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**QNO.1:- Ten Principles of economics.**

**ANS:-1). People face trade-offs:**

The first of the Ten Principles of Economics laid down by N. Gregory Mankiw is “People Face Trade-Offs”. Principles of Macroeconomics, 6th Ed. 2012, p. 4. In language more suited to a high school textbook than a best-selling college textbook, he provides several examples. If you study economics for five hours, then you can’t spend that time studying something useful, like welding or English Literature. If parents have a certain amount of money, every dollar they spend on rent can’t be saved, or used to buy food. Then, as if society were a person, and faced trade-offs in exactly the same way (government is just like a household) he gives two macro examples. 1st

 **For Example: -** The more a society spends on national defense (guns) to protect its shores from foreign aggressors, the less it can spend on consumer goods (butter) to raise the standard of living at home.

There is also a trade-off between a clean environment and a high level of income. If companies have to pay for environmental contamination, they make smaller profits, pay lower wages, or raise prices or some combination. This is the last example:

 **For Example: -** Another trade-off society faces is between efficiency and equality. Efficiency means that society is getting the maximum benefits from its scarce resources. Equality means that those benefits are distributed uniformly among society’s members. Emphasis in original

The statement that individuals face trade-offs in consumption of goods and services as well as every other human activity is vacuously true. We get one life, and at any point in time can only do one thing. If we do one thing we cannot do another. So what’s the point of this principle? I think it’s not the principle itself, but the examples. Each supports the principles of neoliberalism, as described by Philip Mirowski in this article.

One of the goals of neoliberalism, Mirowski’s Number 5, is to change the idea of democracy from one of participation by citizens in determination of social policy to one of consuming state services, like defense. Guns v. butter show how that notion gets into people’s heads. Given the level of corruption in the system, in the broad sense of Zephyr Teach out in her excellent book, Corruption in America, it’s also an example of crony capitalism, part of Number 8. There’s a lot more to unpack in the guns and butter example, but let’s move on.

The environmental example is fascinating. From the very beginning of this country, companies polluted lakes, rivers and the air, to keep costs low and prices down. No one did anything. Then when citizens started complaining about their ability to breathe the air and drink the water, and the rich people and their corporations act all outraged, like they have a right to pollute. Mankiw ignores this history, and ignores the obvious fact that dumping pollutants everywhere hurts everyone in general, and some people dramatically; and profits only a few. Again, the entire issue of pollution and environmental destruction would make fascinating case studies in economics. Mankiw’s discussion supports Mirowski number 10: Thou Shalt Not Blame Monopolies and Corporations.

Finally, there is the trade-off between equality and efficiency. Mankiw’s explanation about the negative effects of a progressive income tax on economic efficiency is flatly wrong. For my explanation, see this and this and this. For a short view, does Mankiw think the economy in the 50s was less efficient strictly because of high income and estate taxes on the rich? I’d love to see a paper showing how that happened. Pickett and Seas suggest a top tax rate of 80%. Here’s a short article explaining their thinking, and here’s an impenetrable paper that lies below it.

**2).The cost of something is what you give up to get it:**

Mankiw’s second principle is The Cost of Something Is What You Give up To Get It. Mankiw explains that you have to include opportunity costs in your calculations. His example is college: the actual cost of going to college includes tuition, but not necessarily all of the costs of room and board, because you need food and a place to sleep whether or not you go to college. It also includes the money you didn’t earn by going to work instead of going to college.

Before I read Mankiw’s explanation, I thought we were going to get a discussion of the way an economist might calculate costs. That was not to be. Maybe I have to buy his Principles of Microeconomics. In the express language Mankiw chooses, you are the sole standard for calculating costs. That kind of calculation fits perfectly with the neoliberal canon of Philip Mirowski. Its part of Number 6: Thou Shalt Become the Manager of Thyself for sure, and it complements Number 3: Thou Salt Worship “Spontaneous Order”, meaning the market.

Again, non-specialist students will likely remember the principle, and will repeat it mindlessly when talking about value and cost, even though this discussion doesn’t include value or even price. This is a license to ignore all the costs that are not visited upon the neoliberal you. Smoking may not make you sick, but smoking makes some people sick directly and others indirectly. The neoliberal you hopefully doesn’t pay those costs, so they aren’t included in the calculations of the neoliberal you. Computers have a number of components that are dangerous to the health of people. Those costs aren’t paid by the neoliberal you, so they aren’t included in the calculation of costs. Coal burning is a major contributor to climate change, but maybe those costs won’t be paid by the neoliberal you, so they don’t count.

Well, perhaps that wasn’t Mankiw’s intent. He does discuss externalities as something government can correct maybe, sometimes, after a fashion, and at a cost to efficiency. The notion of opportunity costs arises directly from Principle 1: People Face Trade-offs. Most likely the only point of the second principle is to make sure there a nice round ten.

**3).Rational people think at the margin:-**

Mankiw’s third principle: Rational People Think at the Margin. His definition is:

He defines marginal change: a small incremental adjustment to a plan of action. He teaches that rational people often compare the results of marginal changes to make decisions. Finally we get to his major premise.

The first example is dinner. The choice, Mankiw says, is not between fasting and eating like a pig, but whether to eat another spoonful of mashed potatoes. At exam time, the choice is not blowing them off versus pulling all-nighters, but whether to put in an hour on your notes or goof off for that hour. His next example is seat prices for airplanes. The airline should sell seats at the price above the marginal cost of flying the passenger. Then we get the water/diamonds example. Water is essential for life, but it’s cheap. Diamonds are an extravagance, but they are very expensive.

All of this is in support of a central element of neoliberal and mainstream economics, that economies can be modeled by treating them as made up of rational agents. This idea fits neatly into Mirowski’s commandments of neoliberalism, specifically number 6: Thou Salt Become the Manager of Thyself. This means that individuals must learn to act rationally to decide upon a set of investments in themselves and changes in their behavior that will improve your appeal to people with money so they will give you money to work for them.

The food example is straight-forward enough, but how is the choice made? Some people are raised to clean their plates, and they do even if they could have skipped the last few forkfuls. Some people feel differently about meat than about French fries or carrots. Some people are abstemious, and always leave food. Others make the choice at the outset, by serving themselves a fixed amount and then eating all of it. Suppose the person would prefer to eat the last few bites of pork chop and skip dessert? If all these are rational choices for individuals, what possible generalization about eating is there? What, if anything, can this principle predict? How would Mankiw use that idea to model eating dinner?

The study example is fascinating. I remember my college days, and I ‘m sure I didn’t rationally choose whether to goof off with my friends or to study for finals. I chose, but it was random. And how would you calculate the benefit of one hour of study versus one hour of relaxing? Is that a real possibility?

The airline example is obvious to anyone familiar with basic business principles. It certainly isn’t an indication of “rationality” in the sense Mankiw is using the term. It merely requires an understanding of the difference between fixed costs and variable costs.

This analysis shows that the margin plays little or no role in the lives of ordinary humans. It’s just a construct used to simplify human life in a way that permits economists to justify their use of calculus.

Here are some possible conclusions:

1. This principle makes sense when considered in the very short run, like the mashed potatoes example. For any longer term, it feels more or less random, mostly because there is no way to determine the probabilities. Some people get lucky and win the game of life. Others don’t get lucky. The number of things that seem perfectly rational at a point in time either work, or they don’t, and the results are unpredictable. That accords with my understanding of markets as minute by minute affairs. In the longer run, investment and housing markets are a real threat to the marginal thinking of Mankiw’s rational people.

2. We all want to think we are pursuing their goals systematically and purposefully, Mankiw’s definition of rational people. We want to believe our success is the result of their personal skill, and many people apparently feel justified in looking down on, and even punishing, the losers. I’d say the reality is that it’s better to be lucky than rational.

2. By deciding that the economy is full of rational people, the door opens to armchair speculation. Hmmm, says Mankiw, if I were faced with a bowl of mashed potatoes, here’s how I’d decide how much to take. I’m rational, so that means everyone would act that way. So, I’ll model mashed potato eating based on purely rational me. In exactly the same way, they figure out how they prepare for retirement, and draw conclusions about the way rational people act and build that into their models. No.

3. I do not think this is the definitive discussion of the role of rationality in human decision making. The entire subject of rational agents has been subjected to criticism on philosophical and practical grounds, and I hope to get to it at some point.

**4).** **People respond to incentives:-**

The Fourth Principle of Economics, which N. Gregory Mankiw assures us, is accepted by almost all economists are: People Respond to Incentives. This is obviously true, so it’s good that almost all economists agree. Neoliberals agree as well; it’s the basis of their understanding of human nature that people respond to money, and not much else.

Here are the examples. When the price of apples goes up, people buy fewer apples, and “…apple orchard owners decide to hire more workers and harvest more apples.” Supply and demand are the direct result of incentives. Taxes can be used as incentives. If the gasoline tax goes up, people drive smaller cars, switch to public transport and buy hybrids. If the price goes high enough, they might even switch to electric cars. Incentives can have unintended consequences. Seat belt laws led to a higher number of accidents, and more accidents involving pedestrians. There are two longer examples, one on changes resulting from the gas price hikes from 2005 to 2008, and one on the way bus drivers are paid in Chile.

It’s no doubt true that generally as prices rise, the amount purchased falls. It’s probably the case that the relationship isn’t continuous. People don’t watch the price of apples at all. When they are at the store or the market to buy they don’t say to themselves “prices are up a penny a pound, so I’ll just buy a bit less.” Instead, they compare apples to other fruits and even vegetables and as long as the prices seem about right, they buy. It takes a pretty good price jump furor people to notice the exact price per pound. On the other hand, maybe people think Fuji’s are about as good as Gala’s, so if one is cheaper, they buy them. Or if one set looks tastier for some reason, they buy those.

The idea that the orchard owners harvest more or less depending on the price seems equally inadequate. Of course, once harvest season is over, there won’t be any more harvesting, so all decisions have to be made during the short season when the apples are at the proper stage of ripeness. If owners think the prices will be higher, maybe they will harvest more. Or, maybe they harvest all they can to protect the trees and the fields, and only sell if the price is right, and feed the rest to the cows. I don’t know enough about running an orchard to have an opinion, but apparently Mankiw does.

The second example, gasoline taxes, supports the idea that demand can be manipulated by society for its own good. I don’t think that was Mankiw’s point though. We return to this idea in Principle 8.

The discussion of seat belt changes shows typical short-term thinking. Assuming that the study Mankiw cites is accurate, and I note he describes it as controversial, in the short term, people acted in a more risky way after the passage of seat belt laws. Here’s a chart from the Statistical Abstract produced by the Census Bureau in 2012 with more recent statistics.

Those statistics tell a different story. They say that the incentive created by one set of changes can be changed once the actual outcomes are known. Cars have become more and more safe, and with the recognition that some of the changes produced bad driving, people were able to find ways of making cars safer in ways that defeated the original incentives.

You’ll note that the deaths of pedestrians were down, too, but that doesn’t tell us much. The number of pedestrians overall may be down.

Finally we have the bus driver example in Chile. It comes from Austan Goolsbee, and explains that drivers paid by the passenger work harder than drivers paid by the hour, including taking the shortest routes between two points when there is a lot of traffic. It doesn’t tell us anything about the response of bus riders who don’t get picked up, one of other people trying to drive on the same streets as racing bus drivers.

So, everyone agrees that people respond to incentives. The question is how people respond to incentives. Mankiw tells us that economists are social scientists, and their field is centered on understanding human behavior. If these examples are typical of economic thinking, the understanding of behavior is rudimentary and reductive. It’s fair to assume that models built on rudimentary and reductive ideas may produce strange and untrustworthy results.

**5).** **Trade can make everyone better off:-**

Mankiw’s fifth principle is: Trade Can Make Everyone Better Off. He says that that my family competes with other families for jobs, and when we shop, we compete with others to find the best prices. But if we cut ourselves off from the market, we would have to grow our own food, make our own clothes, and build our own houses. “Trade allows each person to specialize at what he or she does best, whether it’s farming, sewing, or home building.” In the same way, nations can specialize in what they do best. In both cases, people get a wider range of choices at lower prices.

It’s obvious that there are too many humans for us to exist on this planet without the kind of trade Mankiw is talking about. There isn’t enough arable land to support the huge number of tiny farms we would need to set this up, even if we wanted to, and I don’t think that’s what people want. And the way

Mankiw explains it, it all seems so natural, probably because we’ve been hearing it all our lives. Everyone knows people like to trade for things. Our most ancient ancestors traveled to trade goods, and to party and marry across groups. Codification of this idea goes back at least as far as Adam Smith.

As long as you have lots of money and better things to do, that makes sense. If you have spare time and the means, why not grow your own food and make your own cloth, and save your money for things you can’t make? I assume that was the case for many Britons of Smith’s day. As a maxim, I assume it has much older roots. It’s easy to see why people who live in Whit by, England are specialists in making jet jewelry: the jet there is perhaps the finest in the world, and people have been working it into jewelry for centuries. In the same way, it’s easy to understand that a small town in 18th C. England is better off with a professional blacksmith than with a forge in every home.

People in India have been making beautiful cotton textiles for centuries, as I learned from Empire of Cotton by Sven Becker. Those textiles were shipped around the world for most of recorded history, until what Beckert calls War Capitalism began to take control of it in the 17th Century. For a very brief discussion of the role of cotton in Gandhi’s India, see this.

What we now know is that owners of capital decide where investments are made. With low transportation costs globally, capitalists are able to locate businesses anywhere. The point is that when specialization reaches a certain level, the role of the craftsman comes to a bitter end, replaced by selling fast food or tending children. This is precisely what happened with cotton. Rich merchants stopped importing finished goods, and stopped using independent weavers in distant parts of the world, and built plants with capital intensive machines in Northern England. The price of cotton textiles went down, but millions of India’s workers lost their incomes, and millions of Africans were sold into slavery to raise cheap cotton for shipment to England. Trade didn’t make them better off.

Of course, it happens all the time. One excellent example is aircraft manufacture. Boeing’s principle resource was once its amazing workers, especially its engineers and assembly line workers in northwestern Washington. But its executives wanted the big bucks, so when it came time to build the Dream liner, they broke that system to replace those skilled workers with cheaper unskilled labor all around the world, and increased their own salaries. Then the entire system broke down. Here’s a timeline of the known failures of the Dream liner. Currently, Boeing estimates it is losing $23.2 million on each sold aircraft. Much of this can be blamed on stupid management decisions about production. Boeing CEO James McInerny got about $29 million in 2014 compensation, and the chief of commercial aircraft, Ray Connor, got $16 million. This is payment for abject failure. I guess they benefited from trade.

Maybe that’s why Mankiw’s fifth principle is couched in such weak language. Here’s a better statement: trade can make some people better off, especially if we ignore all the people it makes worse off.

We also see how beautifully this principle supports Mirowski’s Eighth Commandment of Neoliberalism: Thou Shalt Keep Thy Cronyism Cosmopolitan, which teaches the importance of free flows of capital. The capital needed to make aircraft and textiles can be sent wherever labor is cheapest, including South Carolina. That’s neoliberal freedom. You will recall that most of the British assault on India was led by the East India Trading Company, an early corporation. These stories tell us that Mankiw’s fifth principle works well with Mirowski’s Tenth Commandment: Thou Shalt Not Blame Monopolies and Corporations. They are simply not responsible for any of the misery their trade policies hurt. And finally, see how Smith’s maxim works with the average person’s understanding of economics, that what is good for the household is good for the nation.

**6).** **Markets are usually a good way to organize economic activity:-**

Mankiw’s sixth principle of economics is: Markets are usually a Good Way to Organize Economic Activity. There are six paragraphs of explanation. About half say that central planning as in Communist Russia doesn’t work, culminating with this.

Mankiw says that in a market economy, the decisions of a central planner are replaced by decisions of millions of market participants. Firms decide what and how much to make, and households decide where to work and what to buy. It is wonderful how this system is so successful at “organizing economic activity to promote overall economic well-being.” The magic is prices.

As a result of the decisions that buyers and sellers make, market prices reflect both the value of a good to society and the cost to society of making the good.

But, when government interferes with the market and prevents prices from adjusting to supply and demand, disaster awaits. Thus, taxes “adversely affect the allocation of resources, for they distort prices and thus the decisions of households and firms.”

Mankiw doesn’t define the terms market, or marketplace. That fits perfectly with Mirowski’s Second Commandment of Neoliberalism: Thou Shalt Erase Distinctions. Here is his discussion in full.

While neoliberals do not define market, they assert that it is perfect, as Mirowski’s Third Commandment says: Thou Shalt Worship “Spontaneous Order”. Neoliberals assert that markets are emergent phenomena, and are inevitable and perfect. The theory of Natural Law is thus updated for the 21st Century with a metaphor from biology.

Just as Mirowski says, it is difficult to see what Mankiw means by market. There is nothing to be learned from his statement that the market economy consists of the decisions of millions of firms and households, not least because it ignores the decisions of hundreds of thousands of governmental units, controlling the spending of about 1/3 of the GDP. And it’s difficult to understand how the many thousands of rules that govern many thousands of markets can be translated into formal language, let alone into mathematical terms. Mankiw relies on a sort of collective understanding to provide sufficient clues that the average reader will know what he means, which is part of the problem. If the textbook doesn’t define things so that everyone is talking about the same thing, it is dangerous because people assume others agree with them when they don’t. The lack of a definition is a signal of sloppy thinking.

Mankiw gives us mushy statements like markets promote overall economic well-being. The only people who can participate in markets are those with money. The level of participation is directly related to how much money one has. The fact is that markets cater to people with lots of money, those who can

Buy whatever they want. When resources or goods are actually scarce, markets allocate them to those with money. When there is plenty, markets can serve those with less money. But markets will never do anything for poor people.

I’m stunned by the nonchalant statement that households decide where to work. I’m equally stunned by the idea that taxes distort markets because they affect spending decisions. It goes with his forgetting to mention government as a market participant. If we didn’t have taxes, that would distort markets too, because people would have to buy protection and roads and a lot more.

If, as Manikw claims, markets measure the value of goods to society, then the values of goods to society are determined by the rich. Markets do not include all the costs of production and therefore that part of Mankiw’s statement is false, assuming it meant anything measurable.

**7).** **Governments can sometimes improve market outcomes:-**

Mankiw’s Seventh Principle of Economics is: Governments Can Sometimes Improve Market Outcomes. Mankiw says economics will refine the view of the student on the role of government. In Mankiw’s book, government has several acceptable roles:

1. Enforcement of property rights. It is imperative that scarce resources are owned by individuals and firms. Government enforces the rules and protects the institutions that support these property rights. If the rights of creators of products are not protected, people won’t make things. “The invisible hand counts on our ability to enforce our rights.”

2. Government intervention is allowed to achieve greater efficiency or greater equality.

The first point fits squarely with Mirowski’s commandments of neoliberalism. The Fourth Commandment is: Thou Shalt Ret asks the State to Thy Needs. The function of the strong state is to make sure that the neoliberal program can come into existence; it must, as we learn from the First Commandment, be constructed, it will not happen without force and socially acceptable forms of violence. This is accomplished by using the state too marketwise everything, and by ensuring that scarce resources are put into the hands of the wealthy and secured to them. The rest of us become forced customers of private entities, health insurance companies, policing, and education. Can water be far behind? Care to buy your water from Comcast?

As an aside, privatized education really bothers me. We’ve learned that the Educational Testing Service has rewritten the guidelines for AP History to cut back on what wing nuts call negativity and the rest of us call reality, and to focus on US exceptionalism. The ETS is a private corporation. Its Chairman is Robert Morley, who is also the CEO of Apollo Education Group, Inc., which operates Phoenix University. His only interest is making money. The idea that he is a scholar is preposterous. But he sets the standards for many of our smart kids, the lucky ones in schools that have AP classes.

The second allowable activity of government is to achieve greater efficiency. This entails dealing with market failures or with externalities. Neither of these is an allowable function of government in a truly neoliberal society. Markets cannot fail in neoliberalism, as Mirowski explains in Commandment 3, Thou Shalt Worship “Spontaneous Order”. More important, market power is not a problem for neoliberals, as we learn in Commandment 10, Thou Shalt Not Blame Monopolies and Corporations. The idea that a government might intervene to reduce inequality is anathema to neoliberals. Mirowski explains this in his Ninth Commandment: Thou Shalt Know That Inequality is Natural.

For Mankiw, at least theoretically, government is allowed to legislate on externalities and market power. Sadly, all externalities can be litigated indefinitely. Between the courts and flaccid enforcement, antitrust law has been ignored for years. As to inequality, Mankiw tells us that markets reward those who produce things other people want to buy, which is closely related to his Principle Number 8. Markets, he admits, won’t make sure everyone has food, clothing, health care, shelter, or anything else. “This inequality may, depending on one’s political philosophy, call for government intervention.” That might mean welfare, progressive income taxation or other programs. Then we get a full paragraph explaining the problems of using government for these purposes, including this gem: “Sometimes policies are designed simply to reward the politically powerful.”

In my discussion of Principle 6 (markets are usually a good way to organize economic activity) I pointed out that Mankiw ignores the enormous amount of buying done by governments at every level, which in Mankiw’s language probably confuses the Invisible Hand. Similarly, in his discussion of Principle 7, Mankiw ignores the role of government in establishing the rules related to markets, and in enforcing a minimal level of anti-fraud rules. This role of government obviously improves market outcomes, unless the rules are “designed to reward the politically powerful.” I assume he doesn’t mention this crucial role of government in the economy because it would show that markets are a construction, not a given and that would be one too many deviations from neoliberal dogma.

That markets are constructed is most obvious in the area of “intellectual property”, a term that probably came into wide use in the late 1940s. Essentially, the people behind this term want to marketwise intellectual activity, making it an article of commerce rather than a commons.

Several years ago, the group decided to rewrite the section of the Uniform Commercial Code governing security interests, which is the technical term for liens on personal property. The purported problem was that compliance with the requirements of Article 9 was so complex that bank paperwork occasionally didn’t comply. In Chapter 7 cases, the Bankruptcy Trustee is allowed to set aside a defective security interest, and sell the property for the benefit of unsecured creditors. Trustees are paid a small percentage of the funds raised, which encourages them to inspect the paperwork carefully. The idea was to amend the rules so that close enough was good enough... The actual people getting screwed were unsecured creditors. A decent government would have insisted on participation by all relevant groups in the drafting of these changes, which violently upset the original balance between secured and unsecured creditors that once was the hallmark of the UCC.

That’s the kind of institution Mankiw wants the government to protect. Oh, and ALEC.

**8).** **A country's standard of living depends on its ability to produce goods and services:-**

Mankiw’s eighth principle of economics is: a country’s standard of living depends on its ability to produce goods and services. He points out that there are vast differences between the average incomes of different countries. In the US, average income has increased about 2% per year adjusted for increases in the cost of living, he says, and doubles about every 35 years. The explanation for this change is productivity, defined as “the amount of goods and services produced from each unit of labor time.” The growth rate of a nation’s productivity determines the growth rate of its average income, he asserts. He dismisses other explanations, such as the prevalence of labor unions and minimum wage laws. He claims that US productivity dropped in the 1970s which accounts for the slow growth of average wages over that period. He concludes with this claim.

To boost living standards, policymakers need to raise productivity by ensuring that workers are well-educated, have the tools needed to produce goods and services, and have access to the best available technology.

Mankiw’s explanation is intellectually dishonest. He only talks about average incomes, not median incomes, and not the incomes of the working people of the US. That enables him to paint a false picture of the economy, and of the role of productivity in increasing standards of living. The leading work on this issue was done by Larry Michel at the Economic Policy Institute. His April 2012 paper, The Wedges between Productivity and Median Compensation Growth is the seminal work on this issue. Here’s an updated chart showing the disparity between wages and productivity. For a discussion of the productivity measurement, see this 2014 Bureau of Labor Statistics paper. It’s important to note that Michel is using the median wage growth for production/non-supervisory workers, not total labor compensation. With this statistic, we look at the actual experience of approximately 80% of workers.

According to Michel, the gap in the chart from 2000 to 2011 is the result of three factors (see Table 1):

1. Income inequality increased, with the great gains going to the top few percentiles and the rest stagnant or falling, accounting for 39% of the gap.

2. Income shifted from labor to capital, accounting for 45% of the gap.

3. Output prices diverged from consumer prices, accounting for 16% of the gap.

Mankiw doesn’t acknowledge the problems with his principle, problems which have been evident for a long time as the chart shows. The source of this principle is the neoclassical argument of William Stanley Jevons and John Bates Clark which I discuss in detail here and here. Mankiw is preaching from the Natural Law Bible without mentioning it. This is a perfect example of Keynes’ dismissive statement on these writers: “We have not read these authors; we should consider their arguments preposterous if they were to fall into our hands. “ Certainly this principle is preposterous both factually and theoretically.

**9).** **Prices rise when the government prints too much money:-**

Mankiw’s ninth principle of economics is: Prices Rise When the Government Prints Too Much Money. He describes hyperinflation in the Weimar Republic in Germany in the early 1920s. The US hasn’t experienced hyperinflation, but it has had problems with inflation, as in the 1970s. He says that inflation imposes costs on societies, so a goal of policymakers is to keep it under control. He tells us the cause of inflation:

In almost all cases of large or persistent inflation, the culprit is growth in the quantity of money. When a government creates large quantities of the nation’s money, the value of the money falls. … The high inflation of the 1970s was associated with rapid growth in the quantity of money, and the low inflation of more recent experience was associated with slow growth in the quantity of money.

As stated, this principle doesn’t sound quite right. In the US, at least, the government doesn’t print money, as we found out in the uproar over the Trillion Dollar Coin. That idea brought out the flying monkeys, shrieking that it would be wildly illegal for the Treasury to mint money other than small coins. According to Mankiw, in the US substantially all money is created by banks, as he explains in Chapters 16 and 17. He gives the standard description of fractional reserve banking. He explains that the Federal Reserve Board can add to bank reserves, thus creating the possibility of new loans that will create new money, or reduce reserves, reducing the ability of banks to create new money. These tools enable the Fed to control the money supply. He acknowledges that there are serious difficulties facing the Fed in exercising that control, but he claims it can be done as long as the Fed is “vigilant”. Chapter 16, page 339. With this explanation, it is not clear why Mankiw claims that government is responsible for inflation by printing too much money.

I’m also not sure what to make of Mankiw’s claim that the inflation of the 1970s was associated with a “rapid increase in the quantity of money.” Here’s a chart showing the growth of M2 for the period 1965 through 1985. It looks like it is rising, a bit faster after each recession (grey bars). It looks to me like the next chart, gross domestic product over the same period seasonally adjusted. Perhaps there is some other factor, or maybe I’m just reading this wrong

Here’s a chart of M2 from 2000 to the present. There is a noticeable increase in the rate of growth of the money supply in the immediate wake of the Great Crash, leveling off in March 2009. Starting about August 2010, the increase is again greater than in the pre-Crash years. These rapid increases in the money supply match up with the Fed’s Quantitative Easing programs. It has not, as many economists (not Mankiw) predicted, led to rapid inflation.

Mankiw’s phrasing, blaming the government for inflation because of its intervention with the operation of markets, fits nicely with Mirowski’s 10th Commandment: Thou Shalt Not Blame Corporations and Monopolies. It supports Mirowski’s Third Commandment, calling for full reliance on the marvelous market and making sure governments don’t interfere. We get a good look at this in a recent paper by Thomas Palley who has been writing about neoliberalism for some time, titled The US Economy: Explaining Stagnation and Why It Will Persist. Palley says that there are three explanations for the Great Crash.

1. The hardcore neoliberal explanation: it was all the fault of the government. Interest rates were forced too low for too long in the wake of the 2000 recession, interfering with the market for money. For purely political reasons, the government intervened in the housing market to encourage increased homeownership, leading to misallocation of scarce financial and other resources. This is the position of Peter Wallis one of the AEI, whose dissent from the Final Report of the Financial Crisis Inquiry Commission explains this view. It is not recommended reading.

2. The soft-core neoliberal explanation: it was the fault of government regulators. The regulators allowed excessive risk-taking by lenders and perverse incentive pay structures in the financial sector. They allowed deregulation to proceed too far. That enabled bad allocation of the flood of foreign savings into an overblown housing sector. When it popped, the resulting financial disorder deepened a structural business cycle recession into a near depression.

3. The Keynesian explanation: neoliberalism did us in. The explanation is that neoliberal policies destroyed the institutions and rules that kept corporate greed in check and made sure that the benefits of a growing economy were shared between capital and labor. In the end, consumer demand was crushed by inadequate wages. It slowed to the point that it could not drive economic growth as it had during the period 1950-75. As incomes dropped, debt rose, so that when the Great Recession hit, there was no demand left to drive a recovery. The cycle of jobless recoveries has come to the point that stagnation is the plausible future for the US economy.

Mankiw argues for neoliberal explanations and solutions and certainly not the Keynesian explanation or its solutions. For example, in October 2008, he wrote that the Great Depression was largely cured by monetary policy, and pointed to studies saying that New Deal legislation like the expansion of labor rights was counter-productive because it allowed labor power to interfere with market forces.

I don’t doubt that the quantity of money might have something to do with inflation in some cases. I’m not convinced that it explains either the inflation of the 1970s, the lack of inflation in recent times, or the current inflation in Russia.

**10).** **Society faces a short-run tradeoff between Inflation and unemployment:**

Mankiw’s tenth principle of economics is: Society faces a short-run trade-off between inflation and unemployment. He admits that this is more controversial among economists than his other principles. He says that most believe this explanation:

* Increasing the amount of money in the economy stimulates the overall level of spending and thus the demand for goods and services.
* Higher demand may over time cause firms to raise their prices, but in the meantime, it also encourages them to hire more workers and produce a larger quantity of goods and services.
* More hiring means lower unemployment.

This line of reasoning leads to one final economy-wide trade-off: a short-run trade-off between inflation and unemployment.

This gives economic policy-makers a tool for influencing economic trends. “By changing the amount of money it prints”, says Mankiw, government can put more or less money into the economy, and thus influence unemployment, at least in the short run. The Great Crash of 2008 is an example. Mankiw explains that it was caused by “bad bets on the housing market”, and led to high unemployment and lower incomes. The Obama administration responded with a stimulus package of spending and tax cuts and the Fed increased the amount of money in the economy, in an effort to reduce unemployment. He adds: “Some feared, however, that these policies might over time lead to an excessive level of inflation.”

This isn’t so much a principle in the sense of an axiom as it is a theorem, worked up from axioms. The source of the idea is a 1958 paper by William Phillips, showing an historical correlation between inflation and unemployment in the UK, and extended to US data by Paul Samuelson and Robert Solow. The correlation and the explanation worked together to persuade people that both the grounds of explanation and the relationship were more or less permanent features of the economy. The ideas behind the explanation are neoclassical, so the correlation served to validate those neoclassical ideas.

Recently the Wall Street Journal published an essay by Ben Leinsdorf discussing the current understanding of the Phillips Curve debate: The Fed Has a Theory. Trouble Is, the Proof Is Patchy. [Pay wall]. Jared Bernstein discusses it in this post and links to this New York Times post; both are worth reading to see just how unhinged we are from the simple explanation offered by Mankiw. This chart is from the WSJ article.

To read the chart, select an expansion, find the line in that color, and look for the circle, which is the beginning of the period. Then follow the line as it moves showing the changes in inflation (y-axis) and unemployment (x-axis). Here’s Leinsdorf’s explanation:

But the simple link between U.S. unemployment and inflation described by the Phillips curve appeared to break down after the 1960s. High inflation coexisted with high unemployment in the 1970s. In the 1990s, the jobless rate fell as price pressures weakened. Over the past three years, inflation has declined despite a falling jobless rate.

The gray vertical bars are recessions. The chart shows that as the labor share rises, we get a recession. The following chart shows bank prime rates.

As interest rates rise, we get recessions. With the exception of the recession that followed the Great Crash, it’s fair to say that all of these recessions were engineered by the Fed because of inflation or fear of inflation.

The implications are fascinating. Before the Great Crash, almost all US money was created by bank lending and credit expansion. Mankiw’s Principle No. 9 tells us that when too much money is created, we get inflation. The Phillips Curve tells the Fed it has to raise interest rates to stem inflation, and that it does so at the cost of putting people out of jobs. So, businesses lend and borrow too much, creating inflation or fear of inflation, and to solve the problem created by the failure of capitalists, the Fed makes sure only the working people pay the price, by losing their livelihoods, and lately, by watching their incomes stagnate or drop. And that is the outcome of applying Mankiw’s Principles of Economics: damaging workers to protect the rich.

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**QNO2. Thinking like an economist.**

Every field of study has its own language and its own way of thinking. Mathe- maticians talk about axioms, integrals, and vector spaces. Psychologists talk about ego, id, and cognitive dissonance. Lawyers talk about venue, torts, and promissory estoppe.

Economic forces are everywhere around you. You're made aware of that whenever you reach for your wallet, apply for a loan, shop for health care, or try to figure out the best credit card to carry. But that doesn't mean you need to passively accept whatever outcome those forces might press upon you. Instead, you can learn how to use a small handful of basic nuts-and-bolts principles to turn those same forces to your own advantage. $

Before delving into the substance and details of economics, it is helpful to have an overview of how economists approach the world. This chapter, therefore, dis- cusses the field’s methodology. What is distinctive about how economists confront a question? What does it mean to think like an economist?

**THE ECONOMIST AS SCIENTIST:**

Economists try to address their subject with a scientist’s objectivity. They approach the study of the economy in much the same way as a physicist approaches the study of matter and a biologist approaches the study of life: They devise theories, collect data, and then analyze these data in an attempt to verify or refute their theories.

It strikes me because what is appealing to me is that Economics is a field still under contention. When I was a kid in undergrad studying Chemistry, part of what was alienating was that most of the big questions had been answered, or so it seemed. To really understand the interactions of particles at these nano-scales you had to get into physics and then into probabilistic math — once you’re thinking of electrons as probability fields and not point particles, a lot of the simple models seem like child’s play even if they’re fairly accurate representations of how the world works.

Although Einstein’s comment is as true for social sciences such as economics as it is for natural sciences such as physics, most people are not accustomed to looking at society through the eyes of a scientist. Let’s therefore discuss some of the ways in which economists apply the logic of science to examine how an econ- omy works.

**THE SCIENTIFIC METHOD: OBSERVATION, THEORY, AND MORE OBSERVATION:**

Isaac Newton, the famous 17th-century scientist and mathematician, allegedly became intrigued one day when he saw an apple fall from a tree. This observation motivated Newton to develop a theory of gravity that applies not only to an apple falling to the earth but to any two objects in the universe. Subsequent testing of Newton’s theory has shown that it works well in many circumstances (although as Einstein would later emphasize, not in all circumstances). Because Newton’s theory has been so successful at explaining observation, it is still taught today in undergraduate physics courses around the world

This interplay between theory and observation also occurs in the field of economics. An economist might live in a country experiencing rapid increases in prices and be moved by this observation to develop a theory of inflation. The theory might assert that high inflation arises when the government pants too much money. (As you may recall, this was one of the Ten Principles of Economics in Chapter I.) To test this theory, the economist could collect and analyze data on prices and money from many different countries. If growth in the quantity of money were not at all related to the rate at which prices are nosing, the economist would start to doubt the validity of this theory of inflation. If money growth and inflation were strongly correlated in international data, as in fact they are, the economist would become more confident in the theory.

Although economists use theory and observation like other scientists, they do face an obstacle that makes their task especially challenging: Experiments are often difficult in economics. Physicists studying gravity can drop many objects in their laboratories to generate data to test their theories. By contrast, economists studying inflation are not allowed to manipulate a nation’s monetary policy simply to generate useful data. Economists, like astronomers and evolutionary biologists, usually have to make do with whatever data the world happens to give them.

To find a substitute for laboratory experiments, economists pay close attention to the natural experiments offered by history. When a war in the Middle East interrupts the flow of crude oil, for instance, oil prices skyrocket around the world. For consumers of oil and oil products, such an event depresses living standards. For economic policymakers, it poses a difficult choice about how best to respond. But for economic scientists, the event provides an Opportunity to study the effects of a key natural resource on the world’s economies, and this opportunity persists long after the wartime increase in oil prices is over. Throughout this book, therefore, we consider many historical episodes. These episodes are valuable to study because they give us insight into the economy of the past and more important because they allow us to illustrate and evaluate economic theories of the present.

**THE ROLE OF ASSUMPTIONS:**

If you ask a physicist how long it would take for marble to fall from the top of a ten-story buildings, she will answer the question by assuming that the marble falls in a vacuum. Of course this assumption is false. In fact, the building is surrounded by air, which exerts friction on the falling marble and slows it down. Yet the physicist will correctly point that friction on the marble is so small that its effect is negligible. Assuming the marble falls in a vacuum greatly simplifies the problem without substantially affecting the answer

Economists make assumptions for the same reason: Assumptions can simplify the complex world and make it easier to understand. To study the effects of international trade, for example, we may assume that the world consists of only two countries and that each country produces only two goods. Of course, the real world consists of dozens of countries, each of which produces thousands of different types of goods. But by assuming two countries and two goods, we can focus our thinking on the essence of the problem. Once we understand international trade in an imaginary world with two countries and two goods, we are in a better position to understand international trade in the complex world in which we live.

The art in scientific thinking whether in physics, biology or economics is deciding which assumptions to make. Suppose, for instance that we were dropping a beach ball rather than a marble from the top of the building. Our physicist would realize that the assumption of no friction is far less accurate in this case. Friction exerts a greater force on a beach ball than a marble because a beach ball is much larger. The assumption that gravity works in a vacuum is reasonable for studying a falling marble but not for studying a falling beach ball.

High school biology teachers teach basic anatomy with plastic replicas of the human body. These models have all the major organs: the heart, the liver, the kidneys, and so on. The models allow teachers to show their students in a simple way how the important parts of the body fit together. Of course, no one would mistake these plastic models for a real person. These models are stylized and they omit many details. Yet despite this lack of realism studying these models is useful for learning how the human body works.

All the models are built with assumptions to examine various economic issues. Just as a physicist begins the analysis of falling marble without the existence of friction, economists assume away many of the details of the economy that are irrelevant for studying the question at hand. All models in physics, biology and economies simplify reality in understanding of it.

**ECONOMIC MODELS:**

An economic model is a simplified version of reality that allows us to observe, understand, and make predictions about economic behavior. The purpose of a model is to take a complex, real-world situation and pare it down to the essentials. If designed well, a model can give the analyst a better understanding of the situation and any related problems.

A good model is simple enough to be understood while complex enough to capture key information. Sometimes economists use the term theory instead of model. Strictly speaking, a theory is a more abstract representation, while a model is a more applied or empirical representation. Often, models are used to test theories. In this course, however, we will use the terms interchangeably.

**OUR FIRST MODEL: THE CIRCULAR-FLOW DIAGRAM:**

The economy consists of millions of people engaged in many activities – buying selling, working, hiring manufacturing and so on. To understand how the economy works we must find some way to simplify out thinking about all these activities. In other words we need a model that explains in general terms, how the economy is organized and how participate in the economy interact with one another.

Figure presents a visual model of the economy called a circular flow diagram.

Figure

Firms: Produce and sell goods and services. Hire and Use factors of production

Markets for goods and services: Firm sell. Households

Households: Buy and consumer goods and services. Own and sell factors of production

Markets for factors of production: Households sell. Firms buy.

In this model, the economy is simplified to include only two types of decision makers – firms and households. Firms produce goods and services using inputs such as labor land and capital (buildings and machines). These inputs are called the factors of production. Households own the factors of production and consume all the goods and services that the firms produce.

The circular flow diagram is one simple model of the economy. It dispenses with details that, for some purposes are significant. A more complex and realistic circular flow model would include, for instance the roles of government and international trade. Yet these details are not crucial for a basic understanding of how the economy is organized. Because of its simplicity this circular flow diagram is useful to keep in mind when thinking about how the pieces of the economy fit together.

**OUR SECOND MODEL: THE PRODUCTION POSSIBILITIES FRONTIER:**

Most economic models, unlike the circular-flow diagram, are built using the tools of mathematics. Here we consider one of the simplest such models, called the production possibilities frontier, and see how this model illustrates some basic economic ideas.

Although real economies produce thousands of goods and services, let's imagine an economy that produces only two goods—cars and computers. Together the car industry and the computer industry use all of the economy's factors of production. The production possibilities frontier is a graph that shows the various combinations of output—in this case, cars and computers—that the economy can possibly produce given the available factors of production and the available production technology that firms can use to turn these factors into output.

Figure 2-2 is an example of a production possibilities frontier. In this economy, if all resources were used in the car industry, the economy would produce 1,000 cars and no computers. If all resources were used in the computer industry, the economy would produce 3,000 computers and no cars. The two end points of the production possibilities frontier represent these extreme possibilities. If the production possibilities frontier a graph that shows the combinations of output that the economy can possibly produce given the available factors of production and the available production technology

Quantity of Computers Produced

3,000

2,200 2,000

1,000

Quantity of Computers Produced

3,000

2,200 2,000

1,000

**MICROECONOMICS AND MACROECONOMICS:**

Economics is divided into two different categories: microeconomics and macroeconomics. Microeconomics is the study of individuals and business decisions, while macroeconomics looks at the decisions of countries and governments.

While these two branches of economics appear to be different, they are actually interdependent and complement one another. Many overlapping issues exist between the two fields.

**Microeconomics:**

Microeconomics is the study of decisions made by people and businesses regarding the allocation of resources and prices of goods and services. It also takes into account taxes, regulations, and government legislation.

Microeconomics focuses on supply and demand and other forces that determine the price levels in the economy. It takes what is referred to as a bottom-up approach to analyzing the economy. In other words, microeconomics tries to understand human choices, decisions, and the allocation of resources.

Having said that, microeconomics does not try to answer or explain what forces should take place in a market. Rather, it tries to explain what happens when there are changes in certain conditions.

For example, microeconomics examines how a company could maximize its production and capacity so that it could lower prices and better compete in its industry. A lot of microeconomic information can be gleaned from the financial statements.

Microeconomics involves several key principles including (but not limited to):

* **Demand, Supply, and Equilibrium**: Prices are determined by the theory of supply and demand. Under this theory, suppliers offer the same price demanded by consumers in a perfectly competitive market. This creates economic equilibrium.
* **Production Theory**: This principle is the study of how goods and services are created or manufactured.
* **Costs of Production**: According to this theory, the price of goods or services is determined by the cost of the resources used during production.
* **Labor Economics**: This principle looks at workers and employers, and tries to understand the pattern of wages, employment, and income.

**MACROECONOMICS:**

Macroeconomics is the study of economy- wide phenomena. A macroeconomist might study the effects of rent control on housing in New York City, the impact of foreign competition on the U.S. auto in- dusty, or the effects of compulsory school attendance on workers’ earnings. A

Macroeconomist might study the effects of borrowing by the federal government, the changes over time in the economy’s rate of unemployment, or alternative pole- ices to raise growth in national living standards. Microeconomics and macroeconomics are closely intertwined. Because changes in the overall economy arise from the decisions of millions of individuals, it is impossible to understand macroeconomic developments without considering the associated microeconomic decisions. For example, a macroeconomist might study the effect of a cut in the federal income tax on the overall production of goods and services. To analyze this issue, he or she must consider how the tax cut affects the decisions of households about how much to spend on goods and services.

**THE ECONOMIST AS POLICY ADVISER:**

Often economists are asked to explain the causes of economic events. Why, for ex- ample, is unemployment higher for teenagers than for older workers? Sometimes economists are asked to recommend policies to improve economic outcomes. What, for instance, should the government do to improve the economic well-being of teenagers? When economists are trying to explain the world, they are scientists. When they are trying to help improve it, they are policy advisers.

**POSITIVE VERSUS NORMATIVE ANALYSIS:**

While economics is largely an academic discipline, it is quite common for economists to act as business consultants, media analysts, and advisers on government policy. As a result, it's very important to understand when economists are making objective, evidence-based statements about how the world works and when they are making value judgments about what policies should be enacted or what business decisions should be made.

**Positive Analysis**

Descriptive, factual statements about the world are referred to as positive statements by economists. The term "positive" isn't used to imply that economists always convey good news, of course, and economists often make very, well, negative-positive statements. Positive analysis, accordingly, uses scientific principles to arrive at objective, testable conclusions.

**Normative Analysis**

On the other hand, economists refer to prescriptive, value-based statements as normative statements. Normative statements usually use factual evidence as support, but they are not by themselves factual. Instead, they incorporate the opinions and underlying morals and standards of those people making the statements. Normative analysis refers to the process of making recommendations about what action should be taken or taking a particular viewpoint on a topic

**ECONOMISTS IN WASHINGTON:**

President Harry Truman once said that he wanted to find a one-armed economist. When he asked his economists for advice, they always answered, “On the one hand. On the other hand.” Truman was right in realizing that economists’ advice is not always straight- forward. This tendency is rooted in one of the Ten Principles of Economics in Chap- tar 1: People face tradeoffs. Economists are aware that tradeoffs are involved in most policy decisions.

The ideas of economists and political philosophers, both when they are right and when they are wrong, are more powerful than is commonly understood. Indeed, the world is ruled by little else. Practical men, who believe themselves to be quite exempt from intellectual influences, are usually the slaves of some defunct economist. Madmen in authority, who hear voices in the air, are distilling their frenzy from some academic scribbler of a few years back.

**WHY ECONOMISTS DISAGREE:**

“If all economists were laid end to end, they would not reach a conclusion.” This quip from George Bernard Shaw is revealing. Economists as a group are often crit- icized for giving conflicting advice to policymakers. President Ronald Reagan once joked that if the game Trivial Pursuit were designed for economists, it would have 100 questions and 3,000 answers. Why do economists so often appear to give conflicting advice to policy- makers? There are two basic reasons:

* Economists may disagree about the validity of alternative positive theories about how the world works.
* Economists may have different values and, therefore, different normative views about what policy should try to accomplish.

Let’s discuss each of these reasons.

**DIFFERENCES IN SCIENTIFIC JUDGMENTS:**

Several centuries ago, astronomers debated whether the earth or the sun was at the center of the solar system. More recently, meteorologists have debated whether the earth is experiencing “global warming” and, if so, why. Science is a search for understanding about the world around us. It is not surprising that as the search continues, scientists can disagree about the direction in which truth lies. Economists often disagree for the same reason. Economics is a young science, and there is still much to be learned. Economists sometimes disagree because they have different hunches about the validity of alternative theories or about the size of important parameters. For example, economists disagree about whether the government should levy taxes based on a household’s income or its consumption (spending).

**DIFFERENCES IN VALUES:**

Suppose that Peter and Paul both take the same amount of water from the town well. To pay for maintaining the well, the town taxes its residents. Peter has in- come of $50,000 and is taxed $5,000, or 10 percent of his income. Paul has income of $10,000 and is taxed $2,000, or 20 percent of his income. Is this policy fair? If not, who pays too much and who pays too little? Does it matter whether Paul’s low income is due to a medical disability or to his decision to pursue a career in acting? Does it matter whether Peter’s high income is due to a large inheritance or to his willingness to work long hours at a dreary job? These are difficult questions on which people are likely to disagree. If the town hired two experts to study how the town should tax its residents to pay for the well, we would not be surprised if they offered conflicting advice.

**PERCEPTION VERSUS REALITY:**

Because of differences in scientific judgments and differences in values, some disagreement among economists is inevitable. Yet one should not over- state the amount of disagreement. In many cases, economists do offer a united view.

The second proposition in the table concerns tariffs and import quotas. For reasons we will discuss in Chapter 3 and more fully in Chapter 9, almost all econ- omits oppose such barriers to free trade. Nonetheless, over the years, the press- dent and Congress have chosen to restrict the import of certain goods. In 1993 the North American Free Trade Agreement (NAFTA), which reduced barriers to trade among the United States, Canada, and Mexico, passed Congress, but only by a narrow margin, despite overwhelming support from economists. In this case, economists did offer united advice, but many members of Congress chose to ignore it.

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**THE END**