

CHAPTER 1

Preliminaries

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CHAPTER 1 OUTLINE



- 1.1 The Themes of Microeconomics
- 1.2 What Is a Market?
- 1.3 Real versus Nominal Prices
- 1.4 Why Study Microeconomics?

Preliminaries



- **microeconomics** Branch of economics that deals with the behavior of individual economic units—consumers, firms, workers, and investors—as well as the markets that these units comprise.
- **macroeconomics** Branch of economics that deals with aggregate economic variables, such as the level and growth rate of national output, interest rates, unemployment, and inflation.

1.1 THE THEMES OF MICROECONOMICS



Trade Offs

Consumers

Consumers have limited incomes, which can be spent on a wide variety of goods and services, or saved for the future.

Workers

Workers also face constraints and make trade-offs. First, people must decide whether and when to enter the workforce. Second, workers face trade-offs in their choice of employment. Finally, workers must sometimes decide how many hours per week they wish to work, thereby trading off labor for leisure.

Firms

Firms also face limits in terms of the kinds of products that they can produce, and the resources available to produce them.

1.1 THE THEMES OF MICROECONOMICS



Prices and Markets

Microeconomics describes how prices are determined.

In a centrally planned economy, prices are set by the government.

In a market economy, prices are determined by the interactions of consumers, workers, and firms. These interactions occur in *markets*—collections of buyers and sellers that together determine the price of a good.

1.1 THE THEMES OF MICROECONOMICS



Theories and Models

In economics, explanation and prediction are based on *theories*. Theories are developed to explain observed phenomena in terms of a set of basic rules and assumptions.

A *model* is a mathematical representation, based on economic theory, of a firm, a market, or some other entity.

Positive versus Normative Analysis

- **positive analysis** Analysis describing relationships of cause and effect.
- **normative analysis** Analysis examining questions of what ought to be.



- **market** Collection of buyers and sellers that, through their actual or potential interactions, determine the price of a product or set of products.
- **market definition** Determination of the buyers, sellers, and range of products that should be included in a particular market.
- **arbitrage** Practice of buying at a low price at one location and selling at a higher price in another.

1.2 WHAT IS A MARKET?



Competitive versus Noncompetitive Markets

- **perfectly competitive market** Market with many buyers and sellers, so that no single buyer or seller has a significant impact on price.

Market Price

- **market price** Price prevailing in a competitive market.

1.2 WHAT IS A MARKET?



Market Definition—The Extent of a Market

- **extent of a market** Boundaries of a market, both geographical and in terms of range of products produced and sold within it.

Market definition is important for two reasons:

- A company must understand who its actual and potential competitors are for the various products that it sells or might sell in the future.
- Market definition can be important for public policy decisions.

1.2 WHAT IS A MARKET?



EXAMPLE 1.1

Markets for Prescription Drugs



Markets are usually defined in terms of *therapeutic classes* of drugs.

For example, there is a market for *antiulcer drugs* that is very clearly defined.

Sometimes, however, pharmaceutical market boundaries are more ambiguous, like *painkillers*.

There are many types of painkillers, and some work better than others for certain types of pain.

1.2 WHAT IS A MARKET?



EXAMPLE 1.2

The Market for Sweeteners

In 1990, the Archer-Daniels-Midland Company (ADM) acquired the Clinton Corn Processing Company (CCP).

The U.S. Department of Justice (DOJ) challenged the acquisition on the grounds that it would lead to a dominant producer of corn syrup with the power to push prices above competitive levels.

ADM fought the DOJ decision, and the case went to court. The basic issue was whether corn syrup represented a distinct market.

ADM argued that sugar and corn syrup should be considered part of the same market because they are used interchangeably to sweeten a vast array of food products.

1.3 REAL VERSUS NOMINAL PRICES



- **nominal price** Absolute price of a good, unadjusted for inflation.
- **real price** Price of a good relative to an aggregate measure of prices; price adjusted for inflation.
- **Consumer Price Index** Measure of the aggregate price level.
- **Producer Price Index** Measure of the aggregate price level for intermediate products and wholesale goods.

1.3 REAL VERSUS NOMINAL PRICES



EXAMPLE 1.3

The Price of Eggs and the Price of a College Education

Table 1.1 The Real Prices of Eggs and of a College Education

	1970	1975	1980	1985	1990	1998
Consumer Price Index	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	\$1.01	\$1.04
College education	2530	3403	4912	8156	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	2530	2454	2313	2941	3800	4573

The *real* price of eggs in 1970 dollars is calculated as follows:

$$\text{Real price of eggs in 1975} = \frac{CPI_{1970}}{CPI_{1975}} \times \text{nominal price in 1975} = \frac{38.8}{53.8} \times \$0.77 = \$0.56$$

$$\text{Real price of eggs in 1980} = \frac{CPI_{1970}}{CPI_{1980}} \times \text{nominal price in 1980} = \frac{38.8}{82.4} \times \$0.84 = \$0.40$$

While the *nominal* price of eggs rose during these years, the *real* price of eggs actually fell.

1.3 Real versus Nominal Prices

Table 1.1 The Real Prices of Eggs and of a College Education

	1970	1975	1980	1985	1990	1998
Consumer Price Index	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	\$1.01	\$1.04
College education	2530	3403	4912	8156	12,800	19,213
Real Prices (\$1980)						
Grade A large eggs	\$1.30	\$1.18	\$0.84	\$0.61	\$0.64	\$0.53

•The *real* price of eggs in 1980 dollars is calculated as follows:

$$\text{Real price of eggs in 1975} = \frac{CPI_{1980}}{CPI_{1975}} \times \text{nominal price in 1975} = \frac{82.4}{53.8} \times \$0.77 = \$1.18$$

$$\text{Real price of eggs in 1985} = \frac{CPI_{1980}}{CPI_{1985}} \times \text{nominal price in 1985} = \frac{82.4}{107.6} \times \$0.80 = \$0.61$$

1.3 REAL VERSUS NOMINAL PRICES

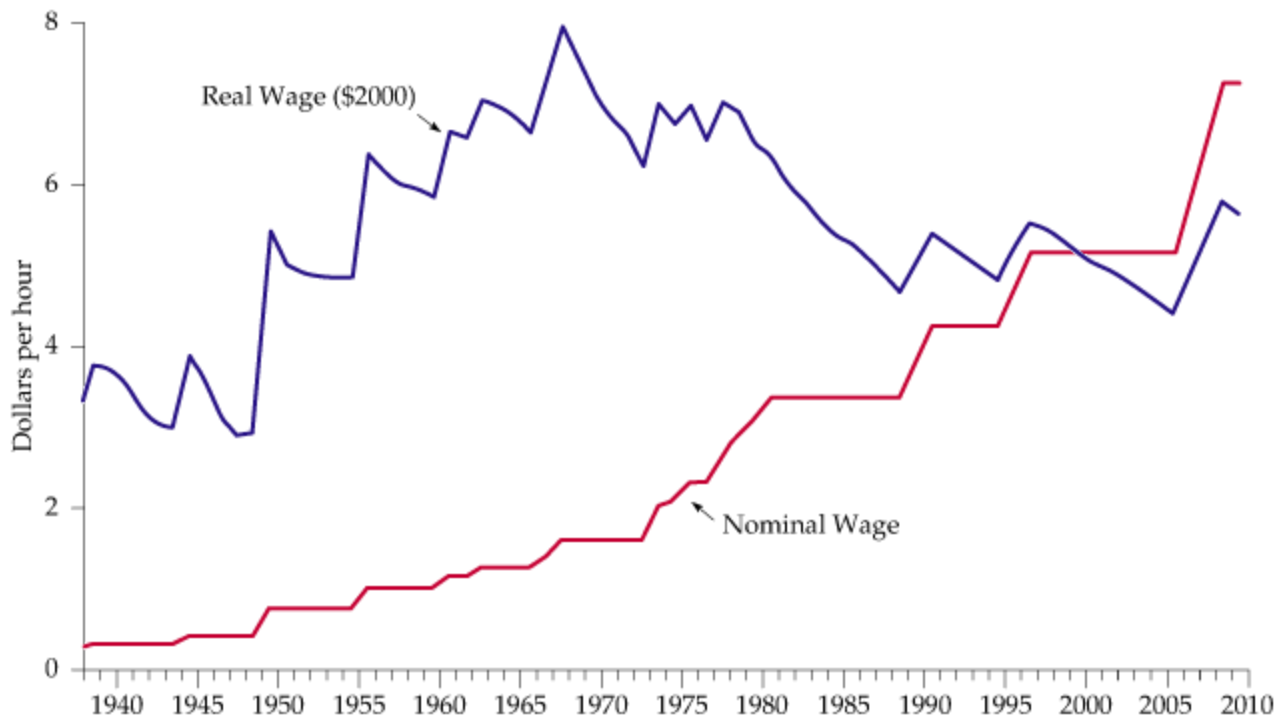


Figure 1.1

The Minimum Wage

In nominal terms, the minimum wage has increased steadily over the past 70 years.

However, in real terms its expected 2010 level is below that of the 1970s.



1.4

WHY STUDY MICROECONOMICS?



Corporate Decision Making: Ford's Sport Utility Vehicles

The design and efficient production of Ford's SUVs involved not only some impressive engineering, but a lot of economics as well.

First, Ford had to think carefully about how the public would react to the design and performance of its new products.

Next, Ford had to be concerned with the cost of manufacturing these cars.

Finally, Ford had to think about its relationship to the government and the effects of regulatory policies.

1.4

WHY STUDY MICROECONOMICS?



Public Policy Design: Automobile Emission Standards for the Twenty-First Century

The design of a program like the Clean Air Act involves a good deal of economics.

First, the government must evaluate the monetary impact of the program on consumers.

The government must determine how new standards will affect the cost of producing cars.

Finally, the government must ask why the problems related to air pollution are not solved by our market-oriented economy.