

Edexcel (B) Economics A-level
**Theme 1: Markets, Consumers and
Firms**

1.3 Introducing the Market

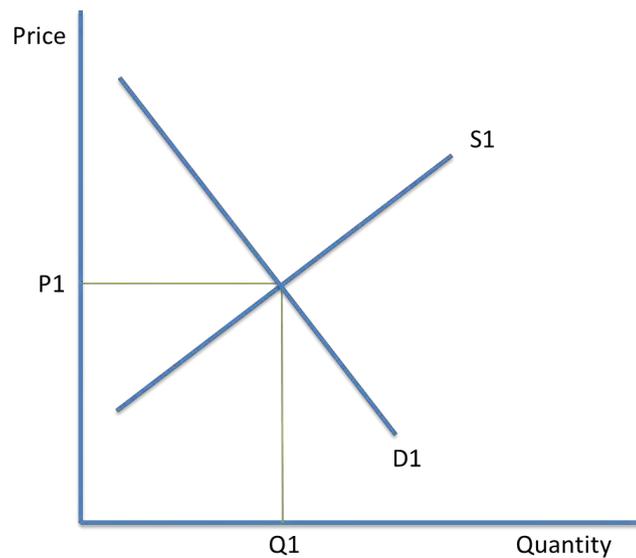
1.3.3 Price determination

Notes



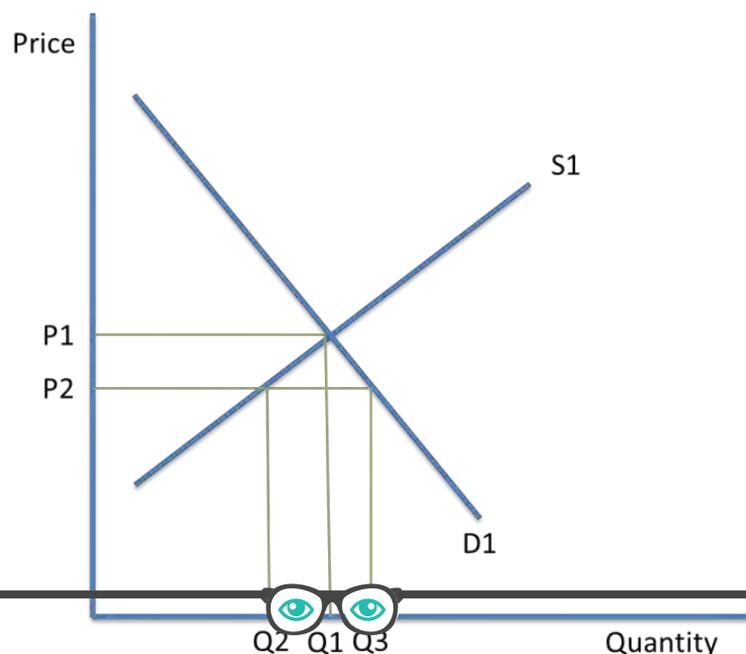
Equilibrium price and quantity and how they are determined

-  This is when supply meets demand. On the diagram, this is shown by P_1 and Q_1 .
-  At market equilibrium, price has no tendency to change, and it is known as the **market clearing price**.



The use of supply and demand diagrams to depict excess supply and excess demand

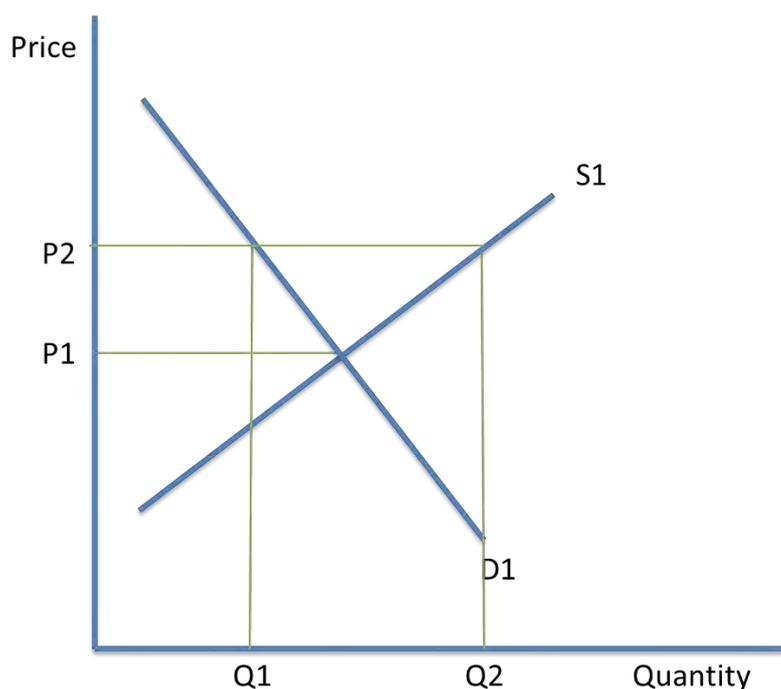
Excess demand



- At Q_2 , price is at P_2 which is below market equilibrium. Demand is now greater than supply, which can be calculated by $Q_3 - Q_2$.
- 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, P_1 .

Excess supply

- This is when price is above P_1 .

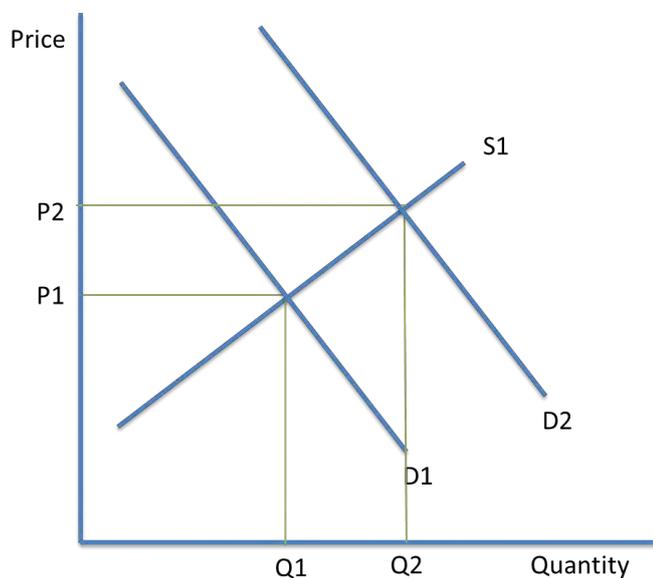


- Supply is now at Q_2 and demand is at Q_1 . There is a **surplus** of $Q_2 - Q_1$. Price will fall back to P_1 as firms lower their prices and try to sell their goods. The market will clear and return to equilibrium.



New market equilibriums

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

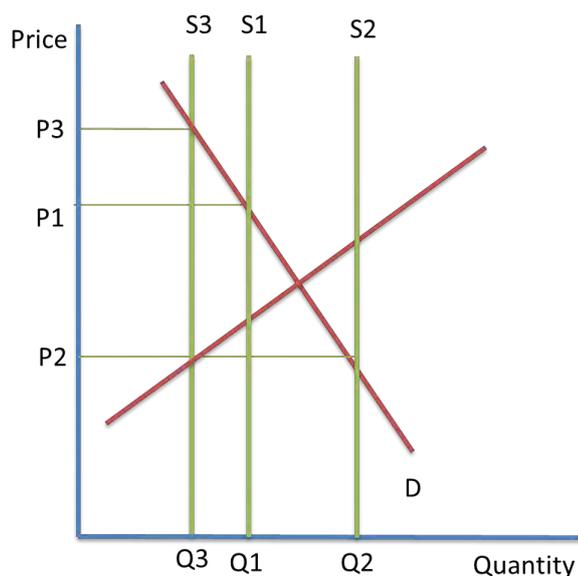


-  For example, if there was an increase in the size of the population, demand would shift from D1 to D2.
-  Price would increase to P2 and suppliers would supply a larger quantity of Q2. A new market equilibrium is established at P2 Q2.

How shifts in demand and supply curves cause the equilibrium price and quantity to change in real-world situations:

-  Commodity prices are usually unstable, especially in the short run. For example, food producers face unstable prices.
-  Incomes have fallen because the supply of food has increased. This is due to better technology which has increased the yield of crops, the entrance of new countries into the market and the increased buying power of supermarkets, which means they can choose how much they pay farmers.
-  The changes in supply affect the price of commodities. The supply changes due to weather patterns and growing conditions.
-  This can be explained using a cobweb diagram:





- 📖 In the short run, supply is at Q1. It ends up less than expected at the equilibrium point. This pushes the price up to P1.
- 📖 The following year, farmers plan the output to be Q2. But, now prices have fallen to P2.
- 📖 This continues until producers are forced to leave the market.
- 📖 It is largely caused by information failure. Farmers are not aware how their decisions affect next year's prices.
- 📖 An increase in supply can also cause a 'cobweb' to form.

📖 **The usefulness of supply and demand in analysing the markets of commodities, housing and transport:**

- 📖 Demand for agricultural produce tends to be stable in the long run, because the largest markets of the US and Europe tend to have stable populations.
- 📖 Since food is a necessity, demand is price inelastic, so it is not very responsive to changes in price.
- 📖 Supply tends to be unstable. This is largely due to:
 - poor technology on individual farms
 - the geographical distance between farms which makes it difficult to coordinate them
 - supply side shocks which destroy output, such as droughts
 - the price elastic nature of the supply in the long run, which encourages producers to enter the market when the price is high
 - imperfect information, linked to the cobweb theory



- 📄 In the housing market, house prices are important because they make up most of consumer wealth in the UK.
- 📄 This means that changes in house prices can significantly affect the rest of the UK.
- 📄 This is through the wealth effect and changes in interest rates.
- 📄 If house prices increase, due to the **wealth effect**, the ratio of the market value of the house to the mortgage increases, and consumers experience an increase in equity.
- 📄 This leads to a rise in consumer spending and a shift to the right of the demand curve.
- 📄 In the long run, house prices increase, but in the short run they are volatile.
- 📄 This can make using supply and demand diagrams less effective.

- 📄 In the transport market, demand varies with times (off peak and peak), and there is often a disequilibrium in the market. Demand exceeds supply during periods of congestion.
- 📄 The demand and supply of transport is affected by other markets, too. For example, the price of petrol, the price of train tickets, substitutes and the time of the journey all impact the mode of transport chosen.

📄 **The usefulness and limitations of supply and demand in explaining real world problems:**

- 📄 The models of supply and demand can only show certain markets.
- 📄 The demand curve assumes that as price goes down, consumers demand more. In reality, this is not the case.
- 📄 Similarly, the supply curve assumes as price increase, suppliers produce more.
- 📄 It also assumes there is perfect information in the market.
- 📄 There are limitations to the model. In real life, consumers and producers do not have perfect information, and they do not always act rationally, like the model suggests.
- 📄 However, the model is useful for competitive markets, where there are many buyers and sellers.

