# Purpose of economics and price mechanisms

ASSIGN BUSTER

Task 1

1. Describe ' economics', the purpose of its activities and identify economic problem.

Economic system is a system aim for producing, distributing and consuming goods and services. It includes the combination of the various institutions, agencies, consumers, entities that comprise the economic structure of a given society or community. Furthermore, it also includes how these agencies and institutions are related to each other, how information flows between them and the social relations within the system which including property rights and the structure of management. The mode of production will be the related concept.

Every economic system provides solutions to four questions: what goods and services will be produced; how they will be produced; for whom they will be produced; and how they will be allocated between consumption (for present use) and investment (for future use). In a devolved economic system, these questions are resolved. This lead to economic coordination to achieved through the price mechanism(Elton, 2014).

The basic economic problem is aboutscarcityandchoicesince there are only a limited amount ofresourcesavailable to produce the unlimited amount of goods and services which human, people wants and needs. Because of scarcity, various economic decisions must be made to allocate resources efficiently.

Resources

A resource is a means of support also can be regarded as any feature of our environment that helps to support our well being. There are three main types of resource:

- The first Physical or natural resource – such as oil, climate, water, minerals, forests and fisheries.
- The second human resource – peoples and their various skills. The third man made resources – e. g. machines, equipments.

Scarcity

Scarcity can be broken down into four key ingredients of factors of production:

- Land – Land includes all natural resources.
- Labour – Labour includes all physical and mental effort.
- Capital – Capital includes machinery and other items that go into further production.
- Enterprise – enterprise is the art of combining the other three factors in the production process.

Scarce goods and services

As notes above, if did not exist, all goods and services would be free. A good is considered scarce if it has a non-zero cost to consume costs something and is scarce. By consuming one good, another good is foregone. Therefore decisions and trade-offs to be made.(T. Ming, 2014,)

The cost of a food is a signal of its scarcity. One good maybe more scare than another, either because of limited resources or higher want (demand) for that good.

Choice

Because resources are scarce and most of our wants are extensive, a choice has to be made about how to use scare resources in the best way. Based on the choice, the highest-value option will be forgone and this is called ' opportunity cost'. This rule applies to organisations, society as a whole, and to individuals.

Choice and opportunity cost

Choice and opportunity cost are two fundamental concepts in economics. Given that resources are limited, producers and consumers have to make choices between competing alternatives. All economic decisions involve making choices. Individuals must choose how best to use their skill and effort, firms must choose how best to use their workers and machinery, and governments must choose how to use taxpayer's money. Making an economic choice creates a sacrifice because alternatives must be given up, which results in the loss of benefit that the alternative would have provided. Similarly, land and other resources, which have been used to build a new school could have been used to build a new factory. The loss of thenext bestoption represents the real sacrifice and is referred to asopportunity cost . The opportunity cost of choosing the school is the loss of the factory, and what could have been produced.

It is necessary to appreciate that opportunity cost relates to the loss of the next best alternative, and not just any alternative. The true cost of any decision is always the closest option not chosen. (Bong, 2014)

2. Define the theory of ‘ price mechanism’ by Adam Smith and illustrate by examples(s) to supports yours answer with relevant issues.

Adam Smith is one of the Founding Fathers of economics described the “ invisible hand of the price mechanism” in which the hidden-hand of the market operating in a competitive market through the pursuit of self-interest allocated resources in society’s best interest. It was the notion of the invisible hand that enabled Adam Smith to develop the first comprehensive theory of the economy as an interrelated social system. (Tay, 2014)

In common, the concept is composed of three logical steps:

The first is the observation that human action often leads to consequences that were unintended and unforeseen by the actors. The second step is the argument that the sum of these unintended consequences over a large number of individuals or over a long period of time may, given the right circumstances, result in an order that is understandable to the human mind and appears as if it were the product of some intelligent planner. The third and final step is the judgments that the overall order is beneficial to the participants in the order in ways that they did not intend but nevertheless find desirable.

The price mechanism performs three main functions:

Rationing

The aim is to ration scare resources when demand in market outstrips supply. When there is a shortage of a good, the price is bid up, leaving only those with the willingness and ability to pay to purchase the product. This can causes supply and demand to reach equilibrium of demand and supply.

Signaling function

They adjust to demonstrate where resources are required or not, via a change in demand.

For example, the price of goods which are scarce will increase. This increase in price should provide an incentive for producers to increase production of the good so that can meet the demand.

Transmission of preferences

Consumers are able to alert producers to changes the nature in wants and needs through their choices so that the market provides the right amount of the right goods. When demand is weaker, then the supply will contracts as the producers cut back on output.

Task 2

1. Identify factors affecting the economics of an organization.

There are few types of competition in business. They are perfect competition, imperfect competition, and monopolistic competition.

Perfect competition

It is a low barrier to entry, many choices by consumers, and no business has supremacy. It means that many companies competing and nobody has a

substantial lead. For examples, restaurants, grocery stores, barbers shop, shopping mall, professional services such as dentist, doctor, contractor and others. It is a theoretical state in which not only single buyer or seller has influence over the any products sold in the market. Sellers are free to enter the market to sell any product and buyers are free to purchase any product wanted. A large number of producers and sellers operate in the perfect competitive market, and the products sold by one producer are easily replaced by a similar product from another producer. Prices for goods or services would be established by the rate in majority of consumers are willing to pay and producers will adjusting the productivity to balance with the price. (ReemHeakal, 2014)

Imperfect competition

It describes a market where many firms offer variations of the same product or multiple products are offered with differences. The difference may be differs in quality, preference, durability, price or utility. However, firm will be forced to departure the market if their products are not purchase by consumers. For example, a hair style cutting may be assisted by more than numbers of barber shops which all differing in style, price and environment. Consumers are bound only by personal preference and affordability in choosing a barber shop. (Hans, 2014)

Monopolistic competition

The sellers feel they do have some competition. There is one big company dominating the market with a few medium or smaller sized companies.

2. Identify source of finance.

Source of finance

Some sources of finance areshort termand must be paid back within a year. Other sources of finance arelong termand can be paid back over many years.

Venture capital provides long-term, dedicated share capital to help unquoted companies grow and succeed. Obtaining venture capital is significantly different from raising debt or a loan from a lender. The lenders have a legal right to interest on a loan and repayment of the capital depends on the business weather success or failure. Venture capital is the money put into an enterprise which may all be lost if the enterprise fails. A businessman starting up a new business will invest venture capital of his own, but he will probably need extra funding from other source, and can be very successful if he gets very high profits and a substantial return on the investment. However, there must be a very high risk of losing the investment and it will take some times to get the return and profits. A venture capitalist will require a high expected rate of return on investments, to recompense for the high risk.

Internal sourcesof finance are funds found inside the business. For example, profits can be kept back to finance expansion. Alternatively the business can sell assets that are no longer really needed to free up cash.

- Internal Sources of finance and growth

It defined as organic growth which is the growth generated through the development and expansion of the business itself. An organic growth can be achieved through generating increasing sales which increase income to influence on overall profit levels. Besides that, it can be used of retained

profit which used to reinvest in the business. Other than that, the company also can sale their asset which can be a double edged sword so that it can reduce the capacity.

External sourcesof finance are found outside the business, eg fromcreditorsor banks.

- External Sources of finance and growth

This can be categorizing into 3 groups which are long term, short term, and inorganic growth. Long term may be paid back after many years or not to be paid. Short term is used to cover variations in cash flow. The growth which generated by gaining is used to define inorganic growth. In long term, there are shares and loans can be practice.

Long term

There are few types of shares in long term shares which are ordinary shares, preference shares, new share issues, rights issue and bonus or scrip issue.

- Ordinary shares (Equities)

Ordinary shareholders have the voting to rights in making any decision for company’s benefits. The dividend can be differing according to their contribution and share capital. Last to be paid back in event of collapse. They share the price varies with trade on stock exchange.

- Preference share

The shareholders will be paid before ordinary shareholders. They have the fixed in return. It is cumulative preference shareholders which have the right to dividend carried over to next year in event of non-payment.

- Rights issue

The present shareholders are given discount on buying new shares. Bonus or scrip issue- It is the change to the share structure which increase number of shares and reduces value but market capitalization will remain the same. There are few types of loan in long term loan which are Debentures, bank loans and mortgages, merchant or investment banks, and government.

- Debentures

It has the fixed in rate of return which first to be paid. Bank loans and mortgages- It is suitable for small to medium sized of corporation where property or some other asset acts as security for the loan.

- Merchant or Investment Banks

It act depends on clients to organize and underwrite raising finance.

Short term

There are some categories in 5 groups including bank loans, overdraft facilities, trade credit, factoring and leasing.

- Bank loans

It has the necessity of paying interest on the payment. The periods of payment is generally from one year then not longer than ten years.

- Overdraft facilities

It is the right to be able to withdraw funds that do not currently have. It provides flexibility for a firm. The interest only paid on the amount been

overdrawn. There is an overdraft limit which is the maximum amount allowed to be drawn.

- Trade credit

It can help the ease of cash flow which commonly can be paid within 90 days.

- Factoring

It is about the sale of debt to a specialist firm who secures payment and charges a commission for the services.

- Leasing

The used of capital can be secure without the ownership. It is effectively a hire agreement.

Inorganic growth

It is about achievement. The components to gain the external finance of inorganic growth are merger and also takeover.

- Merger

The Company agrees to join together which both can remain some of the identity form.

- Takeover

The firm will be secure control by the other, the firm taken over most probability will lose its identity.

Task 3

1. Identify and describe types of financing sources which available for the said projects.

On my opinion, this company should base on medium and long terms sources of finance. Medium termsources are usually repaid between 1 – 5 years. Some sources of finance areshort termand must be paid back within a year. Short term sources are repaid within one tear. Other sources of finance arelong termand can be paid back over many years. Long term sources are usually repaid between 5 – 20 years.

Medium term

Hire purchase: It involves purchasing an asset paying for it over a period of time. Usually a percentage of the price is paid as down payment and the rest is paid in installments for the period of time agreed upon. The business has to pay an interest on these installments.

Leasing: Leasing involves using an asset, but the ownership does not pass to the user. Business can lease a building or machinery and a periodic payment is made as rent, till the time the business uses the assets. The business does not need to purchase the asset.

| Advantage | Disadvantage |
| --- | --- |
| • The business can benefit from the asset without purchasing it.<br>• Usually the maintenance of the asset is done by the leasing firm. | • The total cost of leasing may end higher than the purchasing of ass |

Medium term loans: The business borrows an agreed amount, which is advanced at the start of the loan. A repayment schedule between one and five years is agreed. Interest is charged in line with general interest rates and the category of the borrower is taken into consideration. The business will normally have to provide security for the loan but, with the cash raised, they can avail of cash discounts when buying assets.

Leasing: This form of finance allows a business to use an asset without having to raise the full price. In essence, the business rents the asset from a financial institution. The advantage to the business is that it allows the business claim a tax deduction for the full leasing payments over the life of the lease. The downside is that the asset is not owned unless the business decides to buy out the lease. Leasing is appropriate for IT equipment, which may have to be changed every two to three years

Long term

Ordinary sharesmay be issued to finance a major expansion such as the building of a factory overseas. The board of directors must convince the existing shareholders or attract investors to subscribe to the new issue. The shareholders will expect a dividend and a capital gain on their investment. The proposed expansion must therefore be profitable or else the investors will be disappointed.

Retained earningsare profits, which are ploughed back into the business to create growth. This form of finance is suitable for organic growth as the pace of the expansion can be matched to the funds available. The shareholders

have to give up some or all of their dividends but, if growth is a success, the value of their shares will increase.

Long-term loansare borrowed from financial institutions and must be repaid with interest within five to twenty years. If repayments can be met, borrowing allows the business to grow without introducing any new owners who would have a share of all future profits. Dunes Stores, one of Ireland's leading retail chains, remains a private company and does not look for shareholder funds when expanding. Instead it uses borrowings and retained earnings. This means that a small family group retain absolute control of the business.

Venture capitala special type of financial institution has been formed to help firms grow. Venture capital companies provide money for a limited period of time, usually in the form of a minority equity stake. It is hoped that at the end of this time the company will have grown large enough to achieve a stock exchange quotation. This allows the venture capital company to sell its shares for a large profit.

2. Propose a financing source which is suitable for given project. Justify the reason of the chosen option.

Some sources of finance aremedium termand must be paid back within 5 – 10 years. Other sources of finance arelong termand can be paid back over many years. Long term sources are usually repaid between 5 – 20 years.

Long term

The term ' venture capital' is more specifically associated with putting money, usually in return for an equity stake, into a new business, a management buy-out or a major expansion scheme.

The institution that puts in the money recognizes the gamble inherent in the funding. There is a serious risk of losing the entire investment, and it might take a long time before any profits and returns materialize. But there is also the prospect of very high profits and a substantial return on the investment. A venture capitalist will require a high expected rate of return on investments, to compensate for the high risk.

A venture capital organization will not want to retain its investment in a business indefinitely, and when it considers putting money into a business venture, it will also consider its " exit", that is, how it will be able to pull out of the business eventually and realize its profits. Examples of venture capital organizations are: Merchant Bank of Central Africa Ltd and Anglo American Corporation Services Ltd.

When a company's directors look for help from a venture capital institution, they must recognize that:

- The institution will want an equity stake in the company.
- It will need convincing that the company can be successful.
- It may want to have a representative appointed to the company's board, to look after its interests.

The directors of the company must then contact venture capital organisations, to try and find one or more which would be willing to offer

finance. A venture capital organisation will only give funds to a company that it believes can succeed, and before it will make any definite offer, it will want from the company management:

- A business plan
- Details of how much finance is needed and how it will be used
- The most recent trading figures of the company, a balance sheet, a cash flowforecast
- A profit forecast
- Details of the management team, with evidence of a wide range of management skills
- Details of major shareholders
- Details of the company's current banking arrangements and any other sources of finance
- Any sales literature or publicity material that the company has issued.

A high percentage of requests for venture capital are rejected on an initial screening, and only a small percentage of all requests survive both this screening and further investigation and result in actual investments.

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