The Price Mechanism and Resource Allocation

AS Economics Presentation

2005

Markets

- A market is the place where buyers and sellers meet to exchange a product. Markets require:
  - Consumers i.e. buyers
  - Producers or firms i.e. sellers
  - Goods or services to trade (a recognizable output)
- Examples of markets include:
  - Housing market: home owners and potential buyers
  - Labour market: employers and workers
  - Stock market: share owners and potential buyers
  - Foreign exchange market: trading currencies

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Sub Markets – Market Segmentation

- The market for most goods can be segmented – broken down into sub markets
- The market for houses
  - (i) sub markets for terraced, semi-detached and detached homes
  - (ii) the market for rented properties and owner occupied housing
- The market for cars is made up of sub markets for family saloon cars, hatchbacks and high performance sports cars
- The travel industry is heavily segmented

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Functions of the Price Mechanism

- The price mechanism is the means by which decisions of consumers and businesses interact to determine the allocation of resources between different goods and services
- (1) The signaling function
  - If prices are rising because of stronger demand from consumers, this is a signal to suppliers to expand output to meet the higher demand
  - When demand is strong, higher market prices act as an incentive to raise output (production) because the supplier stands to make a higher profit
- (2) The rationing function
  - Prices serve to ration scarce resources when demand in a market outstrips supply
  - When there is a shortage of a product in the market, the price will rise and thus deter some consumers from purchasing the product

Adam Smith and the 'Invisible Hand'

- The 18th Century economist Adam Smith – one of the founding fathers of modern economics, described how the invisible or hidden hand of the market operated in a competitive market through the pursuit of self-interest to allocate resources in society's best interest
- This remains the central view of all free-market economists, i.e. those who believe in the virtues of a free-market economy with minimal government intervention

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Auctions as a means of allocating scarce resources

- Auctions as a means of allocating resources and determining market prices have gained enormously in popularity in recent years
- "Economists certainly love auctions, because they enable buyers and sellers to come together with full knowledge of supply and demand. Barriers to entry are minimal; an item simply goes to the buyer willing to pay the most for it.
- Raising the number of bidders, in theory, should result in higher demand and higher prices for a good. Increasing the supply of goods at auction lowers their price. Rationing goods at auction is silly, since it leaves money on the table" (The Economist)

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Recent examples of auctions

- Auctioning in November 2000 of licenses for third generation mobile phone services / radio spectrums in the UK and across Europe
- E-Commerce auctioning (e.g. E-bay and QXL)
- Traditional auctioneers markets for example those trading in fine art, livestock, David Beckham's soccer boots, Enron ensignia and the auctioning off of Napsters assets
- Auctions for internationally traded commodities – including coffee and tobacco
- Auctions for marketable pollution permits
- Bidding for the rights to televise sporting events such as the FA Cup and the Olympic Games broadcasting rights

Types of Auctions

(a) Sellers Auction:

- Where items are sold to the highest bidder – in a sellers auction there are normally many buyers and one seller

(b) Procurement Auction:

- Where an item is purchased from the lowest bidder, typically in a procurement auction there are many sellers (e.g. companies bidding for a tender for a project) and only one buyer

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Different auction rules

(1) High-bid auction:

- Where the buyers submit sealed bids and the winner is the high bidder.

(2) Second-price (or Vickrey) auction:

- This has the same rules as the high-bid, except that the winner pay only the second-highest bid to achieve incentive compatibility

(3) English open-cry auction:

- In this auction the buyers call out bids publicly. The winner is the last buyer to bid, and he pays his winning bid.

(4) Dutch auction:

- A Dutch auction occurs when a list of sequentially lower prices are offered by the seller, until a potential buyer accepts one of these prices and then pays that price for the product

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Potential Problems with Auctions

- The time spent by buyers bidding at auction
- Imperfect and asymmetric information
- Insufficient buyers – if the number of buyer (bidders) is small, the auction process may not work optimally (when there are only a few bidders
- The possibility of implicit or explicit collusion among bidders
- Bidders may start to build into their bidding behaviour an expectation of the valuations placed on the product by other bidders (seen or unseen) - can give rise to the winners' curse where it is sometimes the most optimistic, and least well informed, bidder who wins at auction
- Auctions can lead to bid-sniping particularly if an auction house runs a close-off period for bids. E-Bay is the classic example of this
- Auctions focus solely on price