

“Ten Principles” of Economics: Intro

One Approach to Some of the Core
Concepts in Economic Analysis

Ten Principles of Economics

Summary

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

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 Tradeoff between Inflation and Unemployment

Ten Principles of Economics

Summary

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

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 Tradeoff between Inflation and Unemployment

Principle 1: People Face Trade-Offs

- **Fundamental Problem of Economics**
- **Scarcity** Exists
 - Limits
 - Constraints
- **Decisions** Must be Made
 - **Choices**
 - **Trade Offs**
- **Goods & Services**
 - **Provide Satisfaction**
 - **"Utility"**
- **Do It Right**
 - **It Can Work Out OK**



London School of Economics Student, and
geriatric rocker, Mick Jagger

- "I can't get no...
...satisfaction..."
- "You can't always get what
you want..."
- "But if you try sometimes
...you just might find... you
get what you need"

Principle 1: People Face Trade-Offs

- Economics is Study of:
 - Procedures & Institutions
 - Answering Basic Questions
 - **WHAT ?**
 - **HOW ?**
 - **FOR WHOM ?**
- That is:
 - Dealing with Scarcity
 - Making Choices

Principle 2: The Cost of Something is What You Give Up to Get It

- The Difficult Part of Trade-Offs
- **Opportunity Cost**
 - A Reflection of Trade Offs
 - A Measure of Costs
 - Cost of What is Given Up...Next Best Alternative
- Cost of EMBA?
 - Family
 - Work
 - Leisure
 - Sanity

Principle 3:

Rational People Think at the Margin

- **Rational People:**
 - Systematic & Purposeful Behavior
 - Do the Best They Can to Achieve Objectives
- **“Decision Making at the Margin”**
 - Small Adjustments to a Plan of Action
 - Marginal = Extra; Additional; Incremental
 - Evaluate Marginal Benefits vs. Marginal Costs
- **Rational Decision Maker = Take Action Only If:**
 - **Marginal Benefits > Marginal Costs**

Principle 3:

Rational People Think at the Margin

- **General Approach in Econ:**
 - Who is Decision Maker?
 - What Does He/She Give Up & Get?
 - Cash vs. NonCash
 - Psychic Benefits/Costs
- **Observing “Irrational” Behavior?**
 - Check Individual Level Incentive (MB vs. MC)
 - Consider Informational or Other Limitations
 - Acknowledge Quirks of Individual Human Behavior

Principle 4: People Respond to Incentives

- **Market Signals → Price Signals**
 - Price Matters; Price Increase Means:
 - Buyers - Consume Less
 - Sellers - Produce More
- **Public Policy → Affect Marg. Benefits/Costs**
 - Gasoline/Carbon Tax; Cigarette Tax
 - Fuel Efficiency Standards
 - Mortgage & Business Interest Deductibility
 - Tax Credits & Subsidies
- **Aside: Unintended Consequences**
 - Failure to Consider How Policies Affect Incentives
 - Second Round of Responses

Principle 5:

Trade Can Make Everyone Better Off

- “Mutual Gains from Exchange”
- Trade: Voluntary Exchange → Mutual Benefits
 - Marginal Benefits > Marginal Costs: Agree
 - Marginal Benefits < Marginal Costs: Refuse
- Exchange Among Individuals, Groups, Countries
 - **Specialization**: Focus on What Each Does “Best”
 - Total Productivity Increases: More Available
 - Net Gains (Increases) Split Among Participants

Principle 6: Markets Usually a Good Way to Organize Economic Activity

- **Market Economy Organization**:
 - Decentralized: Diffuse Bits of Information
 - Individual Decision Makers: Firms/ Households
- **General Procedures**:
 - Interaction in Markets Produces Market Signals
 - Self Interested Behavior in Response to Prices
 - Competition Constrains Self Interested Behavior
- **Outcome**:
 - Resources Allocated Efficiently
 - Marginal Benefits Matched Against Marginal Costs
 - Adam Smith’s “Invisible Hand”

Principle 7: Governments Can Sometimes Improve Market Outcomes

- What is The Proper Role of Government?
- **Set & Maintain Ground Rules**
 - Establish Laws/Courts; Specify Property Rights
- **Be A Buyer or Provider of Goods**
 - Private Goods
 - Public Goods
- **Fix "Market Failures"**
 - Lack of Competition
 - "Externalities" or "3rd Party Effects"
 - Alter Resource Allocation; Improve Efficiency

Principle 7: Governments Can Sometimes Improve Market Outcomes

- Some Roles More Controversial
- **Redistribution of Income?**
 - Improve “Equity” or “Fairness”
- **Promote Economic Stability?**
 - Dampen Business Cycle
 - Promote Price Stability & “Full” Employment

Principle 8: Standard of Living Depends on Ability to Produce Goods & Services

- Large differences in living standards
 - Among countries
 - Over time
- Explanation: Differences in **Productivity**
- **Higher Productivity = Higher Standard of Living**
- Growth Rate of Nation’s Productivity
 - Determines Growth Rate of Its Average Income
- Productivity
 - Quantity of Goods & Services Produced from Each Unit of Labor Input

Principle 9: Prices Rise When the Government Prints Too Much Money

- **Link Between Money Supply & Inflation**
- Inflation: Broad Based Price Increases
 - Rise in: “General Price Level” - “Overall Price Level”
- **Inflation: Decline in Value of Money**
 - Purchasing Power of Money Falls
 - “Money Doesn’t Buy What it Used to”
- **Must be Connection Between:**
 - Inflation (Decline in Value of Money)
 - Money Supply (Amount Available)
 - Money Demand

Principle 9: Prices Rise When the Government Prints Too Much Money

- Milton Friedman--Famous "Monetarist"
 - "Inflation is always & everywhere a monetary phenomenon."
 - Inflation is "Too Much Money... Chasing Too Few Goods."
- Logic:
 - Money Exchanged for Goods
 - How Much Money Does It Take:
 - Given An Amount of Goods
 - People Offer Money for Goods
 - More Money Available → More Offered
 - Prices Bid Up

Principle 10: The Short-Run Trade-Off Between Inflation & Unemployment

- The "Phillips Curve"
- Short-Run Effects of Monetary Injections:
 - More in Peoples' Hands → More Spending
 - Higher Demand for Goods & Services
 - Firms Hire More; Produce More; Raise Prices
- Short-Run Trade-Off:
 - Hiring Increases → Unemployment Falls
 - Prices Rise → Inflation Increases
- A Concern: Only a Temporary Effect?
 - Depends on Expectations
 - Eventually Everyone Comes to Anticipate
 - Tends to Neutralize Effect

Ten Principles of Economics: Summary

Mostly Micro

How People Make Decisions	#1: People Face Tradeoffs	Scarcity Exists
	#2: The Cost of Something Is What You Give Up to Get It	Opportunity Cost
	#3: Rational People Think at the Margin	MB = MC
	#4: People Respond to Incentives	Laws of Supply/Demand
How People Interact	#5: Trade Can Make Everyone Better Off	Mutual Gains from Exchange
	"Nice Outcome"	#6: Markets Are Usually a Good Way to Organize Economic Activity
	Constrained Self Interest	#7: Governments Can Sometimes Improve Market Outcomes
How the Economy as a Whole Works	"Market Failures"	#8: A Country's Standard of Living Depends on Its Ability to Produce Goods and Services
		Production → Goods → Satisfaction/Utility
Truly "Macro"	"Too Much Money..."	#9: Prices Rise When the Government Prints Too Much Money
	"Phillips Curve"	#10: Society Faces a Short-Run Tradeoff between Inflation and Unemployment
