Microeconomic Principles

Module 1

Content

- Economics defined [meaning and definition].
- Microeconomics Vs Macroeconomics.
- History of Economic Thought [Classical economics (Adam Smith), Keynesian revolution (JM Keynes)].
- Economic systems.
- Principles of economics.
- Economic models.

Introduction - meaning

- “Oikonomos” → household (oikos) management (nomos).
- A branch of social science.
- It studies human behaviour which involves production, distribution, and consumption of goods and services.
- It studies economic actions by different economic agents → consumers, producers, government etc.

Selected definitions:

Wealth definitions

"Economics is the science of wealth"

Adam Smith –

Book- Wealth of Nations -1776

"Economics is the science which treats of wealth"

J.B Say

"Economics is that body of knowledge which relates to wealth"

FA Walker

Scarcity Definition

"the science which studies **human behaviour** as a relationship between **ends** and **scarce means** which have **alternative uses**"

- Lionel Robbins, Nature and Significance of Economic Science, 1931

- Human behaviour?
- Ends – wants – unlimited wants.
- Scarce means – limited resources – alternative uses.
- Science of choice.

Welfare definition

"Economics is a study of mankind in the ordinary business of life; it examines that part of individual and social action which is most closely connected with the attainment and with the use of material requisites of wellbeing"

Alfred Marshall, Principles of Economics -1890

Growth Definition

"Economics is the study of how people and society choose, with or without the use of money, to employ scarce productive resources which could have alternative uses, to produce various commodities over time and distribute them for consumption now and in the future among various persons and groups of society."

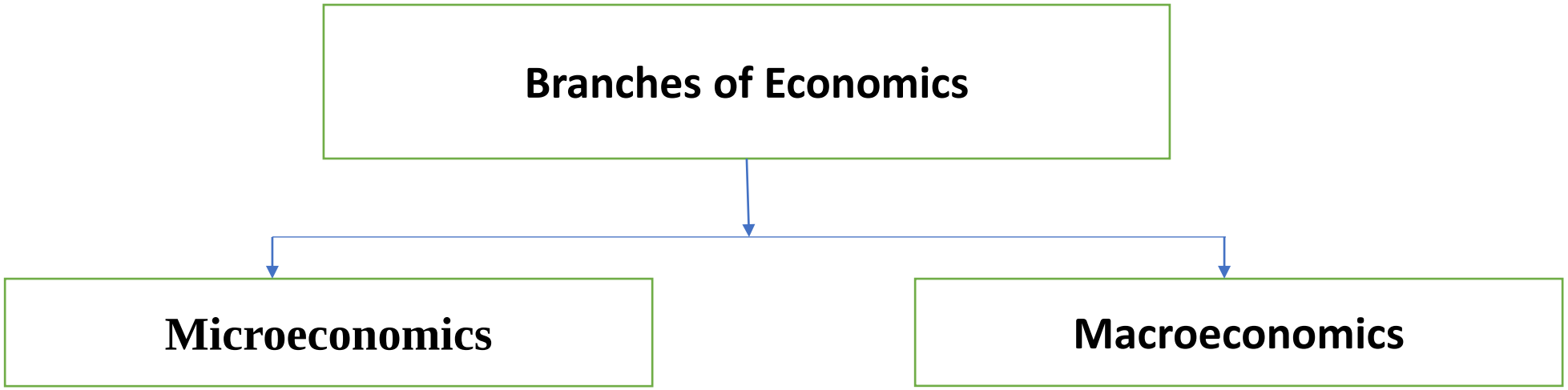
Paul Antony Samuelson

Modern definition

"Economics is the study of the administration of scarce resources and of the determinants of income and employment"

JM Keynes

Context: Keynesian resolution

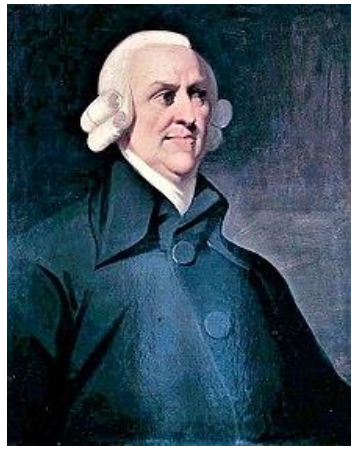


- Origin – Greek word – "**Mikros**" → Small
- Used by Prof: Ragnar Frisch – 1933.
- Study the economic behaviour of small economic units.
- Eg: Consumers, firms, workers, individual industries etc.
- Also known as "theory of price".

- Origin – Greek word – "**Makros**" → large
- Used by Prof: Ragnar Frisch – 1933.
- Study of the economic behaviour of large economic units.
- Eg: National output, total unemployment, inflation, international trade, investment etc.
- Also known as "theory of income and employment".

Modern economics: 18th century [Classical economics]

- Adam Smith "An Inquiry into the Nature and Causes of Wealth of Nations" – 1776:
  - Scottish philosopher (other works).
  - Father of economics.
  - Context: Industrial revolution.
  - Division of labour → specialisation.
  - Role of free market system – no regulation – equilibrium.
  - Invisible hand – no need of market intervention – production and distribution.



- JB Say (Says law of market (Production → demand) – great depression).
- J Bentham, JS Mill → Utilitarianism.
- Ricardo (trade theory).

- Neoclassical economics: Market failure (post 1870s). [macroeconomics]

- Keynesian economics: Great depression of 1929.

    - British economist whose ideas fundamentally changed the theory and practice of macroeconomics and the economic policies of governments. He built on and greatly refined earlier work on the causes of business cycles, and was one of the most influential economists of the 20th century. Widely considered the founder of modern macroeconomics, his ideas are the basis for the school of thought known as Keynesian economics, and its various offshoots

    - Lack of aggregate demand- inefficient market outcomes – need of policy intervention.

- Paul Antony Samuelson – Father of modern economics (1915 -2009) – Importance of mathematics. Neo Keynesian school. MIT.

- Neo-Keynesian economics (Neoclassical + Keynesian).

- Welfare economics (wellbeing).

Important Economic Systems

- Different approaches to answer the **fundamental questions** [what to produce, how to produce and for whom to produce].

- Planned economy (socialism [Sweden] and communism [Cuba]).
- Capitalism (free market).
- Mixed economy (government and free market).
  - Privatisation in China and Eastern Europe.

10 Principles of Economics

1- Trade-offs:

- Decision making – Eg: Time allocation of students on different subjects.

- Gun and butter trade-offs: protection of boundary and standard of living

- Income and environmental protection.

- Equality and efficiency. Eg: Income tax (incentive for work).

2- Opportunity cost:

- Decision making→ Trade-offs
    - Costs, benefits and alternative courses of action.

    - Eg: Studying for a college degree.
        - Costs? ……
        - Benefits? ….

        - What if another course of action, say doing a job.
        - Opportunity cost defined: “the value given up to obtain something”

        - “the value of the next best alternative forgone as a result of decision making”

3- Rational decision makers think at the margin

- Core assumption→ decision makers are rational.
  - Rational decision making at individual level, firms etc.

- Marginal change
  - Example: study plan…… firm's decision, consumer's choice etc.

- Edge: Adjustments around a course of action.

- Decision making: Comparing marginal costs and marginal benefits.
    - Example: Netflix subscription.
    - Contrasting example: Water-Diamond paradox – price and survival/utility.
- Rational decision makers: MB>MC

4- People respond to incentives

- Meaning: something that induces a person to act.
  - Rational choice → incentives
  - Incentives → punishment or reward.
- Examples: Consumers' response to price change
  - A firm's decision to hire new employees
- Public policy: Role of incentives
  - Agricultural subsidy
  - Taxation on harmful products to promote public health.
  - Public laws – safe driving – comparison of MC and MB.

5- Trade can make everyone better off

- Production and trade among different countries.
- Trade → nobody loses but make the participants better off.
- Consumers compete in market → better off everyone though all are competing to get a commodity at a lower price.
- Trade allows specialisation (eg: farming) and trading makes everyone better off.
- In effect, International trade → all are partners though there is competition.

6- Market as an organiser of economic activity

- Central planning (failure of communism) → answering fundamental questions of an economy (what, how much, who produces and consume goods and services).
- Role of market economy and its global prevalence.
- Decentralised planning/decision making.
- In market economy: the key decision making is performed by large number of firms and households.
- Market economy and economic efficiency.
- Social welfare Vs individual welfare (market) in different economic systems.
- One hand tied on economic activity Vs invisible hand (market economy).

7 - Government and market

- Why we need government intervention if invisible hand is so significant?
- Invisible hand is not omnipotent.
- Government intervention to promote **efficiency** and **equality**.
    - Eg: Thomas Picketty's work on inequality.
- Market failure?

  "a situation in which a market left on its own fails to allocate resources **efficiently**"
- Externality as a case of market failure:
    - "the impact of one person's actions on the well-being of another"
    - Example: Industries → pollution → health effects. –ve externality.

- Market power as a case of market failure:

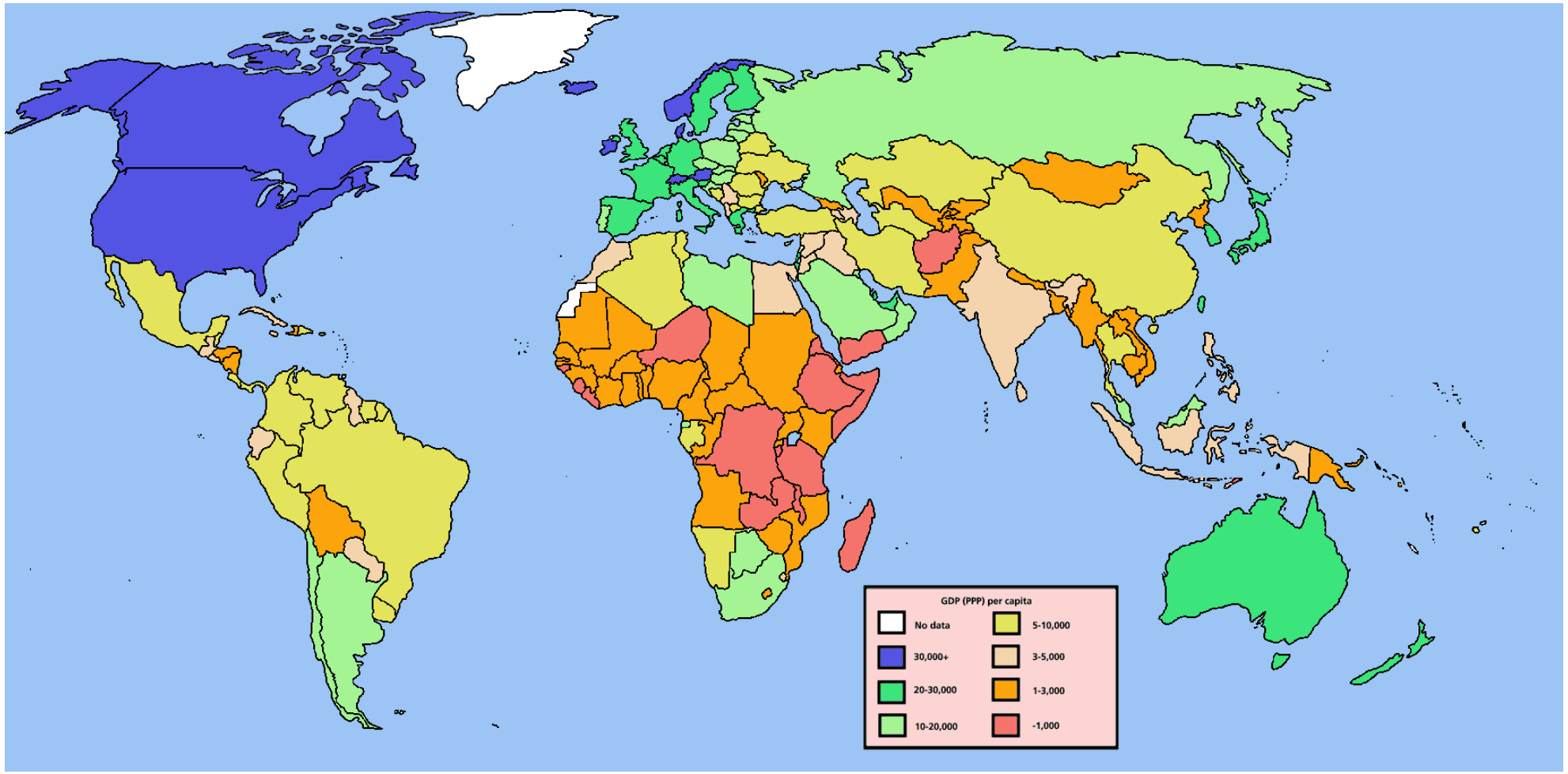
> “the ability of a single economic actor (or a small group of factors) to have a substantial influence on market prices”

- Hypothetical example: monopoly market – water supply by a single producer.
- Role of government action to correct market failure.

- Government actions and equality.
  - Market may not lead to a egalitarian outcome.
  - Example; taxation and welfare system → more equal distribution.

8- Standard of living and ability to produce goods and services

Per capita GDP among countries 2004



Source: https://commons.wikimedia.org/wiki/File:Gdp_per_capita_ppp_world_map.PNG

- Per-capita income and development indicators (health, education, quality of life…)
- Why this difference?
- Productivity

  "the quantity of goods and services produced from each unit of labour input"
- High productivity and standard of living.
- Example: agriculture in developed and developing countries.
- Public policy: to improve standard of living → need to raise productivity by ensuring that workers are educated, have tools they need to produce goods and services, and have access to the best available **technology**.

9- Prices rise when government prints too much money

- Zimbabwean Dollar

- High commodity prices in Zimbabwe

- Inflation

  “an increase in the overall level of prices in the economy”

- Quantity of money and inflation: value of money.

- Inflation is a regular government policy concern and public policy aims to keep inflation rate low.

10- Trade-off between inflation and unemployment (sort-run)

- Short-run → injecting more money → dd ↑ → demand for good and services ↑ → production of goods and services ↑ → unemployment ↓
- Short run inflation and unemployment trade off → business cycle

"fluctuation in economic activity such as unemployment and production "

- Policy making tools: government spending (MGNREGS), amount of taxes and money supply → determine demand for goods and services.

Select Terminologies of Economics

- Scarcity:
  - Scarce of resources and unlimited wants.
  - Scarcity of resources and alternative uses.

- Short-run and long run
  - Based on the possibility of changing production (factor) inputs.

  - Labour and Capital : Long-run
  - Labour : Short-run → fixed capital

- Stock and flow variables

Stock variables: A quantity of a variable at a point in time.

- Eg: Number of books in a library at a particular time.
- Number of persons employed in a country.
- Total money supply at a point of time.
- Population etc.

- Flow variables: A quantity of a variable that are measurable over a period of time.
  - Eg: Depreciation.
  - Capital formation/investment.

- It is performed for convenience .

- Equilibrium and disequilibrium

Equilibrium:

"a situation in which opposite economic forces are in balance and there is no tendency to deviate from this position"

eg: demand and supply analysis

Disequilibrium

"this is a situation in which two opposite economic forces are not balance"

it is a routine matter of any economy.

- Partial equilibrium and general equilibrium analysis

- Partial equilibrium analysis:
  - It is a method of analysis of a part of an economy.
  - Assumption: Other things remain unaffected (ceteris paribus).
  - Eg: Theory of demand.

- General equilibrium analysis:
  - Analysis of economic system as a whole.
  - Comprehensive and realistic view.
  - Study the interrelationships and interdependence of many variables.

- Static and dynamic analysis

Static→ (meaning “Still”)

- An economic analysis which is conducted under static conditions.
- Not a real one. Theoretical model.
- The variables included in the models have no past or future (i.e., no time dimension).
- Comparative statics (two equilibrium).
- Stock is static in nature.

Dynamic → (meaning “casing to change”)

- An economic analysis which is conducted under changing conditions.
- More realistic one.
- Analysis of changing the economy from one equilibrium to another.
- Flow is dynamic in nature.

Economic models

- An economic model is **a simplified description of reality,** designed to yield hypotheses about economic behavior that can be tested.

The End