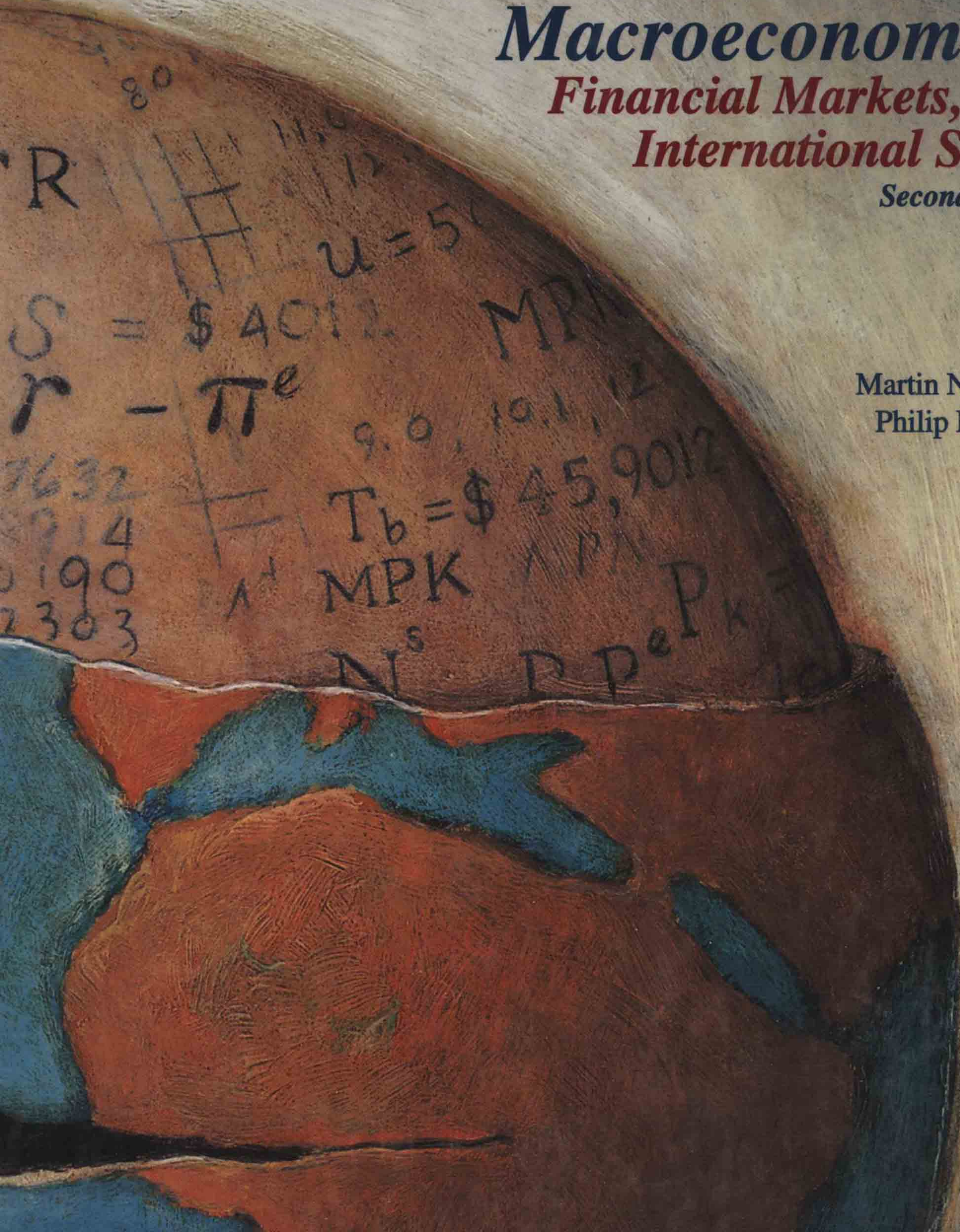
Macroeconomics,
Financial Markets, and the International Sector
Second Edition

Martin Neil Baily
Philip Friedman



Macroeconomics, Financial Markets, and the International Sector

Second Edition

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PREFACE

"This is an exciting but challenging time to teach macroeconomics. Macroeconomics issues are being debated widely and the newspapers are full of stories about the exchange rate, recession fears, concerns about rising inflation, and interest rates."

That was our introduction to the first edition and the last few years since then have proved to be even more challenging. Although the fear of recession is absent from the current concerns in the United States, the economy continues to dominate the national and world scene. This has been especially true in the relationship between the global economy and financial markets—a centerpiece of this text. President Clinton talks publicly about the difference between short-term and long-term interest rates. The Federal Reserve Board is under fire for raising interest rates. Trade relations between the United States and Japan are under strain. G-7 finance ministers work to stabilize world markets. A strange economic recovery is in place—one that was very sluggish to begin with, but that has suddenly built up steam. Debates about economic policy have turned more pointedly toward issues of long-term growth and productivity, and inflationary expectations are driving markets even as current inflation rates hit all time lows.

We have worked to recast this text in the light of recent events and new insights into the workings of the economy.

TEACHING MACROECONOMICS

Given our experience in teaching macroeconomics (to economics majors, MBA students, undergraduate business majors, master's students in public policy, and liberal arts and science majors with a general interest in economic policy), we have found that they *all* want nearly the same thing—a course that will help them understand what is going on in the economic world around them, as well as prepare them for later courses.

Part of the difficulty that faculty face in macro courses is that within the economics profession there is disagreement about the basic approach to the subject, making it hard to give a coherent perspective to students. It is important to provide a fair and rigorous discussion of macroeconomic controversy so that economics majors or graduate students are prepared for advanced courses. At the same time, it is perhaps more important to satisfy the need of all students for a course that is relevant and interesting and that fits with what they observe about ongoing economic events as well as actual business and household behavior.

The standard *IS-LM* model is clearly unrealistic in several respects, notably its depiction of a single rate of interest linking the real and monetary, the domestic and global sectors of the economy, and short-run aggregate demand with long-run aggregate supply. Though we recognize the many limitations of the standard *IS-LM* model, we are convinced that it remains the best framework for laying out the core of a course on macroeconomics. Even within the core section, we extend this framework by introducing growth, financial markets, and the international sector. We also stress the importance of expectations. Once we move beyond the core material, we also look at alternatives to the *IS-LM* framework.

This text develops its ideas using only simple algebra (and not much of that), plus figures, and a series of numerical Worked Examples that we urge you to go over in class. They are designed to present new material in a way that makes it accessible to as many students as possible.

WHY WE WROTE THE SECOND EDITION IN THE WAY WE DID

In the first edition of this text, we attempted a grand synthesis of money, financial, and real markets using the term structure of interest rates to couple the money market [*LM*] with real aggregate goods markets. To that end, we invoked an alternative to the standard *IS-LM* model. The feedback we received from users to this was very positive, with many telling us that ours was the first text to provide a model for students that matched with what they read about the economy.

Unfortunately, many prospective users of the text judged that the extended three chapter development of financial markets was too long and complex for their students. In response, we have tried to preserve the realism and originality of the first edition, but in a shorter and simpler form. The benefits we derived from extending the old model were significant in terms of relevance to current economic issues; these benefits remain. Students are given a richer description of the economy than that which is found in competing texts. This description is just as accessible, if not more so.

As in the first edition, we have tried to bring the best aspects of the new economics to bear on a standard framework in order to give a workable and exciting presentation of the complexity of modern macroeconomics.

Thanks to the input from first-edition adopters, reviewers, and other intermediate macro instructors, a major change can be seen in the splitting of the text into two parts: Part 1, ''Core Macroeconomics,'' covers the essential material of the subject, including one chapter on long-term growth and competitiveness; and Part 2, ''Advanced Topics,'' introduces new issues and deals with others in greater depth. The core analysis of the book is presented in the first eight chapters and then a series of individual chapters on, what we term, advanced topics gives the instructor considerable flexibility in designing a course to meet differing needs and interests of his or her students. The overall structure of the book is as follows:

Part 1: Core Macroeconomics

Chapter 1: The Issues of Macroeconomics
Chapter 2: Long-Term Growth and Competitiveness
Chapter 3: Aggregate Supply and Demand and Income Determination
Chapter 4: Interest Rates, Goods, and Money-Market Equilibrium
Chapter 5: Fiscal Policy, Budgets and Equilibrium Income
Chapter 6: Monetary Policy and Inflation

Chapter 7: The Exchange Rate, Macroeconomic Policy in an Open Economy and the Trade Deficit

Chapter 8: Aggregate Demand, Inflation, Financial Risks, and Policymaking

Part 2: Advanced Topics

Chapter 9: Consumption, Capital Investment, and Economic Fluctuations

Chapter 10: The Federal Reserve Banking System and Financial Crunches

Chapter 11: External Balances and International Economic Policy

Chapter 12: Supply-Shock Inflation and Economic Policy

Chapter 13: Forecasting, Stabilization Policy and the Variability of the Economy

Chapter 14: Monetarism: Classical Roots and Contemporary Implications

Chapter 15: Controversy in Macroeconomics: Equilibrium Models and the Neo-Keynesian Response

Chapter 16: Employment Creation, Unemployment, and Earnings Distribution

Chapter 17: Aggregate Supply, Long-Term Growth, and Productivity

Several central themes emerged clearly from this new organization.

Long-Term Growth and Productivity

In this edition, we decided to introduce long-term growth in Chapter 2. This change reflects the heightened attention being paid to growth issues by both academics and policymakers. The early section focuses on the contrast between short-term variations in output, driven by fluctuations in aggregate demand, and long-term trends in output, driven by outward shifts in aggregate supply. Macroeconomics used to be only about income determination and the business cycle. Now, concerns about productivity growth appropriately deserve more course time. We describe the role of aggregate supply in growth, the importance of technology, and human capital investment, and the impact of the new growth theory. We also discuss the slowdown in productivity growth over the past twenty years.

The Financial Sector in the Macro Economy

In the actual economy, the financial sector is a critical element. We describe how the financial sector provides the link that explicitly connects shifts in monetary conditions to changes in real investment demand. We discuss the term structure of interest rates and the importance of real rates of interest, and we show how business investment decisions are influenced by the real cost of funds. We define the interest-rate gap as the difference between the cost of funds that affects investment and the short-term nominal rate of interest determined in the money market. We show how expectations about inflation and future Federal Reserve policy can alter this gap. The interest-rate gap then allows us to analyze several current policy issues, including the problems with nominal interest-rate targeting in an inflationary environment and the need for policy credibility.

The Importance of the International Sector

Extensive coverage of the international sector is absolutely essential in a modern macro course. To that end, the global economy is introduced in the very first chapter of our text. International competitiveness is introduced in the second chapter along with long-term growth. And the relationship between the budget deficit and the trade deficit (the new crowding out) is covered in Chapter 5.

There are also two extensive separate chapters dealing with the international sector. Chapter 7 covers the exchange rate and the trade deficit and the role played by monetary and fiscal policy in an open economy. This chapter also covers interest-rate differentials and expected exchange rate changes. Chapter 11 looks at the new policies of managed trade and the older issues of protectionism and intervention.

Alternative Approaches to Macroeconomics

In the core section of the text, we do not include any extended discussion of the alternative approaches to macroeconomics. But instructors who judge that this material is essential to a solid introduction to the subject can have students read ahead to the chapters that cover this material. The Monetarist model and the more recent developments of classical thinking including the equilibrium business-cycle models are presented in the advanced topics portion of the text. We also discuss the issue of price flexibility and stickiness and contributions of the neo-Keynesian analyses in this section.

ALTERNATIVE WAYS TO USE THE TEXT

This text has been designed for students who have had at least one previous course in macroeconomics at the introductory level. The entire book can be presented easily in a two-course sequence. Or, by moving rapidly, the entire text can also be covered in a one-semester course if the students have had more exposure to economics than the typical introductory sequence of micro and macroeconomics. For well-prepared students, much of Chapters 1–6 can be covered quickly. Even so, for most curricula there is more material in the text than can be effectively covered in one semester or quarter.

In many departments, a one-semester course will cover only the core material. The advanced topics will then serve as the reading for a more advanced macro course for majors or other students who wish to go further. In other departments, the instructor will move more rapidly through the core material, and include a selection of advanced topics depending on individual choices. Now, a one-semester course using this book can be taught in several different ways by combining and/or omitting various chapters, and we expect that this is typically the way the book will be used. The particular combinations of chapters covered will depend upon the interests and preparation of students, the program of study in which the course is being offered, and the preferences of the instructor.

By selecting certain chapters, the text can support a variety of syllabi. Following are examples of different approaches to a one-semester course. In each, the amount of time you'll want to spend on the early chapters will depend largely upon the preparation of your students.

If you want to concentrate on:	**We suggest you teach these chapters:**
Basic Macroeconomics and Policy	Chapters 1–8, 9*, 10, 12, 13 and 16*
International Macroeconomics	Chapters 1–7 and 11
Macroeconomics and the Financial Sector	Chapters 1–8, 10, and 14
Long-Term Growth and the Macroeconomy	Chapters 1–7, 9, 14, and 17
Macroeconomic Fluctuations	Chapters 1–8, 9, 10, 12, 13–16

* *optional*

THE APPROACH TO PEDAGOGY

Explanations in the text rely heavily on descriptions of simple, but relevant, economic scenarios. The microeconomic basis of macroeconomics is imbedded in these descriptions. We've worked hard to keep the writing accessible and direct, and to make sure that references to the behavior of individuals in the economy are not confused with references to economic models. For example, we might say that a change in the behavior of consumers can be represented by a shift in the consumption function, rather than saying that consumers shifted up the consumption function. As before, this text develops its ideas using only simple algebra. Students will not require a knowledge of calculus, although some material will allow students who do have previous exposure to it to use that knowledge.

There are several specific learning features:

Key statements are highlighted to aid understanding. *Boxes* that offer business, policy, or heuristic explanations are an important text feature. Logos have been developed to differentiate "international" boxes from the more "applications"-oriented boxes. Additionally, most chapters have numerical *Worked Examples.* In the first edition, these Worked Examples appeared within the main text of each chapter; this time, however, we moved them to the end of each chapter in order to improve flow and readability. Notations (called out in the second color) direct students and instructors alike to the appropriate Worked Example for the concept(s) just encountered. *Key terms* are defined in a *Marginal Glossary* where they first occur and are then collected in a list at the end of each chapter. Of course, bulleted-list *Summaries* appear at the end of every chapter. Each chapter also contains *Discussion Questions and Problems* which reinforce the concepts learned and give students the opportunity to test themselves.

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Martin Neil Baily
Philip Friedman

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