WHY ECONOMICS?

CONCEPT #3 SUPPLY & DEMAND: PRICES

What students should know about economics and why: 6 Key Ideas

#3 Who Determines the Prices that We Pay?

Many students and adults think a business can set whatever prices it wants. To the contrary, consumers "control" prices and vote with their feet. In addition, a business needs to set prices that pay all its costs and allow it to make a profit if it is to survive. Understanding the factors that determine prices will not only make us better decision makers as consumers, but will also make us better employees by understanding what impacts the prices our employer can set.

Why do people trade?

Voluntary exchange creates wealth. Because one person's trash is another person's treasure, two people can exchange and both will benefit. So people have been exchanging since time began. Markets are simply interactions between buyers and sellers where the mutual goal is to make a trade. The quandary is that buyers want the lowest price possible and sellers want the highest price possible. How does the pricing issue get resolved?

Where do prices come from?

Imagine an auction where buyers and sellers come together to exchange products. Buyers look over the products and the bidding begins. Prices are likely to be higher if there are many buyers in the room and lower if there are few. Prices are likely to be higher if there are only a few sellers in the room and lower if there are many. So the number of buyers in the room and the number of sellers in the room influence the price of the products. In addition, buyers' willingness and ability to buy will be influenced by their incomes, their tastes, conditions at other auctions for other products, and their expectations about the price and availability of similar products in the future. Sellers will be influenced by their costs of production. They can afford to sell less costly items at lower prices and higher cost items only at higher prices.

Buyers and sellers respond to incentives. Sellers who expect to earn a profit for supplying laptops will do so; buyers who expect to get more pleasure from the laptop than the money they give up will buy a laptop. So prices are incentives for sellers and for buyers. Once all of the

considerations above (incomes, tastes, costs of production) are accounted for, buyers will buy more of a product at lower prices and less of a product at higher prices. After considering production costs, suppliers will supply more of a product if the price is higher and less of the product if the price is lower.

In a competitive market, sellers compete against other suppliers to sell their products and buyers bid against other buyers to obtain the product. This competition of sellers against sellers and buyers against buyers determines the price of the product. It's called supply and demand. The price is the measure of how scarce one product is compared to all other products and all incomes.

What do prices do?

If someone were asked how tall you are, you might answer, "Five feet, eight inches." If you were asked how much you weighed, you might reply "145 pounds." If you were asked how scarce your cup of coffee is, you could reply,"$2.25." Just as feet, inches, and pounds are units of measurement, so too are dollars and cents or Euros or Rupee or Pesos. A price is nothing more than a unit of measure. It measures how scarce a good or service is relative to all incomes and all other goods and services. A yacht is scarcer than a pencil, a diamond is scarcer than the same quantity of water, and a car is scarcer than a bicycle. Relative scarcity is determined by the interaction of supply and demand for a particular product. What makes some products scarcer than others and some products less scarce than others is the relationship between buyers and sellers for that product compared to all others. Prices reflect the relative scarcity of a product and provide information to buyers and sellers.

How do prices change?

The relative scarcity of a product and, therefore, the price of a product, changes if something changes with buyers or sellers in the market. If buyers decide that the laptop is not as desirable as it once was, demand will fall, the laptop will become less scarce, and the price will fall. If there is a flood in the Midwest that wipes out much of the winter wheat crop, supply will fall, the product will become scarcer, and the price will rise. Ideally, when students notice price changes they will recognize that supply or demand has changed and wonder which and why. Having this understanding of markets nd prices will make them savvy consumers, not "victims" of the system.

To understand markets is to understand the human story. Markets have played a pivotal role in the decisions that people have made from the beginning. Ancient civilizations developed as their ability to produce agricultural surpluses gave them the ability to exchange their surplus for other goods and services that they could not produce. The Bronze Age developed as this ability to produce and trade developed. Civilizations in Asia, Africa, and Europe came to know each other as a result of this desire to trade. Marc Antony's original incentive for going to

Egypt was not Cleopatra, but the huge wheat surpluses that largely fed Rome. The European maritime explorers were exploring for a sea route to the spice markets of the East after those markets had been cut off by Mehmet when he conquered Constantinople. While British sympathies lay largely with the North during the American Civil War, they were tempted to aid the South because of British demand for cotton. The history of America and the story of Native Americans owe as much to the beaver, the otter, and the bison and their respective markets as to Pontiac, Crazy Horse, Sitting Bull or George Custer. It probably need not be said that Western foreign policy in the last fifty years has been influence by the oil market.

Once students understand the concept of relative scarcity determined by supply and demand, they can apply the same reasoning to product markets, labor markets, credit markets, and foreign exchange markets. Most important, perhaps, they will understand the application of the phrase, "Make yourself scarce," to their situation in terms of developing skills that are in high demand and low supply in the labor market. Understanding the process of price/wage determination and the fact that higher wages reflect greater scarcity and lower wages reflect less scarcity can provide the incentive for students to adequately prepare themselves for labor market completion.

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