Economics and You

What factors do you consider when you need to make a decision to buy something? Price may be one of the most important factors of all. In this chapter, you will learn how price serves as a signal to both buyers and sellers.
Chapter Objectives

Section 1: Prices as Signals
• Explain how prices act as signals.  
• Describe the advantages of using prices as a way to allocate economic products.  
• Understand the difficulty of allocating scarce goods and services without using prices.

Chapter Objectives

Section 2: The Price System at Work
• Understand how prices are determined in competitive markets.  
• Explain how economic models can be used to predict and explain price changes.  
• Apply the concepts of elasticity to changes in prices.

Chapter Objectives

Section 3: Social Goals vs. Market Efficiency
• Describe the consequence of having a fixed price in a market.  
• Explain how loan supports and deficiency payments work.  
• Understand what is meant when “markets talk.”
Study Guide
Main Idea
Competitive markets and prices are important to capitalism.

Reading Strategy
Graphic Organizer As you read the section, complete a graphic organizer similar to the one on page 137 of your textbook by providing examples from your own experience that show how the price system provides for freedom of choice.

Key Terms
- price
- ration coupon
- rationing
- rebate

Objectives
After studying this section, you will be able to:
- Explain how prices act as signals.
- Describe the advantages of using prices as a way to allocate economic products.
- Understand the difficulty of allocating scarce goods and services without using prices.

Applying Economic Concepts
Rationing Have you and your friends ever tried to share something—a candy bar, cake, or pizza—when there really wasn’t enough to go around? What are different ways to make allocations?

Introduction
- Life is full of signals that help us make decisions.
- A price—the monetary value of a product as established by supply and demand—is a signal that helps us make our economic decisions.
- High prices are signals for producers to produce more and for buyers to buy less.
- Low prices are signals for producers to produce less and for buyers to buy more.
Advantages of Prices

- Prices serve as a link between producers and consumers.
- In doing so, they help decide the three basic WHAT, HOW, and FOR WHOM questions all societies face.
- Without prices, the economy would not run as smoothly, and decisions about allocating goods and services would have to be made some other way.

Advantages of Prices (cont.)

- Finally, prices are something that we have known about all our lives, from the time we were old enough to ask our parents to buy us something to the age where we were old enough to buy it ourselves.

Sections 1-5

Prices serve as a link between producers and consumers. In doing so, they help decide the three basic WHAT, HOW, and FOR WHOM questions all societies face. Without prices, the economy would not run as smoothly, and decisions about allocating goods and services would have to be made some other way.

Advantages of Prices

- Prices perform the allocation function very well for the following reasons.
  - First, prices in a competitive market economy are neutral because they favor neither the producer nor the consumer. This is because prices are the result of competition between buyers and sellers.
  - Second, prices in a market economy are flexible. Unforeseen events such as natural disasters and war affect the prices of many items.
  - Third, prices have no cost of administration. Competitive markets tend to find their own prices without outside help or interference.

Advantages of Prices (cont.)

- Finally, prices are something that we have known about all our lives, from the time we were old enough to ask our parents to buy us something to the age where we were old enough to buy it ourselves.

Sections 1-6

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Allocations Without Prices

- Without prices, another system must be used to decide who gets what.
- One method is rationing—a system under which an agency such as government decides everyone’s “fair” share.
- Under such a system, people receive a ration coupon, a ticket or a receipt that entitles the holder to obtain a certain amount of a product.
- Rationing is used in many societies today, and it has been widely used during wartime, but it can lead to problems.
The Problem of Fairness

• The first problem with rationing is that almost everyone feels his or her share is too small.

• During the oil crisis of the early 1970s, for example, the government made plans for, but never implemented, a gas rationing program.

• One of the major problems with the program was determining how to allocate the gas rationing coupons.

High Administrative Cost

• A second problem of rationing is the cost.

• Someone has to pay for printing the coupons and the salaries of the people who distribute them.

• In addition, no matter how much care is taken, some coupons will be stolen, sold, or counterfeited and used to acquire a product intended for someone else.

Diminishing Incentive

• A third problem is that rationing has a negative impact on people’s incentive to work and produce.

• Suppose that authorities went ahead with a rationing system and that you were given a certain number of coupons. How would this affect your incentive to work?

• Nonprice allocation mechanisms, such as rationing, raise issues that do not occur under a price allocation system.

Prices as a System

• Because of the many difficulties with nonprice allocation systems, economists overwhelmingly favor the price system.

• In fact, prices do more than help individuals in specific markets make decisions: they also serve as signals that help allocate resources between markets.

• Consider the way in which higher oil prices affected producer and consumer decisions when the price of oil went from $5 to over $40 a barrel in the 1970s.
Prices as a System (cont.)
- The market for full-size automobiles was one of the first to feel the effects.
- To move their inventories, some manufacturers began to offer a rebate—a partial refund of the original price of the product.
- As time went on, however, the surplus of unsold cars remained. Automakers began reducing their production of large cars.

Prices as a System (cont.)
- The result of higher prices in the international oil market, then, was a shift of productive resources out of the large car market into other markets.

Section Assessment

Q Main Idea Using your notes from the graphic organizer activity on page 137 of your textbook, describe how price affects decisions that consumers make.
A Consumers will purchase less at a high price and more at a low price. Consumers also weigh the price against their need.

Section Assessment (cont.)
Q Describe how producers and consumers react to prices.
A When prices are high, producers produce more and consumers buy less. When prices are low, producers produce less and consumers demand more.
Section Assessment (cont.)

Q List the advantages of using prices to distribute economic products.

A Advantages include neutrality, flexibility, lack of administrative costs, and familiarity.

Section Assessment (cont.)

Q Explain the difficulties of allocating goods and services without a price system.

A Difficulties include an unfair system of allocation, the high cost of administering the system, and the negative impact of the system on incentive to work and produce.

Section Assessment (cont.)

Q Rationing From your own experience, describe a situation that required some form of rationing. What criteria were used to allocate the good or service, and what were some of the problems with each of the criteria?

A Answers will vary.

Section Assessment (cont.)

Q Understanding Cause and Effect List five items you would like to buy. How does the price of each item affect your decision to allocate your scarce resources—your money and your time? Explain.

A Answers will vary.
Section Close

Debate the following statement:
In every respect, price is the best system of allocating goods and services.

Study Guide

Main Idea
Changes in demand and supply cause prices to change.

Reading Strategy
Graphic Organizer As you read the section, complete a graphic organizer similar to the one on page 142 of your textbook, showing how a surplus and shortage affect prices, demand, and supply.

Study Guide (cont.)

Key Terms
- economic model
- shortage
- market equilibrium
- equilibrium price
- surplus

Objectives
After studying this section, you will be able to:
- Understand how prices are determined in competitive markets.
- Explain how economic models can be used to predict and explain price changes.
- Apply the concepts of elasticity to changes in prices.
**Applying Economic Concepts**

**Equilibrium Price** When something is at equilibrium, it tends to remain at rest. What causes prices to reach, and then stay at, equilibrium?

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**Introduction**

- One of the most appealing features of a competitive market economy is that everyone who participates has a hand in determining prices.
- This is why economists consider prices to be neutral and impartial.
- The process of establishing prices is remarkable because buyers and sellers have exactly the opposite hopes and desires. Buyers want to find good buys at low prices. Sellers hope for high prices and large profits.

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**The Price Adjustment Process**

- Because transactions in a market economy are voluntary, the compromise that eventually takes place must be to the benefit of both parties, or the compromise would not occur in the first place.

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**An Economic Model**

- To show how the adjustment process takes place, we use a supply and demand illustration shown in Figure 6.1a—one of the more popular “tools” used by economists.

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**Figure 6.1a**

*Market Demand and Supply Schedules*

<table>
<thead>
<tr>
<th>Price</th>
<th>Quantity Demanded</th>
<th>Quantity Supplied</th>
<th>Surplus/Shortage</th>
</tr>
</thead>
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<td>3</td>
<td>2</td>
<td>3</td>
</tr>
<tr>
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</tr>
<tr>
<td>20</td>
<td>15</td>
<td>2</td>
<td>13</td>
</tr>
</tbody>
</table>
An Economic Model (cont.)

- The figure illustrates an economic model—a set of assumptions that can be listed in a table, illustrated with a graph, or even stated algebraically—to help analyze behavior and predict outcomes.
- A complete model of the market will allow us to analyze how the interaction of buyers and sellers results in a price that is agreeable to all.

Market Equilibrium

- In a competitive market, the adjustment process moves toward market equilibrium—a situation in which prices are relatively stable, and the quantity of goods or services supplied is equal to the quantity demanded.
- In Figure 6.1b, equilibrium is reached when the price is $15 and the quantity supplied is six units.

Market Equilibrium (cont.)

- How does the market find this equilibrium on its own?
- To answer these questions, we have to examine the reactions of buyers and sellers to market prices.
- In addition, we assume that neither knows the final price, so we’ll have to find it using trial and error.

Surplus

- A surplus is a situation in which the quantity supplied is greater than the quantity demanded at a given price.
- Surplus shows up as unsold products on suppliers’ shelves, and it begins to take up space in the suppliers’ warehouses.
- Sellers now know that their price is too high, and they know that they have to lower their price if they want to attract more buyers and dispose of the surplus.
Surplus (cont.)
• Therefore, the price tends to go down as a result of the surplus, as shown in Figure 6.2a.

Shortage
• A shortage is a situation in which the quantity demanded is greater than the quantity supplied at a given price.
• When a shortage happens, producers have no more products to sell, and they end the day wishing that they had charged higher prices for their products.

Shortage (cont.)
• As a result, both the price and the quantity supplied will go up in the next trading period, as shown in Figure 6.2b.

Equilibrium Price
• The equilibrium price is the price that "clears the market" by leaving neither a surplus nor a shortage at the end of the trading period.
• While our economic model of the market cannot show exactly how long it will take to reach equilibrium, equilibrium will be reached because of the pressure that temporary surpluses and shortages put on prices.
Whenever the price is set too high, the surplus will tend to force it down, as shown in Figure 6.2c.

Whenever the price is set too low, the shortage will tend to force it up. As a result, the market tends to seek its own equilibrium, as shown in Figure 6.2d.

When the equilibrium price is reached, it will tend to remain there because the quantity supplied is exactly equal to the quantity demanded.

Something could come along to disturb the equilibrium, but then new shortages or new surpluses, or both, would appear to push the price to its new equilibrium level.

Economists use their market models to explain how the world around us works and to predict how certain events such as changes in prices might occur.

A change in price is normally the result of a change in supply, a change in demand, or changes in both.

Elasticity of demand is also important when predicting prices.
Changes in Supply

- Consider the case of agriculture, which often experiences wide swings in prices from one year to the next.
- A farmer may keep up with all the latest developments and have the best advice experts can offer, but the farmer never can be sure what price to expect for the crop.
- Weather is one of the main reasons for the variation in agricultural prices.

Changes in Supply (cont.)

- Even if the weather is perfect during the growing season, rain can still prevent the harvest from being gathered. The weather, then, often causes a change in supply.
- The result is that the supply curve is likely to shift, causing the price to go up or down.

Changes in Supply (cont.)

- Because both demand and supply for food is inelastic, a small change in supply is enough to cause a large change in the price.

Importance of Elasticity

- What would happen to prices if the demand for soybeans were highly elastic? The results would be quite different.
- Because this demand curve is much more elastic, the prices would only range from $8 to $10 a bushel instead of from $5 to $20 a bushel.
Importance of Elasticity (cont.)

- Economists consider elasticity of demand whenever a change in supply occurs. 
- When a given change in supply is coupled with an inelastic demand curve, price changes dramatically. 
- When the same change in supply is coupled with a very elastic demand curve, the change in price is much smaller.

Changes in Demand

- A change in demand, like a change in supply, can also affect the price of a good or service. 
- All of the factors we examined in Chapter 4—changes in income, tastes, prices of related products, expectations, and the number of consumers—affect the market demand for goods and services.

Changes in Demand (cont.)

- One example is the demand for gold. Figure 6.4 shows why gold prices have changed so dramatically over a 20-year period.

Changes in Demand (cont.)

- In 1980, rising prices, uncertain economic conditions, and other factors created a high demand for gold, and the price of gold reached $850 per ounce.
Changes in Demand (cont.)

• By the mid-1990s, a combination of increased supply and reduced demand drove the price of gold down to the $400 level.

Figure 6.4

The Price of Gold When Supply and Demand Change

Changes in Demand (cont.)

• In early 1999, the Bank of England announced plans to sell slightly more than half of its official gold stock, causing the supply curve to shift and the price of gold to reach a new low of $280 an ounce.

Figure 6.4

The Price of Gold When Supply and Demand Change

Changes in Demand (cont.)

• However the price of gold fluctuates, one thing is certain—everything depends on the demand and the supply.

• Whenever economic conditions or political instability threatens, people tend to increase their demand for gold and drive the price up.

• Whenever the supply of gold increases dramatically—as when a major holder of gold like the Bank of England sells half of its gold holdings—the supply of gold increases, driving the price down.

The Competitive Price Theory

• The theory of competitive pricing represents a set of ideal conditions and outcomes.

• The theory is important because it serves as a model by which to measure the performance of other, less competitive market structures.

• Even so, many markets come reasonably close to the ideal.
The Competitive Price Theory (cont.)

- The prices of some foods such as milk, flour, bread, and many other items in your community will be relatively similar from one store to the next.
- The great advantage of competitive markets is that they allocate resources efficiently.
- As sellers compete to meet consumer demands, they are forced to lower the price of their goods, which in turn encourages them to keep their costs down.

The Competitive Price Theory (cont.)

- At the same time, competition among buyers helps prevent prices from falling too far.
- In the final analysis, the market economy is one that “runs itself.”

Section Assessment

Q Main Idea Explain how a change in demand can affect prices.

A Changes in income, tastes, and so on affect demand and, therefore, price.

Section Assessment (cont.)

Q Describe how prices are determined in a competitive market.

A Prices are adjusted through competition between buyers and sellers.
**Section Assessment (cont.)**

**Q** Explain why economic models are useful.

**A** They show how markets work by helping analyze behavior and predict outcomes.

**Q** Explain how different cases of demand and supply elasticity are related to price changes.

**A** The more elastic, the smaller the price change; the less elastic, the larger the price change.

**Q** Understanding Cause and Effect

What signal does a high price send to buyers and sellers?

**A** A high price tells buyers that they should buy less and tells sellers they should offer more.

**Q** Making Inferences

What do merchants usually do to sell items that are overstocked? What does this tell you about the equilibrium price for the product?

**A** They lower the price of the items. The equilibrium price is lower than the present price.
Section 2-Assessment 7

Discuss the following:
Price represents the balancing of the forces of demand and supply.

Section Close

End of Section 2

Click the mouse button to return to the Contents slide.

Study Guide

Main Idea
To achieve one or more of its social goals, government sometimes sets prices.

Reading Strategy
Graphic Organizer As you read the section, complete a cause-and-effect chart similar to the one on page 150 of your textbook by explaining how price ceilings affect quantity supplied.

Key Terms
- price ceiling
- target price
- minimum wage
- nonrecourse loan
- price floor
- deficiency payment

Objectives
After studying this section, you will be able to:
- Describe the consequence of having a fixed price in a market.
- Explain how loan supports and deficiency payments work.
- Understand what is meant when “markets talk.”

Study Guide (cont.)
Study Guide (cont.)

Applying Economic Concepts

Price Floor Chances are that you have worked for the minimum wage at some time in your life. Why is this an example of a price floor?

Introduction

- Chapter 2 examined seven broad economic and social goals that most people seem to share.
- Attempts to achieve two of these goals—equity and security—usually require policies that distort market outcomes.
- In other words, we may have to give up a little efficiency and freedom in order to achieve equity and security.
- Whether this is good or bad often depends on a person’s perspective.

Introduction (cont.)

- After all, the person who receives a subsidy is more likely to support it than is the taxpayer who pays for it.
- In general, it is usually wise to evaluate each situation on its own merits, as the benefits of a program may well exceed the costs.
- What is common to all of these situations, however, is that the outcomes can be achieved only at the cost of interfering with the market.

Distorting Market Outcomes

- One of the common ways of achieving social goals involves setting prices at “socially desirable” levels.
- When this happens, prices are not allowed to adjust to their equilibrium levels, and the price system cannot transmit accurate information to other buyers and sellers in the market.
**Price Ceilings**

- A **price ceiling** is a maximum legal price that can be charged for a product.

- For example, without the price ceiling, the market establishes monthly rents at $900, which is an equilibrium price because 2 million apartments would be supplied and rented at that rate.

**Price Ceilings (cont.)**

- If authorities think $900 is too high, and if they want to achieve the social goals of equity and security for people who cannot afford these rents, they can establish, arbitrarily, a price ceiling at $600 a month.

**Price Ceilings** (cont.)

- Demand for apartments would increase. Landlords, on the other hand, would try to convert some apartments to other uses, leaving a shortage of 800,000 apartments.

**Price Ceilings (cont.)**

- The price ceiling, like any other price, affects the allocation of resources—but not in the way intended.

- The attempt to limit rents makes some people happy, until their buildings begin to deteriorate.

- Others, including landlords and potential renters on waiting lists, are unhappy from the beginning.

- Finally, some scarce resources—those used to build and maintain apartments—are slowly shifted out of the rental market.
Price Floors

- Other prices often are considered too low and so steps are taken to keep them higher.
- The minimum wage, the lowest legal wage that can be paid to most workers, is a case in point.
- The minimum wage is actually a price floor, or lowest legal price that can be paid for a good or service.

Price Floors (cont.)

- For example, use a minimum wage of $5.15 per hour as an illustration of a price floor.
- At this wage, the supply curve shows that 14 million people would want to offer their services.

Price Floors (cont.)

- According to the demand curve for labor, however, only 10 million would be hired—leaving a surplus of 4 million workers.

Price Floors (cont.)

- Some economists argue that the minimum wage actually increases the number of people who do not have jobs because employers hire fewer workers.
Agricultural Price Supports

- In the 1930s, the federal government established the Commodity Credit Corporation (CCC), an agency in the Department of Agriculture, to help stabilize agricultural prices.
- The stabilization took two basic forms—the first involved loan supports, and the second involved deficiency payments.
- Both made use of a target price, which is essentially a price floor for farm products.

Loan Supports (cont.)

- Under the loan support program, a farmer borrowed money from the CCC at the target price and pledged his or her crops as security in return.

Loan Supports

- Because the loan was a nonrecourse loan—a loan that carries neither a penalty nor further obligation to repay if not paid back—the farmer could get at least the target price for his or her crops.

Deficiency Payments

- The CCC loan program created problems because the U.S. Department of Agriculture soon owned enormous stockpiles of food.
- The solution was to have farmers sell their crops on the open market for the best price they could get and then have the CCC make up the difference with a deficiency payment—a check sent to producers that makes up the difference between the actual market price and the target price.
Deficiency Payments (cont.)

- For example, under a deficiency payment program, the farmer made $25,000 by selling 10,000 bushels at $2.50 each on the open market.

Reforming Price Supports

- In an effort to make agricultural output responsive to market forces, Congress passed the Federal Agricultural Improvement and Reform (FAIR) Act of 1996.
- Under this law, eligible producers of grains, cotton, and rice can enter into a seven-year program that allows them almost complete flexibility to plant any crop on any land.
- Under FAIR, cash payments take the place of price supports and deficiency payments.

Reforming Price Supports (cont.)

- Because these new payments have turned out to be as large as the ones they replaced, however, the overall cost of farm programs has not gone down.
- When the program expires in the year 2002, farmers will cease to receive all payments.
- If farm income is still down when the bill expires, Congress may decide to bring farm support back—thereby choosing the goal of economic security over efficiency.

When Markets Talk

- Markets are impersonal mechanisms that bring buyers and sellers together.
- Although markets do not talk in the usual sense of the word, they do communicate in that they speak collectively for all of the buyers and sellers who trade in the markets.
- Markets are said to talk when prices in them move up or down significantly.
Section Assessment

**Main Idea** Using your notes from the graphic organizer activity on page 150 of your textbook, describe why price ceilings are often set.

**A** Price ceilings are set to achieve equity and security.

Section Assessment (cont.)

**Describe** two effects of having a fixed price other than the equilibrium price forced on a market.

**A** Shortages result if prices are set below equilibrium. Surpluses result if prices are set above it.

Section Assessment (cont.)

**Explain** how loan supports and deficiency payments work.

**A** Loan supports allow farmers to borrow against crops. Deficiency payments supply farmers with checks for the difference between the target price and the actual price.

Section Assessment (cont.)

**Describe** how markets speak collectively for buyers and sellers.

**A** The significant movements of prices, either up or down, signals the collective decisions.
Section Assessment (cont.)

Q Price Floor Would small businesses be more affected by a change in the minimum wage than large businesses? Explain your answer.
A Salaries represent a larger percentage of costs for small businesses.

Section Assessment (cont.)

Q Understanding Cause and Effect The price of fresh fruit over the course of a year may go up or down by as much as 100 percent. Explain the causes for these changes in terms of changes in supply, and the elasticity of demand for fresh fruit.
A Supply is affected by seasons and by weather. Because demand tends to be stable and slightly inelastic, a change in supply can cause a large change in price.

Section Close

Prices can be viewed as signals. Create a logo or symbol that illustrates this idea.
Section 1: Prices as Signals

- Prices serve as signals to both producers and consumers. In doing so, they help decide the three basic WHAT, HOW, and FOR WHOM questions that all societies face.
- High prices are signals for businesses to produce more and for consumers to buy less. Low prices are signals for businesses to produce less and for consumers to buy more.
- Prices have the advantages of neutrality, flexibility, efficiency, and clarity.

Section 1: Prices as Signals (cont.)

- Other nonprice allocation methods such as rationing can be used. Under such a system, people receive ration coupons, which are similar to tickets or receipts that entitle the holder to purchase a certain amount of a product.
- Nonprice allocation systems suffer from problems regarding fairness, high administrative costs, and diminished incentives to work and produce.
- A market economy is made up of many different markets, and different prices prevail in each. A change in price in one market affects more than the allocation of resources in that market. It also affects the allocation of resources between markets.

Section 2: The Price System at Work

- Economists often use an economic model to help analyze behavior and predict outcomes. Models of economic markets are often represented with supply and demand curves in order to examine the concept of market equilibrium, a situation in which prices are relatively stable, and the quantity of output supplied is equal to the quantity demanded.
- In a competitive market, prices are established by the forces of supply and demand. If the price is too high, a temporary surplus appears until the price goes down. If the price is too low, a temporary shortage appears until the price rises. Eventually the market reaches the equilibrium price where there is neither a shortage nor a surplus.

Section 2: The Price System at Work (cont.)

- A change in price can be caused by a change in supply or a change in demand. The size of the price change is affected by the elasticity of both curves. The more elastic the curves, the smaller the price change; the less elastic the curves, the larger the price change.
- The theory of competitive pricing represents a set of ideal conditions and outcomes. The theory serves as a model by which to measure the performance of other, less competitive markets. Because of this, absolutely pure competition is not needed for the theory of competitive pricing to be practical.
Section 3: Social Goals vs. Market Efficiency

- Governments sometimes fix prices at levels above or below the equilibrium price to achieve the social goals of equity and security.

- If the fixed price is a price ceiling, as in the case of rent controls, a shortage usually appears for as long as the price remains fixed below the equilibrium price.

- Agricultural price supports were introduced during the 1930s to support farm incomes. Nonrecourse loan support programs allowed farmers to borrow against crops, and then keep the loan and forfeit the crop if market prices were low.

Later, deficiency payments were used, supplying the farmer with a check that made up the difference between the target price and the actual price received for the product.

Identifying Key Terms

Identify the key term that is an effect of the five causes stated below. Some causes may have more than one effect.

**Cause:** The government tries to keep prices down by legislating price ceilings. **Effect:** ___

**Cause:** The government wants to allocate scarce goods and services without the help of a price system. **Effect:** ___

**Cause:** A reasonably competitive market is experiencing alternating, yet consecutively smaller, surpluses and shortages. **Effect:** ___

A. rationing  E. equilibrium price
B. economic model  F. loss leader
C. surplus  G. price ceiling
D. shortage  H. price floor
Identifying Key Terms (cont.)

Identify the key term that is an effect of the five causes stated below. Some causes may have more than one effect.

**Cause:** People decide that farmers should receive a higher price for milk and cheese, so a price floor for these products is established. **Effect:** C

**Cause:** A market is at equilibrium, but the product falls out of style before producers can reduce production. **Effect:** C

A. rationing  E. equilibrium price  
B. economic model  F. loss leader  
C. surplus  G. price ceiling  
D. shortage  H. price floor

Reviewing the Facts

**Q** Describe four advantages of using price as an allocating mechanism.

A. Prices are neutral, favoring neither producer nor consumer, and flexible, allowing the market economy to accommodate change. Prices have no administrative costs and are efficient because they are understood by all.

Reviewing the Facts (cont.)

**Q** List three problems of allocating goods and services using nonprice-related methods.

A. establishing fair system of allocation; cost of administering system; negative impact system has on incentive to work and produce

Reviewing the Facts (cont.)

**Q** Cite an example of an economic model used in this chapter.

A. Examples may include graphs of supply and demand curves.
Reviewing the Facts (cont.)

Q Explain the role of shortages and surpluses in competitive markets.

A shortage: the quantity demanded is greater than the quantity supplied at a given price, and prices will go up; surplus: the quantity supplied is greater than the quantity demanded, and prices will go down.

Reviewing the Facts (cont.)

Q Describe three causes of a price change in a market.

A a change in supply, a change in demand, or a change in both.

Reviewing the Facts (cont.)

Q Explain why shortages and surpluses are not temporary when price controls are used.

A At lower prices there is no incentive for producers to produce more, so shortages continue. At higher prices there is no incentive to buy, so surpluses remain.

Reviewing the Facts (cont.)

Q Identify two programs that have historically been used to stabilize farm incomes.

A loan supports, deficiency payments.
Reviewing the Facts (cont.)

Q Explain what is meant by the statement that markets “talk.”

A The significant movement of prices up or down reflects the judgments of all buyers and sellers in the market. Enough buyers or sellers cause significant price movements that communicate to all buyers and sellers.

Thinking Critically

Q Making Generalizations Some people argue that the minimum wage is not a fair price. Use a web like the one on page 158 of your textbook to help you identify reasons for this argument. Explain why you agree or disagree.

A Answers will vary.

Thinking Critically (cont.)

Q Making Predictions Suppose that your state wanted to make health care more affordable for everyone. To do this, state legislators put a series of price controls—price ceilings—in place that cut the cost of medical services in half. What would happen to the demand for medical services at the new, lower price? What would happen to the supply of medical services that doctors would be willing to provide at the new, lower price? Where do you think new doctors would prefer to set up practice? Explain the reasons for your answers.

A Because demand for medical services tends to be inelastic, the quantity demanded will increase only moderately. Because prices for services would be set below market level, there would be less incentive for doctors to offer services. Quantity supplied would probably decrease. New doctors might want to set up practice in states where there were no price ceilings.

Applying Economic Skills

Q Rationing Suppose that a guest speaker visited your class and left 20 ballpoint pens as samples—not knowing that there were 30 students in the class. Devise a nonprice rationing system that would fairly allocate the scarce item to everyone in the class.

A Rationing systems will vary.
Applying Economic Skills (cont.)

Equilibrium Price

Many people feel that the minimum wage is too low. If it increased by $1 per hour, what would happen to the number of students who would want to work after school? What would happen to the number of workers that stores in your community would want to hire? Would the combination of these factors cause a shortage or a surplus of workers in your community? Provide an explanation for each of your answers.

At a higher minimum wage, there would be more incentive for workers to sell their labor. The number of students wanting to work after school would increase. The higher cost of labor would result in store managers hiring fewer workers, so there might be a surplus of workers.

Chapter Bonus Question

Identify what will happen to prices in the following situations: (1) Supply decreases and demand is elastic. (2) Supply increases and demand is inelastic. (3) A surplus exists. (4) Supply remains constant but demand increases. (5) A shortage exists.

A (1) prices rise slightly; (2) prices fall markedly; (3) prices fall; (4) prices rise; (5) prices rise.
Focus Activity 1.1
Continued on next slide.

Focus Activity 1.2
Continued on next slide.

Focus Activity 2.1
Continued on next slide.

Focus Activity 2.2
Continued on next slide.

FOCUS ACTIVITIES Transparency 25

Price as Signals

1. How important do you think price is in making a major purchase, such as a car, as opposed to making a relatively smaller purchase such as a compact disc?

2. What might happen to the price of the car if most potential buyers, like the young person in the picture, choose not to buy the car?

FOCUS ACTIVITIES Transparency 14

Changes in Supply and Equilibrium

1. In the supply-demand model, how is equilibrium indicated?

2. If the economic model of supply is a “vast oversimplification,” why do economists use it?

“Rather amazingly, equilibrium is reached through thousands of individual decisions. It is the price and quantity levels to which the forces of the marketplace naturally gravitate. No one tells anyone else what to do. The bottom line is that we have to ask what difference all of this makes since [the supply-demand model] obviously is a vast oversimplification of our economic behavior. The answer is that the tendency [that] the graphs and schedules portray really are typical behaviors.”

—Elaine Schwartz, economist

Changes in Supply and Equilibrium

1. In the supply-demand model, how is equilibrium indicated? The point where supply and demand curves intersect.

2. If the economic model of supply is a “vast oversimplification,” why do economists use it? Despite its simplification, it does an excellent job of representing complex, real-world behaviors.

—Elaine Schwartz, economist
Write an essay on the role that prices play in the market economy. Illustrate your essay with examples, charts, and graphs. Present and discuss your essay.

Explore online information about the topics introduced in this chapter.

Click on the Connect button to launch your browser and go to the Economics: Principles and Practices Web site. At this site, you will find interactive activities, current events information, and Web sites correlated with the chapters and units in the text. When you finish exploring, exit the browser program to return to this presentation. If you experience difficulty connecting to the Web site, manually launch your Web browser and go to http://epp.glencoe.com.
Explore online information about the topics introduced in this chapter.

Click on the Connect button to launch your browser and go to the BusinessWeek Web site. At this site, you will find up-to-date information dealing with all aspects of economics. When you finish exploring, exit the browser program to return to this presentation. If you experience difficulty connecting to the Web site, manually launch your Web browser and go to http://www.businessweek.com

Consumer Confidence  A statistic called the Consumer Confidence Index attempts to gauge consumers’ feelings about the current condition of the economy and their expectations about the economy’s future direction. The index is weighted 60% in favor of expectations and 40% in favor of current conditions. Large movements in this index indicate or signal changes in consumer spending patterns.

Comparing Food Prices  The top ten countries in terms of cost of living are, in order from highest to lowest: Japan, Hong Kong, Russia, Norway, Switzerland, France, Gabon, United Kingdom, Singapore, and Taiwan. The United States is ranked 17th in cost of living.

The Price of Ivory  In 1989, Kenyan president Daniel Arap Moi ordered officials to burn 2,400 African elephant tusks that had been confiscated from poachers. Some economists were very critical of this policy. By reducing the supply of tusks on the world market, they argued, the price of ivory rose on world markets. This provided a stronger incentive for poachers to kill more elephants. Other economists argued that burning the tusks generated a lot of publicity about the plight of African elephants, and may have decreased demand for ivory.
Economists sometimes refer to a surplus as excess supply and a shortage as excess demand.

Outside the Law In the case of body organs, the government has imposed a price control of zero. While people are allowed to donate organs upon their death, anyone caught selling human organs can get up to five years in prison or a $50,000 fine. Price controls like this, however, often engender black markets. In 1999, for example, someone offered to sell a kidney on eBay, an online auction site. The bidding rose to $5.7 million before eBay cancelled the illegal auction.

Many considerations are involved in an individual's choice of jobs. These include not only whether and how much to work, but where to work.

Read the BusinessWeek Newsclip article on page 156 of your textbook. Think about what influences affect labor demand. What influences affect labor mobility?

Doctors: Charting New Territory

Q Sequencing Information What trend does the RAND research show regarding doctors’ choices of location?

A RAND research shows that generalists and specialists are settling in metro areas with low HMO penetration.
Doctors: Charting New Territory

Finding the Main Idea
What theory do the researchers offer to support this relocation trend?

Doctors are trying to avoid HMOs because these organizations often curb the demand for their services.

Understanding Cause and Effect
Do you think the theory is the best explanation for the trend? What other factors affect where doctors locate their practices?

Answers will vary.

Economics and You
Video 12: The Price System at Work

Objectives
After viewing The Price System at Work, you should be able to:

- Explain how prices are determined by the forces of supply and demand.
- Understand how and why producers use rebates to spur demand.
- Define and explain the goal of a cartel.
- Outline the dynamics of price fluctuation in the agricultural market.
What role did the incentives and rebates play in consumers’ willingness to buy automobiles?

By reducing the final prices of the automobiles, the rebates and incentives had a positive effect on consumer demand for cars.

Synthesizing information involves integrating information from two or more sources. The ability to synthesize, or combine, information is important because information gained from one source often sheds new light upon other information.

Learning the Skill

- Analyze each source separately to understand its meaning.
- Determine what information each source adds to the subject.
- Identify points of agreement and disagreement between the sources. Ask: Can Source A give me new information or new ways of thinking about Source B?

- Find relationships between the information in the sources.
Synthesizing Information

Practicing the Skill
• Study the sources on page 149 of your textbook, then answer the questions on the following slides.

[Continue on next slide]

Synthesizing Information

Q What is the main subject of each excerpt?
A Source A is about the consumer’s decision to either borrow money for a new car, or to pay cash for a less expensive used car. Source B is about borrowing and buying on credit.

[Continue on next slide]

Synthesizing Information

Q What kind of information does Source A add to this subject?
A Source A adds research results, and advantages and disadvantages.

[Continue on next slide]

Synthesizing Information

Q What kind of information does Source B add to this subject?
A Source B considers consumers’ feelings and opinions.
Synthesizing Information

Q Does Source B support or contradict Source A? Explain.

A Both Sources A and B provide information about the economic decision of whether to make purchases using credit.

Continued on next slide.

Synthesizing Information

Q Summarize what you have learned from both sources.

A Answers will vary.

Continued on next slide.

Profiles in Economics 1.1

This feature is found on page 141 of your textbook.

Continued on next slide.

Profiles in Economics 1.2

How are Becker’s and Friedman’s ideas similar and different?

A Becker’s and Friedman’s ideas are similar in that they view economic conditions and decisions as fundamental to other aspects of life; they differ in that Becker focuses on the micro, specifically the decision-making of individuals, while Friedman focuses on the macro, specifically the importance of the supply of money or monetary policy.

Continued on next slide.
Q For Further Research Read an article or book by Becker or Friedman. Present a summary of the work to the class.

A Answers will vary.