Market equilibrium essay sample

Finance, Market

Market equilibrium is a situation where at a certain price level, the quantity supplied by producer and the quantity demanded by consumers are equal. It is a situation where there is no tendency for change in either price of product or quantity supplied and demanded. This situation is brought about by forces of the price mechanism, the interplay of demand and supply market forces.

The situation of market equilibrium is represented by the above figure. Where the two curves of demand and supply intersect at Pe, the equilibrium price Pe and the equilibrium quantity Qe is established. Any other price level other than that of Pe would result in either excess supply or excess demand, which would then lead to the price mechanism equilibrating the market again through interaction between forces of supply and demand.

At price level OP1, the quantity demanded is OQ2, which exceeds the quantity supplied OQ1. This means that there is excess demand in the market, because not enough of the product is supplied to consumers to satiate demand. In this situation, the quantity that the consumers demand exceeds the quantity supplied, and so it would be expected that this would put pressure on the price of the commodity to go up. This upward pressure arises from the limited quantity of supply available to consumers, and so they bid up the price in an attempt to secure the limited quantity of the product. The law of supply states that as the price goes up, the quantity supplied will also increase. So the S curve in the figure would experience an expansion, pushing it towards the right as the price goes up.

The law of demand states, however, that when price goes up, the quantity demanded goes down. The D curve experiences a contraction as the price

goes up, and eventually when the price reaches Pe, the quantity supplied OQe will be equal to the quantity demanded OQe. Consumers would stop bidding up the price at this point, stopping the increase in supply and decrease in demand, keeping quantity demanded and supplied at the same level whilst price remains constant. At this point, market equilibrium is reached.

At price level OP2, the quantity supplied OQ2 exceeds the quantity demanded OQ1. This situation of excess demand is called an oversupply, or glut. At this price point, supply is larger than demand. Firms would lower the price of the good using marketing techniques like specials, sales in order to try to raise demand. By doing so, the price level would decline towards OPe, bringing about an expansion in the demand curve towards OQe because consumers will demand more of the product if the price is lowered. The supply curve contracts towards OQe in response to the price drop, because firms supply less if the price is lowered. At price point OPe and quantity OQe equilibrium is reached.

It can be seen that any surplus or shortages of supply and demand are only temporary, because the imbalanced match between supply and demand will lead to a change in price, which works to move the market towards the equilibrium position through the changes in quantity supplied and demanded brought about by the change in price.

Sometimes, however, market determined equilibrium price and quantity may be considered unsatisfactory. This is because the price mechanism adjustments only consider the costs and benefits of production to supplier

and consumers, not taking into account impacts to outsiders. For example, firms increasing production to equilibrate quantity of supply with rising prices, but failing to acknowledge the impact of pollution on the environment.

When the free market outcomes of equilibrium price and quantity are found to be unsatisfactory, the government may intervene in the market to create changes to the equilibrium, adjusting the levels until a satisfaction is reached.

When the market determined equilibrium price of water at $2, is considered too high, as seen in the above figure, the government may choose to implement price ceilings, which are restrictions to how high the price of the commodity can rise. In this case the price ceiling is at $1, in order to protect low-income families. This leads to quantity demanded OQc exceeding quantity supplied OQp, creating a disequilibrium.

In this figure, the product being represented is wool. The market determined price of $4 is considered by the government as being too low, and it decides to impose a price floor at $5 to protect the wool farmers, resulting in an increased supply of wool to OQp, which exceeds the market demand of OQc. This creates disequilibrium.

In both cases, a disequilibrium is created through the intervention of the government due to the equilibrium price being either too high or too low. The government may further intervene to solve this disequilibrium. In the case of drinking water, the government may choose to subsidise the

production of drinking water, which will lead to suppliers increasing production of drinking water to OQc at the same price level, solving the problem of excess demand. In the case of wool production, the government may enter the market as a buyer to alleviate the surplus supply problem. It can be seen that the government functions as a regulator of market price, and also alternates between supplier/consumer in order to solve the problems of excess demand or supply through entering the market as a buyer or subsidising production.

The social costs and benefits, or externalities of production are often not considered by individual business firms and consumers. As mentioned before, pollution is one of the negative externalities, and the government may intervene with markets that have negative externalities through placing laws that restrict production of such goods. Similarly, services with positive externalities like public transport are encouraged by the government through subsidisation. These goods are sometimes referred to as merit goods, and the government intervenes to assist because these services are often less profitable.

Also, public goods like the defence force, police force and roads are available to everyone. But because consumers get the benefits of such service whether they pay or not, it’s not likely that they’ll pay voluntarily for those services. In this case, the government finances these services with taxation taken from the consumers.

In conclusion, the price mechanism is effective at resolving basic market issues like how much to produce at a price level, and determining the

equilibrium. However, the price mechanism does not take into account externalities, so its possible that unsatisfactory outcomes, or market failure can occur. In these cases the government may intervene to solve the problem through methods like implementing price ceilings and floors, although it may not maximise benefits to both producers and consumers.