Unit 7: Introduction

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Emergence of Macroeconomics

Macroeconomics, as a separate branch of economics, emerged after the British economist John Maynard Keynes published his celebrated book The General Theory of Employment, Interest and Money in 1936. The dominant thinking in economics before Keynes was that all the laborer who are ready to work will find employment and all the factories will be working at their full capacity. This school of thought is known as the classical tradition. However, the Great Depression of 1929 and the subsequent years saw the output and employment levels in the countries of Europe and North America fall by huge amounts.

It affected other countries of the world as well. Demand for goods in the market was low, many factories were lying idle, workers were thrown out of jobs. In USA, from 1929 to 1933, unemployment rate rose from 3 per cent to 25 per cent (unemployment rate may be defined as the number of people who are not working and are looking for jobs divided by the total number of people who are working or looking for jobs).

Over the same period aggregate output in USA fell by about 33 per cent. These events made economists think about the functioning of the economy in a new way. The fact that the economy may have long lasting unemployment had to be theorized about and explained. Keynes' book was an attempt in this direction. Unlike his predecessors, his approach was to examine the working of the economy in its entirety and examine the interdependence of the different sectors. The subject of macroeconomics was born.

Context Of The Present Book Of Macroeconomics

We must remember that the subject under study has a historical context. We shall examine the working of the economy of a capitalist country in this book. In a capitalist country production activity are mainly carried out by capitalist enterprises. A typical capitalist enterprise has one or several entrepreneurs (people who exercise control over major decisions and bear a large part of the risk associated with the firm/enterprise).

They may themselves supply the capital needed to run the enterprise, or they may borrow the capital. To carry out production they also need natural resources – a part consumed in the process of production (e.g. raw materials) and a part fixed (e.g. plots of land). And they need the most important element of human labour to carry out production. This we shall refer to as labour.

After producing output with the help of these three factors of production, namely capital, land and labour, the entrepreneur sells the product in the market. The money that is earned is called revenue. Part of the revenue is paid out as rent for the service rendered by land, part of it is paid to capital as interest and part of it goes to labor as wages.

The rest of the revenue is the earning of the entrepreneurs and it is called profit. Profits are often used by the producers in the next period to buy new machinery or to build new factories, so that production can be expanded. These expenses which raise productive capacity are examples of investment expenditure. In short, a capitalist economy can be defined as an economy in which most of the economic activities have the following characteristics

(a) There is private ownership of means of production
(b) Production takes place for selling the output in the market
(c) There is sale and purchase of labor services at a price which is called the wage rate

In both the developed and developing countries, apart from the private capitalist sector, there is the institution of State. The role of the state includes framing laws, enforcing them, and delivering justice. The state, in many instances, undertakes production – apart from imposing taxes and spending money on building public infrastructure, running schools, colleges, providing health services etc.

These economic functions of the state must be considered when we want to describe the economy of the country. Apart from the firms and the government, there is another major sector in an economy which is called the household sector.

By a household we mean a single individual who takes decisions relating to her own consumption, or a group of individuals for whom decisions relating to consumption are jointly determined. Households also save and pay taxes. We must remember that the households consist of people. These people work in firms as workers and earn wages.

They are the ones who work in the government departments and earn salaries, or they are the owners of firms and earn profits. Indeed, the market in which the firms sell their products could not have been functioning without the demand coming from the households.

All the countries of the world are also engaged in external trade. The external sector is the fourth important sector in our study. Trade with the external sector can be of two kinds

1. The domestic country may sell goods to the rest of the world. These are called exports.
2. The economy may also buy goods from the rest of the world. These are called imports. Besides exports and imports, the rest of the world affects the domestic economy in other ways as well.
3. Capital from foreign countries may flow into the domestic country, or the domestic country may be exporting capital to foreign countries.