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# MACROECONOMICS

*IN THE GLOBAL ECONOMY*

Fall 2009

## YELLOW PAGES

Activities will be done in class. Bring to class everyday.

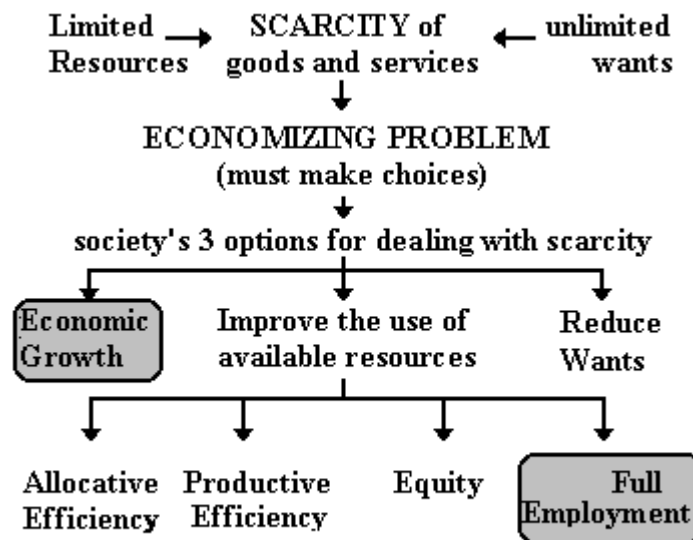
<http://www.harpercollege.edu/mhealy/eco212/machome.htm>

### COURSE DESCRIPTION

Almost every day we hear news reports of economic problems and successes from around the world. All over the world, countries are undertaking economic reforms (often called **STRUCTURAL ADJUSTMENT POLICIES**) that their leaders believe will provide their citizens with lower unemployment and higher living standards.

This course will cover the area of economics commonly defined as *macroeconomics*. The main goal of macroeconomics is to gain a better understanding of the causes of, and remedies for, **UNEMPLOYMENT** and **INFLATION**, as well as the factors that affect **ECONOMIC GROWTH**.

We will study these macroeconomic issues in an international context to try to understand the economic reforms many countries are undertaking.



MACROECONOMICS

## ***Unit 1 - WHAT IS ECONOMICS and GLOBALIZATION ?***

**NOTE: Some of the answers in the back of the study guide are WRONG. Corrected answers and page references can be found on the textbook's website.**

### **Chapter 1 - The 5Es of Economics**

- Reading Assignments:
  - Chapter 1 ALL (including the appendix "Graphs and Their Meaning")
  - PLUS:
    - Efficient Allocation pp. 56-57
    - Personal Distribution of Income pp. 73-74
    - The online lecture is VERY IMPORTANT: The 5Es of Economics
- Study Guide
  - Chapter 1:
    - Multiple Choice: # 1-7, 10-12, 14-24
    - Problems: # 4, 5
  - Appendix to Chapter 1:
    - Multiple Choice: # 1, 2, 6, 11, 12 15, 16, 17
    - Problems: # 1a, 1b, 2a, 4
- Worked Problems: 1.1 and 1.2 @ <http://www.mcconnell18e.com>
- Web Quiz at <http://www.mcconnell18e.com>: ALL questions
- End-of-Chapter Key Questions: # 1-5, 1-7, 1-10, 1-11, 1-14, appendix 1-7  
[the answers to the key questions can be found on our Blackboard site]

### **Chapter 2 - Economic Systems and Globalization**

- Reading Assignments:
  - Chapter 2 ALL
  - PLUS
    - pages 2-13 from Chapter 23W of the 16th edition of our textbook found online at: <http://highered.mcgraw-hill.com/sites/dl/free/0072875577/141636/Webchapter23.pdf>
      - State Ownership and Central Planning: 23W-2 to 23W-3
      - Problems with Central Planning 23W-3 to 23W-5
      - The Collapse of the Soviet Economy 23W-5 to 23W-6
      - The Russian Transition to a Market System 23W-6 to 23W-9
      - Market Reforms in China 23W-10 to 23W-11
      - Outcome and Prospects 23W-11 to 23W-13
      - Conclusion 23W-13
    - The Last Word - "Fair Trade Products" pp. 106-107
    - Last Word: "Shuffling the Deck": p. 41
    - The Last Word - "Economic Growth in China": p. 163
    - Global Competition, p. 108
    - The Last Word - "Petition of the Candlemakers, 1845": p. 407
    - <http://www.harpercollege.edu/mhealy/eco212i/lectures/command/econsys.htm>
- Study Guide
  - Multiple Choice: # 1-3, 6, 7, 9, 11, 12, 13, 19-25
  - Problems: # 1, 4
- Web Quiz Chapter 2 at <http://www.mcconnell18e.com>: ALL

### **Chapter 3 - The Efficiency of Markets: Supply and Demand**

- Reading Assignments:
  - Chapter 3 pp. 45-58 only
  - Chapter 3 appendix: pp. 66-70
  - PLUS: <http://www.harpercollege.edu/mhealy/eco211/lectures/s%26d/sdeff.htm>

- Study Guide
  - Chapter 3:
    - Multiple Choice: # 1-28
    - Problems: # 1-6, 8
  - Chapter 3 Appendix:
    - Multiple Choice: 1-8, 11-15
    - Problems: 1, 2
- Web Quiz at <http://www.mcconnell18e.com>: ALL questions
- End-of-Chapter Key Questions: # 3-3, 3-6, 3-8, 3-9, 3-14  
[the answers to the key questions can be found on our Blackboard site]

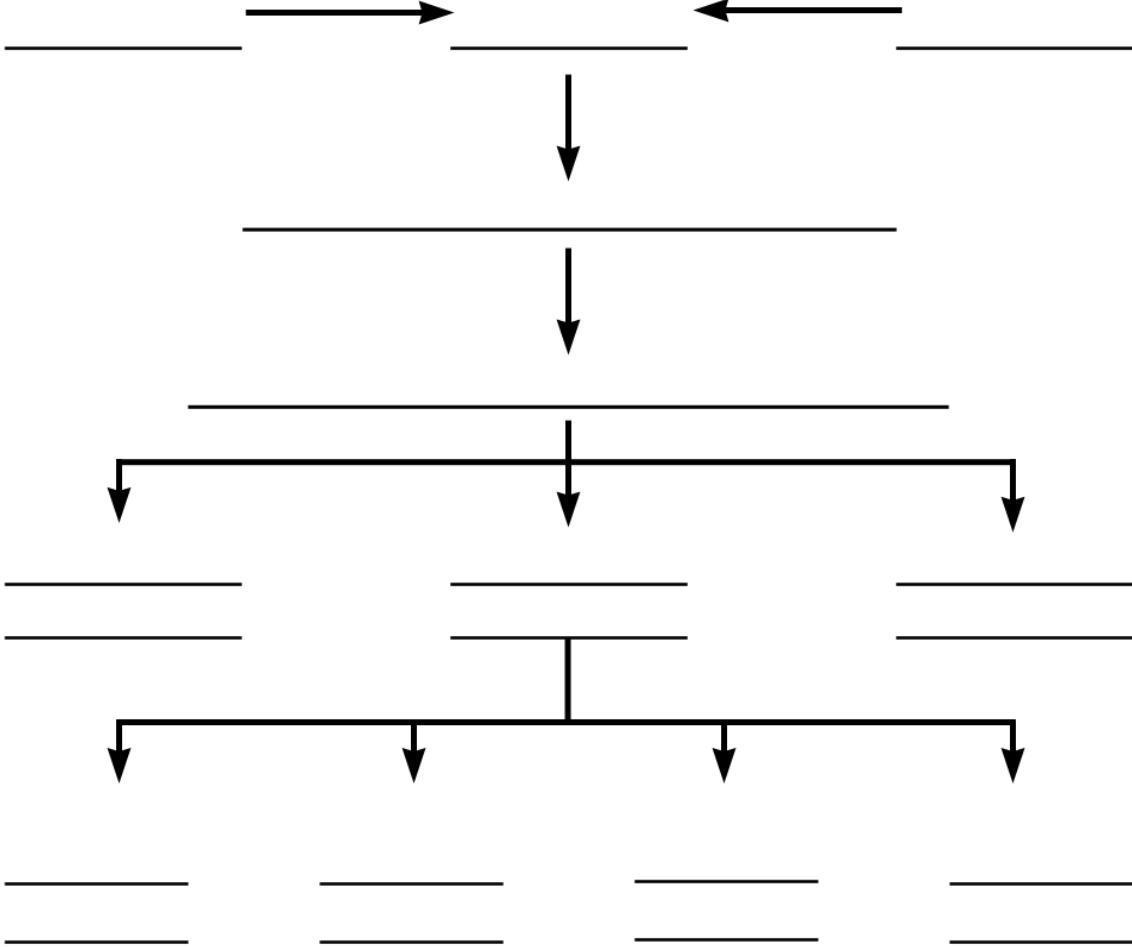
### Chapters 5 and 20 - TRADE: Specialization and Exchange

- Reading Assignments:
  - ALL of chapter 5
  - PLUS
    - Chapter 20 pp. 391-397, 401-406 (ignore supply and demand graphs)
    - Recent U.S. Trade Deficits pp. 425-428
    - "The mystical power of free trade"  
<http://www.cnn.com/ALLPOLITICS/time/1999/12/06/free.trade.html>
    - [http://news.bbc.co.uk/1/shared/spl/hi/pop\\_ups/03/business\\_trade\\_and\\_poor\\_countries/html/1.stm](http://news.bbc.co.uk/1/shared/spl/hi/pop_ups/03/business_trade_and_poor_countries/html/1.stm)
- Study Guide
  - Multiple Choice:
    - Chapter 5: #1, 2, 4, 5, 7-19, 24, 25
    - Chapter 18: # 1-12, 18-25
  - Problems:
    - Chapter 5: # 1, 2, 3, 4
  - Chapter 18: # 1 a-d,
- Worked Problems 5.1 and 20.1 at <http://www.mcconnell18e.com>
- Web Quizzes at <http://www.mcconnell18e.com>
  - Chapter 5: 1,2,4-10
  - Chapter 20: 1-3, 6-8
- End-of-Chapter Key Questions: # 5-4, 5-6, 5-9, 20-4

### Chapter 4 - The Public Sector (Government): Role and Finance

- Reading Assignments:
  - Chapter 3: Application: Government Set Prices pp. 59-62
  - Chapter 4 only pp. 78-88
- Study Guide
  - Multiple Choice:
    - Chapter 3: #29, 30
    - Chapter 3 Appendix: #9, 10
    - Chapter 4: # 9-17, 19-25
  - Problems:
    - Chapter 3: #7
    - Chapter 4: # 2, 4
- Worked Problems at <http://www.mcconnell18e.com>: #4.1
- Chapter 4 Web Quiz at <http://www.mcconnell18e.com>: #2, 3, 6, 7, 9, 10
- End-of-Chapter Key Questions: # 4-9, 4-10, 4-15  
[the answers to the key questions can be found on our Blackboard site]

The 5Es of Economics: Fill in the banks.



Adapted from *Economics: The Options for Dealing with Scarcity* by Frank D. Tinari. Scott, Foresman and Company, Glenview, Illinois, 1986

**Which of the 5 Es of Economics BEST explains the statements that follow:**

- **Economic Growth**
  - **Allocative Efficiency**
  - **Productive Efficiency**
    - **not using more resources than necessary**
    - **using resources where they are best suited**
    - **using the appropriate technology**
  - **Equity**
  - **Full Employment**
- 

- Shortage of Super Bowl Tickets
- Coke lays off 6000 employees and still produces the same amount
- Free trade
- More resources
- Producing more music downloads and fewer CDs
- Law of Diminishing Marginal Utility
- Using all available resources
- Discrimination
- "President Obama Example"
- improved technology
- Due to an economic recession many companies lay off workers
- A "fair" distribution of goods and services
- Food price controls
- Secretaries type letters and truck drivers drive trucks
- Due to government price supports farmers grow too much grain

- Kodak Cuts Jobs - see article below
  - October 24, 2001 Posted: 1728 GMT  
[\[http://edition.cnn.com/2001/BUSINESS/10/24/kodak/index.html\]](http://edition.cnn.com/2001/BUSINESS/10/24/kodak/index.html)

NEW YORK (CNNmoney) -- Eastman Kodak Co. posted a sharp drop in third-quarter profits Wednesday and warned the current quarter won't be much better, adding **it will cut up to 4,000 more jobs**. . . .Film and photography companies have been struggling with the adjustment to a shift to digital photography as the market for traditional film continues to shrink.

Which of the 5Es explains this news article? Explain.

## *Not all Lay-offs are Good for Society*

### **WHY ARE THERE LAY-OFFS?**

- **Productive Efficiency**
  - **Improved Productive efficiency allows business to produce the SAME AMOUNT OF OUTPUT with fewer workers.**
  - **These lay-offs are GOOD for society because they reduce scarcity because more products are produced by the laid-off workers.**
  
- **Allocative Efficiency**
  - **Allocative efficiency means the economy uses its limited resources to produce what people want.**
  - **Resources are not wasted producing products that people do not want**
  - **Some lay-offs occur in industries that were producing products that people no longer wanted.**
  - **These lay-offs are GOOD for society because they reduce scarcity because society gets more utility from its resources.**
  
- **Recession**
  - **Some lay-offs are the result of an economic recession when unemployment rises and people buy fewer products**
  - **These lay-offs are NOT GOOD for society because they result in MORE SCARCITY because fewer products are produced with society's resources.**

## Quick Quiz - Scarcity

1. Economics may best be defined as the:
  - A. interaction between macro and micro considerations.
  - B. social science concerned with how individuals, institutions, and society make optimal choices under conditions of scarcity.
  - C. empirical testing of value judgments through the use of logic.
  - D. use of policy to refute facts and hypotheses.
2. The study of economics is primarily concerned with:
  - A. keeping private businesses from losing money.
  - B. demonstrating that capitalistic economies are superior to socialistic economies.
  - C. choices that are made in seeking the best use of resources.
  - D. determining the most equitable distribution of society's output.
3. The economizing problem is:
  - A. the need to make choices because economic wants exceed economic means.
  - B. how to distribute resources equally amongst all members of society.
  - C. that people's means often exceed their wants.
  - D. that people do not know how to rationally allocate resources.
4. The scarcity problem:
  - A. persists only because countries have failed to achieve continuous full employment.
  - B. persists because economic wants exceed available productive resources.
  - C. has been solved in all industrialized nations.
  - D. has been eliminated in affluent societies such as the United States and Canada.
5. Productive efficiency refers to:
  - A. the use of the least-cost method of production.
  - B. the production of the product-mix most wanted by society.
  - C. the full employment of all available resources.
  - D. production at some point inside of the production possibilities curve.
5. Allocative efficiency involves determining:
  - A. which output-mix will result in the most rapid rate of economic growth.
  - B. which production possibilities curve reflects the lowest opportunity costs.
  - C. the mix of output that will maximize society's satisfaction.
  - D. the optimal rate of technological progress.
6. If an economy produces its most wanted goods but uses outdated production methods, it is:
  - A. achieving productive efficiency, but not allocative efficiency.
  - B. achieving allocative efficiency, but not productive efficiency.
  - C. achieving both productive and allocative efficiency.
  - D. achieving neither productive nor allocative efficiency.



## Resource Quiz

Each of the following is either a/n:

- a. consumer good
- b. consumer service
- c. land
- d. capital
- e. labor
- f. entrepreneur

	Your answer:		Your answer:
medical checkup		taxi ride	
factory		automobile	
highway		autoworker	
candy bar		John DeLorean	
coal		ice cream cone	
coke		haircut	
iron ore		waiter	
Steve Jobs/Steve Wasnik		Ted Turner	
forest		crude oil	
lumber		gasoline	
class lecture		stockings	

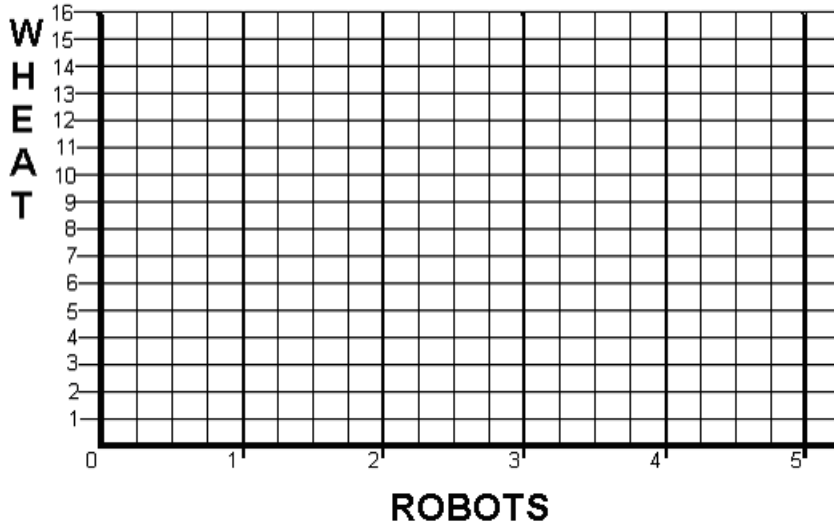
## Quick Quiz – Economic Systems

1. Which of the following is a distinguishing feature of a command system?
  - A. private ownership of all capital.
  - B. central planning.
  - C. heavy reliance on markets.
  - D. wide-spread dispersion of economic power.
2. Examples of command economies are:
  - A. The United States and Japan.
  - B. Sweden and Norway.
  - C. Mexico and Brazil.
  - D. Cuba and North Korea.
3. Economic systems differ according to what two main characteristics?
  - A. Who owns the factors of production, and the methods used to coordinate economic activity.
  - B. The technology used in production, and the quantity and quality of natural resources.
  - C. How goods are produced, and who gets them.
  - D. The political system in place, and the degree of scarcity facing the economy.
4. Command systems are also known as:
  - A. market systems.
  - B. pure capitalism.
  - C. laissez-faire capitalism.
  - D. communism.
5. Which of the following is *not* a characteristic of the market system?
  - A. private property.
  - B. freedom of enterprise.
  - C. government ownership of the major industries.
  - D. competition in product and resource markets.
6. The regulatory mechanism of the market system is:
  - A. self-interest.
  - B. private property.
  - C. competition.
  - D. specialization.
7. Economic profits in an industry suggest the industry:
  - A. can earn more profits by increasing product price.
  - B. should be larger to better satisfy consumers' desire for the product.
  - C. has excess production capacity.
  - D. is the size that consumers want it to be.
8. Two major virtues of the market system are that it:
  - A. allocates resources efficiently and allows economic freedom.
  - B. results in an equitable personal distribution of income and always maintains full employment.
  - C. results in price level stability and a fair personal distribution of income.
  - D. eliminates discrimination and minimizes environmental pollution.

9. "Consumer sovereignty" means that:
- A. buyers can dictate the prices at which goods and services will be purchased.
  - B. advertising is ineffective because consumers already know what they want.
  - C. buyers control the quality of goods and services through regulatory agencies.
  - D. buyers determine what will be produced based on their "dollar votes" for the goods and services offered by sellers.
10. The invisible hand refers to the:
- A. fact that the U.S. tax system redistributes income from rich to poor.
  - B. notion that, under competition, decisions motivated by self-interest promote the social interest.
  - C. tendency of monopolistic sellers to raise prices above competitive levels.
  - D. fact that government controls the functioning of the market system.
11. "Because the outputs of many industries are the inputs to other industries, the failure of any single industry to fulfill the output quantities specified in the central plan caused a chain-reaction of adverse repercussions on production." This quotation best identifies the:
- A. incentive problem under central planning.
  - B. self-sufficiency dilemma under communism.
  - C. resource overcommitment problem under communism.
  - D. coordination problem under central planning.
12. The incentive problem under communist central planning refers to the idea that:
- A. planners had to direct required inputs to each enterprise.
  - B. workers, managers, and entrepreneurs could not personally gain by responding to shortages or surpluses or by introducing new and improved products.
  - C. the immediate effect of more investment was less consumption.
  - D. exports had to be equal to imports for a central plan to work.
13. Innovation lagged in the centrally planned economies because:
- A. there was too much domestic business competition.
  - B. there was too much competition from foreign firms.
  - C. enterprises resisted innovation in fear that their production targets would be raised.
  - D. exports had to equal imports for the plan to work.
14. The failure of Soviet central planning was reflected in:
- A. a declining growth rate.
  - B. poor quality goods.
  - C. the failure to provide promised consumer goods.
  - D. all of these.
15. Since World War II:
- A. North Korea's command economy has significantly outperformed South Korea's market economy.
  - B. South Korea's command economy has significantly outperformed North Korea's market economy.
  - C. North Korea's market economy has significantly outperformed South Korea's command economy.
  - D. South Korea's market economy has significantly outperformed North Korea's command economy.

## Production Possibilities

	A	B	C	D	E	F
ROBOTS	0	1	2	3	4	5
WHEAT	16	15	13	10	6	0



1. What is the Law of Increasing Costs?

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2. Calculate the Opportunity Cost of Producing the first robot:

the first robot = \_\_\_\_\_ wheat;      second robot = \_\_\_\_\_ wheat;

3<sup>rd</sup> = \_\_\_\_\_ wheat;      4<sup>th</sup> = \_\_\_\_\_ wheat;      5<sup>th</sup> = \_\_\_\_\_ wheat.

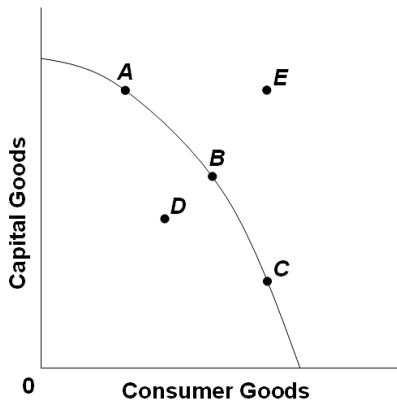
3. Mark a point "N" on your production possibilities graph that represents PRODUCTIVE INEFFICIENCY or UNEMPLOYMENT.

Mark a point "M" that represents a combination of wheat and robots that is Currently IMPOSSIBLE to produce with given resources and technology.

4. On the graph above, sketch in a new PPC that would represent economic growth.
5. If we know that robots are Capital goods and wheat is a Consumer good, which combination of robots and wheat, B, C, D or E, would result in more growth in the future?

## Quick Quiz – Production Possibilities

1. Which of the following will *not* produce an outward shift of the production possibilities curve?
  - A. an upgrading of the quality of a nation's human resources
  - B. the reduction of unemployment
  - C. an increase in the quantity of a society's labor force
  - D. the improvement of a society's technological knowledge
  
2. Unemployment:
  - A. causes the production possibilities curve to shift inward.
  - B. can exist at any point on a production possibilities curve.
  - C. is illustrated by a point outside the production possibilities curve.
  - D. is illustrated by a point inside the production possibilities curve.
  
3. If the production possibilities curve is a straight line:
  - A. the two products will sell at the same market prices.
  - B. economic resources are perfectly substitutable between the production of the two products.
  - C. the two products are equally important to consumers.
  - D. equal quantities of the two products will be produced at each possible point on the curve.
  
4. A production possibilities curve illustrates:
  - A. the necessity of making choices.
  - B. market prices.
  - C. consumer preferences.
  - D. the distribution of income.
  
5. The production possibilities curve is:
  - A. convex to the origin because opportunity costs are constant.
  - B. linear because opportunity costs are constant.
  - C. concave to the origin because of increasing opportunity costs.
  - D. convex to the origin because of increasing opportunity costs.
  
6. If all discrimination in the United States were eliminated, the economy would:
  - A. have a less concave production possibilities curve.
  - B. produce at some point closer to its production possibilities curve.
  - C. be able to produce at some point outside of its production possibilities curve.
  - D. shift the production possibilities curve outward.

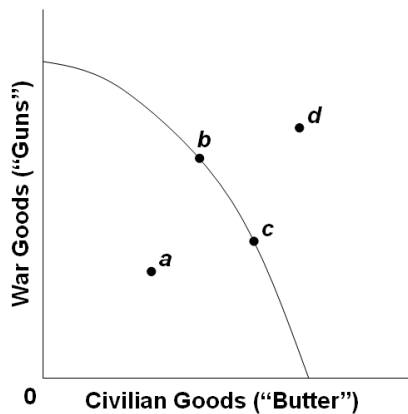


7. Refer to the above diagram. Other things equal, this economy will achieve the most rapid rate of growth if:

- A. it chooses point *A*.
- B. it chooses point *B*.
- C. it chooses point *C*.
- D. it chooses point *D*.

8. Refer to the above diagram. This economy will experience unemployment if it produces at point:

- A. *A*.
- B. *B*.
- C. *C*.
- D. *D*.



9. Refer to the above production possibilities curve. At the onset of the Second World War the United States had large amounts of idle human and property resources. Its economic adjustment from peacetime to wartime can best be described by the movement from point:

- A. *c* to point *b*.
- B. *b* to point *c*.
- C. *a* to point *b*.
- D. *c* to point *d*.

10. Refer to the above production possibilities curve. At the onset of the Second World War the Soviet Union was already at full employment. Its economic adjustment from peacetime to wartime can best be described by the movement from point:

- A. *c* to point *b*.
- B. *b* to point *c*.
- C. *a* to point *b*.
- D. *c* to point *d*.

Answer the next question(s) on the basis of the following production possibilities tables for two countries, North Cantina and South Cantina:

**North Cantina Production Possibilities**

	<u>A</u>	<u>B</u>	<u>C</u>	<u>D</u>	<u>E</u>	<u>F</u>
<b>Capital Goods</b>	<b>5</b>	<b>4</b>	<b>3</b>	<b>2</b>	<b>1</b>	<b>0</b>
<b>Consumer Goods</b>	<b>0</b>	<b>10</b>	<b>18</b>	<b>24</b>	<b>28</b>	<b>30</b>

**South Cantina Production Possibilities**

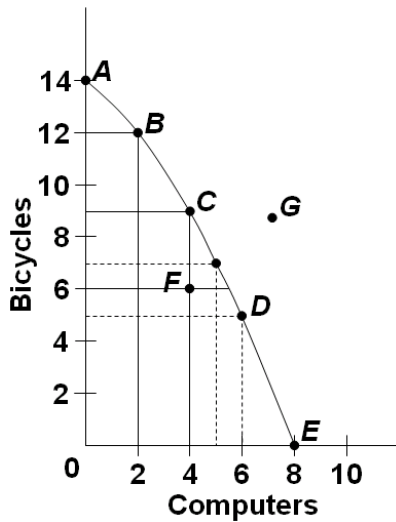
	<u>A</u>	<u>B</u>	<u>C</u>	<u>D</u>	<u>E</u>	<u>F</u>
<b>Capital Goods</b>	<b>5</b>	<b>4</b>	<b>3</b>	<b>2</b>	<b>1</b>	<b>0</b>
<b>Consumer Goods</b>	<b>0</b>	<b>8</b>	<b>15</b>	<b>21</b>	<b>25</b>	<b>27</b>

11. Refer to the above tables. If South Cantina is producing at production alternative D, the opportunity cost of the third unit of capital goods will be:

- A. 3 units of consumer goods.
- B. 4 units of consumer goods.
- C. 5 units of consumer goods.
- D. 6 units of consumer goods.

12. Refer to the above tables. If North Cantina is producing at production alternative B, the opportunity cost of the eleventh unit of consumer goods will be:

- A. 10 units of capital goods.
- B.  $\frac{1}{4}$  of a unit of capital goods.
- C. 8 units of capital goods.
- D.  $\frac{1}{8}$  of a unit of capital goods.



13. Refer to the above diagram. If society is currently producing the combination of bicycles and computers shown by point *D*, the production of 2 more units of bicycles:
- A. cannot be achieved because resources are fully employed.
  - B. will cost 1 unit of computers.
  - C. will cost 2 units of computers.
  - D. will cause some resources to become unemployed.
14. Refer to the above diagram. The combination of computers and bicycles shown by point *F*:
- A. is unattainable, given currently available resources and technology.
  - B. is attainable, but implies that the economy is not using all its resources.
  - C. is irrelevant because it is inconsistent with consumer preferences.
  - D. suggests that opportunity costs are constant.



# Benefit Cost Analysis

Definition: The selection of all possible alternatives where the marginal benefits are greater than the marginal costs.

select ALL possible options up to where  $MB = MC$

this implies ignoring sunk (fixed) costs

**select all where:  $MB > MC$**   
**up to where:  $MB = MC$**   
**but never where:  $MB < MC$**

Purpose: to make the best decision possible

Example 1 – How many guards should be hired?

# guards	total cost	marginal cost	amount lost in shoplifting	total benefit (amount caught)	marginal benefit
0	\$ 0	--	\$ 1000	\$ 0	--
1	\$ 200		\$ 500	\$ 500	
2	\$ 400		\$ 200	\$ 800	
3	\$ 800		\$ 50	\$ 950	

Example 2 - How many bridges should be built?

# bridges	total cost	marginal costs	total benefits	marginal benefits
0	\$ 0	--	\$ 0	--
1	\$ 50 M		\$ 100 M	
2	\$ 120 M		\$ 120 M	

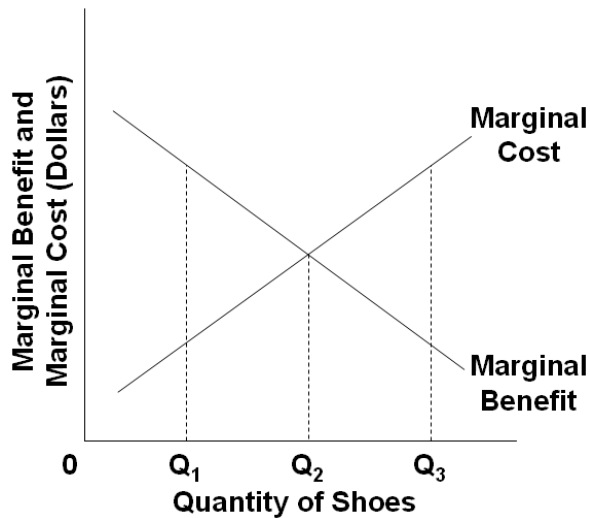
### Quick Quiz – Benefit-Cost Analysis

1. You should decide to go to a movie:
  - A. if the marginal cost of the movie exceeds its marginal benefit.
  - B. if the marginal benefit of the movie exceeds its marginal cost.
  - C. if your income will allow you to buy a ticket.
  - D. because movies are enjoyable.
2. Even though local newspapers are very inexpensive, people rarely buy more than one of them each day. This fact:
  - A. is an example of irrational behavior.
  - B. implies that reading should be taught through phonics rather than the whole language method.
  - C. contradicts the economic perspective.
  - D. implies that, for most people, the marginal benefit of reading a second newspaper is less than the marginal cost.

Answer the next question(s) on the basis of the following information for four highway programs of increasing scope. All figures are in millions of dollars.

<u>Program</u>	<u>Total Cost</u>	<u>Total Benefit</u>
A	\$2	\$9
B	6	16
C	12	21
D	20	23

3. The above data indicate that:
  - A. the marginal costs and marginal benefits cannot be calculated
  - B. the marginal cost and marginal benefit of Program B are \$6 and \$16 respectively.
  - C. the marginal cost and marginal benefit of Program C are \$6 and \$5 respectively.
  - D. the marginal cost and marginal benefit of Program D are \$2 and \$9 respectively.
4. On the basis of the above data we can say that:
  - A. Program A is the most efficient on economic grounds.
  - B. Program B is the most efficient on economic grounds.
  - C. Program C is the most efficient on economic grounds.
  - D. Program D is the most efficient on economic grounds.



5. Refer to the above diagram for athletic shoes. The optimal output of shoes is:

- A.  $Q_1$ .
- B.  $Q_2$ .
- C.  $Q_3$ .
- D. greater than  $Q_3$ .

6. Refer to the above diagram for athletic shoes. If the current output of shoes is  $Q_1$ , then:

- A. society would consider additional units of shoes to be more valuable than alternative uses of those resources.
- B. society would consider additional units of shoes to be less valuable than alternative uses of those resources.
- C. society would experience a net loss by producing more shoes.
- D. resources are being allocated efficiently to the production of shoes.

7. According to the marginal-cost-marginal-benefit rule:

- A. only government projects (as opposed to private projects) should be assessed by comparing marginal costs and marginal benefits.
- B. the optimal project size is the one for which  $MB = MC$ .
- C. the optimal project size is the one for which  $MB$  exceeds  $MC$  by the greatest amount.
- D. project managers should attempt to minimize both  $MB$  and  $MC$ .

8. The marginal benefit curve is:

- A. upsloping because of increasing marginal opportunity costs.
- B. upsloping because successive units of a specific product yield less and less extra benefit.
- C. downsloping because of increasing marginal opportunity costs.
- D. downsloping because successive units of a specific product yield less and less extra benefit.

9. The marginal cost curve is:

- A. upsloping because of increasing marginal opportunity costs.
- B. upsloping because successive units of a specific product yield less and less extra utility.
- C. downsloping because of increasing marginal opportunity costs.
- D. downsloping because successive units of a specific product yield less and less extra utility.

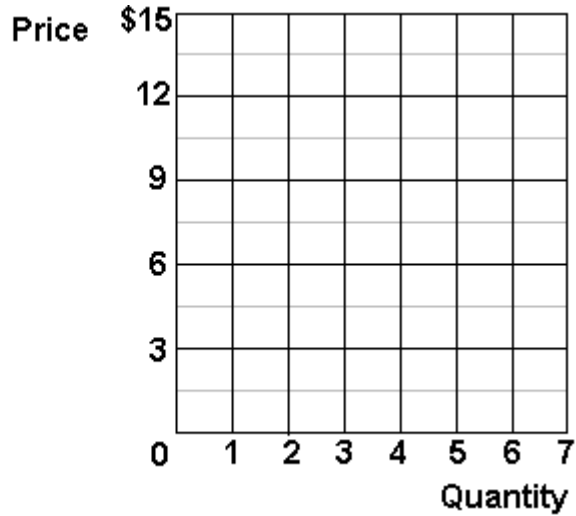
10. The output of MP3 players should be:

- A. reduced if marginal benefits exceed marginal costs.
- B. reduced if marginal costs exceed marginal benefits.
- C. increased if marginal costs exceed marginal benefits.
- D. reduced to zero if their unit costs exceed the unit costs of alternative products.

### CHAPTER 3 DEMAND AND SUPPLY

An individual's demand for Moore's Pizza:

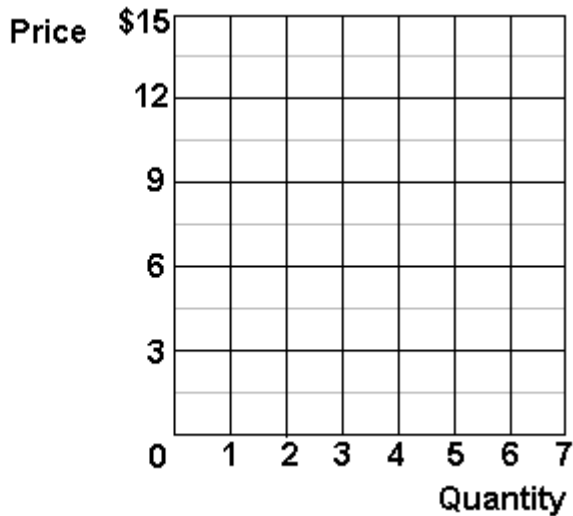
Price	Quantity Demanded per Month
\$15	1
12	2
9	3
6	5
3	7



In the graph above, plot this individual's demand curve for Moore's pizza.

The supply of Moore's pizza:

Price	Quantity Supplied per Month
\$15	5,000
12	4,000
9	3,000
6	2,000
3	1,000

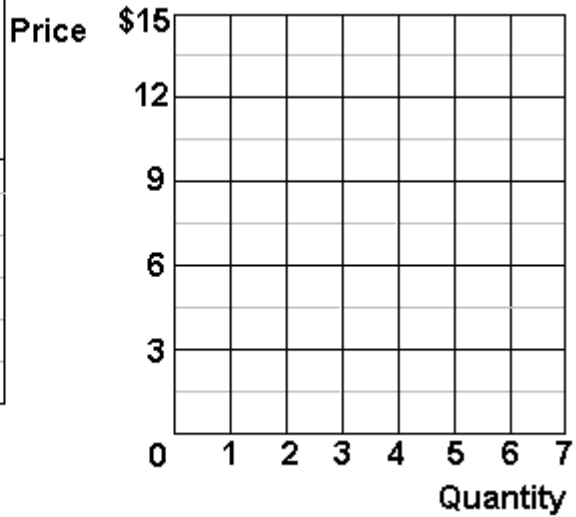


In the graph above, plot the supply curve for Moore's pizza.

**Market Equilibrium:**

Assume that there are 1000 people with identical demand curves for Moore’s Pizza, plot the market demand and supply curves for Moore’s pizza:

Price	Quantity Supplied per Month	Quantity Demanded per Month
\$15	5,000	1,000
12	4,000	2,000
9	3,000	3,000
6	2,000	5,000
3	1,000	7,000



What is the equilibrium price of Moore’s pizza? \_\_\_\_\_

What is the equilibrium quantity? \_\_\_\_\_

**Market Disequilibrium:**

If Moore charged \$12 per pizza:

How many pizzas would be demanded? \_\_\_\_\_

How many pizzas would be supplied? \_\_\_\_\_

There would be a surplus/shortage (circle one) of \_\_\_\_\_ pizzas.

If Moore charged \$6 per pizza:

How many pizzas would be demanded? \_\_\_\_\_

How many pizzas would be supplied? \_\_\_\_\_

There would be a surplus/shortage (circle one) of \_\_\_\_\_ pizzas.

The non-price determinants of demand	The non-price determinants of supply
<p><b>Pe -- expected price</b></p> <p><b>Pog -- price of other goods</b></p> <ul style="list-style-type: none"> <li>1) substitute goods</li> <li>2) complementary goods</li> <li>3) independent goods</li> </ul> <p><b>I -- income</b></p> <ul style="list-style-type: none"> <li>1) normal goods</li> <li>2) inferior goods</li> </ul> <p><b>N -- number of POTENTIAL consumers</b></p> <p><b>T -- tastes and preferences</b></p>	<p><b>Pe -- expected price</b></p> <p><b>Pog -- price of other goods PROD.BY SAME FIRM</b></p> <p><b>Pres -- price of resources</b></p> <p><b>T --technology</b></p> <p><b>T --taxes and subsidies</b></p> <p><b>N -- number of sellers</b></p>

### Increase in Demand

Price	Quantity Demanded per Month	New Quantity Demanded per Month
\$15	1	2
12	2	3
9	3	5
6	5	7
3	7	9



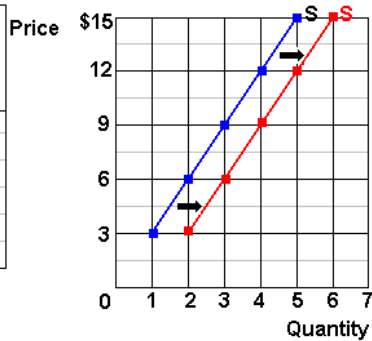
### Decrease in Demand

Price	Quantity Demanded per Month	New Quantity Demanded per Month
\$15	1	0
12	2	1
9	3	2
6	5	4
3	7	6



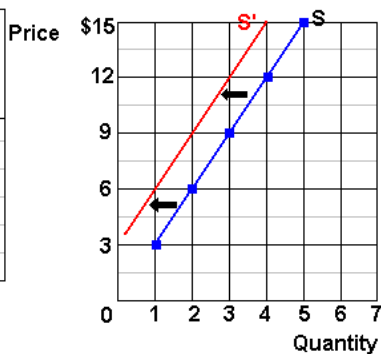
### Increase in Supply

Price	Quantity Supplied per Month	Quantity Supplied per Month
\$15	5,000	6,000
12	4,000	5,000
9	3,000	4,000
6	2,000	3,000
3	1,000	2,000



### Decrease in Supply

Price	Quantity Supplied per Month	Quantity Supplied per Month
\$15	5,000	4,000
12	4,000	3,000
9	3,000	2,000
6	2,000	1,000
3	1,000	0





**List the Five Non-Price Determinants of Demand:**

\_\_\_\_\_, \_\_\_\_\_, \_\_\_\_\_, \_\_\_\_\_, \_\_\_\_\_

Fill in the blanks with either  $\uparrow$  or  $\downarrow$

$\triangle$  **Pe -- expected price**

$\uparrow$  Pe in the future  $\Rightarrow$  \_\_\_ D today

$\downarrow$  Pe in the future  $\Rightarrow$  \_\_\_ D today

$\triangle$  **Pog -- price of other goods**

**1) substitute goods**

$\downarrow$  P Maxwell House coffee  $\Rightarrow$  \_\_\_ D Folgers coffee

$\uparrow$  P of one product  $\Rightarrow$  \_\_\_ D of its substitutes

**2) complementary goods**

$\uparrow$  P of wieners  $\Rightarrow$  \_\_\_ D of buns

$\downarrow$  P of one product  $\Rightarrow$  \_\_\_ D of its complement

$\triangle$  **I -- income**

**1) normal goods**

$\uparrow$  Income  $\Rightarrow$  \_\_\_ D for normal goods

$\downarrow$  Income  $\Rightarrow$  \_\_\_ D for normal goods

**2) inferior goods**

$\uparrow$  Income  $\Rightarrow$  \_\_\_ D for inferior goods

$\downarrow$  Income  $\Rightarrow$  \_\_\_ D for inferior goods

$\triangle$  **Npot -- number of POTENTIAL consumers**

$\uparrow$  Npot  $\Rightarrow$  \_\_\_ D

$\downarrow$  Npot  $\Rightarrow$  \_\_\_ D

$\triangle$  **T -- tastes and preferences**

$\uparrow$  Tastes for a product  $\Rightarrow$  \_\_\_ D for that product

$\downarrow$  Tastes for a product  $\Rightarrow$  \_\_\_ D for that product

**List the Six Non-Price Determinants of Supply:**

\_\_\_\_\_, \_\_\_\_\_, \_\_\_\_\_, \_\_\_\_\_, \_\_\_\_\_, \_\_\_\_\_

Fill in the blanks with either  $\uparrow$  or  $\downarrow$

$\triangle$  **Pe -- expected price**

$\uparrow$  Pe in the future  $\Rightarrow$  \_\_\_ S today

$\downarrow$  Pe in the future  $\Rightarrow$  \_\_\_ S today

$\triangle$  **Pog -- price of other goods also produced by the same firm**

$\uparrow$  P soybeans  $\Rightarrow$  \_\_\_ S corn

$\downarrow$  P soybeans  $\Rightarrow$  \_\_\_ S corn

$\triangle$  **Pres -- price of resources**

$\uparrow$  P autoworkers wages  $\Rightarrow$   $\uparrow$  costs of producing cars  $\Rightarrow$  \_\_\_ S cars

$\uparrow$  Pres  $\Rightarrow$   $\uparrow$  costs  $\Rightarrow$  \_\_\_ S

$\downarrow$  Pres  $\Rightarrow$   $\downarrow$  costs  $\Rightarrow$  \_\_\_ S

$\triangle$  **Tech --technology**

Improved technology  $\Rightarrow$   $\downarrow$  costs  $\Rightarrow$  \_\_\_ S

$\triangle$  **Tax --taxes and subsidies**

$\uparrow$  Taxes  $\Rightarrow$   $\uparrow$  costs  $\Rightarrow$  \_\_\_ S

$\downarrow$  Taxes  $\Rightarrow$   $\downarrow$  costs  $\Rightarrow$  \_\_\_ S

$\uparrow$  Subsidies  $\Rightarrow$   $\downarrow$  costs  $\Rightarrow$  \_\_\_ S

$\downarrow$  Subsidies  $\Rightarrow$   $\uparrow$  costs  $\Rightarrow$  \_\_\_ S

$\triangle$  **N -- number of producers/sellers**

$\uparrow$  Nproducers  $\Rightarrow$  \_\_\_ S

$\downarrow$  Nproducers  $\Rightarrow$  \_\_\_ S

## The Non-Price Determinants of Demand and Supply

Non-Price Determinants of Demand △ <u>Pe</u> , △ <u>Pog</u> , △ <u>I</u> , △ <u>Npot</u> , △ <u>T</u>	Non-Price Determinants of Supply △ <u>Pe</u> , △ <u>Pog</u> , △ <u>Pres</u> , △ <u>Tech</u> , △ <u>Tax</u> , △ <u>Nprod</u>
<p><b>△<u>Pe</u> -- expected price</b></p> <p>↑ Pe in the future ⇒ ↑ D today                      ↓ Pe in the future ⇒ ↓ D today</p> <p><b>△<u>Pog</u> -- price of other goods</b></p> <p>1) <b>substitute goods</b>                      ↓ P Maxwell House coffee ⇒ ↓ D Folgers coffee                      ↑ P of one product ⇒ ↓ D of its substitute</p> <p>2) <b>complementary goods</b></p> <p>↑ P of wieners ⇒ ↓ D of buns                      ↓ P of one product ⇒ ↑ D of its compliment</p> <p><b>△<u>I</u> -- income</b></p> <p>1) <b>normal goods</b>                      ↑ Income ⇒ ↑ D for normal goods                      ↓ Income ⇒ ↓ D for normal goods</p> <p>2) <b>inferior goods</b></p> <p>↑ Income ⇒ ↓ D for inferior goods                      ↓ Income ⇒ ↑ D for inferior goods</p> <p><b>△<u>Npot</u> -- number of POTENTIAL consumers</b></p> <p>↑ Npot ⇒ ↑ D                      ↓ Npot ⇒ ↓ D</p> <p><b>△<u>T</u> -- tastes and preferences</b></p> <p>↑ Tastes for a product ⇒ ↑ D for that product                      ↓ Tastes for a product ⇒ ↓ D for that product</p>	<p><b>△<u>Pe</u> -- expected price</b></p> <p>↑ Pe in the future ⇒ ↓ S today                      ↓ Pe in the future ⇒ ↑ S today</p> <p><b>△<u>Pog</u> -- price of other goods also produced by the same firm</b></p> <p>↑ P soybeans ⇒ ↓ S corn                      ↓ P soybeans ⇒ ↑ S corn</p> <p><b>△<u>Pres</u> -- price of resources</b></p> <p>↑ P autoworkers wages ⇒ ↑ costs of producing cars ⇒ ↓ S cars</p> <p>↑ Pres ⇒ ↑ costs ⇒ ↓ S                      ↓ Pres ⇒ ↓ costs ⇒ ↑ S</p> <p><b>△<u>Tech</u> --technology</b></p> <p>Improved technology ⇒ ↓ costs ⇒ ↑ S</p> <p><b>△<u>Tax</u> --taxes and subsidies</b></p> <p>↑ Taxes ⇒ ↑ costs ⇒ ↓ S                      ↓ Taxes ⇒ ↓ costs ⇒ ↑ S</p> <p>↑ Subsidies ⇒ ↓ costs ⇒ ↑ S                      ↓ Subsidies ⇒ ↑ costs ⇒ ↓ S</p> <p><b>△<u>N</u> -- number of producers/sellers</b></p> <p>↑ Nproducers ⇒ ↑ S                      ↓ Nproducers ⇒ ↓ S</p>

## Change in Demand vs. Change in Quantity Demanded

Matching: Which of the follow tables/graphs shows:

1. a decrease in demand \_\_\_\_\_
2. a change in quantity demanded \_\_\_\_\_
3. an increase in demand \_\_\_\_\_

**A**

Price	Quantity Demanded per Month
\$15	1
12	2
9	3
6	5
3	7

**B**

Price	Quantity Demanded per Month	New Quantity Demanded per Month
\$15	1	2
12	2	3
9	3	5
6	5	7
3	7	9

**C**

Price	Quantity Demanded per Month	New Quantity Demanded per Month
\$15	1	0
12	2	1
9	3	2
6	5	4
3	7	6

## Change in Supply vs. Change in Quantity Supplied

Matching: Which of the follow tables/graphs shows:

1. a decrease in supply \_\_\_\_\_
2. a change in quantity supplied \_\_\_\_\_
3. an increase in supply \_\_\_\_\_

**A**

Price	Quantity Supplied per Month
\$15	5,000
12	4,000
9	3,000
6	2,000
3	1,000

**B**

Price	Quantity Supplied per Month	Quantity Supplied per Month
\$15	5,000	6,000
12	4,000	5,000
9	3,000	4,000
6	2,000	3,000
3	1,000	2,000

**C**

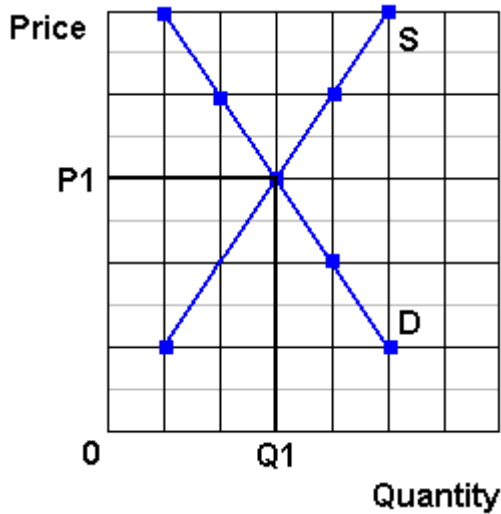
Price	Quantity Supplied per Month	Quantity Supplied per Month
\$15	5,000	4,000
12	4,000	3,000
9	3,000	2,000
6	2,000	1,000
3	1,000	0

## INSTRUCTIONS

Use supply and demand curves to illustrate how each of the following changes will affect the **price** and **quantity** of the stated product, *ceterus paribus*.

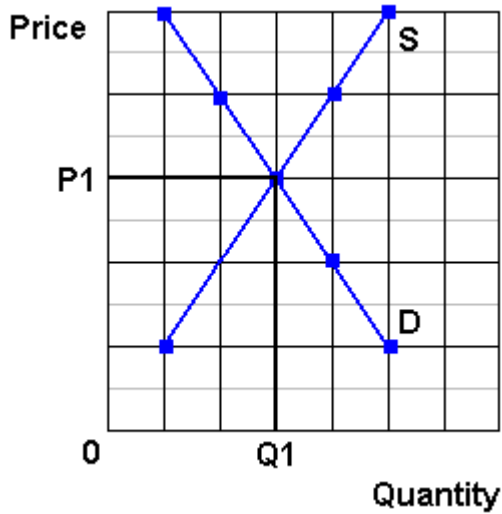
Before you guess, answer the following questions:

- (1) Which determinant has changed?
- (2) Will it affect supply or demand?
- (3) Will supply or demand increase or decrease?
- (4) GRAPH IT! What happens to price and quantity?



<b>1. Computers</b> <b>Consumer</b> <b>incomes</b> <b>increase</b>	(1) Which determinant has changed? (2) Will it affect supply or demand? (3) Will supply or demand increase or decrease? (4) GRAPH IT! What happens to price and quantity?
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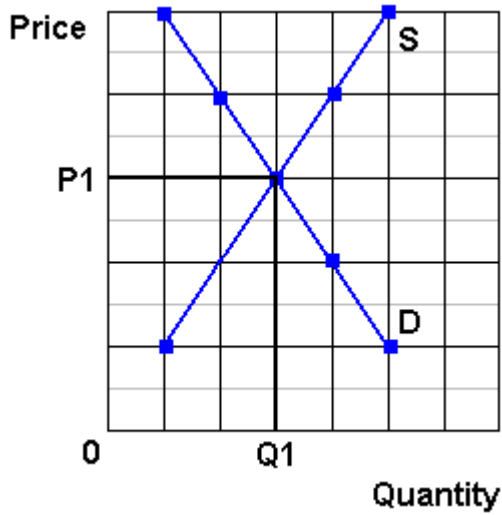
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**2. Calculators**

**Improved technology reduces the costs of production**

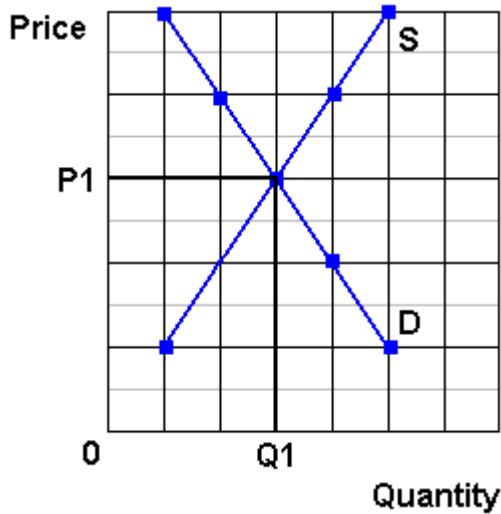
- (1) Which determinant has changed?
- (2) Will it affect supply or demand?
- (3) Will supply or demand increase or decrease?
- (4) GRAPH IT! What happens to price and quantity?



**3. Sony Play Station**

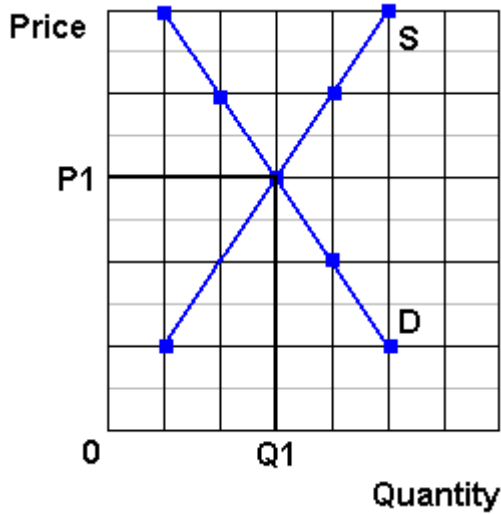
**Computer prices drop**

- (1) Which determinant has changed?
- (2) Will it affect supply or demand?
- (3) Will supply or demand increase or decrease?
- (4) GRAPH IT! What happens to price and quantity? (or maybe)



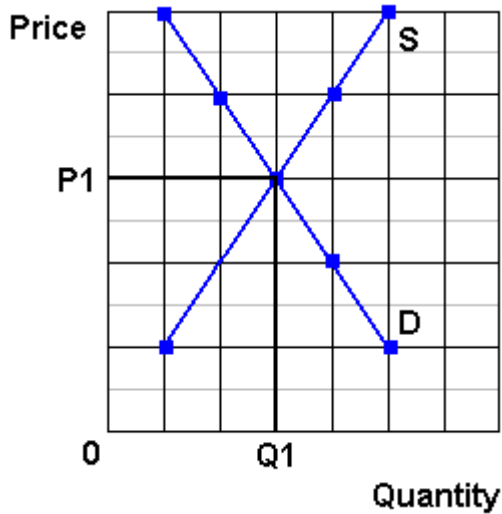
**4. Nikon  
Cameras  
Price of film  
developing  
decreases**

- (1) Which determinant has changed?
- (2) Will it affect supply or demand?
- (3) Will supply or demand increase or decrease?
- (4) GRAPH IT! What happens to price and quantity?



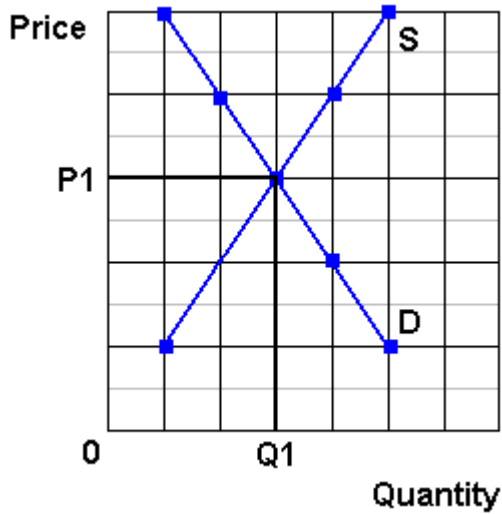
**5. Cigarettes  
Reduced gov't  
farm subsidies  
increase the  
costs of  
production**

- (1) Which determinant has changed?
- (2) Will it affect supply or demand?
- (3) Will supply or demand increase or decrease?
- (4) GRAPH IT! What happens to price and quantity?



**6. Coffee**  
**a report links**  
**coffee drinking**  
**to heart attacks**

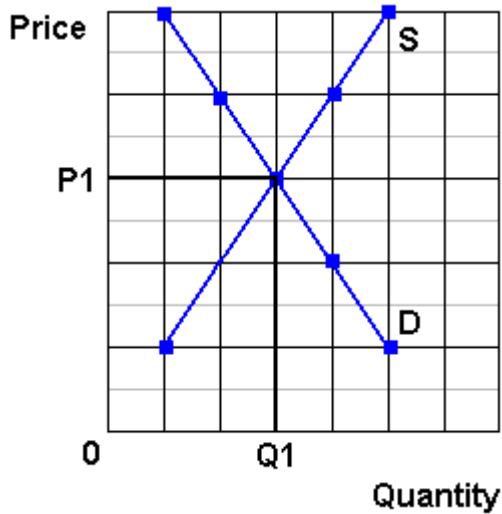
- (1) Which determinant has changed?
- (2) Will it affect supply or demand?
- (3) Will supply or demand increase or decrease?
- (4) GRAPH IT! What happens to price and quantity?



**7. Wood**  
**furniture**  
**Lumber prices**  
**rise**

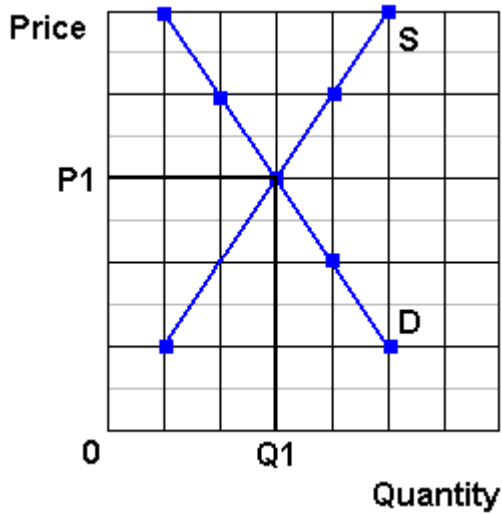
- (1) Which determinant has changed?
- (2) Will it affect supply or demand?
- (3) Will supply or demand increase or decrease?
- (4) GRAPH IT! What happens to price and quantity?





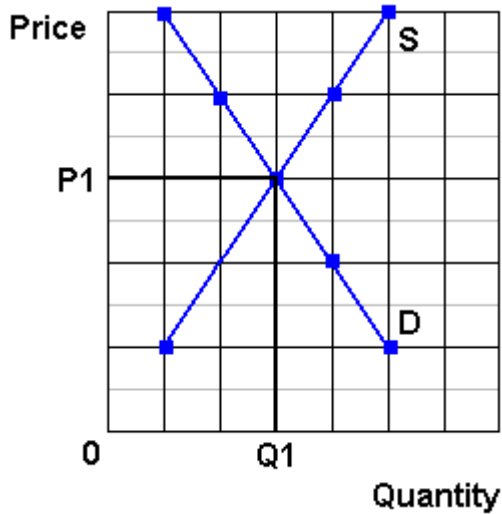
<b>8. Steel Furniture</b> <b>Wood furniture prices increase</b>	(1) Which determinant has changed? (2) Will it affect supply or demand? (3) Will supply or demand increase or decrease? (4) GRAPH IT! What happens to price and quantity?
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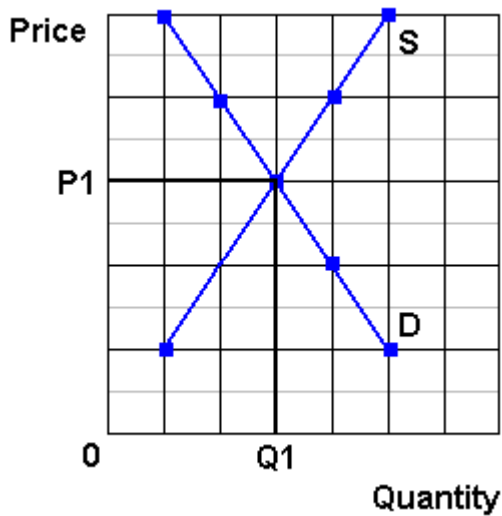
<b>9. Computers</b> <b>5 new firms enter the industry</b>	(1) Which determinant has changed? (2) Will it affect supply or demand? (3) Will supply or demand increase or decrease? (4) GRAPH IT! What happens to price and quantity?
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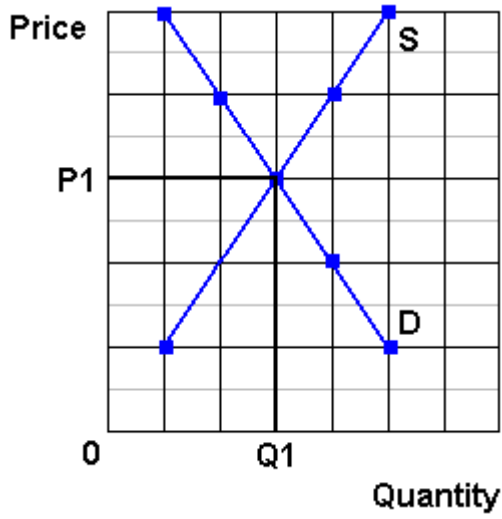
**10. Cigarettes**  
**Gov't announces**  
**a large tax**  
**increase will**  
**begin in 1 week**

- (1) Which determinant has changed?
- (2) Will it affect supply or demand?
- (3) Will supply or demand increase or decrease?
- (4) GRAPH IT! What happens to price and quantity?



**11. Gasoline**  
**Gasoline taxes**  
**increase**

- (1) Which determinant has changed?
- (2) Will it affect supply or demand?
- (3) Will supply or demand increase or decrease?
- (4) GRAPH IT! What happens to price and quantity?

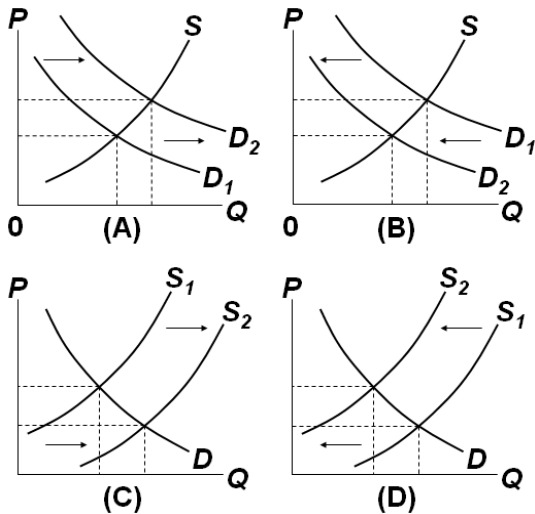


**12. Soybeans**

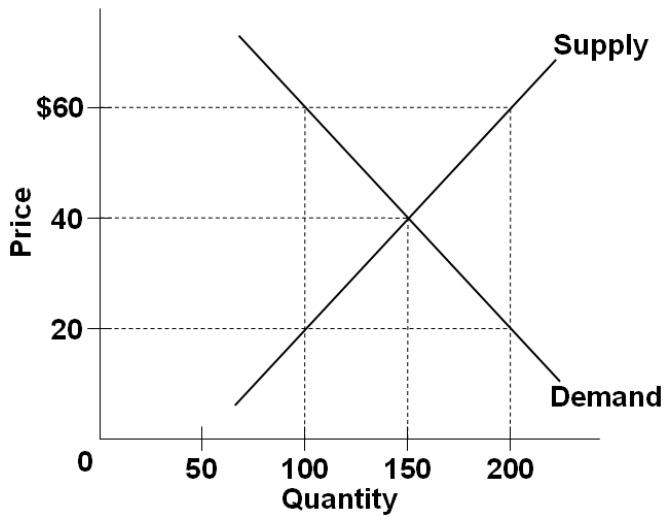
**The price of corn rises**

- (1) Which determinant has changed?
- (2) Will it affect supply or demand?
- (3) Will supply or demand increase or decrease?
- (4) GRAPH IT!\_What happens to price and quantity?

## Quick Quiz – Supply and Demand



- Which diagram above illustrates the effects on the peanut butter market of a higher wage rate for peanut workers?
  - A
  - B
  - C
  - D
- If peanut butter and grape jelly are complementary products, which diagram above illustrates the effect on the peanut butter market of a decrease in the price of grape jelly?
  - A
  - B
  - C
  - D
- If peanut butter and cheese spread are substitute products, which diagram above illustrates the effect on the peanut butter market of a decrease in the price of cheese spread?
  - A
  - B
  - C
  - D
- Which diagram above illustrates the effects on the peanut butter market of a technological advance which reduces the cost of harvesting peanuts?
  - A
  - B
  - C
  - D



5. Refer to the above diagram. A price of \$60 in this market will result in:
- equilibrium.
  - a shortage of 50 units.
  - a surplus of 50 units.
  - a surplus of 100 units.
6. Refer to the above diagram. A price of \$20 in this market will result in:
- a shortage of 50 units.
  - a surplus of 50 units.
  - a surplus of 100 units.
  - a shortage of 100 units.
7. Which of the following will cause a decrease in market equilibrium price and an increase in equilibrium quantity?
- an increase in supply.
  - an increase in demand.
  - a decrease in supply.
  - a decrease in demand.
8. Other things equal, the provision of a per unit subsidy for a product will:
- increase its supply.
  - increase its price.
  - decrease the quantity sold.
  - decrease its demand.
9. Which of the following would *not* shift the demand curve for beef?
- a widely publicized study that indicates beef increases one's cholesterol
  - a reduction in the price of cattle feed
  - an effective advertising campaign by pork producers
  - a change in the incomes of beef consumers
10. A decrease in the price of digital cameras will:
- cause the demand curve for memory cards to become vertical.
  - shift the demand curve for memory cards to the right.
  - shift the demand curve for memory cards to the left.
  - not affect the demand for memory cards.

11. An increase in the excise tax on cigarettes raises the price of cigarettes by shifting the:
- demand curve for cigarettes rightward.
  - demand curve for cigarettes leftward.
  - supply curve for cigarettes rightward.
  - supply curve for cigarettes leftward.

Answer the next question(s) on the basis of the given supply and demand data for wheat:

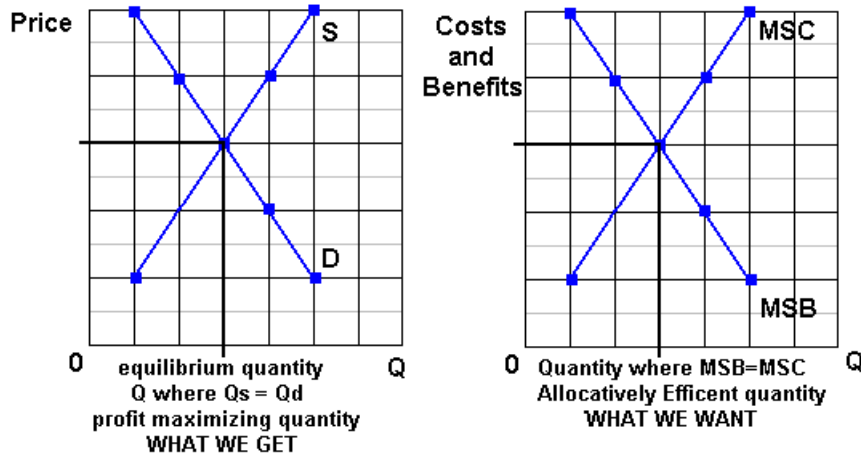
Bushels Demanded Per Month	Price Per Bushel	Bushels Supplied Per Month
45	\$5	77
50	4	73
56	3	68
61	2	61
67	1	57

12. Refer to the above data. Equilibrium price will be:
- \$4.
  - \$3.
  - \$2.
  - \$1.
13. Refer to the above data. If the price in this market was \$4:
- the market would clear; quantity demanded would equal quantity supplied.
  - buyers would want to purchase more wheat than is currently being supplied.
  - farmers would not be able to sell all their wheat.
  - there would be a shortage of wheat.
14. If the supply of a product decreases and the demand for that product simultaneously increases, then equilibrium:
- price must rise, but equilibrium quantity may rise, fall, or remain unchanged.
  - price must rise and equilibrium quantity must fall.
  - price and equilibrium quantity must both increase.
  - price and equilibrium quantity must both decline.
15. Suppose that in 2007 Ford sold 500,000 Mustangs at an average price of \$18,800 per car; in 2008, 600,000 Mustangs were sold at an average price of \$19,500 per car. These statements:
- suggest that the demand for Mustangs decreased between 2007 and 2008.
  - suggest that the supply of Mustangs must have increased between 2007 and 2008.
  - suggest that the demand for Mustangs increased between 2007 and 2008.
  - constitute an exception to the law of demand in that they suggest an upsloping demand curve.

# THE EFFICIENCY OF MARKETS

## Why are Markets Efficient?

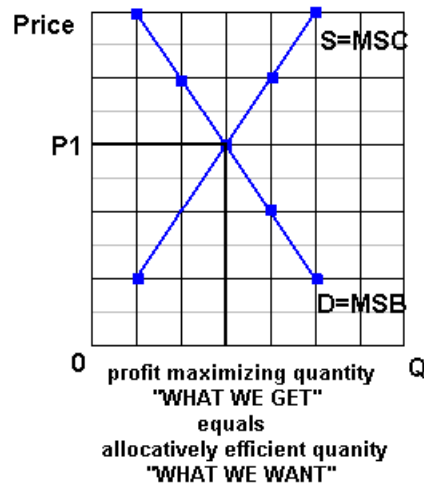
Businesses will produce the profit maximizing quantity. This is the equilibrium quantity where  $Q_d=Q_s$  (see graph below on the left). This is WHAT WE GET.



Society wants the allocatively efficient quantity. This is the quantity where  $MSB=MSC$  (see graph above on the right). This is WHAT WE WANT.

If there are no negative externalities (spillover costs) the  $S = MSC$ , and if there are no positive externalities (spillover benefits) the  $D = MSB$ , THEREFORE: WHAT WE GET = WHAT WE WANT and self-interested, profit maximizing, businesses will end up doing what is best for society - achieving allocative efficiency - as if there is some "invisible hand " guiding their decisions.

### Competitive Markets Achieve Allocative Efficiency



## SUMMARY:

- Businesses will produce the profit maximizing or market equilibrium quantity - the quantity where  $Q_d=Q_s$ ; (WHAT WE GET)
- Society wants the allocatively efficient quantity - the quantity where  $MSB=MSC$  ; (WHAT WE WANT)
- WHAT WE GET = WHAT WE WANT if:
  - Market Demand = Marginal Social Benefits ( $D=MSB$ )  
(and this is true if there are no positive externalities [spillover benefits])
  - Market Supply = Marginal Social Costs ( $S=MSC$ )  
(and this is true if there are no negative externalities [spillover costs])
  - THEREFORE if there are no negative externalities (spillover costs) and no positive externalities (spillover benefits) competitive markets (capitalism) achieves allocative efficiency

WHAT WE GET = WHAT WE WANT

This is the "invisible hand" of capitalism. Even though businesses are not trying to be efficient, when they are selfish and try to maximize their profits, THEY WILL BE EFFICIENT.

**In a market economy with no positive externalities (spillover benefits) and no negative externalities (spillover costs):**

**the profit maximizing or market equilibrium quantity  
(what we get)**

**WILL BE THE SAME AS**

**the allocative efficient quantity  
(what we want)**



# ***The mystical power of free trade***

**Some people find it hard to believe it really works, but it does**

**By Michael Kinsley**

<http://www.cnn.com/ALLPOLITICS/time/1999/12/06/free.trade.html>

**December 6, 1999**

*Web posted at: 1:27 p.m. EST (1827 GMT)*

Free trade is always a hard sell. In all of social science, the proposition that comes closest to being scientific, in terms of being theoretically provable and true in real life, is that a society benefits from allowing its citizens to buy what they wish--even from foreigners. But people resist this conclusion, sometimes violently, as in Seattle last week. Why?

A couple of reasons. First, the principle of free trade may be true, but it's not obviously true. In fact, it's counterintuitive. If a factory shuts down because of a flood of cheap foreign products, how is that good? If middle-class Americans find themselves competing with foreigners being paid practically nothing and living in squalor, how can this send Americans' standard of living up and not down? If another nation is willing to pollute its air and water in order to produce goods for sale in the global economy, how can America join that economy and still hope to keep its own air and water clean?

There are answers to these questions, but they take a bit of background and a bit of persuading. Students of economics are led step by step through layers of reasoning until the moment they see the light. Skeptics think that the whole routine is like induction into a religious cult and that free trade is more like an article of religious faith than a sound policy recommendation. These skeptics are wrong, but their skepticism is understandable.

The other reason it's hard to sell free trade is that any given example tends to benefit a lot of people in small ways that are hard to identify and tends to harm a few people a lot in ways that are vividly evident. When that factory shuts down, the unemployed workers know they've suffered a loss, and they know why. And it's a big enough loss to stir them politically. It will affect their vote at least, if not cause them to march in the streets.

By contrast, budget-conscious clothes shoppers (maybe those same workers) who are able to save a few bucks on a new sweater are not likely to realize they are enjoying a bargain as a result of global trade or to take to the streets to defend their right to a cheap sweater. Or suppose the U.S. slaps a tariff on foreign sweaters and the foreign country retaliates by raising a tariff on something we're selling them--the people who would lose their jobs aren't even identifiable for sure, though for sure they exist. Likewise the people who lose jobs because shoppers who have to pay more for sweaters have less money to spend on other things.

It's by considering all these things--the risk of losing your job one way minus the risk of losing it another, the extra money you make if your industry is shielded from foreign competition minus the extra money you pay for goods and services that are protected--that you reach the conclusion that on average, free trade benefits us all. Yes, there are various economic theories about circumstances in which all this may not be true, but their authors win prizes precisely because the circumstances are unusual. In general, the numbers work irrespective of what policies other countries follow. They just

get worse if one country's trade restrictions lead other countries to impose more of the same. Trouble is, who's got time for all that math?

Still, a half-century of general prosperity in the U.S. has created a climate of toleration, if not enthusiasm, for the free-trade gospel--mostly, indeed, as a gospel of our civic religion rather than out of anyone's buying the math. Alarm about imports tends to ebb and flow with the economy--less in good times, more in bad. So how, in the best times ever, did the World Trade Organization become the global bogeyman? No earnest college kid ever hitched across the country to carry a picket sign against the General Agreement on Tariffs and Trade, the WTO's predecessor, although its function was similar. It took decades for the CIA, the Trilateral Commission and the Council on Foreign Relations to achieve their places in the pantheon of political paranoia. The WTO has joined them in just four years. And it is despised across the entire political spectrum, whereas these other groups symbolize evil only to one political extreme or the other.

Part of the explanation is the special nature of our current prosperity, which is widening the income gap rather than narrowing it, as in the past. Part is the growth of global economic forces that are actually impinging on national sovereignty, even though it's the paranoid hysterics who say so. But the WTO isn't responsible for either of these trends, both of which are probably inevitable and neither of which undermines the basic case for free trade or for an organization empowered to promote trade through binding arbitration of trade disputes.

Maybe it's the name. If you call yourself the World Trade Organization, you can't complain much if people dial your 800 number and gripe about world trade. If a bunch of heads of government plan a triumphalist self-celebration in Seattle, you can't blame party poopers for showing up to horn in on the publicity. But really, the WTO is O.K. Do the math. Or take it on faith.

## QUIZ

### *Do you think like an economist?*

1. The purpose of economic activity is:

- A. to improve consumer well being
- B. to create jobs

2. Work is a:

- A. cost
- B. benefit

3. Imports are a

- A. benefit
- B. cost

4. Exports are a

- A. cost
- B. benefit

5. The objective of trade is to

- A. get goods cheaply
- B. create jobs

Assume there is an attorney who is an excellent auto mechanic and his/her car needs repair.

The attorney could fix it in one hour. An auto mechanic could fix it in two hours. (Note: the auto mechanic is not as good at fixing cars, or at doing law, as the attorney – the attorney is better at both)

Let's say the auto mechanic charges \$50 an hour and the attorney charges \$200 per hour.

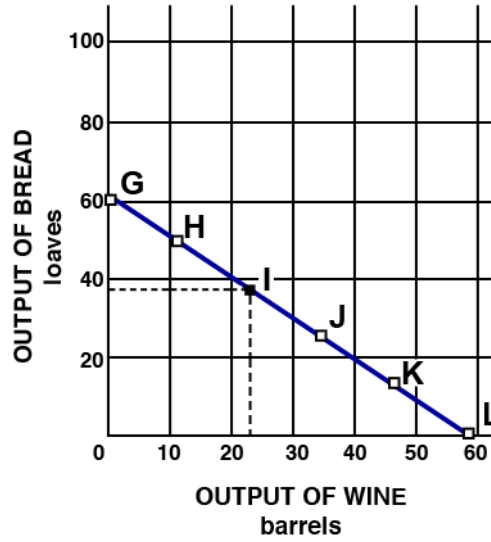
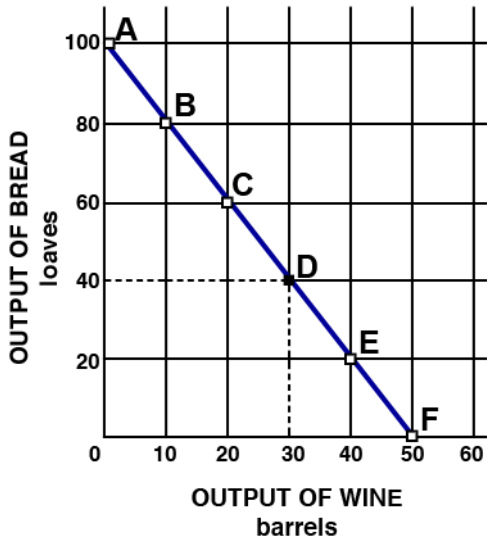
Should the attorney fix the car himself/herself or should they bring it to the auto mechanic?

Why?

## Absolute Advantage

US	
Bread	Wine
100	0
80	10
60	20
40	30
20	40
0	50

FRANCE	
Bread	Wine
15	0
12	12
9	24
6	36
3	48
0	60



**BEFORE**

B      W

US

Fr

total



**SPECIALIZATION**

B      W

US

Fr

total



**EXCHANGE**

B      W

US

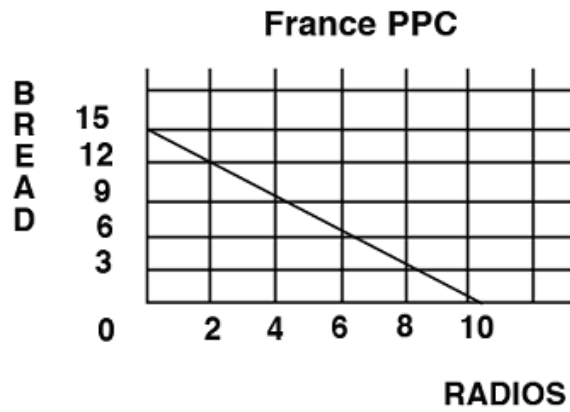
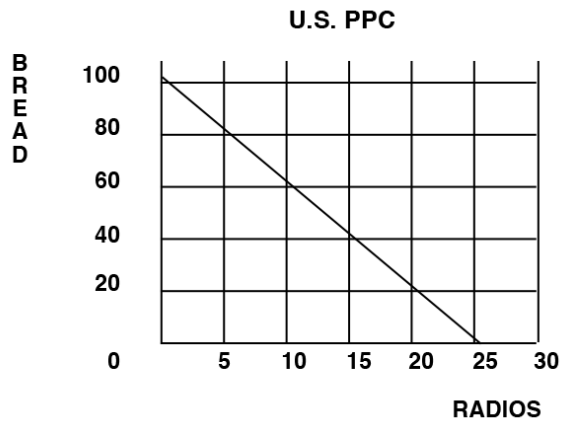
Fr

total



## Comparative Advantage

US	Bread	Radios	FRANCE	Bread	Radios
	100	0		15	0
	80	5		12	2
	60	10		9	4
	40	15		6	6
	20	20		3	8
	0	25		0	10



**BEFORE**

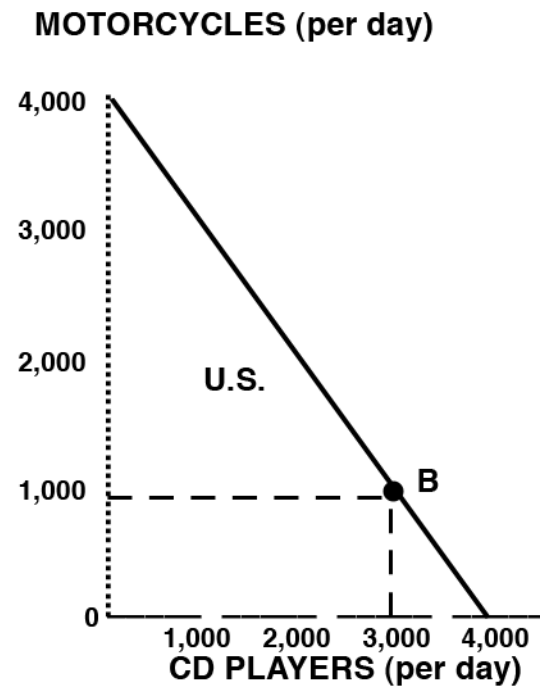
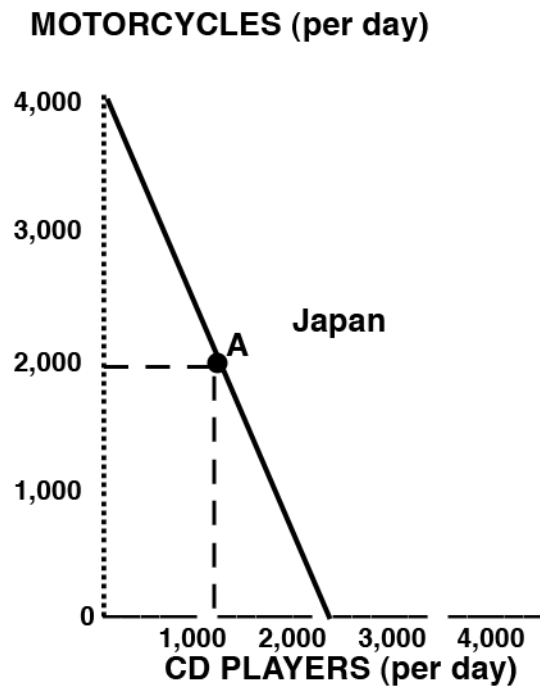
	B	R
US		
Fr		
total	_____	

**SPECIALIZATION**

	B	R
US		
Fr		
total	_____	

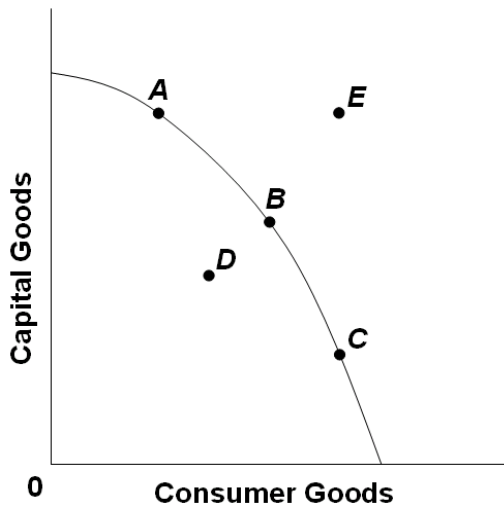
**EXCHANGE**

	B	R
US		
Fr		
total	_____	



1. Who has a comparative advantage in motorcycles?
2. Who has a comparative advantage in CD players?
3. Assume that before specialization and trade Japan is at point A and the U.S. is at point B. If each country specializes 100% according to their comparative advantage, what are the gains from specialization and trade?

## Quick Quiz – Comparative Advantage



1. Refer to the above domestic production possibilities curve for Karalex. The gain to Karalex from specialization and international trade is represented by a move from:

- A. A to B.
- B. C to A.
- C. C to D.
- D. B to E.

2. Renee earns \$500 per hour in the courtroom as a trial lawyer; she can type up her legal documents at a rate of 80 words per minute. Christopher has no training as a trial lawyer, but can type legal documents at a rate of 50 words per minute for a wage of \$30 per hour. Based on the theory of comparative advantage:

- A. Renee should do all of her own typing.
- B. Renee should specialize in courtroom trials and hire Christopher to type her legal documents.
- C. Renee should only hire Christopher if he can raise his typing speed to faster than 80 words per minute.
- D. Comparative advantage doesn't apply to this case because it does not involve international trade.

### Alpha's Production Possibilities:

	<u>A</u>	<u>B</u>	<u>C</u>	<u>D</u>	<u>E</u>
Steel (tons)	60	45	30	15	0
Wheat (tons)	0	15	30	45	60

### Omega's Production Possibilities:

	<u>A</u>	<u>B</u>	<u>C</u>	<u>D</u>	<u>E</u>
Steel (tons)	20	15	10	5	0
Wheat (tons)	0	15	30	45	60



3. The above data would graph as:
- A. a straight line for Alpha, but as a concave curve for Omega.
  - B. a concave curve for Alpha, but as a straight line for Omega.
  - C. concave curves for both Alpha and Omega.
  - D. straight lines for both Alpha and Omega.
4. Refer to the above data. The domestic opportunity cost of producing 1 ton of steel in Alpha is:
- A.  $\frac{1}{2}$  ton of wheat.
  - B. 1 ton of wheat.
  - C. 15 tons of wheat.
  - D. 30 tons of wheat.
5. Refer to the above data. The domestic opportunity cost of producing 1 ton of steel in Omega is:
- A.  $\frac{1}{2}$  ton of wheat.
  - B. 2 tons of wheat.
  - C. 3 tons of wheat.
  - D. 5 tons of wheat.
6. Refer to the above data. Alpha has a comparative advantage in producing:
- A. neither steel nor wheat.
  - B. both steel and wheat.
  - C. steel.
  - D. wheat.
7. Refer to the above data. On the basis of the above information:
- A. Alpha should export both steel and wheat to Omega.
  - B. Omega should export both steel and wheat to Alpha.
  - C. Omega should export steel to Alpha and Alpha should export wheat to Omega.
  - D. Alpha should export steel to Omega and Omega should export wheat to Alpha.
8. Refer to the above data. If Alpha and Omega each were producing at alternatives B before trade, the gain from specialization and trade would be:
- A. 30 tons of wheat.
  - B. 15 tons of steel.
  - C. 30 tons of steel and 30 tons of wheat.
  - D. 60 tons of wheat and 60 tons of steel.
9. According to the concept of comparative advantage, a good should be produced in that nation where:
- A. its domestic opportunity cost is greatest.
  - B. money is used as a medium of exchange.
  - C. its domestic opportunity cost is least.
  - D. the terms of trade are maximized.

## ***Should the US use trade restrictions to protect American jobs?***

### **READ:**

#### **Could your job go to China?**

#### **While U.S. employment leaps ...**

September 7, 2001 Posted: 12:07 PM EDT (1607 GMT)

[<http://www.cnn.com/2001/CAREER/trends/09/06/china.trade.jobs/index.html>]

By Porter Anderson

CNN Career

(CNN) -- Just as Friday's new Labor Department report shows the United States unemployment rate soaring in August to 4.9 percent from 4.6 percent, a newly released, federally funded study reveals that a significant number of production jobs are shifting from the American workplace to China.

Labor Department statistics suggest that U.S. employers cut far more jobs in August than private economists had anticipated -- 113,000 non-farm positions. And this is after American layoffs passed the 1-million mark in July.

But what concerns Stephanie Luce, Ph.D., about her research data is not just her figure of at least 34,900 jobs -- and maybe twice that -- moving from the States to China in a seven-month period as a result of warming Washington-Beijing trade relations.

"What makes it worse," she says, "is that some of these are higher-wage jobs, the type jobs that U.S. cities have been fighting to win. And now they're leaving. Many of those jobs were held by people who'd been working in them for many years, and in some cases their whole lifetimes."

### **QUESTIONS:**

#### **AFTER READING, WHAT DO YOU THINK?**

#### **Should the US use trade restrictions to protect American jobs?**

- What is YOUR answer to this question? YES / NO
- How would most economists answer this question? YES / NO
- According to economic studies which of the following is true for countries that restrict trade?
  - The **benefits** of trade restrictions are much **greater** than their costs
  - The **costs** of trade restrictions are much **greater** than the benefits
- If YOU answered NO to the first question, how do you reconcile your answer with the news article above? OR what could be done instead of trade restrictions?

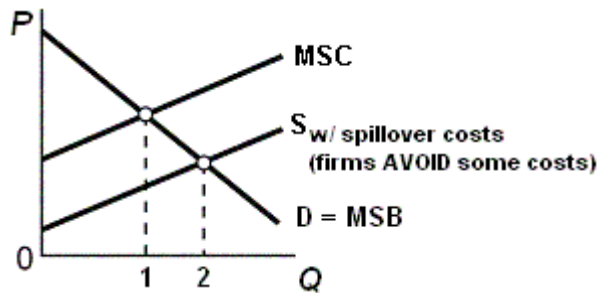
## Ch. 4 -- The Economic Functions of Government and the 5 Es

### NEGATIVE EXTERNALITIES

Define Negative Externalities (Spillover costs):

Examples of Negative Externalities (Spillover costs):

Use the graph below to answer the questions that follow.



What is the allocatively efficient quantity?

What is the profit maximizing quantity?

Which quantity will be produced without government involvement?

Is there an OVER allocation or an UNDERallocation of resources?

What is the goal of government involvement? [When spillover costs are associated with a product like gasoline what should the government try to do to the QUANTITY -- INCREASE OR DECREASE it?]

What are the possible government policies to achieve this goal?

On your graph show the effect of an increase in the excise tax on gasoline

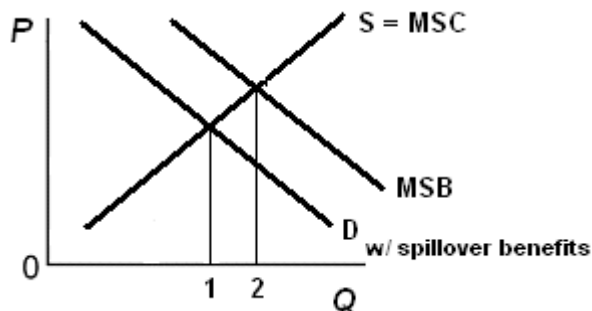
What happens to the quantity and allocative efficiency when the government taxes a product whose production has negative externalities (spillover costs)?

## POSITIVE EXTERNALITIES

**Define Positive Externalities (Spillover benefits):**

**Examples of Positive Externalities (Spillover benefits):**

**Use the graph below to answer the questions that follow.**



What is the allocatively efficient quantity?

What is the profit maximizing quantity?

Which quantity will be produced without government involvement?

Is there an OVER allocation or an UNDERallocation of resources?

What is the goal of government involvement? [When spillover benefits are associated with a product like education what should the government try to do to the QUANTITY -- INCREASE OR DECREASE it?]

What are the possible government policies to achieve this goal?

On your graph show the effect of an increase supply on the market for education.

What happens to quantity and allocative efficiency when the government subsidizes a product whose production has positive externalities (spillover benefits)?

## Quick Quiz - The Economic Functions of Government and the 5 Es

1. A pure market economy overallocates resources to the production of goods that:
  - A. involve negative externalities.
  - B. involve positive externalities.
  - C. are public goods.
  - D. are inexpensive to produce.
  
2. If a market is competitive but externalities are present, the resulting equilibrium output:
  - A. will also be the most efficient output.
  - B. will always be less than the most efficient output.
  - C. will always be greater than the most efficient output.
  - D. may be either larger or smaller than the most efficient output.
  
3. If a good's production creates substantial positive externalities and no negative externalities, then:
  - A. too much of the good will be produced unless firms are subsidized.
  - B. too much of the good will be produced unless firms are taxed.
  - C. too little of the good will be produced unless firms are subsidized.
  - D. too little of the good will be produced unless firms are taxed.
  
4. Suppose a product creates substantial negative externalities. If government adopts a policy that forces producers to pay these costs, the:
  - A. output of the product will decrease.
  - B. initial misallocation of resources will be intensified.
  - C. output of the product will increase.
  - D. price of the product will decrease.
  
5. The Federal government requires automobile manufacturers to install pollution control equipment. This is an illustration of the:
  - A. intrusion problem.
  - B. production of public goods.
  - C. internalization of external benefits.
  - D. internalization of external costs.
  
6. Susie lives in a dorm and likes to play loud music in her room. Her neighbor Kara enjoys the same type of music and gets pleasure from Susie turning up the music. Her other neighbor, Alex, can't stand Susie's music and gets mad when she turns it up for all to hear. When Susie plays her music loudly, she creates:
  - A. a positive externality for Kara, and a negative externality for Alex.
  - B. a negative externality for Kara, and a positive externality for Alex.
  - C. positive externalities for both Kara and Alex.
  - D. negative externalities for both Kara and Alex.