Economics 101A
(Lecture 18)

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Outline

1. Supply Function
2. One-step Profit Maximization
3. Introduction to Market Equilibrium
4. Aggregation
5. Market Equilibrium in the Short-Run

1 Supply Function

- Supply function: $y^* = y^*(w, r, p)$

- What happens to y^* as p increases?

- Is the supply function upward sloping?

- Remember f.o.c:
$$p - c'_y(w, r, y) = 0$$

- Implicit function:
$$\frac{\partial y^*}{\partial p} = -\frac{1}{-c''_{y,y}(w, r, y)} > 0$$
as long as s.o.c. is satisfied.

- Yes! Supply function is upward sloping.

2 One-step Profit Maximization

- Nicholson, Ch. 9, pp. 265–270 [OLD: Ch. 13, pp. 346–350].

- One-step procedure: maximize profits

- Perfect competition. Price p is given
  - Firms are small relative to market
  - Firms do not affect market price p_M
  - Will firm produce at $p > p_M$?
  - Will firm produce at $p < p_M$?
  - $\Longrightarrow p = p_M$

- Revenue: $py = pf\left(L, K\right)$

- Cost: $wL + rK$

- Profit $pf\left(L, K\right) - wL - rK$

- Agent optimization:

$$\max_{L,K} pf(L,K) - wL - rK$$

- First order conditions:

$$pf'_L(L,K) - w = 0$$

and

$$pf'_K(L,K) - r = 0$$

- Second order conditions? $pf''_{L,L}(L,K) < 0$ and

$$\begin{aligned} |H| &= \begin{vmatrix} pf''_{L,L}(L,K) & pf''_{L,K}(L,K) \\ pf''_{L,K}(L,K) & pf''_{K,K}(L,K) \end{vmatrix} = \\ &= p^2 \left[f''_{L,L} f''_{K,K} - \left(f''_{L,K} \right)^2 \right] > 0 \end{aligned}$$

- Need $f''_{L,K}$ not too large for maximum

- Comparative statics with respect to to p, w, and r.

- What happens if w increases?

$$\frac{\partial L^*}{\partial w} = -\frac{\begin{vmatrix} -1 & pf''_{L,K}(L,K) \\ 0 & pf''_{K,K}(L,K) \end{vmatrix}}{\begin{vmatrix} pf''_{L,L}(L,K) & pf''_{L,K}(L,K) \\ pf''_{L,K}(L,K) & pf''_{K,K}(L,K) \end{vmatrix}} < 0$$

and

$$\frac{\partial L^*}{\partial r} =$$

- Sign of $\partial L^* / \partial r$ depends on $f''_{L,K}$.

3 Introduction to Market Equilibrium

- Nicholson, Ch. 10, pp. 279–295 [OLD: Ch. 14, pp. 368–382.

- Two ways to analyze firm behavior:
  - Two-Step Cost Minimization
  - One-Step Profit Maximization

- What did we learn?
  - Optimal demand for inputs L^*, K^* (see above)
  - Optimal quantity produced y^*

- **Supply function**. $y = y^*(p, w, r)$
  - From profit maximization:
$$y = f\left(L^*(p, w, r), K^*(p, w, r)\right)$$
  - From cost minimization:
$$MC \text{ curve above } AC$$
  - Supply function is increasing in p

- Market Equilibrium. Equate demand and supply.

- Aggregation?

- Industry supply function!

4 Aggregation

4.1 Producers aggregation

- J companies, $j = 1, ..., J$, producing good i

- Company j has supply function

$$y_i^j = y_i^{j*}(p_i, w, r)$$

- Industry supply function:

$$Y_i(p_i, w, r) = \sum_{j=1}^{J} y_i^{j*}(p_i, w, r)$$

- Graphically,

4.2 Consumer aggregation

- Nicholson, Ch. 10, pp. 279–282 [OLD: Ch. 7, pp. 172–176]

- *One-consumer economy*

- Utility function $u(x_1, ..., x_n)$

- prices $p_1, ..., p_n$

- Maximization $\Longrightarrow$

$$\begin{aligned} x_1^* &= x_1^*(p_1, ..., p_n, M), \\ &\vdots \\ x_n^* &= x_n^*(p_1, ..., p_n, M). \end{aligned}$$

- Focus on good i. Fix prices $p_1, ..., p_{i-1}, p_{i+1}, ..., p_n$ and M

- **Single-consumer demand function**:

$$x_i^* = x_i^* \left(p_i | p_1, ..., p_{i-1}, p_{i+1}, ..., p_n, M\right)$$

- What is sign of $\partial x_i^* / \partial p_i$?

- Negative if good i is normal

- Negative or positive if good i is inferior

- *Aggregation:* J consumers, $j = 1, ..., J$

- Demand for good i by consumer j :

$$x_i^{j*} = x_i^{j*}\left(p_1, ..., p_n, M^j\right)$$

- Market demand X_i:

$$\begin{aligned} & X_i\left(p_1, ..., p_n, M^1, ..., M^J\right) \\ = & \sum_{j=1}^{J} x_i^{j*}\left(p_1, ..., p_n, M^j\right) \end{aligned}$$

- Graphically,

- Notice: market demand function depends on distribution of income M^J

- Market demand function X_i:

  – Consumption of good i as function of prices $\mathbf{p}$

  – Consumption of good i as function of income distribution M^j

5 Market Equilibrium in the Short-Run

- Nicholson, Ch. 14, pp. 368–382.

- What is equilibrium price p_i?

- Magic of the Market...

- Equilibrium: No excess supply, No excess demand

- Prices $\mathbf{p}^*$ equates demand and supply of good i:

  $Y^* = Y_i^S\left(p_i^*, w, r\right) = X_i^D\left(p_1^*, ..., p_n^*, M^1, ..., M^J\right)$

- Graphically,

- Notice: in short-run firms can make positive profits

- Comparative statics exercises with endogenous price p_i :
  - increase in wage w or interest rate r:
  - change in income distribution

6 Comparative statics of equilibrium

- Supply and Demand function of parameter α :
  - $Y_i^S(p_i, w, r, \alpha)$
  - $X_i^D(\mathbf{p}, \mathbf{M}, \alpha)$

- How does α affect p^* and Y^*?

- Comparative statics with respect to α

- Equilibrium:

$$Y_i^S(p_i, w, r, \alpha) = X_i^D(\mathbf{p}, \mathbf{M}, \alpha)$$

- Can write equilibrium as implicit function:

$$Y_i^S(p_i, w, r, \alpha) - X_i^D(\mathbf{p}, \mathbf{M}, \alpha) = 0$$

- What is $dp^*/d\alpha$?

- Implicit function theorem:

$$\frac{\partial p^*}{\partial \alpha} = -\frac{\frac{\partial Y^S}{\partial \alpha} - \frac{\partial X^D}{\partial \alpha}}{\frac{\partial Y^S}{\partial p} - \frac{\partial X^D}{\partial p}}$$

- What is sign of denominator?

- Sign of $\partial p^*/\partial \alpha$ is negative of sign of numerator

- Examples:

  1. *Fad.* Good becomes more fashionable: $\frac{\partial X^D}{\partial \alpha} > 0 \Longrightarrow \frac{\partial p^*}{\partial \alpha} > 0$

  2. *Recession in Europe.* Negative demand shock for US firms: $\frac{\partial X^D}{\partial \alpha} < 0 \Longrightarrow \frac{\partial p^*}{\partial \alpha} < 0$

  3. *Oil shock.* Import prices increase: $\frac{\partial Y^S}{\partial \alpha} < 0 \Longrightarrow \frac{\partial p^*}{\partial \alpha} > 0$

  4. *Computerization.* Improvement in technology. $\frac{\partial Y^S}{\partial \alpha} > 0 \Longrightarrow \frac{\partial p^*}{\partial \alpha} < 0$

7 Next Lecture

- Elasticities
- Taxes and Subsidies
- Long-Run Equilibrium