Microeconomics

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Introduction

Thinking like an Economist

Course Outline:

Textbooks:

- **Robert H. Frank. Microeconomics and Behavior, 8/e. McGraw–Hill 2010**
- Complementary textbooks:
  - Hal R. Varian. *Intermediate Microeconomics: A Modern Approach, 8/e*. Norton 2009
  - Pindyck, R.S. and D.L. Rubinfeld. *Microeconomics, 7/e*. Pearson Prentice–Hall, 2009
  - Krugman, P. and R. Wells. *Microeconomics*. Worth Publishers, 2009
  - Gravelle, H. and R. Rees. *Microeconomics, 3/e*. Financial Times – Prentice Hall, 2004
- Some introductory books:
  - Robert H. Frank, Ben Bernanke. *Principles of Microeconomics, 3/e*. McGraw–Hill 2009
  - Gregory N. Mankiw. *Principles of Microeconomics, 4/e*. Thompson South–Western 2006

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Cost–Benefit Analysis I

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- Economist's answer: If benefits of doing x overwhelm the costs of doing it

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Definition

Reservation price of activity x the price at which a person would be indifferent between doing x and not doing x

Cost–Benefit Analysis II

Example: Should I attend this class?

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- €4.60 for a Metro ticket etc.

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- Reservation price of attending the class: How much do I have to pay you to get up early and come here?
- Absurd? Economists can make predictions by assuming people act *as if* they made such calculations

Ceteris Paribus Assumption

- *Ceteris paribus* – a Latin phrase which literally means "all other things kept equal"
- Fundamental to economic analysis!

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The Marginal Analysis II

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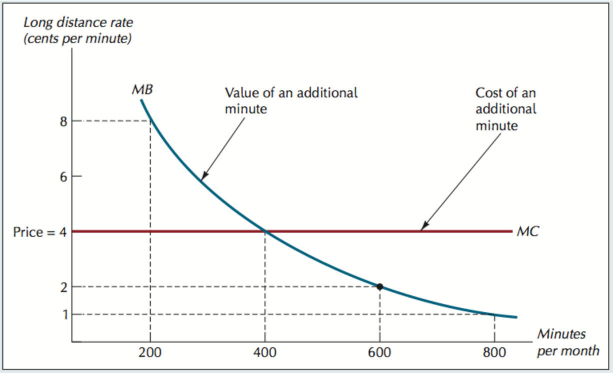

Pitfalls in Decision–making I

Pitfall 1: Ignoring Implicit Costs

Definition: Opportunity Cost

If doing activity x means not being able to do activity y, then the value to you of doing y (had you done it) is an **opportunity cost** of doing x

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- Meeting friends: €20

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- Opportunity Cost: Lost earnings: €20

Pitfalls in Decision–making II

Pitfall 2: Ignoring Sunk Costs

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- Example: A book that interests you costs €100. It is too expensive for you. You buy the book at a conference for half price, but you lose it on the way back. Would you buy the book again for €50?

Pitfalls in Decision–making III

Pitfall 3: Measuring Costs and Benefits as Proportions

- Example:
  Should I go to Media Markt instead of El Corte Inglés to save €10 on a €20 clock?
  Should I go to Media Markt instead of El Corte Inglés to save €10 on a €1000 tv set?

Pitfalls in Decision–making III

Pitfall 3: Measuring Costs and Benefits as Proportions

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  Should I go to Media Markt instead of El Corte Inglés to save €10 on a €20 clock?
  Should I go to Media Markt instead of El Corte Inglés to save €10 on a €1000 tv set?
- In both cases the answer depends on the cost! Not on the fact that in first case we save 50% and in the second 1% of the price!

Pitfalls in Decision–making IV

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Average cost of undertaking *n* units of an activity is the total cost of the activity divided by *n*

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Average benefit of undertaking *n* units of an activity is the total benefit of the activity divided by *n*

Pitfalls in Decision–making V

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100	1,5	3				
200	3	3,1				
300	4	3,7				
400	4,6	4,4				
500	5,3	5,2				
600	5,6	6,0				

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300	4	3,7	1,33	1,23		
400	4,6	4,4	1,15	1,1		
500	5,3	5,2	1,06	1,04		
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Normative Questions – questions about what actions or policies lead to best (desired) outcomes.

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- Modern macroeconomics is **micro–founded**: derives necessary assumptions and results from microeconomic analysis.
- Put differently: Microeconomists are wrong about specific things whereas macroeconomists are wrong about things in general :)