

University of Notre Dame
Department of Finance
Economics of the Firm
Fall 2011

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Readings:

- Freob, Luke and Brian McCann, “Managerial Economics: A Problem Solving Approach 2nd Edition”, SouthWestern, 2010

Course Objectives:

The primary objective for this course is decision making in the context of managing a business. Completion of this problem requires an understanding of two topic areas:

- 1) Supply and demand – we need a basic understanding of how markets work and how both costs and consumer preferences play a role in determining prices.
- 2) Market Structure and Pricing Strategy – If you can set your price, how should you set your price knowing that you face competition in the marketplace? How does a changing marketplace affect your pricing strategy?

However, the bigger picture of this course is to understand decision making in a broader context. Economics is all about human behavior. That is, why do people do what they do? In this sense, being an economist is a lot like being a detective. Just as detectives look for clues to solve a crime, we look at the behavior of individuals and use these observations on human behavior to understand the objectives behind those decisions.

Class Preparation:

Note that for each meeting, I have listed the textbook chapters that will be covered. It would be useful if you could read through the listed chapters before we meet. This should be a very quick reading. I am not looking for you to

completely understand everything (if that was the case, what's the point of the class?!). Your first reading should focus on some of the terminology and a basic familiarity of the concepts. After each session, you should be able to work through the exercises at the end of the chapters. These exercises will not be graded. They are meant to give you a chance to practice some of the tools discussed in class. If you have trouble with any of the exercises, you can contact me, or we can discuss them the following class.

Grading:

We will have a quiz at the beginning of each class. It will be a short quiz intended to cover the basic concepts discussed in the previous class. The quizzes should provide you with a measure of whether or not you are keeping up with the material. There will also be a midterm and a cumulative final.

- 20% Quizzes
- 30% Midterm
- 50% Final Exam

Session I (September 24th): The Basics: Supply and Demand

This session lays out the basic assumptions and tools that we will rely on for the remainder of the class. First and foremost, I will introduce you to *Homo Economicus*, or, "Economic Man". We assume that economic man behaves in a very specific way, so we should spend some time thinking about whether or not our behavioral assumptions are reasonable. Next, we will look at some of the implications the existence of economic man has for how markets function and how market prices are determined. Truthfully, there are very few applications of supply and demand that are reasonable for analyzing the real world, but the simple supply/demand story will always provide some good intuition into how a more complicated world functions. Finally, we will finish up with a few real world examples and a discussion of markets.

- **Froeb & McCann, Chapters 8, 9, 10, 11**

Session II (October 22nd): Competitive Pricing

Once we have some knowledge about our customers, we need to have an understanding of the competitive environment in which it operates. In this session, we will look at the simplest of environments. Specifically, we will focus on industry structures where pricing decisions are competitive (i.e. you choose your price taking the decisions of your competitors as a given constant). In a monopoly environment, you are by definition, the only firm in the marketplace, so competitive pricing is a reasonable assumption. In a pure/monopolistic competition framework, you face the opposite extreme – you have so many

competitors that the effect of any one competitor's behavior is small enough that it can be ignored. In this environment, we will look at a variety of pricing structures from the simplest (you set one price to everybody) to the more complex (you set multiple prices to different customer types).

- **Froeb & McCann, Chapters 12, 13, 14**

Session III (November 5th): Review & Midterm

Session IV (November 19th): Strategic Pricing Techniques

Next, we will move from competitive pricing to strategic pricing. In this environment, you face a small number of competitors (think about the airline or automotive industries). In this market structure, you can no longer ignore your competitors decisions. In fact, you have to assume that any decision you make will cause a reaction from your competitors. Therefore, we need to take those responses into consideration when setting our prices.

- **Froeb & McCann, Chapters 15, 16**

Session V (December 3rd): Risk, Uncertainty and Information

Finally, the last assumption to lift is that of perfect information. So far we have assumed that the outcome of any particular decision is known with perfect certainty. Here we will look at how economic decisions are altered when there is uncertainty with regard to the outcome. For example, how much would you be willing to pay for car insurance given that you are unsure as to if you will actually get into a car accident.

- **Froeb & McCann, Chapters 17, 18, 19, 20**

Final Exam: December 17th, 8:00AM – 10:00AM