

## Outline for lecture 3

ECON 1a, Fall 2008, Warren Gibson

- Circular flow diagram
  - Draw on board
  - Add taxes
- Production possibility frontier
  - Efficient, inefficient, impossible points
  - No money involved in this simple model
  - PPF need not be a straight line. Why?
- Farmer & rancher – text p. 48

	Farmer		Rancher	
	Meat	Potatoes	Meat	Potatoes
Without trade:				
Production & consumption:	4	16	12	24
With trade:				
Production	0	32	18	12
Trade	+5	-15	-5	+15
Consumption	5	17	13	27
Increase in consumption:	+1	+1	+1	+3

- Key concepts:
  - Gains from trade
  - Opportunity costs
  - Absolute advantage
  - Comparative advantage
- Lessons learned:
  - Trade can create new wealth
  - Both parties gain from trade
  - Even people who are generally inefficient gain from trade

- Demand
  - Definition: the desire *and ability* to acquire some good or service at some price. Desire for a Porsche doesn't count if you can't afford one.
  - Law of demand: other things being equal, quantity demanded falls when price rises and vice versa.
  - Demand are curves plotted with
    - \* Q (quantity demanded) on the horizontal axis
    - \* P (price per unit) on the vertical axis
    - \* Demand curves slope downward but need not be straight lines
    - \* Demand curves could apply to a single individual but more often they refer to the total quantity demanded for a group of people.
  - Important terminology:
    - \* “Quantity demanded” refers to Q, represented by a distance on the horizontal axis
    - \* “Quantity” refers to the entire demand curve
  - Shifts in quantity: the entire demand curves moves because something other than price has changed. Examples:
    - \* Increased income usually causes demand curves to shift to the right.
    - \* Increases in the price of substitute goods make demand curves shift to the right.
- Supply
  - Definition: the desire *and ability* to provide some good or service at some price.
  - Law of supply: other things being equal, quantity supplied rises when prices rise and vice versa.
  - Supply curves are plotted
    - \* on the same graph with demand curves (Q horizontal, P vertical)
    - \* Supply curves slope upward but need not be straight lines

- \* Supply curves could apply to a single seller but more often they refer to the total quantity demanded for a group of sellers.
- Important terminology:
  - \* “Quantity supplied” refers to  $Q$ , represented by a distance on the horizontal axis
  - \* “Supply” refers to the entire supply curve
- Shifts in quantity: the entire supply curves moves because something other than price has changed. Examples:
  - \* Increased production efficiency usually causes supply curves to shift to the right.
  - \* Increases in the price of complementary goods make supply curves shift to the right.
- Supply and demand
  - The point where supply and demand curves cross is called *equilibrium*.
  - When the price is above the equilibrium point, there is a *surplus*.
  - When the price is below the equilibrium point, there is a *shortage*. Do not confuse shortage with scarcity. Goods and services that are traded in markets are always scarce. There is only a shortage if the price is below equilibrium.
  - Some facts about supply and demand:
  - Supply and demand curves can almost never be observed in the real world. We can only observe one point: equilibrium. We know nothing about the rest of the curves except their slopes.