SECOND EDITION

NEIL T. SKAGGS
J. LON CARLSON

MACROECONOMICS

INDIVIDUAL CHOICE AND ITS CONSEQUENCES

Macroeconomics
Second Edition

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Macroeconomics
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To Barb and the girls, Caroline, Becky Jo, Meridith, and Lindsey, for sharing me with "the book."

To Brenda, for all her patience, encouragement, and support.

Preface

Macroeconomics is an intriguing subject. Macroeconomists attempt to explain economy-wide changes in output and prices, employment and interest rates, international trade balances and government budget patterns. So many variables affect one another that constructing a relatively simple framework of analysis is a challenge.

In the first edition of *Macroeconomics: Individual Choice and Its Consequences*, we chose to develop our model of macroeconomic behavior in an innovative manner. We believed – and still believe – that one of two problems plague typical macroeconomics texts. Older texts, originally written in the heyday of Keynesian economics, used the "Keynesian-cross," or aggregate-expenditure, model as their basic analytical framework. The model is relatively simple and can be used to produce a number of clear-cut results. Unfortunately, the model's results bear little relationship to the behavior of modern economies. The model's assumptions of fixed prices and interest rates and perfectly elastic aggregate supply do not accord well with economic facts. Simplicity is purchased at the cost of relevance.

Most newer texts create a different problem by combining the older aggregate-expenditure approach with the more-modern aggregate demand-aggregate supply approach. The aggregate-expenditure model is used to derive the aggregate demand curve, then, typically, reappears during discussions of policy actions or historical economic behavior. Students reading these texts are forced to come to grips with two separate models. Given the complexity of macroeconomics, the wisdom of using two models to accomplish what could be done with the aggregate demand-aggregate supply model alone is doubtful.

In the first edition of *Macroeconomics*, we omitted the aggregate-expenditure model altogether. Instead, we used an intuitive approach in developing the theories of aggregate demand and aggregate supply. Our approach called upon students to learn to manipulate only one macroeconomic framework. Furthermore, our approach kept the microeconomic aspects of macroeconomic behavior in the forefront. In this way, we made macroeconomics seem less mechanical and more behavioral. False simplicity was lost, but the possibility of developing a better understanding of real-world economic behavior emerged.

Our experience with the first edition and the experiences of a loyal group of adopters have confirmed in our minds that the "behavioral approach" to macroeconomics makes sense. Thus, the second edition of *Macroeconomics* continues in the pattern set by the first edition, pushing beyond it in a number of ways.

Goals of Macroeconomics

The first edition of *Macroeconomics* was unique in both content and pedagogy. All the major features of the first edition discussed in this section have been carried over into the second edition.

Content

The content of a textbook encompasses the topics covered, the order of the discussion, and the emphasis placed on the various topics. The content of *Macroeconomics* is innovative on all three scores. The topics covered reflect the changing economic problems of an evolving economy. The order of our discussion is designed to be logical and to emphasize what we believe are the fundamental issues facing economists and policymakers today.

Part I: Basic Economic Principles Chapters 1 through 5 provide students who have not yet had a course in microeconomics with all the microeconomic tools needed to assemble and use the macroeconomic model. The unique approach of *Macroeconomics* emerges in Chapter 2, in which students encounter a discussion of the gains from trade and the principle of comparative advantage, using examples ranging from simple individual exchanges to international trade. This provides a solid foundation for the theories of demand and supply. All the basic elements of demand and supply analysis, including the basis of supply in marginal cost, are covered in Chapter 3. In Chapter 4 we present an extended discussion of efficiency under conditions of perfect competition in order to highlight the importance of economic efficiency in all economic decision and policy making. We close Part I with a discussion of how and why market outcomes can fail to be efficient and of the possibility of government intervention to improve efficiency or to achieve other goals. Instructors who prefer to omit Chapters 4 and 5 can do so without loss of continuity.

Part II: Basic Macroeconomic Model In Part II, the innovations in content and pedagogical technique show through clearly. We develop the basic macroeconomic model from simple microeconomic principles, beginning with the concept of a budget constraint, to show how markets are interrelated. From there we develop the theory of aggregate demand from the theories of consumption and investment behavior. We base the theory of aggregate supply on the microeconomics of labor markets. The resulting macroeconomic model is firmly grounded on individual economic choice. In this manner, we overcome what we believe to be one of the major shortcomings of standard texts – the false dichotomy of microeconomics and macroeconomics.

Developing our macroeconomic model in this manner enables us to begin discussing important policy issues very early in the text. Furthermore, by developing theories of both short-run and long-run aggregate supply, we are able to make economic growth an integral topic in our treatment of macroeconomic behavior. Because our short-run aggregate supply curve has behavioral foundations, we are able to discuss why such a curve exists. We can also consider in a natural way such topics as the causes of wage stickiness and the importance of expectations – and using only the demand and supply tools developed in Part I, in addition to the macro model itself.

Other distinctive features of Part II in the first edition were a chapter on the credit (loanable funds) market and a comprehensive treatment of fiscal policy (including aggregate supply effects and the importance of incentives). Because we develop the complete macroeconomic model so early in Part II, instructors have time to actually use the model to examine a variety of issues. The frustration of spending a whole semester simply building the model disappears.

Part III: Application of the Macroeconomic Model As in the first edition, Part III contains a business cycle chapter that confronts alternative theories with empirical evidence and chapters on monetary and fiscal policy that enable interested instructors to go beyond the basics. We carry over many of the techniques used in Part II to the international realm. We use the budget constraint to develop balance of payments accounting in an intuitive way, then go on to construct an open-economy macro model.

Pedagogy

Content and pedagogy go hand in hand. In the first edition we sought to present macroeconomics in a way that

1. highlights the core of economic reasoning – constrained decision making.
2. shows how all areas of economics are related.
3. leads students to understand the basic methods of economists by practicing them repeatedly.
4. applies economic theories to real-world events to show students the relevance of economics.
5. focuses on the process of change – which goes on continually around us – rather than solely on the position of equilibria.

In doing this, we sought to repeatedly use relatively few fundamental principles so as not to overwhelm students with theoretical tools, to draw on the students' own experiences, and to be logically ordered. We continue these emphases in the second edition.

By focusing on microeconomic decision making throughout the text, we are able to accomplish our first two goals. Using demand and supply analysis, we are able to construct the basic macro model and analyze a host of macro issues besides output and price-level determination: employment and wage determination; the behavior of interest rates; the incentive effects of fiscal policies; and determination of exchange rates, to name a few. Furthermore, our approach enables us to discuss why markets may not behave like the simple demand-supply model indicates. We continue to believe that this "New Keynesian" approach to markets makes more sense than the traditional approach of simply assuming markets do not clear.

With regard to economic methods, we continue to practice rather than preach by demonstrating how economists approach their subject.

1. The assumptions of theories are made explicit.
2. Model construction proceeds logically.
3. Models sufficient to analyze policy options are constructed before policy is discussed.
4. Competing explanations of economic events are confronted with historical and statistical evidence, thereby introducing students to the concept of hypothesis testing.

The first edition had a "real-world flavor" because of all the historical examples appearing throughout the text. In addition to extended applications of theory to the real world in the body of the text, we include in each chapter Why the Disagreement? and Does It Make Economic Sense? boxes in which we consider issues of interest to economists and noneconomists alike. Finally, since we live in a dynamic world, we spend a lot of time discussing how the economy gets from one static equilibrium point to another. How people act when confronted with changed circumstances is the focus of many discussions.

New Features of the Second Edition

While the basic framework of *Macroeconomics* has not changed, the second edition goes beyond the first in a number of ways to more fully implement our philosophy. Major changes to the second edition include the following:

1. The development of aggregate-demand theory has been streamlined by simplifying the presentation of consumption theory and investment theory. As in the first edition, we develop the permanent-income theory of consumption. However, the presentation of Keynesian consumption theory included in the first edition has been omitted from the second. The theory of investment demand has been simplified by focusing on nominal interest rates, rather than on expected real interest rates. Unlike the treatment in many other texts, however, our approach explicitly assumes expected inflation to be constant unless otherwise noted. This approach allows for simplification, while still retaining a focus on changes in the expected real interest rate.

2. The discussion of economic growth in Chapter 10 surveys the experiences of European and Japanese economies, as well as the U.S. experience. The experiences

are similar in some important ways and dissimilar in others. The international comparison enables students to better judge the performance of the U.S. economy.

3. All analysis of interest-rate behavior and of monetary policy is conducted using the credit market (loanable funds) model of interest-rate determination. We construct the model and use it to analyze monetary policy over the course of Chapters 12, 13 and 14. We begin with a basic saving-investment framework, expanded to take account of government borrowing. We then add bank credit to the model, showing how changes in the money supply or in money demand affect the supply of credit and the interest rate.

   We believe this approach is superior to the conventional money demand-money supply approach for several reasons. First, students intuitively understand the credit-market framework more easily than the money demand-money supply approach. For example, the effect of government financing on the interest rate is much more easily analyzed in the context of the credit-market model. Second, our approach shifts the focus from the size of the money supply to the behavior of interest rates, while still recognizing changes in the money supply. This accords more closely with the Federal Reserve's policy approach than does the conventional approach. Finally, our approach enables students to directly apply their knowledge to understanding popular discussions of monetary policy actions, thus better satisfying one of Lee Hansen's "proficiencies" than does the conventional approach: "Show what economic concepts and principles are used in economic analyses published in articles from daily newspapers and weekly newsmagazines."[1]

4. The discussion of fiscal policy is divided into treatments of short-run effects and long-run effects. As in the first edition, the necessity of financing any changes in spending or taxes is recognized throughout. We also have added a discussion of the intergenerational equity of government policies, while deleting the discussion of national industrial policy.

5. The discussion of unemployment in Chapter 16 is explicitly in terms of a natural-cyclical division. Frictional and structural unemployment are shown to be the constituent parts of natural unemployment. Turning to the theory of unemployment, we now devote less time to search and contract theories, but we have added a new section on efficiency-wage theory.

6. The discussion of business cycles in Chapter 17 is now organized according to demand-side and supply-side explanations. An expanded treatment of real business cycle theory provides the supply-side theory. As in the first edition, we continue to compare the predictions of the various theories with the relevant empirical data.

7. We now develop the open-economy model in Chapter 21 in the context of two extended examples, one for a flexible exchange-rate system, the other for a fixed exchange-rate system. The first seeks to explain the behavior of the dollar and the U.S. trade balance during the 1980s. The second recounts the successes and failures of the member nations of the European exchange rate mechanism. In total, the

treatment shows how an open-economy macro model works in the context of actual economic history.

Learning Aids

We believe that the most important learning aid in the Macroeconomics package is the organization of the text itself. As in the first edition, the following features reinforce the organizational structure of the text:

1. Chapter overviews give a bird's eye view of what is coming in each chapter.
2. Learning objectives follow each chapter overview and highlight the most important themes in that chapter.
3. Extended examples demonstrate the relevance of economic theory to real-world events.
4. Why the Disagreement? boxes in every chapter present opposing views on current hot topics of economic policy. The economic interests of both parties are explained by showing the underlying economic model and how it applies to the point of disagreement.
5. Does It Make Economic Sense? boxes in every chapter illustrate how economic theory, applied properly, can explain what on the surface appears to be behavior that contradicts economic principles.
6. The Economist's Tool Kit boxes appear in selected chapters and discuss specialized economic techniques or data.
7. Margin definitions of key terms run throughout every chapter.
8. Section Recaps appear in the margin and summarize the major points of each section of the text.
9. Chapter summaries briefly recount each chapter's main arguments.
10. Questions for Thought conclude each chapter and are arranged in three categories: knowledge questions, application questions, and synthesis questions. They are designed to test understanding of the material and to prepare for exams.
11. Glossary of key terms at the end of the text provides a quick and handy reference for review.
12. Carefully selected and designed graphs appear throughout the text. Three features of the graphs are especially useful:
    - Pedagogical use of color: Successive curves are shown in a lighter shade than preceding curves, making shifts of curves easy to follow.
    - Highlight boxes within graphs concisely explain the concept of the graph right next to the graph itself.

- A complete caption for each graph helps interpret and explain the graph in clear and simple terms.

Supplements

Our supplements package includes for the instructor an Instructor's Manual, Test Bank, Computerized Test Bank, and Transparency Masters. For the student, the package includes a Study Guide and Graph Notes.

Acknowledgments

The number of people who contributed to the first edition of the text in various capacities was large, and we cannot recognize them again here. However, their contributions to the project are reflected in this edition of the text, as well as in the first. In particular, we want to note the contribution to the text made by Alan Dillingham, who co-authored the first edition. Since that time, Alan has become Associate Vice President of Instruction and Dean of Undergraduate Students at Illinois State University, a position with as many responsibilities as words in its title. Consequently, Alan is no longer working on the text, but his influence remains strong. We also wish to acknowledge the contributions to this edition by the following people, many of whom also aided in the development of the first edition:

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End Notes

[1] W. Lee Hansen, "What Knowledge Is Most Worth Knowing – for Economics Majors?" American Economic Review 76, May 1986, pp. 149-52.

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