Wojciech Gerson (1831-1901)

CHAPTER 1

Ten Principles of Economics

N. Gregory Nankiw

- Born February 3, 1958, married, 3 children.
- A.B., summa cum laude in economics, Princeton University, 1980. (22)
- Ph.D., Department of Economics, M.I.T., 1984. (26)

- Council of Economic Advisers, Staff Economist, 1982-1983. (24)
- Massachusetts Institute of Technology, Instructor, 1984-1985. (26)
- Harvard University, Assistant Professor, 1985-1987. (27)
- Council of Economic Advisers, Chairman, 2003-2005. (45)
- Harvard University, Professor of Economics, 1987-present. (29)

What Economics Is All About

- **( )**: the limited nature of society's resources
- **( )**: the study of how society manages its scarce resources, e.g.
  - how people decide what to buy, how much to work, save, and spend
  - how firms decide how much to produce, how many workers to hire
  - how society decides how to divide its resources between national defense, consumer goods, protecting the environment, and other needs

The principles of HOW PEOPLE MAKE DECISIONS

©lithian/Shutterstock.com

PRINCIPLE 1

People Face ( )

All decisions involve tradeoffs. Examples:

- Going to a party the night before your midterm leaves less time for studying.
- Having more money to buy stuff requires working longer hours, which leaves less time for leisure.
- Protecting the environment requires resources that could otherwise be used to produce consumer goods.

PRINCIPLE 1

People Face Tradeoffs

- Society faces an important tradeoff:
  efficiency vs. equality
- **(   )**: when society gets the most from its scarce resources
- **(   )**: when prosperity is distributed uniformly among society's members
- Tradeoff: To achieve greater equality, could redistribute income from wealthy to poor. But this reduces incentive to work and produce, shrinks the size of the economic "pie."

6

PRINCIPLE 2

The Cost of Something Is What You Give Up to Get It

- Making decisions requires comparing the costs and benefits of alternative choices.
- The (   ) of any item is whatever must be given up to obtain it.
- It is the relevant cost for decision making.

7

PRINCIPLE 2

The Cost of Something Is What You Give Up to Get It

Examples:

The opportunity cost of…

…going to college for a year is not just the tuition, books, and fees, but also the foregone wages.

…seeing a movie is not just the price of the ticket, but the value of the time you spend in the theater.

8

PRINCIPLE 3

Rational People Think at the Margin

(   )

- systematically and purposefully do the best they can to achieve their objectives.
- make decisions by evaluating costs and benefits of **marginal changes**, incremental adjustments to an existing plan.

9

PRINCIPLE 3

Rational People Think at the Margin

Examples:

- When a student considers whether to go to college for an additional year, he compares the fees & foregone wages to the extra income he could earn with the extra year of education.
- When a manager considers whether to increase output, she compares the cost of the needed labor and materials to the extra revenue.

10

PRINCIPLE 4

People Respond to Incentives

- **(   )**: something that induces a person to act, i.e. the prospect of a reward or punishment.
- Rational people respond to incentives.

  Examples:
  - When gas prices rise, consumers buy more hybrid cars and fewer gas guzzling SUVs.
  - When cigarette taxes increase, teen smoking falls.

11

The principles of HOW PEOPLE INTERACT

PRINCIPLE 5
Trade Can Make Everyone Better Off

- Rather than being self-sufficient, people can specialize in producing one good or service and exchange it for other goods.
- Countries also benefit from trade and specialization:
  - Get a better price abroad for goods they produce
  - Buy other goods more cheaply from abroad than could be produced at home

PRINCIPLE 6
Markets Are Usually A Good Way to Organize Economic Activity

- **(   )**: a group of buyers and sellers (need not be in a single location)
- “Organize economic activity” means determining
  - <u>what</u> goods to produce
  - <u>how</u> to produce them
  - <u>how much</u> of each to produce
  - <u>who</u> gets them

PRINCIPLE 6
Markets Are Usually A Good Way to Organize Economic Activity

- A **market economy** allocates resources through the decentralized decisions of many households and firms as they interact in markets.
- Famous insight by Adam Smith in *The Wealth of Nations* (1776):

  Each of these households and firms acts as if “led by **an invisible hand**” to promote general economic well-being.

PRINCIPLE 6
Markets Are Usually A Good Way to Organize Economic Activity

- The invisible hand works through the price system:
  - The interaction of buyers and sellers determines prices.
  - Each price reflects the good’s value to buyers and the cost of producing the good.
  - Prices guide self-interested households and firms to make decisions that, in many cases, maximize society’s economic well-being.

PRINCIPLE 7
Governments Can Sometimes Improve Market Outcomes

- Important role for govt: **enforce property rights** (with police, courts)
- People are less inclined to work, produce, invest, or purchase if large risk of their property being stolen.

PRINCIPLE 7
Governments Can Sometimes Improve Market Outcomes

- **( ):** when the market fails to allocate society's resources efficiently
- Causes of market failure:
  - **( )**, when the production or consumption of a good affects bystanders (e.g. pollution)
  - **( )**, a single buyer or seller has substantial influence on market price (e.g. monopoly)
- Public policy may **promote efficiency**.

18

PRINCIPLE 7
Governments Can Sometimes Improve Market Outcomes

- Govt may alter market outcome to **promote equity**.
- If the market's distribution of economic well-being is not desirable, tax or welfare policies can change how the economic "pie" is divided.

19

The principles of
HOW THE ECONOMY AS A WHOLE WORKS


©nopporn/Shutterstock.com

PRINCIPLE 8
A Country's Standard of Living Depends on Its Ability to Produce Goods & Services

- Huge variation in living standards across countries and over time:
  - Average income in rich countries is more than ten times average income in poor countries.
  - The U.S. standard of living today is about eight times larger than 100 years ago.

21

PRINCIPLE 8
A Country's Standard of Living Depends on Its Ability to Produce Goods & Services

- The most important determinant of living standards: **productivity**, the amount of goods and services produced per unit of labor.
- Productivity depends on the equipment, skills, and technology available to workers.
- Other factors (e.g., labor unions, competition from abroad) have far less impact on living standards.

22

PRINCIPLE 9
Prices Rise When the Government Prints Too Much Money

- **Inflation**: increases in the general level of prices.
- In the long run, inflation is almost always caused by excessive growth in the quantity of money, which causes the value of money to fall.
- The faster the govt creates money, the greater the inflation rate.

23

PRINCIPLE 10

Society Faces a Short-run Tradeoff Between Inflation and Unemployment

- In the short-run (1–2 years),
  many economic policies push inflation and unemployment in opposite directions.
- Other factors can make this tradeoff more or less favorable, but the tradeoff is always present.