

Price elasticity and cross elasticity of demand differences



**ASSIGN
BUSTER**

Price elasticity of demand (PED) is defined as the degree to which demand for a good/service varies with its price. Price elasticity of demand is used to measure response towards change in demand after a price change. Demand is said to be elastic if price change leads to a bigger percentage change in demand. This therefore means that the PED will be greater than one (Jones 2004)

Demand is elastic if a change in price leads to a bigger percentage change in demand; therefore, the PED will be greater than one. When the PED is greater than one, the good is considered as price elastic and this shows meaning that the demand is responding to price change. However, if the PED is less than one, the commodity is considered as inelastic. If the PED equals one, the commodity is considered as having unit elasticity therefore, percentage change in demand is equal to the percentage change in price. If the PED is equal to zero, the commodity is said to be perfectly inelastic. This is to mean that any changes in price will in no way affect demand for the commodity. However, if the PED is infinity, the commodity is considered as being perfectly elastic. This is to say that any price change will reduce the demand for the commodity to zero as supported by McAuliffe (1981, p. 29).

A number of factors determine Price of elasticity of demand. One of these factors is the number of close substitutes within the market. The more and closer the substitutes are in the market, the more elastic the demand for the commodity is. The substitution effect therefore highly affects PED.

Luxuries and necessities also affect PED. Necessities are generally more inelastic as compared to luxury commodities, which are more elastic.

Necessities include our basic needs like food commodities.

The percentage of income spent on a commodity also affects PED. Often the case if small proportion of income is spent on a commodity, comes more inelastic. Habit-forming goods are also another factor that affects PED. Drugs and other addictive commodities like cigarettes tend to be inelastic. This is to say that habitual consumers of certain commodities tend to be insensitive to any price changes. Time under consideration tends to affect PED, as demand is more elastic in the end rather than in the short run.

Hirshleifer (2005, p. 136) states that cross elasticity of demand (CPed) is used to measure how demand for a product responds to change in price of other related products. To determine the CPed, focus is mainly on the relationship between changes in the prices of substitutes and the complements. Increase in price of one substitute good will lead in demand for a rival product. In this case, CPed will be positive. With goods that are in complementary demand, e. g. decrease in prices of ink pens will lead to an increase for ink bought since more people will buy the pens. However, if there is no relationship between two commodities, the CPed will be zero.

Income elasticity demand is used to measure the relationship between changes in quantity demanded vs. the change in income. Income elasticity of demand changes between normal goods, necessities, luxuries, and inferior goods. Income elasticity of demand depends on various products, as customer preferences for different products tend to vary. For example, what

<https://assignbuster.com/price-elasticity-and-cross-elasticity-of-demand-differences/>

some people consider a luxury may actually be a necessity to others. Spending decisions between individuals also vary. Income elasticity for demand also changes with time, as most market products do not have an infinite life cycle. Consumer preferences will also be affected by other consumers over time and also availability of newer products. E. g. there are so many inventions in telecommunications for example phone come in different shapes and colors and preferences for an individual will likely be influenced by these changes.

Actions to reduce price fluctuations

A number of actions are available for companies and countries to reduce price fluctuations. The main causes of price fluctuations are forces of supply and demand. i. e. when supply is high and demand is low, prices lower and when supply is low and demand is high, prices go up. Price fluctuations affect business stability and it is therefore important to make sure that prices do not fluctuate very often. One good way of limiting pricing fluctuations is through a pricing strategy (Karl, & Ray 2008, p. 53).

When determining price for a product or service, the company should first undertake a marketing analysis. Conducting a marketing analysis helps to know how the market is behaving. With this, one is able to understand when demand is high as well as available market competitors and their strength in supplying the commodity even when there are changes in demand. The company should gauge its ability to sustain demand even when it is at its peak based on research and analysis that it has carried out.

Cost variations associated with procurement or production of the product should also be considered. The company should be well prepared to cushion itself against any unforeseen costs in production and incorporate this in their pricing strategy. In addition, competitor actions and legal constraints should be considered when setting the price for a commodity.

In the case of a country, a number of characteristics of the population should be considered. Price elasticity, peoples spending habits, income levels of the population. Price controls placed by governments should ensure that they take into considerations the different factors that may affect commodity pricing and set them in such a way that they do not have to be adjusted every time an unforeseen incident happens. Alternatively, the price adjustment should be in such a way that when adjustments are made, they should not be too radical.

People's spending habits are a very important factor to consider when setting prices to avoid and/or limit price fluctuations. There are certain times of the year when people freely spend their money while at other times; people do not spend so much. For instance, many people will not mind spending money on gifts and holidays. This may not be the case during other times of the year as people are pre-occupied with other things. People's ability to pay for a commodity should also be considered when trying to determine pricing.

Mattoo (1990, p. 97) observes that future trading is another way of reducing price fluctuations in the market. These include delivery contracts for specified amounts of a commodity at a certain date and time in the future

and at a certain price. For example, a company might foresee decrease in supply of a commodity in future. It therefore opts to contract a supplier to make the deliveries when the supply is low. This will ensure that the decrease in supply does not greatly affect the price as they will have foreseen these and incorporated it during pricing. Futures trading are especially common in agriculture where a farmer may want to guarantee a price for his un-harvested produce. So that he can maintain this price, he would want to sign a futures contract to a company that needs his produce equal to the amount that he expects to get when he harvests

Carbaugh (2008, p. 239) notes that the use of buffer stocks can also help to reduce price fluctuations. Buffer stocks are mostly used in agricultural produce to stabilize the markets. This is mainly a government-supported project where produce is bought in bulk when it is in plenty. The stocks of the product are then released into the market when prices are low.

Governments should create buffer stock schemes to help reduce price fluctuations. For this scheme to be successful, proper estimate of the average price of the product over a period is important as it helps to set maximum and minimum prices of the commodity.

Another strategy that can be used to reduce price fluctuations is shadow pricing. Shadow pricing is the maximum price that a company/producer is willing to pay for an extra unit of a given resource. In this case, a company may consider the amount of money that it is willing to pay in order to increase output when demand is high. This is considered in monetary terms where the company uses it to justify that the amount of money that it will input in increasing output will pay off when the commodities are released <https://assignbuster.com/price-elasticity-and-cross-elasticity-of-demand-differences/>

into the market. The company may use this when pricing during high and low demand seasons (Brent 2008, p. 109).