3 THE PRICE MECHANISM AS A MEANS OF ALLOCATING RESOURCES

In this section we consider the allocation of resources in competitive markets.

We start with the **basic theory of demand and supply** in different markets and analyse how the forces of demand and supply interact to determine equilibrium prices and quantity.

3.1 The Price Mechanism

The **price mechanism** sends prices up when there is **excess demand** and own when there is **excess supply**. The price mechanism relies on the billions of decisions made by independent agents - consumers and producers; it is for example the means by which hotels reduce the prices of rooms that they cannot sell, where travel companies increase the price of package holidays when there is a high demand for their holidays and in which airlines slash prices in the wake of the events of the 11th of September when the market demand for transatlantic travel collapsed in the wake of the terrorist attacks on the United States.

It is usually assumed that one price eventually settles in each market until there is a change in either or both demand and supply conditions.

In a market economy, the **price mechanism** performs a number of very important functions.

3.2 Functions of the Price Mechanism

The **price mechanism** is the means by which decisions of consumers and businesses interact to determine the allocation of resources between different goods and services.

3.2.1 The Signaling Function

Firstly prices have a **signaling function** – if prices are rising because of stronger demand from consumers, this is a signal to suppliers to expand output to meet the higher demand.

In this sense **consumer** preferences send information to producers about the changing nature of our needs and wants. When demand is strong, higher market prices act as an **incentive** to raise output (production) because the supplier stands to make a **higher profit**.

Consider the decisions taken by consumers about which gaming console to use. Our stated preferences expressed in the market between Sony PlayStation II, Microsoft's Xbox and Nintendo's GameCube can ultimately have a huge effect on which console comes out as a leader in the market.

Suppliers do not always respond instantaneously to a change in the level of demand. We shall see later in the study companion that the elasticity of supply is an important concept in determining whether a producer can actually meet an increase in consumer demand. Producers may also wait until they regard demand to be at a sufficiently high level for them to be able to make a profit.

3.2.2 The Rationing Function

Prices serve also to **ration** scarce resources when demand in a market outstrips supply. When there is a shortage of a product, the price is bid up – leaving only those with a **willingness** and **ability to buy** with the effective demand necessary to purchase the product. Be it the demand for cup final tickets or the demand for a rare antique the market price acts a rationing device to equate demand with supply.

The growing popularity of **auctions** as a means of allocating resources is worth considering as a means of allocating resources and clearing a market.

Rationing by other means might be regarded as inefficient. Consumers with the highest income stand to have most influence on what is eventually produced. This can cause difficulties when there is a high degree of inequality in the distribution of income and wealth.

3.2.3 Adam Smith and the Invisible Hand

The 18th Century economist **Adam Smith** – one of the founding fathers of modern economics, described how the invisible or **hidden hand of the market** operated in a competitive market through the **pursuit of self-interest** to allocate resources in society's best interest.

This remains the central view of all free-market economists, i.e. those who believe in the virtues of a free-market economy with minimal government intervention.

The price mechanism is the only allocative mechanism solving the economic problem in a free market

economy. However, most modern economies are **mixed economies**, comprising not only a market sector, but also a non-market sector, where the government uses the planning mechanism to provide goods and services such as police, roads and health.

3.3 Examples of Important Markets

- International Commodity Markets such as the market for coffee, oil and copper
- Foreign Exchange Market - the buying and selling of currencies
- Housing Market - a really important market in determining people's wealth.
- Stock Market – e.g. the FTSE 100 index

3.4 Relative Prices

A **relative price** is the ratio of one price to another.

For example business and leisure travelers might compare the relative price of different modes of transport.

Consider the price of an airline ticket from Newcastle to London Heathrow on a scheduled British Airways flight, compared to the cost of a coach journey using National Express. The price of the airline ticket divided by the coach ticket gives the relative price. It measures how many coach journeys have to be given up to purchase one airline ticket. If rail prices rise, other things remaining equal the relative price of travelling by air will have fallen. This will affect the market demand for flights from Newcastle to Heathrow.

Of course, the price of the ticket is not the only consideration that people will make before choosing their mode of transport – but relative price (or cost) levels will influence their decision.

Recent years has seen the expansion of low cost airlines serving both domestic routes and short haul flights to European destination. As a result, the market demand for short haul flights and European City Breaks has increased in size enormously.

Price wars in markets cause changes in relative prices and will normally lead to **expenditure-switching** by consumers as suppliers engage in a battle for market share.