

Market Equilibrium 8

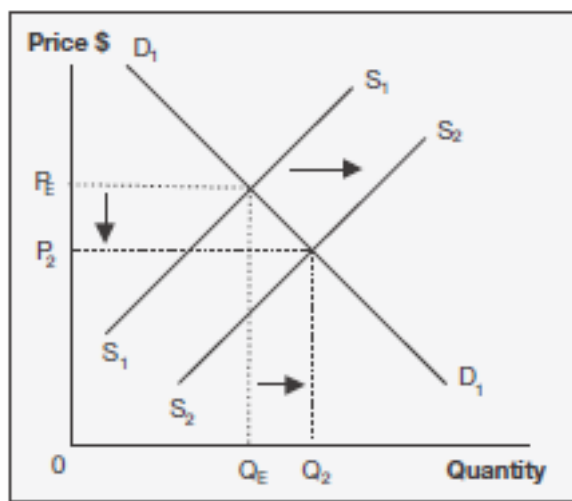
Multiple Choice

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|--------|---------|---------|
| 1. (C) | 6. (C) | 11. (D) |
| 2. (B) | 7. (C) | 12. (C) |
| 3. (A) | 8. (C) | 13. (B) |
| 4. (D) | 9. (C) | 14. (D) |
| 5. (A) | 10. (B) | 15. (C) |

Short Answers

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 floor is a minimum price limit imposed by the government, usually above the equilibrium price. Once imposed in a particular market, the price of the good or service in that market cannot fall below the price floor irrespective of demand or supply.
- (b). Excess supply = $Q_C - Q_P$
- (c). If the government believes the equilibrium price of a good is too low to provide for sufficient wages and guarantee the livelihood of suppliers in a market, it may impose a price floor. The legal minimum wage in Australia is the most common example of such a mechanism. It exists to protect the value of labour and ensure workers receive an adequate wage to maintain a basic standard of living.
- (d). A price floor creates a surplus in the market, however the floor prevents the price from decreasing. Since firms are guaranteed a higher price than at equilibrium, it is likely that more firms will enter 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). Market power is likely to increase the price of a good or service above its equilibrium price, and reduce the quantity of a good or service supplied below the equilibrium quantity in a market.
- (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 structures 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 that would operate if there were perfect competition. Unlike a perfect competition market structure, there are substantial barriers to entry with oligopolies and monopolies and a very low possibility that other firms can enter the market and increase competition to lower prices.