Bounded Rationality
Lecture 1

Three Stories

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January, 2014

Outline

Story 1. The Law of Demand

Gary Becker (1962), "Irrational Behavior and Economic Theory", *Journal of Political Economy*, 70(1), pp. 1-13.

Lesson 1: Very different behaviors can be investigated and modeled (optimising, impulsive, inertian)

Lesson 2: Individual irrationality can be consistent with aggregate rationality (micro $\neq$ macro).

Lesson 3: Some aggregate results hold simply due to shifts in opportunity sets

Story 2. Near-Rational Behavior

George Akerlof, Janet Yellen (1985), "Can Small Deviations from Rationality Make Significant Differences to Economic Equilibria?", *American Economic Review*, 75(4), pp. 708-720.

Lesson 1: Second-order deviations from rationality ("near-rationality" due to inertia) may cause first-order deviations in economic consequences

Lesson 2: Such situation is rather common phenomenon than exception (envelope theorem)

Lesson 3: The result holds in more general (than monopoly) settings: even small amount of near-rational behavior is sufficient.

Story 3. Emerging Property

Thomas Schelling (1969), “Models of Segregation”, *American Economic Review*, 59(2), pp. 488-493.

Lesson 1: Micro-motives can lead to the unexpected and unintended macro-consequences (macro $\neq$ micro)

Lesson 2: Behavior governed by local and random rules may lead to a well-defined, non-trivial outcomes

Lesson 3: There are models with multiple equilibria: how can we predict which equilibrium will be realised?