

Topic 5—The Price Mechanism in Action

Key Terms	
Agriculture	The science or practice of farming, including cultivation of the soil for the growing of crops and the rearing of animals to provide food,
Commodity	Raw materials that are able to be used by firms in the production process
Cartel	An agreement between firms in a market on price and output with the intention of maximising their joint profits
Housing	This covers both owner occupied housing as well as rental properties
Exchange Rate	The value of one currency compared with another.
Derived Demand	Buying a commodity for use as something else.
Stock Market	The issue and trading of equities or stocks of publically held companies.

The Agricultural Market
The supply side of the agricultural market is heavily dependent on weather and climate. This makes accurate supply difficult to forecast and so the prices can be very volatile. Some agricultural products have attempted to stabilise prices by storing surplus stock in good years in order to sell in bad years however this has had varying degrees of success. E.g. wine lakes and butter mountains
The demand for agriculture depends on: <ul style="list-style-type: none"> • Preferences especially health discussions • Public relations especially related to GMOs
The supply of agriculture depends on: <ul style="list-style-type: none"> • Weather and climate • Prices of other goods that could be swapped instead

Specification Link

1.2.7 The price mechanism

The Housing Market

The housing market is not a single market, but rather made up of different segments; Owner occupied, private and public rental.

Each segment of the housing market is a substitute as most households will only have one property.

In the UK there is a much bigger incentive to buy houses, which means that interest rates are a big influence on this. In other countries e.g. Germany there is less requirement to own houses.

Supply of houses in the UK has been expanding very slowly. This has put upward pressure on house prices and is causing a housing shortage in the UK. In addition, due to the high prices, first time buyers struggle to afford houses and this has led to a decline in owner occupancy over the years.

The Commodities Market

Commodities tend to be linked with the agricultural market and follow the same concerns regarding unstable supply.

Some commodity products have attempted to stabilise prices by storing surplus stock in good years in order to sell in bad years or by creating cartels in order to control the level of supply such as oil and OPEC.

The demand for commodities depends on:

- Usually inelastic as they are required for day to day running

The supply of commodities depends on:

- Strength of cartel
- How long it takes to extract
- Availability of substitutes

The Foreign Exchange Market

The foreign exchange market is the same as any other market in the sense that there is demand and supply. When there is equilibrium that is the stable exchange rate at that time.

Demand for £ increases when there is an increase in demand for UK products, or UK based holidays.

Foreign exchange is also an example of derived demand as currency is bought not for its own sake, but to be used to buy goods and services.

The Stock Market

Firms will use the stock market to raise finance for their business buy giving away segments of ownership for money.

Demand for stocks will depend on:

- Expectations in the future
- Herd behaviour

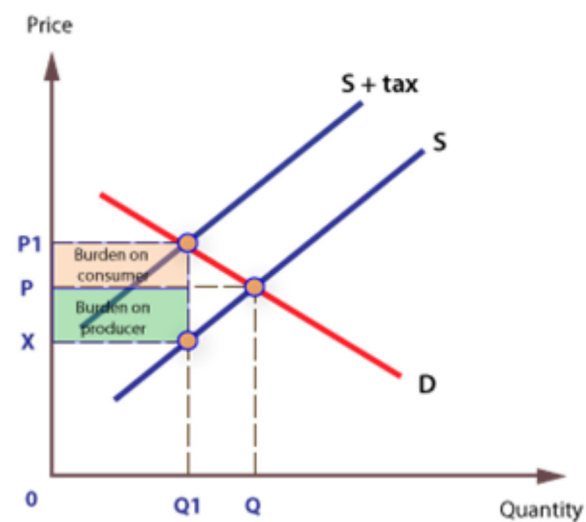
Supply of stocks will depend on firms' expectations of future demand for their product



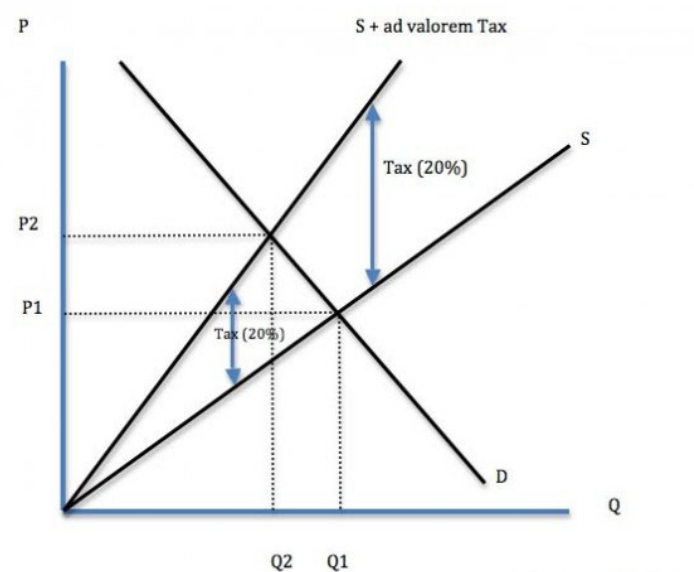
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Key Terms	
Indirect Tax	A tax levied on expenditure on goods or services (as opposed to a direct tax, which is charged directly to an individual or company based on income)
Incidence of Tax	The way in which the burden of paying a sales tax is divided between buyers and sellers
Subsidy	A grant given by the government to producers to encourage production of a good or service

Indirect taxes
Examples of indirect taxes include: VAT and excise duty on alcohol or tobacco
An indirect tax affects the seller and so causes a shift in the supply curve rather than demand.
It is important to understand who pays for the tax in the form of increased prices for consumers or increased costs for producers. This is shown below:
If the demand curve is more inelastic, this will lead to a higher burden on the consumer, whereas if the demand curve is more elastic, there will be a higher burden on the producer.
If the tax is not a constant amount (a specific tax shown above), but a percentage of the price (known as an ad-valorem tax), the supply curve is still affected but it now steepens as the price increases.



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1.2.9 Indirect Taxes and Subsidies

1.2.10 Alternative views of consumer behaviour

Subsidies

Subsidies are popular in farming and in the supply of public services such as buses and trains.

Subsidies allow firms to supply more by giving them more money, therefore causing the supply curve to shift to the right. This lowers the price of the product and increases the overall supply, leading to more benefits being passed on to consumers.

If the demand curve is more elastic, this means that the price does not decline by a lot, but quantity increases by relatively more, this means that producer benefit more than consumers

However if the demand curve is more inelastic, quantity is only slightly increased whilst the price is much lower,

Do Consumers Act Rationally?

In theory we assume that consumers always aim to maximise utility, however in reality this is likely not the case.

Habits:

Sometimes consumers don't react to a price change because they have developed consumption habits, which lead to persistent behaviour

E.g. smoking cigarettes

Herding Behaviour:

Buying a product because others are doing so even if there is less benefits known

E.g. Shopping in expensive clothing retailers because others judge on logos.

Impulse Purchases:

Buying products on a whim rather than thinking it through

E.g. buying chocolate that is on display on the till

Altruistic Nature

Doing something that is more expensive but socially responsible

E.g. Giving to charity

Information Overload

There may be more information than consumers are able to absorb or interpret. There may also be information that is hard to gather or analyse. This means that they can only make the best decision with the information they have. This is called bounded rationality.