3.1.5.1 How markets and prices allocate resources

The Price Mechanism

Functions:

- The price mechanism determines the market price. Adam Smith called this 'the invisible hand of the market'.
- Resources are allocated through the price mechanism in a free market economy. The economic problem of scarce resources is solved through this mechanism. The price moves resources to where they are demanded or where there is a shortage, and removes resources from where there is a surplus.

- The price mechanism uses three main functions to allocate resources:
  - **Rationing**
    When there are scarce resources, price increases due to the excess of demand. The increase in price discourages demand and consequently **rations** resources. For example, plane tickets might rise as seats are sold, because spaces are running out. This is a disincentive to some consumers to purchase the tickets, which rations the tickets.
  - **Incentive**
    This encourages a change in behaviour of a consumer or producer. For example, a high price would encourage firms to supply more to the market, because it is more profitable to do so.
  - **Signalling**
    The price acts as a signal to consumers and new firms entering the market. The price changes show where resources are needed in the market. A high price **signals** firms to enter the market because it is profitable. However, this encourages consumers to reduce demand and therefore leave the market. This shifts the demand and supply curves.

- The price mechanism is the way in which the basic economic problem is resolved in a market economy.