Key Terms

interest rate the "price" of borrowing in the financial market; a rate of return on an investment
minimum wage a price floor that makes it illegal for an employer to pay employees less than a certain hourly rate
usury laws laws that impose an upper limit on the interest rate that lenders can charge

Key Concepts and Summary

4.1 Demand and Supply at Work in Labor Markets

In the labor market, households are on the supply side of the market and firms are on the demand side. In the market for financial capital, households and firms can be on either side of the market: they are suppliers of financial capital when they save or make financial investments, and demanders of financial capital when they borrow or receive financial investments.

In the demand and supply analysis of labor markets, we can measure the price by the annual salary or hourly wage received. We can measure the quantity of labor various ways, like number of workers or the number of hours worked.

Factors that can shift the demand curve for labor include: a change in the quantity demanded of the product that the labor produces; a change in the production process that uses more or less labor; and a change in government policy that affects the quantity of labor that firms wish to hire at a given wage. Demand can also increase or decrease (shift) in response to: workers' level of education and training, technology, the number of companies, and availability and price of other inputs.

The main factors that can shift the supply curve for labor are: how desirable a job appears to workers relative to the alternatives, government policy that either restricts or encourages the quantity of workers trained for the job, the number of workers in the economy, and required education.

4.2 Demand and Supply in Financial Markets

In the demand and supply analysis of financial markets, the "price" is the rate of return or the interest rate received. We measure the quantity by the money that flows from those who supply financial capital to those who demand it.

Two factors can shift the supply of financial capital to a certain investment: if people want to alter their existing levels of consumption, and if the riskiness or return on one investment changes relative to other investments. Factors that can shift demand for capital include business confidence and consumer confidence in the future—since financial investments received in the present are typically repaid in the future.

4.3 The Market System as an Efficient Mechanism for Information

The market price system provides a highly efficient mechanism for disseminating information about relative scarcities of goods, services, labor, and financial capital. Market participants do not need to know why prices have changed, only that the changes require them to revisit previous decisions they made about supply and demand. Price controls hide information about the true scarcity of products and thereby cause misallocation of resources.

Self-Check Questions

1. In the labor market, what causes a movement along the demand curve? What causes a shift in the demand curve?
2. In the labor market, what causes a movement along the supply curve? What causes a shift in the supply curve?

3. Why is a living wage considered a price floor? Does imposing a living wage have the same outcome as a minimum wage?

4. In the financial market, what causes a movement along the demand curve? What causes a shift in the demand curve?

5. In the financial market, what causes a movement along the supply curve? What causes a shift in the supply curve?

6. If a usury law limits interest rates to no more than 35%, what would the likely impact be on the amount of loans made and interest rates paid?

7. Which of the following changes in the financial market will lead to a decline in interest rates:
  a. a rise in demand
  b. a fall in demand
  c. a rise in supply
  d. a fall in supply

8. Which of the following changes in the financial market will lead to an increase in the quantity of loans made and received:
  a. a rise in demand
  b. a fall in demand
  c. a rise in supply
  d. a fall in supply

9. Identify the most accurate statement. A price floor will have the largest effect if it is set:
  a. substantially above the equilibrium price
  b. slightly above the equilibrium price
  c. slightly below the equilibrium price
  d. substantially below the equilibrium price

  Sketch all four of these possibilities on a demand and supply diagram to illustrate your answer.

10. A price ceiling will have the largest effect:
  a. substantially below the equilibrium price
  b. slightly below the equilibrium price
  c. substantially above the equilibrium price
  d. slightly above the equilibrium price

  Sketch all four of these possibilities on a demand and supply diagram to illustrate your answer.

11. Select the correct answer. A price floor will usually shift:
  a. demand
  b. supply
  c. both
  d. neither

  Illustrate your answer with a diagram.

12. Select the correct answer. A price ceiling will usually shift:
  a. demand
  b. supply
  c. both
  d. neither

Review Questions

13. What is the “price” commonly called in the labor market?

14. Are households demanders or suppliers in the goods market? Are firms demanders or suppliers in the goods market? What about the labor market and the financial market?

15. Name some factors that can cause a shift in the demand curve in labor markets.

16. Name some factors that can cause a shift in the supply curve in labor markets.

17. How do economists define equilibrium in financial markets?

18. What would be a sign of a shortage in financial markets?

19. Would usury laws help or hinder resolution of a shortage in financial markets?

20. Whether the product market or the labor market, what happens to the equilibrium price and quantity for each of the four possibilities: increase in demand, decrease in demand, increase in supply, and decrease in supply.

Critical Thinking Questions

21. Other than the demand for labor, what would be another example of a “derived demand?”

22. Suppose that a 5% increase in the minimum wage causes a 5% reduction in employment. How would this affect employers and how would it affect workers? In your opinion, would this be a good policy?

23. Under what circumstances would a minimum wage be a nonbinding price floor? Under what circumstances would a living wage be a binding price floor?

24. Suppose the U.S. economy began to grow more rapidly than other countries in the world. What would be the likely impact on U.S. financial markets as part of the global economy?

25. If the government imposed a federal interest rate ceiling of 20% on all loans, who would gain and who would lose?

26. Why are the factors that shift the demand for a product different from the factors that shift the demand for labor? Why are the factors that shift the supply of a product different from those that shift the supply of labor?

27. During a discussion several years ago on building a pipeline to Alaska to carry natural gas, the U.S. Senate passed a bill stipulating that there should be a guaranteed minimum price for the natural gas that would flow through the pipeline. The thinking behind the bill was that if private firms had a guaranteed price for their natural gas, they would be more willing to drill for gas and to pay to build the pipeline.

a. Using the demand and supply framework, predict the effects of this price floor on the price, quantity demanded, and quantity supplied.
b. With the enactment of this price floor for natural gas, what are some of the likely unintended consequences in the market?
c. Suggest some policies other than the price floor that the government can pursue if it wishes to encourage drilling for natural gas and for a new pipeline in Alaska.

Problems

28. Identify each of the following as involving either demand or supply. Draw a circular flow diagram and label the flows A through F. (Some choices can be on both sides of the goods market.)

a. Households in the labor market
b. Firms in the goods market
c. Firms in the financial market
d. Households in the goods market
e. Firms in the labor market
f. Households in the financial market

29. Predict how each of the following events will raise or lower the equilibrium wage and quantity of oil workers in Texas. In each case, sketch a demand and supply diagram to illustrate your answer.

a. The price of oil rises.
b. New oil-drilling equipment is invented that is cheap and requires few workers to run.
c. Several major companies that do not drill oil open factories in Texas, offering many well-paid jobs outside the oil industry.
d. Government imposes costly new regulations to make oil-drilling a safer job.

30. Predict how each of the following economic changes will affect the equilibrium price and quantity in the financial market for home loans. Sketch a demand and supply diagram to support your answers.

a. The number of people at the most common ages for home-buying increases.
b. People gain confidence that the economy is growing and that their jobs are secure.
c. Banks that have made home loans find that a larger number of people than they expected are not repaying those loans.
d. Because of a threat of a war, people become uncertain about their economic future.
e. The overall level of saving in the economy diminishes.
f. The federal government changes its bank regulations in a way that makes it cheaper and easier for banks to make home loans.

31. Table 4.6 shows the amount of savings and borrowing in a market for loans to purchase homes, measured in millions of dollars, at various interest rates. What is the equilibrium interest rate and quantity in the capital financial market? How can you tell? Now, imagine that because of a shift in the perceptions of foreign investors, the supply curve shifts so that there will be $10 million less supplied at every interest rate. Calculate the new equilibrium interest rate and quantity, and explain why the direction of the interest rate shift makes intuitive sense.

Interest Rate	Qs	Qd
5%	130	170
6%	135	150
7%	140	140
8%	145	135
9%	150	125
10%	155	110

TABLE 4.6

32. Imagine that to preserve the traditional way of life in small fishing villages, a government decides to impose a price floor that will guarantee all fishermen a certain price for their catch.

a. Using the demand and supply framework, predict the effects on the price, quantity demanded, and quantity supplied.
b. With the enactment of this price floor for fish, what are some of the likely unintended consequences in the market?
c. Suggest some policies other than the price floor to make it possible for small fishing villages to continue.

33. What happens to the price and the quantity bought and sold in the cocoa market if countries producing cocoa experience a drought and a new study is released demonstrating the health benefits of cocoa? Illustrate your answer with a demand and supply graph.