WJEC (Wales) Economics
AS-level
Microeconomics

Topic 2: Demand and Supply in Product Markets

2.1 Factors influencing demand and supply in product markets

Notes

- A **product market** is where goods and services are produced by firms and then sold to consumers. Consumers use their income from selling resources, such as labour, to buy the goods and services.

- **Maximisation** for consumers is when consumers aim to generate the greatest utility possible from an economic decision. Firms aim to generate the highest profits possible.
- A consumer's utility is the total satisfaction received from consuming a good or service.
- It is assumed that economic agents only act in their own interests. It is also assumed that firms and consumers behave rationally.
- Some firms might have philanthropic owners who seek to maximise the utility of others.
- Governments are elected and act on behalf of consumers. Governments may intervene to different extents in an economy. For example, some might provide healthcare and education, whilst others might leave healthcare to the free market. In the UK, healthcare is provided by the government, whilst in the US, healthcare is provided by the private sector.

Demand

- **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 is the **quantity of a good or service that consumers are able and willing to buy at a given price during a given period of time.**
- 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.

- The demand curve is downward sloping because of **diminishing marginal utility.** Consumer surplus generally declines with extra units consumed. This is because the extra unit generates less utility than the one already consumed. Therefore, consumers are willing to pay less for extra units. As price falls, consumers demand more.

- **Supply:**

- 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 marginal costs increase, so they need to charge a higher price to cover the costs. The marginal cost is the cost of producing one extra good.
  - It is important to remember the assumption that **firms are price takers in the analysis of a supply curve.**

- **Income Substitution Effect**

- With an increase in price:
  - The good becomes more expensive that alternatives. This is the **substitution** effect and it assumes the same level of income. It measures how much a high price on a good causes the consumer to switch to substitutes.
  - Disposable income reduces, which may lead to a fall in demand. This is the **income** effect. It explores how price changes affect disposable income.