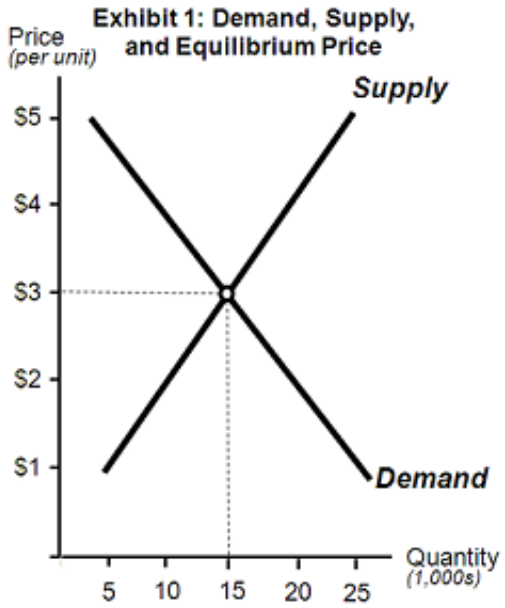
Common Sense Economics Part I. Twelve Key Elements of Economics

Element 6. Prices Bring the Choices of Buyers and Sellers into Balance

Market prices will influence the choices of both buyers and sellers. When a rise in the price of a good makes it more expensive for buyers to purchase it, they will normally choose to buy fewer units. Thus, there is a negative relationship between the price of a good or service and the quantity demanded. This negative relation is known as the "law of demand."

For sellers, the rise in the price of that product brings extra revenue that makes them more willing and able to supply more of it. Thus, there is a positive relationship between the price of a good and the quantity producers will supply. This positive relationship is known as the "law of supply."

Economists often use graphics to illustrate the relationships among price, quantity demanded, and quantity supplied. When doing so, the price of a good is placed on the vertical Y-axis and the quantity per unit time (e. g. week, month, or year) on the X-axis. Using milk as an example, Exhibit 1 illustrates the classic demand and supply graphic. The demand curve indicates the various quantities of milk consumers will purchase at alternative prices. Note how the demand curve slopes downward to the right, indicating that consumers will purchase more milk as its price declines. This is merely a graphic representation of the law of demand.



The supply curve indicates the various quantities milk producers are willing to supply at alternative prices. It slopes upward to the right, indicating that producers will be willing to supply larger quantities at higher prices. The supply curve provides a graphic representation of the law of supply.

Now for a really important point: the price will tend to move toward a level, $3 per gallon in our example, that will bring the quantity demanded into equality with the quantity supplied. At the equilibrium price of $3, consumers will want to purchase 15 thousand gallons of milk per day, the same quantity that

milk producers are willing to supply. Price coordinates the choices of both consumers and producers of milk and brings them into balance.

If the price is higher than $3, for example $4, producers will want to supply more milk per day than consumers will want to purchase. At the $4 price, producers will be unable to sell as many units as they would like. Inventories will rise and this excess supply will lead some producers to cut their price to reduce their excess inventories. The price will tend to decline until the $3 equilibrium price is reached. It is easy to see, then, that if the price is above the equilibrium, market forces will push price down toward equilibrium.

Correspondingly, if the price of milk is less than $3, for example $2, consumers will want to purchase a larger quantity than producers are willing to supply. This generates excess demand and will place upward pressure on price and it will tend to move back toward the equilibrium of $3. The choices of buyers and sellers will be consistent with each other only at the equilibrium price and the market price will gravitate toward this level.

eBay illustrates the operation of demand and supply in a setting that is familiar to many. On eBay, sellers enter their reserve prices—the minimum prices they will accept for goods; buyers enter their maximum bids—the maximum prices they are willing to pay. The auction management system will bid on the buyers behalf in pre-determined monetary increments. Bidding ensues until the trading period expires or a person agrees to pay the stated “Buy-It-Now” price. Exchange occurs only when buyers bid a price greater than the seller’s minimum asking price. But when this happens, an exchange will occur and both the buyer and seller will gain.

Though somewhat less visible than the eBay electronic market, the forces of demand and supply in other markets work similarly. The height of the demand curve indicates the maximum amount the consumer is willing to pay for another unit of the good, while the height of the supply curve shows the minimum price at which producers are willing to supply another unit. As long as the price is between the maximum the consumer is willing to pay and the minimum offer price of a seller, potential gains from trade are present. Moreover, when the equilibrium price is present, all potential gains from exchange will be realized.

Thus, consumers will tend to purchase only units that they value more than actual price. Similarly, producers will supply only units that can be produced at a cost less than that price. When the equilibrium price is present, these conditions imply that units will be produced and purchased as long as the value of the good to consumers exceeds the cost of the resources required for its production. The implication: market prices not only bring the quantity demanded and quantity supplied into balance, but they also direct producers to supply those goods that consumers value more highly than their cost of production. This holds true in any market.

Of course, we live in a dynamic world. Changes in factors like income, the price of substitute goods, and expected future price will alter the demand for goods. Similarly, changes in factors such as technological improvements, resource prices, subsidies and taxes will alter cost and the supply curve.

Lower cost production methods will be discovered and new products introduced. However, if not restricted by price controls or other forms of political intervention, market prices will respond to dynamic changes and provide buyers and sellers with both the information and incentive to bring their choices into harmony. These adjustments will not be instantaneous. It will take time for both consumers and producers to adjust fully to new conditions. Moreover, in a dynamic world, the adjustment process is continuous. As we proceed, we will analyze this process in more detail. [i]

[i] The website, http://CommonSenseEconomics.com, accompanies this book. It provides a supplementary unit on demand and supply, which analyzes the factors that shift the demand and supply curves and provides a more detailed explanation of how market prices adjust to various types of dynamic change. If you would like more depth on this topic, please see this supplementary unit on the CSE website.