UNIT-I

INTRODUCTION

CHAPTER 1

INTRODUCTION TO MACROECONOMICS

Economic decisions of individual households or firms are guided by their rational behaviour in a given market situation. Here, in our pursuit to study the logic of consumption or production decision, we limit our analysis to the determinants of choice and preferences of households or firms, respectively. Though the study of individual decision units is a necessary aspect of our enquiry into the rationale of their economic behaviour, it is by no means a sufficient condition for a complete study. So, there has to be another level of study in which the enquiry is directed to understand the general economic conditions in the economy. It is this distinction between the exercises to understand and interpret the behaviour of individual units on the one hand and the general state of the economy on the other establishes the basic difference between the subject matter of microeconomics and macroeconomics.

Now, what is macroeconomics all about? In simple terms it is the study of the economy as a whole. Everyone is interested in knowing what is happening in the economy. Perhaps, it is the concern about the rate of inflation, level of unemployment, decline in the agricultural and industrial output, fluctuations in business activities, accumulation of foreign exchange reserves, capital market changes, recession in the world economy and so on.

These are macroeconomic events that engage the attention of governments, economists, entrepreneurs and even ordinary people, as all of them receive the impact of these macroeconomic events. To understand the forces behind the overall economic performance, we need concepts and theoretical frameworks and empirical measurements to assess performance in the given reference year. The subject of macroeconomics accomplishes this objective.

Macroeconomic concepts are not often simple and direct; on the contrary, in microeconomics concepts such as price, profit, cost, quantity, etc. are intuitive and easy to understand. So, there is nothing difficult in comprehending a basket of apples as an output and its price. But in macroeconomics, we have a variety of problems in the stage of definition itself. While it is relatively easy to define and measure individual's income, it is not so in the case of aggregate income and output. The scope of macroeconomics could be further made clear if we attempt to distinguish it from microeconomics.

Microeconomics and Macroeconomics

In microeconomics we study the individual household, individual firm or small groupings of firms. If we study one automobile firm or the automobile industry it is microeconomic approach; but when we take up the entire manufacturing sector, we are in the area of macroeconomics. In this sense, macroeconomics studies the aggregates of an economic system. We need to make a separate study of these economic aggregates because what is true at the individual level need not be true at the aggregate level.

Just imagine a case wherein a single farmer produces paddy or wheat. In terms of individual rationality, this farmer has to produce as much output as possible to reach the maximum level of profit. This is perfectly logical insofar as an individual farm is concerned. But, what if all the farmers produce maximum output in their respective farms? For the economy as a whole, this would create more problems than good. There may be excess supply of paddy or wheat relative to demand. Government will have to intervene, as it happens in India, to take away a part of the output to prevent prices falling to an unremunerative level for the farmers. Therefore, what is a good and proper decision at the individual level need not be so at the aggregate level. It is to understand this difference that a separate study of economic aggregates is designed in macroeconomics.

Given all the aggregates such as total employment, output, income, etc. it is essential to find the interrelationship between them. Does an increase in national output mean an increase in employment? Can the value of foreign exchange rate be fixed in terms of domestic country's prices? We will obtain meaningful explanations for the working of the economy only if we systematically work out the interrelationships between the aggregates. Hence, it is said that macroeconomics is also the study of relations between economic aggregates. Basically, macroeconomics is concerned with aggregate level of output, income and spending for all goods and services.

In contrast, microeconomics deals with output of individual firm and with the spending by a single household. Microeconomics is primarily concerned with the allocation of resources by a single firm or household.

Whatever microeconomics takes as given is what macroeconomics considers as the prime variable, whose size and value are to be determined. Alternatively, what microeconomics takes as variable is considered to be given in macroeconomics. For instance, aggregate output of the economy is taken as given in microeconomics but in macroeconomics aggregate output is an important variable. Similarly, macroeconomics takes the distribution of output, for example, as given, but in microeconomics it is an important variable.

Consider our example of a farmer given earlier. An individual farmer is hardly conscious of the aggregate output of paddy or wheat. He is primarily concerned with his own output in his farm. Similarly, when government decides its policy of procurement, it considers only the state of the aggregate output of paddy or wheat and not that of any individual farmer. The same thing is true of a single manufacturing firm as against the aggregate manufacturing output.

Although microeconomics and macroeconomics areas seem to be rigidly distinct, it is not always so in practice. Both areas of economic analysis are interdependent. We seek to explain economic behaviour of individual units in the context of the state of the economy.

That is, a microeconomic decision by an individual unit has to necessarily have a macroeconomic context. The consumption plans of households for instance cannot be independent of the taxation of personal income and commodities. Similarly, microeconomic variables may exert their influence on macroeconomic variables. For instance, aggregate savings and investment are usually influenced by or a function of the pattern of savings at the micro level, namely households and firms. Therefore, micro and macroeconomic analyses are not mutually exclusive categories. Each of them attempts to focus its attention on one aspect that the other does not. *While it is the price system and resource allocation that occupies the centre stage in microeconomics, the twin areas of income determination and stabilisation and growth of the economy form the core of macroeconomics.* In such a context, there is an inevitable interlink between these two major branches of economics.

Which branch of economics assumes primacy and receives maximum attention of economists depends on whether we need a study of the 'part' or the 'whole'. Individual rationality in economic behaviour is an important area of study insofar as we are concerned with demand and supply forces in the market. On the other hand, in the formulation of policies for arresting fluctuations in the economy's performance and for attaining higher growth, macro analysis assumes its importance.

Emergence of Macroeconomics

Interest in macroeconomics deepened after the emergence of the 'Keynesian Revolution'.[1] In the pre-Keynesian economic theory there was no recognition of 'economic crises'. This is because the Classical economics, which was the ruling doctrine then, did not provide an explanation for a major

[1] John Maynard Keynes published the book *General Theory of Employment, Interest and Money* (Macmillan: London, 1936) in which he questioned the basis of the then existing macroeconomics of the Classical School.

setback to the economy. Classical economists strongly believed in the 'automatic adjustment' of the markets so that the system will always be in equilibrium, and that the 'shocks' (that is, disturbances in markets) are only temporary. This contention of the Classical economists was challenged when the Great Depression occurred in 1929. The system failed to automatically correct the crisis situation and therefore the failure of the Classical doctrine paved the way for Keynesian theory. This is the starting point of the present day macroeconomic approach, which is applied extensively in policy-making. There are many variants of Keynesian approach as the subject of macroeconomics evolved since Keynes' contribution.

We may now embark upon learning macroeconomics, concentrating on the Keynesian approach to the structure and working of the macro economy.

EXERCISES

1. What is microeconomics?
2. What do you understand by macroeconomics?
3. Distinguish between micro and macroeconomics.
4. Give examples of macroeconomic variables.