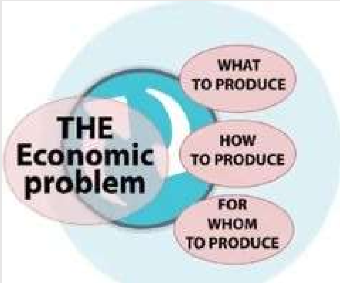
2.4 Price

Key Words

Market forces	Factors that determine price levels and the availability of goods and services in an economy without government intervention
Rationing	Prices serve to ration scarce resources when demand in a market outstrips supply. When there is a shortage, the price is bid up – leaving only those with the willingness and ability to pay to purchase the product.
Signalling	Price changes signal where resource are needed. Prices are the signals that guide the allocation of resources.
Incentive	Through their **choices** consumers send **information to producers** about the **changing nature of needs and wants.** Higher prices act as an incentive to raise output because the supplier stands to make a better profit.
Allocation of resources	How scarce resources are distributed among producers and how scarce goods and services are allocated among consumers

Allocating resources



The basic economic problem arises because there are scarce resources and infinite wants.

This means that resources need to be allocated in some way. We have to make choices about what to produce and how to distribute those goods and services to people.

In a free market economy, resources are allocated on the basis of price.

A feature of an efficient market is where prices of products reflect the worth of resources used in their production.

The role of prices in a market economy

Price fulfils three important function in allocating resources:

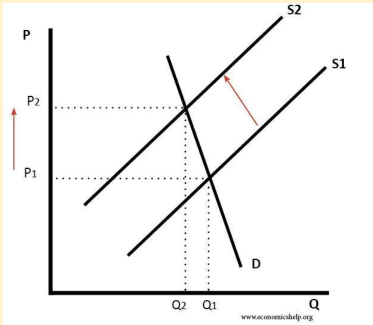
Signalling: prices change to signal where resources are needed. If prices rise, this shows that more resources are required whereas if they fall then fewer resources are needed.

Incentive / transmission of preference: If prices rise this acts as an incentive for producers to enter the market as there is more potential to make a profit. Equally when a products is not doing well and not demanded by consumers then the price will fall and some suppliers may withdraw from this market as the price becomes too low.

Rationing: Prices help to ration scarce resources. If resources are scarce the price rises, so that only those willing and able to pay the price are allocated the resources. Eg Many football clubs have high demand for their tickets, so the price tends to rise which means that some fans cannot afford to buy the tickets and in this way tickets are rationed.

Therefore the price of goods and services plays a crucial role in determining an efficient distribution of resources in a market system.

Adam Smith talked about 'the invisible hand' of the market. This 'invisible hand' relies on the fluctuation of prices to shift resources to where it is needed.(see the video)



For example:
The diagram opposite is for the market for oil. As the supply of oil falls, the price rises. If the price rises the profitability of producing oil increases. The high price **signals** where resources are required. Firms can now make more profit. This acts as an **incentive** for firms to increase supply eg at a low price, it was not worth drilling for oil in the North Sea, but with the high price there is an incentive. Higher prices may cause some consumers to change their travel arrangements. Consumers may start cycling or getting the bus instead of driving.(rationing)

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