

Supply and Demand

Introduction

Supply and demand is the greatest achievement of early economics for a number of reasons, but especially for one. The supply and demand equilibrium shows that agents looking out for their own best interests will reach a reasonable allocation of resources without the intervention of a king, parliament, dictator, or central party. The importance of this result thus reaches deeply into the political organization of society as well as its economic institutions.

The Model

The supply equation is

$$P = 6 + 0.6 P[-1] + 0.8 Q_s - 1 \text{ Weather}$$

The lagged price term has no effect in the static analysis. In the dynamic analysis, the lag in the response of supply does have a noticeable effect.

The demand equation is

$$Q = 5 - 0.5 P + 1 \text{ Income}$$

After you take the “Quick Tour” of the EconModel presentation, go to “Static Model.”

Exercises

1. Draw the supply curve.
2. Draw the demand curve.
3. What are the equilibrium price and quantity?
4. What happens to the equilibrium price and quantity when the weather improves?
5. What happens to the equilibrium price and quantity when income increases?
6. From the “Dynamic Model” section, graph the response over time to changes in income.