**ECO 2306 – Principles of Microeconomics**

Week 2

**Hello and Welcome to the weekly resources for ECO 2306 – Principles of Microeconomics!**

**This week is Week 2 of class, and typically in this week of the semester, your professors are covering these topics below.**  If you do not see the topics your particular section of class is learning this week, please take a look at other weekly resources listed on our website for additional topics throughout of the semester.

We also invite you to **look at the group tutoring chart on our website to see if this course has a group tutoring session offered this semester**.

If you have any questions about these study guides, group tutoring sessions, private 30 minute tutoring appointments, the Baylor Tutoring YouTube channel or any tutoring services we offer, please visit our website [www.baylor.edu/tutoring](http://www.baylor.edu/tutoring) or call our drop in center during open business hours. M-Th 9am-8pm on class days 254-710-4135.

Our main resource is going to be Principles of Microeconomics by N. Gregory Mankiw.

**Topic of the week**

**Thinking like an Economics**

**Keywords:** Circular flow diagram, production possibilities frontier, positive statements, normative statements

**Concepts:**

How do economists think? Every field of study has its own specific language and mode of thinking. We think of economics as a science, so we need to understand the scientific approach to studying the economy. We also learn about the role of economists in policy decisions and the sources of disagreement among different economists.

**The Economists as Scientist**

1. The scientific method and economics:

In order to study the economy in an objective manner, economists use the scientific method. The scientific method requires observations to develop theories, and then more observations to test the theories. Since as economists we can’t test out theories in isolated labs, we look closely at what happens in the real world to collect data.

In order to develop theories, we need to make assumptions. In physics you assume falling objects fall in a vacuum, which is an idealistic assumption. We make similar assumptions to simplify complex issues. Remember how we assumed individuals are rational in the previous chapter? Have you ever made an irrational choice? Exactly! Deciding on the best assumption to make is an important part of an economist’s job.

Assumptions help us represent complex economic concepts using models that are easy to understand. You’ve seen models before, like the small models that show how the solar system works. The first economic model you learn about is known as the **Circular Flow Diagram**. This model shows us how money flows through the market among households and firms. Take some time to study this model and try to come up with real life examples of how this model works.



Figure 1 The Circular Flow Diagram (source: Mankiw)

Households and firms interact in two types of markets. In the *markets for goods and services*, households are buyers, and firms are sellers. In the *markets for the factors of production*, households are sellers, and firms are buyers. Imagine a dollar that begins its journey from a household and follow it through the diagram.

Now we can introduce some mathematical thinking and learn about our second model. In many economic models we think in terms of two goods or two inputs: food vs housing, capital vs labor, saving vs spending, etc. Here, let’s consider the production of cars and computers in an economy. 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 that the economy can possibly produce given the available factors of production and the available production technology that firms use to turn these factors into output.

The economy has to divide its resources between these two goods. It can produce 600 cars and2,200 computers (point A), or produce 700 cars and 2,000 computers (point B). Notice that resources are scarce, so point C is going to be impossible to achieve. An outcome is said to be *efficient* if the economy is getting all it can from the scarce resources it has available. All points on the production possibilities frontier (F, A, B, E) are efficient. Point D represents an *inefficient*

outcome, because it does not maximize output based on the available resources.



Figure 2 Production Possibilities Frontier Figure 3 A Shift in the Production Possibilities Frontier

Remember the concept of trade-offs and opportunity cost? When society moves from point A to point B, it gives up 200 computers to get 100 additional cars. That is, at point A, the opportunity cost of 100 cars is 200 computers. Notice that the opportunity cost of a car equals the slope of the production possibilities frontier. This slope is not constant; depending on the level of production, the opportunity cost of each good is different.

Economic growth as a result of an increase in capital or labor force or advancements of technology will shift the frontier up and allow for more production (figure 3). For example, A technological advance in the computer industry enables the economy to produce more computers for any given number of cars. As a result, the production possibilities frontier shifts outward. If the economy moves from point A to point G, then the production of both cars and computers increases.

As a scientific field, there are two major branches of economics: Microeconomics and Macroeconomics. **Microeconomics** is the study of how households and firms make decisions and how they interact in specific markets. **Macroeconomics** is the study of economywide phenomena. A microeconomist might study the effects of rent control on housing in New York City, the impact of foreign competition on the U.S. auto industry, or the effects of education on workers’ earnings. A macroeconomist might study the effects of borrowing by the federal government, the changes over time in the economy’s unemployment rate, or alternative policies to promote growth in national living standards.

**The Economist as Policy Adviser**

When economists are trying to explain the world, they are scientists. When they are helping improve it, they are policy advisers. To understand the role of economists, we need to examine the use of language. In general, statements about the world come in two types: **Positive statements** are descriptive. They make a claim about how the world is. **Normative statements** are prescriptive. They make a claim about how the world ought to be. We can confirm or refute positive statements by examining evidence. By contrast, evaluating normative statements involves values as well as facts. Deciding what is good or bad policy is not just a matter of science, but also involves our views on ethics, religion, and political philosophy.

As policy advisers, it is usual for different economists to give conflicting advice. One reason is they disagree about their theories and the available data does not solve discrepancies. This is usually because there haven’t been enough experiments to provide necessary observations. Another reason for disagreement is people have different values. An economist might care more about efficiency and another may value equality. Therefore, policy makers have to choose which economist to listen to.

Nonetheless, there are many issues on which most economists agree. Consider these two statements and the percentage of economists who agree with them:

1. A ceiling on rents reduces the quantity and quality of housing available. (93%)

2. Tariffs and import quotas usually reduce general economic welfare. (93%)

Many local and national governments completely ignore economists on these issues. One reason might be that the political process has its own realities and politicians have people other than economists to listen to. Another reason may be that economists haven’t been successful in convincing voters on these issues

**What you might struggle with**

Positive and normative statements may take some getting used to. Try to come up with a few examples for each kind of statement. You also need to understand how changes in labor, capital, and technology might shift the production possibilities frontier. The example in figure 3 shows a breakthrough in computer production technology. What would it look like with changes in labor or capital?

**Check your learning**

1. Name a way that your family interacts in the markets for the factors of production and a way that it interacts in the markets for goods and services. (Source: Mankiw)

2. Name one economic interaction that isn’t covered by the simplified circular-flow diagram. (Source: Mankiw)

3. Classify each of the following statements as positive or normative. Explain.

a. Society faces a short-run trade-off between inflation and unemployment.

b. A reduction in the growth rate of the money supply will reduce the rate of inflation.

c. The Federal Reserve should reduce the growth rate of the money supply.

d. Society ought to require welfare recipients to look for jobs.

e. Lower tax rates encourage more work and more saving. (source: Mankiw)

4. Classify each of the following topics as relating to microeconomics or macroeconomics.

a. A family’s decision about how much income to save

b. The effect of government regulations on auto emissions

c. The impact of higher national saving on economic growth

d. A firm’s decision about how many workers to hire

e. The relationship between the inflation rate and changes in the quantity of money

**Answers**

These are my answers. You should be able to come up with your own arguments that may or may not differ from mine.

1. I work for a company, so I provide labor (a factor of production). I use my wages to buy food from another company in the market for goods and services.

2. Taking a loan.

3. a. positive, b. positive, c. normative, d. normative, e. positive.

4. a. micro, b. macro, c. macro, d. micro, e. macro.

Thanks for checking out these weekly resources!

Don’t forget to check out our website for group tutoring times, video tutorials and lots of other resources: [www.baylor.edu/tutoring](http://www.baylor.edu/tutoring) ! Answers to check your learning questions are below!