



Macroeconomics

THEORIES AND POLICIES

RICHARD T. FROYEN
THIRD EDITION

MACROECONOMICS

Theories and Policies

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Preface

The past two decades have been challenging ones for macroeconomists. Key variables in macroeconomics—the levels of output, inflation, unemployment; interest rates; foreign exchange rates—have proved difficult to explain and predict. This period since 1970 has also been an active one in macroeconomic theory. It has been a period of controversy but also of progress. The 1970s saw a broadening of the issues in the *monetarist–Keynesian* controversy. Additionally, a new challenge to the Keynesian position, the *new classical* economics, emerged. During the 1980s, Keynesian policy prescriptions came under attack from a group called the supply-side economists. But there has been progress as well as controversy; the last twenty years have seen improvements in the handling of expectations, in our understanding of labor market institutions, in modelling of open economies, and in other areas as well.

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 have their basis in theoretical differences in the underlying models.

Features

Distinguishing features of the approach taken here are:

- a detailed analysis of the monetarist and new classical challenges to the neo-Keynesian position.
- an up-to-date summary of the modern Keynesian position, including Keynesian responses to the monetarist and new classical critics, and the new directions Keynesian research has taken in recent years.
- an extensive treatment of monetary policy which considers the optimal strategy for monetary policy, including intermediate targeting on monetary aggregates versus targeting on interest rates.
- an analysis of the post-1970 slowdown in U.S. output growth, capital formation, and growth in labor productivity. It is within this context of intermediate-run growth that the views of the supply-side economists are considered.
- consideration of foreign exchange rate determination and the relative merits of flexible versus fixed exchange rates.
- thorough coverage of money demand including recent difficulties in predicting money demand and the effects of ongoing innovations in the financial sector.
- an analysis of the question of rules versus discretion in macroeconomic policymaking. Rules for monetary policy as well as a constitutional amendment for balancing the federal budget are considered. The *public choice* view of macroeconomic policymaking is examined.

Organization

The organization of the book is as follows. 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 presents the major macroeconomic models beginning with the classical system (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. The recent challenges to the neo-Keynesian position can then be rooted in the parts of the classical model that provide 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 economists. The classical analysis is also useful for a later examination of the policy prescriptions of the supply-side 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. Chapters 9 and 10 examine monetarism and the issues in the monetarist-Keynesian controversy. Chapter 9 focuses on the monetarist view of the importance of money. Chapter 10 examines the monetarist view of the unemployment–inflation tradeoff, the *natural rate* theory, as well as the Keynesian view on the same issue. Chapter 11 considers the *new classical* theory with its central concepts of *rational expectations* and market clearing. The Keynesian response to the new classical theory and some recent new directions in Keynesian research—partly in response to the new classical attack—are then examined. Chapter 12 summarizes and compares the different models.

Part III presents extensions of the models and considers parts of the models in greater detail. The chapters here and in Part IV are designed to be self-contained so that the instructor can choose topics as time and interest allow. Chapter 13 is a more detailed examination of the components of private sector demand: consumption and investment spending. Chapter 14 considers money demand, and Chapter 15 the money supply process. Chapter 16 returns to the supply side of macroeconomic models to discuss long-run equilibrium growth and the determinants of growth over intermediate-run periods, periods too long to fit the short-run framework of the models in Part II, but not necessarily situations of long-run equilibrium.

Part IV deals with macroeconomic policy—fiscal policy in Chapter 17 and monetary policy in Chapter 18. A historical appendix to Part IV describes major macroeconomic policy actions over the period since the Great Depression of the 1930s.

Part V considers *open-economy* macroeconomics. Chapter 19 focuses on exchange rate determination and the choice of an international monetary system. An appendix to Part V considers monetary and fiscal policy in the open economy.

In the section on macroeconomic models, the conceptual approach taken here 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, primarily graphical and verbal analysis. Other pedagogical features are the explanatory captions provided for the graphs in the text; end-of-chapter questions; and a list of selected readings following each chapter.

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

New Features of the Third Edition

The main changes in this revision for a third edition have been:

- updating the discussion in Part II of the major macroeconomic models to reflect developments over the past several years. Recent new directions in Keynesian research including *menu cost* (sticky price) models and *efficiency wage* models are considered (Chapter 11). Models of *hysteresis* in unemployment are discussed (Chapters 10 and 11). Monetarism is considered in the light of the instability of money demand in the 1980s (Chapter 9). And the classical model is related to recent *real business cycle* models (Chapter 3).
- the open economy material has been reorganized and revised. Imports and exports are added to the simple Keynesian model (Appendix to Chapter 5). A number of *Perspectives* (8.1, 16.1, 19.1) focus on international issues. In the chapter on the open economy (Chapter 19), new topics such as *target zones* for exchange rates and the merits and difficulties of international policy coordination are considered.
- the discussion of political influences on macroeconomic policy has been expanded to include *partisan* party models (Chapter 17).
- discussion of the life-cycle versus bequest motives for saving has been added as well as a section on the implications of the rational expectations assumption for the permanent income hypothesis (Chapter 13).
- the chapter on monetary policy (Chapter 18) has been restructured to focus more clearly on monetary aggregates versus interest rates as intermediate targets.
- the natural rate of unemployment concept is reevaluated in the light of persistent high European unemployment (Chapter 10).
- an increased number of *Perspectives* have been included.
- a glossary of key terms has been added.

Teaching Aids and Supplements

A complete set of supplements to the new edition includes:

1. An Instructor's Manual with chapter summaries, answers to all end-of-chapter questions, and test materials that include a greatly increased number of problems, essay questions, and multiple-choice questions.
2. A Study Guide by Lawrence Davidson contains a review outline, problems, multiple-choice questions, and exercises on concepts and techniques for each chapter.
3. New with this edition is a package of computer software, POLICY-MAKER: A Macroeconomic Simulation, which allows students to simulate models in the text under various assumptions.

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Weaknesses or errors that remain, despite such aid, are my responsibility.

R. T. F.

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