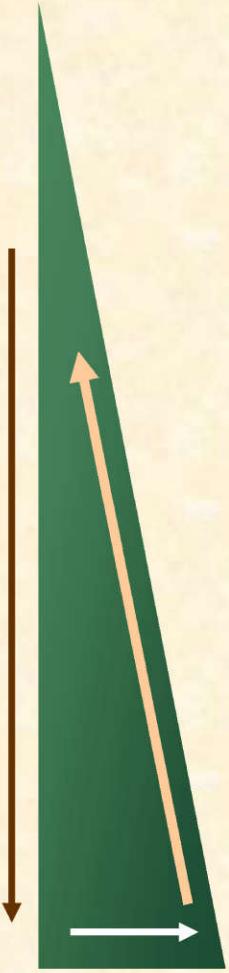


Chapter 1

Preliminaries



Topics to be Discussed

- The Themes of Microeconomics
- What Is a Market?
- Real Versus Nominal Prices
- Why Study Microeconomics?

Preliminaries

- Microeconomics deals with:
 - Behavior of individual units
 - ◆ When Consuming
 - How we choose what to buy

Preliminaries

- Microeconomics deals with:
 - Behavior of individual units
 - ◆ When Producing
 - How we choose what to produce

Preliminaries

- Microeconomics deals with:
 - Markets: The interaction of consumers and producers

Preliminaries

- Macroeconomics deals with:
 - Analysis of aggregate issues:
 - ◆ Economic growth
 - ◆ Inflation
 - ◆ Unemployment

Preliminaries

- The Linkage Between Micro and Macroeconomics
 - Microeconomics is the foundation of macroeconomic analysis

The Themes of Microeconomics

- According to Mick Jagger* & the Rolling Stones
 - “You can’t always get what you want”

*Economics degree from London School of Economics

The Themes of Microeconomics

- Why Not?
 - Limited Resources

The Themes of Microeconomics

- Microeconomics
 - Allocation of Scarce Resources and *Trade-offs*
 - ◆ In a planned economy
 - ◆ In a market economy

The Themes of Microeconomics

- Microeconomics and *Optimal Trade-offs*
 1. Consumer Theory
 2. Workers
 3. Theory of the Firm

The Themes of Microeconomics

- Microeconomics and *Prices*
 - The role of *prices* in a market economy
 - How *prices* are determined

Theories and Models

■ Microeconomic Analysis

- **Theories** are used to explain observed phenomena in terms of a set of basic rules and assumptions.
- For example
 - ◆ The Theory of the Firm
 - ◆ The Theory of Consumer Behavior

Theories and Models

- Microeconomic Analysis

- **Models:**

- ◆ a mathematical representation of a theory used to make a prediction.

Theories and Models

- Microeconomic Analysis

- Validating a Theory

- ◆ The validity of a theory is determined by the quality of its prediction, given the assumptions.

Theories and Models

- Microeconomic Analysis

- Evolving the Theory

- ◆ Testing and refining theories is central to the development of the science of economics.

Positive Versus Normative Analysis

■ Positive Analysis

- **Positive analysis** is the use of theories and models to predict the impact of a choice.
- For example:
 - ◆ What will be the impact of an import quota on foreign cars?
 - ◆ What will be the impact of an increase in the gasoline excise tax?

Positive versus Normative Analysis

■ Normative Analysis

- **Normative analysis** addresses issues from the perspective of “What ought to be?”
- For example:
 - ◆ Consider the equity and efficiency trade-off of an increase in the gasoline excise tax versus import restriction on foreign oil.

What is a Market?

■ Markets

- A geographically defined area where buyers and sellers interact to determine the price of a product or a set of products.

What is a Market?

- Markets vs. Industries
 - Industries are the supply side of the market.

What is a Market?

- Defining the Market

- The market parameters must be set before an analysis of the market can take place.

What is a Market?

- **Arbitrage**

- Buying a product at a low price in one location and selling at a high price in another

What is a Market?

- Competitive vs. Noncompetitive Markets
 - Competitive Markets
 - ◆ Because of the large number of buyers and sellers, no individual buyer or seller can influence the price.
 - ◆ Example: Most agricultural markets

What is a Market?

- Competitive vs. Noncompetitive Markets
 - Noncompetitive Markets
 - ◆ Markets where individual producers can influence the price.
 - ◆ Example: OPEC

What is a Market?

■ Market Price

- Competitive markets establish one price.
- Noncompetitive markets may set many prices for the same product.

What is a Market?

- Market Definition & The Extent of a Market
 - **Market Definition**
 - ◆ Which buyers and sellers should be included in a given market

What is a Market?

- Market Definition - The Extent of a Market
 - **Market Extent**
 - ◆ Defines the boundaries of the market
 - Geographic
 - Range of products

What is a Market?

- Examples

- Geographic boundaries

- ◆ Gasoline: US vs California
- ◆ Housing: Chicago vs a Chicago neighborhood

What is a Market?

- Examples

- Range of Products

- ◆ Gasoline: regular, super, & diesel
- ◆ Cameras: SLR's, point & shoot, digital

What is a Market?

- Examples

- Markets for Prescription Drugs

- ◆ Well-defined markets - therapeutic drugs
- ◆ Ambiguous markets - painkillers

Real Versus Nominal Prices

- **Nominal price** is the absolute or *current dollar price* of a good or service when it is sold.
- **Real price** is the price relative to an aggregate measure of prices or *constant dollar price*.

Real Versus Nominal Prices

- The Consumer Price Index (CPI) is an aggregate measure.
 - Real prices are emphasized to permit the analysis of relative prices.

Real Versus Nominal Prices

■ Calculating Real Prices

$$\text{Real Price}_{\text{(base year = 100)}} = \frac{\text{CPI}_{\text{base year}}}{\text{CPI}_{\text{current year}}} \times \text{Nominal Price}_{\text{current year}}$$

An Example: Calculating the Real Price of Milk

Year	Nominal Price of Milk	CPI	Real Price of Milk in 1970 dollars
1970	.40	38.8	$.40 = 38.8/38.8 \times .40$
1980	.65	82.4	$.31 = 38.8/82.4 \times .65$
1999	1.05	167.0	$.24 = 38.8/167.0 \times 1.05$

Calculating Real Prices: An Example - Eggs & College

$$\text{Real Price of Eggs}_{1998 (1970 = 100)} = \frac{38.8_{1970}}{163} \times 1.04$$

$$\text{Real Price of a College Education}_{1998 (1970 = 100)} = \frac{38.8}{163.0} \times \$19,213 = \$4,573$$

Calculating Real Prices: An Example - Eggs & College

	1970	1975	1980	1985	1990	1998
Consumer Price Index (1983 = 100)	38.8	53.8	82.4	107.6	130.7	163.0
Nominal Prices						
Grade A Large Eggs	\$0.61	\$0.77	\$0.84	\$0.80	\$0.98	\$1.04
College Education	\$2,530	\$3,403	\$4,912	\$8,156	\$12,800	\$19,213
Real Prices (\$1970)						
Grade A Large Eggs	\$0.61	\$0.56	\$0.40	\$0.29	\$0.30	\$0.25
College Education	\$2,530	\$2,454	\$2,313	\$2,941	\$3,800	\$4,573

An Example: The Minimum Wage

■ Observations

1. The minimum wage has been increasing in nominal terms since 1940.
2. The 1999 real minimum wage was no higher in 1999 than 1950.

An Example: The Minimum Wage

- What Do You Think?
 - What are the positive and normative issues of raising the minimum wage?

Why Study Microeconomics?

- Microeconomic concepts are used by everyone to assist them in making choices as consumers and producers.

Why Study Microeconomics?

- Two Examples

- Ford and the development of its SUV's
- Public Policy Design
 - ◆ Automobile emission standards for the 21st century

Why Study Microeconomics?

- Ford and the development of its SUV's
 - Questions
 - ◆ Consumer acceptance and demand
 - ◆ Production cost
 - ◆ Pricing strategy

Why Study Microeconomics?

- Ford and the development of its SUV's
 - Questions
 - ◆ Risk analysis
 - ◆ Organizational decisions
 - ◆ Government regulation

Why Study Microeconomics?

- Auto emission standards for the 21st century
 - Questions
 - ◆ Impact on consumers
 - ◆ Impact on producers
 - ◆ How to enforce the standards
 - ◆ What are the benefits and costs?

Summary

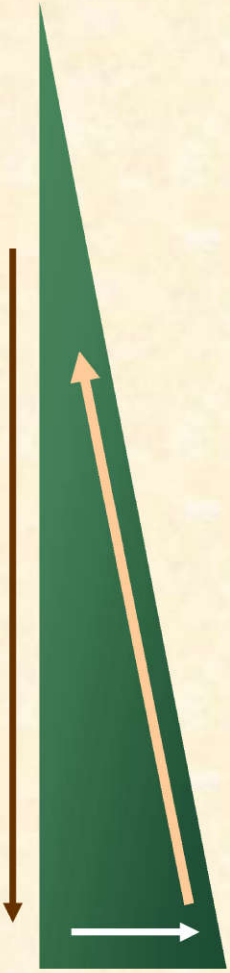
- Microeconomics is concerned with the decisions made by small economic units.
- Microeconomics relies heavily on the use of theory and models.

Summary

- Microeconomics is concerned with positive questions and normative analysis.
- A *market* refers to a collection of buyers and sellers who interact and to the possibility for sales and purchases that results from that interaction.

Summary

- The market price is established by the interaction of buyers and sellers.
- A market's geographic boundaries and range of products must be defined.
- To eliminate the effects of inflation we measure real prices, rather than nominal prices.



End of Chapter 1

Preliminaries