

1 CHAPTER ROADMAP



Theme: markets bring buyers and sellers together. Demand and supply are the two forces that interact to fix price and quantity in a market – understanding how each force behaves (and what shifts it) explains everyday changes in prices, from chicken to room coolers to sugar cane.

2 KEY DEFINITIONS

Demand

Quantity of a good/service buyers are willing AND able to buy at a given price and time – desire alone (without ability to pay) is not demand.

Law of Demand

Ceteris paribus, as price rises the quantity demanded contracts, and as price falls it extends – an inverse price-quantity relationship.

Supply

Amount of a product offered for sale at a given price and moment – NOT the entire stock held by the producer.

Law of Supply

Ceteris paribus, as price rises the quantity supplied extends, and as price falls it contracts – a direct/positive price-quantity relationship.

Market Demand

Horizontal summation of all individual consumers' demand curves in the market.

Equilibrium

Situation where no agent wants to change decisions and all decisions are compatible – market demand = market supply ($Q_d = Q_s$).

Ceteris Paribus

"All other things remaining constant/unchanged" – the key assumption behind both demand and supply laws.

Reservation Price

The lowest price at which a firm is willing to sell a good or provide a service.

3 WHY DEMAND SLOPES DOWNWARD – INCOME & SUBSTITUTION EFFECTS

INCOME EFFECT

- Price rises → consumer's real purchasing power falls → feels poorer → buys less

SUBSTITUTION EFFECT

- Price rises → good becomes dearer relative to alternatives → consumers switch to substitutes

4 ASSUMPTIONS OF LAW OF DEMAND

HELD CONSTANT (CETERIS PARIBUS)

- No change in average income of consumers
- No change in population size
- No change in prices of related goods (substitutes/complements)
- No change in taste, habit, fashion or weather
- No change in future price expectations
- No change in advertisement

5 DEMAND SCHEDULE & CURVE (CHICKEN EXAMPLE)

Price (Rs./kg)	500	400	300	200	100
Quantity Demanded (kg)	10	20	35	55	80

As price falls from Rs.500 to Rs.100, quantity demanded rises from 10kg to 80kg – confirming the inverse price-quantity relationship (downward-sloping demand curve D, price on Y-axis, quantity on X-axis).

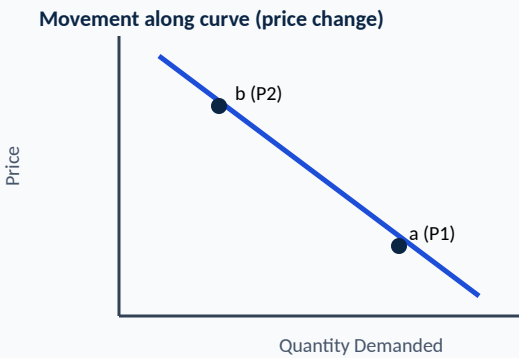
6 MOVEMENT ALONG VS SHIFT OF THE DEMAND CURVE

PRICE OF THE GOOD ITSELF CHANGES?

MOVEMENT along the SAME curve → "Extension" (price ↓ , Qd ↑) or "Contraction" (price ↑ , Qd ↓)
– also called change in quantity demanded

OTHER DETERMINANT CHANGES? (income, taste, weather, population, related-good prices, ads)

SHIFT of the WHOLE curve → "Rise in demand" (shift right) or "Fall in demand" (shift left) – also called change in demand



7 FACTORS CAUSING A SHIFT IN DEMAND – CAUSE & EFFECT

Income ↑	→	Demand for (normal) goods ↑ – curve shifts right
Taste turns favourable	→	Demand ↑ regardless of price
Weather suits the product (e.g. winter → tea)	→	Demand for that product ↑
Population ↑	→	Demand for most goods ↑
Price of a substitute ↑	→	Demand for THIS good ↑ (buyers switch to it)
Successful advertisement	→	Demand for that good ↑

8 EXCEPTIONS TO THE LAW OF DEMAND

BASIC NECESSITIES Sugar, rice, wheat – bought regardless of price change	UNIQUE/DISTINCTIVE GOODS Demand rises WITH price for a particular group (status/prestige goods)	CHANGE IN INCOME Rising income can raise demand even as price rises
CONSUMER IGNORANCE Unaware of cheaper alternatives elsewhere	UNCERTAIN CONDITIONS Fear of future shortage → buy more despite high price	

Practical importance of Law of Demand: helps in price determination, firm's future planning/decision-making, and assists the Finance Minister in setting tax rates without eroding taxable revenue.

9 SUPPLY SCHEDULE & CURVE (RICE EXAMPLE)

Price (Rs./ton)	10	20	30	40	50	60
Quantity Supplied (tons)	0	5	15	30	50	65

Positive/direct relationship – as price rises, quantity supplied rises. Supply curve S is upward sloping (price on Y-axis, quantity on X-axis).

10 ASSUMPTIONS OF LAW OF SUPPLY

HELD CONSTANT (CETERIS PARIBUS)

- Cost of production remains constant
- Technology/technique of production unchanged
- No change in taxes or subsidies
- Input/raw material prices unchanged
- Prices of other goods unaffected

11 MOVEMENT ALONG VS SHIFT OF THE SUPPLY CURVE

PRICE OF THE GOOD ITSELF CHANGES?

OTHER FACTOR CHANGES? (input cost, technology, taxes/subsidies, price of other goods)

MOVEMENT along the SAME curve = change in quantity supplied (extension/contraction)

SHIFT of the WHOLE curve = change in supply (rise = right, fall = left)



12 FACTORS CAUSING A SHIFT IN SUPPLY – CAUSE & EFFECT

Input/resource cost ↑	→	Cost of production ↑ → Supply ↓ (shift left)
Technology improves	→	Less input needed per unit → Supply ↑ (shift right)
Taxes ↑	→	Cost of production ↑ → Supply ↓
Subsidies ↑	→	Effective cost ↓ → Supply ↑
Price of an alternative product firm can make rises	→	Resources switch away → Supply of THIS good ↓

13 PRICE DETERMINATION & MARKET EQUILIBRIUM

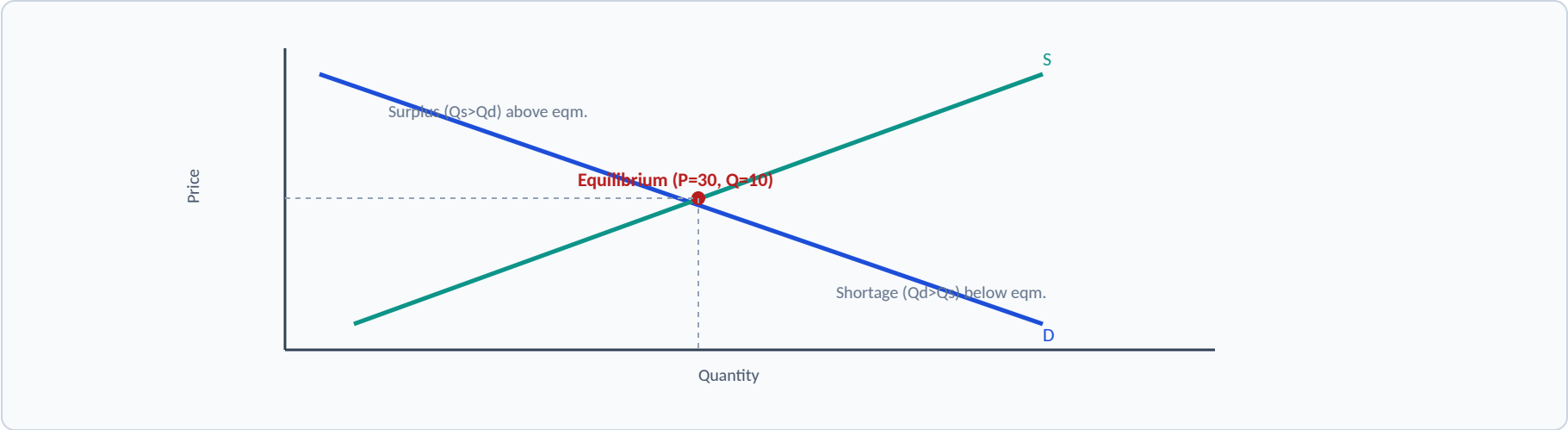
TYPES OF PRICE

- **Equilibrium/Market price** – set by demand & supply forces
- **Regulated price** – set by government/state

CONDITIONS FOR EQUILIBRIUM

- No agent wants to change its decision
- Decisions of all agents are compatible & can be carried out simultaneously
- At equilibrium: planned demand = planned supply ($Q_d = Q_s$)

Price Rs.('000/ton)	Qd (tons)	Qs (tons)	Comparison	Position	Price direction
50	5	15	$Q_d < Q_s$	Surplus	Depresses price
40	7	13	$Q_d < Q_s$	Surplus	Depresses price
30	10	10	$Q_d = Q_s$	Equilibrium	Neutral
20	14	6	$Q_d > Q_s$	Shortage	Drags price up
10	19	1	$Q_d > Q_s$	Shortage	Drags price up



Above equilibrium (e.g. Rs.40): supply exceeds demand → surplus → price falls back. Below equilibrium (e.g. Rs.20): demand exceeds supply → shortage → price rises back. This self-correcting process is the **automatic price mechanism**.

14 GRAPH / APPLICATION DECISION TREE

- 1) What changed – price of the good itself, or another determinant? → 2) Movement (same curve) or Shift (new curve)? → 3) Which curve is affected – D or S? → 4) Direction of shift (right = rise, left = fall)? → 5) New equilibrium price & quantity? → 6) Economic outcome / interpretation

15 SHIFTS IN D & S → EFFECT ON EQUILIBRIUM (4 SCENARIOS)

Scenario	Example	Curve Shift	Equilibrium Price	Equilibrium Quantity
Demand ↑	Income ↑ → more chicken bought	D shifts right (D1→D2)	Rises	Rises
Demand ↓	Summer→Winter → less room-cooler demand	D shifts left (D1→D2)	Falls	Falls
Supply ↑	New factory → more mobile phones	S shifts right (S1→S2)	Falls	Rises
Supply ↓	Input prices ↑ → fewer cars made	S shifts left (S1→S2)	Rises	Falls

Exam clue: Demand-side shifts move Price and Quantity in the SAME direction; Supply-side shifts move Price and Quantity in OPPOSITE directions.

16 MARKET PRICE: PERISHABLE VS DURABLE GOODS

	Perishable Goods	Durable Goods
Meaning	Short shelf-life, consumed quickly (dairy, fruit, vegetables)	Long life, can be stored/shelved (machinery, motorbikes, handsets)
Supply curve	Vertical (fixed) – supply cannot be topped up quickly once produced	Normal upward-sloping, but becomes vertical once stock is exhausted
Price driver	Demand side is dominant – price fluctuates mainly with demand (D1 up, D2 down) along the fixed supply	Price responds to demand within stock limits, then rises sharply once stock runs out

17 AGRICULTURE: WHY FARM PRICES & INCOMES FLUCTUATE



Ironically, when demand is elastic a good harvest can still **reduce** farmer income – a small price fall triggers a disproportionate rise in quantity demanded relative to revenue gained. Strong agents (e.g. big landlords, cartels) can also manipulate supply (hoarding) to distort prices for weaker producers – a key reason for government intervention.

18 BUFFER STOCK SCHEME (GOVT. PRICE STABILITY POLICY)

Mechanism: Government sets a guaranteed minimum (floor) price P1 above the free-market equilibrium P*. When supply expands (S1→S2) and would otherwise push price down to P*, the government buys up the surplus (Q1–Q2) to hold price at P1.

Objective: stable, predictable income for farmers/producers; stock can be released later if a shortage occurs.

DISADVANTAGES OF BUFFER STOCK SCHEME

- **Higher opportunity cost** – upfront cost of buying surplus could fund other policy goals
- **Over-production risk** – market price signal no longer disciplines output
- **Administrative & storage costs** – maintaining buffer stock is costly to run

19 E-BUSINESS & MARKET PRICE – KEY DETERMINANTS

BENEFITS TO FIRMS

- Lower inventory/admin cost
- Faster, cheaper marketing
- Access to global partners

BENEFITS TO CUSTOMERS

- Price comparison & better bargains
- Greater choice, reverse auctions
- Convenience/doorstep delivery

EFFECT ON PRICING

- Full info on floor prices limits over-charging
- Less brand loyalty, frequent switching
- Demand curve shifts more often

20 GLOSSARY – DON'T CONFUSE!

Term	Meaning
Substitute vs Complement	Substitute = used in place of another good; Complement = used together with another good
Demand Schedule vs Curve	Schedule = table of price-quantity combos; Curve = graphical plot of the schedule
Direct vs Derived Demand	Direct = for consumer goods bought to satisfy needs directly; Derived = for capital goods/factors of production
Price Ceiling vs Floor	Ceiling = legal MAXIMUM price; Floor = legal MINIMUM price (govt. usually sets only one per good)
Giffen Good	Exception to law of demand (Robert Giffen) – as price of bread fell, real income rose enough that consumers bought LESS bread and switched to better food

21 EXAM PATTERNS & MCQ QUICK CLUES

"Price of the good itself changes"	→	Movement along curve (extension/contraction)
"Income/taste/weather/population changes"	→	Shift of demand curve
"Input cost/technology/tax changes"	→	Shift of supply curve
"Qd > Qs at current price"	→	Shortage – price will rise
"Qs > Qd at current price"	→	Surplus – price will fall

ECONOMICS EXAM TRAPS

Trap: Confusing "change in demand" (shift, non-price cause) with "change in quantity demanded" (movement, price cause).

Trap: Mixing up which side dominates price for perishables (demand-driven, vertical supply) vs durables (supply matters until stock runs out).

Trap: Assuming supply and demand shifts always move price and quantity the same way – supply shifts move them in OPPOSITE directions.

Trap: Forgetting that basic necessities, Giffen goods and status goods are EXCEPTIONS to the law of demand.

Trap: Treating buffer stock's floor price as a price ceiling – it is a MINIMUM (floor), not a maximum.

PRC-3 ECONOMICS – CHAPTER 2 IN 60 SECONDS

- **Demand:** willing + able to buy; inverse law (income + substitution effects).
- **Supply:** offered for sale at a price/time; direct/positive law.
- **Movement** = own price change; **Shift** = other determinant change.
- **Demand shifters:** income, taste, weather, population, substitute price, ads.
- **Supply shifters:** input cost, technology, taxes/subsidies, price of other goods.
- **Equilibrium:** Qd = Qs; surplus depresses price, shortage drags it up.
- **Demand shift:** price & quantity move SAME way; **Supply shift:** OPPOSITE ways.
- **Perishables:** vertical supply, demand-driven price. **Durables:** stock-limited.
- **Buffer stock:** govt. floor price + buys surplus to stabilise farm income.
- **E-business:** more price transparency, less brand loyalty, frequent demand shifts.

22 CHAPTER MEMORY MAP

