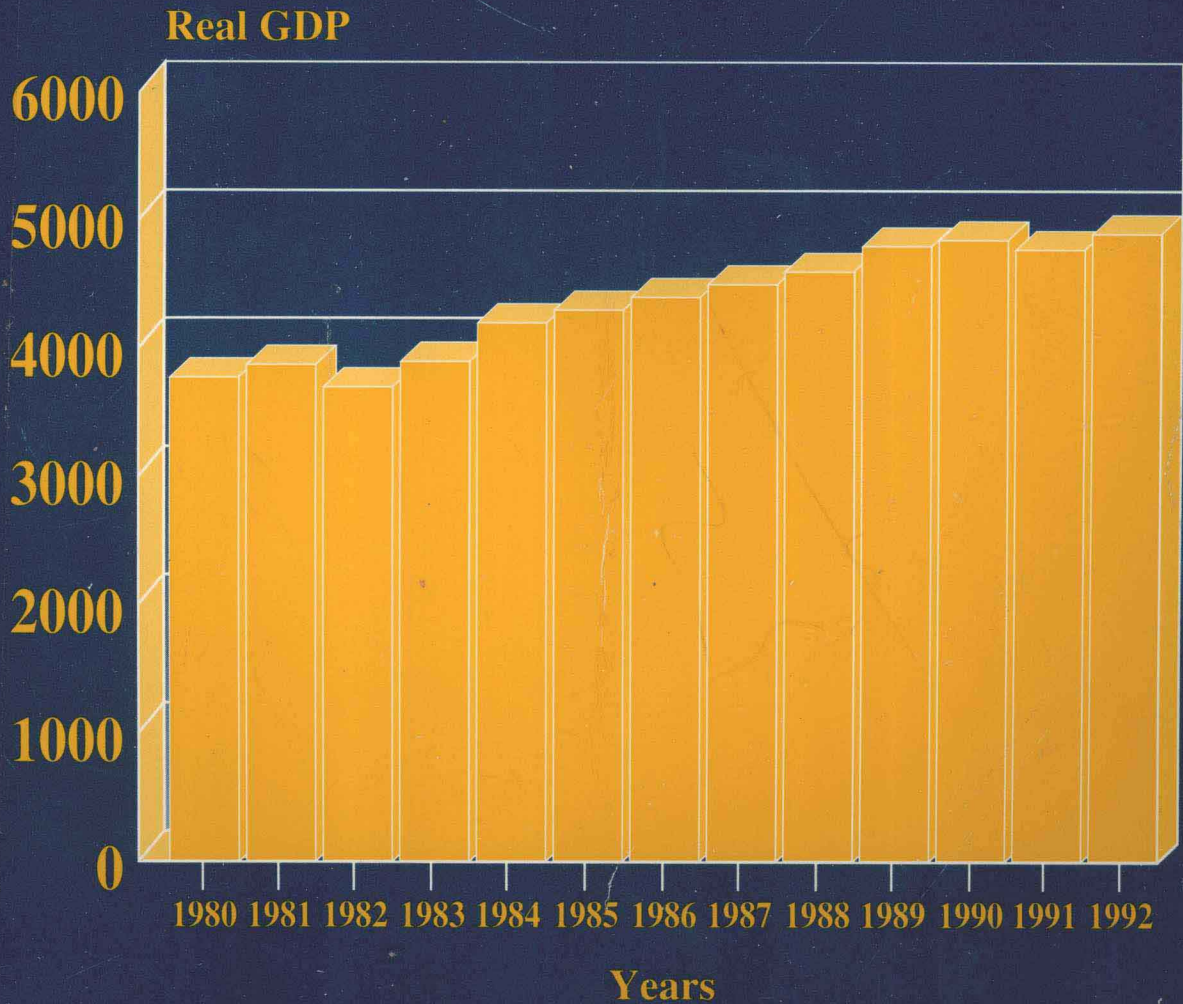


Concepts in Economics

Fifth Edition



Debbie A. Meyer

 College
Custom
Series

Concepts in Economics

Fifth Edition

Debbie A. Meyer
Brookdale Community College

McGraw-Hill, Inc.
College Custom Series

*New York St. Louis San Francisco Auckland Bogotá
Caracas Lisbon London Madrid Mexico Milan Montreal
New Delhi Paris San Juan Singapore Sydney Tokyo Toronto*

McGraw Hill's **College Custom Series** consists of products that are produced from camera-ready copy. Peer review, class testing, and accuracy are primarily the responsibility of the author.

CONCEPTS IN ECONOMICS

Copyright © 1994, 1991, 1990 by McGraw-Hill, Inc. All rights reserved. Printed in the United States of America. Except as permitted under the United States Copyright Act of 1976, no part of this publication may be reproduced or distributed in any form or by any means, or stored in a data base retrieval system, without prior written permission of the publisher.

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

ISBN 0-07-041786-5

Editor: Constance Ditzel

Cover Design: Christopher J. Siwinski

Printer/Binder: Malloy Lithographing, Inc.



This book is printed on recycled paper containing a minimum of 50 % total recycled fiber with 10 % postconsumer deinked fiber.

To my inner circle--my family

To The Student

Concepts in Economics is split between Macroeconomics and Microeconomics. Within each area there are three units which correspond to your course syllabus.

Each unit is composed of several chapters. Each chapter is broken down into:

- Chapter Orientation - to acquaint you with the purpose and focus of the chapter.
- Learning Objectives - are brief statements of expected learning which require you to define, compare, explain, contrast, list, and evaluate each chapter.
- Chapter Highlights - a detailed outline of the chapter's most important content.
- Key Terms - lists the important concepts which you should be able to define.
- Real World Example - relates the theory presented to the real world, which gives you a better understanding of the concept.
- Problems - a "hands on approach" to learning the material.
- Self-Test - provides additional opportunities to assess your mastery of the material. Be sure to check your answers with the "Answer Key" provided.

This student manual is designed to be used in conjunction with Economics, by Campbell R. McConnell and Stanley L. Brue. However, this manual may be used to stand alone or accompany another introductory economics textbook. If you attend the class lectures, read the text carefully and complete the exercises in this concepts book, you should achieve mastery of the economic principles and their applications.

Below is the suggested format for studying:

1. Read the "Chapter Orientation", "Learning Objectives", "Chapter Highlights", "Key Terms", and "Real World Example" sections in this workbook prior to reading the chapter in the text (this gives you an idea of what will be covered in the chapter).
2. Then read the chapter in the text, highlighting important points.
3. After reading the chapter, take notes (use the "Chapter Highlights" in this workbook as a guide).

4. Attend the classroom lecture of the chapter and take notes.
5. Reread the "Chapter Highlights", "Key Terms", and your lecture notes. If there is any concept that seems unclear to you, go to the text and reread the topic.
6. Tackle the problems in this workbook and any additional problems that have been assigned.
7. Answer the questions under the "Self-Test" section. Be sure to check your answers.
8. Finally, go back to the "Learning Objectives" and see if you can answer each item.

Acknowledgements

I would like to thank everyone who helped with the production of this workbook -- my family, friends and colleagues. A special note of gratitude goes to Valerie Hamilton, who spent countless hours on the production of this workbook. Her patience and many suggestions were extremely helpful and her contribution is greatly acknowledged. Also, a special thanks to Daren Eilert, our computer consultant.

Also, I am grateful to the students at Brookdale Community College -- for without their support and encouragement this Concepts Book would never have come into existence.

Why We Can't Live Without Economists

By Gary S. Becker

Jokes about the shortcomings of economists are endless. The reason is simple. Both business and government need guidance that only economists can provide, especially forecasts of inflation, aggregate employment and output, and of the effects of tax reform, the federal deficits, and other events that affect the future of the economy. Yet-and this is the source of the jokes and criticism-such predictions are often unreliable. The fact is economists are poor at forecasting short-term changes in the economy.

The recent annual meeting of the American Economic Assn. in New Orleans spotlighted the current state of thinking about the profession's limitations, as well as its achievements. The 6,000 members in attendance could choose from over 100 sessions on many subjects. The meetings on macroeconomics, which deals with inflation and changes in aggregate output and employment in an economy, were the most popular, whether the speakers holding forth were Keynesians, monetarists, rational expectationists, or supply siders.

The extent of the disagreements at these sessions testifies to the conflicting views within macroeconomics. In one panel, four excellent economists analyzed the effects of federal deficits on the economy. Their conclusions ranged from predictions that there would be rather little effect to moderately adverse effects to sizable adverse effects. Sadly, the available evidence is too weak to permit a choice among these views. My own opinion, and I am not a specialist in macroeconomics, is that even large deficits do not damage an economy if they last for only a few years.

UNSUNG SPECIALTY. My field is microeconomics. This discipline studies how consumers, workers, and other participants in economic activities decide such economic issues as what to buy, how much to save, where to work, and how many hours to work at any given wage. Although microeconomics stirs its share of controversy, economists generally agree-and they have substantial evidence to support their view-about its basic assumption: that economic participants make rational choices. Microeconomics attracts less attention from the media than does macroeconomics, yet it has had stunning practical successes during the past decade.

Although these successes include the industry deregulation movement and several other issues, I will concentrate on two subjects popular at the recent AEA meeting: finance and law.

A revolution in thinking initiated during the 1950s replaced ad hoc precepts about financial issues with models of rational choice. One model, for example, explains how investors determine the type of securities to hold in their portfolios by analyzing the trade-offs between expected return and risk. Related models are used to analyze the effect of company debt on prices of common stock and to guide the use of options and arbitrage.

As a result of such applications, the intellectual foundations of finance have been recast into a microeconomic framework. This approach now dominates the teaching of finance. It also permeates mutual fund management and the behavior of commercial and investment banks and other financial intermediaries.

LEGAL INFLUENCE. The law and economics movement began with the academic economists and lawyers who believed that economic analysis could greatly improve antitrust policy. It has spread to all other legal fields and has also infiltrated legal practice. Microeconomic analysis in legal decisions has grown rapidly partly because scholars of the law and economics, such as Robert H. Bork, Frank H. Easterbrook, and Richard A. Posner, moved from academia to the bench.

Microeconomics has also achieved great success in altering thinking about criminal law. Claims that criminals cannot be deterred by punishment because they are mentally sick or alienated from society dominated thinking about criminal justice in the 1950s and 1960s. The microeconomic approach assumes that, on the contrary, most criminals make rational choices given their

circumstances. This view has had an enormous influence on public policy and judicial decision-making during the past decade. Hostile reaction to judges and legislators considered soft on crime and the revival of capital punishment are part of the evidence that the microeconomic interpretation of criminal behavior has won many followers.

This discussion explains why economists are prominent in public policy debate and in analysis of business decisions. My attention to the important practical and theoretical achievements of microeconomics should not suggest that macroeconomics remains stagnant. The large disagreements among macroeconomists today is far healthier than the agreement in the 1940s and 1950s on an unrealistic model of the economy.

Despite economics' accomplishments, the public demands more from it, especially from macroeconomics, than it can deliver at present. This conflict between what the public wants and what economists can deliver explains why economists continue to face ridicule at the same time they are courted by government, business, and the media.

Reprinted from February 2, 1987 issue of Business Week by special permission, copyright (c)1987 by McGraw-Hill, Inc.

Nobel Memorial Prize in Economic Science

YEAR	NAME(S)	NATIONALITY	RESEARCH
1969	Ragnar Frish & Jan Tinbergen	Norwegian, Dutch	Development of econometrics
1970	Paul A. Samuelson	American	Application of a new scientific analysis to economic theories
1971	Simon Kuznets	American	Introduction of the concept of the gross national product
1972	Kenneth J. Arrow and John R. Hicks	American	Contributions to equilibrium and welfare theories
1973	Wassily Leontief	British American	Analysis showing how changes in one economic variable affect other sectors
1974	Gunnar Myrdal & Friedrich A. von Hayer	Swedish Austrian	Contributions in the theory of money and economic fluctuations
1975	Leonid V. Kantorovich & Tjalling C. Koopmans	Russian American	Applying statistical methods to resource allocation
1976	Milton Friedman	American	Development of monetary theory
1977	Bertil Ohlin & James Edward Meade	Swedish British	Contributions to the theory of international trade
1978	Herbert A. Simon	American	Pioneering work on the decision-making processes in complex economic organizations
1979	Theodore W. Schultz & Sir Arthur Lewis	American	Work in economic development research with special regard to the problems of of developing countries
1980	Lawrence R. Klein	American	Pioneering econometric models to forecast economic trends
1981	James Tobin	American	Analysis of financial markets and their relations to spending decisions, employment, production and prices
1982	George J. Stigler	American	Pioneering studies of industrial production
1983	Gerard Debreu	American	Research on equilibrium in a market economy
1984	Sir Richard Stone	British	Developing accounting systems that help governments allocate their financial resources
1985	Franco Modigliani	American	Analysis of savings and financial markets
1986	James McGill Buchanan	American	Contributions to the theory of economic and political decision-making
1987	Robert M. Solow	American	Showing the impact of Technology on economic growth
1988	Maurice Allans	French	Pioneering development of theories to better understand market behavior and efficient use of resources
1989	Trygve Haavelmo	Norwegian	Pioneering work in methods for testing economic theories that help pave the way for modern economic forecasting
1990	Merton H. Miller	American	Work on the cost of finance and capital structure of corporations
1991	Ronald Coase	American	Explanations of how market economies are shaped by contracts, laws and property rights
1992	Gary S. Becker	American	Extended the domain of economic theory to aspects of human behavior, which had been previously dealt with, if at all, by other social science disciplines.

CONTENTS

Acknowledgements, vii

To the Student, xi

"Why We Can't Live Without Economists", xiii

Nobel Memorial Prizes in Economics Science, xv

MACROECONOMICS

UNIT I

Chapter	1	The Nature and Method of Economics, 3
	2	The Economizing Problem, 11
	3	Pure Capitalism and the Circular Flow, 21
	4	Understanding Individual Markets: Demand and Supply, 25
	5	The Private Sectors and the Market System, 36

Review Sheet: Unit I, 44

UNIT II

Chapter	7	Measuring Domestic Output, National Income, and the Price Level, 51
	10	Classical and Keynesian Theories of Employment, 60
	11	Equilibrium Domestic Output in the Keynesian Model, 74
	12	Fiscal Policy, 87
	18	Budget Deficits and the Public Debt, 97

Review Sheet: Unit II, 105

Unit III

Chapter	8	Macroeconomic Instability: Unemployment and Inflation, 115
	17	The Inflation-Unemployment Relationship, 125
	13	Money and Banking, 135
	14	How Banks Create Money, 145
	15	The Federal Reserve Banks and Monetary Policy, 153

Review Sheet: Unit III, 160

Answers to Self-Test Questions and Selected Problems, 311

MICROECONOMICS

UNIT I

Chapter	1	The Nature and Method of Economics, 3
	4	Understanding Individual Markets: Demand and Supply, 25
	5	The Private Sector and the Market System, 36
	20	Demand and Supply: Elasticities and Applications, 171
	21	Consumer Behavior and Utility Maximization, 181

Review Sheet: Unit I, **188**

UNIT II:

Chapter	22	The Costs of Production, 195
	23	Price and Output Determination: Pure Competition, 208
	24	Price and Output Determination: Pure Monopoly, 219
	25	Price and Output Determination: Monopolistic Competition, 230
	26	Price and Output Determination: Oligopoly, 238

Review Sheet: Unit II, **247**

Unit III

Chapter	27	Production and the Demand for Resources, 259
	28	The Pricing and Employment of Resources: Wage Determination, 270
	29	The Pricing and Employment of Resources: Rent, Interest, and Profits, 285
	36	Labor Market Issues: Unionism, Discrimination, and Immigration, 293

Review Sheet: Unit III, **303**

"Facts About Money", **308**

Glossary of Terms, **309**

Answers to Self-Test Questions and Selected Problems, **311**

ACKNOWLEDGMENTS

Grateful acknowledgment is made to the following for permission to reprint material copyrighted or controlled by them:

PAGE NO.	SOURCE
xiii	Reprinted from the February 2, 1987 issue of <u>Business Week</u> by special permission, copyright (c) 1987 by McGraw-Hill, Inc.
5	Reprinted by permission of the Federal Reserve Bank of Cleveland, <u>Economic Trends</u> , May 1993. Sources: U.S. Department of Commerce, Bureau of Economic Analysis, and Board of Governors of the Federal Reserve System.
6-8	Reprinted from <u>Contemporary Macroeconomics</u> , Fifth Edition, by Milton Spencer, reproduced by permission of Worth Publishers, the copyright holder.
22-23	Reprinted by permission The Associated Press, February 1, 1990, copyright (c) 1990 by The Associated Press.
27-28	Reprinted by permission of the <u>Asbury Park Press</u> , June 4, 1992, copyright (c) 1992 by Asbury Park Press, Inc.
39-42	Reprinted by permission of <u>The Wall Street Journal</u> , copyright (c) 1986 Dow Jones & Company, Inc. All rights reserved worldwide.
53-54	Reprinted by permission of <u>The Wall Street Journal</u> , copyright (c) 1984 Dow Jones & Company, Inc. All rights reserved worldwide.
65-67	Reprinted by permission of <u>The Wall Street Journal</u> , copyright (c) 1986 Dow Jones & Company, Inc. All rights reserved worldwide.
79-80	Reprinted by permission of the <u>Asbury Park Press</u> , March, 1993, copyright (c) 1993 by Asbury Park Press, Inc.
82	Reprinted from <u>Study Guide to Contemporary Macroeconomics</u> , Fifth Edition, by Milton Spencer, reproduced by permission of Worth Publishers, the copyright holder.
83-85	Reprinted from <u>Contemporary Macroeconomics</u> , Fifth Edition, by Milton Spencer, reproduced by permission of Worth Publishers, the copyright holder.
91-92	Reprinted by permission of <u>The Wall Street Journal</u> , copyright (c) 1993 Dow Jones & Company, Inc. All rights reserved worldwide.
101-102	Reprinted by permission of <u>The Wall Street Journal</u> , copyright (c) 1988 Dow Jones & Company, Inc. All rights reserved worldwide.

- 120 Reprinted by permission of the New Jersey Department of Labor, January, 1993. Copyright (c) 1993 the New Jersey Department of Labor.
- 131-132 Reprinted by permission from Fortune, May 3, 1993, copyright (c) 1993 by Time, Inc.
- 141-142 Reprinted by permission of the Federal Reserve Board, Washington D.C., 1984 and 1987. Source: Board of Governors.
- 148 Reprinted from Modern Money Mechanics, October 1982, by permission of the Federal Reserve Bank of Chicago.
- 157 Reprinted from KRTN Graphics Network, June 3, 1987, by permission of the Tribune Media Services.
- 174-175 Reprinted by permission of the Asbury Park Press, January 23, 1984, copyright (c) 1984 by Asbury Park Press, Inc.
- 177-178 Reprinted from Study Guide to Contemporary Macroeconomics, Fifth Edition, by Milton Spencer, reproduced by permission of Worth Publishers, the copyright holder.
- 200-201 Reprinted by permission of the Asbury Park Press, January 31, 1993, copyright (c) 1993 by Asbury Park Press, Inc.
- 213-214 Reprinted by permission of the Asbury Park Press, January 31, 1993, copyright (c) 1993 by Asbury Park Press, Inc.
- 216 Reprinted from Study Guide to Contemporary Macroeconomics, Fifth Edition, by Milton Spencer, reproduced by permission of Worth Publishers, the copyright holder.
- 224-225 Reprinted by permission of The Wall Street Journal, copyright (c) 1990 Dow Jones & Company, Inc. All rights reserved worldwide.
- 226-228 Reprinted from Study Guide to Contemporary Macroeconomics, Fifth Edition, by Milton Spencer, reproduced by permission of Worth Publishers, the copyright holder.
- 233-234 Reprinted by permission of the Asbury Park Press, January 31, 1993, copyright (c) 1993 by Asbury Park Press, Inc.
- 236 Reprinted from Study Guide to Contemporary Macroeconomics, Fifth Edition, by Milton Spencer, reproduced by permission of Worth Publishers, the copyright holder.
- 242 Reprinted by permission from Fortune, May 3, 1993, copyright (c) 1993 by Time, Inc.
- 264-265 Reprinted from the April 26, 1993 issue of Business Week by special permission, copyright (c) 1993 by McGraw-Hill, Inc.

- 277-278 Reprinted by permission The Associated Press, June 10, 1993, copyright (c) 1993 by The Associated Press.
- 289 Reprinted by permission The Associated Press, June 10, 1993, copyright (c) 1993 by The Associated Press.
- 299-300 Reprinted by permission of the Asbury Park Press, May 26, 1993, copyright (c) 1993 by Asbury Park Press, Inc.
- 308-310 Reprinted by permission of the Hammond Almanac, copyright (c) 1987 by Hammond, Inc.

M A C R O E C O N O M I C S

UNIT 1

Chapter Orientation

Chapter 1 sets the stage for your study of economics. After studying these concepts, you will have a foundation with which to build. This chapter acquaints you with several reasons for studying economics; how economic policy is derived; a review of graphing techniques and several important terms. Your study of economics will be more meaningful/enjoyable if you grasp the general framework of the economic concepts outlined in this chapter.

Learning Objectives

After studying this chapter in the text and completing the following exercises in this concepts book, you should be able to:

1. Define economics and give several reasons for studying the economy.
2. List the steps, using positive economics, in deriving economic policy.
3. Cite several potential pitfalls in economic models.
4. Construct graphs from data presented, calculate slopes, and define their relationship.
5. List the seven economic goals in our society.
6. Understand the role of economic models, theory, and assumptions in the study of economics.
7. List the difficulties that economics students often face in studying economics.

Chapter Highlights

- I. The Importance of Studying Economics
 - A. Economics
 1. Definition of Economics
 2. Macro vs. Micro Economics defined
 3. Ceteris paribus defined
 4. Comparative advantage defined
 - B. Reasons for study
 1. Informed citizens (voters)
 2. Knowledge of social environment and behavior
 3. Information for business executives
- II. Deriving Economic Policy
 - A. The Scientific Method (positive economics)
 1. Gathering of relevant facts (descriptive economics)
 2. Deriving principles from facts (economic theory), also called "laws", "theories", and "models"
 - a. Generalizations, assumptions, and abstractions
 - b. Forms of economic models: verbal statements, numerical tables, graphs, and mathematical equations
 3. Test (inductive vs. deductive methods)
 4. Economic policy (to solve a social problem)
 - a. Predictions and implications for the real world
 - b. Steps
 1. Establish a clear statement of goals
 2. Knowledge of alternative policies