

Revision – Demand and supply

Demand: The willingness and ability of a consumer to purchase a quantity of a good or service at a certain price (in a given time period).

Supply: The willingness and ability of a producer to produce a quantity of a good or service at a certain price (in a given time period).

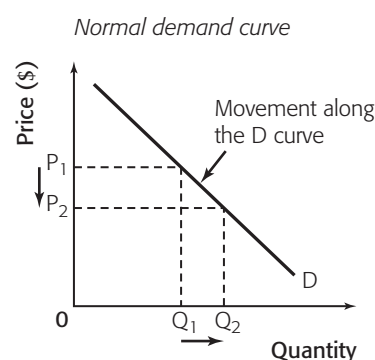
Law of demand: As the price of a good falls, the quantity demanded will normally increase. (The demand curve usually slopes downwards, *ceteris paribus*).

Law of supply: As the price of a good rises, the quantity supplied will normally rise. (The supply curve usually slopes upwards, *ceteris paribus*).

Ceteris paribus: An assumption that means 'all other things being equal'.

Demand and the price of the good or service

A change in the price of the product itself will lead to a change in the quantity demanded of the product, i.e. a movement along the existing demand curve. The phrase '**change in the quantity demanded**' is important, since it differentiates a change in price from the effect of a change in any of the other determinants of demand. (See the diagram on the left below.)



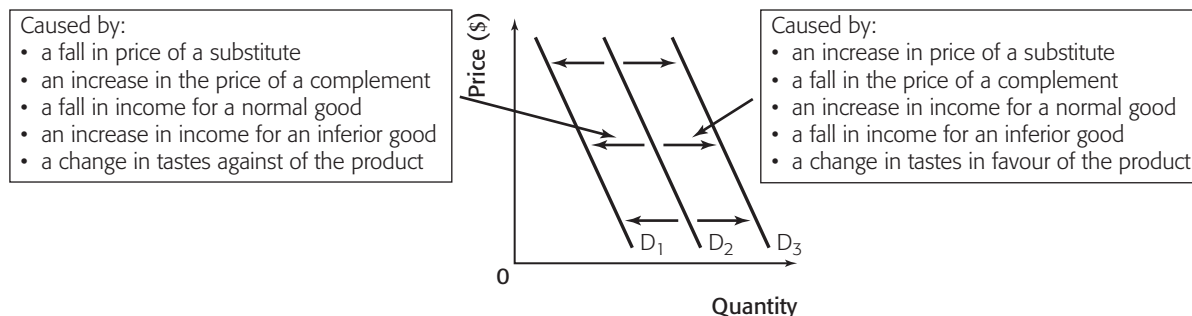
The determinants of demand

There are a number of factors that determine demand and lead to an actual **shift of the demand curve to either the right or the left**. Whenever we look at a change in one of the determinants, we always make the *ceteris paribus* assumption.

Income: Changes shift the demand curve. Outcome depends on whether the goods are normal or inferior.

Price of other goods: Changes shift the demand curve. Outcome depends on whether the products are substitutes or complements.

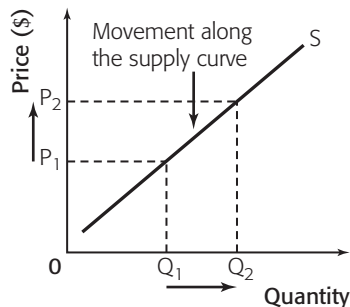
Tastes: Changes shift the demand curve. Outcome depends on whether the change is in favour of or against the product.



Other factors: There are larger factors where changes that may also shift the demand curve, such as changes in the size of the population, changes in income distribution, changes in government policy and seasonal changes.

Supply and the price of the good or service

A change in the price of the product itself will lead to a change in the quantity supplied of the product, i.e. a movement along the existing supply curve. The phrase ‘**change in the quantity supplied**’ is important, since it differentiates a change in price from the effect of a change in any of the other determinants of supply.



The determinants of supply

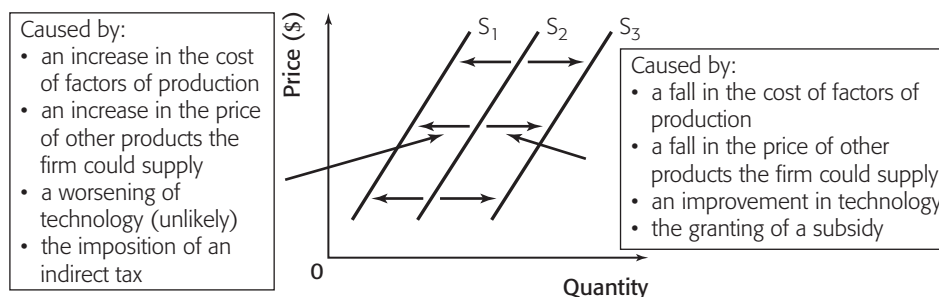
There are a number of factors that determine supply and lead to an actual **shift of the supply curve to either the right or the left**. Whenever we look at a change in one of the determinants, we always make the ceteris paribus assumption.

The cost of factors of production: Changes shift the supply curve. Outcome depends on whether the costs rise or fall.

Price of other products which the producer could produce instead of the existing product: Changes shift the supply curve.

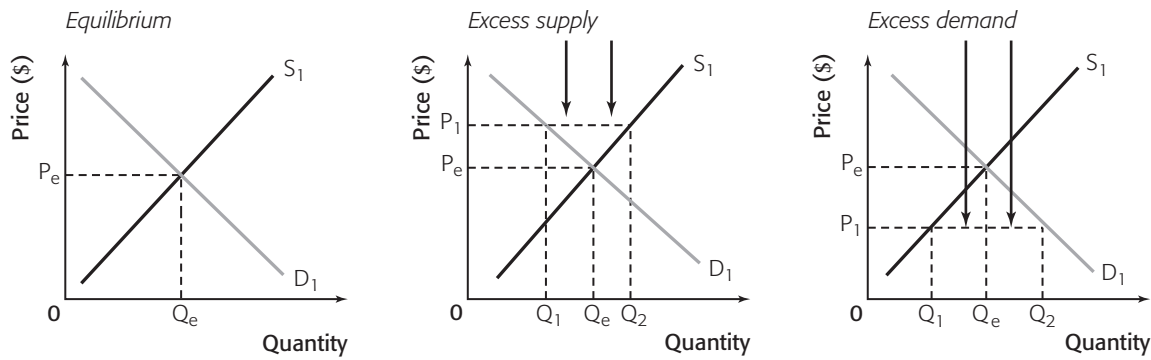
The state of technology: Changes shift the supply curve. Outcome depends on whether the change improves or harms productivity.

Government intervention: There are larger factors where changes may also shift the supply curve, such as the imposition of indirect taxes and the granting of subsidies.

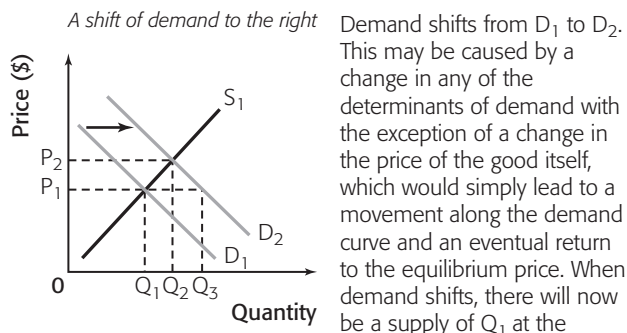


Equilibrium (the market mechanism)

When demand and supply come together, we get the creation of the equilibrium market price and quantity. The equilibrium is self-righting. If a firm tries to raise its price, then there will be **excess supply** at the new price and price will fall back to the equilibrium. In the same way, if a firm tries to lower its price, then there will be **excess demand** at the new price and price will go back up to the equilibrium.

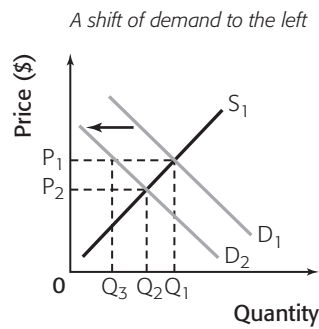


The effect of changes in demand and supply on the equilibrium



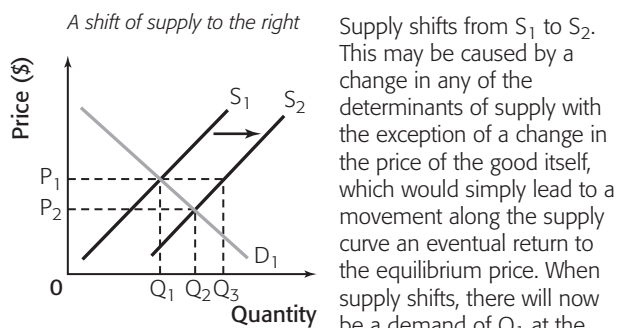
Demand shifts from D_1 to D_2 . This may be caused by a change in any of the determinants of demand with the exception of a change in the price of the good itself, which would simply lead to a movement along the demand curve and an eventual return to the equilibrium price. When demand shifts, there will now be a supply of Q_1 at the

equilibrium price, but a demand of Q_3 . Thus, there will be excess demand of $Q_3 - Q_1$. This means that price will begin to rise. The process will continue until a new equilibrium is reached at P_2 and Q_2 . More will be demanded and supplied at a higher price.



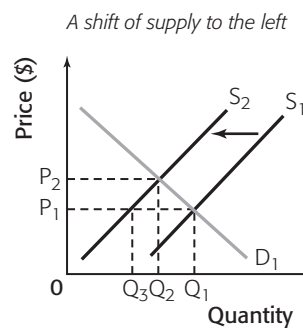
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Supply shifts from S_1 to S_2 . This may be caused by a change in any of the determinants of supply with the exception of a change in the price of the good itself, which would simply lead to a movement along the supply curve and an eventual return to the equilibrium price. When supply shifts, there will now be a demand of Q_1 at the

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