

Principles Of Macroeconomics Mankiw Answer Key

CHAPTER 5 The Open Economy

Questions for Review

1. By rewriting the national income accounts identity, we show in the text that

$$S - I = NX.$$

This form of the national income accounts identity shows the relationship between the international flow of funds for capital accumulation, $S - I$, and the international flow of goods and services, NX .

Net foreign investment refers to the $(S - I)$ part of this identity: it is the excess of domestic saving over domestic investment. In an open economy, domestic saving need not equal domestic investment, because investors can borrow and lend in world financial markets. The trade balance refers to the (NX) part of the identity: it is the difference between what we export and what we import.

Thus, the national accounts identity shows that the international flow of funds to finance capital accumulation and the international flow of goods and services are two sides of the same coin.

2. The *nominal exchange rate* is the relative price of the currency of two countries. The *real exchange rate*, sometimes called the *terms of trade*, is the relative price of the goods of two countries. It tells us the rate at which we can trade the goods of one country for the goods of another.
3. A cut in defense spending increases government saving and, hence, increases national saving. Investment depends on the world rate and is unaffected. Hence, the increase in saving causes the $(S - I)$ schedule to shift to the right, as in Figure 5-1. The trade balance rises, and the real exchange rate falls.

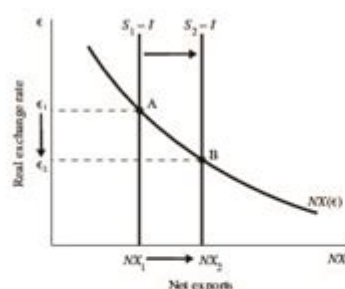


Figure 5-1

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Macroeconomics is a branch of economics that deals with the structure, performance, behavior, and decision-making of an economy as a whole. It encompasses various aspects, including national income, overall levels of prices, employment, and economic growth. One of the most widely used textbooks for learning the principles of macroeconomics is "Principles of Macroeconomics" by N. Gregory Mankiw. This article will provide an overview of key concepts presented in the textbook and

explore the answer key for enhancing understanding and application of these principles.

Overview of Mankiw's Principles of Macroeconomics

Mankiw's "Principles of Macroeconomics" is structured around ten fundamental principles that serve as the foundation for understanding macroeconomic concepts. These principles are categorized into three broad themes: how people make decisions, how people interact, and how the economy as a whole functions.

Ten Principles of Economics

1. **People Face Trade-offs:** Making decisions requires comparing the costs and benefits of different choices. For instance, a student must decide between spending time studying or working a part-time job.
2. **The Cost of Something is What You Give Up to Get It:** This principle emphasizes opportunity cost, the value of the next best alternative that is foregone when a choice is made.
3. **Rational People Think at the Margin:** Rational decision-makers evaluate the additional benefits and costs of a decision rather than considering total costs.
4. **People Respond to Incentives:** Changes in incentives can significantly influence behavior. For example, higher taxes on cigarettes may reduce smoking rates.
5. **Trade Can Make Everyone Better Off:** Trade allows individuals and countries to specialize in what they do best, benefiting from the exchange of goods and services.
6. **Markets Are Usually a Good Way to Organize Economic Activity:** Market economies leverage supply and demand to allocate resources efficiently.

7. Governments Can Sometimes Improve Market Outcomes: Government intervention may be necessary to address market failures and promote equity.
8. A Country's Standard of Living Depends on Its Ability to Produce Goods and Services: Productivity is a key driver of economic growth and living standards.
9. Prices Rise When the Government Prints Too Much Money: Inflation is often a result of excessive money supply in the economy.
10. Society Faces a Short-Run Trade-off Between Inflation and Unemployment: The Phillips curve illustrates the inverse relationship between inflation and unemployment in the short run.

Understanding Macroeconomic Indicators

In macroeconomics, various indicators are used to gauge the health of an economy. Mankiw emphasizes the significance of several key indicators:

Gross Domestic Product (GDP)

- Definition: GDP measures the total value of all goods and services produced within a country's borders in a specific period.
- Components: GDP can be calculated using the expenditure approach, which includes:
 - Consumption (C)
 - Investment (I)
 - Government Spending (G)
 - Net Exports (NX) = Exports - Imports
- Real vs. Nominal GDP: Real GDP is adjusted for inflation, while nominal GDP is not. Real GDP provides a more accurate reflection of an economy's size and growth over time.

Unemployment Rate

- Definition: The unemployment rate measures the percentage of the labor force that is unemployed and actively seeking employment.
- Types of Unemployment:
 - Frictional Unemployment: Short-term unemployment during transitions between jobs.
 - Structural Unemployment: Results from changes in the economy that create a mismatch between skills and job requirements.
 - Cyclical Unemployment: Associated with economic recessions.

Inflation Rate

- Definition: Inflation refers to the rate at which the general level of prices for goods and services rises, eroding purchasing power.
- Measurement: The Consumer Price Index (CPI) and the Producer Price Index (PPI) are commonly used to measure inflation.
- Consequences: Moderate inflation can stimulate spending and investment, while hyperinflation can lead to economic collapse.

Economic Theories and Models

Mankiw introduces several economic theories and models that provide frameworks for understanding macroeconomic phenomena.

Aggregate Demand and Aggregate Supply

- Aggregate Demand (AD): Represents the total quantity of goods and services demanded across all

levels of the economy at a given price level.

- Aggregate Supply (AS): Represents the total quantity of goods and services producers are willing and able to supply at a given price level.
- Equilibrium: The intersection of AD and AS determines the overall price level and output in the economy.

The Keynesian Model

- Principle: The Keynesian model emphasizes the importance of total spending (aggregate demand) in the economy and its effects on output and inflation.
- Policy Implications: It advocates for government intervention through fiscal policy (government spending and tax adjustments) to manage economic cycles.

The Classical Model

- Principle: This model posits that free markets can regulate themselves through the forces of supply and demand.
- Long-Run Growth: Classical economists focus on long-term growth driven by factors such as labor, capital accumulation, and technological advancement.

Policy Tools in Macroeconomics

Governments and central banks employ various tools to influence economic activity and achieve macroeconomic objectives such as stable prices, full employment, and economic growth.

Monetary Policy

- Definition: Monetary policy involves managing the money supply and interest rates to influence economic activity.
- Tools:
 - Open Market Operations: Buying and selling government bonds to adjust the money supply.
 - Discount Rate: The interest rate charged to commercial banks for loans from the central bank.
 - Reserve Requirements: The percentage of deposits that banks must hold in reserve.

Fiscal Policy

- Definition: Fiscal policy refers to government spending and taxation decisions made to influence the economy.
- Types of Policies:
 - Expansionary Fiscal Policy: Involves increasing government spending or decreasing taxes to stimulate economic growth.
 - Contractionary Fiscal Policy: Involves decreasing government spending or increasing taxes to control inflation.

Conclusion

Mankiw's "Principles of Macroeconomics" serves as an essential resource for understanding the complex dynamics of economies around the world. The principles outlined in the textbook provide a foundational framework for analyzing economic behavior, interpreting macroeconomic indicators, and evaluating the effects of various economic policies. By leveraging the concepts introduced in Mankiw's work, students and practitioners alike can gain a deeper insight into the functioning of economies and the impact of their decisions on broader economic outcomes. The answer key, as a supplementary resource, enhances the learning process by providing guidance on problem-solving and application of

theoretical concepts, ultimately fostering a more comprehensive understanding of macroeconomic principles.

Frequently Asked Questions

What are the key principles outlined in Mankiw's 'Principles of Macroeconomics'?

Mankiw outlines ten principles of economics, which include concepts like people face trade-offs, the cost of something is what you give up to get it, rational people think at the margin, and markets are usually a good way to organize economic activity.

How does Mankiw explain the role of government in the economy?

Mankiw discusses that while markets are generally efficient, there are situations where government intervention is necessary to promote efficiency or equity, such as in cases of market failure, externalities, or public goods.

What is the significance of the 'invisible hand' in Mankiw's principles?

The 'invisible hand' concept illustrates how individuals pursuing their own self-interest can lead to positive outcomes for society as a whole, as if guided by an unseen force that promotes overall economic welfare.

How does Mankiw address inflation in his macroeconomic principles?

Mankiw explains that inflation is generally caused by an increase in the money supply, leading to higher prices, and discusses the trade-off between inflation and unemployment in the short run, known as the Phillips Curve.

What does Mankiw say about the importance of productivity in economic growth?

Mankiw emphasizes that productivity is the key determinant of long-term economic growth, as it reflects the efficiency with which inputs are transformed into outputs and is influenced by factors like physical capital, human capital, and technology.

How does Mankiw differentiate between nominal and real variables?

Mankiw defines nominal variables as measured in monetary terms, while real variables are adjusted for inflation, providing a clearer picture of economic performance and enabling better comparisons over time.

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