Unit 1.1 Test M07/3/ECONO/SP1/ENG/TZ0/XX/M

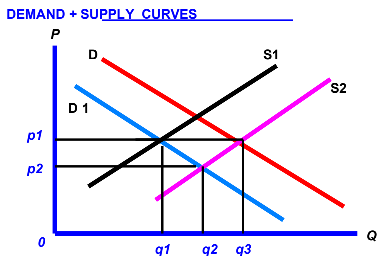
See Syllabus Item 14. This is a difficult item to understand but in fact it is just a simple application of supply and demand theory.

Explain the signalling and incentive functions of price in a market economy. [10 marks]

Answers may include:

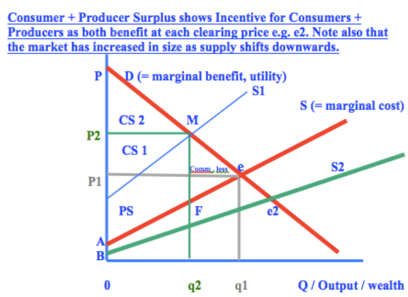
1. definition of market economy
2. description of market forces and how resources are allocated
3. explanation of the signalling function in relation to producers and consumers: e.g. as consumers increase their demand for a good (shift of demand to the right) the price of the good and profits rise, acting as a “green light” signal to producers to increase their output (movement along the supply curve); as the supply of a commodity becomes more scarce, supply shifts to the left (s2 to s1) and the rise in price signals to consumers to reduce their demand (movement along the demand curve); these changes in demand and supply bring about changes in resource allocation and act as signals to the market. Price and non price determinants therefore provide signals to the market in terms of movements and shifts and ultimately the market reacts to the signals. Price and quantity adjust.

Signal



4. explanation of the incentive function in relation to producers: e.g. an increase in demand for a product will raise its price and profitability and provide the incentive for producers to supply more/new firms to enter the market; the higher demand for the product will also lead to an increase in demand for labour to produce the product, causing wages to rise, which will in turn provide an incentive for workers to seek employment in that industry; these changes in demand and supply bring about changes in resource allocation
5. accurate and expert use of appropriate diagrams e.g. demand and supply
6. It is also appropriate to use consumer surplus and producer surplus to highlight the incentive function in the market whereby the firm and the consumer as the main stakeholders benefit from the market and at the clearing price there is incentive for both stakeholders to participate in the market.

Incentive



Candidates may not use the specific terms: signalling and incentive but may explain the functions of price using different terminology and they should be fully rewarded for this.

Please discuss alternative answers with me. For example, you could show a firm increasing its total revenue and therefore increasing its incentive or profitability. Buckley. Tuesday, November 10, 2015