

Introduction to Microeconomics

ECO1104 Section E, Fall 2012
(Lecture #2, Sept. 11)

Introduction

Last lecture:

Started Chapter 1: Ten Principles of Economics

1. People face trade-offs (there is no free lunch)
2. The Cost of Something Is What You Give Up to Get It
(The notion of **Opportunity Cost**)

Today's lecture:

- Finish Chapter 1
- Do the appendix to Chapter 2: Graphing Curves in the Coordinate System

Principle #3: Rational People Think at the Margin

People make decisions by comparing costs and benefits at the margin.

- More specifically, the decision to choose one alternative over another occurs when that alternative's marginal benefits exceed its marginal costs!

Example

- You have spent \$1000 building a hot dog stand based on estimates of sales of \$2000. The hot dog stand is nearly completed but by now you estimate total sales to be only \$800. You can complete the hot dog stand for another \$300. Assuming the resale value of the hot dog stand is zero and operating expenses are negligible, should you complete the hot dog stand?
 - a) Yes
 - b) No.
 - c) There is not enough information to answer this question

Principle #4: People Respond to Incentives

- Because people make decisions by comparing costs and benefits, their behaviour may change when the costs or benefits changes.
- **Example:** MKMR #8, p. 19

In 1997 the govt of Ontario reformed that province's welfare system. The reform allowed welfare recipients to keep a larger part of their welfare payments if they earn some income, but also reduced the amount of welfare payments to a person with no income.

 - a) How does this reform affect the incentive to work?
 - b) How might this reform represent a tradeoff between equity and efficiency?

Principle #5: Trade Can Make Everyone Better Off (Chap. 3)

- Trade allows people to specialize in what they do best.
- Trade is not a “zero-sum” game—everyone is better-off with trade
- *Example*: MKMR, #9, p19

Your roommate is a better cook than you are, but you can clean more quickly than your roommate can.

a) If your roommate did all the cooking and you did all the cleaning, would your chores take you more or less time than if you divided each task evenly?

b) Give a similar example of how specialization and trade can make two countries better off.

Principle #6: Markets Are Usually a Good Way to Organize Economic Activity (Chap. 7)

- A **market** is a group of buyers and sellers. (They need not be in a single location.)
- “Organize economic activity” means determining
 - what goods to produce
 - how to produce them
 - how much of each to produce
 - who gets them

Principle #6: Markets Are Usually a Good Way to Organize Economic Activity (cont.)

- In a market economy, these decisions result from the interactions of many households and firms.
- Famous insight by Adam Smith in *The Wealth of Nations* (1776):

*Each of these households and firms acts as if “led by **an invisible hand**” to promote general economic well-being.*

Principle #6: Markets Are Usually a Good Way to Organize Economic Activity (cont.)

- The **invisible hand** works through the price system:
 - The interaction of buyers and sellers determines prices of goods and services.
 - Each price reflects the good's value to buyers and the cost of producing the good.
 - Prices guide self-interested households and firms to make decisions that, in many cases, maximize society's economic well-being.

Principle #6: Markets Are Usually a Good Way to Organize Economic Activity (cont.)

Example:

Suppose that you own a classic Fender guitar. You have lost interest, and so it is worth only \$50 to you. A number of friends are interested in buying it. Juan would be willing to pay as much as \$950, Ben \$500, Sanam \$1200 and Bill \$2000. Assuming that these individuals are comparably wealthy (actually, everyone of them is kind of broke).

- To maximize this small society's economic well-being, who should get the guitar?
- Who would get the guitar if the guitar was sold on the market (through, for example, an auction)? Assume your friends are the only ones interested in the guitar in this society.

Free market maximizes society's happiness in this instance.

Principle #6: Markets Are Usually a Good Way to Organize Economic Activity (cont.)

- Alternative to market economy: centrally planned economy (i.e., communism).
- Communist countries worked on the premise that central planners in the government were in the best position to guide economic activities.
- But central planning is a very tough (impossible?) job
 - Just imagine yourself trying to plan the production of CDs for Canada. You would need to know the costs of production and also the tastes of all the potential buyers of CDs!
- Communism inevitably led to surpluses of some goods and shortages of others.
- The collapse of communism in the Soviet Union and Eastern Europe may be the most important change in the world during the past half-century.

Principle #7: Government Can Sometimes Improve Market Outcomes

- *Market failure* occurs when the market fails to allocate resources efficiently.
- Reasons for market failures:
- When the market fails (breaks down) government can intervene to promote efficiency and equity.

Principle #8: A Country's Standard of Living Depend on Its Ability to Produce Goods and Services

- Huge variation in living standards across countries and over time:
 - Average income in rich countries is more than ten times average income in poor countries.
 - The U.S. standard of living today is about eight times larger than 100 years ago.
- The most important determinant of living standards: **productivity**, the amount of goods and services produced per unit of labor.
- Productivity depends on the equipment, skills, and technology available to workers.
- Important implications for public policy (will study in Introduction to Macroeconomics)

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

- Inflation is an increase in the overall level of prices in the economy.
- One cause of inflation is the growth in the quantity of money.
- Ideally, the Central Bank should increase the quantity of money at the same rate as national production of goods and services increases.
- If the Central Bank prints too much money \Rightarrow too much money chase too few goods \Rightarrow prices \uparrow
(will study in Introduction to Macroeconomics)

Principle #10: Society Faces a Short-Run Tradeoff between Inflation and Unemployment

- The Phillips Curve (will study in Introduction to Macroeconomics) illustrates the tradeoff between inflation and unemployment:

↓ Inflation \Leftrightarrow ↑ Unemployment

It's a short-run tradeoff

- Remains a controversial issue among economists

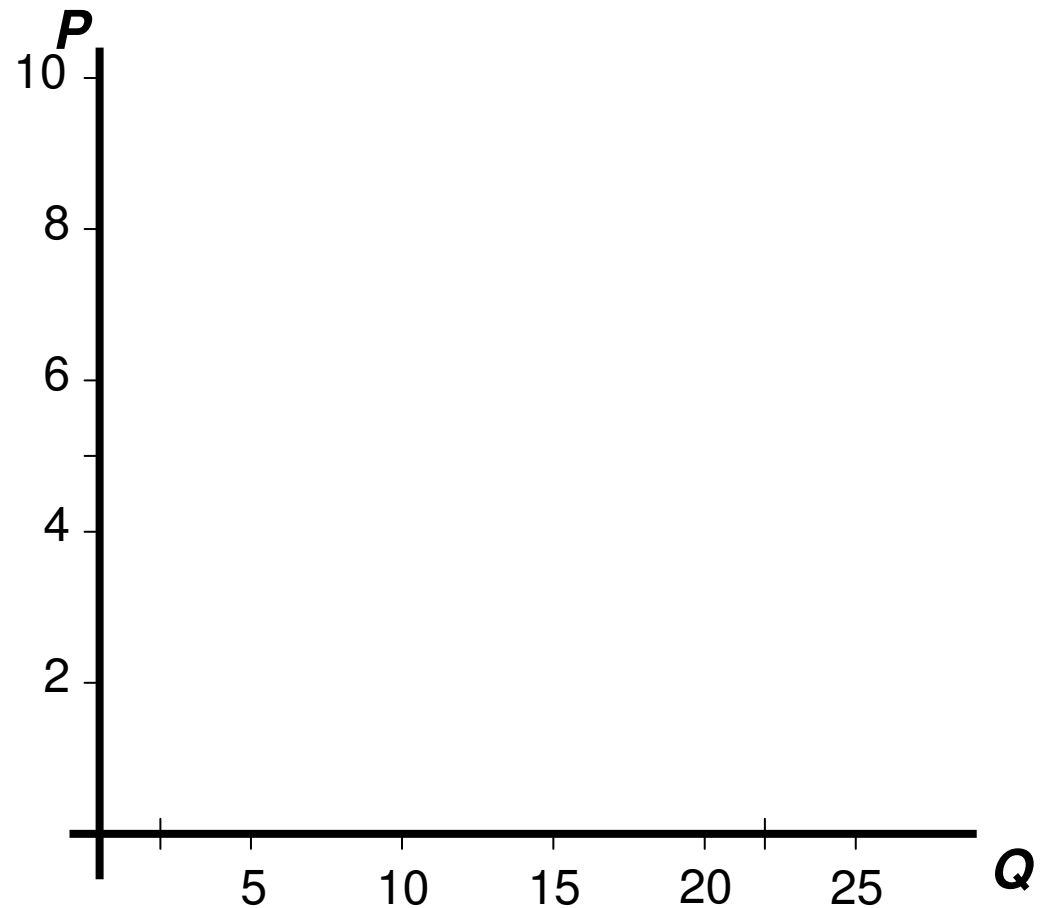
End Chap. 1

Chapter 2--Appendix

Graphing Curves in the Coordinate System

- *Example:* (Table 2.A.1 and Figure 2A.3, p.45)
Income

Price	\$20,000
\$10	2 novels
9	6
8	10
7	14
6	18
5	22



Graphing Curves in the Coordinate System (cont)

- Important observations:
 - When a variable that is not named on either axis changes \Rightarrow
 - When two variables move in the same direction δ variables are _____ or, equivalently, the curve is _____
 - Conversely, when two variables move in opposite directions (such as Emma's demand curve) \Rightarrow variables are _____ or, equivalently, the curve is _____

Graphing Curves in the Coordinate System (cont.)

- **Slope of a curve:** a measure of how much one variable responds to changes in another variable.

$$\text{slope} = \frac{\text{change in } y}{\text{change in } x} = \frac{\Delta y}{\Delta x} = \frac{y_2 - y_1}{x_2 - x_1}$$

- **Example:** choose the two coordinates (14,7) and (22,5).