

Lecture № 02

The Nature of Economics

➤ **Defining Economics**

Economics is part of the social sciences and as such seeks explanations of real events. All social sciences analyze human behavior, as opposed to the physical sciences, which generally analyze the behavior of electrons, atoms, and other nonhuman phenomena. Economics is the study of how people allocate their limited resources in an attempt to satisfy their unlimited wants. As such, economics is the study of how people make choices.

To understand this definition fully, two other words need explaining: *resources* and *wants*. Resources are things that have value and, more specially, are used to produce goods and services that satisfy people's wants. Wants are all of the items that people would purchase if they had unlimited income.

Whenever an individual, a business, or a nation forces alternatives, a choice must be made, and economics helps us study how those choices are made. For example, you have to choose how to spend your limited income. You also have to choose how to spend your limited time. You may have to choose how much of your company's limited funds to spend on advertising and how much to spend on new-product research. In economics, we examine situations in which individuals choose how to do things, when to do things, and with whom to do them. Ultimately, the purpose of economics is to explain choices.

➤ **Microeconomics versus Macroeconomics**

Economics is typically divided into two types of analysis: *microeconomics* and *macroeconomics*.

Macroeconomics is the part of economic analysis that studies decision making undertaken by individuals (or households) and by firms. It is like looking through a microscope to focus on the small parts of our economy. Macroeconomics is the part of economic analysis that studies the behavior of the economy as a whole. It deals with economy wide phenomena such as changes in unemployment, in the general price level, and in national income. Microeconomic analysis, for example, is concerned with the effects of changes in the price of gasoline relative to that of other energy sources. It examines the effects of new taxes on a specific product or industry. If price controls were reinstated in Iran, how individual firms and consumers would react (in the realm of microeconomics)? The effects of higher wages brought about by an effective union strike would also be analyzed using the tools of microeconomics. In contrast, issues such as the rate of inflation, the amount of economy wide unemployment, and the yearly growth in

the output of goods and services in the nation all fall into the realm of macroeconomics analysis. In other words, macroeconomics deals with aggregates, or totals-such as total output in an economy.

Be aware, however, of the blending of microeconomics and macroeconomics in modern economic theory. Modern economists are increasingly using microeconomics analysis-the study of decision making by individuals and by firms-as the basis of macroeconomics analysis. They do this because even though macroeconomics analysis focuses on aggregates, those aggregates are the result of choices made by individuals and firms.

➤ **The Economic Person: Rational Self-Interest**

Economics assume that individuals act as motivated by self-interest and respond predictably to opportunities for gain. This central insight of economics was first clearly articulated by Adam Smith in 1776. Smith wrote in his most famous book, *An Inquiry into the Nature and Causes of the Wealth of Nations*, that “it is not from the benevolence of the butcher, the brewer, or the banker that we expect our dinner, but from their regard to their own interest”. Thus, the typical person about whom economists make behavioral predictions is assumed to act *as thought* motivated by self-interest. Because monetary benefits and costs of actions are often the most easily measured, economists make behavioral predictions about individuals’ responses to opportunities to increase their wealth, measured money terms.

The rationally assumption of economics, simply stated, is as follows: We assume that individuals do not intentionally make decisions that would leave them worse off.

➤ **Economics as a Science**

Economics is a social science that employs the same kinds of methods used in other sciences, such as biology, physics, and chemistry. Like these other sciences, economics uses models, or theories. Economics models, or theories, are simplified representations of the real world that we use to help us understand, explain, and predict economic phenomena in the real world. There are, of course, differences between sciences. The social sciences-especially economics-make little use of laboratory experiments in which changes in variables are studied under controlled conditions. Rather, social scientists, and especially economists, usually have to test their models, or theories, by examining what has already happened in the real world.

➤ **Positive versus Normative Economics**

Economics uses *positive analysis*, a value-free approach to inquiry. No subjective or moral judgments enter into the analysis. Positive analysis relates to statements such as “If A, then B”. For example, “If the price of gasoline goes up relative to all other prices, then the amount of it that people buy will fall”. That is a positive economic statement. It is a statement of *what is*. It is not a statement of anyone’s value judgment or subjective feelings. When our values are interjected into the analysis, we enter the realm of *normative economics*, involving normative analysis. A positive economic statement is “If the price of gasoline rises, people will buy less”. If we add to that analysis the statement “so we should not allow the price to go up”, we have entered the realm of normative

economics-we have expressed a value judgment.

Vocabulary and Comprehension Exercise

Exercise 01: Fill in the blanks with appropriate words from the following list.

theory	normative	model	bounded rationality
rationality	wants	self-interest	microeconomics
positive	unlimited	macroeconomics	ceteris paribus
behavioral			

1. Economics is a social science that involves the study of how individuals choose among alternatives to satisfy their....., which are what people would buy if their incomes were
2. In account of text,, the study of the decision-making process of individuals (or households) and firms, and, the study of the performance of the economy as a whole, are the two main branches into which the study of economics is divided.
3. In economics, we assume that people do not intentionally make decisions that will leave them worse off. This is known as the assumption.
4. In account of text, is not confined to material well-being but also involves any action that makes a person feel better off, such as having more friends, power, or affection or providing more help to others.
5. A, or, uses assumptions and is by nature a simplification of the real world. The usefulness of a model can be evaluated by bringing empirical evidence to bear on its predictions.
6. Most models use the assumption that all other things are held constant, or equal.
7. In account of text, economics emphasizes psychological constraints and complexities that potentially interfere with rational decision making. This approach utilizes the..... hypothesis that people are not quite rational, because they cannot study every possible alternative but instead use simple rules of thumb to decide among choices.
8. In account of text, economics is value-free and relates to statements that can be refused, such as “If A, then B”.
9. In account of text, economics involves people’s value and typically uses the word *should*.

Exercise 02: First read the text carefully and then choose the best choice to complete each question.

1. Which one is not belong to social sciences?
 - a.economics
 - b.biology
 - c.accounting
 - d.management
2. Which one belongs to macroeconomics?
 - a. trade
 - b. price
 - c. production
 - d. inflation
3. According to the passage, which one of the following issues is not the subject matter of economics?
 - a. consumption
 - b. production
 - c. exchange
 - d. political election
4. In account of text, simplifies representations of the real world that we use to help us understand economic phenomena in the real world.
 - a. microeconomics
 - b. theories
 - c. models
 - d. b and c
5. Modern economists are increasingly using..... as the basis macroeconomic analysis.
 - a. Rationality assumption
 - b. models
 - c. Microeconomics analysis
 - d. theories

Exercise 03: Read each statement and decide whether it is true or false. Write "T" before true statements and "F" before false statements. Base your answers on the information given in the passage.

1. Economics is the study of how people make choices.
2. Needs are things that have value and, more specially, are used to produce goods and services that satisfy people's wants.
3. Microeconomics examines the effects of new taxes on a specific product or industry.
4. Economics is a social science that employs the same kinds of

methods used in other sciences.

5. Normative analysis relates to statements such as “If A, then B”.
6. Macroeconomics is like looking through a microscope to focus on the small parts of our economy.

Exercise 04: After reading the text, try to provide full answers to the following questions.

1. What is the purpose of economics?
2. What is the difference between microeconomics and macroeconomics?
3. Categorize each of the following issues either a microeconomic issue, a macroeconomic issue, or not an economic issue.
 - a. The national unemployment rate
 - b. The decision of a work overtime or not
 - c. A family’s choice to have a baby
 - d. The rate of growth of the money supply
 - e. The national government’s budget deficit
 - f. A student’s allocation of study time between two subjects
4. Categorize each of the following conclusions as being the result of positive analysis or normative analysis.
 - a. A higher minimum wage will reduce employment opportunities for minimum wage workers.
 - b. Increase the earnings of minimum wage employees is desirable, and raising the minimum wage is the best way to accomplish this.
 - c. Everyone should enjoy open access to health care.
 - d. Health care subsidies will increase the consumption of health care.