Principle of Economics

Market & Competition

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In chapter 4, we will start studying maybe, the most famous economic model of markets, which is the supply and demand diagram.

Supply and demand is the phrase that economists like to use the most, and that even non-economists like to quote, often times.

And in this chapter, we will see needness of the idea of interaction between consumers and producers in economy markets.

We will study competitive markets for the next few weeks, and later in the semester, we will turn to less competitive forms of market, monopoly, oligopoly and monopolistic competition.

In the next, perhaps 10 chapters, you should keep and back of your head, we are assuming competitive markets by that we mean, there are, there is sufficient number of consumers, sufficient number of producers, both producers compete among each other to sell their product, consumers compete among themselves to buy products at the lowest possible prices.

Both consumers and producers act as price takers.

Because individual consumers and producers are small relative to the overall size of the market, they take market price as given and based on this market price, they choose how much to produce and how much to consume.

Later we will say that, that’s a very different from monopolistic markets, where one side of the market such as the producer, can choose both the price and quantity offered, and the other side of the market, consumers, have to accept that price and cannot negotiate that price.

As a side note on monopoly, we will also look at the case of monopsony, which is the case when consumers, when there is a single consumer who has a market power and is facing a large number of producers.

And because the consumer has market power, he can choose perhaps the price which is lower than competitive price, and can force the producers to accept that price.

The example of this kind of market would be labor market in a small town where there is a single employer, and remember that employer is a consumer of a labor of an individual worker.

And so if the company is facing large number of workers, but all the workers want to get a job at this particular company, this company would have a market power, who would say monopsony power.

So monopoly is the extreme form of the market where there is no competition on the supply side or on the demand side.

Then between competitive markets and monopolistic markets, there are intermediate cases, which we will study in chapters 16 and 17 called oligopoly and monopolistic competition.

Let’s start with the monopolistic competition.

In that kind of industry, we still assume that there are many producers and many consumers, but each producer sells slightly differentiated products.

And because there are differences between products of different companies, each company still has little bit of market power and can choose price which is a little bit different from a competitive price.

So because products differentiated consumers are not in different between individual products, and each producer has a little bit of market power.

In oligopolistic markets, we will say that there are few sellers; it can be 2 sellers, 4 sellers, 10 sellers, relatively small number of sellers.

And there is competition between these producers, but the competition is not too aggressive.

Companies recognize that there are few competitors and they don’t have an urge to undercut each other’s prices as much as in a perfectly competitive market.

So in any market, regardless of the amount of competition, there is, we have a supply side and a demand side.

In this chapter, we will introduce what we mean by demand in the market, what we mean by supply and how these two sides of the markets interact each other.

We will represent the amount of demand by consumers by demand curve and the demand curve will show us the quantities that consumers want to buy at a particular price.

We will say that demand curve shows us the willingness and ability of consumers to pay prices for certain quantities of goods.

And this demand curve will usually be a downwards sloping line.

Intuitively, we should think that the relationship between quantity demand and prices should be negative, the lower the price of the good, the greater the incentives of the consumers to buy that product.

And we will say that the law of demand gives us this relationship between prices and quantities demanded.

Let me give you a simple illustration of a demand curve.

Generally economists draw the relationship between prices and quantities on this kind of graph.

We put price on the vertical axis, quantity on the horizontal axis.

And we could draw a demand curve as a downwards sloping line on this graph.

And you should think that each point on the graph shows us the willingness and ability of consumers to pay for particular quantity of the product.

And, if we, so we could discuss the change in quantity demanded between two points on the demand curve.

We would say that the quantity demand will increase if the price of the commodity decreases.

When we discuss demand, we could also talk about changes in demand.

When we talk about changes in demand, we are actually talking about shifts in the entire demand curve either to the right or to the left, or up or down.

So here, you should be very careful distinguishing changes in quantity demanded which implies a single demand curve along which we are moving and the changing demand which implies a shift in the entire demand curve in some direction.

We will say that there is a number of factors that could shift the entire demand curve.

Let's look at an example.

'Consumer incomes'.

If consumer incomes increase, we would say if the commodity is a normal good, we will define normal goods as commodities for which when income increases, quantity demand will increase for any price, in that case we would say that the demand curve will shift to the right because for whatever price is in the market place with the higher incomes, the consumer demand more of the commodity.

Another side note I want to make is about taxes and subsidies.

This one factor is not mentioned in the textbook.

All of the discussion about taxes and subsidies is on the supply side of the market.

But we should think that if the government introduces taxes on buyers that could influence how much consumers are willing to pay for each unit consumed.

Let me actually, Let me illustrate it.

Suppose we start with a demand curve for a product, and suppose the government introduces a tax on buyers.

The question is what would happen to the consumers' willingness to pay.

So suppose that in the beginning, we are at a point like this, we..

the consumer choose to buy the consumer want to pay this amount for this quantity of the product.

But now, that the consumer also has to pay a tax to the government, he would be willing to pay less to the company than originally.

Now that the consumer has to pay taxes, he would be, he has to pay both a price to producer and also a tax to the government, and he would be willing to pay less in the price to the company.

We would say that the demand curve shifts downwards by the amount of the tax.

The consumer would be willing to pay exactly this much less for this commodity because of the new tax.

Let's discuss the supply side of the market a little bit.

By the law of supply, we would say that supply curve in the market should be upward sloping and again, this law is quite intuitive, we would expect that if prices in the market increases, the consumer, the producer has more incentive to sell products, and he would be willing to sell more units of the good.

So the relationship between prices and quantity supply is positive.

Just like for the consumer, we have a list of, we could discuss changes in the quantity supplied, which are the movements along existing supply curve.

And we could discuss changes in the overall supply, which means that for whatever the price is in the market, the producer would be willing to produce more or less than before, if some of these factors change.

So now we have, look, a little bit at the demand side of the market and the supply side of the market.

And we can introduce a lot of supply and demand, which tells us that in the solution to the market, the market price adjust so that quantity demanded is exactly equal to quantity supplied.

If the market price is above this level, we may think that quantity supplied would be greater than quantity demanded at that price.

And you may think that we would have an excess supply of products.

There will be too many products in the market that consumers don’t want to buy.

This will create pressures on producers to lower their price.

Producers will be willing to cut their price a little bit to sell these unsold units.

And eventually prices will fall all the way to the equilibrium level.

Similarly, if we started at a lower price than the equilibrium, then consumers would exert pressure on the market, they will be willing to offer producers a little bit higher price for the right to purchase the commodity.

And eventually the market price would adjust at the equilibrium level.

Finally, now we’ve discussed changes in quantity demanded, changes in quantity supplied and then we discussed changes in the entire demand and supply schedules.

We can discuss what would happen to the market solution.

If we have a particular change on the demand side and a particular change on the supply side, we can make a simple prediction of, on what would happen to the equilibrium price and quantity in that market.

So, to sum up, this was a very simple model of economic markets.

This model can be used regardless of the amount of competition among producers and among consumers.

We will end up using this model in the majority of chapters in the book.

So, it is important to understand this basic form of the model.