

Lesson – 22

Price Determination Under Perfect Competition

Summary

Determination of prices in a free market happens due to the forces of demand and supply, and this phenomenon is called price determination. So here we will be learning more about price determination in perfect competitive market. We will also see about the changes in supply and demand and its impact on equilibrium price and quantity. This lesson also provides the sound basis for the Government to formulate economic policies for the welfare of common people. In the preceding lesson, you learnt that there are various forms of market in which a firm or industry operate. This lesson is devoted towards determination of price and quantity by the industry and a firm under the market form- perfect competition.

Meaning of Equilibrium Price

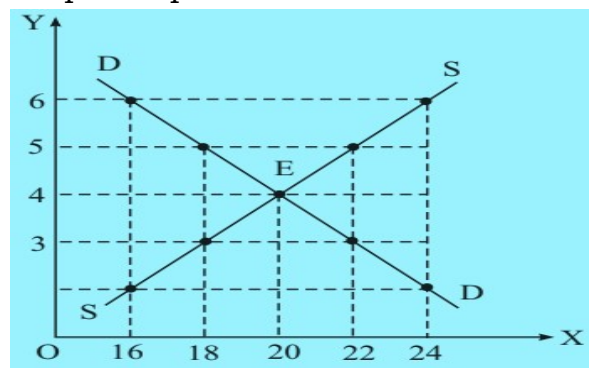
- Equilibrium means a position from which there is no tendency to change.
- Equilibrium price will be determined where quantity demanded is equal to quantity supplied in the market. This is called market equilibrium price of the commodity.
- Prof. Marshall compared demand and supply to the two blades of a pair of scissors.
- The forces of demand and supply determine the price of a commodity. Producers want to sell the goods at the highest price to maximize profit and consumers want to buy the goods at the lowest price to maximize satisfaction.

Process of Arriving at Equilibrium Price

Schedule for determination of Equilibrium Price of a commodity

Price(Rs.)	Demand (Units)	Supply (Units)
6	16	24
5	18	22
4	20	20
3	22	18
2	24	16

Graphical presentation -



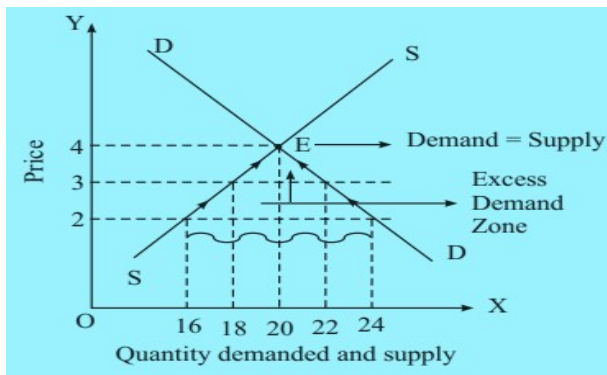
Excess Demand and Excess Supply

Excess Demand

When demand exceeds supply, we call it excess demand that causes price to rise till demand equals supply.

The process of determining equilibrium can be summarized as follow –

- In case of excess demand, price starts rising, as the buyers try to compete out each other.
- As a result of rise in price, demand starts contracting and supply starts expanding.
- All these movements of price, demand and supply result in getting equilibrium restored, though at a higher price, than before.

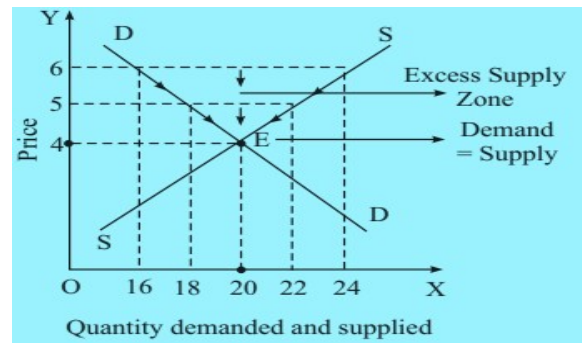


Excess Supply

- When supply exceeds demand, we call it excess supply that causes price to fall till demand and supply become equal to each other.
-

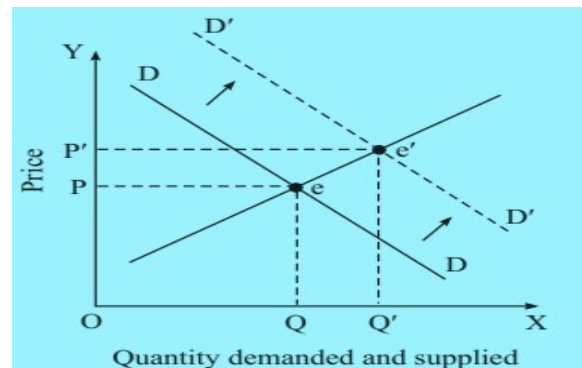
The process of determining equilibrium can be summarized as follow –

- In case of excess supply, price starts falling, as the suppliers try to compete out each other,
- As a result of fall in price, demand starts expanding and supply starts contracting.
- All these movements of price, demand and supply result in getting equilibrium restored, though at a lower price, than before.



Effect of Change in Demand on Equilibrium Price and Quantity

Effect of Increase in demand



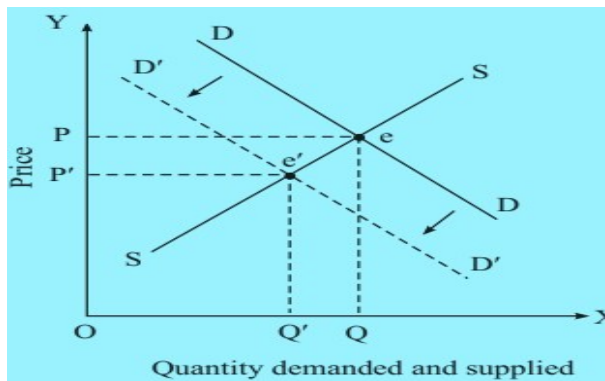
Increase in demand leads to -

- Increase in equilibrium price from OP to OP'.
- Increase in equilibrium quantity from OQ to OQ'.

Increase in supply leads to

- Decrease in equilibrium price from OP to OP'.
- Increase in equilibrium quantity

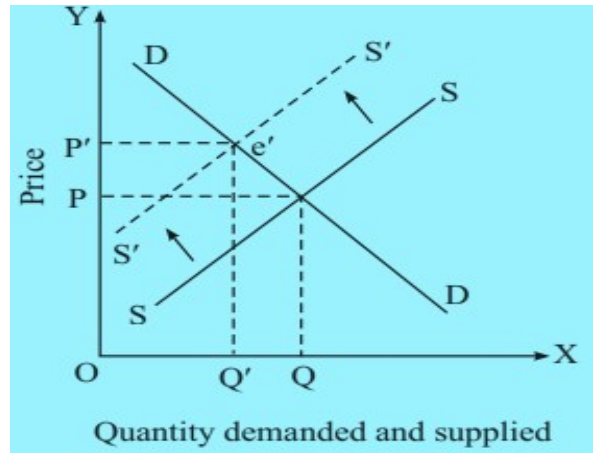
Effect of Decrease in Demand



Decrease in Demand leads to -

- Decrease in Equilibrium price from OP to OP'.
- Decrease in equilibrium quantity from OQ' to OQ.

Effect of Decrease in Supply

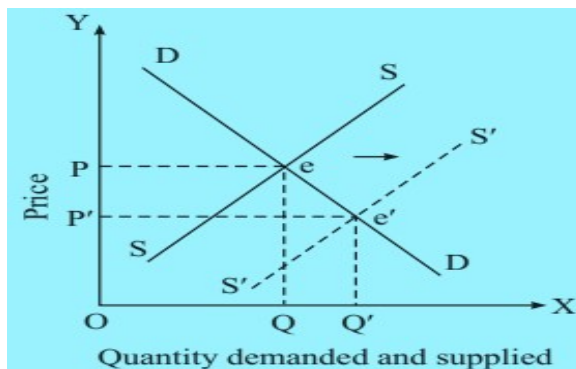


Decrease in supply leads to -

- Increase in equilibrium price from OP to OP'.
- Decrease in equilibrium quantity from OQ to OQ'.

Effect of Change in Supply on Equilibrium Price and Quantity

Effect of Increase in Supply

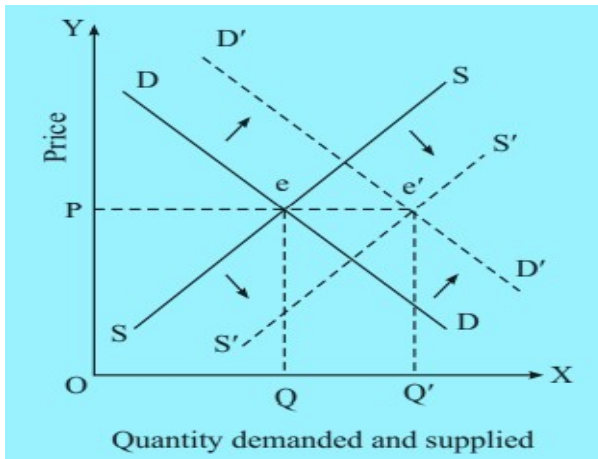


Effect of Simultaneous Change in Demand and Supply on Equilibrium Price and Quantity

Increase in Both Demand and Supply

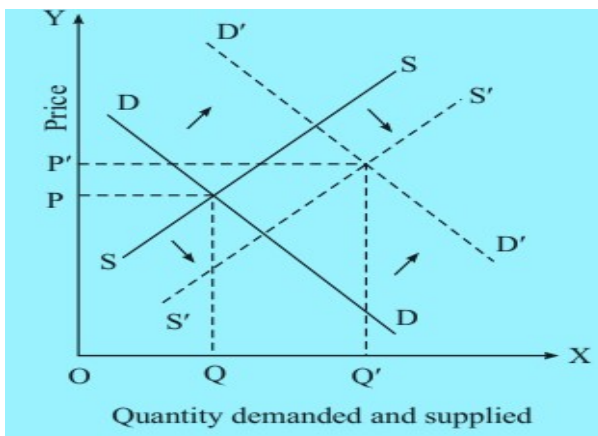
The three possible cases when both demand and supply are increasing can be explained as follows -

Increase in Demand = Increase in Supply



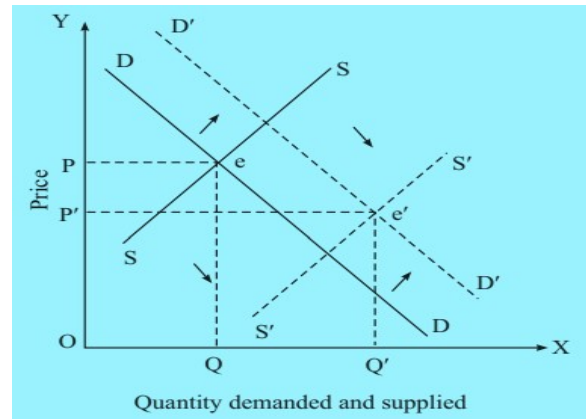
- Equilibrium price remains the same i.e, OP.
- Equilibrium quantity increases from OQ to OQ'.

Increase in Demand > Increase in Supply



- Equilibrium price increases from OP to OP'.
- Equilibrium quantity increases from OQ to OQ'.

Increase in Demand < Increase in Supply



- Equilibrium price increases from OP to OP'.
- Equilibrium quantity increases from OQ to OQ'.

Decrease in Both Demand and Supply

The three possible cases when both demand and supply are increasing can be explained as follows –

Increase in Demand = Increase in Supply

Decrease in Demand > Decrease in Supply

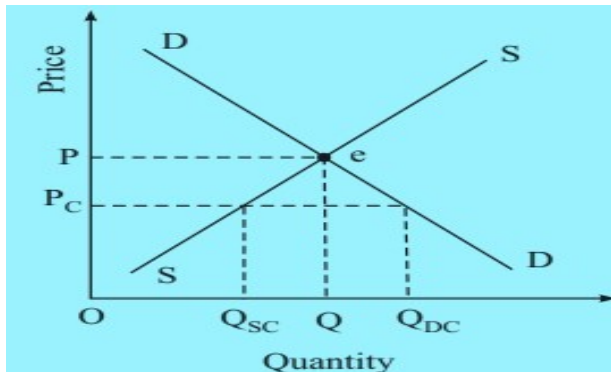
Decrease in Demand < Decrease in Supply

All these three cases can be shown with the diagrammatic presentation similarly what you have learned in previous cases of increase in demand and supply.

Simple application of Demand and Supply

Ceiling price

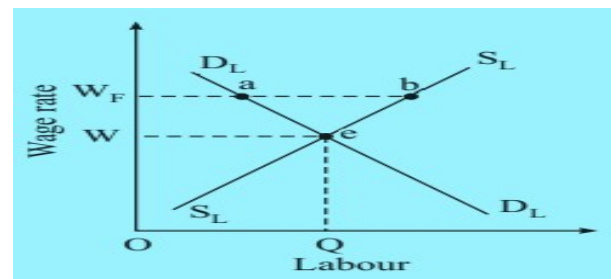
- When the price prevailing in the market is too high and is affecting the interests of the consumers adversely, the government has to step in and decide ceiling price.
- The sellers are not allowed to raise price of their products beyond this ceiling price and thus the interests of the consumers are protected.
- This can be shown with the help of diagram.



Floor Price

- Indian labour market is a market with excessive supply of labour. It is not necessary that price determined is always too high. Sometimes it may be too low also. It may happen especially in markets with excessive supply of something.

- Indian labour market is a market with excessive supply of labour.
- In such a setting, the wage rate determined by the market forces of demand and supply is generally low.
- To protect workers' interests in such a case the government may pass minimum wage legislation.



Evaluate Yourself

Q. With the help of diagrams, show the effect of increase and decrease in demand on price when supply remains constant.

Q. Draw diagram for the situation when simultaneous increase in demand is greater than increase in supply and give interpret the effect.

Q. Explain the effect on equilibrium price and quantity if simultaneous decrease in demand is equal to decrease in supply.

Q. "The concept of equilibrium is compared demand and supply to the two blades of a pair of scissors". Elaborate the Statement