

Lecture I: Definition of Economics

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Readings

What is Economics?

Price as a Signal

Readings for Next Lecture

- ▶ Becker Lectures 3 – 4 (pp. 11 - 19)
- ▶ Landsburg Chapters 4 - 5

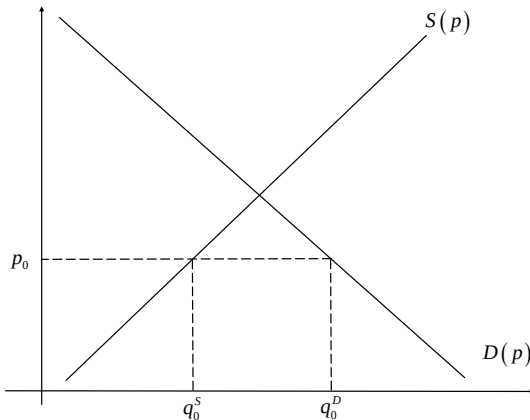
What is Economics?

- ▶ The most basic definition of economics that I have used is – Economics is the study of the allocation of scarce resources to meet unlimited and competing human wants and desires.
- ▶ Some viable alternative concepts is that economics is the study of human action (von Mises – praxeology).
- ▶ Some focus on the concept of choice – economics is the study of human choice.
 - ▶ Becker – It includes the choice of a car, a marriage mate, a religion; the allocation of resources within a family; and political discussions about how much to spend on education or on fighting a war in Vietnam.

Price as a Signal

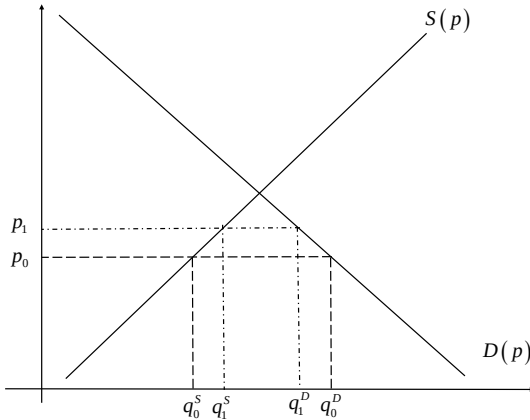
- ▶ In most of the world at the current time, a primary mechanism for this allocation is the price signal.
 - ▶ The relatively more scarce and useful an item is the higher its price.
 - ▶ This increase in price is a signal to the potential suppliers and users of the good.
 - ▶ As the price increases the market signal is to increase the amount of the good offered to the market – **supply**.
 - ▶ As the price increases the market signal is to reduce the amount of the good consumed – **demand**.
- ▶ Looking ahead slightly, we use the supply and demand diagram presented in Figure 1.

Simple Supply and Demand Diagram



- ▶ $S(p)$ represents the quantity of a good that will be offered to the market at any particular price.
- ▶ $D(p)$ represents the quantity of a good that will be demanded from the market at any given price.
- ▶ Suppose we start at the price p_0 in Figure 6. At this price consumers demand q_0^D while producers offer q_0^S .
 - ▶ In the vernacular of economics the excess demand is $q_0^D - q_0^S \gg 0$ (alternatively, there is a negative excess supply at price p_0).
 - ▶ Under typical assumptions, there is a pressure for price to increase.
 - ▶ At least one consumer is willing to pay a higher price because they cannot obtain the goods they want at the current price.
 - ▶ Figure 2 depicts the new equilibrium.

Price increase



- ▶ As the price rises from p_0 to p_1 the quantity demanded declines from q_0^D to q_1^D .
- ▶ As the price rises from p_0 to p_1 the quantity supplied increases from q_0^S to q_1^S .
- ▶ At the price p_1 the market is still not in equilibrium – the quantity demanded is still greater than the quantity supplied. However, the disequilibrium is smaller.

A Couple of Points

- ▶ A couple of points
 - ▶ First, most students have been introduced to this concept in terms of demand for final goods – iPads, beer, pizza, etc. However, supply and demand also holds in the input market.
 - ▶ Second, the location of the supply curve is a function of basic factors of production owned by households.
 - ▶ Individuals chose to sell their factors of production including labor, capital, management skills, etc. to producers.
 - ▶ Most of this class is about the operation of the pricing system.
 - ▶ However, other allocation schemes have been attempted such as central planning.