Lecture

INSTITUTE OF ACTUARIAL
& QUANTITATIVE STUDIES

Class: M.Sc. Sem 2

Subject : Business Economics

Chapter: Unit 1 Chapter 2

Chapter Name: Market Equilibrium, Price Mechanism and Market Efficiency

Today's Agenda

1. Market
    1. Market - Meaning
    2. Types of Market economy

2. Free Market Economy
    1. Price Mechanism
    2. Demand and Supply schedule
    3. Equilibrium
    4. Changes in Equilibrium

3. Interdependence of Markets
    1. Interdependence of Goods and services and Factor Markets
    2. Interdependence of Different Markets

4. Problems of Free Market

5. Mixed Economy
    1. Mixed Economy – Characteristics

1.1 Market – Meaning

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

1.1 Market – Meaning

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

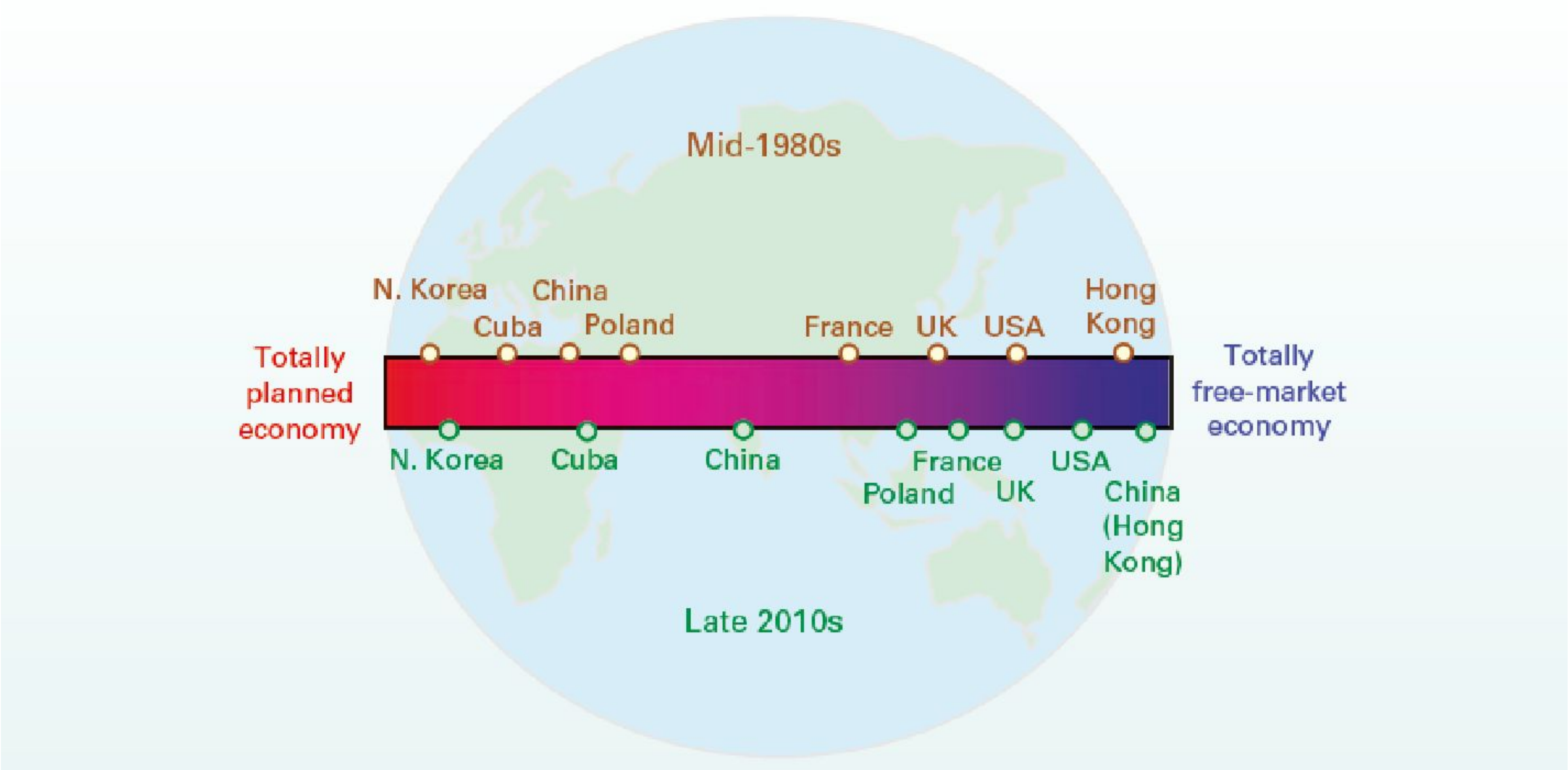
1.2 Types of Market Economy

What can you infer from free market economy and mixed economy?

1.2 Types of Market Economy

USA is free market economy and not mixed economy.
Do you agree with the above statement or not? Why?
Give other examples of both free market economy and mixed economy

1.2 **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**.

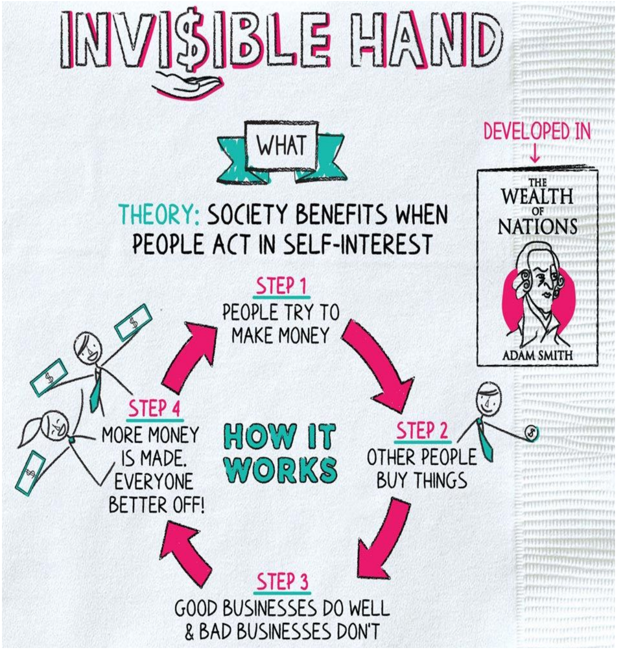
- A purely capitalist economy is a free market economy; the profit motive drives all commerce and forces businesses to operate as efficiently as possible to avoid losing market share to competitors.

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.**



'Adam Smith and the Invisible Hand Theory Explained' – Video

2 Free Market Economy

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Free Market Economy

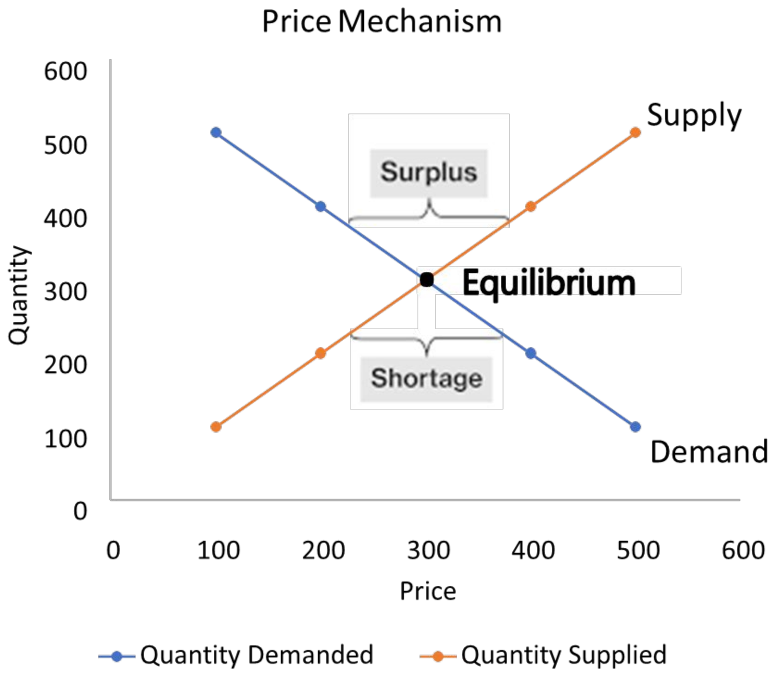
2.1 Price Mechanism

The price mechanism works as follows.

- Prices respond to shortages and surpluses.
- Shortages result in prices rising.
- Surpluses result in prices falling.

2.2 Demand and Supply schedule

Price of Apple	Quantity Demanded	Quantity Supplied	Relationship	Effect
100	500	100	D > S	Shortage (Price ⬆)
200	400	200	D > S	Shortage (Price ⬆)
300	**300**	**300**	**D = S**	**Equilibrium**
400	200	400	D < S	Surplus (Price ⬇)
500	100	500	D < S	Surplus (Price ⬇)



2.3 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.

2.3 Equilibrium

Equilibrium point

- Graphically, the intersection of supply and demand

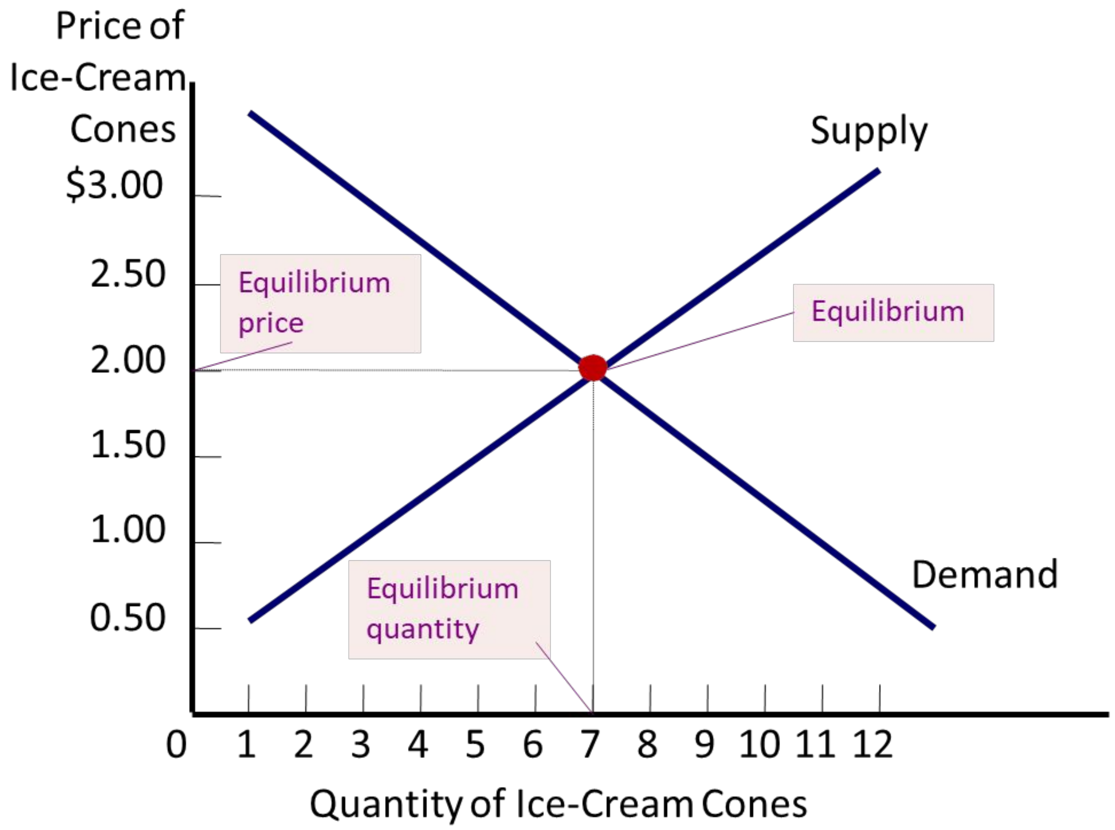
Equilibrium price

- The price that causes quantity supplied to equal quantity demanded.
- The price that "clears the market"

Equilibrium quantity

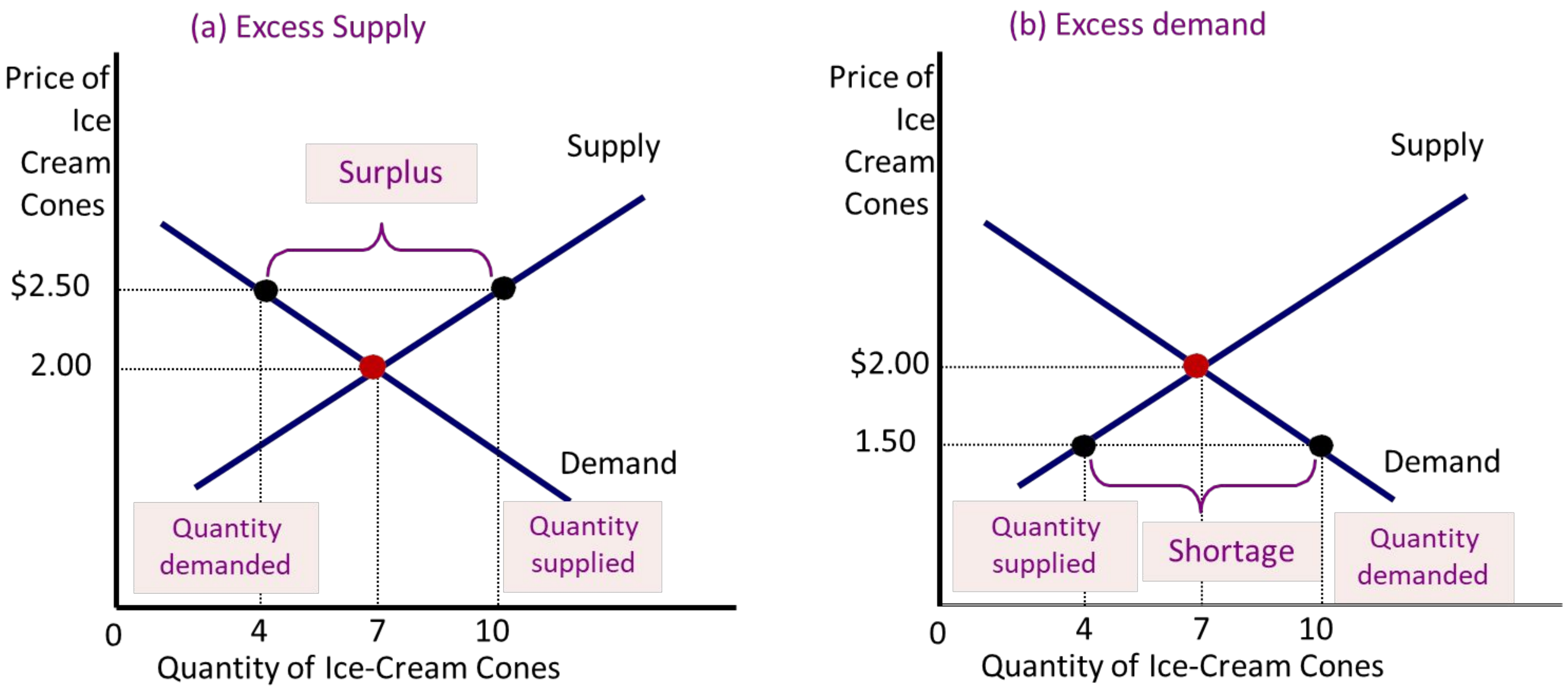
- The numerical quantity (supplied and demanded) at the equilibrium price

2.3 Equilibrium

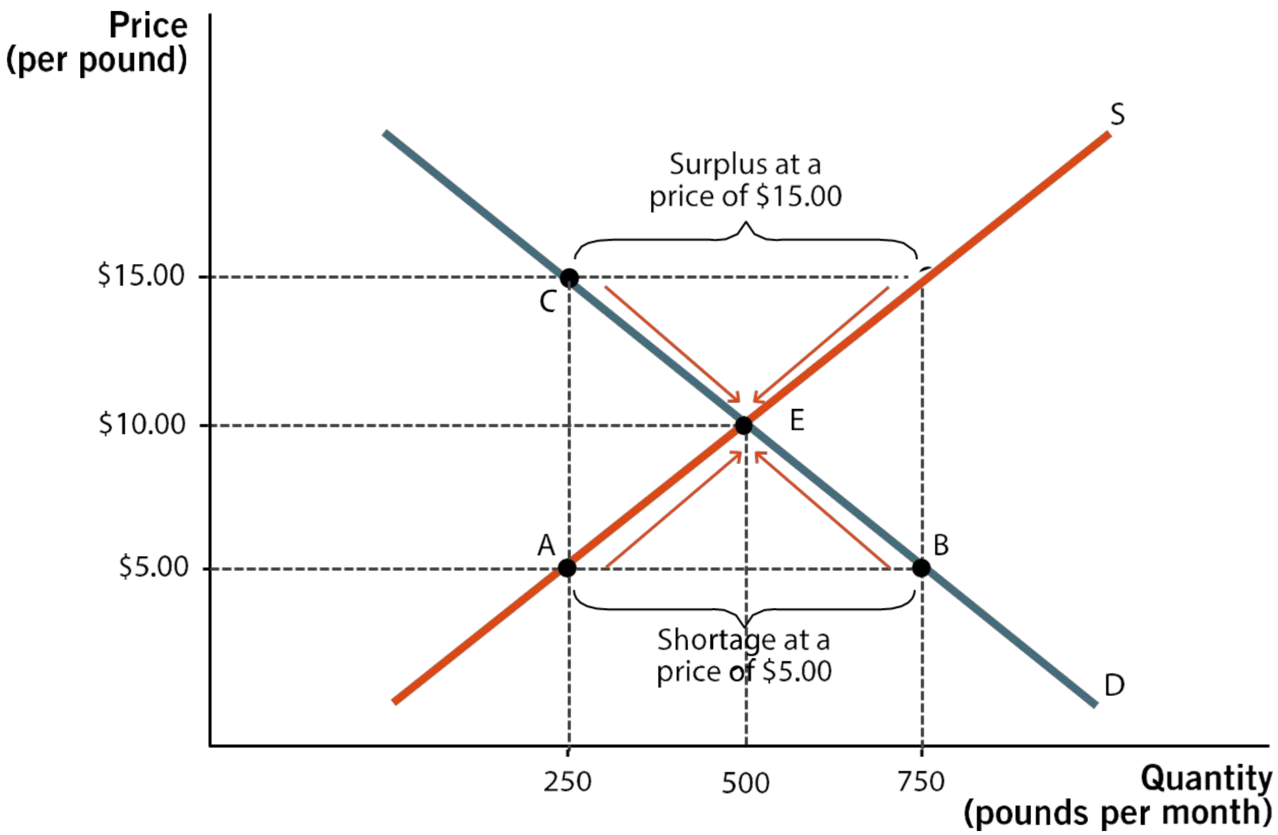


2.3 Equilibrium

Not Equilibrium



2.3 Equilibrium



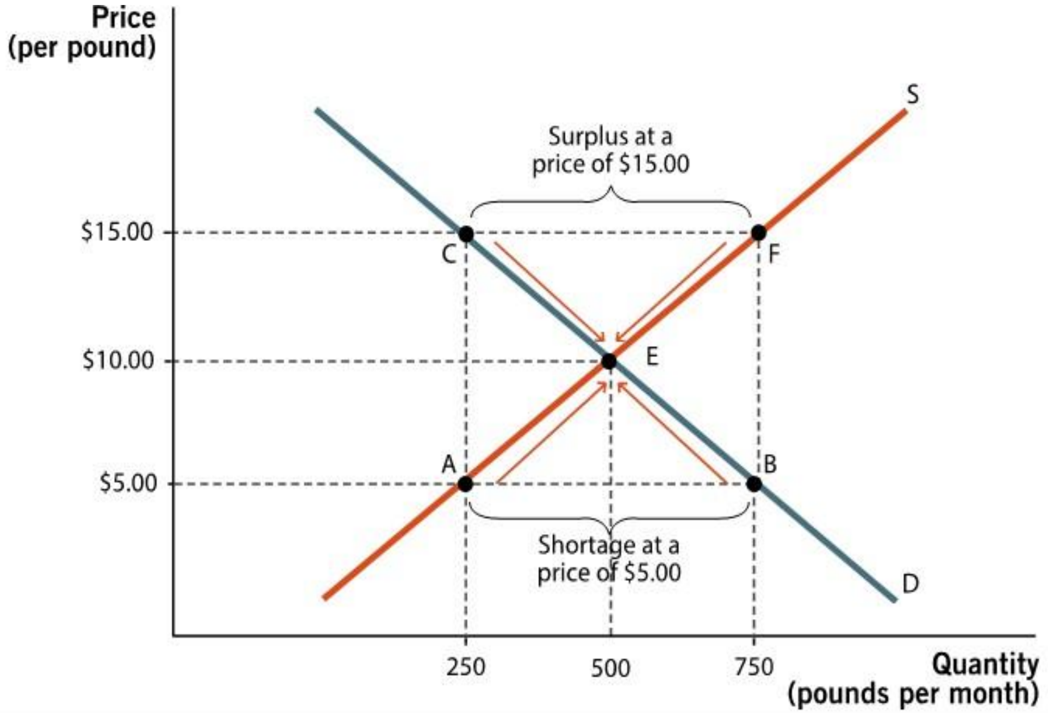
2.3 Equilibrium

Surplus

- Quantity supplied > quantity demanded
- Excess supply
- Downward pressure on price

Shortage

- Quantity demanded > quantity supplied
- Excess demand
- Upward pressure on price



2.3 Equilibrium

Representation of Points

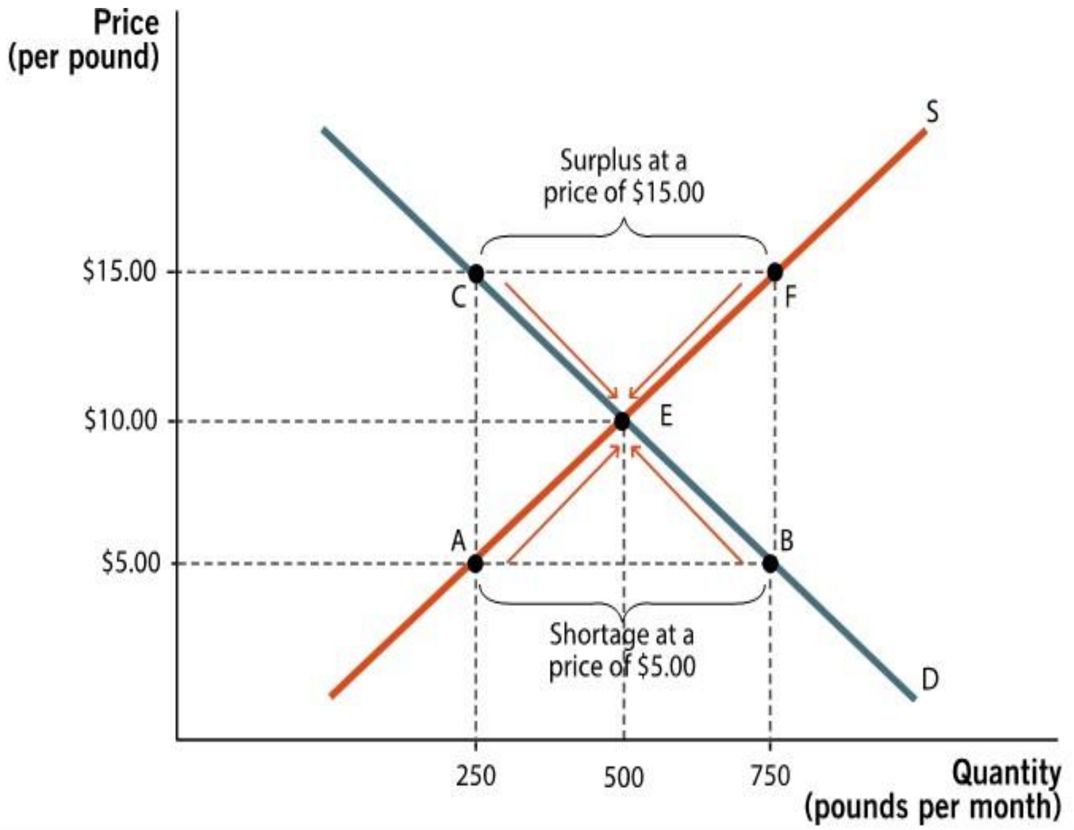
Excess Supply
Point F

Excess Demand
Point B

Equilibrium
Point E

Shortage of Demand
Point C

Shortage of Supply
Point A

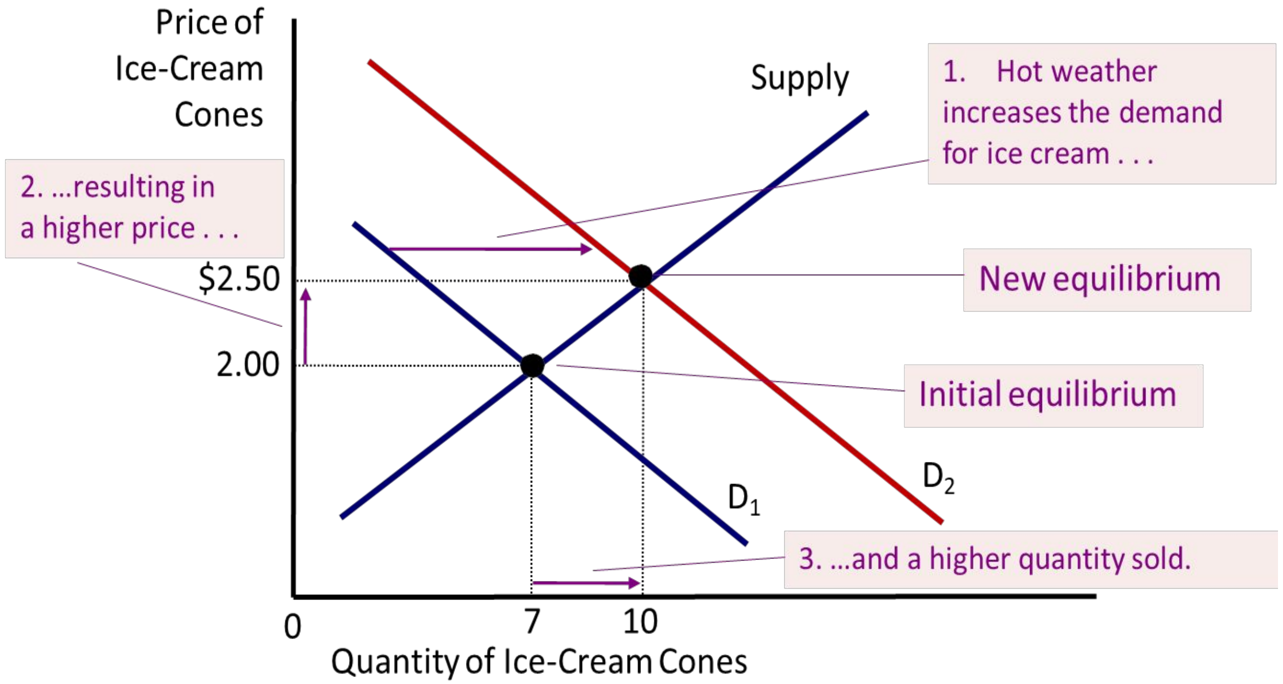


2.4 Changes in Equilibrium

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.

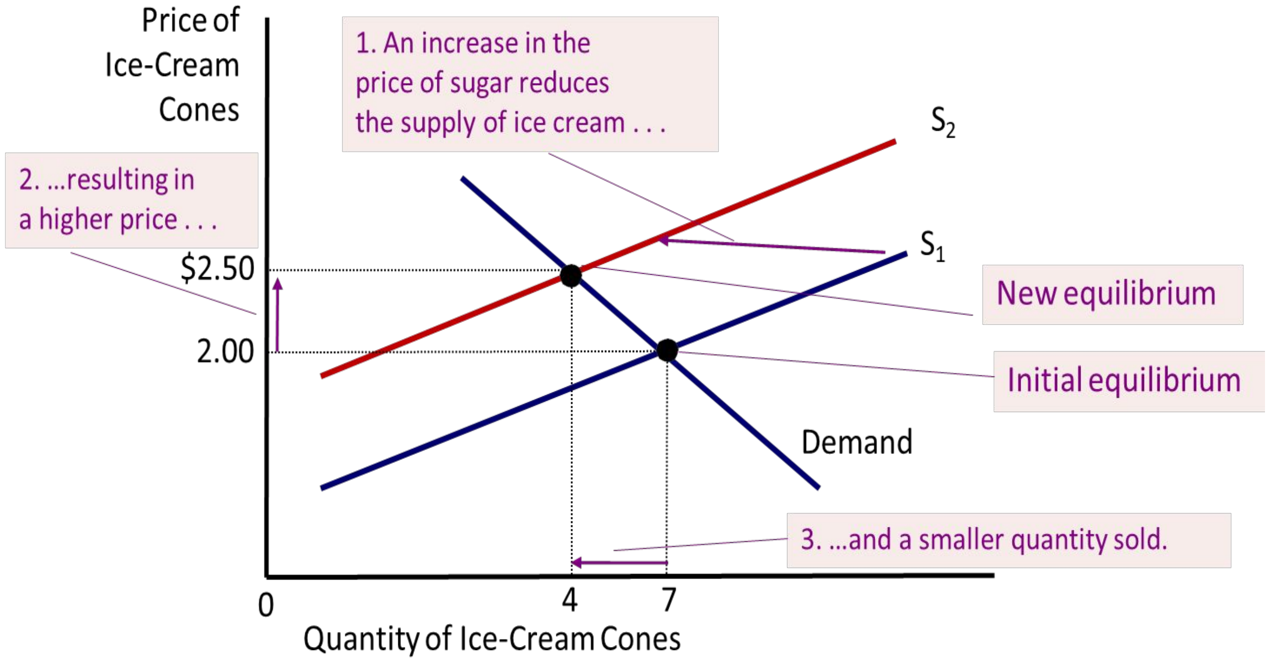
2.4 Changes in Equilibrium

Increase in Demand



2.4 Changes in Equilibrium

Decrease in Supply



2.4 Changes in Equilibrium

Shift in Supply

Exa mple: 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

Effect on the market for ice cream?

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

2.4 Changes in Equilibrium

Shift in both Demand & Supply

Exa mple: shifts in both supply and demand

One summer: hurricane and heat wave

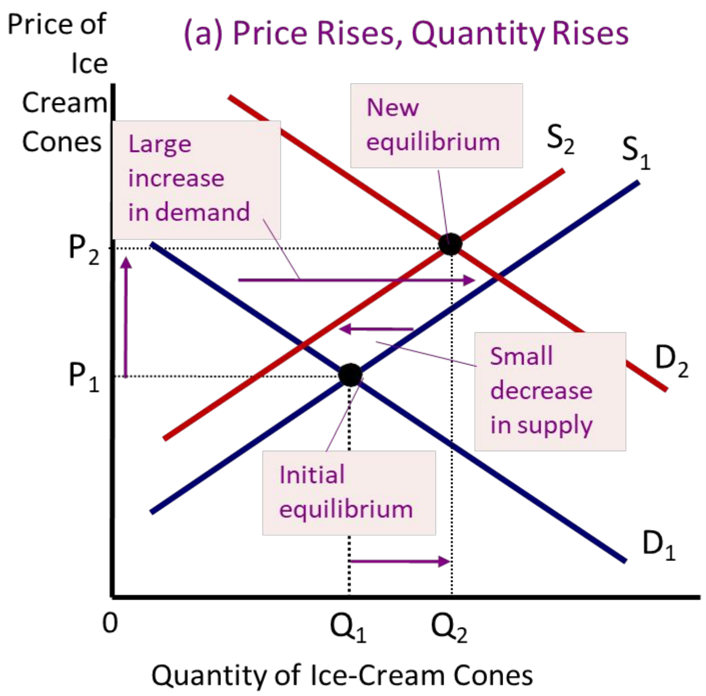
1. Heat wave – shift demand curve;
2. Hurricane – shift supply curve

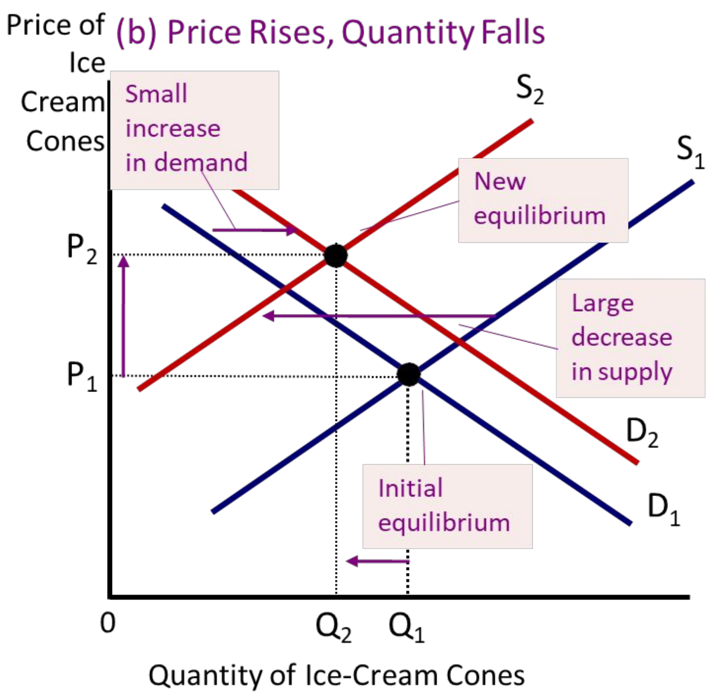
3. Demand curve shifts to the right;
4. Supply curve shifts to the left

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

2.4 Changes in Equilibrium

Shift in both Demand & Supply





2.4 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

3.1 Interdependence of Goods and Factor Markets

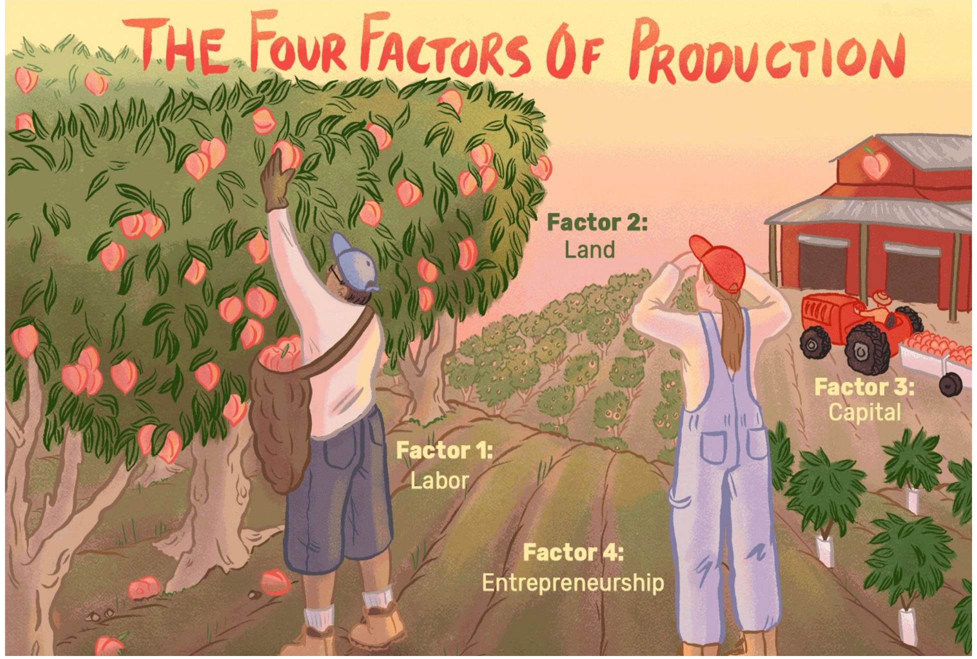
- **Goods Market**

This market is basically related to demand of consumer

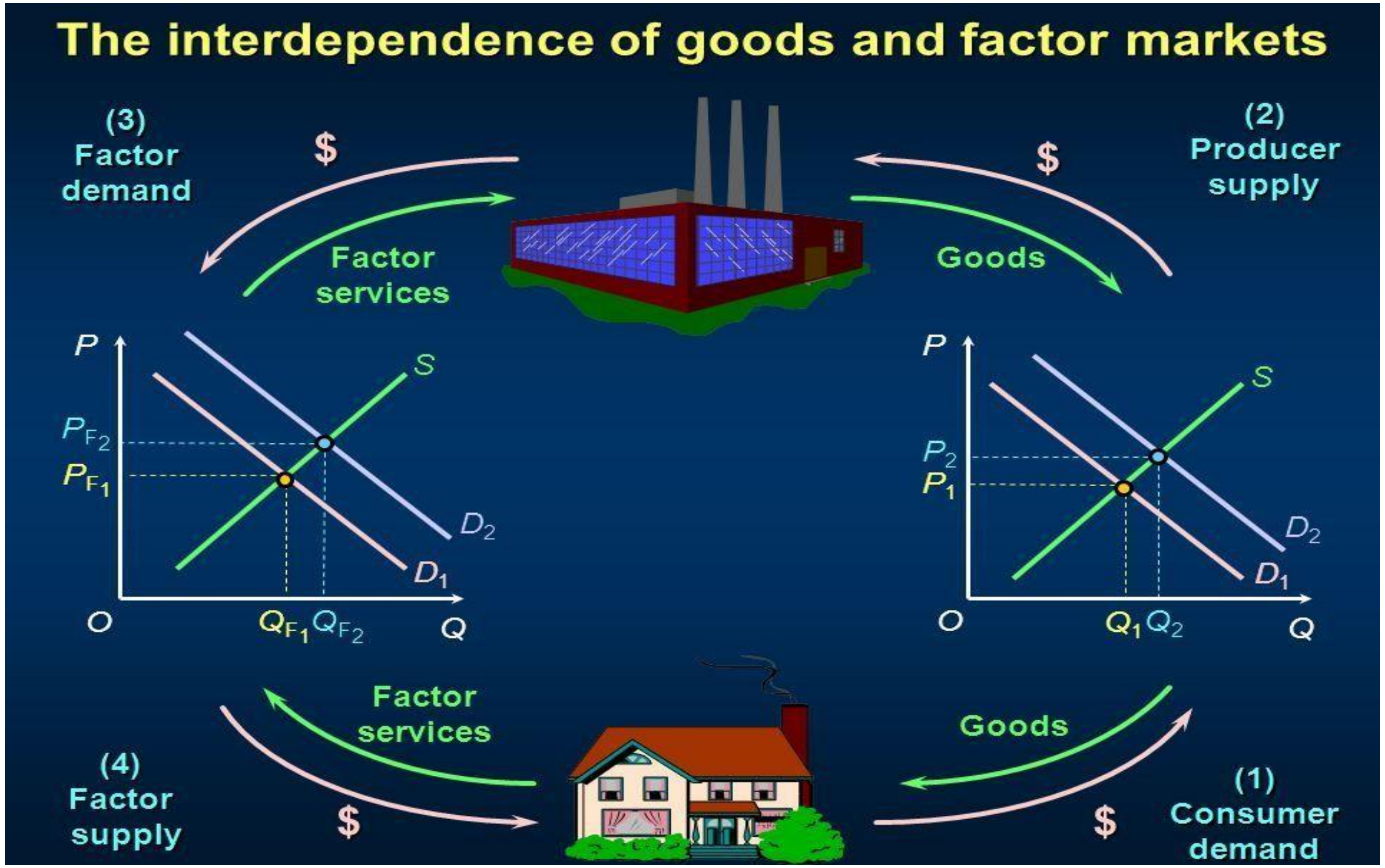
- **Factor market**

This market is related to supplier, Where supplier produce goods with Land, Labour, Capital & Entrepreneur (Factors of production) & given factors are supplied by consumer

So this is how it creates interdependence on market



3.1 Interdependence of Goods and Factor Markets



3.1 Interdependence of Goods and Factor Markets

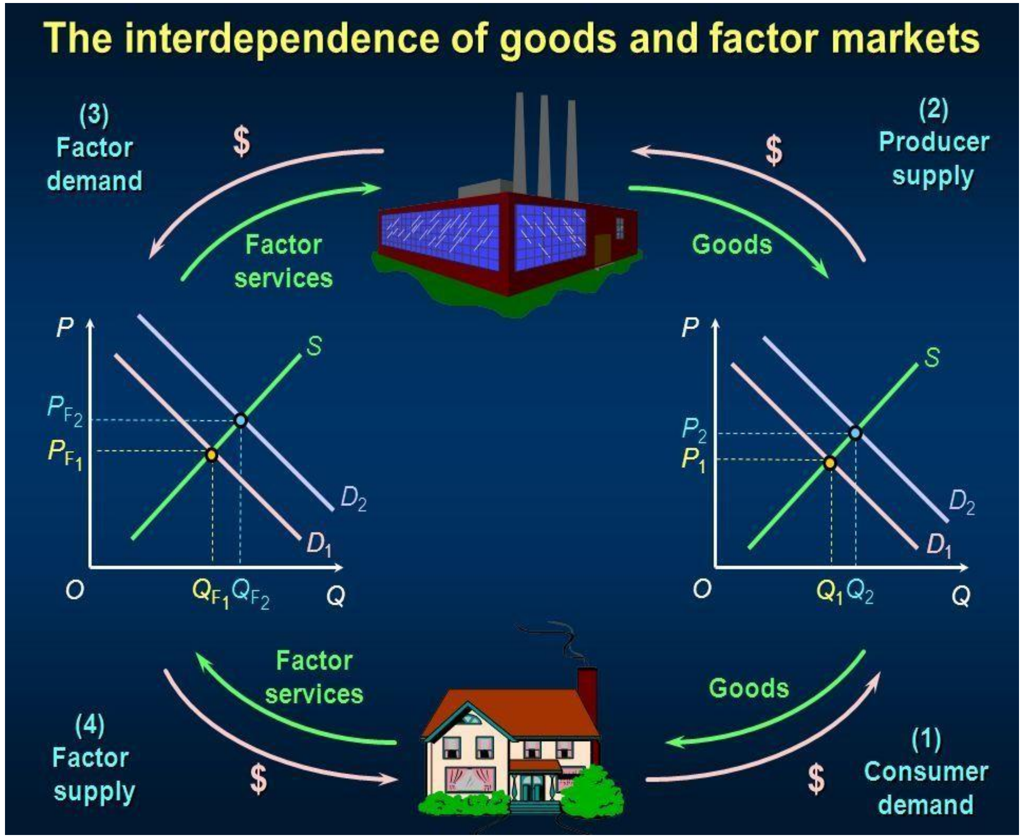
The flow in the picture is something like this

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



3.1 Interdependence of Goods and Factor Markets

Demand for a particular good rises
What effect will this have on the price of the good and price of factors of productions of the good?

3.2 Interdependence of Different Markets

- A rise in the price of one good will encourage consumers to buy alternatives.
- This will drive up the price of alternatives.
- This in turn will encourage producers to supply more of the alternatives.

For example
If Domino’s increase the price of pizza consumer will shift to Pizza Hut

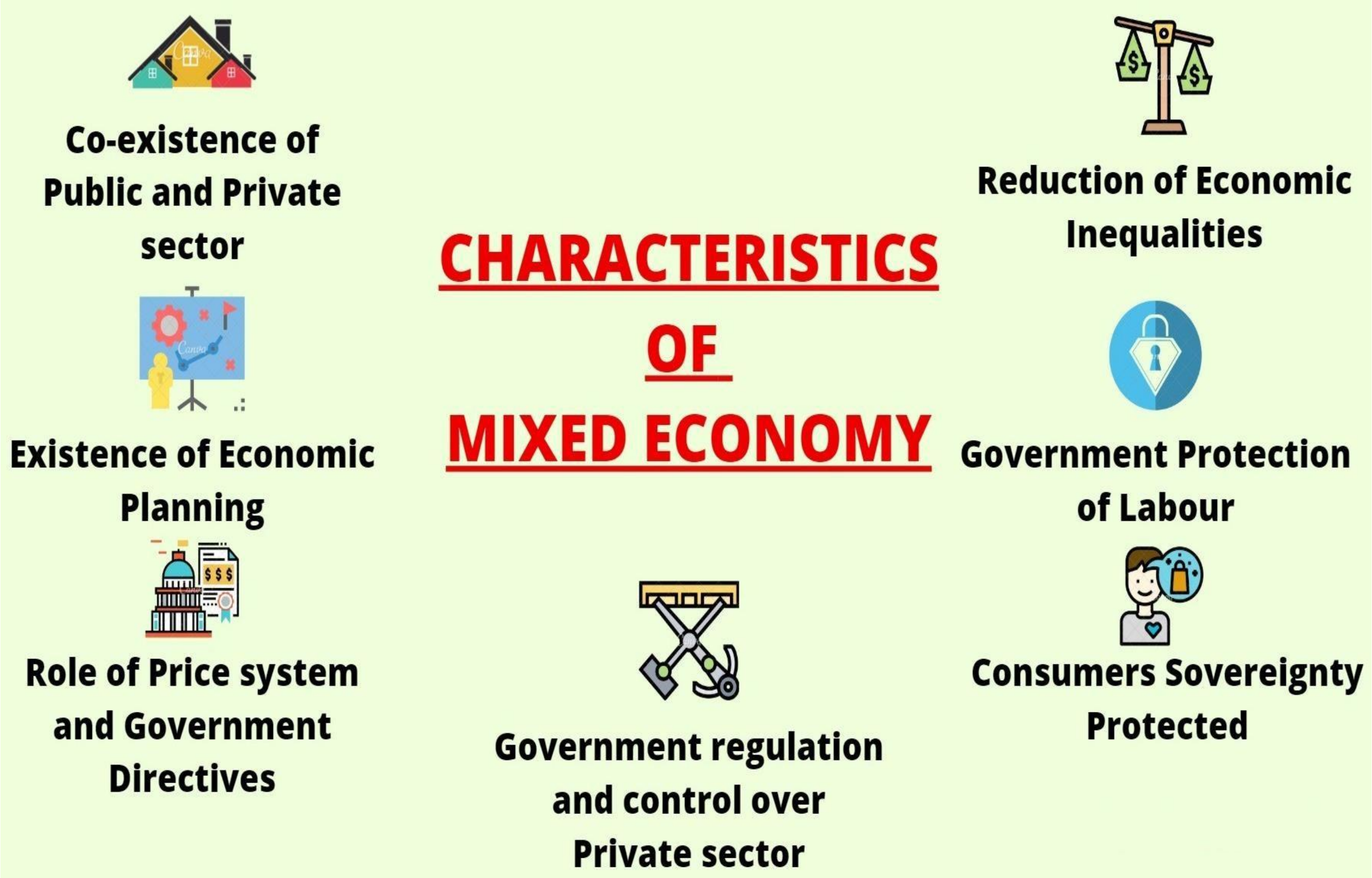
4 Problems of Free Market

- 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

5 Mixed Economy

- Because of the problems of both free-market and command economies, all real-world economies are a mixture of the two systems.
- 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 illegal to produce unsafe goods), by direct provision of goods and services (e.g. education and defence) 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.
- It is important to realize, however, that government actions may bring adverse as well as beneficial consequences.

5.1 Mixed Economy - Characteristics



5.1 Mixed Economy - Characteristics

Five-Year Plan

- The Indian economy embarked on the journey of being a mixed economy premised on the concept of planning through the Five-Year Plans

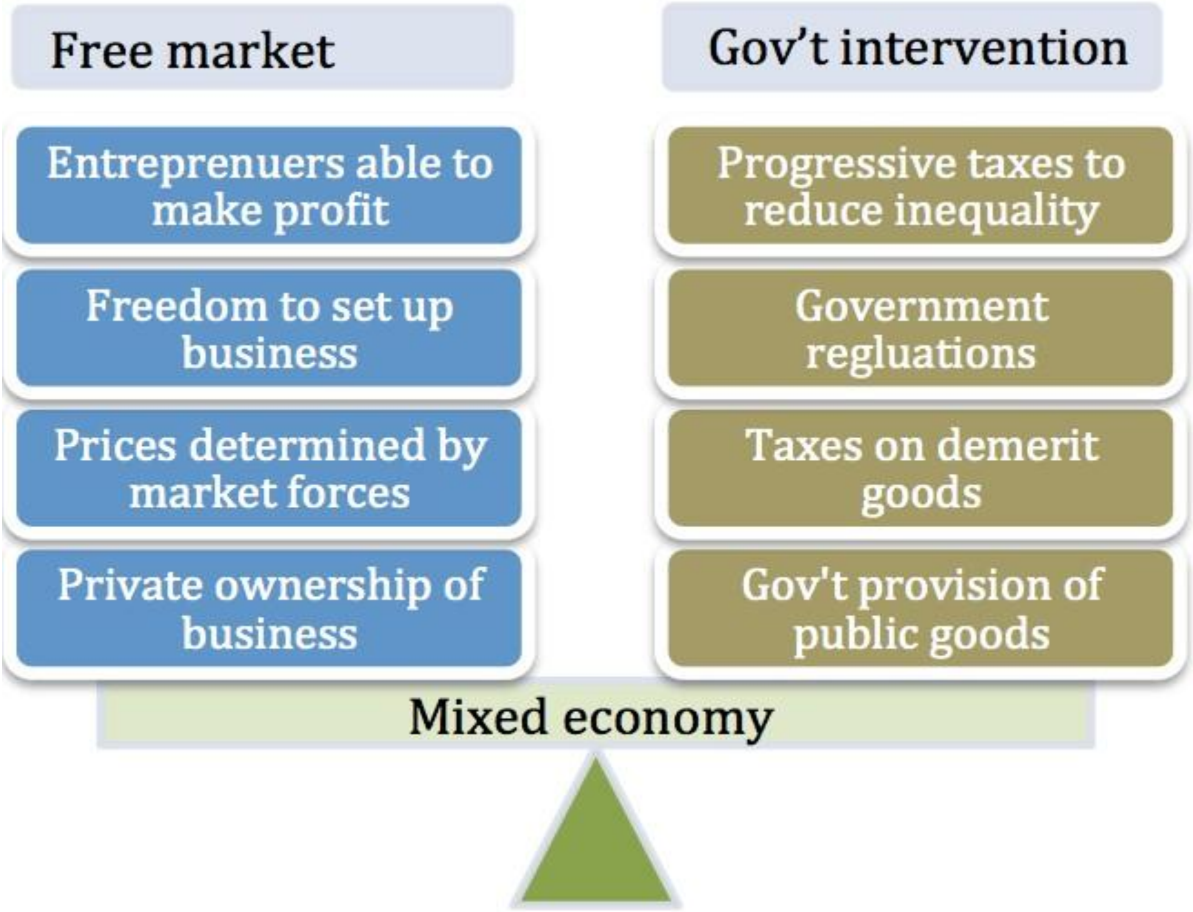
- The First Five-year Plan was launched in 1951 by the first Indian prime minister, Jawaharlal Nehru, which mainly focused in the development of the primary sector.

- There have been twelfth Five-Year Plans so far, last being 2012-17.

- The new government has announced the dissolution of the Planning Commission, and its replacement by a think tank called the NITI Aayog (an acronym for National Institution for Transforming India).

'Why did India opt for a mixed economy' - Video

6 Free Economy vs Mixed Economy



Quick Recap

- **Market** – An arrangement through which buyers and sellers come in contact with each other directly or indirectly and exchange of goods and services takes place among them.
- In a free market, individuals are free to make their own economic decisions.
- Prices respond to shortages (resulting price rise) and surpluses (resulting price fall).
- **Equilibrium price** – The price at which quantity supplied is equal to quantity demanded and where the price clears the market.
- **Equilibrium quantity** – The numerical quantity (supplied and demanded) at the equilibrium price
- A shift in demand and/or supply leads to a change in equilibrium price and/or equilibrium quantity

Quick Recap

- **Goods Market** – Related to Demand

- **Factor Market** – Related to Supply

- There is an interdependence between these markets

- **Features – Mixed Economy**
  1. Co-existence of public and private sector
  2. Existence of economic planning
  3. Role of price system and Government directives
  4. Government regulation and control over Private sector
  5. Reduction of Economic inequalities
  6. Government protection of Labor
  7. Consumers sovereignty protected

Questions

1. What is Market?

Market = __________ + __________ + __________

2. A purely capitalist economy is a free market economy; the __________ motive drives all commerce and forces businesses to operate as efficiently as possible to avoid losing market share to competitors.

A. wants B. profit C. social welfare D. equitable distribution

Questions

Using the given diagram answer the following questions

3. What does point 'A' represent

A. Demand shortage B. Supply shortage
C. Excess demand D. Excess supply

4. What does point 'D' represent

A. Demand shortage B. Supply shortage
C. Excess demand D. Excess supply

5. At price 400, we have

A. Shortage B. Surplus
C. Equilibrium D. Cant say

Questions

6. What are the various factors of productions?

7. What are the factor rewards for these factors of productions?

8. Households demand __________ from firms/industries and supply __________ to firms/industries

A. factor payments, price
B. price, factor payments
C. factors of productions, goods and services
D. goods and services, factors of productions