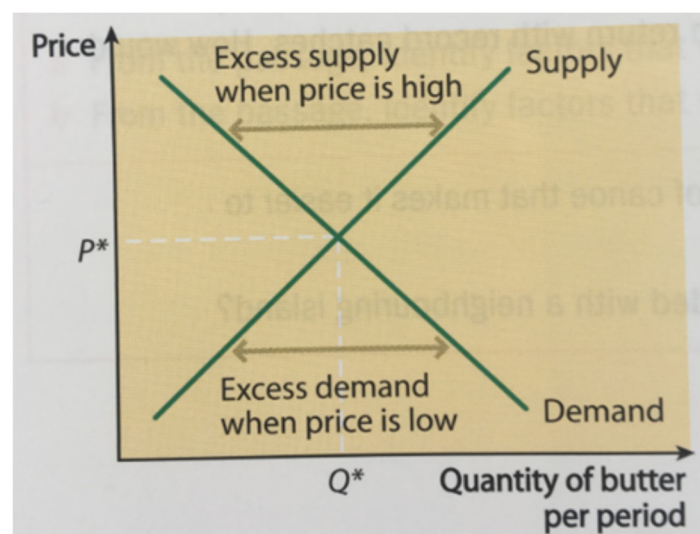


Topic 4—How Markets Work

Key Terms	
Market Equilibrium	A situation that occurs in a market when the price is such that the quantity that consumers wish to buy is exactly balanced by the quantity that producers wish to sell
Comparative Static Analysis	Examines the effect on equilibrium of a change in the external conditions affecting a market
Consumer Surplus	The value that consumers gain from consuming a good or service over and above the price paid
Marginal Social Benefit (MSB)	The additional benefit that society gains from consuming an extra unit of a good
Producer Surplus	The difference between the price received by firms for a good or service and the price at which they would have been prepared to supply
Marginal Cost	The cost of producing an additional unit of output
Allocative Efficiency	Achieved when society is producing an appropriate bundle of goods relative to consumer preferences

Market Equilibrium	
Market equilibrium occurs when the price is agreeable to both consumers and producers. If the price was too high, this would lead to excess supply in the market which would put downward pressure on goods until equilibrium was met.	
If the price is too low, this leads to excess demand in the market, which would put upward pressure on goods until equilibrium is met. Equilibrium occurs when there is no incentive for prices to change.	



Specification Link

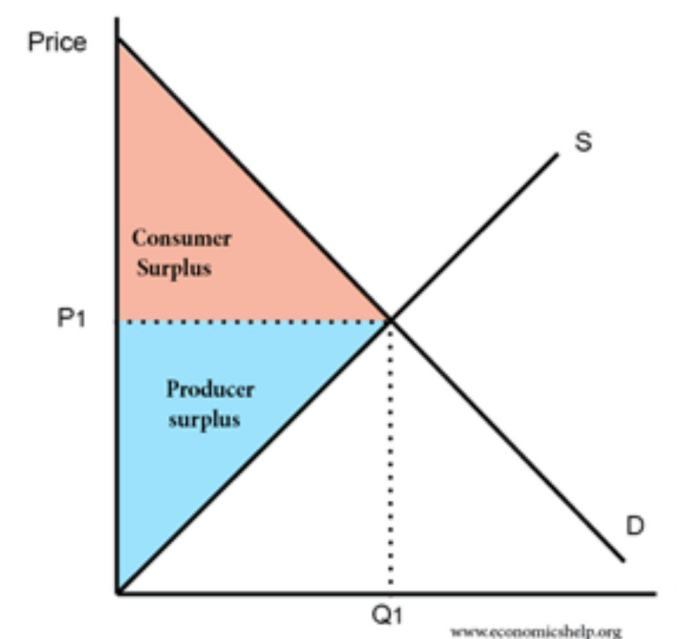
1.2.6 Price Determination

1.2.8 Consumer and Producer Surplus

Consumer and Producer Surplus

At a price P^* there are a certain number of consumers who are willing to pay that price for the good. If the price was to go up even a little, this would lead to one less consumer buying that product. Therefore, at a chosen price there will always be people benefiting from the price because they had been willing to pay a higher price than what they are getting.

Similarly, at P^* there are always suppliers who would have been willing to supply the product for a much lower



Price Signals and Preferences

Prices can be used to show consumers preferences e.g. if consumers no longer like laptops, there will be a decline in demand showing a new lower price to try and entice new consumers

Prices can also be used as a rationing tool e.g. if the harvest for coffee was poor, the higher price would reduce demand allowing equilibrium to be met.

Efficiency

Using the concept of demand and supply it is possible to see where allocative efficiency occurs, this would happen when firms have no incentive to change production and consumers are happy with the options of good and service that they have. This means that there is no reason to reallocate resources as no additional benefit will be made.