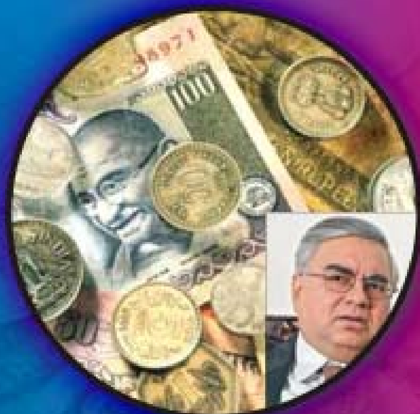
Principles of Economics (Macro)



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Himalaya Publishing House

PRINCIPLES OF ECONOMICS (MACRO)

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First Edition : 2012

Himalaya Publishing House

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First Edition : 2012

Published by	:	Mrs. Meena Pandey for **Himalaya Publishing House Pvt. Ltd.,** "Ramdoot", Dr. Bhalerao Marg, Girgaon, **Mumbai - 400 004.** Phone: 022-23860170/23863863, Fax: 022-23877178 **E-mail: himpub@vsnl.com; Website: www.himpub.com**
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Guwahati	:	House No. 15, Behind Pragjyotish College, Near Sharma Printing Press, P.O. Bharalumukh, Guwahati - 781009, (Assam). Mobile: 09883055590, 09883055536
DTP by	:	HPH, Editorial Office, Bhandup (Swapnali).
Printed at	:	M/s. Sri Bala Offset Printers, Hyderabad, On behalf of HPH.

Preface

The vagaries of business across the globe are more evident than ever before. The economic events that take place at macro level have impact on businesses, households and governments. The policymakers strive to maintain a harmonious economic environment. At this backdrop, recourse to macroeconomics becomes more vital.

This book is especially designed for the management students who want to peep into macroeconomic literature in pursuit of better understanding of macroeconomic concepts and problems. The authors have made an attempt to explore and discuss some of the core macroeconomic topics in a systematic and lucid manner.

The authors acknowledge, in general, their sincere gratitude to all those people whose ideas have been consulted or referred to, with or without specific mention.

D.M. Mithani
G.R. Arora

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CHAPTER One

Introduction to Macroeconomics

Structure

1. DEFINITION AND SCOPE OF MACROECONOMICS

Macroeconomics is the study of the aggregate behaviour of the economy as a whole. It is concerned with the macroeconomic problems such as the growth of output and employment, national income, the rates of inflation, the balance of payments, exchange rates, trade cycles, etc. In its study, we examine the interrelationships and interaction among various aggregates, their determinants and causation.

According to Prof. Ackley: "Macroeconomics deals with economic affairs 'in the large', it concerns the overall dimensions of economic life." In short, macroeconomics deals with the major economic issues, problems and policies of the present times. Macroeconomics is the study of the major economic "aggregates" or totals. National income, money, total investment, savings, unemployment, inflation, balance of payments, exchange rates, etc., are the crucial economic aggregates.

Macroeconomics is a fascinating subject and challenging too, because it takes an overview of the functioning and relationships in the whole economy by reducing complicated details to comprehensive and manageable essentials. In macroeconomic analysis the behaviour of economic agents such as firms, households and government is seen in total, disregarding details at the particular level, i.e., micro level.

An individual consumer, particular market for a given commodity, operation of a firm, etc., are the subject-matter of economics. Macroeconomics deals with the market for all goods as a whole. It is considered as the product or commodity market in general. Similarly, labour market is taken as a whole for the entire labour force in the economy. Likewise, financial market is taken as a whole which covers money market, capital market and all banking and non-banking institutions taken together.

There is no basic conflict between microeconomics and macroeconomics, because, the aggregate of the whole economy is composed by the sum of individual units and sub-markets. In microeconomics, we study the pricing of a particular commodity. In macroeconomics we study the price level.

Methodology of macroeconomics, however, differs from that of the micro-economics. In microeconomic analysis, it is assumed that total output and the general price level of the economy are given; and then an explanation is provided for the determination of equilibrium price and output of an individual product. In macroeconomic analysis, we assume distribution of income and relative prices as given and seek to explain determination of total output/income and the general price level.

It must, however, be recognised that in reality, changes in microeconomic variables carry their impact on the macroeconomic variables, and *vice versa.* Therefore, a complete understanding of economic science requires the study of both micro and macroeconomics.

Prior to Keynesian revolution in economic thinking in the 1930s, the classical economist had concentrated more on microeconomic approach, and macro behaviour was also described as mere summation of individual observations. Prof. J.M. Keynes in 1936, published, *"The General Theory of Employment, Interest and Money"* which revolutionised the whole economic thinking. He suggested that macroeconomic behaviour should be studied separately. Behaviour in total is quite different than what we may try to infer by summation of individual behaviour. He said that, for instance, saving is a private virtue but it is a public vice in a matured economy cause deficiency of demand leading to depression.

Keynes prescribed macroeconomics as a policy-oriented science to deal with the problems like unemployment, inflation etc. Economics of Keynes serves as the foundation centre for the modern economics.

It follows that the score of macroeconomics is confined with the behaviour of the economy in total. It does not examine individual behaviour.

Macroeconomics relates to the economy-wide total or aggregates and problems of general nature. Its policies are general. The subject matter of macroeconomics include the theory of income and employment, theory of money and banking, theory of trade cycles and economic growth.

Short and Long Run Economic Activity

Macroeconomics deals with economic activity as a whole. The functioning of the economic system and the course of economic activity may be viewed from the long and short run point of view. In macroeconomic analysis, short-run is an immediate period and short span of time, covering a year or a few years, at the most. During short run economic activity is assumed to be under given technological conditions, given habits of people, given population, availability of labour force etc. Short run changes are not dynamic and do not radically change the norm of economic activity.

Long run is a long span of time running over decades together. Long run involves dynamic changes. The classical economists assumed long run analysis. In their view long run equilibrium is automatic and there is full employment level. The classical assumption of full employment condition was based on the Say's Law of Market.

Keynes, however asserted that we should adopt a short run analysis, because in the long run we are all dead. Short run is more realistic. We should seeks to solve our problem from short run point of view.

In a developing economy under planning, however, we consider short run and long run views together. India's Five Year Plans are short run plans with annual set of budgetary expenditures. But, the planning as a whole has a long-term perspective for at least 15 years in view.

In cyclical behaviour of economic activity in a capitalist economy also we look into minor and major cycles on long-term considerations.

While, we may also see seasonal variations in short-term view of the economic and business activity.

We may have short-term budgetary policy for a year and a long-term fiscal policy covering a number of years together.

Macro Theories

Macroeconomic theories provide explanation to interrelationship and causation among different macroeconomic variables and issues relating to the aggregate economic behaviour and the associated problems.

Set of macrotheories differ from that of the micro theories. The former deals with aggregates; while, the later deals with individual units.

There are a number of macroeconomic theories. These are:

1. Theory of income and employment – Classical and Keynesian.
2. Theories of trade cycles:
   (a) Pure monetary theory of trade cycle.
   (b) Monetary over investment theory.
   (c) Non-monetary over investment theory.
   (d) Underconsumption theory.
   (e) Psychological theory.
   (f) Innovation theory.
   (g) Keynes's marginal efficiency theory.
   (h) Hicks's theory of trade cycle.
3. Theories of economic growth, e.g., theory of big-push.
4. Theories of inflation, e.g., Phillips curve hypothesis.

5. Theory of fiscal policy, e.g., theory of balanced budget multiplier.
6. Theory of monetary policy, e.g., quantity theory of money-monetarism.

Macro Policies

As Prof. Dernburg puts it: "Macroeconomics is first and foremost a policy science."

Macroeconomics is, thus, a policy-oriented subject. It deals with a number of policies of macro nature to solve many issues and problems.

Macroeconomic policies have macroeconomic goals to fulfill. Macroeconomic goals are:

1. Price stability.
2. Economic stability.
3. Exchange rate stability.
4. Attainment and maintenance of full employment.
5. Economic growth.
6. Economic justice.
7. Improvement of common standard of living.
8. Eradication of poverty.

There are a number of macroeconomic policies, such as:

1. Monetary policy.
2. Fiscal policy.
3. Income policy.
4. Trade policy.
5. Industrial policy.
6. Import-export policy.
7. Banking policy.
8. Planning policy

2. IMPORTANCE OF MACROECONOMIC STUDIES

Macroeconomic studies have unique theoretical and practical significance.

1. ***Macroeconomics Provides an Exploration to the Functioning of an Economy in General:*** Using macroeconomic tools and technique of economic analysis, one can understand the working of the economic system in a better way.
2. ***Empirical Evidences:*** Macro studies are based on empirical evidences of the theoretical issues. Macroeconomics is more realistic.
3. ***Policy-orientation:*** Macroeconomics is a policy-oriented science. It suggests a best of policy measures, such as fiscal policy, monetary policy, income policy, etc., to deal with complex economic problems like unemployment, poverty, inequality, inflation, etc., faced by the country in modern times. To quote Tinbergen, thus: "Working with macroeconomic concepts is a base necessity

in order to contribute to the solutions of the great problems of our times." In short, macroeconomics is more practical. Its study is light-bearing as well as fruit-bearing. As Prof. Dernburg puts it: "The task of the policy-oriented macroeconomist is to show how these (macroeconomic tools) can be used to narrow the gaps between actual employment and full employment, between actual inflation and between the actual growth rate and the growth of potential output."

4. ***National Income:*** Macroeconomics teaches the computation, use and application of national income data. With the help of national income statistics and accounting one can understand and evaluate the growth performance of an economy over a period of time.

5. ***Income and Employment Theory and Monetary Theory:*** Economics of employment and income and monetary economics are the major fields of macroeconomics which have utmost practical relevance. Planning and policy making is not possible without the base of the understanding of these two fields.

6. ***Dynamic Science:*** Macroeconomics is a dynamic science. It studies and suggests solutions to the issue and problems from the dynamic viewpoint. It allows for changes. One can have a better idea of a dynamic perspective in the real economic world in the light of macroeconomic tools and mode of its general equilibrium analysis.

3. LIMITATIONS OF MACROECONOMICS

Macroeconomics has certain limitations. These limitations are due to macroeconomic paradoxes one may come across when attempts are made to yield macroeconomic generalisations from individual experiences. Macro-economic paradox refer to phenomena which are true for economic systems' best nature in individual cases. Macroeconomic appears as follows:

1. ***Macroeconomic Variables Aggregates are Regarded as Homogeneous whole despite Internal heterogeneity —*** In macroeconomic analysis, macro variables are measured in total as a homogeneous components. In doing so, individual heterogeneity is not taken into account. However, macro components are homogeneous whole comprising internal heterogeneity in its structure. For example, inflation is measured as a change in general price level through say, wholesale price index number. The relative price structure and changes in the relative prices of different goods are not recognised. But actually the change in price level is rejected due to changes in the relative prices, but only average price is considered in measuring the change.

2. ***Macroeconomic Behaviour Involves Fallacy of Aggregation —*** Aggregate economic behaviour is formed by the sum total of individual behaviour. But, what is true for an individual does not become necessarily true for the entire economy when taken as a whole. For instance, savings are a private virtue but a public vice. An individual who saves more becomes wealthy. But savings of all individuals together will not make society more wealthy. Then, there is a paradox of thrift. It is a macro-economic paradox.

3. ***Macroeconomics is concerned with General Economic Welfare —*** General welfare disregards individual welfare. For example, increase in national income does not necessarily imply an improvement in the welfare of a particular individual, even though national income is supposed to reflect an aggregate of all individual incomes. Beside these macroeconomic paradoxes or difficulties, a major limitation of macroeconomic analysis lies in its indiscriminate use. Indiscriminate application of macroeconomic tools in analysing economic problems of the real world may sometimes lead us on the erroneous conclusions and wrong prescriptions. For example, check in money supply – a monetary policy measure can be alright for controlling overall inflation, but it cannot be just applied with the same merit for regulation of the prices of selected commodities. Further, measurement of macroeconomic variables such as price level, national income, etc., involve a number of conceptual and statistical difficulties of a practical nature.

4. MULTIPLE CHOICE QUESTIONS

1. The Macroeconomic study deals with
   (a) The level of output and employment in the economy
   (b) The general level of prices
   (c) The growth of real output
   (d) All of the above

Ans. (d)

2. Macroeconomics is study of
   (a) An individual economic entity
   (b) Large aggregates of an economy
   (c) Problem of scarcity
   (d) Problem of choice

Ans. (b)

3. Which of the following is not a macroeconomic concept?
   (a) Aggregate demand
   (b) Aggregate supply
   (c) Pricelevel
   (d) Demand for a product

Ans. (d)

4. Which of the following objectives is not a macroeconomic objective?
   (a) Price stability
   (b) Exchange rate stability
   (c) Determination of equilibrium price of a product
   (d) Economic growth

Ans. (c)

5. Economics has been classified into Microeconomics and Macroeconomics by
   (a) Adam Smith
   (b) Ragnar Frisch
   (c) Lionel Robbins
   (d) J.M.Keynes

Ans. (b)

6. The greek term 'macro' means
   (a) Large
   (b) Small
   (c) Study of economy
   (d) None of the above

Ans. (a)

7. Macroeconomic theories provide explanation for issues related to
   (a) Consumer behaviour
   (b) Firm's behaviour
   (c) Aggregate economic behaviour
   (d) Individual economic behaviour

Ans. (c)

8. In macroeconomic analysis we assume that
   (a) Total output is given
   (b) General Pricelevel is given
   (c) Relatives prices are given
   (d) There is no government intervention in the economy

Ans. (c)

9. The book *"The General Theory of Employment, Interest and Money"* was written by
   (a) Adam Smith
   (b) Marshall
   (c) J.M. Keynes
   (d) Milton Friedman

Ans. (c)

10. Macroeconomics is study of
    (a) Theory of Product pricing
    (b) Theory of Factor pricing
    (c) Theory of Economic welfare
    (d) Theory of Pricelevel

Ans. (d)

5. MODEL QUESTIONS

1. Define macroeconomics.
2. Describe the scope of macroeconomics.
3. What are the macroeconomic paradoxes?
4. What is the theoretical and practical significance of macroeconomic studies?
5. Write notes on:
   (a) Macroeconomic paradox.
   (b) Importance of macroeconomic studies.
   (c) Macro theories and macro policies.
   (d) Short and long run economic analysis.
   (e) Scope of macroeconomics.