## **Chapter-01 (Microeconomics)**

#### Introduction

**Ans1:** 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:

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.

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,

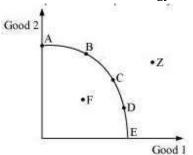
then it is wise to opt for labour-intensive technique so that there is reduction in unemployment.

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.

**Ans2:** 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 utilizing the given technology and available resources.

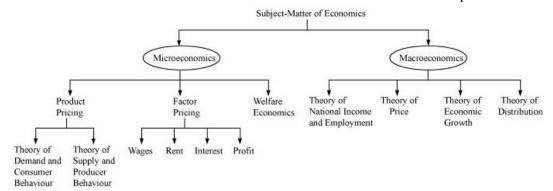
**Ans3:** The production possibility frontier (PPF) refers to a curve that shows various alternative combinations of two goods that can be produced with efficient utilization of the given resources and technology. It is also called production possibility curve (PPC).



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 under utilisation 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.

**Ans4:** 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

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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.

#### Ans5:

	Points of Difference	Centrally Planned Economy	Market Economy
1.	Ownership of factors	Factors of production are	Factors of production
	of production	publically owned; i.e., public	are privately owned.
		ownership.	
2.	Production motive	The motive of production is	The main motive is
		social welfare. Factors of	profit making.
		production are publically	
		owned; i.e., public	
		ownership.	
3.	Governing factor	The production is governed	The production is
		by planning mechanism; i.e.	governed by price
		according to the government	mechanism; i.e., by
		plans.	demand and supply.
4.	Income distribution	The degree of inequality of	There exists unequal
		income is low.	distribution of income.
5.	Government's role	The main role is played by	The main role is played
		the government-from	by private players. They
		production to distribution.	decide what to produce,
			while the role of a
			government is limited to
			maintaining law and
			order in the nation.

**Ans6:** Positive economic analysis refers to the analysis in which we study what is or how an economic problem is solved by analyzing 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.

**Ans7:** 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

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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'.

### Ans8:

	Points of	Microeconomics	Macroeconomics
	Difference		
1.	Study matters	It studies about individual	It studies about an economy as
		economic units like	a whole.
		households, firms, consumers,	
		etc.	
2.	Deals with	It deals with how consumers	It deals with how different
		or producers make their	economic sectors such as
		decisions depending on their	households, industries,
		given budget and other	government and foreign sector
		variables.	make their decisions.
3.	Method	The major microeconomic	The major macroeconomic
		variables are price, individual	variables are aggregate price,
		consumer's demand, wages,	aggregate demand, aggregate
		rent, profit, revenues, etc.	supply, inflation,
			unemployment, etc.
4.	Variables	The major microeconomic	The major macroeconomic
		variables are price, individual	variables are aggregate price,
		consumer's demand, wages,	aggregate demand, aggregate
		rent, profit, revenues, etc.	supply, inflation,
			unemployment, etc.
5.	Theories	Various theories studied are:	Various theories studied are:
		1) Theory of Consumer's	1) Theory of National Income
		Behaviour and Demand	2) Theory of Money
		2) Theory of Producer's	3) Theory of General Price
		Behaviour and Supply	Level
		3) Theory of Price	4) Theory of Employment
		Determination under Different	5) Theory of International
		Market Conditions	Trade