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BRADLEY R. SCHILLER

THE AMERICAN UNIVERSITY

SEVENTH EDITION

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THE MACRO ECONOMY TODAY

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ABOUT THE AUTHOR

Bradley R. Schiller has over two decades of experience teaching introductory economics at The American University, the University of California (Berkeley and Santa Cruz), and the University of Maryland. He has given guest lectures at nearly 100 colleges ranging from Fresno, California, to Istanbul, Turkey. Dr. Schiller's unique contribution to teaching is his ability to relate basic principles to current socioeconomic problems, institutions, and public policy decisions. This perspective is evident throughout *The Economy Today*.

Dr. Schiller derives this policy focus from his extensive experience as a Washington consultant. He has been a consultant to most major federal agencies, many congressional committees, and political candidates. In addition, he has evaluated scores of government programs and helped design others. His studies of discrimination, training programs, tax reform, pensions, welfare, Social Security, and lifetime wage patterns have appeared in both professional journals and popular media. Dr. Schiller is also a frequent commentator on economic policy for television, radio, and newspapers.

Dr. Schiller received his Ph.D. from Harvard in 1969. His B.A. degree, with great distinction, was completed at the University of California (Berkeley) in 1965. He is now a professor of economics in the School of Public Affairs at The American University.

PREFACE

The 1990s may be remembered as the decade of structural change in the world economy. The decade began with the collapse of communism. By mid-decade countries as diverse as India, Uganda, South Africa, and Vietnam were radically transforming basic economic institutions. In the United States political debate is raging over fundamental reforms of the welfare-system, the health care system, the tax system, and the larger role of government in economic affairs. Before the decade ends, Cuba is likely to restructure its economy.

This worldwide wave of structural change rivals in importance those of the 1930s and 1940s. In the midst of such historic shifts, however, one has to wonder about basic principles. Why, after so many decades of central planning, did communist nations conclude that market-directed economies work better? Why was the American electorate suddenly determined to roll back some major government commitments dating back to the New Deal? Were these worldwide trends prompted by greater appreciation of the market mechanism? Or is the relative curtailment of the public sector simply a reaction to increased perceptions of government failure?

These fundamental historical questions go beyond the reach of an introductory economics text. They do, however, help set a theme for an initial exploration of the field. Every nation *does* confront basic choices about how its economy is structured, what role the government plays, and how the trade-off between equity and efficiency should be resolved. As the worldwide epidemic of structural change brings these basic issues into focus, the study of economics appears more relevant, possibly even exciting.

Real-World Focus

The Economy Today tries to bring some of this excitement into the classroom. The real world motivates this text and pervades its pages. *The Economy Today* pioneered the use of domestic and global news boxes to highlight the linkage between theory and reality. Although other texts have now adopted this feature, no other text grounds the entire discussion in empirical reality. This orientation is evident in the first paragraph of Chapter 1, which highlights the economic content of the 1996 presidential debates. Chapter 2 solidifies the real-world roots of the text by describing the *facts* of the U.S. economy (What, How and For Whom output is actually produced), with historical and global comparisons. As several surveys have shown, most Americans are woefully ignorant of those facts (as seen In The News). In these circumstances, we economics professors should assume a responsibility for teaching students the facts of economic life. Once we do, student interest in economic *theory* may also perk up. How is it, they might ask, that per capita incomes in the United States are five times the world average and twenty times those of Cuba? Students might even wonder how and why the role of government varies so much across time and place once we document such structural differences.

The empirical orientation of the text is reinforced in every chapter. The core problems of unemployment (Chapter 6) and inflation (Chapter 7) are introduced in the context of historical upheavals and global comparisons. Current data on who suffers and



IN THE NEWS

Americans Flunk Econ 101

Study Finds Basic Grasp of Terms, Concepts Lacking

Americans have strong opinions on economic matters. The problem is, many of them lack basic economic knowledge on which to base those opinions, according to a national survey of economic literacy. . . .

The survey, done last March for the council by the Gallup Organization, found that "many people do not understand the meaning of basic economic terms," said William B. Walstad, director of the National Center for Research in Economic Education at the University of Nebraska. "In contrast, they have very strong opinions about things about which they have no underlying knowledge."

—John M. Berry

The Washington Post, September 10, 1992. © 1992, The Washington Post. Reprinted with permission.

E Is for Economy

Percentage of Correct Responses

Response	General Public	High School Seniors	College Seniors
Unemployment rate	22%	10%	26%
Inflation rate	11	4	12
Budget deficit definition	51	38	66
Budget deficit size	19	22	24
Federal Reserve purpose	46	38	58
Economic policy	48	39	55
Productivity/wages	68	69	77
Purpose of profits	36	42	52
Supply and demand	64	72	79
Value of dollar/exports	50	38	61
Average	39%	35%	51%

Source: National Council on Economic Education.

Analysis: Most Americans cannot identify basic economic concepts or the dimensions of economic problems. We teachers have our work cut out for us.

how from these macro failures underscore the socio-political significance. In the policy arena, students are asked to use Alan Greenspan's own rule of thumb (page 328) to compare monetary and fiscal policy actions. The tendency of both the Congressional Budget Office (CBO) and the Office of Management and Budget (OMB) to *underestimate* future deficits and to *overestimate* future growth is used to help explain some of our macro policy mistakes (Chapter 19). The Treasury Department's observation that two-thirds of all U.S. currency is held abroad is used to explain some of the difficulties in managing the money supply (Chapters 15 and 18). The raging debate over the limits of non-inflationary growth—Is it really only 2.5 percent?—motivates the exploration of growth theory (Chapter 17). If you want students exposed to the real worlds of economics, you've come to the right place with *The Economy Today*.

Theoretical Clarity

Many instructors fear that too much empiricism drives out the theory. No such trade-off need exist, however. In *The Economy Today* basic economic theories are not distorted to fit the facts. Theoretical principles are presented clearly and correctly, without compromise. The empirical content of the text doesn't *substitute* for theory but instead *motivates* the exploration of theory. Real-world applications are also used to illustrate the limits of theoretical models. This is particularly evident in Chapter 19, which is aptly titled "Theory vs. Reality." If we want students to learn and respect the central theories of our discipline, we need to address their puzzlement about the gap between theoretical expectations and the performance of the real economy.

NEW FEATURES IN THE SEVENTH EDITION

The new edition has been improved in several ways, some quite visible, others more subtle.

Market Reliance vs. Government Intervention

The central theme of market signals vs. government directives has become stronger and more visible. Chapter 1 uses the rhetoric of the 1996 presidential campaign to highlight the fundamental question of when and how to rely on “the market.” This theme pervades the entire text. Students are repeatedly asked to identify not only the virtues of the market mechanism but also its potential failures. Likewise, both the benefits and the risks of government intervention are stressed. The second-best choice between imperfect markets and imperfect interventions is emphasized.

Expanded Coverage of Public Sector

The “Public Sector” chapter has been resurrected from the fifth edition and returned as Chapter 4. The rationale (market failure) for public-sector activity is explained, then the dimensions of state, local, and federal governments are depicted. The discussion contrasts the recent “downsizing” of federal purchases with continuing growth of income transfers and the state/local sectors.

Smoother Integration of Keynesian and AS/AD Models

Everyone claims to have “integrated” Keynesian theory and the AS/AD model, but few have. To do so, one must be able to illustrate Keynesian gaps and the multiplier *explicitly* in the AS/AD framework. One must also be careful to note that the AS/AD model is a framework for analysis, not a unique theory of macro behavior. This edition of *The Economy Today* introduces students to that framework at the outset of the macro-theory sequence (Chapter 7). Then the Keynesian model is used to illustrate the multiplier process that shifts the AD curve (Chapters 8 and 9). The Keynesian adjustment *process* (multiplier) is distinguished from its ultimate *outcomes* (real output and price levels). The inflationary implications of such shifts are emphasized from the outset (Chapters 7, 9, and 10), always in the AS/AD framework. The two models are treated as complements, not substitutes. Keynesian and monetarist perspectives on monetary policy are also illustrated in the same framework. Finally, two chapters are devoted to the short-run and long-run options for shifting aggregate supply, a further complement to demand-side theories.

More Focus on Long-Run Growth

The current debate on the economy’s growth potential (2.5% or more?) is used to highlight productivity and growth issues. The dual role of saving in restraining short-run aggregate demand and financing long-run growth is showcased with a great cartoon (page 360). The Commerce Department’s new treatment of government “investment” expenditure is used to link the short-run and long-run consequences of budget deficits. Chapter 17 is enlivened by Julian Simon’s provocative “Doomsday” wagers.

Cuba!

Few students know how a centrally controlled socialist economy really works. Cuba offers an ideal illustration, especially as Castro now grapples with a possible transition to market capitalism. Cuba gets early attention in Chapter 1 and extensive coverage in Chapter 23 (which itself can be assigned in the first weeks of the course).

More “Hot” Issues

As always, *The Economy Today* strives to cover the salient policy and methodological issues of the day. In this edition these include:

Policy Issues

- Government “downsizing” (Chapter 4)
- The Republican Contract with America (Chapters 1, 4, 12)
- The search for a better gauge of the nation’s economic health (Chapter 5)
- The budget implications of mismeasuring inflation (Chapter 7)
- The 1995–96 shutdowns of the federal government (Chapter 12)
- The sputtering drive for a balanced-budget amendment (Chapter 12)
- The 1995 Mexican bailout (Chapter 21)
- The European Union’s quest for a single “Euro” currency (Chapter 18)
- The effects of NAFTA and GATT (Chapter 20)

Methodological Issues

- The new chain-weighted GDP deflators (Chapter 5)
- The 1996 revisions to money-supply measures (Chapter 13)
- The reclassification of government expenditure into “investment” and “consumption” components (Chapters 5, 12, 17)
- The re-basing of GDP accounts to 1992 (Chapter 5 and elsewhere)
- The 1996 revised productivity indices (Chapters 5, 17, and elsewhere)
- The new presentation of trade and current-account balances (Chapters 2, 18, 20, 21)
- Revisions to World Bank estimates of Chinese GDP (Chapters 2, 22)

Expanded Problem Set

The detachable problem set at the back of the text, introduced in the previous edition, has been immensely popular. In response, more problems, at varying levels of difficulty, have been added. Both the arithmetic and graphing exercises have been formatted to facilitate grading.

New Supplements

The seventh edition is blessed with an entirely new set of printed and computer-based supplements. These new supplements, described in detail below, should greatly facilitate both teaching and learning.

PROVEN FEATURES FROM PRIOR EDITIONS

While always trying to improve, *The Economy Today* retains a core of features that have proven their value in more than 20 years of classroom use.

Readability

The one adjective invariably used to describe *The Economy Today* is “readability.” Professors often express a bit of shock when they get student feedback on the text—students actually *enjoy* reading it. Well, not as much as a dime-store novel, but a whole lot better than most textbooks they’ve had to plow through. What makes *The Economy Today* so user-friendly is a pervasive grounding in real-world applications and clear prose. The various parts of each chapter and section are smoothly linked, not just juxtaposed like a series of flashcards. The writing is motivated by the conviction that students learn better when they are *interested* in a subject.

Readability is, of course, in the eye of the beholder. One way to ascertain the superiority of *The Economy Today* is to ask students to read a chapter, then compare it to competing texts. *The Economy Today* has always done well in this field test.

Careful Pedagogy

Once you've sparked student *interest*, you still have to *teach* them. To help facilitate the learning of basic principles, *The Economy Today* employs important pedagogical aids, including:

Annotated Tables and Graphs. All the tables and graphs in *The Economy Today* are annotated. This shouldn't be a differentiating feature any more, but it still is (check other texts!). Even the news boxes are annotated. Annotations facilitate both initial learning and later review of tabular data and graphs. If you wouldn't show a table, graph, or news clip in class without explanation, why would you use a text that failed to do so?

Grids on Graphs. Another feature that should be universal but still isn't is the use of grids on graphs. Most principles students have never worked with graphs before. Why not make the job easier and the illustrations more precise?

Synchronized Tables and Graphs. It is also difficult for many students to visualize the transition from tabular data to graphs. To facilitate that process, *The Economy Today* places related tables and graphs together in a single illustration. The tabular data and accompanying graphs also use synchronized lettering to highlight their linkage. For examples, see page 59 or page 62.

Running and Repeated Glossary. Many other texts have now adopted *The Economy Today's* feature of placing key-term definitions in the margin (if only copyright laws extended this far!). None other yet *repeats* definitions in subsequent chapters, however. Other texts presume that: (a) students learn key definitions on their first encounter, and (b) instructors always assign chapters in order of the table of contents. *The Economy Today* is designed to be less presumptuous and more flexible. Professors who want to introduce students to Cuba and comparative systems early in the course might appreciate having the definitions of "production possibilities," "market shortage," or "investment" highlighted in Chapter 23, as well as in earlier chapters.

Text-based Problems. Every chapter offers questions for discussion, numerical problems, and graphing exercises. For the 16 core theory chapters, the numerical problems and graphing exercises are available on detachable pages at the end of the text. In every chapter, many of the problems make explicit use of the boxed applications, graphs, or tables contained in the chapter itself. This linkage reinforces the importance of the in-text applications and facilitates retention.

Engrossing Chapter Openers. Chapters begin with real-world illustrations designed to kindle student interest. These are followed by three key questions that constitute learning objectives. These objectives are designed to stimulate critical thinking, not simple memorization. Chapter-opening "stories" include the 1996 presidential campaign (Chapter 1), the fall of the Berlin wall (Chapter 3), hyperinflation in Zaire (Chapter 7), the 1995–96 federal shutdowns (Chapter 12), and Cuba's economic collapse (Chapter 23).

Structured Summaries. Every chapter ends with a summary of key points, sequenced to reflect the chapter's organization. This single summary provides a more convenient and less obtrusive review than the "mini-reviews" that are scattered through other texts.

Great Applications

As noted earlier, the real world pervades and motivates *The Economy Today*. In addition to the core examples woven into the narrative, additional real-world illustrations are featured in:

In the News. These 57 boxed applications focus on domestic news events that illustrate key concepts. All of them are annotated and explicitly referenced in the text. Favorites include the Peace Dividend (page 11), the underground economy (page 109), the rising cost of tuition (page 147), the domino effect of job layoffs (page 236), and the emergence of “e-cash” (page 287).

World View. These 54 boxed applications add a global dimension to every chapter. Like the In the News boxes, all World Views are annotated and explicitly referenced in the text. Favorites include “Cuba Bucks the Past” (page 20), comparative GDP (page 35), the U.S. job loss resulting from the Mexican peso collapse (page 392), and NAFTA winners and losers (Chapter 20).

The Economy Tomorrow. Every chapter ends with an “Economy Tomorrow” capsule that challenges students to assess the implications of core economic ideas. In Chapter 2, students are challenged by the residue of problems in our otherwise prosperous economy. In Chapter 5, a proposed “Index of Social Health” challenges the smugness of national-income accounts. In Chapter 17, students are confronted with the \$100,000 wager offered by Julian Simon in 1996 that *every* dimension of human well-being will improve in the next decade.

NEW AND IMPROVED SUPPLEMENTS

With the seventh edition of *The Economy Today* comes an expanded package of ancillaries for both students and instructors.

Instructor Aids

To facilitate the teaching process, several new and improved supplements are available, including:

Test Bank. Two new co-authors have completely overhauled the text bank. Linda Wilson (University of Texas at Arlington) and Tom Anderson (Montgomery College, Maryland) have edited all the test questions and replaced about one-third. The roughly 2000 questions are classified by level of difficulty and tightly linked to the text. Two software options (RH Testmaker and Brownstone) assure maximum flexibility for test development, including the reconfiguration of graphing exercises.

Power Point Presentations, developed by Norman Hollingworth at Dekalb College using Microsoft Power Point software, is a complete set of presentation slides that illustrate the key issues presented in the text. These slides are ideal in the classroom environment where the professor has the ability to “visually” present the material. The slides are equally valuable to the student for use at home or in the computer lab. In a private, personal environment, the slides provide a step-by-step review of the key points in each of the 23 chapters. This is accomplished in a colorful, real-world manner which serves to reinforce the material taught in the classroom. Approximately 1000 slides, covering the 23 chapters, are available.

Overhead Transparencies. One hundred of the key tables and graphs in the text have been reproduced as full-color overhead transparency acetates. These are made available to adopters by The McGraw-Hill Companies.

Instructor's Resource Manual. The Instructor's Manual has been extensively revised and expanded by Dillon Sanders (Oregon State University) and Tom Carroll (University of Nevada, Las Vegas). The Manual offers a capsule summary and outline of each chapter, "lecture launchers" to stimulate class discussion, and media exercises to extend the analysis. The Instructor's Manual also now provides a ready-to-use quiz (15 multiple-choice and true or false questions) for each chapter. The Manual also contains answers to all the discussion questions and problems contained in the text itself.

Videos. Related to economics, available from McGraw-Hill, these include five selected from "Adam Smith's Money World." They may be used when covering such topics as production possibilities, the role of government, the labor market, monopolistic competition, and international economics. An Instructor's Guide links the videos to the specific content in *The Economy Today* and provides teaching suggestions. Your local McGraw-Hill sales representative can provide details regarding all video offerings.

Issue Modules. Chapter-length (20–30-page) modules on topics of special interest are available for instructors who want to expand beyond the text's table of contents. These modules look exactly like text chapters but are separately bound. They can be made available at no cost to students if ordered in conjunction with the text. Modules already available include:

- Welfare: Too Much or Too Little?
- Owls vs. Loggers: The Economics of Species Preservation
- Social Security: The Economics of an Aging Population
- Budget Deficits: Outcomes, Process, Theory
- Financial Markets: The Links to Economic Questions
- The California Economy Today
- The Texas Economy Today
- State and Local Finances
- Poverty in America
- The Economics of Discrimination
- Social Justice in Political Economy

These modules can be ordered shrink-wrapped with the text or can be incorporated into a bound custom-designed book. Your local McGraw-Hill sales representative can provide details.

News Flashes. As up-to-date as *The Economy Today* is, it can't foretell the future. As the future becomes the present, however, the author writes 2-page News Flashes describing major economic events and relating them to specific text references. These provide good lecture material and can be copied for student use. Adopters of *The Economy Today* have the option of receiving News Flashes via FAX or mail. Four to six News Flashes are sent to adopters each year.

Student Aids

The principles course has also been made more user-friendly for students. At the instructor's discretion, students may directly use the Issue Modules and News Flashes described above. In addition, several other supplements may facilitate learning:

Study Guide. From the student's perspective, the most important of the supplements is the Study Guide. The Guide offers extensive self-study exercise, with succinct explanations of key points. Each chapter of the Study Guide contains these features: Quick Review; Learning Objectives; Key-Term Review; True or False Questions; Multiple-Choice Questions; Problems and Applications; Media Assignments; Common Errors; and Answers. The Study Guide is available in macro and micro splits, as well as in the full text size.

The Student Tutorial. Prepared by Gerald Nelson, University of Illinois at Urbana-Champaign, this is an interactive student tutorial presented in a Windows environment. The tutorial reviews, summarizes, and quizzes the student on key topics. It begins with a table of contents from which the student is able to select any chapter for review. Each topic in the selected chapter is presented in a comprehensive manner that illustrates key terms and concepts, and each key term has a link which proves a definition for further clarification. In addition, the tutorial provides exercises for student practice. These interactive exercises allow students to see how their input affects the outcome of the selected exercise. The program contains optional sound effects which help create an exciting working environment for the student. At the close of each chapter, students have the option to participate in a multiple-choice quiz, which they design, or to answer essay questions which help reinforce the material reviewed in the tutorial.

The Multimedia Economics CD-ROM. Created in PODIUM, and designed by Charles Link, Jeffrey Miller, and Fred Hofstetter, this is an interactive disk containing sound, graphics, images, and exercises in the interactive environment of multimedia. The CD-ROM reviews key issues in economics through illustration and discussion of the concepts. It also allows the student to actively participate in the construction of graphs and charts, thereby illustrating how results are achieved and how common errors affect final outcomes. This Economics CD-ROM is designed for individual student use and could also be used by the professor in the classroom to complement discussion.

ACKNOWLEDGMENTS

Once again, I find myself indebted to a great many individuals who cajoled, motivated, and assisted me in developing another edition of *The Economy Today*. The list must begin with Larry Ziegler, who was a collaborator, critic, and friend for 16 years. Sadly, Larry died shortly after completing this edition. He will be sorely missed but fondly remembered.

I would also like to thank publicly the other members of the author team who worked so diligently to produce a first-rate package of text supplements. Linda Wilson, Dillon Sanders, Tom Carroll, Tom Anderson, and Gerry Nelson have all contributed significantly to the success of *The Economy Today* by developing supplements that facilitate both teaching and learning. I am also indebted to a host of instructors who have taken the time to review and critique the sixth edition or draft versions of this edition. As always, I have profited greatly from the suggestions of the following reviewers:

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Finally, I'd like to thank all the professors and students who are going to use *The Economy Today* as an introduction to economic principles. I would welcome any responses (even the bad ones) you'd like to pass on for future editions.

Bradley R. Schiller

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