Lesson 3 – Open Markets

Presentation Guidelines and Suggestions

1. Review:

    - Explain that the "In the Chips" activity simulated the institution (open markets) that will be the focus of today's lessons. Ask students to identify the institutional rules of the game that characterize this institution. *(See slides, ERP 4)*
    - Ask students to identify the incentives that shaped their behavior as buyers and sellers in "In the Chips."

2. Discuss the role of prices in markets. Illustrate:

    - Changing prices change incentives for buyers. (Connect to opportunity cost.)
    - Changing prices change incentives for sellers. (Connect to opportunity cost.)
    - Prices communicate the information on relative values – causing adjustments by sellers (posted prices) and buyers (purchases). These adjustments move market prices towards equilibrium.
    - Prices reduce the costs of exchange.
    - The reliability of price information depends on open entry and exit (competition).

3. Emphasize that competition in the market is *not* between buyers and sellers. *(See slides.)*

4. Develop the supply and demand model, emphasizing how change occurs in well-functioning markets.

    - Demand and quantity demanded
    - Supply and quantity supplied.
    - Equilibrium (market clearing) price.
    - Discuss the "*ceteris paribus*" assumption.

5. Discuss the equilibrium mechanism in markets.

    - Provide examples and illustrations of how prices change and the incentives created by changing prices.

    - Show video: "The Hudsucker Proxy" to emphasize how dynamic the market equilibrium price can be. http://www.youtube.com/satch?v=D2QlitH4nYY

      (8 min. video, start at 4:10 and play to end.)

6. Discuss the institutions necessary to well-functioning markets.

    - Describe and provide examples of property rights. *(Note: Save more formal definition and description of this institution for lesson 7.)*

        - Develop examples to illustrate the range (as opposed to all-or-nothing) of property rights institutions.

    - Describe the "rule of law" and distinguish from rule of force (anarchy) or the rule of men.

    - Identify the importance of contracts to the operation of markets and the role of the rule of law in people's willingness to enter into contracts.

    - Again, emphasize the range of possibilities in the modern world rather than the all-or-nothing approach. Note contemporary examples (like China) where the rule of man may provide *some* of the stability and security associated with stable rule of law.

7. Competition regulates market activity.

    - Re-run the "In the Chips" activity with limited seller competition.

        - Designate two students to be suppliers of chips; all others are buyers.

        - Position the two suppliers close to each other and split the seller cards equally between them.

        - Instruct buyers to report the transaction prices. *(Note that in the earlier activity, the sellers did this.)*

        - Give each buyer one card, and remind them that, as in the earlier game, they are to make a purchase with the card before turning it in for another.

        - Allow the round to run a few minutes longer as needed.

- Results: There should be fewer transactions and a higher average price than the last round.
- Debriefing questions:
  - How did the level of competition in this market compare to the earlier one?
  - Who had more **market power** – that is, control over the price – the buyers or the sellers?
  - How did they get this market power? *Emphasize that their market power came from their ability to restrict supply. Their market interactions still ultimately determined each transaction price.*
  - Which type of market was best for you if you were a buyer? A seller? Why?
- Explain "tacit" collusion. Identify who gains and who loses when competition is reduced.
  - Provide contemporary examples.
- Explain the impact on economic growth of changing the level of competition by restricting or opening markets.
  - Provide illustrations: restricting competition (Soviet Union) and increasing competition (China since 1978).

8. Highlight the **Economic Reasoning Principles** that formed the basis for this lesson and connect them to the supply and demand model. *(See slides.)*
   - Emphasize that economists assert that price *is* and extremely strong incentive, not that *it should be.*

ERP-3: People respond to incentives in predictable ways.

Choices are influenced by incentives, the rewards that encourage and the punishments that discourage actions. When incentives change, behavior changes in predictable ways.

ERP-4: Institutions are the "rules of the game" that influence choices.

Laws, customs, moral principles, superstitions, and cultural values influence people's choices. These basic institutions controlling behavior set out and establish the incentive structure and the basic design of the economic system.