CHAPTER 2

DEMAND AND SUPPLY

THEORY OF DEMAND

DEMAND refers to the quantity of a good or service that the consumers are willing and able to purchase at various prices during a period of time.

DEMAND depends on the factors like

Desire + Ability to pay + Willingness to buy

Example: If an economically poor person wants to buy a car, it is only a desire, but not a demand as he cannot pay for the car. If a rich man wants to buy a car and is willing to spend money to buy it, it is a demand as he will be able to pay for the car. Thus A desire backed up by purchasing power and willingness to buy is known as demand.

DEFINITION OF DEMAND

Demand is defined as the desire and willingness to buy specific ***quantities*** of goods in a given period of time at a particular ***price***, *ceteris paribus*.

LAW OF DEMAND

Law of demand states that the ***higher the price*** *of a good, the* ***lower*** *is the* ***quantity demanded*** *for that good and the* ***lower the price, the higher is the quantity demanded****, ceteris paribus.*

P ↑ Q_{dd} ↓

P ↓ Q_{dd} ↑

NEGATIVE RELATIONSHIP

The law of demand explains the functional relationship between price of a commodity and quantity demanded.

The law of demand is under Cateris Paribus assumption, which means that only one variable is being changed while other things being equal or unchanged.

The Law of Demand states that "if the price of a commodity falls, the quantity demanded of it will rise, and if the price of the commodity rises, its quantity demanded will decrease"

This shows that there is an inverse relationship between price and quantity demanded. Here price is an independent factor and demand is dependent factor.

Assumptions of the law: 1) No change in the consumers' income
2) No change in consumers' tastes and preferences
3) No changes in the prices of related goods.
4) consumers have perfect knowledge of the market
5) consumers are rational human beings.

DEMAND SCHEDULE AND CURVE

Demand Schedule

Price	Quantity
5	2
4	4
3	6
2	8
1	10

Demand Curve

INDIVIDUAL AND MARKET DEMAND

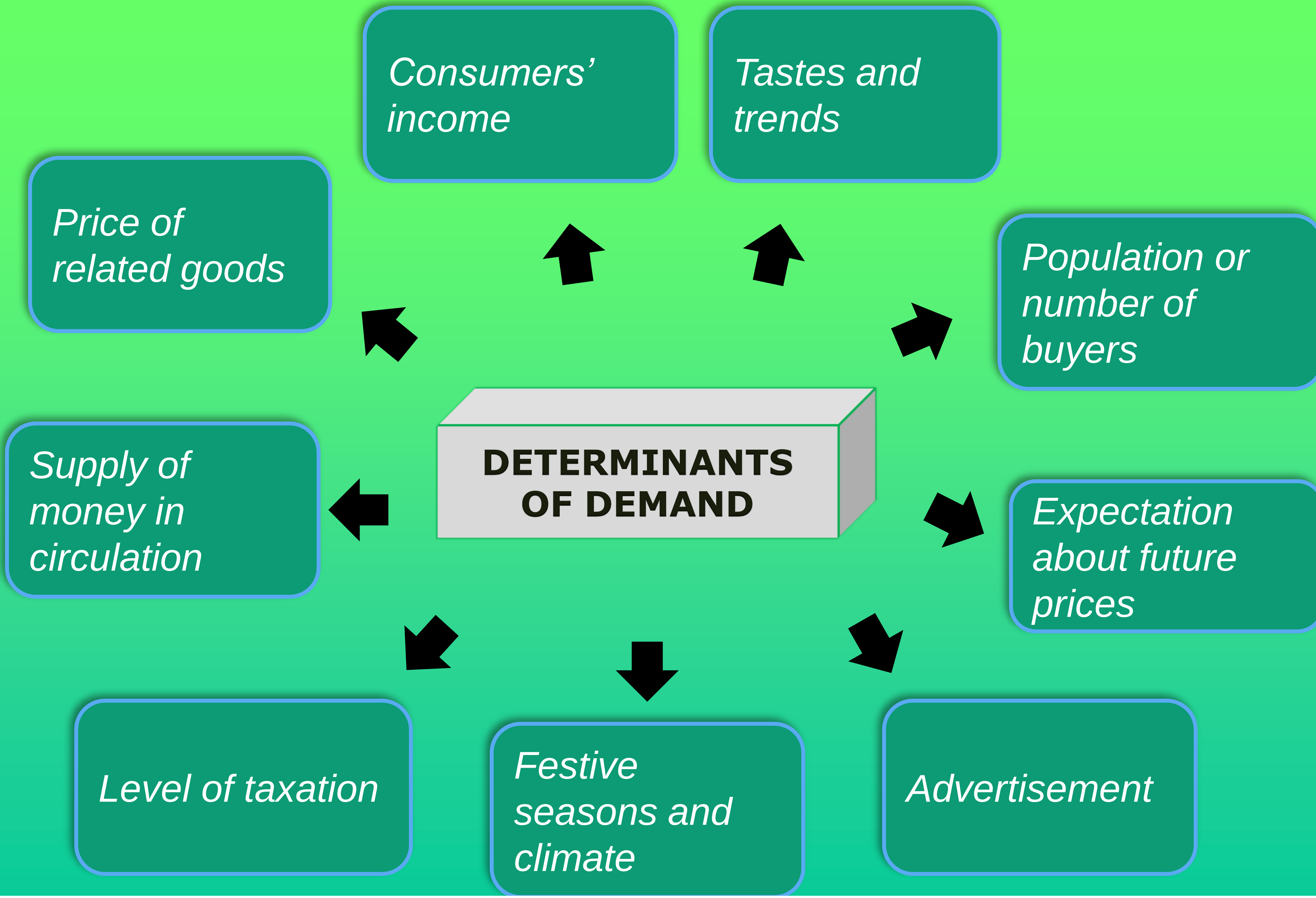
INDIVIDUAL DEMAND

The relationship between the quantity of a good demanded by a ***single individual*** and its price.

MARKET DEMAND

The relationship between the total quantity of a good demanded by adding all the quantities demanded by ***all consumers*** in the market and its price.

DETERMINANTS OF DEMAND


Consumers' income
Tastes and trends
Price of related goods
Population or number of buyers
DETERMINANTS OF DEMAND
Supply of money in circulation
Expectation about future prices
Level of taxation
Festive seasons and climate
Advertisement

Income

Constitutes one of the important determinants of demand.

- The income of a consumer affects his/her purchasing power, which, in turn, influences the demand for a product.
- Increase in the income of a consumer would automatically increase the demand for products by him/her, while other factors are at constant, and vice versa.
- The income-demand relationship can be analyzed by grouping goods into two categories, namely;
- Normal goods
- Inferior goods

What is the difference between…

Normal Good

- A good that consumers demand MORE of as their income INCREASES
- Ex: Butter, Filet mignon

Inferior Good

- A good that consumers demand LESS of as their income DECREASES
- Ex: Margarine, hamburger

Tastes and Preferences of Consumers


Tastes and Preferences of Consumers

- Play a major role in influencing the individual and market demand of a product.
- The tastes and preferences of consumers are affected due to various factors,
- such as **life styles, customs, common habits, and change in fashion, standard of living, religious values, age, and sex.**

Tastes and Preferences of Consumers

- A change in any of these factors leads to change in the tastes and preferences of consumers. Consequently, consumers reduce the consumption of old products and add new products for their consumption.
- For example, if there is change in fashion, consumers would prefer new and advanced products over old-fashioned products, provided differences in prices are proportionate to their income.

Price of Related Goods

- Refer to the fact that the demand for a specific product is influenced by the price of related goods to a greater extent.
- **Related goods can be of two types, namely;**
- **Substitutes and**
- **Complementary goods.**

Substitute

- **Substitutes:** substitutes are at least two products that could be used for the same purpose by the same consumers
- Ex: tea and coffee,
- The increase in the price of a good results in increase in the demand of its substitute with low price.
- Therefore, consumers usually prefer to purchase a substitute, if the price of a particular good gets increase

Substitute Goods

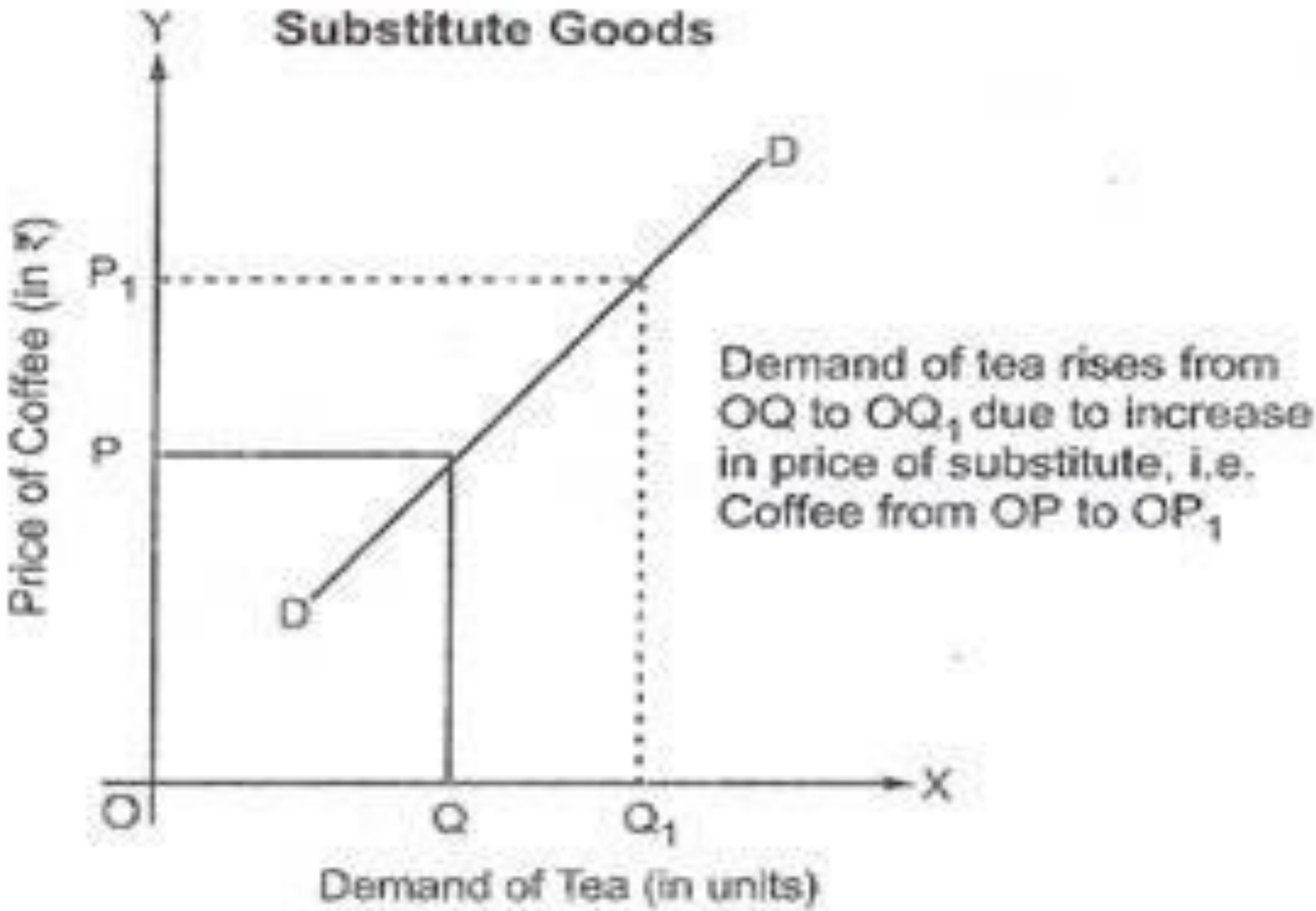
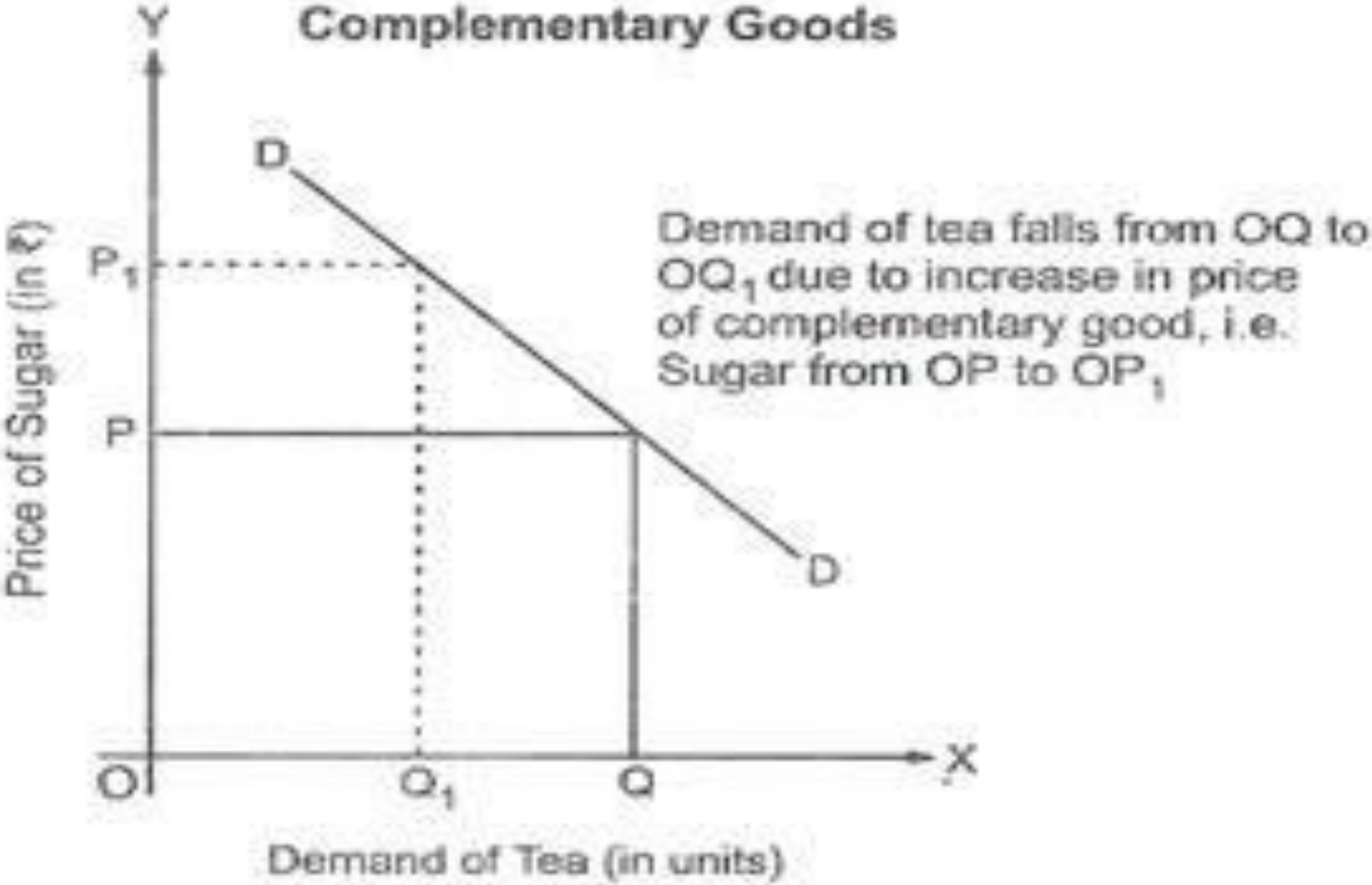

Y
Substitute Goods
D
P1
Price of Coffee (in ₹)
Demand of tea rises from OQ to OQ1 due to increase in price of substitute, i.e. Coffee from OP to OP1
P
D
O
Q
Q1
X
Demand of Tea (in units)

Fig. 3.10

Complementary Goods

- **Complementary Goods:** Refer to goods that are consumed simultaneously or in combination. In other words, complementary goods are consumed together.
- Ex; car and petrol, Therefore, the demand for complementary goods changes simultaneously.
- The complementary goods are inversely related to each other. For example, increase in the prices of car would decrease the demand of petrol.

Complementary Goods



Complementary Goods
Y
D
P1
P
Price of Sugar (in ₹)
Demand of tea falls from OQ to OQ1 due to increase in price of complementary good, i.e. Sugar from OP to OP1
D
X
O
Q1
Q
Demand of Tea (in units)

Fig. 3.11

Effect of Advertisements

- Refers to one of the important factors of determining the demand for a product.

- Effective advertisements are helpful in many ways, such as catching the attention of consumers, informing them about the availability of a product, demonstrating the features of the product to potential consumers, and persuading them to purchase the product.

Effect of Advertisements

- Consumers are highly sensitive about advertisements as sometimes they get attached to advertisements endorsed by their favorite celebrities. This results in the increase demand for a product.

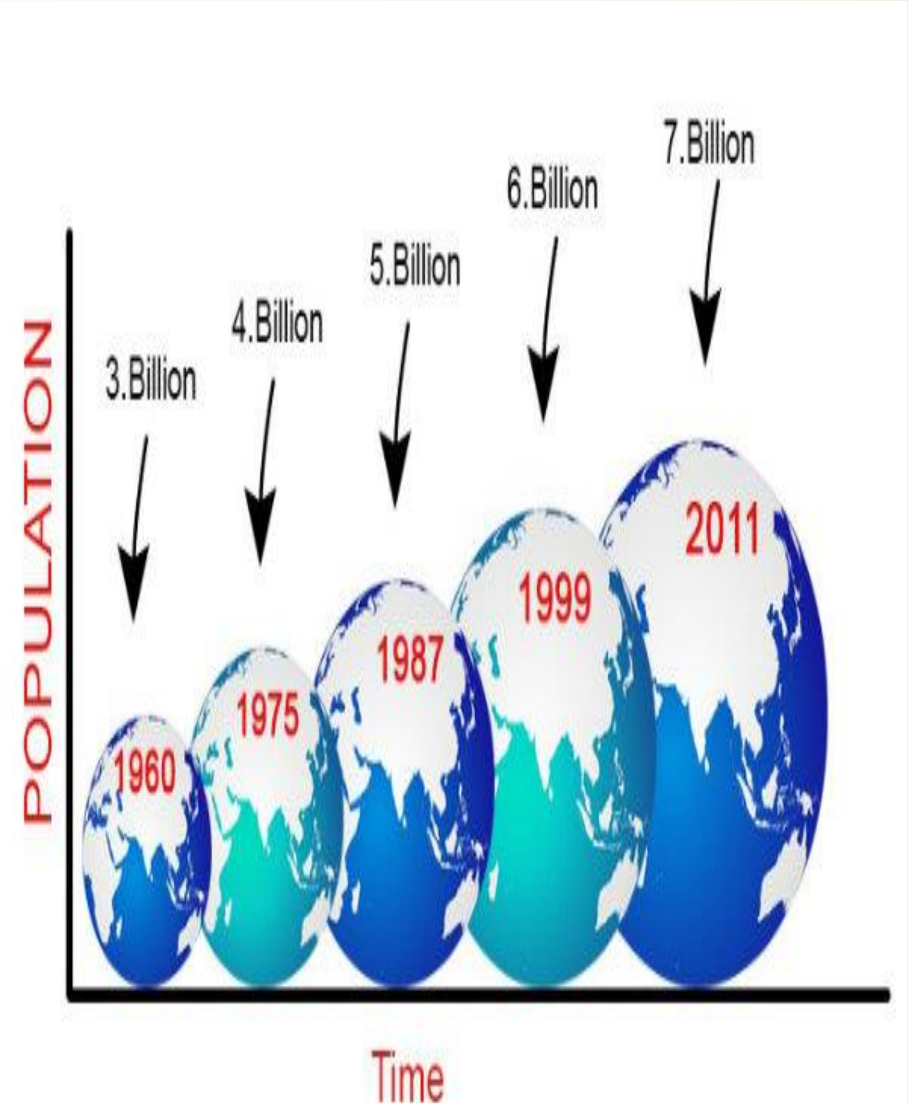
Expectations of Consumers

- Imply that expectations of consumers about future changes in the price of a product affect the demand for that product in the short run.

- For example, if consumers expect that the prices of petrol would rise in the next week, then the demand of petrol would increase in the present.

Growth of Population

- Acts as a crucial factor that affect the market demand of a product.
- If the number of consumers increases in the market, the consumption capacity of consumers would also increase.
- Therefore, high growth of population would result in the increase in the demand for different products.



Government Policy

- If a product has high tax rate, this would increase the price of the product. This would result in the decrease in demand for a product.
- Similarly, the credit policies of a country also induce the demand for a product.
- For example, if sufficient amount of credit is available to consumers, this would increase the demand for products.

Climatic Conditions

- The demand of ice-creams and cold drinks increases in summer

Climatic Conditions

- While tea and coffee are preferred in winter.

Climatic Conditions

- If its raining then we will demand umbrella

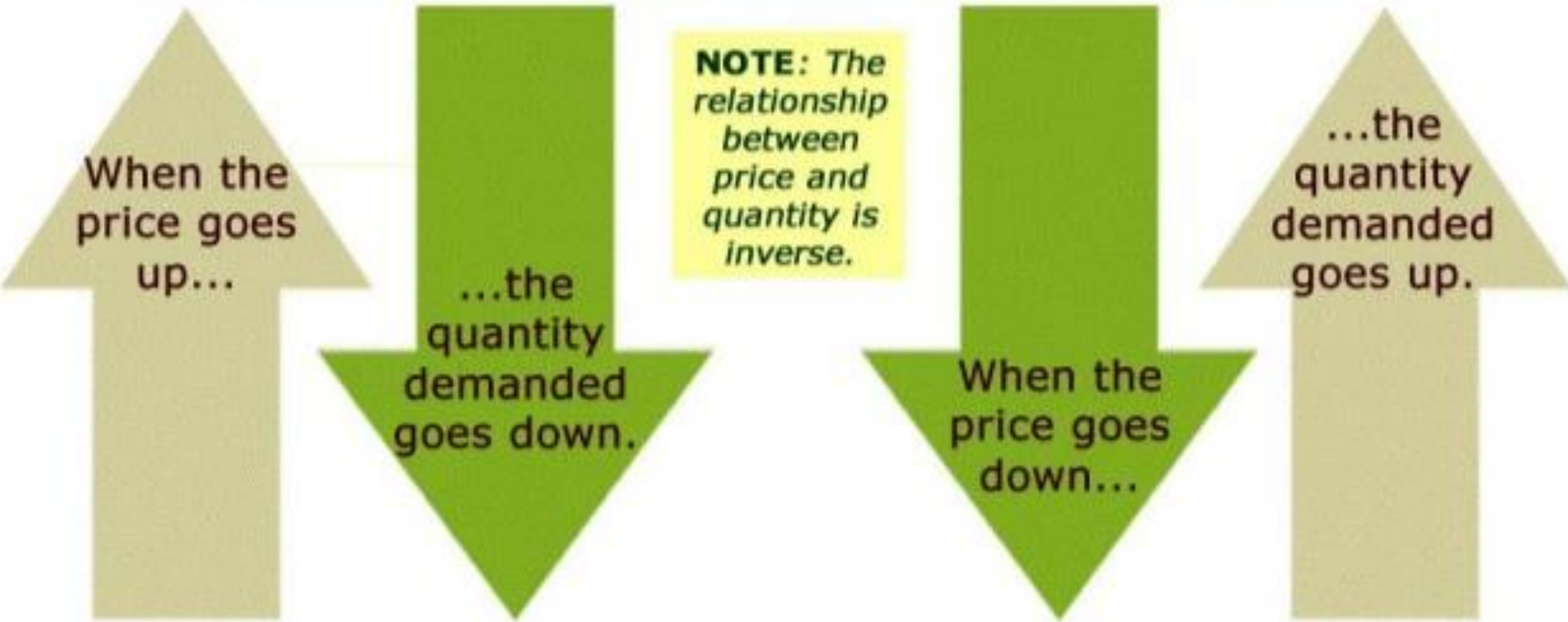
Climatic Conditions

- Some products have a stronger demand in hilly areas than in plains.
- Therefore, individuals demand different products in different climatic conditions.

DETERMINANTS OF DEMAND

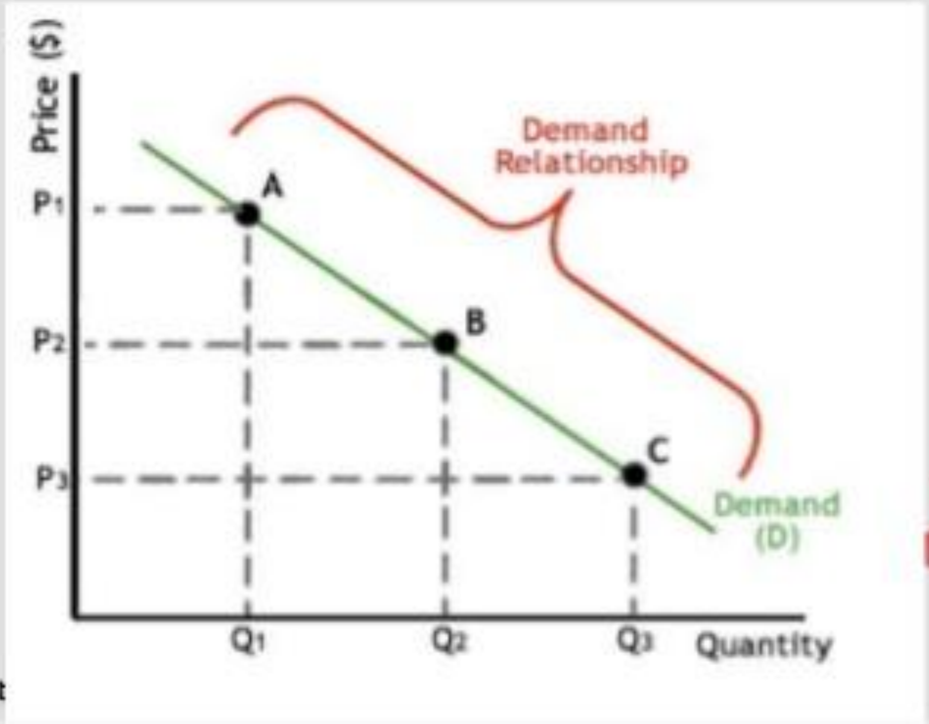
- Price of the Commodity (P)
- Income (Y)
- Test and Preference (T)
- Price of Related Goods (Pr)
- Advertisements (A)
- Future Expectation about the price (Fp)
- Government Policies (Gp)
- Climatic Conditions (W)

Law of Demand



LAW OF DEMAND

- In economics, the **law** states that, all else being equal, as the price of a product increases(↑), quantity demanded falls(↓); likewise, as the price **of** a product decreases(↓), quantity demanded increases(↑).There is an INVERSE relationship between quantity **demand** and its price.



Giffen Goods

- Giffen Goods is a concept that was introduced by Sir Robert Giffen. These goods are goods that are inferior in comparison to luxury goods. However, the unique characteristic of Giffen goods is that as its price increases, the demand also increases. And this feature is what makes it an exception to the law of demand.
- The Irish Potato Famine is a classic example of the Giffen goods concept. Potato is a staple in the Irish diet. During the potato famine, when the price of potatoes increased, people spent less on luxury foods such as meat and bought more potatoes to stick to their diet. So as the price of potatoes increased, so did the demand, which is a complete reversal of the law of demand.

Veblen Goods

- The second exception to the law of demand is the concept of Veblen goods. Veblen Goods is a concept that is named after the economist Veblen, who introduced the theory of "conspicuous Consumption". According to Veblen, there are certain goods that become more valuable as their price increases. If a product is expensive, then its value and utility are perceived to be more, and hence the demand for that product increases.
- And this happens mostly with precious metals and stones such as gold and diamonds and luxury cars such as Rolls-Royce. As the price of these goods increases, their demand also increases because these products then become a status symbol.

Necessary Goods and Services

- Another exception to the law of demand is necessary or basic goods. People will continue to buy necessities such as medicines or basic staples such as salt even if the price increases. The prices of these products do not affect their associated demand.