**EXPLANATION OF THE 3 FUNCTIONS OF THE PRICE MECHANISM**

The price mechanism operates in the free market and has several functions. Prices in a free market can help solve the economic problem and allocate scarce resources by answering the questions: what, how and for whom.

**RATIONING**

* **Who** buys is determined by who wants it and if consumers can afford the price

**INCENTIVE**

* Change in price influences **how much** is produced

**SIGNAL**

* Change in **what** goods are preferred
* Demand & price changes
* Buyers & sellers observe this price

**a) The Signalling Function**

Firstly, prices perform a **signalling function.** This means that market prices will adjust to demonstrate where resources are required, and where they are not i.e. **what** should be produced and consumed.

* **Signalling Consumer Demand:** if market prices are rising because of high and rising demand from consumers, this is a signal to suppliers to expand their production to meet the higher demand. Through the signalling function, consumers are able, through their **expression of preferences,** to send important **information to producers** about the **changing nature of our needs and wants.**
* **Signalling Availability to Consumers:** signalling also occurs with the supply curve.For example, if market prices fall due to advances in technology and higher supply (such as for digital cameras) then this is signalled to consumers with lower prices and they will respond by expanding their demand.

**b) The Incentive Function**

Producers and consumers in the examples above have responded to the **incentives** provided by a change in price. Here the market is decided **how much** should be produced and consumed in the free market i.e. allocating resources.

* **Incentives for producers:** suppliers have the incentive to produce more when demand is high as they will make more profit.
* **Incentives for consumers:** consumers have more incentive to consume goods after supply increases (e.g. due to higher productivity) as the price will be lower.

**c) The Rationing Function**

Prices can ration resources as well. The market here answered the question **for whom** the goods should be provided.

* **Rations Demand:** when demand increases there will be a shortage of a good or service, only those who are able and willing to pay the higher price will be able to afford them.
* **Rations Supply:** prices can also help ration the supply of a good. For example, when a non-renewable resource is running out, the supply will fall and price will rise causing demand to contract. Again, only those with a high willingness and ability to pay can obtain the good.

**INSTRUCTIONS:** Complete the following questions after you have read the information on the other sheet

|  |  |  |
| --- | --- | --- |
| **It is 23rd December, and the town is full of last minute shoppers for presents and the Christmas dinner. Last year’s fashion for goose has this year been replaced by turkey following a TV Chefs “special”. But they have left it rather late, demand was higher than usual and this has caused higher prices in the weeks since the TV show. To satisfy demand supermarkets and butchers were searching Europe!** | | |
| IN THIS EXAMPLE, EXPLAIN HOW PRICES ACT AS “SIGNALS”? |  | http://3.bp.blogspot.com/_PMRs2x2YthE/TE6K-4QvMPI/AAAAAAAABAo/4QiEC32205c/s1600/TurkeyCartoon.jpg |
| IN THIS EXAMPLE, EXPLAIN HOW PRICES ACT AS “INCENTIVES”? |  |
| IN THIS EXAMPLE, EXPLAIN HOW PRICES “RATION” GOODS |  |

**Equilibrium Changes through ‘Disequilibrium Analysis’ using the Terminology of the ‘Roles of Prices’**

**Introduction: Why are we looking at this?**

TASK: Read through the following - We have so far established changes to equilibrium via supply and demand changes. However to maximise your marks in the essay and a 9 mark question, you need to explain these changes with more rigorous analysis. Therefore we need to develop ‘Disequilibrium Analysis’ which breaks down the equilibrium change into various stages. Understanding the ‘role of prices’ through the ‘SIR’ (Signalling, Incentives and Rationing) acronym is vital.

The explanation below demonstrates how you might further your economic analysis when explaining a demand and supply curve shift by using the terminology of Signalling, Incentives and Rationing.

|  |  |
| --- | --- |
| **C** | **STAGE 1: INITIAL EQUILIBRIUM**  The market is in equilibrium – demand equals supply at a suitable price.  **STAGE 2: THE CHANGE IN DEMAND**  As incomes of individuals have risen, however, so has demand for car’s. The demand curve shifts to the right from D1 to D2. D1 could effectively now be taken out as it has been replaced by D2.  **STAGE 3: THE DISEQUILIBRIUM**  At P1, we now have a situation where there is excess demand. The price has stayed at P1 but although demand has changed, supply has stayed the same creating disequilibrium (from A to C).  **STAGE 4: RESTORING EQUILIBRIUM**  As there is excess demand (between Q1 to Q3), suppliers realise they can increase their prices. The increase in prices will send a ‘signal’ to other suppliers of the potential of more profit in this market. As new suppliers are ‘incentivised’ to enter the market in search of higher profits, supply extends ALONG the supply curve. At the same time, higher prices force consumers to cut back (‘ration’) some of their expenditure and demand contracts (moves) ALONG the demand curve from Q3 to Q2 (although overall demand has increased from Q1 to Q2 as a result of the shift in the curve).  **STAGE 5: THE NEW EQUILIBRIUM**  When price has risen sufficiently, enough extra supply has dealt with the shortage and enough consumers have rationed expenditure of the good to create a new AND stable equilibrium at B. |

TASK: Using the 5 stage technique above, complete the following shifts in the demand and supply curves and state what happens to price and quantity as a result:

|  |  |  |
| --- | --- | --- |
| The demand curve for cereals containing protein shifts to the right as consumers want to eat more healthily | Explanation | Diagram |
| The costs of production for a good increase and the supply curve shifts to the left. | Explanation | Diagram |
| The import duty on vital raw materials is reduced by the Government. As a result the supply curve shifts to the right due to the lower costs of production. | Explanation | Diagram |
| Explain what would happen to the market for processed meats (sausages, ham etc.) in light of the recent report suggesting they should be classified in the same category as cigarettes and asbestos? | Explanation | Diagram |