2. THEORY OF DEMAND AND SUPPLY:

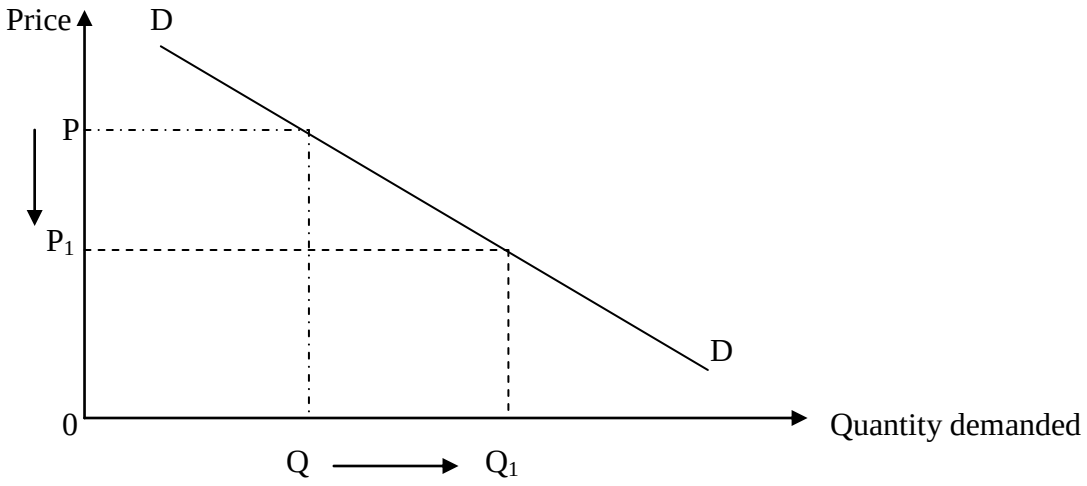
THEORY OF DEMAND:

Demand refers to the quantity of a product that consumers are willing and able to buy at a particular price and over a given period of time. The law of demand states that more is bought at a lower price than at a higher price. In other words, the law of demand postulates an inverse relationship between the price and quantity demanded of a commodity, all other factors affecting demand remain constant (ceteris paribus).

A market demand curve for a certain product is derived from the horizontal summation of all individuals demand curves at each and every price of the quantity demanded.

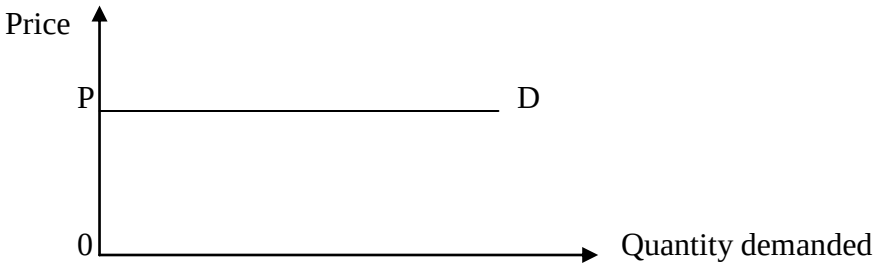
Price ($)	Consumer A	+	Consumer B	+	Consumer C	=	market demand
1	20		30		40		90
2	18		26		35		79
3	15		18		22		55
4	11		12		19		42
5	7		10		12		29

Thus, by plotting price against quantity demanded from the market schedule, a downward sloping demand curve from left to right for the entire market is drawn.

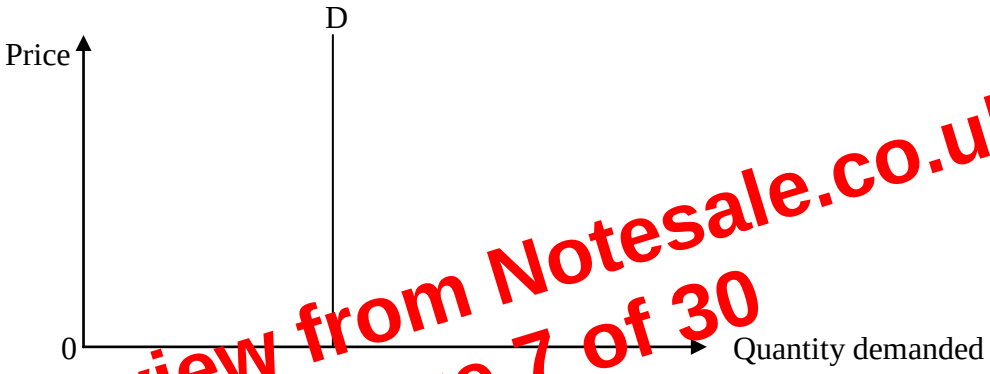


A fall in the price from OP to OP1 expands the quantity demanded from OQ to OQ1, whilst a rise will do the contrary.

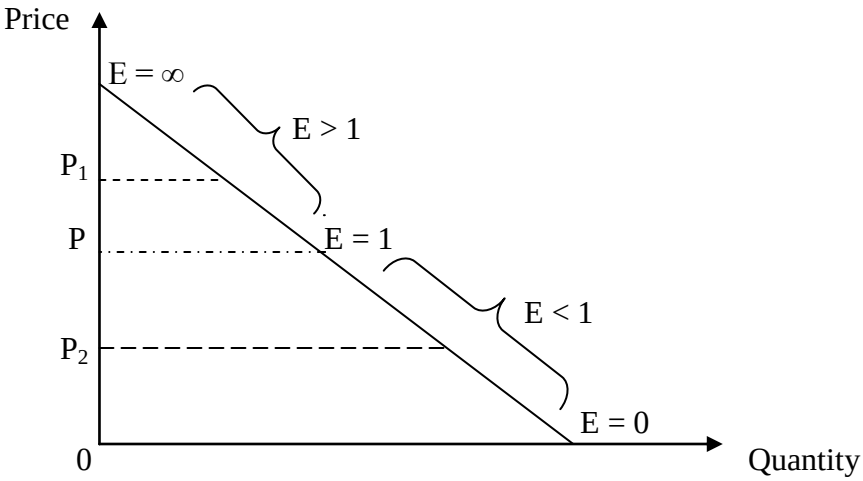
Demand can also be perfectly elastic when a small percentage change in price brings about a change in quantity demanded from zero to infinity. The coefficient of elasticity is equal to infinity.



Demand is perfectly inelastic when a percentage change in price brings about no change in quantity demanded. The value of the PED is zero (PED = 0).

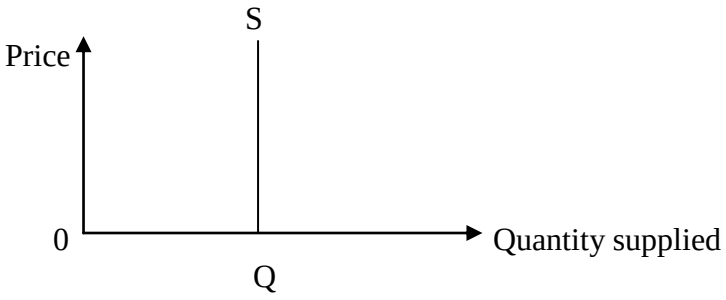


POINT ELASTICITY:

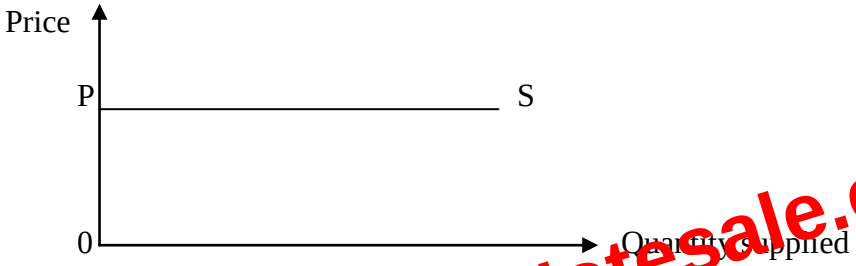


The above diagram shows a demand curve for which the price elasticity of demand is different at every price. It varies according to the level of price. For instance, along the same demand curve, elasticity is unity at price 0P (mid-point of demand curve), elastic at price $0P_1$ and inelastic at price $0P_2$.

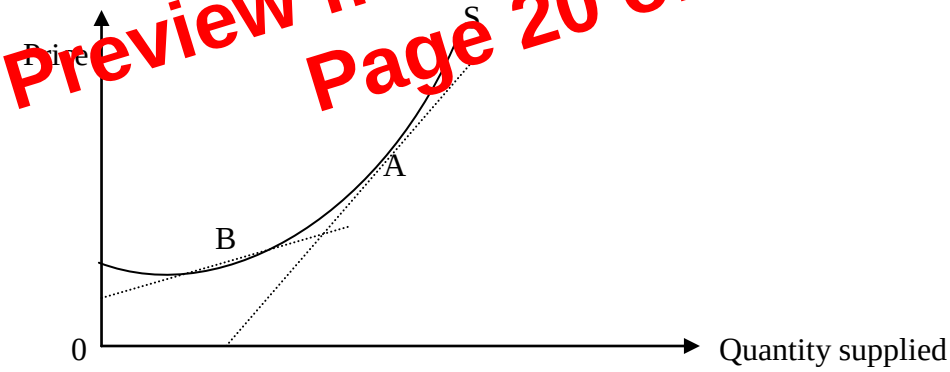
4. Perfectly inelastic supply curve – value of price elasticity of supply is zero.



5. Perfectly elastic supply curve - The coefficient of elasticity is equal to infinity. Nothing is supplied at any price below 0P, while an infinite quantity is supplied at price 0P.



Supply curve of more complex shapes:

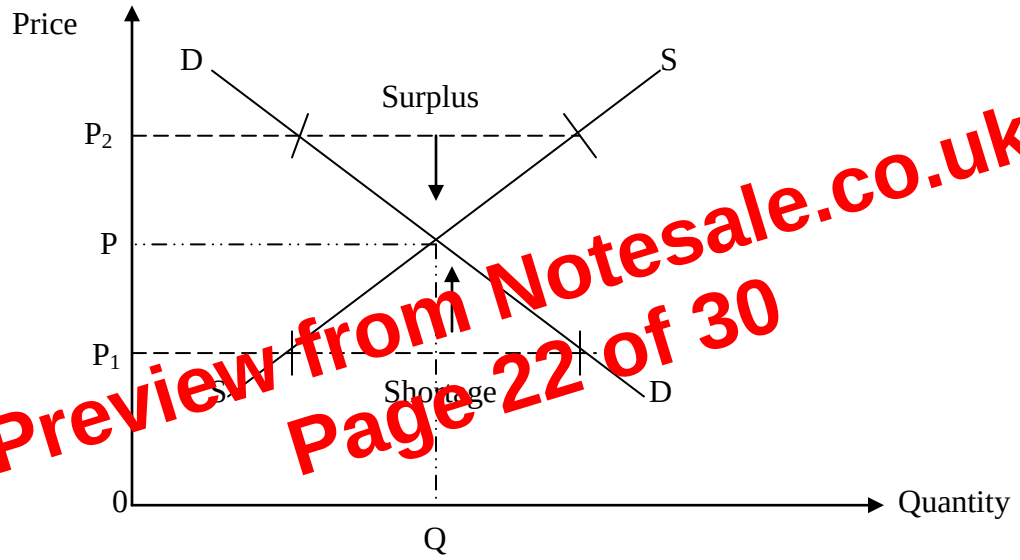


The elasticity of supply at any point on the supply curve may be judged by drawing a tangent to the point of the curve we wish to know about. If the tangent hits the vertical axis, then the supply is elastic. If it hits the Horizontal axis, then it is inelastic. In other words, the elasticity of supply is elastic initially and then it becomes inelastic.

EQUILIBRIUM PRICE AND HOW IT IS SET IN A FREE MARKET:

Equilibrium price refers to a state of rest or a state of balance where there is no tendency either to expand or to contract. In other words, there are neither excesses nor shortages of commodities in the market. Since free market implies no government intervention, the price of any commodity in the free market is determined by the combined forces of demand and supply. Hence, there is an equilibrium price where demand is equal to supply, that is what consumers wish to buy is equal to what producers wish to sell.

With a downward sloping demand curve and an upward sloping supply curve, equilibrium price occurs when these two schedules intersect as shown below:



The equilibrium price is 0P and quantity traded is 0Q. At any other prices, there is disequilibrium and this is corrected by reactions to the price level. For instance, any prices below the equilibrium price, say $0P_1$, there is shortage of goods and market forces will push up the price until demand is equal supply [Producers expand their supply, while consumers contract their demand]. On the other hand, any prices above the equilibrium price, say $0P_2$, there is excess of commodities and market forces will push down the price towards the equilibrium [Producers contract their supply, while consumers expand their demand].

However, this equilibrium price is allowed to change due to changes in demand and supply conditions. For instance, with an increase in demand due to an increase in income or a successful advertising campaign, there will be an increase in both the equilibrium price and quantity traded. This is illustrated as follows:

resources in X and $0G_1$ in the production of other goods. Hence, the rise in price shows how resources are allocated in the production of X rather than other goods, that is, a movement from C to C_1. However, in the long run supply rises to S_1S_1.

Besides, price acts as a rationing device. In other words, price serves to ration the scarce goods among the people who are demanding them. Where the supply of a good or service is insufficient to meet the demands of prospective buyers at the existing price, the market price will rise and continue to rise until the quantity demanded is just equal to the existing supply. Those unable to pay a higher prices will be eliminated from the market. Price rations scarce goods to those who can afford to pay the price. Hence, for price to act as a rationing mechanism, the effect of a rising price must be to reduce the quantity demanded by some individuals.

Moreover, the market price of a good provides the necessary signal to both buyers and sellers about the relative scarcity of the good, which in turn would get manifested in their consumption and production plans. A change in price would indicate a change in consumer behaviour, for example, an increase in price may come about as a result of an increase in demand due to a change in taste. On the other hand, prices also indicate changes in the conditions of supply.

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