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*In this chapter,
look for the answers to these questions:*

- What kinds of questions does economics address?
- What are the principles of how people make decisions?
- What are the principles of how people interact?
- What are the principles of how the economy as a whole works?

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What Economics Is All About

§ **Scarcity:**

§ **Economics:**

- § 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

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The principles of
**HOW PEOPLE
MAKE DECISIONS**



PRINCIPLE #1:
People Face Tradeoffs

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.

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PRINCIPLE #1:
People Face Tradeoffs

§ Society faces an important tradeoff:
efficiency vs. equality

§ **Efficiency:**

§ **Equality:**

§ Tradeoff:

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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 **opportunity cost** of any item is

- § It is the relevant cost for decision making.

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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

 - ...seeing a movie

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PRINCIPLE #3:
Rational People Think at the Margin

Rational people

§

- § make decisions by evaluating costs and benefits of **marginal changes**,

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PRINCIPLE #3:

Rational People Think at the Margin

Examples:

§ When a student considers whether to go to college for an additional year, he compares

§ When a manager considers whether to increase output, she compares

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PRINCIPLE #4:

People Respond to Incentives

§ **Incentive:**

§ 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.

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ACTIVE LEARNING 1

Applying the principles

You are selling your 1996 Mustang. You have already spent \$1000 on repairs.

At the last minute, the transmission dies. You can pay \$600 to have it repaired, or sell the car "as is."

In each of the following scenarios, should you have the transmission repaired? Explain.

- A. Blue book value (what you could get for the car) is \$6500 if transmission works, \$5700 if it doesn't
- B. Blue book value is \$6000 if transmission works, \$5500 if it doesn't

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:

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

§ **Market:**

§ “Organize economic activity” means

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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

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

- § The invisible hand
 - § The interaction of buyers and sellers determines prices.
 - § Each price reflects
- § Prices guide self-interested households and firms to make decisions that, in many cases, maximize society's economic well-being.

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PRINCIPLE #7:
Governments Can Sometimes Improve Market Outcomes

- § Important role for govt:
- § People are less inclined to work, produce, invest, or purchase if large risk of their property being stolen.

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PRINCIPLE #7:
**Governments Can Sometimes
Improve Market Outcomes**

§ **Market failure:**

§ Causes of market failure:

§ **Externalities**

§ **Market power**

§ Public policy may

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PRINCIPLE #7:
**Governments Can Sometimes
Improve Market Outcomes**

§ Govt may alter market outcome to

§ If the market's distribution of economic well-being
is not desirable,

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ACTIVE LEARNING **2**
Discussion Question

In each of the following situations, what is the government's role? Does the government's intervention improve the outcome?

- a. Public schools for K-12
- b. Workplace safety regulations
- c. Public highways
- d. Patent laws, which allow drug companies to charge high prices for life-saving drugs

The principles of
**HOW THE
ECONOMY
AS A WHOLE
WORKS**



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

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- § 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.

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

§ The most important determinant of living standards: **productivity**

§ Productivity depends on

§ Other factors (e.g., labor unions, competition from abroad) have far less impact on living standards.

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

§ **Inflation:**

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

§ In the short-run (1–2 years),

§ Other factors can make this tradeoff more or less favorable, but the tradeoff is always present.

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FYI: How to Read Your Textbook

1. Read before class.
You'll get more out of class.
2. Summarize, don't highlight.
Highlighting is a passive activity that won't improve your comprehension or retention. Instead, summarize each section in your own words. Then, compare your summary to the one at the end of the chapter.

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FYI: How to Read Your Textbook

3. Test yourself.

Try the “Quick Quiz” that follows each section before moving on to the next section. Write your answers down, compare them to the answers in the back of the book. If your answers are incorrect, review the section before moving on.

4. Practice, practice, practice.

Work through the end-of-chapter review questions and problems. They are often good practice for the exams. And the more you use your new knowledge, the more solid it will become.

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FYI: How to Read Your Textbook

5. Go online.

The book comes with excellent web resources, including practice quizzes, tools to strengthen your graphing skills, helpful video clips, and other resources to help you learn the textbook material more easily and effectively. Visit:
<http://academic.cengage.com/economics/mankiw>

6. Study in groups.

Get together with a few classmates to review each chapter, quiz each other, and help each other understand the material.

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FYI: How to Read Your Textbook

7. Teach someone.

The best way to learn something is to teach it to someone else, such as a study partner or friend.

8. Don't skip the real world examples.

Read the Case Studies and “In The News” boxes in each chapter. They will help you see how the new terms, concepts, models, and graphs apply to the real world. As you read the newspaper or watch the evening news, see if you can find the connections with what you're learning in the textbook.

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