1 Introduction to Micro and Macro Economics

Let's recall :

You have already studied in Class XI, the meaning and definitions of economics given by different economists.

Fig. 1.1

Introduction :

Micro economics and Macro economics are the two main branches of modern economics. The term 'micro' is derived from the Greek word, 'Mikros' which means small or a millionth part. The term 'macro' is derived from the Greek word, 'Makros' which means large. These terms were coined by Norwegian Economist Ragnar Frisch of Oslo University in 1933.

Main Branches of Economics

Micro Economics | Macro Economics

Do you know?

Ragnar Anton Kittil Frisch (1895-1973),

a Norwegian econometrician and economist was a joint winner with Jan Tinbergen of the first Nobel Prize for Economics in 1969. He was a pioneer of econometrics- the application of mathematical models and statistical techniques to economic data and theories. He coined many economic terms. In an article on business cycles, Frisch was likely the first person to have referred to the study of individual firm and producer as "Microeconomics." Moreover, he referred to the study of the aggregate economy as "Macroeconomics."

You should know :

Historical review of Micro Economics :

Micro Economic analysis was developed first. It is a traditional approach. Origin of this approach can be traced back to the era of Classical Economists- Adam Smith, David Ricardo, J. S. Mill etc.

It was popularized by Neo-Classical Economist, Prof. Alfred Marshall in his book, 'Principles of Economics', published in 1890. Other economists like Prof. Pigou, J. R. Hicks, Prof. Samuelson, Mrs. Joan Robinson, etc. have also contributed to the development of Micro Economics.

Historical Review of Macro Economics :

Macro Economics did exist in the past before the evolution of Micro Economics. In the 16th and 17th century, followers of Mercantilists (a group of English merchants) advocated policies to the government which were based on macro approach. In the 18th century, Physiocrats (French Thinkers) tried to analyse the concept of national income and wealth. Even the Classical Economic theories of Prof. Adam Smith, Prof. Ricardo and Prof. J. S. Mill discussed the determination of national income and wealth. But their macro analysis was combined with micro analysis. Thus, micro analysis ruled the world of economics till the Great Depression of 1930s.

After the Great Depression, Lord John

Maynard Keynes published his famous book the "General Theory of Employment, Interest and Money" in 1936. Keynes used macro economic approch to analyse economic problems. The credit for the development of macro economic approach goes to Lord Keynes. Besides Keynes, Malthus, Wicksell, Walras, Irving Fisher are other economists who have contributed to the development of macro economics.

Meaning of Micro Economics :

Micro means a small part of a thing. Micro economics thus deals with a small part of the national economy. It studies the economic actions and behaviour of individual units such as an individual consumer, individual producer or a firm, the price of a particular commodity or a factor etc.

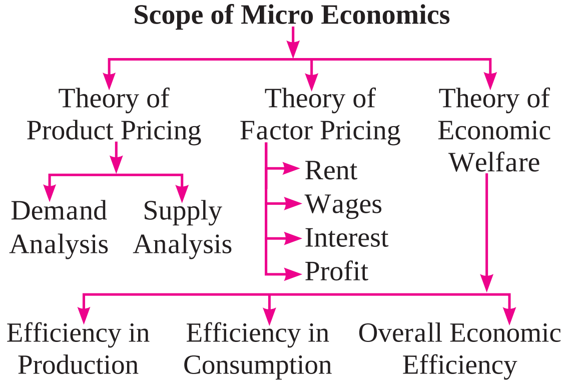
Definitions of Micro Economics :

You have already studied some important definitions of micro economics, let us review some more definitions :

1) Maurice Dobb - "Micro economics is in fact a microscopic study of the economy."
2) Prof A. P. Lerner - "Micro economics consists of looking at the economy through a microscope, as it were, to see how the millions of cells in the body of economy – the individuals or households as consumers and individuals or firms as producers play their part in the working of the whole economic organism."

The following chart gives an idea of the scope of micro economics.

Scope of Micro Economics



(a) Theory of Product Pricing : The price of an individual commodity is determined by the market forces of demand and supply. Micro economics is concerned with demand analysis i.e. individual consumer behaviour, and supply analysis i.e. individual producer behaviour.

(b) Theory of Factor Pricing : In Micro economics, land, labour, capital and entrepreneur are the factors that contribute to the production process. Micro economics helps in determining the factor rewards for land, labour, capital, and entrepreneur in the form of rent, wages, interest, and profit respectively.

(c) Theory of Economic Welfare : Theory of Welfare basically deals with efficiency in the allocation of resources. Efficiency in the allocation of resources is attained when it results in maximization of satisfaction of the people. Economic efficiency involves three efficiencies :

- Efficiency in production : Efficiency in production means producing maximum possible amount of goods and services from the given amount of resources.
- Efficiency in consumption : Efficiency in consumption means distribution of produced goods and services among the people for consumption in such a way as to maximize total satisfaction of the society.
- Overall economic efficiency : It means the production of those goods which are most desired by the people.

Micro economic theory shows under what conditions these efficiencies are achieved.

Thus, the focus of micro economics is mainly confined to price theory and resource allocation. It does not study the aggregates relating to the whole economy. This approach does not study national economic problems such as unemployment, poverty, inequality of income etc. Theory of growth, theory of business cycles, monetary and fiscal policies etc. are beyond the limits of micro economics.

Features of Micro Economics :

1) **Study of Individual Units :** Micro economics is the study of the behaviour of small individual economic units, like individual firm, individual price, individual household etc.

2) **Price Theory :** Micro economics deals with determination of the prices of goods and services as well as factors of production. Hence, it is known as price theory.

3) **Partial Equilibrium :** Equilibrium is the balance between two factors. Micro economic analysis deals with partial equilibrium which analyses equilibrium position of an individual economic unit i.e. individual consumer, individual firm, individual industry etc. It isolates an individual unit from other forces and studies its equilibrium independently.

4) **Based on Certain Assumptions :** Micro economics begins with the fundamental assumption, "Other things remaining constant" (Ceteris Paribus) such as perfect competition, laissez-faire policy, pure capitalism, full employment etc. These assumptions make the analysis simple.

5) **Slicing Method :** Micro economics uses slicing method. It splits or divides the whole economy into small individual units and then studies each unit separately in detail. For example, study of individual income out of national income, study of individual demand out of aggregate demand etc.

6) **Use of Marginalism Principle :** The concept of Marginalism is the key tool of micro economic analysis. The term 'marginal' means change brought in total by an additional unit. Marginal analysis helps to study a variable through the changes. Producers and consumers take economic decisions using this principle.

7) **Analysis of Market Structure :** Micro economics analyses different market structures such as Perfect Competition, Monopoly, Monopolistic Competition, Oligopoly etc.

8) **Limited Scope :** The scope of micro economics is limited to only individual units. It doesn't deal with the nationwide economic problems such as inflation, deflation, balance of payments, poverty, unemployment, population, economic growth etc.

Importance of Micro Economics :

1) **Price Determination :** Micro economics explains how the prices of different products and various factors of production are determined.

2) **Free Market Economy :** Micro economics helps in understanding the working of a free market economy. A free market economy is that economy where the economic decisions regarding production of goods, such as 'What to produce?, How much to produce?, How to produce? etc.' are taken at individual levels. There is no intervention by the Government or any other agency.

3) **Foreign Trade :** Micro economics helps in explaining various aspects of foreign trade like effects of tariff on a particular commodity, determination of currency exchange rates of any two countries, gains from international trade to a particular country etc.

4) **Economic Model Building :** Micro economics helps in understanding various complex economic situations with the help

of economic models. It has made a valuable contribution to economics by developing various terms, concepts, terminologies, tools of economic analysis etc. Economic models are built using various economic variables.

5) **Business Decisions :** Micro economic theories are helpful to businessmen for taking crucial business decisions. These decisions are related to the determination of cost of production, determination of prices of goods, maximization of output and profit, etc.

6) **Useful to Government :** It is useful to government in framing economic policies such as taxation policy, public expenditure policy, price policy etc. These policies help the government to attain its goals of efficient allocation of resources and promoting economic welfare of the society.

7) **Basis of Welfare Economics :** Micro economics explains how best results can be obtained through optimum utilization of resources and its best allocation. It also studies how taxes affect social welfare.

Meaning of Macro Economics :

Macro economics is the branch of economics which analyses the entire economy. It deals with the total employment, national income, national output, total investment, total consumption, total savings, general price level interest rates, inflation, trade cycles, business fluctuations etc. Thus, macro economics is the study of aggregates.

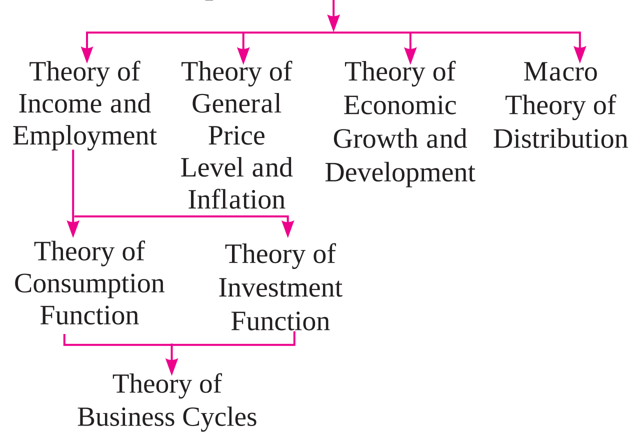
Definitions of Macro Economics :

1) J. L. Hansen - "Macro economics is that branch of economics which considers the relationship between large aggregates such as the volume of employment, total amount of savings, investment, national income etc."

2) Prof Carl Shapiro - "Macro economics deals with the functioning of the economy as a whole."

The following chart gives an idea about the scope of macro economics.

Scope of Macro Economics



i) **Theory of Income and Employment :** Macro economic analysis explains which factors determine the level of national income and employment and what causes fluctuations in the level of income, output and employment. To understand, how the level of employment is determined, we have to study the consumption function and investment function. Theory of Business Cycles is also a part and parcel of the Theory of Income and Employment.

ii) **Theory of General Price Level and Inflation :** Macro economic analysis shows how the general price level is determined and further explains what causes fluctuations in it. The study of general price level is significant on account of the problems created by inflation and deflation.

iii) **Theory of Growth and Development :** Macro economics consists of the theory of economic growth and development. It explains the causes of underdevelopment and poverty. It also suggests strategies for accelerating growth and development.

iv) **Macro Theory of Distribution :** Macro theory of distribution deals with the relative shares of rent, wages, interest and profit in the total national income.

Features of Macro Economics :

1) **Study of Aggregates :** Macro economics deals with the study of economy as a whole. It is concerned with the aggregate concepts such as national income, national output, national employment, general price level, business cycles etc.

2) **Income Theory :** Macro economics studies the concept of national income, its different elements, methods of measurement and social accounting. Macro economics deals with aggregate demand and aggregate supply. It explains the causes of fluctuations in the national income that lead to business cycles i.e. inflation and deflation.

3) **General Equilibrium Analysis :** Macro economics deals with the behaviour of large aggregates and their functional relationship. General Equilibrium deals with the behaviour of demand, supply and prices in the whole economy.

4) **Interdependence :** Macro analysis takes into account interdependence between aggregate economic variables, such as income, output, employment, investments, price level etc. For example, changes in the level of investment will finally result into changes in the levels of income, levels of output, employment and eventually the level of economic growth.

5) **Lumping Method :** Lumping method is the study of the whole economy rather than its part. According to Prof. Boulding, "Forest is an aggregation of trees but it does not reveal the properties of an individual tree." This reveals the difference between micro economics and macro economics.

6) **Growth Models :** Macro economics studies various factors that contribute to economic growth and development. It is useful in developing growth models. These growth models are used for studying economic development. For example, Mahalanobis growth model emphasized on basic heavy industries.

7) **General Price Level :** Determination and changes in general price level are studied in macroeconomics. General price level is the average of all prices of goods and services currently being produced in the economy.

8) **Policy-oriented :** According to Keynes, macro economics is a policy oriented science. It suggests suitable economic policies to promote economic growth, generate employment, control of inflation, and depression etc.

Importance of Macroeconomics :

1) **Functioning of an Economy :** Macro economic analysis gives us an idea of the functioning of an economic system. It helps us to understand the behaviour pattern of aggregative variables in a large and complex economic system.

2) **Economic Fluctuations :** Macro economics helps to analyse the causes of fluctuations in income, output and employment and makes an attempt to control them or reduce their severity.

3) **National Income :** Study of macro economics has brought forward the immense importance of the study of national income and social accounts. Without a study of national income, it is not possible to formulate correct economic policies.

4) **Economic Development :** Advanced studies in macro economics help to understand the problems of developing countries such as poverty, inequalities of income and wealth, differences in the standards of living of the

people etc. It suggests important steps to achieve economic development.

5) **Performance of an Economy :** Macro economics helps us to analyse the performance of an economy. National Income (NI) estimates are used to measure the performance of an economy over time by comparing the production of goods and services in one period with that of the other period.

6) **Study of Macro economic Variables :** To understand the working of the economy, study of macro economic variables are important. Main economic problems are related to the economic variables such as behaviour of total income, output, employment and general price level in the economy.

7) **Level of Employment :** Macro economics helps to analyse the general level of employment and output in an economy.

You should know :

Micro Economics and Macro Economics at a glance

Basis for comparison	Micro economics	Macro economics
Meaning	Micro economics studies the behaviour of individual unit of an economy	Macro economics studies the behaviour of aggregates of the economy as a whole
Tools	Individual Demand and Individual Supply	Aggregate Demand and Aggregate Supply
Scope	Demand, supply, product pricing, factor pricing, production, consumption, economic welfare, etc.	National income, general price level, employment, money etc.
Importance	Price determination, Model building, Business decisions etc.	Economic fluctuations, Study of national income, Economic development etc.
Theory	Price Theory	Income and Employment Theory
Examples	Individual income, Individual output etc.	National income, National output etc.

Try this :

1) Visit the vegetable market in the nearest area and try to get information about income and expenditure items of a particular seller

EXERCISE

Q. 1. Choose the correct option :

1) The branch of economics that deals with the allocation of resources.

   a) Micro economics b) Macro economics

   c) Econometrics d) None of these

Options : 1) a, b and c 2) a and b

3) only a 4) None of these

2) Concepts studied under Micro economics.

   a) National income b) General price level

   c) Factor pricing d) Product pricing

Options : 1) b and c 2) b, c and d

3) a, b and c 4) c and d

3) Method adopted in micro economic analysis.

   a) Lumping method b)Aggregative method

   c) Slicing method d) Inclusive method

Options : 1) a, c and d 2) a, b and d

3) only c 4) only a

4) Concepts studied under Macro economics.

   a) Whole economy b) Economic development

   c) Aggregate supply d) Product pricing

Options : 1) a, b and c 2) b, c and d

3) only d 4) a, b, c and d

Q. 2. Complete the correlation :

1) Micro economics : Slicing method : : Macro economics : ☐
2) Micro economics : Tree : : Macro economics : ☐
3) Macro economic theory : Income and employment : : Micro economics : ☐
4) Makros : Macro economics : : Mikros : ☐
5) General equilibrium : Macro economics :: ☐ : Micro economics

Q. 3. Identify and explain the concepts from the given illustrations :

1) Gauri collected the information about the income of a particular firm.
2) Ramesh decided to take all decisions related to production, such as what and how to produce?
3) Shabana paid wages to workers in her factory and interest on her bank loan.

Q. 4. Answer the following :

1) Explain the features of Micro economics.
2) Explain the importance of Macro economics.
3) Explain the scope of Macro economics.

Q. 5. State with reasons whether you agree or disagree with the following statements :

1) The scope of micro economics is unlimited.
2) Macro economics deals with the study of individual behaviour.
3) Macro economics is different from micro economics.
4) Micro economics uses slicing method.
5) Micro economics is known as Income theory.

Q. 6. Answer in detail :

1) Explain the importance of Micro economics.
2) Explain the concept of Macro economics and its features.