



Chapter 3 Supply and Demand: Theory



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In This Lecture

- Demand
- Supply
- The Market
- Consumers' Surplus, Producers' Surplus, and Total Surplus




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To select a topic, click on its link above

Theory

Economists build theories to answer questions that do not have obvious answers.

Cause  Effect

Theory is an abstract representation of the real world designed with the intent to better understand the world.

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Market

Any place people come together to trade

Trade or exchange may take place at a physical or virtual location




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Demand - A Definition

The willingness and ability of buyers: to purchase different quantities of a good at different prices during a specific time period.





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Law of Demand

As the price of a good rises, the quantity demanded of the good falls, and as the price of a good falls, the quantity demanded of the good rises, ceteris paribus

Price  Quantity 

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Ceteris Paribus

A Latin term meaning "all other things constant" or "nothing else changes."

Ceteris paribus is an assumption used to examine the effect of one influence on an outcome while holding all other influences Constant.

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Why Does Quantity Demanded Go Down as Price Goes Up?

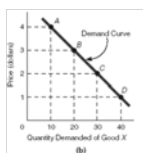
- people substitute lower priced goods for higher priced goods.
- the law of diminishing marginal utility, which states that for a given time period, the marginal (or additional) utility or satisfaction gained by consuming equal successive units of a good will decline as the amount consumed increases.

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Demand

Click graph to watch tutorial on demand.



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Demand Schedule

The numerical tabulation of the quantity demanded of a good at different prices.

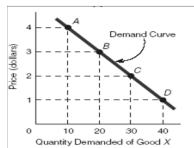
A demand schedule is the numerical representation of the law of demand.

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Downward Sloping Demand Curve

The graphical representation of the demand schedule and law of demand.



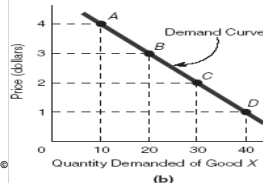
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Demand - Schedule and Graph

Price (dollars)	Quantity Demanded	Point in Part (b)
4	10	A
3	20	B
2	30	C
1	40	D

(a)



(b)

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Why does the price of one more day at Disney World cost less than the cost of the first day?



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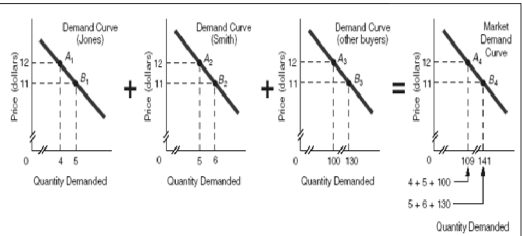
Derivation of Market Demand Schedule

Price	Quantity Demanded						
	Jones	Smith	Other Buyers	All Buyers			
\$15	1	2	20	23			
14	2	3	45	50			
13	3	4	70	77			
12	4	+	5	+	100	=	109
11	5	+	6	+	130	=	141
10	6	7	160	173			

(a)

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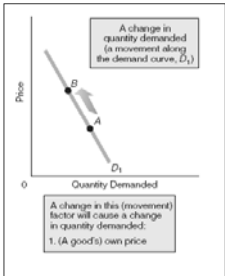
Derivation of Market Demand Curve



(b)

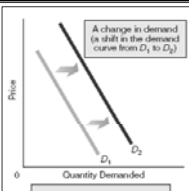
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Change in Quantity Demanded



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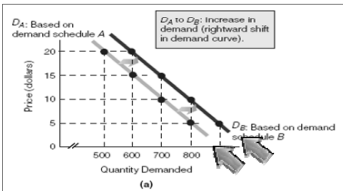
Change in Demand



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Increase in Demand

Demand Schedule A		Demand Schedule B (increase in demand)	
Price	Quantity Demanded	Price	Quantity Demanded
\$20	500	\$20	600
\$15	600	\$15	700
\$10	700	\$10	800
\$ 5	800	\$ 5	900



(a)

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Decrease in Demand

Demand Schedule A		Demand Schedule C (decrease in demand)	
Price	Quantity Demanded	Price	Quantity Demanded
\$20	500	\$20	400
\$15	600	\$15	500
\$10	700	\$10	600
\$ 5	800	\$ 5	700

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Factors Causing a Shift in the Demand Curve

- Income
- Preferences
- Prices of substitute goods
- Prices of complementary goods
- Number of buyers
- Expectations of future prices

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Factors Causing a Shift in the Demand Curve - Income

Normal Good - A good the demand for which rises (falls) as income rises (falls).

Inferior Good - A good the demand for which falls (rises) as income rises (falls).

Neutral Good - A good the demand for which does not change as income rises or falls.

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Factors Causing a Shift in the Demand Curve - Substitutes

Substitutes

Two goods that satisfy similar needs or desires. If two goods are substitutes, the demand for one rises as the price of the other rises (or the demand for one falls as the price of the other falls).

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Factors Causing a Shift in the Demand Curve - Complements

Complements

Two goods that are used jointly in consumption. If two goods are complements, the demand for one rises as the price of the other falls (or the demand for one falls as the price of the other rises).

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Effect on Demand if Price Increases on a Substitute Good

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Effect on Demand if Price Increases on a Complementary Good

COMPLEMENTS

If tennis rackets and tennis balls are complements, a higher price for tennis rackets leads to ...

... a leftward shift in the demand curve for tennis balls.

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Self Test

- As Sandi's income rises, her demand for popcorn rises. As Mark's income falls, his demand for prepaid telephone cards rises. What kinds of goods are popcorn and telephone cards for the people who demand each?
 Popcorn is a normal good for Sandi. Prepaid telephone cards are an inferior good for Mark.

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Self Test

- Why are demand curves downward sloping?
 Asking why demand curves are downward sloping is the same as asking why price and quantity demanded are inversely related (as one rises, the other falls). There are two reasons mentioned in this section:
 (1) As price rises, people substitute lower priced goods for higher priced goods.
 (2) Because individuals receive less utility from an additional unit of a good they consume, they are only willing to pay less for the additional unit. The second reason is a reflection of the law of diminishing marginal utility.

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Self Test

- Give an example that illustrates how to derive a market demand curve.
 Suppose only two people, Bob and Alice, have a demand for good X.
 At a price of \$7, Bob buys 10 units and Alice buys 3 units; at a price of \$6, Bob buys 12 units and Alice buys 5 units.
 One point on the market demand curve represents a price of \$7 and a quantity demanded of 13 units; another point represents \$6 and 17 units.
 A market demand curve is derived by adding the quantities demanded at each price.

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Self Test

- What factors can change demand? What factors can change quantity demanded?
 A change in income, preferences, prices of related goods, number of buyers, and expectations of future price can change demand.
 A change in the price of the good changes the quantity demanded of the good.
 For example, a change in *income* can change the *demand* for oranges, but only a change in the *price* of oranges can directly change the *quantity demanded* of oranges.

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Supply

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Supply

The willingness and ability of sellers to produce and offer to sell different quantities of a good at different prices during a specific time period.

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Law of Supply

As the price of a good rises, the quantity supplied of the good rises, and as the price of a good falls, the quantity supplied of the good falls, *ceteris paribus*.

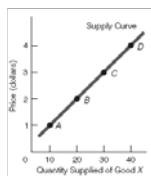


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Supply Curve

The graphical representation of the law of supply, which states that price and quantity supplied are directly related, *ceteris paribus*.



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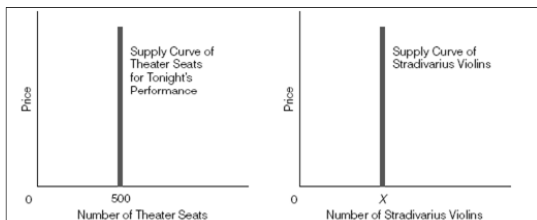
Supply Curve

The graphical representation of the law of supply, which states that price and quantity supplied are directly related, *ceteris paribus*.

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Fixed Supply



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Supply Schedule

- The numerical tabulation of the quantity supplied of a good at different prices.
- A supply schedule is the numerical representation of the law of supply.

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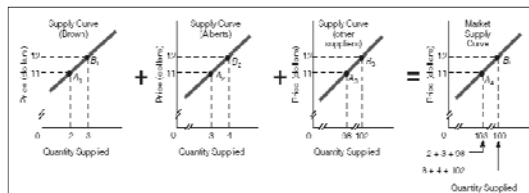
Deriving a Market Supply Schedule

Price	Quantity Supplied						
	Brown	Alberts	Other Suppliers	All Suppliers			
\$10	1	2	96	99			
11	2	+	3	+	98	=	103
12	3	+	4	+	102	=	109
13	4		5		106		115
14	5		6		108		119
15	6		7		110		123

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Deriving a Market Supply Curve



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Changes in Supply Shift in Supply

- The supply of a good can rise or fall. An increase in the supply of a good means that suppliers are willing and able to produce and offer to sell more of the good at all prices.
- The supply of a good decreases if sellers are willing and able to produce and offer to sell less of the good at all prices.

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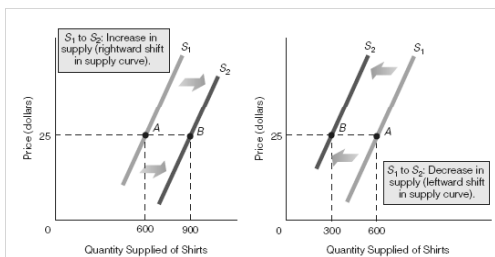
Factors that Cause the Supply Curve to Shift

- Prices of relevant resources
- Technology
- Prices of Other Goods
- Number of sellers
- Expectation of future prices
- Taxes and subsidies
- Government restrictions

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Change in Supply



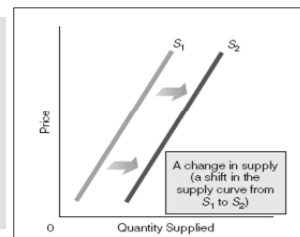
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Change in Supply

A change in any of these (shift) factors can cause a change in supply:

1. Prices of relevant resources
2. Technology
3. Prices of other goods
4. Number of sellers
5. Expectations of future price
6. Taxes and subsidies
7. Government restrictions



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Change in Quantity Supplied

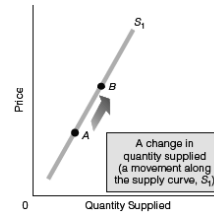
- A change in quantity supplied refers to a movement along a supply curve.
- The only factor that can directly cause a change in the quantity supplied of a good is a change in the price of the good, or own price.

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Change in Quantity Supplied

A change in this (movement) factor will cause a change in quantity supplied:
1. (A good's) own price



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Self Test

1. What would the supply curve for houses (in a given city) look like for a time period of (a) the next ten hours and (b) the next three months?

It would be difficult to increase the quantity supplied of houses over the next ten hours, so the supply curve in (a) is vertical. It is possible to increase the quantity supplied of houses over the next 3 months, however, so the supply curve in (b) is upward sloping.

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Self Test

2. What happens to the supply curve if each of the following occurs?
 - a. The number of sellers decreases.
 - b. A per-unit tax is placed on the production of a good.
 - c. The price of a relevant resource falls.

- a. The supply curve shifts to the left.
- b. The supply curve shifts to the left.
- c. The supply curve shifts to the right.

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Self Test

3. "If the price of apples rises, the supply of apples will rise." True or false? Explain your answer.

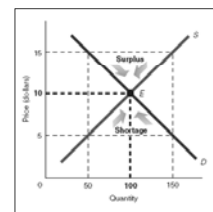
False. If the price of apples rises, the *quantity supplied* of apples will rise—not the *supply* of apples. We are talking about a *movement* from one point on a supply curve to a point higher up on the supply curve and not about a shift in the supply curve.

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Market Equilibrium

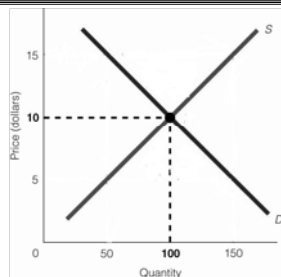
Click graph to watch tutorial



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Putting Supply and Demand Together



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Market Equilibrium

- Equilibrium in a market is the price quantity combination from which there is no tendency for buyers or sellers to move away.
- Graphically, equilibrium is the intersection point of the supply and demand curves.

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Auction at Work in a Market

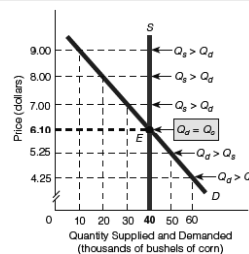
Supply and Demand at Work

- The auctioneer calls out different prices, and buyers record how much they are willing and able to buy.
- At prices of \$9.00, \$8.00, and \$7.00, quantity supplied is greater than quantity demanded.
- At prices of \$4.25 and \$5.25, quantity demanded is greater than quantity supplied.

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Auction at Work in a Market



At a price of \$6.10, quantity demanded equals quantity supplied.

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Surplus and Shortage

Surplus (Excess Supply) - A condition in which quantity supplied is greater than quantity demanded. Surpluses occur only at prices above equilibrium price.

Shortage (Excess Demand) - A condition in which quantity demanded is greater than quantity supplied. Shortages occur only at prices below equilibrium price.

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Equilibrium

Equilibrium Price (Market- Clearing Price)

The price at which quantity demanded of the good equals quantity supplied

Equilibrium Quantity

The quantity that corresponds to equilibrium price. The quantity at which the amount of the good that buyers are willing and able to buy equals the amount that sellers are willing and able to sell, and both equal the amount actually bought and sold.

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Move to Market Equilibrium

Price	Q_d	Q_s	Condition
\$15	150	50	Surplus
10	100	100	Equilibrium
5	50	150	Shortage

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Market Demand and Supply

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Moving to Equilibrium

Units of Good X	Maximum Buying Price	Minimum Selling Price	Result
1st	\$70	\$10	Exchange
2d	60	20	Exchange
3d	50	30	Exchange
4th	40	40	Exchange
5th	30	50	No Exchange

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Consumer and Producer Surplus

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Consumer Surplus

CS = Maximum buying price - Price paid
 The difference between the maximum price a buyer is willing and able to pay for a good or service and the price actually paid.

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Consumer Surplus

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Producer Surplus

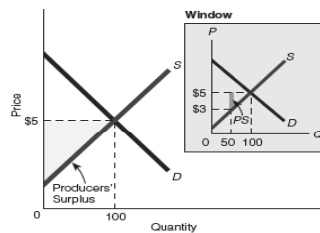
PS = Price received - Minimum Selling Price
 The difference between the price sellers receive for a good and the minimum or lowest price for which they would have sold the good.



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Producer Surplus



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Total Surplus

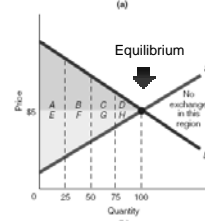
Total Surplus (TS) TS = CS + PS
 The sum of consumers' surplus and producers' surplus.

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Total Surplus

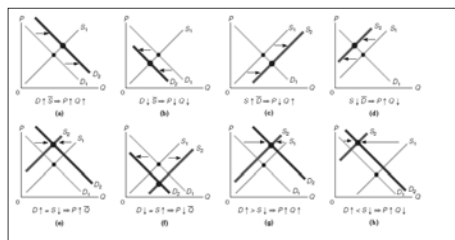
Quantity (units)	Consumers' Surplus	Producers' Surplus
25	A	E
50	A + B	E + F
75	A + B + C	E + F + G
100 (Equilibrium)	A + B + C + D	E + F + G + H



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Equilibrium Price and Quantity Effects of Supply and Demand Curve Shifts



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DEMAND AND SUPPLY AS EQUATIONS

Let's now look at demand and supply as equations. Here is a demand equation: $Q_d = 1,500 - 32P$
 To see what this equation says, we let price (P) in the equation equal \$10 and then solve for quantity demanded Q_d . We get 1,180.

$$Q_d = 1,500 - 32(10) = 1,180$$

So this equation says that if price is \$10, it follows that quantity demanded is 1,180 units. We could find other quantities demanded by plugging in different dollar amounts for price (P).

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DEMAND AND SUPPLY AS EQUATIONS

Now here is a supply equation: $Q_s = 1,200 - 43P$

To find what quantity supplied (Q_s) equals at a particular price, we let \$5 equal price (P) and solve for quantity supplied. We get 1,415.

$$Q_s = 1,200 - 43(5) = 1,415$$

Now suppose we want to find equilibrium price and quantity given our demand and supply equations. How would we do it?

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DEMAND AND SUPPLY AS EQUATIONS

First, we know that in equilibrium the quantity demanded (Q_d) of a good is equal to the quantity supplied (Q_s), so let's set the two equations equal to each other this way:

$$1,500 - 32P = 1,200 + 43P$$

Now we can solve for P . We add $32P$ to both sides of the equal sign and subtract 1,200 from both sides. We are left with: $75P = 300$; It follows then that $P = 300/75$ or \$4.00.

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DEMAND AND SUPPLY AS EQUATIONS

Once we know equilibrium price is \$4.00, we can place this value in either the demand or supply equation to find the equilibrium quantity. Let's place it in the demand equation: $Q_d = 1,500 - 32(4.00) = 1,372$

Just to make sure that 1,372 is also the quantity supplied, we put the equilibrium price of \$4.00 into the supply equation: $Q_s = 1,200 - 43(4.00) = 1,372$

In summary, given our demand and supply equations, equilibrium price is \$4.00 and equilibrium quantity is 1,372.

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Self-Test

1. When a person goes to the grocery store to buy food, there is no auctioneer calling out prices for bread, milk, and other items. Therefore, supply and demand cannot be operative. Do you agree or disagree? Explain your answer.

Disagree. Supply and demand are at work in the grocery store, too, although no auctioneer is present. The essence of the auction example is the auctioneer raising the price when there was a shortage and lowering the price when there was a surplus. The same thing happens at the grocery store. For example, if there is a surplus of corn flakes, the manager of the store is likely to have a sale (lower prices) on corn flakes. Many markets without auctioneers act as if there are auctioneers raising and lowering prices in response to shortages and surpluses.

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Self-Test

2. The price of a given-quality personal computer is lower today than it was five years ago. Is this necessarily the result of a lower demand for computers? Explain your answer.

No. It could be the result of a higher supply of computers. Either a decrease in demand or an increase in supply will lower price.

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Self-Test

3. What is the effect on equilibrium price and quantity of the following?
 - a) A decrease in demand that is greater than the increase in supply
 - Lower price and quantity
 - b) An increase in supply
 - Lower price and higher quantity
 - c) A decrease in supply that is greater than the increase in demand
 - Higher price and lower quantity
 - d) A decrease in demand
 - Lower price and quantity

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Self-Test

4. At equilibrium quantity, what is the relationship between the maximum buying price and the minimum selling price?

At equilibrium quantity, the maximum buying price and the minimum selling price are the same. Equilibrium quantity is the only quantity at which the maximum buying price and the minimum selling price are the same.

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Self-Test

5. If the price paid is \$40 and the consumers' surplus is \$4, then what is the maximum buying price? If the minimum selling price is \$30 and producers' surplus is \$4, then what is the price received by the seller?

\$44;
\$34.

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