

# Contemporary Macroeconomics

The background of the cover is a solid orange color. Overlaid on this are several large, overlapping triangles in different colors: grey, blue, red, and green. These triangles are arranged in a way that creates a sense of depth and movement, with some appearing to be in front of others. The lines of the triangles are thick and clearly defined.

# Contemporary Macroeconomics

SIXTH EDITION

**Milton H. Spencer**

Wayne State University

Worth Publishers, Inc.

**Contemporary Macroeconomics, Sixth Edition**

Copyright © 1971, 1974, 1977, 1980, 1983, 1986 by Milton H. Spencer

All rights reserved

Printed in the United States of America

Library of Congress Catalog Card No. 85-51297

ISBN: 0-87901-298-6

First printing, January 1986

Editor: Rosalind Lippel

Production: José Fonfrias

Design: Malcolm Gear Designers

Composition: Progressive Typographers

Printing and binding: Von Hoffmann Press, Inc.

**Worth Publishers, Inc.**

33 Irving Place

New York, New York 10003

---

# Preface

---

I hear and I forget  
I see and I remember  
I do and I understand  
Confucius

As a professor who has also been a consultant to domestic and foreign corporations and governments, it has been my experience that the most effective and interesting way of learning economics is by “doing” it. It has also been my experience that a sound understanding of basic theory is necessary for the intelligent application of economics. Accordingly, an introductory text in the subject should, in my judgment, provide students with the fundamental theory needed to do three things:

1. Understand matters of public policy
2. Evaluate conflicting opinions
3. Arrive at informed conclusions

This book seeks to achieve these objectives in a number of ways. To an extent not found in other texts, this one abounds with recent news articles, real-world examples, current issues, case studies, and practical problems. Most important, these motivating features are provided *without sacrificing basic theory*. As a result, the book enables students

to become deeply *involved* in the learning process by “practicing” economics instead of merely hearing about it in lectures and seeing it in a text.

## What’s New in the Sixth Edition?

One of the notable features of this edition is that it is considerably shorter than the previous one. This has been accomplished by substantially pruning, rewriting, and recasting nearly 50 percent of the book. Topics that have declined in relative importance have been dropped and much new material has been added — thanks to the suggestions of numerous users. The result is a text that is as modern as today’s journals and as current as today’s news.

Here is a summary of the *major* changes in this edition:

**The Private Sector** (Chapter 3) After a discussion of the reasons for disparities in personal income distribution, the difficulties of measuring disparities are explained. Emphasis is placed on understanding the factual errors of omission and commission that

are often encountered in reports concerning income distribution. The end of the chapter contains a unique class-participation problem in which a Lorenz curve and a Gini coefficient of inequality are derived for the class's distribution of cash on hand. The problem, which can be done in about 15 minutes, is current, practical, and highly motivating.

**The Public Sector** (Chapter 4) A thoroughly revised discussion of externalities is provided, including explanations of how they can be redressed through market and nonmarket methods. New supply-and-demand models illustrating spillovers are included. The diagrams are integrated in a way that makes the basic concepts exceptionally understandable and teachable.

**Economic Instability: Business Cycles, Unemployment, and Inflation** (Chapter 6) The Department of Labor's seven measures of unemployment are illustrated and explained. The new definitions of full employment, natural employment, and natural unemployment are discussed. In accordance with today's views, emphasis is placed on understanding and estimating the GNP gap.

**The Self-Correcting Economy: Introduction to Classical Economics** (Chapter 7) This new chapter introduces the necessary micro foundations of today's macro theory and policy. Classical views of the economy's markets are explained and illustrated with demand-and-supply models. These provide a basis for formulating the aggregate-demand/aggregate-supply model that is refined and extended in later chapters.

**Income and Employment Determination: The Income-Expenditure and Income-Price Models** (Chapter 9) After learning about the classical and Keynesian theories of instability, this chapter compares and contrasts the two views. Two approaches—the income-price (aggregate-demand/aggregate-supply) and income-expenditure (Keynesian-cross) models—are used consistently to illustrate fundamental ideas. The two models are

then integrated to provide a unified illustration of recessionary and inflationary gaps.

**Fiscal Policy and the National Debt** (Chapter 10) Both the income-expenditure and income-price models are employed to analyze fiscal-policy principles and issues. A substantially revised and simplified explanation of the balanced-budget multiplier is provided. Today's fiscal-policy controversies, including the inflation and interest-rate issues, are given major attention.

**Money, Financial Markets, and the Banking System** (Chapter 11) The changing nature of the financial system and the important role of financial (money and capital) markets are emphasized. The “crisis of confidence” in the banking system is also discussed, and some recent bank failures are examined.

**Banking Institutions: Money Creation and Portfolio Management** (Chapter 12) A concise explanation of bank legislation since 1980, a self-explanatory consolidated balance sheet of all U.S. banks, and a revised demonstration of credit creation in terms of uniform transaction accounts are provided. In addition, the money multiplier, as distinguished from the deposit multiplier, is explained and illustrated. The importance of each is discussed in the context of today's monetary thinking.

**Central Banking: Monetary Policy** (Chapter 13) A self-explanatory consolidated balance sheet of the 12 Federal Reserve Banks provides a new starting point for the discussion of central-bank monetary policy.

**Macroeconomic Equilibrium** (Chapter 14) This chapter has been revised to include a more concise discussion of interest-rate theory, classical and Keynesian interpretations, the Fisher effect, and an enlarged schematic outline of the Keynesian model.

**Monetarism and the New Classical Economics: Changing Ideas** (Chapter 15) The section on monetarism has been substantially shortened and rewritten.

ten. It now serves as a “preface” to new-classical economics and the theory of rational expectations. The coverage of this topic is comprehensive and thoroughly modern. Several novel diagrams and illustrations provide interesting pedagogical vehicles that instructors will find extremely useful.

**Understanding Macroeconomic Issues** (Chapter 16) Today’s inflation and unemployment issues are addressed, using the tools provided in previous chapters. Up-to-date data on the Phillips curve are presented, as well as analyses of current major public-policy issues.

**The Open Economy: International Trade and International Finance** (Chapters 17 and 18) These two chapters provide a comprehensive survey of modern international economics. Several supply-and-demand models illustrate tariffs, import quotas, and exchange-rate appreciation/depreciation in interesting and novel ways. A comprehensive and self-explanatory balance-of-payments statement makes it easy for students to understand, and for instructors to teach, this important but difficult topic.

## Special Features

**News Articles, Issues, and Cases** Most chapters contain recent news articles that apply the principles being addressed, and a number of chapters contain controversial Issues or Cases. These brief topical essays focus on real-world situations that allow students to apply concepts learned in the chapter. Many of these essays contain thought-provoking questions for discussion, while others require graphing or problem solving.

**Leaders in Economics** As in previous editions, there are several brief essays on the work of important economists, past and present. These essays focus on the subject’s main ideas and contributions as they relate to the topics discussed in the chapter.

**Dictionary of Economic Terms and Concepts** All technical terms and concepts are defined in the text where they are first discussed. In addition, all of these (and many others) are included in an extensive Dictionary at the back of the book. The Dictionary has been revised and expanded since the last edition, and it now contains approximately 1,000 entries. It will serve as a convenient reference for this course and also for other courses students will take in economics and business.

## Study Guide and Teaching Aids

The following supplements to *Contemporary Macroeconomics* are also available.

**Study Guide** The *Study Guide*, by Muriel W. Converse (University of Michigan), makes use of several pedagogical methods to help students learn the material covered in the text and to provide them with an opportunity to test their mastery of each topic. The *Study Guide* is written to be useful to *all* students, from those who are having difficulty (who may need to spend more time with it) to those who learn things quickly (who may be primarily concerned with self-testing to assure complete comprehension).

**Instructor’s Manual** The *Instructor’s Manual* contains an outline and learning objectives for each chapter. Suggested answers to all of the chapter-end questions in the text are included, as well as a good deal of supplementary material. For example, additional news articles that instructors may want to distribute to their students have been included here.

**Transparencies** Key charts, graphs, and diagrams from the text are available on acetate transparencies for use in lectures on overhead projectors.

**Test Bank and Computerized Test-Generation System** In this edition of the *Test Bank*, many new questions have been added to reflect the content

and organizational changes in the text. Approximately 2,000 five-choice multiple-choice questions and more than 300 true–false questions are included. Most of the questions emphasize theory and applications, while others test for knowledge of important facts. Fourteen ready-made model examinations are provided at the back of the *Test Bank*.

For those who adopt the book, the questions in the *Test Bank* are available on diskettes (for use on an Apple II+/IIe/IIc or an IBM PC) or on a mainframe tape, either of which can be used to generate examinations. Instructors can add their own questions, edit the existing questions, and print out as many as four different versions of an exam.

---

# Acknowledgments

---

It is a pleasure to acknowledge the help and cooperation I have received in the preparation of this book.

A general expression of thanks goes to Muriel Converse. She is not only the author of the accompanying *Study Guide* but also my severest critic. Her demanding standards have made the book much better than it might otherwise have been.

William Bowen of *Fortune* magazine read the entire manuscript and made good use of his wide experience and his impressive power of logic in editing it with great skill.

Julie Hearshen-Miller typed a substantial portion of the manuscript and was helpful in many ways.

Over the life of this book, I have benefited greatly from the criticisms and suggestions of hundreds of dedicated teachers. I cannot list them all here, nor can I list all of my students who have also helped to shape and improve the book. But I am grateful for the many suggestions, over the years, from so many people. I do want to mention and thank those who reviewed substantial portions of this edition and shared their classroom experiences with me:

John Andrulis, WESTERN NEW ENGLAND COLLEGE

Andrew H. Barnett, AUBURN UNIVERSITY

James H. Breece, UNIVERSITY OF MAINE — ORONO

C. Ann Brink, PALOMAR COLLEGE

Lillian Broner, OAKLAND COMMUNITY COLLEGE

Ann Garrison, UNIVERSITY OF NORTHERN  
COLORADO

Curtis E. Harvey, UNIVERSITY OF KENTUCKY

Jack Inch, OAKLAND COMMUNITY COLLEGE

Jack Klauser, CHAMINADE UNIVERSITY OF  
HONOLULU

S. N. Koenigsberg, SAN FRANCISCO STATE  
UNIVERSITY

Thomas Kompas, IOWA STATE UNIVERSITY

Keith R. Leeseberg, MANATEE JUNIOR COLLEGE

Dona K. Lehr, UNIVERSITY OF ALASKA —  
ANCHORAGE

Kenneth Long, NEW RIVER COMMUNITY COLLEGE

Marjorie F. MABREY, DELAWARE COUNTY  
COMMUNITY COLLEGE

Bruce McCrea, LANSING COMMUNITY COLLEGE

Edward S. Phillips, SHEPHERD COLLEGE

David E. Spencer, BRIGHAM YOUNG UNIVERSITY

Gary L. Thiege, CITY COLLEGE OF SAN FRANCISCO

Michael B. Vaughan, WEBER STATE COLLEGE

Walter J. Wessels, NORTH CAROLINA STATE  
UNIVERSITY



# Contents in Brief

Part 1			
<b>Overview: Our Economic System</b>	<b>1</b>		
Introduction	2		
1. Our Mixed Economy: Resources, Goals, and Institutions	10		
2. The Laws of Supply and Demand: The Price System in a Pure Market Economy	28		
3. The Private Sector—Households and Businesses: Income and Industrial Structure	49		
4. The Public Sector—Government: Public Choice and Taxation	66		
Part 2			
<b>National Income, Employment, and Fiscal Policy</b>	<b>89</b>		
5. National Income and Wealth: Measuring the Nation's Economic Health	90		
6. Economic Instability: Business Cycles, Unemployment, and Inflation	108		
7. The Self-Correcting Economy: Introduction to Classical Economics	126		
8. What Causes Unemployment? Introduction to Keynesian Economics	136		
9. Income and Employment Determination: The Income-Expenditure and Income-Price Models	153		
10. Fiscal Policy and the National Debt	172		
Part 3			
<b>Monetary Economics and Macroeconomic Equilibrium</b>	<b>191</b>		
11. Money, Financial Markets, and the Banking System	192		
12. Banking Institutions: Money Creation and Portfolio Management	210		
13. Central Banking: Monetary Policy	231		
14. Macroeconomic Equilibrium	245		
Part 4			
<b>Macroeconomics Today: Ideas, Issues, and Policies</b>	<b>265</b>		
15. Monetarism and the New Classical Economics: Changing Ideas	266		
16. Understanding Macroeconomic Issues	287		
17. The Open Economy: International Trade	308		
18. The Open Economy: International Finance	329		
Acknowledgments	342		
Index	343		
Dictionary of Economic Terms and Concepts	D-1		

# Contents

---

Part 1	
<b>Overview: Our Economic System</b>	<b>1</b>
Introduction	2
What Is Economics About?	2
<i>“Micro” and “Macro”</i>	3
Working with Theories and Models	3
<i>Common Fallacies in Reasoning</i>	4
Working with Graphs	7
Chapter 1	
<b>Our Mixed Economy: Resources, Goals, and Institutions</b>	<b>10</b>
Factors of Production: Resources of Our Economic System	10
<i>Returns to Owners of Resources</i>	12
Goals of Our Economic System: What Do We Want to Accomplish?	13
<i>Efficiency: Full Employment of Resources</i>	13
<i>Equity: Fairness or Economic Justice</i>	14
<i>Stability: Steady Average Price Level</i>	15

<i>Growth: Rising Output per Person</i>	15
<i>Striving for a Mix of Goals</i>	15
Scarcity: A Fact of Life	16
The Great Questions: What? How? For Whom?	16
Society’s Production Possibilities	17
<i>Law of Increasing Costs</i>	19
<i>Conclusion: The Idea of Opportunity Cost</i>	19
Capitalism and Our Mixed Economy	21
Institutions of Capitalism	21
<i>Conclusion: Our Mixed Economy</i>	23
<b>Leaders in Economics</b> Adam Smith	24
The Circular Flow of Economic Activity	25
<i>Limitations of Circular-Flow</i>	26
Chapter 2	
<b>The Laws of Supply and Demand: The Price System in a Pure Market Economy</b>	<b>28</b>
What Do We Mean by Demand?	29
<i>Demand Schedules and Demand Curves</i>	29
<i>The Law of Demand</i>	30
<i>Market Demand Is the Sum of Individual Demands</i>	32

What Do We Mean by Supply?	33
Supply Schedules and Supply Curves	33
The Law of Supply	34
Supply and Demand Together Make a Market	35
Buyers and Sellers in the Marketplace	35
Two Kinds of Changes Involving Demand	36
Changes in the Quantity Demanded	36
Changes in Demand	36
An Important Distinction	39
Two Kinds of Changes Involving Supply	39
Changes in the Quantity Supplied	40
Changes in Supply	40
Summing Up: Another Important Distinction	41
Combined Changes in Demand and Supply	42
The Market Economy: Is It “Good” or “Bad”?	42
Some Real-World Imperfections	44
Relevant Even If Not Realistic	47

## Chapter 3

**The Private Sector — Households and Businesses: Income and Industrial Structure** 49

Households: Income, Wealth, and Equity	49
A Look at the Facts	50
Measuring Inequality and Explaining the Facts	53
The Ethics of Distribution	57
Businesses — Organization and Size	59
Business Size and Problems of Bigness	60

## Chapter 4

**The Public Sector — Government: Public Choice and Taxation** 66

Economic Scope and Functions of Government	67
Promotion and Regulation of the Private Sector	67
Provision of Social Goods	68

Conclusion: Achieving Efficiency Through the Market	68
Spillovers, Market Failure, and Public Choice	70
Redressing Spillovers	70
Conclusion: Efficiency and Public Choice	72
Public Budgeting: Tools for Collective Decision Making	72
Planning-Program-Budgeting Systems (PPBS)	75
Benefit-Cost Analysis	76
Our Tax System	77
Taxes on Income	77
Taxes on Wealth	81
Taxes on Activities	81
Theories of Taxation	81
Principles of Tax Equity	82
Real-World Compromises	83
Tax Shifting and Incidence: Direct and Indirect Taxes	84

## Part 2

**National Income, Employment, and Fiscal Policy** 89

## Chapter 5

**National Income and Wealth: Measuring the Nation's Economic Health** 90

Gross National Product: The Broadest Measure of a Nation's Output	91
Calculating and Interpreting GNP	91
Is GNP a Measure of Society's Well-Being?	94
Conclusion: GNP and Social Welfare	95
Two Ways of Looking at GNP	95
GNP from the Expenditure Viewpoint: A Flow-of-Product Approach	96
GNP from the Income Viewpoint: A Flow-of-Costs Approach	99
Four Other Concepts, All Related	100
Gross National Product to Net National Product	100

<i>Net National Product to National Income</i>	100	<i>Prices and Wages Are Flexible</i>	129
<i>National Income to Personal Income</i>	101	<i>Classical Conclusion: Capitalism Is a</i>	
<i>Personal Income to Disposable Personal</i>		<i>Self-Correcting Economic System</i>	129
<i>Income</i>	101	The Income-Price Model	129
<b>Leaders in Economics</b> Simon Kuznets	102	<b>Leaders in Economics</b> The Classical	
<b>Leaders in Economics</b> Sir Richard Stone	102	Economists: Adam Smith's Children	130
Wealth of a Nation: How Much Is America		<i>The Aggregate Demand Curve</i>	132
Worth?	103	<i>The Aggregate Supply Curve</i>	133
		<i>Conclusion: Today's Classical Views</i>	133
Chapter 6		Chapter 8	
<b>Economic Instability: Business Cycles,</b>		<b>What Causes Unemployment?</b>	
<b>Unemployment, and Inflation</b>	<b>108</b>	<b>Introduction to Keynesian Economics</b>	<b>136</b>
Business Cycles — A Long History of		Essentials of the Keynesian Theory	137
Fluctuations	108	Aggregate Expenditure May Not Equal	
<i>Some Facts About Business Cycles</i>	110	Full-Employment Aggregate Income	137
Tracking the Economy	111	Savers and Investors Are Different People	
Conclusion: The Trade-off Between		with Different Motivations	137
Stability and Freedom	112	Prices and Wages Are Not Flexible	138
Unemployment	113	Keynesian Conclusion: Laissez-Faire	
Types of Unemployment	113	Cannot Ensure Full Employment	138
Measuring Unemployment: Who Are the		Consumption Expenditure	138
Unemployed?	114	The Propensity to Consume	139
Full Employment and "Natural"		The Propensity to Save	140
Unemployment	116	Average Propensities to Consume and	
Causes of Structural Unemployment	116	to Save	141
Conclusion: Costs of Unemployment	116	Marginal Propensities to Consume and	
Inflation	118	to Save	141
Types of Inflation: Is Our Nation		Two Kinds of Changes Involving	
Inflation-Prone?	118	Consumption	142
Who Loses from Inflation? Who Gains?	119	Private Investment Expenditure	144
Measuring Inflation: The Declining		Understanding the MEI	144
Value of Money	120	Cost of Funds: The Rate of Interest	145
Conclusion: The Need for Price Stability	123	The MEI and the Interest Rate	145
		Determinants of the MEI: Shifts of the	
Chapter 7		Curve	147
<b>The Self-Correcting Economy: Introduction</b>		Government Expenditure and Net Foreign	
<b>to Classical Economics</b>	<b>126</b>	Expenditure	149
Essentials of the Classical Theory	126	Conclusion: Reviewing the Basic	
Aggregate Expenditure = Aggregate		Relationships	149
Income or Output	127	<b>Leaders in Economics</b> John Maynard	
All Savings Are Invested	128	Keynes	151

Chapter 9		Public-Choice Problems: Political Business Cycles	182
<b>Income and Employment Determination:</b>		Conclusion: Some Successes and Failures	183
<b>The Income-Expenditure and Income-Price Models</b>	153	Deficits and Debt	184
The Income-Expenditure Model	154	Full-Employment (Structural) Budget	184
Structure of the Model	154	The Public Debt: Today's Issues	185
The Equilibrium Level of Income and Employment	155	Burdens on Future Generations	185
Injections and Withdrawals: The "Bathtub Theorem"	157	External-Debt Burden: Do We "Owe It to Ourselves"?	187
The Income-Price Model	158	Inflationary Burden: Do Deficits Cause Rising Prices?	187
Shapes of the Curves	158	Conclusion: Practical Debt-Management Guidelines	187
Equilibrium Possibilities	160		
Conclusion: Short-Run Determinants Are Important	162		
The Multiplier Principle	162		
Numerical Illustration	163		
Graphic Illustration	163		
Algebraic Illustration	165		
What Happens When the Price Level Varies?	165		
Conclusion: Different-Sized Multipliers	166		
Inflationary and Recessionary Gaps	167		
Conclusion: Closing the Gaps	169		
Chapter 10		Part 3	
<b>Fiscal Policy and the National Debt</b>	172	<b>Monetary Economics and Macroeconomic Equilibrium</b>	191
Bringing in Government	172		
Income-Expenditure Model: Constant Price Level	173		
Income-Price Model: Varying Price Level	176		
Conclusion: Need for Fiscal Understanding	177		
Principles of Fiscal Policy	177		
Nondiscretionary Controls: Automatic Fiscal Stabilizers	177		
Discretionary Fiscal Policy	178		
Where the Money Comes From	179		
Where the Money Goes	180		
Conclusion: Need for Budget Policies	181		
Problems of Fiscal Policy	181		
Cyclical Forecasting and Policy Timing	181		
Unknown Multiplier Effects	182		
Restrictive Effects: Crowding Out	182		
		Chapter 11	
		<b>Money, Financial Markets, and the Banking System</b>	192
		Defining and Measuring Money	193
		M1: Narrow-Transactions Money, the Basic Money Supply	193
		M2: Medium-Range Money	193
		M3: Wide-Range Money	194
		L: Liquid and Near-Liquid Assets	194
		Conclusion: Money Is a Spectrum of Assets	195
		Financial Markets	195
		The Money Market	197
		The Capital Market	198
		Conclusion: Economic Functions of Financial Markets	200
		Financial Intermediaries	200
		Commercial Banks	200
		Other Financial Intermediaries	201
		Rules for Survival	201
		The Federal Reserve System	202
		The Fed: Objectives, Organization, and Functions	202
		Organization of the Banking System	206

<i>Banking Supervision: A Regulatory Thicket</i>	206	<i>Advantages of Monetary Policy</i>	240
<i>Deposit Insurance: Protecting Your Money</i>	206	<i>Limitations of Monetary Policy</i>	240
		<i>Conclusion: Complex Issues</i>	242
Chapter 12		Chapter 14	
<b>Banking Institutions: Money Creation and Portfolio Management</b>	<b>210</b>	<b>Macroeconomic Equilibrium</b>	<b>245</b>
The Fundamental Principle of Deposit Banking	211	Money Affects Output and Prices	246
Proportions of Currency and Checkable Deposits	211	Equation of Exchange	246
The Goldsmiths' Principle	211	The Quantity Theory of Money	247
The Goldsmiths' Principle and Fractional Bank Reserves	211	What the Evidence Shows	247
Deposit Expansion by a Single Bank	214	Modernizing the Quantity Theory: The Importance of Velocity	248
Deposit Expansion by the Banking System	216	<b>Leaders in Economics</b> Irving Fisher	249
The Deposit Multiplier	217	Determination of the Interest Rate	249
Three Real-World Factors	219	Classical Explanation: Fisher's Theory	250
Conclusion: The Money Multiplier	220	An Alternative Explanation: Keynes's Theory	253
Managing a Bank's Portfolio	220	Practical Implications: Interest Rates and Business Investment	256
Objectives: Liquidity, Profitability, and Safety	220	Conclusion: Interest Rates a Continuing Concern	258
The Conflict Between Liquidity and Profitability	221	Macroeconomic Equilibrium: Putting the Pieces Together	259
Priorities for Allocating Bank Funds	222	Outline of the Keynesian Theory	260
Conclusion: Types of Bank Investments	223	Integrating Some Basic Relationships	260
<b>Leaders in Economics</b> James Tobin	223	Conclusion: Putting Monetary Policy to Work	260
Chapter 13			
<b>Central Banking: Monetary Policy</b>	<b>231</b>	Part 4	
General (Major) Controls	232	<b>Macroeconomics Today: Ideas, Issues, and Policies</b>	<b>265</b>
Changing Reserve Ratios	232		
Changing the Discount Rate	233	Chapter 15	
Open-Market Operations	234	<b>Monetarism and the New Classical Economics: Changing Ideas</b>	<b>266</b>
Selective (Minor) Controls	236	Monetarism: Steady Monetary Growth	267
Margin Regulations	236	Origin: The Quantity Theory of Money	267
Moral Suasion	237	Demand for Money	267
How Monetary Policy Affects Interest Rates and Business Investment	238	The Stability of Velocity	270
Bank Portfolio Effects and Business Investment	238	The Transmission Mechanism: Portfolio Adjustments	270
Is Monetary Policy Really Useful?	239		

Evidence and Policy Recommendations	271	Wage-Price Controls: Income Policies	302
Some Agreements and Some Disagreements	273	Economic Planning	303
Rules or Discretion?	273	Conclusion: Economics, Politics, and Rationality	305
Conclusion: Today's Conflicting Views	275		
<b>Leaders in Economics</b> Milton Friedman	275		
New Classicism: The Self-Correcting Economy	277	Chapter 17	
Rational Expectations: What You Foresee Is What You Get	277	<b>The Open Economy: International Trade</b>	<b>308</b>
Income-Price Model	277	Why Trade?	309
Changes in the Curves: Self-Correcting Adjustments	278	Specialization and Trade	310
Underlying Assumptions	284	Specialization and the Gains from Trade	311
Conclusion: Minimize Uncertainty	284	Terms of Trade	312
		Increasing Costs and Incomplete Specialization	313
Chapter 16		The Foreign-Trade Multiplier	314
<b>Understanding Macroeconomic Issues</b>	<b>287</b>	Open-Economy Model	314
Unemployment and Inflation:		Three Possibilities for Net Exports	315
Phillips-Curve Analysis	287	Multiplier Effect	316
Observed Phillips Curves	288	The Case for Free Trade	317
New-Classical Explanation	289	Absolute Advantage	317
Keynesian Explanation	291	Comparative Advantage	317
Conclusion: Today's Phillips Curve	291	Conclusion: The Argument for Free Trade	318
Supply-Side Economics	291	Free Trade Versus Import Protection	318
Rejection of Keynesian Demand-Management Policies	292	Analyzing Quotas and Tariffs	318
Tax Reduction to Stimulate Production	292	Visible and Invisible Effects	321
Nonmonetization of Government Deficits	294	Conclusion: Tariffs Preferred to Quotas	322
Deregulation of Industries and Markets	295	Arguments for Protection	323
Conclusion: Different Emphasis	296	Infant-Industry Argument	323
Curing Recurrent Stagflation: Market Policies	296	National-Security Argument	323
Monetary and Fiscal Guidelines	297	Wage-Protection Argument	324
Employment Programs: Putting People to Work	298	Employment-Protection Argument	326
Productivity: Steps Toward Improving Efficiency	299	Conclusion: Fundamental Principle	327
Curing Recurrent Stagflation: Can Nonmarket Measures Work?	302		
		Chapter 18	
		<b>The Open Economy: International Finance</b>	<b>329</b>
		The Balance of Payments	329
		The Foreign-Exchange Market	331
		Graphic Illustration	331
		Shifts of the Curves: Causes and Effects	332

<i>Conclusion: Important Ideas and</i>		<i>Acknowledgments</i>	<b>342</b>
<i>Potential Problems</i>	<b>333</b>	<i>Index</i>	<b>343</b>
<i>Flexible Versus Fixed Exchange Rates</i>	<b>334</b>	<i>Dictionary of Economic Terms and Concepts</i>	<b>D-1</b>
<i>Flexible (Floating) Exchange Rates</i>	<b>334</b>		
<i>Fixed Exchange Rates</i>	<b>335</b>		
<i>Conclusion: Today's Problems and Policies</i>	<b>337</b>		
<i>Fiscal and Monetary Policies</i>	<b>338</b>		
<i>Trade Controls</i>	<b>338</b>		
<i>Exchange Controls</i>	<b>338</b>		



---

## **Part 1**

# **Overview: Our Economic System**

---