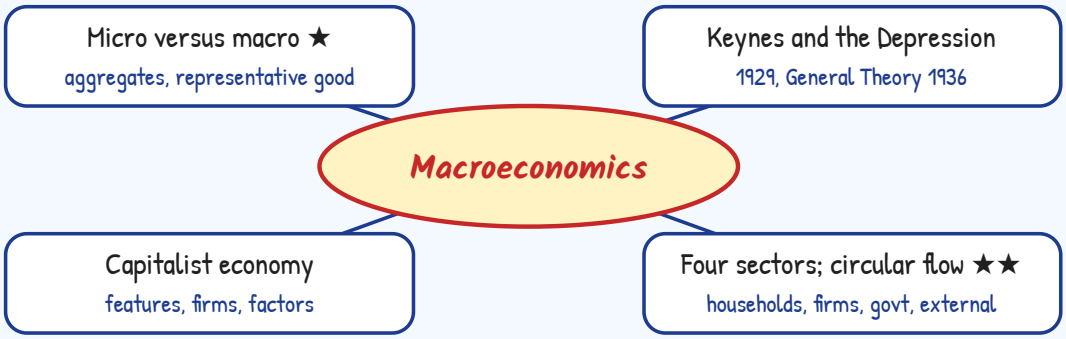
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Chapter 1 Introduction to Macroeconomics

the economy as a whole

NCERT Introductory Macroeconomics (Chapter 1), Reprint 2026-27 · CBSE board 2027

Chapter map (★ = asked often in CBSE papers 2024–2026)



What is inside

1. Concept notes, with the circular flow of income
2. NCERT exercises (all 4), fully solved
3. CBSE PYQs 2024–2026, fully solved
4. Quick-reference sheet; practice A–G, 20 MCQs, 6 A–R, answers, summary

Colour code used

red = key term green = definition

purple = sub-heading black = explanation

★ = high-frequency board topic

1 = mark the examiner gives for that point

★ **Exam tip:** The board tests this chapter through the **circular flow of income** (two-sector model, flows of factor payments, why the three methods give the same income). All those questions are solved in full here; the national income questions are in Chapter 2.

Based on NCERT Introductory Macroeconomics (2026-27), Chapter 1. All answers written by us. Board questions are quoted from the CBSE papers named in each tag; every answer checked against the CBSE marking schemes.

Microeconomics and macroeconomics ★

Macroeconomics studies the economy as a whole: aggregate output (national income), the general price level, total employment, money supply, the rate of interest, the government budget and the balance of payments.

Its basic questions concern every citizen: will prices **as a whole** rise or fall? Is employment in the country getting better or worse? What indicators show whether the economy is doing well? What can the State do to improve it?

The representative good

Output, prices and employment in different production units tend to **move together**: when food grain output grows, industrial output usually grows too; prices of different goods rise or fall together (in an **inflation** they all rise; in a **depression** output and jobs all fall). So macroeconomics can treat **a single imaginary commodity** as the representative of all goods: its output stands for the average output, its price for the general price level.

This simplification may hide distinctive features (farm and factory production differ; a manager's labour differs from an accountant's). So macroeconomics sometimes uses a handful of goods: **agricultural goods, industrial goods and services**, each with its own technology and price, and studies the interlinkages between sectors.

Economic agents (economic units): individuals or institutions that take economic decisions: consumers (what and how much to consume), producers (what and how much to produce), and entities such as the government, corporations and banks (how much to spend, what interest to charge, how much to tax).

basis	microeconomics	macroeconomics
studies	individual units: a consumer, a firm, a market	the economy as a whole and its aggregates
central problem	price determination and allocation of resources	determination of income, output and employment
key variables	demand, supply, price of a good	national income, general price level, aggregate demand and supply
decision-makers	individuals maximising profit or satisfaction	the State and statutory bodies (RBI, SEBI) pursuing public goals
approach	partial: rest of the economy assumed unchanged	takes interlinkages between sectors into account
also called	price theory	income and employment theory

Why macroeconomics was needed

Adam Smith (*Wealth of Nations*, 1776) suggested that if buyers and sellers follow their own self-interest, the wealth of the nation looks after itself. Economists found they had to look further:

1. in some cases markets **did not or could not exist**;
2. in others markets existed but **failed to bring equilibrium** of demand and supply;
3. most importantly, society chose to pursue **social goals** (employment, defence, education, health, administration) that required the aggregate effects of individual decisions to be modified, through taxation, budgets, money supply, interest rates and wage policy.

Two features of macroeconomics follow: (i) its **decision-makers** are the State and statutory bodies (RBI, SEBI) with public goals defined by law; (ii) they go beyond economic objectives and direct resources to **public needs** for the welfare of the country as a whole.

1.1 Emergence of macroeconomics; 1.2 the capitalist economy

1.1 Keynes and the Great Depression

Before Keynes, the **classical tradition** held that everyone willing to work finds a job and all factories work at full capacity (full employment is normal).

The **Great Depression of 1929** and the years after saw output and employment in Europe and North America fall by huge amounts: demand was low, factories lay idle, workers lost jobs. In the USA, 1929–33, the **unemployment rate rose from 3% to 25%** and **aggregate output fell by about 33%**.

Unemployment rate = number of people not working and looking for jobs ÷ total number of people working or looking for jobs.

Long-lasting unemployment had to be explained. **J. M. Keynes** (1883–1946, King's College, Cambridge) published *The General Theory of Employment, Interest and Money* in **1936**. Unlike his predecessors he examined the working of the economy **in its entirety** and the interdependence of its sectors: **macroeconomics was born** as a separate branch.

1.2 Context: a capitalist economy

The book studies a **capitalist** economy, where production is mainly carried out by capitalist enterprises (**firms**). The entrepreneur controls major decisions and bears the risk; supplies or borrows capital; uses natural resources (raw materials, land) and hires **labour**.

Output is sold; the money earned is **revenue**. It is paid out as **rent** (land), **interest** (capital), **wages** (labour); the rest is **profit** (entrepreneur). Profits are often used to buy new machinery or build factories: expenditure that raises productive capacity is **investment expenditure**.

Features of a capitalist economy (most economic activity has these):

1. **private ownership** of the means of production;
2. production for **sale in the market** (for profit);
3. **sale and purchase of labour services** at a price called the wage rate (wage labour).

Capitalist countries arose only in the last 300–400 years, and strictly only a handful qualify. In many underdeveloped countries farming is done by **peasant families** with little wage labour, much of the output is consumed by the family, and capital stock hardly grows; in tribal societies land may belong to the whole tribe. The analysis of this book does not fully apply there, though many developing countries have significant capitalist sectors.

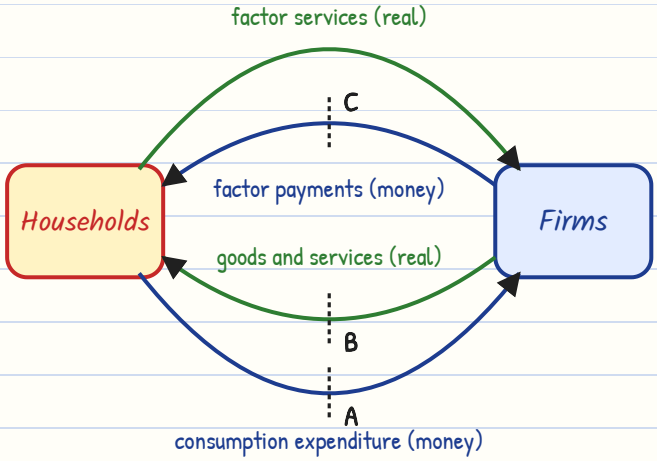
The four sectors of an economy ★

sector	role
households	a single individual, or a group, taking joint consumption decisions; supply factor services (labour, land, capital, enterprise) and earn wages, rent, interest, profit; consume, save and pay taxes; their demand keeps the market going
firms	hire factors, produce goods and services (output) to sell for profit, bearing risk and uncertainty
government (the State)	frames and enforces laws, delivers justice; taxes; spends on public infrastructure, schools, colleges, health; sometimes produces goods itself
external sector (rest of the world)	(1) **exports**: goods sold abroad; (2) **imports**: goods bought from abroad; (3) **capital flows** into or out of the country

> ✗ **Don't do this:** Macroeconomics differs from microeconomics because it studies **aggregates** and the **interlinkages** between these sectors, not one sector assuming the rest unchanged.

Circular flow of income in a two-sector economy ★★

Assume a simple economy with only **households** and **firms**: no government, no foreign trade, and households spend all their income (no saving).



Real flows (green) and money flows (blue) run in opposite directions. Dotted lines: where the flow is measured, A expenditure, B product, C income (Ch 2)

Real flow: flow of factor services from households to firms and of goods and services from firms to households. **Money flow**: flow of factor payments (rent, wages, interest, profit) from firms to households and of consumption expenditure from households to firms.

Why it is circular

Firms produce using households' factor services and pay them factor incomes; households spend that whole income buying the firms' output; this spending is the firms' revenue, used again to pay factors. The same amount flows round: there is no leakage and no injection.

Three points of measurement

phase	flow measured	method
production	value of goods and services produced by firms (value added)	product (value added) method
distribution	factor payments received by households	income method
disposition	expenditure by households on firms' output	expenditure method

Since output = income = expenditure in the circular flow, **all three methods give the same national income**.

Leakages and injections (more sectors)

Leakages withdraw money from the flow: saving, taxes, imports. **Injections** add to it: investment, government expenditure, exports. The flow stays steady when leakages equal injections. With the government and the rest of the world the model has three and four sectors.

> ✗ **Don't do this:** Board trap: in the **disposition** phase, money flows from households to firms as consumption expenditure; it is the **distribution** phase in which factor incomes flow from firms to households.

Stocks and flows, final and intermediate goods and the three methods in detail: Chapter 2.

NCERT exercises, fully solved

1. What is the difference between microeconomics and macroeconomics?

Ans. **Microeconomics** studies individual economic agents and individual markets: how a consumer chooses the best combination of goods given tastes and income, how a producer maximises profit, and how the price of a good is set by its demand and supply. Its decision-makers are individuals (even a large company is "micro" because it acts for its own shareholders). Aggregates such as inflation and unemployment are taken as given.

Macroeconomics studies the economy as a whole: aggregate output, the general price level, employment, the rate of interest, money supply. It treats a representative good (or a few broad goods) and studies the interlinkages between sectors (households, firms, government, rest of the world). Its decision-makers are the State and statutory bodies such as the RBI and SEBI, which pursue public goals (employment, health, education, defence) through budgets, taxation and monetary policy, not private profit.

2. What are the important features of a capitalist economy?

Ans. (i) **Private ownership of the means of production**: land, factories and machines are owned by private individuals and firms.

(ii) **Production for the market**: output is produced to be sold, with the motive of earning profit.

(iii) **Wage labour**: labour services are bought and sold at a price called the wage rate.

Also: entrepreneurs bear risk; the revenue earned is distributed as rent, interest and wages, and the rest is profit, which is reinvested in new machinery and factories (investment) to expand production.

3. Describe the four major sectors in an economy according to the macroeconomic point of view.

Ans. (1) **Household sector**: an individual or a group taking joint consumption decisions. Households supply factor services to firms and the government and earn wages, salaries, rent, interest and profit; they spend on consumption, save and pay taxes. Their demand keeps the market going.

(2) **Firms** (producing sector): hire labour, capital and land, produce goods and services and sell them in the market to earn profit, bearing risk and uncertainty.

(3) **Government**: frames and enforces laws and delivers justice; imposes taxes; spends on public infrastructure, schools, colleges and health; in many cases produces goods itself.

(4) **External sector** (rest of the world): the country exports goods, imports goods, and capital flows into or out of the country.

4. Describe the Great Depression of 1929.

Ans. The Great Depression began in **1929** and lasted through the following years. Output and employment in the countries of Europe and North America fell by huge amounts, and other countries were affected too. The demand for goods was low, many factories lay idle and workers were thrown out of jobs. In the **USA**, from 1929 to 1933, the unemployment rate rose from **3% to 25%** and aggregate output fell by about **33%**.

It contradicted the classical belief that full employment is normal: long-lasting unemployment had to be explained. This led Keynes to write *The General Theory of Employment, Interest and Money* (1936), studying the economy as a whole, and gave birth to macroeconomics.

CBSE board questions 2024–2026, fully solved

Every question on this chapter from the 16 papers (sets 58/1/1 to 58/7/1, 2024–2026), quoted with complete answers.

A. MCQs and Assertion–Reason (1 mark each)

CBSE 2026 · 58/1/1 In a two-sector economy, the flow of factor payments moves from _____ to _____. (A) firms, households (B) firms, government (C) banks, households (D) households, firms [1]

Ans. Firms pay rent, wages, interest and profit to households for their factor services. **(A)**

B. Short answer (3 marks)

CBSE 2024 · 58/4/1 (OR) "The disposition phase of the circular flow of income involves the flow of factor income (rent, wages, interest and profit) from firms to households." Defend or refute with valid reasons. [3]

Ans. **Refuted.** The circular flow has three phases: production (firms produce goods using factors), **distribution** (flow of factor incomes, rent, wages, interest and profit, from firms to households) and **disposition** (households spend their income on goods and services produced by firms, i.e. consumption and investment expenditure). The statement describes the distribution phase, not the disposition phase.

D. Long answer II (6 marks)

CBSE 2024 · 58/1/1 (a) Discuss briefly the concept of circular flow of income in a two-sector model. (b) "Real GDP is a better indicator of economic growth than nominal GDP." Do you agree? Justify with a hypothetical numerical example. [6]

Ans. (a) In a two-sector economy there are households and firms. Households own the factors of production (land, labour, capital, entrepreneurship) and supply them to firms. Firms combine these factors to produce goods and services and pay factor incomes (rent, wages, interest, profit) to households. Households spend this income on buying the final goods and services produced by firms (consumption expenditure). Thus income flows from firms to households as factor payments and back from households to firms as consumption expenditure, completing a circular flow. (Real flow: factor services and goods; money flow: factor payments and expenditure.) With no savings or leakages, the flow continues at the same level.

(b) Yes. **Real GDP** values the final output at **base year (constant) prices**; **nominal GDP** values it at **current year prices**. Nominal GDP can rise only because prices rise, even when output is unchanged.

Year	Price (₹)	Output (units)	Real GDP (P_0Q)	Nominal GDP (PQ)
2010 (base)	10	100	1,000	1,000
2011	15	100	1,000	1,500

Nominal GDP rose by 50% but output did not change; real GDP correctly shows no growth. Real GDP removes the effect of price changes and measures change in physical output, so it is the better indicator of economic growth.

CBSE 2024 · 58/3/1 (i) Explain the concept of circular flow of income in a two-sector economy. (ii) "GDP and the sum of gross value added (GVA) in an economy are always equal." Justify. [6]

Ans. (i) Households own the factors of production (land, labour, capital, entrepreneurship) and supply them to firms. Firms combine them to produce goods and services and make factor payments (rent, wages, interest, profit) to households. Households spend this income on the final goods and services produced by firms. Thus income earned by the factors flows back to the producers as consumption expenditure, completing the circular flow; there is a real flow (factor services one way, goods the other)

and a money flow (factor payments and consumption expenditure).
(ii) GDP is the market value of all **final** goods and services produced within the domestic territory in a year. GVA of a producing unit = value of output – intermediate consumption, i.e. the value it adds. Adding the value added at every stage by all units in the primary, secondary and tertiary sectors counts each good only once, which equals the value of final output. Hence GDP (at market prices) = sum of GVA of all sectors (value added method).

CBSE 2025 · 58/7/1 (OR) (i) "In a two-sector economy, consumption expenditure by households is always equal to aggregate expenditure on goods and services produced by firms." Do you agree? Explain. (ii) "Double counting leads to overestimation of output." Justify with an example. [6]

Ans. (i) **Yes.** In the simple two-sector model, households own the factors and receive all factor payments (rent, wages, interest, profit) from firms; they spend all of it on final goods and services produced by firms (no saving, government or foreign sector). So the income earned flows back to firms entirely as consumption expenditure, and aggregate expenditure equals household consumption.
(ii) **Double counting** is counting the value of a commodity more than once, which overstates output. Example: a farmer produces wheat worth ₹ 100 (no inputs) and sells ₹ 50 of it to a baker, who makes bread worth ₹ 200. If we add 100 + 200 = 300, the ₹ 50 of wheat is counted twice (once as wheat, once inside the bread). Correct output = value added: farmer 100 + baker (200 – 50) 150 = ₹ 250.

What the board asked (16 papers, 2024–2026)

Type	2024	2025	2026	Total
MCQs and Assertion–Reason (1 mark each)	0	0	1	1
Short answer (3 marks)	1	0	0	1
Long answer II (6 marks)	2	1	0	3

Quick-reference sheet

term	one-line meaning
macroeconomics	study of the economy as a whole (aggregates)
economic agents	individuals or institutions taking economic decisions
representative good	one imaginary good standing for all goods
classical tradition	full employment of labour and capacity is normal
Great Depression	1929–33; US unemployment 3% → 25%, output –33%
Keynes, General Theory	1936; birth of macroeconomics
unemployment rate	unemployed seeking work ÷ labour force
investment expenditure	spending that raises productive capacity
factor incomes	rent, wages, interest, profit
four sectors	households, firms, government, external sector
real flow	factor services and goods (opposite to money)
money flow	factor payments and consumption expenditure
leakages / injections	S, T, M / I, G, X

Case study (practice): the island of Sona. Sona has 400 families and 20 workshops. Families rent their land, lend savings and work in the workshops; workshop owners pay ₹ 8 lakh a year as rent, wages and interest, keep ₹ 2 lakh as profit, and sell their entire output of ₹ 10 lakh to the families, who spend all their income. There is no government and no trade.
(i) Name the two sectors and the model. (ii) Identify one real flow and one money flow. (iii) What is the national income of Sona by each of the three methods? (iv) If families start saving ₹ 1 lakh, what happens to the flow unless something else changes? (v) Name the phase in which the ₹ 10 lakh is spent.

★ ***Exam tip:*** Remember the order: **production → distribution → disposition** (produce, pay incomes, spend them).

Practice set: test yourself *Exam-style*

Try every question before looking at the answers at the end of the chapter. 58 or more out of 72 means you are ready for the board.

A. Fill in the blanks (1 mark each)

1. Keynes published the General Theory in _____.
2. The Great Depression began in _____.
3. In the USA (1929–33) unemployment rose from 3% to _____%.
4. Payment for the services of capital is _____.
5. Expenditure that raises productive capacity is _____ expenditure.
6. Goods sold to the rest of the world are _____.
7. Factor payments flow from _____ to households.
8. Saving, taxes and imports are _____ from the circular flow.

B. True or false? (1 mark each)

1. The classical school believed in full employment.
2. Microeconomics studies the general price level.
3. In a two-sector model there is no government.
4. Real and money flows move in the same direction.
5. RBI is a macroeconomic decision-maker.
6. Adam Smith wrote the General Theory.
7. Exports are an injection into the circular flow.
8. Peasant family farms are typical capitalist firms.

C. Very short answer (1 mark each)

1. Define macroeconomics.
2. Who is the father of modern economics?
3. Name the four factors of production.
4. What is the reward of the entrepreneur?
5. Name the four sectors of an economy.
6. Define unemployment rate.

7. State one feature of a capitalist economy.
8. Give one example of a real flow.
9. Name two statutory macroeconomic bodies in India.
10. What is a household?

D. Short answer I (2 marks each)

1. Why can macroeconomics use a representative good?
2. Distinguish between real flow and money flow.
3. State two reasons why economists had to look beyond Adam Smith's view.
4. How is a firm's revenue distributed?
5. State the role of the external sector.
6. Why does the analysis of a capitalist economy not apply to tribal societies?
7. Name the three phases of the circular flow.
8. State two economic functions of the government.

My score (fill in after checking the answers)

Section	A /8	B /8	C /10	D /16	E /18	F /12	G (bonus)	Total /72
My marks								

Rough work

E. Short answer II (3 marks each)

1. Distinguish between microeconomics and macroeconomics on three bases.
2. Explain the features of a capitalist economy.
3. Explain the circular flow of income in a two-sector economy with a diagram.
4. Why did macroeconomics emerge as a separate branch after 1936?
5. Who are the macroeconomic decision-makers and how do their goals differ from those of individual agents?
6. "In the circular flow, output = income = expenditure." Explain.

F. Long answer (6 marks each)

1. Describe the four sectors of an economy and the flows between them.
2. Describe the Great Depression and explain how it led to the birth of macroeconomics.

G. HOTS (higher-order thinking)

1. Why is a large company still a "micro" agent?
2. Why may a model of a capitalist economy not fully capture an economy like India's?
3. Why is saving a leakage but investment an injection?

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4. Why did the Depression contradict the classical view?

20 MCQs

1. Macroeconomics studies:
   (a) a firm (b) a consumer (c) the economy as a whole (d) one market
2. The General Theory was published in:
   (a) 1936 (b) 1929 (c) 1776 (d) 1947
3. The Great Depression began in:
   (a) 1919 (b) 1945 (c) 1936 (d) 1929
4. In the USA (1929–33) aggregate output fell by about:
   (a) 10% (b) 33% (c) 50% (d) 25%
5. The classical tradition assumed:
   (a) mass unemployment (b) full employment (c) no markets (d) state ownership
6. The founding father of modern economics is:
   (a) Keynes (b) Ricardo (c) Marshall (d) Adam Smith
7. Which is a feature of a capitalist economy?
   (a) private ownership of means of production (b) state ownership (c) production for self-use (d) no wage labour
8. The reward for land is:
   (a) wages (b) interest (c) rent (d) profit
9. Expenditure on new machinery is:
   (a) consumption (b) saving (c) transfer (d) investment
10. Which is NOT a sector in macroeconomics?
    (a) households (b) temples (c) firms (d) external sector
11. A macroeconomic decision-maker in India is:
    (a) a consumer (b) a shopkeeper (c) the RBI (d) a farmer
12. In a two-sector model, factor payments flow from:
    (a) firms to households (b) households to firms (c) government to firms (d) firms to government
13. Consumption expenditure is a:
    (a) real flow (b) money flow (c) leakage (d) injection
14. Which is a leakage?
    (a) investment (b) exports (c) saving (d) government expenditure
15. Which is an injection?
    (a) taxes (b) saving (c) imports (d) exports
16. Goods bought from the rest of the world are:
    (a) imports (b) exports (c) transfers (d) investment
17. Keynes studied:
    (a) the economy in its entirety (b) one market (c) only money (d) only trade
18. Price theory is another name for:
    (a) macroeconomics (b) development economics (c) public finance (d) microeconomics
19. The disposition phase measures:
    (a) production (b) expenditure (c) factor incomes (d) saving
20. The unemployment rate in the USA in 1933 was about:
    (a) 3% (b) 33% (c) 25% (d) 10%

1 (c) · 2 (a) · 3 (d) · 4 (b) · 5 (b) · 6 (d) · 7 (a) · 8 (c) · 9 (d) · 10 (b) · 11 (c) · 12 (a) · 13 (b) · 14 (c) · 15 (d) · 16 (a) · 17 (a) · 18 (d) · 19 (b) · 20 (c)

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Assertion–Reason (6)

(a) Both true, R explains A. (b) Both true, R does not explain A. (c) A true, R false. (d) A false, R true.

1. A: Macroeconomics can study a representative good. R: Prices and outputs of goods tend to move together.
2. A: Macroeconomics emerged after 1936. R: The Great Depression showed that unemployment could last long.
3. A: A large company is a micro agent. R: It acts in the interest of its own shareholders.
4. A: Real and money flows move in the same direction. R: Households spend their income on firms' output.
5. A: In the two-sector model the three methods give the same income. R: Households spend their entire income.
6. A: Saving is a leakage. R: Exports bring money into the economy.

Key: 1 (a) · 2 (a) · 3 (a) · 4 (d) · 5 (a) · 6 (b)

Answers to the practice set

A. 1. 1936 2. 1929 3. 25 4. interest 5. investment 6. exports 7. firms 8. leakages

B. 1. T 2. F (macro) 3. T 4. F (opposite) 5. T 6. F (Keynes) 7. T 8. F

C. 1. study of the economy as a whole 2. Adam Smith 3. land, labour, capital, entrepreneurship 4. profit 5. households, firms, government, external sector 6. unemployed persons seeking work ÷ total labour force 7. private ownership (or production for market, wage labour) 8. labour services from households to firms 9. RBI, SEBI 10. an individual or group taking joint consumption decisions

D. 1. outputs, prices and jobs of different goods move together, so one good can stand for all 2. real: goods and factor services; money: payments for them; opposite directions 3. markets may not exist or not clear; society pursues social goals 4. rent, interest, wages; the rest is profit 5. exports, imports, capital inflows and outflows 6. land is owned by the whole tribe and there is no wage labour or production for market 7. production, distribution, disposition 8. making and enforcing laws; taxes and public spending on infrastructure, schools, health

E. 1, 2, 5: see 'Microeconomics and macroeconomics' 3. see 'Circular flow of income in a two-sector economy' 4. Depression of 1929 → Keynes 1936 studied the whole economy 6. firms' output is paid out as factor incomes, which are all spent on that output

F. 1. see '1.1 Emergence of macroeconomics; 1.2 the capitalist economy' 2. see '1.1 Emergence of macroeconomics; 1.2 the capitalist economy' and NCERT Q4

G. 1. it maximises its shareholders' profit, not national welfare 2. much production is by peasant families for self-use, without wage labour 3. saving withdraws income from spending; investment adds spending not from households' consumption 4. unemployment stayed high for years instead of disappearing

Case. (i) households and firms; two-sector model (ii) real: labour or land services (or goods); money: wages, rent, or spending (iii) product ₹ 10 lakh = income (8 + 2) = expenditure ₹ 10 lakh (iv) saving is a leakage; spending and firms' revenue fall to ₹ 9 lakh unless investment of ₹ 1 lakh is injected (v) disposition

Last-night summary

- Macro = economy as a whole; uses a representative good; decision-makers are the State, RBI, SEBI.
- Born with Keynes's General Theory (1936) after the Great Depression (1929; US unemployment 3% → 25%, output −33%).
- Capitalist economy: private ownership, production for market, wage labour; revenue → rent, interest, wages, profit.
- Four sectors: households, firms, government, external sector.

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- Circular flow: real and money flows opposite; output = income = expenditure; leakages S, T, M; injections I, G, X.