KEY IDEAS

- Scarcity exists because we have limited resources and unlimited wants. No society has ever had enough resources to produce all the goods and services its members wanted.
- Because of scarcity, all decisions involve costs.
- Opportunity cost is the forgone benefit of the next best alternative when resources are used for one purpose rather than another.
- A production possibilities curve graphically illustrates scarcity, choices and opportunity costs.
- The slope of a production possibilities curve shows the opportunity cost of producing one more unit of one good in terms of the amount of the other good that must be given up.
- The law of comparative advantage shows how everyone can gain through trade by specializing in producing the good or service with the lowest opportunity cost.
- In a market system, resources are allocated in response to relative prices.
- A demand curve shows all the prices and quantities at which consumers are willing and able to purchase a good or service. The law of demand states that consumers will want to buy more at a lower price and less at a higher price.
- There is a difference between a change in demand and a change in quantity demanded. A change in quantity demanded is a movement along the demand curve and can be caused only by a change in the price of the good or service. At a lower price, a larger quantity is demanded. A change in demand is a shift in the curve whereby more or less is demanded at every price. Changes in preferences, incomes, expectations, population, or the prices of complementary or substitute goods will cause a change in demand.
- A supply curve shows all the prices and quantities at which producers are willing and able to sell a good or service. Producers want to sell more at a higher price and less at a lower price.
- There is a difference between a change in supply and a change in quantity supplied. A change in quantity supplied is a movement along the supply curve and can be caused only by a change in the price of the good or service. At a lower price, a smaller quantity is supplied. A change in supply is a shift of the curve whereby more or less is supplied at every price. A change in technology, in production costs or in the number of sellers (firms) will cause a change in supply.
- In competitive markets, supply and demand schedules are the sum of many individual decisions to sell and to buy. The interaction of supply and demand determines the price and quantity that will clear the market. The price where the quantity supplied and quantity demanded are equal is called the equilibrium or market-clearing price.
- Equilibrium prices and quantities are determined as follows: At a price higher than equilibrium, there is a surplus and pressure on sellers to lower their prices. At a price lower than equilibrium, there is a shortage and pressure on buyers to offer higher prices.
- In a market economy, prices provide information, allocate resources and act as rationing devices. It is important to know how to illustrate a wide range of situations with supply and demand graphs.

- Price elasticity of demand refers to how much the quantity demanded changes in relation to a given change in price. If the percentage change in quantity demanded is greater than the percentage change in price, the demand for the good is considered elastic. If the percentage change in quantity demanded is less than the percentage change in price, the demand for the good is considered inelastic. If the percentage change in price is equal to the percentage change in quantity demanded, the demand for the good is considered unit elastic.