MFP SET

Strategic & Economic Thinking

Lecture 2:

Markets

What is a market?

- A market definition specifies the competing products (close demand or supply substitutes) & geographic area in which competition occurs that determines the price for a given product

- A space where buyers sellers meet to determine the quantities & prices at which goods or services exchange

Why market exchange?

- Because it facilitates change – markets do not require every buyer communicating exact specifications to every possible seller – it is more efficient

What are the alternatives?

- Exchange in a command or directed economy
  – Requires the central authority to have information on buyers’ preferences, suppliers’ inputs & production facilities and a matching of those

  – Informational requirements huge

Then why do firms exist?

- Firms represent a type of command economy – conscious coordination of production decisions
  – Type/characteristics of product, method of production, quantities, price
- If this is inefficient, then why do firms exist?
  – Because of transaction costs

What are the elements of a market?

- Two sides to a market
  - Buyers: they have a *demand* for a particular good or service
  - Sellers: they provide the *supply* of a particular good or service
- The two sides interact to determine the prices & quantities exchanged

Price-taking behaviour

- As a consumer, do I have any say over the price I pay??
- In most cases, no
  - I accept price as given by the seller
- In some cases, I can obtain reductions in price
- Why?

Price-taking behaviour

- As as seller, do I have any influence over price??

- Most would say “Yes, I set the price.”
- However, your ability to do this is limited by:
  - how much consumers are willing to pay
  - what other producers are charging

Price-takers

- Price takers do not have influence over price - they take it as given by the market place
- Whether or not firms or buyers are price takers depends on the number of other buyers & sellers

How are prices determined in the market?

- The process of markets moving toward equilibrium prices & quantities occurs as buyers accept or reject the quantities on offer at the prices put forward by the sellers

- When a particular price clears the market, we have a market equilibrium

What is the equilibrium mechanism?

- If demand is insufficient at existing prices, producers will lower the price to encourage greater demand

- If demand is too great at existing prices, producers will raise prices as a way to ration the existing output

What is behind the change in prices?

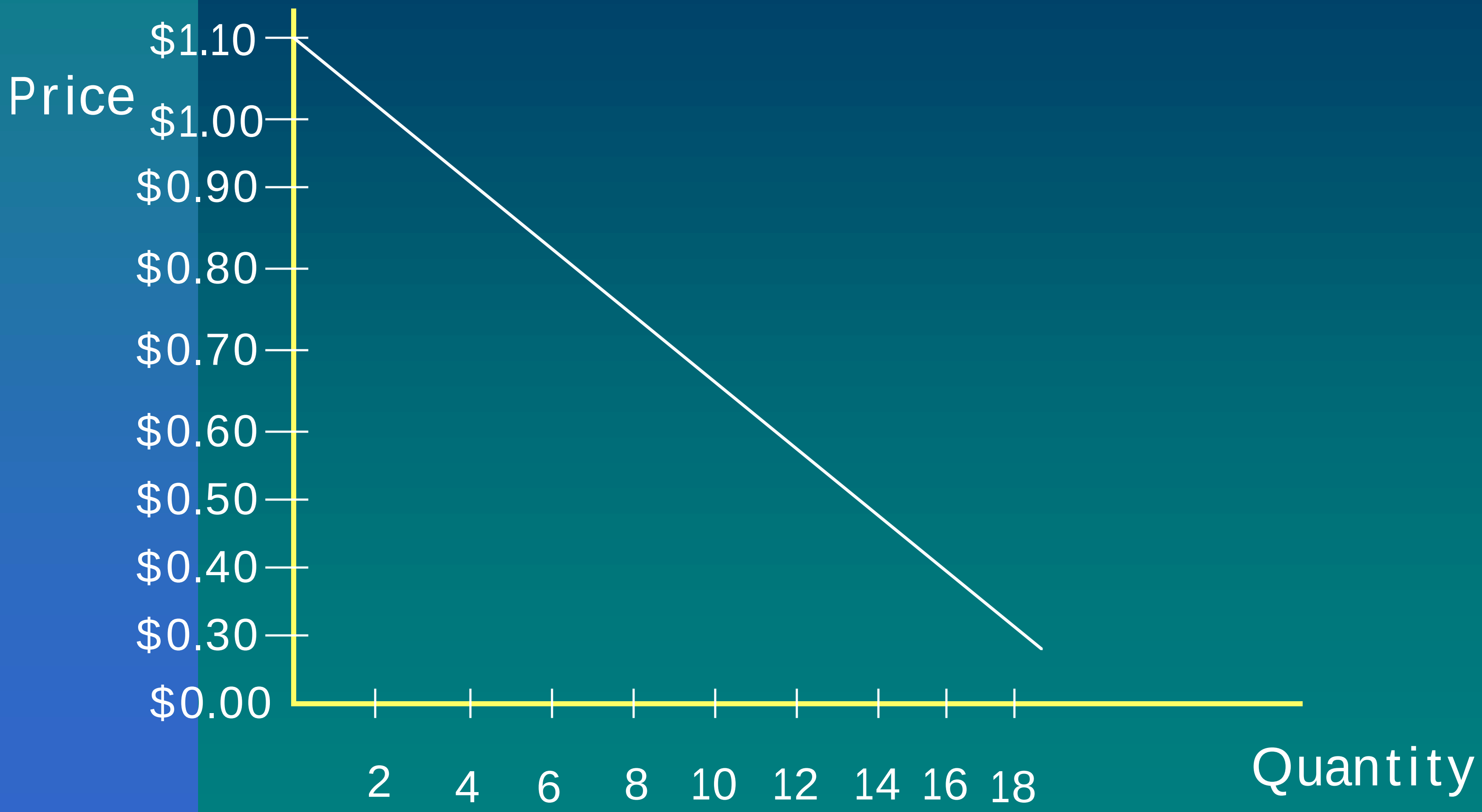
- A basic property of demand: when prices rise, other things being equal, the total quantity demanded falls

- Why?
  - If the price falls, the opportunity cost of obtaining the good falls, so consumers are willing to buy more

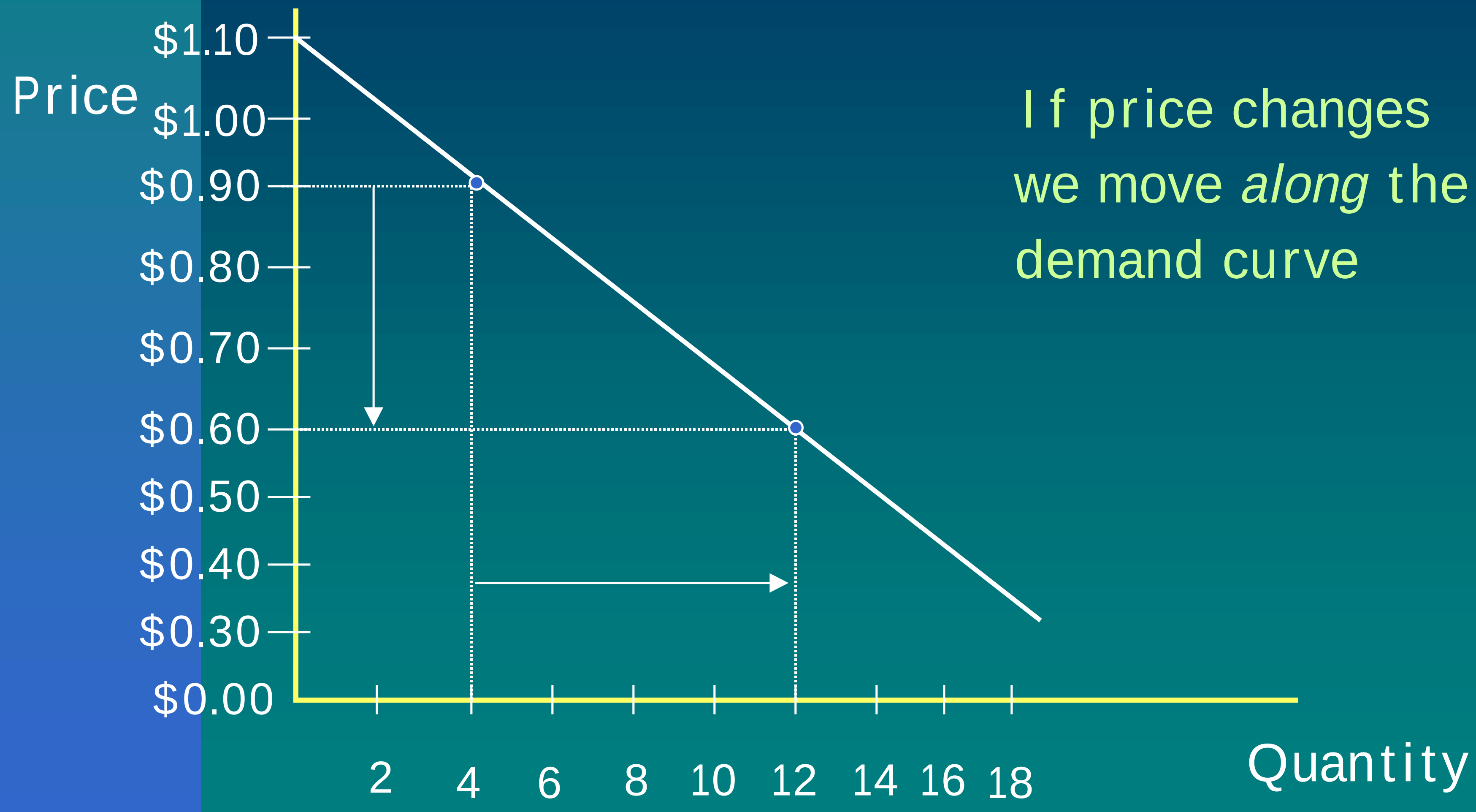
An example

Price	Quantity
$1.00	2
$0.90	4
$0.80	6
$0.70	8
$0.60	10
$0.50	12
$0.40	14

An alternative representation

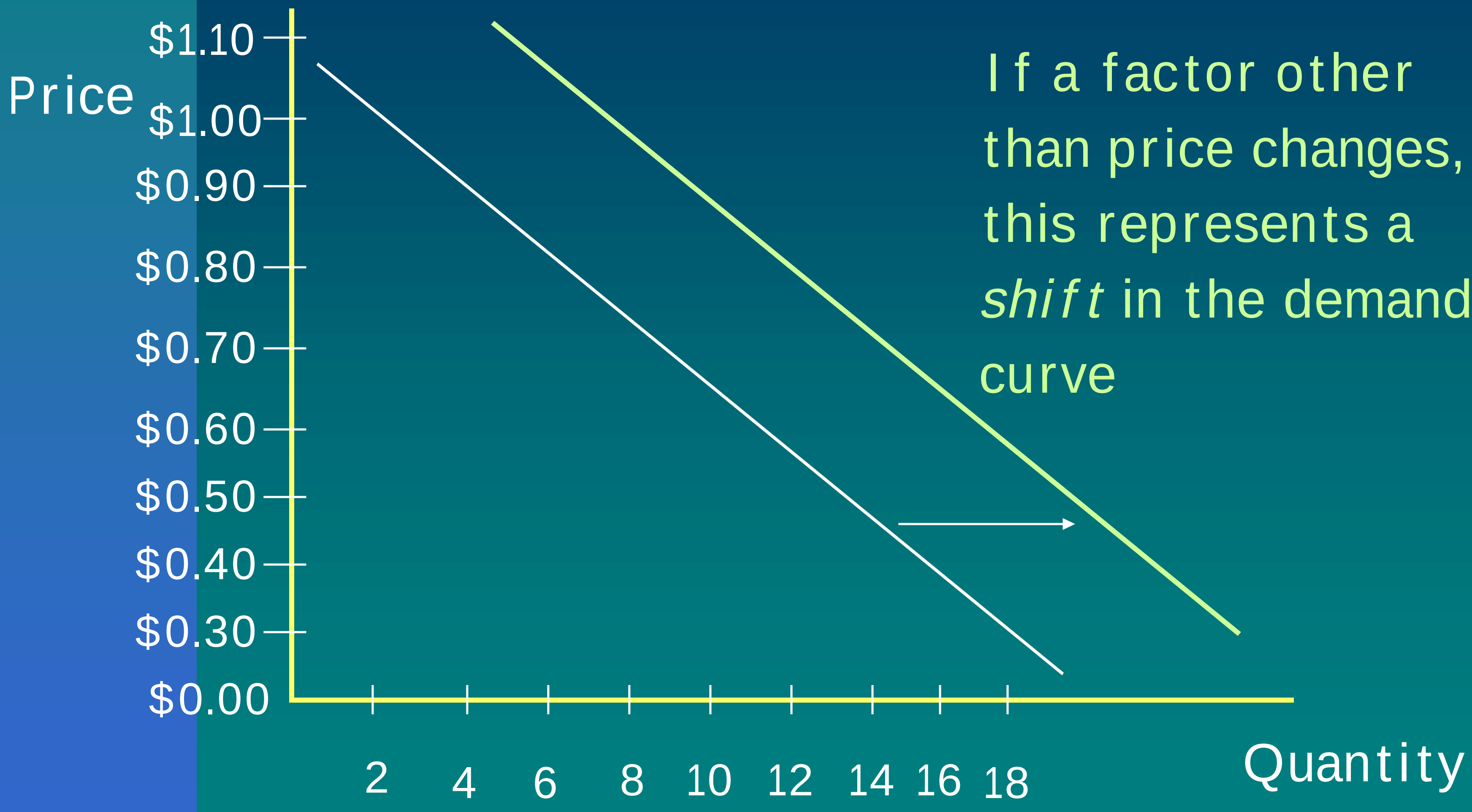


Movement along the demand curve



If price changes we move *along* the demand curve

Shifts in demand



If a factor other than price changes, this represents a *shift* in the demand curve

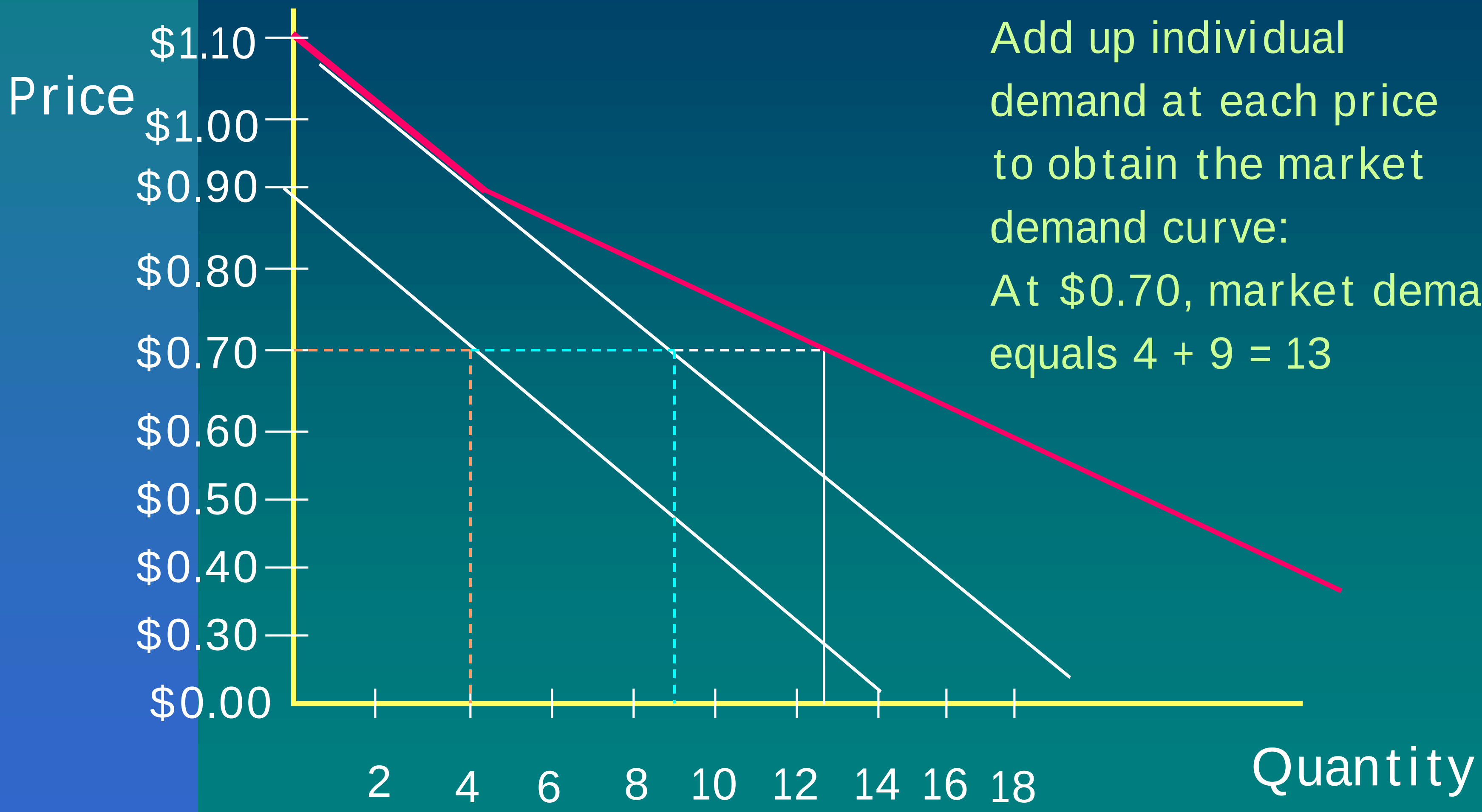
What causes shifts in demand?

- Income
- Change in tastes, preferences
  - As a result of advertising/marketing?
- Changes in the price of complements
- Changes in the price of substitutes
- Changes in expectations

Going from individual demand to market demand

- If we add up each individual's demand at a particular price, we obtain the total market demand at that price
- If we do this for every possible price, then we derive the market demand curve

Market demand



Add up individual demand at each price to obtain the market demand curve:

At $0.70, market demand equals 4 + 9 = 13

Supply relationships

- As prices rise, a greater quantity of goods is supplied, everything else equal
- Why?
  - Because suppliers find it more profitable to sell more output when the price is higher, all else equal

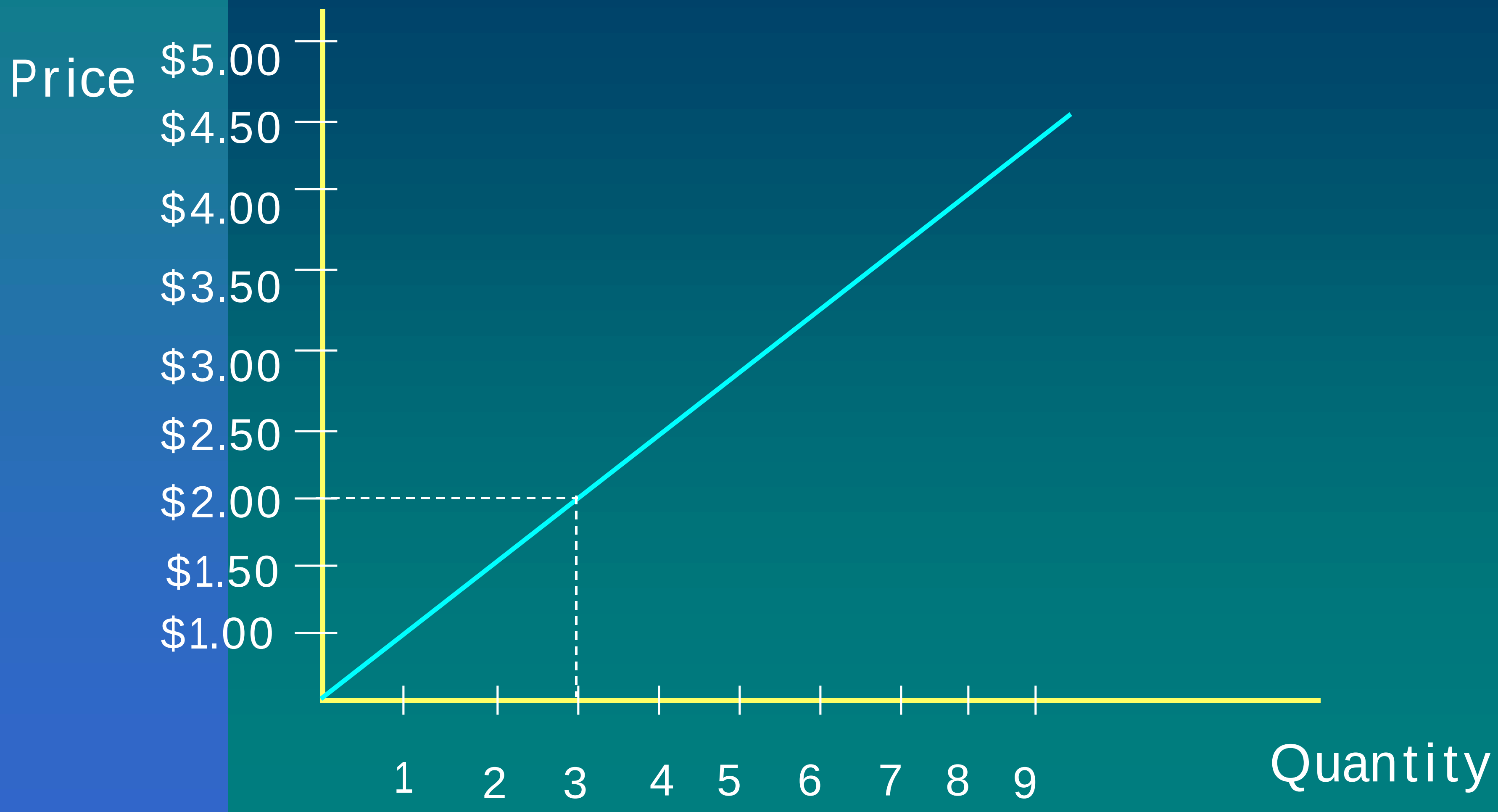
Determinants of supply

- Input prices: when input prices rise, firms will produce the same quantity only if prices rise
- Technology: determines the cost of producing goods & services
- Expectations: if prices are expected to rise, firms may hold off on putting goods on the market

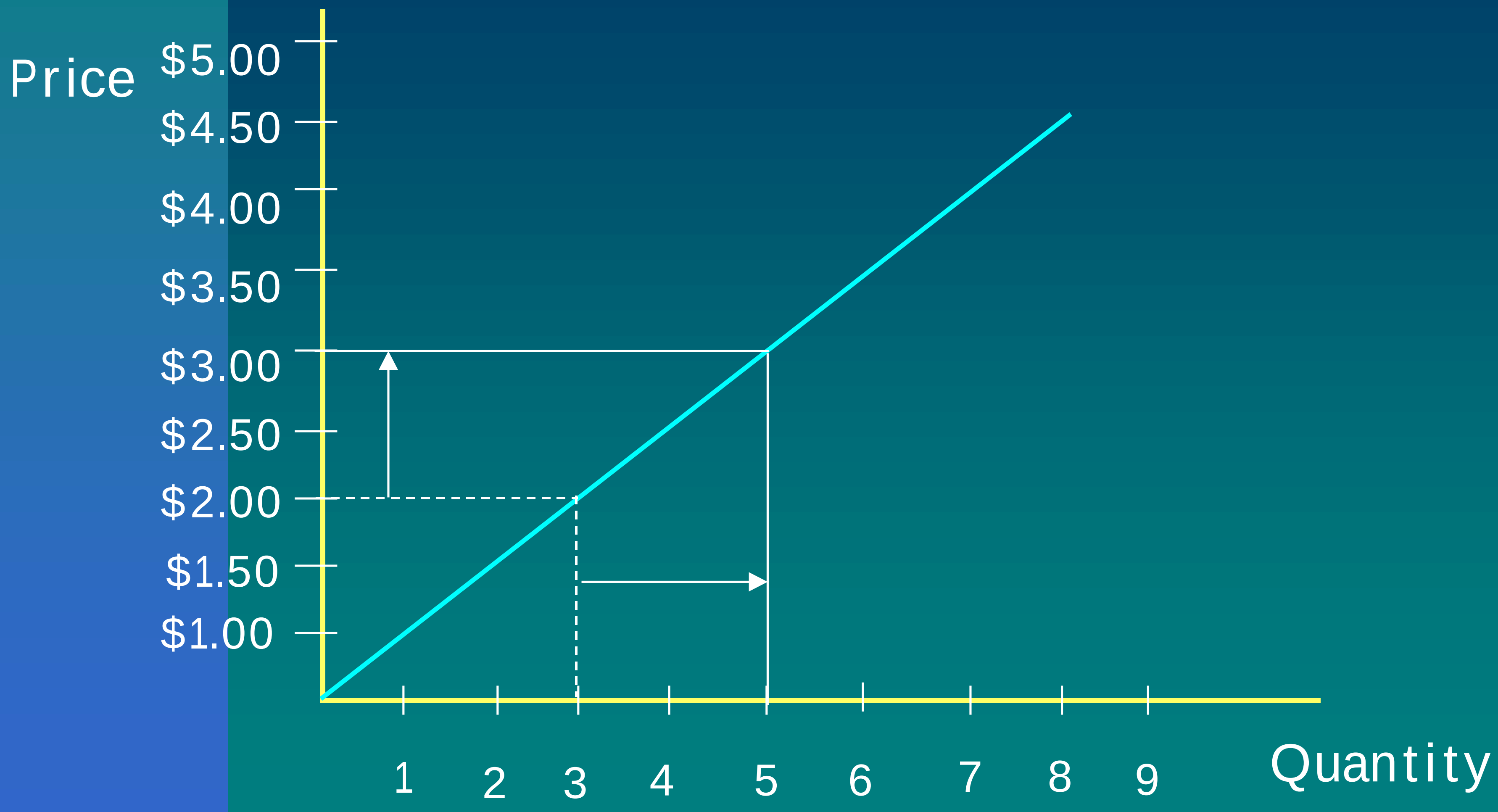
A supply schedule

Price	Quantity
$1.00	1
$1.50	2
$2.00	3
$2.50	4
$3.00	5
$3.50	6
$4.00	7

An alternative representation



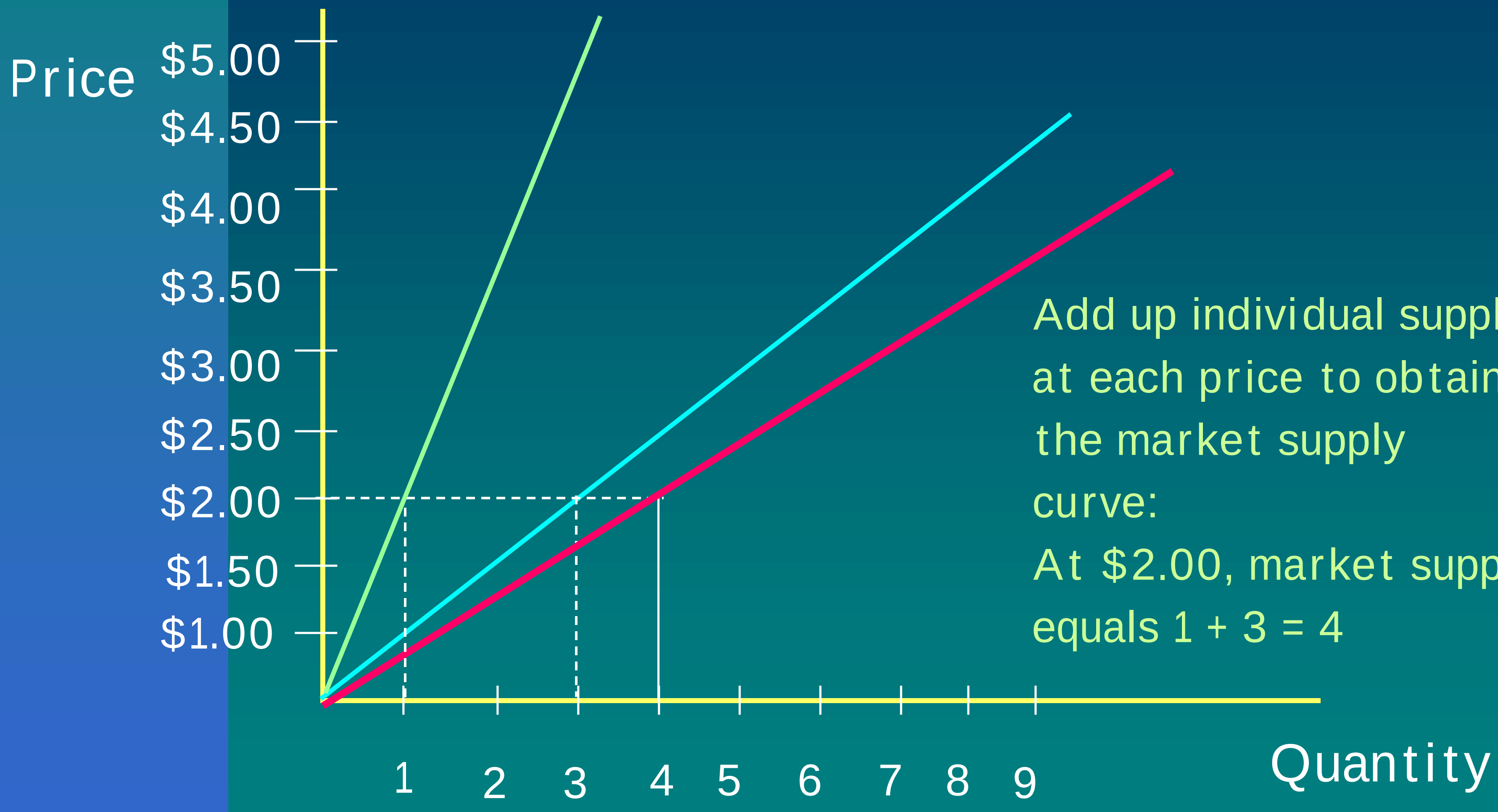
Movements along the supply curve



Going from individual supply to market supply

- Under certain conditions, if we add up each individual firm's supply at a particular price, we obtain the total market supply at that price
- If we do this for every possible price, then we derive the market supply curve

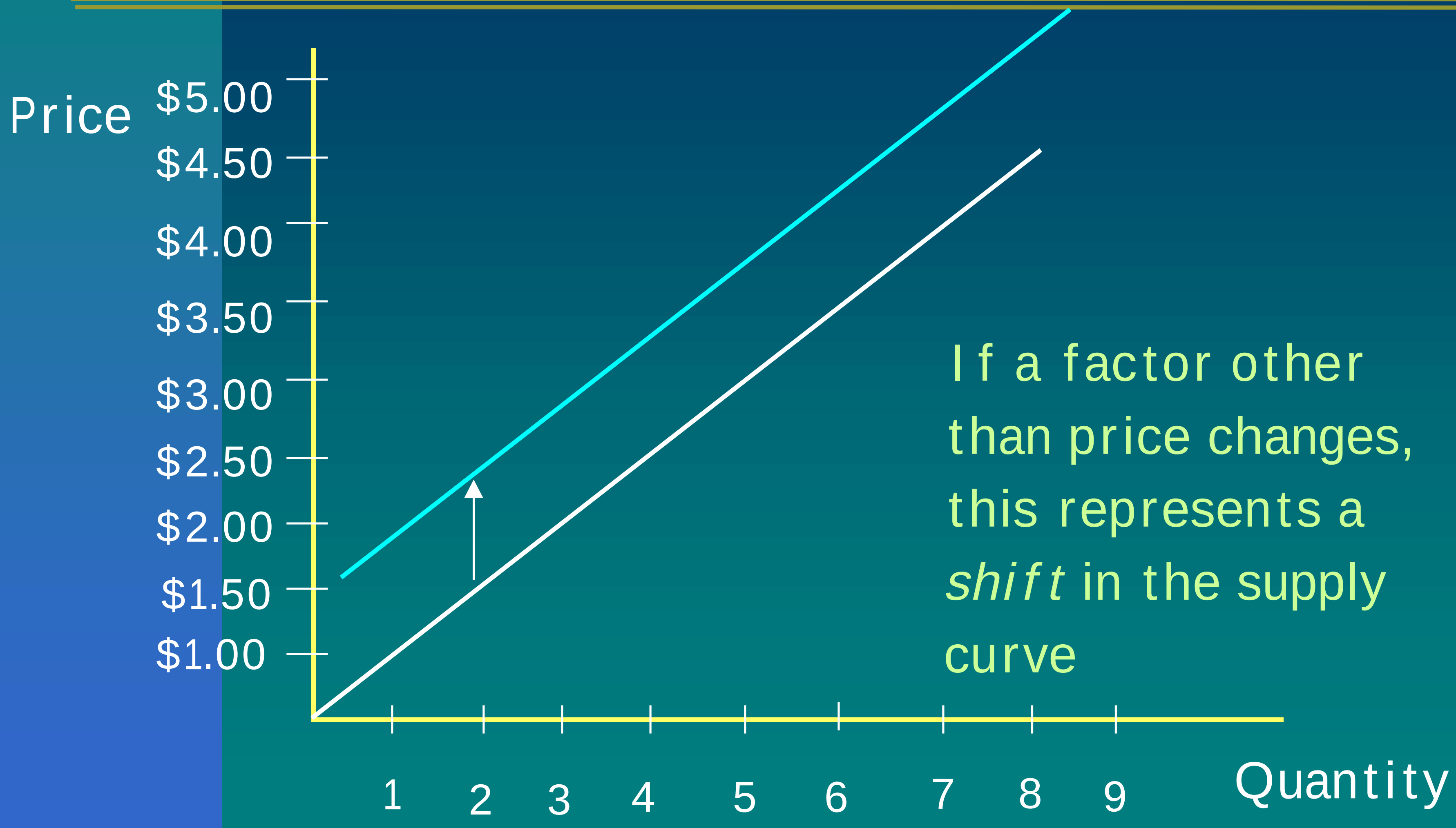
Market supply



Add up individual supply at each price to obtain the market supply curve:

At $2.00, market supply equals 1 + 3 = 4

Shifts in the supply curve

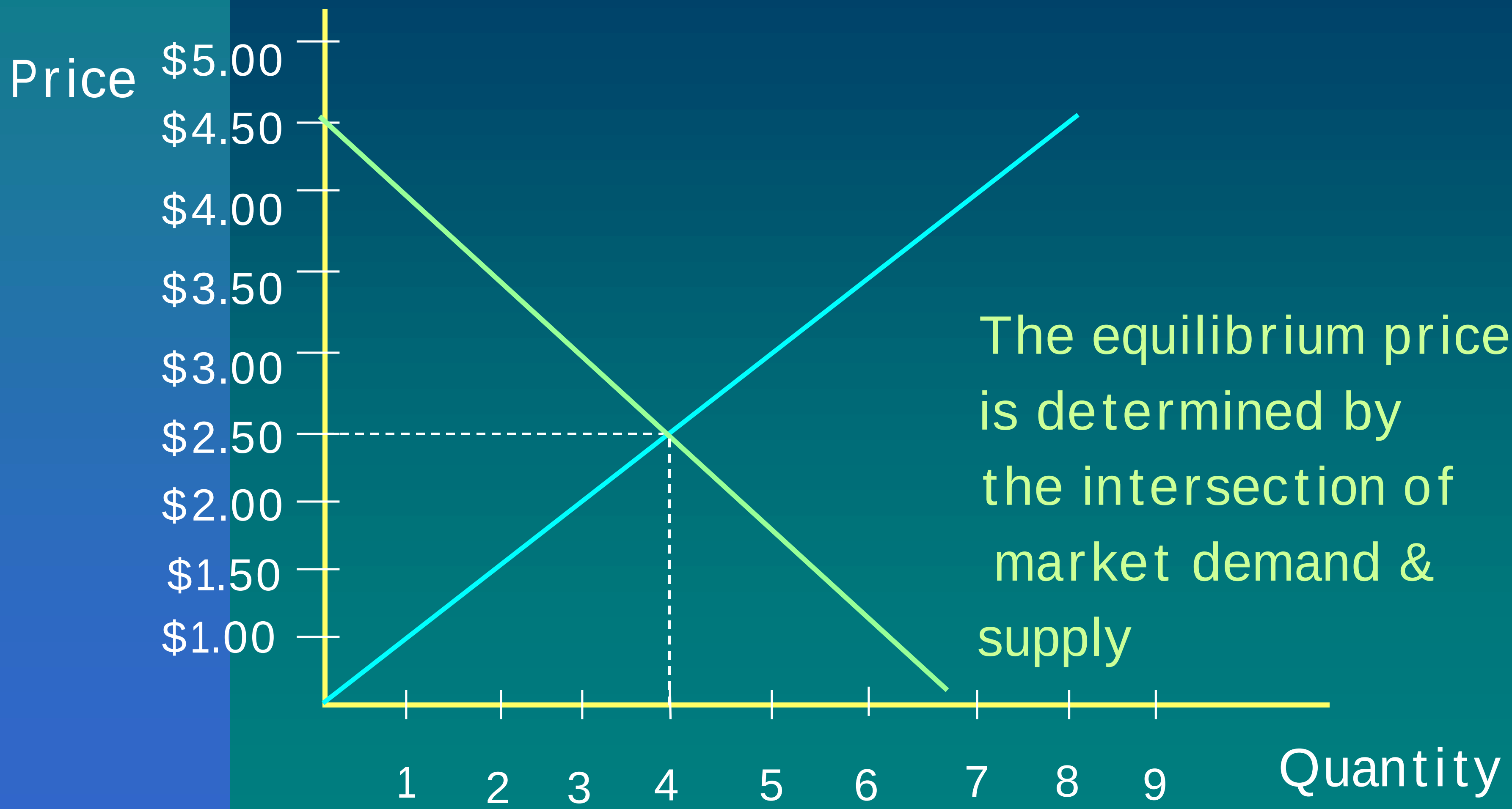


If a factor other than price changes, this represents a *shift* in the supply curve

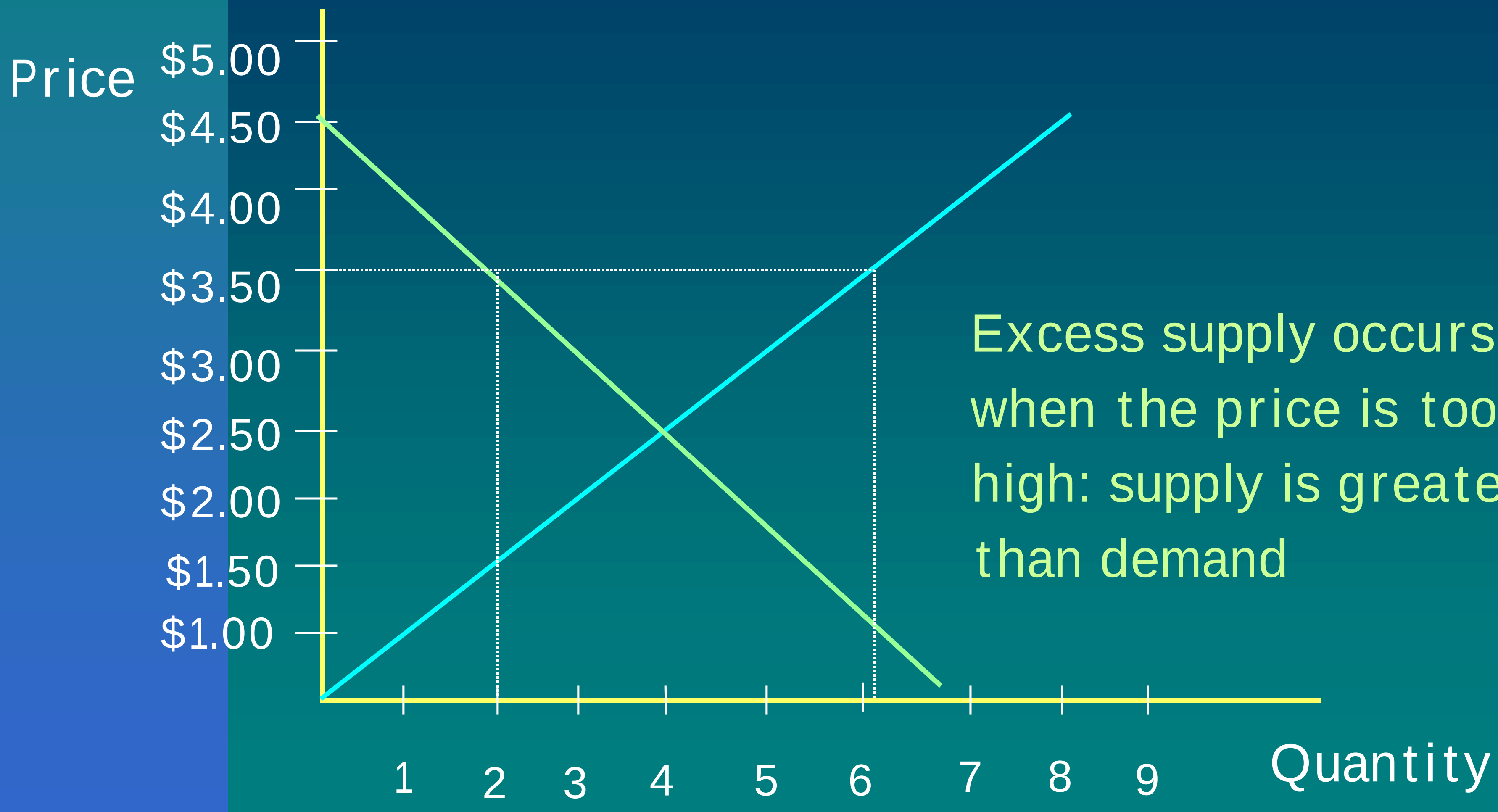
What causes the supply curve to shift?

- Input prices: an increase in input prices causes the supply curve to shift up
  - Taxes: an increase in taxes causes supply curve to shift up
- Technology: a new technology may *lower* the cost of production, shifting the supply curve down
- Expectations: if prices are expected to rise, costs may go up today
- Number of sellers: more sellers shifts curve to right

Market equilibrium



Excess supply



Excess supply occurs when the price is too high: supply is greater than demand

Excess demand