1) Macro Set-1

Introduction

Theory of Income & Employment

1. Define macro economics. Explain the scope and importance of macro economics.

→ Macro economics is defined as that branch of economics which studies economic activities at the level of an economy as a whole.

Scope of macro economics means the areas of study under macro economics. Macro economics largely deals with the following areas of study —

(a) Theory of national income : Macro economics studies the concept of national income, its different elements and the method of measurement.

(b) Theory of employment : Macro economics studies problems relating to employment and unemployment. It studies different factors determining the level of employment.

(c) Theory of general price level : Determination of general price level is also studied under macro economics. Problems relating to inflation and deflation are an important component of macro economics.

(d) Theory of economic growth : Problems relating to economic growth is another important component of macro economics.

Importance of macro economics :—

Macro economics helps us to understand the functioning of the whole economy. For instance, macro economic theories are used to determine national income, sectoral contribution to GDP, rate of inflation etc.

The utility of the study of macro economics derives from the fact that most of the major economic problem of a country are macro economic in character. Further, it not only helps us in identifying the various economic problems, it can also be used to put forth solutions to overcome these problems. Moreover, macro economics helps ~~us~~ in international comparisons. These comparisons are based on aggregates like national income, per capita income etc.

2. Define macro economic variables.

→ Macro economic variables refer to those economic issues or problems which are studied at the level of an economy as a whole. These include national income, aggregate demand, aggregate supply, problem of unemployment, general price level etc.

3. Explain the inter-dependence between micro economics and macro economics.

→ The interdependence between these two branches of economics may be made clear with the

Scanned with CamScanner

-lowing discussion :

(i) Dependence of micro-economics on macro-economics :

The analysis related to aggregates is necessary for proper understanding of the behaviour of particular units. Eg : Price of a commodity is not determined by the demand and supply conditions rather depends on general level of prices or inflationary and deflationary conditions prevailing in the economy.

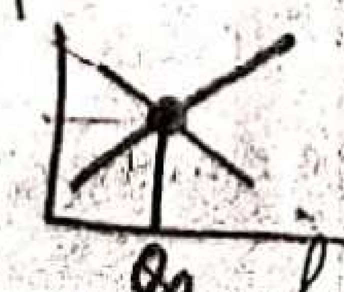
(ii) Dependence of macro-economics on micro-economics :

The aggregates are constituted by particular units. It is difficult, therefore, to separate macro-economics from micro-economics. Eg : With a fall in purchasing power at the hands of workers and other consuming section, overall demand for goods will fall resulting into recessionary conditions in the economy.

Thus, it can be said that the two approaches are intimately connected and mutually interdependent.

(Product Market) (Factor Market) (Money Market)

4. Distinguish between partial equilibrium and general equilibrium.



$D = Q_0$
$S = Q_0$

→ Partial equilibrium refers to equilibrium in one market (say, commodity market) on the assumption that there is no change in other markets (like labour market, capital market, etc).

General equilibrium on the other hand re the to simultaneous equilibrium in all markets of the theory economy.

Partial equilibrium is the method of study in micro economics but general equilibrium is the method of study under macro economics.

5. Define economic agents.

⟶ By economic units or economic agents, we mean those individuals or institutions which take economic decisions. Eg: Consumers, Producers, Governments, Banks etc.

5. Why is there a need for separate theory of macro-economics?

⟶ We need a separate theory of macro economics because of the following two reasons:

(i) What is true or ideal at the micro level may not be true or ideal at the macro level.
Eg: Saving is a virtue at the micro level but not necessarily at the macro level.

(ii) There are certain economic issues which are of critical significance in the competitive world. This relate to growth and development of the country. But such issues cannot be handled the micro level and hence, the need for a separate theory of macro economics.

Q. What is the basic difference between the classical school and Keynesian school?

⟶ Classical School : A free economy without any intervension by the government always achieves equilibrium with fuller utilization of resources. Unemployment, if it occurs will ~~dessapear~~ disappear automatically.

Keynesian school : Unemployment will not disappear automatically. The government must intervene and should undertake investment expenditure to generate opportunities of employment. Equilibrium with full employment is not an automatic phenomenon.

8. Explain the evolution / emergence of macro economics as a distinct branch of economics.

⟶ Emergence of Keynesian school of thought marks the beginning of macro economics as a distinct branch of economics. Earlier the classical economists held the view that in a free economy there would always be full employment. Accordingly, in their ~~economic~~ analysis of economic problems, they only focused on micro issues. It was during the ~~great depr~~ Great Depression of 1930s that the classical prescription of full employment did not work. It was then that Prof. Keynes emphasised the need study macro economic issues like depression and unemployment. This marked the evolution of macro economics as a distinct branch of economics.

Q Write a note on the Great Depression.

⟶ The Great Depression precisely took place in 1929 that effected most ~~devef~~ developed economies ~~economist~~ of the capitalistic world. The output and employment level in the countries of Europe ~~had~~ and North America had fallen by huge amount. Demand for good in the market was low, many factories were not running and workers were thrown out of job. In USA the rate of employment went up from 3% in 1929 to 25% in 1933. The fall in output was recorded at 33% during the same period. It was against this back drop Keynes criticised the classical assumption of full employment and gave his own approach about the functioning of the economy in a new way. According to him unemployment will not disappear automatically. The government must intervene and should undertake investment activities to generate employment opportunities in the economy. Therefore, the failure of the classical theory paved the way for Keynesian

ory which is regarded as the foundation of macro
nomics.

10. Explain the four major sectors of an economy.

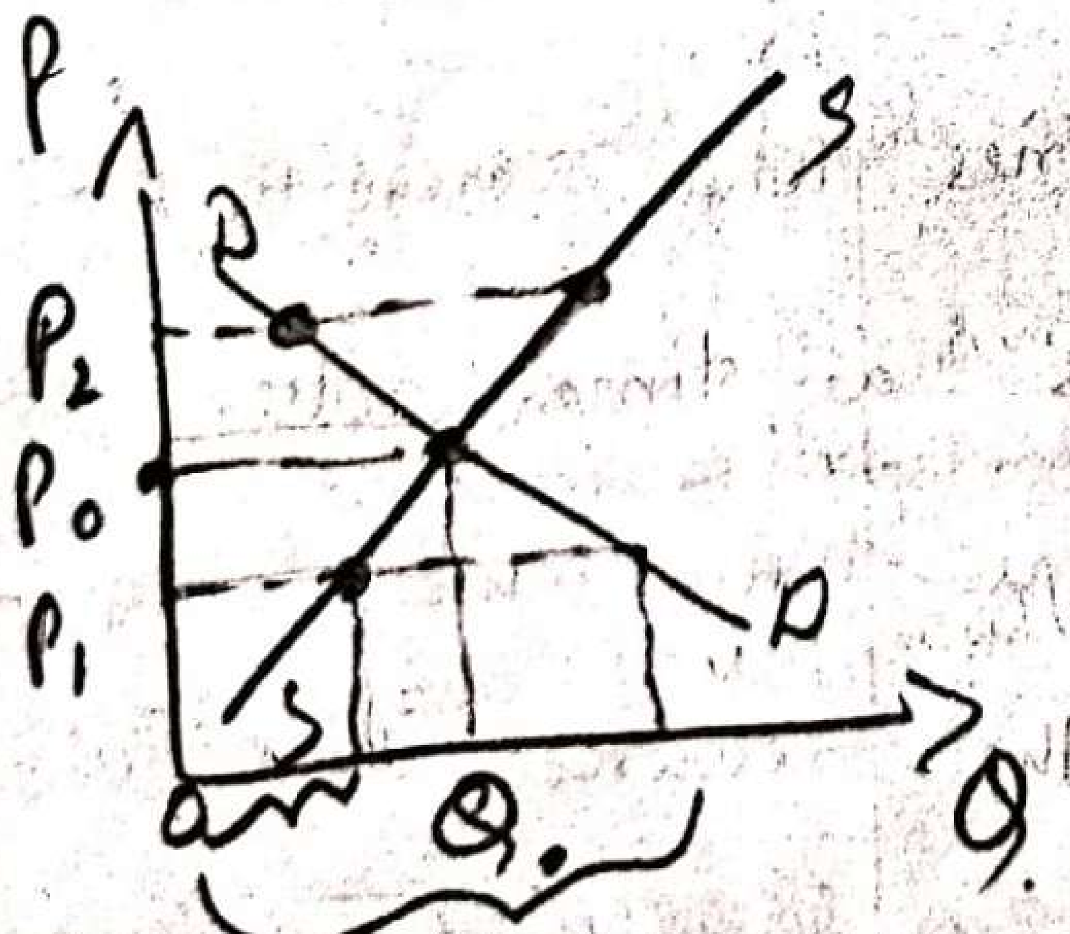
→ From the macro point of view, economy is divided into four principal sectors, ~~of~~ viz.

(i) Househould sectors including consumers of goods and services and owners of factors and production.

(ii) Producers sector, including those engage in production activity.

(iii) Government sector, acting as a welfare agency engaged in maintaining law and order, defence etc.

(iv) The external sector also called the rest of the world sector, engaged in export and import of goods between domestic economy and rest of the world.



$P - P_0$

$Q_D = Q_0$

$Q_S = Q_0$

one year.

21. # Distinguish between stock and flow with the help of examples.

→ A stock is a quantity measured at a particular point of time. On the other hand, a flow is a quantity measured over a specified period of time.

Some examples of stocks and flows are given below:—

Stock	Flow
(i) Wealth	(i) Income.
(ii) Capital	(ii) Capital formation.
(iii) Quantity of Money in a country.	(iii) Change in the quantity of money in a country.
(iv) Bank deposits.	(iv) Interest on capital.
(v) Water in the overhead tank.	(v) Leakage of water from the overhead tank.

Infact, the following relations / differences are observed between stock and flow :

Stock	Flow
(i) It relates to a point of time.	(i) It relates to a period of time.
(ii) Stock is not time dimensional.	(ii) Flow is time dimensional as per hour, per month etc.
(iii) Stock influences the flow. Greater the stock of capital, greater is the flow of goods and services.	(iii) Flow influences the stock. Eg: Monthly increase in the supply of money leads to an increase in the quantity of money.

22. Are the following stocks or flows ?
(i) Investment (ii) Monetary Expenditure (iii) A 200 rupee note (iv) Services of a teacher ; (v) Production of cement (vi) Machinery of a jute mill.

→ (i) Investment — Flow.

(ii) Monetary Expenditure — Flow.

(iii) A 200 rupee note — Stock.

(iv) Service of a teacher — Flow

(v) Production of cement — Flow.

(vi) Machinery of a jute mill — Stock.

23. What do you mean by circular flow of economic activity ?

OR

Explain the three phases of circular flow of income.

⟶ A flow is a quantity measured over a specified period of time. In every economy three activities never stop ⟶

(i) Production of goods and services,
(ii) Generation of income
(iii) Expenditure.

Infact, these activities are the lifeline of an economy. Circular flow of income refers to the unending flow of the activities of production, income generation and expenditure involving different sectors of the economy, the producers and the households in particular. Each activity is the cause as well as the consequence of the other activity. Production in the producing sector generates income for the households who are the owners of factors of production. Expenditure by the households generates demand for further production and consequently the generation of further income. Thus, there is a non-stop flow of production of goods and services, generation of income and disposition of income. Each flow keeps chasing the ther flow and hence it is called circular flow.

4. Name the four kinds of income received during the process of production?

OR.

What are the four fundamental contributions made in the production process?

→ There may ~~be~~ fundamentally be four kinds of contributions made during the production of goods and services —

(a) Contribution made by human labour, ~~remunaretion~~ remuneration for which is called ~~wedge~~ wage.

(b) Contribution made by capital ~~remunaretion~~ remuneration for which is called interest.

(c) Contribution made by entrepreneurship ~~remunaretion~~ reemuneration of which is called profit.

(d) Contribution made by natural resources (also called land) remuneration for which is called rent.

25. What are the two types of circular flow.

→ Circular flow may be of two types —

(i) Real flow : When goods and services flow from one sector of the economy to another, It is known as real flow.

(ii) Money flow : Under it, goods and services produced in the economy are exchanged for money. The households provide factor services to the firms and receive ~~payments~~ payments in terms of money for the services rendered by them. They spend this money income on the purchase of goods and services produced by the firm. Thus money first flows from firms to the households as factor payments and then from households to the firms as consumption expenditure. This is called money flow of income.

26. Define a simple economy.

⟶ A two sector economy (Household & Firm) when functions without the existance of government and external sector, is called a simple economy.

27. Explain how there is circular flow of income in a simple economy / two sector economy.

OR.

How are the firms and households inter dependent upon each other in a circular flow model?

⟶ The functioning of a simplified two sector economy is based on the following assumptions:—

i. There are only two sectors in the economy — household and firms.

ii. Household supply factor services to the firms and firms hire factor services from households.

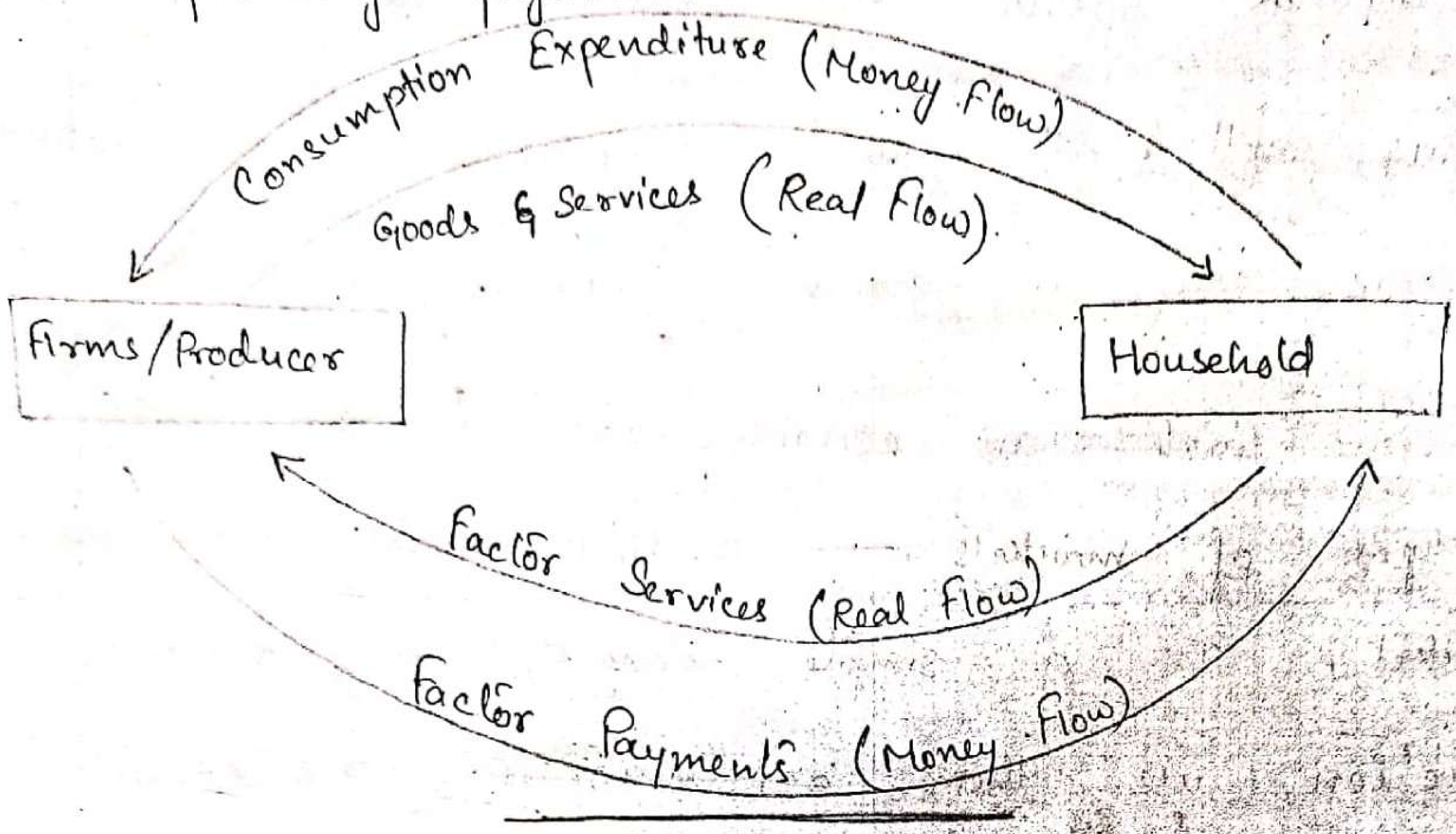
iii. Households spend their entire income on consumption

iv. Firms sell all that is produced to the household.

v. There is no government or foreign trade.

Such an economy as described above has two types of markets — Product market and factor market. In a simple economy, the factors of production use their ~~remunaratio~~ remunerations to buy goods and services which they assisted in producing. The ~~agrigo~~ aggregate consumption by the households is equal to the aggregate ~~expend~~ expenditure on goods and services produced by the firm. The entire income of the economy thus, comes back to the firms in the form of sales revenue. Since there is no leakage from the system, total factor payments by firms and total consumption expenditure by households are equal.

In the next period, the firms will once again ~~poo~~ produce goods and services and again pay ~~remunar.~~ remuneration to the factors of production for their continuous services. These remunerations will once again be used to buy goods and services. Hence, year after year, aggregate income of this simple economy will be flowing in a circular way. This is shown in the following figure:

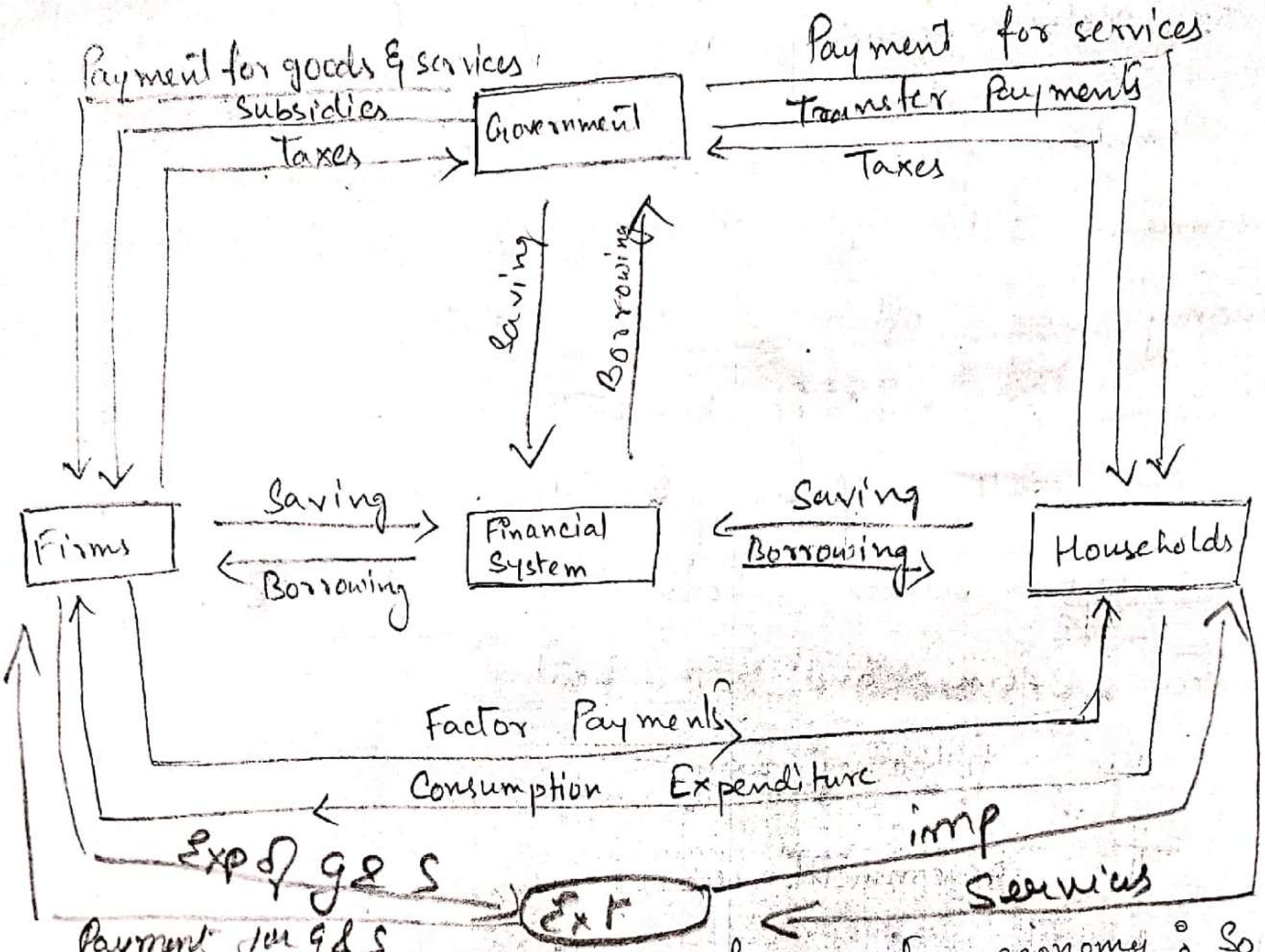


Circular Flow of Income with Financial System: So far we have assumed that households spend their entire income on the purchase of goods and services. But infact, households tend to save a part of their income, which constitutes a leakage from the circular flow of income. The saved amount is made available in the financial system. While firms borrow for the purposes of investment, this becomes injection into the circular flow. Financial institutions act as intermediaries between savers and investors or ~~ba~~ lenders and borrowers. So long ~~and~~ lendings and ~~re~~ borrowings are equal, the circular flow of income will continue indefinitely.

Q8. Write a brief note on circular flow of income in a ~~#~~ three sector economy and a four sector economy.

→ Circular flow in a three sector economy : When government sector is introduced in a two sector economy we obtain a three sector model. Government acts as a regulator as well as an agent of promoting ~~well~~ welfare in the country. The relationships between households and government and between firms and government can be explained in the following way —

The government receives taxes from households and firms which are withdrawals or leakages from the circular flow of income. Government also purchases goods and services from households and firms. These government purchases are injections into the circular flow of income. Apart from purchases, government also makes transfer payments. ~~Transferpa~~ Transfer payments to households are in the form of unemployment allowance, old age pension etc. Government also provide subsidies to the firm. These transfer payments and subsidies by the government add to the flow of income ~~and~~ and hence are also injections into the circular flow. The following diagram is an ~~explat~~ explanation of the working of a three sector economy.



Circular flow of income in four sector economy: So far we have studied circular flow of income in a closed ~~ecom~~ economy. But in actual world situations, economies are open and they do have transactions with the rest of the world, i.e. the external sector. Firms and households ~~by~~ buy goods and services from other countries which are called imports. When payments are made for these imports, less money income is left to spend ~~on~~ on goods and services produced in the domestic economy. Hence, imports are a leakage from the circular flow of income. In the same way, exports are injections to the ~~circ~~ circular flow of income in the domestic economy.

29. Define injections and leakages with examples.

→ Injections are those flow variables which cause an ~~expanti~~ expansion in the process of income generation in the economy. These are investment, exports, consumption expenditure etc. Injections affect the economy in two ways —

(a) It adds to the production capacity of the economy.

(b) Injections generate demand for produced goods and services..

Leakages are those flow variables which have a ~~weak~~ negative impact on the process of income generation in the economy. These are savings, imports, taxes by the govt. etc. All these variables ~~are~~ review the flow of income in the economy and hence called withdrawals or leakages.

30. Explain the significance / importance of the study of circular flow of income models.

→ The study of circular flow is important in the following ways —

(i) Circular flow models help us to understand the ~~mutu~~ mutual inter-dependence among the different sectors viz. households, firms, & government.

(ii) Circular flow of income facilitates the estimation of national income.

iii. Circular flow models give information regarding injections and withdrawals also.

31. State two basic principles of circular flow of income and product.

→ Following are the two principles ←

(i) In any exchange process, the producer receives the same amount that the consumer spends.

(ii) Goods and services flow in one direction and money payments to get these goods and services flow in reverse direction, thereby causing a circular flow.