**CHAPTER 1**

**Introduction to Macroeconomics**

**Points to be remembered:**

**Economy:** A system of providing living to people.

**Microeconomics:** Study of the behavior of individual, small, isolated and disaggregated units.

**Macroeconomics:** Study of groups and broad aggregates of the economy.

**Firm:** An individual producing unit.

**Industry:** A group of firms producing identical or closely related goods.

The term microeconomics and macroeconomics were first given by **Ragner Frisch** in 1933.

**Prof. J.M. Keynes** is known as father of modern macroeconomics.

Macroeconomics became popular after *great depression of 1929- 33*.

**Prof. J.M. Keynes** wrote the book ***General Theory of Employment, Interest and Money***in 1936.

**Meaning of Macroeconomics:**

The term macro has been derived from Greek word ‘*makros*’ which means *large*. It is the study of aggregates or groups or the entire economy such as gross domestic product, total employment, aggregate demand, aggregate supply, total savings, general price level, etc.

**Scope of Macroeconomics:**

Macroeconomics has a wider scope than microeconomics. The study of macroeconomics extends to the following areas:

* Theory of National Income;
* Theory of Employment;
* Theory of Money Supply;
* Theory of General Price Level;
* Theory of International Trade; and
* Theory of Economic Growth.

**Goals and Importance of Macroeconomics:**

* To Achieve Higher Level of Gross Domestic Product;
* To Achieve Higher Level of Employment;
* Stability of Prices;
* Formulation of Economic Policies; and
* Achievement of Economic Development.

**Tools of Macroeconomics:**

**Fiscal Policy:** relates to the management of government revenue, expenditure and debt to achieve favorable effects and avoid unfavorable effects on income, output and employment.

**Monetary Policy:** relates to the management of money supply and credit to step up business activities, promote economic growth, stabilize the price level, achievement of full employment and equilibrium in balance of payments.

**Income Policy:** through this policy direct control is exercised over prices and wages.

**Major Issues and Concerns of Macroeconomics:**

* Employment and Unemployment;
* Determination of National Income (or GNP);
* General Price Level and Inflation;
* Business Cycle;
* Stagflation;
* Economic Growth;
* Balance of Payments and Exchange Rate.

**Differences between Microeconomics and Macroeconomics:**

|  |  |  |
| --- | --- | --- |
| **Differences based on** | **Microeconomics** | **Macroeconomics** |
| 1. **Subject- matter:** | Small segments such as individual household, individual firm, individual price, etc. | Large aggregates such as aggregate demand, aggregate supply, national income, general price level, etc. |
| 1. **Use of techniques:** | Partial equilibrium analysis | General equilibrium analysis |
| 1. **Assumptions:** | Full employment in the economy | Underemployment of resources. |
| 1. **Core differences:** | Price is the main determinant of microeconomics. | Income is the main determinant of macroeconomics. |

Microeconomics and macroeconomics are interdependence.

**Post- Keynesian Developments in Macroeconomics:**

* Monetarism;
* Supply- side Economics;
* Rational Expectations Theory.

***Monetarism:***

Monetarists led by American economist Milton Friedman criticised Keynes’ macroeconomics and developed a new idea that monetary policy is the prime engine in causing fluctuations in economic activity by bringing about change in aggregate demand. He stressed that even the Great Depression of 1930s was primarily caused by tight monetary policy adopted at that time.

There are two differences (issues) between the monetarists and Keynesians. First issue or difference relates to the relationship between money supply and inflation. The second relates to the role of government in the economy.

Monetarists believe that inflation is always and everywhere a monetary phenomenon. According to them, inflation is caused by rapid expansion of money supply in the economy and suggest a constant growth rate of money supply to control inflation.

As Keynesians emphasize that active role should be played by the government to control business cycles and achieve economic stability. Like classical economists, monetarists also believe that free- market economy is inherently stable and if the economy departs from the state of full- employment, full- employment equilibrium is restored through automatic adjustments in it.

***Supply- Side Economics:***

The failure of Keynesians to deal with stagflation (high inflation with high rate of unemployment) led supply- side economics. Supply- side economists pointed out that it was supply- shocks, delivered among others by reduction in oil supplies and increase in oil prices that caused the problem of stagflation. As a result of contraction in supply due to the adverse supply shocks, given the aggregate demand curve, price level and inflation rate could rise on the one hand and aggregate output could fall giving rise to more unemployment on the other.

Supply- side economists suggest that for the expansion in aggregate supply and thereby increase in employment opportunities, incentives to work, save and invest more were required to be promoted.

***New Classical Macroeconomics or Rational Expectation Theory:***

New classical macroeconomics also opposed to Keynesian macroeconomic theory and policy which focused on aggregate demand for goods and services. According to the new classical macroeconomic theory, consumers, workers and producers behave rationally to promote their interests and welfare. On the basis of their rational expectations, based on all the available information, they make quick adjustments in their behaviour. Therefore, according to the new classical macroeconomists or the profounder of rational expectation theory, involuntary unemployment cannot prevail.

A significant difference between the Keynesian theory and rational expectation theory may be noted here. In the Keynesian theory deficit in government budget leads to increase in aggregate demand and will therefore promote private investment. On the other hand, according to rational expectations theory, budget deficit will cause rate of interest to rise which will discourage private investment.

Like Friedman and other monetarists, supporters of rational expectations theory are opposed to the active role by the government.

**Questions for Review**

**Multiple Choice Questions with Answer:**

1. **Who is considered as father of modern macroeconomics?**

|  |  |
| --- | --- |
| a. Adam Smith | b. Prof. J. M. Keynes |
| c. Prof. J. N. Keynes | d. Alfred Marshall |

**2.** **Who wrote the book “*General Theory of Employment, Interest and Money*”?**

|  |  |
| --- | --- |
| a. Adam Smith | b. Prof. J. M. Keynes |
| c. Prof. J. N. Keynes | d. Alfred Marshall |

**3.** **The term *microeconomics* and *macroeconomics* were first given by -----------**

|  |  |
| --- | --- |
| a. Adam Smith | b. Prof. J. M. Keynes |
| c. Ragner Frisch | d. Alfred Marshall |

**4.** **The book “*General Theory of Employment, Interest and Money*” was published in----------**

|  |  |
| --- | --- |
| a. 1836 | b. 1936 |
| c. 1963 | d. None of these |

**5.** **Macroeconomics became popular after-------------**

|  |  |
| --- | --- |
| a. *Great depression of 1929- 33* | b. 1972-73 |
| c. 1996- 97 | d. 2006- 07 |

**6.** **The term ‘*macro’* has been derived from--------------**

|  |  |
| --- | --- |
| a. Greek word ‘*makros*’ which means *large* | b. English word ‘*makros*’ which means *large* |
| c. Greek word ‘*makros*’ which means *small* | d. French word ‘*makros*’ which means *large* |

**7. In macroeconomics, we study about ------------------**

|  |  |
| --- | --- |
| a. Theory of National Income & Employment | b. Theory of Money Supply & Price Level |
| c. Theory of International Trade & Eco growth | d. All of the above. |

**8. Which of the following is/are the goals of macroeconomics-----------**

|  |  |
| --- | --- |
| a. To Achieve Higher Level of GDP | b. To Achieve Higher Level of Employment |
| c. Stability of Prices | d. All of the above. |

**9. What are the tools of macroeconomics?**

|  |  |
| --- | --- |
| a. Monetary Policy | b. Fiscal Policy |
| c. Income Policy | d. All of the above. |

**10. The study of groups and broad aggregates of the economy is known as-----------**

|  |  |
| --- | --- |
| a. Microeconomics | b. Macroeconomics |
| c. International Economics | d. None of the above. |

**Ans:**

|  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| Ques | 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 | 9 | 10 |
| Ans. | b | b | c | b | a | a | d | d | d | b |

**Write *T* for True and *F* for False against each of the following statements:**

1.The term microeconomics and macroeconomics were first given by **Ragner Frisch** in 1933.

2. Prof. J.M. Keynes is known as father of modern macroeconomics.

3. Macroeconomics became popular after *great depression of 1929- 33*.

4. Prof. J. N. Keynes wrote the book *General Theory of Employment, Interest and Money* in 1936.

5. Price is the main determinant of macroeconomics.

6. Income is the main determinant of microeconomics.

7. Partial equilibrium analysis is used in macroeconomics.

8. General equilibrium analysis is applied in microeconomics.

9. Milton Friedman is monetarist.

10. Classical economists and monetarists emphasize that active role should be played by the government to control business cycles and achieve economic stability.

11. Keynesians believe in free- market economy.

12. Friedman and other monetarists as well as supporters of rational expectations theory are opposed to the active role by the government.

13. Microeconomics and macroeconomics are independent to each other.

**Ans:**

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| **Ques** | 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 | 9 | 10 | 11 | 12 | 13 |
| **Ans.** | T | T | T | F | F | F | F | F | T | F | F | T | F |

**Matching Test:**

|  |  |
| --- | --- |
| **Match- I** | **Match- II** |
| A. Father of Modern Macroeconomics | a. Milton Friedman |
| B. The term macroeconomics is given by | b. Prof. J. M. Keynes |
| C. Monetarist | c. Robert Lucas Jr. |
| D. Supply- side economist | d. Ranger Frisch |
| E. New Classical economist | e. Bruce Bartlett |

**Ans:**

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| **Match- I** | A | B | C | D | E |
| **Match- II** | b | d | a | e | c |

**Ques: What is macroeconomics?**

Ans: The term macro has been derived from Greek word ‘*makros*’ which means *large*. It is the study of aggregates or groups or the entire economy such as gross domestic product, total employment, aggregate demand, aggregate supply, total savings, general price level, etc.

**Ques: What are the scopes of macroeconomics?**

Ans: Macroeconomics has a wider scope than microeconomics. The study of macroeconomics extends to the following areas:

* Theory of National Income;
* Theory of Employment;
* Theory of Money Supply;
* Theory of General Price Level;
* Theory of International Trade; and
* Theory of Economic Growth.

**Ques: what are the main objectives/goals of macroeconomics?**

Ans: Followings are the main objectives or goals of macroeconomics:

* To Achieve Higher Level of Gross Domestic Product;
* To Achieve Higher Level of Employment;
* Stability of Prices;
* Formulation of Economic Policies; and
* Achievement of Economic Development.

**Ques: What are the main tools of macroeconomics?**

Ans: **Fiscal Policy:** relates to the management of government revenue, expenditure and debt to achieve favorable effects and avoid unfavorable effects on income, output and employment.

**Monetary Policy:** relates to the management of money supply and credit to step up business activities, promote economic growth, and stabilize the price level, achievement of full employment and equilibrium in balance of payments.

**Income Policy:** through this policy direct control is exercised over prices and wages.

**Ques: What are the major issues and concerns of macroeconomics?**

Ans: The major issues and concerns of macroeconomics are as follows

* + Employment and Unemployment;
  + Determination of National Income (or GNP);
  + General Price Level and Inflation;
  + Business Cycle;
  + Stagflation;
  + Economic Growth;
  + Balance of Payments and Exchange Rate.

**Ques: What are the main differences between microeconomics and macroeconomics?**

Ans: The main differences between microeconomics and macroeconomics are as follows:

|  |  |  |
| --- | --- | --- |
| **Differences based on** | **Microeconomics** | **Macroeconomics** |
| 1. **Subject- matter:** | Small segments such as individual household, individual firm, individual price, etc. | Large aggregates such as aggregate demand, aggregate supply, national income, general price level, etc. |
| 1. **Use of techniques:** | Partial equilibrium analysis | General equilibrium analysis |
| 1. **Assumptions:** | Full employment in the economy | Underemployment of resources. |
| 1. **Core differences:** | Price is the main determinant of microeconomics. | Income is the main determinant of macroeconomics. |