

Lecture 1

Opportunity cost

- = the benefit that could have been received, but was given up in order to take another course of action
- = the value of the next best choice
 - 3rd best and 4th best options do not matter
- Involves
 - Explicit cost = direct payment
 - Implicit cost = opportunities foregone without explicit costs
- Total cost = explicit cost + implicit cost
 - **Does not include sunk cost**
 - Costs that have **already incurred**, hence cannot be recovered
 - e.g. business spend \$100m on advertising and is deciding whether to continue
 - The \$100m is a sunk cost and not part of the opportunity cost

Marginal Analysis

- Marginal = additional or extra
- M benefit = extra benefit derived from buying extra unit
- M revenue = extra revenue derived from buying extra unit
 - Difference between M benefit and M revenue is
 - M benefit = consumers POV
 - M revenue = business POV
- M cost = extra cost derived from buying unit

Ceteris Paribus

- Examining the impact of one change at a time whilst holding everything else constant
- E.g. if a firm wanted to understand the impact of advertising on demand
 - Not removing other factors = not sure influence of advertising
 - ∴ may result in poor decision making

Correlation and causation

- Correlation
 - = 2 or more factors move together or oppositely
 - ∴ they seem related
 - In economics, not interested correlating patterns but the causes
- Causation
 - = situation brings about something else
 - ∴ need to find direct link to determine causation

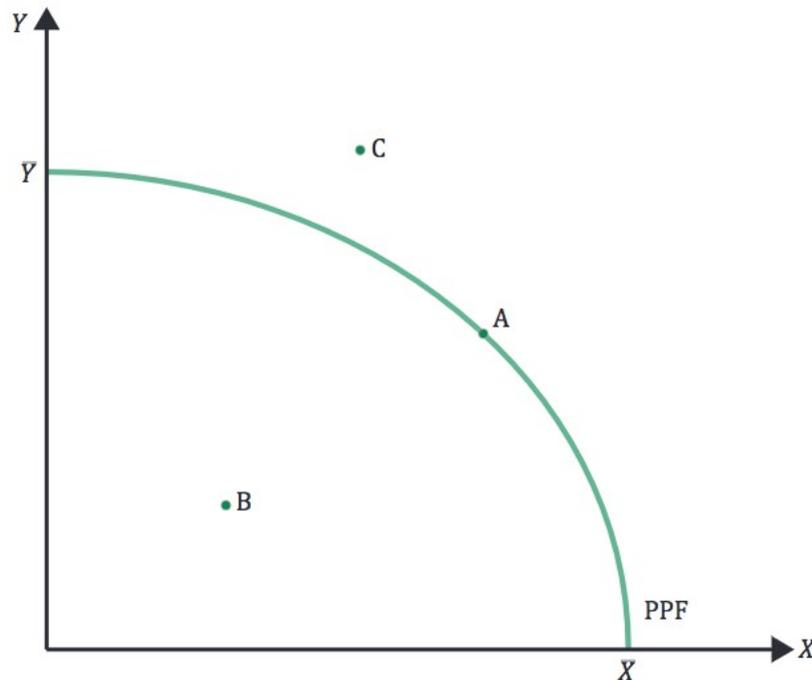
- Develop a theory so we can understand how the world works

Gains from exchange

- Trade makes people better off
 - If person 1 owns a bike and values it bike at \$10, person 2 wants to buy a bike but values it at \$100 and they exchange the bike for \$40, both parties will be better off
 - Trade can only occur if
 - Seller's valuation \leq Price \leq Buyer's valuation
 - Does not have to occur through money if parties value certain goods over others and thus bartering is also possible

Gains from specialisation

- Production Possibility Frontier (PPF)
 - Graphs output of an individual with a particular set of resources
 - Resources are limited
 - \therefore resources used in production of one good cannot be used in production of another
 - Frontier = production efficiency



- Any point on PPF or inside is obtainable
 - However, producing inside PPF = inefficient because resources not fully utilised
- Any point outside PPF = require more resources
 - \uparrow in level of technology can expand PPF line and vice versa

- Can use PPF to measure opportunity cost
- Absolute advantage and comparative advantage
 - Absolute advantage = Party A can produce more of a good than party B with a given amount of resources
 - Comparative advantage = Party A's opportunity cost of produce a good is lower than Party B's opportunity cost
- Broderick can produce 1 pepper mill every hour and 1 salt shaker every hour and Chris can produce 1 pepper mill every 4 hours and 1 salt shaker every 2

	<i>Pepper mills</i>	<i>Salt shakers</i>
Broderick	8	8
Christopher	2	4

	<i>Opp. cost of 1 pepper mill</i>	<i>Opp. cost of 1 salt shaker</i>
Broderick	1 salt shaker	1 pepper mill
Christopher	2 salt shakers	½ pepper mill

- Broderick has absolute advantage over Chris in both categories
- However, Broderick only has the comparative advantage over Chris in producing pepper mill's and not salt shakers, even though he has absolute advantage in producing salt shakers
- ∴ it is possible to have absolute advantage in production of both goods but as a rule of thumb, it is not possible to have the comparative advantage of more than one good, since if one person has the lower opportunity cost for one good, they will have the higher one for the other good
- By using the comparative advantage, we can determine who is better off when producing goods
- ∴ by allowing each Party to specialise in producing the good in which they have the lower opportunity cost, and then trading, both trading parties can potentially be made better off
 - What is a mutually beneficial price for 1 pepper mill?
 - Min P. Broderick will sell = 1 because if less, he can produce more from the same resources
 - Max P. Chris will buy = 2 because if more, he can produce at a cheaper rate