# CIE Economics AS-level

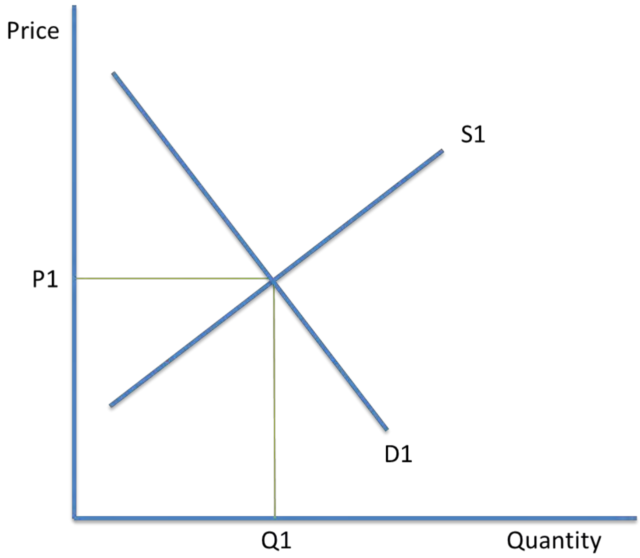
## Topic 2: Price System and the Microeconomy

### d) Interaction of demand and supply
### e) Market equilibrium and disequilibrium

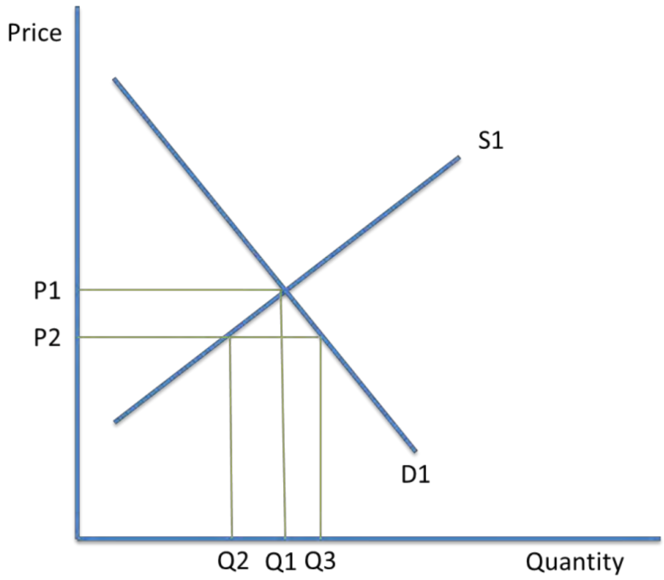
Notes

## Equilibrium price and quantity

- This is when supply meets demand. On the diagram, this is shown by P1 and Q1.
- At market equilibrium, price has no tendency to change, and it is known as the **market clearing price.**




## Excess demand

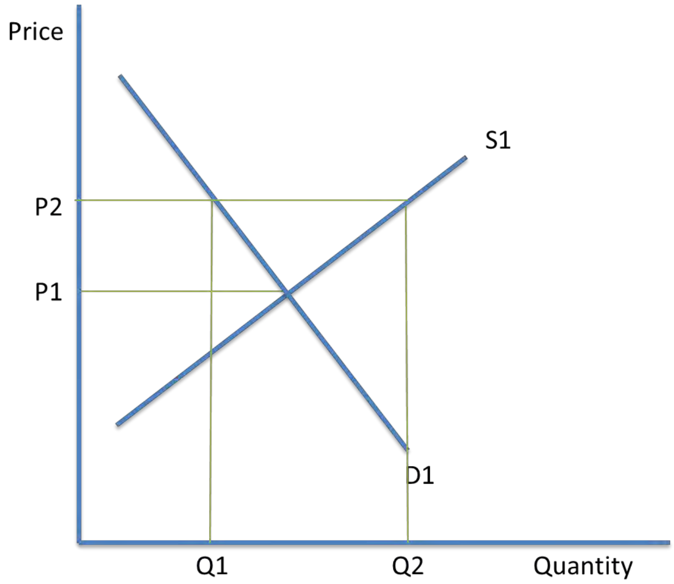



- At Q2, price is at P2 which is below market equilibrium. Demand is now greater than supply, which can be calculated by Q3-Q2. This is a state of **disequilibrium.** The demand price does not equal the supply price, and the quantity demanded does not equal the quantity supplied.

- This is a **shortage** in the market. This pushes prices up and causes firms to supply more. Since prices increase, demand will contract.
- Once supply meets demand again, price will reach the market clearing price, P1.

## Excess supply

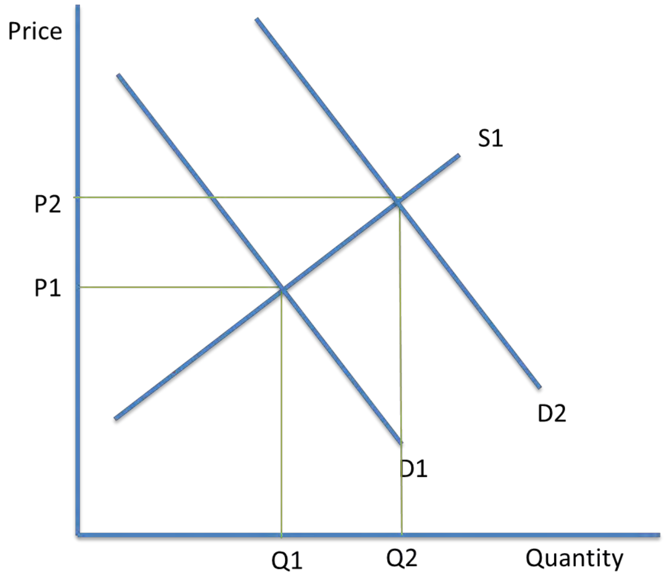
- This is when price is above P1.




- Supply is now at Q2 and demand is at Q1. There is a **surplus** of Q2- Q1. Price will fall back to P1 as firms lower their prices and try to sell their goods. The market will clear and return to equilibrium.

## New market equilibriums

When the demand or supply curves shift due to the PIRATES or PINTSWC reasons, new market equilibriums are established.




For example, if there was an increase in the size of the population, demand would shift from D1 to D2.

Price would increase to P2 and suppliers would supply a larger quantity of Q2. A new market equilibrium is established at P2 Q2.

## Joint demand and alternative demand

**Joint demand:** This is when goods are bought together, such as a digital camera and a memory card. An increase in demand for digital cameras is likely to lead to an increase in demand for memory cards. These are **complements.**

**Alternative demand:** This is when one good is demanded in place of another good. These are **substitutes.** Demanding substitute goods, such as Samsung TVs over Panasonic TVs, would reduce the quantity supplied of Panasonic TVs and also reduce their price.

## Joint supply

**Joint supply:** This is when increasing the supply of one good causes an increase or decrease in the supply of another good. For example, producing more lamb will increase the supply of wool.

# Price Mechanism

## 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 **rations** 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.
  - **Transmission of preferences**
    Consumers can give producers information about what they want by making choices. A high price encourages firms to increase output, because they can make more profit. A low demand, such as in economic decline, means firms produce less.
  - **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.