

Grade 12 Economics Unit 1



Competency Based Short Note



Grade 12 Unit 1: The Fundamental Concepts Of Macroeconomics

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UEE 2016 & 2017

Social

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1.1 Definition and Focus Areas of Macroeconomics Revisited

Competency

- *Define macroeconomics.*
- *Explain the focus areas of macroeconomics.*
- *List the central macroeconomic questions.*
- *Describe what the terms “GDP” and “GNP” represent.*
- *Write down the three approaches to measure GDP*
- *Explain Real Vs Nominal GDP*

1.2 Key Challenges in Macroeconomics

Competency

- *Analyze and explain different challenges of macroeconomics*

1.3 The Schools of Thought in Macroeconomic Analysis

Competency

- *Describe the evolution and recent development in macroeconomic analysis.*
- *List different schools of thought engaged in macroeconomic analysis.*

1.1 Definition and Focus Areas of Macroeconomics Revisited

➤ Define macroeconomics.

- Macroeconomics is defined as:
 - ✓ The study of overall or aggregate behavior of the economy such as the overall level of output, prices and employment.
- It also explains that:
 - ✓ Macroeconomics is the study of the structure and performance of national economies and of the policies that governments use to try to affect economic performance.
- Macroeconomics differs from microeconomics in the following way:
 - ✓ macroeconomics studies the overall or aggregate behaviour of the economy, such as total output, prices, and employment
 - ✓ microeconomics studies the behaviour of individual economic units such as households, firms, and markets
 - ✓ In short, macroeconomics looks at the whole economy, while microeconomics focuses on individual parts of the economy.

Feature	Microeconomics	Macroeconomics
Focus	Study of individuals decision making behavior and actions of economic units, Such as consumers and firms.	Study of the overall behavior of the economy or aggregate economic phenomena
Scope	Individual markets, industries, prices, and resource allocation	→ Aggregate economic indicators → National and global economic trends.
Key concepts	Supply and demand, market equilibrium, consumer behavior, production theory etc...	National income, economic growth, economic policies, trade balance, price stability, employment etc
Analytical tools	Demand-supply, marginal analysis, optimization, cost-benefit analysis.	Aggregate demand and supply etc
Also known as	Price Theory	Income Theory

Sample UEE Questions:

1. Which one of the following is a branch of economics that studies about the aggregate behavior of the economy? **(2016)**
 - A) Microeconomics
 - B) Macroeconomics
 - C) International economics
 - D) Development economics
2. Among the following, which one is a macroeconomic issue? **(2016)**
 - A) Actions of an individual agent within an economy
 - B) The economic activities of a consumer, a producer or industry
 - C) Resource allocation or price determination as central problem
 - D) Structure and performance of the economy as a whole

➤ Explain the focus areas of macroeconomics.

- The focus areas of macroeconomics are the aggregate (overall) behaviour of the economy. These include:
 - ✓ **Economic growth** – how the economy increases its production of goods and services over time
 - ✓ **Employment** – the level of employment and unemployment in the economy
 - ✓ **Inflation** – changes in the general price level of goods and services
 - ✓ **Distribution of income** – how income is shared among different groups in society
 - ✓ **Macroeconomic policies** – government policies used to influence the economy
 - ✓ **International trade** – how the economy interacts with other countries through exports and imports

Sample UEE Question:

1. Which one of the following is the focus area of macroeconomics? **(2017)**
 - A) Inflation caused by different factors
 - B) Cost minimization of a specific company
 - C) The growth of a firm in the economy
 - D) Profit maximization of a corporation

➤ **List the central macroeconomic questions.**

- What factors determine the flow of total output produced in the economy over time?
- How can a nation increase its rate of economic growth?
- Why do outputs and employment sometimes fall?
- What are the causes of inflation and how can it be controlled?
- How do government policies affect output, unemployment, inflation, and growth?
- How can business cycle downturns be managed?
- How does the domestic economy interact with the rest of the world?

➤ **Describe what the terms “GDP” and “GNP” represent.**

- GDP (Gross Domestic Product) is the measure of the market value of all final goods and services produced in a country during a year.

$$GDP = \sum P_i Q_i$$

- Where:
 - ✓ P_i = series of prices of outputs produced in different sectors of an economy in certain period
 - ✓ Q_i = the quantity of various final goods and services produced in an economy
- GNP (Gross National Product) is the total value of final goods and services produced by domestically owned factors of production in a given period, usually one year, regardless of where they are located.
- **In short**, GDP focuses on production within a country, while GNP focuses on production by a country's citizens (both inside and outside the country).
- GDP and GNP are functionally related as: $GNP = GDP + NFI$, where NFI denotes net factor income received from abroad which is equal to factor income received from abroad by a country's citizens less factor income paid for foreigners to abroad.
- NFI (Net Factor Income from abroad) = Factor income received from abroad by a country's citizens - Factor income paid for foreigners to abroad.
- **NFI could be negative, positive or zero.**
 - ♣ If $NFI > 0$, then $GNP > GDP$
 - ♣ If $NFI < 0$, then $GNP < GDP$
 - ♣ If $NFI = 0$, then $GNP = GDP$

➤ **Write down the three approaches to measure GDP**

- The three approaches to measure GDP are:
 1. **Product (value added) approach** – GDP is calculated by adding the market value of all final goods and services produced in each sector of the economy.
 - ✓ There are two possible ways of avoiding double counting.
 - A. Taking only the value of final goods and services
 - B. Taking the sum of the valued added by all firms at each stage of Production.
 2. **Expenditure approach** – GDP is measured by adding total spending on final goods and services, i.e. consumption (C), investment (I), government spending (G), and net exports (NE).
 - $GDP = \text{Personal consumption of households (C)} + \text{Gross private domestic investment (I)} + \text{Government purchases of goods and services (G)} + \text{Net exports (NE)}$.
 3. **Income approach** – GDP is calculated by adding all incomes earned by factors of production such as wages, rent, interest, and profit.
 - $GDP = \text{Compensation of employees (wages \& salaries)} + \text{Rental income} + \text{Interest income} + \text{Profits (proprietors' profit plus corporate profit)} + \text{Indirect business taxes} + \text{Depreciation} - \text{Subsidies} - \text{Transfer payments}$

Rule Reminder:

- ✓ **Income approach:** Focuses on income generated.
- ✓ **Expenditure approach:** Focuses on spending.
- ✓ **Product approach:** Focuses on product or value added.
- All three approaches should, in theory, yield the same GDP figure.
 - ✓ However, in practice, there may be slight differences.
 - ✓ Due to data collection issues and measurement errors.

Sample UEE question:

1. Which of the following is used to calculate GDP by adding all the incomes accruing to all factors of production used in producing the national output?
(2016)
 - A) Product approach
 - B) Expenditure approach
 - C) Income approach
 - D) Value added approach

➤ Explain Real Vs Nominal GDP

❑ **Nominal GDP:** measured in actual (current) market prices.

- Nominal GDP is influenced by *both production quantity and price changes*
- It does not account for inflation

❑ **Real GDP:** measured using at constant prices (base year prices).

- Real GDP adjusted for inflation.
- Real GDP is influenced by *changes in production quantity*.
- Provides a more accurate measure of economic growth.
- An upward or downward movement in real GDP is the most widely used measure of the level and growth of output.

1.2 Key Challenges in Macroeconomics

➤ Analyze different challenges of macroeconomics

• The major challenges of macroeconomics include the following:

1. **Economic growth**
2. **Inflation**
3. **Unemployment**
4. **Business cycle**
5. **Balance of trade**

1. Economic growth

- Economic growth represents an increase in the capacity of an economy to produce goods and services.
- The rate at which the real GDP of a country increases over a period of time is known as the “economic growth rate.”
- Economic growth is a necessary element of high incomes and higher living standards.
- A higher economic growth rate can be achieved by:
 - A. Increasing the quality and amount of factors of production such as
 - ✓ *Labor, Land, Capital and their productivity.*
 - B. Enhancing institutional arrangements
 - ✓ *Adherence to the rule of law,*
 - ✓ *The protection of property rights and contractual rights so that markets can work effectively and efficiently.*

- Economic growth measures economic performance in terms of value of income, expenditure, and output.
 - ✓ Measuring real income in developing countries is not simple as we may think.
- In developing countries real income is generally understated compared to that of developed countries due to:
 - a) *The majority of the population are subsistence farmers who produce for their own consumption and such outputs are not correctly reported.*
 - b) *Underreporting income is common due to fear of tax and it is partly due to inefficient taxation systems.*
 - c) *Distortion in prices is much higher.*
- Besides this, GDP or GNP of developing countries ignores the cost of pollution and environmental degradation.
- In addition, the simple measure of growth has two limitations.
 - ✓ **First**, *it changes as the price level changes.*
 - ✓ **Second**, *it doesn't take population growth into account*
- In order to overcome the above two problems, economists have suggested
 - ✓ *Real GDP for measuring economic growth...to overcome the problem of price changes.*
 - ✓ *Per capita income, which is the ratio of total GNP to total population, as an indication of average standard of living.*
- Per capita income is often used as a measure for economic development. However, it has limitations.
 - ✓ This is due to the fact that, “development” and “economic growth” are different.
 - **Development:** a broader concept that encompasses not only economic growth but also social, political, and environmental factors. It involves improving the quality of life for a country's population
 - **Economic Growth:** a narrow concept that refers the quantitative increase in a country's production of goods and services.
- Per capita income alone is not enough to measure development. While it provides a valuable starting point

Alternative measure:

HDI (Human Development Index)

- Developed by: United Nations Development Program (UNDP) and it is sometimes called the “quality of life index.
- Components: Health (Life expectancy at birth), Education (Expected years of schooling and mean years of schooling), and Income (Per capita Income)
- Focus: Provides a comprehensive assessment of a country's development.

PQLI (Physical Quality of Life Index)

- Developed by: Morris D. Morris
- Components: Health (Infant mortality rate), Education (Literacy rate) and Living standards (Life expectancy at age 60)
- Focus: Emphasizes the physical well-being of a population, particularly health and basic living standards.

Sample UEE question:

1. Which of the following indicates the rank of Ethiopia in its human development despite the effort made to reduce the headcount poverty over the past twenty years? (2016)

- | | |
|--------------------------------|-------------------------|
| A) Low human development index | B) Low Gini coefficient |
| C) Low poverty gap | D) Low headcount ratio |

2. Inflation

- Inflation is defined as a regular and continuous rise in the general price level of goods and services.
- It means that the prices of most goods and services increase over time, not just a few items. Inflation is cumulative, meaning even a small increase in prices at the beginning can become very large over time.
- A substantial and rapid rise in the general price level
 - ✓ Reduces purchasing power of money (money buys less)
 - ✓ Increases cost of living
 - ✓ Reduces the standard of living over time.
- Rate of inflation
 - ✓ It is the percentage change in the overall level of prices.
 - ✓ It varies greatly over time and across countries.
- In general, inflation is an important macroeconomic problem because it affects consumers, reduces the value of money, and is a major concern for policymakers.
- Inflation is the major concern of macroeconomic policy throughout the world.

- ❑ Inflation classified on the basis of speed of occurrence and can be termed as:
 - ✓ **Creeping inflation:** is moderate inflation that occurs when the price level persistently rises over a period of time at a slow rate such as the price rise in 3% or less.
 - ✓ **Walking inflation:** occurs when annual inflation rate is a single digit or in the range of 3 to less than 10% per year.
 - ✓ **Running inflation:** occurs when prices rise rapidly at the rate of 10 to 20% per year.
 - ✓ **Gallop or jumping inflation:** occurs at a quick rate (dual or triple-digit annual rates) for a short period of time.
 - ✓ **Hyperinflation:** refers to a situation where the prices of goods and services rise uncontrollably
- ❑ Likewise, inflation is also classified on the basis of causes:
 - ✓ Demand-Pull Inflation: occurs when aggregate demand exceeds the economy's capacity to supply goods and services.
 - In other words, *consumers are demanding more goods and services than the economy can produce, leading to upward pressure on prices*
 - ✓ Cost-Push Inflation: occurs when *the cost of production increases*, leading businesses to raise prices to maintain their profit margins.
- ❑ Additionally, there are other types of inflation, such as built-in inflation and imported inflation, which can also contribute to the overall price level increase in an economy.

Sample UEE Question:

1. Which one of the following is the main issue of macroeconomic policy? **(2017)**
- A) Restructuring the market
 - B) Encouraging firm's competition
 - C) Controlling inflation
 - D) Maximizing firm's profit

Inflation and Consumer Price Index

- Inflation results in an increased consumer price index (CPI).
 - ✓ The CPI is a price index that reflects changes in the prices of goods and services typically purchased by consumers.
 - ✓ Hence, from the CPI angle, the rate of inflation or deflation is calculated as the percentage rate of change in a price index.

Consumer Price Index (CPI)

$$\text{Consumer Price Index (CPI)} = \frac{\text{The current cost of basket}}{\text{The base year cost of basket}}$$

Inflation Rate

$$\begin{aligned}\text{Inflation rate} &= \frac{\text{Current Date CPI} - \text{Past Date CPI}}{\text{Past Date CPI}} \times 100\% \\ &= \frac{CPI_t - CPI_{t-1}}{CPI_{t-1}} \times 100\%\end{aligned}$$

Where: CPI is Consumer Price Index

Example: Calculating the *consumer price index* (CPI) and the *inflation rate*. Assume a simple economy in which a typical consumer buys only two goods-wheat and edible oil. The consumer buys 50 kg of wheat and 10 liters of oil per year. Assume that the prices of these baskets of goods in three different years are the following.

Year	Price Kilo of Wheat	Price of a Litter of Oil
2000 EC	2 Birr	10 Birr
2001 E.C	3 Birr	13 Birr
2002 E.C	2 Birr	14 Birr
2003 E.C	4 Birr	24 Birr

Find:1. The price index in each year

2. The inflation rate from 2000EC to 2001 EC, from 2001 EC to 2002 EC, from 2002 EC to 2003 EC from 2003 EC to 2000 EC

Solution:

Step 1: Compute the cost of the basket of goods in each year.

Year	price of a kilo of wheat	price of a litter of oil
2000 E.C.	(Birr 2 per kg × 50 kg)	(Birr 10 per liter × 10 liter)
2001 E.C.	(Birr 3 per kg × 50 kg)	(Birr 13 per liter × 10 liter)
2002 E.C.	(Birr 2 per kg × 50 kg)	(Birr 14 per liter × 10 liter)
2003 E.C.	(Birr 4 per kg × 50 kg)	(Birr 20 per liter × 10 liter)

Step 2: Choose one year as a base year (2000) and compute the consumer price index in each year

$$\text{Consumers Price Index in 2000 E.C} = \frac{\text{birr 200}}{\text{birr 200}} \times 100 = 100$$

$$\text{Consumers Price Index in 2001 E.C} = \frac{\text{birr 280}}{\text{birr 200}} \times 100 = 140$$

$$\text{Consumers Price Index in 2002 E.C} = \frac{\text{birr 240}}{\text{birr 200}} \times 100 = 120$$

$$\text{Consumers Price Index in 2003 E.C} = \frac{\text{birr 400}}{\text{birr 200}} \times 100 = 200$$

Step 3: Use the consumer price index to compute the inflation rate from previous year

$$\text{Inflation Rate in year 2} = \frac{CPI_2 - CPI_1}{CPI_1} \times 100$$

$$\text{Inflation Rate in 2002 E.C. from 2001 E.C.} = \frac{(120 - 140)}{140} \times 100 = -14.3\%$$

$$\text{Inflation Rate in 2001 E.C. from 2000 E.C.} = \frac{(140 - 100)}{100} \times 100 = 40\%$$

$$\text{Inflation Rate in 2003 E.C. from 2002 E.C.} = \frac{(200 - 120)}{120} \times 100 = 66.6\%$$

Note that: The value (−14.3%) in the year 2002 E.C. shows a decrease in the general level of the prices of goods and services. A decrease in the general level of the prices of goods and services is known as deflation. Deflation is the opposite of inflation. Therefore, there was inflation in the years 2001 E.C. and 2003 E.C. and deflation in the year 2002 E.C.

Sample UEE Questions:

1. In November 2010, the Consumer Price Index (CPI) for a particular country was 100. In November 2011 the Consumer Price Index CPI for the same country was 130. What was the inflation rate for 2011? (2017)
A) 23% B) 10% C) 30% D) 13%
2. Consider a hypothetical economy in which a consumer buys 2kg of apples and 5kg of oranges at the price of birr 150 and 70 per kilogram respectively in 2016 E.C. If in 2015 E.C. the prices of these two goods, apple and orange, were birr 125 and 55 per kilogram respectively, then what is the rate of inflation during the year 2016 E.C. assuming that 2015 E.C. is the base year? (2016)
A) 10.28% B) 17.65% C) 23.80% D) 21.33%

3. Unemployment

- Unemployment is the macroeconomic problem that affects people most directly and severely.
 - ✓ It has economic costs to broader society.
 - ✓ Hence, making a level of unemployment a low is a public policy priority/ a paramount concern of economic policymakers.
- It has an opportunity costs.
 - ✓ The opportunity cost of unemployment is the output that the unemployed workers could have produced.
- We need to know the following concepts:
 - ✓ **Labor force:** *the sum of the employed and unemployed.*
 - ✓ **Total labor force:** *the percentage of the population that is willing and able to work.*
 - ✓ **Labor-force participation rate:** *the percentage of the adult population that is in the labor force.*
 - ✓ **Unemployment rate:** *the percentage of the labor force that is actively seeking employment but unable to find work.*

Labour Force

$$\text{Labour Force} = \text{Number of Employed} + \text{Number of Unemployed}$$

Unemployment Rate

$$\text{Unemployment Rate} = \frac{\text{Number of Unemployed}}{\text{Labour Force}} \times 100$$

Labour Force Participation Rate

$$\text{Labour Force Participation Rate} = \frac{\text{Labour Force}}{\text{Adult Population}} \times 100$$

- There are different types of unemployment.

A. Frictional unemployment

- ✓ It occurs during the time when workers move between jobs.
- ✓ This results in a lack of perfect mobility of workers between jobs.
- ✓ Example: Individuals entering the workforce for the first time after graduating from college/ university or searching for their first job. They are unemployed until they get their first job.

B. Cyclical unemployment:

- It occurs due to a deficiency of aggregate effective demand resulting from business depressions.
- Example: *workers will be laid off when the economy is in recession.*

C. Structural unemployment

- It is a form of involuntary unemployment that happens when there is lack of adjustment between demand for and supply of labor.
- It caused by mismatch between the skills of the workforce and the available jobs.
- The lack of necessary skills for a particular job.
- Education is the key in minimizing the amount of structural unemployment.

☐ Other forms

- **Underemployment:** Individuals are employed but working below their potential or in undesirable conditions.
- **Disguised Unemployment:** Individuals are employed but their work is unproductive.
- **Marginal Employment:** Individuals who work in low-paying, often temporary or informal jobs.
- **Discouraged Workers:** Individuals who have stopped searching for work due to a lack of suitable job opportunities.

UEE Sample Questions:

1. A census that was conducted in a particular economy shows that the total adult population is 27 million and those who are willing and able to work is 6 million. What is the labor force participation rate in this economy? (2016)
A) 12.18% B) 15.73% C) 22.22% D) 25.37%
2. Suppose in a given economy the population who are willing and able to work is 5 million and out of this total number of employed are 2 million. What is the unemployment rate? (2016)
A) 40% B) 70% C) 30% D) 60%
3. Which of the following is a key challenge of macroeconomics? (2017)
A) The number of unemployed people in a given country
B) The amount of profit earned by a given firm
C) The total amount of laborers hired by a given industry
D) Income and consumption pattern of a given household
4. The unemployment rate for an economy is 4 %. The labor force is estimated to be 55 million. What is the number of unemployed people in millions? (2017)
A) 22 million B) 20 million C) 220 million D) 2.2 million

4. Business Cycle

- ❑ The term “business cycle”, also known as “trade cycle”, “economic cycle” or “boom-bust cycle”, refers to economy-wide fluctuations in production and general economic activities.
 - ✓ The fluctuations represent upward and downward movements in levels of GDP.
 - ✓ Business cycles as fluctuations recur with a certain degree of regularity following a pendulum like oscillation.
 - ✓ Business cycles have four distinct phases: expansion, peak, contraction, and trough.

A. Expansion

- Characterized by increasing employment and economic growth.
- There is upward pressure on prices

B. Peak

- The highest point of the business cycle
- Economy produces maximum possible output
- Employment is at full employment
- Inflationary pressures are evident

C. Contraction

- Economic activity slows down
- Employment declines (unemployment increases)
- Growth decreases and price pressure reduces

D. Trough

- The lowest point of the business cycle
- Economy reaches the bottom level
- From here, the next expansion begins

UEE Sample Question:

1. Which one of the following characterizes period of expansion in the business cycle? (2016)
- A) Unemployment rises at this stage. B) The pressure on prices is upward.
C) Economic growth slows down. D) Full employment occurs at this stage.

5. Balance of Trade

- ❑ The balance of trade is another macroeconomic variable that affects national economies.
 - ✓ The **balance of trade** is the difference between export and the import of goods and services of a country for a given period
- ❑ It is also an important component of the balance of payment of a country.
 - ✓ The balance of payment is the systematic record of a nation's financial transactions with the outside world.
 - ✓ It is divided into current and capital accounts.
 - **The current account:** the market value of a *country's export and import of goods and services, investment income, debt service payments, and private and public net remittances and transfers.*
 - **The capital account:** the volume of *private foreign investment and public grants and loans* that flow into and out of a country over a given period.

UEE Sample Questions:

1. Balance of trade of a country is the difference between **(2017)**
 - A) export and import earning from goods and services.
 - B) Trade surplus and trade deficit.
 - C) Private and public net remittances and transfers.
 - D) Gross domestic product and gross national product.
2. In which of the following is the market values of country's exports and imports of goods and services are shown? **(2016)**
 - A) Capital account
 - B) Terms of trade
 - C) Current account
 - D) Budget surplus

1.3 The Schools of Thought in Macroeconomic Analysis

➤ Describe the evolution and recent development in macroeconomic analysis.

- Different schools of thought have engaged in macroeconomic analysis.

1. Classical and Neoclassical School

A. The Classical School

- It was the predominant economic philosophy until the Great Depression.
- Classical theory views recessions as temporary, with the economy returning to full employment.
- Representatives
 - Adam Smith (1723-1790),
 - David Hume (1711-1776),
 - David Ricardo (1772-1823),
 - Jean Baptiste Say (1767-1832),
 - John Stuart Mill (1806-1873),
 - Knut Wicksell (1851-1926), and
 - Irving Fisher (1867-1947)
- The Classical Principles
 - ✓ **Self-Regulating Markets:** free markets can efficiently allocate resources without government intervention.“Invisible hand”
 - ✓ **Flexibility of prices and wages:** adjust to changes in supply and demand.
 - ✓ Say's Law: "supply creates its own demand."
- In this case, no active fiscal or monetary policy is needed.
 - Fiscal policy is useless in affecting employment and output..... Crowding Out of private investment.
 - Monetary policy has no effects on the real sphere of the economy.....it only leads to a higher price level.
- For classical economists, the real and monetary sectors could be studied separately.
 - ✓ **Real Sector:** focuses on the primarily on production, distribution, and consumption of goods and services.
 - ✓ **Monetary Sector:** primarily influenced the price level and the distribution of income, but had little impact on the real economy in the long run.

B. The Neoclassical School

- Neoclassical emerged at the end of the 19th century and beginning of the 20th century in Europe.
- Neoclassicals base their ideas mainly on the writings of Alfred Marshall and his followers.
 - ✓ Léon Walras (1834-1910) and
 - ✓ Vilfredo Pareto (1848-1923).
- Neoclassicals
 - ✓ Assume rationality of economic agents
 - ✓ Closely follow the findings of the classical school
 - ✓ Use the concept of marginal utility and accept mathematical analysis.
 - ✓ View that in the long run, the economy will fluctuate around its Potential GDP and its natural rate of unemployment.
- The two building blocks of neoclassical economics are that:
 - ✓ The potential GDP determines the economy's size and
 - ✓ Wages and Prices will adjust in a flexible manner so that the economy will adjust back to its potential GDP level of output.
- **The key policy implication is that:** the government should focus more on long-term growth and on controlling inflation than on worrying about recession or cyclical unemployment.
- This means that neoclassical economics is more useful for long-run macroeconomic analysis
- Keynesian economics is more useful for analyzing the macroeconomic short run.

2. Keynesian

- The emergence of Great Depression of the early 1930s changed classical thinking.
 - ✓ The self-correcting feature of the market, the hallmark of classical theory, did not work.
 - ✓ The events of the Great Depression contradicted "Say's Law".
 - ✓ Although production capacity existed, the markets were not able to sell their products.
 - ✓ As a result, real GDP was less than potential GDP.

- Recession, according to the Keynesian view, emerges from two key building blocks.
 - ✓ First, aggregate demand deficiency.
 - ✓ Sticky wages and prices
- According to Keynes, Keynesian economics prescribed active fiscal policy to alleviate weak aggregate demand.
 - ✓ The availability of the factors of production determines a nation's potential GDP
 - ✓ The amount of goods and services that are sold, known as real GDP, depends on how much demand exists across the economy.
- Regarding Policies
 - ✓ Monetary policy is of little help, *as the additional money will simply be absorbed by investors with no noticeable effect on the interest rate.*
 - ✓ Fiscal policy will work well, *as the additional government spending will stimulate aggregate demand and hence employment and output.*

3. Monetarist

- The monetarist view is represented by Milton Friedman (1912-2006) and his colleagues.
- Hence, opposing Keynesian, Monetarists argued that it is monetary policy, and not fiscal policy, that addresses the macroeconomic problems or has real effects.
 - ✓ **Monetary Policy:** Investment is highly sensitive to interest rate.
 - ✓ **Fiscal policy:** Leads only to strong crowding out of private investment
- They recommend a monetary expansion to combat unemployment.
 - ✓ But then monetarists remain doubtful that policy makers are good at timing the monetary policy.
 - ✓ When the policy is set too late, monetary policy can heighten business cycle fluctuations in the economy.
- **Monetarists** suggested that the central bank should follow a constant growth rule for some monetary aggregate.

4. New Classical

- The new classicals are the natural successors of the classical economists.
- That is why they can be termed as the modern-day classical economists.
- Representatives:
 - ✓ Robert Lucas (1937 -)
 - ✓ Thomas Sargent (1943 -)
 - ✓ Robert Barro (1944 -)
 - ✓ Edward Prescott (1940 -).
- The new classicals stress mathematical techniques.
- They support classical ideas such as
 - ✓ Flexible prices and wages,
 - ✓ Rational expectations or perfect foresight,
 - ✓ Efficiency of the market, and
 - ✓ Full employment.

5. New Keynesian

- The New Keynesians are the natural successors of keynesian economics
- Representatives:
 - ✓ George Akerlof (1940 -)
 - ✓ Edmund Phelps (1933 -),
 - ✓ John B. Taylor (1946 -),
 - ✓ Stanley Fischer (1943-)
 - ✓ Olivier Blanchard (1948 -) and
 - ✓ Gregory Mankiw (1958 -).
- The New Keynesians derive their main inspiration from the insights of J.M. Keynes.
- For them, markets may not be as perfect as the classical economists suggest.
- They accepted the REH (rational expectation hypothesis), but stressed the existence of nominal rigidities, arising from multi-period nominal wage contracts.
- Hence, they argue for government to stabilize the economy, even under REH.
- The most recent wave of new Keynesian economics is more micro-based.
- The predominance of imperfect competition, coordination failures, and credit restrictions are stressed.

Summary

- ❑ The state of macroeconomics has evolved since the 1930s and different schools of thought emerged:
 - Classical
 - Neoclassicals
 - Keynesians
 - Monetarists
 - New classical
 - New Keynesians
- ❑ **Classical:** Emphasizes the self-regulating nature of markets and the invisible hand.
- ❑ **Neoclassical:** Built on classical school but incorporates marginal analysis and mathematical modeling and emphasizes the role of supply and demand in determining prices and output.
- ❑ **Keynesian:** Advocates for government intervention, particularly through fiscal policy, to stimulate economic activity.
- ❑ **Monetarism:** Emphasizes the role of money supply in determining economic activity and advocates for a monetary policy rule that targets a stable growth rate for the money supply.
- ❑ **New Classical:** argues that individuals and firms have rational expectations and that economic fluctuations are primarily caused by supply-side shocks.
- ❑ **New Keynesian:** acknowledge the role of market forces but also recognizing the potential for sticky prices and wages, which can lead to persistent unemployment.

Sample UEE Questions:

1. Which one of the following expresses the classical view? **(2016)**
 - A) The economy will move towards full employment of GDP.
 - B) Expansionary fiscal or monetary policy is necessary.
 - C) Demand side policies only affect the real wage, employment and output.
 - D) Monetary policy has effects on the real sphere of the economy.
2. What is the important lesson the world has learnt from the 1930's Great Depression? **(2016)**
 - A) The self-correcting feature of the market works
 - B) The additional government spending will stimulate unemployment.
 - C) The possibility of real GDP to fall below the potential GDP is nil.
 - D) The importance of active stabilization policies

3. Which one of the following school of thoughts suggested that the Central bank should follow a constant growth rule for some monetary aggregate to address macroeconomic problems? (2016)
- A) Keynesian B) Classical C) Monetarism D) New Keynesian
4. Which of the following school of macroeconomic thought was predominant until the occurrence of the Great Depression? (2017)
- A) New Keynesian B) Classical
C) Keynesian D) Monetarist
5. Which of the following is the view of Classical theory? (2017)
- A) There is a need of cutting government spending.
B) Monetary policy can influence output.
C) Recession is a temporary phenomenon.
D) Fiscal policy is useful to influence output.
6. Which of the following macroeconomic school stressed the existence of nominal rigidities arising from nominal wage contracts? (2017)
- A) The monetarist B) The classical
C) The new Keynesian D) The new Classical
7. Which one of the following is true about the differences between monetarist and Keynesian school of thought? (2017)
- A) Monetarist argued that monetary policy addresses macroeconomic problems.
B) Keynesians argued that monetary policy stimulates aggregate demand.
C) Monetarists argued that fiscal policy addresses macroeconomic problems.
D) Keynesians argued that aggregate demand is always automatically high.

➤ **List different schools of thought engaged in macroeconomic analysis.**

- Classical and Neoclassical
- Keynesian
- Monetarist
- New Classical
- New Keynesian

Thank You!!!