People don’t produce most of what they consume. They don’t grow most of their own food, make their own clothes, build their own houses, or provide their own health care and education. Instead, people mainly consume goods and services that others have produced, and in turn, what most people produce is mainly consumed by others. This pattern raises questions. What goods will be produced? What quantities of each good will be produced? How will the goods that are produced be allocated across the population? What role will be played by individuals making decisions about consuming, working, and saving? What role will be played by organizations like businesses? What role will be played by government?

Since a modern economy contains thousands upon thousands of different products that are produced, bought, and consumed, the study of economics must address an extraordinary array of topics. Are gasoline prices likely to rise? Should a new restaurant open or an existing restaurant close? Will it pay off for a high school graduate to go on to college? Can environmental protection go hand in hand with a rising level of consumption of goods and services? Why did the U.S. and world economies suffer such a sharp slowdown starting in 2008? What determines the number of people who want to work but cannot find jobs? When should the government cut taxes, and when should it raise them? Why do people in some countries have high incomes while those in other countries have low incomes? An introductory course in economics will help you develop the analytical tools and vocabulary for thinking and communicating about these issues.

This first chapter introduces some ways in which economies are interconnected. It discusses the range of alternatives from a market-oriented economy
to a command economy. It describes how an economy divides up the tasks that are involved in production of goods and services, and how the total production of goods and services increases as a result. This chapter will also explain the difference between “microeconomics” and “macroeconomics” and lay out how the chapters of this book are organized.

**What Is an Economy?**

An economy is the set of social arrangements that answers three fundamental questions: 1) What is produced? 2) How is it produced? 3) For whom is it produced? Thus, economics is the study of the production, distribution, and consumption of goods and services. In an economics textbook published in 1890, the famous English economist Alfred Marshall (1842–1924) wrote more poetically that economics involved the study of people “as they live and move and think in the ordinary business of life.”

**Market-Oriented vs. Command Economies**

Countries display a wide range of economic institutions. At one end of the spectrum is a market-oriented economy. A market is an institution that brings together buyers and sellers of goods or services, who may be either individuals or businesses. In a market-oriented economy, most economic decisions about what to produce, how to produce it, and for whom to produce it are made by these buyers and sellers. In a command economy, at the other extreme, the government either makes most economic decisions itself or at least strongly influences how the decisions are made.

The U.S. economy is positioned toward the market-oriented end of the spectrum. Many countries in Europe and Latin America, while primarily market-oriented, have a greater degree of government involvement in economic decisions than does the U.S. economy. Countries like China and Russia, while they are closer to having a market-oriented system now than several decades ago, remain closer to the command economy end of the spectrum. In countries like Cuba, Libya, and North Korea, the command economy predominates.

Markets and government rules are always entangled. Even economies that are primarily market-oriented have laws and regulations to support the operation of markets. At a minimum, these laws govern matters like safeguarding private property against theft, protecting people from violence, enforcing legal contracts, preventing fraud, and collecting taxes. Conversely, even the most command-oriented economies operate with substantial black markets, which are markets where the buyers and sellers make transactions without the government’s approval. The question of how to organize economic institutions is typically not a black-or-white choice between all market or all government, but instead involves a balancing act over the appropriate combination of market freedom and government rules.

**The Interconnectedness of an Economy**

In a modern economy, the economic life of every individual is interrelated, at least to a small extent, with the economic lives of thousands or even millions of other individuals. Imagine that when an economic transaction occurs, it leaves behind a line that is visible for people who wear special economist glasses.

For example, if you buy a loaf of bread at the grocery store, a blue line stretches from the store to your kitchen. When you pump gas into your car, a red line runs from the gas station to your car. A green line connects you to your employer, a purple line to the bank where you keep your checking and savings accounts, and a yellow line to the shop where you get your hair cut. This network of lines would also capture the transactions through which goods are produced. A loaf of bread would have colorful lines running to the bakery, to the company that manufactured the plastic bag for packaging, to the farm where the wheat was grown, and to the mill where the wheat was ground into flour. In turn, because the wheat farm used tractors, and trucks transported the bread to the store, lines would also extend from the loaf of bread to tractor and truck manufacturers and to trucking companies. These lines representing economic transactions also extend to those
concerned with the financial side of these businesses: the bankers who provide loans and checking and savings accounts to firms, the accountants who deal with payroll and taxes, and the managers who authorize sending out the checks.

If you could put on special economist glasses to see all the economic lines of connection, a single loaf of bread would appear with a network of lines that eventually reached all over town, across the state and the country, and even around the world. In a modern economy, every person, every business firm, and every product is at the center of a starburst of economic interconnections.

The Division of Labor

The formal study of economics began when Adam Smith (1723–1790) published his famous book *The Wealth of Nations* in 1776. Many authors had written on economic subjects in the centuries before Smith, but he was the first to address the subject in a comprehensive way. In the first chapter of *The Wealth of Nations*, Smith introduces the idea of the division of labor, which refers to how the work required to produce a good or service is divided into a number of simpler tasks that are performed by different workers.

To illustrate the division of labor, Adam Smith used the example of how the tasks of making a pin were divided in a pin factory. He counted the multiple tasks involved with making a pin, including the steps involved in drawing out a piece of wire, cutting it to the right length, straightening it, putting a head on one end and a point on the other, and packaging pins for sale. In observing pin factories, Smith counted 18 distinct tasks that were often done by different workers. Modern businesses divide tasks as well. Even a relatively simple business like a restaurant divides up the task of serving meals into a range of jobs including top chefs, less-skilled kitchen help, servers to wait on the tables, a greeter at the door, janitors to clean up, and a business manager to handle paychecks and bills—not to mention the economic connections a restaurant has with suppliers of food, furniture, kitchen equipment, and the building where it is located. A complex business like a large manufacturing factory or a hospital can have hundreds of job classifications.
Adam Smith was once walking with a friend, talking enthusiastically about the division of labor, and he got so excited with the subject that he tumbled into a pit where workers were tanning hides, a foul-smelling process. Smith was the prototypical never-married, absent-minded professor. He frequently went walking, started talking to himself, and would completely lose track of time and distance. But being one of the first to put on economist glasses and perceive the division of labor must have been a highly distracting experience.

Why the Division of Labor Increases Production

When the tasks involved with producing a good or service are divided and subdivided, workers and businesses can produce a greater quantity of output. In his observations of pin factories, Smith observed that one worker alone might make 20 pins in a day, but that a small business of 10 workers (some of whom would need to do two or three of the 18 tasks involved with pin-making), could make 48,000 pins in a day. How can a group of workers, each focused on certain tasks, produce so much more than the same number of workers who try to produce the entire good or service by themselves? Smith offered three reasons.

First, specialization in a particular small job allows workers to focus on the types of production where they have an advantage. People have different skills, talents, and interests, so they will be better at some jobs than others. The particular advantages workers have may be based on educational choices, which are in turn shaped by interests and talents: for example, only those with medical degrees qualify to become doctors. For some goods, specialization will be affected by geography: for example, it’s easier to be a wheat farmer in North Dakota than in Florida, but easier to run a tourist hotel in Florida than in North Dakota. If you live in or near a big city, it’s easier to attract enough customers to operate a successful dry cleaning business or movie theater than if you live in a sparsely populated rural area.

Second, workers who specialize in certain tasks often learn to produce more quickly and with higher quality. This pattern holds true for many workers, including assembly line laborers who build cars, stylists who cut hair, and doctors who perform heart surgery. In fact, specialized workers often know their jobs well enough to suggest innovative ways to do their work faster and better. A similar pattern often operates within businesses. In many cases, a business that focuses on one or a few products (sometimes called its “core competency”) is more successful than firms that attempt to make a wide range of products.

Third, specialization allows economic agents, or actors, to take advantage of economies of scale, which refers to the common pattern that as the level of production increases for many goods and services, the average cost of producing each individual unit declines. For example, if a factory produces only 100 cars per year, each car will be quite expensive to make on average. However, if a factory produces 10,000 or 50,000 cars each year, then it can set up an assembly line with huge machines and workers performing specialized tasks, and the average cost of production per car will be lower. The ultimate result of workers who can focus on their preferences and talents, learn to do their specialized jobs better, and work in larger organizations is that society as a whole can produce and consume far more than if each person tried to produce individually all of the goods and services that the person wishes to consume.

Trade and Markets

The division of labor helps to explain why most workers do not consume most of what they produce. Instead, workers within an economy use the pay that they receive for doing their jobs to purchase the other goods and services that they desire.

As a result, you don’t have to know anything about electronics or software to use a touchscreen on your smartphone—you just buy the phone and start tapping away. You don’t have to know anything about artificial fibers or the construction of sewing machines if you need a jacket—you just buy the jacket and wear it. You don’t need to know anything about internal combustion engines to operate a car—you just climb in and drive. Instead of trying to acquire all the knowledge and skills involved in producing all of the goods and services that you wish to consume, the market allows you to learn a specialized

---

**specialization:** When workers or firms focus on particular tasks in the overall production process for which they are well-suited.

**economies of scale:** When the average cost of producing each individual unit declines as total output increases.
set of skills and then use the pay you receive to buy goods and services. The economy is a social mechanism that coordinates this division of labor, specialization, and markets.

The Rise of Globalization

Recent decades have seen a trend toward globalization, which means that buying and selling in markets have crossed national borders to an increasing extent. As a result, firms and workers from different countries are increasingly interconnected. Globalization has occurred for a number of reasons. Improvements in shipping and air cargo have driven down transportation costs. Innovations in computing and telecommunications have made it easier and cheaper to manage long-distance economic connections of production and sales. Many valuable products and services in the modern economy can take the form of information—for example, computer software; financial advice; travel planning; music, books and movies; and blueprints for designing a building. These products and many others can be transported over telephone and computer networks at ever-lower costs. Finally, international agreements and treaties between countries have encouraged greater trade.

Exhibit 1-1 presents one measure of globalization. It shows the percentage of domestic economic production that was exported for a selection of countries from 1970 to 2010.

EXHIBIT 1-1 The Extent of Globalization (export/GDP)

One way to measure globalization is to look at the export/GDP ratio. For the world economy and for most individual countries, the export/GDP ratio has risen in recent decades.

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Some High-Income Countries</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>United States</td>
<td>6%</td>
<td>10%</td>
<td>10%</td>
<td>11%</td>
<td>13%</td>
</tr>
<tr>
<td>Canada</td>
<td>22%</td>
<td>28%</td>
<td>26%</td>
<td>46%</td>
<td>29%</td>
</tr>
<tr>
<td>France</td>
<td>16%</td>
<td>21%</td>
<td>21%</td>
<td>29%</td>
<td>26%</td>
</tr>
<tr>
<td>Japan</td>
<td>11%</td>
<td>13%</td>
<td>10%</td>
<td>11%</td>
<td>15%</td>
</tr>
<tr>
<td>South Korea</td>
<td>14%</td>
<td>32%</td>
<td>28%</td>
<td>39%</td>
<td>52%</td>
</tr>
<tr>
<td>Sweden</td>
<td>24%</td>
<td>30%</td>
<td>30%</td>
<td>47%</td>
<td>49%</td>
</tr>
<tr>
<td><strong>Some Upper-Middle-Income Countries</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Brazil</td>
<td>7%</td>
<td>9%</td>
<td>8%</td>
<td>10%</td>
<td>11%</td>
</tr>
<tr>
<td>China</td>
<td>3%</td>
<td>11%</td>
<td>16%</td>
<td>23%</td>
<td>31%</td>
</tr>
<tr>
<td>Mexico</td>
<td>8%</td>
<td>11%</td>
<td>19%</td>
<td>31%</td>
<td>30%</td>
</tr>
<tr>
<td><strong>Some Lower-Middle-Income Countries</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>India</td>
<td>4%</td>
<td>6%</td>
<td>7%</td>
<td>13%</td>
<td>23%</td>
</tr>
<tr>
<td>Nigeria</td>
<td>8%</td>
<td>29%</td>
<td>43%</td>
<td>54%</td>
<td>35%</td>
</tr>
<tr>
<td><strong>Some Low-Income Countries</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Bangladesh</td>
<td>8%</td>
<td>5%</td>
<td>6%</td>
<td>14%</td>
<td>18%</td>
</tr>
<tr>
<td>Chad</td>
<td>16%</td>
<td>17%</td>
<td>13%</td>
<td>17%</td>
<td>39%</td>
</tr>
<tr>
<td>Nepal</td>
<td>5%</td>
<td>12%</td>
<td>11%</td>
<td>23%</td>
<td>10%</td>
</tr>
</tbody>
</table>
**Exports** are the goods and services that are produced domestically and sold in another country; conversely, **imports** are the goods and services that are produced abroad and then sold domestically. The size of total production in an economy is measured by the gross domestic product, often abbreviated as GDP. Thus, the ratio of exports divided by GDP measures what share of a country’s total economic production is sold in other countries.

In recent decades, the export/GDP ratio has generally risen, both worldwide and for the U.S. economy. Interestingly, the share of U.S. exports in proportion to the U.S. economy is well below the global average, in part because large economies like the United States can contain more of the division of labor inside their national borders. However, smaller economies like Korea and Canada need to trade across their borders with other countries to take full advantage of division of labor, specialization, and economies of scale. In this sense, the enormous U.S. economy is less affected by globalization than most other countries. Exhibit 1-1 also shows that many medium- and low-income countries around the world, like Mexico and China, have also experienced a surge of globalization in recent decades. If an astronaut in orbit could put on special economist glasses that make all economic transactions visible as brightly colored lines, and look down at planet Earth, globalization means that the astronaut would see more connections stretching around the world.

**Microeconomics and Macroeconomics**

**Microeconomics** focuses on the actions of particular actors within the economy, like households, workers, and businesses. In contrast, **macroeconomics** looks at the economy as a whole, focusing on issues like the growth rate of production of goods and services, unemployment, the inflationary increase in prices, and levels of exports and imports. Microeconomics and macroeconomics are not separate subjects, but rather complementary perspectives on the overall subject of the economy.

To understand why microeconomic and macroeconomic perspectives are both useful, consider the problem of studying a biological ecosystem like a lake. One person who sets out to study the lake might focus on specific topics: certain kinds of algae or plant life, the characteristics of particular fish or snails, or the trees surrounding the lake. Another person might take an overall view and instead consider the entire ecosystem of the lake from top to bottom: what eats what, how the system stays in a rough balance, and what environmental stresses affect this balance. Both approaches are useful, and both examine the same lake, but the viewpoints are different. In a similar way, both microeconomics and macroeconomics study the same economy, but each has a different viewpoint.

Whether you are looking at lakes or economics, the micro and the macro insights should blend with each other. In studying a lake, the micro insights about particular plants and animals help to understand the overall food chain, while the macro insights about the overall food chain help to explain the environment in which individual plants and animals live. In economics, the micro decisions of individual households and businesses are influenced by whether the macroeconomy is healthy; for example, firms will be more likely to hire workers if the overall economy is growing. In turn, the performance of the macroeconomy ultimately depends on the microeconomic decisions made by households and businesses.

In this book, Chapters 1–6 introduce some basic tools of economics. This first chapter lays out the basic meaning of the economy and economics. Chapter 2 explains how economic decision-making works. Chapter 3 shows how trade and exchange can be mutually beneficial, using the example of trade between nations in the global economy. Chapters 4 and 5 discuss how forces of supply and demand determine prices—and what happens when government attempts to set prices directly. Chapter 6 discusses the debate over globalization and protectionism. With this foundation established, Chapters 7–20 focus on microeconomics. Regardless of whether you are looking through the microeconomics microscope or the macroeconomics telescope, the fundamental subject material of the interconnected economy doesn’t change.
Microeconomics: The Circular Flow Diagram

The circular flow diagram in Exhibit 1-2 pictures the economy as consisting of two groups—households and firms—that interact in three markets: a goods and services market, a labor market, and a financial capital market.

In the goods and services market, firms are sellers and households are buyers, so the arrow for goods and services leads from firms to households. Payments for these goods and services flow back in the other direction, from households to firms, so the arrow for payments flows back in the opposite direction.

In the labor market, households sell their labor as workers to business firms. Conversely, firms buy labor when they hire workers. Thus, the flow of labor runs from households to firms, but the flow of payments for labor—in the form of wages, salaries, bonuses, and benefits—flows from firms to households.

In the financial capital market, individuals or firms who save money and make financial investments are suppliers of financial capital. Those who borrow money or receive financial investments are the recipients of financial capital. For example, someone who deposits money in a savings account at a bank is supplying financial capital, and someone who receives a loan from the bank is demanding financial capital. Individual households and firms can be either suppliers or demanders of capital, depending on whether they are saving or borrowing. However, in the circular flow diagram, the convention is to draw the most common direction of the financial capital flow as running from households to firms—that is, households taken as a group are saving and making financial investments.

EXHIBIT 1-2 The Circular Flow Diagram

The circular flow diagram shows how households and firms interact in the goods and services market, the labor market, and the financial capital market. The direction of the arrows shows that in the goods and services market, households receive goods and services and pay firms for them. In the labor market, households work and receive payment from firms. In the financial capital market, households provide financial capital—that is, savings and financial investment—while firms pay them for that capital by providing a rate of return—for example, an interest payment.
rate of return: The payment in addition to the original investment from those who have received financial capital to those who provided it.

principal: The amount of an original financial investment, before any rate of return is paid.

interest rate: A payment calculated as a percentage of the original amount saved or borrowed, and paid by the borrower to the saver.

model: A simplified representation of an object or situation that includes enough of the key features to be useful.

Payment for financial capital is called the rate of return. Suppliers of financial capital expect that they will eventually receive back both the amount of their original financial investment, called the principal, plus an additional amount called the rate of return. Conversely, demanders of financial capital expect to pay back the original principal they received, plus a rate of return, in exchange for receiving the financial investment. One common example of a rate of return is an interest rate charged for borrowing financial capital. If one person loans $10,000 to another person for one year at an 8% annual interest rate, then the lender—the supplier of financial capital—expects to be repaid $10,000 of principal plus $800 of interest as a rate of return. Meanwhile the borrower—the demander of financial capital—expects to pay back the $10,000 of principal plus $800 in interest. However, the rate of return is not always an interest rate. For example, a person might pay $10,000 for a half-ownership of a small business, with an agreement that the rate of return will be half of any future profits earned by the business. In this case, the rate of return could be high or low, depending on the profits that are eventually earned, if any.

The circular flow diagram is an example of a model, which is a simplified representation of an object or situation that includes enough of the key features to be useful. For example, an architect who is planning a major office building will often build a physical model that sits on a tabletop to show how the entire city block will look after the new building is constructed. Companies often build models of their new products, which are often more rough and unfinished than the final product will be, but can still demonstrate how the new product will work. Economic models like the circular flow diagram are not physical models, but instead are diagrams or graphs or even mathematical equations that represent economic patterns or theories.

The circular flow diagram shown in Exhibit 1-2 is a deliberately simple model. A more complex circular flow model could add a box for “government,” and then show arrows for taxes paid flowing to the government and government spending programs going to households and firms. Boxes could also be added for the “rest of the world,” with arrows showing the exports flowing to those countries and imports flowing back from those countries. But models should be only as complex as needed to illustrate the issue at hand—and not more so. Although issues of government and international economic connections will arise throughout the book, the structure and order of the microeconomics chapters is based on how households and firms interact in these three main markets.

Chapters 7–12 build a theoretical framework for analysis of household and firm decision-making. In particular, Chapters 9–12 discuss how firms make decisions about production, ranging from firms that face many competitors to monopoly firms that face no competitors at all. Chapters 13–20 build on that theoretical framework to discuss some policy issues that arise in microeconomic markets. Chapters 13–15 focus on policies that involve markets for goods: assuring competition between firms, protecting the environment, and encouraging beneficial new technology. Chapters 16–17 then discuss issues that arise in labor markets: poverty, inequality, unions, discrimination, and immigration. Chapters 18–19 discuss issues that arise in financial capital markets involving insurance and financial investments like stocks and bonds. Finally, Chapter 20 discusses how economists analyze some of the political issues involved in setting microeconomic policy.
Macroeconomics: Goals, Frameworks, and Tools

When nations desire a healthy macroeconomy, they typically focus on four goals: growth in the standard of living, a low level of unemployment, low inflation, and a sustainable balance of trade between countries.

Macroeconomics involves thinking about how these four goals relate to each other, and in particular how pursuing any one of these goals might necessitate trade-offs with other goals. Such analysis requires an understanding of how the macroeconomy works, both in the short-run (ranging from months to a couple of years) and in the long-run (ranging from several years to a decade and more).

With macroeconomic goals in mind and the frameworks for analyzing how these goals relate to each other in place, the final step is to think about how macroeconomic policy pursues these goals. The two main tools of macroeconomic policy include monetary policy, which involves policies that affect bank lending, interest rates and financial capital markets, and fiscal policy, which involves government spending and taxation.

Studying Economics Doesn’t Mean Worshiping the Economy

Many newcomers to the study of economics either fear or hope that the subject will mainly discuss why business and markets are always right. Such expectations are inaccurate. Economics overlaps with the study of business decisions, but it reaches much farther to encompass all aspects of production, distribution, and consumption. Economics is concerned with the well-being of all people, including those with jobs and those without jobs, and those with high incomes and low incomes. Economics acknowledges that production of useful goods and services can create problems of environmental pollution. It explores the question of how investing in education helps to develop workers’ skills. It probes questions like how to tell when big businesses or big labor unions are operating in a way that benefits society as a whole, and when they are operating in a way that benefits their owners or members at the expense of others. It discusses how government spending, taxes, and regulations affect decisions about production and consumption. Economics is a structured methodology for investigating these kinds of issues and many others. John Maynard Keynes (1883–1946), one of the greatest economists of the twentieth century, addressed this theme when he wrote: “[Economics] is a method rather than a doctrine, an apparatus of the mind, a technique of thinking, which helps its possessor to draw correct conclusions.”

While the study of economics requires paying attention to the problems that can be generated in society’s process of production, distribution, and consumption, economics is based on the belief that a higher standard of living is a goal worth pursuing. In 1900, the
population of the United States had the highest average income level of any country in the world. However, from a modern perspective, people had a very low standard of living. In the United States of 1900, only one-third of all homes had running water; in rural areas, almost nobody did. Just 3 percent of homes were lit by electricity; most used coal, oil, or kerosene. About 10 percent of those aged 14–17 attended high school; about 6 percent of students graduated from high school; and about 2 percent graduated from college. Life expectancy at birth was just 47 years, and out of every 1,000 babies born, 140 died before they were a year old. (Now life expectancy is above 75 years, and out of every 1,000 babies born, fewer than 10 die in the first year.) The typical workweek for a man was 60 hours, spread over six days. While relatively few women worked in the paid labor force, the typical woman spent about 40 hours a week on meals and meal clean-up, another seven hours per week on laundry, another seven hours on cleaning the home, and an untold number of hours on child care, gardening, making and repairing clothes, fetching water, and filling the stove with wood or coal. The average woman had 10 pregnancies, so even with a high level of infant mortality, she spent about 15 years of her life either pregnant or looking after an infant. Child labor was widespread; the 1900 U.S. Census reports that one-fourth of boys aged 10–15 held a job.

Today, we look back at the people who lived 100 years ago and wonder how they managed. But remember that in 1900, the United States had the highest average income of any country in the world. It had an average standard of living slightly above that of the United Kingdom; almost double that of France or Germany; almost triple that of the richer nations of Latin America at that time, including Argentina and Chile; and quadruple the standard of living of Japan or Mexico (which had about the same standard of living at that time).

Few of us today would wish to return to the standard of living in 1900 because most of us believe that it is better to be educated than illiterate, to live longer and to have fewer babies die, to work fewer hours at less physically demanding tasks, and to have all the life-saving, labor-saving inventions developed over time. This pattern of dramatic advances in the standard of living continues today. Look at the extraordinary advances in recent years in computers and the Internet, in telecommunications, in medicine and health, in biological sciences and genetics, and in new materials.

The economic challenge for society is to chart a course that encourages the beneficial aspects of economic growth while finding ways to curb undesirable and unwanted side effects like pollution, unemployment, and poverty. The introductory course in economics should make you more informed about these issues. When you read newspaper or magazine articles about economic issues, you will begin to recognize terminology and arguments. When you hear classmates, co-workers, or political candidates talking about economics, you will improve your ability to distinguish common sense from nonsense. You will find new ways of thinking about current events and about personal and business decisions, as well as current events and politics. The study of economics does not dictate the answers, but it can illuminate the different choices.

Key Concepts and Summary

1. The economy is the way in which a society organizes the production, distribution, and consumption of goods and services. It is the set of social institutions that answers three questions: what is produced, how is it produced, and for whom is it produced.

2. In a market-oriented economy, individuals and businesses make most economic decisions, with government playing a background role. In a command economy, the government makes most economic decisions; individual and business decisions play only a background role. Most economies lie somewhere between these two extremes and have a substantial role for both the market and the government, although the emphasis varies in different countries.

3. A modern economy is amazingly interconnected. Every person and every good is linked by economic transactions—sometimes directly, often indirectly—to a vast array of other goods, people, and businesses.

4. A modern economy displays a division of labor, in which people earn income by specializing in what they produce and then use that income to purchase the products they desire.
5. The division of labor allows individuals and firms to specialize and to produce more for several reasons: 
a) it allows the agents to focus on areas of advantage due to natural factors and skill levels; b) it encourages the agents to learn and invent; c) it allows agents to take advantage of **economies of scale**.

6. The last few decades have seen **globalization** evolve as a result of growth in commercial and financial networks that cross national borders, making businesses and workers from different economies increasingly interdependent.

7. **Microeconomics** and **macroeconomics** are two different perspectives on the economy. The microeconomic perspective focuses on parts of the economy: individuals, firms, and industries. The macroeconomic perspective looks at the economy as a whole, focusing on overall issues like growth in the standard of living, unemployment, inflation, and levels of foreign trade.

8. The **circular flow diagram** shows how households and firms interact in the **goods and services market**, the **labor market**, and the **financial capital market**.

9. Macroeconomics has four main goals: growth in the standard of living, low unemployment, low inflation, and a sustainable balance of trade. It has two types of policies for pursuing these goals: **monetary policy** and **fiscal policy**.

**Review Questions**

1. What are the three basic questions that every economy must address?
2. What is the key difference between a market-oriented economy and a command economy?
3. What does the phrase “division of labor” mean?
4. What three reasons explain why the division of labor increases an economy’s level of production?
5. What is globalization? How do you think it might have affected the economy over the past decade?
6. What is the difference between microeconomics and macroeconomics?
7. Are households primarily buyers or sellers in the goods and services market? The labor market? The financial capital market? Are firms primarily buyers or sellers in each of these three markets?
8. What are the four primary goals of macroeconomics?