Elasticity and its application chapter 5 answers

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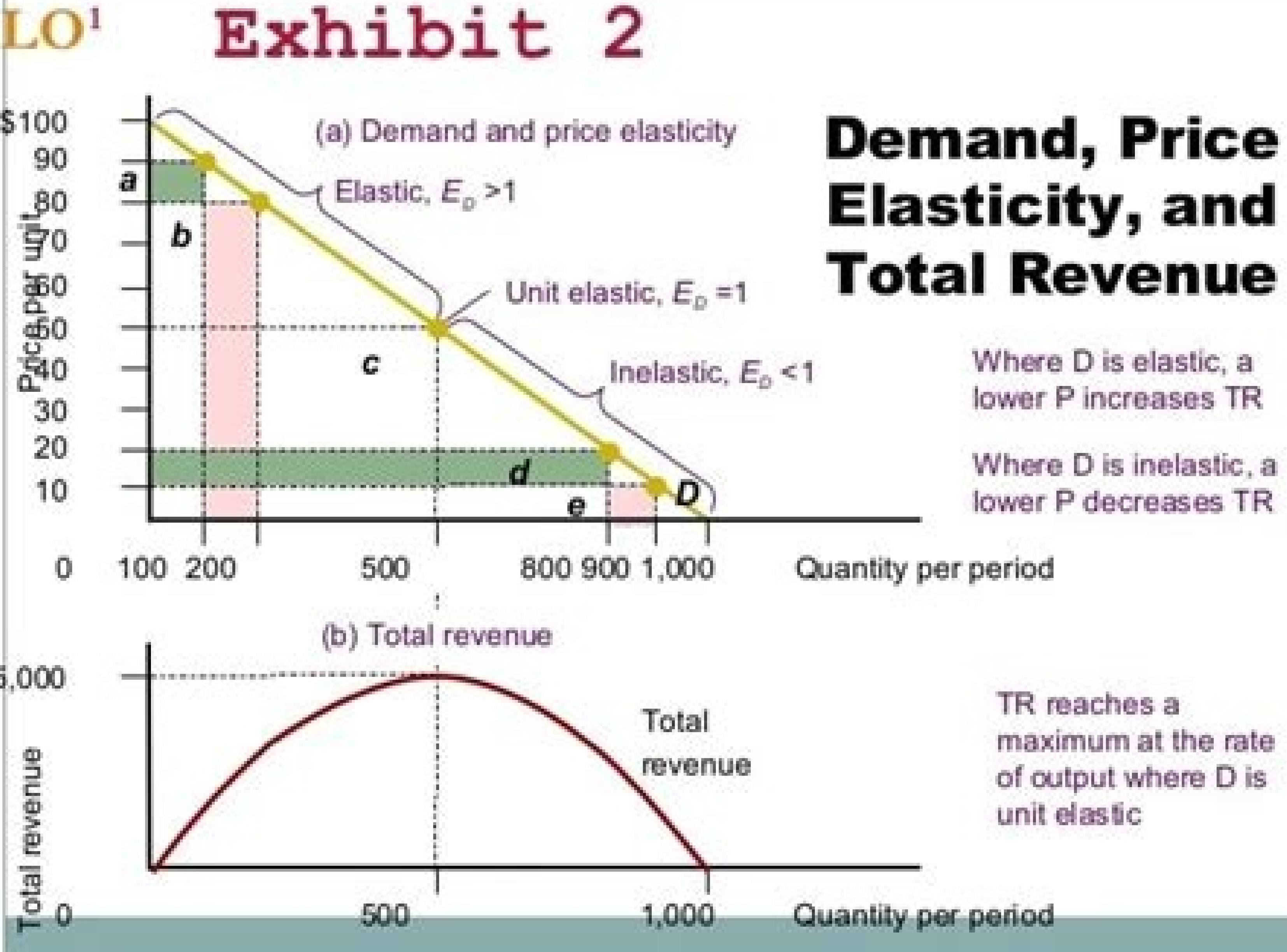

A scenario…

You design websites for local businesses.
You charge $200 per website,
and currently sell 12 websites per month.

Your costs are rising
(including the opportunity cost of your time),
so you consider raising the price to $250.

The law of demand says that you won't sell as many websites if you raise your price.
How many fewer websites? How much will your revenue fall, or might it increase?

2

Chapter 5 elasticity and its applications problems and applications answers. Elasticity and its application chapter 5 summary.

The price of coffee rose sharply last month, while the quantity sold remained the same. Five people suggest various explanations: LEONARD: Demand increased, but supply was perfectly inelastic.SHELDON: Demand increased, but it was perfectly inelastic.PENNY: Demand increased, but supply decreased at the same time.HOWARD: Supply decreased, but demand was unit elastic.RAJ: Supply decreased, but demand was perfectly inelastic. Who could possibly be right? Use graphs to explain your answer. ED Ethan D. Numerade Educator 1 Elasticity and its Application CHAPTER 5 2 In this chapter, look for the answers to these questions: What is elasticity? What kinds of issues can elasticity help us understand? What is the price elasticity of demand? How is it related to the demand curve? How is it related to revenue & expenditure? What is the price elasticity of supply? How is it related to the supply curve? What are the income and cross-price elasticities of demand? 2 3 ELASTICITY AND ITS APPLICATION 3 Elasticity Basic idea: Elasticity measures how much one variable responds to changes in another variable. – One type of elasticity measures how much demand for your websites will fall if you raise your price. Definition: Elasticity is a numerical measure of the responsiveness of Q d or Q s to one of its determinants. 4 ELASTICITY AND ITS APPLICATION 4 Price Elasticity of Demand Price elasticity of demand measures how much Q d responds to a change in P. Price elasticity of demand = Percentage change in Q d Percentage change in P Loosely speaking, it measures the price-sensitivity of buyers' demand. 5 ELASTICITY AND ITS APPLICATION 5 Price Elasticity of Demand Price elasticity of demand equals P Q D Q2Q2 P2P2 P1P1 Q1Q1 P rises by 10% Q falls by 15% 15% 10% = 1.5 Price elasticity of demand = Percentage change in Q d Percentage change in P Example: 6 ELASTICITY AND ITS APPLICATION 6 Price Elasticity of Demand Along a D curve, P and Q move in opposite directions, which would make price elasticity negative. We will drop the minus sign and report all price elasticities as positive numbers. Along a D curve, P and Q move in opposite directions, which would make price elasticity negative. We will drop the minus sign and report all price elasticities as positive numbers. P Q D Q2Q2 P2P2 P1P1 Q1Q1 Price elasticity of demand = Percentage change in Q d Percentage change in P 7 ELASTICITY AND ITS APPLICATION 7 Calculating Percentage Changes P Q D $250 8 B $200 12 A Demand for your websites Standard method of computing the percentage (%) change: end value – start value start value x 100% Going from A to B, the % change in P equals ($250–$200)/$200 = 25% 8 ELASTICITY AND ITS APPLICATION 8 Calculating Percentage Changes So, we instead use the midpoint method: end value – start value midpoint x 100% The midpoint is the number halfway between the start & end values, the average of those values. It doesn't matter which value you use as the "start" and which as the "end" – you get the same answer either way! 9 ELASTICITY AND ITS APPLICATION 9 Calculating Percentage Changes Using the midpoint method, the % change in P equals $250 – $200 $225 x 100% = 22.2% The % change in Q equals 12 – 8 10 x 100% = 40.0% The price elasticity of demand equals 40/22.2 = 1.8 10 ELASTICITY AND ITS APPLICATION 10 What determines price elasticity? To learn the determinants of price elasticity, we look at a series of examples. Each compares two common goods. In each example: – Suppose the prices of both goods rise by 20%. – The good for which Q d falls the most (in percent) has the highest price elasticity of demand. Which good is it? Why? – What lesson does the example teach us about the determinants of the price elasticity of demand? 11 ELASTICITY AND ITS APPLICATION 11 The Determinants of Price Elasticity: A Summary The price elasticity of demand depends on: – the extent to which close substitutes are available – whether the good is a necessity or a luxury – how broadly or narrowly the good is defined – the time horizon – elasticity is higher in the long run than the short run The price elasticity of demand depends on: – the extent to which close substitutes are available – whether the good is a necessity or a luxury – how broadly or narrowly the good is defined – the time horizon – elasticity is higher in the long run than the short run 12 ELASTICITY AND ITS APPLICATION 12 The Variety of Demand Curves The price elasticity of demand is closely related to the slope of the demand curve. Rule of thumb: The flatter the curve, the bigger the elasticity. The steeper the curve, the smaller the elasticity. Five different classifications of D curves.… 13 ELASTICITY AND ITS APPLICATION 13 The Variety of Demand Curves The price elasticity of demand is closely related to the slope of the demand curve. Rule of thumb: The flatter the curve, the bigger the elasticity. The steeper the curve, the smaller the elasticity. Five different classifications of D curves.… 14 ELASTICITY AND ITS APPLICATION 14 Q1Q1 P1P1 D " Perfectly inelastic demand" (one extreme case) P Q P2P2 P falls by 10% Q changes by 0% 0% 10% = 0 Price elasticity of demand = % change in Q % change in P = Consumers' price sensitivity: D curve: Elasticity: vertical none 0 15 ELASTICITY AND ITS APPLICATION 15 D " Inelastic demand" P Q Q1Q1 P1P1 Q2Q2 P2P2 Q rises less than 10% < 10% 10% < 1 Price elasticity of demand = % change in Q % change in P = P falls by 10% Consumers' price sensitivity: D curve: Elasticity: relatively steep relatively low < 1 16 ELASTICITY AND ITS APPLICATION 16 D "Unit elastic demand" P Q Q1Q1 P1P1 Q2Q2 P2P2 Q rises by 10% 10% = 1 Price elasticity of demand = % change in Q % change in P = P falls by 10% Consumers' price sensitivity: Elasticity: intermediate 1 D curve: intermediate slope 17 ELASTICITY AND ITS APPLICATION 17 D "Elastic demand" P Q Q1Q1 P1P1 Q2Q2 P2P2 Q rises more than 10% > 10% 10% > 1 Price elasticity of demand = % change in Q % change in P = P falls by 10% Consumers' price sensitivity: D curve: Elasticity: relatively flat relatively high > 1 18 ELASTICITY AND ITS APPLICATION 18 D "Perfectly elastic demand" (the other extreme) P Q P1P1 Q1Q1 P changes by 0% Q changes by any % any % 0% = infinity Q2Q2 P 2 = Consumers' price sensitivity: D curve: Elasticity: infinity horizontal extreme Price elasticity of demand = % change in Q % change in P = 19 ELASTICITY AND ITS APPLICATION 19 Elasticity of a Linear Demand Curve The slope of a linear demand curve is constant, but its elasticity is not. P Q $30 20 10 $0 0204060 200% 40% = 5.0 E =E = 67% = 1.0 E =E = 40% 200% = 0.2 E =E = 20 ELASTICITY AND ITS APPLICATION 20 Price Elasticity and Total Revenue Continuing our scenario, if you raise your price from $200 to $250, would your revenue rise or fall? Revenue = P x Q A price increase has two effects on revenue: – Higher P means more revenue on each unit you sell. – But you sell fewer units (lower Q), due to Law of Demand. Which of these two effects is bigger? It depends on the price elasticity of demand. 21 ELASTICITY AND ITS APPLICATION 21 Price Elasticity and Total Revenue If demand is elastic, then price elast. of demand > 1 % change in Q > % change in P The fall in revenue from lower Q is greater than the increase in revenue from higher P, so revenue falls. Revenue = P x Q Price elasticity of demand = Percentage change in Q Percentage change in P 22 ELASTICITY AND ITS APPLICATION 22 Price Elasticity of Supply Price elasticity of supply measures how much Q s responds to a change in P. Price elasticity of supply = Percentage change in Q s Percentage change in P Loosely speaking, it measures sellers' price-sensitivity. Again, use the midpoint method to compute the percentage changes. 23 ELASTICITY AND ITS APPLICATION 23 Q2Q2 Price Elasticity of Supply Price elasticity of supply equals P Q S P2P2 Q1Q1 P1P1 P rises by 8% Q rises by 16% 16% 8% = 2.0 Price elasticity of supply = Percentage change in Q s Percentage change in P Example: 24 ELASTICITY AND ITS APPLICATION 24 The Variety of Supply Curves The slope of the supply curve is closely related to price elasticity of supply. Rule of thumb: The flatter the curve, the bigger the elasticity. The steeper the curve, the smaller the elasticity. Five different classifications.… 25 ELASTICITY AND ITS APPLICATION 25 S "Perfectly inelastic" (one extreme) P Q Q1Q1 P1P1 P2P2 Q changes by 0% 0% 10% = 0 Price elasticity of supply = % change in Q % change in P = P rises by 10% Sellers' price sensitivity: S curve: Elasticity: vertical none 0 26 ELASTICITY AND ITS APPLICATION 26 S "Inelastic" P Q Q1Q1 P1P1 Q2Q2 P2P2 Q rises less than 10% < 10% 10% < 1 Price elasticity of supply = % change in Q % change in P = P rises by 10% Sellers' price sensitivity: S curve: Elasticity: relatively steep relatively low < 1 27 ELASTICITY AND ITS APPLICATION 27 S "Unit elastic" P Q Q1Q1 P1P1 Q2Q2 P2P2 Q rises by 10% 10% = 1 Price elasticity of supply = % change in Q % change in P = P rises by 10% Sellers' price sensitivity: S curve: Elasticity: intermediate slope intermediate = 1 28 ELASTICITY AND ITS APPLICATION 28 S "Elastic" P Q Q1Q1 P1P1 Q2Q2 P2P2 Q rises more than 10% > 10% 10% > 1 Price elasticity of supply = % change in Q % change in P = P rises by 10% Sellers' price sensitivity: S curve: Elasticity: relatively flat relatively high > 1 29 ELASTICITY AND ITS APPLICATION 29 S " Perfectly elastic" (the other extreme) P Q P1P1 Q1Q1 P changes by 0% Q changes by any % any % 0% = infinity Price elasticity of supply = % change in Q % change in P = Q2Q2 P 2 = Sellers' price sensitivity: S curve: Elasticity: horizontal extreme infinity 30 ELASTICITY AND ITS APPLICATION 30 The Determinants of Supply Elasticity The more easily sellers can change the quantity they produce, the greater the price elasticity of supply. – Example: Supply of beachfront property is harder to vary and thus less elastic than supply of new cars. For many goods, price elasticity of supply is greater in the long run than in the short run, because firms can build new factories, or new firms may be able to enter the market. 31 ELASTICITY AND ITS APPLICATION 31 Other Elasticities Income elasticity of demand: measures the response of Q d to a change in consumer income Income elasticity of demand = Percent change in Q d Percent change in income Recall from Chapter 4: An increase in income causes an increase in demand for a normal good. Hence, for normal goods, income elasticity > 0. For inferior goods, income elasticity < 0. 32 ELASTICITY AND ITS APPLICATION 32 Other Elasticities Cross-price elasticity of demand: measures the response of demand for one good to changes in the price of another good Cross-price elast. of demand = % change in Q d for good 1 % change in price of good 2 For substitutes, cross-price elasticity > 0 (e.g., an increase in price of beef causes an increase in demand for chicken) For complements, cross-price elasticity < 0 (e.g., an increase in price of computers causes decrease in demand for software) 33 CHAPTER SUMMARY Elasticity measures the responsiveness of Q d or Q s to one of its determinants. Price elasticity of demand equals percentage change in Q d divided by percentage change in P. When it's less than one, demand is "inelastic." When greater than one, demand is "elastic." When demand is inelastic, total revenue rises when price rises. When demand is elastic, total revenue falls when price rises. 33 34 CHAPTER SUMMARY Demand is less elastic in the short run, for necessities, for broadly defined goods, or for goods with few close substitutes. Price elasticity of supply equals percentage change in Q s divided by percentage change in P. When it's less than one, supply is "inelastic." When greater than one, supply is "elastic." Price elasticity of supply is greater in the long run than in the short run. 34 35 CHAPTER SUMMARY The income elasticity of demand measures how much quantity demanded responds to changes in buyers' incomes. The cross-price elasticity of demand measures how much demand for one good responds to changes in the price of another good. 35

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