Fundamentals of Economics
Suggested Answer

Roll No……………. **Maximum Marks - 25**

Total No. of Questions - 2 **Total No. of Printed Pages -1**

Time Allowed – 1 Hour

Marks

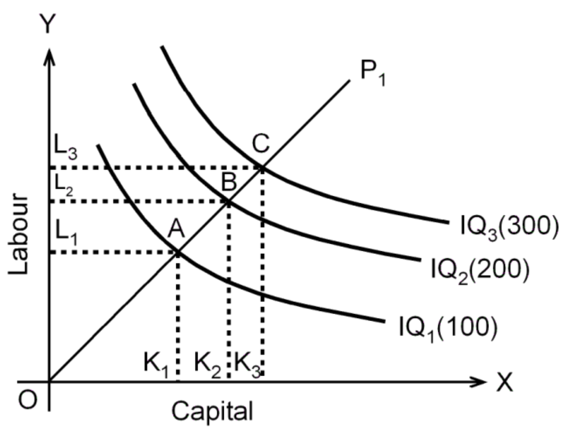
Attempt all questions.

1. Long Answer Questions: **(2×5=10)**
   a) Explain the laws of returns to scale.
   b) "International trade is the Heart of Open Economy" explain the statement with the help of advantages of international trade in case of developing countries like Nepal.

Answer:

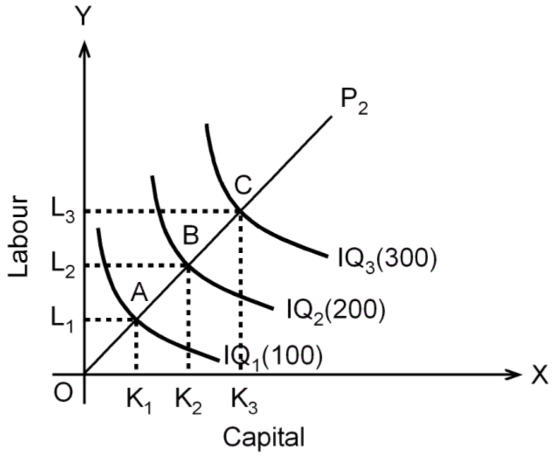
a) Returns to scale reveals the total effect on output with proportionate variations in all inputs. It explains three effects on output. They are explained below:

1. **Increasing Returns to Scale (IRS).** If the percentage or proportionate increase in output is greater than the percentage or proportionate change in input, it is the law of increasing returns to scale in operation.



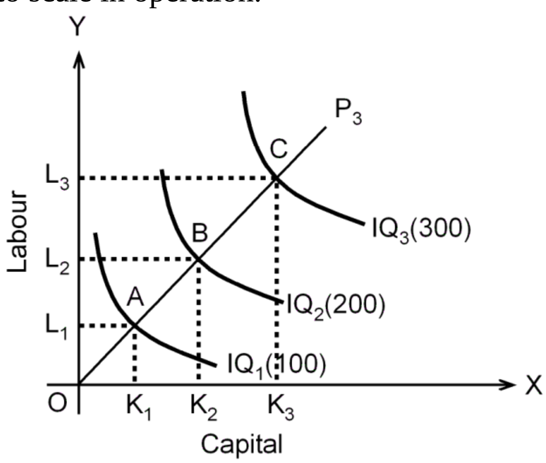
When increasing returns to scale occur, the successive iso-quants will lie at decreasingly smaller distances along a straight line ray OP_1 through the origin. In *Fig.*, the various iso-quants IQ_1, IQ_2 and IQ_3 are drawn, which successively represent 100, 200, 300 units of the output. It will be seen that distances between the successive iso-quants decrease as we expand the output by increasing the scale. Thus, increasing returns to scale occur since $OA\left(\frac{OL_1}{OK_1}\right) > AB\left(\frac{L_1L_2}{K_1K_2}\right) > BC\left(\frac{L_2L_3}{K_2K_3}\right)$, which means that equal increases in output are obtained by smaller and smaller increments in the input.

2. **Constant Returns to Scale (CRS).** If the percentage or proportionate increase in output equals the percentage or proportionate increase in inputs, it is the law of constant returns to scale in operation.



When constant returns to scale occur, the successive iso-quants will lie at the same distances along a straight line ray OP_2 through the origin. In *Fig.*, IQ_2 and IQ_3 are iso-quants which represent the total output of 100, 200 and 300 units. Constant returns to scale are indicated by the equal distance between the iso-quants along the scale line. Thus, constant returns to scale occur since $OA\left(\frac{OL_1}{OK_1}\right) = AB\left(\frac{L_1L_2}{K_1K_2}\right) = BC\left(\frac{L_2L_3}{K_2K_3}\right)$ which means that both inputs and output are increased in the same proportion.

3. **Decreasing Returns to Scale (DRS).** If the percentage or proportionate increase in output is less than the percentage or proportionate increase in inputs, it is the law of decreasing returns to scale in operation.



When decreasing returns to scale occur, the successive iso-quants will lie at increasingly greater distances along a straight line ray OP_3 through the origin. In *Fig.*, successively decreasing returns to scale occur since $OA\left(\frac{OL_1}{OK_1}\right) < AB\left(\frac{L_1L_2}{K_1K_2}\right) < BC\left(\frac{L_2L_3}{K_2K_3}\right)$. It means that more and more of inputs (labour and capital) are required to obtain equal increments in the output.

b) Trade between or among the countries of the world across borders is called as international trade or foreign trade. With the flow of globalization after 1980's the volume as well as role of foreign trade is increasing. Specially in case of developing countries like Nepal, where labor intensive production technique prevails and due to lack of capital and other supplementary factors of production. It is not possible to produce all the goods and services which they consume and they import goods and services from foreign countries. On the other hand when they produce goods even by importing raw materials they have very small market to sell those goods and services to sell. For which they seek foreign market to sell those products and earn more profit. Hence, for developing countries like Nepal, international trade plays very important role in development of the economy as heart plays the main role in operation of human life.

The main advantages of international trade in case of developing countries like Nepal are as follows:

1. **Consumption of quality goods at cheaper price:**
   Import of goods from foreign country in high volume decrease the price of products in domestic market. Hence, the people of developing countries will be able to consume the quality products at cheaper price.
2. **Preservation of consumer's sovereignty:**
   Foreign trade provides the choice to the consumers to consume what they want no matter the product is produced in domestic country or foreign country. It preserves the consumer's sovereignty.
3. **Export promotion and source of foreign currency reserve:**
   Foreign trade provides access to export goods and services to international market which helps to earn foreign currency and improve standard of living of developing countries.
4. **Increase in government revenue:**
   Increase in export and import of goods and services increases export and import taxes to increase government revenue.
5. **Increase in productivity of domestic industries:**
   Competition created by foreign trade also increases the productivity of domestic industries as people choose the superior than inferior. If they produce the inferior, they will exit from the market.
6. **Improvement in relationship between countries:**
   Foreign trade not only increases the trade volume but also improves the relationship between/among countries of the world through the transfer of goods, services, technology and social/cultural norms and values etc.
7. **Helps in internal crisis:**
   If internal production system faces any crisis, foreign trade helps to supply goods and services from international market to fulfill demand of goods and services of domestic people.

With the help of those various benefits of international trade in case of developing countries. It can be justified that foreign trade is the main basis of development in case of developing countries like Nepal in this age of globalization.

2. Short Answer Questions (Any Five):

   a) Describe the scope of microeconomics. **3**

   b) Explain the law of supply. **3**

   c) Define economic and accounting costs. What is the basic difference between them? **(2+1=3)**

d) Explain the three features of monopolistic competition. **3**

e) Explain any three importance of medium and large scale industry in Nepal. **3**

f) State the traditional sources of agri-finance in Nepal. **3**

Answer:

a) Micro economics deals chiefly with the choice and decision-making behavior of households, firms and industries and the relationship between prices and quantities of individual goods and services. The scope of microeconomics can be explained with the help of following components:

(i) Theory of Demand: Under this head, microeconomics studies concepts and theories like demand function, elasticity of demand, etc. related to consumer's behavior.

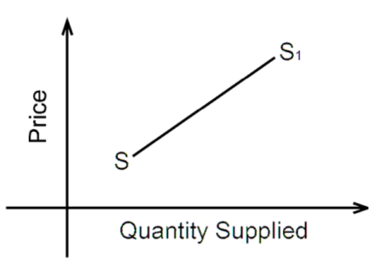
(ii) Theory of production: Under this head, microeconomics studies concepts and theories of production like production function, cost function, etc related to producer's behavior.

(iii) Theory of pricing: Under this head, microeconomics studies the process and basis of determining price of product and impacts under different market structures.

(iv) Theory of economic welfare, microeconomics also studies the theories related to economic welfare.

(v) Theory of factor Pricing: Microeconomics also deals with determination of prices of factor of production such as rent, interest, wage, profit etc.

b) Law of supply states that quantity supplied of a commodity varies positively with price of same commodity, other things being equal. It implies that when price of a commodity increases, quantity supplied of same commodity also increases and vice versa. In other words, it shows the direction of change in quantity supplied due to change price of same commodity.



Based on given figure, SS_1 is the supply curve. It slopes upwards to the right. This slope indicates that quantity supplied of a commodity varies positively with price of same commodity.

c) Cost of production refers to the expenditure made by the producer in various factors of production which directly or indirectly contribute the production process. It mainly depends on two factors: price of inputs and level of output. Since, price of inputs are exogenously determined, cost of production mainly depends on the level of output. Hence, cost function expresses the functional relationship between cost of production and level of output.

Mathematically, C = f(Q)

Accounting cost refers to the monetary payments made on various external factors contributing the production of goods and services. It includes all the costs which can be presented in the accounting by an accountant. Accounting cost only consist explicit cost.

Accounting cost = explicit cost = money cost

Economic cost includes all type of monetary as well as non-monetary payments made by the producer to the various factors of production contributing the production process. It includes both explicit as well as implicit cost.

Economic cost = explicit cost + implicit cost

= money cost + imputed cost + normal profit

The basic difference between accounting cost and economic cost is that, accounting cost only includes explicit of money cost in it whereas, economic cost includes both explicit or money cost as well as implicit cost (sum total of imputed cost and normal profit) in it.

d) Features of Monopolistic Competition

1. **A large number of sellers**:- The number of sellers are sufficiently large that there is no feeling of material interdependence among them. Each firm acts independently without caring for any effect, which its action may have upon those of its competitors.
2. **Differentiated products**:- The large number of buyers have preference for the product of the particular seller. Different sellers may have differentiated products for creating preference for their product in the minds of the buyers.
3. **Free entry**:- Under monopolistic competition, the new firms may enter into the industry freely. They can enter and exit out of the industry and can produce the products which are close substitutes with other products.

e) The main importance of MLSI are explained below.

1. **Rapid Economic Growth.** Productivity in MLSI is higher than that in any other sector of the economy. The development of MLSI can increase the economic growth rate of Nepal. Because MLSI accelerates economic growth, it increase the annual national income.
2. **Resource Utilization.** Nepal is rich in natural resources. Therefore, MLSI should use them. Nepal's limestone deposits came to be used only after the establishment of large-scale cement industries. Similarly, other mineral deposits and water and forest resources could be utilized for upgrading MLSI.
3. **Sectoral Balance.** Nepal's economy is dependent by an large on agriculture. About 65.58% of the total Nepal's population is engaged in this occupation. This position shows the state of sectoral imbalance in Nepal. It is necessary to divert some of the population to the non-agricultural sector. MLSI help in the sectoral balance of economy by

developing transport, communication, electricity, banking, insurance, trade and commerce.

f) The main sources of traditional (or non-institutional) agricultural finance are moneylenders, landlords, traders and private borrowings.

a. **Moneylenders and Landlords.** From the very beginning, moneylenders the main suppliers of short-term and long-terms credits to Nepalese farmers. They provide loans to the farmers for productive as well as unproductive purposes. Their loan advancement process is flexible and the loan has fixed repayment. The moneylenders are somewhat flexible about the execution of documents and the security to be obtained. Their loan is also available readily to those persons whom the lender knows closely. However, the loan obtained from the moneylender is not enough to meet the demands for credit of modern agriculture.

b. **Traders and Private Borrowings.** Another agency, which provides short-term credits to farmers is the traders. They provide loans to the farmers for productive purposes before the harvest is ready on the condition that they (the farmers) will sell their produce to them at pre-determined prices, which are usually very low, compared to prevalent market prices at the time of harvest. This type of loan assumes greater significance in the case of food grains like paddy, wheat and cash crops like cotton, jute, tobacco, cardamom and sugarcane.