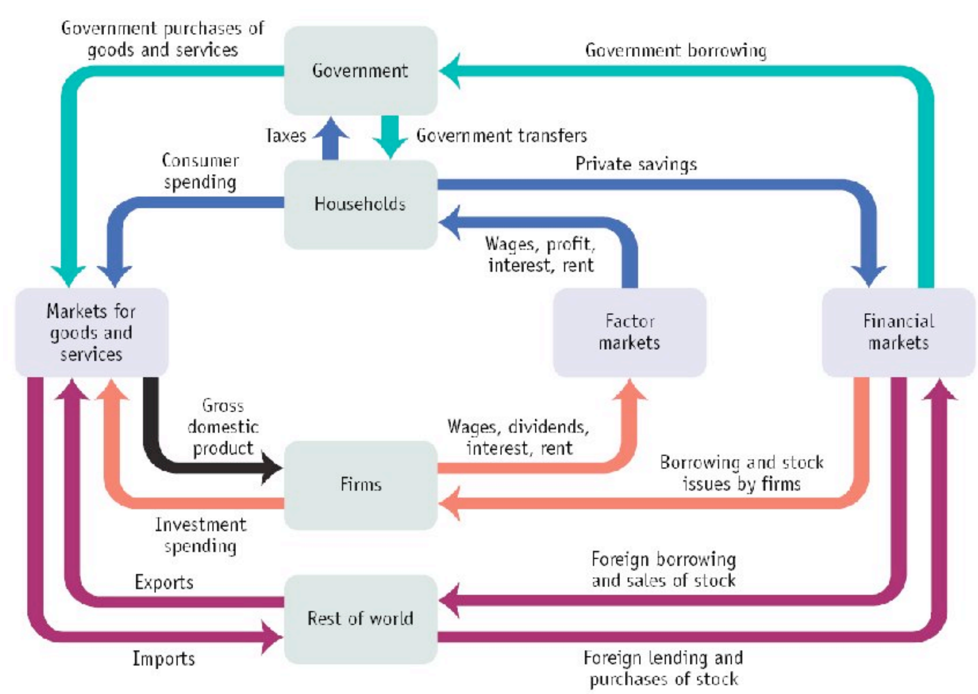
AP Microeconomics
Unit 2 – The Nature and Function of Markets

<u>Circular Flow Diagram</u>

- The Circular Flow of Resources, Goods, Services, and Money Payments. The model provides a perspective on how prices allocate resources in a market economy.
- Illustrates the interdependence of a market economy.
- The way to see the economic interactions among main sectors in the economy
- The Circular Flow shows seven sectors of the economy:
  - Households
    - Sellers in the factor market
    - Receive “national income” from their work
    - Transfer payments: social security benefits, veteran benefits, and welfare payments
    - Buyers in the product market
    - Pay taxes to the government
    - Save by putting money in financial markets
  - Firms
    - Buyers in the factor market
    - Provide payments for the factors of production to the households
    - Sellers in the product market
    - Provide finished goods & services to the households
  - Government
    - Interacts with households & firms
  - Foreign Economies
  - Financial Markets
    - Receive savings from households
  - Product Markets
    - Market where finished goods & services are bought and sold
  - Factor Markets
    - Market where resources are bought and sold

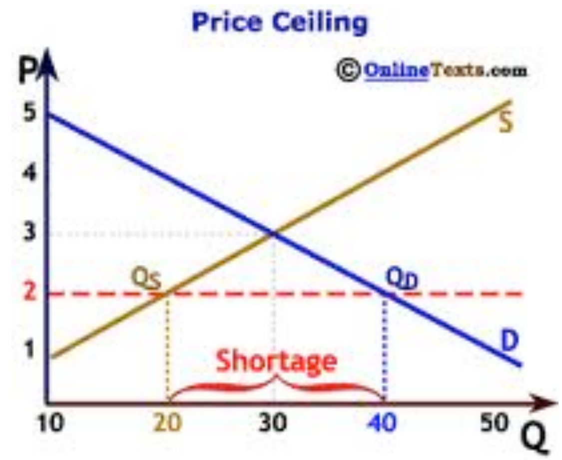


<u>Demand, Supply, & Equilibrium</u>

- Demand
  - The relationship between the quantities of a good consumers are **<u>willing and able</u>** to purchase at various prices in a given period of time.
  - Demand curve has an inverse relationship between price and quantity, as depicted in its graph which runs downward from left to right.
  - **The Law of Demand** states that consumers buy more of a good when its price is low and less when its price increases.
  - Determinants of Demand (Line Shifters)
    - Tastes & Preferences (Consumer Expectations)
    - Income
    - Substitutes and Complements
    - Population of Buyers (# of Buyers)
- Supply
  - The relationship between price and the amount that producers are **<u>willing and able</u>** to sell at various prices in a given period of time.
  - Supply curve has a direct relationship between price and quantity, as depicted in its graph which runs upward from left to right.
  - **The Law of Supply** states that at higher prices, producers are willing to offer more of a product than at the lower prices.
  - Determinants of Supply (Line Shifters)
    - Technology
    - Price of Inputs
    - Tax OR Subsidy
    - Price of Related Goods
    - Population of Sellers (# of Sellers)
- Equilibrium
  - Also known as the market clearing price.
  - Point where supply and demand.
  - Interaction of supply and demand determines price and quantity that will clear the market.
- Elasticity / Inelasticity
  - Elasticity
    - the measure of responsiveness to any stimulus (price change)
  - Elastic Goods
    - The change in quantity is greater than the change in price
    - Characteristics of Elastic goods
      - Many substitutes
      - Not essential to daily life (often luxury items)
      - Requires large part of budget
      - Can be purchased later
  - Inelastic Goods
    - The change in quantity is less than the change in price
    - Characteristics of Inelastic goods
      - Few substitutes
      - Necessity for life
      - Requires small portion of our budget
      - Must be purchased without delay
  - How to measure Elasticity
    - Total Revenue Test
      - Elastic Demand
        - Price Increases, Total Revenue Decreases
        - Price Decreases, Total Revenue Increases

        - Unit Elastic Demand
            - Price Increases, Total Revenue Unchanged
            - Price Decreases, Total Revenue Unchanged
        - Inelastic Demand
            - Price Increases, Total Revenue Increases
            - Price Decreases, Total Revenue Decreases
    - Elasticity Coefficient
        - Elasticity of Demand (E_d)
            - % change in quantity demanded / % change in price
                - $E < 1$ = inelastic
                - $E > 1$ = elastic
                - E = unit elastic

- Price Ceilings and Price Floors
    - Legislators have often been dissatisfied with outcomes of free markets
    - "Invisible Hand" not good enough so they mandate prices higher or lower than equilibrium
    - Changing prices are incentives in determining:
        - What to Produce? How to Produce? For Whom to Produce?
    - **Price Ceiling** – a legal maximum price that might be charged for a good or service.
        - Below equilibrium price
        - Causes a shortage
        - Allows for illegal markets to develop



    - **Price Floor** – a legal minimum price that may be charged for a good or service.
        - Above equilibrium price
        - Causes surpluses