

# The differences between macroeconomics and microeconomics economics essay

[Economics](#), [Microeconomics](#)



Economics is the science that deals with the production, distribution, and consumption of goods and services, or the material welfare of humankind. It is the study of how individuals and societies choose to use the scarce resources that nature and previous generations have provided. Because of scarcity, choices have to be made on a daily basis by all consumers, firms and governments. That is, economics is the study of the trade-offs involved when choosing between alternate sets of decisions.

### **Opportunity Cost:**

Opportunity cost is the cost of forgone benefit i. e. the cost of choosing one alternative/thing over other. Samuelson (1989) explains it as the value of the next best use (or opportunity) for an economic good, or the value of the sacrificed alternative. Thus, say that the inputs used to mine a ton of coal have been used to grow 10 bushels of wheat. The opportunity cost of a ton of coal could have been used to grow 10 bushels of wheat. The opportunity cost is thus the 10 bushels of wheat that could have been produced but were not. Opportunity cost is particularly useful for valuing non-marketed goods such as environmental health or safety. Opportunity cost can't always be measured in monetary or material units, but also in form of anything which possesses any value. In economics, there's a famous saying that, "there are NO free lunch for anyone". If one is not asked to pay for consuming a good or a service, there must be some opportunity cost involved, the next best alternative that might have been produced using those resources, due to the scarce resources that are used up in the production of those goods or services. Opportunity cost assesses the cost of next best alternative foregone

by any economic choice made by the individual or society. There's also the opportunity cost of deciding not to work that is the lost wages foregone

### **Difference between Macroeconomics and Microeconomics:**

Microeconomics and macroeconomics are the two major categories of economics:

Microeconomics- examines the behaviour of individual economic entities: firms and consumers regarding the allocation of resources and prices of goods and services. It monitors and studies the demand-supply mechanism at individual level, effect of income and saving behaviours, costs of production, maximizing profits, and the different market structures.

Microeconomics deals with the effect of macroeconomic factors and shifts on individual's life.

Macroeconomics- is the study of the behaviours and activities economy as a whole, not just of specific areas, but entire industries and economies. It includes the functions and characteristics related to the Federal Reserve System, unemployment, money supply, inflation, interest rate, foreign exchanges rate, gross domestic product, business cycles etc

It also comprise of the effect that unemployment brought to the economy like increase in unemployment decrease the gross domestic product of economy, reduces purchasing power parity. Its good effect is the decrease in inflation rate which is due to reduced money supply followed by increased interest rate. It involves the study of the most prominent economic issue which is inflation. Central banks usually increases the interest rate (lending

rate) to reduce the money supply which results in less lending, less money accumulation (money supply), less income, less purchasing power hence less inflation. But as a counter effect it also decreases the rate of employment of a country which results in low over all GDP of that country.

Fluctuations in total economic activity are known as business cycles, and macroeconomists are concerned with understanding why these cycles occur. Most unemployment and inflation are caused by these fluctuations. (enotes, 2. 011)

## **Demand Curve**

Demand curve is a graphical or diagrammatic representation of the schedule of demand. It is a graphical representation of the relationship between price and quantity. Individual demand curve determines the highest price at which an individual is willing to pay for (different quantities of) the commodity.

Whereas, every single point on the market demand curve depicts the maximum quantity of the commodity which all consumers will collectively be willing to buy, under given demand conditions, at every price level.

Demand curve has a negative slope. It slopes downwards from left to right advocating that the quantity demanded falls with increase in price and vice versa. The factors causing a downward sloping demand curve can give as follows:

Income effect- With the fall in price of a commodity, the purchasing power of consumer increases. Thus, he can buy same quantity of commodity with less

money or he can purchase greater quantities of same commodity with same money.

Substitution effect- When price of a commodity falls, it becomes relatively cheaper compared to other commodities whose price have not changed. Thus, the consumer tends to consume more of the commodity whose price has fallen.

Law of diminishing marginal utility- It is the basic cause of the law of demand. The law of diminishing marginal utility states that as an individual consumes more and more units of a commodity, the utility derived from it goes on decreasing. So as to get maximum satisfaction, an individual purchases in such a manner that the marginal utility of the commodity is equal to the price of the commodity.

(Management study guide, 2011)

### **Firm's Output Decision in Short-Run:**

The demand shock's severity relies on the state of the economy, whereas an economy depends on the Curve of Aggregate Supply. When the economy has excess capacity due to constant costs of production, it is called short run aggregate supply, shown by the flat part of the AS curve. Increases in AE also increases Y while the Price remains the same.

When the economy is facing cost increases, shown as the middle of this graph where the AS curve is sloped diagonally, it is intermediate short run aggregate supply. As shown in the graph, increase in aggregate expenditure

cause increase in output as well as price. When the economy face the trend of rapidly increasing costs, it is classical short run supply, shown as the vertical part of the AS curve. As shown in graph, increases in aggregate expenditure results in increased price at constant output. Basically, the more a demand shock will affect price, the less it will affect output and results in steeper AS.

### **Firm's Output Decision in Long-Run:**

As compare to short run, where the supply curve is the marginal cost curve lays above average variable cost, in the long run, a firm need to make normal profits. When price becomes equal to average total cost, it is known as the break-even point. Therefore, in the long run, it will shut down at any price below this. This leads towards the formation of long run supply curve above average total cost of the marginal cost curve.

This is to mention that for firms operating in perfectly competitive markets, the supply curve can only be derived from the marginal cost curve. The concept of a ' supply curve' is useless in monopoly situations due to the fact that a monopoly is a price-maker, not a " passive" price-taker.

The firm's long-run average cost curve depends on the level of costs variance with respect to the scale of operations. For some firms increase scale or size results in reduced costs. For the rest, it may cause inefficiency. If increase in the production scale of firm lowers the average costs, it can be concluded that there are increasing returns to scale or economies of scale. Whereas if increase in a firm's scale causes higher average costs, then there

are decreasing returns to scale or diseconomies of scale. And if a change in scale doesn't affect the average costs, we can conclude that there are constant returns to scale. Since these are found within the firm so they are considered as internal economies (or diseconomies) of scale.

### **Equilibrium Price and Equilibrium Quantity:**

The market price at which the supply of an item equals the quantity demanded. Price at which the quantity of goods producers wish to supply matches the quantity demanders want to purchase

Supply= Demand= Price

Whereas equilibrium quantity can be defined as amount of goods or services sold at the equilibrium price is the quantity demanded or supplied at the equilibrium price.

Supply= Demand

$Q_S = Q_D = Q_E$

Where  $Q_E$  is at equilibrium position

(JoJmnz144, Wiki-answers)

Equilibrium is a state of equality. Market equilibrium is defined as state of balance between market demand and supply. Absence of shift in demand and/or supply will result in constant market price. As represented by diagram, the quantity demanded and supplied at price  $P_1$  are equal. At any price which is above  $P_1$ , the supply will exceed the demand. While at a price

below  $P_1$ , demand will exceed the supply. We can also say that the prices are termed points of disequilibrium when demand and supply are out of balance. Conditional changes in demand or supply will result in shifting the demand or supply curves. As a result, change in the equilibrium price and quantity in the market can be observed, as shown in the graph (courtesy: tutor2u. net).

Thus the clamouring for more goods might encourage the entry of new suppliers in market. Hence, as observed above the supply will increase due to the entrance of new competitors and this will drive the market for settlement of new equilibrium price.

### **Effects of excess demand on market equilibrium:**

Market equilibrium is the result of intersection of the demand and supply curves. Their intersection point is the point where the quantity demanded is equal to the quantity demanded. Lets consider the excess demand, where the current price is below the equilibrium, as shown in the figure, which reveals that at price  $OP$ , the quantity demanded ( $OQ$ ) exceeds the quantity supplied ( $OQ$ ). Market competition among the buyers due to the limited quantity of goods available means that consumers will start bidding up the price. Increase in the price results in an expansion in supply as well as the contraction in demand which can be determined by the movement along the curves towards the equilibrium point. This will continue until the existence of excess demand. Eventually, the intersection point of the supply and demand curves, where at price  $P_e$ , the quantity supplied  $Q_e$  exactly, equals the quantity demanded by consumers.



## **Effects of excess supply on market equilibrium:**

As shown in figure, the quantity supplied at price  $OP$  ( $OQ$ ) exceeds the quantity demanded, which means we have a situation of excess supply, also known as glut in the market. To eradicate excess supply, sellers will offer to sell their products at lower prices. Decrease in price results in increased demand and a contraction in supply, which can be noticed by the movement along the curves towards the equilibrium point. This will continue till there is excess supply, until we reach the point where supply and demand intersects, where at price  $OP_e$ , the quantity supplied and demanded is equal in the market.

Equilibrium price and quantity will change with the shift in any or both of the supply or demand curve. Changes in conditions behind supply and demand, apart from price changes, cause the shifts in the supply and demand curves.

Equilibrium position can also be affected by increase or decrease in supply. An increase in supply shifts the supply curve to the right resulting in lowering the equilibrium price with the raise in equilibrium quantity. Decrease in supply will shift the supply curve to the left but will raise the equilibrium price and lower the equilibrium quantity. Market mechanism also ensures that equilibrium is reached at the intersection of those two curves along with the efficiency in allocation in the economy. Demand curve advocates the indication of the value that consumers place on a certain product. While the supply curves give the indication of the producers' cost of product supply.

## **Perfect Competition:**

It is defined as the market situation, where there are a large number of sellers and buyers. In addition, the products offered by sellers are homogenous (indistinguishable/undifferentiated). This creates the situation, under which, no firm can affect the market price of product, and thus each firm lies within the perfectly elastic demand curve. This results in the market condition of price takers, where the firms produce as well as sell their output at the prices which are determined by the market.

## **Assumptions behind a Perfectly Competitive Market:**

1. Many suppliers each with an insignificant share of the market.
2. An identical output produced by each firm
3. Consumers have perfect information about the prices all sellers in the market charge
4. All firms (industry participants and new entrants) are assumed to have equal access to resources (technology, other factor inputs) and improvements in production technologies
5. There are assumed to be no barriers to entry & exit of firms in long run
6. No externalities in production and consumption so that there is no divergence between private and social costs and benefits

## **Perfect competition Graph:**

The perfect competition graph is made by plotting, Quantity of products on x-axis and the price of product on y-axis. It derives the demand curve of the product, as shown in the graph, the curve is perfectly elastic. The entrance of new firms or expansion of existing firms (if returns to scale are constant) into the market affects the (horizontal) demand curve of each individual firm towards the downward shift, bringing down the average revenue, marginal revenue and most importantly the price curve at the same time. The final outcome results in the perception that the firm will make only normal profit (zero economic profit) in the long run.

## **Oligopoly:**

An oligopoly can be defined as, the market dominated by a few large suppliers. In oligopoly market, the degree of market concentration is very high because the major portion of the market is strongly dominated (mostly taken up) by the leading firms. Firms which lies with in an oligopoly usually produce branded products (advertising and marketing is an important feature of competition within such markets) and there are also barriers to entry. Another important characteristic of an oligopoly is interdependence between firms. This means that each firm must take into account the likely reactions of other firms in the market when making pricing and investment decisions. This creates uncertainty in such markets - which economists seek to model through the use of game theory. Game theory may be applied in situations in which decision makers must take into account the reasoning of other decision makers. It has been used, for example, to determine the

formation of political coalitions or business conglomerates, the optimum price at which to sell products or services, the best site for a manufacturing plant, and even the behaviour of certain species in the struggle for survival (Adapted from Britannica).

### **Major theories about oligopoly pricing:**

In oligopoly, the dominating firms collaborate to get monopoly profits by charging the monopoly price.

Oligopoly firms undergo price-induced competition in order to gain the same price and profits as a competitive industry

Price and profits of the oligopoly firms retains between the monopoly and competitive ends of the scale

Oligopoly firms exercise indeterminate prices and profits due to the difficulties in modelling interdependent price and output decisions

### **Oligopoly Graph:**

The oligopoly graph is made by plotting Quantity of products on x-axis and the prices and costs of product on y-axis. If the MC curve fluctuates within the discontinuity AB (between MC and  $MC_{\frac{1}{2}}$ ) there is no motivation for the first to change its equilibrium output, assuming the firm is a profit maximising oligopolies.

### **Keynesian Economics:**

It is a macroeconomic theory which is based on the ideas of John Maynard Keynes who was an English economist of 20th century. It argues that:

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' Private sector decisions may leads toward an outcome which is macro-economically inefficient. It advocates active policy public sector responses, which includes central bank's monetary policy actions as well as fiscal policy actions by the government in order to stabilize the business cycle output'.

Keynesian Economics supports a mix economy structure that is dominated by private sector but have a substantial role of public sector and the government as well. The government can stimulate new production with a modest outcome if:

The people who receive this money then spend most on consumption goods and save the rest.

This extra spending allows businesses to hire more people and pay them, which in turn allows a further increase consumer spending.

This economic approach would call for a loose monetary policy to cure a recession. They focus on maintaining low unemployment and are willing to tolerate any inflation that results from stimulative monetary policies. They asses that if few microeconomic actions can be taken by a major portion of individuals and firms, collectively, where the economy operates below its potential output and growth rate, they can lead to inefficient aggregate macroeconomic outcomes. The centralized conclusion of Keynesian economics can be given as no strong automatic mechanism moves employment as well as output towards the levels of full employment, in some situations. This summarized description of Keynesian economics conflicts with the approaches of economic that assume a very strong general

tendency that lead toward equilibrium. The 'neoclassical synthesis' combines the Keynesian macro concepts with a micro foundation. It is the conditions of general equilibrium which allow for the adjustment of price to achieve this goal eventually. In broader terms, Keynesian takes their theory as a general theory that is which utilizes the resources at high or low levels, while the previous economics taken into account the case of full utilization.

### **Monetarist Economics:**

This theory says that the government has a proper economic role in economy. It can control the level of inflation (rate of inflation). This can be done by controlling the amount of money in circulation. It is the monetary economic view that change in rate of the money supply has major impacts on national output in the short run as well as on the level of prices over long run. It shows the objectives of monetary policy which are best met by targeting the rate of growth of the money supply within an economy.

Monetarists actually are critics of expansionary fiscal policy. They argue that expansionary fiscal policy will only result in inflation or crowding out and therefore won't be of any help. This theory presents the principles and paper that was mainly developed by Milton Friedman, supporting the classical liberalism.

The theory of rational expectations suggests that households and business will use historical effects of monetary policy to forecast the impact of an existing policy and act accordingly.

Households spend more with a loose monetary policy to avoid inflation

Businesses will increase their investment with a loose monetary policy to avoid higher costs

Lab or market participants will negotiate higher wages with a loose monetary policy

Thus it strongly supports monetarist view that changes in monetary policy do not have a sustained impact on the economy. They advocates stable and low growth in the money supply, allows economic problems to resolve themselves. Monetarists are concerned about maintaining low inflation and are willing to tolerate a natural rate of unemployment.