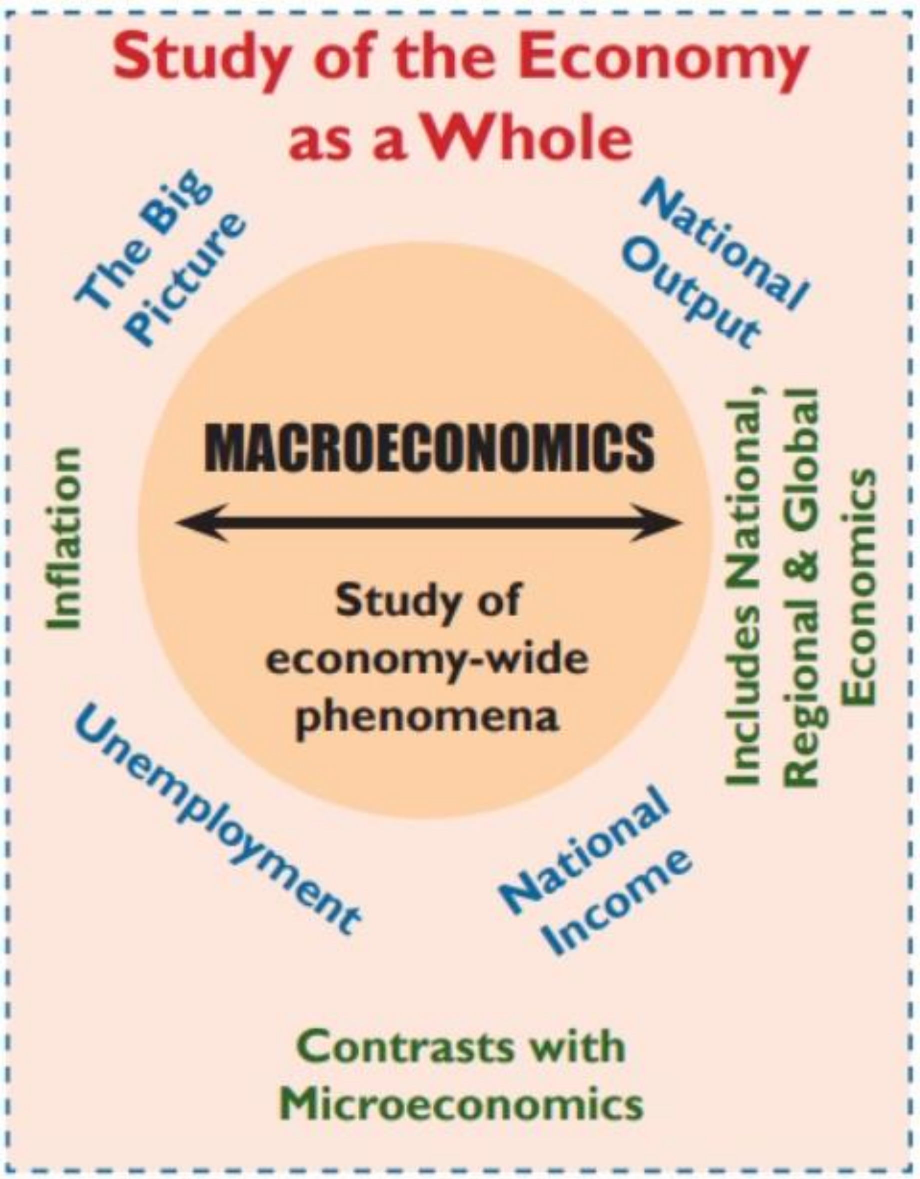
Chapter 03

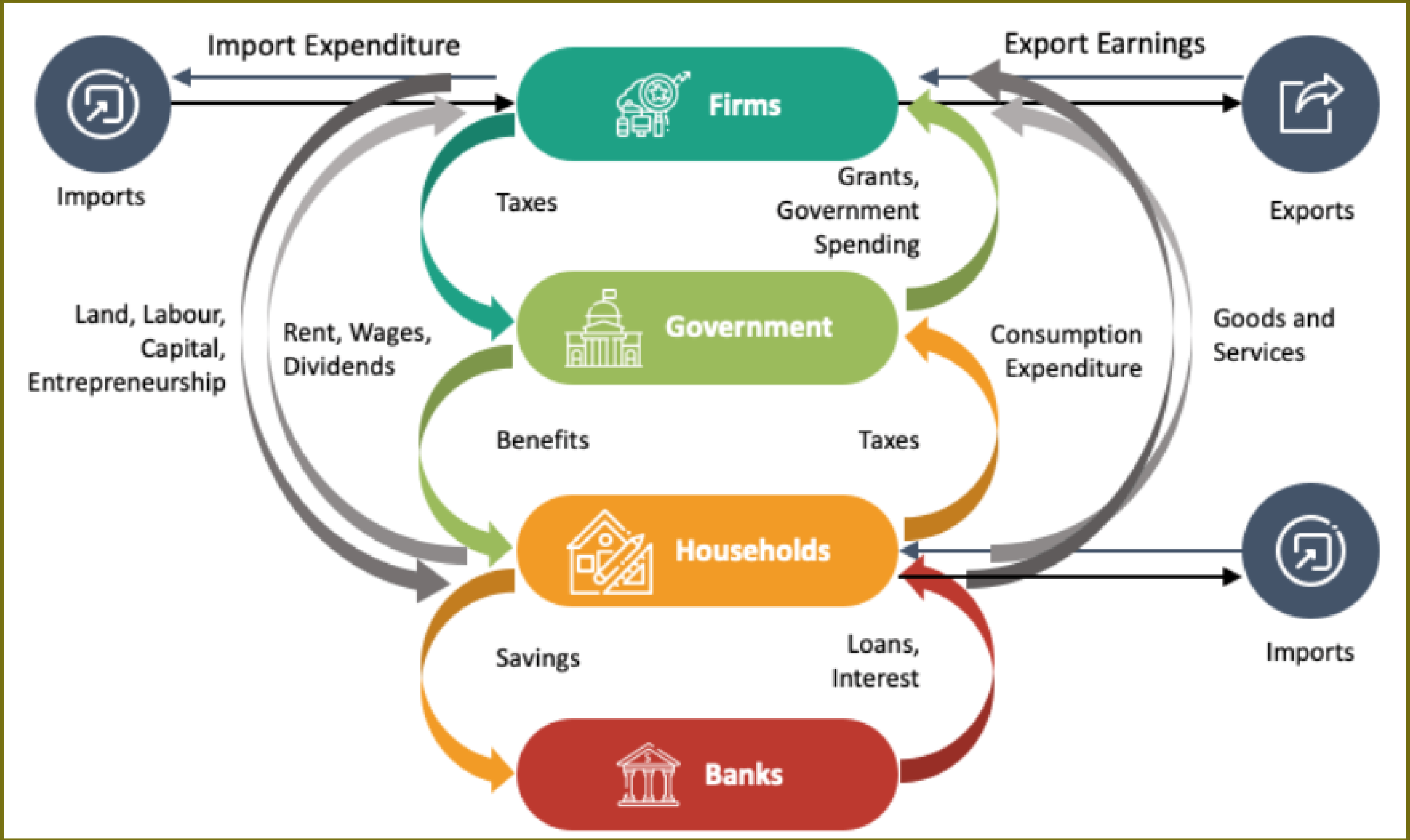
MACRO ECONOMICS CONCEPTS

CONCEPTS OF ECONOMICS

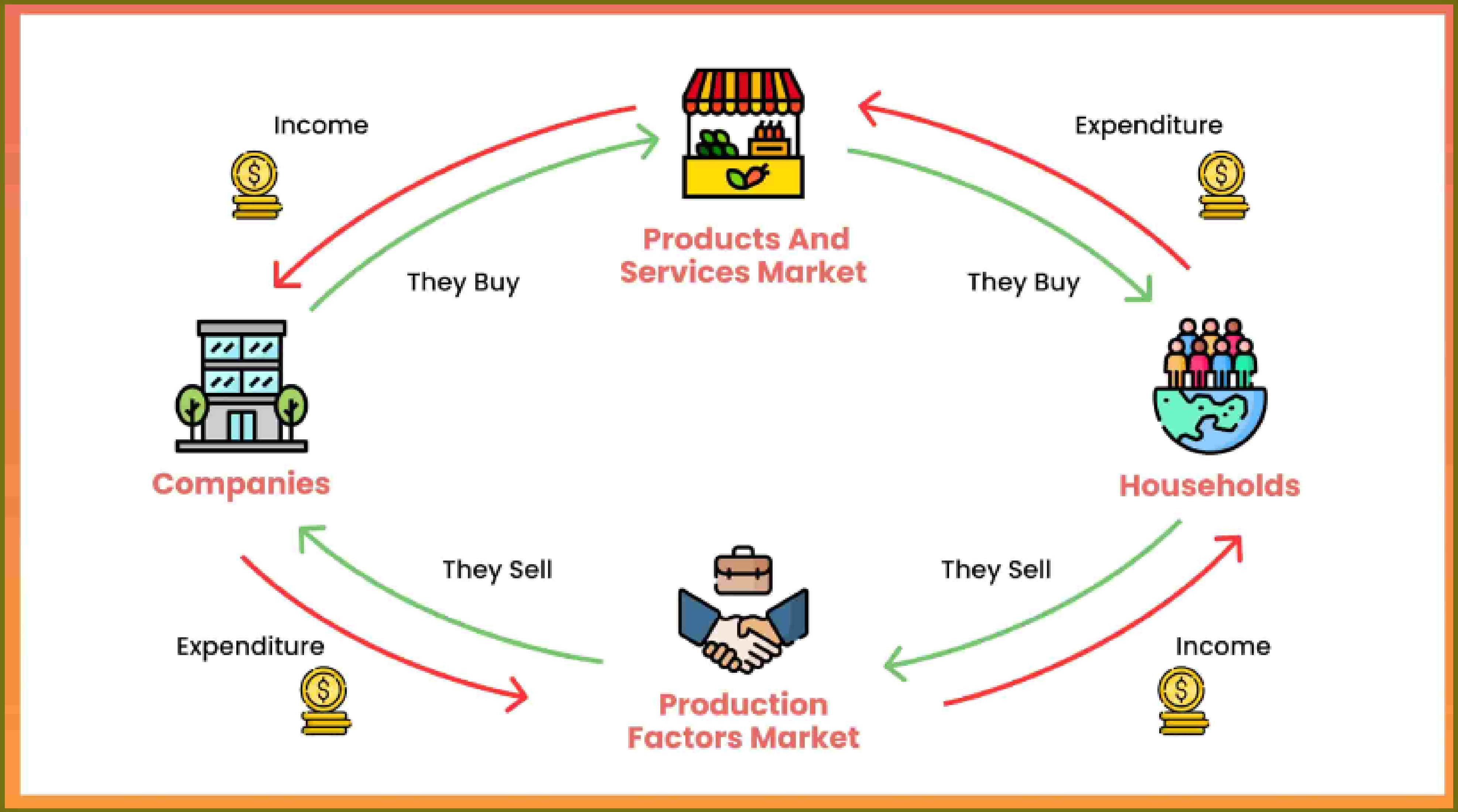
Introduction



Components of Macroeconomics



Circular Flow of Economy



Macroeconomic Concerns

Economic Growth

[redacted] create opportunities for and sustain the growth of economies. The goal of economic growth is not to create more stuff but to improve people's standard of living.

Unemployment

Reducing the economic and social impact of "involuntary" unemployment. Economists view involuntary unemployment as a waste of resources - it is time that is wasted.

Inflation

Control the rate at which money loses its value in terms of its purchasing power. Inflation robs people of the value of their money and investments.

Fundamental Concepts

1. National Income

Gross Domestic Product (GDP)

Gross Domestic Product (GDP) - GDP is the value of all the final goods & services produced within the domestic territory of a country irrespective of the person producing it.

Nominal GDP
(Current prices)

There is a distortion because it includes both goods and prices, it lacks accuracy.

Real GDP
(Constant prices)

It eliminates the distortion of price variations or inflation. It shows the real increase in production.

1. National Income

Gross Domestic Product (GDP)

In 2019 he makes 4 chair and price per chair is Rs. 1000.00

So total value he made= 4X1000=Rs. 4000.00

GDP in 2019= Rs. 4000.00

In 2020 he makes 3 chair and price per chair is Rs. 3000.00

So total value he made= 3X3000=Rs. 9000.00

GDP in 2020= Rs. 9000.00

Base Year 2019

Real GDP in 2019= Rs. 4000
Nominal GDP in 2019= Rs. 4000

Real GDP in 2020= Rs. 3000
Nominal GDP in 2020= Rs. 9000

1. National Income

Net Domestic Product (NDP)

- **Net domestic product (NDP):** GDP less depreciation.

$$\boxed{\textbf{NDP} = \textbf{GDP - Depreciation}}$$

- When we produce, we wear out some of our capital, which must be replaced.
  - Depreciation measures the value of capital we use up.
- NDP is the amount of output we could consume without reducing our stock of capital.

1. National Income

Gross National Product (GNP)

Gross National Product (GNP) - GNP is the value of all the final goods & services produced by the citizen of a country irrespective of where they are being produced.

GNP is equal to

GDP

+

Factor Payments From Abroad

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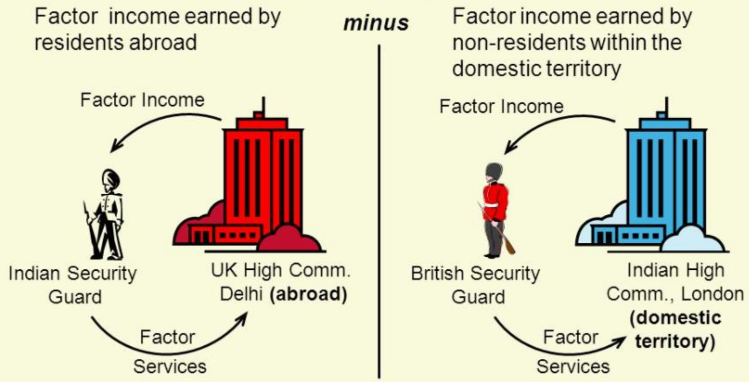
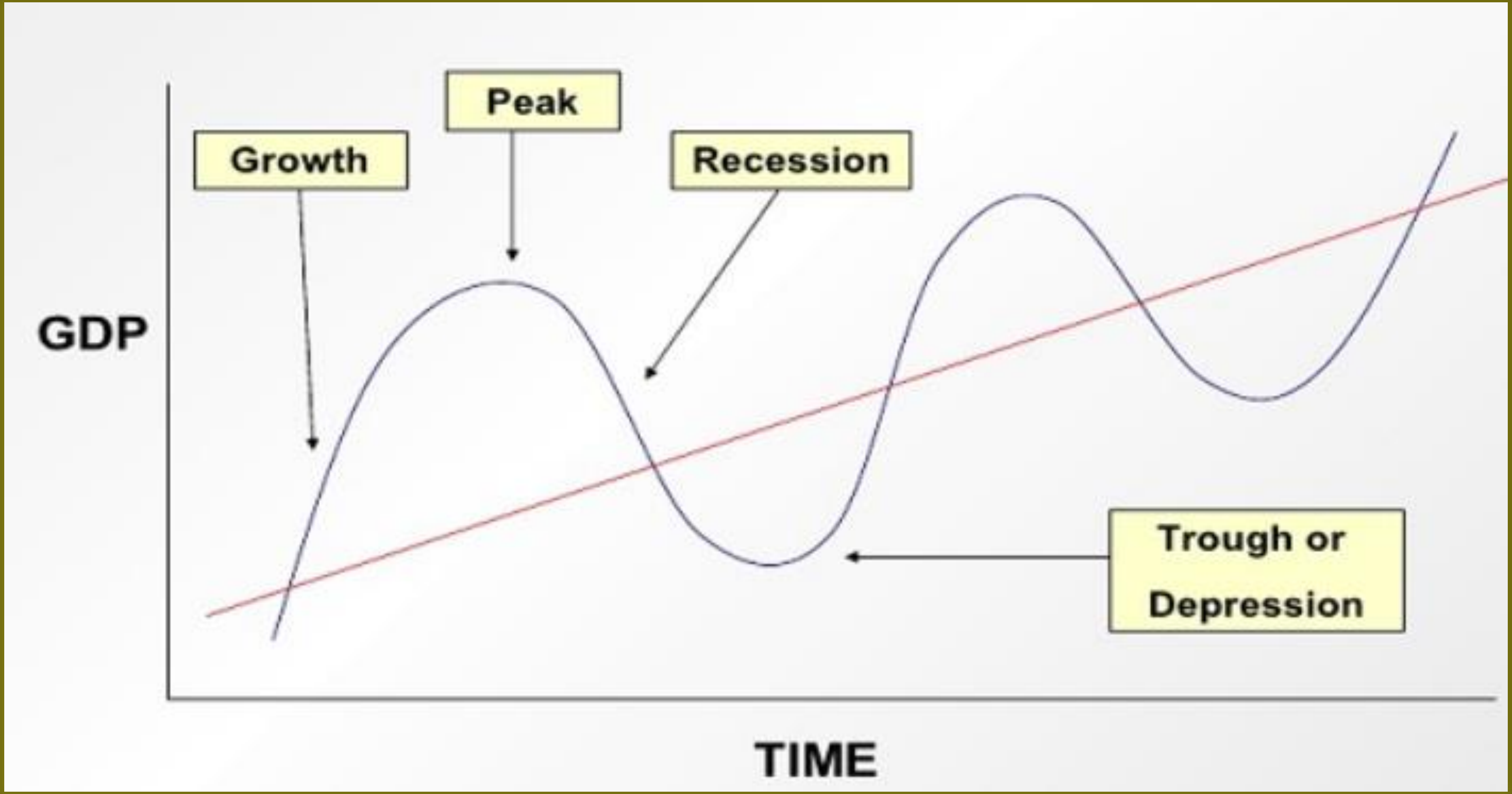
Factor Payments to Abroad

Net factor income from abroad (NFIFA)

✦ NFIFA = Factor income earned by residents abroad - Factor income earned by non-residents in the domestic territory



2. Business Cycle

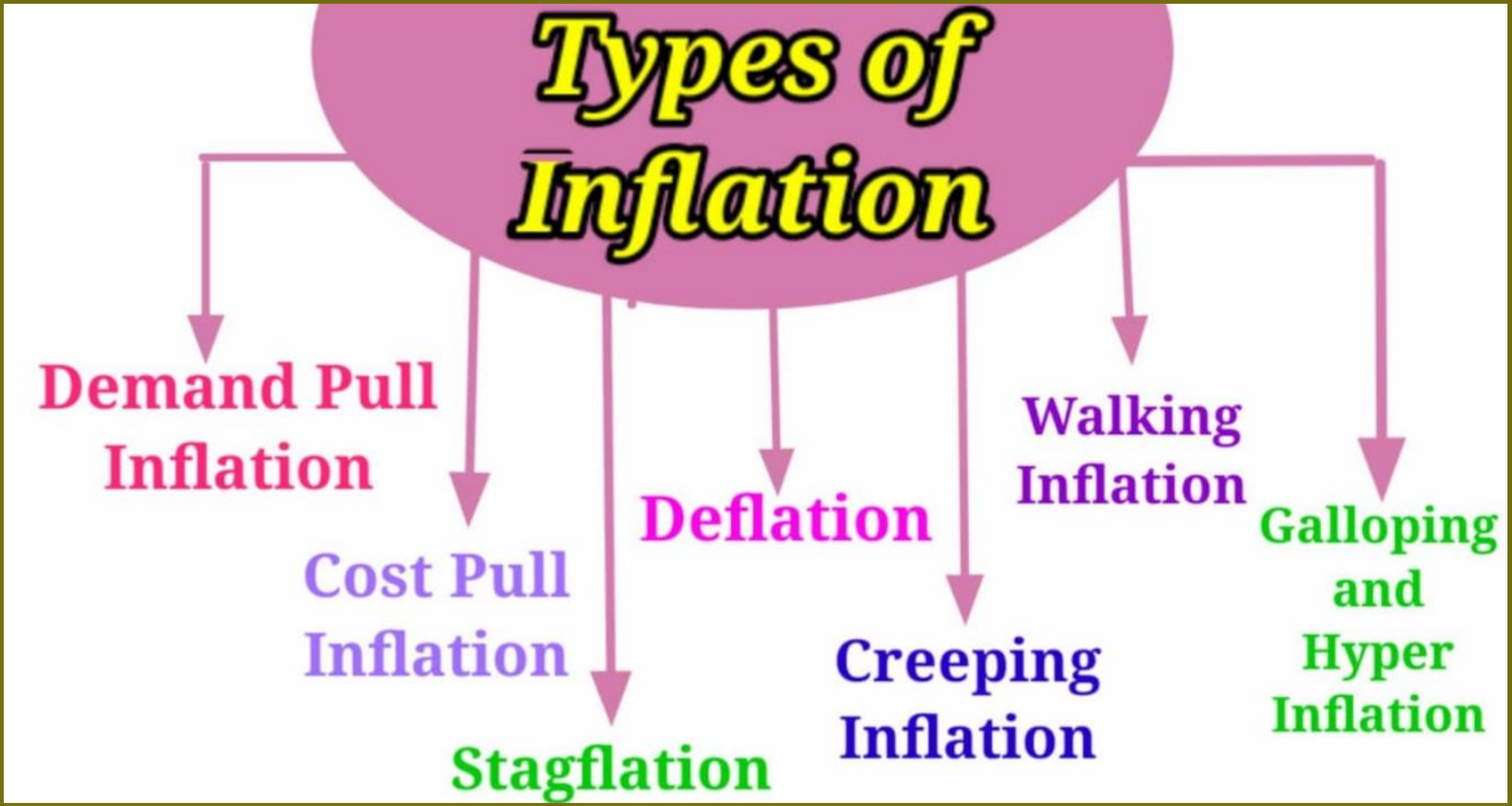


3. Inflation

- Inflation is defined as a sustained increase in the price level or a sustained fall in the value of money.
- To quantify the amount of inflation in the economy, indicators such as the Wholesale Price Index, the Consumer Price Index are used.
- It measures the changes in prices that have occurred between the base year and the current year.

$$\text{Rate of inflation } t = \frac{P_t - P_{t-1}}{P_{t-1}} \times 100$$

3. Inflation



Types of Inflation
Demand Pull Inflation
Cost Pull Inflation
Stagflation
Deflation
Creeping Inflation
Walking Inflation
Galloping and Hyper Inflation

3. Types of Inflation

Deflation

State in which the price are falling and thus purchasing power of money is increasing.

Creeping Inflation

Annual price rise varies between 2% and 3%. It also known as mild-inflation.

Walking Inflation

Rate of annual price increases lies between 3% and 4% then we have a situation of walking inflation.

3. Types of Inflation

Galloping Inflation

Prices rise at 20%-100% rates per annum. It tends to distort relative prices and results in disquieting changes in distribution of purchasing power of different groups of income earners.

Hyper Inflation

Thousand or a million or even a billion per cent per year.
Prices and money supply rise alarmingly.
Germany experienced hyper inflation during 1920-23.
Generally, a result of war, political revolution or some other catastrophic event.

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3. Types of Inflation

Demand Pull Inflation

It means to the phenomenon when prices consistently rises because demand is more than supply of goods and services. Too much money chasing too few goods.

Cost Push Inflation

Situation where price persistently rise because of growing factor costs.

Stagflation

Combine phenomena of demand pull and cost push inflation is called stagflation.

3. Types of Inflation

Money Supply - Demand Pull Theory

- Disposable income and consumer expenditures
- Reduction in direct or indirect taxation
- Depreciation in exchange rate

Business Outlays – Cost Push Theory

- Rising imported raw materials costs
- Rising labour costs
- Higher indirect taxes imposed by govt.

Monetary Policy

- Monetary policy is the process by which the monetary authority of a country controls the supply of money, often targeting a rate of interest for the purpose of promoting economic growth and stability.
- The term monetary policy refers to actions taken by central banks to affect monetary magnitudes or other financial conditions.
- Monetary Policy operates on monetary magnitudes or variables such as money supply, interest rates and availability of credit.
- Monetary Policy ultimately operates through its influence on expenditure flows in the economy.
- In other words, affects liquidity and by affecting liquidity, and thus credit, it affects total demand in the economy.

Credit Policy

- Central Bank (RBI) may directly affect the money supply to control its growth.
- It might act indirectly to affect cost and availability of credit in the economy.
- In modern times the bulk of money in developed economies consists of bank deposits rather than currencies and coins.
- RBI today guide monetary developments with instruments that control over deposit creation and influence general financial conditions.
- Credit policy is concerned with changes in the supply of credit.
- Central Bank administers both the Credit and Monetary policy

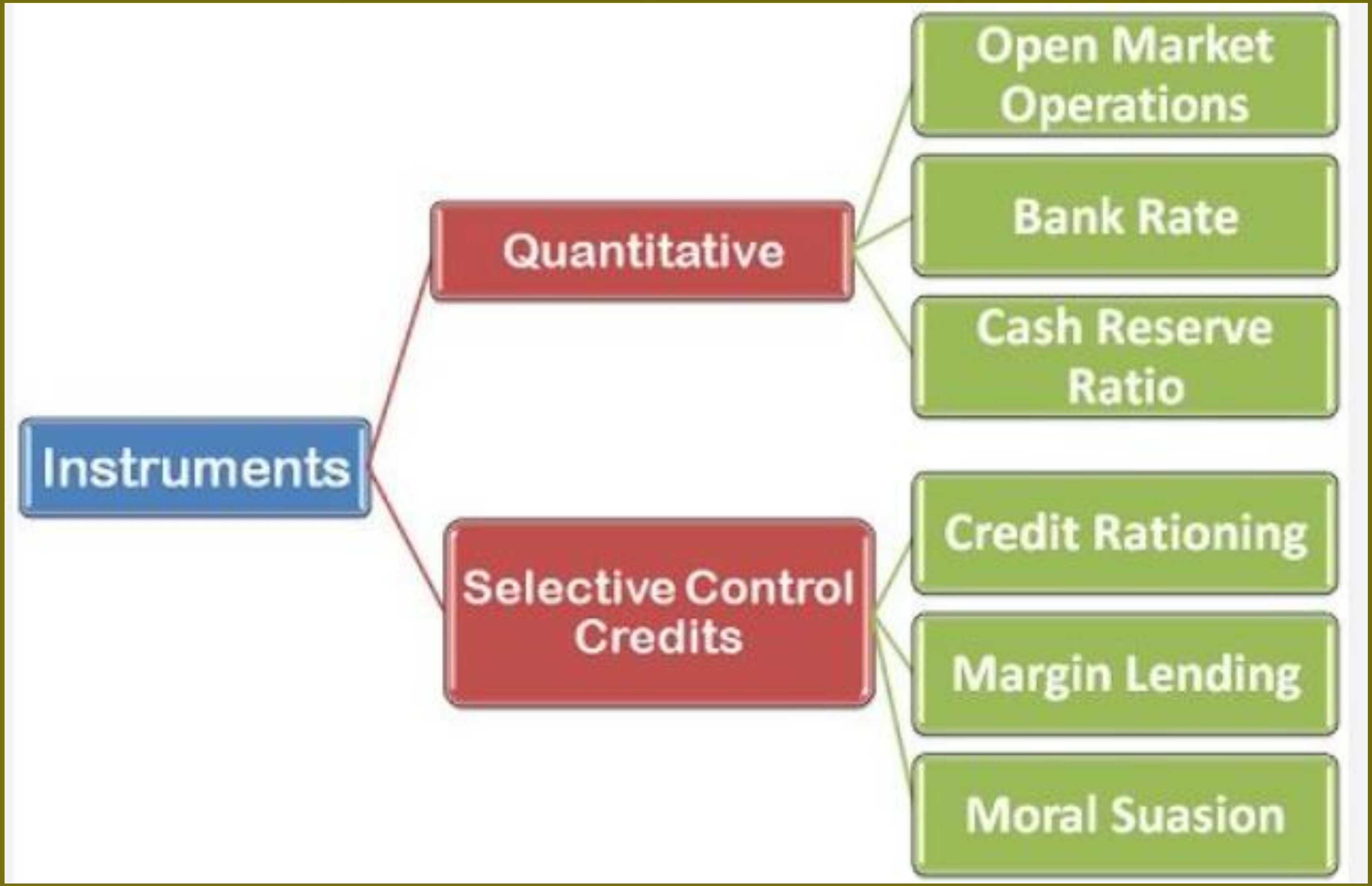
Aims

- ✓ Reasonable Price Stability
- ✓ Full employment
- ✓ Stable exchange rate
- ✓ Economic growth
- ✓ Greater equality in distribution of income & wealth
- ✓ Financial stability

Price Stability – The Dominant Objective

- ✓ Does not mean complete year-to-year price stability which is difficult to attain.
- ✓ Refers to the long run average stability of prices.
- ✓ Involves avoidance of both inflationary and deflationary pressures.
- ✓ Contributes improvements in the standard of living of people.
- ✓ Leads to interest rate stability, and exchange rate stability (via export import stability).
- ✓ Contributes to the overall financial stability of the economy.

Instruments of Monetary Policy



Monetary Policy - Instruments

1. Open Market Operations

- ✓ OMOs involve buying (outright or temporary) and selling of govt. securities by the central bank, from or to the public and banks.
- ✓ In times of inflation, RBI sells securities to mop up the excess money in the market. Similarly, to increase the supply of money, RBI purchases securities.

Monetary Policy - Instruments

2. Bank Rates

- ✓ Bank rate: Rate of interest charged by the central bank for providing funds or loans to the banking system.
- ✓ Raising Bank Rate raises cost of borrowing by commercial banks, causing reduction in credit volume to the banks, and decline in money supply.
- ✓ Market regards the increase in Bank rate as the official signal for beginning of a tight money situation.

3. Repo and Reverse Repo Rate

- ✓ Repo Rate: Rate at which the RBI lends to commercial banks by purchasing securities.

  Repo Rate loans are secured while Bank Rate loans are unsecured.

- ✓ Reverse Repo Rate: The reverse repo rate is the rate at which the RBI borrows funds from the country's commercial banks.
- ✓ It is the rate where the commercial banks in India park excess funds with the Reserve Bank of India, typically for a short period of time.

4. Reserve Ratio

- ✓ Cash Reserve Ratio: CRR is the percentage of money, which a bank has to keep with RBI in the form of cash.

- ✓ Statutory Liquidity Ratio: SLR is the minimum percentage of deposits that a commercial bank has to maintain in the form of liquid cash, gold or other securities.

Monetary Policy - Instruments

Selective Credit Controls

- ✓ Credit Rationing: RBI fixes a ceiling (maximum limit) on loans and advances of various categories, which the commercial banks cannot exceed. This controls the amount of credit for certain sectors and ensures that all sectors get adequate credit. Required for inclusive growth of all sectors.
- ✓ Margin Lending: Type of loan that allows you to borrow money to invest, by using your existing shares, managed funds and/or cash as security.
- ✓ Moral Suasion: Type of influencing procedure which is applied by Central Banks to keep the pressure on commercial banks in order to abide by the monetary policies that are established. It is carried out by transferring speeches, seminars and meetings.

Fiscal Policy

- ✓ The word fisc means 'state treasury' and fiscal policy refers to policy concerning the use of 'state treasury' or the govt. finances to achieve the macroeconomic goals.
- ✓ "Any decision to change the level, composition or timing of govt. expenditure or to vary the burden, the structure or frequency of the tax payment is fiscal policy."
- ✓ The two main instruments of fiscal policy are government expenditure and taxation.

Fiscal Policy and Macro Economic Goals

- ✓ Economic Growth: Creating conditions for increase in savings & investment.
- ✓ Employment: Encouraging the use of labour- absorbing technology
- ✓ Stabilization: Fight with depressionary trends and booming (overheating) indications in the economy
- ✓ Economic Equality: Reducing the income and wealth gaps between the rich and poor.
- ✓ Price Stability: Employed to contain inflationary and deflationary tendencies in the economy.

Fiscal Policy

- ✓ Aggregate demand, which is the total demand for goods and services in the economy, depends on three main variables - consumption, private investment and government spending.
- ✓ When the government increases its expenditure then it spurs the aggregate demand in the economy.
- ✓ A higher aggregate demand in turn will stimulate output, growth and employment.
- ✓ Whereas if the government lowers it's spending then it decreases the aggregate demand and hence slows down the growth of the economy.

Fiscal Policy

- ✓ When Govt. makes use of its revenue and expenditure programmes and affects the aggregate level of demand for goods and services in the economy, then this action is essentially known as fiscal policy. (Union Budget)
- ✓ Related to fiscal policy are deficits and surpluses. When the government's expenditure exceeds its revenue, then there is a fiscal deficit and the opposite of this is known is fiscal surplus. Government should cut taxes and increase spending to bring the economy out of a slump, this kind of a policy action is known is expansionary fiscal policy.
- ✓ Govt. should increase taxes and cut expenditure to bring the economy out of inflationary pressure, that is, it should follow a contractionary fiscal policy.