unlimited wants and

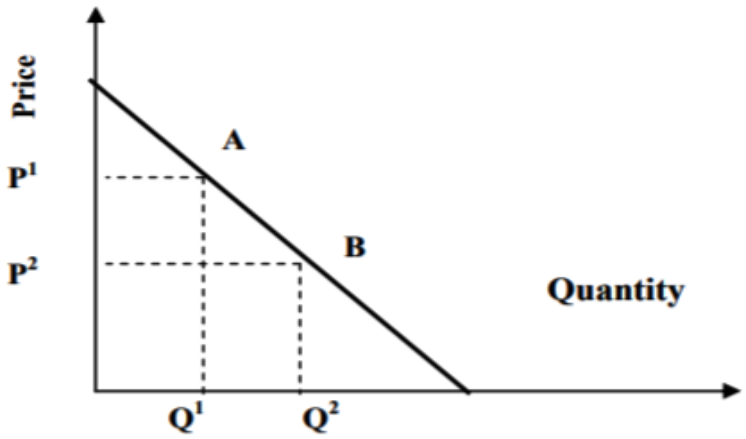
influences consumers decisions what, how much and at what price to buy. We have to distinguish consumer demand and market demand.

Consumer demand is the quantities of a particular good that an individual consumer wants and is able to buy as the price varies, if all other factors influencing demand are constant. These factors are prices of other goods, income, consumer tastes and preferences.

The law of demand

Consumer demand for a product is determined by its price. This relationship between the quantity demanded of a good and its price is called the law of demand: at low prices the demanded quantity will be higher. A price increase will result in a reduction in the quantity demanded. In other words, the higher the price, the lower the level of demand. Thus the sign of this relationship between the quantity demanded and its price is negative, and the demand curve slopes down from left to right.

Figure 7.1 Consumer demand.



A demand curve is constructed on the assumption that 'other things remain equal'. The effect of a change in price is then simply illustrated by a movement along the demand curve (Figure 7.1).

Demand and determinants other that price of a good

There are some factors influencing demand for a good, such as the prices of related goods (substitution effect), consumer incomes, and some others.

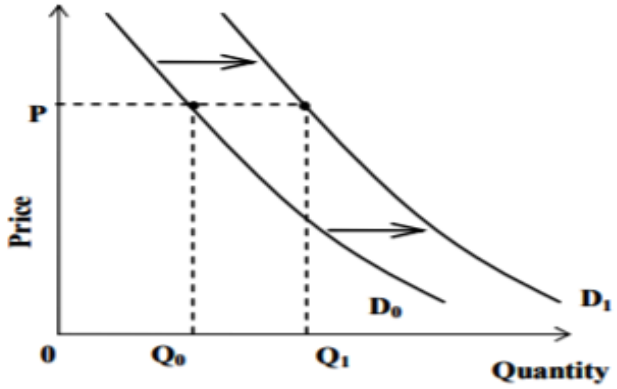
An increase in the price of a substitute good (or a decrease in the price of a complement good) will at the same time raise the demanded quantity.

As consumer income is increased, demand for a normal good will also increase but demand for an inferior good will decrease. A normal good is a good for which demand increases when incomes rise. An inferior good is a good for which demand falls when incomes rise.

What happens with the demand curve when one of other determinants (tastes, the number and the price of other goods, income, expectations of future price changes) does change? The answer is that we have to construct a new demand curve: the curve shifts. If one of the determinants (other than price)

changes, e.g. income rises – the whole curve will shift to the right. This shows that at each price, more will be demanded than before. If a change in a determinant other than price causes demand to fall, the whole curve will shift to the left. To distinguish between movements along and shifts in demand curves, it is usual to distinguish between a change in the quantity demanded and a change in demand. A movement along the demand curve as a result of a change in price is referred to as a change in quantity demanded (see Figure 7.1), whereas a shift in demand is referred to as a change in demand (see Figure 7.2).

Figure 7.2 A shift in the demand curve.



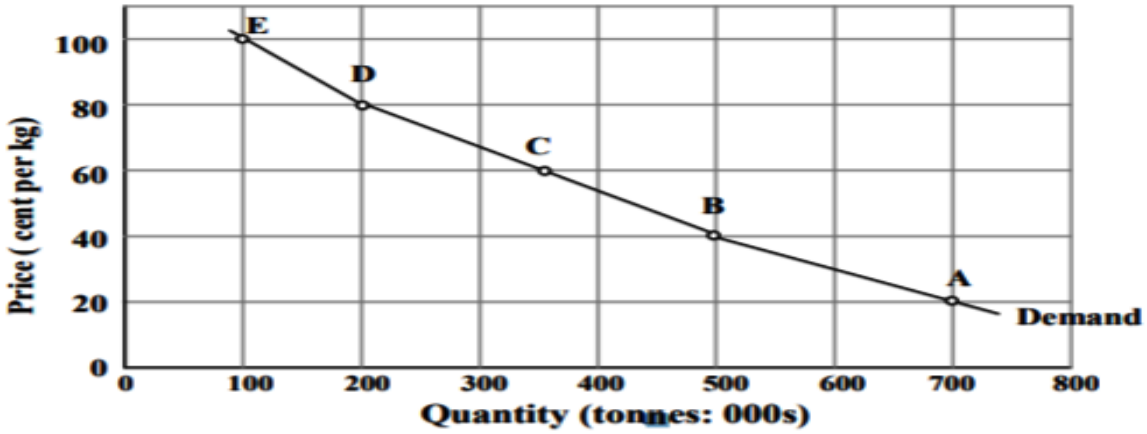
Market demand is the quantities of a good that all consumers in a particular market want and are able to buy as price varies and as all other factors are assumed constant. Market demand depends not only on the factors affecting individual demands, but also on the number of consumers in the market. The law of demand also works with market demand.

Table 7.1 The demand for potatoes (monthly)

	Price (cent per kg)	Total market demand (tonnes: 000s)
A	20	700
B	40	500
C	60	350
D	80	200
E	100	100

For example, Table 7.1 shows how many kilos of potatoes per month would be purchased at various prices by all consumers over a period of time (a month in our example).

Figure 7.3 Market demand curve for potatoes per month.



The theory of supply

The theory of supply is the theory of how much output firms choose to produce. The principal assumption of the supply theory is that the producer will maintain the level of output at which he maximizes his profit.

Supply is the willingness and the ability of producers to produce goods and services for consumers. Unlike demand, supply is limited as it is related to resources. So producers also have to make decisions about what, how much and at what prices to produce. In other words, supply is the quantity of a good that sellers wish to sell at each price. Other things equal, when prices are high, the supplied quantity is high as well.

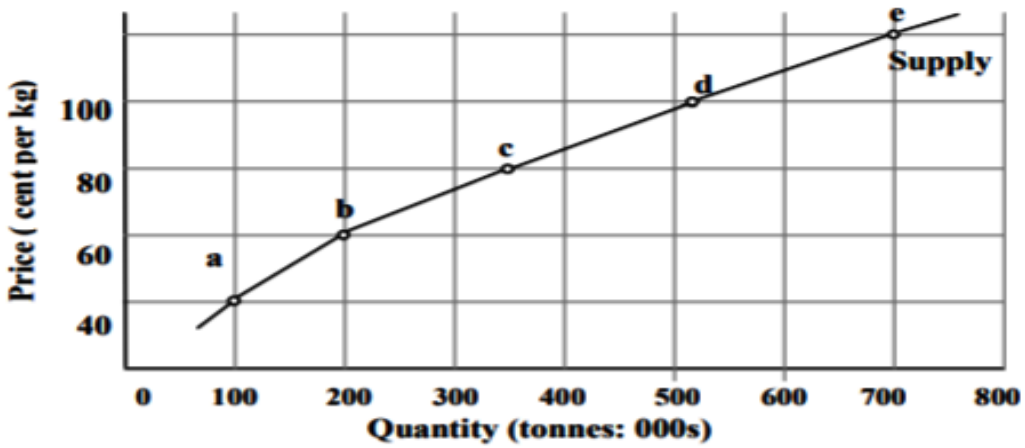
Among the factors assumed constant are technology, the input price, as well as degree of government regulation. An improvement in technology is as important for increasing the supplied quantity of a good as a reduction in input prices.

Making economic forecasts, it is necessary to know the effect of a price change on the whole output rather than the supply of individual firms. Market supply is defined in terms of the alternative quantities of a commodity all firms in a particular market offer as price varies and as all other factors are assumed constant.

Table 7.2 The supply of potatoes (monthly).

	Price (cent per kg)	Total market supply (tonnes: 000s)
a	20	100
b	40	200
c	60	350
d	80	530
e	100	700

Figure 7.4 Market supply curve of potatoes per month

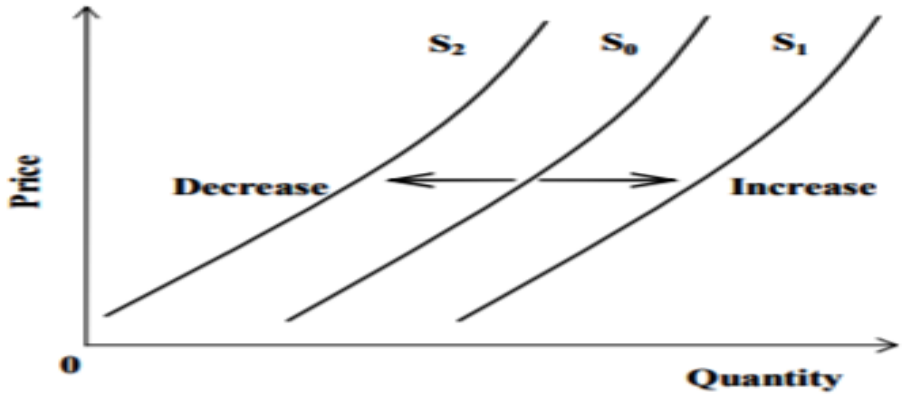


The effect of the change in price is illustrated by a movement along the supply curve. For example, from point d to point e in Figure 7.4 when price rises from 80c to 100c. Quantity supplied rises from 530,000 to 700,000 tonnes per month.

If any other determinant of supply changes, the whole supply curve will shift. A rightward shift illustrates an increase in supply (S1) and a leftward shift illustrates a decrease in supply (S2).

A movement along the supply curve as a result of a change in price is referred to as a change in quantity supplied, whereas a shift in supply is referred to as a change in supply (see Figure 7.5).

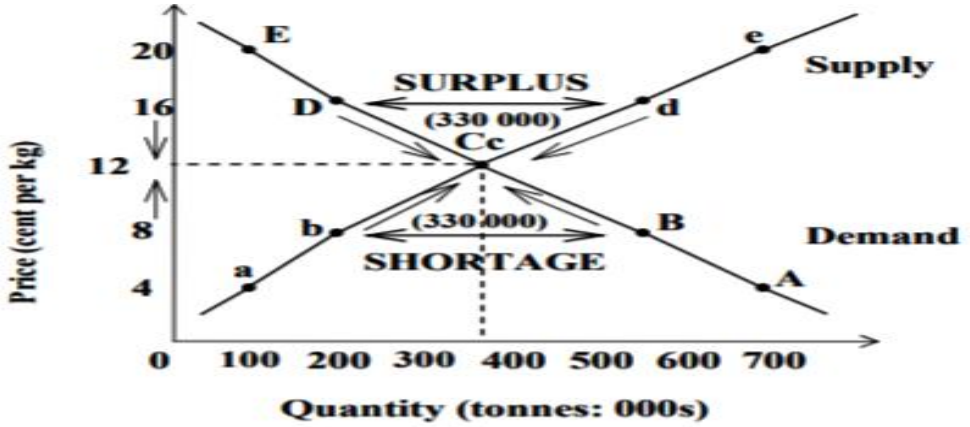
Figure 7.5. Shifts in the supply curve.



Equilibrium market

The market is in equilibrium when the price regulates the quantity supplied by produces and the quantity demanded by consumers. When prices are not so high as the equilibrium price, there is excess demand *(shortage)* raising the price. At prices above the equilibrium price, there is excess supply *(surplus)* reducing the price. We can see these situations on Figure 7.6 with both the market demand curve and the market supply curve.

Figure 7.6. The determination of market equilibrium (potatoes: monthly).



A rise in demand is signaled by a rise in price. This then acts as an incentive for firms to produce more of the good: the quantity supplied rises. A fall in demand is sign a led by a fall in price. This then acts as an incentive for firms to produce less: such goods are less profitable to produce. Thus the quantity supplied falls.

1. Answer the following questions:

1. What determines the amount that consumers buy of a product?
2. What determines how much producers supply of a product?
3. How are market prices determined and when they are likely to rise or fall?
4. How do markets respond to changes in demand or supply?

2. Find the correct answer:

1. Aggregate demand differs from regular demand in that aggregate demand
a. measures demand for the entire economy, rather than one market.
b. includes supply as well as demand.
c. is only used when trying to measure money markets.
d. is inelastic while regular demand is elastic.

2. If the price of an item increases, demand for its substitutes
a. is unaffected
b. decreases
c. increases
d. there is no way to tell

3. If the price of a product falls, which is true regarding demand?
a. demand increases
b. quantity demanded decreases
c. demand decreases

d. quantity demanded increases

4. … is the willingness and the ability of consumers to buy goods and services.
a. Demand
b. Supply
c. Consumer demand
d. Equilibrium market

5. … is the quantities of a particular good that an individual consumer wants and is able to buy as the price varies, if all other factors influencing demand are constant.
a. Demand
b. Supply
c. Consumer demand
d. Equilibrium market

6. …is the willingness and the ability of producers to produce goods and services for consumers.
a. Demand
b. Supply
c. Consumer demand
d. Equilibrium market

7. … is the quantities of a good that all consumers in a particular market want and are able to buy as price varies and as all other factors are assumed constant.
a. Demand
b. Market demand.
c. Consumer demand
d. No answer

8. Consumer demand for a product is determined by its
a. price
b. law
c. quantity
d. level

9. … is a good for which demand increases when incomes rise.
a. An inferior good
b. A normal good
c. A substitute good
d. No answer

10. … is a good for which demand falls when incomes rise.
a. An inferior good
b. A normal good

c. A substitute good
d. No answer

3. True/False

№	Rate the following statements	True/False
1	If both, the supply and the demand increase at the same time, the equilibrium price will definitely increase.	
2	A rent control set below the market equilibrium price will result in a reduction of rental units supplied in the market, assuming the supply is consistent with the law of supply.	
3	An upward slopped supply curve is consistent with the law of supply.	
4	The quantity of a commodity demanded by a consumer is influenced by the price of the commodity.	
5	The cost of production is a major determinant of consumer demand.	
6	The law of supply arises from the fact that the marginal costs are rising with the level of output	
7	If buyers and sellers of homes start to expect inflation in housing values, then both, the current demand and the supply functions will increase	
8	The supply curve of a perfectly competitive firm is identical to the portion of its marginal cost curve that is above its average total cost curve.	
9	When the demand decreases while the supply increases, the market equilibrium price declines	
10	As more firms enter a monopolistically competitive industry, the market supply curve shifts to the right.	
11	The demand for an individual firm's output depends on the demand for the industry's output, the number of firms in the industry, and the structure of the industry.	
12	If the supply curve for a commodity shifts while the demand curve does not shift, then the demand identification problem will not be encountered.	
13	Product price on a competitive market is determined by the intersection of the market demand curve with the market supply curve.	
14	Under perfect competition, changes in market supply do not affect market price.	
15	The law of demand refers to the relationship between consumer income and the quantity of a commodity demanded per time period.	

9. ELASTICITY OF DEMAND AND SUPPLY

Key words:
responsiveness of demand to a change – реагирование спроса на изменение
price elasticity of demand – ценовая эластичность спроса
income elasticity of demand – эластичность спроса по доходу
cross elasticity of demand – перекрестная эластичность спроса
(in)elastic demand – (не)эластичный спрос
formula – формула
figure – число
value – величина
mortgage interest rate – процентная ставка по ипотеке
loan – ссуда
switch – перейти, переключиться
substitute good – товар-заменитель
complementary good – товар-дополнение
normal good – качественный товар
inferior good – некачественный товар
luxury goods – предметы роскоши
basic good (necessity good) – товар первой необходимости

1. Responsiveness of demand to changes in price

According to the law of demand, when the price of a good rises, the quantity demanded will fall. But in most cases we want to know how much the quantity demanded will fall. In other words, we will want to know how responsive demand is to a rise in price.

Take the case of two products: oil and tangerines. In the case of oil, a rise in price is likely to result in a slight fall in the quantity demanded. If people want to continue driving, they have to pay the higher prices for fuel. Some may turn to using public transportation, and some people may try to use the car less often, but for most people, a rise in the price of petrol and diesel will make little difference to how much they use their cars.

In the case of tangerines, however, a rise in price may lead to substantial fall in the quantity demanded. The reason is that there are alternative fruits that people can buy: oranges, apples, or bananas.

The responsiveness of demand to a change in price is called the *price elasticity of demand.* If we know the price elasticity of demand for a product, we can predict the effect on price and quantity of a shift in the supply curve for that product.

Measuring the price elasticity of demand: We need to compare the size of the change in quantity demanded with the size of the change in price in percentage. This gives us the following formula for the price elasticity of demand (Pεd):

$$P\varepsilon d = \%\Delta Qd / \%\Delta P$$

where ε (a Greek letter ‘epsilon’) is the symbol we use for elasticity, and Δ (a capital Greek letter ‘delta’) is the symbol we use for ‘a change in’, Q is quantity, and P is price.

For example, if a 40 per cent rise in the price of oil caused the quantity demanded to fall by 10 per cent, the price elasticity of oil would be:

$$-10\% / 40\% = -0.25$$

On the other hand, if a 5 per cent fall in the price of tangerines caused a 15 per cent rise in the quantity demanded, the price elasticity of demand for tangerines would be:

$$15\% / -5\% = -3$$

The figures (–0.25 and –3) show that tangerines have a more elastic demand than oil. The sign is negative, because price and quantity change in opposite directions. Thus when calculating price elasticity of demand, we either divide a negative change by a positive figure, or positive figure by a negative.

The value (greater or less than 1): if we focus on the number and ignore the sign, we can know whether demand is elastic or inelastic.

• *Elastic demand* ($\varepsilon > 1$). Change in demand is larger than change in price.

• *Inelastic demand* ($\varepsilon < 1$). Change in demand is a smaller number than change in price.

• *Unit elastic demand* ($\varepsilon = 1$). This is where the price and quantity demanded change by the same proportion.

Determinants of price elasticity of demand:

1. The *number of substitute goods;*
2. The proportion of income spent on the good.

The larger the number of substitute goods and the proportion of income spent on a good, the greater will be the price elasticity of demand. For example, salt has a very low price elasticity of demand, but if mortgage interest rates rise (the ‘price’ of loans for house purchase), people may have to cut down on their demand for housing.

3. The time period. When price rises, people may take time to find alternatives. The longer the time period after a price change, the more elastic the demand is likely to be.

To illustrate this, let us return to our example of oil. Between December 1973 and June 1974 the price of crude oil quadrupled, which led to similar increases in the prices of petrol and other oil products. Over the next few months, there was only a very small fall in the consumption of oil products. Demand was highly inelastic (people still wanted to drive their cars).

Over the time, however, as the higher prices persisted, many people switched to smaller cars. Demand was thus much more elastic in the long run.

2. Responsiveness of demand to changes in income

In addition to price elasticity of demand (Pεd) there is also income elasticity of demand (Yεd.). The letter Y is used for income because letter I is already used

for ‘investment’). This measurement enables us to predict how much the demand curve will shift for a given change in income. The formula is as follows:

$$Y\varepsilon d = \%\Delta Qd / \%\Delta Y$$

For example, if a 2 per cent rise in income caused an 8 per cent rise in a product’s demand, then its income elasticity of demand will be:

$$8\% / 2\% = 4$$

The major determinant of income elasticity of demand is the degree of ‘necessity’ of the good. In a developed country, the demand for luxury goods increases rapidly as people’s incomes rise, whereas the demand for basic goods, such as bread, rises only a little. Thus items such as cars and holidays abroad have a high income elasticity, whereas items such as potatoes and bus journeys have a low income elasticity of demand.

The demand for some goods actually decreases as incomes rise. These are inferior goods such as cheap margarine. As people earn more, they switch to butter or better-quality margarine. Unlike normal goods, which have a positive income elasticity of demand, inferior goods have a negative income elasticity of demand.

3. The third type of elasticity of demand is known as cross elasticity of demand. It is a measure of the responsiveness of demand for one product to a change in the price of another (either a substitute or a complement). The formula for the cross elasticity of demand (Cεd) is:

$$C\varepsilon dab = \%\Delta Qda / \%\Delta Pb$$

If a good b is a substitute for good a, a’s demand will rise as b’s price rises. In this case, cross elasticity will be a positive figure.

For example, if the demand for butter rose by 2% when the price of margarine (a substitute) rose by 8%, then the cross elasticity of demand for butter with respect to margarine would be:

$$2\% / 8\% = 0.25$$

If good b is complementary to good a, a’s demand will fall as b’s price rises and thus the quantity of b demanded falls. In this case, cross elasticity of demand will be a negative figure. For example, if a 4% rise in the price of bread led to a 3% fall in demand for butter, the cross elasticity of demand for butter with respect to bread would be: $– 3\% / 4\% = – 0.75$

Firms will wish to know the cross elasticity of demand for their product when considering the effect on the demand for their product of a change in the price of a rival’s product. These are vital pieces of information for firms when making their production plans.

4. *Responsiveness of supply to changes in price*

The importance of the elasticity of the supply of the inputs used in production is best illustrated by considering two extreme examples. First let us consider diamond necklaces. Diamonds are in inelastic supply – even if the price of diamonds doubles, not many more can be found. If the price of diamond necklaces rose, necklace makers would like to supply more necklaces. However, they would

be unable to do it as there would be no more found. The supply of diamond necklaces is inelastic because the supply of diamonds is inelastic.

Next let us consider silicon chips. Silicon comes from sand which is available in almost unlimited quantities and so have a highly elastic supply. If the price of silicon chips rose, their makers would like to supply more and they would be able to get extra sand at about the same price as before. So they could supply more chips at their present price. In other words, the supply of silicon chips is elastic because the supply of sand is highly elastic.

1. Answer the following questions:

1. How responsive is consumer demand to changes in prices and changes in incomes?
2. How responsive is firms' output to a change in price?
3. How does this responsiveness (or 'elasticity') of demand and supply affect the working of markets?

2. Find the correct answer:

1. When the money supply is increased, which is MOST likely to happen?
a. The price level will decrease.
b. The price level will increase.
c. Each dollar will be able to buy more goods.
d. The price level will not be affected.

2. Demand for gasoline is said to be fairly inelastic for most people. This is probably because
a. it has many substitutes and is easily attained.
b. it is difficult to make cheaply.
c. it has few substitutes and is in large supply.
d. it has few substitutes and is necessary for most transportation.

3. If supply and demand both increase by the same amount in a market, which statement will DEFINITELY be true?
a. equilibrium price will increase
b. quantity supplied will decrease
c. equilibrium quantity will increase
d. quantity demanded will decrease

4. Which is LEAST LIKELY to cause an increase in demand?
a. a decrease in income
b. a new ad campaign featuring a prominent celebrity
c. an expectation of higher future prices
d. an increase in the price of a substitute

5. Comparing changes in quantity demanded to changes in prices is related which economic concept?
a. equity
b. opportunity costs
c. elasticity
d. consumer sovereignty

6. The Law of Supply states that
a. as prices increase, supply increases
b. as prices decrease, demand decreases
c. as prices decrease, quantity supplied decreases
d. as prices increase, quantity demanded decreases

7. The responsiveness of demand to a change in price is called
a. the price elasticity of demand.
b. the inelastic demand
c. the unit elastic demand
d. No answer

8. This is where the price and quantity demanded change by the same proportion.
a. Unit elastic demand ($\varepsilon = 1$).
b. Elastic demand ($\varepsilon > 1$).
c. Inelastic demand ($\varepsilon < 1$).
d. No answer

9. Change in demand is larger than change in price.
a. Unit elastic demand ($\varepsilon = 1$).
b. Elastic demand ($\varepsilon > 1$).
c. Inelastic demand ($\varepsilon < 1$).
d. No answer

10. The total amount of goods and services produced throughout the economy is
a. aggregate supply
b. aggregate demand
c. supply shock
d. quantity supplied

3. True/False

№	Rate the following statements	True/False
1	Elasticity is a measure that does not depend on the units used to measure prices and quantities.	
2	The price elasticity of demand is the same as the slope of a demand curve.	
3	The arc price elasticity of demand measures the price elasticity at a point on the demand curve.	
4	The price elasticity of demand for a firm's output is generally more elastic than the price elasticity of demand for the industry's output of the commodity.	
5	If price elasticity of demand for a firm's output becomes more elastic, then the firm's marginal revenue will increase.	
6	If the price elasticity of demand for a firm's output is inelastic, then a decrease in price will reduce the firm's total revenue.	
7	An increase in the number of available substitutes for a commodity will decrease the price elasticity of demand for the commodity.	
8	The long-run price elasticity of demand for a commodity is generally greater then the short-run price elasticity of demand for the commodity.	
9	The income elasticity of demand for an inferior good is negative.	
10	For most goods, the income elasticity of demand is negative.	
11	The cross-price elasticity of demand for two goods is negative if the goods are substitutes.	
12	If two goods are very close complements, then the cross-price elasticity of demand between the two goods will be large and negative.	
13	If the price elasticity of demand for a firm's output is inelastic, then the firm could increase its revenue by reducing price.	
14	Output elasticity is equal to the marginal product of an input divided by the average product of the input.	
15	Price discrimination is most effective if all consumers have the same price elasticity of demand.	

10. CONSUMER CHOICE

Key words:
consumer behaviour – поведение потребителя
satisfaction – удовлетворение
cardinalist approach – кардиналистский (количественный) подход
ordinalist approach – ординалистскый (порядковый) подход
utility – полезность
util – ютил
total utility – общая полезность
diminishing marginal utility – убывающая предельная полезность
term – термин
rank – ранжировать
dimension – измерение
indifference curve – кривая безразличия
consumer's preferences – потребительские предпочтения
budget constraint – бюджетное ограничение
budget line – бюджетная линия
plot – наносить (точки), отмечать
money unit – денежная единица
tangent – касательный
consumer equilibrium – равновесие потребителя

Consumer behaviour

In this module our objective is to explain the behaviour of consumers in the market. The assumption is that consumers make rational decisions choosing those goods that allow them to maximize their satisfaction, or utility as economists call it. In other words, consumers have to allocate their limited incomes between various goods and services available in the market at various prices. There are two approaches to the study of a consumer behaviour – the utility analysis known as the cardinalist approach or theory, and the indifference curve analysis known as the ordinalist approach.

1. The cardinalist approach. When you buy a good, it is because you want it. You want it because you expect to get satisfaction or some other sort of benefit from it. This applies to everything: chocolate bars, bus journeys, CDs, jeans, insurance. Economists use the term *'utility'* to refer to the benefit we get from consumption. A question arises: how to measure 'utility'.

In the 19th century economists (Alfred Marshall was among them) suggested a util as a unit measured in cardinal numbers. For example, a consumer may obtain 20 utils of utility from a dish of potatoes, but only 10 utils from a dish of rice. This was the idea of the cardinalist theory of demand.

However utility is an abstract concept, thus it is a problem to compare subjective satisfaction enjoyed by one individual with that of another individual

because there are different factors which influence an individual's level of utility such as economic, social, and psychological factors.

However there is a simple rule that applies to all people and all goods: As you consume more of a product, your desire for additional units of it will decline. The economists call this rule the principle of diminishing marginal utility: As more and more units of a good are consumed in a given time period, the extra utility from the consumption of additional units eventually falls. For example, when you drink tea in the morning, the utility from the first cup is very high. A second cup may also be very welcome, but its utility level is not as high, and the utility of a third cup is even less. We call the additional utility you get from consuming an extra unit of a product the marginal utility. In other words, marginal utility is the extra utility from the consumption of one more unit of a good, the consumption of all other goods remaining unchanged.

It is reasonable to generalize this consumer behaviour: the more a consumer has of a good, the less utility he derives from the consumption of an additional unit. This rule says that the marginal utility he derives from the consumption of an additional unit. This rule says that the marginal utility will fall as we consume more of a product over a given period of time.

How can marginal utility be measured? One way is to measure marginal utility in money terms: the amount of money that a person would be prepared to pay for one more unit of a product.

Let us take an example. When you go to have a cup of coffee at the café downstairs, you may also wish to buy a cake that costs 20 tenges or so. If you were prepared to pay 20 tenges for an extra cake in our café, then we would say that your marginal utility from consuming this extra cake is 20 tenges. As long as you are prepared to pay more or the same as the actual price, you will buy an additional cake. If you are not prepared to pay, you will not.

Utility maximization

Now let us have a situation when there are two products and the consumer has to choose between two goods, X and Y, which have prices Px and Py. The rational decision of a consumer is to maximize his total utility within the limits of his income. The consumer can maximize it when he allocates his income in such a way that the utility from the consumption of one extra rouble's worth of X is equal to the utility from the consumption of one extra rouble's worth of Y. In other words, when the marginal utility per rouble of X is equal to the marginal utility of extra rouble's worth of Y.

2. The ordinalist theory was developed in the 1930s by such economists as Hicks and Allen, who were influenced by the earlier works of Pareto and Slutsky. They suggested an idea that an individual can rank goods in order of preference, for example, potatoes could be first and rice could be second in terms of utility although 'first, second…' say nothing about the absolute difference between utilities. Indifference curves and budget lines are the means of illustrating this ordinalist approach to demand theory.

Indifference curves can simplify the analysis of the ordinal utility approach graphically in two dimensions. An indifference map (Figure 9.1) shows consumer's preferences for X and Y using 3 indifference curves. An indifference curve joins together all the different combinations of the two goods which have the same utility for the consumer in question. Consider the consumer's choice between two goods X and Y in Figure 9.1.

• Every point on the graph represents a combination of X and Y.

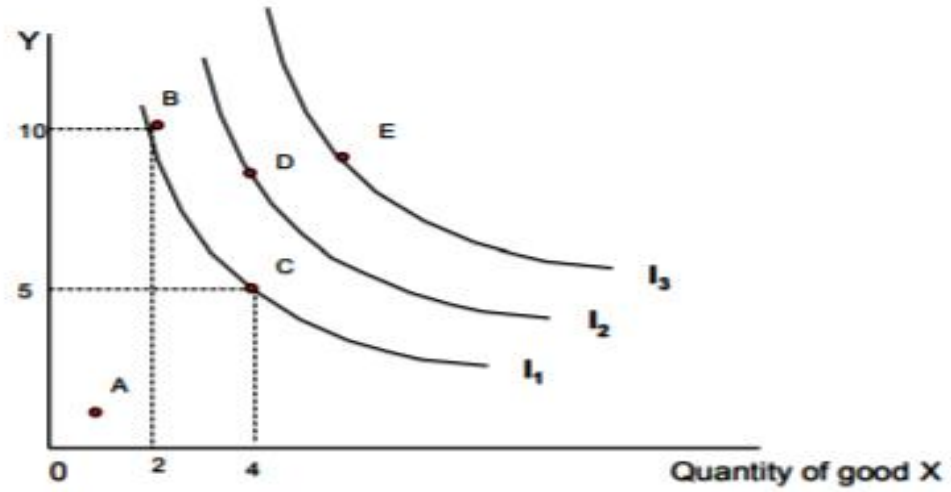
• Point A represents very small quantities of both goods X and Y.

• Points B, C, D represent larger quantities.

• Since combinations B (10 units of Y and 2 units of X) and C (5 units of Y and 4 units of X) are on the same indifference curve, the consumer is said to be indifferent between them, i.e. both combinations mean the same utility to him.

• Combination D is on a higher indifference curve, which implies that he prefers D to both B and C; and E to B, C, and D.

Figure 9.1 An indifference map (field of choice)



Indifference curves do not tell us which combinations of the two goods will be chosen by a consumer. In addition to the consumer's preferences, we need to know his income and the prices of the two goods. Then we can determine the combination of X and Y that the consumer will choose.

As an example, suppose the price of X is 10 money units and the price of Y is 20 money units, and the consumer's income is 100 money units. Table 9.1 shows the combinations of X and Y that he can just afford to buy. Plotting these points on the same graph (Figure 9.2) as the indifference map, we obtain what is called the budget line.

Table 9.1 The combinations of X and Y that a consumer canafford to buy with an income of 100 money units.

Quantity of X (price = 20)	Quantity of Y (price = 10)
0	10
1	8
2	6
3	4
4	2
5	0

Figure 9.2 Consumer equilibrium in point A

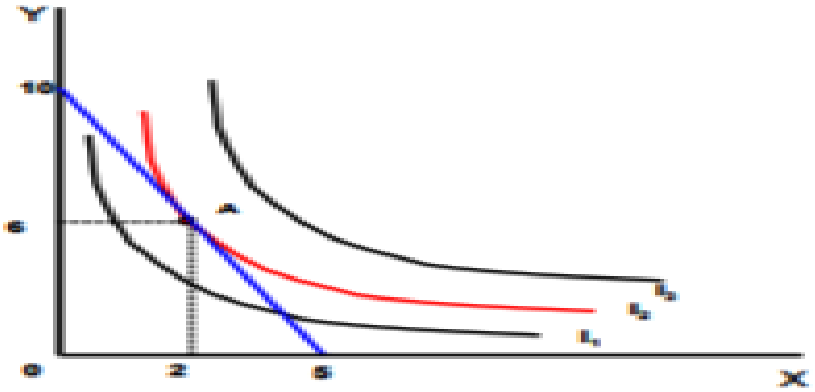


Figure 9.2 shows the indifference map and the budget line o the same graph. Suppose our consumer spends all his income on X and Y, he will choose the combinations represented by point A. This is the point where the budget line is tangent to an indifference curve – I2 is the highest point that can be reached. This point is called 'consumer equilibrium' point, and the consumer is said to be maximizing his utility subject to his budget constraint.

Effect of an income change

If the consumer's income increases, his budget line will shift upwards remaining parallel to the original one. A new consumer equilibrium point will be found on an indifference curve I3 (Figure 9.2). Similarly, if his income falls, his budget line will shift downwards remaining parallel, and this time an equilibrium point will appear on an indifference curve I1. The quantity of X and Y that our consumer will afford to buy will respectively increase or decrease.

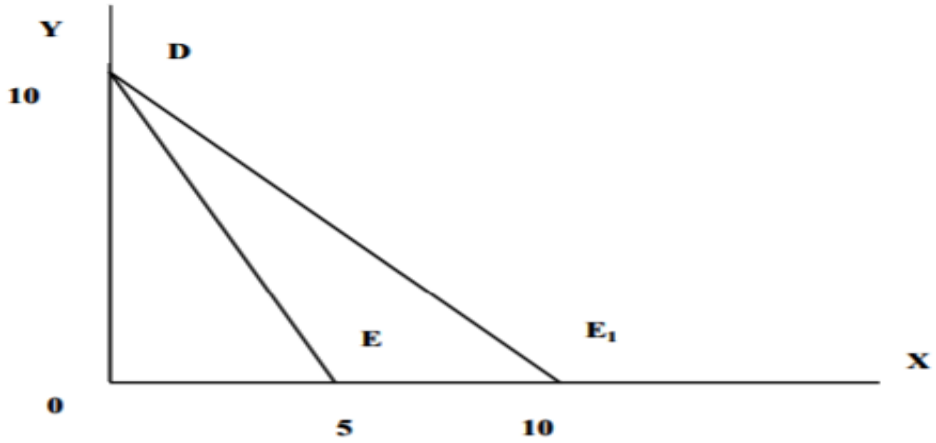
Effect of a price change

Suppose that the price of X falls, ceteris paribus. Table 9.2 shows the combinations that the consumer can just afford to buy when his income is 100 money units, the price of Y is 10 money units and the price of X has fallen to 10.

Table 9.2 The combination of X and Y after a price change.

Quantity of X (price = 10)	Quantity of Y (price = 10)
0	10
2	8
4	6
6	4
8	2
10	0

Figure 9.3 Budget lines before and after a price change of X.



The new budget line DE1 is graphed together with the original one DE in Figure 9.3. Notice that when the price of one of the goods falls, the budget line shifts, but this time it is not parallel to the original one. It becomes less steep reflecting the fall in the price of X.

1. Answer the following questions:

1. What determines how much consumers are prepared to pay for a product?
2. Given a consumer's income and the prices of goods, how will this consumer behave in the market in order to maximize his satisfaction?
3. How can consumer satisfaction be measured?

2. Find the correct answer:

1. Which financial institution is MOST LIKELY to require membership and offer low loan rates to its members?
a. savnings and loan
b. credit union
c. bank

d. retail store

2. What must be given up to obtain an item is called
a. out-of-pocket cost.
b. comparative worth.
c. opportunity cost.
d. absolute value.

3. There are two approaches to the study of a consumer behaviour – …
a. the cardinalist
b. the ordinalist
c. All answers are correct
d. No answer

4. … can simplify the analysis of the ordinal utility approach graphically in two dimensions.
a. Indifference curves
b. Utility maximization
c. The cardinalist approach
d. Consumer behaviour

5. … was developed in the 1930s by such economists as Hicks and Allen, who were influenced by the earlier works of Pareto and Slutsky.
a. The ordinalist approach
b. The cardinalist approach.
c. The economic theory
d. The neoclassical theory

6. … do not tell us which combinations of the two goods will be chosen by a consumer.
a. Difference curves
b. Supply curve
c. Demand curve
d. Indifference curves

7. The indifference curve analysis known as
a. the ordinalist approach
b. The cardinalist approach.
c. The economic theory
d. The neoclassical theory

8. The utility analysis known as
a. the ordinalist approach
b. The cardinalist approach.

c. The economic theory
d. The neoclassical theory

9. Who are the suggested a util as a unit measured in cardinal numbers?
a. In the 19th century economists
b. In the 18th century economists
c. In the 17th century economists
d. In the 16th century economists

10. … is an abstract concept, thus it is a problem to compare subjective satisfaction enjoyed by one individual with that of another individual.
a. Utility
b. Total utility
c. Budget line
d. Money unit

3. True/False

№	Rate the following statements	True/False
1	The quantity of a commodity demanded by a consumer is influenced by the number of consumers in the market.	
2	If the consumption decisions of individual consumers are not independent, then the horizontal sum of individual consumer demand curves is the market demand curve for the commodity.	
3	Logistics refers to the rational assessment of supply and demand by consumers.	
4	*Indifference curves* can simplify the analysis of the ordinal utility approach graphically in two dimensions.	
5	Indifference curves do not tell us which combinations of the two goods will be chosen by a consumer.	
6	Indifference curves and budget lines are the means of illustrating this cardinalist approach to demand theory.	
7	There are two approaches to the study of a consumer behaviour – the utility analysis known as the cardinalist approach or theory, and the indifference curve analysis known as the ordinalist approach.	
8	Marginal utility is the extra utility from the consumption of one more unit of a good, the consumption of all other goods remaining unchanged.	
9	If the consumer's income increases, his budget line will shift upwards remaining parallel to the original one.	
10	Economists use the term *'utility'* to refer to the benefit we get from consumption. A question arises: how to measure 'utility'.	

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