Invisible hand and market equilibrium

Literature, Russian Literature

1. For most goods and services, income elasti of demand tends to be smaller in the short run than in the long run. However, a recent study shows that the demand for a durable good such as automobiles tends to be more income-elastic in the short run than in the long run. Explain why.

The reason why automobiles are income-elastic in the short run is because there are very few alternatives available. Automobiles are a necessity, so consumers would rather stick with them in the short term rather than having to find an appropriate substitute. Also, because automobiles are so expensive (i. e. thousands of dollars), a change in price is likely to go unnoticed in the short term. After a long time, consumers will likely find alternative means of transport, such as buses and trains.

2. Explain how the " invisible hand" makes sure that markets reach equilibrium more quickly than they would if the government sets prices for goods.

In capitalist economics, market forces determine the prices of goods and services. The invisible hand determines the prices of goods and services based on the supply and demand at the time. If the government set prices for goods, then this would slow down growth in the economy. The invisible hand can force markets to equilibrium much faster than the government can. Governments that run economics are often inefficient because they cannot keep up with market forces.

3. Why are some long-run average cost curves steeper on the downward side than others?

The reason why some long-run average cost curves are steeper on the downward side is due to economies of scale. Larger firms try to maximize production output, so the curve would be more positive and steeper than normal. The average fixed cost curve would fall as a larger firm could produce more output. Overall, this would reduce the average fixed cost per unit.

4. Explain the relationship between average fixed cost and marginal cost.

Marginal cost is the cost to produce one more item, while average fixed cost is the total cost divided by total production. These two are linked because marginal cost decreases as the average fixed cost also decreases. This is because fixed cost remains the same no matter the production output, so producing more units reduces the average fixed cost overall. Marginal cost also decreases because while variable cost would go up, the total fixed and variable cost would be divided by more units, thus reducing marginal cost.

5. Explain why a firms shut-down decision does not incorporate the fixed costs of the production facility.

A firm usually chooses to shut down when revenues do not cover the variable costs associated with production. Fixed costs are not considered because they have to be paid regardless of whether the firm is producing anything or not. Just because a firm chooses to shut down does not mean that they will go out of business; they are just temporarily suspending production. If and when the firm decides to resume production, all of the fixed costs will carry on as normal.

6. Firms in the long-run do not experience diminishing marginal returns. Then why do some industries have upward-sloping long-run supply curves?

Because the marginal cost increases, some industries have upward-sloping long-run supply curves even they do not experience diminishing marginal returns. The law of diminishing marginal returns says that for each new worker that is introduced to the workplace, their overall output will be less than the employees already working there. Because a firm can only produce so much, if there are too many workers then this decreases the average output of each worker. Due to economics of scale, some firms that are monopolies can increase the supply of labor, and will lessen total output in the long term. As a result, the supply curve slopes upward.

7. Explain why perfectly competitive firms make zero economic profit in the long run.

In the long run, some firms will exit the market because they are making a loss while new firms will enter the market if there is a profit to be made. Once these balance out, every firm’s profit will be zero because of the competition of other firms. In the short term, if there are some firms that are earning profits, then new firms will enter the market and all firms’ profit will decrease to zero. If some firms are not making a profit, then they will have to alter their strategies or exit the market. Once all firms are making zero economic profit, then there will be no firms that leave the market and no new firms entering the market, thus achieving a perfectly competitive market.