

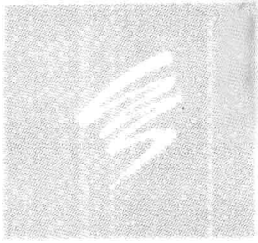


MACROECONOMICS

THEORIES AND POLICIES

SEVENTH EDITION

RICHARD T.
FROYEN



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Theories and Policies

Richard T. Froyen

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Preface



The past three decades have been challenging ones for macroeconomists. Key variables in macroeconomics—the levels of output, inflation, and unemployment; interest rates; and foreign exchange rates—have proved difficult to explain and predict. This period also has been an active one in macroeconomic theory, a period of controversy but also of progress. The years since the late 1960s saw a growing number of challenges to Keynesian economics, which was the dominant paradigm of the early 1960s. The 1970s witnessed a growing interest in *monetarism* and the emergence of the *new classical economics*. In the 1980s, Keynesian policy prescriptions came under attack from a group called the supply-side economists. The 1980s also witnessed the development of two contrasting lines of research on the business cycle: the *new Keynesian economics* and the *real business cycle theory*. However, there has been progress as well as controversy. During the past 30 years there have been significant improvements in the handling of expectations, in our understanding of labor market institutions, in accounting for the macroeconomic implications of various market structures, in the modeling of open economies, and in accounting for the ultimate sources of economic growth.

In this book I have tried to explain macroeconomics, inclusive of recent developments, in a coherent way but without glossing over the fundamental disagreements among macroeconomists on issues of both theory and policy. The major modern macroeconomic theories are presented and compared. Important areas of agreement as well as differences are discussed. An attempt is made to demonstrate that the controversies among macroeconomists center on well-defined issues that are based on theoretical differences in the underlying models.

FEATURES

Distinguishing features of the approach taken here include the following:

- An up-to-date summary of the Keynesian position, including research that has come to be called the new Keynesian economics.
- A detailed analysis of the challenges to the Keynesian position by the monetarists, new classical economists, and real business cycle theorists.
- An extensive treatment of monetary policy that considers the optimal strategy for monetary policy, including targeting on monetary aggregates versus targeting on interest rates, as well as consideration of recent policy changes in central bank operating procedures in a number of other countries—most importantly the move to inflation targeting.

- An analysis of the post-1970 slowdown in U.S. output growth, capital formation, and growth in labor productivity. Within this context of intermediate-run growth the views of the supply-side economists and their critics are examined. Also within this context of the determinants of rates of intermediate-run economic growth, we consider whether there are signs that the productivity slowdown of the 1970s has been reversed. Is there a “new economy” developing for the new century?
- A consideration of the determinants of long-run economic growth. Both the neoclassical growth model and recent models of endogenous growth are discussed.
- Consideration of foreign exchange rate determination, including discussion of recent proposals for policy coordination, target zones for exchange rates, and common currency areas, in particular the euro-zone.
- An examination of monetary and fiscal policy effects in the open economy, within the framework of the Mundell–Fleming model.

ORGANIZATION

Part I (Chapters 1–2) discusses the subject matter of macroeconomics, the recent behavior of the U.S. economy, and questions of measurement. Part II (Chapters 3–13) presents the major macroeconomic models, beginning with the classical system in Chapters 3–4. Consideration of the classical system at the start is useful because the Keynesian model can then be viewed as an attack on the classical orthodoxy. Challenges to the Keynesian position can then be rooted in the parts of the classical model that provides starting points for their analysis: the quantity theory of money for the monetarists, and the classical labor market clearing assumptions and choice-theoretic-based behavioral functions for the new classical and real business cycle economists.

The Keynesian model is analyzed in detail in Chapters 5–8, beginning from a very simple model; more complex models are built up to incorporate monetary influences, wage and price flexibility, changing price expectations, and shocks to aggregate supply. Chapter 9 examines monetarism and the issues in the monetarist–Keynesian controversy. Chapter 10 examines the monetarist view of the unemployment–inflation trade-off and the *natural rate* theory, as well as the Keynesian view on the same issues. Chapter 11 considers the *new classical* theory with its central concepts of *rational expectations* and market clearing. The Keynesian response to the new classical economics is then considered. Chapter 12 examines two recent directions in macroeconomic research. One, very strongly rooted in the classical tradition, is the *real business cycle theory*. The second, the *new Keynesian economics*, is, as its name suggests, firmly in the Keynesian tradition. Chapter 13 summarizes and compares the different models.

Part III considers *open economy* macroeconomics. Chapter 14 focuses on exchange rate determination and the choice of an international monetary system.

Chapter 15 utilizes the Mundell–Fleming model to examine the effects of monetary and fiscal policy in the open economy.

Part IV deals with macroeconomic policy—monetary policy in Chapters 16 and 17, then fiscal policy in Chapter 18.

In Part V we present extensions of the models and consider parts of the models in greater detail. Chapter 19 examines questions of long-term economic growth and the determinants of growth over intermediate periods, periods too long to fit the short-run framework of the models of Part II, but not necessarily situations of long-run equilibrium. Chapter 20 is a more detailed examination of the components of private sector demand: consumption and investment expenditure. Finally, Chapter 21 extends the earlier analysis of money demand.

In the section on macroeconomic models, the conceptual approach taken is to develop each model within the aggregate demand–aggregate supply framework in order to facilitate comparisons among the models. Throughout the book the aim is to provide a clear and rigorous analysis. Other pedagogical features are the explanatory captions provided for the graphs in the text and end-of-chapter questions and problems.

Most chapters also contain *Perspectives* sections, which relate the material in the text to events in the real economy.

NEW FEATURES IN THE SEVENTH EDITION

- There have been a number of pedagogical improvements in this edition. These include: better graphics, some simplifications in notation, more use of graphs rather than tables to display data, and more numerical examples.
- A number of new *Perspectives* sections have been added, several dealing with international questions such as the launch of the Euro, the possibility of a “liquidity trap” in Japan, and the use of currency boards or dollarization as alternative exchange rate mechanisms in countries such as Argentina and Ecuador. Other new *Perspectives* consider the possibility of “irrational exuberance” in the U.S. stock market in the 1990s and the implications of complete elimination of the U.S. national debt.
- The chapter on fiscal policy has been revised to reflect the move from a situation of large budget deficits to one of huge surpluses (at least in the near term future). Longer-term budget trends are also considered.
- The ordering of chapters has also been changed. The international section (now Part III) has been moved forward to directly follow the main section on macroeconomic models (Part II). The policy section (Part IV) comes next, followed by extensions (Part V).
- In order to cover new material without increasing the length of the book, coverage of topics that have become less relevant has been cut back. I have attempted to make the analysis as simple and concise as possible.

Overall, there has been an attempt to make the book more student friendly.

ANCILLARIES

- *Instructor's Manual with Test Bank:* This resource manual provides the instructor with detailed chapter summaries, answers to end-of-chapter questions, and a complete test bank. For each chapter, there are 50 to 70 multiple-choice questions as well as 10 to 15 problems and essay questions.
- *Computerized Test Bank:* Prentice Hall's Custom Test, a Windows-based test program, permits professors to edit and add or delete questions from the test bank to generate their own customized classroom tests.
- *Study Guide:* Each chapter contains a detailed overview with a tips section on equations and graphs called *Techniques in Depth*. The Study Guide also provides a self-test with 30 multiple-choice questions and 10 problems and essay questions.

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