PowerPoint® Lecture Presentation

to accompany

Principles of Economics, Third Edition

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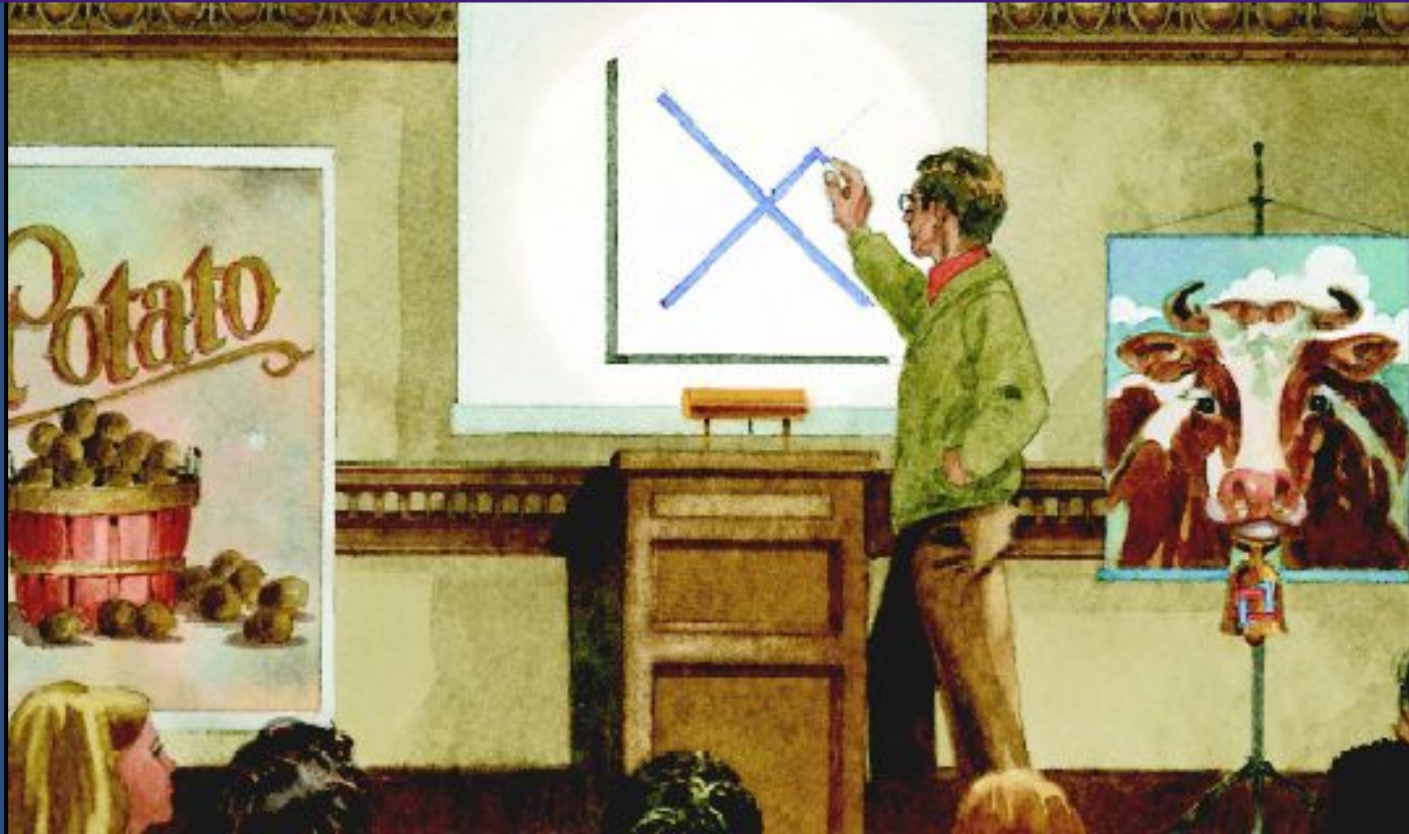
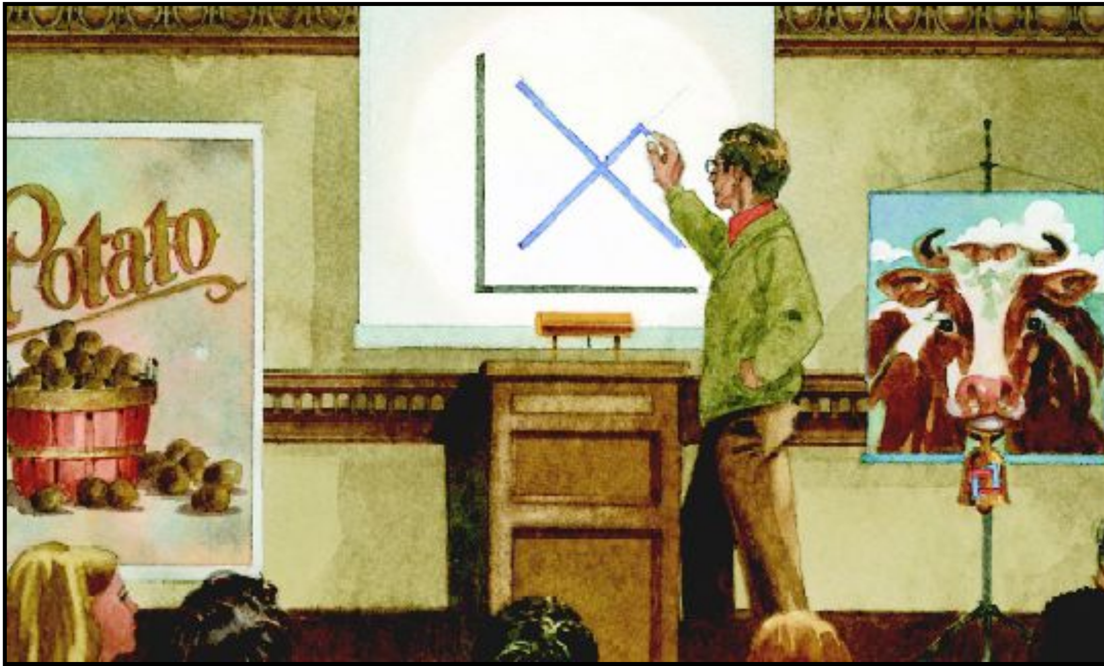
1
INTRODUCTION





1

Ten Principles of Economics

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Economy. . .

. . . The word *economy* comes from a Greek word for "one who manages a household."

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TEN PRINCIPLES OF ECONOMICS

- A household and an economy face many decisions:
  - Who will work?
  - What goods and how many of them should be produced?
  - What resources should be used in production?
  - At what price should the goods be sold?

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TEN PRINCIPLES OF ECONOMICS

Society and Scarce Resources:

- The management of society's resources is important because resources are scarce.
- *Scarcity*. . . means that society has limited resources and therefore cannot produce all the goods and services people wish to have.

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TEN PRINCIPLES OF ECONOMICS

Economics is the study of how society manages its scarce resources.

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TEN PRINCIPLES OF ECONOMICS

- How people make decisions.
  - People face tradeoffs.
  - The cost of something is what you give up to get it.
  - Rational people think at the margin.
  - People respond to incentives.

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TEN PRINCIPLES OF ECONOMICS

- How people interact with each other.
  - Trade can make everyone better off.
  - Markets are usually a good way to organize economic activity.
  - Governments can sometimes improve economic outcomes.

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TEN PRINCIPLES OF ECONOMICS

- The forces and trends that affect how the economy as a whole works.
  - The standard of living depends on a country's production.
  - Prices rise when the government prints too much money.
  - Society faces a short-run tradeoff between inflation and unemployment.

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Principle #1: People Face Tradeoffs.

"There is no such thing as a free lunch!"

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Principle #1: People Face Tradeoffs.

To get one thing, we usually have to give up another thing.

- Guns v. butter
- Food v. clothing
- Leisure time v. work
- Efficiency v. equity

Making decisions requires trading off one goal against another.

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Principle #1: People Face Tradeoffs

- Efficiency v. Equity
  - *Efficiency* means society gets the most that it can from its scarce resources.
  - *Equity* means the benefits of those resources are distributed fairly among the members of society.

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Principle #2: The Cost of Something Is What You Give Up to Get It.

- Decisions require comparing costs and benefits of alternatives.
  - Whether to go to college or to work?
  - Whether to study or go out on a date?
  - Whether to go to class or sleep in?
- The *opportunity cost* of an item is what you give up to obtain that item.

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Principle #3: Rational People Think at the Margin.

- *Marginal changes* are small, incremental adjustments to an existing plan of action.

People make decisions by comparing costs and benefits at the margin.

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Principle #4: People Respond to Incentives.

- Marginal changes in costs or benefits motivate people to respond.
- The decision to choose one alternative over another occurs when that alternative's marginal benefits exceed its marginal costs!

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Principle #5: Trade Can Make Everyone Better Off.

- People gain from their ability to trade with one another.
- Competition results in gains from trading.
- Trade allows people to specialize in what they do best.

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Principle #6: Markets Are Usually a Good Way to Organize Economic Activity.

- A *market economy* is an economy that allocates resources through the decentralized decisions of many firms and households as they interact in markets for goods and services.
  - Households decide what to buy and who to work for.
  - Firms decide who to hire and what to produce.

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Principle #6: Markets Are Usually a Good Way to Organize Economic Activity.

- Adam Smith made the observation that households and firms interacting in markets act as if guided by an "invisible hand."
  - Because households and firms look at prices when deciding what to buy and sell, they unknowingly take into account the social costs of their actions.
  - As a result, prices guide decision makers to reach outcomes that tend to maximize the welfare of society as a whole.

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Principle #7: Governments Can Sometimes Improve Market Outcomes.

- *Market failure* occurs when the market fails to allocate resources efficiently.
- When the market fails (breaks down) government can intervene to promote efficiency and equity.

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Principle #7: Governments Can Sometimes Improve Market Outcomes.

- Market failure may be caused by
  - an *externality*, which is the impact of one person or firm's actions on the well-being of a bystander.
  - *market power*, which is the ability of a single person or firm to unduly influence market prices.

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Principle #8: The Standard of Living Depends on a Country's Production.

- Standard of living may be measured in different ways:
  - By comparing personal incomes.
  - By comparing the total market value of a nation's production.

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Principle #8: The Standard of Living Depends on a Country's Production.

- Almost all variations in living standards are explained by differences in countries' productivities.
- *Productivity* is the amount of goods and services produced from each hour of a worker's time.

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Principle #8: The Standard of Living Depends on a Country's Production.

- Standard of living may be measured in different ways:
  - By comparing personal incomes.
  - By comparing the total market value of a nation's production.

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Principle #9: Prices Rise When the Government Prints Too Much Money.

- Inflation is an increase in the overall level of prices in the economy.
- One cause of inflation is the growth in the quantity of money.
- When the government creates large quantities of money, the value of the money falls.

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Principle #10: Society Faces a Short-run Tradeoff Between Inflation and Unemployment.

- The Phillips Curve illustrates the tradeoff between inflation and unemployment:

  ⇩Inflation ⇨ ⇧Unemployment

  It's a short-run tradeoff!

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Summary

- When individuals make decisions, they face tradeoffs among alternative goals.
- The cost of any action is measured in terms of foregone opportunities.
- Rational people make decisions by comparing marginal costs and marginal benefits.
- People change their behavior in response to the incentives they face.

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Summary

- Trade can be mutually beneficial.
- Markets are usually a good way of coordinating trade among people.
- Government can potentially improve market outcomes if there is some market failure or if the market outcome is inequitable.

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Summary

- Productivity is the ultimate source of living standards.
- Money growth is the ultimate source of inflation.
- Society faces a short-run tradeoff between inflation and unemployment.

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