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CORE CONCEPT OF BUSINESS ECONOMICS

General Equilibrium

General equilibrium analysis is a widespread study of a number of economic variables, their interconnections and inter-reliance for sympathetic operations of the economic structure as a whole. It fetches mutually the grounds and consequent series of changes in prices and volume of products and services in association to the entire financial system. A financial system can be in general equilibrium only if all customers, all firms, all industries and all factor-services are in equilibrium concurrently and they are interrelated through product and factor cost. It subsists when all cost are in equilibrium each customer expends his given earnings in a mode that yields him the utmost satisfaction all firms in each industry are in equilibrium at all prices and productivity and the supply and demand for productive resources are at equal at equilibrium prices.

BREAKING DOWN 'Economic Equilibrium '-

The equilibrium price is where the supply of goods matches demand. When a major index experiences a period of consolidation or sideways momentum, it can be said that the forces of supply and demand are relatively equal and that the market is in a state of equilibrium.

Theory of Consumption-

There are many different theories on income and consumption behavior, and we will focus on some of the more mainstream concepts in consumption theory. The three most important theories of consumption are as follows: 1. Relative Income Theory of Consumption 2. Life Cycle Theory of Consumption 3. Permanent Income Theory of Consumption.

Relative Income Theory of Consumption: An American economist J.S. Duesenberry put forward the theory of consumer behaviour which lays stress on relative income of an individual rather than his absolute income as a determinant of his consumption. Another important departure made by Duesenberry from Keynes's consumption theory is that, according to him, the consumption of a person does not depend on his current income but on certain previously reached income level.

According to Duesenberry's relative income hypothesis, consumption of an individual is not the function of his absolute income but of his relative position in the income distribution in a society, that is, his consumption depends on his income relative to the incomes of other individuals in the society. For example, if the incomes of all individuals in a society increase by the same percentage, then his relative income would remain the same, though his absolute income would have increased.

According to Duesenberry, because his relative income has remained the same the individual will spend the same proportion of his income on consumption as he was doing before the absolute increase in his income. That is, his average propensity to consume (APC) will remain the same despite the increase in his absolute income.

Life Cycle Theory of Consumption: An important post-Keynesian theory of consumption has been put forward by Modigliani and Ando which is known as life cycle theory. According to life cycle theory, the consumption in any period is not the function of current income of that period but of the whole lifetime expected income. Thus, in life cycle hypothesis the individual is assumed to plan a pattern of consumption expenditure based on expected income in their entire lifetime. It is further assumed that individual maintains a more or less constant or slightly increasing level of consumption.

However, this level of consumption is limited by his expectations of lifetime income. A typical individual in this theory in his early years of life spends on consumption either by borrowing from others or spending the assets bequeathed from his parents. It is in his main working years of his lifetime that he consumes less than the income he earns and therefore makes net positive savings. He invests these savings in assets, that is, accumulates wealth which he consumes in the future years. In his lifetime after retirement he again dis-saves, that is, consumes more than his income in these later years of his life but is able to maintain or even slightly increase his consumption in the lifetime after retirement.

Permanent Income Theory of Consumption: Permanent income theory of consumers' behaviour has been put forward by a well-known American economist, Milton Friedman. Though Friedman's permanent income hypothesis differs from life cycle consumption theory in details, it has important common features with the latter. Like the life cycle approach, according to Friedman, consumption is determined by long-term expected income rather than current level of income.

It is this long-term expected income which is called by Friedman as permanent income on the basis of which people make their consumption plans. To make his point clear, Friedman gives an example which is worth quoting. According to Friedman, an individual who is paid or receives income only once a week, say on Friday, he would not concentrate his consumption on one day with zero consumption on all other days of the week.