Chapter 4/5

Demand/Supply

Demand

- Def: ability, willingness and desire to purchase a product at all possible prices.
- Law: The quantity of products demanded will vary inversely with its price.

Demand

- Schedule
- Graph

Demand

- Demand is abstract, can be measured over any amount of time and has nothing to do with how much of the product is actually out there to be purchased.

Change

- Change in QD
- Change in D
- What’s the difference?
- Also, what’s a substitute and a compliment?

Income effect

If P falls, you feel as if you have more $ to burn = increase in consumption

The inverse is true

Carbon Freeze

http://www.youtube.com/watch?v=FCB0vCGykiQ

Substitution Effect

- I'll replace a similar item with one that is less expensive
  - For example, P of pizza declines, pizza becomes relatively cheaper ➔
  - consumers are more willing to purchase pizza when its relative price falls ➔
  - they substitute pizza for other goods

Substitution Effect

- Substitution Effect
  - When the price of a good falls, its relative price makes consumers more willing to purchase this good
  - Alternatively, when the price of a good increases, its relative price makes consumers less willing to purchase this good
- Important to remember that *it is the change in the relative price – the price of one good compared to the prices of other goods – that causes the substitution effect*

Determinants of Demand

- Change in Demand
  1. Individual income
  2. Consumer tastes
     - -Trends and advertising
  3. Prices of related products
     - -Subs and compliments
  4. # of potential buyers
  5. Expectations of future products and prices

Direction

- Increase in demand = right moving shift
- Decrease in demand = left moving shift

Supply

- Law: The higher the price of a product the more of the product will be supplied
- Def: Desire and willingness to produce a product at all prices.
- Supply is abstract and has nothing to do with how many people will actually purchase the product.

Supply Curve

- Use a supply schedule to create it
- Always positive
- If I can sell it for more, I'll make more of it.

QS

- Quantity supplied works just like QD. A change of the sale price will change producer motivation

Determinants of Supply

- Variables that affect supply
  1. Cost of inputs
  2. Technology
  3. # of producers
  4. Producer expectations about the future
  5. Price of alternative products

Markets

- **A market sorts out the conflicting price perspectives of individual participants – buyers and sellers**
- ***Market* represents all the arrangements used to buy and sell a particular good or service**
- **Markets reduce the *transaction costs* of exchange – the costs of time and information required for exchange**
- **The coordination that occurs through markets occurs because of Adam Smith's *invisible hand***

D/S Create a Market

- **Demanders and suppliers have different views of price**
  - **Demanders pay the price**
  - **Suppliers receive it**
- **Thus, a higher price is bad news for consumers but good news for producers**
- **As the price rises, consumers reduce their quantity demanded along the demand curve and producers increase their quantity supplied along the supply curve**

Market Equilibrium

- When QD=QS, all products are sold. Producers place a high emphasis on trying to figure this out.
- Shortage: when there is more D than S, *P will Δ to level market*
- Surplus: When there is more S than D, *P will Δ to clear market*

Who wins?

- Consumer Surplus
- Producer Surplus
  - Pretty Woman

Demand Change

- Increase in demand causes a shortage at the original price.
- Thus prices will rise, Eq will be restored at a higher P and Q.
- Visa-Versa
- REMEMBER: D does not affect S

Supply Change

- Increase in S will cause a surplus at the original price
- Thus prices will fall and Eq will be restored at a lower P and higher Q
- Visa-Versa
- REMEMBER: S does not have an effect on D

Simultaneous Shifts in Demand and Supply

- **As long as only one curve shifts, we can say for sure what will happen to equilibrium price and quantity**
- **If both curves shift, however, the outcome is less obvious**

Who has control?

- It makes a lot of sense to believe that, together, Consumers and Producers control price due to their own self-interest. Adam Smith is given credit for this philosophy. He called it the **invisible hand.** Society benefits from this state of nature. Unintentionally of course.

Unjust Markets (when needs are out priced)

- So what happens when consumers and producers don't unintentionally set appropriate prices? Government?
- Smith didn't think this to be too much of problem. He thought Governments should stay out of the way. (laissez faire)

Smith's mistake

- Adam Smith wasn't wrong in most cases. But he wasn't naïve; he knew there would still be markets where consumers and producers endangered society. He simply underestimated the problem, so government needs to step in. Thus a Mixed Economy is born from Capitalism.

Government Intervention

- Throughout our course we'll examine how Gov't interacts with economics.
- So how does it deal with unjust price setting, when price is too high on needed items?
  - Price Ceilings (Rent)

More Unjust markets

- What happens when producers of needed products aren't profitable? This can be the case in a perfectly competitive market.
- Price Floors (agricultural products)

Problems

- Floors and Ceilings create inefficient markets, which hurt and benefit both consumers and producers.
- How? Get in small groups and discuss.

Quantity control

- Taxi Medallions
- Import Restrictions
- Note: any time the gov't steps in and creates an inefficient market there is a trade-off. There will be winners and losers, if it is argued that the winners don't out-gain the loser's loss, then the gov't intervention will cease.

Natural Inefficient Markets

- Gov't will subsidize these markets because there are spillover benefits. Ex: Public goods
- Or because there are spillover costs. Ex: pollution

Spillover effects of Gov't

- Even though most text books don't discuss it, there may also be spillover effects of price ceilings and floors, making them efficient in the long run.