



ECO101: Introduction to Microeconomics

LECTURER: ADDRITA SHAMS

SECTION: 11

WEEK 02, LECTURE 03

TOPIC: DEMAND

Markets and Prices

- ▶ A market has two sides: buyers and sellers.
- ▶ In this chapter, we're going to study a **competitive market**—a market that has many buyers and many sellers, so no single buyer or seller can influence the price.
- ▶ Producers offer items for sale only if the price is high enough to cover their opportunity cost. And consumers respond to changing opportunity cost by seeking cheaper alternatives to expensive items.
- ▶ In everyday life, the *price* of an object is the number of dollars that must be given up in exchange for it. Economists refer to this price as the **money price**.

Relative Price

- ▶ The *opportunity cost* of an action is the highest valued alternative forgone.
- ▶ The ratio of one price to another is called a **relative price**, and a *relative price is an opportunity cost*.
- ▶ The normal way of expressing a relative price is in terms of a “basket” of all goods and services. To calculate this relative price, we divide the money price of a good by the money price of a “basket” of all goods (called a *price index*).
- ▶ The resulting relative price tells us the opportunity cost of the good in terms of how much of the “basket” we must give up to buy it.
- ▶ The demand and supply model that we are about to study determines *relative prices*, and the word “price” means *relative price*. When we predict that a price will fall, we do not mean that its *money price* will fall—although it might. We mean that its *relative price* will fall. That is, its price will fall *relative* to the average price of other goods and services.

Demand

- ▶ If you demand something, then you
 1. Want it,
 2. Can afford it, and
 3. Plan to buy it.
- ▶ The **quantity demanded** of a good or service is the amount that consumers plan to buy during a given time period at a particular price.
- ▶ The quantity demanded is not necessarily the same as the quantity actually bought. Sometimes the quantity demanded exceeds the amount of goods available, so the quantity bought is less than the quantity demanded.
- ▶ Many factors influence buying plans, and one of them is the price. We look first at the relationship between the quantity demanded of a good and its price- keeping all other things equal.

The Law of Demand

- ▶ The **law of demand** states that other things remaining the same, the higher the price of a good, the smaller is the quantity demanded; and the lower the price of a good, the greater is the quantity demanded.
- ▶ Why does a higher price reduce the quantity demanded? For two reasons:
 - Substitution effect
 - Income effect

Substitution Effect and Income Effect

- ▶ **Substitution Effect** When the price of a good rises, other things remaining the same, its *relative* price—its opportunity cost—rises.
- ▶ Although each good is unique, it has *substitutes*—other goods that can be used in its place. As the opportunity cost of a good rises, the incentive to economize on its use and switch to a substitute becomes stronger.
- ▶ **Income Effect** When a price rises, other things remaining the same, the price rises *relative* to income.
- ▶ Faced with a higher price and an unchanged income, people cannot afford to buy all the things they previously bought. They must decrease the quantities demanded of at least some goods and services. Normally, the good whose price has increased will be one of the goods that people buy less of.

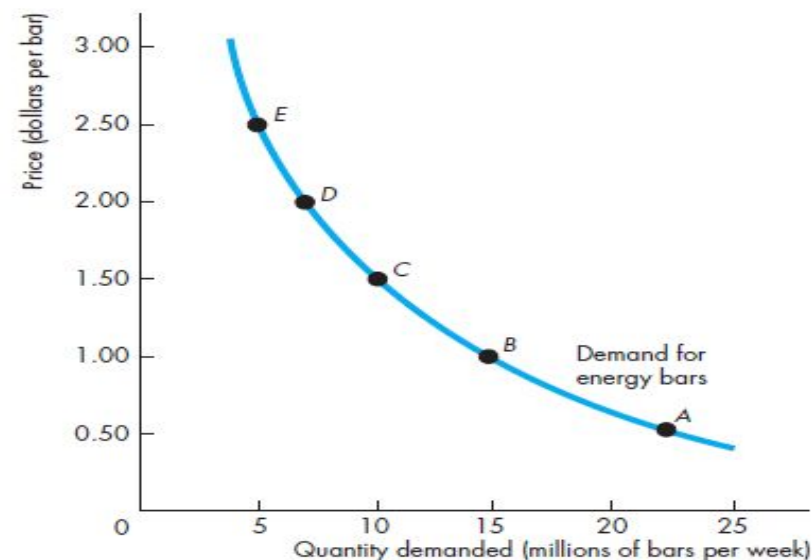
Demand Curve and Demand Schedule

- ▶ The term **demand** refers to the entire relationship between the price of a good and the quantity demanded of that good.
- ▶ Demand is illustrated by the demand curve and the demand schedule.
- ▶ The term *quantity demanded* refers to a point on a demand curve—the quantity demanded at a particular price.
- ▶ Remember the difference between demand and quantity demanded.
- ▶ **A demand curve** shows the relationship between the quantity demanded of a good and its price when all other influences on consumers' planned purchases remain the same.
- ▶ **A demand schedule** lists the quantities demanded at each price when all the other influences on consumers' planned purchases remain the same.

Demand Curve (contd.)

- ▶ We graph the demand schedule as a demand curve with the quantity demanded on the x -axis and the price on the y -axis.
- ▶ The points on the demand curve labeled A through E correspond to the rows of the demand schedule. For example, point A on the graph shows a quantity demanded of 22 million energy bars a week at a price of 50¢ a bar.
- ▶ Another way of looking at the demand curve is as a willingness-and-ability-to-pay curve. The willingness and ability to pay is a measure of *marginal benefit*.

FIGURE 3.1 The Demand Curve

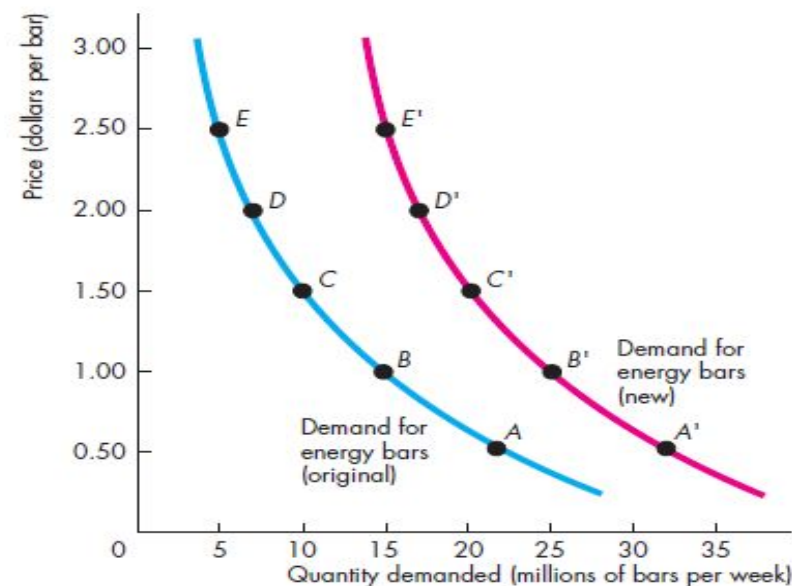


	Price (dollars per bar)	Quantity demanded (millions of bars per week)
A	0.50	22
B	1.00	15
C	1.50	10
D	2.00	7
E	2.50	5

A Change in Demand

- ▶ When any factor that influences buying plans changes, other than the price of the good, there is a **change in demand**.
- ▶ When demand increases, the demand curve shifts rightward and the quantity demanded at each price is greater.
- ▶ Six main factors bring changes in demand. They are changes in
 - The prices of related goods
 - Expected future prices
 - Income
 - Expected future income and credit
 - Population
 - Preferences

FIGURE 3.2 An Increase in Demand



Original demand schedule Original income			New demand schedule New higher income		
	Price (dollars per bar)	Quantity demanded (millions of bars per week)		Price (dollars per bar)	Quantity demanded (millions of bars per week)
A	0.50	22	A'	0.50	32
B	1.00	15	B'	1.00	25
C	1.50	10	C'	1.50	20
D	2.00	7	D'	2.00	17
E	2.50	5	E'	2.50	15

A Change in Quantity Demanded versus a Change in Demand

- ▶ Changes in the influences on buying plans bring either a change in the quantity demanded or a change in demand.
- ▶ Equivalently, they bring either a movement along the demand curve or a shift of the demand curve.
- ▶ The distinction between a change in the quantity demanded and a change in demand is the same as that between a movement along the demand curve and a shift of the demand curve.
- ▶ A point on the demand curve shows the quantity demanded at a given price, so a movement along the demand curve shows a **change in the quantity demanded**.
- ▶ The entire demand curve shows demand, so a shift of the demand curve shows a *change in demand*.

Movement and Shift in the Demand Curve

- ▶ **Movement Along the Demand Curve** If the price of the good changes but no other influence on buying plans changes, we illustrate the effect as a movement along the demand curve.
- ▶ **A Shift of the Demand Curve** If the price of a good remains constant but some other influence on buying plans changes, there is a change in demand for that good.
- ▶ Demand *increases* and the demand curve *shifts rightward* (to the red demand curve D_1)
- ▶ Demand *decreases* and the demand curve *shifts leftward* (to the red demand curve D_2)
- ▶ Note: For an inferior good, the effects of changes in income are in the opposite direction to those described above.

FIGURE 3.3 A Change in the Quantity Demanded Versus a Change in Demand

