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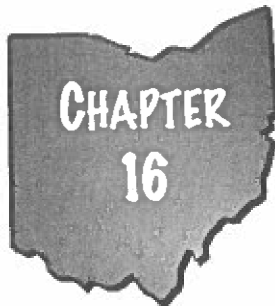

HOW SUPPLY AND DEMAND INFLUENCES PRICE

Markets are places where buyers and sellers interact. Their interaction determines the prices paid for goods and services in a market economy. Their interactions also allocate resources, goods and services.

6.EC.C.15 ***The interaction of supply and demand, influenced by competition, helps to determine price in a market. This interaction also determines the quantities of outputs produced and the quantities of inputs (human resources, natural resources and capital) used.***

After reading this chapter, you should be able to:

- ★ Define the following terms:
  - Law of Demand
  - Demand Curve
  - Law of Supply
  - Supply Curve
  - Equilibrium Price
  - Competition
- ★ Describe the laws of supply and demand.
- ★ Explain how supply and demand determine price in a market economy.
- ★ Identify some of the factors that lead to changes in the supply and demand for a product.

MAIN IDEAS OF THIS CONTENT STATEMENT

In a market economy, people are free to make, sell and buy whatever goods and services they want. Economic decisions are made on the basis of free choice.

There are two basic "laws" that form the foundation of a market economy: the law of supply and the law of demand. These are not "laws" in the sense of rules that people must obey. Rather, they are "laws" that describe what generally happens in a large number of interactions. The laws of supply and demand relate the price charged for a good or service to the quantities that are produced and sold.

THE LAW OF DEMAND

Demand refers to how much of a good or service consumers are willing to buy at a particular price. As the price increases, fewer people are willing to buy a product. As the price decreases, more people are willing to buy the product.

- How many people are willing to buy a frozen yogurt for $3.00? ____________
- How many people are willing to buy the same frozen yogurt for 50 cents? ____________
- What might explain why the demand for the frozen yogurt changes with the price?

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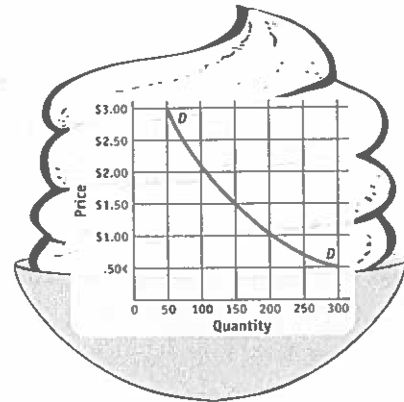

Graph 1: Demand Curve

The curved line in Graph 1 is known as the **demand curve**. It shows how many frozen yogurts that consumers would be willing to buy at different prices.

THE LAW OF SUPPLY

The **law of supply** concerns the decisions of producers. These are the manufacturers and merchants who **supply** the goods and services available for consumers to buy. These are the "**outputs**" of the production process. Producers are willing to sell more of a product as its price rises. More producers may manufacture a good if they think they can charge more. They will also use more resources, even if it becomes more expensive to produce, if they know they can charge more.

- How many frozen yogurts is this store willing to sell at 50 cents each? ____________
- How many frozen yogurts would the store sell at $3.00? ____________
- What happens to the supply of frozen yogurts made available as the price increases?

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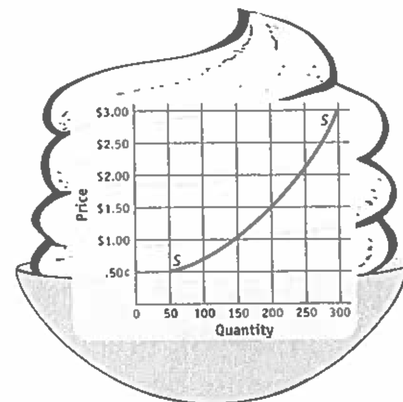


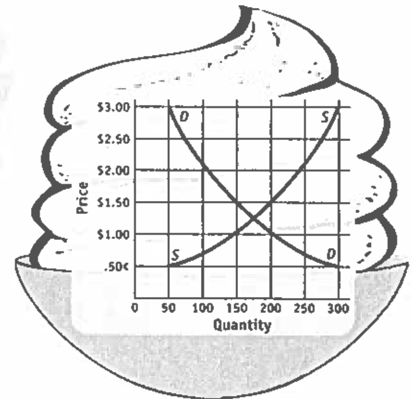
Graph 2: Supply Curve

As you can see, if it can charge $3.00 for each frozen yogurt, the store is willing to buy more sweetener, milk fat and other ingredients to make more frozen yogurt. In addition, they are willing to hire more workers and purchase more machines to make 300 frozen yogurt cups a day. However, if the store can only charge 50¢ for a frozen yogurt, they would look to buy the least expensive ingredients and probably use only one machine in their store. The most they would make in a day at that price would be 50 frozen yogurts.

The curved line in Graph 2 is called a **supply curve**. It shows the quantity of frozen yogurts that producers are willing and able to sell (*supply*) at different prices. The amount that producers are willing to supply will, in turn, affect their need for **resources** — the human resources, natural resources, and capital needed to produce the frozen yogurt. These are the "inputs" into the production process.

HOW PRICES ARE DETERMINED

In a market economy, prices are determined by the interaction of **both** consumers and producers. As the price for an item increases, the **supply** that producers are willing to sell increases. However, as the price rises, the number of items that consumers are willing to buy — the **demand** — decreases. You can see how both of these laws interact in Graph 3.



Graph 3: Supply and Demand Curves

EQUILIBRIUM PRICE

At what price are suppliers willing to sell the same number of cups of frozen yogurt that consumers are willing to buy? The price at which the quantity demanded by consumers equals the quantity supplied by producers is known as the **equilibrium price**. This is where the two curves intersect. This is the price at which producers usually end up selling their goods in a market economy.

- If the price of a good is **higher** than the equilibrium price, the supply of the good will be greater than the quantity of goods demanded. Some of the supply will remain unsold. Producers will not be paid for those items they cannot sell. This puts pressure on producers to lower their prices.
- If the price of a good is **lower** than the equilibrium price, then the demand for that good will be greater than the supply available. Supplies will quickly sell out.

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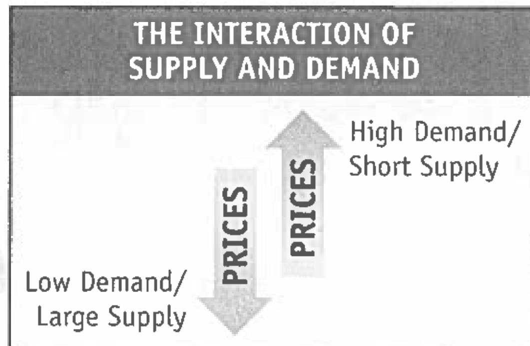
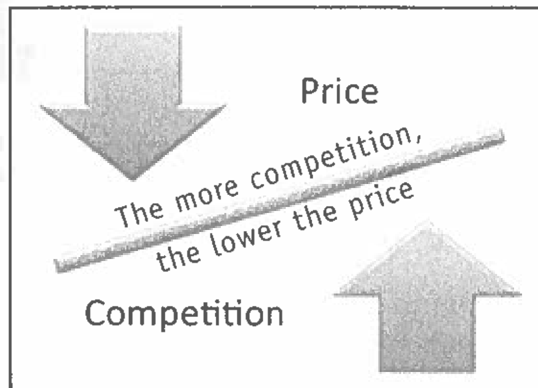


Producers will start to raise their prices and still sell all the supplies they have available. They will continue to raise their prices until they reach the equilibrium price.

Once the **equilibrium price** is reached, the product will continue to be sold at that price until some additional factor causes a change — such as the invention of a new product. The equilibrium price might also change if there is a change in the cost of the "inputs" (human resources, natural resources, and capital) needed to make the product. Such changes affect the supply that producers are willing to make available at different prices.

THE ROLE OF COMPETITION



Competition plays an important role in a market economy. For most goods and services, there are several producers. If the price of a good goes up, even more companies will jump in to produce the good and earn a profit.

If the supply becomes greater than the demand for the good, producers will compete with one another to sell off their existing supply. This encourages them to lower their prices to attract more customers. Producers who are unable to sell their goods because their prices are too high will lose money. If a business continues to lose money for too long, it will eventually be forced to go "out of business" (close down).

James Toys makes wooden yo-yos. Suppose there is a shortage of the wood the company uses to make its yo-yos, causing the price of wood to go much higher.

What will happen to the price of their yo-yos? ______________________ Why?

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Another company has invented a plastic yo-yo that glows in the dark. It charges half the price that James Toys charges for its yo-yos. What effect will this have on James Toys' yo-yo prices? ______________________________

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