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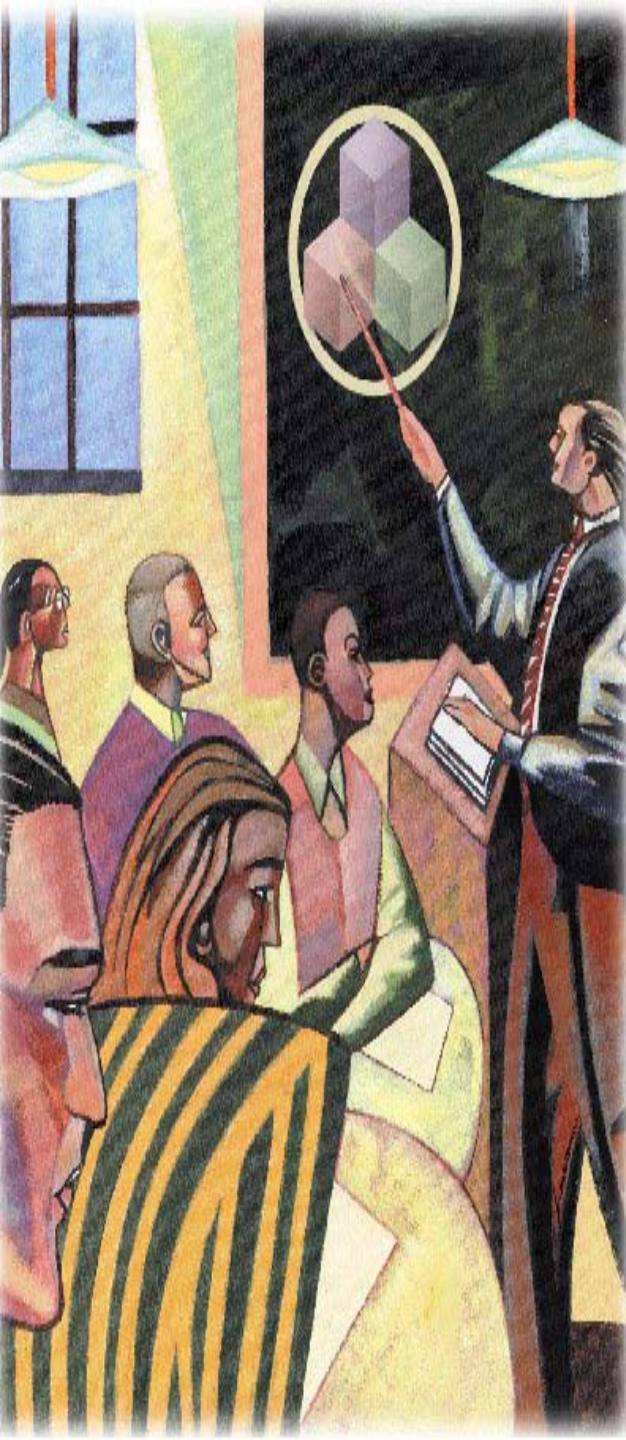
# **Principles of Economics**

**Second Edition**

**by**

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# Ten Principles of Economics

## Chapter 1

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# Economists study. . .

- ◆ *How people make decisions.*
- ◆ *How people interact with each other.*
- ◆ *The forces and trends that affect the economy as a whole.*

# Ten Principles of Economics

## How People Make Decisions

- ① People face tradeoffs.
- 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.

# Ten Principles of Economics

## 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 economic outcomes.

# Ten Principles of Economics

## How the Economy as a Whole Works

- ⑧ The standard of living depends on a country's production.
- ⑨ Prices rise when the government prints too much money.
- ⑩ Society faces a short-run tradeoff between inflation and unemployment.

# 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.**

# 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.

## **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?**

### 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*.

## 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!**

## 4. People respond to incentives.



**LA Laker basketball star Kobe Bryant chose to skip college and go straight to the NBA from high school when offered a \$10 million contract.**

# **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.**

## 6. Markets are usually a good way to organize economic activity.

- ◆ In a market economy, households decide what to buy and who to work for.
- ◆ Firms decide who to hire and what to produce.

## 6. Markets are usually a good way to organize economic activity.

- ◆ 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.

# **7. Governments can sometimes improve market outcomes.**

**When the market fails (breaks down) government can intervene to promote **efficiency** and **equity**.**

# 7. Governments can sometimes improve market outcomes.

**Market failure occurs when the market fails to allocate resources efficiently.**

# 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.

# 7. Governments can sometimes improve market outcomes.

Market failure may also be caused by market power, which is the ability of a single person or firm to unduly influence market prices.

# 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.**

## 8. The standard of living depends on a country's production.

**Productivity** is the amount of goods and services produced from each hour of a worker's time.

***Higher productivity ⇒ Higher standard of living***

# 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.

# 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!

# Summary

- ◆ **When individuals make decisions, they face tradeoffs.**
- ◆ **Rational people make decisions by comparing marginal costs and marginal benefits.**

# Summary

- ◆ **People can benefit by trading with each other.**
- ◆ **Markets are usually a good way of coordinating trades.**
- ◆ **Government can potentially improve market outcomes.**

# Summary

- ◆ **A country's productivity determines its living standards.**
- ◆ **Society faces a short-run tradeoff between inflation and unemployment.**