**ECON 1000 – Contemporary EconomicIssues “How a Market System Functions”**

# Relevant Readings from the Required Textbooks:

* Chapter 4, *Organizing Principles of Capitalist Systems*

# Definitions and Concepts:

* **money** – an asset that is socially and legally accepted as a medium of exchange.
* three functions of money:
  + **medium of exchange** – an asset used as payment when purchasing goods/services
  + **store of value** – an asset that serves as a means of holding wealth
  + **unit of measure** – a basic measure of economic activity
* **demand** – the relationship between the price of a good and the quantity that consumers are willing and able to purchase, all other factors fixed
* **supply** – the relationship between the price of a good and the quantity that firms are willing and able to sell, all other factors fixed
* **Law of Demand** – all other factors fixed, a greater quantity of a good will be demanded at lower prices (demand curves are downward sloping).
* **Law of Supply** – all other factors fixed, a greater quantity of a good will be supplied at higher prices (supply curves are upward sloping).
* “**Horizontal Interpretation” of Demand Curve** – start by focusing on a particular price, and then go over to the demand curve horizontally to determine the corresponding quantity demanded at this particular price.
* “**Vertical Interpretation” of Demand Curve** – start by focusing on a particular quantity demanded, and then go up to the demand curve vertically to determine the corresponding price at which this particular quantity would be demanded.
* “**Horizontal Interpretation” of Supply Curve** – start by focusing on a particular price, and then go over to the supply curve horizontally to determine the corresponding quantity supplied at this particular price.
* “**Vertical Interpretation” of Supply Curve** – start by focusing on a particular quantity supplied, and then go up to the supply curve vertically to determine the corresponding price at which this particular quantity would be supplied.
* **buyer's reservation price** – the maximum amount of money that he is willing to give up to acquire the item.
* **seller’s reservation price** – the minimum amount of money that she is willing to accept in exchange for the item.
* **equilibrium** – a “stable state” for a system which will persist as long as outside factors do not change.
  + at the market equilibrium no individual buyer and no individual seller can alter his or her own behavior in such a way as to increase his or her own surplus.
* **excess supply** – a situation in which quantity supplied is greater than quantity demanded (resulting in “downward pressure” on price).
* **excess demand** – a situation in which quantity demanded is greater than quantity supplied (resulting in “upward pressure” on price).
* The Market Equilibrium in the model of Supply and Demand is:
  + **stable** – if we are there we will stay there, unless outside forces change
  + **unique** – there is one and only one equilibrium, a property which follows from the “Law of Demand” and “Law of Supply”
  + **self enforcing** – at higher prices there is downward pressure on price; at lower prices there is upward pressure on price – therefore if we are at some other price, we will be pushed toward the equilibrium price
* **Increase in Demand** – a change in demand consistent with consumers being more willing to purchase the good, in that at every price the new quantity demanded is greater than the previous quantity demanded (visually, such a change is illustrated as a “rightward shift” of the demand curve).
* **Decrease in Demand** – a change in demand consistent with consumers being less willing to purchase the good, in that at every price the new quantity demanded is less than the previous quantity demanded (visually, such a change is illustrated as a “leftward shift” of the demand curve).
* **Increase in Supply** – a change in supply consistent with firms being more willing to sell the good, in that at every price the new quantity supplied is greater than the previous quantity supplied (visually, such a change is illustrated as a “rightward shift” of the supply curve).
* **Decrease in Supply** – a change in supply consistent with firms being less willing to sell the good, in that at every price the new quantity supplied is less than the previous quantity supplied (visually, such a change is illustrated as a “leftward shift” of the supply curve).
* **Determinants of Demand** (factors that change demand) – changes in the following will result in an increase in demand: (1) a decrease in the price of a Complement Good; (2) an increase in the price of a Substitute Good; (3) an increase in income (for a Normal Good); (4) a decrease in income (for an Inferior Good); (5) an increased

preference for the good by consumers; (6) an increase in “market size”; (7) an expectation of higher future prices. Changing any of these factors in “the opposite direction” would result in a decrease in demand.

* **Determinants of Supply** (factors that change supply) – changes in the following will result in an increase in supply: (1) a decrease in the cost of any factors of production used to produce the good; (2) an improvement in technology that reduces production costs; (3) a favorable realization of “natural events”; (4) an increase in “market size”;

(5) an expectation of lower future prices. Changing any of these factors in “the opposite direction” would result in a decrease in supply.

* **Role of Profits in a free market economy** – profits serve as a vital “signaling device” in free market economies, directing resources to their most valuable use.
* **entrepreneur** – someone who organizes and manages a business, typically with considerable initiative and exposure to risk.
* **Role of the Entrepreneur** – profits can only serve as effective signals insofar as someone is able to recognize, appreciate, and respond according to different levels of profit.
* **Spontaneous Order** – the natural and undirected emergence of order out of seeming chaos
* three surprising insights from “I, Pencil”:
  + no one person possesses the know-how to make a pencil
  + most who helped make the pencil did not intend to or necessarily care to specifically make a pencil
  + but yet, the entire process takes place (and valued goods, such as pencils, are produced) without any planner overseeing or dictating the process

Chapter 4 Study Guide

1. Which of the following could NOT result in a “Change in Supply” for “I-Pads ”?
   1. An improvement in the technology used to produce I-Pads .
   2. A decrease in the price of plastic (an input used in the production of I-Pads).
   3. An increase in the market price of I-Pads .
   4. A decrease in the number of sellers of I-Pads
2. Which markets are represented in the simple “Circular Flow Diagram”?
   1. Markets for “Imports and Exports” and markets for “Factors of production.”
   2. Markets for “Goods and Services” and markets for “Factors of Production.”
   3. Markets for “Financial Assets” and markets for “Imports and Exports.”
   4. Markets for “Goods and Services” and markets for “Financial Assets.”
3. One of the principle functions of money is that it serves as a “unit of account.” This role could be described by recognizing that money
4. is an asset used as payment when purchasing goods and services.
5. is an asset that can be used as a means to hold wealth.
6. is used as a basic unit of measuring economic activity.
7. None of the above answers are correct.
8. During the last several decades, health officials in the United States have argued that eating too much beef might be harmful to humans. As a result, there has been a significant decrease in the amount of beef produced. Which of the following best explains this decrease in production?
9. Government officials ordered beef producers to produce relatively less
10. Animal Rights Activists have made it difficult for both buyers and sellers of beef to freely trade the good in free markets.
11. Beef producers (whose primary concern is the health of their customers) decided to produce relatively less beef.
12. Individual consumers (concerned about their own health) decreased their demand for

beef (resulting in a decrease in both the equilibrium price and equilibrium quantity of beef).

1. Supply
2. refers to the entire relationship between the price of a good and the number of units that firms are willing and able to sell, all other factors fixed.
3. refers to the amount of a good that firms are willing to sell at the equilibrium price.
4. provides a summary of the behavior of buyers in a market.
5. More than one (perhaps all) of the above answers is correct.
6. The “Circular Flow Diagram”
7. summarizes the different combinations of output that a society could produce, given their currently available productive resources.
8. illustrates how Supply and Demand interact to determine the unique equilibrium price and equilibrium quantity in a market.
9. illustrates the interaction between households and firms in a simplified free market economy.
10. None of the above answers are correct.
11. Privately owned enterprises in a free market economy have a primary goal of
    1. exploiting workers.
    2. earning as large of a profit as possible.
    3. tricking consumers into thinking that they are “environmentally conscious.”
    4. More than one (perhaps all) of the above answers is correct.
12. An increase in income will result in a decrease in demand for
    1. a normal good
    2. an inferior good
    3. a substitute good
    4. a complementary good
13. Between August 2013 and August 2016 there was an increase in both price and quantity traded of corn. This change in market equilibrium outcome would result from
14. an increase in Demand
15. a decrease in Demand.
16. an increase in Supply.
17. a decrease in Supply.
18. refers to someone who organizes, manages, and assumes the risks of a firm, taking a new idea or a new product and turning it into a successful business.
19. An Invisible Hand
20. An Entrepreneur
21. A Central Planner
22. A Social Surplus
23. Which of the following demonstrates the “Law of Demand”?
24. After Clarissa got a raise at work, she bought more donuts at $6 per dozen than she did before her raise.
25. After the price of flour increased by 12%, Sabrina chose to sell fewer donuts.
26. Melissa chooses to sell more donuts at $7.25 per dozen than she chooses to sell at

$6.75 per dozen.

1. Joan chooses to buy fewer donuts at $9.00 per dozen than she chooses to buy at

$7.75 per dozen.

1. Consider the market for oranges. If there is “excess demand” at a price of $2.35, then the equilibrium price must be:
2. above $2.35.
3. exactly equal to $2.35.
4. below $2.35.
5. None of the above answers are correct
6. In a “free market economy” profits
   1. refer to the “gain” that a buyer gets from purchasing a good/service.
   2. serve as a “signaling device,” directing resources to their most valued uses.
   3. are only earned by firms who exploit workers.
   4. More than one (perhaps all) of the above answers is correct.
7. Last weekend Brenda won $1,500 at a casino in Biloxi, Mississippi. She decided to use the money to purchase a new TV from Walmart. She was able to use the money to acquire the new TV since money serves as a
8. contract.
9. medium of exchange.
10. store of value.
11. unit of account.
12. Assume that Ford Motor Company engineers achieve a revolutionary technological advance in the production process of automobiles. Which of the following events would you expect to occur?
13. A movement up along an existing supply curve for Ford automobiles
14. A movement down along an existing supply curve for Ford automobiles
15. A shift inward of the supply curve for Ford automobiles
16. A shift outward of the supply curve for Ford automobiles



0 100 200 300 400 500

*S*

50

40

30

20

10

*D*

Quantity

1. Consider the market described by the demand and supply curves in the figure above. Which of the following is true if the current market price is $40 perunit?
2. The quantity sold is 400 units.
3. There is a shortage of 200 units.
4. The quantity demanded is 200 units.
5. The quantity supplied is 200 units.
6. The “Law of Demand” implies that
7. if the price of a good increases, then the quantity demanded of the good will decrease.
8. demand curves should be “downward sloping.”
9. demand for a good will increase if consumers realize an increase in income.
10. More than one (perhaps all) of the above answers is correct.
11. A “seller’s reservation price”
    1. refers to the maximum dollar amount a buyer is willing to pay for an item.
    2. refers to the minimum dollar amount a seller is willing to accept in exchange for an item.
    3. is visually illustrated by the vertical distance between the demand curve and the supply curve.
    4. More than one (perhaps all) of the above answers is correct.
12. In a free market, the equilibrium quantity of trade and equilibrium price of a good are determined by
    1. the interaction of both self-interested buyers and self-interested sellers in the marketplace.
    2. only the buyers in the market.
    3. only the sellers in the market.
    4. neither buyers nor sellers, but rather by a government bureaucrat.
13. A freeze in Peru causes the price of coffee to skyrocket. Which of the following will happen?
14. The demand for coffee will increase, and the demand for tea will increase.
15. The demand for coffee will increase, and the quantity demanded of tea will increase.
16. The quantity demanded of coffee will decrease, and the demand for tea will increase.
17. The quantity demanded of coffee will increase, and the demand for tea will increase.

For questions 21 refer to the graph below. This graph illustrates the supply and demand for hats in 2016.

Price

Supply 2016

17.75

12.00

7.50

0

*(a)*

*(e)*

*(c)*

*(b)*

*(f)*

*(g)*

Demand 2016

quantity

0 1,850 3,700 5,150

*(d)*

1. In equilibrium, hats will be traded, each at a price of . A. (5,150); ($17.75).

B. (3,700); ($12.00).

C. (1,850); ($7.50).

D. None of the above answers are correct.

Answers

1. C 2.B 3.C

4.D

5.A

6.C

7.B

8.B

9.A

10.B

11.D

12.A

13.B

14.B

15.D

16.C

17.D

18.B

19.A

20.C

21. B