The Market Mechanism

EC 201: Principles of Microeconomics

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Winter 2020

Prologue

Agenda

Pit Market Activity

1. Read instructions handout

2. Join a team

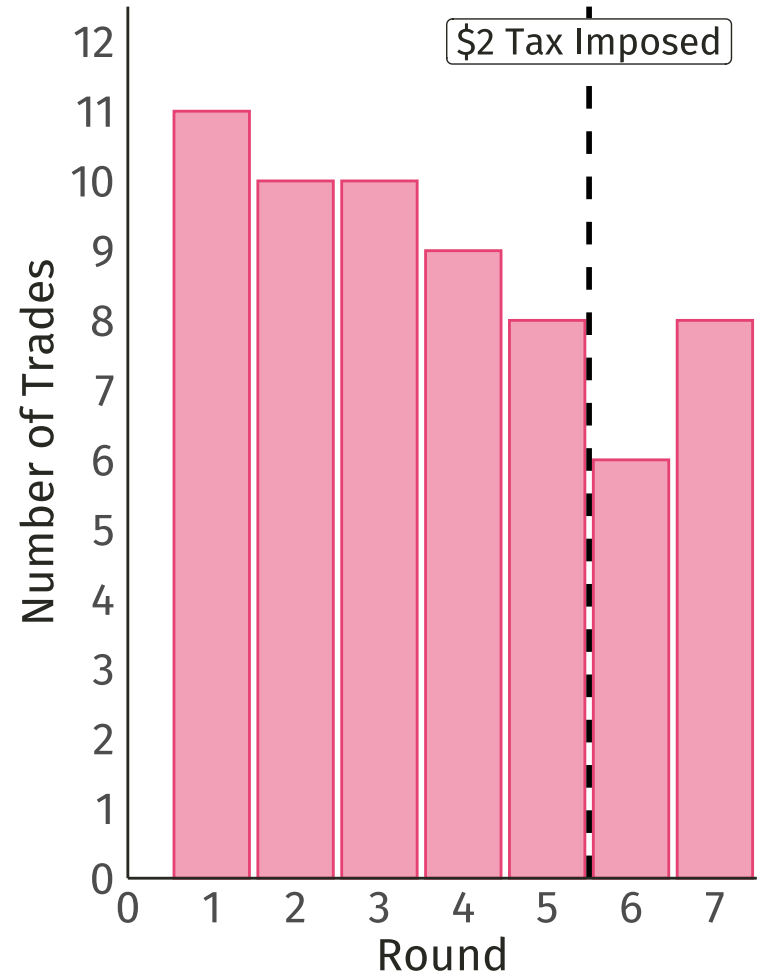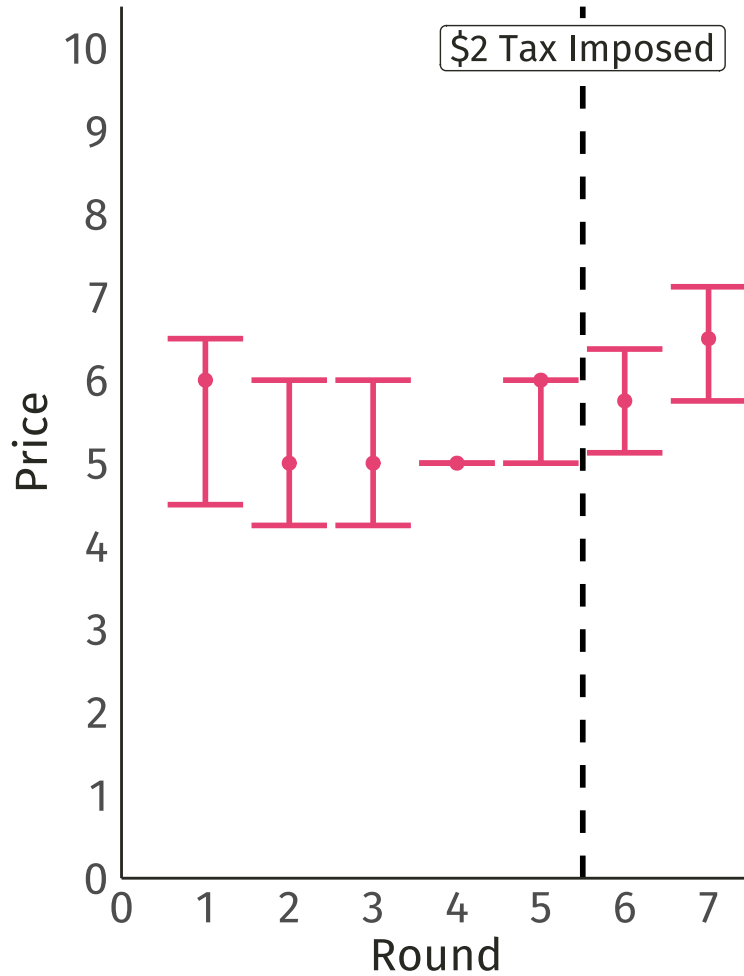3. Make trades and earn extra participation points

The Market Mechanism

- Activity debrief and discussion

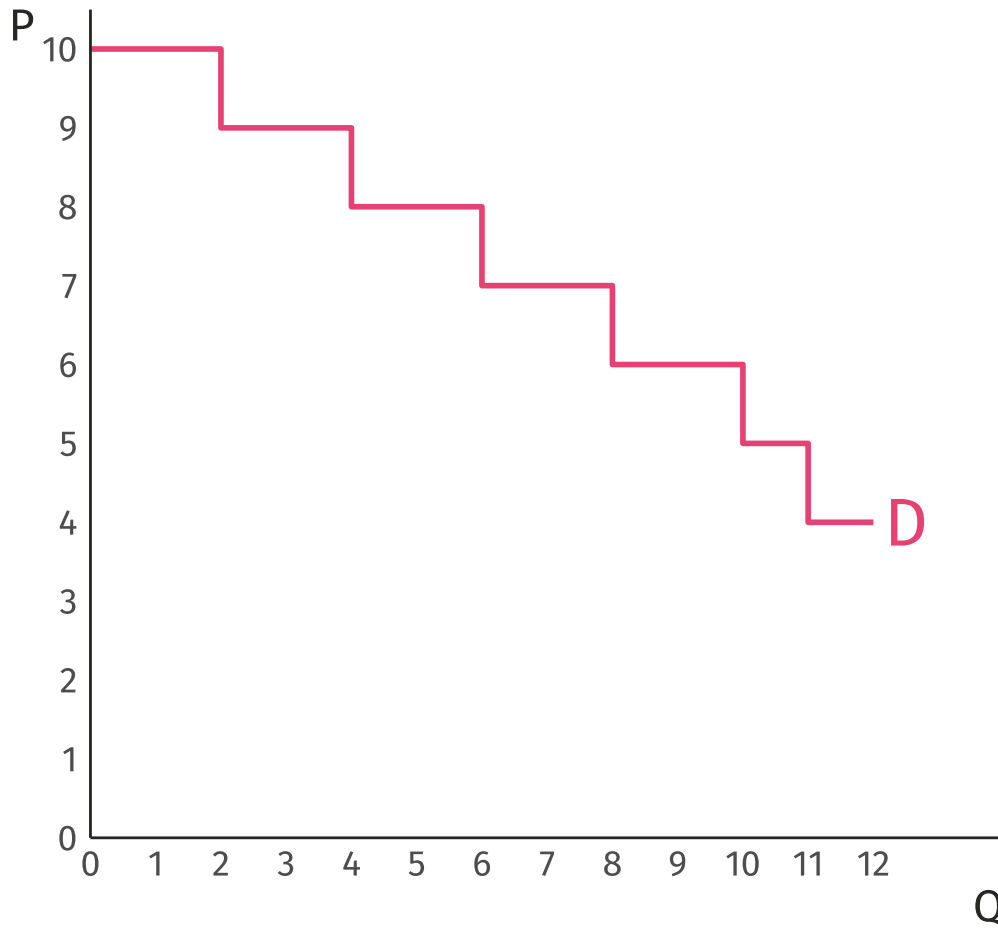## Midterm 1 Overview

- One week from today!

Pit Market Activity

Pit Market Results

The Market Mechanism

Pit Market

Pit Market

Sellers

Minimum willingness to accept:

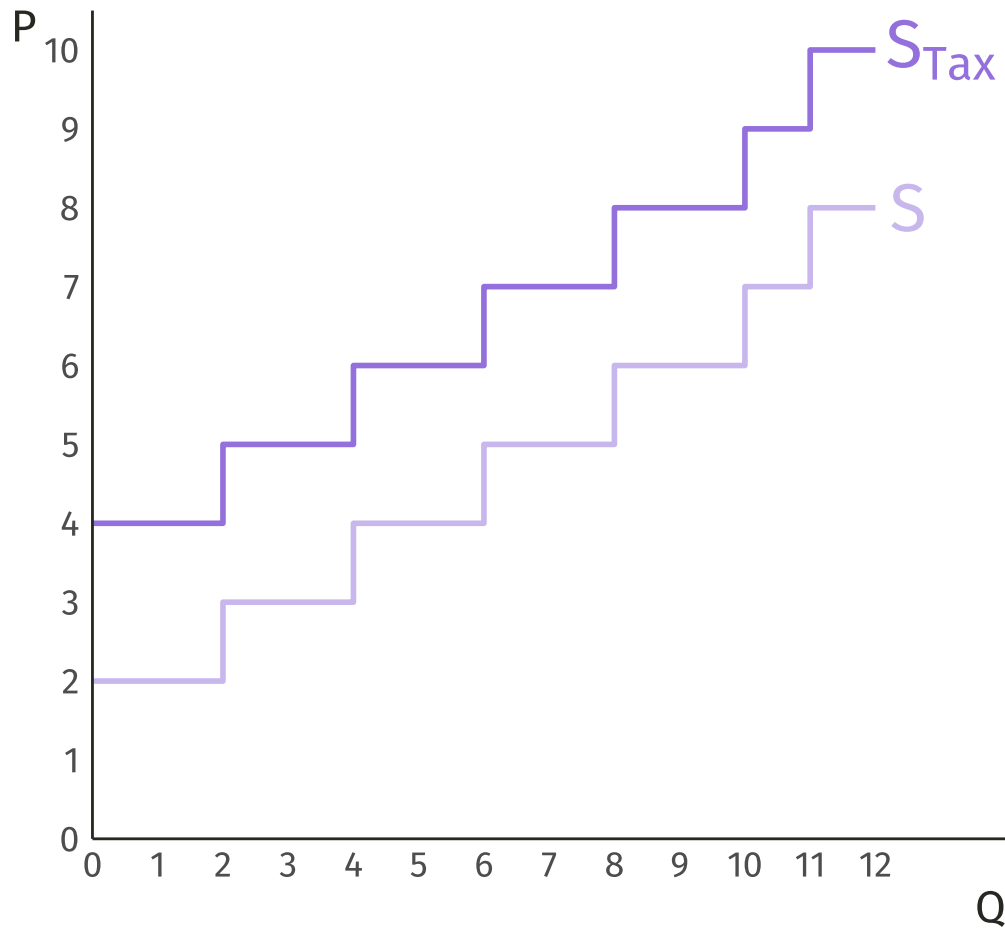|	
2 of ♠	2 of ♣
3 of ♠	3 of ♣
4 of ♠	4 of ♣
5 of ♠	5 of ♣
6 of ♠	6 of ♣
7 of ♠	
8 of ♠	

Pit Market

Sellers

The tax increases each seller's cost by $2.

Pit Market
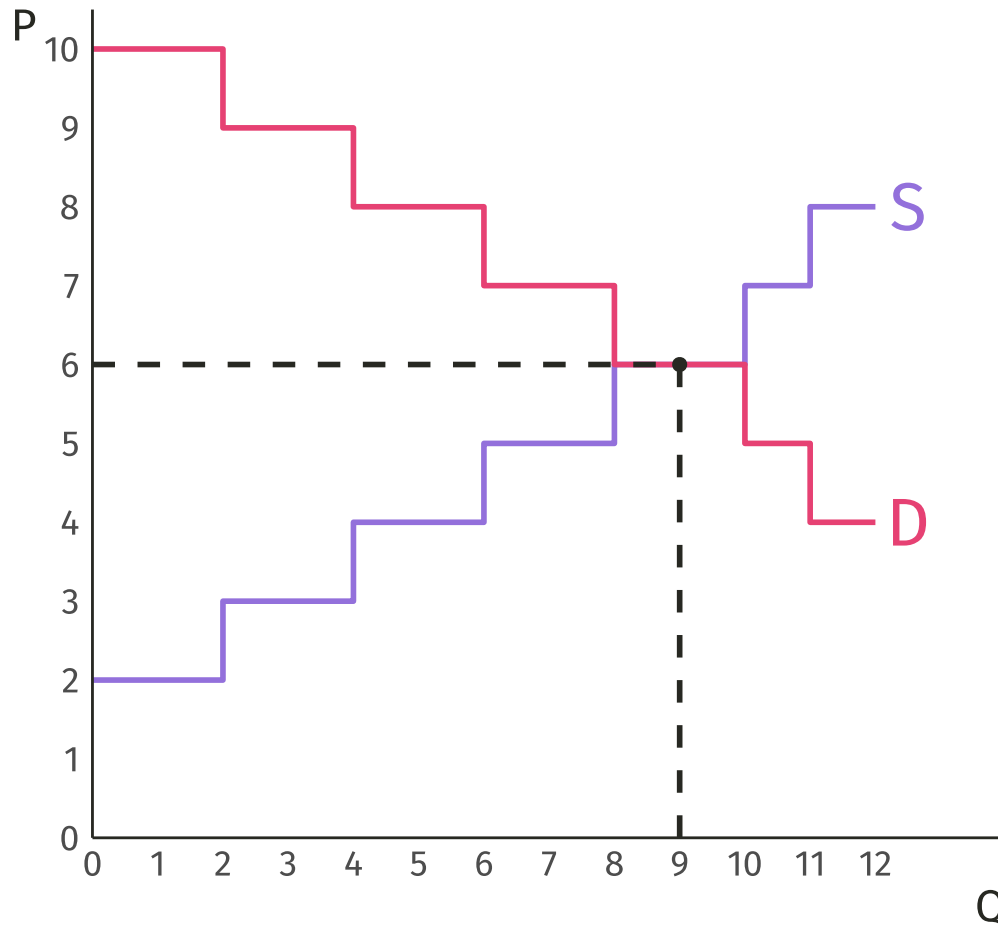
Equilibrium

Theory predicts that a price of \$6 clears the market.[†]

Q: Who trades? Who doesn't?

†: *Clears the market* $\iff Q_D = Q_S$.

Pit Market
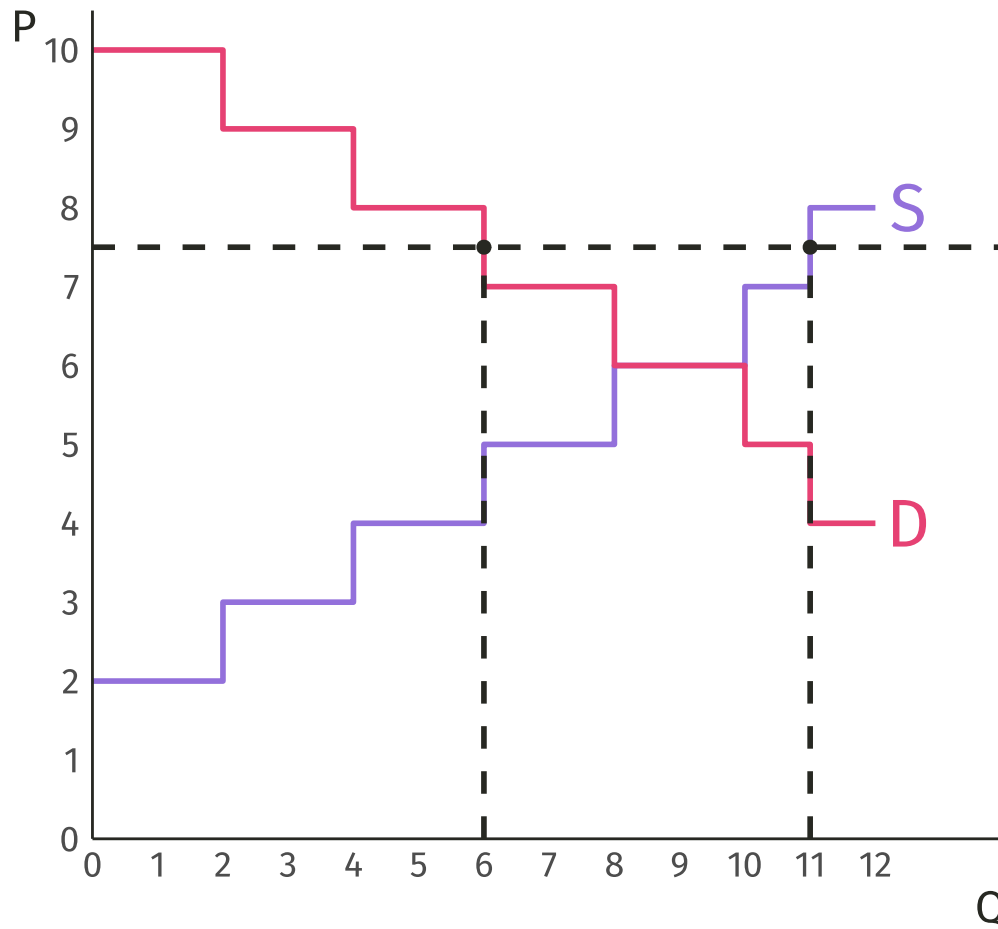
Market Surplus

Theory predicts that prices above $6 create a market surplus.[†]

†: *Market surplus* $\Longleftrightarrow Q_D < Q_S$.

Pit Market
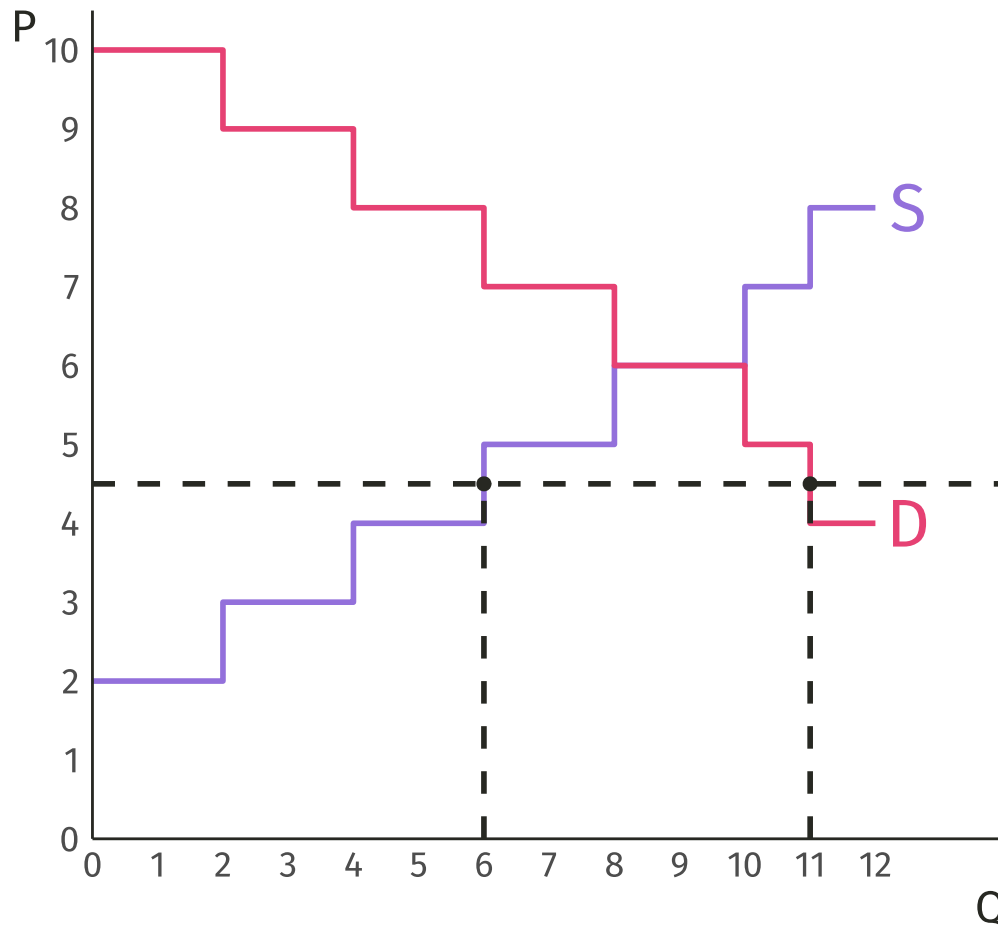
Shortage

Theory predicts that prices below $6 create a shortage.[†]

Pit Market
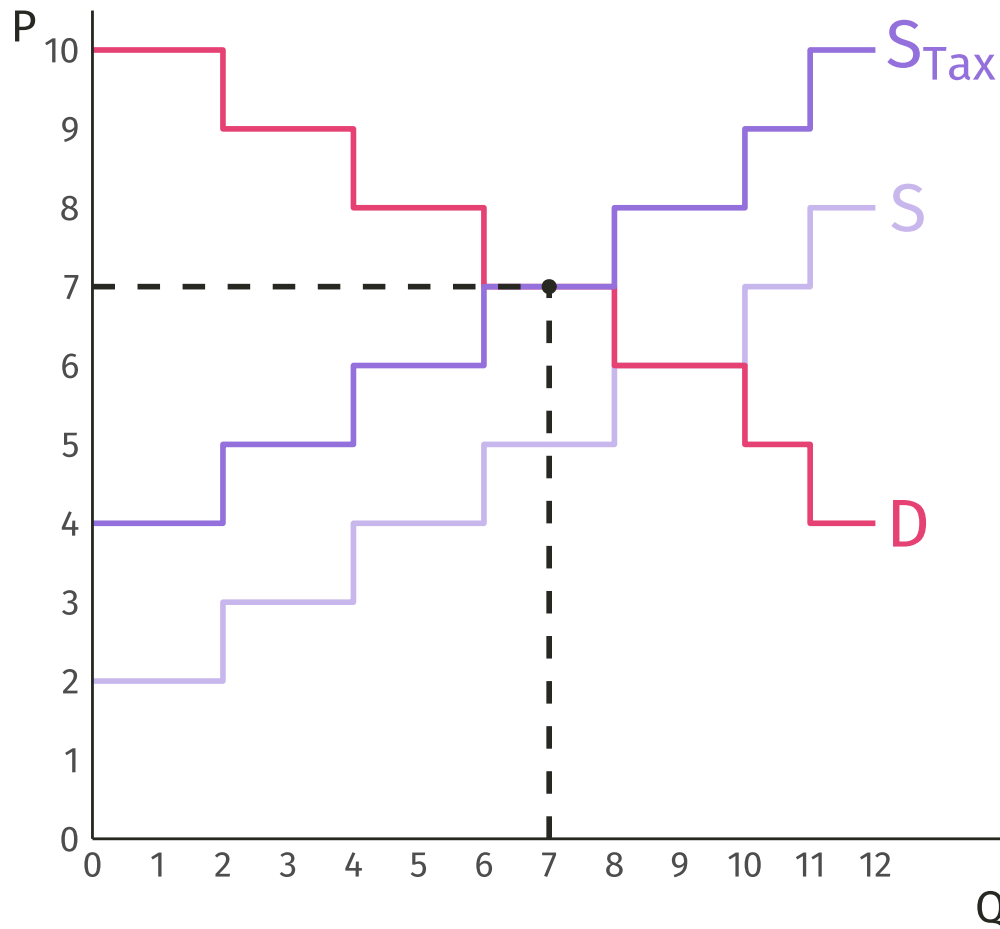
Tax

The tax increases each seller's cost by $2:

1. Supply curve shifts.
2. Market adjusts to a new equilibrium.

Q: By how much does the equilibrium price increase?

Mutual Gains from Trade
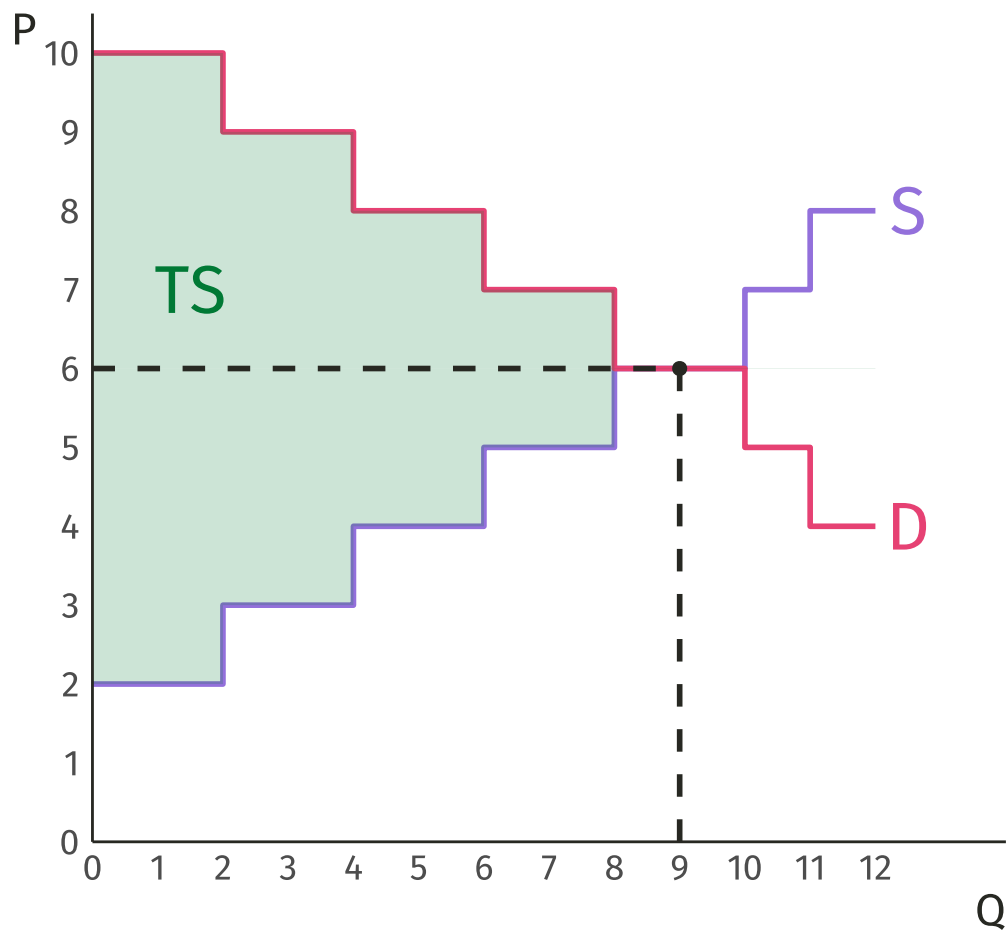
Consumer surplus =
sum of buyers'
earnings.

Producer surplus =
sum of sellers'
earnings.

Total surplus =
consumer surplus +
producer surplus.

Mutual Gains from Trade
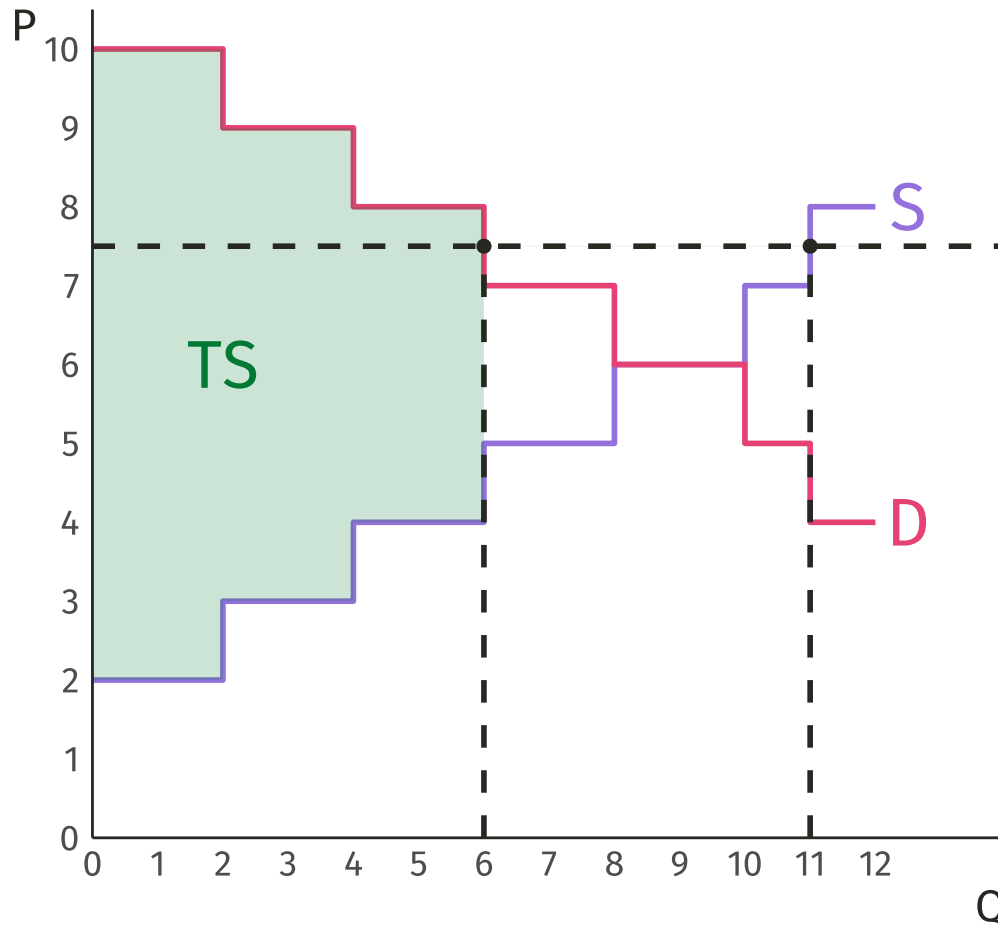
Market Surplus

$P = \$7.50 \implies TS = \$36.$

Mutual Gains from Trade
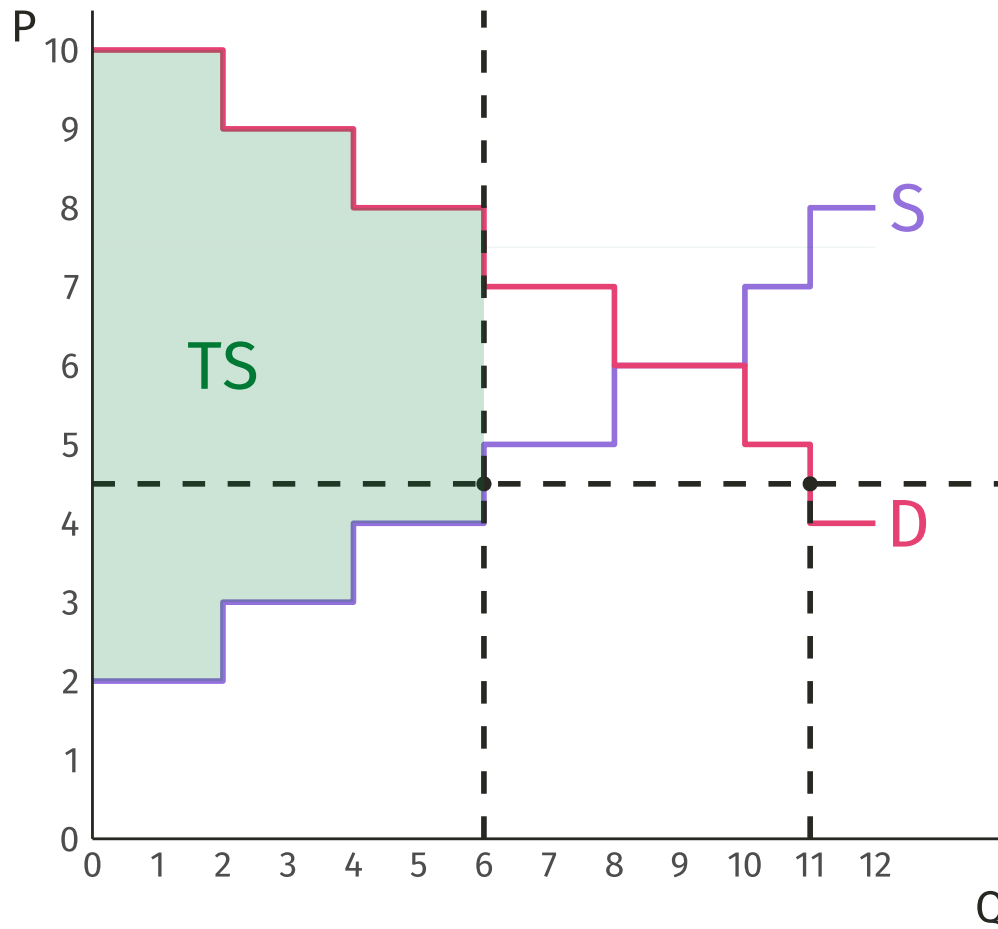
Shortage

$P = \$4.50 \implies TS = \$36.$

Mutual Gains from Trade
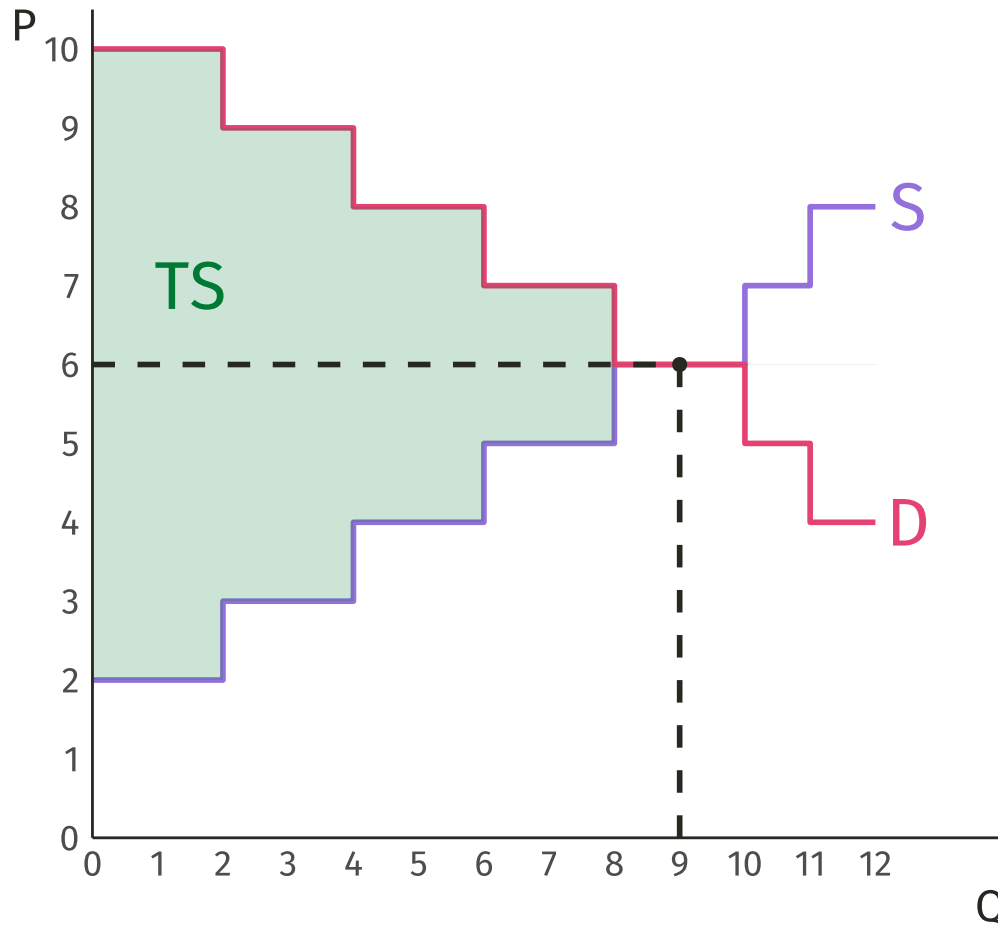
Equilibrium

P = $6 $\implies$ TS = $40.
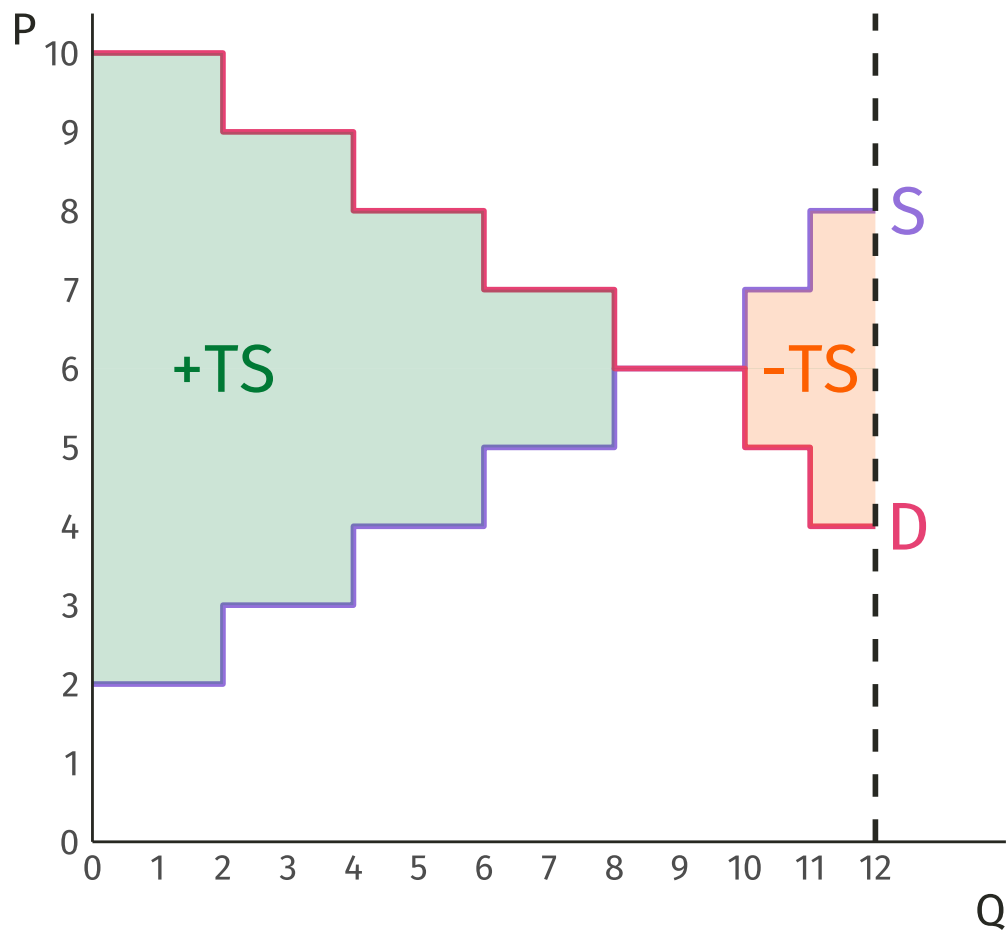
Intervention

Q: True or false? The government can increase TS by mandating 12 trades.

A. True

B. False

TS would decrease from $40 to $34

Q: What is the source of mutual benefits from voluntary trade?

A: Differences in marginal values.

Example: You own a pair of sneakers. You value them at $20. I value them at $50. Could we benefit from trade?

- **A:** Yes! Marginal value differential of $30 = $30 in mutual benefits![†]

†: The distribution of the benefits depends on the price we negotiate.

Q: What role do "middlemen"[†] play?

A: They play match-maker in exchange for part of the marginal-value differential.

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†: *e.g.*, real estate agents, stock brokers, grocers, retailers, *etc.*

Efficiency

Definition 1 (market-specific)

The outcome that maximizes mutual benefits from voluntary trade (*i.e.*, total surplus).

Definition 2 (more general)

The absence of waste.

Definition 3 (*Pareto Efficiency*)

The state in which no person can be made better off without harming someone else.

Podcast Question: What problem(s) did Alaska's food bank have before *Feeding America* established an auction market?

    A. It received too few pickles.

    B. It received so much fresh produce that it would rot before people could eat it.

    C. It received too many potatoes.

    D. It received too few potatoes.

    E. It received too many pickles.

Podcast Question: Which food banks received the most "fake money" to use in the auction market?

A. Those in relatively affluent areas.

B. Those in relatively poor areas.

C. Those with the most donors.

D. Those most willing to pay.

E. Those with the most food stockpiled.

Q: What problems did the *Feeding America* auction market solve?

1. Local information problem: Food bank directors knew exactly what they wanted, but *Feeding America* executives had to make guesses.

2. Shortages and surpluses: Food banks had insufficient quantities of sought-after items but abundant quantities of unwanted items.

Q: Are food banks and their clients better off now than they were before?

A: Yes.

- Less food waste $\longrightarrow$ more food for people in need.

- *Pareto improving:* More mutually beneficial transactions.[†]

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†: *Pareto improvement* = A transaction that makes at least one person better off without harming others.

Efficient Markets

Conditions

1. Well-defined property rights.

2. No market power.

3. *Symmetric* information.

Result

> If all three conditions hold, then an *unregulated* market
> maximizes total surplus.

Efficient Markets

Result

> If all three conditions hold, then an *unregulated* market
> maximizes total surplus.

Implications

1. When all three conditions hold, government intervention in a market
   can generate inefficient outcomes.

2. When at least one condition fails, an *unregulated* market can generate
   inefficient outcomes.

   - Well-designed government intervention *can* redress inefficiencies.

Efficient Markets

Q: What kinds of markets are most likely to yield efficient outcomes?

A: Markets that feature

    1. Transactions that don't hurt or help those outside the transaction.

    2. Many buyers and sellers.

    3. Goods with easily observable quality.

Examples?

Midterm 1

Midterm Topics

Anything from the lectures, discussions, or podcasts **is fair game!**

1. What is Economics?

2. Motivating the Economic Problem

3. Consumer Theory I

4. Consumer Theory II

5. The Market Mechanism

6. Demand and Supply

Midterm Structure

Multiple Choice

- 50 questions
- 1 point per question

Midterm Protocol

Materials

- Writing utensil
- 3-inch-by-5-inch note card
- Basic or scientific calculator (no graphing or programming capabilities)
- **Nothing else**

Procedure

- **Randomized** seating chart
- 80 minutes from *"you may begin"* to *"pencils down"*
- First 30 minutes: **quiet period** (no questions, no getting up)
- Last 50 minutes: ask lots of questions
- Show your UO ID card as you turn-in your exam

Midterm Preparation

1. Lecture slides

2. Discussion worksheets

3. Practice midterm questions

    - No solutions posted, but you can ask about the questions in office hours.

4. Extended office hours

    - M 14:00-15:00 and T 14:30-17:30 in **412 PLC**

5. Textbook (additional practice problems)

6. Prepare your note card