Chapter 1

Introduction of Micro economics

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:
  - Marginal benefits > 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

The Incentive Effects of Gasoline Prices

- 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

The Incentive Effects of Gasoline Prices

- 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

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
  - 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