

Class: SY BSc

Subject : Business Economics – Micro

Chapter: Unit 1 Chp 1

Chapter Name: Economics and Economies

Today's Agenda

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 2. Understanding economic concepts
2. The problem of scarcity
 1. Demand and supply
3. Micro and macro economics
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1 Economics



What is economics?

The study of how individual & society make decision about ways to use scare resources to fulfill want & needs.

1.1 Economy



The economy is the sum total of the work we must perform to produce the goods and services we need to survive and live.

- The “economy” is simply that four-letter word that we curse on Monday mornings: W – O – R – K
- Without work nothing happens in the economy.



1.1 Economy

Economy in Neighborhood

- You can identify the main ingredients of the economy walking around your neighbourhood.
- Take a walk, and keep track of what you see:
 - What **work** are people doing (paid & unpaid)?
 - What do people **consume**, in order to stay alive?
 - What is being **invested** – is enough output ploughed back into improving or expanding the local economy?
 - How do people **finance** their bills? Where do they get **money**?
 - Is the local **environment** healthy, or being degraded?
- This is the “economics of everyday life.”
- We can **ALL** learn enough about economics to be confident in questioning conventional wisdom, and defending our interests

1.2 Understanding Economic concepts



Economics has a lot to do with money: with how much money people earn; how much they spend; what various items cost; how much money firms make; the total amount of money there is in the economy.

It is concerned with the following:

- The **production** of goods and services: The transformation of inputs into outputs by firms in order to earn profit (or to meet some other objective).
- The **consumption** of goods and services: The act of using goods and services to satisfy wants. This will normally involve purchasing the goods and services.

2

The problem of scarcity

Wants are virtually unlimited. Yet the means of fulfilling wants are limited. At any point, the world can only produce a finite amount of goods and services because the world has a limited amount of resources.

These resources, or factors of production as they are often called in economics, are of three broad types:

- Human resources (**labour**): All forms of human input, both physical and mental, into current production.
- Natural resources (**land and raw materials**): Inputs into production that are provided by nature: e.g. unimproved land and mineral deposits in the ground.
- Manufactured resources (**capital**): All inputs into production that have themselves been produced: e.g. factories, machines and tools

2 The problem of scarcity

So this is the fundamental economic problem: **human wants are virtually unlimited, whereas the resources available to meet those wants are limited this is called scarcity**



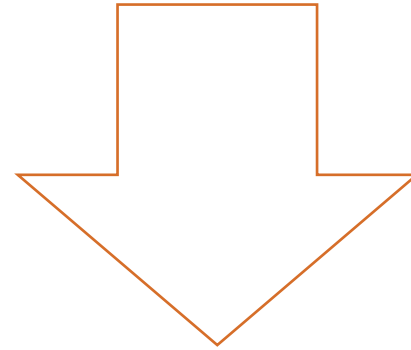
Scarcity is the excess of human wants over what can actually be produced.

2.1 Demand and supply



Demand and supply and the relationship between them lie at the very center of economics.

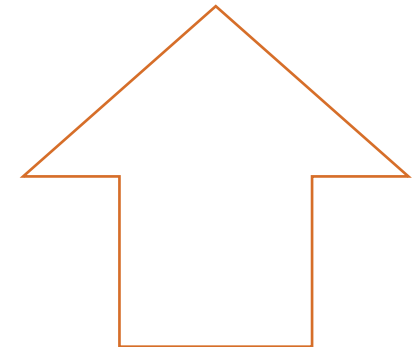
How does this relate to the problem of scarcity?



Demand is related to wants. such wants are likely to be virtually boundless, perhaps only limited by people's imaginations



Supply, on the other hand, is limited. The amount that firms can supply depends on the resources and technology available.



2.1 Demand and supply

Given the problem of scarcity – that human wants exceed what can actually be produced – potential demands will exceed potential supplies. Society has to find some way of dealing with this problem, to try to match demand with supply.

This applies at the level of the economy overall: total or ‘aggregate’ demand needs to be balanced against total or aggregate supply

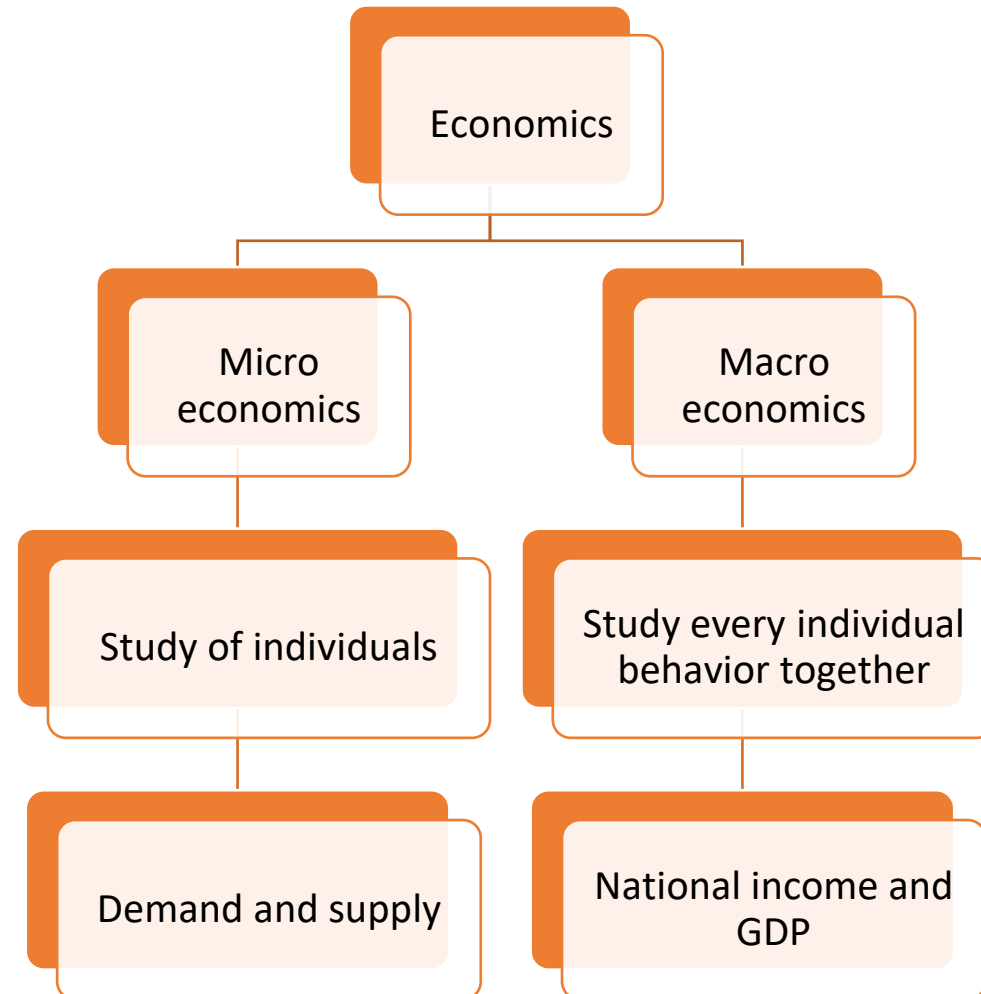
- **Aggregate demand:** The total level of spending in the economy.
- **Aggregate supply:** The total amount of output in the economy.

Economics studies this process. It studies how demand adjusts to available supplies, and how supply adjusts to consumer demands.

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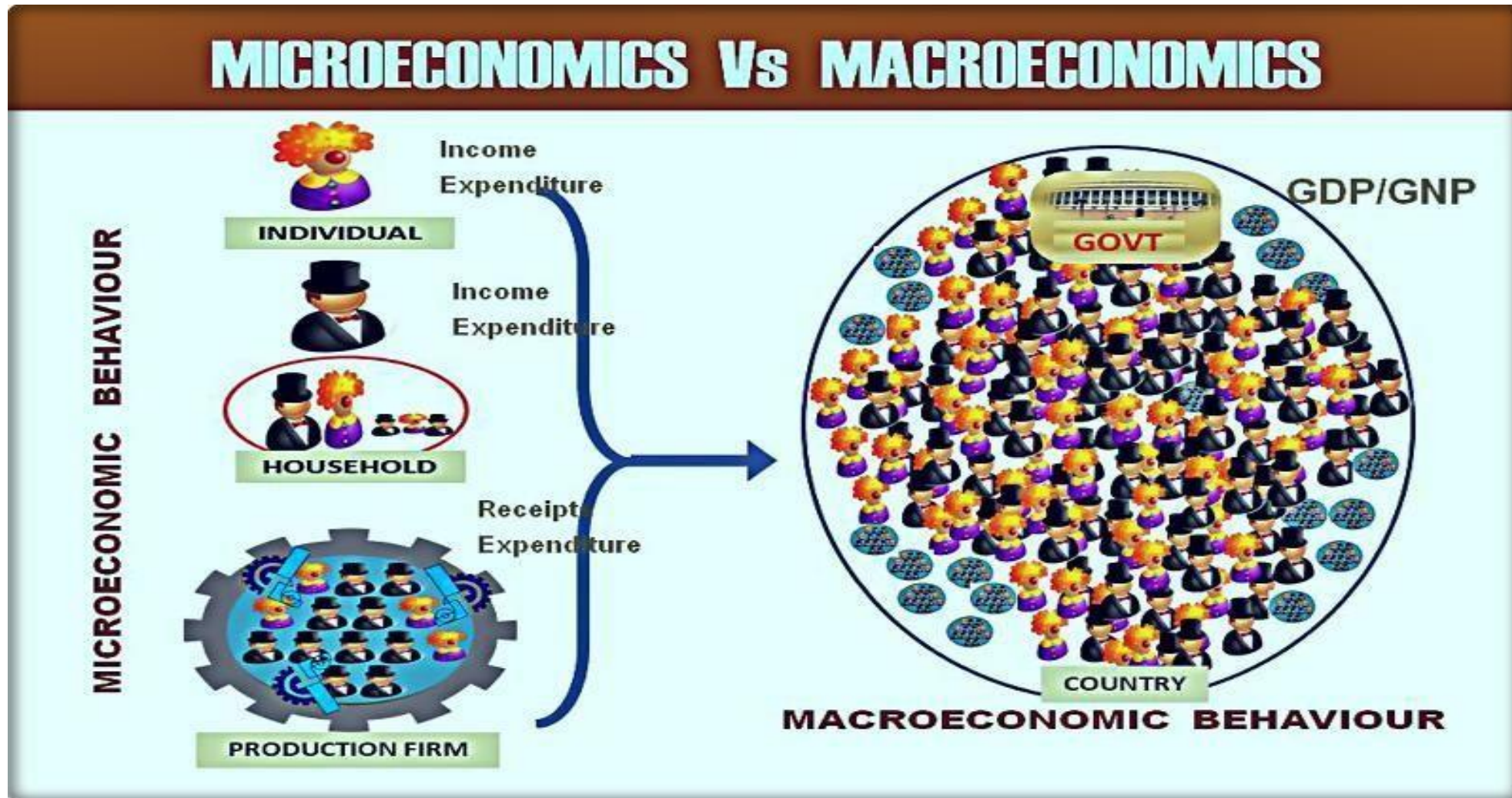
Micro-economics and Macro-economics

The given diagram shows the basic difference between Micro & Macro Economics



3

Micro-economics and Macro-economics



3

Micro-economics and Macro-economics

Why the divide?

- Before the Great Depression, economics did not have micro and macro divisions as we have now
- The severe and prolonged global collapse in economic activity that occurred during the Great Depression of 1929–30 changed that.
- John Maynard Keynes founded and paved the way for macroeconomics after publishing **The General Theory of Employment, Interest and Money**.
- Keynes' work brought forth the bigger picture of the economy and the study of the structure and behavior of the entire economy called macroeconomics emerged, alongside the classical paradigm of microeconomics.



'Origins of Microeconomics and Macroeconomics' – Article

- It is the branch of economics that studies economic aggregates (grand totals): e.g. the overall level of prices, output and employment in the economy.
- Economies have often experienced cycles where periods of growth alternate with periods of recession, such periods varying from a few months to a few years. This is known as the 'business cycle'.
- Macroeconomic problems are closely related to the balance between aggregate demand and aggregate supply.



3.1 Macro economics

If aggregate demand is too high relative to aggregate supply, inflation and trade deficits are likely to result.

- **Inflation** refers to a general rise in the level of prices throughout the economy. If demand is high, they can probably still sell as much as before (if not more) even at the higher prices, and make higher profits. By comparing price levels between different periods we can measure the rate of inflation.
- **Balance of trade deficits** are the excess of imports over exports. If aggregate demand rises, people are likely to buy more imports. So part of the extra spending will go on goods from overseas, such as Japanese TVs, Chinese computers, German cars, etc. Also, if the rate of inflation is high, home-produced goods will become uncompetitive with foreign goods.

If aggregate demand is too low relative to aggregate supply, unemployment and recession may well result.

- **Recession** is where output in the economy declines for two successive quarters or longer. In other words, during this period growth becomes negative.
- **Unemployment** is the number of people of working age who are actively looking for work but are currently without a job. If firms are producing less, they will need to employ fewer people.

3.1 Macro economics

Macroeconomic policy, therefore, tends to focus on the balance of aggregate demand and aggregate supply.

It can be **demand-side policy**, which seeks to influence the level of spending in the economy. This in turn will affect the level of production, prices and employment.

Or it can be **supply-side policy**. This is designed to influence the level of production directly: for example, by trying to create more incentives for firms to innovate.

3.2 Micro-economics

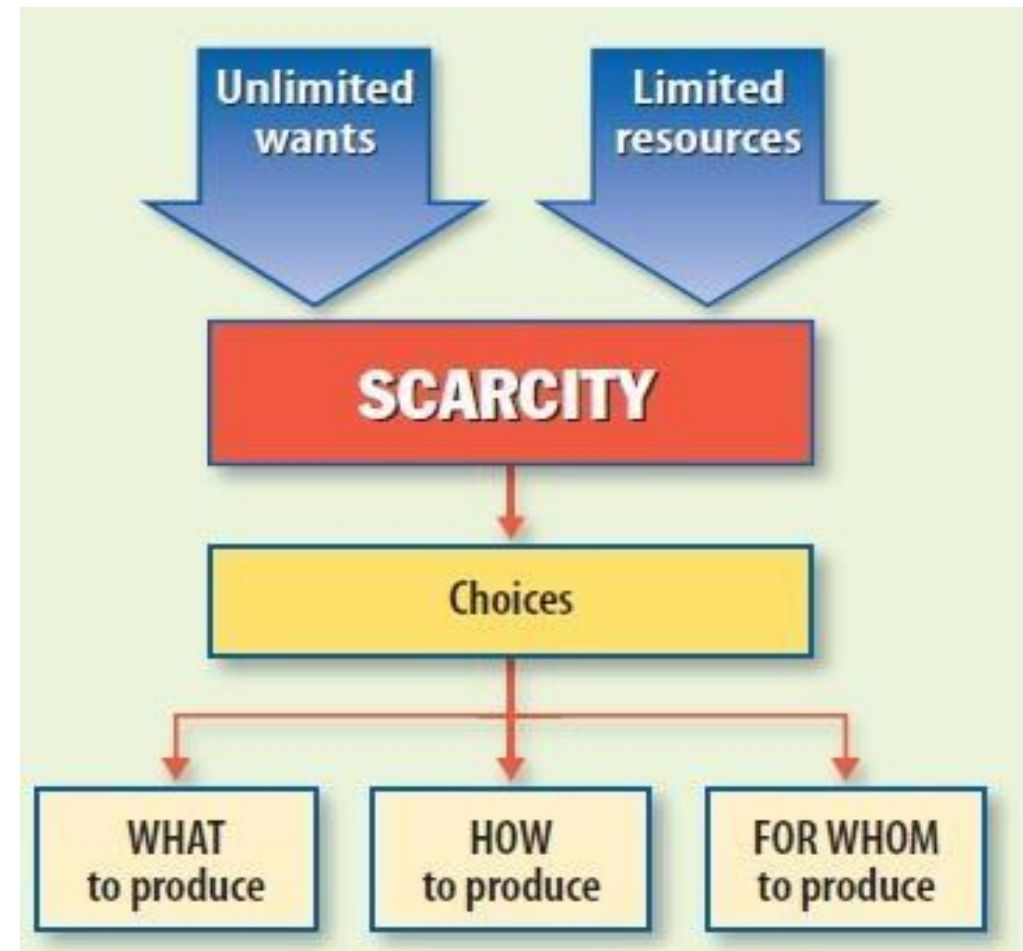
- Microeconomics is the social science that studies the implications of human action, specifically about how those decisions affect the utilization and distribution of scarce resources.
- Microeconomics shows how and why different goods have different values, how individuals make more efficient or more productive decisions, and how individuals best coordinate and cooperate with one another.
- Generally speaking, microeconomics is considered a more complete, advanced, and settled science than macroeconomics.



3.3 Micro-economics & choices

Because resources are scarce, choices have to be made. There are three main categories of choice that must be made in any society:

1. WHAT to produce
2. HOW to produce
3. FOR WHOM to produce



3.4 Choices & opportunity cost

Choices & scarcity is explained in diagram

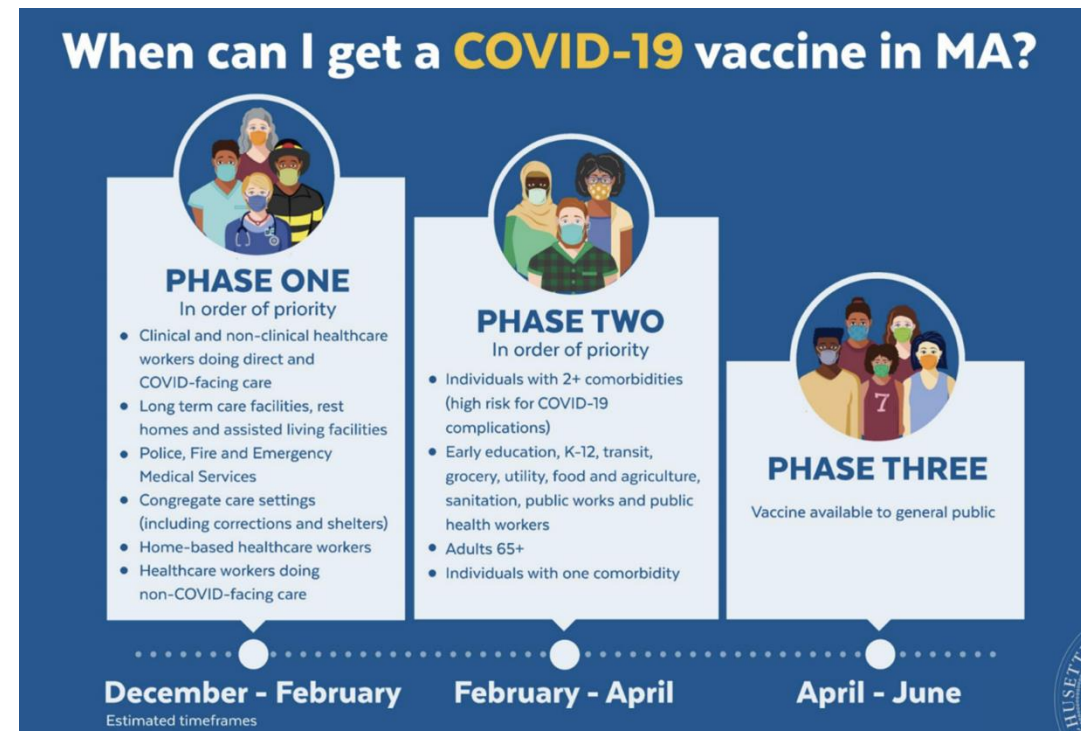


3.4 Choices & opportunity cost

Scarcity



Choice



3.4 Choices & opportunity cost

The more food a nation produces, the fewer resources there will be for producing other goods. In other words, the production or consumption of one thing involves the sacrifice of alternatives. This sacrifice of alternatives in the production (or consumption) of a good is known as its opportunity cost.



The cost of any activity measured in terms of the best alternative forgone is called opportunity cost

3.5 Opportunity Cost



Mr. Brown makes \$400 an hour as an attorney and is considering paying someone \$1000 to paint his house. If he decides to do it himself, it will take four hours. Find his opportunity cost for painting it himself



Caroline has \$15,000 worth of stock she can sell now for \$20,000. She wanted to wait two months because the stock was expected to increase. She decides to sell now. Find his opportunity cost if the share price in 2 months time is

- a) \$22000
- b) \$14000

3.5 Opportunity Cost

Rational choices

Choices that involve weighing up the benefit of any activity against its opportunity cost so that the decision maker successfully maximises their objective: i.e. happiness or profits.

Marginal costs

The additional cost of doing a little bit more (or 1 unit more if a unit can be measured) of an activity.

Marginal benefit

The additional benefits of doing a little bit more (or 1 unit more if a unit can be measured) of an activity.

Rational decision making

Doing more of an activity if its marginal benefit exceeds its marginal cost and doing less if its marginal cost exceeds its marginal benefit.

3.6 Microeconomic objectives

Microeconomics is concerned with the allocation of scarce resources
There are two major objectives that we can identify: efficiency and equity.

Efficiency:

If altering what was produced or how it was produced could make us all better off (or at least make some of us better off without anyone losing), then it would be efficient to do so.

For a society to achieve full economic efficiency, three conditions must be met:

- Efficiency in production (productive efficiency)
- Efficiency in consumption
- Efficiency in specialisation and exchange

These last two are collectively known as allocative efficiency.

3.6 Microeconomic objectives

Equity

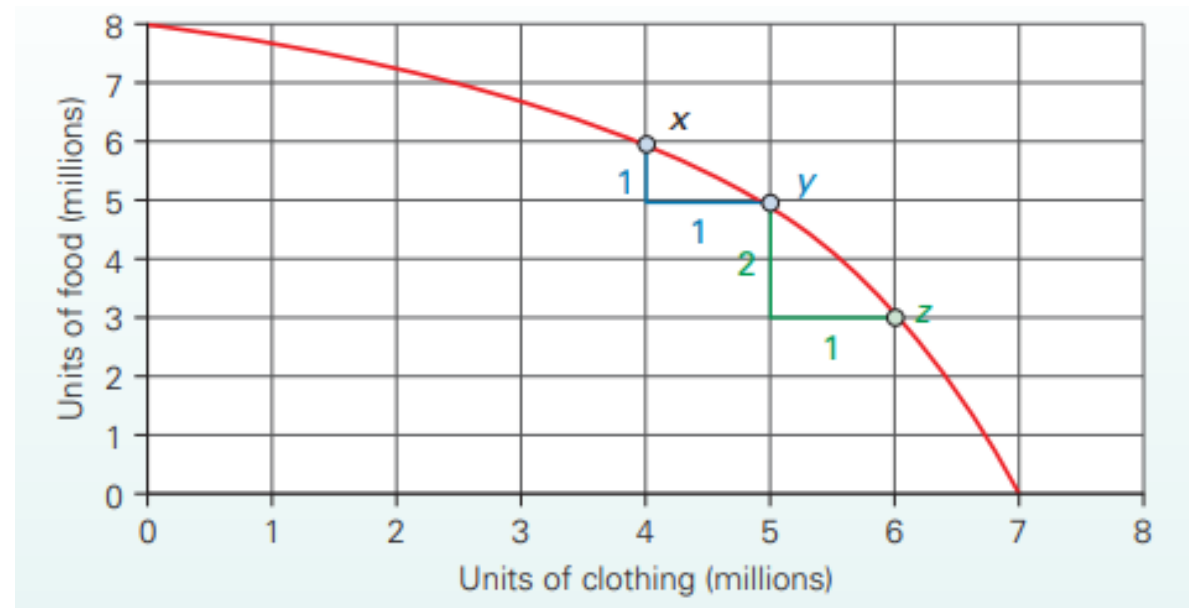
Even though the current levels of production and consumption might be efficient, they could be regarded as unfair, if some people are rich while others are poor. Another microeconomic goal, therefore, is that of equity. Equity is where income is distributed in a way that is considered to be fair or just. Note that an equitable distribution is not the same as an equal distribution and that different people have different views on what is equitable

3.7 Microeconomics and production possibility curve

A production possibility curve illustrates the microeconomic issues of choice and opportunity cost.

The fact that to produce more of one good involves producing less of the other is illustrated by the downward sloping nature of the curve.

For example, the country could move from point x to point y in Figure. In doing so it would be producing an extra 1 million units of clothing, but 1 million units less of food. Thus the opportunity cost of the 1 million extra units of clothing would be the 1 million units of food forgone.



4

Economic school of thoughts

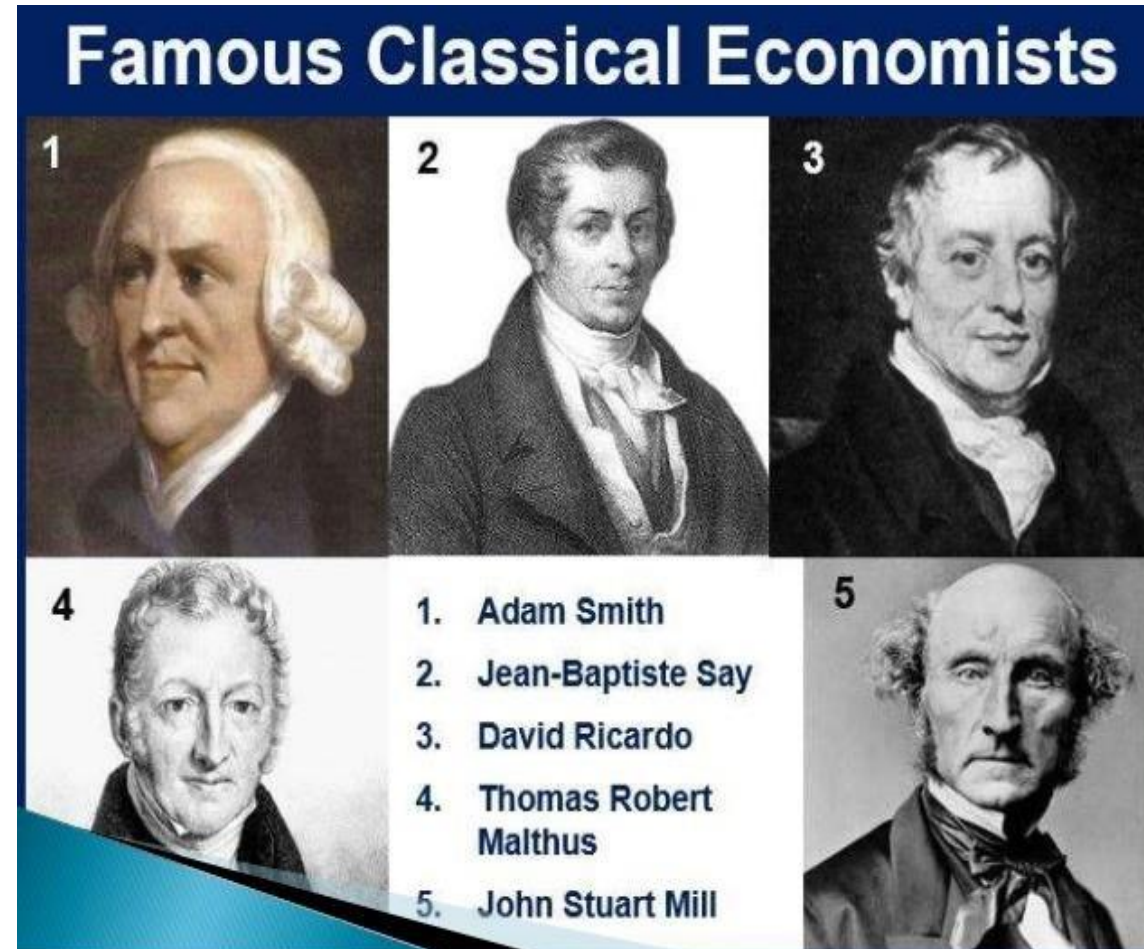


A school of economic thought is a group of economic thinkers who share or shared a common perspective on the way economies work.

There are different schools of thought, with differing views on how the markets and their participants operate.

1. Classical School
2. Neo-Classical
3. New Classical
4. Keynesian Economics
5. Monetarist
6. New Keynesian

4.1 Classical school



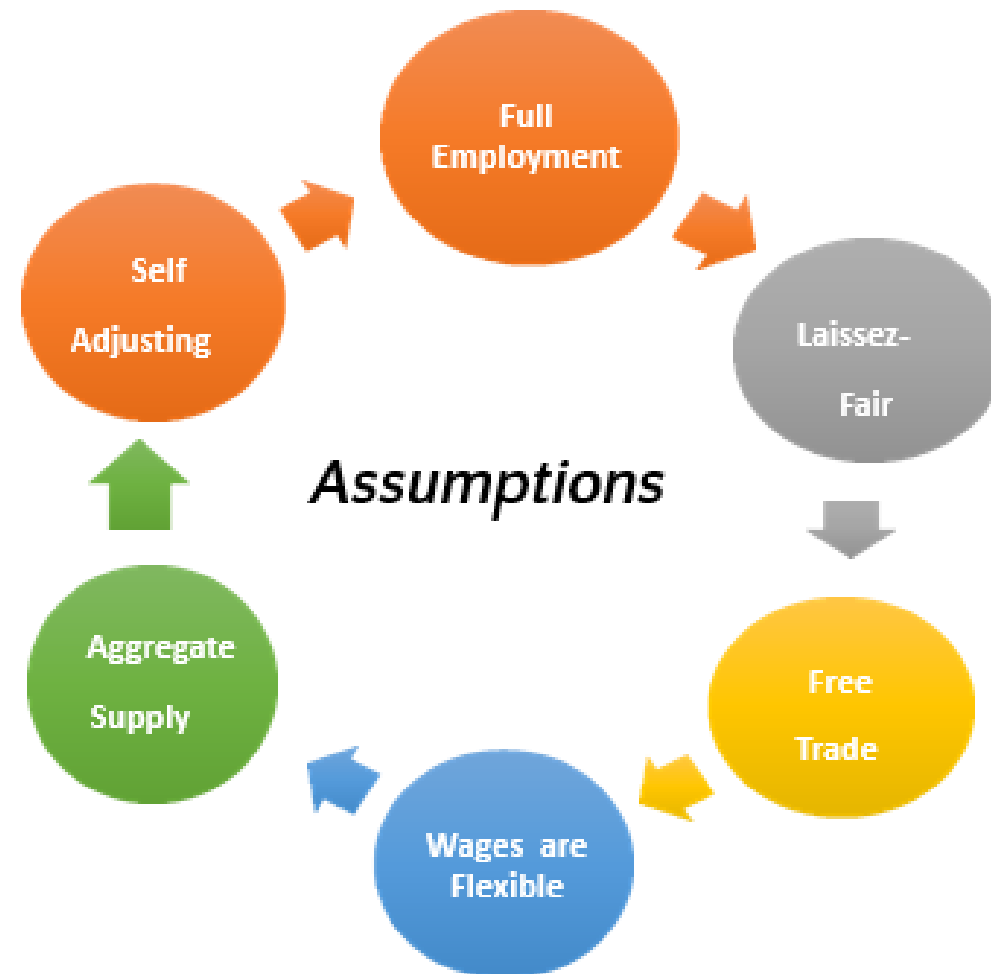
4.1 Classical school

- The Classical school, which is regarded as the **first school of economic thought**, is associated with the 18th Century Scottish economist Adam Smith, and those British economists that followed, such as Robert Malthus and David Ricardo.
- The main idea of the Classical school was that **markets work best when they are left alone, and that there is nothing but the smallest role for government**. The approach is firmly one of **laissez-faire** and a strong belief in the **efficiency of free markets to generate economic development**.
- Markets should be left to work because the price mechanism acts as a powerful **‘invisible hand’** to allocate resources to where they are best employed.
- In terms of explaining value, the **focus** of classical thinking was that it was determined mainly by **scarcity and costs of production**. Classical economists hold that prices, wages, and rates are flexible and **markets always clear**, building on Adam Smith's original theories.

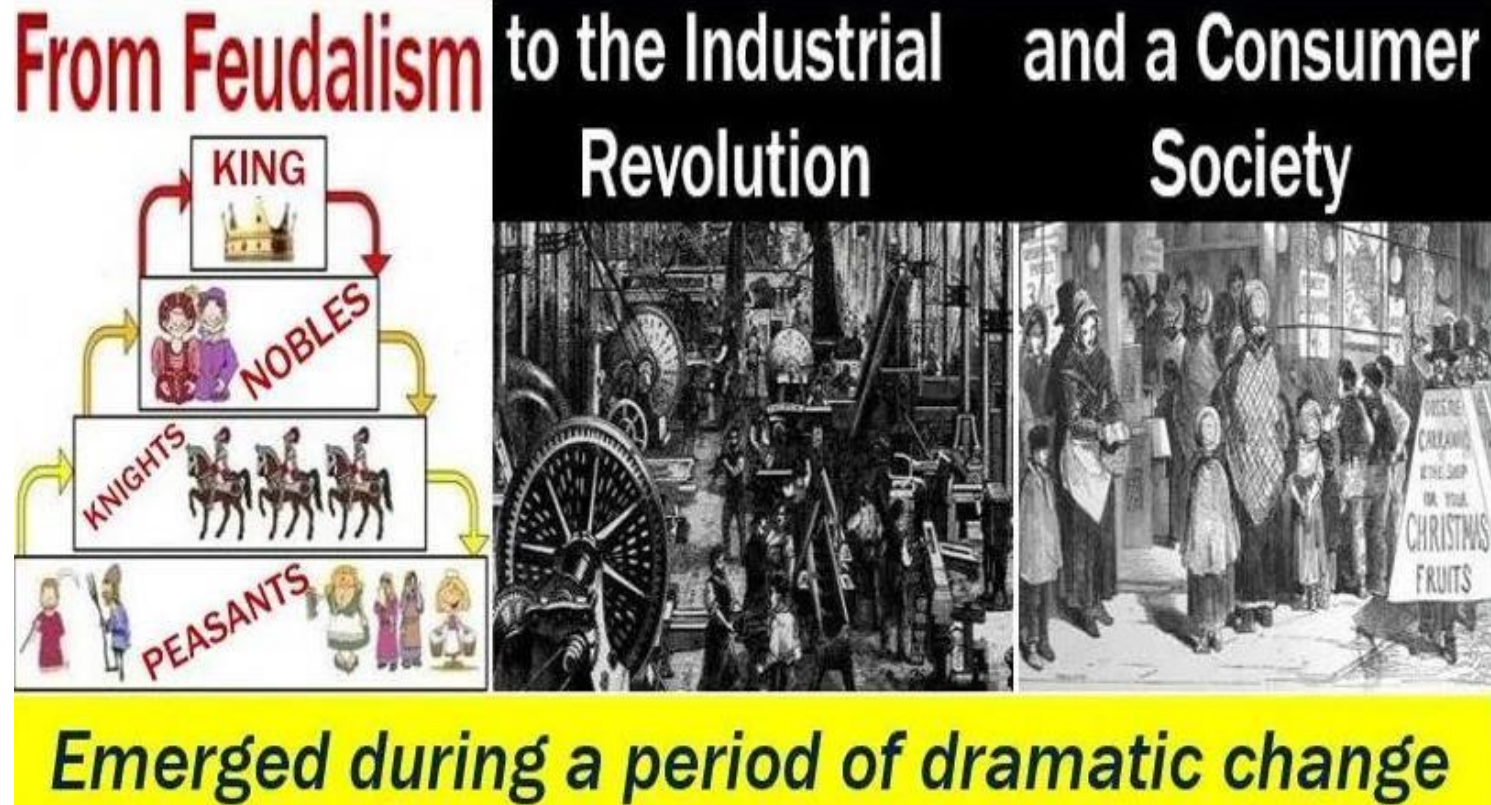
4.1 Classical school

- In terms of the macro-economy, the Classical economists assumed that the economy would **always return to the full-employment level of real output** through an automatic self-adjustment mechanism.
- It is widely recognised that the Classical period lasted until 1870.
- Classical economics believes that the **economy is self-correcting**, Which means that when a recession occurs, It needs no help from anyone

4.1 Classical school



4.1 Classical school



4.1 Classical school

Classical Economics

The market is perfect and self-sustaining

Government intervention can only be a detriment to the economy



David Ricardo

The market automatically adjusts to “booms” and busts

Supply = Demand

Historical Perspective: Classical economics came of age during and after industrialization.

Say’s Law: Supply Creates its own demand. The economy is stimulated when more goods are produced.

4.2 Neo-Classical school



NEO-CLASSICAL ECONOMICS

is a theory, i.e., a school of economics – that believes that the customer or consumer is ultimately the driver of market forces.

By market forces, they mean the forces of supply and demand.

4.2 Neo-Classical school



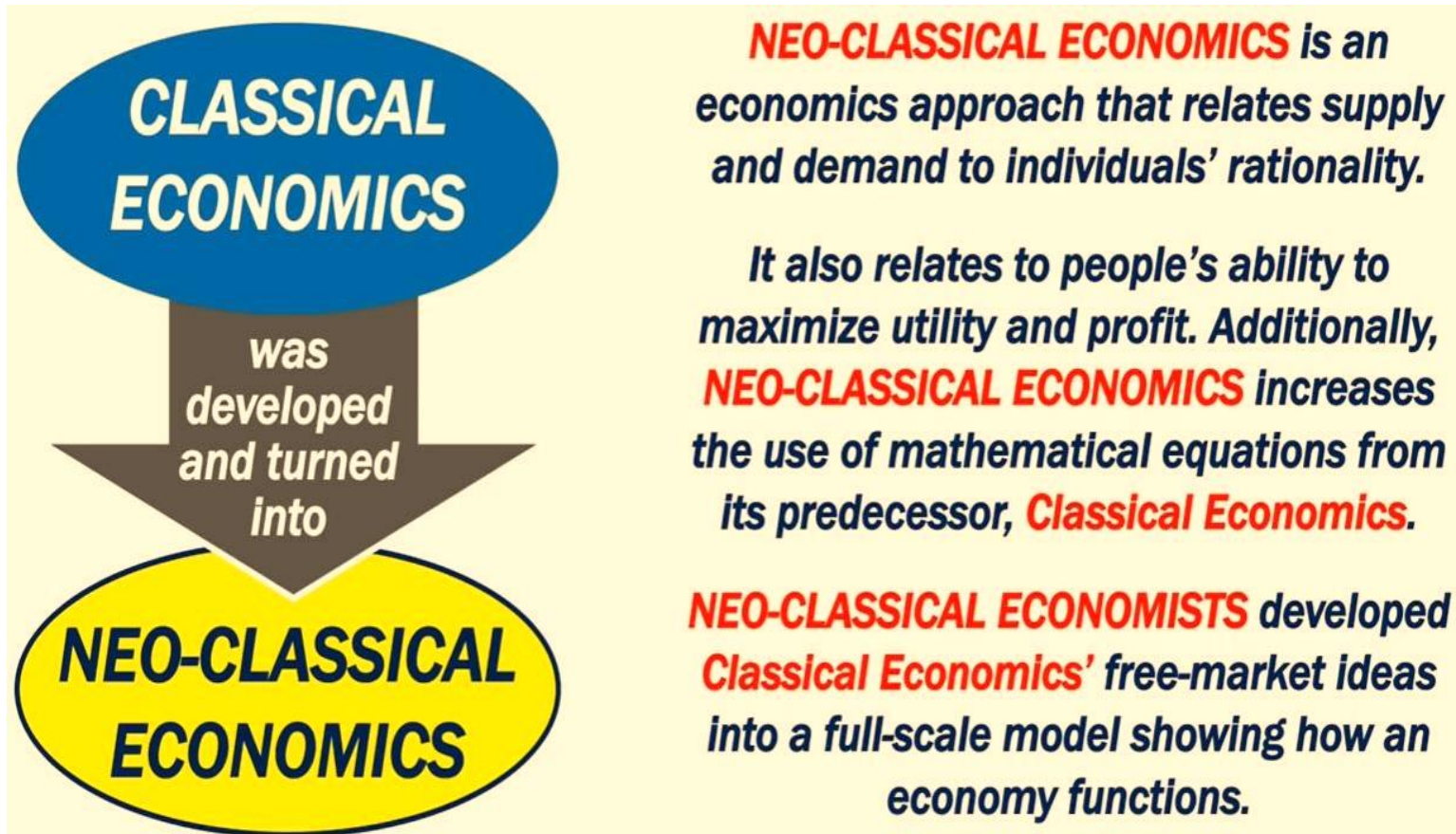
Supporters of **NEO-CLASSICAL ECONOMICS** say that consumers determine market forces for two reasons.

Firstly, the consumer's aim is customer satisfaction.

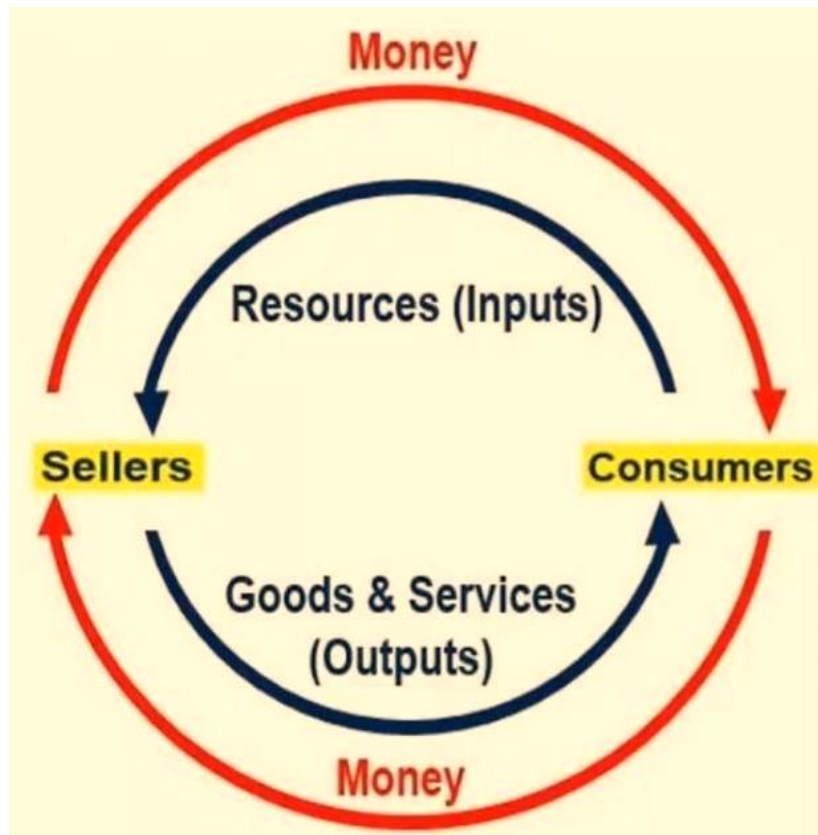
Secondly, the supplier's goal is profit maximization.

Neo-Classical Economics is a theory that focuses on how the perception of the usefulness of products influences supply and demand.

4.2 Neo-Classical school



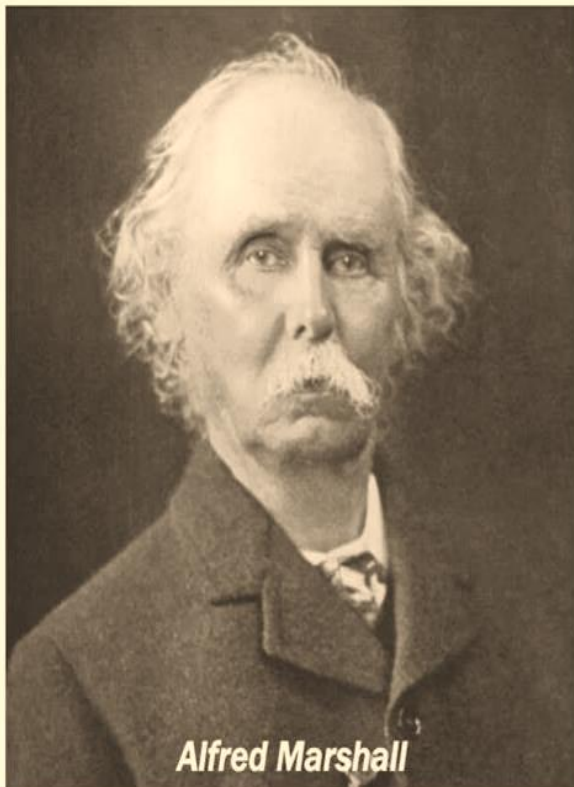
4.2 Neo-Classical school



According to **NEO-CLASSICAL ECONOMICS**, the rational behaviors and goals of the sellers and consumers in the marketplace drive the flow of resources, goods, services, and money.

Their objectives and actions lead to market equilibrium.

4.2 Neo-Classical school



Alfred Marshall

One of the most influential economists of his time.

*The most famous **NEO-CLASSICAL ECONOMIST** is Alfred Marshall (1842-1924), a British economist.*

Marshall took economics to a more mathematically rigorous level.

He extended economics away from the classical market economy focus.

He subsequently made it popular by focusing on human behavior.

4.2 Neo-Classical school

Neo-Classical Economist



Minimum
Intervention

ECONOMY

Followers of **NEO-CLASSICAL ECONOMICS** believe strongly that markets must be free. This means that the state should refrain from creating too many rules and regulations.

They say that if government intervention is minimal, citizens enjoy a higher standard of living.

For example, they receive better wages and have a longer average life expectancy. Also, the country's GDP grows faster.

GDP = Gross Domestic Product

4.2 Neo-Classical school



**Good laws
reduce the
frequency
of this
happening**



NEO-CLASSICAL ECONOMISTS believe that there should be some legislation to make sure business behavior is ethical.

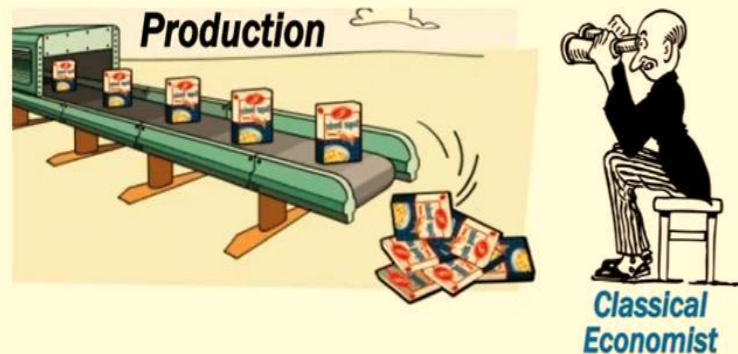
There should also be laws to protect consumers.

That is why we have regulatory bodies in even the world's most laissez-faire economies.

Without oversight in the banking industry, for example, there is a greater risk of frequent and extremely severe financial crises.

4.2 Neo-Classical school

Neo-Classical vs. Classical Economics



Classical Economics focuses on the production of goods and services.

➤ **NEO-CLASSICAL ECONOMICS** concentrates on how individual players operate in an economy.



It emphasizes the exchange of goods and services as the main focus of economic analysis.

4.2 Neo-Classical school

- Neoclassical economists believe that a consumer's first concern is to **maximize personal satisfaction**.
- Therefore, they make **purchasing decisions** based on their evaluations of the **utility of a product or service**.
- This theory coincides with rational behavior theory, which states that **people act rationally when making economic decisions**.
- It emerged in around 1900 to compete with the earlier theories of classical economics.
- Classical economists assume that the **most important factor** in a product's price is its cost of production.
- Neoclassical economists argue that the **consumer's perception of a product's value** is the driving factor in its price.
- They call the **difference between actual production costs and retail price** the **economic surplus**.

4.2 Neo-Classical school

- Further, neoclassical economics stipulates that a product or service often has value above and beyond its production costs.
- While classical economic theory assumes that a product's value derives from the cost of materials plus the cost of labour, neoclassical economists say that **consumer perceptions of the value of a product affect its price and demand.**
- Finally, this economic theory states that **competition leads to an efficient allocation of resources** within an economy. The forces of **supply and demand create market equilibrium.**

4.2 New-Classical school

- New classical economics dates from the 1970s, and is an **attempt to explain** macro-economic problems and issues using **micro-economic concepts like rational behaviour, and rational expectations**.
- New classical economics is associated with the work of Chicago economist, Robert Lucas.
- The New Classical school is **built largely on the Neoclassical School**.
- The New Classical School **emphasizes the importance of microeconomics** and models based on that behaviour. New Classical economists assume that **all agents try to maximize their utility** and have rational expectations.
- They also believe that the **market clears at all times**.
- New Classical economists believe that **unemployment is largely voluntary** and that **discretionary fiscal policy is destabilizing**, while **inflation can be controlled with monetary policy**.

4.3 Keynesian Economics

- A school of thoughts in which **government plays an important role** in mitigating economic recession
- Keynesian theory was **very useful** when there was a **Great Depression** (1929-1933)
- It suggest that **in the time of economic prosperity** when everyone have enough money to spend **government should not pump in money** into system & **in time of recession** where people are struggling with the problem **government should take proper measures** to correct the economy

4.3 Keynesian Economics

Keynesian Economics

The market is imperfect and not self-sustaining

Equilibrium may include unemployment, negative growth



John Maynard Keynes

Consumer income stimulates demand, which causes economic growth.

When economic growth is lacking, the government should stimulate demand.

Historical Background: The Great Depression

4.3 Keynesian Economics

Classical Economics	Points	Keynesian Economics
Laissez-faire approach-market is perfect	Approach	Market is not perfect & not self sustaining
Very less	Government Intervention	It is must
No impact on market	Government Policy	Govt. Policy can influence Demand
Creating Long term solution	Long Term Solution	In long run everything is dead
Supply creates its own demand	Demand	Demand depends on consumer income
Popularised during Industrialisation	Popularity	After The Great Depression

4.4 Monetarist Economics

- The Monetarist school is largely credited to the works of Milton Friedman.
- Monetarist economists believe that the **role of government is to control inflation by controlling the money supply**.
- Monetarists believe that **markets are typically clear** and that **participants have rational expectations**.
- Monetarists **reject the Keynesian notion** that governments can “manage” demand and that attempts to do so are destabilizing and likely to lead to inflation.

4.5 New Keynesian Economics

- The New Keynesian school attempts to **add microeconomic foundations to traditional Keynesian economic theories**.
- While New Keynesians do accept that households and firms operate on the basis of **rational expectations**, they still maintain that **there are a variety of market failures**, including sticky prices and wages.
- Because of this “stickiness”, the **government can improve macroeconomic conditions through fiscal and monetary policy**.