

# CHAPTER 1

## ECONOMIC ACTIVITY IN CONTEXT

*Macroeconomics in Context* (Goodwin, et al.)

### Chapter Overview

This chapter introduces you to the basic topics of macroeconomics, and presents the main macroeconomic goals: 1) living standards growth, 2) stability and security, and 3) financial, social, and ecological sustainability. The chapter highlights that the goal of living standards growth may or may not contribute to the general goal of human well-being. The chapter also provides a brief overview of the major historical developments in macroeconomics, from classical economics, to Keynesian and monetarist economics, to the classical/Keynesian synthesis, and finally to the challenges in the 21<sup>st</sup> century.

### Chapter Objectives

After reading and reviewing this chapter, you should be able to:

1. Distinguish the concerns of macroeconomics from microeconomics.
2. Define the difference between normative and positive questions.
3. Discuss the relationship between economics and well-being.
4. Identify and describe the three main macroeconomic goals.
5. Identify and distinguish the major historical traditions of economic thought.

### Key Terms

economics  
microeconomics  
macroeconomics  
unemployment  
inflation  
macroeconomy  
global economy  
economic actor (agent)  
positive questions  
normative questions  
well-being  
living standards growth  
economic growth  
economic development

labor productivity  
business (trade) cycle  
precautionary principle  
classical economics  
division of labor  
specialization  
laissez-faire economy  
Say's Law  
aggregate demand  
Keynesian economics  
fiscal policy  
monetary policy  
monetarist economics

## Active Review

### *Fill in the Blank*

1. While the study of economic activities of individuals, households, and business at the sub-national level is the concern of \_\_\_\_\_, the study of economic activities of the national and global level is the concern of \_\_\_\_\_.
2. Questions about facts or “how things are” are \_\_\_\_\_ questions, while questions about values and “how things should be” are \_\_\_\_\_ questions.
3. The three main macroeconomic goals identified in this chapter are \_\_\_\_\_, \_\_\_\_\_, and \_\_\_\_\_.
4. The process of moving from a situation of poverty and deprivation to a situation of increased production and plenty is referred to as \_\_\_\_\_.
5. The increase in the level of production in a country or region is called \_\_\_\_\_ growth while improvements in diet, housing, medial attention, education, working conditions, access to care, transportation, communication, entertainment, etc. is called \_\_\_\_\_ growth.
6. The fluctuations in the level of production, between recessions on the one hand and booms on the other hand, is called \_\_\_\_\_.
7. The goal that recognizes a serious responsibility to future generations is the goal of \_\_\_\_\_.
8. The school of economics that is associated with the idea that individual self-interest is a positive force and that governments should let markets function without interference is called \_\_\_\_\_.
9. The economist who argued that the market mechanism can fail by leaving insufficient demand, and that governments could intervene by increasing aggregate demand was named \_\_\_\_\_.
10. The school of thought that argued that governments should aim for steadiness in the money supply rather than play an active role is called \_\_\_\_\_.

### *True or False*

11. Economic phenomenon such as the rate of unemployment and inflation are studied in microeconomics.

12. Living standards growth is defined as increases in the level of production in a country or region.
13. During a recession, the economy often has higher rates of unemployment, whereas during a boom, the economy often has higher rates of inflation.
14. Monetarists believe the government should use monetary policy to boost aggregate demand during a recession.
15. According to the classical/Keynesian synthesis, in the short run we are in the Keynesian world, and in the long run we are in the classical world.

### **Short Answer**

16. What types of questions would concern microeconomics, versus macroeconomics?
17. How have economists traditionally defined “economic growth,” and how is that different from “living standards growth”?
18. What are the “three basic economic questions” that economists often address when examining how much economic output is produced?
19. Once countries already have a high level of production, how might they achieve living standards growth?
20. Why is the goal of stability and security important to many people? What problems typically emerge during periods of instability?
21. The goal of sustainability requires that we address what three questions?
22. Explain the how the classical school views the role of markets and government intervention in fighting business cycles.
23. Explain how Keynesian economics views the role of markets and government intervention in fighting business cycles.
24. Explain how Monetarist economics views the role of markets and government intervention in fighting business cycles.
25. How does the classical/Keynesian synthesis combine elements from both the classical and Keynesian schools?
26. What two developments are demanding new ways of looking at the economic world in the 21<sup>st</sup> century? What kinds of sustainability questions do they raise?

## Self Test

1. With what kinds of topics does macroeconomics concern itself?
  - a. Economic activities of individual firms, households, and other organizations
  - b. Forces of supply and demand in a particular market
  - c. Consumer behavior and firms output decisions
  - d. The labor market, wages, and hiring decisions.
  - e. Aggregate economic phenomena like the rate of unemployment and inflation.
  
2. Which of the following is an example of a normative question?
  - a. What is the nation's rate of economic growth?
  - b. What is the nation's rate of inflation?
  - c. What is the nation's rate of unemployment?
  - d. What is the nation's level of GDP?
  - e. Is the goal of sustainability of greater importance than the goal of economic growth as we move into the 21<sup>st</sup> century?
  
3. Which of the following is one of the three macroeconomic goals discussed in the text?
  - a. Growth in the size of corporations
  - b. Living standards growth
  - c. Growth in trade and globalization
  - d. Technological innovation
  - e. None of the above
  
4. Which of the following is *not* an example of one of the three macroeconomic goals discussed in the text?
  - a. Preventing the economy from experiencing too much unemployment.
  - b. Preventing the economy from experiencing too much inflation.
  - c. Keeping living standards high enough for people to live decent, meaningful lives.
  - d. Making sure the economy is sustainable into the future.
  - e. Providing the best environment for corporations.

5. What explains the fact that the value of global production has grown by a factor of 4.6, while the value of global production per capita has grown by a factor of 2?

- a. the increase in global production has not kept up with the growth in global population
- b. the increase in global production has occurred simultaneously with the decline in global population.
- c. the increase in global production has occurred simultaneously with the growth in the global workforce.
- d. the increase in global production has occurred simultaneously with the decline in the global workforce.
- e. the growth in the global working age population contributing to global production has been greater than the growth in the global population.

6. How is labor productivity defined?

- a. The level of output produced per capita.
- b. The level of output produced per worker (or worker-hour).
- c. The level of output produced as a share of GDP.
- d. The level of human capital in the workforce.
- e. The level of output produced per capital input.

7. What problems are we most likely to see at which stage of the business cycle?

- a. High inflation during recessions.
- b. High unemployment during booms.
- c. Low inflation during booms.
- d. High unemployment during recessions.
- e. Both high unemployment and high inflation during booms.

8. Why is the instability of the business cycle a problem?

- a. During recessions there is high unemployment, and resources are underutilized.
- b. High unemployment is associated with individual and social stress, such as suicide, domestic violence, illness and crime.
- c. During booms, high inflation can erode purchasing power, savings and pensions.
- d. Unpredictable fluctuations in rates of inflation, interest rates, and foreign exchange rates make it difficult for individuals and organizations to plan for the future.
- e. all of the above.

9. Which of the following does *not* describe the economic events of the Great Depression?

- a. Stock markets plummeted in the 1929 stock market crash.
- b. A lack of confidence in banks led to runs on the banks and bank failures.
- c. Production dropped by about 30% between 1929 and 1933.
- d. The unemployment rate peaked to 25% at the height of the depression.
- e. The economic crises was short lived and markets quickly adjusted back to equilibrium.

10. Which of the following are the three dimensions of sustainability as discussed in the text?

- a. ecological, financial, and social sustainability
- b. ecological, financial, and political sustainability
- c. ecological, financial, and cultural sustainability
- d. ecological, technological, and human sustainability
- e. ecological, technological, and social sustainability

11. Which of the following is *not* an issue concerning of social sustainability?

- a. the disparities between the “haves” and the “have nots.”
- b. the ability of the next generation to contribute to a healthy economy and society
- c. the existence of national debt and the draining of financial resources.
- d. the creation of social disruption and political strife
- e. the ability of the next generation to experience social and political participation and inclusion.

12. Which of the following best describes the precautionary principle?

- a. It is incumbent on society to prove if an activity is unsafe to natural systems or human health.
- b. We should err on the side of caution when dealing with natural systems or human health.
- c. The benefits of economic production and growth outweigh the risks of damage to natural systems or human health.
- d. Business should not have to prove a product to be safe before being released on the market; rather a product must be proven unsafe before it is banned and pulled from the market.
- e. We should take precautions before engaging in risky investment.

13. Which of the following is *not* one of the ideas associated with the school of classical economics?

- a. specialization and the division of labor
- b. laissez-faire and the functioning of markets free of government intervention
- c. the pursuit of individual self-interest leads to positive economic outcomes.
- d. supply creates its own demand
- e. markets sometimes fail, necessitating government intervention.

14. Which of the following is *not* one of the ideas of Keynesian economics?

- a. An economy can experience insufficient demand
- b. Governments can step in to help boost aggregate demand
- c. Active use of fiscal policy can help keep aggregate demand high and employment rates up.
- d. Governments should focus on keeping the money supply steady
- e. Lowering interest rates alone may be insufficient if investors lack the confidence to engage in spending.

15. Which of the following best distinguishes fiscal from monetary policy?

- a. Monetary policy deals with the manipulation of government spending and taxation.
- b. Fiscal policy deals with the manipulation of interest rates and the money supply.
- c. Fiscal policy deals with the manipulation of levels of government spending and taxation.
- d. Monetary policy deals with both the manipulation of government spending and taxation, and interest rates and the money supply.
- e. Fiscal policy deals with both the manipulation of government spending and taxation, and interest rates and the money supply.

16. Which of the following was one of Keynes's suggested solutions, *and* was *not* generally adopted in the U.S. in the post-war era?

- a. the use of fiscal policy to stabilize the business cycle.
- b. the use of monetary policy to stabilize the business cycle.
- c. the involvement of government in controlling of the level and direction of national investment.
- d. the role of government in purchasing goods and services to stimulate aggregate demand.
- e. the role of government in manipulating taxation to stimulate aggregate demand.

17. Which of the following is *not* one of the ideas associated with monetarist economics?

- a. Bad government monetary policies are the cause of economic crises
- b. It was easy credit, low interest rates and high levels of money supply that led to the overspending of the late 1920s.
- c. The Great Depression of the 1930s was caused primarily by tight money policies.
- d. Governments should not use active monetary policy, but should keep the money supply stable.
- e. There are times when the government should take an active role by intervening with fiscal policy.

18. Which of the following best describes the classical/Keynesian synthesis?

- a. In the short run we are in the classical world, but in the long run we are in the Keynesian world.
- b. In the short run we are in the Keynesian world, but in the long run we are in the classical world.
- c. We are always in the short run which is characterized by the Keynesian view.
- d. We are always in the long run, which is characterized by the classical view.
- e. The classical and Keynesian schools both share the same basic view of economic agents engaging in rational, optimizing behavior.

19. According to the text, which of the following issues, not previously a major concern of macroeconomics, must macroeconomics confront in the 21<sup>st</sup> century?

- a. The ecological sustainability of our reliance on fossil-fuel based economic growth
- b. The social sustainability of the traditional model of economic development with the persistence of global poverty.
- c. The problem of business cycle fluctuations in unemployment and inflation.
- d. A and b only
- e. None of the above.

20. Which of the following characterizes the environmental challenges of the 21<sup>st</sup> century?
- a. The impressive growth of global GDP in the 20<sup>th</sup> century was accompanied by a dramatic increase in CO<sub>2</sub> emissions.
  - b. Economists are beginning to realize that there are limits to the capacity of the environment to absorb the by-products of economic growth.
  - c. Economists are increasingly questioning the ability of technological advancements to keep problems of resource depletion and pollution at bay.
  - d. If continued at the current rate, the emissions of CO<sub>2</sub> and other greenhouse gasses may lead to dramatic disturbances to our environment and economy.
  - e. all of the above.

### **Answers to Active Review Questions**

- 1. microeconomics, macroeconomics
- 2. positive, normative
- 3. living standards growth, stability and security, sustainability
- 4. economic development
- 5. economic, living standards
- 6. the business cycle
- 7. sustainability
- 8. classical economics
- 9. John Maynard Keynes
- 10. monetarist economics
- 11. False. They are studied in Macroeconomics.
- 12. False. Economic growth, not living standards growth, is defined as increases in the level of production in a country or region.
- 13. True.
- 14. False. Monetarists argued that governments should focus on keeping the money supply steady, even in a recession when unemployment was high.
- 15. True.
- 16. Microeconomics concerns itself with decision-making of individual consumers, firms and other organizations, such as how much to consume or produce of a product, while macroeconomics deals with aggregate production and expenditure, the level of unemployment, inflation, and interactions with the global economy.
- 17. Economists have traditionally defined economic growth in terms of production of goods and services, whereas the concept of “living standards growth” encompasses the improvement in the quality of diet and housing, transportation and communication, health care, education, working conditions, entertainment, and even political freedom and social inclusion.
- 18. The three basic questions are: what is produced, how is it produced, and for whom is it produced.

19. Once countries achieve a high level of production, they may achieve living standards growth by improving cultural, educational and environmental conditions, raising the quality of work-life, and promoting more equity.
20. The instability over the business cycle can be accompanied by high rates of unemployment, which is associated with falling incomes and social stress, like suicide, domestic violence, illness and crime. Alternatively the instability may result in inflation, which can erode the purchasing power of income, or wipe out the value of savings and pensions.
21. The goal of sustainability requires that we address whether economic activities are financially sustainable, whether they are socially sustainable, and whether they are ecologically sustainable.
22. The classical school believes in the smooth functioning of market mechanisms, and that they work best when left alone. They generally do not think governments should intervene, and think that often government intervention makes things worse.
23. Keynesian economics believes markets often fail and governments have a role to intervene, especially in boosting aggregate demand during downturns.
24. Monetarist economics believes that the government should pursue a steady money supply and not use active monetary policy interventions over the course of the business cycle.
25. The classical/Keynesian synthesis believes that in the short run we are in the Keynesian world (where markets fail to adjust and prices remain sticky), but in the long run we are in the classical world in which markets adjust and prices are flexible.
26. Two developments that are demanding new ways of looking at the economic world in the 21<sup>st</sup> century are 1) the environmental impact of long-term fossil-fuel based economic growth, particularly with the dramatic rise in CO<sub>2</sub> emissions; and 2) the persistence of substantial global poverty and its threat to social sustainability.

### **Answers to Self Test Questions**

1. e
2. e
3. c
4. e
5. a
6. b
7. d
8. e
9. e
10. a
11. c
12. b
13. e
14. d
15. c
16. c
17. e

- 18. b
- 19. d
- 20. e