CIE Economics AS-level

Topic 2: Price System and the Microeconomy

a) Demand and supply curves

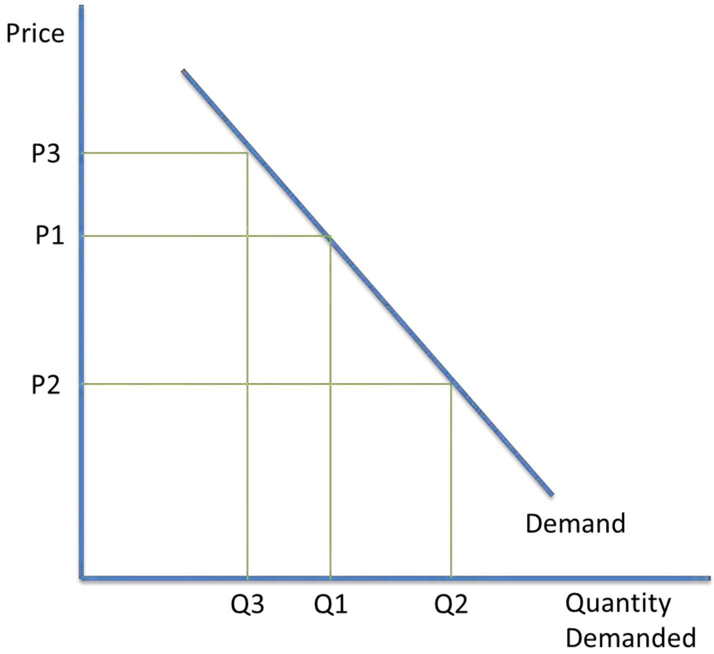
Notes

Demand:

- **Effective demand** is the quantity that consumers are willing to buy at the current market price.
- **Individual demand** is the demand of an individual or firm, measured by the quantity bought at a certain price at one point in time.
- **Market demand** is the sum of all individual demands in a market.

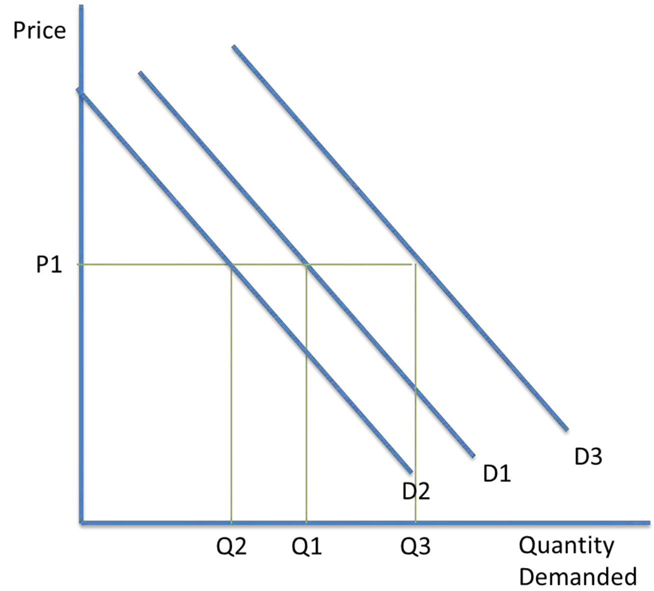
- Demand varies with price. Generally, the lower the price, the more affordable the good and so consumer demand increases. This can be illustrated with the demand curve.

Movements along the demand curve:



- At price P1, a quantity of Q1 is demanded. At the lower price of P2, a larger quantity of Q2 is demanded. This is an **expansion** of demand. At the higher price of P3, a lower quantity of Q3 is demanded. This is a **contraction** of demand. Only changes in price will cause these movements along the demand curve.

Shifting the demand curve:



- Price changes do not shift the demand curve. A shift from D1 to D2 is an inward shift in demand, so a lower quantity of goods is demanded at the market price of P1. A shift from D1 to D3 is an outward shift in demand. More goods are demanded at the market price of P1.
- The factors that shift the demand curve can be remembered using the mnemonic PIRATES:
  - **P- Population.** The larger the population, the higher the demand. Changing the structure of the population also affects demand, such as the distribution of different age groups.
  - **I- Income.** If consumers have more disposable income, they are able to afford more goods, so demand increases.
  - **R- Related goods.** Related goods are **substitutes** or **complements**. A substitute can replace another good, such as two different brands of TV. If the price of the substitute falls, the quantity demanded of the original good will fall because consumers will switch to the cheaper option. A complement goes with another good, such as strawberries and cream. If the price of strawberries increases, the demand for cream will fall because fewer people will be buying strawberries, and hence fewer people will be buying cream.
  - **A- Advertising.** This will increase consumer loyalty to the good and increase demand.
  - **T- Tastes and fashions.** The demand curve will also shift if consumer tastes change. For example, the demand for physical books might fall, if consumers start preferring to read e-books.
  - **E- Expectations.** This is of future price changes. If speculators expect the price of shares in a company to increase in the future, demand is likely to increase in the present.

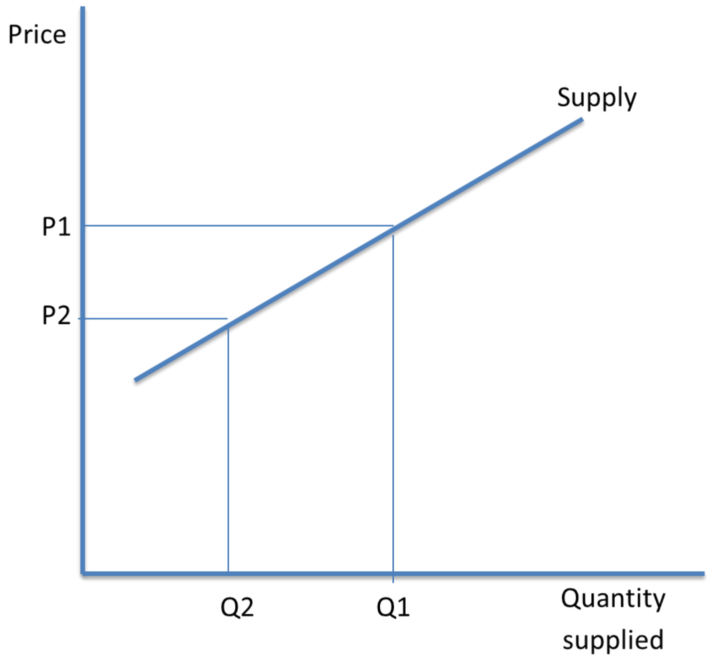
- **S- Seasons.** Demand changes according to the season. For example, in the summer, the demand for ice cream and sun lotions increases.

Supply:

- **Individual supply** is the supply that a producer is willing and able to sell at a given price in a given period of time.
- **Market supply** is the sum of all individual supplies in a market.

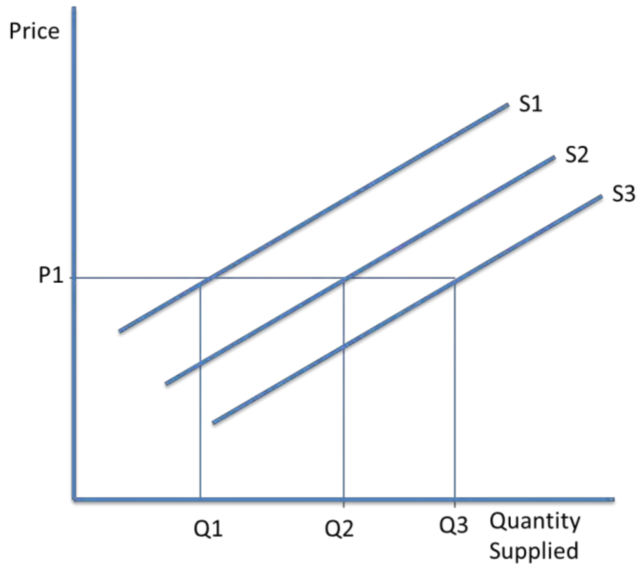
- Supply curves are upward sloping because:
  - If price increases, it is more profitable for firms to supply the good, so supply increases.
  - High prices encourage new firms to enter the market, because it seems profitable, so supply increases.
  - With larger outputs, firm's costs increase, so they need to charge a higher price to cover the costs.

Movements along the supply curve:



- At price P1, a quantity of Q1 is supplied. At the lower price of P2, Q2 is supplied. This is a **contraction** of supply. If price increases from P2 to P1, QS increases from Q2 to Q1. This is an **expansion** of supply. Only changes in price will cause these movements along the supply curve. This is based on the theory of the **profit motive.** Firms are driven by the desire to make large profits.

Shifting the supply curve:



- Price changes do not shift the supply curve. A shift from S1 to S2 is an outward shift in supply, so a larger quantity of goods is supplied at the market price of P1. A shift from S3 to S1 is an inward shift in supply. More goods are supplied at the market price of P1.
- The factors that shift the supply curve can be remembered using the mnemonic PINTSWC:
    - **P- Productivity.** Higher productivity causes an outward shift in supply, because average costs for the firm fall.
    - **I- Indirect taxes.** Inward shift in supply.
    - **N- Number of firms.** The more firms there are, the larger the supply.
    - **T- Technology.** More advanced the technology causes an outward shift in supply.
    - **S- Subsidies.** Subsidies cause an outward shift in supply.
    - **W- Weather.** This is particularly for agricultural produce. Favourable conditions will increase supply.
    - **C- Costs of production.** If costs of production fall, the firm can afford to supply more. If costs rise, such as with higher wages, there will be an inward shift in supply.
    - Also, depreciation in the exchange rate will increase the cost of imports, which will cause an inward shift in supply.