

The economy has gone through wild gyrations in the last few years. For a good many years people thought the economy, the stock market, and home prices would never stop rising. Then the "housing bubble" burst, sending home prices into a steep and sickening slide. With the slide in home prices came a wave of foreclosures—and a drastic decline in people's confidence in the economic outlook. Consumers trimmed their spending on goods and services while businesses slashed their investments in housing, machinery, technology, and factories. These spending cuts pushed the U.S. economy into a steep recession that caused the production of goods and services to contract and unemployment to soar. At the depths of the 2008–2009 recession more than 15 million Americans were unemployed.

The recession of 2008–2009 wasn't the first setback for the U.S. economy—or even the worst. The Great Depression of the 1930s was far deeper and far longer (10 years!). And the other ten U.S. recessions since World War II were painful as well—even if not quite so disastrous. What this record of recessions reminds us is how difficult it is to manage the economy. It also underscores, however, the importance of studying the forces that cause economic setbacks—and identifying the forces that help the economy recover. That's reason enough to study the Essentials of Economics.

There are more personal reasons for studying economics as well. Economic principles help explain how prices are set, how hiring and salary decisions are made, how businesses set production targets, and even how the environment can be better protected. In other words, economics encompasses not just the "big picture"—the *macro* economy—but also the many dimensions of everyday consumption, work, and leisure decisions—the *micro* economy.

FOCUS ON CORE CONCEPTS

It's impossible to squeeze all the content—and the excitement—of both micro and macro economics into a one-semester course, much less an abbreviated intro text. But economics is, after all, the science of choice. Instructors who teach a one-term survey of economics know how hard the content choices can be. There are way too many topics, way too many economic events, and way too little time.

Few textbooks confront this scarcity problem directly. Some one-semester books are nearly as long as full-blown principles texts. The shorter ones tend to condense topics and omit the additional explanations, illustrations, and applications that are especially important in survey courses. Students and teachers alike get frustrated trying to pick out the essentials from abridged principles texts.

Essentials of Economics lives up to its name by making the difficult choices. The standard table of contents has been pruned to the core. The surviving topics are the very essence of economic concepts. In microeconomics, for example, the focus is on the polar models of perfect competition and monopoly. These models are represented as the endpoints of a spectrum of market structures (see figure on p. 117). Intermediate market structures—oligopoly, monopolistic competition, and the like—are noted but not analyzed. The goal here is simply to convey the sense that market structure is an important determinant of

CONTENTS

Section BASICS	Business Organization 40
occion pasies	Government Regulation 42
Chapter 1	Striking a Balance 44
THE CHALLENGE OF ECONOMICS 2	For Whom America Produces 44
THE CHALLEINGE OF ECONOMICS 2	The Distribution of Income 44
The Central Problem of Scarcity 6	Income Mobility 45
Three Basic Economic Questions 7	Taxes and Transfers 46
WHAT to Produce 7	Policy Perspectives
HOW to Produce 12	Global Poverty 47
FOR WHOM to Produce 13	Summary 48
The Mechanisms of Choice 14	Headlines
The Political Process 14	The Education Gap between Rich and Poor Nations 41
The Market Mechanism 14	Income Share of the Rich 46
Central Planning 15	
Mixed Economies 15	Chapter 3
Undesirable Choices 16	SUPPLY AND DEMAND 50
Market Failure 16	\(\frac{1}{4}\)
Government Failure 18	Market Participants 51
What Economics Is All About 19	Goals 51
Macro versus Micro 20	Constraints 51
Theory versus Reality 21	Specialization and Exchange 52
Politics versus Economics 21	Market Interactions 52
Modest Expectations 22	The Two Markets 52
Policy Perspectives	Dollars and Exchange 54
No Free Health Care 22	Supply and Demand 54
Summary 23	Demand 54
Appendix: Using Graphs 25	Individual Demand 54
Slopes 26	Determinants of Demand 57
Shifts 27	Ceteris Paribus 58
Linear versus Nonlinear Curves 28	Shifts in Demand 58
Causation 29	Movements versus Shifts 60
Headlines	Market Demand 60
The Big Picture 4	The Market Demand Curve 61
Will Your Kids Be Better Off? 5	The Use of Demand Curves 62
U.N. Agency Sees Severe Food Shortage in	Supply 62
North Korea 11	Determinants of Supply 63
Declining Faith in Government 19	The Market Supply Curve 63
Chapter 2	Shifts in Supply 64
•	Equilibrium 64
THE U.S. ECONOMY 30	Market Clearing 65
What America Produces 31	Surplus and Shortage 67
How Much Output 31	Changes in Equilibrium 69
The Mix of Output 35	Disequilibrium Pricing 71
Changing Industry Structure 37	Price Ceilings 71
How America Produces 39	Price Floors 72

Laissez Faire 73

Factors of Production 39

Policy Perspectives

Cheap Gas in Hawaii! 74

Summary 75

Headlines

Higher Alcohol Prices and Student Drinking 57
Toyota February Sales Suffer Over Safety Concerns 59
Bitter Florida Cold Drives Up Orange Juice Prices 65
Hannah Tickets through the Roof 67
E-Readers in Short Supply for Holiday 68
U2's 360° Tour Named Top North American Trek of 2009 69

Section II MICROECONOMICS

Chapter 4 CONSUMER DEMAND 78

Patterns of Consumption 79

Determinants of Demand 80

The Sociopsychiatric Explanation 80

The Economic Explanation 82

The Demand Curve 82

Utility Theory 82

Price and Quantity 84

Price Elasticity 86

Elastic versus Inelastic Demand 87
Price Elasticity and Total Revenue 88
Determinants of Price Elasticity 90
Other Changes in Consumer Behavior 92
Changes in Income 93

Policy Perspectives

Caveat Emptor: The Role of Advertising 93

Summary 95

Headlines

Men versus Women: How They Spend 81
To Sustain iPhone, Apple Halves Price 86
Biggest U.S. Tax Hike on Tobacco Takes Effect 88
Starbucks Customers Feel Burned by Surprise
Price Hikes 91
San Francisco: The Butts Stop Here 92
Truck and SUV Sales Plunge as Gas Prices Rise 93

Chapter 5 SUPPLY DECISIONS 98

Capacity Constraints: The Production Function 99

Efficiency 101
Capacity 101
Marginal Physical Product 101
Law of Diminishing Returns 102
Short Run versus Long Run 104

Costs of Production 104

Total Cost 104

Which Costs Matter? 106

Average Cost 106

Marginal Cost 108

Supply Horizons 108

The Short-Run Production Decision 109

The Long-Run Investment Decision 110

Economic versus Accounting Costs 111

Economic Cost 112

Economic Profit 112

Policy Perspectives

Invest in Labor or Capital? 113

Summary 114

Headlines

"We Pretend to Work, They Pretend to Pay Us" 103 Ford Will Increase SUV Production Because of "Low Supplies," Increased Demand 111

Dongfeng Honda to Build Second Auto Plant in China 111

Chapter 6 COMPETITION 116

Market Structure 117

Perfect Competition 119

No Market Power 119

Price Takers 120

Market Demand versus Firm Demand 121

The Firm's Production Decision 122

Output and Revenues 122

Revenues versus Profits 122

Profit Maximization 123

Price 123

Marginal Cost 123

Profit-Maximizing Rate of Output 124

Total Profit 126

Supply Behavior 128

A Firm's Supply 128

Market Supply 129

Industry Entry and Exit 130

Entry 130

Tendency toward Zero Economic Profits 131

Exit 132

Equilibrium 132

Low Barriers to Entry 134

Market Characteristics 135

Policy Perspectives

The Virtues of Competition 135

Summary 137

Headlines

Catfish Farmers Forced Out of Business 120

Flat Panels, Thin Margins 131

Contents xxix

Catfish Growers Face Global Competition 133 T-Shirt Shop Owner's Lament: Too ManyT-Shirt Shops 134

Chapter 7

MONOPOLY 140

Monopoly Structure 141

Monopoly = Industry 142

Price versus Marginal Revenue 142

Monopoly Behavior 144

Profit Maximization 144

The Production Decision 145

The Monopoly Price 145

Monopoly Profits 146

Barriers to Entry 146

Threat of Entry 146

Patent Protection: Polaroid versus Kodak 147

Other Entry Barriers 148

Comparative Outcomes 150

Competition versus Monopoly 151

Near Monopolies 151

WHAT Gets Produced 153

FOR WHOM 153

HOW 153

Any Redeeming Qualities? 154

Research and Development 154

Entrepreneurial Incentives 154

Economies of Scale 154

Natural Monopolies 156

Contestable Markets 156

Structure versus Behavior 156

Policy Perspectives

Flying Monopoly Air 157

Summary 159

Headlines

Suit Threat Slows Linux Sales 149

Judge Says Microsoft Broke Antitrust Law 150

OPEC Leaves Quotas Unchanged, Despite Big

Inventory 152

Music Firms Settle Lawsuit 153

Two Drug Firms Agree to Settle Pricing Suit 155

Why Travelers Benefit When an Airline Hub Closes 158

Following the Fares 159

Chapter 8

THE LABOR MARKET 162

Labor Supply 163

Income versus Leisure 164

Market Supply 165

Labor Demand 165

Derived Demand 165

Marginal Physical Product 168

Marginal Revenue Product 168

The Law of Diminishing Returns 169

The Hiring Decision 171

The Firm's Demand for Labor 171

Market Equilibrium 172

Equilibrium Wage 173

Equilibrium Employment 174

Changing Market Outcomes 174

Changes in Productivity 174

Changes in Price 175

Legal Minimum Wages 175

Labor Unions 177

Policy Perspectives

Capping CEO Pay 178

Summary 180

Headlines

More Than 10,000 Show Up for Job Fair 164

Verizon to Cut More Than 10,000 Jobs in 2010 166

Most Lucrative College Degrees 167

For Alabama, Saban Has Been Worth Every Penny 173

Congress Approves Minimum Wage Hike 175

Obama Lays Out Limits on Executive Pay 179

Chapter 9

GOVERNMENT INTERVENTION 182

Market Failure 183

The Nature of Market Failure 184

Sources of Market Failure 184

Public Goods 184

Joint Consumption 185

The Free-Rider Dilemma 185

Externalities 187

Consumption Decisions 188

Production Decisions 190

Social versus Private Costs 192

Policy Options 194

Market Power 196

Restricted Supply 196

Antitrust Policy 198

Inequity 199

Macro Instability 200

Policy Perspectives

Trust in Government? 200

Summary 202

Headlines

Napster Gets Napped 186

Secondhand Smoke Debate "Over" 188

N.J. Leaders, Environmental Groups Condemn President Obama's Offshore Drilling Proposal 193

Breathe Easy 196

Forced Recycling Is a Waste 197

XXX Contents

Section III MACROECONOMICS

Chapter 10

THE BUSINESS CYCLE 204

Assessing Macro Performance 206

GDP Growth 207

Business Cycles 207

Real GDP 208

Erratic Growth 208

Unemployment 211

The Labor Force 211

The Unemployment Rate 212

The Full-Employment Goal 212

Inflation 215

Relative versus Average Prices 215

Redistributions 217

Uncertainty 222

Measuring Inflation 222

The Price-Stability Goal 223

Summary 224

Headlines

Market in Panic as Stocks Are Dumped in 12,894,600

Share Day; Bankers Halt It 205

Economy: Sharpest Decline in 26 Years 207

Depression Slams World Economies 210

Social Costs of Job Loss 213

Inflation and the Weimar Republic 216

US College Tuition Skyrockets 218

Chapter 11

AGGREGATE SUPPLY AND DEMAND 228

A Macro View 229

Macro Outcomes 229

Macro Determinants 230

Stable or Unstable? 230

Classical Theory 230

The Keynesian Revolution 231

The Aggregate Supply-Demand Model 233

Aggregate Demand 233

Aggregate Supply 234

Macro Equilibrium 235

Macro Failure 236

Undesirable Outcomes 237

Unstable Outcomes 238

Shift Factors 239

Competing Theories of Short-Run

Instability 241

Demand-Side Theories 242

Supply-Side Theories 243

Eclectic Explanations 243

Policy Options 244

Fiscal Policy 244

Monetary Policy 244

Supply-Side Policy 244

Policy Perspectives

The Changing Choice of Policy Levers 245

Summary 247

Headlines

Job Losses Surge as U.S. Downturn Accelerates 238

Consumer Index Sinks to All-Time Low 240

Hurricane Damage to Gulf Ports Delays Deliveries,

Raises Costs 241

Chapter 12

FISCAL POLICY 250

Components of Aggregate Demand 251

Consumption 252

Investment 253

Government Spending 254

Net Exports 254

Equilibrium 254

The Nature of Fiscal Policy 255

Fiscal Stimulus 256

More Government Spending 257

Tax Cuts 261

Inflation Worries 264

Fiscal Restraint 264

Budget Cuts 265

Tax Hikes 265

Fiscal Guidelines 266

Policy Perspectives

Unbalanced Budgets 266

Summary 268

Headlines

Here Comes the Recession 253

Senate Passes \$787 Billion Stimulus Bill 257

The 2008 Economic Stimulus: First Take on Consumer Response 263

Chapter 13

MONEY AND BANKS 270

The Uses of Money 271

Many Types of Money 272

The Money Supply 272

Cash versus Money 272

Transactions Accounts 273 Basic Money Supply 274

Near Money 274

Aggregate Demand 275

Creation of Money 276

Deposit Creation 276

A Monopoly Bank 277

Reserve Requirements 279

Excess Reserves 279

A Multibank World 280

The Money Multiplier 280

Limits to Deposit Creation 281

Excess Reserves as Lending Power 282

The Macro Role of Banks 282

Financing Aggregate Demand 282

Constraints on Money Creation 283

Policy Perspectives

Digital Money 284

Summary 285

Headlines

Goods Replace Rubles in Russia's Vast Web of Trade 273 How Would You Like to Pay for That? 275

Chapter 14

MONETARY POLICY 288

The Federal Reserve System 290

Federal Reserve Banks 290

The Board of Governors 290

The Fed Chairman 291

Monetary Tools 291

Reserve Requirements 291

The Discount Rate 293

Open-Market Operations 295

Powerful Levers 298

Shifting Aggregate Demand 298

Expansionary Policy 298

Restrictive Policy 299

Interest-Rate Targets 300

Price versus Output Effects 300

Aggregate Demand 300

Aggregate Supply 300

Policy Perspectives

Fixed Rules or Discretion? 302

Summary 304

Headlines

China Tries to Cool Economy by Ordering Banks to

Boost Reserves 293

Fed Cuts Key Interest Rate Half-Point to 1 Percent 296

Chapter 15

ECONOMIC GROWTH 306

The Nature of Growth 307

Short-Run Changes in Capacity Use 307 Long-Run Changes in Capacity 307

Nominal versus Real GDP 308

Growth Indexes 309

The GDP Growth Rate 309

GDP per Capita: A Measure of Living

Standards 310

GDP per Worker: A Measure of Productivity 313

Sources of Productivity Growth 314

Labor Quality 314

Capital Investment 314

Management 314

Research and Development 315

Policy Levers 315

Education and Training 315

Immigration Policy 316

Investment Incentives 317

Savings Incentives 317

Government Finances 317

Deregulation 318

Economic Freedom 320

Policy Perspectives

Is More Growth Desirable 321

Summary 322

Headlines

What Economic Growth Has Done for U.S.

Families 311

Point System for Immigrants at Heart of U.S. Immigration

Debate 316

Americans Save Little 318

Improvement in Economic Freedom and Economic

Growth 320

Chapter 16

THEORY AND REALITY 324

Policy Tools 325

Fiscal Policy 325

Monetary Policy 328

Supply-Side Policy 330

Idealized Uses 331

Case 1: Recession 331

Case 2: Inflation 332

Case 3: Stagflation 332

Fine-Tuning 333

The Economic Record 334

Why Things Don't Always Work 336

Goal Conflicts 336

Measurement Problems 336

Design Problems 338

Implementation Problems 338

Policy Perspectives

Hands Off or Hands On? 342

Summary 344

Headlines

Budget Deficit Sets Record in February 328

Macro Performance in the 1990s 335

NBER Makes If Official: Recession Started in

December 2007 337

Tough Calls in Economic Forecasting 339

One Year Later, Political Battle Rages Over Stimulus'

Effectiveness 341

Section IV INTERNATIONAL

Chapter 17

INTERNATIONAL TRADE 346

U.S. Trade Patterns 347

Imports 347

Exports 347

Trade Balances 349

Motivation to Trade 350

Production and Consumption without Trade 350

Trade Increases Specialization and World

Output 352

Comparative Advantage 353

Opportunity Costs 353

Absolute Costs Don't Count 354

Terms of Trade 354

Limits to the Terms of Trade 355

The Market Mechanism 355

Protectionist Pressures 356

Microeconomic Losers 356

The Net Gain 358

Barriers to Trade 358

Tariffs 358

Quotas 358

Nontariff Barriers 361

Exchange Rates 362

Global Pricing 362

Appreciation/Depreciation 362

Foreign Exchange Markets 363

Policy Perspectives

Policing World Trade 365

Summary 368

Headlines

Exports in Relation to GDP 348

California Grape Growers Protest Mixing Foreign

Wine 356

A Litany of Losers 357

How Sweet It Isn't: Big Sugar Sours Trade Deal 361

Travelers Flock to Europe as Dollar Gets Stronger 363

China Ends Fixed-Rate Currency 365

U.S. Trade Restrictions Draw Warning 366

Glossary 370

Index 375