MS4002D Industrial Economics: Understanding Economy

Economy

- Economy
  - Govt
  - Consumers/Households
  - Businessmen
  - Resources
  - Banker
  - Investors
  - Extraneous factors

Main Economic Activities

- Production
- Consumption
- Capital formation

Factors of Production

- Land
- Labour
- Capital
- Entrepreneurship

Economic System

- Capitalism
- Socialism
- Mixed economy

Central problems of an economy

- What to produce?
  - should the emphasis be on agriculture, manufacturing or services, should it be on health, manufacturing or housing?
- How to produce?
  - labour intensive, land intensive, capital intensive?
- Whom to produce?
  - Should income distribution be evenly distributed?
  - Whether to produce for domestic territory or to have trade relations

Buzz words

- Opportunity Principle
- Discounting
- Production Possibility Curve
- Time perspective

Opportunity Principle

- Cost of next best alternative foregone
- Definition – the cost expressed in terms of the next best alternative sacrificed
- Helps us view the true cost of decision making
- Implies valuing different choices
- Highest valued benefit that must be sacrificed as a result of choosing an alternative

Opportunity cost

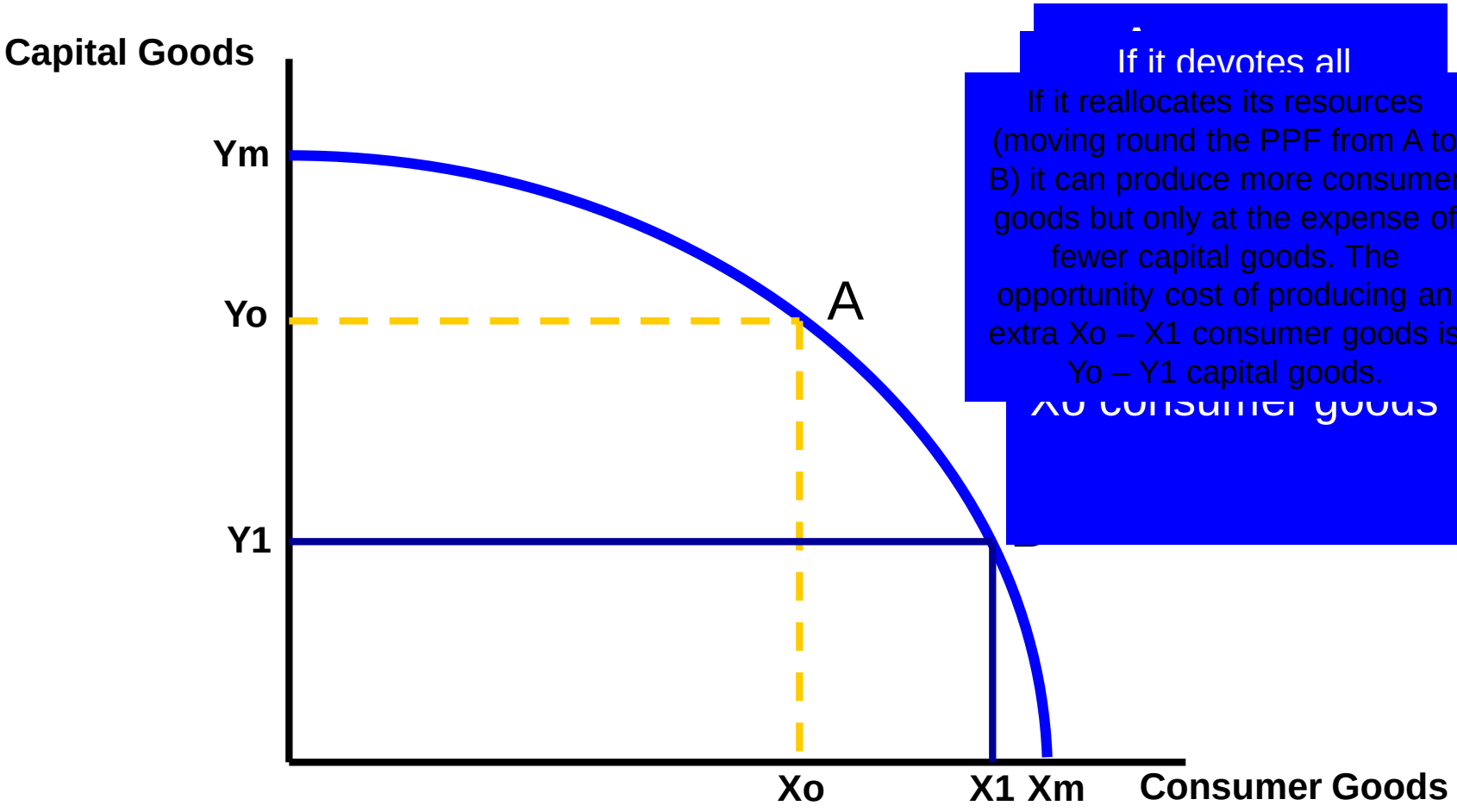
- Suppose a machine can produce either X or Y. The opportunity cost for producing a given quantity of X is the quantity of Y,which the resource would have produced.

- If the machine can produce 10units of X and or 20 units of Y, the opportunity cost of 1x is 2Y.

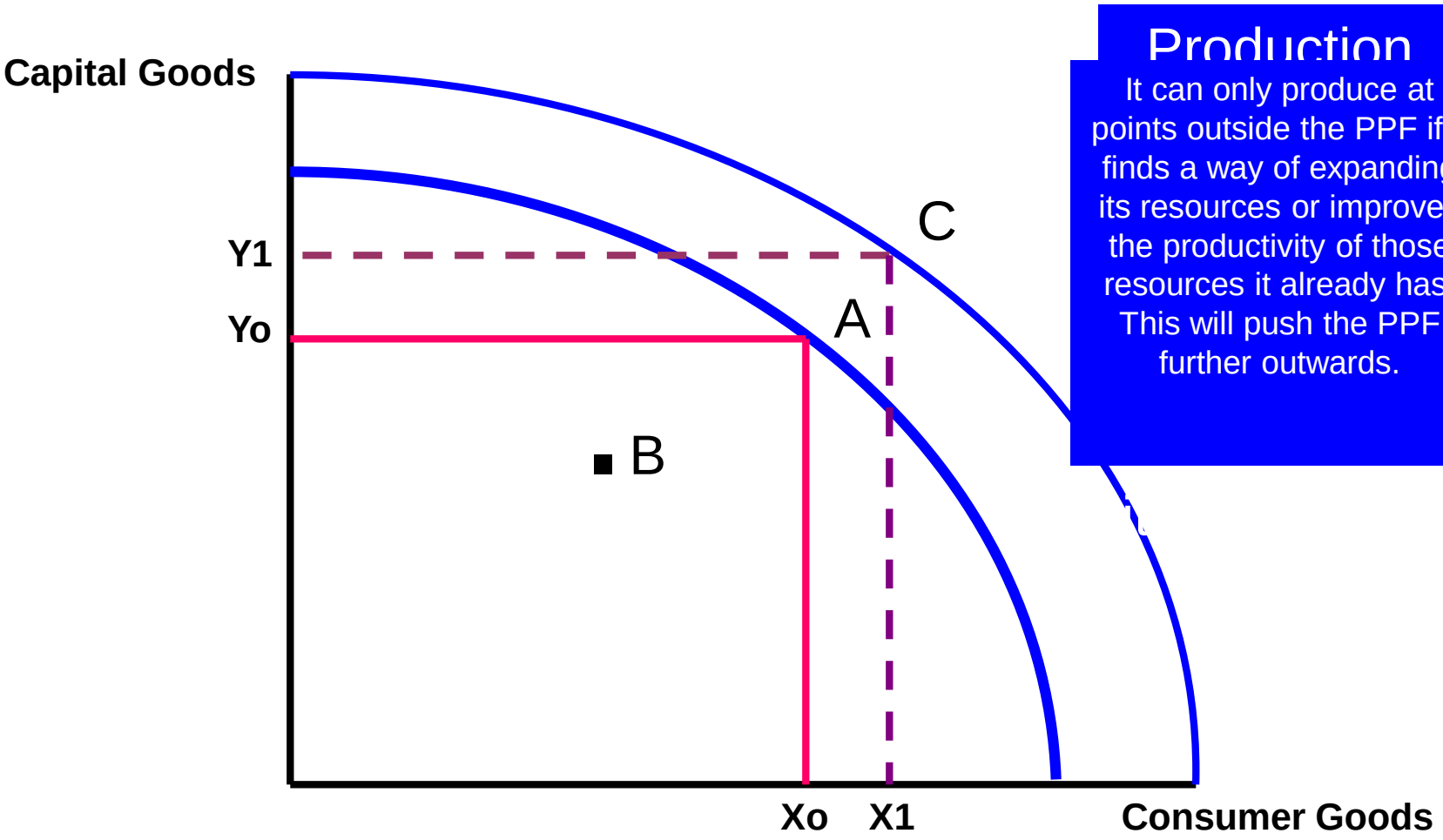
Production Possibility Frontiers

- Show the different combinations of goods and services that can be produced with a given amount of resources
- No ‘ideal’ point on the curve
- Any point inside the curve – suggests resources are not being utilised efficiently
- Any point outside the curve – not attainable with the current level of resources
- Useful to demonstrate economic growth and opportunity cost

Production Possibility Frontiers



Production Possibility Frontiers



Production

It can only produce at points outside the PPF if it finds a way of expanding its resources or improves the productivity of those resources it already has. This will push the PPF further outwards.

Discounting

- The concept of discounting is based on the fact that a rupee now is worth more than a rupee earned a year after.

- Even if one is sure about future income, yet it has to be discounted because to wait for future implies a sacrifice for the present

- Suppose a sum of Rs 100 is due after one year. Let the rate of interest be 10 percent. Then we can determine the sum to be invested now so as to produce the return (R) of Rs 100 at the end of the year. The present value or the discounted values of Rs100 will then be

$$V1 = \frac{R}{(1+i)}$$

V1 = Future value of a sum of Rupees after a year,R= Present sum of money I =Interest rate

Discounted value of money

$$\frac{V_1}{(1+i)}$$

$$= \frac{100}{(1+.10)}$$

$$= \text{Rs.}90.90$$

A present value of Rs100 due two years later would be

$$V_2 = \frac{\text{Rs}100}{(1+.10)^2} = 82.64$$

Time perspective

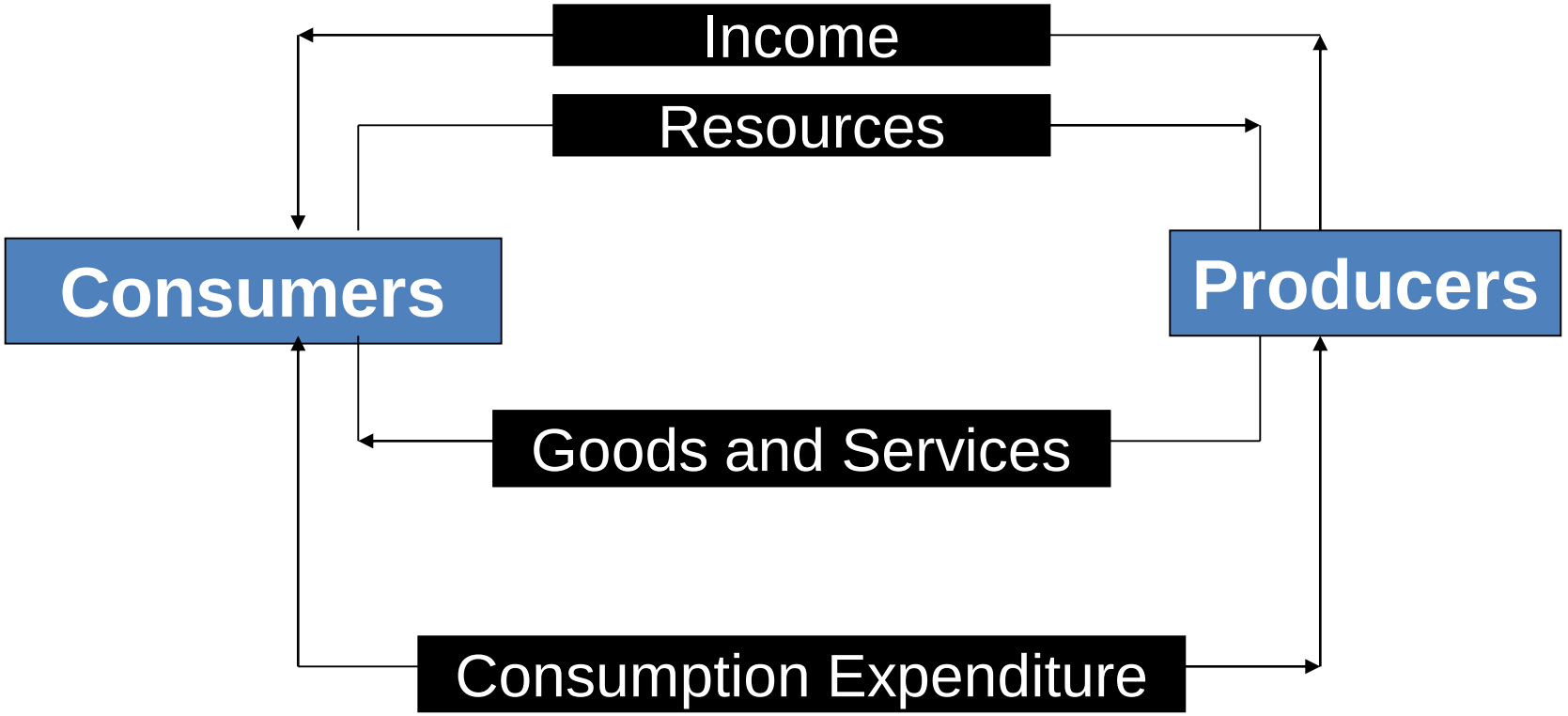
- Short run Versus long run
  - Very short run
  - Short run
  - Long run

    - Fixed versus variable costs of production

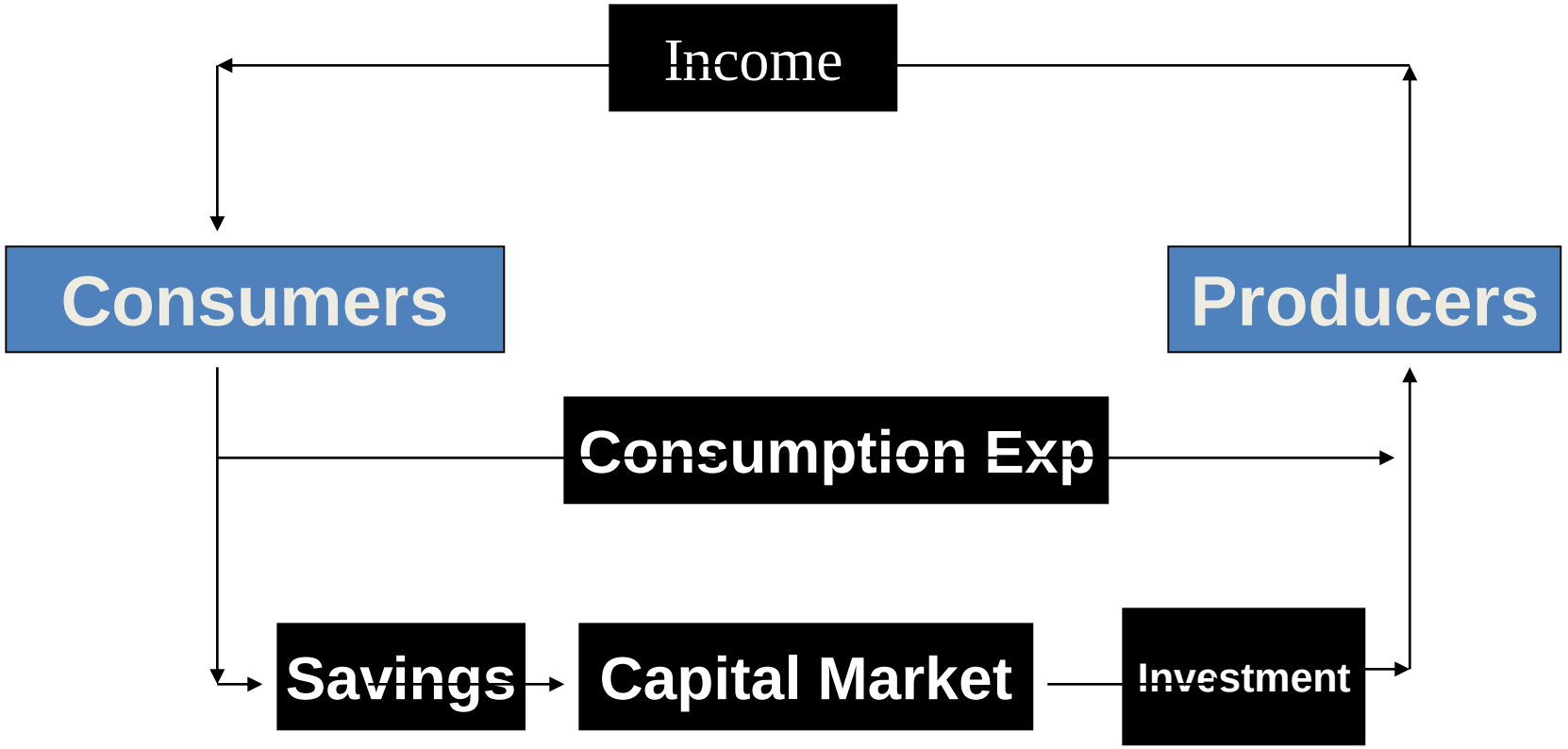
Circular Flow - Simple

- Assumptions:
  - Only two sectors - **Consumers** and **Producers**
  - **All** production is sold to the consumers
  - **Producers** provide all the Goods and Services
  - **Consumers** spend all their Income on goods an services
  - **No** government and **no** overseas sectors
  - **Consumers** are the owners of productive **resource -** land, labour, capital and enterprise

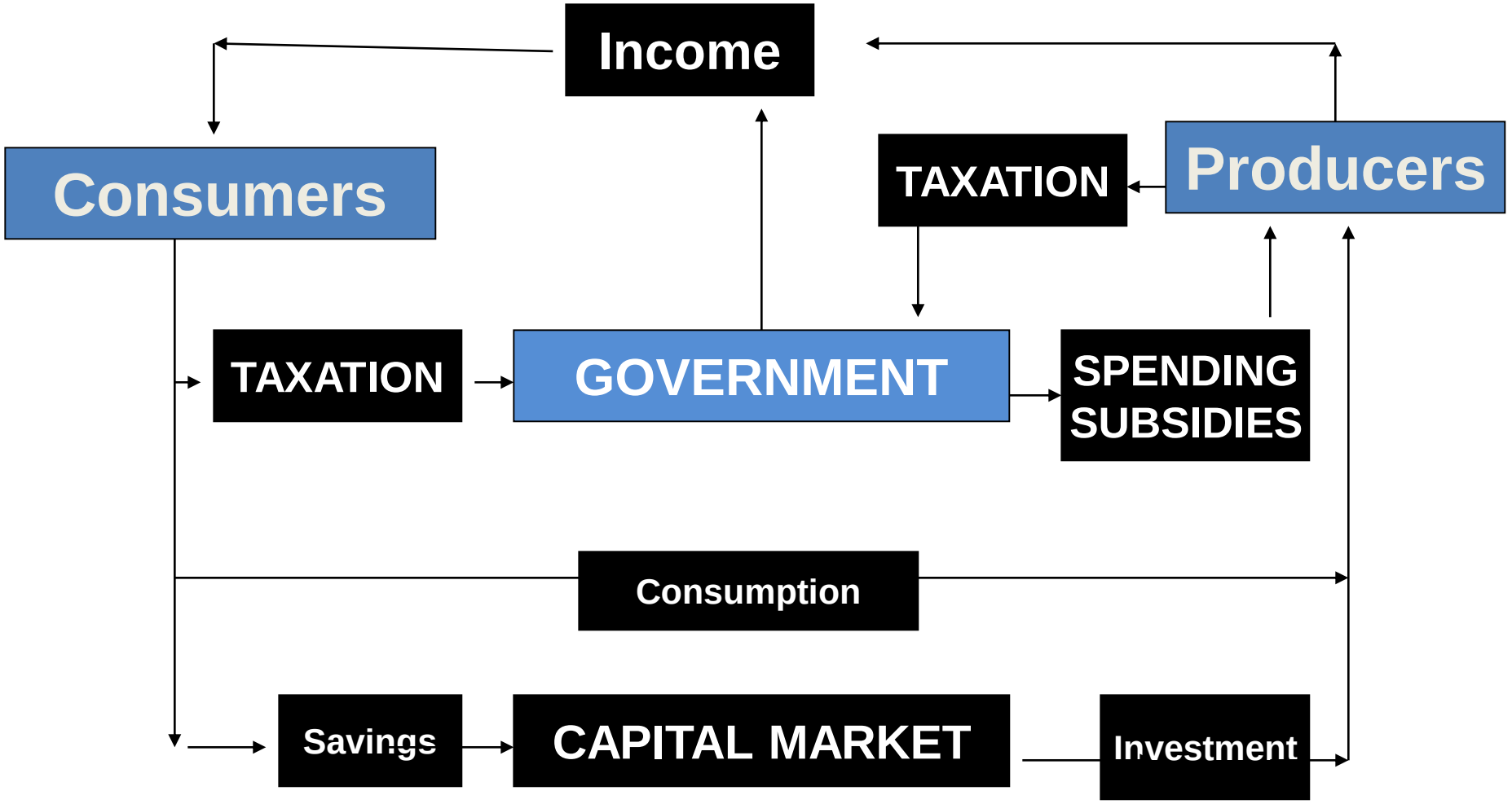
Circular Flow – Simple Two Sector model



Circular Flow - Savings and Investment



Circular Flow - Government Sector
Three Sector Model



Circular Flow - Four Sectors