

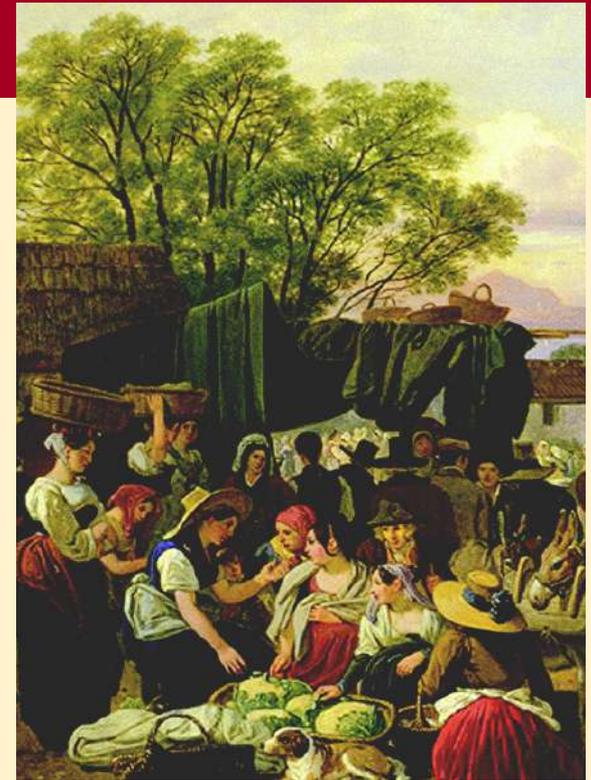
N. Gregory Mankiw

# Principles of Economics

Sixth Edition

2

## Thinking Like an Economist



*Premium PowerPoint  
Slides by  
Ron Cronovich*

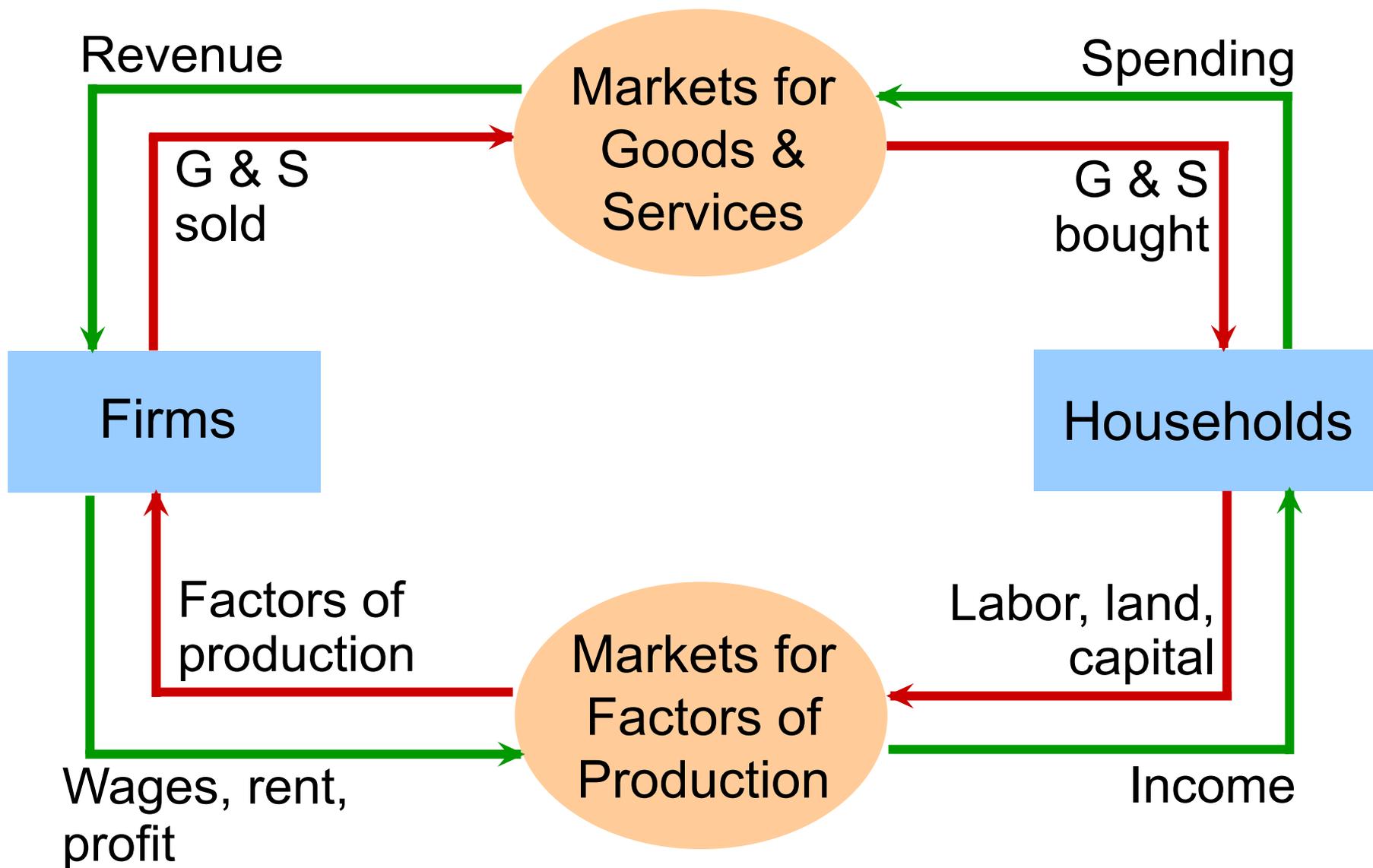
# Our First Model: The Circular-Flow Diagram

- 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

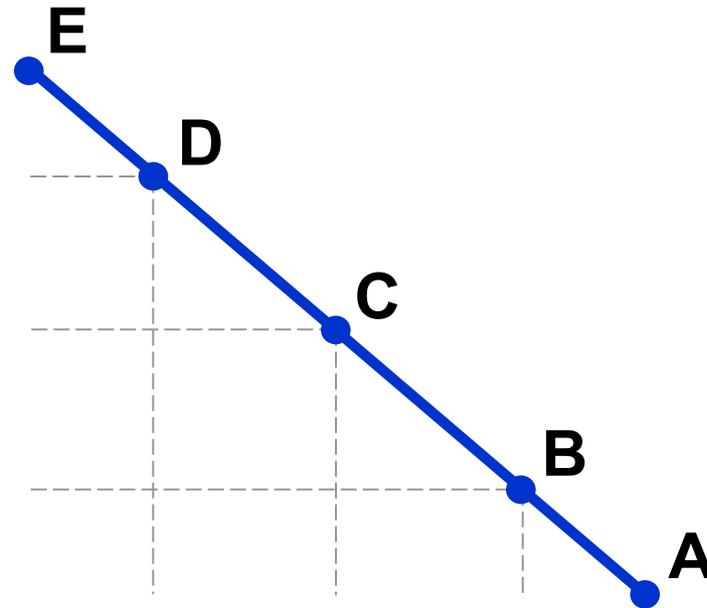
- Producing one computer requires 100 hours labor.
- Producing one ton of wheat requires 10 hours labor.

	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
<b>A</b>	500	0
<b>B</b>	400	1,000
<b>C</b>	250	2,500
<b>D</b>	100	4,000
<b>E</b>	0	5,000



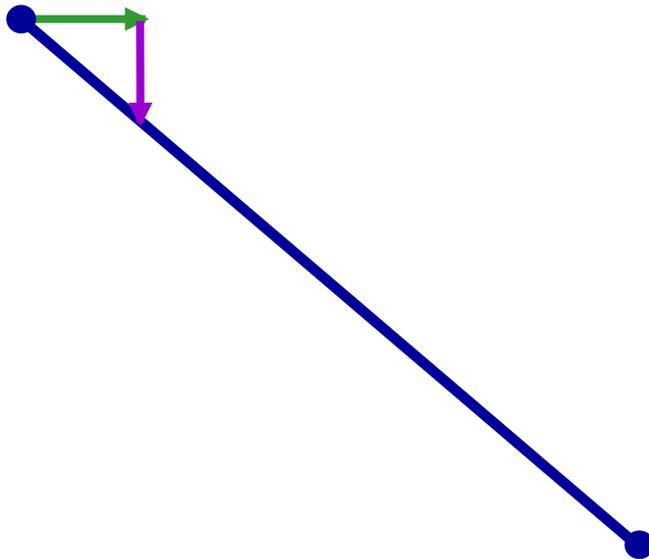
# The PPF and Opportunity Cost

- 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.

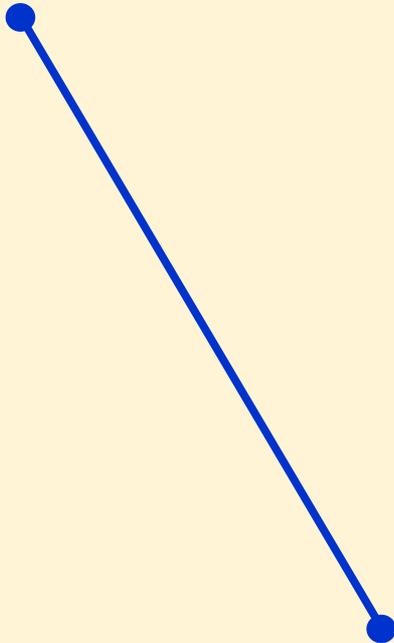
Here, the opportunity cost of a computer is 10 tons of wheat.

# PPF and Opportunity Cost

In which country is the opportunity cost of cloth lower?

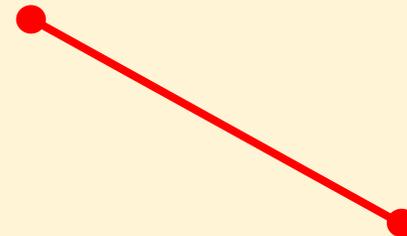
✘

**FRANCE**



✘

**ENGLAND**

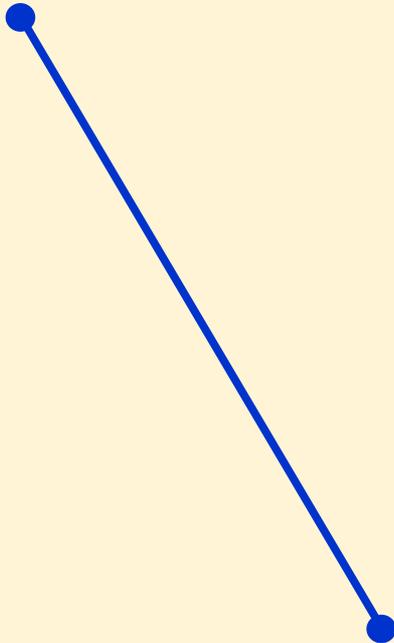


# Answer

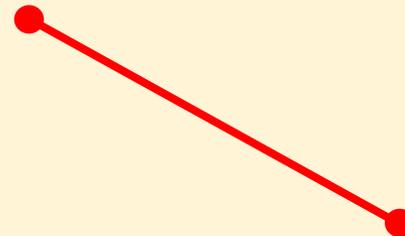
**England**, because its PPF is not as steep as France's.



**FRANCE**



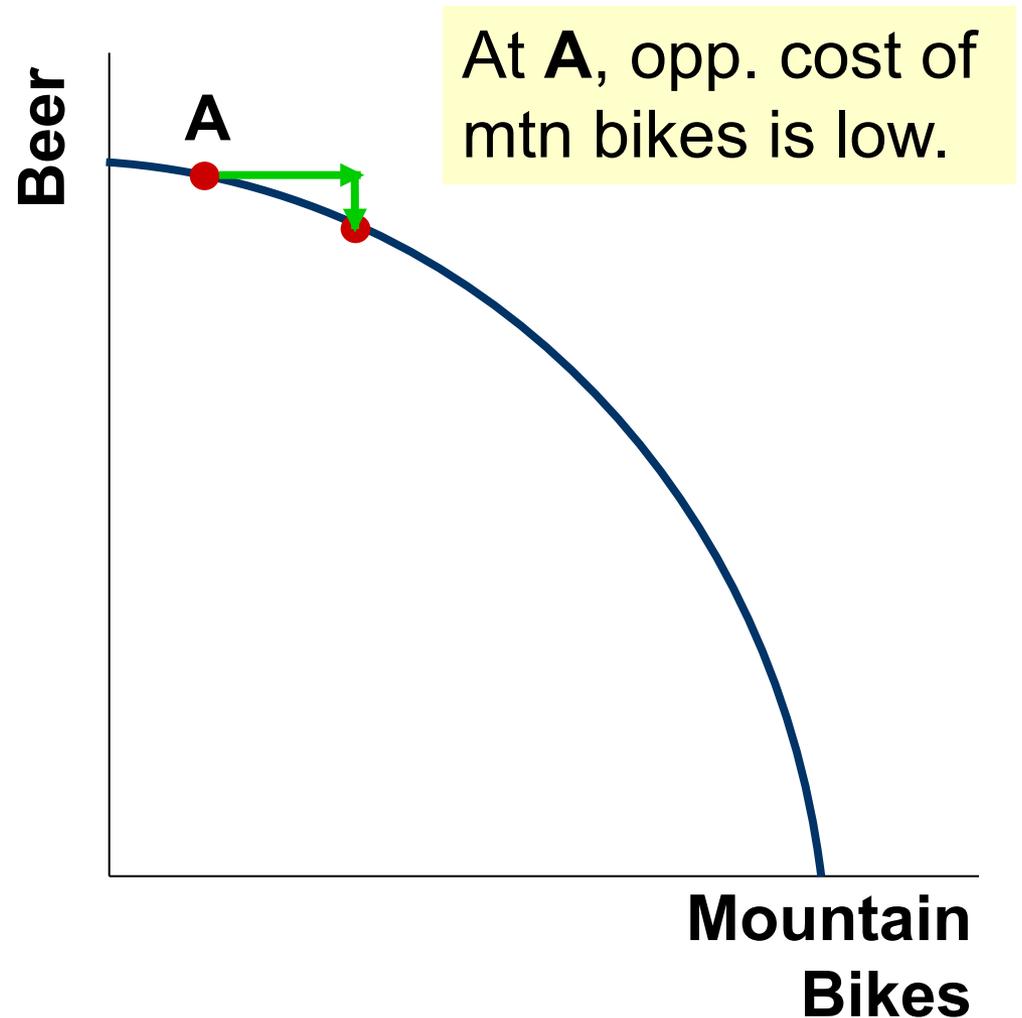
**ENGLAND**



# Why the PPF Might Be Bow-Shaped

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

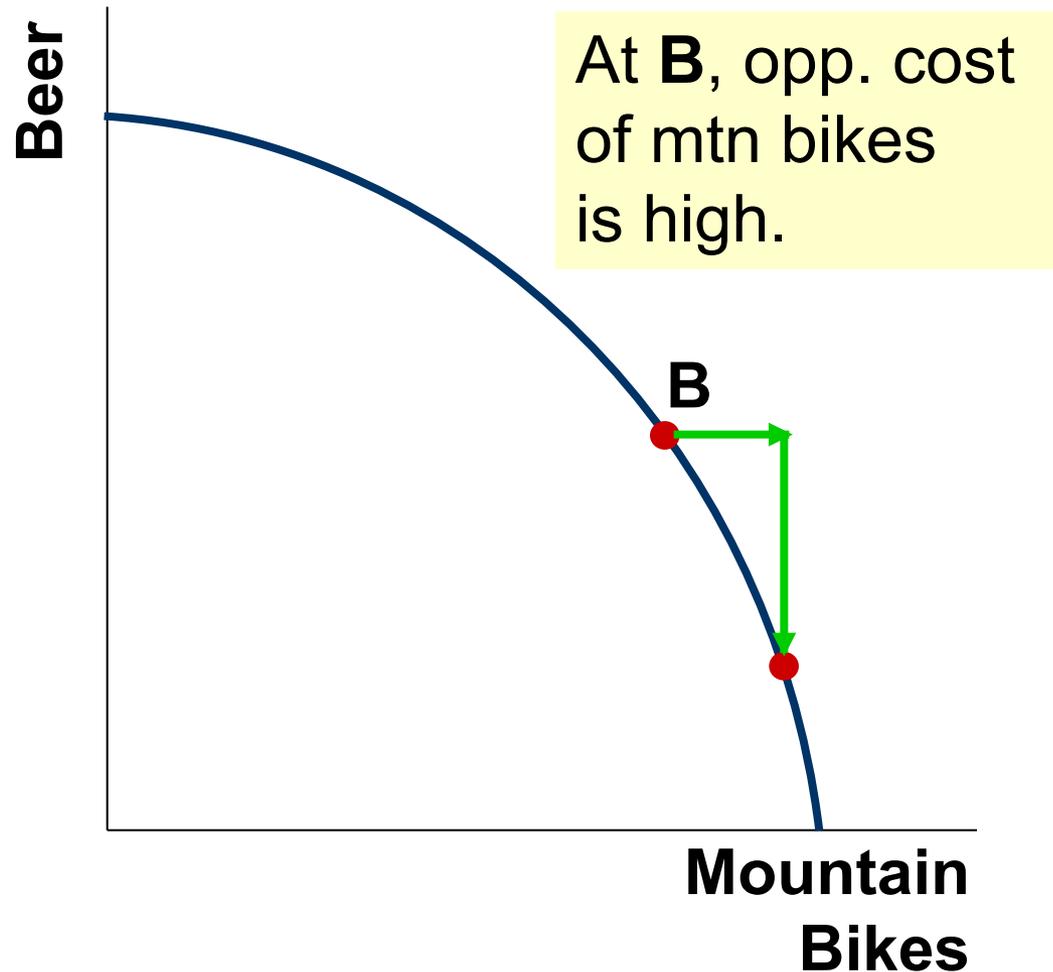
So, do not have to give up much beer to get more bikes.



# 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%)