

3. General equilibrium analysis has found its most extensive use in welfare economics. In this branch of economics, we study the 'best' allocation of resources, given the objectives of society. The search for such an organization of the economy leads us to apply the methods of general equilibrium.
4. Monetary theory and policy have been revolutionised by the introduction of general equilibrium analysis. It is now widely recognized that a meaningful monetary policy must apply to all the assets in the economy which are related to all the goods, capital and labour markets. Such a monetary policy is nothing but a study of general equilibrium effects of government policy.

12. BASIC CONCEPTS

1. GOODS

In economics, anything capable of satisfying a want is called a 'good'. Goods are desirable things like food, clothing, shoes, cars, houses etc.

There are some items of consumption which cause dissatisfaction or definite harm to the consumer. Examples are liquor, tobacco and drugs. These are called economic bads.

Some goods are free such as sunlight, air and natural water. Other goods are paid for such as shirts and pants, TV and computers.

Goods can be classified in many ways. We discuss the main classes of goods as follows.

Material and non-material goods

Material goods are those which can be transferred from one person to another. These are tangible in nature. Examples, are scooter, cooler and refrigerator.

Non-material goods are called services. The jobs done by teachers, doctors, lawyers and commission agents are called services.

Economic goods and free goods

All those goods which are produced or shaped by man have a price in the market. The supply of such goods in the market is limited as compared to demand. In other words, economic goods are scarce. Examples are food items, footwear and entertainment.

As against economic goods, there are some free goods. These are gifts of nature such as air, sunshine, water falls etc. These are plentiful in supply as compared to demand. Therefore, free goods have no market price.

It should be noted that due to the fast increasing world population, there are no absolutely free goods available now. This is because of development of world tourism and processing of natural water.

Consumer and producer goods

Consumer goods are meant for direct consumption. Goods such as pen, bread, butter and ink are meant only to be used for personal satisfaction. These consumer goods may be durable or perishable. Durable goods last for several months or may be years. TV, Car, Scooter and steel almirahs are durable goods. These are not in daily demand. Perishable consumer goods are meant for single use. Milk, fruit and petrol are single use goods and therefore, these are in regular demand.

Producer goods are those which are bought by producers of goods and services. Examples of such goods are steel, machines and machine oils. These goods need investment. Such goods are produced on demand from producers. These are mostly durable goods such as factories, engines and plants of various sizes. But there are some single use producer goods such as raw-materials cotton, jute and coal.

■ Public and private goods

Public goods are all those which are owned and maintained by government bodies and are open for use by the general public under proper rules and regulations. Roads, railways, bridges, public parks and aerodromes are public goods. All these goods have maintenance costs and are often priced directly or indirectly. No consumer of these goods can be excluded from its use as long as he/she is obeying the rules.

Private goods are those which are not freely accessible to the general public for use. Private houses, clubs, gardens and resorts are privately owned and used as such.

The distinction between public and private goods is very thin. A private good can be thrown public at any time. For example, a private princely house may be made open to public for charges fixed by the owner. Similarly, some erstwhile palaces are now hotels. These are public goods now.

■ 2. UTILITY

Utility is the want-satisfying power of a good. Cold drinks have utility in that these can quench the thirst. Books have utility for students.

Utility is not necessarily usefulness. Drugs have utility for their purchases because they pay for these. But these are not useful for their consumers. Similarly, utility does not always mean pleasure. Medicines are having utility but these are not always pleasant to take.

Utility cannot be easily measured. It is something subjective. It differs from person to person. Some young men like fast food very much. Older men are not advised to take these as these have excessive fats. The same food has different utility for them. Therefore, utility is subjective.

Utility is also relative. It differs for the same good from time to time and place to place. Ice cream is welcome in hot weather but not so much when it is snowing. A man who had a cup of coffee an hour before does not like the same immediately.

A fundamental principle about utility is that when a person goes on consuming more and more units of the same good, the utility of the successive units consumed by him goes on diminishing. *This is known as the law of diminishing marginal utility.*

Alfred Marshall, the famous economist, suggested that we can measure utility with the help of money. The more useful is a commodity to me, the more I would be prepared to pay for it. Money has a general utility. When a consumer buys a commodity, he compares its utility with that of money which he is asked to pay for it. In other words, he is measuring utility in rupees. This is called cardinal measure of utility.

But Marshall's measure of utility through money has been criticised. The critics point out that the value of money itself changes over time. The value of money to a rich man is different from its value to a poor man. Therefore, money is not a fit measure of utility. We need something which remains constant as the consumer uses more and more of the commodity.

■ 5. CONSUMPTION

Consumption is the direct use of goods and services for satisfying current wants. Consumption takes place when a commodity or service is used for benefit. Taking of food, enjoyment of a play, driving a car for going to the hills are examples of consumption. Consumption may be slow or fast. Durable goods are consumed slowly. Perishable goods like consumption and fruit are consumed fast. Thus, consumption is the process of use of utilities, vegetables and fruit are consumed last. Thus, consumption is the process of use of utilities.

Direct consumption must be distinguished from indirect consumption. Food items are consumed directly. Cooking gas is used to prepare foods. Thus, it is indirectly consumed. A car is directly used and consumed but the steel used in its body is indirect consumption.

A consumer has a choice to consume a commodity immediately or to keep some of it for tomorrow. Today's consumption is different from tomorrow's consumption. This distinction assumes more importance before a nation. A nation has reserves of resources. It can use these to-day or postpone it for many years. The choice is between the consumption of the present generation and of the future generations.

Consumption has great importance in the study of Economics. It has been said that consumption is the beginning and end of all economic activity. Consumers demand commodities and services. Producers get the signal to produce them. Some producers produce for other producers. Producers of goods and services also consume goods and services produced by others. Thus, goods are exchanged for goods in the market through the use of money and prices. Ultimately, the goods meant for production are sold to the consumers. Therefore, the study of Economics starts with the study of consumption although there cannot be any consumption without production.

Consumption can be wasteful if the consumer does not know the proper use of a good. A battery has to be regularly charged for its maintenance. Careless use of the same would shorten its life. It is wasteful consumption. Another example of wasteful consumption is over-eating which builds fat and causes heart attacks. Some people use more medicines than are advised medically just in the hope of getting well quickly. This is wasteful consumption.

■ 6. PRODUCTION

Production is the process of creation of economic utility. Nature produces the raw-material; man uses these raw-materials to produce goods and services. Production of saleable goods and services is just the process of adding utility to the raw-materials. Take the case of crude oil which lies beneath the earth's surface. When it is pumped out, it can be sold to an oil refinery. This refinery separates many petro-products out of the crude oil. These processes go on adding utility to the natural raw-material called crude oil. Thus

■ **Production is the process of value addition to the given raw-materials**

There are different methods of creation of utility. Firstly, it may be just the creation of utility by changing the form of some raw-material. For example, steel sheet can be formed into a box or a cylinder for storage of some goods.

Secondly, there can be the creation of time utility in a commodity. For example, if a farmer grows a sugarcane variety which is harvested in late winter, he gets a higher price for the same at the factory gate.

Thirdly, the process of production may be the creation of place utility in a commodity. For example, apples are grown in Kashmir. These are transported to Bombay where these sell at a higher rate. Thus, the transporter is also doing production.

Fourthly, the process of production can be the creation of service utility in a commodity. For example, training of staff in catering at restaurants and hotels is creation of service utility. Training of nurses and other para-medical staff is also production.

Fifthly, utility in a commodity is also increased when it goes to the right person called possession utility. For example, when a musical instrument is in the possession of a person who does not know music it has little utility. He searches for a musician who plays upon that instrument to earn his livelihood, it is creation of possession utility. Thus, fruit search is also a process of production.

Sixthly, production can also take place through creation of knowledge utility. Columbus had to go on a voyage of the ocean in search of an alternative route to India. He discovered the vast continent called America. Europeans got the knowledge of the existence of agricultural lands and gold mines there. Thus, Columbus had also done production. So he was rewarded by the king.

From the examples given above, it should be clear that in Economics the term 'production' has a much wider meaning than that is given to it in common use. Production process is a type of value addition whether through manufacturing, imparting training, searching, transporting. It should be understood that production has great importance in economic activities. There cannot be any consumption without production. Further, production generates employment to people. Greater the production, higher the level of employment. As the volume of production increases, the country also progresses.

7. THE MARKET MECHANISM

Let us begin with a brief review of the basic supply-demand diagram as shown in Figure 1.5. The vertical axis shows the price of a good, P , measured in per unit. This is the price that sellers receive for a given quantity supplied and that buyers will pay for a given quantity demanded. The horizontal axis shows the total quantity demanded and supplied, Q , measured in number of units per period.

The *supply curve* S tells us how much producers are willing to sell for each price that they receive in the market. The curve slopes upward because the higher the price, the more firms are usually able and willing to produce and sell. For example, a higher price may enable existing firms to expand production in the short run by hiring extra workers or by having existing workers work overtime (at greater cost to the firm), and in the long run by increasing the size of their plants. A higher price may also attract into the market new firms that face higher costs because of their inexperience and that therefore would have found entry into the market uneconomical at lower price.

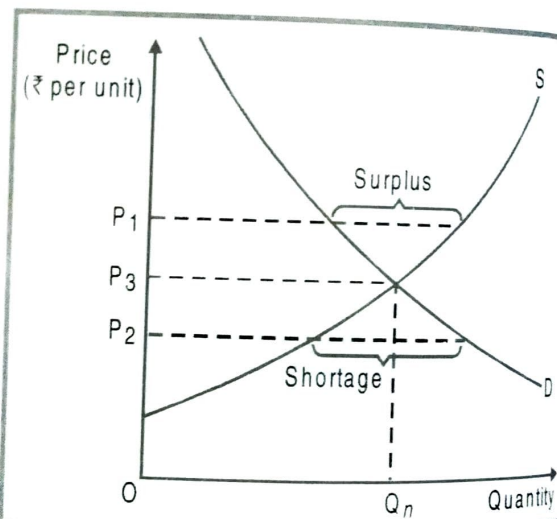


Fig. 1.5 Supply and Demand. The market clears at price P_0 and quantity Q_0 . At the higher price P_1 a surplus develops, so price falls. At the lower price P_2 there is a shortage, so price is bid up.

The demand curve D tells us how much consumers are willing to buy for each price per unit that they must pay. It slopes downward because consumers are usually ready to buy more if the price is lower. For example, a lower price may encourage consumers who have already been buying the good to consume a larger quantity, and it may enable other consumers who previously might not have been able to afford the good to begin buying it.

The two curves intersect at the *equilibrium, or market-clearing, price and quantity*. At this price P_0 the quantity supplied and the quantity demanded are just equal (to Q_0). The *market mechanism* is the tendency in a free market for the price to change until the market clears (i.e., until the quantity supplied and the quantity demanded are equal). At this point there is neither shortage nor excess supply, so there is also no pressure for the price to change further. Supply and demand might not *always* be in equilibrium, and some markets might not clear quickly when conditions change suddenly, but the *tendency* is for markets to clear.

To understand why markets tend to clear, suppose the price were initially above the market clearing level, say, P_1 in Figure 1.5. Then producers would try to produce and sell more than consumers were willing to buy. A surplus would accumulate, and to sell this surplus or at least prevent it from growing, producers would begin to lower their prices. Eventually price would fall, quantity demanded would increase, and quantity supplied would decrease until the equilibrium price P_0 was reached.

The opposite would happen if the price were initially below P_0 , say, at P_2 . A shortage would develop because consumers would be unable to purchase all they would like at this price. This would put upward pressure on price as consumers tried to outbid one another for existing supplies and producers reacted by increasing price and expanding output. Again, the price would eventually reach P_0 .

When we draw and use supply and demand curves, we are assuming that at any given price, a given quantity will be produced and sold. This makes sense only if a market is at least roughly competitive. By this we mean that both sellers and buyers should have little market power (i.e., little ability individually to affect the market price). Suppose instead that supply were controlled by a single producer—a monopolist. In this case there would no longer be a simple one-to-one relationship between price and quantity supplied. The reason is that a monopolist's behaviour depends on the shape and position of the demand curve. If the demand curve shifted in a particular way, it might be in the monopolist's interest to keep the quantity fixed but change the price, or keep the price fixed and change the quantity. So when we work with supply and demand curves, we implicitly assume that we are referring to a competitive market.

QUESTIONS

Q.1. FILL IN THE BLANKS :

- (a) The term micro economics has been derived from the Greek Word _____
- (b) Micro economics is the study of _____
- (c) Micro economics is based on _____ equilibrium analysis.
- (d) Static economics studies only the _____
- (e) _____ Goods having a particular Shape.
- (f) _____ Goods are Scarce.
- (g) _____ Goods directly satisfy human Wants.
- (h) All the economic goods are _____ .

Story, Story