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Case Study

## **Chapter 1** **Ten Principles of Economics**

*One of the most important events in economics in recent times occurred during 2007 – 2009. The financial crisis and the recession which followed have generated problems for almost every country on the planet. The textbook looks in some detail at the events which led to the crisis and some of the questions which have arisen as a result. Such an event highlights the dynamic nature of economics, how the subject is always evolving and how our understanding of the world is shaped by these changes and developments.*

*The financial crisis and the debate which has followed also highlighted a number of the Ten Principles of Economics covered in the first chapter of the book. The article which follows outlines some of the key issues associated with the financial crisis. We will then look at how these issues relate to some of the Ten Principles of Economics and the pose some questions for you to think about and try to answer to help some initial understanding about these principles.  
Here is a reminder of the Ten Principles of Economics:*

Principle 1: People Face Trade-Offs

Principle 2: The Cost of Something Is What You Give Up to Get It

Principle 3: Rational People Think at the Margin

Principle 4: People Respond to Incentives

Principle 5: Trade Can Make Everyone Better Off

Principle 6: Markets Are Usually a Good Way to Organize Economic Activity

Principle 7: Governments Can Sometimes Improve Market Outcomes

Principle 8: An Economy's Standard of Living Depends on Its Ability to Produce Goods and Services

Principle 9: Prices Rise When the Government Prints Too Much Money

## Principle 10: Society Faces a Short-Run Trade-Off Between Inflation and Unemployment

In July 2010, Adair Turner, the head of the UK Financial Services Authority (FSA), at the time on of the regulators of the financial services industry, presented a paper at a conference organised by the London School of Economics under the title *'The Future of Finance'*. In his address, Lord Turner highlighted a number of issues that needed to be addressed in any reform of the financial services industry. One of the key messages at this conference was that the problems in the financial markets affected millions of people around the world, many of whom have little understanding (or desire to understand) and that any subsequent reform of the industry would equally affect these same people.

Part of the reason for the financial crisis arising was that the markets took advantage of deregulation both in Europe and in the United States and developed new products and new ways of doing business. The benefits of this were that consumers accessed credit far more easily than had previously been the case and the price that they paid was "too low". The cost was that financial markets became less stable. To address this problem, regulators are looking to find a balance between creating a financial system that is more stable and the ease with which consumers are able to access credit. In other words there is a trade-off (Principle 1); this trade-off is greater financial stability through higher capital and liquidity requirements at banks and other financial institutions (taking care not to hinder growth too much in the process) but at the expense of easier access to credit by consumers and less choice.

Prior to the financial crisis there were a series of trade-offs between consumer choice and consumer protection in addition to consumer and producer responsibility. What this resulted in was a market where consumers had relatively easy access to loans and mortgages with a huge range of such products available to choose from. Markets seemed to be working to the benefit of everyone (Principle 6). But as highlighted in Principle 7, sometimes governments can improve market outcomes. The role of government and regulators across the world now is to find a way in which financial stability can be improved but at a cost to consumers who will now experience less choice and freedom to access loans and mortgages; how far this shift in emphasis goes is a key issue for debate said Lord Turner.

What this will mean for consumers is that people trying to access mortgages, for example, will have to have deposits, will find the loan to value ratios (the proportion of money a bank or mortgage provider is willing to lend in relation to the value of the property being purchased) more stringent, greater checks will be carried out to ensure that borrowers have the income they say they have, and interest rates on borrowing may be higher. This will make it much harder for many people to get access to credit (loans). The key question is, therefore, are the costs to consumers of this move outweighed by the benefits to society as a whole of greater financial stability? Those who are currently unemployed as a result of the fall out from the financial crisis may believe that it is.

The reason for the focus on financial stability is because of the way in which problems in the financial system developed. Lord Turner points to the large bank bonuses paid for selling “over-complex and risky products of little real use to humanity” as a major problem. Inherent in this comment is Principle 4, People respond to incentives. “Poor incentives for good underwriting [led to traders and originators (banks and other financial institutions which initially create and offer loans) caring] little whether the credit was good as long as they could sell it before any problems arose.” How does the regulation system change the incentives structure that financial institutions offer in order to influence behaviour and improve financial stability?

Lord Turner is clear about the potential effects of improving financial stability in this way. If the cost of credit is increased then capital investment will be reduced and some investments will go un-financed. Why? Because of Principle 3, Rational people think at the margin. For a business seeking finance to invest in new plant, for example, the higher cost of securing that finance will affect its decision. The marginal benefit must be greater than or equal to the marginal cost of the investment. If the cost of finance increases then this changes these costs and benefits at the margin and some investment decisions will be shelved as a result of the fact that they are no longer deemed viable; if finance was cheaper then these investment decisions would have been made. To quote Lord Turner: “The assumed model here is that of a marginal efficiency of capital schedule with possible investment projects ranked by order of return, and with the level of investment in the economy, the number of projects which get financed, determined by how many deliver a return higher than the cost of capital. Increase the cost of credit...and fewer projects will be financed.” If this does happen then it will affect society’s ability to produce goods and services and so affect standards of living (principle 8)

Lord Turner also points to the important role that mortgage debt plays in “enabling individuals to smooth the consumption of housing services through their life cycle”. What this means is that few people have the funds to purchase a house outright but taking on mortgage debt allows individuals to purchase housing services on the basis of expected future income streams from earnings. What also needs to be considered is that this type of activity also helps individuals build up wealth. If a person takes out a mortgage on a house and pays it off after 25 years, the value of the property is likely to have risen over that time. Assuming inflation is taken into consideration it could be that the owner is able to generate a real return on the property if it is then sold or passed onto children. The housing trade can help to make everyone better off.

One of the aims of regulation in the future, according to Lord Turner, will be to “help people understand that there is no free lunch and that if you want higher return, you will have to face higher risk.” This means that if regulators can make people understand more that “making decisions requires trading off one goal against another” (Mankiw & Taylor, page x) then this should improve the quality of decision-making. Thus when making important financial decisions, for example, about taking on mortgages, choosing pension schemes, insurance services, savings plans and so on,

the sort of things that almost everyone has make use of at some point in their lives, consumers have to weigh up the costs and benefits associated but need to have a greater understanding of those costs and benefits prior to making the decision. Many people put off decisions to take out pension and insurance/assurance policies and the reason is primarily due to opportunity cost – Principle 2.

Taking out a pension policy when you are 21 means that you have to sacrifice what the premiums paid could have bought. The benefits of a pension plan will only become visible many years into the future – possibly over 40 years into the future. The sacrifice of material and leisure goods represented by the spending on a monthly pension premium may be deemed too great by many young people with the result that they put off taking out a pension until it may be too late. Lord Turner indicated that improving understanding of the costs and benefits of making financial decisions (making people more aware of the opportunity cost involved of decision-making) would be a desirable goal for regulation.

### Questions:

1. A trade-off is the recognition that decision-making involves giving up the benefits of something else whilst opportunity cost quantifies what the sacrifice involved may be. Using the example of an individual deciding whether to take out a life assurance policy (you can decide their age and circumstances) explain the difference between a trade-off and opportunity cost.
2. If markets are ‘usually a good way of making people better off’, then what is wrong with people accessing credit at low prices? Is this not simply the market allocating scarce resources appropriately?
3. Imagine that you are about to try and buy your first house or flat. Would you care about the stability of the financial system or would you rather be able to get your mortgage easily and cheaply? Explain.
4. It has been said that traders and originators had ‘distorted incentives’ in the period before the financial crisis. What do you think is meant by this term?
5. Are people always rational and do they always think at the margin? Explain your views using appropriate examples to highlight the points you make.
6. If people are not rational and don’t always think at the margin then what is the point of having this as a fundamental principle of economics?
7. A business is considering investing in re-structuring and re-equipping its warehouse and distribution site, an investment estimated to cost €4.5 million, financed by a loan. During the planning phase the cost of credit rises and the business decides to postpone the plan. Examine the possible reasons why it decided to postpone the investment.
8. How does a higher cost of credit feed through to a lower standard of living?

9. Given the importance of mortgage debt in ‘smoothing the consumption of housing services through an individuals life-cycle’, do you agree with the suggestion from Lord Turner that improved financial stability at the expense of cheap and easy access to credit for consumers is a price worth paying? Explain.
10. Is the opportunity cost of taking out a pension plan at a young age too great to warrant doing so? Explain.
11. To what extent should society invest more in educating young people that there is no such thing as a free-lunch and that the greater awareness of the costs and benefits of decision-making is a good thing?

Post Script:

After (or during) thinking about and writing the answers to these questions you may want to get a bit of light relief to help you through the tasks. The following link is to a video on YouTube which presents a slightly different interpretation of Mankiw’s *Ten Principles of Economics*.

<http://www.youtube.com/watch?v=VVp8UGjECt4&feature=related>