Higher

Economics

HSN80014
Unit 1 Topic 4

Contents

Topic 4 – Operation of Markets

The Market

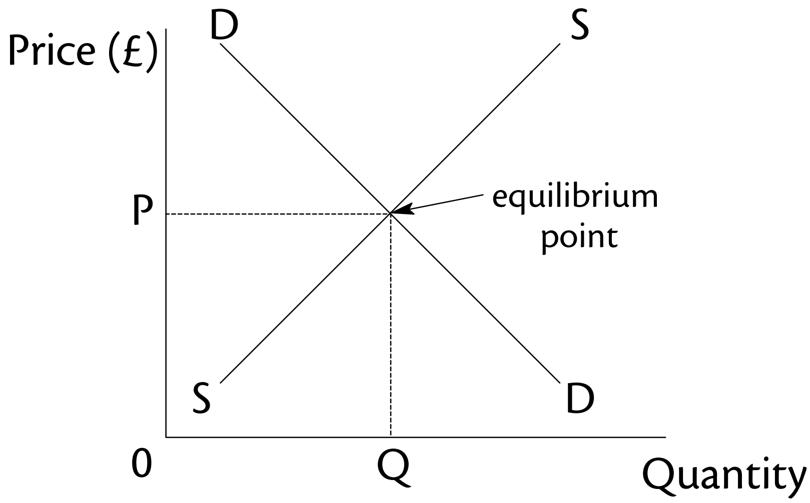
In economics, a market is anywhere where buyers and sellers come into contact in order to exchange goods or services for money. It includes the good or service itself.

The buyer could be an individual, a firm or the government. The supplier is normally a firm, but could also be an individual or the government.

The term "market forces" refers to demand and supply.

Equilibrium Point

In a competitive market (see *Types of Markets*), price will be established at the point where the quantity demanded equals the quantity supplied. This point is known as the equilibrium price and quantity. This means that at a particular price, the amount consumers are willing to buy is the same as the amount producers are willing to sell.

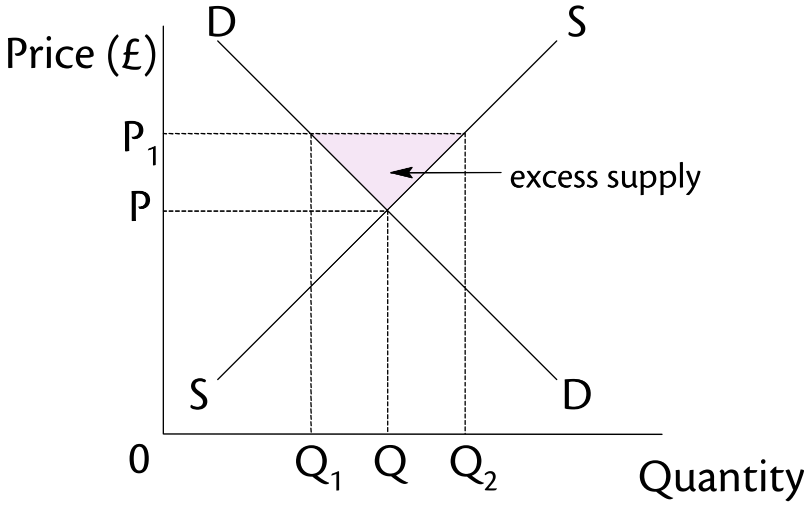


The equilibrium price is also known as the *market clearing price*. This is because at this price all consumers have been satisfied (there are no shortages) and all producers have been satisfied (there are no surpluses). The market is therefore cleared.

Outwith the Equilibrium

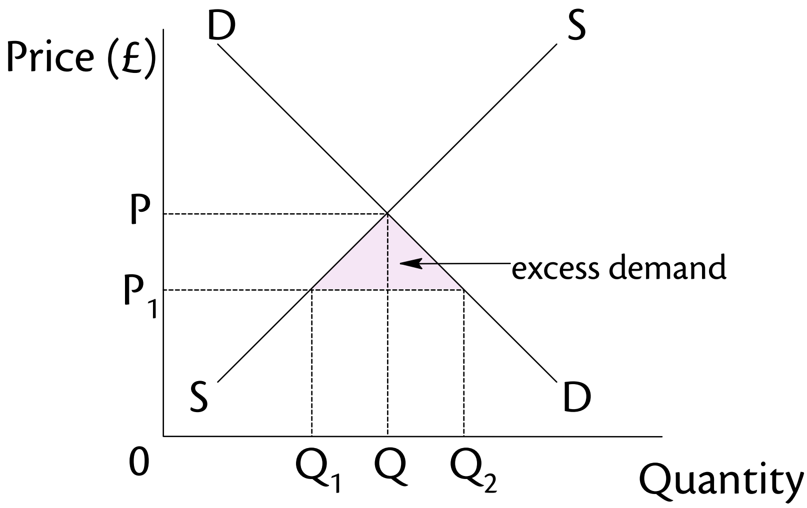
Circumstances may arise where the price in the market is above or below the equilibrium level. The market forces will push the price back towards the equilibrium level.

The price could be above the equilibrium level causing excess supply within the market.



The price above the equilibrium (£P_1) has caused excess supply in the market. Producers are willing to supply Q_2 of the product whilst consumers are only willing to buy Q_1. Producers will lower prices until the equilibrium is reached.

Alternatively, the price could be below the equilibrium level causing excess demand within the market.



The price below the equilibrium (£P_1) has caused excess demand in the market. Producers are only willing to supply Q_1 of the product whilst consumers are willing to buy Q_2. Producers will raise prices until the equilibrium is reached.

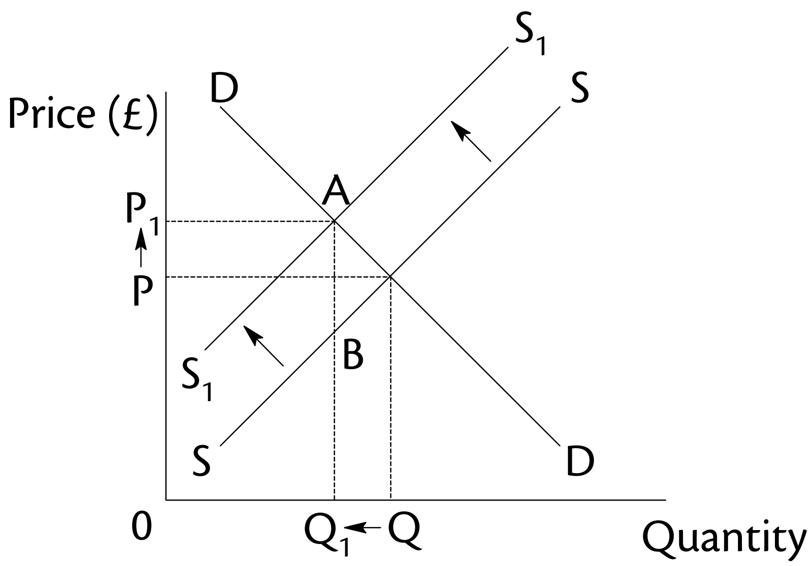
Market Intervention

There are four key ways the government can intervene in a market which can affect the price and quantity demanded and supplied. These are:

- imposition of a tax
- granting of a subsidy
- setting of a minimum price
- setting of a maximum price

Imposition of a Tax

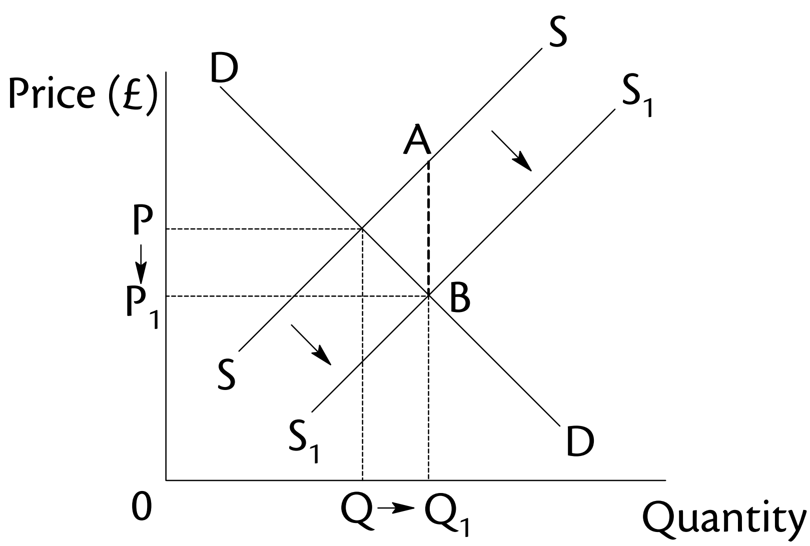
Taxes are a sum of money a producer has to pay to the government which raises their costs of production. In order to protect profits, producers will restrict supply to raise prices.



The supply curve shifts to the left by the amount of the tax (line AB). There will be a new equilibrium point as equilibrium price rises from £P to £P_1, and equilibrium quantity falls from Q to Q_1.

Granting of a Subsidy

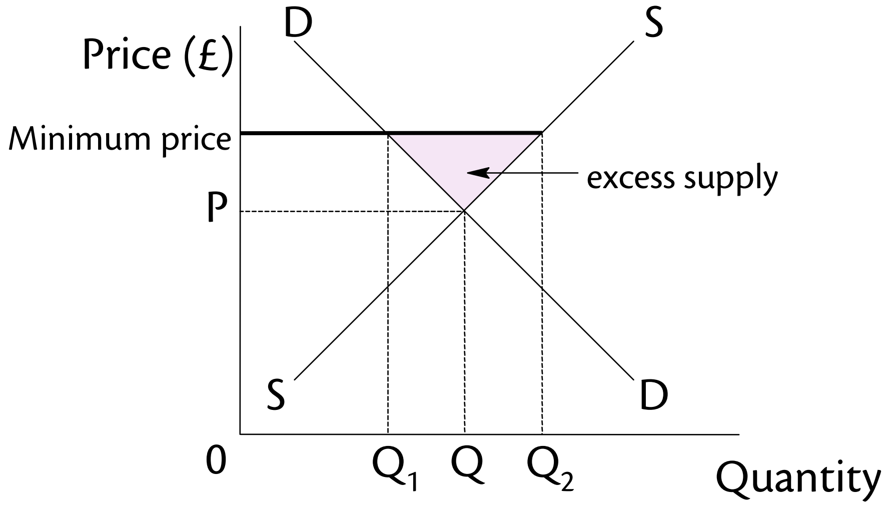
Subsidies are a type of grant given to a producer by the government which help pay part of the costs of production. By reducing production costs for the producer, they can now supply more of the product to the market and reduce the price.



The supply curve shifts to the right by the amount of the subsidy (line AB). There will be a new equilibrium point as equilibrium price falls from £P to £P_1, and equilibrium quantity rises from Q to Q_1.

Setting of a Minimum Price

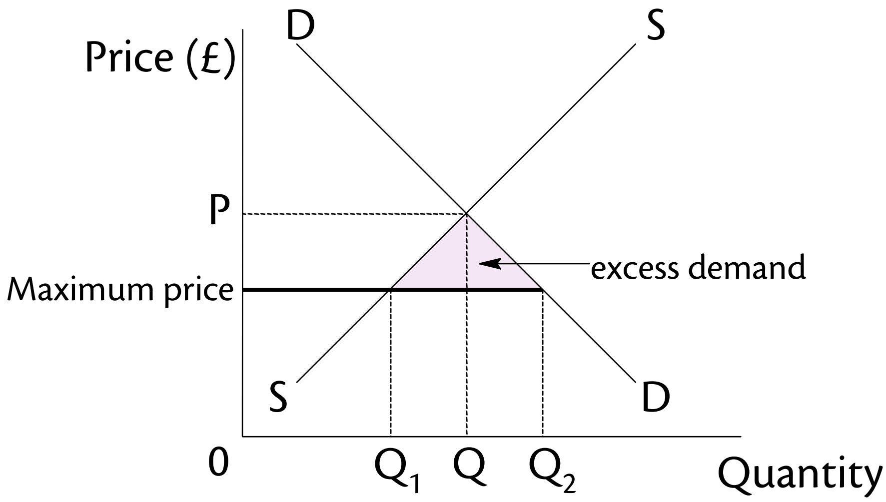
A minimum price is a price set by the government above the equilibrium level.



The government may set a minimum price to ensure producers receive a fair income. However, by doing this excess supply is created within the market. Producers are willing to supply more at a higher price (due to increased profits), but consumers will demand less. This creates surpluses.

Setting of a Maximum Price

A maximum price is a price set by the government below the equilibrium level.



The government may set a maximum price to restrict supply in order to restrict producer's income, or possibly as part of a deflationary campaign. However, by doing this excess demand is created within the market. Producers are willing to supply less, but consumers are demanding more. This creates shortages and often leads to the development of "black markets". This occurs when people buy up the good at the maximum price and then re-sell the good at the equilibrium price. A common example of this is ticket touts at concerts.