Introduction to Economics

Microeconomics

Price Determination

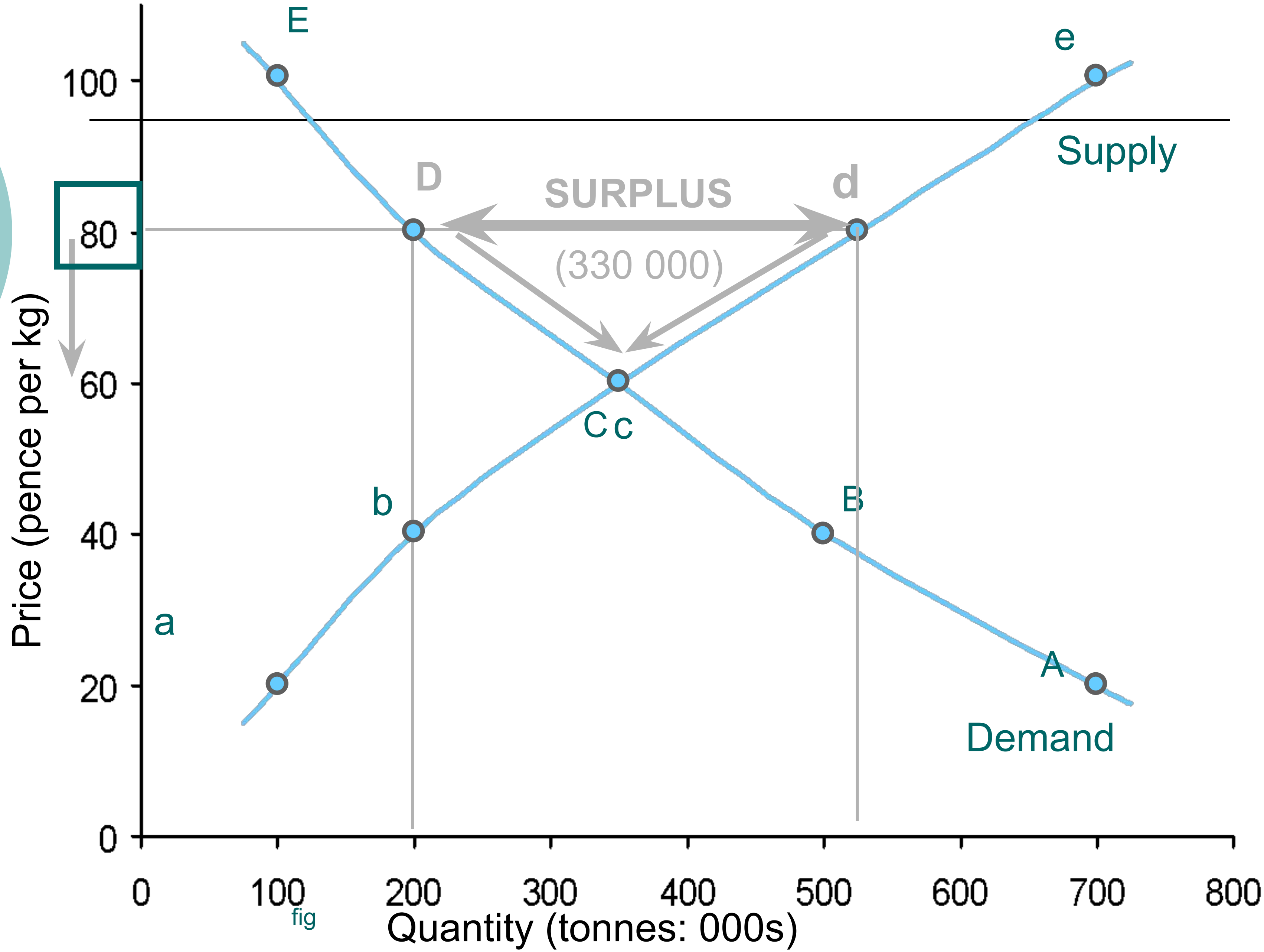
Key terms

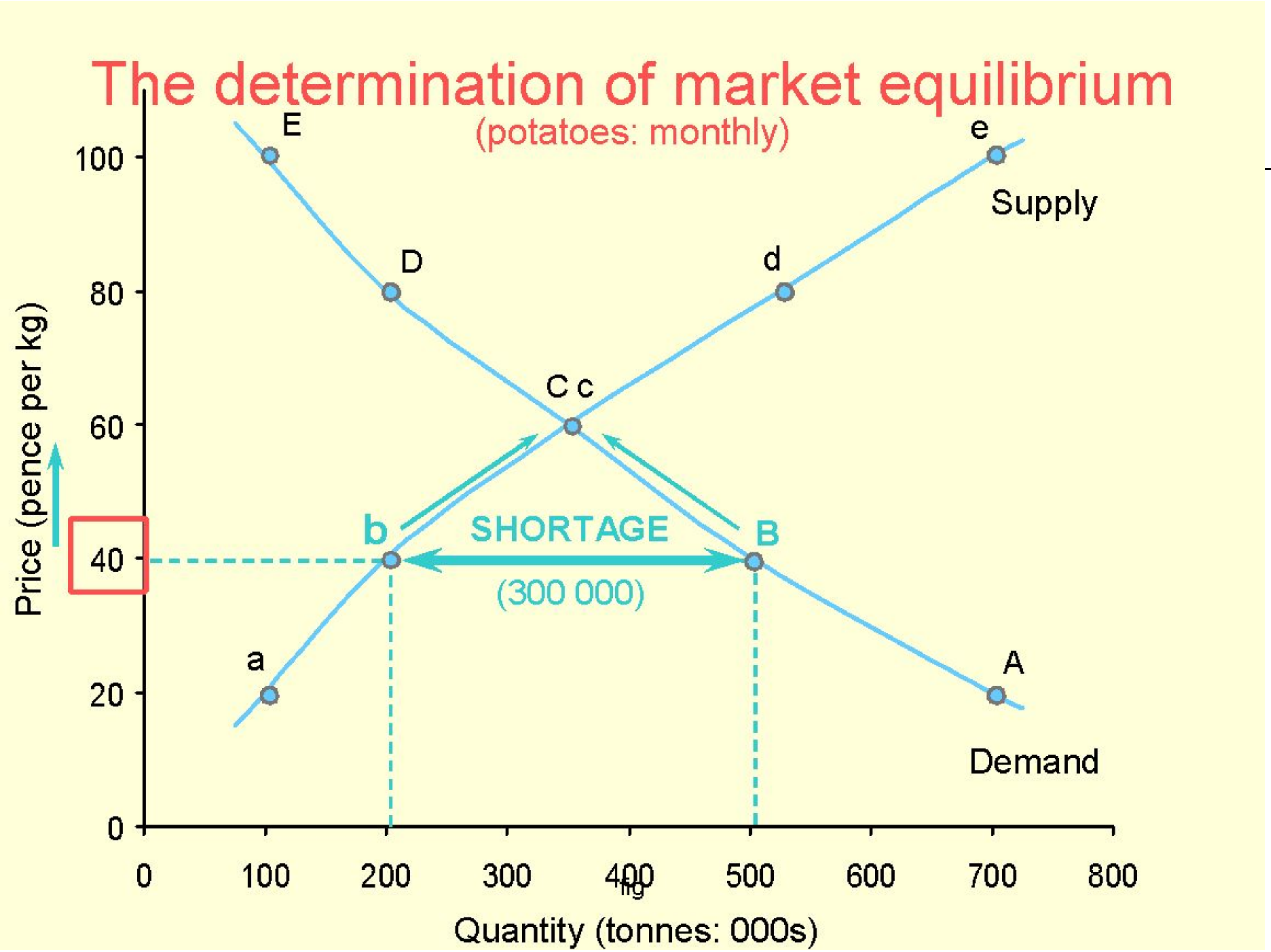
- Market equilibrium
- Price mechanism
- Market clearing price
- Shortage, excess demand
- Surplus, excess supply

Equilibrium price and output

- Combines analysis of demand and supply
- Market clearing – when supply matches demand
- Equilibrium is the point where conflicting interests are balanced
- Price is determined by the INTERACTION BETWEEN demand and supply in a competitive market

The determination of market equilibrium
(potatoes: monthly)





The determination of market equilibrium
(potatoes: monthly)
E
e
D
d
C c
b
B
a
A
Supply
Demand
SHORTAGE
(300 000)
100
80
60
40
20
0
0
100
200
300
400
500
600
700
800
fig
Price (pence per kg)
Quantity (tonnes: 000s)

The Determination of Price and Output

- Demand and supply curves
  - effect of price being above equilibrium
    - price falls

Why does the price fall if above equilibrium?

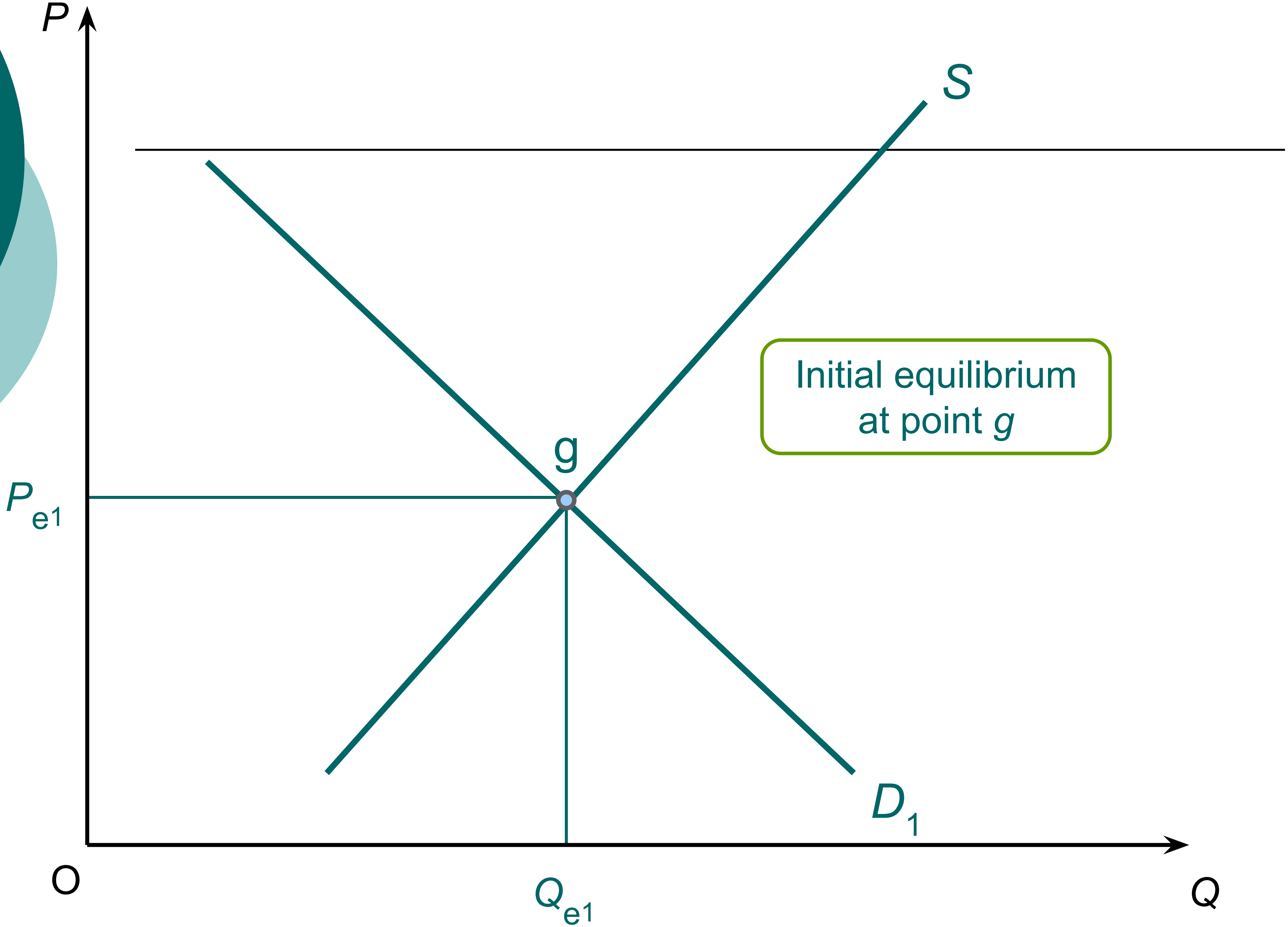
Change in demand

- Determinant other than price changes
- Demand curve shifts
  - Right if demand increases
  - Left if demand decreases

Change in supply

- Determinant other than price changes
- Supply curve shifts:
  - Right if supply increases
  - Left if supply decreases

Effect of a shift in the demand curve



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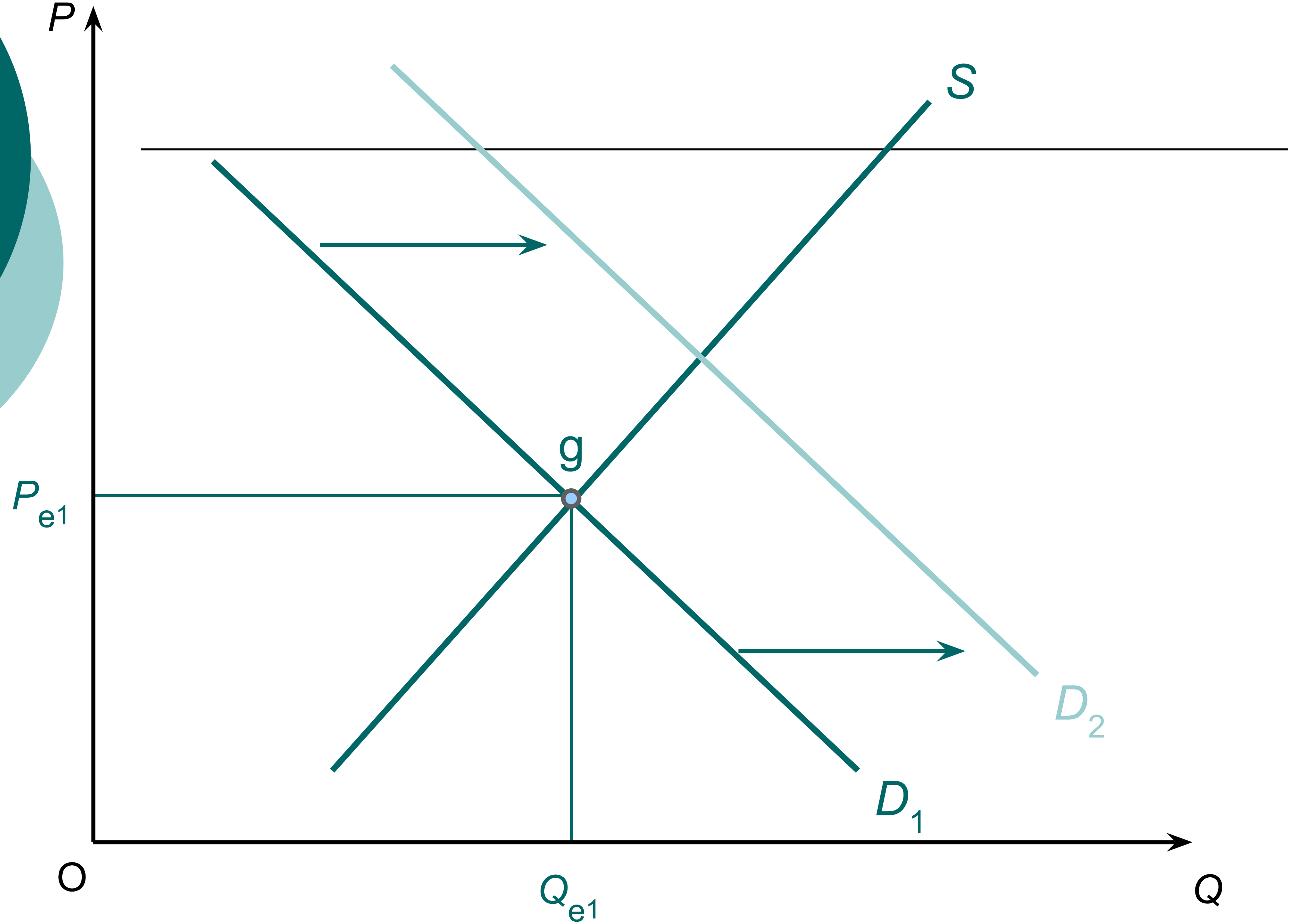
Effect of a shift in the demand curve



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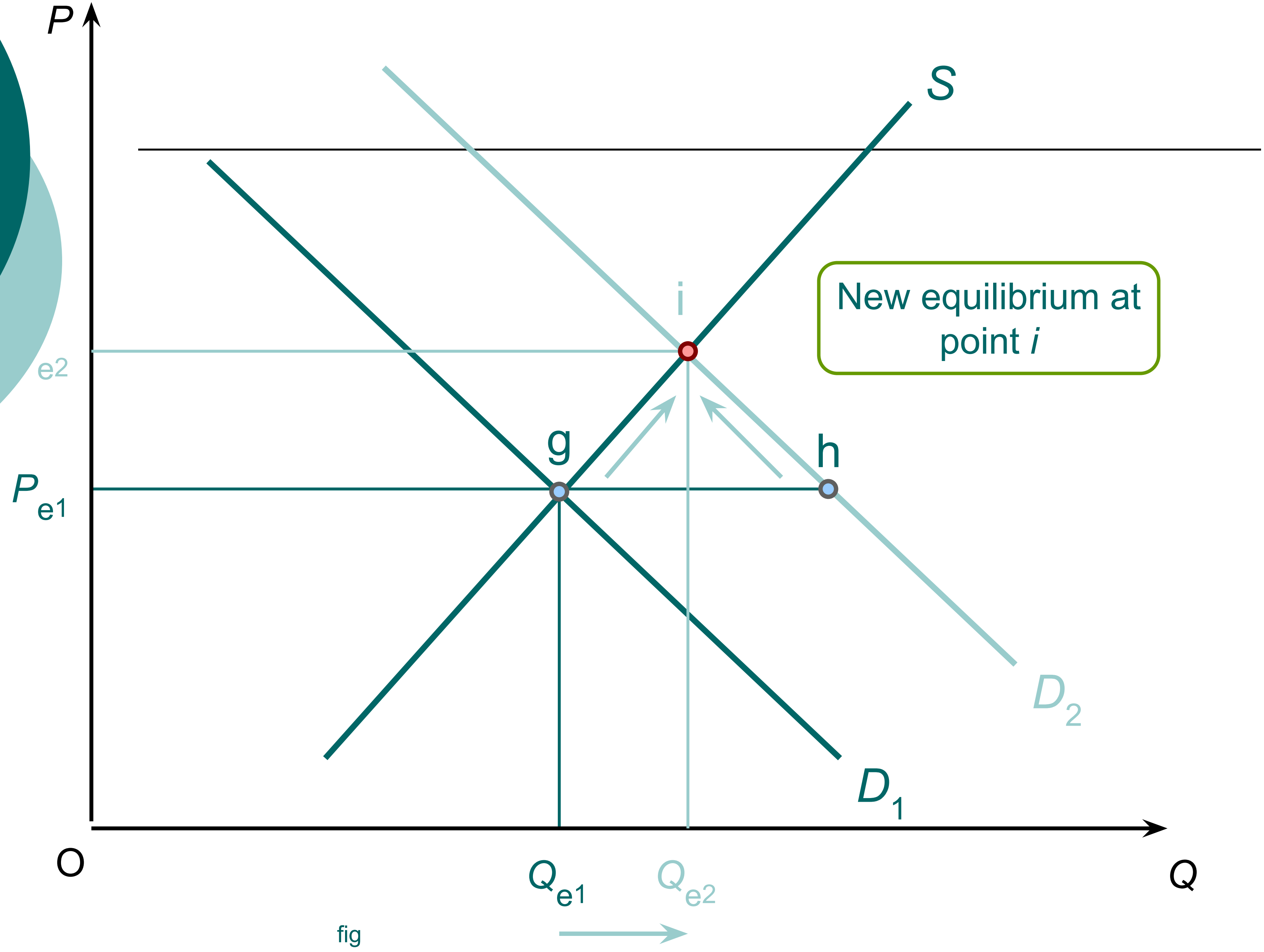
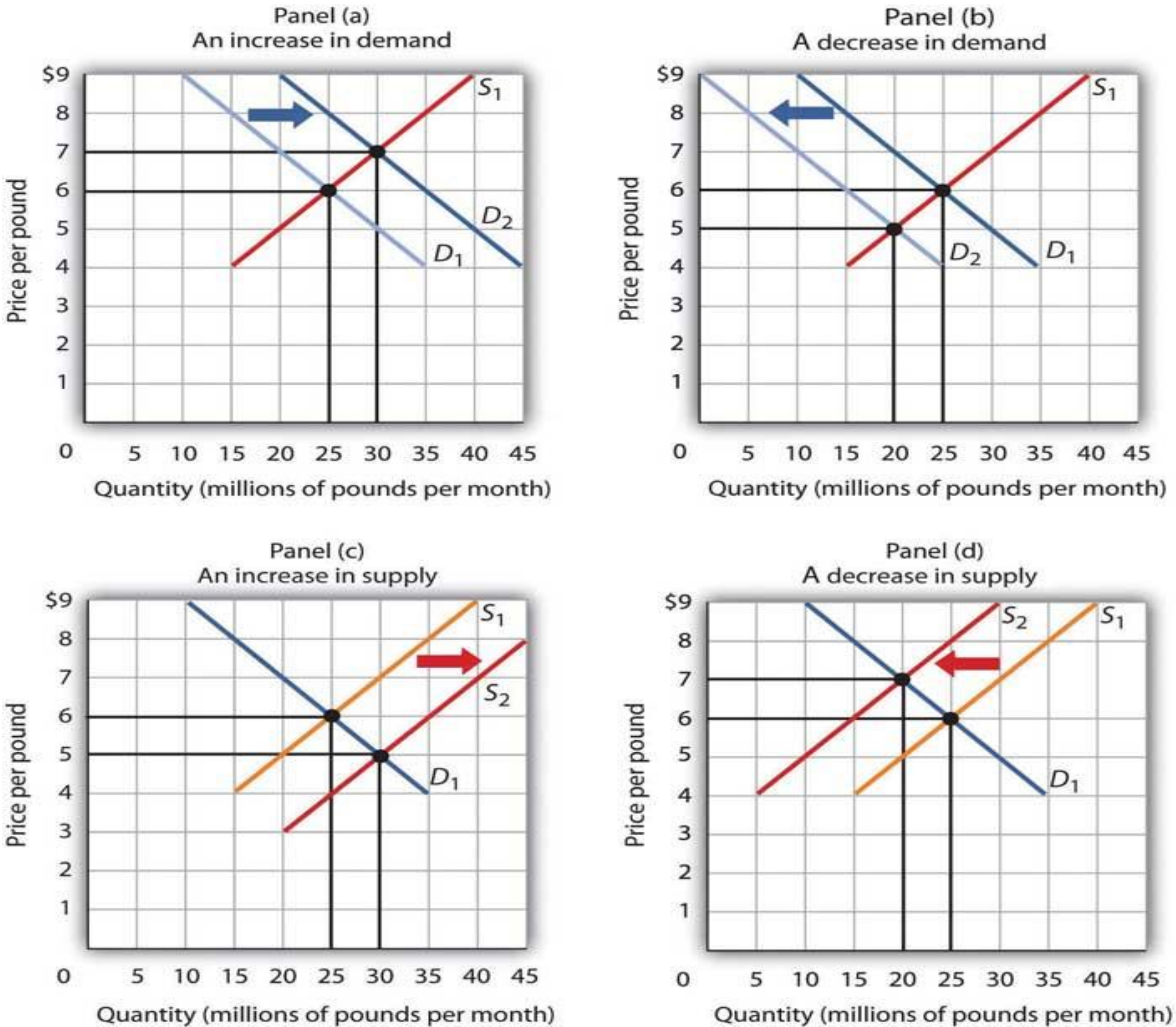
Effect of a shift in the demand curve



Movement to a new equilibrium

- Shift in one curve means movement along the other
- New intersection is the new equilibrium
- Changes in more than one determinant means BOTH curves can shift
- If both curves move, new equilibrium is where the NEW curves meet

Movement to a new equilibrium



Discussion

- Is the following statement true?

'An increase in demand will cause an increase in price. This increase in price will cause a reduction in demand, until demand is reduced back to its original level'.

Summary

- Demand exceeds supply = shortage, leads to a rise in price
- Supply exceed demand = surplus, leads to fall in price
- Price settles at equilibrium i.e. where demand = supply
- Demand or supply curve shifts, leads to shortage or surplus – price moves to new equilibrium where supply and demand curves now intersect