

The nature of managerial economics economics essay

[Profession](#), [Manager](#)



Managerial Economics is the intergration of/ bridges the gap between economic theory with/& business practice so as to facilitate decision making”
Comment/ outline the nature and scope of Managerial Economics in light of this statement.

Spencer and Siegelman have defined Managerial Economics as “ the integration of economic theory with business practice for the purpose of facilitating decision-making and forward planning by management.”

The above definitions suggest that Managerial economics is the discipline, which deals with the application of economic theory to business management. Managerial Economics thus lies on the margin between economics and business management and serves as the bridge between the two disciplines. The following Figure 1. 1 shows the relationship between economics, business management and managerial economics.

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NATURE OF MANAGERIAL ECONOMICS

There are certain chief characteristics of managerial economics, which can help to understand the nature of the subject matter and help in a clear understanding of the following terms:

Managerial economics is micro-economic in character. This is because the unit of study is a firm and its problems. Managerial economics does not deal with the entire economy as a unit of study.

Managerial economics largely uses that body of economic concepts and principles, which is known as Theory of the Firm or Economics of the Firm. Managerial economics is concrete and realistic. It avoids difficult abstract issues of economic theory. But it also involves complications ignored in economic theory in order to face the overall situation in which decisions are made. Economic theory ignores the variety of backgrounds and training found in individual firms.

Managerial economics belongs to normative economics rather than positive economics. Normative economy is the branch of economics in which judgments about the desirability of various policies are made. Positive economics describes how the economy behaves and predicts how it might change. In other words, managerial economics is prescriptive rather than descriptive. It remains confined to descriptive hypothesis.

Managerial economics also simplifies the relations among different variables without judging what is desirable or undesirable. For instance, the law of demand states that as price increases, demand goes down or vice-versa but this statement does not imply if the result is desirable or not. Managerial economics, however, is concerned with what decisions ought to be made and hence involves value judgments. This further has two aspects: first, it tells what aims and objectives a firm should pursue; and secondly, how best to achieve these aims in particular situations.

Macroeconomics is also useful to managerial economics since it provides an intelligent understanding of the business environment. This understanding

enables a business executive to adjust with the external forces that are beyond the management's control but which play a crucial role in the well being of the firm.

SCOPE OF MANAGERIAL ECONOMICS

As regards the scope of managerial economics, there is no general uniform pattern. However, the following aspects may be said to be inclusive under managerial economics:

Demand analysis and forecasting.

Cost and production analysis.

Pricing decisions, policies and practices.

Profit management.

Capital management.

Demand Analysis and Forecasting

A business firm is an economic Organisation, which transforms productive resources into goods that are to be sold in a market. A major part of managerial decision-making depends on accurate estimates of demand. This is because before production schedules can be prepared and resources are employed, a forecast of future sales is essential. This forecast can also guide the management in maintaining or strengthening the market position and enlarging profits. The demand analysis helps to identify the various factors influencing demand for a firm's product and thus provides guidelines to

manipulate demand. Demand analysis and forecasting, thus, is essential for business planning and occupies a strategic place in managerial economics. It comprises of discovering the forces determining sales and their measurement

Demand determinants

Demand distinctions

Demand forecasting.

Cost and Production Analysis

A study of economic costs, combined with the data drawn from the firm's accounting records, can yield significant cost estimates. These estimates are useful for management decisions. The factors causing variations in costs must be recognised and thereby should be used for taking management decisions. This facilitates the management to arrive at cost estimates, which are significant for planning purposes. An element of cost uncertainty exists in this because all the factors determining costs are not always known or controllable. Therefore, it is essential to discover economic costs and measure them for effective profit planning, cost control and sound pricing practices. Production analysis is narrower in scope than cost analysis. The chief topics covered under cost and production analysis are:

Cost concepts and classifications

Cost-output relationships

Economics of scale

Production functions

Cost control.

Pricing Decisions, Policies and Practices

Pricing is a very important area of managerial economics. In fact price is the origin of the revenue of a firm. As such the success of a business firm largely depends on the accuracy of price decisions of that firm. The important aspects dealt under area, are as follows:

Price determination in various market forms

Pricing methods

Differential pricing product-line pricing and price forecasting.

Profit Management

Business firms are generally organised with the purpose of making profits. In the long run, profits provide the chief measure of success. In this connection, an important point worth considering is the element of uncertainty existing about profits. This uncertainty occurs because of variations in costs and revenues. These are caused by factors such as internal and external. If knowledge about the future were perfect, profit analysis would have been a very easy task. However, in a world of uncertainty, expectations are not always realised. Thus profit planning and measurement make up the difficult area of managerial economics. The important aspects covered under this area are:

Nature and measurement of profit.

Profit policies and techniques of profit planning.

Capital Management

Among the various types and classes of business problems, the most complex and troublesome for the business manager are those relating to the firm's capital investments. Capital management implies planning and control and capital expenditure. In this procedure, relatively large sums are involved and the problems are so complex that their disposal not only requires considerable time and labour but also top-level decisions. The main elements dealt with cost management are:

Cost of capital

Rate of return and selection of projects.

The various aspects outlined above represent the major uncertainties, which a business firm has to consider viz., demand uncertainty, cost uncertainty, price uncertainty, profit uncertainty and capital uncertainty. We can, therefore, conclude that managerial economics is mainly concerned with applying economic principles and concepts to adjust with the various uncertainties faced by a business firm.

Managerial Economics serves as ' a link between traditional economics and the decision making sciences' for business decision making.

The best way to get acquainted with managerial economics and decision making is to come face to face with real world decision problems.

Managerial economics is used by firms to improve their profitability. It is the economics applied to problems of choices and allocation of scarce resources by the firms. It refers to the application of economic theory and the tools of analysis of decision science to examine how an organisation can achieve its objective most efficiently.

Ques No 2.

Discuss the role of Managerial Economist in a Business Organization.

A managerial economist helps the management by using his analytical skills and highly developed techniques in solving complex issues of successful decision-making and future advanced planning.

The role of managerial economist can be summarized as follows:

He studies the economic patterns at macro-level and analysis it's significance to the specific firm he is working in.

He has to consistently examine the probabilities of transforming an ever-changing economic environment into profitable business avenues.

He assists the business planning process of a firm.

He also carries cost-benefit analysis.

He assists the management in the decisions pertaining to internal functioning of a firm such as changes in price, investment plans, type of goods /services to be produced, inputs to be used, techniques of production to be employed, expansion/ contraction of firm, allocation of capital, location of new plants, quantity of output to be produced, replacement of plant equipment, sales forecasting, inventory forecasting, etc.

In addition, a managerial economist has to analyze changes in macro-economic indicators such as national income, population, business cycles, and their possible effect on the firm's functioning.

He is also involved in advising the management on public relations, foreign exchange, and trade. He guides the firm on the likely impact of changes in monetary and fiscal policy on the firm's functioning.

He also makes an economic analysis of the firms in competition. He has to collect economic data and examine all crucial information about the environment in which the firm operates.

The most significant function of a managerial economist is to conduct a detailed research on industrial market.

In order to perform all these roles, a managerial economist has to conduct an elaborate statistical analysis.

He must be vigilant and must have ability to cope up with the pressures.

He also provides management with economic information such as tax rates, competitor's price and product, etc. They give their valuable advice to government authorities as well.

At times, a managerial economist has to prepare speeches for top management.

Ques No 3.

Critically explain the role of the concept of Time value of Money in Mangerial decisions?

The time value concept of money assumes importance because of the fact that future is always associated with uncertainty. A rupee in hand today is valued higher than the one rupee that is expecting to be recovered tomorrow. The following are points that come in support of the fact that the concept of time value of money is quite relevant in any area of decision making :

(a) The purchasing power of money over period of tinw goes down in real times. That means, though numerically the same, the purchasing power of one rupee today is considered to be high economically than its value as on a future date.

(b) Individuals prefer present consumption to future consuiilption. This is because of the risk a n d uncertainty associated with future.

(c) There is always related costs in any investment. These costs tend to bring down future value of money.

The concept of time value of money figures in many day-to-day decisions. For example, in the vital decision making areas in the management like the effective rate of interest on a business loan. The mortgage payment in real estate transaction and evaluation of true Return on investment etc. the time value of money plays an important role. Wherever use of money is involved and its inflow and outflow patterns are spread over a time horizon, this concept very useful. For example consider the following:

- * A banker must establish the term of loan
- * A finance manager is who considers various alternative sources of funds in terms of cost.
- * A portfolio manager is one who evaluates various securities

Ques No 4

Compare the Cardinal & Ordinal Approaches to Consumer Behaviour. Which of these enables us to bifurcate the price effect and how?

Cardinal Approach refers that you can calculate or Measure the utility (degree of satisfaction) Numerically, while According to ordinal approach you can not measure the utility numerically.

Cardinal Approach follow the Law of Diminishing Marginal Utility while Ordinal Approach follow the Indifference Curve.

Cardinal Approach Emphasis on units while ordinal approach is based on rank.

When discussing cardinal vs. ordinal, it is helpful to look at what the words mean. The distinguishing factor here is between cardinal and ordinal numbers. Cardinal numbers are 1, 2, 3; ordinal numbers, 1st, 2nd, 3rd. Some crucial differences follow from that. Whereas mathematical operations can be performed on cardinal numbers, they cannot be performed on ordinal numbers. Now, when talking about cardinal utility, it is an attempt to "measure the utility of various alternatives. When talking about ordinal utility, it is the "ranking of alternatives.""

Cardinal utility is, however, an erroneous concept. It is impossible to "measure" utility. People can only say "I prefer A to B", but cannot meaningfully say "I prefer A 2.5 times more than B" or something to that effect. Furthermore, comparisons of utility between different individuals are impossible and meaningless, as well as between the same individual at different points in time (as individuals can and do change their preferences — that is, ordinal value-scale rankings). Because value is subjective, we cannot measure it and cannot compare between two different people, or even between the same person at different times.

To clarify, ordinal utility culminates in value-scales:

1st: A

2nd: B

3rd: C

whereas cardinal utility is the erroneous attempt at measurement:

10utils — A

7utils — B

3utils — C

Ques No 5.

“ Managerial Economics is inter- disciplinary in nature” Comment/ Explain the relationship of ME with other disciplines.

Managerial economics is essentially applied economics in the field of business management.

-It is the economics of business.

-It pertains to all economics aspects of managerial decisions making.

-It is the integration of economic principles with business management practices.

-Managerial economics rests on the edifice of economics.

-A fundamental knowledge of economics and economic theory is needed for a meaningful analysis of business situation

Managerial economics is linked with various other fields of study like-

Microeconomic Theory: As stated in the introduction, the roots of managerial economics spring from micro-economic theory. Price theory, demand concepts and

theories of market structure are few elements of micro economics used by managerial economists. It has an applied bias as it applies economic theories in order to solve real world problems of enterprises.

Macroeconomic Theory: This field has little relevance for managerial economics

but at least one part of it is incorporated in managerial economics i. e. national

income forecasting. The latter could be an important aid to business condition

analysis, which in turn could be a valuable input for forecasting the demand for

specific product groups.

Operations Research: This field is used in managerial economics to find out the

best of all possibilities. Linear programming is a great aid in decision making in

business and industry as it can help in solving problems like determination of facilities on machine scheduling, distribution of commodities and optimum product mix etc.

Theory of Decision Making: Decision theory has been developed to deal with problems of choice or decision making under uncertainty, where the applicability of

figures required for the utility calculus are not available. Economic theory is based on

assumptions of a single goal whereas decision theory breaks new grounds by recognizing multiplicity of goals and persuasiveness of uncertainty in the real world

of management.

Statistics: Statistics helps in empirical testing of theory. With its help, better decisions relating to demand and cost functions, production, sales or distribution are

taken. Managerial economics is heavily dependent on statistical methods.

Management Theory and Accounting: Maximisation of profit has been regarded as a central concept in the theory of the firm in microeconomics.

Ques No 6.

Discuss the properties of Indifference Curves. Discuss their role in consumer's decision making process?

Indifference Curves

Each point in the diagram stands for a basket of meat and ghee (cooking oil) A, B, C, D are all baskets among which a certain consumer is indifferent. All give equal utility. These points and all others on a smooth curve connecting them constitute an indifference set. An indifference curve is a graphical representation of an indifferent set.

Indifference Curve Properties

Following are the indifference curve properties:

1. If two commodities are perfect substitute the indifference curve is a straight line.

<http://www.studylecturenotes.com/images/stories/Indifference%20Curve%20Properties%20Fig%201.jpg>

When two commodities are not substitutable then the shape is represented by two vertical and horizontal lines.

<http://www.studylecturenotes.com/images/stories/Indifference%20Curve%20Properties%20Fig%202.jpg>

In more typical cases, in which the two commodities can be substituted for each other but are not perfect substitutes, the indifference curve will be curved as

<http://www.studylecturenotes.com/images/stories/Indifference%20Curve%20Properties%20Fig%203.jpg>

4. The more easily the two commodities can be substituted for each other the nearer will the curve approach straight line.

5. Indifference curves normally slope downward, the upward sloping portion of curve shown here is impossible. Basket A has more goods than basket B and therefore it could not be on the same indifference curve. The indifference curves have normally negative slopes - sloping downward.

<http://www.studylecturenotes.com/images/stories/Indifference%20Curve%20Properties%20Fig%204.jpg>

6. The absolute value of the slope of an indifference curve at any point represents the ratio of the marginal utility of the good on the horizontal axis to the marginal utility of the good on the vertical axis. The rate at which one good can be substituted for the other without gain or loss in satisfaction is called marginal rate of substitution.

7. Indifference curves are convex, that is, their slope decreases as one moves down and to the right along them. This implies that the ratio of the marginal

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utility of meat to the marginal utility of the ghee (cooking oil) also known as marginal ratio of substitution of meat for ghee (cooking oil) diminishes as one moves down and to the right along the curve.

8. Indifference curves can be drawn through the point that represents the basket of goods whatsoever.

Ques No 7.

Discuss the concept of Production Possibility Curve? What is the reason behind its shape? Do you think there are exceptions to it?

Production Possibility curves

The production possibility curves is a hypothetical representation of the amount of two different goods that can be obtained by shifting resources from the production of one, to the production of the other. The curve is used to describe a society's choice between two different goods. Figure 1, shows the two goods as consumption and investment. Investment goods are goods that are involved in the production of further consumption goods. They include physical capital such as machines, buildings, roads etc. and human investments such as education and training. The sums of all investments make up the capital stock of a society. To show the point where all resources were used to produce consumption goods, one should move straight up the vertical axes to the curve. To show the point where all resources were used to produce investment goods, one should move straight on the horizontal axes to the curve. Both points are extreme and unrealistic. Both points A and B represented more realistic combinations, with point A showing more

consumption and less investment, while point B shows more investment and less consumption.

<http://krypton.mnsu.edu/~renner/image001.JPG>

The production possibility curve of figure 1., shows the trade off in production between investments and consumption goods. Any two categories of different goods could be chosen. What they are is arbitrary. The curve is used to show during a specific period, what could be produced of the combination of the two goods, if all resources are fully employed, while technology and institutions do not change. Given those conditions, societies output potential is realized anywhere on the curve (which is called the production possibility curve's frontier). Unemployed resources (labor, capital, physical resources) of any kind would result in an inefficient production level, and would be shown as a point to the left, or inside the curve. By definition all point to the right or outside of the production possibility curve (frontier) are impossible, given the limits of resources and technology.

Opportunity Cost

This hypothetical curve shows how much of consumption must be given up to increase investments (the movement from A to B). This demonstrates the important economic concept of Opportunity Cost, which is the cost of anything (such as an investment in a new road), in terms of what has to be given up. This is the general concept of cost in economics. For the individual, these costs could be financial, but they could include a individual's time and

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other intangibles. For society the production possibility curve shows opportunity cost only on the curve itself. If society found itself inside the curve, for instance, during a recession (where all resources are not being utilized), then a movement out to the production possibility curve has no real opportunity cost. The unemployed resources are just being utilized (unemployed labor going back to work).

Opportunity cost is different than accounting cost, and unfortunately is not so easily calculated. Opportunity cost has a subjective element. For instance, to determine the opportunity cost of a new highway, includes the obvious cost of materials, of labor, of land, (these are the easily determined accounting cost), but there are also intangible cost, such as the cost to the community of the disruption involved with new construction, and the change in the communities effected by the highway. Also there may be costs connected to increase pollution (with health effects), increased noise, and an increase in general unattractiveness. These cost are real, but are difficult to both measure and evaluate. Putting a dollar value on these cost adds a subjective element to the evaluation. As a result sometimes they are ignored.

Ques No 8.

Graphically explain the Law of Diminishing Marginal utility. Discuss its applicability in the intergrated Global Economy

Law of Diminishing Marginal Utility

The Law of Diminishing Marginal Utility states that as the consumer consumes more and more units of a commodity the marginal utility of the commodity falls.

The law of diminishing marginal utility is a psychological law arrived at by introspection and by empirical evidence.

The example of this law is when a consumer drinks water on a hot afternoon; the first glass of water gives him more satisfaction as compared to the second (as the thirst has decreased after consuming one glass of water). The second glass of water gives more satisfaction as compared to the third and so on.

The Law of Diminishing Marginal Utility, which states that as the consumer consumes more and more units of a commodity the marginal utility of the commodity falls.

If $MU_x \geq \frac{3}{4} MU_y$

$P_x \geq P_y$

it means that good 'x' is giving more satisfaction to the consumer as compared to good 'y'. Therefore the consumer would gain satisfaction by consuming more of good 'x' and less of good 'y'. As he consumes more of good 'x', MU_x will fall which would lead to fall in MU_x/P_x . Similarly MU_y will rise as he consumes less of good 'y'. This would increase MU_y/P_y . This process will continue till we reach the equilibrium point where

$MU_x = MU_y = MU$ of the last rupee spent on each good

$P_x P_y$

Similarly if $MU_x < MU_y$

$P_x P_y$

The consumer would increase the consumption of good ' y' and reduce the consumption of good ' x' till he reaches the equilibrium point where

$MU_x = MU_y = MU$ of the last rupee spent on each good

$P_x P_y$

EXAMPLE OF DIMINISHING MARGINAL UTILITY :-

This law can be explained by the following example. Suppose in the month of June a person start drinking water. First glass of water has a great utility for him. If he takes the second glass of water, the utility will be less than the first. If he drinks the third glass , the utility of third will be less than the second, and so on. The utility goes on diminishing with the consumption of every next unit and it drops down to zero. If the consumer is forced further, the utility will become negative. This law can also be explained by the following table :

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EXPLANATION :- The above table show that first glass of water gives units of utility to the thirsty man. When he takes second the marginal utility drops down to 8. When he consumes the 6th glass the marginal utility drops down to zero and by the use of 7th it becomes negative.

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EXPLANATION :- Along “ OX” we measure the units of commodity consumed along “ OY” utility derived from them. The utility of the first glass of water is represented by the first rectangle and second glass by the second rectangle and so on. FF’ curve is the diminishing utility curve.

ASSUMPTIONS OF DIMINISHING MARGINAL UTILITY

1. NATURE OF THE COMMODITY :- There should be no change in the nature of the commodity. For example, If first mango taken is not better, while the second is better, then the utility will not decrease and the utility of second will be greater than first.

2. REASONABLE UNITS :- It is assumed that the units of a commodity which are used should be suitable and reasonable if the units are too small then this law will not operate.

3. CONTINUOUS USE :- It is also assumed that the units of the commodity should be used continuously. If there is interval between the consumption the same two units then the law will not be applicable.

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4. NO CHANGE IN INCOME :- It is also assumed that the income of the consumer should not change, otherwise the law may not operate.
5. NO CHANGE IN FASHION AND CUSTOMS :- If there is a sudden change in fashion or customs of a consumer, the law may not operate.
6. RARE COLLECTIONS :- If there are two diamonds in the world the possession of the second diamond will push up the marginal utility.
7. NO CHANGE IN THE STOCK OF OTHER PEOPLE :- Sometimes an increase in the stock of a commodity increases the marginal utility. For example the number of telephone increase in the city, but the utility of our telephone increases.
8. STATE OF MIND SHOULD NOT CHANGE :- If a consumer has been told that mango is a tonic for his health, then marginal utility will increase instead of falling.

EXCEPTIONS OR LIMITATIONS

1. DESIRE OF MONEY :- This law is not applicable in case of money with an increase in wealth man wants to get more and more.
2. DESIRE OF KNOWLEDGE :- Some experts say that man wants to get more and more knowledge so the law can not be applied in this case.
3. USE OF LIQUOR :- With the additional use of liquor like wine marginal utility also goes on increasing.

4. PERSONAL HOBBY :- In case of hobby also this law can not operate. For example , as the collection of tickets increases, its utility also increases.

5. FASHION :- Utility also depends upon fashion. If the fashion of any commodity changes, its utility drops down to zero. On the other hand if fashion exists then utility increases.

Ques No 9.

Describe how Marginalism, Opportunity cost & Incremental concept aid Decision Making.

The marginalist explanation is as follows: The total utility or satisfaction of water exceeds that of diamonds. We would all rather do without diamonds than without water. But almost all of us would prefer to win a prize of a diamond rather than an additional bucket of water. To make this last choice, we ask ourselves not whether diamonds or water give more satisfaction in total, but whether one more diamond gives greater additional satisfaction than one more bucket of water. For this marginal utility question, our answer will depend on how much of each we already have. Though the first units of water we consume every month are of enormous value to us, the last units are not. The utility of additional (or marginal) units continues to decrease as we consume more and more.

Economists believe that sensible choice requires comparing marginal utilities and marginal costs. They also think that people apply the marginalism concept regularly, even if subconsciously, in their private decisions. In

southern states, for example, a much lower fraction of people buy snow shovels than in northern states. The reason is that although snow shovels cost about the same from state to state, the marginal benefit of a snow shovel is much higher in northern states. But in discussions of public-policy issues, where most of the benefits and costs do not accrue to the individual making the policy decision (e. g., subsidies for health care), the appeal of total utility and intrinsic worth as the basis for decision can mask the insights of marginalism.

Even good answers to certain grand questions give little guidance for rational public policy choices. For example, what is more important, health or recreation? If forced to choose, everyone would find health more important than recreation. But marginalism suggests that our real concern should be with proportion, not rank. Finding health in total to be more important than recreation in total does not imply that all diving boards should be removed from swimming pools just because a few people die in diving accidents. We need to compare the number of lives saved from fewer diving accidents, that is, the marginal benefit of getting rid of diving boards, with the pleasure given up by getting rid of diving boards, that is, the marginal cost of getting r