Introduction

Economy

- It is a **system** which provides people :

  Means to work   **Earn a living**

- Enable people to earn an income .
- Help to produce **goods and services** which people require for use.
- Indian Economy consists of **all sources of production** in **agriculture, industry, transport and communication, banking, etc .**

Process of an Economy

- Economy is a system which **provides living to the people.**
- It is necessary that every economy should undertake **three economics activities :**

1. Production

2. Consumption

3. Capital Formation

Scarcity

- It refers to the **limitation of supply** **in relation to demand** for a **commodity .**
- When **wants exceed** the available resources.
- As a result, **goods are not readily available and society does not have enough resources to satisfy all the wants of its people.**
- Scarcity is **universal,** every individual, organisation and economy faces scarcity of resources.

For Example :

- Petrol is scarce in relation to its demand. But there is one more problem. In addition to its scarcity, it is used not only in vehicles, but also in machines, railway engines, airlines, generation, etc .

Economic Problem

- Human wants are **unlimited**, **but the means to satisfy them are limited.** Therefore, all our wants cannot be fulfilled .
- In order to **maximise satisfaction**, every consumer exercises choice, as to which **goods should be consumed and in what quantity.**
- **Economic problem is a problem of choice involving satisfaction of unlimited wants out of limited resources having alternative uses.**

Reason for Economic Problem

There are three main reason for the origin of economic problem in a country		
Scarcity of resources	Unlimited Human Wants	Alternative uses

(i) Scarcity of Resources :

- Resources **(land, labour and capital etc)** are limited in relation to their **demand and economy** cannot produce all what people wants .
- It is the basic reason for **existence of economic problems** in all economies.
- Scarcity is **universal** and applies to all **individuals, organisation and countries.**

(ii) Unlimited Human Wants :

- Human wants are **never ending** i.e they can never be fully satisfied.
- As soon as want is satisfied, another new want emerges.
- Human wants also **differ in priorities,** i.e. all wants are not of equal intensity.

(iii) Alternate Uses :

- Resources are **not only scarce**, but they can also be put to various uses.
- It makes choice among resources more important.

Central Problems of an economy : (Imp)

There are three main central problem of an economy which are discussed below :

What to Produce	How to Produce	For whom to Produce

- **Production**, **distribution and disposition of goods and services** are the basic **economic activities of life.**

- In the **course of these activities**, **every society has to face scarcity of resources**. Because of this scarcity, every society has to decide how to allocate the scarce resources .

- **It leads to following Central Problems, that are faced by every economy :**

1. What to Produce
2. How to Produce
3. For Whom to Produce

1. <u>What to Produce</u> :

- This problem involves **selection of goods and services** to be **produced and the quantity to be produced** of each selected commodity.

- Every economy has **limited resources** and thus, **cannot produce all the goods .**

- More of one good or services usually means less of others .

The Problem of ' What to produce' has two aspects :

(i) What possible commodities to produce :

- An economy has to **decide**, which **consumer goods (rice, wheat, clothes, etc.)** and which of the **capital goods (machinery, equipments, etc.)** are to be produced.

- In the same way, economy has to make a **choice** between **civil goods (bread, butter, etc) and war goods (guns, tanks, etc)**

(ii) How much to produce :

- After deciding the **goods to be produced**, economy has to **decide the quantity of each commodity**, that is selected.

- It means, it involves a decision regarding the **quantity to be produced**, of **consumer and capital goods, civil and war goods** and so on .

2. How to Produce :

- These problem refers to **selection of technique** to be used for **production of goods and services.**

- A good can be produced using **different techniques of production.**

- By 'technique', we mean which particular combination of inputs to be used .

- Generally, technique are classified as : **Labour intensive technique (LIT) and Capital intensive techniques (CIT)**

- In **Labour intensive technique**, **more labour and less capital** (in the form of machines, etc.) is used.

- In **Capital intensive technique**, there is **more capital and less labour utilisation.**

3. <u>For Whom to Produce</u> :

- This problem relates to the **distribution of produced goods and services** among the individuals within the economy, selection of the category of people who will ultimately consume the goods, whether to produce goods for more poor and less rich or more rich and less poor.

- **Since resources are scarce in every economy, no society can satisfy all the wants.**

Opportunity Cost

- Resources are **scarce,** the society is always forced to make choices .

- To produce more of one good, a certain amount of other goods has to be sacrificed.

- The **true cost** of using **economic resources** in any given project is the **loss of the alternative output** which they might have produced .

- **Opportunity Cost is the cost of next best alternative foregone .**

Meaning of Economic

Economics is a **social science** which studies the way a **society to use its limited resources**, which have alternate uses, to produce **goods and services** and to distribute them among different group of people.

Positive Economics and Normative Economics

Positive Economics :

- Positive economics studies **the facts of life** i.e. it deals with 'things as they are '.
- Positive Economics deals with **what are the economic problems and how are they actually solved .**

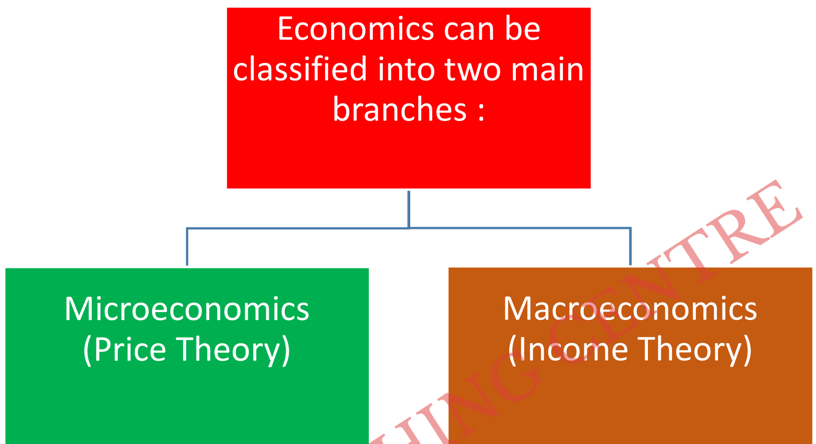
Normative Economics :

- Normative economics tells us **'what ought to be '**
- Normative Economics deals with **what ought to be or how the economic problems** should be solved.
- Normative economics discusses what are **desirable things and should be realised** and what are **undesirable things and should be avoided .**

Difference between Positive Economics and Normative Economics

Basic	Positive Economics	Normative Economics
Meaning	It deals with **what is or how** the **economic problems** are actually solved.	It deals with **what ought to be or how** the economic problems should be solved.
Verification	It **can be** verified with actual data	It **cannot** be verified with actual data
Purpose	It aims to make real description of an economic activity.	It aims to determine the ideals.
Suggestive	It is based upon **facts,** and thus, **not suggestive.**	It is based upon **individual opinion** and therefore, it is **suggestive in nature.**

Value judgement	It **does not** give any value judgement, i.e it is neutral between ends.	It gives value judgements.
Examples	1. Prices in Indian economy are constantly rising 2. There are inequalities of income in our economy.	1. India should take steps to control rising prices. 2. Income inequalities should be reduced.



MICROECONOMICS AND MACROECONOMICS

The subjects matter of economics has been studied under two broad category :

1. Microeconomics (Price Theory)
2. Macroeconomics (Income Theory)

1. Microeconomics :

- **Adam Smith** is considered to be the **founder of the field of microeconomics.**
- The term **' micro'** has been derived from **Greek word ' mikros'** which means **'small'.**
- **Microeconomics** deals with **analysis of behaviour and economic**

action of **small and individual units** of the economy, like a particular consumer, a firm or a small group of individual units.

- The **concept of microeconomics** is very important as it **supplies the foundation** for most of our understanding of the **functioning of an economy.**

- Microeconomics is that part of economic theory, which studies the behaviour of **individual unit** of an economy.

For example:

Individual income, individual output, price of a commodity, etc .
Its main tools are Demand and Supply.

2. Macroeconomics :

- The term **' macro'** has been derived from the **Greek word** **' makros'** which means **'large'.**

- Macroeconomics deals with **overall performance of the economy.**

- It is concerned with study of problems of the economy like inflation, unemployment, poverty, etc.

- Macroeconomics is that part of economic theory which studies the behaviour of **aggregate** of the economy as a whole.

For example:

National income, aggregate output, aggregate consumption, etc .
Its main tools are Aggregate Demand and Aggregate Supply.

Difference between Microeconomics and macroeconomics

Basic	Microeconomics	Macroeconomics
Meaning	Microeconomics is that part of economic theory, which studies the behaviour of	Macroeconomics is that part of economic theory which studies

	individual unit of an economy.	the behaviour of **aggregate** of the economy as a whole.
Tools	Demand and Supply	Aggregate Demand and Aggregate Supply.
Basic Objective	It aims to **determine price of a commodity or factors of production.**	It aims to **determine income and employment level of the economy.**
Degree of Aggregation	It assumes all the **macro variables** to be constant, it assumes that national income, consumption, saving, etc are constant.	It assumes all the **micro variable**, like decision of households and firms, prices of individual products, etc. are constant.
Other Name	Microeconomics is also known as ' **Price Theory** ' as it is primarily concerned with determination of price of commodities and factor of production.	Macroeconomics is also known as '**Income and Employment Theory**' as it is primarily concerned with determination of income and employmen
Examples	**Individual** income, **individual** output	**National** income, **National** Output.

<u>Interdependence of Microeconomics and Macroeconomics</u>

It means, **microeconomics and macroeconomics** are **not independent of each other and there is much common ground between the two**. **It means, both microeconomics and macroeconomics are interdependent.**

<u>Microeconomics depends on Macroeconomics</u>

1. **Law of demand** came into existence from the **analysis of the behaviour of a group (aggregate) of people.**

2. **Price of a commodity** is influenced by the **general price level** prevailing in the economy.

Macroeconomics depends on Microeconomics

1. **National income** of a country is nothing but the **sum total of incomes of individual units** of the country.

2. **Aggregate demand** depends on **demand of individual households** of the economy.

Production Possibility Frontier (PPF)

- PPF is also known by the following names :

1. Production Possibility Curve.

2. Production Possibility Boundary.

3. Transformation Curve.

4. Transformation Boundary.

5. Transformation Frontier.

- It refers to the **graphical presentation** of **possible combination** of **2 goods** which can be **produced** with given **resources and technology.**

Assumptions for PPF :

- Resources in an **economy is fixed.**
- With given resources, **only 2 goods can be Produced.**
- Resources are **fully and efficiently utilised.**

- Level of **technology** is assumed to be **constant.**

Example:

Combination	**Bread (in units)**	**Butter (in units)**	**MOC**
A	15	0	-
B	14	1	1/1=1
C	12	2	2/1 = 2
D	9	3	3/1 =3
E	5	4	4/1 =4
F	0	5	5/1 =5

(Diagram 1.1)

Marginal Opportunity Cost (MOC)

- MOC refers to the **number of units** of a **commodity sacrificed** to **gain one additional unit of another commodity.**

- **In case of PPF, MOC is always increasing**, i.e. more and more units of a commodity have to be sacrificed to gain an additional unit of another commodity.

Marginal Rate of Transformation (MRT)

- MRT is the **ratio** of **number of units** of a commodity **sacrificed to gain an additional unit** of another commodity.

$$\text{MRT} = \frac{\text{Units Sacrificed}}{\text{Units Gained}}$$

Characteristics or properties of PPF

The **two basic characteristics** or features or properties of PPF are :

1. <u>PPF slopes Downwards</u> :

- PPF slopes **downwards** from left to right because there **exists an inverse relationship** between change in **quantity of one commodity and change in quantity of the other commodity .**

- In other words **more of one good** can be produced only taking **resources away from production of another good.**

2. <u>PPF is Concave Shaped</u> :

- PPF is concave shaped because of **increasing marginal rate of cost (MOC)** i.e. more and more units of one commodity are sacrificed to gain an additional unit of another commodity.

- If the resources are **increasing** then **curve shift toward rightward** and if the resources are **decreasing** then **shift toward leftward.**

Whether Economy will Always Operate on PPF ?

The exact point of operation depends on how well the resources of the economy are used.

1. Economy will operate on PPF only when resources are fully and efficiently utilized.

2. Economy will operate at any point inside PPF if resources are not fully and efficiently utilized.

3. Economy cannot operate at any point inside PPF as it is unattainable with the avalable productive capacity.

Attainable and Unattainable Combination

Attainable Combination :

- It refers to those combinations at which economy can operate .

There can be **two attainable options**

1. Optimum utilisation of resources :

- If the resources are used in the best possible manner, then economy wil operate at any point (like A, B, C or D) on PPF.

(Diagram 1.2)

2. Inefficient utilisation of resources :

- However, the **actual production can fall short** of its capabilities. If there is wastage or inefficient utilisation of resources, then economy will operate at any point **inside the PPF** (like E).

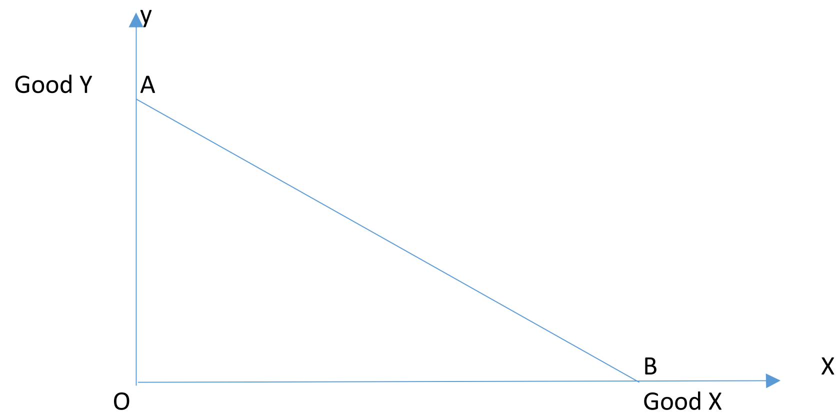
Unattainable Combination :

- With the given amount of available resources, it is impossible for the economy to produce any combination more than the given possible combination i.e. an economy can never operate at any point **outside the PPF** (like F).

Can PPF be a straight line ?

- PPF can be a **straight line** if we assume that **MRT is constant**, i.e. same amount of a commodity is sacrificed to gain an additional unit of another commodity.

- It is possible only when we assume that all the resources are equally efficient in production of all goods.

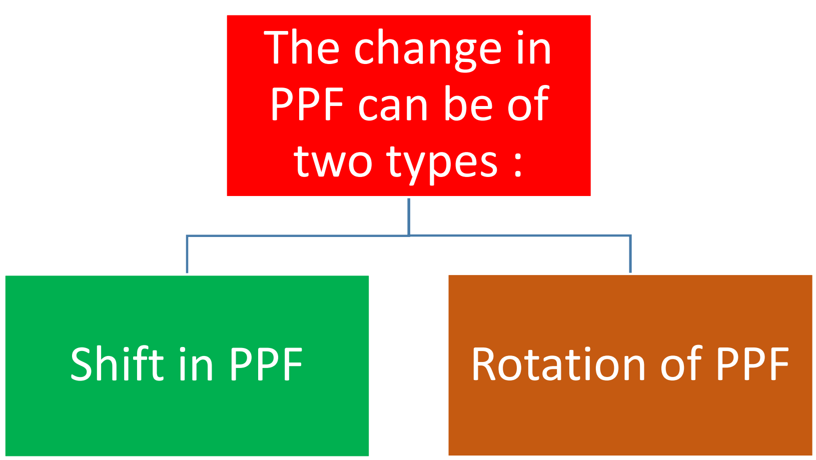


Can PPF be Convex to the Origin ?

- PPF can be convex to the origin if **MRT is decreasing**, i.e. less and less units of a commodity are sacrificed to gain an additional unit of another commodity. In such case, PPF will be a convex shaped curve .

(Diagram 1.3)

Change in PPF



- PPF is based on the **assumption**, that resources of an economy are fixed.

- However, in this changing world, the **productive capacity** of an economy is **constantly changing** due to **increase or decrease** in resources.

- Such changes in resources lead to change in PPF.

- The **change in PPF** indicates either an **increase or** a **decrease** in the productive capacity of the economy.

- **The change in PPF can be of two types :**

1. Shift in PPF :

- PPF will shift toward right or left, when there is **change in productive capacity (resources or technology)** with respect to **both the goods.**

2. Rotation of PPF :

- PPF will rotate when there is **change in productive capacity (resources or technology)** with respect to **only one good.**

1. Shift in PPF :

- The PPF can shift either towards **right or towards left**, when there is change in resources or technology with respect to both the goods.

(i) Rightward shift in PPF :

- When there is " **Upgradation of technology** " and " **Growth of Resources** " in respect to **both the goods**, then PPF will **shift to the right .**

(Diagram 1.4)

For example :

- If there is increase in resources for production of butter and guns, we can produce more of both the goods.

(i) Leftward shift in PPF :

- PPF will **shift toward left**, when there is a **technological degradation and decrease in resources** with respect to both the goods.

(Diagram 1.5)

For example :

- If there is increase in resources for production of butter and guns, we can produce more of both the goods.

2. Rotation of PPF :

- It happens when there is change in productive capacity (resources or technology) with respect to only one good.
- The rotation can be either for the commodity on the **X-axis or** for commodity on **Y-axis** .

(i) Rotation for commodity on the X-axis :

- When there is a **technological improvement or an increase in resources** for production of the commodity on the **X-axis (say, butter)**, then PPF will rotate from **AB to AC** .

- However, in case of **technological degradation or decrease in resources** for production of butter, PPF will rotate to the **left** from **AB to AD.**

(Diagram 1.6)

(ii) Rotation for commodity on the Y-axis :

- A **technological improvement or an increase in resources** for production of commodity on **Y-axis (say, guns)**, will rotate the PPF from **AB to CB.**

- However, in case of **degradation in technology or a decrease in resources** for production of guns., PPF will rotate to the **left** from **AB to DB .**

(Diagram 1.7)

Overview of PPF

1. PPF slopes **downwards**, as an **increase in production of one good** requires **decrease in production of the other.**

2. PPF is **concave shaped** due to **increasing MRT .**

3. PPF shows **transformation of one good into another**, not physically, but by diverting resources from one use to the other.

4. PPF shows the **maximum available possibilities**. The exact point of operation depends on how well the resources of the economy are used.

5. If the **economy operates on PPF (like points A, B or C)**, it means resources **are not fully and efficiently utilised.**

6. If the **economy operates at any point inside PPF (like point'D') ,** it means resources are **not fully and efficiently utilised.**

7. Economy **cannot operate** at any point **outside PPF (like point 'E')** , as it is unattainable with the available productive capacity.

8. An **outward shift** in **PPF from P1P1** means, that the economy can produce more of both the commodities, which was not possible earlier.

9. An **inward shift** in **PPF from PP to P2P2** means, that the

economy capicity to produce both the commodities has reduced.

(Diagram 1.8)

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