LOVELY PROFESSIONAL UNIVERSITY PUNJAB (INDIA)

ECONOMICS FOR DAILY LIFE

(ECO905)

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Unit II Aggregate demand, Employment and Personal Economic Decisions

Components of aggregate demand- consumption, investment, government expenditure and net exports, economic performance of India post 1991, employment and compensation, personal finance- saving and investing your money wisely, personal spending- your purchases among uncertainties of life.

Aggregate Demand (AD)

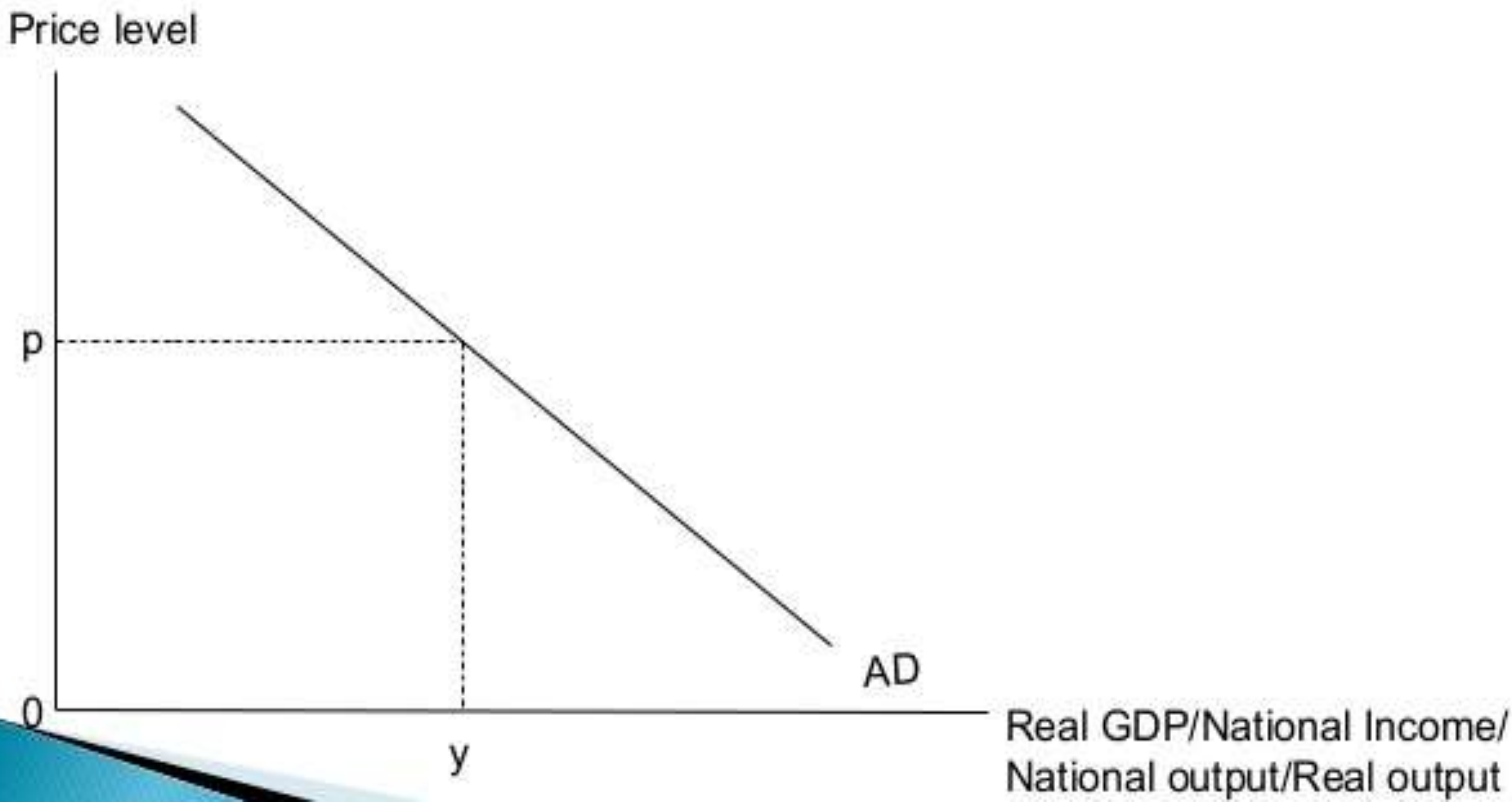
- AD curve has traditional negative slope.
- AD is the total demand (total spending) for a country's goods and services at a given price level in a given time period.

AD = C + I + G + (X – M)

- C= Consumption
- I= Investment
- G = Government Spending
- X-M= Net Exports

The Aggregate Demand Curve and Price level

The AD curve shows the relationship between the average price level and real output.



Consumption

- This is spending by households on good and services to meet its wants.
- E.g. Food and Clothes or TV Service
- Influences
  - Disposable Income, the more consumers have typically the higher AD
  - Distribution of Income, an even distribution causes a greater rise in AD
  - Availability of Credit, is credit is cheap then AD rises, if not AD falls

What causes changes in consumption:

- Changes in income
- Changes in interest rates
- Changes in wealth
- Changes in expectations and consumer confidence

Investment

- Spending by Businesses on capital goods e.g. Factories.
- Influences
  - Changes in income, as incomes rise, people demand more so businesses invest to cope with demand
  - Rate of Interest, a lower rate will stimulate investment as the cost of borrowing is low
  - Profit Level, if profits are expected to be high
  - Government Policy, lower corporation tax etc

What causes changes in investment?

- Interest rates
- Changes in the level of national income
- Technological changes
- Expectations and business confidence

Government Spending

- Spending by Government
- Main areas are Social Security, Health, Education and Defence
- Influences
  - Public Opinion
  - State of the Economy
  - Market Failures

What causes changes to government spending?

- Commitment to financial support to industry
- Spending to correct market failure
- New education or health policy – new schools or hospitals

Net Exports

- This is total exports (X) minus total imports (M)
- Influences on Net Exports
  - Domestic Income, if incomes are high we tend to suck in imports, which lowers AD
  - Foreign Income, if incomes in other countries rise, they will suck in British Exports
  - Exchange Rates if the currency is weak against another then it will encourage exports

What causes changes in net export?

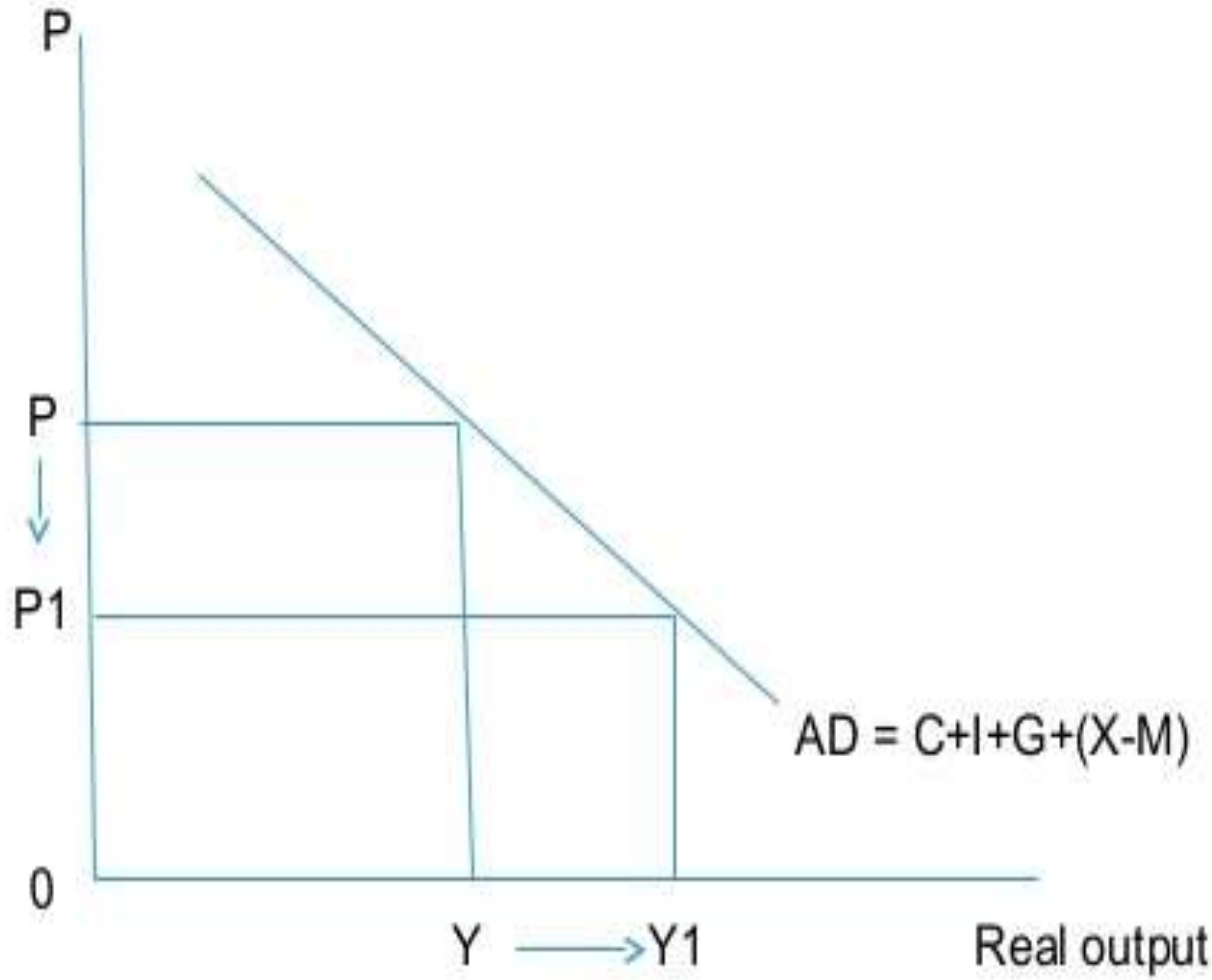
- Export:

  If foreign income rises, this leads to more imported goods and services being consumed.

- Import:

  When national income grows, this leads to an increase in consumption. As more goods and services are being consumed, some of these will be imported goods.

When price in the economy falls from p to p1, C+I+G+(X-M) increases from Y to Y1.



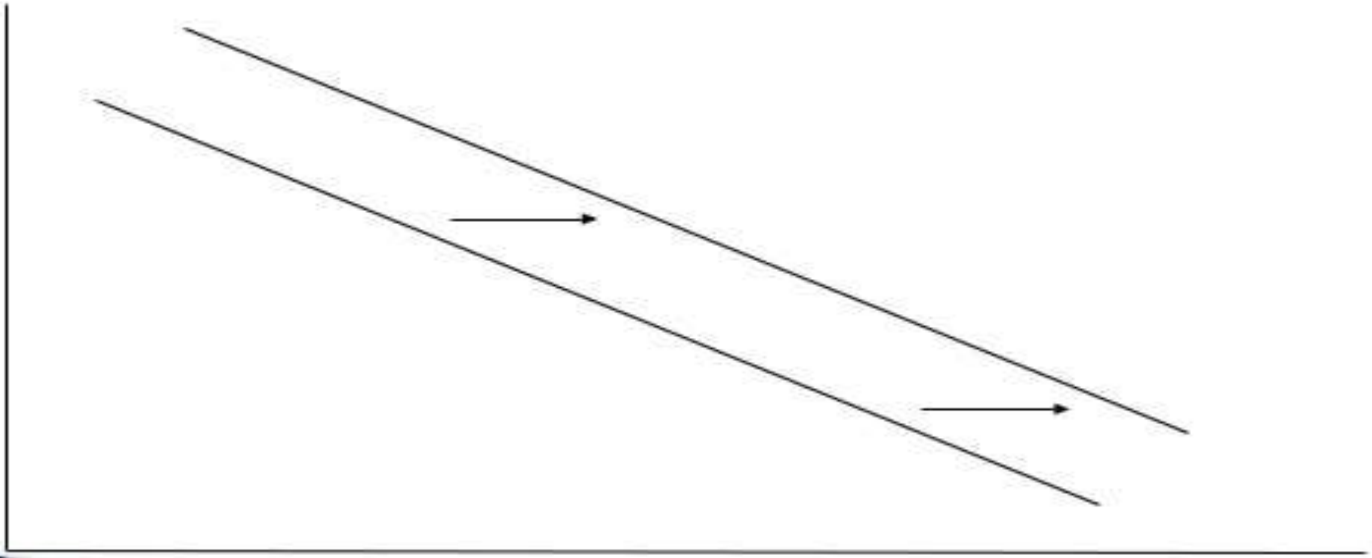
Changes in AD:

- Changes in price causes a **movement** along the AD curve, from one level of real output to another

- Changes in the components of AD will cause a **shift** in the demand curve.

- A change in AD is caused by a change in an influence on AD other than a change in price level;
- An increase in AD is a rise in planned spending and is represented by a shift to the right of the AD curve;
- A decrease in AD is shown by a shift to the left of the AD curve

Shift in Aggregate Demand



Possible causes of an increase in AD

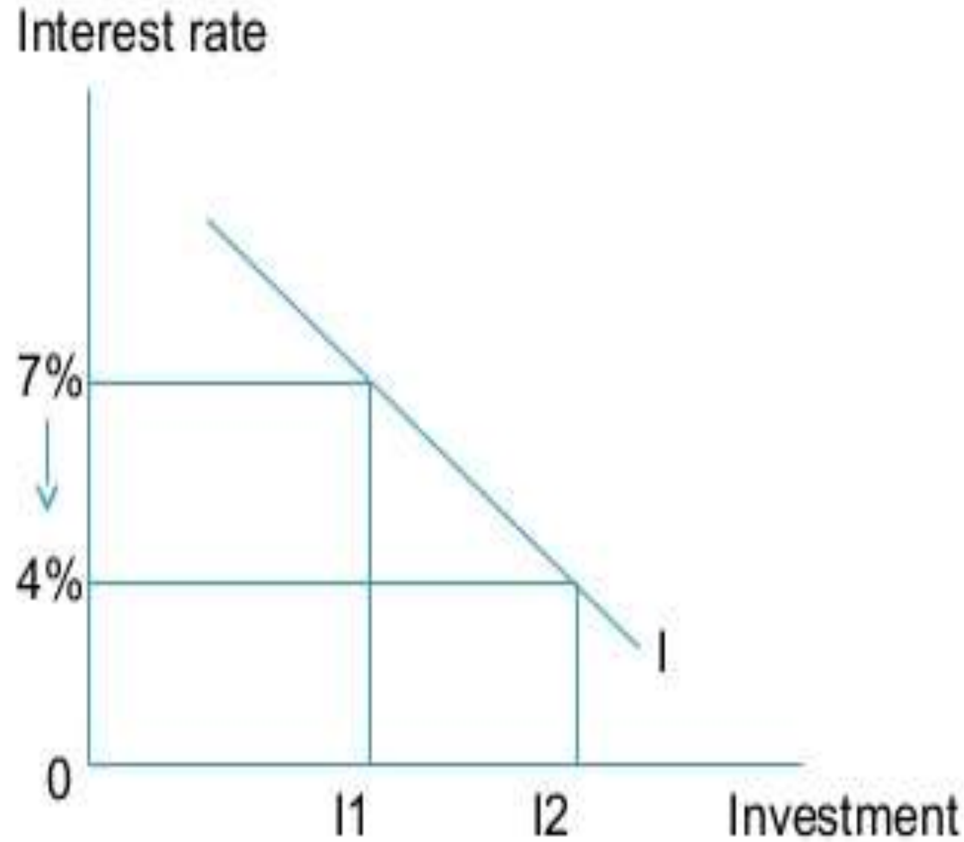
- An increase in ***government spending***, which may occur in a deliberate attempt to increase AD;

- An increase in ***consumption*** arising from an increase in wealth, an increase in the money supply, a cut in taxation, a rise in population, increased optimism ('feel-good factor') etc.

- An increase in ***investment*** due to change in technology, a rise in expectation, a fall in the rate of interest;

- An increase in ***export*** because of a rise in quality, a fall in the country's exchange rate, a rise in income abroad.

The relationship between investment and interest rate shows when interest rate Decreases, there is no incentive to save, and lead to increase in borrowing, which increases investment from I1 to I2. Increase in interest rate will have the opposite Effect.



Government policies affecting AD:

- Fiscal policy – taxes
- Expansionary fiscal policy
- Monetary policy – interest rates

New Economic Policy of 1991

In 1991, the P. V. Narasimha Rao government reduced the import duties, opened reserved sector for the private players, devalued the Indian currency to increase the export and reduce the adverse Balance of Payment (BOP) situation.
This is also known as the LPG Model of growth.

New Economic Policy refers to economic liberalization or relaxation in the import tariffs, deregulation of markets or opening the markets for private and foreign players, and reduction of taxes to expand the economic wings of the country.

Former Prime Minister **Dr. Manmohan Singh** is considered to be the father of New Economic Policy (NEP) of India. **Manmohan Singh introduced the NEP on July 24,1991.**

The main objectives behind the launching of the New Economic policy (NEP) in 1991 by the union Finance Minister Dr. Manmohan Singh are stated as follows:

1. The main objective was to plunge **Indian Economy** in to the arena of 'Globalization and to give it a new thrust on market orientation.

2. The NEP intended to bring down the rate of inflation.

3. It intended to move towards higher economic growth rate and to build sufficient foreign exchange reserves.

4. It wanted to achieve economic stabilization and to convert the economy into a market economy by removing all kinds of un-necessary restrictions.

5. It wanted to permit the international flow of goods, services, capital, human resources and technology, without many restrictions.

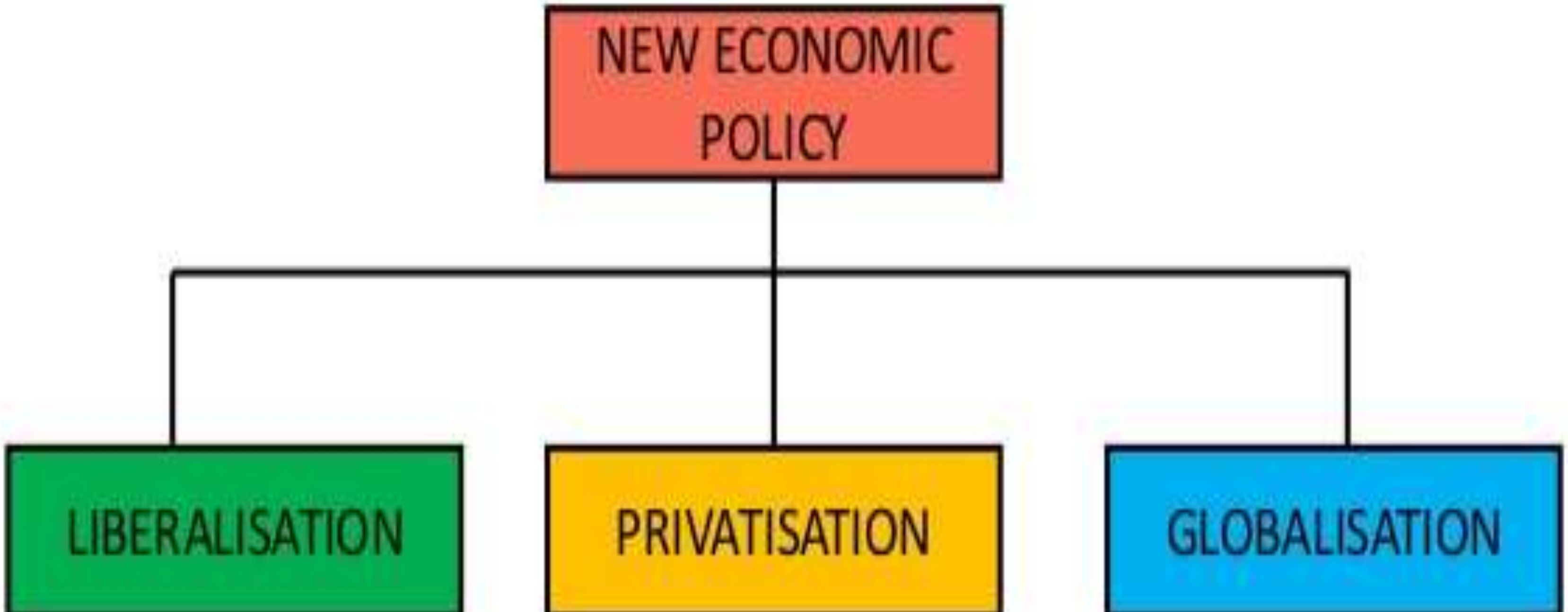
6. It wanted to increase the participation of private players in the all sectors of the economy. That is why the reserved numbers of sectors for government were reduced.

The thrust of the **New Economic Policy** has been towards creating a **more competitive environment** in the economy as a means to **improving the productivity and efficiency** of the system. This was to be achieved by removing the barriers to entry and the restrictions on the growth of firms.

Main Measures Adopted in the New Economic Policy

Due to various controls, the economy became defective. The entrepreneurs were unwilling to establish new industries. Corruption, undue delays and inefficiency risen due to these controls. Rate of economic growth of the economy came down. So in such a scenario economic reforms were introduced to reduce the restrictions imposed on the economy.

BRANCHES OF NEW ECONOMIC POLICY



1. Liberalisation

Removal of Industrial Licensing and Registration:

Previously private sector had to obtain license from Govt. for starting a new venture. In this policy private sector has been freed from licensing and other restrictions.

Industries licensing is necessary for following industries:

(i) Liquor

(ii) Cigarette

(iii) Defence equipment

(iv) Industrial explosives

(v) Drugs

(vi) Hazardous chemicals

Following steps were taken under the Liberalisation measure:

(i) Free determination of interest rate by the <u>commercial Banks:</u>

Under the policy of liberalisation interest rate of the banking system will not be determined by RBI rather all commercial Banks are independent to determine the rate of interest.

(ii) Increase in the investment limit for the <u>Small Scale Industries (SSIs):</u>

Investment limit of the small scale industries has been raised to Rs. 1 crore. So these companies can upgrade their machinery and improve their efficiency.

(iii) Freedom to import capital goods:

Indian industries will be free to buy machines and raw materials from foreign countries to do their holistic development.

(iv) Freedom for expansion and production to Industries:
In this new liberalized era now the Industries are free to diversify their production capacities and reduce the cost of production. Earlier government used to fix the maximum limit of production capacity. No industry could produce beyond that limit. Now the industries are free to decide their production by their own on the basis of the requirement of the markets.

(v) Abolition of Restrictive Trade Practices:
According to **Monopolies and Restrictive Trade Practices (MRTP) Act 1969**, all those companies having assets worth Rs. 100 crore or more were called MRTP firms and were subjected to several restrictions. Now these firms have not to obtain prior approval of the Govt. for taking investment decision. Now MRTP Act is replaced by the competition Act, 2002.

2. Privatisation:

Simply speaking, privatisation means permitting the private sector to set up industries which were previously reserved for the public sector. Under this policy many PSU’s were sold to private sector.

The main reason for privatisation was in currency of PSU’s were running in losses due to political interference. The managers cannot work independently. Production capacity remained under-utilized. To increase competition and efficiency privatisation of PSUs was inevitable.

Step taken for Privatisation:

The following steps are taken for privatisation:

1. **Sale of shares of PSUs:**
Indian Govt. started selling shares of PSU's to public and financial institution. Now the private sector will acquire ownership of these PSU's. The share of private sector has increased from 45% to 55%.

2. Disinvestment in PSU's:
The Govt. has started the process of disinvestment in those PSU's which had been running into loss. It means that Govt. has been selling out these industries to private sector. Govt. has sold enterprises worth Rs. 30,000 crores to the private sector.

3. Minimization of Public Sector:
Previously Public sector was given the importance with a view to help in industrialization and removal of poverty. But these PSU's could not able to achieve this objective and policy of contraction of PSU's was followed under new economic reforms. **Number of industries reserved for public sector was reduces from 17 to 2.**
(a) Railway operations
(b) Atomic energy

3. Globalization:

Literally speaking Globalization means to make Global or worldwide, otherwise taking into consideration the whole world. Broadly speaking, Globalization means the interaction of the domestic economy with the rest of the world with regard to foreign investment, trade, production and financial matters.

Steps taken for Globalization:

Following steps are taken for Globalization:

(i) Reduction in tariffs:

Custom duties and tariffs imposed on imports and exports are reduced gradually just to make India economy attractive to the global investors.

(ii) Long term Trade Policy:

Trade policy was enforced for longer duration.

(iii) Partial Convertibility of Indian currency:

Partial convertibility can be defined as to convert Indian currency (up to specific extent) in the currency of other countries. So that the flow of foreign investment in terms of Foreign Institutional Investment (FII) and foreign Direct Investment (FDI).

(iv) Increase in Equity Limit of Foreign Investment:

Equity limit of foreign capital investment has been raised from 40% to 100% percent. In 47 high priority industries foreign direct investment (FDI) to the extent of 100% will be allowed without any restriction. In this regard **Foreign Exchange Management Act (FEMA)** will be enforced.

If the Indian economy is shining at the world map currently, its sole attribution goes to the implementation of the New Economic Policy in 1991.

PERSONAL FINANCE

Objective 1.01

Understand responsible earning, spending, savings, borrowing.

There are Four Basic Economic Activities of Consumers

- Earning
- Spending
- Savings
- Borrowing

Earning

- **Earning ---** gaining money by working, owning a business, or receiving investment returns. Money gained from earning is called ***earnings***.

A person's career choices, ability to find employment, and ability to advance determine his or her expected earnings and standard of living.

Factors Affecting Earnings

Career Choices

- Type of career/job
- Place of employment

Ability to Find Employment

- Education level
- Employability skills
- Prior job performance
- Economic conditions
- Workplace trends and opportunities

Ability to Advance

- Type of career/job
- Education level
- Job performance
- Economic conditions
- Workplace trends and opportunities

Earnings

Standard of Living

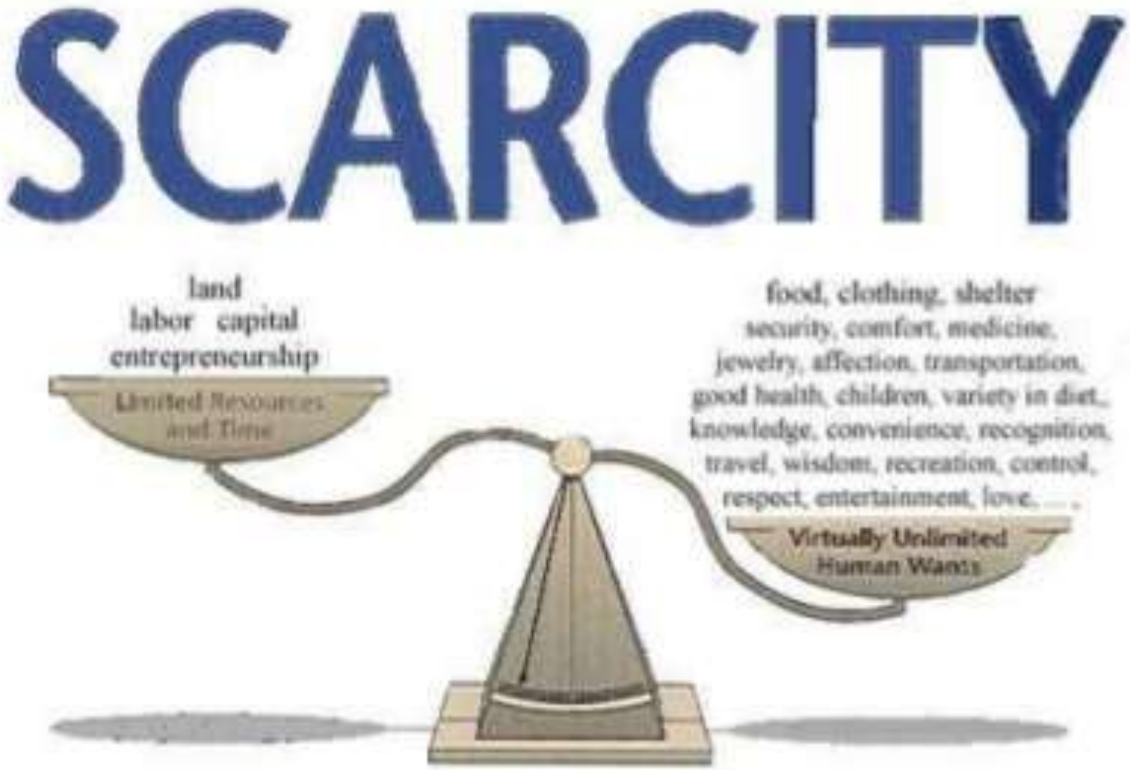
Responsible Earning *involves realizing that career choices greatly affect lifetime earnings & standard of living & considering these factors when making career choices.*

Spending

- **Spending** --- using money to purchase goods and services.
- The way a person spends money determines the value received and influences the economy.
  - Each purchase contributes to the demand for the product or service purchased

Law of Scarcity

- **Law of Scarcity**: An economic system cannot produce all goods and services that consumers want, and most consumers do not have the resources to purchase everything they want.
  - Choices must be made about how limited resources (time, money) are used.



Trade-offs and Opportunity Costs

- Because of **scarcity**, any time a choice is made there are alternatives that are not chosen.
- When making a choice, other alternatives must be sacrificed.
- The highest-valued alternative that must be given up when a choice is made is the **opportunity cost** of the choice.
- The choice of one item while giving up another is called a **trade-off**.

Responsible spending

- ***Responsible spending*** *includes researching and planning purchases in advance and making wise choices in light of opportunity costs and trade-offs that apply*

Saving

- **Saving ---** putting aside money for later use.
  - Money may be “saved” in a bank account or in a wallet.
    - The form of savings used determines the financial return

“Later Uses” For Savings

- Emergencies
- Recurring expenses
- Future purchases
- Financial goals
- Retirement

Benefits of Saving

- Provide money for future purchases
- Can be used to earn income
- Produce a healthy economy
- Increase personal financial security
- Provide growth opportunities for business ventures

Responsible Saving -
forming the habit of saving regularly & finding forms of saving that yield high returns

Borrowing

- **Borrowing** --- obtaining money, goods, or services at present in exchange for the promise of future payment . . . "Buy now, pay later."

Examples of Borrowing

- Buying with a credit card
- Buying on installment
- Payday loans
- Cash advances
- Layaway purchases

Reasons for Borrowing

- Major purchases
- Emergencies
- Convenience
- Prepare for future goals
- Take advantage of good sales/offers

Responsible borrowing means borrowing only what can be paid back when due