# CHAPTER 1

# INTRODUCTION

- **Macroeconomics** is a branch of economics that studies the economic variables of an economy as a whole.
- **Difference between Microeconomics and Macroeconomics**

| Points of Difference | Microeconomics | Macroeconomics |
|---|---|---|
| 1. Study matters | It studies about individual economic units like households, firms, consumers, etc. | It studies about an economy as a whole. |
| 2. Deals with | It deals with how consumers or producers make their decisions depending on their given budget and other variables. | It deals with how different economic sectors such as households, industries, government and foreign sector make their decisions. |
| 3. Method | It uses the method of partial equilibrium, i.e. equilibrium in one market. | It uses the method of general equilibrium, i.e. equilibrium in all markets of an economy as a whole. |
| 4. Variables | The major microeconomic variables are price, individual consumer's demand, wages, rent, profit, revenues, etc. | The major macroeconomic variables are aggregate price, aggregate demand, aggregate supply, inflation, unemployment, etc. |

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|---|---|---|---|
| 5. | Theories | Various theories studied are:<br>1) Theory of Consumer's Behaviour and Demand<br>2) Theory of Producer's Behaviour and Supply<br>3) Theory of Price Determination under Different Market Conditions | Various theories studied are:<br>1) Theory of National Income<br>2) Theory of Money<br>3) Theory of General Price Level<br>4) Theory of Employment<br>5) Theory of International Trade |
| 6. | Popularised by | Alfred Marshall | Keynes |

- **Partial equilibrium**

  It refers to equilibrium in one market, assuming that there is no change in other markets for example, while analysing the equilibrium of an individual producer (optimising his/her cost of production), we assume that there exists no change in other markets like labour and capital markets. And consequently, wage rate and interest rate are held constant. It is the method of study in microeconomics.

- **General equilibrium**

  General equilibrium is the method to study equilibrium in different markets simultaneously. It is the method of study in macroeconomics.

- **Economic agents**

  Those individuals or institutions which take economic decisions and optimising their resources by solving their choice problems in a rational manner are called economic agents. For example, producers, consumers, government, banks etc.

- **Adam Smith** who is known as the father of modern economics is associated with classical school of economic thoughts.

- **Emergence of Macroeconomics**

  The Great Depression was a severe economic crisis that started in the year 1929. It originated in the United States of America with the crash of the stock market and gradually spread to other countries of the world. The main cause behind this crisis was the fall in aggregate demand due to under consumption and over investment.

- **The cause and effect relationship of the Great Depression can be summed up in this flow chart**

  **Low demand → overinvestment → low level of employment → low level of output → low income → low demand.**

- The Great depression led to the failure of classical approach and paved the way for emergence of Keynesian approach.

- **Difference between Classical and Keynesian School**

| Classical School | Keynesian School |
|---|---|
| 1. Classical economists advocated for free economy where resources are fully utilised and the economy automatically reaches to a state of full employment equilibrium. | Keynesian economists believed there always exist certain level of unemployment which would not disappear automatically and hence calls for government regulations. |
| 2. These economists were strong proponents of market and did not believe in state intervention. | 2. These economists strongly believed in state intervention to generate employment opportunities |
| 3. The Classical school of thought prevails in the long run. | 3. This Keynesian school of thought dominates in the short run. |

- **Capitalist economy (or *laissez-faire*)**
  - The role of the government is limited.
  - The economy is driven by the motive of profit maximisation
  - The central problems of an economy are solved by the market forces of demand and supply.
  - There is a dominant role of private individuals in taking important economic decisions like, productions etc.

- **Four sectors of the economy**