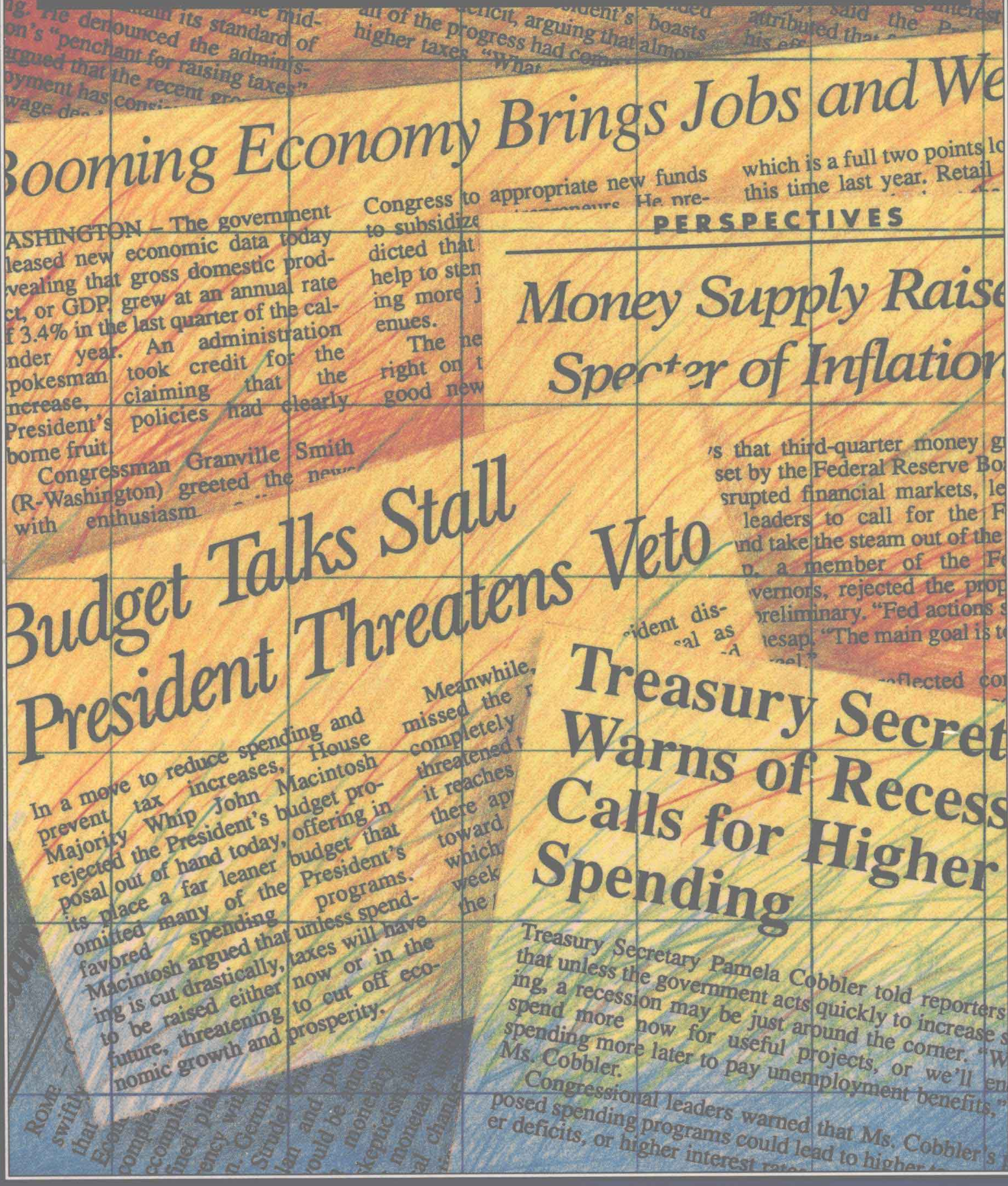
Macroeconomics

STEVEN E. LANDSBURG / LAUREN J. FEINSTONE



Macroeconomics

STEVEN E. LANDSBURG
University of Rochester

LAUREN J. FEINSTONE

The McGraw-Hill Companies, Inc.
NEW YORK ST. LOUIS SAN FRANCISCO AUCKLAND BOGOTÁ CARACAS
LISBON LONDON MADRID MEXICO CITY MILAN MONTREAL NEW DELHI
SAN JUAN SINGAPORE SYDNEY TOKYO TORONTO

McGraw-Hill

A Division of The ***McGraw-Hill*** *Companies*

Macroeconomics

This book was printed on acid-free paper.

1 2 3 4 5 6 7 8 9 0 VNH VNH 9 0 9 8 7

ISBN 0-07-020496-9

This book was set in Times Roman by GTS Graphics, Inc.

The editors were Lucille H. Sutton, Adrienne D'Ambrosio, and Elaine Rosenberg;

the production supervisor was Leroy A. Young.

The design manager was Charles A. Carson.

The designer was Edward A. Butler.

Drawings were done by Fine Line Illustrations.

Von Hoffmann Press, Inc. was printer and binder.

Library of Congress Cataloging-in-Publication Data

Landsburg, Steven E.
Macroeconomics / Steven E. Landsburg, Lauren Feinstone.
p. cm.
Includes index.
ISBN 0-07-020496-9
1. Macroeconomics. I. Feinstone, Lauren J., 1952– .
II. Title.
HB172.5.L36 1997
339—dc21 96-45453

INTERNATIONAL EDITION

When ordering this title, use ISBN 0-07-020496-9.

http://www.mhcollege.com

Preface

Macroeconomics today is a different subject than it was just a few decades ago. Old controversies have been resolved, new ones have arisen, and in the process some widespread areas of consensus have emerged. We believe that the paradigm of intertemporal choice is the basis for this emerging consensus in macroeconomics and that the new paradigm is sufficiently developed to serve as the unifying theme of an undergraduate textbook. This is that textbook.

Our strategy is to first develop a basic model whose component pieces are largely noncontroversial and then show how variations in certain key assumptions can lead to alternative conclusions. This enables us to emphasize the existence of an established body of knowledge without denying the controversies that remain.

The fundamental model is one of intertemporal exchange and production. This allows us, right from the start, to address the dynamic issues which are the basis for the modern approach to macroeconomics. As we introduce different sectors of the economy, we repeatedly return to the intertemporal aspects, using these as a unifying theme.

The book's chapters can be roughly classified into "building-block" chapters, "application" chapters, and "institutional" chapters. The building-block chapters introduce the microeconomic foundations of macroeconomics in an environment with flexible prices and perfect information. They include chapters on the dynamic elements of borrowing and lending (Chapter 3), consumption (Chapters 4 and 5), investment (Chapter 7), and labor (Chapter 9). These components are added to the model one at a time, so that the student is able to master equilibrium and comparative statics first in a pure endowment economy and then in successively richer models. Throughout, we emphasize supply, demand, and equilibrium—tools that will be familiar to some students but are developed from scratch with macroeconomic examples.

Early in the development, we incorporate the international economy, highlighting the parallel economics of trade across nations and trade between individuals. We also add another building block—a government sector—and address the traditional concerns of macroeconomics, including government expenditure and taxation (Chapter 6) and the market for money (Chapter 9). Along the way we highlight such issues as the debate surrounding Ricardian equivalence and the causes of inflation.

The application chapters combine these building blocks into more substantial structures—the theory of long-run economic growth (Chapter 8) and the theory of business cycles and short-run income determination (Chapters 11 through 14). Because growth theory requires only some of the building blocks, we have been able to position it even before all of the building blocks are in place. Some instructors will want to cover this chapter in sequence; others will prefer to complete the building-block Chapters 9 and 10 (and possibly some of the subsequent application Chapters 11 through 14) before returning to the topic of growth. We have carefully tailored the presentation so that instructors can follow either sequence without any loss of continuity. Let a thousand flowers bloom.

In the application Chapters 11 through 14, we first discuss some of the evidence and controversies involved in defining, measuring, and predicting business cycles. In Chapter 11, we use this material to call attention to some of the inadequacies of a flexible-price, full-information model. With this as motivation, we integrate the original building blocks into more sophisticated models, incorporating sticky wages (Chapter 12), sticky prices (Chapter 13), and monetary misperceptions (Chapter 14). We emphasize the question of what governments can and cannot do, and how the answer depends critically on what one believes about the existence and nature of distortions in the economy. At the same time, we insist that despite their different policy implications, all of these models are variations on a single theme. We eschew a pedagogy of "dueling models" with nothing in common, which can leave students with the impression that macroeconomists typically have nothing to say to each other. Instead, we provide a common language in which all schools of macroeconomic thought can be communicated and compared.

While we encourage students to think abstractly, we also encourage them to remember that the purpose of abstract thought is ultimately to understand the real world. Real-world institutions and history are referenced repeatedly in every chapter. A few chapters are exclusively devoted to tying the model to reality; these institutional chapters cover, among other topics, the national income accounts (Chapter 2), the money supply process (Chapter 15), and the making of economic policy (Chapter 17). A separate chapter on international finance (Chapter 16) is both an introduction to important real-world institutions and a new sort of building block, which (as we show the student) can be used to embellish the models and analysis elsewhere in the book.

We believe that students learn best by working problems. We have provided a large number of problems, at every level of difficulty. Within the chapters are exercises which should be easy for any student who has understood the preceding few paragraphs; students can use these exercises to slow themselves down and make sure they have grasped one point before rushing on to the next. The end-of-chapter problem sets call for deeper thought and understanding.

There are many other learning aids, including glossary items in the margins and "special warnings" to alert the students to points of particular subtlety. Special warnings are marked with the symbol below.

Supplements

The supplements that accompany Macroeconomics include a Study Guide prepared by William Weber of Eastern Illinois University as well as an Instructor's Manual, a Testbank in printed and computerized versions, Excel spreadsheet software by Tim

About The Authors

Steven E. Landsburg is an associate professor teaching at the University of Rochester. He has also taught at Colorado State University, Cornell University, the University of Iowa, and the University of Chicago. He is the author of two previous books about economics, *Price Theory and Applications* and *The Armchair Economist.* His monthly columns on economic matters have appeared in *Forbes* and the *Washington Post* and are currently appearing in *Slate.*

Lauren J. Feinstone has been a member of the faculty at the University of Rochester and the Economics Institute in Boulder, Colorado. She received a Ph.D. in economics from the University of Chicago. In 1988–1989, she was a Senior Economist on the President's Council of Economic Advisers, with primary responsibility for international macroeconomics. She is the author of the international finance chapter in the *Economic Report of the President* issued in February 1989.

Contents in Brief

Contents