

## Economics (Paper 1)

## MCQs (answers)

- |       |       |
|-------|-------|
| 1. E  | 2. B  |
| 3. C  | 4. A  |
| 5. C  | 6. A  |
| 7. B  | 8. A  |
| 9. B  | 10. B |
| 11. C | 12. C |
| 13. C | 14. A |
| 15. A | 16. B |
| 17. D | 18. C |
| 19. B | 20. A |

Q31 Introduction:

International trade is a phenomenon where a country trades with another country for different goods and services, which has competitive advantage. In this way, countries are able to enjoy the best products and by specializing in the production of those products in which they have edge, help them to gain economies of scale by lowering down the overall costs. Comparative advantage, one theory of international trade by Ricardo says, produce those goods in a country, in which that country inhibits less opportunity

cost. Hence, has a comparative advantage in producing it. Moreover, Factor endowments are the factors of production available in that country.

## II Theory of Comparative advantage:

Comparative advantage theory was proposed by Ricardo. According to him, a country should produce those products or services in which they have an edge that is they bears less opportunity costs. For example, France can produce 5 clothes per labor<sub>m</sub> and 10 wine per labor<sub>m</sub> whereas US can produce 10 clothes and 10 wines per labor. As shown below

|        | cloth | wine |
|--------|-------|------|
| France | 5     | 10   |
| USA    | 10    | 10   |

Opportunity cost for France for producing:

$$1 \text{ cloth} = 2 \text{ wines}$$

$$1 \text{ wine} = \frac{1}{2} \text{ cloth}$$

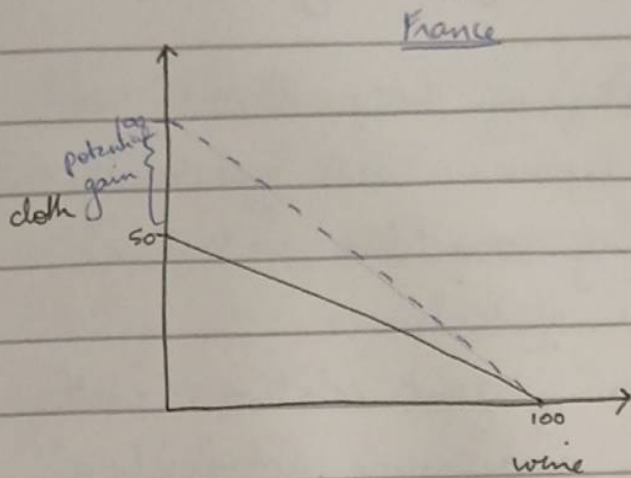
Hence, France faces less opportunity cost in producing wine.

Opportunity cost for USA for producing:

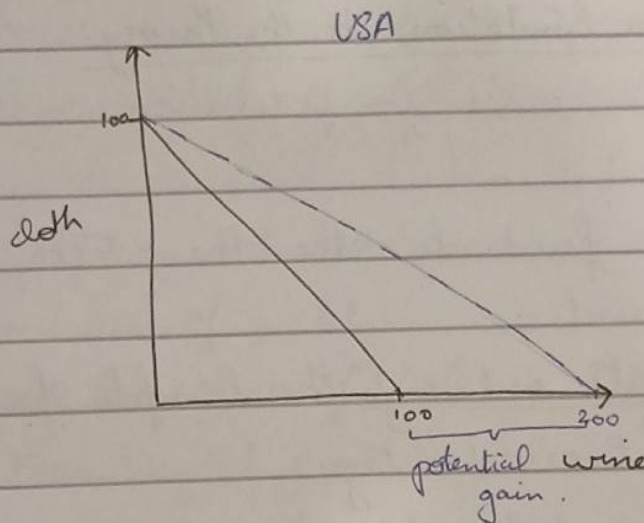
$$1 \text{ cloth} = 1 \text{ wine}$$

USA has absolute advantage in producing both goods but if they will trade with

France, they would be better off.  
 Let's assume cost of labor per hour



By trading,  
 France would  
 have 50<sup>th</sup> potential  
 gain as shown



USA by  
 trading would  
 also have a  
 potential gain  
 in wine

Therefore, by international trade, countries are able to enjoy potential gains and could specialize in those in which they have comparative advantage.

### Assumptions:

1. Free trade or no barriers in the process of international trade.
2. Immobility of labour and factors of production
3. 2<sup>nd</sup> 2 model, two countries, two products.

### III Advantages and disadvantages of Comparative advantage theory:

#### Advantages:

- 1- Countries specialize in the products or services in which they experience less opportunity costs.
- 2- Helps in gaining competitive advantage and economies of scale.
- 3- Helps in maintaining good relations with other countries and more globalisation.

#### Disadvantages or limitations to the theory:

- 1- Dependency increases for production on other countries.
- 2- There is no free trade other than FTA agreement countries.
- 3- Transport costs outweigh the benefits of the comparative advantage.
- 4- Assumes two products and two countries only.

### IV Factor Endowments:

Factor endowments are resources a country has: Land, labour, capital and entrepreneurship. With these factor endowments, a country can gain economically and socially. By proper utilizing of the resources upto its full potential a country's economy can grow and develop. Thus, there should be optimum

utilization of resources by practicing sustainable practices and policies.

## V How Pakistan can gain benefits?

By increasing trade, and by focusing more on the goods and services in which Pakistan can attain efficiency can increase exports and can import those in which they bear high costs.

### 1. Increased exports due to specialization:

By specializing in the production of those goods in which Pakistan incurs less opportunity cost, could increase the production and level of quality.

### 2. Gain Economies of scale in targeted production:

More targeted production leads to specialization and help in attaining economies of scale by producing more quantities.

### 3. Balance of trade improves:

BoT would be better off when export will increase due to comparative advantage and usage of factor endowments.

### 4. Optimum usage of the resources:

The capabilities of production would increase with more rise in factor endowments and by increasing capacity to the fullest.

## VI Conclusion:

With the rise in international trade, various benefits could be attained and especially for the countries like Pakistan which is in developing stage. For Pakistan, focusing on exports by specializing in certain products helps to better off its terms of trade. However, with international trade rise dependency levels also increases. There are other various hidden costs such as transportation, research costs, etc. which a country has to bear. Specially, a developing country like Pakistan faces trade barriers and other costs which increases their costs compared to advantages as well.

## Q4.I Introduction:

Producers Equilibrium is where the producer is enjoying the most benefits or where he is earning normal profits or abnormal profits. In other words, where his total costs are covering. There are various approaches to producers equilibrium; that are TR-TC approach and MR-MC approach. With the help of these approaches, producer is able to set his optimum

level of production where he can have increased profits compared to costs.

## II TR-TC (Total Revenue minus total cost approach)

Total revenue is the revenue (Price  $\times$  quantity) earned by the firm from the total sale of the production. Total cost is the cost which a firm bears in producing those units or quantity.

The total costs includes fixed costs (F.C) e.g. rent, wages, etc. and variable costs (V.C) e.g. costs for producing one unit.

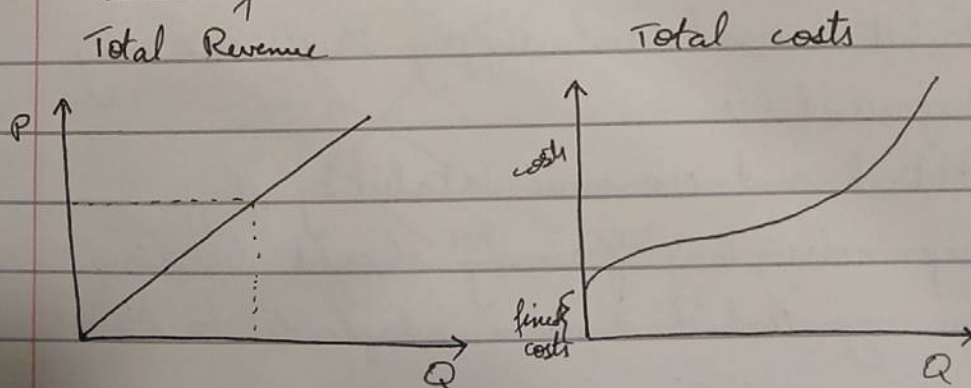
$$\boxed{T.C = F.C + V.C}$$

$$\boxed{TR = P \times Q}$$

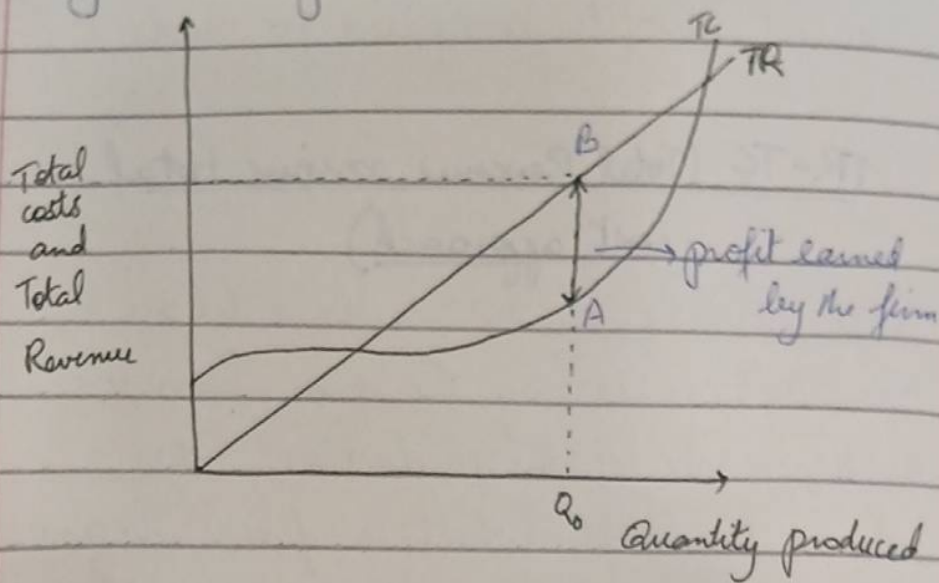
Total profit = Total Revenue - Total costs.

Therefore, producer's equilibrium is where he earns the maximum profit, that is where he has the highest difference between Total revenue and total costs.

Curves for Total Revenue and Total costs:



By combining both curves:



Where the difference between the total revenue and total costs will be the highest that will be the producers equilibrium or the quantity that producer will produce as shown in the diagram  $Q_0$  and profit  $A-B$ , point where the difference is the highest.

Limitations to TR-TC approach:

1. Difficult for the producer to calculate the highest difference <sup>between TR & TC</sup> for quantity allocation.
2. Market demand and supply shifts are very unpredictable.
3. Political and economic stability plays major roles, thus planning should be done in way that it remains adaptable to the.



environment.

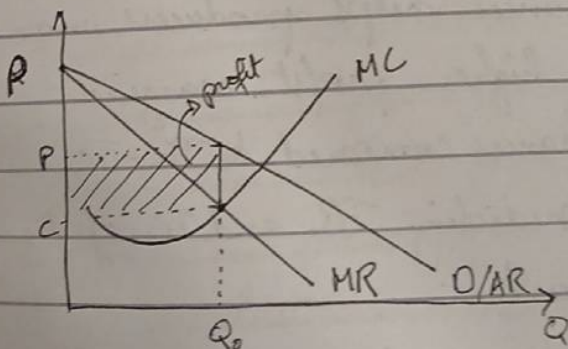
### III Difference of TR-TC approach from other approaches (MR=MC):

It considers total revenue and total costs of the firm whereas in the MR=MC approach Marginal revenue and marginal cost that is the revenue earned from each additional unit and cost incurred on each additional unit respectively.

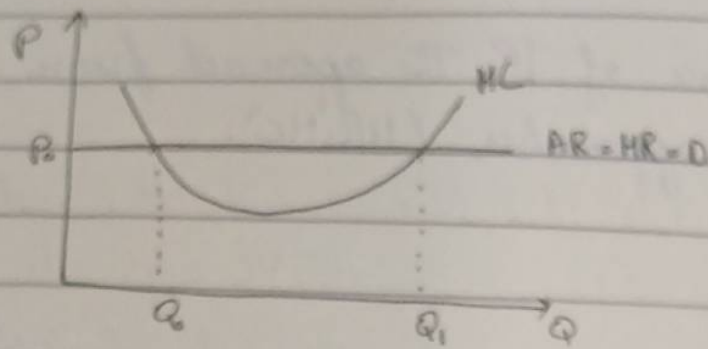
### MR=MC Approach (Marginal revenue = Marginal cost)

In this approach producer produces upto the point where the marginal costs equals to the marginal revenue or where the marginal costs cut the marginal revenue from below as shown in the diagrams below:

In Imperfect Competition:



### In Perfect competition:



Firm will produce  $Q_0$  where MC is cutting the MR from below as this is the point where firm earns profit (normal profit).

Thus, one of the major difference is when a firm calculates its maximum profit or quantity to be produced on the basis of marginal costs and revenue instead of total revenue and costs because this gives a better picture to the producer.

Marginal differences helps producers more in calculating higher profit margins with more chances compared to TR-TC approach as predicting TR and TC of the firm is difficult.

#### IV Conclusion:

TR-TC approach is where firm produces equilibrium achieved where the difference between the total revenue and total is the highest because that is the point where producer will earn the highest profit. Whereas in other approach,  $MR=MC$ , producer set its equilibrium point where Marginal revenue equals the Marginal cost as this is the point where producer in perfect competition earns normal profit and in imperfect competition, they <sup>can</sup> earn abnormal profit too (in case of monopoly). Hence, comparing marginal revenue and costs is comparatively better indicator as predicting firm's total cost and revenue would be difficult.

#### Q.1 Introduction:

Price elasticity is a numerical value or ratio that helps in knowing the responsiveness of <sup>quantity</sup> demand changes according to the changes in prices. It is a measure of responsiveness or percentage change in quantity demanded to percentage change in prices. Own-price, cross-price and income elasticities helps in knowing

The effects of changes due to the price and income levels.

## II Own-Price Elasticity:

Own Price elasticity is the proportionate change in the quantity demanded to the proportionate change in the prices.

$$\text{PED} = \frac{\% \text{ in Quantity demanded}}{\% \text{ change in Prices}}$$

$$\text{PED} = \frac{Q_1 - Q_0}{Q_0} \div \frac{P_1 - P_0}{P_0}$$

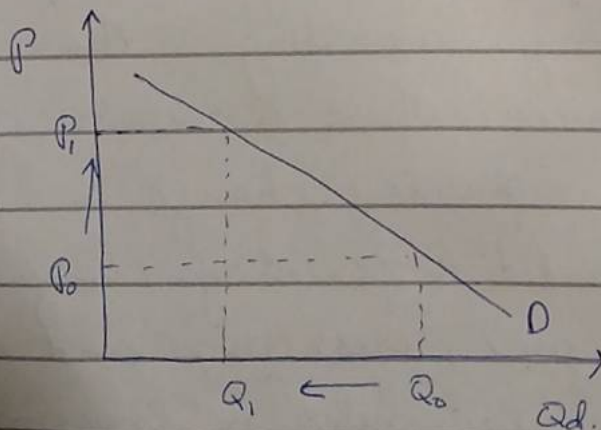
$$\text{PED} = \frac{\Delta Q}{Q_0} \times \frac{P_0}{\Delta P}$$

Own Price elasticity (PED) is always negative due to the inverse relation of the price and quantity demanded.

Higher the price, lesser the quantity demanded and,

Lower the price, higher the quantity demanded.

As shown below:



### III Cross-Price Elasticity:

Cross price elasticity (XED) is the proportionate change in Quantity demanded of A and proportionate change in the price level of B. It shows the effect of price changes on one quantity and the quantity demanded of the other product such as in cases of substitutes and complements.

$$\text{XED} = \frac{\Delta\% \text{ in Quantity demanded (A)}}{\Delta\% \text{ in Price (B)}}$$

$$\text{XED} = \frac{\Delta Q(A)}{Q_0(A)} \div \frac{\Delta P(B)}{P_0(B)}$$

$$\text{XED} = \frac{\Delta Q(A)}{Q_0(A)} \times \frac{P_0(B)}{\Delta P(B)}$$

If the value of XED is positive:

Then the two products are substitutes.

If the value of XED is negative:

Then the two products are complements.

### IV Income Elasticity:

Income elasticity <sup>(YED)</sup> shows the changes in income levels effects the quantity demanded. Therefore, percentage change in quantity demanded to the percentage change in

income levels. As the decrease or increase in the income affects the quantity demanded of the goods.

income elasticity =  $\frac{\% \text{ in Quantity demanded}}{\% \text{ in Income}}$

$$YED = \frac{\Delta Q}{Q_0} \times \frac{I_0}{\Delta I}$$

$$YED = \frac{\Delta Q}{Q_0} \times \frac{I_0}{\Delta I}$$

1. If the increase in income has a negative effect on the good = inferior good
2. If the income change has a positive effect but not so large = normal good
3. If the income change has a high positive impact then the good = luxury good

#### V Relationship between Own-price elasticity and Total Revenue:

Total Revenue is the total earnings of the firm by selling the products or services at certain level of price.

1. In case of inelastic demand:  
Small changes in price will not affect the total revenue a lot. For example, a larger price increase will only shift small amount of quantity

- demand, not affecting TR at all.
2. In case of Elastic demand:  
A large change (increase) in price will affect the total revenue. As in high price change will shift the quantity demanded as to lower levels due to which TR will fall. Hence, an indirect relation.
3. Unitary elastic demand:  
no change in Total Revenue at all.

### Conclusion:

Price elasticity shows the changes in the quantity demanded with the changes in the own prices, cross prices and income changes. With these differences and shifts, products are taken as complements, substitutes, inferior, luxury and normal goods. Thus, the relationship between the quantity demanded in prices also elasticity (inelastic and elastic) plays major role in determining the total revenue of the firm.

### Q8 Introduction:

Inflation is a very major

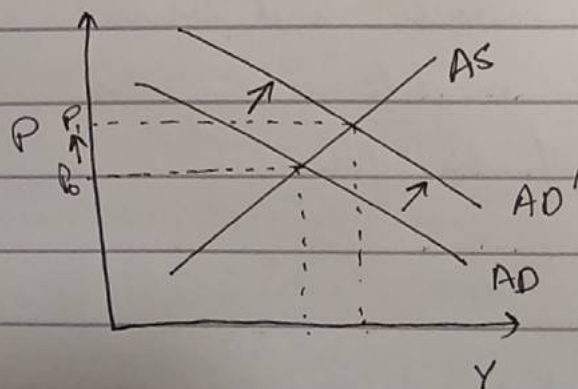
problem of Pakistan is facing due to the lack of political-economic-social stabilities. Import rises, changes in price levels in global markets, IMF policies and improper implementation decisions of government is the leading issues or sources in inflation. Pakistan is the consumption oriented economy, thus more consumption, more price level rises due to higher <sup>aggregate</sup> demand.

## II Major Sources of Inflation in Pakistan:

### 1. High consumption rates:

Pakistan is a consumption oriented economy, due to which the consumption increases which increases the Aggregate demand of economy and leads to higher price levels.

$C \uparrow \rightarrow AD \uparrow \rightarrow P \uparrow \rightarrow \text{inflation} \uparrow$





## 2. Improper policies<sup>making</sup> by Government:

Pakistan's government has been facing a lot of instability due to various factors such as corruption, nepotism etc. due to which focus diverts and proper policy making is not done or either the implementation is not done.

## 3. Rise in Population:

Due to drastic rise in the population levels of Pakistan, economy is failing to fulfil the needs of the economy due to rising demand.

## 4. High import bills:

Import levels and fiscal<sup>& trade</sup> deficits are rising due to which economy is facing high inflation rates.

## 5. Changing Prices in the global market:

Globally, prices shifts can lead to high inflation rates. As due to Middle east crisis the Price levels of oil increased in the market due to which Pakistan faced high rates of oil, thus high inflation.

## Mitigating measures of these issues:

1. Less consumption of Imported items:

With reducing the consumption on those products that could be made domestically could help in reducing the import bill

2. Proper policy making mechanisms by government.
3. Population control measures:  
By increasing awareness through awareness programmes.
4. By focusing on the export items of Pakistan.

### Conclusion:

Inflation is a rising problem in Pakistan due to many reasons whether government incapabilities, economy consumption levels, population crises etc. However, with different and effective measures, these problems should be mitigated otherwise it would create a major fall for the economy and would lead to stone age times to Pakistan. Inflationary problem is also a leading factor in brain drain too.