Notes by Dr. Mrs. Lina Thatte

Dear Students

These notes are prepared to equip you with some basic concepts in economics. The extra reading in green is to widen your understanding further in the subject. It provides some additional examples or explanation of some related concepts.

I hope you will find these notes useful. In case of any query, contact me at **lthatte@gmail.com**

With Best Wishes

Dr.Mrs.Lina R.Thatte

Associate Professor &Head

Department of Economics

29-5-2012

INDEX

1. Micro Economics

In every area of human enterprise and endeavor, there's a big picture and a little picture, the macro and the micro. The macro looks at things through a wide-angle lens; the micro looks at things through a narrow-focus lens.

This is also true in economics and its two branches, macroeconomics and microeconomics.

Macroeconomics studies large-scale phenomena in the national economy, and even in global economies, because they're interrelated. These would include central bank interest rates, national employment numbers, gross national product figures, trade deficits or surpluses, foreign currency exchange rates, and other major economic activity and data.

By contrast, microeconomics studies a limited, smaller area of economics, including the actions of individual consumers and businesses, and the process by which both make their economic decisions – buying, selling, the prices businesses charge for their goods and services and how much of these goods and services they produce and or offer.

Microeconomics also studies supply-demand ratios and its effect on consumer spending and business decision-making.

At the heart of consumer purchasing is the concept of utility, a classic economic idea. Utility is the term applied to a consumer's satisfaction after the purchase of some product or service. Because a consumer's feeling of satisfaction may be impossible to precisely quantify in actual numbers, the concept may seem impractical. But a reasonably close approximation is useful to businesses, and may also be useful to the individual consumer who can probably measure that feeling of satisfaction with a "gut" reaction.

As early as the 18th century, economists were studying the decision-making processes of consumers, a principal concern of microeconomics. Swiss mathematician Nicholas Bernoulli (1695-1726) proposed an extensive theory of how consumers make their buying choices in what was perhaps the first written explanation of how this often mysterious and always complex process works.

According to Bernoulli's theory, consumers make buying decisions based on the expected results of their purchases. Consumers are assumed to be rational thinkers who purchase, among the choices available, the product or service they believe will provide maximum satisfaction or well-being.

In Marshall's book, "Principles of Economics, Vol. 1." published in 1890, he proposed, as Bernoulli had three centuries earlier, the study of consumer decision making. Marshall proposed a new idea as well - the study of specific, individual markets and firms, as a means of understanding the dynamics of economics. Marshall also formulated the concepts of consumer utility, price elasticity of demand and the demand curve.

The study of consumer decision-making reveals how the price of products and services affects demand, how consumer satisfaction – although not precisely measurable – works in the decision-making process, and provides useful information to businesses selling products and services to these consumers.

The decision-making processes of a business would include how much to make of a certain product and how to price these products to compete in the marketplace against other similar products. The same decision-making dynamic is true of any business that sells services rather than products.

Conclusion

And so the history of microeconomics continues to unfold, awaiting perhaps another Bernoulli, Adam Smith, Alfred Marshall, or John Maynard Keynes, to provide it with some new, revolutionary ideas.

Extra Reading

For some 200 years beginning in the mid-1700s, the dominant economic theory was Adam's Smith's *laissez-faire* (French for "leave alone" or "let do") approach to the economy, which advocated a government hands-off policy regarding free markets and the machinery of capitalism. The *laissez-faire* theory argues that an economy functions best when the "invisible hand" of self-interest is allowed to operate freely, without government intervention.

Scottish-born Smith (1723-1790) wrote in his book, "Wealth of Nations," that if the government does not tamper with the economy, a nation's resources will be most efficiently used, free-market problems will correct themselves and a country's welfare and best interests will be served.
Smith's views on the economy prevailed through two centuries, but in the late 19th and early 20the century, the ideas of Alfred Marshall (1842-1924), a London-born economist, had a major impact on economic thought.

Keynes
At the time of Marshall's death, John Maynard Keynes (1883-1946), who would become the most influential economist of the 20th century starting in the 1930s, was already at work on his revolutionary ideas about government management of the economy.

Born in Cambridge, England, Keynes' contributions to economic theory have guided the thinking and policy-making of central bankers and government economists for decades, both globally and in the U.S.

So much of U.S. monetary policy, the setting of key interest rates, government spending to stimulate the economy, support of private enterprise through various measures, tax policy and government borrowing through the issuance of Treasury bonds, bills and notes, have been influenced by the revolutionary ideas of Keynes, which he introduced in his books and essays.

What all these concepts had in common was their advocacy of government management of the economy. Keynes advocated government intervention into free markets and into the general economy when market crises warranted, an unprecedented idea when proposed during the Great Depression.

Government spending to stimulate an economy, a Keynesian idea, was used during the Depression to put unemployed people to work, thus providing cash to millions of consumers to buy the country's products and services. Most of Keynes' views were the exact opposites of Adam Smith's. An economy, for optimum functioning, must be managed by government, Keynes wrote.

Thus was born the modern science of macroeconomics – the big picture view of the economy – evolving in large part from what came to be called Keynesian economic theory. These are among the tools of microeconomics, and their principles, along with others, are still employed today by economists who specialize in this area.

Keynes' policies, to varying degrees, have been, and continue to be, employed with generally successful results worldwide in almost all modern capitalist economies. If and when economic problems occur, many economists often attribute them to some misapplication or non-application of a Keynesian principle.

Microeconomic Renaissance
While Keynesian economic theory was being applied in most of the world's major economies, the new concept of microeconomics, pioneered by Marshall, was also taking hold in economic circles. The study of smaller, more focused aspects of the economy, which previously were not given major importance, was fast becoming an integral part of the entire economic picture.

Microeconomics had practical appeal to economists because it sought to understand the most basic machinery of an economic system: consumer decision-making and spending patterns, and the decision-making processes of individual businesses.

Utility Theory
Some 200 years after Bernoulli's theory was first introduced, it was expanded upon by Hungarian John von Neumann (1903-1957), and Austrian Oskar Morgenstern (1920-1976). A more detailed and nuanced theory than Bernoulli's and Marshall's emerged from their collaboration, which they called utility theory. The theory was elaborated in their book, "Theory of Games and Economic Behavior," published in 1944.

In the 1950s, Herbert A. Simon (1916-2001), a 1978 Nobel Memorial Prize-winner in economics, introduced a simpler theory of consumer behavior called "satisficing". The satisficing theory contends that when consumers find what they want, they then abandon the quest and decision-making processes, and buy the product or service which seems to them as "good enough." (For more on the Nobel Memorial Prize, read *Nobel Winners Are Economic Prizes*.)

Although economics is a broad continuum of all the factors - both large and small - that make up an economy, microeconomics does not take into direct account what macroeconomics considers.

Macroeconomics is concerned principally with government spending, personal income taxes, corporate taxes, capital gains taxes and other taxes; the key interest rates set by the Federal Reserve, the banking system and other economic factors such as consumer confidence, unemployment or gross national product, which may influence the entire economy. (For more on macroeconomics read, *Macroeconomic Analysis*.)

Economics, like all sciences, is continually evolving, with new ideas being introduced regularly, and old ideas being refined, revised, and rethought.

---

2. Ceteris Paribus

Definition

Ceteris Paribus is a Latin phrase meaning 'all other things remaining equal'

The concept of ceteris paribus is important in economics because in the real world it is usually hard to isolate all the different variables.

Example of Ceteris Paribus in Economics

An increase in interest rates will 'ceteris paribus' cause demand for loans to fall. Higher interest rates increase the cost of borrowing so there will be less demand for loans. However, if confidence was high, people might still want to borrow more. Ceteris paribus assumes things like confidence remain the same.

Significance of Ceteris paribus

When using *ceteris paribus* in economics, assume all other variables except those under immediate consideration are held constant. For example, if the price of coke *increases—ceteris paribus—*the quantity of coke demanded by buyers will *decrease*. In this example, the clause ceteris paribus is used to describe everything surrounding the relationship between both the *price* and the *demand* of a good.

This description intentionally ignores both known and unknown factors that may also influence the relationship between price and quantity demanded, and thus to assume *ceteris paribus* is to assume away any interference with the given example. Such factors that would be intentionally ignored include: the relative change in price of substitute goods, (e.g., the price of coke vs 7 up or mirinda); the level of risk aversion among buyers (e.g., fear of pesticide use in coke); and the level of overall demand for a good regardless of its current price level (e.g., a societal shift toward health drinks).

The clause is often loosely translated as "holding all else constant."

Extra reading

A ***ceteris paribus* assumption** is often fundamental to the *predictive* purpose of scientific inquiry. In order to formulate scientific laws, it is usually necessary to rule out factors which interfere with examining a specific causal relationship. Under scientific experiments, the *ceteris paribus* assumption is realized when a scientist controls for all of the independent variables other than the one under study, so that the effect of a *single* independent variable on the dependent variable can be isolated.

Characterization given by Alfred Marshall

The clause is used to consider the effect of some causes in isolation, by assuming that other influences are absent. Alfred Marshall expressed the use of the clause as follows:

> The element of time is a chief cause of those difficulties in economic investigations which make it necessary for man with his limited powers to go step by step; breaking up a complex question, studying one bit at a time, and at last combining his partial solutions into a more or less complete solution of the whole riddle. In breaking it up, he segregates those disturbing causes, whose wanderings happen to be inconvenient, for the time in a pound called Ceteris Paribus. The study of some group of tendencies is isolated by the assumption other things being equal: the existence of other tendencies is not denied, but their disturbing effect is neglected for a time. The more the issue is thus narrowed, the more exactly can it be handled: but also the less closely does it correspond to real life. Each exact and firm handling of a narrow issue, however, helps towards treating broader issues, in which that narrow issue is contained, more exactly than would otherwise have been possible. With each step more things can be let out of the pound; exact discussions can be made less abstract, realistic discussions can be made less inexact than was possible at an earlier stage. (Principles of Economics, Bk.V,Ch.V in paragraph V.V.10).

Two uses

The above passage by Marshall highlights two ways in which the *ceteris paribus* clause may be used: The one is *hypothetical*, in the sense that some factor is assumed fixed in order to analyse the influence of another factor in isolation. This would be **hypothetical isolation**. An example would be the hypothetical separation of the income effect and the substitution effect of a price change, which actually go together. The other use of the *ceteris paribus* clause is to see it as a means for obtaining an approximate solution. Here it would yield a **substantive isolation**.

Substantive isolation has two aspects: Temporal and causal. **Temporal isolation** requires the factors fixed under the *ceteris paribus* clause to actually move so slowly relative to the other influence that they can be taken as practically constant at any point in time. So, if vegetarianism spreads very slowly, inducing a slow decline in the demand for beef, and the market for beef clears comparatively quickly, we can determine the price of beef at any instant by the intersection of supply and demand, and the changing demand for beef will account for the price changes over time (→Temporary Equilibrium Method).

The other aspect of substantive isolation is **causal isolation**: Those factors frozen under a *ceteris paribus* clause should not significantly be affected by the processes under study. If a change in government policies induces changes in consumers' behavior on the same time scale, the assumption that consumer behaviour remains unchanged while policy changes is inadmissible as a substantive isolation (→Lucas critique).

---

3. Partial Equilibrium and General Equilibrium

Partial Equilibrium, studies equilibrium of individual firm, consumer, seller and industry. It studies one variable in isolation keeping all the other variables constant.

General Equilibrium, studies a number of economic variable, their inter relation and inter dependencies for understanding the economic system.

Examples of Partial equilibrium :

Partial equilibrium discusses, when does an individual, a firm, an industry, factors of production attain their equilibrium points.

1. A consumer is in a state of equilibrium when he achieves maximum aggregate satisfaction on the expenditure that he makes depending on the set of conditions relating to his tastes and preferences, income, price and supply of the commodity etc.
2. Producers' equilibrium occurs when he maximizes his net profit subject to a given set of economic situations.
3. A firm's equilibrium point is when it has no inclination in changing its production. In short run **Marginal revenue = Marginal Cost** and in long run **LMC=MR=AR=LAC** at its minimum are the conditions of equilibrium. It means that a firm is earning only a 'normal profit' and has no intension to leave the industry.
4. Equilibrium for an industry happens when there is normal profit made by an industry It is such a situation when no new firm wants to enter into it and the existing firm does not want to exit. Only one price prevails in the market for a single product where the quantity of goods purchased by a buyer = total quantity produced by different firms. All the firms produce till that level where **Marginal Cost=Marginal revenue**, and sells the product at market price ruling at that point of time.
5. Factors of production, i.e. land, labor, capital and entrepreneurs are in equilibrium when they are paid the maximum possible so as maximize the income. Here the **Price = Marginal Revenue Product**. At this price it does not have any inducement to look for employment anywhere else.The quantity of factors which its owners want to sell should be = the quantity which the entrepreneurs are ready to hire.

General equilibrium theory is a branch of theoretical economics. The theory dates to the 1870s, particularly the work of French economist Léon Walras in his pioneering 1874 work *Elements of Pure Economics*.

It seeks to explain the behavior of supply, demand, and prices in a whole economy with several or many interacting markets, by seeking to prove that a set of prices exists that will result in an overall equilibrium, hence *general* equilibrium, in contrast to *partial* equilibrium, which only analyzes single markets. As with all models, this is an abstraction from a real economy; it is proposed as being a useful model, both by considering equilibrium prices as long-term prices and by considering actual prices as deviations from equilibrium.

General equilibrium theory both studies economies using the model of equilibrium pricing and seeks to determine in which circumstances the assumptions of general equilibrium will hold.

Distinction between General Equilibrium & Partial Equilibrium

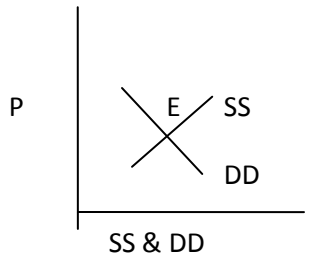
Partial Equilibrium	General Equilibrium
• Developed by Alfred Marshall. • Related to single variable • Based on two assumptions- 1. Ceteris Paribus 2. Other sectors are not affected due to change in one sector. • Other things remaining constant, price of a good is determined.	• Léon Walras was first to develop it. • More than one variable or economy as a whole is taken into consideration • It is based on the assumption that various sectors are mutually interdependent. There is an effect on other sectors due to change in one. •Prices of goods are determined simultaneously and mutually. Hence all product and factor markets are simultaneously in equilibrium.

4. Static and Dynamic Equilibrium

The word static originates from the field of physics. It is used to denote some kind of movement in which speed is constantly maintained. It is similar to taking a photo when you press the button for a shot then the photo is just at a particular point of time. In economics , we say the market is in equilibrium when demand and supply equate one another, which is graphically represented by the intersection point of demand and supply curve at point E in Fig.1. This is a static analysis since we only see the picture at a point of time.

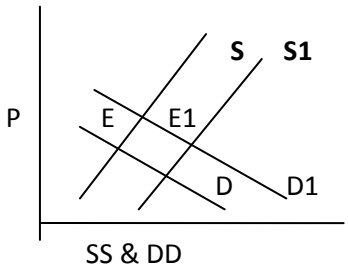
In dynamic analysis, we focus on the change of time and how the equilibrium changes with time. It is the same as watching the movie you can see how the image animate and movement. Dynamic analysis allows us to see the path of variable, how the variable changes with time. It helps us to see whether the equilibrium will reach or not. Here it is seen whether the variable will converge to a point which we called stable or steady state or it will diverge from the point or unstable state. An example is over time the equilibrium shifts from one point E to another E1 , due to rise in population leading to increase in demand faced by the firms and thus result is the rightward shift of the demand curve. As demand rises, supply also jumps up leading to next equilibrium point E1 as seen in Fig.2.

Fig.1



STATIC ANALYSIS

Fig.2



DYNAMIC ANALYSIS

5. Positive Economics and Normative Economics

Positive Economics

Positive economics can be described as “what is, what was, and what probably will be” economics. Statements are based on economic theory rather than raw emotion. Often these statements will be expressed in the form of a **hypothesis** that can be analysed and evaluated.

Examples:

- A rise in interest rates will cause a rise in the exchange rate and an increase in the demand for imported products.
- Lower taxes may stimulate better tax complince.
- A national minimum wage is likely to cause a contraction in the demand for low-skilled labour.
- The Indian economy now has lower unemployment than in 1980s.
- The Indian stock market has crashed in recent years.

Normative Economics

On the other hand normative economics is that branch of economics which passes value judgments rather than giving only data. It makes statements about “What ought to be” and hence it passes judgment whether it is advisable to do it or not.

Normative statements are **subjective** - based on opinion only - often without a basis in fact or theory. They are value-laden, emotional statements that focus on "what ought to be".

Examples:

- The decision to grant independence for the RBI is unwise and should be reversed
- A national minimum wage is totally undesirable as it does not help the poor and causes higher unemployment and inflation
- The national minimum wage should be increased as a method of reducing poverty
- Protectionism is the only proper way to improve the living standards of workers whose jobs are threatened by cheap imports.

It is important to be able to distinguish between these types of statements - particularly when heated arguments and debates are taking place. Most economists tend to adopt a positive approach.

6.Scarcity

A pervasive condition of human existence that exists because society has unlimited wants and needs, but limited resources used for their satisfaction In slightly different words, this scarcity problem means:

(1) that there's never enough resources to produce everything that everyone would like to produce;

(2) that some people will have to do without some of the goods that they want or need;

(3) that doing one thing, producing one good, performing one activity, forces society to give up something else; and

(4) that the same resources can not be used to produce two different goods at the same time.

We live in a big, bad world of scarcity. This big, bad world of scarcity is what the study of economics is all about. That's why we usually subtitle scarcity: THE ECONOMIC PROBLEM.

In classical economics recognizes the fact that resources are limited while desires are unlimited. The existence of scarcity requires the efficient allocation of resources and drives innovation to work around limitations. That is, scarcity often refers to trading one good or service for another, but it may cause an economic actor such as consumer or a firm or the government or a NGO to invent something that will satisfy as many desires as possible.

---

7. Wealth

About 90% of global wealth is distributed in North America, Europe, and "rich Asia-Pacific" countries (not including India), and 1% of adults are estimated to hold 40% of world wealth, a number which falls to 32% when adjusted for purchasing power parity.

In economics, wealth is the net worth of a person, household, or nation, that is, the value of all assets owned net of all liabilities owed at a point in time. For national wealth as measured in the national accounts, the net liabilities are those owed to the rest of the world. The term may also be used more broadly as referring to the productive capacity of a society or as a contrast to poverty. Analytical emphasis may be on its determinants or distribution.

Economic terminology distinguishes between two types of variables: stock and flow. Wealth, as measurable *at a point* in time, is a *stock*, like the value of an orchard apples on December 31 minus debt owed on the orchard. For a given amount of wealth, say at the beginning of the year, income from that wealth, as measurable *over* say a year is a *flow*. What marks the income as a flow is its measurement per unit of time, like the value of apples yielded from the orchard per year.

In macroeconomic theory the 'wealth effect' may refer to the increase in aggregate consumption from an increase in national wealth. One measure of it is the wealth elasticity of demand. It is the percentage change in the amount demanded of consumption for each one-percent change in wealth.

Environmental assets are not usually counted in measuring wealth, in part due to the difficulty of valuation of these goods. Environmental or green accounting is a method of social accounting for formulating and deriving natural and social wealth.

Extra Reading:

In economics, **purchasing power parity** (**PPP**) asks how much money would be needed to purchase the same goods and services in two countries, and uses that to calculate an implicit foreign exchange rate. Using that PPP rate, an amount of money thus has the same purchasing power in different countries. Among other uses, PPP rates facilitate international comparisons of income, as market exchange rates are often volatile, are affected by political and financial factors that do not lead to immediate changes in income and tend to systematically understate the standard of living in poor countries, due to the Balassa–Samuelson effect.

8. Welfare

The well-being of the entire society is welfare. Social welfare is more concerned with the quality of life that includes factors such as the quality of the environment (air, soil, water), level of crime, extent of drug abuse, availability of essential social services, as well as religious and spiritual aspects of life.

Branch of economics established in the 20th century that seeks to evaluate economic policies in terms of their effects on the community's well-being. Early theorists defined welfare as the sum of the satisfactions accruing to an individual through an economic system. Believing it was possible to compare the well-being of two or more individuals, they argued that a poor person would derive more satisfaction from an increase in income than would a rich person. Later writers argued that making such comparisons with any precision was impossible. A new and more limited criterion was later developed: one economic situation was deemed superior to another if at least one person had been made better off without anyone else being made worse off.

Pareto, one of the originators of welfare economics, defined total welfare as an improvement in a person's condition that was not achieved at any other person's expense.

Extra Reading :

Does Economics Growth Bring Increased Living Standards?

Increasing the rates of economic growth has long been the holy grail of conventional economics and politics. To a large extent, most developed economies have been highly successful in increasing economic output. But, has such an impressive increase in national output actually improved people's standard of living?

To decide whether economic growth has increased happiness is highly subjective, and it is difficult for economists to make concrete arguments. However, it is worth noting the various side effects of growth and consider their impact on general living standards.
