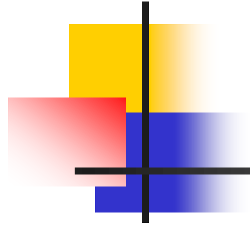
Nature and Scope of Managerial Economics

Chapter 1

What is Managerial Economics About?

- **Economics** studies human behavior about producing, consuming and distributing goods and services in a world of scarce resources.
- **Management** is the study of organizing and allocating a firm's scarce resources to achieve its desired objectives.



- **Managerial Economics** is:

  the use of economic analysis
  to make business decisions
  for the best use of an organization’s
  scarce resources.

Interaction of Managerial Economics with Other Disciplines of Management

- Marketing
  - Demand
  - Price Elasticity
- Finance
  - Capital Budgeting
  - Break-Even Analysis
  - Opportunity Cost
  - Economic Value Added

- Managerial Accounting
  - Relevant Cost
  - Break-Even Analysis
  - Incremental Cost Analysis
  - Opportunity Cost
- Strategy
  - Types of Competition
  - Structure-Conduct-Performance Analysis
- Management Science
  - Linear Programming
  - Regression Analysis
  - Forecasting

Important Economic Terms

- Microeconomics
  - Study of individual consumers and producers in specific markets
    - Supply and demand, pricing of outputs and inputs, production and cost structures
- Macroeconomics
  - Study of the aggregate economy
    - Gross domestic product, unemployment, inflation, fiscal and monetary policy, trade among nations

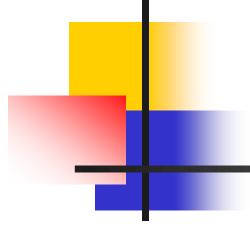
Important Economic Terms (Cont'd)

- Scarcity
  - A condition in which resources are not available to satisfy all the needs and wants of a specified group of people
- Resources
  - Land
  - Labor
  - Capital
  - Entrepreneurship and management skills

Important Questions in Economics

- What goods and services should be produced and in what quantities?
  - The “product” decision
- How should these goods and services be produced?
  - The “hiring, staffing, procurement, and capital-budgeting” decisions
- For whom should these goods and services be produced?
  - The “market segmentation” decision

- Market Process
  - The use of supply, demand and material incentives to answer the questions
- Command Process
  - The use of the government or a central authority to answer the questions
- Traditional Process
  - The use of customs and traditions to answer the questions



The Theory of the Firm

- A firm is a collection of resources that is transformed into products demanded by consumers.
- The cost of production depends on the level of technology.
- The price of goods and services sold depends on the structure of the market.

Economic Goal of the Firm

- The principal objective of the firm is to maximize its profits.
- Other goals
  - Market share maximization
  - Revenue growth
  - Return on investment
  - Technology
  - Customer satisfaction

Economic Goal of the Firm (Cont'd)

- Different goals will lead to different managerial decisions given the same amount of limited resources.
- The optimal decision in managerial economics is one that brings the firm closest to its goal.

- Provide a good place for our employees to work.
- Provide good products/services to our customers.
- Act as a good citizen in our society.

Is There a Conflict Between Profit-Maximization and Noneconomic Objectives?

- No!
- Satisfied workers tend to be more productive.
- Satisfied customers tend to be more loyal.
- Social goals will create goodwill and ultimately potential sales.

- It is relatively easy to accomplish profit maximization for very short periods of time (e.g. one year).
- For a business organization that is expected to operate into the infinite future, profit maximization for one period may prove to be an incomplete goal.

Maximizing the Wealth of Stockholders (The “Finance” View)

- Since the firm is expected to operate infinitely into the future,

  while determining the goal of the firm,

  take into consideration the stream of earnings over time

  instead of the “day-to-day” look of profit maximization.

- Evaluate the stream of expected earnings over the life of the firm.
- Take into account the time value of money.
- Take into account the risks associated with the stream of earnings.

Maximizing the Wealth of Shareholders (Cont'd)

- Value of the firm today is equal to the present value of the stream of earnings that the stockholders expect to earn from this firm in the future.

$$V = \frac{CF_1}{(1+k)^1} + \frac{CF_2}{(1+k)^2} + \ldots + \frac{CF_n}{(1+k)^n}$$

Maximizing the Wealth of Shareholders (Cont’d)

- **V** is the value of the firm today.
- **CFs** are the cash flows stockholders expect to receive from the firm.
- **k** is the discount rate applied in order to find the present value of the future stream of earnings;
  - **k** represents the risks involved in the stream of cash flows.

Why Do We DISCOUNT the Stream of Cash Flows?

- The value of money depends on time (the time value of money).
- One lira/dollar received next month is less valuable than one lira/dollar received today.
- By simply investing the lira/dollar in hand today, we can receive a sum greater than one lira/dollar next month.

What is k?

- k is the **discount rate**.
- k represents the amount of return the stockholders want to receive from their investment in the firm.
- Stockholders want this return as a compensation for assuming risk by investing in the firm.

What are the risks associated with investing in a firm?

- Business Risk
  - Variation in returns due to the ups and downs of the economy, the industry and the firm.
    - Uncertainty about demand (unit sales).
    - Uncertainty about output prices.
    - Uncertainty about input costs.

- Financial Risk
  - Variation in returns due to borrowing done by the firm.
    - Additional business risk concentrated on common stockholders when the firm borrows from outside creditors.
    - The creditors of a firm get paid before everybody else.
    - If a firm has FIXED DEBT OBLIGATIONS to pay on a periodic basis, then the stockholders will be uncertain about the income that will be left for distribution.