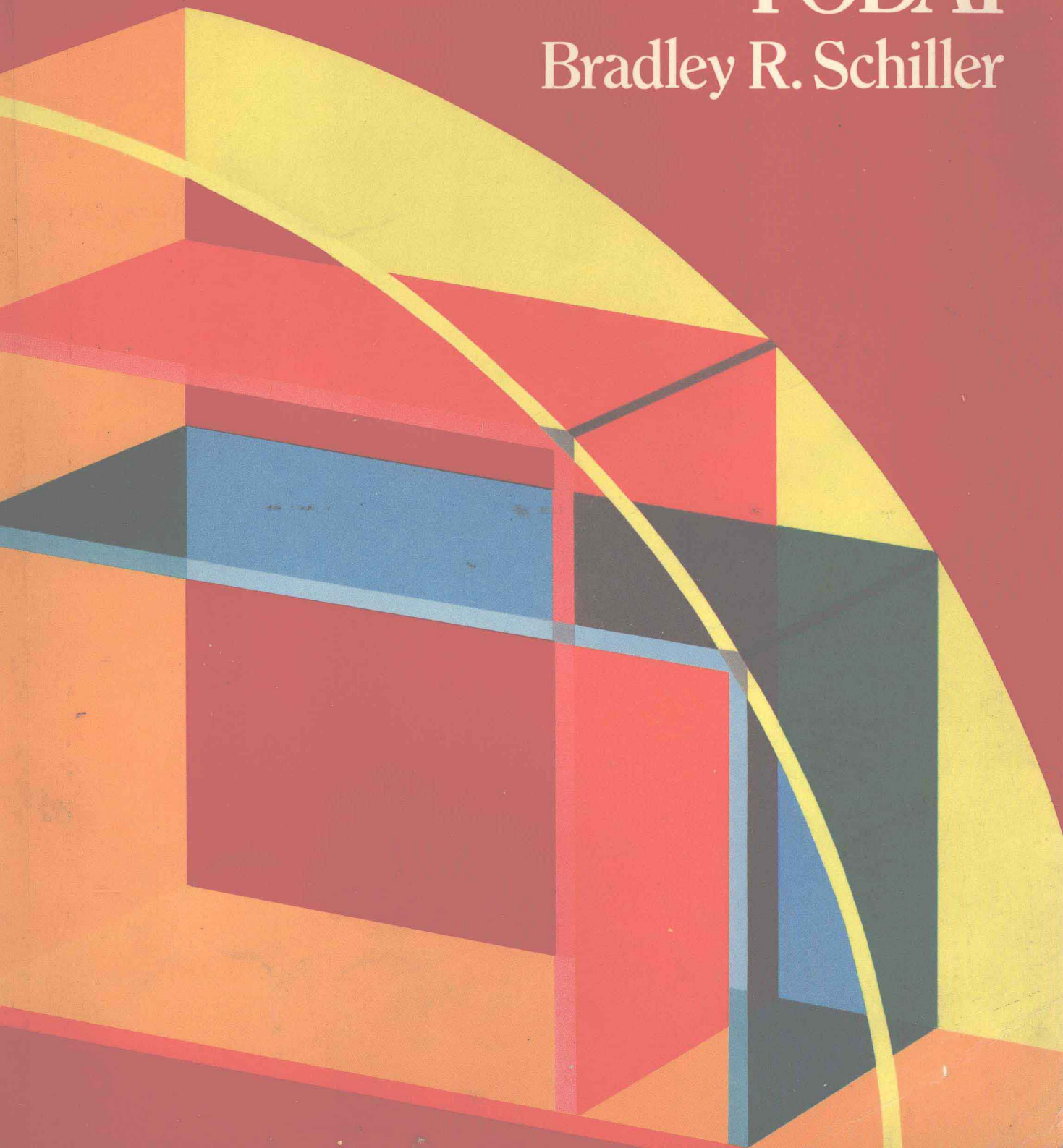


# THE MACRO ECONOMY TODAY

Third Edition

Bradley R. Schiller



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THIRD EDITION

**BRADLEY R. SCHILLER**

The American University



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# THE MACRO ECONOMY TODAY

Third Edition



# PREFACE

The third edition of *The Macro Economy Today* is exciting. The economy comes alive in this edition even more than in previous editions.

## REAL-WORLD FOCUS

The macro section bristles with the controversies of Keynesians, Monetarists, Supply-siders—as debated not only in academic symposia but also in the halls of Congress and the White House. What should a president do to combat unemployment or inflation? Whom should he listen to? The Keynesians offer one policy prescription; the Monetarists another, often contradictory one. Then there are the Supply-siders, who proffer a wholly different diagnosis of the economy's ills and still a third remedy for them. As the president and Congress try to make sense of these competing prescriptions, a chorus of Rational Expectationists and New Classical Economists chants the inevitable failure of all discretionary policies.

What's a president or a Congress to do in this situation? Harry Truman pleaded for a one-armed economist—one whose policy prescriptions wouldn't be qualified by the economist's standard “on the one hand. . . , on the other hand” ambivalence. Today, it seems, the president and Congress are surrounded by one-armed economists, all pointing in different directions. Decision makers are often left to choose their own favorite policy prescription, as much on the basis of politics and personality as on compelling logic.

Like its predecessors, this edition of *The Macro Economy Today* puts all this controversy

and confusion right on the table. Each major macro perspective is presented on its own best terms, then compared to its rivals. This edition then takes a couple of further steps. After highlighting the theoretical differences among Keynesians, Monetarists, and Supply-siders, the text explores their policy implications in detail. The conflicting policy advice offered by each macro camp is emphasized, under conditions of recession, runaway inflation, and stagflation. To further spotlight the relevance of these differences, recent efforts to implement each prescription (e.g., the Fed's 1979 adoption of monetarist guidelines; the 1981 supply-side tax cuts; the Keynesian budget cuts of 1984) are scrutinized. By the end of the book, a student will know not only the basic content of competing macro theories, but also why those macro controversies are so intense and important.

## BASIC OBJECTIVES OF THE TEXT

The core “stories” of this edition—the macro controversies—reflect the basic orientation of *The Macro Economy Today*. The first objective is to teach the basic principles of economics in a clear and accurate fashion. The second objective is to stimulate student interest so that students want to learn those principles. This stimulus is provided by the world around us—the institutions and agencies of macro policy, the ceaseless struggle for survival in the Third World, and the clash of ideology and economics in China and the Soviet Union. The simple proposition that you can't teach someone until you get their attention, re-

mains the maxim for *The Macro Economy Today*. The travails of the fictional ABC Company trying to wring profits from widget production rarely rivet anyone's attention, but the real-life stories in *The Macro Economy Today* just might spark student interest.

## CONTENT OF THE TEXT

This edition offers many new and established features that will solidify student understanding of how the economy works. The more notable features include:

### Business Cycles

An entirely new chapter on business cycles (Chapter 5) introduces the macro section. The purpose of this chapter is to highlight the business cycle as both the central dilemma of macro theory and the core challenge of macro policy. The chapter begins with a brief historical review of the U.S. economy's gyrations; the need to explain and control these cyclical swings is then emphasized. This sets the stage for a search for solutions. The search begins with an introduction to aggregate supply and demand. Then the leading macro theories are introduced as potential explanations for the business cycle. The link between a theoretically correct explanation and sound policy intervention is also stressed. By the end of this chapter, students should have a sense of what macro theory is all about and why it is worth studying.

### Aggregate Supply and Demand

Aggregate supply and demand curves are introduced in Chapter 5. By themselves, these curves provide a superficial explanation of the business cycle, by attributing all of the economy's ills to either "supply" or "demand." More importantly, the aggregate curves provide a common framework for illustrating the competing macro theories put forth by Keynesians, Monetarists, and Supply-siders. The key notion here is "integration." Most principles texts now claim to integrate the aggregate supply-demand model with specific macro theories. But, like virtue, the claim of integration is asserted more often than it is demonstrated. Typically, the aggregate supply-demand model is introduced and then forgotten, as the presentation

proceeds to the traditional apparatus (and unique graphs) of Keynesian, monetarist, or supply-side theories.

Things are different in *The Macro Economy Today*. The macro theories are first introduced as explanations for the shape or position of the aggregate supply-demand curves (Chapter 5, pp. 108–111). Then the aggregate supply-demand framework is used throughout the core macro section to explain specific theories and to illustrate their differences (see, for example, pp. 160–163, 287, 304, 308–311, 325, 378–381). The students never lose sight of the aggregate supply-demand model because it serves as an integrating force throughout the macro section.

### The Nature of Macro Failures

The discussions of the business cycle and aggregate supply and aggregate demand set the stage for macro theory. But many students may still not appreciate the significance of cyclical swings. Few undergraduates have suffered any serious pain from unemployment or inflation. These are abstractions to them, not serious socioeconomic ills. To enhance their sensitivity, Chapters 6 and 7 offer a close view of what unemployment and inflation are all about, who suffers from them, and what their consequences are for the economy in general. These graphic "problem" chapters are easy reading and should increase student interest in macroeconomics.

### Competing Views

*The Macro Economy Today* is an "equal opportunity" teacher. All major macro theories get fair and equal treatment. Rather than pushing one point of view at students, the text seeks to explain the competing perspectives of Keynesians, Monetarists, and Supply-siders. The emphasis here is on presenting each theory objectively, then highlighting their differences in a common framework (for example, aggregate supply and demand and the equation of exchange). Many students will be frustrated that the text doesn't offer a "correct" theory—but isn't that ambivalence really a fair reflection of macro theory and policy today?

### Monetary Approaches

The emphasis on competing views is more explicit in the monetary chapters of this edition.

Specifically, the sharply different views of Keynesians and Monetarists on the nature and effectiveness of monetary policy are highlighted (see, for example, pp. 274–275, 284–286, 293). This approach not only increases understanding of how monetary policy might work but also has the secondary effect of reclaiming monetary theory as an arena of controversy. After reading Chapter 13, students should have some appreciation of why interest rates and the money supply are such disputed policy levers.

## Theory and Reality

The interrelationships of theory and reality—the need to explain the economy today—constitute the driving force of this text. In the third edition, this emphasis is apparent throughout the text and again given unique treatment in a separate chapter. Chapter 15 serves several functions. First, it provides a new review of competing macro theories by illustrating their idealized use under conditions of recession, inflation, and stagflation (pp. 333–336). It also offers a quick and slightly humorous checklist of all the competing macro perspectives (see the “Who’s on First?” box on p. 335).

After providing this theoretical tour de force, Chapter 15 focuses on real-world policy constraints. These include competing goals, measurement problems (“Where’s the fire?”), design problems (“How do we put it out?”), and implementation problems (“Can we get there in time?”). After reviewing this maze of policy obstacles, students may have some sympathy for the errors of economic policy making.

## Reagan Economics

The Reagan years provide an excellent illustration of the travails of economic policy making. The intense competition among Supply-siders, Keynesians, and Monetarists for the president’s affection is well-known. So, too, are the Reagan administration’s shifts from one macro approach to another as circumstances seem to dictate. Chapter 16 examines this eclectic approach to macro policy and offers post-mortems on the 1980–81 and 1981–82 recessions. The chapter concludes with a look at the debate over the FY 1986 budget and a discussion of competing economic forecasts.

## External Shocks

The most convenient explanation for our macro ills is external shocks. We may be able to manipulate the budget, the money supply, and production incentives, but we can’t control the weather, natural disasters, or the rest of the world. This leaves even the best policy packages vulnerable to external shocks. Chapter 17 provides a brief discussion of how such shocks affect aggregate supply and demand and thereby employment and price levels. Alternative Keynesian, monetarist, and supply-side responses to external shocks are also examined (pp. 378–381).

## Economic Growth

Most of the controversy in macro theory and policy focuses on the short-term business cycle. But long-term growth is the ultimate determinant of living standards. Chapter 18 highlights the long term by reviewing Malthus’ early doomsday projections, assessing their failure, then discussing the forces that promote or retard long-run changes in real GNP. A brief discussion of the pros and cons of industrial policy concludes the chapter.

## International Topics

The final section of the text focuses on international subjects. International trade and finance receive substantial attention, in recognition of their growing influence on the performance of the U.S. economy. In each case the motivations for trade and finance are discussed at length. The market mechanism is then related to those motivations. Finally, the sources of resistance (both micro and macro) to free trade and finance are identified as constraints on policy decisions. In the process, David Ricardo’s theories and vested economic interests are both viewed as important determinants of trade flows. A single story about Franco-American trade in wheat and wine weaves through the trade and finance chapters, helping to drive home the intrinsic relationships of trade and finance.

Chapter 21 examines the economic problems of less developed countries. The problem of economic development is related both to traditional measures of income and to more general “human needs.” The constraints on economic growth are then discussed, with an eye toward identifying an

optimal growth strategy. The role of external financing (and the “debt crisis”) is given special emphasis.

The final chapter of the text examines in detail the purposes and mechanics of socialist planning. Students are asked to meet the challenge of planning head-on, as the superplanner in a newly established socialist order. We begin with basics (production possibilities), then assemble tools for resolving the questions of *WHAT*, *HOW*, and *FOR WHOM* to produce. The actual experiences of the Soviet Union and China are used to illustrate both the challenge of planning and alternative responses. The chapter (and the text) concludes with a discussion of the profound changes now taking place in China and the Soviet Union and a comparative assessment of U.S., Soviet, and Chinese economic performance.

## STUDENT LEARNING AIDS

It is hoped that the style and approach of *The Macro Economy Today* will motivate students to learn macroeconomics. Motivation is not enough, however. A text must also “teach” basic principles. In this regard, the core theory chapters of the text cover the standard topics of macro theory, in a familiar order. The learning process is reinforced by the following features.

### Textual learning aids

To facilitate comprehension and retention, each chapter contains the following learning aids:

**CHAPTER PREVIEW** Each chapter begins with a narrative introduction to the content and purpose of the chapter. Each preview highlights basic questions to be answered and relates them to previous chapters.

**RUNNING GLOSSARY** Definitions of key terms are provided in the margins, to facilitate retention and quick review. Definitions are repeated in successive chapters where they are relevant, in recognition of the fact that students do not always remember basic terms after only one “lesson.” All of these terms are compiled into a complete glossary, with chapter references, at the end of the book.

**FULLY ANNOTATED GRAPHS AND TABLES** All graphs and tables in the text are accompanied by self-

contained captions. These reinforce the in-text discussions and facilitate quick review. In addition, the contents of related schedules and graphs are explicitly synchronized with the aid of labeled rows (in schedules) and dots (on graphs). The demand schedule and curve in Chapter 2 illustrate this feature. Color is used in tables and graphs throughout to highlight new or important concepts.

**SELF-CONTAINED EXAMPLES** The text makes considerable use of shaded boxes to illustrate key points of the text. Some of these are designed to highlight a basic concept (such as *ceteris paribus*). Others are illustrative digressions in the form of reprints of newspaper and magazine clippings, results of public-opinion polls, or short summaries of related material. The use of shaded boxes clearly distinguishes all of this material from the flow of the basic text.

**POLICY IMPLICATIONS** Every theory chapter contains a brief discussion of a specific policy implication. These sections reinforce the basic theoretical presentations by underscoring the use of the principles introduced in the chapter.

**NARRATIVE SUMMARIES** Chapter summaries highlight basic points and principles in brief, sequenced paragraphs.

**KEY-TERM REVIEW** Each chapter ends with a list of key terms for quick review. These lists include all terms in the running glossary of the chapter.

**DISCUSSION QUESTIONS** Four or five discussion questions are provided at the end of each chapter. These relate directly to basic principles covered in the chapter and can be used for student review, class discussion, or homework assignments.

**NUMERICAL PROBLEM** Most chapters conclude with one numerical problem. This tests the student’s ability to solve typical exam-type problems. Answers are in the *Instructor’s Resource Manual*.

## Study Guide

There are several supplements available to accompany the text itself. From the student’s perspective, the most important of these is the *Study Guide*, prepared by Professors Michael Tansey at



Rockhurst College and Lawrence Ziegler at the University of Texas (Arlington). Each chapter of the *Study Guide* contains these features:

**QUICK REVIEW** Key points in the text chapter are restated at the beginning of each *Study Guide* chapter. The reviews are parallel to and reinforce the chapter summaries provided in the text.

**LEARNING OBJECTIVES** The salient lessons of the text chapters are noted at the outset of each *Study Guide* chapter. These objectives focus the student's study and help to ensure that key points will not be overlooked. The objectives are keyed to the exercises in the *Study Guide* to help reinforce learning.

**KEY-TERM REVIEW** Early in each chapter the students are asked to match definitions with key terms. This relatively simple exercise is designed to refresh the student's memory and provide a basis for subsequent exercises.

**TRUE-FALSE QUESTIONS** Twenty or so true-false questions are provided in each chapter. These questions have been class-tested to ensure their effectiveness in highlighting basic principles.

**MULTIPLE-CHOICE QUESTIONS** Approximately fifteen multiple-choice questions per chapter are provided. These questions allow only one correct answer and also focus on basic principles.

**PROBLEMS AND APPLICATIONS** There are more than forty new exercises in the *Study Guide*, most of which stress current issues and events. The exercise relating to bonds, debt, and interest rates (Chapter 10) highlights macro principles, for example.

**COMMON ERRORS** In each chapter of the *Study Guide*, errors that students frequently make are identified. The bases for those errors are then explained, along with the correct principles. This unique feature is very effective in helping students discover their own mistakes.

**ANSWERS** Answers to *all* problems, exercises, and questions are provided at the end of each chapter. Difficult problems have annotated answers. These answers make the *Study Guide* self-contained, thus allowing students to use it for self-study.

## Microcomputer Simulations

New to this edition is a set of three microcomputer simulations in macroeconomics by Rae Jean Goodman of the U.S. Naval Academy, on fiscal policy, monetary policy, and budget and deficit analysis. These simulations put the student in the role of decision makers such as Chairman of the Federal Reserve Board, Director of the Office of Management and Budget, and Chairman of the Council of Economic Advisers. The student must make decisions, for example, on appropriate long-run monetary policies, or must decide on which specific industries to tax in order to increase tax revenues. Students will gain experience deciding which information is most important in macro policy making.

## Computerized Graphics Tutor

A program for the IBM-PC has been prepared by William D. Gunther, of the University of Alabama, to help students understand key macroeconomic concepts through the use of interactive graphic presentations.

## INSTRUCTOR'S AIDS

We have tried to make the learning process easier for teachers as well as students. To this end, Professors Virginia Owen and Alan Dillingham (Illinois State University) have prepared an *Instructor's Resource Manual*. In addition, Professor Michael Ellis (Texas Wesleyan College) has compiled an updated *Test Bank* of more than 2,500 multiple-choice questions.

### Instructor's Resource Manual

The purpose of the *Instructor's Resource Manual* is to provide a ready source of lecture and discussion material for classroom teaching. To this end, it offers a variety of material, including:

**CHAPTER OUTLINE** The first section of each chapter briefly summarizes the material under the text's major headings. Instructors can duplicate this section for students as an aid in studying.

**TEXT EXPANSIONS** The second section of each chapter highlights subjects that often require special attention, giving many interesting examples for classroom discussion.

**CONTROVERSIAL ISSUES** The third section of each chapter, "Take a Stand," describes a controversial issue associated with the theory presented in the text. Chapter 2 of the text, for example, discusses the basic elements of supply and demand. The *Resource Manual* discusses the pros and cons of taxing imported refined gasoline, drawing on the text and a recent news article. No resolution of the issue is offered. "Take a Stand" is intended to start a classroom discussion or to form the basis for essay-type questions.

**NEWS UPDATE** The fourth section of each *Resource Manual* chapter provides a summary and analysis of a recent economics event. The core of the "News Updates" is drawn from *The Wall Street Journal*, *Business Week*, or similar publications. The news summary is supplemented by a brief analysis that ties the story directly to the content of the text.

**SUPPLEMENTARY RESOURCES** The final section in each chapter serves two separate functions. First, it provides a list of audio-visual and printed materials that can be readily obtained for class use. Second, it provides references for additional lecture material or student assignments.

## Test Bank

A completely new *Test Bank* was prepared for this edition. The *Test Bank* includes: 39 chapter tests of approximately 65 multiple-choice questions per chapter, totaling 2,510 questions. Each question has been classified according to its level of difficulty. There are three levels. The first requires the simple recall of facts, names, or definitions. The second level of question is analytical, requiring greater comprehension and an understanding of functional relationships. The third level, the most difficult, demands a thorough comprehension of theory and a high degree of analytical reasoning.

About half of the *Test Bank* questions are cross-referenced directly to the learning objectives in the *Study Guide*. Two prepared midterms and two comprehensive final examinations, totaling 300 questions, are also available in the *Test Bank*.

**RANDOM HOUSE TESTMAKER** The entire *Test Bank* is available on IBM-PC, Apple II, and Macintosh microcomputers. This program enables instructors to view, edit, and test questions to create exams. Scrambled versions of the same test can be created. Questions can be selected based on level of difficulty or learning objective.

**CUSTOMIZED TEST** Instructors may have tests custom prepared by the publisher by calling the publisher's special test service. Masters prepared from the *Test Bank* will be mailed out within 72 hours.

## Overhead Transparencies

Over 100 of the key tables and graphs in the text have been reproduced as overhead masters. These are made available to users by the publisher.

## A COMPLETE TEACHING PACKAGE

We have tried to assemble a complete teaching package for classroom use. In the process we have introduced several unique text features, including the chapters concerned with economic problems; the liberal use of news stories and other supplementary materials; the running glossary; and an explicit, simultaneous introduction to both theory and institutions. In the *Study Guide* we have introduced the "Common Errors" section and a greater emphasis on learning basic definitions. The *Instructor's Resource Manual* features the "Take a Stand" section, as well as "News Updates." We have tried to present all of the material in a lively manner that stimulates student interest.

Have we succeeded in producing a new and effective teaching package? We hope so. The real test will be administered by students who use this text. Success will be measured in terms of increased student interest in and understanding of the economy today.

## ACKNOWLEDGMENTS

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BRADLEY R. SCHILLER  
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 Washington, D.C.  
 January 1986

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