

Macroeconomics Cribs *4E13*

1. Explain and analyse two theories of investment behaviour. [100]

Candidates could outline the following:

- (i) **Classical loanable funds theory – which shows that investment depends on the rate of interest. Candidates should outline why investment is negatively related to the rate of interest (the marginal efficiency of capital) and why savings are positively related to the rate of interest. Better candidates will discuss the limitation of the loanable funds theory – such as the Keynesian ‘paradox of thrift’ and uncertainty.**
- (ii) **Accelerator theory – which shows that investment depends on the level of economic activity. Better candidates will distinguish between the flexible and naïve accelerator models and consider the limitations of accelerator models (eg they ignore the role of the price mechanism and assume a constant capital-output ratio).**
- (iii) **Keynesian ‘animal spirits’ theory – that investment is primarily determined by expectations – better candidates will emphasise that much investment is ‘lumpy’ and non-reversible.**

Note: there are number of other theories of investment that candidates could analyse but they are not lectured on in this course.

2. If a country has an overvalued exchange rate, evaluate its impact on the following macroeconomic variables in that country:

- (a) International trade [40]

Candidates will evaluate the impact on trade flows (exports and imports) and the usual assumption that trade will deteriorate (exports will fall and imports will rise) and the balance of payments will deteriorate. Candidates should consider the Marshal-Lerner condition the importance of lags and the J-curve. Better candidates will discuss the importance of non-price factors for some goods and services; the importance of the level of world economic activity for exports; the importance of the duration of overvaluation and the possibility of trade hysteresis .

- (b) Inflation [30]

A higher exchange rate should lead to lower cost-push inflation - the overall impact will depend on the impact on the cost-wage-price mechanism. Also, an overvalued exchange rate might be symptomatic of relatively tight monetary conditions leading to lower demand-pull inflation.

- (c) Economic growth [30]

Economic growth may be reduced by deterioration in trade performance but this will depend on whether the county is suffering from a balance of payments constraint (long-run or short-run) and the importance of trade in national income.

Better candidates may consider that an overvalued exchange rate may encourage firms to improve efficiency and lower inflation may improve stability and growth.

3. Evaluate the impact of an increase in interest rates on the following:

(a) Inflation [50]

Increased interest rates may reduce inflation through a number of mechanisms: demand pull (reducing expenditure on consumption and investment); asset market effects (especially the property market); cost push effects (especially through the exchange rate). Better candidates will note the importance of lags and will use examples.

(b) Output and employment [50]

Increased interest rates may reduce output and employment through a number of mechanisms: reduced expenditure on consumption and investment and a deteriorating trade performance. Better candidates will consider the importance of lags and that the overall impact will also depend on fiscal policy and developments in the world economy.

4. (a) Explain the causes of deindustrialisation in advanced economies [60]

Candidates should draw the distinction between 'positive' and 'negative' deindustrialisation. Positive deindustrialisation reflects economic maturity and mechanisms include different sectoral income elasticities and different growth rates of productivity. It also, includes organisational change and the contracting-out of service functions by manufacturing firms. Negative deindustrialisation reflects economic failure and inappropriate business practices and industrial policies that lead to slow growth in the manufacturing sector and an inability to exploit economies of scale.

(b) Does the relative decline of the manufacturing sector have any implications for economic growth in the United Kingdom? [40]

Candidates should evaluate whether the UK has been undergoing a process of positive or negative deindustrialisation. Those who argue that 'manufacturing does not matter' stress that the UK is now primarily a service-based economy that can buy manufactures that are produced more cheaply abroad. Those that argue that manufacturing does matter argue that the relative decline of manufacturing has reduced the UK's long-term growth potential as manufacturing is an important source of economies of scale and technological development and the manufacturing sector remains the most important source of exports.