CITY UNIVERSITY LONDON

Microeconomics Pre-sessional September 2016

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Organisation of the Microeconomics Pre-sessional

Introduction	10:00-10:30
Demand and Supply	10:30-11:10
Break	
Consumer Theory	11:25-13:00
Lunch Break	
Problems – Refreshing by Doing	14:00-14:30
Theory of the Firm	14:30 -15:30
Break	
Problems – Refreshing by Doing	15:45 -16:30

Introduction

- About Microeconomics
  - Definition
  - Modelling
  - Endogeneous versus Exogeneous Variables
- Key Analytical Tools
  - Constrained Maximization
  - Equilibrium
  - Comparative Statics

Defining Economics

Economics is the study of how **society** decides what, how and for whom to produce.
(Begg, Fischer and Dornbusch, *Economics*)

Macro economics:
"Concerned with the economy as a whole".

Micro economics:
"Concerned with individual parts of the economy e.g. consumers, firms in particular markets".

Defining Microeconomics

Microeconomics is the study of the economic **behavior** of **individual economic decision-makers** such as consumers, workers, firms or managers. This study involves both the behavior of these economic agents on their own and the way their behavior interacts to form larger units, such as markets.

Defining Microeconomics

Microeconomics is the study of human behaviour when confronted with **scarcity of resources**.

- There are not enough resources to meet all of the wants that people have. Therefore …..
- We have to choose which wants are met and which are not met. Therefore ….
- Every choice is a trade-off between competing uses of resources

Defining Microeconomics

Using resources in one way means that something of value is given up by not using them in another way.

Opportunity cost = Highest valued alternative forgone

Microeconomic Modelling

Economic **theory** sets out expected relationships between variables of interest (e.g., if price falls, demand rises)

Models:

"Fables"

- Used to **explain** or **predict** economic phenomena.
- **Abstractions of reality**
- Proceed by making **simplifying assumptions**.
- Can be judged according to how successful they are in explaining and predicting phenomena.

Microeconomic Modelling

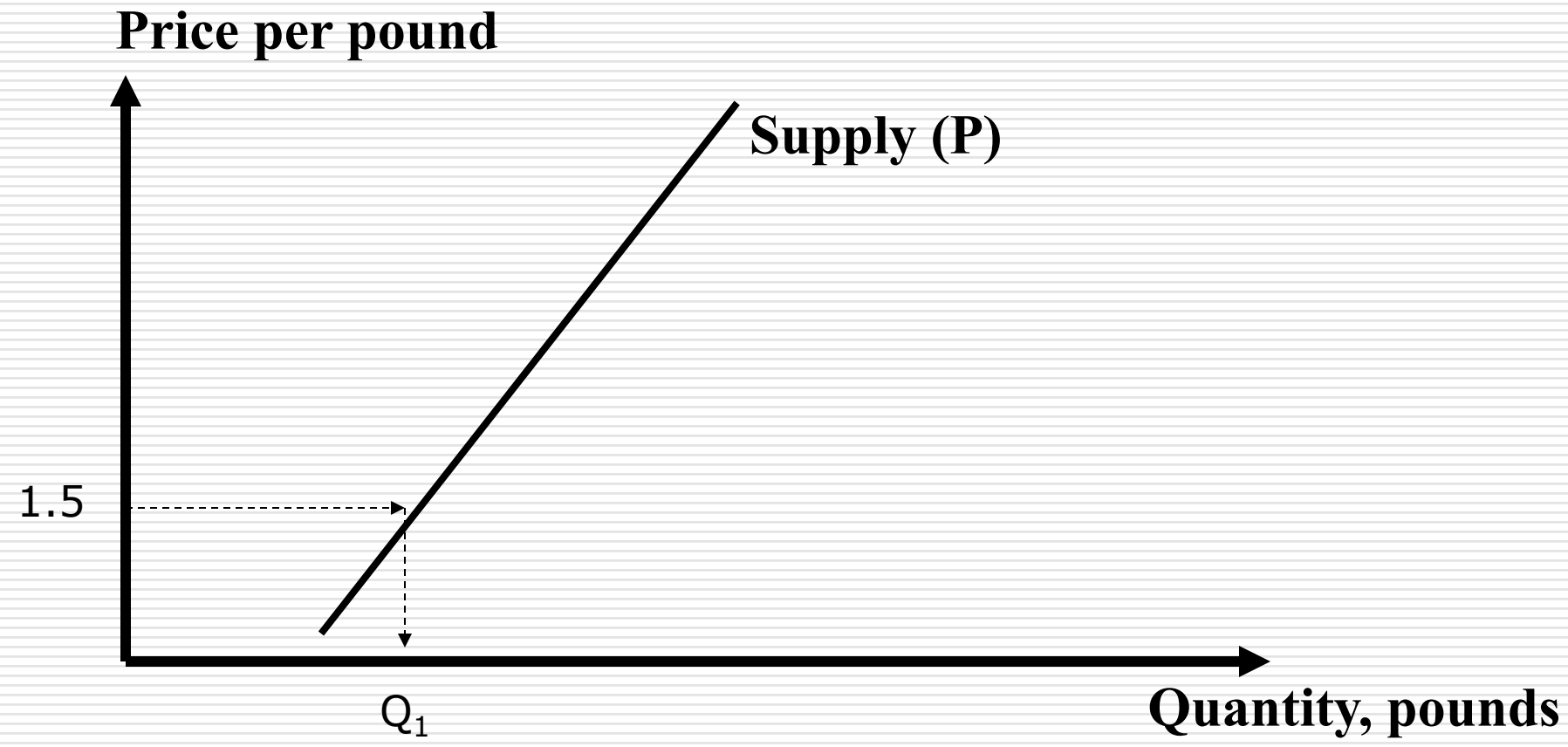
Economic **theory** sets out expected relationships between variables of interest (e.g., if price falls, demand rises)

Models:

• Some models do not explain reality (for example 'perfect competition') **but** provide a benchmark against which real life economies can be compared and better understood.

Example

Worldwide market for unprocessed coffee beans



Example

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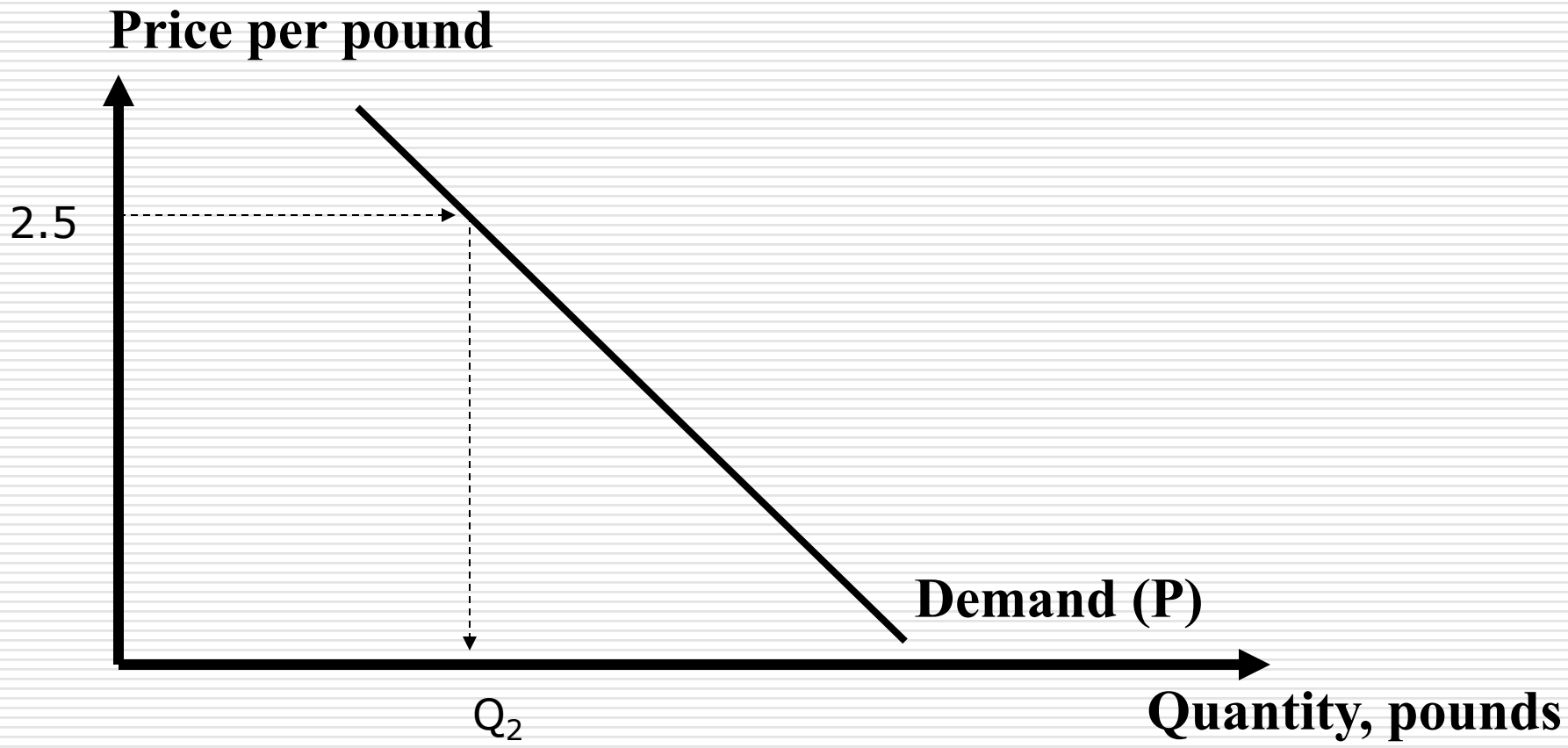

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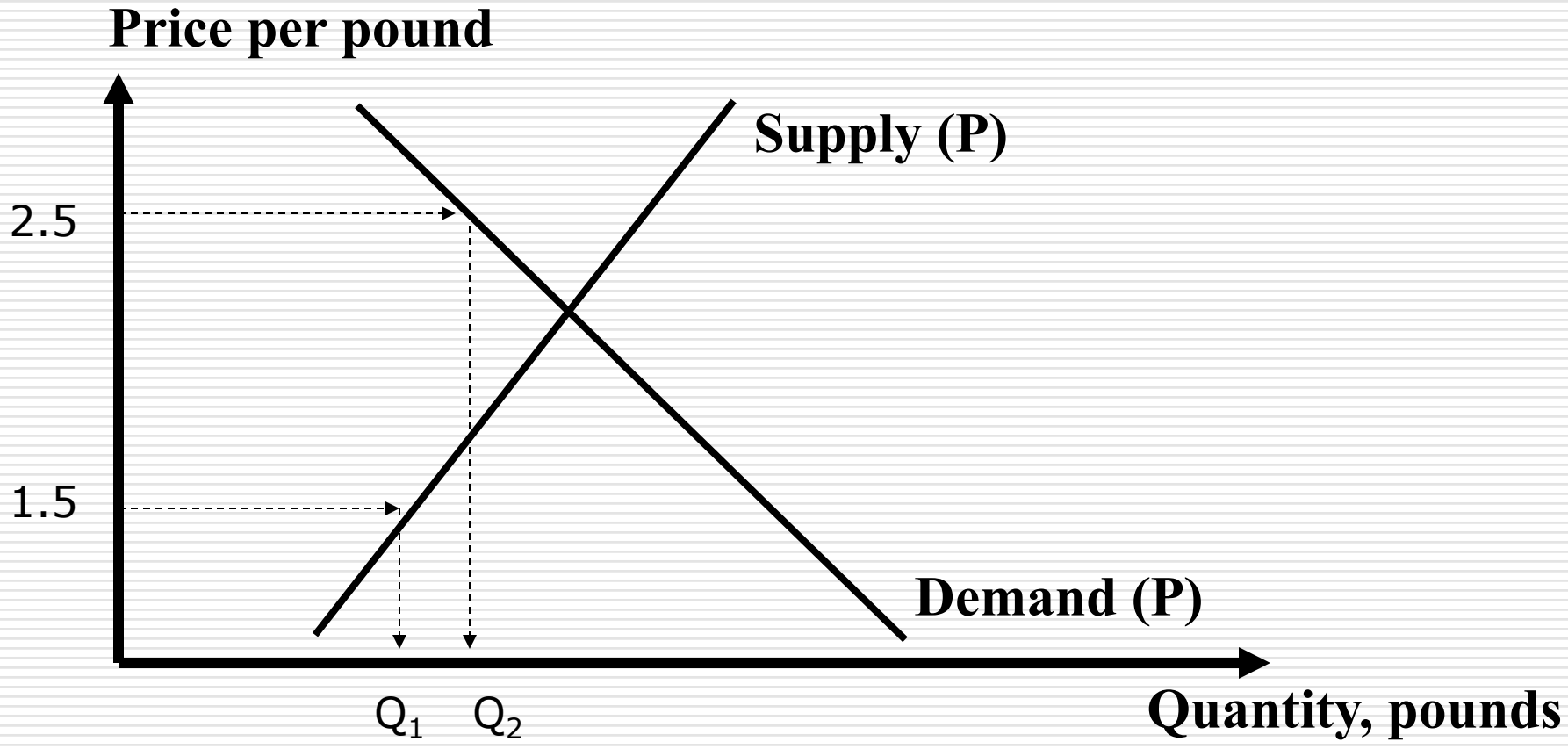

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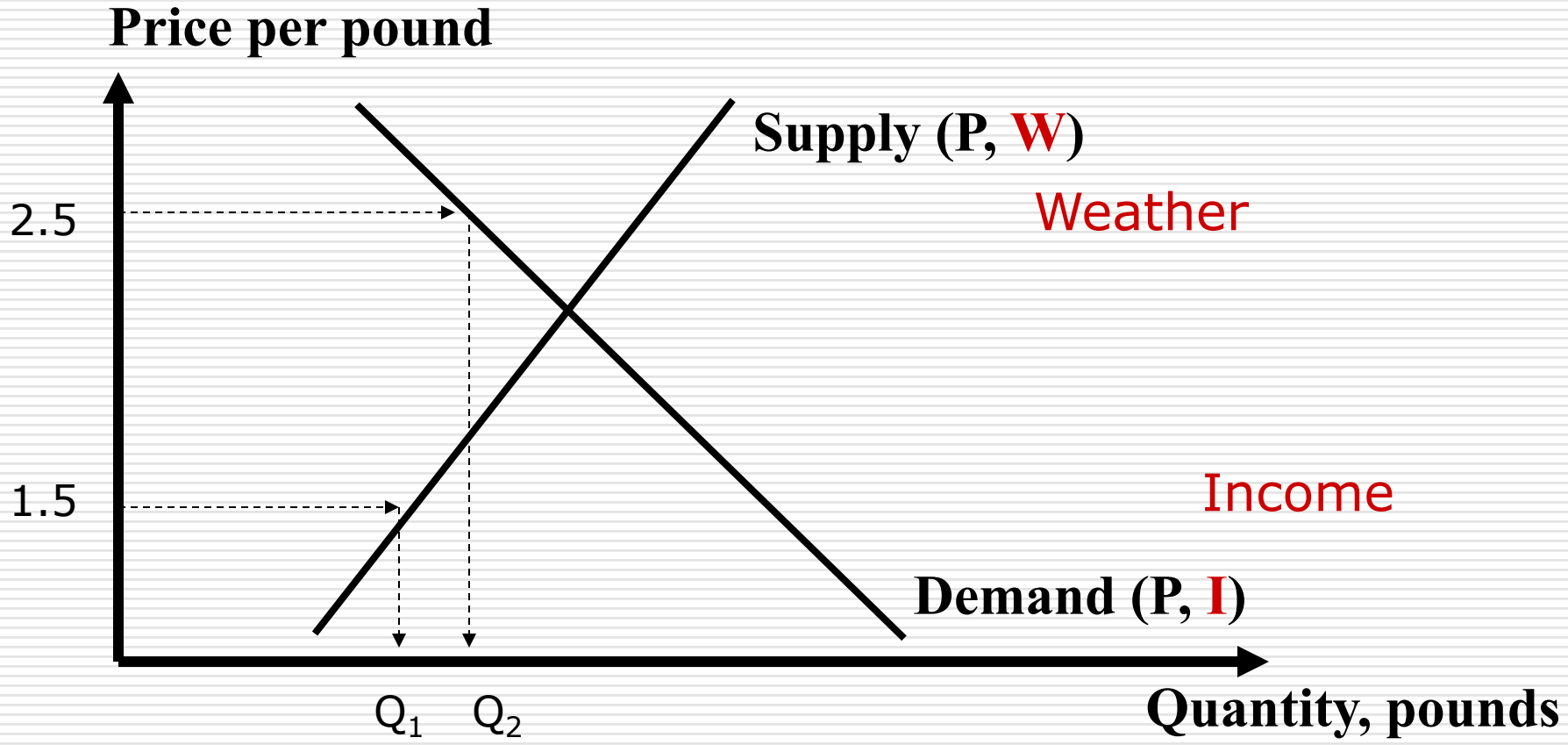


Exogenous and Endogenous Variables

Definition: Variables that have values that are taken as given in the analysis are **exogenous variables**. Variables that have values that are determined as a result of the workings of the model are **endogenous variables**.

Key Analytical Tools

1. Constrained optimization
2. Equilibrium analysis
3. Comparative statics

Example
Consumer Purchases

Food (F), Clothing (C), Income (I)
Price of food (p_f), price of clothing (p_c)

Satisfaction from purchases: $S = (FC)^{1/2}$

$$\underset{(F,C)}{\text{Max } S}$$

subject to: $p_f F + p_c C \leq I$

1. Constrained Maximization - elements

Definition: The **Objective Function** specifies what the agent cares about

Example: Does a manager care about raising profits or increasing "power"?

1. Constrained Maximization - elements

Definition: The **constraints** are whatever limits are placed on the resources available to the agent

Example: Our manager's budget is $100

The Constrained Optimisation

Agent's behavior can be modeled as optimizing the objective function, subject to his various constraints

2. Equilibrium

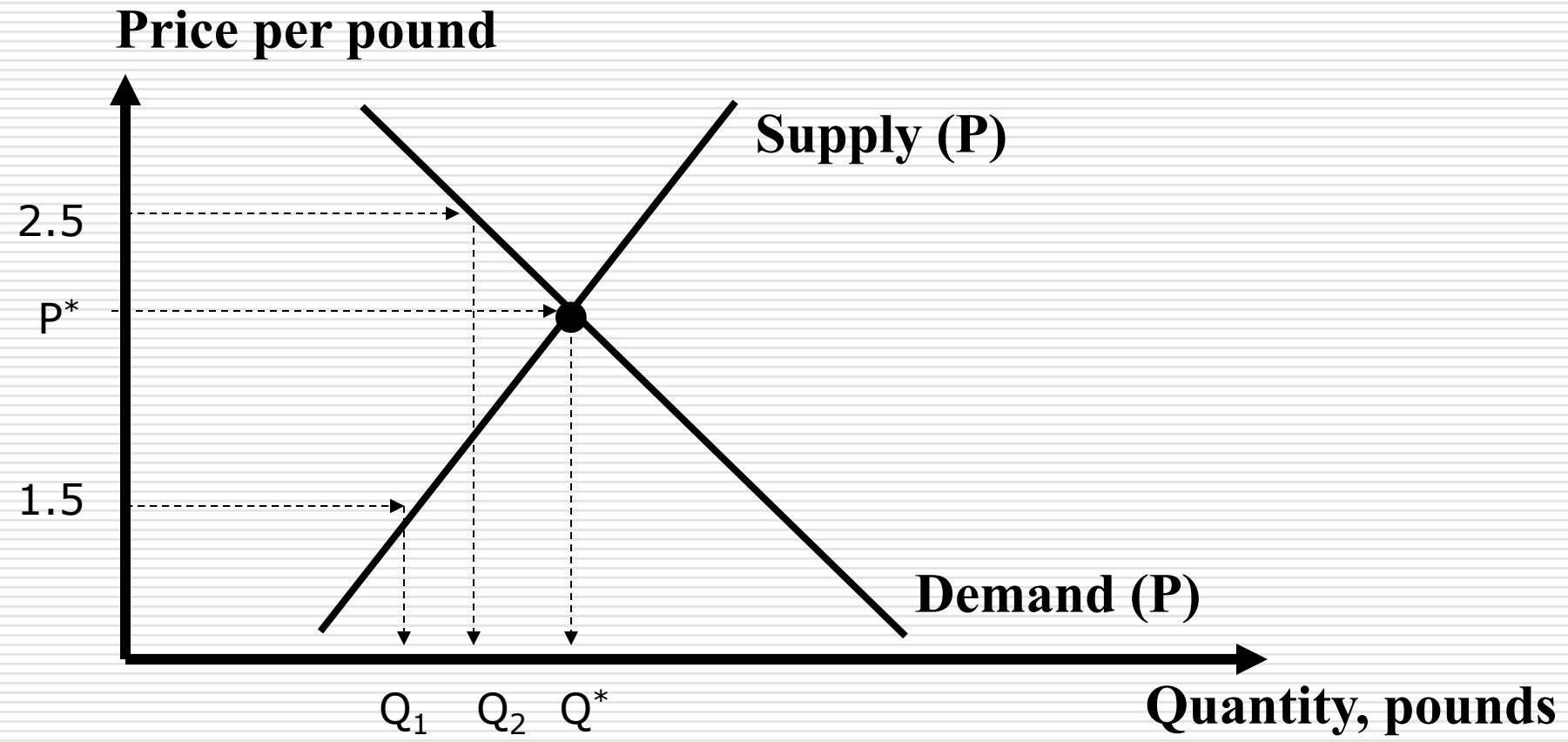
Idea (market): equilibrium is achieved at a price at which the market **clears**

(ie a price at which the quantity offered for sale just equals the quantity demanded by consumers)

General Definition: **Equilibrium analysis** is an analysis of a system in a state that will continue indefinitely as long as the exogenous factors remain unchanged

Example

Worldwide market for unprocessed coffee beans

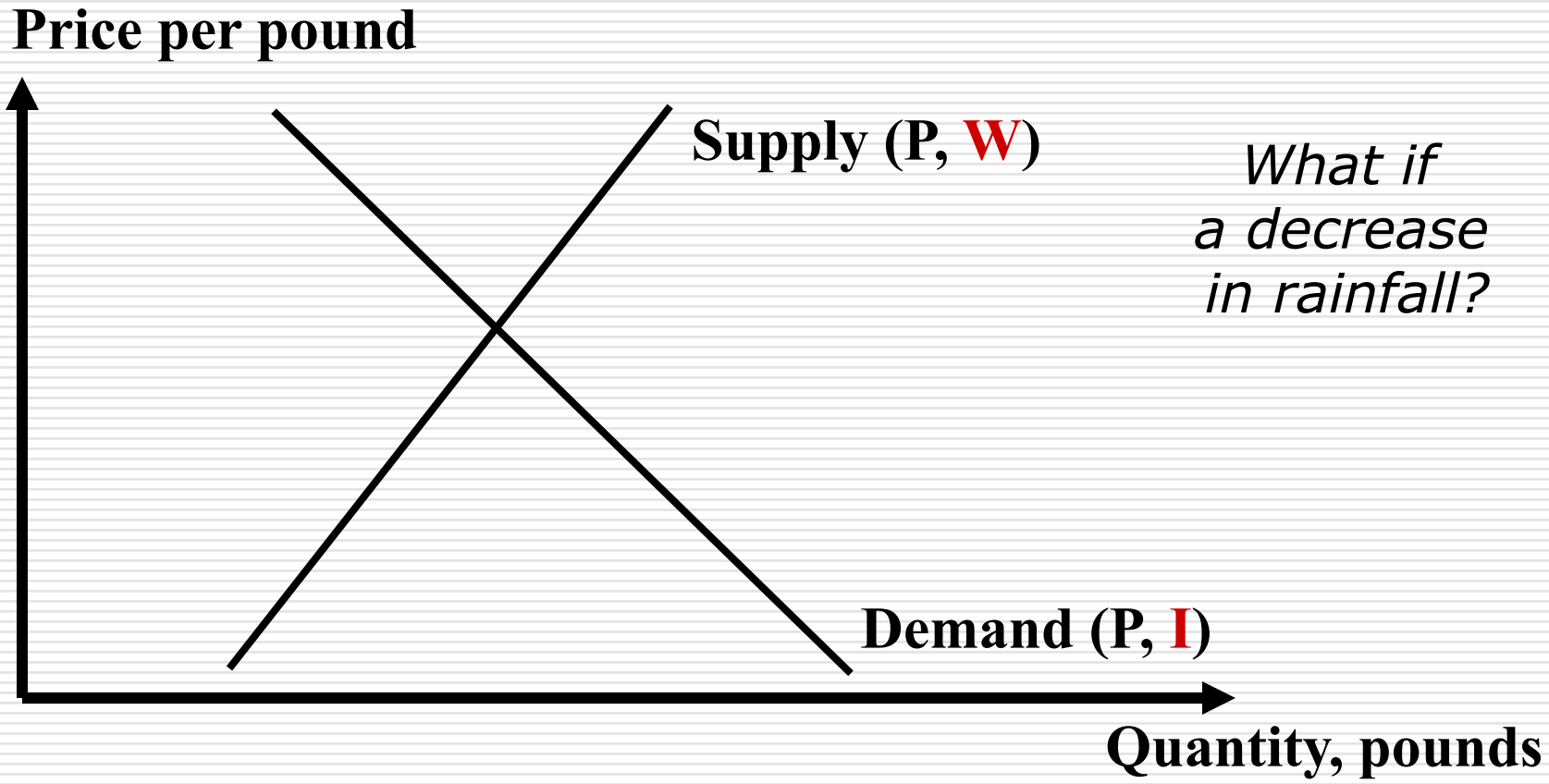


3. Comparative Statics

Definition: **Comparative Statics analysis** is used to examine how a change in an exogenous variable will affect the level of an endogenous variable

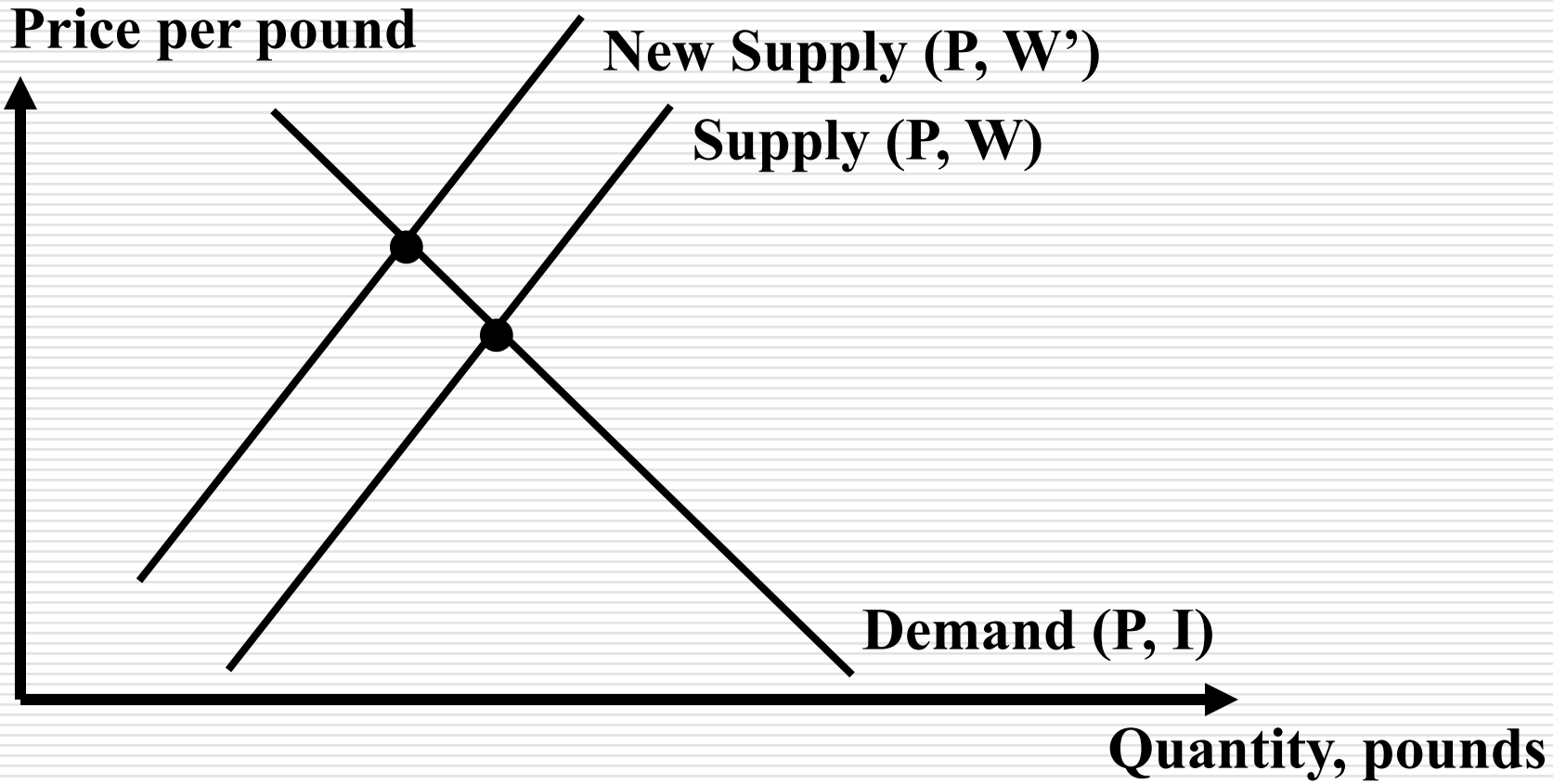
Example

Worldwide market for unprocessed coffee beans



3. Example

Worldwide market for unprocessed coffee beans



Positive and Normative Questions

Definition: **Positive analysis** can explain what has happened due to an economic policy or it can predict what might happen due to an economic policy.

Definition: **Normative analysis** is an analysis of what should be done (a value judgment)

Positive and Normative Questions

Positive	• **How the world is** • **Testable** • **Empirical or Logical**
Normative	• **How the world should be** • **Not testable** • **Based on value judgements**

Positive BEFORE Normative