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Principles of Economics

Sixth Edition

2

Thinking Like an Economist



*Premium PowerPoint
Slides by
Ron Cronovich*

Our First Model:

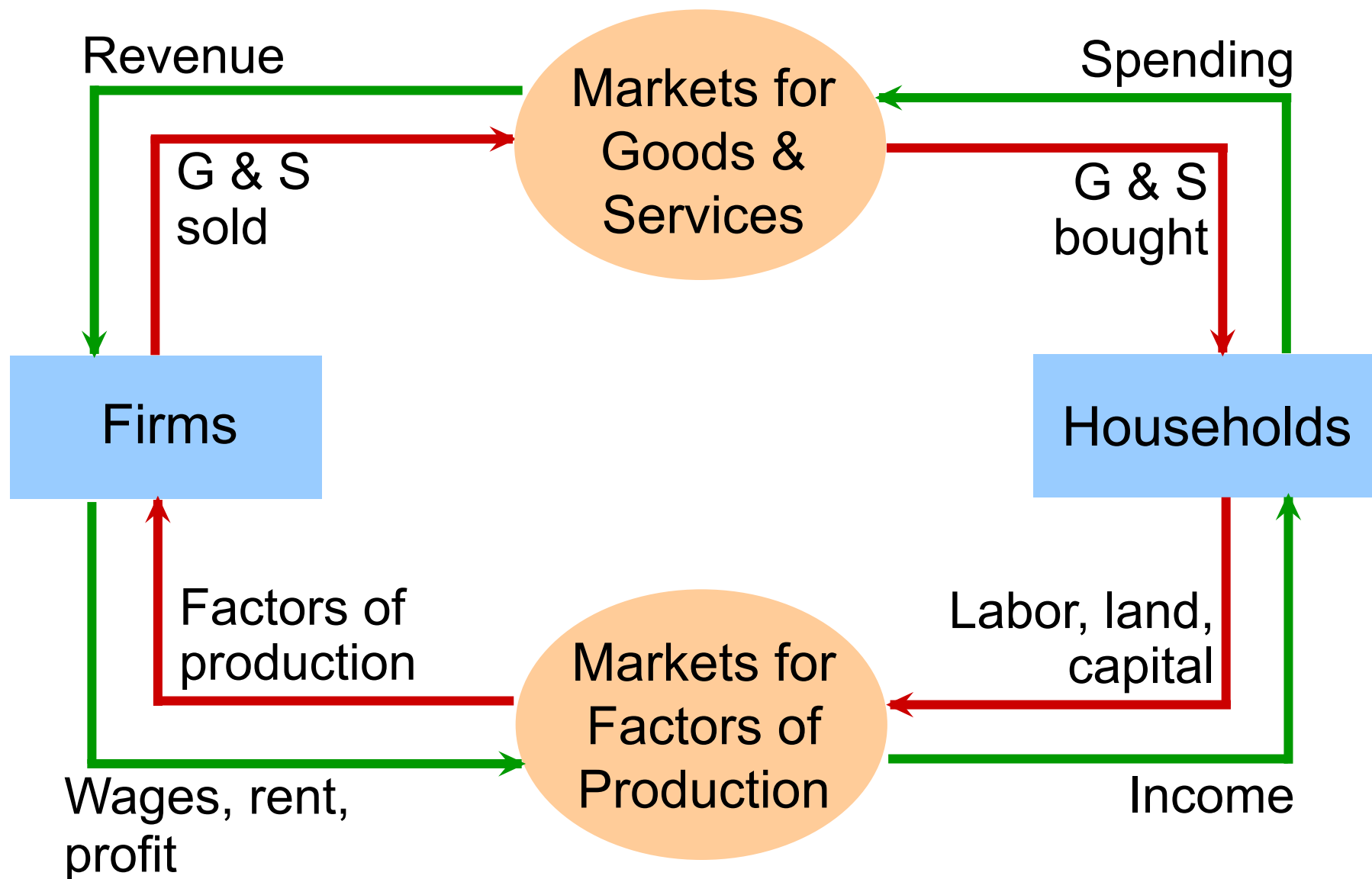
The Circular-Flow Diagram

- The **Circular-Flow Diagram**: a visual model of the economy, shows how dollars flow through markets among households and firms
- Two types of “actors”:
 - households
 - firms
- Two markets:
 - Product Market
 - Factor Market

Factor Market

- **Factors of production:** the resources the economy uses to produce goods & services, including
 - labor
 - land
 - capital (buildings & machines used in production)

FIGURE 1: The Circular-Flow Diagram



Our Second Model:

The Production Possibilities Frontier

- The **Production Possibilities Frontier (PPF)**: a graph that shows the combinations of two goods the economy can possibly produce given the available resources and the available technology
- Example:
 - Two goods: computers and wheat
 - One resource: labor (measured in hours)
 - Economy has 50,000 labor hours per month available for production.

PPF Example

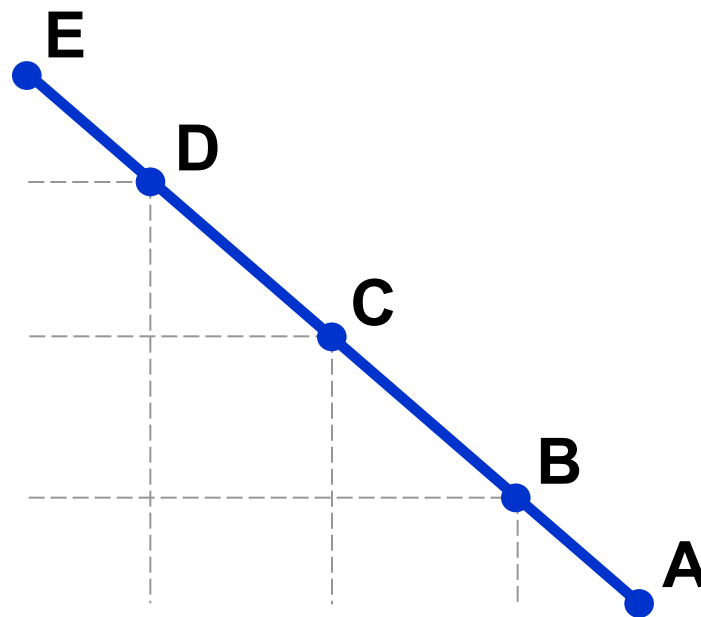
- Producing one computer requires 100 hours labor.
- Producing one ton of wheat requires 10 hours labor.

	Employment of labor hours		Production	
	Computers	Wheat	Computers	Wheat
A	50,000	0	500	0
B	40,000	10,000	400	1,000
C	25,000	25,000	250	2,500
D	10,000	40,000	100	4,000
E	0	50,000	0	5,000

PPF Example



Point on graph	Production	
	Com- puters	Wheat
A	500	0
B	400	1,000
C	250	2,500
D	100	4,000
E	0	5,000



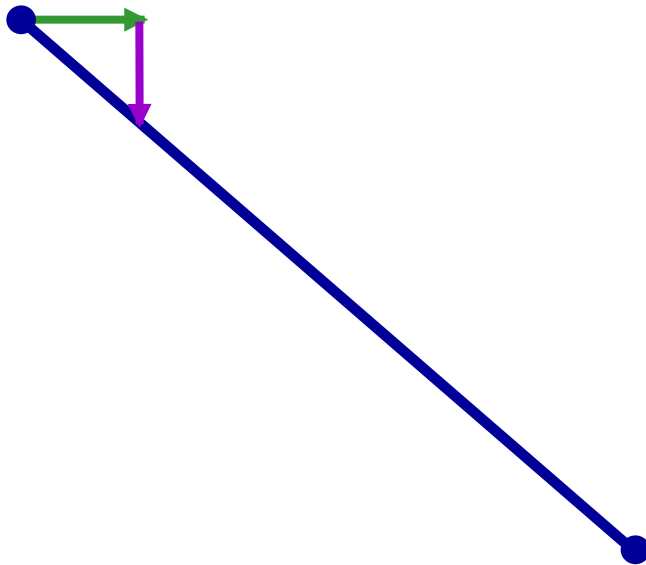
The PPF and Opportunity Cost

- Recall: The **opportunity cost** of an item is what must be given up to obtain that item.
- Moving along a PPF involves shifting resources (e.g., labor) from the production of one good to the other.
- Society faces a tradeoff: Getting more of one good requires sacrificing some of the other.
- The slope of the PPF tells you the opportunity cost of one good in terms of the other.

The PPF and Opportunity Cost



$$\text{slope} = \frac{-1000}{100} = -10$$



The slope of a line equals the “**rise** over the **run**,” the amount the line rises when you move to the right by one unit.

Here, the opportunity cost of a computer is 10 tons of wheat.

PPF and Opportunity Cost

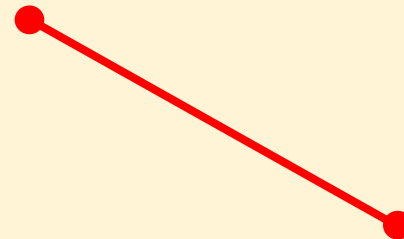
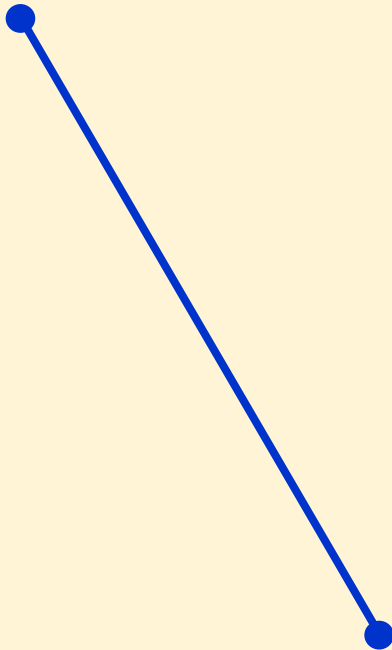
In which country is the opportunity cost of cloth lower?



FRANCE



ENGLAND

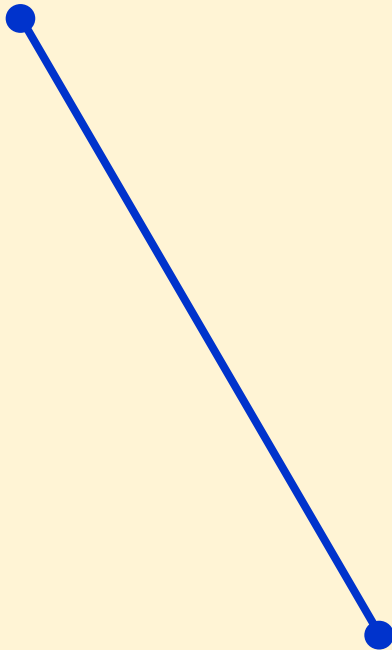


Answer

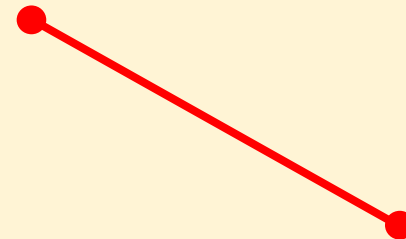
England, because its PPF is not as steep as France's.



FRANCE



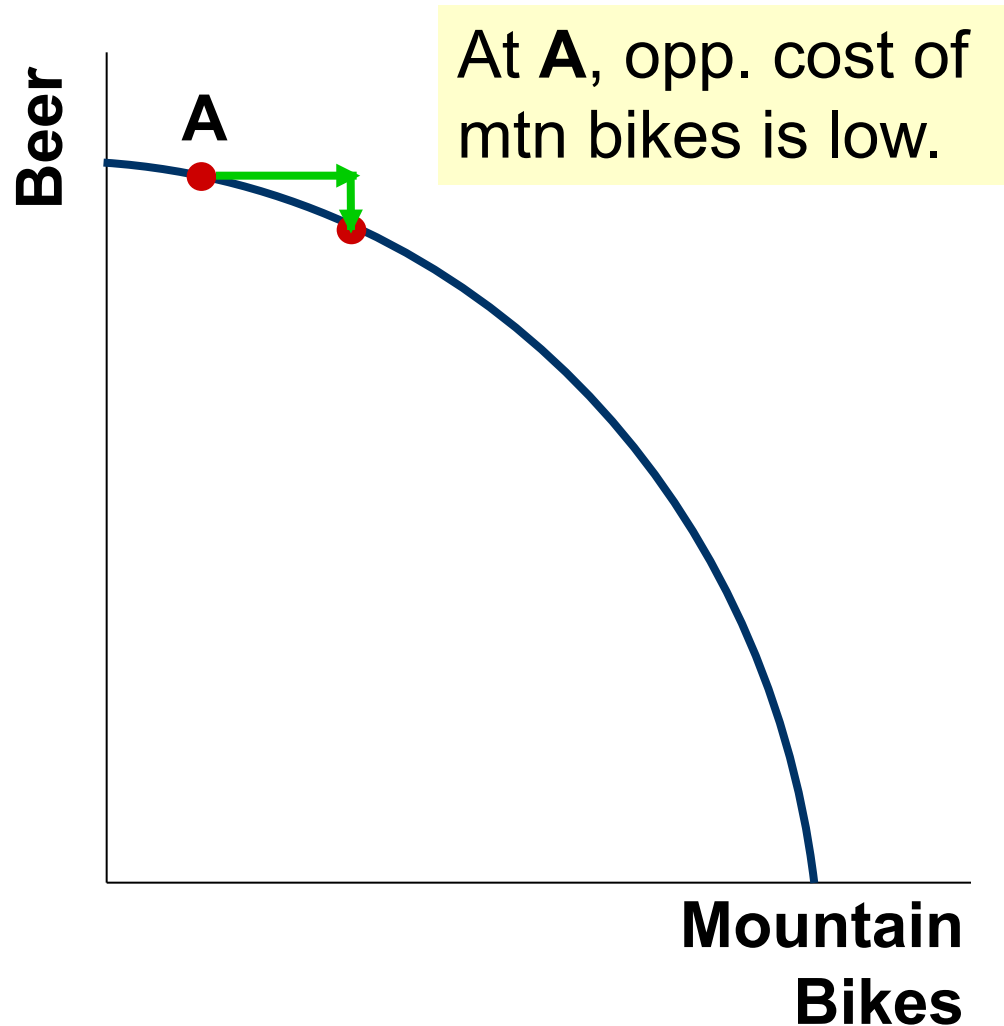
ENGLAND



Why the PPF Might Be Bow-Shaped

At point **A**, most workers are producing beer, even those who are better suited to building bikes.

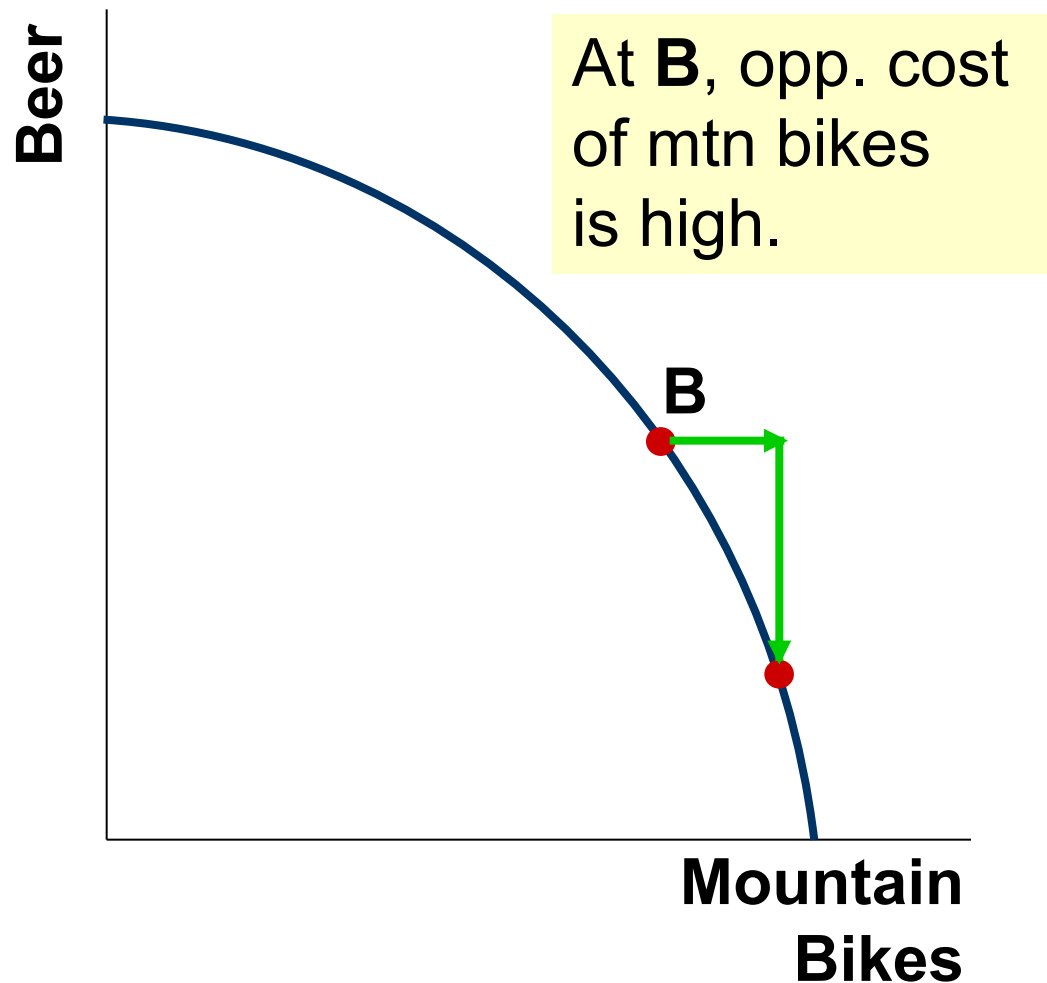
So, do not have to give up much beer to get more bikes.



Why the PPF Might Be Bow-Shaped

At **B**, most workers are producing bikes. The few left in beer are the best brewers.

Producing more bikes would require shifting some of the best brewers away from beer production, causing a big drop in beer output.



Microeconomics and Macroeconomics

- **Microeconomics** is the study of how households and firms make decisions and how they interact in markets.
- **Macroeconomics** is the study of economy-wide phenomena, including inflation, unemployment, and economic growth.

The Economist as Policy Advisor

- As scientists, economists make **positive statements**, which attempt to describe the world as it is.
- As policy advisors, economists make **normative statements**, which attempt to prescribe how the world should be.
- Positive statements can be confirmed or refuted, normative statements cannot.
- Govt employs many economists for policy advice. E.g., the U.S. President has a *Council of Economic Advisors*, which the author of this textbook chaired from 2003 to 2005.

Why Economists Disagree

- Economists often give conflicting policy advice.
- They sometimes disagree about the validity of alternative positive theories about the world.
- They may have different values and, therefore, different normative views about what policy should try to accomplish.
- Yet, there are many propositions about which most economists agree.

Propositions about Which Most Economists Agree (and % who agree)

- A ceiling on rents reduces the quantity and quality of housing available. (93%)
- Tariffs and import quotas usually reduce general economic welfare. (93%)
- The United States should not restrict employers from outsourcing work to foreign countries. (90%)
- The United States should eliminate agriculture subsidies. (85%)