Concepts of Demand and Supply

Demand

Quantity of the good that buyers are willing and able to purchase at different prices is called Demand.

Factors Affecting Demand

- **Price of the Own Commodity**

Price and quantity demanded of a commodity are inversely related. If price of a commodity rises, its quantity demanded falls and vice versa. The logic behind this inverse relation is that rise in the price of the commodity lowers the purchasing power of the consumer and this therefore discourages him to increase his consumption.

Price of Related Goods

Goods can be related to each other as substitutes or complementaries.

Substitute goods: These are the goods that can be used alternatively. For example: tea and coffee, pepsi and coke, etc.

Imagine a rise in the price of tea. What will be its impact on the quantitydemanded for coffee? A rise in the price of tea means consuming tea becomes expensive to the consumer and thus he may want to shift to some other cheaper alternative, that is, tea. Therefore higher price for tea lowers its quantity demanded but increases the quantity demanded for coffee.

Hence, we observe a direct relation between price and quantity demanded for substitute goods.

Complementary goods: These are the goods that are used simultaneously to satisfy a common purpose. For example: car and petrol.

Imagine a rise in the price of petrol. What will be its impact on the quantity demanded of car? A rise in the price of petrol means driving cars now become costlier to the consumer. The consumer might prefer travelling by public means of transport or any other means. This therefore lowers the quantity demanded for cars.

Hence, we observe an inverse relation between price and quantity demanded for complementary goods.

Income of the Consumer

The relation between income and quantity demanded of a good depends upon the nature of the good.

There is a direct relation between income and quantity demanded for normal goods, but an inverse relation exists between the two in case of inferior goods.

The logic behind this relation is that with rise in income the consumer is able to save some money and consume more of a better quality good (normal good) than inferior good.

Tastes and Preferences

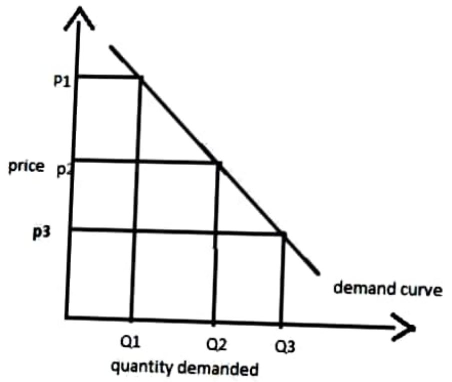
Developing favourable tastes and preferences towards a commodity increases its quantity demanded. For example: people have developed favourable tastes and preferences towards colour television relative to black and white televisions. So the quantity demanded for colour television rises relative to black and white televisions.

Role of Expectations

Expecting a rise in the prices in future motivates the consumer to increase his consumption in present and vice versa.

Law of Demand

It is a statement which says that quantity demanded of any good is inversely proportional to the prices, keeping all other things/factors constant.



Properties of Law of Demand

- **One sided**

  Law of demand explains the effect of change in quantity demanded due to change in price but it does not tell us the change in price caused due to change in quantity demanded. Hence it operates one sidedly only.

- **Qualitative but not quantitative**

  Law of demand is a qualitative statement. It tells us only the direction of change in quantity demanded due to change in price but not the magnitude of change in demand due to change in price.

Exceptions to Law of Demand

- Necessary goods: These are the goods essential for survival to a person. These can be medicines or drugs. Even when prices of such commodities rise, the consumer still buys it rather than reducing his demand. Law of demand does not operate in this case.
- Highly luxurious goods: These are some goods demanded by the super wealthy people. It could be a private chopper or any other luxurious good. If they experience a price rise, the consumer would still want it. Hence, law of demand does not operate in this case.
- **Giffen goods: (As explained earlier)**

Fashion-related goods

Goods related to fashion do not follow law of demand and their demand increases even with a rise in their prices. For example: If any particular type of dress is in fashion, then demand for such dress will increase even if its price is rising.

Supply

Quantity of a good that the seller/producer is willing to sell at different prices in the market is called Supply.

Factors affecting supply

- **Price of the Commodity**

  The price and quantity supplied for a commodity are directly related. It means, as price rises, the quantity supplied of the given commodity also rises and vice versa. It happens because at higher prices, there are greater chances of making profit. This induces the firm to offer more for sale in the market.

- **Prices of other goods**

  Increase in the prices of other goods, makes them more profitable in comparison to the given commodity. As a result, firm shifts its limited resources from production of given commodity to production of other goods. For example: increase in the price of other good (say, wheat) will induce the farmer to use land for cultivation of wheat in place of the given commodity (say, rice).

- **Prices of factors of production (inputs)**

  When amount payable to factors of production and cost of inputs increases, the cost of production also increases. This decreases the profitability. As a result, seller reduces the supply of the commodity. On the other hand, decrease in prices of factors of production, increases the supply due to fall in the cost of production and subsequent rise in profit margin.

- **State of Technology**

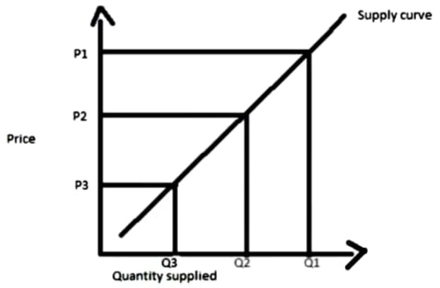
  Technological changes influence the supply of a commodity. Advanced and improved technology reduces the cost of production, which raises the profit margin. It induces the seller to increase the supply.

- **Government Policy (Taxes and subsidy)**

  Increase in taxes raises the cost of production and thus reduces the supply, due to lower profit margin. On the other hand, subsidies increase the supply as they make it more profitable for the firms to supply goods.

Law of Supply

It is a statement which says that quantity supplied of any good is directly related to the price of the own good, keeping other factors constant.



Changes in Demand and Supply

When changes in demand and supply occur due to price alone, it is called **expansion and contraction** of demand and supply.

When changes in demand and supply happen due to factors other than price, it is called **increase and decrease** in demand and supply.

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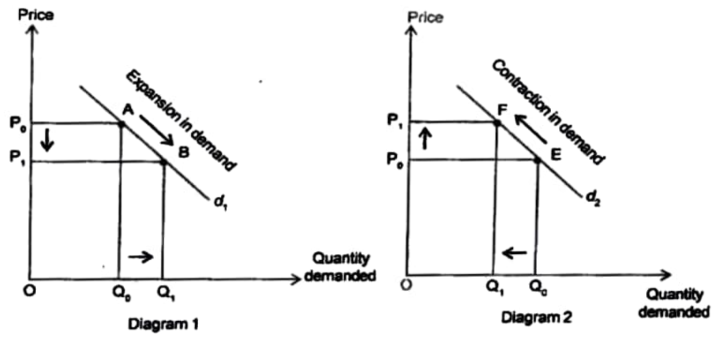
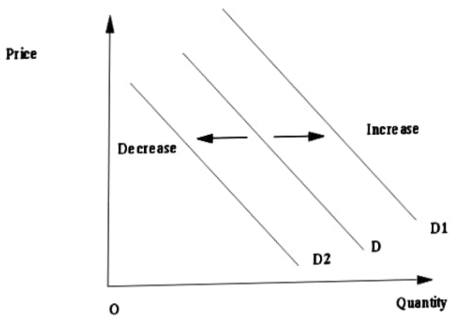
Expansion of demand: When quantity demanded of a commodity rises due to fall in the price of the commodity alone, it is called expansion of demand. It is shown by a downward movement along the demand curve.

Contraction of demand: When quantity demanded of a commodity falls due to rise in the price of the commodity alone, it is called contraction of demand.



Increase in demand: When demand for a commodity rises due to factors other than price, it is called increase in demand.

Decrease in demand: When demand for a commodity falls due to factors other than price, it is called decrease in demand.



Expansion of supply: When quantity supplied of a commodity rises due to rise in the price of the commodity alone, it is called expansion of supply.

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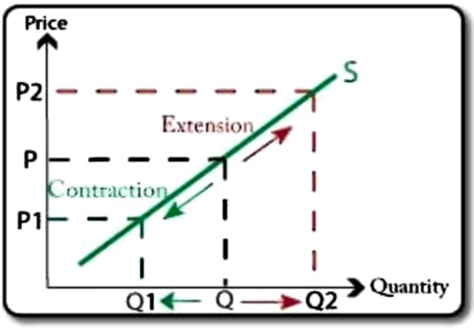

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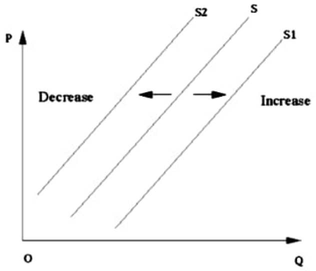

Market Equilibrium

Equilibrium means a state of balance or a state of rest. A market is said to be in equilibrium when demand of a good equals its supply, that is, there should be neither excess demand nor excess supply of any good in the market.