ECONOMICS [ECN]

[103]

Supplementary for Chapter 01,03,04,05

Economic Concepts and Systems related to Business Environment Behavior of Production Process and Different Market Structures, National Accounting and Role of the Government, Financial System, Money and General Price Level

This supplementary to the Study Text will be tested from July 2020 Examination.

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Reference –Chapter 3-Page 81-English Study Text

Demand Curve of a Monopoly

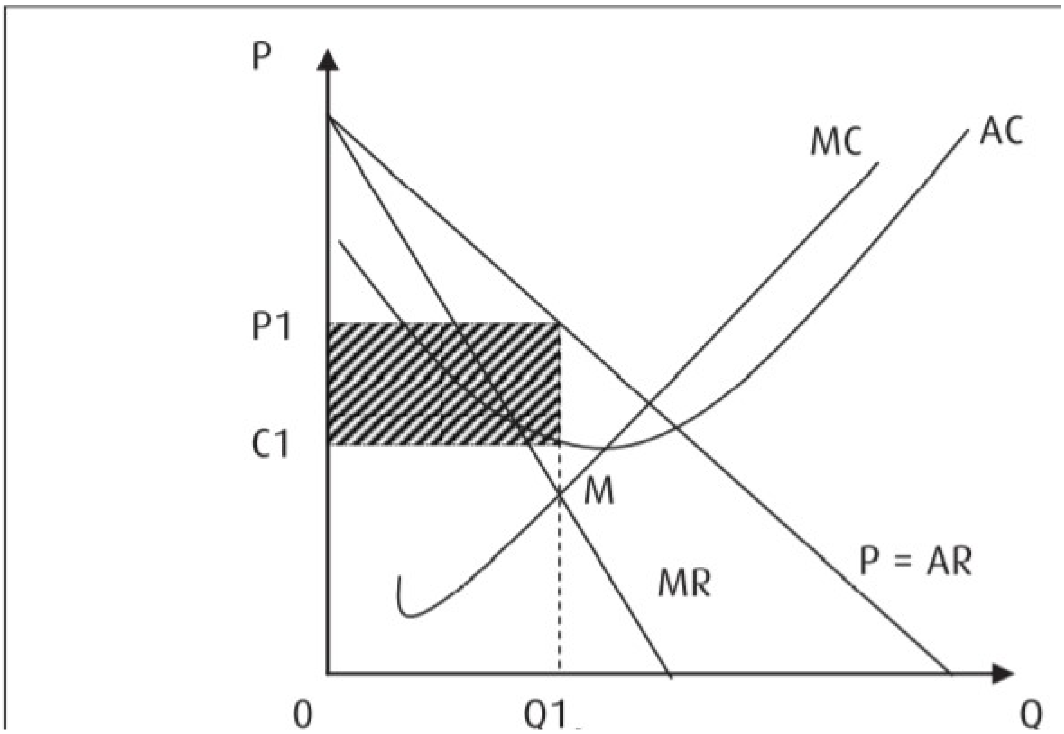
Demand curve of a monopoly will be similar to the demand curve of the industry. That is a downward sloping curve from right to left. All the relevant prices should be decreased to in order to increase one unit of sales.

In perfect competition, sales can be increased under a same price hence, Marginal Revenue (MR) curve can be drawn parallel to the horizontal axis.

Profit Maximization under Monopoly

In a monopoly, to identify the profit maximizing equilibrium, MR and MC curves should be considered. The monopolist reaches his profit maximizing equilibrium at point where MR=MC.

When a monopoly firm is in profit maximizing equilibrium, its MC is always less than the price it charges for its output. A profit – maximizing monopoly will never sell in the range where the demand curve is inelastic.



Equilibrium of a Monopoly

Long- run Monopoly Equilibrium

In both monopoly and perfect competitive industries, losses and profits provide incentives for exit and entry. But unlike perfect competition, there are entry barriers to a monopoly.

Therefore, in the long-run a monopoly will remain in business only if it can make a profit (or at least break even) by producing the best level of output. The best level of output in the long-run is given by the point where the LMC curve intersects the MR curve.

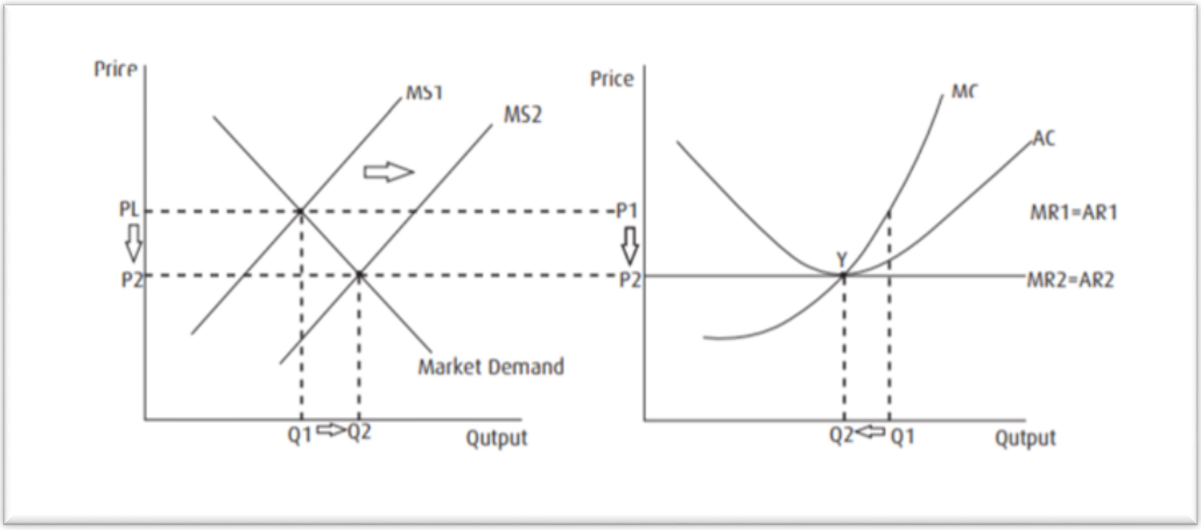
Reference-Chapter 3-Page 84-English Study Text

Long Run Equilibrium in Perfect Competition

The main factor that decides long run equilibrium is the ability to enter the market and exit from it. In the short run equilibrium, there will be different economic profit levels in companies. Such economic profits and losses will provide signals to those who enter and exit from the market.

If a firm earns profits in the equilibrium of the short run, it will attract more firms into the industry. That will result in a rise in the market supply, leading to a fall in the equilibrium price. Therefore the economic profits will fall down and new firms will enter the market until the economic profits disappears.

Alternatively, if the firm incurs a loss in short run, some firms will be forced to leave the market as they will fear making losses. That will result in a decrease in the market supply, leading to a rise in the price. The firms will exit until the economic losses disappear.Hence, the perfectly competitive firm earns neither economic profit nor makes an economic loss in the long run. That means in long run equilibrium, all firms only earn normal profits.



Long Run Equilibrium in Perfect Competition

Reference –Chapter 3-Page 87-English Study Text

Nature of the market	**Number of firms**	**Entry to the market**	**Nature of product**	**Examples**	**Demand curve of the firm**
Perfect competition	Very large	No barriers (Free entry)	Homogenous goods	Paddy , Corn carrot, pumpkin	Parallel to the horizontal line price taker
Monopoly	One firm	Barriers	special goods	Railway service, water supply , Electricity supply	Slope downward price maker
Monopolistic competitive	Large	No Barriers	heterogeneous goods	canteen, grocery, saloon	Slope down ward - can affect the price - comparatively - elastic demand
Oligopoly	Few Firms	Barriers	Heterogeneous or homogenous goods	Newspapers Television, channels commercials bank, gas, soap	Slope down ward - can effect to the price - comparatively in elastic demand

Reference –Chapter 4-Page 118- English Study Text

The budget deficit and ways of financing

There are situations where expected expenditures of the government for the next financial year exceed expected government revenue, is known as a budget deficit. The main source used by the government to finance budget deficit is the public borrowings.

Two main sources are used for deficit financing are;

1. **Domestic sources**
   Domestic sources are again two types;

   1.1 Market sources
   If government borrows money through financial instruments of treasury bills and treasury bonds it is the borrowing of money through market sources.
   Market sources again classify into two types;

   1.1.1 Borrowing money from the banking system
   Loans obtained from the central bank and commercial banks are identified as loans obtained from the banking system. It is also called as borrowing money from inflationary sources. When borrowing money from banking. Sector to fulfill budget deficit it will occur money expansion within the economy.

   1.1.2 Borrowing money from the non-banking sources
   Borrowing money from non-bank institutions which cannot create money such as national savings bank, development banks, insurance companies, employee provident fund and trust fund is called borrowings from non-bank sector
   When borrowing money from non-bank sector as it cannot create money it does not affects over money supply. There are few such sources.

   - Administrative loans
   - Deposits at treasury (Central bank advances)
   - Other deposits

   1.2 Non market sources
   Borrowing money without intervention to the financial market is the borrowing money from non – market sources. This includes obtaining money from the deposits and surplus funds of government institutions temporarily to finance the budget.

2. **Foreign sources**
   There can be a monetary expansion with foreign loans and foreign aids as well. As the amount of foreign assets increase when using foreign sources to finance budget deficit it generates an inflationary effect over money supply. Also when converting foreign loans and aids into domestic currency inflationary effects can be occurred.

   There are two foreign sources of financing budget deficit.

2.1 Foreign loans

Financing budget deficit by the loans granted from a foreign government, international financial institutions or international markets are called foreign debt sources.
Loans obtained through this way again classified as concessionary and as non-concessionary based on the conditions of the debt obtained. Foreign loans are more important than foreign aids in financing budget deficit. Concessionary loans are provided without conditions or at a low interest rate or with a grace period. Non-Concessionary loans also called as commercial loans. Loans obtained at a high interest rate and under various conditions are identified as non-concessionary loans.

2.2 Foreign aids

- However borrowing money from domestic and foreign sources affect over Sri Lanka economy is explained by the economic consequences of public debt. These economic consequences depend upon the nature of the debt source that used to fulfill budget deficit.

- Two unfavorable effects generate over the economy with continuing budget deficit and increase in public debt.

    - Increase in market interest rate
    - Creating of a shortage of domestic financial resources available for the private sector investments.

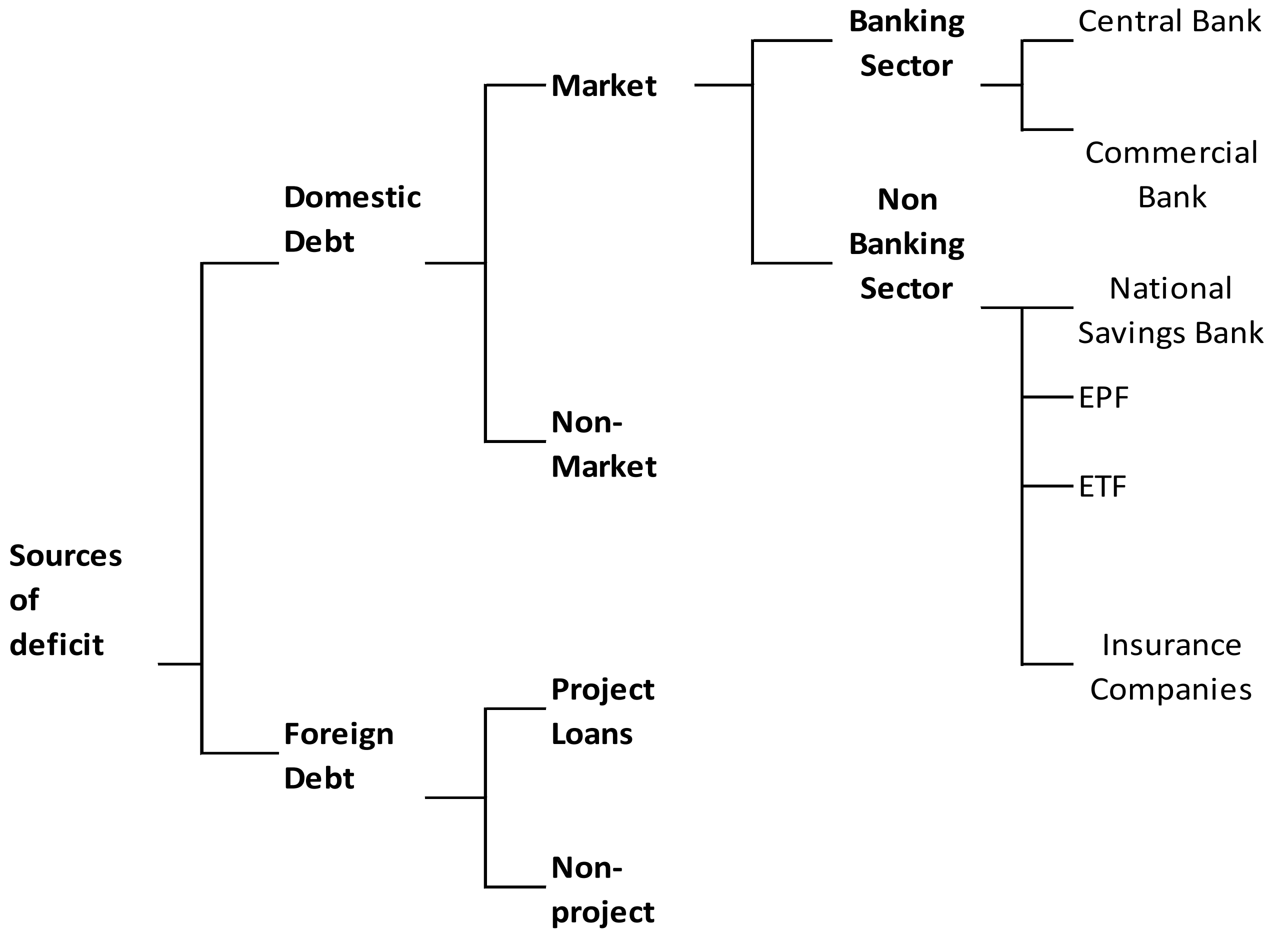
- Due to the competitiveness arise when government borrows money form financial market and private sector demand loans from commercial banks, credit interest rate increases. Moreover, unfavorable effects are generated over the economy when borrowing money from the central bank and commercial banks.

- Private sector investments are discouraged when government sector and private sector compete for limited amount of financial resources. Those unfavorable effects are generated because of commercial banks and the central bank being inflationary sources.

- Borrowing money through non-market sources to fulfill budget deficit do not generate such unfavorable effects.

  Eg; Use of surplus funds of various government institutions at the end of year to finance budget deficit is called administrative loans. In this situation there is neither expansion in money supply nor any inflationary effect.

Reference –Chapter 4-Page 124- English Study Text



Reference –Chapter 5-Page 136- English Study Text

5.2.5.1 Narrow Money Supply (M1)

This includes the money held for transaction motive and money which facilitates Medium of Exchange Function.

$$\boxed{M_1 = C_P + DD_P}$$

M1 =Narrow money supply

Cp = Currency held by the public

DDp = Demand deposits held by the

5.2.5.2 Broad Money Supply (M2)

This definition includes all items mentioned in Narrow Money Supply and Money held for Precautionary Motive and Money which facilitates the Store of Value Function.

$$\boxed{M_2 = M_1 + TSD_{CP}}$$

Where

M_2 = Broad in only supply

M_1 = Narrow Money Supply

TSD_{CP} = Demand deposits held by the public at commercial banks