Economy Lecture 2 – Class Notes

Markets are classified into –

1) Perfect Competition 2) Monopoly 3) Monopolistic Competition 4) Oligopoly

Perfect competition describes markets such that no participants are large enough to have the market power to set the price of a homogeneous product. There are few if any perfectly competitive markets. Still, buyers and sellers in some auction-type markets, say for commodities (like wheat) or some financial assets, may be closer to this market. Demand and supply curves become fully operational only in the case of perfect competition. Specific characteristics of a perfect market are

- Infinite (very large number of) buyers and sellers
- Zero entry and exit barriers
- Perfect factor mobility
- Perfect information
- Zero transaction costs
- Property rights

A **monopoly** is a market structure in which a single supplier produces and sells a given product. If there is a single seller in a certain industry and there are no close substitutes for the product, then the market structure is that of a "pure monopoly". Railway is a pure monopoly, but since it is for public good, it is desirable.

Sometimes, there are many sellers in an industry and/or there exist many close substitutes for the goods being produced, but nevertheless companies retain some market power. This is termed **monopolistic competition.** Most of the items we find in the grocery shops are part of monopolistic competition.

An **oligopoly** is a market form in which a market or industry is dominated by a small number of sellers. Because there are few sellers, each oligopolist is likely to be aware of the actions of the others. The decisions of one firm influence, and are influenced by, the decisions of other firms. For example, telecom and civil aviation – if one firm reduces the price, others will also have to be.

Cartels convert oligopolistic markets into monopoly. Most famous cartel is OPEC, for petroleum pricing.

Resource Allocation – "What to produce…and in what quantity?"

Two ways of allocation

- Government (Planning Commission) through taxation, subsidies, licensing, quota etc
    - Advantage – Can take care of even those who are willing, but 'unable' to buy; can take care of the macroeconomic problems (unemployment)
    - Disadvantage – Less efficient
- Market Mechanism based on demand and supply considerations
    - Advantage – Based on collective wishes of people; more competition leading to higher efficiency of firms; more initiatives (by private players)

- Disadvantage – Cannot ensure social justice; cannot fill the gap between 'need and supply'; insensitive to the macroeconomic problems (inflation, environment degradation)

Government Intervention: In general, govt intervention in the market mechanism creates distortions like suppliers reducing production, shortages, unequal distribution and black marketing.

- But the govt can provide subsidies to (poor) consumers and incentives to (unwilling) producers
- Administrative measures can take care of black marketing (Acts like Prevention of Black Marketing and Maintenance of Essential Supplies)

Post reforms (1991), govt has started inviting private players to participate in otherwise non-profitable sectors (like infrastructure) by providing them Viability Gap Funding (VGF)

- **VGF** - Ministry of Finance Department, Department of Economic affairs has introduced a scheme for support to public private partnership (PPP) in infrastructure. G.O.I. has made provision to financially support the viability gap **to the tune of 20% of the cost of the project** in the form of capital grant from its viability gap fund. The scheme is confined to Public Private Partnership projects taken by the Government or its agencies, where the private sector is selected through **open competitive public bidding**. Under the scheme of Government of India, a provision has been made that Government of India's support will be limited to tune of 20% of the cost of the Project. It is also mentioned that State Government or its agencies that owns the project may also provide additional grants out of its budget not exceeding further 20% of the total cost of the Project.
  LPG – Liberalization (reducing govt control and allowing economic units to take their own decisions, Privatization (increasing the role of private sector), Globalization (integrating Indian economy with the world economy)
  Competition Commission of India created in 2002 is not anti-competition – it ensures that the companies play by the rules and no company takes undue advantages

National Income Accounting

Gross Domestic Product (**GDP**) – Monetary value of all final goods and services produced in the domestic territory of a country during an accounting year.

  Capital goods (e.g. machinery) are included in GDP, but intermediate goods (e.g. raw materials) are not
  Same good can be final (you consuming milk) or intermediate (milk in the restaurant) depending on the usage
- Intermediate goods and services are not included to avoid double counting
- In India, Services Sector contributes 60% to the GDP
- Domestic Territory = Country's boundary + Embassies/Consulates + Military Establishments of the country abroad + Ships/Aircrafts/Fishing Vessels/Oil Rigs belonging to the residents of the country
- Accounting Year = Fiscal Year; for India it is 1^{st} of April to 31^{st} of March (next year)

- Will include the income generated by MNCs in India

Gross National Product – GNP is the total value of final goods and services by normal residents of India within an accounting year. GDP includes the contribution made by non-resident producers - who work in the domestic territory of other countries - by way of wages, rent, interest and profits. For example, the income of all people working in Indian banks abroad is the factor income earned abroad. Net factor income from abroad is the difference between the income received from abroad for rendering factor services and the income paid for the factor services rendered by non-residents in the domestic territory of a country. GNP is, thus, the sum of GDP and net factor incomes from abroad.

In brief, GNP = GDP + NFIA (net factor income from abroad).

- Normal Resident – GoI defines it as someone who has <u>long term economic interest in India</u>.
- Inputs – 1) Factor: Land, Labour, Capital & Entrepreneurship 2) Non-factor: All others (raw materials)
- NFIA may be positive or negative. In case of India, it is negative; so **our GDP > GNP**

Net value = Gross – Depreciation

- Net Domestic Product (NDP) = GDP – Depreciation
- Net National Product (NNP) = GNP – Depreciation
- NNP = NDP + NFIA (similar to the relation between GNP & GDP)
- Theoretically 'net' is a better measure of the health of an economy than 'gross' but it is difficult to estimate net values – so GDP & GNP are commonly used measures

Factor Cost (FC) vs Market Price (MP)

- FC includes rent, wages, interest and profit
- MP = FC + Net Indirect Taxes
    - Net Indirect Taxes = Indirect Taxes – Subsidies
    - Therefore, GDP at MP = GDP at FC + Net Indirect Taxes
- Direct Taxes imposed on income and wealth of people and corporates (Income tax, wealth tax etc); indirect taxes on goods and services (sales tax, excise duty)
- FC is used for estimating growth (e.g. our annual GDP numbers)
    - GDP at MP can increase merely by increasing the taxes, even without increase in production

Current Prices vs Constant Prices

- Current – Values estimated at prevailing (current) prices
    - GDP at current prices is called Nominal GDP
    - Govt always gets its data in terms of Nominal GDP and then converts it to Real GDP
- Constant – Values estimated at the prices of a base year
    - For India, the base year is **2004-05**
    - Growth is always estimated at constant price

- So, when we say that the GDP growth rate of India in 2011-12 was 6.5 %, it is **estimated at factor cost and constant prices**.
- GDP at current price can increase because of inflation – not a true indicator of increase in production. So it is not used.
- **GDP at Constant Prices is called Real GDP** – it cannot increase without a real increase in production.

- Converting Nominal to Real GDP – Two ways
  - Estimate inflation, deduct its impact on the nominal GDP – deflating the nominal GDP
    - Real GDP = (Nominal GDP/GDP Deflator) x 100
    - GDP Deflator is an index number used to represent inflation
  - Estimate the actual numbers of production – very tough to do.
- Criteria for selection of base year
  - Normal year – neither too high nor too low
  - Latest possible year
  - Relevant data for that year should be readily available
- Two data collection agencies in India
  - Central Statistical Organisation (CSO) – Estimates National Income
  - National Sample Survey Organisation (NSSO) – Collects data on employment, poverty, consumption, expenditure, etc
    - Sample Surveys conducted annually, but Large Sample Surveys conducted every 5 years
    - Latest was the 66th Round of NSSO (2009-10) – but not selected as a base year, because it wasn't a normal year (economy affected by financial crisis)
      - ✓ So, the last Large Sample Survey (61st Round, 2004-05) was used for selecting the base year