

Exercise walk-through

# 2.1

## The role of markets in allocating resources

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IGCSE Economics

# The price mechanism

In a free **market** , the **price mechanism** **allocates** resources – deciding what is made, how, & for whom.

- **signalling** – tells what to make
- **incentive** – a reason to supply
- **rationing** – shares out scarce goods



*Prices guide who buys and what is made*

# Private, external and social



*A power station's plume falls on third parties, not the producer*

- **private cost** – to the person doing it.
- **external cost** – paid by other people: factory smoke harming nearby families.
- **social cost** = private + external.

Benefits work the same way. Markets fail because firms and consumers weigh only the **private** side.

# The market system, weighed both ways

## advantage

prices guide resources to where they are wanted, **without anyone planning**

## advantage

consumers have wide choice, and firms compete to win them

## advantage

a strong incentive to work, invest and invent

## drawback

the strong – rich firms and people – do well; the weak may be left with nothing

## drawback

some goods are not supplied at all, and pollution is not counted

## inefficient outcomes

monopoly power, and missing information, both distort the price signal

The mixed economy exists because both columns are true. Every evaluation question wants at least one line from each.

## Exercises 2.1-2.3

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**2.1** Define the term *market*.

[2]

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**2.2** State the three functions of the price mechanism.

[3]

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**2.3** State the difference between microeconomics and macroeconomics.

[2]

## Exercises 2.1-2.3

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2.1 Define the term *market*. [2]

2.1

- a **market** is any place or system where **buyers and sellers** meet to trade (K)
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2.2 State the three functions of the price mechanism. [3]

2.2

- the three functions of the price mechanism
  - **signalling**, **incentive**, **rationing** (K each)
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2.3 State the difference between microeconomics and macroeconomics. [2]

2.3

- **microeconomics** studies one market or firm (K)
- **macroeconomics** studies the **whole economy** (jobs, prices, growth) (K)

## Exercises 3.1-3.2

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3.1 A rising price acts as an **incentive** because it:

[1]

☐

A signals what to produce

B gives firms a reason to produce more

C rations a scarce good

D reduces consumer demand

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3.2 Explain how the price mechanism allocates resources in a free market.

[4]

## Exercises 3.1-3.2

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3.1 A rising price acts as an **incentive** because it:

[1]

☐

- A signals what to produce
- B gives firms a reason to produce more
- C rations a scarce good
- D reduces consumer demand

3.1 B

- an **incentive** gives firms a **reason to produce more** (K)
- A is signalling; C is rationing; D is a demand effect, not an incentive

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3.2 Explain how the price mechanism allocates resources in a free market.

[4]

3.2

- a price change **signals** what buyers want (K)
- it gives firms an **incentive** to supply more of wanted goods (An)
- it **rations** scarce goods to those willing to pay – resources move to where they are most valued (An)

## Exercise 3.3

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**3.3** Analyse how the price of a good responds to a sudden rise in demand for it. [6]

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### 3.3

- a rise in demand means buyers want more at the current price (K)
- this creates a **shortage** (excess demand) (An)
- buyers bid the price up; firms supply more → a **new, higher equilibrium** price and quantity (An)