

# Chapter 1

## Preliminaries

# Topics to be Discussed

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

# Preliminaries

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

# Preliminaries

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

# Preliminaries

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

# Preliminaries

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

# Preliminaries

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

# The Themes of Microeconomics

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- 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

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- Why Not?
  - Limited Resources

# The Themes of Microeconomics

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

# The Themes of Microeconomics

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

# The Themes of Microeconomics

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

# Theories and Models

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- 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

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- Microeconomic Analysis

- Models:

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

# Theories and Models

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

# Theories and Models

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- Microeconomic Analysis
  - Evolving the Theory
    - ◆ Testing and refining theories is central to the development of the science of economics.



# Positive Versus Normative Analysis

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## ■ 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

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# Normative Analysis

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## ■ 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?

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## ■ 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?

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

# What is a Market?

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

# What is a Market?

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## ■ Arbitrage

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

# What is a Market?

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- 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?

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



# What is a Market?

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## ■ Market Price

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

# What is a Market?

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

# What is a Market?

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

# What is a Market?

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## ■ Examples

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

# What is a Market?

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## ■ Examples

### ● Range of Products

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

# What is a Market?

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## ■ Examples

### ● Markets for Prescription Drugs

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

# Real Versus Nominal Prices

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- **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

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



# Real Versus Nominal Prices

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## ■ 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

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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

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

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

# Calculating Real Prices:

## An Example - Eggs & College

	1970	1975	1980	1985	1990	1998
<b>Consumer Price Index (100)</b>	38.8	53.8	82.4	107.6	130.7	(1983 = 163.0)
<b>Nominal Prices</b>						<b>Grade</b>
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
<b>Real Prices (\$1970)</b>						<b>Grade</b>
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

## The Minimum Wage

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### ■ 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!

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## The Minimum Wage

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

# Why Study Microeconomics?

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

# Why Study Microeconomics?

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## ■ Two Examples

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



# Why Study Microeconomics?

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

# Why Study Microeconomics?

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

# Why Study Microeconomics?

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- 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

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

# Summary

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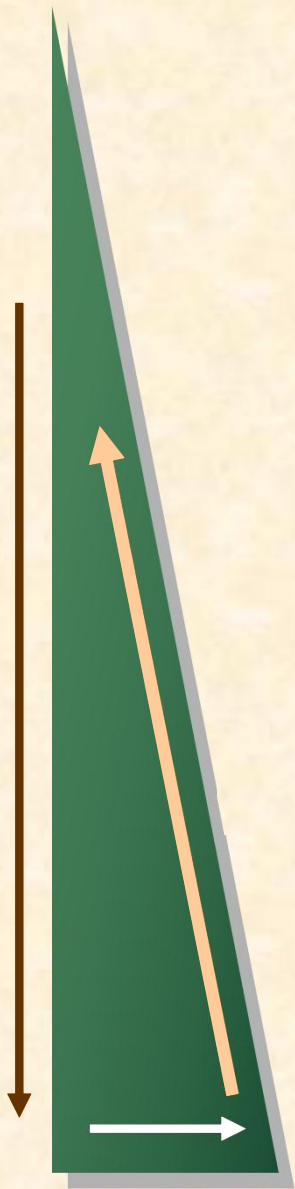
- Microeconomics is concerned with positive questions and normative analysis.
- A *market* refers to a collection of buyers and sellers who interact and to the possibility for sales and purchases that results from that interaction.

# Summary

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- 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