The Co-operative University of Kenya

EXAMINATIONS FOR DIPLOMA
CODE:CMBA 1201
COURSE TITLE: INTRODUCTION TO MACRO-ECONOMICS
ANSWER SHEET

1. **Differences between Macro and Micro Economies**

a) Macroeconomics deals with the behavior of the economy as a whole. Microeconomics focuses primarily on economic decisions by individuals and firms.

b) Macroeconomics is broad where it deals with economic issues at national level. Microeconomics is concerned with analyzing market mechanisms that establish relative prices and resource allocation.

c) Macroeconomic variables include output (GDP) unemployment, inflation, international trade etc. Microeconomic variables are demand & supply, scarcity & choice, resource allocation, utility, market equilibrium etc.

ii) Discuss FIVE (5) key macro-economic policy objectives of an economy (10 Marks)

- Achievement of full employment of factors
- To control inflation
- For sustained economic growth
- To achieve trade balance between countries

iii) Nominal and Real GDP

Nominal & Real GDP – nominal output describes the measurement of total output in current prices. It does not factor in inflation; therefore, price indices are used to adjust nominal values using a base year to reflect real values.
Real output refers to the value of total output measured in market prices adjusted by a base year less inflation.

2. a)Discuss the Fiscal policy and its objectives (10mrks)
It is defined as the process of shaping government taxation and expenditure to achieve desired economic and social objectives.
The objectives of fiscal policy are not specified these change with the level of economic development. The objectives of fiscal policy may differ from country to country. Following are the main objectives of fiscal policy in the development countries.

Objectives and Role of Fiscal Policy

1. Increase in Savings :-
This policy is also used to increase the rate of savings in the country. In the developing countries rich class spends a lot of money on luxuries. The government can impose taxes on them and can provide the basic necessities of life to the poor class on low rate. In this way by providing incentives, savings can be increased.

2. To Encourage Investment :-
The government can encourage the investment by providing various incentives like the tax holiday in the various sectors of the economy. The capital can be shifted from less productrive sectors to more productive sectors. So the resources of the country can be utilized maximum.

3. To Achieve Equal Distribution of Wealth :-
Fiscal policy is very useful for the achievement of equal distribution of wealth. When the wealth is equally distributed among the various classes then their purchasing power increases which ensures the high level of employment and production.

4. To Control Inflation :-
Fiscal policy is very useful weapon for controlling the rate of inflation. When the expenditure on non productive projects is reduced or the rate of taxes are increased then the purchasing power of the people reduces.

5. To Reduce the Regional Disparity :-
In the less developing countries the regional disparity is found. Some areas are more developed while the others are less developed. Government provides the infrastructure facilities in less developed areas. The tax holiday incentive is also provided in these areas which is very useful in increasing the per capita income.

6. Stabilization of Price Level :-
Fiscal policy is also used to achieve desirable level of prices in the country. It means the cost and price should be at such level that production and employment may increase.

7. Increase in Agriculture and Industrial output :-
Fiscal policy is also used that the output of various sectors of the economy must increase. The demand inside and out side the country should be satisfied.

8. To Attain Maximum Welfare of the People :-
Fiscal policy main objective is to achieve maximum welfare of the people. The quality of life must improve in the country.

9. To Check Rapid Increase in Consumption :-
Fiscal policy is also used to check the rapid increase in the consumption will be high then the rate of saving will be low and consequently rate of investment will be low. So one country cannot improve its economic condition without increasing the investment.

b) How can the government of Kenya deal with the rising rates of unemployment among the Kenyan Youth (10mrks)

1) Increasing job creation in the private sector by creating enabling environment for private sector development. The State can provide incentives to micro-finance institutions to provide capital to SMEs. Equally important is development of informal sector through provision of cheap credit.
2) Pricing policies that encourage use of appropriate technology. Removing factor price distortions depends on how labour can be substituted for capital. Government policies should aim at lowering price of labour to create job opportunities.

3) Adopting relevant education systems geared towards technical and professional skills
4) Diversification of economic activities. Introducing labour-intensive industries or creation of manufacturing industries will reduce unemployment.
5) Diversification of products and markest. Prouct diversification should include value addition and use of labour-intensive technology. Firms should seek new markets for their products to stimulate demand.
6) Rural development tartegies through creation of rural industries, infrastructure development, provision of social ameities to curb rural-urban migration.
7) Encouraging foreign direct investment

Proper utilization of existing resources

3. **(a) Circular flow of income** (10 marks)

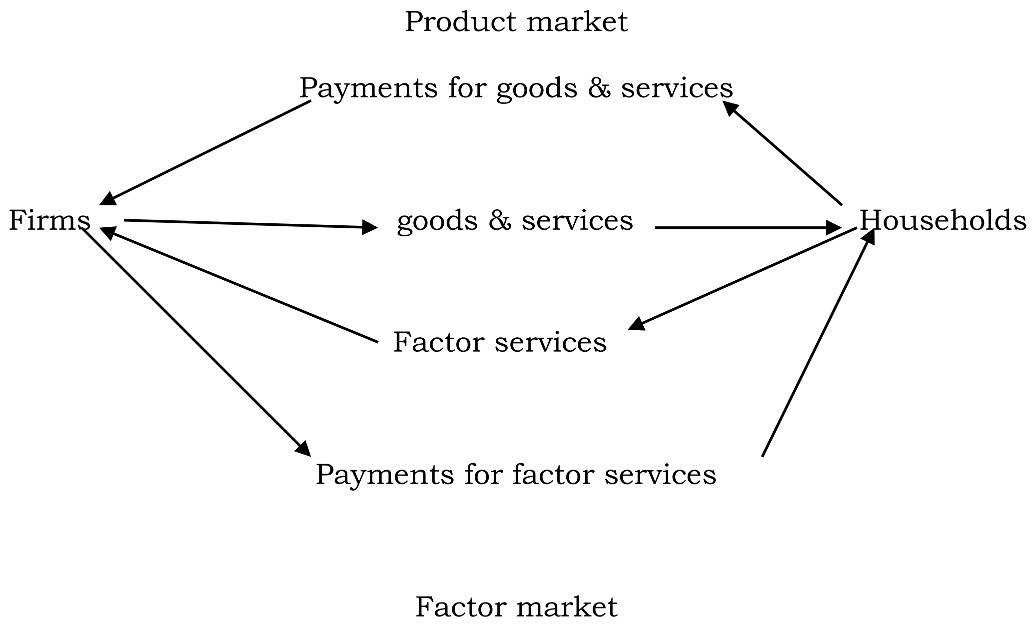
This is a simple model depicting the movements of resources between producers and consumers. It consists of;

- Wages and salaries paid by firms to households
- Money spent by households and received by firms

Corresponding to these flows is a flow of a real resource in return, i.e

- labor provided by households to firms
- goods and services provided by firms to households

Hence, there is a total of four flows between 2 sectors of households and firms. Each provides the other with some real resource, and each receives cash in return. Additionally, each spends that cash on the supply of the other.



(b) **Define inflation and explain its causes.** (10 marks)

Inflation is the rate of increase of the general level of prices for goods and services. In other words, it is the term used when the prices for goods and services increase over time.

Causes of Inflation

a) Cost-Push Inflation

This type of inflation occurs when production costs push prices high. It occurs because of;

- Increases in factory wages without a corresponding increase in output.
- A rise in import prices of crude oil which forms a substantial proportion of production costs. Devaluation of the local currency unit may also increase import prices.
- Structural rigidities in production especially agriculture which leads to rising average costs.
- Increases in indirect taxes

NB// The actual increase in prices depends on the elasticity of demand and supply.

b) Demand-Pull Inflation

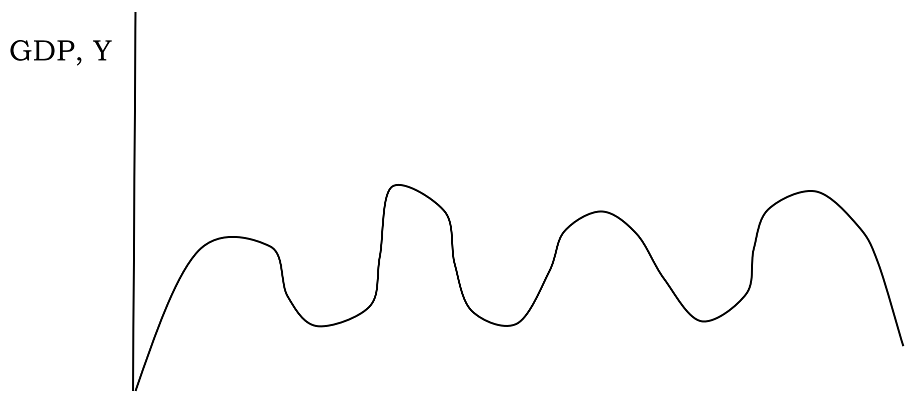
This occurs when aggregate demand persistently exceeds aggregate supply. If firms do not respond quickly to increase output, then inflation occurs. Firms may be unable to respond to increases in demand because of other constraints within a certain period.

Generally, demand-pull inflation is caused by;

- An increase in demand for goods and services but with a corresponding limited supply.
- General shortages of goods and services in times of disasters like floods, earthquakes, political turmoil, cyclones etc
- A country trying to export more at the expense of local production
- Government fiscal policies eg borrowing domestically but with little or no output expansion.

(c) (a) In the process of economic growth business cycles are inevitable. With examples discuss the business trade cycles (10 marks)

These are cyclical fluctuations in national income over a time period.



Time, t

A **recession** means unemployment of labour and capital due to low levels of demand. Firms cut down on production and lay off workers due to low consumption and investments. The cycle can continue till when an economy hits an all time low. This is known as **depression**. In this phase, demand falls, profits fall and output and employment levels fall. There is very little economic activity.

A recession or depression could be followed by a fiscal or monetary policy stimulus by the government that could revive the economy. This phase is called **recovery** phase. Demand rises hence creating optimism. Investments rise and output expands and unemployment declines. The economy peaks at the **boom** phase where there are low unemployment levels, high levels of demand and full capacity in firms.

(b) Discuss the objectives of the Monetary Policy (10 mrks)

- Full Employment:
- Price Stability:
- Economic Growth:
- Balance of Payments:
- Bank Rate Policy:
- Open Market Operations:
- Changes in Reserve Ratios:
- Selective Credit Controls:

(d) (a) According to Keynes there are different motives for holding money discuss (10 marks)

Keynes identifies three reasons why people hold money rather than marketable securities.

a) Transaction motive – that households need money to pay for their daily purchases
b) Precautionary motive – money is held in order to finance unplanned transactions.
c) Speculative motive – people choose to hold money to take advantage of profitable opportunities in financial markets eg to invest in bonds

(b). Explain the concept of international trade citing the reasons “For” and “Against”. (10mrks)

International trade refers to the exchange of goods and services between two countries.

5(a) According to Keynes there are different motives for holding money discuss (10 marks)
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(b). Explain the concept of international trade citing the reasons "For" and "Against". (10mrks) **Advantages of Int'l Trade**

- It leads to an increase in standards of living of all people of different countries. Consumers have a wide range of choice of goods and services.
- Some countries sell off their resources thereby earning foreign exchange
- It encourages efficiency since exporters try to be competitive in both local and foreign markets
- It promotes peace and security because countries enjoy mutual cooperation through trade.
- It enlarges commodity markets for a country's products
- It can lead to economies of scale through specialization in areas where it has comparative advantage in production.