

Ten Principles of Economics and How Economists Think

Principles of Micro Lecture 1

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Feb. 2016

Unlimited Wants Vs. Limited Resources

Can you have everything you want?

Unlimited Wants Vs. Limited Resources

Can you have everything you want?

- **Scarcity**: limited resources

Unlimited Wants Vs. Limited Resources

Can you have everything you want?

- **Scarcity**: limited resources

⇒ the need to make choices.

Economics: the intuitive way to see what economists do

A study of the *reasons* people, firms and governments make their **choices** with the limited resources they have and of the *consequences* of those choices.

What is Economics?

Economics: the textbook way

A study of the production, exchange and consumption of goods and services, and of the distribution of income received from production and exchange. More generally, Economics is the study of how society manages its scarce resources.

Economics: the professional way

A study of the economy by using economic *models*.

- theoretical models: use maths or intuition to predict patterns of behavior → build *hypotheses*
- empirical models: test these hypotheses by using data

Ten Principles of Economics

How people make decisions?

- 1 People face **trade-offs**: Food Vs. clothing; Leisure vs. Work (Facebook vs. studying)
- 2 The cost of something is what you give up to get it: How many new friends will I never make (at the disco) by spending an hour of studying? → **opportunity costs**
- 3 Rational people think **at the margin** (taking into account small, marginal, changes): Does it make sense to spend an *additional* hour of biking/swimming?
- 4 People respond to **incentives**: if 1 hr. of studying increases my grade by 5 pts., then I will spend more time studying (especially before exams)

Ten Principles of Economics

How people interact?

- 5 Trade makes everyone better-off: you **specialize** in what you do best
→ you make more per hour → you produce cheaper → compete with others.
- 6 Markets are usually a good way to organize economic activity: because of **prices** → a guide for action/inaction. When everyone does what is best for themselves, the society improves welfare (as a whole).
- 7 Governments can sometimes improve economic outcomes: sometimes markets fail and government action is needed. Typical market failures:
 - negative **externality**: what's best for you harms others
 - **market power**: e.g., monopoly

Ten Principles of Economics

How the economy as a whole works?

- 8 The **standard of living** depends on a country's **productivity**: how much the average person produces per hour?
- 9 Prices rise when the government/central bank prints too much money: **inflation**
- 10 Society faces a short-run trade-off between inflation and unemployment: $I \uparrow \Leftrightarrow U \downarrow$

How Economics Works?

What are the models economists use?

When modeling the world, economists:

- 1 use **abstraction** from the real world: we refrain from irrelevant stuff to be able to better predict human action based on the relevant information. Example: your grade does not depend on the color of your shoes
- 2 make **assumptions** about agents: agents care about one or two most important things. Example: consumers care about consumption and leisure; firms care about profits
- 3 design **experiments**: how consumers spend income
- 4 work with large **data**: e.g. “big data” \Rightarrow abstraction, assumptions, experiments and data help us understand the world better.

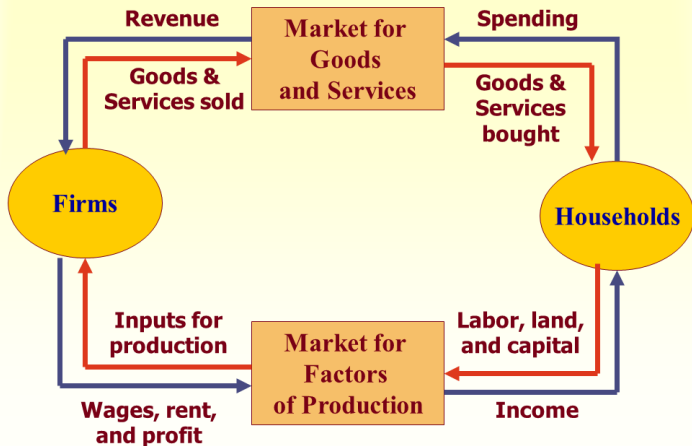
Two basic models:

- The Circular Flow Model
- The Production Possibilities Frontier (PPF)

The Circular Flow Model

A graphical illustration

The Circular-Flow Diagram



The Circular Flow Model

Who and What to Whom and Where?

Who and What?

- ① Households: buy and consume products, own **production factors**
- ② Firms: produce and sell products, hire production factors

To/From Whom and Where?

- ① The **goods markets**: HH buy, F sell
- ② The **factor markets**: HH sell, F buy

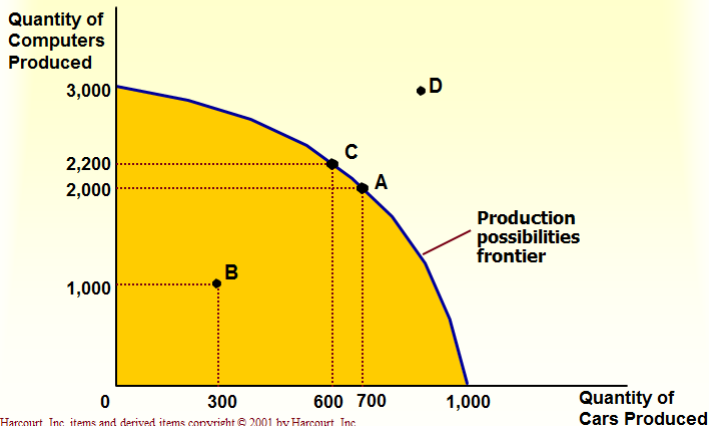
What are the production factors:

- ① Inputs into the production process to make final products possible.
- ② Examples?

The Production Possibility Frontier

A graphical illustration

The Production Possibilities Frontier



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The PPF

Importance

It shows you:

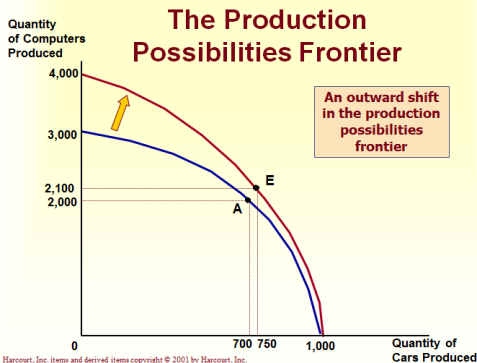
- ① Trade-offs in an economy, household or an individual
- ② Opportunity costs
- ③ Efficiency
- ④ Growth and increase in productivity

The PPF

Importance

It shows you:

- 1 Trade-offs in an economy, household or an individual
- 2 Opportunity costs
- 3 Efficiency
- 4 Growth and increase in productivity



Where do economists work?

Wide career choices

After an economists graduates:

- ① academia: teachers, researchers
- ② business: manufacturing, and consultancies
- ③ government: policy makers
- ④ central banks: research departments
- ⑤ non-government organizations: policy advice and lobbying
- ⑥ international organizations: research
- ⑦ private companies: entrepreneurs

More career options in this AEA video: <https://vimeo.com/135871291>

Further reading

Reading:

M-T, Chapters 1,2: pp.1-40.

Do not miss:

economist.com; wsj.com; the economic news on TV