Chapter 3: Demand, Supply, and Market Equilibrium

How can a massive market economy, with millions of consumers and producers, possibly determine the appropriate output levels to avoid the waste of scarce resources? The interaction of supply and demand is the mechanism by which our market economy functions. Changes in supply and demand establish product prices and quantities produced, which in turn affect profit, employment, wages, and government revenue. Chapter 3 introduces principles explaining the behavior of consumers and producers in markets, as well as the effects of government policies on market activity.

The Law of Demand explains that consumers are willing and able to buy more products at lower prices than at higher prices, as illustrated by the downward-sloping demand curve. As the price of the product changes, the consumer responds by changing the quantity demanded, as illustrated by a movement from one point to another on the stationary demand curve. But as other factors change—tastes, the number of buyers, income, the prices of substitutes or complements, or consumer expectations—the entire demand curve shifts, as consumers buy more or fewer products at every price.

The Law of Supply states that producers are willing and able to produce more products at higher prices than at lower prices, as they are driven by the profit motive. Producers respond to price changes by changing the quantity supplied, moving among points on the stationary supply curve. But when other supply-related factors change—the costs of resources, technology, taxes and subsidies, the prices of other goods the firm could produce, producer expectations, or the number of sellers in the market—the entire supply curve shifts, as firms produce more or fewer products at every price.

Equilibrium is achieved where the quantity demanded equals the quantity supplied at a given price. No shortage is driving prices up; nor is a surplus driving prices down. An efficient allocation of scarce resources is achieved at equilibrium. We have a very dynamic economy, though, so supply and demand are constantly changing, causing equilibrium price and output to change, as well. The government may also create policies to affect the market, setting price ceilings or price floors, or rationing products in an attempt to meet goals other than efficiency.

A complete understanding of supply and demand is vital for success in the economics course and the AP Economics exams. The concepts of supply and demand reappear throughout the economics course in discussions of output and profit determination, wage setting, interest rates, currency values, and several other concepts. Material from Chapter 3 is heavily covered on the multiple-choice and free-response sections of both AP Economics exams, but the Macroeconomics questions are more likely to show up in the form of application to loanable funds, money, currency, or other aggregate markets. It is critically important to be able to graphically illustrate and explain the effects of changes in supply and demand (as well as shifts in both simultaneously) on prices and quantities sold, as well as the effects of price ceilings and floors.