

## 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. It also provides an introduction to the key economic activities of (1) resource management, (2) consumption, (3) production, and (4) distribution. The chapter also provides a brief overview of the major historical developments in macroeconomics, from classical economics, to Keynesian and monetarist economics, 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. Differentiate between intermediate and final goals.
4. Discuss the relationship between economics and well-being.
5. Identify and describe the three main macroeconomic goals.
6. Define the four essential economic activities.
7. Define the five types of capital.
8. Explain the difference between stock and flows.
9. Understand the importance of managing capital stocks.
10. Identify and distinguish the major historical traditions of economic thought.

### Key Terms

economics

well-being

microeconomics

macroeconomics

recession

unemployment

inflation

macroeconomy

global economy

economic actor (agent)

positive questions

normative questions

assets

intermediate goal

final goal

living standards growth

economic growth

gross domestic product (GDP)

economic development

labor productivity

business cycle (trade) cycle

technological progress  
conscious consumption  
restorative development  
precautionary principle  
contextual economics  
resource management  
capital stock  
natural capital  
manufactured capital  
human capital  
social capital  
financial capital  
investment  
depreciation  
production  
inputs  
outputs  
investment goods  
waste products  
stock

flow  
stock-flow diagram  
distribution  
exchange  
transfer  
in-kind transfers  
dependency needs  
consumption  
saving  
classical economics  
division of labor  
specialization  
capitalists  
laissez-faire economy  
Say's Law  
aggregate demand  
Keynesian economics  
Monetarism

### 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 national and global level is the concern of, the study of economic activities 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, medical attention, education, working conditions, access to care, transportation, communication, entertainment, etc. is called \_\_\_\_\_ growth.

6. The fluctuations in the level of production, including 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. Protecting wildlife in a national park is an example of the economic activity of \_\_\_\_\_.
9. Gary's Gasoline Station is for sale. Gary hopes to get a good price for the station in part because he has built up a good reputation with customers. The good will of Gary's customers is a form of \_\_\_\_\_ capital.
10. The activity that turns inputs into new goods and services, or outputs, is called \_\_\_\_\_.
11. Your grandmother sends you a check for \$100. This form of resource distribution is referred to as a \_\_\_\_\_.
12. A gardener hears that a pesticide he has been using may have toxic effects on birds. Rather than wait to find out what further studies show about its effects, he finds another way of controlling insects in his garden. By taking action to protect birds, despite uncertainty about the dangers of the pesticide, the gardener is exercising the \_\_\_\_\_ principle.
13. 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 \_\_\_\_\_.
14. 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 \_\_\_\_\_.
15. 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*

16. Economic phenomena such as the rate of unemployment and inflation are studied in microeconomics.
17. The number of fish sold per day at Big City Fish Shop is an example of a stock.
18. Planting new trees in a forest is an example of making an investment.
19. Monetarists believe the government should change money supply to boost aggregate demand during a recession.

20. According to the Keynesians, the government can reduce unemployment through changes in its spending and taxation policies.

### **Short Answer**

21. What types of questions would concern microeconomics, versus macroeconomics?

22. What are the “three basic economic questions” that economists often address when examining how much economic output is produced?

23. Once countries already have a high level of production, how might they achieve living standards growth?

24. Why is the goal of stability and security important to many people? What problems typically emerge during periods of instability?

25. The goal of sustainability requires that we address what three questions?

26. Identify the four essential economic activities.

27. Name the five types of capital.

28. Explain the difference between a stock and a flow.

29. What are the two main forms of economic distribution? What is the difference between them?

30. Explain how the classical school views the role of markets and government intervention in fighting business cycles.
31. Explain how Keynesian economics views the role of markets and government intervention in fighting business cycles.
32. Explain how Monetarist economics views the role of markets and government intervention in fighting business cycles.
33. Describe some of the key changes that the U.S. economy has undergone since the 1980s.
34. 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 *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.
  
4. What explains the fact that the value of global production grew by a factor of 7.2 between 1960 and 2020, while the value of global production per capita has grown by a factor of 2.8?
  - A. Global population also grew, though not as fast as total production.
  - B. The increase in global production has occurred simultaneously with a decline in global population.
  - C. The increase in global production has occurred simultaneously with growth in the global workforce.
  - D. The increase in global production has occurred simultaneously with decline in the global workforce.
  - E. The growth in the global population has been greater than the growth in global production.
  
5. 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.
  
6. 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.
  
7. 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

8. Which of the following is *not* an issue concerning 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 need for steady growth in production
  - D. The creation of social disruption and political strife
  - E. The ability of the next generation to experience social and political participation and inclusion.
9. Which of the following best describes the precautionary principle?
- A. Clear cause and effect relationships must be established before taking action.
  - 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 business investment.
10. Which of the following best describes the notion of conscious consumption?
- A. making consumption choices based on advertisements
  - B. making consumption choices based on price of goods
  - C. making consumption choices considering the environmental and social consequences of the choices made
  - D. making consumption choices based on cultural influences
  - E. making consumption choices based on income levels
11. Enjoying art at a museum is an example of
- A. production
  - B. consumption
  - C. exchange
  - D. transfer
  - E. resource management
12. Which of the following activities would be described as a resource management effort?
- A. Limiting the use of fossil fuels in an effort to limit global warming
  - B. Harvesting fish at a high rate
  - C. Extracting oil from known oil reserves
  - D. Using a well-designed machine to process leather for shoes
  - E. Selling seeds on the international market

13. Which of the following is an example of the economic activity of distribution?
- A. A baker makes 10 loaves of bread.
  - B. A plumber fixes a leak.
  - C. The legal speed limit is raised from 65 to 75 mph.
  - D. A couple enjoys a walk in the forest.
  - E. A retired worker receives Social Security benefits.
14. Which of the following is an example of a stock?
- A. The knowledge you have gained from your past education.
  - B. The amount of water that passes over a waterfall per second
  - C. The number of screwdrivers sold by a hardware store each week
  - D. The number of fish produced at a hatchery each day
  - E. The number of goldfish in the pet store's aquarium
15. A city government builds a new road. After five years the road develops some potholes, making it less useful. This decline in the value of the road over time is an example of
- A. fixed inventory
  - B. flows of capital services
  - C. depreciation
  - D. substitutability
  - E. a renewable resource
16. A diagram that shows how flows change the level of a stock over time is known as a(n)
- A. flow chart
  - B. flow diagram
  - C. stock-flow diagram
  - D. input-output model
  - E. capital stock diagram
17. 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.



18. 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.
19. 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. Changes in government spending and taxation can help keep 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.
20. 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. Changes in government spending to stabilize the business cycle.
  - B. The role of government in keeping interest rates low to stimulate investment.
  - 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.
21. Which of the following contributed to rising unemployment and increased inflation in the 1970s?
- A. Declining profits of U.S. firms due to increased competition from other industrialized nations
  - B. Decline in wages
  - C. High expenditures by the government
  - D. (a) and (c) only
  - E. (a) and (b) only
22. Which of the following is *not* one of the ideas associated with monetarist economics?
- A. Free-market economy drives out inefficiencies in the economic system.
  - B. A smaller government is good for the economy as it encourages private initiatives.
  - C. Efforts by the government to push unemployment too low could lead to inflation.
  - D. Governments should keep the money supply stable.
  - E. There are times when the government should take an active role by changing its spending policies.

23. 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.

24. 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. There are limits to the capacity of the environment to absorb the by-products of economic growth.
- C. It is becoming more difficult for 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. resource management
  9. social (capital)
  10. production
  11. transfer
  12. precautionary (principle)
  13. classical economics
  14. John Maynard Keynes
  15. monetarist economics
  16. False. They are studied in Macroeconomics.
  17. False, it's a flow.
  18. True
  19. False. Monetarists argued that governments should focus on keeping the money supply
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steady, even in a recession when unemployment was high.

20. True.
21. 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.
22. The three basic questions are: what is produced, how is it produced, and for whom is it produced.
23. 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.
24. 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.
25. 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.
26. The four essential economic activities are: resource management, production, distribution, and consumption.
27. The five types of capital are: natural capital, manufactured capital, human capital, social capital, and financial capital.
28. A stock is something whose quantity is measured at a point in time, whereas a flow measures the quantity of something over a period of time.
29. The two main forms of economic distribution are exchange and transfer. Exchange involves a two-way distribution, trading one thing for another, whereas a transfer involves a one-way distribution, giving something with nothing specific expected in return.
30. 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.
31. Keynesian economics believes markets often fail and governments have a role to intervene, especially in boosting aggregate demand during downturns.
32. Monetarist economics believes that the government should pursue a steady money supply and not intervene in the market actively over the course of the business cycle.
33. Since the 1980s, there have been periods of long economic expansions, through the rate of growth during these expansions have been lower than that in previous decades. Also, the occurrence of large asset bubbles, driven by speculation, has become more common, real wages have remained stagnant, inequality has increased, and big corporations have grown and more powerful.
34. 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 – this raises questions about ecological sustainability; and 2) the persistence of substantial global poverty and its threat to social sustainability.

## Answers to Self Test Questions

- |       |       |
|-------|-------|
| 1. E  | 13. E |
| 2. E  | 14. E |
| 3. E  | 15. C |
| 4. A  | 16. C |
| 5. B  | 17. E |
| 6. E  | 18. E |
| 7. A  | 19. D |
| 8. C  | 20. C |
| 9. B  | 21. D |
| 10. C | 22. E |
| 11. B | 23. D |
| 12. A | 24. E |