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Dr. Babasaheb Ambedkar
Open University
(Established by Government of Gujarat)

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BBA/DBA
SEMESTER - 2
BBAEC206
DBAEC206

Macro Economics for Management

Message for the Students

Dr. Babasaheb Ambedkar Open (University is the only state Open University, established by the Government of Gujarat by the Act No. 14 of 1994 passed by the Gujarat State Legislature; in the memory of the creator of Indian Constitution and Bharat Ratna Dr. Babasaheb Ambedkar. We Stand at the seventh position in terms of establishment of the Open Universities in the country. The University provides as many as 54 courses including various Certificate, Diploma, UG, PG as well as Doctoral to strengthen Higher Education across the state.

On the occasion of the birth anniversary of Babasaheb Ambedkar, the Gujarat government secured a quiet place with the latest convenience for University, and created a building with all the modern amenities named 'Jyotirmay' Parisar. The Board of Management of the University has greatly contributed to the making of the University and will continue to this by all the means.

Education is the perceived capital investment. Education can contribute more to improving the quality of the people. Here I remember the educational philosophy laid down by Shri Swami Vivekananda:

> ***"We want the education by which the character is formed, strength of mind is Increased, the intellect is expand and by which one can stand on one's own feet".***

In order to provide students with qualitative, skill and life oriented education at their threshold. Dr. Babaasaheb Ambedkar Open University is dedicated to this very manifestation of education. The university is incessantly working to provide higher education to the wider mass across the state of Gujarat and prepare them to face day to day challenges and lead their lives with all the capacity for the upliftment of the society in general and the nation in particular.

The university following the core motto 'स्वाध्यायः परमम् तपः' does believe in offering enriched curriculum to the student. The university has come up with lucid material for the better understanding of the students in their concerned subject. With this, the university has widened scope for those students who are not able to continue with their education in regular/conventional mode. In every subject a dedicated term for Self Learning Material comprising of Programme advisory committee members, content writers and content and language reviewers has been formed to cater the needs of the students.

Matching with the pace of the digital world, the university has its own digital platform Omkar-e to provide education through ICT. Very soon, the University going to offer new online Certificate and Diploma programme on various subjects like Yoga, Naturopathy, and Indian Classical Dance etc. would be available as elective also.

With all these efforts, Dr. Babasaheb Ambedkar Open University is in the process of being core centre of Knowledge and Education and we invite you to join hands to this pious *Yajna* and bring the dreams of Dr. Babasaheb Ambedkar of Harmonious Society come true.

Prof. Ami Upadhyay

Vice Chancellor,

Dr. Babasaheb Ambedkar Open University,

Ahmedabad.

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MACRO ECONOMICS FOR MANAGEMENT

BLOCK-1

BLOCK-2

BLOCK-3

BBA
SEMESTER-2
MACRO ECONOMICS FOR MANAGEMENT
BLOCK: 1

Authors' Name: Dr. Kamal K. Agal, Associate Professor, Dr. BAOU, Ahmedabad
Dr. Dhaval Pandya, Assistant Professor, Dr. BAOU, Ahmedabad
Mr. Krunal Mistri, Assistant Professor, Dr. BAOU, Ahmedabad

Review (Subject): Dr. Anjali Gokhru, Assistant Professor, K.S. School of Business Management, Ahmedabad

Review (Language): Dr. Jainee Shah, Assistant Professor, Nirma University, Ahmedabad

Editor's Name: Prof. (Dr.) Manoj Shah
Professor and Director,
School of Commerce and Management,
Dr. Babasaheb Ambedkar Open University,
Ahmedabad.

Publisher's Name: Dr. Ajaysinh Jadeja
Registrar,
Dr. Babasaheb Ambedkar Open University
'Jyotirmay Parisar', Opp. Shri Balaji Temple, Chharodi,
Ahmedabad, 382481,
Gujarat, India.

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Unit - 1 INTRODUCTION TO MACROECONOMICS

1.1 Introduction

Macroeconomics is the study of large-scale economic issues, such as inflation, GDP (GNP), and unemployment. It helps form the basis of a large part of government economic policy.

Macroeconomics focuses on the performance of economies – changes in economic output, inflation, interest and foreign exchange rates, and the balance of payments. Poverty reduction, social equity, and sustainable growth are only possible with sound monetary and fiscal policies.

The world has entered a new era of rapid global change driven by major shifts in demographics, wealth, technology, and climate.

But economic growth has been uneven, has come at the expense of the environment, and has already slowed due to climate damages. Global challenges — including fiscal strains on governments exacerbated by the COVID-19 pandemic, conflicts, environmental degradation, resource depletion, and record levels of displacement — are threatening recent gains. These challenges are compounded by intensifying systemic risks, including trade tensions, rising debt levels, and increasing inequality.

To accelerate sustainable economic growth and inclusion, developing countries must tackle a variety of challenges. These include low levels of productivity and international competitiveness, inefficient public spending, inadequate domestic resource mobilization, price distortions from fiscal systems that discourage sustainability, lack of economic resilience, increasing debt levels, and the rising danger of climate change. The study of economics is traditionally divided into two fields-micro and macro. Microeconomics deals with the behavior of disaggregated individual decision makers such as a single consumer or a saver or a single production unit (firm) or an industry (collection of firms producing similar or closely related products). Macroeconomics, on the other hand, takes as its subject the economic activity of the entire nation as an indivisible unit. The analysis, in contrast with microeconomics, is very aggregative in nature. Some of the most important macroeconomic variables are national income, national investment, the overall state of employment in the economy, budgetary policy of the government.

Macroeconomists try to understand how an economy operates and, on the basis of that understanding, suggest policies that may be adopted to improve the performance of the economy. To understand and improve the economic performance of an economy is not possible without a proper quantification of the values of the major macroeconomic variables. This is not an easy task, given the highly aggregative nature of the concepts involved. The standard technique developed by economists and statisticians for the purpose of measuring the performance of a modern economy are collectively known as methods of national income accounting.

When the economy of a nation is in an abridged context, it appears that the output degrees of all the commodities and services in the economy have a tendency to move together. For example, if the outcome of a food item experiences a development, then normally, it accompanies an increase in the output degree of industrial commodities.

Also, within the classification of industrial commodities, the output of different kinds of commodities tend to increase or decrease concurrently. Similarly, the cost price of distinct commodities and services have a tendency to increase or decrease concurrently. It is noticeable that the employment degree in different manufacturing units simultaneously increases or decreases.

If the average output degree, cost price degree, or employment degree in the different manufacturing units of an economy reinforce close association to each other, then the task of scrutinising the entire economy becomes relatively easy. Instead of dealing with the given variables at disaggregated degrees, we can think of a single commodity as the degree of all the commodities and services manufactured within the economy.

This characteristic commodity has a degree of production that is commensurate to the average production degree of all the commodities and services. Similarly, the cost price or employment degree of this representative commodity reflects the general cost price and employment degree of the economy.

Generally, in macroeconomics, we clarify the survey of how the nation’s total manufacture and the degree of employment are associated with the features (variables), like cost prices, wage rates, rate of interest, profits, etc., by concentrating on a single imaginary good and what happens to it.

We can manage this clarification and completely forego studying about what happens to the real goods that are purchased and sold in the marketplace. Due to this we generally see what happens to the cost prices, wages, interests, and profits, etc., for one good more or less also happens for the others.

Especially, these features begin to change quickly, when the prices increase (known as inflation) or employment and production degrees decrease (heading towards a depression). The common directions of the movements of these variables for all the individual goods are normally similar to that of the aggregates for the economy.

1.2 Meaning

Macroeconomics is the branch of economics that focuses on the overall performance, structure, behavior, and decision-making of an entire economy. It takes a bird's-eye view, examining the big picture rather than individual economic agents like households or firms. By studying aggregate economic variables, macroeconomics helps us understand how economies function and how governments can shape their course.

1.3 Definition

Macroeconomics is the branch of economics that deals with the structure, performance, behavior, and decision-making of the whole, or aggregate, economy.

❖ **Classic Definitions:**

Kenneth Boulding: "Macroeconomic theory is that part of economics which studies the overall averages and aggregates of the system."

Edward Shapiro: "Macroeconomics deals with the functioning of the economy as a whole."

❖ **Modern Interpretations:**

Investopedia: "Macroeconomics is the branch of economics that deals with the structure, performance, behavior, and decision-making of the whole, or aggregate, economy."

The Economic Times: "Macroeconomics is the branch of economics that studies the behavior and performance of an economy as a whole. It focuses on the aggregate changes in the economy such as unemployment, growth rate, gross domestic product and inflation."

❖ **Key Themes in Macroeconomic Definitions:**

Focus on the Aggregate: Macroeconomics examines the economy as a whole, rather than individual economic agents.

Key Economic Variables: It analyses aggregate variables like GDP, inflation, unemployment, and economic growth.

Economic Performance and Policy: Macroeconomics studies how economies function, the factors that influence their performance, and the role of government policies in shaping economic outcomes.

Ultimately, macroeconomics provides a framework for understanding the big picture of the economy, helping us analyse economic trends, make informed decisions, and design effective economic policies.

1.4 Concept

Key Macroeconomic Concepts:

Gross Domestic Product (GDP): This is the most fundamental measure of economic activity, representing the total value of all final goods and services produced within a country's borders over a specific period.

Inflation: This refers to the general increase in prices of goods and services over time, eroding the purchasing power of money.

Unemployment: This measures the percentage of the labor force actively seeking employment but unable to find it, indicating economic distress.

Economic Growth: This signifies an increase in a country's production capacity over time, essential for raising living standards.

Business Cycles: Economies experience fluctuations known as business cycles, alternating between periods of expansion (booms) and contraction (recessions).

❖ **Why Macroeconomics Matters:**

Understanding Economic Trends: Macroeconomics helps us understand how economies function, how they grow, and what factors influence their performance.

Informing Policy Decisions: Governments use macroeconomic analysis to develop and implement policies that promote economic growth, price stability, and low unemployment.

Making Informed Financial Decisions: Individuals and businesses can use macroeconomic information to make informed decisions about spending, saving, and investment.

❖ **Key Macroeconomic Issues:**

Economic Growth: How can we sustain long-term economic growth? What policies can promote innovation and productivity?

Inflation: How can we control inflation and maintain price stability? What are the causes of inflation, and how can they be addressed?

Unemployment: How can we reduce unemployment and create jobs? What are the factors that contribute to unemployment, and what policies can be implemented to address them?

Economic Inequality: How can we reduce income and wealth inequality? What are the causes of inequality, and how can they be mitigated?

Global Economic Integration: How can countries cooperate to address global economic challenges, such as climate change and financial instability?

Macroeconomics in the context of the recent Indian economy addresses broad economic trends, policy impacts, and their effects on key indicators like GDP growth, inflation, employment, fiscal health, and international trade. Here are some significant themes shaping the current Indian economy:

1. Economic Growth and Development

- **GDP Performance**: India has emerged as one of the fastest-growing major economies post-COVID-19. GDP growth has been driven by sectors such as technology, services, and manufacturing under initiatives like *Make in India* and *Digital India*.

- **Regional Disparities**: Growth is uneven, with urban centers thriving while rural areas face challenges in infrastructure, employment, and income levels.

2. Inflation and Monetary Policy

- **Inflation Control**: The Reserve Bank of India (RBI) has actively managed inflation through interest rate adjustments. Recently, high food prices have been a major contributor to inflation.

- **Monetary Policy**: Balancing inflation and economic growth, the RBI has been cautious with interest rate hikes in response to global pressures like the Russia-Ukraine war and supply chain disruptions.

3. Employment and Labor Market Trends

- **Unemployment Rates**: Urban unemployment has seen some recovery, but rural areas still face challenges due to underemployment and dependency on agriculture.

- **Formalization of Economy**: Schemes like *Pradhan Mantri Rozgar Protsahan Yojana* aim to boost formal employment, supported by digitization and initiatives like UPI for financial inclusion.

4. Fiscal Policy and Government Spending

- **Infrastructure Development**: Massive investments in roads, railways, and renewable energy under the *National Infrastructure Pipeline (NIP)* are expected to drive long-term growth.

- **Deficit Management**: The fiscal deficit is being monitored closely, with the government balancing welfare schemes like *PM Kisan* and subsidies against revenue mobilization through taxes.

5. International Trade and External Sector

- **Export Growth**: India’s exports, especially in software, pharmaceuticals, and textiles, have been growing, supported by *Production Linked Incentive (PLI)* schemes.

- **Trade Balance**: A widening trade deficit due to high oil imports and global economic slowdown remains a concern.

- **Global Supply Chains**: India is emerging as an alternative manufacturing hub amid global supply chain diversification.

6. Structural Reforms and Policy Initiatives

- **NEP and Skill Development**: The National Education Policy (NEP) focuses on creating a skilled workforce aligned with industrial demands.

- **ESG Focus**: Sustainability initiatives are gaining traction, with a push for green energy, electric vehicles, and decarbonization.

7. Challenges in Macroeconomic Stability

- **Global Uncertainties**: Geopolitical tensions, global economic slowdown, and climate change pose risks to growth.

- **Inequality**: Rising income disparities, especially post-pandemic, need policy focus for equitable growth.

Recent Highlights (2023-2024)

- India's GDP growth for FY2024 is projected to be around **6-6.5%** (as per various estimates).

- Inflation remains in the range of **4-6%**, influenced by global commodity prices and domestic supply bottlenecks.

- Efforts to attract Foreign Direct Investment (FDI) and boost startups are underway, with India ranking high in the global startup ecosystem.

Macroeconomic management in India reflects a careful balancing act between domestic priorities and global challenges, leveraging technology, innovation, and inclusive policies for sustainable growth.

1.5 Importance

Macroeconomics is crucial for understanding and shaping the overall health and performance of an economy. Its significance lies in various aspects:

1.5.1. Informing Policy Decisions

Fiscal Policy: Governments use macroeconomic analysis to determine appropriate levels of taxation and government spending to influence economic activity.

Monetary Policy: Central banks rely on macroeconomic principles to set interest rates and control the money supply to stabilize inflation and promote growth.

1.5.2. Understanding Economic Trends

Predicting Economic Cycles: Macroeconomic analysis helps forecast business cycles, enabling individuals and businesses to make informed decisions about spending, saving, and investment.

Identifying Economic Risks: By monitoring key economic indicators, policymakers and businesses can anticipate potential economic challenges and take preventive measures.

1.5.3. Improving Economic Performance

Promoting Economic Growth: Macroeconomic policies can be designed to stimulate economic growth, create jobs, and improve living standards.

Controlling Inflation: Macroeconomic tools can be used to manage inflation and prevent it from spiralling out of control.

Reducing Unemployment: Governments can implement policies to reduce unemployment rates and ensure a stable labor market.

1.5.4. International Economic Relations

Exchange Rate Policies: Macroeconomic analysis helps countries determine appropriate exchange rate policies to maintain competitiveness and balance trade.

Global Economic Integration: Understanding global economic trends is essential for countries to participate effectively in the global economy.

1.5.5. Individual and Business Decision-Making

Financial Planning: Individuals can use macroeconomic information to make informed decisions about saving, investing, and retirement planning.

Business Strategy: Businesses can use macroeconomic analysis to make strategic decisions about production, pricing, and investment.

In essence, macroeconomics provides a framework for understanding the big picture of the economy, enabling individuals, businesses, and policymakers to make informed decisions and shape economic policies for the betterment of society.

1.6 Scope of Macroeconomics

Macroeconomics is a branch of economics that focuses on the behavior and performance of the entire economy, rather than individual markets or sectors. It studies aggregate indicators such as national income, unemployment rates, inflation, and overall economic growth. By examining these broad economic phenomena, macroeconomics helps policymakers and businesses make informed decisions that can affect the welfare of a nation and its people. The scope of macroeconomics is vast, covering multiple facets that range from economic output and employment to inflation and fiscal policy.

1.6.1. National Income and Output

One of the central focuses of macroeconomics is the measurement of national income and output. The national income is the total value of goods and services produced within a country in a given period, typically measured annually or quarterly. The Gross Domestic Product (GDP) is the most widely used indicator of national output, reflecting the economic health of a country. Macroeconomics studies the factors that contribute to economic growth and the distribution of income within a country.

Economic output is also concerned with understanding how various sectors of the economy—such as agriculture, industry, and services—interact to produce goods and services. This helps policymakers to design strategies to foster balanced economic growth and avoid overreliance on any one sector.

1.6.2. Unemployment and Employment

Unemployment is a key area of macroeconomic study, as it directly affects a nation’s overall productivity and social well-being. Macroeconomics seeks to explain the causes of unemployment, such as cyclical unemployment (due to economic downturns), structural unemployment (due to changes in industry demands or technological advancements), and frictional unemployment (resulting from workers transitioning between jobs). Understanding these causes helps in formulating policies to reduce unemployment rates, such as fiscal stimulus, job training programs, and labor market reforms.

Macroeconomics also focuses on labor force participation and the effects of unemployment on individuals and the economy at large, such as the loss of skills, reduction in economic output, and social challenges.

1.6.3. Inflation and Price Levels

Inflation refers to the general increase in the price levels of goods and services over time. Macroeconomics studies the causes of inflation, which can result from demand-pull inflation (excessive demand for goods and services), cost-push inflation (rising production costs), or built-in inflation (wage-price spirals). Inflation erodes purchasing power, leading to higher costs of living and potential destabilization of the economy.

A key goal of macroeconomics is to understand and manage inflation. This is often done through monetary policy, where central banks control the money supply and interest rates to maintain price stability. Macroeconomic theories like the Phillips Curve examine the trade-offs between inflation and unemployment, helping policymakers balance these two critical factors.

1.6.4. Monetary and Fiscal Policies

Macroeconomics is closely linked to government policy, particularly fiscal and monetary policies, which are tools used to regulate the economy. Fiscal policy refers to government spending and taxation decisions aimed at influencing the economy. For example, during a recession, the government may increase spending or cut taxes to stimulate demand and reduce unemployment. Conversely, during periods of high inflation, the government may reduce spending or raise taxes to cool down the economy.

Monetary policy on the other hand, is managed by a country’s central bank and involves controlling the money supply and interest rates. By adjusting interest rates, the central bank influences borrowing and spending. Lower interest rates can stimulate investment and consumption, while higher rates can curb inflation and excessive borrowing. Macroeconomics explores how these policies interact with each other to stabilize the economy.

1.6.5. Economic Growth and Développent

Macroeconomics also encompasses the study of economic growth—the long-term increase in a country’s productive capacity and standard of living. Understanding the drivers of growth, such as technological innovation, capital accumulation, and human capital, is essential for creating policies that foster sustainable economic development. Macroeconomists examine the role of education, infrastructure, and innovation in boosting productivity and improving living standards.

Economic development, which goes beyond just growth, involves improving the quality of life, reducing poverty, and addressing income inequality. Macroeconomics explores the challenges developing countries face in achieving both growth and development, and it informs international aid, trade, and investment policies.

1.6.6. International Trade and Finance

Globalization has made international trade and finance central to macroeconomics. Macroeconomics investigates how countries trade with each other, exchange currencies, and interact through financial markets. This area also examines the balance of payments, trade deficits, and surpluses, and the effects of exchange rates on a country’s economy. A major concern for macroeconomists is how international trade and finance affect domestic economies, including the potential risks of financial crises or external shocks.

Policies related to trade tariffs, international investment, and exchange rate management are key aspects of macroeconomics, as they can influence a nation's competitiveness, economic stability, and growth prospects.

1.6.7. Business Cycles

The study of business cycles is an integral part of macroeconomics. These cycles are the natural fluctuations in economic activity over time, characterized by periods of expansion (economic growth) and contraction (recession). Macroeconomists try to understand the causes and consequences of business cycles, such as changes in consumer demand, investment, and government policy. They also analyze the role of monetary and fiscal policy in mitigating recessions or preventing overheating during periods of rapid growth.

The scope of macroeconomics is vast and complex, encompassing a wide range of issues from national income and employment to inflation, growth, and international trade. Through the study of these topics, macroeconomics provides valuable insights into how economies function as a whole and how policies can be designed to promote stability, growth, and social welfare. The field is essential not only for economists but also for policymakers, businesses, and individuals who seek to understand the dynamics of the economy and make informed decisions.

1.7 Importance of Macroeconomics

Macroeconomics is a crucial branch of economics that examines the behavior of an economy as a whole rather than focusing on individual markets. It is concerned with aggregate indicators like national income, unemployment, inflation, economic growth, and government policies. Understanding macroeconomics is vital for several reasons, as it helps policymakers, businesses, and individuals make informed decisions that impact national and global economies. Below are some of the key reasons why macroeconomics is of great importance.

1.7.1. Guiding Economic Policy

Macroeconomics provides the foundation for formulating effective economic policies. Governments rely on macroeconomic theory to design fiscal and monetary policies that can manage economic stability and growth. Fiscal policy involves government decisions regarding spending and taxation, while monetary policy is implemented by central banks to control the money supply and interest rates. Both policies are essential tools for managing inflation, reducing unemployment, and fostering long-term economic growth.

For example, during an economic recession, a government might increase public spending or cut taxes to stimulate demand and job creation. Conversely, if inflation is rising too quickly, central banks may increase interest rates to reduce borrowing and spending, thus controlling price rises. Without an understanding of macroeconomics, policymakers would struggle to navigate economic challenges and adjust to changing conditions.

1.7.2. Economic Stability and Growth

Macroeconomics plays a central role in ensuring long-term economic stability and growth. By studying the factors that contribute to economic fluctuations—such as changes in consumer demand, business investment, or external shocks—macroeconomists can offer insights into how to stabilize the economy. Understanding these cycles, such as business cycles, helps in predicting recessions and expansions, allowing for timely interventions to avoid economic downturns or overheating.

Moreover, economic growth is a primary goal for many governments, and macroeconomics helps in identifying the drivers of growth, such as technological progress, capital investment, and improvements in education. By promoting policies that stimulate growth, countries can improve living standards, reduce poverty, and enhance overall prosperity. The study of macroeconomics is key to crafting strategies for sustainable development that balance economic output with environmental and social considerations.

1.7.3. Unemployment and Job Creation

One of the most critical aspects of macroeconomics is understanding the causes and consequences of unemployment. High levels of unemployment can lead to reduced consumer spending, lower national output, and increased social unrest. Macroeconomics studies the different types of unemployment—cyclical, structural, frictional, and seasonal—and helps policymakers design targeted solutions to reduce joblessness.

For instance, during economic downturns, cyclical unemployment rises as businesses cut back on production and hiring. Macroeconomic theories suggest that in such times, expansionary fiscal or monetary policies—such as increased government spending or lower interest rates—can help boost aggregate demand and stimulate job creation. On the other hand, addressing structural unemployment may require investment in education and job training to equip workers with skills that meet changing industry demands.

1.7.4. Inflation Control

Inflation is another central focus of macroeconomics. Persistent inflation can erode purchasing power, increase the cost of living, and destabilize an economy. By understanding the factors that drive inflation, such as demand-pull inflation (when demand exceeds supply) or cost-push inflation (when production costs rise), macroeconomics helps design policies to control price rises.

Central banks, for instance, use monetary policy tools, such as adjusting interest rates, to control inflation. A critical lesson from macroeconomics is the trade-off between inflation and unemployment, known as the Phillips Curve. Policymakers must balance these two economic concerns, as efforts to reduce inflation too aggressively can lead to higher unemployment, while excessive attention to full employment can spur runaway inflation.

1.7.5. Global Economic Integration

In today's globalized world, macroeconomics also emphasizes the interdependence of national economies. International trade, capital flows, and investment affect domestic economies in complex ways. Understanding macroeconomics helps countries manage their relations with other nations, including how to balance trade deficits or surpluses, manage foreign exchange rates, and attract foreign investment.

The 2008 global financial crisis demonstrated how interconnected economies are, with a problem in one country quickly spreading to others. Through the study of macroeconomics, economists and policymakers can develop strategies for managing international financial crises, stabilizing currencies, and navigating global economic challenges.

1.7.6. Addressing Inequality and Poverty

Macroeconomics is not just about economic growth but also about how that growth is distributed. Unequal distribution of wealth and income can lead to social unrest and hinder overall development. By studying the distributional effects of economic policies, macroeconomics can inform policies that aim to reduce inequality and poverty. For example, through progressive taxation, social safety nets, and targeted welfare programs, governments can help improve the living standards of the most vulnerable segments of society.

Moreover, macroeconomists assess how different sectors of the economy contribute to inequality and design strategies to promote inclusive growth. Understanding the role of education, healthcare, and access to capital in lifting people out of poverty is crucial for addressing long-term societal challenges.

1.7.7. Investment and Business Decision Making

For businesses, understanding macroeconomic trends is essential for making informed investment decisions. Changes in interest rates, inflation, and overall economic growth can influence a company's decisions about production, pricing, and expansion. Businesses often use macroeconomic data to forecast future demand for their products or services and to decide when to invest in new projects or enter new markets.

For example, in a booming economy, businesses may expand their operations in anticipation of increased consumer demand, while during periods of economic uncertainty, they might scale back investment plans. Understanding the broader economic environment enables businesses to manage risks effectively and align their strategies with the prevailing economic conditions.

Macroeconomics is fundamental to understanding how economies function at a large scale. It provides the tools and frameworks needed for effective policy-making, guiding governments in addressing key challenges like inflation, unemployment, and economic growth. By understanding macroeconomic principles, policymakers, businesses, and individuals can make better decisions, promote stability, and foster sustainable development. In an increasingly interconnected world, macroeconomics also helps nations navigate global challenges and create a more equitable and prosperous future for all.

1.8 Macroeconomic Goals:

Macroeconomics is primarily concerned with the overall health of the economy and the achievement of certain key objectives. These objectives are essential for promoting a stable and prosperous economic environment. The four major macroeconomic goals are economic growth, full employment, price stability, and balance of payments. Achieving these goals ensures a country's economy operates efficiently, equitably, and sustainably. Let's explore each of these goals in more detail.

1.8.1. Economic Growth

Economic growth refers to the increase in a country's output of goods and services over time. It is typically measured by the annual percentage change in Gross Domestic Product (GDP). A growing economy signifies that a country is producing more goods and services, which usually leads to higher living standards for its citizens.

❖ **Importance of Economic Growth:**

Improved living standards: As the economy grows, people generally experience higher wages, better job opportunities, and enhanced access to goods and services.

Poverty reduction: Sustainable growth helps reduce poverty levels by creating jobs, increasing incomes, and supporting social programs.

Increased government revenue: A growing economy generates higher tax revenues, which allows the government to invest in infrastructure, education, healthcare, and other public goods.

However, it's essential to ensure that economic growth is inclusive and sustainable. Economic growth that leads to environmental degradation or income inequality can ultimately undermine long-term prosperity.

1.8.2. Full Employment

Full employment refers to a situation where all individuals who are willing and able to work at prevailing wage rates are employed, with the exception of frictional, seasonal, and structural unemployment. It does not mean zero unemployment, as there will always be some level of frictional unemployment (people temporarily out of work due to changing jobs) and structural unemployment (mismatch between workers' skills and market demands). Full employment is a key goal because it helps optimize resource use, maximizes national output, and reduces social costs associated with unemployment.

❖ **Importance of Full Employment:**

Higher productivity: When most people are employed, national output increases because the economy is utilizing its labor force efficiently.

Reduced social problems: High employment leads to reduced poverty and lessens the social issues associated with unemployment, such as crime, inequality, and mental health problems.

Increased consumer spending: Employed individuals have disposable income, which contributes to consumer demand, supporting further economic growth.

However, policymakers must also be cautious about overemployment or forcing the economy into a position where labor shortages lead to rising wages and inflation. Thus, the goal is not just high employment but also sustainable and productive employment levels.

1.8.3. Price Stability

Price stability refers to maintaining a steady price level in the economy, avoiding both excessive inflation and deflation. Inflation is the sustained increase in the general price level of goods and services over time, while deflation is a decrease in the general price level. Both inflation and deflation can have negative effects on the economy, so price stability is a key macroeconomic goal.

❖ **Importance of Price Stability:**

Predictability and confidence: Price stability creates a predictable environment for consumers and businesses, allowing them to make long-term decisions about spending, saving, and investment without fearing the erosion of purchasing power or uncertainty about future prices.

Avoiding inflationary pressures: Inflation can erode the purchasing power of money, hurt savings, and lead to uncertainty. High inflation can also reduce the competitiveness of a country's exports.

Avoiding deflation: While inflation is commonly feared, deflation can be equally damaging. Falling prices lead to reduced consumer spending, as people may delay purchases in anticipation of lower prices. This can lead to an economic slowdown, lower wages, and increased unemployment.

Central banks, such as the Federal Reserve in the U.S. or the European Central Bank, use tools like interest rates and open market operations to keep inflation in check and ensure price stability.

1.8.4. Balance of Payments (BOP)

The balance of payments refers to a record of all financial transactions between a country and the rest of the world over a specific period. It includes two main accounts: the current account (which covers trade in goods and services, income from abroad, and current transfers) and the capital/financial account (which includes investments, loans, and financial transfers). A balanced or stable BOP is essential for maintaining economic stability.

❖ **Importance of Balance of Payments:**

Exchange rate stability: A consistent balance of payments ensures the stability of a country's exchange rate. A current account deficit (importing more than exporting) over a prolonged period can lead to a depreciation of the national currency, which could create inflationary pressures and undermine economic stability.

Financial stability: A country needs sufficient foreign reserves or access to international credit markets to manage external payments, especially when running a current account deficit. A persistent BOP imbalance could lead to debt crises, as countries may struggle to service foreign debt obligations.

Encouraging foreign investment: A stable BOP signals to foreign investors that the country is economically stable, encouraging investment inflows that are crucial for economic growth. Conversely, persistent BOP imbalances may signal economic mismanagement or excessive borrowing, potentially discouraging investment.

Achieving the Macroeconomic Goals: To achieve these macroeconomic goals, governments typically use a combination of fiscal and monetary policies:

Fiscal policy involves government spending and taxation decisions. For example, during periods of low economic growth, governments may increase spending or cut taxes to stimulate demand and promote job creation.

Monetary policy involves the control of the money supply and interest rates by central banks. Lowering interest rates can stimulate borrowing and investment, while raising rates can help curb inflation and stabilize the economy.

Policymakers must balance these goals because they can sometimes conflict. For instance, policies that aim to reduce inflation (e.g., raising interest rates) might lead to higher unemployment or slower economic growth. Conversely, policies that stimulate economic growth might lead to inflationary pressures.

The four key macroeconomic goals—economic growth, full employment, price stability, and balance of payments—are essential for maintaining a stable and prosperous economy. Each goal is interconnected, and achieving one often depends on the successful management of others. Policymakers must carefully balance these objectives, using fiscal and monetary tools to promote a healthy, sustainable economy. Ultimately, these goals contribute to improving the standard of living, ensuring financial stability, and fostering a prosperous society for future generations.

❖ **Long Questions:-**

1. What is macroeconomics? Explain in detail.
2. What are the importance of macroeconomics.

❖ **Short notes:-**

1. Write a note on Scopes of Marco Economics.
2. Give a brief sense of macroeconomics.

UNIT - 2	ECONOMIC GROWTH & DEVELOPMENT

2.1 Introduction

Economic growth and development are two foundational concepts in the study of economics, often used interchangeably, but they represent distinct aspects of a country's economic progress. Economic growth refers to the increase in a country's output of goods and services over time, typically measured by changes in Gross Domestic Product (GDP). Development, on the other hand, encompasses broader measures of a nation's well-being, including improvements in living standards, income distribution, health, education, and environmental sustainability.

❖ Economic Growth:

Economic growth is primarily concerned with the quantitative aspect of the economy. It is often measured by the annual percentage increase in real GDP, which adjusts for inflation and reflects the total value of goods and services produced within a country. Growth can be driven by various factors, including increased investment, technological advancements, improved productivity, and favourable policy environments. When a country experiences consistent growth, it may lead to greater employment opportunities, higher incomes, and an expanded capacity to fund public services such as education, healthcare, and infrastructure.

However, growth alone does not guarantee a better quality of life for all citizens. In fact, if growth benefits only a small segment of society, it can exacerbate income inequality and social unrest. Therefore, while growth is essential for economic progress, it is not sufficient by itself to improve living standards.

❖ Economic Development:

Economic development, in contrast to growth, is a multidimensional concept that focuses on the improvement of human well-being and the quality of life. It takes into account not just economic indicators, but also social factors such as education, healthcare, poverty reduction, environmental sustainability, and political stability. A key distinction is that development emphasizes equity—ensuring that the benefits of economic growth are distributed fairly across society.

Development also includes structural changes in the economy, such as shifts from agriculture-based industries to industrialization and, more recently, the growth of services and knowledge-based industries. These changes reflect improvements in productivity, as well as the diversification of an economy, making it less reliant on a single sector or resource.

❖ **The Relationship between Growth and Development:**

While economic growth and development are interconnected, they are not always aligned. A country may experience rapid growth without significant development if the growth is not inclusive or if it leads to environmental degradation. For instance, a nation rich in natural resources might achieve high GDP growth through resource extraction, but if the wealth generated is concentrated in the hands of a few, it may not result in meaningful improvements in education, healthcare, or living standards for the broader population.

On the other hand, economic development can occur without rapid growth. Some nations prioritize sustainable development and may accept slower growth in exchange for greater social equity, environmental protection, or improved quality of life. In such cases, the goal is not just to increase economic output but to ensure that development benefits the entire population.

Economic growth is an important indicator of a nation's economic performance, but it must be accompanied by a focus on equitable development to enhance the well-being of all citizens. Policymakers must balance the drive for growth with strategies that promote social and environmental sustainability. Understanding the interplay between growth and development is crucial for fostering long-term prosperity and improving the quality of life for future generations.

2.2 Meaning

Economic growth refers to the increase in a country's output of goods and services over time, typically measured by the rise in Gross Domestic Product (GDP). It signifies the expansion of an economy’s productive capacity, often driven by factors such as technological advancement, investment, labor force growth, and improvements in productivity. Growth is a key indicator of economic performance, as it often leads to higher income levels, more job opportunities, and greater wealth generation. However, growth alone does not necessarily ensure improvements in living standards or equitable wealth distribution.

Economic development, on the other hand, is a broader concept that encompasses improvements in quality of life and well-being. It goes beyond just economic growth to include factors such as better education, healthcare, poverty reduction, income equality, environmental sustainability, and social justice. Development focuses on enhancing human capabilities and ensuring that economic benefits are widely shared across society.

While growth and development are closely linked, they are not the same. A country can experience economic growth without significant development, especially if the benefits of growth are unequally distributed. Therefore, true progress requires a combination of both sustained economic growth and inclusive, sustainable development.

2.3 Definition

- **Economic Growth:**

Economic growth refers to the increase in the total value of goods and services produced by an economy over a period of time, typically measured by the rise in Gross Domestic Product (GDP). It indicates the expansion of an economy's productive capacity, driven by factors such as capital investment, technological progress, labor force growth, and improvements in productivity. Economic growth is generally viewed as a key indicator of a country's economic health and prosperity.

- **Economic Development:**

Economic development is a broader concept that involves improvements in living standards, quality of life, and economic well-being across a population. It encompasses not just the increase in output but also factors like poverty reduction, income distribution, healthcare, education, social inclusion, and environmental sustainability. Unlike economic growth, which focuses on quantitative expansion, economic development emphasizes qualitative progress and equitable growth that benefits all segments of society. It is a multidimensional process aimed at enhancing the overall welfare and capabilities of individuals within a society.

2.4 Concept

2.4.1 Economic Growth:

Economic growth is the increase in the total output of goods and services produced by an economy over time. It is most commonly measured by the rise in Gross Domestic Product (GDP) or Gross National Product (GNP), adjusted for inflation to reflect real growth. Economic growth reflects the expansion of an economy's productive capacity and is typically driven by factors such as technological innovation, capital accumulation, labor force growth, and improvements in productivity. It is a quantitative concept that emphasizes the increase in wealth, income, and employment opportunities, and is often considered essential for raising living standards.

However, while growth can signal an improving economy, it does not necessarily lead to improvements in the quality of life for all citizens. Economic growth can be uneven, with some segments of society or regions benefiting more than others, leading to inequality. Additionally, rapid growth without proper management may result in environmental degradation or resource depletion.

2.4.2 Economic Development:

Economic development, in contrast, is a broader and more holistic concept that goes beyond just increasing a nation's economic output. It includes improvements in living standards, social welfare, health, education, income distribution, and the overall well-being of a society. Development focuses on enhancing human capabilities, reducing poverty, promoting equity, and ensuring that the benefits of growth are widely shared.

Unlike economic growth, which is quantitative, economic development is qualitative. It considers factors such as the sustainability of growth, social inclusivity, and the distribution of resources. Economic development also emphasizes structural changes in the economy, such as the transition from an agrarian to an industrial or post-industrial economy, and seeks to improve the broader social fabric, including healthcare access, education levels, and income equality.

2.4.3. The Relationship Between Growth and Development:

While economic growth is often a precursor to development, the two are not always aligned. A country can experience high growth without substantial development if that growth is not inclusive or sustainable. For example, a country might experience rapid economic growth driven by industries like oil extraction, but if the wealth generated is not equitably distributed, or if the environmental consequences are severe, the overall development may be limited. Conversely, a focus on sustainable and inclusive development can lead to a higher quality of life for the population, even if growth rates are slower.

Economic growth and economic development are interrelated but distinct concepts. Growth is an important driver of development, but development requires more than just increasing the total economic output—it involves ensuring that the benefits of growth are widely shared and that it leads to broader improvements in human well-being.

2.5 Importance

Economic growth and development are pivotal in shaping the trajectory of a nation's prosperity and the well-being of its citizens. While economic growth refers to the increase in a country's output of goods and services, economic development involves broader improvements in living standards, quality of life, and equitable distribution of wealth. The importance of both these concepts can be summarized in the following points:

2.5.1. Improvement in Living Standards

Economic growth directly enhances the material wealth of a nation. As a country's economy expands, individuals typically experience higher incomes, better job opportunities, and greater access to essential goods and services.

Improved living standards include not just wealth but access to better housing, healthcare, education, and nutrition, all of which are crucial for the overall well-being of citizens.

Economic development ensures that this growth translates into tangible improvements in quality of life, benefiting all sectors of society, especially the underserved.

2.5.2. Poverty Reduction

One of the most significant benefits of economic growth is the potential to reduce poverty. As the economy expands, more jobs are created, wages rise, and fewer people are pushed into extreme poverty.

With increased resources, governments can fund social safety nets and programs aimed at lifting people out of poverty. For instance, economic growth allows for investment in poverty alleviation programs like subsidized housing, food assistance, and rural development.

Economic development; in a broader sense, promotes inclusive growth, ensuring that the benefits of growth are distributed fairly, reducing income inequality.

2.5.3. Job Creation

Economic growth stimulates the creation of new industries and expansion of existing ones, leading to more job opportunities for the population. A growing economy attracts both domestic and foreign investments, creating employment in sectors like manufacturing, technology, agriculture, and services. Job creation not only provides income for individuals but also empowers them to contribute to the broader economic ecosystem, further driving growth.

2.5.4. Government Revenue and Fiscal Health

With increased economic activity, governments experience higher tax revenues, which can be reinvested into the economy through public infrastructure, social services, and other welfare programs. Strong economic performance enables governments to reduce fiscal deficits and public debt, creating fiscal stability. This allows for greater investment in social infrastructure such as healthcare, education, and public services, improving the long-term prosperity and stability of the country.

2.5.5. Infrastructure Development

Economic growth is crucial for financing and expanding the infrastructure needed to support an economy. This includes transportation networks (roads, ports, airports), energy systems (electricity, renewable resources), and communication technologies (internet, mobile networks). Well-developed infrastructure reduces transaction costs, boosts productivity, and attracts investments, both domestic and international, which further contributes to the country’s growth. The improvement of public services, such as healthcare and sanitation systems, also contributes to a higher quality of life.

2.5.6. Human Capital Development

Economic development is linked to improving education, health, and skills, fostering human capital. This leads to a more educated and skilled workforce, which can drive further economic growth. Access to quality education and healthcare helps reduce illiteracy, improve life expectancy, and enhance productivity. As the workforce becomes more skilled, it can innovate, adopt new technologies, and contribute more effectively to the economy, fuelling continued development.

2.5.7. Innovation and Technological Advancements

Economic growth provides the resources needed for investment in research and development (R&D), leading to technological innovation. A growing economy encourages private enterprises to invest in new technologies, improve existing products, and find creative solutions to social and environmental challenges. Technological advancements in areas such as agriculture, renewable energy, healthcare, and communication can drive further growth and development, improving efficiency and sustainability.

2.5.8. Global Competitiveness

Economic growth and development increase a country's competitiveness on the global stage. As the domestic economy strengthens, it can attract foreign direct investment (FDI), trade partners, and international businesses. A competitive economy also helps in improving a country's position in global markets, allowing it to export more goods and services and thereby increase its foreign exchange reserves. A developed economy also strengthens its global influence, as it can leverage economic power to shape international policies and trade agreements.

2.5.9. Social Stability and Cohesion

Economic development fosters social stability by creating a more equitable distribution of wealth. When citizens benefit from economic opportunities, social tensions decrease, and political stability improves. Growth can also reduce social inequality by expanding access to education, healthcare, and other services, leading to a more inclusive society. Economic prosperity can reduce the risk of social unrest, as people are more likely to be satisfied with their lives when they experience tangible improvements in their well-being.

2.5.10. Environmental Sustainability

While rapid economic growth can sometimes strain the environment, economic development allows for the implementation of policies and technologies that promote sustainability. As income levels rise, there is greater public demand for cleaner environments, renewable energy, and sustainable development practices. Economic development facilitates the funding of green technologies, environmental conservation efforts, and sustainable urban planning, helping balance economic growth with ecological preservation.

2.5.11. Increased Investment in Healthcare

Economic growth enables governments and private enterprises to invest in healthcare systems, leading to better medical services, infrastructure, and access to care. Improved healthcare systems contribute to a healthier population, lower mortality rates, and higher life expectancy, creating a productive workforce that can sustain long-term growth.

2.5.12. Improved Global Relations

Economically strong nations often play a pivotal role in international relations. Economic growth enhances a country’s soft power and ability to collaborate on global issues such as climate change, trade, security, and human rights. Prosperous countries can provide aid to others, contribute to peacekeeping missions, and play a leadership role in international organizations. Economic growth and development are fundamental to the progress and stability of any nation. They not only improve material well-being but also create the foundation for social progress, poverty reduction, and innovation. By fostering a strong, sustainable, and inclusive economy, countries can build a better future for their citizens, enhance their global standing, and tackle the challenges of the 21st century.

2.6 Definition and Measurement of Economic Growth

Economic growth refers to the increase in the value of goods and services produced by an economy over time, typically measured by the rise in a country's Gross Domestic Product (GDP) or Gross National Product (GNP). It represents the overall expansion of an economy's productive capacity and is often used as a key indicator of economic health. Economic growth is essential because it reflects improvements in the material well-being of a society, providing more resources for public spending, investment, and the welfare of individuals.

Economic growth can result from several factors, including increases in labor productivity, advancements in technology, greater capital investment, and improvements in human capital (education and skills). It is usually viewed as a long-term trend rather than a short-term fluctuation, focusing on sustained increases in output.

- **Measurement of Economic Growth**

The measurement of economic growth is primarily based on the calculation of changes in a nation's GDP. GDP measures the total market value of all final goods and services produced within a country's borders over a specified period, typically a year or a quarter. There are several ways to measure and assess economic growth, with the most common methods outlined below:

2.6.1. Real GDP Growth Rate

The most widely used method to measure economic growth is the real GDP growth rate, which adjusts GDP for inflation. Unlike nominal GDP, which simply measures the value of goods and services at current prices, real GDP accounts for changes in the price level, thus offering a more accurate reflection of an economy's true growth. This growth rate expresses the percentage change in real GDP between two periods, allowing policymakers, economists, and analysts to determine whether an economy is expanding or contracting.

2.6.2. Nominal GDP

Nominal GDP, while not adjusted for inflation, is another measure of economic growth. It reflects the total value of goods and services produced in an economy at current market prices. However, it is often less useful for comparing growth over time, as it can be distorted by inflation or deflation. When comparing

GDP across different periods, economists often use the real GDP figure, as it provides a more accurate picture of actual growth.

2.6.3. GDP per Capita

GDP per capita is another key indicator used to measure economic growth, especially in terms of living standards. It divides the GDP of a country by its total population, offering an average measure of economic output per person. This measure helps to assess whether economic growth is translating into improved living standards for the population. While GDP per capita is a useful indicator, it does not account for income inequality, meaning that growth may be occurring without necessarily benefiting all citizens equally.

2.6.4. Growth Accounting

Growth accounting is a technique used to determine the sources of economic growth by decomposing GDP growth into different contributing factors, such as increases in labor, capital, and technological progress. This method allows economists to assess how much of an economy's growth is due to the accumulation of physical capital, the growth in the labor force, and improvements in productivity. For instance, increases in capital investment (factories, machinery, etc.) or improvements in labor productivity through better education and training can lead to higher output per worker, driving economic growth.

2.6.5. Limitations of GDP as a Growth Measure

While GDP is a central tool for measuring economic growth, it has its limitations. It does not account for: Income inequality: Economic growth may not be equally distributed among all segments of society.

Environmental degradation: Growth may come at the expense of natural resources or environmental quality.

Non-market activities: GDP ignores unpaid labor (e.g., home care, volunteer work), which is significant in many economies.

Thus, while GDP growth is an important metric, a broader perspective, such as considering indicators of social well-being or sustainability, is often recommended for a more comprehensive understanding of economic development. Economic growth is the increase in the output of goods and services within an economy, typically measured by GDP or GNP. The most common ways to measure growth are through the real GDP growth rate, nominal GDP, and GDP per capita. While GDP provides valuable insights, it is important to recognize its limitations and consider additional factors when assessing a nation's true development and prosperity.

2.7 Factors affecting Economic Growth

Economic growth is influenced by a variety of factors that interact in complex ways to shape the overall economic performance of a nation. These factors can be broadly categorized into physical capital, human capital, technological innovation, natural resources, institutions, and other external variables. Below is a detailed explanation of the key factors that impact economic growth:

2.7.1. Capital Investment (Physical Capital)

Definition: Capital investment refers to the accumulation of physical assets such as machinery, factories, infrastructure, and equipment used in production processes.

Impact: Increased investment in capital allows businesses to enhance productivity, expand operations, and produce more efficiently. As capital stock grows, so does the capacity to produce goods and services, directly influencing economic output.

Example: Investment in infrastructure like roads, bridges, and ports reduces transportation costs, facilitates trade, and enhances economic activity.

2.7.2. Human Capital (Labor and Skills)

Definition: Human capital encompasses the knowledge, skills, education, and health of the workforce. A more educated and healthier population is typically more productive. Impact: A well-educated and skilled labor force contributes to higher productivity, innovation, and economic growth. Investments in education, healthcare, and training are crucial for enhancing human capital.

Example: Countries like South Korea and Singapore have significantly improved their economic growth by investing heavily in education and skill development.

2.7.3. Technological Innovation and Advancements

Definition: Technological innovation refers to the creation and adoption of new technologies that improve the efficiency and productivity of an economy.

Impact: Technological progress enables businesses to increase output while reducing costs, leading to higher productivity and economic growth. It also opens new industries and markets.

Example: The rise of digital technologies like the internet, automation, and artificial intelligence has transformed industries such as manufacturing, healthcare, and finance, spurring economic growth globally.

2.7.4. Natural Resources

Definition: Natural resources are raw materials such as minerals, oil, gas, water, and land that are used in the production of goods and services.

Impact: Availability of natural resources can be a key driver of economic growth, especially in resource-rich countries. Proper management of these resources can boost production and export revenues, leading to economic expansion.

Example: Countries like Saudi Arabia and Venezuela have experienced significant economic growth due to their vast oil reserves, though dependency on a single resource can also create vulnerabilities.

2.7.5. Institutional Quality and Governance

Definition: Institutions refer to the legal, political, and economic frameworks that govern a society, including property rights, rule of law, corruption levels, and the efficiency of public services.

Impact: Strong institutions create a favourable environment for investment, innovation, and efficient resource allocation. Poor governance, corruption, and weak rule of law, on the other hand, hinder growth by increasing risks and transaction costs.

Example: Economies with strong institutions, like those in Nordic countries, tend to experience sustained growth, whereas countries with weak institutions often face stagnation or decline.

2.7.6. Macroeconomic Stability

Definition: Macroeconomic stability refers to low inflation, stable interest rates, and manageable public debt levels.

Impact: Stability encourages investment and long-term planning by reducing uncertainty. High inflation or excessive public debt can undermine confidence in the economy, leading to slower growth.

Example: Countries like Switzerland and Japan have maintained economic stability, which has contributed to their consistent growth and high standards of living.

2.7.7. Trade and Globalization

Definition: International trade involves the exchange of goods and services across borders, while globalization refers to the increasing interconnectedness of the global economy.

Impact: Access to larger markets and the exchange of ideas, technology, and capital stimulate economic growth. Trade openness encourages competition, fosters innovation, and allows nations to specialize in their comparative advantage.

Example: China’s rapid economic growth has been partly driven by its integration into the global economy, with massive exports and foreign direct investment inflows.

2.7.8. Entrepreneurship and Innovation

Definition: Entrepreneurship involves the creation and development of new businesses, often introducing new products, services, and technologies.

Impact: A thriving entrepreneurial ecosystem fosters innovation, creates jobs, and promotes competition, which boosts productivity and economic growth.

Example: Silicon Valley in the United States is a hub of entrepreneurship and innovation, contributing to the country's growth through new technologies and businesses in sectors like software, biotechnology, and clean energy.

2.7.9. Access to Finance and Credit

Definition: Access to finance refers to the availability of capital for individuals and businesses to invest and grow. This includes both formal financial markets and informal lending mechanisms.

Impact: The ability to access affordable credit allows businesses to expand, invest in new projects, and improve their operations, driving economic growth. Lack of access to finance, however, limits entrepreneurial activity and growth.

Example: The availability of venture capital in countries like the United States has been crucial in supporting the growth of tech companies such as Google, Amazon, and Apple.

2.7.10. Government Policies and Economic Framework

Definition: Government policies include fiscal policies (taxation and spending), monetary policies (interest rates and money supply), and regulatory policies (business regulations and labor laws).

Impact: Sound government policies can create a conducive environment for economic growth by promoting investment, innovation, and efficient resource allocation. Poor policy decisions can stifle growth through overregulation, high taxes, or excessive government interference.

Example: Policies that encourage foreign investment, ease of doing business, and innovation (e.g., tax incentives for start-ups) have spurred growth in nations like Ireland and Estonia.

2.7.11. Demographics and Population Growth

Definition: Demographics refer to the size, age, and distribution of a country's population. Population growth and the working-age population, in particular, play a significant role in shaping economic performance.

Impact: A growing working-age population can boost labor supply and increase output, while a declining population may lead to labor shortages and slower economic growth.

Example: India's large and youthful population provides a significant labor force that can drive economic growth, whereas Japan's aging population poses challenges for its economy.

2.7.12. External Shocks and Global Events

Definition: External shocks are unexpected events, such as natural disasters, geopolitical crises, or global financial recessions, which can disrupt economic activities.

Impact: External shocks can halt economic growth, destroy infrastructure, disrupt supply chains, and cause widespread uncertainty, leading to slower growth. However, resilient economies can recover quickly from such shocks.

Example: The COVID-19 pandemic caused a global economic contraction, but countries with strong healthcare systems and robust economic frameworks were able to recover faster.

Economic growth is influenced by a diverse set of factors that range from capital accumulation and technological progress to the quality of governance and access to global markets. Each of these elements plays a crucial role in shaping an economy's growth potential. Policymakers must therefore consider a broad range of internal and external factors when crafting strategies to foster sustained and inclusive economic growth.

2.8 Strategies for economic development

Economic development is a multifaceted process that aims to improve the living standards, quality of life, and overall economic health of a country or region. Achieving sustainable and inclusive economic development requires a combination of policies, investments, and reforms across various sectors. Below are some key strategies for fostering economic development:

2.8.1. Investment in Education and Human Capital

Rationale: A skilled and educated workforce is essential for economic development. Education increases productivity, promotes innovation, and helps individuals adapt to changing economic conditions.

Strategy: Governments and private sectors should prioritize investment in education and vocational training programs to enhance human capital. This includes improving access to primary, secondary, and higher education, as well as developing technical skills that match industry needs.
Example: Countries like South Korea and Singapore have invested heavily in education, leading to rapid industrialization and economic growth.

2.8.2. Infrastructure Development

Rationale: Infrastructure—such as transportation, energy, and telecommunications—is the backbone of economic activity. It facilitates trade, improves productivity, and reduces costs for businesses and consumers.

Strategy: Governments should focus on upgrading existing infrastructure and building new projects in key sectors like roads, railways, airports, power grids, and digital connectivity. Public-private partnerships (PPPs) can be leveraged for large-scale projects.

Example: China's extensive investment in infrastructure, including the Belt and Road Initiative, has facilitated trade, boosted local economies, and enhanced connectivity with global markets.

2.8.3. Promoting Industrialization and Diversification

Rationale: Economic development is often driven by the growth of industrial sectors, which can create jobs, enhance productivity, and diversify a country's economic base, reducing dependency on single industries.

Strategy: Governments should create policies that encourage industrialization by offering incentives such as tax breaks, subsidies, and grants to key industries. Additionally, promoting diversification by developing new sectors (e.g., tech, renewable energy) can make the economy more resilient.

Example: Malaysia's successful transition from a largely agrarian economy to a manufacturing and services-based economy, including electronics and biotechnology, has been a key driver of its economic growth.

2.8.4. Fostering Entrepreneurship and Innovation

Rationale: Entrepreneurs drive innovation, create jobs, and stimulate competition, all of which contribute to economic growth. Innovation leads to new products, services, and business models that can improve productivity and living standards.

Strategy: Governments should establish a conducive environment for entrepreneurship by reducing bureaucratic barriers, offering start-up grants, and promoting access to venture capital. Encouraging research and development (R&D) in both public and private sectors can also boost innovation.

Example: The United States has fostered a thriving entrepreneurial ecosystem, particularly in technology, through initiatives like Silicon Valley and government-backed R&D programs.

2.8.5. Enhancing Access to Finance

Rationale: Access to finance is crucial for entrepreneurship and business expansion. Small and medium-sized enterprises (SMEs), which are often the backbone of developing economies, require access to credit to grow and create jobs.

Strategy: Financial institutions should be encouraged to expand access to credit, particularly in underserved regions. Additionally, microfinance programs and community lending initiatives can help provide capital to small businesses.

Example: Grameen Bank in Bangladesh pioneered microfinance, providing small loans to entrepreneurs, particularly women, helping them start businesses and contribute to economic development.

2.8.6. Strengthening Governance and Institutions

Rationale: Strong institutions and good governance create an environment of stability, trust, and predictability, which is essential for attracting investment and promoting economic growth. Weak institutions can hinder development by fostering corruption, inefficiency, and social instability.

Strategy: Governments should focus on improving the rule of law, fighting corruption, ensuring property rights, and streamlining administrative processes. Transparency and accountability should be promoted to build confidence among investors and citizens.

Example: Countries like Singapore and New Zealand have been successful in building transparent and efficient institutions, leading to sustained economic growth.

2.8.7. Sustainable Environmental Practices

Rationale: Economic growth should not come at the expense of the environment. Unsustainable practices can lead to long-term damage to natural resources, climate change, and health crises, which in turn undermine development.

Strategy: Governments should integrate sustainable environmental policies into economic development strategies, promoting the use of renewable energy, sustainable agriculture, and green technologies. International cooperation on environmental issues is also vital.

Example: Costa Rica has successfully developed a sustainable tourism industry, combining economic growth with environmental protection by investing in eco-friendly practices and biodiversity conservation.

2.8.8. Trade Liberalization and Regional Integration

Rationale: Opening up to international trade and forming regional trade agreements can enhance access to larger markets, foster competition, and stimulate innovation.

Strategy: Countries should pursue trade liberalization policies, reduce tariffs and non-tariff barriers, and join regional trade agreements that provide access to broader markets.

Example: The European Union (EU) is an example of how regional integration can promote economic growth by reducing trade barriers and encouraging the free movement of goods, services, and labor.

2.8.9. Social Inclusion and Poverty Reduction

Rationale: Economic development is most effective when it benefits all segments of society. Reducing poverty and inequality can boost social stability, foster human capital development, and create a more productive workforce.

Strategy: Governments should implement social protection programs, improve access to basic services like education and healthcare, and promote inclusive growth policies that ensure marginalized groups have access to economic opportunities.

Example: Brazil's Bolsa Familia program, which provides cash transfers to low-income families, has helped reduce poverty and improve social mobility.

2.8.10. Health and Well-being

Rationale: A healthy population is essential for a productive economy. Poor health reduces worker productivity, increases healthcare costs, and hinders human development.

Strategy: Governments should invest in healthcare infrastructure, improve access to medical services, and promote public health initiatives to reduce disease and increase life expectancy.

Example: The success of public health campaigns, such as those in Thailand to combat HIV/AIDS, shows how improving public health can contribute to long-term economic development by maintaining a healthy, productive workforce.

2.8.11. Attracting Foreign Direct Investment (FDI)

Rationale: FDI brings in capital, technology, managerial expertise, and access to global markets, all of which can stimulate economic growth.

Strategy: Governments should create investor-friendly environments by offering tax incentives, ensuring political stability, and providing legal protections for foreign investors.

Example: Countries like Ireland and Singapore have successfully attracted FDI by offering favourable tax policies, skilled labor, and a stable business environment.

Economic development is a complex and multidimensional process that requires coordinated efforts across various sectors. Governments, businesses, and civil society must collaborate to implement effective strategies that promote growth, innovation, social inclusion, and sustainability. By focusing on education, infrastructure, entrepreneurship, good governance, and environmental sustainability, nations can pave the way for long-term prosperity and development.

❖ **Long Questions: -**

1. What is economic growth and development explain with help of importance.
2. Explain factors affecting economic.

❖ **Short Notes: -**

1. Explain the meaning and concept of economic growth and development.
2. What are the strategies for economic development?

UNIT - 3	AGGREGATE DEMAND AND SUPPLY

3.1 Introduction:

The **Aggregate Demand (AD) and Aggregate Supply (AS)** model is a fundamental framework in macroeconomics used to explain the total demand and total supply in an economy. Aggregate demand represents the total quantity of goods and services demanded across all levels of an economy at different price levels, while aggregate supply reflects the total quantity of goods and services that producers in an economy are willing and able to supply at different price levels. The interaction between these two forces determines key economic outcomes such as real output, inflation, and employment. This chapter explores the factors influencing AD and AS, their equilibrium, and how shifts in either curve can affect macroeconomic stability.

3.2 Meaning:

3.2.1 Meaning of Aggregate Demand:

Aggregate Demand (AD) is the total amount of goods and services that all sectors of an economy (households, businesses, government, and foreign buyers) are willing to purchase at various price levels, during a specific period. It is the sum of consumption, investment, government spending, and net exports (exports minus imports).

3.2.2 Meaning of Aggregate Supply:

Aggregate Supply (AS) is the total quantity of goods and services that producers in an economy are willing and able to supply at different price levels, over a specific period of time. It reflects the economy's overall production capacity and is influenced by factors such as labour, capital, technology, and resource availability.

3.3 Definition:

3.3.1 Aggregate Demand:

According to John Maynard Keynes, “Aggregate demand is the sum of spending by households, businesses, and the government, and is the primary cause of short-run economic events like recessions.”

3.3.2 Aggregate Supply:

According to John Maynard Keynes, "Aggregate Supply is the price of output that entrepreneurs expect to make from a given amount of employment."

3.4 Concept:

Aggregate Demand (AD) in macroeconomics refers to the total demand for goods and services in an economy at a given overall price level and within a specific time period. It represents the relationship between the quantities of goods and services demanded (real GDP) and the price level. Aggregate demand is a crucial concept in understanding economic fluctuations and policy-making.

Components of Aggregate Demand (AD)

Aggregate demand is typically represented by the equation:

AD = C + I + G + (X - M)

Where:

1. **C (Consumption)**: Spending by households on goods and services, such as food, clothing, and entertainment.
2. **I (Investment)**: Expenditures by businesses on capital goods like machinery and buildings, as well as investments in residential housing.
3. **G (Government Spending)**: Expenditures by the government on public goods and services, such as infrastructure, education, and defence.
4. **(X - M) (Net Exports)**: The difference between exports (X) and imports (M). Exports add to aggregate demand, while imports are subtracted because they represent spending on foreign goods and services.

Aggregate supply (AS) in macroeconomics refers to the total quantity of goods and services that producers in an economy are willing and able to supply at a given overall price level over a specific period. It represents the production side of the economy and is influenced by factors such as resource availability, production technology, and the cost of inputs.

Components of Aggregate Supply (AS)

1. **Labour Supply**: The workforce available to produce goods and services.
2. **Capital Stock**: Machinery, tools, buildings, and equipment used in production.
3. **Land and Natural Resources**: Raw materials and physical land used in production.
4. **Entrepreneurship**: The ability to organize and manage resources effectively to create output.
5. **Technology and Productivity**: Innovations and efficiency in production processes that increase output.

6. **Government Policies**: Taxes, subsidies, and regulations affecting production costs and incentives.

3.5 Importance:

❖ Importance of Aggregate Demand:

The concept of **aggregate demand (AD)** is crucial in macroeconomics because it represents the total demand for goods and services in an economy and serves as a key driver of economic activity. Understanding aggregate demand helps economists and policymakers analyse economic fluctuations, design effective policies, and address issues like unemployment and inflation. Here's why aggregate demand is important:

1. Determines Economic Output and Employment

- **Aggregate demand drives economic activity**:
    - Higher aggregate demand encourages businesses to increase production to meet the demand, leading to greater output (GDP) and employment.
    - When aggregate demand is low (e.g., during recessions), firms reduce production, leading to layoffs and higher unemployment.

2. Guides Policy Decisions

- **Aggregate demand is a primary focus of fiscal and monetary policy**:
    - **Fiscal Policy**: Governments can increase aggregate demand by boosting spending or cutting taxes, especially during economic downturns.
    - **Monetary Policy**: Central banks manage aggregate demand by adjusting interest rates or using quantitative easing to encourage spending and investment.
- Policymakers aim to stabilize aggregate demand to avoid economic volatility, ensuring steady growth and low unemployment.

3. Influences Inflation

- Aggregate demand plays a major role in inflationary pressures:
    - **Demand-Pull Inflation**: When aggregate demand grows faster than an economy's productive capacity, it can lead to rising prices.
    - Conversely, low aggregate demand can cause deflation or disinflation, reducing price stability and discouraging investment.

4. Explains Economic Fluctuations

- Aggregate demand helps explain the ups and downs of the business cycle:

- **Recessions**: Often caused by a decline in aggregate demand due to reduced consumer spending, lower business investment, or cuts in government spending.
- **Economic Booms**: Driven by strong aggregate demand, leading to higher output and employment but sometimes causing inflationary pressures.

5. Encourages Investment and Innovation

- When aggregate demand is strong, businesses have incentives to:
  - Invest in capital, technology, and infrastructure to meet growing demand.
  - Innovate and improve efficiency to maintain competitiveness in expanding markets.

6. Impacts Living Standards

- A rise in aggregate demand often leads to higher production and incomes, improving living standards for households:
  - Increased consumption reflects greater purchasing power and confidence.
  - Governments can use higher tax revenues (from increased economic activity) to fund social programs and public services.

7. Balances Supply and Demand

- Aggregate demand helps ensure an equilibrium with aggregate supply (AS):
  - When AD and AS are balanced, the economy operates at full employment and stable prices.
  - Imbalances, such as insufficient aggregate demand, can lead to unemployment and idle resources, while excessive demand can strain productive capacity and fuel inflation.

8. Helps Address Unemployment

- Increasing aggregate demand is a key strategy for reducing unemployment, especially during economic slowdowns:
  - Expansionary policies that boost AD encourage businesses to hire more workers to meet rising demand.

9. Stimulates Economic Growth

- Sustained growth in aggregate demand drives long-term economic development:
  - Rising consumption, investment, and exports contribute to higher GDP.

- Stable growth in aggregate demand ensures that businesses and governments can plan for the future with confidence.

10. Highlights Consumer and Market Confidence

- Aggregate demand reflects the overall confidence in an economy:
  - High consumer and business confidence leads to increased spending and investment, boosting aggregate demand.
  - Low confidence can result in reduced spending, creating a downward economic spiral.

In summary, **aggregate demand is critical for understanding and managing economic performance**, as it directly influences output, employment, inflation, and living standards. By focusing on aggregate demand, policymakers can address economic instability, promote growth, and ensure the efficient use of resources.

❖ **Importance of Aggregate Supply:**

The concept of **aggregate supply (AS)** is vital in macroeconomics as it represents the production side of an economy. Understanding aggregate supply helps policymakers, economists, and businesses analyse economic performance, address issues like inflation and unemployment, and promote sustainable economic growth. Here are some key reasons why aggregate supply is important:

1. Determines Economic Output and Growth

- **Aggregate supply reflects an economy's productive capacity**:
  - In the short run, it determines how much output firms can produce given current prices and resources.
  - In the long run, it determines the economy's potential output, or full-employment GDP, which depends on factors like labour, capital, and technology.
- Economic growth over time is linked to shifts in long-run aggregate supply (LRAS), driven by investments in technology, infrastructure, education, and resource development.

2. Helps Analyse Inflation

- Aggregate supply plays a crucial role in understanding different types of inflation:
  - **Cost-Push Inflation**: When production costs (e.g., wages or raw materials) increase, the SRAS curve shifts left, leading to higher prices and lower output.
  - **Demand-Pull Inflation**: If aggregate demand rises too quickly and surpasses the economy's productive capacity (LRAS), it leads to inflationary pressures.

3. Addresses Unemployment

- Aggregate supply is closely tied to the labour market:

- In the short run, an increase in demand for goods and services (shift in AD) can lead to higher production and employment as firms hire more workers.
- In the long run, policies that expand LRAS (e.g., through training programs, infrastructure investments, or tax incentives) help reduce structural unemployment by creating more job opportunities.

4. Guides Policy Decisions

- Policymakers use aggregate supply to craft effective fiscal and monetary policies:
    - **Short-Run Supply Management**: Governments may address temporary supply-side shocks (e.g., energy crises) through subsidies or price controls.
    - **Long-Run Economic Growth**: Investments in education, technology, and infrastructure help shift LRAS outward, promoting sustainable economic growth.
    - Central banks also monitor aggregate supply to manage inflation without stifling production.

5. Explains Economic Fluctuations

- Aggregate supply helps explain periods of economic booms and recessions:
    - During **recessions**, production declines due to falling aggregate demand or negative supply shocks, causing unemployment to rise.
    - During **booms**, producers may increase output to meet rising demand, often at the expense of higher prices if resources are fully utilized.

6. Balances between Production and Demand

- Economic equilibrium depends on the interaction between aggregate supply and aggregate demand:
    - If AS cannot keep pace with AD (e.g., due to supply chain issues or labour shortages), it can cause inflation and slow economic recovery.
    - A growing aggregate supply ensures that rising aggregate demand does not lead to excessive inflation, maintaining economic stability.

7. Supports Sustainability and Productivity

- Policies focused on shifting aggregate supply outward promote long-term improvements in productivity and resource efficiency. For example:
    - Investing in green energy and sustainable technologies can reduce costs while ensuring sustainable growth.
    - Enhancing education and workforce skills boosts human capital, increasing the economy's productive capacity.

In summary, aggregate supply is crucial for understanding how economies grow, how to address inflation and unemployment, and how to design policies that promote sustainable and stable economic performance. It is the backbone of production and directly influences an economy's potential to improve living standards.

3.6 Aggregate Demand Curve:

- **The Aggregate Demand Curve**

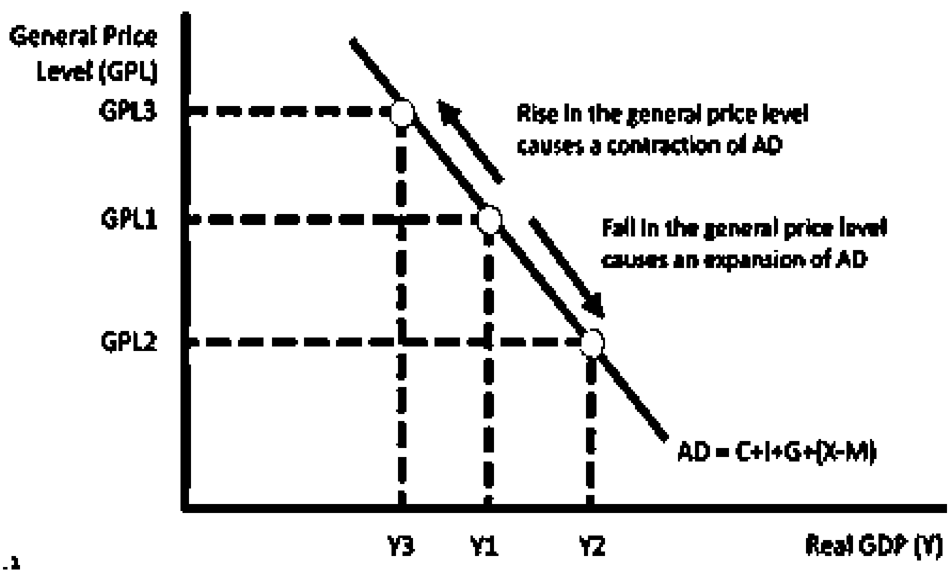
The aggregate demand curve shows the relationship between the price level and the quantity of goods and services demanded:

- **Downward Sloping**: The curve slopes downward, meaning that as the price level decreases, the quantity of goods and services demanded increases. This happens due to:
    1. **The Wealth Effect**: Lower price levels increase consumers' purchasing power, leading to higher consumption.
    2. **The Interest Rate Effect**: Lower price levels reduce the demand for money, decreasing interest rates, which encourages investment and consumption.
    3. **The Exchange Rate Effect**: Lower domestic price levels make a country's goods and services more competitive internationally, increasing net exports.

Shifts in Aggregate Demand

The aggregate demand curve can shift due to changes in any of its components:

1. **Consumption**: Changes in consumer confidence, disposable income, or tax rates.
2. **Investment**: Fluctuations in business confidence, interest rates, or technological advancements.
3. **Government Spending**: Increases or decreases in fiscal policy spending.
4. **Net Exports**: Changes in global economic conditions, exchange rates, or trade policies.



The **aggregate demand curve (AD curve)** represents the relationship between the total quantity of goods and services demanded in an economy (measured as real GDP) and the overall price level, holding all other factors constant. It is a key concept in macroeconomics and is downward-sloping, reflecting an inverse relationship between the price level and the quantity of goods and services demanded.

- **Why the Aggregate Demand Curve is Downward Sloping**

The AD curve slopes downward for the following reasons:

1. **The Wealth Effect**:
   - A lower price level increases the real purchasing power of consumers' wealth and savings.
   - As a result, consumers feel wealthier and spend more, increasing aggregate demand.
2. **The Interest Rate Effect**:
   - At lower price levels, households and businesses need less money for transactions, leading to lower interest rates.
   - Lower interest rates reduce the cost of borrowing, encouraging more investment (I) and consumption (C), which increases aggregate demand.
3. **The Exchange Rate Effect**:
   - When the domestic price level falls, domestic goods become cheaper relative to foreign goods.
   - This increases exports (X) and reduces imports (M), leading to higher net exports (X - M), which boosts aggregate demand.

- **Shifts in the Aggregate Demand Curve**

The AD curve shifts when factors other than the price level change aggregate demand. These shifts can occur due to changes in the components of aggregate demand: **C (consumption), I (investment), G (government spending), and (X - M) (net exports)**.

- **Causes of a Rightward Shift (Increase in AD):**

1. **Higher Consumer Spending**:
   - Increased disposable income (e.g., from tax cuts or higher wages).
   - Rising consumer confidence.
2. **Increased Investment**:
   - Lower interest rates or improved business confidence.
   - Technological advancements or favourable tax incentives.
3. **Higher Government Spending**:
   - Expansionary fiscal policies or increased public investments.
4. **Higher Net Exports**:
   - Improved global demand for domestic goods.

   - Depreciation of the domestic currency, making exports cheaper.

- **Causes of a Leftward Shift (Decrease in AD):**

1. **Lower Consumer Spending**:
   - Higher taxes or rising debt levels.
   - Falling consumer confidence or reduced wealth.
2. **Decreased Investment**:
   - Rising interest rates or economic uncertainty.
   - Declining profitability of businesses.
3. **Reduced Government Spending**:
   - Austerity measures or budget cuts.
4. **Lower Net Exports**:
   - A stronger domestic currency, making exports more expensive.
   - A slowdown in global trade or demand.

- **Shape of the Aggregate Demand Curve:**

1. **Downward Slope**: The inverse relationship between price level and real GDP, driven by the wealth effect, interest rate effect, and exchange rate effect.
2. **Shifts vs. Movements Along the Curve**:
   - A change in the price level leads to a movement *along* the AD curve.
   - A change in non-price factors (e.g., fiscal policy, consumer confidence) causes the entire AD curve to shift.

- **Applications of the AD Curve:**

1. **Policy Analysis**:
   - Helps policymakers understand the effects of fiscal and monetary policies on the economy.
   - For instance, expansionary policies aim to shift the AD curve to the right to combat recessions.
2. **Explaining Economic Fluctuations**:
   - A decline in aggregate demand can lead to recessions and unemployment, while excessive AD growth can result in inflation.
3. **Inflation and Output Trade-Offs**:
   - The AD curve interacts with the aggregate supply (AS) curve to determine equilibrium price levels and output, helping explain inflationary and deflationary gaps.

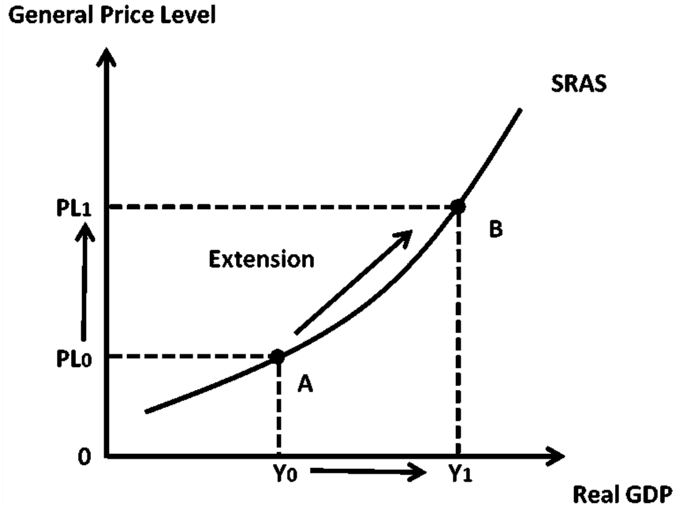
In summary, the aggregate demand curve is a vital tool in macroeconomic analysis, helping to explain how changes in price levels and external factors influence the overall demand for goods and services in an economy.

3.7 Aggregate supply curve: short-run and long-run

The **aggregate supply (AS) curve** represents the relationship between the total quantity of goods and services (real GDP) that producers in an economy are willing and able to supply at different price levels. It reflects the production side of the economy and is critical for understanding how output and price levels are determined in macroeconomics. The shape and characteristics of the AS curve depend on whether it is in the **short run** or the **long run**.

1. The Short-Run Aggregate Supply Curve (SRAS)

- The **SRAS curve** is **upward-sloping**, meaning that as the price level increases, producers are willing to supply more goods and services.
- **Why it is upward-sloping**:
    1. **Sticky Wages**: In the short run, wages and some other input prices do not immediately adjust to changes in the price level. Higher prices increase firms' revenues without a proportional rise in costs, encouraging more production.
    2. **Sticky Prices**: Some firms are slow to adjust their output prices due to menu costs (costs of changing prices), leading to higher profit when prices rise.
    3. **Misperceptions Theory**: Producers may mistake higher price levels as a signal of increased demand for their products, prompting them to increase output.



Shifts in the SRAS Curve:

The SRAS curve can shift due to changes in production costs or other short-term factors.

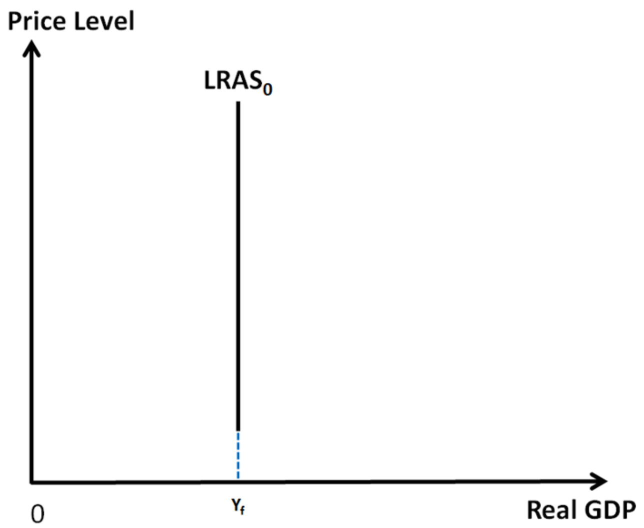
- **Rightward Shift (Increase in AS):**
    - Decrease in input costs (e.g., lower wages or cheaper raw materials).
    - Improved productivity (e.g., due to technological advancements).
    - Favourable short-term shocks (e.g., good weather for agriculture).

- **Leftward Shift (Decrease in AS):**
  - Increase in input costs (e.g., rising oil prices or wages).
  - Adverse shocks (e.g., natural disasters or geopolitical conflicts).
  - Supply chain disruptions.

2. The Long-Run Aggregate Supply Curve (LRAS)

- The **LRAS curve** is **vertical** because, in the long run, the economy's output is determined by its productive capacity (potential GDP) rather than the price level.

- **Why it is vertical**:
  - In the long run, all prices (including wages and input costs) are flexible and adjust to changes in the price level.
  - Output depends on factors like technology, labour, capital, and natural resources, not on the price level.



- **Shifts in the LRAS Curve**

The LRAS curve shifts when there are changes in the economy's productive capacity:

- **Rightward Shift (Increase in Potential GDP)**:
  - Technological advancements.
  - Increase in the labour force or improvement in labour productivity.
  - Investment in capital (e.g., machinery, infrastructure).
  - Discovery of new natural resources or better resource management.

- **Leftward Shift (Decrease in Potential GDP)**:
  - Loss of productive capacity (e.g., due to natural disasters or war).
  - Long-term structural problems (e.g., declining workforce or outdated technology).

3. Differences between SRAS and LRAS

Aspect	SRAS	LRAS
Slope	Upward-sloping	Vertical
Time Frame	Short run	Long run
Price Flexibility	Some prices (e.g., wages) are sticky	All prices are flexible
Output Dependency	Influenced by price levels	Determined by productive capacity

4. Interaction with Aggregate Demand

The aggregate supply curve interacts with the **aggregate demand (AD) curve** to determine equilibrium in the economy:

- In the **short run**, equilibrium is determined by the intersection of AD and SRAS, leading to changes in output and price levels.
- In the **long run**, the economy adjusts to full employment, and output is determined by the LRAS, while price levels depend on shifts in AD.

5. Economic Implications

- **Inflation**:
  - Cost-push inflation occurs when SRAS shifts left due to rising production costs.
  - Demand-pull inflation happens when AD increases beyond the economy's productive capacity (LRAS).
- **Recessions**:
  - A leftward shift in SRAS (e.g., due to supply shocks) can reduce output and increase unemployment.
- **Growth**:
  - Long-term economic growth requires shifting the LRAS curve to the right through investments in technology, infrastructure, and education.

6. Applications of the Aggregate Supply Curve

- **Policy Design**:
  - Helps governments and central banks understand whether to focus on stimulating demand (e.g., during recessions) or addressing supply-side issues (e.g., productivity improvements).

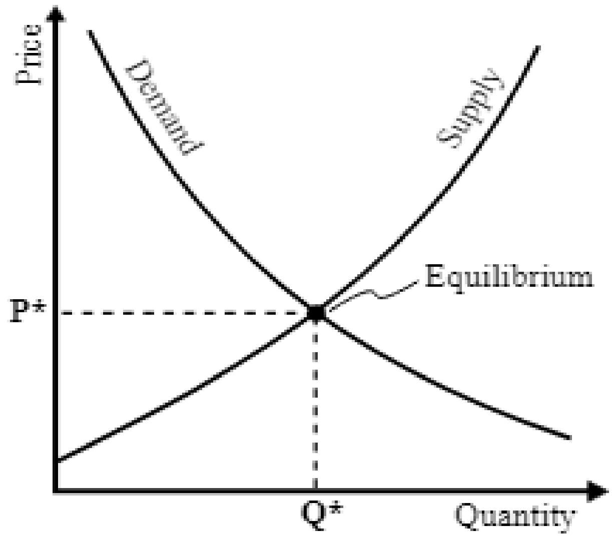
- **Economic Fluctuations**:
  - Explains how economies respond to short-term shocks and long-term growth opportunities.
- **Price Stability**:
  - Understanding AS helps policymakers manage inflation and stabilize the economy.

In summary, the aggregate supply curve is essential for understanding how output and prices are determined in an economy. The SRAS curve captures short-term fluctuations, while the LRAS curve focuses on the long-term productive potential of the economy.

3.8 Equilibrium in the Goods Market - AD-AS model:

Equilibrium in the Goods Market: AD-AS Model

In the **AD-AS model** (Aggregate Demand - Aggregate Supply model), equilibrium in the goods market occurs where the **Aggregate Demand (AD) curve** intersects the **Aggregate Supply (AS) curve**. This point represents the economy's equilibrium level of output (real GDP) and the overall price level.



1. Key Components of the AD-AS Model

- **Aggregate Demand (AD)**: The total demand for goods and services in the economy, determined by consumption (C), investment (I), government spending (G), and net exports (X - M).

- **Short-Run Aggregate Supply (SRAS)**: The total production of goods and services in the economy at different price levels in the short run, where some input prices (e.g., wages) are sticky.

- **Long-Run Aggregate Supply (LRAS)**: The total production of goods and services in the economy at full employment or the potential output, independent of the price level.

2. Equilibrium in the Short Run

- **Equilibrium Output and Price Level**:
    - The point where the AD curve intersects the SRAS curve determines the equilibrium price level and the equilibrium real GDP.
    - At this point, the quantity of goods and services demanded equals the quantity supplied in the short run.

Possible Short-Run Scenarios:

1. **Short-Run Equilibrium at Full Employment**:
    - The equilibrium point aligns with the LRAS curve, meaning the economy is operating at its potential output with no inflationary or deflationary pressure.
2. **Recessionary Gap**:
    - The equilibrium point lies to the left of the LRAS curve, indicating that actual output is below potential output.
    - This is typically associated with high unemployment and underutilized resources.
3. **Inflationary Gap**:
    - The equilibrium point lies to the right of the LRAS curve, indicating that actual output exceeds potential output.
    - This often leads to rising inflation as resources are over utilized.

3. Equilibrium in the Long Run

In the **long run**, prices and wages are flexible, and the economy adjusts to return to its potential output (on the LRAS curve):

- If the economy is in a **recessionary gap**, wages and input prices will fall, shifting SRAS to the right until the economy reaches full employment.
- If the economy is in an **inflationary gap**, wages and input prices will rise, shifting SRAS to the left until the economy returns to its potential output.

❖ **In the long-run equilibrium:**

- Real GDP equals potential GDP (on the LRAS curve).
- The price level is determined by the intersection of AD and LRAS.

4. Shocks and Their Impact on Equilibrium

The AD-AS model helps explain how the economy responds to different shocks:

- **Demand-Side Shocks**:

- A sudden increase in AD (e.g., due to higher government spending or increased consumer confidence) shifts the AD curve to the right:
  - In the short run, this leads to higher output and price levels.
  - In the long run, the economy returns to potential GDP as SRAS shifts left due to rising input costs, but the price level remains elevated.
- A sudden decrease in AD (e.g., due to a fall in investment or exports) shifts the AD curve to the left:
  - In the short run, this causes lower output and price levels (recessionary gap).
  - In the long run, SRAS shifts right as input costs fall, bringing the economy back to potential GDP with a lower price level.

- **Supply-Side Shocks**:

- A negative supply shock (e.g., higher oil prices or natural disasters) shifts the SRAS curve to the left:
  - This leads to **stagflation** (lower output and higher price levels).
  - In the long run, SRAS may return to its original position as input costs stabilize or policies address the shock.
- A positive supply shock (e.g., technological improvements or lower input costs) shifts SRAS to the right:
  - This increases output and lowers the price level.

5. Policy Implications of the AD-AS Model

Policymakers use the AD-AS model to stabilize the economy:

- **Fiscal Policy**: Adjusting government spending and taxation to influence AD.
  - Expansionary policy shifts AD right to combat a recessionary gap.
  - Contractionary policy shifts AD left to combat inflationary pressures.
- **Monetary Policy**: Central banks adjust interest rates or money supply to manage AD.
  - Lowering interest rates boosts AD, while raising them reduces AD.

- **Supply-Side Policies**: Focus on increasing the productive capacity of the economy (LRAS) through investments in technology, infrastructure, and education.

6. Visualization

❖ **In a typical AD-AS diagram:**

- The **x-axis** represents real GDP (output).
- The **y-axis** represents the price level.
- **Equilibrium** occurs at the intersection of the AD, SRAS, and LRAS curves (in the long run). In the short run, equilibrium is at the intersection of AD and SRAS, which may or may not align with the LRAS.

The AD-AS model is a powerful tool for analysing how price levels and output are determined in the economy, how the economy responds to shocks, and how policies can stabilize or stimulate growth.

3.9 Difference between Aggregate Demand and Aggregate Supply:

The primary difference between **aggregate demand (AD)** and **aggregate supply (AS)** lies in what they represent and how they function within an economy. While aggregate demand focuses on the demand side of the economy (total spending), aggregate supply focuses on the supply side (total production). Here's a detailed comparison:

1. Definition

Aspect	Aggregate Demand (AD)	Aggregate Supply (AS)
Definition	The total demand for goods and services in an economy at a given price level and time.	The total supply of goods and services produced in an economy at a given price level and time.

2. Components

Aggregate Demand	Aggregate Supply
Consists of four components: **C + I + G + (X - M)**:	Comprises all goods and services produced in the economy:
- **Consumption (C):** Household spending on goods and services.	- Goods and services from businesses.
- **Investment (I):** Business spending on	- Production from government entities

Aggregate Demand	Aggregate Supply
capital goods.	(e.g., infrastructure).
- **Government Spending (G):** Expenditures by the government.	- Agricultural, industrial, and service outputs.
- **Net Exports (X - M):** Exports minus imports.	

3. Curve Behaviour

Aggregate Demand Curve (AD)	Aggregate Supply Curve (AS)
Downward-sloping: Shows an inverse relationship between price level and real GDP demanded.	Upward-sloping in the short run (SRAS): Indicates that higher price levels lead to higher output due to sticky input costs.
Reasons for downward slope:	Vertical in the long run (LRAS): Reflects the economy's potential output at full employment.
- **Wealth Effect**: Lower price levels increase purchasing power.	
- **Interest Rate Effect**: Lower price levels reduce interest rates, encouraging investment.	
- **Exchange Rate Effect**: Lower price levels make exports cheaper.	

4. Influencing Factors

Aggregate Demand	Aggregate Supply
Influenced by factors affecting **spending**:	Influenced by factors affecting **production**:
- Consumer confidence, disposable income, and interest rates.	- Costs of production (e.g., wages, raw materials, energy).
- Business confidence and access to credit.	- Productivity, technology, and innovation.
- Government fiscal and monetary	- Availability of resources (labour, capital,

Aggregate Demand	Aggregate Supply
policies.	natural resources).
- Exchange rates and global demand for exports.	- Government regulations and taxes affecting supply.

5. Equilibrium

Aggregate Demand	Aggregate Supply
Intersects with AS to determine equilibrium price level and output in the economy.	Works with AD to determine short-run and long-run equilibrium.

6. Shifts in the Curve

Aggregate Demand Shifts	Aggregate Supply Shifts
Rightward Shift: Indicates increased spending, e.g., due to:	**Rightward Shift**: Indicates increased productive capacity, e.g., due to:
- Higher government spending or tax cuts.	- Improved technology or increased labour productivity.
- Increased investment or consumer confidence.	- Lower production costs or greater resource availability.
- Higher net exports.	
Leftward Shift: Indicates decreased spending, e.g., due to:	**Leftward Shift**: Indicates reduced supply, e.g., due to:
- Lower consumer confidence or higher interest rates.	- Higher production costs or supply chain disruptions.
- Reduced government spending or global demand.	- Natural disasters or geopolitical shocks.

7. Time Frame

Aggregate Demand	Aggregate Supply
Operates in both the short run and long run.	Has different curves for the short run (SRAS) and the long run (LRAS).

Aggregate Demand	Aggregate Supply
In the short run, AD changes can significantly influence output and employment.	Short-run supply is influenced by sticky wages and prices, while long-run supply depends on the economy's productive capacity.

8. Key Implications

Aggregate Demand	Aggregate Supply
AD drives **economic growth** and affects short-run fluctuations in output and employment.	AS determines the economy's ability to meet demand and influences inflation and potential output.
Changes in AD are often associated with **business cycles**, including booms and recessions.	Changes in AS are linked to **long-term growth** and resource efficiency.

Summary

Aspect	Aggregate Demand (AD)	Aggregate Supply (AS)
Focus	Total spending in the economy.	Total production in the economy.
Slope	Downward-sloping.	Upward-sloping (short run), vertical (long run).
Main Influences	Consumption, investment, government spending, and net exports.	Production costs, technology, labour, and resource availability.
Goal	Reflects demand for goods and services.	Reflects the capacity to produce goods and services.

Understanding the interaction between aggregate demand and aggregate supply is crucial for analysing macroeconomic equilibrium, inflation, unemployment, and economic growth.

❖ **Exercise:**

Q-1 Explain the meaning of aggregate demand and aggregate supply.
Q-2 Explain the concepts of aggregate demand and aggregate supply.
Q-3 Discuss the importance of aggregate demand and aggregate supply
Q-4 Write in details about the aggregate demand curve: consumption, investment, government spending and net exports.

Q-5 Write in details about the aggregate supply curve: short-run and long-run.

Q-6 Write short note on Equilibrium in the goods market: AD-AS model.

Q-7 Explain the Difference between aggregate demand and aggregate supply.

Q-8 Multiple Choice Questions: (MCQs)

1. What does the Aggregate Demand curve represent?

a) The total supply of goods and services in the economy.
b) The total amount of money the government is willing to spend.
c) The total quantity of goods and services demanded in an economy at different price levels.
d) The total amount of money circulating in the economy.

Answer: c) The total quantity of goods and services demanded in an economy at different price levels.

2. Which of the following is most likely to cause a shift in the Aggregate Supply curve in the long run?

a) A change in the price of oil.
b) A change in government spending.
c) An increase in labour productivity.
d) A change in consumer confidence.

Answer: c) An increase in labour productivity.

3. In the short run, the Aggregate Supply curve is typically:

a) Vertical.
b) Horizontal.
c) Upward sloping.
d) Downward sloping.

Answer: c) Upward sloping.

4. Which of the following would most likely cause a shift to the left in the Aggregate Demand curve?

a) A decrease in the interest rate.
b) An increase in government spending.
c) A fall in consumer confidence.
d) An increase in exports.

Answer: c) A fall in consumer confidence.

5. A movement along the Aggregate Demand curve is caused by:

a) A change in the money supply.
b) A change in the overall price level.
c) A change in government spending.
d) A change in taxes.

Answer: b) A change in the overall price level.

6. Which of the following would likely cause a short-run shift to the right in the Aggregate Supply curve?

a) A reduction in the price of raw materials.
b) A decrease in wages.
c) An increase in technological innovation.
d) All of the above.
Answer: d) All of the above.

7. In the long run, the Aggregate Supply curve is:
a) Upward sloping.
b) Downward sloping.
c) Vertical.
d) Horizontal.
Answer: c) Vertical.

8. What happens if Aggregate Demand exceeds Aggregate Supply in an economy?
a) There will be a recession.
b) Inflationary pressure may arise.
c) Unemployment will increase.
d) Economic output will decrease.
Answer: b) Inflationary pressure may arise.

9. An increase in the price of oil will likely result in:
a) A leftward shift of the Aggregate Supply curve.
b) A rightward shift of the Aggregate Demand curve.
c) A rightward shift of the Aggregate Supply curve.
d) A downward movement along the Aggregate Demand curve.
Answer: a) A leftward shift of the Aggregate Supply curve.

10. Which of the following is most likely to cause a movement along the Aggregate Demand curve?
a) A change in government tax policy.
b) A change in the level of consumer wealth.
c) A change in the price level.
d) A change in business investment.
Answer: c) A change in the price level.

UNIT -4 INFLATION AND DEFLATION

4.1 Introduction and Meaning

Inflation happens when the price of goods and services increase, while deflation takes place when the price of the goods and services decrease in the country. Inflation and deflation are the opposite sides of the same coin. Maintaining the balance between these two economic conditions, i.e. inflation and deflation is essential as the economy can quickly swing from one condition to the other as a result of these two conditions. The Reserve Bank of India keeps an eye on the levels of price changes and controls deflation or inflation by conducting monetary policy, such as setting interest rates in India.

Inflation and deflation are two commonly used terms in Macroeconomics. These two phenomena are experienced by almost every country in the world. It can be said that inflation and deflation are two sides of the same coin.

- Inflation is referred to as the situation when the price level of goods and services rise, which leads to decrease in the purchasing power in the economy or in other words decreases the buying power of the money.
- Rate of Inflation = (Price in this Period – Price in the Previous Period) X 100/ Price in the Previous Period.

Inflation is characterised by two conditions, (1) there is always a steady or sustained rise in the prices of goods and services, which is not seasonal and has a tendency of continuing for a long time (2) the impact is felt across most of the sectors of the economy.

Inflation refers to the sustained increase in the general price level of goods and services in an economy over a period of time. It is a key economic indicator that affects the purchasing power of money and can have significant implications for businesses, consumers, and governments. Understanding inflation is crucial for making informed financial decisions, formulating effective monetary and fiscal policies, and maintaining economic stability. A moderate level of inflation is generally considered healthy for an economy, while high or volatile inflation can have negative consequences.

Deflation is the exact opposite of inflation. In this condition, the price level of goods and services decrease exponentially which results in an increase of the buying power of the money. In other words, in case of deflation, the people in an economy are able to purchase more quantities of products with limited amounts of money.

4.2 Types of Inflation

Based on the underlying causes, inflation is, broadly, categorized into the following types.
It can be categorized on the basis of its rate as well as its causes. Different types of inflation based on these two parameters have been explained in detail.

1) Types of Inflation based on Causes

1) Demand-Pull Inflation

Demand-pull inflation occurs when aggregate demand for goods and services outpaces aggregate supply, leading to higher prices. This type of inflation can be driven by factors such as increased consumer spending, business investment, or government expenditure. A rise in prices of goods and services due to an increase in aggregate demand and consumption is called Demand-Pull Inflation. The underlying reason for this type of inflation is, usually, the increased disposable income in the hands of households, thereby increasing their demands for goods and services. This, in turn, means that while the aggregate supply of goods and services remains the same, their aggregate demand increases sharply, thus raising their prices.

2) Cost-Push Inflation

Cost-push inflation results from rising production costs, such as wages or raw materials, which lead to higher prices for goods and services. This type of inflation can be triggered by supply-side factors like labour strikes, natural disasters, or geopolitical events.

3) Built-in Inflation

Built-in inflation arises from the expectation of future price increases, which can cause businesses to raise prices and workers to demand higher wages, perpetuating the inflationary cycle. This type of inflation can be influenced by historical inflation trends and psychological factors.

4) Structural Inflation or Bottleneck Inflation

A rise in prices of goods and services due to deficiencies existing in the economy such as inefficient storage and distribution facilities, poor productivity, etc. is called Structural or Bottleneck Inflation. These deficiencies lead to shortages of supply of the good/service, which, in turn, results in its increased price. Hence, the Government faces a tough time tackling this type of inflation.

5) Supply-Shock Inflation

A rise in prices of goods and services due to either an unexpected or unforeseen sharp fall in the supply of commodities is called Supply-Shock Inflation. It is called “Supply-Shock” because its causal factors lie out of the control of either the firms or the workers.

2) Types of Inflation based on Rate

1) Hyperinflation

Hyperinflation is an extreme form of inflation characterized by rapidly accelerating price increases, typically driven by the expansion of the money supply or a loss of confidence in a currency. Hyperinflation can have severe consequences for the economy and society, often leading to financial collapse.

2) Creeping inflation or mild inflation or low inflation

As the name suggests, this type of inflation creeps, which means that the rise in prices is slow but continuous. Generally, the rate of price rise between 2 % and 3 % is categorized as Creeping Inflation. This inflation is manageable and is, generally, considered good for the growth of the economy. At this rate of price rise (2 % to 3 %), the producers and traders make reasonable profits, which encourage them to invest more.

3) Galloping inflation or hopping inflation or running inflation

When the rate of price rise is more than 10 % and below 50 %, it is known as Galloping Inflation. Due to this high level of price rise, businesses and employees' incomes cannot keep up with the costs and prices. Investors also refrain from investing in economies with this high level of inflation.

4) Walking inflation or trotting inflation

When the rate of rise in prices is more than that in Creeping Inflation, then it is called Walking Inflation or Trotting Inflation. Generally, the range of this inflation is between 3% to 10%. It must be taken by the government as a wake-up call as, if not checked, it may lead to Running Inflation or Galloping Inflation.

4.3 Factors affecting Inflation

1) Increase in Demand

An increase in demand for goods and services can lead to inflation, as greater demand relative to supply drives up prices. Demand-side factors that can contribute to inflation include population growth, rising incomes, and increased consumer confidence.

2) Decrease in Supply

A decrease in the supply of goods and services can also cause inflation, as reduced availability of products leads to higher prices. Supply-side factors that can contribute to inflation include natural disasters, labour strikes, or geopolitical events that disrupt production.

3) Expansion of Money Supply

An expansion of the money supply can lead to inflation, as an increase in the amount of money circulating in the economy can drive up the demand for goods and services, resulting in higher prices. Central banks often control the money supply through monetary policy tools like interest rates and open market operations.

4) Government Policies

Government policies can contribute to inflation through fiscal measures, such as increased government spending or tax cuts, which can stimulate demand and raise prices. Additionally, regulatory changes or trade policies can impact production costs and influence inflation rates.

5) International Factors

International factors, such as changes in global commodity prices, currency exchange rates, or geopolitical events, can affect domestic inflation rates by influencing the costs of imported goods and services, as well as the overall demand for domestic products.

6) Psychological Factors

Psychological factors, such as expectations of future inflation, can influence pricing and wage-setting behaviour, leading to self-fulfilling inflationary cycles. Public perception of inflation trends and economic conditions can play a role in shaping inflationary expectations.

4.4 Causes of inflation

1) Effects of Inflation on Consumers

1. Purchasing Power

Inflation affects consumers by eroding the purchasing power of money, as higher prices mean that a given amount of money can buy fewer goods and services. This can lead to a decline in the standard of living, particularly for those on fixed incomes.

2. Income Redistribution

Inflation can lead to income redistribution, as the impact of rising prices may not be felt evenly across the population. Those with fixed incomes or limited ability to adjust their spending may be disproportionately affected, while those with more flexible incomes or assets that appreciate with inflation may be better protected.

3. Uncertainty and Saving Behaviour

Inflation can create uncertainty about future price levels, which may influence consumer saving and spending behaviour. High or unpredictable inflation can discourage saving and encourage short-term spending, potentially contributing to further inflationary pressures.

2) Effects of Inflation on Businesses

1. Cost of Production

Inflation affects businesses by increasing the cost of production, as higher prices for raw materials, labour, and other inputs can erode profit margins. Companies may need to raise prices or find ways to cut costs to maintain profitability in the face of inflation.

2. Investment Decisions

Inflation can influence business investment decisions, as it affects the cost of capital and the expected return on investments. Higher inflation can lead to higher interest rates, which may discourage borrowing and investment in capital projects.

3. **Profitability and Competitiveness**

Inflation can impact business profitability and competitiveness, as companies may struggle to maintain margins in the face of rising costs. Additionally, uneven inflation rates between countries can affect the competitiveness of exports and imports, potentially impacting trade balances and economic growth.

3) Effects of Inflation on the Economy

1. **Economic Growth**

Inflation can influence economic growth, as moderate levels of inflation are generally considered conducive to growth, while high or volatile inflation can hinder growth by creating uncertainty and discouraging investment.

2. **Employment**

Inflation can affect employment levels, as rising costs may lead businesses to cut back on hiring or lay off workers to reduce expenses. However, moderate inflation can also stimulate economic activity and job creation by encouraging spending and investment.

3. **Balance of Payments**

Inflation can impact a country's balance of payments, as higher domestic inflation can make exports more expensive and imports cheaper, potentially leading to trade deficits and currency depreciation.

4. **Income Inequality**

Inflation can exacerbate income inequality, as those with fixed incomes or limited ability to adjust their spending may be disproportionately affected by rising prices. Meanwhile, individuals with assets that appreciate with inflation or flexible incomes may be better protected.

4.5 Measurement of Inflation

To effectively monitor and control the level of inflation in an economy, policymakers use various kinds of instruments. In India, inflation is mainly measured through 2 price indices the Wholesale Price Index (WPI) and the Consumer Price Index (CPI). Another measure of inflation frequently used across the world is GDP Deflator. All these measures of inflation are explained below.

1. Consumer Price Index (CPI)

The CPI is a widely used measure of inflation, tracking the changes in prices of a representative basket of goods and services consumed by households. The CPI is calculated by comparing the cost of the basket at different points in time, providing an estimate of overall price changes. The Consumer Price Index (CPI) measures the average change in prices paid by ultimate consumers for a particular basket of goods and services over a period of time.

In other words, the Consumer Price Index (CPI) measures changes over time in the general level of prices of goods and services that households acquire for the purpose of consumption because of the different socioeconomic conditions of consumers, various types of Consumer Price Indices (CPIs) are calculated in India.

2. Producer Price Index (PPI)

The PPI measures the changes in prices received by producers for their goods and services. This index helps track inflation at the wholesale level and can provide early signals of changes in consumer prices.

3. Gross Domestic Product (GDP) Deflator

The GDP deflator is a measure of inflation that compares the nominal GDP (GDP at current prices) with the real GDP (GDP adjusted for inflation). This index provides a broad measure of price changes across the entire economy, including consumer goods, investment goods, and government spending. GDP Deflator refers to the ratio between GDP at Current Prices and GDP at Constant Prices. It can be calculated as:

GDP Deflator = GDP at Current Prices/GDP at Constant Prices

By giving an idea about the changes in the level of prices, it acts as an indicator of the level of price rise.

If the GDP Deflator = 1, it implies no change in the general price level.

If the GDP Deflator > 1, it implies an increase in the general price level.

If the GDP Deflator < 1, it implies a decrease in the general price level.

As compared to WPI and CPI, GDP Deflator is a better measure of inflation as it takes into account all the goods and services of the economy. But, still, it is not used for short-term inflation targeting as GDP-related data are not available on a monthly basis.

4. Personal Consumption Expenditures (PCE)

The PCE index measures the changes in prices of goods and services purchased by consumers. This index is similar to the CPI but includes a broader range of expenditures and adjusts for changes in consumer spending patterns over time.

5. Core Inflation Measures

Core inflation measures exclude volatile components, such as food and energy prices, to provide a more stable and reliable measure of underlying inflation trends. These measures can help policymakers and analysts better understand the long-term trajectory of inflation and its potential drivers.

4.6 Controlling Inflation

Controlling inflation is a big question. Measures, usually, taken to control the price rise can be studied under the following heads.

1. Monetary Policy

The RBI uses monetary tools to reduce the money supply in the market. It leads to a reduction in demand, and hence prices. In some extreme situations, Demonetization of Currency (i.e. declaring a currency of a particular denomination as invalid) is done. It suddenly reduces the money supply in the market and hence demands for goods and services.

- **Interest Rates**

Central banks use interest rates as a tool to control inflation, as raising interest rates can help slow down economic activity and reduce inflationary pressures. Conversely, lowering interest rates can stimulate spending and investment, potentially leading to higher inflation.

- **Open Market Operations**

Open market operations involve the buying and selling of government securities by central banks to influence the money supply and interest rates. By adjusting the supply of money, central banks can affect the overall demand for goods and services, thereby influencing inflation.

- **Reserve Requirements**

Central banks can control inflation by adjusting the reserve requirements for commercial banks, which affects the amount of money available for lending. Higher reserve requirements can reduce the money supply, helping to curb inflation, while lower requirements can increase the money supply and potentially contribute to inflation.

2. Fiscal Policy

Reduction in government expenditure, which helps reduce demand and hence brings down the price level. The government resorts to increasing direct taxes like Income Tax. It reduces the disposable income available to the people, thus leading to low demand and hence lower prices. The government may also resort to decreasing indirect taxes like Excise Duty, Sales Tax, etc. It directly brings down the prices of goods and services. The government may also pass a surplus budget, which means less expenditure than receipts. This reduces money supply and hence demands for goods and services.

- **Government Spending**

Government spending can influence inflation by affecting the overall demand for goods and services. Increased government spending can stimulate demand and lead to higher inflation, while reduced spending can have the opposite effect.

- **Taxation**

Changes in taxation policies can also affect inflation by influencing consumer spending and business investment. Tax cuts can increase disposable income, potentially leading to higher demand and inflation, while tax increases can reduce spending and curb inflationary pressures.

- **Supply-Side Policies**

Supply-side policies focus on increasing the productive capacity of the economy to help control inflation. These policies can include investments in infrastructure, education, and technology, as well as regulatory reforms to promote competition and efficiency.

- **Wage and Price Controls**

Wage and price controls involve government-imposed limits on price increases or wage growth to combat inflation. While these measures can provide short-term relief, they can also create distortions in the economy and may not address the underlying causes of inflation.

- **Inflation Targeting**

Inflation targeting is a monetary policy framework in which central banks set a specific inflation rate as their primary goal. By adjusting monetary policy tools, such as interest rates and open market operations, central banks aim to maintain price stability and promote economic growth.

3) Trade Measures

Various trade measures can be taken to tackle the shortage of goods in the domestic market, such as the import of goods from foreign countries. The higher supply helps to bring down the prices.

4) Administrative Measures

A rational Wage Policy helps to bring the cost of production and hence prices of goods and services under control. At times, the government may resort to direct price control by fixing maximum price limits through the Administered Price System or Subsidy Programs. The method of rationing (i.e. fixing quota for consumption of a particular good) helps keep the demand under control and hence reduces prices.

Thus, Inflation is an intricate part of the economic fabric influencing financial decisions and economic policies. Its effective management requires a careful balance of monetary policy, fiscal policy, and regulatory measures to maintain economic stability and promote sustained growth. By understanding and anticipating its causes and effects, governments, businesses, and individuals can better prepare and adapt to its inevitable challenges.

4.7 Deflation- Meaning and Definition

Deflation is the opposite of inflation, referring to a sustained decrease in the general price level of goods and services in an economy over time. Deflation can have negative consequences, as falling prices can lead to reduced consumer spending, business investment, and economic growth.

Deflation is a phenomenon, which is exactly the opposite of inflation. When deflation occurs, the prices of goods and services fall which in turn increases the purchasing power of the money. It also means that more goods and services can be bought with the same amount of money. This situation comes naturally in an economy when the money supply of an economy gets restricted. Deflation is generally regarded as an economic crisis which is linked with unemployment and very low productivity levels of goods and services. In a deflation kind of situation, businesses and the public at large accumulate less wealth and thus spending becomes very low, which reduces the demand further. With decrease in demand, corporates tend to lower the prices of goods and services to increase the demand.

4.8 Causes of Deflation

Deflation can be caused by factors such as a decline in aggregate demand, technological advancements that reduce production costs, or an increase in the supply of goods and services. Additionally, tight monetary policy and high levels of debt can contribute to deflationary pressures.

Deflation can have negative effects on the economy, including reduced consumer spending, lower business investment, and increased unemployment. Furthermore, deflation can exacerbate debt burdens, as the real value of debt increases when prices fall.

i. **Decrease in demand:** The fall in demand for goods and services triggers a decline in the prices of the goods and services, which causes deflation in an economy.
ii. **Increasing Interest Rates:** Increase in interest rates means restricted spending power. So, generally people instead of spending money prefer to save it. Increase in rate means more borrowing costs on home loans and car loans, which also discourages people from spending more.
iii. **Low Production Costs**: A decline in price for production inputs or raw material will decrease the overall production costs. And, with low costs, producers will tend to increase their production output, which causes an oversupply in the economy. And, if the demand remains low or unchanged, the producers have to decrease the prices of goods and services to make people buy the products.

4.9 Difference between Inflation vs. Deflation

Inflation is an important economic concept that affects the purchasing power of money, business decisions, and overall economic growth. Understanding inflation's causes, effects, and measures is crucial for making informed financial decisions and managing the economy. Effectively managing inflation is essential for maintaining economic stability and promoting growth. Policymakers, businesses, and individuals need to be aware of inflationary trends and their potential consequences to make informed decisions and navigate economic challenges. As the global economy continues to evolve, managing inflation will remain a critical challenge for policymakers, businesses, and individuals. Factors such as technological advancements, demographic shifts, and global economic integration may influence inflation dynamics and require on-going adaptation of policy tools and strategies. Given the complexities of inflation and its potential impact on financial well-being, seeking professional wealth management services can be a wise decision. Inflation and Deflation Comparison. Inflation and deflation both have significant implications for the economy, consumers, and businesses. While moderate inflation is generally considered healthy for an economy, high or volatile inflation can be harmful. Deflation, on the other hand, is typically seen as a negative phenomenon that can lead to economic stagnation and financial instability.

4.10 Role of RBI in controlling Inflation

The effectiveness of the RBI’s efforts to control inflation can be seen in the recent years’ inflation data. Inflation in India has largely remained within the target range set by the RBI. The inflation targeting framework, coupled with the use of various monetary tools, has helped in anchoring inflation expectations and maintaining price stability. However, it is important to note that controlling inflation is a complex task and influenced by various factors such as global commodity prices, supply-side constraints, and fiscal policy. The RBI’s measures can only act as a catalyst, and coordinated efforts from various stakeholders are necessary to achieve long-term inflation control and economic stability. The RBI plays a critical role in controlling inflation in India. Through its monetary policy framework, quantitative tools, supervision, and regulation of banks, exchange rate policy, and effective communication, the central bank aims to maintain price stability and promote sustainable economic growth. While the success of these measures depends on various external factors, the RBI’s efforts have been instrumental in keeping inflation under control and ensuring a stable economic environment for the country.

The following are some ways to control inflation.

1. Monetary Policy

The RBI formulates and implements the monetary policy of India, which primarily focuses on maintaining price stability. The central bank uses various tools at its disposal to manage inflation. One such tool is the repo rate, which is the rate at which the RBI lends money to commercial banks. By hiking the repo rate, the RBI makes borrowing more expensive for banks, thereby reducing their ability to lend. This, in turn, reduces the money supply in the economy, curbing inflationary pressures.

2. Cash Reserve Ratio (CRR)

The RBI also stipulates the cash reserve ratio (CRR) for banks, which is the percentage of deposits that banks are required to keep with the central bank. By increasing the CRR, the RBI reduces the funds available for lending by banks, thereby restricting the money supply and controlling inflation.

3. Open Market Operations (OMO)

Open market operations refer to the buying and selling of government securities in the open market by the central bank. By selling government securities, the RBI absorbs excess liquidity from the market, reducing the money supply and curbing inflationary pressures. Conversely, by buying government securities, the RBI injects liquidity into the market, stimulating economic growth and countering deflationary pressures.

4. Quantitative Tools

Apart from the above measures, the RBI also uses quantitative tools such as statutory liquidity ratio (SLR) and liquidity adjustment facility (LAF) to manage inflation. The SLR requires banks to maintain a certain percentage of their deposits in the form of government securities. By increasing the SLR, the RBI restricts the ability of banks to lend, thus reducing the money supply and curbing inflation. The LAF allows banks to borrow from or lend to the RBI on a short-term basis, helping to manage liquidity in the banking system and control inflation.

5. Inflation Targeting

Since 2016, the RBI has adopted a formal inflation targeting framework, with the aim of maintaining a specified target level of inflation. The target is set by the government in consultation with the RBI, and the central bank adjusts its policies to achieve this target. This approach provides clarity and transparency to stakeholders and helps anchor inflation expectations, which is crucial in controlling inflation.

6. Supervision and Regulation

The RBI plays a vital role in supervising and regulating the banking sector in India. It monitors the operations of banks to ensure that they adhere to prudent lending practices and maintain adequate capital and liquidity buffers. By doing so, the RBI aims to prevent excessive credit growth and speculative activities that could lead to inflationary pressures.

7. Exchange Rate Policy

The RBI manages the exchange rate of the Indian rupee against other currencies. A depreciating rupee can lead to imported inflation, as the cost of imported goods and commodities increases. The RBI intervenes in the foreign exchange market to stabilize the rupee and prevent excessive inflation caused by external factors.

8. Communication and Guidance

The RBI emphasizes effective communication and guidance to the public and market participants regarding its policy stance on inflation. By providing clear communication about its inflation goals and policy measures, the central bank helps in shaping market expectations, which can influence inflationary pressures and behaviour.

❖ Exercise

Q-1 Multiple choice Questions:

1. High inflation levels in the economy leads to _______ in the supply of money.

   a. Increase
   b. Decrease
   c. No change
   d. None of the above

   Answer: a

2. Which of the following concepts is the opposite of inflation?

   a. Deflation
   b. Stagflation
   c. Recession
   d. None of the above

   Answer: a

3. A government resorts to __________ to reduce inflation.

   a. Cuts in government spending
   b. Increase in government expenditure
   c. Reduction in repo rate
   d. None of the above

   Answer: a

4. When the price levels of goods and services are falling continuously, this phenomenon is called _________.

   a. Deflation
   b. Stagflation
   c. Inflation
   d. None of the above

   Answer: a

5. If too much money is chasing too few goods, the resulting inflation is known as __________.

   a. Stagflation
   b. Cost-push inflation
   c. Demand-pull inflation

d. None of the above

Answer: c

6. The main causes of inflation in India are ___________.

a. The inadequate rise in industrial production
b. Erratic agricultural growth
c. Deficit financing
d. All of the above

Answer: d

7. _____ is an effective method to control inflation in the economy.

a. Cash reserve ratio
b. Selective control of credit
c. Bank rate policy
d. None of the above

Answer: a

8. Inflation is measured by _______.

a. Consumer price index
b. Wholesale price index
c. Marshall’s index
d. None of the above

Answer: a

9. When inflation is a result of an increase in the price of factors of production, the result is ________.

a. Stagflation
b. Cost-push inflation
c. Demand-pull inflation
d. None of the above

Answer: b

10. The combination of stagnation and inflation is known as _____.

a. Stagflation
b. Cost-push inflation
c. Demand-pull inflation
d. None of the above

Answer: a

11. When the central government reduces the value of the domestic currency in terms of foreign currency, this phenomenon is called ______.

a. Depreciation
b. Appreciation
c. Devaluation
d. None of the above

Answer: c

12. In the context of inflation control, what does one mean when they say sterilisation of foreign inflow?

   a. Withdrawing an equivalent local currency to maintain the desired rate of exchange
   b. Complying with the regulations for import and export
   c. Filtering of the black money within an economy
   d. None of the above

   Answer: a

13. The Reserve Bank of India (RBI) can take the measure of __________ to control inflation within the country.

   a. Rationing of credit
   b. Introducing a progressive tax system
   c. Improving profits of the public sector
   d. Controlling public expenditure

   Answer: a

14. Which one of the following steps taken by the Government of India effectively controlled the double-digit rate of inflation in the economy in the 1970s?

   a. Contain unproductive expenditure and budget deficits
   b. Pursue an export-oriented strategy
   c. Streamline public distribution system
   d. Enhance production of all public goods

   Answer: a

15. The purchasing power of money varies _______.

   a. Directly with the volume of employment
   b. Inversely with the price level
   c. Directly with the interest rate
   d. Directly with the price level

   Answer: b

16. How does inflation help in the redistribution of income?

   a. Disproportional change in prices
   b. Proportional changes in prices
   c. Falling prices
   d. Rising prices

   Answer: a

17. The item with the maximum weightage in the Wholesale Price Index is ________.

   a. Food items
   b. Manufactured products
   c. Fuel and power
   d. None of the above

   Answer: b

18. The Consumer Price Index helps to measure the degree to which ___________.

    a. Consumer prices have risen relative to the wage level in the economy
    b. Distribution of income between two different sets of income recipients at the same point in time
    c. Distribution of income between two different sets of income recipients during different periods
    d. None of the above

    Answer: c

19. The share of food items within India's total consumption expenditure has reduced within the last two decades because of _________.

    a. Increase in people's income levels
    b. The availability of food grains has declined in the country
    c. Increase in the share of non-food items
    d. None of the above

    Answer: a

Q-2 Answer the following Questions:

1. Referring to the use of each price index, distinguish between the producer price index (PPI) and the consumer price index (CPI).
2. Distinguish between demand-pull inflation and cost-push inflation.
3. Examine the consequences of high inflation for an economy.
4. With reference to how the rate of inflation is measured, explain issues with the accurate measurement of inflation.
5. Compare and contrast the economic consequences of deflation and inflation.
6. Discuss whether deflation or inflation poses the greater risk to an economy.
7. Explain how the rate of inflation (as measured by the CPI) will have a different impact on different households in an economy.
8. Governments should aim for deflation because inflation has negative effects on economic activity. Discuss this point of view.

Q-3 Short note:

1. Types of Inflation
2. Factors affecting Inflation
3. Causes of Inflation
4. Measurement of Inflation
5. Effects of Inflation
6. Inflation vs. Deflation
7. Role of RBI in controlling Inflation

BBA
SEMESTER-2
MACRO ECONOMICS FOR MANAGEMENT
BLOCK: 2

Authors' Name:	Dr. Khushbu Jadav, Assistant Professor, Dr. BAOU, Ahmedabad Mr. Ankit Joshi, Assistant Professor, Dr. BAOU, Ahmedabad
Review (Subject):	Dr. Anjali Gokhru, Assistant Professor, K.S. School of Business Management, Ahmedabad Dr. Satyajeet Deshpande, Associate Professor, Central University Of Gujarat, Gandhinagar
Review (Language):	Dr. Jainee Shah, Assistant Professor, Nirma University, Ahmedabad
Editor's Name:	Prof. (Dr.) Manoj Shah Professor and Director, School of Commerce and Management, Dr. Babasaheb Ambedkar Open University, Ahmedabad.

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UNIT -5 UNEMPLOYMENT

5.1 Introduction

As of 2023-2024, the Unemployment Rate in India is 3.2%, the same as the previous year. Unemployment in India refers to the condition where individuals actively seek employment but are unable to secure a job. It is a key indicator of the nation's economic health, shaped by factors such as caste-based discrimination, overpopulation, and sluggish economic growth. Unemployment in India also highlights significant disparities across rural and urban areas, compounded by automation and skill mismatches. To address these challenges, efforts must focus on diversifying rural employment, enhancing private sector participation, and aligning skill development with industry demands to create sustainable job opportunities.

5.2 Meaning and Definition

The population of any country consists of two components (i) Labour Force (ii) Non-Labour Force. Labour force means all persons who are working (i.e. being engaged in the economic activity) as well as those who are not working but are seeking or available for work at the current wage rate. It means the labour force consists of both employed and unemployed people. The component of population which is not a part of the labour force is Non-Labour Force. It includes all those who are not working and are neither seeking nor available for work. Unemployment can be defined as a state of worklessness for a person who is fit and willing to work at the current wage rate. It is a condition of involuntary and not voluntary idleness. Simply stated an unemployed person is the one who is an active member of the labour force and is seeking work, but is unable to find the same. In case of voluntary unemployment a person is out of job on his own accord or choice, doesn't work on the prevalent or prescribed wages. Either he wants higher wages or doesn't want to work at all. The involuntary unemployment on the other hand is the situation when a person is separated from remunerative work and devoid of wages although he is capable of earning his wages and is also anxious to earn them. It is the involuntary idleness that constitutes unemployment. Involuntary unemployment can be further divided into cyclical unemployment, seasonal unemployment, structural unemployment, and frictional unemployment, natural rate of unemployment, disguised unemployment and under employment.

Unemployment is an adverse condition where individuals who are capable of working and actively seeking employment are unable to find suitable jobs. It is a multifaceted socio-economic issue that stems from factors such as population growth, economic opportunities, education and individual skills. In a developing country such as India, where even the steady rate of economic growth is unable to match the requirements of its educated, qualified youth looking for employment, unemployment is a peculiar phenomenon. With a young and burgeoning workforce, the challenge of unemployment in India is not merely a statistical concern but a social and economic imperative in order to balance the rapid growth with the welfare of the country's vast population.

The term unemployment refers to the condition where individuals actively seek employment but are unable to secure a job. It serves as a crucial indicator of a nation's economic health. The unemployment rate a widely used metric, is calculated by dividing the number of unemployed individuals by the total labour force. Unemployment in India is defined as the situation where people who are willing to work at the going wages cannot find suitable employment. However, the phenomenon of unemployment is not simply characterized by a lack of jobs, but is a multidimensional issue that has social, economic and political causes and implications.

Unemployment is the condition where individuals who are capable of working, actively seeking work, but are unable to find any form of employment. The unemployed are individuals in the labour force, primarily in the age group of 15 – 59 years, who currently do not have a job or a steady source of income. As individuals who are capable and willing to work are unable to find gainful employment, it leads to wastage of manpower resources. Unemployment and its related metrics are typically used to measure the health of a country's economy.

According to National Statistical Office (NSO), employment and unemployment can be defined by the following activity statuses of an individual.

1. **Employed –** Individuals engaged in any economic activity are classified as 'Employed.' This includes full-time, part-time, and temporary work, reflecting a broad understanding of employment.

2. **Unemployed –** Individuals who are actively seeking or available for work but are not currently engaged in any economic activity. This emphasizes the willingness and ability to work as key criteria.

3. **Neither working nor willing to work –** Individuals who are neither seeking nor available for work fall outside the labour force, according to NSO. This category might include students, retirees, or homemakers.

4. **The first two categories,** i.e., Employed and Unemployed constitute the Labour Force of an economy. It is typically the individuals between the age group of 15–59 years.

5. **The following formula** can be used to calculate the unemployment rate of a country.

$$\text{Unemployment Rate} = \frac{\text{Number of Unemployed Individuals}}{\text{Total Labour Force}} * 100$$

According to the International Labour Organization (ILO), unemployment is defined as being out of a job, available for work, and actively searching for employment. Therefore, an individual who has lost work but does not look for another job is not unemployed.

5.3 Types of Unemployment

Unemployment in developing countries, including India, manifests in various forms. They are as follows:

- Voluntary (job refusal due to dissatisfaction) and involuntary (lack of opportunities despite active seeking).
- Structural (skill mismatches)
- Seasonal (demand fluctuations)
- Cyclical (economic downturns)
- Disguised (low productivity)
- Frictional (job transitions)

1) **Involuntary Unemployment**: This represents a scenario where individuals actively seek jobs but cannot find any due to the excess labour supply. For Example, fresh graduates in urban areas struggle to secure employment despite multiple applications. Involuntary unemployment occurs when individuals who are willing and able to work at the prevailing wage rate are unable to find employment. This type of unemployment is not a result of a personal choice or voluntary decision to leave a job; rather, it's a situation where individuals are actively seeking employment but are unable to secure a position. An example might be factory workers who lose their jobs due to a factory closure and are unable to find new employment despite their best efforts. Involuntary unemployment can be particularly distressing as it's often beyond the control of the individual and may require broader economic or policy interventions to address. It can encompass aspects of structural, cyclical, and demand deficient unemployment, reflecting broader economic challenges and trends.

2) **Voluntary Unemployment**: This occurs when individuals choose not to work despite job availability, often due to dissatisfaction with pay, job quality, or dignity concerns. For example, a highly qualified engineer refusing a low-paying customer service job. Voluntary unemployment happens when a worker decides to leave a job because it is no longer financially compelling or satisfying. An example might be a worker whose take-home pay is less than his or her cost of living or someone who leaves a job to pursue a hobby or other personal interests. While it's a personal choice, it can still contribute to the overall unemployment rate.

3) **Structural Unemployment**: Changes in the economy create mismatches between job requirements and workforce skills. This creates Structural Unemployment. For example, factory workers lose jobs due to automation in manufacturing industries. Structural unemployment arises when there is a mismatch between the skills that workers in the economy can offer and the skills demanded by employers. For instance, the automation of manufacturing processes may render certain manual jobs obsolete, leaving those without the necessary technological skills unemployed. This type of unemployment can be long-term and may require significant retraining and education to overcome.

4) **Seasonal Unemployment**: Affects workers in industries with seasonal demand, leading to temporary joblessness during off-seasons. For example, tourist guides and hotel staff face unemployment during the off-peak travel season. Seasonal unemployment occurs when individuals are unemployed during certain seasons or times of the year when their skills or labour are not in demand. This type of unemployment is common in industries that are dependent on particular seasons, such as agriculture, tourism, and construction. For example, agricultural workers may face unemployment after the harvest season, while ski resort employees might be without work during the summer months. Governments and industries often address seasonal unemployment through temporary employment opportunities and unemployment benefits tailored to these fluctuations.

5) **Cyclical Unemployment:** This occurs due to economic downturns when businesses lay off workers during recessions but rehire them during recovery phases. For example, layoffs in the retail sector during economic slumps due to reduced consumer spending. Cyclical unemployment is related to the fluctuations in the economy over the course of the business cycle. During recessions, many industries can suffer, leading to layoffs and thus, higher unemployment. An example would be the increase in unemployment during the global financial crisis of 2008. Cyclical unemployment will decrease when the economy starts to improve.

6) **Disguised Unemployment**: Found in sectors where excess workers contribute little or no additional productivity. For example, multiple interns in an office duplicate tasks that do not add value to operations. Disguised unemployment refers to a situation where more people are employed in a job than is actually required. It is often prevalent in the agricultural sector, especially in developing countries like India. For example, a farm may need only three workers, but the entire family of five may be working. The extra two workers appear to be employed, but their contribution to productivity is minimal or nil. Disguised unemployment represents an inefficient allocation of labour, where individuals are underemployed rather than completely unemployed.

7) **Frictional Unemployment**: Temporary unemployment during job transitions, as individuals leaves one job to search for another. For example, a software developer quit to find a better role in a different company. Frictional unemployment occurs when individuals are temporarily without a job, while transitioning from one position to another or entering the workforce for the first time. For example, a recent graduate actively looking for a job or a professional who has quit one job to find a more suitable one would fall into

this category. This type of unemployment is generally short-term and is often seen as a regular and healthy part of a dynamic economy.

5.4 Causes of Unemployment in India

Unemployment in India stems from socio-economic challenges like caste-based discrimination, sluggish growth, and overpopulation. Seasonal agriculture, informal sectors, flawed education, skill gaps, automation, and limited accessibility further hinder job creation, reflecting the complex dynamics of India's labour market. The detailed explanation of these factors is provided below:

1) **Sluggish Economic Growth:** The underdeveloped economy fails to generate sufficient jobs to meet the demands of a rapidly growing population, resulting in widespread unemployment. During the planning period the trend rate of growth was considerably lower than the targeted rate. Therefore, jobs in adequate number were not created. Further, economic growth by itself does not solve the problem of unemployment. In the recent past there has been deceleration in the growth of employment in spite of the accelerated economic growth. This can be explained in terms of steady decline in the degree of response of employment to change in output in all the major sectors of economic activity except in construction. According to T.S. Papola, over a period of time, the output growth in agriculture and manufacturing sector has become more input and technology-intensive and less labour-intensive. Besides, the sectoral composition of growth is also an important determinant of unemployment. Excessive dependence on agriculture and slow growth of non-farm activities limit employment generation

2) **Overpopulation:** Overpopulation refers to a population which exceeds its sustainable size within a particular environment or habitat. Overpopulation results from an increased birth rate, decreased death rate, the immigration to a new ecological niche with fewer predators, or the sudden decline in available resources**.** Rapid population growth exacerbates job scarcity, with the unemployment rate reaching concerning levels, such as 11.1% during the 10th Five-Year Plan period. Population growth affects many aspects of society, including the overall quality of life. One of the key ways it does this is by causing prices of important goods and services to rise, thus causing hardship for the poorest sections of the population. This occurs even in highly developed and wealthy countries like Japan.

3) Seasonal nature of agriculture: The agriculture sector is largely seasonal and offers only temporary employment, leaving a significant part of the rural population jobless during off-seasons. For example:

- Climatic conditions like temperature, rainfall, and daylight hours, which vary with the seasons, are critical for crop growth, etc.
- Harvesting cycles for different crops have different planting and harvesting times, leading to seasonal variations in supply.
- Seasonal demand for certain foods, such as higher demand for certain fruits during summer, can also influence prices.

3) **Underemployment:** Limited access to production resources, such as raw materials and energy, prevents many individuals, especially in rural areas, from working full-time.

4) **Informal Sector Challenges:** The majority of the workforce operates in unorganized sectors with low wages and poor job security, which makes them perceive their employment as inadequate.

5) **Underperforming Service Sector:** Despite contributing significantly to GDP, the service sector in India employs only a small fraction of the workforce compared to developed countries.

6) **Flawed Education System:** The present educational system has theoretical bias and has limited utility for productive purposes. It lacks the emphasis on the development of aptitude and technical qualifications required for various types of work among job seekers. This has created a mismatch between the need and availability of relevant skills and training, which results in unemployment, especially of youth and educated while shortage of technical and specialized personnel continues. Education systems fail to equip students with industry-relevant skills, rendering a large number of graduates unemployable. For example, 80% of India's 1.5 million engineering graduates lack employable skills. By 2026, India may face a shortage of 1.4–1.9 million tech professionals (NASSCOM).

7) **Skill Gaps in Emerging Industries:** Job seekers often lack the technical and soft skills needed for new-age industries like IT, data analytics, and robotics, limiting their employability. The Economic Survey 2024 highlights AI's potential to disrupt India's job market, urging strategies to mitigate its risks while leveraging its benefits. It emphasizes government intervention to ensure job security across sectors.

8) **Limited Accessibility:** Barriers such as illiteracy, poor communication skills, inadequate childcare, and lack of transportation hinder workforce participation, particularly among marginalized groups.

9) **Impact of Automation:** Automation and AI have reduced traditional jobs while creating demand for specialized skills in machine learning, blockchain, and similar technologies.

10) **Region-Caste Based Discrimination:** To some extent this also leads to job allocation based on regional basis and societal affiliations rather than merit, reducing employment opportunities for deserving candidates.

11) **Increase in Labour force:** There are two important factors that have caused an increase in the labour force which are as follows:

    (i) Rapid Population Growth: Rising population has led to the growth in the labour supply and without corresponding increase in the employment opportunities for the increasing labour force has aggravated the unemployment problem.

    (ii) Social Factors: Since independence, education among women has changed their attitude toward employment. Many of them now compete with men for jobs in the labour market. The economy has however failed to respond to these challenges and the net result is a continuous increase in unemployment backlogs.

12) **Rural-Urban Migration**: The unemployment in urban area is mainly the result of substantial rural migration to urban areas. Rural areas have failed to provide subsistence living in agriculture and allied activities and so large scale migration is taking place to cities. However, economic development in cities has failed to create enough additional jobs for the new urban entrants to the labour market. Thus only some of the migrants are absorbed in productive activities and the rest join the reserve army of unemployed workers.

13) **Inappropriate Technology:** In India, though capital is a scarce factor, labour is available in abundant quantity; yet producers are increasingly substituting capital for labour. This policy results in larger unemployment. Despite the abundance of labour, capital intensive technology is adopted in India mainly because of rigid labour laws. It is quite difficult to follow easy hire and fire policy and so right sizing of manpower is difficult for the enterprises. It is difficult to reduce the number of labour-force. Further, the factors like labour-unrest and lack of work-culture leads to the increased inefficiency of labour and thus provide incentives to follow labour-saving technology by organizations.

14) **Lack of Infrastructure Development**: Lack of investment and infrastructure development limits the growth and productive capacity of different sectors which leads to inadequate generation of employment opportunities in the economy.

15) **Lack of Employability**: India faces poor health and nutrition situation among masses which reduces the capacity of person to be employable and it causes unemployment.

5.5 Unemployment Rate in India

The unemployment rate in India, as per CMIE, rose to 9.2% in June 2024, marking an eight-month high compared to 7% in May 2024 and 8.5% in June 2023, reflecting persistent challenges. The status of unemployment in India is as follows:

- According to recent **Reserve Bank of India (RBI) data**, India's unemployment rate has declined, with the employment growth rate rising to 6% in FY2024 from 3.2% in FY2023, indicating significant job additions. This estimate derived using the **KLEMS database**, measures productivity across 27 industries and key inputs like Capital, labour, Energy, Materials, and Services. The database aggregates data from sources like NSO, NSSO, and ASI for sectoral analysis.

- The **India Employment Report 2024**, jointly prepared by the Institute for Human Development and the ILO, highlights that India's working population grew from 61% in 2011 to 64% in 2021 and is projected to reach 65% by 2036. However, youth participation in economic activities declined to 37% in 2022.

- According to data the **Centre for Monitoring the Indian Economy (CMIE)**, the unemployment rate rose to 9.2% in June 2024, an eight-month high, up from 7% in May 2024. This marks an increase compared to 8.5% in June 2023.
- **Rural Unemployment**: Rural areas experienced a significant rise in unemployment 9.3% in June 2024, up from 6.3% in May 2024 and 8.8% in June 2023.
- **Gender Disparities:**
- **Female Unemployment Rate:** Rose to 18.5% in June 2024 from 15.1% in June 2023, higher than the national average.
- **Male Unemployment Rate**: Marginally increased to 7.8% in June 2024 compared to 7.7% in June 2023.
- **Periodic Labour Force Survey (PLFS) 2024:** Data pertains to individuals aged 15 and above for 2023 and 2024.
- **Labour Force Participation Rate (LFPR)**
    - Overall: Increased from 49.3% to 50.4%.
    - Male: Increased from 73.8% to 75.0%, showing a positive trend.
    - Female: Increased from 24.0% to 25.5%.
- **Worker Population Ratio (WPR): Overall increased from 46.0% to 47.2%.**
- **Unemployment Rate (UR)**-Overall: Decreased from 6.6% to 6.4%, Male: Decreased from 6.0% to 5.7%, Female: Decreased from 8.6% to 8.4%. The government has implemented several programs t**o increase female employability,** including: - Training through Women Industrial Training Institutes, and National Vocational Training Institutes.

5.6 Measuring Unemployment in India

India employs various methodologies to measure unemployment, reflecting its complex labour market dynamics across formal and informal sectors. Multiple agencies and surveys provide insights into employment trends and labour force engagement.

- **Primary Agencies**

Primary agencies responsible for collecting and analysing unemployment data are as follows:

1) **Ministry of Labour and Employment:** Through the Labour Bureau and Directorate General of Employment and Training **(DGE&T)** collect data on organized sector employment and unemployment under various labour laws.

2) **National Sample Survey Office (NSSO):** This office conducts annual and quinquennial surveys on employment and unemployment, providing detailed data on labour force dynamics.

3) **Central Statistical Organisation (CSO):** Conducts Economic Census, collecting employment data across agricultural and non-agricultural enterprises.

Measure Unemployment in India

The following methodologies collectively provide a comprehensive picture of employment and unemployment trends in India's complex labour market, addressing both formal and informal sectors.

1) **Periodic Labour Force Survey (PLFS):** Conducted annually by the Ministry of Statistics and Programme Implementation (MoSPI) since 2017-18. Measures Labour Force Participation Rate (LFPR), Worker Population Ratio (WPR), and unemployment rates using "usual status" and "current weekly status."

2) **Usual Status (UPSS):** It categorizes individuals based on their primary economic activity over the last year, distinguishing between principal and subsidiary activities to capture long-term employment trends.

3) **Current Weekly Status (CWS):** Identifies employment or unemployment based on activities during the seven days preceding the survey, effectively capturing short-term unemployment trends.

4) **Worker Population Ratio (WPR):** This represents the proportion of the working-age population that is currently employed, providing insights into overall workforce utilization.

5) **Labour Force Participation Rate (LFPR):** Measures the proportion of the working-age population that is either employed or actively seeking employment, reflecting overall workforce engagement.

6) **Census Data (Decennial):** Conducted every 10 years by the Registrar General and Census Commissioner, offering insights into workforce distribution, unemployment levels, and main and marginal workers.

7) **Economic Census by CSO:** Gathers employment data periodically across agricultural and non-agricultural enterprises, providing a broad understanding of enterprise-based workforce dynamics.

8) **NSSO Employment-Unemployment Surveys:** Conducted quinquennially and annually, provide detailed employment and unemployment data, analysing labour market dynamics using demographic, social, and economic parameters.

9) **Employment Exchange Data:** The Employment Market Information Programme (EMIP) collects statistics on job vacancies and registrations, reflecting trends in the organized sector but limited to formal employment.

10) **Centre for Monitoring Indian Economy (CMIE):** Conducts frequent surveys with shorter reference periods, offering real-time insights into unemployment trends, particularly in informal and dynamic labour markets.

5.7 Challenges in measuring Unemployment in India

Measuring unemployment in India is fraught with challenges due to the informal nature of jobs, short-term employment patterns, and socio-economic factors. These complexities often hinder the accurate representation of the labour market. The key challenges in measuring unemployment in India are as follows:

1) **Informal nature of jobs:** A large informal sector complicates consistent employment classification as individuals often work intermittently across various activities. The informal sector is considered to be a vital sector of the Indian Economy. The works of the informal one are excluded in the GDP and GNP of India. Thus, India being one of the developing countries, the informal employment accounts for the majority of employment, however, it is not considered much, in comparison to the formal sector. It also gives out the definition of employment in the Informal Sector as per the International Labour Organisation (ILO) and is an assemblage of employment in micro, small and medium enterprises, casual, self-employed and rural workers, impact of economic reforms on informal employment in India, rural and urban informal employment and labour migration and employment conditions of Indians working as informal workers abroad. An effort has been made to highlight the difficulties of the informal and unorganized economy in the country through various diameters such as work deficit, labour market distress and poverty.

2) **Short-term employment:** Workers may alternate between casual labour, seasonal jobs and unemployment within a year, making accurate categorization challenging.

3) **Exclusion of willing workers**: Social norms, especially for women, prevent many from actively seeking work. For example, several rural women reported willingness to work if jobs were available at home, yet they remain excluded from the labour force.

4) **Economic disruptions**: Events like the 2020 lockdown led to temporary job losses. The rate of recovery in labour market has been comparatively much slower in case of salaried jobs, youth employment, particularly in rural areas and with elementary education. The economic consequences such disruptions on employment front were even much more serious as a very low percentage of households reporting improvement in their incomes. The most worrying aspect is that though the return to normalcy may take some time; there have been general recessionary trends in employment in India, which have been visible much before the COVID-19 crisis. The policy measures need to be extraordinary in such difficult times, focusing on securing employment and welfare of affected workers through sound and effective social protection programmes along with a major drive for promoting labour-intensive economic activities such as micro and small enterprises, extension of employment security to poor urban households.

5.8 Impact of Unemployment in India

Unemployment in India has far-reaching consequences, impacting individuals, society, and the economy. It leads to exploitation, social unrest, and underutilization of human resources, hindering national development. The key consequences of unemployment in India are as follows:

1) **Under-utilization of Human Resources**: The potential of the workforce remains unutilized, resulting in a loss of valuable human resources. Proper utilization of these resources could significantly contribute to national economic growth.

2) **Rising Poverty**: Lack of income due to unemployment leads to increased poverty, higher debt burdens, and a rise in economic hardships for affected individuals and families.

3) **Social Issues**: Unemployment fuels societal problems such as corruption, gambling, and unethical behaviour. These issues undermine law and order and disrupt societal harmony.

4) **Industrial Disputes**: Unemployment contributes to increased disputes between employers and employees, disrupting workplace harmony and further escalating joblessness.

5) **Exploitation of Labour**: Unemployed individuals are compelled to accept low wages and work under poor conditions, leading to their exploitation.

6) **Political Instability**: Joblessness breeds dissatisfaction with the government, prompting individuals to engage in disruptive activities and weakening political stability. This, in turn, hinders economic progress.

5.9 Unemployment in India Government Initiatives:

The Government has launched several initiatives to tackle unemployment, focusing on skill development, job creation, and livelihood enhancement. These programs address urban and rural employment challenges while boosting employability across sectors. Key employment schemes and Initiatives are as follows:

1) **National Career Service (NCS) Project:** Transforms employment services with job matching, career counselling, skill development info, apprenticeships, and internships via the NCS Portal, Model Career Centres, and Employment Exchanges.

2) **Mahatma Gandhi National Rural Employment Guarantee Act (MGNREGA):** The vision of Mahatma Gandhi NREGA is to enhance the livelihood security of rural households across the country by providing at least 100 days of guaranteed wage employment in a financial year to every rural household whose adult members volunteer to do unskilled manual work. Mahatma Gandhi NREGA recognizes the importance of strengthening the livelihood resource base of the poor by reaching the most vulnerable sections of rural areas. Mahatma Gandhi NREGA prioritizes sustainable development and environmental stewardship, striving to create a greener, more sustainable

future for generations to come by prioritizing works that contribute to ecological conservation and rural infrastructure development.

3) **Aajeevika -** National Rural Livelihoods Mission (NRLM): National Rural Livelihoods Mission (NRLM) also known as Aajeevika has been launched by Ministry of Rural Development to create platforms enabling poor rural people to increase their household income through sustainable livelihood enhancements and improved access to financial services**.** It empowers rural poor by building institutional platforms for sustainable livelihoods and offering placement-linked skill development for youth under DDU-GKY.

4) **Deendayal Antyodaya Yojana - National Urban Livelihoods Mission (DAY-NULM):** Reduces urban poverty by enabling self-employment and skill development, providing shelters for urban homeless, and strengthening grassroots institutions. To reduce poverty and vulnerability of the urban poor households by enabling them to access gainful self-employment and skilled wage employment opportunities, resulting in an appreciable improvement in their livelihoods on a sustainable basis, through building strong grassroots level institutions of the poor. The mission would aim at providing shelters equipped with essential services to the urban homeless in a phased manner. In addition, the mission would also address livelihood concerns of the urban street vendors by facilitating access to suitable spaces, institutional credit, social security and skills to the urban street vendors for accessing emerging market opportunities.

5) **Prime Minister's Employment Generation Programme (PMEGP):** A credit-linked subsidy scheme promoting self-employment by helping artisans and unemployed youth establish non-farm micro-enterprises. The scheme is implemented by Khadi and Village Industries Commission (KVIC) functioning as the nodal agency at the national level. At the state level, the scheme is implemented through State KVIC Directorates, State Khadi and Village Industries Boards (KVIBs), District Industries Centres (DICs) and banks. In such cases KVIC routes government subsidy through designated banks for eventual disbursal to the beneficiaries / entrepreneurs directly into their bank accounts.

6) **Pradhan Mantri Kaushal Vikas Yojana (PMKVY):** Under the Ministry of Skill Development and Entrepreneurship, PMKVY facilitates skill certification and industry-relevant training for youth, enhancing their employability. Pradhan Mantri Kaushal Vikas Yojana (PMKVY) is the flagship scheme of the Ministry of Skill Development & Entrepreneurship (MSDE) implemented by National Skill Development Corporation. The objective of this Skill Certification Scheme is to enable a large number of Indian youth to take up industry-relevant skill training that will help them in securing a better livelihood. Individuals with prior learning experience or skills will also be assessed and certified under Recognition of Prior Learning (RPL).

7) **National Apprenticeship Promotion Scheme (NAPS):** Apprenticeship training means a course of training in any industry or establishment undergone in pursuance of a contract of apprenticeship on prescribed terms and conditions, which may be different for different categories of apprentices. Under the scheme, training will be imparted in Designated Trades and Optional Trades. This scheme promotes apprenticeships through financial incentives, covering employers' 25% stipend (up to ₹1500) and basic training costs (up to ₹7500).

Exercise

Q-1 Give the answers of the following questions in details.

1) Give meaning and definition of unemployment.
2) Describe the types of unemployment.
3) Write the causes of unemployment in India
4) Explain unemployment rate in India.
5) Write a note on measuring unemployment in India.
6) Write the challenges in measuring unemployment in India.
7) Explain impact of unemployment in India.
8) Write down the government initiatives for unemployment in India.

UNIT - 6	POVERTY

6.1 Introduction

Poverty is both an individual concern as well as a broader social problem. At the individual or household level, not being able to make ends meet can lead to a range of social, physical, and mental issues. At the societal level, high poverty rates can be a damper on economic growth and be associated with problems like crime, unemployment, urban decay, poor education, and poor public health. Governments often put social welfare programs in place to help lift individuals, families, and communities out of poverty. Some countries have stronger welfare states (social safety nets) than others. For instance, the United States tends to be much more individualistic and has relatively limited welfare programs. European countries, in comparison, have a much broader range of welfare programs and supports for those in need. Welfare programs are used by governments to help alleviate poverty. Poverty is the result of a confluence of factors, and not determined solely by income.

Poverty as a phenomenon is as old as human existence; its significance has evolved over time. Under the traditional mode of economic production, widespread poverty had been accepted as inevitable. This meant the total output of goods and services, even if equally divided, would still be insufficient for the entire population to lead a comfortable life. However, this was proved wrong by industrialization, as industrialized nations have outputs sufficient to raise the entire population to a comfortable level.

❖ Understanding Poverty

Poverty is both an individual as well as a broader social problem. On the individual level, ends are not met which can lead to physical and mental issues. At the societal level, high poverty can damper to overall economic growth and be associated with problems like unemployment, crime, urban decay, lack of education, and detrimental health.

Important points related to poverty are:

- The two main dimensions of poverty are hunger and lack of shelter.
- Poverty is a condition where one is barely having basic necessities of life. When parents are not able to send their children to school or a situation where individuals or families can’t afford medical facilities
- Lack of clean water and sanitation facilities is also one of the conditions of poverty.
- Lack of regular job to earn or live a regular life with basic necessities of life.

- **Meaning:**

The term poverty refers to the state or condition in which people or communities lack the financial resources and other essentials for a minimum standard of living. As such, they cannot meet their basic human needs. People and families who live in poverty may go without proper housing, clean water, healthy food, and medical attention. Each nation may have its own criteria for determining the poverty line and counting how many of its people live in poverty.

Poverty is a socioeconomic condition that is the result of multiple factors, not just income. These factors include race, sexual identity, sexual orientation, and access to education, among others. Poverty is a state or condition in which a person or community lacks the financial resources and other essentials for a minimum standard of living. Poverty-stricken people and families might go without proper housing, clean water, healthy food, and medical attention.

Poverty refers to the lack of adequate financial resources such that individuals, households, and entire communities don't have the means to subsist or to acquire the basic necessities for a flourishing life. This absence of means can result in struggles to obtain food, clothing, shelter, and medicine.

Poverty is both an individual concern as well as a broader social problem. At the individual or household level, not being able to make ends meet can lead to a range of social, physical, and mental issues. At the societal level, high poverty rates can be a damper on economic growth and be associated with problems like crime, unemployment, urban decay, poor education, and poor public health.

Definition of Poverty: When a person is unable to get the minimum necessities of life this situation is known as poverty. Poverty means that the income level from employment is so low or no employment that basic human needs are not met. Poverty-stricken people live without proper housing, clean water, healthy food, and medical attention.

Progress has been made in measuring and analysing poverty, the World Bank Organisation is working to identify other indicators and dimensions of poverty. This includes identifying social indicators to track education, health, access to services, social exclusion, and vulnerability.

6.2 Characteristics of Poverty

1. Hunger, Starvation, and Malnutrition

Starvation and hunger are the basic problems of the poorest household. The rate of malnutrition among the poor is alarmingly high.

2. Poor Health

Poor people are generally physically weak due to ill health, disability, or serious illness. Their children have a lower chance of surviving or being healthy when they are born.

3. Limited Economic Opportunities

Due to their illiteracy and lack of skills, they have very limited opportunities. Poor people are highly vulnerable. Therefore, they are unable to negotiate their legal wages and get exploited by employers.

4. Debt Trap

Debt Trap is a situation in which a debtor is not able to repay the debt incurred. Poor people usually take loans from moneylenders, who charge high rates of interest that force them into persistent debt.

5. Lack of Facilities for Electricity and Water

Poor people lack access to electricity. They cook their food on firewood and cow dung cake. A major part of the population that is poor does not have access to safe drinking water.

6. Gender Inequality

Extreme gender inequality is seen in how women and men participate in the workforce, classroom, and in family decision-making. Besides, on the path to motherhood, less attention is provided to poor women.

7. Bigger Families

The poor families are more prominent in size, which makes their economic condition worse.

6.3 Types of Poverty

Poverty is an economic state where people are experiencing scarcity or the lack of certain commodities that are required for the lives of human beings like money and material things. Therefore, poverty is a multifaceted concept inclusive of social, economic and political elements.

Poverty is an economic state where people are experiencing scarcity or the lack of certain commodities that are required for the lives of human beings like money and material things. Therefore, poverty is a multifaceted concept inclusive of social, economic and political elements.

The word poverty comes from French word **“poverté”** which means **poor.**

It is complex to define poverty. Because it is depend on multifaceted and multidimensional elements like region, era, geographical condition, circumstances and many more.

On the basis of social, economic and political aspects, there are different ways to identify the type of Poverty**:**

1. Absolute poverty
2. Relative Poverty
3. Situational Poverty
4. Generational Poverty
5. Rural Poverty
6. Urban Poverty

- **Now let us understand them one by one:**

1. Absolute Poverty: Also known as extreme poverty or abject poverty, it involves the scarcity of basic food, clean water, health, shelter, education and information. Those who belong to absolute poverty tend to struggle to live and experience a lot of child deaths from preventable diseases like malaria, cholera and water-contamination related diseases. Absolute Poverty is usually uncommon in developed countries.

It was first introduced in 1990, the “dollar a day” poverty line measured absolute poverty by the standards of the world's poorest countries. In October 2015, the World Bank reset it to $1.90 a day. This number is controversial; therefore each nation has its own threshold for absolute poverty line.

"It is a condition so limited by malnutrition, illiteracy, disease, squalid surroundings, high infant mortality, and low life expectancy as to be beneath any reasonable definition of human decency." - says Robert McNamara, the former president of the World Bank

2. Relative Poverty: It is defined from the social perspective that is living standard compared to the economic standards of population living in surroundings. Hence it is a measure of income inequality. For example, a family can be considered poor if it cannot afford vacations, or cannot buy presents for children at Christmas, or cannot send its young to the university.

Usually, relative poverty is measured as the percentage of the population with income less than some fixed proportion of median income.

It is a widely used measure to ascertain poverty rates in wealthy developed nations.

In European Union the "relative poverty measure is the **most prominent and most–quoted** of the EU social inclusion indicators"

3. Situational Poverty: It is a temporary type of poverty based on occurrence of an adverse event like environmental disaster, job loss and severe health problem. People can help themselves even with a small assistance, as the poverty comes because of unfortunate event.

4. Generational Poverty: It is handed over to individual and families from one generation to the one. This is more complicated as there is no escape because the people are trapped in its cause and unable to access the tools required to get out of it.

5. Rural Poverty: It occurs in rural areas with population below 50,000. It is the area where there are less job opportunities, less access to services, less support for disabilities and quality education opportunities. People are tending to live mostly on the farming and other menial work available to the surroundings.

The rural poverty rate is growing and has exceeded the urban rate every year since data collection began in the 1960s. The difference between the two poverty rates has averaged about 5 percent for the last 30 years, with urban rates near 10–15 percent and rural rates near 15–20 percent (Jolliffe, 2004).

6. Urban Poverty: It occurs in the metropolitan areas with population over 50,000. These are some major challenges faced by the Urban Poor:

- Limited access to health and education.
- Inadequate housing and services.
- Violent and unhealthy environment because of overcrowding.
- Little or no social protection mechanism.

6.4 Causes of Poverty

1) Rapidly rising population: India’s population has steadily increased through the years. During the past 45 years, it has risen at a rate of 2.2% per year, which means, on average; about 17 million people are added to the country’s population each year. This also increases the demand for consumption goods tremendously.

2) Low productivity in agriculture: A major reason for poverty is low productivity in the agriculture sector. The reason for low productivity is manifold. Chiefly, it is because of fragmented and subdivided landholdings, lack of capital, illiteracy about

new technologies in farming, the use of traditional methods of cultivation, wastage during storage, etc.

3) Underutilized resources: There is underemployment and disguised unemployment in the country, particularly in the farming sector. This has resulted in low agricultural output and also led to a dip in the standard of living.

4) Low rate of economic development: Economic development has been low in India. There is a gap between the requirement and the availability of goods and services.

5) Price Rise: Price rise has been steady in the country and this has added to the burden the poor carry. Although a few people have benefited from this, the lower-income groups have suffered because of it, and are not even able to satisfy their basic minimum wants.

6) Unemployment: Unemployment is another factor causing poverty in India. The ever-increasing population has led to a higher number of job-seekers. However, there is not enough expansion in opportunities to match this demand for employment.

7) Shortage of capital and able entrepreneurship: The shortage of capital and entrepreneurship is making it harder to increase production.

8) Hunger and malnutrition: It’s a vicious cycle: poverty causes hunger, but hunger is also a key cause of poverty. If a person doesn’t get enough food, they’ll lack the strength and energy needed to work. Or their immune system will weaken from malnutrition and leave them more susceptible to illness that prevents them from getting to work. They may also go into further debt if they need to see a doctor or get on-going care.

9) This can lead to a vicious cycle, especially for children. From womb to world, the first 1,000 days of a child’s life are critical for a lifetime of health. However, malnourished mothers are more likely to have malnourished children, and the costs of malnutrition can be felt over a lifetime. Adults who were stunted as children earn, on average, 22% less than those who weren't stunted. In Ethiopia, stunting contributes to GDP losses as high as 16%.

10) Social Factors: Apart from economic and commercial, there are also social factors hindering the eradication of poverty in India. Some of the hindrances in this regard are the laws of inheritance, caste system, certain traditions, etc. Read about vulnerability due to caste on the linked page.

11) Political Factors: The British colonization and rule over India for about two centuries have caused damaging harm to the nature of India’s economy. India, which was once a chief producer, has been reduced to a big market. Much of the natural resources of the country were used to benefit British coffers and a lot of wealth was siphoned off to the homeland of the rulers. They also reduced many classes of people such as farmers, artisans, potters, weavers, etc. to their current state of poverty.

12) Inequality in the Distribution of Income and Assets: The poor mainly consists of unskilled labour, which typically does not command a high enough level of wage income.

    a. The benefits of the growth have been concentrated and have not “trickled down” sufficiently to ensure improved consumption among the lower income groups.

13) Lack of Access to Social Services: The lack of access to social services such as health and education compound the problems arising from inequality in the ownership of physical and human assets

14) Lack of access to Institutional Credit: The banks and other financial institutions are biased in the provision of loans to the poor for the fear of default in the repayment of loans.

    a. Further, the rules regarding collateral security, documentary evidences etc. present constraints for the poor to avail loan facility from banks

15) Lack of Productive Employment: The magnitude of poverty is directly linked to the unemployment situation.

    a. The present employment conditions don't permit a reasonable level of living causing poverty.

    b. The lack of productive employment is mainly due to problems of infrastructure, inputs, credit, technology and marketing support. The gainful employment opportunities are lacking in the system.

16) Caste system: Caste system in India has always been responsible for rural poverty. The subordination of the low caste people by the high caste people caused the poverty of the former

17) Social customs: The rural people generally spend a large percentage of annual earnings on social ceremonies like marriage, death feast etc. and borrow largely to meet these requirements. As a result, they remain in debt and poverty.

18) Vicious Circle of Poverty: Low level of saving reduces the scope for investment; low level of investment yields low income and thus the circle of poverty goes on indefinitely.

19) Low Productivity in Agriculture: The level of productivity in agriculture is low due to subdivided and fragmented holdings, lack of capital, use of traditional methods of cultivation, illiteracy etc.

6.5 Poverty Line

Meaning: The poverty line is an estimated, imaginary line developed by economists in order to define a poor person. Using certain standard measures, the poverty line is calculated such that all poor people lie below the poverty line and any one above the poverty line is not poor.

The "Poverty Line" is that threshold level at which the individual or household falls below and, therefore, should be considered to be in poverty. This may be considered a measure to indicate the minimum level of income or consumption level that would rescue at least a decent standard of living. Many who fall below this line often cannot afford such basic needs as food, shelter, and health care. The poverty line is a very important concept in policy formulation, welfare programs, and economic planning since it estimates the number of people whose living standards need improvement. It forms the basis through which governments and organizations can reposition and better apportion means toward successful eradication of poverty and resulting in better living standards.

6.5.1 Need for Defining a Poverty Line

It is useful to define a line of poverty for a number of reasons. It enables one to point out who the poor are and to target the resources channelled efficiently into favoured welfare programs. It also offers a base with which one can monitor and assess the efficiency of measures taken to alleviate poverty. In addition, a well-defined poverty line will help in the overall comprehension of the disparities in socio-economic terms within a nation and the approach to take in coming up with an evidence-based policy aimed at combating such life challenges.

6.5.2 Estimation of Poverty line

- Tendulkar committee (2009): Poverty line in the Suresh Tendulkar methodology was expenditure of ₹33 a day in urban areas and ₹27 a day in rural areas. Thus, India's poors as percentage of total population in 2011-12 as per the Tendulkar committee was 21.9.
- Rangarajan committee (2014): In the Rangarajan methodology, it was ₹47 a day in urban areas and ₹30 a day in rural areas. Thus, India's poor population as percentage of Indian population in 2011-12 was 29.5, as per Rangarajan committee.
- Current poverty line calculation by NITI Aayog: A new approach has evolved by the NITI Aayog to incorporate multiple dimensions and non-income factors in the form of Multidimensional Poverty Index, based on National Family Health Surveys (NFHS) results. At the core of the MPI is the Alkire-Foster (AF) methodology, a globally accepted general framework for measuring multidimensional poverty, which captures overlapping deprivations in health, education, and living standards.
- International Poverty Line: The World Bank defines a person as extremely poor if she is living on less than $2.15 per day, which is adjusted for inflation as well as price differences between countries.

6.5.3 Suggestions

- Inequalities of income, education, and opportunity are all interconnected and must be addressed together.
- Reducing inequalities of opportunity and of incomes among individuals, populations, and regions can foster social cohesion and boost general well-being.
- Jobs and employment are the surest way to reduce poverty and inequality.
- Poverty eradication must be mainstreamed into the national policies and actions in accordance with the internationally agreed development goals forming part of the broad United Nations Development Agenda.
- Education and health: It is essential that the government should provide education and health services free of cost for the deserving citizens and those from the socially oppressed classes.

6.5.4 Government Initiatives to Reduce Poverty in India

- Mahatma Gandhi National Rural Employment Guarantee Work (MGNREGA): It provides wage employment while also focusing on strengthening natural resource management through works that address causes of chronic poverty.
- Flagship programmes like the Poshan Abhiyan and Anaemia Mukt Bharat have contributed to reduced deprivations in health.
- Initiatives such as Swachh Bharat Mission (SBM) and Jal Jeevan Mission (JJM) have improved sanitation across the country.

- The provision of subsidized cooking fuel through the Pradhan Mantri Ujjwala Yojana (PMUY) has positively transformed lives in rural areas.

- Initiatives like Saubhagya, Pradhan Mantri Awas Yojana (PMAY), Pradhan Mantri Jan Dhan Yojana (PMJDY), and Samagra Shiksha have also played a major role in significantly reducing multidimensional poverty in the country.

6.5.5 Factors Affecting the Estimation of the Poverty Line

- Cost of Living: The poverty line shall have to ensure that standards of living are comparable across regions.

- Inflation: It becomes important to periodically update so that changes due to variations caused by inflation still hold good.

- Consumption Patterns: If one knows the consumption pattern of an average person, then it would help in setting a more realistic poverty line.

- Economic Conditions: Macroeconomic conditions such as employment and wage levels determine poverty measures.

6.5.6 Measurement of Poverty Line

In India, the measurement of the poverty line is done by the following methodology:

I. Consumption Expenditure Surveys: Household consumption data is gathered through surveys undertaken by the NSSO. These surveys provide inputs to help demarcate the poverty line based on minimum expenditure required to meet basic needs.
II. The Cost of Basic Needs Method: This method determines the cost of a basket of goods and services that would ensure the fulfilment of a minimum acceptable level of living. It is further adjusted regionally to reflect differences in costs.
III. Income-Based Measures: These measures estimate poverty based on levels of income that determine a basic standard of living.

6.6 Measurement of Poverty

- **Poverty Measurement in India**

Poverty Measurement in India, like in many other countries, is a complex and multifaceted process that takes into account various economic, social, and demographic factors. India has a long history of poverty measurement and has evolved its methodologies over time to provide a more accurate picture of poverty in the country. This comprehensive process plays a pivotal role in shaping government policies and social welfare programs aimed at alleviating poverty and improving the lives of those affected by it. In this article, we will cover the methods of Poverty Measurement in India in detail.

6.6.1 Methods of Measurement of Poverty

The measurement of poverty is a way to determine how many people in a country or a region are living in poverty, which means they do not have enough income or resources to meet their basic needs for a decent standard of living. There are several methods to measure poverty:

1. Income-Based Measurement

Income-based measurement is the most common way to measure poverty. It looks at how much money people or households earn. If their income falls below a certain threshold, they are considered to be in poverty. The threshold can vary by country and region and is adjusted for factors like family size. For example, in the United States, the poverty threshold for a family of four might be around $25,000 per year.

2. Consumption-Based Measurement

Instead of just looking at income, the Consumption-Based Measurement method considers what people consume or spend on goods and services. It's based on the idea that what people actually use is a better measure of their well-being than just their income.

3. Multidimensional Poverty Index (MPI)

The Multidimensional Poverty Index (MPI) approach goes beyond just income and looks at various aspects of people's lives, such as access to education, healthcare, clean water, and housing. It measures how deprived people are in these different dimensions and combines them to get an overall poverty score.

6.7 BPL (Below Poverty line)

The full form of BPL is Below Poverty Line. It is an economic benchmark related to threshold income. It is fixed by the Government of India. It can help one identify the financially weaker people and households in immediate need of government aid. The people whose income is beneath this threshold are below the poverty line. The Government makes use of several parameters to recognise the below poverty line (BPL) sections. These parameters may differ from state to state and may be different for rural and urban areas. Furthermore, the other countries have different parameters and ways to define the poverty line. In India, in the year 2011, the poverty line was defined by the Suresh Tendulkar Committee. It was determined on the basis of monthly expenses on food, education, health, transport and electricity. According to this committee, a person who is spending Rs. 33 a day in urban areas and only Rs. 27 a day in rural areas live below the poverty line. Dadabhai Naoroji was the first person to highlight the concept of a poverty line. Please give the latest figure

- The poverty line refers to the cut-off point which divides people of a region as poor and non-poor.
- Methods to determine the poverty line are many.
- The monetary value (per capita expenditure) is one such method. Here, the minimum calorie intake is estimated at 2400 calories for a rural person and at 2100 for an urban person.

The Variables that define BPL

1. Type of residence
2. Status of children
3. Consumer products
4. Food safety
5. Clothing
6. Literacy
7. Land ownership
8. Sanitation, etc.

6.7.1 Role of Public Distribution System in Poverty Alleviation

The Public Distribution System (PDS) which evolved as a system of management for food and distribution of food grains plays a major role in poverty alleviation. This programme is operated jointly by the Central Government and the State Government of India. The responsibilities include:

- Allocations of commodities such as rice, wheat, kerosene, and sugar to the States and Union Territories.
- Issue of Ration Cards for the people below the poverty line.
- Identification of families living below the poverty line.
- Management of food scarcity and distribution of food grains.

PDS was later relaunched as Targeted Public Distribution System (TPDS) in June 1997 and is controlled by the Ministry of Consumer Affairs, Government of India. TPDS plays a major role in the implementation and identification of the poor for proper arrangement and delivery of food grains. Therefore, the Targeted Public Distribution System (TPDS) under the Government of India plays the same role as the PDS but adds a special focus on the people below the poverty line.

6.8 Poverty Alleviation Programmes

1. Prime Minister Rozgar Yojana (PMRY)

It provides financial assistance to set up any kind of enterprise. It generates employment opportunities to the educated unemployed from low income families in rural and urban areas.

2. Rural Employment Generation Programme (REGP)

It is implemented through the Khadi and Village Industries Commission to assist eligible entrepreneurs to set up village industry units. It creates employment opportunities in villages including small towns with a population of up to 20,000.

3. Mahatma Gandhi National Rural Employment Guarantee Act (MGNREGA)

- Parliament enacted MGNREGA Act in 2005.
- It promises to give minimum 100 days of unskilled manual labour to rural household whose adult members volunteer for it. Households are eligible for unemployment allowances if employment not been provided within 15 days of demand.
- MNREGA labourers are used for creating durable assets as per local needs e.g. ponds, wells, cattle sheds, granary, vermicomposting plants, crematorium, renovation of Anganwadi centres, school buildings- No contractors / machinery allowed.
- In any project, 60% of amount should go towards wages and 40% towards material
- Union bears 100% wage cost and 75% of material cost. - Wages are linked to Consumer Price Index Social audit by the gram sabha at least once in every 6 months.
- In this scheme, the state governments provide at least 100 days of guaranteed wage employment in every financial year to every household whose adult members volunteer to do unskilled manual work. If work is not provided within a 15-day period, then the applicant is eligible for unemployment allowance by the state governments.

4. Swarna Jayanti Gram Swarozgar Yojana (SJGSY)

This was launched in 2000 to reduce the levels of poverty in India. The central government provided financial assistance to the states for the fulfilment of necessities such as primary health and education. It also aims to provide clean drinking water in the rural areas and to provide shelter to the poor.

- **A critical assessment on poverty alleviation programmes**

Due to unequal distribution of land and other assets, the benefits from alleviation programmes have been appropriated by the non-poor. Compared to the magnitude of poverty, the amount of resources allocated for these programmes is not sufficient. Resources are inefficiently used and wasted because the officials involved in the implementation of the programme are ill-motivated, inadequately trained, corrupt and vulnerable to pressure from a variety of local elites. Government policies have also failed to address the vast majority of vulnerable people who are living on or just above the poverty line.

6.9 Poverty in India

A large section of the rural poor in India are the small farmers. The land that they have is, in general, less fertile and dependent on monsoon. Their survival depends on subsistence crops and sometimes on livestock. With the rapid growth of population and without alternative sources of employment, the per-head availability of land for cultivation has steadily declined leading to fragmentation of land holdings. The income from these small land holdings is not sufficient to meet the family's basic requirements and to pay back the loans that they have taken for cultivation and other domestic needs. In situations of drought and other natural calamities make them take extreme steps like suicide. A large section of urban poor in India are largely the overflow of the rural poor who migrate to urban areas in search of employment and a livelihood. Industrialisation has not been able to absorb all these people. The urban poor are either unemployed or intermittently employed as casual labourers. Casual labourers are among the most vulnerable in society as they have no job security, no assets, limited skills, sparse opportunities and no surplus to sustain them. Poverty is, therefore, also closely related to nature of employment. Unemployment or under employment and the casual and intermittent nature of work in both rural and urban areas that compels indebtedness, in turn, reinforces poverty. Indebtedness is one of the significant factors of poverty. A steep rise in the price of food grains and other essential goods, at a rate higher than the price of luxury goods, further intensifies the hardship and deprivation of lower income groups. The unequal distribution of income and assets has also led to the persistence of poverty in India. All this has created two distinct groups in society: those who possess the means of production and earn good incomes and those who have only their labour to trade for survival. Over the years, the gap between the rich and the poor in India has widened. Poverty is a multi-dimensional challenge for India that needs to be addressed on a war footing. Poverty entails more than the lack of income and productive resources to ensure sustainable livelihoods. Its manifestations include hunger and malnutrition, limited access to education and other basic services, social discrimination and exclusion as well as the lack of participation in decision-making. Poverty in India remains a complex challenge despite significant reductions in recent decades.

❖ **Current issues of poverty**

- Debates on Definition and Measurement: Different poverty lines (income levels considered poor) and data sources lead to varying estimates.
- The World Bank, using the $2.15 per day benchmark (PPP – Purchasing Power Parity), estimates an 11.9% poverty rate for India.
- The Indian government claims a lower national poverty, with figures below 5% of the population below the poverty line.
- Government Data: The Indian government uses its own poverty indicators, which tends to show lower poverty rates compared to international benchmarks.
- Uneven Progress: Poverty reduction has been faster in rural areas compared to urban areas.

❖ **Exercise:**

Q-1 MCQ:

1. ________ poor are the people who move in and out of poverty on a regular basis.

   a. Occasionally
   b. Chronic
   c. Churning
   d. None of the above

   Answer: b

2. Which of the following is a characteristic of people below the poverty line?

   a. Debt trap
   b. Gender inequality
   c. Poor health
   d. All of the above

   Answer: d

3. Wh*i*ch of the following is the full form of MPCE?

   a. Minimum per capita expenditure
   b. Maximum per capita expenditure
   c. Monthly per capita expenditure
   d. None of the above

   Answer: c

4. Which of the following are examples of self-employment programs in India?

   a. Swarna Jayanti Shahri Rozgar Yojna
   b. Prime Minister's Rozgar Yojna
   c. Both a and b are incorrect
   d. Both a and b are correct

   Answer: d

5. Which of the following is a part of transient poor?

   a. Churning poor
   b. Occasionally poor
   c. Both a and b are correct
   d. Both a and b are incorrect

   Answer: c

6. In which year was the National Food for Work Programme launched in India?

   a. 2005
   b. 2004
   c. 2002
   d. 2001

   Answer: b

7. Which of the following programs was initiated by the Government of India to improve the food and nutritional levels of the poor in the country?

   a. Midday meal scheme
   b. Integrated child development scheme

c. Public distribution scheme
d. All of the above
Answer: d

8. Which of the following methods do economists use to identify the poor?

a. Ownership of assets and occupation
b. Annual income
c. Savings
d. None of the above
Answer: a

9. Which of the following is the main reason behind the poor people in India getting limited economic opportunities?

a. Lack of skills and basic literacy
b. Scarcity of resources
c. Most of them live in rural areas
d. None of the above
Answer: a

10. Which of the following is the main reason for the decline in the per capita availability of land for the purpose of cultivation?

a. Rapid growth of population and lack of employment
b. Pollution in land and water bodies because of excessive usage of agrochemicals
c. Frequent droughts
d. All of the above
Answer: d

11. Which of the following are the two categories of poverty identified by the United Nations Development Programme?

a. Income and human poverty
b. Income and relative poverty
c. Rural and absolute poverty
d. Rural and relative poverty
Answer: a

12. Which of the following countries has a greater prevalence of relative poverty?

a. Developed countries
b. Underdeveloped countries
c. Socialist countries
d. Capitalist countries
Answer: d

13. Which of the following countries has a greater prevalence of absolute poverty?

a. Developed countries
b. Underdeveloped countries
c. Developing countries
d. Capitalist countries
Answer: c

UNIT - 7 FISCAL POLICY

7.1 Introduction

It guides the government that how, what amount and where to spend the public money in order to develop and grow the economy. The main objective of every developing country is to make the country developed and, in this process, government has to prepare various policies such as economic policy, monetary policy, fiscal policy and budget. In simple words, fiscal policy is a detailed description of government spending. The main objective of fiscal policy is sustainable growth and reduction of poverty.

7.2 Meaning of Fiscal Policy

In order to accomplish the goal, governments use fiscal policy as one of their main instruments for controlling and influencing the economy. It is as simple as that fiscal policy is the combination of tax and spending to affect the course of the economy. The government's use of taxes and public spending to stabilize or expand the economy is what it signifies. We can say that fiscal policy is the government's budgetary strategy, which involves regulating the amount of money it spends and taxes.

7.3 Definition of Fiscal Policy

Fiscal policy refers to the use of government spending and taxation to influence the economic activity. It is a tool used by governments to promote economic growth, stability, and prosperity within the economy and country.

According to International Monetary Fund (IMF), fiscal policy is defined as “the use of government spending and taxation to influence the level of economic activity, the level of employment, the level of output and the level of prices.

7.4 Objectives of Fiscal Policy: The main objectives of fiscal policy are as follows:

1. Employment:

The main objectives of fiscal policy are to create jobs, reduce unemployment, achieve and sustain full employment in an economy in the country. The main goal in developing countries is to prevent unemployment and reach towards the full employment. Therefore, the government should allocate enough funds for social and economic expenditures in order to lower unemployment. These investments would boost the economy's productive efficiency and aid to generate additional job possibilities in the economy.

2. Price stability:

The main objective of fiscal policy is to stabilize the economy during times of economic recession or inflation. Price fluctuations have an impact on persons, society, customers, workers, employees, farmers, producers, traders, etc. Price increases have a negative impact on the general public. By eliminating the negative effects of price increases and decreases, fiscal policy aims to stabilize prices and reducing taxes or offering subsidies can decline the impact of the price increase.

3. Accelerating economic growth and development:

The economic growth and development can be possible by increasing aggregate demand in the society and market. In a developing country, fiscal policy should primarily focus on accelerating economic growth and development. In order to prevent negative effects on consumption, production and distribution, government uses the fiscal tools and techniques such as reduction in taxes, deficit financing and public borrowing. It should boost the overall economy, which raises both the national and per capita incomes.

4. Optimal utilization and allocation of resources:

The distribution and utilization of resources across different sectors such as agriculture, industries and services can be significantly impacted by fiscal policies tools and techniques such as taxes and public spending. The distribution of resources can be positively impacted by public spending in the form of subsidies and incentives, tax exemptions and concessions. Conversely, excessive taxation could diminish resources in a certain industry.

5. Equitable distribution of wealth and income:

Social justice should be achieved by a welfare state through an equitable distribution of wealth and income to the all level or segment of the society. Both developed and developing countries can use fiscal policy as an efficient tool to achieve equitable distribution. A progressive tax structure can be very helpful in achieving equitable distribution of wealth and income. Additionally, the public spending aids in shifting wealth from the wealthy and richest persons to the underprivileged people of the society. A tool of reducing income inequality by redistributing wealth through taxation and government spending is called Income Redistribution.

6. Economic stability:

It is the key goal of an upright fiscal strategy is economic stability. This objective wants relative price stabilization and full employment in the economy. It is vital to prevent depression and reduce inflation in the economy. In short, the major objectives of a growing country's fiscal policy are stability and economic progress and reduced the inflationary pressures on the economy; the forces driving the growth process should be strengthened. In the global cyclical swings, fiscal policies support economic stability. These up and down in the economy, lead to differences in trade, which are most advantageous to industrialized economies. As an effect, fiscal policy is vital to preserving economic stability despite internal and foreign pressures in the economy.

7. Capital formation:

It is the major objective of fiscal policy to Increase the public and private sectors investment Because of high unemployment and low per capital income in developing nations have relatively low rates of capital accumulation. The primary issue facing is the poverty cycle in the economy. Therefore, in industrialized nations, fiscal policy is implemented in such a way that lowers consumption and promotes savings in order to prevent undesired consumption.

7.5 Types of Fiscal Policy:

There are two major types of fiscal policy which is explained as follows. Fiscal policy has advantages and disadvantages, and its effectiveness depends on various factors, such as the economy of the nations, the level of government debt, and the responsiveness of the economy to fiscal policy changes.

1. **Neutral fiscal policy:** When government expenditures remain constant over time relative to tax receipts is considered as neutral fiscal policy. When an economy is in equilibrium not rapidly grown or contracted this kind of policy is typically used or implemented. In this case, tax income or collection provides the entire funding for government spending, which has no impact on the level of economic activity.

2. **Discretionary fiscal policy:** This type of fiscal policy is when the government makes changes to taxation or spending. Its goal is to adjust the economy's size as necessary. There are two types of it:

(a) Expansionary Fiscal Policy: When the government spends more money than what it takes collected through taxes, it is considered to be implementing an expansionary fiscal policy. Typically, this kind of fiscal policy is implemented to boost economic activity during recessions. It is increasing government spending or cutting taxes to stimulate economic growth. This type of fiscal policy is very helpful in getting the growth levels of developing nations at the time of recession because it cut the taxes and more money spent on public spending.

(b) Contractionary Fiscal Policy: When government expenditures fall short of tax receipts, discretionary fiscal policy is considered contractionary. The goals of this kind of fiscal policy are to reduce inflation and pay down the national debt. It reducing government spending or increasing taxes to slow down economic growth and control inflation.

7.6 Components of Fiscal policy:

The fiscal policy is the combination or comprises forms of all government actions pertaining to taxation, resource mobilization, and spending. The following are the four main pillars of fiscal policy such as Taxation Policy, Government Expenditure Policy, Investment and Disinvestment Policy and Debt/Surplus Management which are discussed as follows.

1. Taxation Policy:

The government need to reasonable and controls, direct and indirect taxes. It collects money by imposing both direct and indirect taxes while also preserving price stability. Therefore, it is critical that the government implement appropriate tax rates, such as progressive tax, and adhere to a judicial system for taxation. There are two reasons for this: first one is People’s purchasing power decreases when taxes rise and Production and investment will decline as a consequence and a second one is People will have more money after paying less in taxes, which will encourage spending and raise inflation. The main objective of this component is increasing or decreasing taxes to influence aggregate demand in the economy.

2. Government Expenditure Policy:

This policy addresses capital expenditures and revenue in the economy. The purchase of long-term assets, such as buildings or manufacturing machinery, which will create business or extra income for the government, is a part of in capital expenditures. Revenue expenditures are those that don't generate any future incomes or any productive assets, like interest paid by the Indian government on internal and external loans, government employee wages and pensions. The main objectives of this policy are Increasing or decreasing government expenditures on goods and services.

3. Investment and Disinvestment Policy:

This policy covers both the disinvestment of government holdings in public or private shares and foreign direct investment (FDI) and foreign direct investment (FII) in an economy. As per the government requirement can choose investment wherever it requires in terms of social welfare or sometimes choose disinvestment when there is a shortage of funds for spending in the economy. The main objective of this policy is making payments to individuals or households, such as social security benefits or unemployment benefits.

4. Debt/Surplus Management:

A surplus occurs when the government receives more money than it spends. A deficit occurs when government spending exceeds revenue. The government must borrow money from both domestic and foreign sources to cover the deficit. Additionally, it can print money to finance deficits.

7.7 Role and Function of Fiscal Policies in Developing Economies:

In an emergent economy, promoting the maximum capital formation is the primary objective of fiscal policy. It would seem that fiscal policy in developing economy should support economic growth. Fiscal policy can no longer be used as a compensatory measure in developing economies. It faces the challenge of growth-cum-stability and role to play in a developing economy. The following is a role and functions of fiscal policies in developing economies.

1. Resource Mobilization:

In emerging economies, there is a high marginal propensity to consume due to extreme poverty. Consequently, these economies have very low levels of saving. Therefore, through taxation and public borrowing, fiscal policy plays a significant role in encouraging saving for capital formation. By offering different tax breaks and subsidies, it can also have an impact on private sector savings and capital development.

2. Growth of the Private Sector:

The private sector is a significant economic component in emerging nations. Fiscal policy can have an impact on the private sector's output and productivity. To increase private sector productivity, tax breaks, rebates, and subsidies may be offered. The capital market can be stimulated by fiscal tools and policies to guarantee that the private sector has access to sufficient resources.

3. Resource Allocation and Optimization:

Fiscal methods can be used to achieve the best possible resource allocation in developing nations. Resources in the private sector are frequently allocated to the creation of items that meet the needs of the wealthier segments of society. The collected resources can be distributed across preferred investment avenues through the use of fiscal mechanisms. Reallocation can therefore be accomplished through a variety of tax incentive and subsidy programs.

4. Creation of Social and Economic Overheads:

One of the main issues in growing economy is the improper development of fundamental infrastructures, which are essential for economic growth. The ability of people to be productive will be directly increased by the provision of social overheads like healthcare and education. Expenditures made to provide economic overheads that will accelerate industrialization, such as transportation infrastructure, power generation, and telecommunications facilities. Therefore, through fiscal measures like taxation and spending plans, the government must invest in the development of social and economic overheads.

5. Balanced Regional Development:

When it comes to economic development, developing economies struggle with regional imbalance. As part of the strategies for balanced growth, fiscal measures such as tax holidays, tax discounts, subsidies, and concessions in the use of infrastructure can be provided to private investors in order to attract them to these underdeveloped regions.

6. Economic Stability:

Taxation and spending plans are two examples of fiscal measures that can be used effectively to manage cyclical changes that occur during the course of economic development. One useful tool for addressing both inflationary and deflationary conditions is taxation.

7. Reduction of Inequality:

In developing economies, ensuring equality in income, wealth, and opportunity is a crucial component of economic growth. One significant factor in lowering inequality is fiscal policy. Redistribution of income must be achieved through the progressive taxation policy. The following fiscal measures for reducing wealth, income and opportunity inequality are taxes on luxury goods, progressive income taxes, tax exemptions or concessions for daily used commodities, government spending on relief initiatives, and the distribution of commodities to the disadvantages people of the society at reduced prices.

7.8 The Difference between Monetary and Fiscal Policy

Base of difference	Monetary policy	Fiscal policy
Definitions	The actions of a central bank (e.g., Reserve Bank of India) to control the money supply and interest rates to promote economic growth, stability, and low inflation.	The use of government spending and taxation to influence the overall level of economic activity.
Deals with	Monetary policy deals with the total amount of money in the	Fiscal policy deals with how the government spends and collects

	economy.	money.
Who decided	Central banks typically decide the monetary policy.	The legislative and executive branches often determine fiscal policy.
Uses	To encourage (or discourage) consumer spending, stable levels of inflation and employment government used monetary policy.	To encourage (or discourage) Changing taxation, spending levels and Aggregate demand are the most important tools of fiscal policy.
Tools	Interest rates, reserve requirements, open market operations, and quantitative easing are the various tools of monetary policy.	Government spending, taxation, and transfer payments are the various tools of Fiscal policy.
Objective	The major objectives of monetary are Price stability, economic growth, and full employment.	The major objectives of fiscal policy are Economic growth, full employment, and income redistribution.
Impact	It affects aggregate demand, inflation, and employment.	It affects aggregate demand, economic growth, and income distribution.
Implementation	Central bank decisions are typically implemented quickly.	Government decisions are typically implemented slowly due to legislative processes.
Institutional framework	Monetary policy is controlled by the central bank,	Fiscal policy is controlled by the government.
Elements	Monetary policy uses interest rates and money supply,	Fiscal policy uses government spending and taxation
Impact on economy	Monetary policy has a faster impact on the economy,	Fiscal policy has a slower impact due to legislative processes.
Flexibility	Monetary policy is more flexible, as central banks can adjust interest rates quickly.	Fiscal policy is less flexible, as government spending and taxation require legislative approval.

7.9 Spending and Taxes as a tool of Fiscal Policy:

Spending and Taxes are the major tools of fiscal policy that governments use to achieve their economic objectives. These are two major tools of fiscal policy which are given below:

1. Spending tools and
2. Income tools.

1. **Spending Tools:** It is also known as an expenditure that government has to incur for economic growth and development. There are various sources of the spending tools which are discussed below.

1. **Transfer Payments:** Transfer payments means a minimum amount of income that is provided to low-income households such as social security and unemployment insurance. It simply means transferring of wealth from the wealthy to the underprivileged persons of the society. It does not include in GDP calculations. The government can increase or decrease transfer payments, such as:

   - Unemployment benefits
   - Social security benefits
   - Subsidies to industries or farmers
   - Tax credits to low-income households

2. **Current Spending:** This includes continuous government expenditures on different sector of the economy such as defense, education, and health. The skill labor productivity of an economy can be impacted by this kind of expenditure. Current spending will be useful in economic development of current financial year and more focused the yearly budget through which the grants allotted.

3. **Capital Spending:** This refers to the amount that the government spends on facilities like hospitals, schools, and public transportation. It is anticipated that capital expenditures would increase future productivity. It is a long-term expenditure which provides benefits for a longer period of time. It includes building infrastructure, supporting growth and unemployment targets, ensuring a minimum standard of living, and providing basic facilities that government expenditure can be justified on both an economic and social level.

4. **Government Expenditure:** It is a type of capital expenditure which is belongs to a long period of time. The government can increase or decrease its spending on goods and services, which belongs to social overhead such as:
   - Infrastructure projects (roads, bridges, airports)
   - Education and healthcare services
   - Defense and national security
   - Social welfare programs (unemployment benefits, pensions)

5. **Public Works:** It is a type of expenditure which is for the benefit of general public or the society. The government can invest in public works projects, such as:
   - Building new roads, bridges, or public buildings
   - Upgrading existing infrastructure
   - Developing public transportation systems

6. **Subsidies**: It is one type of price reduction or concession in the fair amount. The government can provide subsidies to support specific industries or activities, such as:
   - Agricultural subsidies to support farmers
   - Export subsidies to support domestic industries
   - Renewable energy subsidies to encourage sustainable energy production

2. **Income tools**: It is known as a back bone of the government because; it provides finance from various sources which run the whole economy. It is called sources of

income for government. In short, it is a revenue tool. There are various types of the income tools which are discussed below.

1. **Direct Taxes**
2. **Indirect Taxes**

1. **Direct Taxes:** These include or cover those taxes which are recognized in the constitution and directly collected from the individuals or taxpayers such as capital gains taxes, traditional taxes, property taxes, and personal and corporate income taxes. They are imposed on wealth and income. Direct tax is also known as non- transferable tax.

   1. **Income Tax :** It is levied on the income of the assesses (individual and corporate). The government can increase or decrease income tax rates to influence disposable income and consumption. There are two methods of calculating income tax which is as under:

      - Progressive taxation: higher tax rates for higher income earners
      - Regressive taxation: higher tax rates for lower income earners

   2. **Corporate Tax :** It is levied on the incomes of the corporate houses. In short, it is tax on corporate profit. The government can increase or decrease corporate tax rates to influence business investment and profitability. There are two ways or sources through government collect direct tax which includes: Tax incentives for research and development or investment in specific industries and tax penalties for companies that engage in tax evasion or aggressive tax planning. Tax penalties are sources of revenue with the tax liability.

   3. **Wealth Tax:** It is levied on the wealth of the individuals. The government can impose a tax on wealth or property to reduce income inequality and generate revenue. It includes the Tax on inheritances or gifts and tax on wealth above a certain threshold.

   4. **Tax Credits:** It is a one type of relief provided to assess. The government can provide tax credits to individuals or businesses to encourage specific behaviors. It includes the tax credits for investing in renewable energy or energy-efficient technologies. It is known as growth strategy for economy. Tax credits for hiring workers from disadvantaged groups or investing in employee training. It is way of providing front seat to underprivileged people of the society.

2. **Indirect taxes:** These are those types of taxes that are imposed on products and services such as Sales taxes, value-added taxes, and excise taxes, alcohol and tobacco taxes are the example of it. Now all the above tax is abolished and there is only one indirect tax known as GST. It is possible to lower the usage of certain products and services, such as gambling, alcohol, and tobacco, by imposing more taxes. Indirect tax is also known as transferable tax.

It is possible to defend taxes by arguing that they are necessary to redistribute income and wealth and to provide funds for spending. Four desirable characteristics of tax policy are taken into consideration by economists: sufficiency, efficiency, fairness, and simplicity.

Goods and services tax (GST) is a new reform in Indian economic structure which abolished or merged all the types of indirect tax which prevailed before it. It is implemented to avoid double taxation. Excise and customs are also indirect tax. It includes taxes on specific goods (e.g., tobacco, gasoline).

7.10 Benefits and Disadvantages of Fiscal Policy:

Benefits and Advantages of Fiscal Policy

1. Stabilization of Economy: Fiscal policy helps stabilize the economy by increasing government spending and cutting taxes during economic downfall, and reducing spending and increasing taxes during economic upswings.
2. Job Creation: Fiscal policy can create jobs by increasing government spending on infrastructure projects, education, and healthcare.
3. Redistribution of Income: Fiscal policy can redistribute income from the rich to the poor through progressive taxation and social welfare programs.
4. Encourages Economic Growth: Fiscal policy can encourage economic growth by providing incentives for businesses to invest and expand.
5. Helps in Times of Crisis: Fiscal policy can help the economy recover from crises such as natural disasters, wars, and economic downturns.
6. Benefits of Fiscal Policy include the capacity to swiftly adopt social policies through excise taxes and the speedy implementation of indirect taxes.
7. Helpful in generating employment, balance the price level and inflation,
8. Helpful in developing infrastructure, and economic growth and developments.

Disadvantages of Fiscal Policy:

1. The long implementation periods for capital investment projects and the time required to apply direct taxes and transfer payments are the important drawbacks of fiscal policy.
2. Announcing changes in fiscal policy can also have significant effects on expectations, such as an announcement of future increases in personal income tax reducing current consumption.
3. Time Lag: Fiscal policy can take time to implement, which can delay its impact on the economy.
4. Inflation: Excessive government spending and tax cuts can lead to inflation, which can erode the purchasing power of consumers.
5. Deficits and Debt: Fiscal policy can lead to budget deficits and debt, which can be difficult to manage and can lead to financial instability.
6. Inefficient Allocation of Resources: Government spending can lead to inefficient allocation of resources, as government decisions may not always reflect market priorities.

7. Dependence on Government Support: Fiscal policy can create dependence on government support, which can lead to a lack of competitiveness and innovation in the private sector.
8. Limited Scope: Fiscal policy may not be effective in addressing specific economic problems, such as supply-side constraints or structural issues.
9. Uncertainty: Fiscal policy can create uncertainty, as changes in government spending and taxation can affect business and consumer confidence.

7.11 Effects of Fiscal Policy on the Economy:

1. Multiplier effect:

According to the multiplier effect theory, government expenditures aimed at boosting the economy led to increases in private spending, which further boosts the economy. Private expenditure multiplies government spending. For instance, private construction firms will subsequently develop homes and businesses along a public transportation system that is financed by the government. Customers will spend money at those establishments, and employees will work there.

In the case of direct stimulus, on the other hand, government expenditures enhance household incomes, which in turn raises consumer spending. Consequently, the economy is further stimulated by higher business revenues, production, capital expenditures, and employment.

In theory, the multiplier effect is strong enough to ultimately generate a rise in the overall gross domestic product (GDP) that exceeds the level of additional government expenditure. The outcome is a rise in national income.

2. Crowding-Out Effect:

The crowding-out effect theoretically counters the multiplier effect. It denotes the government's "crowding out" of private expenditure by consuming a portion of the total financial resources available. In summary, the crowding-out effect refers to the reduction in private-sector spending that occurs as a consequence of public sector spending.

The crowding-out theory is based on the premise that government expenditure has to be supported by the private sector, either through higher taxes or through financing. Consequently, government expenditures effectively consume private resources. It transforms into an expense that must be balanced against the potential advantages gained from it. However, assessing that cost can be challenging, as it requires estimating the potential economic gain the private sector might have experienced if its resources hadn't been allocated to the government.

A component of the crowding-out theory is based on the notion that there is a limited amount of money available for funding, which means that any borrowing by the government diminishes private sector borrowing, potentially harming business investments in growth. However, the presence of flat currencies and a worldwide capital market complicates this concept by challenging the very idea of a limited money supply.

3. Budget Deficit:

A budget deficit occurs when a government's expenditures exceed its revenues over a specific period, typically a fiscal year. In simple words, it means government expenditure is more than the sources of revenues that government receives.

- **Causes of Budget Deficits**
  1. Increased Government Spending: Rising expenditures on public goods and services, such as infrastructure, education, and healthcare.
  2. Reduced Tax Revenues: Decrease in tax collections due to economic downturns, tax cuts, or tax evasion.
  3. Economic Downturns: Recessions or economic slowdowns can lead to decreased tax revenues and increased government spending.
- **Measures to Reduce or Solve the Budget Deficits**
  1. Fiscal Consolidation: Implementing policies to reduce deficits, such as spending cuts or tax increases.
  2. Expenditure Reforms: Improving the efficiency and effectiveness of government spending.
  3. Revenue Mobilization: Implementing policies to increase tax revenues, such as tax reforms or improved tax administration.
  4. Debt Management: Implementing strategies to manage and reduce government debt.

4. Fiscal Deficit:

Fiscal deficit refers to the excess of government's total expenditure over its total revenue, excluding borrowings. It is a measure of the government's borrowing requirement to finance its expenditure. The policymakers can make informed decisions about managing fiscal deficit and promoting economic growth and stability.

❖ **Impact of Fiscal Deficit on the Economy**

The impact of fiscal deficit on the economy can be both positive and negative:

- **Positive Impact**

1. Stimulates Economic Growth: Fiscal deficit can be used to finance government expenditure on infrastructure, social welfare programs, and other development projects, which can stimulate economic growth.
2. Reduces Unemployment: Fiscal deficit can be used to finance government programs that create jobs and reduce unemployment.
3. Increases Aggregate Demand: Fiscal deficit can increase aggregate demand by putting more money in the hands of consumers and businesses.

- **Negative Impact**

1. Inflation: Excessive fiscal deficit can lead to inflation, as the increased money supply chases a limited number of goods and services.

2. Crowding Out: Fiscal deficit can crowd out private investment, as government borrowing increases interest rates and makes it more expensive for private businesses to borrow.
3. Increased Debt Burden: Persistent fiscal deficits can lead to a rising debt burden, making it difficult for the government to service its debt.
4. Reduced Credit Rating: Excessive fiscal deficit can lead to a reduction in the country's credit rating, making it more expensive to borrow in the future.
5. Uncertainty and Volatility: Fiscal deficit can create uncertainty and volatility in the economy, making it difficult for businesses and investors to make decisions.

7.12 Conclusion:

Fiscal policy is a powerful tool used by government to manage economy, economic growth, and full employment and price stability whereas it also has some limitation such as inflation, debt and deficits.

❖ **Exercises**

1. Multiple choice questions (MCQ):

1. What is fiscal policy?

A) Monetary policy
B) Government spending and taxation
C) Supply-side economics
D) Demand-side economics

Answer: B) Government spending and taxation

2. Which of the following is a tool of fiscal policy?

A) Interest rates
B) Reserve requirements
C) Government spending
D) Quantitative easing

Answer: C) Government spending

3. What is the primary objective of fiscal policy?

A) Price stability
B) Economic growth
C) Full employment
D) All of the above

Answer: D) All of the above

4. Which of the following is a consequence of a budget deficit?

A) Reduced government debt
B) Increased interest rates
C) Decreased inflation
D) Increased economic growth

Answer: B) Increased interest rates

5. What is fiscal consolidation?

A) Increasing government spending
B) Reducing government spending
C) Increasing taxation
D) Reducing taxation

Answer: B) Reducing government spending

6. Which of the following is a type of fiscal policy?

A) Expansionary fiscal policy
B) Contractionary fiscal policy
C) Neutral fiscal policy
D) All of the above

Answer: D) All of the above

7. What is the difference between discretionary fiscal policy and automatic stabilizers?

A) Discretionary fiscal policy is mandatory, while automatic stabilizers are optional.
B) Discretionary fiscal policy requires government intervention, while automatic stabilizers do not.
C) Discretionary fiscal policy is used during economic downturns, while automatic stabilizers are used during economic upswings.
D) Discretionary fiscal policy is long-term, while automatic stabilizers are short-term.

Answer: B) Discretionary fiscal policy requires government intervention, while automatic stabilizers do not.

8. Which of the following is an example of a fiscal policy tool?
A) Open market operations
B) Reserve requirements
C) Government subsidies
D) Interest rates

Answer: C) Government subsidies

2. Answer the following short and long questions.

1. Explain the meaning of Fiscal Policy.
2. Explain the definition of Fiscal Policy.
3. Explain the objectives of Fiscal Policy.
4. Explain the types of Fiscal Policy.
5. Explain the components of Fiscal Policy.
6. Explain the role and function of Fiscal policies in developing economies.
7. Explain the difference between Monetary and Fiscal Policy.
8. Explain the spending and taxes as a tool of Fiscal Policy.
9. Explain the benefits and disadvantages of Fiscal Policy in details.
10. Explain the effects of fiscal policy on the economy.
11. Write a short note on multiplier effect.
12. Write a short note on crowding out.
13. Write a short note on budget deficits.
14. Explain the causes and effects of budget deficits.
15. Explain the consequences and measures to reduce or solve the budget deficits.

UNIT - 8 MONETARY POLICY

8.1 Introduction

It is a macroeconomic policy tool used by the Central Bank to influence the money supply in the economy to achieve certain macroeconomic goals. It involves the use of monetary instruments by the central bank to regulate the availability of credit in the market to achieve the ultimate objective of economic policy. Monetary policy refers to the use of instruments under the control of the central bank to regulate the availability, cost, and use of money and credit. The goal: achieving specific economic objectives, such as low and stable inflation and promoting growth.

The monetary policy of a nation involves the overall set of laws and practices that control the quantity and quality of money in an economy. From these definitions, it is clear that a monetary policy is related to the availability and cost of money supply in the economy in order to attain certain broad objectives. The Central Bank of a nation keeps control of the supply of money to attain the objectives of its monetary policy. Monetary policy is a fundamental aspect of economics that plays a crucial role in managing and influencing the overall performance of an economy. It is the domain of central banks or monetary authorities, which are responsible for controlling the money supply, interest rates, and other financial variables.

8.2 Meaning:

Monetary policy strategies include revising interest rates and changing bank reserve requirements. Monetary policy is commonly classified as either expansionary or contractionary. The Federal Reserve commonly uses three strategies for monetary policy including reserve requirements, the discount rate, and open market operations.

Monetary policy is the control of the quantity of money available in an economy and the channels by which new money is supplied. Economic statistics such as gross domestic product (GDP), the rate of inflation, and industry and sector-specific growth rates influence monetary policy strategy.

A central bank may revise the interest rates it charges to loan money to the nation's banks. As rates rise or fall, financial institutions adjust rates for their customers such as businesses or home buyers. Additionally, it may buy or sell government bonds, target foreign exchange rates, and revise the amount of cash that the banks are required to maintain as reserves.

❖ Definitions:

Monetary Policy can be defined as “Monetary policy is a set of actions to control a nation's overall money supply and achieve economic growth.”

These are the definitions of monetary policy by economists:

- **Prof. Harry Johnson –** “A policy employing the central banks control of the supply of money as an instrument for achieving the objectives of general economic policy is a monetary policy.”
- A.G. Hart - “A policy which influences the public stock of money substitute of public demand for such assets of both that is policy which influences public liquidity position is known as a monetary policy.”

❖ Nature of Monetary Policy

Monetary policy is inherently dynamic and multifaceted, characterized by its strategic use of various tools and instruments to achieve specific economic goals. The nature of monetary policy can be understood through the following key aspects:

1. **Macroeconomic Orientation:** Monetary policy is primarily macroeconomic in nature, meaning it focuses on broad economic objectives that impact the overall economy, such as inflation control, economic growth, exchange rate stability, and financial stability. It is not concerned with individual sectors but rather with aggregate economic variables like money supply, interest rates, and overall credit availability.

2. **Regulatory and Stabilizing Function:** The fundamental nature of monetary policy is regulatory. It aims to regulate the economy's money supply and interest rates to ensure stable economic growth and price stability. By managing these variables, the central bank can mitigate economic fluctuations, prevent excessive inflation or deflation, and stabilize the financial system.

3. **Dual Approach: Expansionary and Contractionary:** Monetary policy has a dual nature in terms of its approach:

   - **Expansionary Policy:** This approach is used to stimulate economic growth during periods of recession or economic slowdown. It involves lowering interest rates and increasing the money supply to encourage borrowing, spending, and investment.

   - **Contractionary Policy:** This is applied to control inflation during periods of economic overheating. It involves raising interest rates and reducing the money supply to curb excessive spending and stabilize prices.

4. **Instrument-Based Implementation:** The nature of monetary policy is also defined by the instruments it employs. These tools can be quantitative, such as the repo rate, reverse repo rate; cash reserve ratio (CRR), statutory liquidity ratio (SLR), and open market operations (OMO), or qualitative, like credit controls and moral suasion. These instruments are used to manage the supply and cost of money in the economy, thereby influencing inflation, growth, and employment levels.

5. **Flexible and Adaptive:** Monetary policy is inherently flexible and must adapt to changing economic conditions. It is continually reassessed and adjusted based on current economic data, trends, and forecasts. This adaptive nature allows central banks to respond effectively to economic shocks, such as financial crises, geopolitical tensions, or unexpected inflationary pressures.

6. **Forward-Looking and Pre-emptive:** The nature of monetary policy is forward-looking, as it seeks to pre-empt economic issues before they become severe. Central banks analyse various economic indicators and trends to make informed predictions about future economic conditions and take proactive measures to prevent adverse outcomes.

7. **Goal-Oriented:** Monetary policy is goal-oriented and is designed to achieve specific economic objectives. In India, for example, the primary goal of monetary policy is to maintain price stability while fostering conditions for sustainable growth. This goal-oriented nature makes monetary policy a critical tool for managing the economy's health and stability.

8. **Coordinative and Collaborative:** The implementation of monetary policy often requires coordination with other areas of economic policy, such as fiscal policy, exchange rate policy, and trade policy. Effective coordination ensures that different policies complement each other in achieving macroeconomic objectives.

9. **Dependent on Policy Transmission Mechanism:** The effectiveness of monetary policy relies heavily on the transmission mechanism, the process through which policy actions affect the real economy. This involves multiple channels, including interest rates, credit availability, asset prices, and exchange rates, all of which influence economic activity. The nature of the monetary transmission mechanism can vary based on structural features of the economy, such as the financial sector's development and the responsiveness of consumers and businesses to changes in interest rates.

10. **Centralized and Authoritative:** Monetary policy is centralized, with the central bank (such as the Reserve Bank of India) holding the authority to make decisions independently of political influences. This independence allows the central bank to focus on long-term economic stability rather than short-term political considerations.

In summary, the nature of monetary policy is complex and multifaceted, involving a blend of strategic, flexible, and adaptive approaches aimed at achieving a balance between economic growth, price stability, and financial stability. Its effective implementation requires a deep understanding of economic conditions and a careful selection of tools and tactics to navigate the dynamic economic environment.

8.3 History of Monetary Policy

History of monetary policy in India explained below:

The evolution of monetary policy in India can be broadly divided into several phases:

- **Pre-Independence Period (1935-1947):** The Reserve Bank of India (RBI) was established in 1935 under the Reserve Bank of India Act, 1934. Initially, its role was limited to issuing currency notes, managing the exchange rate, and acting as a banker to the government. Monetary policy was largely dictated by the colonial government, and the primary focus was on maintaining the value of the Indian rupee and managing the country's gold reserves.

- **Post-Independence Period (1947-1991):** After independence, the RBI's role expanded to include developmental functions such as promoting agricultural and industrial development. Monetary policy during this period was characterized by direct controls, such as credit controls, interest rate controls, and statutory liquidity requirements. The emphasis was on ensuring the availability of credit to key sectors of the economy, particularly agriculture and small-scale industries.

- **Liberalization Period (1991-Present):** With the economic liberalization in 1991, India shifted from a system of direct monetary controls to a market-based approach. The RBI adopted a more flexible monetary policy framework, focusing on price stability and financial stability. The liberalization period saw a shift towards using indirect instruments like open market operations, bank rates, and the cash reserve ratio (CRR) to manage the money supply and interest rates.

- **Adoption of Inflation Targeting (2016-Present):** In 2016, India formally adopted a flexible inflation-targeting framework. The RBI and the government set an inflation target of 4%, with a tolerance band of +/- 2%. The primary objective of monetary policy became maintaining price stability while keeping in mind the objective of growth.

8.4 Objectives of Monetary Policy

Monetary policy is adopted by the monetary authority of a country that controls either the interest rate payable on very short-term borrowing or the money supply. The policy often targets inflation or interest rate to ensure price stability and generate trust in the currency. Simply put the main objective of monetary policy is to maintain price stability while keeping in mind the objective of growth as price stability is a necessary precondition for sustainable economic growth. In India, the RBI plays an important role in controlling inflation through the consultation process regarding inflation targeting. The current inflation-targeting framework in India is flexible**.** The monetary policy in India is carried out under the authority of the Reserve Bank of India.

1) Price stability

One of the primary objectives is to maintain price stability by controlling inflation. Price stability is crucial for economic stability and the purchasing power of money. By managing the money supply and influencing interest rates, central banks aim to keep inflation within a target range deemed appropriate for sustainable economic growth. Controlling inflation is the primary objective. By maintaining price stability, the RBI aims to ensure a predictable and stable economic environment conducive to investment and economic growth.

2) Economic growth and employment

Monetary policy also seeks to promote economic growth and reduce unemployment. By adjusting interest rates and influencing borrowing costs, central banks can stimulate or restrain economic activity. Lowering interest rates encourages borrowing and investment, which can boost economic growth and job creation. Conversely, raising interest rates can help cool down an overheating economy and reduce inflationary pressures. Ensuring adequate availability of credit to support investment and consumption is a key objective. The RBI seeks to achieve a balance between controlling inflation and fostering growth.

3) Exchange rate stability

Some central banks consider exchange rate stability as an objective. They may intervene in foreign exchange markets to influence the value of their currency relative to other currencies. Exchange rate stability can help support international trade, investment, and overall economic stability. Maintaining a stable exchange rate is crucial for external stability. The RBI may intervene in the foreign exchange markets to prevent excessive volatility in the Indian rupee.

4) Interest rate stability

Stability in interest rates is another objective of monetary policy. Large and rapid fluctuations in interest rates can create uncertainty, disrupt financial markets, and adversely impact borrowing and investment decisions. Central banks aim to manage interest rate movements to ensure stability and predictability in the financial system.

5) Sustainable external balance

Some countries aim to achieve a sustainable external balance as part of their monetary policy objectives. This involves managing the balance of trade and payments with the rest of the world to ensure long-term economic stability and avoid excessive dependence on foreign borrowing or imbalances in international trade.

6) Financial Stability:

Ensuring the stability of the financial system, including the banking sector, is another key objective. The RBI monitors the health of financial institutions and takes measures to prevent financial crises.

7) Full Employment:

While not a primary focus, the RBI aims to support employment by promoting growth through accommodative monetary policy when inflation is under control.

8) Stabilising the Business Cycle:

Monetary policy has an important effect on both actual GDP and potential GDP. Industrially advanced countries rely on monetary policy to stabilise the economy by controlling business. But it becomes impotent in deep recessions.

8.5 Types of Monetary Policy

The following are the most common types of monetary policy.

1) Expansionary Monetary Policy

- Expansionary monetary policy aims to stimulate economic growth and combat recessions. It involves measures to increase the money supply, lower interest rates, and encourage borrowing and spending. Central banks implement expansionary policies by decreasing reserve requirements, conducting open market purchases, lowering the discount rate, or reducing benchmark interest rates. These actions inject liquidity into the financial system, making credit more accessible and promoting economic activity. It is also called Accommodative Monetary Policy. Its primary purpose is to increase the money supply in the economy through measures such as: It makes it less expensive for consumers to borrow money, thus increasing the money supply in the market. Lowering reserve requirements for banks – It leaves commercial banks with more money to lend to the public, thus infusing more money into the economy. A purchasing government security by central banks – The RBI buys government securities by paying cash. This means that money available in the market increases. It is aimed at fuelling economic growth by stimulating business activities and consumer spending and also helps to lower unemployment rates. However, it may have an adverse effect of occasional hyperinflation.

2) Contractionary Monetary Policy

Contractionary monetary policy is implemented to curb inflationary pressures and prevent excessive economic expansion. Its objective is to slow down economic growth and cool down an overheating economy. This type of policy involves measures to decrease the money supply, increase interest rates, and discourage borrowing and spending. Central banks adopt contractionary policies by raising reserve requirements, conducting open market sales, increasing the discount rate, or raising benchmark interest rates. These actions reduce liquidity in the financial system, making credit more expensive and dampening economic activity. It is used to decrease the amount of money supply in the economy through measures such as: It makes it more expensive for consumers to borrow money, thus reducing the money supply in the market. It leaves commercial banks with less money to lend to the public, thus reducing the money supply in the economy. The buyers of government securities pay cash to the RBI. This means that money available in the market decreases. It is aimed at reducing inflation.

8.6 Tools of Monetary Policy

Central banks use various tools and strategies to conduct monetary policy. Some common tools include:

1. Open Market Operations

Central banks buy or sell government securities (such as bonds) in the open market to influence the amount of money in circulation. When the central bank buys securities, it adds more money to the economy, which means there is more money available. On the other hand, when it sells securities, it takes away some money from the economy, which means there is less money available.

2. Reserve Requirements

Central banks are considered as authoritative by all the other banks. They make rules telling commercial banks the smallest amount of money they must keep in their vaults. It’s like a teacher saying you must have at least 5 pencils in your bag at all times. By adjusting these requirements, the central bank can influence the amount of money that banks can lend and thus impact the overall money supply.

Discount Rate: The discount rate is a special interest rate that lets commercial banks borrow money from the central bank. It’s like a special rate the central bank offers to commercial banks. When the central bank changes this rate, it affects how much it costs for commercial banks to borrow money. This, in turn, affects how much money they lend out to people and businesses, which can impact the overall economy.

3. Interest Rate

Central banks also use interest rates to influence borrowing costs and stimulate or restrain economic activity. By adjusting the benchmark interest rate, such as the overnight lending rate, the central bank can influence market interest rates, which affect borrowing costs for individuals and businesses.

8.7 Instruments of Monetary policy

The Reserve Bank of India (RBI) uses various instruments to implement monetary policy and achieve its objectives, such as controlling inflation, maintaining price stability, promoting economic growth, and ensuring financial stability. These instruments can be broadly classified into two categories: **Quantitative (General) Instruments** and **Qualitative (Selective) Instruments**. Each instrument influences the money supply, interest rates, and credit conditions in the economy differently.

1. Quantitative Instruments (General Tools)

Quantitative instruments affect the overall volume of money and credit in the economy. The main quantitative instruments used by the RBI are:

a) Open Market Operations: An open market operation is an instrument which involves buying/selling of securities like government bond from or to the public and banks. The RBI sells government securities to control the flow of credit and buys government securities to increase credit flow. OMO means buying and selling of government securities in the open market by the RBI. It is used to regulate the money supply and interest rates in the economy. Buying securities injects liquidity, while selling securities absorbs liquidity. In 2021, the RBI conducted OMOs to infuse ₹2 lakh crore of liquidity into the financial system to support the economy during the pandemic. In July 2022, the RBI sold ₹8,000 crore worth of government securities in an OMO to absorb excess liquidity and manage inflationary pressures.

b) Cash Reserve Ratio (CRR): The percentage of a bank's total deposits that must be kept as reserves with the RBI in cash form. **It is used** to control the money supply in the economy by regulating the amounts of funds banks have available to lend. Cash Reserve Ratio is a specified amount of bank deposits which banks are required to keep with the RBI in the form of reserves or balances. The higher the CRR with the RBI, the lower will be the liquidity in the system and vice versa. The CRR was reduced from 15% in 1990 to 5 % in 2002. As of 31st December 2019, the CRR is at 4%. As of August 2023, the CRR is 4.5%. An increase in the CRR means banks must hold a larger portion of their deposits with the RBI, reducing the amount they can lend. For instance, if the CRR is raised by 1%, banks' lending capacity is reduced by approximately ₹1 trillion. In 2020, the RBI reduced the CRR by 100 basis points from 4% to 3% to release ₹1.37 lakh crore of liquidity into the banking system during the COVID-19 crisis.

- Cash Reserve Ratio (CRR) is the minimum percentage of a bank's total Demand and Time Liabilities (DTL) that a Scheduled Commercial Bank is obligated to deposit with the RBI in the form of cash. RBI does not pay any interest on CRR deposits. RBI Act does not prescribe any range (ceiling or floor) for fixing CRR. Thus, RBI has the freedom to fix the CRR at any rate depending on the macroeconomic conditions.

- **If CRR is increased**: If the RBI increases the CRR, the commercial banks have to deposit more money with the RBI and are left with less money to lend to customers. Thus, the effect is reduced money supply in the economy.
- **If CRR is decreased**: If the RBI decreases the CRR, the commercial banks have to deposit less money with the RBI and are left with more money to lend to customers. Thus, the effect is increased money supply in the economy.

c) Statutory Liquidity Ratio (SLR): Statutory Liquidity Ratio (SLR) is the percentage of Net Demand and Time Liabilities (NDTL) that a Scheduled Commercial Bank (SCB) has to keep with itself, in the form of: Cash, or Gold, or SLR Securities (such as government bonds, treasury bills, and any other instrument notified by the RBI), or Any combination of this three. Unlike the CRR, SLR need not be deposited with RBI. The range of SLR prescribed by the RBI is from 0 percent to 40 percent. If SLR is increased: If the RBI increases the SLR, the commercial banks are left with less money to lend to customers. Thus, the effect is reduced money supply in the economy.

- All financial institutions have to maintain a certain quantity of liquid assets with themselves at any point in time of their total time and demand liabilities. This is known as the Statutory Liquidity Ratio. The assets are kept in non-cash forms such as precious metals, bonds, etc. As of December 2019, SLR stands at 18.25%.The percentage of a bank's net demand and time liabilities (NDTL) that must be maintained in the form of liquid assets, such as cash, gold, or government securities. It ensures the solvency and liquidity of banks, influences credit growth, and regulates the money supply. As of August 2023, the SLR is 18%. If the RBI increases the SLR, banks must invest a larger portion of their deposits in government securities, reducing their capacity to lend to the private sector. Historically, the SLR in India has been as high as 38.5% in the early 1990s, but it has gradually been reduced to align with international norms and promote lending to the private sector. If the RBI decreases the SLR, the commercial banks are left with more money to lend to customers. Thus, the effect is increased money supply in the economy. If the bank fails to maintain the required SLR, then it is liable to pay penal interest at (Bank Rate + 3%) per annum above the bank rate, on the shortfall amount. If the shortfall continues for the next succeeding day, penal interest is to be paid at (Bank Rate + 5%).

d) Marginal Standing Facility (MSF):

- A facility that allows banks to borrow overnight funds from the RBI in an emergency situation when interbank liquidity dries up. It is seen as a safety valve to provide liquidity to banks against their statutory liquidity ratio (SLR) holdings. The MSF rate is typically 25 basis points above the repo rate. As of August 2023, with the repo rate at 6.50%, the MSF rate is 6.75%. In 2020, during the COVID-19 pandemic, banks frequently used the MSF window to meet their liquidity needs. The MSF was introduced by the RBI in 2011 as a part of the monetary policy framework to improve the liquidity management of banks.

e) Bank Rate Policy:

- Also known as the discount rate, bank rates are interest charged by the RBI for providing funds and loans to the banking system. An increase in bank rate increases the cost of borrowing by commercial banks which results in the reduction in credit volume to the banks and hence the supply of money declines. An increase in the bank rate is the symbol of the tightening of the RBI monetary policy. As of 31 December 2019, the bank rate is 5.40%.

f) Market Stabilization Scheme (MSS)

- Market Stabilization Scheme (MSS) refers to intervention by the RBI to withdraw excess liquidity by selling government securities in the economy. Under it, the RBI sells government bonds on a general basis depending upon the volume of excess liquidity in the system. Here bonds go to financial institutions and money goes back to the RBI. This withdrawal of excess liquidity is called sterilization. The securities issued under the MSS are, basically, government bonds and are called Market Stabilization Bonds (MSBs).

2. Qualitative Instruments (Selective Tools)

Qualitative instruments, also known as selective credit controls, are used to direct credit flow to specific sectors and influence the quality of credit. These instruments include:

a) Credit Rationing:

- This instrument, RBI issues prior information or direction that loans to the commercial bank will be given up to a certain limit. In this case, a commercial bank will be tight in advancing loans to the public. They will allocate loans to limited sectors.
- A few examples of credit ceiling are agriculture sector advances and priority sector lending. Setting limits on the amount of credit that can be extended to specific sectors or industries. **It** Ensures that critical sectors like agriculture, small-scale industries, and infrastructure receive adequate credit while restricting credit to speculative activities.
- The RBI may direct banks to allocate a certain percentage of their loans to priority sectors, such as agriculture and micro, small, and medium enterprises (MSMEs). For example, as of 2023, banks are required to lend 40% of their adjusted net bank credit (ANBC) or credit equivalent amount of off-balance sheet exposure, whichever is higher, to priority sectors.
- In 2021, priority sector lending by banks in India totalled around ₹35 lakh crore, supporting sectors crucial for inclusive growth.

b) Moral Suasion:

- The use of persuasion and requests by the RBI to encourage or discourage certain lending practices by banks. It Influences the behaviour of banks without resorting to formal measures, promoting cooperation between the central bank and the financial sector.
- During periods of high inflation, the RBI may use moral suasion to advice banks to avoid aggressive lending to speculative sectors, like real estate, that could exacerbate inflationary pressures.
- In 2020, the RBI used moral suasion to encourage banks to pass on the benefits of repo rate cuts to borrowers to support economic recovery during the pandemic.

c) Margin Requirements:

- Setting minimum down payments or margins for loans, especially for speculative purposes. It Controls the volume of credit in specific sectors and prevents excessive credit growth that could lead to asset bubbles. If the RBI sets a higher margin requirement for stock market loans, it restricts the amount of money that can be borrowed against securities, reducing speculative activities. In the early 2000s, the RBI adjusted margin requirements on non-banking financial companies (NBFCs) to curb speculative activities in the stock market.

8.8 Role of Monetary Policy in Developing Countries

The monetary policy in a developing economy will have to be quite different from that of a developed economy mainly due to different economic conditions and requirements of the two types of economies. A developed country may adopt full employment or price stabilisation or exchange stability as a goal of the monetary policy but in a developing or underdeveloped country, economic growth is the primary and basic necessity. Thus, in a developing economy the monetary policy should aim at promoting economic growth. The monetary authority of a developing economy can play a vital role by adopting such a monetary policy which creates conditions necessary for rapid economic growth.

1. Creation and expansion of financial institutions

The primary aim of the monetary policy in a developing economy must be to improve its currency and credit system. More banks and financial institutions should be set up, particularly in those areas which lack these facilities. The extension of commercial banks and setting up of other financial institutions like saving banks, cooperative saving societies, mutual societies, etc. will help in increasing credit facilities, mobilising voluntary savings of the people, and channelizing them into productive uses. It is also the responsibility of the monetary authority to ensure that the funds of the institutions are diverted into priority sectors or industries as per requirements of our development plan of the country.

2. Effective central banking

To meet the developmental needs the central bank of an underdeveloped country must function effectively to control and regulate the volume of credit through various monetary instruments, like bank rate, open market operations, cash-reserve ratio etc. Greater and more effective credit controls will influence the allocation of resources by diverting savings from speculative and unproductive activities to productive uses.

3. Integration of organised and unorganised money market

Most underdeveloped countries are characterized by dual monetary system in which a small but highly organised money market on the one hand and large but unorganised money market on the other hand operates simultaneously.

The unorganised money market remains outside the control of the central bank. By adopting effective measures, the monetary authority should integrate the unorganised and organised sectors of the money market.

4. Developing banking habits

The monetary authority of a less developed country should take appropriate measures to increase the proportion of bank money in the total money supply of the country. This requires increase in the bank deposits by developing the banking habits of the people and popularising the use of credit instruments (e.g., cheques, drafts, etc.).

5. Monetisation of economy:

An underdeveloped country is also marked by the existence of large non-monetised sector. In this sector, all transactions are made through barter system and changes in money supply and the rate of interest do not influence the economic activity at all. The monetary authority should take measures to monetise this non-monetised sector and bring it under its control.

6. Integrated interest rate structure:

In an underdeveloped economy, there is absence of an integrated interest rate structure. There is wide disparity of interest rates prevailing in the different sectors of the economy and these rates do not respond to the changes in the bank rate, thus making the monetary policy ineffective. The monetary authority should take effective steps to integrate the interest rate structure of the economy. Moreover, a suitable interest rate structure should be developed which not only encourages savings and investment in the country but also discourages speculative and unproductive loans.

7. Debt management:

Debt management is another function of monetary policy in a developing country. Debt management aims at- (a) deciding proper timing and issuing of government bonds, (b) stabilising their prices, and (c) minimising the cost of servicing public debt. The monetary authority should conduct the debt management in such a manner that conditions are created “in which public borrowing can increase from year to year and on a big scale without giving any jolt to the system. And this must be on cheap rates to keep the burden of the debt low. “However, the success of debt management requires the existence of a well- developed money and capital market along with a variety of short- term and long-term securities.

8. Maintaining equilibrium in balance of payments:

The monetary policy in a developing economy should also solve the problem of adverse balance of payments. Such a problem generally arises in the initial stages of economic development when the import of machinery, raw material, etc., increase considerably, but the export may not increase to the same extent. The monetary authority should adopt direct foreign exchange controls and other measures to correct the adverse balance of payment.

9. Controlling inflationary pressures:

Developing economies are highly sensitive to inflationary pressures. Large expenditures on developmental schemes increase aggregate demand. But, output of consumer’s goods does not increase in the same proportion. This leads to inflationary rise in prices.

❖ Exercise

Q-1 MCQ:

1. What is meant by Repo Rate?

i) Rate at which RBI lends commercial banks in place of Government securities

ii) Rate at which Commercial Banks lend the clients

a) Only i
b) Only ii
c) Both i and ii
d) None of the above

Ans. A

2) **What is the CRR?**

i) It is a percentage of bank deposits that they keep with the RBI as Gold deposits only

ii) It is a deposit made by banks with RBI in form of reserve or balances

a) Only i
b) Only ii
c) Both i and ii
d) None of the above

Ans. b

3) **Which of the following statements is true of SLR?**

a) It is to be maintained by all Financial Institutions
b) It is to be maintained as liquid assets
c) These need to be kept in non-cash form
d) All of the above

Ans. d

4) **Which of the following are the indicators of the Monetary Policy?**

a) Inflation
b) GDP
c) MSF Rate
d) All of the above

Ans. D

5) Who is empowered to control the expansion of bank credit?

a) Finance Minister
b) Home Minister
c) Reserve Bank of India
d) None of the above

Ans. C

Q-2 Long Questions:

1) Write the Meaning and Definition of Monetary Policy.
2) Describe the Nature of Monetary Policy.
3) Write down the History of Monetary Policy.
4) Write the Objectives of Monetary policy.
5) State and explain the types of Monetary Policy.
6) State and explain the Tools of Monetary Policy
7) Describe the Instruments of Monetary policy.

BBA
SEMESTER-2
MACRO ECONOMICS FOR MANAGEMENT
BLOCK: 3

Authors' Name:	Prof. (Dr.) Manoj Shah, Professor & Director, Dr. BAOU, Ahmedabad Dr. Dhaval Pandya, Assistant Professor, Dr. BAOU, Ahmedabad Dr. Kamal K. Agal, Associate Professor, Dr. BAOU, Ahmedabad
Review (Subject):	Dr. Satyajeet Deshpande, Associate Professor, Central University of Gujarat, Gandhinagar
Review (Language):	Dr. Jainee Shah, Assistant Professor, Nirma University, Ahmedabad
Editor's Name:	Prof. (Dr.) Manoj Shah Professor and Director, School of Commerce and Management, Dr. Babasaheb Ambedkar Open University, Ahmedabad.

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UNIT - 9	INTERNATIONAL TRADE & FINANCE

9.1 Introduction

As we know man in modern times does not live in isolation, he lives in a society of human beings who support and satisfy each other's wants. The division of labor specialization and use of machinery have all led to the interdependence of individuals on each other; hence, the need for exchange has risen. Production in modern times is not always undertaken for direct consumption. It is largely undertaken for the market and the market is nothing but a mechanism that facilitates exchange or trade.

Thus, the term trade is commonly understood to mean the exchange of goods and commodities between individuals or groups. In other words, trade implies the exchange of goods and services between two parties. This exchange may be direct through barter or indirect through the use of money as a medium of exchange in a modern economy trade or exchange basically takes place through the use of money. Broadly speaking there are two types of trade, internal and international trade.

9.2 Meaning and Definition

- **Internal Trade:**

It refers to the exchange of goods and services within the geographical boundaries of a nation. Now, since a country may be divided into many regions trade between different regions of a country is known as inter-regional trade which is the something as internal trade. Thus, e.g. trade between Gujarat and Maharashtra is a case of internal or inter-regional trade.

- **International Trade:**

International trade on the other hand refers to trade or exchange of goods and services between two or more nations. Thus for e.g. trade between India and America is a case of international trade.

9.3 Difference between Internal & International Trade

1. Internal trade refers to the exchange of the domestically provided goods within the political boundaries of the country where as international trade refers to trade between two or more nations. Thus, terms like exports and imports, rate of exchange etc. are more often used in international trade rather than internal trade. Exports imply selling of goods to a foreign country while imports imply buying goods from a foreign country.
2. Another important difference between the two is that whereas, trade within in a country is trade amongst the same group of people. Trade between countries have a wide difference in social-economic environment. Whereas, within the same country it is more or less homogeneous. In this connection Fredrich has rightly observed that domestic trade is amongst us while international trade is between us and them.
3. Another major difference between internal and international trade lies in the degrees of mobility of factors of production. Thus in internal trade the degree of mobility of factors like labour & capital id greater as compared to international trade. Differences in language, customs, traditions, religion, social & Political environment, immigration laws, discrimination against foreign cap. Restrictions on cap. In flows and out flows as also rigid restrictions of profits & dividends, fear of nationalization etc. all this obstruct the international mobility of labour and capital.
4. Again in the case of internal trade all transactions take place through a single uniform currency. While in the case of international trade. However, transaction between different countries hence there arises the problem of foreign exchange and exchange rate. The fixing of an appropriate exchange rate by the governments of different countries rises several issues that cannot be settles easily. Again there are fluctuations in exchange rates which effects international capital movement and consequently the level of production employment and income in the country such problems hardly arise in internal trade.
5. Besides in the case of internal trade the economic policy that is monetary policy, fiscal policy, trade policy, etc. is more or less uniform for the entire country like-wise industrial policy, labour policy, social security measures etc. are made applicable more or less in a similar manner throughout the country as a whole. However all this policies differ widely in different countries.
6. There are cultural distinctions as between different markets. Internal trade takes place in a more or less homogenous market situation where as in the case of international trade markets lack homogeneity on account of difference in languages, Preferences, customs etc. The behavior of international buyer would therefore be different in each case.

9.4 Balance of Trade:

Balance of trade, the concept of balance of trade and balance of payments occupy a significant place in the sphere of international trade and foreign exchange. The term balance of trade refers the systematic record of transactions pertaining to all visible items of exports and imports of a country during a given period. It represents the value of all goods and commodities exported & imported by a country. This movement of goods between different countries is known as visible trade because the movement is open and can be verified by the custom official.

During the given period of time if the money alone of exports of a country is equal to the money value of its imports. The balance of trade is said to be imbalance. But this need not be the case everytime. Because those who export and import are not necessarily the same persons. As such if the money value of exports of a country exceeds the money value of its imports, the balance of trade is said to be favorable. On the other hand if the money value of its import exceeds the money value of its exports, the balance of trade is said to be unfavorable.

9.5 Balance of Payment:

The balance of payments of a country is a systematic record of all economic transactions between the residences of a reporting country. And the residence of foreign countries during a given period of time. The record is so prepared as to provide meaning and measure to the various components of countries external economic transactions. It indicates the total payments which a country has to make to other countries of the world and the total payments which it has to receive from the other countries of the world. It thus follows that:

1. Balance of payment is a statement of systematic record of all economic transactions which a country has entered into with the other countries of the world.
2. The transactions include both current A/c and capital A/c transactions.
3. It refers to a specifies period of time which is generally a year i.e. it's an annual statement.
4. It adopts a double entry book keeping system i.e. to say there are two sides of the balance of payment: Credit and Debit.
5. In the accounting sense Debit and Credit will always balance each other i.e. the balance of payment of a country is always in a balance.

9.6 Difference between Balance of Trade and Balance of Payment

Sr. No	**Balance of Trade**	**Balance of Payment**
1	It includes only the visible items i.e. (goods and commodities) of foreign trade.	It includes both the visible and the invisible items of foreign trade.
	Balance of trade is part of balance of payment.	Balance of payment includes balance of trade.
3	Its narrow concept of trade accounting.	Its wider concept of trade accounting.
4	Balance of trade need not be imbalance in the long run.	Balance of payment is always imbalance in the long run.
5	A favorable balance of trade is not necessarily indicative of economic prosperity of country.	A favorable balance of payment is indicative of the sound economic position of the country.

9.7 Concept of Exchange Rate:

- **Introduction**:

The problem of exchange rate and its determination arises in international trade because different countries have different systems of currency. In the case of internal or inter-regional trade. As there is only one currency system which operates throughout the country, the problem of foreign exchange does not arise. However, in the case of international trade as different systems of currency prevail in different countries there arises the question of converting the currency of the one country into the currency of the other country. Foreign exchange, therefore, refers to the mechanism of the ways and means by which payments in connection with international trade are effected. Foreign exchange is that branch of the science of economics in which we seek to determine the principle on which the people of the world settle their debts one to other. It may be noted that the foreign exchange is the name given to any foreign currency. Thus, for e.g. US-dollar or British-Pounds are foreign exchange for India.

- **Meaning Exchange Rate**

The rate at which the currency of one country is exchanged for the currency of another country is known as the rate of exchange. It is the rate at which two or more currency are exchange for one another. The rate of exchange is the price of one currency expressed in terms of another. It should also be noted here that exchange rate is not always constant or fixed. It goes on changing from time to time on account of changes in the demand for a supply of foreign currency.

Besides, changes in exchange rate affect the value and volume of exports and imports of a currency and therefore each country has a certain definite exchange rate policy taking into account its own interest. We may also mention here that the markets in which currency of various countries are exchanged traded or converted is known as Foreign exchange Market.

The foreign exchange market is not any physical place but a network of communication system connecting the whole complex of Institutions including Banks, Specialized foreign exchange dealers and official Govt. agencies threw which the currency of one country can be exchange for that of another.

9.8 Types of Exchange Rate:

1. Spot and Forward Exchange Rate:

Spot exchange rate refers to the price of foreign exchange in terms of domestic currency payable for the immediate delivery of a particular foreign currency. It is thus a day to day rate.

Forward rate of exchange on the other hand refers to the price at which a particular transaction will be consummated at some specific time in future, the transaction of forward exchange market are known as forward exchange transactions, which involve the purchase or sale of a foreign currency for delivery at some-time in future. The rates of which these transactions are conducted are therefore known as Forward Rates. Forward exchange rate is determined at the time of sale but the payment is made only after the exchange is delivered by the seller. Normally, the forward rates are quoted on the basis of a discount or premium over or under the spot rate of exchange.

2. Flexible Exchange Rate:

When the exchange rate is allowed to fluctuate freely without any intervention on the path of the monetary authority. It is said to be a flexible or fluctuating exchange rate. The rate of exchange is the price of one currency expressed in terms of another currency and that like the price of any other commodity it is determined by the demand and supply of foreign exchange when this forces of demand & supply are allowed a free play in the foreign exchange market the rate of exchange fluctuates with every change in the demand for and supply of foreign exchange. The exchange rate so determined is known as fluctuating exchange rate.

3. Fixed Exchange Rate:

Under the present monetary system of international monetary fund fixed or stable exchange rates are also known as pegged exchange rate. In fact one of the objectives of the international monetary fund is to work for the stabilization of exchange rates with proper safe guards for adjustments whenever necessary. Under the system of fixed exchange rates as adopted by the member countries of the fund the exchange rate is determined by the govt. of the country & enforced by pegging operations or by taking recourse to some form of exchange control. Under the pegging operations the govt. fixes and official power of exchange stabilization.

4. Floating Exchange Rate:

An extreme form of flexible exchange rate is the system of floating exchange rate under this system a country allows the exchange rate of its currency to find its own level and rise and full according to the market forces. Floating rates have been adopted by many countries of the world since 1971. When they found it difficult to maintain fixed exchange rates or even adjustable rates. India too has adopted this system of exchange rate since 1975 however it should be noted have that a free or a floating exchange rate doesn't imply complete absence of control over the foreign exchange rate.

9.9 Advantages and Disadvantages of International Trade

International trade enables governments, states, brands, and businesses to buy and sell in different marketplaces. This commerce expands the range of products and services available to domestic clients. It provides the opportunity for growth and expansion while eliminating the risks associated with internal research and development. Trade is not without issues. One country can benefit substantially by exporting goods and services rather than importing them. It can also be used to undercut domestic markets by delivering lower-cost but equally valuable products. There are numerous pros and downsides to international trade in all of its forms.

➢ Advantages of International Trade

1) Economies of Scale

If a country wants to sell its goods in the international market, it will have to produce more than what is needed to meet the domestic demand. So, producing higher volume leads to economies of scale that means the cost of producing each item is reduced.

2) Competition

Selling goods and services in a foreign market also boosts the competition in that market. In a way, it is good for local suppliers and consumers as well. Suppliers will have to ensure that their prices and quality are competitive enough to meet the foreign.

3) Transfer of Technology

International trade often leads to the transfer of technology from a developed nation to a developing nation. Government in the developing nation often lay terms for foreign companies that involve developing local manufacturing capacities.

4) Employment Generation

An increase in international trade also creates job opportunities in both countries. That is a major reason why big trading nations like the US, Japan, and South Korea have lower unemployment rates.

5) Enables financial assistance:

International trade finance enables various businesses to raise money to support smooth international transactions, assisting them in avoiding any disruption due to sales made on credit or any other issue. Businesses, importers, and exporters turn to international factoring or forfaiting to eliminate any financial risks on account of sales made on credit.

6) Improved relations between buyers and sellers:

International trade finance helps businesses by providing immediate cash to enable trade. By ensuring that both buyers and sellers are able to meet their financial obligations with each other, allowing buyers and sellers to maintain healthy and stress-free trade relations.

7) Expand their global operations:

With international trade finance, businesses can increase or expand their global operations and make money through trade by providing financial assistance. Expanding global operations will come with ease when working capital is not disturbed or blocked due to sales made on credit to overseas buyers. Since international trade finance can also aid businesses in lowering the dangers of financial non-payment from overseas buyers, expansion of global operations can be initiated.

- **Disadvantages:**

1) **Dependency :** Countries or companies involved in foreign trade are vulnerable to global events. An unfavorable event may impact the demand for the product and could even lead to job losses. For example, the recent US-China trade war adversely affects the Chinese export industry.
2) **Unfair to new startups:** New companies or start-ups that do not have much resources and experience may find it difficult to compete against the big foreign firms.
3) **Threat to national security:** If a country is over-dependent on the imports for strategic industries, then exporters may force it to decide that may not be in the national interest.

4) **Limited natural resources:** A country only has limited natural resources. But, if it opens its doors to foreign companies, it could drain those natural resources much quicker.

5) **Risk of proprietary information theft :** Going into an international market with a product or service increases the risk of another brand or business stealing proprietary information, marketing concepts, or even a personal identity.

6) **Credit Risk :**Many brands and businesses tend to overlook the risk of non-payment when they begin to operate in the world of international trade. Credit risks can be managed by obtaining insurance or a letter of credit, but customer finances and credit can still impact the number of potential sales that can be received within a market. Without an understanding of the B2B and B2C credit potential of an international market, the success a brand and business can receive will be hit or miss at best.

7) **Cultural complications :** Distinct cultures have distinct attitudes, standards, and expectations, which can provide challenges for a brand and business. Failure to address the expectations of a different culture can result in mistakes that harm the brand's reputation and are extremely costly to the bottom line. Any step in the sales process could result in an infraction. Something as basic as incorrect packaging can forever harm a brand's reputation.

9.10 Theories of International trade

1) Mercantilism
2) Absolute advantage
3) Comparative advantage
4) Heckscher –ohlin

1) Mercantilism

Mercantilism is an exercise that is more than 500 years old. The base of this theory was the "commercial revolution", the transition from local economies to national economies, from feudalism to capitalism, and from a rudimentary trade to a larger international trade. The theory of mercantilism postulates that countries should encourage exports and discourage imports. The tendency to export more and import less and receive gold (as gold was the medium of exchange) in exchange is called Mercantilism.

Mercantilism was the economic system of the major trading nations during the 16th to 18th centuries. The theory assumed that national wealth and power were best served by increasing exports and collecting precious metals like gold in return. The theory states that government should play a vital role in regulating the economy to encourage exports and discourage imports by using subsidies and taxes. According to this theory, the government should accumulate as much gold as possible, which can only be done through exports.

2) Absolute Advantage

Adam Smith propounded the basic theory of international trade in 1776. Adam Smith in his seminal work, an inquiry into the nature and causes of the “Wealth of the Nation” for the first time, provided a theoretical explanation of why trade should take place between two nations.

Adam Smith, in his book propounded the theory of absolute advantage, which states that a country should specialize in those products which it can produce efficiently, where efficiency is measured in terms of absolute labour costs. This theory assumes that there is only one factor of production that is labour.

Adam Smith wrote in “The Wealth of Nations”, “If a foreign country can supply us with a commodity cheaper than we can make it, better buy it of them with some part of the produce of our industry, employed in a way in which we have some advantage".

According to Adam Smith, trade between two nations is based on absolute cost advantage. When one is more efficient than (or has an absolute advantage over) another in the production of one commodity but is less efficient than (or has an absolute disadvantage with respect to) the other nation in producing a second commodity, then both the nations can gain by each specializing in the production of the commodity of its absolute advantage and exchanging part of its output with the other nation for the commodity of its absolute disadvantage. In this process, the resources are utilized most efficiently and the output of both commodities will rise. This increase in output of both the commodities measures the gains from specialization in production available to be divided between the two nations through trade.

In very simple words, he stated that trade would benefit both countries if country A exported the goods, which it can produce at a lower cost than country B and imported the goods, which country B can produce at a lower cost than it. The above description of the theory can be understood better with the following example.

Suppose there are two countries A and B, which produce wheat and rice with an equal amount of resources i.e. 200 laborers. Country A uses 10 laborers to produce 1 ton of wheat and 20 laborers to produce 1 ton of rice. Country B uses 25 units of laborers to produce 1 ton of wheat and 5 units of laborers to produce 1 ton of rice.

Table 1.1 Number of laborers used by Country A and Country B for producing 1 ton of Wheat and Rice

	Country A	Country B
Wheat (1 ton)	10 laborers	25 laborers
Rice (1 ton)	20 laborers	5 laborers

This is evident from Table 1.1 that country A has an absolute advantage in producing wheat as it can produce 1 ton of wheat by using fewer laborers as compared to country B. On the other hand, country B has an absolute advantage in producing rice as it can produce 1 ton of rice by employing fewer laborers in comparison to country A. Now, if there is no trade between these countries and resources (in this case there are a total of 200 laborers) are being used equally to produce wheat and rice, country A would produce 10 tons of wheat (100/10), and 5 tons of rice (100/20) and country B would produce 4 tons of wheat (100/25) and 20 tons of rice (100/5). Thus, total production without trade (i.e., autarky) is 39 tons (14 tons of wheat and 25 tons of rice).

Table 1.2 Production volume of wheat and rice without trade

	Country A (in Tons)	Country B (in Tons)
Wheat	10	4
Rice	5	20

Now, if both countries open up to trade with each other and specialize in goods in which they have an absolute advantage, the total production would be higher. If a trade takes place, Country A would produce 20 tons of wheat with 200 laborers; whereas, country B would produce 40 tons of rice with 200 laborers. Thus, total production would be 60 units (20 tons of wheat and 40 tons of rice). It is clear from the above descriptive example that without specialization, the total production of countries was 39 tons which increased to 60 tons after specialization from trade opportunities. This is the welfare gains from trade. Therefore, the theory of absolute advantages shows that pattern of trade based on absolute cost differences would benefit both the countries.

Table 1.3 Production volumes of wheat and rice with trade

	Country A (in Tons)	Country B (in Tons)
Wheat	20	0
Rice	0	40

3) Comparative advantage

David Ricardo presented his work in 1817 in his book 'Principles of Political Economy and Taxation'. In this book, he presented the law of comparative advantage. This is one of the most important and still unchallenged laws of economics with many practical applications. The Ricardian theory states that trade can be beneficial for two countries even if one country has an absolute advantage in all the products and the other country has no absolute advantage in any of the products.

Ricardo argued that "A nation, like a person, gains from the trade by exporting the goods or services in which it has its greatest comparative advantage in productivity and importing those in which it has the least comparative advantage".

A nation behaves no differently from an individual who does not attempt to produce all the commodities he needs. Rather, he produces only the commodity that he can produce most efficiently and then exchanges part of his output for the other commodities he needs or wants. The first nation would be better off provided they specialize in the production and export of those commodities in which its absolute disadvantage is smaller (this is the commodity of its comparative advantage) and import the commodity in which its absolute disadvantage is greater (this is the commodity of its comparative disadvantage). This theory assumes that labour is the only factor of production in two countries, with zero transport costs, and no trade barriers within the countries.

4) Heckscher –Ohlin

A brief introduction of this theory is as follows:

We have seen that the difference in relative commodity prices between two nations is the reason for their comparative advantage, which forms the basis for mutually beneficial trade. Then we explained the reason, or cause, for the difference in relative commodity prices and comparative advantage between the two nations.

The second way we extend our trade model is to analyze the effect of international trade on the earnings of factors of production in the two trading nations. That is, we want to examine the effect of international trade on the earnings of labour as well as on international differences in earnings. These two important questions were left largely unanswered by Smith, Ricardo, and Mill.

According to classical economists, the comparative advantage was based on the difference in the productivity of labour among nations, but they did not explain such a difference in productivity, except for possible differences in climate.

The Heckscher–Ohlin theory goes much beyond that by extending the trade model of the previous sections to examine the basis for comparative advantage and the effect that trade has on factor earnings in the two nations. Theory of International Trade Bertil Ohlin has advocated the Modern Theory of international trade. Ohlin has drawn his ideas from Eli Heckscher's General Equilibrium Analysis. Hence it is also known as Heckscher Ohlin (H-O) Theory.

Heckscher-Ohlin theory begins where the Ricardian theory of international trade ends. The Ricardian theory states that the basis of international trade is the comparative or relative cost differences. But he did not explain how this comparative cost difference emerges. Ohlin’s theory explains the real cause of this difference. Ohlin states that trade takes place due to the different relative prices of different goods in different countries. The difference in the relative price of a commodity is due to differences in the relative costs and factor prices in different countries.

According to the H-O theory, the differences in factor prices are due to differences in factor endowments in different countries. The trade pattern is explained in terms of differences in relative factor endowments i.e., the relative resource supply in an economy. Ohlin’s theory is also described as the factor endowment theory. Ohlin’s theory is usually expounded in terms of a two-factor model with labour and capital as the two factors of endowments. Trade occurs due to the differences in factor endowments. Some countries have plenty of capital, while others have an abundance of labour. The Heckscher-Ohlin theorem postulates that countries rich in labour will export labour-intensive goods and countries with plenty of capital will export capital-intensive products.

Heckscher-Ohlin's theory explains the modern approach to international trade based on the following assumptions: -

1) There are two countries involved, countries A and B
2) There are two factors of production i.e. labour and capital.
3) There are two goods, X and Y, of which X is labour-intensive, and Y is capital-intensive.
4) Country A is a labour-abundant country B is capital-rich.
5) There is perfect competition in both the commodity and factor markets.
6) All production functions are homogeneous of the first degree. Hence there are constant returns to the scale.
7) There are no transport costs or other impediments to trade.
8) Demand conditions are identical in both countries.

These assumptions have been made to explain the meaning of comparative price advantage or relative price difference and to deduce the major propositions of the factor endowment theory. Given these assumptions, Ohlin's thesis contends that, 20 country exports goods which use relatively a greater proportion of its relatively abundant and thus cheap factors. It is implied that trade occurs because differences in relative commodity prices are caused by differences in relative factor prices (thus a comparative advantage) because of differences in the factor endowments among the countries. The two countries, two commodities & two-factor model, imply that the capital rich country will export capital-intensive commodities and the labour-rich country will export labour-intensive commodities. But the concept of a country being rich in one factor or the other is not very clear. Economists quite often define factor abundance in terms of factor prices. Ohlin himself has followed this approach. Alternatively, factor abundance can be defined in physical terms. In this case, physical amounts of capital & Labour are to be compared.

❖ **Exercise:**

Q-1 Give the answer of the following Questions:

1) Give the meaning and definition of Internal and International Trade.
2) Find out the difference between Internal & International Trade.
3) Explain balance of trade.
4) Describe balance of payment.
5) Differentiate between balance of trade and balance of payment.
6) Explain the concept of exchange rate.
7) State and explain the types of exchange rate.
8) Write down the advantages and disadvantages of international trade.
9) Explain any one theory of international trade.

Q-2 MCQ:

1) International trade and domestic trade differ because of_____

A. Different government policies
B. Immobility of factors
C. Trade restrictions
D. All of the above

Answer: D

2) .Which of the following is international trade?

A. Trade between countries
B. Trade between regions
C. Trade between provinces
D. Both (b) and (c)

Answer: A

3) Market in which currencies buy and sell and their prices settle on is called the ____________________

A. International bond market
B. International capital market
C. Foreign exchange market

D. Eurocurrency market

Answer: C

4) According to Ricardo, trade is possible between two countries when _________

A. One country has absolute advantage in production of both commodities
B. One country has an absolute advantage for production of both commodities but comparative advantage in the production of one commodity than the other country
C. One country does not have any advantage in the production of both commodities
D. A country does not have any line of production

Answer: B. One country has an absolute advantage for production of both commodities but comparative advantage in the production of one commodity than the other country.

5) The importance of international trade includes _________________

A. Adverse terms of trade
B. Lack of industrial diversification
C. Balance of Payments deficit
D. None of the above

Answer: D. None of the above

6) International trade refers to _______________

A. Domestic trade
B. Inter-regional trade
C. Trade between two nations or countries
D. Internal trade

Answer: C. Trade between two nations or countries

7) Which factor does not influence terms of trade?

A. Devaluation
B. Overpopulation
C. Trade policy
D. Immigration

Answer D: Immigration

8) Trade among two nations can be helpful if the price ratios of products are____________

A. Equal
B. Decreasing
C. Undetermined
D. Different

Answer: D- Different

9) Domestic trade and International trade differ because of __________________

A. Trade restrictions
B. Immobility of factors
C. Different government policies
D. All of the above

Answer: D All of the above

10) Foreign trade is an exchange of capital, goods, and services across _________ borders or territories.

A. Intranational
B. National
C. International
D. Both A & C

Answer: International

11) _______is the oldest International Trade theory.

A. Country Similarity Theory
B. Theory of Absolute Cost advantage
C. Product Life Cycle Theory
D. Mercantilism Theory

Answer: Mercantilism Theory

UNIT - 10	NATIONAL INCOME

10.1 Introduction

The ultimate objective of all our economic actuaries is to produce goods & services for the satisfaction of human wants some goods & service satisfy human wants directly. These are known as consumer goods & services E.g. - Foods grains, Clothes, etc.
Some other goods & services satisfy human wants indirectly i.e. helping us in the products of consumption goods & services. Such goods & services are called 'producers goods & services' E.g. - Tractor, textile, machinery, etc.

The greater the production of goods & production of goods & services the higher will be the level of satisfaction of human wants & the smaller the production of goods & services the lower will be the level of satisfaction of human wants. The level of satisfaction of human wants is the most appropriate measure of economic development of a country but satisfaction is a state of mind & hence direct measurement of satisfaction is not possible in practice. We can measure it only indirectly by measuring the flow of goods & service produced in the country during a year. In economics the term grow national product is used to refer to the flow of goods & service produced in the country during a year.
To measure natural income, it is necessary to be familiar with the concept of circular flow of income the contract idea of this concept is that production creates income which leads the spending which in turn calls forth production. Thus, the circle is completed.
The economy is made up of two sectors.

(i) The business sector
(ii) The household sector

The business sector is made up of firms while household sector is made up of consumers. The firm purchases the services of the factors of production from the household that own them. In return (rent, profit to the household) for these services, the firm pays wages, rent, profit to the household the firm then use factor service to make commodities that are sold to the household. In other words the household earn income by selling factor services to firms & spend this income on buying commodities from the firms. This time, money flows from households to firms. Therefore, we can define circular flow of income of the flow of payments from firm to households back again.

10.1.1 Meaning and Definition

Meaning:

- National Income defines a country's wealth. This income depicts the value of goods and services which are produced by an economy. This gives effect to the net result of all the economic activities performed in the country.
- National income is the sum total of the value of all the goods and services manufactured by the residents of the country, in a year, within its domestic boundaries or outside. It is the net amount of income of the citizens by production in a year.
- To be more precise, national income is the accumulated money value of all final goods and services produced in a country during one financial year. Computation of National Income is very vital as it indicates the overall health of our economy for that particular year. The aggregate economic performance of a nation is calculated with the help of National income data. The basic purpose of national income is to throw light on aggregate output and income and provide a basis for the government to formulate its policy, programs, to maximize the national welfare of the people. Central Statistical Organization calculates the national income in India.

❖ **Definition:**

The definition of National Income if of two types (a) Traditional Definition of National Income and (b) Modern Definition

(a) Traditional Definition of National Income:

According to Marshall “The labor and capital of a country acting on its natural resources produce annually a certain net aggregate of commodities, material and immaterial including services of all kinds. This is the true net annual income or revenue of the country or national dividend.”

(b) Modern Definition

This definition has two subparts i.e. GDP and GNP

10.2 Gross Domestic Product

Gross Domestic Product, abbreviated as GDP, is the aggregate value of goods and services produced in a country. GDP is calculated over regular time intervals, such as a quarter or a year. GDP as an economic indicator is used worldwide to measure the growth of countries economy.

❖ **Constituents of GDP**

- Wages and salaries

- Rent
- Interest
- Undistributed profits
- Mixed-income
- Direct taxes
- Dividend
- Depreciation

The Formula for Calculation of GDP is as follows:

- **GDP = consumption + investment + government spending + exports - imports**.

10.3 GNP- Gross National Product

- GNP = GDP + NR (Net income from assets abroad or Net Income Receipts) - NP (Net payment outflow to foreign assets).

- GNP is the sum of the money values if all final goods & services that are produced by the nationals of a country during a year. The definition of GNP has several important aspects which must be clarified as follows:

1. GNP is a monetary measure:

We add up the money values of final goods & services. This is because GNP consists of a large number of dissimilar goods & services. To combine them all into a single number, it is necessary to convert every goods & services into money terms. In order words, quantity produced of each final goods & services is to be multiplied by its price & then the money values of the output of all final goods & services are to be added together. The sum of money valued is GNP.

Commodit	Output	Market Price	Money value of output
Rice	100 Kg	Rs.5	Rs.500
Sugar	75 Kgs	Rs.16	Rs.1,200
Cloth	100 M.	Rs.50	Rs.5,000
		T	Rs.6,700

2. GNP for a particulars year includes only those goods & services that are produced during that year. Goods & services produced in previous year are excluded. If you purchase a product in 2002 made in 1998, it was already counted in the GNP for 1998 when it was first produced. The same is true of the purchase of old buildings & other existing assets such as shares & debentures.

10.4 NNP –Net National Product

Net national product (NNP) is the financial value of finished goods and services provided by a country's citizens, abroad and domestically. It is the equivalent of the gross national product (GNP), the total value of a nation's yearly output, minus the amount of GNP needed to purchase new goods to maintain existing stock, otherwise known as depreciation.

Gross national product is defined as the money value of final goods & services produced by the residence of a country during a year. The total output consists of consumption goods & capital goods. A part of the output of new capital goods is used for replacing the capital which is consumed in the process of producing final goods & services throughout the year. Only a part of the output of new capital goods represents net income in economy's capitals stock.

The formula for NNP is:

- NNP= MVFG + MVFS -Depreciation where MVFG = market value of finished goods MVFS = market value of finished services

Alternatively, NNP can be calculated as: NNP=Gross National Product−Depreciation

Net natural product is therefore total output of consumption goods + net increase in economy's capital stock. The net increase in capital stock is called net investment. Net national income is total output of consumption goods + net investment.

10.5 Methods to Measure National Income

There are 3 methods to measure national income.

(1) Product Method
(2) Income Method
(3) Expenditure Method

1) **Product Method:** This method, gives us the most comprehensive measure of gross natural product usually knows as gross national product. The GNP is the money value of all goods & services produced annually in a country. Under the product method the output of each commodity produced during the year is multiplied by its market price then money value of all this goods & services are added together. The sum of money values is called GNP.
2) **Income Method:** Each Rupee of output produced is matched by each rupee of income generated. The value of GNP therefore has a counterpart in GNI. Thus, GNI is the sum of all income earned in the process of production of GNP of a man receives income in the form of donation or a gift, it is not included in national income because there has been no corresponding economic activity resulting in production of goods & services.
3) **Expenditure Method:** Under this method national income is obtained by aggregation the flow of total expenditure on final goods & services in the economy. In other words, GNP according to expenditure method is aggregate of the money value of all final goods & services sold in the market during a year. If a part of output remains, unsold, it is considered as purchase by the firm themselves. There are four components of national product under expenditure method.

   i) Money expenditure of the people on consumption goods.
   ii) Money expenditure of the private firms on capital goods.
   iii) Money expenditure of the goods on consumption & capital goods both.
   iv) Total export, total, import which represents money expenditure of the foreigners on domestic goods.

- **Money Income & Real Income:** Measurement of national income requires it's to multiply quantity of output by money prices. If quantity of output & money crisis both relate to the same year. Eg2002 it is called, GNP at current price. But if the quantity of the output of current year is multiplied by money crisis of the base year it is called GNP at constant prices, or simply real natural product. Usually changes in money value of national product are cause party by the change in physically volume of output of final goods & services & partly by the change in market prices of those goods & services.

- Hence, in order to have a meaningful comparison of the national product between two time periods we must separate that part of change in money value of national product which is the result of price change from that part which is due to the change in real output. The derivation of real gross national product can be explained with the help of an example.

Year	Money GNP (Rs. Crores)	Index No. of Prices	Real GNP (Rs. Crores)
1993-94	14,000	100	14,000 X $\frac{100}{100}$ = 14,000
2001-02	35,000	175	35,000 X $\frac{100}{175}$ = 20,000

The above table shows that between 1993-94 & 2001-02 money GNP has increased from 14,000 crores to 35,000 crores which real GNP has increased from Rs.14,000 crores to Rs.20,000 crores of the total increase of Rs.21,000 crores (i.e. 35,000-14,000) in the money GNP during this year Rs.6,000 crores its due to increase in real output while Rs.15,000 crores (i.e. 35,000-20,000) is due to price rise over the period 1993-94 to 2001-02.

- **Per Capita Income:**

The term PCI refers to the income per head of population. It is the average income of the individuals of a country in a particulars year. PCI is therefore obtained by during National income by total population of the same year.

Per Capita Income in 2002 = $\frac{National\ Income\ in\ 2002}{Population\ in\ 2002}$

Like national income per capita income also can be calculated either at current prices or at constant prices for the purpose of arriving at real PCI following formula is employed.

Real PCI in 2002 = $\frac{Real\ National\ Income\ in\ 2002}{Population\ in\ 2002}$

Real PCI is average income of the people at a constant price & not at the current prices. Therefore it gives us a current idea of the change in PCI caused by the change in output per head of the population.

10.6 Components of GDP

The components of GDP using the expenditure approach are consumption, investment, government spending, and net exports. The expenditure approach to calculating Gross Domestic Product (GDP) is based on the idea that all goods and services produced in an economy must be purchased by someone. Therefore, by adding up all the spending on goods and services, we can calculate the total value of a country's economic output.

This approach is often summarised by the formula: GDP = C + I + G + (X - M), where C stands for consumption, I for investment, G for government spending, and (X - M) for net exports.

10.6.1 Consumption (C)

It is the total spending by households on goods and services. This does not include purchases of new housing, which are counted as an investment. Consumption is typically the largest component of GDP and can be broken down into three categories: durable goods, non-durable goods, and services.

10.6.1 Investment (I)

It includes business spending on physical capital, such as machinery and buildings, and changes in business inventories. It also includes residential investment, which is the purchase of new housing by households. Investment is a volatile component of GDP as it can be affected by interest rates and business confidence.

10.6.2 Government spending (G)

It is the sum of government expenditures on final goods and services. It includes spending on defence, education, public safety, infrastructure, and other public services. Transfer payments, such as social security or unemployment benefits, are not included as they do not represent a purchase of goods or services.

10.6.4 Net exports (X - M)

It represents the difference between what a country exports and what it imports. If a country exports more than it imports, net exports are positive, contributing to GDP. If a country imports more than it exports, net exports are negative, reducing GDP.

In summary, the expenditure approach to calculating GDP adds up all the spending on final goods and services in an economy. This includes consumption by households, investment by businesses, government spending, and the balance of exports and imports.

10.7 National Income Accounting

National Income accounting developed by Noble prize Winner economists Simon Kuznets and Richard Stone.

- Simon Kuznets defined it as “the sum of incomes earned by resource suppliers for their contributions to GDP, plus taxes on production and imports, less subsidies, during a specified period, usually a year.”
- Paul Samuelson defined national income accounting as “the study of the process of income determination with all its attendant controversies.”
- Lord Keynes viewed national income accounting as “the art of tracing the flow of money in the national income accounts.”
- Richard Stone defined it as “the study of the measurement and analysis of the economy’s performance. It focuses on the level and growth of output, employment, and prices.”

National income accounting refers to the government bookkeeping system that measures the health of an economy, projected growth, economic activity, and development during a certain period of time. It helps in assessing the performance of an economy and the flow of money in an economy. The double entry system principle of accounting is used to prepare the national income accounts.

10.7.1 Meaning and Concept

National income accounting is a double-entry accounting system used by governments to measure how well a country's economy is performing. The value-added approach, income approach, and expenditure approach are different ways to calculate national income. They can be used in combination, depending on the concerned income group and sector. The statistics provided by national income accounting can be used by the government to set or modify economic policies, interest rates, and monetary policy.

The national income equation represents the relationship between national income and the economy's expense, along with other attributes, as shown in the following equation:

$Y= C+I+G(X-M)$

Where: Y – National income, C – Personal consumption expenditure, I – Private investment, G – Government spending, X – Exports, M – Imports

Gross Domestic Product (GDP), Net National Product (NNP), Gross National Product (GNP), personal income, and disposable income are the important metrics determined by national income accounting. However, the most commonly used measure of the economy is GDP.

10.7.2 Benefits and Limitations

❖ **The benefits of National Income Accounting are as follows:**

I. National income serves as an indicator of a nation's economic performance, offering insights into its overall growth and development.
II. National income figures play a pivotal role in shaping economic policies, including decisions concerning taxation, government expenditures, and trade.
III. The assessment of national income forms the foundation for comparing economic achievements among different countries, revealing their relative strengths and weaknesses.
IV. National income statistics aid in the efficient allocation of resources, enabling the identification of sectors requiring increased investment and promoting economic advancement.
V. National income data serves as a basis for economic projections, enabling the anticipation of forthcoming economic patterns and challenges.
VI. The analysis of national income data allows for the examination of employment trends, enabling targeted interventions to foster greater job creation.
VII. National income metrics contribute to determine standard of living, facilitating the development of strategies to enhance it by stimulating economic progress.
VIII. International organizations utilize national income data to extend aid and support to nations confronting economic difficulties.

❖ **The limitations of National Income Accounting are as follows:**

National income serves as a valuable tool for assessing a country's economic performance, yet it is subject to certain limitations. Several constraints associated with national income are as follows:

I. National income only includes monetary transactions, excluding non-monetary activities such as unpaid home duties and volunteer work. These characteristics, while important for the economy, are overlooked.

II. National income focuses solely on formal sector involvement, ignoring contributions from the informal sector. This absence may lead to an underestimate of a country's actual economic activity.

III. National income does not reflect the population's quality of life. A nation with a high national income may yet have a low quality of life due to reasons such as income disparity, unsuitable living conditions, and a lack of essential utilities. National income does not consider the environmental impact of economic activities. It is possible for a country to have a significant national income together with increased

IV. National income does not accurately reflect income distribution within a country. Even in a country with a high national income, there may be significant income inequality, which can contribute to socioeconomic problems. Data on national income may be out of date due to temporal delays in computation. This time gap might be troublesome in rapidly developing economies.

❖ **Exercise**

Q-1 Answer the following Questions:

1) Write the Meaning and Definition of National Income accounting.
2) Write the concept of GNP- Gross National Product.
3) Explain about GDP- Gross Domestic Product.
4) Discuss the Methods to measure National Income.
5) Explain the Components of GDP.
6) Explain the National Income Accounting concept.
7) Write the Benefits and Limitations of National Income accounting.

Q-2 MCQ:

1. What does GDP stand for?

a) Gross Domestic Product
b) Gross Domestic Profit
c) General Domestic Product
d) Gross Direct Product
Answer: a) Gross Domestic Product

2. National income includes the total value of goods and services produced within a country in a **__________** period.
a) Monthly
b) Quarterly

c) Weekly
d) Annual
Answer: d) Annual

3. Which of the following is not a component of national income?
a) Wages
b) Rent
c) Taxes
d) Interest
Answer: c) Taxes

4. GDP at constant prices is also known as __________.
a) Real GDP
b) Nominal GDP
c) Adjusted GDP
d) Effective GDP
Answer: a) Real GDP

5. Net National Product (NNP) is calculated by deducting __________ from GNP.
a) Depreciation
b) Taxes
c) Savings
d) Investments
Answer: a) Depreciation

6. Which of the following methods is used to calculate national income?
a) Production method
b) Income method
c) Expenditure method
d) All of the above
Answer: d) All of the above

7. What does NNP at factor cost represent?
a) GDP after adding indirect taxes
b) NNP after deducting depreciation and taxes
c) GNP minus indirect taxes
d) NNP excluding subsidies
Answer: b) NNP after deducting depreciation and taxes

8. The total income received by households in an economy is called __________.
a) Personal income
b) Disposable income
c) Net income
d) Aggregate income
Answer: a) Personal income

9. Which term refers to the total market value of all final goods and services produced by the residents of a country within a year?
a) Gross Domestic Product
b) Gross National Product
c) National Income

d) Net Domestic Product
Answer: b) Gross National Product

10. Disposable income is calculated by subtracting __________ from personal income. [MCQ]
a) Subsidies
b) Taxes
c) Rent
d) Savings
Answer: b) Taxes

11. In national income accounting, GNP minus depreciation is known as __________.
a) Net Domestic Product
b) Net National Product
c) Gross Domestic Product
d) Gross National Income
Answer: b) Net National Product

12. The formula for calculating national income using the income method includes wages, rent, interest, and __________.
a) Exports
b) Subsidies
c) Profits
d) Taxes
Answer: c) Profits

13. Nominal GDP measures the total economic output using __________ prices.
a) Current
b) Constant
c) Adjusted
d) Base year
Answer: a) Current

14. Which of the following is subtracted from GDP to calculate Net Domestic Product (NDP)?
a) Depreciation
b) Imports
c) Taxes
d) Exports
Answer: a) Depreciation

15. Which of the following does not contribute to calculating GDP?
a) Consumer spending
b) Government spending
c) Imports
d) Exports
Answer: c) Imports

16. In the income method of calculating national income, which type of income is not included?
a) Wages

b) Rent
c) Transfer payments
d) Interest
Answer: c) Transfer payments

17. Which of these represents the economic measure of standard of living?
a) GDP per capita
b) Net National Product
c) Gross National Product
d) Net Domestic Product
Answer: a) GDP per capita

18. What term is used to describe a decrease in national income?
a) Depression
b) Deflation
c) Recession
d) Contraction
Answer: c) Recession

19. Which of the following is included in GDP calculation?
a) Black market transactions
b) Transfer payments
c) Expenditure on final goods and services
d) Illegal transactions
Answer: c) Expenditure on final goods and services

20. Which of the following is the correct formula for calculating GDP using the expenditure approach?
a) GDP = C + I + G + (X – M)
b) GDP = C + I + G + (M – X)
c) GDP = I + G + (X – M)
d) GDP = C + G + (X – M)
Answer: a) GDP = C + I + G + (X – M)

21. The income earned by factors of production such as land, labour, capital, and entrepreneurship is known as __________.
a) Gross income
b) Factor income
c) Disposable income
d) National income
Answer: b) Factor income

22. Net Exports in GDP calculation is represented by __________.
a) Imports + Exports
b) Exports – Imports
c) Exports + Imports
d) Imports – Exports
Answer: b) Exports – Imports

23. An increase in the level of economic activity is generally referred to as __________.
a) Inflation

b) Recession
c) Economic growth
d) Depression
Answer: c) Economic growth

24. The value of total goods and services produced in a country adjusted for price changes is known as __________.
a) Nominal GDP
b) Real GDP
c) Gross National Income
d) National Income
Answer: b) Real GDP

25. The difference between Gross National Product (GNP) and Net National Product (NNP) is known as __________.
a) Depreciation
b) Interest
c) Taxation
d) Savings
Answer: a) Depreciation

26. The method of calculating national income by summing up the final values of all goods and services produced is called the __________ method.
a) Production
b) Income
c) Expenditure
d) Value-added
Answer: d) Value-added

27. Which of the following is not included in the calculation of National Income in the Income method?
a) Wages
b) Rent
c) Interest
d) Capital gains
Answer: d) Capital gains

28. What is the primary reason for adjusting GDP with inflation?
a) To calculate GNP
b) To obtain Real GDP
c) To calculate taxes
d) To calculate Gross Fixed Capital Formation
Answer: b) To obtain Real GDP

29. What does the term "factor cost" refer to in national income accounting?
a) The price paid by the consumer
b) The cost of production of final goods
c) The cost excluding indirect taxes
d) The cost after accounting for subsidies
Answer: c) The cost excluding indirect taxes

30. What is the major limitation of GDP as a measure of national income?
a) It does not account for depreciation
b) It includes both private and government spending
c) It does not account for income distribution
d) It only considers monetary transactions
Answer: c) It does not account for income distribution

31. The measurement of national income using the production method is based on which of the following?
a) Value-added in each sector
b) Income earned by individuals
c) Expenditure on goods and services
d) Total wages and profits
Answer: a) Value-added in each sector

32. The expenditure method calculates national income by summing up the total __________.
a) Value of factors of production
b) Taxes collected by the government
c) Expenditure on final goods and services
d) Savings and investments
Answer: c) Expenditure on final goods and services

33. In national income accounting, which of the following is considered a transfer payment?
a) Social security payments
b) Wages
c) Rent
d) Interest on savings
Answer: a) Social security payments

34. The term "per capita income" refers to __________.
a) Total national income divided by population
b) Total income of the wealthiest individuals in a country
c) The income of an average household
d) The income from foreign trade
Answer: a) Total national income divided by population

35. Which of the following measures is used to determine the level of economic well-being of a country?
a) Gross Domestic Product
b) Gross National Income
c) Net Domestic Product
d) Per capita income
Answer: d) Per capita income

36. The total value of goods and services produced by the residents of a country in a year is measured by __________.
a) Gross Domestic Product
b) Gross National Product
c) Net National Product

d) National Disposable Income
Answer: b) Gross National Product

37. Which of the following is considered a final good in GDP calculations?
a) Intermediate goods
b) Stocks of raw materials
c) Machines used in manufacturing
d) Food products sold in retail stores
Answer: d) Food products sold in retail stores

38. What is the basic difference between GNP and GDP?
a) GNP includes the income from abroad, while GDP does not
b) GDP accounts for depreciation, while GNP does not
c) GNP includes transfer payments, while GDP does not
d) GDP includes income earned by citizens abroad, while GNP does not
Answer: a) GNP includes the income from abroad, while GDP does not

39. The difference between nominal GDP and real GDP is due to __________.
b) Changes in the population
c) Government taxes
d) Changes in savings
Answer: a) Price level changes

40. The GDP deflator is used to measure __________.
a) The inflation rate
b) The growth of the economy
c) The level of exports
d) The total consumption expenditure
Answer: a) The inflation rate

41. In national income accounting, which of the following is classified as a direct tax?
a) Sales tax
b) Income tax
c) Service tax
d) Value-added tax
Answer: b) Income tax

42. Which of the following is not an example of capital formation in national income accounting?
a) Investment in machinery
b) Construction of buildings
c) Purchase of stocks
d) Government expenditure on infrastructure
Answer: c) Purchase of stocks

43. What is the key difference between gross and net national product?
a) Gross national product includes depreciation, while net national product does not
b) Net national product excludes depreciation from gross national product
c) Gross national product includes transfer payments, while net national product does not

d) Net national product includes the income earned abroad, while gross national product does not

Answer: b) Net national product excludes depreciation from gross national product

44. The sum of consumption expenditure, investment, government expenditure, and net exports is the formula for calculating __________.

a) Gross National Product
b) Gross Domestic Product
c) Net National Product
d) National Income

Answer: b) Gross Domestic Product

45. Which of the following transactions is included in the national income calculation?

a) Government spending on defense
b) Charity donations
c) Household labour without payment
d) Interest payments on loans

Answer: a) Government spending on defense

46. The income earned from exports of goods and services is included in the calculation of __________.

a) Gross National Income
b) Gross Domestic Product
c) Net Domestic Product
d) National Disposable Income

Answer: a) Gross National Income

47. In the income method of calculating national income, which of the following is included?

a) Wages and salaries
b) Transfer payments
c) Public debt
d) Foreign investments

Answer: a) Wages and salaries

48. The formula for calculating Net National Income (NNI) is____________

a) GNP – Depreciation
b) GDP – Depreciation
c) NNP + Depreciation
d) GNP + Depreciation

Answer: a) GNP – Depreciation

49. Which of the following is included in the calculation of GDP but not in GNP?

a) Wages of domestic workers employed abroad
b) Income earned by foreign nationals in the country
c) Government expenditure
d) Remittances sent by citizens working abroad

Answer: b) Income earned by foreign nationals in the country

Q-3 Give answers in brief:

1) Explain Product Method of National Income
2) Discuss the Income Method and Expenditure Method in brief.
3) How GDP, GNP, NNP is different from each other?
4) Explain the components of GDP in brief.

UNIT - 11 BUSINESS CYCLE AND FLUCTUATIONS

11.1 Introduction

Economic activity of most countries of the world is marked by waves of expansion and contraction. The economic history of these countries narrates good times and bad times, The economic activity in a country at times expands with production, employment, income and prices rising in accumulative manner. During depression economic activity slows down and the production income, employment as well as prices decline gradually, disturbances of these kinds are often witnessed in the economy. The courses of economic activities in a country at any given times run smooth. It is often market by occasional fluctuations these fluctuations or ups and downs are generally known as a trade cycles business cycles.

11.2 Meaning

Business cycle, also known as the economic cycle or trade cycle, is the fluctuations in economic activities or rise and fall movement of gross domestic product (GDP) around its long-term growth trend. Business cycle, also known as the economic cycle or trade cycle, is the fluctuations in economic activities or rise and fall movement of gross domestic product (GDP) around its long-term growth trend.

11.3 Definitions

The term business cycle refers to fluctuations in business activities in a country, in other words, it refers to fluctuations in production, employment and income of the people. Business cycles are a features of a free economy in which the role of govt. In economy matters is highly limited.

1.) Cyclic fluctuations are characterised by alternating waves of expansion and contraction. They do not have a fix rhythm, but they are cycle in the phases of contraction and expansion recur frequently and unfairly similar patterns.

- Estey

2.) A trade cycle is composed of period of good trade characterised by a rising prices and low unemployment percentage alternating with periods of characterised by falling prices and high unemployment percentage.

- Keynes

3.) Measuring business cycle is perhaps most satisfactory to borrow their words. Business cycles are a type fluctuations found in the aggregate economic activity of nations that organised their work. Mainly in business enterprises a cycle consist of expansions recurring at about the same time in many economic activities. This sequence of changes is recurrent but not periodic.

- Michell & Burns

11.4 Characteristics / Features of Business Cycle

(1) Cyclic fluctuation or trade cycles are marked by tides and cubes of economic activity rather than movement only in one direction. They are wave-like changes of expansion and construction following each other.

(2) Trace cycles have a regular cyclical sequence. The different phases of business cycle flow in a regular sequence.

Example: Expansion ultimately clears the trucks of recession into contraction. Contraction the way for revival around back to expansion the movement is thus clock wise.

(3) Cyclic fluctuation are universal i.e. they have a tendency to append in all the important spheres of business activities.

(4) Cyclic fluctuations also cross the boundaries of a nation and tend to become international in score.

(5) Although cycles have similar pattern and Shape no two trade cycles are exactly alive.

11.5 Kinds of Fluctuations:

1. Secular Trends:

Secular trends refer to continuous movement in one direction for a very long time. Such trends generally show or upward movement or economic activity spread over longer period though they may as well relate to sustained downward movement of economic activity.

2. Seasonal Fluctuations:

Seasonal fluctuations are variation in economic activity that takes place because of the effects of changing reasons. Seasonal fluctuation occurs during one year.

3 Random Fluctuations:

The term random fluctuation refers to changes in economic activity caused by unexpected natural calamities as also all sorts of other distributing factors. Like earthquake, fire, storms, flood, cyclones etc. cause such irregular untypical changes. Even war, elections, etc. also bring about changes. Such random irregular fluctuations are purely incidental & have no sequence.

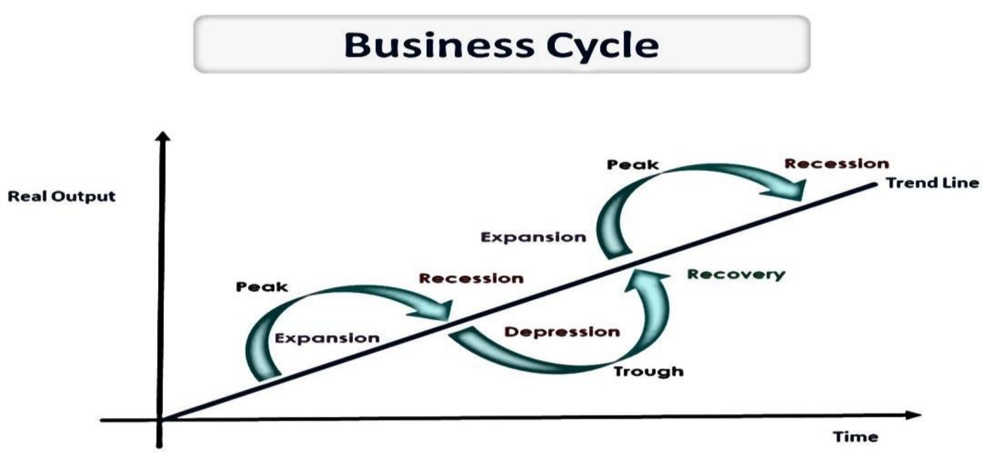
4. Cyclic Fluctuations:

They are alternating periods of business expansion and contraction following each other. They are typical wave like changes marked by boom? Burst of economic activity. Cyclical fluctuations are spread over a relatively longer period than that of seasonal changes, although their life - span is much shorter than that of secular trends. The life of a normal business cycle is about 7 to 11 years.

11.6 Phases of Trade Cycle

A trade cycle occurs when a country's economic growth rate changes. This can be attributed to a variety of variables, including fluctuations in consumer demand, money movements, and government policy. These swings force enterprises to rethink their production plans and investments. They can also affect employment levels, product and service prices, interest rates, and currency rates. The repercussions are far-reaching. During periods of expansion, increasing investment leads to higher productivity. It promotes economic growth while simultaneously lowering unemployment rates. In contrast, during a contraction, corporate activity slows as investment dries up, resulting in lower output and greater unemployment rates. Inflationary pressures may also develop as businesses pass on higher expenses owing to input prices.

According to the economist Joseph Schumpeter's trade cycle definition; these patterns of contraction and expansion in economic activities are inherent features of capitalist economies. Overall governments need to manage these cycles effectively for sustained long-term economic growth. They can achieve this through various fiscal measures, such as reducing taxes or increasing spending during recessions to stimulate aggregate demand. Central banks may also intervene through monetary policy, such as setting interest rates, which again helps regulate macroeconomic variables, like GDP growth and inflation over time.



Business cycle are a type of fluctuation found in the aggregate economic activity of nations that organize their work mainly in business enterprises: a cycle consists of expansions occurring at about the same time in many economic activities, followed by similarly general recessions, contractions, and revivals which merge into the expansion phase of the next cycle; in duration, business cycle vary from more than one year to ten or twelve years; they are not divisible into shorter cycle of similar characteristics with amplitudes approximating their own.

(1) Depression:

Here the purchasing power of money is high but that of man is law. The general purchasing power of the community being very low the productive activity both in the production of consumers' goods and producers goods. Especially the latter is at a very low level. Business settles down at a new equilibrium at a low level of prices costs and profits. This new adjustment may last for a number of years. A depression is a severe and prolonged downturn in economic activity. A depression may be defined as an extreme recession that lasts three or more years or that leads to a decline in real gross domestic product (GDP) of at least 10% in a given year. Depressions are far less common than milder recessions. Both tend to be accompanied by relatively high unemployment and relatively low inflation.

(2) Recovery:

After the depression has lasted for some time rays of hope appear. The depression contains within itself the germs of recovery. After the depression has lasted for some time the situation is found favorable for a business venture wages are low even for efficient workers sufficient number of whom is now available prices may be low. This includes an entrepreneur who may have sufficient financial barking to take the risk. Economic recovery is the business cycle stage following a recession that is characterized by a sustained period of improving business activity. Normally, during an economic recovery, gross domestic product (GDP) grows, incomes rise, and unemployment falls as the economy rebounds.

In this phase, there is a turnaround in the economy, and it begins to recover from the negative growth rate. Demand starts to pick up due to low prices and, consequently, supply begins to increase. The population develops a positive attitude towards investment and employment and production starts increasing. Employment begins to rise and, due to accumulated cash balances with the bankers, lending also shows positive signals. In this phase, depreciated capital is

replaced, leading to new investments in the production process. Recovery continues until the economy returns to steady growth levels. During an economic recovery, the economy undergoes a process of adaptation and adjustment to new conditions, including the factors that triggered the recession in the first place and the new policies and rules implemented by governments and central banks in response to the recession. The labor, capital goods, and other productive resources that were tied up in businesses that failed and went under during the recession are re-employed in new activities as unemployed workers find new jobs and failed firms are bought up or divided up by others. Recovery is an economy healing itself from the damage done, and it sets the stage for a new expansion.

(3) Prosperity / Full employment:

The commutative process of recovery continuous, till the economy reaches full employment. Full employment implies that all the available men are employed. During this Phase there is an all-round economic stability i.e. stability in output, wages, prices & incomes.

(4) Inflation (Boom):

The economy then reaches a saturation point, or peak, which is the second stage of the business cycle. The maximum limit of growth is attained. The economic indicators do not grow further and are at their highest. Prices are at their peak. This stage marks the reversal point in the trend of economic growth. Consumers tend to restructure their budgets at this point. Beyond the stage of full employment the rise in investment can only mean increased pressure for the available man and materials and hence rise in wages and prices. At this stage there is a hectic activity going on everywhere i.e. new buildings come up as well as many new trades are started. Money wages rise, profit increase and interest rates go up.

(5) Recession:

The recession is the stage that follows the peak phase. The demand for goods and services starts declining rapidly and steadily in this phase. Producers do not notice the decrease in demand instantly and go on producing, which creates a situation of excess supply in the market. Prices tend to fall. All positive economic indicators such as income, output, wages, etc., consequently start to fall. The entrepreneurs realize their mistakes and find that many of ventures started during the inflation (boom) period are not profitable. Business expansion stops, orders are cancelled and workers are laid off. Unemployment leads to fall on income, expenditure, prices and profits.

11.7 Effects of Fluctuations on Economy

Economic fluctuations are unpredictable and irregular. They do not follow regular patterns. Another characteristic is that macroeconomic factors such as employment and inflation change together. Also, when output decreases, unemployment rates increase. A leading cause of fluctuations in the economy is changes in macroeconomic factors such as productivity and employment. Another cause is changes in aggregate demand and supply. The business cycle is a continuous cycle of economic activity. It is not necessarily a good thing for the economy, but it is inevitable. Depending on the circumstances, the economy may undergo one or more cycles in a given period. Short-term fluctuations in the economy are the main reason for business cycles. These events lead to different levels of growth and decline. In the long run, it is a cycle of recessions and expansions. The economic cycle also affects the growth rate of businesses. A boom in an economy means that the demand for the goods and services will rise. During a downturn, it will be difficult for an economy to recover.

During a contraction, the economy will grow slower and produce less. During this time, it will become harder for businesses to find labor and produce goods. This is the best time to invest in your business, which is why economic cycles are so important for your business. If you're interested in the long run, the economic cycle will continue to affect you for a long period of times. This can be a good thing or a bad thing.

Economic fluctuations can affect both the real and the financial markets. When the economy is recovering from a recession, the price of goods and services will decrease. On the other hand, a strong demand for goods and services will lead to a rebound in prices. But there is also a downturn in the economy, so it is important to understand the causes and effects of these movements in the economy. This happens when the country has a strong GDP. During recessions, the economy experiences a cycle of expansion and contraction. These two periods of high economic activity are known as "business cycles." In these periods, a business may experience low demand, which results in a recession. If the economy is growing, demand is high and prices are low. A weak economy may also trigger a boom. While the business cycle can have an adverse effect on the market, the most common cause of economic fluctuations is the lack of money. The causes of an economic cycle are widely debated among different economic schools of thought. Monetarists, for example, link the economic cycle to the credit cycle. Here, interest rates, which intimately affect the price of debt, influence consumer spending and economic activity. On the other hand, a Keynesian approach suggests that the economic cycle is caused by volatility or investment demand, which in turn affects spending and employment.

11.8 How to Manage Economic Cycle?

Investors, financial institutions, and governments all respond differently to economic cycles. Governments may use expansionary fiscal policies, such raising spending and maintaining budget deficits, to boost the economy during a recession. In order to control excessive aggregate spending and keep the economy from overheating, they may, on the other hand, implement contractionary fiscal policies during times of economic expansion by increasing taxes and aiming for a budget surplus. Central banks use monetary policy to control economic cycles. In order to stimulate investment and spending during a slump, they may implement expansionary policies or cut interest rates. Contractionary monetary policy, on the other hand, involves raising interest rates and restricting credit in order to slow economic development during an economic upturn.

During periods of economic expansion, investors frequently concentrate on prospects related to technology, capital goods, and energy. On the other hand, they may move their investments to sectors like utilities, consumer staples, and healthcare that do well during recessions. Companies that keep an eye on how their performance links to economic cycles can make strategic plans to protect themselves from future downturns and take advantage of expansionary times. For example, early warning signs of an impending recession may caution against expanding your business if it develops similarly to the overall economy. It could be better to concentrate on increasing your cash reserves instead.

11.9 Factors Influencing the Business Cycle

There are many factors that can influence the business cycle. The following are some of the most important factors:

I. Global economic conditions: A country's business cycle may be impacted by the state of the economy in other countries. The recession in a country that exports a lot of goods to, say, a major trading partner may have an effect on that country's business cycle.

II. Business and consumer confidence: Confidence has a big impact on the business cycle. Optimism about the future increases the likelihood that businesses and consumers will spend money and support economic growth. When people lack confidence, they are less likely to spend money, which can lead to the economy faltering.

III. Economic policy: Governments and central banks' economic policy choices can have a big impact on the business cycle. For instance, adjustments to fiscal or monetary policy, such as adjustments to government spending, may have an impact on economic activity.

IV. Technological change: The business cycle can be significantly impacted by technological advancements. For instance, while the obsolescence of older technologies might result in a fall in economic activity, the introduction of new technology can boost productivity and economic growth.

V. Natural disasters and political instability: Natural disasters, such as hurricanes, earthquakes, and droughts, can disrupt economic activity and impact the business cycle and Political instability, such as wars, civil unrest, and changes in government, can also affect the business cycle.

❖ **Exercise:**

Q-1 Answer the following questions in detail.

1) Give the meaning and definition of Business cycle.
2) Write the characteristics / features of Business cycle.
3) State and explain the kinds of Fluctuations.
4) Describe the phases of Trade Cycle.
5) Explain the effects of fluctuations on economy.
6) How economic cycle can be managed? Explain in your own words.

Q-2 Multiple Choice Questions:

1) The term business cycle refers to______________________

- **A. Fluctuations in aggregate economic activity over time**
- B. Ups and down in the production of goods
- C. Increasing unemployment
- D. Declining savings

2. Which one of the following is not the characteristic of business cycle?

- A. They are recurrent
- B. They are not at regular intervals
- **C. They have uniform causes**
- D. All of the above

3. The turning points of the business cycle are ___________________

A. Expansion and peak
B. Peak and Contraction
C. Contraction and Trough
D. Peak and Trough

4. Which of the following is referred to the top or the highest point of business cycle ______________?

A. Expansion
B. Peak
C. Expansion and Peak
D. None of the above

5. Trade cycles are caused by_________________________________

A. Fiscal factors
B. Monetary factors
C. Both monetary and non-monetary factors
D. None of the above

6. During the phase of recovery_______________________

A. Aggregate demand remains constant
B. Aggregate demand increases
C. Aggregate demand decreases
D. None of the above

7. Who stated that "Trade Cycle is purely a monetary phenomenon".________________?

A. Keynes
B. Hawtrey
C. Crowther
D. Hayek

8. During the phases of recession of a trade cycle

A. Investment, income, employment and demand decline
B. Investment falls but income rises
C. Income, employment and investment rise
D. None of the above

9. During the downward phase of trade cycle, the central bank of the country should

A. Increase the cash reserve ratio
B. Lower-down the cash reserve ratio
C. Raise the bank rate
D. None of the above

10. When aggregate economic activity is declining, the economy is said to be in

A. An expansion
B. A contraction
C. A peak
D. A turning point

11. Peaks and troughs of the business cycle are collectively known as

A. Volatility
B. Turning points
C. Equilibrium points
D. Real business cycle events

12 Cost of living increases when business cycle is
A. Expanding
B. Contracting
C. At peak
D. At lowest point

Q-3 Write a Short note on following points:

1) Phases of trade cycle

2) Types/kinds of fluctuations

3) Effects of fluctuations on economy

UNIT - 12 GLOBALIZATION

12.1 Introduction

In simple terms, globalization is the process by which people and goods move easily across borders. Principally, it's an economic concept that means the integration of markets, trade and investments with few barriers to slow the flow of products and services between nations. Globalisation as an interchange of various attributes among different societies is not a new phenomenon, but an on-going process. What makes the present day process of globalisation different and distinct from the earlier ones is the rapid increase in the frequency and the density of these interchanges. It is important to learn more about the current pace of the process of globalisation and related aspects.

12.2 Meaning and Definition

The term globalisation refers to the integration of the economy of the nation with the world economy. It is a multifaceted aspect. It is a result of the collection of multiple strategies that are directed at transforming the world towards a greater interdependence and integration. It includes the creation of networks and pursuits transforming social, economic, and geographical barriers. Globalisation tries to build links in such a way that the events in India can be determined by the events happening distances away. To put it in other words, globalisation is the method of interaction and union among people, corporations, and governments universally.

Globalization is the process by which ideas, knowledge, information, goods and services spread around the world. In business, the term is used in an economic context to describe integrated economies marked by free trade, the free flow of capital among countries and easy access to foreign resources, including labour markets, to maximize returns and benefit for the common good. Globalization is driven by the convergence of cultural and economic systems. This convergence promotes and in some cases necessitates increased interaction, integration and interdependence among nations. The more countries and regions of the world become intertwined politically, culturally and economically, the more globalized the world becomes.

In very simple terms globalisation can be depicted as increasing global interconnectedness. It is a process rather than an outcome, which refers to the trend toward the growing interconnectedness of different parts of the world, not to their being interconnected. It primarily is an interchange of economic, social, cultural, political, technological attributes that takes place between societies when different societies come into contact with each other. Though this interchange is going on for times immemorial, this process was termed as “globalisation” for the first time around the second half of 20th century while much of the literature on this has appeared since the late 1970s and 1980s (Beyer 2003).

Henderson (1999), an economist, views globalisation as a model of fully internationally integrated markets meeting the two conditions of i) the free movement of goods, services, labour and capital resulting in a single market in inputs and outputs, and ii) full national treatment for foreign investors as well as nationals working oversees, so that economically speaking there are no foreigners. For Meghnad Desai (2004) globalisation is the growing reciprocal interdependence and integration of various economies around the globe.

12.3 Concept and Importance

12.3.1 Concept

Globalization is more than just an economic phenomenon; it has had a deep impact on society and culture. It offers some advantages as well as disadvantages, but the advantages outweigh the disadvantages as globalization allows people to experience new cultures and ways of life that were previously inaccessible due to geographical boundaries. Globalization changes the way nations, businesses and people interact. Specifically, it changes the nature of international economic activity, expanding trade, opening global supply chains and providing access to natural resources and labour markets. Changing the way trade and financial exchange and interaction occur among nations also promotes the cultural exchange of ideas. It removes the barriers caused by geographic constraints, political boundaries and political economies.

For example, globalization enables businesses in one nation to access another nation's resources. More open access changes the way products are developed, supply chains are managed and organizations communicate. Businesses find cheaper raw materials and parts, less expensive or more skilled labour and more efficient ways to develop products.

With fewer restrictions on trade, globalization creates opportunities to expand. Increased trade promotes international competition. This in turn, spurs innovation and in some cases, the exchange of ideas and know-how. In addition, people coming from other nations to do business and work bring with them their own cultures, which influence and mix with other cultures. The many types of exchange that globalization facilitates can have positive and negative effects.

For instance, the exchange of people and goods across borders can bring fresh ideas and help business. However, this movement can also increase the spread of disease and promote ideas that might destabilize political economies. For example, increased international trade and travel in the late 1990s led to West Nile Virus being introduced to North America, likely as a result of infected species being transported or people traveling there.

12.3.2 Importance

Globalisation is important to expand the markets and enable a business to make a sensible utilisation of the available resources. It also solves various issues of an individual and the nation, giving them many options to choose from and satisfy their needs.

Globalisation boosts exports, discourages import, and uplifts foreign exchange. The points of importance of Globalization are as follows:

1. Access to new cultures

One of the most important impacts has to do with people's exposure to other cultures. As borders between different countries become more permeable, it becomes much easier for citizens of one country to experience other ways of living and visiting different places. With globalization, understanding other people's culture becomes a lot easier and simpler so it certainly makes sense for people who have no interest in going abroad whatsoever to explore the opportunities that globalization offers them.

Trade allows countries to specialize in what they produce the most efficiently and sell their goods for a profit, while importing goods that cannot be produced domestically or are cheaper to import than produce locally.

2. Technology and Information

Globalization is useful not only for opening doors to new places but also for sharing technology and information across borders so everyone can benefit from it, especially those who live in less developed countries, so they experience important improvements which increase their standard of living. Globalization enables access to different kinds of information across borders, which people use to improve their lives in various ways. For example, when countries adopt certain technologies developed by other countries, this improves employment conditions for their citizens.

3. Economic growth

The world's economy is expected to grow by 4.9 percent by 2022, just because of globalization. This shows how globalization can be a big step forward towards economic growth and prosperity for everyone, encouraging countries to produce more goods and services. India is projected to be the fastest growing economic among the G20 Countries with a 7% GDP growth rate for 2024, followed by Indonesia in the second spot with 5 %while China is ranked 3rd with an economic growth rate of 4.8%

4. Better job opportunities

On a similar note, globalization increases the availability of jobs worldwide which is a great thing for people because more job opportunities mean higher salaries and living standards, which in turn keeps bringing new money into the economy so it feeds itself allowing everyone to benefit from globalization.

5. Lowers the costs

When a commodity becomes available from another region or country, it gets produced there instead of somewhere else, which drives the costs of that commodity down worldwide. This makes goods and services more affordable for everyone who can then purchase them.

6. Allows people to stay

Globalization helps local people maintain their traditions and way of living because they don't have to migrate or leave their home countries in search of better lifestyles somewhere else. Especially to a place where they'd have to abandon all that's familiar and important to them just for the sake of earning more money. This ultimately benefits many families – financially and emotionally.

7. Globalization erases the borders

Because of globalization, the world has become a much smaller place where distances between countries have been eliminated which allows people to do things much more easily and quickly than before. Thanks to globalization, it's now easier for everyone to visit new places or see what life is like there because you can always find information about them on the internet or watch international TV channels.

8. Better acceptance of self

Globalization has made us more accepting towards self. Countries are now more aware of different cultures and traditions, which helps them. This growing openness towards different cultures has helped us learn what makes us special and unique, while at the same time learning about the similarities we share with one another.

9. Increased Productivity

Globalization makes us more productive by enabling us to use resources from around the world, which allows us to produce better results without having to increase our efforts or work hours. This is part of what's known as economies of scale where businesses can make huge profits by producing more items with less effort and time while still charging the same price for each item.

10. Promotes cultural diversity

One of the best things about globalization is that it spreads different cultures and traditions worldwide which helps us learn from one another, making us more tolerant towards those who are different from ourselves as well as accepting our own differences as something special. This ultimately makes everyone feel appreciated for being unique individuals

11. Prepares for future challenges

The future is unknown, which is why it's important to prepare ourselves for whatever might come next. Globalization has made the world more connected which allows us to work together towards the future by sharing ideas and experiences that will help us overcome any obstacles we might face, regardless of where they come from.

12. Reduces inequality

In a world where globalization is widely accepted, those who work hard will be able to climb the social ladder despite their background because everyone has equal opportunities. Those who were born into poor families can pull themselves out of poverty by learning new skills and embracing global knowledge which allows them to get better jobs and move up the social ladder.

13. Resolves disputes

Conflicts can occur anywhere in the world, which is why it's important for us to have a way to resolve them quickly while minimizing any damage that they might cause. When we are all aware of each other's culture and traditions, we can easily work together to resolve any issues that might arise and avoid such conflicts from happening again.

14. Empowers individuals

One of the most important things that globalization brings with it is a sense of empowerment for individuals who no longer have to rely on others in order to get what they want, instead taking matters into their own hands and going after whatever will make them happy. This sense of independence makes life much more enjoyable for those who embrace it as globalization continues to grow around us as we speak.

15. Value of people

Although technology and culture might change with time, globalization ensures that people's values will remain the same regardless of such changes since it allows them to grow alongside one another instead of becoming isolated from each other. This helps protect our traditions and keeps our cultures from disappearing as technology and culture continue to change.

12.4 LPG

LPG stands for Liberalization, Privatization, and Globalization. India under its New Economic Policy approached International Banks for development of the country. These agencies asked Indian Government to open its restrictions on trade done by the private sector and between India and other countries. Indian Government agreed to the conditions of lending agencies and announced New Economic Policy (NEP) which consisted wide range of reforms. Broadly we can classify the measures in two groups:

1. Structural Reforms

With long-term perspective and eyeing for improvement of the economy and enhancing the international competitiveness, reforms were made to remove rigidity in various segments of Indian economy i.e. Liberalization and Indian Economy During Reforms.

2. Stabilization Measures (LPG)

These measures were undertaken to correct the inherent weakness that has developed in Balance of Payments and control the inflation. These measures were short-term in nature. Various Long-Term Structural Reforms were categorized as Liberalization, Privatization and Globalization. Collectively they are known by their acronym LPG. The balance of Payment is the system of recording the economic transactions of a country with the rest of the world over a period of one year. When the general prices of goods and services are increasing in an economy over a period of time, the same situation is called Inflation.

12.4.1 Liberalization

The basic aim of liberalization was to put an end to those restrictions which became hindrances in the development and growth of the nation. The loosening of government control in a country and when private sector companies' start working without or with fewer restrictions and government allow private players to expand for the growth of the country depicts liberalization in a country.

- **Objectives of Liberalization Policy**
  - To increase competition amongst domestic industries.

- To encourage foreign trade with other countries with regulated imports and exports.
- To enhance foreign capital and technology.
- To expand global market frontiers of the country.
- To diminish the debt burden of the country.

12.4.2 Privatization

This is the second of the three policies of LPG. It is the increment of the dominating role of private sector companies and the reduced role of public sector companies. In other words, it is the reduction of ownership of the management of a government-owned enterprise. Government companies can be converted into private companies in two ways:

- By disinvestment
- By withdrawal of governmental ownership and management of public sector companies.

12.4.2.1 Forms of Privatization

1) Denationalization or Strategic Sale: When 100% government ownership of productive assets is transferred to the private sector players, the act is called denationalization.

2) Partial Privatization or Partial Sale: When private sector owns more than 50% but less than 100% ownership in a previously construed public sector company by transfer of shares, it is called partial privatization. Here the private sector owns the majority of shares. Consequently, the private sector possesses substantial control in the functioning and autonomy of the company.

3) Deficit Privatization or Token Privatization: When the government disinvests its share capital to an extent of 5-10% to meet the deficit in the budget is termed as deficit privatization.

➢ **Objectives of Privatization**

- Improve the financial situation of the government.
- Reduce the workload of public sector companies.
- Raise funds from disinvestment.
- Increase the efficiency of government organizations.
- Provide better and improved goods and services to the consumer.
- Create healthy competition in the society.
- Encouraging foreign direct investments (FDI) in India.

12.4.3 Globalization

It means to integrate the economy of one country with the global economy. During Globalization the main focus is on foreign trade & private and institutional foreign investment. It is the last policy of LPG to be implemented.

Globalization as a term has a very complex phenomenon. The main aim is to transform the world towards independence and integration of the world as a whole by setting various strategic policies. Globalization is attempting to create a borderless world, wherein the need of one country can be driven from across the globe and turning into one large economy. The most important outcome of the globalization process is Outsourcing. During the outsourcing model, a company of a country hires a professional from some other country to get their work done, which was earlier conducted by their internal resource of their own country. The best part of outsourcing is that the work can be done at a lower rate and from the superior source available anywhere in the world. Services like legal advice, marketing, technical support, etc. As Information Technology has grown in the past few years, the outsourcing of contractual work from one country to another has grown tremendously. As a mode of communication has wide reach, all economic activities have expanded globally.

Various Business Process Outsourcing companies or call centres, which have their model of a voice-based business process, have developed in India. Activities like accounting and book-keeping services, clinical advice, banking services or even education are been outsourced from developed countries to India. The most important advantage of outsourcing is that big multi-national corporate or even small enterprises can avail good services at a cheaper rate as compared to their country's standards. The skill set in India is considered most dynamic and effective across the world. Indian professionals are best at their work. The low wage rate and specialized personnel with high skills have made India the most favourable destination for global outsourcing in the later stage of reformation.

12.5 Effects of Globalization on Economy

India is one of the countries that succeeded significantly after the initiation and implementation of globalisation. The growth of foreign investment in the field of corporate, retail, and the scientific sector is enormous in the country.

It also had a tremendous impact on the social, monetary, cultural, and political areas. In recent years, globalisation has increased due to improvements in transportation and information technology. With the improved global synergies, comes the growth of global trade, doctrines, and culture. Indian society is changing drastically after urbanisation and globalisation. The economic policies have had a direct influence in forming the basic framework of the economy. Economic policies established and administered by the government also performed an essential role in planning levels of savings, employment, income, and investments in the society.

Cross country culture is one of the critical impacts of globalisation on Indian society. It has significantly changed several aspects of the country, including cultural, social, political, and economical. However, economic unification is the main factor that contributes maximum to a country's economy into an international economy. In short, there are some positive impacts of globalisation like Creates efficient markets, Increases competition, Stabilises security and Increases wealth equality across the world.

i. Increase in employment

With the opportunity of special economic zones (SEZ), there is an increase in the number of new jobs available. Including the export processing zones (EPZ) centre in India is very useful in employing thousands of people.

ii.Cheap labour

This feature motivates the big companies in the west to outsource employees from other regions and cause more employment. Increase in compensation: After globalisation, the level of compensation has increased as compared to the domestic companies due to the skill and knowledge a foreign company offers. This opportunity also emerged as an alteration of the management structure. High standard of living: With the outbreak of globalisation, the Indian economy and the standard of living of an individual have increased. This change is notified with the purchasing behaviour of a person, especially with those who are associated with foreign companies. Hence, many cities are undergoing a better standard of living along with business development.

iii. Outsourcing

This is one of the principal results of the globalisation method. In outsourcing, a company recruits regular service from the outside sources, often from other nations, that was earlier implemented internally or from within the nation (like computer service, legal advice, security, each presented by individual departments of the corporation, and advertisement). As a kind of economic venture, outsourcing has increased, in recent times, because of the increase in quick methods of communication, especially the growth of information technology (IT). Many of the services such as voice-based business processes (commonly known as BPS, BPO, or call centres), accountancy, record keeping, music recording, banking services, book transcription, film editing, clinical advice, or teachers are being outsourced by the companies from the advanced countries to India.

iii. Individuals

A variety of international influences affect ordinary people. Globalization can make it easier for people to access raw materials, products and services. It can also lower the prices they pay and their ability to travel to other countries.

iv. Communities

Globalization also changes how local and regional organizations, businesses and economies function and interact. It affects who lives in communities, where they work, who they work for, their ability to move out of their community and into one in another area, etc. Globalization also changes the way local cultures develop within communities.

v. Institutions

Multinational corporations, national governments and other organizations such as colleges and universities are all affected by their country's approach to and acceptance of globalization. Globalization affects the ability of a company to grow and expand a university's ability to diversify and grow its student body and a government's ability to pursue specific economic policies.

12.6 Types of Globalization

The impacts of globalization are multi-dimensional. It affects worldwide societies in the aspects of Economic, Social, Political, Cultural, and environmental. There are main 5 types of globalization.

1) Economic Globalization
2) Social Globalization
3) Cultural Globalization

4) Political Globalization
5) Environmental Globalization

1. Economic Globalization

The emphasis here is on the integration of international financial markets and the coordination of financial trade. Economic globalisation is represented through free trade agreements like the Trans-Pacific Partnership and the North American Free Trade Agreement. Economic globalisation is greatly influenced by multinational firms, which have business in two or more nations. The concept of globalization as a whole is largely economic. Globalization has emerged and developed mainly as an economic concept and system. Economic globalization is the economic connection of a country with the global economic system. Globalization in the economic field is free economic adoption. This is to remove the regulatory rules imposed on a country's economic affairs and to expose the domestic economy to the world.

➢ **Features of Economic Globalization**

Prominent economist **Peter Drucker** in his **New Realities** discusses the economic features of globalization. They are as follows:

i. Due to globalization, international organizations have spread globally to make the entire world a mere production and product-service market.

ii. The main objective of the global economy is to maximize the market.

iii. Investment in the globalization process has become a trade, not an investment in the trade.

iv. Due to globalization, the power to make decisions is transferred from the national state to the regional alliances.

v. In the globalization economy, the management system dominates as a component of production.

vi. Globalization is mainly driven by the transaction of money. Again, the existence of an individual response to these financial transactions is seen. Unproductive foreign capital creates adverse effects on the global market.

vii. In economic globalization, there is a process of almost spontaneous lending, finance, and investment throughout the world. Information beyond the borders of the national state organizes this process.

2. Social Globalization

It is another one of the important types of globalization. Social globalization is a process. As a result of this process, traditional social institutions become weak. The identity of the socialized people is renewed. People are no longer members of a particular community or nation because of the new identity. In the pre-modern world, the context of human identity was narrow and limited. In terms of family, ethnicity, tribe, village, religion, etc., the identity of individual people was determined.

The target population is also made up of the population of the state. As a member of the state, the identity of the citizenship or nationality of the people prevails. According to the opinion of a group of sociologists, as the globalization process expands, the personal and collective identities of people become weaker. Former identities of the past lose their importance. Relationships with people from distant places developed due to the development and expansion of new technologies, the expansion of business and communication systems, In this case, the Internet, e-mail, website, etc. opens up a new world in front of people.

3. Cultural Globalization

This element of globalisation mainly focuses on the sociological and technological elements that are generating cultural integration. These include improved communication, widespread use of social media, and access to better and faster transportation. The process of cultural globalization is also sometimes called McDonaldization. Cultural globalization is the process by which a world-class of goods, ideas, and information is produced in one part of the world. As a result, cultural differences between different races, regions, and individuals are removed.

The emergence and development of international or multinational companies and the emergence of global goods have partly driven the process of globalization. The revolutionary development and expansion of information technology, the expansion of satellite-based communication systems, the Internet, the telecommunication infrastructure, and various global media corporations are highlighting the process of globalization.

However, as culture helps globalization, so does obstruction. As the elements or forces of globalization are enriched by culture, so is resistance. Hollywood movies are screened worldwide. Adidas sports goods are sold around the world. The Coca-Cola market is worldwide. McDonald's has demanded the world's fast food market. Such products are many and varied worldwide. But all these international brands have to do with the dignity of local culture and the touch of social customs.

4. Political Globalization

This type of globalisation includes policies made by the government that encourages and foster international cooperation on a political, economic, and cultural level. The UN and NATO, for example, are involved in the political globalisation process. Political ideology is often referred to as one of the characteristics of globalization. That is, the expression of globalization also occurs in political ideology.

The transformation of liberalism is called an example of political ideology in the process of globalization. Moreover, the emergence, development, and expansion of Non-Governmental Organizations (NGOs) as an expression of political globalization; The role of the national states is to refer to the role of climate change and so on. The expression of political globalization has occurred in international organizations. All these organizations exceed the national boundaries.

Extending the boundaries of the single state of the international organization extends to the international sphere of many states. There are many and many international organizations in the present world. Most of these were formed in the aftermath of World War II. Notable examples of this are the United Nations Organization (UNO), the European Economic Community (EEC), the World Bank, the International Monetary Fund (IMF), and the World Trade Organization (WTO), etc. Theoretically, nation-states can take the initiative in organizing international organizations in a coherent and organized manner without sacrificing their sovereignty. Transnational-state boundaries may force international institutions to impose their will on states.

5. **Environmental Globalization**

Environmental globalization refers to internationally coordinated practices and regulations in the form of international treaties regarding environmental protection. The growth of globalization and its impact on the global environment is an important concern to the world.

According to some environmentalists, there is no doubt that the tide of development that has come under the influence of globalization is actually polluting the environment. To them, globalization increases our consumption of a lot of products made through natural resources which is affecting the ecological cycle very badly. Many think that industrialization is part of globalization and the process of industrialization has been increasing with the help of globalization. Due to industrialization harmful chemicals have been thrown to the environment and it affects the environment dangerously.

12.7 Advantages and Disadvantages of Globalization

12.7.1 Advantages of Globalization are as follows:

1. Employment Growth

The creation of Special Economic Zones (SEZs) has increased the number of new jobs that are available. It is highly beneficial to include the export processing zones (EPZs) centre in India in order to employ lakhs of people. India's affordable labour is an additional element. As a result, large corporations hire workers from other areas, which lead to an increase in employment.

2. Increase in Compensation

As a result of globalisation, international corporations now offer more skill and expertise than domestic companies, which has led to an increase in compensation. This opportunity also caused changes to the managerial structure.

3. High Level of Living

With globalisation, both the Indian economy and the average person's standard of living have improved. This shift is visible in a person's purchasing habits, particularly among those who work for overseas corporations. Thus, a higher standard of life and business development is occurring in many places.

4. Encourages Mutual Understanding across Cultures

It improves accessibility to travel and encountering diverse cultures as a good aspect of globalisation that can foster cooperation and peace on a global scale.

5. Encourages Economic Growth

Theoretically, globalisation provides less developed nations with access to capital and technology from abroad that they would not otherwise have. Foreign investment can raise the living standards of those countries' populations.

6. Transfer of technology

Transfer of technology throughout the globe is good for us. Any country can borrow the technology through the agreement and can implement it in their country for their overall development. We can communicate with each other easily from any part of the globe by using advanced technology at minimal cost, time, and effort.

7. Better Services

Globalization always provides us with better services. Through technological advancement, our services like water supply, mobile networking, internet, electricity supply, and other services have been easier and better than before. By the way, easy access to the internet throughout the globe is also the result of globalization.

8. Standardization of Living

The integration of economies as the key process of globalization enables countries to fight against poverty and improve the standard of living of the people. Many researchers have stated that when a country opens up its trade to the globe, its rate of economic growth is faster and living standards tend to increase.

9. Development of Infrastructure

Technological advancement and its transfer throughout the globe help to improve the country's infrastructure. Countries are more enabling to deliver their services to the people. The development of infrastructure means the overall development of respective countries. Here it is necessary to say that economic growth and the development of infrastructure are compatible with each other.

10. Foreign Exchange Reserves

Through globalization, countries can build foreign exchange reserves owing to international financial flows.

11. Economic Growth

Globalization entails to optimum utilization of resources wherein deficit resources are procured and surplus resources are exported to other countries. This ensures overall economic growth.

12. Affordable Products

With access to the latest technology, the countries can provide products to their countrymen at affordable prices. Globalization promotes competition in domestic economies and in their endeavour to compete against competition; companies reduce product prices or follow a penetration pricing strategy.

13. Contribution to World GDP Growth Rate –

Globalization ensures the contribution of every country to the world's GDP growth.

14. Extensions of Market

Above all, Globalization promotes the extension of the market. It provides an opportunity for domestic companies in going global. For instance, domestically, companies can witness saturation in the demand for their products or services but through globalization, domestic companies can sustain and satisfy the growing demands of foreign customers.

12.7.2 Disadvantages of Globalisation

1. Instability in the market

The removal of trade restrictions and increased freedom of movement are cited as reasons why national policies and regional cultures are being undermined by proponents of globalisation. Labour markets are impacted when people cross borders in quest of higher-paying jobs or when businesses outsource work and positions to cheaper labour markets.

One of the significant effects of globalisation is outsourcing. Outsourcing is the practice of contracting out third-party activities that were previously handled by the organisation. For instance, many businesses now contract with other organisations to provide security services. Due to the development of faster methods of communication, especially the development of information technology, it has become more intense in recent times. Modern telecommunication systems allow digitized text, speech, and visual information related to these services to be transmitted in real-time across continents and national boundaries.

2. Causes environmental damage

Transporting products and people across borders releases greenhouse gases and has a negative impact on the environment. Industries like fishing and logging frequently relocate to areas with the best economic opportunities or rules, which has led to overfishing and deforestation in some regions of the world.

3. Encourages worldwide economic recessions

A greater likelihood of global recessions exists in tightly integrated global markets. A good illustration of how interconnected global markets are and how financial issues in one country or region can quickly influence other parts of the world is the 2007–2009 financial crises and the Great Recession. The ability of individual countries to effectively use monetary and fiscal policy to govern the national economy is diminished by globalisation.

4. Growing inequality

Globalization can increase inequality throughout the world by increasing specialization and trade. Although specialization and trade boost the per-capita income it may cause relative poverty. For Example, All dominated MNCs in the world are located in the United States. All these companies are buying cheaper labour from developing or underdeveloped countries for their product manufacturing or assembling. China, India, and Africa are prime examples of this. It increases the employment of such countries but they are lagging behind relatively developed countries. Again those companies coming to these countries for cheap labour, they also deprive of that country's i.e. American people from work. So it appears that relative poverty is being created in developed countries as well.

5. Increasing the unemployment rate

Globalization can increase the unemployment rate. Globalization demands higher-skilled work at cheaper prices. But countries, where Institutions are relatively weak, are not capable of producing highly skilled workers. As a result, the unemployment rate is increasing in those countries. When many foreign companies invest heavily in developing countries, they hire employees from that country. In some cases, their salaries are very lower than in other developed countries. Moreover, the demand for these employees in developed countries is very low. Moreover, with the emergence of the Global Economic Crisis, their jobs are at risk of losing.

6. Trade imbalance

The balance of trade refers to the balance of values between a country's exported and imported goods and services. As a result of globalization, any country can trade with any part of the globe. That is why, in some cases, developing countries are so much dependent on developed countries in terms of importing goods but their export capabilities are lower than import. The trade imbalance has been occurring. So, trade imbalance refers to the imbalance of values between a country's import and export goods and services. It is also called a trade deficit. Trade imbalance may be increased in developed countries by their competitors.

7. Environmental concern

The pace of industrialization is increasing as a result of globalization. Industrialization boosts economic growth but it harms the environment as well. Globalization loots nature and it harms us very badly. For example,

i. Coca-Cola is the world's leading soft drink company. This company consumes a huge amount of water for making soft drinks. In a state of northern India, Uttar Pradesh, a Coca-Cola bottle plant was closed by the government order because of too much usage of water claimed by local farmers.
ii. In North India, the level of groundwater is very low, but huge usage of this water for the interest of an MNC is very harmful to domestic farming.
iii. In Kerala, a state in southern India, the Coca-Cola plant was also closed due to the pollution of the water which was supplied to the local communities.
iv. Also, MNCs use the natural resources of different countries extensively for their personal gain.
v. Various chemical industries are very harmful to our health by polluting the soil, water, and air.

❖ **Exercise**

Q-1 Multiple choice questions:

1) ______________means integrating the Indian economy with the world economy.
   a. Liberalisation
   b. Privatisation
   c. Globalisation
   d. None of the above

2) Globalisation is the outcome of__________ and ________.
   a. Liberalisation
   b. Privatisation
   c. Globalisation
   d. Both (a) and (b)

3) Globalisation aims to create ____________ world.

a. Limited
b. Restricted
c. Borderless
d. None of the above

4) What is the amalgamation and rapid unification between countries identified as?
a. Globalisation
b. Liberalisation
c. Socialisation
d. Privatisation

5) Globalisation has improved the living structure of which of the following?
a. All the people
b. People living in developing countries
c. People living in developed countries
d. None of the above

6) Which Indian industries have been hit by globalisation?

a. Cement
b. Jute
c. Toy making
d. Information technology (IT)

7) Which of these organisations emphasises on the liberalisation of foreign investment and foreign trade?

a. International Monetary Fund
b. World Health Organisation
c. World Trade Organisation
d. International Labour Organisation

8) Tax on imports is considered as an example of __________
a. Collateral
b. Trade barriers
c. Foreign trade
d. Terms of trade

9) Which of the following is the main reason behind the investments of MNCs?

a. To benefit foreign countries
b. To provide financial support to the country's government
c. For the welfare of underprivileged people
d. To increase the assets and earn profits

10) Which of these institutes supports investments and foreign trade in India?
a. International Monetary Fund (IMF)
b. World Trade Organisation (WTO)
c. World Bank
d. International Labour Organisation (ILO)

Q-2 Answer the following Questions:

1) Give meaning and definition of Globalization.
2) Write the concept and importance of Globalization.
3) Write a note on LPG.
4) What are the effects of Globalization on economy?
5) State and explain the types of Globalization
6) What are the advantages and disadvantages of Globalization?

UNIT - 13 FINANCIAL INSTITUTIONS

13.1 Introduction

Financial institutions are organizations that provide various services related to money management, including lending, investing, and facilitating financial transactions. They play a vital role in the economy by supporting economic growth, enabling businesses and individuals to manage financial risks, and fostering the flow of capital.

There are several types of financial institutions, each serving different needs. Commercial banks are the most common, offering services like deposit accounts, loans, and payment processing. Investment banks focus on helping businesses raise capital, engage in trading, and provide advisory services on mergers and acquisitions. Credit unions, member-owned cooperatives, offer similar services to banks but generally at more favourable rates for members. Insurance companies provide coverage against risks such as health, life, and property, while pension funds manage retirement savings for individuals. Mutual funds pool money from investors to invest in a diversified portfolio of stocks, bonds, and other assets.

Additionally, microfinance institutions provide small loans to low-income individuals in developing countries, helping them start businesses or improve their livelihoods. Hedge funds are investment firms that cater to wealthy clients, using high-risk strategies to maximize returns.

Financial institutions serve key functions in the economy: they mobilize savings, provide credit, manage risk, facilitate payments, and offer investment opportunities. By acting as intermediaries between savers and borrowers, these institutions help channel funds into productive investments, supporting both personal financial goals and broader economic development. They also foster financial stability, ensuring efficient resource allocation and promoting confidence in the financial system. In short, financial institutions are essential for the smooth functioning of modern economies and the financial well-being of individuals and businesses alike.

13.2 Meaning

Financial institutions are organizations that provide various financial services, playing a crucial role in the economy by facilitating the flow of money and credit. They serve as intermediaries between savers and borrowers, helping individuals, businesses, and governments manage their financial needs. There are different types of financial institutions, each with specific functions.

Commercial Banks are the most common type, offering services such as savings and checking accounts, loans, and credit. They are the primary source of credit for consumers and businesses. Investment Banks specialize in helping companies raise capital, providing advisory services, and facilitating mergers and acquisitions. They also deal with securities trading and asset management.

Insurance Companies provide risk management by offering policies that protect individuals and businesses from financial losses caused by accidents, illnesses, or property damage. Credit Unions are member-owned institutions that offer many of the same services as commercial banks but tend to focus on serving a specific community or group. They often offer lower fees and better interest rates due to their nonprofit nature.

Pension Funds manage retirement savings for individuals or employees, investing the contributions to generate returns that provide income during retirement. Mutual Funds pool money from many investors to invest in a diversified portfolio of stocks, bonds, or other assets. Hedge Funds and Private Equity Firms are more specialized institutions that cater to high-net-worth individuals or institutional investors, often focusing on high-risk, high-reward investment strategies.

Together, these institutions contribute to economic stability by enabling savings, investment, and efficient allocation of resources, making them essential to the functioning of both national and global economies.

13.3 Definition

The definition of financial institutions varies slightly depending on the perspective and focus of the author. Below are some definitions by different authors:

Hodgetts (2002) defines financial institutions as "organizations that provide services as intermediaries between those who need capital and those who have it." According to this definition, financial institutions facilitate the transfer of funds from savers to borrowers, enabling economic activity and growth.

Mishkin (2007) describes financial institutions as "organizations that provide financial services such as loans, insurance, and investment management." Mishkin emphasizes the broad scope of financial services these institutions offer, ranging from basic banking services to more complex investment options.

Saunders & Allen (2010) define financial institutions as "entities that facilitate the flow of capital in the financial system, providing a platform for the exchange of funds between savers and borrowers." This definition focuses on the intermediary role that financial institutions play in connecting different participants in the economy.

Black & Skipper (2017) provide a comprehensive definition, stating that "financial institutions are organizations that pool, allocate, and manage funds to meet the financial needs of individuals, businesses, and governments." This definition highlights their role in managing risks and helping with the allocation of financial resources.

Gordon & Natarajan (2011) define financial institutions as "institutions that deal with the mobilization of savings and provide a mechanism for the investment of funds into productive ventures." This focuses more on the role of financial institutions in channelling savings into investment activities that promote economic development.

In essence, while the terminology may differ, all definitions agree that financial institutions are vital intermediaries that facilitate the efficient movement of capital, contribute to economic growth, and provide services that help manage financial risks and investments.

13.4 Concept

Definition: Financial institutions are organizations that provide a wide range of financial services, acting as intermediaries between savers and borrowers. They facilitate the movement of money and capital in the economy, supporting economic growth, investment, and development.

13.4.1 Types of Financial Institutions:

Commercial Banks: These are the most common type, offering services like savings accounts, checking accounts, loans, and mortgages. They cater to individuals, businesses, and governments.

Investment Banks: Specialize in large, complex transactions such as underwriting securities, mergers and acquisitions, and advisory services for corporations. They also deal with securities trading.

Credit Unions: Nonprofit institutions that provide financial services to members who share a common bond (e.g., employees of a company, members of a community). They often offer lower interest rates and fees compared to commercial banks.

Insurance Companies: Provide risk management by offering insurance products, including life, health, property, and casualty insurance. They help individuals and businesses mitigate financial risks.

Pension Funds: Manage retirement savings, investing contributions made by individuals or employees to ensure a source of income during retirement.

Mutual Funds: Pool capital from multiple investors to create diversified investment portfolios, providing individuals access to a wide range of securities like stocks, bonds, and other assets.

Hedge Funds and Private Equity Firms: These institutions cater to high-net-worth individuals and institutional investors, using advanced strategies like leveraging, derivatives, and market speculation to generate high returns.

13.4.2.Functions of Financial Institutions:

Mobilization of Savings: Financial institutions encourage individuals and organizations to save by offering various types of deposit accounts, thereby helping to pool idle funds.

Providing Credit: They lend money to individuals, businesses, and governments, helping to finance consumption, investment, and development projects.

Risk Management: By offering insurance and investment products, financial institutions help mitigate risks associated with health, property, business activities, and financial markets.

Facilitating Payments: Financial institutions provide payment systems such as electronic funds transfers, credit/debit card services, and checks that enable the efficient transfer of money.

Investment Facilitation: By offering investment options like stocks, bonds, and mutual funds, financial institutions help channel funds into productive investments that promote economic growth.

Economic Role: Financial institutions ensure the efficient allocation of resources by directing funds from savers to borrowers, which supports business expansion, innovation, and infrastructure development. They contribute to price discovery and liquidity in financial markets by buying and selling assets, such as stocks and bonds.

Regulation and Oversight: Financial institutions are typically regulated by government agencies (e.g., central banks, financial regulatory authorities) to maintain financial stability, protect consumers, and prevent fraud and abuse in the system. In summary, financial institutions are integral to the functioning of modern economies. They provide essential services like saving, lending, investing, and risk management, thus ensuring the smooth flow of capital, promoting economic stability, and fostering growth.

13.5 Importance

Financial institutions are the backbone of any economy, playing a pivotal role in supporting economic growth, stability, and development. These institutions provide the infrastructure for the efficient functioning of the financial system, facilitate the movement of capital, and help individuals, businesses, and governments manage financial resources effectively. Below are key points that highlight the importance of financial institutions in an economy:

13.5.1. Facilitating Capital Allocation

One of the primary functions of financial institutions is to allocate resources efficiently. These institutions collect funds from savers and direct them toward borrowers who need capital for investment. By offering loans, mortgages, and credit, financial institutions help businesses expand, households make large purchases, and governments fund infrastructure projects. This efficient allocation of capital drives economic activity, promotes investment in innovation, and fosters the growth of industries, which in turn contributes to overall economic development.

13.5.2. Promoting Economic Growth

Financial institutions are essential for stimulating economic growth by enabling businesses and consumers to access credit. By offering loans and other financial products, these institutions support the growth of industries and enable individuals to make investments in housing, education, and entrepreneurship. For instance, businesses can borrow to expand their operations, hire employees, and innovate, which directly contributes to GDP growth and job creation. Similarly, consumers benefit from access to mortgages and personal loans, which enables homeownership and drives demand for goods and services, further propelling economic growth.

13.5.3. Risk Management and Insurance

Financial institutions, particularly insurance companies, play a crucial role in risk management. They offer products that allow individuals and businesses to protect themselves against financial losses from unforeseen events such as accidents, health issues, natural disasters, or market fluctuations. Through risk pooling and diversification, insurance companies reduce the financial impact of these risks on policyholders. Furthermore, banks and other financial institutions use various financial instruments like derivatives to help businesses hedge against risks related to currency fluctuations, interest rate changes, and commodity price movements.

13.5.4. Liquidity and Financial Stability

Financial institutions ensure liquidity in the economy by providing mechanisms for individuals and businesses to easily convert assets into cash when needed. Banks, for example, provide checking accounts, savings accounts, and short-term loans, which help facilitate the smooth flow of transactions. Moreover, they manage the risk of liquidity crises by maintaining reserves and ensuring that there is enough capital to meet withdrawal demands. By offering liquidity and stability, financial institutions reduce the likelihood of financial crises and create a more stable financial environment.

13.5.5. Facilitating Payments and Transactions

Financial institutions are central to the functioning of modern payment systems. They facilitate transactions, both domestic and international, by providing payment platforms such as checks, debit and credit cards, and electronic fund transfers (EFTs). These payment systems are essential for everyday commerce, as they allow individuals and businesses to transfer money, make purchases, and settle debts. The efficiency and reliability of these systems enhance the velocity of money circulation, which supports economic activity and reduces transaction costs.

13.5.6. Financial Inclusion

Financial institutions contribute to financial inclusion by providing access to banking services for underserved and low-income populations. Microfinance institutions, for example, offer small loans to individuals in developing regions who may not have access to traditional banking services. By offering savings accounts, loans, and insurance to people in rural or impoverished areas, financial institutions help individuals build financial security, improve their standard of living, and contribute to poverty alleviation. Access to financial services also allows individuals to accumulate savings, invest in education, and start businesses, further boosting economic development.

13.5.7. Investment and Wealth Creation

Financial institutions, including banks, mutual funds, and pension funds, help individuals and businesses manage their investments and create wealth. These institutions provide a range of investment products such as stocks, bonds, and retirement accounts that allow individuals to grow their savings over time. Moreover, they provide investment advice and asset management services to help clients make informed decisions. By pooling resources from multiple investors, mutual funds and pension funds enable diversification, reducing risk while maximizing returns. Wealth creation through investment supports consumer spending, which is a key driver of economic growth.

13.5.8. Monetary Policy Implementation

Financial institutions are instrumental in the transmission of monetary policy. Central banks, such as the Federal Reserve in the U.S. or the European Central Bank, use financial institutions as channels to implement policies that regulate inflation, control interest rates, and manage the money supply. By adjusting interest rates and conducting open market operations, central banks influence the borrowing and lending behaviours of financial institutions, which in turn affects consumer spending, investment, and overall economic activity. Through this process, financial institutions play a vital role in maintaining economic stability.

13.5.9. Enhancing International Trade

In the global economy, financial institutions facilitate international trade by providing mechanisms for currency exchange, trade financing, and the management of cross-border transactions. Banks, in particular, offer services such as letters of credit, trade financing, and foreign exchange to businesses engaged in global commerce. These services ensure that international transactions are secure, timely, and efficient, reducing the risks associated with trading across borders. Financial institutions contribute to economic integration by enabling businesses to access global markets, thus fostering trade and economic cooperation.

13.5.10. Supporting Government Activities

Financial institutions are also vital to government operations. They facilitate the issuance and management of public debt, providing a market for government bonds and securities. By purchasing government debt, financial institutions help fund government spending on infrastructure, social programs, and other public services. They also play a key role in tax collection and the efficient allocation of government resources. Through their activities, financial institutions help governments manage fiscal policies and promote economic development.

Financial institutions are essential for the functioning and growth of modern economies. They facilitate the efficient allocation of capital, promote economic growth, provide risk management services, ensure liquidity, and support the implementation of monetary policies. These institutions also contribute to financial inclusion, enhance international trade, and support government activities. Their ability to manage resources, offer financial services, and promote economic stability makes them indispensable for both individual financial well-being and national economic development. The strength and efficiency of financial institutions are directly linked to the overall health and prosperity of an economy.

Financial institutions play a critical role in the global economy by facilitating the flow of capital, offering various services, and supporting economic stability. These institutions range from banks and credit unions to insurance companies and investment firms.

❖ **Their importance can be outlined as follows:**

1. Intermediation Between Savers and Borrowers

Financial institutions act as intermediaries between those who have surplus funds (savers) and those who need funds (borrowers). This function is crucial in ensuring that money flows efficiently from individuals, businesses, or governments with excess capital to those with investment needs. By pooling funds from many savers, these institutions provide loans for business expansion, infrastructure projects, and consumer credit.

Example: Banks offer savings accounts to individuals and, in turn, lend these funds to businesses for capital investment or to individuals for mortgages, education, and personal loans.

2. Promoting Investment

Financial institutions provide mechanisms for investment in a variety of assets, including stocks, bonds, real estate, and more. They channel savings into productive investments, which stimulates economic growth, creates jobs, and enhances productivity. This process helps businesses grow, encourages entrepreneurship, and contributes to the development of key sectors such as technology, manufacturing, and services.

Example: Investment banks assist in raising capital for companies through initial public offerings (IPOs) and bond issuance, which supports business expansion and innovation.

3. Ensuring Liquidity in the Economy

Liquidity refers to the ease with which assets can be converted into cash. Financial institutions provide liquidity by offering products like checking accounts, savings accounts, and money market funds that allow individuals and businesses to access their funds as needed. The ability to convert assets into cash ensures economic stability, as businesses can pay employees, suppliers, and creditors on time, and consumers can make purchases without worrying about cash flow issues.

Example: A central bank, such as the Federal Reserve in the U.S., provides liquidity to the banking system through mechanisms like repurchase agreements and adjusting interest rates.

4. Risk Management

Financial institutions help manage and spread financial risks through products like insurance, derivatives, and hedging strategies. By pooling the risk of many participants, these institutions reduce the individual financial burden of unforeseen events (e.g., natural disasters, accidents, or market fluctuations). They help mitigate the impact of these risks on both businesses and individuals.

Example: Insurance companies offer policies to individuals and businesses, covering risks like health, property damage, or business interruption.

5. Fostering Financial Stability

A well-regulated and stable financial system is critical to the overall health of the economy. Financial institutions, especially central banks, are central to ensuring that the financial system remains stable and resilient to shocks. Through prudent regulation, capital adequacy requirements, and oversight, they help prevent excessive risk-taking and ensure institutions can weather economic crises without collapsing.

Example: The Federal Reserve and other central banks regulate financial institutions, ensuring they hold sufficient capital and adhere to lending standards to avoid systemic failures.

6. Facilitating International Trade and Investment

Global financial institutions, such as multinational banks and investment firms, enable cross-border trade and investment by providing services like foreign exchange, trade financing, and international wire transfers. These institutions help businesses access global markets, manage currency risk, and secure the necessary capital to operate internationally. They also enable countries to invest in each other's economies, fostering a globalized financial system.

Example: Banks like JPMorgan Chase or HSBC facilitate international trade by providing trade credit, foreign exchange services, and financing for cross-border transactions.

7. Financial Inclusion and Social Welfare

Financial institutions help foster financial inclusion by providing services to underserved populations, including low-income individuals, rural communities, and small businesses. Access to financial products such as loans, savings accounts, and insurance helps lift people out of poverty and encourages economic empowerment. By offering affordable financial services, these institutions support social welfare and contribute to the reduction of inequality.

13.6 Overview of different Financial Institutions

Financial institutions play an essential role in the functioning of any economy. They act as intermediaries that channel funds from savers to borrowers, manage financial risks, and provide various services that facilitate economic activities. These institutions vary in terms of their functions, services, and target markets. Below is an overview of the different types of financial institutions, categorized based on their primary roles:

13.6.1. Commercial Banks

Definition: Commercial banks are financial institutions that accept deposits from the public, provide loans, and offer other basic financial services such as checking and savings accounts.

Key Functions:

Accept deposits and provide loans to individuals, businesses, and governments.

Facilitate payments through various mechanisms, including checks, credit cards, and electronic funds transfers (EFT). Provide short-term credit facilities like overdrafts and personal loans.

Examples: JPMorgan Chase, Bank of America, Barclays.

13.6.2. Investment Banks

Definition: Investment banks specialize in underwriting and facilitating the buying and selling of securities (stocks, bonds, etc.) in the capital markets.

Key Functions:

Help companies raise capital by issuing shares and bonds.
Offer advisory services on mergers, acquisitions, and corporate restructuring.
Engage in market-making activities, ensuring liquidity in the capital markets.
Facilitate large-scale investments and provide asset management services.

Examples: Goldman Sachs, Morgan Stanley, Citi Investment Banking.

13.6.3. Insurance Companies

Definition: Insurance companies provide risk management services by offering policies that protect individuals and businesses from potential financial losses due to various risks.

Key Functions:

Offer a wide range of insurance products, including life, health, property, and casualty insurance. Collect premiums from policyholders and provide payouts when insured events occur.

Help individuals and businesses manage risk through underwriting and actuarial services.

Examples: State Farm, Allianz, Prudential.

13.6.4. Credit Unions

Definition: Credit unions are member-owned financial cooperatives that provide financial services, particularly in the form of savings accounts, loans, and mortgages.

Key Functions:

Provide lower-cost loans and better interest rates on savings compared to commercial banks due to their non-profit nature. Offer checking accounts, savings accounts, and mortgages to their members. Focus on serving a specific community, such as employees of a particular organization or residents of a specific region.

Examples: Navy Federal Credit Union, Alliant Credit Union.

13.6.5. Savings and Loan Associations (S&Ls)

Definition: Savings and loan associations, also known as thrifts, specialize in accepting savings deposits and making home loans.

Key Functions:

Provide savings accounts and long-term mortgages.

Focus primarily on home lending, offering favourable interest rates for mortgages.
Encourage saving among individuals and provide credit for residential property purchases.

Examples: Washington Mutual (historically), Quicken Loans.

13.6.6. Pension Funds

Definition: Pension funds are investment vehicles that pool resources from employers and employees to provide retirement benefits.

Key Functions:

Collect and invest contributions from workers and employers to fund retirement benefits.

Invest in stocks, bonds, and other financial instruments to grow the fund's value over time.
Provide retirement income to individuals upon retirement.

Examples: CalPERS (California Public Employees' Retirement System), Canada Pension Plan Investment Board (CPPIB).

13.6.7. Hedge Funds

Definition: Hedge funds are private investment funds that employ various strategies to generate high returns for their investors, typically targeting high-net-worth individuals or institutions.

Key Functions:

Use diverse strategies, including short selling, leverage, and derivatives, to achieve high returns.
Focus on high-risk, high-reward investments, including both traditional and alternative asset classes.
Often aim to hedge against market downturns and economic uncertainty.

Examples: Bridgewater Associates, Renaissance Technologies.

13.6.8. Mutual Funds

Definition: Mutual funds pool money from many investors to invest in a diversified portfolio of stocks, bonds, or other securities.

Key Functions:

Offer individual investors access to a diversified portfolio of investments.

Allow for pooling of resources, making it easier for small investors to gain exposure to large and diverse markets. Managed by professional fund managers, who allocate funds according to the fund's objectives.

Examples: Vanguard, Fidelity, T. Rowe Price.

13.6.9. Private Equity Firms

Definition: Private equity firms invest in private companies or buy out publicly traded companies to restructure them for future growth and profitability.

Key Functions:

Provide capital to companies in exchange for ownership stakes. Focus on long-term value creation, often by improving business operations, streamlining management, and driving expansion. Often exit their investments through selling the company or taking it public.

Examples: Blackstone, KKR, Carlyle Group.

13.6.10. Microfinance Institutions (MFIs)

Definition: Microfinance institutions provide financial services, including small loans and savings accounts, to low-income individuals and small businesses, often in developing countries.

Key Functions:

Offer microloans to individuals and small businesses that do not have access to traditional banking services. Promote financial inclusion by serving underserved populations, particularly in rural areas.

Provide financial education and encourage entrepreneurship in low-income communities.

Examples: Grameen Bank, FINCA International.

13.6.11. Development Banks

Definition: Development banks are government-owned institutions that provide long-term financing for projects that promote economic development, typically in infrastructure and industrial sectors.

Key Functions:

Provide loans and financial assistance to large-scale developmental projects.

Focus on sectors such as housing, transportation, energy, and agriculture.

Support economic development in regions or countries with limited access to capital markets.

Examples: World Bank, Asian Development Bank (ADB), Export-Import Bank of the United States.

13.6.12. Central Banks

Definition: Central banks are national institutions responsible for managing a country's currency, money supply, and interest rates. They also regulate the banking system.

Key Functions:

Control the money supply through monetary policy tools like interest rates and open market operations. Act as a lender of last resort to other financial institutions.

Oversee the stability of the financial system and manage foreign exchange reserves.

Examples: Federal Reserve (U.S.), European Central Bank (ECB), Bank of England.

Financial Institutions in India: A National Economic Perspective

Financial institutions in India play a pivotal role in shaping the country's economic development. They function as intermediaries that channel resources, mobilize savings, facilitate investments, and promote economic growth. These institutions cater to a diverse array of economic actors, from individuals and small businesses to large corporations and government entities. This report examines the types of financial institutions in India, their contributions to the national economy, and the challenges they face.

Types of Financial Institutions in India
Financial institutions in India are broadly categorized into banking and non-banking institutions, further segmented based on their functions and services.

1. Banking Institutions

- **Commercial Banks:** These include public sector banks (e.g., State Bank of India), private sector banks (e.g., HDFC Bank), and foreign banks operating in India. They provide traditional banking services like deposits, loans, and credit facilities.

- **Regional Rural Banks (RRBs):** Established to cater to rural areas, RRBs focus on providing credit to agriculture, small industries, and other rural development activities.

- **Cooperative Banks: These** banks serve cooperative societies and individual members in rural and urban areas, playing a significant role in agriculture and microfinance.

- P**ayments Banks and Small Finance Banks:** New-age banking institutions designed to enhance financial inclusion by offering limited banking services like deposits and remittances.

2. Non-Banking Financial Companies (NBFCs)

NBFCs complement banks by providing loans, credit, asset management, and insurance services. They cater to sectors often underserved by traditional banks, such as small businesses and rural enterprises.

3. Development Financial Institutions (DFIs)

DFIs like NABARD (National Bank for Agriculture and Rural Development), SIDBI (Small Industries Development Bank of India), and EXIM Bank focus on long-term financing for specific sectors like agriculture, small industries, and foreign trade.

4. Insurance Companies

Life insurance (e.g., LIC) and general insurance companies mobilize long-term savings and mitigate risks, contributing significantly to economic stability.

5. Capital Market Institutions

Institutions like the Securities and Exchange Board of India (SEBI), stock exchanges (e.g., NSE, BSE), and mutual funds play a crucial role in mobilizing investments, regulating markets, and ensuring transparency.

6. Microfinance Institutions (MFIs)

MFIs focus on financial inclusion by offering small loans and credit facilities to underserved populations, particularly in rural and semi-urban areas.

❖ **Contributions of Financial Institutions to the National Economy**

1. Mobilization of Savings and Investments

Financial institutions act as custodians of public savings, channelling them into productive investments. By offering various saving instruments like fixed deposits, mutual funds, and insurance policies, these institutions encourage individuals and businesses to contribute to economic growth.

2. Credit Availability

Institutions like commercial banks and NBFCs provide critical credit for agriculture, manufacturing, infrastructure, and services. Adequate credit availability fuels entrepreneurship, innovation, and job creation.

3. Financial Inclusion

Initiatives like the Pradhan Mantri Jan Dhan Yojana (PMJDY), payment banks, and MFIs have improved access to financial services in remote and underserved areas, fostering inclusive growth.

4. Infrastructure Development

Development banks and DFIs like NABARD and NHB (National Housing Bank) play a critical role in financing large-scale infrastructure projects, which are essential for sustained economic growth.

5. Employment Generation

The financial sector is a significant employer, directly and indirectly supporting millions of jobs across various skill levels. Moreover, its role in supporting businesses contributes to employment generation in the broader economy.

6. Foreign Exchange and International Trade

Institutions like the Reserve Bank of India (RBI) and EXIM Bank regulate foreign exchange and provide trade finance, facilitating India's integration into the global economy.

7. Economic Stabilization

The RBI, as the central bank, uses monetary policy tools to regulate inflation, control liquidity, and ensure financial stability. During economic shocks, financial institutions act as stabilizers by supporting businesses and individuals.

8. Capital Formation

The capital market and institutions like SEBI and mutual funds encourage investments in equity and debt instruments, contributing to capital formation and entrepreneurial activities.

❖ **Challenges Faced by Financial Institutions**

Despite their significant contributions, financial institutions in India encounter several challenges:

1. Non-Performing Assets (NPAs)

High levels of NPAs in public sector banks have strained their financial health, limiting their capacity to lend and invest.

2. Financial Exclusion

While financial inclusion has improved, a substantial portion of the rural population remains excluded from formal financial services.

3. Regulatory Challenges

Balancing innovation (e.g., fintech) with regulatory compliance poses a challenge for institutions striving to expand their services.

4. Technological Disruptions

While technology has enhanced efficiency, it has also exposed institutions to risks like cyber threats and data breaches.

5. Limited Capital Base

DFIs and NBFCs often face capital constraints, restricting their ability to support long-term projects and underserved sectors.

6. Economic Uncertainty

Global factors like geopolitical tensions, inflationary pressures, and economic slowdowns affect the stability of financial institutions.

❖ **Government Initiatives to Strengthen Financial Institutions**

1. Recapitalization of Banks

The government has infused capital into public sector banks to address NPAs and improve their lending capacity.

2. Financial Inclusion Schemes

Programs like PMJDY, PMMY (Pradhan Mantri Mudra Yojana), and DBT (Direct Benefit Transfer) have enhanced financial access.

3. Digital Transformation

The promotion of UPI (Unified Payments Interface), digital wallets, and online banking has revolutionized the financial landscape, making transactions faster and more secure.

4. Strengthening NBFCs and DFIs

The establishment of a new Development Finance Institution (NaBFID) focuses on financing infrastructure projects.

5. Reforms in Capital Markets

The government has introduced measures to deepen capital markets, including greater participation by retail investors and easier access to IPOs.

6. Insolvency and Bankruptcy Code (IBC)

The IBC has streamlined the resolution of distressed assets, improving the credit ecosystem.

❖ Future Prospects

1. Growth of Fintech

India’s fintech revolution is expected to make financial services more efficient, accessible, and inclusive. Digital lending, AI-based credit scoring, and blockchain technology will likely transform the sector.

2. Green Finance

As India commits to sustainability goals, financial institutions will play a key role in financing renewable energy, electric vehicles, and other green initiatives.

3. Expanding Global Presence

Indian financial institutions are poised to expand their international footprint, particularly in South Asia and Africa, leveraging India's economic and technological strengths.

4. Enhanced Financial Literacy

Improved financial literacy programs will empower individuals to make informed decisions, further boosting savings and investments.

5. Strengthening Resilience

Building robust risk management frameworks will enable financial institutions to navigate economic uncertainties and maintain stability.

❖ Conclusion

Financial institutions are the backbone of India’s economic development. By mobilizing resources, fostering inclusion, and supporting growth across sectors, they contribute significantly to national progress. However, addressing challenges like NPAs, financial exclusion, and technological disruptions is essential for realizing their full potential. With continued reforms, digital advancements, and policy support, financial institutions in India are well-positioned to drive sustainable and inclusive economic growth in the coming decades.

As financial institutions are essential pillars of the economy, each with its distinct roles. They range from commercial banks offering basic banking services to specialized institutions like hedge funds and private equity firms that manage high-risk investments. Institutions such as insurance companies and pension funds help individuals manage risks and secure their future, while microfinance institutions and development banks foster economic development in underserved regions. Together, these financial entities contribute to economic stability, growth, and financial inclusion across the globe.

❖ Long Question:-

1. Introduction to financial institutions.
2. What are concept of financial institutions.

❖ **Short notes:-**

1. Importance of financial institutions.
2. Overview of different financial institutions.

UNIT - 14 CURRENT MACRO-ECONOMIC ISSUES

14.1 Introduction

The global economy is facing a complex web of macroeconomic challenges, marked by a combination of inflationary pressures, supply chain disruptions, fluctuating energy prices, and shifting labor markets. These issues, exacerbated by the aftermath of the COVID-19 pandemic and geopolitical tensions, particularly the war in Ukraine, have created a volatile economic landscape. Understanding these macroeconomic concerns is essential for policymakers, businesses, and individuals to navigate the current environment effectively. This essay will explore some of the most pressing macroeconomic issues today, including inflation, global supply chain disruptions, energy crises, labor market shifts, and fiscal and monetary policy responses.

14.1.1 Inflation and Cost of Living Crisis

One of the most significant macroeconomic challenges facing the global economy is high inflation. After years of relatively stable prices, inflation has surged in many countries, driven by a combination of factors. The pandemic disrupted supply chains, leading to shortages in goods and services. Simultaneously, demand rebounded sharply as economies reopened, exacerbating the price pressures. Additionally, geopolitical factors, particularly the war in Ukraine, have led to soaring food and energy prices. Central banks, particularly the U.S. Federal Reserve and the European Central Bank, have responded by raising interest rates in an attempt to curb inflation. However, these actions come with trade-offs, such as slowing economic growth and increasing the cost of borrowing. The inflationary environment has created a cost-of-living crisis for many households, as wages fail to keep pace with rising prices, eroding purchasing power and living standards.

14.1.2. Global Supply Chain Disruptions

The COVID-19 pandemic exposed the vulnerabilities in global supply chains, which have continued to impact economies worldwide. Factory shutdowns, transportation bottlenecks, and labor shortages led to delays and shortages in critical goods such as electronics, automobiles, and medical supplies. While some supply chain issues have eased, others persist, especially in sectors dependent on just-in-time inventory systems. The pandemic’s long-term effects, coupled with geopolitical tensions, have exposed the fragility of relying on a globalized supply chain. The war in Ukraine, for example, has disrupted the flow of raw materials like wheat, oil, and natural gas, causing price volatility and shortages. These disruptions not only slow economic growth but also fuel inflation, as businesses pass on higher costs to consumers.

14.1.3 Energy Crisis and Climate Change

The ongoing energy crisis, largely exacerbated by the war in Ukraine, has raised concerns about energy security and sustainability. Europe, in particular, has faced severe energy shortages, with Russia's invasion of Ukraine disrupting natural gas supplies. This has led to skyrocketing energy prices, which in turn have increased production costs across many industries. While energy prices have fluctuated, the underlying issue of transitioning to a cleaner and more sustainable energy system remains. Climate change concerns have pushed many countries to invest in renewable energy and decarbonization efforts, but the transition comes with its own set of challenges, including the high costs of infrastructure, technological innovation, and political opposition. The global energy crisis highlights the delicate balance between economic growth, energy security, and environmental sustainability.

14.1.4 Labor Market Shifts

The labor market has undergone significant transformations in recent years, partly due to the pandemic and accelerated by technological advancements. In many developed economies, the labor force is experiencing structural shifts, including labor shortages in certain sectors and a rise in remote work. While some industries, such as hospitality and retail, face acute shortages of workers, others, like technology and healthcare, are seeing increased demand for skilled labor. The so-called "Great Resignation" in the U.S. and similar trends elsewhere have led to a rethinking of work, with many individuals opting for greater flexibility, work-life balance, and higher wages. These shifts are reshaping labor markets and posing challenges for employers trying to fill vacancies while adjusting to the changing needs of the workforce. Additionally, the rapid growth of gig and freelance work, while offering flexibility, raises concerns about job security, benefits, and long-term financial stability for workers.

14.1.5. Fiscal and Monetary Policy Challenges

Governments and central banks worldwide are grappling with how to balance fiscal and monetary policies in a way that fosters economic stability and growth. In response to the pandemic, many countries implemented expansive fiscal policies, including stimulus packages and government spending to prop up economies. However, the long-term sustainability of this level of government intervention is in question, especially as debt levels in both developed and developing countries have risen to record levels. Simultaneously, central banks are tightening monetary policy to combat inflation, but there are concerns that raising interest rates too quickly could trigger a recession. Striking the right balance between stimulating growth, managing inflation, and ensuring fiscal sustainability is one of the most challenging aspects of contemporary macroeconomic management.

14.2 Meaning

Current macroeconomic issues refer to the significant challenges facing national and global economies that affect growth, inflation, employment, and the overall economic stability of countries. These issues arise from a combination of global and domestic factors, often interconnected, and have widespread consequences for governments, businesses, and individuals.

One of the primary macroeconomic concerns today is high inflation, which has surged in many countries due to supply chain disruptions, energy price increases, and the aftermath of the COVID-19 pandemic. Central banks have raised interest rates to combat inflation, but these measures can also slow economic growth and increase borrowing costs.

Another pressing issue is supply chain disruptions, which have led to shortages in key goods and higher production costs. These disruptions were triggered by the pandemic, labor shortages, and geopolitical tensions, such as the war in Ukraine. As a result, businesses face higher operational costs, which often get passed on to consumers in the form of higher prices.

The energy crisis is another major concern, especially in Europe, where rising energy prices—due in part to reduced supplies from Russia—have strained economies and increased production costs. This crisis highlights the global challenge of transitioning to more sustainable energy sources while ensuring energy security.

In addition, labor market shifts are occurring, with some sectors facing worker shortages and others experiencing shifts toward remote work and gig employment. These changes are reshaping economies and labor policies, raising questions about job security and income inequality.

Overall, these macroeconomic issues reflect the complexities of the modern global economy, requiring coordinated responses from governments and businesses to manage risks and foster stability.

14.3 Definition

Current macroeconomic issues refer to the large-scale economic challenges affecting national and global economies. These issues encompass a range of factors that influence overall economic performance, including inflation, unemployment, fiscal and monetary policy, supply chains, energy prices, and economic growth. Macroeconomic issues are interconnected, and changes in one area often have ripple effects across others, influencing businesses, governments, and households alike. Understanding these issues is essential for policymakers, businesses, and individuals to navigate the complexities of the global economy.

One of the most prominent current macroeconomic issues is inflation. In recent years, inflation rates have surged in many countries due to supply chain disruptions, pent-up demand following the COVID-19 pandemic, and rising energy prices. The increased cost of goods and services erodes purchasing power and can lead to economic instability. Central banks, such as the U.S. Federal Reserve and the European Central Bank, have responded by raising interest rates to curb inflation, but these measures can also slow economic growth and lead to higher borrowing costs for consumers and businesses.

Another significant issue is global supply chain disruptions. The pandemic exposed the vulnerabilities of global supply networks, causing delays, shortages, and higher costs for many products, including electronics, food, and pharmaceuticals.

Geopolitical tensions, particularly the war in Ukraine, have further strained supply chains, especially for energy and raw materials. These disruptions create inflationary pressures and reduce economic efficiency, affecting both production and consumption.

The energy crisis is also a critical concern, particularly in Europe, where the war in Ukraine has disrupted the flow of natural gas from Russia. Energy prices have skyrocketed, impacting everything from household heating bills to industrial production costs. Countries are increasingly focusing on transitioning to renewable energy sources, but the shift requires substantial investment and faces technological and political challenges.

Additionally, there are labor market shifts that have been accelerated by the pandemic, including labor shortages in certain sectors and the rise of remote work and gig economy jobs. These changes are reshaping employment patterns, creating new challenges for businesses and policymakers regarding wages, job security, and worker rights.

Together, these issues define the macroeconomic landscape and require coordinated policy responses to maintain stability and promote sustainable economic growth.

14.4 Concept

The concept of current macroeconomic issues refers to the key economic challenges that are affecting national and global economies today. These issues are large-scale and interconnected, influencing economic growth, inflation, employment, and overall economic stability. Here is a point-wise breakdown of some of the most pressing macroeconomic concerns:

14.4.1. High Inflation

Definition: Inflation refers to the sustained rise in the general price level of goods and services over time, leading to a reduction in the purchasing power of money.

Cause: The surge in inflation has been driven by factors such as disruptions in global supply chains, pent-up demand after the pandemic, rising energy prices, and increased government spending.

Impact: High inflation erodes household purchasing power, making it more difficult for consumers to afford basic goods and services. It also leads to higher costs for businesses, which may pass these costs onto consumers, further fuelling inflation.

Policy Response: Central banks, including the U.S. Federal Reserve and European Central Bank, have raised interest rates in an attempt to curb inflation, but these measures risk slowing down economic growth and increasing borrowing costs.

1.4.4.2. Supply Chain Disruptions

Definition: Supply chain disruptions refer to interruptions in the production and distribution networks that supply goods and services.

Cause: The COVID-19 pandemic disrupted manufacturing, labor forces, and logistics globally. Geopolitical tensions, particularly the war in Ukraine, have further strained supply chains, especially for key raw materials like energy, food, and semiconductors.

Impact: Supply chain issues lead to product shortages, delays, and increased costs for consumers and businesses. Sectors like electronics, automobiles, and healthcare have been particularly affected.

Long-Term Effect: Businesses may reassess their dependence on global supply chains, considering reshoring or diversifying suppliers, which could lead to longer-term structural changes in global trade patterns.

14.4.3. Energy Crisis

Definition: The energy crisis refers to disruptions in the global supply and distribution of energy resources like oil, natural gas, and electricity.

Cause: The war in Ukraine has severely disrupted energy supplies from Russia, especially in Europe. Additionally, global demand for energy has surged as economies recover from the pandemic, pushing up prices.

Impact: Higher energy prices contribute to inflation and raise the cost of living. Energy-intensive industries, such as manufacturing and transportation, are particularly affected. Energy scarcity also exposes vulnerabilities in energy security, prompting countries to reconsider their energy dependencies.

Policy Response: Many countries are accelerating investments in renewable energy sources to reduce dependence on fossil fuels. However, the transition is costly and requires time.

14.4.4. Labor Market Shifts

Definition: Labor market shifts refer to changes in employment patterns, job types, and worker expectations.

Cause: The COVID-19 pandemic accelerated remote work, while rising wages and labor shortages in certain sectors have led to significant changes in the labor market. The so-called "Great Resignation" has seen many workers leave their jobs, while gig and freelance work has increased.

Impact: Businesses face challenges in hiring and retaining skilled workers, leading to labor shortages in key sectors like healthcare, technology, and hospitality. The shift to remote work also requires businesses to adapt to new modes of operation.

Long-Term Effect: The labor market is becoming more flexible, with workers demanding higher wages, better working conditions, and more flexibility in their jobs. This may result in greater income inequality, especially for workers in low-skill or precarious jobs.

14.4.5. Fiscal and Monetary Policy Challenges

Definition: Fiscal policy involves government spending and taxation, while monetary policy is controlled by central banks and includes tools like interest rates and money supply to manage inflation and economic growth.

Cause: Governments and central banks are facing the challenge of managing the economic recovery post-pandemic while addressing inflationary pressures. The need for fiscal stimulus during the pandemic led to increased government debt, while central banks' response to inflation involves tightening monetary policy.

Impact: The rise in government debt raises concerns about long-term fiscal sustainability. Meanwhile, higher interest rates aimed at controlling inflation may reduce consumer spending and business investment, leading to slower economic growth or even recession.

Policy Dilemma: Policymakers are caught between the need to curb inflation through tighter monetary policies and the desire to stimulate economic growth through fiscal spending. Balancing these priorities is a significant challenge.

14.4.6. Global Trade Tensions

Definition: Global trade tensions refer to the growing conflicts and barriers between countries regarding tariffs, trade agreements, and market access.

Cause: Trade wars, particularly between major economies like the U.S. and China, have led to increased tariffs and other trade restrictions. The broader trend of de-globalization, spurred by concerns over supply chain vulnerabilities and national security, is also contributing to trade tensions.

Impact: Trade restrictions increase the cost of goods and reduce the efficiency of global markets. Economies that depend on exports or imports are especially vulnerable to trade disruptions.

Long-Term Effect: A shift towards protectionism could lead to fragmented global markets, reduced international cooperation, and slower economic growth.

14.4.7. Technological Disruptions and Digital Transformation

Definition: Technological disruptions refer to rapid advancements in technology that change how businesses operate and how economies function.

Cause: The widespread adoption of automation, artificial intelligence (AI), and digital platforms is reshaping industries and labor markets.

Impact: Technological disruptions create new opportunities for innovation and economic growth but also lead to job displacement, especially in traditional sectors. The digital divide between advanced and developing economies may widen, exacerbating inequality.

Policy Response: Governments are investing in digital infrastructure and education to harness the benefits of new technologies while managing their societal impacts.

Current macroeconomic issues, including inflation, supply chain disruptions, energy crises, labor market shifts, fiscal and monetary challenges, and technological disruptions, present complex challenges for policymakers. These issues are interrelated, and their impact is felt across the global economy. To address these problems, coordinated international efforts, innovative policy solutions, and structural adjustments will be necessary to stabilize economies and promote sustainable growth.

14.5 Importance

The macroeconomic landscape is currently shaped by several pressing challenges that have far-reaching implications for national and global economies. Understanding and addressing these issues is crucial for maintaining economic stability, fostering sustainable growth, and ensuring the well-being of individuals and societies. The importance of current macroeconomic issues today can be highlighted in the following key areas:

14.5.1. Inflation and Cost of Living Pressures

Importance: Inflation remains one of the most significant macroeconomic concerns across the globe. As inflation rises, the purchasing power of consumers is eroded, making it more difficult to afford essential goods and services. This has become particularly crucial in the context of everyday living, as prices for food, energy, housing, and healthcare increase.

Impact on Socioeconomic conditions: High inflation disproportionately affects lower-income households, as they spend a larger share of their income on basic necessities. This exacerbates income inequality and social unrest, leading to calls for wage increases and government intervention. Inflation also impacts businesses by raising input costs, which could slow economic growth or lead to layoffs.

Policy Response: Central banks, including the U.S. Federal Reserve and the European Central Bank, have responded by raising interest rates in an attempt to curb inflation, but these actions can also slow economic recovery. The balance between controlling inflation and supporting economic growth is delicate and requires careful management.

14.5.2. Global Supply Chain Disruptions

Importance: Supply chain disruptions have become a key challenge since the onset of the COVID-19 pandemic and have continued due to various factors like geopolitical tensions, natural disasters, and labor shortages.

Impact on Global Trade: Supply chain interruptions affect the flow of goods and services, resulting in shortages, price hikes, and delays. Critical industries such as electronics, automotive manufacturing, pharmaceuticals, and food production have been hit hard by supply bottlenecks.

Economic Ripple Effects: These disruptions cause inflationary pressures by increasing costs for businesses, which are then passed on to consumers. Additionally, they hamper economic recovery in post-pandemic economies by slowing production and trade.

Long-Term Repercussions: Global supply chains are likely to become more localized or diversified, which could increase costs but reduce vulnerabilities to global shocks. Businesses and governments need to rethink supply chain strategies to ensure resilience against future crises.

14.5.3. Energy Crisis and Rising Costs

Importance: The ongoing global energy crisis, particularly in Europe due to the war in Ukraine, has pushed energy prices to historically high levels, leading to inflation and economic instability.

Energy Security: Countries that depend heavily on imported fossil fuels, particularly natural gas and oil, have faced significant challenges. The disruption of energy supplies from Russia has forced Europe to find alternative sources of energy, highlighting the importance of energy security in the modern geopolitical landscape.

Impact on Production and Consumption: Rising energy costs affect nearly every aspect of the economy. Energy-intensive industries such as manufacturing, transportation, and agriculture are particularly vulnerable, as higher energy costs translate into increased production costs and, ultimately, higher prices for consumers.

Environmental Implications: The energy crisis underscores the urgency of transitioning to renewable energy sources. Governments are increasingly focused on reducing dependence on fossil fuels and investing in cleaner energy technologies, but the transition presents both challenges and opportunities for long-term sustainability.

14.5.4. Labor Market Shifts and Employment Challenges

Importance: Labor markets worldwide are undergoing rapid transformation due to shifts in work preferences, technological advancements, and demographic changes. The COVID-19 pandemic accelerated trends like remote work, the gig economy, and automation, all of which are reshaping employment structures.

Worker Shortages: Many sectors, especially in healthcare, technology, and hospitality, face acute labor shortages. The so-called "Great Resignation," where workers voluntarily left their jobs in search of better pay, working conditions, and flexibility, has added to the labor market challenges.

Wage Growth and Inequality: In many countries, wages are not keeping pace with inflation, leading to growing income inequality. While certain high-demand sectors, like tech, have seen wage growth, many workers in low-skill industries have not shared in this prosperity.

Automation and Job Displacement: The rise of automation and artificial intelligence is another important labor market issue. While these technologies create new opportunities, they also lead to job displacement, particularly in low-skilled sectors. Policymakers must address the need for upskilling and retraining workers to adapt to these changes.

14.5.5. Fiscal and Monetary Policy Responses

Importance: Governments and central banks play crucial roles in managing economic stability through fiscal and monetary policy. The global response to the COVID-19 crisis involved massive fiscal stimulus packages to support individuals and businesses, leading to a significant rise in public debt.

Rising Debt Levels: With debt levels soaring in both developed and developing nations, the challenge is to manage fiscal sustainability. While debt can be used to stimulate economies during times of crisis, excessive borrowing could lead to long-term financial instability, higher interest payments, and reduced fiscal space for future crises.

Monetary Policy Dilemma: Central banks are faced with the difficult task of controlling inflation through higher interest rates without pushing economies into recession. Tightening monetary policy to curb inflation can slow down economic growth, which raises concerns about the potential for stagflation—when an economy experiences stagnation and high inflation simultaneously.

Global Coordination: Effective policy coordination between countries is crucial, especially in a highly interconnected global economy. Trade, investment, and monetary policies must be aligned to prevent exacerbating global imbalances and to ensure long-term stability.

14.5.6. Technological Disruption and Digital Transformation

Importance: Technology continues to evolve at a rapid pace, impacting nearly every aspect of the economy. The digital transformation of industries, driven by artificial intelligence, automation, and blockchain, is reshaping business models, productivity, and consumer behavior.

Impact on Employment and Productivity: While technology boosts productivity and innovation, it also displaces certain jobs, particularly in manufacturing and routine service industries. However, it creates new jobs in tech, data analysis, and digital services, requiring significant investment in workforce training and education.

Data and Cyber security: The rise of digital economies also brings concerns over data privacy, cybersecurity, and the regulation of technology companies. Countries must establish robust legal frameworks to manage the digital economy while balancing innovation with privacy rights.

14.5.7. Geopolitical Risks and Global Trade Tensions

Importance: Geopolitical risks, including trade wars, regional conflicts, and diplomatic tensions, continue to disrupt the global economic order. The U.S.-China trade war, the war in Ukraine, and rising protectionism have led to shifts in global trade patterns.

Impact on Globalization: The trend toward de-globalization, with countries implementing tariffs and trade restrictions, challenges the efficiency of global markets and raises costs for businesses and consumers. A fragmented global market could slow economic growth and reduce international cooperation.

Energy and Resource Competition: Geopolitical conflicts often centre on the control of valuable resources such as oil, gas, and rare earth minerals, which can have global economic implications.

The importance of current macroeconomic issues cannot be overstated, as they influence nearly every aspect of modern life. From inflation and supply chain disruptions to labor market changes and energy crises, these challenges have profound effects on economic stability, growth, and social well-being. Policymakers, businesses, and individuals must work together to navigate these issues, adapt to changing circumstances, and find solutions that promote long-term sustainability and prosperity in an increasingly interconnected global economy.

14.6 Remedies for Current Macro Economic issues

The global economy is currently facing a range of macroeconomic challenges that are shaping economic performance across both developed and developing countries. These challenges stem from a combination of longstanding structural issues and more recent shocks, such as the COVID-19 pandemic and the geopolitical instability caused by the war in Ukraine. Some of the most prominent macroeconomic issues today include high inflation, supply chain disruptions, energy price volatility, labor market shifts, rising public debt, and geopolitical risks. These issues are interconnected, creating complex economic conditions that affect inflation rates, economic growth, employment levels, and overall stability.

High inflation has emerged as one of the most pressing issues in many economies, largely driven by supply chain disruptions, energy price hikes, and increased demand for goods and services following the pandemic. Supply chain disruptions, which began with the pandemic, continue to strain global trade, affecting everything from electronics to food production. The energy crisis, intensified by geopolitical tensions, particularly the war in Ukraine, has led to significant volatility in energy prices, impacting both consumers and industries. Labor market shifts, driven by remote work trends and the gig economy, have changed employment patterns, causing worker shortages in certain sectors. Finally, the fiscal and monetary policy dilemma, where governments and central banks must balance managing inflation while fostering economic growth, has added to the complexity of decision-making.

As these macroeconomic issues continue to evolve, addressing them requires coordinated policy responses, innovation, and structural reforms.

Remedies for current Macroeconomic issues

14.6.1. Combating Inflation

- **Monetary Policy Tightening:**

Action: Central banks, such as the Federal Reserve and European Central Bank, have raised interest rates to curb inflation. Higher interest rates make borrowing more expensive, which can reduce consumer spending and business investment, helping to cool down demand-driven inflation.

Impact: While raising interest rates can effectively reduce inflation, it may slow economic growth and increase unemployment if not managed carefully.

- **Targeted Fiscal Policies:**

Action: Governments can implement targeted fiscal policies, such as direct subsidies or tax rebates, for low- and middle-income households. These measures can help mitigate the cost-of-living crisis without stimulating broad-based inflation.

Impact: Targeted fiscal interventions ensure that relief reaches those most affected by inflation without exacerbating the overall demand pressures.

- **Improving Supply Chains:**

Action: Governments and businesses can work on reducing bottlenecks in supply chains by investing in infrastructure, such as ports, railways, and logistics networks. This can help ease the pressure on the cost of goods and services, thus curbing inflation.

Impact: Reducing supply chain inefficiencies can alleviate price hikes in critical sectors, such as food, energy, and manufacturing, contributing to overall price stability.

14.6.2. Addressing Supply Chain Disruptions

- **Diversification of Suppliers:**

Action: Companies can reduce their dependence on single suppliers or regions by diversifying their sourcing strategies. This includes exploring alternative suppliers or bringing production closer to home (nearshoring or reshoring).

Impact: Diversifying supply chains makes businesses more resilient to disruptions, whether caused by geopolitical tensions, pandemics, or natural disasters, ensuring that production remains stable.

- **Investment in Digital and Green Technologies:**

Action: Governments and businesses should invest in digital technologies like blockchain and artificial intelligence to improve supply chain transparency and efficiency. Similarly, investing in green technologies can help build more sustainable and resilient supply chains.

Impact: Digital tools and green energy solutions improve supply chain tracking, reduce inefficiencies, and lower the environmental footprint, helping businesses remain competitive in a changing global market.

- **Strengthening Regional Trade Agreements:**

Action: Countries can work to strengthen regional trade agreements and reduce trade barriers to facilitate smoother cross-border trade. This may include improving customs procedures and fostering better cooperation between neighbouring countries.

Impact: Strengthening regional trade can mitigate the impact of global disruptions and improve the resilience of supply chains, especially in key sectors like food and medicine.

14.6.3. Mitigating the Energy Crisis

- **Accelerating the Transition to Renewable Energy:**

Action: Governments should increase investments in renewable energy sources such as wind, solar, and hydroelectric power. Providing incentives for businesses and households to adopt clean energy technologies will reduce dependence on volatile fossil fuels.

Impact: Long-term investments in renewables can reduce the impact of energy price volatility and contribute to sustainable economic growth, reducing the global dependence on oil and gas.

- **Energy Efficiency Programs:**

Action: Governments can implement energy efficiency measures across industries and residential sectors, such as upgrading infrastructure and providing incentives for energy-saving appliances and technologies.

Impact: By lowering overall energy consumption, these programs can help mitigate the immediate cost pressures caused by high energy prices, providing both short-term relief and long-term savings.

- **Energy Security and Storage:**

Action: Countries should invest in energy storage solutions, such as battery technology, to manage fluctuations in energy production and consumption. Furthermore, diversifying energy imports through multiple suppliers can help ensure energy security.

Impact: Enhanced energy storage and diversified energy imports can help countries manage supply disruptions and stabilize prices, ensuring that the economy remains resilient to future energy crises.

14.6.4. Adapting to Labor Market Shifts

- **Upskilling and Reskilling Programs:**

Action: Governments and businesses should prioritize investments in upskilling and reskilling programs, particularly for workers displaced by automation or changing industries. Public-private partnerships can help create training programs aligned with future job market needs.

Impact: These programs enable workers to transition into high-demand sectors, such as tech and renewable energy, thus reducing unemployment and fostering inclusive economic growth.

- **Promoting Remote and Hybrid Work:**

Action: Governments can implement policies that encourage flexible work arrangements, such as remote or hybrid models, which offer workers greater work-life balance while meeting the needs of businesses.

Impact: Expanding remote work options can help alleviate labor shortages in sectors where physical presence is not required. It also allows workers to access a broader job market, improving labor mobility and job satisfaction.

- **Strengthening Social Safety Nets:**

Action: Strengthening social safety nets through unemployment insurance, health benefits, and retraining programs can help workers who lose jobs due to technological disruptions or economic shifts.

Impact: A robust safety net helps maintain consumer spending during periods of labor market transition, thus stabilizing the economy and reducing social inequality.

14.6.5. Managing Fiscal and Monetary Policy

- **Fiscal Prudence and Debt Management:**

Action: Governments need to adopt fiscal policies that prioritize long-term sustainability, such as reducing deficits over time and finding ways to restructure existing debt. This could include extending debt maturities or implementing reforms that promote economic growth.

Impact: A disciplined fiscal approach ensures that government spending is targeted effectively while managing debt levels, creating room for future policy interventions if necessary.

- **Coordinating Monetary Policies:**

Action: Central banks should collaborate internationally to ensure that their monetary policies do not destabilize global markets. Coordination is particularly important when dealing with inflationary pressures that can impact currency values and trade balances.

Impact: Coordinated monetary policies reduce the risk of competitive devaluation and currency crises, helping to stabilize global financial markets.

- **Promoting Inclusive Growth:**

Action: Governments should prioritize inclusive economic growth through policies that support small and medium-sized enterprises (SMEs), rural development, and social inclusion.

Impact: Inclusive growth reduces inequality and fosters social stability, ensuring that the benefits of economic recovery are shared broadly across society.

Addressing current macroeconomic issues requires a multifaceted approach that combines monetary, fiscal, and structural reforms. While no single solution can resolve all of the challenges at hand, a coordinated effort involving governments, businesses, and international organizations will be essential to navigate the complexities of today's global economy. Through targeted interventions, strategic investments, and long-term planning, countries can mitigate the impact of these macroeconomic issues and set the stage for sustainable economic growth.

❖ **Long Questions:-**

1. Explain macroeconomics.
2. Explain meaning and concept of Macroeconomics.

❖ **Short Notes: -**

1. Write a note on importance of macroeconomics.
2. Give a Brief Introduction on Current Macro Economic Issues Remedies for Current Macroeconomics issues

યુનિવર્સિટી ગીત

સ્વાધ્યાયઃ પરમં તપઃ
સ્વાધ્યાયઃ પરમં તપઃ
સ્વાધ્યાયઃ પરમં તપઃ

શિક્ષણ, સંસ્કૃતિ, સદ્ભાવ, દિવ્યબોધનું ધામ
ડૉ. બાબાસાહેબ આંબેડકર ઓપન યુનિવર્સિટી નામ;
સૌને સૌની પાંખ મળે, ને સૌને સૌનું આભ,
દશે દિશામાં સ્મિત વહે હો દશે દિશે શુભ-લાભ.

અભણ રહી અજ્ઞાનના શાને, અંધકારને પીવો ?
કહે બુદ્ધ આંબેડકર કહે, તું થા તારો દીવો;
શારદીય અજવાળા પહોંચ્યાં ગુર્જર ગામે ગામ
ધ્રુવ તારકની જેમ ઝળહળે એકલવ્યની શાન.

સરસ્વતીના મયૂર તમારે ફળિયે આવી ગહેકે
અંધકારને હડસેલીને ઉજાસના ફૂલ મહેંકે;
બંધન નહીં કો સ્થાન સમયના જવું ન ઘરથી દૂર
ઘર આવી મા હરે શારદા દૈન્ય તિમિરના પૂર.

સંસ્કારોની સુગંધ મહેંકે, મન મંદિરને ધામે
સુખની ટપાલ પહોંચે સૌને પોતાને સરનામે;
સમાજ કેરે દરિયે હાંકી શિક્ષણ કેરું વહાણ,
આવો કરીયે આપણ સૌ
ભવ્ય રાષ્ટ્ર નિર્માણ...
દિવ્ય રાષ્ટ્ર નિર્માણ...
ભવ્ય રાષ્ટ્ર નિર્માણ

DR. BABASAHEB AMBEDKAR OPEN UNIVERSITY
(Established by Government of Gujarat)
'Jyotirmay' Parisar,
Sarkhej-Gandhinagar Highway, Chharodi, Ahmedabad-382 481
Website : www.baou.edu.in