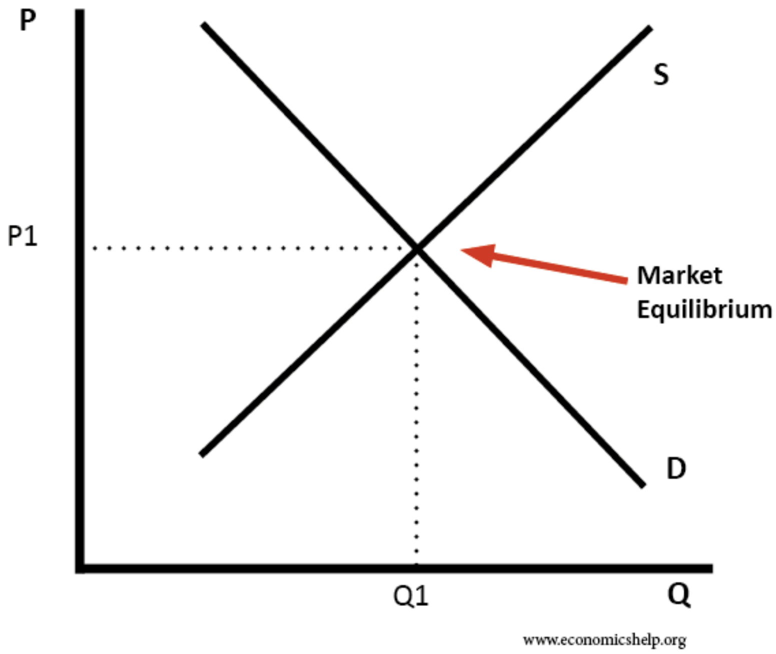
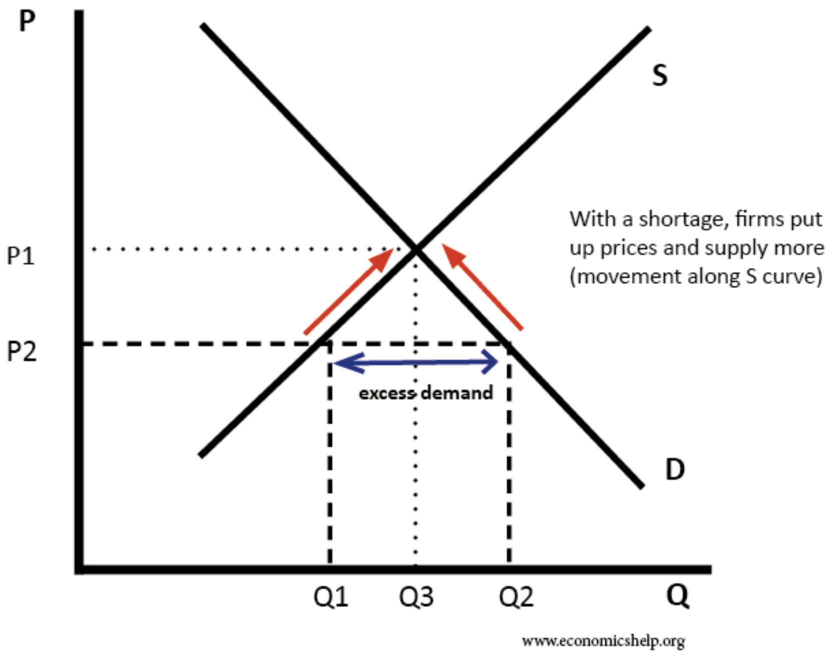
Market equilibrium

The price mechanism refers to how supply and demand interact to set the market price and the amount of goods sold.



Market equilibrium occurs when supply = demand and there is no tendency for the price to change.

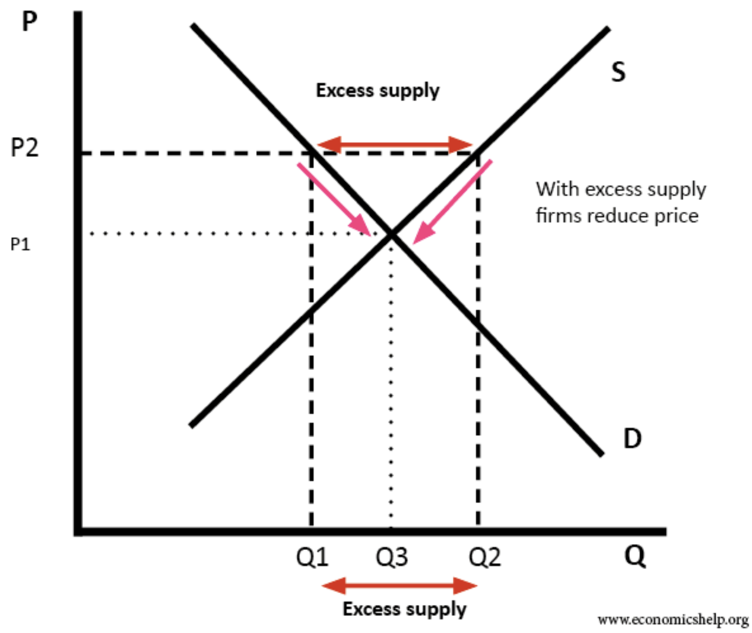
Excess demand



If the price is below equilibrium (p2), demand is greater than supply (Q2 – Q1) – causing a **shortage.**

- Therefore, with consumers wanting to buy more firms will put up prices and supply more.
- As price rises, there will be movement along the demand curve and less will be demanded.
- Prices will rise until supply equals demand.

Excess supply



- If the price is above equilibrium (p2), supply is greater than demand (Q2-Q1) – causing a **surplus**.
- To sell the unsold goods, firms reduce the price and reduce supply (movement along supply curve). The lower price also encourages more demand.
- The price falls to P1 where supply equals demand.

Impact of increase in demand

- If consumers saw an increase in income, we would see an increase in demand for goods like TV's; the demand curve would shift to the right.
- Initially there would be a shortage, but the higher demand would cause the price to rise and suppliers to supply more.

How to Measure Inflation - Consumer Price Index (CPI)

Steps to measuring inflation:

1. Household expenditure survey - this seeks to measure what people spend their money on. From this we get a typical basket of goods which is used to measure typical prices.
2. This basket of goods gives a relative importance to each different item, e.g. if the price of petrol increased this would have more effect than an increase in the price radios because petrol has a higher weighting.
3. The basket of goods is updated each year to take into account changes in expenditure
4. Every month changes in the price of goods and services are monitored and combined into a single figure with using the weights in the basket.

Problems with Calculating Inflation

1. Family Expenditure survey does not include everybody, e.g. pensioners are excluded, but pensioners have different spending habits e.g. heating is more important for old people.
2. Changes in Quality: Computers have many more features than 10 years ago, so it is difficult to compare prices because they are different goods. If prices of computers increase, is it inflation or a reflection of better quality?
3. Spending habits are always changing. We have to keep updating the basket of goods because we start buying new items.

Costs of Inflation

1. **Cost of reducing inflation**

   High inflation is deemed unacceptable therefore governments feel it is best to reduce it. To reduce inflation requires higher interest rates, but higher interest rates lead to lower economic growth and higher unemployment.

2. **International competitiveness**

   Higher UK inflation will make British goods less competitive, leading to a fall in exports and a worsening in the current account, balance of payments.

3. **Confusion and Uncertainty**

   When inflation is high people are uncertain what to spend their money on. Also, when inflation is high firms may be less willing to invest because they are uncertain about future profits.

4. **Menu Costs**

   This is the cost of changing price lists to keep up with inflation.

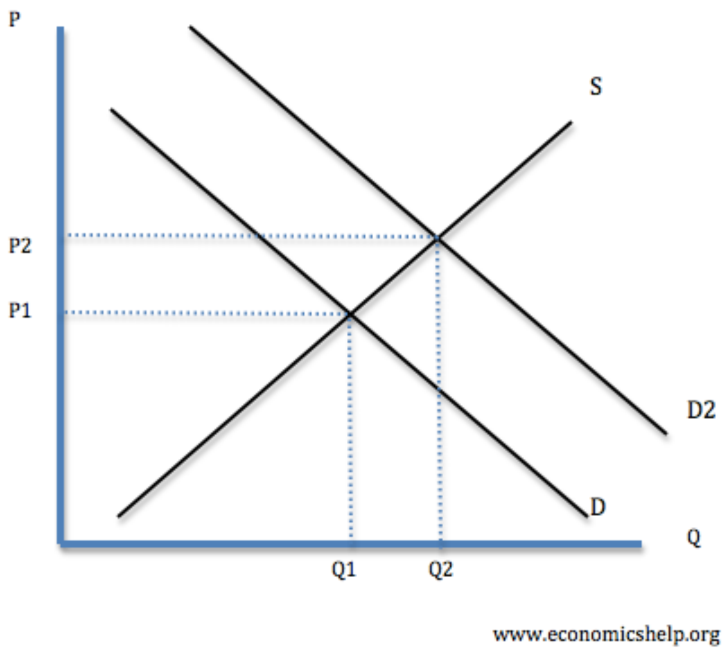
5. **Income redistribution**

   With higher inflation people will see the value of their savings fall. This could lead to lower income for pensioners who rely on savings.

Causes of Inflation

1. Demand Pull inflation

- If demand in the economy increases faster than productive capacity, then firms respond to the excess demand by pushing up prices.
- If the economy approaches full employment, firms may find it difficult to employ workers. Therefore, this shortage of labour tends to push up wages, which creates higher spending and inflation.
- We tend to get inflation, if economic growth is too fast – demand in the economy rising faster than productive capacity.



With increase in demand, firms push up prices.

2. Cost Push Inflation

Inflation can also be caused by an increase in the cost of production. If there is an increase in the costs of firms then they will respond by putting up prices for consumers. Cost-push inflation could be caused by several factors, such as:

1. **Higher Wages.** If trades unions bargain for higher wages, this will lead to an increase in costs for firms. It may also cause demand-pull inflation as workers have more income to spend.
2. **Import prices**. One third of all goods are imported in the UK. If there is a devaluation then import prices will become more expensive leading to an increase in the price of imported goods.
3. **Raw Material Prices** If raw materials such as oil prices increase then this will have a significant impact on costs and increase inflation.
4. **Declining productivity.** Lower productivity increases costs.