

KEY TAKEAWAYS 2

Chapter 2 : Demand and Supply in a context of a Market Economy

I- Market Economy

In a free market, the price and quantity of an item are determined by the supply and demand for that item.

Key Points

- A market is defined as a system or institution whereby parties engage in exchange. A market economy is an economy in which decisions regarding investment, production, and distribution are based on supply and demand, and prices of goods and services are determined in a free price system.
- In a perfectly competitive market there are many buyers and sellers so no individual actor may affect a good's price; there are no barriers to exit or entry; products are homogeneous; and all actors in the economy have perfect information.
- Changes to the market supply and market demand will cause changes in the equilibrium price and quantity of the good produced.
- When markets are perfectly competitive, the equilibrium outcome of trade in the market is economically efficient. This means that the market is producing the largest net gain possible for society, given consumers' utility functions and producers' production functions.

II- Demand

1- The Law of Demand

In general, the law of demand states that the quantity demanded and the price of a good or service is inversely related, other things remaining constant.

Key Points

- The demand curve is downward sloping, indicating the negative relationship between the price of a product and the quantity demanded.
- For normal goods, a change in price will be reflected as a move along the demand curve while a non-price change will result in a shift of the demand curve.
- Two exceptions to the law of demand are Giffen goods and Veblen goods.
- In economics, the law of demand states that the quantity demanded and the price of a good or service is inversely related, other things remaining constant. Therefore, the demand curve will generally be downward sloping, indicating the negative relationship between the price of a good or service and the quantity demanded.

2- Movement along the Demand Curve

If the income of the consumer, prices of the related goods, and preferences of the consumer remain unchanged, then the change in quantity of good demanded by the consumer will be negatively correlated to the change in the price of the good or service. The change in price will be reflected as a move along the demand curve.

3- Shift in the Demand Curve

- The demand curve will shift, move either inward or outward as a result of non-price factors.
- A shift in demand can be related to the many factors (non-exhaustive list):
 - Consumer preferences
 - Consumer income
 - Change in the price of related goods (i.e. compliments)
 - Change in the number of buyers
 - Consumer expectations

4- Demand Schedules

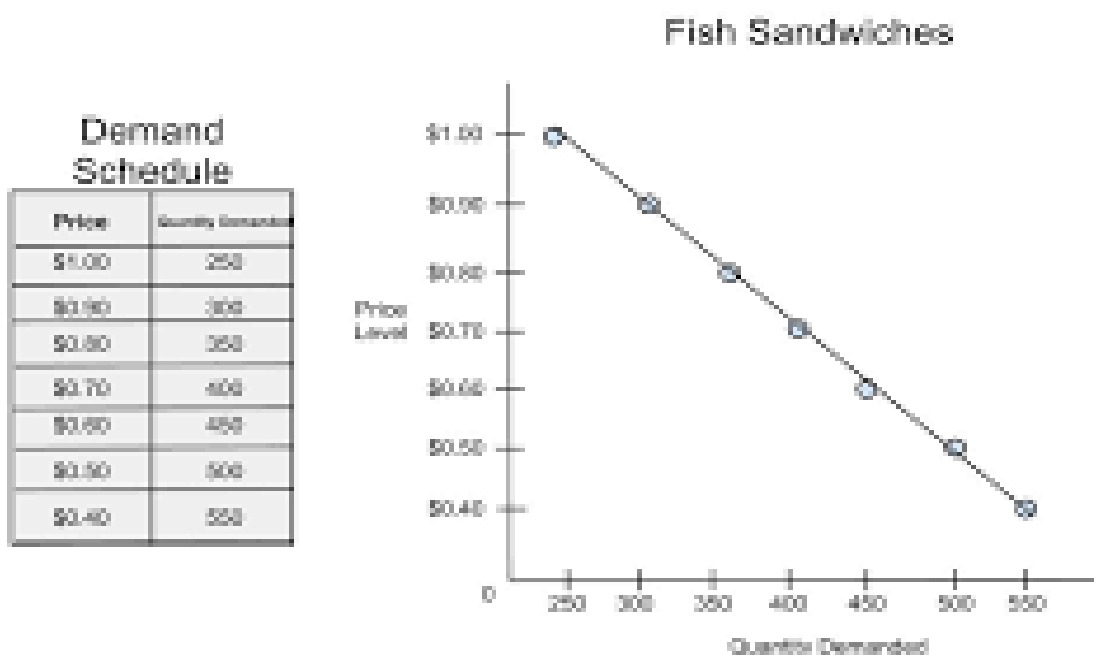
- A demand curve depicts the price and quantity combinations listed in a demand schedule.

Key Points

- Demand curves are a graphical representation of a demand schedule, which is the table view of an economic agents' price to quantity relationship.
- Demand curves embody preferences, substitution potential and income, as well as other characteristics that influence an economic agent's ability to assess willingness to pay at a specific point in time for goods and services.
- Demand curves may be linear or curved.
- Aggregate demand is the sum of the quantity demanded for a specific price over a group of economic agents.

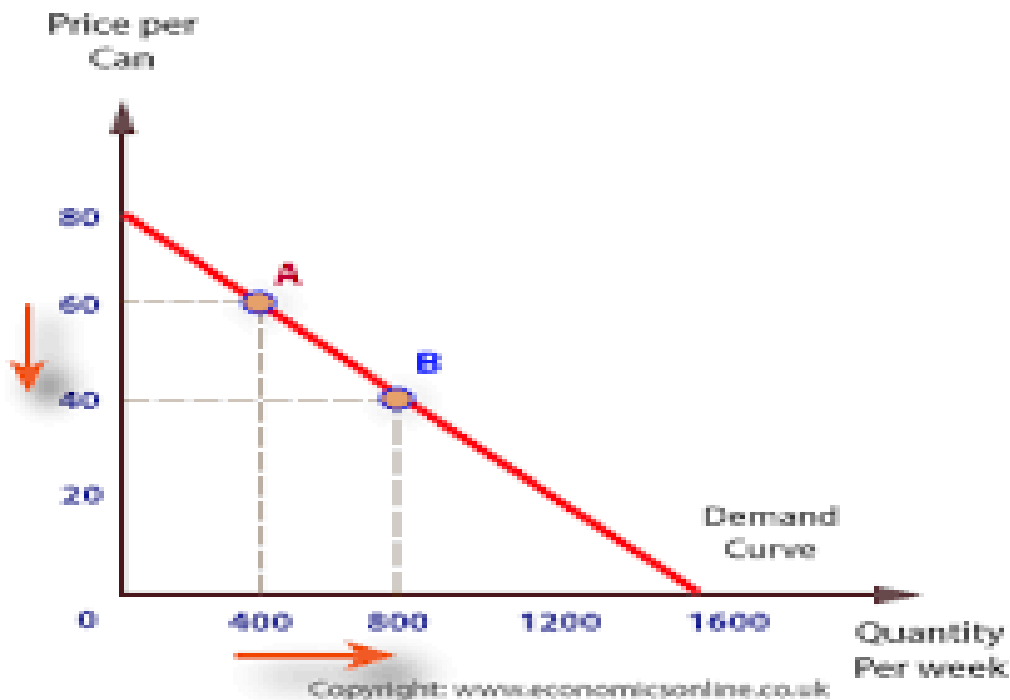
5- Demand Schedule and Curve:

The demand curve is the graphical representation of the economic entity's willingness to pay for a good or service. It is derived from a demand schedule, which is the table view of the price and quantity pairs that comprise the demand curve.



III- Market Demand

- Market demand is the summation of the individual quantities that consumers are willing to purchase at a given price.



1- Market demand schedule

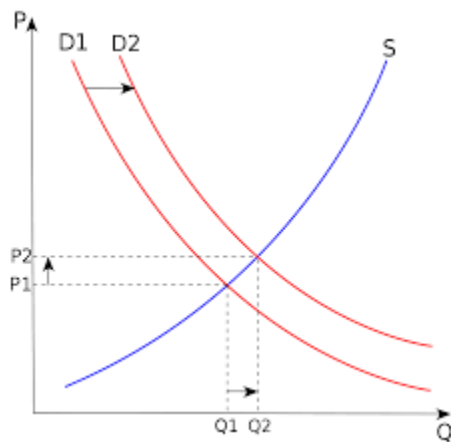
A market demand schedule is a table that lists the quantity of a good all consumers in a market will buy at every different price.

A market demand schedule for a product indicates that there is an inverse relationship between price and quantity demanded.

The graphical representation of a market demand schedule is called the market demand curve.

2- Market demand Curve:

A demand curve provides an economic agent's price to quantity relationship related to a specific good or service. Movements along a demand curve are related to a change in price, resulting in a change in quantity; shifts in demand (D1 to D2) are specific to changes in income, preferences, availability of substitutes and other factors.



3- Changes in Demand

Demand is the relationship between the willingness to purchase a quantity of a good or service at a specific price.

Key Points

- A change in price will result in a movement along a demand curve.
- A change in a non-price variable will result in a shift in the demand curve.
- **Movements** along the demand curve are due to a change in the price of a good, holding constant other variables, such as the price of a substitute. If the price of a good or service changes the consumer will adjust the quantity demanded based on the preferences, income and prices of other factors embedded within a given curve for the time period under consideration.

4- Shifts in the Demand Curve

Key Points

- An outward shift in demand will occur if income increases, in the case of a normal good; however, for an inferior good, the demand curve will shift inward noting that the consumer only purchases the good as a result of an income constraint on the purchase of a preferred good.

- **Shifts** in the demand curve are related to non-price events that include income, preferences and the price of substitutes and complements. An increase in income will cause an outward shift in demand (to the right) if the good or service assessed is a *normal good* or a good that is desirable and is therefore positively correlated with income. Alternatively, an increase in income could result in an inward shift of demand (to the left) if the good or service assessed is an *inferior good* or a good that is not desirable but is acceptable when the consumer is constrained by income.

IV- Supply

1- The Law of Supply

The law of supply states that there is a positive relationship between the quantity that suppliers are willing to sell and the price level.

Key Points

- Quantity supplied moves in the same direction as price.
- The supply curve is an upward sloping curve.
- Producers are willing to increase production at higher prices to increase profit.

The law of supply is a fundamental principle of economic theory. It states that an increase in price will result in an increase in the quantity supplied, all else held constant.

2- Supply Schedules

- A supply schedule is a table that shows the relationship between the price of a good and the quantity supplied. The supply curve is a graphical depiction of the supply schedule that illustrates that relationship between the price of a good and the quantity supplied.

3- Supply Curves

- The supply curve provides one side of the price-to-quantity relationship that ensures a functional market. The other

component is demand. When the supply and demand curves are graphed together they will intersect at a point that represents the market equilibrium – the point where supply equals demand and the market clears.

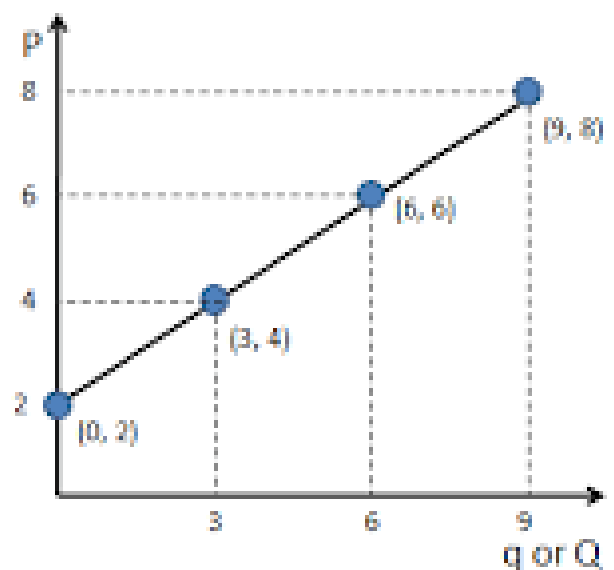
4- Market Supply

- Market supply is the summation of the individual supply curves within a specific market where the market is characterized as being perfectly competitive.

Key Points

- A **supply curve** is the graphical representation of the supplier's positive correlation between the price and quantity of a good or service.
- The **supply curve** can only be attributed to a depiction of a perfectly competitive market due to the unique attributes of perfect competition: firms are price takers, no single firm's actions can influence the market price, and ease of exit and entry.
- The **market supply curve** is derived by summing the quantity for a given price across all market participants (suppliers). It depicts the price-to-quantity combinations available to consumers of the good or service.

Price	Quantity Supplied
\$2	0
\$4	3
\$6	6
\$8	9



5- Changes in Supply Curve

The supply curve depicts the supplier's positive relationship between price and quantity.

Key Points

- A change in the price of a good or service, holding all else constant, will result in a movement along the supply curve.

6- Shifts in the Supply Curve

- A change in the cost of an input will impact the cost of producing a good and will result in a shift in supply; supply will shift outward if costs decrease and will shift inward if they increase.
- A change in the expected demand for a good or service will result in a shift in supply; supply will shift outward if enthusiasm is expected to increase and will shift inward if there is an expectation for consumers preferences to change in favor of an alternate good or service.

III- Price changes and movement along supply curve

If the price of the good or service changes, all else held constant such as price of substitutes, the supplier will adjust the quantity supplied to the level that is

consistent with its willingness to accept the prevailing price. The change in price will result in a movement along the supply curve, called a change in quantity supplied, but *not* a shift in the supply curve. Changes in supply are due to non-price changes.

a. Non-price changes and shifts of the supply curve

If production costs increase, the supplier will face increasing costs for each quantity level. Holding all else the same, the supply curve would shift inward (to the left), reflecting the increased cost of production. The supplier will supply less at each quantity level.

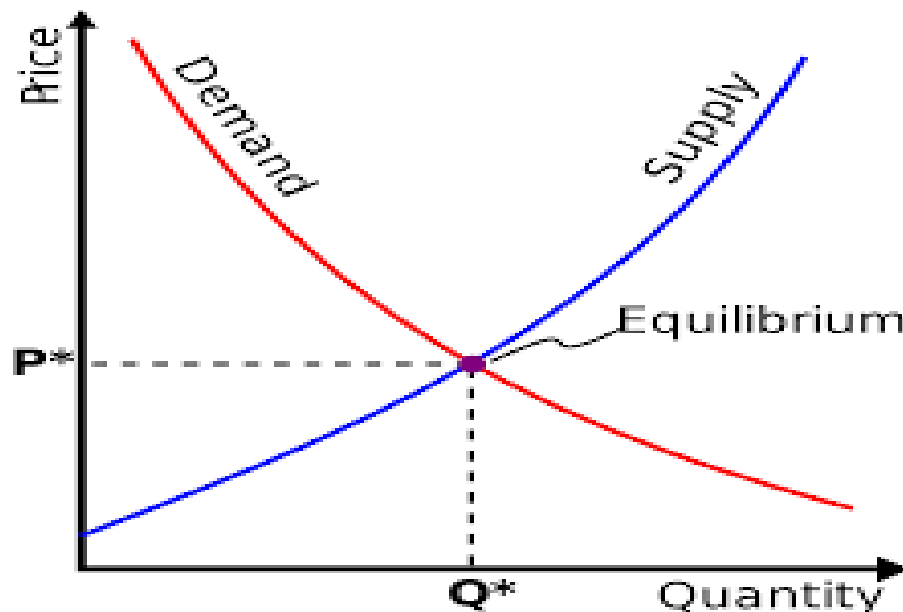
V-Market Equilibrium Price and Quantity

- When a market achieves perfect equilibrium there is no excess supply or demand, which theoretically results in a market clearing.

Key Points

- The interdependent relationship between supply and demand in the field of economics is inherently designed to identify the ideal price and quantity of a given product or service in a marketplace.
- A market clearing, by definition, is the economic assumption that the quantity supplied will consistently align with the quantity demanded.
- Market clearing requires a variety of assumptions which simplify the complexities of real markets to coincide with a more theoretical framework, most centrally the assumptions of perfect competition and Say's Law.
- While this concept of market clearing resonates well in theory, the actual execution of markets is very rarely perfect. The concepts of consolidated markets and 'sticky' markets reduces the accuracy of these models.
- The interdependent relationship between supply and demand in the field of economics is inherently designed to identify the ideal price and quantity of a given product or service in a marketplace.

- This equilibrium point is represented by the intersection of a downward sloping demand line and an upward sloping supply line, with price as the y-axis and quantity as the x-axis.
- At perfect equilibrium there is no excess demand (represented by 'A' in the figure) or excess supply (represented by 'B' in the figure), which theoretically results in a market clearing.



Equilibrium Pricing: This chart effectively highlights the various basic implications of a simple supply and demand chart. The equilibrium point is where market clearing will theoretically occur.