CHAPTER 1

INTRODUCTION

- **Economics** is the study of mechanism that an economy or a society uses to make choices and to allocate the scarce resources to the areas with maximum possible and optimum returns. Economics is about how an individual or a particular society makes these decisions regarding their choices.
- The need for economics stems from the basic problem of scarcity and choice. The basic concern of economics is to allocate the scarce resources to the best possible use in the face of unlimited wants.
- **Positive statements**

  These are factual and objective statements, and describe what was, what is and what would be. These statements can be tested, proven or disproven and does not include personal value judgments.
- **Normative Statements**

  These describe what should be or what ought to be. These statements cannot be tested. These involve personnel value judgments and are usually debatable in nature. These statements are subjective in nature.
- **Examples of positive and normative statements**

  'Indian stock market has boomed in recent years' is an example of positive statements.

  'Indian government should make legal formalities for foreign investors less-stringent' is an example of normative statements.
- **Microeconomics and Macroeconomics**

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 Demand 2) Theory of Producer's Behaviour and Supply 3) Theory of Price Determination under Different Market Conditions	Various theories studied are: 1) Theory of National Income 2) Theory of Money 3) Theory of General Price Level 4) Theory of Employment 5) Theory of International Trade
6. Popularised by	Alfred Marshall	Keynes

❖ Scarcity of Resources & Problem of Choice

The resources available to any economy are always limited and are never sufficient to meet the unlimited demands of everyone. Further, these scarce resources have alternative uses, and can be allocated in the production of different goods and services.

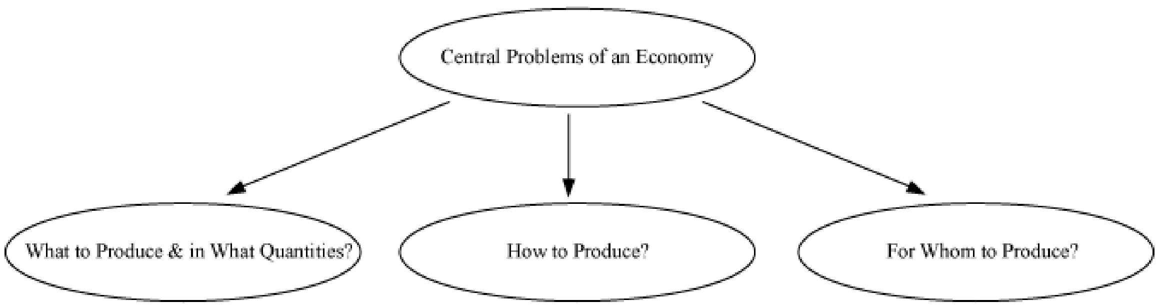
The economy need to analyse the opportunity cost of the resources and choose as to which use of resources will benefit the economy the most.

Thus, due to the scarce availability of resources with alternative uses and simultaneously unlimited wants, we confront the problem of choice. We can say that the choice is the consequence of the problem of scarcity of resources. For example, one cannot buy both TV and refrigerator with Rs 10000.

❖ Central Problems of an Economy

Due to problem of allocating the scarce resources to their alternative uses and the problem of choice, every economy faces mainly three central problems. These are:

1) What to produce?
2) How to produce?
3) For whom to produce?



❖ Labour Intensive Technique

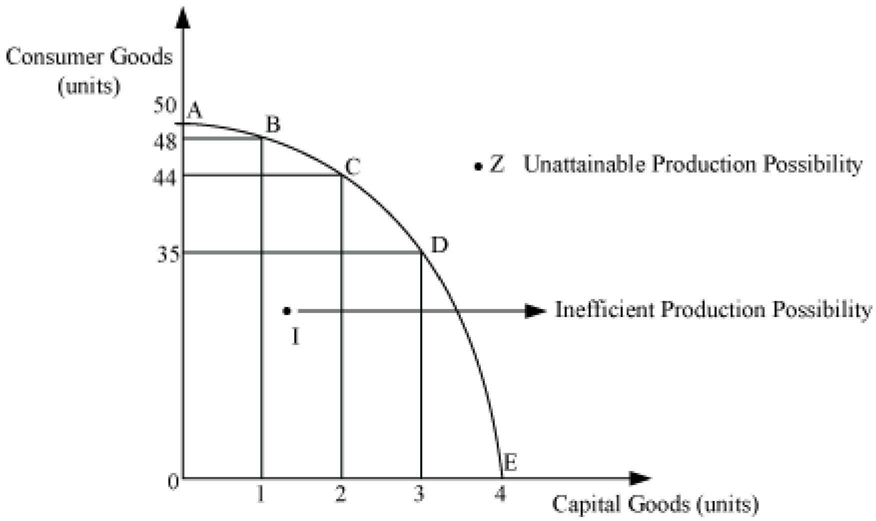
The production process in which labour is used comparatively more than capital or machine is called labour intensive technique of production. Example for the same can be activities related to agriculture.

❖ Capital Intensive Technique

The production process in which capital is used comparatively more than labour is called capital intensive technique of production. For instance, production of durables goods like T.V, refrigerator, vehicles, etc employs capital intensive production technique.

❖ Production Possibility Curve (PPC)

It is a curve which shows combinations of two goods and services, that can be produced with full utilisation of a given amount of resources in their most efficient way and with the given production technology. It is also called production possibility frontier (or PPF).



Production Possibility Curve

- **Opportunity Cost (Economic Cost)**

  If the economy decides to use resources in the production of one good (say consumer goods) then it needs to forego or sacrifice some amount of other goods (say capital goods) as the resources will be withdrawn from the production of capital goods and will be employed in the production of consumer goods. The cost of enjoying more of one good in terms of sacrificing the benefit of other goods is called opportunity cost of the additional unit of the first good. It is also known as economic cost.

- **Production Possibility Schedule**

  The schedule which depicts the various possibilities of production of consumer and capital goods is known as production possibility schedule.

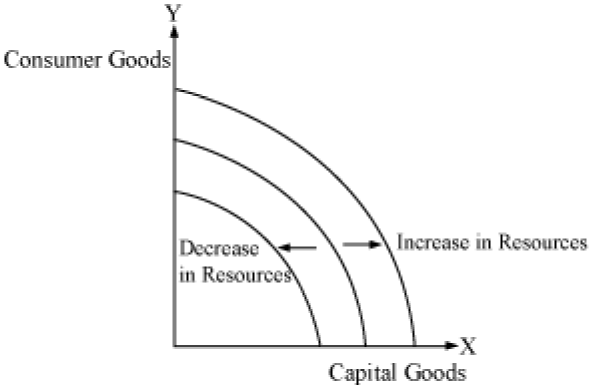
- **Shifting and Rotation of PPC**

  PPC of any economy depends on two factors:

  1) Quantity and quality of productive resource endowment
  2) Level of technology

1) Change in Endowment of Resources

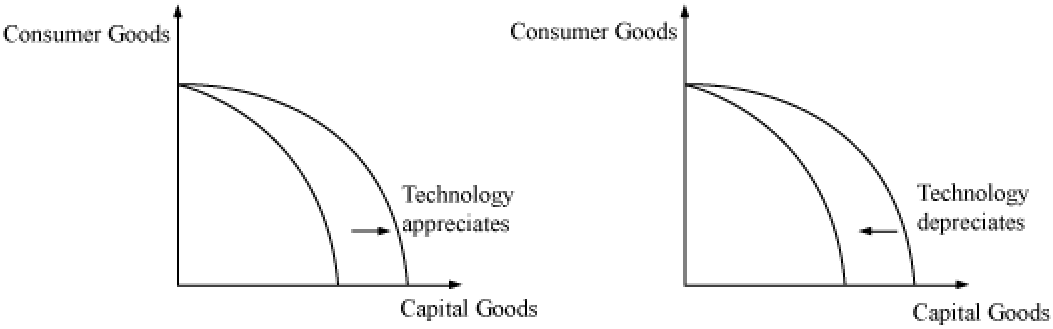
If resource availability in the economy increases (decreases) then the PPC will shift outwards (inwards) to the right (left).



2) ***Change in Technology***

***a) Change in technology in production of capital goods*:-**

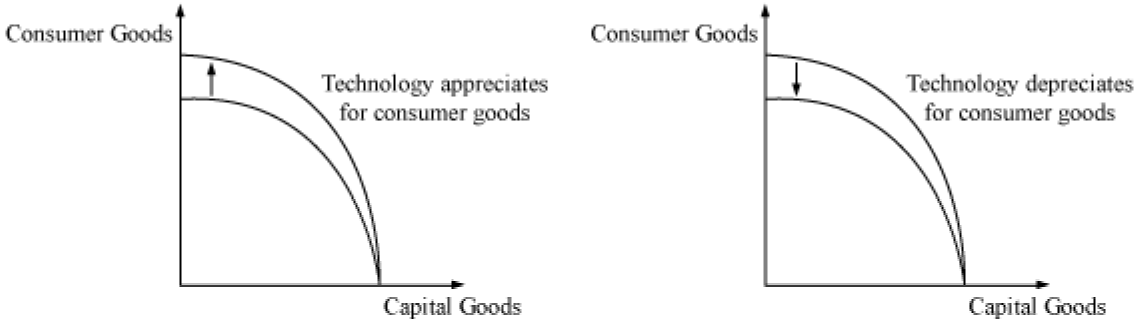
If the technology employed in the production of capital goods appreciates (depreciates), then the production of capital goods will be more (less) with the same level of resources or inputs and PPC pivots outwards (inwards) with the same vertical intercept.



Change in Technology in Production of Capital Goods

b) Change in technology in production of consumer goods

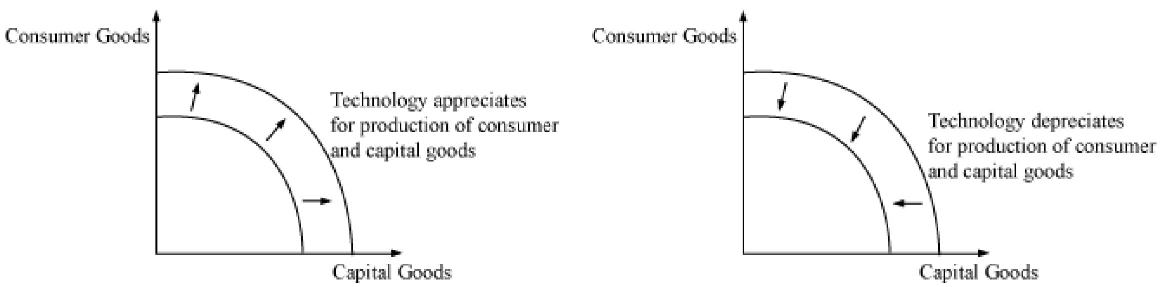
If the technology employed in the production of consumers good appreciates (depreciates), the PPC pivots outwards (inwards) along the same horizontal intercept. The economy has more (less) amount of consumer goods if the technology appreciates (depreciates) with the same level of productive resources.



Change in Technology in Production of Consumer Goods

c) Change in technology in production of both the goods

If the technology employed in the production of both the goods appreciates (depreciates) then the economy has more (less) of both the goods – consumer and capital goods. The PPC curve shifts outwards (inwards) to the right (left).



Change in Technology in Production of Both Goods – Consumer and Capital Goods

❖ Economic Activity

An activity which involves the use of scarce resources for the production of goods and services for the fulfillment of the satisfaction of human wants is called an economic activity. For example, consumption, investment, etc.

❖ Classification of Economic Activity

Based on the nature of economic activities economies can be classified as:

1) Market Economy

2) Centrally Planned Economy
3) Mixed Economy

❖ Market Economy/Capitalist Economy

1) The capitalists or the private entrepreneurs, who own capital, organise and undertake production with the sole motive of profit making.
2) They are guided by profit motive.
3) The role of government is required only for defence and to maintain law and order. Besides this, the government does not interfere in the economic activities.
4) This system is known as free market economy or *laissez-faire* system.
5) Price mechanism plays an important role in determining what to produce, how to produce and for whom to produce. Price reflects the valuation and need of the society for a particular good or service.
6) Price acts as a signal for the capitalists.
7) For example, the economy of Britain during the industrial revolution period is classified as a market economy.

❖ Centrally Planned Economy

1) Central authority or state plans and organises all important economic activities.
2) The state controls, owns and manages the production units. It also decides and controls the distribution of goods and services among the population in the pattern that the state feels desirable.
3) Central planning plays an important determining role.
4) The private entrepreneur has no role to play and everything is determined by the state.
5) The main focus is to enhance social welfare and service.
6) For example, Soviet Union had centrally planned economy for a major part of the twentieth century.

❖ Mixed Economy

1) Both private and public sectors works side by side.

2) The private sector is free to choose its production line but is simultaneously governed by the public sector.
3) State (government) interferes in the private sector activities in order to safeguard the interests of workers and consumers and. It also ensures social justice along with accomplishing higher growth rate.
4) While the state owns the core and base industries, the less important industries are owned by the private sector.
5) The state also keeps a keen watch and tries to curtail the formation of monopolies and price rigging, manipulation and unfair trade practices. India is a mixed economy.