Lecture 3(i)

Announcements

HW2 due Tues 11:45 pm

Lecture

1. Discuss auction experiments

2. Elasticity: general idea

3. Midpoint formula

4. Special Cases

Last class: discussed direction of effects.

For example:

(1) own price ↑ then QD ↓

(2) substitute price ↑ then QD ↑

This class: beyond the direction, we are interested in the magnitude.

Sure QD ↓ when own price↑.

But by how much?

Sure QD ↑ when substitute price ↑. But by how much?

Magnitudes are crucial (Look back to end of last lecture when two things change. Relative magnitude determines net effect.)

Elasticity

Responsiveness of demand and supply to changes.

How much does it bend?

How about slope?



Defective because of units issue.

i). Compare slope for California and Delaware

ii). Compare Minnesota and British Columbia

Get units out by using percentages

Price elasticity of Demand (midpoint method)

(ugliest formula we see, all semster!)

= eD





When we report the eD we drop the minus sign (following the convention of the book). To get rid of the minus sign we have to put an extra minus sign in. (That’s why the minus sign shows up in the formula)

We remember that own price effect is an inverse relationship, so OK to drop sign.

Need to keep track of sign for:

**Cross-price elasticities (**how demand for good responds when a different price changes)

**Income elasticities**

Special Cases

Perfectly Inelastic Demand

eD = 0

Examples:



Who is this man?

Hint: Something to do with demand elasticity for a rare drug.

Perfectly Inelastic Supply

eS  = 0

Examples:

Perfectly Elastic Demand

eD = infinity

Examples:

In Between Cases

(1) When eD < 1 we say

Demand is Inelastic

Total Spending = P\*Q increases

as P increases.

(2) When eD > 1 we say

Demand is Elastic

Total Spending = P\*Q decreases as P increases.

(3) When eD = 1 we say

Demand is Unit Elastic