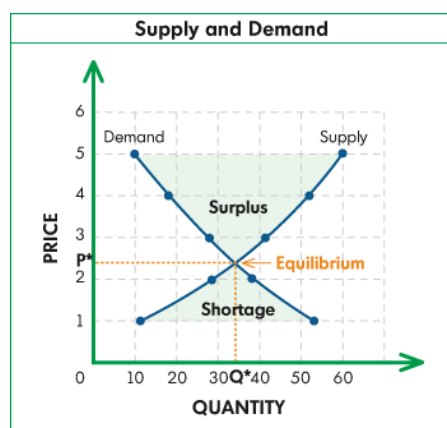


Individual Markets: Demand and Supply



Characteristics of the Market System

- Private individuals and firms own most of the private property (land and capital).
 - Private property, coupled with the freedom to negotiate binding legal contracts, enables individuals and businesses to obtain, control, use, and dispose of this property.
 - Private property rights encourage investment, innovation, exchange of assets, maintenance of property, and economic growth.
 - Property rights extend to intellectual property through patents, copyrights, and trademarks.
- Freedom of enterprise and choice exist.
 - Freedom of enterprise means that entrepreneurs and businesses have the freedom to obtain and use resources, to produce products of their choice, and to sell these products in the markets of their choice.
 - Freedom of choice means:
 - Owners of property and money resources can use resources as they choose.
 - Workers can choose the training, occupations, and job of their choice.
 - Consumers are free to spend their income in such a way as to best satisfy their wants (consumer sovereignty).
- Self-interest
 - Self interest is one of the driving forces in a market system. Entrepreneurs try to maximize profits or minimize losses; resource suppliers try to maximize income; consumers maximize satisfaction.
 - As each tries to maximize profits, income, satisfaction, the economy will benefit if competition is present.
- Competition among buyers and sellers is a controlling mechanism.

- Large numbers of sellers mean that no single producer or seller can control the price or market supply.
 - Large number of buyers means that no single consumer or employer can control the price or market demand.
 - Depending upon market conditions, producers can enter or leave industry easily.
- Markets and prices
 - A market system conveys the decisions of the many buyers and sellers of the product and resource markets. Recall the demand and supply model in Chapter 3.
 - A change in the market price signals that a change in the market has occurred.
 - Those who respond to the market signals will be rewarded with profits and income.
- Reliance on technology and capital goods
 - Competition, freedom of choice, self-interest, and the potential of profits provide the incentive for capital accumulation (investment).
 - Advanced technology and capital goods uses the more efficient roundabout method of technology.
- Specialization
 - Division of labor allows workers to specialize.
 - People can take advantage of differences in abilities and skills.
 - People with identical skills may still benefit from specialization and improving certain skills
 - Specialization saves time involved in shifting from one task to another.
 - Geographic specialization: Regional and international specialization take advantage of localized resources.
- Use of money as a medium of exchange
 - Money substitutes for barter, which requires a coincidence of wants. (I may want what you produce but you may not want to exchange for what I have.)
 - Willingness to accept money in place of goods permits 3-way trades (or multilateral trades). See Figure 4-1 and examples in text.
 - Floridians give money to Nebraskans for wheat who give money to Idahoans for potatoes who give money to Florida for oranges.
 - Foreign exchange markets permit Americans, Japanese, Germans, Britons, and Mexicans to complete international exchanges of goods and services.
 - Detroit autoworker produces crankshafts for Buicks. If the worker were paid in crankshafts, he would have to find grocers, clothing retailers, etc., who would be willing to exchange their products for a crankshaft. It is much more efficient to use money wages than to accept one's wages in crankshafts!
 - Active, but limited government
 - Although the market system promotes efficiency, it has certain shortcomings (over production of goods with social costs, under production of goods with social benefits, tendency for business to increase monopoly power, macro instability).
 - Chapter 5 deals with how the government can increase the overall effectiveness of the market system.

The Market System at Work

- The market system is made up of millions of individual decision makers who make trillions of decisions all of which are attempting to maximize their individual or business self-interest.
- The market is a mechanism by which the consumers and producers can come together to respond to each other's desires and wants in an efficient way.
- Although the focus of this chapter is on the market system, the four fundamental questions must be answered by all economic systems.
 - What goods and services will to be produced?
 - How will these goods and services be produced?
 - Who will get the goods and services?
 - How will the system accommodate change?
- What will be produced?
 - In order to be profitable, businesses must respond to consumers' (individuals, other businesses, and the government) wants and desires.
 - When businesses allocate resources in a way that is responsive, businesses will be profitable and allocative efficiency will be achieved.
 - Accounting profits are total revenue minus total accounting costs.
 - In economics, the return to the entrepreneur is treated just like the return to the worker, i.e., it is an economic cost and must be received if the entrepreneur is going to continue to produce in that industry.
 - Normal profits are the return to the entrepreneur that is necessary for him/her to continue to produce that product. Any revenue received beyond normal profits is pure or economic profit.
 - If producers in an industry are receiving pure or economic profits, additional producers will move into the industry, the industry supply will increase, and the price will decrease thus squeezing out the economic profits. Refer to Figure 3-6(c).
 - If producers in an industry are experiencing economic losses, some of these producers will exit the industry, the industry supply will decrease, and the price will increase thus eliminating the economic losses. Refer to 3-6(d).
 - Consumer sovereignty is the key to determining the types and quantities of the various products that will be produced. "Dollar votes" for a product when purchases are made and "dollar votes" against a product when products are ignored will determine which industries continue to exist and which individual products survive or fail.
 - Businesses are not really "free" to produce what they wish. They must match their production choices with consumer choices or face losses and eventual bankruptcy. Profit-seeking firms must consider the allocation of the "dollar votes" when they make their production decisions.
 - Resource demand is a "derived" demand, i.e., it depends on the demand for the products produced by the resource.

- How will the goods and services be produced?
 - The market system encourages and rewards those producers who are achieving productive efficiency, i.e., least-cost production.
 - Least-cost production techniques include: locating firms in the optimum location considering resource prices, resource productivity, and transportation costs, available technology, and resource prices in general.
 - The most efficient technique will be the one that produces a given amount of output with the smallest input of scarce resources when both inputs and outputs are measured in dollars and cents.(Key Question 7)
- Who will get the goods and services?
 - The answer to this question is directly related to how the income is distributed among the individuals and the households and the tastes and preferences of consumers.
 - Products go to those who are willing and able to pay for them.
 - The productivity of the resources, the relative supply of particular resources, and the ownership of the resources will determine the income of individuals and households.
 - The resource markets, which determine income, are linked to this decision.
- How will the system accommodate change?
 - Accommodating changes in consumer tastes and the guiding function of prices:
 - An increase in demand for some products will lead to higher prices in those markets.
 - A decrease in demand for other products will lead to lower prices in those markets.
 - Increased demand leads to higher prices that induce greater quantities of output. The opposite is true for a decrease in demand.
 - Higher prices lead to more profits and new firms entering the market.
 - Lower prices lead to losses and firms leaving the industry.
 - The market system promotes technological improvements and capital accumulation.
 - An entrepreneur or firm that introduces a popular new product will be rewarded with increased revenue and profits.
 - New technologies that reduce production costs, and thus product price, will spread throughout the industry as a result of competition.
 - Creative destruction occurs when new products and production methods destroy the market positions of firms that are not able or willing to adjust.

Competition and the "Invisible Hand":

- Competition is the mechanism of control for the market system. It not only guarantees that industry responds to consumer wants, but it also forces firms to adopt the most efficient production techniques.
- Adam Smith talked of the "invisible hand" which promotes public interest through a market system where the primary motivation is self-interest. By attempting to maximize profits, firms will also be producing the goods and services most wanted by society.

LAST WORD: Shuffling the Deck

- If one thoroughly shuffles a deck of cards, there is a virtual 100% chance that the resulting arrangement of cards will be unlike any previous arrangement.
- Yet, even though there are tens of billions of resources in the world, these resources are arranged in such a way as to produce the products and services that serve human needs.
- Private property eliminates the possibility that resource arrangements will be random because each resource owner will choose a particular course of action if it promises rewards to the owner that exceed the rewards promised by all other available actions.
- The result is a complex and productive arrangement of countless resources.