1. Public policy in the United States discourages consumption of such drugs as cocaine. Explain and show graphically how an increase in the price of cocaine serves public policy. Explain and illustrate how a price decrease would serve public policy. Under what circumstances would a price increase (decrease) not serve public policy?

2. Hurricane Sandy, which struck the east coast in October 2012, damaged or destroyed an estimated 305,000 housing units in New York State alone. If rent is the price of consuming housing, use supply/demand to show the effect the storm had on the housing market. Discuss the effect of emergency measures restricting rent changes in the aftermath of the storm.

Price

S

P\*

D

Q\* Quantity

1. Model arises from assumption that consumers maximize well-being (utility) and firms maximize profits.

2. No individual decision-maker has influence over price.

No monopoly or monopsony power.

3. Upward slope of supply reflects scarcity: as more output is produced, resources used become more scarce and therefore more expensive.

4. Supply/demand is only an approximation to what occurs in many markets, due to individual market power.

5. Price serves as a rationing mechanism and an incentive to produce.

6. At equilibrium price, P\*, quantity demanded equals quantity supplied.

7. At the equilibrium, all exchanges that are mutually beneficial have taken place (efficiency).