Lecture

INSTITUTE OF ACTUARIAL & QUANTITATIVE STUDIES

Class: SY BSc

Subject : Business economics – Micro

Chapter: Unit 1 Chapter 2

Chapter Name: Market Equilibrium, Price Mechanism and Market Efficiency

Today's Agenda

1. Market
   1. Types of Market economy

2. Free market economy
   1. Demand & supply schedule
   2. Equilibrium
   3. Changes in equilibrium
   4. Interdependence of markets
   5. Problems of free market

3. The Command Economy
   1. Assessment of the command economy

4. Mixed Economy

1 Market

What comes to mind when you think of the term '**MARKET**'?

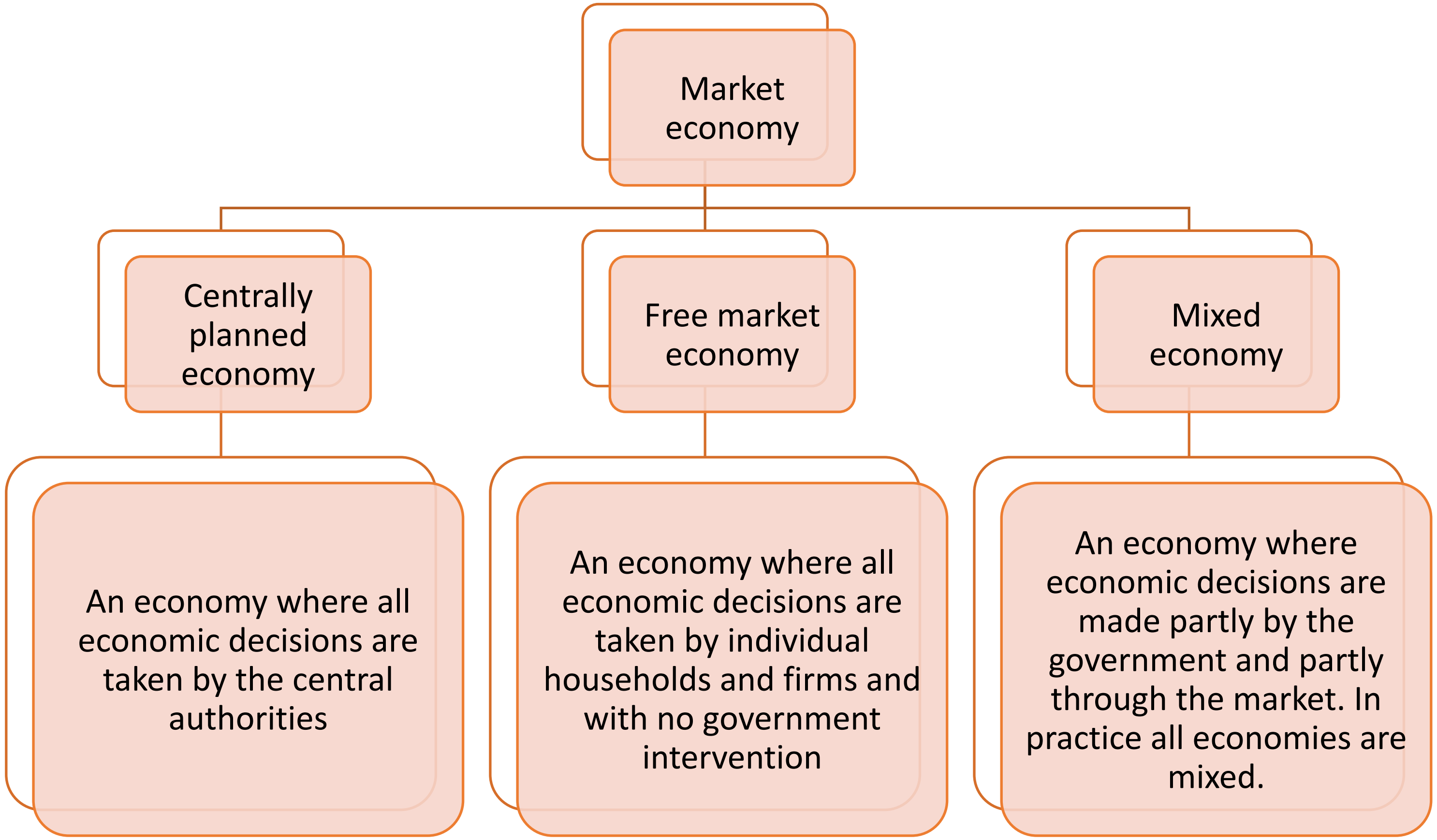
1 Market

Market	=	Particular place	+	Two Parties (Buyer & Seller)	+	Facilitate the Exchange of Goods & Services

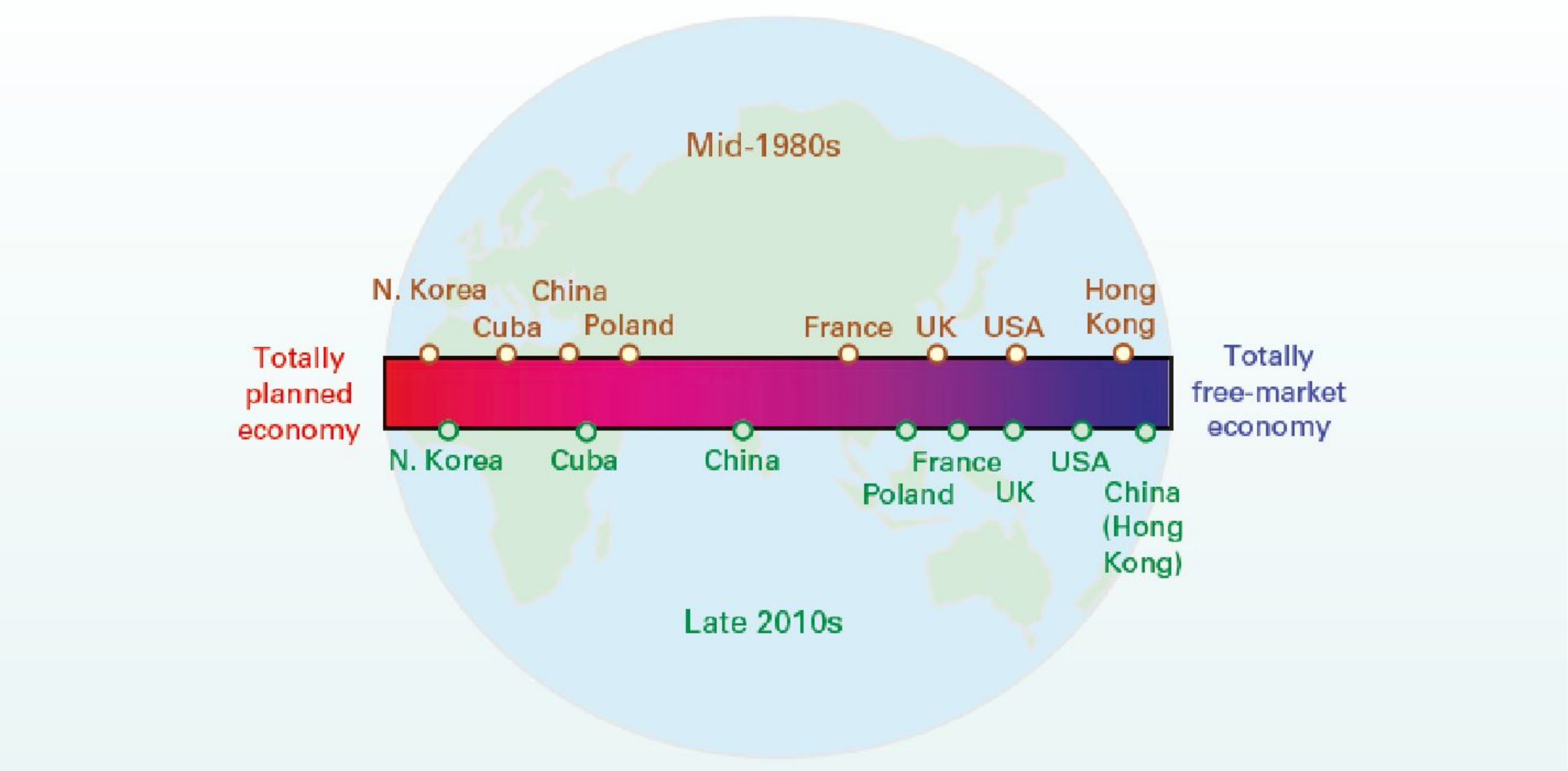
1.1 Types of Market Economy

All societies differ considerably in the way they tackle the problem. One important difference between societies is in the degree of government control of the economy: the extent to which government decides ‘what’, ‘how’ and ‘for whom’ to produce.

There are 3 types of market economy:



1.1 Types of Market Economy



2 Free Market Economy

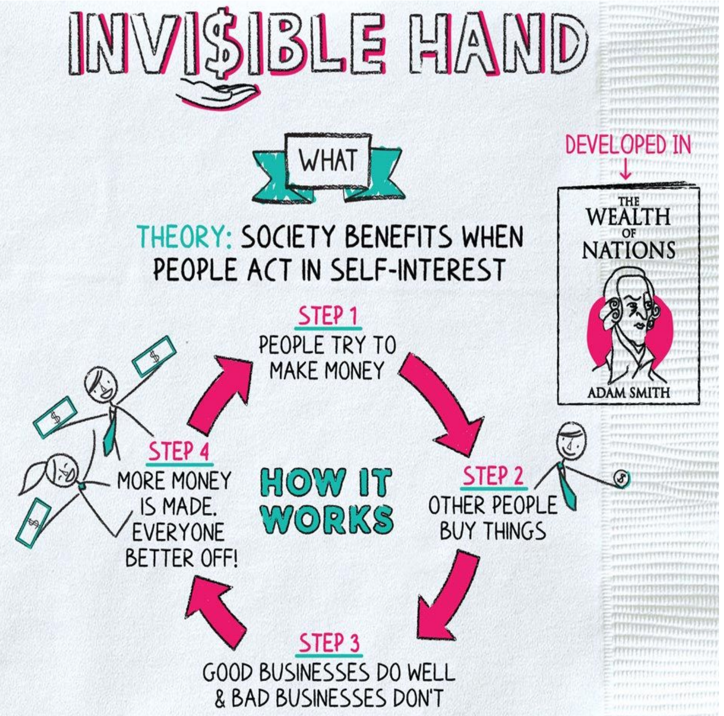
- Government highly control some economies. Government controls the means of production and the distribution of wealth, dictating the prices of goods and services and the wages workers receive.
- In a free market economy, the law of supply and demand, rather than a central government, regulates production and labour.
- Companies sell goods and services at the **highest price consumers are willing to pay** while workers earn the **highest wages companies are willing to pay for their services**.
- A purely capitalist economy is a free market economy; the profit motive drives all commerce and forces businesses to operate as efficiently as possible to avoid losing market share to competitors.

2 Free Market Economy

Invisible Hand

- The invisible hand is a metaphor for the unseen forces that move the free market economy. Through **individual self-interest**, the best interest of society, as a whole, are fulfilled.

- Real Life Example
  Cantillon, the economist from whom the idea of invisible hand was inspired, described an isolated estate that was divided into competing leased farms. Independent entrepreneurs ran each farm to maximize their production and returns. The successful farmers introduced better equipment and techniques and brought to market only those goods for which consumers were willing to pay. **He showed that returns were far higher when competing self-interests ran the estate rather than the previous landlord's command economy.**



2 Free Market Economy

Characteristics of free market economy:

- **Free decision making by individuals**

In a free market, individuals are free to make their own economic decisions. Consumers are free to decide what to buy with their incomes: free to make demand decisions. Firms are free to choose what to sell and what production methods to use: free to make supply decisions. The demand and supply decisions of consumers and firms are transmitted to each other through their effect on prices: through the price mechanism. The prices that result are the prices that firms and consumers have to accept

- **Price mechanism**

The price mechanism works as follows. Prices respond to shortages and surpluses. Shortages result in prices rising. Surpluses result in prices falling.
This price, where demand equals supply, is called the equilibrium price. By equilibrium we mean a point of balance or a point of rest: in other words, a point towards which there is a tendency to move

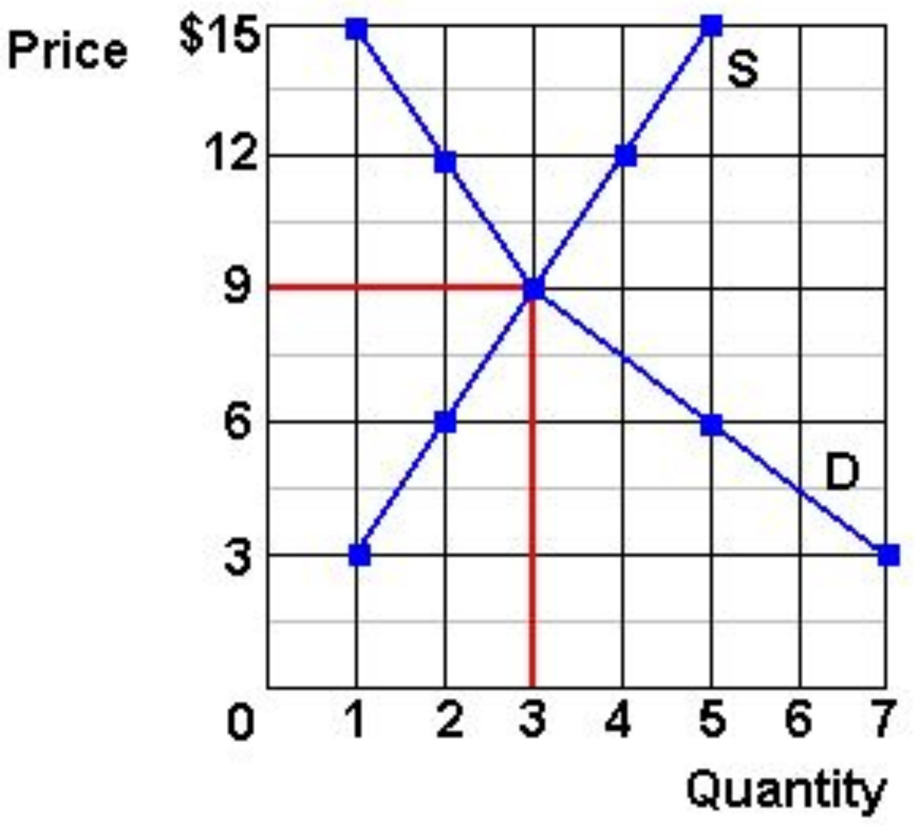
2 Free Market Economy

- **The effect of changes in demand and supply**

In all cases of changes in demand and supply, the resulting changes in price act as both signals and incentives.
A rise in demand is signaled by a rise in price, which then acts as an incentive for supply to rise. A fall in demand is signaled by a fall in price. This then acts as an incentive for supply to fall.
A rise in supply is signaled by a fall in price. This then acts as an incentive for demand to rise. A fall in supply is signaled by a rise in price. This then acts as an incentive for demand to fall.

2.1 Demand and Supply schedule

Price	Quantity Supplied per Month	Quantity Demanded per Month
$15	5,000	1,000
12	4,000	2,000
9	3,000	3,000
6	2,000	5,000
3	1,000	7,000



2.2 Equilibrium

How is the price of a good determined?

- The market forces of supply & demand work simultaneously to determine the price.

The law of supply and demand

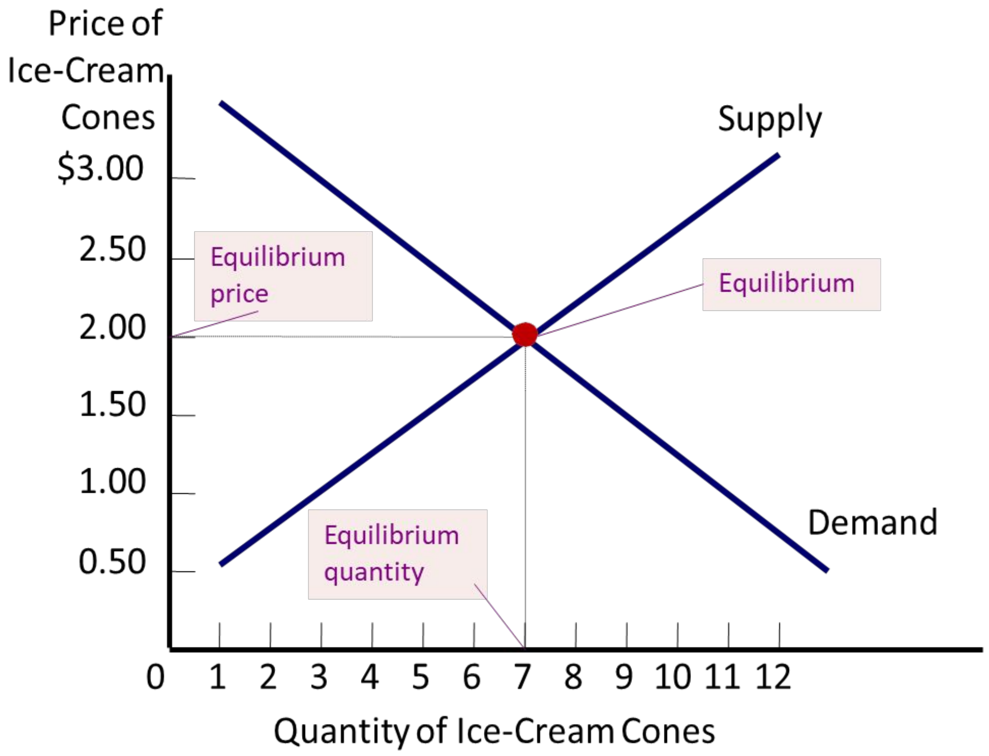
- The price of any good will adjust to bring the quantity supplied and quantity demanded into balance.

Equilibrium price

- The price that causes quantity supplied to equal quantity demanded.

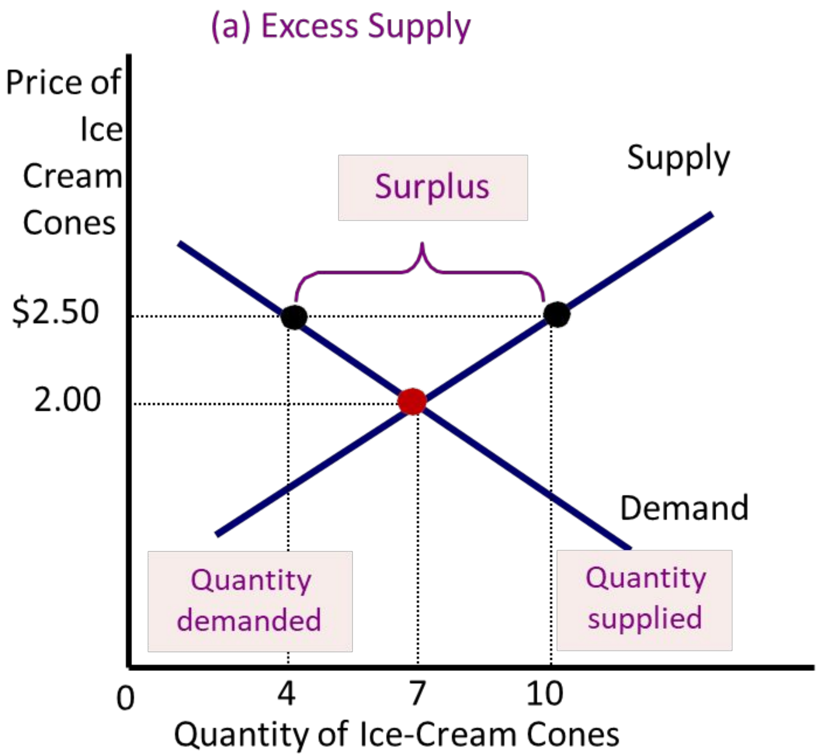
Equilibrium quantity

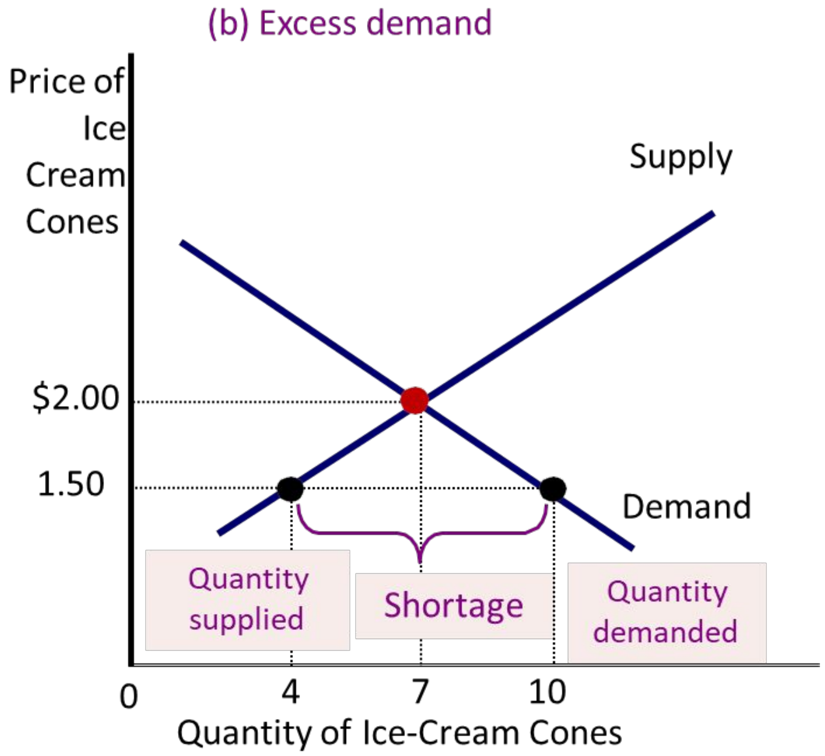
- The numerical quantity (supplied and demanded) at the equilibrium price



2.2 Equilibrium

Not equilibrium





2.2 Equilibrium

Representation of Points

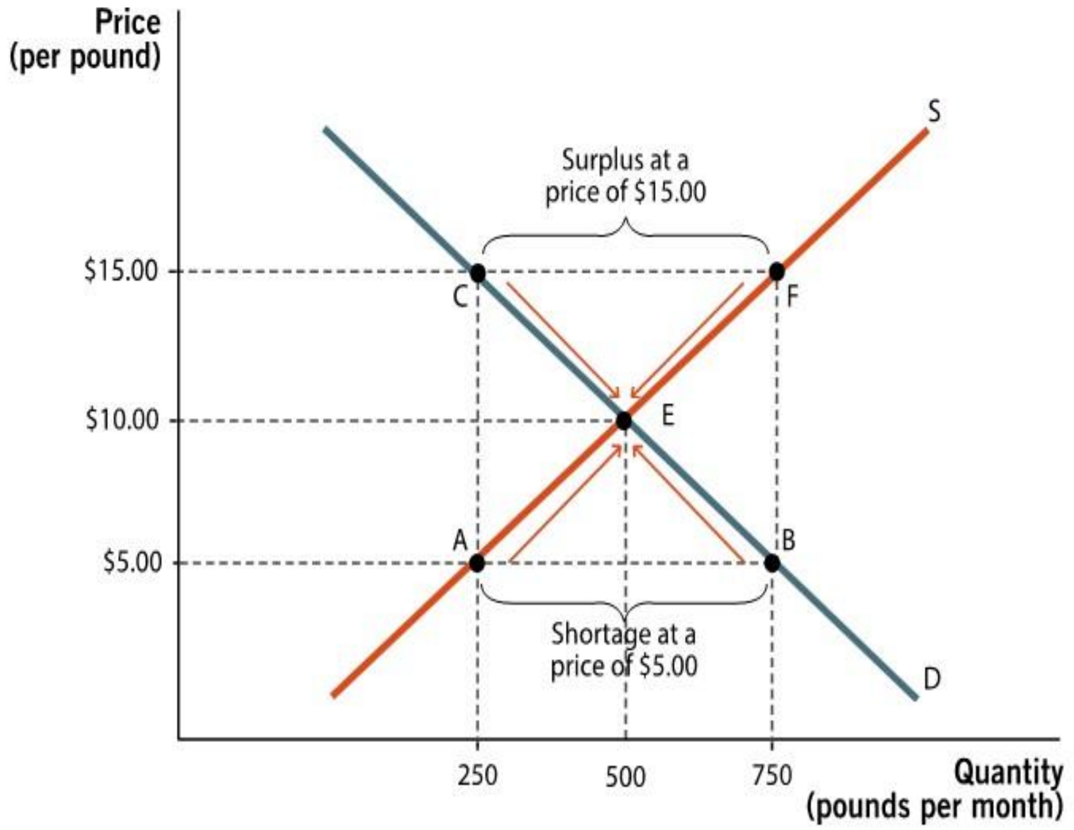
Excess Supply
Point F

Excess Demand
Point B

Equilibrium
Point E

Shortage of Demand
Point C

Shortage of Supply
Point A



2.3 Changes in Equilibrium

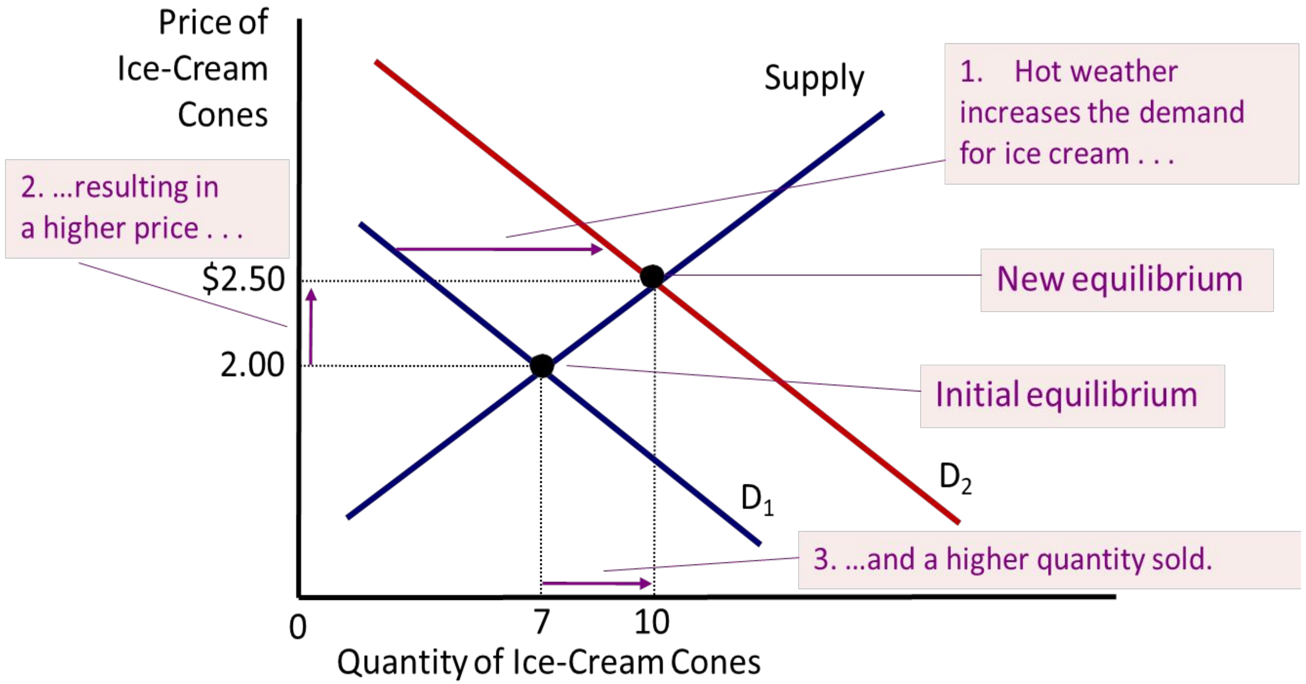
1. Decide whether the event shifts the supply or demand curve (or perhaps both).

2. Decide in which direction the curve shifts.

3. Use the supply-and demand diagram to see how the shift changes the equilibrium price and quantity.

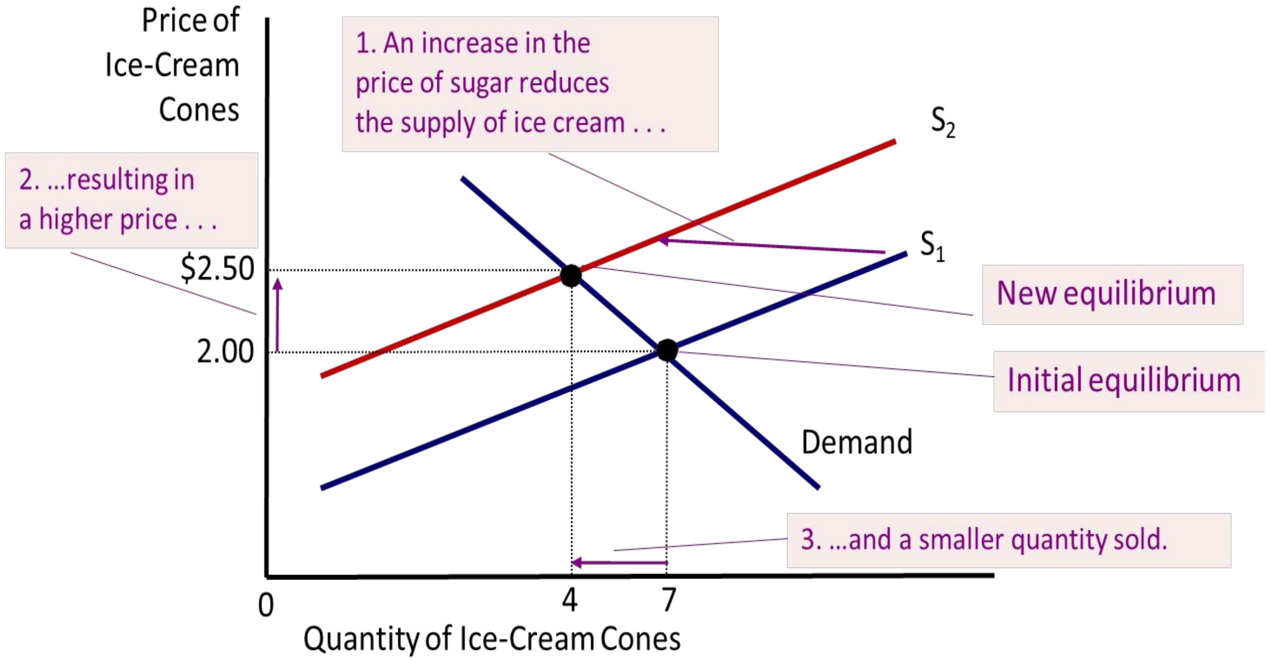
2.3 Changes in Equilibrium

Increase in Demand



2.3 Changes in Equilibrium

Decrease in supply



2.3

Changes in Equilibrium

Shift in supply

Example: A change in market equilibrium due to a shift in supply

- One summer – a hurricane destroys part of the sugarcane crop
- Price of sugar – increases

<u>Effect on the market for ice cream?</u>

1. Change in price of sugar – supply curve
2. Supply curve – shifts to the left
3. Higher equilibrium price; lower equilibrium quantity

2.3 Changes in Equilibrium

Shift in both demand & supply

Example: shifts in both supply and demand

One summer: hurricane and heat wave

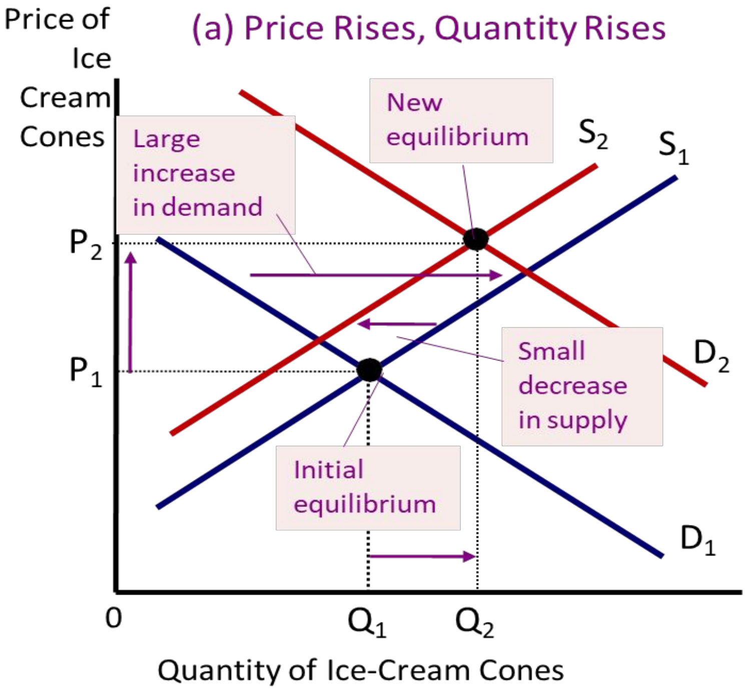
1. Heat wave – shift demand curve;
2. Hurricane – shift supply curve

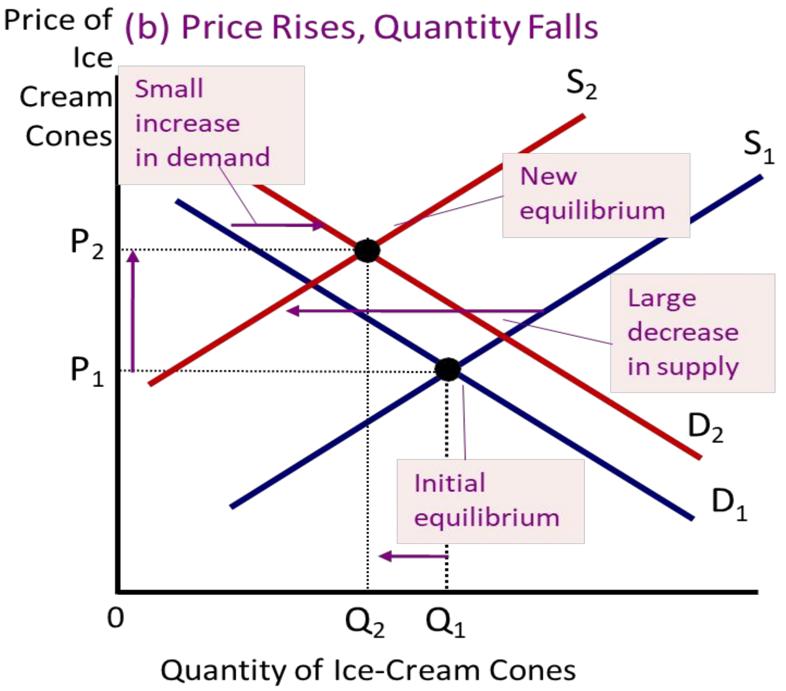
3. Demand curve shifts to the right;
4. Supply curve shifts to the left

5. Equilibrium price raises
   - If demand rises substantially while supply falls just a little: equilibrium quantity rises
   - If supply falls substantially while demand rises just a little: equilibrium quantity falls

2.3 Changes in Equilibrium

Shift in both demand & supply





2.3 Changes in Equilibrium

	No change in Supply	An increase in supply	An decrease in supply
No change in demand	P same Q same	P down Q up	P up Q down
An increase in demand	P up Q up	P ambiguous Q up	P up Q ambiguous
An decrease in demand	P down Q down	P Down Q ambiguous	P ambiguous Q down

2.4 Interdependence of markets

A rise in demand for a good will raise its price and profitability. Firms will respond by supplying more. But to do this they will need more inputs. Thus the demand for the inputs (factors of production) will rise, which in turn will raise the price of the inputs. The suppliers of inputs will respond to this incentive by supplying more. This can be summarized as follows:

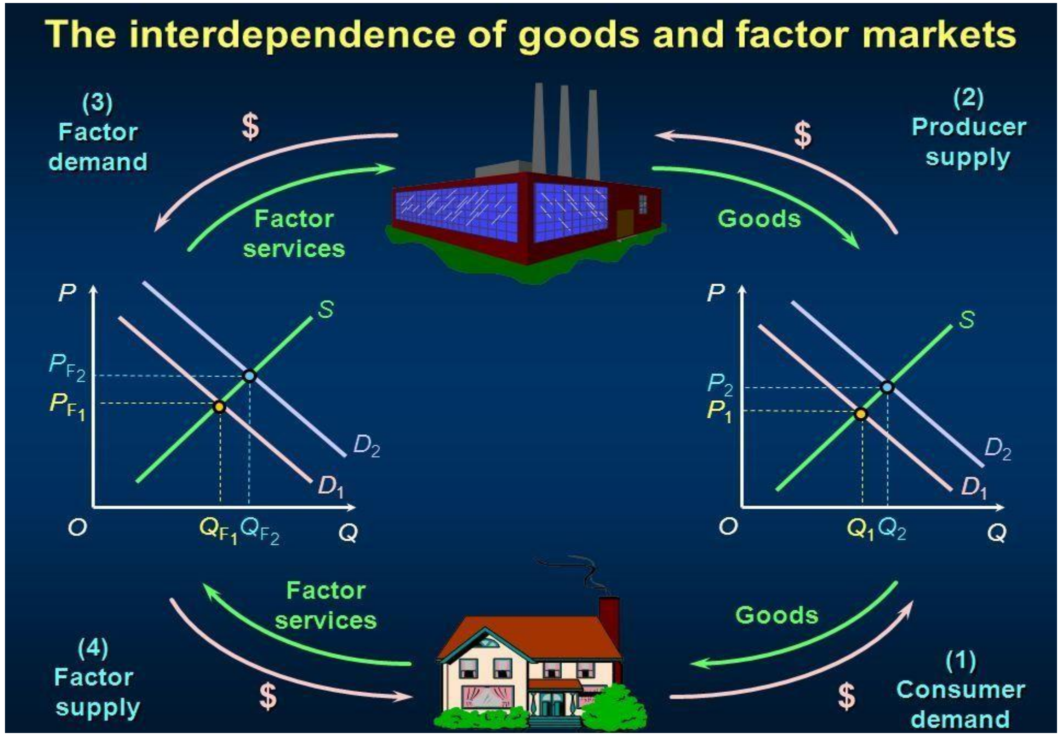
1. Goods market
- Demand for the good rises.
- This creates a shortage.
- This causes the price of the good to rise.
- This eliminates the shortage by reducing demand and encouraging firms to produce more

2. Factor market
- The increased supply of the good causes an increase in the demand for factors of production (i.e. inputs) used in making it.
- This causes a shortage of those inputs.
- This causes their prices to rise.
- This eliminates their shortage by reducing demand and encouraging the suppliers of inputs to supply more.

2.4 Interdependence of markets

The flow in the picture is something like this

1. Consumer demands the product
2. Producer supplies the same
3. Supplier produces the product with help of factor of production (If the demand goes up demand for factor of production also goes up)
4. Factor need for production are supplied by household



2.5 Problem of free market

- Power & Property may be unequally distributed
- Competition between firms is often limited.
- Insufficient Information
- Advertisement influence the consumers
- Social desires are avoided
- Unethical Practices
- Macroeconomic instability
- Self-interest

3 Command Economy

The command economy is usually associated with a socialist or communist economic system, where land and capital are collectively owned. The state plans the allocation of resources at three levels:

- It plans the allocation of resources between current consumption and investment for the future
- It plans the output of each industry and firm, the techniques that will be used, and the labour and other resources required by each industry and firm.
- It plans the distribution of output between consumers.

3.1 Assessment of the Command Economy

In practice, a command economy could achieve these goals only at considerable social and economic cost. The reasons are as follows:

- The larger and more complex the economy, the greater the task of collecting and analysing the information essential to planning, and the more complex the plan.
- If there is no system of prices, or if prices are set arbitrarily by the state, planning is likely to involve the inefficient use of resources.
- It is difficult to devise appropriate incentives to encourage workers and managers to be more productive without a reduction in quality.
- Complete state control over resource allocation would involve a considerable loss of individual liberty.
- If production is planned, but consumers are free to spend money incomes as they wish, there will be a problem if the wishes of consumers change.

4

The Mixed Economy

In mixed market economies, the government may control the following:

- Relative prices of goods and inputs, by taxing or subsidising them or by direct price controls.
- Relative incomes, by the use of income taxes, welfare payments or direct controls over wages, profits, rents, etc.
- The pattern of production and consumption, by the use of legislation (e.g. making it illegal to produce unsafe goods), by direct provision of goods and services (e.g. education and defense) or by taxes and subsidies.
- The macroeconomic problems of unemployment, inflation, lack of growth, balance of trade deficits and exchange rate fluctuations, by the use of taxes and government expenditure, the control of bank lending and interest rates, the direct control of prices and the control of foreign exchange rates.