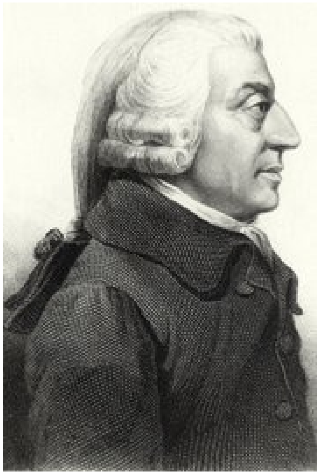
Functions of the Price Mechanism



The invisible hand – the workings of the price mechanism

Adam Smith, one of the Founding Fathers of modern economics once described the “invisible hand of the price mechanism” in which the hidden hand of the market operating in a competitive market through the pursuit of **self-interest** allocated resources in society’s best interest. This remains a view held by free-market economists who believe in the virtues of an economy with minimal government intervention.

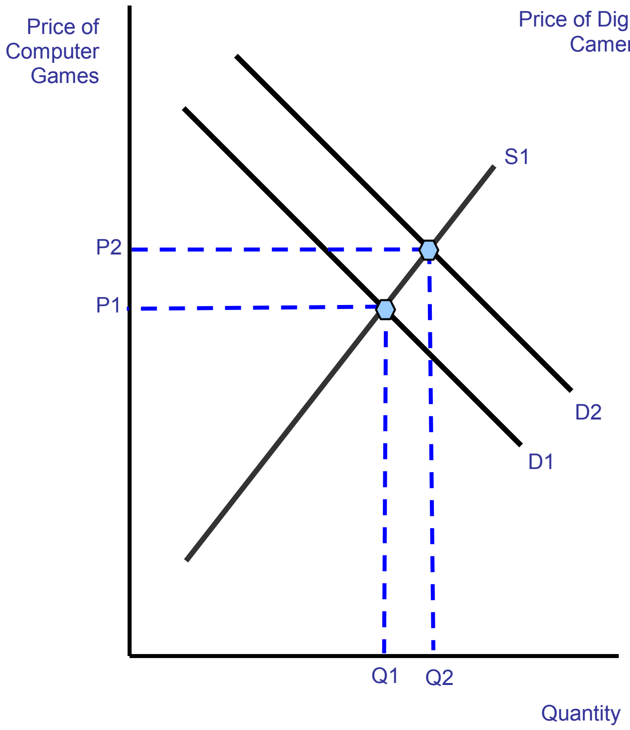
The **price mechanism** describes the means by which millions of decisions taken by consumers and businesses interact to determine the allocation of scarce resources between competing uses. The **price mechanism** plays **three important functions** in a market:

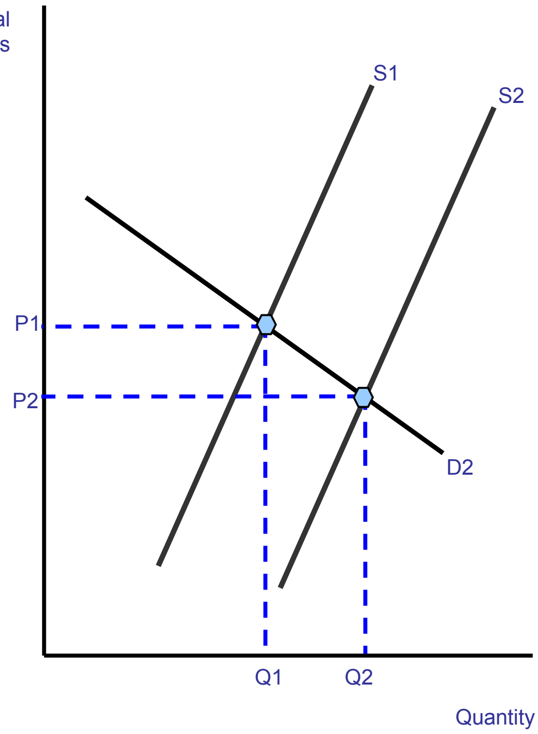
1/ the signalling function

Prices perform a **signalling function –** they adjust to demonstrate where resources are required, and where they are not. Prices rise and fall to reflect scarcities and surpluses. So, for example, if prices are rising because of high demand from consumers, this is a signal to suppliers to expand production to meet the higher demand.

Higher demand signals to producers to step up production – if they are driven by the profit motive. Total revenue is higher at price P2 and output Q2

In this diagram, an increase in supply leads to lower market prices – a signal to consumers that their real income has increased – they can afford to buy more





In the example on the right, an increase in market supply causes a fall in the relative prices of digital cameras and prompts an expansion along the market demand curve

Conversely, a rise in costs of production will induce suppliers to decrease supply, while consumers will react to the resulting higher price by reducing demand for the good or services.

> **Scarcity and market prices**
>
> **"**We are no longer living in an age of abundant resources. The high prices of scarce resources such as oil and gas are the market's response to huge shifts in supply and demand. The market is saying that we must use more wisely resources that have now become more valuable. The market is right."
>
> *Source: Adapted from Martin Wolf, Financial Times www.ft.com accessed May 14th 2008*

2/ signalling Function – the transmission of preferences

Through their **choices** consumers send **information to producers** about the **changing nature of needs and wants**. Higher prices act as an incentive to raise output because the supplier stands to make a better profit. When demand is weaker (for example during a recession) then market supply contract as producers cut back on output.

One of the features of a market economy system is that decision-making is **decentralised** i.e. there is no single body responsible for deciding what is to be produced and in what quantities. This is a remarkable feature of an **organic market system**.

3/ Rationing function

Prices serve to **ration scarce resources** when demand in a market outstrips supply. When there is a **shortage**, the price is bid up – leaving only those with the **willingness and ability to pay** to purchase the product. Be it the demand for tickets among England supporters for an Ashes cricket series or the demand for a rare antique, the market price acts a **rationing device** to equate demand with supply. The popularity of **auctions** as a means of allocating resources is worth considering as a means of allocating resources and clearing a market.

Most economies are **mixed economies**, comprising not only a market sector, but also a **non-market sector**, where the **government** (or state) uses **planning** to provide public goods and services such as police, roads and **merit goods** such as education, libraries and health.

In a **command economy,** planning directs resources to where the state thinks there is greatest need. Following the collapse of communism in the late 1980s and early 1990s, the market-based economy is now the dominant system – even though we are increasingly aware of many **imperfections in the operation of the market**.

Prices and incentives

- **Incentives** matter! For competitive markets to work efficiently all 'economic agents' (i.e. consumers and producers) must respond to **appropriate price signals** in the market.

- **Market failure** occurs when the signalling and incentive functions of the price mechanism fail to operate optimally leading to a loss of economic and social welfare. For example, the market may fail to take into account the **external costs and benefits** arising from production and consumption. Consumer preferences for goods and services may be based on **imperfect information** on the costs and benefits of a particular decision to buy and consume a product.

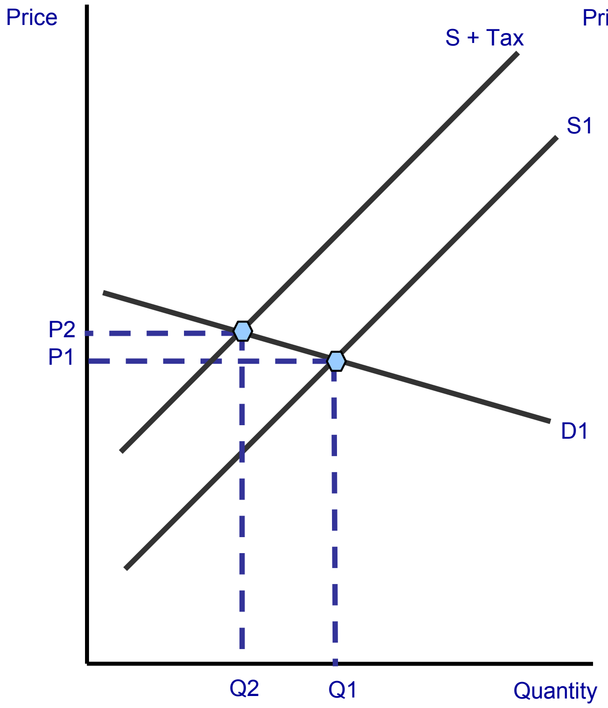
Secondary markets

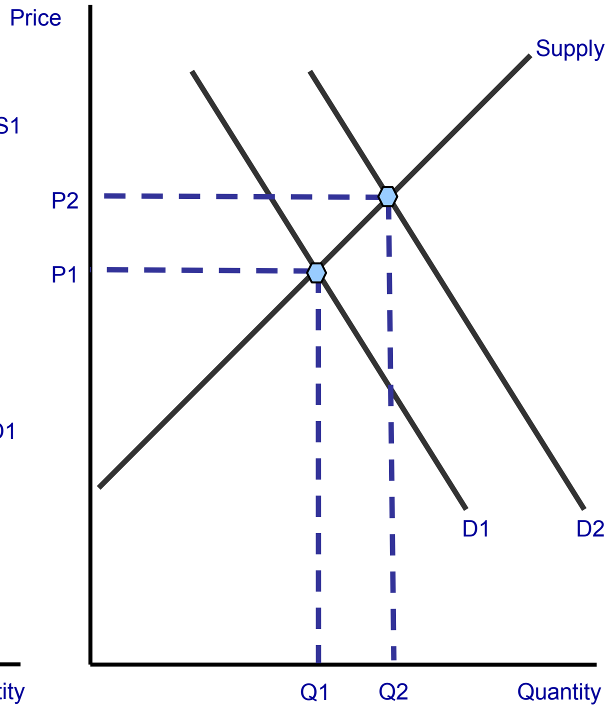
Secondary markets occur when buyers and sellers are prepared to use a second market to re-sell items that have already been purchased. Perhaps the best example is the secondary market in tickets for concerts and sporting-events.

Government intervention in the market mechanism

Often the incentives that consumers and producers have can be changed by **government intervention** in markets. For example a change in relative prices brought about by the introduction of **government subsidies and taxation**.

Indirect Taxes	**Government Subsidies**
An indirect tax increases the relative price of a product and should cause a contraction of demand. The government is intervening in the market because it wants to changes the price signals and incentives of producers and consumers. In this case the justification may be a desire to correct for negative externalities.	A subsidy to consumers to cover some of the costs of buying child care or employing nannies is designed to reduce the relative cost of this and therefore increase demand. The justification could be to encourage more young mothers to actively seek work, expand the labour supply and contribute to the country's productive potential.





- Agents may not always respond to incentives in the manner in which textbook economics suggests.

- The **"law of unintended consequences"** encapsulates the idea that government intervention can often be misguided of have unintended consequences!