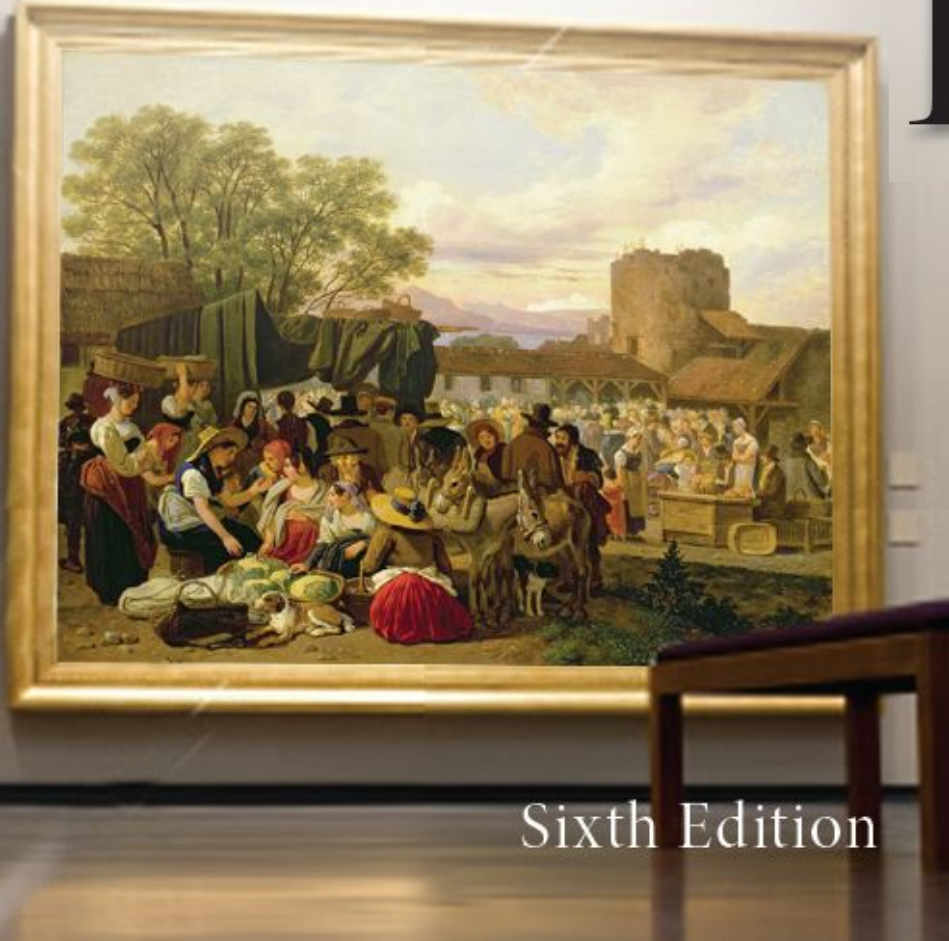


# N. Gregory Mankiw

## Principles of Economics



Sixth Edition

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# Ten Principles of Economics



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# Ten Principles of Economics

- **Economy – “oikonomos” (Greek)**
  - “One who manages a household”
- **Household - many decisions**
  - Allocate scarce resources
    - Ability, effort, and desire
- **Society - many decisions**
  - Allocate resources
  - Allocate output





# Ten Principles of Economics

- Resources are scarce
- Scarcity
  - The limited nature of society's resources
- Economics
  - Study of how society manages its scarce resources





# Ten Principles of Economics

- **Economists study:**
  - How people make decisions
  - How people interact with one another
  - Analyze forces and trends that affect the economy as a whole





# How People Make Decisions

## Principle 1: People face trade-offs

- **Making decisions**

- Trade off one goal against another
- Student – time
- Parents – income
- Society
  - National defense vs. consumer goods
  - Clean environment vs. high level of income
  - Efficiency vs. equality







# How People Make Decisions

- **Efficiency**

- Society getting the most it can from its scarce resources
- Size of the economic pie

- **Equality**

- Distributing economic prosperity uniformly among the members of society
- How the pie is divided into individual slices





# How People Make Decisions

Principle 2: The cost of something is what you give up to get it

- **People face trade-offs**
  - Make decisions
    - Compare cost with benefits of alternatives
- **Opportunity cost**
  - Whatever must be given up to obtain one item







# How People Make Decisions

## Principle 3: Rational people think at the margin

- **Rational people**
  - Systematically & purposefully do the best they can to achieve their objectives
- **Marginal changes**
  - Small incremental adjustments to a plan of action





# How People Make Decisions

- **Marginal benefits**
  - Additional benefits
- **Marginal costs**
  - Additional costs
- **Rational decision maker**
  - Take action only if:
  - $\text{Marginal benefits} > \text{Marginal costs}$





# How People Make Decisions

## Principle 4: People respond to incentives

- **Incentive**

- Something that induces a person to act
- Higher price
  - Buyers - consume less
  - Sellers - produce more
- Public policy
  - Change costs or benefits
  - Change people's behavior



- 2005 to 2008, price of oil in world oil markets skyrocketed
  - Limited supplies
  - Surging demand from robust world growth
  - Price of gasoline in the United States rose from about \$2 to about \$4 a gallon

- Increased incentive to conserve gas
  - Smaller cars, scooters, bicycles, mass transit
  - Camels (India)
  - New, more fuel-efficient aircraft
    - Airbus A320 and Boeing 737
  - Moving near an Amtrak station
  - Online courses
  - Sean “Diddy” Combs - flying on commercial airlines



# How People Interact

## Principle 5: Trade can make everyone better off

- **Trade**
  - Allows each person to specialize in the activities he or she does best
  - Enjoy a greater variety of goods and services at lower cost



# How People Interact

Principle 6: Markets are usually a good way to organize economic activity

- **Communist countries – central planning**
  - Government officials (central planners)
    - Allocate economy's scarce resources
      - What goods & services were produced
      - How much was produced
      - Who produced & consumed these goods & services







# How People Interact

- **Market economy - allocates resources**
  - Through decentralized decisions of many firms and households
  - As they interact in markets for goods and services
  - Guided by prices and self interest



# How People Interact

- Adam Smith's "invisible hand"
  - Households and firms interacting in markets
    - Act as if they are guided by an "invisible hand"
    - Leads them to desirable market outcomes
  - Corollary: Government intervention
    - Prevents the invisible hand's ability to coordinate the decisions of the households and firms that make up the economy



# How People Interact

## Principle 7: Governments can sometimes improve market outcomes

- **We need government**
  - Enforce rules and maintain institutions
    - Enforce property rights
  - Promote efficiency
    - Avoid market failure
  - Promote equality
    - Avoid disparities in economic wellbeing





# How People Interact

- **Property rights**
  - Ability of an individual to own and exercise control over scarce resources
- **Market failure**
  - Situation in which the market on its own fails to produce an efficient allocation of resources





# How People Interact

- Causes for market failure
- Externality
  - Impact of one person's actions on the well-being of a bystander
- Market power
  - Ability of a single economic actor (or small group of actors) to have a substantial influence on market prices





# How People Interact

- **Disparities in economic wellbeing**
  - Market economy rewards people
    - According to their ability to produce things that other people are willing to pay for
  - Government intervention: Public policies
    - May diminish inequality
    - Process far from perfect





# How the Economy as a Whole Works

Principle 8: A country's standard of living depends on its ability to produce goods and services

- Large differences in living standards
  - Among countries
  - Over time
- Explanation: differences in productivity





# How the Economy as a Whole Works

- **Productivity**

- Quantity of goods and services produced from each unit of labor input
- Higher productivity
  - Higher standard of living
- Growth rate of nation's productivity
  - Determines growth rate of its average income



# How the Economy as a Whole Works

## Principle 9: Prices rise when the government prints too much money

- **Inflation**

- An increase in the overall level of prices in the economy

- **Causes for large / persistent inflation**

- Growth in quantity of money

- Value of money falls



# How the Economy as a Whole Works

## Principle 10: Society faces a short-run trade-off between inflation and unemployment

- **Short-run effects of monetary injections:**
  - Stimulates the overall level of spending
    - Higher demand for goods and services
  - Firms – raise prices; hire more workers; produce more goods and services
  - Lower unemployment



# How the Economy as a Whole Works

- Short-run trade-off between unemployment and inflation
  - Key role – analysis of business cycle
- Business cycle
  - Fluctuations in economic activity
    - Employment
    - Production

# Table 1

## Ten Principles of Economics

### **How People Make Decisions**

- 1: People Face Trade-offs
- 2: The Cost of Something Is What You Give Up to Get It
- 3: Rational People Think at the Margin
- 4: People Respond to Incentives

### **How People Interact**

- 5: Trade Can Make Everyone Better Off
- 6: Markets Are Usually a Good Way to Organize Economic Activity
- 7: Governments Can Sometimes Improve Market Outcomes

### **How the Economy as a Whole Works**

- 8: A Country's Standard of Living Depends on Its Ability to Produce Goods and Services
- 9: Prices Rise When the Government Prints Too Much Money
- 10: Society Faces a Short-Run Trade-off between Inflation and Unemployment