Market Mechanism

IGCSE

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Price Mechanism

- Every good and service produced in markets have some price associated with them.
- Market forces of a product determine its price.

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Demand

- Demand refers to willingness and ability of consumers to purchase certain product at certain price.
- Demand curve has inverse relationship with prices. At higher prices consumers demand lesser quantities of any product and vice versa.
- Because of this inverse relationship demand curve is always downward sloping with regards to product prices.

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Supply

- Supply refers to willingness and ability of producers to produce certain product at certain price.
- Supply has direct relationship with price. At higher prices producers are willing to produce larger quantities of certain product and vice versa.
- Because of direct relationship supply curve is always upwards sloping with regards to product price.

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Market Equilibrium

- Market equilibrium is a situation where demand for a good is equal to its supply.
- This is where market demand curve intersects with market supply curve.
- Changes in market demand and / or market supply causes change in market equilibrium.

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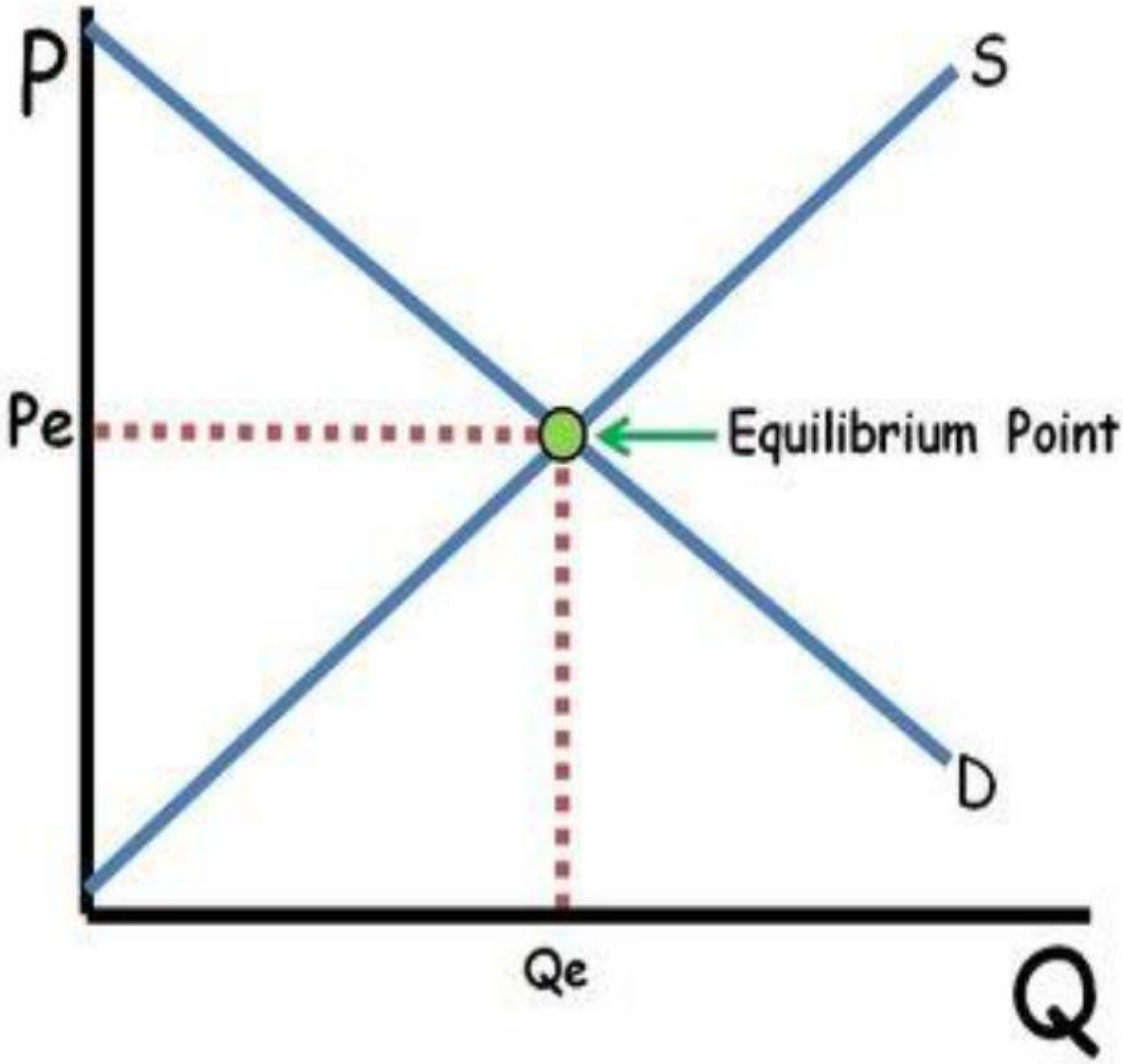
Market Equilibrium



Extension and Contraction in Demand

- Price is one of the many factors that affect demand for a good / service.
- There are many other factors that affect demand.
- Economists differentiate between changes in demand arising because of price and non-price factors.
- Changes in demand that arise because of price changes are referred to as Extension or Contraction in demand.
- Price falls cause extension in quantity demanded. Price increase cause contraction in quantity demanded.

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Movement along the Demand Curve

Movement along a demand curve occurs when there's a change in relevant variable measured on either axis

Increase in Qty demanded of goods due to decrease in price of that good is termed as Extension of Demand

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Shifts in Demand Curve

- Non price factors that affect demand cause demand curve to shift rightwards or leftwards.
- Increase or decrease in demand is shown as rightward or leftward shift of demand curve respectively.
- Increase in population will cause demand curve to shift rightwards.
- Increase in price of substitutes will cause demand curve to shift rightwards and vice versa.
- Increase in price of complementary goods will cause demand curve to shift leftwards and vice versa.

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Shifts in Demand Curve

- Higher the consumers' income, higher the demand for products and vice versa.
- Higher the taxes, lower the demand and vice versa.

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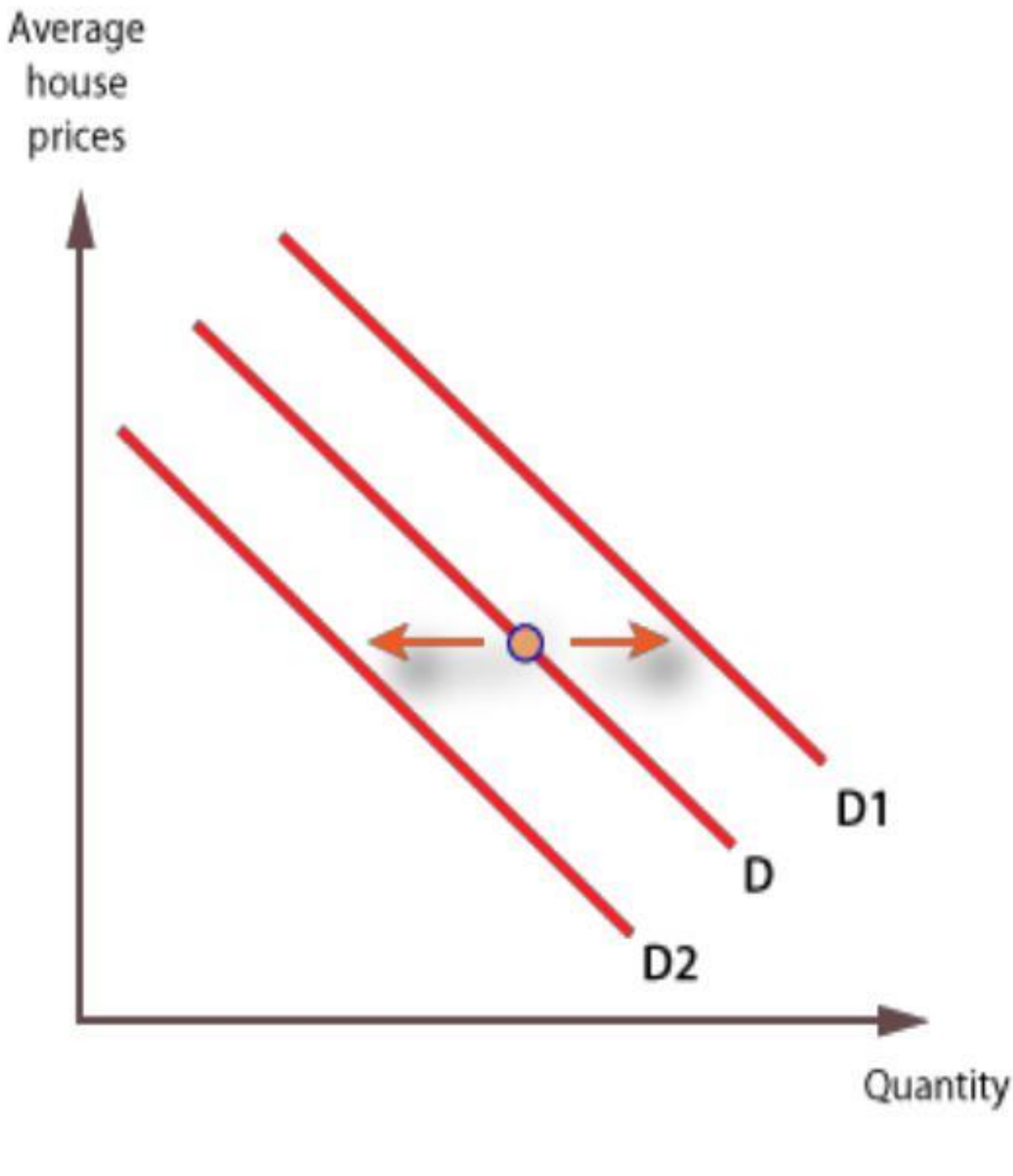
Shifts in Demand Curve



Extension and Contraction in Supply Curve

- Price changes cause supply curve to Extend or Contract.
- Increase in prices cause Extension in supply curve and decrease in prices cause Contraction in supply curve.
- These changes are shown through movement along the supply curve.

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Movement along the Supply Curve

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Shifts in Supply Curve

- Just like Demand Curve that shifts right and leftwards due to changes in non-price factors, Supply Curve also shifts right and leftwards due to changes in non-price factors.
- Decrease in cost of production cause supply curve to rightwards and vice versa.
- Technological advancements that decrease cost of production and / or ease production process also cause supply curve to shift rightwards.

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Shifts in Supply Curve

- Indirect taxes ad Subsidies affect market supply curve.
- Imposition of indirect taxes cause supply curve to shift leftwards.
- Provision of subsidies cause market supply curve to shift rightwards.
- Subsidies are financial payments made to producers for producing certain products.

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Shifts in Supply Curve

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Price Elasticity of Demand

- Price Elasticity of Demand is quantitative measure of responsiveness of quantity demanded following change in product price.
- Values of PED are classified as More and Less Elastic.
- Products with More Elastic demand depict greater change in quantity demanded following change in product price and vice versa.

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Factors affecting PED

- Necessity versus Luxury: Necessities have Less Elastic Demand as compared to products that are considered as luxurious items.

- Availability of Substitutes: If more substitutes are available for a certain product then it is expected to have More Elastic Demand and vice versa. This is because for given increase in price, consumers' demand will decrease more knowing that they have more substitutes available.

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Factors affecting PED

- Proportion of Income spent:
  Goods on which consumers spend larger proportion of their income are expected to have More Elastic Demand and vice versa.

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Formula of PED

$$\text{PED} = \frac{\text{Percentage change in quantity demanded}}{\text{Percentage change in Price}}$$

$$\text{PED} = \frac{Q2-Q1}{Q1} \times \frac{P1}{P2-P1}$$

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Price Elasticity of Supply

- Price Elasticity of Supply (PES) is quantitative measure that calculates responsiveness of quantity supplied following changes in product price.
- Products for which supply is more responsive to changes in prices are known to have More Elastic Supply and vice versa.

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Price Elasticity of Supply

- A formula that captures the extent of change in quantity supplied of a product due to given change in product price.

Price Elasticity of Supply = $\dfrac{\text{\% Change in Qty Supplied}}{\text{\& Change in Price}}$

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Factors Affecting PES

- Availability of Raw Material: Greater availability of raw material makes a good's / service's PES More Elastic and vice versa. Similarly if any good can be easily stocked it is expected to have More Elastic supply and vice versa.

- Number of Firms: Products that are produced by greater number of firms are expected to have More Elastic Supply and vice versa.

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Factors Affecting PES

- Complexity of Production Process: Goods with simpler production process and readily available raw materials have More Elastic Supply and vice versa.

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