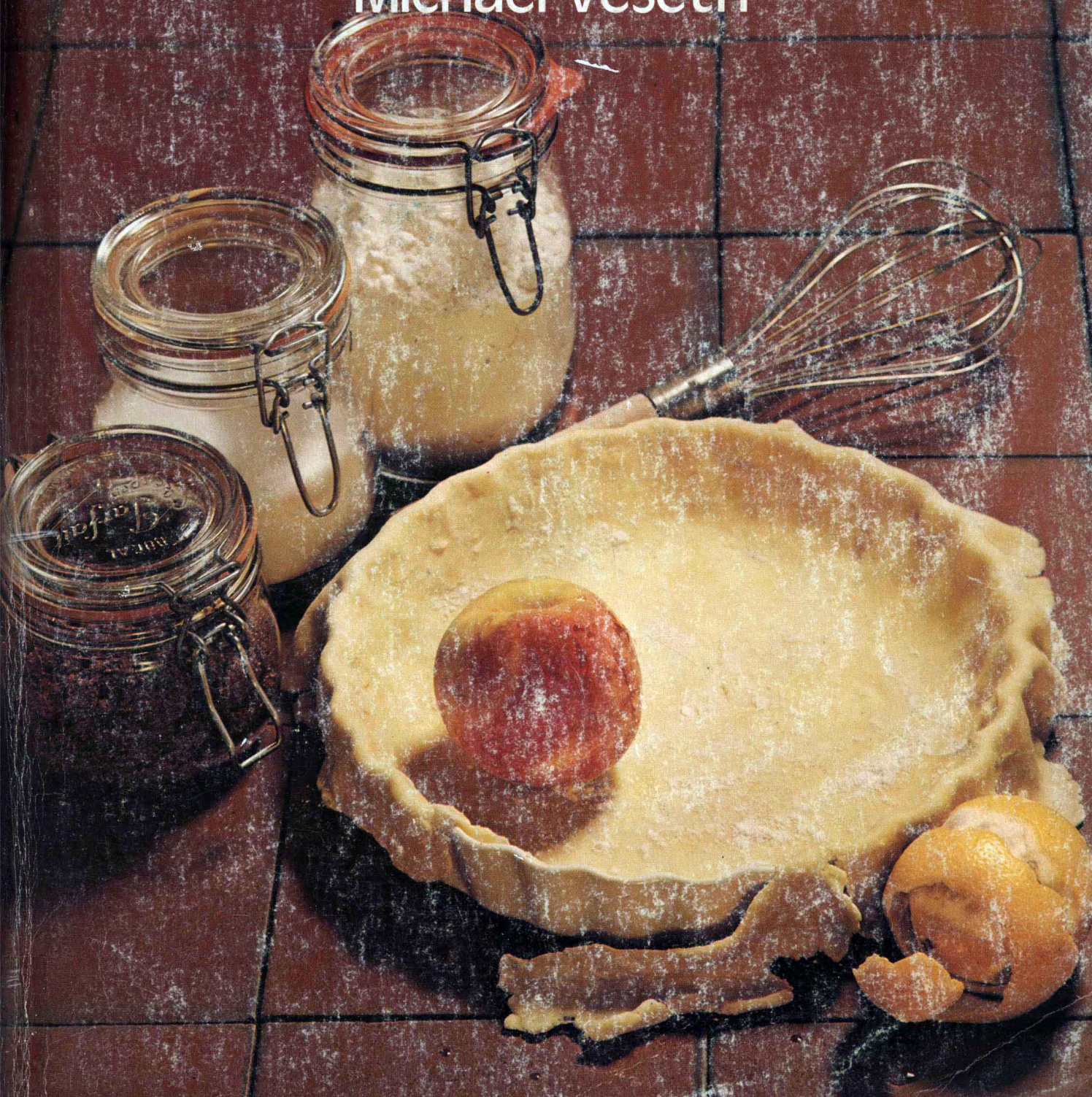


Introductory Macroeconomics

Michael Veseth



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UNIVERSITY OF PUGET SOUND

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Preface

These are fascinating times to study economics, because economic events have taken on a new importance. Even relatively obscure economic statistics routinely make the front pages. Television news programs employ full-time economic correspondents. Presidents, senators, and congressmen are quizzed as much on their economic stand as other issues. The polls tell us that inflation, not crime or pollution, is the number one problem facing the nation.

To understand how the economic system operates and to make intelligent decisions within that system is not an easy task. Yet it is absolutely crucial that today's students have a thorough working knowledge of the national economy.

This book is designed to help students understand how the economy works and how economic events affect them, and to give them a sound knowledge base for making decisions in the future. It provides an up-to-date picture of our current economic problems and their possible solutions in a clear, understandable form.

WHAT THIS BOOK IS ABOUT

The interest in economics today has been amplified by the changing nature of the economy: we have clearly entered what may be called the Second Era of Modern Macroeconomics. The First Era of Macroeconomics began in the 1930s when we learned that the economy is not self-regulating. Unemployment is a real and pre-

sent danger. Nothing automatically assures that high levels of employment will prevail. The study of macroeconomics began as an attempt to understand the problem of high unemployment and to discover ways of achieving and managing prosperity.

The Second Era of Macroeconomics began in the 1970s. Equipped with tools to fight unemployment, we found ourselves plagued by another economic malady, high rates of price inflation. High unemployment rates combined with soaring inflation proved to be a new kind of problem requiring a new brand of medicine. The "old time religion" of macroeconomics was of only limited usefulness.

Most previous macroeconomics texts have concentrated on an analysis of the causes of and cures for high unemployment rates. The causes of inflation and, in particular, the oddly changing relationship between inflation and unemployment, have taken a back seat. This has left students (and instructors) confused and dissatisfied.

This book is designed to take students into the Second Era of Modern Macroeconomics. Both inflation and unemployment need to be analyzed in a real world setting. The causes of recession, rising prices, and worst of all, the *stagflation* which combines joblessness with rising prices, need to be discussed in a clear and understandable fashion.

In order to do this, some new approaches are necessary. The economic models used in this text differ

somewhat from those found in *traditional* textbooks in that they focus quite clearly on current problems and deal explicitly with the problem of inflation as well as unemployment. Some of the important features of this text include:

Discussion of current problems. It is not enough to be able to list our economic problems and their potential solutions. In order to deal with these issues effectively on either a national or personal level, today's student must truly understand what our economic problems are, why they are problems, and what their economic impacts can be. A major portion of this text is devoted to understanding the nature of inflation and unemployment and their impacts on nations and on individuals.

Analysis of inflation. A thorough discussion of inflation has been included throughout the text. Every chapter features some discussion of inflation's causes or economic implications. This heavy emphasis on inflation is entirely appropriate. Inflation is today's most severe economic problem. It is also our least understood problem. Today's student must understand how inflation works and the damage that it does.

Economic policy. This text concentrates on understanding the nature of our economic problems and the trade-offs inherent in any solutions of those problems. Thus it concentrates on economic policy rather than economic theory or institutions. This makes the analysis interesting and useful to the student and provides the tools necessary to understand how the economy works.

International economics. National economic policies cannot be discussed in a vacuum. International economic events are no longer buried in the financial pages; today they make front page headlines. Any student who does not understand the basics of international trade and exchange rates is truly ill-equipped to deal with the modern world. Fully one-fourth of this text deals with international economics. International trade and payments, exchange rates, and economic policy are all discussed with the depth necessary for the 1980s.

Understandable presentation. Finally, this text is designed to present economic problems, tools, and theories in a way that is easily understandable so that the important concepts of macroeconomics can be retained for longer than just a semester. Of course not all of the details will *stick* in the reader's mind forever, but the intention here is to provide a basic economic education for a lifetime. Important economic concepts, because they are presented in a way that is easy to understand, should form a lasting base from which to view a changing economic world.

ACKNOWLEDGMENTS

Any work of this nature benefits from the contributions of a host of individuals whose names do not, alas, appear on the title page. I wish to thank the administration of the University of Puget Sound for providing an atmosphere of freedom and creativity in which to think, write, and teach. Thanks must go, as well, to my colleagues at U.P.S., Ernie Combs, Bruce Mann, and Douglas Goodman, who provided constructive criticism throughout the course of this volume's preparation. Editors at Academic Press, Susan J. Anderson and Randi Kashan, and a number of referees contributed greatly to the final draft of this text. A large measure of credit (but no blame) may also be assigned my wife, Sue, who contributed patience and understanding during the long months when the manuscript was in preparation.

Finally, I wish to thank a generation of students at the University of Puget Sound who willingly subjected themselves to experimental material as this text developed. This volume is dedicated to them.

To the Instructor

The first thing that most people ask when they pick up a new text is, "What's so new about this? Why do we need another macroeconomics text when there are so many around already?" These are good questions and they deserve good answers.

A macroeconomics text should be able to really explain the problems that face the economy today. Most current texts, while they present good economics, fail this test.

The typical macro text presents a fairly traditional Keynesian picture of the economy. The principal economic model used is the well-worn Keynesian cross (45-degree-line) model and, in some cases, the IS-LM description of an economy with money. These models are useful and informative but they do not adequately address current problems. The Keynesian cross model was designed to show how economic equilibrium is established and to teach us how we can shift that equilibrium in order to fight unemployment. This is the virtue of the model and also its chief vice: it is designed to help us understand how unemployment occurs. It tells little about inflation.

Today's students want to understand today's problems. They quickly become disillusioned with a macroeconomics course which fights unemployment for the most part and then, at the last minute, throws in a Phillips Curve as an explanation of the relationship between inflation and unemployment. When they press for more details, students are generally told that all of this is too

complicated for an introductory course, but that their questions will be answered in the intermediate theory course next Fall.

The problem is that the teaching of macroeconomics has failed to keep pace with economic theory. While instructors and textbook authors have sought out new gimmicks to increase understanding of the traditional models, economists and policy-makers have found that new models are needed to deal with our changing economy. These more realistic and useful pictures of the economy have recently filtered down to the intermediate undergraduate level. The vast majority of undergraduate students, however, are left with the same *traditional* tools and topics that have been around for thirty years.

To really understand how the economy works, we must take into account both of our national economic problems: inflation and unemployment. This text accomplishes this by building a model of the national economy using a simplified version of the aggregate demand-aggregate supply analysis which is now widely used at the intermediate theory level. This model of the economy allows us to understand the causes and cures of inflation, and those of unemployment; to see clearly how these two problems are related and the nature of the trade-offs between them.

The second goal of this text is to make macroeconomics as understandable and exciting for students as it has always been for professors. Many texts make the error of presenting material in a way that prepares stu-

dents for the next round of theory classes, but does little to help students understand the world today. This method may benefit the minority that go on in economics, but leaves the vast majority out in the cold. This text is written for the majority. Some students take only one class in macroeconomics. They will have just this one chance to really understand how the economy works. This text makes the most of that one chance. Macroeconomics is presented in a clear, readable form. The stress is on applications. Tools, problems, or theories which teach more geometry than economics have been scrapped or revised. The simplified picture of the economy that results actually contains more economics than is found in many more theoretically elegant treatments. The time saved in explaining geometry is efficiently used to discuss important topics in economics.

All of this may be good for the student who does not go into economics, but doesn't it harm the potential economics major? The answer here is a resounding "NO". Students who are exposed to this approach learn how the economy works and will understand the nature of our current economic problems. Students exposed to the traditional approach by and large have spent an apprenticeship in manipulating economic models. Both types of students tend to do well in later economics courses. The *traditional* students are equipped with manipulative skills which they can use to help them understand economic models. Students who have learned this newer approach have a better idea of where they are going, so they are better able to use the tools that they pick up along the way. These students are especially well equipped for intermediate theory courses which emphasize aggregate demand and supply.

ORGANIZATION OF THE TEXT

The text is divided into four parts. Most instructors will want to use material from each of the four parts, although individual chapters may be deleted and extra material added to fit the needs of the particular students or courses. In *Part I: Tools and Problems*, the reader is

exposed to a discussion of our national economic problems and equipped with the basic tools of supply and demand for use in analyzing those problems. Chapter 1 presents an overview of macroeconomics and recent economic history, focusing on the changing relationship between inflation and unemployment. Chapter 2 develops the supply and demand model of market activity with emphasis on particular applications which will be seen again, in a different context, in later chapters. Chapter 3 looks at the problem of unemployment and attempts to determine what unemployment means, how it is caused, and how serious a problem it is. Chapter 4 ends the first part of the text with a discussion of the economic effects of inflation.

Part II: A Simple Model of the Economy constructs a simple but effective framework of analysis for use in understanding how the national economy works. Chapter 5 develops necessary definitions such as gross national product and Real GNP and shows how they can be used to measure economic activity. Chapter 6 discusses aggregate demand by looking at the circular flow of economic activity, the Keynesian income-expenditure analysis of national income and, finally, aggregate demand in a world that includes inflation. Chapter 7 develops the concept of aggregate supply and looks at how aggregate demand and aggregate supply can be used as a simple but powerful tool to unravel the causes of our economic problems. Chapter 8 examines fiscal policy and applies the aggregate demand-supply model to the analysis of governmental economic policies.

Part III: Money, Credit, and the Economy looks at the role of money in a modern economy. Chapter 9 presents the definitions of money and interest rates and describes the operation of fractional reserve banks. The credit market is introduced in Chapter 10. The determination of interest rates through the interaction of the demands and supplies for credit is discussed along with applications of this analysis to the real world. Chapter 11 compares monetary and fiscal policies and examines the impacts of different schemes for financing government spending. Finally, a simple model of the monetarist view of the economy is presented in Chapter 12. The conclu-

sions of monetarist and traditional theories are compared and discussed.

Part IV: International Economics looks at length at the international forces affecting national economic problems and policies. Chapter 13 looks at international trade and payments. Comparative advantage, tariffs and quotas, and the Balance of Payments and Trade are discussed here. Chapter 14 models the foreign exchange markets and shows how exchange rates are determined. The systems of flexible and fixed exchange rates are discussed, as is exchange rate intervention. Chapter 15 evaluates the effectiveness of various national economic policies when their international impacts are taken into consideration. Chapter 16 ends the text with review of the goals and problems of the national economy and a reminder of the trade-offs that economic policy-makers face.

SPECIAL FEATURES OF THE TEXT

This text has several special features designed to make it more useful to both student and instructor. Eight economic debates are presented in the *Economic Controversies* sections. Here topics such as wage and price controls, the independence of the Federal Reserve, and the relative importance of fighting inflation versus controlling unemployment are debated, with the final

analysis of the trade-offs left to the reader. These sections allow the student to apply the principles developed in past chapters to current problems and make good topics for class discussion.

Each chapter begins with a *Preview* which presents a number of questions that will be answered in the coming pages. This gives the student an idea of what is coming and what topics are central to the chapter.

Each chapter ends with a number of important features. A chapter *Summary* lets the reader check to see if all of the principal points of the text have been absorbed. *Discussion Questions* give the student the chance to think about the topics covered in greater depth. These questions provide, as well, a good basis for classroom discussions of the material. A number of objective questions are presented in *Test Yourself*. Answers to these sample questions are at the end of the text. *Suggestions for Further Reading* can also be found at the back of the book. Students who pursue the suggested reading will learn even more about how the economy works and the way that economists think. Instructors can vary the breadth and depth of their courses by use of these readings. A *Glossary* of all important terms appears at the back of the book as well.

These features of the text make it a self-contained guide to macroeconomics that can be used in a wide variety of classroom situations.

Table Of Contents

Preface	xi
To the Instructor	xiii

PART 1 **Tools and Problems**

Chapter 1 **Macroeconomic Problems 3**

What Is Economics?	4
Macro- versus Microeconomics	6
Macroeconomics Goals and Problems	7
The Great Depression	8
The Forties	10
The Fifties	10
The Sixties	12
The Phillips Curve	13
The Seventies	14
What Happened to the Phillips Curve?	16
The Eighties and Beyond	17
Summary	18
Discussion Questions	19
Test Yourself	19
<i>Economic Controversies I:</i>	
<i>Another Great Depression?</i>	20
The Coming Bust	20

We Can Manage Prosperity	21
Discussion Questions	22

Chapter 2 **Supply and Demand 23**

The Concept of Demand	25
The Demand Curve	29
The Concept of Supply	32
The Supply Curve	35
Changes in Supply	37
The Market at Work	40
Some Applications	43
Inflation: A Preview	48
Review of Market Actions	51
Summary	52
Discussion Questions	54
Test Yourself	55

Chapter 3 **The Problem of Unemployment 57**

The Unemployment Rate	59
The Labor Market	61
Cyclical Unemployment	63
Structural Unemployment	66
Frictional Unemployment	66
Unemployment Insurance	69
The Goal of Full Employment	69

How Serious Is the Unemployment Problem?	70
Summary	75
Discussion Questions	76
Test Yourself	76

Chapter 4

Understanding Inflation 79

What Is Inflation?	80
The Inflation Record	81
Economic Effects of Inflation	82
The Role of Expectations	86
Winners and Losers	88
The Power of Compound Inflation	88
Coping with Inflation	89
Measuring Inflation	91
Three Inflation Measures	95
Real versus Nominal Values	96
Summary	97
Discussion Questions	98
Test Yourself	99
<i>Economic Controversies II:</i>	
<i>Inflation or Unemployment?</i>	100
Winners and Losers	100
Unemployment Is More Important	101
Fight Inflation First	102
Discussion Questions	103

PART 2

A Simple Model of the Economy

Chapter 5

Measuring Economic Activity 107

Gross National Product	108
GNP as a Measure of Well-Being	111
Three Views of GNP	112
A Grain of Salt	113
Real Gross National Product	114
Per Capita RGNP	116
International Comparisons	116

Summary	118
Discussion Questions	119
Test Yourself	119

Chapter 6

Aggregate Demand 121

Spending and Income	122
Macroeconomic Equilibrium	125
Is Equilibrium Good?	127
Consumption Spending	127
Investment Spending	130
Government Spending	130
Net Export Spending	131
The Aggregate Demand Curve	131
Changes in Aggregate Demand	133
Slope of the AD Curve	135
Appendix: The Keynesian 45-Degree-Line Model	136
Summary	140
Discussion Questions	141
Test Yourself	141

Chapter 7

Aggregate Supply and the Economy 143

Aggregate Supply	144
The Aggregate Supply Curve	148
Changes in Aggregate Supply	152
Macroeconomic Equilibrium	154
Inventory Adjustments	158
Causes of Unemployment	158
Causes of Inflation	162
The Old-Time Religion	163
Wage and Price Controls	164
Indexation	165
Increasing Aggregate Supply	166
Winners and Losers from Economic Policies	167
Summary	169
Discussion Questions	170
Test Yourself	171
<i>Economic Controversies III:</i>	
<i>Wage and Price Controls</i>	172

Controls Are Useful 172
 Price Controls Are Bad 173
 Discussion Questions 174

Chapter 8

Fiscal Policy 175

The Role of Government 176
 Government Spending 177
 The Multiplier 180
 The Multiplier in the Real World 183
 Taxes 184
 The Balanced-Budget Multiplier 187
 Different Types of Taxes 188
 The Total Tax Burden 195
 Tax Expenditures 195
 Transfer Payments 197
 Automatic Stabilizers 197
 Advantages and Disadvantages of Fiscal Policies 198
 Deficit Spending and the National Debt 200
 Summary 201
 Discussion Questions 202
 Test Yourself 203
Economic Controversies IV:
Taxes and the Laffer Curve 204
 The Tax Wedge 204
 Cut Taxes Now! 205
 Don't Bet on the Lafferites 206
 Discussion Questions 207

PART 3

Money, Credit, and the Economy

Chapter 9

Money and Banking 211

The Money Supply 213
 Money Substitutes 215
 The Interest Rate 216
 Money and Banks 221
 Fractional-Reserve Banking 222
 How Banks "Create" Money 224

The Fed 227
 Open Market Operations 227
 Reserve Requirement Policy 229
 Discount Rate Policy 229
 Summary 231
 Discussion Questions 231
 Test Yourself 232

Chapter 10

Money, Credit, and the Economy 235

The Credit Market 236
 The Stock Market 238
 Demand for Credit 239
 The Credit Demand Curve 242
 The Supply of Credit 244
 The Credit Market at Work 246
 The Inflation Premium 249
 Disintermediation 252
 The Real Interest Rate 253
 Investment and the Credit Market 254
 Monetary Policy 256
 Summary 258
 Discussion Questions 259
 Test Yourself 259
Economic Controversies V:
Credit Market Controls? 260
 Credit Regulations Needed 260
 Deregulate the Credit Market 261
 Discussion Questions 262

Chapter 11

Monetary versus Fiscal Policy 263

Expansionary Monetary Policies 264
 Expansionary Fiscal Policies 266
 Public versus Private Sector Growth 267
 Inflation in the Long Run 268
 Advantages and Disadvantages 269
 Contractionary Policies 272
 Financing Government Spending 273
 Borrowing from the Public 275

Borrowing from the FRS	277
Accommodating Monetary Policy	279
Conflicting Monetary Policy	280
Summary	281
Discussion Questions	282
Test Yourself	282

Chapter 12

The Monetarists 285

The Equation of Exchange	286
The Barter Economy	289
Money as a Commodity	293
Money and the Economy	295
Monetary Policy: The Monetarist View	296
Fiscal Policy: The Monetarist View	298
Monetarist Policy Recommendations	299
Criticisms of Monetary Policies	299
Friedman's Policy of Rules	300
Who's Right, Here?	300
Summary	301
Discussion Questions	302
Test Yourself	302
<i>Economic Controversies VI:</i>	
<i>Independence of the Federal Reserve System</i>	303
End the FRS' Independence	303
Keep the FRS Independent	304
Discussion Questions	305

PART 4

International Economics

Chapter 13

International Trade 309

Why Do Nations Trade?	310
Gains from Trade	313
Comparative Advantage in the Real World	316
Trade Restrictions	317
Who Pays the Tariff?	319
The Rationale of Barriers to Trade	323

The Balance of Payments	325
Stages of Balance of Payments	326
The Balance of Trade	327
Summary	329
Discussion Questions	329
Test Yourself	330

Chapter 14

The Foreign Exchange Market 331

The Exchange Rate	332
The Foreign Exchange Market	333
The Foreign Exchange Market at Work	341
Exchange Market Intervention	348
Fixed Exchange Rates	350
Summary	350
Discussion Questions	351
Test Yourself	351
<i>Economic Controversies VII:</i>	
<i>Flexible or Fixed Exchange Rates?</i>	352
Fixed Exchange Rates	353
Let Exchange Rates Float	353
Discussion Questions	354

Chapter 15

International Economics 357

Trade and the Economy	358
International Credit Markets	359
Eurodollars	362
Monetary Policy with Flexible Exchange Rates	363
Fiscal Policy with Flexible Exchange Rates	365
Economic Policy with Flexible Exchange Rates	366
Economic Policy with Intervention	367
Fixed Exchange Rates	369
International Economic Policies	372
Summary	373
Discussion Questions	374
Test Yourself	374

Chapter 16

Problems, Goals, and Trade-Offs 377

Macroeconomic Goals	378
International Economic Goals	381
Policy Tools	382
Trade-Offs in Economic Policies	383
Economic Policy Choices	384
Policy Problems	387
Setting National Priorities	388
Summary	388
Discussion Questions	389
Test Yourself	389
<i>Economic Controversies VIII:</i>	
<i>Defending the Dollar</i>	390
Defend the Dollar!	390
Fight Inflation First	391
Let the Dollar Fall	391
Discussion Questions	392

Suggestions for Further Reading 393

Glossary 397

Answers To "Test Yourself" 405

Index 407

Part 1 Tools and Problems

CHAPTER 1

MACROECONOMIC PROBLEMS

ECONOMIC CONTROVERSIES I

ANOTHER GREAT DEPRESSION?

CHAPTER 2

SUPPLY AND DEMAND

CHAPTER 3

THE PROBLEM OF UNEMPLOYMENT

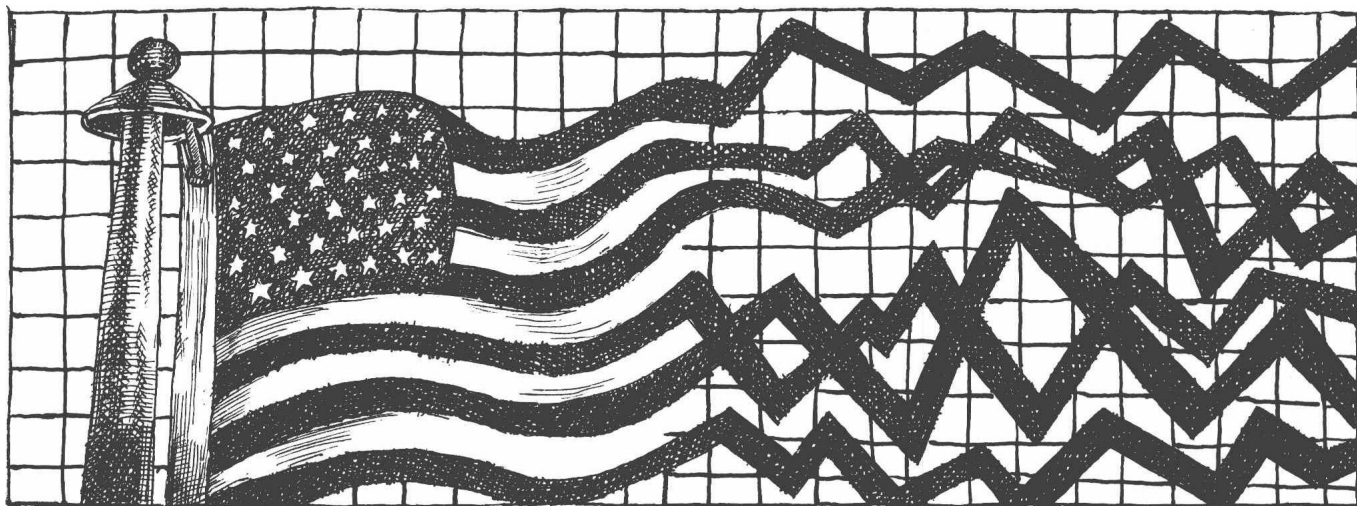
CHAPTER 4

UNDERSTANDING INFLATION

ECONOMIC CONTROVERSIES II

INFLATION OR UNEMPLOYMENT?

1 Macroeconomic Problems



This chapter will introduce you to economics in general and macroeconomics in particular. It will give you a better feel for our current economic problems and help you understand these problems within a historical context. This chapter will provide the answers to the following important questions:

What is economics?

How does macroeconomics differ from microeconomics?

What are our current macroeconomic goals?

Have we been successful in achieving these goals?

What is the Phillips curve? How does it work?

Why hasn't the Phillips curve worked recently?

Many of our most important social problems are fundamentally economic problems. To understand the world and make intelligent choices, therefore, it is necessary to understand something of economics.

It is astounding to consider how much economic events have come to monopolize our time and influence our lives. The federal government was once primarily a lawmaker and defender. Now much of Congress's time is spent attempting to regulate prosperity and enhance economic welfare. Newspapers that used to count on stories of fires, murders, and kidnappings to increase circulation now rely on inflation predictions and unemployment statistics. Businesses that once spent all of their time worrying about gross profits now worry first about gross national product. Farmers are experts in exchange rates. Private citizens who five years ago didn't know the difference between a prime rate and a prime rib have discovered that they must master some pretty sophisticated economics in order to make even relatively simple decisions with confidence.

Economics is important stuff, and this book is designed to help you *understand economic events and policies*. It is the goal of this text to increase your understanding of our current economic problems, their causes, and some possible cures. Strong medicines, however, often have undesirable side effects, so a perfect prescription for the economy may not exist. Policies that reduce one economic problem may inflame another, be politically unwise, or have unacceptable social consequences. Pat answers are hard to come by, but an understanding of the options available will help us make more intelligent decisions in the choices that we face.

This chapter will answer some basic questions that many students have regarding economics and macroeconomics, and briefly discuss our national economic goals and problems. We will also take a short trip down memory lane with a small dose of recent economic history to help you understand not only what today's problems are, but how we got here as well.

WHAT IS ECONOMICS?

Suppose you were to pose the question "What is economics?" to a hundred "people on the street" in a major city in an attempt to find out what economics is all about. The results might be something like those shown in Table 1-1.

Most of the people in our hypothetical sample group don't have a very clear idea of what economics is all about. But as luck would have it, one economics professor stumbled into the sample and gave us the textbook