Changes in equilibrium

The market equilibrium will change if there's change in supply and demand conditions.

A CHANGES IN DEMAND

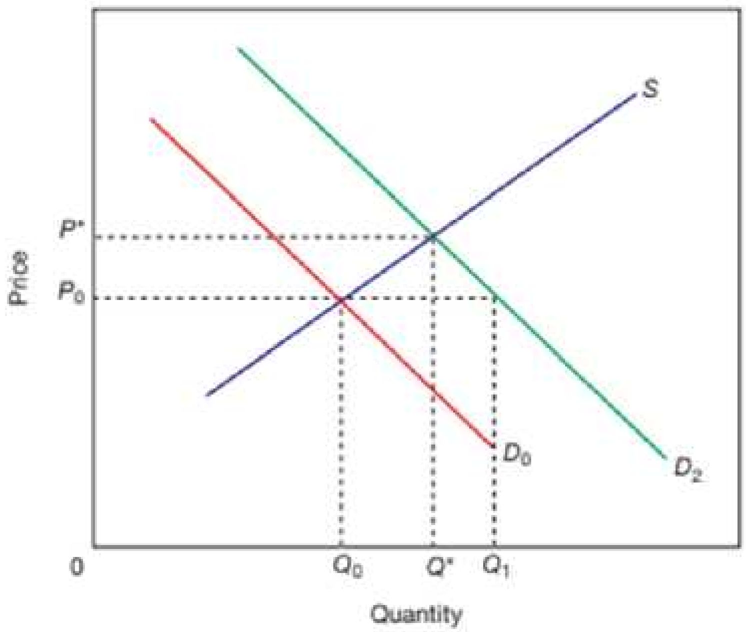

Figure 2.16 The effect of a shift of the demand curve on equilibrium price and quantity

- Increase in demand will cause disequilibrium of excessive demand.
- Suppliers will raise price and increase quantity supplied.
- As a result both price and quantity produced output will increase.

A CHANGE IN SUPPLY

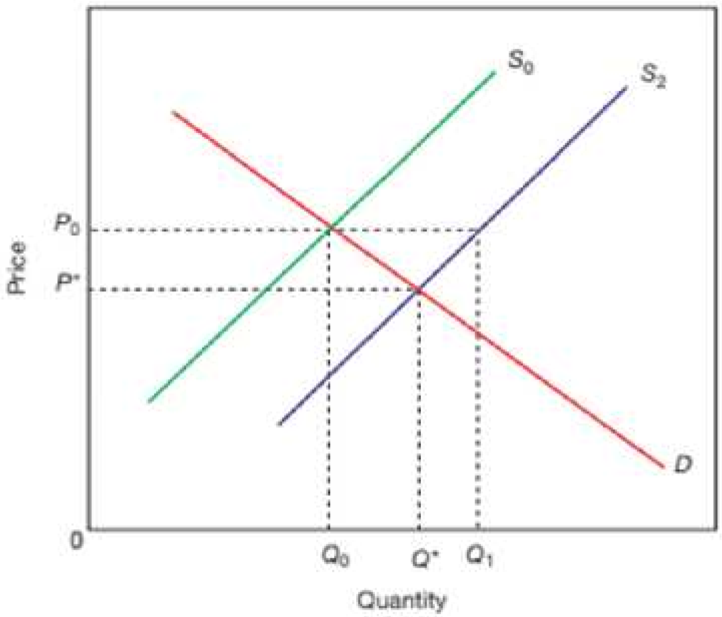

Figure 2.17 The effect of a shift in the supply curve on equilibrium price and quantity

- Increase in supply causes disequilibrium of excessive supply.
- The price of the product falls.
- Then quantity traded in equilibrium rises.

A CHANGE IN SUPPLY AND DEMAND

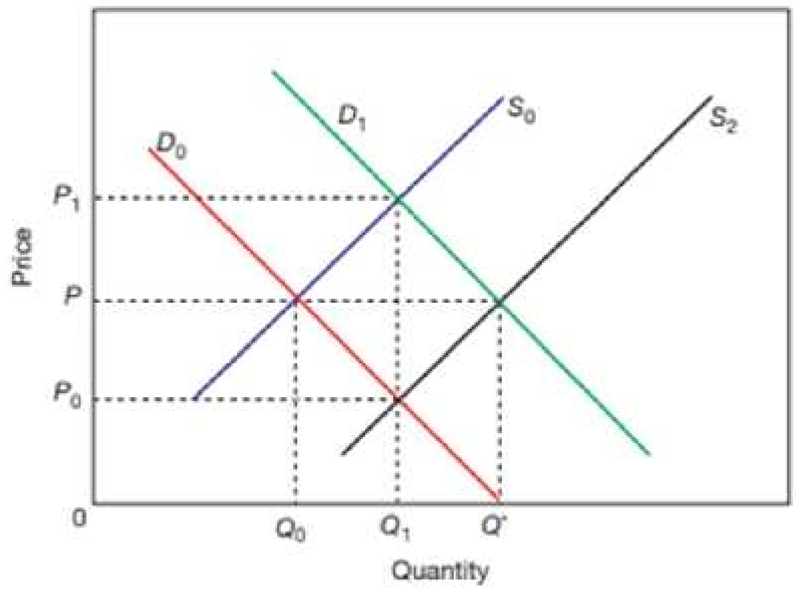

Figure 2.18 An unchanged equilibrium price and a changed equilibrium quantity

- Both supply and demand may change simultaneously.
- Increase in demand for product puts upward pressure on price.
- Simultaneous increase in supply puts downward pressure on price
- Quantity traded will increase significantly though there’s no change in equilibrium.

The workings of the price mechanism

- “The price mechanism works automatically” referred by Adam Smith as “the invisible hand”.
- The price acts a signal to both producers and consumers.
- The outcome is a new equilibrium position consumers demand equal to producers supply.
- The price system can ration products in the market.
- The price mechanism allows the preferences of consumers to be made which is called transmission of preferences.
- But best allocation of resources does not exist when market mechanism is left free to operate on its own and government intervene in the market mechanism.