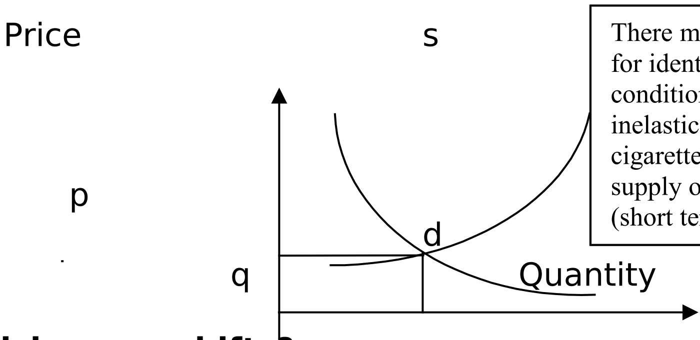
Simpletons’ Guide to Demand and Supply

The usual exam question on this goes something like “Using demand and supply analysis, explain what will happen to the price and quantity if….”. The best answer will go something like this:

1. **Draw the diagram** - at this stage, one demand curve and one supply curve:

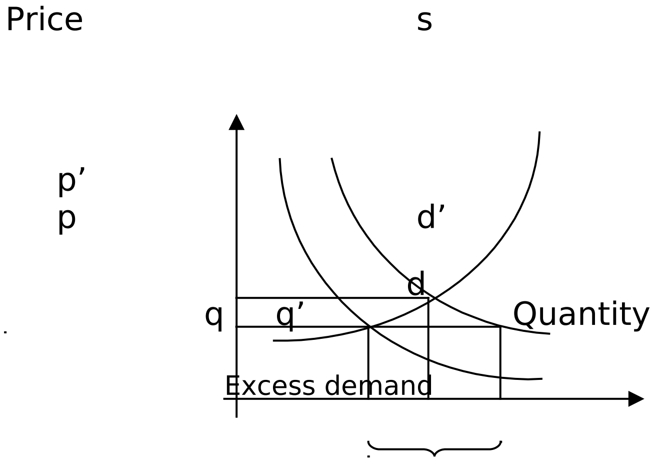


There might be a bonus mark for identifying curious conditions here - e.g., highly inelastic demand for oil, cigarettes, etc., or inelastic supply of houses, coffee beans (short term), etc.

2. **Which curve shifts?**
   Demand curve is shifted by a change in
   - Income
   - Tastes
   - Price of substitutes or complements

   Supply curve (being really a cost curve) is shifted by changes in production conditions - productivity, raw materials, rent….

3. **Which way does it shift?** Demand curves shift left (fall) or right (rise); supply curves shift up (rise in costs, but a FALL in supply) or down (fall in costs but a RISE in supply). The diagram below shows what happens as a result of an increase in income (for a normal good):



4. **Identify the surplus (excess supply) or shortage (excess demand)** at the original price. (In the case above, the rise in demand has caused an excess demand which forces price up from p to p’, at which q’ will now be sold.)

5. What has happened to

- Price?
- Quantity?

6. EXPLAIN all this in your text!

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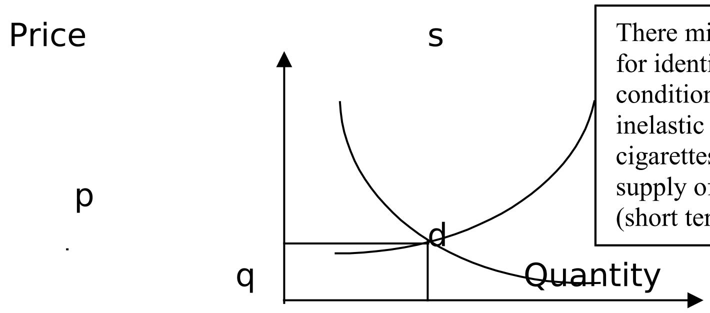

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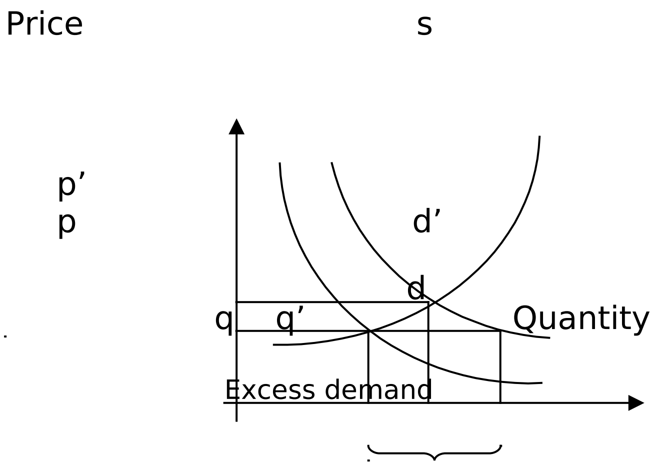

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