ECONOMICS BASIC NOTES – PART 5

BASED ON: **NCERT XII ECONOMICS INTRODUCTORY MACROECONOMICS**

1. If output of food grain is experiencing a growth, it is generally accompanied by a rise in the output level of industrial goods. The employment level in different production units also goes up or down together.

2. In macroeconomics we usually do the analysis of how the country's total production and the level of employment are related to variables like prices, rate of interest, wage rates, profits and so on. In macroeconomics we study the effects in the markets of taxation and other budgetary policies, and policies for bringing about changes in money supply, the rate of interest, wages, employment, and output.

3. **ADAM SMITH**: Adam Smith is regarded as the founding father of modern economics. He was a Scotsman and a professor at the University of Glasgow. His well-known work An Enquiry into the Nature and Cause of the Wealth of Nations (1776) is regarded as the first major comprehensive book on the subject.

4. **JOHN MAYNARD KEYNES**: Published his celebrated book The General Theory of Employment, Interest and Money in 1936. The dominant thinking in economics before Keynes was that all the Labourers who are ready to work will find employment and all the factories will be working at their full capacity. This school of thought is known as the classical tradition.
He prophesied the breakdown of the peace agreement of the War in the book The Economic Consequences of the Peace (1919). His book General Theory of Employment, Interest and Money (1936) is regarded as one of the most influential economics books of the twentieth century. He was also a shrewd foreign currency speculator.

5. THE GREAT DEPRESSIONS: The Great Depression of 1929 and subsequent years saw the output and employment levels in the countries of Europe and North America fall by huge amounts. It affected other countries of the world as well. Demand for goods in the market was low, many factories were lying idle, workers were thrown out of jobs. In USA, from 1929 to 1933, unemployment rate rose from 3% to 25%. Over the same period aggregate output in USA fell by about 33%.
Keynes' book examined the working of the economy in its entirety and examined the interdependence of the different sectors.
We can consider this as the time of beginning of Macroeconomics.

6. Macroeconomics sees an economy as a combination of four sectors, namely households, firms, government and external sector.

7. The production units are called firms. Firm hires wage labour from the market, employs the services of capital and land as well. After hiring these inputs firms undertakes the task of production. The motive of firm is to earn profit.
The role of government includes framing laws, enforcing them and delivering justice. Sometimes the government undertakes production- apart from imposing taxes and spending money on building public infrastructure, running schools, colleges, providing health services etc. There is another major sector in an economy which is called the household sector. Household as a single individual takes decisions relating to her own consumption. Household also save and pay taxes. The people in a household work and earns money. They also earn profits the owner of land and firms. They also earn rent by leasing land or earn interest by lending capital.
The external sector is the fourth important sector. The countries of the world engaged in external trade exports and imports which is called as external sector. Capital from foreign countries may flow into the domestic country or the domestic country may be exporting capital to foreign countries.

NATIONAL INCOME ACCOUNTING.

1. The economic wealth, or well-being of a country does not necessarily depend on the mere possession of resources. The important factor is how these resources are used in generating a flow of production and how as a consequence income and wealth are generated from that process.
Flow of production arises when production of commodities-goods and services takes place by millions of enterprises large and small. All goods and services produced are to be sold to the consumers. The goods produced may be for final consumption by the consumers or it may be used as raw material for further making of goods and services meant for final use. The good which does not require to pass through any further stages of production or refining is called a final good. Once the good is passed for final consumption it is said to has passed out of the active economic flow. Some good is transformed before consumption like tea, coffee etc.

2. **CONSUMPTION GOODS AND CAPITAL GOODS**: Goods like food and clothing and services like recreation that are consumed when purchased by their ultimate consumers are called consumption goods or consumer goods
There are other goods that are of durable character which are used in the production process. These are tools, implements and machines. While they make production of other commodities feasible, they themselves don't get transformed in the production process. They are also final goods, yet they are not final goods to be ultimately consumed. These goods are crucial backbone of any production process, in aiding and enabling the production to take place. These goods form a part of capital, one of the crucial factors of production in which a productive enterprise has invested, and they continue to enable the production process to go on for go on for continuous cycles of production. These are capital goods and they gradually undergo wear and tear, and thus are repaired or gradually replaced over time.

3. **CONSUMER DURABLES**: Some commodities like televisions, automobiles or home computers, although they are for ultimate consumption are also durables. They have a relatively long life as compared to articles such as food or even clothing. They also undergo wear and tear with gradual use and often need repairs and replacements of parts. Thus, like machines they also need to be preserved, maintained and renewed. They are called consumer durables.

4. **INTERMEDIATE GOODS**: A large number of products don't end up in final consumption and are not capital goods either. Such goods may be used by other producers as material inputs. Ex. Steel sheets used for making automobiles and copper used for making utensils. These are intermediate goods. They are mostly used as raw material or inputs for production of other commodities. These are not final goods.

5. **STOCKS AND FLOWS**: Total flow of production in the economy that is quantitative measure of the aggregate level of final goods produced in the economy. As each of these commodities is produced for sale, the sum total of the monetary value of these diverse commodities gives us a measure of final output. The value of intermediate goods is included in the final goods.
Income, or output or profits are concepts that make sense only when a time period is specified. These are called flows because they occur in a period of time. Flows are defined over a period of time.
In contrast, capital goods or consumer durables once produced do not wear out or get consumed quickly. In fact, capital goods continue to serve us through different cycles of production. The buildings or machines in a factory are there irrespective of the specific time period. These are called. Stocks.
Stocks are defined at a particular point of time.
However, we can measure addition and reduction in stock over a specific period of time.
Such changes in stock are thus flows.

A particular machine can be part of the capital stock for many years but that machine can be part of the flow of new machines added to the capital stock only for a single year when it was initially installed.

6. **GROSS INVESTMENT DEPRECIATION. NET INVESTMENT**: Addition of capital goods constitutes gross investment of an economy. These may be machines, tools and implements, buildings, office spaces, storehouses or infrastructure like roads, bridges airports or jetties. But all the capital goods produced in a year do not constitute an addition to the capital stock already existing capital stock suffers wear and tear and needs maintenance and replacement. A part of the capital goods produced this year goes for replacement of existing capital goods and is not an addition to the stock of capital goods already existing and its value needs to be subtracted from gross investment for arriving at the measure for net investment. This deletion, which is made from the value of gross investment in order to accommodate regular wear and tear of capital, is called depreciation.
So new addition to capital stock in an economy is measured by net investment or new capital formation
Net Investment = Gross investment – Depreciation

7. **CIRCULAR FLOW OF INCOME**
The households receive their payments from the firms for productive activities they perform for firms. There may be fundamentally be four kinds of contributions that can be made during the production of goods and services:
    1. Contribution made by human labour: as wages
    2. Contribution made by capital: as interest
    3. Contribution made by entrepreneurship: as Profit
    4. Contribution made by land: as rent

Household disposes off their earnings- by spending their income on the goods and services produced by domestic firms
We assume household do not save and pay taxes to government and they do not buy imported goods.
Factors of production use their earnings to buy goods and services which they assisted in producing.
The aggregate consumption by the households of the economy is equal to the aggregate expenditure on goods and services produced by the firms in the economy. The entire income of the economy, therefore, comes back to the producers in the form of sales revenue.
There is no leakage in the system.

Money is circulated every year between producers and consumers.
Since the value of expenditure must be equal to the value of goods and services, we can equivalently measure the aggregate income by calculating the aggregate value of goods and services produced by the firms. When the aggregate revenue received by the firms is paid out to the factors of production it takes the form of aggregate income.

Since the same amount of money, representing the aggregate value of goods and services, is moving in a circular way, if we want to estimate the aggregate value of goods and services produced during a year we can measure the spending. This method is called the expenditure method.
If we measure the flow by measuring the aggregate value of final goods and services produced by all the firms, it will be called product method.
Measuring the sum total of all factor payments is called income method.
Aggregate spending of the economy must be equal to the aggregate income earned by the factors of production.

8. THE PRODUCT OR VALUE-ADDED METHOD OR NET OUTPUT METHOD

- In product method we calculate the aggregate annual value of goods and services produced in a year.

Value of output:

- It refers to market value of the goods or services produced by a firm during an accounting year. If the entire output of the year is sold during the year, value of output = sales.
- Value added is the difference between value of output of an enterprise and the value of its intermediate consumption.

- INTERMEDIATE CONSUMPTION: It refers to value of non-factor inputs (all inputs other than factor inputs of land, labour, capital, and entrepreneurship). Primarily it includes value of raw material used in the process of production.

Item producing enterprise	Value of output	Cost of intermediate consumption	Value added	What product
Farmer	600	200	400	Wheat
Flour Mill	800	600	200	Flour
Baker	1000	800	200	Bread
Shopkeeper	1200	1000	200	Selling bread
Total	3600	2600	1000	

It is assumed that the production of wheat involves cost of intermediate consumption of Rs. 200. It may include cost of inputs like seeds, fertilizers etc. Accordingly, value added by the farmer is equal to 400.
The flour mill buys wheat for 600 and sell flour for 800. The value added=200

GDP(MP): Gross Domestic Product at Market Price
Gross value added by all the producing enterprises within the domestic territory of a country during an accounting year is called GDP (MP)

Having estimated GDP (MP) we find out NNP (FC) at factor cost = National Income

GDP (MP) – Depreciation = NDP (MP)

NDP (MP) – Net indirect taxes = NDP (FC)

NDP (FC) + Net factor income from abroad = NDP (FC) = National Income

PRECAUTIONS REGARDING VALUE ADDED METHOD

1. Value of the sale and purchase of second-hand goods is not counted
2. Commission earned on account of the sale of second-hand vehicle is added
3. Own account production of goods is added
4. Value of intermediate goods is not included
5. The value added in the government sector is equal to compensation of employees only.

9. INCOME METHOD: According to this method, national income is measured in terms of factor payments (compensation of employees, rent, interest and profit) to the owners of factors of production (labour, land, capital and enterprise) during an accounting year. National income is estimated as the sum total of factor incomes earned by the normal residents of a country as rewards for rendering their factor services during an accounting year. A factor income refers to income earned by a person as a reward for rendering his factor service. It can be in the form of wage/salary for his labour, rent for his land, interest for his capital or profit for his entrepreneurship. Factor income must be earned.

TYPES OF FACTOR INCOME:

1. Compensation of employees
2. Operating surplus – includes income from property and entrepreneurship which includes rent, interest and profit
3. Mixed income: incomes of the self-employed persons using their own labour, land, capital, and entrepreneurship to produce goods and services.

PRECAUTIONS TO BE TAKEN WHILE CALCULATING NATIONAL INCOME:

1. Transfer earnings like old-age pensions etc. not to be taken into account
2. Income from illegal activities like gambling etc. not be taken into account.
3. Commission paid on the sale of second-hand goods
4. Income from lotteries
5. Corporate tax, dividends and undistributed profits are all the components of corporate profits. Once profit is included in the estimation of national income any these components should not be separately added.
6. Income tax is paid out of compensation of employees. It should not be added in the estimation of national income

10. **EXPENDITURE METHOD**: According to this method, national income is measured in terms of expenditure on purchase of final goods and services produced in the economy during an accounting year. Since final expenditure comprises C (consumption) and I(investment), it is also called Consumption and Investment Method, or Income Disposal Method. Estimation of expenditure on the final goods produced during the year within the domestic territory of a country is equal to the market value of GDP called GDP(MP). It is adjusted to find NNP (FC) or national income.

MONEY AND BANKING

1. Money is the commonly accepted medium of exchange. Money is not perishable and can be stored easily. It acts as a store of value for individuals.
2. We are moving towards an economy which use less of cash and more of digital transactions. Digital transactions are fast and cost of transaction to economy is greatly reduced.
3. Since money is required to conduct transactions, the value of transactions will determine the money people will want to keep. The larger is the quantum of transactions to be made, the larger is the quantity of money demanded. Since the quantum of transactions to be made depends on income. A rise in income will lead to rise in demand for money. With higher rates of interest offered by banks people will keep less money at home as reserve, in that case the demand for money comes down.

4. **SUPPLY OF MONEY**: In a modern economy, money comprises cash and bank deposits. There are two types of Banks- Central Bank and Commercial Banks.

5. **CENTRAL BANK**: Central Bank is a very important institution in a modern economy. It is a regulator of money supply in the economy. It issues the currency of the country. It controls money supply of the country through various methods like bank rate, open market operations and variations in reserve ratios. It acts as a banker to the government. It is the custodian of the foreign exchange reserves of the economy. It is a bank to other banks.

   THE CURRENCY ISSUED BY THE CENTRAL BANK CAN BE HELD BY THE PUBLIC OR BY THE COMMERCIAL BANKS AND IS CALLED THE 'HIGH-POWERED MONEY' OR 'RESERVEMONEY' OR 'MONETARY BASE' AS IT ACTS AS A BASIS FOR CREDIT CREATION.

6. **COMMERCIAL BANKS**: Commercial banks are a part of the money-creating system of the economy. They accept deposits from the public and lend out part of these funds to those who want to borrow. The interest rate paid by the banks to depositors is lower than the rate charged from the borrowers. This difference between these two types of interest rates, called the 'SPREAD' is the profit appropriated by the bank.

7. **MONEY CREATION BY BANKING SYSTEM**: Banks can lend simply because they do not expect all the depositors to withdraw what they have deposited at the same time. When the banks lend to any person, a new deposit is opened in that person's name. Thus, money supply increases to old deposits plus new deposit.

   EXAMPLE:
   - Assume that there is only one bank in the country. Let us construct a fictional balance sheet for the bank. Balance sheet is a record of assets and liabilities of any firm. The assets of the firm are recorded on the left-hand side and liabilities on the right-hand side.
   - Accounting rules say that both sides of the balance sheet must be equal or total assets must be equal to the total liabilities
   - ASSETS are things a firm owns or what a firm can claim from others.
   - For a bank apart from buildings, furniture, etc. its assets are loans given to public. Another asset that a bank has is RESERVES.
   - Reserves are deposits which commercial banks keep with the Central Bank (RBI) and its cash.
   - Reserves with RBI are kept partly cash and partly in the form of financial instruments like bonds and treasury bills issued by RBI.
   - These reserves kept with RBI can be withdrawn at any time
   - Therefore ASSETS = RESERVES + LOANS
   - LIABILITIES for any firm are its debts or what it owes to others. For a bank the main liability is the deposits which people keep with the bank
   - LIABILITIES OF BANK = DEPOSITS
   - Accounting rule states the both sides of the account must balance. Hence if assets are greater than liabilities, they are recorded on the right-hand side as Net Worth.
     NET WORTH = ASSETS – LIABILITIES

8. **BALANCE SHEET OF A FICTIONAL BANK**
   Let the bank start with a deposit of Rs. 100 from one customer. The bank has deposited Rs. 100 with RBI. If we assume that there is no currency in circulation, then the total money supply in the economy will be equal to Rs. 100.

   M_1 = Currency + Deposit = 0 + 100

9. **LIMITS TO CREDIT CREATION AND MONEY MULTIPLIER**: Suppose Mr. X comes to the bank for a loan of Rs. 500. Bank can give loan to X. X deposit the loan amount of Rs. 500 in the same bank. Now bank give loan again. This way bank can create credit unlimited number of times. However, the credit creation is controlled by RBI.

   The RBI decides a certain percentage of deposits which every bank must keep as reserves. This is done to ensure that no bank is over landing. This is a legal requirement and is binding on the banks. This is called the Required Reserve Rati or Reserve Ratio or Cash Reserve Ratio. Cash Reserve Ratio (CRR) = Percentage of deposits which a bank must keep as cash reserve with itself.

   Apart from the CRR, banks are also required to keep some reserves in liquid form in the short term. This ratio is called Statutory Liquidity Ratio or SLR.

10. MONEY MULTIPLIER PROCESS: Let us assume that our bank starts with a deposit of Rs. 100. The cash reserve ratio is 20%. Thus, bank can give loan of Rs. 80.

Round	Deposit in Bank	Required Reserve	Loan given by Bank
1	100	20	80
2	180	36	64
3	244	48.8	51.2
4	295.2	59.04	40.96
5	336.16	67.23	32.76
6	368.92	73,78	26.208
7	395.12	79.024	20.96
8	416.08	83.216	16.768
9	432.8	86.56	13.41
10	446.21	89.24	10.728
11	456.938	91.387	8.57
12	465.47	93.094	6.856
13	472.326	94.4652	5.484
14	477.8	95.56	4.388
15	482.18	96.43	3.5104
16	485.69	97.138	2.80
17	488.49	97.698	2.24
18	490.73	98.146	1.792
19	492.522	98.50	1.433
20	493.955	98.79	1.146
21	495.1	99.02	0.9168
22	496.01	99.20	0.7334
23	496.7	99.34	0.58672
24	497.28	99.45	0.4693
25	497.74	99.50	0.37544
26	498.11	99.62	0.30035
27	498.41	99.682	0.24028
28	498.65	99.730	0.192224
29	498.842	99.7684	0.15377
30	498.99	99.798	0.12301
31	499.11	99.822	0.098408
32	499.20	99.84	0.07872
33	499.27	99.854	0.062976
34	499.30	99.86	0.050380
35	499.35	99.87	
LAST	500	100	400

Balance sheet of the bank now

ASSETS		LIABILITIES	
RESERVES	100	DEPOSITS 100+ 400	500
LOANS	400		
TOTAL	500	TOTAL	500

The bank is only expected to keep 20% of its deposits as reserves. Reserve of Rs. 100 can support the deposits of Rs. 500.
thus, bank can give loan up to Rs. 400.

M_1 = Currency + Deposits
= 0 + 500

THUS MONEY SUPPLY INCREASES FROM RS. 100 TO RS. 500
Given CRR= 20%
The bank cannot give loan beyond Rs. 400
Hence, requirement of reserves acts as a limit to money creation.

Money Multiplier =. 1/ CRR

IN ABOVE EXAMPLE MONEY MULTIPLIER = 1/20%
= 1/0.2
= 5

THUS, RESERVES OF RS. 100 CREATE DEPOSITS OF RS. 5 X 100 = RS. 500

1. LENDER OF LAST RESORT
2. OPEN MARKET OPERATION
3. REPO AND REVERSE REPO
4. VELOCITY OF CIRCULATION OF MONEY
5. LIQUIDITY TRAP
6. TIME DEPOSITS
7. NARROW AND BROAD MONEY

GOVERNMENT BUDGET AND THE ECONOMY

1. Mixed economy: Both private sector and Government control economic activity in a economy.

2. **GOVERNMENT BUDGET**: There are many ways in which the government influences economic life. Government Budget is main method of controlling the economic activities and giving the desired direction for development and striving for the social and economic goals set in our Constitution. Budget bring out the sources of government revenue and avenues of government spending.

3. There is a constitutional requirement in India (Article 112) to present before the Parliament a statement of estimated receipts and expenditures of the government in respect of every financial year which runs from 1 April to 31 March. This ‘Annual Financial Statement’ constitutes the main budget document of the government.

4. **REVENUE BUDGET**: Accounts that relate to the current financial year only
5. **CAPITAL BUDGET**: Accounts that concern the assets and liabilities of the government

6. **OBJECTIVES OF GOVERNMENT BUDGET**: The government plays a very important role in increasing the welfare of the people.
   - Government provides certain goods and services which cannot be provided by the market mechanism. Examples of such goods are national defence, roads, infrastructure. They are also referred as Public Goods. The benefits of public goods are available to all and not only restricted to one particular consumer. The benefit of Government controlling the pollution will be available to all. One person’s consumption of a good does not reduce the amount available for consumption for others. Ex. Street lights. Public goods are non-excludable. Everyone can enjoy the benefits even if he is not a tax payer to the government. These non-paying users are known as ‘free-riders’.

Public Provision and Public Production: Public provision means that they are financed through the budget and can be used without any direct payment. Public goods may be produced by the government or the private sector. When goods are produced directly by the government it is called public production.

- Private Goods are clothes, cars, food items etc. The benefit of consuming private goods is restricted to individual. It is not available to others. In case of private goods anyone who does not pay for the goods can be excluded from enjoying its benefits.

- *REDISTRIBUTION FUNCTION OF GOVERNMENT BUDGET*: The government sector affects the personal disposable income of households by making transfers and collecting taxes. It is through this that the government can change the distribution of income and bring about a distribution that is considered fair by society. This is the redistribution function.

  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 (Now GST) 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.

- *STABILISATION FUNCTION OF GOVERNMENT BUDGET*: The government may need to correct fluctuations in income and employment. The intervention of the government whether to expand demand or reduce it constitutes the stabilization function. The overall level of employment and prices in the economy depends upon the level of aggregate demand which depends on the spending decisions of millions of private agents apart from the government.

  Government spending depend on its income and credit availability. Government need to intervene to raise the aggregate demand for generating employment. In contrast, when inflation is high government has to adopt restrictive conditions to reduce demand.

  The government intervention whether to expand or reduce the demand constitutes the stabilization function.

7. CLASSIFICATION OF RECEIPTS TO GOVERNMENT:

REVENUE RECEIPTS: Tax and non-tax revenues are revenue receipts. These receipts are not to be returned by the government. They are therefore termed non-redeemable.
Tax revenues are further divided in to:
DIRECT TAXES: Personal income tax and on firms as corporation tax
INDIRECT TAXES: Like excise taxes (duties levied on goods produced within the country) and Service tax. Now it has been replaced by GST. Customs duties (taxes imposed on goods imported into and exported out of India)
Other direct taxes like wealth tax, gift tax do not bring in large amount of revenue and thus have been referred to as 'paper taxes'.
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.
Cash grants-in-aid from foreign countries and international organizations are also included.

8. FINANCE BILL: A Finance Bill presented along with the Annual Financial Statement, provides details on the imposition, abolition, remission, alteration or regulation of taxes proposed in the budget.

9. **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 PSUs which is referred as 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 in future these loans are to be returned with interest. These receipts are debt creating.
When government sells an asset, then it means that in future its earnings from that assets will disappear. These receipts are non-debt creating.

10. **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.
- expenses incurred for normal functioning of the government
- interest payments on debt
- grants given to state governments

PLAN AND NON-PLAN EXPENDITURE: PLAN revenue expenditure relates to central Plans (Five Year Plans) and central assistance for State and Union Territory Plans
NON-PLAN 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 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 is hardly any scope of reduction in defence expenditure. Subsidies are an important welfare policy. Subsidies are given to education and health services.
The government also extends subsidies to exports, interest on loans, food and fertilizers.
THE AMOUNT OF SUBSIDIES AS A PERCENT OF GDP WAS 2.02 PER CENT IN 2014-15 AND 1.7 PERCENT OF GDP IN 2015-16.

CAPITAL EXPENDITURE: These 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 UTs, PSUs etc.
Capital Expenditure is also categorized as plan and non-plan.
Plan Expenditure relates to central plan and central assistance for state and UTs. Non-Plan capital expenditure covers various general, social and economic services provided by the government.

11. **BUDGET:** Budget is a significant national policy statement. It determines the shape of 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 productivity capital receipts including market borrowings are being utilized.
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.

12. BALANCED BUDGET: When government expenditure is equal to the revenue it collects.

13. SURPLUS BUDGET: When revenue exceeds expenditure

14. DEFICIT BUDGET: When expenditure exceeds the revenue. Deficit budget is the most common feature.

15. 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

RECEIPTS AND EXPENDITURE OF THE CENTRAL GOVERNMENT 2015-16

S.No.	Item	As per cent of GDP
1.	Revenue Receipts (A + B)	8.1
	A Tax revenue (net of states' share)	6.5
	B Non-tax revenue	1.6
2.	Revenue Expenditure of which	10.9
	A) Interest payments	3.2
	B) Major subsidies	1.6
	C) Defence expenditure	1.1
3.	Revenue Deficit 2-1	2.8
4.	Capital Receipts (A+B+C) of which	4.5
	A) Recovery of loans	0.1
	B) Other receipts mainly PSU disinvestment	0.5
	C) Borrowings and other liabilities	3.9
5	Capital Expenditure	1.7
6.	Total Expenditure	12.6
	2+ 5 = 6 (A) + 6 (B)	
7	Fiscal deficit. 6- 1 -4 (A) – 4 (B) OR 3+5-4 (A) – 4 (B)	3.9
8	PRIMARY DEFICIT. 7-2 (A)	0.7

16. Above table shows that revenue deficit in 2015-16 was 2.8% of GDP. The revenue deficit includes only such transactions that affect the current income and expenditure of the government.
When the government incurs a revenue deficit, it implies that the government is dissaving and is using up the savings of the other sectors of the economy to finance a part of its consumption expenditure.

This situation means that the government will have to borrow not only to finance its investment but also its consumption requirements. This will lead to government to cut on expenditure. Since a major part of revenue expenditure is committed expenditure, it cannot be reduced. Often the government reduces productive capital expenditure or welfare expenditure.
This would mean lower growth and adverse welfare implications.

17. FISCAL DEFICIT:

Fiscal deficit is the difference between the government
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 PSUs.

The fiscal deficit will have to be financed through borrowing. It indicates the total borrowing requirements of the government from all sources.

Gross fiscal deficit = Net borrowing at home + Borrowing from RBI + Borrowing from abroad

Net borrowing at home includes that directly borrowed from public through debt instruments. For example, the various small saving schemes. And indirectly from commercial banks through Statutory Liquidity Ratio (SLR). The gross fiscal deficit is a key variable in judging the financial health of the public sector and the stability of the economy.

Fiscal Deficit = Revenue deficit + Capital Expenditure – non-debt creating capital receipts

A large share of revenue deficit in fiscal deficit indicated that a large part of borrowing is being used to meet its consumption expenditure needs rather than investment.

18. **PRIMARY DEFICIT:** 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.
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.

19. **DEBT:** Budgetary deficits must be financed by either taxation, borrowing or printing money. Government have mostly relied on borrowing, giving rise to what is called government debt. If the government continuous to borrow year after year, it leads to the accumulation of debt and the government has to pay more and more by way of interest. These interest payments themselves contribute to the debt.

20. **DEFICIT REDUCTION:** Government deficit can be reduced by:
-increase in taxes
-reduction in expenditure
-Disinvestment of PSUs by selling of shares

21. The same fiscal measures can give rise to a large or small deficit, depending on the state of the economy. For example, if an economy experiences a recessions and GDP falls, tax revenues fall because firms and households pay lower taxes when they earn less. This means that the deficit increases in a recession and falls in a boom, even with no change in fiscal policy.

22. **FISCAL RESPONSIBILITY AND BUDGET MANAGEMENT ACT 2003 (FRBMA):** The enactment of the FRBMA, in August 2003, marked a turning point in fiscal reforms, binding the government through an institutional framework to pursue a prudent fiscal policy. The central government must ensure intergenerational equity and long-term macro-economic stability by achieving sufficient revenue surplus, removing fiscal obstacles to monetary policy and effective debt management by limiting deficits and borrowing. The rules under the act were notified with effect from July, 2004.

MAIN FEATURES:

1. The Act mandates the central government to take appropriate measures to reduce fiscal deficit to not more than 3% of GDP and to eliminate the revenue deficit by March 31, 2009 and thereafter build up adequate revenue surplus.
2. It requires the reduction in fiscal deficit by 0.3% of GDP each year and the revenue deficit by 0.5%. If this is not achieved through tax revenues, the necessary adjustment has to come from a reduction in expenditure.
3. The actual deficit may exceed the targets specified only on grounds of national security or natural calamity or such other exceptional grounds as the central government may specify.
4. The central government shall not borrow from the Reserve Bank of India except by way of advances to meet temporary excess of cash disbursements over cash receipts.
5. The RBI must not subscribe to the primary issues of central government securities from the year 2006-07.
6. Measures to be taken to ensure greater transparency in fiscal operations.
7. The central government to lay before both Houses of Parliament three statements- Medium-term Fiscal Policy Statement, The Fiscal Policy Strategy Statement, The Macroeconomic Framework Statement along with the Annual Financial Statement.
8. Quarterly review of the trends in receipts and expenditure in relation to the budget be placed before both Houses of Parliament.

THE FRBMA IS AN IMPORTANT INSTITUTIONAL MECHANISM TO ENSURE FISCAL PRUDENCE AND SUPPORT MACRO ECONOMIC BALANCE THERE HAVE BEEN FEARS THAT WELFARE EXPENDITURE MAY GET REDUCED TO MEET THE TARGETS MANDATED BY THE ACT.

23. **GST**: ONE NATION, ONE TAX, ONE MARKET. Goods and Service Tax is the single comprehensive indirect tax operational from 1 July 2017, on supply of goods and services, right from the manufacturer/service provider to the consumer.
It is a destination-based consumption tax with facility of Input Tax Credit in the supply chain.
It is applicable throughout the country with one rate for one type of goods/service.
It has amalgamated a large number of taxes on goods and services levied on production; sale of goods; or provision of service.
Under GST, the tax is discharged at every stage of supply and credit of tax paid at the previous stage is available for set off at the next stage of supply of goods and or services.
It is thus effectively a tax on value addition at each stage of supply
It has replaced various types of taxes and cesses levied by the Central and State/UT governments.
Some of the major taxes that were levied by Centre were Central Excise Duty, Service Tax, Central Sales Tax, Cesses like KKC and SBC
The major State taxes were VAT/Sales Tax, Entry Tax, Luxury Tax, Octroi, Entertainment Tax, Taxes on Advertisements, Taxes on lottery, betting etc. State Cesses on goods etc.
These have been subsumed in GST.

Five petroleum products have been kept out of GST for time being.
State governments will continue to levy VAT on alcoholic liquor for human consumption.
Tobacco and tobacco products will attract both GST and Central Excise Duty.
GST is the biggest tax reform in the country since independence and was rolled out on the mid-night of 30 June /1 July, 2017 during a special midnight session of the Parliament.
The 101st Constitution Amendment Act received assent of the President of India on 8th September 2016.

The amendment introduced Article 246A in the Constitution cross empowering Parliament and Legislatures of States to make laws with reference to Goods and Service Tax imposed by the Union and the States.

Thereafter CGST Act, UTGST Act and SGST Acts were enacted for GST. GST has simplified the multiplicity of taxes on goods and services. The laws, procedures and rates of taxes across the country are standardized. It has facilitated the freedom of movement of goods and services and created a common market in the country.

It is aimed at reducing the cost of business operations and cascading effect of various taxes on consumers.
It has also reduced the overall cost of production, which will make Indian products/Services more competitive in the domestic and international markets.
It will also result into higher economic growth as GDP is expected to rise by about 2%.
Compliance will also be easier as all tax payments related services like registration, returns, payments are available online through a common portal www.gst.gov.in.
It has expanded the tax base introduced higher transparency in the taxation system, reduced human interface between Taxpayer and government and is furthering ease of doing business.

OPEN ECONOMY MACROECONOMICS

1. An open economy is one which interacts with other countries and have economic activities/ exchange with other countries in the world.

2. **OPEN MARKET**: An economy can trade in goods and services with other countries. Consumers and producers have a wider choice, as can choose between domestic and foreign goods.

3. **FINANCIAL MARKET**: Very often an economy can buy financial assets from other countries. This gives investors the opportunity to choose between domestic and foreign assets

4. **LABOUR MARKET**: Firms can choose where to locate production and workers to choose where to work. There are various immigration laws which restrict the movement of labour between countries.

5. Thus, an open economy is said to be one that trades with other nations in goods and services and very often, also trade in financial assets.

6. Foreign trade influences Indian aggregate demand:
A) When Indians buy foreign goods, these spending escapes as a leakage from the circular flow of income decreasing aggregate demand
B) Our exports to foreigners enter as an injection into the circular flow, increasing aggregate demand for goods produced within the domestic economy.

7. **FOREIGN EXCHANGE RATE**: The price of one currency in terms of another currency is known as the foreign exchange rate.

8. **BALANCE OF PAYMENTS**: The Balance of Payments (BoP) record the transactions in goods, services and assets between residents of a country with the rest of the world for a specified time period generally a year.
There are two main accounts in Balance of Payment:
A. Current Account
B. Capital Account

9. **CURRENT ACCOUNT**: Current Account is the record of trade in goods and services and transfer payments.

Trade in goods includes exports and imports of goods.

Trade in services includes factor income and non-factor income transactions

Transfer Payments are the receipts which the residents of a country get for free, without having to provide any goods or service in return. Ex. Indian sending money from foreign country to his parents. They may consist of gifts, remittances and grants.

Buying foreign goods is expenditure from our country and it becomes the income of that foreign country. The purchase of foreign goods or imports decreases the domestic demand for goods and services in our country.

Similarly, selling of foreign goods or exports brings income to our country and adds to the aggregate domestic demand for goods and services in our country.

BALANCE ON CURRENT ACCOUNT: Current account is in balance when receipts are equal to payments. RECEIPTS = PAYMENTS

A SURPLUS current account means that nation is lender to other countries RECEIPTS > PAYMENTS

A DEFICIT current account means that the nation is a borrower from other countries. RECEIPTS < PAYMENTS

CURRENT ACCOUNT HAS TWO COMPONENTS

1. Balance of Trade. Or Trade Balance
2. Balance on Invisibles

BALANCE OF TRADE: is the difference between the value of exports and value of imports of goods of a country in a given period of time.

Export value = Import value ……….BOT in Balance

Surplus BOT = Trade Surplus when exports exceed imports

INVISIBLES: includes services, transfers and flows of income that take place between different countries.

Services trade includes both factor and non-factor income.

Factor income includes net international earnings on factors of production like labour, land and capital.

Non-factor income is net sale of service products like shipping, banking, tourism, software services, etc.

CAPITAL ACCOUNT: Capital Account records all international transactions of assets. An asset is any one of the forms in which wealth can be held for example money stocks bonds, Government debt, etc.

Purchase of assets is a debit item on the capital account.

If an Indian buy a UK car company, it enters capital account transactions as a debit item AS FOREIGN EXCHANGE IS FLOWING OUT OF INDIA.

On the other hand, sale of assets like sale of share of an Indian company to a Chinese customer is a credit item on the capital account transactions.

These items are Foreign Direct Investments (FDI), Foreign Institutional Investments (FIIS), external borrowings and assistance.

BALANCE ON CAPITAL ACCOUNT: Capital account is in balance when capital inflows like receipts of loans from abroad, sale of assets or shares in foreign companies are equal to capital outflows like repayment of loans, purchase of assets or shares in foreign countries.

Surplus in capital account arises when capital inflows are greater than capital outflows, whereas deficit in capital account arises when capital inflows are lesser than capital outflows.

10. BALANCE OF PAYMENTS SURPLUS AND DEFICIT: Deficit in current account can be balanced by selling assets or by borrowing abroad. Thus, any current account deficit must be financed by a capital account surplus, that is a net capital in- flow.
current Account + Capital Account = Zero

The country can use its reserves of foreign exchange in order to balance any deficit in its balance of payments.

The reserve bank sells foreign exchange when there is a deficit.
This is called official reserve sale.
The decrease or increase in official reserves is called the overall balance of payments deficit or surplus.

11. AUTONOMOUS TRANSACTIONS: International economic transactions are autonomous when transactions are made to earn profit. These are not linked to settle the BoP. These items are called 'above the line' items in the BoP. The BoP is said to be in surplus if autonomous receipts are greater than autonomous payments. The BoP is said to be in deficit if autonomous receipts are less than autonomous payments.

12. ACCOMMODATING TRANSACTIONS: They are also termed 'below the line' items.
The official reserve transactions are made to bridge the gap in the BoP. They are seen as the accommodating item in the BoP.

13. ERRORS AND OMISSIONS: It is difficult to record all international transactions accurately. Thus, we have a third element of BoP called errors and omissions.

14. SAMPLE OF BoP

BALANCE OF PAYMENTS FOR INDIA (IN MILLION USD)

No.	Item	Million USD
1.	Exports of goods only	150
2	Imports of goods only	240
3	Trade Balance 2-1	-90
4.	(Net) Invisible 4A + 4B + 4C	52
	A Non-factor Services	30
	B Income	-10
	C Transfers	32
5	Current Account Balance 3+4	-38
6	Capital Account Balance	41.15
	A) external Assistance (net)	0.15
	B) external commercial borrowings (net)	2
	C Short-term Debt	10
	D Banking Capital (net) of which	15
	Non-resident Deposits (net)	9
	E Foreign Investments (net) of which 6EX+6EY	19
	X FDI (net)	13
	Y Portfolio (net)	6
	F Other Flows (net)	-5
7	Errors and Omissions	3.15
8	Overall Balance 5+6+7	0
9	Reserve Change	0

15 **FOREIGN EXCHANGE MARKET**: An Indian going on a holiday abroad is import of tourist services.

The market in which national currencies are traded for one another is known as the foreign exchange market. Market is world-wide.

Market is managed by commercial banks, foreign exchange brokers and other authorized dealers and monetary authorities.

FOREIGN EXCHANGE RATE: Foreign Exchange Rate also called Forex Rate is the price of one currency in terms of another. It enables comparison of international costs and prices.

DEMAND FOR FOREIGN EXCHANGE: People demand foreign exchange because they want to purchase goods and services from other countries. They want to visit other countries, they want to send gifts abroad and they want to purchase financial assets of a certain country.

A rise in price of foreign exchange will increase the cost in terms of Rs. Of purchasing a foreign good. This will also reduce demand for imports and hence demand for foreign exchange also decreases.

SUPPLY OF FOREIGN EXCHANGE: When foreigners purchase Indian goods and services, or foreigners send gifts or make transfer or assets are bought by them: Foreign currency flows into India.
A rise in price of foreign exchange will reduce the foreigner's cost while purchasing products from India. This will increase India's exports and hence supply for foreign exchange may increase.

DETERMINATION OF THE EXCHANGE RATE: Different countries have different methods of determining their currency's exchange rate. It can be determined through Flexible Exchange Rate, Fixed Exchange Rate or Managed Floating Exchange Rate.

FLEXIBLE EXCHANGE RATE: This exchange rate is determined by the market forces of demand and supply. It is also known as Floating Exchange Rate. The exchange rate is the interacting point of demand and supply of currencies.

In a completely flexible system, the Central banks do not intervene in the foreign exchange market. Ex. Today's exchange rate is Rs. 50 for 1$
With increase in imports or more Indians travelling to US the demand of dollars will increase. Say it increases to Rs 60 for 1$
This means we need to pay more rupees for a dollar.
It indicates that the value of rupees in terms of dollars has fallen and the value of dollar in terms of rupees has risen.
Increase in exchange rate implies that the price of foreign currency $ in terms of domestic currency Rs. has increased. This is called DEPRECIATION of domestic currency in terms of foreign currency.
Similarly, in a flexible exchange rate regime, when the price of domestic currency in terms of foreign currency increases, it is called APPRECIATION.

SPECULATION:
Money in any country is an asset. If Indians believe that British pound will have higher value in near future, they would like to hold pounds.
This preference of holding may affect the exchange rate as the demand rises.

INTEREST RATES AND EXCHANGE RATE: In the short run the differential interest between two countries may trigger change in exchange rate.
There are huge funds owned by banks, multinational corporations and wealthy individuals which move around the world in search of the highest interest rates. Investors will move to country offering higher rates and buy the currency of that country.
THUS, A RISE IN THE INTEREST RATES AT HOME OFTEN LEADS TO AN APPRECIATION OF THE DOMESTIC CURRENCY.

INCOME AND THE EXCHANGE RATE: When income increases, consumer spending increases. Spending on imported goods is also likely to increase. When imports increase, the demand curve for foreign exchange shifts to the right. There is a depreciation of the domestic currency. A country whose aggregate demand grows faster than rest of the world's normally finds its currency depreciating because its imports grow faster than its exports.

EXCHANGE RATES IN THE LONG RUN: As long as there are no barriers to trade like tariffs and quotas exchange rates should eventually adjust so that the same product costs the same whether measured in rupees in India, or dollars in the US, yen in Japan and so on, except for differences in transportation. Over the long run, therefore, exchange rates between any two national currencies adjust to reflect differences in the price levels in the two countries.

FIXED EXCHANGE RATES: The Government fixes the exchange rate at a particular level. If Indian government wants to encourage exports for which it needs to make rupee cheaper for foreigners, it would fix higher exchange rate than the current exchange rate.

At this rate the supply of dollars exceeds the demand for dollars. The RBI intervenes to purchase the dollars for rupees in the foreign exchange market in order to absorb this excess supply.

Thus, through intervention, the government can maintain any exchange rate in the economy. On the other hand, if government was to set an exchange rate at a lower level, there would be excess demand for dollars in the foreign exchange market. To meet this excess demand for dollars the government would have to withdraw dollars from its past holdings of dollars.
In a fixed exchange rate system, when some government action increases the exchange rate, thereby making domestic currency cheaper is called Devaluation.

On the other hand, a Revaluation is said to occur, when the government decreases the exchange rate, thereby making domestic currency costlier, in a fixed exchange rate system.

ADVANTAGES OF THE FLEXIBLE EXCHANGE RATE SYSTEM: The flexible exchange rate system gives the government more flexibility and they do not need to maintain large stocks of foreign exchange reserves. The major advantage of flexible exchange rates is that movements in the exchange rate automatically take care of the surpluses and deficits in the BoP.

MANAGED FLOATING: World has moved to managed floating exchange rate system. Central banks intervene to buy and sell foreign currencies in an attempt to moderate exchange rate movements whenever they feel that such actions are appropriate.

EXCHANGE RATE SYSTEM OVER THE YEARS:

1. Around World War I the system was the gold standard linked to fixed exchange rate system. All currencies were defined in terms of gold
2. If one unit of say currency A was worth one gram of gold and other currency B is worth two gram of gold. The currency B would be worth twice as much as currency A.
3. Several crises caused the gold standard to break down many times. The main reason was the production of gold equivalent to GDP.
4. Many countries adopted gold exchange standard by keeping their money exchangeable at fixed prices with respect to gold but held little or no gold.
5. THE BRETTON WOODS SYSTEM: The Bretton Woods Conference was held in 1944. World Bank and IMF reestablished a system of fixed exchange rates. The US monetary authorities guaranteed the convertibility of the dollar into gold at the fixed price of $ 35 per ounce of gold.

Each member participating in the system gave commitment to convert their currency into dollars at a fixed price. This was called the official exchange rate.
Ex. French Francs could be exchanged for dollars at roughly 5 francs per dollar
The dollars could be exchanged with dollar $35 per ounce
So175 francs per ounce of gold

Why we adopted this: gold reserves across countries was uneven with the US having almost 70% of the official world gold reserves.

It was believed that existing gold stock would be insufficient to sustain the growing demand for international liquidity.

The system failed quickly as US could not kept the commitment.
In August 1971, the British demanded that US guarantee the gold value of the dollar holdings. This led to the US decision to give up the link between the dollar and gold.

Triffin suggested that the IMF should turned into a deposit bank for central banks and a new 'reserve asset' be created under the control of the IMF.

In 1967, gold was displaced by creating the Special Drawing Rights (SDRs) also known as 'paper gold'

SDR has been defined several times since then.
At present, it is calculated daily as the weighted sum of the values in dollars of four currencies euro, dollar, Japanese yen, pound sterling of the five countries France, Germany, Japan, the UK and the US.

IT drives its strength from IMF members being willing to use it as a reserve currency and use it as a means of payment between central banks to exchange for national currencies.
The original installments of SDRs were distributed to member countries according to their quota in the Fund. The quota was broadly related to the country's economic importance as indicated by the value of its international trade.

At present, the international system is now characterized by a multiple of regimes. Most exchange rates change slightly on a day to day basis, and market forces generally determine the basic trends. Even those advocating greater fixity in exchange rates generally propose certain ranges within which governments should keep rates, rather than literally fix them.