CHAPTER 7

Derivatives of More-Than-One Independent Variable Function

Topics:

- First-order partial derivatives
- Second-order partial derivatives
- Differential
- Total differential
- Total derivatives
- Implicit function and its derivative
- Examples in economics
  - Partial market equilibrium
  - Multipliers in macroeconomic models
  - Utility function
  - Production function
  - Etc.

In comparative-static analysis, we are likely to encounter the situation in which several parameters/independent variables appear in a model. Many functions in economics, such as Production function, Cost function, Profit function, Utility function, Demand function, deal with many independent variables. Therefore, we must learn how to find the derivative of a function of more than one variable (Multivariable calculus).

"Transition of idea"

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Examples of multivariable function in economics

The constant elasticity demand function

$$q_1 = f(p_1, p_2, y) = kp_1^{\alpha}\, p_2^{\beta} y^{\gamma}$$

The firm's production function

Linear:

$$q = a_1x_1 + a_2x_2$$

Cobb-Douglas:

$$q = kx_1^{\alpha}x_2^{\beta}$$

Leontief:

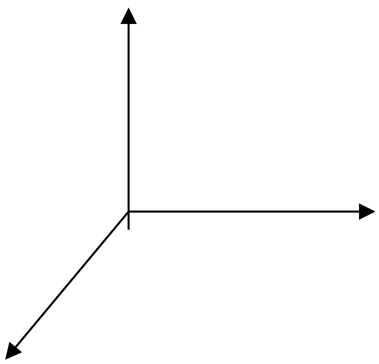
$$q = min\left\{\frac{x_1}{c_1}, \frac{x_2}{c_2}\right\}$$

Constant elasticity of substitution:

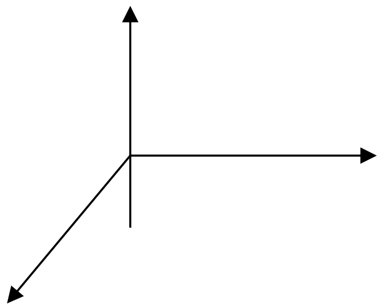
$$q = C\left[\pi x_1^{\frac{\sigma-1}{\sigma}} + (1-\pi)x_2^{\frac{\sigma-1}{\sigma}}\right]^{\frac{\sigma}{\sigma-1}}$$

Geometric Representations of Functions of ***Several*** *Variables*

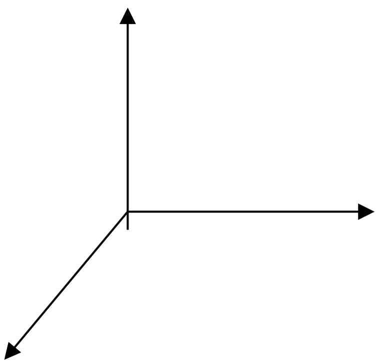
$x = a$



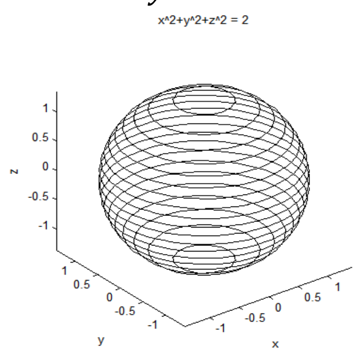
$px + qy + rz = m$



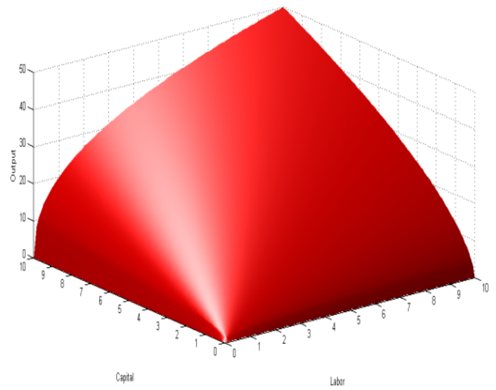
$z = x^2 + y^2$

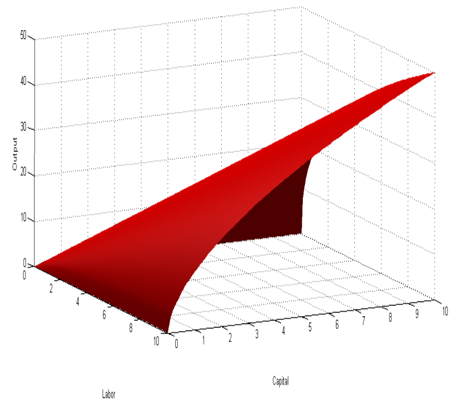


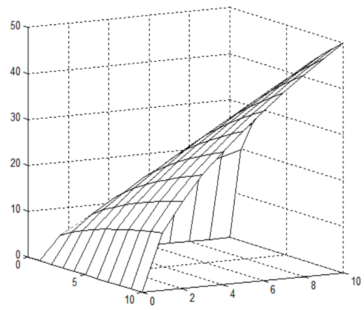
$x^2 + y^2 + z^2 = 2$



Cobb-Douglas production function with labor and capital



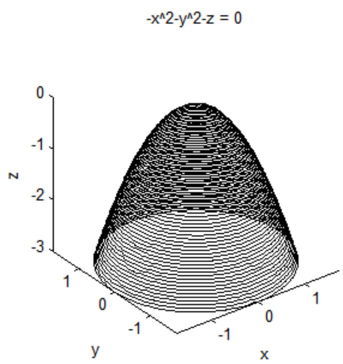




Level Curves for $z = f(x, y)$

From above three-dimensional graphs, we can find the relationship between x and y at each level of function f. That is, we can find x and y such that $f(x, y) = c$. Looking at each level of f and plot the relevant x and y, then we will get "the level curve" at that level of f.

Draw the level curve of $z = f(x, y) = -x^2 - y^2$



A level curve of production function is an isoquant curve.

Partial Derivative

Let

$$y = f(x_1, x_2, \dots, x_n),$$

where $x_1, \dots, x_n$ are independent variable and all independent of one another, so that each can vary by itself <u>without affecting the others</u>. If the variable x_1 changes by Δx_1, while $x_2, \dots, x_n$ all remain fixed, there will be a corresponding change in y, Δy. The difference quotient is:

$$\frac{\Delta y}{\Delta x_1} = \frac{f(x_1 + \Delta x_1, x_2, \dots, x_n) - f(x_1, x_2, \dots, x_n)}{\Delta x_1}$$

The partial derivative of y with respect to x_1 is:

$$\lim_{\Delta x_1 \to 0} \frac{\Delta y}{\Delta x_1} = \lim_{\Delta x_1 \to 0} \frac{f(x_1 + \Delta x_1, x_2, \dots, x_n) - f(x_1, x_2, \dots, x_n)}{\Delta x_1} \equiv \frac{\partial y}{\partial x_1} \equiv f_1$$

The key:

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Example: $y = f(x_1, x_2) = 3x_1^2 + x_1x_2 + 4x_2^2$, what are $\frac{\partial y}{\partial x_1}, \frac{\partial y}{\partial x_2}$?

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Example: $y = f(u, v) = (u + 4)(3u + 2v)$, what are $\frac{\partial y}{\partial u}, \frac{\partial y}{\partial v}$?

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Example: $y = f(u, v) = (3u - 2v)/(u^2 + 3v)$, what are $\frac{\partial y}{\partial u}, \frac{\partial y}{\partial v}$?

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H.W.

- *Compute all the partial derivatives of the following function*

  a) $4x^2y - 3xy^3 + 6x$

  b) xy

  c) xy^2

  d) e^{2x+3y}

  e) $\frac{x+y}{x-y}$

  f) $3x^2y - 7x\sqrt{y}$

- *Compute the partial derivative of the Cobb-Douglas function*

  $q = k_1 x_1^{a_1} x_2^{a_2}$ *and of the Constant Elasticity of Substitution (CES)*

  production function $q = C\left[\pi x_1^{\frac{\sigma-1}{\sigma}} + (1-\pi)x_2^{\frac{\sigma-1}{\sigma}}\right]^{\frac{\sigma}{\sigma-1}}$

Economic Interpretation

$\frac{\partial F(K,L)}{\partial K}$ is Marginal product of capital, MP_K

$\frac{\partial F(K,L)}{\partial L}$ is Marginal product of labor, MP_L

Example: Find MP_K and MP_L of Cobb-Douglas production function $Q = 4K^{\frac{3}{4}}L^{\frac{1}{4}}$, at the current level of factors at $L = 625$, $K = 10{,}000$

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Example: Find MU_{x_1}, MU_{x_2} of the utility function $U(x_1, x_2) = x_1 log x_2$

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Higher-Order Partial Derivative

Since $\frac{\partial f}{\partial x_1}$ is a function of $x_1, \ldots, x_n$, we can also find partial derivative of $\frac{\partial f}{\partial x_1}$

The second order partial derivative of f is:

$$\frac{\partial}{\partial x_j}\left(\frac{\partial f}{\partial x_i}\right) = \frac{\partial^2 f}{\partial x_j \partial x_i}$$

$$\frac{\partial^2 f}{\partial x_i \partial x_i} = \frac{\partial^2 f}{\partial x_i^2}$$

$\frac{\partial^2 f}{\partial x_j \partial x_i}, i \neq j$, is called cross partial derivatives or mixed partial derivatives.

Second-order Derivative and Hessians

Example: Find all second derivatives of $\mathrm{Q} = 4\mathrm{K}^{\frac{3}{4}}\mathrm{L}^{\frac{1}{4}}$

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Function with n independent variables will n^2 second order partial derivatives, from which we can write out the $n \times n$ matrix. Row i, Column j corresponds to $\frac{\partial^2 f}{\partial x_i \partial x_j}$. This matrix is called Hessian Matrix. The Hessian matrix is a symmetric matrix (Young's theorem).

$y = f(x_1, x_2, \ldots, x_n) \rightarrow \frac{\partial f}{\partial x_1}, \frac{\partial f}{\partial x_2}, \ldots, \frac{\partial f}{\partial x_n}$

$$\boxed{H} = D^2 f_x = \begin{bmatrix} \frac{\partial^2 f}{\partial x_1^2} & \frac{\partial^2 f}{\partial x_1 \partial x_2} & \cdots & \frac{\partial^2 f}{\partial x_1 \partial x_n} \\ \frac{\partial^2 f}{\partial x_2 \partial x_1} & \frac{\partial^2 f}{\partial x_2^2} & \cdots & \frac{\partial^2 f}{\partial x_2 \partial x_n} \\ \vdots & \vdots & \ddots & \vdots \\ \frac{\partial^2 f}{\partial x_n \partial x_1} & \frac{\partial^2 f}{\partial x_n \partial x_2} & \cdots & \frac{\partial^2 f}{\partial x_n^2} \end{bmatrix}$$

Hessian Matrix

H.W.

1) Let $y = f(x_1, x_2) = x_1 e^{x_1 + x_2^2}$ *find* f_1, f_2*, and Hessian Matrix*

2) Let $Q = f(K, L, T) = AK^{\alpha} L^{\beta} T^{\gamma}$*, find marginal products, and Hessian matrix*

The Total Differential of A Function of Several Variables

Derivatives vs. Differentials

The symbol $\frac{dy}{dx}$ for the derivative of the function $y = f(x)$ has been regarded as a single entity.

We shall now reinterpret $\frac{dy}{dx}$ as a ratio of two quantities, dy and dx, the differentials of y and x, respectively.

rate of change when x change 1 unit

$dy = f(x) dx$ how much x changes

$y = f(x)$

derivative

dy, dx as 1 entity

differential of y

$$\frac{dy}{dx} = f'(x)$$

$$\boxed{dy = f'(x)dx}$$

$f'(x)$ is a "converter" translating a given independent change dx into a counterpart change in dependent change dy.

The process of finding dy from a given function $y = f(x)$ is called differentiation.

The process of finding derivative $\frac{dy}{dx}$ from a given function $y = f(x)$ is called differentiation with respect to x.

H.W. Given that $y = 3x^2 + 7x - 5$, *find* dy

Total differentials

total diff

The concept of differential can easily be extended to a function of two or more independent variable. Consider a saving function:

$$S = S(Y, i)$$

$\Rightarrow$ Total differential of S or dS

S is Saving, Y is national Income, i is Interest rate.

The partial derivative of S with respect to Y: ......$\frac{\partial S}{\partial Y}$...................... marginal propensity to save

change in S when Y change 1 unit, when i constant

For any change in Y, ~~dy~~ dY, the resulting change in S can be approximated by the quantity: ....$\frac{\partial S}{\partial Y} dY$..............................

The partial derivative of S with respect to i: ......$\frac{\partial S}{\partial i}$...................... change in S when i changes 1 unit, given Y is constant.

For any change in i, di, the resulting change in S can be approximated by the quantity: ....$\frac{\partial S}{\partial i} di$..............................

The total change in S is then approximated by **the total differential of saving function**:

total change in S, or total differential is S

$ds = \frac{\partial S}{\partial Y} dY + \frac{\partial S}{\partial i} di$

The partial differential of the saving function:

$S_Y dY$, $S_i di$

Rule of Differentials

For a constant k, and function $U(X_1, X_2)$ and $V(X_1, X_2)$

Rule 1: $dk = 0$
Rule 2: $d(cU^n) = cnU^{n-1}dU$
Rule 3 : $d(U \pm V) = dU \pm dV$
Rule 4 : $d(UV) = UdV + VdU$
Rule 5: $d\left(\frac{U}{V}\right) = \frac{VdU - UdV}{V^2}$

H.W. Find dy for

1) $\boxed{y = 5x_1^2 + 3x_2}$
2) $y = 3x_1^2 + x_1x_2^2$
3) $y = \frac{x_1 + x_2}{2x_1^2}$
4) $y = 3x_1(2x_2 - 1)(x_3 + 5)$
5) $y = -5 + 30x_1 - 3x_1^2 + 25x_2 - 5x_2^2 + x_1x_2$, *given that* $x_1 = 5$, $x_2 = 2$, $dx_1 = 0.02$, $dx_2 = 0$

① $y = f(x_1, x_2) = 5x_1^2 + 3x_2$
→ $dy = f_1 dx_1 + f_2 dx_2$
$dy = 10x_1 dx_1 + 3dx_2$ #
→ $dy = d(5x_1^2 + 3x_2)$
$= 5d(x_1^2) + 3dx_2$
$= 5(2x_1)dx_1 + 3dx_2$ #

Total Derivatives

Question: Consider equilibrium consumption function which is a function of equilibrium national income and exogenous tax, $\boxed{C(Y^*, T_0)}$. What is the rate of change of the function $C(Y^*, T_0)$ with respect to T_0, when Y^* and T_0 are related?

How much C would change when T_0 changes?

$C(Y, T_0)$

Why not use just $\frac{\partial C}{\partial T_0}$? direct effect

Channel diagram

C ← direct effect — To

Y^*

indirect effect

To answer this question, we need to learn about total derivative.

Unlike a partial derivative, a total derivative does not require the argument Y^* to remain constant as T_0 varies. A total derivative allows for the postulated relationship between the two arguments.

Finding the Total Derivative

Consider $y = f(x, w)$, where $x = g(w)$

Question: What is the total derivative of y with respect to w? How to do the total differentiation of y with respect to w?

Note that: the two functions f and g can be combined into a composite function $y = f(g(w), w)$

The three variables y, x, w are related to one another. In the following *channel map, w,* the ultimate source of change, can affect y through two separate channels:

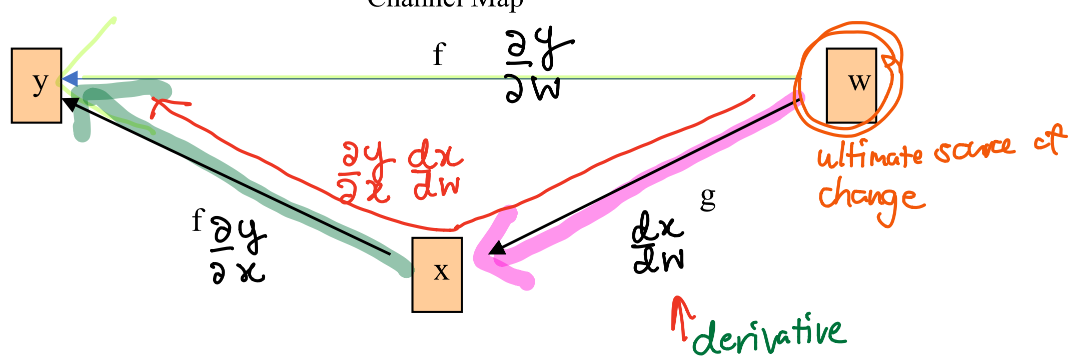
(1) Directly, via the function f

(2) Indirectly, via the function g, then f

$\frac{dx}{dw} = \frac{\partial x}{\partial w}$

$y = f(x, w)$, $\boxed{x = g(w)}$

"Channel Map"



The direct effect can be represented by the partial derivative

$\frac{\partial f}{\partial w}$, i.e. f_w how much y changes when w change, holding x constant

The indirect effect can be represented by a product of two derivatives:

$\frac{\partial f}{\partial x} \times \frac{dx}{dw}$, i.e. $f_x \frac{dx}{dw}$

, by the chain rule for a composite function

how much y change when x changes, which is a result of change in w.

earlier : $y = f(x_1, x_2, \dots, x_n)$ partial derivative now : $y = f(x, w)$, $x = g(w)$ total derivative

Adding up the two effects give us the total derivative of y with respect to w:

$$\frac{dy}{dw} = \underbrace{f_x \frac{dx}{dw}}_{\text{indirect effect}} + f_w$$

direct effect

Alternatively, we can also find the total derivative by:

(a.) Total differentiating the function $\boldsymbol{y = f(x, w)}$

$$dy = f_x\, dx + f_w\, dw$$

(b.) Dividing through the total differential by dw

$$\frac{dy}{dw} = f_x \frac{dx}{dw} + f_w \frac{dw}{dw}$$

$$\frac{dy}{dw} = f_x \frac{dx}{dw} + f_w$$

Example 1: Find Total derivative $\frac{dy}{dw}$, when
$y = f(x, w) = 3x - w^2$, $x = g(w) = 2w^2 + w + 4$

1

$$\frac{dy}{dw} = f_w + f_x \frac{dx}{dw}$$

$$= -2w + 3(4w + 1)$$

$$= 10w + 3$$

2

$$y = 3x - w^2$$

$$= 3(2w^2 + w + 4) - w^2$$

$$y = 5w^2 + 3w + 12$$

$$\frac{dy}{dw} = 10w + 3$$

Example 2: $U = u(c,s)$, and $s = g(c)$, c is quantity of coffee, s is quantity of sugar, which depends on quantity of coffee consumed. How much will total utility change as quantity of coffee consumed changes?

$$U \xleftarrow{u} c, \qquad U \xleftarrow{u} s \xleftarrow{g} c$$

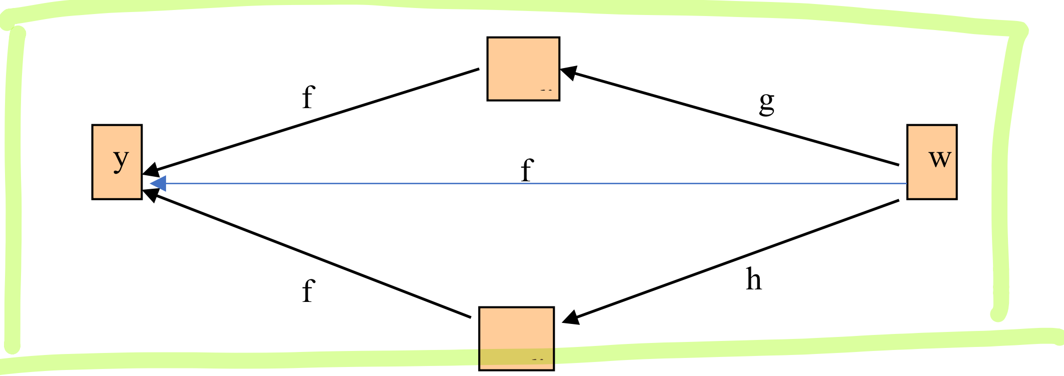
$$\frac{dU}{dc} = \underset{\text{direct effect}}{u_c} + \underbrace{u_s \frac{ds}{dc}}_{\text{indirect effect}}$$

Three channels: the ultimate source of change is w

$$\boxed{y = f(x_1, x_2, w),\ x_1 = g(w), x_2 = h(w) \text{ What is } \frac{dy}{dw}\text{ ?}}$$

$$\frac{dy}{dw} = \underset{\text{direct effect}}{f_w} + \underbrace{f_{x_1} \frac{dx_1}{dw} + f_{x_2} \frac{dx_2}{dw}}_{\text{indirect effect}}$$

$\frac{dx_1}{dw} \to \frac{dg}{dw}$, $\frac{dx_2}{dw} \to \frac{dh}{dw}$



Example 3: $Q = Q(K, L, t)$, $K = K(t)$, $L = L(t)$ Question: $\frac{dQ}{dt}$?

$$Q \xleftarrow{Q} t, \qquad Q \leftarrow L \leftarrow t, \qquad Q \leftarrow K \xleftarrow{K} t$$

$$\frac{dQ}{dt} = Q_t + Q_K \frac{dK}{dt} + Q_L \frac{dL}{dt}$$

Example 4: $Q^D = g(P, I)$, $I = f(P)$, Q^D *is quantity demanded,* I *is income, and* P *is price.*

$$\begin{tikzcd} Q^D & & P \arrow[ll] \arrow[dl] \\ & I \arrow[ul] & \end{tikzcd}$$

$$\underbrace{\frac{dQ^D}{dP}}_{\text{Total effect}} = \underbrace{\frac{\partial Q^D}{\partial P}}_{\text{Substitution effect}} + \underbrace{\frac{\partial Q^D}{\partial I}\cdot\frac{dI}{dP}}_{\text{income effect}}$$

H.W. Find total derivative of

(1.) $z = f(x, y, t), x = a + bt, y = c + dt$

(2.) $z = f(x, y) = 2x + xy - y^2, x = g(y) = 3y^2$

Chain rule:

$$\begin{tikzcd} & x_1 \arrow[dl] & t \arrow[l] \arrow[dl] \\ y & x_2 \arrow[l] & \end{tikzcd}$$

Example 5: Let $y = \ln(x_1 + x_2)$, $x_1 = t$, *and* $x_2 = t^2$. *Find* $\frac{dy}{dt}$ *by direct substitution, draw channel diagram, and also find* $\frac{dy}{dt}$ *by chain rule.*

$$\frac{dy}{dt} = ?$$

By direct substitution: $y = \ln(t + t^2)$

$$\frac{dy}{dt} = \frac{1}{t + t^2}(1 + 2t) \quad \#$$

By chain rule :

$$\frac{dy}{dt} = \frac{\partial y}{\partial x_1}\frac{dx_1}{dt} + \frac{\partial y}{\partial x_2}\frac{dx_2}{dt}$$

$$= \frac{1}{x_1 + x_2}(1) + \frac{1}{x_1 + x_2}2t$$

$$= \frac{1}{t + t^2}(1 + 2t) \quad \#$$

H.W. Find $\frac{dz}{dt}$ *at* $t = 0$, $z = \frac{5t^2 + 3xy}{2w^2 y}$, $x = t^2 + 1$, $y = \sqrt{t^2 + 1}$, $w = e^t + 1$

⓪ $y = f(x)$ explicitly

① $F(x,y) = 0$

$y = g(x) \Rightarrow$ "implicit function"

Would like to have $\frac{dy}{dx}$

Implicit Functions

A function given in the form of $y = f(x)$ is called an explicit function, because the variable y is explicitly expressed as a function of x. For example, $y = f(x) = 3x^4$.

Consider a given $\boxed{F(y,x) = 0}$. For $F(y,x) = 0$, the left hand side is a function of the two variables y and x.

y in terms of x

For example, $\boxed{y^3 - x^2y - \frac{1}{y} + 5xy = 0.}$

$F(y,x) = 0$ can imply the function $y = f(x)$, in which case the function f is called an implicit function.

Derivatives of Implicit function

If the equation $F(y,x) = 0$ can be solved for y, we can write out the function $y = f(x)$ and find its derivatives by the methods learned before.

But if the equation $F(y,x) = 0$ cannot be solved for y, the derivatives of implicit function can be found by applying the concept of total differentiation.

① $$F(y,x) = 0$$

take total differential on LHS, RHS

$$dF(y,x) = d0$$

$$d\underbrace{F(y,x)}_{z} = 0$$

$$F_y dy + F_x dx = 0$$

Thus, the implicit-function rule:

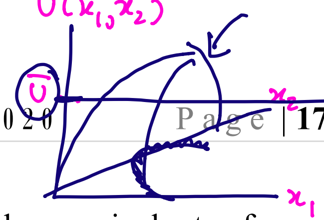
② $$\frac{dy}{dx} = -\frac{F_x}{F_y}$$

F_x: $\frac{\partial F}{\partial x}$, F_y: $\frac{\partial F}{\partial y}$

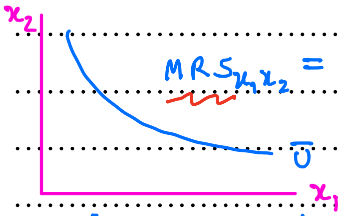
For $\boxed{F(y, x_1, \dots, x_m) = 0}$, the partial derivative f_i of the implicit function $y = f(x_1, \dots, x_m)$ is:

$$\boxed{f_i \equiv \frac{\partial y}{\partial x_i} = -\frac{F_{x_i}}{F_y}}$$

F_{x_i}: $\frac{\partial F}{\partial x_i}$, F_y: $\frac{\partial F}{\partial y}$



Example: Consider Utility function $U = U(x_1, x_2)$, find the marginal rate of substitution. And, if $U = U(x_1, x_2) = x_1^{\alpha} x_2^{\beta}$, Is the indifferent curve convex?



$MRS_{x_1 x_2} = \left.\frac{dx_2}{dx_1}\right|_{U=\bar{U}}$

Marginal rate of substitution of x_1 for x_2 = the amount of x_2 which a consumer can exchange for one unit of x_1 = slope of IC curve

IC is convex when $\frac{d\,MRS_{x_1x_2}}{dx_1} > 0$, $\frac{d^2 x_2}{dx_1^2} > 0$

We find $MRS_{x_1x_2}$ from Utility fn $U(x_1,x_2)$ by the concept that Indifferent curve is (x_1,x_2) that gives equal level of utility

IC curve : $U(x_1,x_2) = \bar{U}$

$z = F(x_1,x_2) = U(x_1,x_2) - \bar{U} = 0$

Alternatively, $dU = d\bar{U}$, $dU = 0$

$$dF = \underbrace{F_{x_1}dx_1}_{\text{How much F changes as } x_1 \text{ changes } dx_1} + \underbrace{F_{x_2}dx_2}_{\text{How much F changes as } x_2 \text{ changes } dx_2} = 0$$

$\frac{\partial F(x_1,x_2)}{\partial x_1} = \frac{\partial U(x_1,x_2)}{\partial x_1} - \cancel{\frac{\partial \bar{U}}{\partial x_1}} \to 0$

$= MU_{x_1}$

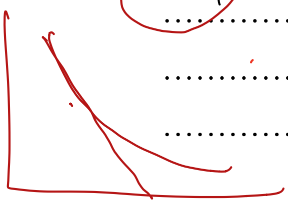
$F_{x_2}dx_2 = -F_{x_1}dx_1$

$MRS_{x_1x_2} = \frac{dx_2}{dx_1} = -\frac{F_{x_1}}{F_{x_2}} = -\frac{\frac{\partial F}{\partial x_1}}{\frac{\partial F}{\partial x_2}} = \frac{-\frac{\partial U}{\partial x_1}}{\frac{\partial U}{\partial x_2}} = -\frac{MU_{x_1}}{MU_{x_2}}$ #

$U = x_1^{\alpha} x_2^{\beta}$

$MRS_{x_1x_2} = \frac{dx_2}{dx_1} = -\frac{\frac{\partial U}{\partial x_1}}{\frac{\partial U}{\partial x_2}} = -\frac{\alpha x_1^{\alpha-1} x_2^{\beta}}{\beta x_1^{\alpha} x_2^{\beta-1}} = -\frac{\alpha}{\beta}\frac{x_2}{x_1} < 0$

$MRS_{x_1x_2} \leftarrow x_1$, x_2



$\boxed{MRS_{x_1x_2} = -\frac{\alpha}{\beta}\frac{x_2}{x_1}}$

$$\frac{d}{dx_1}MRS_{x_1x_2} = \underbrace{\frac{\partial MRS_{x_1x_2}}{\partial x_1}\cdot\frac{dx_1}{dx_1}}_{\text{change in MRS from change in } x_1} + \frac{\partial MRS_{x_1x_2}}{\partial x_2}\cdot\frac{dx_2}{dx_1}$$

$\frac{\partial}{\partial x_1}\left(-\frac{\alpha}{\beta}\frac{x_2}{x_1}\right)$, $-\frac{\alpha}{\beta}x_2x_1^{-1}$

$-\frac{\alpha}{\beta}\frac{x_2}{x_1}$

$= \frac{\alpha}{\beta}\frac{x_2}{x_1^2} + -\frac{\alpha}{\beta}\cdot\frac{1}{x_1}\boxed{\frac{dx_2}{dx_1}}$

$= \frac{\alpha}{\beta}\frac{x_2}{x_1^2} - \frac{\alpha}{\beta x_1}\left(-\frac{\alpha}{\beta}\frac{x_2}{x_1}\right)$

$\Rightarrow \frac{d^2x_2}{dx_1^2} = \frac{\alpha}{\beta}\left(1+\frac{\alpha}{\beta}\right)\frac{x_2}{x_1^2} > 0$

$\Rightarrow$ IC Curve is convex.

Homework: Find $\frac{dy}{dx}$ for when:

1.) $y^3 - x^2y - \frac{1}{y} + 5xy = 0$

2.) $x^3 + 2x^2y - 3xy^2 - y^3 = 0$

3.) $x^2y^2 + e^x - e^y = 0$

4.) $3\ln(x+y) = y^2 - 4x^2$

Applications in Economics

Utility function

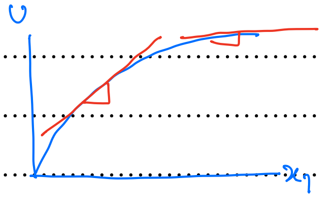
Consider Utility function $U = U(x_1, x_2)$. Find marginal utility of each good. What are the conditions for law of diminishing marginal utility to hold?

$MU_{x_1} = \frac{\partial U(x_1, x_2)}{\partial x_1} = U_{x_1}$

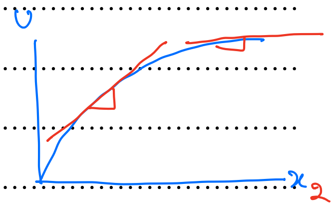
$MU_{x_2} = \frac{\partial U(x_1, x_2)}{\partial x_2} = U_{x_2}$

Law of diminishing MU

$\frac{\partial MU_{x_1}}{\partial x_1} = U_{x_1 x_1} < 0$



$\frac{\partial MU_{x_2}}{\partial x_2} = U_{x_2 x_2} < 0$



Let $\boxed{U(x_1, x_2) = (x_1 + 2)^2 (x_2 + 3)^2}$. Compare marginal utility of good 1 and good 2 when $\boxed{x_1 = x_2 = 3 \text{ units}}$

$MU_{x_1} = \frac{\partial U}{\partial x_1} = 2(x_1 + 2)(x_2 + 3)^2$

$MU_{x_2} = \frac{\partial U}{\partial x_2} = 2(x_1 + 2)^2 (x_2 + 3)$

$MU_{x_1}\big|_{x_1 = x_2 = 3} = 2(3+2)(3+3)^2 = 360$

$MU_{x_2}\big|_{x_1 = x_2 = 3} = 2(3+2)^2(3+3) = 300$

Production function

Consider $Q = f(K,L) = \boxed{AK^{\alpha}L^{\beta}}, 0 < \alpha, \beta < 1$

Find marginal product of each factor of production. What are the conditions for law of diminishing marginal product to hold?

$MP_L = \frac{\partial Q}{\partial L} = \boxed{\beta A K^{\alpha} L^{\beta-1}}$

$MP_K = \frac{\partial Q}{\partial K} = \alpha A K^{\alpha-1} L^{\beta}$

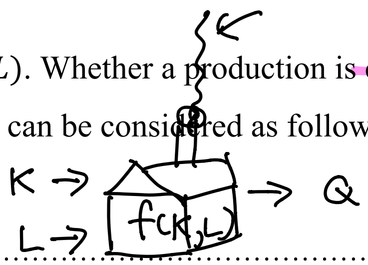
$\frac{\partial MP_L}{\partial L} = \frac{\partial^2 Q}{\partial L^2} = \beta(\beta-1) A K^{\alpha} L^{\beta-2} < 0$ if $\beta < 1$

$L\uparrow, MP_L \downarrow$

$\frac{\partial MP_K}{\partial K} = \frac{\partial^2 Q}{\partial K^2} = \alpha(\alpha-1) A K^{\alpha-2} L^{\beta} < 0$ if $\alpha < 1$

$K\uparrow, MP_K \downarrow$

Consider $Q = f(K,L)$. Whether a production is constant, increasing and decreasing return to scale can be considered as follows.



constant rts : increase K, L t times → Q increases t times

$\% \Delta Q = \% \Delta$ Input

increasing rts " ——————— " → " ——————— " > t times

$\% \Delta Q > \% \Delta$ Input

decreasing rts " ——————— " → " ——————— " < t times

$\% \Delta Q < \% \Delta$ Input

When increase K, L t times, we get $f(tK, tL)$

When Q increases t times, $tf(K,L)$

Output when we input t times of K, L

t times of the original output

c rts : $f(tK, tL) = t f(K,L)$

i rts : $f(tK, tL) > t f(K,L)$

d rts : $f(tK, tL) < t f(K,L)$

If we let $Q = f(K,L) = AK^{\alpha}L^{\beta}$, and let K, L increase t times

we will get $f(tK, tL) = A(tK)^{\alpha}(tL)^{\beta}$

$$= \boxed{t^{\alpha+\beta} \underbrace{AK^{\alpha}L^{\beta}}}$$

$$f(tK, tL) = t^{\alpha+\beta} f(K,L)$$

c rts $t^{\alpha+\beta} f(K,L) = t f(K,L) \Rightarrow \alpha+\beta = 1$

i rts $>$ $\alpha+\beta > 1$

d rts $<$ $\alpha+\beta < 1$

If we can write any function in the form of

$$y = f(tx_1, tx_2) = t^k f(x_1, x_2)$$

, we can call that f^n as "homogenous f^n of degree k"

cobb-douglass production function has degree $\alpha+\beta$

Elasticity

Elasticity of output with respect to factor of production

$AP_L \Rightarrow \frac{AK^\alpha L^\beta}{L}$

$Q = f(K, L) = AK^\alpha L^\beta, 0 < \alpha, \beta < 1$

$E_L = \frac{\partial Q}{\partial L} \cdot \frac{L}{Q} = \frac{\frac{\partial Q}{\partial L}}{\frac{Q}{L}} = \frac{MP_L}{AP_L}$

$= \frac{\beta A K^\alpha L^{\beta-1}}{AK^\alpha L^{\beta-1}} = \beta$

$E_K = \frac{\partial Q}{\partial K} \cdot \frac{K}{Q} = \frac{MP_K}{AP_K}$

$= \frac{\alpha A K^{\alpha-1} L^\beta}{A K^{\alpha-1} L^\beta} = \alpha$

Elasticity of ~~output with respect to factor of production~~ demand

Consider $\boxed{Q_A^D = f(P_A, P_B, y) = 100 - 10P_A + 15P_B + 0.3\cancel{y}}$ I, Find own price/cross price/income elasticity of quantity demanded. Let $P_A = 8, P_B = 5, I = 500, Q_A = 60$

Own price elasticity:

$E_{P_A} = \frac{\partial Q_A^D}{\partial P_A} \cdot \frac{P_A}{Q_A} = -10 \cdot \frac{P_A}{Q_A}$ 8 60 $= -\frac{4}{3} < 0$

Cross price elasticity:

$E_{P_B} = \frac{\partial Q_A^D}{\partial P_B} \cdot \frac{P_B}{Q_A^D} = 15 \times \frac{5}{60} = \frac{5}{4} > 0$

A & B are substitute $P_B \uparrow \rightarrow Q_B^D \downarrow \; Q_A^D \uparrow$

$E_{P_B} > 0 \rightarrow$ substitute

$E_{P_B} < 0 \rightarrow$ complement

Income elasticity:

$E_I = \frac{\partial Q_A^D}{\partial I} \cdot \frac{I}{Q_A^D} = 0.3 \cdot \frac{500}{60} = 2.5$

$E_I > 0$ if normal good

$E_I < 0$ if inferior goods

HOMEWORK

1.) Market equilibrium

$Q_d = Q_s$

$Q_d = a - bP \quad (a,b>0)$ $\quad P^* = f(a, c, b, d)$

$Q_s = -c + dP \quad (c,d>0)$ $\quad Q^* = g(a, b, c, d)$

$\boxed{P^* = \frac{a+c}{b+d}}$, $\boxed{Q^* = \frac{ad-bc}{b+d}}$

What are $\frac{\partial P^*}{\partial a}, \frac{\partial Q^*}{\partial a}, \frac{\partial P^*}{\partial c}, \frac{\partial Q^*}{\partial c}, \frac{\partial P^*}{\partial b}, \frac{\partial Q^*}{\partial b}, \frac{\partial P^*}{\partial d}, \frac{\partial Q^*}{\partial d}$?

$\frac{\partial P^*}{\partial a} = \frac{1}{b+d}$ $\qquad \frac{\partial Q^*}{\partial b} = \frac{(b+d)(-c) - (ad-bc)}{(b+d)^2}$

2.) **Multipliers in Keynesian crossing model**

$$Y = C + I + G + X - M$$

$$Y = C_0 + C_1(Y - T) + I_0 + iY + G_0 + X_0 + \gamma_0 Y^* - M_0 - \lambda_0 Y$$

$$Y = C_0 + C_1(Y - t_0 - t_1 Y) + I_0 + iY + G_0 + X_0 + \gamma_0 Y^* - M_0 - \lambda_0 Y$$

$$\boxed{Y_E = \frac{C_0 - t_0 C_1 + I_0 + G_0 + X_0 + \gamma_0 Y^* - M_0}{1 - C_1(1 - t_1) - i + \lambda_0}}$$

What are $\frac{\partial Y_E}{\partial Y^*}, \frac{\partial Y_E}{\partial I_0}, \frac{\partial Y_E}{\partial C_0}, \frac{\partial Y_E}{\partial C_1}$?