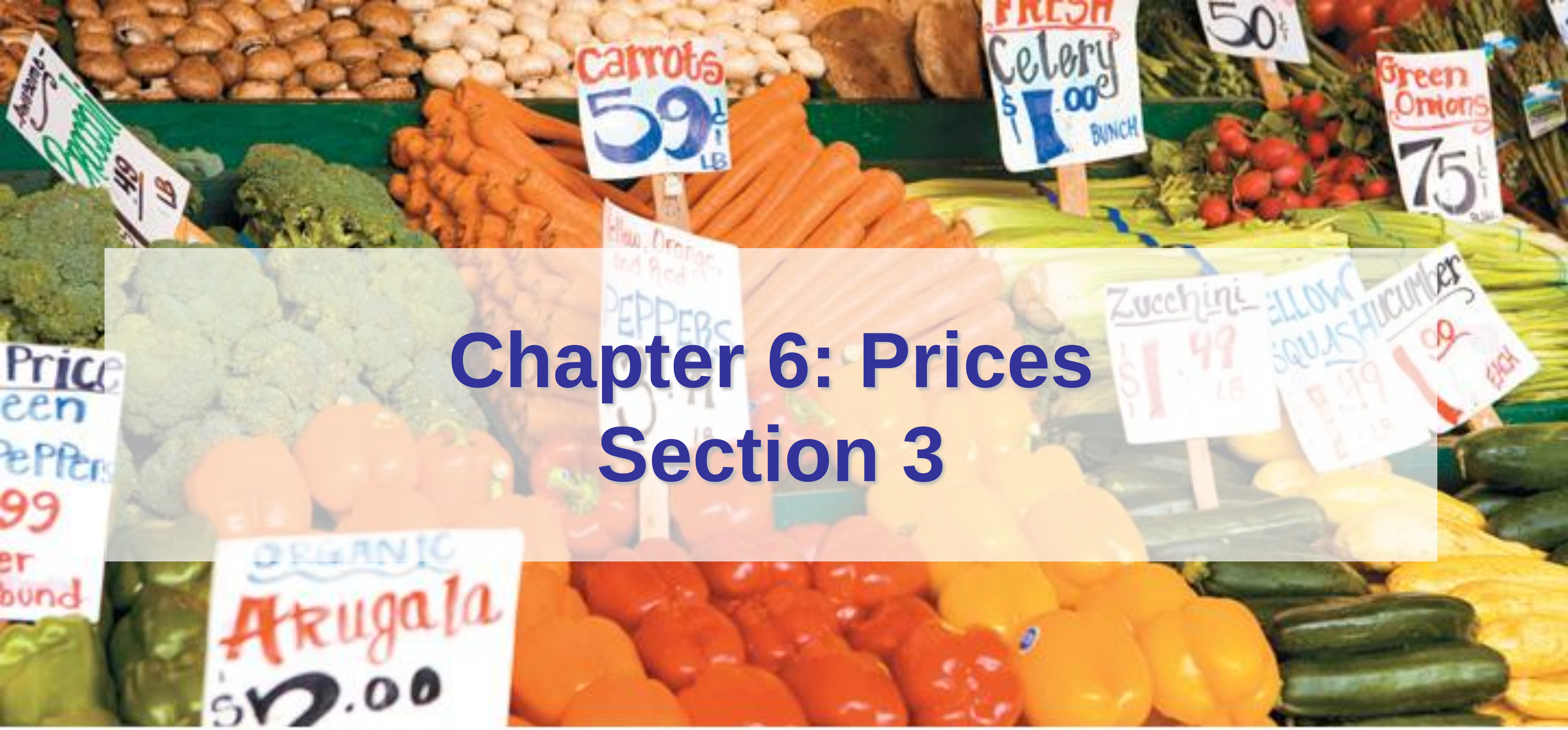


Chapter 6: Prices
Section 3

Prentice Hall
ECONOMICS
PEARSON
In Partnership With
THE WALL STREET JOURNAL
CLASSROOM EDITION

Objectives

1. **Identify** the many roles that prices play in a free market.
2. **List** the advantages of a price-based system.
3. **Explain** how a price-based system leads to a wider choice of goods and more efficient allocation of resources.
4. **Describe** the relationship between prices and the profit incentive.

Key Terms

- **supply shock**: a sudden shortage of a good
- **rationing**: a system of allocating scarce goods and services using criteria other than price
- **black market**: a market in which goods are sold illegally, without regard for government controls on price quantity

Introduction

- What roles do prices play in a free market economy?

  - In a free market economy, prices are used to distribute goods and resources throughout the economy.
  - Prices play other roles, including:
    - Serving as a language for buyers and sellers
    - Serving as an incentive for producers
    - Serving as a signal of economic conditions

Price as an Incentive

- Prices provide a standard of measure of value throughout the world.
  - Prices act as a signal that tells producers and consumers how to adjust.
  - Prices tell buyers and sellers whether goods are in short supply or readily available.
  - The price system is flexible and free, and it allows for a wide diversity of goods and services.

Prices as a Signal

- Prices can act as a signal to both producers and consumers:
  - A high price tells producers that a product is in demand and they should make more.
  - A low price indicates to producers that a good is being overproduced.
  - A high price tells consumers to think about their purchases more carefully.
  - A low price indicates to consumers to buy more of the product.

Flexibility of Prices

- Prices are flexible, which means they can be increased to solve problems of shortage and decreased to solve problems of surplus.
- Raising prices is one of the quickest ways to solve a shortage. It reduces quantity demanded and only people who have enough money will be able to pay the higher prices. This will cause the market to settle at a new equilibrium.

Free Market v. Command

- Free market systems based on prices cost nothing to administer.
- Central planning, on the other hand, requires a number of people to decide how resources are distributed, such as in the former Soviet Union.
- Unlike central planning, free market pricing is based on decisions made by consumers and suppliers.

Consumer Choices

- In a free market economy, prices help consumers choose among similar products and allow producers to target their customers with the products the customers want most.
- In a command economy, production is restricted to a few varieties of each product. As a result, there are fewer consumer choices.

Rationing & the Black Market

- In a command economy, or in a free market economy during wartime, shortages are common.
- One response to shortages is rationing.
  - Since the government cannot track all of the goods passing through the economy, people sometimes conduct business on the illegal black market in order to bypass rationing.

Rationing During WWII

- During World War II, the federal government used rationing to control shortages.
  - Each family was given tickets for such items as butter, sugar, or shoes. If you used up your allotment, you could not legally buy these items again until new tickets were issued.

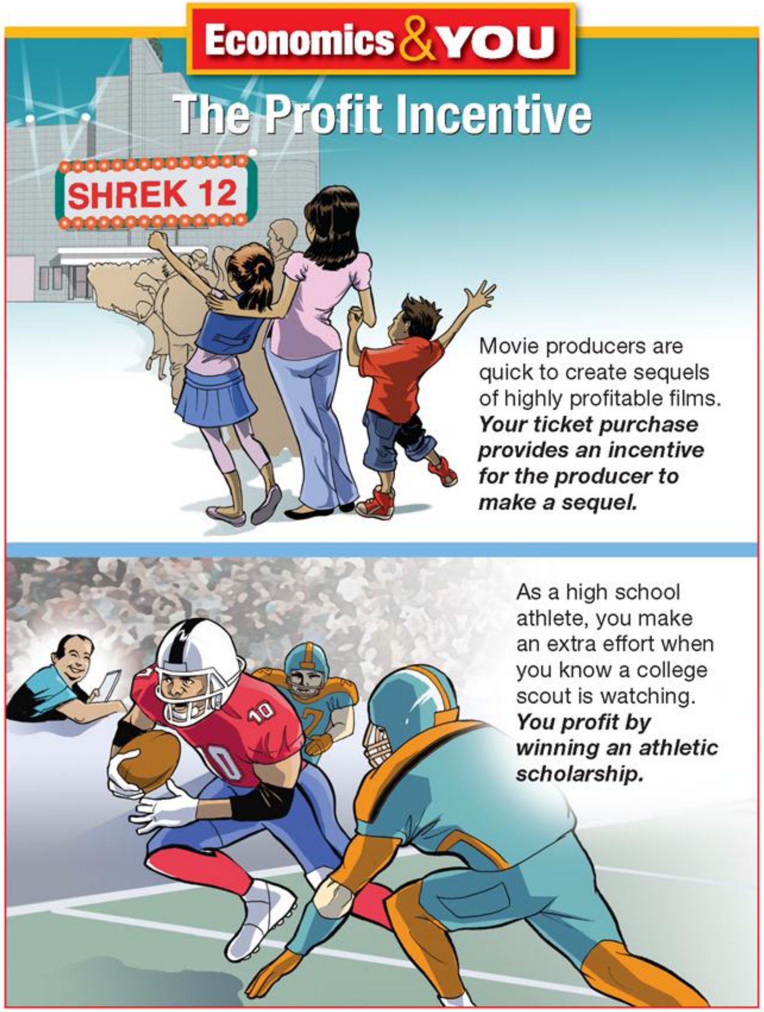
Efficient Resource Allocation

- The free market system allows for efficient resource allocation, which means that the factors of production will be used for their most valuable purposes.

- Efficient resource allocation works with the profit incentive. Producers will use the resources available to them to ensure the greatest amount of profit.

The Profit Incentive

- In *The Wealth of Nations*, Adam Smith wrote that businesses do best when they provide what people need.
- Financial rewards motivate people. How have you provided or benefited from the profit incentive?



Market Problems

- Checkpoint: Under what circumstances may the free market system fail to allocate resources efficiently?
  – Imperfect Competition
    - Can affect prices, which in turn affect consumer decisions
  – Negative Externalities
    - Side effects of production, which include unintended costs
  – Imperfect Information
    - Prevents a market from operating smoothly

Review

- Now that you have learned what roles prices play in a free market economy, go back and answer the Chapter Essential Question.
  – What is the right price?