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Principles of Economics

Some Definitions (in approximate order of use in the class.)

Economics: The study of how individuals and societies should best use their limited resources to try to satisfy their material wants.

Cost-Benefit Analysis: Evaluating the merit of a proposed action by weighing its predicted benefits against its predicted costs.

Resources (a.k.a. *inputs*, or *factors of production*):

Land: Gifts of nature used in the production process

Labor: Human talents used in the production process

Capital: Manufactured aids to production

Opportunity Cost: The next best alternative surrendered when a choice is made.

Laissez-faire (Free Market) Economy: An economy in which buyers and sellers can operate with little government intervention.

Command Economy: An economy in which government controls virtually all allocation, production, and distribution.

Mixed Economy: An economy with moderate government involvement in markets.

Production Possibilities Frontier (PPF): A graph illustrating the maximum possible output combinations of an economy.

Marginal Rate of Transformation (MRT): The number of units of 1 good that must be sacrificed in order to increase production of another good.

Market: An institution or mechanism allowing buyers and sellers to make exchanges.

Demand: Willingness to buy

Ceteris Paribus: Latin, meaning "All else remaining constant"

Law of Demand: Ceteris paribus, if the price of an item falls, then buyers are willing to buy more of it.

Substitutes: 2 goods that serve roughly the same purpose to buyers

Complements: 2 goods which are often consumed together.

Inferior good: A good whose demand falls when buyers' incomes rise.

Normal good: A good whose demand rises when buyers' incomes rise.

Law of Supply: Ceteris Paribus, if buyers are willing to pay a higher price for an item, then sellers are willing to sell more of it

Excise tax: A tax on a good or service.

Equilibrium: A stable situation in which quantity demanded equals quantity supplied

Price ceiling: A legal maximum price

Price floor: A legal minimum price

Shortage: When quantity demanded exceeds quantity supplied

Surplus: When quantity supplied exceeds quantity demanded

Gross Domestic Product (GDP) = the total value of all final goods and services produced in an economy

National Income (NI) = Income earned by households for use of their resources in production.

Disposable Personal Income (DI) = Income available for spending and saving by households

Personal Consumption Expenditures: Total spending by consumers on products.

Gross Private Investment: Total purchases of capital and new housing by the private sector, plus increases in firms' inventories.

Indirect Business Taxes: Taxes and fees levied on products. (An example: sales taxes)

Depreciation: The total amount that the value of capital falls in a given time period

Transfer payments: Spending by government for which it receives no good or service in return. (Example: unemployment benefits)

Net exports: Exports of goods and services minus imports of goods and services. (When this number is positive it is known as a trade surplus; when it is negative it is a trade deficit.)

Officially unemployed: To be officially unemployed, one must not be working at all for pay, be actively seeking work, and be 16 years of age or older.

Labor force: To be a member of the labor force, one must be working for pay, or be officially unemployed.

Official unemployment rate: The number of people officially unemployed, divided by the number of people in the labor force.

Cyclical unemployment: Unemployment caused because there is insufficient GDP for jobs to be available to job seekers with employable skills.

Structural unemployment: Unemployment caused by obsolete job skills. Job-seekers whose skills do not match those needed for any job.

Frictional unemployment: Temporary unemployment of people with good job skills, as they take time to look for jobs that best match their skills.

Full employment unemployment rate: The unemployment rate when cyclical unemployment is eliminated.

Full employment (Potential) GDP: The level of GDP at which cyclical unemployment is eliminated.

Price index: A measure of the average price level of a basket of goods

Inflation: An increase in the average price level

Consumer Price Index (CPI): A measure of the average price level of about 10000 goods purchased by the typical consumer.

GDP deflator: A measure of the average price level of all final goods & services produced in the U.S.

Cost push inflation: Inflation caused by a general increase in production costs in an economy

Demand pull inflation: Inflation caused when demand for products temporarily outstrips the capacity to increase production.

Aggregate expenditures: Total planned spending on goods and services in the economy.

Aggregate supply: Total production of goods and services in the economy.

Consumption function: A graph which shows precisely how much consumption rises when disposable income rises.

Marginal propensity to consume: The fraction of a dollar by which consumption rises when disposable income rises by \$1.

Marginal propensity to save: The fraction of a dollar by which savings rises when disposable income rises by \$1.

The multiplier effect: An initial increase in aggregate expenditures by \$1 will cause GDP to rise by more than \$1 in the short run.

Paradox of thrift: Attempts by households to save a larger percentage of their disposable income may not increase the total dollar amount of aggregate personal savings.

Household income tax rate: The average percentage of national income that government collects in personal income taxes.

Fiscal policy: When government alters its taxing and/or spending to try to affect the economy.

The balanced budget multiplier: An increase in government purchases by \$1 funded by an equal increase in household taxes will cause GDP to increase by \$1.

Budget deficit: Amount that total government spending exceeds tax and fee revenue in a year.

Budget surplus: Amount that tax and fee revenue exceeds total government spending in a year.

National debt: Total amount of debt that government owes to the public—equals the sum of all past budget deficits, minus past budget surpluses.

Money: Anything that is generally accepted as payment (for products, resources, and debt).

The (M1) Money Supply: Currency in circulation + checkable deposits.

Monetary policy: Central bank manipulation of the money supply, meant to affect economic performance.

Required reserve ratio: Legal minimum ratio of reserves to deposits.

Discount rate: The interest rate that the Central Bank (Fed) charges banks when they borrow from it (to avoid reserve shortfalls).

U.S. Government securities: Treasury notes, treasury bills, treasury bonds—issued by the U.S. Treasury.

Open market operations: Buying and selling of (used) government securities by the Fed.

Transactions demand for money: Money demanded as a medium of exchange.

Asset demand for money: Money demanded as a store of value.

Crowding out: The reduction in investment caused by expansionary fiscal policy's effect on interest rates.

Foreign exchange rate: Number of units of foreign currency that trade for a unit of domestic currency.

Absolute advantage: Occurs when a country's workers are more productive at producing a good than another country's workers.

Comparative advantage: Occurs when a country's producers have a lower opportunity cost of production of a good than another country.