NAME: ______________________________ DATE: ______________

Understanding the Laws of Supply and Demand

Supply and demand are economic factors that determine price in a market. Supply is the amount of the good or service available. Demand is the rate at which the good or service is consumed. These two factors work together, influencing each other to determine price. In general, when supply is high and demand is low, price is low. And when supply is low and demand is high, price is high.

Let's look closer at this relationship by exploring what economists call the four basic laws of supply and demand in the marketplace. Keep in mind that the examples provided aren't necessarily real-life examples, since each takes a natural variable and makes it constant. Nevertheless, these examples will help you understand the meaning of the law.

I. If demand increases and supply remains constant, a shortage occurs leading to a higher equilibrium price.

   Example: Assume a software company launches a new video game. But the company only has enough factory production capacity to produce a set number of video games, no more. After a huge ad campaign begins for their new video game, sales increase and soon stores have sold most of the games in stock. The stores raise the price of the remaining games until the company produces more games.

II. If demand decreases and supply remains constant, a surplus occurs leading to a lower equilibrium price.

   Example: Assume a musical group releases a new album. After the release, however, sales of their previous album slows as people purchase the new album. Soon stores have a surplus of the older CD and reduce the price to encourage sales.

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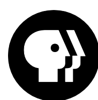

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III. If demand remains constant and supply decreases, a shortage occurs leading to a higher equilibrium price.

Example: Assume the supply of Grade A eggs is plentiful and stores charge about $1.59 for one dozen. But then in the late spring a virus emerges in the farms and causes large numbers of chickens to die. As a result, the supply decreases significantly and there is a shortage. Stores respond by raising the price of one dozen eggs to $1.89.

IV. If demand remains constant and supply increases, a surplus occurs leading to a lower equilibrium price.

Example: Assume rainfall is plentiful in the spring and summer, so farmers produce a record corn crop. In order to sell the increased supply, producers reduce the price of corn.

*Examples do not include government price supports and other "artificial" factors.

Now read the scenarios from early American history on the following page and write a brief paragraph answering the questions.

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Scenarios

1. The European colonies in North American served the important economic purpose of providing raw materials for European businesses. In a system called mercantilism, timber, indigo, and many other raw materials were shipped to Europe. In return, European merchants sent finished products—glass, textiles, and similar goods—to the colonies. One of the first important products to enter the mercantile system was animal furs. Fur became such a valuable fashion accessory that groups of French, Dutch, English, and Russian traders collected furs from Native American hunters for shipment to Europe. By the end of the 18th century, furriers found it difficult to acquire enough pelts and hunters and traders were having to expand their territories to provide enough furs. Which principle of supply and demand is described in the scenario? Explain your answer.

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2. By the mid-1800 furs had gone out of fashion in Europe. What most likely happened to the prices paid for furs? Which law of supply and demand is illustrated by this historical fact? Explain your answer.

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