INTRODUCTION AND STRUCTURE OF MACROECONOMICS

- **Macroeconomics** is the part of economic theory that studies the economy as a whole, such as national income, aggregate employment, general price level, aggregate consumption, aggregate investment, etc. Its main instruments are aggregate demand and aggregate supply. It is also called the **'Income Theory'** or **'EmploymentTheory'**.

- **Structure of macro economy:** As we know, Macroeconomics is concerned with economic problems at the level of an economy as a whole. Structure of Macroeconomics implies study of different sectors of the economy. An economy may be divided into different sectors depending on the nature of study.
  (a) Producer sector engaged in the production of goods and services.
  (b) Household sector engaged in the consumption of goods and services.
  Note: Households are taken as the owners of factors of production.
  (c) The government sector engaged in activities like taxation and subsidies
  (d) Rest of the world sector engaged in exports and imports.
  (e) Financial sector (or financial system) engaged in the activity of borrowing and lending.

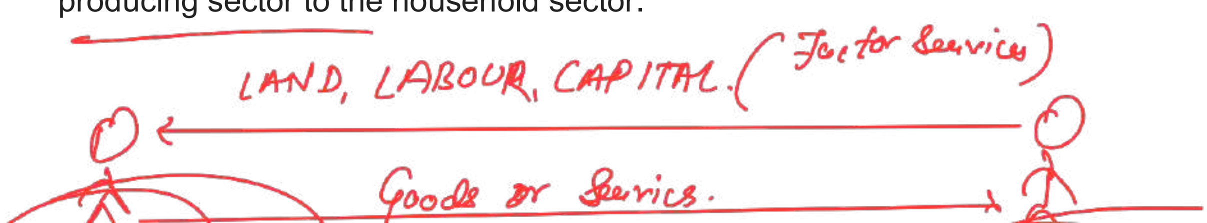
Household sector. Govt.
Producer sector Financial
Rest of the World.

- **Circular flow of income.**

  It refers to flow of money, income or the flow of goods and services across different sectors of the economy in a circular form.
  There are two types of Circular flow:
  (a) Real/Product/Physical Flow
  (b) Money/Monetary/Nominal Flow

(a) Real flow

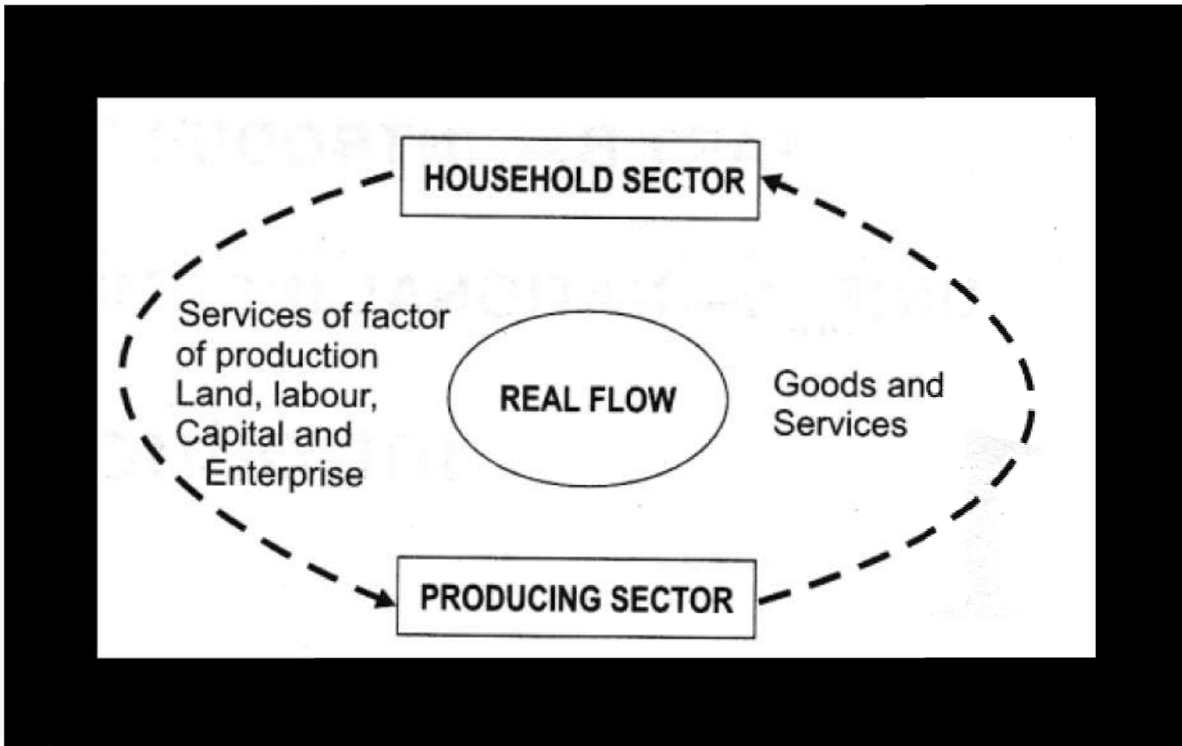
Real flow of income implies the flow of factor services from the household sector to the producing sector and corresponding flow of goods and services from the producing sector to the household sector.



Producer.

Household

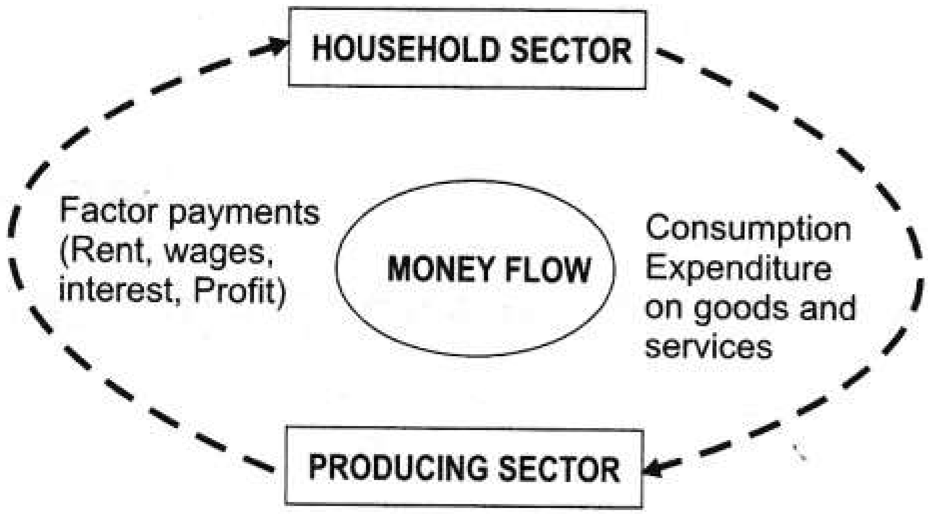
Let us consider a simple economy consisting only of 2 sectors:
• Producer Sector.
• Household Sector.



These two sectors are dependent on each other in the following ways:
• Producers supply goods and services to the households.
• Household (as the owners of factors of production) supplies factors of production (or factor services) to the producers.
This interdependence can be explained with the help of the diagram given here.

Money Flow

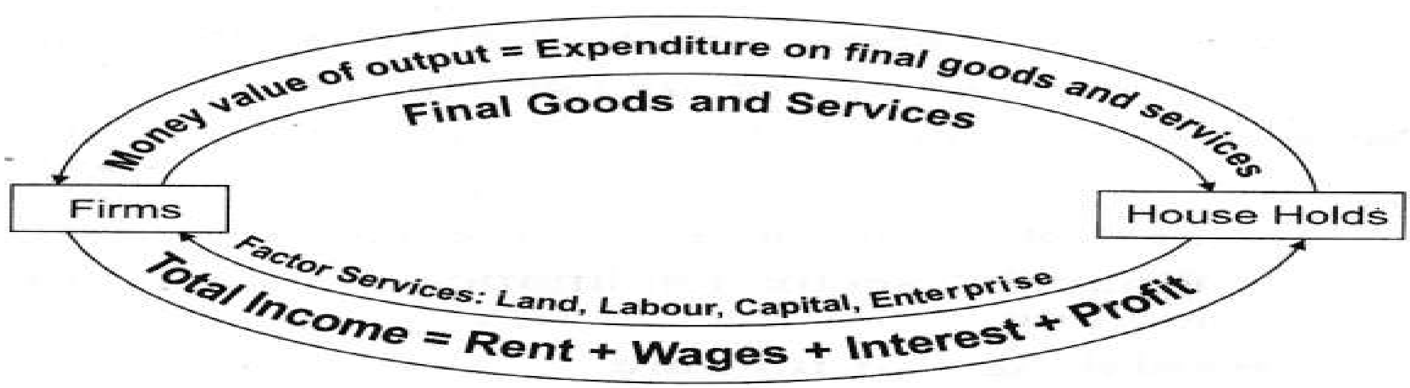
.Money flow refers to the flow of factor income, as rent, interest, profit and wages from the producing sector to the household sector as monetary rewards for their factor services as shown in the flowchart.



The households spend their incomes on the goods and services produced by the producing sector. Accordingly, money flows back to the producing sector as household expenditure as shown in the flowchart.

Circular Flow Of Income In Two Sector Model:

The following assumptions with regard to a simple economy with only two sector of economics activity are:



(i) There are only two sectors in the economy; that is, household and firms.

(ii) Household supply factor services to firms.

(iii) Firms hire factor services from Households.

(iv) Households spend their entire income on consumption.

(v) Firms sell all that is produced to the households.

(vi) There is no government or foreign trade.

Such an economy described above has two types of markets.

(i) Market for goods and services i.e. product market.

(ii) Market for factors of production i.e. factor market.

As a result we can derive the following, in the case of our simple economy

- Total production of goods and services by firms = Total consumption of goods and services by Household Sector.
- Factor Payments by Firms = Factor Incomes of Household Sector.
- Consumption expenditure of Household sector = Income of Firm.

Hence, Real flows of production and consumption of Firms and households = Money flows of income and expenditure of Firms and Households

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PHASES OF CIRCULAR FLOW

Three types of phases of Circular flow:-

(i) Production Phase:

• It deals with the production of goods and services by the producer sector.

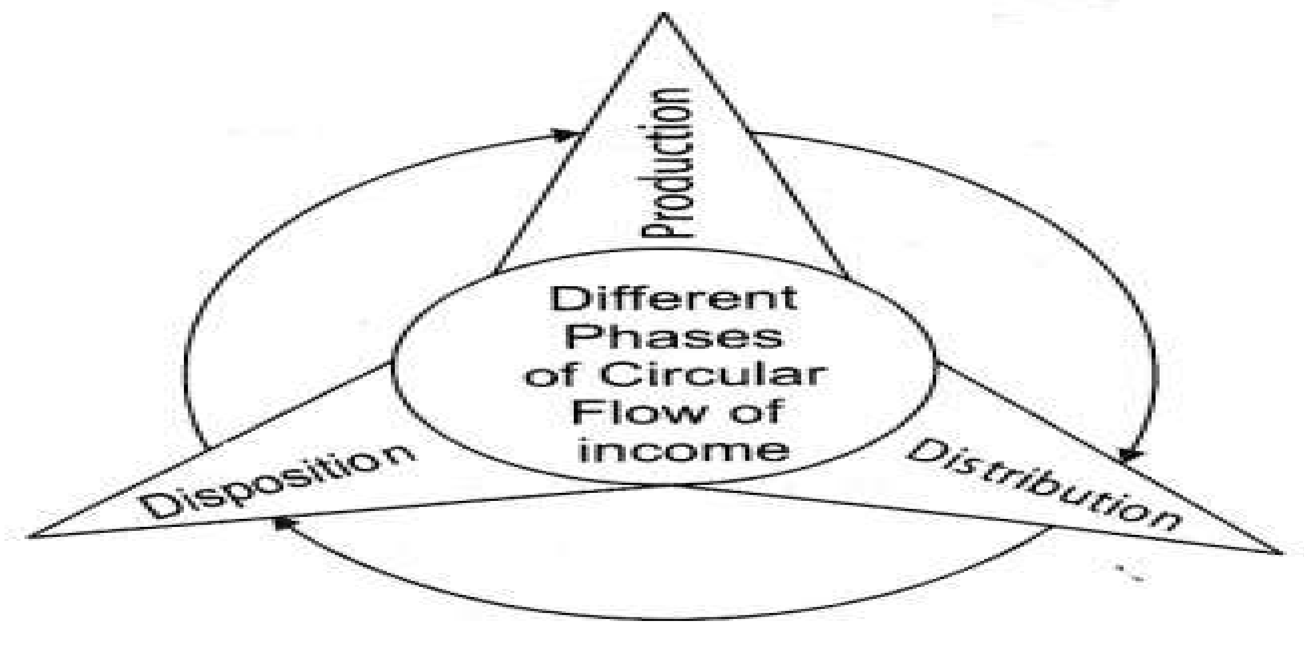
• If we study it in term of the quantity of goods and services produced, it is a Real Flow. But, it is a Money flow, if we study it in terms of the market value of the goods produced.

(ii) Distribution Phase: It means the flow of income in the form of rent, interest, profit and wages, paid by producer sector to the household sector. It is a Money Flow.

(iii) Disposition Phase:

• Disposition means expenditure made. This phase deals with expenditure on the purchase of goods and services by households and other sectors.

• This is a Money Flow from other sectors to the producer sector. These phases are illustrated in the figure given here.



Some Basic Concepts Of Macro-Economics

1. Factor Income

(a) Income earned by factor of production by rendering their productive services in the production process is known as Factor Income.

(b) It is a bilateral [Two-Sided] Concept.

(c) It is included in National Income as it contributes something in the flow of goods and services.

Examples: Rent, interest, wages and profit.

2. Transfer Income

(a) Income received without rendering any productive services is known as transfer income.

(b) It is a unilateral [one-sided] concept.

(c) It is not included in National Income as it does not contribute anything in the flow of goods and services.

Examples: Old Age Pension, Scholarship, Unemployment allowance.

There are two types of transfers:

(i) Current transfers (ii) Capital transfers

(i) Current Transfers

• Transfers made from the income of the payer and added to the income of the recipient (who receive) for consumption expenditure are called current transfers.

• It is recurring or regular in nature.
For example, scholarships, gifts, old age pension, etc.

(ii) Capital Transfers
• Capital transfers are defined as transfers in cash and in kind for the purpose of investment to recipients, made out of the wealth or saving of the donor.
• It is non recurring or irregular in nature.
For example, investment grant, capital gains tax, war damages, etc.

Stock

(a) Any economic variable which is calculated at a particular point of time is known as stock.

(b) It is static in nature, i.e., it do not change.

(c) There is no time dimension in stock variables..

For example, Distance, Amount of Money, Money Supply, Water in Tank, etc.

Flow

(a) Any economic variable which is calculated during a period of time is known as flow.

(b) It is dynamic in nature, i.e., it can be changed.

(c) There is time dimension in flow variables.

For example, Speed, Spending of Money, Water in River, Exports, Imports, etc.

Economic territory or Domestic Territory:

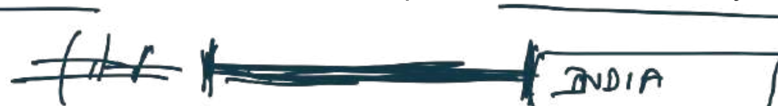
(a) According to the United Nations, economic territory is the geographical territory administered by a government within which persons, goods and capital circulate freely.

(b) The above definition is based on the criterion “freedom of circulation of persons, goods and capital”. Clearly, those parts of the political frontiers (or boundaries) of a country where the government of that country does not enjoy the above “freedom” are not to be included in economic territory of that country.

(iii) In layman terms, the domestic territory of a nation is understood to be the territory lying within the political frontiers (or boundaries) of a country. But in national income accounting, the term domestic territory is used in a wider sense. Based on ‘freedom’ criterion, the scope of economic territory is defined to cover:.

• **Ships and aircrafts** owned and operated by normal residents between two or more countries. For example, Indian Ships moving between china and India i regularly are part of domestic territory of India. Similarly, planes operated by Air India between Russia and Japan are part of the domestic territory of India. Similarly, planes operated by Malaysian Airlines between India and Japan are a part of the domestic territory of Malaysia

• **Fishing vessels, oil and natural gas rigs and floating platforms** operated by the residents of a country in the international waters where they have exclusive rights of operation. For example, Fishing boats operated by Indian fishermen in international waters of Indian Ocean will be considered a part of domestic territory of India.



• **Embassies, consulates and military establishments of a country located abroad**. For example, Indian Embassy in Russia is a part of the domestic territory of India. ‘Consulate’ is an office or building used by consul (an officer commissioned by the government to reside in a foreign country to promote the interest of the countiy to which he belongs)

6. Citizenship/Nationalship

(a) Citizenship is basically a legal concept based on the place of birth of the person or some legal provisions allowing a person to become a citizen.

(b) It means, Indian citizenship can arise in two ways:-

(i) When a person is born in India, he acquires automatic citizenship of India.

(ii) A person born outside India applies for citizenship and Indian Law allows him to become ~~Indian Citizen~~.

7. Normal Resident/Resident

A Normal resident, whether a person or an institution, is one whose centre of economic interest lies in the economic territory of the country in which he lives.

The centre of economic interest implies in two things

(i)The resident lives or is located within the economic territory for more than one year and
(ii) The resident carries out the basic economic activities of earnings, spending and accumulation from that location

There is a difference between the terms normal resident (resident) and citizen (or national).

A person becomes a national of a country because he was born in the country or on the basis of some other legal criterion.

(ii) A person is treated resident of a country on the basis of economic criterion.
(iii) It is not necessary that a resident must also be the national of that country. Even foreigners can be the residents if they pass the above stated economic criterion.

For example, a large number of Indian nationals have settled in U.S.A., England, Australia, etc. as residents (and not as nationals) of these countries. For India, they are Non-resident Indians (NRI) but continue to remain Indian nationals.

Following are not included under the category of Normal residents:

(i) Foreign visitors in the country for such purposes as recreation, holidays, medical treatment, study tours, conferences, sports events, business etc. (they are supposed to stay in the host

country for less than one year. In case they continue to stay for one year or more in the host country, they will be treated as normal residents of the host countiy).

(ii) Crew members of foreign vessels, commercial travelers and seasonal workers in , the country (Foreign workers who work part of the year in the country in response to the varying seasonal demand for labour and return to their households and border workers who regularly cross the frontier each day or somewhat less regularly, (i.e. each week) to work in the neighbouring country are the normal residents of their own countries. Example: Nepal.

(iii) Officials, diplomats and members of the armed forces of a foreign country.

(iv) International bodies like World Bank, World Health Organisation or International Monetary Fund are not considered residents of the country in which these organisations operate but are treated as residents of international territory. However, the staffs of these bodies are treated as normal residents of the country in which the international body operates. For example, international body like World Health Organisation located in India is not normal resident of India but Americans working in its office for more than a year will be treated as normal residents of India.

(v) Foreigners who are the employees of non-resident enterprises and who have come to the country for purposes of installing machinery or equipment purchased from their employers. (They are supposed to stay for less than one year. In case they continue to stay for one year or more, they will be treated as normal residents of the host country).

Final Goods

(a) These are the goods that are used for:
(i) Personal Consumption (like bread purchased by consumer household), or (if) Investment Or Capital Formation (like building, machinery purchased by a firm)
(b) In other words, final goods are those, which require no further processing and are available in an economy for consumption purpose or investment. These give direct satisfaction to a consumer.
(c) According to production boundary, if a good crosses the imaginary line around the production unit and reaches to final consumer or investment made by a producer within the imaginary line of production unit is known as the final good.

INTERMEDIATE GOODS

(a) These are the goods that are used for:
(i) Further processing (like sugar used for making sweets); or
(ii) Resale in the same year (If car purchased by car dealer for resale).

(b) In other words, intermediate goods are the ones, which require further processing and are not available in an economy for the purpose of consumption. These goods give indirect satisfaction to a consumer.
(c) According to the production boundary, if a good does not cross the imaginary line around the production unit and reaches to other firm within the production boundary, is known as intermediate good.

POINT TO REMEMBER FOR FINAL GOODS AND INTERMEDIATE GOODS

(a) Basis of Classification:

If a good is used for:
Personal consumption or Investment
Then it is a final good, whereas

if a good is used for:

Further processing or Resale in the same year,
then it is known as intermediate good.
Thus, the basis of classification between these two goods is not the commodity itself, but the use made of it..

PRODUCTION BOUNDARY

Production boundary plays a vital role to differentiate between intermediate and final goods. The production boundary is the imaginary line around the production unit.
According to the production boundary, if a good crosses the imaginary line around the production unit and reaches to final consumer or investment made by a producer within the imaginary line of production unit, it is known as final good.