Module I

Exploring the Subject Matter of Economics

Introduction

Welcome to the *science of* economics. Yes, economics is a social science, like chemistry is a physical science. It is true that there are no test tubes and sophisticated equipment required to study economics, but Just as physical sciences are means to understand how the real physical world around us works - our planet, the solar system or the universe - in economics, we try to understand how the economy of a particular region, a country or the global economy works. There are principles or laws of economics (parallel to laws of Chemistry or physics).With the help of these principles; we analyze how an economy works. There is no universally accepted, single, definition of economics. But we can understand what it is about. Many non-economists think that it only concerns the matters of money - how to make or manage money. Not true. Economics is about making choices in the presence of scarcity. The notions “scarcity” and “choice” is very important in economics. You may not see these words in all chapters to come, but they are in the background throughout. Scarcity and choice go together if things were available in plenty (literally) then there would have been no choice problem; you can have anything you want. Unfortunately, this may be true only in heaven, not in the real world. Even the richest person on earth would have to face scarcity and make choice. If nothing else, time is scarce. Ratan Tata, a leading Industrialist of India, between 6 p.m. and 8 p.m. in a particular evening, may have to decide whether to go to a musical concert, or just keep working in his office. Think about the length of syllabi of various subjects that you have to cover before the final exam. We do not need to convince you that time is scarce. Likewise, food, clothing, housing, clean air, drinkable water etc. are scarce in every country in the world, except that the degree of scarcity varies. The point is that *problems of choice arise because of scarcity.* The study of such “choice problems”, at the individual, social, national and international level is what economics is about.

Why study economics?

Economics is the study of how societies use scarce resources to produce valuable commodities and distribute them among different people. Behind this definition are two key ideas in economics: those goods are scarce and that society must use its resources efficiently. Indeed, economics is an important subject because of the fact of scarcity and the desire for efficiency. Samuelson and Nordhaus also provide some insights into the role of economists in Chapter 1 of their book. They declare that, “Throughout the world economists are laboring to collect data and improve our understanding of economic trends.” Moreover, as they note, economists are studying and trying to explain a wide and expanding array of activities, ranging from international trade to unemployment and inflation, from investing retirement funds to controlling pollution. Economic analysis, both theoretical and empirical, can generate important insights into individual and aggregate behavior and relationships, and help in society's efforts to use scarce resources in a more efficient manner. The ultimate goal of economic science is to improve the living conditions of people in their everyday lives. Increasing the gross domestic product is not just a numbers game. Higher incomes mean good food, warm houses, and hot water. They mean safe drinking water and inoculations against the perennial plagues of humanity. The study of economics has provided with a systematic framework for analyzing, researching, writing, and teaching about a wide array financial and regional economic issues. Economics has provided with a methodology for understanding and making sense of our complex environment.

Economists are well known for advising the president, prime minister and chief ministers on economic issues, formulating policies at the Reserve Bank, and analyzing economic conditions for investment banks, brokerage houses, real estate companies, and other private sector businesses. They also contribute to the development of many other public policies including health care, welfare, and school reform and efforts to reduce inequality, pollution and crime. The study of economics can also provide valuable knowledge for making decisions in everyday life. It offers a tool with which to approach questions about the desirability of a particular financial investment opportunity, whether or not to attend college or graduate school, the benefits and costs of alternative careers, and the likely impacts of public policies including universal health care and a higher minimum wage.

Micro versus Macro

1. Microeconomics

The term ‘micro’ is derived from the Greek word ‘Mikros’ which means ‘small’. It was, for the first time, used in economic literature by Ragnar Frisch of Oslo University in 1933. Microeconomics as a specialized branch of economics is developed largely by the efforts of Adam Smith. Microeconomics is the branch of economics based on the economic behaviour of small economic units. The economic units studied in microeconomics are consumers, workers, savers, business managers, firms, individual industries and markets. Consumers decide how much of various goods to purchase, workers decide what jobs to take, and business people decide how many workers to hire and how much output to produce. Microeconomics encompasses the factors that influence these choices and the way these innumerable small decisions merge to determine the workings of the entire economy.

Because of the important effects that prices have on these individual decisions, microeconomics is frequently called price theory. Microeconomics, however, is not limited to small issues. Instead, many 'big issues' can best be understood using microeconomics by recognizing that they are composed of numerous smaller parts. Much of our knowledge of economics is on the study of individual behaviour. Microeconomics studies how choices are made at the individual level under conditions of scarcity. If there was no scarcity, there would be no need to make choices. Choice must be made from among alternatives. If there are no alternatives available, then the freedom to choose has little meaning. Microeconomics encompasses the factors that influence the decisions made by millions of individuals and the way these innumerable decisions merge to determine the workings of the entire economy. Consumers decide how much of various goods to purchase, workers decide what jobs to take, and firms decide how much output to produce. Microeconomics examines the allocation decisions of individual consumers and firms. Consumers and firms are guided by the objective of maximization of satisfaction and profits respectively. Since markets are important in the maximization efforts of both consumers and firms, microeconomics studies the markets in detail. The understanding of individual behaviour provides the basis for understanding markets, since a market is comprised of many individual agents. Microeconomic theory is capable of dealing with some of the most important social issues of the day. The important among them are environmental pollution, poverty and welfare programmes, monopolies and consumer wellbeing, labour unions and real wages, rising medical expenditure, discrimination in employment, energy problems, taxation and work incentives.

The uses of Microeconomics

The uses of microeconomics are the following:

a) Microeconomics is useful in analyzing how prices are determined in different markets and how resources are allocated to various uses.

b) Microeconomic theory can be used as basis for conditional predictions. For example, if the demand curve is negatively sloped and supply curve is positively sloped, then a price rise above the equilibrium price will create a surplus on the market.

c) Microeconomic theory provides the analytical tools for economic policies affecting prices and production. The effect of government policies on prices of commodities and wages and their impact on the allocation of resources can be analyzed with the help of microeconomics.

d) Microeconomics can be used to examine the conditions of economic welfare. Economic welfare consists of the subjective satisfactions that individuals get from consuming goods and services and from enjoying leisure. It can suggest methods to raise the level of consumption of goods and services.

e) Microeconomics is useful in decision making in the employment of resources in government programmes. Because of the availability of the tested methods of analyzing costs and benefits of a programme, price theory can help the decision makers in achieving efficiency in the use of scarce resources.

2. Macro Economics:

It is a branch of Economics which deals with aggregates. The word 'Micro Economics and Macro Economics' were first coined by Ragnar Frisch in 1933. John Maynard Keynes is considered as the father of Macro Economics. The main difference between Micro and Macro Economics is shown by the table (1.1).

Table (1.1): Difference Between Micro and Macro Economics

Points Of Difference	**Micro Economics**	**Macro Economics**
Unit of study	Individual	Aggregate
Method	Partial Equilibrium	General Equilibrium
View point	Worm's eye view	Bird's eye View
Example	Demand for a pen, salary of a person, utility, cost etc.	National income, aggregate demand, inflation, money supply

Emergence of Macro Economics:

Classical Economists like Adam Smith, David Ricardo, J. B. Say etc. are believed in and argued for 'Laisses faire' and 'Say's law of market'. Laissez faire means least intervention of government in the economy. 'Say's law means "supply creates its own demand". They believed the invisible hand' will ensure equilibrium and full employment. Classical ideas were proved wrong by the Great Depression of 1929-1930 periods in USA. During this period unemployment rate rose from 3% to 25% and the aggregate output in USA fell by about 33%. During this period in 1936 John Maynard Keynes published his book 'The General Theory of Employment Interest and Money'. According to Keynes "Output of an economy is determined by aggregate demand and aggregate supply". This is why a new branch of Economics is emerged. It is called Macro Economics. And John Maynard Keynes is considered as the father of Macro Economics.

Scope of Macroeconomics:

The scope of Macro Economics consists of the following.

1. Theory of National Income
2. Theory of Employment
3. Theory of Inflation
4. Theory of Trade Cycles
5. Theory of economic growth
6. Theory of monetary and fiscal policies.

Importance of Macroeconomics:

The study of Macro Economics is important because it is

1. Helpful to understand the functioning of the economy.
2. Helpful to compare the various economies.
3. Useful in planning and forecasting.
4. Helpful in the formulation of economic policies.

According to Macroeconomic point of view there are four main sectors in an economy. They are following

1. Firms: Tiny production units in an economy are called firms. Their main motive is to produce goods and services and to sell in market to earn profit.
2. Household: A single Individual or group of individuals who takes decisions related to consumption. They consume, save and also pay taxes.
3. Government: It is the regulatory body of the economy. The role of the government is framing laws, enforcing them and delivering justice.
4. External Sector: If refers to the economic transaction of the domestic economy with the rest of the world. The domestic country may sell goods to the rest of the world. If is called export. The domestic country may buy goods from the rest of the world. If is called import.

Limitations of Macro Economics:

Macro Economics suffers the following limitations.

1. It cannot be applied to explain individual behaviour.
2. Conclusions drawn from Macro economic analysis maybe misleading.
3. Macro economics deals with aggregates. Aggregates may be approximation of realities.
4. Most Macro Economics magnitudes are subject to errors and ambiguities