

Equilibrium

- In a free market, the forces of supply and demand interact to determine equilibrium quantity and equilibrium price.

Equilibrium

- *Equilibrium price* – the price toward which the invisible hand drives the market.
- *Equilibrium quantity* – the amount bought and sold at the equilibrium price.

What Equilibrium Isn't

- Equilibrium isn't a state of the world, it is a characteristic of a model.
- Equilibrium isn't inherently good or bad, it is simply a state in which dynamic pressures offset each other.

What Equilibrium Isn't

- When the market is not in equilibrium, you get either excess supply or excess demand, and a tendency for price to change.

Excess Supply

- *Excess supply* – a surplus, the quantity supplied is greater than quantity demanded
- Prices tend to fall.

Excess Demand

- *Excess demand* – a shortage, the quantity demanded is greater than quantity supplied
- Prices tend to rise.

Price Adjusts

- The greater the difference between quantity supplied and quantity demanded, the more pressure there is for prices to rise or fall.

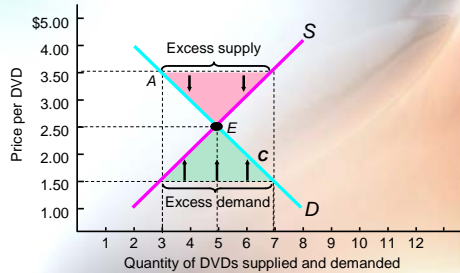
Price Adjusts

- When quantity demanded equals quantity supplied, prices have no tendency to change.

The Graphical Interaction of Supply and Demand

Price (per DVD)	Quantity Supplied	Quantity Demanded	Surplus (+) Shortage (-)
\$3.50	7	3	+4
\$2.50	5	5	0
\$1.50	3	7	-4

The Graphical Interaction of Supply and Demand



The Graphical Interaction of Supply and Demand

- When price is \$3.50 each, quantity supplied equals 7 and quantity demanded equals 3.
- The excess supply of 4 pushes price down.

The Graphical Interaction of Supply and Demand

- When price is \$1.50 each, quantity supplied equals 3 and quantity demanded equals 7.
- The excess demand of 4 pushes price up.

The Graphical Interaction of Supply and Demand

- When price is \$2.50 each, quantity supplied equals 5 and quantity demanded equals 5.
- There is no excess supply or excess demand, so price will not rise or fall.

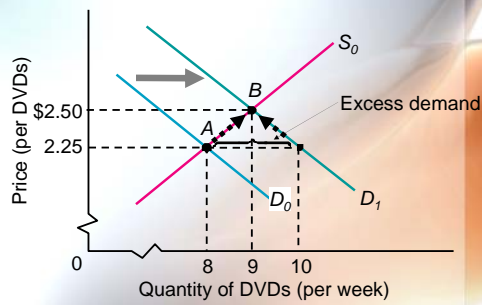
Shifts in Supply and Demand

- Shifts in either supply or demand change equilibrium price and quantity.

Increase in Demand

- An increase in demand creates excess demand at the original equilibrium price.
- The excess demand pushes price upward until a new higher price and quantity are reached.

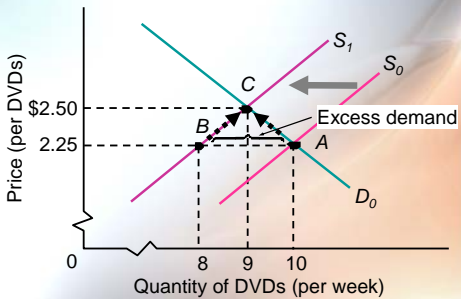
Increase in Demand



Decrease in Supply

- A decrease in supply creates excess demand at the original equilibrium price.
- The excess demand pushes price upward until a new higher price and lower quantity are reached.

Decrease in Supply



The Limitations Of Supply And Demand Analysis

- Sometimes supply and demand are interconnected.
- Other things don't remain constant.

The Limitations Of Supply And Demand Analysis

- All actions have a multitude of ripple and possible feedback effects.
- The ripple effect is smaller when the goods are a small percentage of the entire economy.

The Limitations Of Supply And Demand Analysis

- The other-things-constant assumption is likely not to hold when the goods represent a large percentage of the entire economy.

The Fallacy of Composition

- The *fallacy of composition* is the false assumption that what is true for a part will also be true for the whole.

The Fallacy of Composition

- The fallacy of composition is of central relevance to macroeconomics.

– In macroeconomics, the other-things-constant assumption, central to microeconomic supply/demand analysis, cannot hold.
