ENGLISH BLOCK DESIGN

Karnataka State Open University
Mukthagangotri, Mysore-570006

Department of Studies &
Research in Economics
I-Semester M.A Economics
HC1.1: MICRO ECONOMIC ANALYSIS – I

BLOCK 1

Fundamentals to Micro Economics

UNIT-1	:	Introduction to Micro Economic Analysis
UNIT-2	:	Basic Problems of Economy
UNIT-3	:	Method of Economic Analysis
UNIT-4	:	Tools in Economic Analysis

CREDIT PAGE

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Mukthagangotri, Mysore-570006

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COURSE WRITER

Dr.M.S.Ramananda Unit:1 to 4
Associate Professor, DOS&R in Economics, KSOU, Mysore
Dr.R.H.Pavithra Unit: 5 to 8
Assistant Professor, DOS&R in Economics, KSOU, Mysore
Dr.N.Harish Unit: 9 to 12
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Prof.RavindraKumara.B Unit: 13 to 16
Professor, DOS&R in Economics, Tumkur University, Tumkur

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HC.1.1 MICROECONOMICANALYIS–I

BLOCK-1

Block1

Block 1(Unit 1- Unit 4): IntroductionThis
block contains4units.

Unit 1: In unit 1 you will study Origin, Nature and Scope of Micro Economicanalysis. This unit deals with Micro economics, Macro economics and theirinterdependencies.

Unit 2: This unit deals with Production Possibility curve, its construction anduses.Thisunitexplains Basic Problems of Economy.

Unit 3: In this unit you will learn about Economic statics, Comparative Staticsand their limitations. This unit highlights the concept of Economic Dynamicsand itsSignificance and Limitations.

Unit 4: This Unit comprises of various tools employed in Economic analysis. ItanalysistheDeductiveandInductivemethodswiththeirmeritsanddemerits.

UNIT1:

IntroductiontoMicroEconomicAnalysis

1.0 Objectives

Attheend ofthisunit,you shouldbeableto

- DistinguishbetweenMicroEconomicsandMacroEconomicsandtheinter-relationshipbetweenthe two.

1.1 Introduction-Origin –Nature- Scope

The core of modern economics comprises two branches - micro economics andmacro economics. Adam Smith is usually considered as the founder of the field ofmicroeconomics,thebranchofeconomicswhichtodayisconcernedwiththebehavior of individual entities such as markets, firms and households. In Wealth ofNations(1776),Smithconsideredhowindividualpricesareset,studiedthedetermination of prices of land, labour and capital, and inquired into the strengths andweaknesses of the market mechanism. Most important, he identified the remarkableefficiency properties of markets and saw that economic benefit comes from the self-interested actions of individuals. These remain important issues today, and while thestudy of micro-economics has surely advanced greatly since Smith"s day, he is stillcited.

The othermajor branch is Macro economics, which is concerned with theoverall performance of the economy. Macro economics did not exist in its modernform until 1935, when John Maynard Keynes published his revolutionary "GeneralTheory of Employment, Interest and Money". At the time, England and the UnitedStates were still staruck in the Great Depression of the 1930s, with over one-quarter ofthe American labour force unemployed. In his new theory, Keynes developed ananalysis of what causes business cycles, with alternating spells of high unemploymentand high inflation. Today, Macro economics examines a wide variety of areas such ashow total investment and consumption are determined, how central banks managemoneyandinterestrates.

What causes international crises, and why some nations grow rapidly whileothers stagnate. Although Macro economics has progressed far since his insights, theissuesaddressedKeynesstilldefinethestudyofMacroeconomicstoday.

- Inwhatfollows,youwillbeintroduced,atsomelength,totherelativemeritsanddemeritsofthe twobranches.

MicroEconomicsandmacroeconomics

1.2 Micro Economics

Lookatthefollowingtwodefinitionsof thetermmicroeconomics:

"Analysis dealing with the behavior of individual elements in an economy – such asthe determination of price of a single producer or the behavior of a single consumer orbusinessfirm(SamuelsonandNordhans);

"The study of individual units within the economy (such as households, firms andindustries) and their interrelationships. They study of the allocation of resources andthedistributionofincome".(WonnacottandWonnacott)

Micro literally means millionth of a part. Thus, as can be seen from the abovetwo definitions. Micro economics deals with a small part of the national economy of acountry. In micro economics we examine the trees, not the forest. It is an inquiry as tohow a particular person maximizes profits, or how a particular family adjusts itsexpenditure to income, comes within the domain of micro economics. Since microeconomics splits up the economy into smaller parts for the purpose of intensive study,it is sometimes referred to as theslicingmethod. Marginal analysisis an importanttool in micro economics. Some important laws in economics are derived from themarginalanalysis,thelawofdiminishingmarginalutility, forexample.

Micro economics is also referred to as the Price theory since prices act as theindicatorsofresourceallocation.

Toputina nutshell, microeconomicsstudiesthefollowing:

i) Howresourcesareallocatedtotheproductionofparticulargoodsandservices;

ii) Howthegoodsandservicesaredistributed amongthepeopleand

iii) How efficientlytheyare distributed;

While studying the conditions in which the price of a particular good is determined,micro economics assumes the total quantity of resources as given and seeks to explaintheir allocation to the production of that commodity. Such an allocation is influencedby the prices of other goods and the prices of factors producing them. It is, thereforethe relative prices of goods and services that determine the allocation of resources.Stateddifferently,otherthingsbeingequal,itistheallocationofresourcesthatdetermines whattoproduce,howtoproduceandhowmuchtoproduce.

Typesof microeconomics:

Generally, micro economics is divided into three types: i) Micro Statics ii)Comparativemicrostaticsandiii)Microdynamics.

Micro statics is a method of analysis which deals with the relationship betweendifferent micro variables at a given time under conditions of equilibrium. Ex: the priceof a commodity in a market is determined by the equilibrium of demand and supply atagiven time. Itdoesnotexplain theprocessofthisequilibrium.

Incomparativemicrostatics,equilibriumpositionsarecomparedbetweenmicro variables at different points of time. The transition from one equilibrium toanotherisnotexplained.Heretwo ‟still‟ picturesarecompared.

Micro dynamics refers to that process whereby we reach from one position ofequilibriumtothatofanother.Thatis,theprocessoftransitionfromoneequilibriumtoanother isexplained.

Importanceofmicroeconomics:

It need not be said that micro economics has both theoretical and practicalsignificance.Look at thesespecificaspects:

i) EfficientUtilisationofscarceresources:

You know, one of the major problems facing all economic systems is how bestto utilize the available scarce resources. In other words, how to produce the highestlevel of output at the lowest possible cost? What conditions are to be fulfilled toachieve efficiency in both consumption and production? In a way, micro economicssetsthegroundrulesforachievingeconomicefficiency.

ii) Understandingthe makingof aneconomy

Micro economics has a pivotal role in explaining the working of a free enterpriseeconomy. As you know, in a free enterprise economy, the fundamental problems areanswered by market forces. That is, there is no agency to plan and coordinate theworking of economic system. Then, how are the basic problems answered? Microeconomics providesthenecessarytheoreticaltoolsandguidance.

iii) Helpsinunderstanding the mechanismof internationaltrade

Thetoolsofmicroeconomicsareusedtoexplainthegainsfrominternationaltrade,balanceofpayments anddisequilibriumthereonandthedeterminationofexchange rates. It is the relative elasticity‟s of demand for each other‟s produce thatdeterminegainsfrominternationaltrade.Disequilibriuminbalanceofpayments occurs because of inequality between demand and supply of foreign currency. As youknow, in the present day world economy where there is floating exchange rates, theexchangerateis determined bydemand andsupplyfactors.

iv) Implicationsoftaxation:

Take a simple example like the usefulness of the law of diminishing marginalutility. It is the theoretical basis for explaining the rationale behind introduction ofprogression in taxation. Similarly, it is possible to measure the burden of a tax and itsincidence.

v) Basisforwelfareeconomics:

Welfare economists, as you know, is concerned with the normative analysis ofeconomicsystems,thatis,thestudyofwhatis"wrong"or,,right‟abouttheeconomy‟sfunctioning. The entire structure of welfare economics is built on price theory which isnothing but micro economics. Allocation of resources should be such that it promotes,the,,greatesthappiness ofthegreatestnumber‟.

vi) Providestoolsforevaluatingeconomicpolicies:

Microeconomics theory provides tools for evaluating efficiency in consumptionand production and highlight the factors which are responsible for the departure fromefficiency.Pricepolicyisalsoanimportanttoolforeconomicpolicies.

vii) Conditionalpredictionspossible:

Microeconomicshelpsinmakingpredictingeconomiceventsbasedonpastexperience.Youareallawareofthephrase."CeterisParibus"orotherthingsremainingconstant.Givencertainconditions,theeconomist,predictsthatcertainevents arelikelytooccur.

viii) Constructionanduseofeconomicmodels:

An economic model is an abstraction of an economic reality, micro economicsconstructsanduses simple modelfortheunderstandingof theactualphenomena.

Limitationsofmicroeconomics

It is clear from the above that micro economics has great relevance both as atheoretical tool and as a practical guide. But it has certain limitations. A few suchlimitingfactorsaresummarized below:

i) The major limitation is the assumption of full employment which, in a way,is to assume our ,,problemsaway‟. You know that full employment is onlyanexceptionandnota ruleasisassumedin microeconomics.

ii) Micro economics assumes laissez-faire which is not what is happening atpresent.

iii) Certainproblemsassociatedwiththepresentdayworldeconomylikeeconomic development tax policy cannot be analysed in micro economicsframework.

iv) Thecollectivefunctioningof theeconomycannotbevisualized.

v) Duetoitsabstractness,microeconomicsfails asaguidetopolicymaking.

1.3 MacroEconomics

WenotedthatMacroeconomicsis"thestudyoftheoverallaggregatesoftheeconomy (such as total employment, the unemployment rate, national product, and therateofinflation)".Itisastudyofaggregatesandthereforeisthestudyoftheeconomicsystemasawhole .ThisiswhatKennethE.Bouldingsaysaboutthemeaning of Macro economics". Macro economics deals not with individual quantitiesas such, but with aggregates of these quantities, not with individual incomes but withnational incomes not with individual outputs but with the national outputs. It is amethod of lumping. We noted in the introduction how, it was the „General Theory‟‟ ofKeynes that emphasized the importance of Macro economics. A good example ofMacroeconomicsisthenowfamiliarcircularflowofincomeconcept.

ThefieldofMacroeconomicscomprises thefollowing:

-Theoryofincome,outputandemployment,includingthetheoryofbusinesscycles.

-Theories of prices with its constituents of the theories of inflation, deflation andreflation.

-Thetheoryofeconomicgrowth.

-The macro theory of distribution dealing with the relative shares of wages and profitsintotalnationalincome.

TypesofMacroeconomics:

Similar to micro economics, Macro economics is also grouped under threetypes,namely, macrostatics,comparativemacrostaticsand macrodynamics.

Macro statics explains certain aggregative relations in a stationary state. It doesnot say anything about the processby which the nationaleconomy reachesfinalequilibrium.

Comparative macro statics involves: comparative study of different equilibriumattainedbytheeconomy.Butthemethoddoesnotdetailtheprocessofadjustmentby whichtheeconomymovesfromoneequilibriumtoanother.Itpresentsa„„still‟pictureo fthevariousequilibriareachedbytheeconomy.

Macro dynamics, which is more realistic, studies how the equilibrium in theeconomy is reached consequent upon changes in the macrovariables and aggregates.Itindicatesthe processes ofchange.

ImportanceofMacroeconomics:

It may not be an exaggeration to say that the economic policies of governmentare basically influenced by macro variables. Consequently, its significance has alsogreatly expanded. Look at some of the ways by which the present day economics areshapedbymacroindicators:

i) **Necessary for formulation and execution of government policies**:Moderngovernmentsbeing„welfare‟oriented,havetointerfe reinthedevelopmental process to achieve certain socio-econo

ii) **Tounderstand theworkingoftheeconomy**:
Ultimately, it is aggregative working ofit economy that determines thelevel and nature of economic progress of a country. These could be in termsofgrowth rates,inflationarypressures,capacityutilizationetc.

iii) **Understandingmonetaryissues**:
Macro economics has its armoury, a number of monetary and fiscal policytools. Their effects on the stability of prices and value of money are of greatimportanceinpromotingeconomic growth.

iv) **Inbusinesscycles**:
Promoting growth with stability is an important macro economic goal. Butin a modern capitalist society, economics are subject to fluctuations.
Macroeconomictoolscanbehelpfulinpromotinggrowthwithstability.

Limitations:

As a method of economic analysis, it is only an approach. Thus the methodcannot be used under all circumstances and at all times. A few major limitations arehighlightedhere:

- Macroeconomicsregardsaggregatesashomogenousinnature.Butthereare fartoomanydifferenceswhichareignored.
- Aggregatesmaynotreflecttheparticular.Forexample,ariseinnationalincomeneednotnecessarilymeanincreasedpercapitaincomes(duetoincreasing population)andequaldistribution.
- Macroeconomicmodelshavetoinvariablybasetheirtheoriesonmicrolevel changes,all ofwhich maynotberepresented properlyin the aggregate.
- Measuring macro variables have their own statistical and conceptualdifficulties.

1.4 Interdependencebetween MicroeconomicsandMacroeconomics

You may all be now familiar with the famous comparison of micro economicsto a „tree‟andMacro economicsto a „forest‟made byKenneth E.Boulding. Both the„tree‟ and the „forest‟ are complementary to each other, and yet they are distinct!Stated simply, an aggregation of trees results in a forest.Similarly adding all microunits‟resultsinamacrounit.That‟swheretheanalogyends.Treehascertaincharacteristics which the forest does not possess and vice versa. Similar is the casewithregardtomicroeconomicsandMacroeconomics.Let us take an example from the world of economics. Take the case of savings.Savings as you know is a virtue for you and me. What if the entire population reducesits consumption and increases savings? The result is an overall decline in aggregatespendinganddemand.Thiswouldmeanlowerprices,profits,investment,employment and output. So, as you can see, what is considered a “virtue” in microeconomicsturnsoutto bea„vice‟in Macroeconomics!One thing is obvious: A combination of both these approaches would be anideal answer. Read this saying of Samuelon: “there is really no opposition betweenmicro and macro economics. Both are absolutely vital. You are less than half-educatedifyouunderstandtheonewhilebeingignorantoftheother”.

CheckYourProgress

1. JohnMaynardKeyneswrote…………….
2. The study of individual units within the economy and theirinterrelationshipis called as Micro Economics

   TrueorFalse

3. isanimportanttoolinmicroeconomics
4. WriteanoteonInterdependencebetweenmicroeconomicsandmacroeconomics.
5. Microeconomicsisconcernedwiththebehaviourof…………
6. a)individualunitsb)averageunitsc)aggregateunitsd)marginalunits

AnswersforCheckyourprogress

1. GeneralTheoryofemploymentInterestandmoney
2. True
3. MarginalAnalysis

4.1.2.3

5.(a)

1.5 Summary:

- StudyofEconomicscanbeapproachedintwo differentways,namely,microeconomicsandMacroeconomics.
- Micro economics is concerned with the behavior of individual units such asmarkets,firms,andhouseholds.
- Macroeconomicsisconcernedwithaggregatessuchashowtotal investmentand consumption are determined, and with such variables as level ofunemployment,inflationetc:
- Microeconomicsisdividedintothreetypes,namely, microstatics,comparativemicrostaticsandmicrodynamics.
- Microeconomicsissignificantinnumberofways:helpsinefficientutilization of scare resources, understanding the working of an economy,

implications fortaxationandisthebasisforwelfareeconomics.

- Microeconomicsfailswhenitcomestoexplainingthetotalityof an economicsystemanditsgreatestweaknessistheassumptionof fullemployment.
- Macro economics assumed great significance with the publications of "GeneralTheoryofEmployment,InterestandMoney"byJ.M.Keynesin19 36.
- Similartomicroeconomics,Macroeconomicscanalsobeclassifiedintothr eetypes,namely,macrostatics,comparativemacrostaticsandmacrodyna mics.
- Macroeconomicshasgreatrelevanceincontemporaryeconomicssinceith elpsin understanding the working of an economy, the significance of monetary andfiscalpoliciesetc.
- Macro economics, similar to micro economics, only partially explains theworkingofaneconomicsystem.
- BothmicroandMacroeconomicsareinterdependent.

1.6 Keywords:

<u>Micro economics</u>: The study of individual units within the economy (such ashouseholds,firms andindustries)andtheirinterrelationships.Thestudyoftheallocationofresou rceand the distributionofincome.
<u>Macrostatics</u>:Studiestherelationshipbetweendifferentmicrovariablesatagiventi meunderconditionsofequilibrium.
<u>Comparative micro statics</u>: Equilibrium positions are compared between microvariablesat differentpointsof time.Itis acomparativestudyofdifferentequilibriaatdifferentpointsoftime.
<u>MicroDynamics</u>:Itisaprocesswherebywereachfromoneposition.

1.7 QuestionsforSelfStudy:

1. Micro economics and Macro economics are complementary to each other".Criticallyexaminethisstatement.
2. Examine the significance of micro economics and Macro economics inanalyzingeconomicproblems.
3.

1.8 References:

1. Samuleson,P.AandNordhans:Economics
2. WonnacottandWonnacott:Economics

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