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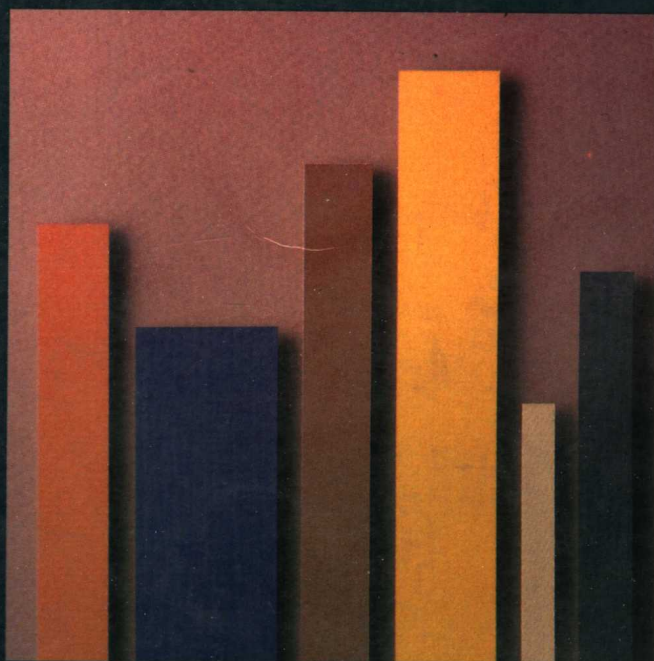
# Principles of

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# Macroeconomics

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Fleisher / Ray / Kniesner



Principles of  
**Macroeconomics**

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Principles of  
**Macroeconomics**

*To  
Don and David  
Beth, Stephanie, Katherine,  
and Michael  
Grace*

# Preface

What? Still one more principles text?

Yes. The reason we believe that we can contribute something of value to the already crowded field of introductory economics textbooks is that none of the other existing books matches our needs in teaching *Principles of Macroeconomics*. Needless to say, we hope that others perceive some of the needs that we have tried to address. We desired a text that uses a building-block approach, which means that each theoretical tool is developed on the basis of what has gone before, without time- and space-wasting repetition and without theoretical gaps or inconsistencies. Our goal has been a book that illustrates in every chapter the applicability of economic analysis to important social problems and integrates our knowledge of the economic process with social choices made in a political context. We also wanted a text that would be more effective than any other now available in helping students to understand the role of the United States in the rapidly changing international economy and to appreciate the political-economic problems faced by the world's developing nations. Finally, we believe it is crucial that the beginning student grasp the fundamental interrelationships between the real economy and monetary economy (microeconomics and macroeconomics). This requires understanding the "microfoundations" of the determination of unemployment, interest rate, price level, and aggregate production. However, we wanted to avoid the burden of the complex IS-LM analysis that is usually relegated to an appendix in other texts (if it appears at all). Pedagogically, we wished to avoid a text cluttered with "boxed inserts" that, in our judgment, divert students' attention from basic, important issues in economics.

*Principles of Macroeconomics* has been written on the assumption that a few tools, well-learned, provide insights that are unavailable to those who have not studied modern economic analysis. It serves as a summary of basic principles for those who may never enroll in another course beyond the usual two-term introductory sequence and as a foundation for additional courses taken by economics majors and business students. We have strived to keep theoretical analysis simple, yet correct, so that nothing need be "unlearned" by students going on to intermediate

or graduate level course work. Numerous applications of economic analysis to policy issues are linked to an analysis of the political process through which social policies are developed. A broad spectrum of policy applications is covered, including health economics, agriculture, technological progress, poverty, the problems of the world's developing nations, current international economic problems, and more. Students' understanding of policy formulation is enhanced by repeated analysis of "winners" and "losers" from alternative policies and how their political power influences actual policy decisions.

## Organization

Part I is comprised of a single chapter that introduces the fundamental economic principles of scarcity, the *What*, *How*, and *For Whom* questions, the production possibilities frontier, opportunity cost, and comparative advantage, with some attention-grabbing applications, including the economics of life and death choices and the 55-mph speed limit. The role of economic theory and the distinction between positive and normative analysis are discussed.

Part II introduces the basic concepts of demand and supply, showing how scarcity affects a market economy. The analysis of a market economy has three elements or building blocks: demand, supply, and the interaction of demand and supply. These three elements comprise the basic model of how buyers and sellers behave in pursuit of their private goals. Upon this foundation, the text shows how government actions alter the outcome that would prevail if supply and demand operated on their own. Chapter 2 begins with an overview of how supply and demand interact to determine the equilibrium price and quantity in a market framework. Chapter 3 develops in more depth the foundations of demand, and includes a discussion of elasticity. Chapter 4 deals with firms' costs and supply decisions.

Part III is the first macroeconomics section. Chapter 4 defines macroeconomics and introduces GNP and the other principal aggregate economic variables—price levels, interest rates, and unemployment. Chapter 5 begins with an overview of the loanable-funds analysis of the macroeconomy and then introduces the labor market, a crucial *micro-*

foundation of modern *macroeconomics*. Chapter 6 describes the aggregate expenditure on goods and services that leads to a particular level of GNP in the goods market. The notion of an open economy is introduced at this point, and the importance of the foreign sector for the domestic macroeconomy is woven into the analysis from this point on. Chapter 7 extends the analysis of the equilibrium in the goods market to the Keynesian multiplier, economic fluctuations, and a brief introduction to fiscal policy. Chapters 8, 9, and 10 introduce the financial sector and describe the determination of the interest rate, using a loanable funds approach. We believe that we are unique in using the loanable-funds approach to link the real and monetary sectors, and that this pedagogical device allows the student to learn much more about the mutual interaction of exogenous expenditure components with the interest rate and monetary and fiscal policies than is possible with any other existing text. The loanable-funds approach makes it particularly easy to incorporate international financial aspects into the macroeconomic model.

In Part IV, we discuss the labor, goods, and credit markets in order to develop a model of general macroeconomic equilibrium in chapter 12. We use the model to illustrate what happens in each market during recessions and inflationary periods. Chapter 13 emphasizes determination of the price level, using aggregate demand and supply. Chapter 14 deals with fiscal and monetary policies in a closed economy.

In Part V, we deal intensively with open-economy macroanalysis and policy. Chapters 15 and 16 extend the analysis of macroeconomic policy to open-economy situations. Chapter 17 emphasizes the practice versus the theory of macroeconomic policy, and chapter 18 summarizes major issues in macroeconomics by comparing Keynesian, monetarist, and supply-side approaches.

Part VI, *The International Economy*, deals with the pure theory of international trade, and Part VII includes the capstone chapters on economic growth and comparative systems. Once again, the applications of economic tools and empirical issues are stressed. In chapter 21, we pay particular attention to the productivity slowdown in the United States and to the role of "industrial policy" in economic development. Chapter 22 compares the allocation mechanisms of free market and mixed economies with those of planned, socialist economies and emphasizes a comparison of various measures of social and economic welfare between planned economies and those of the other industrialized nations.

## Pedagogy

*Principles of Macroeconomics* offers a variety of pedagogical aids for students and teachers. Each chapter opens with a chapter outline, learning objectives, and a prologue/scenario as part of the introduction. The introduction provides a real-world lead-in to the material and relates chapter content to previous and subsequent chapters. The key terms are listed and page referenced at the end of the chapter. Numerous end-of-chapter questions aid student comprehension of the material.

Each major section of the text concludes with a feature called Policy Issue. These policy puzzles direct students to put themselves in the position of an economic policymaker and formulate decisions regarding the issues presented. An appendix at the back of the book instructs students on how to analyze and work through the policy puzzles.

The text contains numerous direct and rhetorical questions designed to get the student to think more deeply about economic principles and applications discussed. Outlines of answers to these questions are provided in the instructor's manual.

There are numerous applications of such important contemporary topics as public choice analysis, the economics of information, the economics of the allocation of time, and rational expectations. These applications repeatedly stress the political, or "public choice" ramifications of policy formation. At the same time, the authors have carefully avoided taking sides politically, while emphasizing the political limits on economic policymakers.

There is a distinct pedagogical advantage to our use of loanable funds analysis in developing a macroeconomic model of both the real and monetary sectors. Most texts use the loanable funds model in microeconomic analysis of the interest rate, but then drop it in the macro portion of the text. Some texts use the loanable funds theory of interest in describing how monetary policy works but do not integrate this analysis with the goods market and fiscal policy. This gives the appearance of two different theories of the interest rate and macroeconomic policy, which can only leave students confused. Our use of the loanable funds analysis of interest rates, depending only on the tools of supply and demand and combined with the microfoundations of supply and demand for labor, determination of real wage rates, and unemployment, shows how microeconomics applies to an understanding of the complex interrelationships of the macroeconomy. The loanable funds approach illustrates directly how monetary and fiscal policies

are *related* means of achieving macroeconomic stability. The impacts of monetary and fiscal policies on GNP, employment, the interest rate, real investment, and the price level are easily compared. The power of this approach has enabled us to include brief histories of the Great Depression and economic experience in the United States since the 1960s that are superior in depth and scope to any existing principles text. The loanable funds approach is equally well adapted to a Keynesian or monetarist orientation, and the text clearly and succinctly explains the distinctions between modern Keynesians, monetarists, and supply siders in terms of the macroeconomic tools developed.

### For the Instructor

*Instructor's Manual:* Includes chapter outline with teaching tips, suggested answers to questions, and a list of additional readings from magazines and newspapers.

*Test Bank:* Includes approximately 1000 carefully designed and revised test questions as an aid in preparing exams and quizzes.

*Transparency Masters:* Selected diagrams to aid instructors in preparing class presentations. The transparency masters and the test bank are included in the *Instructor's Manual*.

### For the Student

*Student Study Guide:* Each chapter contains an overview that summarizes the basic concepts introduced in each text chapter, a vocabulary check that reviews the key terms and definitions in the text, and numerous self-testing items, including true-false and multiple-choice questions and answers.

*Study Pak:* An interactive student study guide on the microcomputer available for students to purchase. Students will review study materials selected for a particular text chapter and receive instant feedback. Printed study materials supplement the program to provide maximum coverage of each text chapter.

To highlight the significant features of our text, we have summarized some of them below:

1. Uses a building-block approach that stresses the applicability of supply and demand analysis throughout.
2. Extensive policy applications to the household, business, health care, and government sectors and to developing nations.
3. Simply presented and current data.
4. A tools-oriented approach to the economist's way of thinking.
5. A unique, loanable funds approach to macroeconomics that facilitates incorporation of real and monetary disturbances in the basic macro model.
6. Stresses the microfoundations of macroeconomics.
7. Three chapters devoted to macroeconomic policy, including a unique historical analysis of two major episodes that continue to influence our lives today and an up-to-date comparison of Keynesian, monetarist, and supply-side policy positions.
8. Macroanalysis that focuses on the three crucial policy variables, inflation, unemployment, and interest rates.
9. Up-to-date analysis of the international economy as it affects the United States and the world's less-developed and -industrialized nations.
10. Fresh applications to the important policy areas of income distribution, externalities, public choice, international trade, and international financial problems.
11. Application of basic economic principles to the problems of developing nations.
12. Emphasis on comparing ideal policies with those that are practicable as determined by the reality of politics and the relationships of government to society.
13. Emphasizes international economic issues (most complete treatment available).



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