ROAD MAP

- Why study real sector of the economy
- Understanding NIA
  - Basic Framework
- Key Issues & Recent Data
- Fiscal Policy
  - Basic Framework
  - Key Issues & recent data
- Exercise

Real Sector: National Income Accounts

Why Study Real Sector of the Economy?

Real Sector is concerned with the actual production of goods and services in the economy

- To measure a country's level of economic activity (economic power)
- To measure a country's standard of living over time
- To make comparison among countries
- For policy formulation

How to measure its performance?

- By using National Income Accounts
- Two summary measures are of great importance
  - Gross Domestic Product (GDP): is the market value of all final goods and services produced in an economy during a year. It is the single most-used economic measure.
  - Gross National Product (GNP): is the aggregate final output of citizens and businesses of a country in a year.
- GNP = GDP + Net Factor Income

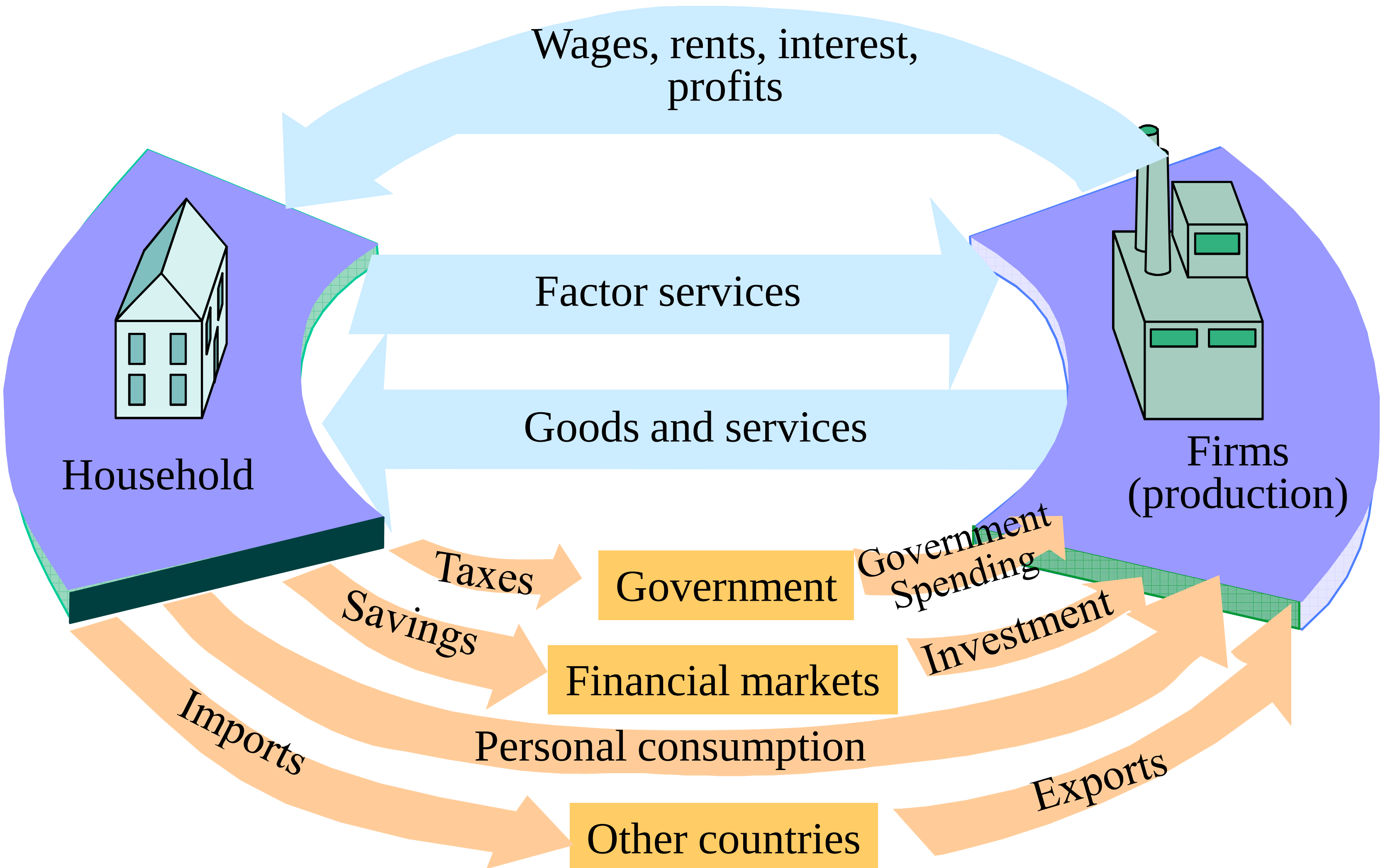
Calculating GDP-I

- Requires adding together million of goods and services
- All goods and services produced by an economy must be weighted, i.e., each good and service must be multiplied by its price to calculate a value .
- Finally, all the value measures are added to calculate that year's GDP.
- GDP counts final output but not intermediate goods.

Calculating GDP-II

- ***Final output*** – goods and services purchased for final use.
- ***Intermediate products -*** are used as inputs in the production of some other product.
- GDP does not measure total transactions in the economy.
    - Selling your car to neighbor
    - Selling your car through a used car dealer
- GDP is a flow measure (an amount per year).

The Circular Flow



Expenditure Approach-I

Expenditures are shown on the bottom half of the circular flow

Specifically, GDP is equal to the sum of four categories of expenditures

$$GDP=C+I+G+(X-M)$$

When individual receive income, they can:

- Spend it on domestic goods
- Save
- Pay taxes
- Buy foreign goods

Expenditure Approach-II

The portion of income that individuals save leaves the spending stream and goes into financial markets.

Business spending on equipment, structures, and inventories is counted as part of ***gross private investment***, together with household spending on new owner-occupied housing.

Economists differentiate between total or gross private domestic investment, and the new investment that is above and beyond replacement investment.

Net private investment – gross private investment less depreciation.

Expenditure Approach-III

GDP=C+I+G+(X-M)

When individuals pay taxes, those taxes are either spent by government on goods and services or are returned to individuals in the form of transfer payments.

There is a connection between the government and the financial markets.

If the government runs a deficit, it must borrow from financial markets to make up the difference.

Expenditure Approach-IV

GDP=C+I+G+(X-M)

Exports are added to total expenditures.

These flows are usually combined into ***net exports*** (exports minus imports).

This approach is of very important from monetary policy point of view. Why?

Factor Income Approach

The income approach is shown on the top half of the circular flow.

Firms make payments to households for supplying their services as factors of production.

National income is the total income earned by citizens and businesses of a country.

It consists of employee compensation, rent, interest, and profits.

When we add indirect taxes (less subsidies) and depreciation to nations income, we have GDP.

GDP: Omissions or Under estimation

- Voluntary services (Edhi ambulance, work of housewives)
- Illegal activities (narcotics, gambling, smuggling etc.)
- Undesirable effects of production (pollution, traffic congestion)
- No consideration is made for the changes in leisure time
- Defense expenditures are included, but no consideration is made for the negative impact of higher crimes
- Distribution of national income and wealth
- Non-economic contributors to well-being are excluded

Interpreting GDP

Could be a misleading indicator of economic and human developments

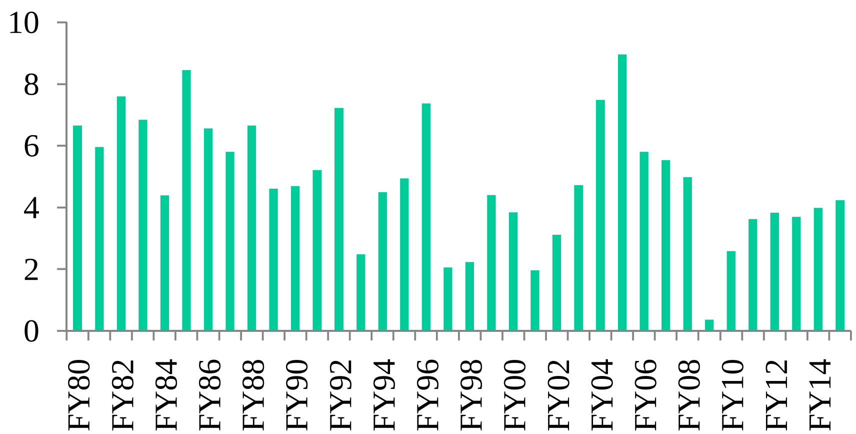
To be fair, GDP is never intended to be an accurate measure of a country's well-being

But politicians and economists often place disproportionate importance on GDP

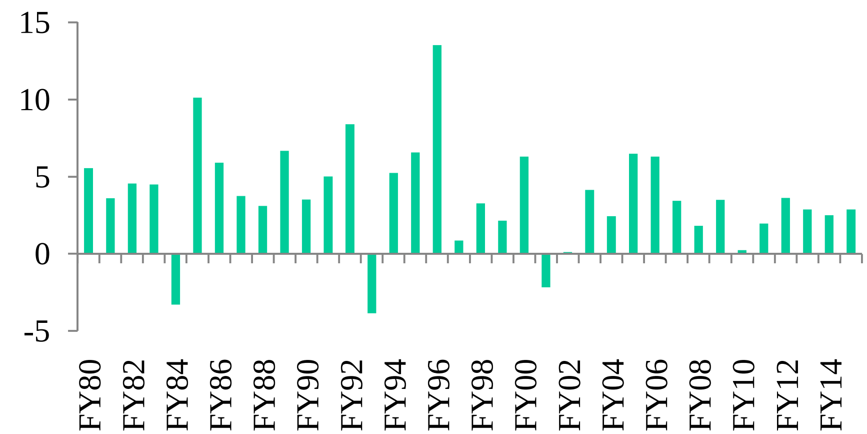
But maximizing GDP can conflict with other goals such as promoting social equity or protecting the environment

GDP growth

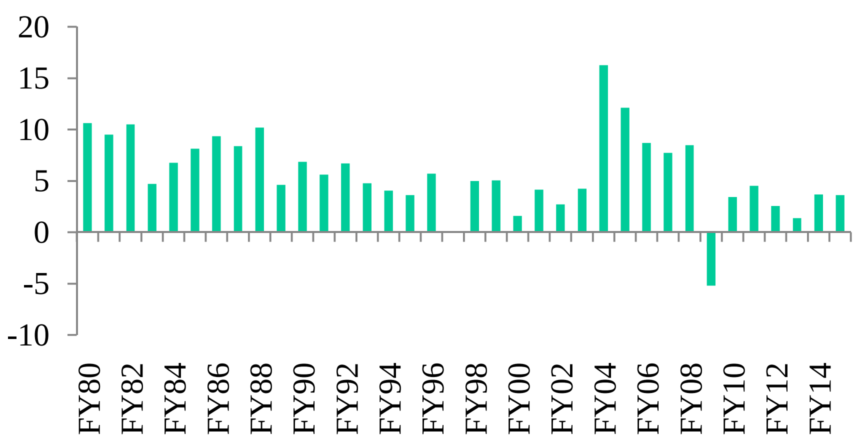
GDP: growth-%



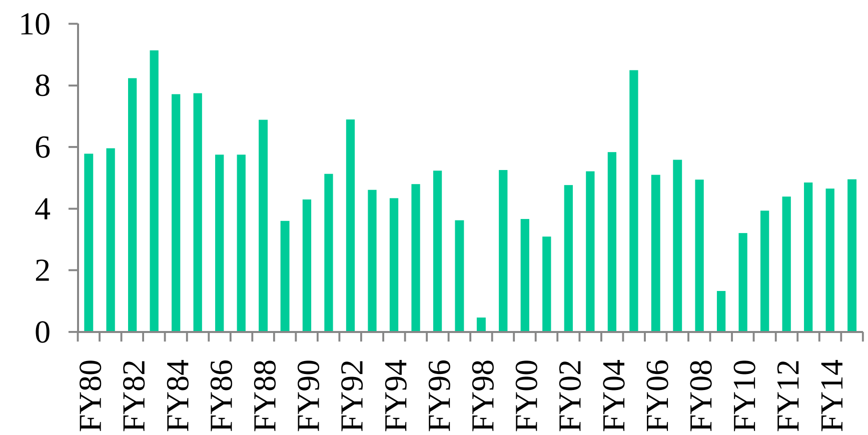
Agriculture: growth-%



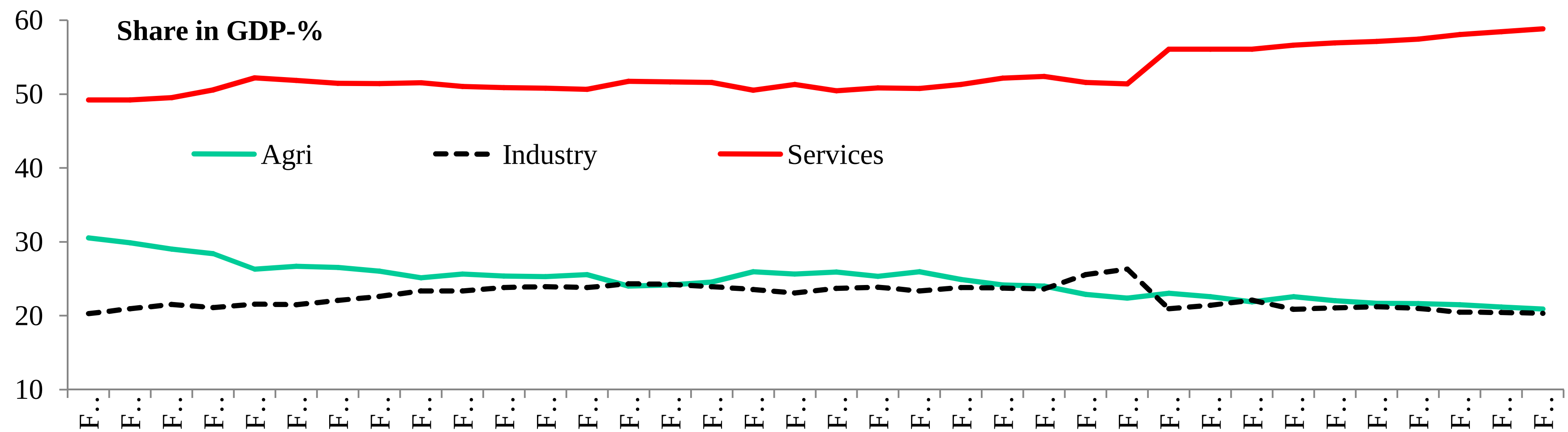
Industry: growth-%

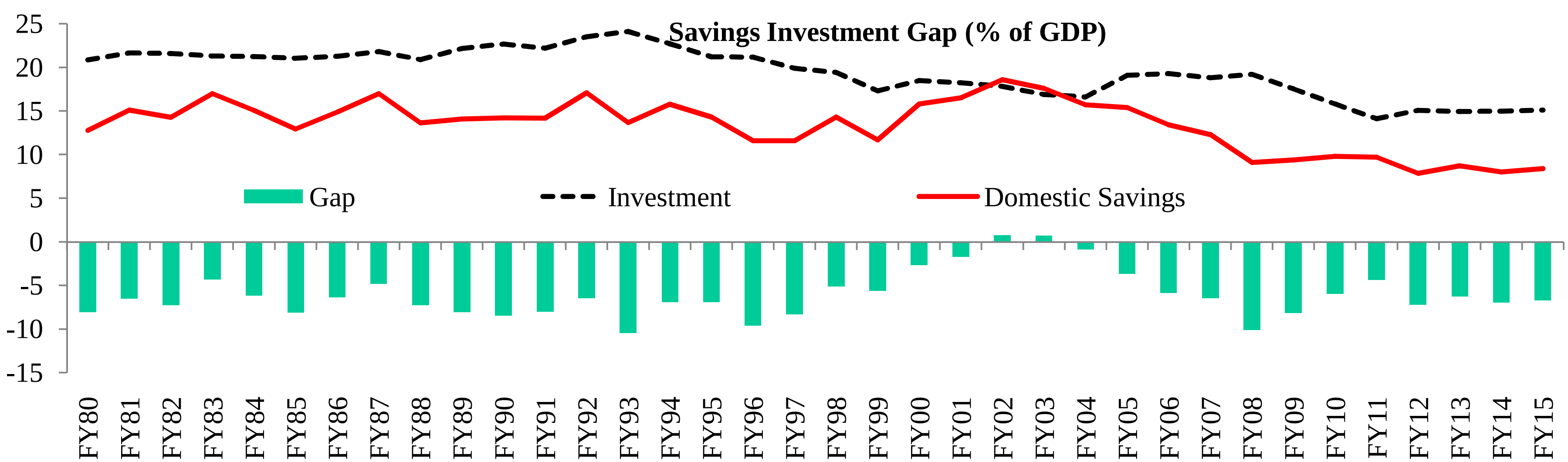


Services: growth-%



Savings & Investments





Fiscal Policy and Public Finance

Public Finance & Fiscal Policy

- Public Finance: acquiring income and allocating it to different heads of public expenditures
- Fiscal policy: art of using public finance as a tool to:
    - achieve social objectives (income distribution)
    - stabilize the economy
    - achieve structural adjustment
- Relevance for SBP: Coordination between monetary and fiscal policies

Fiscal Policy Tools

- Expenditures
  - Current expenditures
  - Developments expenditures
- Revenues
  - Tax revenues
  - Non-tax revenues

Assessing Fiscal Policy-I

- Fiscal Balances
  - Overall balance; (Revenue – expenditures)
  - Revenue balance (revenue – current expenditures)
  - Primary balance (revenue – expenditures net of interest)
- Analysis of Revenue
  - Tax-to-GDP ratio
  - Composition of revenues (volatility)
  - tax elasticity/ Buoyancy (automatic stabilization)

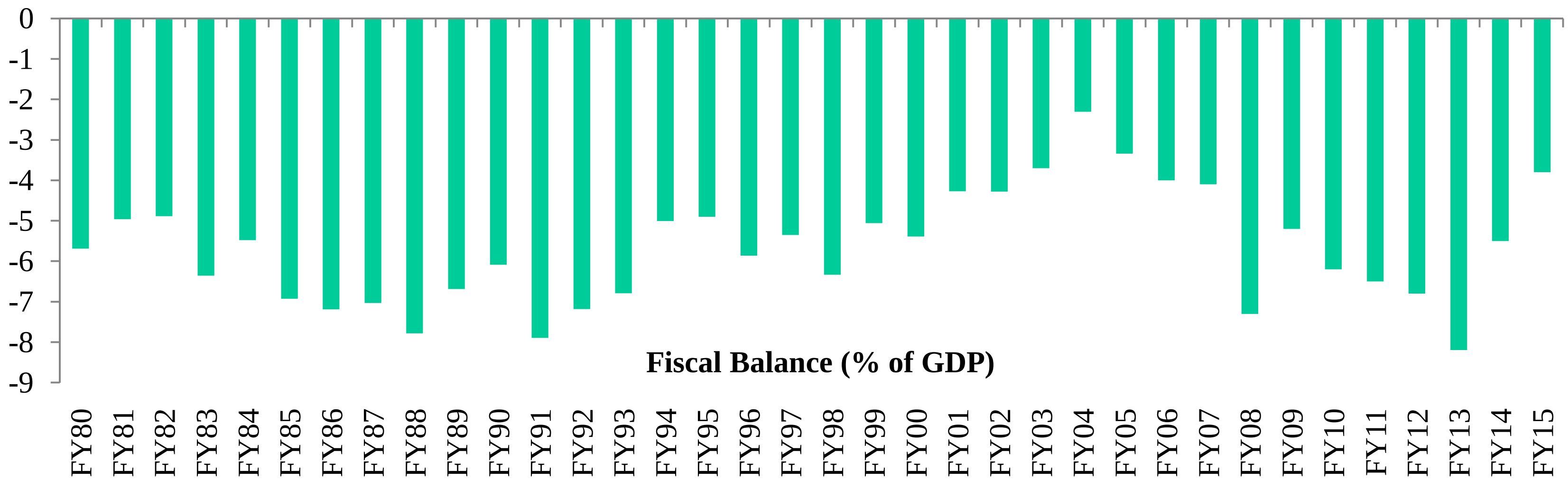
Assessing Fiscal Policy-II

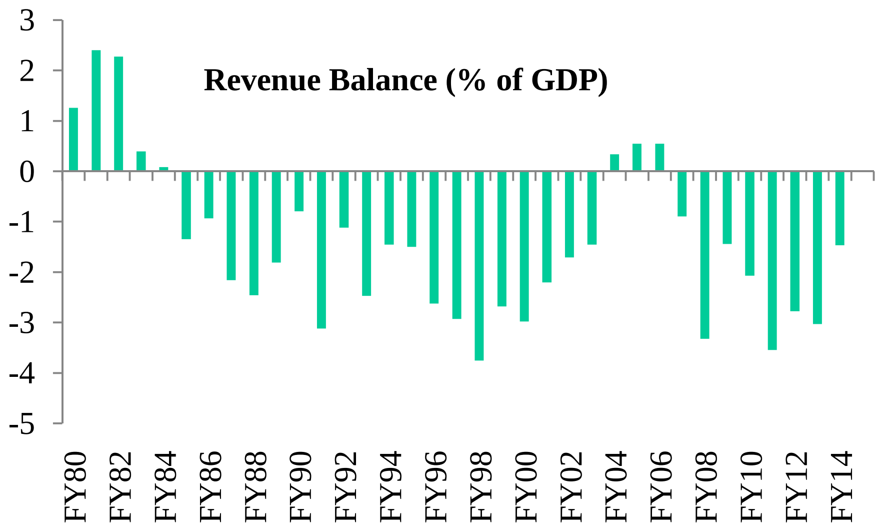
- Analysis of expenditures
  - Composition of expenditures
  - Expenditures-to-GDP ratio
  - Expenditure Buoyancy
- Policy issues related to expenditures
  - Overall size of public sector (how much to spend)
  - Priority areas (efficiency & optimal output)

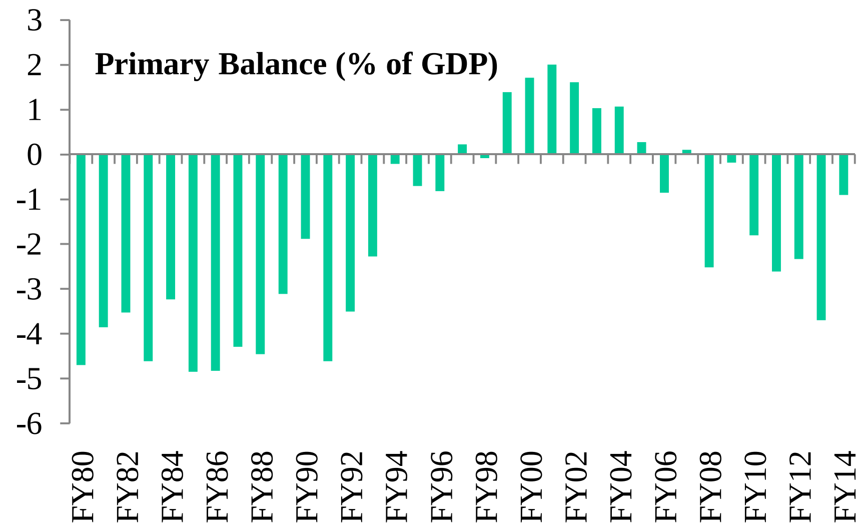
Assessing Fiscal Policy-III

- Financing of deficit
  - Monetization of deficits (printing of money)
  - Non-bank financing (borrowing from general public)
  - Borrowing from abroad
  - Accumulation of arrears (payments delayed)
- Other issues
  - Quasi-fiscal expenditures
  - Contingent liabilities
  - Tax expenditures

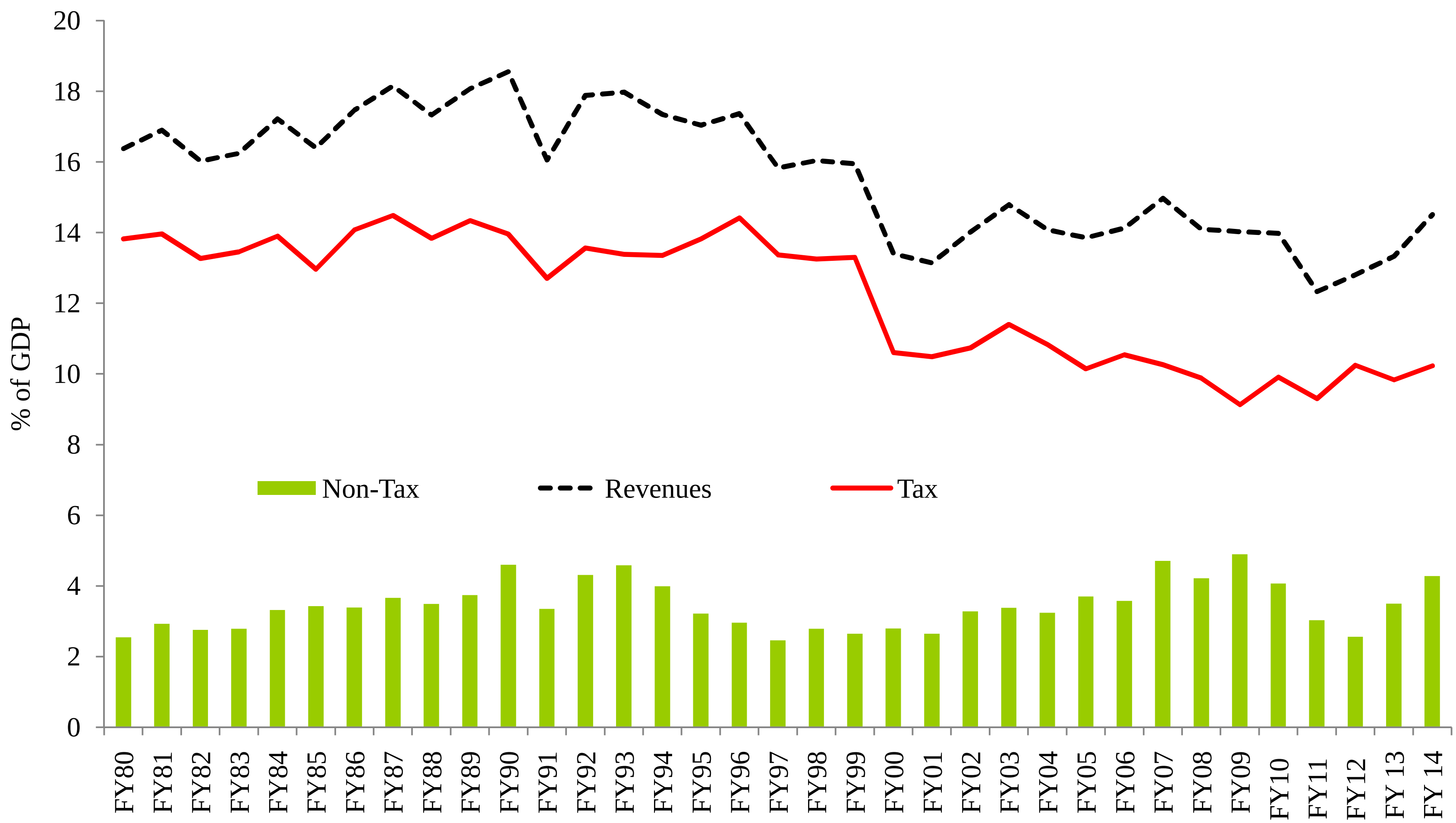
Fiscal Balances



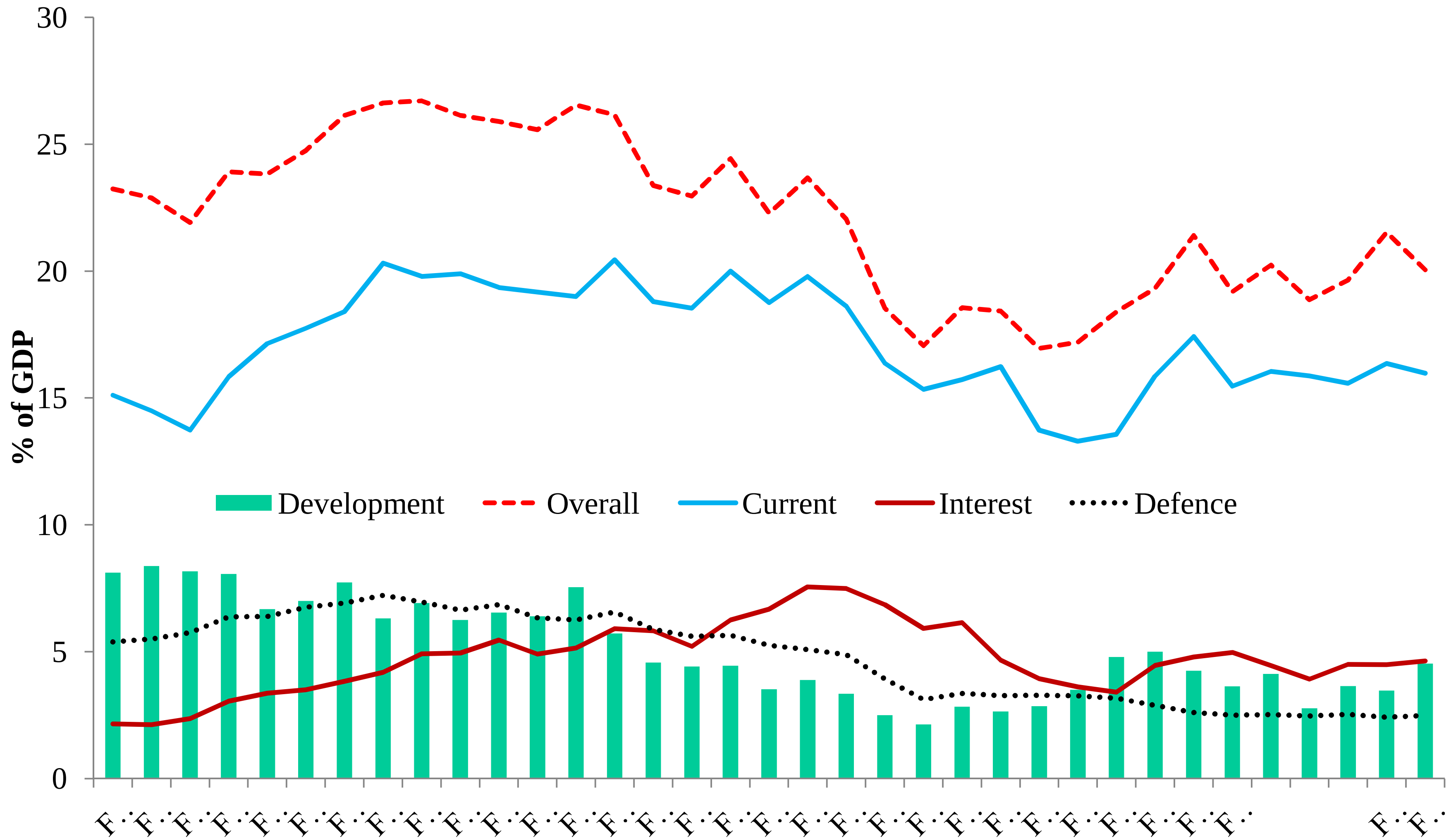




Government Revenues



Government Expenditures



Thanks