

Learning Objectives

Chapter 1

In this chapter you will

- Learn that economics is about the allocation of scarce resources
- Examine some of the trade-offs that people face
- Learn the meaning of opportunity cost
- See how to use marginal reasoning when making decisions
- Discuss how incentives affect people's behaviour
- Consider why trade among people or nations can be good for everyone
- Discuss why markets are a good, but not perfect, way to allocate resources
- Learn what determines some trends in the overall economy

You should be able to

- Define scarcity
- Explain the classic trade-off between "guns and butter"
- Add up your particular opportunity cost of attending university
- Compare the marginal costs and marginal benefits of continuing to attend school indefinitely
- Consider how a quadrupling of your tuition payments would affect your decision to educate yourself
- Explain why specialization and trade improve people's choices
- Give an example of an externality
- Explain the source of large and persistent inflation

Chapter 2

In this chapter you will

- See how economists apply the methods of science
- Consider how assumptions and models can shed light on the world
- Learn two simple models—the circular-flow and the production possibilities frontier
- Distinguish between microeconomics and macroeconomics
- Learn the difference between positive and normative statements
- Examine the role of economists in making policy
- Consider why economists sometimes disagree with one another

You should be able to

- Describe the scientific method
- Understand the art of making useful assumptions
- Explain the slope of a production possibilities frontier

- Place economic issues into the categories of microeconomics or macroeconomics
- Place economic statements into the categories of normative or positive.
- See the link between policy making and normative statements
- List two reasons why economists disagree

Chapter 3

In this chapter you will

- Consider how everyone can benefit when people trade with one another
- Learn the meaning of absolute advantage and comparative advantage
- See how comparative advantage explains the gains from trade
- Apply the theory of comparative advantage to everyday life and national policy

You should be able to

- Show how total production rises when individuals specialize in the production of goods for which they have a comparative advantage
- Explain why all people have a comparative advantage even if they have no absolute advantage
- Demonstrate the link between comparative advantage and opportunity cost
- Explain why people who are good at everything still tend to specialize

Chapter 4

In this chapter you will

- Learn what a competitive market is
- Examine what determines the demand for a good in a competitive market
- Examine what determines the supply of a good in a competitive market
- See how supply and demand together set the price of a good and the quantity sold
- Consider the key role of prices in allocating scarce resources in market economies

You should be able to

- List the two characteristics of a competitive market
- List the factors that affect the amount that consumers wish to buy in a market
- List the factors that affect the amount that producers wish to sell in a market

- Draw a graph of supply and demand in a market and find the equilibrium price and quantity
- Shift supply and demand curves in response to an economic event and find the new equilibrium price and quantity

Chapter 5

In this chapter you will

- Learn the meaning of the elasticity of demand
- Examine what determines the elasticity of demand
- Learn the meaning of the elasticity of supply
- Examine what determines the elasticity of supply
- Apply the concept of elasticity in three very different markets

You should be able to

- Calculate the price and income elasticity of demand
- Distinguish between the price elasticity of demand for necessities and luxuries
- Calculate the price elasticity of supply
- Distinguish between an inelastic and elastic supply curve
- Demonstrate the impact of the price elasticity of demand on total revenue

Chapter 6

In this chapter you will

- Examine the effects of government policies that place a ceiling on prices
- Examine the effects of government policies that put a floor under prices
- Consider how a tax on a good affects the price of the good and the quantity sold
- Learn that taxes levied on buyers and taxes levied on sellers are equivalent
- See how the burden of a tax is split between buyers and sellers

You should be able to

- Describe the conditions necessary for a price ceiling to be a binding constraint
- Explain why a binding price floor creates a surplus
- Demonstrate why a tax placed on a good generally reduces the quantity of the good sold
- Demonstrate why the results are the same when a tax is placed on the buyers or sellers of a good
- Show whether the buyers or sellers of a good bear the burden of the tax when demand is inelastic and supply is elastic

Chapter 7

In this chapter you will

- Examine the link between buyers' willingness to pay for a good and the demand curve
- Learn how to define and measure consumer surplus
- Examine the link between sellers' costs of producing a good and the supply curve
- Learn how to define and measure producer surplus
- See that the equilibrium of supply and demand maximizes total surplus in a market

You should be able to

- Derive a demand curve from a group of individual buyers' willingness to pay schedules
- Locate consumer surplus on a supply and demand graph
- Derive a supply curve from a group of individual sellers' cost of production schedules
- Locate producer surplus on a supply and demand graph
- Demonstrate why all other quantities other than the equilibrium quantity fail to maximize total surplus in a market

Chapter 8

In this chapter you will

- Examine how taxes reduce consumer and producer surplus
- Learn the meaning and causes of the deadweight loss of a tax
- Consider why some taxes have larger deadweight losses than others
- Examine how tax revenue and deadweight loss vary with the size of a tax

You should be able to

- Place a tax wedge in a supply and demand graph and determine the tax revenue and the levels of consumer and producer surplus
- Place a tax wedge in a supply and demand graph and determine the value of the deadweight loss
- Show why a given tax will generate a greater deadweight loss if supply and demand are elastic than if they are inelastic
- Demonstrate why some very large taxes generate little tax revenue but a great deal of deadweight loss

Chapter 9

In this chapter you will

- Consider what determines whether a country imports or exports a good
- Examine who wins and who loses from international trade
- Learn that the gains to winners from international trade exceed the losses to losers
- Analyse the welfare effects of tariffs and import quotas
- Examine the arguments people use to advocate trade restrictions

You should be able to

- Determine whether a country imports or exports a good if the world price is greater than the before-trade domestic price
- Show that the consumer wins and the producer loses when a country imports a good
- Use consumer and producer surplus to show that the gains of the consumer exceed the losses of the producer when a country imports a good
- Show the deadweight loss associated with a tariff or a quota
- Defeat the arguments made in support of trade restrictions

Chapter 10

In this chapter you will

- Learn what an externality is
- See why externalities can make market outcomes inefficient
- Examine how people can sometimes solve the problem of externalities on their own
- Consider why private solutions to externalities sometimes do not work
- Examine the various government policies aimed at solving the problem of externalities

You should be able to

- Distinguish between a positive and a negative externality
- Demonstrate why the optimal quantity and the market quantity differ in the presence of an externality
- Define the Coase theorem
- Explain how transaction costs may impede a private solution to an externality
- Demonstrate the potential equality of a Pigovian tax and pollution permits

Chapter 11

In this chapter you will

- Learn the defining characteristics of public goods and common resources

- Examine why private markets fail to provide public goods
- Consider some of the important public goods in our economy
- See why the cost-benefit analysis of public goods is both necessary and difficult
- Examine why people tend to use common resources too much
- Consider some of the important common resources in our economy

You should be able to

- Classify goods into the categories of public goods, private goods, common resources, or goods produced by a natural monopoly
- Explain why production of public goods is unprofitable to private industry
- Explain the public good nature of national defence
- Explain why surveys to determine the benefits of public goods are a less precise valuation of benefits than prices of private goods
- Tell the story of the "tragedy of the commons"
- Explain why fish and wildlife are common resources

Chapter 12

In this chapter you will

- Get an overview of how the UK government raises and spends money
- Examine the efficiency costs of taxes
- Learn alternative ways to judge the equity of a tax system
- See why studying tax incidence is crucial for evaluating tax equity
- Consider the trade-off between efficiency and equity in the design of a tax system

You should be able to

- List the three largest sources of tax revenue to the UK government from the largest to the smallest source
- Describe the administrative burdens of a tax
- Compare the benefits principle to the ability-to-pay principle of allocating a tax burden
- Explain why the burden of a tax is often borne by someone other than the person from whom the tax is collected
- Discuss the efficiency and equity of a flat tax

Chapter 13

In this chapter you will

- Examine what items are included in a firm's costs of production
- Analyse the link between a firm's production process and its total costs

- Learn the meaning of average total cost and marginal cost and how they are related
- Consider the shape of a typical firm's cost curves
- Examine the relationship between short-run and long-run costs

You should be able to

- Explain the difference between economic profit and accounting profit
- Utilize a production function to derive a total cost curve
- Explain why the marginal cost curve must intersect the average total cost curve at the minimum point of the average total cost curve
- Explain why a production function might exhibit increasing marginal product at low levels of output and decreasing marginal product at high levels of output
- Explain why, as a firm expands its scale of operation, it tends to first exhibit economies of scale, then constant returns to scale, then diseconomies of scale

Chapter 14

In this chapter you will

- Learn what characteristics make a market competitive
- Examine how competitive firms decide how much output to produce
- Examine how competitive firms decide when to shut down production temporarily
- Examine how competitive firms decide whether to exit or enter a market
- See how firm behaviour determines a market's short-run and long-run supply curves

You should be able to

- List up to three conditions that characterize a competitive market
- Locate the supply curve for a competitive firm on a graph of its cost curves
- Demonstrate why firms temporarily shut down if the price they receive for their output is less than average variable cost
- Demonstrate why firms exit a market permanently if the price they receive for their output is less than average total cost
- Show why the long-run supply curve in a competitive market is more elastic than the short-run supply curve

Chapter 15

In this chapter you will

- Learn why some markets have only one seller

- Analyse how a monopoly determines the quantity to produce and the price to charge
- See how the monopoly's decisions affect economic well-being
- Consider the various public policies aimed at solving the problem of monopoly
- See why monopolies try to charge different prices to different customers

You should be able to

- List three reasons why a monopoly can remain the sole seller of a product in a market
- Use a monopolist's cost curves and the demand curve it faces to show the profit earned by a monopolist
- Show the deadweight loss from a monopolist's production decision
- Show why forcing a natural monopoly to set its selling price equal to its marginal cost of production creates losses for the monopolist
- Demonstrate the surprising result that price discrimination by a monopolist can raise economic welfare above that generated by standard monopoly pricing

Chapter 16

In this chapter you will

- See what market structures lie between monopoly and competition
- Examine what outcomes are possible when a market is an oligopoly
- Learn about the prisoners' dilemma and how it applies to oligopoly and other issues
- Consider how competition laws try to foster competition in oligopolistic markets

You should be able to

- Describe the characteristics of oligopoly and monopolistic competition
- Describe the conditions under which an oligopolistic market generates the same outcome as a monopolistic market
- Show why the outcome of the prisoners' dilemma may change if the game is repeated
- Show why some business practices that appear to reduce competition may have a legitimate business purpose

Chapter 17

In this chapter you will

- Analyse competition among firms that sell differentiated products
- Compare the outcome under monopolistic competition and under perfect competition
- Consider the desirability of outcomes in monopolistically competitive markets
- Examine the debate over the effects of advertising
- Examine the debate over the role of brand names

You should be able to

- Show the long-run adjustment that takes place in a monopolistically competitive market when a firm generates economic profits
- Show why monopolistically competitive firms produce at less than efficient scale in the long run
- Discuss the inefficiencies of monopolistically competitive markets
- Provide an argument in support of and in opposition to the use of advertising
- Provide an argument in support of and in opposition to the use of brand names

Chapter 18

In this chapter you will

- Analyse the labour demand of competitive, profit-maximizing firms
- Consider the household decisions that lie behind labour supply
- Learn why equilibrium wages equal the value of the marginal product of labour
- Consider how the other factors of production—land and capital—are compensated
- Examine how a change in the supply of one factor alters the earnings of all the factors

You should be able to

- Explain why the labour demand curve is the value of the marginal product curve for labour
- Explain why the labour supply curve is usually upward sloping
- Explain why a competitive firm maximizes profit when it hires labour to the point where the wage equals the value of the marginal product of labour
- Demonstrate the similarity between the labour market and the market for other factors of production
- Explain why the change in the supply of one factor alters the value of the marginal product of the other factors

Chapter 19

In this chapter you will

- Examine how wages compensate for differences in job characteristics
- Learn and compare the human capital and signalling theories of education
- Examine why in some occupations a few superstars earn tremendous incomes
- Learn why wages rise above the level that balances supply and demand
- Consider why it is difficult to measure the impact of discrimination on wages
- See when market forces can and cannot provide a natural remedy for discrimination

You should be able to

- Explain why an economics lecturer earns less than a corporate economist of similar age, background, and training
- Explain the differing impact of policies aimed at increasing the educational attainment of all workers under the signalling and the human capital view of education
- List the characteristics of a market where superstars can arise
- List three reasons why a wage can rise above the equilibrium wage
- Explain why differences in wages among groups does not by itself say anything about how much discrimination there is in the labour market
- Explain why competitive employers are unlikely to discriminate against groups of employees unless the customers or the government demands it

Chapter 20

In this chapter you will

- Examine the degree of economic inequality in our society
- Consider some problems that arise when measuring economic inequality
- See how political philosophers view the government's role in redistributing income
- Consider the various policies aimed at helping poor families escape poverty

You should be able to

- Explain how the changing role of women in the economy has affected the distribution of income
- Name some factors that cause the measurement of income distribution to exaggerate the degree of income inequality
- Compare and contrast utilitarianism, liberalism, and libertarianism
- Explain the concept of a negative income tax

Chapter 21

In this chapter you will

- See how a budget constraint represents the choices a consumer can afford
- Learn how indifference curves can be used to represent a consumer's preferences
- Analyse how a consumer's optimal choices are determined
- See how a consumer responds to changes in income and changes in prices
- Decompose the impact of a price change into an income effect and a substitution effect
- Apply the theory of consumer choice to three questions about household behaviour

You should be able to

- Draw a budget constraint on a graph if you are given the value of income and the prices of the goods
- Explain why indifference curves must slope downward if the two products considered are "goods"
- Explain the relationship between the relative prices and the marginal rate of substitution between two goods at the consumer's optimum
- Shift the budget constraint when the price of a good increases
- Demonstrate the income and substitution effect on a graph using indifference curves and budget constraints
- Show why someone's labour-supply curve might be backward sloping

Chapter 22

In this chapter you will:

- Examine the problems caused by asymmetric information
- Learn about market solutions to asymmetric information
- Consider why democratic voting systems may not represent the preferences of society
- Consider why people may not always behave as rational maximizers

You should be able to:

- Describe the information asymmetry in the labour market
- Explain why insurance companies screen potential customers
- Generate an example of the Condorcet voting paradox
- Explain why people are willing to sign contracts that require them to contribute a portion of their salary to a retirement savings program

Ch 23

In this chapter you will

- Consider why an economy's total income equals its total expenditure
- Learn how gross domestic product (GDP) is defined and calculated
- See the breakdown of GDP into its four major components
- Learn the distinction between real GDP and nominal GDP
- Consider whether GDP is a good measure of economic well-being

You should be able to

- Demonstrate why income equals expenditure equals output
- Explain the key words and phrases in the definition of GDP
- Define consumption, investment, government purchases, and net exports
- Calculate real and nominal GDP using base year and current year prices
- List a number of welfare-enhancing activities that are not captured by GDP

Chapter 24

In this chapter you will

- Learn how the consumer price index (CPI) is constructed
- Consider why the CPI is an imperfect measure of the cost of living
- Compare the CPI and the GDP deflator as measures of the overall price level
- See how to use a price index to compare dollar amounts from different times
- Learn the distinction between real and nominal interest rates

You should be able to

- List the five steps necessary to calculate the inflation rate
- Discuss three reasons why the CPI may be biased
- Describe two differences between the CPI and GDP deflator
- Convert a value measured in 1965 pounds (or euros) to its value measured in 1990 pounds (or euros)
- Explain the relationship between the real interest rate, the nominal interest rate, and the inflation rate

Chapter 25

In this chapter you will

- See how much economic growth differs around the world
- Consider why productivity is the key determinant of a country's standard of living
- Analyse the factors that determine a country's productivity
- Examine how a country's policies influence its productivity growth

You should be able to

- List the countries with the highest GDP per person and the countries whose GDP per person is growing the fastest
- Explain why production limits consumption in the long run
- List and explain the factors of production
- Explain seven areas of policy action that may influence a country's productivity and growth

Chapter 26

In this chapter you will

- Learn about some of the important financial institutions in the economy
- Consider how the financial system is related to key macroeconomic variables
- Develop a model of the supply and demand for loanable funds in financial markets
- Use the loanable funds model to analyse various government policies
- Consider how government budget deficits affect the economy

You should be able to

- List and describe four important types of financial institutions
- Describe the relationship between national saving, government deficits, and investment
- Explain the slope of the supply and demand for loanable funds
- Shift supply and demand curves in a model of the loanable funds market in response to a change in taxes on interest or investment
- Shift supply and demand curves in a model of the loanable funds market in response to a change in the government's budget deficit

Chapter 27

In this chapter you will:

- Learn the relationship between present value and future value
- Consider the effects of compound growth
- Learn how risk-averse people reduce the risk they face
- Analyse how asset prices are determined

You should be able to:

- Choose between receiving €100 now or €120 two years from now, given an interest rate of 8 percent

- Explain why two people whose incomes grow at slightly different rates may end up with significantly different incomes after a number of years
- Explain the benefits of diversification
- Show why randomly choosing stocks may be as good as more sophisticated stock picking methods

Chapter 28

In this chapter you will

- Learn about the data used to measure the amount of unemployment
- Consider how unemployment can result from minimum wage laws
- See how unemployment can arise from bargaining between firms and unions
- Examine how unemployment results when firms choose to pay efficiency wages

You should be able to

- Use data on the number of employed, unemployed, and not in the labour force to calculate the unemployment rate and the labour force participation rate
- Explain why some unemployment is inevitable
- Illustrate in a diagram the impact of the minimum wage on high wage and low wage sectors
- List the reasons why unions cause unemployment and, alternatively, why unions might increase efficiency in some cases
- Describe the four reasons why firms may choose to pay wages in excess of the competitive wage

Chapter 29

In this chapter you will

- Consider what money is and what functions money has in the economy
- Learn what a central bank is
- Examine how the banking system helps determine the supply of money
- See what tools central banks use to alter the supply of money

You should be able to

- Define money and list the three functions of money
- Explain the role of the central bank in money creation
- Explain the money multiplier in a fractional reserve banking system
- List and explain the three tools central banks use to change the money supply

Chapter 30

In this chapter you will

- See why inflation results from rapid growth in the money supply
- Learn the meaning of the classical dichotomy and monetary neutrality
- See why some countries print so much money that they experience hyperinflation
- Examine how the nominal interest rate responds to the inflation rate
- Consider the various costs that inflation imposes on society

You should be able to

- Demonstrate the link between money and prices with the quantity equation
- Explain why money has no impact on real variables in the long run
- Explain the concept of an inflation tax
- Show the relationship between the nominal interest rate, the real interest rate, and the inflation rate
- Explain who gains and who loses on a loan contract when inflation rises unexpectedly

Chapter 31

In this chapter you will

- Learn how net exports measure the international flow of goods and services
- Learn how net capital outflow measures the international flow of capital
- Consider why net exports must always equal net capital outflow
- See how saving, domestic investment, and net capital outflow are related
- Learn the meaning of the nominal exchange rate and the real exchange rate
- Examine purchasing power parity as a theory of how exchange rates are determined

You should be able to

- Define net exports
- Define net capital outflow
- Explain why net exports and net capital outflow are two sides of the same coin
- Explain why a trade deficit and a negative net capital outflow can be beneficial to a country if that country has a small savings rate
- Show the relationship between the real and nominal exchange rate
- Show why the nominal exchange rate between two country's currencies should equal their relative price levels

Chapter 32

In this chapter you will

- Build a model to explain an open economy's trade balance and exchange rate
- Use the model to analyse the effects of government budget deficits
- Use the model to analyse the macroeconomic effects of trade policies
- Use the model to analyse political instability and capital flight

You should be able to

- Explain the slope of supply and demand curves in the market for foreign currency exchange
- Show why a budget deficit tends to cause a trade deficit
- Demonstrate that a quota on imports fails to have an effect on net exports
- Show why capital flight causes a currency to depreciate

Chapter 33

In this chapter you will

- Learn three key facts about short-run fluctuations
- Consider how the economy in the short run differs from the economy in the long run
- Use the model of aggregate demand and aggregate supply to explain economic fluctuations
- See how shifts in either aggregate demand or aggregate supply can cause booms and recessions

You should be able to

- Explain why the term "business cycle" is misleading
- Explain why money is unlikely to be neutral in the short run
- List three reasons why the aggregate demand curve is downward sloping
- Demonstrate the short-run and long-run effects of an oil price shock on the economy

Chapter 34

In this chapter you will

- Learn the theory of liquidity preference as a short-run theory of the interest rate
- Analyse how monetary policy affects interest rates and aggregate demand
- Analyse how fiscal policy affects interest rates and aggregate demand

- Discuss the debate over whether policy makers should try to stabilize the economy

You should be able to

- Show what an increase in the money supply does to the interest rate in the short run
- Illustrate what an increase in the money supply does to aggregate demand
- Explain crowding out
- Describe the lags in fiscal and monetary policy

Chapter 35

In this chapter you will

- Learn why policy makers face a short-run trade-off between inflation and unemployment
- Consider why the inflation-unemployment trade-off disappears in the long run
- See how supply shocks can shift the inflation-unemployment trade-off
- Consider the short-run cost of reducing the rate of inflation
- See how policy makers' credibility affects the cost of reducing inflation

You should be able to

- Draw a graph of a short-run Phillips curve
- Draw a graph of a long-run Phillips curve
- Show the relationship between a shift in the short-run aggregate supply curve and a shift in the short-run Phillips curve
- Explain the sacrifice ratio
- Explain why more than rational expectations are needed to reduce inflation costlessly

Chapter 36

In this chapter you will

- Consider the characteristics of an optimum currency area.
- Consider the benefits and costs that might be expected to arise from a country joining a currency union.
- Learn about the debate concerning whether the euro area is an optimum currency area.

You should be able to

- Explain the characteristics a group of countries should have if they are to be considered an optimum currency area
- Explain and illustrate with diagrams the macroeconomic effects of asymmetric shocks in a common currency area, wherein exchange rate adjustment is not possible
- Explain and illustrate with diagrams how fiscal policy could be used for macroeconomic stabilization in the absence of exchange rate adjustment and independent monetary policy

Chapter 37

In this chapter you will

- Consider whether policymakers should try to stabilize the economy
- Consider whether monetary policy should be made by rule rather than by discretion
- Consider whether the government should balance its budget
- Consider whether the tax laws should be reformed to encourage saving
- Consider whether the UK should join the European monetary union

You should be able to

- Give an example of a macroeconomic policy response that "leans against the wind"
- Explain what is meant by the "time inconsistency of policy"
- Explain the benefits of reducing the budget deficit
- Explain why a consumption tax encourages saving but enhances economic inequality
- Discuss the five tests laid down by the UK government and which the government has said must be passed before the UK joins EMU