

What actions might
be taken limit price
fluctuations?



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Title: Distinguish between price elasticity of demand, cross elasticity of demand and income elasticity of demand. What actions might be taken by countries and companies to reduce or limit price fluctuations? Class:

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Word account: Introduction: Nowadays in modern developed market change in prices and other factors are very expected. The change in one of the factors for instance price and effect of it on another factor like demand or supply are measured by elasticity. Elasticity is the measure of how the change in one of the factor will be affected on the other factors.

Elasticity measures extent to which demand will change. Measure easily can be calculated in percentage (Anderton 2008). After a calculation of elasticity, it's divided into three types which are classified by values of elasticity: perfectly elastic-infinity; elastic - if value is greater than one; perfectly inelastic- equals zero; inelastic - if the value of elasticity less than one; unitary elasticity - if the value is exactly one (Anderton 2008). There are four basic types of elasticity measure: Price elasticity of demand; Income elasticity of demand; Cross elasticity of demand and Price elasticity of supply.

In this essay will be discussed types of elasticity and government intervention in the open market, benefits and negative impacts (Anderton 2008). Note: New quantity demanded - \hat{Q} ; New price - \hat{P} ; Original Demand - Q ; Original Price - P ; Percentage change in quantity demanded - $\%Q$; Percentage change in quantity of supply - $\%S$; Percentage change in Price - $\%P$ Formula: $P \text{ (times) } \hat{Q} \text{ (over) } Q \text{ (times) } \hat{P}$ Price Elasticity of Demand: Price Elasticity of Demand or also known as Own Price Elasticity of

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Demand (PED), measures the responsiveness of change in quantity demanded to change in price.

The formula is: percentage change in quantity demanded over the percentage change in price. PED has - (negative) sign in front of it; because as price rises demand falls and vice-versa (inverse relationship between price and demand). Determinants of PED are the availability of substitutes and time. PED have some links with changes in total expenditure (Anderton 2008). Example: After increasing price from P1 to P percentage change in price was 10, demand for good X is decreased from Q1 to Q and percentage change in quantity demanded is 60, what is price elasticity of this good?

Solution: Formula is $\%Q / \%D$, so $60/10 = 6$. PED is greater than one so its elastic good. Elastic demand curve of the Good X Price P P1 0 Q Q1 Quantity
Income Elasticity of Demand: Changes in real income of individuals can change the spending pattern of consumers. For instance if the consumer use to buy ketchup made by supermarket which is Normal good, after the increasing of income he can buy a Heinz ketchup so, Heinz will come as normal good, and the ketchup of supermarket production will be inferior good (Anderton 2008).

This change measured by Income Elasticity of Demand (Anderton 2008). The formula is percentage change in quantity demanded over percentage change in income. If the answer will be positive sign it means its normal good; if negative sign, inferior good. Difference between inferior good and normal is by their income elasticity of demand. For instance holidays and recreational activities are with high income elasticity of demand, whereas

washing up liquid have a low income elasticity of demand. If the value of income elasticity is lies between +1 and -1 so its inelastic.

If it greater +1 or less than -1 so it is elastic. Example: Demand for housing increase by 10 per cent, simultaneous income of consumers rises by 5 per cent. Calculate income elasticity of demand. Solution: Formula is percentage change in quantity demanded over percentage change in income, so $10/5 = 2$. The value of income elasticity of demand is greater than one, so it is elastic. Cross elasticity of demand: As it knows change in price of good can affect change in demand of that good. However, if the goods are substitute or complements, the change of price in one of them, may lead to change in another.

Cross elasticity of demand measures this kind of changes (Anderton 2008). Good which are substitutes will have a positive cross elasticity, and if goods are complement, it will have a negative cross elasticity. If the goods have a small relationship between each other the may have a zero cross elasticity. For instance a rise in demand for luxury cars, likely may have no effect on Tipp-Ex. Demand is cross elastic if it is between +1 and -1, if cross elasticity is greater than +1 or less than -1, then it is elastic.

Example: Price of macaroni was increased by 10 per cent. Quantity demanded for cheese was increased by 20 per cent. What is cross elasticity of demand. Solution: The formula is Percentage change in quantity demanded of Good X over percentage change in price of Good Y. So, $20/10 = 2$. Value is greater than one, so it is elastic. Price elasticity of supply: Also can be measured the responsiveness of quantity supplied to changes in

price, this is called Price Elasticity of Supply (Anderton 2008). The formula is: percentage change in supply over percentage change in price.

The curve of supply is upward sloping; it means an increase in price leads to an increase in quantity supplied. An elasticity of supply equal one can have a straight line which passes supply curve. For instance if the price of shoes goes up, producers to make more profit produce more shoes which leads to increase the supply. Example: The percentage change in price is 10, the percentage change in quantity supplied is 20. Calculate the price elasticity of supply. Solution: $20/10 = 2$, so product is elastic. Elastic demand curve of the Good X P P1 Price / Q Q1 Quantity The prices of commodity goods are going up and down. The reason of price fluctuation is changes in supply or demand. Equilibrium in price find when supply and demand will intersect each other. The change in one of them will cause price fluctuate. For instance the problem with supply may cause poor harvest or loss in production. Change in demand can be caused by change in technology, income or substitutes (Parkin 2010). Mostly in agricultural or commodity markets there is large price fluctuation in price in very short time.

This can give negative impact on producers, for instance they may have over or under production in short term; or calculate over or under investment in long terms. Also prices can be too high for essential goods, like bread or rice, problem with this goods can cause a disorder in country caused by young adults which not satisfied with high prices, similar situation was in Egypt in 2011. On the other hand prices can be too low, for instance cigarettes, its generally known that smoking harms health, governments to protect citizens

making new rules, for which they spend money, for that reason it can make negative impact on governments economic.

Another example can be farmers, if the incomes of farmers will be too low, they can leave the land and stop production, so governments needs to decide to increase their incomes (Parkin 2010). Although there is also other motives of intervention government to market. Government can intervene market for benefits of their citizens or themselves. For instance, Organization of the Petroleum Exporting Countries or OPEC, this organization is a group of countries which sets prices high in long term to increase their revenues (Parkin 2010). By the way theoretically it can increase living standard of citizens that country.

Stable prices: The reason why stable prices are important for companies or government is that big firms can have a plan on a long term basis; if consumer spend on one good more than on another it may cause problem for other part of economy of country. Governments of each country decide how to reduce or limit fluctuation. There are few ways that government can equalize the price and keep it stable. For instance: maximum/minimum prices; encourage the development of substitutes; establish buffer stock; use of subsidies; devote more factor resources; export bans or changes in import tariffs.

Now will be discussed they ways of intervention with the positive and negative sides. Maximum prices: Government can intervene market and set up new maximum price which will be lower than previous to help consumers in short term be available to purchase that good. In long term it can cause problem, because consumer will demand more, but sellers will supply as <https://assignbuster.com/what-actions-might-be-taken-limit-price-fluctuations/>

usually, so there may be arise problem with excess demand. Minimum prices: Minimum prices are usually to help producers increase their incomes.

Negative impact of this change is that consumers can react on higher price of good, and decrease the demand, so in the end there will be excess supply (Parkin 2010). However, there is two solutions for excess supply. One of them is to buy the extra production by the government and sell it back in low prices, sale it to farmers for their animals, offering it to those who in need this good in EU or to sell it to Third World countries at rock bottom prices (Parkin 2010). Another way to solve it is to restrict the production. The government can force the farmers to leave the part of their land uncultivated(Parkin 2010).

This can lead to shifting the supply curve to the left. Reducing output to achieve higher prices is the way in which OPEC works(Parkin 2010). New substitutes: Government can encourage new substitutes. For instance substitutes for coal energy can be solar energy or wind energy (Parkin 2010). New substitutes can increase supply, by shifting it to the right and decrease the price. These substitutes at beginning need a lot of investment. They need to be invested in long term to keep it working. Also there is other factors which can decrease or increase spending.

For instance if it is dusty country government need to keep clean the solar energy equipment. So there is needed machinery and people who will keep it clean in every period that needed. Buffer stock: Buffer stock is an organization which buys and sells goods in the open market to stable price in the market. If the price of goods goes down, buffer stock, buys the goods for stabilizing price, if the price goes up, buffer stock sells good, to take price
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down. The way buffer stock theoretically seems to be easy in practise, but actually it needs a lot of investment (Sloman 2006).

First needs in money is for the goods that must be bought in market. Secondly goods must be stored at condition that can keep it over long time for use. For instance rice must be kept in place with access to fresh air in +15 +20 temperature. Thirdly goods must be under security. On the other hand, theoretically buffer stock can bring profit, because the goods are bought in low market price where was intervention and sold below the intervention. This is mostly with primary products, such as gold, tin and agricultural-wheat and beef. This mainly due to supply side influences.

For instance demand and supply for canned tomatoes can be staying same for long term, nearly one year. If there excess in supply, canned tomatoes can be stored, if demand increase they can sell from stored. However, this is different for fresh tomatoes, for instance supply in summer time is great and price relatively low, but in winter time the supply is low and prices are high. Example for intervention of buffer stock on market can be olive oil. In European Union there is excess supply and prices of oil going down. Farmers are disappointed because they lose profits. European Union decided to buy olive oil for 24\$ million dollars.

Use of subsidies: Government to stabilize the price can use of subsidies. Subsidies is the money which is granted to producers to reduce the production, or to decrease the price. For instance producers of the rice have excess supply over long term which leads to decreasing the price. Next time government gives money for farmers to leave a piece of land uncultivated so there will be no excess supply. The different interventions are likely to be:
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The different interventions are likely to have some advantages and disadvantages. Government should make a research before starting intervention on market (McDowell 2012).

It must be taken into account every question which can be come up in realisation of the project. For instance before encourage new substitutes how it can effect market, is it effective, or how much needed investment for start-up. All this question must be seem from every sides so in the future there will not be problem. Bibliography: Anderton, A (2008). Economics Fifth Edition AQA. 5th ed. Essex: Pearsoneducation. P30-132. McDowell, M. (2012). Economics. London: McGraw-Hill Higher Education. p45-62. Parkin M. (2010). Economics. 9th ed. US: Pearson. p56-60. Sloman, J. (2006). Economics. 6th ed. London: Financial Times Prentice Hall. p89-104.