Wheeler Consulting, LLC

Demand, Supply and Price

Price

Price is the mechanism by which resources are allocated in a market economy. When more people want something that is scarce, the price will go up, thereby limiting the number of people who can afford it. When fewer people want to buy something, the price will go down until it becomes more affordable for more people.

Demand

Demand is the amount of any good or service that will be consumed at a given price. When prices rise, demand will fall; if prices fall, demand will rise. Factors that influence demand include the propensity to consume or save, the perception of utility, and the availability of substitutes.

The propensity to consume measures how likely you are to save what you earn rather than spend it for current consumption. This propensity varies from culture to culture. In the US, for example, the propensity to consume is high, whereas in Europe it is lower. When the propensity to consume is high, price has less of an impact on demand.

The perception of utility measures how necessary an item is perceived to be. The more necessary it is, the less price will influence how much is consumed. People need food and gasoline, regardless of how much it costs. However, air travel is very sensitive to changes in price, as it is largely discretionary. ***Marginal utility*** is a measure of how much you benefit from each additional unit of a good or service. For example, you only need one newspaper per day; no matter how cheap it is, you don't benefit from having more than one. The lower the marginal utility, the less impact price has on demand.

The availability of substitutes also affects demand. If there is something similar you can buy instead, then a price increase in one good may have an outsize effect on demand. For example, if soft drinks go up in price, you can drink water or juice. The more substitutes there are, the more the price of something will impact demand for it.

Elasticity of demand is a term that describes the degree to which changes in price will affect the quantity consumed. Goods that are inelastic reflect small changes in total quantity consumed when prices go up and down. These goods are usually essential goods (such as gasoline or electricity) or goods for which there is no adequate substitute. Goods that are elastic reflect larger changes in total quantity consumed when prices go up and down. These goods are generally non-essential goods or goods for which there are available substitutes.

Supply

Supply is the amount that will be produced at a given price. When prices rise, supply will rise; if prices fall, supply will fall (although changes in supply take longer to materialize than changes in demand due to the limitations of installed capacity). Factors that influence supply include barriers to entry, availability of capital, the prevalence of monopolies and government regulation.

Barriers to entry are things that make it hard for competitors to enter a given market, and they vary from industry to industry. For example, it is very hard to establish a new electricity provider, but easier to open a new restaurant. The higher the barriers to entry, the less price impacts supply, because it is harder to set up new businesses.

When capital is available, it is easier to find people to invest in your business. The more capital that is available, the easier it is to set up new businesses, and the less price will impact supply.

Government regulation can also make it easier or harder to start new businesses. If there are high taxes or tariffs related to the business, the harder it will be to start up a new business. The more government intervenes, the harder it is for new businesses to compete, and the less supply will be available of a given good or service.

Equilibrium

Equilibrium is the outcome of the market process. When demand and supply are in equilibrium, prices remain stable. Price stability is defined as a condition in which price changes are not a factor in the decision-making of households or businesses. Maintaining price stability is part of the Fed's dual mandate.

The biggest challenge in a market economy is the fact that demand is essentially limitless, while supply is not. If price were no object, most people would consume as much of any given item as they could and probably with high levels of waste. Supply, on the other hand, is limited, especially in the short run. The supply of land and labor is limited, and new factories take time to build. Without new supply the economy cannot grow, but without adequate demand existing supply will not be consumed. Both demand and supply are essential to the proper functioning of an economy.