Example of essay on economics: demand and supply

Business, Customers

Demand and Supply

Introduction

The paper aims to answer four questions quoted here pertaining to demand and supply of oil and how it is driving the oil prices.

Question 1: How do changes in supply and demand affect oil prices?

Answer: Changes in supply and demand of oil significantly affect oil prices around the world, which is discussed in this section.

Effect of Demand on Oil Prices:

Oil demand is directly correlated with its price, other things remaining constant. The recent trend is such that increase in world over oil demand is putting upward pressure on its price. Globalisation, trade liberalisation and economic growth have resulted in higher oil demand. To a great extent, this growth is being support by economic expansion in the developing countries. Two large developing economies, China and India, have played a vital role in increasing oil demand. According to U. S. Energy Information Association (2014), China is the world's second largest oil consumer and will surpass the United States as the largest net oil importer by 2014. This increase in oil demand for China can be attributed mainly to factors like rapid growth in gross domestic product, sharp increase in industrial demand and population growth. Similar growth spurt is being experienced in India. According to U. S. Energy Information Association (2014), India was the fourth-largest energy consumer in the world in 2011. And oil demand in the country is constantly on the rise. U. S. Energy Information Association (2014) projects India and

China will account for about half of global energy demand growth through 2040.

Effect of Supply on Oil Prices:

There is a negative correlation between supply of oil and its price. As supply of oil decreases, its price increases. Oil is a natural resource and its supply is limited. To a large extent, the world is dependent on a few oil producing countries for oil supply. Any downturn or turmoil in these oil producing countries impacts world-over supply of oil, and thereby affects it price. According to Anderson and Buol (2005), several oil-producing countries have undergone turmoil that has affected their abilities to produce at full capacity. Middle East is one of the major producers of oil in the world. The recent political turmoil in Middle East is led to oil price spikes in anticipation of reduction in oil supply.

Question 2 (a): Explain what happens to quantity of oil demanded when the price of oil decreases, assuming that the supply doesn’t change.

Answer: Given that supply is constant, quantity of oil demanded increases with decrease in oil prices. This can be explained simply through the law of demand and demand curve. The law demand states that, other things remaining constant, there is inverse correlation between price of a good and its quantity demanded. The demand curve slopes downward. As the price of oil drops, demand moves down the curve. Since the curve is downward sloping, movement downwards, means higher quantity demanded. Thus, downward sloping demand curve also signifies that as the price of good increases, its quantity demanded decreases.

In present day, the oil prices are regulated to a considerable extent by the major oil producing countries based on estimated global demand for oil. Oil producing and exporting countries (OPEC) form a cartel to regulate global oil prices.

Question 2 (b): Explain what happens to the price of oil and quantity of oil supplied when Congress approves drilling for the reserves in Alaska, assuming that the demand doesn’t change.

Answer: When congress approves drilling of oil reserves in Alaska, oil production in the country increases. Drilling a new oil reserve produces additional oil and the quantity of oil supplied increases. Given that demand is constant, increase in supply of oil puts a downward pressure on oil prices and oil price drops. This is because more quantity is now available in the market, which reduces its dearness. Thus, price moves downward on the supply curve.

Question 2 (c): Explain what happens to the price of oil and quantity of oil demanded when if China experiences rapid economic growth, assuming that the supply doesn’t change.

Answer: If China experience rapid economic growth, it will produce more goods and services. Oil is one of the major factors of production for most of the industries. Thus, economic growth will lead to higher oil demand from China. Since supply is constant, the rise in demand will put an upward pressure on the demand curve resulting in increase in oil price. This can also be explained with law of demand. The law of demand states that higher demand will lead to price rise, if supply is constant. Thus, price moves upward on the demand curve.

Question 3: Gas prices have reached record highs in many states. Would you advocate a price control for oil so that you pay less than the market price at the pump? Why or why not? (Be sure to include your own research to support your answer.

Answer: There are many cases where government puts price regulation or provides subsidy for purchase of a necessary commodity. Gas prices are record high in many states, but I do not advocate a control or ceiling to be imposed on gas price. This is because I feel that economy works best when demand and supply forces determine the price of the commodity, and price is not decided or controlled by an external agent.

Price control disrupts the natural price determination mechanism, thereby leading to overall losses in long run. This can be explained through the concept of deadweight loss. Deadweight loss is the overall losses caused to society due to disruption in price determination phenomenon. According to Moffatt (n. d.), the deadweight loss is measured by the sum total of both the consumer surplus and producer surplus caused by the policy. When control or ceiling is issued on gas price, consumer surplus is created as consumers can buy more at the lesser price. But, sellers do not have any incentive to sell at the lower price and negative producer surplus is created. Thus, the quantity supplied is expected to reduce, thereby leading to economic inefficiency. In other words, the negative producer surplus created far outweighs the consumer surplus created.

Price control can manifest itself negatively in two ways. First, it can lead to hoarding of gas. The sellers will have incentive to sell the gas in the black market at prices higher than the original price, thereby burdening the customer even more. The consumer will have to make extra effort to identify the point of sales as well. Second, price control will lead to decrease in quantity supplied. This will put pressure on the government to take measures to incentivise sellers to bring quantity back to optimal levels. Hence, I would like the market demand and supply forces to determine gas price, without any external disruption. This will help create maximum surplus for consumers as well as producers in the long run.

Conclusion

Supply and demand forces significantly impact price of gas and oil. While increase in supply decreases the price, increase in demand increases the price. It is best to let market forces determine the price of a commodity as price control or any other intervention can cause deadweight loss.

References

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