Quick View

What Does *Microeconomics* Mean?

The branch of economics that analyzes the market behaviour of individual consumers and firms in an attempt to understand the decision-making process of firms and households. It is concerned with the interaction between individual buyers and sellers and the factors that influence the choices made by buyers and sellers. In particular, microeconomics focuses on patterns of supply and demand and the determination of price and output in individual markets (e.g. coffee industry).

What Does *Macroeconomics* Mean?

The field of economics that studies the behaviour of the aggregate economy. Macroeconomics examines economy-wide phenomena such as changes in unemployment, national income, rate of growth, gross domestic product, inflation and price levels.

What Does *Positive Economics* Mean?

The study of economics based on objective analysis. Most economists today focus on positive economic analysis, which uses what is and what has been occurring in an economy as the basis for any statements about the future. Positive economics stands in contrast to normative economics, which uses value judgments.

What Does *Normative Economics* Mean?

A perspective on economics that incorporates subjectivity within its analyses. It is the study or presentation of "what ought to be" rather than what actually is. Normative economics deals heavily in value judgments and theoretical scenarios. It is the opposite of positive economics.

An example of a normative economic statement would be, "We should cut taxes in half to increase disposable income levels". By contrast, a positive (or objective) economic observation would be, "Big tax cuts would help many people, but government budget constraints make that option infeasible."

Define economy.

An economy consists of the specific economic system of a country or other area, the labor, capital and land resources, and the economic agents that socially participate in the production, exchange, distribution, and consumption of goods and services of that area.

The Economic Problem

How do we sum up the basic economic problem? We all suffer from it and spend most of our lives trying to resolve it. Essentially, the economic problem stems from the fact that as humans, we have unlimited wants and needs. A need is something that can be seen as being essential to survival, such as food, water, shelter and warmth. A want is something that we would like to have but which is not essential to survival - a car, the latest version of the PlayStation, that new top you have seen in Top Shop, the mobile phone with all the latest gadgets on etc.

The problem is that the world and every individual in it have limited resources in relation to the wants and needs we have. We never have enough money to get what we 'want'. There are never enough resources to make sure the health service works properly; teachers and lecturers will always moan about how they never have enough resources to do their job properly. In recent times, we have heard much about the problems faced by the armed forces in conflict zones around the world 'not having the tools to get the job done'.

The basic economic problem that arises because people have unlimited wants but resources are limited. Because of scarcity, various economic decisions must be made to allocate resources efficiently.

To sum up, the causes of economic problem are

- Unlimited wants
- Limited resources
- Alternative uses of resources

Central Problems of an Economy

- What and how much to produce
- How to produce
- For whom to produce

What to produce and How Much: The main cause of this problem is our limited resources and their alternative uses. The society has to decide which goods or services should be produced and in what quantities to get maximum efficiency from our resources. Eg. More wheat should be produced or more rice should be produced. We should produce more cotton or more coffee. More cars should be produced or more tanks should be produced. A decision has to be taken between consumer goods and producer goods.

How to produce: This problem actually deals with the choice of technology to produce goods and services. The technology is generally classified into Labour intensive and Capital Intensive technology.

Labour Intensive Technology is used in a labour surplus economy where production is undertaken manually. In a Capital Intensive Technology, use of machines is prevalent.

The society has to decide which technology is better for them.

For Whom to Produce: This problem actually deals with the distribution of goods and services among the people. We already know, the wants are unlimited but the resources are limited. The society cannot fulfill the wishes of all the people. It has to determine which category of people get what and how much.

Market Economy: A system of allocating resources based only on the interaction of market forces, such as supply and demand. A true market economy is free of governmental influence, collusion and other external interference.

Planned Economy: A type of economy that gives the government total control over the allocation of resources. A planned economy alleviates the use of private enterprises and allows the government to determine everything from distribution to pricing. Planned economies basically give the government dictatorship type control over the resources of the country. Planned economies can provide stability, but also can limit the growth and advancement of the country if the government does not allocate resources to the innovative enterprises.

Opportunity Cost: The cost expressed in terms of the next best alternative foregone or sacrificed. In other words, it is the next-best choice available to someone who has picked between several mutually exclusive choices.

Examples: a) A person who has $15 can either buy a CD or a shirt. If he buys the shirt the opportunity cost is the CD and if he buys the CD the opportunity cost is the shirt. If there are more choices than two, the opportunity cost is still only one item, never all of them.

b) A person who sells stock for $10,000 denies himself or herself the opportunity to sell the stock for a higher price (say $12,000) in the future, inheriting an opportunity cost equal to the future price of $12,000 (and not the future price minus the sale price).

Production Possibilities Frontier

The production possibilities (PP) curve is a graphical medium of highlighting the central problem of 'what to produce'. To decide what to produce and in what quantities, it is first necessary to know what is obtainable. The PP curve shows the options that are obtainable, or simply the production possibilities. What is obtainable is based on the following assumptions:

1 The resources available are fixed.

2 The technology remains unchanged.

3 The resources are fully employed.

4 The resources are efficiently employed.

5 The resources are not equally efficient in production of all products. Thus if resources are transferred from production of one good to another, the cost increases. In other words marginal opportunity cost increases.

The last assumption needs explanation because it determines the shape of the PP curve. If this assumption changes, the shape changes.
Efficiency in production means productivity i.e. output per unit of an input. Let the input be worker. Suppose an economy produces only two goods X and Y. Suppose a worker is employed in production of X because he is best suited for it. But when the economy decides to reduce production of X and increase that of Y, the worker is transferred to Y. He is not that efficient in production of Y as he was in X. His productivity in Y will be low, and so cost of production high.
The implication is clear. If the resources are transferred from one use to another, the less and less efficient resources will be transferred leading to rise in the marginal opportunity cost which is technically termed as marginal rate of transformation (MRT). What is MRT?

Marginal Rate of Transformation

To simplify, let us assume that only two goods are produced in an economy. Let these two goods be guns and butter, the famous example given by Samuelson. The guns symbolize defense goods and butter, the civilian goods. The example, therefore, symbolizes the problem of choice between civilian goods and war goods. In fact it is a problem of choice before all the countries of the world.

Suppose if all the resources are engaged in the production of guns, there will be a maximum amount of guns that can be produced per year. Let it be 15 units (one unit may be taken as equal to 1000, or one lakh and so on). At the other extreme suppose all the resources are employed in production of butter only. Let the maximum amount of butter that can be produced is 5 units. These are the two extreme possibilities. In between there are others if the resources are partly used for the production of guns and partly for production of butter. Given the extremes and the in-between possibilities, a schedule can be prepared. It can be called a production possibilities schedule. Let the schedule be:

Production Possibility Schedule

Possibilities	Guns (units)	Butter (units)	MRT = Guns Butter
A	15	0	-
B	14	1	1G : IB
C	12	2	2G : IB
D	9	3	3G : IB
E	5	4	4G : IB
F	0	5	5G : IB

In the table the possibility A is one extreme. The society devotes all the resources to guns and nothing to butter. Suppose the society wants one unit of butter. Since resources are limited and fully and efficiently employed, to produce one unit of butter some of the resources engaged in production of guns have to be transferred to the production of butter. Let the resources worth one unit of gun are enough to produce one unit of butter. This gives us the second possibility with MRT = 1G/IB. Now suppose that the society wants another unit of butter. This requires transfer of more resources from the production of guns. Now we require transfer of resources worth 2 units of guns to produce one more unit of butter. The MRT rises to 2G/IB. MRT rises because now less efficient resources are being transferred. In this way MRT goes on rising.

We can now define MRT in general terms. MRT is the ratio of units of one good sacrificed to produce one more unit of the other good.

$$MRT = \frac{Units\ of\ one\ good\ produced}{More\ units\ of\ another\ good\ produced} = \frac{\Delta Guns}{\Delta Butter}$$

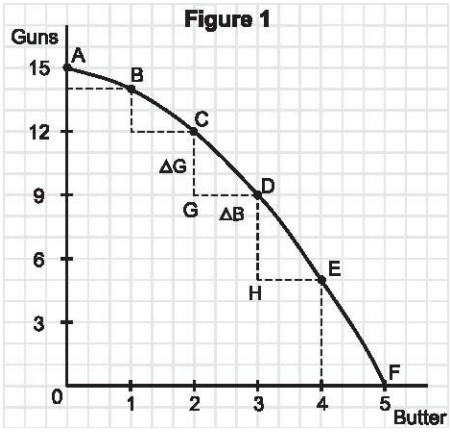
Or, MRT is the rate at which the quantity of output of one good is sacrificed to produce on more units of the other good.

Production Possibility Curve

By converting the schedule into a diagram, we can get the PP curve. Refer to the figure I which is based on the PP schedule. Butter's production is shown on the x-axis and that of guns on the y-axis.

We can measure MRT on the PP curve. For example MRT between the possibilities C and D is equal to CG/GD. Between D and E it is equal to DH/HE, and so on.

Diagrammatically, the slope of the PP curve is a measure of the MRT. Since the slope of a concave curve increases as we move downwards along the curve, the MRT rises as we move downwards along the curve.



Characteristics

A typical PP curve has two characteristics:

1) **Downward sloping from left to right**

   It implies that in order to produce more units of one good, some units of the other good must be sacrificed (because of limited resources).

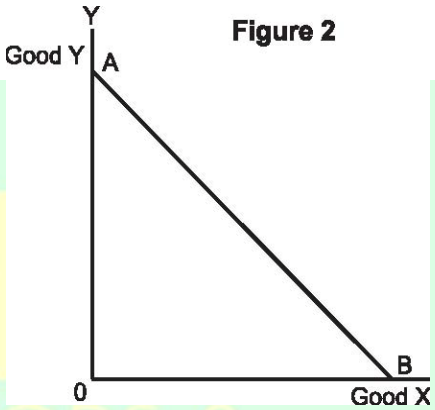
2) **Concave to the origin**

   A concave downward sloping curve has an increasing slope. The slope is the same as MRT. So, concavity implies increasing MRT, an assumption on which the PP curve is based.

Can PP curve be a straight line?

Yes, if we assume that MRT is constant, i.e. slope is constant. When the slope is constant the curve must be a straight line. But when is MRT constant? It is constant if we assume that all the resources are equally efficient in production of all goods.
Note that a typical PP curve is taken to be a concave curve because it is based on a more realistic assumption that all resources are not equally efficient in production of all goods.

Figure 2

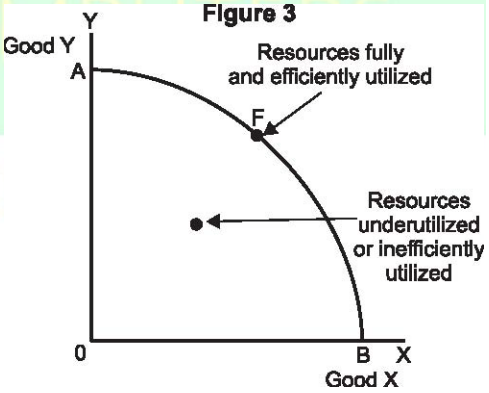


Does Production takes place only on the PP curve

Yes and no, both. Yes, if the given resources are fully and efficiently utilized. No, if the resources are underutilized or inefficiently utilized or both.

Refer to the figure 3.
On point F, and for that matter on any point on the PP curve AB, the resources are fully and efficiently employed. On point U, below the PP curve or any other point but below the PP curve, the resources are either underutilized or inefficiently utilised or both. Any point below the PP curve thus highlights the problem of unemployment and inefficiency in the economy.

Figure 3



Can the PP curve shift?

Yes, if resources increase. More labor, more capital goods, better technology, all mean more production of both the goods. A PP curve is based on the assumption that resources remain unchanged. If resources increase, the assumption is broken, and the existing PP curve is no longer valid. With increased resources there is a new PP curve to the right of the existing PP curve.

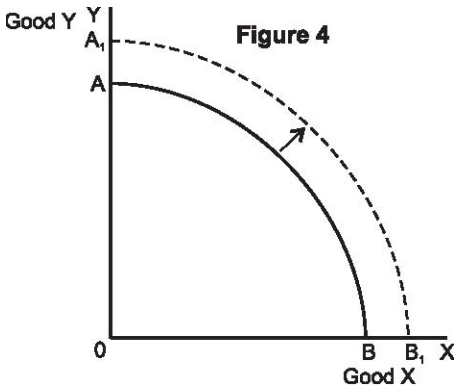


Figure 4

It can also shift, to the left if the resources decrease. It is a rare possibility but sometimes it may happen due to fall in population, due to destruction of capital stock caused by large scale natural calamities, war, etc.

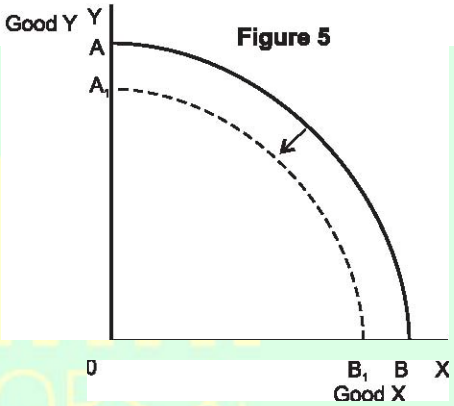


Figure 5

SHARP
TUTORS &
COMPUTERS
WE BREED EXCELLENCE