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Q1: (a)What effect will each of the following have on the demand for small automobiles such as the Mini Cooper and Smart car? (5 Marks)

a. Small automobiles become more fashionable.

b. The price of large automobiles rises (with the price of small autos remaining the same).

c. Income declines and small autos are an inferior good.

d. Consumers anticipate that the price of small autos will greatly come down in the near future.

e. The price of gasoline substantially drops.

(b) Explain the law of demand. Why does a demand curve slope downward? How is a market demand curve derived from individual demand curves? (5 Marks)

Q2: Define monetary policy and explain in detail the instruments of monetary policy? (10 Marks)

Q3: Explain the following. (10 Marks)

a) Deduction & induction method
b) Micro & Macroeconomics
c) Positive science & Normative science
d) Any of the four principles of economics

What effect will each of the following have on the demand for small automobiles such as the Mini Cooper and Smart car?

a. Small automobiles become more fashionable - demand increases.

b. The price of large automobiles rises (with the price of small autos remaining the same) - demand increases.

c. Income declines and small autos are an inferior good - demand increases.

d. Consumers anticipate that the price of small autos will greatly come down in the near future - demand increases.

e. The price of gasoline substantially drops - demand increases.

(b)

Law of demand

Definition: The law of demand states that other factors being constant (cetris peribus), price and quantity demand of any good and service are inversely related to each other. When the price of a product increases, the demand for the same product will fall.

Why does demand curve slope downward?

The demand of a product refers to the desire of acquiring it by the consumer but backed by his purchasing power and willingness to pay the price. The law of demand states that there is an inverse proportional relationship between price and demand of a commodity. When the price of commodity increases, its demand decreases. Similarly, when the price of a commodity decreases its demand increases. The law of demand assumes that the other factors affecting the demand of a commodity remain the same.

How is market demand curve derived from individual demand curve?

A market demand curve is the horizontal summation of all individual demand curves. Any factor that can shift an individual demand curve can shift a market demand curve.To derive a market demand curve, simply add the quantities that each consumer buys at each price. The prices on the vertical axis do not change, but the quantities on the horizontal axis are the sums of the consumers’ demand. This group of quantities is called horizontal summation.

Q2)

Definition: Monetary policy is the macroeconomic policy laid down by the central bank. It involves management of money supply and interest rate and is the demand side economic policy used by the government of a country to achieve macroeconomic objectives like inflation, consumption, growth and liquidity.

The instruments of monetary policy used by the Central Bank depend on the level of development of the economy, especially its financial sector. The commonly used instruments are discussed below.

Reserve Requirement: The Central Bank may require Deposit Money Banks to hold a fraction (or a combination) of their deposit liabilities (reserves) as vault cash and or deposits with it. Fractional reserve limits the amount of loans banks can make to the domestic economy and thus limit the supply of money. The assumption is that Deposit Money Banks generally maintain a stable relationship between their reserve holdings and the amount of credit they extend to the public.

Open Market Operations: The Central Bank buys or sells securities to the banking and non-banking public. One such security is Treasury Bills. When the Central Bank sells securities, it reduces the supply of reserves and when it buys (back) securities-by redeeming them-it increases the supply of reserves to the Deposit Money Banks, thus affecting the supply of money.

Lending by the Central Bank: The Central Bank sometimes provide credit to Deposit Money Banks, thus affecting the level of reserves and hence the monetary base.

Interest Rate: The Central Bank lends to financially sound Deposit Money Banks at a most favorable rate of interest, called the minimum rediscount rate (MRR). The MRR sets the floor for the interest rate regime in the money market (the nominal anchor rate) and thereby affects the supply of credit, the supply of savings and the supply of investment.

Direct Credit Control: The Central Bank can direct Deposit Money Banks on the maximum percentage or amount of loans (credit ceilings) to different economic sectors or activities, interest rate caps, liquid asset ratio and issue credit guarantee to preferred loans. In this way the available savings is allocated and investment directed in particular directions.

Key points:

- Monetary policy is how a central bank or other agency governs the supply of money and interest rates in an economy in order to influence output, employment, and prices.
- Monetary policy can be broadly classified as either expansionary or contractionary.
- Monetary policy tools include open market operations, direct lending to banks, bank reserve requirements, unconventional emergency lending programs, and managing market expectations (subject to the central bank's credibility).

Deduction:-

A form of logical reasoning that derives a conclusion from a set of premises and the conclusion cannot be false if the premises are true.

Deduction works from the more general to the more specific. Sometimes this is informally called a “top-down” approach. We might begin with thinking up a *theory* about our topic of interest. We then narrow that down into more specific *hypotheses* that we can test. We narrow down even further when we collect *observations* to address the hypotheses. This ultimately leads us to be able to test the hypotheses with specific data – a *confirmation* (or not) of our original theories.

Induction :-

Definition

Induction is a method of reasoning that moves from specific instances to a general conclusion. Also called *inductive reasoning*.

In an inductive argument, a rhetor (that is, a speaker or writer) collects a number of instances and forms a generalization that is meant to apply to all instances.

Observations

Induction operates in two ways. It either advances a conjecture by what are called confirming instances, or it falsifies a conjecture by contrary or disconfirming evidence. A common example is the hypothesis that all crows are black. Each time a new crow is observed and found to be black the conjecture is increasingly confirmed. But if a crow is found to be not black the conjecture is falsified.

2) Microeconomics

Microeconomics is the study of economics at an individual, group or company level. Microeconomics focuses on issues that affect individuals and companies. This could mean studying the supply and demand for a specific product, the production that an individual or business is capable of, or the effects of regulations on a business.

Macroeconomics

Macroeconomics, is the study of a national economy as a whole. Macroeconomics focuses on issues that affect the economy as a whole. Some of the most common focuses of macroeconomics include unemployment rates, the gross domestic product of an economy, and the effects of exports and imports.

3)

Positive Economics

Positive economics is a stream of economics that focuses on the description, quantification, and explanation of economic developments, expectations, and associated phenomena. It relies on objective data analysis, relevant facts, and associated figures. It attempts to establish any cause-and-effect relationships or behavioral associations which can help ascertain and test the development of economics theories.

Normative Economics

Normative economics focuses on the ideological, opinion-oriented, prescriptive, value judgments, and "what should be" statements aimed toward economic development, investment projects, and scenarios. Its goal is to summarize people's desirability (or the lack thereof) to various economic developments, situations, and programs by asking or quoting what should happen or what ought to be.

Principles of economics

1. **People Face Tradeoffs**
    - To get one thing, we usually have to give up something else
        - Ex. Leisure time vs. work
2. **The Cost of Something is What You Give Up to Get It**
    - Opportunity cost is the second best alternative foregone.
        - Ex. The opportunity cost of going to college is the money you could have earned if you used that time to work.
3. **Rational People Think at the Margin**
    - Marginal changes are small, incremental changes to an existing plan of action
        - Ex. Deciding to produce one more pencil or not
    - People will only take action of the marginal benefit exceed the marginal cost
4. **People Respond to Incentives**
    - Incentive is something that causes a person to act. Because people use cost and benefit analysis, they also respond to incentives
        - Ex. Higher taxes on cigarettes to *prevent smoking*