Chapter 1

Questions

1. Explain the concept of opportunity cost.

Opportunity cost is the value of the next best alternative which must be forgone in order to obtain a good or service. For example, the cost of doing these exercises and reading this answer might be the TV you could have watched.

2. List goods, or services, that compete for your income. Similarly, list activities that compete for your time. In deciding what you will spend your income on and how you will allocate your time, do you minimize your opportunity costs?

Goods or services competing for your income might include rent, food, heating and travel. Activities competing for your time might include studying, work, sleep and leisure activities, such as the cinema, drinking and sport.

In assessing whether you minimize your opportunity costs you need to examine what you decided to do, or consume, and compare these with what you decided not to do, or consume. If you minimized your opportunity costs, then you have chosen all the things that provide you with the maximum amount of benefit.

3. Consider whether it is ever possible to solve the problem of scarcity.

The problem of scarcity cannot ever be resolved. Resources are finite and wants are unlimited. For example, if we discover new oil fields in the world, this does not mean that the oil supply is no longer finite. At some point we will stop finding oil. Nor does the new discovery stop the world's demand for oil increasing.

4. An economy produces two goods, Ferraris and Ray-Ban sunglasses. Using a production possibility frontier assess what must happen to the production of Ferraris, if the production of Ray-Ban sunglasses decreases.

If the production of Ray-Ban sunglasses reduces, then resource such as labour will become available. This under utilised resource can be hired by Ferrari and so the production of Ferraris could increase.

5. The same Ferrari and Ray-Ban economy receives an influx of migrant workers. What do you think will happen to the production possibility frontier for this economy?

An influx of migrant workers is an addition to the labour resource in an economy. With more resource, more output can be produced. So the production possibility frontier will move outwards to the right.

6. How does the production possibility frontier illustrate the concept of opportunity cost?

It depicts the trade-off between goods and/or services produced. As resources are used for the production of one commodity those resources cannot be used for the production of another good or service.

7. Why does the law of diminishing returns require the production possibility frontier to be curved, rather than a straight line?

The slope of the production possibility frontier shows the opportunity cost of increasing the production of one type of good or service. For example, as more capital goods are produced the opportunity cost in terms of consumer goods foregone increases. This could result from the fact that some resources are more efficient in the production of one type of good, or that changing the proportion of factors employed in one form of production causes the output to increase at a decreasing rate. This is explained by the law of diminishing returns and gives the P.P.F a circular appearance.

8. Explain the resource allocation mechanism within a market economy and also a planned economy.

The recourse allocation mechanism within a market economy is the price mechanism/system. It is based on the idea of a competitive market in which no individual can influence the price of factors of production and no single firm can influence the market price of its product. A market exists when buyers and sellers of a particular commodity are in communication for the purpose of exchange. Market forces operate to satisfy the desire of one person to sell something and the desire of another to buy it. A price is agreed which is acceptable to both the buyer and the seller. Price acts as the mechanism which equalises the demand for and supply of a commodity.

A planned economy is a system in which all economic decisions are made by the central authorities; unlike the price/market system which assumes in its purest state no government interference in economic activity. In a command or planned economy a central planning body makes all the basic economic decisions, the state owns or controls all the factors of production and determines what to produce by assessment of consumer needs and the requirements of the state. Priorities are drawn up and production quotas set accordingly.

9. Using examples, highlight why your own economy is probably best described as a mixed economy.

A mixed economy is an economy in which decisions are made partly by the state and partly by individuals and firms. In Britain the production and sale of groceries is a market solution with private firms supplying consumers via supermarkets and similar outlets. Health care for most British people is provided by the state. Hence Britain is a mixed economy.

10. Which of the following statements relate to macro or microeconomics? (a) During the last 12 months average car prices have fallen; (b) inflation for the past 12 months has been 3.5 per cent; (c) strong sales in the housing market have prevented the Bank of England from reducing interest rates.

(a) The price of cars is a microeconomic issue. It is an issue associated with one market, or sector. (b) Inflation is the rise in prices across the entire economy and, therefore, represents a macroeconomic problem. (c) Strong sales in the housing market are a micro issue as they relate to a single market. However, the housing market is linked to the macroeconomy and, in this example, has led to the Bank of England holding interest rates constant. As interest rates are set for the whole economy, this is a macroeconomic issue.

11. Is the labour market a micro or macroeconomic topic?

Factors affecting the labour market as a whole, e.g. the national level of unemployment, wage inflation, are macroeconomic. Factors affecting individual labour markets, e.g. the supply of carpenters, the wages of doctors, are microeconomic.

12. Why does business need to understand the functioning of markets?

Firms operate within markets. If product markets are a collection of firms supplying products and consumers buying products, then it is important for business to understand how consumers and firms interact in markets. Furthermore, firms will also be interested in understanding how competing firms interact in markets. Business also buys its inputs, such as labour, from markets, so the costs of firms are, in part, determined within markets. Therefore, understanding markets can lead to an understanding of profitability.

13. Why does business need to understand the functioning of the economy?

Firms also operate within economies. Governments seek to control economies. Understanding how government economic policy will influence consumers' ability to spend, firms' ability to invest and the level of international trade and competition are all important issues for business to comprehend.

Questions 14 and 15 relate to material within the appendix

14. Which of the following is positive and which is normative? (a) It is in the long-term interest of the UK to be a member of the Euro; (b) Will entry into the Euro reduce UK inflation?

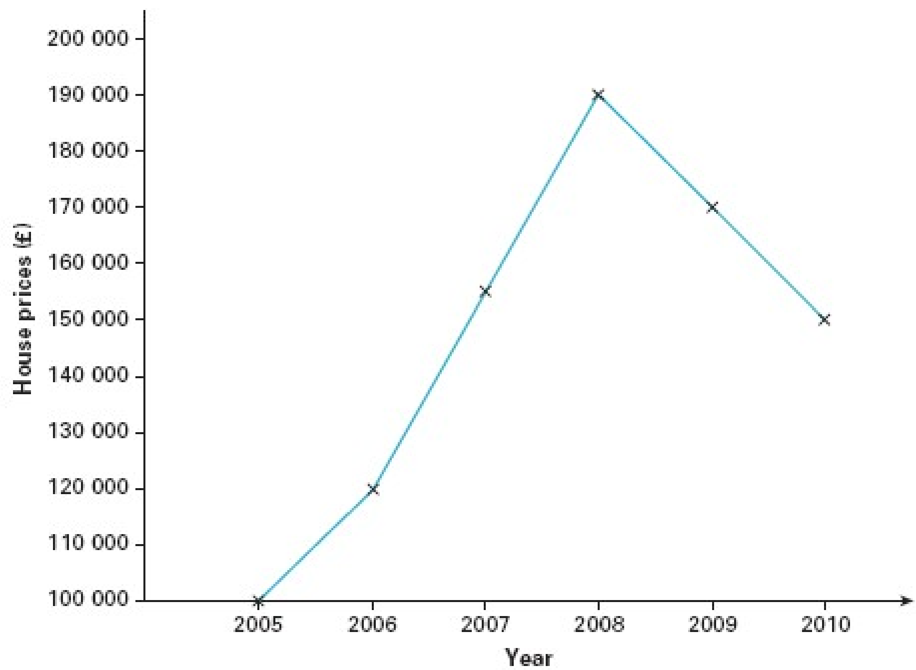
(a) Asserts an opinion without any supporting theory. It is, therefore, a normative statement. (b) In contrast, this asks a question that can be answered using economic theory. It is, therefore, a positive statement.

15. Using the data listed below, plot house prices on the Y axis and time on the X axis. Is there a positive or negative relationship between time and house prices? Convert the data series on house prices into an index using 2005 as the base year.

Calculate the percentage increase in house prices for each year.

Year	Average price of a house

2005	£100 000
2006	£120 000
2007	£155 000
2008	£190000
2009	£170 000
2010	£150 000



The plot of house prices against year shows a positive relationship until 2008, and a negative relationship from 2008 to 2010.

	Year	Index	% increase	
	2005	100		
	2006	120	20	
	2007	155	29.2	
	2008	190	22.6	
	2009	170	-10.5	
	2010	150	-11.8	

Index of house price movements

Exercises

1. True or False?

a) Economics is about human behaviour and so cannot be a science.

b) An expansion of the economy's productive capacity would be reflected in an outward movement of the production possibility frontier.

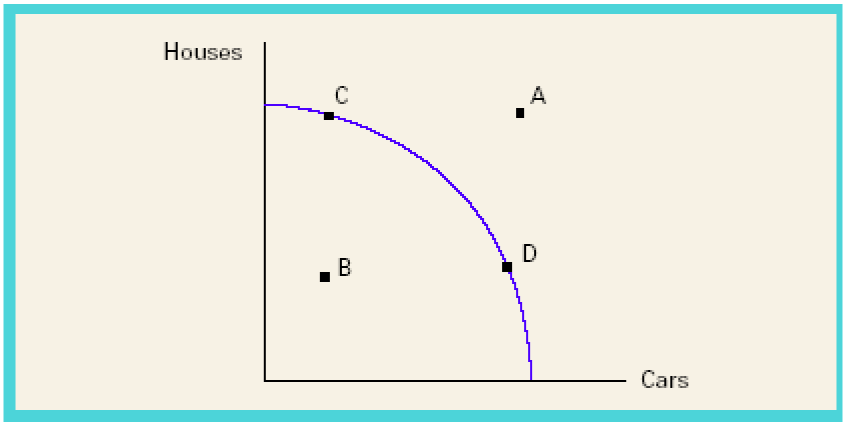
c) China is an example of a command economy in which private markets play no part.

d) When you make a choice there will always be an opportunity cost.

e) Firms should operate in the interests of their wider stakeholders is an example of a normative economic statement.

f) Economists assume that business operates in a purely economic environment

a) False. Economics is a social science
b) True. As the production possibility frontier moves out, then more of both goods can be produced.
c) False. China in the last 30 years has increasingly moved towards a market based economy.
d) True. A choice means that one thing is chosen and so something else is foregone. Opportunity cost the cost of foregoing the other choice.
e) True. It is a statement of opinion, not a statement of theory.
f) False. Economists are interested in understanding the economic environment that businesses operate in, but they also recognise the social and political environment of business.

2. 

a) Which combination of goods can be produced, with surplus resources being unemployed?

b) Which combination of goods would represent full employment, with resources mainly allocated to the production of houses?

c) Which combination of goods cannot currently be achieved?

d) Which combination of goods represents full employment, with resources mainly allocated to the production of cars?

e) How might the level of output identified in c) be achieved in the future?

f) Can you envisage circumstances under which the production possibility frontier could move to the left?

a) B
b) C
c) A
d) D
e) Through an increase in the number of factors of production or the efficiency of the factors of production, e.g. if more labour, capital and raw materials become available.
f) Through disruption of productive capacity as a result of war and/or natural disaster or a reduction of the labour supply as a result of a falling birth rate/ reduction of immigration/increase in emigration relative to immigration.