DMS 201 : INTRODUCTION TO MANAGEMENT

MODULE-II: FINANCIAL MANAGEMENT

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MODULE OVERVIEW

Module-II: Financial Management			
1	Business Environment	Introduction to microeconomics: Demand and supply analysis Introduction to macroeconomics: GDP, inflation, real vs. nominal variables Inter-linkage between economic concepts and financial market: Fiscal and monetary policies	5
2	Financial Markets and Instruments	Introduction to financial markets and institutions Characteristics of equity and debt instruments Financing an enterprise: Banking and capital markets	4
3	Tools of Financial Analysis	Time value of money Discounted cash flow approach to valuation of securities Introduction to financial statement analysis	4

Assessment

- 2 MCQs
  - 1st MCQ on 26 Feb 2024 (Monday)
  - 2nd MCQ on 11 March 2024 (Monday)
- Final Exam

Recommended Books

- Principles of Corporate Finance by Brealy, Myers, Allen.
- Economics by Samuelson and Nordhaus, McGraw Hill.

PART 1: BUSINESS ENVIRONMENT

LECTURE 1: 10 PRINCIPALS OF ECONOMICS

In Lecture 1
We look for the answers to these questions:

- What kinds of questions does economics address?
- What are the principles of how people make decisions?
- What are the principles of how people interact?
- What are the principles of how the economy as a whole works?

LEARNING OBJECTIVES

- that economics is about the allocation of scarce resources.
- that individuals face trade-offs.
- the meaning of opportunity cost.
- how to use marginal reasoning when making decisions.
- how incentives affect people's behavior.
- why trade among people or nations can be good for everyone.
- why markets are a good, but not perfect, way to allocate resources.
- what determines some trends in the overall economy.

What Economics Is All About

- **Scarcity**: the limited nature of society's resources
- **Economics**: the study of how society manages its scarce resources, e.g.
  - how people decide what to buy,
    how much to work, save, and spend
  - how firms decide how much to produce,
    how many workers to hire
  - how society decides how to divide its resources between national defense, consumer goods,
    protecting the environment, and other needs

THE PRINCIPLES OF HOW PEOPLE MAKE DECISIONS

PRINCIPLE #1:
People Face Tradeoffs

All decisions involve tradeoffs.

Examples:

- Going to a party the night before your midterm leaves less time for studying.
- Having more money to buy stuff requires working longer hours, which leaves less time for leisure.
- Protecting the environment requires resources that could otherwise be used to produce consumer goods.

PRINCIPLE #1:
People Face Tradeoffs

- Society faces an important tradeoff:
  efficiency vs. equality
- **Efficiency**: when society gets the most from its scarce resources
- **Equality**: when prosperity is distributed uniformly among society's members
- Tradeoff: To achieve greater equality,
  could redistribute income from wealthy to poor.
  But this reduces incentive to work and produce, shrinks the size of the economic "pie."
  - E.g.: US and EU countries

PRINCIPLE #2:

The Cost of Something Is What You Give Up to Get It

- Making decisions requires comparing the costs and benefits of alternative choices.
- The **opportunity cost** of any item is whatever must be given up to obtain it.
- It is the relevant cost for decision making.

PRINCIPLE #2:

The Cost of Something Is What You Give Up to Get It

Examples:

The opportunity cost of…

…going to college for a year is not just the tuition, books, and fees, but also the foregone wages.

…seeing a movie is not just the price of the ticket,
but the value of the time you spend in the theater.

PRINCIPLE #3:
Rational People Think at the Margin

Rational people

- systematically and purposefully do the best they can to achieve their objectives.
- make decisions by evaluating costs and benefits of **marginal changes**, incremental adjustments to an existing plan.

PRINCIPLE #3:
Rational People Think at the Margin

Examples:

- When a student considers whether to go to college for an additional year, he compares the fees & foregone wages to the extra income
  he could earn with the extra year of education.
- When a manager considers whether to increase output, she compares the cost of the needed labor and materials to the extra revenue.
  - The diamond-water paradox: water is essential for life but virtually free; diamonds are inessential but expensive.

PRINCIPLE #4:
People Respond to Incentives

- **Incentive**: something that induces a person to act, i.e. the prospect of a reward or punishment.
- Rational people respond to incentives.
- Examples:
  - When gas prices rise, consumers buy more hybrid cars and fewer gas guzzling SUVs.
  - When cigarette taxes increase, teen smoking falls.

ACTIVE LEARNING 1
Applying the principles

You are selling your Nano car. You have already spent Rs 1000 on repairs.

At the last minute, the transmission dies. You can pay Rs 600 to have it repaired, or sell the car "as is."

In each of the following scenarios, should you have the transmission repaired? Explain.

A. Blue book value (what you could get for the car) is Rs 6500 if transmission works, Rs 5700 if it doesn't

B. Blue book value is Rs 6000 if transmission works, Rs 5500 if it doesn't

ACTIVE LEARNING 1

Answers

Cost of fixing transmission = Rs 600

A. Blue book value is Rs 6500 if transmission works, Rs 5700 if it doesn't

Benefit of fixing the transmission = Rs 800 (Rs 6500 – 5700).

It's worthwhile to have the transmission fixed.

B. Blue book value is Rs 6000 if transmission works, Rs 5500 if it doesn't

Benefit of fixing the transmission is only Rs 500.

Paying Rs 600 to fix transmission is not worthwhile.

ACTIVE LEARNING 1
Observations

- The Rs 1000 you previously spent on repairs is irrelevant. What matters is the cost and benefit of the *marginal* repair (the transmission).
- The change in incentives from scenario A to scenario B caused your decision to change.

THE PRINCIPLES OF HOW PEOPLE INTERACT

PRINCIPLE #5:
Trade Can Make Everyone Better Off

- Rather than being self-sufficient,
  people can specialize in producing one good or service and exchange it for other goods.
- Countries also benefit from trade and specialization:
  - Get a better price abroad for goods they produce
  - Buy other goods more cheaply from abroad than could be produced at home

PRINCIPLE #6:

Markets Are Usually A Good Way to Organize Economic Activity

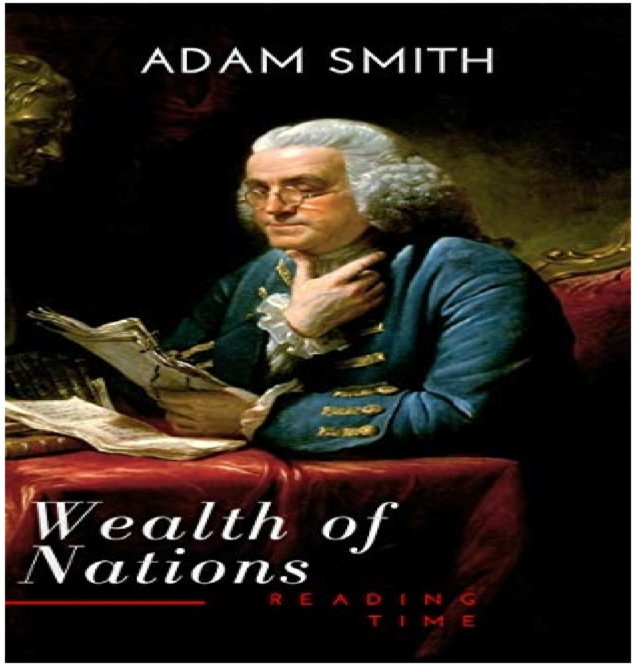
- **Market**: a group of buyers and sellers (need not be in a single location)
- "Organize economic activity" means determining
  - what goods to produce
  - how to produce them
  - how much of each to produce
  - who gets them

PRINCIPLE #6:

Markets Are Usually A Good Way to Organize Economic Activity

- A **market economy** allocates resources through the decentralized decisions of many households and firms as they interact in markets.
- Famous insight by **Adam Smith** in *The Wealth of Nations* (1776):

  Each of these households and firms acts as if "led by **an invisible hand**" to promote general economic well-being.



Adam Smith: The father of Economics

PRINCIPLE #6:
Markets Are Usually A Good Way to Organize Economic Activity

- The invisible hand works through the price system:
  - The interaction of buyers and sellers determines prices.
  - Each price reflects the good's value to buyers and the cost of producing the good.
  - Prices guide self-interested households and firms to make decisions that, in many cases, maximize society's economic well-being.

PRINCIPLE #7:

Governments Can Sometimes Improve Market Outcomes

- Important role for govt: **enforce property rights** (with police, courts)
- People are less inclined to work, produce, invest, or purchase if large risk of their property being stolen.

PRINCIPLE #7:

Governments Can Sometimes Improve Market Outcomes

- **Market failure:** when the market fails to allocate society's resources efficiently
- Causes of market failure:
  - **Externalities**, when the production or consumption of a good affects bystanders (e.g. pollution)
  - **Market power**, a single buyer or seller has substantial influence on market price (e.g. monopoly)
- Public policy may **promote efficiency**.

PRINCIPLE #7: Governments Can Sometimes Improve Market Outcomes

- Govt may alter market outcome to **promote equity**.
- Because a market economy rewards people for their ability to produce things that other people are willing to pay for, there will be an unequal distribution of economic well-being.
- If the market's distribution of economic well-being is not desirable, tax or welfare policies can change how the economic "pie" is divided.

THE PRINCIPLES OF HOW THE ECONOMY AS A WHOLE WORKS

PRINCIPLE #8:
A Country's Standard of Living Depends on Its Ability to Produce Goods & Services

- Huge variation in living standards across countries and over time:
  - Average income in rich countries is more than ten times average income in poor countries.
  - Real GDP per capita in India has risen by 219% since 1998 and has only fallen once in 2020.

PRINCIPLE #8:

A Country’s Standard of Living Depends on Its Ability to Produce Goods & Services

- The most important determinant of living standards: **productivity**, the amount of goods and services produced per unit of labor.
- Productivity depends on the equipment, skills, and technology available to workers.
- Other factors (e.g., labor unions, competition from abroad) have far less impact on living standards.

PRINCIPLE #9:

Prices Rise When the Government Prints Too Much Money

- **Inflation**: increases in the general level of prices.
- In the long run, inflation is almost always caused by excessive growth in the quantity of money, which causes the value of money to fall.
- The faster the govt creates money, the greater the inflation rate.

PRINCIPLE #10:

Society Faces a Short-run Tradeoff Between Inflation and Unemployment

- In the short-run (1–2 years),
  many economic policies push inflation and unemployment in opposite directions.

- Mainstream economists believe the following: An increase in the quantity of money causes spending to rise, which causes prices to rise, which induces firms to produce more goods and services, which requires that they hire more workers. Hence, in the short-run, increasing the quantity of money causes inflation to rise, but unemployment to fall.

- Of course, REDUCING the quantity of money would have the opposite effects (inflation would fall, while unemployment would rise) in the short run.

SUMMARY

The principles of decision making are:

People face tradeoffs.

The cost of any action is measured in terms of foregone opportunities.

Rational people make decisions by comparing marginal costs and marginal benefits.

People respond to incentives.

SUMMARY

The principles of interactions among people are:

Trade can be mutually beneficial.

Markets are usually a good way of coordinating trade.

Govt can potentially improve market outcomes if there is a market failure or if the market outcome is inequitable.

SUMMARY

The principles of the economy as a whole are:

Productivity is the ultimate source of living standards.

Money growth is the ultimate source of inflation.

Society faces a short-run tradeoff between inflation and unemployment.

Key Takeaways

- The fundamental lessons about individual decision-making are that people face trade-offs among alternative goals, that the cost of any action is measured in terms of forgone opportunities, that rational people make decisions by comparing marginal costs and marginal benefits, and that people change their behavior in response to the incentives they face.
- The fundamental lessons about interactions among people are that trade and interdependence can be mutually beneficial, that markets are usually a good way of coordinating economic activity among people, and that the government can potentially improve market outcomes by remeding a market failure or by promoting greater economic equality.
- The fundamental lessons about the economy as a whole are that productivity is the ultimate source of living standards, that growth in the quantity of money is the ultimate source of inflation, and that society faces a short-run trade-off between inflation and unemployment.