Learning Objectives

Upon completion of this unit, students should be able to:

1. Explain the role of the household in an economic system.
2. Identify the different types of firms and describe their roles in the economy.
3. Outline the ways governments affect their economies.
4. Explain how the law of demand affects market activity.
5. Explain how the law of supply affects market activity.
6. Describe how the interaction between supply and demand creates markets.
7. Describe how markets reach equilibrium.
8. Explain how markets react during periods of disequilibrium.

Unit Summary

In Unit I, the foundation of economic activity was introduced. Unit II analyzes the elements of market activity on a slightly deeper basis. One of the most important components of an economy is households, and Chapter 3 details the role of households in an economic system. Households receive income, purchase goods and services, pay taxes, and make efforts to maximize satisfaction and well-being. Each of these factors has a significant impact on what goods and services an economy produces and the prices of those goods and services. Essentially, households and consumers are synonymous in macroeconomics.

Interaction in the market for goods and services occurs between households and firms, and the laws of supply and demand tend to govern the market. The law of demand explains the rational behavior of consumers in that as the prices for goods decrease, consumers will purchase more. Conversely, the law of supply states that as prices increase, producers desire to supply more of the good. Both of these laws are used to design supply and demand schedules or various prices and quantities supplied and demanded by producers and consumers, respectively. The schedules can then be plotted in one quadrant of the coordinate plane to construct the supply and demand curves. (The supplemental material for this unit lists this process step by step. It can be accessed by clicking the image below.)

Key Terms

1. Complements
2. Cooperative
3. Corporation
4. Demand
5. Demand curve
6. Equilibrium
7. Externality
8. Firms
9. Individual demand
10. Industrial Revolution
11. Inferior good
12. Law of demand
13. Law of supply
14. Market demand
15. Market failure
16. Monopoly
17. Movement along a demand curve
18. Movement along a supply curve
19. Natural monopoly
20. Normal good
21. Not-for-profit organizations

(Click image for interactive learning material)
Economists use models to simplify otherwise complex interactions in the economy. The supply and demand graph is an excellent example of an economic model. When the demand and supply schedules are graphed, equilibrium price and quantity become intuitive. Working with the supply and demand graph is much more efficient than using the schedules, definitions, mathematical calculations, and extensive written explanations required for otherwise depicting various occurrences in an economy.

After deriving the supply and demand curves, it is necessary to understand what causes movements along each curve, and furthermore, what can cause each curve to shift. Changes in prices are the only events that can cause movement along the supply and demand curves. However, several factors can cause the curves to shift. The demand curve for households can shift with a change in income, preferences, or the demand for substitutes. The supply curve shifts with a change in the factors of production or a change in the price of substitutes.

At times, the government may impose protective measures in order to restrict free market prices. A price floor is a minimum price set by the government in order to prevent market prices from becoming too low. Often, price floors are used to protect the producers of agricultural goods. A price ceiling is similar to a price floor, only it is a government-controlled price maximum. Controlling prices in this manner protects the public from predatory pricing by businesses when demand increases. The housing market can require this type of protection.

This unit introduced one of the most important models in economics. Supply and demand analysis is a valuable tool for businessmen, politicians, and researchers. Remember, the supplemental material is available as a resource for better comprehension.