

CHAPTER 3

MARKET INSTITUTIONS

Microeconomics in Context (Goodwin, et al.), 1st Edition (Study Guide 2008)

Chapter Overview

Exploring the wide variety of market structures that exist in the real world, and the basic characteristics that all markets share, this chapter introduces you to the real-world aspects of markets.

The chapter includes a historical discussion of how markets developed and expanded over a span of several centuries. This history puts current market structures in context, highlighting the fact that a market economy is just one of many ways that people can structure their lives together. As you read this chapter, make sure you understand the structure of the market that is featured in the traditional microeconomic model, as well as the other market structures that appear globally.

Objectives

After reading and reviewing this chapter, you should be able to:

1. Understand the different definitions of markets.
2. Discuss the history of markets.
3. Describe what is necessary for markets to function effectively.
4. Discuss the relationship between markets and well-being.
5. Identify different types of markets.
6. Describe various ways in which market prices may be determined.

Key Terms

market
laissez-faire economy
“just price” doctrine
private property
explicit contract
money
wholesale markets
intermediate goods markets
labor markets
financial markets
posted prices
market value
open auction
sealed-bid auction
bargaining
futures market

institutions
guilds
laissez-faire proprietary capitalism
implicit contract
physical infrastructure
retail markets
product markets
resale markets
factor markets
underground markets
mark-up (or cost-plus) pricing
auction market
Dutch auction
double-auction
spot market
long-term contracts

Active Review Questions

Fill in the blank

1. An economy with very little government regulation is known as a(n) _____ economy.
2. Roads, warehouses, and transport equipment are all examples of physical _____.
3. A market in which consumer buy goods for personal use is known as a _____ market.
4. Markets for labor, natural resources, and manufactured capital goods are referred to as _____ markets.
5. A drug dealer imports illegal drugs and sells them in a dark alley. The dealer is part of a(n) _____ market.
6. At an old-fashioned, open-air market you might bargain over the price of a T-shirt. At your local mall, you are more likely to simply pay the _____ for an item.
7. A market where an item is sold to the highest bidder is known as a(n) _____ market.
8. At the New York Stock Exchange, both buyers and sellers state prices at which they are willing to make transactions. This is an example of a _____.
9. In a fish market, buyers and sellers negotiate for immediate delivery of fresh fish. This is an example of a(n) _____ market.
10. A situation in which a single buyer and a single seller negotiate the price of an item is known as _____.

True or False

11. The ratio of labor to materials and energy in industrial production has declined since the Industrial Revolution.
12. As worker productivity increases, workers always spend fewer hours on the job.
13. In 19th century Russia, industrialization was complete and feudalism was obsolete.
14. When external barriers are removed, people will naturally revert to market behaviors.

15. An implicit contract, based on common norms or traditions, can facilitate successful transaction of an exchange between buyer and seller.

Short Answer

16. A group of shipwrecked sailors decide to set up a functioning economy with whatever is available on the tropical island where they have been washed ashore. One sailor suggests they use tropical fruits as their unit of exchange, since they don't have any money on the island. What's one problem with this suggestion? What might be a better item to use in place of money?

17. In what sense is money itself a social institution of trust?

18. Describe the concept of "time dollars," and explain one way in which they can be useful.

19. Name two possible disadvantages of markets.

20. The tropical country of Exemplia is going through a modernization process. The government decides to encourage farmers to stop growing corn for use within Exemplia, and to start growing coffee for export. Within five years, Exemplian farmers are exporting substantial amounts of coffee, and 90% of the corn consumed in Exemplia is imported from abroad. Explain one risk associated with Exemplia's decision to participate in international markets for agricultural products.

21. State the two definitions of a market.

22. Name the four basic institutions required for a market institution to function.

Self Test

1. Which of the following is a valid definition of the word "market"?
 - a. A place where people meet to buy and sell goods.
 - b. An institution that brings together buyers and sellers.
 - c. Any social system in which people interact.
 - d. Any social system that provides health care and education to a large number of people.
 - e. Both a and b.

2. Which of the following statements is false?
 - a. Markets facilitate the exchange of information among buyers and sellers.
 - b. Markets are institutions.
 - c. The term "market" can refer to a physical location.
 - d. Markets only exist in laissez-faire economies.
 - e. The existence of private property is a necessary condition for the existence of a market.

3. Which of the following would *not* be described as an institution?
 - a. a hospital
 - b. a stock exchange
 - c. laws governing inheritance
 - d. a newly built house
 - e. the market for health foods in the USA

4. Which of the following statements is false?

- a. Medieval peasant life was strongly shaped by market forces.
 - b. Medieval artisans organized their work through guilds.
 - c. In the 11th century, most production of food and clothing occurred at home.
 - d. Markets were largely irrelevant to the daily lives of most medieval people.
 - e. The "just price" doctrine held that prices charged should always be fair.
5. Which of the following statements is *false*?
- a. In the 16th century, laws were passed to reaffirm the rights of the poor to receive needed support.
 - b. In the 18th century, land and agricultural products were increasingly bought and sold in markets.
 - c. In the 17th century, England was embroiled in a two-decade-long civil war.
 - d. The first wave of rapid industrialization occurred in Russia.
 - e. The British conquest of India in the 18th century expanded export markets for British textiles.
6. Which of the following ideas was *not* characteristic of the Industrial Revolution?
- a. individualism
 - b. instrumental rationality
 - c. valuing private property
 - d. valuing luxury purchases
 - e. increasing attention to spiritual issues
7. Which of the following is *not* a requirement for the functioning of markets?
- a. Individualist institutions of property and decision making.
 - b. Social institutions of trust.
 - c. Infrastructure for industrial production.
 - d. Infrastructure for the flow of goods and information.
 - e. Money as a medium of exchange.
8. Within an individual company, the main form of coordination is generally
- a. exchange
 - b. market value
 - c. administration
 - d. money
 - e. custom
9. Which of the following institutions is governed primarily by exchange?
- a. a centrally planned economy

- b. a corporation
- c. an elementary school
- d. a market
- e. both b and d

10. Which of the following is an example of a social institution of trust?

- a. Barbara's Bakery has a reputation for delivering birthday cakes on time.
- b. Carlos has been purchasing goods from Christina for years, and knows she always charges a fair price.
- c. The local grocery extends credit to a long-time customer who plans to pay when his next paycheck arrives.
- d. A consultant seals an agreement with a client with a handshake.
- e. All of the above.

11. Which of the following is *not* an advantage to markets as a form of social coordination?

- a. Markets allow the flow of important information, in the form of prices.
- b. Markets can give people substantial freedom to choose among various goods or activities.
- c. Markets can encourage beneficial innovation.
- d. Markets ensure that excessive concentration of economic power will not occur.
- e. Markets allow producers to gauge consumers' desires, via information about sales volumes.

12. Unified Chemical Corporation makes a chemical used in many plastics. It sells this chemical to Northern Plastics Company. What type of market does this exemplify?

- a. resale market
- b. retail market
- c. financial market
- d. intermediate goods market
- e. wholesale market

13. Which of the following is an example of a factor market?

- a. the market for silver
- b. the labor market
- c. the retail market
- d. a car dealership
- e. a drug cartel

14. Which of the following statements is false?

- a. On their own, markets cannot necessarily address the needs of elderly or disabled people.
 - b. Markets contain a built-in solution to excessive concentration of economic power.
 - c. Markets do not necessarily do well on their own at protecting environmental resources.
 - d. Markets have no built-in mechanism for efficient provision of public goods.
 - e. Markets can make people vulnerable to the actions of their trading partners.
15. Which set of terms accurately describes the type of market featured in the traditional microeconomic model?
- a. double-auction, spot, product market
 - b. single-auction, spot, futures market
 - c. producer/consumer futures market
 - d. open-auction market-value system
 - e. single buyer, single seller, bargaining market
16. At its end-of-the-year fundraiser, Anytown High School auctions off a high-quality bicycle. The school principal starts by stating a high price for the bicycle. She then lowers the price gradually until someone offers to buy it. This is an example of:
- a. a posted price
 - b. a double auction
 - c. a bargaining situation
 - d. a Dutch auction
 - e. an open auction
17. Which of the following statements accurately describes an open auction?
- a. The opening price is set high, and then drops gradually.
 - b. The opening price is set low, and rises as potential buyers offer competing bids.
 - c. A single buyer and a single seller negotiate the price of an item.
 - d. Both buyers and sellers state prices at which they are willing to make transactions.
 - e. Individual bids are given privately to the auctioneer.
18. Which of the following statements accurately describes a spot market?
- a. Buyers and sellers contract for immediate delivery of a specified amount of a good.

- b. Buyers and sellers contract for future delivery of a good.
- c. Buyers and sellers enter into a long-term agreement for delivery of a good over time.
- d. Workers contract to provide labor over an extended period of time.
- e. Companies agree to exchange intermediate goods over an extended period of time.

19. In which of the following situations are long-term contracts frequently used?

- a. apartment rentals
- b. mortgages
- c. energy purchases
- d. raw material purchases
- e. all of the above

20. Which of the following assumptions is made in the traditional microeconomic model?

- a. Firms (producers) sell directly to households (consumers).
- b. Firms enter into long-term contracts.
- c. Firms operate in futures markets.
- d. Firms use an open auction model.
- e. All of the above.

Answers to Active Review Questions

1. laissez faire
2. infrastructure
3. retail
4. factor
5. underground
6. posted price
7. auction
8. double auction
9. spot
10. bargaining
11. True.
12. False. Increased productivity can, but does not necessarily, lead to decreased working hours.
13. False.
14. False.
15. True.
16. Tropical fruits will rot within a few days. Thus, they do not provide a durable store of value. Alternatives could include carved stones, a specific kind of shell, or some other item that can be stored over time.

17. Money is ultimately based on common agreement: the understanding that other people will accept it in exchange. The value of money derives from this understanding.
18. Time dollars are credits exchanged for services within a local network. Time dollar systems can allow exchanges among people who might not otherwise have the opportunity for productive interchange. In this way, they can increase productive activity as well as strengthening bonds within a community.
19. Markets can make parties who trade more vulnerable to each other's actions (e.g. cutting off supplies). Markets also have no inherent ability to correct for the excessive concentration of economic power. These are two of several possible points you could make in response to this question, based on the information in the textbook.
20. One risk is that Exempla's population is now vulnerable to fluctuations in international markets. If prices change dramatically, or if a major trading partner stops exporting corn, Exempla's population could find itself facing a severe corn shortage. Since corn is a central source of nutrition in many countries, such an outcome could lead to serious problems of hunger and malnutrition.
21. A market can be defined as a physical location where buyers and sellers gather to exchange products or services. A market can also be defined as an institution that brings buyers and sellers into communication with each other, structuring and coordinating their actions.
22. Individualist institutions related to property and decision-making; social institutions of trust; infrastructure for the smooth flow of goods and information; and money as a medium of exchange.

Answers to Self Test Questions

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|-------|-------|
| 1. e | 11. d |
| 2. d | 12. d |
| 3. d | 13. b |
| 4. a | 14. b |
| 5. d | 15. a |
| 6. e | 16. d |
| 7. c | 17. b |
| 8. c | 18. a |
| 9. d | 19. e |
| 10. e | 20. a |