Some Basic Concepts of Macroeconomics

Classification of Goods

- Final goods
- Intermediate goods
- Consumption / Consumer goods
- Capital goods

1. **Final goods** : These are those goods which have crossed the boundary line of production and are ready for use by their final users.

   (i) **Final consumer goods** : goods which are ready for use by their final users, and consumers are their final users.

   Eg - Bread and butter.

   (ii) **Final producer goods** : goods which are ready for use by their final users, and producers are their final users.

   Eg - Tracters and harvesters

   $$\boxed{\text{Expenditure on final goods} = \text{Consumption expenditure} + \text{Investment expenditure}}$$

2. **Intermediate goods** : Those goods which have yet not crossed the boundary line of production, value is still to be added to these goods, and which are ~~not~~ yet not for use by their final users.

FOCUS ZONE

Expenditure on intermediate goods by the producers during an accounting year is called Intermediate consumption or intermediate cost. If intermediate consumption is deducted from the value of output, we get 'gross value addition'

Value of output − intermediate consumption = gross value addition.

- **The same good may be Final or Intermediate**

It is not possible to name one set of goods as final goods and another set as intermediate goods. The same good may be final or intermediate good. The distinction depends on the end-use of the goods.

- **What matters is the End-use of Goods.**

While classifying goods as final or intermediate, what matters is the end-use of goods. You are to check what end-use a good is put to. If it is used by the producers as a raw material, it is to be treated as an intermediate good. But if it is used by the producer as a fixed asset (like tractor used by the farmer) is to be treated as a final goods.

Intermediate goods	Final Goods.
• These goods remain within the boundary line of production and are not ready for use by their final users.	These goods are outside the boundary line of production and are ready for use by their final users.
• They are used as a raw material.	These goods are not used as a raw material.
• These goods may be resold by the firm for profit	These goods are not resold by the firm for profit.
• Value is yet to be added to these goods.	Value is not to be added to these goods.
• Expenditure on these goods is called intermediate consumption.	Expenditure on these goods is called final expenditure.
• These goods are not included in the estimation of national product or national income.	These goods are included in the estimation of national product or national income.

• **Consumption / Consumer Goods:** They are those goods which are directly used for the satisfaction of human eg – Ice cream, milk, clothes, etc.

- **Classification of consumption goods.**

(i) Durable consumption goods : Those goods which can be used for several years and are of relatively high value.
Eg → T.V, radio, car, washing machine, etc.

(ii) Semi-durable consumption goods : Those goods which can be used for a period of one year or slightly more.
Eg → clothes, furniture, crockery, etc.

(iii) Non-durable / single-use consumption goods : Those goods which are used-up in a single act of consumption.
Eg → bread, LPG, Ink, etc.

(iv) Services / Non-material goods : Services are those non-material goods which directly satisfy human wants.
Eg → doctor, lawyer, etc.

- Capital goods : They are fixed assets of the producers. These goods are used in the process of production for several years and are of high value. Use of these goods leads to depreciation.
Eg → Plant and machinery.

- All capitals goods are producer goods, But all producer goods are not capital goods.

Producer goods include all those goods which are used in the process of production. It includes goods used as

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raw material by the producers, like wood and nails used for making furniture, and goods used as fixed assets by the producers, like machinery. So all capital goods are producer goods. Capital goods include only fixed assets used by the producer for making furniture. It does not include raw material. So, all producer goods are not capital goods.

Consumption Goods	Capital Goods
• They lead to direct satisfaction of human wants.	• They do not lead to direct satisfaction of human wants.
• These goods are consumed by households when purchase.	• They do not consumed by the households. These are used by the producers for production.
• Expenditure on consumption goods is called consumption expenditure.	• Expenditure on capital goods are called investment expenditure.
• Higher production of consumption goods leads to higher level of welfare of the people. It raises quality of life.	• Higher level of production of capital goods leads to higher production capacity. It's the backbone of GDP growth.
• limited lifetime of use.	Lifespan of more than one year.

CONCEPTS AND COMPONENTS OF CONSUMPTION EXPENDITURE

- In macroeconomics, consumption expenditure refers to aggregate consumption expenditure in the economy.

- Who are consumer in an economy:
  (i) households [satisfaction of their wants.
  (ii) Government [goods distribute among defence forces, mid-day meal in govt. schools, etc]
  (iii) Non-profit private institution (NGOs) - [for charity]

Aggregate consumption expenditure = households + government + Non-profit private institution

CONCEPT AND COMPONENTS OF INVESTMENT

- Investment : It refers to increase in the stock of capital of a firm. It also known as CAPITAL FORMATON.

$$\boxed{I = \Delta K}$$

I = Investment
K = Capital stock
ΔK = Change in capital stock

Types of Investment

(i) Fixed investment : It refers to increase in the stock of fixed assets (like plant and machinery)
It is also known as FIXED CAPITAL FORMATION

Fixed investment = stock of fixed assets at the end of accounting year − stock of fixed assets at the beginning of the year

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- ## Significance of Fixed Investment

(i) It raises production capacity of the producers.
(ii) It leads to higher level of output in the economy.
(iii) Higher level of output leads to economic growth (GDP growth)
(iv) It enables the producer to meet the future demand for their product.

(ii) **Inventory Investment** : It refers to increase in the stock of finished goods, semi-finished goods and raw materials.
रु जो लगाते हैं। (unsold)

Inventory Investment = Inventory stock at the end of accounting year − Inventory stock at the beginning of accounting year.

- ## Significance of Inventory Investment

(i) Uninterrupted supply of inputs to the producers.
(ii) Enough stock of raw material means producer can avoid day-to-day purchases from the market.
(iii) Uncertainties of market related to availability of raw material can be avoided.

- ## Significinace of maintaining stock of finished goods.

→ It enables the producers to meet the potential (future) demand for their product.

- **Desired inventory stock** : It is planned inventory stock maintained by the producers to meet immediate demand.

- Undesired inventory stock : It is unplanned inventory stock. It arises when demand for the product less than expected.

- **GROSS INVESTMENT, NET INVESTMENT AND DEPRECIATION**

- Gross investment : It refers to total production of capital goods (machines) during the year.

→ capital goods used for replacement of existing capital stock which is worn-out (depreciation or replacement investment)

→ capital goods used as net addition to the existing capital stock - net investment.

$$\boxed{\text{Gross investment} = \text{Net investment} + \text{Depreciation}}$$

$$\boxed{\text{Net investment} = \text{Gross investment} - \text{Depreciation}}$$

- Significance of Net Investment (new machine)

→ It increases stock of capital in the economy. It increases the availability of capital per unit of labour. Hence, efficiency of labour rises.

→ It generates employment opportunities.

→ It increases production capacity which leads to GDP growth.

Gross Investment	Net Investment
• It includes expenditure by producer on purchase of new assets as well as expenditure on replacement of existing asset during an year.	• It includes expenditure by producer on purchase of new assets only.

• It ~~not~~ includes replacement investment (depreciation)	• It does not include replacement investment (depreciation)
• It does not show net addition to existing stock.	• It shows net addition to existing capital stock.
• It need not necessarily lead to increase in production capacity. Therefore, doesn't cause increase in GDP.	• It lead to increase in production capacity, and therefore cause increase in GDP.

Ques- How does higher rate of net capital formation lead to higher level of productivity/efficiency of labour?

Ans- Higher rate of net capital formation implies greater availability of capital (like machine, plant, building) to the firm's per unit of labour. By the help of machines, efficiency of labour definitely increases. That's why developed countries (like USA) is more efficient than in less developed countries (India).

◆ **Depreciation** : It's the loss of value of fixed assets in use due to normal wear and tear, accidental damages and expected obsolescene (change in technology). It's also known as 'CONSUMPTION OF FIXED CAPITALS'.

→ Because of depreciation assets need to be replaced from time to time. Replacement of fixed assets requires funds. Provision for the funds is made on annual basis to replace the existing machinery. This is called depreciation reserve fund.

→ Depreciation reserve fund : It refers to that fund which the producers keep for replacement investment.

• **Significance of Depreciation Reserve Fund.**

→ It fulfills the need for replacement investment.
→ Lack of replacement investment means lack of gross investment.
→ Hence, overall investment tends to fall. This lead to fall in the level of output and economy will slip into the state of 'economic slowdown'.

Expected Obsolescence	Unexpected Obsolescence
• Fall in the value of fixed assets due to change in technology or change in demand.	• Fall in the value of fixed assets due to natural calamities or due to economic recession
• It's part of depreciation.	• It's not depreciation. It's a capital loss.
• It's manage through depreciation reserve fund.	• It's manage through insurance of fixed assets.

Consumption of Fixed Assets/ Depreciation	Unexpected obsolescence / Capital loss.
• It's the loss of value of fixed assets in use due to normal wear and tear, accidental damages and expected obsolescence.	• Fall in the the value of fixed assets due to normal calamities or fall in the value of assets due to economic recession.

• It occurs while they are being continuously used in the process of production.	• It occurs even when the fixed assets are not in use.
• It is managed through depreciation reserve fund.	• It is managed through insurance of fixed assets.

Ques 1 Distinguish between depreciation and depreciation reserve fund.

Ans -

Depreciation	Depreciation Reserve Fund.
• It's a loss of fixed assets due to normal wear and tear, accidental damage and expected obsolescence.	• It's a provision of fund to cope with depreciation losses. These fund are used for replacement of fixed assets when they become obsolete or ~~worn~~ worn - out.

Ques 2 What is current replacement cost?

Ans- It refers to the estimated / total value of depreciation for all the producing units in the economy during the period of accounting year.

STOCKS AND FLOWS

- Stock : Stock is a quantity measured at a particular point of time.

  Eg - wealth, population of a country, bank deposits, capital, distance, etc.

- Flow : Flow is a quantity measured ~~at~~ over a specified period of time.

  Eg - income, capital formation, interest on capital, speed, etc.

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STOCK	FLOW
• Stock is a quantity measured at a point of time.	• Flow is a quantity measured over a period of time.
• Stock impacts flow. Greater the stock of capital, greater the flow of goods and services.	• Flow impacts stock. Greater the flow of income, greater is the stock of wealth.
• It's not time dimensional. It's measured at a specific point of time.	• It is time dimensional. It's measured per hour, per month, per year.

• <u>Mutual Dependence between Stock and Flow</u>

FLOW: DEPOSITS ₹2000/month → STOCK: Saving A/C ₹20000 1/1/2021 → FLOW: WITHDRAWAL ₹1000 per month.

→ Deposits of money in your saving A/C on 1 Jan 2021, this is a stock of your savings. The withdrawal from this account is a flow concept. Likewise, deposits of money per month is a flow concept.

• FOUR SECTORS OF THE ECONOMY

1) Household sector : It includes consumers of goods and services. They are owners of factors of production (land, labour, capital, enterpreneur)

2) Producer sector : It includes ~~consumers of goods~~ all producing units in the economy. They use factor of production

3. Government sector: It includes government as a welfare agency and government as a producer. Welfare agency performs such welfare functions as of law and order and defence.

4. The external sector: It includes activities related to export and import. It's also known as "Rest of the World Sector".

- Factors of production

1. Land : rent
2. Labour : wages
3. Capital : Interest
4. Entrepreneur : profit.

- INTERSECTORAL FLOWS

→ Each sector of the economy depends on the other. This is called intersectoral dependence.

(i) The household sector depends on the producer sector for the supply of goods and services.

(ii) The producer sector depends on the household sector for the supply of factors of production.

(iii) The government depends on the household and producer sector for its tax and non-tax revenue.

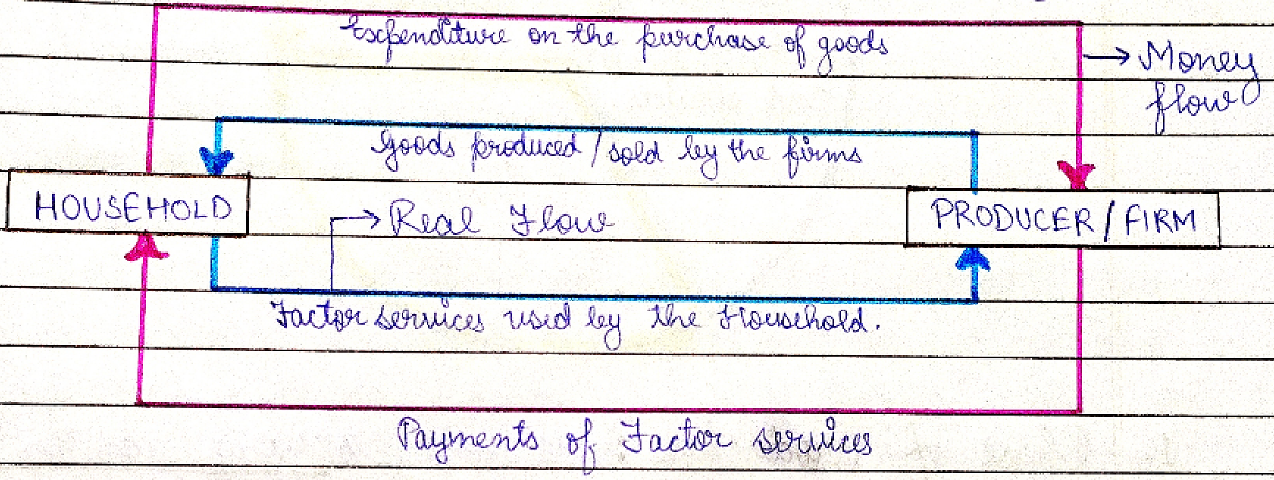
(iv) Producers and households depend on the government for various administrative services and law, order and defence.

→ Intersectoral dependence leads to Intersectoral Flows.

INTERSECTORAL FLOWS
- Real Flows
- Money Flows.

- **Real Flows:** It refers to the flow of goods and services among different sectors of the economy.

- **Money Flows:** It refers to the flow of money across different sectors of the economy.



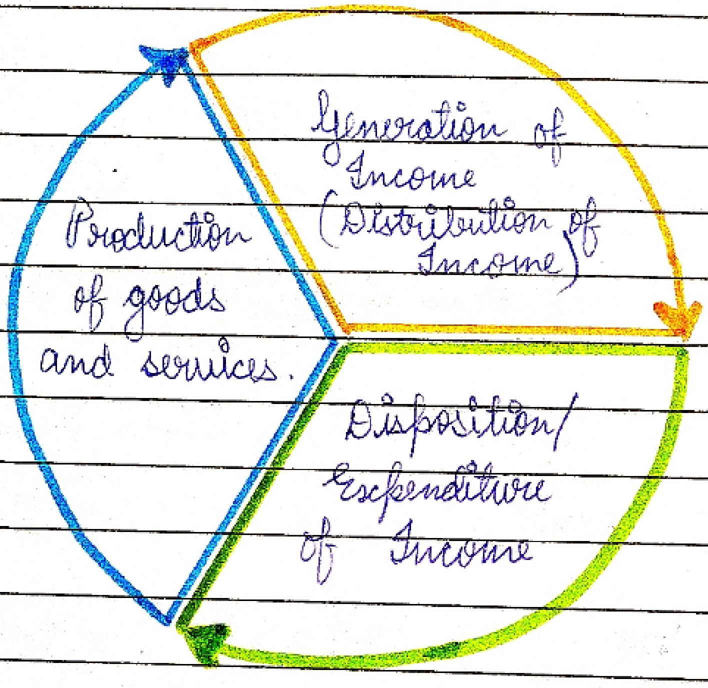
Basis	REAL FLOWS	MONEY FLOWS
Meaning	It refers to the flow of goods and services among different sectors of the economy.	It refers to the flow of money across different sectors of the economy.
Nature	It is a flow physical output	It is a flow of monetary transaction
Impact	Higher level of real flows leads to higher level of output in the economy.	Higher level of money flows need not necessarily lead to higher level of output in the economy.

• CIRCULAR FLOW OF INCOME

→ It refers to the unending flow of the activities of production, income generation and expenditure involving different sectors of the economy, the producers and households particular.

→ These activities are lifeline of the economy.

• Three Phases of Circular Flow



1. Phase of Production : It refers to 'value addition' (conversion of raw materials into final goods). process by the producing sector.

2. Phase of Income Generation : Household sector gives factor services to producer sector. In return the household sector gets factor payments (rent, salary, wages and interest on capital and profit). Here value addition is converted into factor income.

3. Phase of Expenditure : Generated income is disposed on the purchase of goods and

services. Consumption and investment expenditure generate demand for goods and services.

★ $\boxed{\text{So, Production = Income generated = Expenditure}}$

★ This is called <u>Triple Identity</u>.

• Assumptions

(i) There are two sectors in the economy, households and producers.

(ii) The household sector spends their ~~et~~ entire income, so that there are no savings.

(iii) The domestic economy is a closed economy (no external sector).

(iv) There is no government sector.

• Significance

(i) Estimation of national income: It facilitates the estimation of national income. National income is the sum total of factor income (rent + wages + interest + profit)

(ii) Knowledge of intersectoral interdependence: It helps to understand how different sectors of the economy are depend on each other.