

Illustration 2.1

Effects of Changes in Determinants of Demand on Price and Sales

Much of the discussion of demand in this chapter concerns the effects of changes in the determinants of demand, or demand-shifting variables, on demand functions, and the consequent effects of these shifts on prices and sales. Some actual examples of these effects, all of which were reported in *The Wall Street Journal*, should illustrate and reinforce this theoretical analysis. These examples illustrate the consequences of changes in income for normal goods, changes in the price of a related good (both substitutes and complements), changes in taste, and changes in price expectations. The examples also provide some insight into how managers can adjust to such changes in a way that benefits the firm.

Changes in Income

Ross Perot warned that free trade with Mexico would create a “giant sucking sound” as jobs moved from the United States to Mexico. Perot’s prediction about job loss to Mexico proved to be incorrect, but in 1996 the *WSJ* reported that Perot may still be hearing a “giant sucking sound” but it may be the sound of goods, not jobs, being sucked from the United States into Mexico. Mexico, along with the rest of the so-called emerging markets worldwide, is booming. Rapidly increasing real income in Latin America is creating a boom in the demand for normal goods produced in the United States.

Managers of U.S. corporations selling normal goods (e.g., earthmovers, cellular phones, soft drinks, and cognac) are taking advantage of increased demand by foreign consumers. The *WSJ* quoted Joseph Quinlan, senior international economist at Dean Witter Reynolds, who observed that there is “a greater urgency in corporate America to sell more cigarettes and soft drinks to the emerging markets.” For many firms, rising per capita incomes in foreign nations offer an opportunity to add a profitable new source of demand to keep sales rising.

Changes in Price of Related Goods

In June 1996, auto industry analyst Thomas M. Galvin, with Deutsche Morgan Grenfell/C. J. Lawrence in New York, downgraded his “buy” recommendation for auto stocks on the basis of what he and many other analysts believed to be the most reliable “warning signal” for predicting when the new-car market is likely to “go south.” What cooled Galvin’s interest in stocks of auto manufacturers was the downward spiral of retail prices for used cars. As we showed in this chapter, a decrease in the price of a substitute good, all other things constant, causes a decrease in the demand for a good. The *WSJ* reported that expiring leases in 1996 returned 4.6 million two- and three-year-old vehicles to dealerships as used vehicles—up from 3.9 million in 1995. The increase in the supply of used cars caused used-car prices to fall sharply in 1996. Facing lower prices for used cars, “the consumer starts to think more seriously about buying a used car in the future

than a new car.” Many consumers did buy used cars instead of new cars, and the demand for new cars decreased in 1996.

When two goods are complements, an increase in the price of one causes a decrease in demand for the other good. In spring 1996, rising gasoline prices proved to be a mixed blessing for the many retail gasoline stations that are now also convenience stores. The *WSJ* reported that nearly 70 percent of the profit of gasoline station–convenience store combinations is generated by merchandise sales inside the stores. While rising gasoline prices may increase revenue from the gas pump, fewer gasoline buyers go into the stores for the convenience items, which carry relatively high profit margins.

Changes in Taste

As we stressed, consumer taste is an important determinant of demand. In 1996, the *WSJ* reported that, in a throwback to the 1950s, shiny chrome and aluminum products were fashionable again. Chrome blenders, toasters, and mixers became top-10 sellers at Williams-Sonoma in San Francisco. Demand for similar items with a white finish practically vanished.

Changes in Price Expectations

One would expect that expectations about the future price of a good would have an insignificant effect on the price of some goods, such as bread, movies, pizza, and other goods that are not durable or expensive. Price expectations would have a stronger effect on the demand for more durable, higher-priced goods, such as automobiles, jewelry, and major appliances. In a 1992 article about the bankruptcy of a huge Canadian real estate company, the *WSJ* stated, “More than any other business, real estate is dependent upon people’s expectations about the future. When those expectations are hopeful, . . . the value of real estate soars. When those expectations turn gloomy, . . . real estate values crash.”

Later in the article, the *WSJ* asked, “But where do these expectations come from? There is a tendency to dismiss them as irrational, mere ‘animal spirits.’” The answer, “Most of the time, though, expectations come from the market’s sifting of the best judgments of tens of thousands of highly intelligent people. And the best judgments are drab and dismal compared to those of the middle 1980s.” These illustrations should give you some idea of the way that changes in the determinants of demand actually shift the demand for goods and services and how such shifts affect the price and sales of the products. They should also give an insight into how managers can forecast and react to such changes in a manner that furthers the goals of the organization.

Sources: Bernard Wysocki, Jr., “Imports Are Surging in Developing Nations,” *The Wall Street Journal*, July 8, 1996; Oscar Suris, “Used-Car Prices Cool, Chilling Detroit: Drop since Spring Is Bad Omen for New-Vehicle Sales,” *The Wall Street Journal*, Oct. 1, 1996; Business Bulletin: “Convenience Stores That Sell Gas Find Higher Prices a Mixed Blessing,” *The Wall Street Journal*, May 16, 1996; Louise Lee, “Consumers Are Taking a Shine to Products That Gleam,” *The Wall Street Journal*, Aug. 8, 1996; David Frum, “Real Estate Victim of the '90s,” *The Wall Street Journal*, Apr. 3, 1992.