Cross price elasticity essay

Economics

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In economics, cross price elasticity measures the responsiveness of the demand for a good to a change in the price of another good. It is measured that a percentage change in demand of the first good occurs in response to the percentage change in price of the second good. For example, the price of fuel has increased by 10%, in response to the increase of the price of fuel, the demand for vehicles that do not use fuel decreases 20%.

The cross elasticity of demand would be –2. We are able to distinct between subsitute and complementary goods because of cross price elasticity. A positive cross price elasticity denotes that the two goods are substitutes. For example, if a price of one good increases, the demand for it's rival product will increase.

As you can see from the diagram above, when the price of Coca Cola increases, the demand for pepsi will also increase as pepsi is a substitute for coca cola and people would choose a cheaper and more affordable good. When two products are complements, the cross price elasticity will be negative. As the price of one good increases, the demand for it's complement will decrease. For example, as you can see from the diagram, when the price of popcorn increases, the demand for soft drinks decreases.

Popcorn is very affordable but is sold at a much higher price. Thus, the sales of popcorn is more than enough to compensate for the low sales of soft drinks. Complements can also be elastic and inelastic. An elastic complement will be a close complement whereas an inelastic one will be a not so close complement.