How does the market mechanism work?

Economic Systems -Basic Tasks

- Meet needs of the people
- Solve scarcity problem
- Allocate resources
- Combine factors of production
- Coordinate all actors
- Work efficiently

Systems of economic decision-making

- Allocation by government decision: central planning / political decision-making
- Allocation by decentralised individual plans coordinated by market-price mechanism
- No third system of decision-making - only combinations of those two
- No pure form exists; but all existing systems follow one basic form and mix the other system in for some goods and services

Constitutive Principles of Market System

- Market price mechanism fundamental
- Monetary stability – no distortions, low risk
- Open markets to sustain competition
- Private Property
- Freedom of contract
- Liability Principle
- Steadiness of economic policy – lower risk

Regulating Principles

- Competition policy – no concentration of economic power in few hands
- Moderate redistribution – basic social safety
- Internalisation of externalities – charge for costs of pollution, congestion, etc., organise or pay for important goods and services that the market won't provide, like infrastructure
- Correct anomalies of supply

Consequences of market economy

- High degree of individual freedom and choice
- Efficient allocation of resources as prices signal scarcity
- Liability principle induces better risk management
- Competition spurs innovation and rewards individual effort

Problems of market system

- Actors try to avoid competition
- Actors try to evade liability
- Fast pace of change breeds fear
- Risk management grows complex
- High pressure to adapt and innovate
- Financial system induces business cycles that cause pain

The role of the state – strong but mainly neutral arbiter, i.e. rule of law

- Define and protect property rights
- Enforce contracts
- Keep markets open – competition policy
- Enforce liability
- Run sound monetary policy
- Internalize externalities
- Provide targetted basic safety net

The messy reality: selective intervention

- State ownership of some industries and banks
- Price regulations for politically sensitive goods
- Quantitative restrictions on goods
- Restrictions on movements of goods, capital and people
- Barriers to market entry by licensing
- Restrictions on contracts through regulation
- Liability not enforced by courts or assumed by state

Problems of selective intervention

Problems of selective intervention

- Government uses other people's money, violating liability principle, leading to misuse of funds
- Fixing prices and quantities leads to distorted incentives, inducing harmful consequences
- Barriers to enter markets creates vested interests and breeds corruption
- Regulation imposes costs that are hidden and have to be borne by others – no liability, danger of abuse

Problems of selective intervention…

- Liability assumed by state leads to unnecessary risks. Ex.: nuclear power
- Unenforced liability, including enforcement of contracts, leads to high risks, high transaction costs, thus limiting exchange – economy stagnates