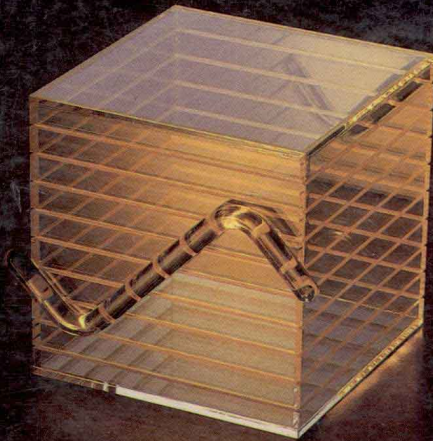


# ECONOMICS

Principles and Policy • Third Edition



## MACROECONOMICS

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William J. Baumol and Alan S. Blinder

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# Preface

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**F**or decades, the “principles of economics” book has been expected to codify the entire discipline of economics. In recent years, this has become at once more difficult and more imperative. The explosion of economic knowledge has made it impossible to put all of economics between two covers. But at the same time, more and more public policy issues either are basically economic in nature or involve important economic considerations. Intelligent citizens can no longer afford to be innocent of economics.

While this Third Edition represents an extensive revision of the Second Edition, its preparation continued to be guided by this dilemma. We have studiously avoided the encyclopedic approach and abandoned the fiction, so popular among textbook writers, that literally everything is of the utmost importance. Since students are sufficiently intelligent to see through this ruse in any event, we have tried to highlight those important ideas that are likely to be of lasting significance—principles that you will want to remember long after the course is over because they offer insights that are far from obvious, because they are of practical importance, and because they are widely misunderstood by intelligent laymen. A dozen of the most important of these ideas have been selected as **12 Ideas for Beyond the Final Exam** and are called to your attention when they occur through the use of the book’s logo. 

All modern economics textbooks abound with “real world” examples, but we have tried to go beyond this, to elevate the examples to preeminence. For in our view, the policy issue or everyday economic problem ought to lead the student naturally to the economic principle, not the other way around. For this reason, many chapters start with a real policy issue or a practical problem that may seem puzzling or paradoxical to noneconomists, and then proceed to describe the economic analysis required to remove the mystery. In doing this, we have tried to utilize technical jargon and diagrams only where there is a clear need, never for their own sake.

Still, economics is a somewhat technical subject and, except for a few rather light chapters, this is a book for the desk, not for the bed. We have, however, made strenuous efforts to simplify the technical level of the discussion as much as we could without sacrificing content. Fortunately, almost every important idea in economics can be explained in plain English, and this, in general, is how we have tried to explain them. Yet, even while reducing the technical difficulty of the book, we have incorporated some elements of economic analysis that have traditionally been left out of introductory books but that are really too important to omit.

Foremost among these is our extensive treatment of prices and inflation in Parts 2 and 3. For years, textbooks devoted many chapters to unrealistic, but presumably simpler, economic models in which prices never rose. Ours was the first introductory text to put inflation into the story from the very beginning, rather than as an afterthought—a practice we maintain and expand in the Third Edition.

## Changes from the Second Edition

### Macroeconomics

Overall, the macroeconomic section (Parts 2 and 3) is similar to that of the Second Edition, but it has been updated to include: (1) the most current data available; (2) changes in institutions and policy issues since publication of the Second Edition; and (3) the economic history of 1981–1984—for example, the Reagan program, the deep recession of 1981–1982, and the dramatic decline in inflation. In particular, an extended discussion of “supply-side” economics and related matters now appears in Chapter 11, whereas these materials were scattered over three chapters in the Second Edition. There are also expanded discussions of aggregate supply, wage stickiness, rational expectations, and monetary targeting—all of which take account of recent events.

Suggestions from readers and changes in the economy dictated that some organizational changes be made in the macroeconomic sections. Most notably, an entirely new chapter (Chapter 15) has been added on what seems likely to be *the* central macroeconomic issue of the next three years—the federal budget deficit. While some of the material in this chapter appeared in the Second Edition, most is new, and some of the topics have never before appeared in an introductory textbook.

To make room for this new chapter, we have condensed most of what comprised Chapters 14, 15 and 17 of the Second Edition into two new chapters: 14 (Money and the National Economy: The Keynesian-Monetarist Debate) and 17 (Further Controversies over Stabilization Policy). Also, in response to suggestions from readers, we have reversed the order of Chapters 9 and 10.

The chapters on international economics (18 and 19) have also been revised extensively. Chapter 18 has a different, more patient, and more detailed explanation of comparative advantage, and much more material on current issues in trade policy. Chapter 19 has been updated to reflect the ever-changing international monetary system (including a discussion of the

soaring value of the U.S. dollar), and has a new appendix which explains how exports and imports affect the basic macroeconomic model of Parts 2 and 3.

Some twenty years of lag in the growth rate of American productivity behind that of a substantial number of European and Far Eastern countries has elicited worries about the consequences for U.S. competitiveness. Our belief that U.S. productivity performance will continue to be a major concern of policymakers has prompted us to add an entirely new chapter on this subject. Our new Chapter 20 describes the pertinent facts, examines some of the explanations that have been offered, analyzes the consequences of a protracted lag in productivity growth, and discusses some of the productivity stimulation policies that have been proposed. To make room in curricula for the new chapter on productivity, we have combined economic growth and the problems of the less developed countries into a single chapter (Chapter 21).

## Studying Principles of Economies

Whatever the nature of your course, we would like to offer one suggestion. Unlike some of the other courses you may be taking, principles of economics is cumulative—each week's lesson builds on what you have learned before. You will save yourself a lot of frustration (and also a lot of work) if you keep up on a week-to-week basis. To help you do this, there is a chapter summary, a list of important terms and concepts, and a selection of discussion questions to help you review at the end of each chapter. In addition to these aids, many students will find the *Study Guide*, designed specifically to accompany this text by Professor Craig Swan, helpful as a self-testing and diagnostic device. When you encounter difficulties in the *Study Guide*, you will know which sections of the text you need to review.

## Note to the Instructor

In trying to improve the book from one edition to the next, we rely heavily on our own experiences as teachers. But our experience using the book is miniscule compared to that of the hundreds of instructors who use it nationwide. If you encounter problems, or have suggestions for improving the book, we urge you to let us know by writing to either one of us in care of Harcourt Brace Jovanovich, College Department, 1250 Sixth Avenue, San Diego, California 92101. Such letters are invaluable, and we are glad to receive them, even if they are critical.

What follows is a set of suggested course outlines.

## OUTLINE FOR A ONE-SEMESTER COURSE IN MACROECONOMICS

Chapter Number	Title
1	What Is Economics?
2	The Use and Misuse of Graphs
3	<i>The Economic Problem</i>
4	Supply and Demand: An Initial Look
5	Macroeconomics and Microeconomics
6	Unemployment and Inflation: The Twin Evils of Macroeconomics
7	Income and Spending: The Powerful Consumer
8	Demand-Side Equilibrium: Unemployment or Inflation?
9	Changes on the Demand Side: Multiplier Analysis
10	Supply-Side Equilibrium: Unemployment <i>and</i> Inflation?
11	Fiscal Policy and Supply-Side Economics
12	Banking and the Creation of Money
13	Central Banking and Monetary Policy
14	Money and the National Economy: The Keynesian—Monetarist Debate
15	Budget Deficits and the National Debt: Fact and Fiction
16	The Trade-Off between Inflation and Unemployment
17	Further Controversies over Stabilization Policy
18	International Trade and Comparative Advantage
19	The International Monetary System: Order or Disorder?
20	Productivity Problems
21	Growth in Developed and Developing Countries

## OUTLINE FOR A ONE-QUARTER COURSE IN MACROECONOMICS

Chapter Number	Title
1	What Is Economics?
2	The Use and Misuse of Graphs
4	Supply and Demand: An Initial Look
5	Macroeconomics and Microeconomics
6	Unemployment and Inflation: The Twin Evils of Macroeconomics
7	Income and Spending: The Powerful Consumer
8	Demand-Side Equilibrium: Unemployment or Inflation?
9	Changes on the Demand Side: Multiplier Analysis
10	Supply-Side Equilibrium: Unemployment <i>and</i> Inflation?
11	Fiscal Policy and Supply-Side Economics
12	Banking and the Creation of Money
13	Central Banking and Monetary Policy
14	Money and the National Economy: The Keynesian—Monetarist Debate
15	Budget Deficits and the National Debt: Fact and Fiction
16	The Trade-Off between Inflation and Unemployment

## **With Thanks**

Finally, and with great pleasure, we turn to the customary acknowledgments of indebtedness. Ours have been accumulating now through three editions. In these days of specialization, not even a pair of authors can master every subject that an introductory text must cover. Our friends and colleagues Charles Berry, William Branson, Lester Chandler, Gregory Chow, Avinash Dixit, Stephen Goldfeld, Claudia Goldin, Ronald Grieson, Daniel Hamermesh, Peter Kenen, Melvin Krauss, Arthur Lewis, Burton Malkiel, Edwin Mills, Janusz Ordover, Uwe Reinhardt, Harvey Rosen, Hans Soderstrom, Laura Tyson, and Martin Weitzman have all given generously of their knowledge in particular areas over the course of three editions. We have learned much from them, and only wish we had learned more.

Many economists at other colleges and universities offered useful suggestions for improvements, many of which we have incorporated into the Third Edition. We wish to thank Mohsen Bahmani-Oskooee of University of Wisconsin–Milwaukee, Philip Bartholomew of University of Michigan, Merton Bernstein of Washington University, Vito Blomo of East Carolina University, Martin Bronfenbrenner of Aoyama Gakuin University (Tokyo), Robert Cherry of Brooklyn College, Fred Curtis of Drew University, Lawrence De Brock of University of Illinois–Champaign, Susan Feiner of Virginia Commonwealth University, Donald Frearson of Western Australian Institute of Technology, Gordon Galbraith of Portland Community College, R. Scott Gassler of Guilford College, Dermot Gately of New York University, David George of LaSalle College, Amyra Grossbard-Shechtman of San Diego State University, Art Gutowsky of California State University–Sacramento, James S. Hanson of Willamette University, Derek Jones of Hamilton College, Abraham Kidane of California State University–Dominquez Hills, Gary F. Langer of Roosevelt University, Alan Mandelstamm of Virginia Polytechnic Institute and State University, Benjamin N. Matta of New Mexico State University, Henry N. McCarl of University of Alabama–Birmingham, William Mounts of Mercer University, Mark Plant of University of California–Los Angeles, Robert Reilly of Virginia Commonwealth University, David Ring of State University of New York–Oneonta, Richard Roehl of University of Michigan–Dearborn, Francis (Bill) Rushing of Georgia State University, William Sher of Duquesne University, Mary A. Shulman of Northwestern University, James Starkey of University of Rhode Island, Robert Thomas of Iowa State University, William Thweatt of Vanderbilt



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We were, of course, most gratified by a number of spontaneous and kind letters from student readers. Since it is for such readers that the book is primarily intended, no other comments have meant as much to us.

The book you hold in your hand was not done by us alone. The fine people at Harcourt Brace Jovanovich, including Hannah McHugh, Johanna Schmid, Barbara Girard, Avery Hallowell, Don Fujimoto, and Fran Wager, worked hard and well to turn our manuscript into the book you see. We appreciate their efforts.

Our sanity and survival during the preparation of the Third Edition were assured by the intelligence, ability, and pleasantness of our secretaries, Phyllis Durepos and Mary Mateja, who did so many things and did them all so well. Sue Anne Batey Blackman, who seems to know our thoughts on the subject better than we do ourselves, brought up to date the chapters on the environment and the economics of natural resources.

And finally there are our wives, Hilda Baumol and Madeline Blinder. They have now participated in this project for nine years, and with each successive revision they help in more and more ways. Their patience, good judgment, and love have made everything go more smoothly than we had any right to expect. We salute them.

**William J. Baumol**  
**Alan S. Blinder**

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