Introduction

Introduction to Macroeconomics and Emergence

Objectives

After going through this chapter, you shall be able to understand the following concepts.

- Introduction to Macroeconomics
- Need to Study Macroeconomics
- Emergence of Macroeconomics and The Great Depression of 1929
- Classical School of Thoughts *versus* Keynesian School of Thoughts
- Macroeconomics *versus* Microeconomics

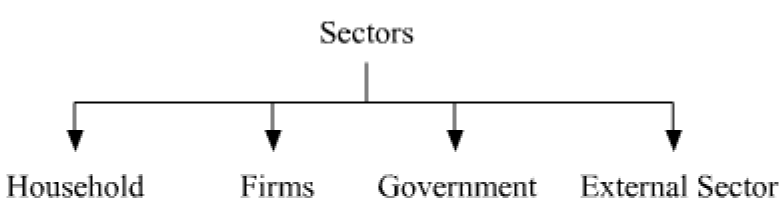
Introduction to Macroeconomics

The word 'Macro' comes from the Greek word '*Makros*' which means 'large'. In terms of economics, macroeconomics is concerned about the large sections of the economy or the economy as a whole. It is that branch of economics, which deals with the economics activities by all the economic spheres, varying economic situations and economic problems for the economy as a whole.

Unlike, microeconomics, macroeconomics does not study only one individual consumer or one individual producer, in fact, macroeconomics studies the behaviour, problems and economic situation of all the consumers at a time. In other words, it can be said that macroeconomics involves aggregation of all the consuming units.

Although there exists a considerable difference in the domain of these two branches, but they are complementary to each other. It can be said that macroeconomics uses the principle of microeconomics as its foundation and the former is a magnified version of the latter.

From the macroeconomics point of view, the economy can be divided into four major sectors-



Households- Households refer to a single individual/group of individuals who is/are the consumers of goods and services. Households are also the owners of factors of production (such as land, labour, capital and entrepreneur) and render their services in the production process in exchange of factor incomes (rent, wages, interest and profit).

Firms- Firms refer to the economic units that undertake the production process. They hire and employ the factors of production from the households and make payments to them in return of the factor services received.

Government- Similar to the firms, the government also participates in the production process. They employ factors of production from the households and makes payments to them in return of their services. The government receives payment from both the firms and the households in the form of taxes (direct taxes and indirect taxes).

It also makes payment to the households in the form of transfer payments (payments made without use of factor services) such as pensions, scholarships, etc. Similarly, it also makes payments to the firms in the form of subsidies (compensation to firms for lowering the prices).

Some of the important functions of government is to provide administrative services and to maintain law and order in an economy. In addition to this, government also ensures maintaining steady and consistent economic growth and stability by investing adequately in the social sectors such as education, health, heavy industries, etc.

External sector- This sector deals with the exports and imports of goods and services. If a country sells goods to the rest of the world (ROW), then it is known as exports. On the other hand, if the country purchases goods and services from the rest of the world (ROW), then it is known as imports. The exports and imports of goods and services can be by households, firms, government.

Macroeconomics studies Interlinkages among Economic Sectors

Macroeconomics not only studies different economic sectors, but also aims at focusing the interlinkages that exist among these sectors. Interlinkages basically imply the relationship or dependency among these economic sectors. For example, households and firms are interrelated, in a sense that households provide factors of production such as land, labour, etc. to the firms.

The firms in turn employ these factors to produce goods and services and in return make payments to the household sector in exchange of their services in the production process.

The households spend their income (payment received from the firms) for purchasing finished goods and services of the firms. Such forms of interrelationship or dependency is termed as interlinkages.

Emergence of Macroeconomics

The need for a separate branch of economics, i.e. macroeconomics was felt inevitable during the period of 'The Great Depression- 1929'. In this regard, The Great Depression can be treated as a landmark for the emergence of macroeconomics. Before, the advent of the great depression, the subject matter of Economics was only limited to Microeconomics. This was dominated by the Classical School of Economic thoughts.

Classical School of Economic Thoughts

This was popularized by the economists Adam Smith and David Ricardo. They advocated for a *laissez-faire* economy that is, no/minimum government intervention in the economic activities. In other words, they believed in a free-market economy.

They asserted that in a free-market economy, there always exists full employment of factors and if any unemployment exists, then it will be automatically corrected by the market forces (that is, demand and supply).

As per the Classicals, the role of the government is limited only to provide security (defence) services and to maintain law and order in the economy.

The Classicals bilindly believed on the markets and chanted their assumption by popularising, "Supply creates its own demand"- also known as Say's Law. This statement implies that whatever is produced by the producers, there is always a demand for it. That is, in other words, market can absorb anything and everything that is being produced.

However; during The Great Depression, the classical assumptions broke down and their paradigm was shattered. The Great Depression paved the path for the emergence of macroeconomics. This was due to the inability of the Classicals' thought to explain the prolonged unemployment and failure of market in the economy. Let us now learn what was Great Depression.

Great Depression

The Great Depression was a severe economic crisis that started in the year 1929, with the crash of stock market in U.S.A. and gradually spread to other parts of the world. The main factor that triggered great depression was an acute fall in the level of aggregate demand. The fall in the aggregate demand was due to continuous squeezing of wages by the capitalists.

The capitalists in the blind rage of earning increased profits continuously reduced the wages of the labourers. This implies that people are left with lesser income to purchase goods and services. This led to the fell in the aggregate level of purchasing power, thus, lowered aggregate demand. Due to the reduced demand, the capitalists experienced accumulation of huge stock of unsold finished goods. As result, the profits of the capitalist fell and lesser amount available for reinvestment.

The capitalist responded by lowering the employment of factors and also started laying-off labourers. This in turn reduced the employment level and aggregate income level in the economy also fell. Thus, there was a vicious circle of low income level and low aggregate demand.

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

Low Demand → Overinvestment (in terms of accumulated unsold stock of finished products)→ Low Prices (to increase sales)→ Low Profit → Low level of Employment → Low level of Income → Low Demand.

In fact, it was found that during the period 1929 to 1933, the aggregate output fell by 33% and the unemployment rate (the % of total labour force that are willing and able to but are not getting work) rose to 25%. This chain of events led to the undermining the classical theory, thus, emerged the new school of thought– "The Keynesian School of Thought".

The Great Depression has its own implications and importance in economics, as it proved the failure of the Classical Approach. It was this incident that provided the economists with sufficient evidence to recognise macroeconomics as a separate branch of economics.

Keynesian School of Thoughts

It was popularised by John Maynard Keynes. He advocated for government intervention and suggested government to invest heavily so as to create new employment opportunities and to pull the economy out of the low level of income and demand. He propounded the slogan, "Dig earth and fill the pits".

During the Great Depression, the classical theory of full employment failed and there was massive unemployment.

To this, Keynes argued that an economy can never operate at full employment level.

He also opposed *laissez-faire* and advocated that government must intervene. Let us now distinguish the two ideologies.

Difference between Classical and Keynesian School of Thoughts

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 exists 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.
4. This was advocated by economists such as Adam Smith and David Ricardo.	4. This was advocated by economist, John Keynes.

From Micro to Macroeconomics

The following are the some of the most often terms, which although are same, but have different meaning in context of macroeconomics.

1. Firms- Unlike microeconomics, where firms imply an individual production unit operating under an industry, in macroeconomics, the term 'firms' is used for collection of all the production units within an economy. Often, the use of word 'Industry' is avoided, as it is synonymous to 'firms'.

2. Price- In microeconomics, price means price of a single commodity or market price (total market price) of the ***same commodity*** produced by the different firms in the same industry, for example, price of tea or market price of tea produced by different firms under the tea industry.

On the other hand, in macroeconomics, price always implies the aggregate price. That is, price of all the commodities produced by different industry of an economy.

For example, price in macroeconomics means price of tea + price of coffee+ price of shoes+ price of clothes+ price of food+.......etc. In other words, price implies aggregate or ***general price level***.

3. Income- On the contrast to microeconomics, where income implies money income of an individual consumer, in macroeconomics, income implies National Income. That is, aggregate income of the all the individuals in an economy.

Domain and Subject Matter of Macroeconomics

In Macroeconomics, we study how an economy as a whole operates. It focuses on the aggregate measures such as, Aggregate Demand, Aggregate Supply, Aggregate Price Level, etc. It studies how these variables are determined and how they change over time.

It helps us in understanding various economic relationships and economic problems at the economy or aggregate level. It is also known as the *Theory of Income and Employment* as its main focus is on how income and employment levels are determined.

In Macroeconomics, we confront major problems such as poverty, unemployment, inflation, BOP disequilibrium, etc. The following are the important Macroeconomic theories.

1. Theory of National Income (***Chapter-2***)
2. Theory of Employment (***Chapter-4***)
3. Theory of Money (***Chapter-3***)
4. Theory of General Price Level (***Chapter-4***)
5. Theory of International Trade (***Chapter-6***)
6. Theory of Taxation, Budget, Government Deficit and Fiscal Policy. (***Chapter-5***)
7. Theory of Economic Growth **