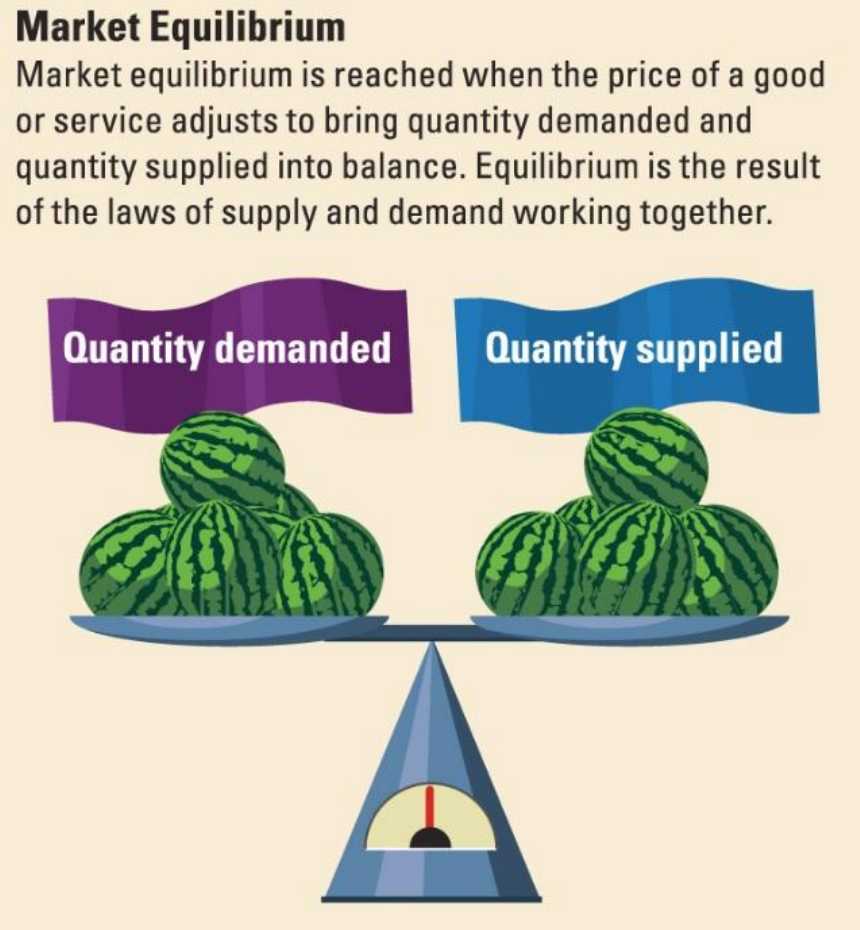
Markets, Equilibrium, and Prices

Tuesday 3/20

Market Equilibrium

In a market where consumers and producers are completely free to buy and sell goods and services, demand and supply work together to determine prices.

At market equilibrium, the quantity of a good or service that consumers are willing and able to buy equals the quantity that producers are willing and able to sell. Both consumers and producers are satisfied.



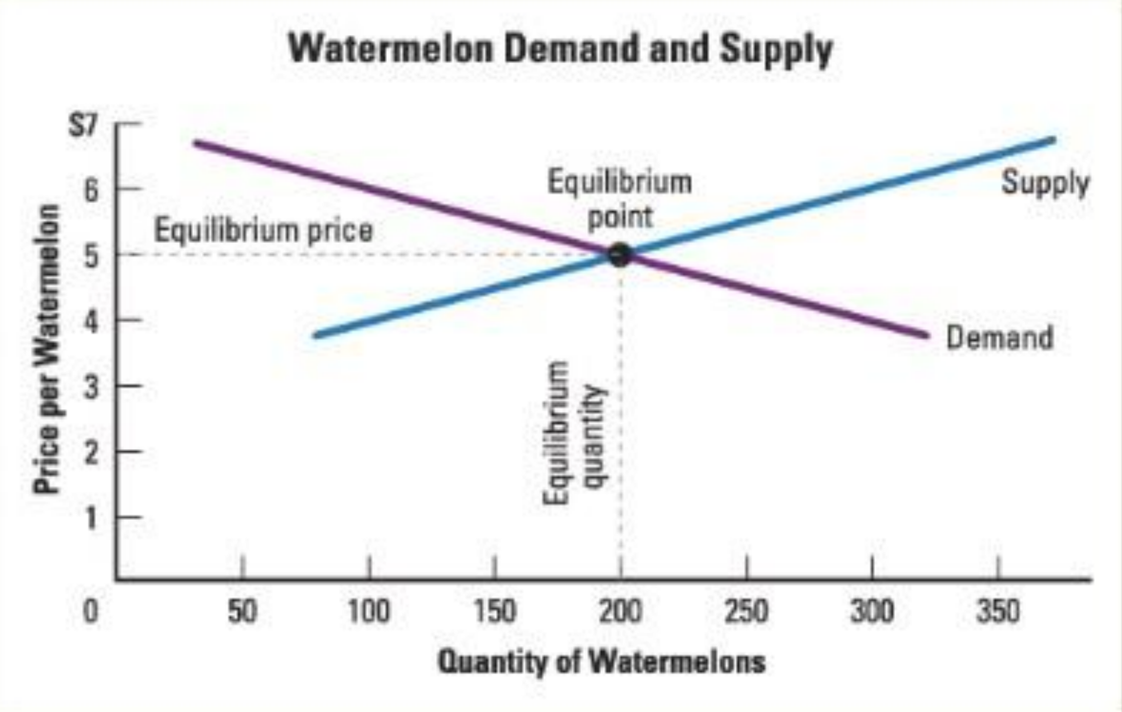
Reaching Market Equilibrium

A market reaches equilibrium when the quantity demanded by consumers equals the quantity supplied by producers. On the graph, equilibrium is found at the point where the demand and supply curves intersect.

- What is the equilibrium price at this point?
- What is the equilibrium quantity?

Watermelon Demand and Supply Schedule

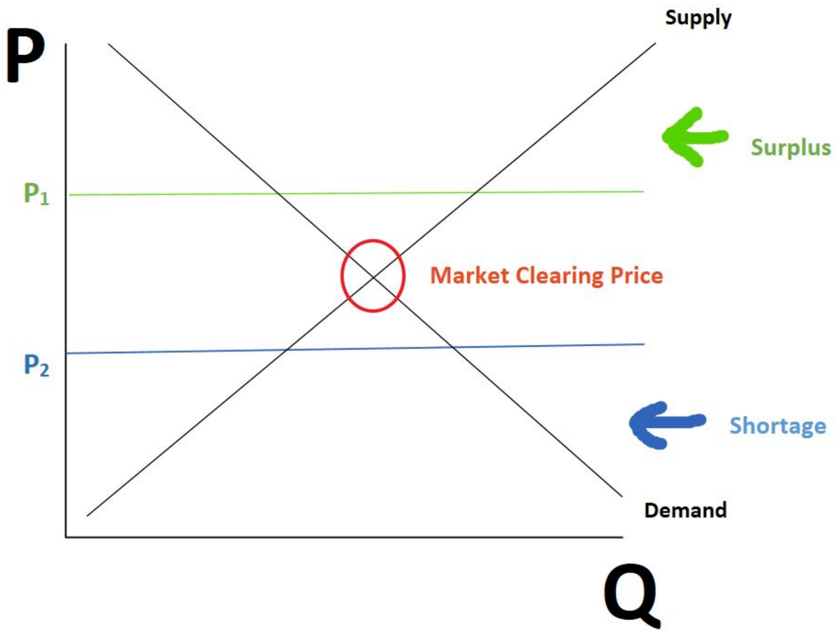
Price	Quantity Demanded	Quantity Supplied
$4.00	300	100
4.50	250	150
5.00	200	200
5.50	150	250
6.00	100	300
6.50	50	350



Market Equilibrium

The equilibrium price is also known as the market-clearing price because at this price, the market will be “cleared” of all surpluses and shortages.

- No consumers will leave the market empty-handed.
- No producers will leave the market with leftover inventory.



Market Equilibrium

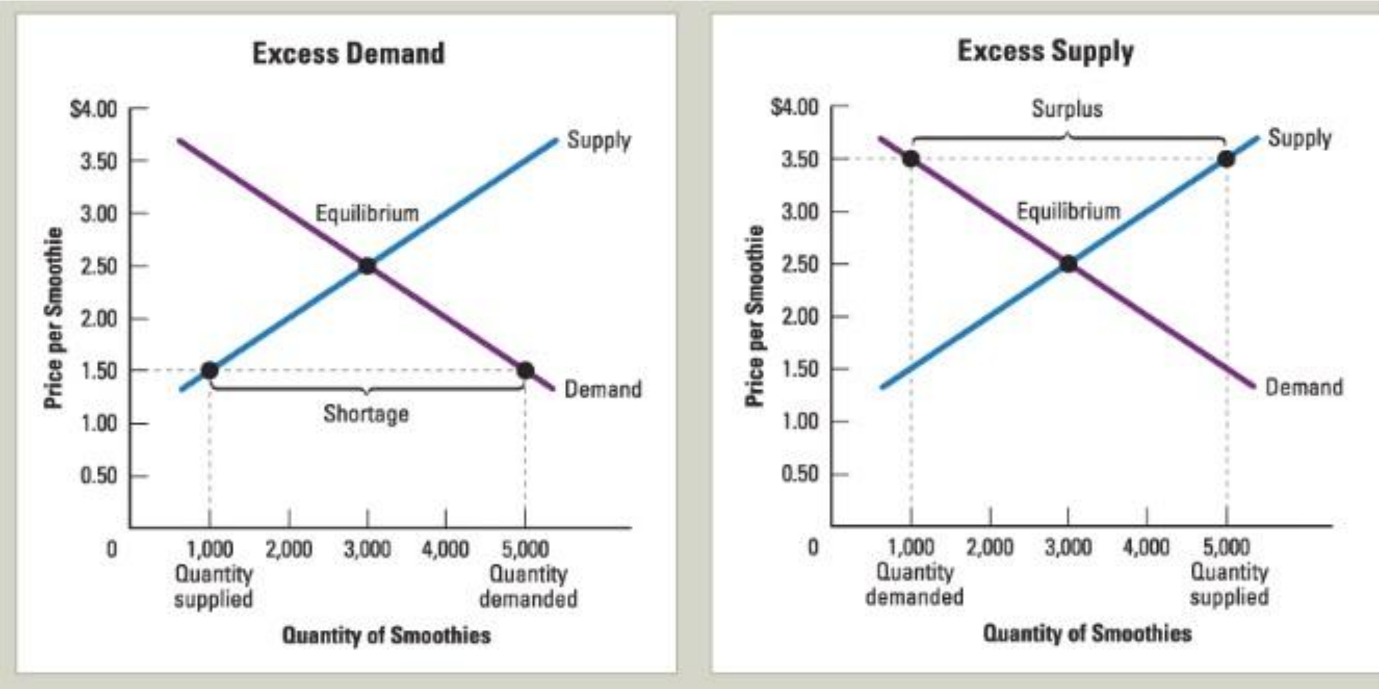
Economist Alfred Marshall compared supply and demand to the blades of a pair of scissors.

It would be impossible to determine whether it is the top blade or the bottom blade that cuts through a piece of paper. The two blades operate in unison.

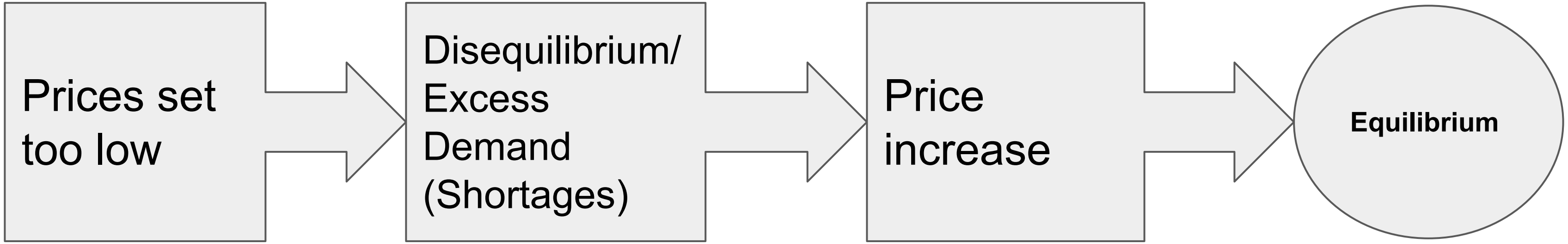
In the same way, the laws of supply and demand operate together to arrive at equilibrium.

Disequilibrium

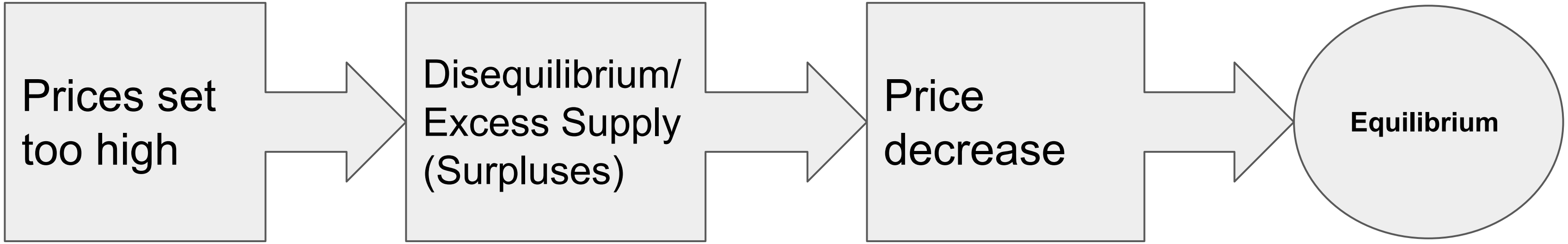
Sometimes producers set a market price that is above or below equilibrium. The result is a shortage or a surplus.



Flowchart of Excess Demand



Flowchart of Excess Supply



Disequilibrium

In a free market, surpluses and shortages are usually temporary. When a market is in disequilibrium, the actions of many producers and consumers serve to move the market price towards equilibrium. How long it takes to restore the equilibrium price varies from market to market.

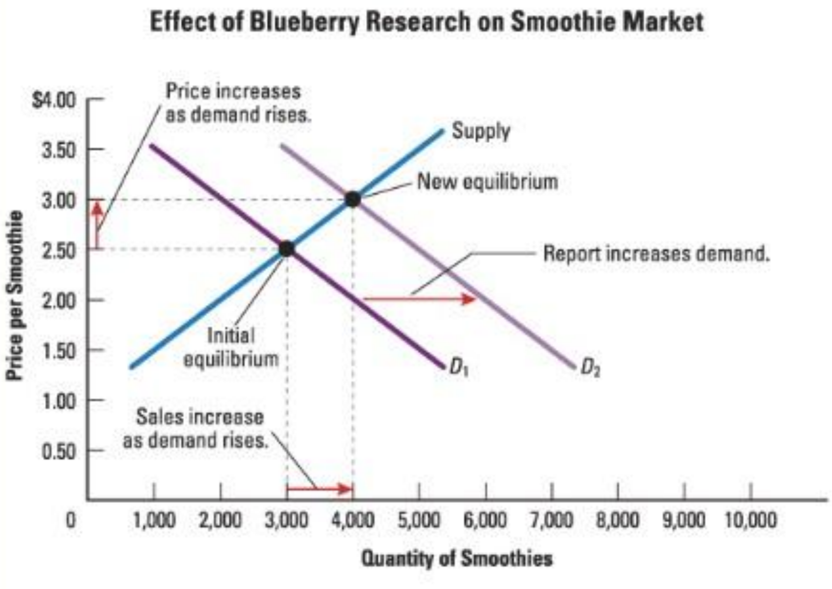
Shifts in Demand or Supply

So far we have looked at shortages and surpluses that were caused by changes in price. In these cases, equilibrium was restored by adjusting prices.

If the market experiences a change in demand or supply, the curve of either demand or supply would shift and create a new equilibrium.

Questions to Consider

1. Does the event affect demand, supply, or both?
2. Does the event shift the demand or supply curve to the right (increasing) or to the left (decreasing)?
3. What are the new equilibrium price and quantity, and how have they changed as a result of the event?



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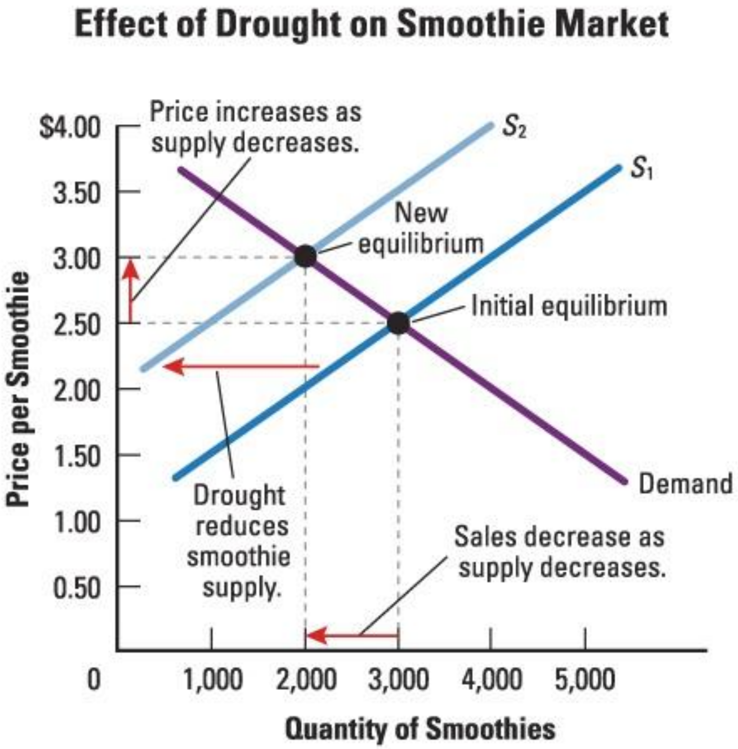
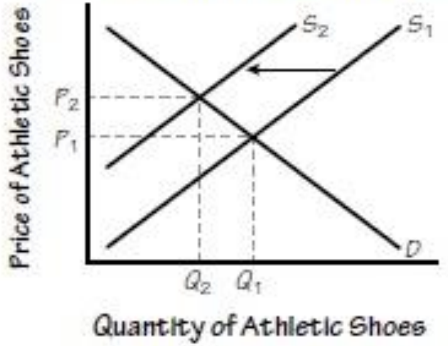


PRACTICE

Analyze the effects of each new headline about the athletic shoe market.

1. Label the graph appropriately.
2. Explain the effect of the event on the demand or supply curve for athletic shoes.
3. Graph the resulting change in equilibrium price and equilibrium quantity.

1 Price of Rubber Increases Dramatically



Because of an increase in the cost of inputs, the supply curve will decrease, or shift to the left. Equilibrium price increases. Equilibrium quantity decreases.

Guided Reading Notes

Complete the chart summarizing the four roles prices play in a modern mixed economy.

Also, use the chart provided to explain the roles of demand and supply in changing gasoline prices after Hurricanes Katrina and Rita.

Government Intervention in Markets

Price controls are government-imposed limits on the prices that producers may charge in the market.

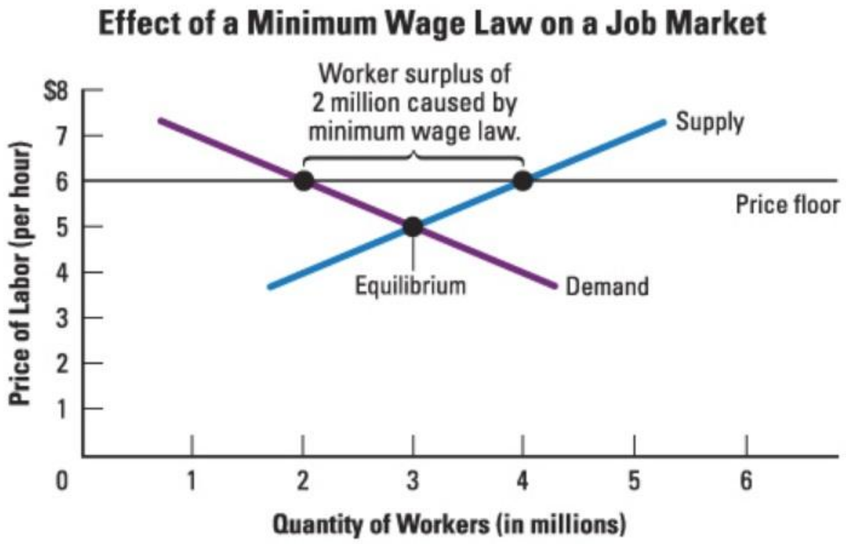
Governments usually impose price controls when they are persuaded that supply and demand will result in prices that are unfairly high for consumers or unfairly low for producers.

Price Floors

A minimum price consumers are required to pay for a good or service. Price floors are meant to push prices up, ensuring that producers receive a benefit for providing a good or service.

Examples include agricultural products and minimum wage for workers.

While price floors may benefit some people, the larger effect of a price floor is excessive supply.

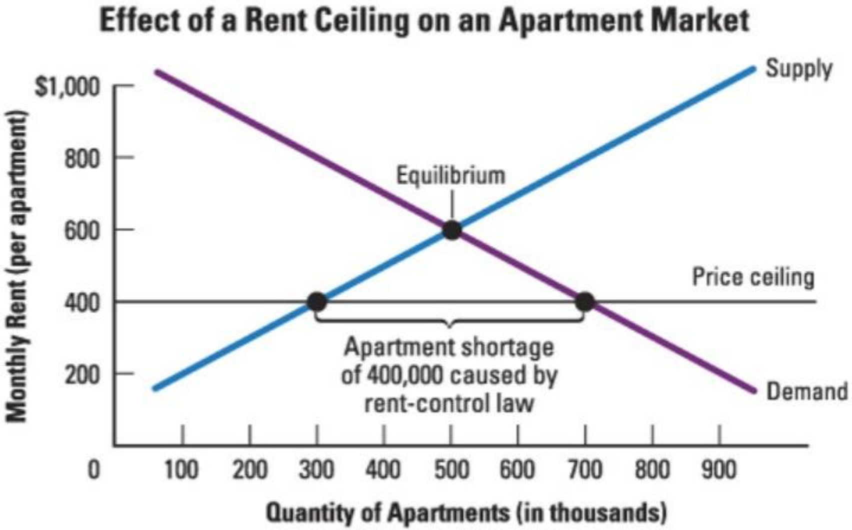


Price Ceilings

A maximum price consumers may be required to pay for a good or service.

Government impose price ceilings to enable consumers to buy essential goods or services they wouldn’t be able to afford at equilibrium price.

Usually established in response to a crisis. Rent control is another example. It was introduced in NYC during WWII to protect poor families. Landlords look for other ways to use their properties instead.



Rationing

Controlled distribution of a limited supply of a good or service.

Examples: 1973 oil crisis, WWII, limiting how much farmers are allowed to grow, giving surplus crops to developing countries as foreign aid

Black Market

An illegal market in which goods are traded at prices or in quantities higher than those set by law.

Effects of Price Controls

Most economists argue against price controls but the issue tends to be more political than economic.