The government or an industry regulator can set a maximum price in an attempt to prevent the market price from rising above a certain level. One aim of this might be to prevent the monopolistic exploitation of consumers.

To be effective a maximum price has to be set below the free market price.

The normal equilibrium price is Pe – but the government imposes a maximum price of Pmax. This price ceiling creates excess demand equal to quantity Q2-Q2 because the price has been held below the equilibrium, so producers will decrease their production.

It is worth noting that a price ceiling set above the free market equilibrium price would have no effect whatsoever on the market – because for a price floor to be effective, it must be set below the normal market-clearing price.

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