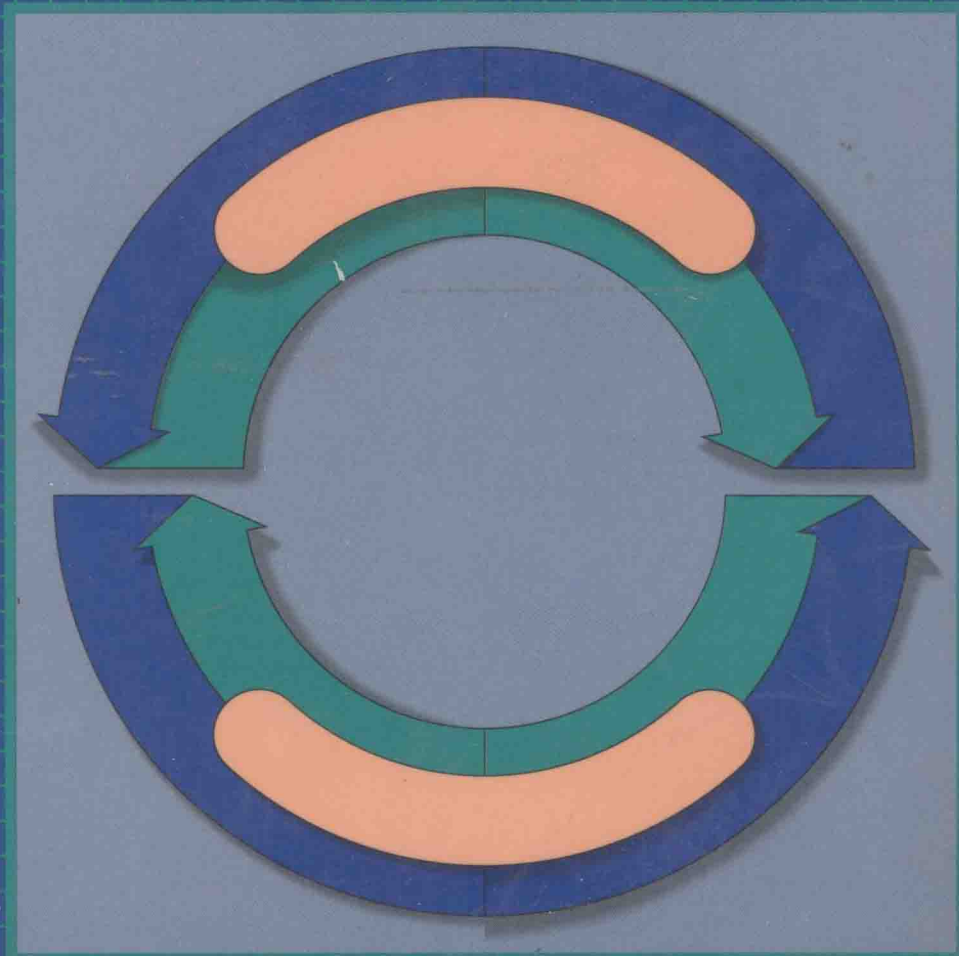


# MACROECONOMICS

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PRIVATE AND PUBLIC CHOICE



FIFTH EDITION

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JAMES D. GWARTNEY ■ RICHARD L. STROUP

FIFTH EDITION

# MACROECONOMICS

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PRIVATE AND PUBLIC CHOICE

JAMES D. G WARTNEY

Florida State University

RICHARD L. STROUP

Montana State University

*with the assistance of*

A. H. STUDENMUND

Occidental College

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## **PREFACE**

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This is an exciting time to teach and study economics. Knowledge of economics enhances our understanding of the changing world in which we live. Economic factors underlie seemingly disconnected events—from the outcome of presidential elections in the United States to political changes in the Soviet Union, China, and Eastern Europe. Why, in some countries, are many people rich, while in other countries the majority lives on the edge of starvation? What forces lead to economic prosperity? What can governments do to promote prosperity? Is there a danger that we will soon run out of key economic resources? Throughout this textbook, we will use the tools of economics to address these and other crucial questions.

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## **FIFTH EDITION**

As in previous editions, our approach emphasizes the importance of the economic way of thinking. We want to stimulate students, challenge their reasoning ability, and teach them to *think* like economists. To meet these objectives, we expanded the use of examples; drew from real-world data more freely as a means of enriching the theory; and doubled the number of critical analysis questions at the end of each chapter. In addition, we integrated a “Great Debates” series—short readings that provide contrasting views on major issues of our day—into the accompanying *Coursebook*. We think these features will make the study of economics more relevant for both student and teacher.

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## **CHANGES IN THE CORE MACROECONOMICS**

Macroeconomics has undergone enormous changes during the last decade. Modern macroeconomics stresses the importance of (a) expectations, (b) whether a change is anticipated or unanticipated, (c) interrelations among aggregate markets, (d) whether a change is expected to be temporary or permanent, and (e) differences between the long-run and short-run effects of a macroeconomic change. Reduction in transportation and communication costs enhances the importance of worldwide markets, particularly in the financial and manufacturing sectors. To reflect these changes, we present the core macroeconomics within the framework of a multimarket open economy. This multimarket, aggregate-demand/aggregate-supply framework makes it easier to visualize the importance of price changes, the interrelationships among markets, and the role of expectations. The macroeconomic model of this textbook is an “open economy” model from the outset.

Constant attention is given to how changes in international markets affect domestic output, employment, and prices.

The macroeconomic section contains a new chapter (Chapter 16) examining budget deficits and the national debt. Alternative views on the impact of debt financing are presented and analyzed in this chapter. The link between budget deficits and trade deficits is considered. Potential dangers of a large national debt are analyzed. The link between the current budget-making process and the presence of budget deficits is discussed. This chapter is the most comprehensive treatment of the deficit issue currently available in a principles book.

While the organization of the core macroeconomics is basically the same as for the previous edition, several new features have been incorporated into this edition, including:

- Expanded coverage of the search theory of employment (Chapter 7), and a more complete integration of the theory into our analysis of labor markets.
- A sharper focus on the macroeconomic importance of changes in international markets (Chapters 11, 13, and 18).
- A more comprehensive presentation of the short-run and long-run adjustment process within the framework of the aggregate demand/aggregate supply model (Chapters 8 and 9).
- Analysis of the savings and loan crisis (Chapter 12).
- Expanded coverage of the factors influencing the monetary policy decision-making of the Federal Reserve (Chapter 14).
- Integration of public choice theory and the importance of political rules into the analysis of budget deficits (Chapter 16).
- Coverage of the U.S.–Canadian Free Trade Agreement (Chapter 17).
- Expanded analysis of the current account deficit and related international debt issues (Chapter 18).

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## DISTINGUISHING FEATURES OF OUR APPROACH

As we stated previously, our primary goal is to challenge students to think like economists. The following points are of specific interest in this regard:

1. *Economic Principles Are Presented in a Highly Readable Fashion.* Difficult language and terminology can often hinder successful learning, particularly of economic concepts. Without sacrificing accuracy, we have sought to employ simple language. Simplicity, however, has not been substituted for depth. Rather, our aim is to highlight the power and accessibility of economic concepts. Where complex ideas are essential to our analysis, they are developed fully. We believe that the economics required for the 1990s can be comprehensible to the student as well as challenging and applicable to the real world.
2. *Economic Reasoning and Its Applications Are Emphasized.* Although models, theories, and exercises are important, they are only tools with which to develop the economic way of thinking. Abstractions and mechanics are not stressed in such a way as to obscure major concepts. We consistently emphasize the basics and their real-world applications.
3. *Microeconomic Reasoning Is a Fundamental Component of Macroeconomic Analysis.* The central principle of economics is that incentives matter. The

microstructure of an economy does have macroeconomic ramifications. Microincentives influence such macrofactors as the rate of unemployment, the level of current spending, saving, and aggregate output. In this book, the importance of the microincentive structure that is the foundation of our macroeconomic markets is highlighted.

4. *Economic Tools Are Applied to Both the Market and the Political Process.* Most textbooks tell students how an *ideal* market economy would operate, how real-world markets differ from the hypothetical ideal, and how ideal public policy can correct the shortcomings of the market. In addition to discussing these three basic issues, we analyze what real-world public policy is *likely to do*. Building on recent developments in the area of public choice, we apply the tools of economics to the political process as well as to market allocation. We think this approach emphasizes both the power and relevance of economics.
5. *The Role of the Individual Decision-Maker Is Stressed.* Students often feel that economists exclude human beings from the economic process. In most economics textbooks, business decision-makers are depicted as having perfect knowledge of demand and cost. Like computers, they always arrive at the maximum-profit solution. Likewise, government planners, knowing precisely the deficiency in aggregate demand and the size of the multiplier, simply increase government spending by the right amount to restore full employment. The employer, knowing the marginal productivity of each resource, utilizes each in exactly the proper proportion. Decision-making is treated as a mechanical exercise, removed from the real world. Throughout this book, we stress the importance of information, uncertainty, trial-and-error decision-making, expectations, and other factors that influence real-world choices. Economics is more than a set of guidelines. If students are to be convinced of its applicability, we must delineate the dynamic factors that influence and motivate human beings.

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## ORGANIZATIONAL FEATURES

We have employed several organizational features designed to make the presentation more understandable and interesting.

1. *Myths of Economics* In a series of boxed articles, commonly held fallacies of economic reasoning are dispelled. Each myth is followed by a concise explanation of why it is incorrect and is presented within a chapter containing closely related material.
2. *Applications in Economics* These boxed features apply economic theory to real-world issues and controversies. They add breadth on topics of special interest and illustrate the relevance of basic principles to the world in which we live.
3. *Measures of Economic Activity* Measurement is an important element of economics. These features explain how important economic indicators such as the Consumer Price Index, unemployment rate, and index of leading indicators are assembled.
4. *Outstanding Economists* These brief profiles stress the contributions of several economists, both current and historical, whose work has been important

in the development of the field. This series is designed both to enhance the student's appreciation of economic history and to provide depth on the contributions of several présent-day economists.

5. *Chapter Focus Questions and Closing Summaries* Each chapter begins with several questions that summarize the focus of the chapter. A summary, which provides the student with a concise statement of the material (chapter learning objectives), appears at the end of each chapter. Reviewing the focus questions and chapter summaries will help the student better understand the material and integrate it into the broader economic picture.
6. *Key Terms* The terminology of economics is often confusing to introductory students. Key terms are introduced in the text in color type; simultaneously, each term is defined in the margin opposite the first reference to the term. A glossary containing the key terms also appears at the end of the book.
7. *Critical Analysis Questions.* Each chapter concludes with a set of discussion questions designed to test the student's ability to analyze an economic problem and to apply economic theory to real-world events. Appendix B at the end of the text contains suggested answers for approximately half of the critical analysis questions. We think these answers, illustrating the power of economics, will interest students and will help them develop the economic way of thinking.

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## SUPPLEMENTARY MATERIALS

A complete set of support materials accompanies this textbook and includes:

**Coursebook.** We call the student handbook accompanying the textbook a *Coursebook*, since it is more than a study guide. Of course, it contains numerous multiple choice, true-false, and discussion questions permitting students to self-test their knowledge of each chapter. Answers and short explanations for most questions are provided in the back of the *Coursebook*. Each chapter also contains problem and project exercises designed to improve the student's knowledge of the mechanics. A set of short readings chosen to supplement the classroom teaching of important topics is also included in the *Coursebook*. Several of the readings are arranged in a debate format and cover areas of controversy in economics. Discussion questions follow each article, challenging students to demonstrate their understanding of the material and their ability to distinguish a sound argument from economic nonsense. Like the textbook, the *Coursebook* is designed to help students develop the economic way of thinking.

**Testbanks.** Two testbanks accompany the Fifth Edition. Testbank I contains over 2,900 multiple-choice questions, most of which have been extensively tested in the classroom. Within each chapter, the questions correspond to the major subheadings of the text. Testbank II, prepared by J. J. Bethune of Bellarmine College, provides approximately 1,800 new multiple-choice questions. This expanded stock of questions should be of particular interest to our past users. Both testbanks are available on computer diskette.

**Instructor's Manual.** The *Instructor's Manual* is divided into two parts. The first part, which is also available on computer diskette, is a detailed outline of each



chapter in lecture-note form. It is designed to help instructors organize and structure their current lecture notes according to the format of the Fifth Edition of *Economics: Private and Public Choice*. Instructors can easily prepare a detailed, personalized set of notes by revising the computerized form of the notes. The second part of the *Instructor's Manual* contains teaching tips, sources of supplementary materials, and other helpful information. Part 3 provides instructors with several games designed to illustrate and enliven important economic concepts. Suggested answers to most of the critical analysis questions that were not answered in Appendix B of the text are also provided in the *Instructor's Manual*.

**Color Transparencies.** Color transparencies of the major exhibits of the Fifth Edition have been especially prepared for overhead projectors. They are available to adopters upon request.

**Computer Simulation Package.** *ECO Talk*, a computer simulation package, is available free to adopters (and to their students for a nominal fee). *ECO Talk* consists of ten microeconomic and ten macroeconomic models designed to help users master important concepts through simulations, practice with graphics, and quizzes on the models. *ECO Talk* was developed by Michael Claudon of Middlebury College and Kipley Olson of Apple Computer. While it is not tied to a specific textbook, it contains the primary models presented in this textbook.

## ACKNOWLEDGMENTS

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## A NOTE TO STUDENTS

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This text contains several features that we think will help you maximize (a good economics term) the returns derived from your study effort. Our past experience indicates that awareness of the following points will help you to use the book more effectively.

- Each chapter begins with a series of focus questions which communicate the central issues of the chapter. Before you read the chapter, briefly think about the focus questions, why they are important, and how they relate to the material of prior chapters.
- The textbook is organized in the form of an outline. The headings within the text are the major points of the outline. Minor headings (contained in the margins) are subpoints under the major headings. In addition, important subpoints within sections are often set off and numbered. Sometimes thumbnail sketches are used to help the reader better organize important points. Careful use of the headings and thumbnail sketches will help you better visualize the organization of the material.
- A summary appears at the end of each chapter. Use the summary as a checklist to determine whether or not you understand the major points of the chapter.
- Review of the exhibits will also provide you with a summary of each chapter. The accompanying legend briefly describes the content and analysis of each exhibit. After studying the chapter, briefly review the exhibits to ensure that you have mastered the central points.
- The key terms introduced in each chapter are defined in the margins. As you study the chapter, go over the marginal definition of each key term as it is introduced. Later, you may also find it useful to review the marginal definitions. If you have forgotten the meaning of a term introduced earlier, consult the glossary at the end of the book.
- The boxed features provide additional depth on various topics without disrupting the flow of the text. In general, the topics of the boxed features have been chosen because of their relevance as an application of the theory or because of past student interest in the topic. Reading the boxed features will supplement the text and enhance your understanding of important economic concepts.
- The Critical Analysis Questions at the end of each chapter are intended to test your understanding of the economic way of thinking. They provide you with another opportunity to review each chapter. Answers to approximately 40 percent of these questions are provided in Appendix B.
- If you are having trouble, be sure to obtain a *Coursebook* and work the questions and problems for each chapter. The *Coursebook* also contains the answers to the multiple-choice questions and a brief explanation of why an answer is correct (and other choices incorrect). In most cases, if you master the concepts of the test items in the *Coursebook*, you will do well on the quizzes and examinations of your instructor.

# MEASURES OF ECONOMIC ACTIVITY

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## CHAPTER

## SUBJECT

5	The Underground Economy
5	How Does Indexing Work?
6	Deriving the GNP Deflator and the Consumer Price Index
7	Deriving the Unemployment Rate
8	How Large Is the Natural Rate of Unemployment?
15	The Capacity Utilization Rate
15	The Index of Leading Indicators
18	Is the U.S. the World's Largest Debtor?

# MYTHS OF ECONOMICS

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## CHAPTER

## SUBJECT

- |           |  |
|-----------|--|
| <b>1</b>  | “Economic analysis assumes people act only out of selfish motives. It rejects the humanitarian side of humankind.” |
| <b>2</b>  | “In exchange, when someone gains, someone else must lose.”   |
| <b>3</b>  | “Rent controls are an effective method of ensuring adequate housing at a price the poor can afford.”               |
| <b>7</b>  | “Unemployed resources would not exist if the economy were operating efficiently.”                                  |
| <b>17</b> | “Free trade with low-wage countries such as China and India would cause the wages of U.S. workers to fall.”        |

# APPLICATIONS IN ECONOMICS

CHAPTER	SUBJECT
1	Do Incentives Matter?
4	Perspectives on the Cost of Political Competition
5	Tax Rate Changes and the Taxes Paid by the Rich and Others
8	Bonds, Interest Rates, and Bond Prices
10	The Keynesian View of the Business Cycle
11	Marginal Tax Rates and Aggregate Supply
12	The Savings and Loan Crisis
13	What Caused the Great Depression?
15	Can Economists Forecast the Future?
17	Frédéric Bastiat on Obstacles to Gains from Trade
18	The Gold Standard International Monetary System
19	Do High Marginal Tax Rates Retard the Economic Growth of Less Developed Countries?
19	Rich and Poor Nations—Are They Two Worlds Drifting Apart?
21	The Importance of Common and Private Property Rights
21	Private Provisions of Public Goods
22	Why General Motors Receives Better Signals Than Congress
22	Private Versus Public-Sector Production of Fire Protection

FIFTH EDITION

# MACROECONOMICS

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PRIVATE AND PUBLIC CHOICE



# CONTENTS

PREFACE	v
A NOTE TO STUDENTS	xiii
CONTENTS IN BRIEF	xv

## PART ONE

## THE ECONOMIC WAY OF THINKING—AN INTRODUCTION

1

<b>1</b>	<b>The Economic Approach</b>	<b>3</b>
	What Is Economics About?	4
	The Economic Way of Thinking	6
	<i>Myths of Economics</i> : “Economic analysis assumes people act only out of selfish motives. It rejects the humanitarian side of humankind.”	9
	<i>Applications in Economics</i> : Do Incentives Matter?	10
	Positive and Normative Economics	13
	Pitfalls to Avoid in Economic Thinking	14
	What Do Economists Do?	16
	<i>Outstanding Economist</i> : Adam Smith and the Historical Roots of Economics	18
	Addendum: Understanding Graphs	20
<b>2</b>	<b>Some Tools of the Economist</b>	<b>29</b>
	Opportunity Cost Is the Highest Valued Opportunity Lost	30
	Trade Creates Value	32
	<i>Outstanding Economist</i> : Thomas Sowell	33
	What Is Traded—Property Rights	34
	The Production Possibilities Curve: Separating the Possible from the Impossible	36
	Trade, Comparative Advantage, and Realizing Our Production Possibilities	41
	Division of Labor, Specialization, and Exchange in Accordance with the Law of Comparative Advantage	43
	<i>Myths of Economics</i> : “In exchange, when someone gains, someone else must lose.”	44



Three Economizing Decisions Facing All Nations: What, How, and for Whom?	46
Two Methods of Making Decisions—The Market and Government Planning	47

<b>3</b>	<b>Supply, Demand, and the Market Process</b>	<b>51</b>
	Scarcity Necessitates Rationing	52
	Consumer Choice and the Law of Demand	53
	Producer Choice and the Law of Supply	56
	Markets Coordinate Supply and Demand Activities	58
	Shifts in Demand and Changes in Quantity Demanded	62
	<i>Outstanding Economist:</i> Alfred Marshall	63
	Shifts in Supply	65
	Time and the Adjustment Process	68
	Repealing the Laws of Supply and Demand	70
	How the Market Answers the Three Basic Economic Questions	71
	<i>Myths of Economics:</i> “Rent controls are an effective method of ensuring adequate housing at a price the poor can afford.”	72
	The Invisible Hand Principle	74

<b>4</b>	<b>Supply and Demand for the Public Sector</b>	<b>81</b>
	Ideal Economic Efficiency	82
	Why Might the Invisible Hand Fail?	84
	The Economics of Collective Action	88
	<i>Applications in Economics:</i> Perspectives on the Cost of Political Competition	89
	Conflicts Between Good Economics and Good Politics	94
	Implications of Public Choice	96
	<i>Outstanding Economist:</i> James Buchanan	97

<b>5</b>	<b>Government Spending and Taxation</b>	<b>100</b>
	The Growth of Government	101
	What Do Federal, State, and Local Government Do?	102
	Government Purchases and Transfer Payments	103
	Financing Government’s Expenditures	106
	Personal Income Taxes	107
	The Issues of Efficiency and Equity	110
	Taxes and Economic Efficiency	111
	The Tax Policy Debate of the 1980s	113
	<i>Measures of Economic Activity:</i> The Underground Economy	114
	<i>Applications in Economics:</i> Tax Rate Changes and the Taxes Paid by the Rich and Others	118
	<i>Measures of Economic Activity:</i> How Does Indexing Work?	120
	Who Pays the Tax Bill?	122
	The Cost of Government	123
	The Size of Government in Other Countries	124

**PART TWO****MACROECONOMICS****129**

<b>6</b>	<b>Taking the Nation's Economic Pulse</b>	<b>131</b>
	The Concept of the GNP	132
	Two Ways of Measuring GNP	135
	The Gross National Product or Gross National Cost?	141
	Real and Nominal GNP	142
	Problems with GNP as a Measuring Rod	143
	<i>Measures of Economic Activity: Deriving the GNP Deflator and the Consumer Price Index</i>	144
	GNP and Measuring Economic Welfare	149
	The Great Contribution of GNP	150
	Other Related Income Measures	151
	The Real Income—Real Output Link	152
<b>7</b>	<b>Economic Fluctuations, Unemployment, and Inflation</b>	<b>156</b>
	Swings in the Economic Pendulum	157
	Employment Fluctuations in a Dynamic Economy	159
	<i>Measures of Economic Activity: Deriving the Unemployment Rate</i>	160
	<i>Myths of Economics: "Unemployed resources would not exist if the economy were operating efficiently."</i>	165
	The Concept of Full Employment	166
	The Rate of Unemployment or the Rate of Employment—Some Measurement Problems	168
	Actual and Potential GNP	170
	Inflation and the Modern Economy	172
<b>8</b>	<b>An Introduction to Basic Macroeconomic Markets</b>	<b>180</b>
	Understanding Macroeconomics: Our Game Plan	181
	Three Key Markets: Resources, Loanable Funds, and Goods and Services	182
	Aggregate Demand for Goods and Services	184
	Aggregate Supply and Short-Run Equilibrium	186
	Aggregate Supply and Long-Run Equilibrium	189
	<i>Measure of Economic Activity: How Large is the Natural Rate of Unemployment?</i>	192
	Resource Market	194
	Loanable Funds Market	195
	Equilibrium in Our Three-Market Macroeconomy	197
	<i>Applications in Economics: Bonds, Interest Rates, and Bond Prices</i>	198
<b>9</b>	<b>Working with Our Basic Aggregate Demand/Aggregate Supply Model</b>	<b>203</b>
	Shifts in Aggregate Demand	204
	Shifts in Aggregate Supply	206