CHAPTER 1: INTRODUCTION OF MACROECONOMICS

Macroeconomics

Macro

Macros

Large/ whole/ Wide

Economics

Study of Economic Problems

Economics is the study of scarcity and its implications for the use of resources, production of goods and services, growth of production and welfare over time.

Macroeconomics is that branch of economics which deals with aggregates or issues related to the economy as a whole. It is concerned with the determination of aggregate output and general price level in the economy as a whole.

It studies the problems at the level of an economy such as:

- problems of inflation,
- unemployment,
- national income
- foreign exchange rate etc.

SUBJECT MATTER OF MACROECONOMICS

The study of macroeconomics includes:

1. **Theory if Employment** –
   It studies the employment in the economy, which further includes study of full employment, underemployment, voluntary and involuntary unemployment etc.
2. **Theory of National Income Determination**:
   It studies determination of domestic income and national income by different methods.
3. **Theory of general pricing**:
   Issues related to inflation, deflation, excess demand, deficient demand, etc. are studied under this theory.
4. **Theory of Money**:
   It explains the important role of money and banking in the functioning of the economy.
5. **Theory of international trade**:
   It studies all international transactions between home country and rest of the world. Determination of foreign exchange rate also comes under the subject matter macroeconomics.

IMPORTANCE/ SCOPE OF MACROECONOMICS:

1. It helps in *Policy Formulation* of Government.
2. It helps to understand the *Distribution of Income* among different groups of people.
3. It has special significance in *Studying Monetary Problems* that adversely affects the economy.
4. It facilitates *International Comparison.*

DIFFERENCES BETWEEN MICROECONOMICS AND MACROECONOMICS

Basis	Microeconomics	Macroeconomics
Basis of Study	Microeconomics studies problems of scarcity and choice at the level of an individual. As a household, a firm or an industry etc.	Macroeconomics studies problems od scarcity and choice at the level of an economy as a whole. As national income, money, employment etc.
Economic Variables	Microeconomics uses microeconomic variables such as consumer's demand or producer's supply.	Macroeconomics uses macroeconomic variables such as aggregate demand and aggregate supply.
Economic Agents	Individual economic agents include consumers and producers. They Focus on the maximization of personal gains.	Institutional economic agents include state or statutory bodies like: RBI, SEBI, TRAI

Degree of Aggregation	Microeconomics studies equilibrium of an industry; it is an aggregation of all the firms producing a particular commodity.	Macroeconomics studies equilibrium of the economy as a whole; it is an aggregation of all units in the economy.
Central issue	Allocation of resources is the central issue in microeconomics.	Determination of the overall level of output/employment is the central issue in macroeconomics.
Method of study	Method of study in microeconomics is often described as 'Partial Equilibrium Analyses.	Method of study in macroeconomics is often described as 'General Equilibrium Analyses.

Partial Equilibrium and General Equilibrium: -

Partial Equilibrium refers to equilibrium in one market (Commodity Market) on the assumption that is no change in other market. It is the method to study in Microeconomics.

General equilibrium refers to simultaneous equilibrium in all the markets in the economy. It in the method of study in macroeconomics.

TOPIC: TYPES OF GOODS

Classification of Goods

Final Goods

The goods which *crossed the boundary line of production* and are *ready to use by their users* such as consumers and producers.

Final Goods are classified as:

1. Final Consumer Goods:

The Goods which are ready to be used by the consumers, in an act of consumption are called final goods.

Example: *eatable products - milk, vegetables, bread etc.*

Stationary – pen, notebooks, books etc.

2. Final Producers Goods:

The Goods which are used by the producers, in the production process are called final producer goods.

Example:

machinery, tools, furniture etc.

Intermediate Goods

Intermediate Goods are those goods:

- Which have yet not crossed the boundary line of production
- Value is still to be added to these goods
- Which are yet not ready for use by their final users

These goods are those goods which are used as Raw Material or are purchased by the firms for resale.

Example:

- ❖Sugarcane to produce sugar
- ❖Sugar to make sweets
- ❖Papers to prepare notebooks.

Difference between Intermediate and Final Goods

Basis	Intermediate Goods	Final Goods
Meaning	They are those goods which are still within the production boundary, i.e., either value need to be added or are meant for resale.	They are those goods which are out of the production boundary and available for direct consumption by their buyers.
Purpose of uses	These goods may be resold by the firms to make profits during the accounting year.	These goods are not resold by the firms to make profits during the accounting year.
Consumption	These goods are not ready for use by their final users.	These goods are ready for use by their final users.
Value addition	Value is yet to be added to these goods.	Value is not to be added to these goods.

Consumer Goods (Consumption Goods)

Those goods which are directly used by the *satisfaction of human wants* and are not used in the production of other goods.

e.g. – ice cream, milk

Types of Consumers Goods: -

1. Durable Goods
2. Semi-Durable Goods
3. Nom-durable Goods
4. Non-Material Goods or Services

1. **Durable Goods**: Those goods which can used for several years (more than one year) and are of relatively high value.

   Example: TV, Radio, Car, Washing Machine etc.

2. **Semi-Durable Goods: Those consumer goods which have a life span generally lesser than durable goods.**
   These goods can be used for a period of one year or slightly more.
   Example: Clothes, crockery etc.

3. **Non-Durable Goods: These goods are also known as single use goods.**
   Those goods which are used up in a single act of consumption.
   Example: Bread, Fruits, Vegetables, Milk Products etc.

4. **Non- material Goods/ Services:**
   Those goods which satisfy human wants. ***These goods cannot be seen or touched however the benefits can be enjoyed.***
   Example: Watching movie, getting treatment from doctor, getting advices from a lawyer etc.

Capital Goods

The goods which are used in the process of production for several years and which are of high value are called capital goods.

These goods are fixed assets of the producers.

These goods are used by the producers either of:

- **The replacement of the capital stock, or for**
- **Addition to the capital stock.**

Use of these goods leads to *depreciation.*

Example: Building, Plant and Machines, Vehicles etc.

Differences between Consumption Goods and Capital Goods

Basis	Consumption Goods	Capital Goods
Satisfaction	Consumption goods lead to direct- satisfaction of human wants.	Capital goods do not lead to direct -satisfaction of human wants
Consumer	These goods are consumed by the households when purchased.	These goods are not consumed by the households, while these goods are used by the producers for further production.
Type of expenditure	Expenditure on consumption goods is called consumption expenditure.	Expenditure on capital goods is called investment expenditure.
Beneficial Parties	Higher production of consumption goods leads to higher level of welfare of the people. *It raises their quality of life.*	Higher production of capital goods leads to higher production capacity in the economy. *It is the backbone of GDP growth.*

Consumption Expenditure

Aggregate consumption expenditure in the economy by the consumers.

Consumers:

I. **Households – buy consumer goods for the satisfaction of their wants**

II. **Government – buys consumer goods for distribution among the residents and other institutions.**

III. **Non-profit private institutions- buy consumer goods for charity.**

Consumption Expenditure = Expenditure by Households + Expenditure by Government + Expenditure by Non-profit private institutions

Concept of Investment

Investment is the *process of capital formation by a firm* or *addition to the stock of capital.*

Here, I = Investment; K = Capital Stock

$$I = \Delta K$$

Note: Change in stock is also known as capital formation.

Components of Investments:

I. **Fixed investment**
II. **Inventory investment**

1. **Fixed Investment**: It refers to increase or addition in the stock of fixed assets of the production units during an accounting year. *Example- Plant and machinery, Buildings*

   Significance:

   i. Fixed Investment raise production capacity of the producers.
   ii. Leads to higher level of output in the economy.
   iii. Leads to higher rate of economic growth (GDP growth)

2. **Inventory Investment: refers to change in inventory stock during the year is called inventory investment of the producers.**

Here Inventory stock contains-

- Finished goods (unsold goods)
- Semi-finished goods (under production process)
- Raw – material

Significance:

i. **It ensures uninterrupted supply of inputs to the producers.**

ii. **Ensures the enough stock of raw materials**

Types Investment

Gross Investment

Net Investment

1. **Gross Investment:** **The total addition to the existing stock of capital during a given time period is called gross investment.**

Components of Gross Investment –

Gross Fixed Investment and Inventory Investment

Gross Investment = Expenditure on fixed assets + Expenditure on Inventory Stock

Or

Gross Investment = Net Investment + Depreciation

2. **Net Investment**: It is the actual increase in stock of capital during an accounting year. It is also termed as new capital formation.

Net Investment = Gross Investment - Depreciation

Concept of Depreciation:

Depreciation is the loss of value of assets-

i. Normal Wear and Tear
ii. Accidental Damages
iii. Expected obsolescence

Depreciation is also known as consumption of fixed capital.

Depreciation Reserve Fund

Depreciation reserve fund is a fund to replace the worn-out fixed assets. It fulfils the need for replacement investment.

It is the fund created by the producers to meet the upcoming depreciation losses in the process of production.

Differences between Depreciation and Depreciation Reserve Fund

Basis	Depreciation	Depreciation reserve fund
Concept	It is the loss of value of fixed assets in use, on account of normal wear and tear.	It is a provision of funds created by producers to cope up with depreciation losses.
Effect	It leads to correct computation of profit	These funds are used for the replacement of fixed assets when these are worn out.
Reason	Expected or foreseen obsolescence, normal wear and tear.	Obsolete/ outdated assets need to be replaced.

STOCK AND FLOWS

Meaning of *Stock*:

A stock iStock variable are defined as any quantity which is measured at a point of time.

Example:

- Number of machines in a plant
- Bank balance on a specific date
- Population as at 31st March 2022

Meaning of *flow:*

Flow variable are defined as any quantity which is measured over a period of time.

Example:

- Population of India in during the year 2022
- Monthly Salary of an employee.

DIFFERENCE BETWEEN STOCK AND FLOW

Basis	Stock	Flow
Meaning	Stock variable refers to that variable, which is measured at a point of time.	Flow variable refers to that variable, which is measured over a period of time.
Time Dimension	it is not having a time dimension.	It is a time dimension as its magnitude can be measured over a period of time.
Nature of concept	It is a static concept.	It is a dynamic concept.
Example	• Population of India as on 31.03.2024, • Total number of students in a class., • Money supply, • Stock of garments	Number of births during 2023, Total number of students enrolled in academic year 2023-24, Expenditure in money, National Income

SECTORS OF THE ECONOMY

Economy is divided into four sectors:

1. Household Sector:

→It includes consumers of goods and services.
→Households are also the owners of the factors of production.
→They supply factors like land, labour, capital and entrepreneur
→Receive income in return in the form of rent, wages, interest and profit.

2. Producer Sector:

→It includes all producing units (firms) in the economy.

→To produce goods and services, the firm hires factors of production from the households.

3. Government:

Government acts in two capacities:

- **As a welfare agency** – *maintaining law and order, defence and other services of public welfare*
- **As a producer** – *it produces goods and services in public sector enterprises.*

4. The External Sector:

→It includes all such activities which are related to export and import of goods.
→This includes transactions with the rest of the world.

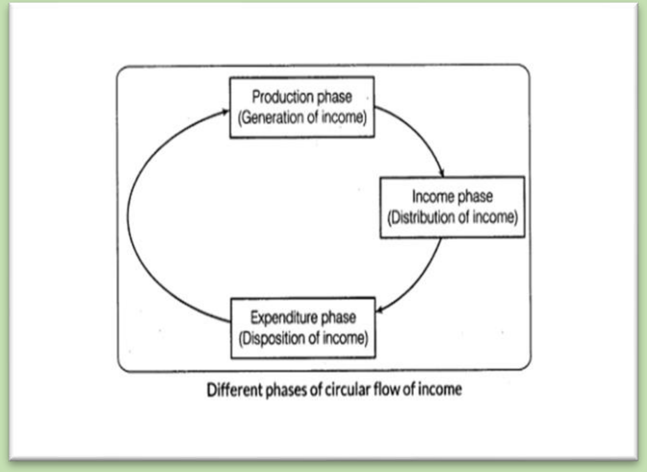
CIRCULAR FLOW OF INCOME

It refers to cycle of generation of income in the production process, its distribution among the factors of production and finally, its circulation from households to firms in the form of consumption expenditure on goods and services produced by them.

PHASES OF CIRCULAR FLOW

There are three phases in any circular flow of income-

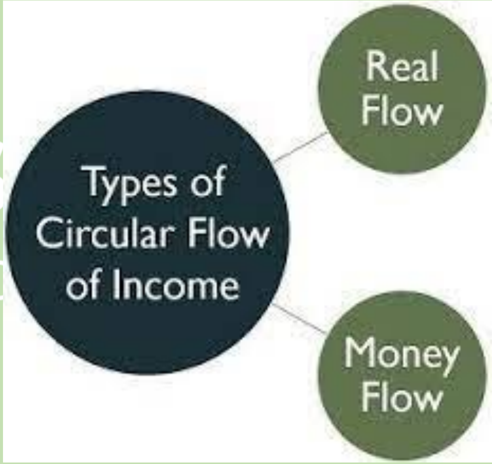
1. Production Phase – Generation – firms produce goods and services with the help of factor services.
2. Income Phase – Distribution – this phase involves the flow of factor income (rent, wages, interest and profits) from firms to the households.
3. Expenditure Phase – Disposition – in this phase, the income received by factors of production, is spent on the goods and services produced by firms.



Different phases of circular flow of income

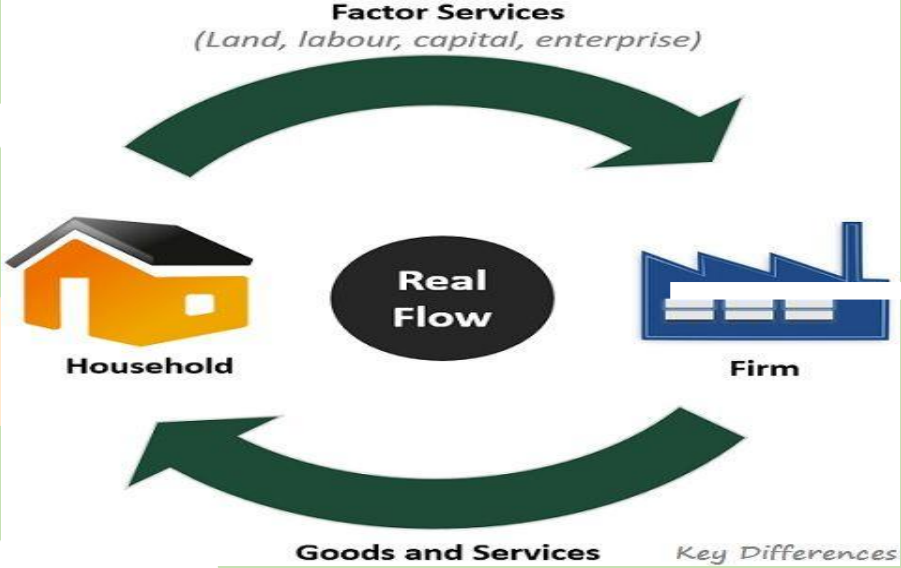
TYPES OF CIRCULAR FLOW

There are two types of circular flow -



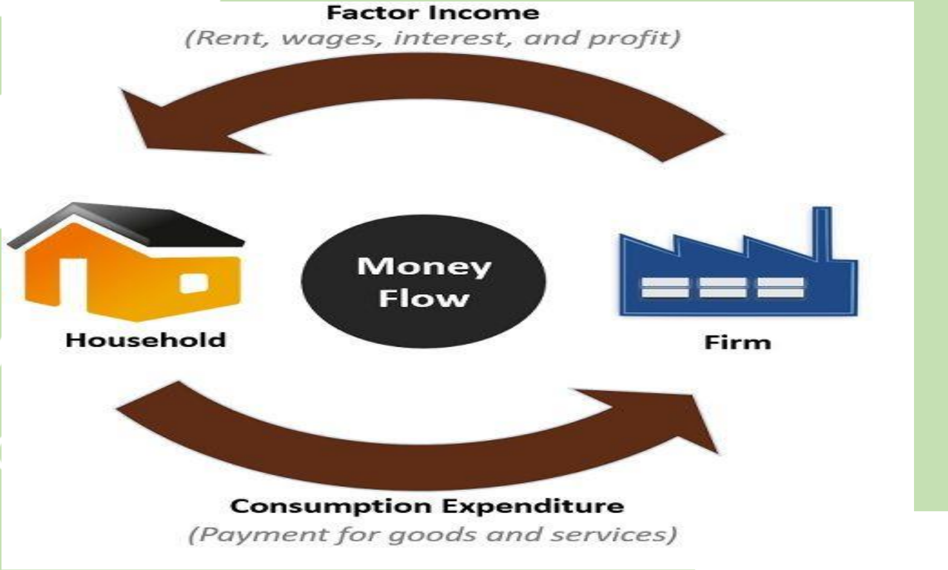
1. Real Flow-

Real flow refers to the flow of factor services from households to firms and the corresponding flow of goods and services from firms to households
It is also known as Physical Flow.



2. Money Flow:

Money flow refers to flow of factor payments from firms to households for their factor services and corresponding flow of consumption expenditure from households to firms for purchase of goods and services produced by the firms.



Difference between Real Flow and Money Flow

Basis	Real Flow	Money Flow
Meaning	It is the flow of goods and services between firms and households.	It is the flow of money between firms and households.
Kind of Exchange	It involves exchange of goods and services.	It involves exchange of money.
Difficulty in exchange	There may be difficulties of barter system in exchange of goods and factor services.	There is no such difficulty in case of money flow.
Alternative Name	It is also known as Physical Flow	It is also known as Nominal Flow

CIRCULAR FLOW IN A SIMPLE ECONOMY (TWO SECTOR ECONOMY)

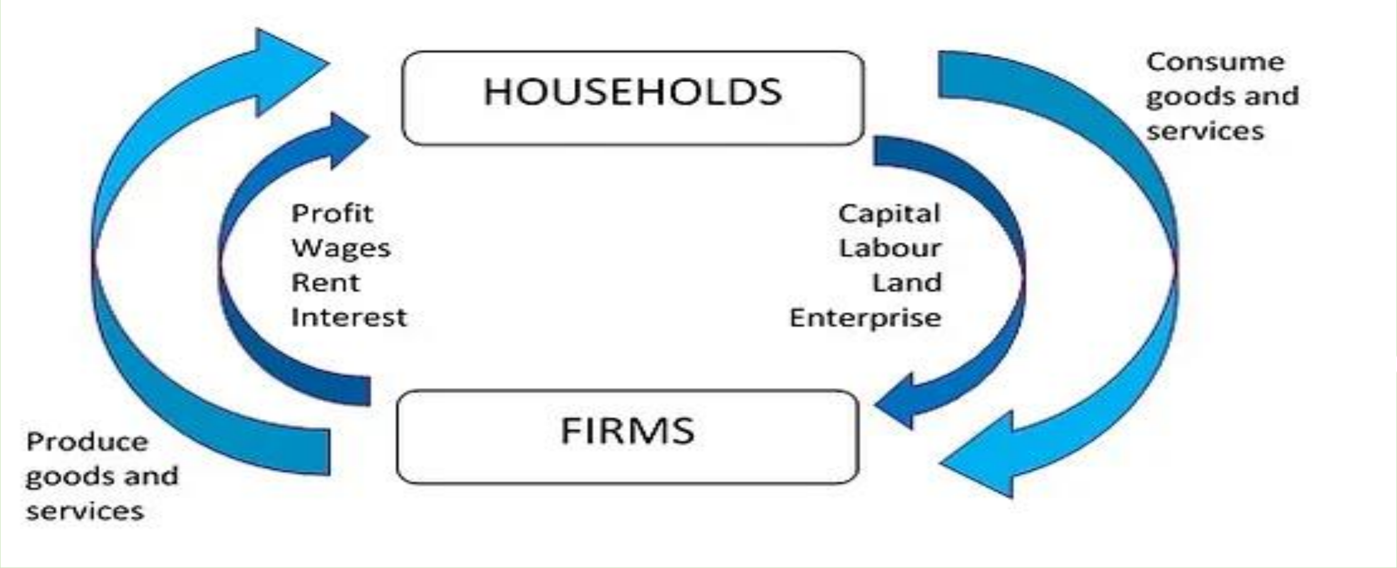
In a two-sector economy, there are only two sectors of economic activity –

(1) HOUSEHOLDS ***(2) FIRMS.***

1. HOUSEHOLDS - **the owner of factors or production and consumers of goods and services. Households spend their entire income on consumption.**

2. FIRMS – produces goods and services and sell them to the households.

It is the simplest form of CLOSED ECONOMY.



Assumptions of Circular Flow of Income

1. There are only two sectors in the economy- Households and Firms. It means, there is no Government and Foreign Sector.
2. Household sector supplies factor services only to firms and the firms hire factor services only from households.
3. Firms produces goods and services and sell their entire output to the households.
4. Households receive factor income for their services and spend the entire amount on consumption of goods and services.
5. There are no savings in the economy, i.e. neither the households save from their incomes, nor the firms save from their profits.