

Chapter 4

SUPPLY AND DEMAND

Principles of Economics in Context (Goodwin, et al.), 2nd Edition

Chapter Overview

In this chapter, you'll find the basics of supply and demand analysis. As you work through this chapter, you will start learning how to manipulate supply and demand curves as a way to analyze the relationships among prices, volume of production, and other factors. You will learn about the various factors that can shift a supply or demand curve up or down, and the concepts of equilibrium and market adjustment.

Objectives

After reading and reviewing this chapter, you should be able to:

1. Interpret supply and demand curves.
2. Understand the difference between a change in supply (demand) and a change in the quantity supplied (demanded).
3. List the nonprice determinants of supply by businesses and demand by households.
4. Explain how price adjusts due to changes in supply and demand.
5. Understand topics of market analysis including scarcity, shortage, inadequacy, and equity.
6. Explain the difference between accuracy and precision.

Key Term Review

demand	supply
market price	market quantity sold
individual supply	market (or aggregate) supply
supply schedule	supply curve
change in quantity supplied	change in supply
nonprice determinants of supply	demand schedule
demand curve	market (or aggregate) demand
individual demand	change in quantity demanded
change in demand	nonprice determinants of demand
substitute good	complementary good
surplus	shortage
market equilibrium	theory of market adjustment
market disequilibrium	markup (or cost-plus) pricing
market value	social value
inadequacy	precise
accurate	

Active Review

Fill in the Blank

1. A curve indicating the quantities that buyers are willing to purchase at various prices is known as a(n) _____ curve.
2. Mark would like to buy a new car for \$20,000. However, he doesn't have any savings and he doesn't qualify for a loan. Thus, his desire for a car does not translate into _____ demand.
3. Tabitha needs furniture for her room. She is deciding between a medium-sized couch and a large armchair. Either the couch or the armchair could fulfill her need for sitting space in the room. The couch and the armchair can be referred to as _____ goods.
4. When people eat french fries, they like to put ketchup on them. Due to an increase in the price of french fries, total sales of french fries decrease. At the same time, ketchup sales also decrease. This phenomenon can be explained by noting that french fries and ketchup are _____ goods.
5. Surplus and shortage are both instances of _____.
6. In general, in a basic model showing supply and demand, if the supply curve shifts to the right, equilibrium price will _____ and equilibrium quantity supplied will _____.

True or False

7. The price of limes could be a nonprice determinant of the supply of lemons.
8. The demand curve for a good shows the same information as the demand schedule.
9. Tastes and preferences act as nonprice determinants of demand.
10. In general, an increase in demand tends to increase equilibrium price and decrease equilibrium quantity.
11. If both supply and demand increase, the price of the good will also increase.
12. If demand increases and supply decreases, the price of the good will increase.
13. The more precise a model is, the more likely it is to be accurate.

Short Answer

14. There are ten restaurants in your town. On a given night, each restaurant has the ability to produce up to twenty full course dinners at a price of \$20 each. What is the total market supply of full course dinners tonight, at a price of \$20?

15. Name six nonprice determinants of supply, for a producing business.

16. Why do demand curves generally slope downward?

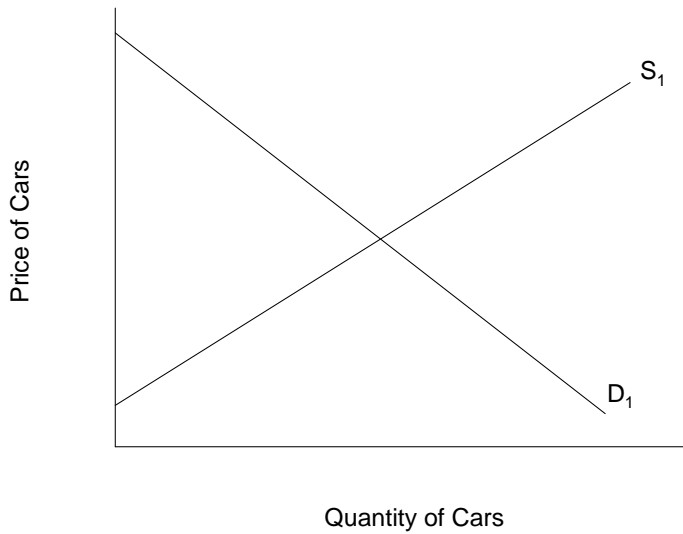
17. Suggest a possible exception to the "law of demand," in which people buy less of a good as its price increases.

18. Explain the difference between a *change in quantity demanded* and a *change in demand*.

19. Describe a possible case in which adjustment to equilibrium may take many years, or not happen at all.

20. A new movie is released after having been heavily promoted to teenagers. On the first night, the tickets sell out and there are still teenagers waiting outside theaters, desperate to see the movie and unable to get a ticket. Is this market in equilibrium? Explain.

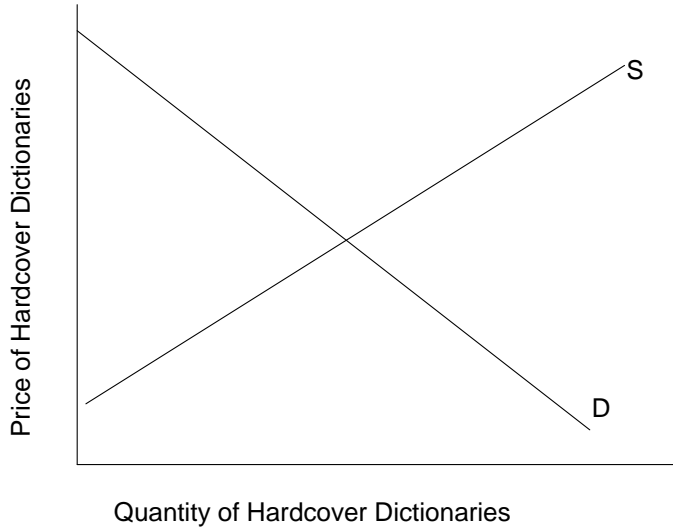
Problems



1. For the following questions, refer to the graph shown above.

- a. Label the equilibrium point as E_1 , the equilibrium quantity as Q_1 , and the equilibrium price as P_1 .
- b. Show how the supply curve will change if car manufacturers achieve a technological breakthrough that allows them to produce cars more cheaply.
- c. If the price stayed at P_1 , would a surplus or a shortage result from the technological breakthrough described in part (b)? Answer in words, and show on the graph.

- d. Assuming market forces work quickly, show the new equilibrium price to which the market will adjust. Label this point as E_2 . Label the new equilibrium quantity as Q_2 , and the new equilibrium price as P_2 .
- e. In words, summarize the information that you have shown in your adjustments to the graph in parts (a) through (d).



2. The graph above shows supply and demand for hardcover English dictionaries. Suppose that a new dictionary resource is created on the Internet, decreasing people's interest in buying large dictionaries in book form. For the questions below, state the answer in words and, where relevant, diagram your answer.

- a. What happens to the demand curve for hardcover dictionaries, as a result of this Internet innovation? (Answer in words and diagram.)

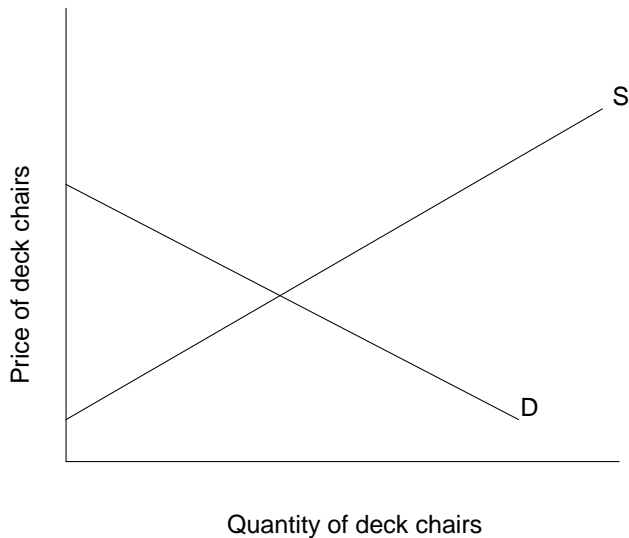
- b. What happens to the supply curve as a result of the Internet innovation? (Answer in words and diagram.)

- c. What happens to the price of hardcover dictionaries as a result of the innovation? Show the new price level on the graph you drew for part (b).

- d. Suggest one or more factors that could prevent this market from adjusting to equilibrium.

3. Refer again to the graph above, showing the market for hardcover dictionaries. What are the two types of change in this market that would lead the equilibrium price to *rise*?

4. In a popular new movie, a central character spends much of his time sitting on a white deck chair. Suddenly, white deck chairs come into fashion and everybody wants one. The graph below shows the market for deck chairs *before* the movie came out.



- On the diagram above, show what happens to the market for deck chairs as a result of the movie.
- Show the size of the shortage that exists in the short term, before the market adjusts to equilibrium.
- Label the new equilibrium point as E_2 .

5. Using the same example of the market in white deck chairs, describe and, on separate graphs, show the changes in equilibrium price and quantity that would occur in response to the following events.

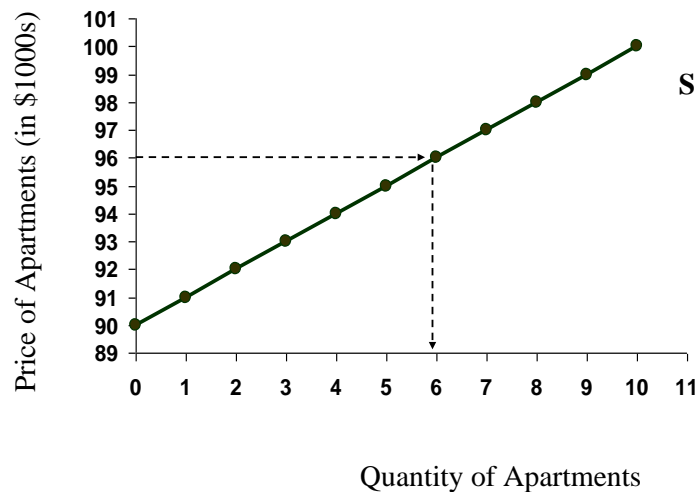
- A key input for making deck chairs becomes more expensive (*ceteris paribus*).
- In a highly publicized event, someone falls off a poorly constructed deck chair and sustains a serious head injury (*ceteris paribus*).

Self Test

1. Suppose when the price of shirts increases from \$20 to \$25, the quantity supplied increases. This change is best described as ...
 - a. movement along a supply curve.
 - b. a change in supply.
 - c. movement along a demand curve.
 - d. a change in demand.
 - e. none of the above.
2. Which one of the following statements is false?
 - a. Demand curves tend to slope downward.
 - b. The relationship between price and quantity demanded is generally positive.
 - c. The relationship between price and quantity supplied is generally direct.
 - d. At equilibrium, the quantity demanded equals the quantity supplied.
 - e. A shortage occurs when the quantity demanded exceeds the quantity supplied.

Questions 3 to 5 refer to the following graph:

The Supply Curve for Apartments



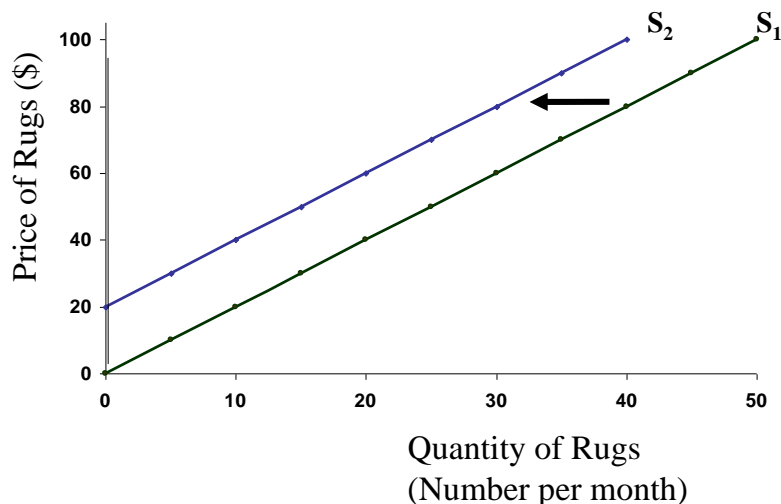
3. Based on the figure above, how many apartment owners would be willing to sell their apartments for \$91,000?
 - a. None
 - b. One
 - c. Two
 - d. Six
 - e. Ten

4. In the graph above, up to ten apartments may be available for sale. Suppose that ten more apartment owners enter the market, for a total of twenty available apartments. These new entrants into the market would be willing to sell their apartments for any price above \$90,000. Which of the following statements accurately describes the resulting change in the supply curve?
 - a. The supply curve shifts upward.
 - b. The supply curve shifts to the right.
 - c. The supply curve shifts to the left.
 - d. The supply curve becomes longer.
 - e. The supply curve can no longer be represented by a straight line.

5. In the situation described in Question #4, how many apartment owners would be willing to sell their apartments for \$91,000?
 - a. None
 - b. One
 - c. Two
 - d. Ten
 - e. Eleven

6. Which of the following statements is true, regarding the supply of a particular good, and that good's own price?
 - a. A price increase shifts the supply curve to the right.
 - b. A price decrease shifts the supply curve to the right.
 - c. A price increase shifts the supply curve downward.
 - d. A price change alone does not shift the supply curve.
 - e. A price change is the only way to shift the supply curve.

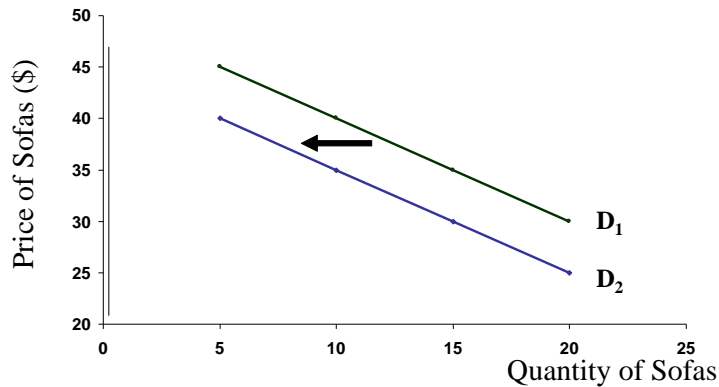
Question #7 refers to the following graph.



7. The graph shown above depicts two possible supply curves for production of handmade rugs. S_1 is the initial supply curve, and S_2 is the new supply curve after a change has occurred in the market. Which of the following events could have caused this shift?
- Several rug makers have left the market, making handmade rugs more scarce.
 - Several new rug makers have entered the market, making handmade rugs more plentiful.
 - The price of thread used in rugs has dropped, making it cheaper to produce rugs.
 - Rugs have come into fashion, so buyers want more of them.
 - Rugs have gone out of fashion, so buyers want fewer of them.
8. Which of the following is *not* an example of a “nonprice determinant of supply” of handmade rugs?
- Available technology for making rugs.
 - The price of looms for weaving rugs.
 - Number of rug producers.
 - Price of related goods and services.
 - Price of handmade rugs.
9. Which of the following is an example of movement *along* a supply curve?
- The quantity of apples offered for sale increases as the price of apples rises.
 - An apple orchard burns down in an accidental fire, decreasing the number of suppliers on the market.
 - Thanks to good weather conditions, apple growers enjoy a bumper crop this year.
 - The price of pears doubles, increasing demand for apples.
 - The price of fertilizer increases, making it more expensive to produce apples.
10. Which of the following statements is true?
- Markets respond to both effective and latent demand.
 - Markets respond to demand, even if that demand is not backed up by cash.
 - Markets respond only to wants or needs that are backed up by the ability to pay.
 - Demand curves represent "effective demand" only.
 - Both c and d are true.

11. Suppose the number of engineers graduating from college increases at the same time as the demand for engineers increases. Which one of the following is true?
- The number of engineers employed will increase, and engineer wages will increase.
 - The number of engineers employed will increase, and engineer wages will decrease.
 - The number of engineers employed will increase, but the effect on engineer wages is ambiguous.
 - Engineer wages will increase, but the effect of the number of engineers employed is ambiguous.
 - The effect on both engineer wages and the number of engineers employed is ambiguous.

Question #12 refers to the following graph.

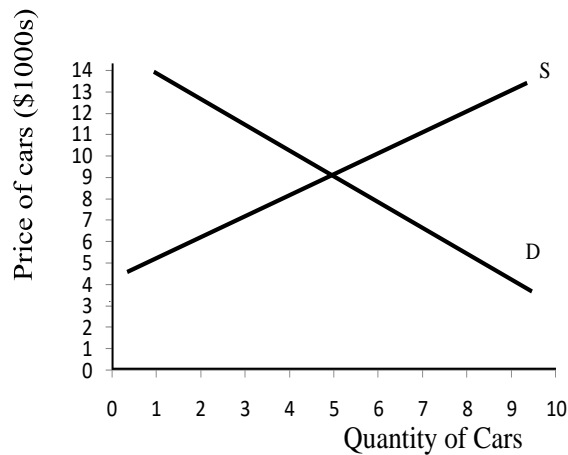


12. Assume that sofas and arm chairs are substitute goods. The graph shown above illustrates the demand curve for sofas. Which of the following events could have triggered the shift in demand from D₁ to D₂, as shown above?

- The price of sofas increased.
- The price of armchairs increased.
- The price of labor for making sofas increased.
- The price of sofas decreased.
- The price of armchairs decreased.

13. A bike shop in a small town has received a shipment of 10 new bicycles. The shop offers the bikes for sale at a price of \$300 each. At this price, however, there are only two people in town who are willing to buy a bicycle. This situation can be described as
- disequilibrium
 - shortage
 - surplus
 - equilibrium
 - both a and c are correct

Questions 14 to 16 refer to the graph below.



14. When the price of cars is \$5000, which of the following terms is not an accurate description of the situation?
- Quantity demanded exceeds quantity supplied.
 - A shortage exists.
 - The market is in disequilibrium.
 - Fewer than five cars are available for sale.
 - The market is in equilibrium.
15. Beginning from the price of \$5000, which of the following events would be predicted by the theory of market adjustment?
- Some buyers who are willing to pay more will bid the price of cars up.
 - The market will remain in disequilibrium.
 - Prices will fall.
 - All buyers will remain in the market.
 - The supply and demand curves will shift to achieve equilibrium.

16. Now suppose that the local government invests in a new, very efficient fleet of buses. Now, it is easy and affordable to get from one place to another without having your own car. What change in the graph shown above is most likely to result from the new bus service?
- The supply curve shifts to the right.
 - The supply curve shifts to the left.
 - The demand curve shifts to the right.
 - The demand curve shifts to the left.
 - None of the above.
17. At the end of a hot day, ten people want to buy a glass of lemonade. However, the local lemonade stand only has five glasses of lemonade left. The lemonade stand operator sells the remaining five glasses to the five people who are willing and able to pay the most. This is an example of ...
- a surplus
 - rationing by price
 - disequilibrium
 - a shift in the demand curve
 - a lottery
18. Suppose there is a drought that reduces the harvest of corn. At the same time, the demand for corn increases due to expanded use of ethanol fuels. Which one of the following statements is true?
- The price of corn will increase, but the effect on the quantity of corn sold is ambiguous.
 - The price of corn will decrease, but the effect on the quantity of corn sold is ambiguous.
 - The quantity of corn sold will increase, but the effect on the price of corn is ambiguous.
 - The quantity of corn sold will decrease, but the effect on the price of corn is ambiguous.
 - The effect on both the quantity of corn sold and the price of corn is ambiguous.
19. Which one of the following would be most likely to increase (shift to the right) the demand curve for public transportation?
- Increasing the frequency of bus stops
 - Lower fares for bus tickets
 - Lower prices for airline tickets
 - Higher gasoline prices
 - Lower automobile prices

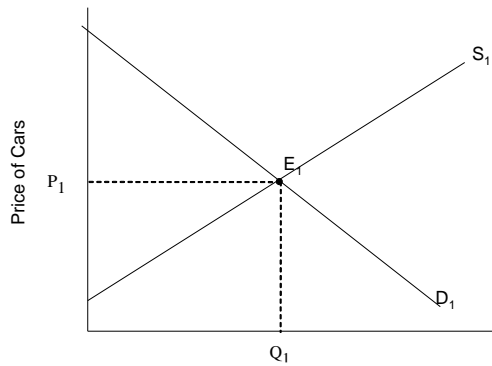
20. When the supply of a good increases, what happens to equilibrium price and quantity?
- a. They both increase
 - b. They both decrease
 - c. Price increases, quantity decreases
 - d. Price decreases, quantity increases
 - e. The effect is ambiguous

Answers to Active Review Questions

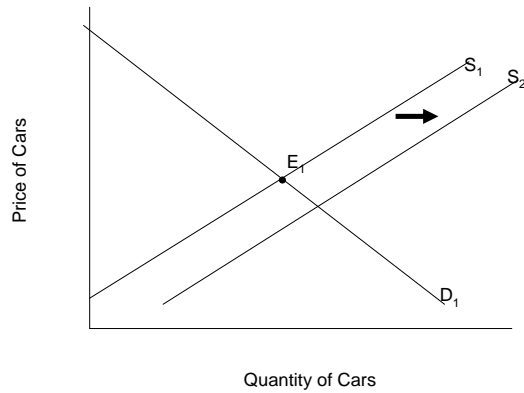
1. demand
2. effective
3. substitute
4. complementary
5. disequilibrium
6. decrease, increase
7. True. For example, if limes command a high price, lemon producers might switch to lime production, thus decreasing the total supply of lemons available.
8. True.
9. True.
10. False. In general, an increase in demand tends to increase both equilibrium price and equilibrium quantity.
11. False. The impact of these changes on equilibrium price is ambiguous.
12. True.
13. False. The more precise a model is, the less likely it is to be accurate.
14. Market supply is 200.
15. Available technology of production; resource prices; number of producers; producer expectations about future prices and technology; prices of related goods and services; physical supply of a natural resource.
16. The demand curve slopes downward because in general, the higher the price of the good, the fewer people will want to buy it.
17. Occasionally, people will want more of a good if it is sold as a "prestige" good at a high price. This phenomenon might sometimes be observed with specialty foods, clothes, or cars.
18. "Change in quantity demanded" refers to movement *along* the demand curve. For example, if the price of apples rises, all other things being equal, people will buy fewer apples; thus, the quantity demanded will decrease. A "change in demand" refers to a situation in which the entire demand curve shifts. For example, if a large number of new people move into your neighborhood, there will be a larger pool of people interested in buying apples at the local grocery store.
19. One example is the shortage of nursing staff in health care settings, a shortage that has existed for decades. You may come up with other real-life or hypothetical examples. For example, adjustment to equilibrium might take a long time in a housing market; sellers might keep prices high for a period of time, hoping to find takers, even though few people are willing to purchase homes at those prices.
20. No, this market is not in equilibrium; there is a shortage of movie tickets.

Answers to Problems

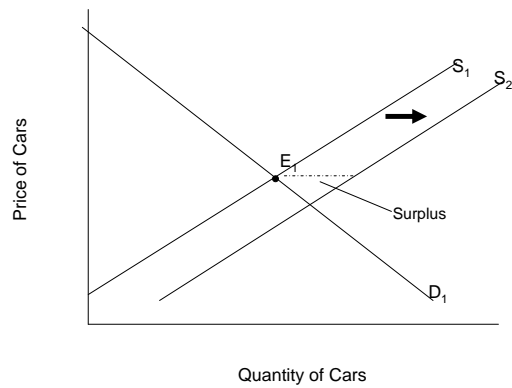
1. a.



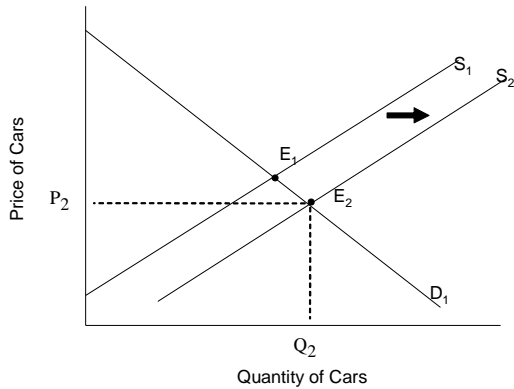
1. b.



1. c. The shift in the supply curve creates a temporary surplus.

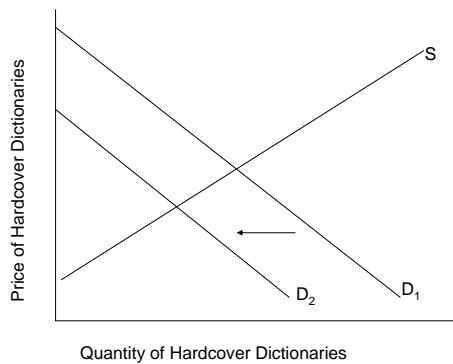


1. d.



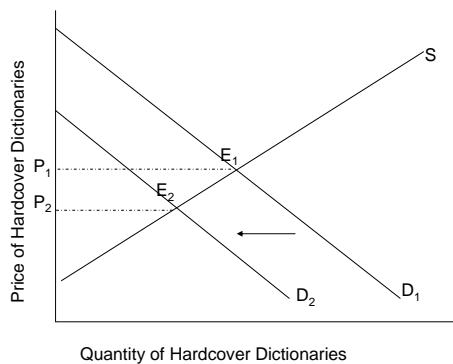
1. e. The supply curve has shifted to the right. The equilibrium price has fallen, and equilibrium quantity has risen.

2. a. The demand curve shifts to the left.



2. b. The supply curve does not shift.

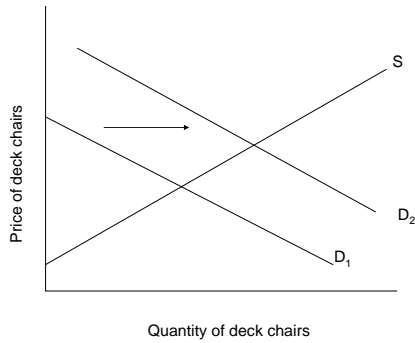
2. c. The price of hardcover dictionaries at the new equilibrium, E_2 , is lower.



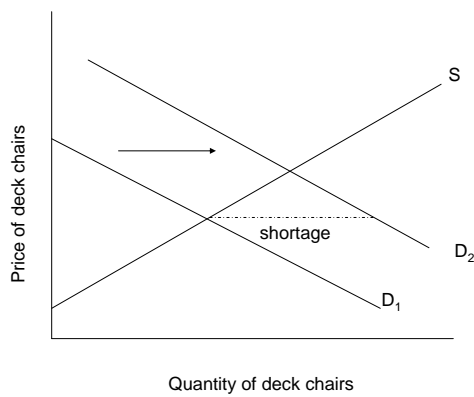
d. Many answers are possible here. For example, dictionary producers might continue charging high prices out of habit, failing to recognize – or not wanting to admit – that demand has changed significantly.

3. The equilibrium price could rise as a result of the supply curve shifting to the left (i.e. a decrease in supply), or as a result of the demand curve shifting to the right (i.e. an increase in demand).

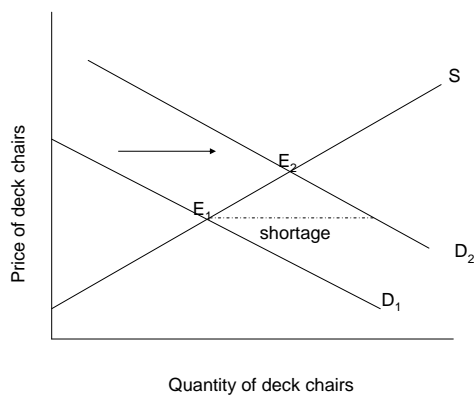
4. a.. The demand curve shifts to the right, as shown below.



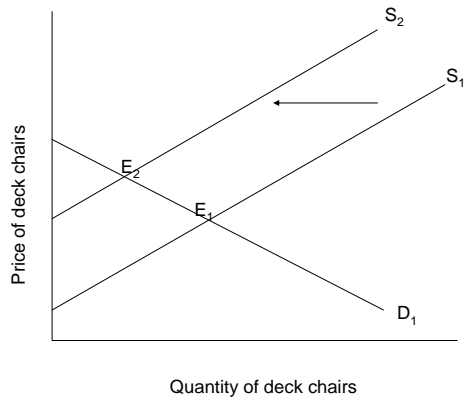
4. b.



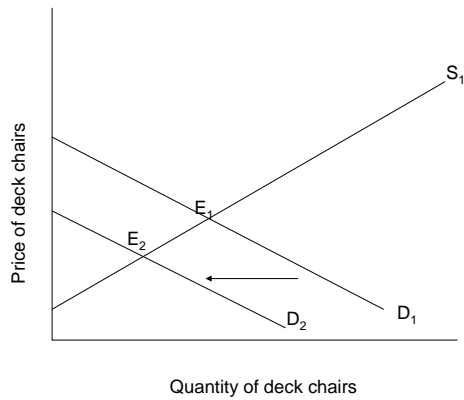
4. c.



5. a. The supply curve shifts to the left, leading to a higher equilibrium price and lower equilibrium quantity.



5. b. The demand curve shifts to the left, leading to a lower equilibrium price and lower equilibrium quantity.



Answers to Self Test Questions

- | | |
|-------|-------|
| 1. a | 11. c |
| 2. b | 12. e |
| 3. b | 13. e |
| 4. b | 14. e |
| 5. e | 15. a |
| 6. d | 16. d |
| 7. a | 17. b |
| 8. e | 18. a |
| 9. a | 19. d |
| 10. e | 20. d |