PARMAR SSC

Microeconomics

Lecture - 2



BY PARMAR SIR

INTRODUCTION TO MICROECONOMICS& FUNDAMENTAL CONCEPTS

Central Problem of Economics

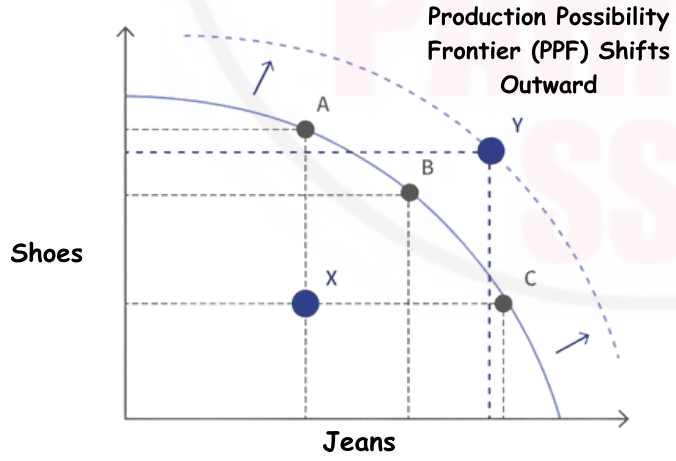
- The fundamental problem of economics arises from the conflict between limited resources and unlimited human wants.
  - **Scarcity:** Resources (money, land, labor, time) are finite.
  - **Choice:** Because resources are limited, an economy cannot produce everything. It must choose how to allocate resources effectively.

Production Possibility Curve (PPC)

- **Definition:** A curve depicting all maximum possible combinations of two goods that an economy can produce with available resources and technology, assuming full and efficient utilization. Also known as the Production Possibility Frontier (PPF).

Example (Budget Constraint):

- Imagine a person has ₹6000.
- Option A: Buy 6 pairs of shoes (₹6000) and 0 jeans.
- Option B: Buy 6 pairs of jeans (₹6000) and 0 shoes.
- **Inverse Relationship:** As spending on one product increases, funds available for the other decrease.



- **On the curve:** Full and efficient utilization of resources (e.g., spending the full ₹6000).
- **Inside/Below the curve:** Under-utilization of resources (e.g., spending only ₹4000 out of ₹6000).
- **Outside/Above the curve:** Unattainable/Not achievable with current limited resources (e.g., trying to spend ₹7000 when you only have ₹6000).

Graph Characteristics:

- It shows the trade-off between two goods (e.g., Shoes and Jeans).
- **Slope:** Downward sloping (Negative slope) because to produce more of one good, you must produce less of the other due to limited resources.
- **Shape:** Concave to the origin. This is due to the increasing Marginal Rate of Transformation (MRT)—you sacrifice more of one good to gain an extra unit of the other.

Marginal Rate of Transformation (MRT):

- The slope of the PPC is determined by the MRT.
- It represents the amount of one good that must be sacrificed to produce one extra unit of another good.

Opportunity Cost

Definition:

- Opportunity cost is the value of the next best alternative that is foregone (given up) when making a choice.

Example:

1. If you choose to buy jeans instead of shoes, the shoes you didn't buy are the opportunity cost.
2. If you choose to prepare for SSC exams instead of a banking job, the banking job is the opportunity cost.

Free Goods:

- Goods like air and sunlight have **no opportunity cost** because they are abundant in nature and not scarce. No sacrifice is needed to obtain them.

Utility Analysis

- Utility is the satisfaction or benefit derived from consuming a good or service.

Types of Utility Measurement

1. **Cardinal Utility:** Satisfaction is measured in numerical values (Quantitative). Less realistic.
2. **Ordinal Utility:** Satisfaction is ranked (Qualitative/Psychological). More realistic.

Marginal Utility (MU)

- The additional satisfaction gained from consuming one extra unit of a commodity.

Law of Diminishing Marginal Utility

- As a consumer consumes more units of a good continuously, the additional satisfaction (MU) from each successive unit decreases.
  - **Example (Golgappa/Panipuri):** The first Golgappa gives immense joy. By the 10th one, the "maza" (fun/satisfaction) drops significantly.





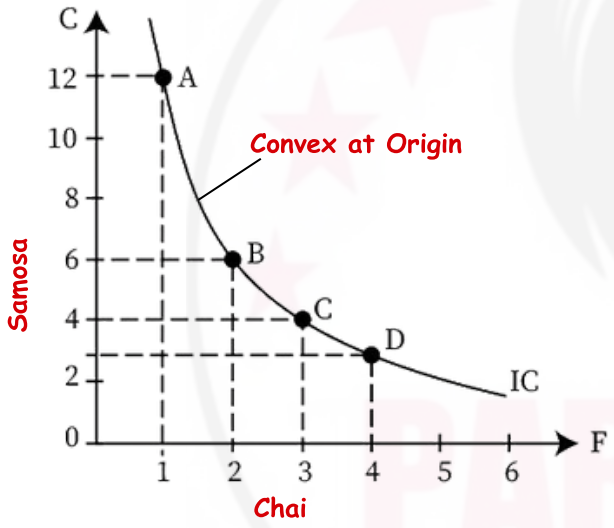
Indifference Curve (IC)

Definition

A graph showing different **combinations of two goods that provide the consumer with the same level of satisfaction.** The consumer is "indifferent" (equally happy) with any point on the curve.

Properties

- **Shape:** Convex to the origin (Rectangular Hyperbola).
- **Slope:** Determined by the **Marginal Rate of Substitution (MRS)** = $\frac{\Delta \text{Sacrifice}}{\Delta \text{Gain}}$) —the rate at which a consumer is willing to give up one good for another to maintain the same satisfaction.
- **No Intersection:** Two ICs never intersect.



A Consumer's indifference curve

The "Chai & Samosa" Combination

Scenario: You love both Chai and Samosas. You are equally happy (indifferent) with any of these combinations:

Combo A: 1 Chai + 12 Samosas (Starting point).

Combo B: You want a 2nd Chai. You are willing to sacrifice 6 Samosas to get it. New Total: 2 Chai + 6 Samosas.

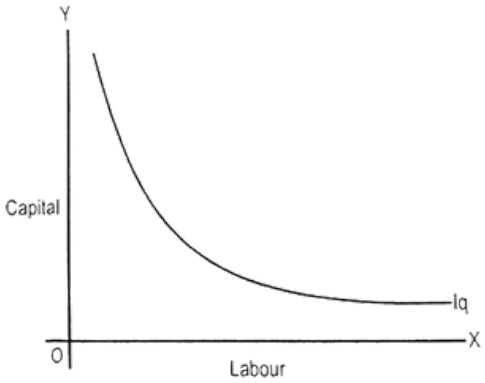
Combo C: You want a 3rd Chai. Since you have fewer Samosas left, you are only willing to sacrifice 2 Samosas. New Total: 3 Chai + 4 Samosas.

Combo D: You want a 4th Chai. You value your remaining Samosas highly, so you only sacrifice 1 Samosa. New Total: 4 Chai + 3 Samosas.

Conclusion: You are willing to give up less and less of one good to get more of the other. This decreasing rate is why the curve is convex (bends inward).

Isoquant Curve

- **Definition:** A curve showing combinations of inputs (e.g., Labor and Capital) that produce the same quantity of output.
- **Slope:** Marginal Rate of Technical Substitution (MRTS).



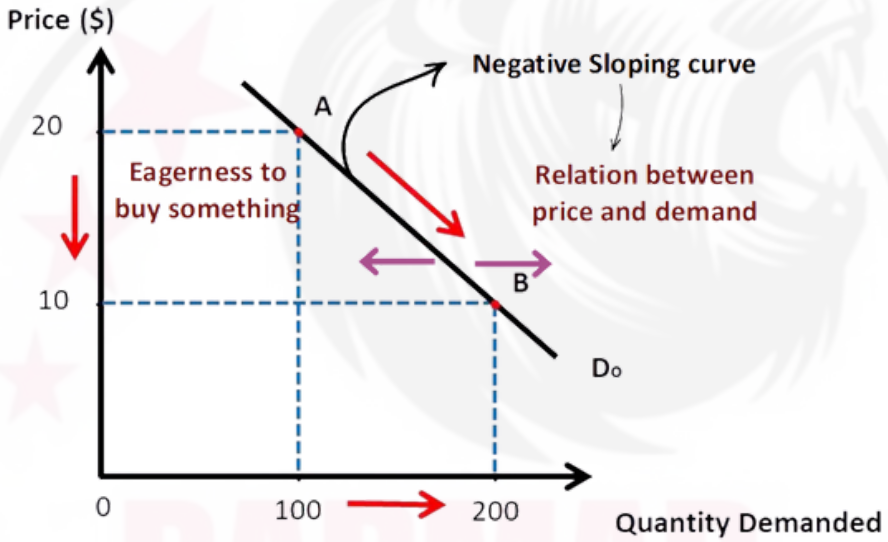
Demand

Definition

- The quantity of a good or service that consumers are willing and able to buy at a particular price during a specific period of time (willingness + ability).

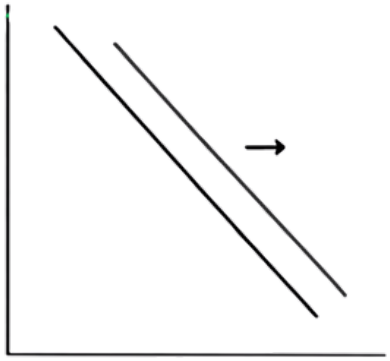
Demand Curve

- There is an inverse relationship between Price and Quantity Demanded (keeping other factors constant, i.e., Ceteris Paribus — such as Income, Price of other goods, and Consumer Preferences).
  - **Price ↑ → Demand ↓**
  - **Price ↓ → Demand ↑**

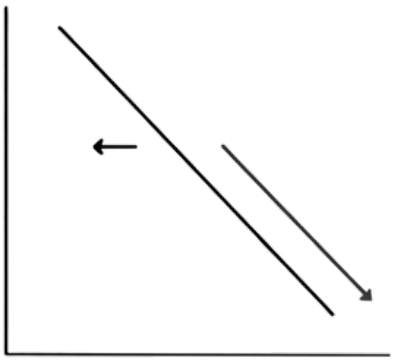


Movement vs. Shift

1. **Movement (Along the curve):** Caused by a change in Price.
   - Expansion/Contraction of demand.
2. **Shift (Of the curve):** Caused by factors other than Price (e.g., Income, Preferences).
   - Rightward Shift: Increase in demand.
   - Leftward Shift: Decrease in demand.



Curve Shift to the Rightward



Curve Shift to the Lefttward

Exceptions to Law of Demand

- **Giffen Goods:** Giffen goods are low-income, non-luxury, and essential products (like rice or bread) that defy the standard law of demand. Demand for these items rises as their price increases and falls when the price decreases.
- **Veblen Goods:** Luxury goods driven by status (Snob effect).
  - Example: iPhone, Mercedes. Higher price makes them more desirable for show-off.

Supply

Definition

- The amount of a product or service that producers are willing and able to provide at a given price during a specific period.

Supply Curve

- There is a direct (positive) relationship between Price and Quantity Supplied.
- **Price ↑ → Supply ↑** (Producers want to maximize profit).



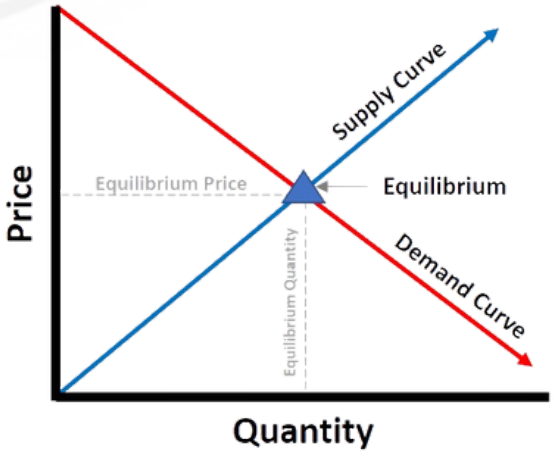
Why is the Curve Upward Sloping?

Reason: Producers want to maximize profit. They produce more when they get a better price for their product.

Equilibrium

- **Definition:** The point where the Demand Curve intersects the Supply Curve.
  - **At this point:** Quantity Demanded = Quantity Supplied.
  - This determines the "Equilibrium Price" or Market Clearing Price.
- **Effect of Shifts**
  - Equilibrium is not static; it shifts if any factor (Demand or Supply) changes.
  - Example: If Demand increases, the curve shifts to the right, changing the equilibrium point.

Supply and Demand Curve



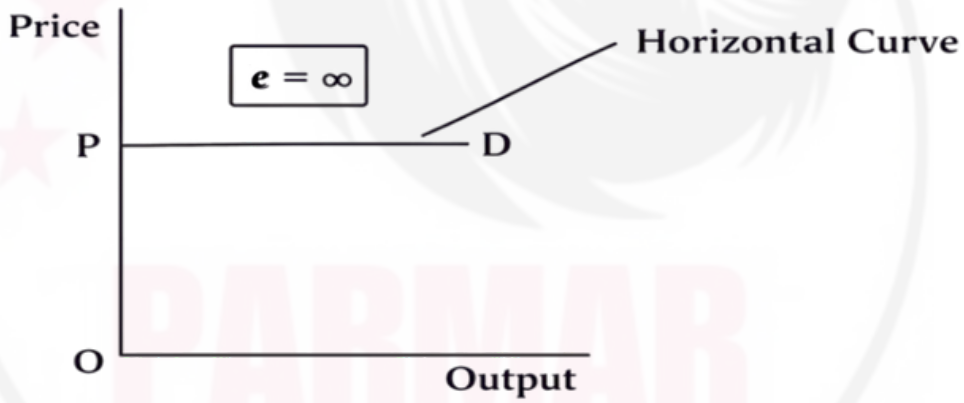
Price Elasticity

- Price elasticity of demand measures how much the quantity demanded of a good or service changes in response to a change in its price.

$$E_d = \frac{\%\ \text{Change in Quantity Demanded}}{\%\ \text{Change in Price}}$$

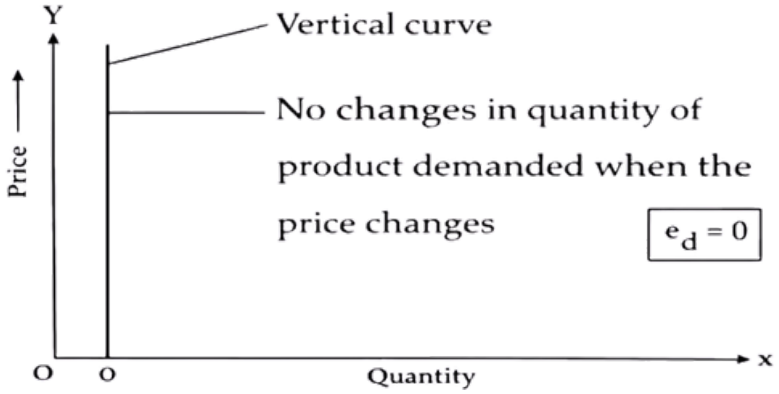
Perfectly Elastic Demand

- In perfectly elastic demand, a small rise in price results in a fall in demand to zero, while a small fall in price causes an increase in demand to infinity. In such a case, the demand is perfectly elastic.
- E.g., luxury products such as gold and cars.



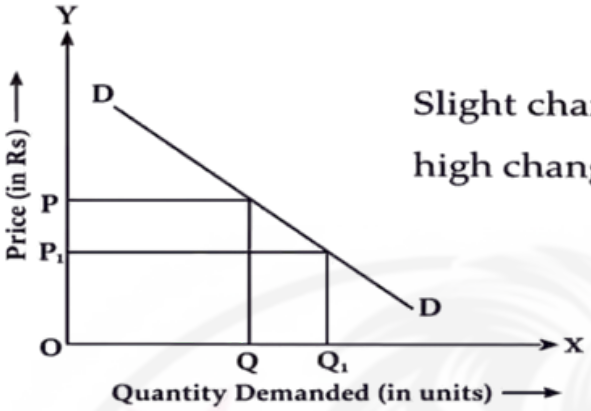
Perfectly Inelastic Demand

- Perfectly inelastic demand is when the demand for a product remains the same regardless of price changes. This means that the quantity demanded is fixed and does not change.
- **E.g.** Necessary goods (water, wheat, and rice).



Relatively Elastic Demand

- Relatively elastic demand is when a small change in price leads to a large change in the quantity demanded of a product or service. This means that consumers are sensitive to price changes.

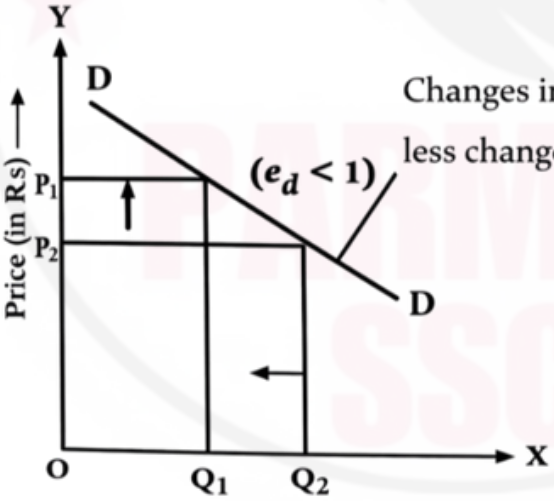


Slight change in price result in high change in demand

$e_d > 1$

Relatively Inelastic Demand

- Relatively inelastic demand is when the demand for a product changes in response to price, but the change is not proportional to the price change. This means that the price of a product changes more than the demand for that product.



Changes in price causes relatively less change in quantity demand

$e_d < 1$

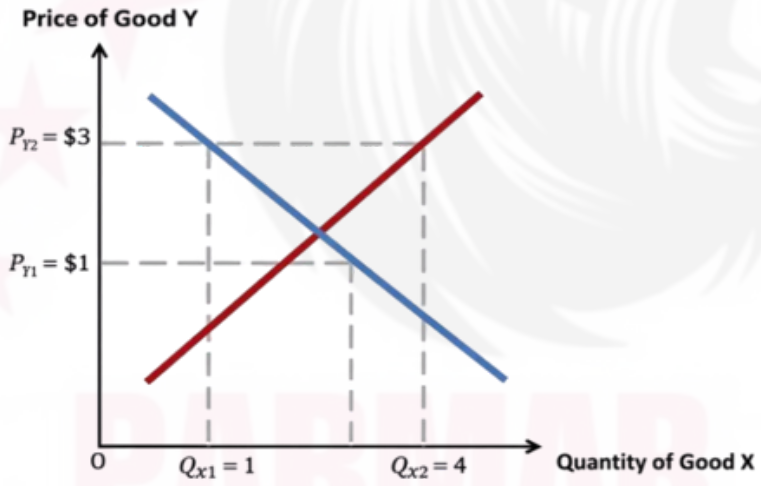
Income Elasticity

- Income elasticity of demand measures the relationship between a change in the quantity demanded for a particular good and a change in real income.
- For most goods, when income goes up, demand goes up. The demand curve shifts to the right, showing a positive relationship.
- For inferior goods (like cheaper options), when income rises, demand goes down. When income drops, demand for these goods goes up. The demand curve moves in the opposite direction.



Cross-Price Elasticity

- Cross-price elasticity is an economic measure of how a change in the price of one good affects the demand for another good.
- **E.g.**, if the price of Pepsi rises by 10% and Coke's demand increases by 5%



Complementary Goods vs Substitute Goods

Substitute Goods	Complementary Goods
They refer to those goods which can be used in place of one another to satisfy a particular want	They refer to those goods which are used together to satisfy a particular want
They have a competitive demand	They have a joint demand
Price of one substitute good has a positive relationship with the quantity demanded of another substitute good	Price of one complementary good has a negative relationship with the quantity demanded of another complementary good
Examples: Tea and Coffee, Coke and Pepsi	Examples: Tea and Sugar, Car and Petrol

Types of market

Monopoly



- One seller controls the entire market.
- No close substitutes for the product.
- High barriers to entry.
- **E.g.**, Indian railways

Oligopoly



- A few large firms dominate the market.
- Products may be similar or differentiated.
- Many buyers for one product.
- No easy entry.
- **E.g.**, Telecom sector, laptop market

Monopolistic Competition



- Many sellers and many buyers for one product.
- **Products are similar but not identical (differentiated products).**
- Some control over price.
- Easy entry and exit.
- **E.g.**, Toothpaste

Perfect Competition



- Many buyers and sellers.
- Products are identical (homogeneous).
- No barriers to entry.
- Price is determined by supply and demand.
- **E.g.**, Agricultural products



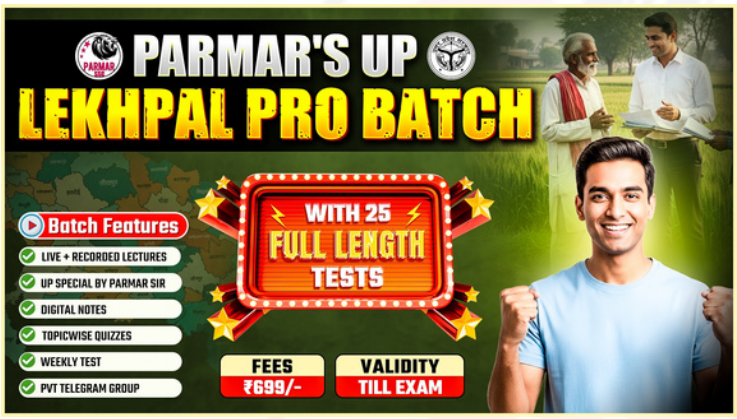


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