Market Economies and the Price System

The Three Fundamental Economic Questions:

- **WHAT** is to be produced?
- **HOW** are these goods to be produced?
- **FOR WHOM** are the goods to be produced?

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Market Economies and the Price System

- **Two Alternative Approaches to Answering the Three Fundamental Questions**:

– **Market Economy**: an economy where most decisions of how, what and for whom to produce are made by individual firms, consumers and governments interacting in markets. In this economy, production and prices are determined in markets.

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– **Command Economy**: an economy where most decisions of how, what and for whom to produce are made by a select group of individuals and firms that control the government. In this economy, production and prices are determined by the government.

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Key Elements of a Market Economy

- **Freely determined price:** a price that is determined by the interaction of individuals and firms in the market.
- **Property rights:** rights over the use, sale and proceeds from a good or a resource.
- **Incentives:** motivate people to take action, usually so as to increase economic efficiency.
- **Freedom to Trade:** allowing people to interact freely both within and beyond national borders.

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A Role for the Government

- **Market failure:** any situation in which the market does not lead to an efficient economic outcome.

- **Government failure:** a situation in which the government makes things worse than the market, even though there may be market failure.

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The Price System

- **The Uses of the Price System in a Market Economy**
  - **Signals**: the price of a good (profits) sends a signal to producers to increase or decrease production.
  - **Incentives**: higher (lower) prices of goods will increase (decrease) the incentives for firms to produce those goods.
  - **Distribution**: Those who add the most value to resources tend to earn higher incomes. Those with higher income, buy more stuff.

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Financial Crises and Recessions

- In August 2007, the U.S. economy experienced the beginning of a deep financial crisis.
- The crisis was the likely cause for the recession that started in December 2007 and ended in June 2009.
- The worst financial crisis and recession in U.S. history occurred during the Great Depression.
- **The Great Debate:** Are financial crises market failures or government failures?

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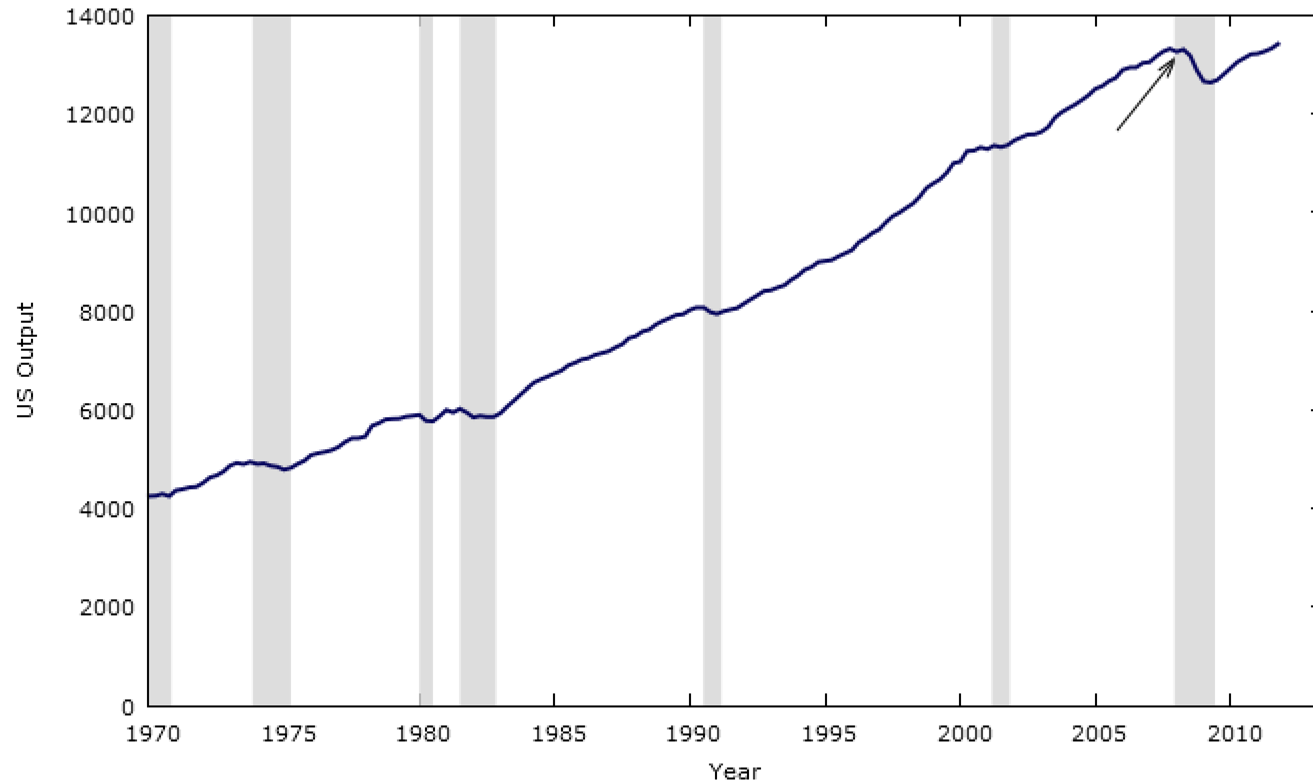
U.S. Output 1970-2011



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Explaining an Economic Event

Economic Variable: any economic measure that can vary over a range of values.

Economic Variables: Examples:

- Vehicle miles traveled per person
- Price of gasoline

Two variables are said to be *correlated* if they tend to move up or down together.

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Explaining an Economic Event

Positive Correlation: occurs when two variables move in the same direction; when one goes up, the other also goes up.

Negative Correlation: occurs when two variables move in different directions; when one goes up, the other goes down.

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Explaining an Economic Event

Correlation versus Causation

Correlation: means that one event is usually observed to occur along with another.

Causation: means that one event brings about another event.

Note: Correlation does not imply causation.

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Explaining an Economic Event

Controlled Experiments: empirical tests of theories in a controlled setting in which particular effects can be isolated.

Experimental Economics: a branch of economics that uses laboratory experiments to analyze economic behavior.

Observational Economics: Economists observe economic events and try to determine the direction and size of causal relationships without controlled experimentation. -- (Econometrics)

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Economic Models

Economic Model: an explanation of how the economy or part of the economy works; an abstraction or simplification of the real world.

Note: In economics, the term ***economic theory***, ***economic model,*** and ***economic law*** are sometimes used interchangeably, though theory is mostly used for general explanations while "model" suggests a more specific explanation.

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Economic Models

Microeconomics: the branch of economics that examines individual decision-making at firms and households and the way they interact in specific industries and markets.

Macroeconomics: the branch of economics that examines the workings and problems of the economy as a whole; focuses on variables such as GDP growth and unemployment.

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Economic Models

Positively Related: a situation in which an increase in one variable is associated with an increase in another variable (also called directly related).

Negatively Related: a situation in which an increase in one variable is associated with a decrease in another variable (also called inversely related).

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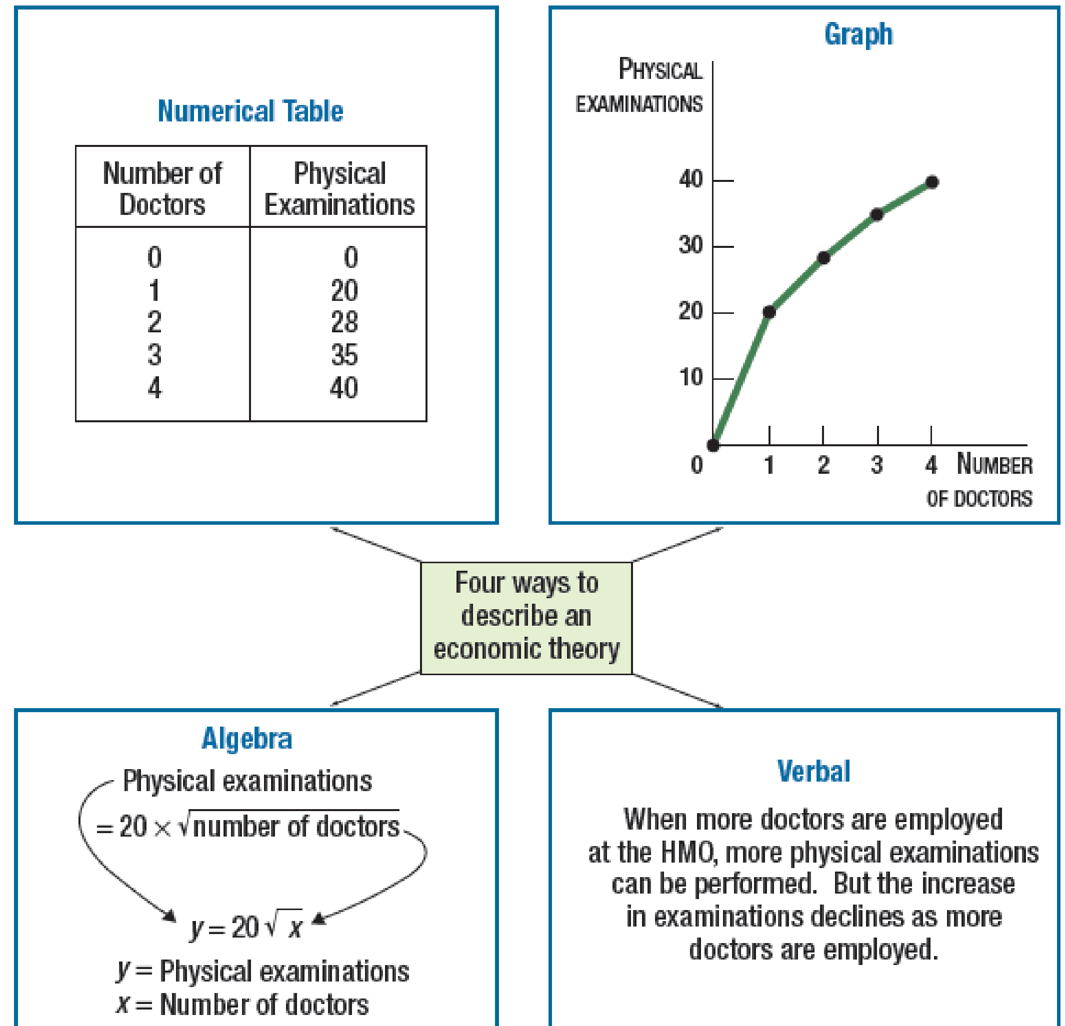
Figure 2-6

Economic Models in Four Ways



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The *Ceteris Paribus* Assumption

Ceteris Paribus: "all other things equal"; refers to holding all other variables constant or keeping all other things the same when one variable is changed.

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Recommending Appropriate Policies

Capitalism: an economic system in which capital is individually owned and production and employment decisions are decentralized.

Socialism: an economic system in which the government owns and controls all the capital and makes decisions about prices and quantities.

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Recommending Appropriate Policies

Mixed Economy: a market economy in which the government plays a very large role.

Fascism: Fascism is a system in which the government leaves nominal ownership of the means of production in the hands of private individuals but exercises control by regulatory legislation and reaps most of the profit by means of heavy taxation. In effect, fascism is simply a more subtle form of government ownership than is socialism.

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Positive versus Normative Economics

Positive Economics: economic analysis that explains what happens in the economy and why, without making recommendations about economic policy.

Example of the scope of positive economics:

- Explaining why driving declined in 2005

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Positive versus Normative Economics

Normative Economics: economic analysis that makes recommendations about economic policy; aims to develop and recommend policies about what the government should do.

Example of the scope of normative economics: Recommending policies that will prevent driving from rising in the future

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Council of Economic Advisers

Council of Economic Advisers:

- A three-member group of economists appointed by the president of the United States to analyze the economy and make recommendations about economic policy.
- Founded in 1946
- Does not represent a specific group, as the Department of Commerce does with businesses.

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The Council of Economic Advisers

President Obama's Council of Economic Advisers

- Alan Kreuger (labor), Chairman
- Carl Shapiro (IO), Member ?
- Katharine Abraham (macro/labor), Member

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