**Subject: Microeconomics**

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**Program: BBA**

**Samester: 1st**

**Examination: mid term**

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**Q1: (a) 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)**

**Ans**. In microeconomics the law of states that “ conditional on all else being equal, as the price of a good increases, quantity demanded decreases, conversely as the price of a good decreases, quantity demanded increases.

In other words, the law of demand describes an inverse relationship between price and quantity demanded of a good. Alternative other things are being constant quantity demanded of a commodity is inversely related to the price of the commodity for example ; a consumer may demand 1 kilogram of apple at Rs:160 per kg; he may however demand half kg(500 g) if the price rises to Rs:200 per kg. This has been the general human behaviour on relationship between the price of the commodity and the quantity demanded. The factors held constant refer to other determinants of demand such as the prices of other goods and the consumer’s income.

The demand curve slopes downward because of diminishing marginal utility and also because of the substitution and income effects.

* Law of diminishing the marginal utility
* Substitution effect
* Income effect

**1\_The law of diminishing the marginal utility**

The law of diminishing marginal utility state that each increasing quantity of the commodity its marginal utility declines.

For example; when a person is very hungry the first piece of meal that he eats will give him the most satisfaction. As he will consume more meal pieces. His level of satisfaction will diminish.

So, when the quantity of goods is more the marginal utility of the commodity is less so the consumer is not willing to pay more price for the commodity and its demand will decline. Hence the demand curve slopes downward.

**2\_Substitution effect**

Let understand this with an example; tea and coffee are substitute goods. If the price of tea rises consumer will shift to coffee. This will decrease the demand for tea and increase the demand for coffee. So the demand curve of tea will slope downward.

**3\_Income effect**

Income effect refers to the change in the real income or the purchasing power of the consumers when the prices level rises the purchasing power of the consumer decreases and they buy less quantity of goods. Similarly when the price level falls the purchasing power of the consumer’s increases & they buy more goods.

**(b) What are the determinants of demand? What happens to the demand curve when any of these determinants change? Distinguish between a change in demand and a change in the quantity demanded, noting the cause(s) of each. (5 Marks)**

**Ans**. The determinants of demand are consumers’ tastes, the number of buyers in the market, consumer incomes, the prices of related goods and consumer expectations. And more than that, it seems that the actual price of the good itself is a primary consideration but it effects the curve up and down rather than side to side. When a price increases the curve leads to movement up the curve to the right and as it decreases it leads to movement down the curve.

When any of the determinants of demand change, a change in the demand of the item will change. An increase in demand can be shown as a shift of the demand curve to the right and a decrease in demand will be shown as a shift in the curve to the left.

When increased in demand from an increased market, increased desire for a good. Higher competitor prices or and the fear of a the price increase the curve will shift to the right and if the reverse is true, the market is shrinking, the item is outdated, competitor prices are dropping or there is a predicted price reduction the demand will fall which will move the entire curve to the left.

**Q2: Suppose that when everyone wakes up tomorrow, they discover that the government has, them an additional amount of money equal to the amount they already had. Explain what effect this doubling of the money supply will likely have on the following: (10 Marks)**

a. the total amount spent on goods and services

b. the quantity of goods and services purchased if prices are sticky

c. the prices of goods and services if prices can adjust

Ans. When everyone wakes up tomorrow, they discover that the government has them an additional amount of money equal to the amount they already had. The increase in the money supply will lead to an increase consumer spending. So this increase will shift the AD curve to the right.

1. The effect of this doubling of the money supply consumer spend this money on fine goods and services by individuals and household for personal use. Consumer spending include private purchases of durable goods. Consumer spending also can be regarded as complementary products.

**Q3: Explain any of the five principles of economics in your own words? (10 Marks)**

**Ans**. The word economy comes from the Greek word for “one who manages a household” but in fact households and economies have much in common

A household faces a lot of decisions. It must decide which members of the house do which tasks & what each member gets in return. Who cooks lunch? Who does washing the dishes? Who gets to choose for children what video game to play? In short the household must allocate its scarce resources among its various membersand taking into account each members abilities, efforts and desires.

Like a house hold a society faces many decisions. A society must be decide what job or service will be done and who will do them. It needs some people to grow food, some people to make shoes and still other to cars, computer software

There are about Ten principles of economics in microeconomics.

**Principle #1:** RATIONAL PEOPLE THINK AT THE MARGIN

Decisions in life are rarely black and white but in most case involve shades of grey. When it’s for dinner, the decision you face is not between fasting or eating like a donkey, but whether to take that extra spoonful of mashed potatoes. When exams roll around your decision is not between blowing them off or studying 20 hours a day but to spend an extra hour reviewing your book, notes or slides instead of playing video games. Economics use to term marginal changes to describe small incremental adjustments to an existing plan of action. Margin means “edge” so marginal changes are adjustments around the edges of what you are doing or taking action.

In other many situations people make the good decision by thinking at the margin suppose for instance that you ask a friend for advice about how many years to stay in school. If he were to compare for you the life style of a person with a PH.D or master degree to that of a grade school dropout, You might drop out complain about that this comparison is not helpful for your decision. you have some education already and most likely are deciding whether to spend an year to make this decision, you need to know the additional benefits that an extra year in school would offer higher salary throughout life and the sheer joy of learning and the additional costs that you would incur tuition and the forgone salary /wages while you are in school. By comparing these marginal benefits and marginal costs, you can evaluate whether the extra year is worthwhile..

In this example show firms and individuals can make better decisions by thinking at the margin. So a rational decision maker takes an action if the marginal benefit of the action exceeds the marginal cost.

**Principle #:2** PEOPLE RESPOND TO INCENTIVES

This is because people make decisions by comparing costs & benefits, there behaviour change when the cost or benefits change. That is why people respond to incentives. When the price of an orange rises, people decide to eat more pears and fewer oranges, this is because the cost of buying an orange is higher. At the same time orange orchards decide to hire more workers and harvest more oranges, because the benefit of selling an orange is also higher. The effect of price on the behaviour of buyers and sellers in a market in this case the market for oranges is crucial for understanding how the economy works

Public policymakers should never forget about incentives, for many policies change the costs, for many policies change the costs or benefits that people face therefore alter behaviour. A tax on petrol, for instance, encourages people to drive smaller, huge fuel efficient cars. It also encourages people to take public transportation rather than drive and live closer to where they work. If the tax were high enough people would start driving electric cars. Policies have effects that are not obvious in advance. There four when analysing any policies we must consider not only the direct effects but also the indirect effects that work through incentives. If the policy changes incentives it will cause people to alter their behaviour.

**Principle # 3** TRADE CAN MAKE EVERYONE BETTER OFF

You may have probably heard on the news that the Japanese are our competitors in the world economy. In some ways this is true, for American & Japanese firms do produce many of the same product .