

Examination of the operation of the market economy



**ASSIGN
BUSTER**

Economies have to find a mechanism to allocate scarce resources because of the economic problem. The What, How, For Whom questions are central to the operation of this mechanism. To recap from the economic system lesson, the mechanism used by different systems: Command economy: Planning mechanism as dictated by the state Free Market economy: Price mechanism as dictated by consumer spending Mixed economy: A mixture of state planning and the market mechanism.

Central to this module is an examination of the operation of the market economy, and how the price mechanism works to answer the what, how and for whom questions. Market: a mechanism which brings buyers and sellers together to trade if they are both happy. Different types of markets can exist, all operating along the same principles: Product: the market for goods, eg market for oranges Factor: the market for resource inputs, eg the labour market Capital: the market for finance, eg the market for bank loans

We will start off with examining the operation of a competitive market, where the buyers and sellers trade under equal conditions, and look how the price mechanism works to influence resource allocation. The essential role of prices is to transmit information to different agents in the market place. Changes in price will result from changes in supply and demand conditions and will signal information about the state of the market which will influence the allocation of resources.

On the consumer side, changes in price perform a rationing function, transmitting information to them about whether they can afford to buy a product and how much they could buy at a particular price with a <https://assignbuster.com/examination-of-the-operation-of-the-market-economy/>

given amount of income. If the price of a product were to rise, consumers would be rationed out of the market, because their spending power would go down, ie they could not buy as much with a set amount of income. Conversely, if prices fell, consumers would be rationed into the market because their income could buy more goods.

On the producers side, changes in price perform an incentive function, signalling to them whether they should produce more or less of a good. If prices rise, a signal would be sent to producers to make more (meaning allocating more resources to the production of the good) with the aim of earning more profit. Conversely a fall in price would discourage production reducing the amount of resources allocated to that good, since profits would be assumed to be falling. Consumer sovereignty: in a market economy consumers will have the power to influence resource allocation.

Their spending decisions will send signals to the producers about what goods to produce and how many to produce. All this will be done through the workings of the price mechanism, eg Consumers decide to buy less carrots. This fall in demand will result in falling prices. In response to falling prices, producers will see reduced profits and will allocate fewer resources to the growing of carrots. If consumers decide to buy more peas, prices of peas will rise and this will encourage producers to allocate more resources to pea production.

Therefore the spending patterns of consumers will dictate to producers what they will make, since their motive is profit, and they will not make any if they produce goods which consumers do not want. Reference: http://www.oocities.org/sutcoleconomics/how_markets_allocate_resources.htm Due to the <https://assignbuster.com/examination-of-the-operation-of-the-market-economy/>

market system and the price mechanism that is the forces of supply and demand there may be several factors to consider when determining why individuals prefer this particular market system as appose to other methods of allocating and distributing resources in an economy.

It is to ones belief that the economy under review may be classed as a market economy if there is price determination through the market forces as well as the possibility of government intervention. For this there may be several reasons as to why people believe that the market system may be the better mechanism for allocating recourses in an economy. Fundamentally, the market system thrives on price determination through the forces of supply and demand, which is resources are distributed through the price mechanism which in turn is determined by the forces of demand and supply for these resources.

More over under this type of economic system, government interference in the economy is kept to an absolute minimum as emphasis is placed on the freedom of the individual. Thus in such a market it would be safe to say that a positive investment climate is more or less dependent upon the individual.

References: <http://essaysforstudent.com/Business/Reasons-People-Believe-Market-System/81590.html> Why do some people believe that the market system is the best mechanism for allocating scarce resources and thereby encouraging a positive investment climate?

Explain your answer There are three different types of ways of allocating scarce resources which are pure market economy, pure command economy and mixed economy. Some people believe that the free market is the best mechanism for allocating scarce resources. A pure command economy is an <https://assignbuster.com/examination-of-the-operation-of-the-market-economy/>

economy in which the government makes all allocation decisions and answers all three questions of allocation. A mixed economy is a mixture between markets and the government making decisions on allocating resources. A pure market economy is markets that alone allocated the resources of land, labour and capital.

The Government also have no role in resource allocation. A pure market economy also has price determination, thus bringing supply and demand into balance. Advantages of a pure market economy is that buyers are free to buy what they like in whatever amount they wish, the biggest advantage that the free market has is the determination of price, determined by the demand and supply, the decision of what to produce and in what quantities is taken by the free market and is not determined by the state. This is why it is believed to be the best way of allocating scarce resources.