

Introduction to

MACROECONOMICS

Second Edition



Edwin G. Dolan

Introduction to

MACROECONOMICS

SECOND EDITION



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PREFACE



AS THE ECONOMY changes, teaching materials must change, too. Many such changes are incorporated in this second edition of *Introduction to Macroeconomics* and *Introduction to Microeconomics* from Best Value Textbooks.

Many of the changes reflect the increased globalization of economic life. Years ago, international topics were confined to one or two chapters, usually tucked in at the end of textbooks, and usually skipped over in the rush to complete the semester. That approach is no longer suitable today. In the macroeconomics volume, discussion of the balance of payments, net exports, exchange rates, international financial flows, and related topics are fully integrated into the chapters where the related theory and policy issues are discussed. There is no separate international macro chapter at all. In the microeconomics volume, there is still a separate chapter at the end covering international trade and trade policy, but this is no longer the first introduction to these topics. Instead, it is a capstone chapter that pulls together individual threads of international economics that have been introduced chapter by chapter, starting in Chapter 1.

The globalization of this text is not confined to discussion of the big issues, like exchange rates or comparative advantage. It is also reflected in a wide variety of small boxed cases and examples incorporated throughout the text. These are not drawn exclusively from U.S. experience, as was the case in textbooks of the past, and why should they be? Principles such as supply and demand, marginal cost, and the effects of expansionary monetary policy apply as much in Russia or Malawi as they do in Kansas or California. The inclusion of examples from many places around the world will make the presentation of economic principles more vivid both for increasingly outward-looking American students and for the large number of students from abroad who come to the United States for an education.

Other changes reflect trends in economics itself. Neoclassical models of rational choice remain the foundation of microeconomics, but they are increasingly supplemented by expanded approaches that incorporate insights of other social sciences. Users of the microeconomics volume will find these expanded approaches incorporated at many points. Similarly, recent years have seen a restoration of balance in the

teaching of macroeconomics between long-run and short-run perspectives, and between the real and monetary sectors of the economy. The macroeconomics chapters of this new edition begin with an introduction to the theory of economic growth before introducing short-run business cycle considerations. Also, the chapters on money, banking, and monetary policy are moved to an earlier place in the book in keeping with their importance. The short-run “Keynesian cross” income determination model no longer receives chapter-length treatment, although it is still included in a shorter form.

As was the case with the first edition, it has been a pleasure for me to work with such an innovative publisher. Short publication lead times and affordable prices made possible by the latest publishing technologies will help to make this a book that gives both students and professors the true Best Value.

Acknowledgments

My first thanks must go to my long-time co-author, David E. Lindsey, with whom I worked on earlier editions of this text over a period of many years. During his years as Deputy Director of the Division of Monetary Affairs of the Board of Governors of the Federal Reserve System, David was able to find the ideal balance between the theory and practice of economics. Although he did not contribute to preparation of this new edition, his strong influence can still be seen in both the macroeconomic and microeconomic chapters.

Second, I thank the entire publishing and editorial staff of Best Value Textbooks for introducing me to this great new concept in college publishing. I hope you, the user, benefit as much as I have.

Finally, I would like to acknowledge the support and inspiration of Jere Calmes who encouraged me to try my hand at textbook writing more than 30 years ago. Without his energy and commitment over many years, this book would never have been written.

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Features of This Edition

- *State of the art pedagogy.* An abundance of case studies introduce and illustrate the subject matter of every chapter.
- *Integrated international economics.* As the world economy itself comes closer together, international economics must be more closely integrated into the principles course. Accordingly, topics in international economic theory and policy, ranging from balance of payments accounts to the foreign exchange operations of the Fed, are introduced in the chapters in which they occur naturally, rather than presented separately in a single chapter.

Supplements

Test Bank

The accompanying Test Bank contains over 2,000 questions in a variety of formats including multiple choice, true/false, and essay questions.

Instructor's Manual

The expanded Instructor's Manual contains material which can be easily included in lectures. The manual also includes all of its traditional elements, including instructional objectives, lecture notes, and suggestions.

Study Guide

The Study Guide has hands-on applications and self-testing programs. It is available in two versions, *Macroeconomics*, and *Microeconomics*. Students can gain an advantage by reinforcing their reading and lecture notes with the following study guide features:

- *Where You're Going*. The objectives and terms for each chapter are recapped to tie concepts together.
- *Walking Tour*. The "Walking Tour" section provides a narrative summary of the chapter and incorporates questions on key points. Answers are given in the margin.
- *Hands On*. Geographical and numerical exercises clarify concepts and better prepare students for tests and quizzes.
- *Economics in the News*. A news item illustrates how concepts covered in the chapter can appear in the real world. Questions and answers reinforce the concepts.
- *Questions for Review*. These questions and answers follow the key chapter concepts, preparing students for the self-test.
- *Self-Test*. Extra test preparation increases a student's understanding and ability to succeed.
- *Careers in Economics*. Formerly an appendix in the text, this material provides students with an understanding of where the study of economics could lead them.

Online Student Tutorial

Created to support and enhance the student's comprehension of the economic principles discussed in the textbook. The online tutorial includes chapters objectives and study questions. To access the tutorial please visit our Students section on our Web site www.bestvaluetextbooks.com. Username: Economics Password: DolanLindsey

Economic PowerPoint Transparencies

This PowerPoint slide set combines graphics and text to further illustrate the economic principles discussed in the text.

About the Author

EDWIN G. DOLAN was born in Oklahoma and grew up in a small town in Oregon. He attended Earlham College and Indiana University, where he majored in Russian Studies and received the Certificate of Indiana University's famed Russian and East-European Institute. After earning a doctorate in economics from Yale University, he taught at Dartmouth College, the University of Chicago, George Mason University and Gettysburg College. In 1990, he began teaching in Moscow, Russia, where he and his wife founded the American Institute of Business and Economics, an independent, not-for-profit MBA program. Since retiring as President of that institution in 2001, he has taught global macroeconomics, managerial economics and public policy in Latvia, Hungary, Croatia, Bulgaria, and the Czech Republic. When not lecturing abroad, he makes his home in Washington's San Juan Islands.

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CHAPTER 1

The Economic Way of Thinking

After reading this chapter, you will understand:

1. The subject matter of economics
 2. The considerations underlying four fundamental economic choices:
 - What an economy will produce
 - How goods and services will be produced
 - Who will produce which goods and services
 - For whom goods will be produced
 - How to coordinate economic choices
 3. How economists use theory, graphs, and evidence in their work
-

THE YEAR 2005 was a tough one for General Motors, the world's largest car-maker. In the first three months of the year alone, it lost \$1.1 billion as sales of its largest SUVs plunged. On Wall Street, the company's bonds were downgraded to "junk" status, as were those of rival Ford Motor Company, which was also heavily reliant on sales of large SUVs and pickups. Meanwhile, sales of fuel-efficient hybrids made by Toyota and Honda were booming. The cause of all this turmoil? Soaring gasoline prices and record-high world prices for the crude oil from which gasoline is refined.

Scarcity

A situation in which there is not enough of a resource to meet all of everyone's wants.

Rising gasoline prices and falling SUV sales are examples of **scarcity** and the choices people make when there is not enough of something to meet everyone's wants. In this case the scarce resource is energy. American consumers want to use a lot of the world's scarce energy resources to run the large cars they love so much. But consumers in rapidly growing China and India want energy to build a lifestyle based on

Economics

The social science that seeks to understand the choices people make in using scarce resources to meet their wants.

Microeconomics

The branch of economics that studies the choices of individuals, including households, business firms, and government agencies.

Macroeconomics

The branch of economics that studies large-scale economic phenomena, particularly inflation, unemployment, and economic growth.

refrigerators, air conditioners, and motor transport, too. There is not enough oil in the world to satisfy all wants at once, so choices must be made. Scarcity and the way people deal with it are the central topics of **economics**, which can be defined as the social science that seeks to understand the choices people make in using scarce resources to meet their wants.

Economics, as the definition makes clear, is a study not of things or money or wealth but of *people*. Economics is about people because scarcity itself is a human phenomenon. Deposits of crude oil lay undisturbed in the ground for millions of years before they became the object of human wants. Only at that point did they become *scarce* in the sense that economists understand the term. It is the focus on the human dimension of scarcity and choice that makes economics a social science rather than a branch of engineering or mathematics.

Scarcity and choice, the ideas that unify all of economics, have many different applications. The example of gasoline prices and vehicle choices are applications from **microeconomics**. The prefix *micro*, meaning “small,” indicates that this branch of economics deals with the choices of small economic units such as households, firms, and government agencies. Although microeconomics studies individual behavior, its scope can be worldwide. When households, firms, and government agencies conduct worldwide trade in such goods as cars and crude oil, that trade and the policies regulating it fall within the scope of microeconomics.

Economics also has another branch, known as **macroeconomics**. The prefix *macro*, meaning “large,” indicates that this branch deals with larger-scale economic phenomena. Typical problems in macroeconomics include how to maintain conditions in which people who want jobs can find them, how to protect the economy against the distortions caused by widespread price increases (inflation), and how to provide for a continued increase in living standards over time. Choices studied by macroeconomics include those made by governments, for example, choices among alternative policies concerning taxes, expenditures, budget deficits, and the financial system. However, because macroeconomic phenomena, such as inflation, represent the end result of millions of individual choices regarding the prices of particular goods and services, macroeconomics ultimately rests on a microeconomic foundation.

Whether one is dealing with microeconomics or macroeconomics, and whether with domestic or international economic relationships, all economic analysis comes down to a special way of thinking about how people choose to use scarce resources.

WHAT? HOW? WHO? FOR WHOM?

In every economy certain basic choices must be made. Among these, the most important are *what* goods will be produced, *how* they will be produced, *who* will do which jobs, and *for whom* the results of economic activity will be made available. Each of