The Whole Economy Approach of the Input-Output Model

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The Whole Economy Approach of the Input-Output Model

FENGQUAN LIU*

Abstract

In macroeconomy research that uses technological table, most studies have only considered a special aspect. This paper develops an input-output model that extends to the whole economy by adding finance into transaction table. This forms a integrated capital flow cycling system for whole economy. Economic growth is used to reflect economic dynamic characteristics. Whole economy is divided into five subsystems. On the basis of subsystem’s balance sheet, we set up the simultaneous equation of whole economy. As part of the disposal income, the new loan of the subsystems are affected by money supply badly and the income ratio is not stable. In this paper, expenditure ratio of subsystems is used to solve the simultaneous equation. The subsystem’s balance sheets and the simultaneous equation can be applied to study fundamental economic issues effectively.

1 Introduction

In mathematical logic, Leontief built up the legitimate relationship among macro economic variables. It is a system of simultaneous equation of economic variables expressed with technological matrix [Leo86]. Input-output model (I-O in short) is very well known among economists and policy analysts, and it is widely used to study economic impacts of one sector on an economy in the national and the regional level [Mou00].

Leontief set up the relationship of environment pollution with consumption and production [Leo70]. M. Peneder illustrated the effect of industrial structure on aggregate income and growth [Pen03]. Swenson and Moore presented a method to determine full economic impacts of tax law [SM87]. Santos identified regional perturbations pursuant to disaster scenarios [JR12].

The application of technological table is too long to list. They have a common feature that every application is specialized in a particular aspect due to short of finance system. With finance in transaction table, it forms a integrated capital flow cycling system for the whole economy. Together with production, consumption and investment, taking finance into consideration is essential to build technological matrix, with which we can depict macroeconomy phenomena and explain its mechanism reasonably as a whole.

This paper attempts to fill the gap. On the closed economy, we divided whole economy into five subsystems: household, government, enterprise, investment and finance. As a result, the technological matrix is simplified to each subsystem’s receipts and expenditure table. For every sectors on the technological table, input equals output and for every subsystem’s on transaction table, disposal income equals payment. Both of them are in accordance with Walrasian general equilibrium theory [Wal54].

To illustrate economic dynamic characteristic, economic growth is introduced into transaction table. Then we get simultaneous equation of whole economy on the basis of transaction table and balance sheets. To solve the equation, we use output (expenditure) ratio instead of input (income) ratio. As part of disposal income, new loan amount is affected by money supply very badly, and as part of expenditure, the amount of loan to be repaid is decided by total loan of previous period. This suggests that expenditure ratio is more stable than income ratio. With the help of expenditure ratio, the dependent variables are replaced by independent ones. After plugging replaced variables into these equations, they become solvable. They can be used to illustrate

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economic mechanism, to perform economic simulating experiments, and to explain economic phenomena and fundamental issues such as money supply, calculation of inflation rate and economy growth, reasonable interest rate and exchange rate, and the cause of stagnation.

2 Transaction Table

To analyze macroeconomic situation as a whole, we divide closed economy system into 5 subsystems: household, government, enterprise, investment and finance. By tracing capital flows among subsystems, we get closed macroeconomy’s technological table similar to Leontief’s I-O table [Leo86]. Because subsystem’s receipt is its input and payment is the output, the macroeconomy’s technological table is also transaction table. We use \( x_{ij} \) to represent the capital flows among subsystems. \( x_{ij} \) indicates subsystem \( i \) paid \( x \) amount of money to subsystem \( j \). The row sum \( \sum_{j=1}^{n} x_{ij} \) represents subsystem’s total payments and column sum \( \sum_{i=1}^{n} x_{ij} \) total receipts.

<table>
<thead>
<tr>
<th></th>
<th>H</th>
<th>G</th>
<th>E</th>
<th>I</th>
<th>F</th>
</tr>
</thead>
<tbody>
<tr>
<td>H</td>
<td>( x_{12} )</td>
<td>( x_{13} )</td>
<td>( x_{14} )</td>
<td>( x_{15} )</td>
<td></td>
</tr>
<tr>
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<td>( x_{23} )</td>
<td>( x_{24} )</td>
<td>( x_{25} )</td>
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<tr>
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<td>( x_{31} )</td>
<td>( x_{32} )</td>
<td>( x_{34} )</td>
<td>( x_{35} )</td>
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<tr>
<td>I</td>
<td>( x_{41} )</td>
<td>( x_{42} )</td>
<td>( x_{43} )</td>
<td>( x_{45} )</td>
<td></td>
</tr>
<tr>
<td>F</td>
<td>( x_{51} )</td>
<td>( x_{52} )</td>
<td>( x_{53} )</td>
<td>( x_{54} )</td>
<td></td>
</tr>
</tbody>
</table>

Table 1: Transaction Table. H: Household; G: Government; E: Enterprise; I: Investment; F: Finance.

For Leontief’s I-O table, it is evident that every sector’s total input equals total output and for the transaction table above, receipts equal payments. Both of them are in accordance with the general equilibrium presented by Walras [Wal54]. The equilibrium of subsystems capital flows are exactly the balance sheets used in accounting. For the purpose of easy to understand and convenient to discuss in depth, the components of income and payment of every subsystem will be listed and their relationship will be studied.

3 Balance Sheets

The balance sheet discussed here is in a broad sense. The income is all the money a subsystem can get (including new loan), and payment consists of all the money a subsystem can use. To complete balance sheets, the variables and their meanings are given in Table 2.

Take household as an example to demonstrate the establishment of subsystem’s balance sheets. Household incomes and payments are listed in Table 3.

Writing in symbols, household balance sheet becomes:

\[
L_{ce} + B_{e} + P_{rh} + S_{L} + B_{g} + L_{cg} + L_{ci} + L_{h} + D_{ih} = C_{h} + C_{ih} + S + B_{en} + B_{gn} + L_{ah} + D_{h} + L_{ih}.
\]

Inspecting the balance sheet, we find that the loan is still part of disposal income. Actually in the whole inspecting period, the loan was gradually used and used up at the end of period. The new loan added to entire economy caused the price goes up and quantity rises. In turn, comparing with last period, it enhanced every sub-system’s actual income. In short, every sub-system’s loan melt down in the entire economy by the work of economical mechanism and increased sub-systems’ actual incomes by feedback. The problem appeared above is caused by analyzing dynamic economic issues with static analysis method. Therefore the balance sheet has to be reformatted to approach actual economic condition.

For simplicity, we assume constant increment to scale. That is if nominal growth increase by 5 percent, all the transaction variables in inspecting period will also increase by 5 percent, except for the variables related
<table>
<thead>
<tr>
<th>Variables</th>
<th>Meaning</th>
</tr>
</thead>
<tbody>
<tr>
<td>$A_i$</td>
<td>Asset bought from government for investment (mainly land).</td>
</tr>
<tr>
<td>$AR$</td>
<td>Available money to be loaned and deposit reserve.</td>
</tr>
<tr>
<td>$B$</td>
<td>Bond. $B_e$: bonds becoming due by enterprise, $B_{en}$: bonds newly issued by enterprise. $B_g$: bonds becoming due by enterprise, $B_{gn}$: bonds newly issued by government.</td>
</tr>
<tr>
<td>$C$</td>
<td>Consumption. $C_g$: Government consumption, $C_h$: Household consumption, $C_i$: Investment consumption, $C_{ig}$: Capital Construction consumption, $C_{ih}$: Housed investing consumption.</td>
</tr>
<tr>
<td>$C_r$</td>
<td>Unit material cost rate</td>
</tr>
<tr>
<td>$D$</td>
<td>Deposit. $D_e$: enterprise deposit, $D_g$: government deposit. $D_h$: household deposit, $D_i$: investment deposit.</td>
</tr>
<tr>
<td>$D_i$</td>
<td>Deposit interest. $D_{ie}$: Interest income from enterprise deposit, $D_{ig}$: Interest income from government deposit, $D_{ih}$: Interest income from household deposit, $D_{ii}$: Interest income from investment deposit.</td>
</tr>
<tr>
<td>$I$</td>
<td>Investment. $I_{gi}$: government investment to state owned companies.</td>
</tr>
<tr>
<td>$L_a$</td>
<td>The amount of the loan to be repaid. $L_{ae}$: loan amount needed to be paid to finance by enterprise, $L_{ag}$: . . . government, $L_{ah}$: . . . household, $L_{ai}$: . . . investment.</td>
</tr>
<tr>
<td>$L_c$</td>
<td>Labor cost. $L_{ce}$: enterprise labor costs, $L_{cg}$: government labor costs, $L_{ci}$: investment labor costs.</td>
</tr>
<tr>
<td>$L_i$</td>
<td>Loan interest. $L_{ie}$: loan interest paid to finance by enterprise, $L_{ig}$: . . . by government, $L_{ih}$: . . . by household, $L_{ii}$: . . . by investment.</td>
</tr>
<tr>
<td>$M$</td>
<td>Money. Newly issued money.</td>
</tr>
<tr>
<td>$P$</td>
<td>Price.</td>
</tr>
<tr>
<td>$P_r$</td>
<td>Profit. $P_{rg}$: profits paid to government by enterprise, $P_{rh}$: profits paid to household by enterprise, $P_{ri}$: profits used for new investment by enterprise.</td>
</tr>
<tr>
<td>$Q$</td>
<td>Quantity. The amount of goods and service.</td>
</tr>
<tr>
<td>$S$</td>
<td>Stock.</td>
</tr>
<tr>
<td>$T$</td>
<td>Tax.</td>
</tr>
</tbody>
</table>

Table 2: List of variables and their meanings.
to finance $x_{ij}$ and $x_{i5}(i, j = 1, \ldots, 5)$. The reason that finance related variables do not move together with growth is that new loan is decided by new issued money and repaid loan is affected by total loan.

Take actual income from last period new plus loan and interest of deposit from this period as this period’s disposal income, and take the sum of actual payment of last period and its nominal increment from this period, plus payback to finance from this period as this period’s payments, the reformatted household balance sheet is shown below:

$$L_{ce}^o + B_e^o + P_{rh}^o + S_L^o + B_g^o + L_{cg}^o + L_{ci}^o + L_h^o + D_{ih}^o = (1 + Q')(C_h^o + C_{ih}^o + S^o + B_{en}^o + B_{gn}^o) + L_{ah}^o + D_h^o + L_{ih}^o,$$

where superscripts $^o$ indicates Last period (year), and $'$ indicates the inspecting period (this year).

Likewise Government balance sheet:

$$T^o + P_{rg}^o + B_{gn}^o + A_i^o + L_g^o + D_{ig}^o = (1 + Q')(C_g^o + C_{ig}^o + I_{gi}^o + SL^o + B_g^o + L_{cg}^o) + L_{ag}^o + D_g^o + L_{ig}^o.$$

Enterprise balance sheet

$$P^oQ^o + L_e^o + D_{ie}^o = (1 + Q')(C_e^oQ_e^o + L_{ce}^o + B_e^o + P_{rh}^o + P_{ri}^o + P_{rg}^o + T^o) + L_{ae}^o + D_e^o + L_{ie}^o.$$

Note that total sales $PQ$, intermediate goods $C_rQ$ and final goods satisfy:

$$PQ - C_rQ = C_h + C_{ih} + C_g + C_{ig} + C_i.$$

If the ratio of intermediate goods to total sales $\lambda$ is a constant. The intermediate goods could be replaced by $\lambda$ and the final goods:

$$PQ = \frac{1}{1 - \lambda}(C_h + C_{ih} + C_g + C_{ig} + C_i), \quad PQ = \frac{C_rQ}{\lambda}.$$

This gives

$$C_rQ = \frac{\lambda}{1 - \lambda}(C_h + C_{ih} + C_g + C_{ig} + C_i), \quad Q'C_rQ = \frac{\lambda Q'}{1 - \lambda}(C_h + C_{ih} + C_g + C_{ig} + C_i).$$

Hence the transformed enterprise balance sheet will be:

$$(1 - \frac{\lambda Q'}{1 - \lambda})(C_h^o + C_{ih}^o + C_g^o + C_{ig}^o + C_i^o) + L_e^o + D_{ie}^o = (1 + Q')(L_{ce}^o + B_e^o + P_{rh}^o + P_{ri}^o + P_{rg}^o + T^o) + L_{ae}^o + D_e^o + L_{ie}^o.$$
Investment balance sheet

\[ P_{ri}^o + S^o + B_{en}^o + I_{gy}^o + L_i^t + D_i' = (1 + Q^t)(C_i^o + A_i^o + L_i'^o) + L_{ai} + D_i' + L_{ii}' \]

and the Finance balance sheet

\[ M' + L_{ah}' + D_h' + L_{ih}' + L_{ag}' + D_g' + L_{ig}' + L_{ae}' + D_e' + L_{ie}' + D_i' + L_{ii}' = \Delta AR' + L_h' + D_{ih}' + L_g' + D_{ig}' + L_{ie}' + D_i' + L_{ii}' \]

4 Macro Economy Mechanism

Summing up all the money one subsystem can get from others forms capital flow variables \( x_{ij} \) used in trans-action table. See Table 4.

<table>
<thead>
<tr>
<th>( x_{21} )</th>
<th>( x_{12} )</th>
<th>( x_{31} )</th>
<th>( x_{13} )</th>
<th>( x_{41} )</th>
</tr>
</thead>
<tbody>
<tr>
<td>( S_L + B_g + L_{cg} )</td>
<td>( B_{gn} )</td>
<td>( L_{ce} + P_{rh} + B_e )</td>
<td>( C_h + C_{th} )</td>
<td>( L_{ci} )</td>
</tr>
<tr>
<td>( x_{14} )</td>
<td>( x_{24} )</td>
<td>( x_{42} )</td>
<td>( x_{23} )</td>
<td>( x_{32} )</td>
</tr>
<tr>
<td>( B_{en} + S )</td>
<td>( I_{gi} )</td>
<td>( A_i )</td>
<td>( C_g + C_{ig} )</td>
<td>( P_{rg} + T )</td>
</tr>
<tr>
<td>( x_{34} )</td>
<td>( x_{43} )</td>
<td>( x_{51} )</td>
<td>( x_{15} )</td>
<td>( x_{52} )</td>
</tr>
<tr>
<td>( P_{ri} )</td>
<td>( C_i )</td>
<td>( L_h + D_{ih} )</td>
<td>( L_{ah} + L_{ih} + D_h )</td>
<td>( L_g + D_{ig} )</td>
</tr>
<tr>
<td>( x_{25} )</td>
<td>( x_{54} )</td>
<td>( x_{45} )</td>
<td>( x_{53} )</td>
<td>( x_{35} )</td>
</tr>
<tr>
<td>( L_{ag} + L_{ig} + D_g )</td>
<td>( L_i + D_{ii} )</td>
<td>( L_{ai} + L_{ii} + D_i )</td>
<td>( L_e + D_{ie} )</td>
<td>( L_{ae} + L_{ie} + D_e )</td>
</tr>
</tbody>
</table>

Table 4: Components of \( x_{ij} \).

On the basis of sub-system’s balance sheets and summed up capital flow variables, the working mechanism chart of entire-dynamic macro economy can be drawn as Figure 1.

Figure 1: Illustration of the entire dynamic macro economy. NR: Natural Resource; M: Money Supply; AR: Available money to be loaned and deposit reserve.
Figure 1 depicts the working mechanism of entire dynamic macro economy and how it is running orderly and effectively. On the market, profits drive economic units, resource provides basic needs and monetary policy ensures the market moving smoothly. The capital flows formed in market transaction makes all the economic activities a whole macro economy. The changes of amount and direction of capital flows determine the state of macro economy.

5 Dynamic Transaction Table

Among sub-systems of macro economy, there are capital inter-flows. It is the capital inter-flows of subsystems, which connect one sub-system to another inseparably, forming a whole organic macro economy. In the following discussion, the simultaneous equations will be set-up according to the quantities of capital flow among sub-systems, which contains the logical relationship of all the macro-economic variables.

Putting summed up variable $x_{ij}$ into balance sheets, we get simultaneous equations composed of 5 sub-system balance sheets:

$$x_{21} + x_{31} + x_{41} + x_{51} = (1 + Q')(x_{12} + x_{13} + x_{14}) + x'_{15}$$
$$x_{12} + x_{24} + x_{32} + x'_{52} = (1 + Q')(x_{21} + x_{24} + x_{23}) + x'_{25}$$
$$(1 - \frac{\lambda Q'}{1 - \lambda})(x_{13} + x_{23} + x_{43}) + x'_{53} = (1 + Q')(x_{31} + x_{32} + x_{34}) + x'_{35}$$
$$x_{14} + x_{24} + x_{44} + x_{54} = (1 + Q')(x_{41} + x_{42} + x_{43}) + x'_{45}$$
$$x'_{15} + x'_{25} + x'_{45} + x'_{35} + M'_1 = x'_{51} + x'_{52} + x'_{54} + x'_{53}$$

Table 1 is a static and settled accounts transaction matrix. We can establish a dynamic one according to the equations above. See Table 5.

<table>
<thead>
<tr>
<th></th>
<th>H</th>
<th>G</th>
<th>E</th>
<th>I</th>
<th>F</th>
</tr>
</thead>
<tbody>
<tr>
<td>H</td>
<td>(1 + $\theta'$)x_{12}</td>
<td>(1 + $\theta'$)x_{13}</td>
<td>(1 + $\theta'$)x_{14}</td>
<td>$x'_{15}$</td>
<td></td>
</tr>
<tr>
<td>G</td>
<td>$x_{21}$</td>
<td>(1 - $x_{12}'$)x_{13}</td>
<td>$x_{14}$</td>
<td>$x'_{25}$</td>
<td></td>
</tr>
<tr>
<td>E</td>
<td>(1 + $\theta'$)x_{31}</td>
<td>(1 + $\theta'$)x_{23}</td>
<td>(1 + $\theta'$)x_{24}</td>
<td>$x'_{35}$</td>
<td></td>
</tr>
<tr>
<td>I</td>
<td>$x_{41}$</td>
<td>$x_{42}$</td>
<td>(1 - $x_{34}'$)x_{34}</td>
<td>$x'_{45}$</td>
<td></td>
</tr>
<tr>
<td>F</td>
<td>$x'_{51}$</td>
<td>$x'_{52}$</td>
<td>$x'_{53}$</td>
<td>$x'_{54}$</td>
<td>$M'_1$</td>
</tr>
</tbody>
</table>

Table 5: Dynamic transaction Table. The variables on the top of each cell are used to calculate payments and those on the bottom are used to calculate receipts.

6 Simultaneous Equation

Even taking $M'_1$ as known, the simultaneous equation has 20 unknowns and only 5 linear equations. To solve it, we need the second assumption. Similar to single process production function assumption used in I-O model [Leo86], we assume that there is a fixed expenditure pattern for every subsystem. The constant payment to scale is that subsystems single payment will increase with its total income by the same precent. The payment proportion to total income of subsystems is subject to economic structure. They are relatively
stable, so we take it as constant. For example, during the 11 years from 2001 to 2012 in United Kingdom, the living cost and food expenditure remains steady, 489 pound per week (inflation adjusted). It is almost a level line [NS113]. The statistical analysis of Americans household expenditure proportion got similar conclusion [WSJ12].

Emphasizing the stability of expenditure ratio does not deny its little change. The payment ratio is only an instrument used to solve the equation here. In the process of applying them, we need to adjust them according to actual statistic results. The payment ratio can be used to reform the simultaneous equations. Payment ratio of sub-systems is in Table 6.

<table>
<thead>
<tr>
<th>Household Variable</th>
<th>$x_{12}$</th>
<th>$x_{13}$</th>
<th>$x_{14}$</th>
<th>$x_{15}$</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ratio</td>
<td>$\alpha_1$</td>
<td>$\alpha_2$</td>
<td>$\alpha_3$</td>
<td>$\alpha_4$</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Government Variable</th>
<th>$x_{21}$</th>
<th>$x_{24}$</th>
<th>$x_{23}$</th>
<th>$x_{25}$</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ratio</td>
<td>$\beta_1$</td>
<td>$\beta_2$</td>
<td>$\beta_3$</td>
<td>$\beta_4$</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Enterprise Variable</th>
<th>$x_{31}$</th>
<th>$x_{32}$</th>
<th>$x_{34}$</th>
<th>$x_{35}$</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ratio</td>
<td>$\gamma_1$</td>
<td>$\gamma_2$</td>
<td>$\gamma_3$</td>
<td>$\gamma_4$</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Investment Variable</th>
<th>$x_{41}$</th>
<th>$x_{42}$</th>
<th>$x_{43}$</th>
<th>$x_{45}$</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ratio</td>
<td>$\zeta_1$</td>
<td>$\zeta_2$</td>
<td>$\zeta_3$</td>
<td>$\zeta_4$</td>
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</table>

<table>
<thead>
<tr>
<th>Finance Variable</th>
<th>$x_{51}$</th>
<th>$x_{52}$</th>
<th>$x_{54}$</th>
<th>$x_{53}$</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ratio</td>
<td>$\varepsilon_1$</td>
<td>$\varepsilon_2$</td>
<td>$\varepsilon_3$</td>
<td>$\varepsilon_4$</td>
</tr>
</tbody>
</table>

Table 6: Payment ratio of subsystems.

The calculation of payment ratio is shown in Table 7.

<table>
<thead>
<tr>
<th>$\alpha_1$</th>
<th>$\alpha_2$</th>
<th>$\alpha_3$</th>
<th>$\alpha_4$</th>
</tr>
</thead>
<tbody>
<tr>
<td>$(1+Q)x_{12}^o$</td>
<td>$(1+Q)x_{12}^o$</td>
<td>$(1+Q)x_{12}^o$</td>
<td>$(1+Q)x_{12}^o$</td>
</tr>
<tr>
<td>$\frac{x_{12}^o + x_{13}^o + x_{14}^o + x_{15}^o}{x_{12}^o + x_{13}^o + x_{14}^o + x_{15}^o}$</td>
<td>$\frac{x_{12}^o + x_{13}^o + x_{14}^o + x_{15}^o}{x_{12}^o + x_{13}^o + x_{14}^o + x_{15}^o}$</td>
<td>$\frac{x_{12}^o + x_{13}^o + x_{14}^o + x_{15}^o}{x_{12}^o + x_{13}^o + x_{14}^o + x_{15}^o}$</td>
<td>$\frac{x_{12}^o + x_{13}^o + x_{14}^o + x_{15}^o}{x_{12}^o + x_{13}^o + x_{14}^o + x_{15}^o}$</td>
</tr>
<tr>
<td>$\beta_1$</td>
<td>$\beta_2$</td>
<td>$\beta_3$</td>
<td>$\beta_4$</td>
</tr>
<tr>
<td>$\frac{x_{21}^o + x_{24}^o + x_{23}^o + x_{25}^o}{x_{21}^o + x_{24}^o + x_{23}^o + x_{25}^o}$</td>
<td>$\frac{x_{21}^o + x_{24}^o + x_{23}^o + x_{25}^o}{x_{21}^o + x_{24}^o + x_{23}^o + x_{25}^o}$</td>
<td>$\frac{x_{21}^o + x_{24}^o + x_{23}^o + x_{25}^o}{x_{21}^o + x_{24}^o + x_{23}^o + x_{25}^o}$</td>
<td>$\frac{x_{21}^o + x_{24}^o + x_{23}^o + x_{25}^o}{x_{21}^o + x_{24}^o + x_{23}^o + x_{25}^o}$</td>
</tr>
</tbody>
</table>

Table 7: Payment ratio calculation.

On the basis of the second assumption, every sub-system’s expenditure variables are all interrelated and dependent variables. There is only one independent expenditure variable in each sub-system. They can be replaced one by the other. Therefore, the simultaneous equation has 5 independent variables with 5 linear equations. It can be solved uniquely. Choosing one payment variable such as $x_{21}^o$ and 4 income variables $x_{12}, x_{32}, x_{42}, x_{52}$ in one sub-system’s balance sheet as basic variables, we build new simultaneous equations, shown below.
Putting replaced variables into new simultaneous equations, we have re-organized 5 elements linear function simultaneous equations. See below.

\[
x_{21}^o = \frac{\beta_1}{1 + Q'}(x_{12}^o + x_{42}^o + x_{32}^o + x_{52}^o)
\]
\[
x_{12}^o = \frac{\alpha_1}{1 + Q'}(x_{21}^o + x_{31}^o + x_{41}^o + x_{51}^o)
\]
\[
x_{42}^o = \frac{\zeta_1}{1 + Q'}(x_{14}^o + x_{24}^o + x_{34}^o + x_{54}^o)
\]
\[
x_{32}^o = \frac{\gamma_2}{1 + Q'}[(1 - \frac{\lambda Q'}{1 - \lambda})(x_{13}^o + x_{23}^o + x_{43}^o + x_{53}^o)]
\]
\[
x_{52}^o = \varepsilon_2(x_{15}^o + x_{25}^o + x_{45}^o + x_{35}^o + M_1^f)
\]

To get solvable equations, we need to replace all other variables by basic ones with the aid of variable replacement table. See Table 8.

<table>
<thead>
<tr>
<th>Government</th>
<th>Variable</th>
<th>(x_{21}^o)</th>
<th>(x_{23}^o)</th>
<th>(x_{23}^o)</th>
<th>(x_{25}^o)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Replacement</td>
<td>(\frac{\beta_1}{\beta_2}x_{21}^o)</td>
<td>(\frac{\beta_3}{\beta_2}x_{23}^o)</td>
<td>(\frac{\beta_4}{\beta_2}x_{25}^o)</td>
<td>(\frac{\beta_4(1+Q')}{\beta_2}x_{21}^o)</td>
</tr>
<tr>
<td>Household</td>
<td>Variable</td>
<td>(x_{12}^o)</td>
<td>(x_{31}^o)</td>
<td>(x_{14}^o)</td>
<td>(x_{15}^o)</td>
</tr>
<tr>
<td></td>
<td>Replacement</td>
<td>(\frac{\alpha_2}{\alpha_1}x_{12}^o)</td>
<td>(\frac{\alpha_2}{\alpha_1}x_{31}^o)</td>
<td>(\frac{\alpha_2}{\alpha_1}x_{14}^o)</td>
<td>(\frac{\alpha_2}{\alpha_1}x_{15}^o)</td>
</tr>
<tr>
<td>Investment</td>
<td>Variable</td>
<td>(x_{42}^o)</td>
<td>(x_{43}^o)</td>
<td>(x_{43}^o)</td>
<td>(x_{45}^o)</td>
</tr>
<tr>
<td></td>
<td>Replacement</td>
<td>(\frac{\zeta_2}{\zeta_2}x_{42}^o)</td>
<td>(\frac{\zeta_2}{\zeta_2}x_{43}^o)</td>
<td>(\frac{\zeta_2}{\zeta_2}x_{43}^o)</td>
<td>(\frac{\zeta_2}{\zeta_2}x_{45}^o)</td>
</tr>
<tr>
<td>Enterprise</td>
<td>Variable</td>
<td>(x_{32}^o)</td>
<td>(x_{31}^o)</td>
<td>(x_{34}^o)</td>
<td>(x_{35}^o)</td>
</tr>
<tr>
<td></td>
<td>Replacement</td>
<td>(\frac{\gamma_2}{\gamma_2}x_{32}^o)</td>
<td>(\frac{\gamma_2}{\gamma_2}x_{31}^o)</td>
<td>(\frac{\gamma_2}{\gamma_2}x_{34}^o)</td>
<td>(\frac{\gamma_2}{\gamma_2}x_{35}^o)</td>
</tr>
<tr>
<td>Finance</td>
<td>Variable</td>
<td>(x_{52}^o)</td>
<td>(x_{51}^o)</td>
<td>(x_{54}^o)</td>
<td>(x_{53}^o)</td>
</tr>
<tr>
<td></td>
<td>Replacement</td>
<td>(\frac{\varepsilon_2}{\varepsilon_2}x_{52}^o)</td>
<td>(\frac{\varepsilon_2}{\varepsilon_2}x_{51}^o)</td>
<td>(\frac{\varepsilon_2}{\varepsilon_2}x_{54}^o)</td>
<td>(\frac{\varepsilon_2}{\varepsilon_2}x_{53}^o)</td>
</tr>
</tbody>
</table>

**Table 8: Variable Replacement Table**

Putting replaced variables into new simultaneous equations, we have re-organized 5 elements linear function simultaneous equations. See below.

\[
x_{21}^o = \frac{\beta_1}{1 + Q'}(x_{12}^o + x_{42}^o + x_{32}^o + x_{52}^o)
\]
\[
x_{12}^o = \frac{\alpha_1}{1 + Q'}(x_{21}^o + x_{31}^o + x_{41}^o + x_{51}^o)
\]
\[
x_{42}^o = \frac{\zeta_1}{1 + Q'}(\beta_2x_{21}^o + \alpha_3x_{12}^o + \gamma_3x_{32}^o + \varepsilon_3x_{52}^o)
\]
\[
x_{32}^o = \frac{\gamma_2}{1 + Q'} \left[ (1 - \frac{\lambda Q'}{1 - \lambda}) (\beta_3x_{21}^o + \alpha_2x_{12}^o + \gamma_2x_{42}^o) + \varepsilon_2x_{52}^o \right]
\]
\[
x_{52}^o = \varepsilon_2(1 + Q') (\beta_4x_{21}^o + \alpha_2x_{12}^o + \varepsilon_4x_{32}^o) + \gamma_2x_{52}^o + \varepsilon_2M_1^f
\]

Taking economic structure ratio \(\alpha_i, \beta_i, \gamma_i, \zeta, \varepsilon_i\) and nominal growth rate \(Q'\) as known. \(x_{ij}\) can be solved, which are expressed by \(M_1^f\). The determinant solution of the simultaneous equation is given below:
7 The Usage of Simultaneous Equation

To demonstrate the usage of simultaneous equation, a hypothetical payment ratio table is given in Table 9.

\[
\begin{pmatrix}
1 & -\frac{\beta_1}{1+Q'} & -\frac{\beta_1}{1+Q'} & -\frac{\beta_1}{1+Q'} & -\frac{\beta_1}{1+Q'} \\
-\frac{\alpha_1}{1+Q'} & 1 & -\frac{\alpha_1}{1+Q'} & -\frac{\alpha_1}{1+Q'} & -\frac{\alpha_1}{1+Q'} \\
-\frac{\beta_1}{1+Q'} & -\frac{\beta_1}{1+Q'} & 1 & -\frac{\beta_1}{1+Q'} & -\frac{\beta_1}{1+Q'} \\
-\frac{\beta_1}{1+Q'} & -\frac{\beta_1}{1+Q'} & -\frac{\beta_1}{1+Q'} & 1 & -\frac{\beta_1}{1+Q'} \\
-\frac{\beta_1}{1+Q'} & -\frac{\beta_1}{1+Q'} & -\frac{\beta_1}{1+Q'} & -\frac{\beta_1}{1+Q'} & 1
\end{pmatrix}
= \begin{pmatrix}
0 \\
0 \\
0 \\
0 \\
\varepsilon_2 M_1'
\end{pmatrix}
\]

Table 9: Hypothetical Payment Ratio

<table>
<thead>
<tr>
<th>Series</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ratio</td>
<td>α</td>
<td>β</td>
<td>γ</td>
<td>η</td>
</tr>
<tr>
<td></td>
<td>.05</td>
<td>.15</td>
<td>.35</td>
<td>.2</td>
</tr>
<tr>
<td></td>
<td>.4</td>
<td>.1</td>
<td>.3</td>
<td>.4</td>
</tr>
<tr>
<td></td>
<td>.1</td>
<td>.55</td>
<td>.2</td>
<td>.15</td>
</tr>
<tr>
<td></td>
<td>.45</td>
<td>.2</td>
<td>.15</td>
<td>.18</td>
</tr>
</tbody>
</table>

If the hypothetical nominal growth \( \theta' \) and intermediate goods ratio \( \lambda \) are .25 and .4 respectively. The calculated determinant solution of the simultaneous equation is

\[
\begin{pmatrix}
1 & -0.12 & -0.12 & -0.12 \\
-0.04 & 1 & -0.08 & -0.0466 & -0.0166 \\
-0.0533 & -0.16 & 1 & -0.0533 & -0.1067 \\
-0.7333 & -1.1 & -1.1 & 1 & -1.1444 \\
-0.5 & -3.375 & -5.625 & -1.875 & 1
\end{pmatrix}
= \begin{pmatrix}
0 \\
0 \\
0 \\
0 \\
0.3M_1'
\end{pmatrix}
\]

After solving the equation, we get \( x_{ij}^o \) and \( x_{ij}' \) in Table 10.

<table>
<thead>
<tr>
<th>( x_{12}^o )</th>
<th>( x_{13}^o )</th>
<th>( x_{14}^o )</th>
<th>( x_{15}^o )</th>
</tr>
</thead>
<tbody>
<tr>
<td>.04077</td>
<td>.32616</td>
<td>.08154</td>
<td>.45866</td>
</tr>
<tr>
<td>( x_{21}^o )</td>
<td>( x_{23}^o )</td>
<td>( x_{24}^o )</td>
<td>( x_{25}^o )</td>
</tr>
<tr>
<td>.13687</td>
<td>.50816</td>
<td>.09125</td>
<td>.22812</td>
</tr>
<tr>
<td>( x_{31}^o )</td>
<td>( x_{32}^o )</td>
<td>( x_{34}^o )</td>
<td>( x_{35}^o )</td>
</tr>
<tr>
<td>.42864</td>
<td>.36741</td>
<td>.24494</td>
<td>.22963</td>
</tr>
<tr>
<td>( x_{41}^o )</td>
<td>( x_{42}^o )</td>
<td>( x_{43}^o )</td>
<td>( x_{45}^o )</td>
</tr>
<tr>
<td>.20158</td>
<td>.10079</td>
<td>.55435</td>
<td>.18898</td>
</tr>
<tr>
<td>( x_{51}^o )</td>
<td>( x_{52}^o )</td>
<td>( x_{53}^o )</td>
<td>( x_{54}^o )</td>
</tr>
<tr>
<td>.25264</td>
<td>.63160</td>
<td>.37896</td>
<td>.84213</td>
</tr>
</tbody>
</table>

Table 10: \( x_{ij} \) solutions. We omit the \( M_1' \) factor in all entries.

Now the dynamic transaction table becomes:
Table 11: Hypothetical dynamic transaction table.

8 Applications

The result discussed above can be used widely in macroeconomy. We give a few examples demonstrating applications of balance sheets and the simulation equation.

8.1 Applications of Balance Sheets

Monetary Equation. The money supply can be captured by summing up sub-systems balance sheets. After added up and reorganized, we have the money supply:

\[ M' = \Delta AR + \Delta C_r^o + \Delta C_g^o + \Delta C_i^o + \Delta C_f^o \cdot Q^o \]

Total sales increment \( \Delta(PQ) \)

\[ + \Delta L_c^o + \Delta L_{ci}^o + \Delta L_{cg}^o + \Delta S L^o \]

Labor cost increment \( \Delta L_c \)

\[ + \Delta P_r^o + \Delta P_{rg}^o + \Delta P_{ri}^o \]

Profit increment \( \Delta P_r \)

\[ + \Delta B_{rn}^o + \Delta B_{rg}^o + \Delta B_{re}^o + \Delta B_{ry}^o + \Delta S^o \]

security market volume increment \( \Delta B \)

\[ + \Delta T^o \]

Tax increment

\[ + \Delta A^o \]

Asset increment

\[ + \Delta I_{gn}^o \]

State owned co investment increment by government

Let \( Y = LC + P_r + B + T + A_i + I_{gi} \) denote the yield. The money supply is equal to total income increment plus available loan and reserve increment. Equation can be written in short:

\[ M' = \Delta(PQ)^o + \Delta Y^o + \Delta AR' \quad \text{or} \quad M'_1 = \Delta(PQ)^o + \Delta Y^o. \]

Compared with monetary exchange equation \( MV = PQ \) by Irving Fisher in 1911 [Fis11], it is evident that its foundation is not enough. Except for total income increment of the year, last year’s total income is supported by existing money in the system. Furthermore, the velocity of money has no direct connection with money supply, because money owner can only use their money once.

Inflation rate and economy growth calculation. By changing monetary equation into another form, the relationship among money supply, all sales, inflation rate and economic growth will surface. Dividing both sides of monetary equation with total sales \( P^oQ^o \) and reorganizing it we get inflation rate and the economy growth formula:

\[ \frac{\Delta P}{P} + \frac{\Delta Q}{Q} = \frac{M' - \Delta AR' - \Delta Y^o}{P^oQ^o} \quad \text{or} \quad \frac{\Delta P}{P} + \frac{\Delta Q}{Q} = \frac{M'_1 - \Delta Y^o}{P^oQ^o}. \]
The formula above tells that inflation rate plus growth equals new issued money minus available loan and reserve increment and yield increment divided by total sales of last year. Actually in the article “Relationship Between the Money Supply and Inflation” [FMI12] already got close conclusion with the formula above: The perception relationship between money supply and inflation should take economic growth into consideration.

**Interest rate calculation in closed economy.** By summing up the balance sheets of four subsystems (H, G, E, I), the relationship among economy growth, total loan and deposit of the term, accumulative total loan and deposit of last term, difference value between loan and deposit interest rate, time limit of loan and loan interest rate is uncovered. The reasonable loan interest rate in a closed economy setting can be calculated with the formula below:

\[
i_t = \frac{TL' - TD'}{ATL_o - ATD_o} - \frac{TL' / K + wTD_o}{ATL_o - ATD_o} - \frac{Q'((PQ)^o + Y^o)}{ATL_o - ATD_o}.
\]

Here \(TL\) and \(TD\) are the total loan and deposit of this term respectively, \(ATL\) and \(ATD\) are accumulative total loan and deposit of last term resp., \(K\) is the time limit of the loan and \(w\) represents the difference value of loan and deposit interest rate.

In Taylor’s monetary and policy rule, interest rate responses to changes in inflation and output [Tay93]. The formula above provides a more close approach by taking new issued money into consideration.

**Exchange rate calculation in open economy.** Adding merchandise trading amount of export and import and capital flows in and out of the country to subsystem’s balance sheet of closed economy, we get subsystems’ balance sheets of open economy. By summing up five subsystems’ balance sheets in an open economy setting, the relationship among supply, economy growth, export of last term, import of this term, surplus of capital flow and exchange rate will appear. We can calculate the exchange rate from the formula below:

\[
Re = \frac{M_1' - Q'(P^oQ^o + Y^o)}{(1 + Q')IM^o - EX^o - S^o_c},
\]

where \(Re\) means exchange rate, \(IM\) represents import, \(EX\) denotes export and \(S\) means capital flow surplus. OANDA only listed top 5 factors affecting exchange rate: interest rate, employment outlook, economic growth expectation, trade balance and central bank action [OA]. The formula also expounded the mathematical relationship among these factors.

8.2 Applications of Simultaneous Equation

The impacts of one variable to others. As the I-O model, simultaneous equation can be used to study the economic impacts of one variable change on others [Mou00]. Actually, if we take \(M_1'\) as a variable, the equation is a homogeneous system. Its solutions can be expressed with any one of six variables. So we can study the economic impacts on the other five variables caused by on variable change.

Economic simulating experiment. The simultaneous equation can be used to do economic simulating experiment. Input different set of macroeconomic control instruments like \(M_1', \beta_i\) and \(t\) (tax rate) with controlled level of inflation \(\Delta p\) and expected target of growth \(\Delta Q\) together into simultaneous equation, we can get different set of \(x_{ij}\). According to the desired economic state \((x_{ij})\), economy reality and feasibility of the instruments, policy maker can opt one set of macroeconomic control instrument \((M_1', \beta_i, t)\) and put them into practice.

Reasons for stagnation. After the stagnation happened, the transaction variables \(x_{ij}^o\) in the period of economy crisis and \(x_{ij}'\) in the period of stagnation are all known. Rewrite simultaneous equation, the inflation rate \(\Delta P/P\), subsystems’s actual growth \((\Delta Q_h/\Delta Q, \Delta Q_o/\Delta Q, \Delta Q_e/\Delta Q, \Delta Q_i/\Delta Q)\) can be solved.
\[\begin{align*}
x_{21}^o + x_{31}^o + x_{41}^o + x_{51}^o &= (1 + \frac{\Delta P}{P} + \frac{\Delta Q_h}{Q_h}) (x_{12}^o + x_{13}^o + x_{14}^o) + x_{15}' \\
x_{12}^o + x_{32}^o + x_{42}^o + x_{52}^o &= (1 + \frac{\Delta P}{P} + \frac{\Delta Q_g}{Q_g}) (x_{21}^o + x_{23}^o + x_{24}^o) + x_{25}' \\
\left[1 - \frac{\lambda}{1-\lambda} \left(\frac{\Delta P}{P} + \frac{\Delta Q_e}{Q_e}\right)\right] (x_{i3}^o + x_{i2}^o + x_{i4}^o) + x_{i5}' &= (1 + \frac{\Delta P}{P} + \frac{\Delta Q_e}{Q_e}) (x_{31}^o + x_{32}^o + x_{34}^o) + x_{35}' \\
x_{14}^o + x_{24}^o + x_{34}^o + x_{54}^o &= (1 + \frac{\Delta P}{P} + \frac{\Delta Q_i}{Q_i}) (x_{41}^o + x_{42}^o + x_{43}^o) + x_{45}'
\end{align*}\]

To show how to use the equation above, we use the hypothetical \(x_{ij}^o\) and \(x_{ij}'\), \(i = 1, \ldots, 4\). Reallocation total loan with \(\varepsilon_1(.1), \varepsilon_2(.4), \varepsilon_3(.35), \varepsilon_4(.15)\), and get

\[x_{51}' = .21584M_1', x_{52}' = .86336M_1', x_{53}' = .75544M_1', x_{54}' = .32376M_1'.\]

Plug those known values \((x_{ij}^o, x_{ij}')\) into the equation we get:

\[\frac{\Delta P}{P} + \frac{\Delta Q_h}{Q_h} \approx .17, \quad \frac{\Delta P}{P} + \frac{\Delta Q_g}{Q_g} \approx .57, \quad \frac{\Delta P}{P} + \frac{\Delta Q_e}{Q_e} \approx .22, \quad \frac{\Delta P}{P} + \frac{\Delta Q_i}{Q_i} \approx .15.\]

By the try and error method, we will obtain

- Inflation rate \(\frac{\Delta P}{P} = 28\%\)
- Household real consumption growth \(\frac{\Delta Q_h}{Q_h} = -11\%\)
- Government consumption growth \(\frac{\Delta Q_g}{Q_g} = 29\%\)
- Enterprise real production growth \(\frac{\Delta Q_e}{Q_e} = -6\%\)
- Invest real growth \(\frac{\Delta Q_i}{Q_i} = -13\%\)
Therefore on the basis of economic crisis, government’s stimulating measures are the reason for stagnation. This conclusion provides a theoretical support to some existing deduction [CSM11].

9 Conclusions

We summarize below the main results and observations in this paper. Making use of balance sheets, we solve fundamental macro-economic issue.

- Monetary equation: 
  \[ M' = \Delta(PQ)^o + \Delta Y^o + \Delta AR'. \]

- Inflation rate and economy growth formula: 
  \[ \frac{\Delta P}{P} + \frac{\Delta Q}{Q} = \frac{M' - \Delta AR^o - \Delta Y^o}{P^o Q^o}. \]

- Interest rate formula: 
  \[ i_t = \frac{TL' - TD'}{ATL^o - ATD^o} - \frac{TL^o/K + wTD^o}{ATL^o - ATD^o} - \frac{Q'((PQ)^o + Y^o)}{ATL^o - ATD^o}. \]

- Exchange rate formula: 
  \[ Re = \frac{M' - Q'(P^o Q^o + Y^o)}{(1 + Q')IM^o - EX^o - S_c'}. \]

Applying simultaneous equation, we can do economic simulating experiment on computer, to provide scientific basic for macro economy management. We also see that government’s stimulating measures in economic crisis are the reason for stagnation.
References


