

Maharshi Dayanand College of Arts, Science and
Commerce, Parel, Mumbai- 12.

Department of Economics

Online Lecture Series

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Micro Economics (FYBA Revised Syllabus June 2019)

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Topic 3: Role of Price Mechanism

The price mechanism means coordination of decisions taken by consumers and production houses while interacting to determine the allocation of scarce resources between competing uses.

1. Signalling function (It provides information regarding changes into the market conditions to producers as well as consumers)

- Rise and fall to reflect scarcities and surpluses
- When prices are rising because of high demand from consumers, it is a signal to suppliers to expand production to meet the rising demand
- If there is excess supply in the market the price mechanism will help to eliminate a surplus of a good by allowing the market price to fall.

1. Preference Transmission (Choices, Preferences, Wants and Needs of Consumers are reflected)

- Higher prices provides an incentive to producers to raise output because the supplier stands to make a better profit.
- During recession when demand is weaker, supply contracts as producers cut back on output.

Topic 3: Role of Price Mechanism Contd...

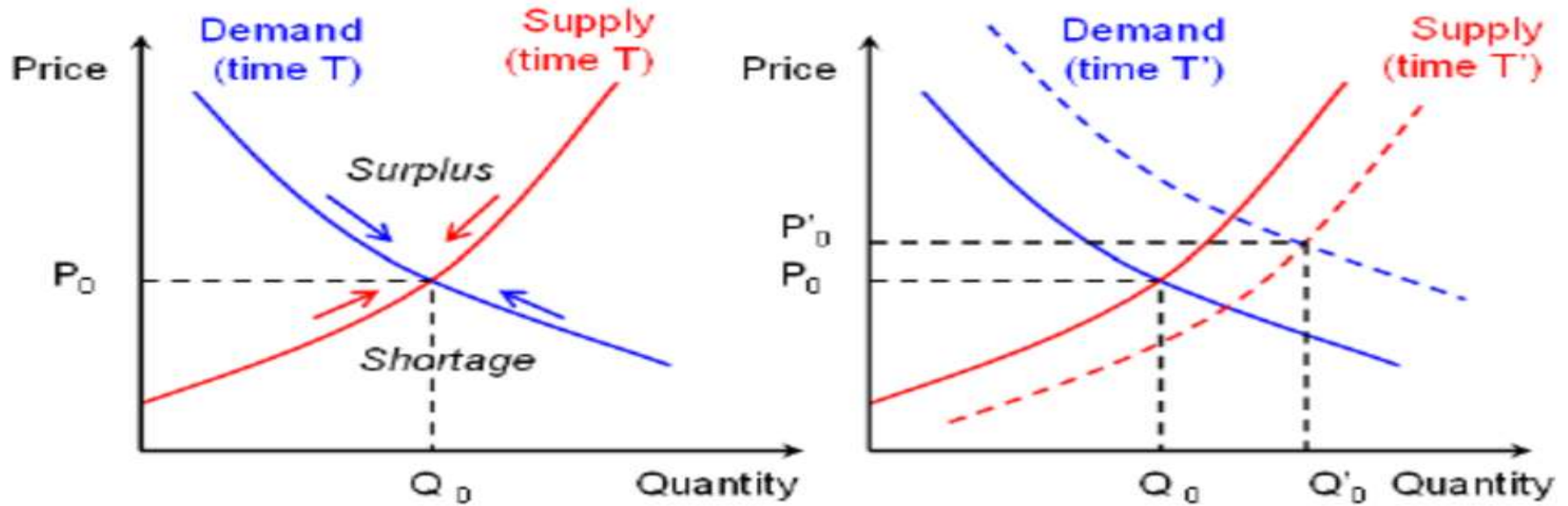
3. **Rationing function (Shortages of products will put upward pressure on prices**

and will deter consumers automatically deter the consumption)

- When demand in a market outstrips supply **Prices** serve to ration scarce resources
- When there is supply shortages, the price is bid up leaving only those with the willingness and ability to pay to purchase the product
- The popularity of auctions as a means of allocating resources is worth considering as a means of allocating resources and clearing a market

Topic 3: Role of Price Mechanism Contd...

Rationing Mechanism



Topic 3: Role of Price Mechanism Contd...

Economies and Price Mechanism

1. Market Economy

- In this market economy system the decision-making is decentralised i.e. there is no single body responsible for deciding what is to be produced and in what quantities.
- Price of the product is purely decided by the market forces i.e. demand and supply

1. Command Economy

- In a command economy, planning of the government directs resources to where the state thinks there is greatest need.

1. Mixed Economy

- In this economy the government uses plans to provide public goods and services such as police, roads and merit goods such as education, libraries and health.

Topic 3: Role of Price Mechanism Contd...

Relationship between Prices and Incentives

- For competitive markets to work efficiently all 'economic agents' (i.e. consumers and producers) must respond to appropriate pricing signals in the given market.
- Market failure occurs when the signalling and incentive functions of the price mechanism fail to operate optimally leading to a loss of economic and social welfare.
- Market Failure is the effect of a cause of asymmetric information existing in the real world.
- Market fails when market mechanism fails to allocate resources efficiently to achieve **social, technical, allocative, productive and consumption efficiency.**

Thank You

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