CHAPTER ONE

INTRODUCTION TO MANAGERIAL ECONOMICS

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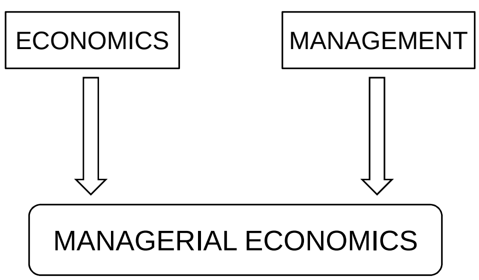
Economics and Managerial Decision Making

- **Managerial economics is one of the most important and useful courses.**
- **It will provide you with a foundation of a theoretical framework for studying other courses in finance, marketing, operations research, and managerial accounting.**
- **From its name, managerial economics is a combination of two words: economics and management.**



- **Economics is the study of how best people (firms, societies) make their choices to allocate their scarce resources among competing uses of production, distribution, and consumption of goods and services.**
- **Management is the discipline of organizing and allocating firm's scarce resources to achieve its desired objectives.**
- **It involves the ability to organize and administer various tasks in pursuit of certain objectives.**

- **We can combine these two terms and define managerial economics**
- **Managerial economics (ME)is the study of how managers can apply economic principles and analyses as well as quantitative tools in making an effective (optimal) business and managerial decisions involving the best use (allocation) of the organizations' scarce resources to achieve their objectives.**

WHY DO WE STUDY MANAGERIAL ECONOMICS?

1.To provide students with a basic understanding of the economic theory and analytical tools that can be applied in real life decision making problems facing the managers of private, public, and not-for-profit organizations.

2.To show students how to combine the scarce economic resources of a business so that these resources are allocated in the most efficient manner and to enable them to maximize the value of their enterprise.

MANAGERIAL ECONOMICS and OTHER BUSINESS DISCIPLINES

- Managerial Economics is essentially a course in applied microeconomics that includes selected quantitative techniques such as:

1. Regression Analysis and Forecasting,
2. Linear Programming,
3. Capital Budgeting,
4. Break-Even Analysis,
5. Relevant and Incremental Cost Analysis,
6. Structure-Conduct-Performance Analysis.

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Important Questions in Managerial Decision Making Process

- In making key business decisions, managers must answer the following questions:

1. What are the microeconomic conditions in a particular market?

These questions might include:

a. Market Structure (number of firms competing with one another),

b. Market Supply and Demand Conditions (elastic or inelastic, how to increase demand),

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c. How consumer behavior affects revenues

d. How the available technology affects production,

e. How input prices affect costs,

f. Government Regulations,

g. International Dimensions,

h. future Conditions,

i. Whether entry into the market is easy or difficult,

j. Amount of information available to market participants

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2. What are the macroeconomic factors?

a. Gross Domestic Product (GDP)

b. Factors affecting macro spending behavior

c. Changes in consumption and investment behavior of private individuals

d. New directions of a country's monetary or fiscal policies

e. Developments occurring internationally that affect domestic economy

- Changes in the macro environment affect individual firms and industries through the microeconomic factors of demand, production, cost, and profitability.

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3. Should our firm be in this business?

- The answer to this question is based one the previous two questions

4. If so, what price and output levels achieve our goals (of maximizing profits or minimizing costs?)

- This requires a careful study of the current market structure and demand components and sensitivity as well as the firm's production capacity

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5. How can we maintain a competitive advantage over our competitors? (by organizing and investing in the organization's resources)

a. Cost-leader? (A business strategy where a firm becomes the low cost producer in the industry)

b. Product Differentiation (whether products sold are differentiated or undifferentiated)

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c. Market Niche? (A targetable subgroup within a market segment distinguishable from the rest of the market by certain characteristics)
d. Outsourcing, alliances, mergers, acquisitions?
e. International Dimensions?

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6. What are the risks involved?

- Risk can be defined as the chance or possibility that outcomes of an action will turn out to be worse than expected
- In economic or financial theory, the two terms risk and uncertainty have somewhat different meanings, even though they are often used interchangeably.
- Although no future events are known with certainty, some events can be assigned probabilities, and other cannot.

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- Where future events can be defined and probabilities assigned, we have a case of risk.
- If there is no way to assign any probabilities to future random events, we are addressing pure uncertainty.
- Even though this distinction is theoretically important, many writers omit it as a matter of convenience.

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- There are many types of risk that business face such as:

1. Changes in demand and supply conditions
2. Technological changes and the effect of competition
3. Changes in interest rates and inflation rate
4. Exchange rates for companies engaged in international trade
5. Political risk for companies with foreign operations

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Steps for Managerial Decision Making:

1. Defining the goals of the organization
2. Identifying problems and opportunities
3. Analyzing alternatives from which choices can be made (Choosing alternatives always have costs and benefits)
4. Making choices that are best from the standpoint of the firm or organization (Optimal choice)
5. Comparing actual and targeted performance, and defining any problems.
6. Implementation and monitoring the remedial actions.

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Other considerations for a manager to keep in mind

1. The firm must minimize cost for each level of output
2. The anticipated objective of management is to increase the firm's value
3. The firm must develop a strategy consistent with its market structure
4. The firm's value is measured by its expected profits
5. The firm's growth depends on rational investment decisions
6. Successful firms deal rationally and ethically with laws and regulations

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THE ECONOMICS OF A BUSINESS

- The economics of a business refers to the key factors that affect the ability of a firm to earn an acceptable rate of return on its owners' investment.
- The most important of these factors (microeconomic conditions) are

1. Competition: how the market environment influences their ability to set prices and responds to competitors
2. technology: how production technology and input prices affect costs

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3. Customers: how consumer behavior affects revenue

- To understand the impact of changing economic conditions on an established firm we will study it within a framework of "four-stage model" of change
- The "four-stage model" shows how changing economic conditions affect well-established firms.

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Stage I: Cost Plus

- "The good old days".
- This refers to the ability of a well-established firm to dominate the market and control the price (kind of monopoly).
- It marks up its costs to achieve high profit margins (cost-plus pricing).

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Stage II: Cost Management

- Stage II occurs when changes in technology, competition and customers put downward pressure on a company's profit margins and market share.
- The company seeks refuge in cost management through cost cutting, downsizing, restructuring, and reengineering in response to these changes.
- Markets now are highly competitive.

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- In this stage the firm is most likely to contemplate the nature of its production methods and cost behavior and assess the current level of competition
- But continual focus on cost had its limits in the ability of increasing profits. Firm must go to stage III.

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Stage III: Revenue Management

- Because of the limits to the growth in profits, company tries to shift its focus from cost management to revenue management.
- Firms in stage III focus on narrowing product lines to those offering the greatest revenue potential.
- The focus is on "top-line growth" (which means the increase in gross sales or revenues).

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- **Although the company may have reaffirmed its ability to grow its top line, there is a question about its ability to grow in a profitable manner.**
- **Thus, stage IV becomes a necessary part of a company's full recovery from the impact of changing economics.**

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Stage IV: Revenue Plus

- **Company strives for profitable growth (revenue-plus).**
- **The firm in this stage will continue to increase its revenue but with more focus on profit.**
- **It is a necessary part of the company's full recovery from changing economics.**
- **The "four-stage model" shows how managerial economics is concerned on whether or not a potential market is penetrable and profitable to the firm.**

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APPENDIX 1

REVIEW OF ECONOMIC TERMS

- **Microeconomics Vs. Macroeconomics**
- **Scarcity and Opportunity Cost**
  - **Economic Goods Vs. Free Goods**
  - **marginal or incremental approach**
  - **optimization**
  - **Allocation decision**
- **Resources (Factors of Production)**
- **Society: What, How, and For Whom**

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Firm: What, How, and For Whom

What:

- **It is a production decision.**
- **The firm should produce whatever is profitable given the demand for these products and the cost of using scarce resources.**
- **With these conditions, a firm may decide to provide new or different goods and services or to stop producing a particular good or service.**

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How:

- **It is about the best (optimal) combination of scarce resources to produce maximum output in the least costly way.**
- **It is about the most economically efficient combination of inputs (cost effective mix, hiring, staffing, procurement, and capital budgeting decisions).**

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For Whom:

- **It is about firm's policy toward market segmentation.**
- **The output of goods and services should be allocated to whomever is willing and able to pay for them.**
- **Of course, the ability to pay depends on the distribution of income and wealth.**
- **The nature of the product, its quality, and the firm pricing and marketing policies normally determines which segment of the society will be able to get the product.**

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- **Although firms mainly are market oriented we can apply the command and traditional process to them.**
- **There are essentially five ways a country can answer these questions:**

1. Market process (Mechanism):
2. Command Process (Mechanism):
3. Mixed Process (Mechanism):
4. Islamic Process (Mechanism):
5. Traditional Process (Mechanism):

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Economic Models

- **An economic model is a simplified representation of reality, often using diagrams or equations that show how variables interact.**
- **An economic model has two components: assumptions and implications**
- **Managers formulate models and then use them to: (1) explain and predict the behavior of different variables and (2) design and evaluate the proper policies.**

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Entrepreneurs versus Managers

- **Entrepreneurship is the willingness to take certain risks in the pursuit of goals. It is broadly defined to include management.**
- **Entrepreneur is the owner and innovator who initiates new investment projects, brings resources together, and is willing to take certain risks associated with this new business activity.**

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- **Manager is the individual who is in charge of organization and allocation of scarce resources in order to achieve the firm's objective.**
- **Ideally, the successful manager or entrepreneur should have both capabilities.**

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