Ahmednagar Jilha Maratha Vidya Prasarak Samaj’s

NEW LAW COLLEGE, AHMEDNAGAR

Macro Economics Policies and Practices

(Subject Code – BA203)

STUDY MATERIAL
FOR
B.A.LL.B. – I (Sem. – II) Pattern – 2017

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ACADEMIC YEAR
2020-21

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Module 1 Introduction to Macroeconomics

Macroeconomics

Macroeconomics is a branch of economics that studies how an overall economy—the market systems that operate on a large scale—behaves. Macroeconomics studies economy-wide phenomena such as inflation, price levels, rate of economic growth, national income, gross domestic product (GDP), and changes in unemployment.

Some of the key questions addressed by macroeconomics include: What causes unemployment? What causes inflation? What creates or stimulates economic growth? Macroeconomics attempts to measure how well an economy is performing, to understand what forces drive it, and to project how performance can improve.

Macroeconomics deals with the performance, structure, and behavior of the entire economy, in contrast to microeconomics, which is more focused on the choices made by individual actors in the economy ((like people, households, industries, etc.).

Understanding Macroeconomics

There are two sides to the study of economics: macroeconomics and microeconomics. As the term implies, macroeconomics looks at the overall, big-picture scenario of the economy. Put simply, it focuses on the way the economy performs as a whole and then analyzes how different sectors of the economy relate to one another to understand how the aggregate functions. This includes looking at variables like unemployment, GDP, and inflation. Macroeconomists develop models explaining relationships between these factors. Such macroeconomic models, and the forecasts they produce, are used by government entities to aid in the construction and evaluation of economic, monetary and fiscal policy; by businesses to set strategy in domestic and global markets; and by investors to predict and plan for movements in various asset classes.

Given the enormous scale of government budgets and the impact of economic policy on consumers and businesses, macroeconomics clearly concerns itself with significant issues. Properly applied, economic theories can offer illuminating insights on how economies function and the long-term consequences of particular policies and decisions. Macroeconomic theory can also help individual businesses and investors make better decisions through a more thorough understanding of what motivates ot, andarties and how to best maximize utility and scarce resources.

Limits of Macroeconomics

It is also important to understand the limitations of economic theory. Theories are often created in a vacuum and lack certain real-world details like taxation, regulation and transaction costs. The real world is also decidedly complicated and their matters of social preference and conscience that do not lend themselves to mathematical analysis.

Even with the limits of economic theory, it is important and worthwhile to follow the major macroeconomic indicators like GDP, inflation and unemployment. The performance of companies, and by extension their stocks, is significantly influenced by the economic conditions in which the companies operate and the study of macroeconomic statistics can help an investor make better decisions and spot turning points.

Likewise, it can be invaluable to understand which theories are in favor and influencing a particular government administration. The underlying economic principles of a government will say much about how that government will approach taxation, regulation, government spending, and similar policies. By better understanding economics and the ramifications of economic decisions, investors can get at least a glimpse of the probable future and act accordingly with confidence.

Meaning :

It is that part of economic theory which studies the economy in its totality or as a whole.

It studies not individual economic units like a household, a firm or an industry but the whole economic system. Macroeconomics is the study of aggregates and averages of the entire economy.

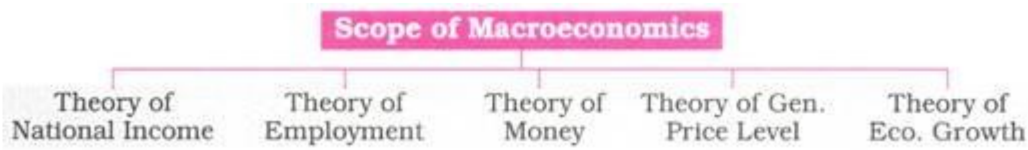
Such aggregates are national income, total employment, aggregate savings and investment, aggregate demand, aggregate supply general price level, etc.

Here, we study how these aggregates and averages of the economy as a whole are determined and what causes fluctuations in them. Having understood the determinants, the aim is how to ensure the maximum level of income and employment in a country.

In short, macroeconomics is the study of national aggregates or economy-wide aggregates. In a way it is like study of economic forest as distinguished from trees that comprise the forest. Main tools of its analysis are aggregate demand and aggregate supply.

Since the subject matter of macroeconomics revolves around determination of the level of income and employment, therefore, it is also known as 'Theory of Income and

The scope of macroeconomics includes the following parts:



Clearly, the study of the problem of unemployment in India or general price level or problem of balance of payment is macroeconomic study because these relate to the economy as a whole.

Importance of Macroeconomics:

1. It helps to understand the functioning of a complicated modern economic system. It describes how the economy as a whole functions and how the level of national income and employment is determined on the basis of aggregate demand and aggregate supply.

2. It helps to achieve the goal of economic growth, higher level of GDP and higher level of employment. It analyses the forces which determine economic growth of a country and explains how to reach the highest state of economic growth and sustain it.

3. It helps to bring stability in price level and analyses fluctuations in business activities. It suggests policy measures to control Inflation and deflation.

3. **Interdependence between Micro and Macroeconomics**

Actually micro and macroeconomics are interdependent. The theories regarding the behaviour of some macroeconomic aggregates (but not all) are derived from theories of individual behaviour.

For instance, the theory of investment, which is a part and parcel of the microeconomic theory, is derived from the behaviour of individual entrepreneur.

According to this theory, an individual entrepreneur in his investment activity is governed by the expected rate of profit on the one hand and rate of interest on the other. And so is the aggregate investment function. Similarly, the theory of aggregate consumption function is based upon the behaviour patterns of individual consumers.

It may be noted that we are able to draw aggregate investment function and aggregate consumption function because in this respect the behaviour of the aggregate is in no way different from the behaviour patterns of individual components. Moreover, we can derive the behaviour of these aggregates only if either the composition of aggregates is constant or the composition changes in some regular way as the size of aggregates changes.

From this it should not be understood that behaviour of all macroeconomic relationship is in conformity with behaviour patterns of individuals composing them. As we saw above, saving-investment relationship and wage-employment relationship for the economic system as a whole are quite different from the corresponding relationships in case of individual parts.

Microeconomic theory contributes to macroeconomic theory in another way also. The theory of relative prices of products and factors is essential in the explanation of the determination of general price level. Even Keynes used microeconomic theory to explain the rise in the general price level as a result of the increase in the cost of production in the economy. According to Keynes, when as a result of the increase in money supply and consequently the aggregate demand, more output is produced, the cost of production rises. With the rise in the cost of production, the prices rise.

According to Keynes, cost of production rises because of:

(1) The law of diminishing returns operates and

(2) Wages and prices of raw materials may rise as the economy approaches full- employment level.

Now, the influences of cost of production, diminishing returns, etc., on the determination of prices are the parts of microeconomics. Not only does macroeconomics depend upon to some extent on microeconomics, the latter also depends upon to some extent on macroeconomics. The determination of the rate of profit and the rate of interest are well-known microeconomic topics, but they greatly depend upon the macroeconomic aggregates.

In microeconomic theory, the profits are regarded as reward for uncertainty bearing but microeconomic theory fails to show the economic forces which determine the magnitude of profits earned by the entrepreneur and why there are fluctuations in them. The magnitude of profits depends upon the level of aggregate demand, national income, and the general price level in the country.

We know that at times of depression when the levels of aggregate demand, national income and price level are low, the entrepreneurs in the various fields of the economy suffer losses. On the other hand, when aggregate demands, incomes of the people, the general price level go up and conditions of boom prevail, the entrepreneurs earn huge profits.

Now, take the case of the rate of interest. Strictly speaking theory of the rate of interest has now become a subject of macroeconomic theory. Partial equilibrium theory of interest which belongs to microeconomic theory would not reveal all the forces which take part in the determination of the rate of interest. Keynes showed that the rate of interest is determined by the liquidity preference function and the stock (or supply) of money in the economy.

The liquidity preference function and the stock of money in the economy are macroeconomic concepts. No doubt, the Keynesian theory has also been shown to be indeterminate, but in the modern theory of interest Keynesian aggregative concepts of liquidity preference and stock of money play an important role in the determination of the rate of interest.

Moreover, in the modern interest theory (i.e., determination of interest rate through intersection of LM and IS curves) along with liquidity preference and the supply of money, the other two forces which are used to explain the determination of interest are saving and investment functions which are also conceived in aggregative or macro terms.

It is thus clear from above that the determination of profits and rate of interest cannot be explained without the tools and concepts of macroeconomics. It follows that though microeconomics and macroeconomics deal with different subjects, but there is a good deal of interdependence between them. In the explanation of many economic phenomena, both micro and macro-economic tools and concepts have to be applied. About interdependence between microeconomics and macroeconomics. Professor Ackley's remarks are worth quoting.

He says, "The relationship between macroeconomics and theory of individual behaviour is a two-way street. On the one hand, microeconomic theory should provide the building blocks for our aggregate theories. But macroeconomics may also contribute to microeconomic understanding. If we discover, for example, empirically stable macroeconomic generalisations which appear inconsistent with microeconomic theories, or which relate to aspects of behaviour which microeconomics has neglected, macroeconomics may permit us to improve our understanding of individual behaviour."

Module 2 National Income

Basic Concepts

National Income is total amount of goods and services produced within the nation during the given period say, 1 year. It is the total of factor income i.e. wages, interest, rent, profit, received by factors of production i.e. labour, capital, land and entrepreneurship of a nation.

Concepts of National Income

There are various concepts of National Income, such as GDP, GNP, NNP, NI, PI, DI, and PCI which explain the facts of economic activities.

1. GDP at market price: Is money value of all goods and services produced within the domestic domain with the available resources during a year.

GDP = (P*Q)

Where,

GDP = gross domestic product

P = Price of goods and services

Q= Quantity of goods and services

GDP is made up of 4 Components

2. consumption
3. investment
4. government expenditure
5. net foreign exports of a country

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

Where,

C=Consumption

I=Investment

G=Government expenditure

(X-M) =Export minus import

6. Gross National Product (GNP): Is market value of final goods and services produced in a year by the residents of the country within the domestic territory as well as abroad. GNP is the value of goods and services that the country's citizens produce regardless of their location.

GNP=GDP+NFIA or

,

GNP=C+I+G+(X-M) +NFIA

Where,

C=Consumption

I=Investment

G=Government expenditure

(X-M) =Export minus import

NFIA= Net factor income from abroad.

7. Net National Product (NNP) at MP: Is market value of net output of final goods and services produced by an economy during a year and net factor income from abroad.
NNP=GNP-Depreciation
or, NNP=C+I+G+(X-M) +NFIA- IT-Depreciation

Where,

C=Consumption

I=Investment

G=Government expenditure

(X-M) =Export minus import

NFIA= Net factor income from abroad.

IT= Indirect Taxes

1. National Income (NI): Is also known as National Income at factor cost which means total income earned by resources for their contribution of land, labour, capital and

organisational ability. Hence, the sum of the income received by factors of production in the form of rent, wages, interest and profit is called National Income.

Symbolically,

NI=NNP +Subsidies-Interest Taxes

or, GNP-Depreciation +Subsidies-Indirect Taxes

or, NI=C+G+I+(X-M) +NFIA-Depreciation-Indirect Taxes +Subsidies

1. Personal Income (PI): Is the total money income received by individuals and households of a country from all possible sources before direct taxes. Therefore, personal income can be expressed as follows:

   PI=NI-Corporate Income Taxes-Undistributed Corporate Profits- Social Security Contribution +Transfer Payments.

2. Disposable Income (DI) : It is the income left with the individuals after the payment of direct taxes from personal income. It is the actual income left for disposal or that can be spent for consumption by individuals.

Thus, it can be expressed as:

DI=PI-Direct Taxes

1. Per Capita Income (PCI): Is calculated by dividing the national income of the country by the total population of a country.

Thus, PCI=Total National Income/Total National Population

Measurement of National Income

There are three methods to calculate National Income:

1. Income Method

2. Product/ Value Added Method

3. Expenditure Method

1. INCOME METHOD

In this National Income is measured as flow of income.

We can calculate NI as:

NET NATIONAL INCOME = Compensation of Employees+ Operating surplus mixed (w +R +P +I) + Net income + Net factor income from abroad.

Where,

W = Wages and salaries

R = Rental Income

P = Profit

I = Mixed Income

1. Product/ Value Added Method

In this National Income is measured as flow of goods and services.

We can calculate NI as:

NATIONAL INCOME = G.N.P – COST OF CAPITAL – DEPRECIATION – INDIRECT TAXES

1. Expenditure Method

In this National Income is measured as flow of expenditure.

We can calculate NI through Expenditure method as:

National Income=National Product=National Expenditure.

Green Accounting

Environmental Changes are a global problem which requires a global solution. It has potential to slow our economic growth. The Green accounting system is considered one of the important management systems to enable improvement of economic and environmental performance of a business firm.

What is Green Accounting System?

The **Green accounting system** is a type of accounting that attempts to factor environmental costs into the financial results of operations. It has been argued that gross domestic product ignores the environment and therefore policymakers need a revised model that incorporates green accounting. The term was first brought into common usage by **economist and Professor Peter Wood** in the 1980s. **India's former Environment Minister Mr. Jairam Ramesh** first time stressed the need and importance to bring Green Accounting practices to the forefront of accounting in India.

What is Objectives of Green Accounting System?

The objectives of green accounting system are discussed below:

1. To identify that part of the gross domestic product that reflects the costs necessary to compensate for the negative impacts of economic growth, that is, the defensive expenditures.

2. To established the linkage of Physical Resource Accounts with Monetary Environmental Accounts

3. To assessment of Environmental Costs and Benefits

4. To accounting for the Maintenance of Tangible resources

5. To elaborate and Measurement of Indicators of Environmentally Adjusted Product and Income.

What is the importance of Green Accounting System?

Changes in the environment have a negative bearing on not just the Environment but on the economy as a whole. And, it is a well-known fact that changes in the economy have a direct bearing on the changes in any business. It is also important to note that the Gross domestic product of a country can be affected by the environmental and climatic change.

Therefore, it is the best tool for the businesses to understand and manage the potential quid pro quo between traditional economic goals and environmental goals. It also increases the important information available for analysing policy issues, especially when those vital pieces of information are often overlooked.

Hence, we can say that it is necessary for understanding of “better lose the saddle than horse”, enterprises designing their accounting system organizations without taking environmental costs into consideration should fulfil this requirement as soon as possible.

Union budget

The **Union Budget of India**, also referred to as the *Annual Financial Statement* in the Article 112 of the Constitution of India, is the annual budget of the Republic of India. The Government presents it on the first day of February so that it could be materialised before the beginning of new financial year in April. Until 2016 it was presented on the last working day of February by the Finance Minister in Parliament. The budget, which is presented by means of the Finance bill and the Appropriation bill has to be passed by Lok Sabha before it can come into effect on 1 April, the start of India's financial year.

Although the budget document relates to the receipts and expenditure of the government for a particular financial year, the impact of it will be there in subsequent years.There is a need therefore to have two accounts- those that relate to the current financial year only are included in the revenue account (also called revenue budget) and those that concern the assets and liabilities of the government into the capital account (also called capital budget). In order to understand the accounts, it is important to first understand the objectives of the government budget.

Objectives of Government Budget

1.Allocation Function of Government Budget

2.Redistribution Function of Government Budget

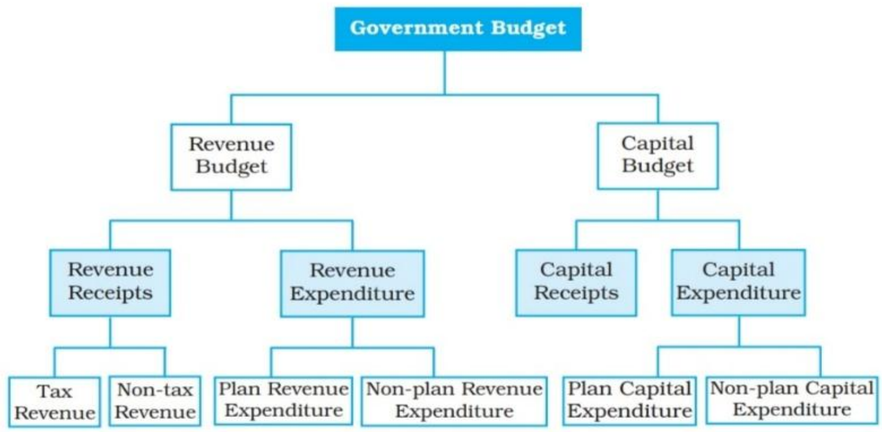


Chart 1: The Components of the Government Budget

3. Function of Government Budget

Classification of Receipts

Revenue Receipts: Revenue receipts are those receipts that do not lead to a claim on the government. They are therefore termed non-redeemable. They are divided into tax and non-tax revenues. Tax revenues, an important component of revenue receipts, have for long been divided into direct taxes (personal income tax) and firms (corporation tax), and indirect taxes like excise taxes (duties levied

on goods produced within the country), customs duties (taxes imposed on goods imported into and exported out of India) and service tax., Other direct taxes like wealth tax, gift tax and estate duty (now abolished) have never brought in large amount of revenue and thus have been referred to as ‘paper taxes’.The redistribution objective is sought to be achieved through progressive income taxation, in which higher the income, higher is the tax rate. Firms are taxed on a proportional basis, where the tax rate is a particular proportion of profits. With respect to excise taxes, necessities of life are exempted or taxed at low rates, comforts and semi-luxuries are moderately taxed, and luxuries, tobacco and petroleum products are taxed heavily.Non-tax revenue of the central government mainly consists of interest receipts on account of loans by the central government, dividends and profits on investments made by the government, fees and other receipts for services rendered by the government. Cash grants-in-aid from foreign countries and international organisations are also included.The estimates of revenue receipts take into account the effects of tax proposals made in the Finance Bill.

Capital Receipts: The government also receives money by way of loans or from the sale of its assets. Loans will have to be returned to the agencies from which they have been borrowed. Thus they create liability. Sale of government assets, like sale of shares in Public Sector Undertakings (PSUs) which is referred to as PSU disinvestment, reduce the total amount of financial assets of the government. All those receipts of the government which create liability or reduce financial assets are termed as capital receipts. When government takes fresh loans it will mean that in future these loans will have to be returned and interest will have to be paid on these loans. Similarly, when government sells an asset, then it means that in future its earnings from that asset, will disappear. Thus,these receipts can be debt creating or non-debt creating.

Classification of Expenditure

Revenue Expenditure

Revenue Expenditure is expenditure incurred for purposes other than the creation of physical or financial assets of the central government. It relates to those expenses incurred for the normal functioning of the government departments and various services, interest payments on debt incurred by the government, and grants given to state governments and other parties (even though some of the grants may be meant for creation of assets). Budget documents classify total expenditure into plan and non-plan expenditure.

within revenue expenditure, a distinction is made between plan and non-plan.According to this classification, plan revenue expenditure relates to central Plans(the Five-Year Plans) and central assistance for State and Union Territory plans. Non-plan expenditure, the more important component of revenue expenditure, covers a vast range of general, economic and social services of the government. The main items of non-plan expenditure are interest payments,defence services, subsidies, salaries and pensions.

Interest payments on market loans, external loans and from various reserve funds constitute the single largest component of non-plan revenue expenditure.Defence expenditure, is committed expenditure in the sense that given the national security concerns, there exists little scope for drastic reduction. Subsidies are an important policy instrument which aim at increasing welfare.

Apart from providing implicit subsidies through under-pricing of public goods and services like education and health, the government also extends subsidies explicitly on items such as exports, interest on loans, food and fertilisers. The amount of subsidies as a per cent of GDP was 2.02 per cent in 2014-15 and is 1.7 percent of GDP in 2015-16 (B.E).

Capital Expenditure

There are expenditures of the government which result in creation of physical or financial assets or reduction in financial liabilities. This includes expenditure on the acquisition of land, building, machinery,equipment, investment in shares, and loans and advances by the central government to state and union territory governments, PSUs and other parties. Capital expenditure is also categorised as plan and non-plan in the budget documents. Plan capital expenditure, like its revenue counterpart, relates to central plan and central assistance for state and union territory plans. Non-plan capital expenditure covers various general, social and economic services provided by the government.The budget is not merely a statement of receipts and expenditures.Since Independence, with the launching of the Five-Year Plans, it has also become a significant national policy statement. The budget, it has been argued, reflects and shapes, and is, in turn, shaped by the country's economic life. Along with the budget, three policy statements are mandated by the Fiscal Responsibility and Budget Management Act,2003 (FRBMA). The Medium-term Fiscal Policy Statement sets a three year rolling target for specific fiscal indicators and examines whether revenue expenditure can be financed through revenue receipts on a sustainable basis and how productively capital receipts including market borrowings are being utilised. The Fiscal Policy Strategy Statement sets the priorities of the government in the fiscal area, examining current policies and justifying any deviation in important fiscal measures. The Macroeconomic Framework Statement assesses the prospects of the economy with respect to the GDP growth rate, fiscal balance of the central government and external balance.

BALANCED, SURPLUS AND DEFICIT BUDGET

The government may spend an amount equal to the revenue it collects. This is known as a balanced budget. If it needs to incur higher expenditure, it will have to raise the amount through taxes in order to keep the budget balanced. When tax collection exceeds the required expenditure, the budget is said to be in surplus. However, the most common feature is the situation when expenditure exceeds revenue. This is when the government runs a budget deficit.

Measures of Government Deficit

Revenue Deficit: The revenue deficit refers to the excess of government's revenue expenditure over revenue receipts

Revenue deficit = Revenue expenditure – Revenue receipts

Fiscal Deficit: Fiscal deficit is the difference between the government's total expenditure and its total receipts excluding borrowing

Gross fiscal deficit = Total expenditure – (Revenue receipts +Non-debt creating capital receipts)

Non-debt creating capital receipts are those receipts which are not borrowings

and, therefore, do not give rise to debt. Examples are recovery of loans and the

proceeds from the sale of PSUs.

Primary Deficit: We must note that the borrowing requirement of the government includes interest obligations on accumulated debt. The goal of measuring primary deficit is to focus on present fiscal imbalances.

To obtain an estimate of borrowing on account of current expenditures exceeding revenues, we need to calculate what has been called the primary deficit. It is simply the fiscal deficit minus the interest payments.

Gross primary deficit = Gross fiscal deficit – Net interest liabilities

Net interest liabilities consist of interest payments minus interest receipts by the government on net domestic lending.

Deficit Reduction: Government deficit can be reduced by an increase in taxes or reduction in expenditure. In India, the government has been trying to increase tax revenue with greater reliance on direct taxes (indirect taxes are regressive in nature– they impact all income groups equally).There has also been an attempt to raise receipts through the sale of shares in PSUs. However, the major thrust has been towards reduction in government expenditure. This could be achieved through making government activities more efficient through better planning of programmes and better administration.

Module 3 Business Cycle and Inflation

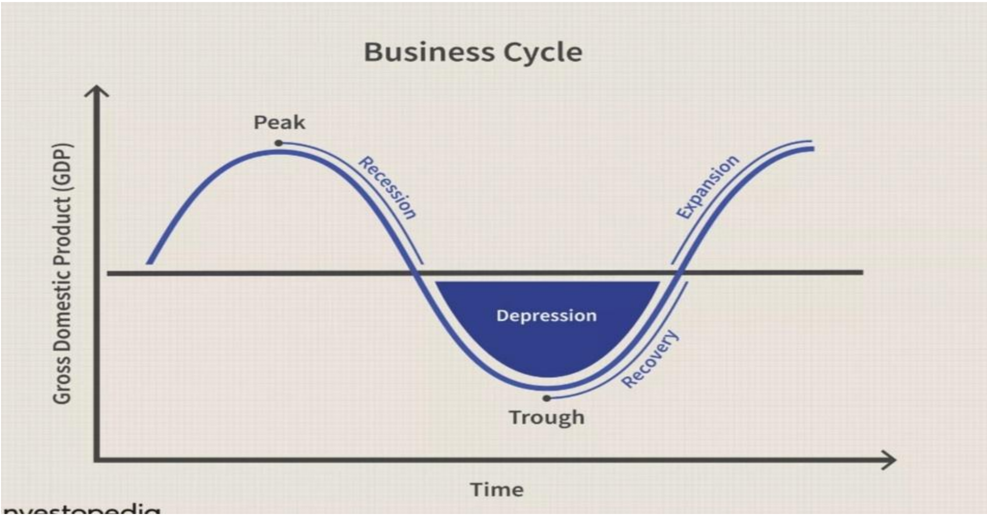
Business Cycle

The business cycle describes the rise and fall in production output of goods and services in an economy. Business cycles are generally measured using the rise and fall in the real gross domestic product (GDP) or the GDP adjusted for inflation. The business cycle is also known as the economic cycle or trade cycle. Business cycles are fluctuations in economic activity that an economy experiences over a period of time. Actual fluctuations in real GDP, however, are far from consistent. These fluctuations include output from all sectors including households, nonprofits, governments, as well as business output. "Output cycle" is thus a better description of what is measured.

The business cycle is characterized by expansion and contraction. During expansion, the economy experiences growth, while a contraction is a period of economic decline. Contractions are also called recessions.

Stages of the Business Cycle

All business cycles are characterized by several different stages, as seen below.



1. Expansion

This is the first stage. When the expansion occurs, there is an increase in employment, incomes, production, and sales. People generally pay their debts on time. The economy has a steady flow in the money supply and investment is booming.

2. Peak

The second stage is a peak when the economy hits a snag, having reached the maximum level of growth. Prices hit their highest level, and economic indicators stop growing. Many people start to restructure as the economy's growth starts to reverse.

3. Recession

These are periods of contraction. During a recession, unemployment rises, production slows down, sales start to drop because of a decline in demand, and incomes become stagnant or decline.

4. Depression

Economic growth continues to drop while unemployment rises and production plummets. Consumers and businesses find it hard to secure credit, trade is reduced, and bankruptcies start to increase. Consumer confidence and investment levels also drop.

5. Trough

This period marks the end of the depression, leading an economy into the next step: recovery.

6. Recovery

In this stage, the economy starts to turn around. Low prices spur an increase in demand, employment and production start to rise, and lenders start to open up their credit coffers. This stage marks the end of one business cycle.

Inflation

In economics, **inflation** is a sustained increase in the general price level of goods and services in an economy over a period of time. When the general price level rises, each unit of currency buys fewer goods and services; consequently, inflation reflects a reduction in the purchasing power per unit of money – a loss of real value in the medium of exchange and unit of account within the economy. The opposite of inflation is deflation, a sustained decrease in the general price level of goods and services. The common measure of inflation is the **inflation rate**, the annualized percentage change in a general price index, usually the consumer price index, over time.

Deflation

In economics, **deflation** is a decrease in the general price level of goods and services. Deflation occurs when the inflation rate falls below 0% (a negative inflation rate). Inflation reduces the value of currency over time, but sudden deflation increases it. This allows more goods and services to be bought than before with the same amount of currency. Deflation is distinct from disinflation, a slow-down in the inflation rate, i.e. when inflation declines to a lower rate but is still positive.

Economists generally believe that a sudden deflationary shock is a problem in a modern economy because it increases the real debt, especially if the deflation is unexpected. Deflation may also aggravate recessions and lead to a deflationary spiral.

Deflation usually happens when supply is high (when excess production occurs), when demand is low (when consumption decreases), or when the money supply decreases (sometimes in response to a contraction created from careless investment or a credit crunch) or because of a net capital outflow from the economy. It can also occur due to too much competition and too little market concentration.

Stagflation

In economics, **stagflation**, or recession-inflation, is a situation in which the inflation rate is high, the economic growth rate slows, and unemployment remains steadily high. It presents a dilemma for economic policy, since actions intended to lower inflation may exacerbate unemployment.

Cost-Push Inflation

Aggregate supply is the total volume of goods and services produced by an economy at a given price level. When the aggregate supply of goods and services decreases because of an increase in production costs, it results in cost-push inflation.

Cost-push inflation means prices have been "pushed up" by increases in the costs of any of the four factors of production—labor, capital, land, or entrepreneurship—when companies are already running at full production capacity. Companies cannot maintain profit margins by producing the same amounts of goods and services when their costs are higher and their productivity is maximized.

The price for raw materials may also cause an increase in costs. This may occur because of a scarcity of raw materials, an increase in the cost of labor to produce the raw materials, or an increase in the cost of importing raw materials. The government may also increase taxes to cover higher fuel and energy costs, forcing companies to allocate more resources to paying taxes.

In order to compensate, the increase in costs is passed on to consumers, causing a rise in the general price level or inflation.

For cost-push inflation to occur, demand for goods must be static or inelastic. That means demand must remain constant while the supply of goods and services decreases.

Demand-Pull Inflation

Demand-pull inflation occurs when there is an increase in aggregate demand, categorized by the four sections of the macroeconomy : households, businesses, governments, and foreign buyers.

When concurrent demand for output exceeds what the economy can produce, the four sectors compete to purchase a limited amount of goods and services. That means the buyers "bid prices up" again and cause inflation. This excessive demand, also referred to as "too much money chasing too few goods," usually occurs in an expanding economy.

The increase in aggregate demand that causes demand-pull inflation can be the result of various economic dynamics. For example, an increase in government spending can increase aggregate demand, thus raising prices. Another factor can be the depreciation of local exchange rates, which raises the price of imports and, for foreigners, reduces the price of exports. As a result, the purchasing of imports decreases while the buying of exports by foreigners increases. This raises the overall level of aggregate demand—assuming aggregate supply cannot keep up with aggregate demand as a result of full employment in the economy.

Multiplier

In economics, a multiplier broadly refers to an economic factor that, when increased or changed, causes increases or changes in many other related economic variables. In terms of gross domestic product, the multiplier gains in total output to be greater than the change in spending that caused it.

The term multiplier is usually used in reference to the relationship between government spending and total national income. Multipliers are also used in explaining fractional reserve banking, known as the deposit multiplier.

- A multiplier refers to an economic factor that, when applied, amplifies the effect of some other outcome.
- A multiplier value of 2x would therefore have the result of doubling some effect; 3x would triple it.

Accelerator

The **accelerator effect** in economics is a positive effect on private fixed investment of the growth of the market economy (measured e.g. by a change in Gross Domestic Product). Rising GDP (an economic boom or prosperity) implies that businesses in general see rising profits, increased sales and cash flow, and greater use of existing capacity. This usually implies that profit expectations and business confidence rise, encouraging businesses to build more factories and other buildings and to install more machinery. (This expenditure is called *fixed investment*.) This may lead to further growth of the economy through the stimulation of consumer incomes and purchases, i.e., via the multiplier effect.

The accelerator effect also goes the other way: falling GDP (a recession) hurts business profits, sales, cash flow, use of capacity and expectations. This in turn discourages fixed investment, worsening a recession by the multiplier effect.

The accelerator effect fits the behavior of an economy best when either the economy is moving away from full employment or when it is already below that level of production. This is because high levels of aggregate demand hit against the limits set by the existing labour force, the existing stock of capital goods, the availability of natural resources, and the technical ability of an economy to convert inputs into products.

Phases of a Business Cycle

Business cycles are characterized by boom in one period and collapse in the subsequent period in the economic activities of a country.

These fluctuations in the economic activities are termed as phases of business cycles.

The fluctuations are compared with ebb and flow. The upward and downward fluctuations in the cumulative economic magnitudes of a country show variations in different economic activities in terms of production, investment, employment, credits, prices, and wages. Such changes represent different phases of business cycles.

The different phases of business cycles are shown in Figure-1:

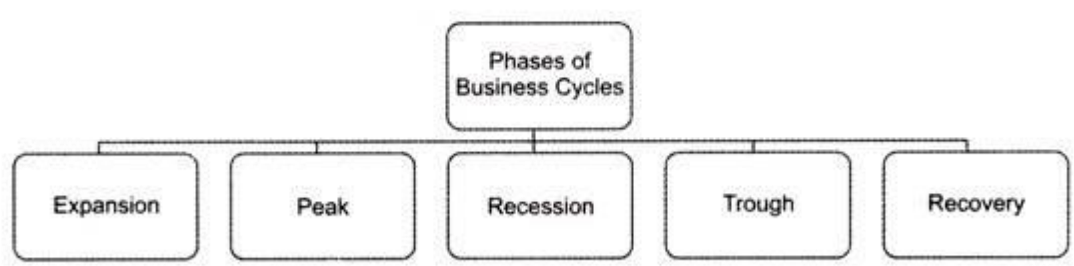


Figure-1:Different Phases of a Business Cycle

There are basically two important phases in a business cycle that are prosperity and depression. The other phases that are expansion, peak, trough and recovery are intermediary phases.

As shown in Figure-2, the steady growth line represents the growth of economy when there are no business cycles. On the other hand, the line of cycle shows the business cycles that move up and down the steady growth line. The different phases of a business cycle (as shown in Figure-2)

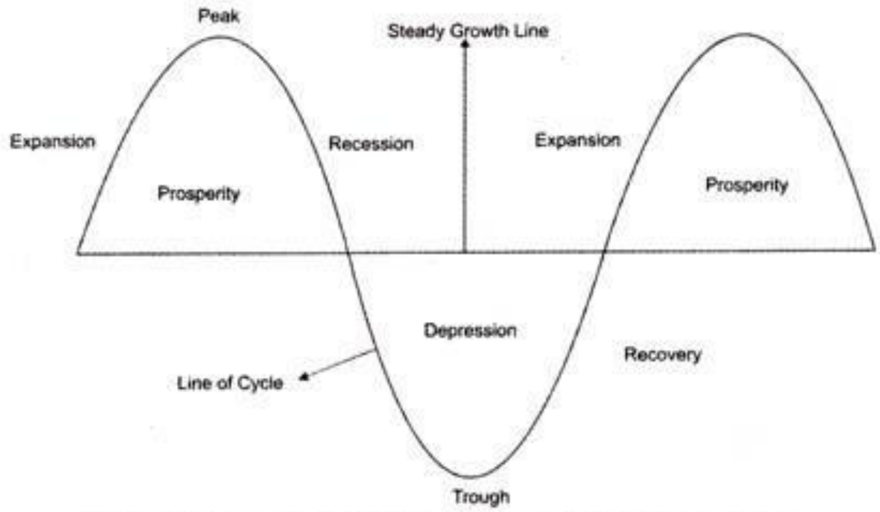


Figure-2: Representation of Phases of a Business Cycle

are explained below.

1. Expansion:

The line of cycle that moves above the steady growth line represents the expansion phase of a business cycle. In the expansion phase, there is an increase in various economic factors, such as production, employment, output, wages, profits, demand and supply of products, and sales.

In addition, in the expansion phase, the prices of factor of production and output increases simultaneously. In this phase, debtors are generally in good financial condition to repay their debts; therefore, creditors lend money at higher interest rates. This leads to an increase in the flow of money.

In expansion phase, due to increase in investment opportunities, idle funds of organizations or individuals are utilized for various investment purposes. Therefore, in such a case, the cash inflow and outflow of businesses are equal. This expansion continues till the economic conditions are favorable.

2. Peak:

The growth in the expansion phase eventually slows down and reaches to its peak. This phase is known as peak phase. In other words, peak phase refers to the phase in which the increase in growth rate of business cycle achieves its maximum limit. In peak phase, the economic factors, such as production, profit, sales, and employment, are higher, but do not increase further. In peak phase, there is a gradual decrease in the demand of various products due to increase in the prices of input.

The increase in the prices of input leads to an increase in the prices of final products, while the income of individuals remains constant. This also leads consumers to restructure their monthly budget. As a result, the demand for products, such as jewellery, homes, automobiles, refrigerators and other durables, starts falling.

3. Recession:

As discussed earlier, in peak phase, there is a gradual decrease in the demand of various products due to increase in the prices of input. When the decline in the demand of products becomes rapid and steady, the recession phase takes place.

In recession phase, all the economic factors, such as production, prices, saving and investment, starts decreasing. Generally, producers are unaware of decrease in the demand of products and they continue to produce goods and services. In such a case, the supply of products exceeds the demand.

Over the time, producers realize the surplus of supply when the cost of manufacturing of a product is more than profit generated. This condition firstly experienced by few industries and slowly spread to all industries.

This situation is firstly considered as a small fluctuation in the market, but as the problem exists for a longer duration, producers start noticing it. Consequently, producers avoid any type of further investment in factor of production, such as labor, machinery, and furniture. This leads to the reduction in the prices of factor, which results in the decline of demand of inputs as well as output.

4. Trough:

During the trough phase, the economic activities of a country decline below the normal level. In this phase, the growth rate of an economy becomes negative. In addition, in trough phase, there is a rapid decline in national income and expenditure.

In this phase, it becomes difficult for debtors to pay off their debts. As a result, the rate of interest decreases; therefore, banks do not prefer to lend money. Consequently, banks face the situation of increase in their cash balances.

Apart from this, the level of economic output of a country becomes low and unemployment becomes high. In addition, in trough phase, investors do not invest in stock markets. In trough phase, many weak organizations leave industries or rather dissolve. At this point, an economy reaches to the lowest level of shrinking.

5. Recovery:

As discussed above, in trough phase, an economy reaches to the lowest level of shrinking. This lowest level is the limit to which an economy shrinks. Once the economy touches the lowest level, it happens to be the end of negativism and beginning of positivism.

This leads to reversal of the process of business cycle. As a result, individuals and organizations start developing a positive attitude toward the various economic factors, such as investment, employment, and production. This process of reversal starts from the labor market.

Consequently, organizations discontinue laying off individuals and start hiring but in limited number. At this stage, wages provided by organizations to individuals is less as compared to their skills and abilities. This marks the beginning of the recovery phase.

In recovery phase, consumers increase their rate of consumption, as they assume that there would be no further reduction in the prices of products. As a result, the demand for consumer products increases.

In addition in recovery phase, bankers start utilizing their accumulated cash balances by declining the lending rate and increasing investment in various securities and bonds. Similarly, adopting a positive approach other private investors also start investing in the stock market As a result, security prices increase and rate of interest decreases.

Price mechanism plays a very important role in the recovery phase of economy. As discussed earlier, during recession the rate at which the price of factor of production falls is greater than the rate of reduction in the prices of final products.

Therefore producers are always able to earn a certain amount of profit, which increases at trough stage. The increase in profit also continues in the recovery phase. Apart from this, in recovery phase, some of the depreciated capital goods are replaced by producers and some are maintained by them. As a result, investment and employment by organizations increases. As this process gains momentum an economy again enters into the phase of expansion. Thus, a business cycle gets completed.

3.3 Policies to control business cycle Fiscal Policy and Monetary policy

1. <u>Monetary Policy:</u>

Whatever may be the cause of the short-business cycle it is always aggravated by the monetary factors.The RBI is the main body that controls the monetary policy in India. They control the flow of money into the market through various instruments of monetary policy. This helps the RBI control the inflation and liquidity in the economy.

The RBI is the central bank of India. It was established in 1935 under a special act of the **parliament**. The RBI is the main **authority** for the monetary policy of the country. The main functions of the RBI are to maintain **financial** stability and the required level of liquidity in the **economy**. The RBI also controls and regulates the currency system of our economy. It is the sole issuer of currency notes in **India**. The RBI is the central banks that **control** all the other commercial banks, financial institutes, finance **firms** etc. It supervises the entire financial sector of the country.

Instruments of Monetary Policy

Monetary policy is a way for the RBI to control the supply of money in the economy. So these credit policies help control the inflation and in turn help with the economic growth and development of the country. So now let us take a look at the various instruments of monetary policy that the RBI has at its disposal.

1] Open Market Operations -Open Market Operations is when the RBI involves itself directly and buys or sells short-term securities in the open market. This is a direct and effective way to increase or decrease the supply of money in the market. It also has a direct effect on the ongoing rate of interest in the market. Let us say the market is in equilibrium. Then the RBI decides to sell short-term securities in the market. The supply of money in the market will reduce. And subsequently, the demand for credit facilities would increase. And so correspondingly the rate of interest would also see a boost. On the other hand, if RBI was purchasing securities from the open market it would have the opposite effect. The supply of money to the market would increase. And so, in turn, the rate of interest would go down since the demand for credit would fall.

2] Bank Rate-**One of the most effective instruments of monetary policy is the bank rate. A bank rate is essentially the rate at which the RBI lends money to commercial banks without any security or collateral. It is also the standard rate at which the RBI will buy or discount bills of exchange and other such commercial instruments.**

So now if the RBI were to increase the bank rate, the commercial banks would also have to increase their lending rates. And this will help control the supply of money in the market. And the reverse will obviously increase the supply of money in the market.

3] Variable Reserve Requirement-**There are two components to this instrument of monetary policy, namely – The Cash Reserve Ratio (CLR) and the Statutory Liquidity Ratio (SLR). Let us understand them both.**

Cash Reserve Ratio (CRR) is the portion of deposits with the commercial banks that it has to deposit to the RBI. So CRR is the percent of deposits the commercial banks have to keep with the RBI. The RBI will adjust the said percentage to control the supply of money available with the bank. And accordingly, the loans given by the bank will either become cheaper or more expensive. The CRR is a great tool to control inflation. The Statutory Liquidity Ratio (SLR) is the percent of total deposits that the commercial banks have to keep with themselves in form of cash reserves or gold. So increasing the SLR will mean the banks have fewer funds to give as loans thus controlling the supply of money in the economy. And the opposite is true as well.

4] Liquidity Adjustment Facility-**The Liquidity Adjustment Facility (LAF) is an indirect instrument for monetary control. It controls the flow of money through repo rates and reverse repo rates. The repo rate is actually the rate at which commercial banks and other institutes obtain short-term loans from the Central Bank.**

And the reverse repo rate is the rate at which the RBI parks its funds with the commercial banks for short time periods. So the RBI constantly changes these rates to control the flow of money in the market according to the economic situations.

5] Moral Suasion-**This is an informal method of monetary control. The RBI is the Central Bank of the country and thus enjoys a supervisory position in the banking system. If there is a need it can urge the banks to exercise credit control at times to maintain the balance of funds in the market. This method is actually quite effective since banks tend to follow the policies set by the RBI.**

2. Fiscal Policy:

Monetary policy taken alone may not suffice to check cyclical business fluctuations. It is therefore suggested that monetary policy should be properly integrated with a suitable fiscal policy to achieve the desired results. Keynes and the Keynesians such as Alvin Hansen and others have recommended compensatory finance or compensatory fiscal policy to bring about stabilisation of business activity.

Through the fiscal policy, the government of a country controls the flow of tax revenues and public expenditure to navigate the economy. If the government receives more revenue than it spends, it runs a surplus, while if it spends more than the tax and non-tax receipts, it runs a deficit. To meet additional expenditures, the government needs to borrow domestically or from overseas. Alternatively, the government may also choose to draw upon its foreign exchange reserves or print additional money.

It is therefore suggested that the government should regulate its activities in such a manner as to off-set the cyclical fluctuations in private business activity. The three main instruments of fiscal policy-taxation, spending and borrowing can be used by the Government to achieve this purpose.

If business activity shows signs of slackening down or there are symptoms of a downswing, the Government should at once enforce its three instruments of fiscal policy to check the down trend and ensure stability in the economy. At such a time the Government should not levy and new taxes on the people. Even the existing taxes should be substantially reduced.

This would leave more money in the hands of the people who should be encouraged to spend in on buying additional goods and services to off-set the decline in demand and business activity.

At the same time, the government itself should embark on a vast spending programme to stimulate business activity in the economy. The Government, at the time of depression should initiate Public Works Projects of various kinds involving expenditure of money and additional employment of labour.

The Government is expected to keep ready a number of Public Works Schemes, such as construction of roads, canals, parks, schools, hospitals etc., and execute them at the first sign of the coming depression.

These public works projects by giving employment to the unemployed workers, provide them with purchasing power to buy consumer goods. This would help in off-setting the decline in effective demand and business activity. The funds to finance the public works projects should be obtained either by printing more paper money or by borrowing from the banks.

In either case, more money would be created and put into circulation, thus off-setting the deflationary effect of reduced business spending. The Government should at such a time follow the policy of Deficit budgeting, which alone will increase the flow of income stream into the economy.

When the economy recovers and a wave of prosperity sets in the Government should follow an exactly opposite policy. Now, it should raise the existing taxes and even levy new taxes to check private spending. It should reduce its expenditure on public works and similar projects.

It should retire paper money and pay off its debts to the banks and the public, thereby reducing the quantity of money in circulation. The idea is that the Government at the time of boom should follow a policy of surplus budgeting. It is thus, evident that a compensatory fiscal policy followed by the Government would help to maintain a constant circuit flow by bringing about stabilisation in the economy.

What is the difference between fiscal policy and monetary policy?

The government uses both monetary and fiscal policy to meet the county’s economic objectives. The central bank of a country mainly administers monetary policy. In India, the Monetary Policy is under the Reserve Bank of India or RBI. Monetary policy majorly deals with money, currency, and interest rates. On the other hand, under the fiscal policy, the government deals with taxation and spending by the Centre

Module 4 Output and Employment

The Classical Theory of Employment

The classical economists believed in the existence of full employment in the economy. To them, full employment was a normal situation and any deviation from this regarded as something abnormal. According to Pigou, the tendency of the economic system is to automatically provide full employment in the labour market when the demand and supply of labour are equal.

Unemployment results from the rigidity in the wage structure and interference in the working of free market system in the form of trade union legislation, minimum wage legislation etc. Full employment exists "when everybody who at the running rate of wages wishes to be employed."

Those who are not prepared to work at the existing wage rate are not unemployed because they are voluntarily unemployed. Thus full employment is a situation where there is no possibility of involuntary unemployment in the sense that people are prepared to work at the current wage rate but they do not find work.

The basis of the classical theory is Say's Law of Markets which was carried forward by classical economists like Marshall and Pigou. They explained the determination of output and employment divided into individual markets for labour, goods and money. Each market involves a built-in equilibrium mechanism to ensure full employment in the economy.

It's ***Assumptions****:*

1. There is the existence of full employment without inflation.

2. There is a laissez-faire capitalist economy without government interference.

3. It is a closed economy without foreign trade.

4. There is perfect competition in labour and product markets.

5. Labour is homogeneous.

6. Total output of the economy is divided between consumption and investment expenditures.

7. The quantity of money is given and money is only the medium of exchange.

8. Wages and prices are perfectly flexible.

9. There is perfect information on the part of all market participants.

10. Money wages and real wages are directly related and proportional.

11. Savings are automatically invested and equality between the two is brought about by the rate of interest

12. Capital stock and technical knowledge are given.

13. The law of diminishing returns operates in production.

14. It assumes long run.

Say's Law of Markets:

Say's law of markets is the core of the classical theory of employment. An early 19th century French Economist, J.B. Say, enunciated the proposition that "supply creates its own demand." Therefore, there cannot be general overproduction and the problem of unemployment in the economy.

If there is general overproduction in the economy, then some labourers may be asked to leave their jobs. The problem of unemployment arises in the economy in the short run. In the long run, the economy will automatically tend toward full employment when the demand and supply of goods become equal.

When a producer produces goods and pays wages to workers, the workers, in turn, buy those goods in the market. Thus the very act of supplying (producing) goods implies a demand for them. It is in this way that supply creates its own demand.

In the classical theory, the determination of output and employment takes place in labour, goods and money markets of the economy, as shown in Fig. 6. The forces of demand and supply in these markets will ultimately bring full employment in the economy.

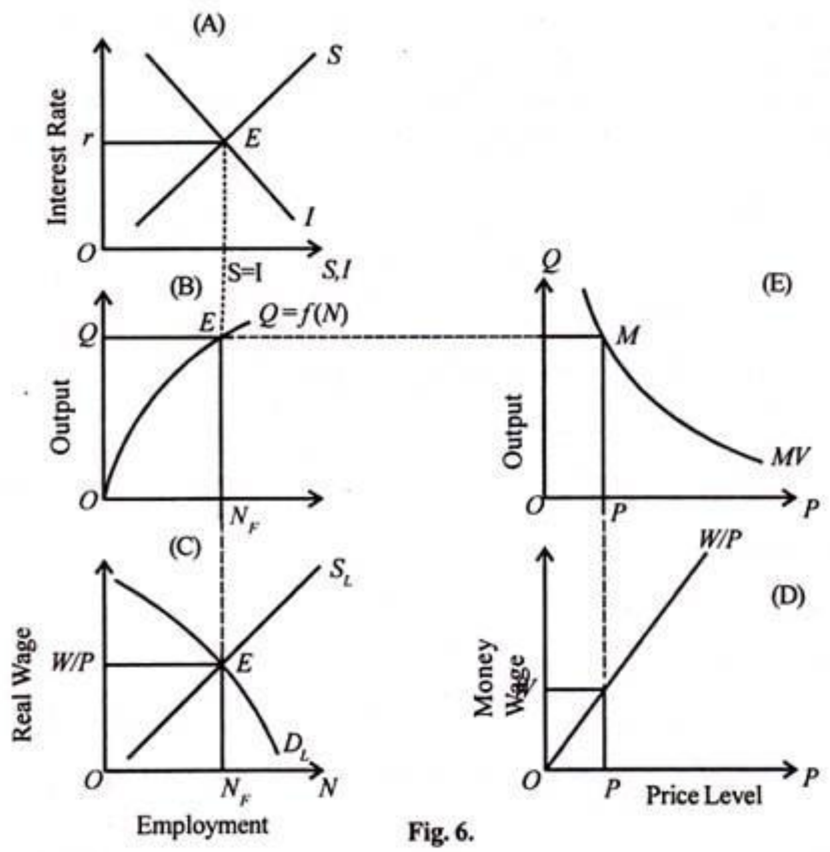


Fig. 6.

In the classical analysis, output and employment in the economy are determined by the aggregate production function, demand for labour and supply of labour. Given the stock of capital, technical knowledge and other factors, there is a precise relation between total output and employment (number of workers).

This is expressed as Q = f (K, T, N). In other words, total output (Q) is a function (f) of capital stock (K), technical knowledge T, and number of workers (TV). Given K and T, total output (Q) is an increasing function of the number of workers (N): Q=f (N) as shown in Panel (B). At point E, ON_F workers produce OQ output. But beyond point E, as more workers are employed, diminishing marginal returns start.

Labour Market Equilibrium:

In the labour market, the demand for and supply of labour determine output and employment in the economy. The demand for labour depends on total output. As production increases, the demand for labour also increases.

The demand for labour, in turn, depends on the marginal productivity (MP) of labour which declines as more workers are employed. The supply of labour depends on the wage rate, S_L = f (W/P), and is an increasing function of the wage rate.

The demand for labour also depends on the wage rate, D_L=f (W/P), and is a decreasing function of the wage rate. Thus both the demand for and supply of labour are the functions of real wage rate (W/P). The intersection point E of D_L and S_L curves at W/ P wage rate in Panel (C) of the figure determines the full employment level $ON_{F.}$

Goods Market Equilibrium:

In the classical analysis, the goods market is in equilibrium when saving and investment are in equilibrium (S=I). This equality is brought about by the mechanism of interest rate at the full employment level of output so that the quantity of goods demanded is equal to the quantity of goods supplied. This is shown in Panel (A) of the figure where S=I at point E when the interest rate is Or.

Money Market Equilibrium:

The money market is in equilibrium when the demand for money equals the supply of money. This is explained by the Quantity Theory of Money which states that the quantity of money is a function of the price level, P=f (MV). Changes in the general price level are proportional to the quantity of money.

The equilibrium in the money market is shown by the equation MV = PT where MV is the supply of money and PT is the demand for money. The equilibrium of the money market explains the price level corresponding to the full employment level of output which relates Panel (E) and Panel (B) with MQ line.

The price level OP is determined by total output (Q) and the quantity of money (MV), as shown in Panel (E). Then the real wage corresponding with the money wage is determined by the (W/P) curve, as shown in Panel (D).

When the money wage increases, the real wage also increases in the same proportion and there is no effect on the level of output and employment. It follows that the money wage should be reduced in order to attain the full employment level in the economy. Thus the classicists favoured a flexible price-wage policy to maintain full employment.

2.Keynesian Theory of Employment

As per Keynes theory of employment, effective demand signifies the money spent on the consumption of goods and services and on investment.

The total expenditure is equal to the national income, which is equivalent to the national output.

Therefore, effective demand is equal to total expenditure as well as national income and national output.

The theory of Keynes was against the belief of classical economists that the market forces in capitalist economy adjust themselves to attain equilibrium. He has criticized classical theory of employment in his book. Vie General Theory of Employment, Interest and Money. Keynes not only criticized classical economists, but also advocated his own theory of employment.

His theory was followed by several modern economists. Keynes book was published post-Great Depression period. The Great Depression had proved that market forces cannot attain equilibrium themselves; they need an external support for achieving it. This became a major reason for accepting the Keynes view of employment.

The Keynes theory of employment was based on the view of the short run. In the short run, he assumed that the factors of production, such as capital goods, supply of labor, technology, and efficiency of labor, remain unchanged while determining the level of employment. Therefore, according to Keynes, level of employment is dependent on national income and output.

In addition, Keynes advocated that if there is an increase in national income, there would be an increase in level of employment and vice versa. Therefore, Keynes theory of employment is also known as theory of employment determination and theory of income determination.

Principle of Effective Demand:

The main point related to starting point of Keynes theory of employment is the principle of effective demand. Keynes propounded that the level of employment in the short run is dependent on the aggregate effective demand of products and services.

According to him, an increase in the aggregate effective demand would increase the level of employment and vice-versa. Total employment of a country can be determined with the help of total demand of the country. A decline in total effective demand would lead to unemployment.

As per Keynes theory of employment, effective demand signifies the money spent on the consumption of goods and services and on investment. The total expenditure is equal to the national income, which is equivalent to the national output. Therefore, effective demand is equal to total expenditure as well as national income and national output.

The effective demand can be expressed as follows:
Effective demand = National Income = National Output

Therefore effective demand affects employment level of a country, national income, and national output. It declines due to the mismatch of income and consumption and this decline lead to unemployment.

With the increase in the national income the consumption rate also increases, but the increase in consumption rate is relatively low as compared to the increase in national income. Low consumption rate leads to a decline in effective demand.

Therefore, the gap between the income and consumption rate should be reduced by increasing the number of investment opportunities. Consequently, effective demand also increases, which further helps in reducing unemployment and bringing full employment condition.

Moreover, effective demand refers to the total expenditure of an economy at a particular employment level. The total equal to the total supply price of economy (cost of production of products and services) at a certain level of employment. Therefore, effective demand refers to the demand of consumption and investment of an economy.

Determination of Effective Demand:
Keynes has used two key terms, namely, aggregate demand price and aggregate supply price, for determining effective demand. Aggregate demand price and aggregate supply price together

contribute to determine effective demand, which further helps in estimating the level of employment of an economy at a particular period of time.

In an economy, the employment level depends on the number of workers that are employed, so that maximum profit can be drawn. Therefore, the employment level of an economy is dependent on the decisions of organizations related to hiring of employee and placing them.

The level of employment can be determined with the help of aggregate supply price and aggregate demand price. Let us study these two concepts in detail.

Aggregate Supply Price: Aggregate supply price refers to the total amount of money that all organizations in an economy should receive from the sale of output produced by employing a specific number of workers. In simpler words, aggregate supply price is the cost of production of products and services at a particular level of employment.

It is the total amount of money paid by organizations to the different factors of production involved in the production of output. Therefore, organizations would not employ the factors of production until they can recover the cost of production incurred for employing them.

A certain minimum amount of price is required for inducing employers to offer a specific amount of employment. According to Dillard, “This minimum price or proceeds, which will just induce employment on a given scale, is called the aggregate supply price of that amount of employment.”

If an organization does not get an adequate price so that cost of production is covered, then it employs less number of workers. Therefore the aggregate supply price varies according to different number of workers employed. So, aggregate supply price schedule Id Tut can be prepared as per the total number of workers employed.

Aggregate supply price schedule is a schedule of minimum price required to induce the different quantities of employment. Thus, higher the price required to induce the different quantities of employment, greater the level of employment would be. Therefore, the slope of the aggregate supply curve is upward to the right.

Aggregate Demand Price:

Aggregate demand price is different from demand for products of individual organizations and industries. The demand for individual organizations or industries refers to a schedule of quantity purchased at different levels of price of a single product.

On the hand, aggregate demand price is the total amount of money that an organization expects to receive from the sale of output produced by a specific number of workers. In other words, the aggregate demand price signifies the expected sale receipts received by the organization by employing a specific number of workers.

Aggregate demand price schedule refers to the schedule of expected earnings by selling the product at different level of employment Mo higher the level of employment, greater the level of output would be.

Consequently, the increase in the employment level would increase the aggregate demand price. Thus, the slope of aggregate demand curve would be upward to the right. However, the individual demand curve slopes downward.

The basic difference between the aggregate supply price and aggregate demand price should be analyzed carefully as both of them seem to be same. In aggregate supply price, organizations should receive money from the sale of output produced by employing a specific number of workers.

However, in aggregate demand price, organizations expect to receive from the sale of output produced by a specific number of workers. Therefore, in aggregate supply price, the amount of money is the necessary amount that should be received by the organization, while in aggregate demand price the amount of money may or may not be received.

Determination of Equilibrium Level of Employment:

The aggregate demand price and aggregate supply price help in determining the equilibrium level of employment.

The aggregate demand (AD) and aggregate supply (AS) curve are used for determining the equilibrium level of employment, as shown in
Figure-3:

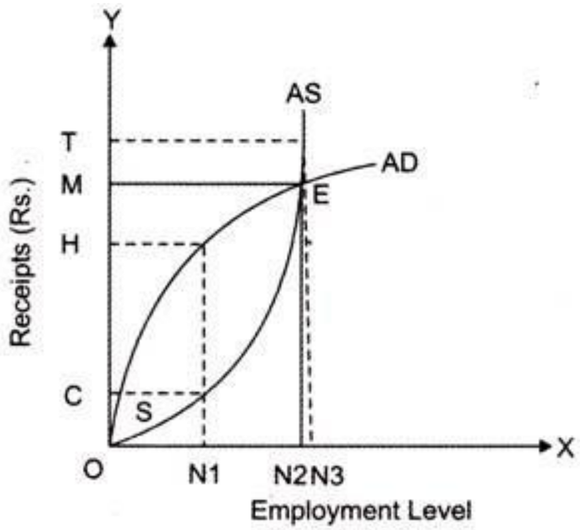


Figure-3: Determination of Employment Level

In Figure-3, AD represents the aggregate demand curve, while AS represents the aggregate supply curve. It can be interpreted from Figure-3 that although the aggregate demand and aggregate supply curve are moving in the same direction, but they are not alike. There are different aggregate demand price and aggregate supply price for different levels of employment.

For example, in Figure-3, at AS curve, the organization would employ ON_1number of workers, when they receive OC amount of sales receipts. Similarly, in case of AD curve, the organization would employ ON_1number of workers with the expectation that they would produce OH amount of sales receipt for them.

The aggregate demand price exceeds the aggregate supply price or vice versa at some levels of employment. For example, at ON_1 employment level, the aggregate demand price (OH) is greater than the aggregate supply price (OC). However, at certain level of employment, the aggregate demand price and aggregate supply price become equal.

At this point, aggregate demand and aggregate supply curve intersect each other. This point of intersection is termed as the equilibrium level of employment. In Figure-3, point E represents the equilibrium level of employment because at this point, the aggregate demand curve and aggregate supply curve intersect each other.

In Figure-3, initially, there is a slow movement in the AS curve, but after a certain point of time it shows a sharp rise. This implies that when a number of workers increases initially, the cost incurred for production also increases but at a slow rate. However, when the amount of sales receipt increases, the organization starts employing more and more workers. In Figure-3, the ON_1 numbers of workers are employed, when OT amount of sales receipts are received by the organization.

On the other hand, the AD curve shows a rapid increase initially, but after some time it gets flattened. This means that the expected sales receipts increase with an increase in the number of workers. As a result, the expectations of the organization to earn more profit increases. As a result, the organization start employing more workers. However, after a certain level, the increase in employment level would not show an increase in the amount of sales receipts.

In Figure-3, before reaching the employment level of ON_2, the employment level keeps on increasing as the organizations want to higher more and more workers to get the maximum profit. However, when the employment level crosses the ON_{21} level, the AD curve is below the AS curve, which shows that the aggregate supply price exceeds the aggregate demand price. As a result, the organization would start incurring losses; therefore would reduce the employment rate. Thus, the economy would be in equilibrium when the aggregate supply price and aggregate demand price become equal. In other words, equilibrium can be achieved when the amount of sales receipt necessary and the amount of sales receipt expected to be received by the organization at a specified level of employment are equal.

Module 5 Economic Growth

Concept of Economic Growth

Economic growth is an increase in the the production of economic goods and services, compared from one period of time to another. It can be measured in nominal or real (adjusted for inflation) terms. Traditionally, aggregate economic growth is measured in terms of gross national product (GNP) or gross domestic product (GDP).

1. Economic growth is an increase in the production of goods and services in an economy.
2. Increases in capital goods, labor force, technology, and human capital can all contribute to economic growth.
3. Economic growth is commonly measured in terms of the increase in aggregated market value of additional goods and services produced, using estimates such as GDP.

For more clarification see video [Economic Growth Explained]

In words of ***Prof.*** **Meier,** “*we shall define economic growth as the process whereby per capita real income of a country increases over a long period of time.*[91]

According to ***Prof.*** **Salvatore,** *“Economic growth has been defined as the process whereby a country's real per capital gross national product (GNP) or income increases over a sustained period of time through continuing increase in per capita productivity.”*

2.Growth vs Development

Economic Growth is a narrower concept than economic development.It is an increase in a country's real level of national output which can be caused by an increase in the quality of resources (by education etc.), increase in the quantity of resources & improvements in technology or in another way an increase in the value of goods and services produced by every sector of the economy. Economic Growth can be measured by an increase in a country's GDP (gross domestic product).

Economic development is a normative concept i.e. it applies in the context of people's sense of morality(right and wrong, good and bad). The definition of economic development given by Michael Todaro is an increase in living standards, improvement in self-esteem needs and freedom from oppression as well as a greater choice. The most accurate method of measuring development is the Human Development Index which takes into account the literacy rates & life expectancy which affect productivity and could lead to Economic Growth. It also leads to the creation of more opportunities in the sectors of education, healthcare, employment and the conservation of the environment.It implies an increase in the per capita income of every citizen.

Comparison chart

Economic Development versus Economic Growth comparison chart

	Economic Development	Economic Growth
Implications	Economic development implies an upward movement of the entire social system in terms of income, savings and investment along with progressive changes in socioeconomic structure of country (institutional and technological changes).	Economic growth refers to an increase over time in a country`s real output of goods and services (GNP) or real output per capita income.
Factors	Development relates to growth of human capital indexes, a decrease in inequality figures, and structural changes that improve the general population's quality of life.	Growth relates to a gradual increase in one of the components of Gross Domestic Product: consumption, government spending, investment, net exports.
Measurement	Qualitative.HDI (Human Development Index), gender- related index (GDI), Human poverty index (HPI), infant mortality, literacy rate etc.	Quantitative. Increases in real GDP.
Effect	Brings qualitative and quantitative changes in the economy	Brings quantitative changes in the economy
Relevance	Economic development is more relevant to measure progress and quality of life in developing nations.	Economic growth is a more relevant metric for progress in developed countries. But it's

Economic Development versus Economic Growth comparison chart

	Economic Development	Economic Growth
		widely used in all countries because growth is a necessary condition for development.
Scope	Concerned with structural changes in the economy	Growth is concerned with increase in the economy's output

<u>3.Indicators of Economic Growth</u>

Economic growth is a quantitative term and measures the rate of growth in economy via following indicators -

- **National income or GDP**- Higher the growth in national income, higher will be the economic growth since population will have a bigger chunk of income for distribution among themselves.
- **Per capita Income** - We incorporate population so as to take care of increasing population. If population increase at a higher rate than national income then of course economy will be no better off. Hence we look at per person income which is national income divided by population.
- **Per capita consumption** - We look at it to basically distinguish between what part of income is going for savings and what part for consumption.Very high saving rate especially in developed countries can bring about recessionary conditions. And in general too stressing too much on savings at the cost of producing essential goods can adversely

impact welfare. Hence an increase in per capita consumption is seen as another measure to indicate economic growth.

Indicators of Economic Development

To know the level of economic development of a country there are a different indicators which are used.These indicators help in understanding the level of development,comparisons with other countries, or different time periods.These indicators help in better planning towards achieving economic development.

The indicators of economic development are:

Growth rate of National Income:

- In this indicator real income is calculated on constant prices
- If there is rise in national income, this indicates economic development.
- When there is high rate of national income, development rate is high and vice versa

Per Capita Income (PCI):

- The average income of the people living in the country is the per capita income.
- A rise in PCI is an important indicator of economic development
- The rise in PCI indicates economic welfare of the country

Per Capita Consumption (PCC):

- The increase in consumption of goods and services by the people is measured in PCC.
- Example clothing, food, education, health etc
- An increase in PCC shows better quality of life of people and higher economic development of the country.

Productivity per Hector of Land

It means total crops production (kgs) divided by total Land under Crops (Hector).

Physical Quality Life Index (PQLI) and Human Development Index (HDI):

- PQLI is the overall welfare of the people in life expectancy, infant mortality rate, standard of living.
- HDI measures life expectancy, education and standard of living.
- A rise in PQLI and HDI shows an improvement in quality of life of people and therefore economic development.

Industrial progress:

Industrial progress is an important indicator of the economic development of a country. It helps to increase per capita income and the national output of the country.

Capital formation:

It means investing in transport, irrigation, roads, electricity, technology etc. higher capital formation will lead to higher economic development.

- The indicators under economic development are more towards the qualitative improvement of people in the country.
- A higher rate of these indicators shows a higher level of economic development

4.Economic Growth In India

Prior to India's Independence, from the period of 1900 to 1947, per capita income in India had either declined or stagnated. Post-Independence, Jawaharal Nehru enacted an economic policy based on import substitution industrialization. The Nehru-Mahalanobis approach, often referred to as the Second Five Year Plan, emphasized the development of basic and heavy industries as a means of accelerating economic growth. These included steel, copper, petrochemicals, paper, coal, and oil. Mahalanobis strived for India to reach autonomy, ridding any outstanding debts. Critics disagreed with this approach, stating that World Bank's claim of Indian export prospects being low were falsified and due to India's inward-looking strategy, the growth opportunity of the world economy was missed. Nonetheless, over 1950-1965, India's acceleration of per capita income growth had increased an average of 1.7%, a value not exceeded since.

The **economic development in India** followed socialist-inspired politicians for most of its independent history, including state-ownership of many sectors; India's per capita income increased at only around 1% annualised rate in the three decades after its independence. Since the mid-1980s, India has slowly opened up its markets through economic liberalisation. After more fundamental reforms since 1991 and their renewal in the 2000s, India has progressed towards a free market economy.

In the late 2000s, India's growth reached 7.5%, which will double the average income in a decade.

States have large responsibilities over their economies. The average annual growth rates (2007–12) for Gujarat (13.86%), Uttarakhand (13.66%), Bihar(10.15%) or Jharkhand (9.85%) were higher than for West Bengal (6.24%), Maharashtra(7.84%), Odisha (7.05%), Punjab (11.78%) or Assam (5.88%).

India is the sixth-largest economy in the world and the third largest by purchasing power parity adjusted exchange rates (PPP). On per capita basis, it ranks 140th in the world or 129th by PPP.

The economic growth has been driven by the expansion of the services that have been growing consistently faster than other sectors. It is argued that the pattern of Indian development has been a specific one and that the country may be able to skip the intermediate industrialisation-led phase in the transformation of its economic structure. Serious concerns have been raised about the jobless nature of the economic growth.

Favourable macroeconomic performance has been a necessary but not sufficient condition for the significant reduction of poverty amongst the Indian population. The rate of poverty decline has not been higher in the post-reform period (since 1991)[*citation needed*]. The improvements in some other non-economic dimensions of social development have been even less favourable. The most pronounced example is an exceptionally high and persistent level of child malnutrition (46% in 2005–6).

For 2018, India ranked 77th in Ease of Doing Business Index. According to Index of Economic Freedom World Ranking an annual survey on economic freedom of the nations, India ranks 123rd as compared with China and Russia which ranks 138th and 144th respectively in 2014.

At the turn of the century India's GDP was at around US$480 billion. As economic reforms picked up pace, India's GDP grew five-fold to reach US$2.2 trillion in 2015 (as per IMF estimates).

India's GDP growth during January–March period of 2015 was at 7.5% compared to China's 7%, making it the fastest growing economy. During 2014–15, India's GDP growth recovered marginally to 7.3% from 6.9% in the previous fiscal. During 2014–15, India's services sector grew by 10.1%, manufacturing sector by 7.1% & agriculture by 0.2%. Indian Economy grew at 7.6 & 7.1 in FY 2015–16 and FY 2016–17 respectively as major reforms had taken place like Demonitisation and implementation of GST in FY 2016–17.The Economic Growth has Been Slow Down in 2017–18 and it is expected to grow at 6.7 and forecasted to Rebound by 8.2% in 2018–19.

5.Problem of Unemployment and Government Policies for combating Unemployment

Unemployment

Introduction

You might have seen people looking for jobs in newspapers. Some look for a job through friends and relatives. In many cities, you might find people standing in some select areas looking for people to employ them for that day's work. Some go to factories and offices and give their bio-data and ask whether there is any vacancy in their factory or office. Many in the rural areas do not go out and ask for a job but stay home when there is no work. Some go to employment exchanges and register themselves for vacancies notified through employment exchanges.

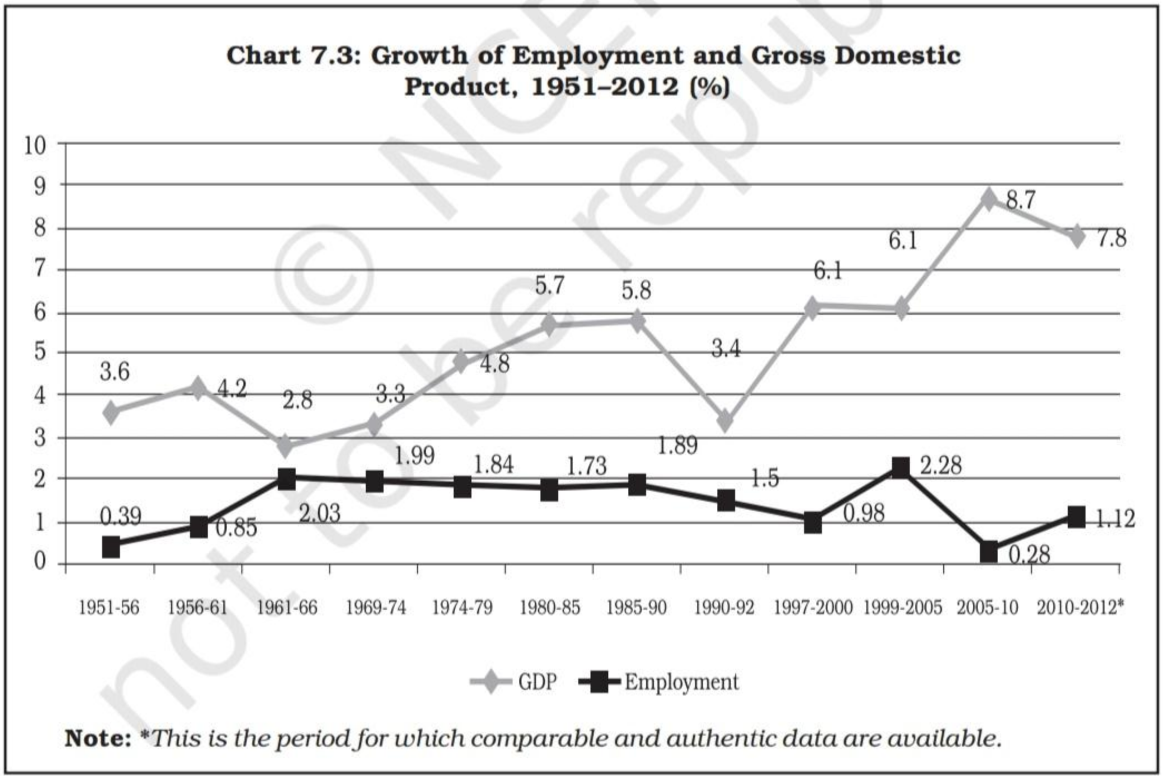
NSSO defines unemployment as a situation in which all those who, owing to lack of work, are not working but either seek work through employment exchanges, intermediaries, friends or relatives or by making applications to prospective employers or express their willingness or availability for work under the prevailing condition of work and remunerations.

Source: Unemployment in India statistics has traditionally been collected, compiled and disseminated once every five years by the Ministry of Labour and Employment (MLE), primarily from sample studies conducted by the National Sample Survey Office. There are a variety of ways by which an unemployed person is identified. Economists define unemployed person as one who is not able to get employment of even one hour in half a day. There are three sources of data on unemployment : Reports of Census of India, National Sample Survey Organisation's Reports of Employment and Unemployment Situation and Directorate General of Employment and Training Data of Registration with Employment Exchanges.

Economists call unemployment prevailing in Indian farms as disguised unemployment.What is disguised unemployment? Suppose a farmer has four acres of land and he actually needs only two workers and himself to carry out various operations on his farm in a year, but if he employs five workers and his family members such as his wife and children,this situation is known as **disguised unemployment**.

There are no employment opportunities in the village for all months in the year. When there is no work to do on farms, people go to urban areas and look for jobs.This kind of unemployment is known as **seasonal unemployment**. This is also a common form of unemployment prevailing in India.

Though we have witnessed slow growth of employment, have you seen people being unemployed over a very long time? Scholars say that in India,people cannot remain completely unemployed for very long because their desperate economic condition would not allow them to be so. You will rather find them being forced to accept jobs that nobody else would do, unpleasant or even dangerous jobs in unclean, or unhealthy surroundings. **Some statistics**



Trends in Employment Pattern (Sector-wise and Status-wise), 1972-2012 (in %)

Item	*1972-73*	*1983*	*1993-94*	*1999-2000*	*2011-2012*
		Sector			
Primary	74.3	68.6	64	60.4	48.9
Secondary	10.9	11.5	16	15.8	24.3
Services	14.8	16.9	20	23.8	26.8
Total	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**
		Status			
Self-employed	61.4	57.3	54.6	52.6	52.0
Regular Salaried Employees	15.4	13.8	13.6	14.6	18.0
Casual Wage Labourers	23.2	28.9	31.8	32.8	30.0
Total	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**

Government Policies for combatting unemployment

The Mahatma Gandhi National Rural Employment Guarantee Act 2005. It promises 100 days of guaranteed wage employment to all rural households who volunteer to do unskilled manual work. This scheme is one of the many measures the government has implemented to generate employment for those who are in need of jobs in rural areas.

Since Independence, the Union and State governments have played an important role in generating employment or creating opportunities for employment generation. Their efforts can be broadly categorised into two — direct and indirect. , the government employs people in various departments for administrative purposes. It also runs industries, hotels and transport companies, and hence, provides employment directly to workers. When the output of goods and services from government enterprises increases, then private enterprises which receive raw materials from government enterprises will also raise their output and hence increase the number of employment opportunities in the economy. For example, when a government owned steel company increases its output, it will result in direct increase in employment in that government company. Simultaneously, private companies, which purchase steel from it, will also increase their output and thus employment. This is the indirect generation of employment opportunities by the government initiatives in the economy.

Many programmes that the governments implement, aimed at alleviating poverty, are through employment generation. They are also known as employment generation programmes. All these programmes aim at providing not only employment but also services in areas such as primary health, primary education, rural drinking water, nutrition, assistance for people to buy income and employment generating assets, development of community assets by generating wage employment, construction of houses and sanitation, assistance for constructing houses, laying of rural roads, development of wastelands/degraded lands.

Steps taken on Disguised Unemployment

Agriculture is the most labour absorbing sector of the economy. In recent years, there has been a decline in the dependence of population on agriculture partly because of disguised unemployment. Some of the surplus labour in agriculture has moved to either secondary or the tertiary sector. In the secondary sector, small scale manufacturing is the most labour absorbing. In case of the tertiary sector, various new services are now appearing like biotechnology, information technology and so on. The government has taken steps in these sectors for the disguised unemployed people in these methods.

National Career Service Scheme

The Government of India has initiated National Career Service Scheme whereby a web portal named National Career Service Portal (www.ncs.gov.in) has been launched by the Ministry of Labour and Employment (India). Through this portal, job-seekers and employers can avail the facility of a common platform for seeking and updating job information. Not only private vacancies, contractual jobs available in the government sector are also available on the portal.

Conclusion

There has been a change in the structure of workforce in India. Newly emerging jobs are found mostly in the service sector. The expansion of the service sector and the advent of high technology now frequently permit a highly competitive existence for efficient small scale and often individual enterprises or specialist workers side by side with the multinationals. In the last two decades, there has been rapid growth in the gross domestic product, but without simultaneous increase in employment opportunities. This has forced the government to take up initiatives in generating employment opportunities particularly in the rural areas.

6.Poverty

Problem of Poverty

Poverty is not having enough material possessions or income for a person's needs. Poverty may include social, economic, and political elements.

Absolute poverty is the complete lack of the means necessary to meet basic personal needs, such as food, clothing and shelter. The threshold at which *absolute poverty* is defined is always about the same, independent of the person's permanent location or era.

On the other hand, *relative poverty* occurs when a person cannot meet a minimum level of living standards, compared to others in the same time and place. Therefore, the threshold at which *relative poverty* is defined varies from one country to another, or from one society to another.

Definition

Income Poverty: a family's income fails to meet a federally] established threshold that differs across countries.

United Nations: Fundamentally, poverty is the inability of having choices and opportunities, a violation of human dignity. It means lack of basic capacity to participate effectively in society. It means not having enough to feed and clothe a family, not having a school or clinic to go to, not having the land on which to grow one's food or a job to earn one's living, not having access to credit. It means insecurity, powerlessness and exclusion of individuals, households and communities.

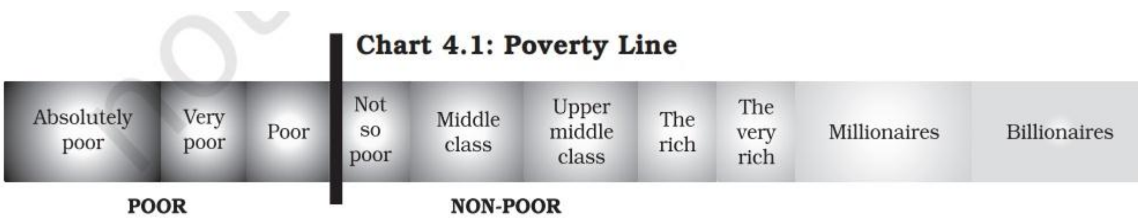
World Bank: Poverty is pronounced deprivation in well-being, and comprises many dimensions. It includes low incomes and the inability to acquire the basic goods and services necessary for survival with dignity. Poverty also encompasses low levels of health and education, poor access to clean water and sanitation, inadequate physical security, lack of voice, and insufficient capacity and opportunity to better one's life.

HOW ARE POOR PEOPLE IDENTIFIED?

In pre-independent India,Dadabhai Naoroji was the first to discuss the concept of a Poverty Line. He used the menu for a prisoner and used appropriate prevailing prices to arrive at what may be called 'jail cost of living'. However, only adults stay in jail whereas, in an actual society, there are children too. He, therefore,appropriately adjusted this cost of living to arrive at the poverty line.

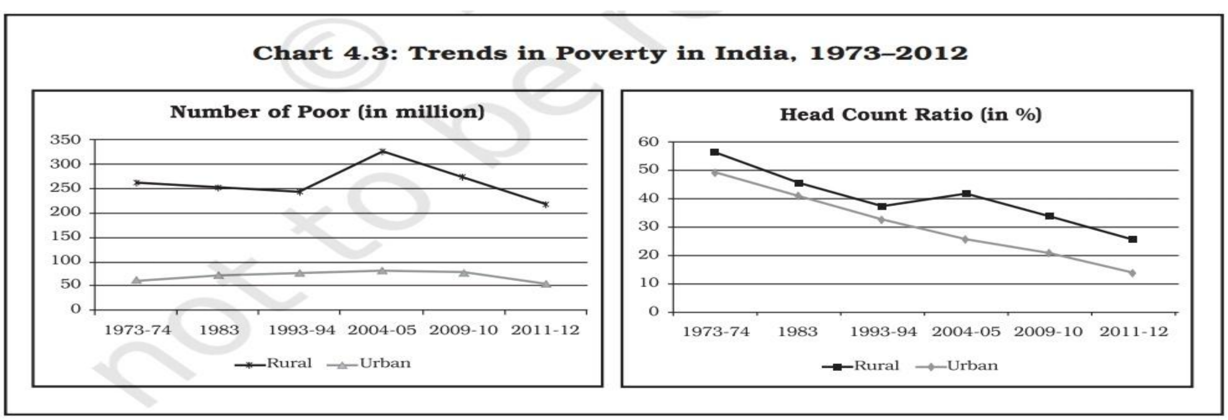
In post-independent India, there have been several attempts to work out a mechanism to identify the number of poor in the country. For instance, in 1962, the Planning Commission formed a Study Group. In 1979, another body called the 'Task Force on Projections of Minimum Needs and Effective Consumption Demand' was formed. In 1989 and 2005, 'Expert Groups' were constituted for the same purpose.

The Poverty Line: Now, let us examine how to determine the poverty line. There are many ways of measuring poverty. One way is to determine it by the monetary value (per capita expenditure) of the minimum calorie intake that was estimated at 2,400 calories for a rural person and 2,100 for a person in the urban area. Based on this, in 2011-12, the poverty line was defined for rural areas as consumption worth Rs 816 per person a month and for urban areas it was Rs 1,000.



THE NUMBER OF POOR IN INDIA

The official data on poverty is made available to the public by the Planning Commission. It is



estimated on the basis of consumption expenditure data collected by the National Sample Survey Organisation (NSSO). Chart shows the number of poor and their proportion to the population in India for the years 1973-2012. In 1973-74, more than 320 million people were below the poverty line. In 2011-12, this number has come down to about 270 million.

WHAT CAUSES POVERTY?

1. Lack of Inclusive Economic Growth:

The first important reason for mass poverty prevailing in India is lack of adequate economic growth in India. In the first three decades of planned development (1951-81) in India, annual average growth in national income had been 3.6 per cent.

2. Sluggish Agricultural Performance and Poverty:

Many economists have pointed out that in the year of good agricultural output, poverty ratio declines. Good performance in agriculture leads to more employment opportunities and fall in prices of food grains. More employment opportunities and lower food price cause poverty ratio to decline.

3. Non-implementation of Land Reforms:

Equitable access to land is an important measure of poverty reduction. Access to adequate land, a productive asset, is necessary for fuller employment of members of an agricultural household. They are unable to find employment throughout the year. As a result, they remain unemployed and under-employed for a large number of days in a year.

4. Rapid Population Growth

5. Unemployment and Under-employment

6. Inflation and Food Prices:

Rate of inflation and level of food prices is an important factor that causes poverty. Inflation, especially rise in food prices, raises the cost of minimum consumption expenditure required to meet the basic needs. Thus, inflation especially rise in food prices pushes down many households below the poverty line.

Government Policies for combatting Poverty

Since the very first five year plan initiated by the government in the year 1951, the removal of poverty has been on the list. Every consecutive five years, the plan has seen a renewed vow so as to alleviate poverty. Government understand well that the major cause of India being the underdeveloped country is the increasing level of poverty in the country.

Following are some of the poverty alleviation policies introduced by the government:

National Rural Employment Guarantee Act

Also known as **NREGA,** this is the flagship programme of Government directly touching lives of the poor and promoting inclusive growth. It aims at enhancing the general livelihood of the rural people by guaranteeing at least a 100 days of employment in a financial year to adults of the household who are willing to do unskilled labour. It was enforced on 2nd February 2006 and implemented in phases. Today it is indeed one of the largest employment generating scheme of the government.

Sampoorna Grameen Rozgar Yojna

SGRY was launched in the year 2001 by way of merging two ongoing schemes- EAS and JGSY. The objective was to provide additional food security and wage employment to the rural sector. It also helped in creating durable community assets for the rural people. The program targeted poor with special emphasis on women, SCs, STs and parents of children withdrawn from hazardous industries.

National Food For Work Programme

This programme was launched in November 2004 in 150 backward districts of the country that were identified by the Planning Commission. The aim of this project was to offer additional sources for rural employment apart from SGRY to these 150 districts. This scheme was entirely sponsored by the Central Government. Since then the program has been merged with NREGA, identifying in total 200 districts to implement the scheme.

Pradhan Mantri Sadak Yojna

PMGSY launched on 25th December 2002 was a fully Central Sponsored Scheme. The objective of this scheme was to construct roads connecting the rural and urban centres through quality roads. This generated employment for rural labourers and lead to infrastructure development.

Jawahar Gram Samriddhi Yojna

Launched in 1999, JGSY aimed at creating demand-driven infrastructure in the village, for the use of village community. Secondly, it aimed at creating an additional source of employment for the rural populace. The scheme is prepared and implemented by Village Panchayat.

Indira Aawas Yojna

This is the flagship rural housing scheme introduced by the Government. Under this scheme, states were to provide shelter to those below the poverty line. The objective was to create new accommodation for the poor construction of new houses as well as by converting the unserviceable *kuchha* houses into *pucca* and *semi-pucca* houses.

Credit-Cum-Subsidy Scheme For Rural Housing

The houses that could not be covered under the IAY because of some reason, were included in this scheme. Under this scheme, the houses were constructed for the families who could afford a certain amount of repayment capacity. The families could apply for a loan at a highly subsidised rate and get a home under this scheme. All those poor who could not be included in IAY were included in this scheme.

The objective behind initiating all these and many more similar schemes was to gradually rid the nation of the plague of poverty, once and for all. The schemes were designed in such a way as to offer not just financial health but means of employment by which the poor could continue to feed their family and gradually raise their standard of living.

The schemes aim at a sustained development. While the schemes have benefited many poor people and helped change the face of several rural villages. But there is still a very long way to go before the country can be rid of poverty. Probably, things will get better in the coming future.

Module 6 International Trade

Meaning and Definition

Foreign trade is exchange of capital, goods, and services across international borders or territories. In most countries, it represents a significant share of gross domestic product (GDP). While international trade has been present throughout much of history, its economic, social, and political importance has been on the rise in recent centuries.

All countries need goods and services to satisfy wants of their people. Production of goods and services requires resources. Every country has only limited resources. No country can produce all the goods and services that it requires. It has to buy from other countries what it cannot produce or can produce less than its requirements. Similarly, it sells to other countries the goods which it has in surplus quantities. India too, buys from and sells to other countries various types of goods and services.

Generally no country is self-sufficient. It has to depend upon other countries for importing the goods which are either non-available with it or are available in insufficient quantities. Similarly, it can export goods, which are in excess quantity with it and are in high demand outside.

International trade means trade between the two or more countries. International trade involves different currencies of different countries and is regulated by laws, rules and regulations of the concerned countries. Thus, International trade is more complex.

According to Wasserman and Haltman, "International trade consists of transaction between residents of different countries".

According to Anatol Marad,"International trade is a trade between nations".

According to Eugeworth,"International trade means trade between nations".

Industrialization, advanced transportation, globalization, multinational corporations, and outsourcing are all having a major impact on the international trade system. Increasing international trade is crucial to the continuance of globalization. Without international trade, nations would be limited to the goods and services produced within their own borders.To smoothen and justify the process of trade between countries of different economic standing, some international economic organisations were formed, such as the World Trade Organization.

These organisations work towards the facilitation and growth of international trade. Statistical services of intergovernmental and supranational organisations and national statistical agencies publish official statistics on international trade.

2.Domestic Trade vs Foreign Trade

The major differences between domestic trade and international trade

1. Domestic trade always takes place within the borders of a given country, while international trade always goes beyond the borders of a given country.
2. Domestic trade can never involve more than one country, but international trade always involves two or more countries.
3. Domestic trade, to a large extent involves the use of mainly local currency in trading, whereas international trade involves the use of foreign currencies. The U.S. dollar is the standard currency used in international trade.
4. Domestic trade is free off restriction, so long as it is a legal commodity being traded. Legal and wholesome commodities dealt with in domestic trade can move around the country without facing any forms of restrictions such as embargoes and quotas. But this is not the case for international trade. In international trade, certain goods, though legal, can be subjected to certain restrictions such as embargoes and quotas. There are so many reasons why sometimes commodities dealt with in international trade face certain restrictions. Some of these reasons include the following, in order to protect infant industries within a country, in order to raise the level of employment within a country, in order to discourage the importation of legal but harmful goods such as tobacco into a country, in order to ensure self-sufficiency, etc.
5. Domestic trade is not subject to being controlled by external bodies, but this isn’t the same for international trade. International trade is controlled by certain external bodies to which a country is a member. A very good example of an external body that controls trade all over the world is the World Trade Organization.
6. International trade generally involves very long distances, but this is normally not the case with domestic trade. Take for example a trade between South Africa and Sweden or between New Zealand and Egypt. These trades certainly involve very lengthy

distances to be covered. But a trade between any two points in South Africa or Sweden can never be that lengthy.

3.Advantages and Disadvantages of International Trade

Advantages of International Trade:

(i) Optimal use of natural resources:

International trade helps each country to make optimum use of its natural resources. Each country can concentrate on production of those goods for which its resources are best suited. Wastage of resources is avoided.

(ii) Availability of all types of goods:

It enables a country to obtain goods which it cannot produce or which it is not producing due to higher costs, by importing from other countries at lower costs.

(iii) Specialisation:

Foreign trade leads to specialisation and encourages production of different goods in different countries. Goods can be produced at a comparatively low cost due to advantages of division of labour.

(iv) Advantages of large-scale production:

Due to international trade, goods are produced not only for home consumption but for export to other countries also. Nations of the world can dispose of goods which they have in surplus in the international markets. This leads to production at large scale and the advantages of large scale production can be obtained by all the countries of the world.

(v) Stability in prices:

International trade irons out wild fluctuations in prices. It equalizes the prices of goods throughout the world (ignoring cost of transportation, etc.)

(vi) Exchange of technical know-how and establishment of new industries:

Underdeveloped countries can establish and develop new industries with the machinery, equipment and technical know-how imported from developed countries. This helps in the development of these countries and the economy of the world at large.

(vii) Increase in efficiency:

Due to international competition, the producers in a country attempt to produce better quality goods and at the minimum possible cost. This increases the efficiency and benefits to the consumers all over the world.

(viii) Development of the means of transport and communication:

International trade requires the best means of transport and communication. For the advantages of international trade, development in the means of transport and communication is also made possible.

(ix) International co-operation and understanding:

The people of different countries come in contact with each other. Commercial intercourse amongst nations of the world encourages exchange of ideas and culture. It creates co-operation, understanding, cordial relations amongst various nations.

(x) Ability to face natural calamities:

Natural calamities such as drought, floods, famine, earthquake etc., affect the production of a country adversely. Deficiency in the supply of goods at the time of such natural calamities can be met by imports from other countries.

(xi) Other advantages:

International trade helps in many other ways such as benefits to consumers, international peace and better standard of living.

Disadvantages of International Trade:

Though foreign trade has many advantages, its dangers or disadvantages should not be ignored.

(i) Impediment in the Development of Home Industries:

International trade has an adverse effect on the development of home industries. It poses a threat to the survival of infant industries at home. Due to foreign competition and unrestricted imports, the upcoming industries in the country may collapse.

(ii) Economic Dependence:

The underdeveloped countries have to depend upon the developed ones for their economic development. Such reliance often leads to economic exploitation. For instance, most of the underdeveloped countries in Africa and Asia have been exploited by European countries.

(iii) Political Dependence:

International trade often encourages subjugation and slavery. It impairs economic independence which endangers political dependence. For example, the Britishers came to India as traders and ultimately ruled over India for a very long time.

(iv) Mis-utilisation of Natural Resources:

Excessive exports may exhaust the natural resources of a country in a shorter span of time than it would have been otherwise. This will cause economic downfall of the country in the long run.

(v) Import of Harmful Goods:

Import of spurious drugs, luxury articles, etc. adversely affects the economy and well-being of the people.

(vi) Storage of Goods:

Sometimes the essential commodities required in a country and in short supply are also exported to earn foreign exchange. This results in shortage of these goods at home and causes inflation. For example, India has been exporting sugar to earn foreign trade exchange; hence the exalting prices of sugar in the country.

(vii) Danger to International Peace:

International trade gives an opportunity to foreign agents to settle down in the country which ultimately endangers its internal peace.

(viii) World Wars:

International trade breeds rivalries amongst nations due to competition in the foreign markets. This may eventually lead to wars and disturb world peace.

(ix) Hardships in times of War:

International trade promotes lopsided development of a country as only those goods which have comparative cost advantage are produced in a country. During wars or when good relations do not prevail between nations, many hardships may follow.

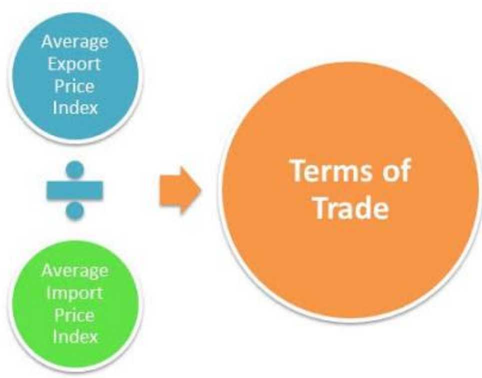
6.4 Concepts of International Trade

1. Concept of Terms of Trade (ToT)

Terms of trade (TOT) represent the ratio between a country's export prices and its import prices. How many units of exports are required to purchase a single unit of imports? The ratio is calculated by dividing the price of the exports by the price of the imports and multiplying the result by 100.

The **terms of trade** (**TOT**) is the relative price of exports in terms of imports and is defined as the ratio of export prices to import prices. It can be interpreted as the amount of import goods an economy can purchase per unit of export goods.

For example, if an economy is only exporting apples and only importing oranges, then the terms of trade are simply the price of apples divided by the price of oranges — in other



words, how many oranges can be obtained for a unit of apples.

An improvement of a nation's terms of trade benefits that country in the sense that it can buy more imports for any given level of exports. The terms of trade may be influenced by the exchange rate because a rise in the value of a country's currency lowers the domestic prices of its imports but may not directly affect the prices of the commodities it exports.

Terms of trade should not be used as synonymous with social welfare, or economic welfare. Terms of trade calculations do not tell us about the volume of the countries' exports, only relative changes between countries. To understand how a country's social utility changes, it is necessary to consider changes in the volume of trade, changes in productivity and resource allocation, and changes in capital flows.

2. Balance of Trade (BoT)

The **balance of trade**, **commercial balance**, or **net exports** (sometimes symbolized as **NX**), is the difference between the monetary value of a nation's exports and imports over a certain time period. Sometimes a distinction is made between a balance of trade for goods versus one for services.

Balance of trade (BOT) is the difference between the value of a country's imports and exports for a given period and is the largest component of a country's balance of payments (BOP).

The formula for calculating the BOT can be simplified as the total value of imports minus the total value of exports.

The balance of trade measures a flow of exports and imports over a given period of time. The notion of the balance of trade does not mean that exports and imports are "in balance" with each other.

Factors that can affect the balance of trade include:

1. The cost of production (land, labor, capital, taxes, incentives, etc.) in the exporting economy *vis-à-vis* those in the importing economy;
2. The cost and availability of raw materials, intermediate goods and other inputs;
3. Currency exchange rate movements;
4. Multilateral, bilateral and unilateral taxes or restrictions on trade;
5. Non-tariff barriers such as environmental, health or safety standards;
6. The availability of adequate foreign exchange with which to pay for imports; and
7. Prices of goods manufactured at home (influenced by the responsiveness of supply)

If a country exports a greater value than it imports, it has a **trade surplus** or **positive trade balance**, and conversely, if a country imports a greater value than it exports, it has a **trade deficit** or **negative trade balance.** As of 2016, about 60 out of 200 countries have a trade surplus.

3.Balance of Payments (BoP)

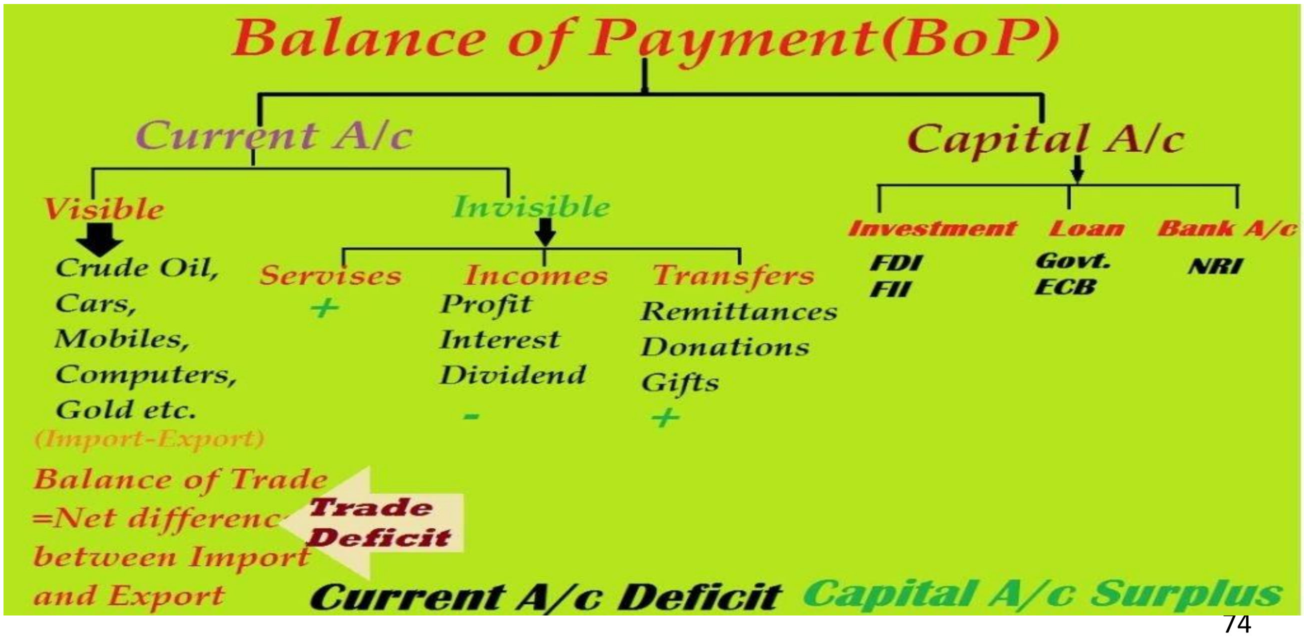
The **balance of payments**, also known as **balance of international payments** and abbreviated **B.O.P.** or **BoP**, of a country is the record of all economic transactions between the residents of the country and the rest of the world in a particular period of time (e.g., a quarter of a year). These transactions are made by individuals, firms and government bodies. Thus the balance of payments includes all external visible and non-visible transactions of a country.

These transactions consist of imports and exports of goods, services, and capital, as well as transfer payments, such as foreign aid and remittances.

The balance of payments divides transactions in two accounts: the current account and the capital account. Sometimes the capital account is called the financial account, with a separate, usually very small, capital account listed separately. The current account includes transactions in goods, services, investment income, and current transfers.

The capital account, broadly defined, includes transactions in financial instruments and central bank reserves. Narrowly defined, it includes only transactions in financial instruments. The current account is included in calculations of national output, while the capital account is not.

To sum of



all transactions recorded in the balance of payments must be zero, as long as the capital account is defined broadly. The reason is that every credit appearing in the current account has a corresponding debit in the capital account, and vice-versa. If a country exports an item (a current account transaction), it effectively imports foreign capital when that item is paid for (a capital account transaction).

Importance

The BoP statement provides information pertaining to the demand and supply of the country's currency. The trade data shows a clear picture of whether the country's currency is appreciating or depreciating in comparison with other countries. Next, the country's BoP determines its potential as a constructive economic partner. In addition, a country's BoP indicates its position in international economic growth.

By studying its BoP statement and its components closely, a country would be able to identify trends that may be beneficial or harmful to the economy and take appropriate measures.

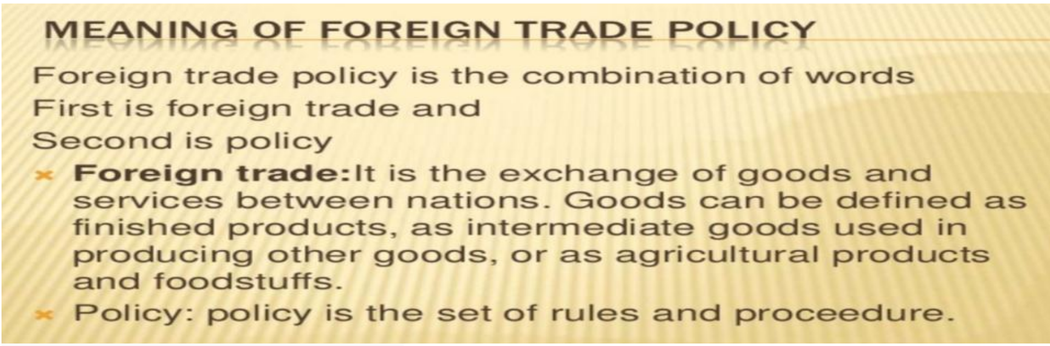
See video for more clarity Balance of Payment

Balance of trade vs. balance of payments

Balance of trade	Balance of payments
Includes only visible imports and exports, i.e. imports and exports of merchandise. The difference between exports and imports is called the balance of trade. If imports are greater than exports, it is sometimes called an unfavourable balance of trade. If exports exceed imports, it is sometimes called a favourable balance of trade.	Includes all those visible and invisible items exported from and imported into the country in addition to exports and imports of merchandise.
Includes revenues received or paid on account of imports and exports of merchandise. It shows only revenue items.	Includes all revenue and capital items whether visible or non-visible. The balance of trade thus forms a part of the balance of payments.

6.5 Foreign Trade Policy

Introduction



FOREIGN TRADE POLICY

Policies enacted by the government sector of a domestic economy to discourage imports from, and encourage exports to, the foreign sector. The three most common foreign trade policies are tariffs, import quotas, and export subsidies. Tariffs and import quotas are designed to discourage imports and export subsidies are designed to encourage exports. The general goal of these foreign trade policies is to create or increase a country's balance of trade surplus, that is, to increase net exports.

Foreign trade policies are government actions, especially tariffs, import quotas, and export subsidies, designed to increase net exports by promoting exports or restricting imports. By increasing net exports (and creating a more "favorable" balance of trade), the domestic production of a nation increases, which then increases domestic income and employment.

Tariffs

The first of three foreign trade policies designed to restrict imports and promote exports is tariffs on imports. Tariffs are simply taxes placed on imports. They work like any other taxes. A tariff is added to the price of the imported good. The resulting price of the import is thus higher, which tends to decrease the quantity purchased. And if fewer imports are purchased, then more domestic production is sold.

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Import Quotas

The second of three foreign trade policies designed to restrict imports and promote exports is quotas on imports. In general, a quota is simply a quantity restriction placed on a good, service, or activity.

Import quotas are then merely legal restrictions on the quantities of imports that are imposed by the domestic government.

Export Subsidies

The third of three common foreign trade policies is export subsidies. In general, a subsidy is a payment made by the government sector, either to a business or consumer, with no expectations of receiving any production in exchange. That is, subsidies are merely gifts.

Subsidies are usually paid to encourage or promote specific activity.

5.Foreign Trade Policy in India

India is known as one of the most important and emerging player in the global economy. Its foreign trade policies and government reforms have made it a significant destination for foreign investments around the world. Also, technological and infrastructural developments being carried out all over the country enable efficient trade and economic practices. For the successful economic development of a country, vigorous foreign trade policy is of great importance. Therefore, India adopted a foreign trade policy known as the EXIM Policy or the Export-Import policy.

The current Foreign Trade Policy is for the period 2015 – 2020 announced by the Government of India, **Ministry of Commerce and Industry** according to **section 5 of foreign Trade (development and regulations)of Act,1992** on1st April 2015. Foreign trade policy needs amendments every five years and aims at developing export capability, improving export performance and structure, encouraging foreign trade, and creating a suitable balance of payments position. It is updated every year on the 31st of March, and the modifications, improvements and new schemes become effective from 1st April each year.

India in 1991, after liberalization, totally lifted all sorts of restrictions from trade for the purpose of improvement in the balance of payment position. A strong need was felt for Indian markets to work globally, and the economy was set free. But in a developing economy, it is not possible to develop industries without the protection of policies. Therefore, later, it was necessary for India to impose a restriction on its economy through trade policies to regulate import and export.

The foreign trade policy of India is based on the following **major objectives** as follows:

1. To enable substantial growth in exports from India and import to India to boost the economy.
2. To at least double the percentage share of global merchandise trade conducted within the next five years.
3. To improve the balance of payment and trade.
4. To **act** as an effective instrument of economic growth by creating employment opportunities for the citizens; the larger the expansion of trade activities, the more the workforce required.
5. To provide for sustainable growth by giving access to essential raw materials for production and other components, consumables and capital goods required for increasing production and providing efficient services.
6. To raise the technological capacity for production and cost-effectiveness of industry and services, thereby improving their competitive strength in comparison to other countries, and to encourage the accomplishment of internationally accepted standards of quality.

7. To provide buyers or clients with high-quality goods and services at globally competitive rates and quality. ‘Canalization’- an important feature of Foreign Trade Policy under which specific class of goods can be imported only by designated agencies.
8. Creation of opportunities by engaging in good and ethical practices.
9. Accelerating the economy from low-level economic activities to high-level economic activities by making it a globally oriented and vibrant economy
10. To derive maximum benefits from expanding the global market and seizing the best opportunities available.
11. Making policies that favor ease of doing business and e-governance.
12. To allow for hassle-free transactions for both import and export.
13. Reducing the interference between the exporters and Directorate General of Foreign Trade by reducing the number of export documents.
14. To allow the import of technology and equipment’s which may help in achieving better international standards of quality and reduce the cost of production.
15. Establishing the Advance Licensing System for imported goods needed for manufacturing various goods for export. An Advance License is issued by the Directorate General of Foreign Trade to allow duty-free import of inputs, which are physically integrated with the export product (making normal allowance for wastage).
16. To allow the import of certain goods as listed in the Open General License; a kind of export license which is issued by Government to domestic suppliers.

Conclusion

Boosted by the forthcoming FTP, India's exports are expected reach US$ 330-340 billion by 2019-20 according to Federation of India Export Organisation (FIEO).

With the help of foreign trade policies, a country can lead to equality of pricing to ensure a stable demand and supply situation within the economy. Foreign trade policy also enables a nation to import certain products at the time of a natural calamity and therefore manage scarcity when demand is high by proving better quality and quantity of goods. It also assists in raising the standard of living and making commodities available at a lower cost. Therefore, the Foreign

Trade Policy in India is a complete policy to enhance the position of India in the international market and create benefits for all.

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