MACRO ECONOMICS

LEARNING MATERIAL

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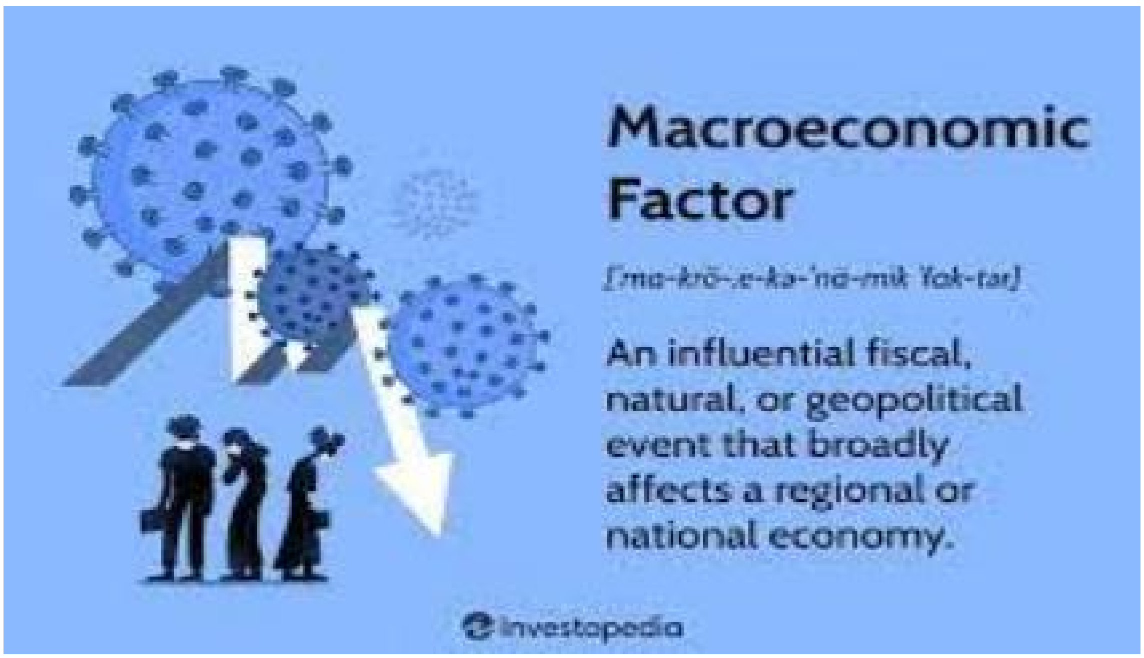


CLASSIFICATION OF GOODS

- I – FINAL GOODS AND INTERMEDIATE GOODS
- II – CONSUMPTION GOODS AND CAPTIAL GOODS

FINAL GOODS

- Those goods which have crossed the boundary line of production and ready for use by their final users
- **Who are final users?**
- - Consumers and Producers
- **Final Consumer goods** are the goods which are ready for use by their final users. Eg. Readymade Shirt
- Final producer goods are the goods which are ready for use by the producers and are generally used in the process of production.

EXPENDITURE ON FINAL GOODS

- **Expenditure on final Goods**
  - = Consumption Expenditure + Investment Expenditure
- Consumption Expenditure
  - Expenditure on final consumer goods by the households is called as consumption expenditure
- Investment Expenditure
  - Expenditure on final producer goods by the producer is called as investment expenditure

INTERMEDIATE GOODS

- These Goods are
  - Which have yet not crossed the boundary line of production
  - Value is still to be added to these goods
  - Which are not yet ready for use by their final users
- These goods are purchased as raw materials or as goods for resale
- Intermediate goods are not included in the estimation of national product or national income otherwise this may lead to Double Counting

EXPENDITURE ON INTERMEDIATE GOODS

- Expenditure on intermediate goods by the producers during an accounting year is called as intermediate consumption or intermediate cost

- Intermediate consumption is deducted from the value of output to get gross value of addition.

SAME GOOD MAY BE FINAL AND INTERMEDIATE GOODS

- Same good may be final good and Intermediate good.
- The distinction depends on the End-use of the goods.
- For eg. Sugar may be used as a raw material in the production of biscuits is an intermediate goods
- But if it is used by the households in milk or tea is a final good.

DIFFERENCE BETWEEN FINAL AND INTERMEDIATE GOODS

Ans. The differences are given in the table below

Final goods	*Intermediate goods*
Used for final consumption.	Not used for final consumption.
Ready for use by final users.	Not ready for use by final users.
Made using intermediate goods.	Used as raw material for production of final goods.
They are finished goods.	They are unfinished goods.
Value is calculated for GDP.	Not calculated, as the value of final goods included the value of intermediate goods.
e.g. biscuits are final goods.	e.g. flour, milk and sugar are intermediate goods used in making biscuits.

CONSUMER AND CAPITAL GOODS

CLASSIFICATION OF CONSUMER GOODS

- Durable Consumption Goods
  - Used for Several Years and of high value
- Semi-Durable Consumption goods
  - Used for a period of one year or slightly more and not of high value
- Non-Durable or Single-Use Consumption Goods
  - Used up in a single act of consumption
- Non-Material Goods or Services
  - Non-Material goods which directly satisfy human wants

THE DIFFERENCE – CONSUMPTION AND CAPITAL GOODS

Consumer Goods	Capital Goods
• These goods are consumed to satisfy current wants of consumers directly. • For example, food, shirt, shoes, cigarettes, pen, TV set, and radio, etc. are all consumer goods. • Similarly, services rendered to consumers by hotels, retailers, barbers, etc. are consumer services. • Consumption goods sustain the basic objective of an economy, i.e., to sustain the consumption of entire population of the economy. • Consumer goods are further classified into durable and non-durable goods. • Durable goods are those which can be used in consumption again and again over a considerable period of time, e.g., chair, car, fridge, shoes, TV set. • Non-durable goods are like single use goods which are used up by consumers in a single act of consumption, e.g., milk, fruits, matches, cigarettes, coal, etc.	• There are the goods that are of durable character which are used in the production process. • While they make production of other commodities feasible, they themselves don't get transformed in the production process. • These goods form a part of capital, one of the crucial factors of production in which a productive enterprise has invested. • They gradually undergo wear and tear, and thus are repaired or gradually replaced over time.

ALL PRODUCERS GOOD ARE NOT CAPITAL GOODS

- Producers goods include goods as raw materials as wood, oil etc and goods as fixed assets like plant and machinery
- Capital goods include only fixed assets of the producers
- Producers goods like raw materials are single use producers goods on the other hand capital goods are durable use producers goods
- Accordingly all producers goods are not capital goods

CONSUMPTION EXPENDITURE & INVESTMENT SESSION - 3

DR. K. CHITRA

Consumption and consumer

- Consumption in Economics, is the use of goods and services by households
- Consumer is anyone who buys or uses a good or service
- Consumers can be classified as
  - Households
  - The Government
  - Non-Profit Private Institutions (NGO, Temples, others)

Consumption expenditure

- The purchase of goods and services by use of households is called consumption expenditure
- In Macro Economics, consumption Expenditure refers to aggregate consumption expenditure in the economy
- Aggregate Consumption Expenditure

  = CE by the Households + CE by the Govt. + CE by the Non-profit private institutions

Concept and components of investment

- Investment refers to increase in the stock of capital
- $I = \Delta K$
- Here I = Investment
- K = Capital Stock

  ΔK = Change in capital stock during the year
- Change in the stock of capital is called as capital formation

Investment and its types

- Investment refers to total production of capital goods during an accounting year
- These capital goods may be used either for the replacement of existing capital stock or for adding to the existing capital stock
- Components of Investment
  - Fixed investment
  - Inventory investment

FIXED INVESTMENT & INVENTORY INVESTMENT

- Fixed investment refers to increase in the stock of fixed assets (plant & machinery) of the producers during an accounting year.
- Inventory investment change in inventory stock during the year
- Producers hold the stock various kinds of goods and we call them as inventory stock.

GROSS INVESTMENT, NET INVESTMENT AND DEPRECIATION

- Gross Investment refers to total production of capital goods
- This includes
  - Capital goods used for the replacement of existing capital stock (depreciation)
  - Capital gods used as a net addition to the existing stock (net investment)
- Gross Investment = Net investment +Depreciation
- Net Investment = Gross Investment - Depreciation

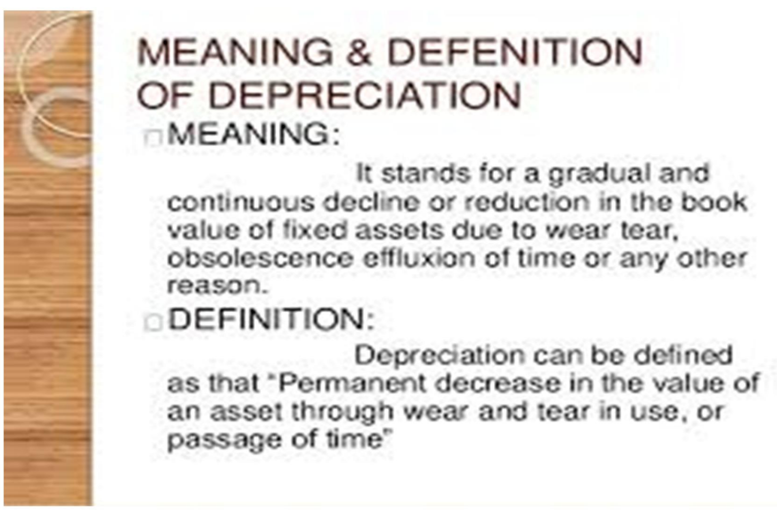
DIFFERENCE BETWEEN GROSS AND NET INVESTMENT

Gross Investment versus Net Investment

- **Gross investment** is the total value of all newly produced capital goods (plant, equipment, housing, and inventory) produced in a given period.
- **Depreciation** is the amount by which an asset's value falls in a given period.
- **Net investment** equals gross investment minus depreciation.

$$\text{capital}_{\text{end of period}} = \text{capital}_{\text{beginning of period}} + \text{net investment}$$

DEPRECIATION



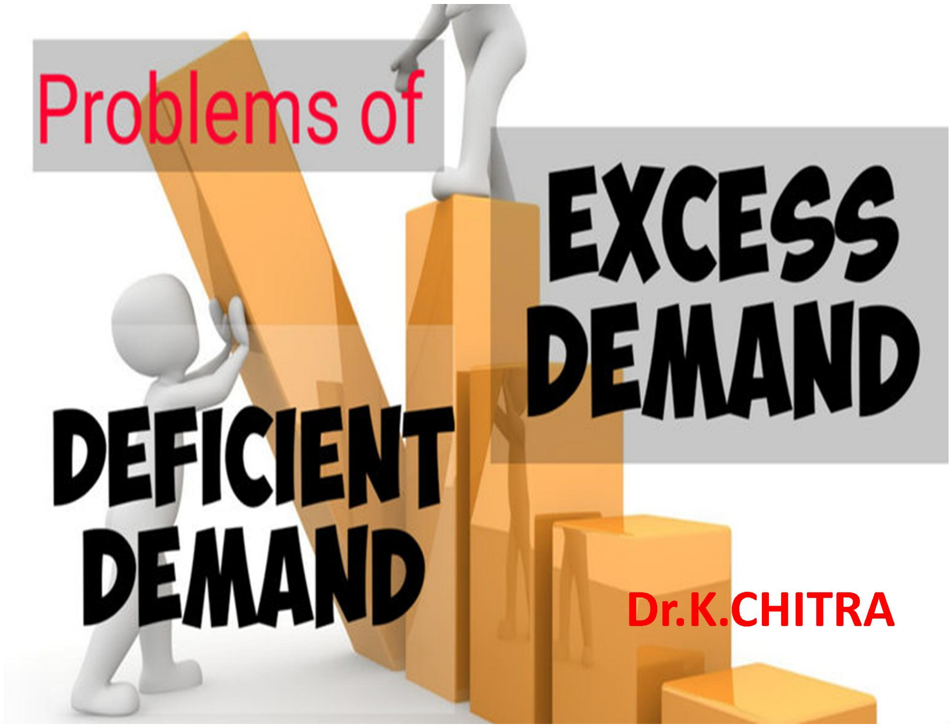
Reason for loss of value

Depreciation

- Depreciation is defined as the gradual decrease in the value of an asset.
- Causes of depreciation are:
  - Wear and tear
  - Exhaustion
  - Obsolescence
  - Efflux of time
  - Accidents

Formula for depreciation

$$\frac{\underset{\text{Cost of asset}}{\$25{,}000} - \underset{\text{Salvage value}}{\$5{,}000}}{\underset{\text{Years of estimated useful life}}{5}} = \underset{\text{Straight Line Depreciation}}{\$4{,}000}$$



Definitions

- **Full Employment**

It is situation in which all the workers who are capable and willing to working and get employment at reasonable wages. (It's meaning not be derive that all adults have must Jobs)

- **Unemployment**

It is also a situation in which all the workers who are capable and willing to working do not get employment or jobs.

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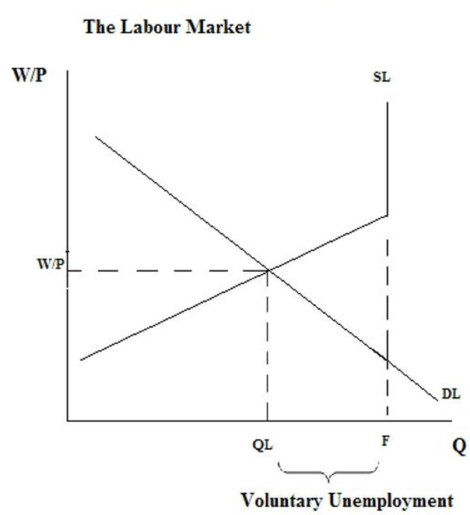
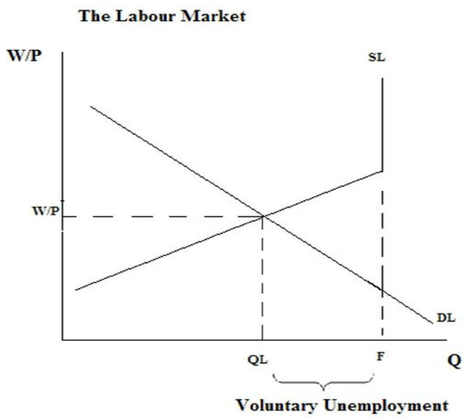
Voluntary and Involuntary Unemployment



- Voluntary Unemployment= Those people who don't have a job, but at the existing wage do not seek employment
- Involuntary Unemployment = Those who would like to work at the existing wage rate but cannot get a job.

At the equilibrium wage rate there is no involuntary unemployment.

Voluntary and Involuntary Unemployment



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Full Employment

Definition: Full employment means a situation in which all of the people who are willing and able to work are able to find employment.

Determining Full Employment

- Some unemployment is voluntary and some unemployment is involuntary.
- The *natural rate of unemployment* is:
  - The unemployment rate at which there is neither excess demand nor excess supply in the labor market, or
  - The unemployment rate that will occur in the long run if the expected and actual rates of inflation are equal.
- The natural rate of unemployment changes over time.

So… what is full employment?

Full employment is not the same as *zero* unemployment.

The economy strives to reach its potential which means that full employment is essential.

When the **actual rate of unemployment exceeds the natural rate,** the actual output of the economy will fall below its potential.

Resources are underutilized (inside production possibility curve.)

Types of Unemployment

Frictional Unemployment

- **Occurs when people change jobs, get laid off from their current jobs, take some time to find the right job after they finish their schooling, or take time off from working for a variety of other reasons**

Structural Unemployment

- **Occurs when workers' skills do not match the jobs that are available. Technological advances are one cause of structural unemployment**

Seasonal Unemployment

- **Occurs when industries slow or shut down for a season or make seasonal shifts in their production schedules**

Cyclical Unemployment

- **Unemployment that rises during economic downturns and falls when the economy improves**

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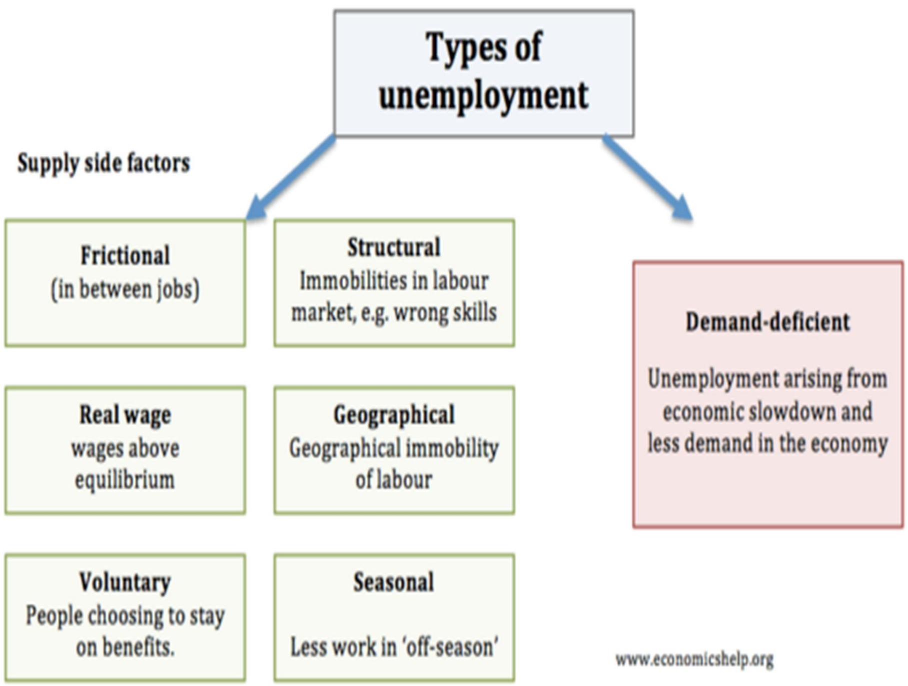
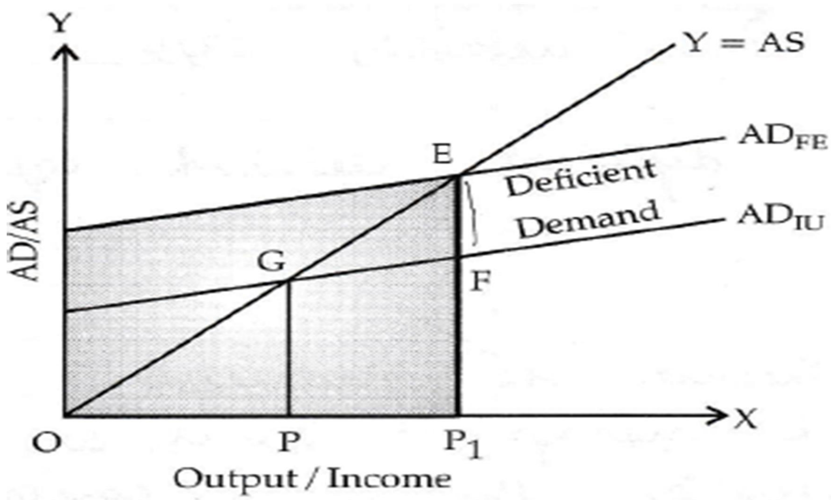


SUMMARIZATION

EXCESS DEMAND	DEFICIENT DEMAND
Meaning ::	**Meaning ::**
(1) It is a situation when AD > AS at the full employment level.	(1) It is a situation when AD < AS at the full employment level.

MEASUREMENT OF DEFICIENT DEMAND



CAUSES OF DEFICIENT DEMAND

Two Sector Economy

- ❖Reduction in Private Consumption Expenditure (C)
- ❖Reduction in Private investment Expenditure (I)

Four Sector Economy

- ❖Reduction in Government Expenditure (G)
- ❖Decline in Exports (X)
- ❖Rise in Imports (M)
- ❖Increase in Tax Rates

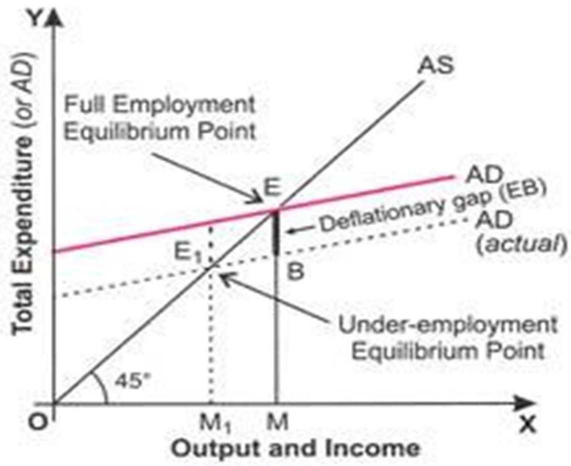
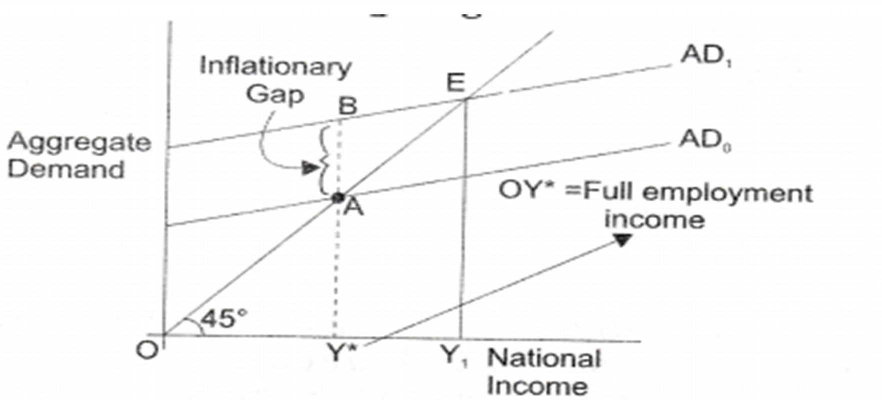

Y
X
O
Total Expenditure (or AD)
AS
Full Employment
Equilibrium Point
E
AD
Deflationary gap (EB)
AD
(actual)
E_1
B
Under-employment
Equilibrium Point
45°
M_1
M
Output and Income

Fig 8.17

Excess Demand

- The problem of excess demand occurs when quantity demanded is more than quantity supplied. When the actual price in the market is below the equilibrium price you have excess demand, because a low price encourages buyers and discourages sellers. As long as there is excess demand and the quantity demanded exceeds the quantity supplied, suppliers will keep raising the price to meet equilibrium.



In the above diagram Excess Demand is of AB because at Full Employment Y*, Aggregate demand (BY*) is greater than Aggregate Supply (AY*).

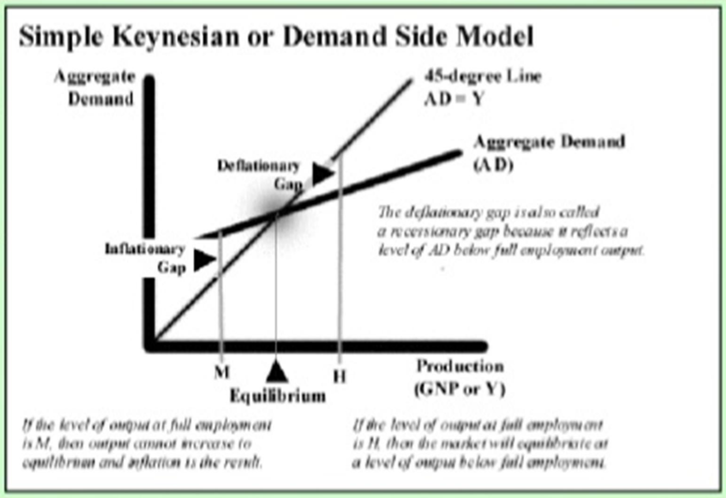
Causes of Excess Demand

- Deficit financing (printing of currency notes),
- Increase in Marginal Propensity to consume
- Increase in autonomous investment.

CONSEQUENCES OF EXCESS AD

- **Inflationary Gap**
- **Static GDP**
- **Excess Demand and wage-Price spiral**
- **Loss of profit**

Inflationary and Deflationary Gaps



How to escape from Inflationary and Deflationary gaps?

Inflationary Gap	Basis	Deflationary Gap
When in an economy aggregate demand exceeds "aggregate supply at full employment level", the demand is said to be an excess demand and the gap is called inflationary gap.	**Meaning**	When in an economy, aggregate demand falls short of aggregate supply at full employment level, the demand is said to be a deficient demand and the gap is called deflationary gap.
(*i*) Increase in household consumption demand due to rise in propensity to consume. (*ii*) Increase in private investment demand because of rise in credit facilities. (*iii*) Increase in public (government) expenditure. (*iv*) Increase in export demand. (*v*) Increase in money supply or increase in disposable income.	**Reasons**	(*i*) Decrease in household consumption demand due to fall in propensity to consume. (*ii*) Decrease in private investment demand because of fall in credit facilities. (*iii*) Decrease in public (Government) expenditure. (*iv*) Decrease in export demand. (*v*) Decrease in money supply or decrease in disposable income.
(*i*) **Effect on General Price Level** Excess demand gives a rise to general price level. (*ii*) **Effect on Output** Excess demand has no effect on the level of output because economy is at full employment level. (*iii*) **Effect on Employment** There will be no change in the level of employment also. The economy is operating at full employment equilibrium already and hence there is no unemployment.	**Impact**	(*i*) **Effect on General Price Level** Deficient demand causes the general price level to fall. (*ii*) **Effect on Employment** Due to deficient demand, investment level is reduced, which causes involuntary unemployment in the economy due to fall in planned output. (*iii*) **Effect on Output** Low level of investment. An employment implies low level of output.

Difference between Monetary and Fiscal Policy

Monetary Policy

1. **Objective** – to maintain price stability, full employment and economic growth
2. **Regulates** – money supply and cost and availability of credit. Also influences and borrowing rates of commercial banks

Fiscal Policy

1. **Objective** – to change aggregate demand, to control inflation and to overcome recession
2. Causes a deliberate change in govt. revenue and expenditure with a view to influencing the price level and the quantum of national output

Both monetary and fiscal policies are instruments that are available to different arms of the govt. Though both are formulated and implemented by the same govt. they are done by different departments – monetary policy through Central bank and fiscal policy through the treasury or the ministry of finance

Fiscal Policy	Monetary Policy
Change in government spending and tax rates	Change in interest rates / money supply.
Set by the Government	Set by a Central bank
No specific target	Target inflation
Side effect on government budget / borrowing	Side effect on exchange rate and housing market
Strong political dimension to changing tax rates	Mostly independent from the political process

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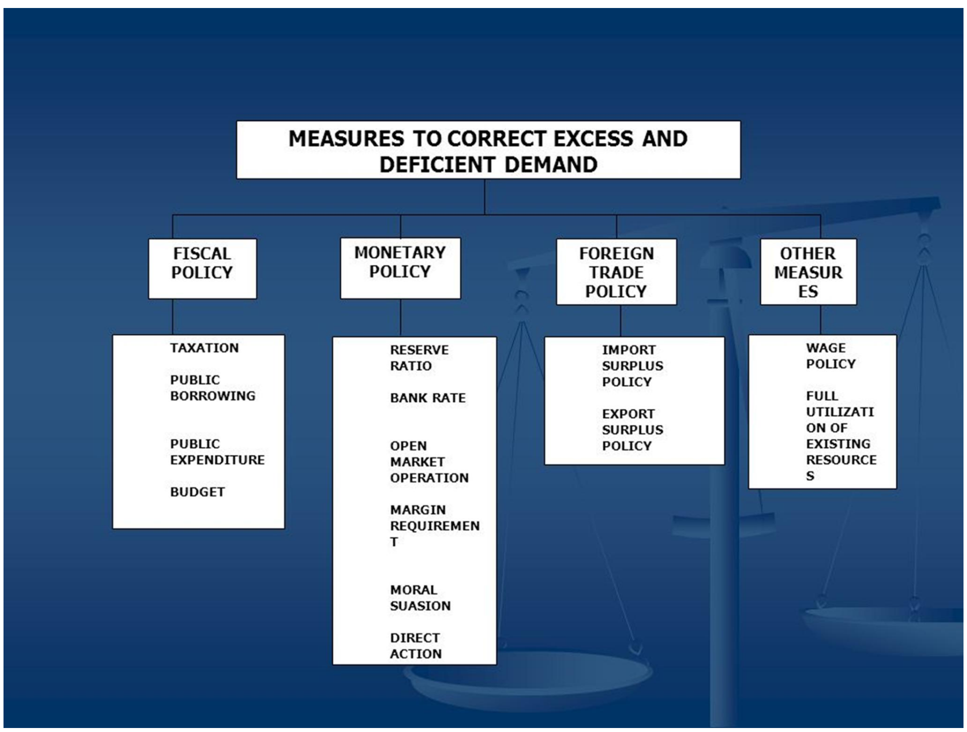

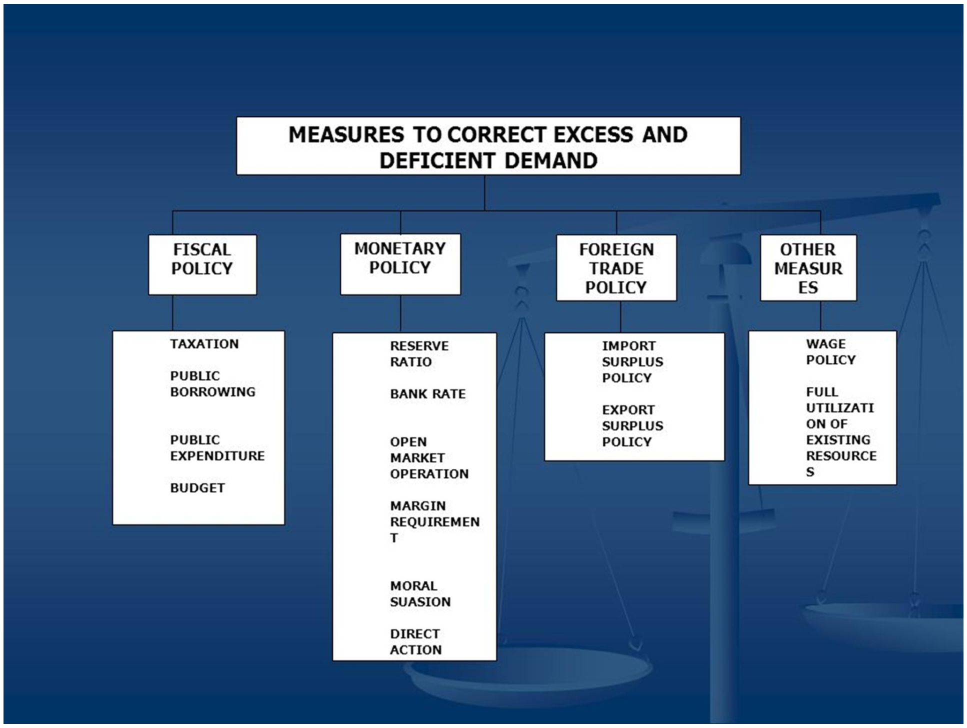
MEASURES TO CORRECT EXCESS AND DEFICIENT DEMAND
FISCAL POLICY
MONETARY POLICY
FOREIGN TRADE POLICY
OTHER MEASURES
TAXATION
PUBLIC BORROWING
PUBLIC EXPENDITURE
BUDGET
RESERVE RATIO
BANK RATE
OPEN MARKET OPERATION
MARGIN REQUIREMENT
MORAL SUASION
DIRECT ACTION
IMPORT SURPLUS POLICY
EXPORT SURPLUS POLICY
WAGE POLICY
FULL UTILIZATION OF EXISTING RESOURCES