Nilai UNIVERSITY

OBM3102

FOUNDATION IN BUSINESS

SELF INSTRUCTIONAL MATERIALS

ACADEMIC YEAR 2023

FACULTY OF BUSINESS, HUMANITIES & HOSPITALITY

BACHELOR OF COMMERCE (HONS) IN INTERNATIONAL BUSINESS

Topic 9 ▸ Economic (Part 1)

LEARNING OUTCOMES

By the end of this topic, you will be able to:

1. Explain economics;
2. Explain 4 basic concepts of microeconomics; and
3. Explain 4 economic indicator in macroeconomics.

► INTRODUCTION

Economics is the study of how people allocate scarce resources for production, distribution, and consumption, both individually and collectively. The two branches of economics are microeconomics and macroeconomics. Economics focuses on efficiency in production and exchange.

9.1 WHAT ECONOMICS IS ALL ABOUT?

At its core, Economics is the study of how humans make decisions in the face of scarcity. These can be individual decisions, family decisions, business decisions or societal decisions. If you look around carefully, you will see that scarcity is a fact of life. Scarcity means that human wants for goods, services and resources exceed what is available. Resources, such as labor, tools, land, and raw materials are necessary to produce the goods and services we want but they exist in limited supply. Of course, the ultimate scarce resource is time – everyone, rich or

poor, has just 24 hours in the day to try to acquire the goods they want. At any point in time, there is only a finite amount of resources available.

Think about it this way: In 2016, the labor force in Canada contained 19.4 million workers, according to Statistics Canada. The total area of the Canada is 9.99 million square kilometres. These are large numbers for such crucial resources, however, they are limited. Because these resources are limited, so are the numbers of goods and services we produce with them. Combine this with the fact that human wants seem to be virtually infinite, and you can see why scarcity is a problem.

If you still do not believe that scarcity is a problem, consider the following: Does everyone need food to eat? Does everyone need a decent place to live? Does everyone have access to healthcare? In every country in the world, there are people who are hungry, homeless, and in need of healthcare, just to focus on a few critical goods and services. Why is this the case? It is because of scarcity. Let's delve into the concept of scarcity a little deeper, because it is crucial to understanding economics.

9.1.1 The Problem of Scarcity

Think about all the things you consume: food, shelter, clothing, transportation, healthcare, and entertainment. How do you acquire those items? You do not produce them yourself. You buy them. How do you afford the things you buy? You work for a wage. Or if you do not, someone else does on your behalf. Yet most of us never have enough to buy all the things we want. This is because of scarcity. So how do we solve the problem of scarcity?

Every society, at every level, must make choices about how to use its resources. Families must decide whether to spend their money on a new car or a vacation. Towns must choose whether to put more of the budget into police and fire protection or into the school system. Nations must decide whether to devote more funds to national defence or to protecting the environment. In most cases, there just isn't enough money in the budget to do everything. So why do we not each just produce all of the things we consume? The simple answer is most of us do not know how, but that is not the main reason. Think back to pioneer days, when individuals knew how to do many more practical tasks than we do today, from building their homes, to growing crops, to hunting for food, or repairing their equipment. Most of us do not know how to do all—or any—of those things. It is not because we could not learn. Rather, we do not have to.

9.1.2 The Division of and Specialization of Labor

The formal study of economics began when Adam Smith (1723–1790) published his famous book *The Wealth of Nations* in 1776. Many authors had written on economics in the centuries before Smith, but he was the first to address the subject in a comprehensive way. In the first chapter, Smith introduces the **division of labor**, which means that the way a good or service is produced is divided into a number of tasks that are performed by different workers, instead of all the tasks being done by the same person.

To illustrate the division of labor, Smith counted how many tasks went into making a pin: drawing out a piece of wire, cutting it to the right length, straightening it, putting a head on one end and a point on the other, and packaging pins for sale, to name just a few. Smith counted 18 distinct tasks that were often done by different people—all for a pin!

Modern businesses divide tasks as well. Even a relatively simple business like a restaurant divides up the task of serving meals into a range of jobs like top chef, sous chefs, kitchen help, servers to wait on the tables, a greeter at the door, janitors to clean up, and a business manager to handle paychecks and bills—not to mention the economic connections a restaurant has with suppliers of food, furniture, kitchen equipment, and the building where it is located. A complex business like a large manufacturing factory, such as the shoe factory shown in Figure 3 can have hundreds of job classifications.

9.1.3 Why the Division of Labor Increases Production

When the tasks involved with producing a good or service are divided and subdivided, workers and businesses can produce a greater quantity of output. In his observations of pin factories, Smith observed that one worker alone might make 20 pins in a day, but that a small business of 10 workers (some of whom would need to do two or three of the 18 tasks involved with pin-making), could make 48,000 pins in a day. How can a group of workers, each specializing in certain tasks, produce so much more than the same number of workers who try to produce the entire good or service by themselves? Smith offered three reasons.

First, **specialization** in a particular small job allows workers to focus on the parts of the production process where they have an advantage. (In later topics, we will develop this idea by discussing **comparative advantage**.) People have different skills, talents, and interests, so they will be better at some jobs than at others. The particular advantages may be based on educational choices, which are in turn shaped by interests and talents. Only those with medical degrees qualify to become doctors, for instance. For some goods, specialization will be affected by geography—it is easier to be a wheat farmer in Saskatchewan than in British Columbia, but easier to run a tourist hotel in BC than in Saskatchewan. If you live in or near a big city, it is easier to attract enough customers to operate a successful dry cleaning business or movie theater than if you live in a sparsely populated rural area. Whatever the reason, if people specialize in the production of what they do best, they will be more productive than if they produce a combination of things, some of which they are good at and some of which they are not.

Second, workers who specialize in certain tasks often learn to produce more quickly and with higher quality. This pattern holds true for many workers, including assembly line laborers who build cars, stylists who cut hair, and doctors who perform heart surgery. In fact, specialized workers often know their jobs well enough to suggest innovative ways to do their work faster and better.

Third, specialization allows businesses to take advantage of **economies of scale**, which means that for many goods, as the level of production increases, the average cost of producing each individual unit declines. For example, if a factory produces only 100 cars per year, each car will be quite expensive to make on average. However, if a factory produces 50,000 cars each year, then it can set up an assembly line with huge machines and workers performing specialized tasks, and the average cost of production per car will be lower. The ultimate result of workers who can focus on their preferences and talents, learn to do their specialized jobs better, and work in larger organizations is that society as a whole can produce and consume far more than if each person tried to produce all of their own goods and services. The division and specialization of labor has been a force against the problem of scarcity.

9.1.4 Trade and Markets

However, specialization only makes sense if workers can use the pay they receive for doing their jobs to purchase the other goods and services that they need. In short, specialization requires trade.

You do not have to know anything about electronics or sound systems to play music—you just buy a phone, download the music and listen. You do not have to know anything about artificial fibers or the construction of sewing machines to wear a jacket—you just buy the jacket and wear it. You do not need to know anything about internal combustion engines to operate a car—you just get in and drive. Instead of trying to acquire all the knowledge and skills involved in producing all of the goods and services that you wish to consume, the market allows you to learn a specialized set of skills and then use the pay you receive to buy the goods and services you need or want. This is how our modern society has evolved into a strong economy.

9.1.5 Why Study Economics?

Now that we have an overview of what economics studies, let's quickly discuss why you are right to study it. Economics is not primarily a collection of facts to be memorized, though there are plenty of important concepts to be learned. Instead, economics is better thought of as a collection of questions to be answered or puzzles to be worked out. Most important, economics provides the tools to work out those puzzles. If you have yet to be been bitten by the economics "bug," here are some other reasons why you should study economics:

Virtually every major problem facing the world today, from global warming, to world poverty, to the conflicts in Syria, Afghanistan, and Somalia, has an economic dimension. If you are going to be part of solving those problems, you need to be able to understand them. Economics is crucial.

It is hard to overstate the importance of economics to good citizenship. You need to be able to vote intelligently on budgets, regulations, and laws in general.

A basic understanding of economics makes you a well-rounded thinker. When you read articles about economic issues, you will understand and be able to evaluate the writer's argument. When you hear classmates, co-workers, or political candidates talking about economics, you will be able to distinguish between common sense and nonsense. You will find new ways of thinking about current events and about personal and business decisions, as well as current events and politics.

The study of economics does not dictate the answers, but it can illuminate the different choices.

SELF CHECK 9.1

1. In your opinion, how does knowledge in economics improve your business? Post your thoughts in Nilai Uni Connect.

9.2 MICROECONOMIC

Microeconomics is the social science that studies the implications of incentives and decisions, specifically how those affect the utilization and distribution of resources. Microeconomics shows how and why different goods have different values, how individuals and businesses conduct and benefit from efficient production and exchange, and how individuals best coordinate and cooperate with one another. Generally speaking, microeconomics provides a more complete and detailed understanding than macroeconomics.

Microeconomics is the study of what is likely to happen (tendencies) when individuals make choices in response to changes in incentives, prices, resources, and/or methods of production. Individual actors are often grouped into microeconomic subgroups, such as buyers, sellers, and business owners. These groups create the supply and demand for resources, using money and interest rates as a pricing mechanism for coordination.

Microeconomics can be applied in a positive or normative sense. Positive microeconomics describes economic behavior and explains what to expect if certain conditions change. If a manufacturer raises the prices of cars, positive microeconomics says consumers will tend to buy fewer than before. If a major copper mine collapses in South America, the price of copper will tend to increase, because supply is restricted. Positive microeconomics could help an investor see why Apple Inc. stock prices might fall if consumers buy fewer iPhones. Microeconomics could also explain why a higher minimum wage might force The Wendy's Company to hire fewer workers.

These explanations, conclusions, and predictions of positive microeconomics can then also be applied normatively to prescribe what people, businesses, and governments should do in order to

attain the most valuable or beneficial patterns of production, exchange, and consumption among market participants. This extension of the implications of microeconomics from what is to what ought to be or what people ought to do also requires at least the implicit application of some sort of ethical or moral theory or principles, which usually means some form of utilitarianism.

9.2.1 Method of Microeconomics

Microeconomic study historically has been performed according to general equilibrium theory, developed by Léon Walras in Elements of Pure Economics (1874) and partial equilibrium theory, introduced by Alfred Marshall in Principles of Economics (1890).

The Marshallian and Walrasian methods fall under the larger umbrella of neoclassical microeconomics. Neoclassical economics focuses on how consumers and producers make rational choices to maximize their economic well being, subject to the constraints of how much income and resources they have available. Neoclassical economists make simplifying assumptions about markets—such as perfect knowledge, infinite numbers of buyers and sellers, homogeneous goods, or static variable relationships—in order to construct mathematical models of economic behavior.

These methods attempt to represent human behavior in functional mathematical language, which allows economists to develop mathematically testable models of individual markets. Neoclassicals believe in constructing measurable hypotheses about economic events, then using empirical evidence to see which hypotheses work best. In this way, they follow in the "logical positivism" or "logical empiricism" branch of philosophy. Microeconomics applies a range of research methods, depending on the question being studied and the behaviors involved.

9.2.2 Basic Concepts of Microeconomics

The study of microeconomics involves several key concepts, including (but not limited to):

BASIC CONCEPTS OF MICROECONOMICS	
Incentives and behaviors	How people, as individuals or in firms, react to the situations with which they are confronted.
Utility theory	Consumers will choose to purchase and consume a combination of goods that will maximize their happiness or "utility," subject to the constraint of how much income they have available to spend.
Production theory	This is the study of production—or the process of converting inputs into outputs. Producers seek to choose the combination of inputs and methods of combining them that will minimize cost in order to maximize their profits.
Price theory	Utility and production theory interact to produce the theory of supply and demand, which determine prices in a competitive market. In a perfectly competitive market, it concludes that the price demanded by consumers is the same supplied by producers. That results in economic equilibrium.

SELF CHECK 9.2

Does your company respond to changes in microeconomics?.

9.3 MACROECONOMICS

Macroeconomics refers to the study of the overall performance of the economy. While microeconomics studies how individual people make decisions, macroeconomics deals with the overall aggregate effect of microeconomics. Macroeconomics is crucial for the government to understand and predict the long-term consequences of their decisions.

Goals of Macroeconomics

The overarching goals of macroeconomics are to maximize the standard of living and achieve stable economic growth. The goals are supported by objectives such as minimizing unemployment, increasing productivity, controlling inflation, and more. The macroeconomy of a country is affected by many forces, and as such, economic indicators are invaluable to assessing different aspects of performance.

9.3.1 Economic Indicators

1. **Gross Domestic Product (GDP)**

Often used as the primary indicator of macroeconomics, absolute GDP represents the economy's size at a point in time. GDP is usually calculated and released by the government on a quarterly or annual basis.

GROSS DOMESTIC PRODUCT (GDP) CALCULATION
GDP = Consumptions + Investments + Government Expenditure + (Exports – Imports)

As a rule of thumb, spending stimulates growth. Individual consumer consumption drives businesses, business investments promote growth, and government spending maintains

social welfare. Net exports, as calculated by (exports – imports), measures trade. Positive net exports represent a trade surplus, while negative net exports represent a trade deficit.

Economic growth can be calculated by comparing GDP over time, such as year-over-year increases.

2. Inflation

Inflation is the increase of overall price levels and consequently the decrease in purchasing power. It occurs primarily due to increased demand for products and services, which, in turn, raises prices. Inflation, therefore, represents growth.

However, too much inflation is also harmful if purchasing power decreases much more than inflated prices, decreasing overall spending and devaluing the currency. The target inflation rate is usually around 1% to 3%.

3. Unemployment

Unemployment accounts for individuals who are jobless and are actively seeking one. Individuals who are retired or disabled are not included as unemployed. Unemployment is a natural occurrence and cannot be completely eliminated. We can distinguish unemployment into different categories:

UNEMPLOYMENT CALCULATION
Natural Unemployment = Frictional + Structural Actual Unemployment = Frictional + Structural + Cyclical **Note:** Frictional unemployment occurs when individuals spend time searching for a job. Structural unemployment occurs when jobs are eliminated due to economic structural changes. Cyclical unemployment occurs due to fluctuations in the business cycle.

The sum of frictional and structural is called natural unemployment. It arises from everyday events, such as individuals changing jobs or industries shrinking from a decline in demand.

The sum of natural unemployment and cyclical unemployment represents the actual unemployment. Naturally, in recessions, employees are laid off, and in times of prosperity, employment rates skyrocket.

Since employment is directly related to economic output, it is a good indicator of economic conditions. Actual unemployment is useful to gauge the economy's short-term conditions, while natural unemployment can identify trends in the long term.

4. Interest Rates

Interest rates are the return the borrower pays from lending. They are set by the central bank – the Federal Reserve in the U.S. and the Bank of Canada in Canada. Because interest rates influence consumer decisions, it is a very useful tool for influencing economic activity.

When interest rates are high, borrowing becomes more expensive, so consumers are incentivized to reduce spending. Conversely, when interest rates are low, it is cheaper to borrow, so consumers will be incentivized to spend more.

9.3.2 How Does the Government Influence the Macroeconomy?

Monetary Policy

Implemented by central banks, monetary policy is an action that influences money supply and interest rates. The central bank can set interest rate targets for direct results. Money supply also affects the interest rate, with increased supply usually lowering interest rates (negative correlation). As previously mentioned, interest rates influence consumer consumption and investment. There are two types of monetary policy:

TWO TYPES OF MONETARY POLICY	
1. Expansionary Monetary Policy	In times of economic slump, the government can encourage economic growth by implementing an expansionary monetary policy. They purchase securities from the open market and ease

	reserve requirements to increase the money supply, and on the other hand, lowering the interest rate target.
2. Contractionary Monetary Policy	In economic booms, high inflation rates in the long term can spell trouble by reducing purchasing power. To cool down inflation, the government can decrease the money supply and increase interest rates by selling securities on the open market, tightening reserve requirements, and increasing the interest rate target.

Fiscal Policy

The government implements fiscal policy through spending and taxes to guide the macroeconomy. Government spending influences job creation and infrastructure improvements, which, in turn, affects money in circulation. Taxes affect consumer disposable income. Fiscal policy is also segmented into two types:

TWO TYPES OF FISCAL POLICY	
1. Expansionary Fiscal Policy	To increase inflation, governments increase spending to increase money in circulation or cut taxes, so consumers have more money to spend.
2. Contractionary Fiscal Policy	To ease inflation, governments decrease spending to reduce money in circulation or increase taxes. As a result, money available for consumers to spend becomes less.

Points to Ponder/Takeaways

- Economics is the study of how humans make decisions in the face of scarcity..
- Microeconomics deals with prices and production in single markets and the interaction between different markets but leaves the study of economy-wide aggregates to macroeconomics.
- Microeconomists formulate various types of models based on logic and observed human behavior and test the models against real-world observations.
- Macroeconomics refers to the study of the aggregate economy.
- The primary goals of macroeconomics are to achieve stable economic growth and maximize the standard of living.
- Economic indicators are a good source of information to track macroeconomic performance.

- Monetary policy and fiscal policy are tools used by the government to control economic performance and reach macroeconomic goals.

References

1. https://pressbooks.bccampus.ca/uvicecon103/chapter/1-1-what-is-economics-and-why-is-it-important/
2. https://www.investopedia.com/terms/m/microeconomics.asp
3. https://corporatefinanceinstitute.com/resources/economics/macroeconomics/