Test Yourself: Demand and Supply

If all economists were laid end to end, they would still not reach a conclusion.

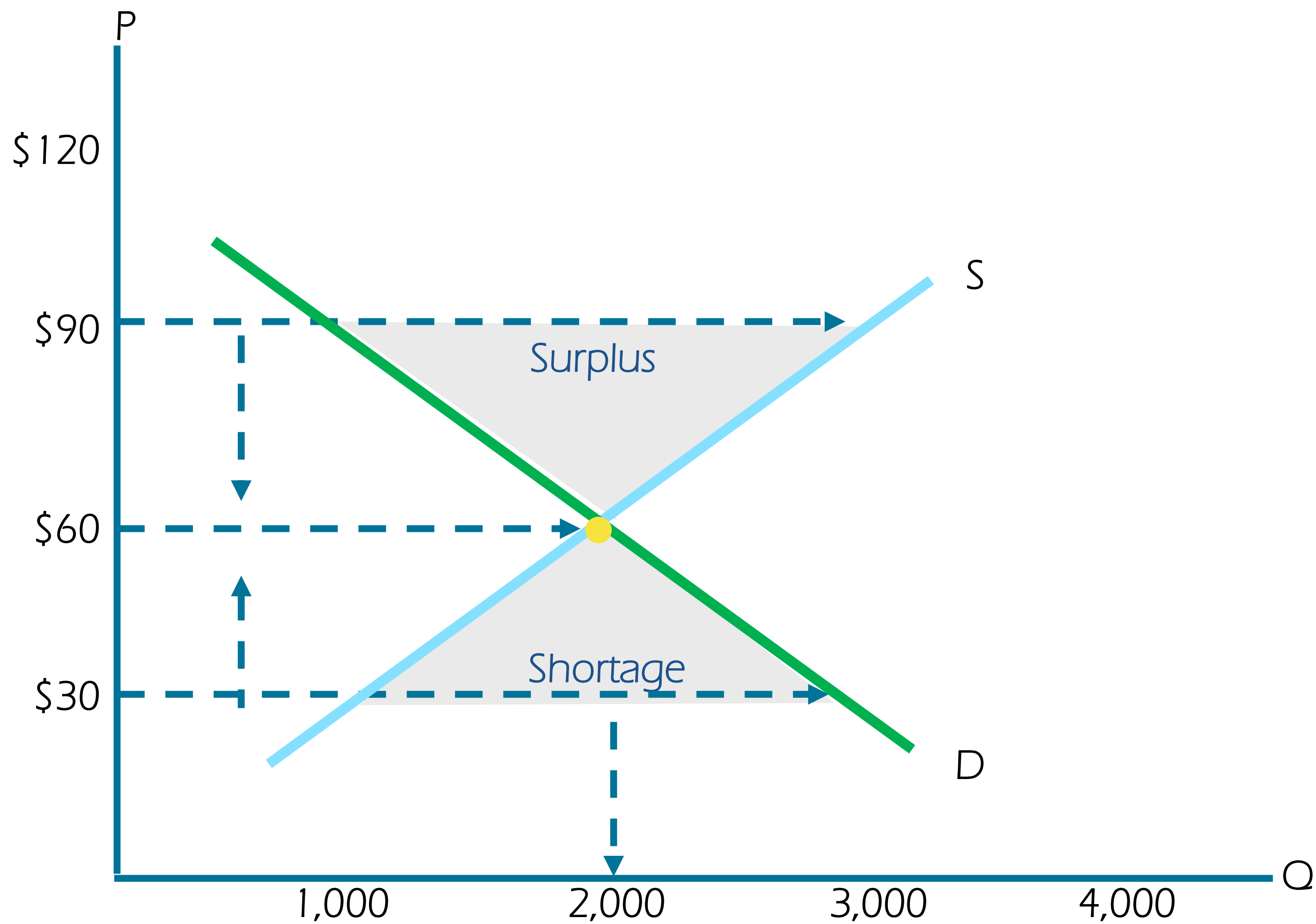
GB Shaw

What is the equilibrium price?

The equilibrium price is the price towards which the economy tends.

It is at the price where the quantity demanded and the quantity supplied are equal.

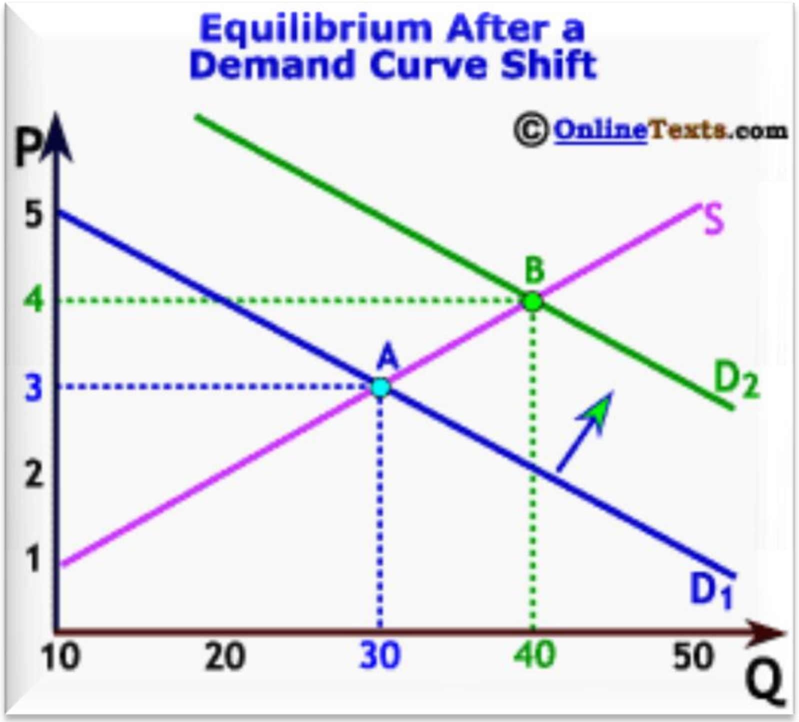
Chart: The Equilibrium Price



What causes a change in market equilibrium?

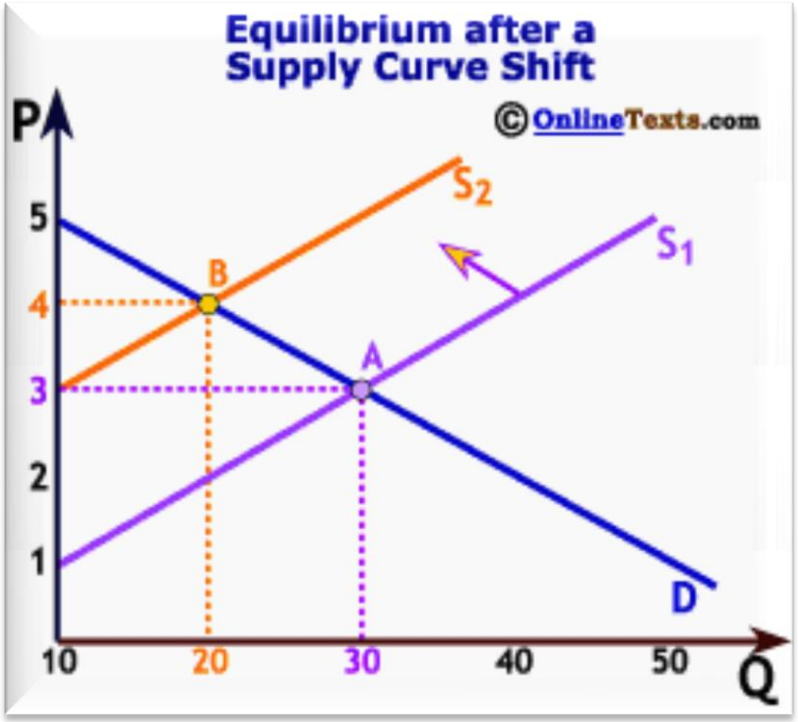
A change in demand or a change in supply will cause a change in market equilibrium.

Chart: Changes in Equilibrium: Demand Shift



The shift in the demand curve moves the market equilibrium from point A to point B, resulting in a higher price (from \$3 to \$4) and a higher quantity (from 30 to 40 units). Note that if the demand curve shifts to the left, both the equilibrium price and the equilibrium quantity will decline.

Chart: Changes in Equilibrium: A Supply Shift



The shift of the supply curve moves the equilibrium from point A to point B, resulting in a higher price (from \$3 to \$4) and lower quantity (from 30 to 20). Conversely, a rightward shift of the supply curve reduces the equilibrium price and increases the equilibrium quantity.

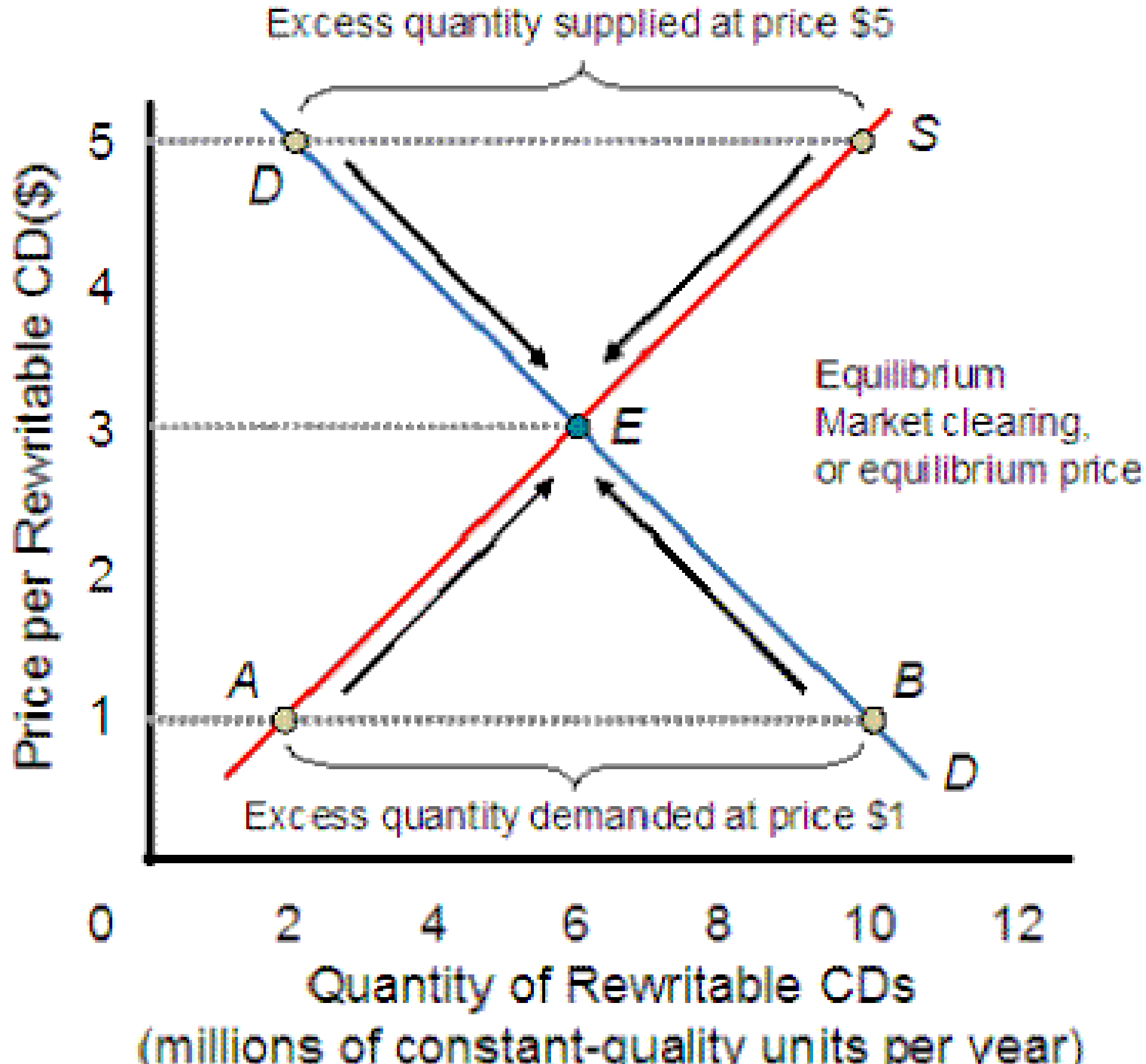
What is a shortage?

A shortage is a situation in which quantity demanded is *greater than* quantity supplied. At a price below the equilibrium price there is a shortage which is corrected when price increases. Quantity demanded will fall and quantity supplied will increase until equilibrium is reached.

What is a surplus?

A surplus is a situation in which quantity demanded is *less than* quantity supplied. At a price above the equilibrium price there is a surplus that is corrected when price decreases. Quantity demanded will rise and quantity supplied will fall until equilibrium is reached.

Chart: Equilibrium, Surplus, Shortage



So … how do we answer the three fundamental economic questions?

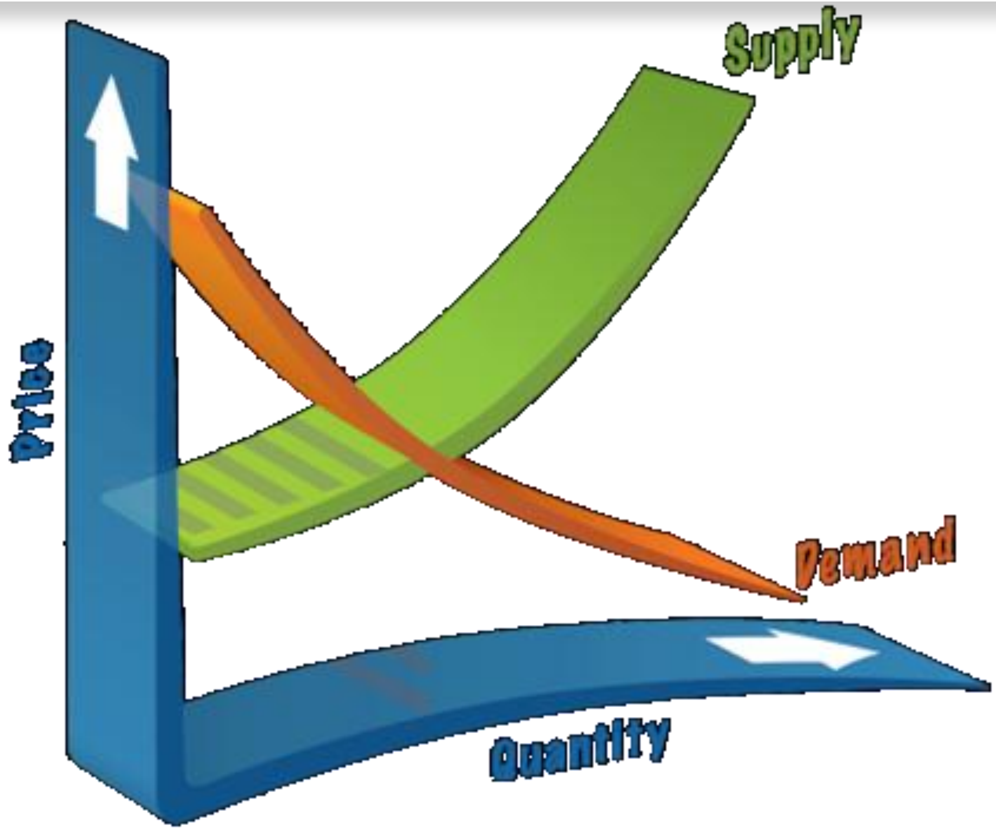
(1) What to produce?
(2) How to produce?
(3) For whom to produce?

WHAT we produce is determined by the equilibrium of the markets.

HOW we produce is determined by profit-seeking behavior and efficient resource usage.

FOR WHOM we produce is determined by those willing and able to pay the equilibrium price.

How did you do?! If you didn't do as well as you'd like, review the margin notes and presentations and test yourself again.



CONTINUED IN TEST YOURSELF: THE PRICE SYSTEM