

Chapter 1

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THE RANGE OF ECONOMICS

Definition of Economics

- Question asked in economics is "What makes nations wealthy?"
 - Adam Smith (1723 - 1790)
 - "political economy " was concerned with what were the causes of the wealth of nations
 - Once nations achieve economic growth and markets widened, question of distribution of output became centre stage
 - David Ricardo (1772 - 1823)
 - The principal problem of economics was to discover the mechanisms or laws which regulate the distribution of produce of the earth
 - Karl Marx (1818 - 1883)
 - Economics simply became the study of the laws of motion of capitalism - the study of how economies grow and stagnate as they undergo social stresses and strains that accompany big historical transformations
 - Alfred Marshall (1842 - 1924)
 - **Economics** - is a method of analyzing individual and social behaviour, especially as it relates to a market phenomena
 - It is the study of mankind in the ordinary businesses of life and for whom what distinguishes economics from non-economists are the analytical tools and methods used to explain different aspects of social phenomena
 - John Maynard Keynes (1883 - 1946)
 - Economics was seen as a method rather than a doctrine, an apparatus of the mind, a technique of thinking
 - Lionel Robbins (1898 - 1984)
 - Defined economics as a science which studies human behaviour as a relationship between ends and scarce means which have alternative uses"
 - Economics is the study of behaviour conditioned by scarcity
 - Scarcity is the focus of analysis - it is the binding constraint on human activity that imposes trade-offs and forces individuals to make choices in allocating resources among alternative needs

Microeconomics versus Macroeconomics

- **Microeconomics**
 - Issue of scarcity is at the core of microeconomics
 - Individual agents - consumers, individual firms, agencies, governments - or to particular industries
 - Prices play key role as they reflect the degree of scarcity - relatively scarce things carry high prices
 - **Opportunity Costs** - the value of what one must give up in order to acquire something else
 - You decided to go to university. As a result, you are forgoing the earning that some friends are making by working full time. You have given up these earnings and you pay tuition fees and may also encounter additional lodging and food costs. These are opportunity costs. The trade-off in this case is that you will learn a lot in university, and that will increase future income.
 - Most of microeconomics is based on search for efficiency
 - **Constrained Optimization** - given the time and financial or resource constraints, what is the best that can be done? What is the optimal decision if agent wishes to maximize profits, growth, happiness, etc...?
- **Macroeconomics**
 - Field of macroeconomics created by Keynes when he tried to explain the deep recession of the 1930s through arguments that were not connected to the malfunctioning of individual markets but rather to paradoxical effects that were arising when the intended behaviour of individuals led to exactly opposite aggregate results when all these individuals acted in a similar way
 - **Paradox** - a contradiction between two principles that operate at different levels, often involved outcome that is contrary to intuition
 - **Fallacy of Composition** - error of believing that what is true of each part of a system will always be true of the system as a whole
 - Paradox Keynes highlighted is called **paradox of saving** or **paradox of thrift**
 - As individuals try to save more, less will be spent on consumer goods
 - Therefore, firms will lose sales and make less profit and will be induced to hire fewer personnel
 - In the end, employees and owners will wind up with less income, and hence will not be able to save as much as intended
 - Macroeconomists are interested in the economic system as a whole, while microeconomists are mainly concerned with the study of individual markets or agents in isolation
 - In terms of principle of scarcity, not a big part of macroeconomics but it does there are trade-offs to be understood in that context
 - Low unemployment normally makes inflation rise and high unemployment makes inflation fall
 - Poses a fundamental dilemma of national economic policy

INSIDE THE ECONOMISTS TOOL KIT

The Need for Abstraction

- Economic theory does make some unrealistic assumptions
- Abstraction from unimportant details is necessary to understand the functioning of anything as complex as the economy
- **Abstract** - means ignoring many details so as to focus on the important elements of the problem
- Economists try to abstract from confusing details
 - A too detailed map might tell you about the smaller streets but confuse your initial route
- The proper degree of abstraction depends on the objective of the analysis. A model that is a gross oversimplification for one purpose may need to be needlessly complicated for another

The Role of Economic Theory

- **Theory** - a deliberate simplification of relationships used to explain how those relationships work
- **Price theory** - seeks to describe and explain how buyers and sellers interact in markets to determine prices
- False distinction between theory and practical policy
 - It is precisely the concern for policy that makes economic theory so necessary and important
 - To analyze policy options, economists are forced to deal with possibilities that have not actually occurred
 - For example, to learn how to shorten periods of high unemployment, they must investigate whether a proposed new policy that has never been tried can help

Correlation and Causation

- **Correlation** - two variables are said to be correlated if they tend to go up or down together. Correlation need not imply causation
- Monetarism (macroeconomics) - the theory, based on the empirical observation that prices and money supply grow in tandem, which claims that price inflation is primarily caused by an excessive growth rate of the money supply

- Statistical correlation need not imply causation. Some theory is usually needed to interpret data
- One of the best known relationships in economics is the positive relationship between stock of money and price level
 - Two different theories have been put forward
 1. Based on monetarism, the amount of money in the economy explains or causes the price level
 2. In alternative story, nearly just as old - the *banking school of economics* view - it is the price level that explains or causes the amount of money
- **Post hoc, ergo propter hoc fallacy** - the error of assuming that if some event occurred before another, then the first one must have caused the second one
- Despite all the difficulties involved, assessing causality is crucially important in economics.
- Theories based on the same facts will yield different predictions because they rely on different causation methods
- Having a causal story also allows the economist to know which policy should be put in place

What is an Economic Model?

- **Economic model** - a simplified, small-scale version of some aspect of the economy.
- It is a representation of a theory or part of a theory, often used to gain insight into cause and effect

The Role of Assumptions

- An important cause of disagreements among economists is that theorizing is based on assumptions
- Assumptions play a key role in economic analysis
- Changing the assumptions will lead to different results and most likely to different policy recommendations
- Whatever the quality of the analysis, if the assumptions are wrong - if they do not adequately reflect stylized facts or the behaviour of people - the conclusions reached are most likely to be wrong as well
- Different assumptions in economics will often lead to different conclusions, different predictions, and different policy recommendation. For this reason, it is important to clearly spell out our assumptions
- It should be pointed out that an assumption may be quite appropriate in some circumstances and invalid in others.
- A problem that most economists face is ascertaining the domain of validity of an assumption

The Role of Value Judgements

- Many disputes among economists are not scientific disputes at all. Sometimes the pertinent facts are simply unknown
- Another important source of disagreements is that economists have different political views - each may have a different solution for policy problems
- Although economic science can contribute theoretical and factual knowledge on a particular issue, the final decision on policy questions often rests either on information that is not currently available or on social values and ethical opinions about which people differ, or on both

Two Views of Scientific Research

- Naïve view
 - Economists first collect objective statistical facts and observe agent behaviour
 - Then from this formulate theories and build models and make predictions
 - Conduct empirical tests
 - If theory is falsified then they abandon theory
 - If theory is corroborated, then further work can be done to improve theory and models and final propose a policy
- Modern view
 - Issues of concern
 - Constructed facts, stylized facts and assumptions
 - Theories are formulated and models are constructed to make predictions
 - Conduct empirical tests and find new facts - based on opinions, values, and ideology
 - If theory is refuted, then hold onto theory and protect it -can still propose policies
 - If theory is corroborated, then improve theory and models and propose policies
- In addition, whether a given model will seem to be confirmed or disparaged by the test results will, to an extent, depend on the *a priori* opinions of the researcher
- In the naïve view of research in the social sciences, researchers are impervious to ideological or pecuniary influences
- In the modern view, prior opinions and values have an impact at every stage of research