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Basic economic principles

To get a better understanding of what Iconomix considers to be fundamental economic principles and concepts, please refer the following list of topics:

- **01. Scarcity, trade-offs and opportunity costs** Productive resources are limited. In particular, the available resources are not sufficient to meet people's – essentially unlimited – wants. This forces people to make choices. People are faced with trade-offs every day of their lives; choices made in favour of one thing, means giving something else up. Opportunity cost is the economic term used to describe what has been given up.

- **02. People respond to incentives** People respond to positive and negative incentives. How they will respond is generally predictable. Before making a decision, people first compare the (marginal) cost and (marginal) benefit of an action, so as to derive the greatest possible benefit for themselves. Their behaviour changes if the cost or benefit changes. Incentives can be either material or immaterial in nature. Understanding effective incentives helps explain and gauge people's behaviour.

- **03. Benefits of trade and specialisation** A voluntary exchange is one that makes all participating parties better off (or at least not worse off). This applies both to trade between individuals and trade between countries. Trade is a prerequisite for specialisation; it allows individuals, regions or countries to specialise in the production of goods and services for which they have a comparative advantage; in other words, goods and services which they are better positioned to produce than others in terms of cost and quality. Trade and specialisation increase production and consumption, and have played a major role in boosting affluence in the history of mankind.

- **04. Market, the role of prices and competition** The price relationship between different goods, referred to as the relative price, sends important signals and provides incentives to buyers and sellers. Relative prices reflect the scarcity of a good; a high price is an indication of how scarce the good is in relation to how great demand for it is. Market prices are determined by supply and demand, and continue to adjust themselves until the equilibrium price has been achieved; in other words, the price at which the quantity supplied equals the quantity demanded. An increase in demand or a decrease in supply can push up the price of a good. Buyers and sellers of goods and services interact on markets. Markets generally ensure the efficient allocation of scarce goods. This means that the market mechanism sees to it that suppliers provide consumers with those goods and services that are most required (in the right amount, at the right place and at the right time). The counterpart to market mechanism is central planning a System — however, that has proved less than successful in the past. Competition among suppliers ensures that production is efficient and that the price/performance ratio of the goods and services supplied is at an optimum level. Competition varies in intensity depending on the different types of market structure. In addition to markets for goods and services, other important markets are the labour market and the financial markets (cf. items 15 and 16 below).

- **05. Entrepreneurs, capital and profits** Entrepreneurs are people who take risks in organising resources (capital, time and effort) to produce goods and services. Profit is an important incentive that acts as compensation for the risks taken. Entrepreneurial activity is vital in promoting innovation and the creation of jobs. In contrast to private companies, the owners and managers of joint-stock companies are often not one and the same person. The question here is whether the company is actually managed in accordance with the owner's wishes (principal-agent problem).

- **06. Externalities, common pool resources and public goods** Externalities refer to the costs and benefits that are not reflected in market prices. They arise from the absence of property rights or the lack of enforcement of such rights. Negative externalities occur when the social costs of an activity are too high, or in the case of positive externalities, when the benefits are too few. This is due to the fact that decision-makers do not take costs and benefits adequately into account. In both cases, government intervention is often the result. Common pool resources are goods that can be used by everyone – as no one can be excluded from using them – but where rivalry between the users exists. This can often lead to overuse or exploitation of a resource (e.g. fish stocks in public waters). Public goods, meanwhile, are both non-excludable and non-rival; no one can be excluded from using them and no rivalry exists between users. Although parties are interested in the good, no one is willing to pay a market price for it. It is thus typically the case that the state supplies such goods (e.g. national defence).

- **07. Economic role of government** The government has an important role to play in a market economy. It provides a legal system and ensures basic and property rights. In the event of market failure, it can intervene in the economic process and take corrective measures. It can redistribute income and wealth if the public is not completely satisfied with the market's allocation. Government intervention can, however, also have undesired secondary effects and generate additional costs. Generally speaking, it is difficult to override market forces. Furthermore, numerous interest groups try to influence government activities and promote their own interests.

- **08. Money and inflation** Money is a medium of exchange, a unit of account and a store of value. It facilitates the exchange of goods, comparisons of the value of different goods, services, income flows, assets, etc., as well as investment and borrowing. An economy that uses money is more efficient than a barter economy. Money is supplied by central banks. Inflation denotes the increase in the overall level of prices. It is costly, it impairs the functioning of money, and it leads to a redistribution of wealth – notably at the expense of savers and pensioners. Inflation arises when too much money is pumped into the economy. Therefore, ensuring price stability is the main task of central banks today.

- **09. Strategic thinking** Thinking strategically plays a major role in situations in which the result of an action of one party is largely dependent on the behaviour of another. It involves taking into consideration how others will react to one's actions, in the knowledge that the others are doing just the same. When no player has any incentive to deviate from their current strategy, the game is said to be in equilibrium; hence the situation is considered to be stable. Without any binding arrangements, the situation may produce results which no party desires. Important elements in strategic situations are timing, credibility and commitment. Promises and threats are only effective if it is plausible that these can also be implemented should the need arise.

- **10. Asymmetric information** Information is a vital requirement in daily decision-making; attaining it can be costly and, in some cases, impossible. The various market participants are therefore not always adequately informed. Some participants are often better informed than others; in other words, participants are asymmetrically informed. Circumstances such as these can influence the behaviour of the players – those who are better informed can use the information to their advantage, while those who are less well informed are aware of this. This can impair the smooth functioning of the markets.

- **11. Uncertainty, risk and insurance** Life is characterised by uncertainty. It is rarely possible to predict the exact outcome of an action. The term risk describes the possibility that the result of an action will not turn out as expected. The more different the potential outcomes, the greater the risk. Most people are risk averse. They would, for instance, prefer to receive a guaranteed sum of money, rather than take a 50% chance of receiving double the amount or nothing at all. Or they would prefer to pay a small amount for certainty, rather than taking a small risk of suffering a big loss. This is why people take out insurance policies. Insurance policies have a major impact on policyholders' behaviour and can typically result in them behaving more carelessly.

- **12. Interest rates, loans, savings and investments** Interest is the price paid by a borrower to a creditor for money placed at their disposal. Interest payments compensate the creditor for postponing consumption and for the risk that the borrower will default. Interest rates are set according to maturity, currency and creditworthiness. Those who spend more than they take in go into debt. A loan allows a borrower to buy something without having to pay for it immediately. The price for being able to do this is that they pay more for it later (interest). There are different forms of loans, such as credit cards, leasing, consumer loans, mortgage loans, etc. Those who take in more than they spend accumulate savings. There are a number of ways of investing savings; these include bank accounts, shares, bonds, investment funds, derivatives, real estate, etc. These options generally give rise to a trade-off – the higher the expected yield, the greater the risk. Thanks to diversification, however, the risk can be somewhat reduced, without minimising the expected yield.

- **13. Growth and development** Growth denotes a long-term (real) increase in the production of a country's goods and services. The per capita production of goods and services at market prices is an important (albeit imperfect) measure of a country's prosperity. Another key factor for prosperity is productivity: countries that can produce large quantities of goods and services per hour of labour invested achieve a higher standard of living. Major factors influencing growth are human capital and real capital, technological progress and the quality of institutions (e.g. the legal system, which protects, for instance, property rights).

- **14. Business cycles** Business cycle fluctuations occur in the short term. Economic upswings are characterised by above-average growth and low unemployment; recessions by below-average (negative) growth and high unemployment. Monetary, fiscal and spending policies influence output, unemployment and price levels. These economic policy instruments can be used in an attempt to smooth cyclical fluctuations. This in turn allows monetary policy to utilise to a certain degree the short-term trade-off that exists between the inflation and output of an economy. In the long term, however, monetary policy only influences inflation, in other words, it is neutral.

- **15. Labour market and income** For the majority of people, income earned from work is the principal form of income. Earned income is determined in the labour market, where suppliers (workforce) and users (generally companies) meet. The income is usually determined by the market value of the service provided. This market value depends to a large degree on employees' skills, and thus, too, on their training.

- **16. The role of financial markets and institutions** Financial markets ensure the flow of funds from those wishing to save to those wishing to invest. The opportunities offered by financial markets with regard to borrowing or investment mean that income, on the one hand, and consumption or investment, on the other, do not have to occur simultaneously. This in turn facilitates the exchange of goods over time. Two of the most important financial market institutions are banks and stock exchanges. In view of the fact that it would be inefficient if all creditors and borrowers were to deal directly with one another, banks intervene and operate as financial intermediaries.

- **17. International aspects** People, goods, services, capital and information are increasingly able to move freely across national borders. The reasons behind this are falling transaction costs and the fragmentation of production processes. This growing international integration and its consequences are referred to as globalisation. It opens up new opportunities and scope, e.g. for trade, investment, information flows and migration. It is also controversial, however, because of its impact on jobs and earnings, structural change, environmental and labour market standards, economic stability and governmental room for manoeuvre. It is therefore natural that globalisation should be a major political issue and that different sections of the population and interest groups should adopt widely varying stances towards it.