1.DNL.SES

Topic 3: Price determination in a perfectly competition market

1. What are the different of types of market?

Document 1: The perfectly competition market.

The model of perfect competition (1) describes a market where there is a high degree of competition (…) A perfectly competitive market must possess four characteristics.
- There must be many buyers and sellers in the markets, none of whom is large enough to influence price. Buyers and sellers are said price takers. This type of market has many relatively small firms that supply goods to a large number of small buyers.
- There is freedom of entry to exit from industry. Firms must be able to establish themselves in the industry easily and quickly. Barriers to entry must therefore be low. If a firm wishes to cease production or leave the market, it must be free to do so.
- Buyers and sellers possess perfect knowledge of prices. If one firm charges a higher price than the market price, the demand for its product will be zero as buyers buy elsewhere in the market. Hence the firm has to accept the market price if it wishes to sell into the market (i.e. it must be a price taker).
- All firms produce homogeneous product. There is no branding of product and products are identical.

There are relatively few industries in the world which approximate to this type of market structure.

In agriculture there is a …………….. number of farmers supplying the market, none of whom is ………….…… enough to influence price. → ………….. ……………….

It is ………… to buy a farm and set up in business. Equally it is ………… to sell a farm and leave the industry.--> ……………………

Farmers on the whole possess ……………….. knowledge. They know what prices prevail in the market, for instance from the farming press. → …………………………

Finally, famers produce a range of ………………….. products. King Edward potatoes from one farm are indistinguishable from King Edward potatoes from another.→ …………………………. product.

In Europe and in many countries around the world, farming is in certain instances not a perfectly competitive market. This is because governments may interfere in the market, buying and selling to fix a price.

Economics, fifth edition, Alan Anderton, 2008.

(1) The model of perfect competition is an idealized market situation and not a real one. This model is based on assumptions aiming to understand mechanisms of the market.

Questions

1. Explain the four assumptions of a perfectly competitive market in your own words.

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2. Fill in the second part of the text.

3. How could governments intervene in the agricultural sector?

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Document 2: Competitive markets and uncompetitive markets.

The extent to which markets are competitive or uncompetitive is a great importance. At one extreme a market is highly competitive (…)
At the other extreme is a market in which there is no competition at all, simply because there is only one firm in the market, protected by entry barriers. Such as market is called monopoly. Monopolies can often exploit consumer, for example by hiking up the price, restricting the output they make available and also restricting consumer choice.
Real-world markets usually lie somewhere between the extremes of a high degree of competition and monopoly. In many markets, such as the market of mobile phones, real-word firm's product differ from the competitors 'products. As a result, prices usually vary for the branded products sold by each of the firms in the market. However, the ability to influence consumers in this way is not nearly so prevalent in the market for an agricultural good such as tomatoes, where large numbers of farmers produce a similar uniform product.

AS Economics, Ray Powell, 2008.

Questions:

1. Recap the four assumptions behind the model of perfect competition.

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2. Define monopoly. Give one example.

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3. Why does competitive market sound better than monopoly?

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4. From one example explain why the real-world markets are different from both the perfect competition and the Monopoly.

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Document 3: Slideshow

Is each example displayed on the slideshow a case of a perfectly competitive market?

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Sump up

Fill in the following:

Perfect competition: an …………………….. market situation in which the ……………… number of buyers and sellers possess …………… market information on homogenous product and …………… /……………enter or leave the market. In other words, the model of a perfectly competition market is based on four ……………………:

- a large number or sellers and buyers who are price …………..;
- homogeneous product;
- transparency;
- no …………….-barriers.

Price taker: occurs in a …………………… competition market when both sellers and buyers are so ……………………that each are able to buy and sell any desired quantity ………………… affecting the market price.

Monopoly: a market situation with only ………….. seller who is price ………………….

2. How to set the equilibrium price in a competitive market?

<u>Exercise 1:</u>

Buyers and sellers come together in a market. A price, sometimes called the market price is **stuck*** and goods and services are exchanged. Consider Table 1. It shows the demand and supply schedule for a good at prices between £2 and £10.

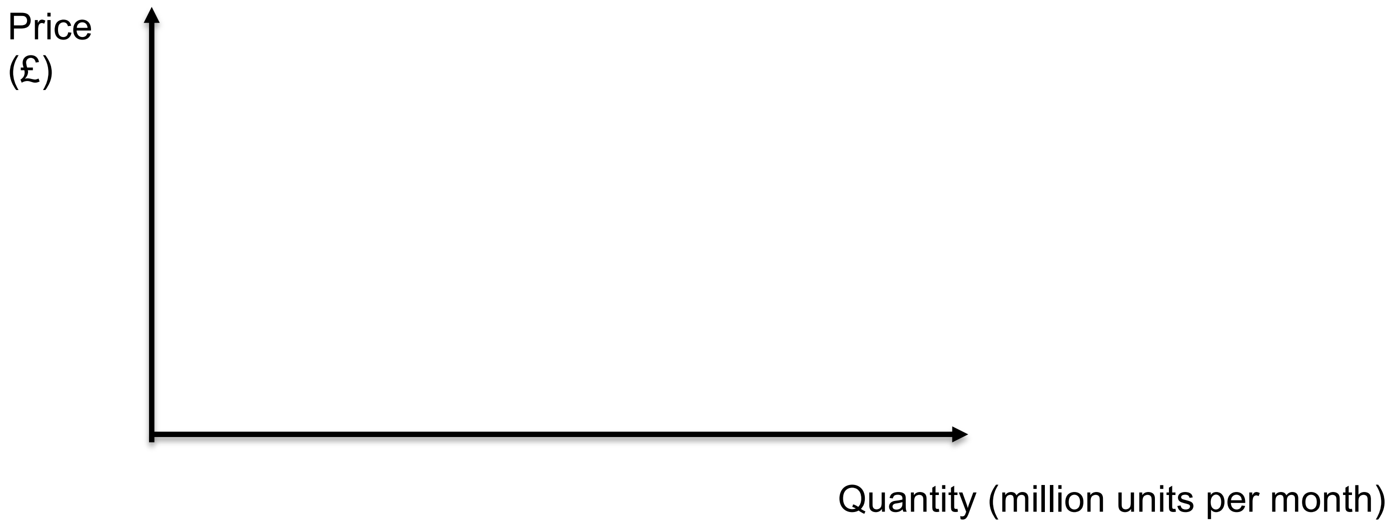
*To stick: to fix.

Table 1

Price (£)	Quantity demanded (million units per month)	Quantity supplied (million units per month)
2	12	2
4	9	4
6	6	6
8	3	8
10	0	10

<u>Step 1 : To set the equilibrium price</u>

Figure 1: Equilibrium



1. Draw the demand curve and the supply curve in figure 1.

2. Explain the shape for each curve.

3. From the demand curve shape define « normal demand ».

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4. At what price is the market in equilibrium? Why?

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5. What happens when a change in price occurs? Show the movement for each curve in figure 1. What does the change in price involve in the market?

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6. Fill in the following sentence:

The equilibrium or market clearing price is set where demand ………………… supply.
A change in price would lead to a change in quantity demanded or supplied, shown by a movement ………………. the demand or supply curve.

Extension material:

In your opinion, does the equilibrium study come from microeconomics or macroeconomics?

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Step 2 : Excess demand and excess supply.

1. According to figure 1, complete the text below:

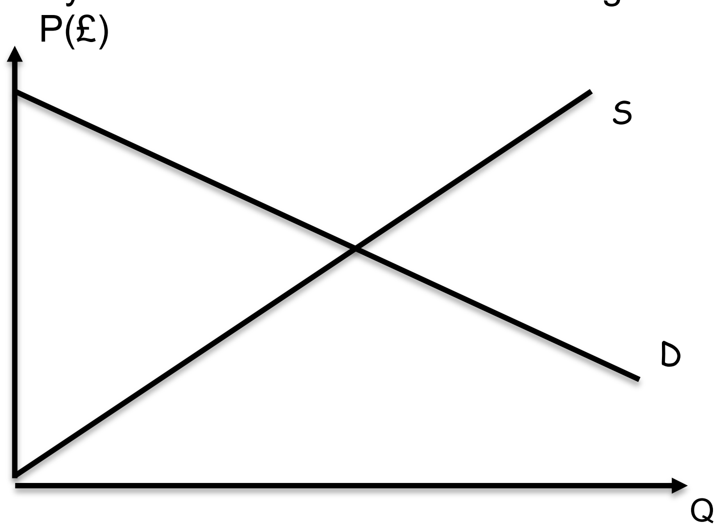
- **CASE 1** : If the price is £2, demand will be ….. million units but only ….. million units will be supplied. Demand is ……………… than supply and there is therefore **EXCESS DEMAND**, i.e., too ………..demand in relation to supply, in the market. There will be a **shortage*** of products in the market. Some buyers will be lucky and they will be **snap up*** the 2 million units being sold. But there will be a …… million unit **shortfall*** in supply for the rest of the unlucky buyers in the market. For instance, it is not possible to buy some luxury cars without being on a waiting list for several years because current demand is too ……………...

- **CASE 2:** If the price is £10, buyers will ……………. goods. Sellers on the other hand will wish to supply ….. million units. Supply is …………….than demand and therefore there will be an **EXCESS SUPPLY**. There will be a glut or surplus of products in the market. …… million units will ……………… unsold. A sale in a shop is often evidence of excess supply in the past. Firms tried to sell the goods at a higher price and failed.

- **CASE 3:** There is only price where demand equals supply. This is at price of £6 where demand and supply both ……. million units. This price is known as the ………………………. ……………………… This is the only price where the planned demand of buyers equals the planned supply of sellers in the market. It is also known as the MARKET –CLEARING price because all the products supplied to the market are …………………. or cleared from the market, but no buyer is left frustrated in his wishes to buy goods.

Help box **To snap up**: rush to obtain **Shortage**: a lack of products needed **Shortfall**: less than it's required.

2. Can you localise each case in the diagram below?



Note: in shorthand, Supply = S, Price =P, Quantity = Q, Demand = D

Step 3: Changes in demand and supply

It was explained in the previous step 1 that a change in price would lead to a change in quantity demanded or supplied.

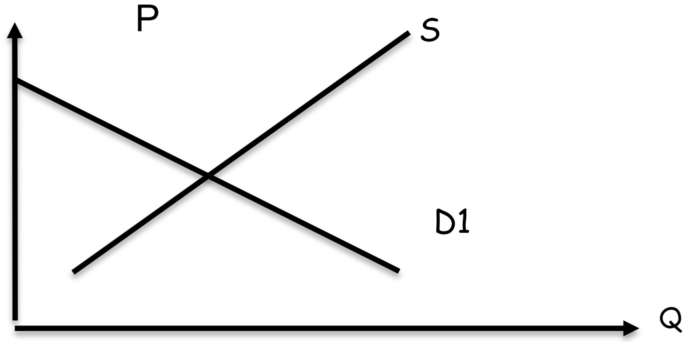
A change in any other variable, such as income or the costs of production, would lead to an increase or decrease in demand or supply, therefore a shift in the demand or supply curve.

Exercise 2:

EXAMPLE 1: The effect of a rise in consumer incomes.

1. What does a rise in income involve in the demand for a normal good? Show this change in the diagram below:

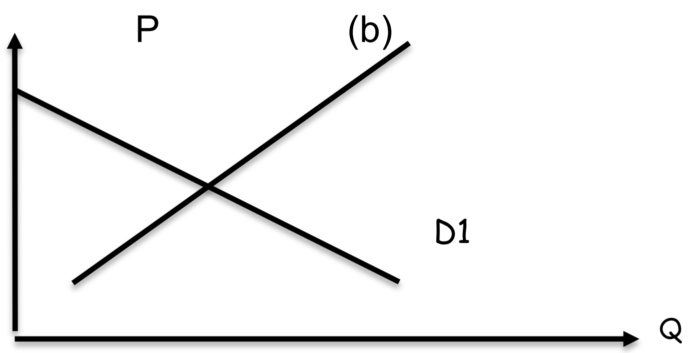
(a)



2. According to the results in the diagram (a) fill in the text:

A rise in income lead to push the demand curve from …… to ……. As can be seen from the diagram, the equilibrium price ………… from P1 to P2. The quantity bought and sold in equilibrium ………… from Q1 to Q2. The model of demand and supply predicts that an increase in incomes, all other things being equal (the ceteris paribus condition) will lead to an ………………… both in the price of the product and in the quantity sold. Note that the increase in income shifts the demand curve and this then leads to a movement …………… the supply curve.

3. Conversely, what does a fall in income involve in the demand for a normal good? Show this change in the diagram (b):

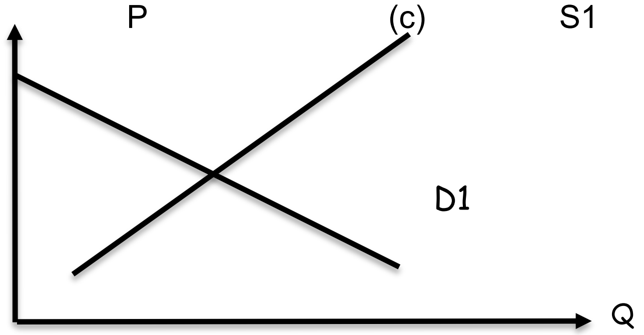


Sum up and write down the comment about diagram (b):

EXAMPLE 2: The market of televisions in the early 2000s.

In the early 2000s, many manufacturers introduced flat screen, slim line televisions.
As a result, there was a boom in sales of these televisions and a slump in sales of older, more bulky set. In economics terms the demand for older, bulky sets……….

1. Draw the new demand curve for older, called D2, showing this shift in the diagram (c):



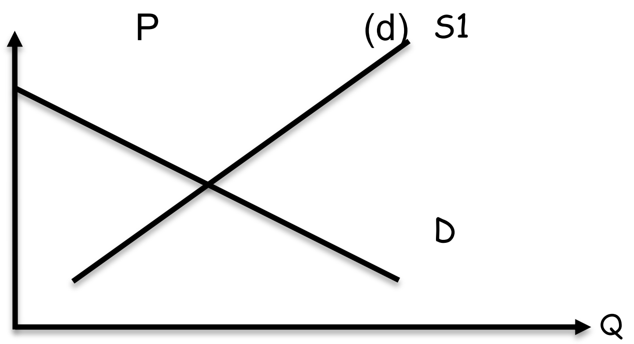
2. From the diagram fill in the text:

The equilibrium level of sale in (b) ………… from ………….. whilst equilibrium price ………………from ………….. Note again that a shift in the demand curve leads to a movement along the …………….. curve.

EXAMPLE 3 : a fall in costs of production

Prices of many models of television set tended to fall in the 1970s and 1980s. The main reason for this was an increase in productive efficiency due to the introduction of new technology, enabling costs of production to fall.

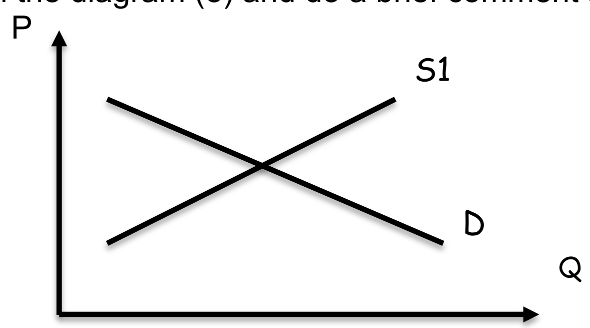
1. What is the shift of the supply curve when a fall in costs of production occurs? Draw this shift in the diagram (d):



2. From the diagram (d) fill in the text:

At any given quantity of output, firms will be prepared to supply ……………. television sets to the market. The result is an …………………….in quantity bought and sold from ….. to ….. and a ……..in price from …….. to ……. Note that there is a shift in the supply curve which leads to a movement along the ………………….. curve.

3. What is the shift of the supply curve when an increase in costs of production occurs? Draw this shift in the diagram (e) and do a brief comment about it.



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