Module 4 Macroeconomic Concepts

Syllabus

- Circular flow of economic activities – Stock and flow – Final goods and intermediate goods –
- Gross Domestic Product - National Income – Three sectors of an economy- Methods of measuring national income –
- Inflation- causes and effects – Measures to control inflation Monetary and fiscal policies
- Business financing- Bonds and shares -Money market and Capital market – Stock market – Demat account and Trading account - SENSEX and NIFTY.

Four Sectors of Economy

1. Household sector

- consumers of goods and services
- owners of factors of production

2. Producer sector

- All producing firms

3. Government sector

- Government as a welfare agency
- Government as a producer

4. External sector (Foreign sector)

The Circular Flow of Income

- The circular flow of income and expenditure refers to the process whereby the national income and expenditure of an economy flow in a circular manner continuously through time.

3 Models:

1. Circular Flow in a Two Sector Economy

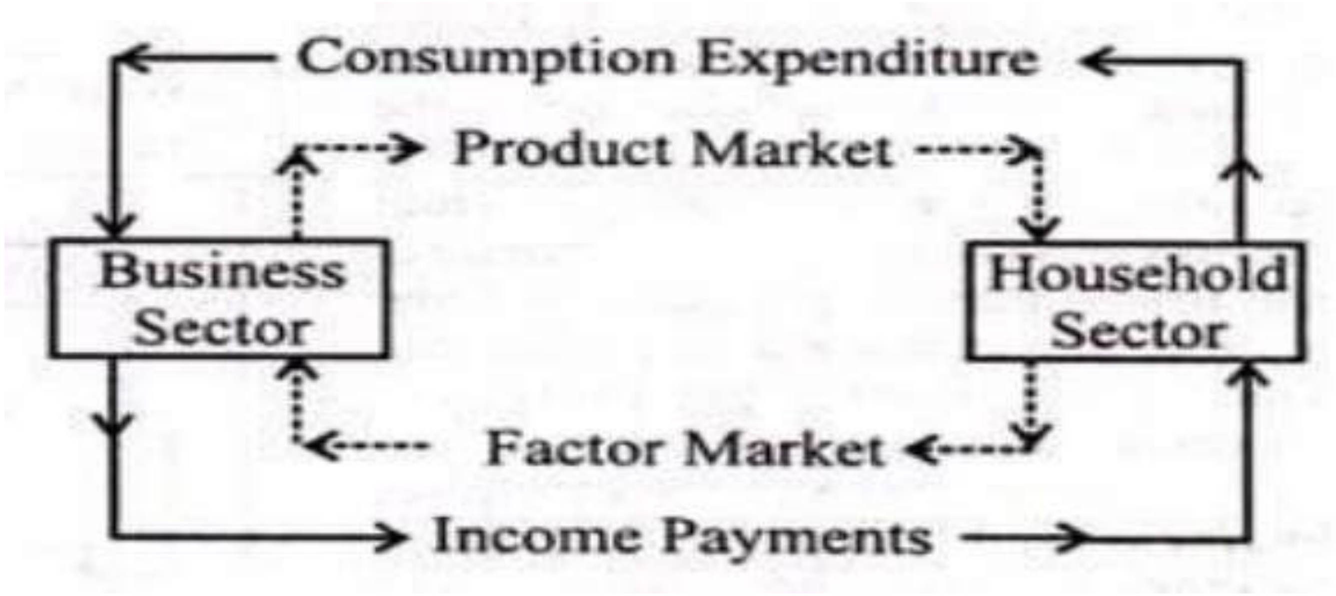
2. Circular Flow in a Three- Sector Economy

3. Circular Flow in a Four - Sector Economy

Real flows
Money flows

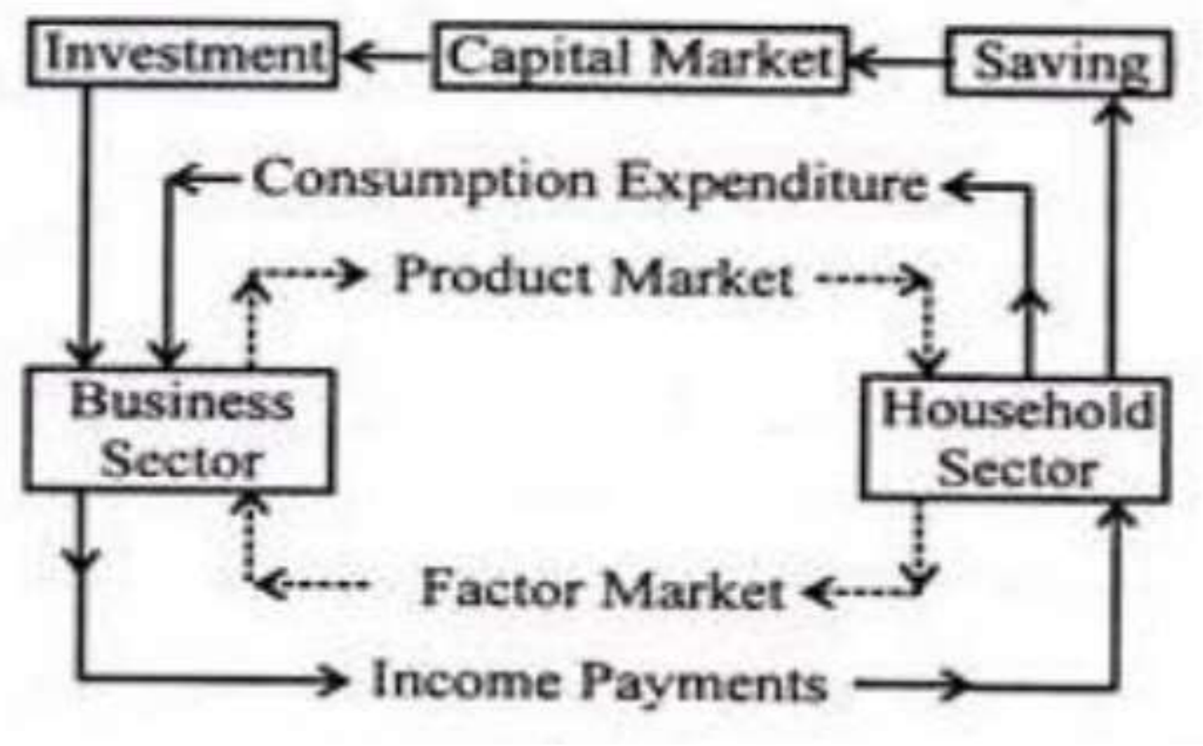
Two Sector Economy

$$Y = C + I$$



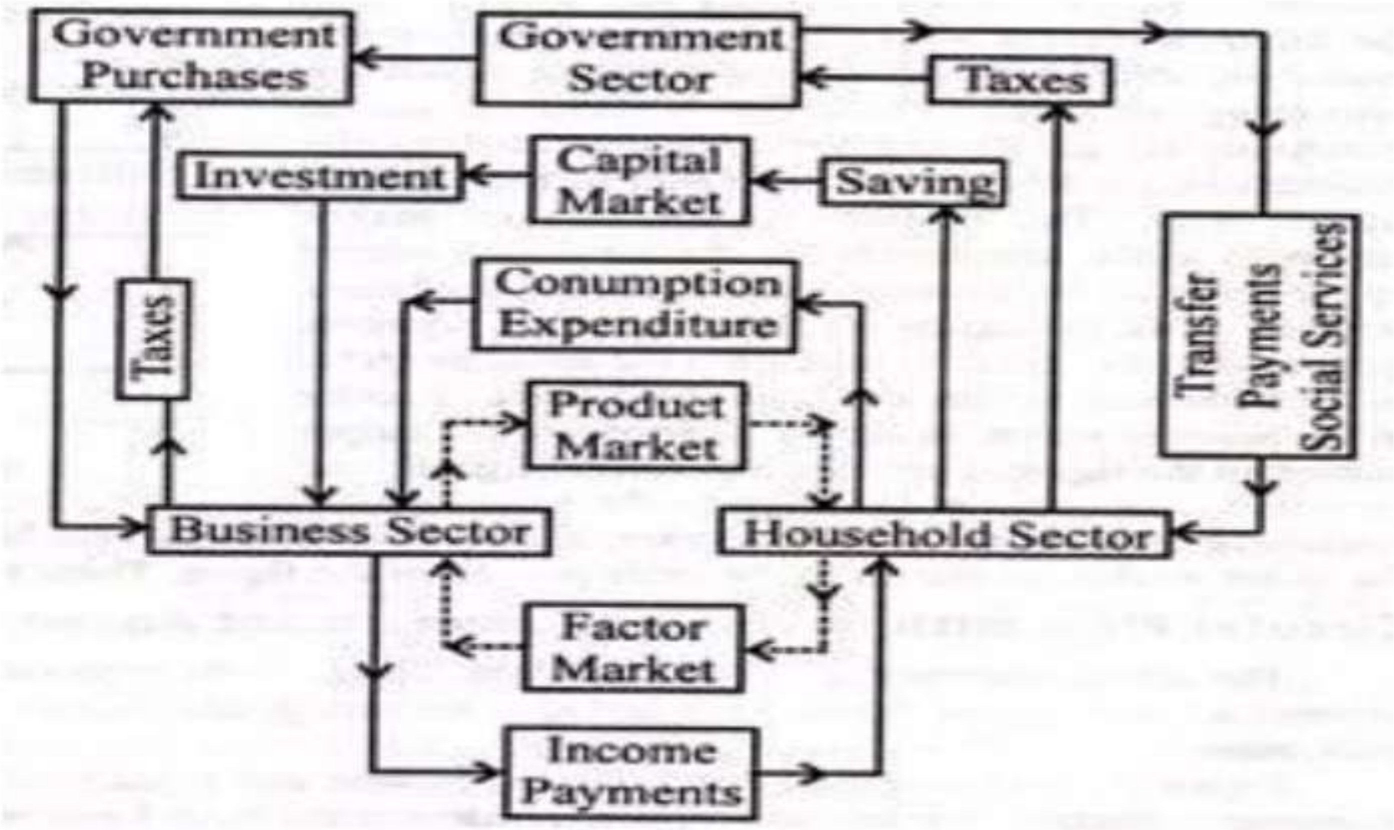
Two sector model with Banking system

$Y = C + I$

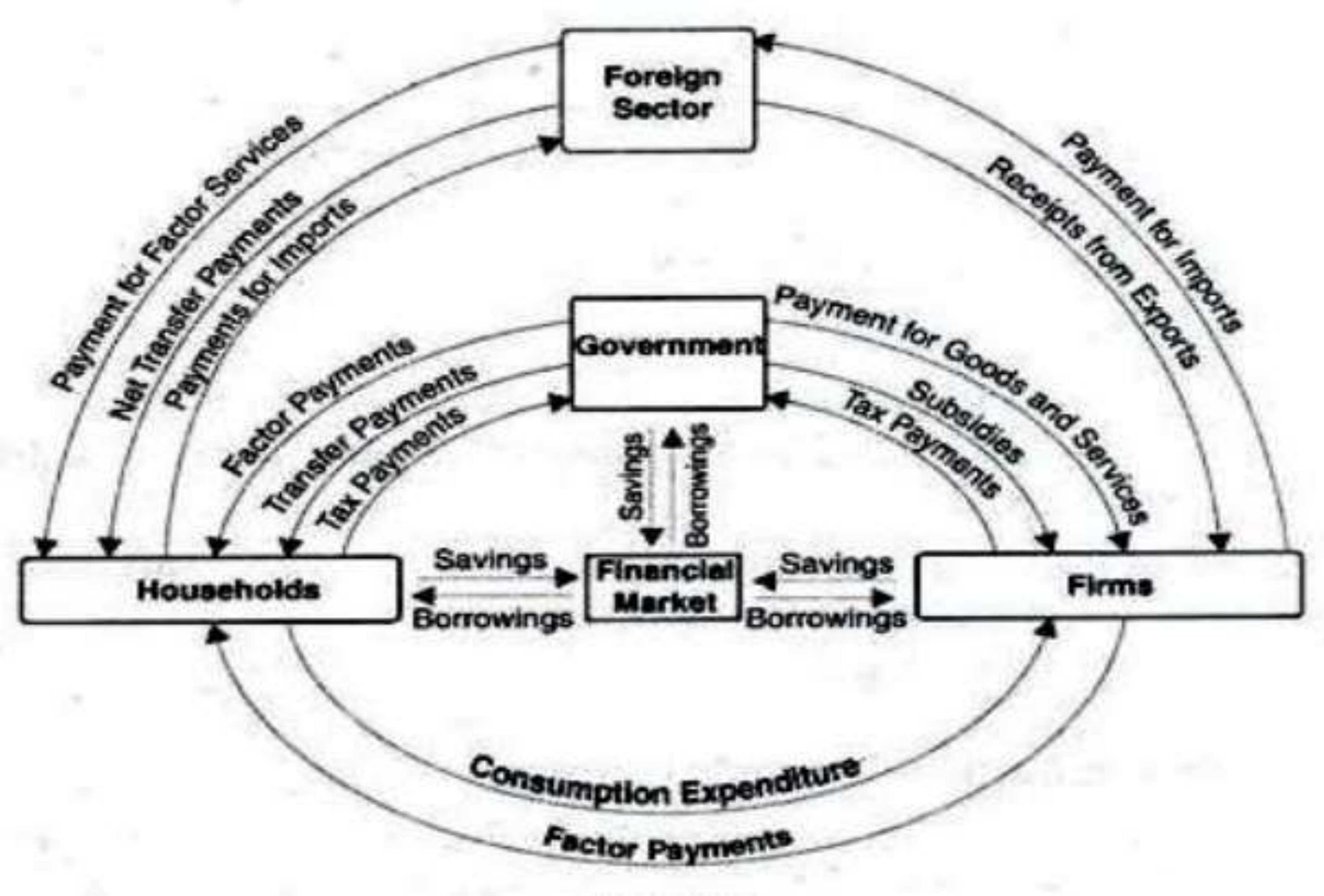


Three- Sector Model

Y = C + I + G



Four Sector Model $Y = C + I + G + (X-M)$



Stock and Flow

- Stock is a quantity measurable at a particular point of time. e.g. total wealth of a person.

eg, capital, quantity of money, amount of wealth stored

- Flow is a quantity measured over a period of time. e.g. annual salary of an individual.

eg, Income, expenditure, production, consumption, interest

Stock and Flow

Stock	Flow
Point of time	Over a period of time
No time dimension	Involves time dimension
Static concept	Dynamic concept
Stock influences he flow. Greater the stock of capital, greater is the flow of goods and services	Flow influences the stock. For eg., monthly increase in the supply of moneu leads to an increase in the quantity of money

INFLATION

- It is the persistent increase in general price level or persistent decline in the real income of the people
- It means as the price rises, the value of money declines

Definition

- Coulborn " Too much money chasing too few goods" Inflation occurs due to an imbalance in demand and supply of money

Inflation

Current year price – Base year price/ Base year price x 100

Types of Inflation

1. Demand pull inflation

2. Cost push inflation

3. Creeping inflation > 0 – 3 %

4. Walking inflation > 3 – 10 %

5. Galloping inflation > More than 10%

6. Hyper inflation > More than 50%

Causes of Inflation

- Causes of inflation has been classified into two:

Demand side factors and Supply side factors

Demand side Factors

- **Increase in money supply**
- **Increase in disposable income**
- **Increase in consumer spending**
- **Black money**
- **Increase in exports**
- **Cheap monetary policy**

Supply side factors

- Shortage in factors of production
- Industrial dispute
- Natural calamities
- Artificial scarcity (Hoarding)
- International factors

Consequences of Inflation

- Uncertainty in industry
- Deprecation of money
- Decrease in investment
- Social and political effects
- Effects on manufacturers

Methods to control Inflation

Monetary measures

- Bank Rate
- Open market operations
- Variable reserve ratio

Fiscal Measures

- Reduction of unnecessary expenditure
- Increase taxes
- Increase savings

Other measures

- Increase output
- Price control
- More imports
- Control black money

Final Goods and Intermediate Goods

- Intermediate goods are referred to as those goods that are used by businesses in producing goods or services. These goods are also known as producer goods.
- Final goods are referred to as those goods which do not require further processing. These goods are also known as consumer goods and are produced for the purpose of direct consumption by the end consumer

National Income (NI)

- NI is defined as the money value of the total goods and services produced in a country during a financial year
- It is the total income of nation
- In India, it is central statistical organization (CSO) who is responsible for national income accounting

Gross Domestic Product (GDP)

- It is the market value of all final goods and services produced in a country’s boundary during a financial year

Gross National Product (GNP)

- It is the market value of all final goods and services produced by a country’s citizens during a financial year irrespective of their locations.
- GDP = GNP – NFIA
- GNP = GDP + NFIA

Net domestic product (NDP)

- It is the market value of all final goods and services produced in an economy during a financial year after deducting depreciation (consumption of fixed capital)
- Deprecation refers to the fall in value of capital due to wear and tear

NDP = GDP – Deprecation

Market price & Factor cost

Market price is the price paid by the buyer of a commodity in the market

Factor cost is the cost paid by the producer to the factor of production for their contribution in the production of commodity

MP = Cost of production + Indirect taxes – Subsidies

FC = Cost of production - Indirect taxes + Subsidies

Personal Income (PI)

It is the sum of all income actually received by an individual from different sources in a country during financial year

Disposable income (DPI)

DPI = Personal income – Direct taxes

Percapita Income (PCI) It is the per person average national income

PCI = NI / Population

3 sectors of the economy

- Primary Sector: This sector deals with the extraction and harvesting of natural resources such as agriculture and mining. ---Agriculture
- Secondary Sector: This sector comprises construction, manufacturing, and processing. ---Industry
- Tertiary Sector: Retailers, entertainment, and financial companies make up this sector---Service

Significance of NI statistics

- Provides information regarding income yielding sectors of the economy
- Reveals the overall production performance of economy
- By comparing NI estimate over a period of time we can know whether the economy is growing , stagnant or declining
- Enables te government to find out taxable capacity of the people in the country
- It contains the figures of consumption saving and investment in the economy

METHODS FOR ESTIMATING NATIONAL INCOME

3 METHODS –depending on availability of data

1. Output method / Production method
2. Income method
3. Expenditure method

1. Output method / Production method

It is also known as value added method .

Steps

1. Production units divides into different sectors like agriculture , industry , services sectors
2. Estimating the net value added by each sector
3. Summing it up to get the value of the domestic product (GDP)
4. Add NFIA with the domestic product=NI

1. Output method / Production method (Cnt..)

- This method enables us to trace the origin of NI aggregate to different sectors of the economy- NI by Industrial origin.
- Adv: Reveals the relative importance of different sectors of economy by showing their respective contributions t the NI.
- Disadvantage: Double counting-output of many businesses is the input of some other businesses

2. Income Method

- Using this method , NI is obtained by adding up all the income of all individuals and business enterprises in the economy
- Calculated by adding all the income earned by various factors of production
- Income earned in the form of Rent (Land) , Wage (Labour) , Interest (Capital) , Profit (Organization)
- **NI = Rent + Wage + Interest + Profit**

2. Income Method (Cnt..)

Steps

- Production units divides into different sectors like agriculture , industry , services sectors
- Estimating factor income (Rent , Wage , Interest , Profit)
- Calculate NFIA

Domestic Factor Income + NFIA = NI

- This methd indicates the distribution of NI among different income group **–NI by distributive shares**
- Disadvantage: problem of double counting

Expenditure Method

- It is also known as consumption – saving method
- This method considers the computation of NI by adding up all the expenditure made on goods and services during a given year

Types of Expenditures

1. Consumption expenditure (C) by households
2. Investment expenditure (I) by firms
3. Government expenditure (G)
4. Net Exports (X – M)

NI = C + I + G +(X – M)

Difficulties in the estimation of NI

- Income generated from the process of production for self- consumption
- All transfer payments
- Illegal income like smuggling , Black money etc.,
- Value of second hand goods
- Service of house-wives
- Lack of statistical data
- Problem of double counting
- Illiteracy
- Non- availability of data
- Lack of accountability

Business Financing

- Business finance refers to funds availed by business owners to meet their needs that may include commencing a business, obtaining top-up funds to finance business operations, obtaining finance to purchase capital assets for the business, or to deal with a sudden cash crunch faced by the business

Sources of Capital

- Internal self – finance
- Public Deposits
- Loans from Bank
- Indigenous Bankers
- Development finance institutions

Bonds and Shares

- A bond is a fixed-income instrument that represents a loan made by an investor to a borrower (typically corporate or governmental).
- A share represents a unit of equity ownership in a company. Shareholders are entitled to any profits that the company may earn in the form of dividends.

Bonds and Shares

Bonds	Shares
The investor lends money to the company	The investor owns part of the company
Risk is low	High risk
Issued by Govt. Institutions, Financial institutions etc.,	Issued by Corporate enterprises
Bond holders get interest, as a fixed payment	Shareholders get dividend- variable according to companys performance
Return is certain	Return is uncertain
Maturity period is fixed	No maturity period

Money Market and Capital Market

- A financial market is a place where buyers and seller come together to trade in financial assets such as bonds, stocks, derivatives, currencies and commodities.
- The two most important components of financial market are the money market and capital market.

Money Market

- The money market is a good place for individuals, banks, other companies, and governments to park cash for a short period of time, usually one year or less.

Capital Market

- The capital market is a type of financial market where financial products like stocks, bonds, debentures are traded for a long duration of time.

Capital Market	Money Market
Long-term securities are traded in capital markets	Short-term securities are traded in money markets
Capital markets are well organized	Money markets are not that organized
Instruments in money markets are a low risk	Capital markets are the comparatively high risk
Capital markets are the comparatively high risk	Money markets give a low return on investments

Stock Market

- The stock market refers to public markets that exist for issuing, buying, and selling stocks that trade on a stock exchange.

Functions of Stock Market

- Fair Dealing in Securities Transactions
- Pricing of securities
- Investor Protection
- Safety of transaction
- Contributes to economic growth

Demat Account

- Demat is the abbreviation for "Dematerialization", which means to convert physical shares and securities into electronic form.
- A Demat Account or Dematerialised Account provides the facility of holding shares and securities in an electronic format

Trading Account

- A trading account is an investment account for transacting in securities. We can buy or sell assets frequently through your trading account.
- Trading account acts as an investment account to holds your securities and other holdings

Sensex

- It an investable index used to track the performance of India's 30 largest and most financially sound companies. These companies are listed on the BSE (previously known as the Bombay Stock Exchange) and represent some of the biggest and most important sectors of the Indian economy.
- The Sensex was launched on Jan. 1, 1986.

NIFTY

- The Nifty meaning is a derivation from the mix of two words, i.e. “National Stock Exchange” and “fifty”.
- It is an abbreviation of the National Stock Exchange Fifty.
- It is a collection of top performing 50 equity stocks that are actively trading in the index. However, 51 stocks are currently trading on Nifty. Hence, Nifty is also known as Nifty50 or CNX Nifty