

Edexcel Economics AS-level

Unit 1: Markets in Action



Topic 4: Price Determination


4.3 Functions of the price mechanism

Notes



Functions

-  The price mechanism determines the market price. Adam Smith called this ‘the invisible hand of the market’.
-  Resources are allocated through the price mechanism in a free market economy. The economic problem of scarce resources is solved through this mechanism. The price moves resources to where they are demanded or where there is a shortage, and removes resources from where there is a surplus.

 The price mechanism uses three main functions to allocate resources:

- **Rationing**

When there are scarce resources, price increases due to the excess of demand. The increase in price discourages demand and consequently **ration**s resources. For example, plane tickets might rise as seats are sold, because spaces are running out. This is a disincentive to some consumers to purchase the tickets, which rations the tickets.

- **Incentive**

This encourages a change in behaviour of a consumer or producer. For example, a high price would encourage firms to supply more to the market, because it is more profitable to do so.



- **Signalling**

The price acts as a signal to consumers and new firms entering the market. The price changes show where resources are needed in the market. A high price **signals** firms to enter the market because it is profitable. However, this encourages consumers to reduce demand and therefore leave the market. This shifts the demand and supply curves.

The price mechanism in the context of mass and niche markets

-  A mass market is the largest group of consumers for a product, such as restaurants.



-  A niche market is a smaller market, where a specific product is focused on. For example, it might be a particular cuisine, such as Italian.
-  The price mechanism can allocate resources to where they are needed and wanted. A niche market is generally better at allocating resources to where consumers want, since niche markets are closer to the consumer. It could be argued that it is more profitable to be in a niche market, since the consumers are targeted directly, rather than generally. This makes the allocation of resources more efficient.

