GOVERNMENT GOLLEGE FOR WOMEN (AUTONOMOUS) KUMBAKONAM

DEPARTMENT OF ECONOMICS

M.A. ECONOMICS

MICRO ECONOMIC ANALYSIS - 1

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MODULE- II
DEMAND ANALYSIS

DEFINITION OF DEMAND ANALYSIS

The Demand Analysis is a process whereby the management makes decisions with respect to the production, cost allocation, advertising, inventory holding, pricing, etc.

Although, how much a firm produces depends on its production capacity but how much it must endeavor to produce depends on the potential demand for its product.

The demand shows the relationship between two economic variables, the price of the product and the quantity of product that a consumer is willing to buy for a given period of time, other things being equal.

FEATURES/CHARACTERISTICS OF DEMAND

The demand is the specific quantity that a consumer is willing to purchase. Thus, it is expressed in numbers. The demand must mean the demand per unit of time, per month, per week, per day.

The demand is always at a price, e. any change in the price of a commodity will bring about a certain change in its quantity demanded.

The demand is always in a market, a place where a set of buyers and sellers meet. The market needs not to be a geographical area.

LAW OF DEMAND

The Law of Demand asserts that there is an inverse relationship between the price, and the quantity demanded.

"when the price increases the demand for the commodity decreases and when the price decreases the demand for the commodity increases, other things remaining unchanged"

FUNDAMENTAL THEOREM OR DEMAND THEOREM

Assumptions

1)The consumer's tastes do not change.

2)His choice for a combination reveals his preference for that.

3)The consumer chooses only one combination at a given price-income line, i.e., any change in relative prices will always lead to some change in what he purchases.

4)He prefers a combination of more goods to less in any situation.

5)The consumer's choice is based on strong ordering.

6)Income elasticity of demand is positive i.e., more commodity is demanded when income increases, and less when income falls.

Samuelson states his "Fundamental Theorem of Consumption Theory," also known as demand theorem, thus: "Any good that is known always to increase in demand when money income alone rises must definitely shrink in demand when its price alone rises."

It means that when income elasticity of demand is positive, price elasticity of demand is negative. This can be shown both in the case of a rise and a fall in the price of a good.

REVEALED PREFERENCE

In economics, utility refers to how much satisfaction or pleasure consumers get from the purchase of a product, service, or experienced event.

Samuelson's "Revealed Preference Theory," which posited that consumer behavior was not based on utility, but on observable behavior that relied on a small number of relatively uncontested assumptions.

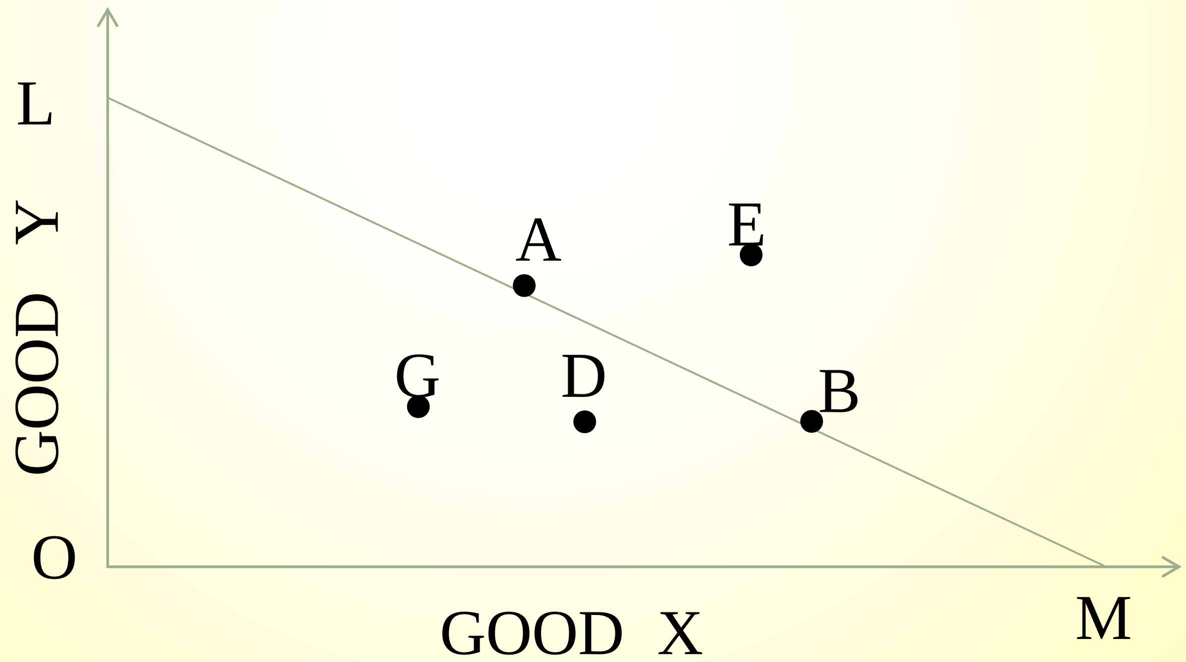
Revealed preference is an economic theory regarding an individual's consumption patterns, which asserts that the best way to measure consumer preferences is to observe their purchasing behavior. Revealed preference theory works on the assumption that consumers are rational.

REVEALED PREFERENCE THEORY OF DEMAND

Prof. Samuelson's theory of demand is based on the revealed preference axiom or hypothesis which states that choice reveals preference. Keeping this fact into view, a consumer buys a combination of two goods either because he likes this combination in relation to others or this is cheaper than others.

Suppose the consumer buys combination A rather than combination B. C or D. It means that he reveals his preference for combination A. He can do this for two reasons. First, combination A may be cheaper than the other combinations B, C, D.

Seconds combination A may be dearer than others and even then he likes it more than other combinations. In such a situation, it can be said that A is revealed preferred to B, C, D or B, C, D are revealed inferior to A.



Given the income and prices of the two goods X and Y. LM is the price-income line of the consumer. The triangle OLM is the area of choice for the consumer which shows the various combinations of X and Y on the given price- income situation LM. In other words, the consumer can choose any combination between A and B on the line LM or between C and D below this line.

If he chooses A, it is revealed preferred to B. Combinations C and D are revealed inferior to A because they are below the price-income line LM. But combination E is beyond the reach of the consumer being dearer for him because it lies above his price-income line LM. Therefore, A is revealed preferred to other combinations within and on the triangle OLM.

CRITICISM OF REVEALED PREFERENCE THEORY

Neglects Indifference

- ❖Not Possible to Separate Substitution Effect
- ❖Excludes Giffen Paradox
- ❖Consumer does not choose only one Combination
- ❖Choice does not reveal Preference
- ❖Fails to derive Market Demand Curve
- ❖Not Valid for Game Theory
- ❖Fails in Risky or Uncertain Situations

HICK'S LOGICAL THEORY OF DEMAND

Preference Hypothesis and Logic of Ordering

In order to explain the behaviour of an ideal consumer Prof. Hicks assumes preference hypothesis as a principle which governs the behaviour of such a consumer.The assumption of behavior according to a scale of preferences is known as preference hypothesis.

Hicks explains the meaning of preference hypothesis or behaviour according to the scale of preference as follows:

"The ideal consumer chooses that alternative out of the various alternatives open to him, which he most prefers, or ranks most highly. In one set of market conditions he makes one choice, in others other choices; but the choices he makes always express the same ordering, and must, therefore, be consistent with one another. This is the hypothesis made about the behaviour of the ideal consumer."

According to him, "the demand theory which is based upon the preference hypothesis turns out to be nothing else but an economic application of the logical theory of ordering."

Therefore, before deriving demand theory from preference hypothesis he explains the "logic of order". In this context he draws out difference between strong ordering and weak ordering. He then proceeds to base his demand theory on weak-ordering form of preference hypothesis.

Strong and Weak Orderings Distinguished

Strong ordering implies that there is definite ordering of various combinations in consumer's scale of preferences and therefore the choice of a combination by a consumer reveals his definite preference for that over all other alternatives open to him.

"A weak ordering consists of a division into groups, in which sequence of groups is strongly ordered, but in which there is no ordering within the groups."

It should be noted that indifference curves imply weak ordering in as much as all the points on a given indifference curve are equally desirable and hence occupy same place in the order. Choice can reveal preference for a combination only if all the alternative combinations are strongly ordered.

Weak ordering implies that the consumer chooses a position and rejects others open to him, then the rejected positions need not be inferior to the position actually chosen but may have been indifferent to it. Hence, under weak ordering, actual choice fails to reveal definite preference.

BANDWAGON EFFECT

The bandwagon effect arises from psychological, sociological, and, to some extent, economic factors. People like to be on the winning team and they like to signal their social identity.

Economically, some amount of bandwagon effect can make sense, in that it allows people to economize on the costs of gathering information by relying on the knowledge and opinions of others.

The bandwagon effect permeates many aspects of life, from stock markets to clothing trends to sports fandom.

The bandwagon effect has been shown to be so powerful that its effect has been observed in politics, public policy, and marketing.

- The bandwagon effect is when people start doing something because everybody else seems to be doing it.

- The bandwagon effect can be attributed to psychological, social, and economic factors.

- The bandwagon effect originates in politics, where people vote for the candidate who appears to have the most support because they want to be part of the majority.

The bandwagon effect has wider implications outside of politics and buying behaviors. In social psychology, this tendency of people to align their beliefs and behaviors with those of a group is also called "herd mentality" or “groupthink.”

VEBLEN EFFECT

Abnormal market behavior where consumers purchase the higher-priced goods whereas similar low-priced (but not identical) substitutes are available. It is caused either by the belief that higher price means higher quality, or by the desire for conspicuous consumption (to be seen as buying an expensive, prestige item).

Veblen good is a type of luxury good named after American economist Thorstein Veblen. It shows a positive relationship between price and demand, and thus an upward-sloping demand curve.

The demand for a Veblen good rises (drops) when its price increases (decreases). A Veblen good generally is considered a high-quality product and a status symbol. When the price gets higher, its status symbol makes the Veblen good more desirable to consumers with high social and economic standing.

VEBLEN GOOD AND THE LAW OF DEMAND

Veblen good is an exclusion to the law of demand, which is a concept of microeconomics. It states that the price and quantity of demand for goods demonstrate an inverse relationship as a result of the substitute effect.

When the price of good increases, the quantity of demand decreases, and when the price drops, the quantity of demand increases. However, due to its specific features as a luxury, a Veblen good will see a higher demand when its price increases.

VEBLEN GOOD – SNOB EFFECT

The abnormal demand for Veblen goods is influenced by the snob effect, a situation that consumers prefer to own exclusive products that are different from the common preferred ones. It leads to a higher demand for a product when its price increases.

If the price of the product decreases, its snob appeal diminishes, which makes it less desirable to wealthy consumers. Generally, the fewer items available in the market, the higher their snob values are. Veblen goods are a typical sort of product with snob value status.

The snob value of a product can be identified through its demand curve. Sometimes, a Veblen good can take on a downward-sloping demand curve and show the characteristics of normal goods at lower prices. When the price is above a certain level, the snob effect starts to play a role in turning the demand curve upward. The product turns into a Veblen good and starts to assume snob value.

THANK YOU