Supply And Demand Essay, Research Paper

Market demand is best defined as each consumer s demand for a particular product, or each firm s demand for a particular factor. The law of demand specifies that the amount demanded varies inversely with price . The following diagram can best demonstrate this. The table shows the maximum rate of purchase. That is, where the price is $40, consumers will buy 200 units and no more.

Price $ Quantity Demanded

20 240

40 200

60 160

80 120

100 80

120 40

The demand curve can be used to give a graphical representation of the above data.

Movement along the demand curve is caused only by a change in price. An Increase in price results in a move upward in the demand curve. This is known a contraction in demand (or a decrease in the quantity demanded). Conversely, if the price falls, then there is an expansion in demand (or an increase in the quantity demanded).

Some conditions result in a shift of the curve itself (or in this case line). It is important to understand that unlike a movement along the demand curve, this change as nothing to do with price, and in fact has a number of contributing factors. A shift to the right of the original curve represents an increase in demand, and a shift to the left, represents a decrease in demand. An increase in demand means that consumers are more willing and able to purchase a given quantity of the product in question at the same price.

Possible reasons for increase in demand

+ Increased income levels

+ Higher price of substitutes (e.g. Chocolate and Carob)

+ Expected future price rises (consumer expectation causes increase)

+ Changes in fashion, preference and taste

+ Increase in population

A decrease in demand means that consumers are less willing and less able to purchase a given quantity of the good at the original price. It also means that consumers are able to buy a given quantity at a lower price than before.

Possible reasons for a decrease in demand

+ Decreased income levels

+ Lower price of substitutes

+ Expected future price falls (consumer expectation causes decrease)

+ Changes in fashion, preference and taste

+ Decrease in population

Market Supply is defined as the quantity of goods and services that an industry is willing and able to offer the market at different price levels at a given point in time. The laws of supply state that producers will supply more of a product at a higher price and less at a lower price .

Price $ Quantity Supplied

120 240

100 200

80 160

60 120

40 80

20 40

The supply curve can show the above information graphically.

Like the demand curve, movement along the supply curve is only caused by a change in price. If the price rises, then so does supply, and if the price falls, supply does too. These movements are known as expansions and contractions in supply.

Like the demand curve, certain circumstances cause the curve to shift. An increase in supply is represented by the curve shifting to the right as shown below.

Factors leading to this increase in supply may include:

+ Improvement in technology

+ Fall in the cost of factors of production (land, labour, capital)

+ Increase in availability of the factors of production

+ More favourable seasonal conditions (fresh produce etc.)

+ Fall in the cost of other goods resulting in them being less profitable to produce and resources being shifted to production of good in question as it is more profitable

A decrease in supply has the opposite effect. The supply curve moves to the left as shown below.

Factors leading to this decrease in supply may include:

+ Increase in the cost of factors of production (land, labour, capital)

+ Decrease in availability of the factors of production

+ Less favourable seasonal conditions (fresh produce etc.)

+ Increase in the cost of other goods resulting in them being more profitable to produce and resources being shifted to production of these goods and taken away from the good in question.

+ Regulations restricting the supply of the good in question (quotas on imports etc.)

If we combine Demand and Supply, we are given a good model of the price mechanism. The price mechanism is the fundamental determinant that governs the price at which commodities will be sold in a perfect market, but because no market is free from some form of intervention, it is not totally accurate.

By using this supply and demand model, we are shown market equilibrium. This is the point where at a certain price level, supply and demand are equal. If market equilibrium is not met, then there will be an excess of supply and a shortage of demand or vice versa.

If the price is above the equilibrium, then there will be an excess of supply and a shortage of demand. This is due to the laws of supply and demand as described before. As the price is high, there is more profit to be made in the production of the good. However, with the high price, consumers are less willing and able to purchase the product. To counter this excess supply, producers must lower the price and thereby raise the demand to meet supply. As a result, equilibrium is met.

If the price is below the equilibrium price, then there is an excess of demand. This will be rectified by competition between buyers pushing the price up, resulting in an increase of supply and a contraction in demand until the equilibrium price is met.

If we apply the previous theories of increases and decreases in demand and supply to this model that encompasses both supply and demand, we can gain further insight into how markets work.

An increase in demand creates excess in demand at the previous equilibrium price. The price will be forced up causing an expansion in supply until the new equilibrium is reached at P1. An increase in demand raises both equilibrium price and quantity.

A decrease in demand creates excess in supply and the previous equilibrium price (P1). The price will be forced down causing a contraction in supply until equilibrium is reached at e. As demand falls, so will equilibrium price and quantity.