Quadrant II – Notes

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Market supply:

Market supply is the total amount of an item producers are willing and able to sell at different prices, over a given period of time e.g. one month. Industry, a market supply curve is the horizontal summation of all each individual firm's supply curves. The entry of new firms into an industry will cause an outward shift of market supply; so too would an industry-wide improvement in the technology available to producers.

The market supply curve is derived by summing the quantity suppliers are willing to produce when the product can be sold for a given price. As a result, it depicts the price to quantity combinations available to consumers of the good or service. In combination with market demand, the market supply curve is requisite for determining the market equilibrium price and quantity.

By its very nature, conceptualizing a supply curve requires the firm to be a perfect competitor, namely requires the firm to have no influence over the market price. This is true because each point on the supply curve is the answer to the question "If this firm is faced with this potential price, how much output will it be able to and willing to sell? " If a firm has market power, its decision of how much output to provide to the market influences the market price, then the firm is not "faced with" any price, and the question is meaningless.

The attributes of a competitive market signal that the price is set external to any firm. Therefore, production in the market is a sliding scale dependent on price. As price increases, quantity increases due to low barriers to entry, and as the price falls, quantity decreases as some firms may even opt out of the market.

The supply curve can be derived by compiling the price-to-quantity relationship of a seller. A seller could set the price of a good or service equal to zero and then incrementally increase the price; at each price he could calculate the hypothetical quantity he would be willing to supply. Following this process the seller would be able to trace out its complete individual supply function. The market supply curve is simply the sum of every seller's individual supply curve.

Market Equilibrium:

Consumers and producers react differently to price changes. Higher prices tend to reduce demand while encouraging supply, and lower prices increase demand while discouraging supply.

Economic theory suggests that, in a free market there will be a single price which brings demand and supply into balance, called equilibrium price. Both parties require the scarce resource that the other has and hence there is a considerable incentive to engage in an exchange.

Surplus and shortage:

If the market price is above the equilibrium price, quantity supplied is greater than quantity demanded, creating a surplus. Market price will fall.

Example: if you are the producer, you have a lot of excess inventory that cannot sell. Will you put them on sale? It is most likely yes. Once you lower the price of your product, your product's quantity demanded will rise until equilibrium is reached. Therefore, surplus drives price down.

If the market price is below the equilibrium price, quantity supplied is less than quantity demanded, creating a shortage. The market is not clear. It is in shortage. Market price will rise because of this shortage.

Example: if you are the producer, your product is always out of stock. Will you raise the price to make more profit? Most for-profit firms will say yes. Once you raise the price of your product, your product's quantity demanded will drop until equilibrium is reached. Therefore, shortage drives price up.

If a surplus exist, price must fall in order to entice additional quantity demanded and reduce quantity supplied until the surplus is eliminated. If a shortage exists, price must rise in order to entice additional supply and reduce quantity demanded until the shortage is eliminated.

Changes in equilibrium price and quantity:

Equilibrium price and quantity are determined by the intersection of supply and demand. A change in supply, or demand, or both, will necessarily change the equilibrium price, quantity or both. It is highly unlikely that the change in supply and demand perfectly offset one another so that equilibrium remains the same.

Example: This example is based on the assumption of Ceteris Paribus.

1) If there is an exporter who is willing to export oranges from Florida to Asia, he will increase the demand for Florida's oranges. An increase in demand will create a shortage, which increases the equilibrium price and equilibrium quantity.

2) If there is an importer who is willing to import oranges from Mexico to Florida, he will increase the supply for Florida's oranges. An increase in supply will create a surplus, which lowers the equilibrium price and increase the equilibrium quantity.

3) What will happen if the exporter and importer enter the Florida's orange market at the same time? From the above analysis, we can tell that equilibrium quantity will be higher. But the import and exporter's impact on price is opposite. Therefore, the change in equilibrium price cannot be determined unless more details are provided. Detail information should include the exact quantity the exporter and importer is engaged in. By comparing the quantity between importer and exporter, we can determine who has more impact on the market.