Introduction to microeconomics

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Markets

- Market Exchange – transfer of property rights
  - Monetary
  - Barter
- Characteristics of market exchange
- Market
  - All the selling and buying activities of those persons wishing to trade
  - Suppliers and demanders
  - Neoclassical definition
  - Location
  - Market as an institution – set of rules
- Competitive markets

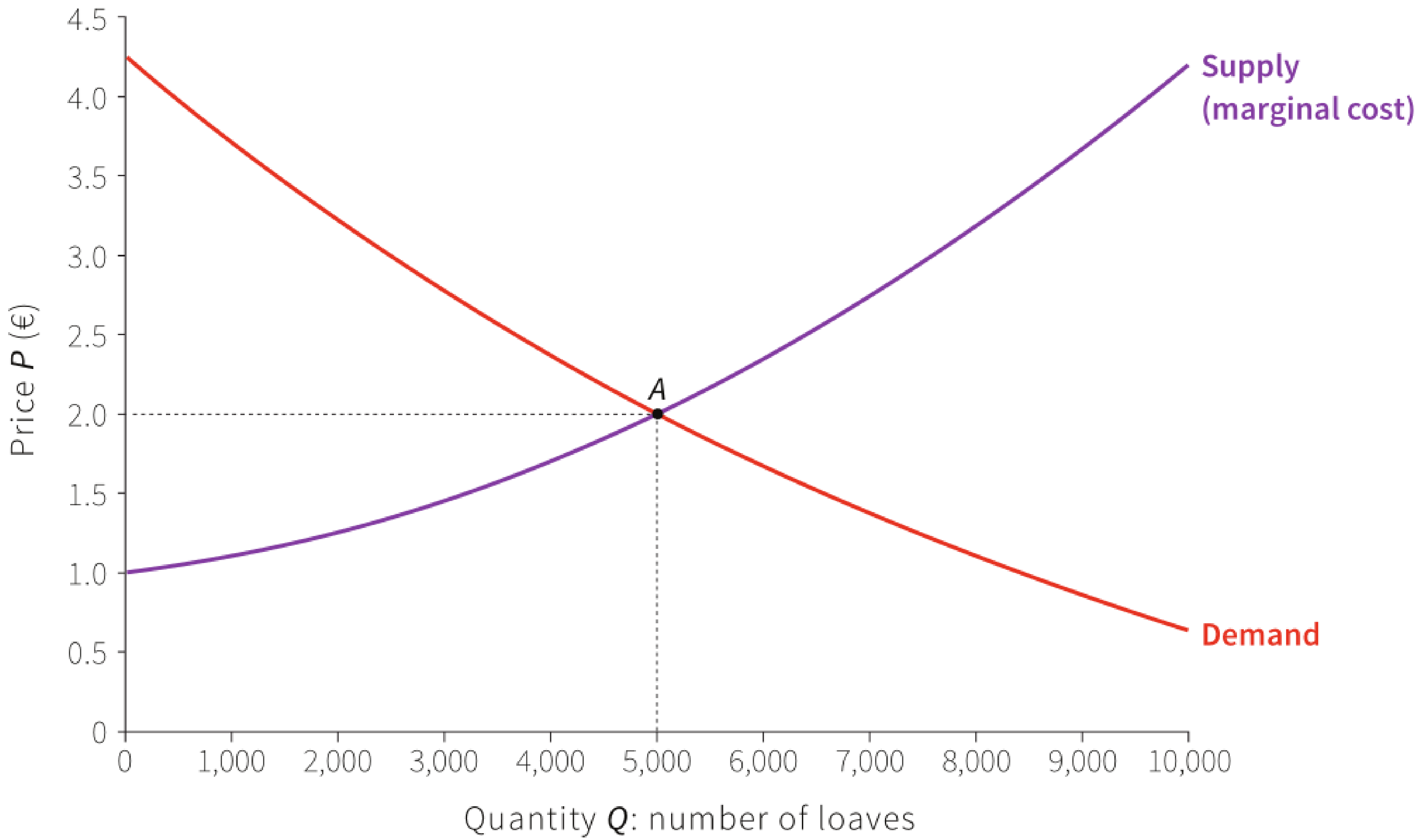
Supply and demand

- **Demand curve** – indicates for each possible price, how much of the good or service demanders are willing to pay
- Characteristics of the demand curve
  - Downward sloping
  - Represents what people want and are able to purchase, given the price and their **incomes**
- Deriving the demand curve – consumer theory
  - Theories of marginal utility (cardinal and ordinal)
  - Complements and substitutes
- The demand curve allows us to say how a change in the price will affect quantity demanded **if nothing else changes** (ceteris paribus)

Supply and demand

- **Supply curve** – indicates, for each possible price how much of the good or service suppliers wish to sell
- Characteristics of the supply curve
  - Upward sloping
  - Represents how much of goods and services firms want to supply, given the price and their **costs**
- Deriving the supply curve – theory of the firm
  - Marginal cost vs average cost
  - Increasing returns to scale
- The supply curve allows us to say how a change in the price will affect quantity supplied **if nothing else changes** (ceteris paribus)

Supply and demand



Source: The Core Team (2015) The Economy

Supply and demand interacting

- S and D interaction determines both the **price (P)** of a good and its **quantity (Q)**
- **Excess supply** – at a particular price more of some good or service is supplied than is demanded
- **Excess demand** – at a particular price more of some good or service is demanded than is supplied
- The market **clearing price** – the price at which buyers want to purchase exactly the quantity that sellers want to sell
- **Equilibrium** – a situation (price and quantity) in which there are no forces internal to the situation pushing it to change

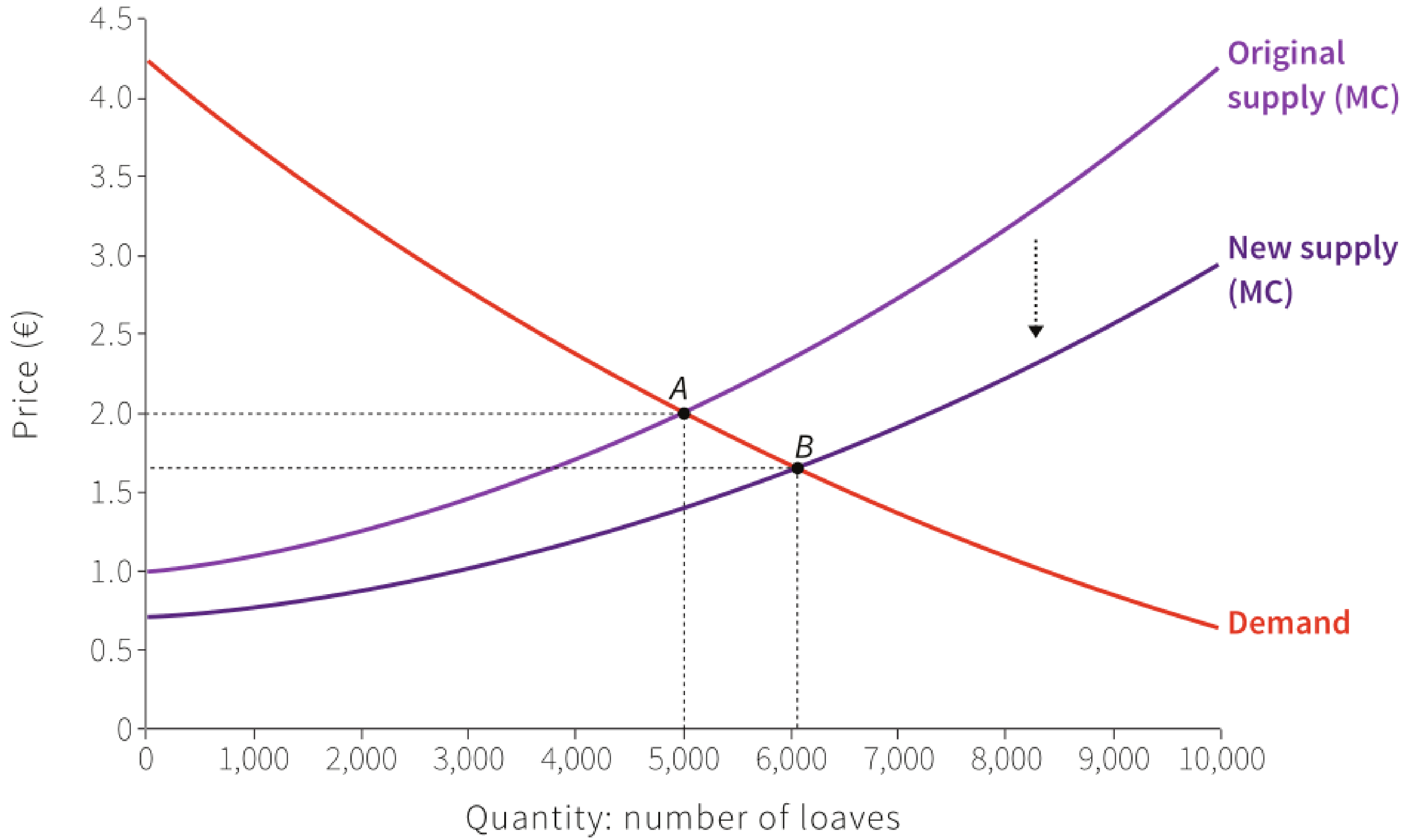
Supply and demand interacting

- Exogenous × endogenous source of change
- Market clearing price and equilibrium
- Homogenous product
- **RESULT OF COMPETITIVE MARKETS**
  - When a competitive market is in equilibrium, the price of the good will be equal to its marginal cost
  - $P = MC$
  - Competitive markets are an efficient means of economic interaction (the best way to allocate limited resources among unlimited wants)

Shifts in demand and supply

- **Moving along** the curves
  - Functional relationship between the quantity and the price
  - Ceteris paribus
- **Shifting** the demand curve
  - Changes in preferences
  - Changes in the prices of substitutes or complements
  - Other forces
- **Shifting** the supply curve
  - Technological advance
  - Changes in the costs of inputs
  - Other forces

Shift in supply



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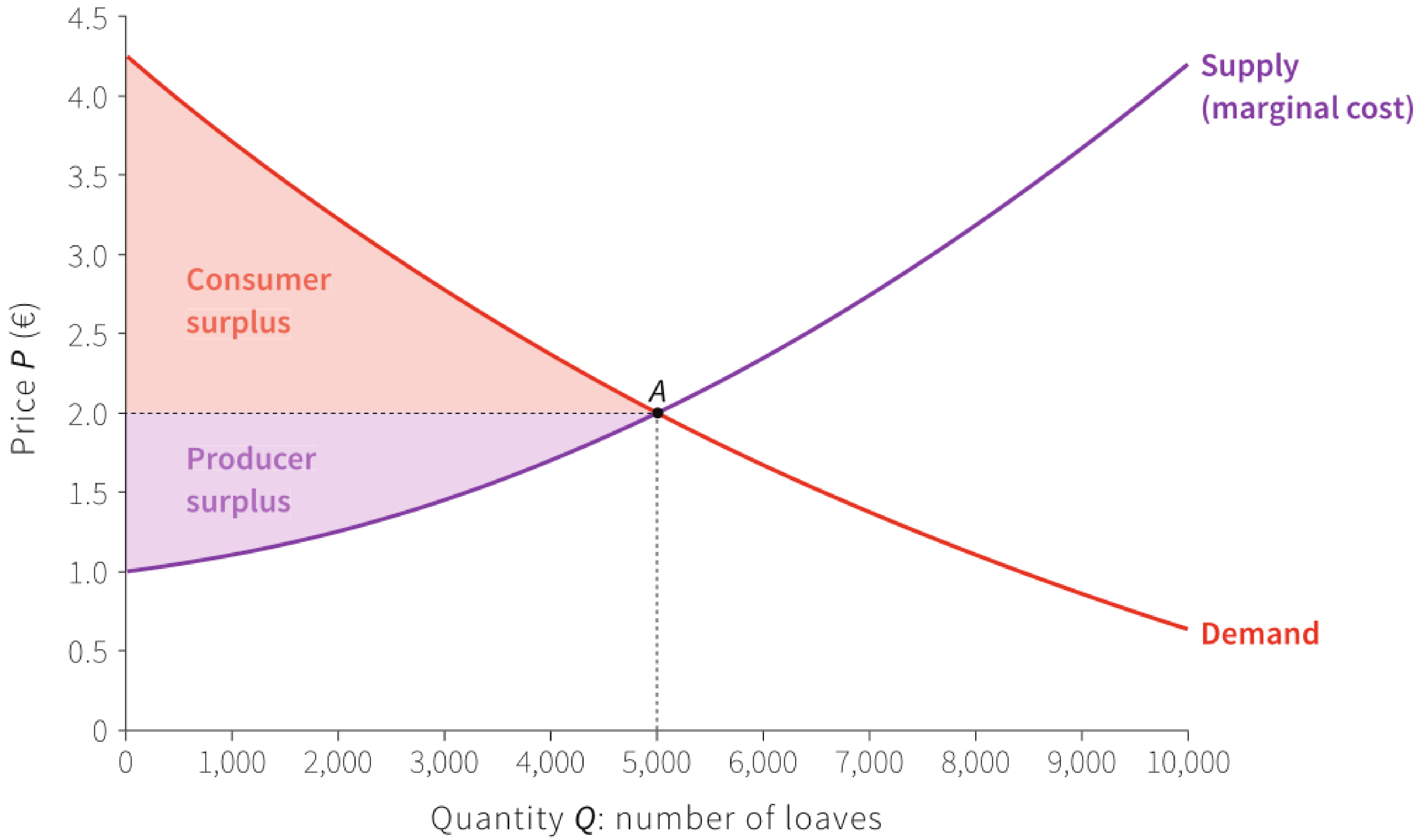
Economic coordination

- Markets are only one of many ways people can coordinate
- Various way of economic coordination in history
- Types of coordination
  - **Coordination by rules** – interactions are governed by general principles of behavior
  - **Coordination by command** – interactions are governed by rules specifying precise behavior
- The importance of **information** and **motivation**

Invisible hand

- Invisible hand is a coordination by these specific rules
  - **Market competition**
  - **Private property**
- Markets transmit economically important information and they provide the motivation to act on the information
- Information - the price (rather than quantity) of a good measures its scarcity
- Motivation
  - Motivation for the consumers
  - Motivation for the producers

Efficiency of the market



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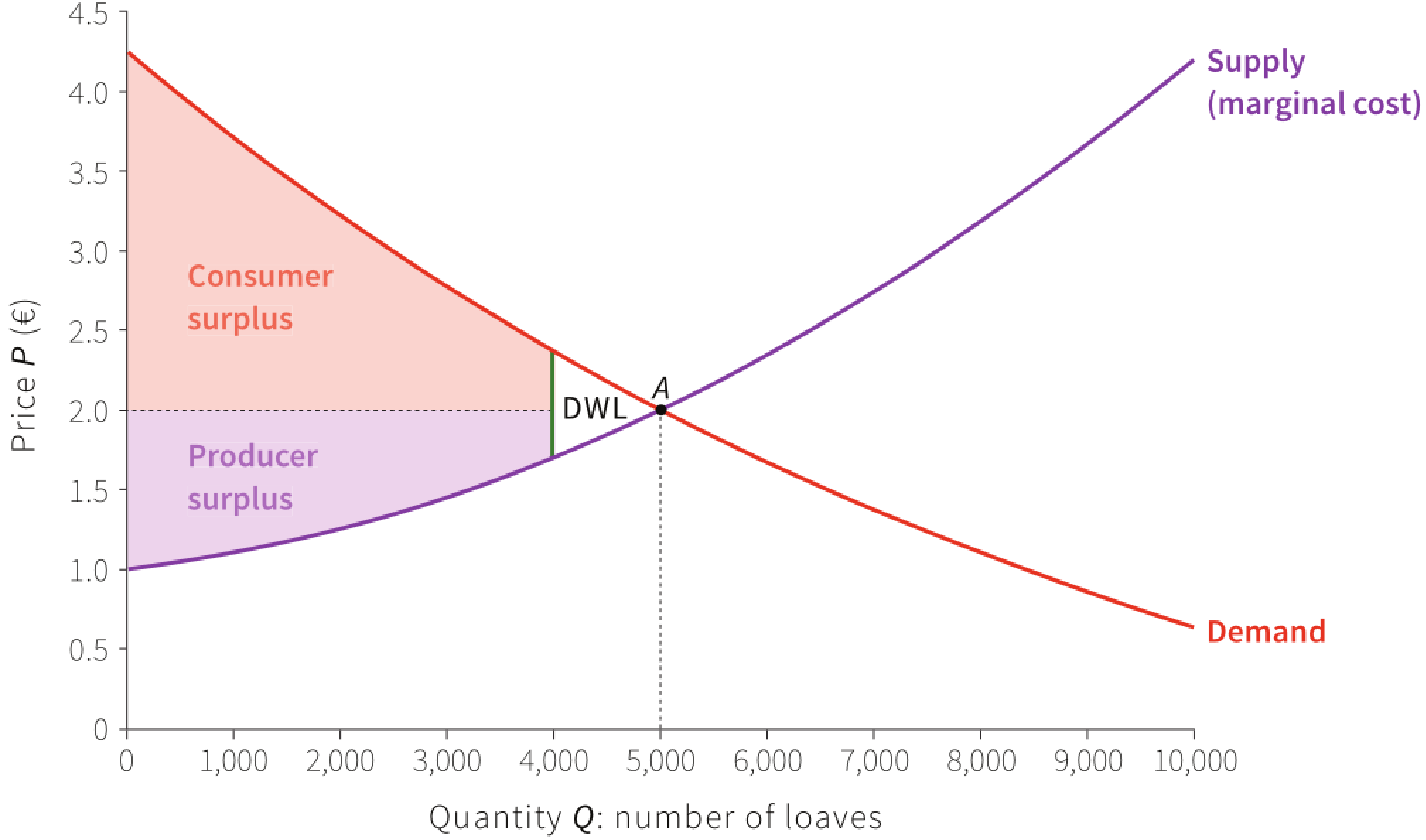
Market interventions



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Coordination failure

- **Coordination failure** – when the pursuit of self-interest does not produce desirable outcomes, even when accompanied by rules
- Under **certain conditions** competition based on self interest but coordinated by markets will bring about a desirable allocation of economic resources
- Under **other conditions** lack of cooperation results in coordination failure
- **Prisoners dilemma**
  - Self interested behavior leads to suboptimal overall outcome

The Prisoner's Dilemma

Original game		Prisoner B	
		Confesses	Denies
Prisoner A	Confesses	3;3	1;4
	Denies	4;1	2;2

Incentives for FDI		Country B	
		Tax	Tax break
Country A	Tax	3;3	1;4
	Tax break	4;1	2;2

Coordination failure

- **The tragedy of the commons**
  - Possibility that environmental destruction will result from the uncoordinated pursuit of individual self-interest
  - Here again, what is rational for one is not beneficial for all
  - Atmosphere, oceans
- Solutions
  - Social regulation
  - Private property

Market failure

- **Market failure** occurs when the spontaneous interactions of self-interested buyers and sellers in markets results in generally undesirable outcome
- Market prices often fail to take into account all the effects of our actions on others
- Examples – pollution, software, voluntary work
- Externalities
  - Positive
  - Negative

Reasons for market failure

- Prices inadequately measure the scarcity of the goods in question
- Discrepancy between private and social costs and benefits
- Incomplete contract
- Market power
  - Monopoly (oligopoly)
  - Barriers to entry
- Increasing returns to scale
- In general: $P \neq MC$

Final remarks

- Markets, pareto efficiency and just distribution of resources
- Government failure
- Private property solution to market failures
    - Narrow the gap between the private and the social costs or benefits
    - Market with pollution permits
- Special interests and market failures