Market Equilibrium

Essay
Define what is meant by market equilibrium. With the aid of diagrams, explain how market forces determine equilibrium price and quantity. What circumstances can lead to a change in market equilibrium.

A particularly notable feature of market economies is the effect of the price mechanism on demand and supply. The price mechanism determines the equilibrium in the market and consists of the interplay of the forces of supply and demand in determining the prices at which commodities will be bought and sold in the market. Market equilibrium is the situation, where at a certain price level, the quantity supplied and the quantity demanded of a particular commodity are equal. Thus, the market can clear, with no excess supply or demand, and there is no tendency to change in either price or quantity.

Diagrammatically, market equilibrium occurs where the demand and supply curves intersect, at the point where the quantity demanded is exactly equal to the quantity demanded. Let us first consider the case where there is excess demand, where the current price is below that of equilibrium, as shown in Figure 1:

Figure 1 reveals that at price $0P_1$, the quantity demanded ($0Q_2$) exceeds the quantity supplied ($0Q_1$). Competition among buyers for the limited quantity of goods available means that consumers will start bidding up the price. The rise in the price results in an expansion in supply and a contraction in demand (movement along the curves towards the equilibrium point). This will continue to occur as long as there is excess demand. Eventually, we will reach the intersection of the supply and demand curves, where at price $0P_e$, the quantity supplied $0Q_e$ exactly equals the quantity demanded by consumers.

In Figure 2, the quantity supplied at price $0P_1$ ($0Q_2$) exceeds the quantity demanded. Thus, we have a situation of excess supply or a glut in the market. In order to remove excess supply, sellers will offer to sell at a lower price. The fall in the price results in an expansion of demand, and a contraction in supply (movement along the curves towards the equilibrium point). This will continue to occur as long as there is excess supply, until we reach the intersection of supply and demand, where at price $0P_e$, the market clears, that is, the quantity supplied and demanded is equal.
Figure 2: Excess supply situation

The equilibrium price and quantity will be changed if there is a shift in either or both of the supply or demand curve. Shifts in the supply and demand curves are caused by changes in conditions behind supply and demand – not price changes.

For example, an increase in demand means that more of a good will be demanded at the same price. Factors that may cause an increase in demand include a rise in the price of substitute goods and a fall in the price of complementary goods, higher prices expected in the future, a good becoming more fashionable and rising consumer incomes. Because the demand curve shifts to the right, the quantity demanded exceeds the quantity supplied. Competition among buyers will begin to force the limited quantity of the good in question up, causing an expansion in supply and a contraction in demand. This will continue to occur until the market clears again at a new equilibrium point – both the equilibrium price and quantity have risen. Similarly, a decrease in demand will lower both the equilibrium price and quantity.

An increase or decrease in supply will also affect the equilibrium position. An increase in supply shifts the supply curve to the right, thus lowering equilibrium price while raising equilibrium quantity. A decrease in supply, which shifts the supply curve to the left, however, raises equilibrium price and lowers equilibrium quantity.

As mentioned earlier, the price or market mechanism plays the most important function in determining the solutions to the economic problem in market economies. The price determined in the market conveys important information that helps in providing answers to the questions about the production, distribution and exchange of goods and services in the economy. Producers will only produce those goods and services for which there is consumer demand. The quantity of goods and services produced and sold, is determined through the interaction of supply and demand, resulting in the equilibrium price and quantity. Increasing demand for good X will be translated into a higher market price, which will signal producers to reallocate resources away from other areas of production, in order to produce more of product X.

In addition, it is said that the market mechanism also ensures efficiency in allocation in the economy. The demand curve gives us an indication of the value that consumers place on a certain product, while the supply curve gives us an indication of the producers’ cost in supplying that product. The market mechanism ensures that equilibrium is reached at the intersection of those two curves.

In conclusion, the market forces of supply and demand interact to bring about the equilibrium price, clearing the market of excess demand or supply. In this way, it is said that the market mechanism achieves consistency between the plans and outcomes for consumers and producers without explicit coordination.