

Theory of Demand And supply

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Unit 1 :- Law of Demand and Elasticity of Demand

Demand Meaning :-

• Demand refers to the quantity of goods or services that consumers are willing and able to purchase, in a given market, on various prices, in a given period of time.

• Desire is only a wish to have any thing.

• Basic factors?

a) Desire

b) Willingness to pay

c) Ability to pay

Determinants of Demand :-

1) Price of the commodity

• Other things being equal, the demand for a commodity is inversely related with its price.

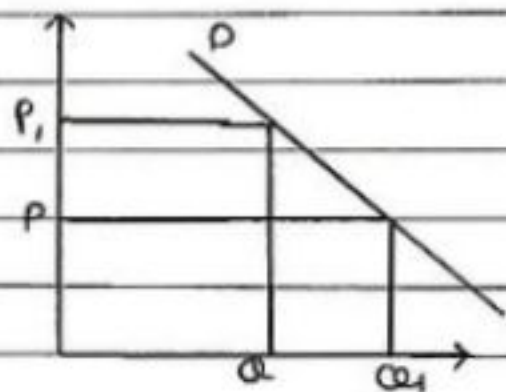
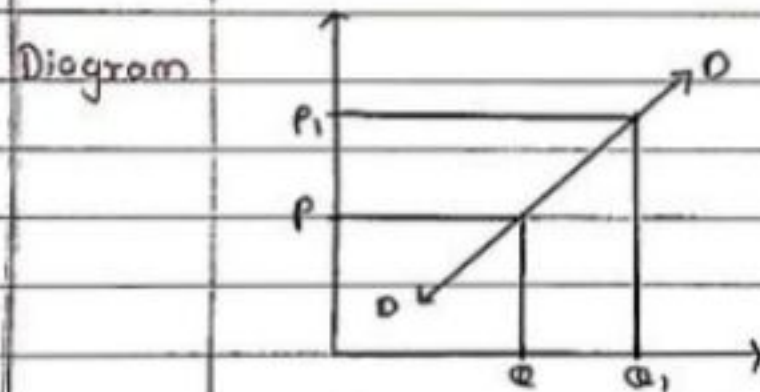
• It means that a rise in price of a commodity brings about fall in its demand and vice-versa.

• This happens because of income and substitution effects.

2) Price of Related Goods :-

• The demand for a commodity also depend on the prices of related commodities.

Points	Complementary Goods	Substitute Goods
Meaning	1) Goods which are consumed together.	1) Goods which can be used with ease in place of one another.
Effect on Demand	2) Inverse relationship	2) Direct Relationship
Example	3) Tea and sugar, Pen and Ink, car and Petrol.	3) Tea and coffee, Coke & Pepsi, Lays & Boloji.



3) Income of the Consumer:-

- Other things being equal, generally the quantity demanded of a commodity bears a Direct relationship to the income of the consumer.
- With Income $\uparrow \Rightarrow$ Demand \uparrow
- However this may not always hold true. In case of necessities, luxurious, inferior goods as the Income \uparrow Demand \downarrow / Demand \uparrow rises at higher prices also.

4) Tastes and Preferences of consumers:-

- Tastes and preferences of consumers generally change over time due to fashion, advertisement, habits, age, family composition, etc.

- Modern goods or fashionable goods have more demand than the goods which are of old design & out of fashion.

eg. Now people prefer to buy from malls than small shops.

- Consumer's tastes & preferences are also influenced by 'Demonstration Effect' i.e. by seeing another person use a particular product/commodity, eg. Music system, Home Theatre.

- A good loses its prestige when it becomes a commonly used good. This is called 'snob effect'.

5) Other Factor:-

A] Size & Composition of population:

- Generally larger size of population of a country, more will be the demand of the commodity.

- eg. If the number of teenagers is large, the demand for trendy cloths, shoes, movies etc. will be high.

B] The level of National Income & Its Distribution:-

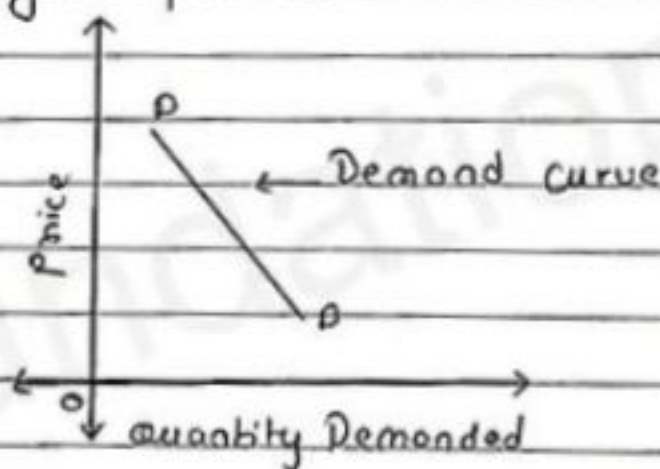
- Higher the national income, higher will be the demand for normal goods and services.

- If the income is evenly distributed, there is higher demand for consumer goods and vice-versa.

- Demand for a commodity expands when price falls and contracts when price rises.
- Law of demand is qualitative statement not quantitative.

* Assumptions :-

- 1] Consumers income remain unchanged.
- 2] Tastes and preferences of consumers remain unchanged.
- 3] Prices of substitutes goods and Complementary goods remain unchanged.
- 4] No expectations of future price changes.
- 5] No change in the fashion.
- 6] No change in govt. policies.



* Reasons for the law of Demand and downward slope of demand curve

□ The Law of DMU :-

- A consumer goes on purchasing a commodity till the marginal Utility of the commodity is greater than its market price & stops when $MU = Price$. i.e. when consumer is at equilibrium.

c) Sociological factors:-

- eg. Class, family background, education, marital status, age, locality etc.

D) Weather Conditions:

- e.g. In hot summer demand for ice-creams, cold drinks, coolers, etc.

E) Advertisement:-

- A Clever and continuous campaign & advertisement creates a new types of demand.

F) Govt. Policy:-

- e.g. High tax on a commodity will lead to fall in demand of the Commodity.

G) Expectations about future prices:

Law of Demand :-

• Statement :-

- "Other things being equal, if the price of a commodity falls, the quantity demanded of it will rise and if the price of a commodity rises, its quantity demanded will decline."

• Law of demand expresses the nature of functional relationship betⁿ prices and quantity Demanded.

• When the price of the commodity falls, MU of the commodity becomes greater than price & so consumer starts purchasing more till again $MU = Price$

2) Change in the no. of consumer's:-

• When the price of a commodity falls more consumers start buying it because some of them could not afford to buy it earlier, may now afford to buy it. This increases consumers of a commodity at a lower price.

3) Price Effect:-

A) Substitution Effect:-

- When price of a commodity falls it becomes relatively cheaper than other commodities, so the consumer would like to substitute it for other commodities which have now become more expensive.

- e.g. With the fall in price of tea, coffee's price remaining the same, tea will be substituted for coffee.

- Total demand for the cheaper commodity increases

B) Income Effect:-

• When price of a commodity falls, the purchasing power (i.e. the real income) of the consumer increases.

• Thus he can purchase the same quantity with lesser money or he can get more quantity for the same money.

4) Different Uses:-

- Commodity may have many uses. The number of uses to which the consumer can be put will increase at a lower price & vice-versa.

* Exceptions:-

1) Prestigious goods / Conspicuous goods :-

- If the commodity is expensive consumers think that it has got more utility.
- If the use of commodity confers prestige & distinction, wealthy consumers buy less when the price is low and buy more when it is at high prices.
- eg. Diamonds are symbols of a prestige, so higher the price \uparrow higher demand \uparrow

2) Giffen Goods:-

- When the price of inferior goods fall, less quantity is purchased due to consumers increased preference for superior commodity with the rise in their "Real income".
- Hence, other things being constant, if price of a Giffen good fall its demand also falls.
- There is positive price effect.
- eg. jowar, bajra, cheap bread, etc.

3) Basic Necessities :-

• As price is the basic necessity of life consumers has to adjust their budget / Expenses to control the expenditure rised of those commodities price is increased.

- eg. cooking gas, Petrol.

4) Conspicuous Necessities :-

• Demand for some goods is influenced by the 'Demonstration effect' i.e. consumption pattern of social group to which the person belongs.

• Due to their constant usage, those goods, become their necessities of life

• eg. TV, Mobiles, coolers, AC.

5) Future Price expectations.

6) Irrational Consumers.

7) Consumer's illusion :-

• Many consumers have a wrong illusion that the quality of commodity also changes with change in price.