

**MCOM SECOND SEMESTER**  
**COMM -CC201- MACRO ECONOMICS**

**PREPARED BY: Dr PINKI RANI DEI**  
**ASSISTANT PROFESSOR OF COMMERCE**

**Unit- I: Introduction to Macro Economics:** Introduction, Micro vs. Macro Economics, Importance of Macro Economics, Overview of Economics Systems: Mixed Economy, Socialism Economy, Capitalism Economy and Islamic Economy, Lab based assignments.

**Introduction to Macroeconomics-**Macroeconomics is a branch of economics that focuses on the **big picture**—the overall performance, structure, behavior, and decision-making of an economy. Unlike microeconomics, which studies individual economic actors, macroeconomics examines economy-wide phenomena such as inflation, unemployment, and economic growth.

The field of macroeconomics as we know it today largely emerged in the aftermath of the Great Depression, with the work of British economist John Maynard Keynes. Before this time, classical economic theory primarily focused on individual markets and assumed that the economy would naturally self-correct. The severity and persistence of the Great Depression, however, challenged these assumptions and highlighted the need for a new framework to understand and address large-scale economic problems.

**Micro vs. Macro Economics-**The key difference between microeconomics and macroeconomics lies in their **scope and scale**.

Feature	Microeconomics	Macroeconomics
<b>Focus</b>	Individual economic units, such as a consumer, a household, or a single firm.	The economy as a whole, including aggregates like national income, total employment, and general price levels.
<b>Key Questions</b>	How does a firm decide the price of its product? How does a consumer	What causes inflation or unemployment? What drives a

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Feature	Microeconomics	Macroeconomics
	choose which goods to buy? What determines the supply and demand for a specific good?	country's economic growth? How do government policies affect the overall economy?
<b>Topics Studied</b>	Supply and demand, consumer behavior, market structures, price determination, and resource allocation within a specific market.	Gross Domestic Product (GDP), inflation, unemployment, national income, monetary policy, and fiscal policy.
<b>Perspective</b>	"Bottom-up" approach, analyzing how individual decisions shape markets.	"Top-down" approach, looking at the entire economy and the interactions between its various sectors.

While they are distinct fields, microeconomics and macroeconomics are interconnected. Macroeconomic trends are the result of countless microeconomic decisions, and the overall state of the economy (a macroeconomic factor) significantly influences the choices that individuals and businesses make (microeconomic factors).

**Importance of Macroeconomics**-The study of macroeconomics is essential for several reasons, impacting governments, businesses, and individuals alike.

- **Understanding the Overall Economy:** Macroeconomics provides a framework for understanding how the entire economic system works. It helps us analyze the forces that determine national income, employment levels, and economic output.
- **Formulating Economic Policies:** Governments and central banks use macroeconomic analysis to formulate and implement policies aimed at achieving national goals. For instance:
  - **Fiscal Policy:** The government's use of taxation and spending to influence the economy. During a recession, the government might increase spending or cut taxes to stimulate demand.
  - **Monetary Policy:** Central banks use tools like interest rates and money supply to control inflation and promote economic stability.

- **Solving Major Economic Problems:** Macroeconomics is crucial for addressing widespread issues like unemployment, poverty, and inflation. It provides the tools to identify the causes of these problems and to devise effective policy solutions.
- **Informing Business Decisions:** Businesses do not operate in a vacuum. Macroeconomic factors like interest rates, inflation, and consumer spending power directly affect a firm's costs, revenue, and investment decisions. An understanding of macroeconomic trends helps businesses with strategic planning, expansion decisions, and risk management.
- **International Comparisons:** Macroeconomic data, such as GDP and per capita income, allows for meaningful comparisons of economic performance and living standards between different countries. This is vital for international trade, foreign investment, and global policy coordination.

### **Economics Systems: Mixed Economy, Socialism Economy, Capitalism Economy and Islamic Economy**

Economic systems are the methods societies use to produce, distribute, and consume goods and services. While there are many variations, most can be categorized into a few main types based on who controls the means of production and how resources are allocated.

**Mixed Economy-**A **mixed economy** combines elements of both capitalism and socialism. In this system, both the private sector and the government play significant roles. While most production is privately owned and driven by market forces, the government intervenes to regulate the market, provide public goods and services (like healthcare and education), and ensure a social safety net. The goal is to balance economic efficiency and growth with social equity and welfare. Most modern economies, including those of the United States and Western European nations, are considered mixed economies.

**Socialist Economy-**In a **socialist economy**, the **means of production** (factories, land, machinery) are owned and controlled by the state or the community as a whole, rather than by private individuals. The primary objective is to eliminate economic inequality and ensure the equal distribution of wealth and resources. Economic decisions are often made by a central planning authority, which sets production

quotas and prices. Competition is de-emphasized in favor of cooperation, with the focus on meeting societal needs rather than generating profit.

**Capitalism Economy**-A **capitalism economy** is based on **private ownership** of the means of production. In this system, individuals and private firms own and control capital assets with the goal of generating profit. The market, driven by **supply and demand**, determines prices and allocates resources. The government's role is typically limited to protecting private property rights and enforcing contracts. Competition is encouraged, as it's believed to lead to innovation, efficiency, and a wider variety of goods and services for consumers.

**Islamic Economy**-An **Islamic economy** is a unique system based on the principles of **Sharia** (Islamic law). It is a type of market economy but with a strong ethical and moral framework. Key features include:

- **Prohibition of Riba (interest):** Charging or paying interest is forbidden, as wealth should be generated from real economic activity rather than from lending money.
- **Zakat:** An obligatory annual tax on wealth for the purpose of redistribution to the poor and needy, ensuring a degree of social welfare.
- **Ethical and Moral Constraints:** The economy forbids activities considered harmful, such as gambling and the sale of alcohol. It promotes risk-sharing and profit-sharing instead of debt.

The Islamic economy aims to create a just and equitable society where economic activity is balanced with social responsibility.

**Unit – II: National Income Accounting: Meaning, Concepts & Variants of GDP, Three Methods of Calculating the National Income, Methods of GDP Accounting, Government & Private Sector Savings, Price Index, GDP Deflator, Concept of Circular Flow of Income, Lab based assignments.**

### **National Income Accounting: Meaning, Concepts & Variants of GDP**

National income accounting is a government bookkeeping system that measures a country's economic activity and performance over a specific period, typically a year. It provides a comprehensive view of the economy's health, growth, and development.

**Concepts of National Income Accounting**-National income accounting is a key tool in macroeconomics, and it relies on several core concepts to measure economic activity. The most widely used measure is Gross Domestic Product (GDP), but other related aggregates provide a more detailed picture.

- **Gross Domestic Product (GDP):** The total market value of all final goods and services produced **within a country's geographical borders** in a specific period. It's the most common indicator of a nation's economic health.
- **Gross National Product (GNP):** The total market value of all final goods and services produced by a country's **citizens**, regardless of their location. It includes income earned by domestic residents from abroad and excludes income earned by foreigners within the country.
- **Net Domestic Product (NDP):** This is GDP minus depreciation (the wear and tear on capital goods like machinery and buildings). It provides a more accurate measure of a country's actual net output after accounting for the cost of maintaining its capital stock.
- **Net National Product (NNP):** This is GNP minus depreciation. It represents the net value of all goods and services produced by a country's citizens.
- **National Income (NI):** This is the total income earned by a country's residents for their contribution of land, labor, capital, and entrepreneurship. It's often calculated as NNP at factor cost (NNP - indirect taxes + subsidies).
- **Per Capita Income (PCI):** This is a measure of the average income per person in a country. It's calculated by dividing the national income by the total population.

**Variants of GDP**-Economists use different variants of GDP to analyze specific aspects of economic performance.

- **Nominal GDP:** Measures a country's economic output using **current market prices**. Because it includes the effects of inflation, it can be a misleading indicator of real economic growth.
- **Real GDP:** Measures a country's economic output using prices from a **constant base year**, effectively adjusting for inflation. This provides a more accurate measure of the actual increase or decrease in the quantity of goods and services produced.

- **GDP at Market Price:** This value includes **indirect taxes** (like sales tax) and **excludes subsidies**. This is the price consumers actually pay in the market.
- **GDP at Factor Cost:** This value measures the cost of the factors of production (wages, rent, interest, and profit). It is calculated as GDP at Market Price minus indirect taxes plus subsidies. This metric represents the income earned by the producers.
- **GDP per capita:** This is the GDP divided by the total population. It's often used as an indicator of a country's standard of living, as it provides an average measure of economic output per person.

**Three Methods of Calculating the National Income** -National income can be calculated using three primary methods, all of which should yield the same result in theory. These methods provide different perspectives on the economy: the value of what's produced, the income earned from that production, or the total spending on it.

**1. The Production (or Value-Added) Method**-This method measures the **total value of all final goods and services** produced in an economy during a given period. To avoid **double-counting** (for example, counting the value of both a car and the steel used to make it), this method sums the **value added** by each firm at every stage of production.

- **Formula:** National Income = Sum of Gross Value Added (GVA) of all sectors - Depreciation - Net Indirect Taxes + Net Factor Income from Abroad (NFIA).
- **Concept:** It focuses on the output side of the economy by dividing it into sectors like agriculture, manufacturing, and services and then summing up the value each sector adds to the final product.

**2. The Income Method**-This method measures national income by adding up all the **incomes earned by the factors of production** (land, labor, capital, and entrepreneurship) in the process of producing goods and services. It reflects the flow of income to households.

- **Formula:** National Income = Compensation of Employees (wages, salaries) + Operating Surplus (rent, interest, profit) + Mixed Income of the Self-Employed + Net Factor Income from Abroad (NFIA).

- **Concept:** It focuses on the distribution of income within the economy. For every product made, there's a corresponding income earned by those who helped produce it.

**3. The Expenditure Method-**This method calculates national income by summing up all the **spending on final goods and services** within an economy. This is the most widely used method to calculate a country's Gross Domestic Product (GDP).

- **Formula:** National Income = Private Final Consumption Expenditure (C) + Government Final Consumption Expenditure (G) + Gross Domestic Capital Formation (I) + Net Exports (Exports - Imports) (X-M).
- **Concept:** It follows the logic that all goods and services produced are either consumed, invested, purchased by the government, or exported. This approach measures the economy from the demand side.

**Methods of GDP Accounting** -National income, and specifically Gross Domestic Product (GDP), can be calculated using three main methods. All three methods should theoretically result in the same figure, as they are different ways of measuring the same thing: the total economic activity within a country.

**1. The Expenditure Method-**This is the most common method and measures GDP by summing up all the spending on final goods and services in an economy. The logic is that everything produced must be purchased by someone. It includes spending by households, businesses, the government, and foreign entities.

The formula is:  $GDP=C+I+G+(X-M)$

- C is **Consumption:** The spending by households on goods and services (e.g., food, cars, haircuts).
- I is **Investment:** The spending by businesses on capital goods (e.g., machinery, new factories) and residential construction.
- G is **Government Spending:** The spending by the government on public goods and services (e.g., infrastructure, defense, salaries of public employees).
- (X-M) is **Net Exports:** The value of a country's exports (X) minus the value of its imports (M). This component ensures that only domestically produced goods and services are counted.

**2. The Income Method-**This method calculates GDP by adding up all the income earned by the factors of production (land, labor, capital, and entrepreneurship) in the process of producing goods and services. For every dollar of output, there is a corresponding dollar of income.

The formula is:

$GDP = \text{Wages} + \text{Rent} + \text{Interest} + \text{Profits} + \text{Indirect Taxes} - \text{Subsidies} + \text{Depreciation}$

- **Wages and Salaries:** The income earned by labor.
- **Rent:** Income from land and property ownership.
- **Interest:** Income from capital.
- **Profits:** The income earned by business owners and entrepreneurs.
- **Indirect Taxes - Subsidies:** These are added to convert the income from factor costs to market prices.
- **Depreciation:** Also known as Consumption of Fixed Capital, this accounts for the wear and tear on machinery and other capital goods and is added to reach a "gross" figure.

**3. The Production (or Value-Added) Method-**This method calculates GDP by summing the "value added" at each stage of production. This approach avoids the problem of **double-counting**, which would happen if you counted the value of intermediate goods (like flour) and the final product (like bread) separately. The value added is the difference between the value of a firm's output and the cost of its intermediate inputs.

The formula is:  $GDP = \text{Sum of Gross Value Added of all sectors}$

- **Gross Value Added (GVA)** is calculated as:  
 $GVA = \text{Value of Output} - \text{Value of Intermediate Consumption}$
- This method aggregates the value added from all industries within the economy, from agriculture to manufacturing to services, to arrive at the total GDP.

**Government & Private Sector Savings-Savings** are a vital part of an economy, providing the funds for investment and future growth. Savings are categorized into two main sectors:

- **Private Sector Savings** are the savings of households and businesses. Household saving is the portion of disposable income that is not spent on consumption. Business saving (or corporate saving) is the portion of a firm's profits that is not paid out in dividends to shareholders. These savings are channeled into the financial system and are used to fund capital investment.
- **Government Sector Savings** (or Public Savings) occur when a government's tax revenue exceeds its spending. This is known as a **budget surplus**. When government spending exceeds tax revenue, it is a **budget deficit**, which represents negative saving for the government.

**Price Index & GDP Deflator**-A **price index** is a measure of the average change in the prices of a basket of goods and services over time. It's used to measure inflation. The two most common price indices are the Consumer Price Index (CPI) and the Producer Price Index (PPI).

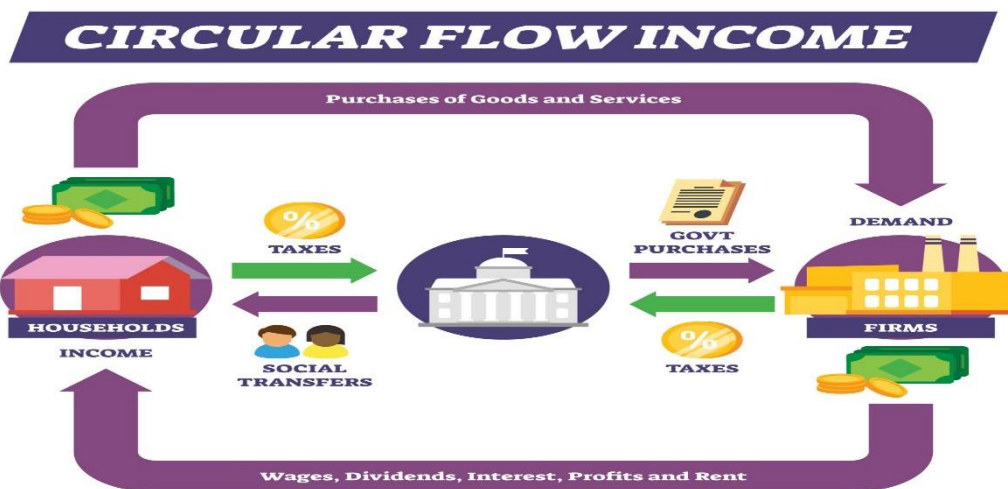
The **GDP deflator** is a more comprehensive price index that measures the average price level of all new, domestically produced, final goods and services in an economy. It's a key tool for distinguishing between nominal and real GDP.

Feature	Price Index (e.g., CPI)	GDP Deflator
<b>Scope</b>	Measures prices of a fixed basket of consumer goods and services bought by households.	Measures prices of all goods and services produced domestically, including consumption, investment, government purchases, and exports.
<b>Composition</b>	Uses a <b>fixed basket</b> of goods from a base period, which may not reflect changes in consumer buying habits.	Uses a <b>changing basket</b> of all goods and services produced in the current year, automatically reflecting changes in production and consumption patterns.
<b>Imports</b>	Includes the prices of imported consumer goods.	Excludes the prices of imported goods, focusing only on domestic production.

The formula for the GDP deflator is:  $\text{GDP Deflator} = \frac{\text{Real GDP}}{\text{Nominal GDP}} \times 100$  This formula allows economists to "deflate" the nominal GDP (which is measured in current prices) to find the real GDP (which is adjusted for inflation), providing a true measure of economic growth.

**The Concept of Circular Flow of Income-**The circular flow of income is a foundational macroeconomic model that illustrates how money and resources move through an economy. It shows the interdependence of different sectors—households, firms, the government, and the foreign sector—through a continuous flow of income, goods, services, and factors of production.

- **Two-Sector Model:** This simplest model shows the flow between **households** and **firms**. Households supply labor and other factors of production to firms and receive income (wages, rent, interest, and profits) in return. Firms use these factors to produce goods and services, which they sell to households, completing the circle.
- **Leakages and Injections:** The model can be expanded to include other sectors. **Leakages** are money that leaves the circular flow, such as **savings, taxes, and imports**. **Injections** are money that enters the flow, such as **investment, government spending, and exports**.



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- **Equilibrium:** The economy is in equilibrium when total leakages equal total injections

(Savings+Taxes+Imports=Investment+GovernmentSpending+Exports). If injections are greater than leakages, the economy expands; if leakages are greater than injections, the economy contracts.

**Unit III: Money & Monetary Policy:** Barter System, Money and Its Origin, Functions of Money, Quantity Theory of Money. Demand for Money, Credit Creation and Monetary Policy: Central Bank in India, Credit Creation, Monetary Policy and Its Tools and Objectives, Lab based assignments.

### **Money & Monetary Policy: Barter System, Money and Its Origin, Functions of Money**

Money arose out of the inefficiencies of the **barter system**, and its development as a medium of exchange has allowed for the specialization and complexity of modern economies.

**The Barter System-**The barter system is a method of exchange where goods or services are directly traded for other goods or services without using a medium of exchange like money. It's the oldest form of commerce and works on the principle of a "**double coincidence of wants.**" For a trade to occur, both parties must have what the other person wants. For example, a farmer with a surplus of wheat who needs a pair of shoes must find a shoemaker who not only wants wheat but is also willing to trade shoes for it.

The barter system suffers from several key disadvantages:

- **Lack of Double Coincidence of Wants:** This is the most significant problem. Finding someone with the exact item you want who also wants the exact item you have is often difficult and time-consuming.
- **Lack of a Common Measure of Value:** Without a common unit of value, it's hard to determine the worth of one good relative to another. How many loaves of bread equal one cow? This makes fair exchange challenging.
- **Difficulty in Storing Wealth:** Many goods are perishable (like crops) or bulky, making it impractical to save wealth for future use.

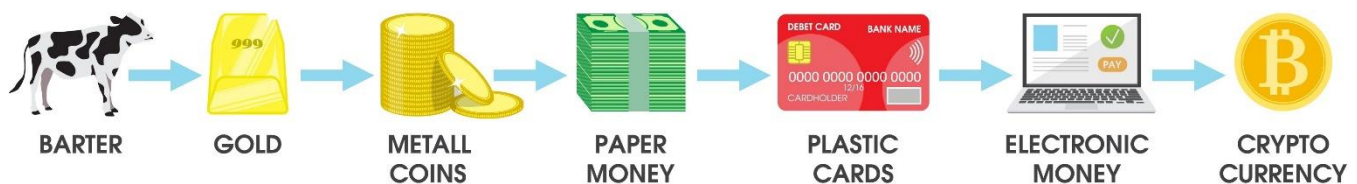
**Money and Its Origin-**Money originated as a solution to the problems of the barter system. The first forms of money were **commodity money**, items with intrinsic value

that were widely accepted for exchange. These included things like cowrie shells, salt, cattle, and even metal coins. Over time, societies moved towards using metals like gold and silver, which were durable, portable, and easily divisible, making them ideal for trade.

The invention of **coinage** in ancient Lydia (modern-day Turkey) around 600 BCE was a major step. These were standardized pieces of metal stamped with a government seal, guaranteeing their weight and purity. This eliminated the need to weigh and test metal every time a transaction was made.

Later, **paper money** was introduced in China, initially as receipts for deposits of precious metals, which could then be traded as a stand-in for the actual metal. This evolved into modern **fiat money**—currency that has no intrinsic value but is declared legal tender by the government and gains value through public trust and acceptance.

## EVOLUTION OF MONEY



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**Functions of Money**-Money serves four main functions in an economy, which overcome the limitations of the barter system:

1. **Medium of Exchange:** This is the most important function. Money acts as an intermediary in a transaction. Instead of trading goods for goods, you can sell your goods for money and then use that money to buy what you want. This eliminates the need for a double coincidence of wants.
2. **Unit of Account:** Money provides a common measure for the value of all goods and services. It allows us to set prices and compare the value of different items

(e.g., a car is worth 100 times more than a loaf of bread). This simplifies economic calculations and decision-making.

3. **Store of Value:** Money allows people to save their purchasing power for future use. While other assets like real estate or stocks can also store value, money is unique in its liquidity. It can be easily stored, retrieved, and used for transactions at any time.
4. **Standard of Deferred Payment:** Money allows for the creation of debt and credit. It's a standard unit for making future payments. This function is crucial for a modern economy based on borrowing, lending, and contracts. For example, a loan is paid back in a specified amount of money over time.

**Quantity Theory of Money. Demand for Money, Credit Creation and Monetary Policy** -The Quantity Theory of Money, the demand for money, credit creation, and monetary policy are all interconnected concepts in macroeconomics that explain how the money supply affects the economy.

**1. Quantity Theory of Money (QTM)**-The **Quantity Theory of Money** is an economic theory that states the general price level of goods and services is directly proportional to the amount of money in circulation, or the money supply. This means if the money supply doubles, prices are expected to double as well, leading to inflation.

The theory is best expressed by the **equation of exchange**: $MV=PY$

- **M = Money Supply:** The total amount of money in circulation.
- **V = Velocity of Money:** The average number of times a unit of money is spent on final goods and services in a given period.
- **P = Price Level:** The average price of all goods and services.
- **Y = Real Output:** The total volume of goods and services produced in the economy.

The theory assumes that V (velocity) and Y (real output) are relatively stable in the short run. Therefore, any change in the money supply (M) directly and proportionally affects the price level (P).

**2. Demand for Money-**The **demand for money** refers to the total amount of money that individuals and firms want to hold, rather than spending or investing it. This demand is not for a physical currency but for the convenience and liquidity that money provides. Economist John Maynard Keynes identified three main motives for holding money:

- **Transaction Motive:** People hold money to pay for day-to-day transactions and purchases. This demand is directly related to income; as income rises, people need more money for their increased spending.
- **Precautionary Motive:** People hold money for unforeseen expenses or emergencies, like a sudden illness or job loss. The amount of money held for this purpose depends on economic uncertainty and an individual's financial stability.
- **Speculative Motive:** People hold money as an asset, waiting for a better time to invest in other assets like stocks or bonds. This demand is inversely related to interest rates. When interest rates are low, people may hold more cash, speculating that rates will rise in the future and bond prices will fall.

**3. Credit Creation-Credit creation** is the process by which commercial banks increase the money supply by lending out a portion of their deposits. This process is based on the **fractional reserve banking system**, where banks are required to hold only a fraction of their deposits as reserves and can lend out the rest. Here's how it works:

1. A customer deposits money into a bank. This is the **primary deposit**.
2. The bank is legally required to hold a certain percentage of this deposit as a **reserve**.
3. The bank can then lend out the remaining portion. This loan often ends up being deposited in another bank, creating a new deposit.
4. This new deposit allows the second bank to lend out a portion, and the cycle continues.

This process has a **multiplier effect**, where an initial deposit can lead to a much larger increase in the total money supply. The **credit multiplier** is calculated as  $1/\text{Reserve Ratio}$ . A lower reserve ratio allows banks to lend more, leading to a larger expansion of the money supply.

**4. Monetary Policy-**Monetary policy is the set of tools and actions used by a country's **central bank** (like the Federal Reserve in the U.S. or the RBI in India) to control the money supply and credit conditions to achieve macroeconomic goals.

**The primary objectives of monetary policy are:**

- **Price Stability:** Keeping inflation low and stable.
- **Full Employment:** Promoting a high level of employment.
- **Economic Growth:** Fostering sustainable economic development.

The central bank uses several tools to implement monetary policy:

- **Open Market Operations (OMOs):** The central bank's buying and selling of government securities in the open market. Buying securities increases the money supply, while selling them decreases it.
- **Reserve Requirements:** The percentage of deposits that banks are legally required to hold as reserves. Lowering this ratio increases the money banks can lend out, expanding the money supply and vice versa.
- **Discount Rate/Policy Rate:** The interest rate at which commercial banks can borrow money directly from the central bank. Lowering this rate makes it cheaper for banks to borrow, encouraging them to lend more and stimulating the economy.

## **Central Bank in India, Credit Creation, Monetary Policy and Its Tools and Objectives**

The Reserve Bank of India (RBI) is the central bank of India, responsible for managing the money supply, controlling inflation, and ensuring the stability of the financial system. It's the central authority that issues currency, acts as a banker to the government and other banks, and formulates monetary policy.

**Credit Creation-Credit creation** is the process by which commercial banks expand the money supply by lending out a portion of the deposits they receive. This process works on the principle of **fractional reserve banking**. When a bank receives a deposit, it's required by the central bank to hold a fraction of it as a reserve and is free to lend the rest. This loaned money is then deposited in another bank, creating a new deposit that can be lent out again. This cycle continues, with each new deposit

generating a portion of new loans, which leads to a **multiple expansion** of the initial deposit.

The extent of credit creation is determined by the **money multiplier**, which is calculated as  $1/\text{Reserve Ratio}$ . A lower reserve ratio means banks can lend more, leading to a larger credit multiplier and a greater expansion of the money supply.

**Monetary Policy: Objectives and Tools**-Monetary policy in India is the process by which the RBI influences the money supply and credit conditions to achieve specific macroeconomic goals.

**Objectives**-The primary objectives of the RBI's monetary policy are:

- **Price Stability:** The main goal is to control inflation. The RBI aims to keep inflation within a target range (currently 4% with a +/- 2% tolerance band).
- **Economic Growth:** The RBI also works to ensure that there is enough credit available to support productive sectors of the economy and promote sustainable economic growth.
- **Financial Stability:** The RBI's policies are designed to maintain confidence in the financial system and prevent systemic crises.

**Tools**-The RBI uses a variety of tools to achieve its monetary policy objectives. These are broadly categorized into quantitative and qualitative tools.

**Quantitative Tools** These tools control the overall volume of credit in the economy.

- **Repo Rate:** The interest rate at which commercial banks borrow money from the RBI for short-term liquidity needs. When the RBI wants to increase the money supply, it lowers the repo rate, making it cheaper for banks to borrow and lend.
- **Reverse Repo Rate:** The rate at which the RBI borrows money from commercial banks. Raising this rate incentivizes banks to deposit their excess funds with the RBI, which absorbs liquidity from the banking system.
- **Cash Reserve Ratio (CRR):** The percentage of a bank's total deposits that it must hold as cash reserves with the RBI. An increase in CRR reduces the amount of money available for lending and vice versa.

- **Statutory Liquidity Ratio (SLR):** The percentage of a bank's net demand and time liabilities that it must maintain in liquid assets like cash, gold, or government securities. A higher SLR restricts the bank's ability to lend.
- **Open Market Operations (OMOs):** The buying and selling of government securities by the RBI in the open market. The RBI buys securities to inject money into the system (increasing liquidity) and sells them to absorb money (decreasing liquidity).

**Qualitative Tools** These tools control the direction and use of credit for specific purposes.

- **Moral Suasion:** The RBI persuades or pressures commercial banks to follow its monetary policy goals through advice, requests, and public statements.
- **Credit Rationing:** The RBI can place limits on the amount of credit that commercial banks can lend for certain purposes or sectors to control speculative activities.
- **Margin Requirements:** The RBI can change the margin (the difference between the market value of a security and the loan amount against it) to control the flow of credit to specific sectors.

**Unit IV: Fiscal Policy and Issues in Economic Development:** Introduction to Fiscal policy, Objectives of Fiscal Policy, Components, Budget Deficit and Its types, Unemployment, Inflation, Deflation, Depression, Lab based assignments.

**Fiscal Policy and Issues in Economic Development: Introduction to Fiscal policy, Objectives of Fiscal Policy**

**Introduction to Fiscal Policy-**Fiscal policy is the use of government **spending** and **taxation** to influence a country's economy. It is a key tool for managing the macroeconomy, particularly for influencing aggregate demand. The government can use fiscal policy to stimulate economic activity during a recession (an **expansionary** policy) or to cool down an overheating economy and combat inflation (a **contractionary** policy).

While monetary policy, managed by a central bank, focuses on interest rates and the money supply, fiscal policy directly impacts the economy through the government's budget decisions.

**Objectives of Fiscal Policy**-The primary objectives of fiscal policy, especially in developing economies, are multifaceted and aim to achieve both short-term stabilization and long-term development goals.

- **Economic Growth:** One of the main goals is to stimulate and sustain economic growth. By increasing government spending on infrastructure, education, and healthcare, the government can directly create jobs and enhance the productive capacity of the economy. Lowering taxes can also encourage private consumption and investment, which in turn boosts economic activity.
- **Full Employment:** Fiscal policy is used to reduce unemployment. During economic downturns, the government can implement an expansionary policy by increasing spending on public works projects, which directly creates jobs. Tax cuts can also increase disposable income, leading to higher consumer demand and encouraging businesses to hire more workers.
- **Price Stability:** Fiscal policy helps in controlling inflation and deflation. When the economy is experiencing high inflation, the government can use a contractionary policy by either cutting spending or raising taxes. This reduces aggregate demand, which helps to cool down the economy and stabilize prices.
- **Equitable Distribution of Income and Wealth:** Governments use fiscal tools to reduce income inequality. A **progressive tax system**, where higher-income earners pay a larger percentage of their income in taxes, combined with targeted social welfare programs and subsidies for the poor, can redistribute wealth and promote social justice.
- **Capital Formation:** Especially in developing countries, fiscal policy aims to accelerate capital formation. Governments can incentivize private savings and investment through tax breaks and subsidies. They also directly invest in key sectors to build up the country's capital stock, which is essential for long-term economic growth.

**Components of a Government Budget-**A government budget is an annual financial statement that outlines the government's estimated **receipts** (revenue) and **expenditures** for a fiscal year. It serves as a tool for planning, resource allocation, and achieving economic goals. The two main components are the Revenue Budget and the Capital Budget.

- **Revenue Budget:** This includes the government's current receipts and expenditures that do not impact its assets or liabilities.
  - **Revenue Receipts:** Income from sources like **tax revenues** (income tax, corporate tax, GST) and **non-tax revenues** (fees, fines, interest, and dividends from public sector enterprises).
  - **Revenue Expenditures:** Spending on regular, day-to-day operations that do not create assets, such as salaries, pensions, subsidies, and interest payments on past debt.
- **Capital Budget:** This deals with the government's long-term assets and liabilities.
  - **Capital Receipts:** Funds received through the creation of liabilities (e.g., borrowings) or reduction of assets (e.g., disinvestment of public sector companies, recovery of loans).
  - **Capital Expenditures:** Spending that creates assets or reduces liabilities, such as building infrastructure (roads, bridges), acquiring machinery, or providing loans to states.

**Budget Deficit and Its Types-**A **budget deficit** occurs when a government's total expenditure exceeds its total revenue. This indicates that the government must borrow money to cover its expenses. There are three main types of budget deficits:

- **Revenue Deficit:** Occurs when a government's **revenue expenditure** is greater than its **revenue receipts**. This is a concerning indicator as it implies the government is unable to fund its regular, day-to-day operations with its own revenue, forcing it to borrow for consumption rather than investment.
- **Fiscal Deficit:** This is the most comprehensive measure of a government's financial health. It's the difference between the government's **total expenditure** and its **total receipts** (excluding borrowings). It essentially represents the total borrowing required by the government to meet its obligations.

- **Primary Deficit:** Calculated as the **Fiscal Deficit minus interest payments** on previous borrowings. It shows the amount of borrowing the government needs for its current fiscal actions, excluding the burden of past debt. A low or zero primary deficit suggests that the government is borrowing only to pay interest on old debt.

## Unemployment, Inflation, Deflation, and Depression

- **Unemployment:** A situation where people who are willing and able to work cannot find a job. Economists categorize unemployment into different types based on its causes:
  - **Frictional Unemployment:** Short-term unemployment that occurs when workers are in between jobs or are just entering the workforce. It is considered a natural and healthy part of a dynamic economy.
  - **Structural Unemployment:** Arises from a mismatch between the skills workers have and the skills employers need. This is often caused by technological changes, shifts in the economy, or globalization.
  - **Cyclical Unemployment:** Caused by downturns in the business cycle, such as a recession. As demand for goods and services falls, companies reduce production and lay off workers.
- **Inflation:** A sustained increase in the general price level of goods and services in an economy over a period of time. It reduces the **purchasing power** of money; as prices rise, each unit of currency buys fewer items.
- **Deflation:** The opposite of inflation, it is a sustained decrease in the general price level. While falling prices might seem positive, it can signal a weak economy. Consumers may delay purchases in anticipation of further price drops, leading to decreased demand, reduced production, and higher unemployment.
- **Depression:** A severe and prolonged economic downturn. It is a more extreme form of a recession, characterized by a steep decline in economic activity, a massive drop in GDP, widespread unemployment, and a significant fall in prices (often leading to a deflationary spiral). The Great Depression of the 1930s is a historical example.