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PRINCIPLES OF MICROECENOMICS

Following are the ten principles of microeconomics

1. PEOPLE FACE TRADE-OFF
2. THE COST OF SOMETHING IS WHAT YOU GIVE UP TO GET IT
3. RATIONAL PEOPLE THINK AT THE MARGIN
4. PEOPLE RESPOND TO INCENTI
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
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 TRADE-OFF BETWEEN INFLATION AND UNEMPLOYMENT

PRINCIPLE 1: PEOPLE FACE TRADE-OFFS

It means losing one quality or aspect of something in return for gaining another quality or aspect. It often implies a decision to be made with full comprehension of both the upside and downside of a particular choice; the term is also used in an evolutionary context, in which case the selection process acts as the "decision-maker"     The word" "People face tradeoffs” means ”There is no such thing as a free lunch!" or to get one thing, we usually have to give up another thing.

  For example,Like in eating junk food to taste the food of your friend you must trade first your food before you can trade of their food.

PRINCIPLE 2: THE COST OF SOMETHING IS WHAT YOU GIVE UP TO GET IT

Another point of the Ten principles of economics is that the cost of something is what you give up to get it. This is called the opportunity cost. The production possibilities frontier shows the opportunity cost of one good as measure in terms of the other good.Consider the decision to go to college. The main benefits are intellectual enrichment and a lifetime of better job opportunities. But what are the costs? To answer this question, you might be tempted to add up the money you spend on tuition, books, room, and board. Yet this total does not truly represent what you give up to spend a year in college. There are two problems with this calculation. First, it includes some things that are not really costs of going to college. Even if you quit school, you need a place to sleep and food to eat. Room and board are costs of going to college only to the extent that they are more expensive at college than elsewhere. Second, this calculation ignores the largest cost of going to college—your time. When you spend a year listening to lectures, reading textbooks, and writing papers, you cannot spend that time working at a job. For most students, the earnings given up to attend school are the largest single cost of their educationThe opportunity cost of an item is what you give up to get that item. When making any decision, decision makers should be aware of the opportunity costs efficiency the property of society getting the most it can from its scarce resources equality the property of distributing economic prosperity uniformly among the members of society opportunity cost whatever must be given up to obtain some item CHAPTER 1 TEN PRINCIPLES OF ECONOMICS 5 that accompany each possible action. In fact, they usually are. College athletes who can earn millions if they drop out of school and play professional sports are well aware that their opportunity cost of college is very high. It is not surprising that they often decide that the benefit is not worth the cost.

PRINCIPLE 3: RATIONAL PEOPLE THINK AT THE MARGIN

Many economics courses start with the principle that "rational people think at the margin". What this means is that people make decisions by calculating the additional (marginal) benefits and additional (marginal) costs of a decision. If the marginal benefits exceed the marginal costs, they take the action. If the marginal costs exceed the marginal benefits, you should not take the action. As you study economics, you will encounter firms that decide how many workers to hire and how much of their product to manufacture and sell to maximize profits. You will also encounter individuals who decide how much time to spend working and what goods and services to buy with the resulting income to achieve the highest possible level of satisfactionFor example, consider an airline deciding how much to charge passengers who fly standby. Suppose that flying a 200-seat plane across the United States costs the airline $100,000. In this case, the average cost of each seat is $100,000/200, which is $500. One might be tempted to conclude that the airline should never sell a ticket for less than $500. In fact, a rational airline can often find ways to raise its profits by thinking at the margin. Imagine that a plane is about to take off with ten empty seats, and a standby passenger waiting at the gate will pay $300 for a seat. Should the airline sell the ticket? Of course it should. If the plane has empty seats, the cost of adding one more passenger is tiny. Although the average cost of flying a passenger is $500, the marginal cost is merely the cost of the bag of peanuts and can of soda that the extra passenger will consume. As long as the standby passenger pays more than the marginal cost, selling the ticket is profitable

PRINCIPLE 4: PEOPLE RESPOND TO INCENTIVES

Incentive is something that induces a person to act by offering rewards to people who change their behaviorBecause rational people make decisions by comparing costs and benefits, they respond to incentives.Incentives may possess a negative or a positive intentionIncentives are crucial to analyzing how markets work. For example, when the price of an apple rises, people decide to eat fewer apples. At the same time, apple orchards decide to hire more workers and harvest more apples. In other words, a higher price in a market provides an incentive for buyers to consume less and an incentive for sellers to produce more. As we will see, the influence of prices on the behavior of consumers and producers is crucial for how a market economy allocates scarce resourcesWhen policymakers fail to consider how their policies affect incentives, they often end up with unintended consequences. For example, consider public policy regarding auto safety. Today, all cars have seat belts, but this was not true 50 years ago. In the 1960s, Ralph Nader’s book Unsafe at Any Speed generated much public concern over auto safety. Congress responded with laws requiring seat belts as standard equipment on new cars

PRINCIPLE 5: TRADE CAN MAKE EVERYONE BETTER OFF

When a member of your family looks for a job, he or she competes against members of other families who are looking for jobs. Families also compete against one another when they go shopping because each family wants to buy the best goods at the lowest prices. In a sense, each family in the economy is competing with all other families. Despite this competition, your family would not be better off isolating itself from all other families. If it did, your family would need to grow its own food, make its own clothes, and build its own home. Clearly, your family gains much from its ability to trade with others. Trade allows each person to specialize in the activities he or she does best, whether it is farming, sewing, or home building. By trading with others, people can buy a greater variety of goods and services at lower cost. Countries as well as families benefit from the ability to trade with one another. Trade allows countries to specialize in what they do best and to enjoy a greater variety of goods and services. The Japanese, as well as the French and the Egyptians and the Brazilians, are as much our partners in the world economy as they are our competitors.Yet it is easy to be misled when thinking about competition among countries. Trade between the United States and Japan is not like a sports contest in which one side wins and the other side loses. In fact, the opposite is true: Trade between two countries can make each country better off.

PRINCIPLE 6: MARKETS ARE USUALLY A GOOD WAY TO ORGANIZE ECONOMIC ACTIVITY

Markets are usually a good way to organize economic activity because the invisible hand leads markets to desirable outcomes. Governments can sometimes improve market outcomes because sometimes markets fail to allocate resources efficiently because of an externality or market power. Most countries that once had centrally planned economies have abandoned the system and are instead developing market economiesAs you study economics, you will learn that prices are the instrument with which the invisible hand directs economic activity. In any market, buyers look at the price when determining how much to demand, and sellers look at the price when deciding how much to supply. 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. Smith’s great insight was that prices adjust to guide these individual buyers and sellers to reach outcomes that, in many cases, maximize the well-being of society as a whole.In Communist countries, prices were not determined in the marketplace but were dictated by central planners. These planners lacked the necessary information about consumers’ tastes and producers’ costs, which in a market economy are reflected in prices. Central planners failed because they tried to run the economy with one hand tied behind their backs—the invisible hand of the marketplace.

PRINCIPLE 7: GOVERNMENTS CAN SOMETIMES IMPROVE MARKET OUTCOMES

Governments can sometimes improve market outcomes. A country's standard of living depends on its ability to produce goods and services. Prices rise when the government prints too much money. Society faces a short-run tradeoff between Inflation and unemployment.One reason we need government is that the invisible hand can work its magic only if the government enforces the rules and maintains the institutions that are key to a market economy. Most important, market economies need institutions to enforce property rights so individuals can own and control scarce resourcesYet there is another reason we need government: The invisible hand is powerful, but it is not omnipotent. There are two broad reasons for a government to intervene in the economy and change the allocation of resources that people would choose on their own: to promote efficiency or to promote equality. That is, most policies aim either to enlarge the economic pie or to change how the pie is divided.Now consider the goal of equality. Even when the invisible hand is yielding efficient outcomes, it can nonetheless leave sizable disparities in economic wellbeing. A market economy rewards people according to their ability to produce things that other people are willing to pay for. The world’s best basketball player earns more than the world’s best chess player simply because people are willing to pay more to watch basketball than chess. The invisible hand does not ensure that everyone has sufficient food, decent clothing, and adequate healthcare. This inequality may, depending on one’s political philosophy, call for government intervention. In practice, many public policies, such as the income tax and the welfare system, aim to achieve a more equal distribution of economic well-being.

PRINCIPLE 8: A COUNTRY’S STANDARD OF LIVING DEPENDS ON ITS ABILITY TO PRODUCE GOODS AND SERVICES

Productivity is important because a country's standard of living depends on its ability to produce goods and services. The greater a country's productivity (the amount of goods and services produced from each hour of a worker's time), the greater will be its standard of living.Changes in living standards over time are also large. In the United States, incomes have historically grown about 2 percent per year (after adjusting forchanges in the cost of living). At this rate, average income doubles every 35 years. Over the past century, average income has risen about eightfold.The fundamental relationship between productivity and living standards is simple, but its implications are far-reaching. If productivity is the primary determinant of living standards, other explanations must be of secondary importance. For example, it might be tempting to credit labor unions or minimum-wage laws for the rise in living standards of American workers over the past century. Yet the real hero of American workers is their rising productivity. As another example, some commentators have claimed that increased competition from Japan and other countries explained the slow growth in U.S. incomes during the 1970s and 1980s. Yet the real villain was not competition from abroad but flagging productivity growth in the United States.The relationship between productivity and living standards also has profound implications for public policy. When thinking about how any policy will affect living standards, the key question is how it will affect our ability to produce goods and services. 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.

PRINCIPLE 9: PRICES RISE WHEN THE GOVERNMENT PRINTS TOO MUCH MONEY

In January 1921, a daily newspaper in Germany cost 0.30 marks. Less than two years later, in November 1922, the same newspaper cost 70,000,000 marks. All other prices in the economy rose by similar amounts. This episode is one of history’s most spectacular examples of inflation, an increase in the overall level of prices in the economy. Although the United States has never experienced inflation even close to that in Germany in the 1920s, inflation has at times been an economic problem. During the 1970s, for instance, when the overall level of prices more than doubled, President Gerald Ford called inflation “public enemy number one.” By contrast, inflation in the first decade of the 21st century has run about 21⁄2 percent per year; at this rate, it would take almost 30 years for prices to double. Because high inflation imposes various costs on society, keeping inflation at a low level is a goal of economic policymakers around the world. What causes 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. In Germany in the early 1920s, when prices were on average tripling every month, the quantity of money was also tripling every month. Although less dramatic, the economic history of the United States points to a similar conclusion: The high inflation of the 1970s was associated with rapid growth in the quantity of money, and the lowinflation of more recent experience was associated with slow growth in the quantity of money

PRINCIPLE 10: SOCIETY FACES A SHORT-RUN TRADE-OFF BETWEEN INFLATION AND UNEMPLOYMENT

As unemployment rates increase, inflation decreases; as unemployment rates decrease, inflation increases. Short-Run Phillips Curve: The short-run Phillips curve shows that in the short-term there is a tradeoff between inflation and unemployment. ... As unemployment decreases to 1%, the inflation rate increases to 15%.Although a higher level of prices is, in the long run, the primary effect of increasing the quantity of money, the short-run story is more complex and controversial. Most economists describe the short-run effects of monetary injections as follows:

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.

Policymakers can exploit the short-run trade-off between inflation and unemployment using various policy instruments. By changing the amount that the government spends, the amount it taxes, and the amount of money it prints, policymakers can influence the overall demand for goods and services. Changes in demand in turn influence the combination of inflation and unemployment that the economy experiences in the short-run. Because these instruments of economic policy are potentially so powerful, how policymakers should use these instruments to control the economy, if at all, is a subject of continuing debate.

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Chapter 2 (thinking like economists)

SUMMARY.

• Economists try to address their subject with a scientist’s objectivity. Like all scientists, they make appropriate assumptions and build simplified models to understand the world around them. Two simple economic models are the circularflow diagram and the production possibilities frontier.

• The field of economics is divided into two subfields microeconomics and macroeconomics. Microeconomists study decision making by households and firms and the interaction among households and firms in the marketplace. Mac- roeconomists study the forces and trends that affect the economy as a whole.

A positive statement is an assertion about how the world is. A normative statement is an assertion about how the world ought to be. When economists make normative statements, they are acting more as policy advisers than as scientists.

• Economists who advise policymakers offer con flicting advice either because of differences in scientific judgments or because of differences in values. At other times, economists are united in the advice they offer, but policymakers may chose to ignor it.

Before delving into the substance and details of economics, it is helpful to have an overview of how economists approach the world.

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 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.

To beginners, it can seem odd to claim that economics is a science. After all, economists do not work with test tubes or telescopes. The essence of science, however, is the scientific method the dispassionate development and testing of theories about how the world works. This method of inquiry is as applicable to studying a nation’s economy as it is to studying the earth’s gravity or a species’ evolution. As Albert Einstein once put it, “The whole of science is nothing more than the refinement of everyday thinking.

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 discuss some of the ways in which economists apply the logic of science to examine how an economy 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 in under- graduate physics courses around the world.

This interplay between theory and observation also occurs in the field of eco- nomics. An economist might live in a country experiencing rapidly increasing prices and be moved by this observation to develop a theory of inflation. The the- ory might assert that high inflation arises when the government prints too much money. 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 rising, 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 face an obstacle that makes their task especially challenging: In economics, conduct- ing experiments is often difficult and sometimes impossible. 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 manipu- late 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 atten- tion 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.

Revenue

Goods

and services sold

MARKETS

FOR

GOODS AND SERVICES

• Firms sell

• Households buy

Spending

Goods and services bought

FIRMS

• Produce and sell

goods and services

• Hire and use factors

of production

HOUSEHOLDS

• Buy and consume

goods and services

• Own and sell factors

of production

Factors of production

Wages, rent, and profit

MARKETS

FOR

FACTORS OF PRODUCTION • Households sell

• Firms buy

Labor, land, and capital

Income

Flow of inputs and outputs

Flow of dollars

Most economic models unlike the circularflow diagram, are built using the tools of mathematics. Here we use one of the simplest such models called the production possibilities frontier to illustrate some basic economic ideas.

MICROECONOMICS.

the study of how house- holds and firms make decisions and how they interact in markets.

MACROECONOMIC.

the study of economy- wide phenomena, including inflation, unemployment, and economic growth

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 that measure how economic variables are related.

For example, economists disagree about whether the government should tax a household’s income or its consumption (spending). Advocates of a switch from the current income tax to a consumption tax believe that the change would encour- age households to save more because income that is saved would not be taxed.

DIFFERENCES IN VALUES.

Suppose that Peter and Paula both take the same amount of water from the town well. To pay for maintaining the well, the town taxes its residents. Peter has income of $50,000 and is taxed $5,000, or 10 percent of his income. Paula has income of $10,000 and is taxed $2,000, or 20 percent of her income.

Is this policy fair? If not, who pays too much and who pays too little? Does it matter whether Paula’s low income is due to a medical disability or to her decision.

PERCEPTION VERSUS REALITY.

Because of differences in scientific judgments and differences in values, some disagreement among economists is inevitable. Yet one should not overstate the amount of disagreement. Economists agree with one another far more than is sometimes understood.

Table 1 contains 14 propositions about economic policy. In surveys of profes- sional economists, these propositions were endorsed by an overwhelming major- ity of respondents. Most of these propositions would fail to command a similar consensus among the public