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SUPPLY AND DEMAND: THE PRICE MECHANISM

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Microeconomics:

Microeconomics is that branch of economics that deals with economic behaviour of individuals or individual units of the economic system such as household firms and industry. The word micro is derived from a Greek word called “Mikros” which means “Small”. Microeconomics is also called the price theory. Microeconomics focuses on the determination of price and allocation of the scarce resources on basis of consumers wants. Demand and supply are the key instruments of microeconomics.

Demand:

Demand refers to the quantity of a good or service that a consumer is willing and able to purchase or will likely to purchase from the market at a given price during the given period of time holding all other factors constant.

Law of demand: As per the law of demand there is an inverse relationship between the price of the commodity and the quantity demanded, if the price of the commodity decreases the demand of the consumers for the commodity increases because the customer can now buy more commodity at the same price and when the price increases the demand decreases because now the customer will get less quantity in his budget.

Effect on demand due to change in price of related goods:

1. Complementary goods: The demand of product decreases when the price of its complimentary good increase, there is an inverse relationship between the demand for the product and the price of its complementary good. For example, the demand of cars decreases when the price of petrol increases and the demand of printer decreases when the price of its ink cartridges increases.

2. Substitute goods: The demand of product decreases when the price of its substitute decreases, there is a direct relationship between the demand for the product and the price of its substitute good. For example, the demand for cola of company A decreases when the price of the cola of company B decreases.

However, the law of demand is not applicable on essential items in as much as these items have an inelastic demand. The demand of a product is said to be inelastic when there is no change in the quantity demanded due to a change in price, i.e., if it is necessary for a consumer to buy a certain quantity of goods then he will be buying it at any rate. Further, the demand of addictive goods like tobacco, alcohol and cigarettes is also inelastic, therefore their demand will also not change due to a change in the price. Therefore, it can be said that the demand for inelastic goods does not change due to change in price.

Elasticity of demand: The change in quantity demanded of the commodity divided by the change in the price is known as elasticity of demand.

Relationship between demand and income: when the income of a consumer increases, his/her disposable income also increases which leads to an increase in demand. With the increased income, one has more money in hand to spend and this increase the demand in the market.

Demand function: It shows the inverse relationship between quantity demanded for a commodity and various determinants and factors affecting it

There are two kinds of demand function:

1. Individual demand function: It shows the functional relationship between demand for a good and/or service by a consumer in the markets and its various determinants.

2. Market demand function: It shoes the functional relationship between demand for a good and/or service by all the consumers in the market and its various determinants.

Supply:

It is the quantity of goods and or service the producer/seller is willing and able to produce and sell at a given price during a given period of time. There are two key words 'willing' and 'able'. Both of these aspects control the supply of any product within a market. Supply can be controlled by the suppliers up to a limit. However, some limitations are imposed by the scarcity of resources, production capacity, government policy, import-export restrictions, etc. and therefore, the supply of a product cannot be increased/decreased beyond that limit.

Law of supply: As per the law of supply there is a direct relationship between the price of the commodity and the quantity supplied, when the price decreases the quantity supplied also decreases and when the price increases the quantity supplied also increases. However, if the supplier is of the opinion that the prices of his products will increase more in the future then he would be selling less quantity of goods even at a higher price in the present with an intention to sell more in the future at even higher prices. The law of supply is not applicable on perishable goods, in case of perishable goods, the supplier is willing to sell as many goods as he can sell even at falling prices.

Elasticity of supply: The change in quantity supplied of the commodity divided by the change in the price is known as elasticity of supply.

Supply function: It is a tool that expresses the relationship between quantity supplied for a commodity and various determinants and factors affecting it.

Price Elasticity of Supply or Demand:

As the price of a good rises, the quantity offered usually increases, and the willingness of consumers to buy the good normally declines, but those changes are not necessarily proportional. The measure of the responsiveness of supply and demand to changes in price is called the price elasticity of supply or demand, calculated as the ratio of the percentage change in quantity supplied or demanded to the percentage change in price.

Supply and Demand Relationship:

'Supply and demand' refer to the relationship between the ability or will of customers to purchase a particular product, commodity, or service and the ability or will of suppliers to produce and sell that particular product, commodity, or service. This is an economic theory that drives the market equilibrium.

Equilibrium Price:

Consumers buy more when price decreases and buy less when price increase and suppliers sell more when price increase and sell less when price decreases. The law of supply and demand combines two fundamental economic principles that describe how changes in the price of a product/service affect its supply and demand. Supply rises which demand declines as the prices increases. Supply constricts while demand grows as the price drops.

Therefore, there needs to be a level of price where sellers agree to sell the buyer's desired quantity at a price which the buyers are ready to pay or it can also be said that buyers are ready to pay a price to acquire his/her desired quantity that the sellers want to receive. The relationship between supply and demand is the key factor in price determination of a product/service. The price of commodity is determined by the interaction of supply and demand in a market. The resulting price is referred to as the equilibrium price and represents an agreement between the producers and consumers of the good. In equilibrium, the quantity of a good supplied by producers equals the quantity demanded by consumers. Equilibrium is the economic condition where market demand and market supply are equal to each other, which ultimately brings stability in the price levels.

An equilibrium price is the price at which the quantity of goods and or services demanded by consumers is equal to the quantity supplied by the producers/suppliers. The tendency to move toward the equilibrium price is known as the market mechanism, and the resulting balance between supply and demand is called a market equilibrium.

Price Mechanism:

Price refers to the amount of money required to purchase a product or service. Price plays an essential role in the economy. When prices are allowed to change naturally without intervention, they help to facilitate the distribution of goods and services to people who want them. Prices also help indicate supply and demand—how much of certain products people need—so that producers can determine how much to produce. This system is called the "price mechanism," and it assumes prices naturally move until the supply of a product matches demand.

With all this said, there's no such thing as totally free and uncontrolled movement in prices. There is no unfettered price mechanism. Even in economies that operate on a relative "free market" basis, there are still monopolies, government interventions, and other conditions that interfere with price as a mechanism to help balance supply and demand. In some centrally planned economies, governments may choose to implement price controls for various political and social reasons.

However, supply and demand are the two most fundamental principles of an economic system and they always go hand in hand. These two key market forces settle the price of a commodity, by demonstrating the relationship between the quantity of that product that suppliers are willing to supply, and the quantity that consumers are willing to purchase. Though, this concept ignores many other aspects of a real economy like changing seasons, fashion trend, preferences, purchasing power, market instability, natural calamity, exceptional circumstances, etc.

References & Resources:

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