

Economics Revision

AS Economics

Determining Market Price

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Date:

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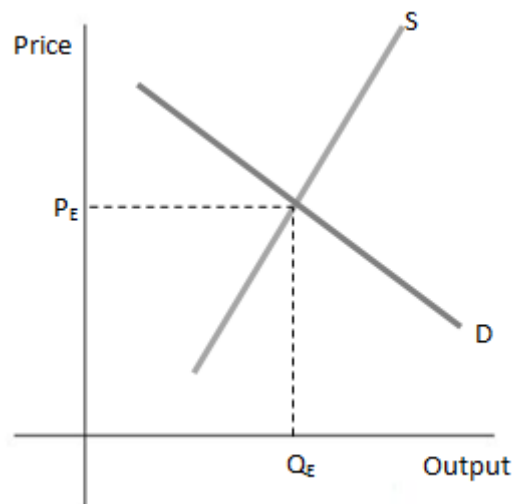
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Market Equilibrium

Market equilibrium occurs when planned supply and demand are equal, and there is no incentive for producers or consumers to change their market plans.

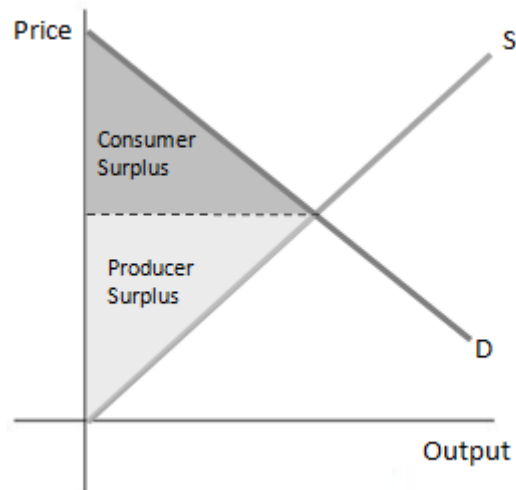
→ Point of intersection of the S and D curves.

If excess S or D exists then the market is in disequilibrium.



Consumer and Producer Surplus

The consumer surplus is the difference between what consumers in the market are prepared to pay for a good and what they actually pay. It is the utility gained from a good in excess of that price paid for it. It is the area above the equilibrium price but below the D curve.



Producer surplus is the difference between the market price and what producers are willing to sell their good for. It is the extra earnings above the minimum needed to produce the good. It is represented by the area above the S curve and below P_e .

Functions of the price mechanism

Price mechanism consists of three functions:

1) **Signalling function:**

- Prices carry information used by producers and consumers to make market plans.

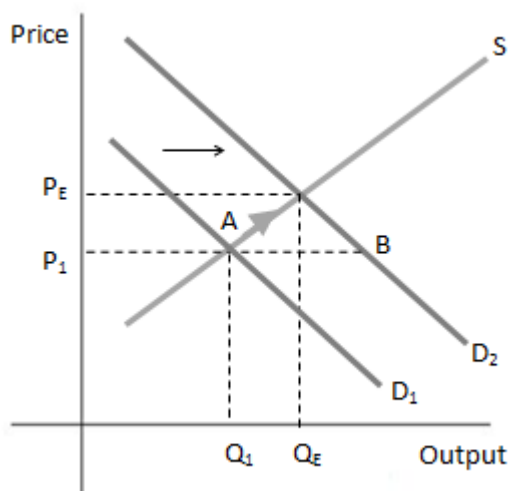
2) **Rationing/allocative function:**

- Scarcity → increased P as consumers bid up the price in order to obtain the good or service.
- QD in the market decreases as consumers who can't afford the good leave the market → resources are allocated to those willing to pay most for them.

3) **Incentive function:**

- Producers – objective of maximising profit – higher P is an incentive to increase supply.
- Also means of production costs of increased supply are covered.
- Consumers – maximise utility – incentive to increase QD at a lower price.

Elimination of excess demand:



As demand shifts from D_1 to D_2 , at price P_1 QD is higher than QS (excess demand of AB).

Consumers bid up price to obtain the scarce good (rationing function).

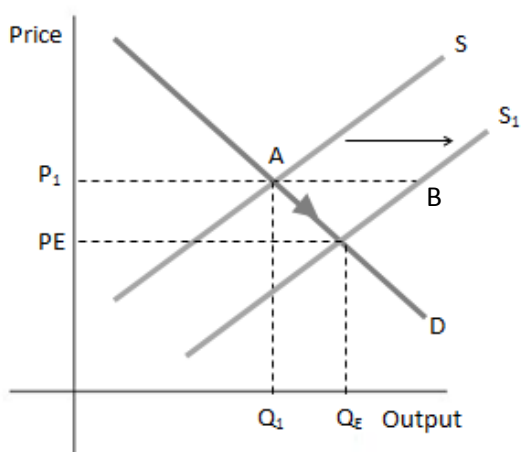
Demand contracts.

Producers see there has been a change in the market (signalling function).

Incentive function – producers increase quantity supplied.

When $QD = QS$ at Q_E the process stops, with a corresponding P of P_E .

Elimination of excess supply:



As supply shifts from S_1 to S_2 , at price P_1 QS is greater than QD (excess supply of AB).

Producers with stocks of unsold goods reduce prices to sell off stock.

Some make a loss and leave the market – no longer have the incentive to produce.

Signalling function – lower prices lead consumers to increase demand – greater income.

Continues until $QS = QD$ at Q_E with a lower equilibrium P of P_E .

Price mechanism → no govt. intervention is needed to achieve equilibrium.

→ Just need economic agents pursuing their own self interest.

Competition – needed for market to allocate resources efficiently – a competitive market has several firms, each not big enough to influence market price – must accept equilibrium price.