Microeconomics

Unit 1 – Exploring the subject matter of Economics

What Is Economics?

- Economics is a social science that focuses on the production, distribution, and consumption of goods and services, and analyzes the choices that individuals, businesses, governments, and nations make to allocate resources.

Why do we need to study Economics?

- Production, Consumption and distribution
- Helps in management
- Helps in forecasting future values
- Helps in decision making
- Helps to determine choice
- Allocation of resources

Scope of Economics

- Basically the scope of economics is understood from its main two branches namely
- **Microeconomics –**branch of economics that studies the behaviour of individual consumers and firms. Eg- Consumer equilibrium, individual income and savings are examples of microeconomics.
- **Macroeconomics –** Macroeconomics is a branch of economics dealing with performance, structure, behavior, and decision-making of an economy as a whole. For eg-Unemployment, interest rates, inflation, GDP

Methods of Economics

- Basically there are two main methods of Economics. They are

1. Deductive method
2. Inductive method

Deductive method

The deductive method is also called abstract, analytical and a priori method and represents an abstract approach to the derivation of economic generalisations and theories.

The principal steps in the process of deriving economic generalisations through deductive logic are:

(a) Perception of the problem to be enquired into.

(b) Defining precisely the technical terms and making appropriate assumptions, often called postulates or premises.

(c) Deducing hypotheses, that is, deriving conclusions from the premises through the process of logical reasoning.

(d) Testing of hypothesis deduced.

Inductive method

The inductive method which is also called empirical method derives economic generalisations on the basis of experience and observations. In this method detailed data are collected with regard to a certain economic phenomenon and effort is then made to arrive at certain generalisations which follow from the observations collected. There are three ways which can be used for deriving economic principles and theories.

They are:

(a) Experimentation,

(b) observations,

(c) statistical or econometric method.

Problems of an Economy

Scarcity and Choice

Scarcity is one of the key concepts of economics. It means that the demand for a good or service is greater than the availability of the good or service. Therefore, scarcity can limit the choices available to the consumers who ultimately make up the economy.

Choice refers to the ability of a consumer or producer to decide which good, service or resource to purchase or provide from a range of possible options.

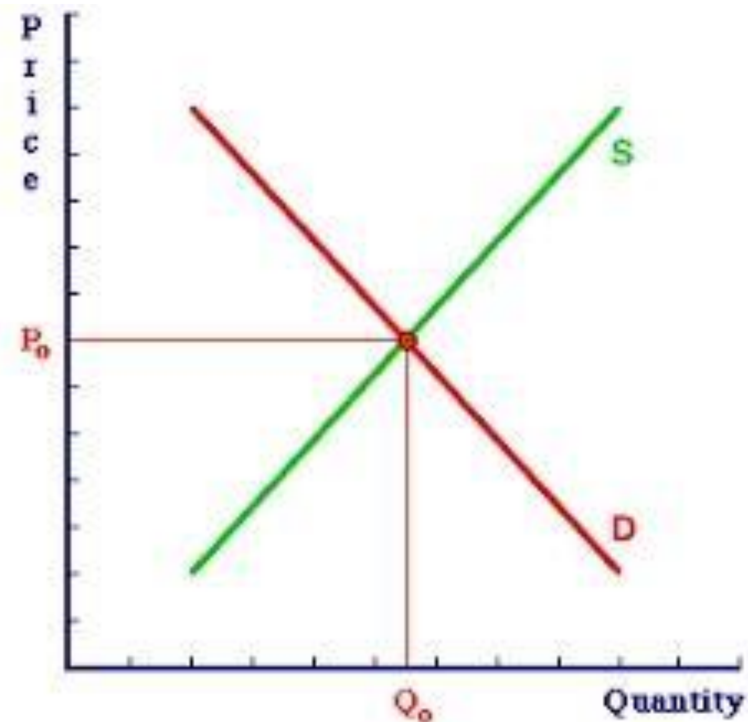
The main economic problems

Production, Distribution, and Exchange of goods and services are among the basic economic activities of life. During the period of these economic activities, every society has to suffer from scarcity of resources and it is the scarcity of resources that arises the problem of choice. The scarce resource of an economy has several usages. In other words, every society decides how to use scarce resources optimally? The problems of an economy are often summarized in the following three ways:

1. What to produce and in what quantity?
2. How to produce?
3. For whom to produce?

Basic competitive model

- The basic Competitive Model in Economics deals with a free market economy where the firms motive is the maximisation of profit and the consumers are well-informed. It is a situation of perfect competition where the prices cannot be controlled by any single buyer or seller but is decided by the market conditions.

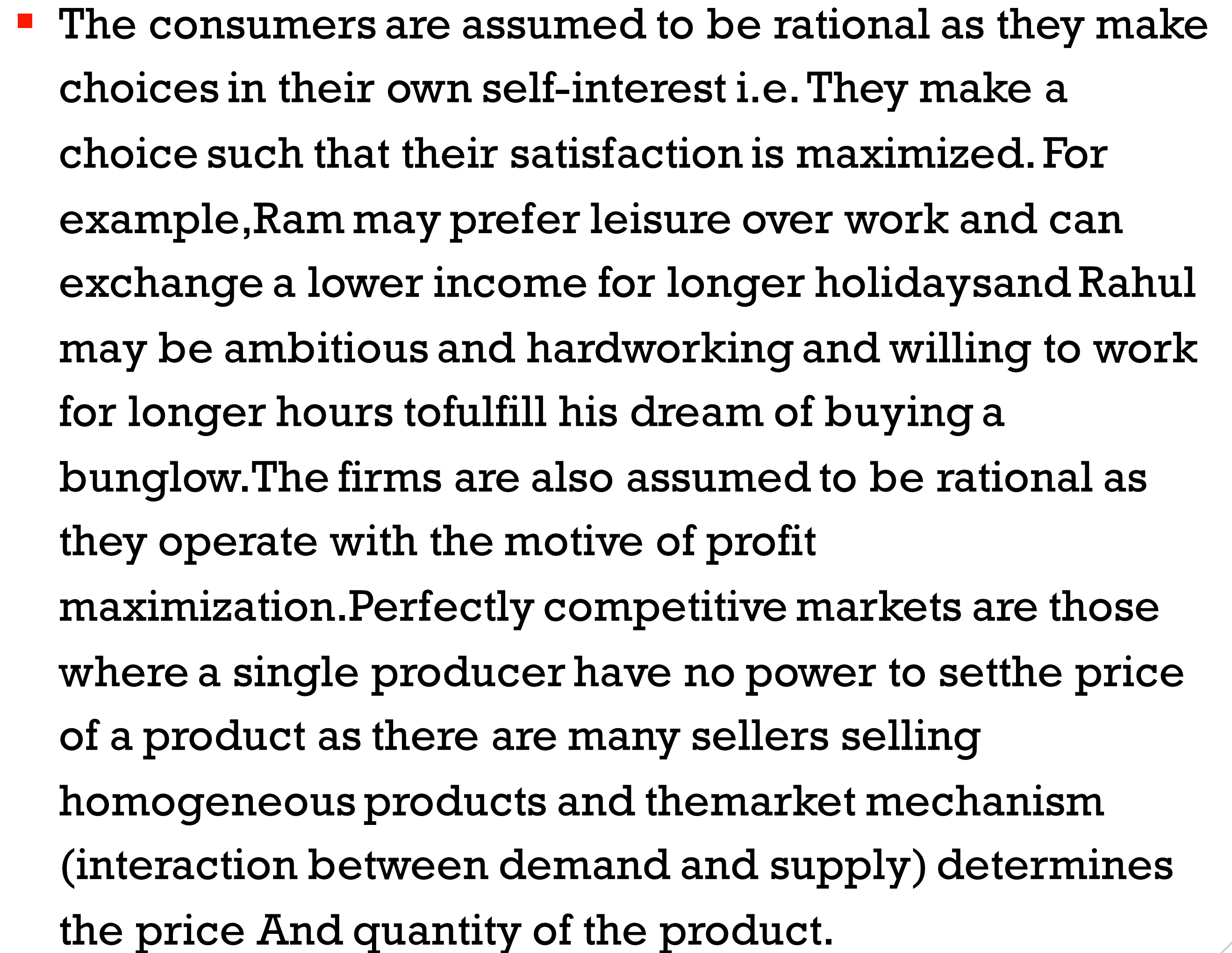


The basic competitive market model

Assumptions

1.There are two participants in the market i.e. Producers and Consumers 2. There are alarge number of buyers and sellers in a competitive market and thus they compete among themselves. 3. Profit maximisation is the main motive . 4. Consumer is rational.

Producers compete with each other by providing the desiredproducts to the consumers at the lowest possible price and the consumers compete withone another by paying the price for the products they are willing to buy, while othersmay not be able to afford the product.This is known as the basic competitive model.The basic competitive model is themodel which assumesthat the firms are interestedin profit maximization, consumers are rational or self-interested and themarkets are perfectly competitive.


The consumers are assumed to be rational as they make choices in their own self-interest i.e. They make a choice such that their satisfaction is maximized. For example,Ram may prefer leisure over work and can exchange a lower income for longer holidaysand Rahul may be ambitious and hardworking and willing to work for longer hours tofulfill his dream of buying a bunglow.The firms are also assumed to be rational as they operate with the motive of profit maximization.Perfectly competitive markets are those where a single producer have no power to setthe price of a product as there are many sellers selling homogeneous products and themarket mechanism (interaction between demand and supply) determines the price And quantity of the product.

Prices

Price is the monetary value of a good, service or resource established during a transaction. In other words, it also expresses the value of the goods produced and the services rendered by factors of production such as land, labor, and capital. Thus, the determination of prices is of great significance in an economy. Generally, market mechanism i.e. interaction between demand and supply determine prices. For example, price of air cooler may be less in winters due to lowdemand but increases in summers with increase in demand. Sometimes, governmentintervenes and determines the price either fully or partially. For example, GOI fixes upprice for critical goods like petrol and necessities like wheat to protect the interest ofboth producers and consumers.

Determination of price

Determination of Prices means to determine the cost of goods sold and services rendered in the free market. In a free market, the forces of demand and supply determine the prices.

The Government does not interfere in the determination of the prices. However, in some cases, the Government may intervene in determining the prices. For example, the Government has fixed the minimum selling price for the wheat.

Factors affecting Determination of Prices

The factors which affect the price determination of the product are:

1] Product Cost

2] The Utility and Demand

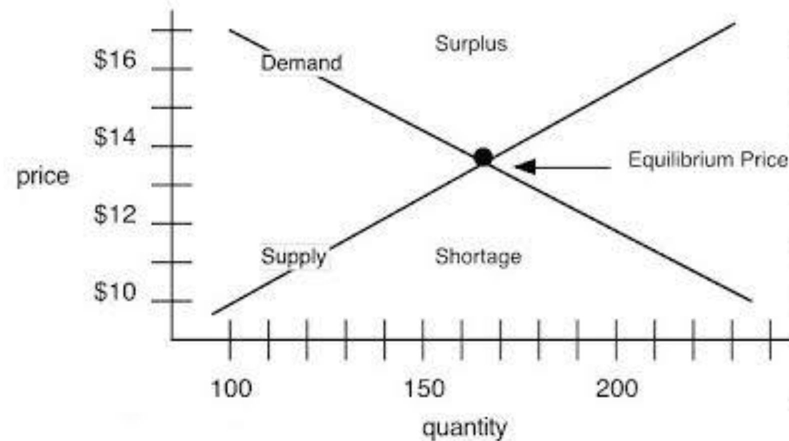
3] The extent of Competition in the Market

4] Government and Legal Regulations

5] Pricing Objectives

Determination of Equilibrium Price

Equilibrium Price



The point at which the supply curve and the demand curve intersect indicates the equilibrium price and quantity in a market.

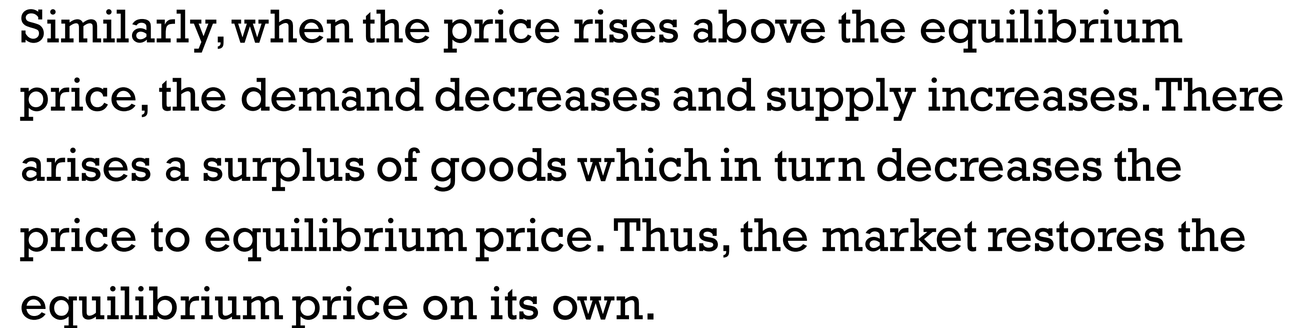
This is also called the market clearing price.

Determination of Equilibrium Price

The price that makes demand equivalent to supply is called the equilibrium price. Graphically, it can be said that the equilibrium price is the point where the demand curve and supply curve intersect. It is the price at which there is no unsold stock left neither is any demand unfulfilled. Thus, it is also known as the market clearing price.

Once the Equilibrium price and quantity are reached, we attain Stable Equilibrium. Stable equilibrium adjusts any disturbance in the demand and supply and restores the original equilibrium.

Other things remaining the same, when the price falls below the equilibrium price, the demand increases and supply decreases. There arises a shortage of goods which in turn increases the price to equilibrium price.



However, the prices are not determined only by the forces of demand and supply. Other factors such as the price of substitute goods, price of related goods, government policies, competition in the market, etc. Also play an important role in the determination of the prices.

Incentives and Information

Incentives are the core of economics. Without incentives, have you ever thought whywould someone take the risk of inventing a new product or save for future contingenciesor work hard? In an economic system where government takes the decisions, it makes central plan to decide what to produce, how to allocate the resources to produce thosegoods and whom to sell the goods. This economic system has a drawback that since nobody owns the resources that are used in the production of goods and services, these sources may not be fully utilized. So property rights should be enforced on theSe ources so that the private owner will have an incentive, to produce goods andservices, if the resources are fully utilized.For example, WTO (World trade organization) contains the protection of Intellectual Property Rights (IPR). Intellectual property is a tangible form of original creative work ofmind, eg. , literary works, industrial designs etc. Thus, it should be legally protected.

Property Rights

Property rights explain the legal and intellectual ownership of assets and resources and one can make use of the same. These assets and resources can be both intangible or tangible in nature, and the owner can be government, individuals, and businesses.

A property right is the exclusive authority to determine how a resource is used, whether that resource is owned by government or by individuals. Property rights confer legal control or ownership of a good. For markets to operate efficiently, property rights must be clearly defined and protected – perhaps through government legislation and regulation.