Chapter Six

Demand

Properties of Demand Functions

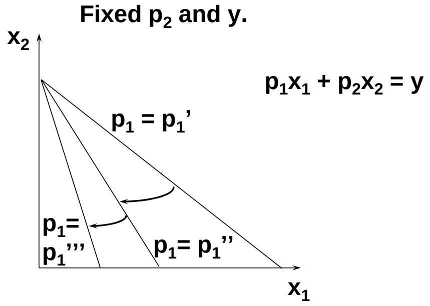
- Comparative statics analysis of ordinary demand functions -- the study of how ordinary demands $x_1^*(p_1,p_2,y)$ and $x_2^*(p_1,p_2,y)$ change as prices p_1, p_2 and income y change.

Own-Price Changes

- How does $x_1^*(p_1,p_2,y)$ change as p_1 changes, holding p_2 and y constant?
- Suppose only p_1 increases, from p_1' to p_1'' and then to p_1'''.

Own-Price Changes

Fixed p_2 and y.



Own-Price Changes

- The curve containing all the utility-maximizing bundles traced out as p_1 changes, with p_2 and y constant, is the p_1-price offer curve.
- The plot of the x_1-coordinate of the p_1-price offer curve against p_1 is the ordinary demand curve for commodity 1.

Own-Price Changes

- What does a p_1 price-offer curve look like for Cobb-Douglas preferences?
- Take

$$U(x_1, x_2) = x_1^a x_2^b.$$

Then the ordinary demand functions for commodities 1 and 2 are

Own-Price Changes

$$x_1^*(p_1, p_2, y) = \frac{a}{a+b} \times \frac{y}{p_1}$$

and

$$x_2^*(p_1, p_2, y) = \frac{b}{a+b} \times \frac{y}{p_2}.$$

Notice that x_2* does not vary with p_1 so the p_1 price offer curve is flat and the ordinary demand curve for commodity 1 is a rectangular hyperbola.

Own-Price Changes

- What does a p_1 price-offer curve look like for a perfect-complements utility function?

$$U(x_1, x_2) = \min\{x_1, x_2\}.$$

Then the ordinary demand functions for commodities 1 and 2 are

Own-Price Changes

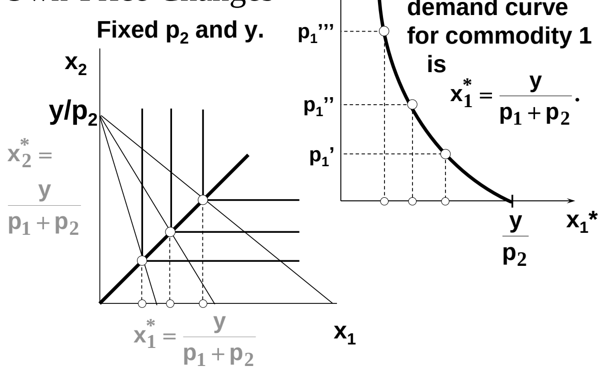
$$x_1^*(p_1, p_2, y) = x_2^*(p_1, p_2, y) = \frac{y}{p_1 + p_2}.$$

With p_2 and y fixed, higher p_1 causes smaller x_1* and x_2*.

As $p_1 \to 0, \quad x_1^* = x_2^* \to \dfrac{y}{p_2}.$

As $p_1 \to \infty, \quad x_1^* = x_2^* \to 0.$

Own-Price Changes



perfect-substitutes utility

- What does a p_1 price-offer curve look like for a perfect-substitutes utility function?

$$U(x_1, x_2) = x_1 + x_2.$$

Then the ordinary demand functions for commodities 1 and 2 are

Own-Price Changes

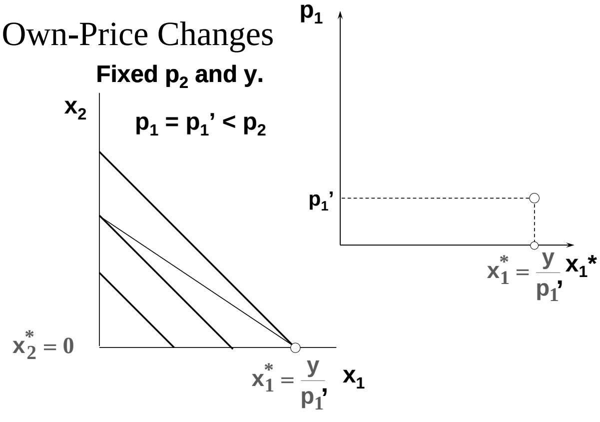
$$x_1^*(p_1, p_2, y) = \begin{cases} 0 & , \text{if } p_1 > p_2 \\ y/p_1 & , \text{if } p_1 < p_2 \end{cases}$$

and

$$x_2^*(p_1, p_2, y) = \begin{cases} 0 & , \text{if } p_1 < p_2 \\ y/p_2 & , \text{if } p_1 > p_2. \end{cases}$$

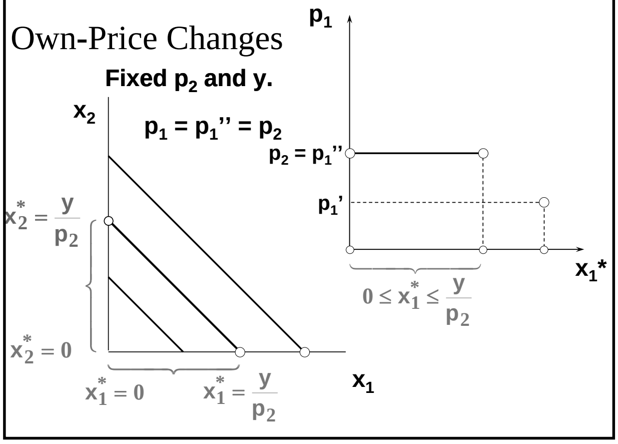
Own-Price Changes

Fixed p_2 and y.

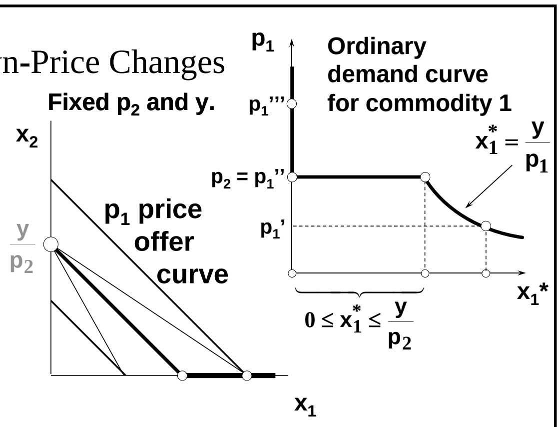


Own-Price Changes

Fixed p_2 and y.



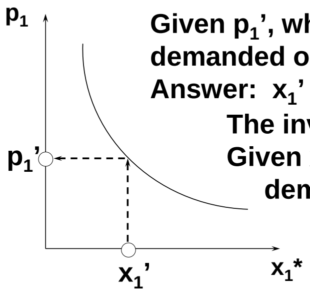
Own-Price Changes



Inverse demand function

- Usually we ask "Given the price for commodity 1 what is the quantity demanded of commodity 1?"
- But we could also ask the inverse question "At what price for commodity 1 would a given quantity of commodity 1 be demanded?"

Own-Price Changes



Given p_1', what quantity is demanded of commodity 1? Answer: x_1' units.

The inverse question is: Given x_1' units are demanded, what is the price of commodity 1? Answer: p_1'

Own-Price Changes

- Taking quantity demanded as given and then asking what must be price describes the inverse demand function of a commodity.

Own-Price Changes

A Cobb-Douglas example:

$$x_1^* = \frac{ay}{(a+b)p_1}$$

is the ordinary demand function and

$$p_1 = \frac{ay}{(a+b)x_1^*}$$

is the inverse demand function.

Own-Price Changes

A perfect-complements example:

$$x_1^* = \frac{y}{p_1 + p_2}$$

is the ordinary demand function and

$$p_1 = \frac{y}{x_1^*} - p_2$$

is the inverse demand function.

Income Changes

- How does the value of $x_1^*(p_1,p_2,y)$ change as y changes, holding both p_1 and p_2 constant?

Income Changes

- A plot of quantity demanded against income is called an Engel curve.

Income Changes and Cobb-Douglas Preferences

- An example of computing the equations of Engel curves; the Cobb-Douglas case.

$$U(x_1, x_2) = x_1^a x_2^b.$$

- The ordinary demand equations are

$$x_1^* = \frac{ay}{(a+b)p_1}; \quad x_2^* = \frac{by}{(a+b)p_2}.$$

Income Changes and Cobb-Douglas Preferences

$$x_1^* = \frac{ay}{(a+b)p_1}; \quad x_2^* = \frac{by}{(a+b)p_2}.$$

Rearranged to isolate y, these are:

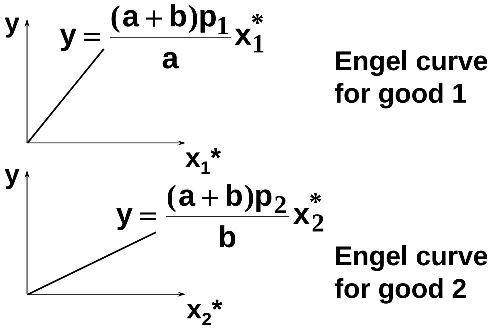
$$y = \frac{(a+b)p_1}{a} x_1^* \quad \textbf{Engel curve for good 1}$$

$$y = \frac{(a+b)p_2}{b} x_2^* \quad \textbf{Engel curve for good 2}$$

Income Changes and Cobb-Douglas Preferences

$$y = \frac{(a+b)p_1}{a}x_1^*$$

$$y = \frac{(a+b)p_2}{b}x_2^*$$



Income Changes and Perfectly-Complementary Preferences

- Another example of computing the equations of Engel curves; the perfectly-complementary case.

$$U(x_1, x_2) = \min\{x_1, x_2\}.$$

- The ordinary demand equations are

$$x_1^* = x_2^* = \frac{y}{p_1 + p_2}.$$

Income Changes and Perfectly-Complementary Preferences

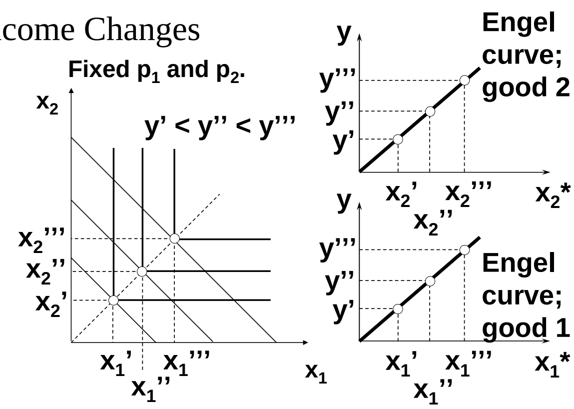
$$x_1^* = x_2^* = \frac{y}{p_1 + p_2}.$$

Rearranged to isolate y, these are:

$y = (p_1 + p_2)x_1^*$ **Engel curve for good 1**

$y = (p_1 + p_2)x_2^*$ **Engel curve for good 2**

Income Changes

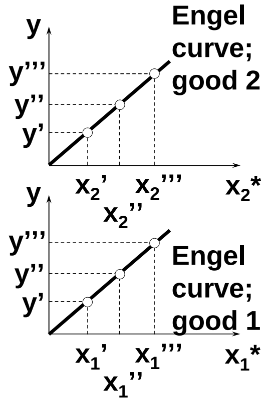


Income Changes

Fixed p_1 and p_2.

$$y = (p_1 + p_2)x_2^*$$

$$y = (p_1 + p_2)x_1^*$$



Income Changes and Perfectly-Substitutable Preferences

- Another example of computing the equations of Engel curves; the perfectly-substitution case.

$$U(x_1,x_2) = x_1 + x_2.$$

- The ordinary demand equations are

Income Changes and Perfectly-Substitutable Preferences

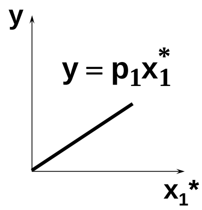
$$x_1^*(p_1,p_2,y) = \begin{cases} 0 & \text{, if } p_1 > p_2 \\ y/p_1 & \text{, if } p_1 < p_2 \end{cases}$$

$$x_2^*(p_1,p_2,y) = \begin{cases} 0 & \text{, if } p_1 < p_2 \\ y/p_2 & \text{, if } p_1 > p_2. \end{cases}$$

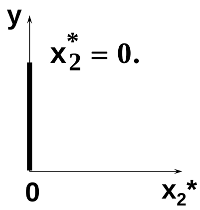
Suppose $p_1 < p_2$. Then $x_1^* = \dfrac{y}{p_1}$ **and** $x_2^* = 0$

$\Rightarrow$ $y = p_1 x_1^*$ **and** $x_2^* = 0.$

Income Changes and Perfectly-Substitutable Preferences



Engel curve for good 1



Engel curve for good 2

Income Changes

- In every example so far the Engel curves have all been straight lines?
  Q: Is this true in general?
- A: No. Engel curves are straight lines if the consumer's preferences are homothetic.

Homotheticity

- A consumer's preferences are homothetic if and only if

$$(x_1,x_2) \prec (y_1,y_2) \Leftrightarrow (kx_1,kx_2) \prec (ky_1,ky_2)$$

  for every k > 0.
- That is, the consumer's MRS is the same anywhere on a straight line drawn from the origin.

Income Effects -- A Nonhomothetic Example

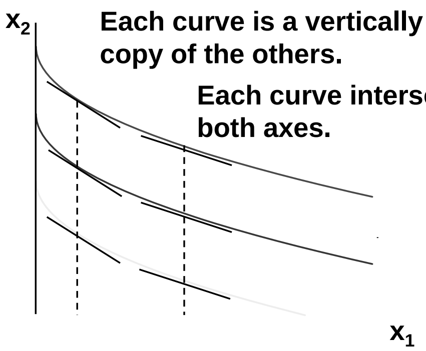
- Quasilinear preferences are not homothetic.

$$U(x_1,x_2) = f(x_1) + x_2.$$

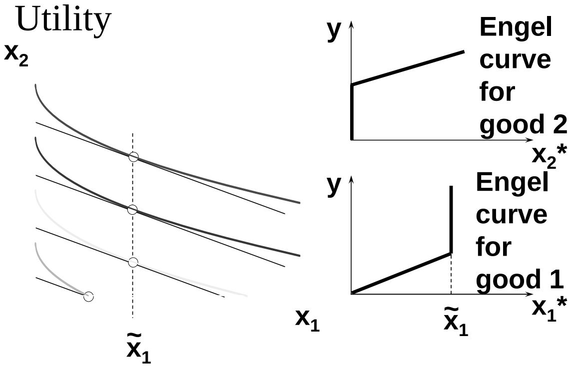
- For example,

$$U(x_1,x_2) = \sqrt{x_1} + x_2.$$

Quasi-linear Indifference Curves



Income Changes; Quasilinear Utility



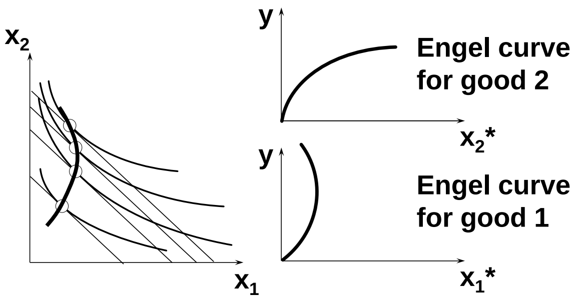
Income Effects

- A good for which quantity demanded rises with income is called normal.
- Therefore a normal good's Engel curve is positively sloped.

Income Effects

- A good for which quantity demanded falls as income increases is called income inferior.
- Therefore an income inferior good's Engel curve is negatively sloped.

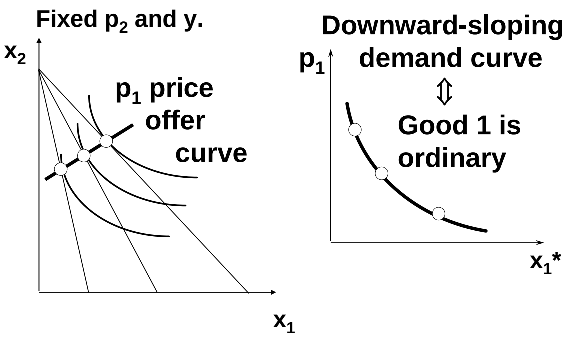
Income Changes; Good 2 Is Normal, Good 1 Becomes Income Inferior



Ordinary Goods

- A good is called ordinary if the quantity demanded of it always increases as its own price decreases.

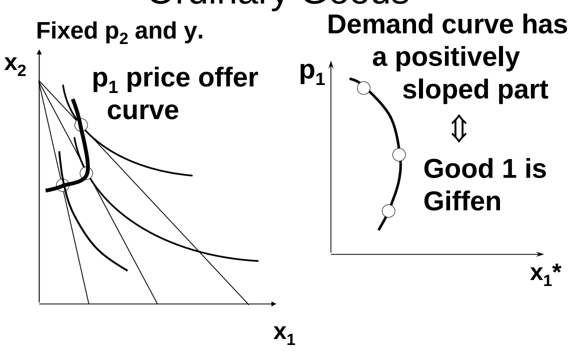
Ordinary Goods



Giffen Goods

- If, for some values of its own price, the quantity demanded of a good rises as its own-price increases then the good is called Giffen.

Ordinary Goods



Cross-Price Effects

- If an increase in p_2
  - increases demand for commodity 1 then commodity 1 is a gross substitute for commodity 2.
  - reduces demand for commodity 1 then commodity 1 is a gross complement for commodity 2.

Cross-Price Effects

A perfect-complements example:

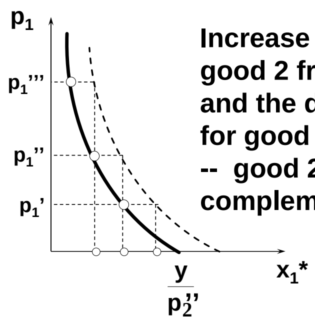
$$x_1^* = \frac{y}{p_1 + p_2}$$

so

$$\frac{\partial x_1^*}{\partial p_2} = -\frac{y}{(p_1 + p_2)^2} < 0.$$

Therefore commodity 2 is a gross complement for commodity 1.

Cross-Price Effects



Increase the price of good 2 from p_2' to p_2'' and the demand curve for good 1 shifts inwards -- good 2 is a complement for good 1.

Cross-Price Effects

A Cobb- Douglas example:

$$\mathbf{x_2^* = \frac{by}{(a+b)p_2}}$$

so

$$\frac{\partial \mathbf{x_2^*}}{\partial \mathbf{p_1}} = \mathbf{0.}$$

Therefore commodity 1 is neither a gross complement nor a gross substitute for commodity 2.

Warning of the concept

- When there are more than 2 goods, x1 may be a substitutes for x3 but x3 may be a complement for x1.
- Net substitutes and net complement are more precise.