- # <u>Chapter 1 – Introduction to Microeconomics</u>

Question 1:

Discuss the central problems of an economy.
Answer:

Every economy faces three central problems due to scarce availability of resources. This scarcity challenges the best possible usage of these available resources to fulfil the unlimited demands. The three central problems of an economy are as follows:

1. *What to produce and in what quantities?*

The very first problem encountered by any economy is to decide what goods are to be produced and in what quantities or amount. There is a lot to be decided; whether to produce consumer goods or luxury goods; agricultural goods or investment goods; whether to cater education and healthcare sector or to strengthen country's military. An appropriate example was set by the Latin American nation Costa Rica; they dismantled their military in 1949 and invested the money, which earlier was spent on the maintenance of their army, on education and healthcare. Once it is decided, what to produce, the next decision is to estimate the amount or quantity of the production. So the economy constantly struggles to choose what to produce and in what quantities.

2. *How to produce?*

The second problem that arrives is **how** to harvest the given or available resources? That is, what technique is to be used for producing various goods and services? It depends majorly on the nation's endowment of resources in deciding the optimum technique. It has to be decided whether efficient production is possible through labour-intensive or capital-intensive techniques. This decision rest on the present economic conditions and also that the selected technique shall not only reduce the cost of production but also add to the social and economic welfare. For example, if a country is facing wide unemployment possibly due to huge population, then it is wise to opt for labour-intensive technique so that there is reduction in unemployment.

3. *For whom to produce?*

Finally, the purposeful distribution of final goods and services produced (national income) has to be done; that is, who gets what and how much? The economy needs to decide the best suitable mechanism for distribution of the final products among different segments of the society. The objective behind selecting such mechanism is to reduce inequality of income, to reduce poverty and to add to the social welfare and standard of living of people.

Question 2:

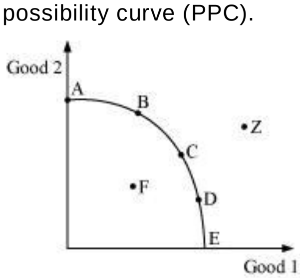
Answer: What do you mean by the production possibilities of an economy?

Production possibilities of an economy imply those numerous alternative combinations of goods and services, which a particular economy can produce, with the given technology and employing the available resources fully and efficiently. In other words, it refers to various feasible bundles of goods and services that can be produced together by efficiently utilising the given technology and available resources.

Question 3:

What is a production possibility frontier?
Answer:

The production possibility frontier (PPF) refers to a curve that shows various alternative combinations of two goods that can be produced with efficient utilisation of the given resources and technology. It is also called production possibility curve (PPC).



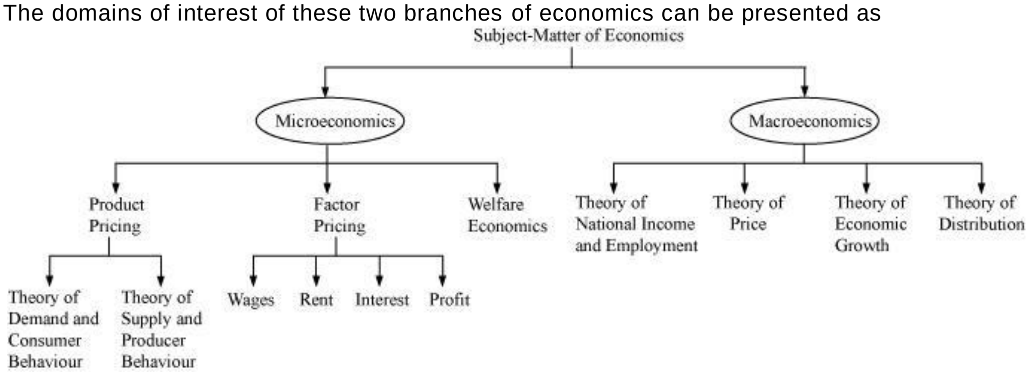
All the points lying on the PPC, that is curve AE, are associated with different quantities of good 1 and good 2 produced, by employing the available resources fully and in an efficient manner. While any point lying under the curve, like F, depicts inefficiency or underutilisation of available resources. Whereas any point lying outside the curve, like Z, depicts over utilisation of the available endowment of resources and technology; making it non-feasible.

Question 4:

Discuss the subject matter of economics.
Answer:

The subject matter of economics is sub-divided into two core branches, Micro Economics and Macro Economics. This division came into existence only after 1930 as per the suggestion by Ragnar Frisch.

The domains of interest of these two branches of economics can be presented as



Microeconomics is the study of individual economic units, i.e. the behaviour of consumers and firms. The study of how they utilise the given resources in the best possible manner in order to maximise their rational objectives falls under the domain of microeconomics. It is also the study of demand and supply and how their interaction determines prices of various goods and services. Microeconomics helps in solving the three central problems of an economy. It is also called the *Price theory* as it primarily focuses on how prices are determined both in commodity and factor markets.
In Macroeconomics we study how the economy as a whole operates. It focuses on the determination of the aggregate measures, like aggregate demand, aggregate supply and overall price level and how they change over time. It is also known as the *Theory of Income and Employment* as its main focus is on how income and employment levels are determined. Macroeconomics helps in understanding and solving problems like inflation, unemployment, Balance of Payments (BOP) disequilibrium, poverty, etc.

Question 5:

Distinguish between a centrally planned economy and a market economy.
Answer:

	Points of Difference	Centrally Planned Economy	Market Economy
1	Ownership of factors of production	Factors of production are publically owned; i.e., public ownership.	Factors of production are privately owned.
2	Production motive	The motive of production is social welfare.	The main motive is profit making.

3	Governing factor	The production is governed by planning mechanism; i.e. according to the government plans.	The production is governed by price mechanism; i.e., by demand and supply.
4	Income distribution	The degree of inequality of income is low.	There exists unequal distribution of income.
5	Government's role	The main role is played by the government−from production to distribution.	The main role is played by private players. They decide what to produce, while the role of a government is limited to maintaining law and order in the nation.

Question 6:

What do you understand by positive economic analysis?
Answer:

Positive economic analysis refers to the analysis in which we study what is or how an economic problem is solved by analysing various *positive statements* and mechanisms. These are factual statements and describe what was, what is and what would be. These statements can be tested, proven or disproven and do not involve personal value judgments. For example, if someone says that it is raining outside, then the truth of this statement can be verified. It deals with actual or realistic situations.

Question 7:

What do you understand by normative economic analysis?
Answer:

Normative economic analysis refers to the analysis in which we study whether a particular mechanism is desirable or not. In this analysis, we study what ought to be the desired situation or in what ways the economic problems should be solved. In other words, it is concerned with what should be and what should not be, and what is desirable and what is not? In normative economic analysis we come across *normative statements* that cannot be tested as they involve personal value judgments. It deals with idealistic situations and is based on ethics. An example of a normative statement could be, 'Central government should not stop providing minimum support price to the farmers'.

Question 8:

Distinguish between microeconomics and macroeconomics.
Answer:

Points of Difference		Microeconomics	Macroeconomics
1	Study matters	It studies about individual economic units like households, firms, consumers, etc.	It studies about an economy as a whole.

2	Deals with	It deals with how consumers or producers make their decisions depending on their given budget and other variables.	It deals with how different economic sectors such as households, industries, government and foreign sector make their decisions.
3	Method	It uses the method of partial equilibrium, i.e. equilibrium in one market.	It uses the method of general equilibrium, i.e. equilibrium in all markets of an economy as a whole.
4	Variables	The major microeconomic variables are price, individual consumer’s demand, wages, rent, profit, revenues, etc.	The major macroeconomic variables are aggregate price, aggregate demand, aggregate supply, inflation, unemployment, etc.
5	Theories	Various theories studied are:1) Theory of Consumer’s Behaviour and Demand2) Theory of Producer’s Behaviour and Supply3) Theory of Price Determination under Different Market Conditions	Various theories studied are:1) Theory of National Income2) Theory of Money3) Theory of General Price Level 4) Theory of Employment 5) Theory of International Trade