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MOVEMENT TO EQUILIBRIUM

How does the market reach the equilibrium price, to bring the market into balance, if a shortage or surplus exists?

If the price is initially set above equilibrium, then quantity supplied will be greater than quantity demanded creating a **surplus** in the market. For example, if the price was set at $20, quantity demanded would be 500 but the quantity supplied would be 1500 creating a surplus of 1000 CDs.

Suppliers will notice that they are not selling all of the CDs they have supplied at existing prices. They may offer the CDs at a discounted price which encourages new buyers to enter the market (demand will expand). At the same time the suppliers will no longer find the production and supply of CDs to be as profitable, so they may supply less CDs and/or leave the CD market (a contraction in supply). Therefore, this will continue until the market converges and meets at the equilibrium price.

If the price is initially set below the equilibrium, the quantity demanded will be greater than quantity supplied creating a **shortage** in the market. For example, if the price was set at $10 the quantity demanded would be 1500 with a quantity supplied of 500. This creates a shortage of 1000 CDs.

Some consumers in a competitive market will be willing to pay more for the CDs than the going price and will therefore try to 'outbid' competing consumers to obtain the product, causing the price to increase. As the price increases suppliers will find it more profitable to supply CDs and therefore **supply will expand**. The higher prices will reduce the number of consumers who are willing and able to purchase the product resulting in a **contraction in demand**. Prices will continue to increase until demand and supply converge and meet at the equilibrium price.

QUESTION 4 (VCAA 2015)
The effect on the market for product A of a rise in the price of a substitute product B will be:

A Shift the demand curve left and decrease the equilibrium price of product A.
B Shift the demand curve right and increase the equilibrium price of product A.
C Shift the supply curve left and increase the equilibrium price of product A.
D Shift the supply curve right and decrease the equilibrium price of product A.

QUESTION 5 (VCAA 2015)
An expansion in the quantity supplied would be shown graphically as a:

A Movement up the supply curve.
B Shift to the left of the supply curve.
C Shift to the right of the supply curve.
D Movement down the supply curve.

QUESTION 6 (VCAA 2014)
A major determinant of demand in one particular market could be the:

A Cost of raw materials.
B Method of production.
C Number of sellers in the market.
D Disposable incomes of buyers in the market.

QUESTION 7 (VCAA 2014)
The effect on the market for product A from a rise in the price of a complementary product B will:

A Shift the demand curve right and increase the equilibrium price.
B Shift the demand curve left and decrease the equilibrium price.
C Shift the supply curve left and increase the equilibrium price.
D Shift the supply curve right and decrease the equilibrium price.

QUESTION 8 (VCAA 2013)
The effect of an introduction of a carbon tax of $23 per tonne of CO2 emissions on the market for electricity that is generated from burning coal would be to:

A Shift the supply curve to the left and cause a contraction in supply.
B Shift the supply curve to the left and cause a contraction in demand.
C Shift the demand curve to the left and cause a contraction in supply.
D Shift the demand curve to the left and cause a contraction in demand.

QUESTION 9 (VCAA 2012)
Which one of the following will cause the supply curve for a good or service to increase (shift to the right)?

A An increase in government taxes.
B An increase in the level of income.
C An increase in worker productivity.
D A decrease in the price of a substitute good or service.

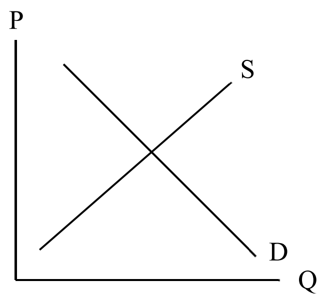
QUESTION 10 (VCAA 2016)
When resources are used to produce the goods and services that best satisfy society's needs and wants, this is known as:

A Dynamic efficiency
B Allocative Efficiency
C Intertemporal efficiency
D Productive or technical efficiency

QUESTION 11
On the curves shown below, indicate:

A The shift of the curve.
B The effect on the equilibrium price and quantity.

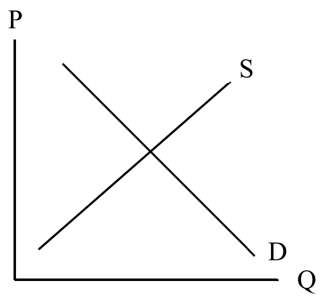
Train tickets



Petrol prices increase

Effect on: P Q

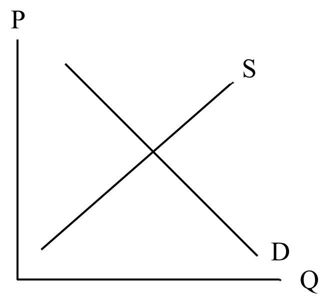
Tomato Sauce



Pies increase in price

P Q

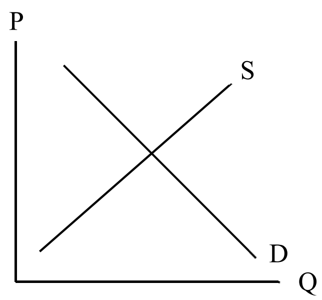
iPods



The tax free threshold is increased to $8,000

P Q

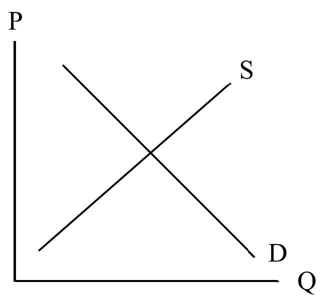
Apples



A shortage of bananas

Effect on: P Q

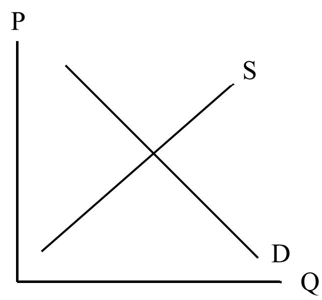
Haircuts



Increase wages for hairdressers

P Q

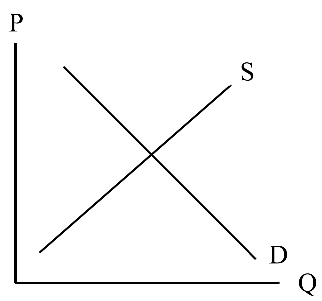
Motorscooters



An increase in petrol prices

P Q

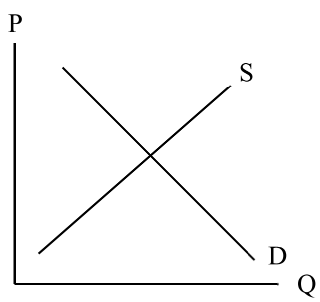
Leather



The increased popularity of steak

Effect on: P Q

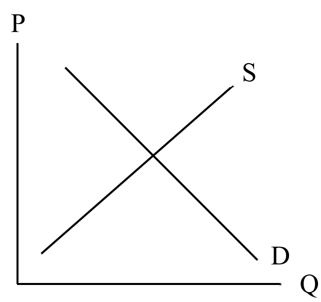
Private health cover



An increase in average weekly earnings

P Q

Electricity



Water shortages

P Q

THE STRUCTURE OF RELATIVE PRICES

The price for a product in a competitive market is determined by the interaction of supply and demand. Markets for different goods and services are inter-related and price movements in one market may affect several others (which may not initially appear as an obvious consequence).

For example, a product may be used as a raw material in the production of another product. This is will increase the cost of production for the supplier who may increase the price of his/her product (depending on price elasticity).

Exam Tip

The concept of price changes or relative prices has appeared on exam papers in recent years.

A change in ‘relative prices’ means that the price of a good increases or decreases relative to another good.

There are obviously many markets each with a set of prices. Relative prices of goods and services exist and act as signals to both consumers and producers. When the price of a good or service increases this may be the result of increased demand and/or decreased supply. If the change in price is a result of increased demand, then this will indicate to suppliers that there is greater profitability in the product.

New producers may be enticed to enter the market and in doing so they may direct resources away from less profitable industries. The increase in supply may also mean that they require more factors of production so labour resources may be enticed from other areas. In order to entice the extra labour higher wages may need to be offered.

The structure of relative prices therefore affects Resource Allocation.

QUESTION 12

In a competitive market economy, explain how the market (price) mechanism allocates resources.

QUESTION 13 (VCAA 2014)
Explain how a change in relative prices might result in a reallocation of resources.

QUESTION 14 (VCAA 2013)
Explain what is meant by an efficient allocation of resources.

QUESTION 15 (VCAA 2011)
With reference to the price mechanism, describe how resources are allocated in a competitive market.

ELASTICITY

Elasticity is a measure of the responsiveness of changes in one variable (quantity) to changes in another variable. An important part of consumer and producer behaviour relates to price elasticity of demand and price elasticity of supply. That is, the percentage change in demand or supply in response to a certain percentage change in price.

PRICE ELASTICITY OF DEMAND

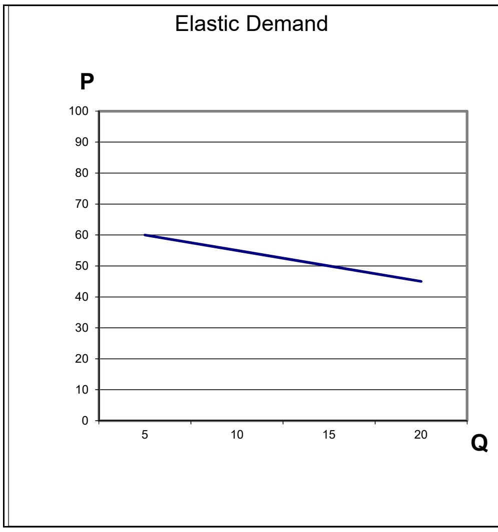
Measures the responsiveness of quantity demanded (as a percentage) to changes in price (as a percentage).

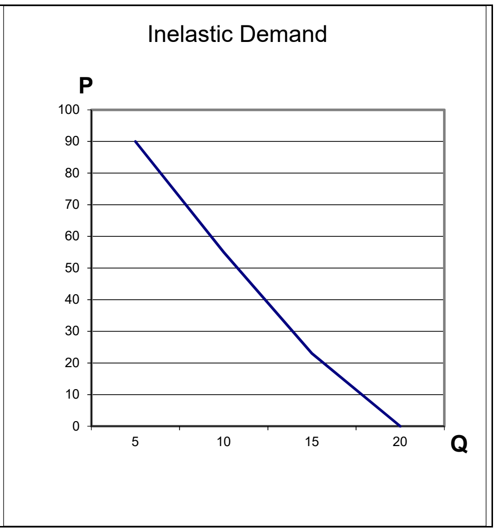
i.e. When price increases, to what extent do consumers reduce their demand?

- If demand is ***relatively elastic***, the demand for a product changes more than proportionally with a change in price, e.g. A 10% fall in price results in a 20% rise in quantity demanded. Products with elastic demand have a 'flat' demand curve.

- If demand is **relatively inelastic**, the quantity demanded changes less than proportionally with a change in price, e.g. A 10% fall in price results in a 5% rise in quantity demanded. Products with inelastic demand have a 'steep' demand curve.

- If demand is of **unit elasticity**, the quantity demanded changes by the same proportion as the change in price, e.g. A 10% fall in price leads to a 10% rise in quantity demanded.





Factors affecting price elasticity of demand:

- **Availability of substitutes.**

  If a good or service has a number of viable alternatives (substitutes) and it is traded in a competitive market then price elasticity of demand will tend to be higher (more elastic). Fully informed rational consumers will want to change quickly from the more expensive good to the readily available substitute.

- **Proportion of income.**

  Demand will decrease by a relatively small percentage if the price of the good or service represents a small proportion of consumers' incomes. i.e. Demand is relatively inelastic. If the product represents a high proportion of consumer's incomes, demand is relatively elastic.

- **Degree of necessity.**

  Those goods and services which are essential will tend to be less responsive to price changes. i.e. Demand is relatively inelastic. On the other hand, demand for luxury products is more likely to be elastic.

- **Time period.**

  Demand is more elastic in the long term as time gives buyers the opportunity to find alternatives.