Econ 204: Microeconomics

Introduction

Introduction

'Economics is the study of how men and society ***choose***, with or without the use of money, to employ ***scarce*** productive resources, which could have ***alternative uses***, to produce various comodities over time and ***distribute*** them for consumption, now and in the future, among various people and groups in society.'

Paul Samuelson

Introduction

'Economics is concerned with modeling the behavior of individuals and organizations—firms, nonprofit organizations, and so on-- in market and nonmarket settings. Its models almost always assume that behavior is ***purposeful*** -- directed at some clear goal -- and it usually studies how diverse behaviors that have conflicting objectives are brought into ***equilibrium*** by market and nonmarket institutions.'

David M. Kreps

Introduction

'The Theory of Economics does not furnish a body of settled conclusions immediately applicable to policy. It is a method rather than a doctrine, an apparatus of the mind, a technique of thinking which helps its possessor to draw correct conclusions'

John Maynard Keynes

Introduction

Microeconomics studies the economy 'in the small'. It focuses on:

(i) The economic problems of individual consumers, business firms, nonprofit organizations and government agencies;
(ii) The incentives that motivate them to engage in economic exchanges with one another;
(iii) The results of their economic exchanges for particular goods and factors of production.

Introduction

Macroeconomics studies the economy 'in the large'. It focuses on aggregate data. Macroeconomic policy has four broad objectives:

(i) Long-run economic growth;
(ii) Full employment;
(iii) Price stability;
(iv) Stability in international economic relations.

Introduction

Pitfalls in Economic Reasoning:

(i) Ceteris paribus (other things equal)

There is high level interdependence among economic units. To simplify the analysis we assume other things equal.

(ii) Post Hoc Fallacy

'After the event' does not necessarily imply 'because of the event'.

(iii) Fallacy of Composition

What is true for a part is not necessarily true for the whole.

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Normative versus Positive Economics:

Positive economics describes the facts and behavior in the economy.

Normative economics involves ethical precepts and value judgements.

Introduction

Economic Theory of Value:

- What is the definition of value?
  - Early Economic Thought
    - "value" was considered to be synonymous with "importance", "essential", "godliness".
    - since prices were determined by humans, it was possible for the price of an item to differ from its value
    - prices > value were judged to be "unjust"

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Economic Theory of Value:

- What is the definition of value?

St. Thomas Aquinas believed value to be divinely determined.

For him, the “just” rate of interest was zero. Any lender who demanded a payment for the use of money was charging an “unjust” price and could be prosecuted by church officials.

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Economic Theory of Value:

- What is the definition of value?

Founding fathers (Smith and Ricardo):

The value of a commodity is its “value in use”, whereas the price represented its “value in exchange”.
(Famous water-diamond paradox.)

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Economic Theory of Value:

- What is the definition of value?

The concept of value in use was left to philosophers to debate,

while economists turned their attention to explaining the determinants of value in exchange (that is, to explain relative prices).

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Economic Theory of Value:

- **Labor Theory of Exchange Value**
  - the exchange values of goods are determined by what it costs to produce them
    - these costs of production were primarily affected by labor costs
    - therefore, the exchange values of goods were determined by the quantities of labor used to produce them
  - producing diamonds requires more labor than producing water

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Economic Theory of Value:

- What is the definition of value?

Marginalists (Alfred Marshall):

The importance of demand and supply.

Introduction
Economic Theory of Value:

- What is the definition of value?

It is not the total usefulness of a commodity that helps to determine its exchange value, but rather the usefulness of the *last unit consumed*.

(Because water is plentiful, consuming an additional unit has a relatively low value to individuals.)

Introduction

Economic Theory of Value:

- **Marshallian Supply-Demand Synthesis**
  - Alfred Marshall showed that supply and demand simultaneously operate to determine price:
  - prices reflect both the marginal evaluation that consumers place on goods and the marginal costs of producing the goods
    - water has a low marginal value and a low marginal cost of production ☑ Low price
    - diamonds have a high marginal value and a high marginal cost of production ☑ High price

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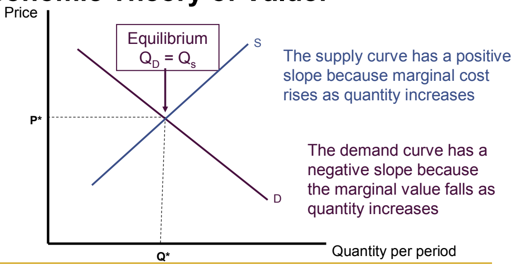
Economic Theory of Value:



Introduction

Elements of Economic Analysis

Economic Problem:

(i) ***Objectives:***
People must have objectives to have an economic problem.

(ii) ***Alternatives:***
The term alternative refers to necessity of making choices.

(iii) ***Constraints:***
The limitations that prevent economic agents from achieving their objectives.

Introduction

Elements of Economic Analysis

Key Actors of Economies:

(i) ***Consumers***:
They consume goods and services and supply the primary factors of production.

(ii) ***Producers:***
They produce goods and services and demand for primary factors of production.

(iii) ***Governments:***
They are both producers and consumers of goods and services.

Introduction

Two Principles of Economic Problem

Interdependence:

The principle that economic decisions are interrelated such that the consequences of a decision always spread beyond the immediate objectives of the decision.

Opportunity cost:

It is the economic meaning of the cost: the value of the next best alternative (in terms of the objective).

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Solving the Economic Problem

Fundamental Assumption of Economic Analysis:

People are self-interested.

Introduction

Solving the Economic Problem

Judgement of Solutions:

(i) **Efficiency:**

It means that the choice best meets the objective.

If there is a single objective, then efficiency means coming as close to the objective as possible.

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Solving the Economic Problem

Judgement of Solutions:

(i) Efficiency:

If there are more than one objective, then efficiency means to make a set of choices such that moving closer to any one objective is not possible without moving away from at least one other objective.

An allocation (set of choices) is **Pareto efficient** if it leaves everyone at least as well off and makes some people strictly better off.

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Solving the Economic Problem

Judgement of Solutions:

(ii) Equity (or Fairness):

End-result-equity

A criterion for judging the solution to an economic problem that asks whether economic outcomes are fair.
'Equals receive equal treatment.'

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Solving the Economic Problem

Judgement of Solutions:

(ii) Equity (or Fairness):

Process-equity

A criterion for judging economic activity that asks whether the rules under which the economy operates is fair.
'Equal opportunity.'

(Remark: End-result-equity and process-equity are not mutually exclusive.)

Introduction

- How Do We Know That The Solutions To Economic Problems Are Efficient And Equitable?
  - Command Economy
    - The government in such an economy is supposed to be benevolent.

    (The rulers are self-interested.)

Introduction

- How Do We Know That The Solutions To Economic Problems Are Efficient And Equitable?
  - Market Economy
    - A market is a collection of buyers and sellers that interact, resulting in the possibility of exchange.
    - Markets, supposedly the collective conscience of the society, determines who wants what and how much and all this information is conveyed in prices.

    (Does this conscience work all the time? Do the prices really convey all information?)