

SECOND EDITION

MACROECONOMICS

MICHAEL PARKIN • ROBIN BADE



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MACROECONOMICS

Michael Parkin

Robin Bade

The University of Western Ontario



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Preface

To make the macroeconomics of the 1990s accessible to students of the 1990s. To enable today's students to understand today's macroeconomics issues and participate in the policy debate with confidence from a well-informed position. These are our goals in writing this book.

Perspective, Position, and Pedagogy

Macroeconomics presents a clear and comprehensive account of the mainstream theories of economic fluctuations, inflation, unemployment, exchange rates, debts and deficits, fiscal and monetary policy, and global economic coordination and integration. It also presents a deeper look at the microeconomic foundations of these mainstream theories. Finally, it gives a guide to the new developments in macroeconomics and the current research agendas.

The dead debates of the past are not found in these pages. The live debates of the present (and future) *are* found here. But they are presented for what they are: scientific disagreements that conscientious, thoughtful, and creative scholars are attempting to resolve using normal methods of enquiry. No sides are taken—at least not consciously—and we have striven hard to suppress our own provisional guesses as to which of the competing views is likely to turn out to be right.

But this book is not a flat, featureless plain of knowledge and ideas. It is permeated with the point of view that macroeconomics is a mature social science that has made great progress in understanding its range of phenomena and that progress has been made by developing macroeconomic models—caricatures of real economies—and then confronting these models with the facts generated by real life experiments. This interplay between models, theories, and facts that has brought progress in our endeavor as macroeconomists forms the fundamental organizing principle of this book.

Every chapter begins with a scene-setter—an overview of either some aspect of the real macroeconomy or a body of theory—and then proceeds to set out some facts to be explained (which we highlight as *MACROFACTS*). Following such a section, we proceed to develop and explain a relevant body of theory that explains (or purports to explain) the highlighted facts. This is followed with a return to the facts, sometimes the same facts, sometimes to new facts that “test” the theory (which we highlight as *TESTCASE*). This pattern is

repeated as each chapter unfolds, sometimes several times within a single chapter.

The facts in question are those generated by our macroeconomic experience. Since this book is for students in colleges and universities in the United States, the experience of the U.S. economy dominates our selection of examples, especially when we deal with policy issues. But the globe is ever-shrinking, and we are now members of a world economy. Because of this, we have used a liberal sprinkling of examples from around the world, choosing the best example available to illustrate a particular idea or theory. (We are fortunate in having had the opportunity to live, work, and teach not only in the United States but also in Canada, Australia, Europe, and Japan, and have benefited enormously from the exposure this diversity has brought.)

We've also created a series of boxes that look at the human face of macroeconomics. They put flesh and blood on the bare bones of macroeconomic analysis. Some of them are about the personalities of macroeconomics and others give a glimpse at the wide variety of human problems that macroeconomics can help us understand and, hopefully, solve.

But the overwhelming thrust of this book is directed toward *understanding macroeconomic phenomena*, not *improving macroeconomic performance*. If the latter occurs as a result of this book's helping to create a better informed community of citizens and voters, we will not be disappointed. But our goal is enlightenment, not persuasion.

To Students

Uppermost in our minds in writing this book has been you, the student. We have written a book that we hope you will find not only informative, but also stimulating and interesting. To achieve this end, we have used a variety of pedagogic devices. They are:

- Chapter opening scene-setter
- Chapter objectives
- Annotated and actively labeled figures
- Extended captions to figures
- Chapter summaries
- Highlighted key terms
- End of chapter key terms and concepts
- End of chapter review questions
- End of chapter problems

When you begin a new chapter, read the scene-setter and objectives a couple of times and make sure you have a good sense of what the chapter contains and how it builds on what you've already studied. Then read the body of the chapter at a pace that enables you to follow the logic of what you are reading. Your aim is not to read and remember: it is to read and *understand*. Once you've understood something, you can't forget it even if you try!

This book contains a large number of figures and each figure has been designed to make your job easier. Be especially careful to "read" each figure

along with the text that explains its action. And when you begin to “read” a figure pay careful attention to the labels on its axes. Some figures present facts; others explain theories. Many of those that present facts also show relationships among variables. In studying these figures, look for the patterns. The figures that present theories use color in a systematic way. Color highlights the action: the starting point is always black (or grey) and the ending point is always blue. Bold arrows, colored to match the shifting curves, emphasize the action that brought about the change. In studying these figures, keep this set of “color rules” in mind.

Most figures contain short notes or labels, highlighting key features of the figure. All the figures have an extended caption that gives a summary of the figure. When you have read the chapter twice and think you understand it, look again at each figure and read its caption. This will give you a quick review of the chapter and enable you to check your understanding.

After your first reading of a chapter, look at the end of chapter review. Check the chapter summary to see if you understand it. Check the key terms and concepts to see if you know them. Then attempt to answer the review questions. Make a note of any question you can’t answer and be especially on the look out for its answer on your second reading of the chapter. When you think you’re completely on top of the chapter, do the end of chapter problems.

The *Study Guide* provides you with even more insight into *Macroeconomics*. For each chapter of the text, it contains learning objectives, summaries, multiple choice and true/false questions, worked problems, problems for you to work, and answers.

To Instructors

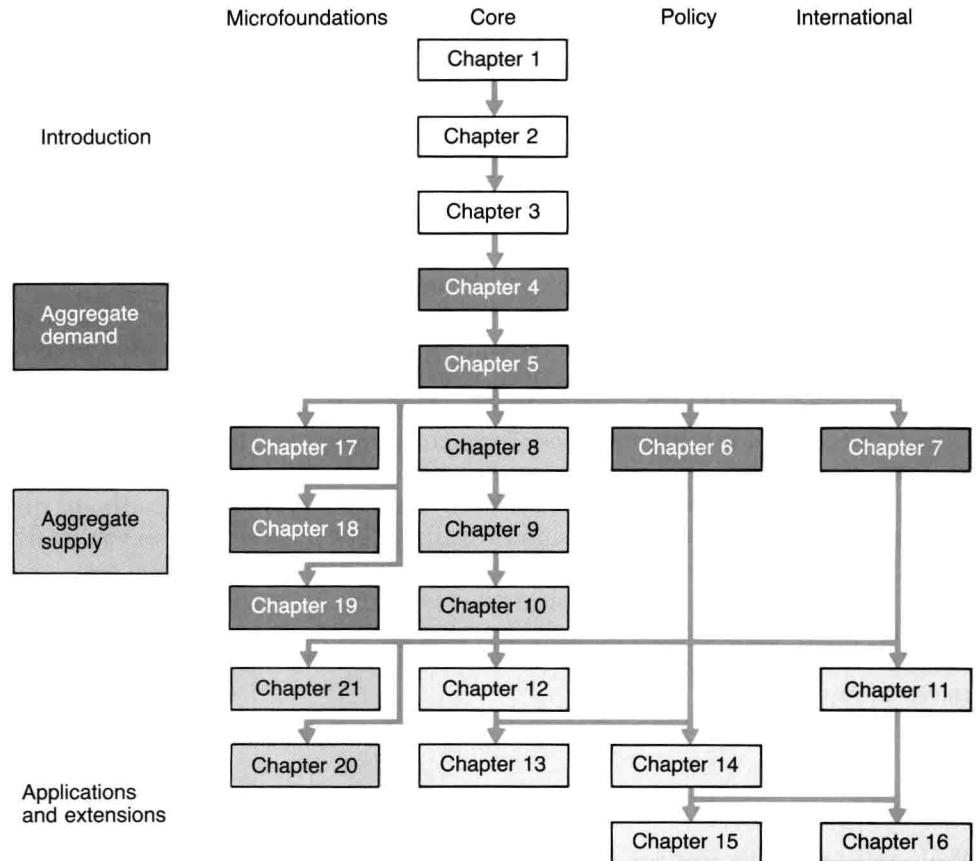
We’ve also had you, our colleagues, the teachers of macroeconomics, in mind as well. We know only too well that there remains a great deal of well-based and legitimate disagreement as to which aspects of macroeconomics are the most relevant and which order to unfold the complexities of this subject is best. To give you the maximum possible flexibility, we’ve written a book that can be used in a wide variety of orders. We’ve also consciously *not* presented the material in the order that most closely conforms to that in which we teach it. Instead, we have built in flexibility by placing later in the book most of the material that can be treated as optional.

Organization and Flexibility

The book contains *four main themes*. They are:

- Microfoundations
- Core
- Policy
- International

The following organization and flexibility chart shows how the chapters handle these themes.

Macroeconomics Flexibility Guide

A logical sequence of core theory runs from Chapter 1 through 3 (introduction), Chapters 4 and 5 (the *IS-LM* model of aggregate demand), Chapters 8 through 10 (aggregate supply, unemployment, and growth), and Chapters 12 and 13 (inflation, deficits, and debts). But the order of the aggregate demand block together with its microfoundations, policy and international applications (Chapters 4, 5, 6, 7, 17, 18, and 19) and the aggregate supply block together with its microfoundations (Chapters 8, 9, 10, 20, and 21) may be reversed if desired.

Policy permeates the book and appears in many of the core chapters. But three chapters treat policy themes more explicitly. These can be done as a group after completing the core, or can be taken in their set order.

International examples also permeate the core chapters, but there are three complete open economy and international chapters. Again, these may be deferred until after completing the core, or can be taken in their set order.

The microfoundations of aggregate demand, Chapters 17 through 19, can be brought forward and studied immediately following Chapter 5. The microfoundations of aggregate supply (the “new macroeconomics”), Chapters 20 and 21, can be brought forward and studied immediately following Chapter 10.

Supplements are available to enhance your use of the text. They are:

- *Instructor's Manual* by Jack Adams. The instructor's manual contains chapter outlines, chapter learning objectives, and the answers to all the questions in the text.
- *Test Item File* by Jack Adams. This is a comprehensive bank of multiple choice, true/false, and essay questions. Answers are provided, and all questions are page-referenced to the text.
- *The Prentice Hall Test Manager*. A computerized version of the printed test bank, this test manager allows instructors to generate, edit, add to, and save tests. The Test Manager is available in both 5.25" and 3.5" IBM formats.

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We thank our students, the more than 4,000 undergraduates in ten universities, on four continents, whom it has been our privilege to teach macroeconomics during the past 27 years. The instant feedback that comes from the look of puzzlement or excitement in the classroom has taught us how to teach this subject.

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We are grateful to our colleagues and students in the department of economics at the University of Western Ontario for providing us with the stimulation and opportunity to write this book. We are also grateful to Doug McTaggart and the School of Business at Bond University for creating the perfect academic working environment in which this book was finally completed, in the Queensland winter of 1991.

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Michael Parkin
Robin Bade

Bond University, Gold Coast,
Queensland, Australia

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