

Contents at a Glance

Introduction	1
Part I: Economics — The Science of How People Deal with Scarcity	7
Chapter 1: What Does Economics Study? And Why Should You Care?	9
Chapter 2: Cookies or Ice Cream? Tracking Consumer Choices	23
Chapter 3: Producing the Right Stuff the Right Way to Maximize Human Happiness	35
Part II: Macroeconomics — The Science of Economic Growth and Stability	55
Chapter 4: Measuring the Macroeconomy: How Economists Keep Track of Everything	57
Chapter 5: Inflation Frustration: Why More Money Isn't Always a Good Thing	77
Chapter 6: Understanding Why Recessions Happen	97
Chapter 7: Fighting Recessions with Monetary and Fiscal Policy	123
Part III: Microeconomics — The Science of Consumer and Firm Behavior	149
Chapter 8: Supply and Demand Made Easy	151
Chapter 9: Getting to Know <i>Homo Economicus</i> , the Utility-Maximizing Consumer	175
Chapter 10: The Core of Capitalism: The Profit-Maximizing Firm	193
Chapter 11: Why Economists Love Free Markets and Competition	219
Chapter 12: Monopolies: How Badly Would <i>You</i> Behave If You Had No Competition?	243
Chapter 13: Oligopoly and Monopolistic Competition: Middle Grounds	265
Chapter 14: Property Rights and Wrongs	287
Chapter 15: Market Failure: Asymmetric Information and Public Goods	299
Part IV: The Part of Tens	315
Chapter 16: Ten (Or So) Famous Economists	317
Chapter 17: Ten Seductive Economic Fallacies	325
Chapter 18: Ten Economic Ideas to Hold Dear	333

Appendix.....339
Index.....345

Table of Contents

.....

<i>Introduction</i>	1
About This Book.....	2
Conventions Used in This Book	3
What You're Not to Read.....	3
Foolish Assumptions	4
How This Book Is Organized.....	4
Part I: Economics — The Science of How People Deal with Scarcity	4
Part II: Macroeconomics — The Science of Economic Growth and Stability.....	5
Part III: Microeconomics — The Science of Consumer and Firm Behavior.....	5
Part IV: The Part of Tens.....	5
Icons Used in This Book.....	6
Where to Go from Here.....	6

<i>Part I: Economics — The Science of How People Deal with Scarcity</i>	7
--	----------

Chapter 1: What Does Economics Study? And Why Should You Care?	9
---	----------

Considering a Little Economic History	10
Pondering just how nasty, brutish, and short life used to be.....	10
Identifying the institutions that led to higher living standards	11
Looking toward the future.....	12
Sending Macroeconomics and Microeconomics to Separate Corners	12
Framing Economics As the Science of Scarcity.....	13
Zooming Out: Macroeconomics and the Big Picture.....	14
Measuring the economy	14
Recognizing what causes recessions	14
Fighting recessions with monetary and fiscal policies	15
Getting Up Close and Personal: Microeconomics.....	15
Balancing supply and demand.....	16
Considering why competition is so great.....	16
Examining problems caused by lack of competition.....	16
Reforming property rights	17
Dealing with other common market failures	17

Understanding How Economists Use Models and Graphs	18
Abstracting from reality is a good thing.....	18
Introducing your first model: The demand curve.....	18
Drawing your own demand curve.....	21
Chapter 2: Cookies or Ice Cream? Tracking Consumer Choices . . .	23
Considering a Model of Human Behavior	24
Maximizing Happiness Is the Objective	25
Using utility to measure happiness.....	25
Taking altruism and generosity into account	25
Realizing that self-interest can promote the common good.....	26
Red Light: Examining Your Limitations	27
Resource constraints	27
Technology constraints	27
Time constraints.....	28
Opportunity cost: The unavoidable constraint.....	28
Making Your Final Choice.....	29
Exploring Limitations and Violations of the Economist's	
Choice Model	31
Understanding uninformed decision-making.....	31
Getting rational about irrationality.....	32
Chapter 3: Producing the Right Stuff the Right Way to Maximize	
Human Happiness	35
Reaching the Limit: Determining What's Possible to Produce.....	36
Classifying resources used in production.....	37
Getting less of a good thing: Diminishing returns.....	38
A little here, a little there: Allocating resources.....	39
Graphing your production possibilities	39
Pushin' the line with better technology	42
Determining What Should Be Produced.....	44
Weighing pros and cons of markets and government	
interventions	45
Opting for a mixed economy.....	50
Encouraging Technology and Innovation	53
 Part II: Macroeconomics — The Science of Economic	
Growth and Stability	55
 Chapter 4: Measuring the Macroeconomy: How Economists	
Keep Track of Everything	57
Using GDP to Track the Economy	58
Leaving some things out of GDP.....	58
Gettin' in the flow: Tallying up what counts in GDP	59
Considering flows of income and assets	60

Following the funds, around and around62
 Counting stuff when it’s made, not when it’s sold63
 The good, the bad, and the ugly: All things increase GDP64
 Introducing the GDP Equation65
 C is for consumption (that’s good enough for me!)66
 I is for investment in capital stock (or should it be “I am”?)67
 G whiz! Government, that is69
 NX: Not a foreign sports car70
 Understanding How International Trade Affects the Economy71
 Trade deficits can be good for you!71
 Considering assets — not just cash73
 Wielding a comparative advantage74

**Chapter 5: Inflation Frustration: Why More Money Isn’t
 Always a Good Thing77**

Buying an Inflation: The Risks of Too Much Money78
 Balancing money supply and demand78
 Giving in to the inflation temptation80
 Tallying up the effects of inflation85
 Measuring Inflation: Price Indexes87
 Creating your very own market basket88
 Calculating the inflation rate89
 Setting up a price index89
 Determining the real standard of living with the price index91
 Identifying price index problems91
 Pricing the Future: Nominal and Real Interest Rates92
 Using the Fisher equation93
 Realizing that predictions aren’t perfect94

Chapter 6: Understanding Why Recessions Happen97

Examining the Business Cycle98
 Striving for Full-Employment Output99
 Returning to Y*: The Natural Result of Price Adjustments100
 Responding to Economic Shocks: Short-Run and Long-Run Effects101
 Defining some critical terms101
 The tao of P: Looking at price adjustments in the long run103
 A shock to the system: Adjusting to a shift
 in aggregate demand104
 Dealing with fixed prices in the short run105
 Putting together the long and short of it107
 Heading Toward Recession: Getting Stuck with Sticky Prices109
 Cutting wages or cutting workers110
 Adding up the costs of wages and profits110
 Returning to Y* with and without government intervention111
 Achieving Equilibrium with Sticky Prices: The Keynesian Model112
 Adjusting inventories instead of prices113
 Boosting GDP in the Keynesian model121

Chapter 7: Fighting Recessions with Monetary and Fiscal Policy	123
Stimulating Demand to End Recessions.....	124
Aiming for full-employment output.....	124
Shifting the AD curve to the right — or, putting people back to work	126
Generating Inflation: The Risk of Too Much Stimulation	126
An exercise in futility: Trying to increase output beyond Y^*	127
A temporary high: Tracing the movement of real wages	128
Failing to stimulate: What happens when a stimulus is expected.....	131
Figuring Out Fiscal Policy	134
Increasing government spending to help end recessions.....	134
Dealing with deficits.....	136
Dissecting Monetary Policy.....	138
Identifying the benefits of fiat money	138
Realizing that you can have too much money!.....	140
Getting the basics about bonds.....	141
Seeing the link between bond prices and interest rates	142
Changing the money supply to change interest rates	143
Lowering interest rates to stimulate the economy.....	145
Understanding how rational expectations can limit monetary policy.....	145

Part III: Microeconomics — The Science of Consumer and Firm Behavior

149

Chapter 8: Supply and Demand Made Easy	151
Making Sense of Markets.....	152
Deconstructing Demand.....	152
Getting our terms straight.....	153
Graphing the demand curve	154
Opportunity costs: Determining the slope of the demand curve	156
Defining demand elasticity.....	157
Sorting Out Supply.....	159
Graphing the supply curve	159
Understanding extreme supply cases.....	163
Interacting Supply and Demand to Find Market Equilibrium.....	164
Finding market equilibrium.....	165
Demonstrating the stability of the market equilibrium.....	166
Adjusting to New Market Equilibriums when Supply or Demand Changes	168
Reacting to an increase in demand	168
Reacting to a decrease in supply.....	170

Constructing Impediments to Market Equilibrium171
 Raising price ceilings171
 Propping up price floors.....173

**Chapter 9: Getting to Know *Homo Economicus*,
 the Utility-Maximizing Consumer175**

Knowing the Name of the Game: Constrained Optimization176
 Finding a Common Denominator to Measure Happiness: Utility176
 Getting Less from More: Diminishing Marginal Utility177
 Choosing Among Many Options When Facing a Limited Budget.....180
 Trying to buy as much (marginal) utility as you can.....181
 Allocating money between two goods
 to maximize total utility183
 Equalizing the marginal utility per dollar
 of all goods and services186
 Deriving Demand Curves from Diminishing Marginal Utility188
 Seeing how price changes affect quantities demanded188
 Graphing the price and quantity changes
 to form a demand curve190

**Chapter 10: The Core of Capitalism:
 The Profit-Maximizing Firm193**

Maximizing Profits Is a Firm’s Goal194
 Facing Competition195
 Listing the requirements for perfect competition.....195
 Acting as price takers but quantity makers.....196
 Distinguishing between accounting profits
 and economic profits198
 Analyzing a Firm’s Cost Structure199
 Focusing on costs per unit of output.....200
 Examining average variable costs202
 Watching average fixed costs fall203
 Tracking the movement of average total costs204
 Focusing on marginal costs.....205
 Noticing where the MC curve crosses the AVC
 and ATC curves205
 Comparing Marginal Revenues with Marginal Costs207
 The magic formula: Finding where $MR = MC$ 208
 Visualizing profits.....210
 Visualizing losses213
 Pulling the Plug: When Producing Nothing Is Your Best Bet214
 The short-run shutdown condition: Variable costs
 exceed total revenues214
 The long-run shutdown condition: Total costs exceed
 total revenues.....216
 At the mercy of the market price217

Chapter 11: Why Economists Love Free Markets and Competition	219
The Beauty of Competitive Free Markets: Ensuring That Benefits Exceed Costs	220
Examining prerequisites for properly functioning markets	220
Analyzing the efficiency of free markets	222
Using total surplus to measure gains	225
When Free Markets Lose Their Freedom: Dealing with Deadweight Losses	230
Dissecting the deadweight loss from a price ceiling	231
Analyzing the deadweight loss of a tax	232
Hallmarks of Perfect Competition: Zero Profits and Lowest Possible Costs	235
Understanding the causes and consequences of perfect competition	235
Peering into the process of perfect competition	236
Graphing how profits guide firm entry and exit	238
Chapter 12: Monopolies: How Badly Would <i>You</i> Behave If You Had No Competition?	243
Examining Profit-Maximizing Monopolies	244
Zeroing in on the problems monopolies cause	244
Identifying the source of the problem: Decreasing marginal revenues	245
Choosing an output level to maximize profits	250
Comparing Monopolies with Competitive Firms	253
Looking at output and price levels	253
Deadweight losses: Quantifying the harm caused by monopolies	255
Focusing on efficiency	256
Considering Examples of Good Monopolies	257
Encouraging innovation and investment with patents	257
Reducing annoyingly redundant competitors	257
Keeping costs low with natural monopolies	258
Regulating Monopolies	259
Subsidizing a monopoly to increase output	259
Imposing minimum output requirements	259
Regulating monopoly pricing	260
Breaking up a monopoly into several competing firms	262
Chapter 13: Oligopoly and Monopolistic Competition: Middle Grounds	265
Choosing to Compete or Collude	266
Realizing that oligopoly firms interact strategically	266
Comparing the outcomes of competition and collusion	267

Cartel Behavior: Trying to Imitate Monopolists268
 Coordinating a cartel is hard work268
 Examining OPEC to see the difficulties of collusion268
 Understanding the Prisoner’s Dilemma Model270
 Fleshing out the Prisoner’s Dilemma270
 Using omerta to resolve the Prisoner’s Dilemma.....274
 Applying the Prisoner’s Dilemma to Cartels.....275
 Seeing that OPEC is trapped in a Prisoner’s Dilemma.....277
 Using an enforcer to help OPEC members stick to quotas278
 Regulating Oligopolies.....279
 Dealing with dominant firms279
 Applying antitrust laws.....279
 Studying a Hybrid: Monopolistic Competition.....280
 Benefiting from product differentiation.....280
 Facing profit limits281

Chapter 14: Property Rights and Wrongs287

Allowing Markets to Reach Socially Optimal Outcomes288
 Examining Externalities: The Costs and Benefits Others Feel
 from Our Actions289
 Defining positive and negative externalities290
 Noting the effects of negative externalities290
 Realizing that you want positive amounts
 of negative externalities.....292
 Dealing with negative externalities293
 Calculating the consequences of positive externalities294
 Taking in the Tragedy of the Commons296
 Having a cow: Overgrazing on a commonly owned field296
 Sleeping with the fishes: Extinctions caused
 by poor property rights297

**Chapter 15: Market Failure: Asymmetric Information
 and Public Goods299**

Facing Up to Asymmetric Information300
 Realizing that asymmetric information limits trade300
 Souring on the lemons problem: The used car market301
 Issuing insurance when you can’t tell individuals apart.....305
 Providing Public Goods.....309
 Taxing to provide public goods309
 Enlisting philanthropy to provide public goods310
 Providing a public good by selling a related private good311
 Ranking new technology as a public good.....311

Part IV: The Part of Tens	315
Chapter 16: Ten (Or So) Famous Economists	317
Adam Smith	317
David Ricardo	318
Karl Marx	318
Alfred Marshall	319
John Maynard Keynes	319
Kenneth Arrow and Gerard Debreu	320
Milton Friedman	320
Paul Samuelson	321
Robert Solow	321
Gary Becker	322
Robert Lucas	322
Chapter 17: Ten Seductive Economic Fallacies	325
The Lump of Labor Fallacy	325
The World Is Facing an Overpopulation Problem	326
The Fallacy of Confusing Sequence with Causation	327
Protectionism Is the Best Solution to Foreign Competition	327
The Fallacy of Composition	328
If It's Worth Doing, Do It 100 Percent	328
Free Markets Are Dangerously Unstable	329
Low Foreign Wages Mean That Rich Countries Can't Compete	329
Tax Rates Don't Affect Work Effort	330
Forgetting That Policies Have Unintended Consequences, Too	331
Chapter 18: Ten Economic Ideas to Hold Dear	333
Society Is Better Off When People Pursue Their Own Interests	333
Free Markets Require Regulation	334
Economic Growth Depends on Innovation	334
Freedom and Democracy Make Us Richer	334
Education Raises Living Standards	334
Protecting Intellectual Property Rights Promotes Innovation	335
Weak Property Rights Cause All Environmental Problems	335
International Trade Is a Good Thing	336
Free Enterprise Has a Hard Time Providing Public Goods	336
Preventing Inflation Is Easy	337
Appendix: Glossary	339
Index	345