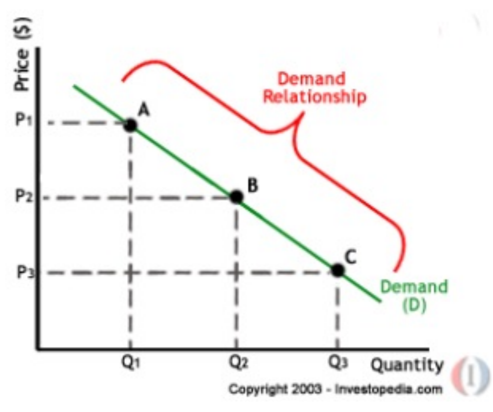
Understanding Supply and Demand

Supply and demand is perhaps one of the most fundamental concepts of economics and it is the backbone of a market economy. **Demand** refers to how much (quantity) of a product or service is desired by buyers. The relationship between price and quantity demanded is known as the demand relationship. **Supply** represents how much the market can offer. The quantity supplied refers to the amount of a certain good producers are willing to supply when receiving a certain price. The relationship between price and how much of a good or service is supplied to the market is known as the supply relationship. Price, therefore, is a reflection of supply and demand.

The relationship between demand and supply underlie the forces behind the distribution of resources.
In market economy theories, demand and supply theory will distribute resources in the most efficient way possible. How? Let us take a closer look at the law of demand and the law of supply.

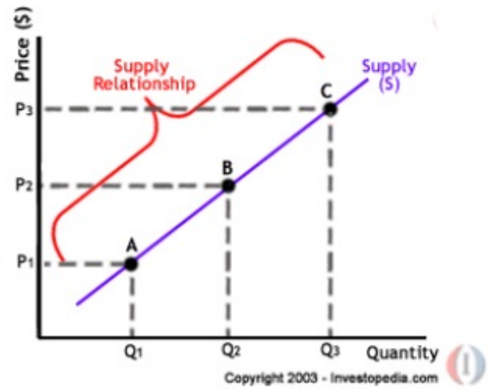
The Law of Demand

The law of demand states that, if all other factors remain equal, the higher the price of a good, the less people will demand that good. In other words, the higher the price, the lower the quantity demanded. The amount of a good that buyers purchase at a higher price is less because as the price of a good goes up, so does the opportunity cost of buying that good. As a result, people will naturally avoid buying a product that will force them to forgo the consumption of something else they value more. The chart below shows that the line is a negative slope.



The Law of Supply

Like the law of demand, the law of supply demonstrates the quantities that will be sold at a certain price. But unlike the law of demand, the supply relationship shows a positive slope. This means that the higher the price, the higher the quantity supplied. Producers supply more at a higher price because selling a higher quantity at a higher price increases income.



Time and Supply

Unlike the demand relationship, however, the supply relationship is a factor of time. Time is important to supply because suppliers must, but cannot always, react quickly to a change in demand or price. So it is important to try and determine whether a price change that is caused by demand will be temporary or permanent.

Let's say there's a sudden increase in the demand and price for umbrellas in an unexpected rainy season; suppliers may simply accommodate demand by using their production equipment more intensively. If, however, there is a climate change, and the population will need umbrellas year-round, the change in demand and price will be expected to be long term; suppliers will have to change their equipment and production facilities in order to meet the long-term levels of demand.

Supply and Demand Relationship

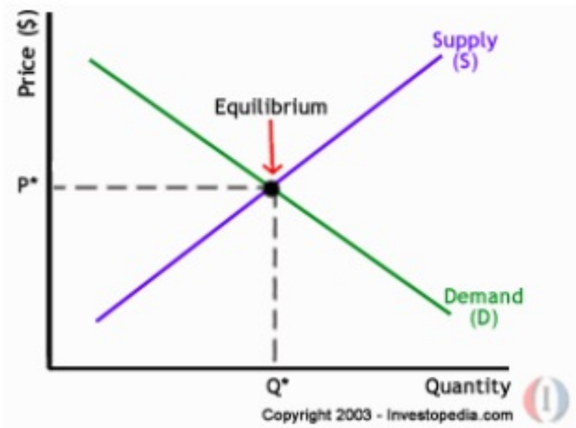
Now that we know the laws of supply and demand, let's turn to an example to show how supply and demand affect price.

Imagine that a special edition CD of your favorite band is released for $20. Because the record company's previous analysis showed that consumers will not demand CDs at a price higher than $20, only ten CDs were released because the opportunity cost is too high for suppliers to produce more. If, however, the ten CDs are demanded by 20 people, the price will subsequently rise because, according to the demand relationship, as demand increases, so does the price. Consequently, the rise in price should prompt more CDs to be supplied as the supply relationship shows that the higher the price, the higher the quantity supplied.

If, however, there are 30 CDs produced and demand is still at 20, the price will not be pushed up because the supply more than accommodates demand. In fact after the 20 consumers have been satisfied with their CD purchases, the price of the leftover CDs may drop as CD producers attempt to sell the remaining ten CDs. The lower price will then make the CD more available to people who had previously decided that the opportunity cost of buying the CD at $20 was too high.

Equilibrium

When supply and demand are equal (i.e. when the supply function and demand function intersect) the economy is said to be at equilibrium. At this point, the distribution of goods is at its most efficient because the amount of goods being supplied is exactly the same as the amount of goods being demanded. Thus, everyone (individuals, firms, or countries) is satisfied with the current economic condition. At the given price, suppliers are selling all the goods that they have produced and consumers are getting all the goods that they are demanding.



In the real market place, equilibrium can only ever be reached in theory, so the prices of goods and services are constantly changing in relation to fluctuations in demand and supply.