* Income Elasticity of Demand.

YED provides information on how the quantity demanded varies with a change in income. It is potentially of great importance for businesses and for government in forecasting the future demand for a whole range of consumer goods and services.

If the YED for a normal good is greater than 1, then demand will be expected to grow more rapidly than consumer incomes.

If YED is negative, in the case of inferior goods, firms that produce these can expect their sales to decline, when the economy is doing well; at a time of recession, though, demand for their product is likely to increase.

* Cross Elasticity of Demand.

Many companies are concerned with the impact that rival pricing strategies will have on the demand for their own product.

↳ Remember that substitutes are characterized by a positive XED: the higher the price, the more likely it is that consumers will buy a cheaper substitute.

↳ In such cases there is a high degree of interdependence between suppliers, and the dangers of a rival cutting price are likely to be very significant indeed.

XED will identify those products that are most complementary and help a company introduce a pricing structure that generates more revenue.

* Cautionary Note.

2.8. Price Elasticity of Supply.

- Price elasticity of supply (PES): A numerical measure of the responsiveness of the quantity supplied to a change in the price of the product.

↳ $PES = \frac{\%\ \text{change in quantity supplied}}{\%\ \text{in price (change)}}$

* Factors influencing PES.

PES is supply flexibility - if businesses and industries are more flexible in the way they operate, then supply tends to be more elastic.

· The ease with which businesses can accumulate or reduce stocks of goods.

↳ More easily manufacturers can accumulate or reduce stocks of good, the higher the PES. However, companies that provide service are unable to build up stocks and in most cases, the product is perishable.

• The ease which they can increase production.

↳ In the SR businesses and industries with spare productive capacity will tend to higher PES. However, shortages of critical factor inputs (skilled workers, components, fuel) will often lead to an inelastic PES.

• Over time, companies can invest to increase their productive capacity, they can also, over time, enter or leave an industry and this will increase the flexibility of supply.

* Business relevance of price elasticity of supply.

PES explains the speed and the ease ~~whi.~~ with which business can respond to changed market conditions. If a business has elastic supply it can respond to increased demand more quickly than an inelastic ~~d.~~ supply would, because elastic supply means they have spare capacity and can increase production more easily. For businesses working at the full capacity, it's necessary to expand its scale of operations and this can take time. Also, if a business thinks it is worthwhile to diversify because of the price increase, it can take time.

2. 9. Interaction of demand and supply - markets in equilibrium and disequilibrium.

- Equilibrium: a situation where there is no tendency for change.
- Equilibrium price: the price where demand and supply are equal, where the market clears.
- Equilibrium quantity: the amount that is traded at the equilibrium price.
- Disequilibrium: a situation where demand and supply are not equal.

Where there is disequilibrium due to ↑ supply (surplus), cut prices and/or reduce the quantity supplied.
excess
Where there is disequilibrium due to ↓ demand (shortage), raise the prices and/or increase the Q supplied.

2. 10. Shifts in the demand (market) curve.

- Change in demand: when there is a shift in the demand curve due to a change in factors other than the price of the particular product.

* Causes of shifts in the demand curve.

Economists have identified 3 key non-price categories that can be used to describe and analyse the factors that influence the demand for most products. They are:

1) The income/ability to pay for the product.
2) The price and availibility of related products.
3) Fashion, taste and attitudes.

· Income / the ability to pay.

Influences for the ability to pay are:

↳ An individual's income, or, more specifically, the purchasing power of their income after taxation.

↳ The ability of loans / credit and the interest rate that must be paid on loans or credit card balances.

Normal goods → Positive relationship is expected between the ability to pay and the D for the product.
represented / causes rightward shift in the curve.

Inferior goods → Negative relationship is expected between the ability to pay and the demand for the product.

· The price and the availability of related products.

Substitude products → A change in the price, availability and even the attractiveness of one product will have an impact on the demand for all substitute goods. If the price ↑, then the demand for substitudes will increase as consumers switch their demand to the relatively cheaper products. But, even if the price ↑ if there is a positive report in the media the demand can ↑.

Complement products → A ↑ in price of one product will reduce the quantity demanded for it and its associated product.

· Fashion, taste and attitudes.

We are influenced by our own individual dislikes and likes, by peer pressure and by various forms of advertising and the marketing immages when it comes to buging.

2. 11. Shifts in the market supply curve.

* Causes of shifts in the supply curve.

The 3 key non-price categories:

1) The costs associated with supplying the product.

2) The size, structure and nature of the industry.

3) Government policy.

· Costs

If any factor pushes up costs there is likely to be a leftward shift in the S curve or ↓ in S, if the factor lowers costs, there is likely to be an increase in supply:

↳ wage rates. ↳ worker productivity (output per worker). ↳ the state of technology.

↳ energy costs. ↳ raw material and component prices.

↳ transport costs. ↳ equipment maintainance costs.

· Size and nature of the industry.

If the size of the industry increases, because there are more firms or bigger firms, then it is likely that the supply of the industry will increase. Equally, if firms in the industry start to compete more intensively on price, it is likely that the supply curve will shift to the right as the effects of this price competition start to affect the price that all companies are willing to accept for their products.

· Government policy.

- Specific tax: an indirect tax that is fixed per unit purchased.
- Ad valurem tax: a tax that is charged as a given percentage of the price.

· Legislation designed to protect consumers or workers may impose additional costs on companies and this can affect the supply curve.

Governments may also impose a specific tax such as excise duties on the output of companies or an ad valoran tax such as sales tax or value added tax on particular goods and services.

The impact of tax is like a cost increase because companies may seek to pass the tax on to the consumer in the form of higher prices. As such, indirect taxes often result in a decrease in supply.

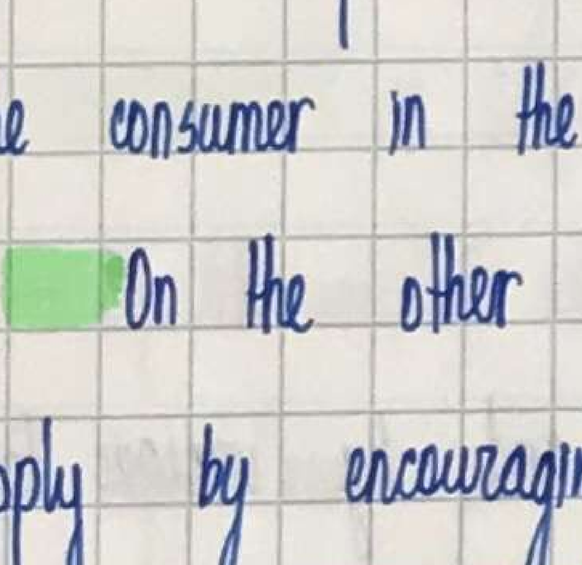
On the other hand, a relaxation of certain types of legislation or government subsidies can increase supply by encouraging them to reduce prices for any given level of output.

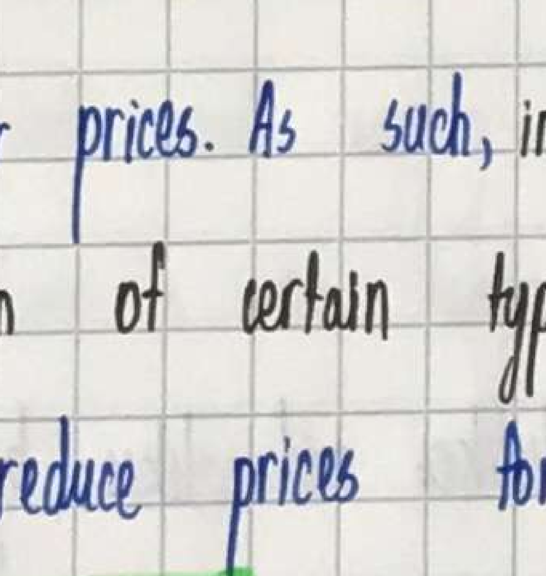
· Other supply influencing factors.

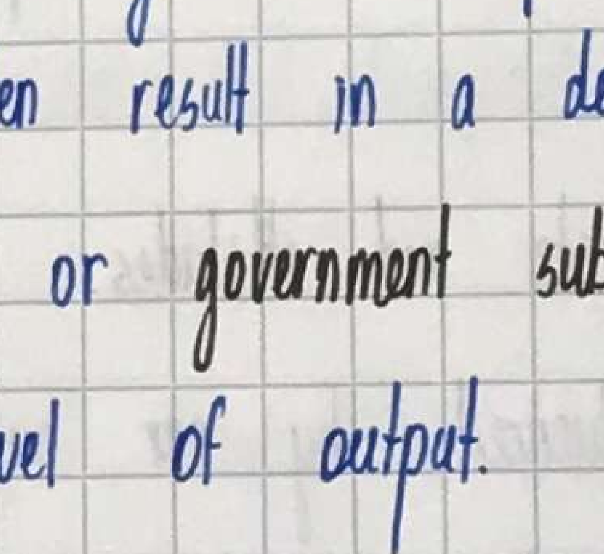
- Joint supply: when two items are produced together.

Weather conditions, the relative profitability of alternative product types may be important, and supply also may be significantly influenced by expectations of future prices and unanticipated exogenous shocks as a result of a political crises. There is also the case of joint supply.

2.12. Changes in the equilibrium.







↳ Unchanged P, changed Q.

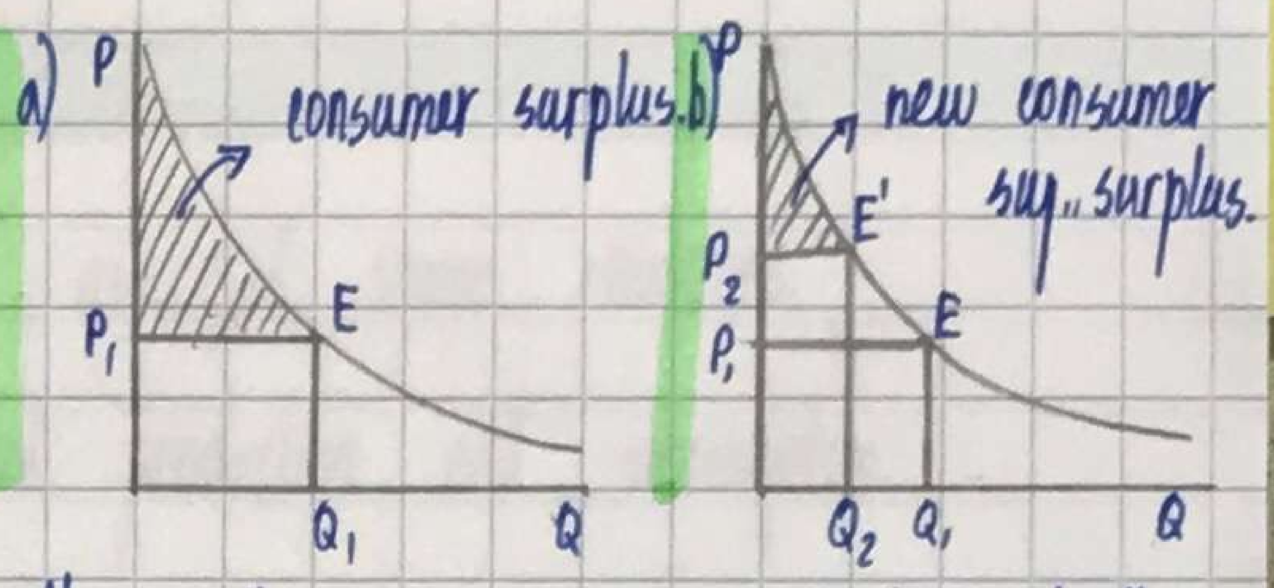
2.13 The workings of the price mechanism - final thoughts.

Prices have a very important role in the allocation of resources in the market economy. Prices act as a signal to both producers and consumers. In other situations, the price system can ration products in the market. It should be clear that the price mechanism allows the preferences of consumers to be made known to producers. This is so called transmission of preferences.

- Transmission of preferences: The automatic way in which the market allows the preferences of consumers to be made known to producers.

2.14. Consumer surplus.

- Consumer surplus: the difference between the value a consumer places on units consumed and the payment needed to actually purchase that product.

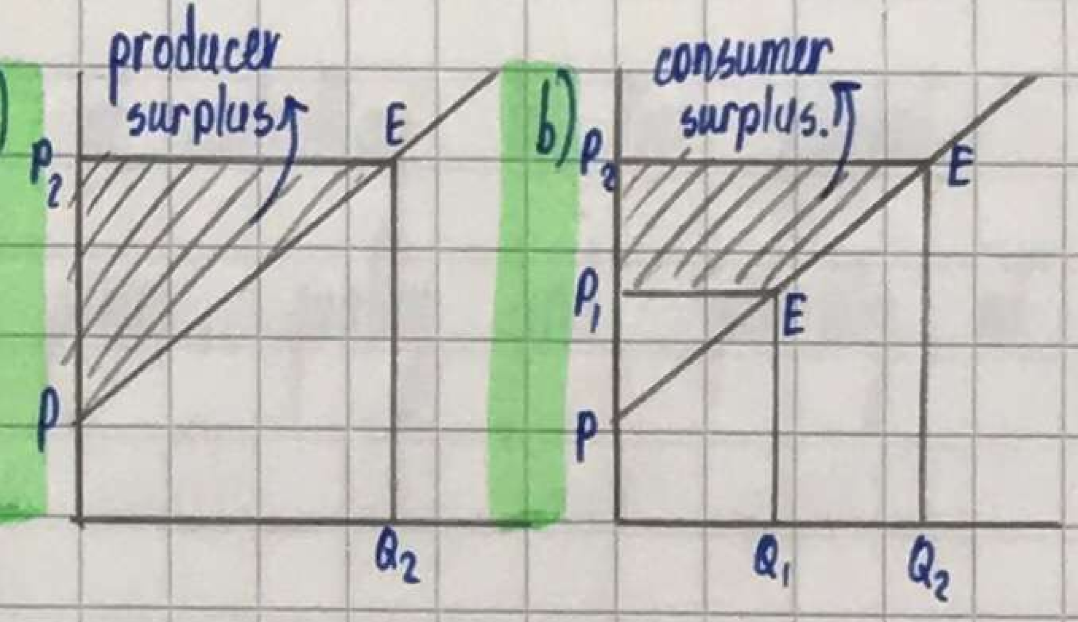


↳ It arises because some consumers are willing to pay more than the given price for all but the last unit they buy.

↳ A fall in the market price will lead to an increase in consumer ~~sup.~~ surplus, because consumers who were willing to pay above the new market price now end up paying less.

2.15. Producer Surplus.

- Producer surplus: the difference between the price a producer is willing to accept and what is actually paid.



↳ The graph (b) shows the producer surplus changes with the change in quantity supplied.