

# [Price elasticity income elasticity and cross elasticity](https://assignbuster.com/price-elasticity-income-elasticity-and-cross-elasticity/)

Explain the concept of elasticity of demand and discuss the factors that determine elasticity of demand. Distinguish between price elasticity, income elasticity and cross elasticity of demand and evaluate on their importance especially to businessmen.

## Solutions to Question 2

## 2. 1: Concept of Elasticity of Demand

Elasticity is a term that was initially developed by known economic scholar called Alfred Marshall, and has been since used in measuring the relationship that exists between product price and its quantity demanded. It typically followed the law of demand that states that the lower the price of goods and services, the higher the quantity that will be demanded of such goods and services i. e. it primarily explains only the actual directions of changes in the demand for the commodity, but not really explaining the extent of that change. A further development on these lapses led to the concept of elasticity of demands.

In practical term, elasticity means the act of responsiveness. Meanwhile, elasticity of demand has been theoretically defined as the responsiveness of the actual quantity demanded of a product to the change in its actual price. E. K. Estham argued further that elasticity of demand could be defined as the measure of the degree of responsiveness of the quantity demanded to any small change in its price.

This measure of the degree of responsiveness of the actual quantity demanded of a product to any changes in its price can be calculated with the use of the formula below:

A good diagram to represent the established downward sloping curve of elasticity of demand could be seen as the incremental changes that are caused in the quantity that is demanded along the x axis, notably going in the opposite directions that are relative to these changes in the commodity price along the y axis. Below is figure 1 that aptly depicts the degree of responsiveness of demand due to changes in prices of the commodity:

Thus, vivid observations of the above elasticity of demand complement the simple mathematical presentations of the elasticity of demand as presented above. Notably, the elasticity of demand is commonly expressed as “ Ed”. Diagram 1 above indicates that depending on the actual responsiveness to any changes in prices of commodity, elasticity of demand could be either elastic or inelastic as seen described through the angles of the above demand curves. Importantly, economist have argued that the flatter these curves, the more elastic is the price of the commodity, meanwhile steeper curves will mean the more the price is inelastic.

## 2. 2: Factors that determine elasticity of demand

Below are the important factors that directly or indirectly influence the degree of demand to any small change in price:

## 1. Nature of the commodity

Elasticity has been argued has primarily depending on if the actual commodity to be demanded is a basic necessity, a comfort or a luxury. This is because goods that fall under the basic necessities of life have been categorized as having inelastic demand, while those comforts and luxuries goods are categorized under the elastic demand.

## 2. Availability of the substitutes of goods or services

Goods or services with available substitutes have been theoretically and practically argued and established as having elastic demand and those goods and services that are without available substitutes normally have inelastic demand. Good examples of these goods are coffee and tea that serve as substitutes to each other. They are substitutes because a change in the price of tea might make people to switch over to buying coffee. Alternatively, an increase in the price of coffee may also make people shift to buying tea. But a good example of inelastic good is salt because it has no substitute.

## 3. Uses and/or applications of the goods or services

The usage of goods or services may affect its elasticity either elastic or inelastic. Good example is electricity, any decrease in its price will eventually led to consumers ability to make more use and further establishing electricity as having elastic demand curve.

## 4. Consumers’ proportion of the income that is spent on the commodity

Practically we have noticed that the consumers can spend only a very small percentage of its income in buying such goods. Good example is salt and matches that normally take a very small percentage of consumers’ income, making them having inelastic demand curve.

## 5. The prices of goods

Generally speaking, cheap goods and services normally have inelastic demand curve, while the expensive goods normally have elastic demand curve.

## 6. Income of the consumers

Scholarly arguments have shown that the rich or high income earners normally have inelastic demand curves for their goods and services, while the poor or lower income earners normally have elastic demand curve. This is because he rich and high income earners will buy the goods and services at every levels of its prices, whereas the poor or lower income earners tends to change along the quantity of their consumptions due to changes in price.

## 7. Time period

Evidence has shown that elasticity of demand would better occur in the long run production of the goods or services than at the short run. This is primarily because in the long run production and supply processes, the consumers could adjust to their individual demands by switching or trying cheaper substitutes. Industry evidence has shown that productions of the cheaper substitutes are only possible only at the long run operational processes.

## 8. Income and Wealth Distribution in the society

The presence of unequal distributions of the national income would the demand for the goods and services to be relatively inelastic. Most advance countries that allow even distributions of their income and wealth will make possible elastic demand for its commodity.

## 2. 3: Differences between price elasticity, income elasticity and cross elasticity of demand

Below are the three types of elasticity:-

Price elasticity

Income elasticity is further divided into 3 i. e. Zero income elasticity of demand, Negative income elasticity of demand and Positive income elasticity of demand.

Cross elasticity

## 1. Price Elasticity of demand

Price elasticity of demand has been defined as the actual degree of responsiveness of the quantity that is demanded of a good or services in response to the changes in its actual price i. e. price elasticity of demand primarily measures how much of a change in actual price of any good that affects the demand for these goods or services, leaving all other factors to be constant. To calculate price elasticity, there is need to divide the proportionate of change in the quantity that is demanded by the proportion of change in the price.

EP= Percentage change in the quantity demanded

Percentage change in the price

## 2. Income elasticity

Income elasticity of demand has been argued as measuring how much of a change in consumers’ income that affects the demand for such goods or services if its price and all other factors remained constant. Below is the formula for calculating income elasticity of demand:

EY= Percentage change in the quantity demanded

Percentage change in the income

As divided into three, Zero income elasticity shows that a change in the consumers’ income will have no significant effect on the quantity that is demanded of such goods. Good examples are salts, matches and cigarettes. Next is negative income elasticity that shows that an increase in the incomes of consumers will lead to the decrease in the quantity that is demanded of such goods. This situation mostly occurs in inferior goods. Last is positive income elasticity that means an increase in the incomes of consumers will lead to the increase in quantity that is demanded of such goods.

## 3. Cross elasticity

Cross elasticity of demand measures the actual change in the demand for commodity A due to the change in the price of commodity B.

ED= Percentage change in the quantity that is demanded of commodity A

Percentage change in the price of commodity B

The above formula indicates that if the goods or services that have substitutes and cross elasticity are positive i. e. as above any increase in price of commodity X will finally result in the increase in sales of commodity Y.

## 2. 4: Importance Elasticity of Demand to businessmen.

As evident above, the concept of elasticity of demand has been playing a vital role in the decision making processes of the business world, especially as it relate to fixing commodity prices with the aim of making larger profits. Good example is if the cost of production tends to be increasing the company will want to pass this rising cost to the consumers through raising the price of the commodity. Practical examples have also shown that some companies do change their commodity price even without any visible change in the actual cost of their productions. But practically, whether the raising price is following any rise in the cost of production or otherwise has proved to be beneficial depends on the following situations:

The actual price elasticity of the demand for such goods or ser product, i. e. the percentage change is subject to how high or low the proportionate changes in its actual demand relate to the percentage change in commodity price.

The price elasticity of the demand is also very relevant for business in determining the value of their substitute, this is because when the commodity price increases the actual demand for the product substitutes also increases automatically even if the products prices generally remained unchanged.

Businessmen are also able to know that increasing the price of their goods would only be beneficial if:

The demand for their products is less elastic

The demand for their product’s substitutes is also much less elastic.

Finally, the usefulness of elasticity of demand also stands in its ability established the required quantitative relationships that exist between the quantity demanded of a product and its price or any other determinants of demand.

Question 4: Discuss some of the characteristics of the Malaysian economy. Discuss some of its weaknesses and suggest some appropriate policy proposals to strengthen the economy in order to enable it to become a developed economy by 2020.

Solution to Question 4:

## 4. 1: Characteristics of the Malaysian economy.

Malaysia is one of the countries located in the Southeastern Asia. The capital is called Kuala Lumpur. Malaysia comprised of two parts, one part is the Peninsular Malaysia and while the other is the East Malaysia which is called Malaysian Borneo. The Peninsular part has 11 states while the East Malaysia comprises of 2 states. Malaysian economy system is an open economy system; the economic involves domestic community and the international community. More so the economy is a state oriented market economy. The country has a fast growing economy. The economy was ranked 3rd largest among the south East Asian countries in 2007. Where Malaysia suited is a great advantage for its foreign trade.

## Malaysia GDP

The Gross Domestic Product of Malaysia depends solely on its agricultural, manufacturing industries and the service sectors. The agricultural sector contributed 9. 7 % to the country GDP in 2007.  Also in the area of manufacturing industries it contributed 44. 6% to the country and t of service sector contributed 45. 7 % as well to the GDP. For the PPP (Purchasing Power Parity), the country is ranked 29th in the world. They have GDP growth rate of 20 % and it was realized towards the end of 20th century. In 2009 GDP of Malaysia was estimated US$ 207, 400 billion PPP was calculated to be $ 3. 9 billion.

## Malaysia Natural Resources

Malaysia is rich natural resource, like agriculture, minerals and forestry. Most agricultural plant resources of Malaysia are rubber, pine apple, palm oil tobacco etc. The country’s economy In the area of Forestry, the loggings contributed a larger amount to the country’s economy. More so, in the plantation area is timber, rubber plant and palm tree. When we talk of minerals resources, Malaysia is a rich deposit of minerals like tin and petroleum.

## Sectors of Malaysia Economy

## Malaysian Industries

## Mining Industry: Malaysian Economy

Malaysia mining industry has contributed a lot to the economy through the export of mine products. The most important ones are oil, gas and tin. Malaysia was ranked has the world’s largest producer of tin in 1980. The sea transportation was easy because the mine is located in location of the mines in the peninsular Malaysia. Crude oil production and natural gas has increased to a higher level over the last few years. In 1999, the overall production of petroleum reached 693, 000 barrels. Production of liquefied natural gas was estimated to be 3. 8 billion cubic feet. There are major oil refiners in Malaysia

## Manufacturing Industry : Malaysian Economy

In Malaysia there are many developed manufacturing industries. The manufacturing industries of Malaysia are, electronics manufacturing industries, furniture manufacturing industries and Food processing industries etc. In the sector of manufacturing, the country is ranked in the 23rd position in the world countries.

## Malaysian Services

## Malaysian Tourism: Malaysian Economy

Malaysia in the sector of tourism was ranking the 9th position in the world. The common tourism locations in Malaysia are Kuala Lumpur, Sabah, Perlis, Malacca, Terengganu etc

## Banking and Finance:

The bank Negara Malaysia is in charge of finance sector. Master Plan was introduced in 2001 after the 1999 financial crisis and this gave more room for to Islamic banking. May Bank is said to be the largest bank in Asia Pacific that practice Islamic Banking. However Malaysian government plan to give licensure to more sectors by the end of 2010 to improve the opportunities of Islamic Banking.

## 4. 2: Some Weaknesses in Malaysian economy.

## 4. 2. 1: Political Weakness

In Malaysia Malay half of the population holds the constitutionally position in society, and this a kind of discrimination among the three race, this is not only in jobs but in wealth as well. Controversial Internal Security Act (ISA), give room for detention without trial, has been abuse by the government on many occasions with intention of quelling unrest. More so, some of the detentions government used it to oppress the government opposition.

## BMI Political Risk Ratings

The Malaysia’s short-term political risk rating (STPR) of 80. 2 shows higher compared to other regional country like Indonesia, Philippines and Thailand. As the opposition to Pakatan Rakyat always challenges the BN coalition being witnessed in the defeat of the 2010 budget bill in parliament in 2009, the people thought that general political stability will be maintained. However, it is encourage that Malaysia was able to maintain a peaceful political environment, but this all depend on Prime Minister Najib Razak’s his straight to encourage unity in the nation with diverse ethnicity and faiths.

## 4. 2. 2: Economic Weakness

Malaysia’s is becoming importer of oil in the next few years, Malaysia Economic openness will be as much of a burden as a benefit, because of it confirmations of a high level of vulnerability to global growth and capital flows. The taxes collected on oil contribute over 40% of the state’s revenues despite the fact that it was expected to become a net oil importer by the beginning of 2011. Because the government had difficult in having alternative income, this will make hard for the government’s function perfectly and maintain economic development, which is potentially leading to stagnate economy.

## BMI Economic Risk Ratings

In the previous quarterly report Malaysia’s STER rating has being declining to be 73. 5. And still Malaysia is still in the respectable ‘ V-shaped’ recovery of 4. 1% now the 2009. The actual GDP growth is1. 7%), never the less Malaysia is exposed to a Chinese double-dip slowdown, most especially if Beijing was unable to diffuse the satisfactorily recent property bubble in the near future. Malaysia in addition, has a huge fiscal deficit that is over 7% of GDP in the year 2009 and this has bring the LTER rating down to 72. 6.

## 4. 2. 3: Business Environment Weakness

The country will keep price subsidization will a peripheral and it has become part of the economy system or economy life of Malaysia. Some of the big construction project and contract for foreign firm are all under the domain of formal Prime Minister Mahathir Mohamed so they are not directly connected to the government. In order words engaging in businesses in the country will always mean doing businesses with the politically connected people.

## BMI Business Environment Risk Ratings

Furthermore, in (BER) Business Environment Rating Malaysia scores over average which is 63. 4 but the score was dragged down because of the comparatively low score of 55. 3 for the Infrastructure subcomponent like public transportation, mean while, in 2009 a reduction in the amount of red tape boosted the Institutions subcomponent to a score of 66. 9 from 59. 4.

## 4. 3: Some policy proposals to strengthen Malaysian economy.

There is a recommendation policy which must be followed accompanied with this, is other improvements in the economy.

Firstly there should be huge notification should be on diversification. Most of the Malaysia’s export markets focused on technology sector and electronics which are vulnerable to global slumps in demand, mostly the US, the US are major exporter of Malaysian goods. Opening trade of a country economy is an important factor to decide a kind of exchange rate system that is desirable. If any country relies on trade, the fixed exchange rates provide stability in the market economy. Anyway, when having the exchange rate fixed does not mean the economy will remain competitive in foreign trade when some other countries are faced with inflation. Never the less it resulted to the second element, the inflation rates.

The inflation rate of the trade partner is relevant factor so as the inflation of domestic inflation with the fixed rate; in order words the approach is not straightforward. So it is better for the country to remain with the fixed rate to avoid inflation tendency in the economy. Another recommendation is labor market flexibility which is used to determine which exchange is better in a given period of time. In this respect if there is flexibility in the labor market, the fixed exchange system work better. There must be flexible labor market and flexible exchange rate in order to avoid unemployment because of the output shock.

Further more, the degree of financial development of the country is important. So when a country seems to be financially underdeveloped, fixed exchange rate is better to avoid urge effects of foreign speculation.

Lastly is how to decide on which exchange rate system is better, and the mobility of capital. Mean while, it is better for exchange rate to be flexible when the capital mobility is high. Observation, Malaysia’s decision in pegging its currency to the dollar seems adequate. With solid financial institutions and credible policymakers, it would be adequate, as well transforming to a flexible exchange rate system.

Concludsivly, easing the changing’s Malaysia will have to persistently implement consistent macroeconomic policies so as to maintain financial stability and sustainable fiscal and external positions.

Question 7: Elaborate what you understand by deficit financing. What are its limitation as an instrument of economic development. Assuming that you are the economic advisor to the prime minister and he/she ask for your recommendations to eliminate a federal deficit, what would you recommend?

Solution to Question 7:

## 7. 1: Elaborate what you understand by deficit financing.

What do we mean by deficit financing this is a strategy or ways to management of money which when spending is more than collected at the same period of time. In order words this is referred to budget deficit, this approach is used in business that is small, household budgets, in corporations and also in, governments sector mostly in all the level. If deficit financing is used in the right way it will help to launch a chain of the event and this will help in financing situation instead of any debt may cause problem or difficult to pay. Mostly common or know example of government deficit financing is how the government stimulate the economy of that country or nation to put a stop to any recession that country is facing. The government has a set aside a plan which will involved using borrow resource’s to purchase, the government can use different strategy like increasing demand output for product in all business sector of that nation. It also helps in the motivation of many business in order for them to hire more employees and it will reduced the level of unemployment in the country during the period of recession. Further more, the consumer confidence and trust will be restored in the market place because of the safe transformation, and these make it safe for the buyer to buy more goods and services. If the economy of a country in closely looked into and the deficit financing is carefully monitored, it will bring back economy stability in the country over short period of time like few month or few years.

Deficit spending in economic does not only occurred in the government sector only but also in all business as well A company may plan to spend a certain amount of money as a kind of upfront thinking that they will be able to generate the fund back for investment . An investor or company owner may decide to buy a new machine for the company production with the hope that a new machine will hasten and make the production of goods in a less period of time with larger unit of goods, and with less cost. This kind of idea or strategy in business help the business to flourish and the manufacturer will be able to pay off his debt and have budget surplus instead of deficit, the owner of the business will be debt free and enjoy the surplus.

## 7. 2: The limitations of Deficit financing being an instrument of economic development.

In any given economy, the government normally embarked many projects that assisted it in generating the desired economy outputs both in investment and other capital projects. If the government prints more money out it will cause inflation in that economy and this situation usually affected the poor people in that society. The rich will be richer and the poor will be poorer. The buyer straight will be reducing to greater level and the businessmen profit margin will increase. In any society there is always the people that have and those who do not have so any increase made in price domestic’s goods leads to importation of cheap goods and the domestic goods high price will reduced the export. This in turn leads to adverse in balance of payments. Never the less this will affect the cost of the production because the raw material used in process of production has being increased, so the goods will be increased as well, perhaps it will definitely reflect on foreign investment, it will be less attracted by other country. Good example is figure 3 below that aptly depict government spending in OECD countries:

Source: OECD (2010).

Listed below are the disadvantages of deficit financing and some other cogent reasons to be alert about a National debt.

## The interest Payment

In a society people do not lend to the government with the charity. Government must pay interest on every debt they are involved in just like any one in the society, it was recorded that last year government spent the sum of £31 billon on interest payments alone. Looking at this in a perspective manner it will equate to 15 p on income tax. This amount is more than what UK spends on National Defense. The government borrowing for the year 2007/08 going to be £42 billion same amount the government pays in interest.

## The Crowding Out effects

The government debt always affect the private sector because they sell bond to the private sector in order for the government to borrow money and this in turn lead to less private investment because the government has bombard them with the bonds. Also the private spending is more efficient than the government level of spending because the government result to inefficient spending . this is what we called crowing out, the private investor is crowded out with government bonds because the government needs to borrow

## The financial crowding out

The financial crowding out is when the government want to borrow large sum of money and they tried to increase the interest rate on bonds in order to attract many lender. The bonds rate is increased this will definitely put pressure on the interest rate generally, in order words this increase in the interest rate will affect the economy of that country because people will reduced their way of spending, investment level will be low and later run the economy growth will be low.

## The tax rises for the future.

The tax rises for the future look into how the public sector debt is being paid. Any increasing public sector debts indicated that the future taxpayer will be the one to bear the burden by paying the bill. No matter the situation of the public sector debt reduced or not, the future taxpayer will be the one to pay the interest on the debts. Further this will a problem because, has it was mentioned above, changing of demographics show that government finances is usually placed under pressure, though without borrowing from at that moment of time.

## Limits Fiscal Policy

In a normal situation the government should be able expand the fiscal policy in a situation where the economy is facing problem or recession. When a government has urge public debt they tried to reduced the scope by lowering tax in order to enhance demand. Then government must increase taxes and cut their spending in order to meet up with the budget . this is advisable because of the existing problems in the market economy.

## 7. 3: Suggested recommendations to eliminate a federal deficit

In summary, I like to recommend these three-step formulas for prosperity:

1) Elimination of federal taxes.

It will good to cancel government taxes because when the citizen gives money to the government is just like “ throwing coals to Newcastle.” Government is the maker of money, they are the producer that has no limitation to their production. . When the citizen sends taxes to the government, they just used it to pay debt. When you send your tax money to the government, the government simply uses it to pay down debt. When paying down debt it destroys the economy money in a given society. In order words taxes damaged money in the society.

More so, the federal tax system is a waste of resources, it will be good if the government can spend the billions of dollars spent on compliance on production of useful goods for citizen and this will ease the problem of the economy and the people.

The first suggested tax that should be eliminated is; the Medicare taxes and Social Security taxes. These will be politically popular; also regressive taxes directly impact businesses on low and the middle income people. That politician that ends FICA will becomes a hero.

This will give federal government the opportunity to create money to support retirement and health care sector.

## 2) Elimination of federal borrowing.

Government being a producer of money, an established government will not need to borrow money. These are inefficient; they are harmful, the exercise which provides no economic benefit. The Federal government borrowing provides semantic impression that government is in debt, and people it find repugnant.

If there no borrowing; there would not be debt.

## 3) Establishing a national, money-supply goal.

It is good to organize a congress, a congress that will look into the checking account called money created,” They will add money to this account when needed. They will write checks and make a kind of transfers from the Money Created account in payment for all goods and services.

This will be the suggested system for federal money creation in our economy. The congress will be the one to determine on how much money to be added to the Money Created account, however giving Congress power over money creation. Thus, the Federal will continue to control the interest rates and inflation.

The congress will spend what is necessary on retirement, the military health care, crime prevention, education, the infrastructure, and other national needs.

The country will be free the tyranny of semantics and the problem of federal debt. This society prosper has rapid growth in their economy.

Question 8: What are the constraints normally countries face in achieving a sustainable economic growth. What are the merits and demerits of attempting to achieve a faster growth rate in this country.

Solution to Question 8:

## 8. 1: Constraints facing the achievement of a sustainable economic growth.

As evident in existing literatures that ‘ sustainable’ literally means ability of a system to endure and ‘ last long. So, sustainable economic growth means an economic development that is able to last longer! According to late David Pearce who happen to be one of the best environmental economists in his generation, states that sustainable economic growth primarily indicates that each of the generation should be able to pass on much of its capital as inheritance to its coming generations, under this Pearce approach he defined capital as including physical capital like machineries and infrastructures, also intellectual capitals like knowledge and technology and lastly environmental capitals like environmental qualities and stocks of the natural resources.

This sustainable growth is what the world is witnessing from the groups of emerging economies have been trying all within them to continue to excel, particularly China and India that have remained as major drivers of the recent global expansions.

But, evidence has shown that while the recent global growth outlook seems more positive, I will like to use this opportunity to mention that there are major four constraints which could threaten the sustainable growth of any country, i. e.:

The prices of Oil – the unpredictable increase in the prices of oil by producing countries have always been tried to remedy by both the OECD and its other sister organizations such as International Energy Agency all working very add to help many countries in addressing their short and long-term growth challenges as a result of sudden increase in energy prices, problems or fluctuations in security of supply and other alternative sources.  If not properly curtailed globally, fluctuations in oil prices could significantly impede economic growth of countries.

External imbalances in trades – The imbalances in current accounts of trading partners across the globe has reached an unprecedented levels especially between countries like the US, Japan, China, and some other Asian coun