Basic Principles of Microeconomics

Mini-lecture # 2

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Outline

Contents

1 Micro vs. Macroeconomics

1.1 Fields of Economics

Microeconomics A definition

The study of how households and firms make decisions and interact in markets.

Macroeconomics A definition

The study of how economy wide phenomena including inflation, unemployment and economic growth.

2 Principles of Micro

- Chapter 1 in Mankiw introduces 10 principles of economics.
- This mini-lecture briefly mentions the ones relevant to this course.
- How to use this section?
  - As a roadmap to the main ideas.
  - Come back and re-read the section at the end of the course.

2.1 Principle 1

People face trade-offs

- "there's no such thing as a free lunch"
- All decisions involve a *trade-off*: listening to this mini-lecture instead of being at the beach.
- Part of thinking like an economist is recognizing these trade-offs.

2.2 Principle 2

Opportunity Cost

- *Opportunity Cost*: the cost of something is what you give up to get it.
- Example: calling in sick to go on a friend's yacht.
- The key to sound decision making is recognizing *opportunity cost*.

2.3 Principle 3

People think at the margin

- Definition: a *marginal* change is a small incremental adjustment to a plan or action.
- Only take an action if the *marginal benefit* $>$ *marginal cost*.
- Example: A hotel with an empty room. What is the minimum price to accept?

2.4 Principle 4

People respond to incentives

- Definition: *incentive* is something that induces people to act.
- Markets work through *incentives*: if price $\uparrow$ then buy less of a good.
- Government policies have *incentives*, sometimes unintended.
- Example: performance-based pay for professional athletes.

2.5 Principle 5

Trade can make everyone better off.

- *Trade* allows people or countries to *specialize* and consume/produce more.
- Example: think of all the things you wouldn't have if there was no specialization.

2.6 Principle 6

Markets are usually a good way to organize economic activity

- Definition: a *market* economy is one that *allocates* resources through the decentralized decisions of many firms and households as they *interact in markets* for goods and services.
- A key point of this course: the *best outcome* usually occurs when prices and self-interest direct individuals and firms.

2.7 Principle 7

Sometimes governments can improve market outcomes

- Markets sometimes fail.
- Example: pollution.