8 Market Equilibrium

Multiple Choice Answers

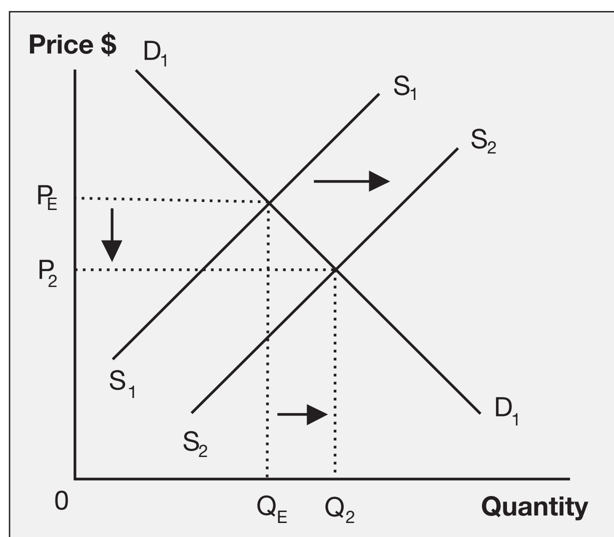
1	C	**6**	C	**11**	D
2	B	**7**	B	**12**	C
3	A	**8**	B	**13**	C
4	D	**9**	B	**14**	C
5	A	**10**	C	**15**	D

Short Answer Questions

Question 1

(a) The price mechanism refers to the interaction of the forces of supply and demand to determine an equilibrium quantity and price in the market.

(b)



(c) Equilibrium price falls, equilibrium quantity rises.

(d) If the market price is below equilibrium, the quantity demanded exceeds the quantity supplied. This creates a shortage in the market. As consumers bid against each other for the fewer goods, they will bid up the price. Some consumers will not longer demand the product at the higher price, causing a contraction in demand. The higher price will encourage more suppliers in the market, expanding supply. This continues until quantity demanded equals quantity supplied.

(e) The market is generally considered the most efficient mechanism to solve the economic problem. Since price and quantity will move to ensure that there is no surplus or shortage in the market, production will only occur to satisfy consumer wants, and there will be no wastage. This is known as allocative efficiency. However the market only responds to individual demands, and does not capture benefits society as a whole, and so the government may need to intervene in the market to ensure a more equitable outcome.

Question 2

(a) A price ceiling is a maximum price limit imposed by the government, usually below equilibrium.

(b) $Q_C - Q_P$

(c) If a product is considered a necessity for consumer's standard of living (such as water or basic food), the government will wish to ensure that consumers are able to afford the product. If equilibrium is too high, the government will impose a price ceiling.

(d) A price ceiling creates a shortage in the market, however firms are unable to increase their prices to increase their revenue. Since firms cannot raise their prices, there is likely to be less competition in the industry.

(e) A government can discourage the production of goods which produce negative externalities by taxing the products. By raising the price through a tax, consumers will demand less of the undesirable product, reducing the equilibrium quantity in the market. The government may wish to encourage production of a good which has a wider benefit to society than to an individual (a merit good). This may be done through subsidies, which lower the cost of production to firms, increasing supply and lowering equilibrium price and raising equilibrium quantity.

Question 3

(a) Market power is the ability of a firm to raise its price above a competitive market equilibrium.

(b) Perfect competition

(c) Perfect competition is the opposite in terms of competition to monopoly. Under perfect competition a very large number of firms compete with identical products, and have no market power. Under a monopoly there is only one firm, and no competition. That one firm has complete market power since it sets the price and quantity in the market. In perfect competition there are no barriers to entry, however in monopoly there are very high barriers to entry, making it impossible to enter the industry.

(d) An oligopoly contains a small number of large similar sized firms which dominate the industry. The products are highly differentiated, and there are substantial barriers to entry.

(e) Oligopoly and monopoly will often result in disequilibrium due to the substantial market power possessed by firms. Since there are very few firms in the market, firms are able to set prices above equilibrium if it would be more profitable for the firm, restricting quantity, and raising prices above the equilibrium price. Since there are substantial barriers to entry, there is no possibility that other firms can enter the market and increase competition, lowering prices.

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