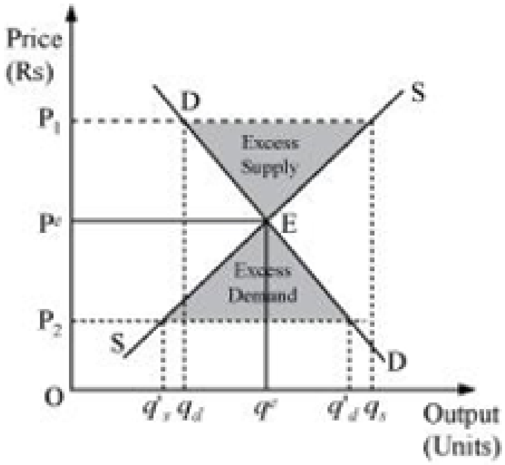
Q 4. What will happen if the price prevailing in the market is
(i) above the equilibrium price?
(ii) below the equilibrium price?
Ans: (i) If the market price is above the equilibrium price, there occurs the situation of excess supply.



In the given figure, the equilibrium price and quantity is demoted by P^e and q^e.
Let us assume that the market price (P_1) is above the equilibrium price P^e. Now, according to the demand curve, the quantity demanded is q_d. Whereas, according to the supply curve, the quantity supplied is q_s. Thus, there exists a situation of excess supply equivalent to $(q_s - q_d)$.

(ii) If the market price is below the equilibrium price, there occurs the situation of excess demand.

Let us assume that the market price P_2 is below the equilibrium price P^e. According to the demand curve, quantity demanded is q'_d. Whereas, according to the supply curve, the quantity supplied is q'_s. So, it can be seen that there emerges the situation of excess supply equivalent to $(q'_d - q'_s)$.

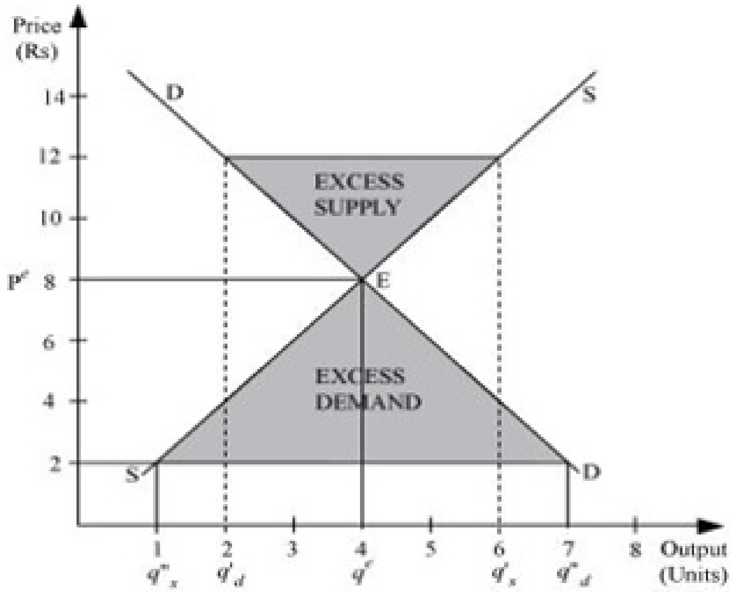
Q5. Explain how price is determined in a perfectly competitive market with fixed number of firms.

Ans: When the number of firms in a perfectly competitive market is fixed, the firms are operating in the short-run. The equilibrium price is determined by the intersection of market demand curve and supply curve. It is the price at which the market demand equals market supply.

In the given figure, if at any price above p^e , let us say Rs 12, there will be an excess supply, which will increase the competition among the sellers and they will reduce the price in order to sell more output. This causes a fall in the price, finally to Rs 8 , where the demand equals supply.

If at any price lower $(p)^e$ than p^e, let us say Rs 2, there will be an excess demand that will raise the competition among the buyers or consumers and they will be ready to pay higher price for the given output. This will increase the price to Rs 8 (equilibrium price), where the market will reach the equilibrium.

Thus, the invisible hands of market operate automatically whenever there exist excess demand and excess supply; ensuring equilibrium in the market.



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