BUS 603
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<mark>STUDY NOTES CHAPTERS 6-10</mark>

Chapter 6: Simple Pricing

- Pricing is a powerful but often neglected tool

- Profit = (P-AC) x Q, however many businesses focus on Q or AC

- Marginal analysis is used to decide consumer's amount

- A demand curves entails how much consumers are willing to purchase at a certain price

- Law of demand: consumer purchases more as price falls

- Consumer surplus: the difference between the price a consumer pays for an item and the price he would be willing to pay rather than do without it

- Individual demand: the number of units an individual will purchase at a given price

- Aggregate demand (market demand): the total number of units that will be purchased by a group of consumers at a given price

- Pricing is considered an extent decision (Reduce price if MR>MC)

- Optimal price is where MR = MC

- Price elasticity of demand, e (% change in quantity demanded) : (change in price)

- Estimated price elasticity: [(Q1 - Q2/ (Q1 + Q2)] : [(P1 - P2) / (P1 + P2)] is used to estimate demand elasticity from a price and quantity change

- If |e|>1, demand is elastic; if |e|< demand is inelastic

- MR > MC implies that (P-MC) / P>1 |e|, the more elastic the demand, the lower the optimal price

- Factors affecting elasticity include: products with close substitutes have more elastic demand, products with many complements have less elastic demand, demand for brands is more elastic than industry demand, demand becomes more elastic eventually, as price increases, demand becomes more elastic

- Income elasticity, cross-price elasticity, advertising elasticity are measures of how changes in these other factors affect demand

- Stay-even analysis can be used to determine the quantity change required to offset a price change

- Proposed price increase is profitable if the predicted quantity loss is less than the stay-even quantity

Chapter 7: Economics of Scale and Scope

- Law of diminishing marginal states that as you increase output, your marginal productivity (the extra output associated with extra inputs) eventually declines

- Increasing marginal costs eventually leads to increasing average costs, thus making it more difficult to compute break-even prices

- Increasing returns to scale when marginal costs if average cost falls with output

- If average costs are constant with respect to output, it leads to constant returns to scale

- If average costs rise with output, it leads to decreasing returns to scale or diseconomies of scale

- Learning curves mean that current production lowers future costs

- If cost of producing two outputs jointly is less than the cost of producing them separately, there are economies of scope between the two products

Chapter 8: Understanding Markets and Industry Changes

- Each market has a product, geographic and time dimension

- Market demand describes the buyer's behavior; market supply describes the seller's behavior in a competitive market

- If price changes, quantity demanded increases or decreases

- If a factor other than price changes, demand curve increases or decreases as well

- Supply curves describe the behavior of sellers and indicate how much will be sold at a given price

- Market equilibrium is the price at which quantity supplied equals quantity demanded

- If price is above the equilibrium price, there are too many sellers, forcing price down and vice versa

- Prices convey valuable information; high prices tell buyers to conserve and sellers to increase supply

- Making a market is costly and competition between market makers forces the bid ask spread down to the costs of making a market

- If the costs of making a market are large, then the equilibrium price may be better viewed as a spread rather than a single price

Chapter 9: Market Structure and Long-Run Equilibrium

- A firm in a competitive industry can earn positive or negative profit in the short run until entry or exit occurs

- In the long run, competitive firms earn only an average rate of return

- Profit exhibits mean reversion or regression towards the mean

- If an asset is mobile, in equilibrium the asset will be indifferent about where it is used, unattractive jobs will pay compensating wage differentials and risky investments will pay compensating risk differentials or a risk premium

- The difference between stock returns and bond yields is a compensating risk premium

- When risk premium become too small, some investors view this as a time to get away from risky assets because the market may be ignoring risk in pursuit of higher returns

- Monopoly firms can earn positive profit for a longer period of time compared to competitive firms, however entry of competing firms and imitation eventually erode in their profits as well

Chapter 10: The Quest to Keep Profit From Eroding

- Strategy means to increase performance, there needs to be a way to increase P (price) or reduce C (cost)

- The industrial organization economics perspective assumes that the industry structure is the most important determinant of long-run profitability

- Five Forces model is a framework for analyzing the attractiveness of an industry

- Attractive industries have low supplier power, low buyer power, low threat of entry, low threat of entry, low threat of substitutes and low rivalry

- Strategy is considered the art of matching the resources and capabilities of a firm to the opportunities and risks in external environment for the purpose of developing a sustainable competitive advantage

- When staying ahead of the forces of competition, a firm can adopt one of three basic strategies: cost reduction, product differentiation or reduction in the intensity of competition