CHAPTER 1

BASIC CONCEPTS OF MICRO AND MACRO-ECONOMICS

1.1. Introduction

The various problems studied under Economics can be divided into two broad groups. One group of problems relates to the study of national income — its size and distribution as between different social classes (such as workers, capitalists, etc.), growth of national income and its fluctuations over time. The branch of Economics dealing with these problems is known as *Macroeconomics*. The major questions discussed in macroeconomics are : what determines the level of national income in a country during any given time period? Why does the national income or output remain at a low level ? Is it due to the limited availability of economic resources ? Or, is it due to the underutilisation of the available resources ? What factors are responsible for the unemployment or underemployment of resources in a country ? What are the causes of fluctuation in the national output over time ? What are the reasons behind inflation and deflation ? Macroeconomic theories try to answer these questions.

The other group of problems relates to the composition of national output. What factors govern the composition of national output, or the types of goods and services produced in a country during any given period ? What governs their relative prices ? How are the prices of factors of production determined ? The branch of Economics that deals with these questions is called *Microeconomics*. Thus, the principal problems studied under microeconomics relate to the allocation of resources of the economy as between the production of different goods and services, and the determination of prices of goods as well as factors of production. Here, the units of our study are 'small', viz., the price and quantity of individual commodities, the behaviour of individual firms or consumers, etc. In macroeconomics, on the other hand, the units of our study are 'large', viz., the size of national output, the level of unemployment, the general price level, etc.

1.2. Branches of economics

Economic theory, as it stands today, has several branches. Of these, two are most important. These are *microeconomics* and *macroeconomics*. We shall now briefly mention the major features of these two branches.

1.2.1. Microeconomics

Microeconomics is that branch of economics which is concerned with the decision-making of a single unit of an economic system. How does an individual (or a family) decide on how much of various commodities and services to consume ? How does a business firm decide how much of its product (or products) to produce ? These are the typical questions discussed in microeconomics. Determination of income, employment, etc., in the economic system as a whole is not the concern of microeconomics. Thus, microeconomics can be defined as the study of economic decision-making by micro-units.

1.2.2. Usefulness of microeconomics

(1) **Determination of demand pattern :** The study of microeconomics has several uses. It determines the pattern of demand in the economy, i.e., the amounts of the demand for the different goods and services in the economy, because the total demand for a good or service is the sum total of the demands of all the individuals. Thus, by determining the demand patterns of every individual or family, microeconomics determines the demand pattern in the country as a whole.

(2) **Determination of the pattern of supply :** In a similar way, the pattern of supply in the country as a whole, can be obtained from the amounts of goods and services produced by the firms in the economy. Microeconomics, therefore, determines the pattern of supply as well.

(3) **Pricing :** Probably the most important economic question is the one of price determination. The prices of the various goods and services determine the pattern of resource allocation in the economy. The prices, in turn, are determined by the interaction of the forces of demand and supply of the goods and services. By determining demand and supply, microeconomics helps us in understanding the process of price determination and, hence, the process of determination of resource allocation in a society.

(4) **Policies for improvement of resource allocation :** As is well-known, economic development stresses the need for improving the pattern of resource allocation in the country. Development policies, therefore, can be formulated only if we understand how the pattern of resource allocation is determined. For instance, if we want to analyse how a tax or a subsidy will affect the use of the scarce resources in the economy, we have to know how these will affect their prices. By explaining prices and, hence, the pattern of resource allocation, microeconomics helps us to formulate appropriate development policies for an underdeveloped economy.

(5) **Solution to the problems of micro-units :** Finally, it goes without saying that, since the study of microeconomics starts with the individual consumers and producers, policies for the correction of any wrong decisions at the micro-level are also facilitated by microeconomics. For example, if a firm has to know exactly what it should do in order to run efficiently, it has to know the optimal quantities of outputs produced and of inputs purchased. Only then can any deviation from these optimal levels be corrected. In this sense, microeconomics helps the formulation of policies at the micro-level.

1.2.3. Limitations of microeconomics

However, microeconomics has its limitations as well :

(1) Monetary and fiscal policies : Although total demand and total supply in the economy is the sum of individual demands and individual supplies respectively, the total economic picture of the country cannot always be understood in this simplistic way. There are many factors affecting the total economic system, which are outside the scope of microeconomics. For example, the role of monetary and fiscal policies in the determination of the economic variables cannot be analysed completely without going beyond microeconomics.

(2) Income determination : Microeconomics also does not tell us anything about how the income of a country (i.e., national income) is determined.

(3) Business cycles : A related point is that, it does not analyse the causes of fluctuations in national income. The ups-and-downs of national income over time are known as *business cycles.* Microeconomics does not help us in understanding as to why these cycles occur and what the remedies are.

(4) Unemployment : One of the main economic problems faced by an economy like India is the problem of unemployment. This, again, is one of the areas on which microeconomics does not shed much light. Because, if we are to find a solution to the unemployment problem, we must first understand the causes of this problem. For that, in turn, we must understand how the total employment level in the economy is determined. This is difficult to understand from within the confines of microeconomics.

1.2.4. Macroeconomics

Macroeconomics is that branch of economics which is concerned with the economic magnitudes relating to the economic system as a whole, rather than to the microeconomic units like individuals or firms. It has, therefore, been called 'aggregative economics'. In the picturesque language of Kenneth Boulding, "Macroeconomics deals .... not with individual income but with national income, not with individual prices but with the price level, not with individual outputs but with national output".

1.2.5. Importance of macroeconomics

Why is the study of macroeconomics important ? To put it briefly, macroeconomics deals with some of the questions untouched by microeconomics. The study of economics is, therefore, left incomplete, if we do not study macroeconomics. Some of the important issues analysed in macroeconomics are the following :

(i) Income and employment determination : The determination of national income and of total employment in the country are vital concerns of macroeconomics. Since the volume of unemployment is simply population minus the number of people employed, unemployment is determined as soon as the employment level is known.

(ii) Price level : The determination of the general price level is discussed in macroeconomic theories. Upward movement of the general price level is known as *inflation*. Thus, if we want to understand the process of inflation and find ways of controlling it, we must resort to the study of macroeconomics.

(iii) Business cycles : The economic booms and depressions in the levels of income and employment follow one another in a cyclical fashion. While income rises and employment expands during boom periods, they shrink during depressions. Since depressions bring business failures and unemployment in their wake, economists have sought remedies to depressions. Discussion of business cycles in general and anti-depression policies in particular, fall within the scope of macroeconomics.

(iv) Balance of payments : The balance of payments theory is also a part of macroeconomics. The difference between the total inflow and the total outflow of foreign exchange is known as the balance of payments of a country. When this balance is negative (i.e., outflow exceeds inflow), the country faces a lot of economic hardships. The causes and remedies of such balance of payments problems are discussed in macroeconomics.

(v) Government policies : The effects of various Government policies on the economic variables like national income or the general price level are also studied in macroeconomics. [It should be noted that, we are talking of the macroeconomic effects of Government policies. The effects of these policies on the micro-units (for instance, the effects of taxes on the output of an individual firm), are the subject-matter of microeconomics.] Since, the Government occupies an important position in any modern economic system, the analysis of these effects is of obvious importance.

(vi) Interrelations between markets : Probably, the most important contribution of macroeconomic theories is to show that different markets of the economic system (for example, the commodity market, the labour market, the bond market, the money market, etc.) are interrelated. Any disturbance in one of these markets affects all the others. (Again, it should be noted that, it is the interrelation between the macroeconomic markets that we are talking about here. The relationship between the markets of the individual commodities is the subject-matter of 'general equilibrium theory', which is a part of microeconomics).

Thus, we see that the study of microeconomics and that of macroeconomics are complementary to each other. The limitations of microeconomics are covered by macroeconomics. On the other hand, macroeconomics does not make a detailed study of the individual consumer or producer. This is taken care of by microeconomics. One can hope to form a comprehensive notion of what economics is all about only when one is acquainted with both microeconomics and macroeconomics.

1.2.6. Differences between Microeconomics and Macroeconomics

We can now indicate some of the important differences between Microeconomics and Macroeconomics. This is shown in Table-1 and Chart-1.

Table-1

Differences between Microeconomics and Macroeconomics

Microeconomics	Macroeconomics
1. It is that branch of economics which deals with the economic decision-making of individual economic agents such as the producer, the consumer, etc.	1. It is that branch of economics which deals with aggregates and averages of the entire economy, e.g., aggregate output, national income, aggregate savings and investment, etc.
2. It takes into account small components of the whole economy.	2. It takes into consideration the economy of any country as a whole.
3. It deals with the process of price-determination in case of individual products and factors of production.	3. It deals with the general price level in any economy.
4. It is known as price theory (since it explains the process of allocation of economic resources along alternative lines of production on the basis of relative prices of various goods and services.)	4. It is also known as the income theory (since it explains the changing levels of national income in any economy during any particular time period.)
5. It is concerned with the optimisation goals of individual consumers and producers (e.g., individual consumers are utility-maximisers, while individual producers are profit-maximisers.)	5. It is concerned with the optimisation of the growth process of the entire economy.
6. It studies the flow of economic resources or factors of production from any individual owner of such resources to any individual user of these resources, etc.	6. It studies the circular flow of income and expenditure between different sectors of the economy (say, between the firm sector and the household sector.)
7. Microeconomic theories help us in formulating appropriate policies for resource allocation at the firm level.	7. Macroeconomic theories help us in formulating appropriate policies for controlling inflation (i.e., rising price level), unemployment, etc.
8. It takes into account the aggregates over homogeneous or similar products (e.g., the supply of steel in an economy.)	8. It takes into account the aggregates over heterogeneous or dissimilar products (say, the Gross Domestic Product of any country during any year.)

Chart-1

Different branches of Economics

MICROECONOMICS	MACROECONOMICS
Individual decision-making and smaller components of the economy.	Decision-making at the national level and aggregate economic variables.
Individual income	National income
Individual consumption	Aggregate consumption
Individual savings	National savings
Individual investment	Aggregate investment
Output of an individual firm	National output
Output of an industry	Aggregate expenditure
Individual expenditure	
Price of any product/factor	General price level
Demand/supply of any product or a factor	Inflation and deflation
Employment/unemployment in any industry	Aggregate employment or unemployment
Export or import of a given product/factor	Aggregate exports and imports of a country