MERIDIAN EDUCATION

Foundations of Economics

PPC, price mechanism and efficient allocation

TOPIC 1.1 | SAMPLE ESSAYS

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Coverage

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source pages

- Definitions and diagram explanation
- Scarcity, choice and opportunity cost
- Price signaling and incentive functions

Key things to remember for 10 mark questions:

- Include definitions of key terms mentioned in the question
- Draw diagram
- Explain diagram and what it is showing
- Real world example
- Answer the question

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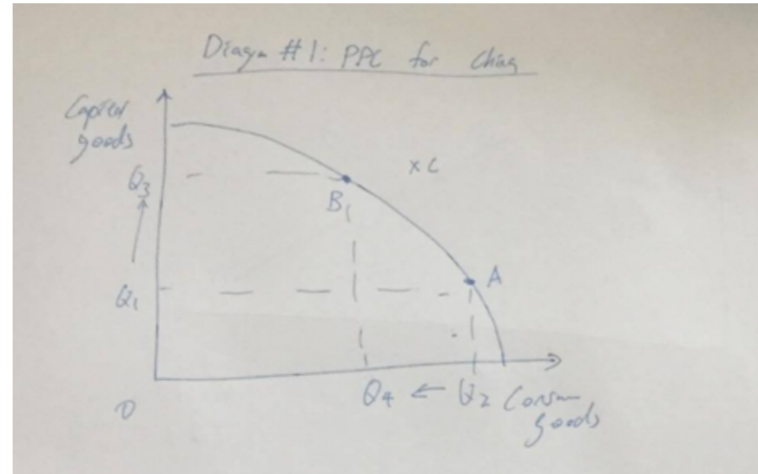
Sample essay:
With reference to the PPC, explain the concepts of scarcity, resource allocation, choice, opportunity cost

The hypothetical production possibility curve for China shows the maximum possible combinations of output that can be produced with the factors of production in an economy.



Scarcity refers to how factors of production are limited while consumers' wants are unlimited. Hence, goods and services are scarce relative to people's unlimited wants. The PPC shows the maximum possible combinations of goods that can be produced. Any point outside of the PPC, such as point C shown in the diagram above, is unattainable for China. This shows how scarcity exists in an economy, as limited factors of production cannot produce sufficient goods and services to meet people's unlimited wants.

Since resources are scarce, an economy must make a choice about how to allocate its resources. Each point on the PPC or inside is a specific resource allocation that the economy can choose from. For example, referring to the diagram 1, if the Chinese economy produces on point A, resources are allocated in a way to produce Q1 units of capital goods and Q2 units of consumer goods. If the Chinese Economy decides to produce on another point on the PPC or inside the PPC, this would be a reallocation of resources

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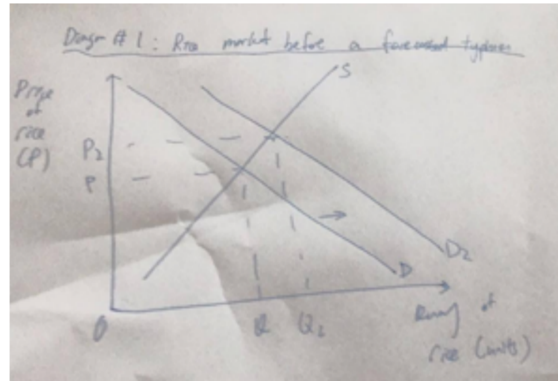
Opportunity cost is defined as the next best alternative foregone. Since resources are scarce, reallocating resources can often bring about an opportunity cost. For example, if the Chinese Economy changes production from point A to point B, there will be an increase in production of capital goods from Q1 to Q3, but a reduction in the production of consumer goods from Q2 to Q4. It can be said that the opportunity cost of production Q1-Q3 units of capital goods is Q2-Q4 units of consumer goods. The reason for this opportunity cost is because resources are limited. Hence, when more resources are allocated in China to produce capital goods, there will be fewer resources available to produce consumer goods.

Sample essay: Explain the incentive and signaling function of price (10 marks)

The signaling function of price refers to how price changes can send out signals to consumers and producers. The incentive function of price refers to how changes in price can incentivize consumers or producers to change their behavior.

Consider the following example for the price of rice in the wet market before a forecasted typhoon.



During a typhoon, the demand for rice increases as households expect a sharp increase in price during a typhoon, due to limited supply. This exception will cause an increase in demand for rice as shown in the diagram above. initially, the equilibrium price is at P,Q. When the demand of rice increase, there will be excess demand at the original price. The bidding process causes price to start to rise. As the price rise, it sends out a signal to all consumers and producers that there is a shortage in the rice market. For producers, the increase in price incentives them to increase quantity supplied by increasing the profitability of providing the good. For consumers, the increase in price incentives them to reduce quality supplied due to the income effect and the substitution effect. The income effect refers to how a rise in price will reduce the purchasing power of a certain amount of income. The substitution effect refers to how when the price of rice rise, consumers will switch to substitutes. Ultimately, as the price rises, quantity supplied rises while quantity demanded falls, until quantity demand equal quantity supplied and equilibrium is established again.

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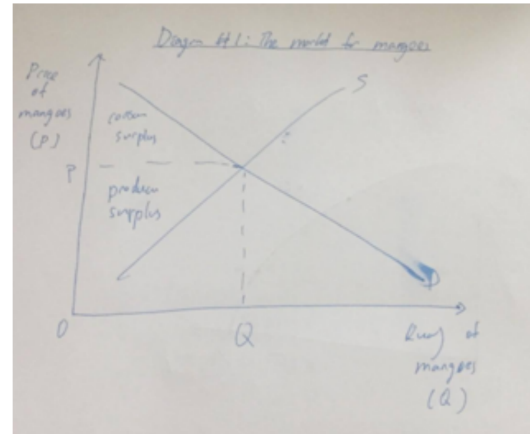
Sample essay: Explain why the price mechanism leads to an efficient allocation of resource

The price mechanism refers to how demand and supply interacts in a free market to set an equilibrium price in a market. Equilibrium price is the price in which quantity demand equals quantity supplied.

Consider the diagram below



The diagram above shows the market for mangoes in Hong Kong in equilibrium. There are two reasons why the price mechanism leads to an efficient allocation of resource. Firstly, the price mechanism always work to eliminate excess demand or excess supply. If there is excess supply, producers will start to cut price in free market, leading to a fall in quantity supplied and a rise in quantity demanded until excess supply is eliminated. If there is excess demand, price will start to rise due to the bidding process, leading to a rise in quantity supplied and a fall in quantity demanded until equilibrium is established again. The elimination of excess demand or excess supply means that consumers and producers wants can be met efficiently.

Secondly, when the market is in equilibrium, consumer surplus and producer surplus are maximized. Consumer surplus, equal to the area labelled in the diagram, refers to the difference between the price that consumers are willing to pay and the equilibrium price. Producer surplus, equals to the area labelled in the diagram, refers to the difference between the equilibrium price and the price that producers are willing to accept. When the market price is at equilibrium, both consumer and producer surplus are maximized.

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