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Business Economics (Macro) · D.M. Mithani · Anjali Sane

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Business Economics
(Macro)

(Strictly as per the Syllabus of Pune University, for S.Y. BBA, Semester III)

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Preface

This book is intended to serve as a comprehensive textbook on ***Business Economics (Macro)*** for the Second Year BBA degree course of Savitribai Phule Pune University (formerly Pune University) under the revised curriculum effective from June 2014. Its main objectives are:

1. To introduce basic macroeconomic concepts to the students
2. To study the applications of macroeconomics in policy making
3. To understand the policy issues for the new century.

The new century has witnessed spectacular changes in the living standards of most of the world. People are asking whether the 21st century can repeat the success of the last century. Will the affluence of few developed countries spread to the many in poor countries? Answers to these questions depend mainly on the economic success of the countries — in sectors such as education, investment, foreign trade, etc. It is heartening to note that the subject Business Economics (Macro) is an integral part of the revised BBA curriculum. The revised syllabus will definitely help the students in their career at academic as well as professional level.

The book is the outcome of long teaching, research and writing experience of the authors. The authors humbly claim the following distinct features of the book:

- It is written for students with simplicity and lucidity of exposition of complexities of the subject matter of topics included in the revised syllabus, simultaneously maintaining the standard of the textbook as well as the desired level of discussion.
- In writing the book, special care has been taken to avoid gaps in the sequential arrangement of topics in the syllabus.
- Topics covered are discussed as far as possible in a fairly self-contained manner.
- Model questions are provided to facilitate a systematic study of the subject.
- It contains a lucid and synthesized review of the subject matter from existing relevant literature so that the reader is spared of searching them in scattered places.

Authors

Syllabus

Objectives

1. To study the behavior of working of the economy as a whole.
2. To develop an analytical framework to understand the interlinkages among the crucial macroeconomic variables.
3. To apply economic reasoning to problems of business and public policy.

Unit 1: Introduction **(6L)**

- Definition and Nature of Macroeconomics.
- Scope, Importance and Limitations.

Unit 2: National Income Accounting **(8L)**

- National Income Aggregates (GDP, GNP, etc. at market price and factor cost).
- Approaches to measuring national income.
- Nominal and real measures of national income.

Unit 3: Theory of Income and Employment **(12L)**

- Say's Law of Markets.
- Consumption Function.
- Saving Function.
- Investment Function.
- Aggregate Expenditure Function.
- Keynes' Theory of Income and Employment.
- Concept of Underemployment Equilibrium .

Unit 4: Business Cycle, Inflation and Deflation **(11L)**

- Nature and Characteristics of Business Cycle.
- Phases of Business Cycle.
- Inflation – Meaning, Types, Causes and Control.
- Concept of Deflation.

Unit 5: Macro Economic Policies **(11L)**

- Creation of Credit
- Monetary Policy, Fiscal Policy.
- Supply side Economics – An Introduction.

Paper Pattern

Time: 3 Hours | Total Marks: 80

Instructions:

1. All questions are compulsory.
2. Figures to the right indicate full marks.

Q1.	Theory Question	(15 marks)
	OR	
	Theory Question	
Q2.	Theory Question	(15 marks)
	OR	
	Theory Question	
Q3.	Theory Question	(15 marks)
	OR	
	Theory Question	
Q4.	Theory Question	(15 marks)
	OR	
	Theory Question	
Q5.	Write Short Note (any 4 out of 6)	(20 marks)

Contents

1

Nature, Scope and Subject-matter of Macroeconomics

1. NATURE AND SCOPE OF MACRO-ECONOMICS

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.

Microeconomics 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, house-holds 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 micro-economics and macroeconomics, because, the aggregate of the whole economy is composed by the sum of individual units and sub-markets. In micro-economics, 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 micro-economic 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 micro-economic variables carry their impact on the macro-economic variables, and *vice versa.* Therefore, a complete understanding of economic science requires the study of both micro and macro-economics.

Prior to Keynesian revolution in economic thinking in the 1930s, the classical economist had concentrated more on micro-economic 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 then 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 macro-economics 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. It 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.

2. SHORT-RUN 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-run 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. (This we shall discuss in detail in later stage in the book.)

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 cycles 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 budgetory policy for a year and a long-term fiscal policy covering a number of years together.

3. MACRO CONCEPTS

Macro concepts relate to aggregates in units and behaviour of total. These are macro-economic variables. We may illustrate a few macro-economic concepts as under.

1. National Income: The total income of the nation is called "national income". The aggregate economic performance of the whole economy is measured by the national income data. In fact, national income data provide a summary statement of a country's aggregate economic activity.

In real terms, national income is the flow of goods and services produced in an economy in a particular period a year.

Modern economy is a money economy. Thus, national income of the country is expressed in money terms. A national Sample Survey has, therefore, defined national income as: "money measures of the net aggregates of all commodities and services accruing to the inhabitants of community during a specific period."

More elaborately, however, we may say that national income is a money measure of value of net aggregate of goods and services becoming available annually to the nation as a result of the economic activities of the community at large, consisting of households or individuals, business firms, and social and political institutions.

Like many other terms in common use, the concept "national income" has various connotations. For instance, national income is variously described. Sometimes it is known as "national income", at other times, "national product", or "national dividend." As a matter of fact, all these terms mean one and the same thing.

In national income accounting, thus, the concept of national income has been interpreted in three ways, as: (1) National Product, (2) National Dividend, (3) National Expenditure.

National Product: It consists of all the goods and services produced by the community and exchanged for money during a year. It does not include goods and services, which are not paid for, such as hobbies, housewives' services, charitable work, etc.

National Dividend: It consists of all the incomes, in cash and kind, accruing to the factors of production in the course of generating the national product. It represents the total of income flow which will exactly equal the value of the national product turned out by the community during the year.

National Expenditure: This represents the total spending or outlay of the community on the goods and services (of all types, capital as well as consumption) produced during a given year. Since income is the source of expenditure, national expenditure constitutes the disposal of national income, which is evidently equal to it in value or in other words, National Expenditure equals National Income.

Indeed, one man's income is another man's expenditure. When a person buys milk, it is his expenditure, but this very expenditure is the milkman's income. When the milkman spends parts of this income in buying sugar, it becomes income for the sugar merchant and so on. In a sense, therefore, the sum of expenditure of all agents of production is equal to the total income received by the factors of production during that year. National income can, therefore, be also defined as a sum of the expenditure on producer goods, consumer goods and services of agents of all production.

In fact, there is a fundamental equality between the total income of the community and its total expenditure, as one's expenditure becomes another's income in the economy. Hence, there is a large circular flow established in which each expenditure creates an income, which in its turn is spent and creates other incomes. Therefore, this total national income will be equal to total national expenditure.

2. Concept of Employment: "Employment of factor" refers to its use in the process of production. Employment of labour is an important macro-economic variable. In relation of labour, therefore, usually, the term "employment" refers to the employment of workers. Worker is said to be employed when he is engaged in an act of production. Usually, it is thought that a worker is employed at a particular wage rate. When a worker is employed he feels that the work he is doing is an irksome act, because his labour services are used in the process of production. Not only is his leisure sacrificed, but he also feels the pain of strain, physical as well as mental, and a fatigue or tiredness, after some hours of work. The end result of employment is the creation of some type of utility or an addition to value, in other words, employment of inputs in the creation of output. It is from the value of this output that the factors employed are compensated for their economic contribution.

The concept of employment then is a complex phenomenon. This is because it has to be related to some notion of "value" of the work accomplished. The question of valuation is very important in this context, because employment cannot always be defined in terms of physical activity only. For instance, a film actress just lying in the bed on the set is engaged in gainful employment. Economists have not paid much attention to the crucial problem of the measurement of employment. Keynes, for instance, treated the measurement

of employment as essentially a trivial problem. However, this is erroneous thinking. Again, in developing countries, the problem of the measurement of employment becomes more serious. In these countries, the concept of employment has become vague on account of the weak wages system and the widespread practice of the self-employment and of "unpaid family labour." Indeed, as Prof. Sen says, for an economy of peasants and artisans, the concept of employment loses its straightforward meaning and economic activity merges into a wider complex of family-based activities. The criterion of being paid a wage does not apply, and that of productivity is difficult to use since it is not easy to separate out of the productive contribution of any particular member of the family in the total family enterprise."

According to Prof. A.K. Sen, there are three important aspects of employment: (*i*) the income aspect, (*ii*) the production aspect, and (*iii*) the recognition aspect.

The *income aspect* indicates that employment of a worker yields an income to him, that is, when a worker sells his labour services for a wage, he is accepting employment in exchange for some earnings. A worker always wants that his earnings should be sufficient enough for him to maintain himself and his family. The earnings of labor become costs of production to the firm. The firm, under the profit motive, considers what returns are received by it from the employment of the worker against what has been paid to him.

The *production aspect* of employment suggests that employment leads to generation of output. When a worker is gainfully employed, he must contribute to the increase of GNP. The worker's employment is judged by the fruit of his labour. His marginal production must be positive. A worker who is employed in an activity, but whose marginal product is zero, cannot be regarded as gainfully or fruitfully employed. He is said to be disguisedly unemployed.

In policy matters, sometimes the income aspect of employment is divorced from its production aspect. For instance, when government wants to increase the income of a section of society, it may do so by just expanding employment in that section, irrespective of its productivity. In such cases, income would rise due to employment, but the production may not in some public projects (like digging out holes and refilling them). Such disharmony between the income and production aspects of employment is dangerous for the economic growth of an underdeveloped country. It results in inflation rather than growth. Thus, in selecting investment projects which are employment-oriented, it should be carefully determined as to what extent they are output-oriented, along with their income-orientation. In case of self-employment, however, the income aspect is difficult to separate from the production aspect, As Prof. Sen mentions, "a family farm's income comes from its production and contributing to the latter expands the former as well." From the income point of view, a person seems to be employed but, from the point of view of production, he may really be unemployed. Thus, his outward employment may actually be disguised unemployment may suggest contrasting estimates of employment and unemployment in the economy.

The recognition aspect of employment implies that employment gives a worker the recognition of being engaged in some occupation which makes his life worth living. "Employment can be a factor in self-esteem and indeed in esteem of others." In any society, an unemployed person just does not remain without income but also receives no respect as unemployment is regarded as a mark of disgrace. Again, the type of employment gives him a specific social prestige. For example, a professor enjoys a higher social prestige than a cabaret dancer does, even though both may receive equal earnings in their respective jobs.

Prof. Sen, thus, specifies two important problems in the evaluation of employment in an economy: (1) identification of who is "employed" and who is "unemployed", and (2) weighting of different types of employment in order to arrive at a total sum. In this view, thus, employment is not simply a number but a vector, *i.e.,* a set of numbers giving employment of each kind of labour.

3. Consumption: It refers to total consumption of the household sector.

4. Savings: In macro-economics, savings refer to savings of the community of economy as whole.

Saving = Total Income – Total Consumption.

Total Savings = Savings of households – Savings of firms or Corporate Savings + Savings of the government sector.

5. Investment: Investment refers to total investment of the firm. Investment of the private sector is induced.

6. Government Expenditure: Government sector spends on consumption and investment.

Public sector investment is autonomous.

7. Households: Household sector includes all consuming individual units.

8. Firms: The firm sector includes all producing entrepreneurial units.

9. Economic Sector: The entire economy is sometimes divided into four major sectors:

(a) *Primary:* Agricultural and allied activities.

(b) *Secondary:* Industries and manufacturing activities.

(c) *Tertiary:* Services, such as professions, banking, trade etc. activities.

(d) *Foreign or External:* This refers to rest of the world as sector confined to international trade and transactions.

10. Price Level: Prices of goods in general. Price level is statistically measured through price index number.

11. Aggregate Demand: Demand for all goods and services taken together.

12. Aggregate Supply: Supply of all goods and services in general.

4. MACRO THEORIES

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

Set of macro-theories 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*) Under-consumption 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 multiple.
6. Theory of monetary policy, *e.g.,* quantity theory of money-monetarism.

5. 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 fulfil. 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 macro-economic 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.

6. MACROECONOMIC PARADOX

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. Macroeconommic 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 when saves more he becomes wealthy. But savings of all individuals together will not make society mere wealthy. Then, there is a paradox of thrift. It is a macroeconomic 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 merely supply — a monetary policy measure can be alright for controlling over-all 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.

7. 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 (macro-economic 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 view point. 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.

MODEL QUESTIONS

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

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