THEORY OF DEMAND

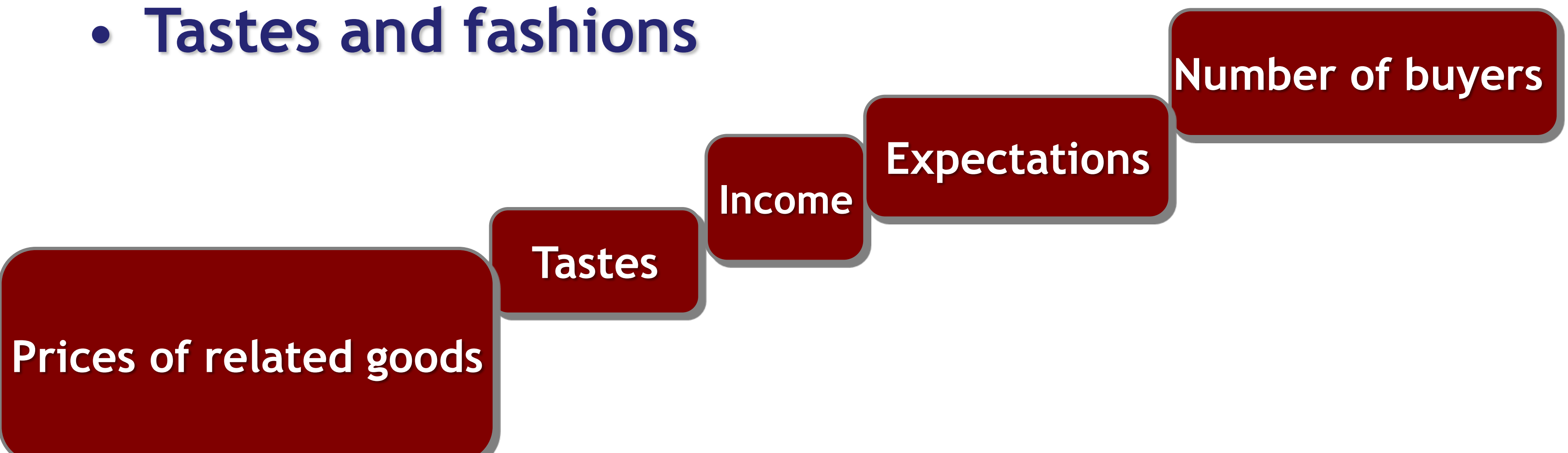
P. Bharathi

What is Demand?

- The willingness to buy a good or service at all prices backed by purchasing power
- What is the law of Demand?
  - People demand more at lower prices and low at higher prices.

Determinants of Demand

- Prices of other goods (substitute or complementary)
- Consumers' expectations (about future income and prices)
- Income (normal goods versus inferior goods)
- Number of potential customers
- Tastes and fashions

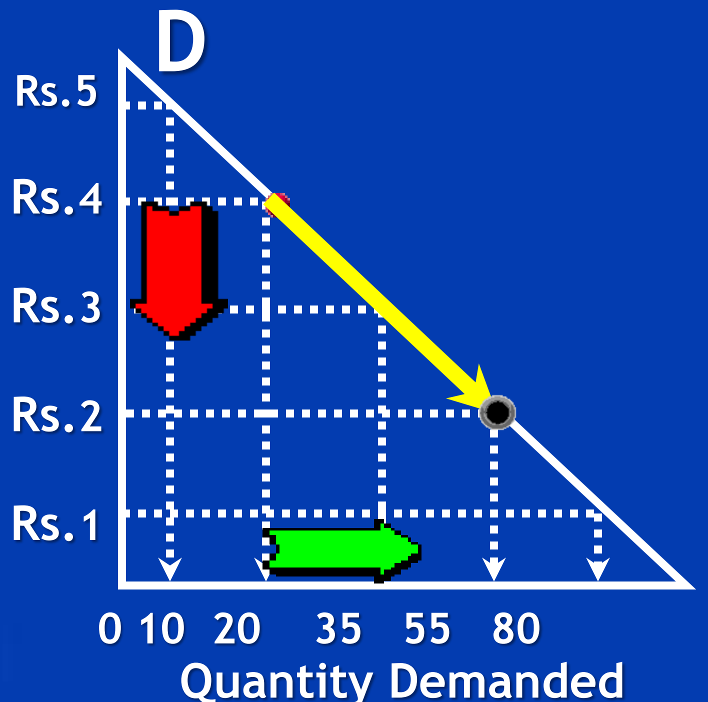


DEMAND SCHEDULE

Consumers "willingness to buy"

Price decreases; QD increases

P	Q_D
Rs.5	10
4	20
3	35
2	55
1	80



…in a given time period

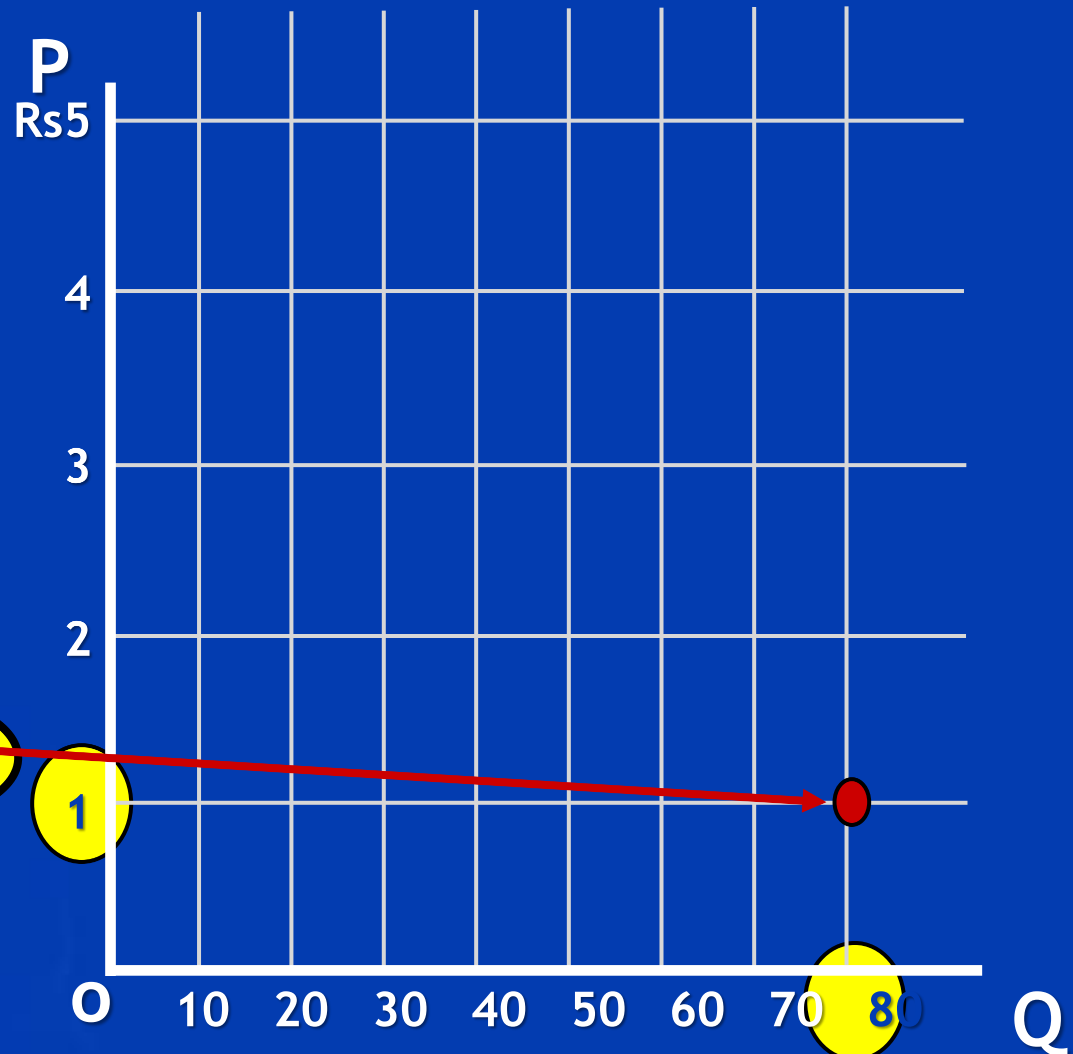
…other things remaining constant

GRAPHING DEMAND

Price of Corn

CORN

P	Q_D
$5	10
4	20
3	35
2	55
1	80

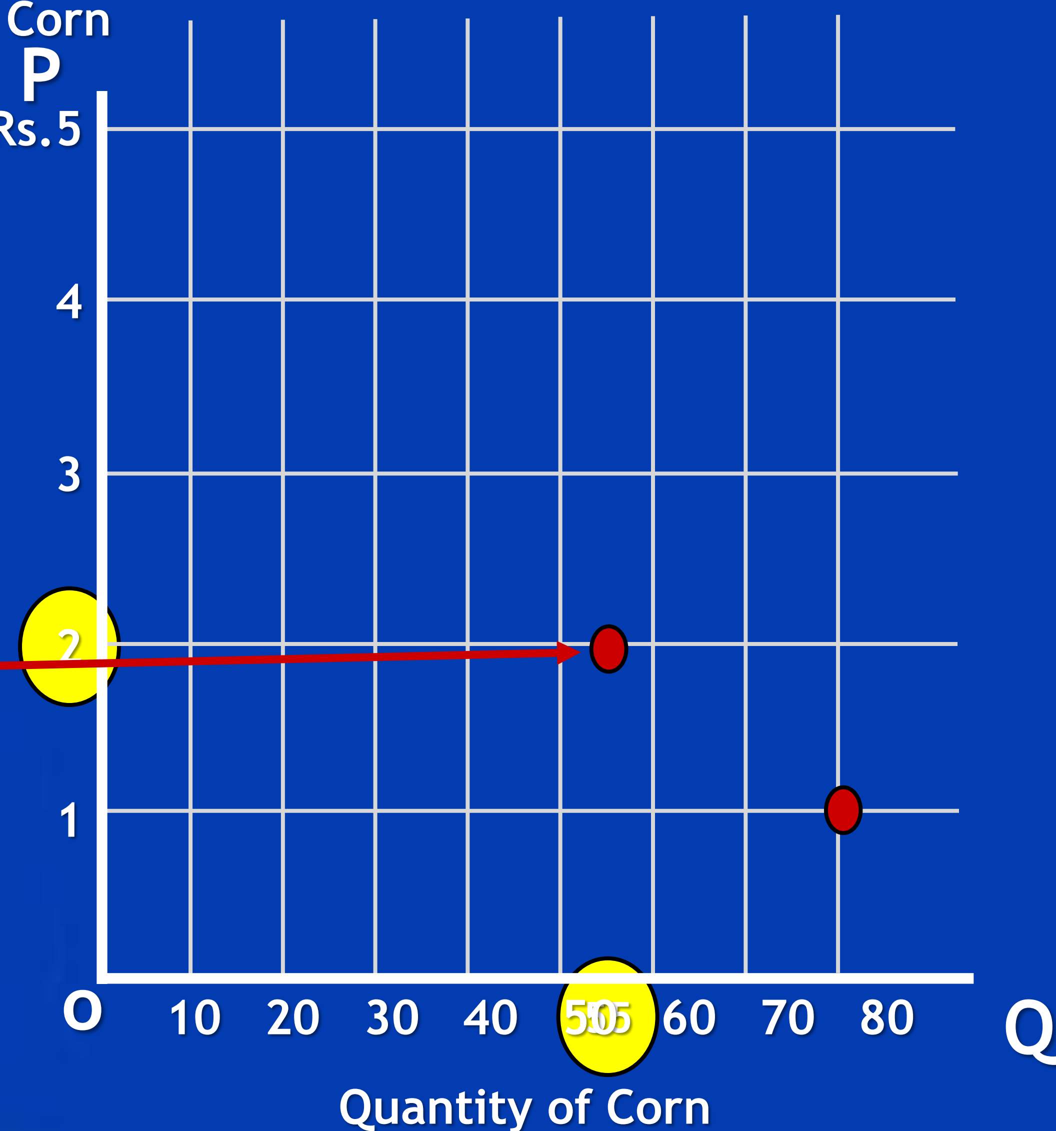


Quantity of Corn

GRAPHING DEMAND

CORN

P	Q_D
Rs.5	10
4	20
3	35
2	55
1	80



GRAPHING DEMAND

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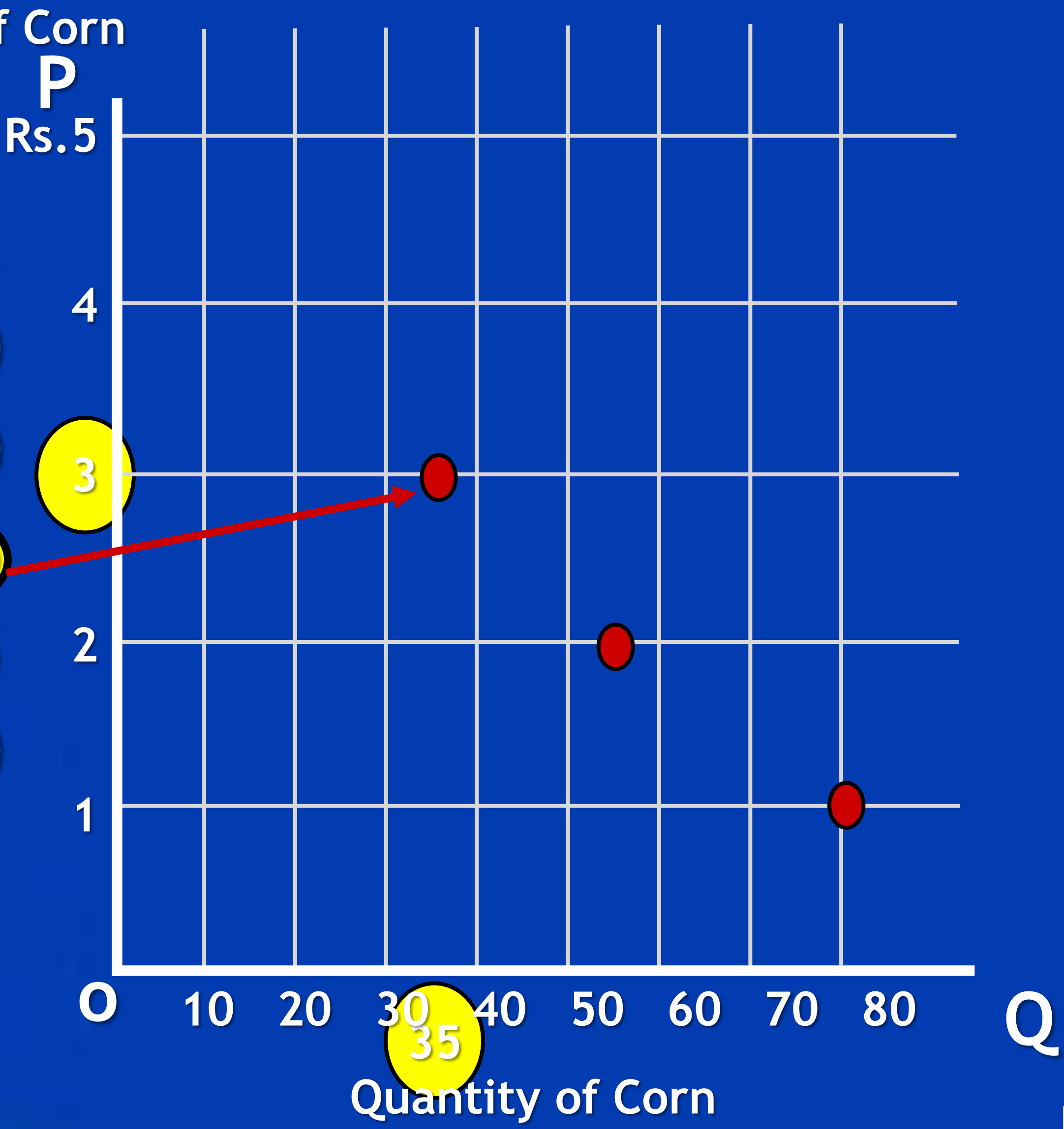

GRAPHING DEMAND

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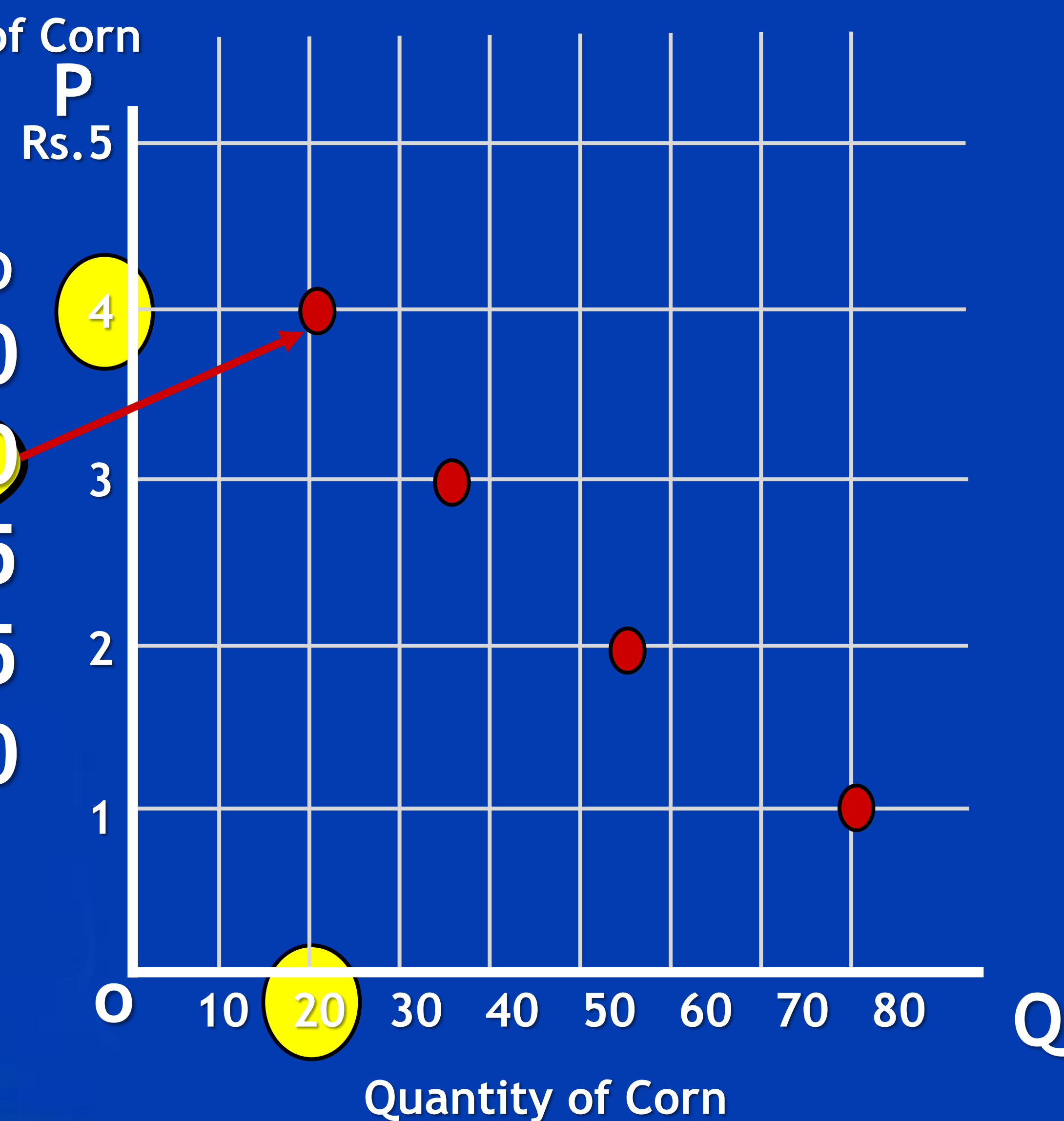
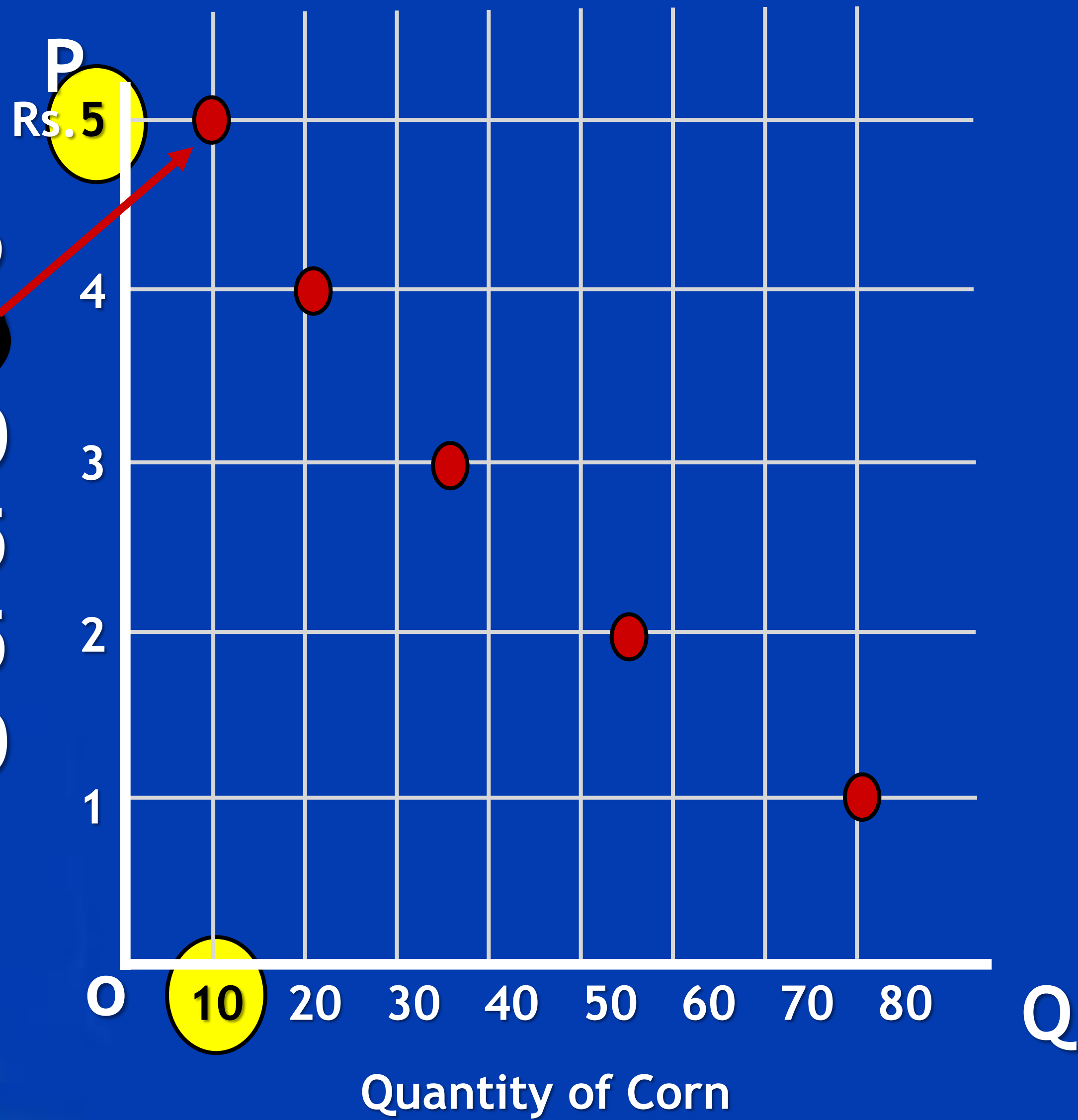


DEMAND CURVE

Price of Corn

CORN

P	Q_D
Rs.5	10
4	20
3	35
2	55
1	80



DEMAND CURVE

Price of Corn

CORN

P	Q_D
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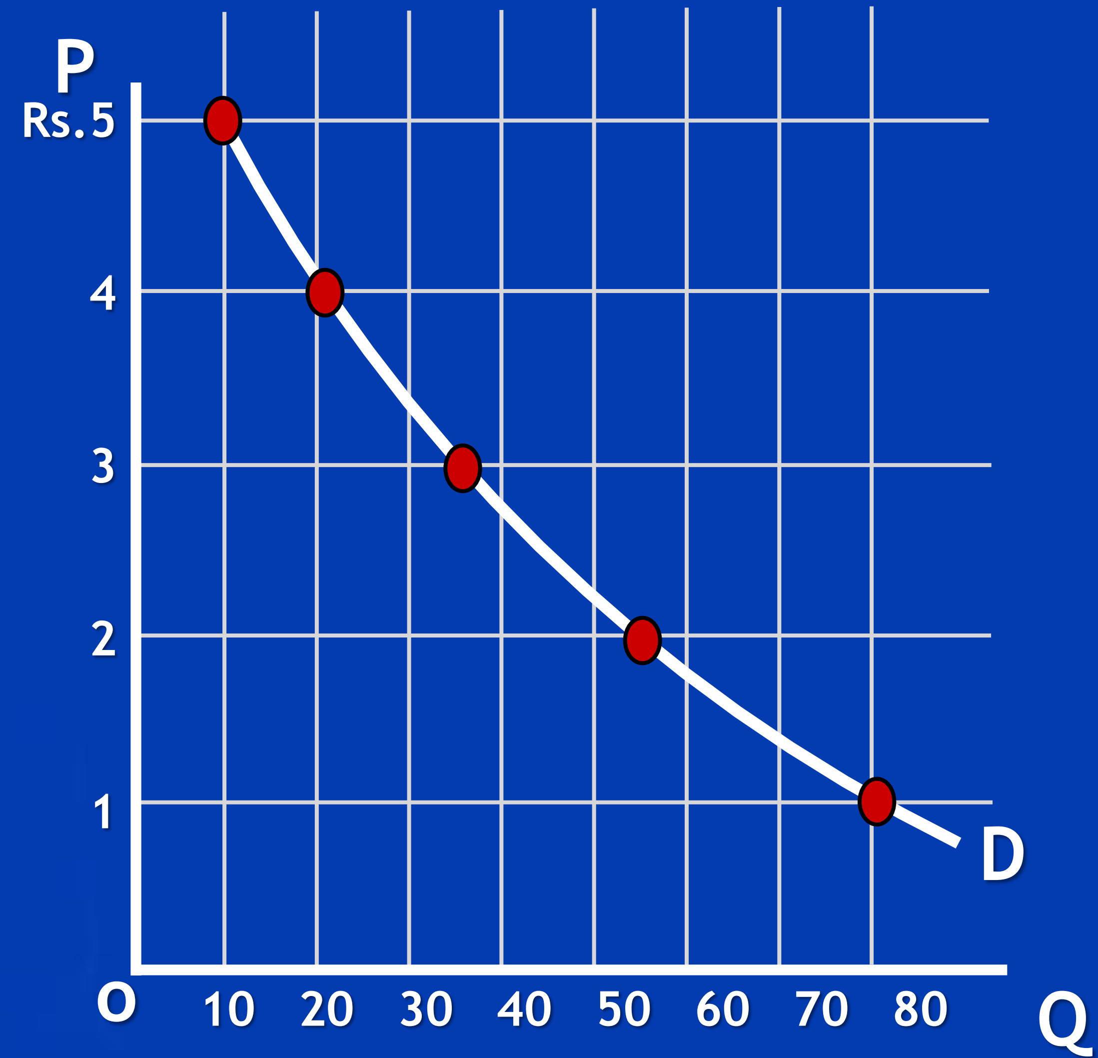
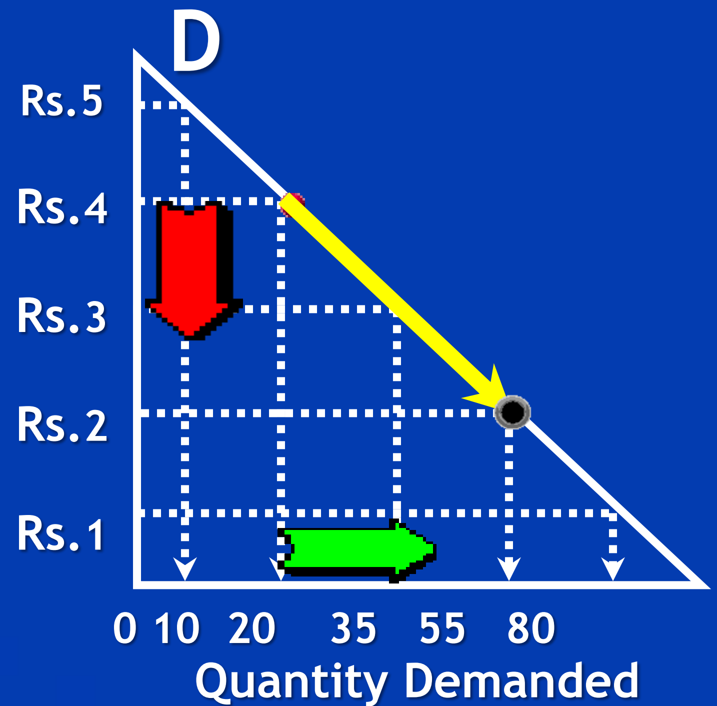


Quantity of Corn

DEMAND CURVE

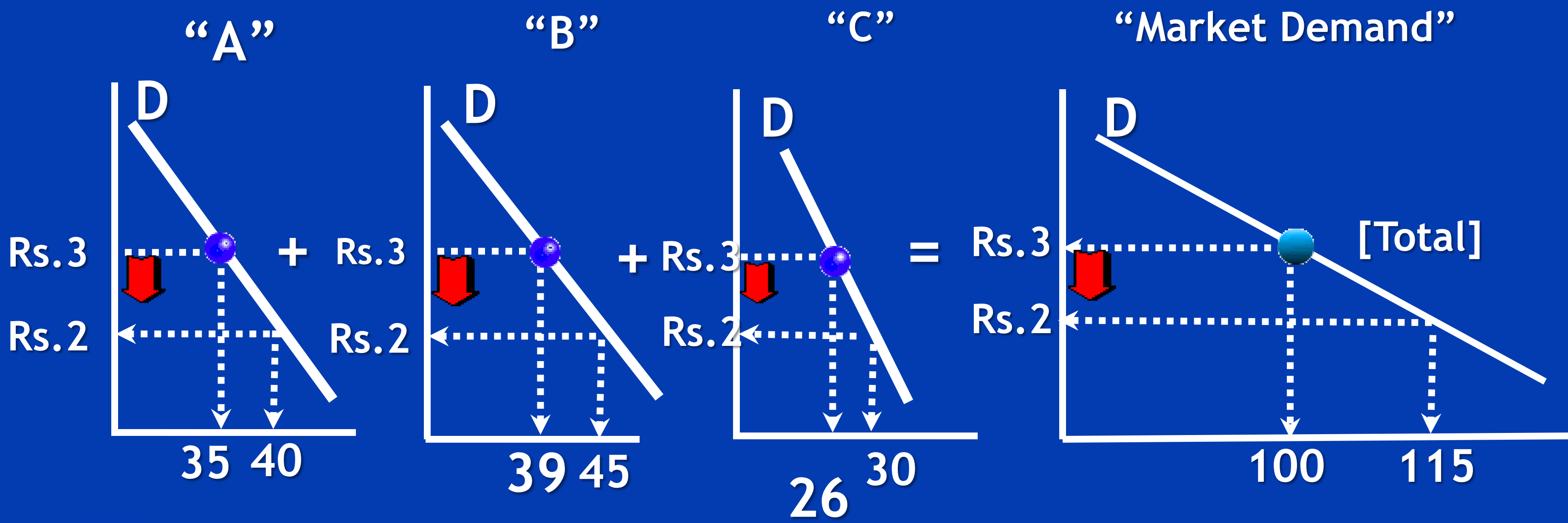
Price decreases; QD increases



...in a given time period

...other things remaining constant

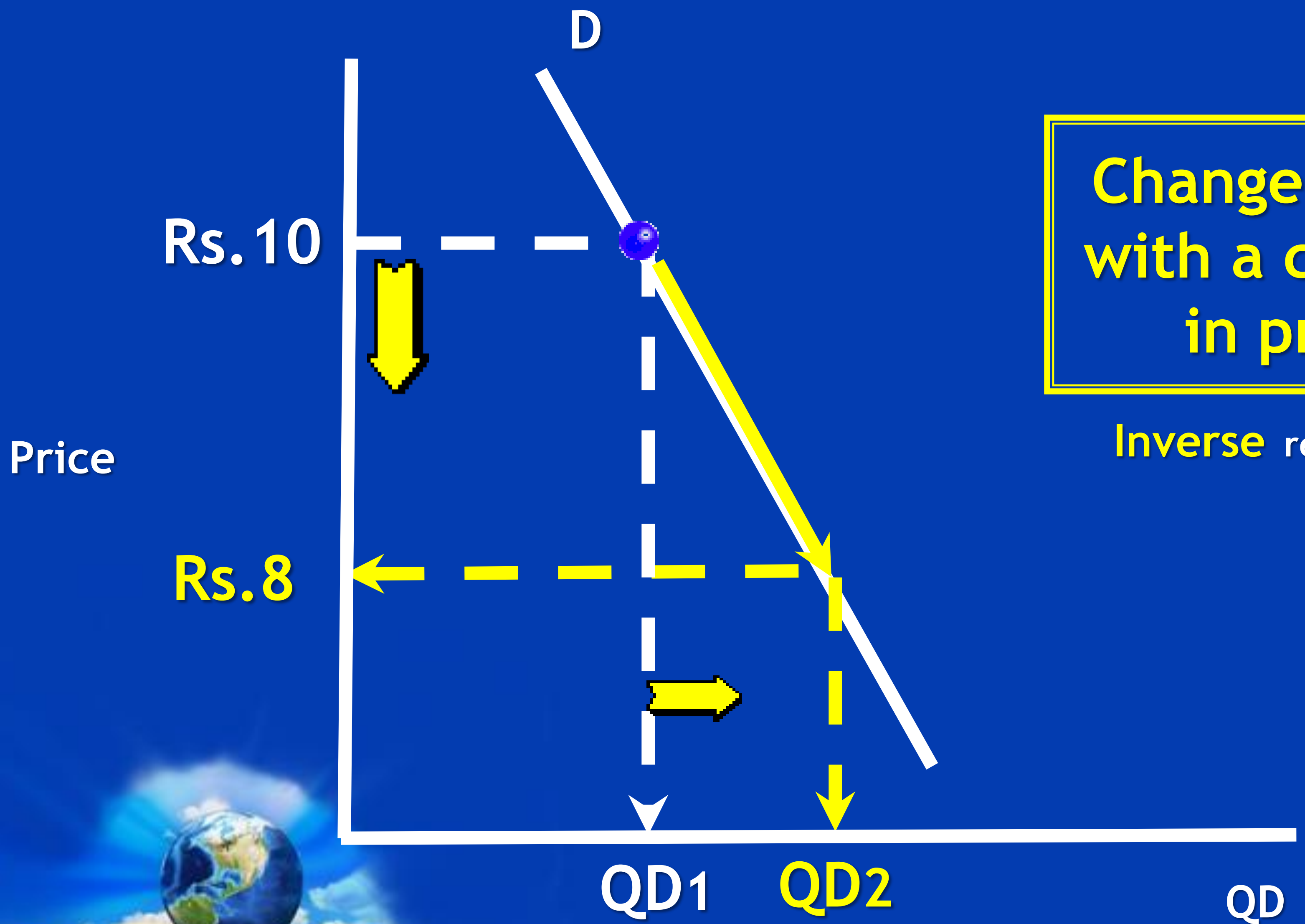
INDIVIDUAL DEMAND AND MARKET DEMAND



From "individual" demand to "market" demand

And, what if the price of this product drops from Rs.3 to Rs.2?

LAW OF DEMAND



Change in QD with a change in price

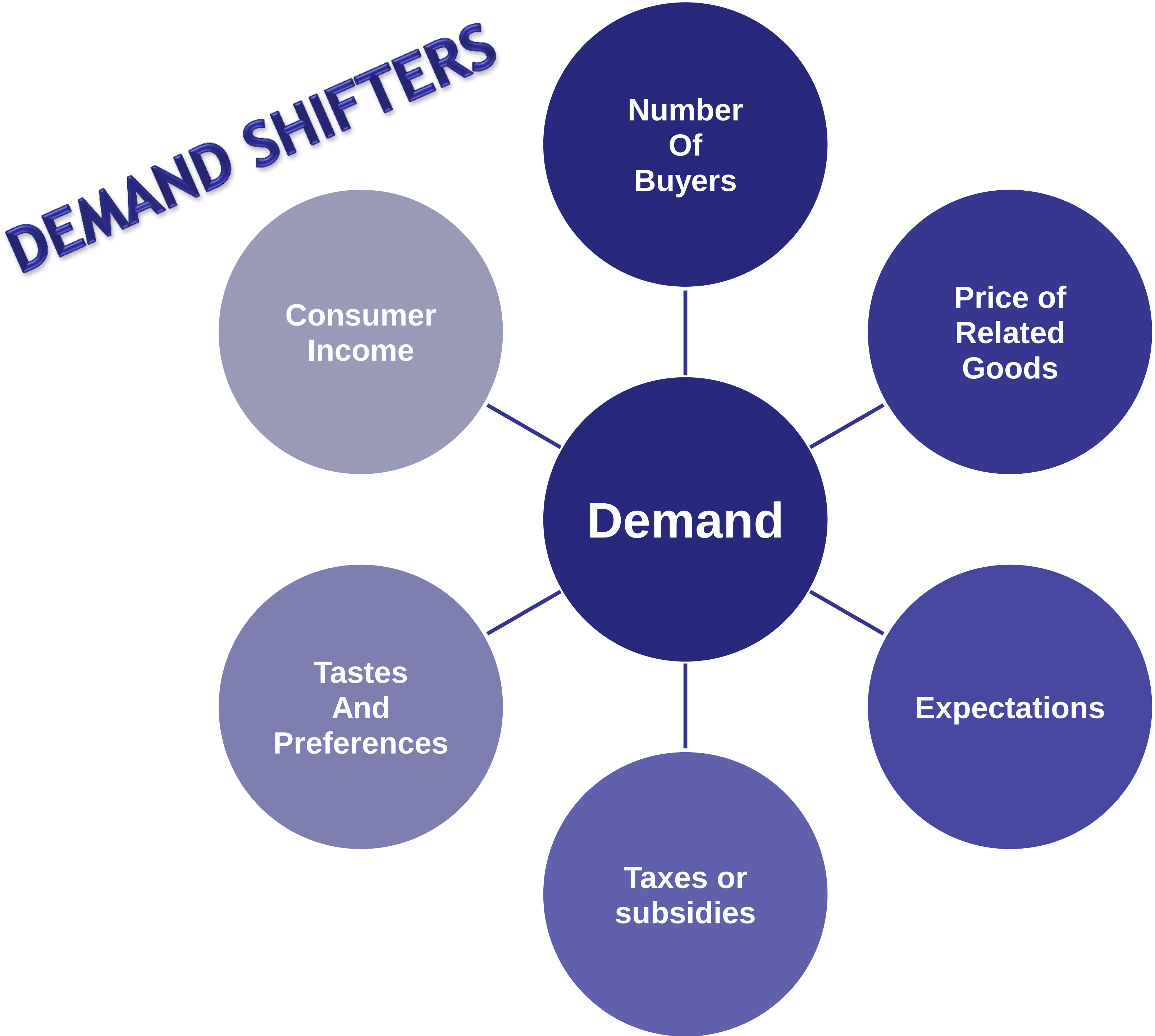
Inverse relationship

Reasons for inverse relation

1. **Income Effect** - current buyers buy more.

2. **Substitution Effect** - new buyers.

3. **Diminishing Marginal Utility** - because buyers of successive units receive less marginal utility, they will buy more only when the price is lowered.


DEMAND SHIFTERS
Number Of Buyers
Consumer Income
Price of Related Goods
Demand
Tastes And Preferences
Expectations
Taxes or subsidies

DEMAND SHIFTERS

- Consumer Income
  - As income increases the demand for a *normal good* will increase
  - As income increases the demand for an *inferior good* will decrease
- Prices of Related Goods
  - When a fall in the price of one good reduces the demand for another good, the two goods are called *substitutes*
  - When a fall in the price of one good increases the demand for another good, the two goods are called *complements*

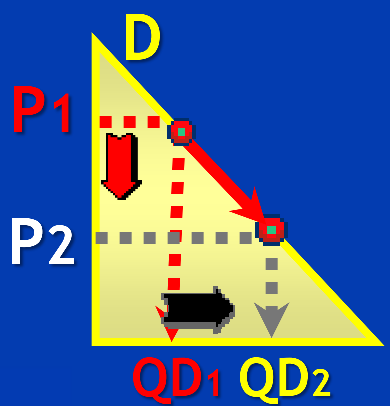
Contd...

DEMAND SHIFTERS

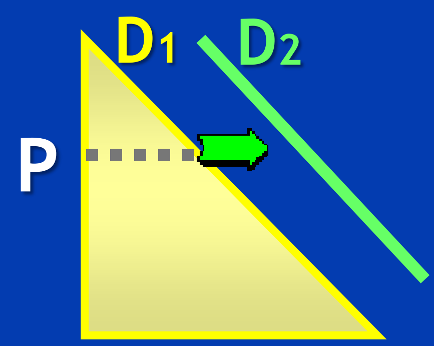
- Tastes
  - A change in taste will change demand with no change in price.
- Expectations
  - If consumers expect a rise in the price, they may consume more now.
  - If consumers expect prices to fall in the future, they may consume less now.
- Taxes and Subsidies
  - Taxes levied on consumers increase the cost of goods to consumers, thereby reducing demand.
  - Subsidies have an opposite effect.

DEMAND SHIFTERS

Substitutes & Complements

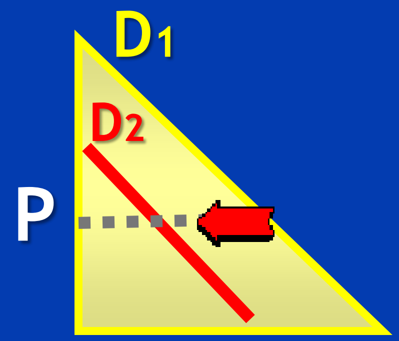


Bread



Complement

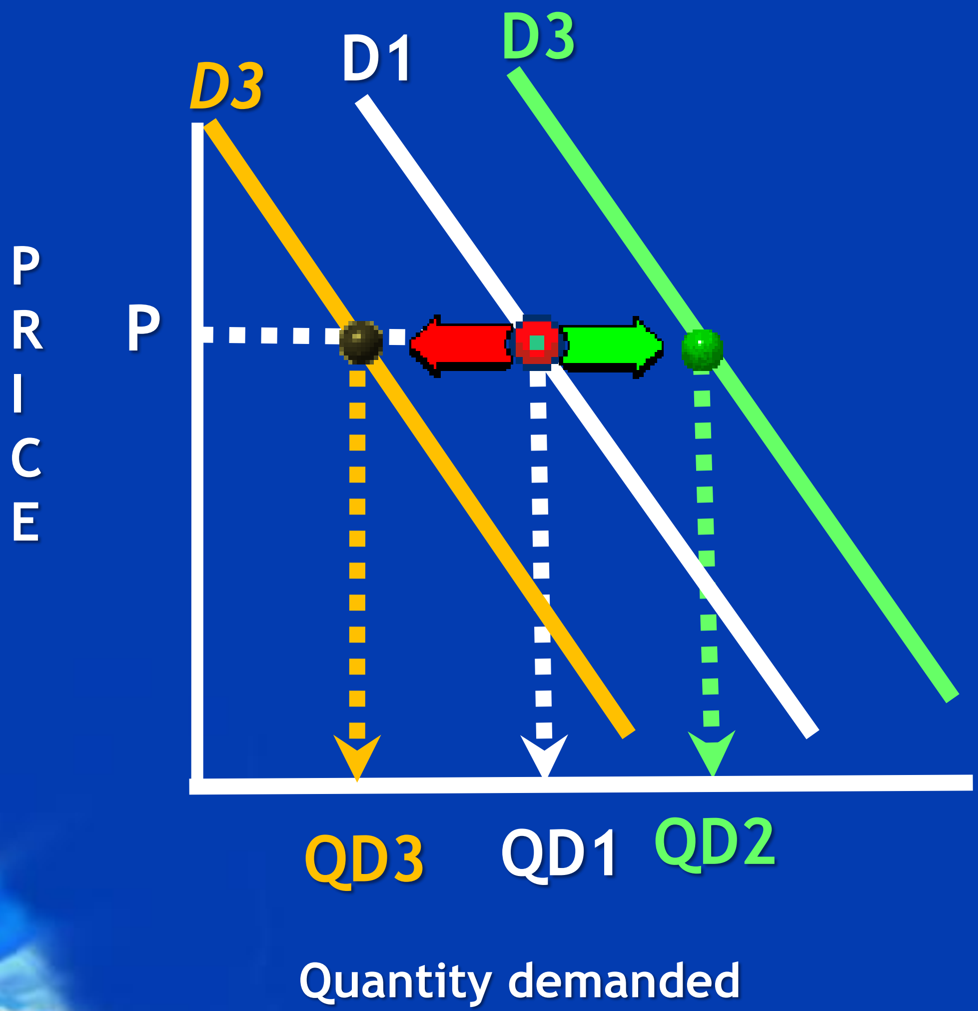
Butter



Substitute

Coffee

CHANGE IN DEMAND



TYPES OF DEMAND

PRICE DEMAND → DEMAND CHANGES WITH THE CHANGE IN PRICES PROVIDED INCOME, TASTES & PREFERENCES AND PRICES OF OTHER GOODS REMAIN CONSTANT

INCOME DEMAND → WHEN THE CONSUMER'S INCOME GOES UP, THE DEMAND FOR SUPERIOR QUALITY GOODS GOES UP. WHEN IT FALLS THE DEMAND FOR INFERIOR GOODS TEND TO RISE

CROSS DEMAND → CHANGE IN THE QUANTITY DEMANDED FOR ONE PRODUCT AS A RESULT OF CHANGE IN THE PRICE OF ANOTHER COMMODITY

ELASTICITY OF DEMAND

ELASTICITY OF DEMAND

"Relationship between proportionate change in price and quantity demanded"

KINDS OF ELASTICITY OF DEMAND

1. **Price Elasticity of Demand:**

   Ratio between the proportionate change in demand to a change in price.

2. **Income elasticity of Demand:**

   Ratio between the proportionate change in demand to a change in income.

3. **Cross Elasticity of Demand:**

   Ratio between the proportionate change in demand for good A to a change in price of good B .

PRICE ELASTICITY OF DEMAND

1. Price Elasticity of Demand:

The degree of responsiveness demand to a change in price.

The Formula:

$$P_{ed} = \frac{\text{\% Change in Quantity Demanded}}{\text{\% Change in Price}}$$

INCOME ELASTICITY OF DEMAND

2. Income Elasticity of Demand:

– The degree of responsiveness of demand to a change in income

The Formula:

$$Y_{ed} = \frac{\%\text{ Change in Quantity Demanded}}{\%\text{ Change in Income}}$$

- **Normal Good –** demand rises as income rises and vice versa
- **Inferior Good –** demand falls as income rises and vice versa

CROSS ELASTICITY OF DEMAND

- **Cross Elasticity:**
  - The degree of responsiveness of demand of X good to a change in the price of Y good (either a substitute or a complement)

The Formula:

$$P_{ed\ xy} = \frac{\%\ \Delta\ \text{Qd of good X}}{\%\ \Delta\ \text{Price of good Y}}$$

- Complements – demand for X good decreases as price of Y good rises and vice versa (Inverse relation)
- Substitutes– demand for X good increases as price of Y good rises and vice versa (Direct relation)

Factors governing the elasticity of demand:

- Number and closeness of substitutes
- Significance of commodity in budgets
- Degree of necessity of goods
- Habits and attitude of consumer
- Uses of the commodity
- Time of demand

Factors influencing demand

- Number of consumers
- Price level
- Availability of substitutes
- Distribution of wealth
- Tastes & Fashions
- Possibility of change in price
- Climate
- Advertisement

Importance

- In Consumption
- To the producers
- In exchange
- In distribution
- Public finance