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MARÍA TERESA FREIRE

THE ANALYSIS OF ECONOMIC ENVIRONMENT

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The Analysis of Economic Environment

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BUSINESS&**MARKETING**SCHOOL

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Introduction

When analysing the economic environment, whatever our field of study is, the approach should be directed to the understanding of the framework in which our activities are taking place, and therefore, knowing to what extent the issues such as the economic situation of the country, the functioning of the markets or the value of the CPI influence decision-making within the company.

We will begin with the most detailed analysis of the economy, that is, the microeconomic analysis, in order to see how the markets of goods and services work, where the individual decisions of buyers and producers take place and how both reach an agreement based on the price mechanism. Once the criteria for individual economic decisions have been defined, we will move on to describe how the main economic problems are measured at an aggregated level, that is, at the macroeconomic level, to see how to calculate the inflation rate; the unemployment rate and the growth rate of an economy. Next, we will carry out an economic analysis with direct references to the case of Spain to see how the country achieves economic growth and establishes production factors, economic sectors and institutional aspects determining economic growth. Finally, and within the framework of current globalization and increasing internationalization of economic relations, we will review the main issues and problems of the current international economy.

To start with the analysis of economic decision-making, we will begin by raising some basic questions in order to understand the economic reasoning and will propose the definition of "economics", which will serve as the starting point for the analysis of the economic environment.

1
Definition of Economics

Let us start by giving a definition of economics that tries to encompass the most prominent aspects in the presentation of the economic activities and includes basic concepts when taking any decision from the economic point of view.

Economy is a social science that studies human behaviour in a world of scarce resources where it is necessary to use these resources appropriately in order to achieve the greatest possible well-being at all times.[1]

Let us analyse this definition in detail, based on the concepts that we can derive from it:

Economics studies human behaviour: studying human behaviour implies that economics ***is a social science***, which means that we study humans making decisions from an economic point of view. In this sense, it coincides with other sciences such as psychology or sociology, which also study human behaviour from other perspectives.

We appeal to rationality: We assume that **an individual is rational**, that is, that he/she is consistent when making decisions and that

[1] Cuerdo, M. y Freire, M. T. (2008): *Introducción a la microeconomía. Comportamientos, intercambio y mercados.* 3rd ed., revised and updated, ESIC Editorial, Madrid.

he/she is guided by the criteria of logic and reason. In short, we assume that an individual behaves according to social norms and thinks before making decisions while being responsible for the consequences at the same time.

When making decisions, ***people seek the greatest satisfaction for the least possible sacrifice***: As in any aspect of our life, an individual constantly has to choose from different options that are given to him/her: "What do I buy?"; "How much money do I spend?"; "How many hours do I have to work?" and such. Therefore, an individual has to assess each option and choose the one that interests him/her most. This choice is fundamental since all the economic theories look at the criteria for each option and how to choose the best option from all. As a general rule, whatever we are evaluating, we always choose the option that involves the lowest **Opportunity Cost**, meaning the cost that we pay when loosing or giving up on something when preferring one option over another one. In short, whenever we choose something we bear a cost, since we always give up something. Therefore, the criterion must be established that when making a decision we choose the option which involves the lowest opportunity cost.

A limited set of means *is used according to their own criteria*: which is another of the basic premises of economics, concretely, the means we have at the time are always limited (e.g. money which I need to buy something, the number of workers I need to produce something, etc.). There are always some limited means (e.g. money, production factors, etc.), to fulfil unlimited human desires. For example, if we did not have any money restriction and had to write down what we would like to buy, that list would never end. However, there are always some limitations: the amount of money available to each individual to buy and the most scarce good that exists and which is, therefore, the most limited one: time. We must bear in mind that each individual values things differently and for that reason, and based on the limitation of the means, each individual according to "his, or her own criteria", chooses where to allocate those limited means.

We have to choose from an unlimited amount of concrete objectives: Every choice must have a clear objective towards which all decisions are directed, where as a general criterion and whatever the economic sphere is (e.g. consumption; production; etc.) in which we are deciding, we have to always ***look for the option which satisfies us most and which presupposes the lowest possible opportunity cost***.

In short, we can summarize all of the above by saying that people set economic goals to reach a desired objective when incentives are put into action as a clear signal of what people are willing to do to achieve a particular thing. For this reason, we set the value of things based on what we sacrifice to obtain them, or what is the same, we express the value of the objective to be achieved in accordance with the objective to be renounced. To sum it up, we can say that the value of goods in economics is basically a relative concept.

2

Economic Agents

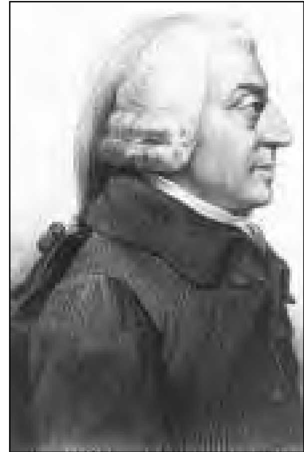
To analyse different economic agents, which means the individuals who make economic decisions, we are going to establish a simile between economics and theatre. Concretely, we are going to devise a play in which each actor plays a different role depending on the type of decisions he, or she makes. In this way, we will define different economic agents.

The stage in our case will be the market economy, a society characterized by the set of complex relations based on the freedom of entry and exit of institutions in which individuals, also freely, obtain what they want by renouncing what they are asked for in return. This is a free market, where individuals can choose whatever they want and where there exists competition between individual agents.

When we speak about the **market**, we refer to the place where people who participate in an economic activity meet and interact freely. It is therefore an institution where people inform each other about what they want to obtain (buy; sell, etc.) and what they are willing to give in return. That is why it is on the market where the **exchange** occurs, where the agents reach an agreement on their assessment of what they want and what they are willing to give for it. Simply, when they agree on the **price** of the product in question.

The actors are the individuals themselves or the institutions which act according to their own criteria, which are limited by the use of resources available to them. Such are the **consumers** whose role is to buy goods and services they want and for which they pay money in return. This money that the consumer uses to buy something is called *Income*. The objective of the consumers is to buy on the market in such a way that they reach the highest possible satisfaction for paying the lowest possible *price* (or buy the cheapest possible thing). On the other hand, there are **entrepreneurs or producers** who produce new goods and services requested by consumers. Finally, there is another actor of great importance: **the state**, which is the institution responsible for supplying certain goods and services alternatively to the business sector, based, generally, on the peculiar characteristics which their goods and services represent (e.g. defence; education; health, etc.). The free market economy stands for the minimal intervention of the state in the economy whose main function must be to safeguard the stability of the institutions and to protect the economic environment in which these exchanges take place.

The director of this market economy is **the invisible hand**, defined by Adam Smith (1723-1790), the "father of economy",[2] as the ability to get all the actors (consumers and producers) act according to their role in order to support the play (exchange) without any intervention (the state) into their performance (free market).



Adam Smith.

[2] Adam Smith is considered to be the ideological father of economic liberalism who summarizes all his economic knowledge in the work *An Inquiry into the Nature and Causes of the Wealth of Nations* (*The Wealth of Nations*) published in 1776. In turn, he was the master of the Classical School (eighteenth and nineteenth centuries) which is the basis of the whole modern economy, and which includes authors such as: T. R. Malthus, D. Ricardo, J. S. Mill and others.