Managerial Economics

By: Divya Chawla

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Published by:

NEERAJ PUBLICATIONS

(Publishers of Educational Books)

Sales Office : 1507, 1st Floor,
Nai Sarak, Delhi-110 006
E-mail: info@neerajbooks.com
Website: www.neerajbooks.com

Typesetting by: Competent Computers

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1

INTRODUCTION

Since economics has two primary classifications namely macroeconomics and microeconomics. The basic difference between the both is that macroeconomics is considered as the study of the whole economy, which caters to areas like Gross National Product, Inflation, Unemployment, Exports, Imports, Tax Policies, etc. On the other hand, microeconomics deals with the individual factors in the economy that is firms and individuals.

It is vital to understand that macroeconomics also provides answers to questions pertaining to any changes in investments, employment, prices, exchange rate of the rupee, etc, as these affect the economy at large. Microeconomic data on the other hand forms a part of the data for macroeconomic study of variables. Since only aggregate data of the above mentioned variables is considered, however, the aggregate also includes the data for changes in output of a number of individual firms, plus the consumer's consumption levels and their choice based on any change in the prices of the particular goods and services.

It is on the basis of the importance that the macroeconomics and microeconomics issues command that one gets the attention in media and newspapers while the latter is taken care of in the day-to-day handlings of the manager.

It is said that in order to take appropriate managerial decisions it is important to have an analytical perspective blended with rational decision making skills. These can be enhanced with the understanding of the applications of Managerial Economics.

Managerial Economics falls under the microeconomics section, which caters to a wide variety of topics that may range from risk, demand, supply to the understanding of the cost and market structure. Thus, in layman's language it can be said that market is a place where individuals and various products come in contact with each other and the prices of the products are determined. Therefore it is important to keep the profit maximization quotient for the firm producing the products in mind. The entity, which makes available the factors of production in the form of produced goods and services, is termed as a firm.

The main aim of economics is to have the appropriate allocation of resources, so that they can be utilized to their maximum capacity. It is with the help of economics that managers are able to take the optimizing decisions keeping in mind the alternatives available vis-à-vis the best option for the resources.

The firms operate in the market whereby the forces of demand and supply, inflation, government policies affect it. Thus, it is with the help of managerial economics that the firm is able to react to such changes in the economic environment and predict and devise the best possible alternative, so that their objectives are also met.

CHAPTER AT A GLANCE

As mentioned in the introduction, Managerial Economics is a part of microeconomics. Thus, it deals with the micro aspects of the economy. The main aim of Managerial Economics through microeconomics usage is to focus on the interaction of firms and individuals in the market. It can also be said that managerial Economics has emerged due to a close interrelationship between management and economics.

This chapter provides for a basic introduction to Managerial Economics, also mentioning its importance in the current economic phase. Since economics being a vast subject it provides a platform to various parts of it to be dealt as specific subjects, these may include industry, public finance, international trade, etc. Managerial Economics is one such part of economics. Thereby, it provides for place where, the various desires of individuals co-ordinate with each other for them to be fulfilled. This can further be studied in the form of allocation of scarce resources in order to satisfy the wants and desires of individuals.

It is in the market that the firms make available the various products that can fulfill the desire of the individuals. It is not necessary for the market to be a physical one; it refers to any place where exchange is involved. It is in the market that the firms operate and they tend to improve on their profitability with the help of Managerial Economics principles. Since there is no restriction on the number of firms that may enter the market, thus the mere individual is flooded with choice in order to fulfill their desire.

Since the main of the individual is the fulfilment of his wants and desires, on the hand the firm's aim is to provide goods and services for the fulfilment. It is a known fact that human wants are unlimited and insatiable while at the other end; the economic resources available to satisfy the same are limited. This gives rise to the fundamental issue of scarcity of resources.

Thus, it is important for the firm to have a clear idea about what it wants to produce, the manner of production, i.e. how to produce and the third vital point the category for which such production has to be undertaken. It is on the basis of answers to the above questions of "what, how and whom" that an effective strategy can be developed so that resources can be utilized to their maximum capacity.

In order to answer the above questions, the firms are faced with three options namely, using the market mechanism; secondly, entirely by the government; the third option is the one most commonly used by the firm, i.e. using the combination of the above. Therefore it needs to be kept in mind that the resources need to be allocated effectively. Efficiency is maintained by making anybody better off without making somebody else worse-off.

It is important to understand the scope and importance that Managerial Economics carries to the firms. It helps them in solving the choice and allocation of scarce resources issues. It helps the firm to identify the activities to which the scarce resources need to be allocated for its proper functioning. The scope of Managerial Economics is not limited to just allocation of resources, it also provides a platform for rational decision-making and forward planning concepts in the managerial decisions. The managers are responsible for appropriate resource allocation, inventory, price and investment issues, which can be taken care of with the help of Managerial Economics concepts.

The aim of the economic activity is to strike a balance between ends and means due to the scarcity of resources. It can be said that the center of economic activity is decision making by management, as it involves making a choice among the various alternative courses of action. Thus, the best economic choices, keeping in mind the objectives and obstacles are the outcome of best decision-making skills. The various tools that come handy to the management for taking rational decisions may include micro-macro, partial-general equilibrium, and positive-normative analysis. Therefore, it can be said that Managerial Economics acts as a link between traditional economics and the decision-making sciences for the business firms.

As it is with the help of Managerial Economics tools that firms tend to improve their profitability. In other words, it is the application of economic theory blended with the analysis of decisions that the firms can know the path for achieving their objectives in an effective manner.

Managerial Economics also have a bearing on other fields of study as well. Since it is considered a microeconomics thus its direct relation is created with Microeconomic Theory. As mentioned in the introduction that microeconomics forms a part of macroeconomics thus, it can be linked with Macroeconomic Theory as well. Likewise, its association can be found with operations research, theory of decision-making, statistics, accounting as well.

Therefore, it can be said that Managerial decisions are evaluated through various concepts, tools and techniques of economic analysis.

CHECK YOUR PROGRESS

Q. 1. Development of Managerial Economics is the result of close interrelationship between management and economics. Discuss.

Ans. As according to McNair and Meriam, "Managerial Economics is the use of economic modes of thought to analyze business situations." Based on this definition of Managerial Economics, the relationship between economics and management may be justified. The management provides the guidance, leadership as well as the way to appropriately channelize the efforts of a group of individuals towards the attainment of some common objective. While economics, provides for analyzing and providing solution to the big question of scarcity of resources.

According to Koontz and O'Donell, "Management is the creation and maintenance of an internal environment in an enterprise where individuals, working together in groups, can perform efficiently and effectively towards the attainment of group goals." Therefore, management is co-ordination, an ongoing activity, a purposive process and the manner of getting work done through others.

While economics provides for answers to the basic questions such as what should the firm produce, the production process, i.e. how to produce and the third, for whom to produce. It is in these answers that relationship between management and economics lies. As the firm wants to produce so that it delivers goods and services to the individuals and thereby attain objective and also derive some profits as well. For which certain factors of production in the form of material, machine, labour etc, need to be deployed. And it is also a known fact that such resources are scarce in nature, as compared to the unlimited and insatiable human wants. Thus here economics comes as a savior as provides for the concepts and tools to determine the best possible alternative for the factors of production.

Q. 2. Which statement is true of the basic economic problem?

- ***(a)*** **The problem will exist as long as resources are limited and desires are unlimited.**
- ***(b)*** **The problem exists only in less developed countries.**
- ***(c)*** **The problem will disappear as production expands.**
- ***(d)*** **The advancement of technology will cause the problem to disappear.**

Ans. *(a)* The problem will exist as long as resources are limited and desires are unlimited.

As the 3 choice problems faced by an economy are:

(a) What to produce?
(b) How to produce?
(c) For whom to produce?

These problems arise due to the scarcity of resources. Managerial economics caters to the fundamental question of scarcity of resources by providing the organization with appropriate analysis of the various activities undertaken by the organization vis-à-vis the best possible alternative for the effective utilization of the factors of production.

As the scarcity of resources results from the following issues, namely:

- *(a)* Human wants being unlimited and insatiable.
- *(b)* Limited economic resources available to satisfy the wants and desires.

The effective and efficient use of the available resources is thus very important, that is the resources need to be utilized to their maximum capacity so that the profits are enhanced and maximum returns are available to the organization as a whole. The purpose of this ongoing process is to maximize the returns and thereby the profits.

Q. 3. Why is decision making by any management truly economic in nature?

Ans. Mostly managerial decisions are economic in nature as the firms' management is faced with the "problems of choice" in simple words various alternatives. And it is the management's responsibility to see that the resources are allocated appropriately as they are scarce in nature. As the firms operate in the market and are responsible for providing goods and services to the individuals, they are also affected by the economic environment they function in. Therefore, managerial economic provides for the study of allocation of resources available with firm vis-à-vis its activities, keeping in mind the best possible alternative available to the firm.

The management is therefore responsible for taking rational decisions and future planning with regards to the economic concepts and problem analysis. As it needs to ensure that scarce resources are utilized to the utmost efficiency and that best results are achieved. The resource allocation decision may include taking decisions pertaining to production and transportation process.

The mangers are also faced with inventory issues, which involve taking decisions pertaining to holding the appropriate levels of stock of raw materials and finished goods for a period of time. For which it is important to understand the demand and supply conditions in the market.

The decision-making process also involves an important decision relating to fixing the prices of the products. For which various methods may be adopted keeping in mind that the price is neither too high nor too low. As, if the price is high, it will be out of reach for various individuals and if the price is too low then people may tend to have second thoughts about its quality. As the firms operate for profits thus accurate price decisions play a vital role in the growth of the organization as a whole.

The managers are also faced with taking decisions regarding future planning. It relates to taking various investment decisions.

Therefore, any management decision has a bearing either direct or indirect on the economic standing of the organization and vice-versa, any change in the economic environment, like changes in the government policies etc. have a bearing on the organizations business as well.

Q. 4. Enlist the major groups of problems in decision-making.

Ans. The major groups of problems faced in the decision-making process may be listed as follows:

(a) Resource Allocation

(b) Inventory and queuing problem

(c) Pricing problem

(d) Investment problem

Resource Allocation: Since the resources are scarce in nature as compared to the unlimited wants and desires of individuals, which makes it important for the resources to be properly allocated so that the best results are achieved from the same. This problem also caters to the questions pertaining to planning the production process and the problem of transporting the necessary factors of production to the particular activity. Therefore it is the manager's responsibility to decide the appropriate areas for resource allocation keeping in mind the achievement of the organizational objectives.

Inventory and Queuing Problem: The mangers are also faced with inventory issues, which involve taking decisions pertaining to holding the appropriate levels of stock of raw materials and finished goods for a period of time. For which it is important to understand the demand and supply conditions in the market. Queuing problems relate to the decisions regarding the installation of additional machines or hiring extra labour.

Pricing problem: The decision making process also involves an important decision relating to fixing the prices of the products. For which various methods may be adopted keeping in mind that the price is neither too high nor too low for example, demand elasticity study. As, if the price is high, it will be out of reach for various individuals and if the price is too low then people may tend to have second thoughts about its quality. As the firms operate for profits thus accurate price decisions play a vital role in the growth of the organization as a whole.

Investment problem: The managers are also faced with taking decisions regarding future planning. It relates to taking various investment decisions. For example, investing in new plants, how much to invest, sources of funds, etc.

Q. 5. Mention the 3 choice problems of an economy. And also explain why these problems arise.

Ans. The 3 choice problems of an economy are:

(a) What to produce?

(b) How to produce?

(c) For whom to produce?

The problems arise due to the scarcity of resources.

In order to solve the above questions the firms are provided with three choices, with the first being depending on the market mechanism, the second one is being totally dependent on the government. However, the third option is the most commonly used option in today's world where firms make their decisions based on the combination of both the market mechanism and the prevailing government policies. For example, more institutes will start providing for MBA courses and more students with opt for the same