

Economics 1: Introduction to Economics

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Administrivia

April 27, 2016 8-9 AM
Wheeler Auditorium, U.C. Berkeley

The Wrap-Up

- 2016-04-27 We: Final Lecture
 - 2016-04-27 We/-28 Th: Assignment: Problem Set 8 (international and other issues)
- 2016-05-04 We: Q&A in Wheeler
- 2016-05-04 We/-05 Th: Section Review Meetings
 - 2016-05-04 We/-05 Th: “Assignment”: “Problem Set 9”, i.e., sample final exam due **everyone gets a 4**
- 2016-05-09 Mo: FINAL EXAM 3-6 PM RSF Fieldhouse
<http://tinyurl.com/hd2y9tm>

Final Exam

- No calculators
- Two parts—so put your name on both parts, and hand in both parts
- “Problem Set 9” will be a good guide to the format of the exam
- As David Romer asked one of your peers in Econ 2 yesterday: “Are the students anxious?”

“Are the Students Anxious”

- Yes
- We have thrown a year’s worth of material into a semester
- We have, furthermore, gone as deeply as we can into what we think are the most important topics
- For you in-state students: We have taken very seriously our moral obligation to the Regents, the Governor and Legislature, and the people of California
- For you out-of-state students: We have taken very seriously our moral obligation to your parents, your relatives, and your future selves that will have to pay back student loans

Plus: Economics Is Strange

- A lot of it is counterintuitive
- Emergent properties of systems are not what you would naively expect from just taking the parts one by one
- Adam Smith:
 - “He intends only his own security... only his own gain; and he is in this, as in many other cases, led by an invisible hand to promote an end which was no part of his intention... By pursuing his own interest he frequently promotes that of the society more effectually than when he really intends to promote it...”
- It is part of our rhetorical style to try to wake you up by shocking you with such paradoxes
- Sometimes the paradoxical conclusion is right; sometimes it isn't; you have to think hard to figure out which it is and when it is

Study Strategies for the Final

- Review: problem sets and section exercises
- Reread: the outside book(s) that you read
- Reskim: the FBAH textbook
- Review: your lecture notes

- DO “PROBLEM SET 9”

- You should, collectively, be fine...

After the Final: Resell Your Textbook!

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After the Final: Help Us Out

- **The Professor's Dilemma**
 - Econ 1: The Samuelsonian tradition
 - Graphs, equations, words
 - Analytic geometry, algebra, narratives
 - Econ 1: Technology
 - Econ 1: Conflict
 - The course for future majors
 - The course for economic literacy

After the Final: Email Me

- I want to know:
 - One topic in the course that should be dropped
 - One topic in the course that should be fixed—and how to fix it
 - One topic in the course that is among the very best—and how to make it even more awesome
 - One topic left out of the course that should be added

After the Final: Talk to California Hall

- Deans, etc. sit in their offices...
- They gradually lose touch with the world...
- Eager to please people who show up in their offices—especially if those people seem high status
- But most eager to arrange their lives so as not to be yelled out:
 1. Donors
 2. Governor, legislators, regents, etc.
 3. Senior faculty
 4. Junior faculty
 5. Graduate students
 6. Undergraduates
 7. Staff
- That determines the hierarchy of focus and attention of the university's resources

To Your i>Clickers

- Are you here?
 - A. Yes
 - B. In body, but not in spirit
 - C. What is this “here” of which you speak?
 - D. Not sure
 - E. No

To Your i>Clickers

- Have you been to 3/4 or more of the lectures?
 - A. Yes
 - B. No

Orientation

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“The Market” as an Institution

- We start from what look like to us deep truths of human psychology
 - People are *acquisitive*
 - People engage in *reciprocity*—i.e., want to enter into reciprocal gift-exchange relationships in which they are neither cheaters nor saps
 - With those they *trust*...

“The Market” as an Institution II

- We devised property as a way of constructing expectations of trust...
- We devised money as a substitute for trust...
- And so, on the back of these human propensities for acquisition and for trusted gift-exchange...
- We have constructed a largely-peaceful global 7.4B-strong highly-productive societal division of labor

“The Market” as an Institution III

- Our largely-peaceful global 7.4B-strong highly-productive societal division of labor is:
 - A very valuable and important societal institution
 - Built on assigning resources to *owners*
 - Owners thus have responsibility for stewardship...
 - And on very large-scale webs of *win-win* exchange
 - Owners thus have incentive to be good stewards...
 - Webs of exchange regulated by *market equilibrium prices*
 - This last generates all the interesting emergent and counterintuitive and paradoxical properties of the system as a whole
- Economics is the study of how this—what we usually call “the market system”—works...

“The Market” as an Institution IV

- In analyzing the market as an institution, we need to cover:
 - The success of the market
 - The failures of the market
 - The peculiar domain of “macroeconomics” as an arena for market failure
 - The political-economic-sociological-historical context of the market
 - The impact of a market economy on the other institutions and practices of society

The Market Balance Sheet

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The Market Balance Sheet: Pro

- The market failure-free competitive market in equilibrium, from the perspective of a utilitarian seeking to achieve the greatest-good-of-the-greatest-number, accomplishes these goals:
 1. It produces at a scale that exhausts all possible *win-win exchanges*—and is “efficient” in that sense.
 2. It allocates the roles of producers and sellers to those who can make and sell commodities in a way least costly to society’s overall resources—to those with the lowest *opportunity cost*.
 3. It rations the commodities produced to those with the greatest *willingness-to-pay*—to those who, by the money standard, need and want them the most.

The Market Balance Sheet: Con

- Markets can go wrong. They can:
 1. not fail but be failed by governments that fail to properly structure and support them—or that break them via quotas, price floors/ceilings, etc.
 2. be out-of-equilibrium
 3. see actors have market power
 4. be afflicted—if that is the word—by non-rivalry (increasing returns to scale; natural monopolies)
 5. suffer externalities (in production and in consumption, positive and negative; closely related to non-excludability)
 6. suffer from information lack or asymmetry
 7. suffer from maldistributions—for the market will only see you if you have a willingness to pay, which is predicated on an ability to pay...
 8. suffer from non-excludability (public goods, etc.)
 9. suffer from miscalculations and behavioral biases
 10. suffer from failures of *aggregate demand*

Types of Market Failure

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Market Failure 1 and 2: When Exchange Does Not Take Place at Appropriate Scale

- Errors of omission:
 - When government does not define property rights
 - When government does not enforce contracts
- Errors of commission: when government imposes
 - price ceilings,
 - price floors,
 - quota restrictions,
 - or quantitative mandates *without good reason*
- Errors of information dissemination:
 - When markets fail to reach equilibrium

Market Failure 3 and 4: Market Power and Non-Rivalry

- Prices serve as signals of societal needs and also of societal scarce-resource costs
 - They balance supply and demand
 - They provide incentives to undertake societally-desirable behaviors, and they also provide resources to keep activities sustainable
- With market power, people turn to manipulating prices
 - Thus sending signals that do not correspond to any rational assessment of societal needs or scarce resource-costs
- With non-rivalry, the price system cannot both
 - Provide the proper incentives to undertake societally-desirable activities
 - Provide the resources to keep those activities sustainable

Market Failures 5 and 6: Externalities and Non-Excludability

- With externalities, people who are directly affected by activities cannot signal their willingness-to-pay, and so their utility cannot enter into the market calculus
 - This is so no matter what the sign of the externality
 - Thus the market will produce too much of an activity that has a negative externality
 - And too little of an activity that has a positive externality
- Non-excludability creates situations in which individuals who benefit have a strong incentive to free-ride
- Hence getting them to reveal their true willingness-to-pay and to provide resources to sustain activities that are societal win-wins is very fraught

Market Failure 7: Information Asymmetry and Information Absence

- What happens when one party to a transaction knows much much more about the value/cost of what is being provided than the other?
- Then we have the American question: if this is such a good deal for me, how can it also be a good deal for you?
- Markets subject to adverse selection and moral hazard break down
- Markets in which quality is unknown create enormous incentives for middlemen to serve as sources of information about quality—and also enormous incentives for such middlemen to cash in their reputational capital by misleading their clients and customers

Market Failure 8: Maldistribution of Income and Wealth

- The market values commodities based on their purchasers' willingness-to-pay
- Willingness-to-pay predisposes ability—which predisposes income
- If you have no income, the market does not care whether you live or die
- Literally: the market mechanism *does not care*.
- Only if the distribution of income and wealth corresponds to desert and utility is there a case for the market as an optimal societal calculation, allocation, and distribution mechanism

Market Failure 9: Miscalculations and Behavioral Biases

- Been to Las Vegas?
- Ever wonder why we here in America spend 8% of GDP on the services of financial intermediaries rather than the 3% we spent back in the 1950s?
 - Wall Street in 2008-9 did not cover itself with glory as far as societal usefulness is concerned, did it?
- What George Akerlof and Robert Shiller call “phishing for phools”—making money off of the behavioral biases of others
- There are some deep questions of human autonomy and psychology in behavioral economics
- But mostly it is about presenting people with information in the right way so that they can make decisions they can look back in without great regret...
- The study of these kinds of market failures is still in its infancy

Market Failure 10: Aggregate Demand

- General gluts—an excess demand for money, and an excess supply of pretty much everything else
- Their counterpart: a great inflation—too much money chasing too few goods
- There is a demand for money, and:
 - The private sector cannot create supply money when it is “in request”, for when it is in request is when the credit-worthiness of private-sector agents is in doubt...
 - The private sector cannot extinguish money save through inflation
 - Inflation as disease and as cure

Market Failure 10: Aggregate Demand II

- General gluts and great inflations
- $Y = \mu[c_0 + I_0 + NX] + \mu G + \mu l_r r$
- $r = i + \rho + \tau - \pi$
- Shocks:
 - Shocks to spending: consumer confidence, animal spirits, foreign demand for exports
 - Shocks to interest rates—to the *risk premium* and to the *term premium*
 - Shocks to the inflation rate from supply disturbances
- Fill in the troughs: match Y to potential output Y^*

Key Equations

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Key Equations: Macro: Aggregate Demand

- Income and Expenditure:
 - $Y = E = \mu[c_0 + I_0 + NX] + \mu G + \mu I_r r$
 - $C = c_0 + c_y \times Y$
 - $I = I_0 + I_r \times r$
- Financial Markets and Monetary Policy
 - $r = i + \rho + \tau - \pi$

Key Equations: Macro: Aggregate Supply

- $P = P^e + \beta'[(Y - Y^*)/Y^*]$
- $P = P^e - \beta(u - u^*)$
- $\pi = \pi^e - \beta(u - u^*)$
- $\pi = \pi^e + \beta'[(Y - Y^*)/Y^*]$
- $\pi = \pi_{-1} - \beta(u - u^*)$
- $\pi = \pi_{-1} + \beta'[(Y - Y^*)/Y^*]$

Key Equations: Micro: Competitive Equilibrium

- Supply: $P = P_{s0} + s \times Q$
- Demand: $P = P_{d0} - d \times Q$

- Equilibrium: $Q = (P_{d0} - P_{s0}) / (s + d)$
- Equilibrium: $P = [s / (s + d)] \times P_{d0} + [d / (s + d)] \times P_{s0}$

- Consumer surplus: $CS = Q \times [P_{d0} - P] / 2$
- Producer surplus: $PS = Q \times [P - P_{s0}] / 2$
- Total surplus: $TS = PS + CS = Q \times [P_{d0} - P_{s0}] / 2$
- Total surplus: $TS = [(P_{d0} - P_{s0})^2] / [2 \times (s + d)]$

Key Equations: Micro: Market Power Equilibrium

- Demand: $P = P_{d0} - d \times Q$
- Marginal cost: $MC = MC_0 + m \times Q$
- Amortization on fixed costs: $AFC = (r + \delta) \times F$
- Marginal revenue: $MR = P_{d0} - 2 \times d \times Q$
- Equilibrium: $MR = MC$
- Equilibrium: $Q = (P_{d0} - MC_0)/(m + 2 \times d)$
- Equilibrium: $P = [(m+d)/(m+2d)]P_{d0} + [d/(m+2d)]MC_0$

Key Equations: Micro: Market Power Surplus

- $CS = Q \times [P_{d0} - P]/2$
- $MP = Q \times [P - MC_0]/2 - AFC$
- $TS = MP + CS$
- $TS = Q \times [P_{d0} - MC_0]/2 - AFC$
- $TS = [(P_{d0} - MC_0)^2]/(2m + 4d) - AFC$