Key terms of macroeconomics

Economics, Macroeconomics

Introduction The study of economics is divided by the modern economists into two parts biz. Micro economics and Macro economics. This division is shown in the chart above. Micro economics and Macro economics, both the terms were used in 1933 by Proof. Raglan Frisks from Oslo University of Norway. Macroeconomics (from the Greek prefix macro- meaning " large" and economics) is a branch of economics dealing with the performance, structure, behavior, and decision-making of an economy as a whole, rather than individual markets. This includes national, regional, and global economies.

Macroeconomics study aggregated indicators such as GAP, unemployment rates, and price indices to understand how the whole economy functions. Macroeconomics develop models that explain the relationship between such factors as national income, output, consumption, unemployment, inflation, savings, investment, international trade and internationalfinance. In contrast, microeconomics is primarily focused on the actions of individual agents, such as firms and consumers, and how their behavior determines prices and quantities in specific markets.

While macroeconomics is a broad field of study, there are two areas f research that are emblematic of the discipline: the attempt to understand the causes and consequences of short-run fluctuations in national income (the business cycle), and the attempt to understand the determinants of long-run economic growth (increases in national income). Macroeconomic models and their forecasts are used by both governments and large corporations to assist in the development and evaluation of economic policy and business strategy. Basic concept of macroeconomics: The field of economics that studies the behavior of the aggregate economy.

Macroeconomics examines economy-wide phenomena such as changes in employment, national income, rate of growth, gross domestic product, inflation and price levels. According to P. A Samuelsson " Macroeconomics is the study of the behavior of the economy as a whole. It examines the overall level of a nation's output, employment, prices and foreign trade. " According to J. M Culbertson " Macroeconomic theory is the theory of income, employment, prices andmoney. " Key Terms of Macroeconomics By lecherous The subject matter of macro economics are as follows: 1 .

Determination of National Income: The first major issue in macro economics is to explain what determines the level of employment and national income in an economy and therefore what causes involuntary unemployment. The level of national income and employment are very low in times ofdepressionas in sass in various capitalist countries of the world. This will explain the cause of huge unemployment that emerged in these countries. Classical economists denied that there could be involuntary unemployment of labor and other resources for a long time.

Classical economist thought that with changes in wages and prices, unemployment would be automatically removed and full employment established. But this did not appear to be so at the time of great oppression in the thirties (1930) and after. Keynes explained the level of employment and national income is determined by aggregate demand and aggregate supply. With aggregate supply curve remaining unchanged in the short run, it is the deficiency of aggregate demand that causes under employment equilibrium with the appearance of involuntary unemployment. 2.

Inflation Inflation is a key concept in macroeconomics, and a major concern for government policymakers, companies, workers and investors. Inflation refers to a broad increase in prices across many goods and services in an economy over a sustained period of mime. Conversely, inflation can also be thought of as the erosion in value of an economy's currency (a unit of currency buys fewer goods and services than in prior periods). Inflation means a sustained increase in the aggregate or general price level in an economy. Inflation means there is an increase in the cost of living. Inflation means that your money won't buy as much today as you could yesterday. " 3. Business Cycle: The business cycle is the pattern of expansion, contraction and recovery in the economy. Generally speaking, the business cycle is measured and tracked in terms of GAP and unemployment - GAP rises and unemployment shrinks during expansion phases, while reversing in periods of recession. Wherever one starts in the cycle, the economy is observed to go through four periods - expansion, peak, contraction and trough. 4. Contraction: specifically, contraction occurs after the business cycle peaks, but before it becomes a trough.

According to most economists, a contraction is said to occur when a country's real GAP has declined for two or more consecutive quarters. For most people, a contraction in the economy can be source of economic hardship; as the economy plunges into a contraction, people start losing their Jobs. While no economic contraction lasts forever, it is very difficult to assess Just how long a downtrend will continue before it reverses because history has shown that a contraction can last for many years (such as during theGreat Depression). 5.

Economic Performance and Growth: Income is one of the most significant factors in measuring economic performance, and gross domestic product (GAP) is the most commonly used measure of a country's economic activity. In short, GAP reflects the value of all final goods and services equally produced in an economy in a given time period. The distinction between final goods and intermediate goods is an important one. A tomato sold to a ketchup manufacturer would NOT be included in the GAP number, while a tomato sold in a store as produce would be included, as it represents the final use of that good.

It is also worth noting that trade in illegal goods and services are also excluded from GAP figures. 6. Balance of Payment: A record of all transactions made between one particular country and all other countries during a specified period of time. BOP compares the dollar difference of he amount of exports and imports, including all financial exports and imports. A negative balance of payments means that more money is flowing out of the country than coming in, and vice versa. Balance of payments may be used as an indicator of economic and political stability.

For example, if a country has a consistently positive BOP, this could mean that there is significant foreign investment within that country. It may also mean that the country does not export much of its currency. This is Just another economic indicator of a country's relative value and, along with all other indicators, should be used with caution. The BOP includes the trade balance, foreign investments and investments by foreigners. 7. Exchange Rate: For citizens of different countries to conduct trade, they have to buy and sell each other's currencies.

The price of a nation's currency, expressed as an amount of a second country's currency, is referred to as the exchange rate. As exchange rates play a significant role in trade and capital flows, it is an important concept in macroeconomics. (I) 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. (II) It helps to achieve the goal of economic growth, higher level of GAP 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. (III) It helps to bring stability in price level and analyses fluctuations in business activities. It suggests policy measures to control inflation and deflation. (V) It explains factors which determine balance of payment. At the same time, it identifies causes of deficit in balance of payment and suggests remedial measures. (V) It helps to solve economic problems likepoverty, unemployment, inflation, deflation etc. , whose solution is possible at macro level only, I. . , at the level of whole economy. (VI) With detailed knowledge of functioning of an economy at macro level, it has been possible to formulate correct economic policies and also coordinate international economic policies. (W) Last but not the least merit is that macroeconomic theory has saved us from the dangers of application of microeconomic theory to the problems of the economy as a hole. Circular Flow of Income: The circular flow of income is a neoclassical economic model depicting how money flows through the economy. In the simplest version, the economy is modeled as consisting only of households and firms.

Money flows to workers in the form of suggests the old economic adage, " Supply creates its own demand. " 1 . Circular Flow of Income in a Two Sector Economy: In Economics, the terms circular flow of income or circular flow refer to a simple economic model which describes the reciprocal circulation of income between producers and consumers. The modern economy is a monetary economy. In the modern economy, money is used as a medium of exchange. While analyzing the circular flow of income in a two sector model of the economy, we assume: There are only two sectors in the economy; a.

Household Sector and b. Business Sector. 2. The business sector (or the firms) hires factors of production owned by the household sector and it is the sole producer of goods and services in the economy. 3. The household sector (or the households) is the sole _ buyer of goods and services. It spends its entire income on the goods and services produced by the business sector. They are also suppliers of labor and various of other factors of production. 4. The business sector sells the entire output to households. It does not store. There are, therefore, no inventories. 5.

There are no savings and investment in the economy. 6. The household sector receives income by selling or renting the factors of production owned by it 7. Government does not exist for all such practical purposes (No public expenditures, no taxes, no subsidies, no social insurance contribution, etc.) 8. The economy is closed one having no international trade relations. In this hypothetical economy stated above, we explain the circular flow of economic Principles of Circular Flow of Income: In the simple circular flow of income and product, there are two principles which are involved.

First. In the business transactions, the sellers of goods receive exactly the same amount which the buyers spend on them. Second. The goods and services flow in one direction and money payment flow in the other direction. Circular Income Flow: In a two sector economy, there are business firms which produce goods and services. The other sector is households which supplies their factors services to the rims and also buy, goods and services produced by them. The households supply the economic resources to the firms and receive payments in terms of money.

There is, thus, a flow of money corresponding to the flow of economic resources. These money incomes are spent by households on goods and services produced by the firms. With this the money comes back to the firms. This circular flow of income in flow of income in a two sector economy is explained with the help of a figure. In this figure, it is shown that the economy consists of two sectors households and business. In the upper loop of this figure, the resources such as land, capital, labor and entrepreneurial ability flow from households to business firms as indicated by the arrow mark.

In opposite, direction to this, money flows from business firms to the households as factors payments such as rent, wages, interest and profit. In the lower pipe line, money flows from households to firms as consumption expenditure made by the households on the goods and services produced by the firms. The flow of . Goods and services is in opposite direction from business firms to households. We, hush, find that money flows from business firms to households as factor payments and then it flows back from households to firms. Thus there is in fact a circular flow of income.

This circular flow of money or income continues year after year. This is how the economy functions. 2. Circular Money Flow with Saving & Investment: In the circular flow of money, saving is one of the leakages and investment is an injection. In fact, the household and business sectors do not spend their entire money income. The consumers who represent the household sector do not spend their income wholly in purchasing goods and services. Rather, they save a part of their income for a variety of motives. Similarly, business firms do not spend their entire income from the sale of goods.

But they keep a part of it in the form of undistributed profit. Such savings of consumers and firms are not hoarded but are invested in bonds, shares, debentures, etc. In the capital market. They flow in to the capital market. On the other hand, business firms borrow funds from the capital market for making investment. Thus savings which flow into the capital market are taken away by the business sector for investment and the circular flow of money is maintained in the economy. In this figure shows how the circular flow of money is altered by the inclusion of saving and investment.

Expenditure has now two paths: (I) directly via consumption from the households to the business sector, and (ii) Indirectly via investment expenditure by the business sector. In the centre of Figure, there is the capital (or credit or financial) market which shows the inflow of savings from the household sector and the business sector into the capital market, and the outflow of investment into the business sector from the capital market. The capital raked coordinates the saving and investment activities of the household and business sector s and maintain the circular flow of money in the economy. . Circular flow of income in three sectors with the government sector: So far we have add the government sector so as to make it a three-sector closed model. For this, we add taxation and government purchases (or expenditure) in our presentation. Taxation is a leakage from the circular flow and government purchases are injections into the circular flow of money. First, take the circular flow between the household sector and the government sector. Taxes in the form of personal income tax and commodity taxes paid by the household sector are outflows or leakages from the circular flow.

But the government purchases the services of the households, makes transfer payments in the form of old age pensions, unemployment relief, sickness benefit, etc. , and also spends on them to provide certain social services likeeducation, health, housing, water, parks and other facilities. All such expenditures by the government are injections into the circular flow of money. Next take the circular flow between the business sector and the government sector. All types of taxes paid y the business sector to the government are leakages from the circular flow.

On the other hand, the government purchases all its requirements of goods of all types from the business sector, gives subsidies and makes transfer payments to firms in order to encourage their production. These government expenditures are injections into the circular flow of money. Now we take the household, business and government sectors together to show their inflows and outflows in the circular flow. As already noted, taxation is a leakage from the circular flow. It tends to reduce consumption and saving of the household sector.

Reduced consumption, in turn, reduces the sales and incomes of the firms. On the other hand, taxes on business firms tend to reduce their investment and production. The government offsets these leakages by making purchases from the business sector and buying services of the household sector equal to the amount of taxes. Thus total sales again equal production of firms. In this way, the circular flows of income and expenditure remain in equilibrium. To the government. Now the government makes investment and for this purchases goods from the household.

Thus government purchases of goods and services are an injection in the circular flow of income and taxes are leakages. If government purchases exceed net taxes then the government will incur a deficit equal to the difference between the two, I. E. , government expenditure and taxes. The government finances its deficit by borrowing from the capital market which receives funds from household sector in the form of saving. On the other hand, if net taxes exceed government purchases the government will have a budget surplus.

In this case, the government reduces the public debt and supplies funds to the capital market which are received by the business sector. . Circular flow of money with foreign sector: So far the circular flow of income and expenditure has been shown in the case of a closed economy. But the actual economy is an open one where foreign trade plays an important role. Exports are an injection or inflows into the economy. They create incomes for the domestic firms. When foreigners buy goods and services produced by domestic firms, they are exports in the circular flow of income.

On the other hand, imports are leakages from the circular flow. They are expenditures incurred by the household sector to purchase goods from foreign countries. These exports and imports in the circular flow are shown in Figure. Take the inflows and outflows of the household, business and government sectors in relation to the foreign sector. The household sector buys goods imported from abroad and makes payment for them of money. The householder may receive transfer payments from the foreign sector for the services rendered by them in foreign countries.

On the other hand, the business sector exports goods to foreign countries and its receipts are an injection in the circular flow. Similarly, there are many services rendered by business firms to foreign Mounties such as shipping, insurance, banking, etc. For which they receive payments from abroad. They also receive royalties, interests, dividends, profits, etc. For investments made in foreign countries. On the other hand, the business sector makes payments to the foreign sector for Imports of capital goods, machinery, raw materials, consumer goods, and services from abroad.

These are the leakages from the circular flow. Like the business sector, modern governments also export and import goods and services, and lend to and borrow from foreign countries. For all exports of goods, the government receives payments from abroad. Similarly, the government receives payments from foreigners when they visit the country as tourists and for receiving education, etc. And also when the government provides shipping, insurance and banking services to foreigners through the state-owned agencies. It also receives royalties, interest, dividends etc. Or investments made payments made for the purchase of goods and services to foreigners. In this figure shows the circular flow of the four-sector open economy with saving, taxes and imports shown as leakages from the circular flow on the right hand side of he figure, and investment, government purchases and exports as injections into the circular flow on the left side of the figure. Further, imports, exports and transfer payments have been shown to arise from the three domestic sectors? the household, the business and the government.

These outflows and inflows pass through the foreign sector which is also called the " Balance of Payments Sector. " Thus Figure shows the circular flow of money where there are inflows and outflows of money receipts and payments among the business sector, the household sector, the government sector and the foreign sector in currents and cross-currents. Conclusion: 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 other parties and how to best maximize utility and scarce resources. 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 GAP, 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 et at least a glimpse of the probable future and act accordingly with confidence