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The Market Mechanism

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Introduction

- A market economy is a mechanism for coordinating people, activities, and businesses through a system of prices and markets
- No single individual or organization is responsible for production, consumption, distribution, or pricing
- A market “is a mechanism through which buyers and sellers interact to determine prices and exchange goods, services, and assets”.



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- Prices are the balance wheel of the market mechanism
- If consumers want more of any good, the price will increase, sending a signal to producers that more supply is needed
- This is true in both product markets and factor markets
- Higher prices tend to reduce consumer purchases and encourage production
- Lower prices encourage consumption and discourage production..



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Market Equilibrium

- A market equilibrium represents a balance among all the different buyers and sellers
- Markets achieve equilibrium by balancing supply and demand forces, that is the quantity demanded is equal to the quantity supplied
- Markets also can solve the three economic problems (what, how, and for whom) through the market mechanism.

How Markets Solve the Three Economic problems?

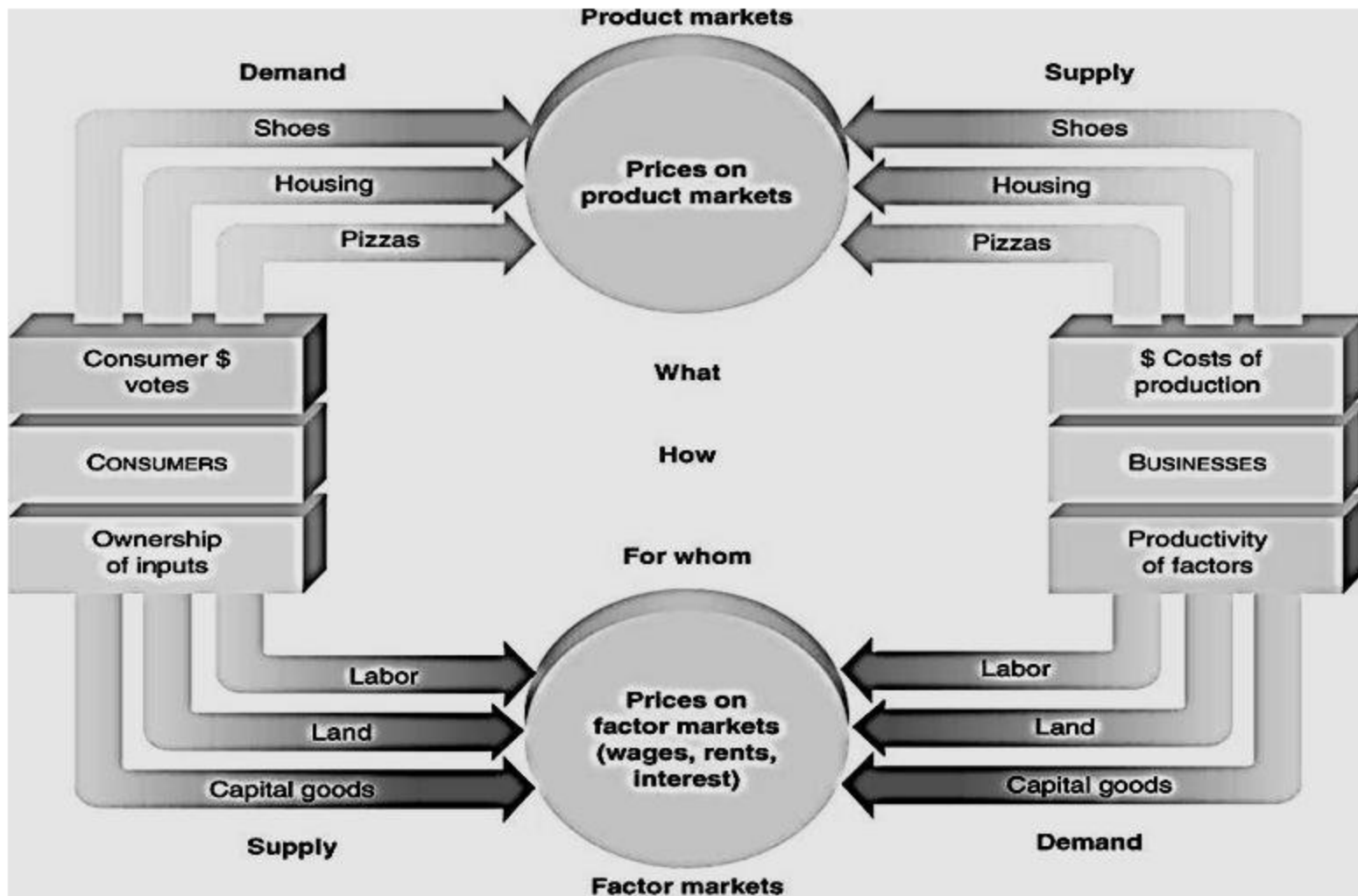


FIGURE 2-1. The Market System Relies on Supply and Demand to Solve the Trio of Economic Problems



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- In this circular flow, the three problems are solved in the following way:
- What goods and services will be produced is determined by the tastes expressed in the dollar votes of consumer demands
- Firms, in turn are motivated by the desire to maximize profits (the difference between total sales and total costs).



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- How things are produced is determined by the competition among different producers
- The best way for producers is to keep costs at a minimum by using the most efficient methods of production (resources and technology available to a society)
- For whom things are produced depend largely on the factor prices that are determined by household supply and business demand in the factor markets.



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The Invisible Hand

- Adam Smith recognized how a market economy organizes through what he called the invisible hand
- The invisible hand “states that private interest can lead to public gain when it takes place in a well-functioning market mechanism”
- But the functioning of the invisible hand requires a perfectly competitive economy with no market failures
- Market failures like monopolies or pollution will require government interference.



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The Visible Hand of the Government

- In reality, no economy conforms totally to world of the invisible hand
- There are flaws in the market mechanism that requires government intervention such as pollution, unemployment, and extremes of wealth and poverty
- Governments have three main economic functions in a market economy: **to increase efficiency, promote equity, and foster macroeconomic growth and stability**



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Efficiency

- Adam Smith recognized that the benefits of the market mechanism are achieved only when perfect competition is present
- Perfect competition “refers to a market in which no firm or consumer is large enough to affect the market price”
- There are many ways that markets cannot achieve perfect competition such as: imperfect competition, externalities, and public goods.



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Equity

- The market economy may not produce fair distribution of income
- In this case, government can use progressive taxation and make transfer payments or subsidize consumption



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Macroeconomic Growth And Stability

Since its origins, capitalism has experienced periodic fluctuations of inflation (rising prices) and recession (high unemployment)

- Governments can stabilize economic growth and face these fluctuations by using fiscal policies (taxing and spending) along with monetary policies (interest rates and credit conditions)
- Such government intervention in the market economy explains why most economies are now mixed economies



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