Principles of Business : course n°5

The market system in action : Supply and Demand Mechanisms

BA 2nd Year - 05/02/2020

Questions on previous course

What is a business cycle ?

What is the main metric used to measure a business cycle ?

What is your opinion on the current economic situation ?

How would you qualifie the current price of oil ?

At what level are interest rate in develloped countries ?

Which sector is most dynamic : industry (secondary sector) or services (tertiary sector) ?

Definition of Laws of Supply and Demand

The most basic laws in economics are the law of supply and the law of demand. Indeed, almost every economic event or phenomenon is the product of the interaction of these two laws. The law of supply states that the quantity of a good supplied (i.e., the amount owners or producers offer for sale) rises as the market price rises, and falls as the price falls. Conversely, the law of demand (see demand) says that the quantity of a good demanded falls as the price rises, and vice versa. (Economists do not really have a “law” of supply, though they talk and write as though they do.)

Source : Al Ehrbar

In search of Equilibrium

One function of markets is to find “equilibrium” prices that balance the supplies of and demands for goods and services. An equilibrium price (also known as a “market-clearing” price) is one at which each producer can sell all he wants to produce and each consumer can buy all he demands.
Naturally, producers always would like to charge higher prices. But even if they have no competitors, they are limited by the law of demand : if producers insist on a higher price, consumers will buy fewer units. The law of supply puts a similar limit on consumers. They always would prefer to pay a lower price than the current one. But if they successfully insist on paying less (say, through price controls), suppliers will produce less and some demand will go unsatisfied.

Source : Al Ehrbar

In search of Equilibrium !

Economists often talk of “demand curves” and “supply curves.” A demand curve traces the quantity of a good that consumers will buy at various prices. As the price rises, the number of units demanded declines. That is because everyone’s resources are finite ; as the price of one good rises, consumers buy less of that and, sometimes, more of other goods that now are relatively cheaper. Similarly, a supply curve traces the quantity of a good that sellers will produce at various prices. As the price falls, so does the number of units supplied. Equilibrium is the point at which the demand and supply curves intersect—the single price at which the quantity demanded and the quantity supplied are the same.

Source : Al Ehrbar

Equilibrium ? How come ?

Supposly, markets in which prices can move freely are always in equilibrium or moving toward it.

For example, if the market for a good is already in equilibrium and producers raise prices, consumers will buy fewer units than they did in equilibrium, and fewer units than producers have available for sale. In that case producers have two choices. They can reduce price until supply and demand return to the old equilibrium, or they can cut production until the quantity supplied falls to the lower number of units demanded at the higher price. But they cannot keep the price high and sell as many units as they did before.

Source : Al Ehrbar

Shifts vs. Movement

A **movement** refers to a change along a curve.

On the demand curve, a movement denotes a change in both price and quantity demanded from one point to another on the curve. The movement implies that the demand relationship remains consistent. Therefore, a movement along the demand curve will occur when the price of the good changes and the quantity demanded changes in accordance to the original demand relationship. In other words, a movement occurs when a change in the quantity demanded is caused only by a change in price, and vice versa.

Meanwhile, a **shift** in a demand or supply curve occurs when a good's quantity demanded or supplied changes even though price remains the same.

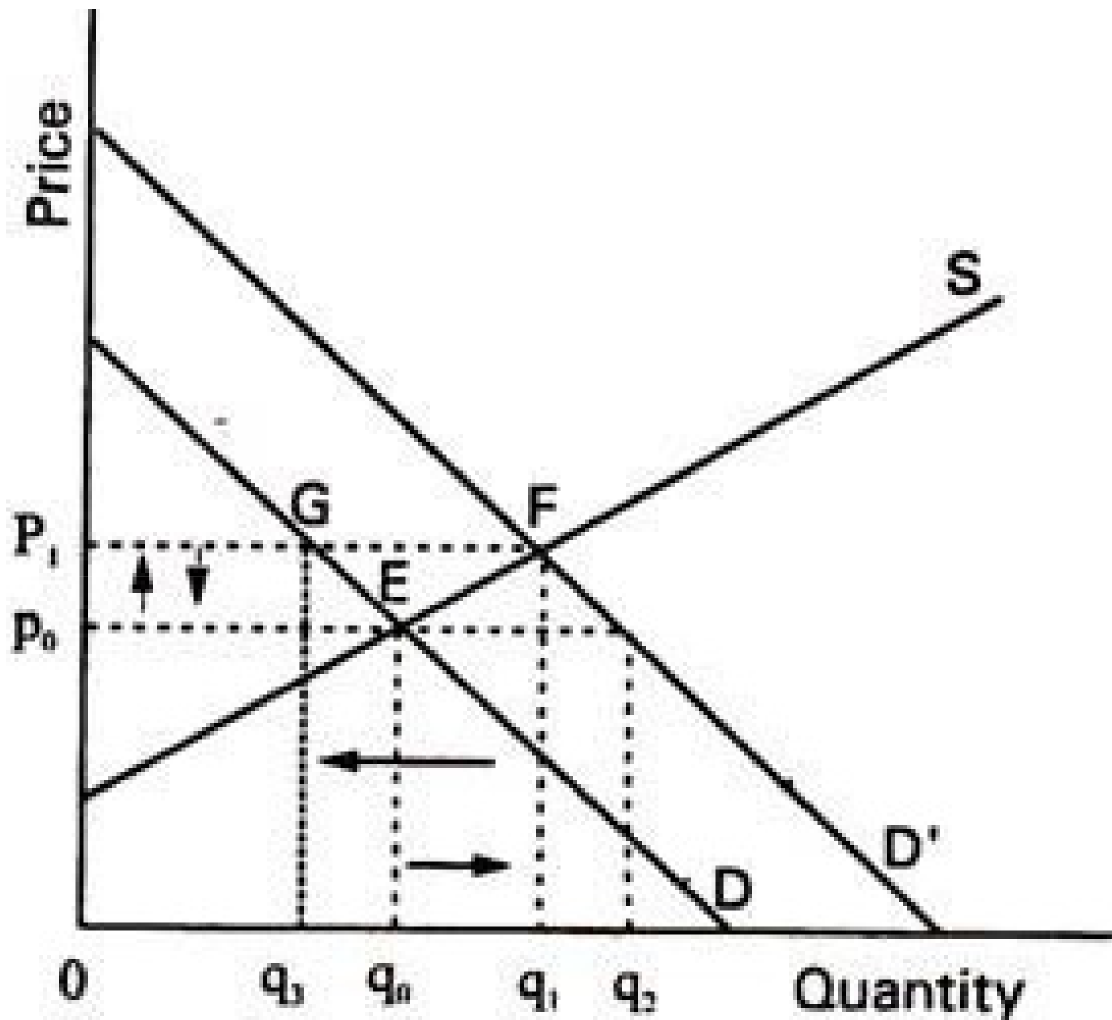


Fig. 9.3. The effect of a shift of the demand curve

Reading a Supply & Demand graphical representation

Source : « Shifts in Demand and Supply (With Diagram) » ; Sanket Suman ; http://www.economicsdiscussion.net

Reading a Supply & Demand graphical representation

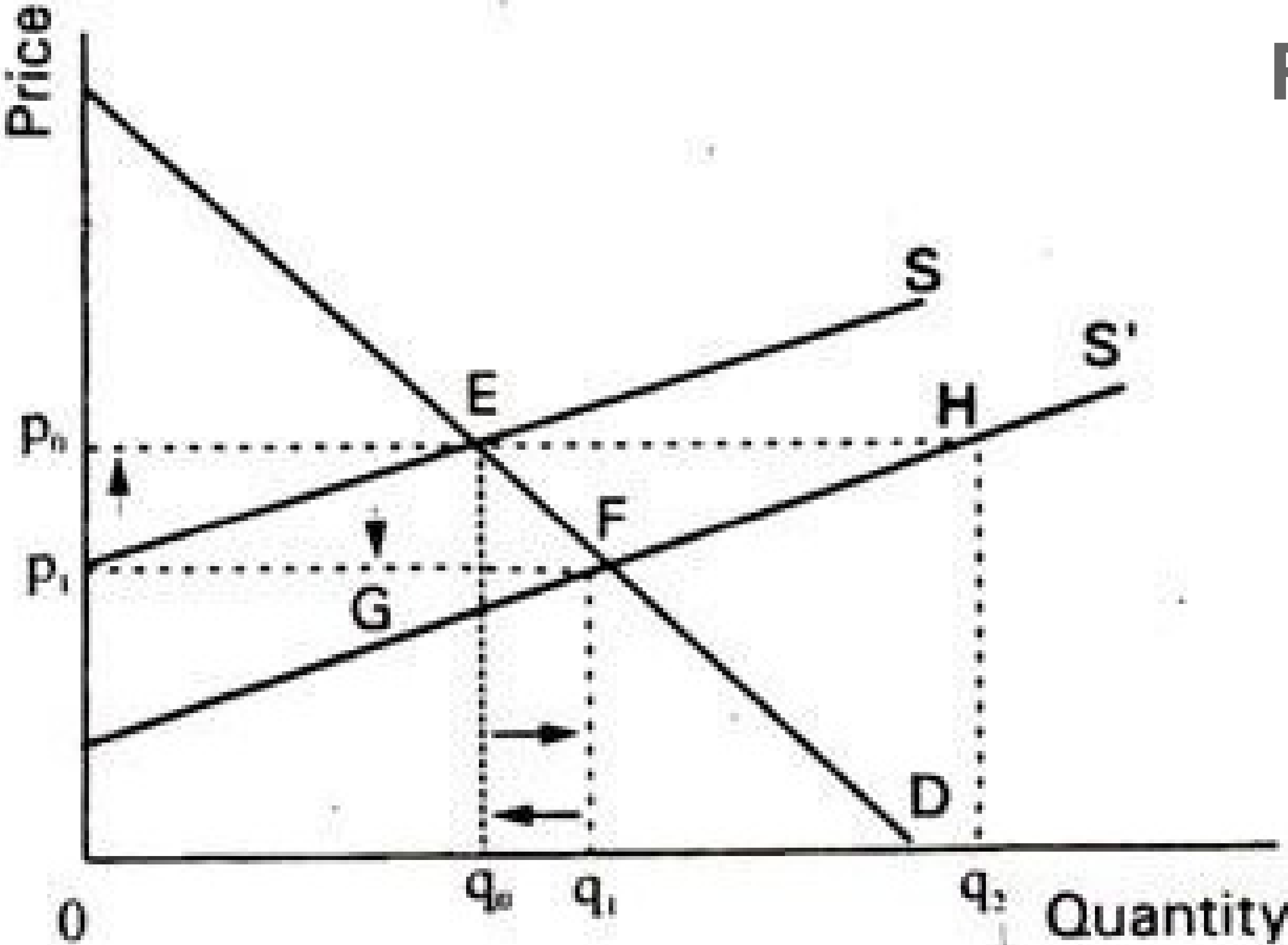


Fig. 9.4. The effects of shifts of the supply curve

Source : « Shifts in Demand and Supply (With Diagram) » ; Sanket Suman ; http://www.economicsdiscussion.net

Reading a Supply & Demand graphical representation

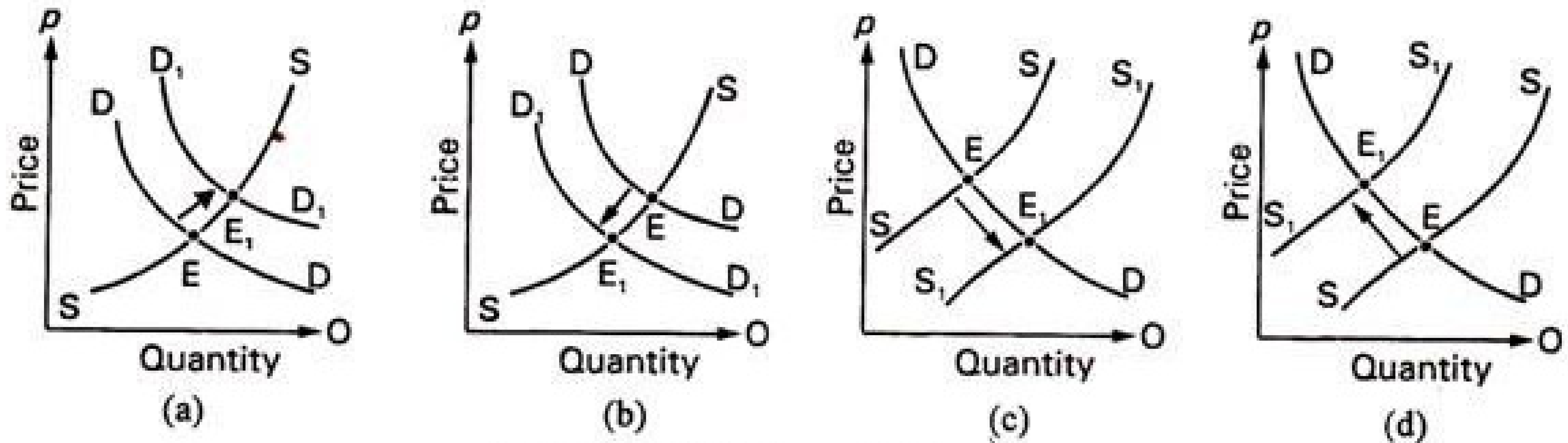
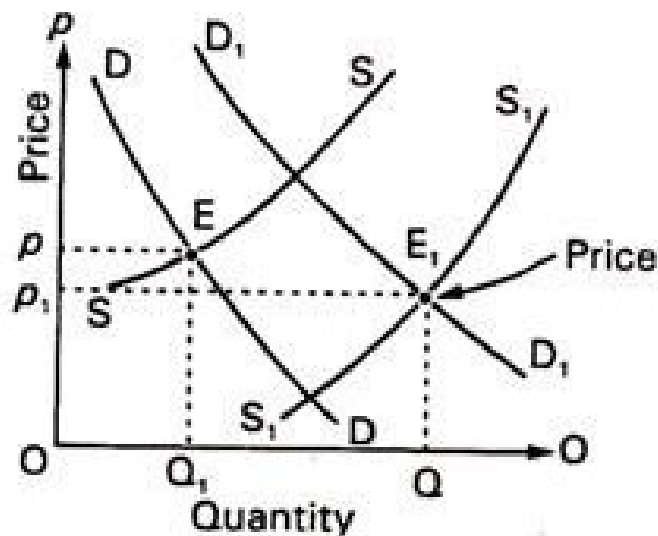


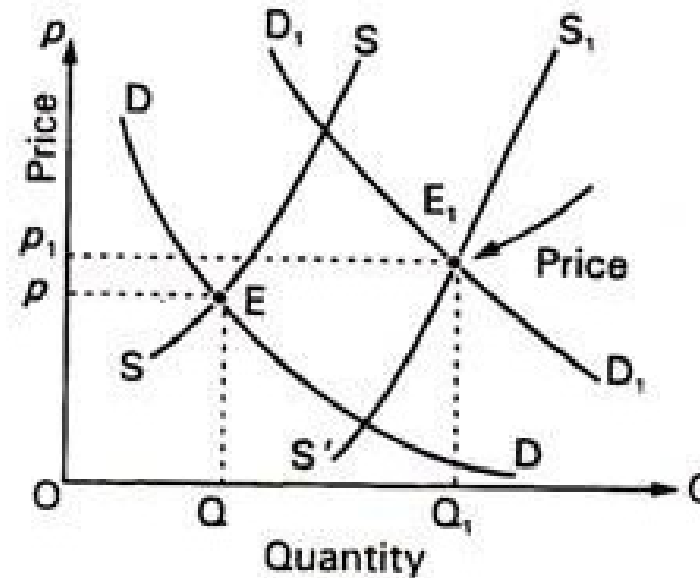
Fig. 9.5. Changes in equilibrium price

Source : « Shifts in Demand and Supply (With Diagram) » ; Sanket Suman ; http://www.economicsdiscussion.net

Reading a Supply & Demand graphical representation



(a)



(b)

Fig. 9.6. Complex shifts in demand and supply

Source : « Shifts in Demand and Supply (With Diagram) » ; Sanket Suman ; http://www.economicsdiscussion.net

Supply & Demand understanding check

« An increase in income causes demand to rise. The rise in demand causes an increase in price. The increase in price causes an increase in supply, which pushes price back towards its original level. »

What is the mistake in this quotation?

Source : « Shifts in Demand and Supply (With Diagram) » ; Sanket Suman ; http://www.economicsdiscussion.net

Supply & Demand understanding check

« An increase in income causes demand to rise. The rise in demand causes an increase in price. The increase in price causes an increase in supply, which pushes price back towards its original level. »

Solution : There is no doubt that an increase in income certainly shifts the demand curve to the right. As a result of a rise in demand, price rises. It is also true that the rise in price tends to increase the quantity supplied. But the rest of the statement is wrong. How can supply increase along the same supply curve (because there is no shift of the supply curve) ?
In fact, there is an increase in quantity supplied along the same supply curve.

Source : « Shifts in Demand and Supply (With Diagram) » ; Sanket Suman ; http://www.economicsdiscussion.net

Factors affecting Supply & Demand

Factors affecting supply

Production capacity, production costs such as labor and materials, and the number of competitors directly affect how much supply businesses can create. Ancillary factors such as material availability, weather, and the reliability of supply chains also can affect supply.

Factors affecting demand

The number of available substitutes, consumer preferences, and the shifts in the price of complementary products affect demand. For example, if the price of video game consoles drops, the demand for games for that console may increase as more people buy the console and want games for it.