CBSE Class–12 Economics

NCERT Solutions

Chapter-01 (Macroeconomic)

Introduction

Question 1: Whatisthedifferencebetweenmicroeconomicsandmacroeconomics?

Solution:

S.No	Points of Difference	Microeconomics	Macroeconomics
1	Origin	The word micro comes from a Greek word 'Mikros' which means small./ millions of small parts	The word macro comes from a Greek word 'Makros' which means large.
2	Definition	It is a branch of economics that studies the economic relationshipsorissuesatan individual or group level like the households, the firms, the consumersetc.	It is a branch of economics that studies the economic relationships or issues of an economy as a whole like total consumption, saving etc.
3	Objective	Itsmainobjectiveistoanalyse the principles, problems and policies for the achievementof the goal of optimumallocation ofresources.	It investigates the principles, problems and policies relating to achievement of full employment and expansion of productive capacity.
4	Evolution	Its evolution took place earlier than macroeconomics, mostly before 18th century	It evolved only after the publication of Keynesian's book, 'The Theory of Employment, Interest, and Money'.
5	Deals With	It deals with how consumers	It deals with how different

		equilibrium (i.e. equilibrium in one market) is used.	equilibrium (i.e. equilibrium in all the markets, simultaneously) is used.
6	Assumptions	It assumes that while studying micro economics, macro variables remains constant.	Study of macro economics assumes that micro variables remains constant.
7	Variables	The major variables involved are price, consumer's demand, wages, rent, profit, firm's revenue, cost, etc.	The major variables involved are aggregate demand, aggregate supply, inflation, unemployment, poverty, etc.
8	Significant role	In the context of micro economics 'market mechanism' plays an important role.	In the context of macro economics 'government' plays a significant role.
9	Approach	Microeconomics takes a bottoms-up approach to analyzing the economy	Macroeconomics takes a top-down approach
10	Theories	Various theories studied under Micro Economics are: 1.Theory of Consumer's Behaviour and Demand 2. Theory ofProducer's Behaviour andSupply 3. Theory of price Determination underdifferent marketconditions	Various theories studied are 1. Theory of NationalIncome 2. Theory ofMoney 3. TheoryofGeneralPricelevel 4. Theory ofEmployment 5. TheoryofInternationaltrade
11	Limitations	It is based on unrealistic assumptions, i.e. it is assumed that there is a full employment in the society which is not at all possible	It has been analyzed that 'Fallacy of Composition' involves, which sometimes doesn't prove true because it is possible that what is true for aggregate may not be true for individuals too.
12	Popularized by	Alfred Marshal	John Maynard Keynes

Question 2: What are the important features of a capitalist economy?

Solution: Capitalisteconomyisaneconomicsystemgovernedbycapitalisti.e.,wherethemeans of production and distribution are privately or corporately owned. It is primarily run by price mechanism, without any interferenceofgovernment. Government role is to maintain law and order only.This economy's mainmotiveistoearnprofit.Thiseconomicstructureisalso knownasfreemarketeconomyorlaissezfaire. Examples of capitalist economies are Hong Kong, Singapore, Canada, UAE, Ireland etc

Famous quotes about capitalism:

*"Doing well is the result of doing good. That's what capitalism is all about." - **Ralph Waldo Emerson***

*"The problem of social organization is how to set up an arrangement under which greed will do the least harm. Capitalism is that kind of a system." - **Milton Friedman***

Following are the features of a capitalist economy:

1. **Role of the government:** The government doesn't interfere in the day-to-day economic activities.Thismeansproducersaefreetotakedecisions.Thegovernmentprovidesthebasic framework for the smooth functioning of an economy is responsible for maintenance of law andorder,justice,growthandstability,Defenceetc.

2. **Profit motive:** The economic agents are driven by the prime motive of profit maximization.

3. **Centralproblems:**Thecentralproblemsofaneconomyaresolvedbythemarketforcesof demand and supply, i.e., the law of demand and supply operates here. The producers will supplyonlythosegoodsandservicesthataredemandedbytheeconomy.

4. **Roleofprivatesector:**Theroleofprivateindividualsismoredominant.Themainroleof undertaking production and organizing factors of production are played by the private individuals andcapitalists.

5. **Laissez-faire:** This economy is also called 'laissez faire'. It has minimum interference or restriction from thegovernment.

Question 3: Describe the four major sectors in an economy according to the macroeconomic point ofview.

Solution: The four aggregate macroeconomic sectors that form the foundation for macroeconomic analysis are the Household Sector, the Business Sector, the Government Sector and the Foreign sector. These four key functions are responsible for four expenditures on Gross Domestic Product (GDP).

Thefourmajorsectorsofaneconomyaccordingtothemacroeconomicpointofview are:

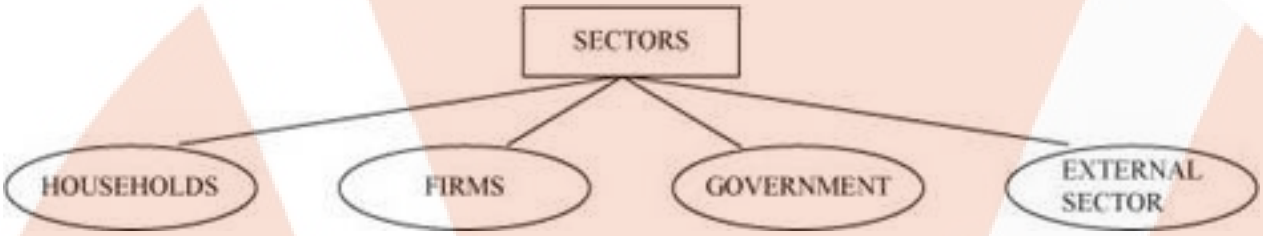
i. Households

ii. Firms / Business

iii. Government

iv. Externalsector / Foreign

These can be represented in the following flow chart:



i. **Households:** Household means a single individual or a group of individuals who independently take decisions regarding their economics activities (i.e., consumption and production). Household sector buy goods and services for consumption and also supply factors of production like land, labour, capital, and entrepreneur. Households provide the marketfortheoutputofthefirms. In short, this sector includes everyone, consumers, people and every member of the society. This sector is responsible for the consumption expenditures role in GDP.

ii. **Firms:**Firmsareeconomicunitsthatcarryouttheproduction.Theyemployandorganize factorsofproductionandundertakeproductionprocessforthemotiveofprofitmaking. This includes sole proprietorship, partnerships and corporations. This sector is responsible for investment expenditure role in GDP.

iii. **Government:** A state/government provides law and order, maintains growth and stability and provides administrative services. The main motive of a government is to undertake developmental projects such as dams, roads, heavy industries that usually have longgestationperiodsbyimposingtaxes.Thegovernmentinvestsineducation,healthsector andprovidestheseservicesatnominalprice.Themotiveofagovernmentistoserveandnot to makeprofits. Transportation Dept, Environmental Protection agencies are its examples. This sector is responsible for government purchase role in GDP.

iv. **External sector:** This sector is engaged in export and import (external trade) of goods and services. If domestically produced goods and services are sold to the rest of the world, then it is called export. If the goods and services are purchased from the rest of the world, then it is called import. Apart from export and import of goods, there can be inflow of goods (i.e., a country inviting capital from foreign countries) and outflow of foreign capital (i.e., investing in foreigncountries).The expenditure on gross domestic product attributable to the foreign sector is net exports.

Question 4: DescribetheGreatDepressionof1929.

Solution: The Great Depression was the worst economic downturn in the history of the industrialized world. It began after the stock market crash of October 1929, which sent Wall Street in panic and wiped out millions of investors. TheGreatDepressionwasasevereeconomiccrisisthatstartedintheyear1929.Itwas thelongestanddeepestandmostwidespreaddepressionof20thcentury.In21stcentury,the Great Depression is commonly used as an example of how far an economy can decline. It originated in the United States of America when the stock market crashed which resultsinthe beginning of a decade of high unemployment, poverty, low profit and deflation and it gradually spread to other countries of the world. The worldwide GDP fell by 15% as compared to less than 1% during the Great Recession in 2008-2009. The main cause behind thiscrisiswasthefallinaggregatedemandduetounderconsumptionandoverinvestment. Aggregate supply was greater than aggregate demand which resulted into depressing activities.Duetounderconsumptionandoverinvestmentthestockoffinishedgoodsstarted pilingup,whichresultedinlowpricelevelandconsequentlythelowprofitlevel.Themoney intheeconomywasconvertedintounsoldstockoffinishedgoodsthatleadtoanacutefallin employment and hence income level fell drastically. The demand for goods in the economy was so low that the production was lowered leading to the unemployment. In USA, the rate of unemployment increased from 3% to25%.

The Great depression has its own implications and importance in economics, as it leads to the failure of the classical approach of economics. Those who believed in the market forces of demand and supply, paved the way for emergence of the Keynesian approach. It was this incident that provided the economists with sufficient evidence to recognize macroeconomics as a separate branch of economics.

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

Low demand $\rightarrow$ overinvestment $\rightarrow$ low level of employment $\rightarrow$ low level ofoutput $\rightarrow$ low income $\rightarrow$ low demand.