

ECON 1001

MICROECONOMICS

Scarcity: “the limited nature of society’s resources”

Economics: “The study of how society manages its scarce resources”

Chapter 1

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 organise economic activity

Principle 7: Governments can sometimes improve market outcomes

Principle 8: A country’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 term trade off between inflation and unemployment

Principles 1 to 4 are principles of individual decision making

Principles 5 to 7 are principles involving economic interactions

Principles 8 to 10 describe how the economy as a whole works

Efficiency: “The property of society getting the most it can from its scarce resources”

Equity: “The property of distributing economic prosperity fairly among the members of society”

Opportunity cost: “Whatever must be given up to obtain some item”

Marginal changes: “Small incremental adjustments to a plan of action”

Market economy: An economy that allocates resource through the decentralised decisions of many firms and households as they interact in markets for goods and services

Market failure: “A situation in which a market left on its own fails to allocate resources efficiently”

Externality: “The impact of one person’s actions on the wellbeing of a bystander”

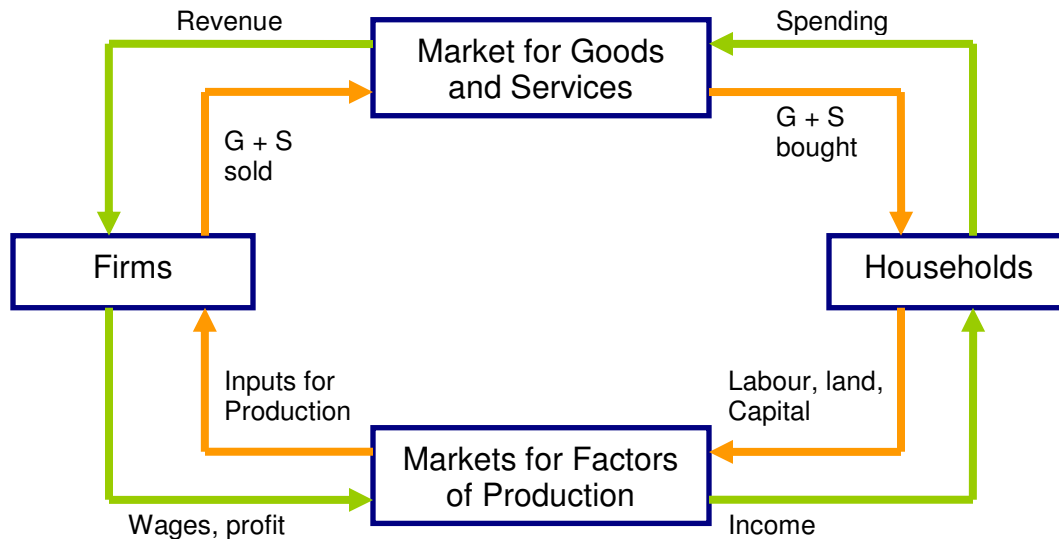
Market power: “The ability of a single economic actor to have a substantial influence on market prices”

Productivity: “The quantity of goods and services produced from each hour of a worker’s time”

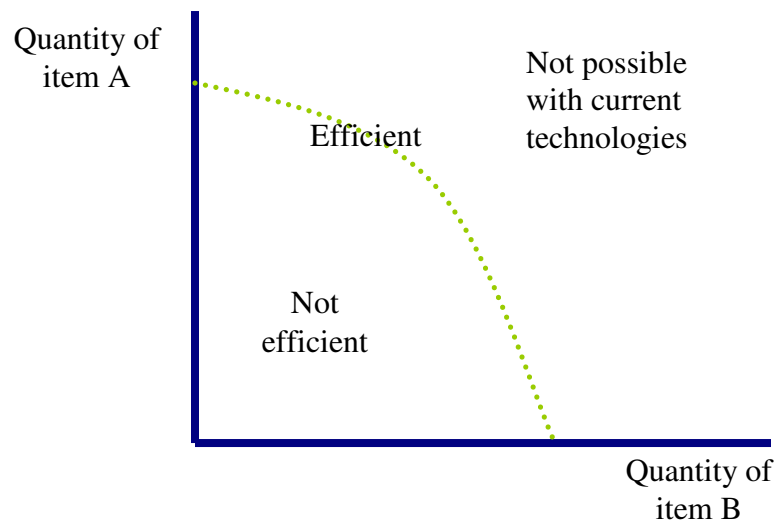
Inflation: “an increase in the overall level of prices in the economy”

Phillips Curve: “The short term trade off between inflation and unemployment”

Chapter 2



A circular flow diagram represents the organisation of the economy



Production Possibilities Frontier: “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”

Why Economists Disagree:

- Differences in scientific judgements
- Difference in values
- Perception versus reality

Microeconomics: “the study of how households and firms make decisions and how they interact in specific markets”

Macroeconomics: “the study of economy wide phenomena.”

Positive statements: Descriptive, based on current reality, how the world is

Normative statements: Prescriptive, “how the world should be”, judgemental, should

Chapter 3: Interdependence and the Gains from Trade

Trade: allows people to consume goods that they cannot produce, a new good, and also benefits everyone in society because it “allows people to specialise in activities in which they have a comparative advantage”

Specialisation: lowers cost of production, can make both parties better off

Absolute advantage: the party that is more efficient in the production of a good is said to have absolute advantage

Comparative advantage: The producer that has a lower opportunity cost in the production of a good is said to have comparative advantage

Lecture 3: Bargaining

Two person bargaining- take it or leave it: A good produced by Party A has no value to anyone bar Party B. Party B has \$1 value of the good, which they might use for various purposes. Party A anticipates what Party B will do with the good, and therefore what they will be ready to pay for the good. Party A makes an offer. If the offer is under Party B’s value for the good, the offer is rejected. If a reasonable offer is made, then Party A receives x dollars, Party B gains 1-x value. Person A has bargaining power

Two period: Person making last offer has bargaining power

Chapter 4: Supply and Demand I: How Markets Work

Markets and Competition

Competitive Markets: “A market in which there are many buyers and sellers so that each has a negligible impact on the market price”

Perfectly competitive market: a market where the “goods being offered for sale are all the same” and “the buyers and sellers are so numerous that no single buyer can influence the price”

Price takers: buyers who accept the shelf price

Monopoly: Markets with only one seller

Oligopoly: Few sellers who do not compete aggressively (e.g. Airline companies)

Monopolistically competitive: Each seller sells a slightly different product at different prices

Demand

Quantity Demanded: How much of a good a buyer will and can purchase

Law of demand: The quantity demanded decreases as price increases

Normal Good: If your income increases, consumption of a normal good increases (e.g. Sorbents toilet paper with puppy prints on them, scented at the core)

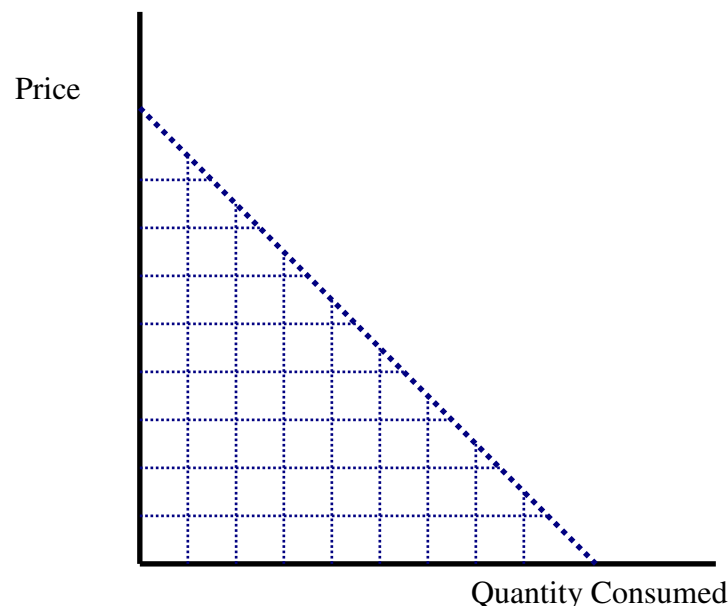
Inferior good: if your income increases, consumption of an inferior good decreases (e.g. Lousy Reject Shop brand toilet paper that smells like chlorine)

Substitutes: Two goods where a “decrease in the price of one good leads to a decrease in the demand for the other good” (e.g. If the price of McCains Shepherd pie decreases, the demand for Home Brand Shepherd pie would decrease)

Complements: where an increase in demand in one good would lead to an increase in demand of the other. (e.g. corn chips and salsa)

Price	Quantity demanded
\$0.50	6
\$0.60	5

The demand schedule



The demand curve represents the relationship between the price and the demand
Ceteris paribus: “other things being equal”- everything else is assumed constant, not considered.

Market demand: the sum total of individual demands

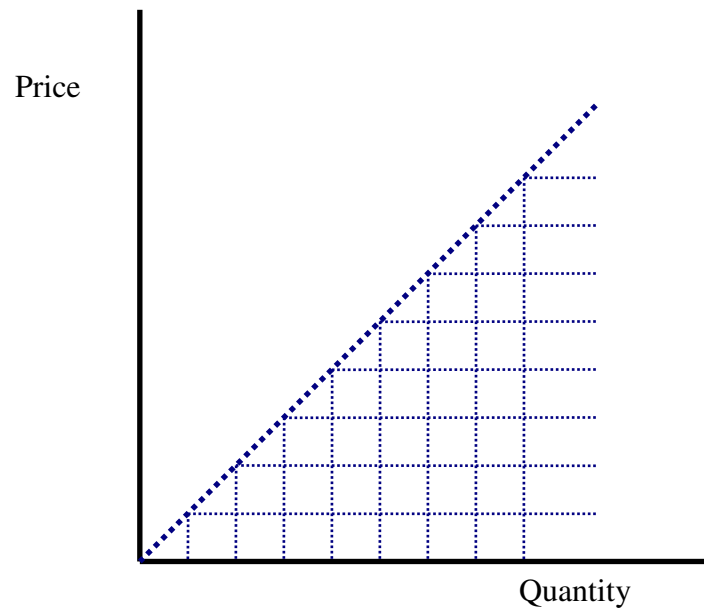
Supply

Quantity supplied: “the amount of a good that sellers are willing and able to sell”

Law of supply: when prices are high, quantity supplied rises

Price	Supply
\$3	6
\$2.80	5

The Supply Schedule



Supply Curve

Market supply: the sum of individual supplies

Supply and Demand together

Equilibrium: “situation where supply and demand have been brought into balance”. Equilibrium is located where the demand and supply curves meet.

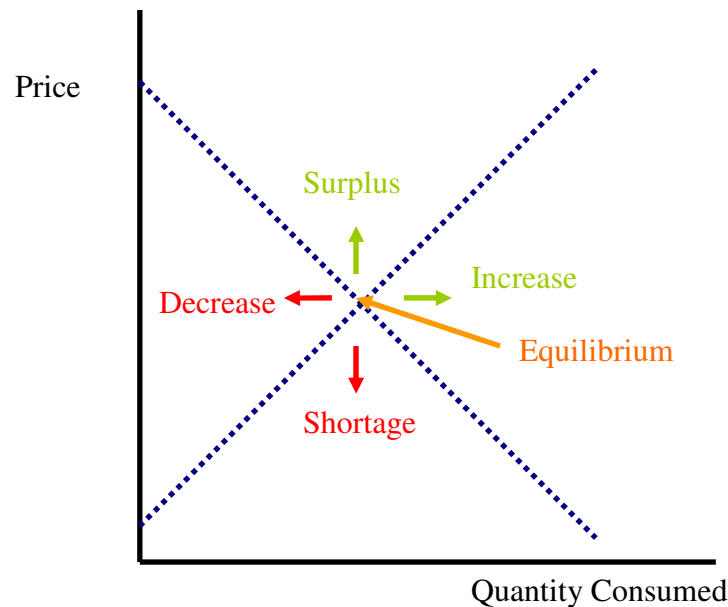
Equilibrium price: “price that balances supply and demand”

Equilibrium supply: “quantity supplied and demanded when the price has adjusted to balance supply and demand”

Surplus: “quantity supplied is greater than quantity demanded”

Shortage: “quantity demanded is greater than quantity supplied”

Law of supply and demand: “the price of any good adjusts to bring the supply and demand for that good into balance”



Chapter 5: Elasticity and its Application

Elasticity of demand

Elasticity: “measure of the responsiveness of quantity demanded or quantity supplied to one of its determinants”.

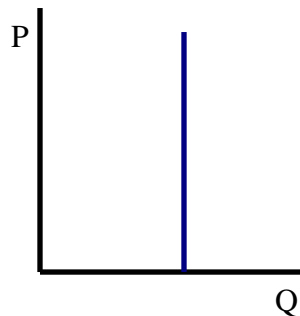
Whether a good is elastic or inelastic depends on the following

- Necessities versus discretionary expenditure (necessities tend to be inelastic)
- Availability of close substitutes (lots of substitutes = more elastic)
- Definition of the market (eg Food market is inelastic, but ice cream is elastic. Narrowly defined markets tend to have more elastic demand)
- Time horizon (“goods tend to have more elastic demand over longer time horizons)

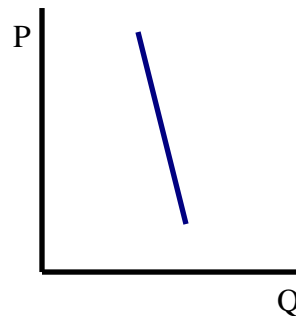
Price elasticity of demand: “how much the quantity demanded of a good responds to a change in the price of that good”

Price elasticity of demand = % change in quantity demanded / % change in price

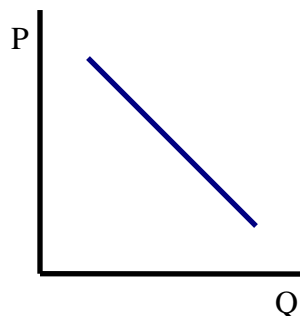
$$\text{Price } \epsilon \text{ of demand} = \frac{\% \Delta Q_d}{\% \Delta P}$$



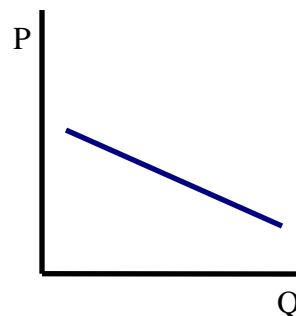
Perfectly Inelastic
 $\epsilon = 0$



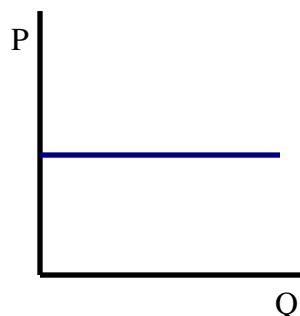
Inelastic demand
 $\epsilon < 1$



Unit elastic demand
 $\epsilon = 1$



Elastic demand
 $\epsilon > 1$



Perfectly elastic
 $\epsilon = \infty$

Price ϵ of demand > 1 ~ Elastic
Price ϵ of demand < 1 ~ Inelastic
Price ϵ of demand = unit elasticity
(quantity moves the same amount proportionately as price)

Total Revenue

$$\text{Total Revenue} = P \times Q$$

Inelastic demand: If price increases, total revenue increases

Elastic demand: As price increases, total revenue decreases as the proportional decrease in quantity out weights the proportional increase in price. (i.e. slope is less gradient)

Unit elastic demand: change in price does not affect revenue

Income elasticity of demand

Measures how the quantity demanded changes as consumer income changes

$$\text{Income elasticity of demand} = \frac{\% \Delta Q_d}{\% \Delta \text{Income}}$$

Cross-price elasticity of demand

Measure how the quantity demanded of one good changes as the price of another good changes

$$\text{Cross price elasticity of demand} = \frac{\% \Delta Q_d \text{ (good 1)}}{\% \Delta P \text{ (good 2)}}$$

Cross price elasticity of demand > 0: the products are substitutes

Cross price elasticity of demand < 0: the products are complementary

The Elasticity of Supply