

1.4 WHAT INFLUENCES DEMAND?



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1.4 WHAT INFLUENCES DEMAND?

In section 1.3 we defined the term demand as referring to the wants and needs of consumers for a product. This section looks at what kind of factors influence the demand for products.

Any business will need to watch for changes in the level of demand, whether increases or decreases, and ask what the causes of that change may be. Any number of factors will influence demand, but those listed below are some of the general ones that have an effect in all sorts of markets:

- Price
- Consumer income
- What other firms do
- Marketing activity
- Seasonal factors

Price

Whenever the price of a product is increased, the firm that supplies the product will see a fall in demand. (In other words, the volume of sales will fall.) When price falls, demand will increase. This is a basic principle of demand that will always apply.

It would be a mistake to assume that because changes in price do not influence the purchasing decisions of some individual customers, this rule of demand is unreliable. Demand in the market - from customers *as a whole* - will be affected by changes in price. To economists (and entrepreneurs) this is an unavoidable fact of life. What can be noticed, however, is that the more a product is perceived as a necessity, the less sensitive to price changes demand is.

When the product in question is a luxury, demand will be very sensitive to price changes. For example, a 10% increase in the price of bread will result in a smaller percentage fall in demand than would apply to a 10% increase in the price of perfume.

Another factor that affects the extent to which demand is sensitive to price changes is the degree to which there are easily available substitutes for a product. For example, if the price paid by households for gas increases by 20% in a year, the demand for gas will almost certainly decrease by less than by 20%. This is because it is not easy (or cheap) for consumers to quickly switch to alternative forms of energy.

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On the other hand, if the price of lamb goes up by 20% in a year, consumers will switch to buying other types of meat in very large numbers as it is easy for them to do this.

Now test your understanding by answering Activity 8 on the next page.

ACTIVITY 8 : Price changes

TASKS

1. In each of the situations given below, state what will happen to levels of demand for the product. Will it increase, decrease, or stay the same?
2. In which one of the four situations would you expect the smallest percentage change in demand to occur? Explain your answer.
3. In which one of the four situations would you expect the largest percentage change in demand to occur? Explain your answer.
 - The OPEC oil producing countries announce that they have agreed to increase the price of crude oil by 2%.
 - A large champagne producer has been able to reduce the price of champagne by 2% due to a good grape harvest.
 - The price of English Cox apples has increased by 25%.
 - Due to a fall in advertising revenues, most national newspaper companies feel that they need to increase the price of newspapers by up to 25%.

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Consumer income

This is concerned primarily with ability to pay, whereas price, as an influence on demand, is more concerned with willingness to pay. If average consumer incomes increase, demand will increase. If average consumer incomes fall, demand will fall.

Changes in interest rates (the cost of borrowing) and in taxation will alter overall demand. This is because of a reduction in disposable incomes. Disposable income is income which is left to spend after all essential items, such as heating, tax and mortgage payments have been accounted for. Home purchase loans (mortgages) account for a large proportion of typical household expenditure. If percentage interest rates increase or taxation increases, disposable incomes will be less and consumer demand will fall. If interest rates decrease, consumer demand will rise.

A recession is a period of falls in national production and income. One feature of a recession is higher unemployment as firms compensate for falling sales by reducing their labour costs. If unemployment is increasing, the demand for luxury goods such as holidays, jewellery and fashion clothing will fall. The pattern of consumer demand tends to change as incomes change. Consumers will purchase fewer luxuries if average consumer incomes fall.

During the recession of 2008-9, for instance, many high and middle income households in the UK switched their buying habits. Consumers who had lost their jobs or were worried about unemployment sought to make savings. For example, up-market supermarkets such as Waitrose lost sales to price discounting chains such as Aldi and Lidl. This was because affluent shoppers wanted a way of reducing their weekly shopping spend. This illustrates the point that the impact of changing levels of consumer income really depends on the nature of the product in question.

What other firms do

The level of demand for a given product will be influenced by what else consumers can buy. Very few businesses have no competition. Competition can take two forms. One sort of competitor is a business making a similar product. But you also need to think of the bigger picture. Two quite different products may be in competition with each other. For example, plumbers and electricians compete with Do-It-Yourself stores, because some householders may attempt to carry out some jobs themselves.

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The actions of other firms can influence the demand for the product of a business in a number of ways. These include:

- The price of alternative (substitute) goods or complementary goods
- The features of competing products

Complementary goods are those that are used alongside each other. For example, computer games and games consoles. If the demand for computer games changes, the demand for consoles will inevitably change as well.

If a firm develops a product that makes it seem better than its competitors in some way, then demand for that product will rise. Improvements in reliability, performance or versatility are examples of ways in which demand for a product may increase.

Developments such as online catalogues and price comparison web sites mean that businesses must be well informed about what their competitors are doing - it is often quite easy for their customers to be well informed.

Marketing activity

Demand for a great product that is available at a competitive price may be low if the business concerned has not organised effective marketing. In other words, the scale and effectiveness of marketing will influence demand. Marketing is partly about promotion but marketing management involves lots of other things too. Marketing can be defined as the management process concerned with identifying, anticipating and satisfying customer needs profitably. Marketing as a business activity is further discussed in Unit 2.

Seasonal factors

The demand for some products is largely seasonal. In the British winter, there is increased demand for warm clothing and fuel, for example. In the summer, producers of barbecues and sun tan lotion have greatly increased levels of demand.

Businesses that experience these seasonal fluctuations in demand have to plan levels of output accordingly. Tertiary sector firms such as hotels will employ fewer staff during quiet times of the year.

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In the parts of the secondary sector that are affected by seasonal demand, businesses either stockpile to cope with their busy season or organise production so that it is on a larger scale during busy sales months



Are these complimentary goods or substitutes?



Self Check Questions

1. Name two factors that influence the sensitivity of demand to price changes.
2. What will be the effect of an increase in interest rates on demand?
3. What are complementary goods?
4. Give an example of a product where demand is seasonal
5. What effect will a costly television advertising campaign by the airline Lufthansa have on sales of British Airways tickets?.

ACTIVITY 9 : Falling beer sales

Beer sales fall as the recession bites

An historic Southampton pub which featured in the film *Titanic*, starring Kate Winslet and Leonardo DiCaprio, was one of the many forced to close due to the economic downturn in 2008. The Grapes public house was opened in 1856. It is said to be the place where six crew members of the Titanic were drinking when they missed the liner's disastrous maiden voyage. They lost track of time.

In 2008 the banking system was rescued by the UK government (at huge expense to taxpayers), consumer confidence collapsed and unemployment rose sharply. But it seems that not everybody was drowning their sorrows in the pub. The British Beer and Pub Association (BBPA) calculated that 39 pubs a week were closing in Britain over the year. This represented a closure rate 20 times faster than just 3 years earlier. UK beer sales fell more than 8%, according to the BBPA.

Even off-trade (supermarket and off licence) sales plummeted, despite the trend for many drinkers to save money by drinking at home instead of in public houses. To make matters worse, changes in government duty (tax) on beer sales put an average of 5p extra on a pint of beer, according to the BBPA. The BBPA said that 753,000 fewer pints of beer were sold via the on-trade (pubs, bars and restaurants) in the first 3 months of 2009. This represented a fall of 6.3% on the same quarter in 2008.

The BBPA's chief executive, David Long, said: "Falling beer sales means more publicans struggling to keep their pub doors open. Closing pubs means tens of thousands of job losses and the heart taken out of many communities."

(Source: adapted from guardian.co.uk 28th April 2009.)

TASKS

1. Suggest a product that might be seen as a close substitute for beer. (1)
2. Explain two factors that, according to the article, caused a fall in the demand for beer in 2008. (6)
3. Why have pubs suffered from falling sales more than the off-trade? (3)
4. Illustrate one other factor that might influence demand, using the beer market. (4)