

Unit 6

The Fundamental Concerns of Macroeconomics

6.1 CONCERNS OF MACROECONOMICS

- *Macroeconomics deals with the aggregates or averages covering an entire economy. For instance, total employment, national income, national output, total investments, total consumption, total savings, aggregate supply, aggregate demand and general price level, wage level and cost structure come under the scope of macroeconomics.*

The Fundamental Concerns (Scope) of Macroeconomics

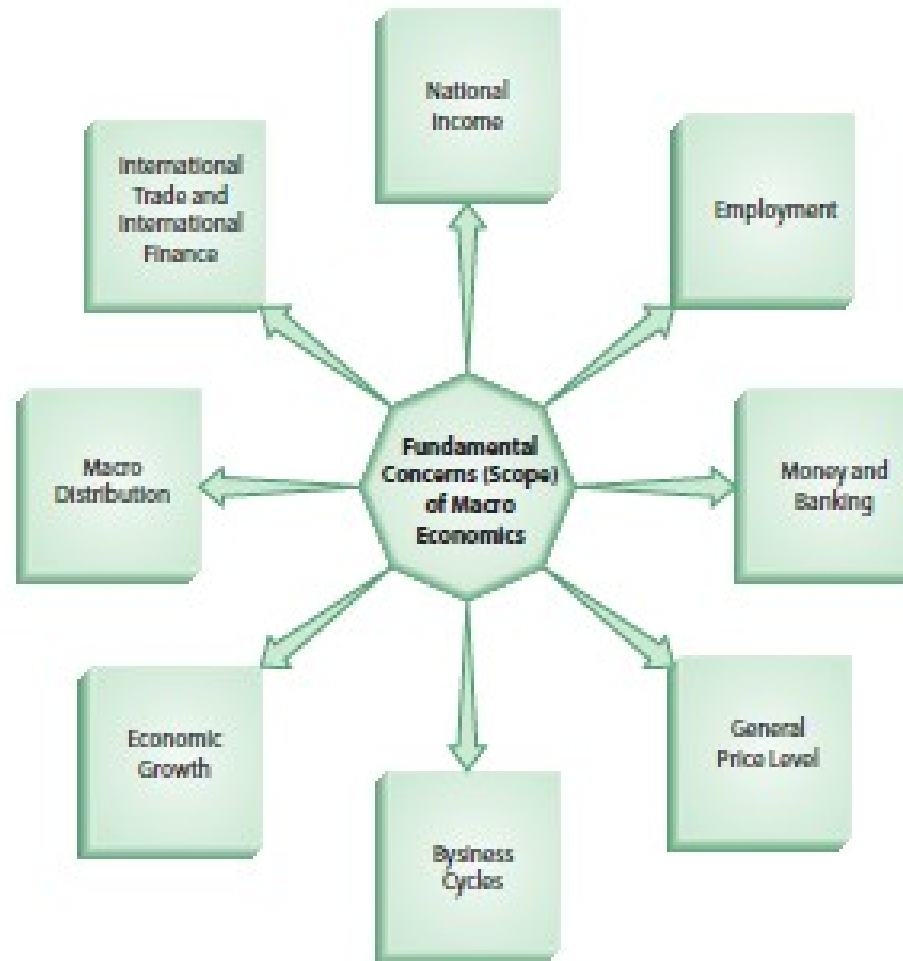
- **National Income:** *It includes the study of the concepts of national income, product, and expenditure and the methods of measurement of aggregates and sub aggregates of national income and output.*
- **Employment:** *It deals with aggregate demand, aggregate supply, consumption, savings, and investment functions which determine the level of employment in an economy.*
- **Money and Banking:** *deals with monetary theory, which further deals with the demand and supply of money, central banking, commercial banking, monetary policy, and the impact of monetary changes upon the general level of economic activity.*

- **General Price Level:** concentrates upon the general level of prices. It explains the inflationary and deflationary movements in the system and the impact of these movements upon the general level of economic activity.
- **Business Cycles:** The theories of business cycles and policies to control cyclical fluctuations come within the sphere of macroeconomics.
- **Economic Growth:** It depends upon complex economic, sociological, institutional and technical factors. Macroeconomics analyses the actions and interactions of these factors.
- **Macro distribution:** deal with the distribution of income among various factors

- **International Trade:** deals with the theories of international trade, problems related to tariff and non-tariff barriers upon trade, balance of payments, foreign exchange, international capital flows, and international economic order.

- **Figure**
Macroeconomics

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General Objectives of Macroeconomic Policy

- ❖ *maximum feasible output*
- ❖ *high rate of economic growth*
- ❖ *full employment*
- ❖ *price stability*
- ❖ *equality in the distribution of income and wealth, and*
- ❖ *a healthy balance of payments*
- To achieve these objectives, normally three types of macro-economic policies – *fiscal policy, monetary policy, and income policy* – are adopted.

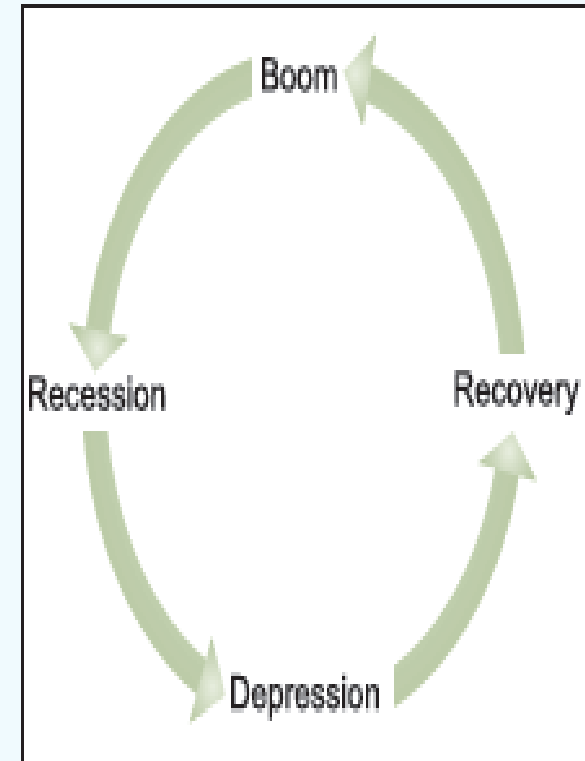
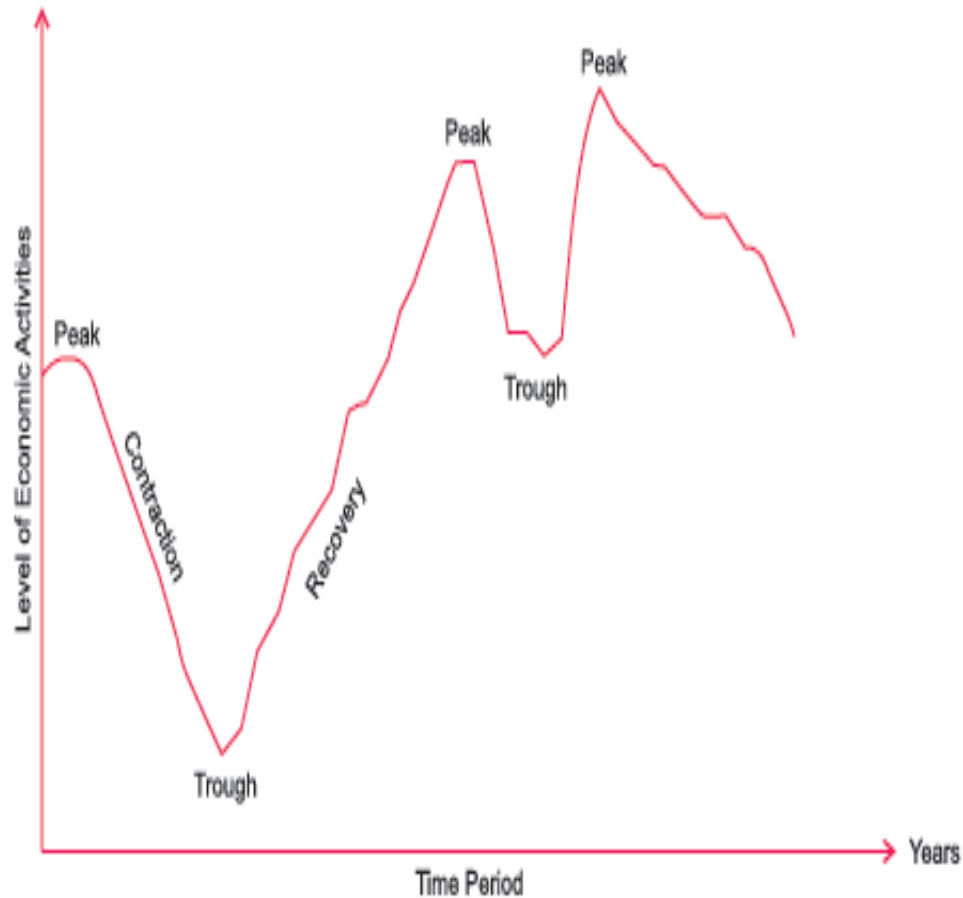
6.2 PROBLEMS OF MACROECONOMICS

- the central problem of macroeconomics is the problem of determination of income and employment.
- We also know that macroeconomics is concerned with problems such as inflation, business fluctuations, inequalities of income and wealth, instability of prices, budget and trade deficit, etc.

Business Cycle

- *Business cycle or trade cycle refers to the regularly occurring fluctuations in economic activity in market economies.*
- *In a business cycle, there are wave-like fluctuations in four interlinked economic variables: employment, income output and price level*

Figure 6.2: Business Cycle Phases



- **Peak or Boom:** *This is a phase of economic activity characterized by rising demand, rising prices, rising investment, rising employment, rising incomes, rising purchasing power and so on.*
- **Contraction or Recession:** *If that occur, the monetary authorities, the financial institutions and business itself may become cautious. Thus, there may be cuts in investment, resulting in cuts in employment, a fall in incomes, and declines in purchasing power and demand. Prices may then begin to fall.*
- **Trough or Depression:** *This is a stage when the business confidence is at its lowest. Investment, employment, output, income, and prices reach bottom.*

- **Recovery:** *As the economy moves out of depression, it enters the phase of recovery.*
- *In a sustained recovery, the level of investment, employment, output, income and prices move upwards.*

Characteristic Features of Business Cycles

- *the wave-like fluctuations in economic activity. These fluctuations are cyclical in nature,*
- *□□The sequence of changes in a business cycle (i.e., boom, recession, depression and recovery) recur frequently and in a fairly similar pattern,*
- *□□Periodicity between the cycles need not be same or similar*
- *Business cycles are fluctuations found in overall economic activities, and are not limited to any particular firm or industry,*
- *Business cycles usually last for a period of 2 to 10 years.*

Causes of Business Cycles

- Business cycle is the tendency for real output to rise and fall over time in a reasonably regular pattern. It is alternating increase and decrease in level of economic activity.

Unemployment

- First employment *refers to any arrangement by which a person earns income or a means of livelihood.*
- Such an arrangement may be in the form of self-employment, wherein a person uses his/her own resources (apart from his/her labor) to make a living.

- In which a worker sells his/her labor and earns wages in return, is called *wage-employment*. In this case, the supplier of labor (worker) is called *employee* and the buyer of the labor is called an *employer*.
- A labor force consists of all those who are fit for work and are willing and available to work. In other words, if we exclude children, old persons, individuals who are unable to work, etc., from the population of a country, we get the number of those who are able to work.
- **Unemployment** refers to a situation where the persons who are able to work and willing to work, at the current market wage rate, fail to secure work or activity which gives them income or a means of livelihood.

- *Thus the person categorized that the person is without a job and able to work*
- *the person wants to have a job and is willing to work at the current market wage rate.*
- Those people who have other means of living, like property incomes, and thus do not desire to have a job cannot be called unemployed. Thus they can be termed as 'voluntarily unemployed'.
- Involuntary unemployment exists when able-bodied, willing persons fail to get jobs at the on-going wage rate.

Types of Unemployment

- Normally, in economics, three different types of unemployment are identified—*frictional, structural, and cyclical*.

Frictional Unemployment

- *This is temporary unemployment which exists during a period of the transfer of labor from one occupation to another.*
- Frictional unemployment may also arise where people are thrown out of work in one location and are unwilling or unable to move to a similar work in another area.

Structural Unemployment

- Structural unemployment refers to a situation in which workers become jobless due to loss of demand in particular regions or industries. For example, a change of energy use from coal to electric power is bound to curtail coal mining activity and cause unemployment there.
- Thus, *unemployment which arises due to change in the pattern of demand, leading to changes in the structure of production in the economy, is called structural unemployment.*

Cyclical Unemployment

- As the name 'cyclical unemployment' suggests, this form of unemployment is associated with 'trade cycles' or 'business cycles' or cyclical fluctuations

- During depressions, investment activities get discouraged. Contractions in business activities renders large numbers of workers unemployed.
- Thus, *unemployment which arises due to inadequate overall demand associated with the downswing, recession or depression period of a trade cycle is called cyclical unemployment*
- ❖ *In the study and analysis of unemployment, we come across many other terms and concepts.*
- **Full Employment:** *This refers to a situation where all those workers who are able and willing to work get employment.*
- **Underemployment:** *This refers to a situation in which people are engaged in jobs but these jobs do not measure up to their capabilities, efficiency and qualifications*

- ***Involuntary Unemployment:*** *This refers to a situation in which the workers are willing to work under any conditions and at any wage rate but they fail to get employment.*
- ***Voluntary Unemployment:*** *When the economy offers employment opportunities to the workers, but they themselves are not willing to take up jobs because employment conditions, such as wage rate, location, promotional avenues, physical environment, attitude of the employer, etc*
- ***Technological Unemployment:*** *The main cause of this unemployment is the introduction of a new technology which requires changes in a labor force.*

- ***Disguised Unemployment:*** *When more workers are engaged in a type of work than actually are required to do that work.*
- ***Seasonal Unemployment:*** *Employment and unemployment levels vary with different seasons in many sectors of the economy.*

Measurement of Unemployment

- Unemployment is usually measured as the ratio of the unemployed persons to the total labor force in a country and is expressed in percentage terms.
- $$\text{Rate of unemployment} = \frac{\text{No. of unemployed persons}}{\text{Total labor force}} \times 100$$

Impact of Unemployment on Economic Growth

- Unemployment is a major problem worldwide, affecting not only developing countries but also the developed ones.
- We list below some of the major adverse economic effects of unemployment.
 - ❖ *Loss of Valuable Human Resources*
 - ❖ *Increase in Poverty*
 - ❖ *Unemployment is Demoralizing*
 - ❖ *Exploitation of Labor*

Inflation

- *Inflation is generally described as a situation characterized by a sustained increase in the general price level.*
- *A small rise in prices or an irregular price rise cannot be called inflation. It is a persistent and appreciable rise in prices which is called inflation.*
- *□ During inflation, all costs and prices do not rise together and in the same proportion. It is an increase in the general level of prices measured by a price index, which is an average of consumer or producer prices.*

Causes of Inflation

- Normally, these factors are divided into two broad types *Demand-Pull factors and Cost-Push factors.*

Causes of Inflation

Demand-Pull Inflation

- When the demand for goods and services exceeds the available supply at current prices, it is a demand-pull inflation.
- The situation is described as “*too much money chasing too few goods*”.
- The various causes for *demand-pull inflation* include:
 - ***An increase in government expenditure***
 - ***An increase in money supply***
 - ***An increase in investment***
 - ***An increase in wages***
 - ***Black money***
 - ***Deficit financing***
 - ***Credit Expansion***

Cost-Push Inflation

- *Inflation resulting from rising costs of production and slack resource utilization is called cost-push inflation.*
- It caused by shortage of raw materials, power breakdowns, strikes and lockouts, bad weather conditions, increase in input prices, hoarding etc.
- *Demand-pull and cost-push inflation go together in an economy. In both situations, two common features exist:*
 - *□□ rise in the prices of factor inputs, and*
 - *□□ rise in the prices of final goods.*

Measuring Inflation

- Inflation means a persistent or sustained rise in general price level. Thus measuring inflation means a measurement of variations in general price level.

- To do this, various types of *price index numbers* or simply *price indexes*, such as *wholesale price index*, *consumer price index*, etc. are constructed.
- The Consumer Price Index (CPI) is the most widely accepted index for measuring the rate of inflation.

$$\text{CPI} = \frac{\text{Cost of a market basket of consumer goods and services in a particular year}}{\text{cost of same basket during the base year}} \times 100$$

- Rate of inflation measures the extent of the increase in the general price level over time. It is usually measured as the *percentage change in the general price level from one year to the next*.

$$\text{Rate of inflation (year } t) = \frac{\text{CPI (year } t) - \text{CPI (year } t-1)}{\text{CPI (year } t-1)} \times 100$$

The Impact of Inflation On Economic Growth

- Inflation has different levels or degrees of severity, described as moderate, galloping, and hyper inflation. A moderate inflation is generally believed to be a necessary condition of economic growth.

- For a better understanding of the impact of inflation on economic growth, we classify these effects into two categories: favorable effects and adverse effects.

Favorable Effects

- *Effect on Production*
- *Effect on Capital Formation*
- *Effect on Employment*
- *Effect on Economic Development*
- *Inflation May be Self-Liquidating*

Adverse Effects

- *Income Effect*
- *Saving Effect*
- *Redistribution Effect*
- *Price-Wage Spiral*
- *Effect on Economic Planning*
- *Effect on Balance of Payments*

Meaning of Budget

- The budget provides details of the various sources through which money flows to the government, and also the details of the various types of expenses on which money is spent by the government.
- It is a useful tool to plan and control the fiscal affairs of the government

Objectives of a Government

Budget

- **Economic Growth:** to promote rapid economic growth so as to improve the living standard of the people.
- **Reduction of Poverty and Unemployment:** to eradicate mass poverty and unemployment by creating maximum employment opportunities and providing maximum social benefits to the poor
- **Reallocation of Resources:** to reallocate resources in line with social and economic objectives.
- **Reduction of Inequalities:** to reduce inequalities of income and wealth through levying taxes and granting subsidies.
- **Price Stability:** to maintain price stability and correct business cycles involving depression characterized by falling output, falling prices, and increasing unemployment.
- **Management of Public Enterprises:** to manage public enterprises which are of the nature of monopolies like railways, electricity, etc.

Types of Budget

- As we now know, a budget shows the receipts and expenditures of the government.
- It is not necessary that the receipts and expenditure should be equal. There may be a surplus or deficit in the budget. Accordingly, we have the following three types of budget:
- ***A Surplus Budget:*** If the receipts of the gov't are more than its expenditure, the government is said to have a surplus budget.
- It implies that the government is pumping out more money from the economic system than what it is pumping back in.

B Balanced Budget: If the receipts of the government equal its expenditures, the government will be said to have a balanced budget.

- A balanced budget will have a neutral effect on the level of economic activity. It will have neither an expansionary effect nor a contractionary effect on the economy.

C Deficit Budget: If the receipts of the government are less than its expenditure, the government is said to have a deficit budget.

- It implies that the government is pumping more money into the economic system than it is pumping out.
- A deficit budget is financed by domestic borrowing, external borrowing, and the printing of new currency.

Budget

- Usually, budget is divided into two parts: *Revenue Budget and Expenditure Budget.*

A Revenue Budget; This forecasts the total revenue collections of the government from tax and nontax sources.

- In Ethiopia, it is classified into three parts:

1. Ordinary Revenue: *The total of ordinary revenue is made up by tax revenue and non-tax revenue. Tax revenue is further divided into three parts – direct tax, indirect tax, and foreign trade tax. (Read the text about tax revenue). However non-tax revenue collected by the government from sources other than tax. Example charges, fees, fines, pension contribution, and investment revenue.*

2. External Assistance: Grants received in cash, or some other form, from outside the country are known as external assistance.

- External assistance received from friendly countries is called *bilateral assistance*; whereas assistance (grant) received from multilateral or international institutions is known as *multilateral assistance*.

3. Capital Revenue: Capital revenue is the third constituent of revenue budget. It comprises the money received by the government from the sale of government assets, collection of loans, counterpart fund and external loans.

Expenditure Budget

- *Expenditure budget is a forecast of the total expenditure by the government, in a year. In Ethiopia, it is classified into two parts:*

1.Recurrent Expenditure: represents expenses made by the government which are recurrent in nature, i.e., they are repeated.

- *Normally, it is an expense on consumables that facilitate productive activities, for example, salaries of civil servants, purchase of raw materials, fuels and other factors of production.*
- *In Ethiopia classified under four functional categories: Administrative and General Services; Economic Services; Social Services; and Other Expenditures.*

- I. Administrative and General Services include such activities as performed by political organs of the state such as council of representatives, ministries, defense and so on.
- II. Economic Services include such activities as ones that come under agricultural, industrial and service sectors.
- III. The Social Services include such activities as health, education, and culture.
- IV. Other Expenditures include pension payments, repayment of public debts, provision of unforeseen expenses and similar items.

2. Capital Expenditure: *Capital expenditure represents expenses made by the government for the implementation and expansion of development projects. These are in the nature of acquisitions of fixed assets like buildings, machinery, equipment, etc.*

- in Ethiopia classified under three categories: Economic Development; Social Development and General Development.
- Economic Development includes production activities in the agricultural and industrial sectors and economic infrastructure in mining, roads, energy, commerce and communication.
- Social Development includes such activities as education, health, urban development and social welfare.
- General Development includes services in statistics, cartography, and public and administrative buildings.