Webnote 120

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1.2 Big Ideas

Big Idea 1

Big Idea 2

Big Idea 3

Big Idea 4

Big Idea 5

Big Idea 6

Key Terms:

1.2 – Elasticity

- complementary goods (see also 1.1)
- elasticity
- elastic
- inelastic
- PED
- PES
- substitute goods (see also 1.1, webnote 103)
- complementary goods (see also 1.1 webnote 103)
- unit elasticity
- XED
- YED
- Primary commodities
-
- HL ONLY
- arc elasticity of demand (not in syllabus)
- flat rate tax
- incidence of a tax (impact of elasticity)

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1.2 Big Questions for 99

- Big Questions:

1. Why is elasticity important for firms and government?
2. How does elasticity affect markets in terms of resource allocation and market size?
3. Evaluate the impact of 2 elasticities for 2 stakeholders.

Syllabus Focus

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I.b Syllabus 1.2: Microeconomics

Syllabus Items 18-25
PeD

- **120: Big Ideas**
- **121: Worksheet**
- **122: Ped – the big idea**
- **123: 4 Elasticities**
- **124: 8 Exam Questions**

Exam Focus

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- **May 2013 syllabus 1.2 SL**
- **2(a) Explain the factors which might influence the cross price elasticity of demand between different products.**

tip: see web 123

- **2 (b) Examine the importance of income elasticity of demand for the producers of primary products, manufactured goods and services.**

  (M13/3/ECONO/SP1/ENG/TZ1/XX)

Big Idea 1

4 elasticities = 1 formula. Q / P or Y. Value>1 = elastic. Value <1 inelastic

The FORMULA….

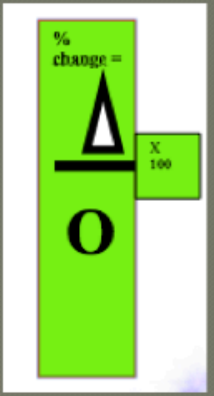
4 Elasticities: 1 Formula

See webnote 122

$$\frac{\%\ \text{Change in Q}}{\%\ \text{Change in P/Y}}$$

- **How to calculate a % change?**

Use this simple formula



- Price goes from 20 to 25.
- Divide the change by the original and multiply by 100
- Change = 5. Original price = 20
- = 5/20 = 0.25 x 100 = 25%

Big Idea

2

4 elasticities = 4 stories summarized in table below. Each elastity has a special focus e.g. ped connects with total revenue

4 Elasticities: 4 stories

PeD →	> 1 < 1 = 1	↓ TR ↑
YeD “i to I”	> 1 < 1 = 1	+ or - (inf)
XeD →	> 1 < 1 = 1	+(sub) or - (com)
PeS →	> 1 < 1 = 1	+ or - (time)

Big Idea
3

P e D: key focus is Total Revenue (price x quantity). Will the firm win or lose from a price change?

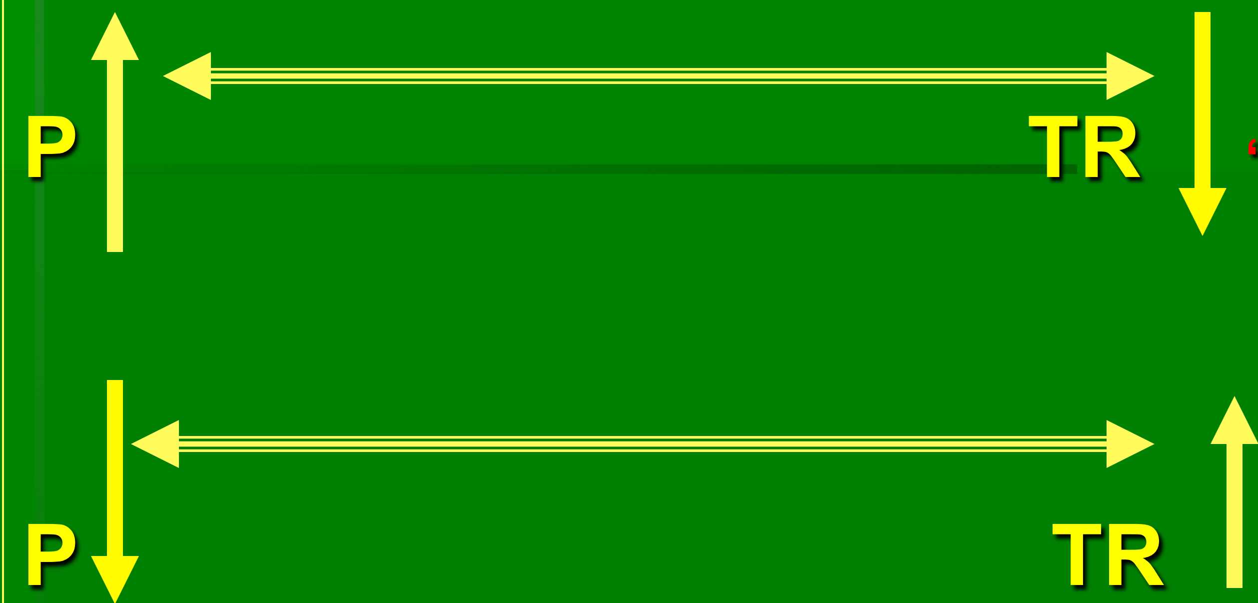
Webnote 120

PeD and TR: what you need to remember

1. P e d Elastic: effect on TR (p x q)

See webnote 122

'pedro factor'



Note: total revenue moves in opposite direction to price

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PeD and TR: what you need to remember

Ped inelastic effect on TR (pxq)

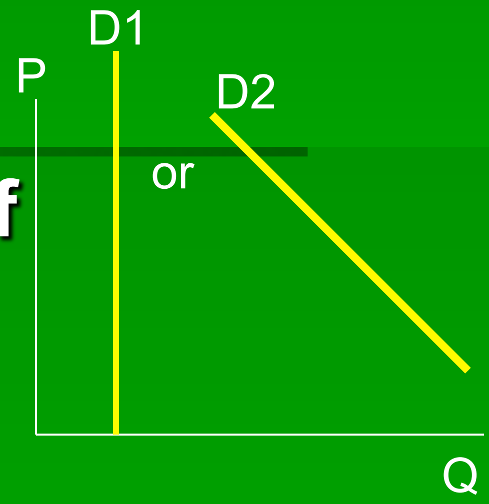
See webnote 122

P TR 'island factor'

P then TR

Note: total revenue moves in same direction as price

7 factors that influence ped?



1. The number and closeness of substitutes
2. The passage of time
3. Addiction / habit
4. % of income spent on the good/service
5. Branding and advertising
6. Durability
7. Expectations of price changes / inconsistent

The BIG ideas!

Section 1.2 Markets

Big Idea

4

Yed focus is how income changes affect demand and this is of concern to government and firms who need to plan for the size of the firm (F) or the economy (G)

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Yed- what you need to remember§

The BIG ideas!

See webnote 123

1. **INFERIOR (yed, negative)**
2. **YED elasticity is a key issue for LDC's**

   Commodities / primary goods income inelastic. Necessities such as food products. This is critical for LDC's Increases in incomes not a great benefit for LDC's selling food.

3. **BUT manufactured+luxury goods tend to be income elastic (yed 4). DC's benefit by selling luxury goods and services. More profits!**

The BIG ideas!

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Big Idea

5

PES allows firms to learn about how they can adjust output to changes in price. This has significant implications for resource allocation. How effectively can a firm respond to higher prices by increasing output?

123

See webnote 123

The BIG ideas!

P e S

1. **Shows ability of firms to adjust to changes in price. Firms that have elastic price elasticity of supply can benefit from sudden changes in price. More profit can be made by firms that can react to market changes**

Section 1.2 Markets

The BIG ideas!

Webnote 120

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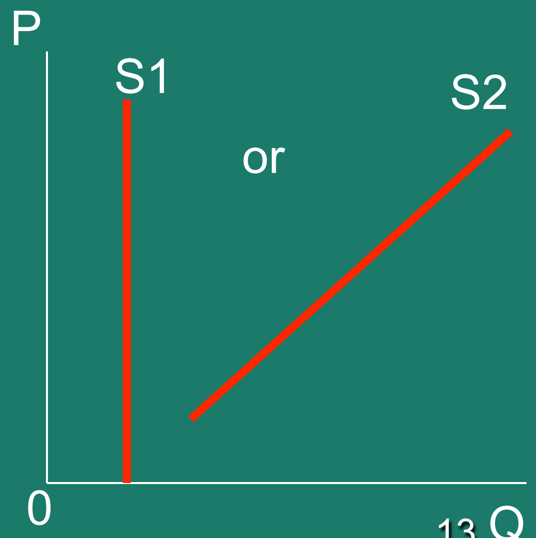
PeS – what influences

The BIG ideas!

See webnote 123

P e S

1. Perishability
2. Availability of substitutes
3. Time factor
4. Availibility of stocks
5. Storage costs
6. Input / FoP costs



The BIG ideas!

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Big Idea

6

XED allows firms to understand how changes in their prices will affect competitor firms or visa versa.

The BIG ideas!

See webnote 123

Xed – see webnote 126

x e D

- SUBSTITUTES (X e D positive) e.g. + 5.8 = close substitute
- COMPLEMENTARY (X e D, negative) e.g. - 5.8 = close complement

HP 3