

## LEARNING UNIT 5

- **DATE:** MARCH 2014
- **MODULE:** PMIC6111
- **TEXTBOOK REFERENCE:** pgs 135 -150
- **THEME:** Demand and Supply in Action
  
- **OBJECTIVES:** BY END OF LEARNING UNIT 5 – YOU SHOULD KNOW THE FOLLOWING:
  - WITH AID OF A DIAGRAM, SHOW HOW A CHANGE IN DEMAND OR SUPPLY WILL AFFECT EQUILIBRIUM PRICE AND QUANTITY
  - EXPLAIN HOW SIMULTANEOUS CHANGES IN DEMAND AND SUPPLY WILL AFFECT EQUILIBRIUM PRICE & QUANTITY IN MARKET
  - EXPLAIN HOW CHANGES IN (1) ONE ASPECT CAN AFFECT EQUILIBRIUM
  - EXPLAIN THE IMPACT OF GOVERNMENT INTERVENTION – MIN & MAX PRICE SETTING
  - WELFARE COST OF MAXIMUM AND MINIMUM PRICE SETTING
  - GOVERNMENT INTERVENTION

## LEARNING UNIT 5

- **CHANGES IN DEMAND**
  - INCREASE IN DEMAND
    - RESULTS IN INCREASE IN PRICE
    - INCREASE IN QUANTITY EXCHANGED
    - RIGHTWARD SHIFT OF DEMAND CURVE
  - DECREASE IN DEMAND
    - RESULTS IN DECREASE IN PRICE
    - DECREASE IN QUANTITY EXCHANGED
    - LEFTWARD SHIFT OF DEMAND CURVE
- **WHAT HAPPENS TO SUPPLY?**
  - WHEN THERE IS AN **INCREASE** IN DEMAND
    - SUPPLY CURVE REMAINS UNCHANGED
    - **BUT** QUANTITY SUPPLIED INCREASES (PRICE INCREASES)

## LEARNING UNIT 5

- WHEN THERE IS A **DECREASE** IN DEMAND
  - SUPPLY CURVE REMAINS UNCHANGED
  - **BUT** QUANTITY SUPPLIED DECREASES (PRICE DECREASES)
- SHIFTS OF DEMAND AND SUPPLY CURVES WILL HAPPEN UNTIL EQUILIBRIUM IS ONCE AGAIN REACHED
- EXAMPLES:
  - a ) INCREASE IN INCOME:- 'X' IS A NORMAL GOOD
  - b ) INCREASE IN INCOME :- 'X' IS AN INFERIOR GOOD
  - c ) DECREASE IN INCOME :- 'X' IS A NORMAL GOOD
  - d ) DECREASE IN INCOME :- 'X' IS AN INFERIOR GOOD
  - e ) INCREASE IN PRICE OF SUBSTITUTE FOR 'X'
  - f ) DECREASE IN PRICE OF SUBSTITUTE FOR 'X'
  - g ) DECREASE IN PRICE OF COMPLEMENT FOR 'X'
  - h ) INCREASE IN PRICE OF COMPLEMENT FOR 'X'

## LEARNING UNIT 5

- **CHANGES IN SUPPLY**
  - INCREASE IN SUPPLY
    - RESULTS IN DECREASE IN PRICE
    - INCREASE IN QUANTITY EXCHANGED
    - RIGHTWARD SHIFT OF SUPPLY CURVE
  - DECREASE IN SUPPLY
    - RESULTS IN INCREASE IN PRICE
    - DECREASE IN QUANTITY EXCHANGED
    - LEFTWARD SHIFT OF SUPPLY CURVE
- **WHAT HAPPENS TO DEMAND?**
  - WHEN THERE IS AN **INCREASE** IN SUPPLY
    - DEMAND CURVE REMAINS UNCHANGED
    - **BUT** QUANTITY DEMANDED INCREASES (PRICE DECREASES)

## LEARNING UNIT 5

- WHEN THERE IS A **DECREASE** IN SUPPLY
  - DEMAND CURVE REMAINS UNCHANGED
  - **BUT** QUANTITY DEMANDED DECREASES (PRICE INCREASES)
- SHIFTS OF DEMAND AND SUPPLY CURVES WILL HAPPEN UNTIL EQUILIBRIUM IS ONCE AGAIN REACHED

## LEARNING UNIT 5

- EXAMPLES OF CHANGES IN SUPPLY
  - a ) INCREASE IN PRICE OF FACTOR OF PRODUCTION
  - b ) DECREASE IN PRICE OF FACTOR OF PRODUCTION
  - c ) INCREASE IN PRODUCTIVITY
  - d ) DECREASE IN PRODUCTIVITY

## LEARNING UNIT 5

### ➤ SIMULTANEOUS CHANGES IN DEMAND AND SUPPLY

- POSSIBLE TO PREDICT WHAT WILL HAPPEN TO EQUILIBRIUM WHEN ONLY DEMAND OR SUPPLY CHANGE
- MORE DIFFICULT TO PREDICT WHEN SIMULTANEOUS CHANGE OCCURS
- EQUILIBRIUM PRICE COULD, REMAIN UNCHANGED, RISE OR FALL DEPENDING ON RELATIVE SIZE OF CHANGES IN DEMAND AND SUPPLY

Change in Demand	Change in supply	Change in price	Change in quantity
Increase	Increase	Uncertain	Increase
Increase	Decrease	Increase	Uncertain
Decrease	Increase	Decrease	Uncertain
Decrease	Decrease	Uncertain	Decrease

## LEARNING UNIT 5

### ➤ INTERACTION BETWEEN RELATED MARKETS

- SOME PRODUCTS ARE SUBSTITUTES OR COMPLEMENTARY GOODS
- JOINT PRODUCTS

## LEARNING UNIT 5

### ➤ GOVERNMENT INTERVENTION

- DECISION BY GOVERNMENT TO INFLUENCE PRICES
- CONSUMERS, TRADE UNIONS, FARMERS CAN PUT PRESSURE ON GOVERNMENT TO INFLUENCE PRICES

### ➤ FORMS OF INTERVENTION

- MAXIMUM PRICES – “PRICE CEILINGS”
- MINIMUM PRICES – “PRICE FLOORS”
- SUBSIDISING PRODUCTS
- TAXING PRODUCTS

## LEARNING UNIT 5

### ➤ MAXIMUM PRICES

- ANALYSE IMPACT OF MAX PRICES

### ➤ TWO SCENARIOS:

- MAXIMUM PRICE SET ABOVE EQUILIBRIUM PRICE – NO EFFECT
- MAXIMUM PRICE SET BELOW EQUILIBRIUM PRICE – SIGNIFICANT EFFECTS
  - MARKET SHORTAGE/EXCESS DEMAND
  - PREVENT MARKET FORCES TO ALLOCATE AVAILABLE RESOURCES

### ➤ BASIC PROBLEM – HOW TO ALLOCATE AVAILABLE QUANTITY WHEN DEMAND IS IN EXCESS

- FIRST COME FIRST SERVED
- INFORMAL RATIONING SYSTEMS – SET UP BY SELLER
- OFFICIAL RATIONING SYSTEM – SET UP BY GOVERNMENT
- BLACK MARKETS OCCUR

## LEARNING UNIT 5

- NORMALLY SEEN AS DOING THE BEST FOR SOCIETY
- BUT – CREATE PROBLEMS:
  - EG RENT CONTROLS
    - IMPLEMENTED TO PROTECT TENANTS FROM BEING EXPLOITED BY LANDLORDS AFTER WAR
    - SHORTAGE OF HOUSES – SOLDIERS COULD NOT AFFORD HOUSING
    - THEREFORE RENTALS KEPT LOW
    - OWNERS COULD REACT IN FOLLOWING WAYS:
      - SELL FLATS UNDER SECTIONAL TITLE
      - CONVERT INTO OFFICES
      - LOWER OPERATING COSTS – BY KEEPING REPAIRS & MAINTENANCE LOW
      - STOP RENTING OUT NEW PLACES

## LEARNING UNIT 5

- **MINIMUM PRICES (PRICE FLOORS)**
  - AGRICULTURAL PRICES
    - SUPPLY FLUCTUATES – DUE TO WEATHER/FARMING CONDITIONS
    - THEREFORE FARMER'S INCOME IS UNSTABLE
    - MINIMUM PRICE INTRODUCED TO STABILISE PRICES
- **SETTING OF MINIMUM PRICES**
  - IF SET **BELOW** EQUILIBRIUM PRICE – NO EFFECT
  - IF SET **ABOVE** EQUILIBRIUM PRICE - THERE IS A SURPLUS OF DEMAND
  - REQUIRES FURTHER GOVT INTERVENTION TO RID OF SURPLUS
    - GOVT PURCHASES SURPLUS – EXPORTS IT
    - OR GOVT STORES IT
    - PRODUCTION QUOTAS ARE INTRODUCED
    - GOVT DESTROYS SURPLUS
    - PRODUCERS DESTROY SURPLUS

## LEARNING UNIT 5

- BETTER OPTION WOULD BE TO SUBSIDIZE PRODUCERS
- GIVE SURPLUS TO POOR – ENTAILS DISTRIBUTION COSTS
- PROBLEM WITH SURPLUS – COULD RE-SELL AT A LOWER PRICE
  
- **DISADVANTAGES OF MINIMUM PRICES:**
  - ALL CONSUMERS HAVE TO PAY A HIGHER PRICE
  - BULK OF BENEFIT ACCRUES TO LARGE FARMERS
  - INEFFICIENT PRODUCERS ARE PROTECTED
  - DISPOSAL OF SURPLUS ENTAILS EXTRA COSTS

## LEARNING UNIT 5

- **WELFARE COSTS**
  - CONCEPTS OF CONSUMER AND PRODUCER SURPLUS CAN BE USED TO ILLUSTRATE WELFARE LOSS
  
  - SEE DIAGRAM PG 150