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ECONOMICS OF MANAGEMENT

University of Technology Sydney



Chapter 2 Demand, Supply and Equilibrium Prices	5
For Manager	5
Demand	5
Non-price Factors Influencing Demand	5
Demand Function	6
Demand Curve	6
Individual vs Market Demand Curves	7
Supply	7
Non-price Factors Influencing Supply	7
Supply Function	8
Supply Curve	8
Demand, Supply and Equilibrium	9
Changes in Equilibrium Prices and Quantities	9
Chapter 3 Demand Elasticity	12
Demand Elasticity	12
Own-Price Elasticity of Demand	12
Price Elasticity Values	12
Determinants of Price Elasticity of Demand	13
Other Functions Related to Demand	13
Income and Cross-Price Elasticity of Demand	15
Income Elasticity of Demand	15
Cross Price Elasticity of Demand	15
Chapter 5 Production and Cost Analysis in the Short Run	16
Defining the Production Function	16
The Production Function	16
Fixed Inputs and Variable Inputs	16
Short-Run Versus Long-Run Production Functions	16
Model of a Short-Run Production Function	16
Relationship Among Total, Average, and Marginal Product	17
Economic Explanation of the Short-Run Production Function	18
Model of Short-Run Cost Functions	18
Accounting Profit Versus Economic Profit Measures	18
Short-Run Cost Functions & Fixed Versus Variable Cost	19
Relationships Among Total, Average, and Marginal Costs	20
Relationship Between Short-Run Production and Cost	20
Chapter 6 Production and Cost Analysis in the Long Run	21
Model of a Long-run Production Functions	21
Input Substitution	21
Model of a Long-Run Cost Function	21
Economic and Diseconomic of Scale	22
The Minimum Efficient Scale of Operation	22
Chapter 7 Market Structure: Perfect Competition	23
The Model of Perfect Competition	23
Model of the Industry or Market and the Firm	23
The Short Run in Perfect Competition: Shut down or Stay	25
Long-Run Adjustment in Perfect Competition: Entry and Exit	25
Long-Run Adjustment in Perfect Competition: The Optimal Scale of Production	25
Chapter 8 Market Structure: Monopoly and Monopolistic Competition	27
Firms with Market Power	27
The Monopoly Model	27
Comparing Monopoly and Perfect Competition	28
Sources of Market Power: Barrier to Entry	29
Chapter 9 Oligopoly	30

Oligopoly Model.....	30
Non-cooperative Oligopoly Models	30
Cooperative Oligopoly Models.....	32
Chapter 10 Pricing Strategies for the Firm	34
The Role of Mark-up Pricing.....	34
Price Discrimination	34
Theoretical Models of Price Discrimination.....	34
Chapter 12 Spending by Individuals, Firms, and Government on Real Good and Services.....	35
Framework for Macroeconomic Analysis	35
Short-run vs. Long-run.....	35
Analysis in Real vs. Nominal Terms	35
The Components of Aggregate Expenditure (Keynesian Model).....	36
Personal Consumption	36
Investment Expenditure	37
Government Spending	38
Net Export Expenditure	38
Aggregate Expenditure and Equilibrium Income and Output	39
Effect of the Interest Rate on Aggregate Expenditures	39
Chapter 13 The Role of Money in the Macro Economy	40
Money and the U.S. Financial System.....	40
Definition of Money	40
Measures of the Money Supply	40
Depository Institutions and the Fractionl Reserve Banking System	40
Tools of Monetary Policy	41
Equilibrium in the Money Market	42
The Supply of Money	42
The Demand for Money.....	42
.....	43
Equilibrium in the Money Market	43
Change in the Supply of Money	43
Change in the Demand of Money	43
Chapter 14 The Aggregate Model of the Macro Economy	45
The Model of Aggregate Demand and Supply	45
The Aggregate Demand Curve	45
Fiscal and Monetary Policy Implementation	46
The Aggregate Supply Curve.....	47
Short-Run Aggregate Supply Curve (Horizontal and Upward Sloping)	48
Long-Run Aggregate Supply Curve (Vertical).....	48
Shifts in Short-Run Aggregate Supply	49
Shift in Long-Run Aggregate Supply	50
Measuring Changes in Aggregate Demand and Supply	50
Chapter 15 International and Balance of Payments Issues in the Macro Economy	51
Exchange Rate	51
Equilibrium in the Open Economy	52
US International Transaction in 2011 (Balance of Payments).....	53
The Current Account.....	53
The Financial Account (or the Capital Account).....	54
Revenue or T-Account.....	54
.....	55
Deriving the Foreign Exchange Market.....	55
The Demand for and Supply of Dollars in the Foreign Exchange Market	55
Equilibrium in the Foreign Exchange Market	57

Exchange Rate System.....	57
The Effect on the Money Supply	58
Sterilisation	58
Policy Effectiveness with Different Exchange Rate Regimes.....	59

Economic for Management

Chapter 2 Demand, Supply and Equilibrium Prices

For Manager

- Managers need to understand supply and demand to develop their own competitive strategies and to respond to the actions of their competitors
- Managers need to understand how the structure of the market (i.e. competitive market) that their firm operates in impacts supply and demand
- Managers need to understand how public policy will impact supply and demand

Demand

- The functional relationship between the price of a good or service and the quantity demanded by consumers in a given period of time, all else held constant

Non-price Factors Influencing Demand

- a. Tastes and Preferences – consumers' tastes and preferences change in accordance to trends, environmental issues, product lines, reports, marital status etc.
- b. Income – the level of a person's income also affects demand, because demand incorporates both *willingness* and *ability* to pay for good.
 - **Normal goods** – an increase in an individual's income will increase the demand for a normal good i.e. an increased in income will cause a person to buy for steak (positively related)
 - Firms selling *normal goods* i.e. jewellery, automobiles experience increases in sales when the general economy is booming
 - **Inferior goods** – an increase in an individual's income will decrease the demand for an inferior good i.e. an increased in income will cause a person to eat less chicken (negatively related)
 - Firms selling *inferior goods* i.e. hamburger, cheap clothing experience increases in sales when the general economy is in recession
- c. Prices of related goods
 - **Substitute goods** – two goods, X and Y are substitutes if an increase in the *price* of good Y causes consumers to increase their *demand* for good X or a decrease in the *price* of good Y causes consumers to decrease their *demand* for good X
 - Consumers view the 2 goods as being essentially the same and purchase the cheaper of the 2 goods i.e. Coke and Pepsi, McDonald and Hungry Jack
 - **Complementary goods** – two goods, X and Y are complementary if an increase in the price of good Y causes consumers to decrease their demand for good X or if a decrease in the price of good Y causes consumers to increase their demand for good X
 - Products or services that consumer use together (cross elasticity) i.e. computers and printers, frame and lenses
- d. Future expectation – if consumers expect prices to be lower in the future, they may have less current demand than if they did not have those expectations. Likewise, if prices are expected to increase, consumers may demand more for the good at present
- e. Number of potential consumers
 - A firm's marketing strategy is based on finding new groups of consumers who will purchase the product
 - Increasing migration from overseas will have a direct impact on the property and rental market
 - Increasing middle class in China will directly impact on the demand of Australian food export

Demand Function

$$2.1 \quad Q_{XD} = f(P_X, T, I, P_Y, P_Z, EXC, NC, \dots)$$

where

Q_{XD} = quantity demanded of good X

P_X = price of good X

T = variables representing an individual's tastes and preferences

I = income

P_Y, P_Z = prices of goods Y and Z , which are related to the consumption of good X

EXC = consumer expectations about future prices

NC = number of consumers

Demand Curve

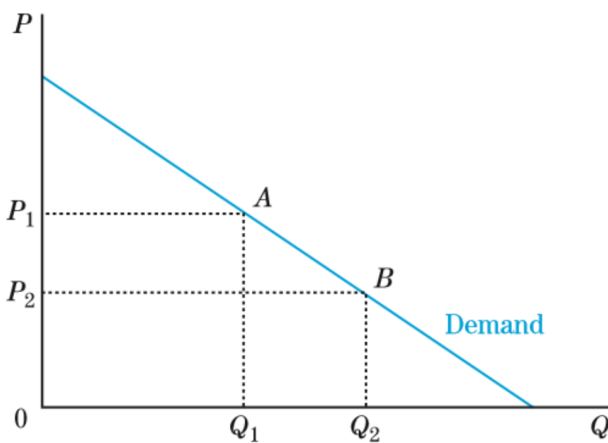


FIGURE 2.1

The Demand Curve for a Product

A demand curve shows the relationship between the price of a good and the quantity demanded, all else held constant.

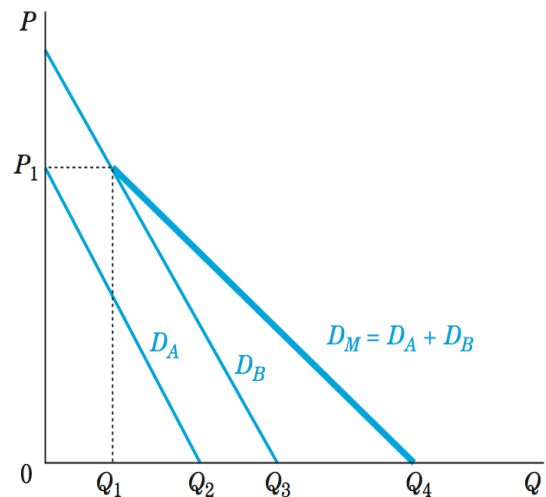
- Demand curve are generally downward sloping, showing a negative or inverse relationship between the price of a good and the quantity demanded at that price, all else held constant
- As price decreases from P_1 to P_2 , quantity increase from Q_1 to Q_2
- **Change in quantity demand** - the change in quantity consumers purchase when the price of good changes, all other factors held constant, pictured as a movement along a given demand curve
- **Change in demand** – the change in quantity purchased when one or more of the demand shifters change, pictured as a shift of the entire demand curve i.e. income increases, quantity demand will increase

Individual vs Market Demand Curves

FIGURE 2.3

Individual Versus Market Demand Curve

A market demand curve is derived from the horizontal summation of individual demand curves; that is, for every price, add the quantity each individual demands at that price to determine the market quantity demanded at that price.



- To derive the market demand curve for both individual (D_A and D_B), we do a *horizontal summation of individual demand curves*
- Based on the information in Figure 2.3, if another individual C enter into the market, the market demand curve would shift further to the right

Supply

- The functional relationship between the price (P) of a G&S and the quantity supplied (Q_s) by producers in a given time period, all else held constant

Non-price Factors Influencing Supply

- a. State of technology
 - The state of technology, or the body of knowledge about how to combine the inputs of production, affects what output producers will supply
 - Technology influences how the G&S is actually produced, which in turn affects the cost of production
- b. Input prices
 - Input prices are the prices of all the inputs or factors of production – labour, capital, land and raw materials, used to produce the given product
 - These input prices affect the costs of production and, therefore, the prices at which producers are willing to supply different amounts of output
- c. Prices of related in production
 - The prices of other goods related in production can also affect the supply of a particular good
 - **Substitute** – 2 goods are substitute in production if the same inputs can be used to produce either of the good such as switching from corn to tobacco plantation, annual income increase by 35%
 - **Complementary** – 2 goods are complementary in production if the production of one is a by product of the production of the other i.e. as more oil are produced, the supply of sulphur, which is removed from the products, also increases
- d. Future expectation
 - If producers expect prices to increase in the future, they may supply less output now than without those expectations
 - The opposite could happen if produce expect prices to decrease in the future
- e. Number of producers
 - The number of producers influences the total supply of a product at any given price
 - The number of producers may increase because of perceived profitability in a given industry or because of changes in law or regulations such as trade barrier i.e. increase competition due to deregulation and removal of import tax

Supply Function

$$2.4 \quad Q_{XS} = f(P_X, TX, P_I, P_A, P_B, EXP, NP, \dots)$$

where

Q_{XS} = quantity supplied of good X

P_X = price of good X

TX = state of technology

P_I = prices of the inputs of production

P_A, P_B = prices of goods A and B , which are related in production to good X

EXP = producer expectations about future prices

NP = number of producers

Supply Curve

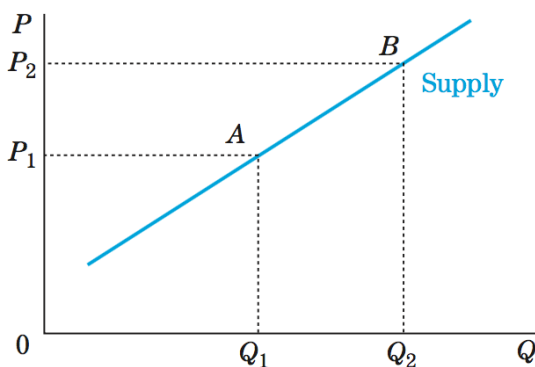


FIGURE 2.4

The Supply Curve for a Product

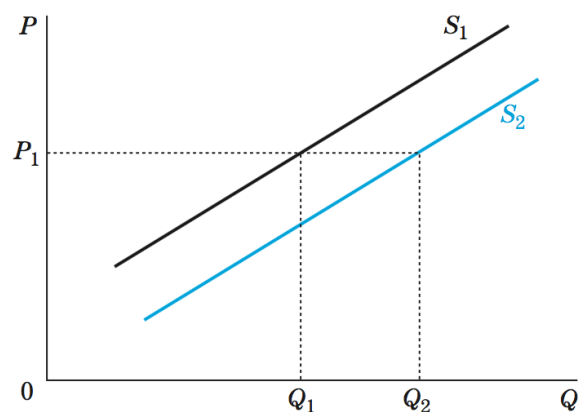
A supply curve shows the relationship between the price of a good and the quantity supplied, all else held constant.

- Supply curve generally slopes upward, indicating a positive or direct relationship between the price of the product and the quantity producers are willing to supply
- When the price of a good rises from P_1 to P_2 , the quantity supplied rises from Q_1 to Q_2 , all else equal
- **Change in quantity supply** – the change in amount of a good supplied when the price of the good changes, all other factors held constant, pictured as a movement along a given supply curve
- **Change in supply** – the change in the amount of a good supplied when one or more of a supply shifter change, pictured in as a shift of the entire supply curve i.e. technology improves, the at the same price P_1 , the quantity supplied increases from Q_1 to Q_2

FIGURE 2.5

Change (Increase) in Supply

A change in supply occurs when one or more of the factors held constant in defining a given supply curve changes.



Demand, Supply and Equilibrium

- Market equilibrium – the market equilibrium price is that price for which the quantity supplied is equal to the quantity demanded

$$Q_s = Q_d$$

Shortage Disequilibrium

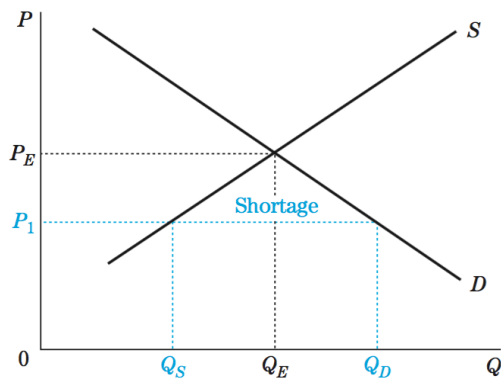


FIGURE 2.7

A Lower-Than-Equilibrium Price

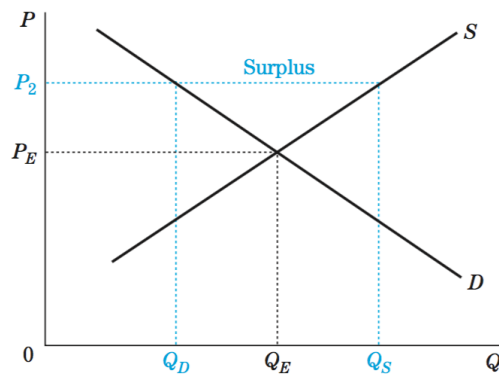
A shortage of a good results when the market price, P_1 , is below the equilibrium price, P_E .

Surplus Disequilibrium

FIGURE 2.8

A Higher-Than-Equilibrium Price

A surplus of a good results when the market price, P_2 , is above the equilibrium price, P_E .



Changes in Equilibrium Prices and Quantities

- Changes in equilibrium prices and quantities occur when market forces cause either the demand or the supply curve for a product to shift or both curves shift
- These shifts occur when one or more of the factors held constant behind a given demand or supply curve change
- Change in Demand**
 - When non-price demand factors change i.e. consumers' tastes and preference, income, expectation, the demand curve shifts and produces a change in the equilibrium price and quantity

FIGURE 2.9

Change in Demand

A change in demand, represented by a shift of the demand curve, results in a movement along the supply curve.

