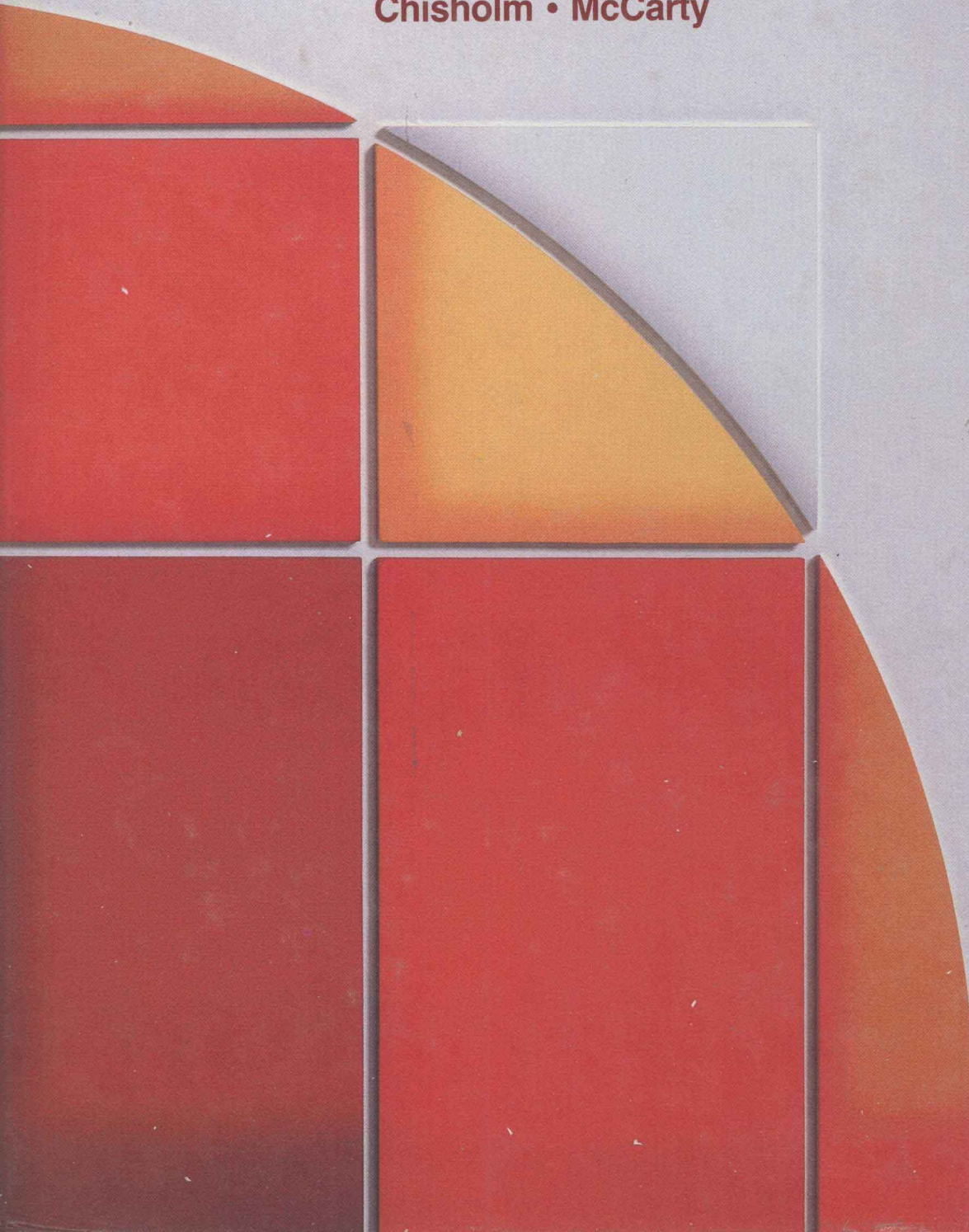


Principles of Economics

SECOND EDITION

Chisholm • McCarty



Principles of Economics

SECOND EDITION

Roger Chisholm
Memphis State University

Marilu McCarty
Georgia Institute of Technology

Scott, Foresman and Company
Glenview, Illinois

Dallas, Texas Oakland, New Jersey Palo Alto, California
Tucker, Georgia London, England

Photograph Acknowledgments

Lawrence Klein: Courtesy Lawrence Klein.
Karl Marx: Brown Brothers.
Simon Kuznets: Courtesy Harvard University.
Wassily Leontief: Wide World.
John Maynard Keynes: United Press International.
Paul Samuelson: Wide World.
John Law: Brown Brothers.
Nicholas Biddle: Culver Pictures, Inc.
Charles Dow: Courtesy *The Wall Street Journal*.
Irving Fisher: Wide World.
Arthur Burns: United Press International.
Paul Volcker: United Press International.
Milton Friedman: Courtesy Hoover Institution, Stanford University.
David Ricardo: Brown Brothers.
W. Arthur Lewis: Courtesy Princeton University; photograph by Robert Bielk.
Robert Triffin: Courtesy Yale University; photograph by Andre Germain.
William Stanley Jevons: BBC Hulton Picture Library.
Alfred Marshall: Historical Pictures Service, Inc., Chicago.
Thorstein Veblen: Brown Brothers.
Paul Sweezy: Courtesy of *Monthly Review Press*.
Joan Robinson: Ramsey & Muspratt, Cambridge.
Andrew Carnegie: Brown Brothers.
John Kenneth Galbraith: Wide World.
George Stigler: Courtesy University of Chicago.
Lillian Gilbreth: United Press International.
Frank Knight: Courtesy University of Chicago.
Arthur Okun: Courtesy The Brookings Institute.
Kenneth Arrow: United Press International.

Library of Congress Cataloging in Publication Data

Chisholm, Roger K
Principles of economics.

Also issued in two separate editions under titles: Principles of microeconomics and Principles of macroeconomics.

Includes index.

1. Economics. I. McCarty, Marilu Hurt, joint author.

II. Title.

HB171.5.C629 1981 330 80-26407

ISBN 0-673-15492-0

Copyright © 1981, 1978 Scott, Foresman and Company.
All Rights Reserved.
Printed in the United States of America.

Preface

This text is intended for the one-year principles of economics course. Therefore, it is written for the student encountering economics for the first time. The “usual” subject matter of the first course is treated in a complete and detailed manner. However, this book is not an encyclopedia of economic topics or a grab bag offering far more than any instructor can cover. Fewer topics are covered but these are the core topics and they are explored in depth. Stressing a balance between economic theory and real-world examples, chapters are often a couple of pages longer than those found in other texts.

We have paid particular attention to writing style and level. Chapters were reworked and polished many times to improve clarity and relevance. The terminology is that of the economist while the language is that of the economic journalist. Thus the writing style is like that found in *Business Week*, *The New York Times*, or *The Wall Street Journal*. The book speaks to today’s students in a lively, colloquial fashion without emphasizing slang or adopting other overly cute devices. We hope that such language, besides facilitating learning, will convey the excitement of current economics.

An economics course should be, for most students, one of their most exciting and relevant courses. We believe this text will fulfill this goal.

The general organization of the text is fairly traditional. An introductory section of four chapters is followed by the macroeconomic chapters and then the microeconomic chapters.

However, any instructor who chooses can just as easily make the jump from the introductory section directly to the microeconomics. We wrote the micro and macro portions so that each could stand alone.

SPECIAL FEATURES

Much effort was directed toward juxtaposing real-world examples and problems with economic theory and ideas. Three basic issues inserts were employed: Extended Examples, Viewpoints, and Economic Thinkers.

The **Extended Examples** are just what the title says; each explores a significant topic from the real world in greater depth and shows how it is an example of economic theory in action. In the chapter on monopoly, there is an Extended Example on monopoly in shopping malls. This example describes how exclusionary agreements are sometimes used to ensure profit for initial tenants in shopping malls. In the chapter on Inflation, we have an Extended Example entitled “Inflation Fighting in Great Britain”; this example shows how the Conservative government of Margaret Thatcher fought inflation but was severely challenged politically for the measures taken. Another Extended Example, found in the fiscal policy chapter, is called “Mr. Carter’s \$50 Misunderstanding”; it discusses what happened to Carter’s proposed \$50 rebate and demonstrates some shortcomings of fiscal policy in the real world.

The **Viewpoints** deal with economic controversies and with many of the unsolved economic problems of our times. Quite literally, the Viewpoints are taken from the headlines of newspapers and magazines. The Viewpoints enable students to apply the theory they have just learned. In fact, many of the Viewpoints challenge students to defend or disagree with the argument. The chapter on the government's role in the economy has a Viewpoint on the value-added tax; the issue of whether VAT is a better system than ours is discussed, with arguments for and against. In the chapter on Unemployment we include two opposing Viewpoints, one called "Unemployment Statistics Overestimate the Problem" and the other "Unemployment Statistics Underestimate the Problem."

Our third issues insert is the **Economic Thinkers**, biographies of great economists. Actually, biographical data are limited to one or two paragraphs. Most of the biography deals with the important economic ideas contributed by that thinker. Some of our Economic Thinkers are Galbraith, Marx, Veblen, Marshall, Lawrence Klein, Irving Fisher, Kenneth Arrow, Joan Robinson—the list goes on and on.

The average length of these issues inserts is two text columns, or one full page. Thus, these issues are not intended as diversions; they provide some real "meat" for students.

Other useful pedagogical tools are included. Each chapter starts with learning objectives. At the end of each chapter is a summary, a key words and phrases list, and questions for review. The key words and phrases are actually glossaries of all new terms in that chapter. In the interests of "pedagogical repetition," some terms appear in more than one glossary.

The Instructor's Manual provides suggestions for readings from popular magazines for both the students and teacher.

MACROECONOMIC TOPICS OF NOTE

Macroeconomic thinking has been changing rapidly in recent years. So rapid has the change been that many new ideas are not yet integrated into the main body of economic thought. Clearly, a textbook is not the place to achieve integration. However, we have presented the new ideas in a way that shows their origin and their place in the body of economic knowledge. We do not set one school of thought against another, though the instructor may wish to do so. We

do not merely add new ideas, as economic afterthoughts. We do familiarize students with various macroeconomic ideas and prepare them to follow, if not enter, the on-going debates.

Many of the topics which students and instructors alike found useful in the first edition have been retained. For example, national income accounting (Chapter 5) is still treated with enthusiasm and clarity, not as something to be endured until we can get on to other matters. We hope to motivate students by stressing, very early, the problems of the macroeconomy: Economic instability, uncertainty, inflation, and unemployment are covered in Chapter 6.

The real sector of the economy is developed (Chapters 7–9) to show how the production of goods and services is ultimately what economics is all about. How the economy reaches the equilibrium level of output and what we may do to change that equilibrium are clearly described. We had already emphasized aggregate supply in the first edition; this topic is retained and expanded in this edition. For example, the components of the aggregate supply curve are discussed.

The chapter on nonbank financial intermediaries was well received by both students and instructors in the first edition. The chapter (Chapter 12) has been expanded in this edition to include discussions of the money market funds and the operation of the futures market.

The treatment of monetary policy (Chapters 13–14) continues to embrace both the Keynesian and the monetarist perspective. This is possible because the demand for money is built upon both sets of assumptions. The supply of money is described in the traditional chapters on money and the commercial banking system.

The important topics of inflation and unemployment are given prominent attention in this edition, as in the first. To further emphasize such important topics, each is treated in a separate chapter (Chapters 15 and 16). Economic growth, both in industrialized and developing nations, is shown to be an important and difficult problem. The growing energy crisis is examined for its effect on economic growth and development.

Many innovations have come about with this new edition. As has been mentioned, aggregate supply, along with the underlying labor market, is given expanded treatment. Aggregate supply is then used in models of the price level and inflation. Considerations of aggregate supply also allow introduction of current concerns

about falling productivity and the “supply side” school of macroeconomics. The fiscal policy suggestions of Professor Laffer are also considered.

Additional innovations are found in the monetary chapters. The new definitions of the money supply as well as the changes brought about by the Banking Law of 1980 are discussed. Recent monetary policy actions are reviewed. The rational expectations arguments are presented, as is a discussion of the activist-nonactivist debate about the role of policy in macroeconomic affairs.

The structural problems leading to inflation have been given greater weight in the now separate chapter on inflation. With the inflation models in hand, students are then shown that unemployment remains a serious issue, especially in light of the 1980 recession. Much greater use is then made of both the short-run and the long-run Phillips curve in the analysis of unemployment and inflation.

The growth theory chapter stresses neoclassical models and the effects of high energy costs and government borrowing. The growth and development chapter utilizes several case studies and offers a good treatment of the effects of cultural factors on economic growth.

The three chapters on international economics stress basic theory and its application to current problems and policies. The trade chapters discuss changing terms of trade, the North-South dilemma, pressures for protection, responses to competition, and exporting technology. The finance chapter covers lending and debt, interest rate wars, exporting monetary policy, floating exchange rate problems, and problems with the dollar.

MICROECONOMIC TOPICS OF NOTE

The chapters on consumer demand (Chapters 22–24) carefully develop fundamental concepts necessary for complete understanding of a wide range of economic principles. Marginal relationships, elasticity, and substitution and income effects receive extended verbal, mathematical, and graphical treatment. These and the following chapter on supply theory amplify fundamental concepts through application to current economic issues: productivity and government policies, expectations and incentives, taxes and subsidies.

Separate explorations of short- and long-

run production theory (Chapters 25–26) give particular emphasis to the character and function of profit in making decisions. Important issues include corporate accountability, corporate democracy, efficient scale, innovation and adjustment to change, external economies and diseconomies, and price fluctuations in agriculture (the cobweb theorem).

Imperfect competition (Chapters 27–29) is critically examined as to its causes and consequences, with emphasis on considerations of equity and efficiency. The question of market power and regulation is explored in depth, along with the issues of price discrimination and social externalities. The treatment of theory is rigorous and the language is precise.

Chapters on resource employment and income distribution (Chapters 30–33) have been expanded and reorganized to focus separately on marginal productivity theory, work and labor resources, land and rent, capital employment and profits, and the problem of poverty. Modern production theory is integrated with the historical evolution of philosophies of and policies toward resource markets. Some significant issues have been added, including worker fringe benefits, labor-management cooperation to increase productivity, human capital investment, the diminishing supply of farmland, and the effects of discrimination in education.

The last part of the text (Chapters 34–36) takes an entirely new look at economic theory in a socio-political context. Market failure and public choice are discussed at some length. The actual results of market behavior are shown to differ significantly from the efficient and equitable results reached in theory. Proposed remedies from both ends of the political spectrum are examined in detail. Theory and policy considerations are then discussed fully in specific sectors of market failure: the health-care industry, energy, and environmental health and safety. The last chapter covers alternative economic systems, emphasizing socialist thought, the various roles of planning, and the ways in which all economic systems can be compared.

ACKNOWLEDGMENTS

Naturally, such a major undertaking as writing a basic economics text leaves the authors in debt to many people. First there is the intellectual debt to many economists and other mentors, some of whom the authors have never met.

Then there are the many students whose comments and complaints shape the authors' teaching of the course.

We would particularly like to thank the following professors who offered constructive comments on the manuscript:

Abraham Bertisch, Nassau C.C.
Donna Bialik, Indiana University—
Purdue University (Ft. Wayne)
Donald Coffin, Indiana University—
Purdue University (Indianapolis)
Loy Despain, Mesa Community College
Steven Erickson, Purdue University
Margaret Greenbaum, Northwestern
University
James Johannes, Michigan State
University

Robert Kenney, Miami-Dade C.C.
Margaret Moore, Franklin University
Athanasius Njoku, Benedict College
Pierce Nolan, El Paso C.C.
Rheyburn Nolan, Tyler Junior College
Sam Parigi, Lamar University
Stephen Renas, Wright State University
Dorothy Sanford, College of Notre Dame
Basil Zimmer, Central Michigan University

Author Chisholm would like to give special thanks to his wife, Jean, and his three daughters, Margaret, Janet, and Elizabeth, who have now endured the preparation of two editions of this book.

Roger K. Chisholm
Marilu H. McCarty

Contents

PART 1

An Introduction to Economics 1

1 What Is Economics? 2

What Economists Do 2

EXTENDED EXAMPLE The Economics of
Housing 3

Economics as a Course of Study 4
Microeconomics and Macroeconomics

Economics as a Science 5
*The Scientific Method / Economic Models / Positive
and Normative Sciences / Try to Keep Cool / Some
Traps to Avoid*

ECONOMIC THINKERS The Model Builders 8

VIEWPOINT Economics and Politics 10

Criteria for Evaluating an Economic
System 12

VIEWPOINT Reverse Discrimination? 13

Issues We Face 14

Summary 14
Key Words and Phrases 14
Questions for Review 15

APPENDIX Using Graphs 16

*Time-Series Graphs / Functional Graphs / Key
Words and Phrases*

2 The Economic Problem 19

Managing in a World of Scarcity 20

Kinds of Resources 20
Land / Labor / Capital / Entrepreneurship

Production Possibilities 22

*Graphing Production / Opportunity Cost /
The Law of Increasing Costs / Unemployment of
Resources / Overemployment and Inflation /
Changes in Production Possibilities*

EXTENDED EXAMPLE Western Land Use Vs.
Waste 24

VIEWPOINT The Opportunity Costs of
R and D 28

Choosing Production 29
*Specialization / Guns Vs. Butter / Private Vs.
Public Consumption / Work Vs. Play*

How Is the Choice Made? 31
The Four Questions

Types of Economic Systems 33
*Traditional Economies / Command Economies /
Market Economies*

EXTENDED EXAMPLE To Work or Not to
Work 33

ECONOMIC THINKER Karl Marx 35

Summary 37
Key Words and Phrases 37
Questions for Review 38

3 The Free Market: Supply and Demand 39

The Market: Some Dimensions 39

Beginnings: Adam Smith 40

Demand 41
*Law of Demand / Graphing Demand / Changes in
Demand / Changes in Demand Vs. Changes in
Quantity Demanded*

Supply 44
*Law of Supply / Changes in Supply / Changes in
Supply Vs. Changes in Quantity Supplied*

Market Equilibrium	47
<i>Changes in Supply and Demand / Expectations Can Make It So / The Search for Equilibrium</i>	

EXTENDED EXAMPLE Markets for Commodities	50
--	----

Functions of the Price System	51
<i>The Rationing Function / The Incentive Function / What Goods Will Be Produced / How Goods Will Be Produced / Who Will Get the Output / When Goods Will Be Enjoyed</i>	

The Market System: Pros and Cons	53
<i>Advantages of the Market System / Disadvantages of the Market System</i>	

VIEWPOINT Should the Free Market Prevail?	54
---	----

Summary	55
Key Words and Phrases	55
Questions for Review	56

4 Government's Role in the Economy 58

Economic Functions of Government	59
<i>Protect Private Property / Regulate Money / Allocate Public Goods and Services / Assess Social Costs / Regulate and Maintain Competition / Promote Economic Stability / Fight Poverty / Eliminate Discrimination</i>	

VIEWPOINT Government and the Free Market	63
--	----

Levels of Government	64
----------------------	----

Government Outlays	65
<i>State and Local Government / Federal Government</i>	

Government Taxation Policies	68
<i>State and Local Government Taxation / Regressive Taxes and State and Local Government / Federal Government Taxation</i>	

Progressive Nature of Federal Income Taxes	71
<i>Disadvantages and Advantages of Progressive Taxes / Social Security Taxes</i>	

VIEWPOINT The Value-Added Tax	73
-------------------------------	----

Evaluating Our Tax Structure	74
------------------------------	----

Summary	75
Key Words and Phrases	75
Questions for Review	76

PART 2 National Income and Fiscal Policy 77

5 National Income Accounting 78

The Circular Flow	79
-------------------	----

Households	80
<i>Households as Buyers / Households as Sellers</i>	

Businesses	81
<i>Product Markets and Resource Markets / Money Flows and Real Flows</i>	

Additional Components of Circular Flow	83
<i>Saving and Investment / Government / International Trade</i>	

Flows and Stocks	85
------------------	----

Changes in the Circular Flow	85
<i>Short-Term Fluctuations / Growth and the Circular Flow</i>	

Measuring GNP Flows: An Overview	86
<i>Output Approach / Expenditures Approach / Income Approach</i>	

ECONOMIC THINKER Simon Kuznets	87
--------------------------------	----

Real and Money GNP	89
<i>The Price Index / The GNP Deflator</i>	

GNP from the Output Side	91
<i>The Business Sector / The Government Sector / The Household Sector / The Rest of the World / Summary: GNP by Sector of Origin</i>	

GNP from the Expenditures Side	94
<i>Personal Consumption Expenditures / Gross Private Domestic Investment / Government Purchases / Net Exports</i>	

GNP from the Income Side	95
<i>National Income / Nonincome Items / Related Income Accounts</i>	

GNP Counting Problems	97
<i>Avoid Double Counting / Things That Aren't Counted</i>	

EXTENDED EXAMPLE The Underground Economy	98
--	----

Shortcomings of GNP Accounting	99
<i>Statistical Difficulties / Welfare Measurement Difficulties / Externalities / Social Welfare Indicators / A Final Word on GNP Shortcomings</i>	

EXTENDED EXAMPLE My Wife, I Think I'll Keep Her	100
---	-----

ECONOMIC THINKER Wassily Leontief 103

Summary 103

Key Words and Phrases 104

Questions for Review 105

6 Business Cycles 107

Growth and Economic Stability 108

Economic Stability / Why the Economy Fluctuates

Business Cycle Problems 109

Inflation / Unemployment / What Unemployment Costs Us

Description of a Typical Cycle 112

Expansion / Peak / Slowdown and Decline / Trough / Recovery

VIEWPOINT Do Business Cycles Occur in a Planned Economy? 114

U.S. Business Cycles 115

The Early History / Post-World War II and the 1950s / The Boom of the 1960s / The 1970s

Theories of Business Cycles 119

Investment Cycles and the Accelerator / Inventory Cycles / Monetary Cycles / Short Waves and Long Waves / Political Business Cycles

Business Cycle Forecasting 122

ECONOMIC THINKER Nikolai Kondratieff 123

EXTENDED EXAMPLE Reading the Economic Tea Leaves 125

Summary 124

Key Words and Phrases 127

Questions for Review 127

7 Aggregate Demand 128

Theories of Aggregate Demand 129

Classical Theory / The Savings and Investment Problem / Keynesian Theory

ECONOMIC THINKER John Maynard Keynes 131

Sources of Aggregate Demand 132

Consumption (C) 132

Consumption Vs. Saving / Consumption and Income / Average Propensities to Consume and to Save / Marginal Propensities to Consume and to Save / The Consumption Function / Nonincome Determinants of Consumption / The Saving Function

Investment (I) 140

Determinants of Investment / Marginal Efficiency of Investment (MEI)

Government Demand (G) 145

Net Exports (X_n) 145

Summary 146

Key Words and Phrases 146

Questions for Review 147

8 Aggregate Supply and Equilibrium 148

A Keynesian Model 149

Balancing Aggregate Demand and Aggregate Supply / Saving-Investment Approach to Equilibrium

The Multiplier 154

Other Multipliers / The Paradox of Thrift

EXTENDED EXAMPLE Calculating the Multiplier 156

Equilibria: Good or Bad? 157

Full-Employment Equilibrium / Less Than Full-Employment Equilibrium (Recessionary Gap) / Inflationary Gap

Aggregate Supply and the Price Level 159

Aggregate Supply / The Full-Employment Level (Y^) / Explaining the AS Curve Shape / Shifts in the AS Curve / Aggregate Demand, Again / Equilibrium with Sticky Prices / Equilibrium at Full Employment / Equilibrium in the Curved Area / Equilibrium After an AS Shift*

Summary 168

Key Words and Phrases 169

Questions for Review 169

9 Fiscal Policy 170

The Federal Budget 171

The Budget Process / A Sample Budget

The Theory of Fiscal Policy 175

Government Expenditures / Taxation Policies / Spending and Taxing: A Synthesis / The Tax Multiplier / The Balanced Budget Multiplier

Budget Philosophies 180

Continuously Balanced Budget / Balance Over the Cycle / Fully Managed Budget / Full-Employment Budget

ECONOMIC THINKER Paul Samuelson 181

Automatic Stabilizers	182
The Public Debt	184
<i>Some Criticisms of the Public Debt / Advantages of the Public Debt</i>	
Additional Fiscal Policy Problems	187
<i>Mixed Goals / What to Do with a Surplus / What to Do with a Deficit / Four Problems in Using Fiscal Policy</i>	
EXTENDED EXAMPLE	Mr. Carter's \$50 Misunderstanding 189
EXTENDED EXAMPLE	The Politics of Budget Making 190
Summary	191
<i>Key Words and Phrases</i> 192	
<i>Questions for Review</i> 193	

PART 3 **Money, Banking, and Monetary Policy** 195

10 Money and the Banking System 196

Aspects of Money	196
<i>Primitive Societies: Life Without Money / Functions of Money</i>	
Demand for Money	198
<i>Transactions / Precautionary / Speculative</i>	
What Has Served as Money	199
<i>Commodity Money / Coins / Paper Money</i>	
Definitions of Money Today	201
<i>Currency / Demand Deposits / Narrow Money, M1A / Other Definitions of Money / A Final Word on Money Definitions</i>	
Commercial Banks and Money	203
ECONOMIC THINKER	John Law 204
The Federal Reserve System	206
<i>The Operation of the Federal Reserve System / What the Federal Reserve System Does</i>	
Summary	210
<i>Key Words and Phrases</i> 211	
<i>Questions for Review</i> 212	

11 Commercial Banks and the Creation of Money 213

Historical Development of Banking	213
Banks in the United States	215
<i>Bank Charters in the United States / The Federal Deposit Insurance Corporation</i>	
ECONOMIC THINKER	Nicholas Biddle 216
EXTENDED EXAMPLE	Bank Failure Without Panic 218
Current Issues in Banking	218
<i>Bank Expansion / Electronic Banking / Securities / Competition / Foreign Banking Interests</i>	
The Business of Commercial Banking	221
<i>The Balance Sheet of a Commercial Bank / Deposits / Loans / Other Commercial Banking Services</i>	
Commercial Banks and Money Creation	224
<i>Bank Reserves / Money Creation by a Single Bank / Multiple-Bank Deposit Expansion / The Deposit Expansion Multiplier / Other Limits on Actual Deposit Expansion</i>	
Summary	230
<i>Key Words and Phrases</i> 231	
<i>Questions for Review</i> 232	

12 Nonbank Financial Intermediaries 233

Thrift Institutions	234
<i>Savings and Loan Associations / Mutual Savings Banks / Credit Unions / Economic Impact of Mortgage Money</i>	
The Insurance Industry	239
<i>Background / The Economics of Insurance / Economic Impact of the Insurance Industry</i>	
The Securities Market	241
<i>Stocks / Bonds / Mutual Funds and Money Markets / How the Securities Market Operates / Regulation of the Securities Market / Futures Markets / The Economic Impact of the Securities Market</i>	
EXTENDED EXAMPLE	Buying Stock: What Are the Costs? 251
ECONOMIC THINKER	Charles Dow 254
EXTENDED EXAMPLE	The Uses of Futures Markets by Nonagricultural Firms 257
Summary	258
<i>Key Words and Phrases</i> 260	
<i>Questions for Review</i> 261	

13 Demand for Money 262

The Equation of Exchange 263

The Classical View 263

*The Equation of Exchange as Demand for Money /
The Interest Rate and the Equation of Exchange*

Keynes and the Demand for Money 265

*The Price of Securities / The Interest Rate and
Money Supply / The Interest Rate and an Increase
in the Money Supply / Velocity Once Again*

ECONOMIC THINKER Irving Fisher 266

The Demand for Money: The Monetarist
View 270

*The Demand for Money Balances / Money Demand,
Securities Prices, and Interest Rates / Other
Variables in Money Demand*

In Conclusion 275

*Classical (or Pre-Keynesian) / Keynesian /
Monetarist*

Summary 276

Key Words and Phrases 277

Questions for Review 277

14 Money Supply and Monetary Policy 278

Monetary Policy and $MV = PQ$ 279

*The Trough and Unemployment / The Peak and
Inflation*

Money Supply and the Federal Reserve 280

*Balance Sheet for the Federal Reserve / Monetary
Policy Activities and Goals*

Monetary Policy Tools: Quantitative
Controls 282

*Reserve Ratios / Discount Rate / Open Market
Operations*

EXTENDED EXAMPLE How the Open Market
Committee Changes Money Supply 285

Other Policy Tools: Qualitative
Controls 286

*Selective Credit Controls / Selective Interest
Controls / Moral Suasion*

EXTENDED EXAMPLE Selective Credit Controls in
Action 287

Evaluating Monetary Policy 290

*The Activist Arguments / The Nonactivist Argu-
ments / Monetarists: What Monetary Policy Cannot
Do / Rational Expectations / Some Final Questions
About Federal Reserve Policies*

ECONOMIC THINKERS Recent Chairmen of the
Federal Reserve Board 291

EXTENDED EXAMPLE The Fed Shoots at a
Moving Target 295

VIEWPOINT Money Vs. Credit 296

ECONOMIC THINKER Milton Friedman 298

Summary 302

Key Words and Phrases 303

Questions for Review 304

PART 4

Stabilization Policies and Growth

15 Inflation 306

Rate of Inflation 306

*Measuring the Inflation Rate / Creeping Inflation /
Double-Digit Inflation / Hyperinflation*

EXTENDED EXAMPLE The CPI: Some History and
Current Controversy 309

Types of Inflation 312

*Demand-Pull Inflation / Cost-Push Inflation /
Structural Inflation*

Causes of Inflation 314

*Demand-Pull Inflation / Cost-Push Inflation /
Structural Inflation*

Effects of Inflation 318

Redistribution of Income / Reduced Saving

VIEWPOINT Recent History of Inflation 319

Fighting Inflation 322

*Fighting Demand-Pull Inflation / Fighting Cost-
Push Inflation / Fighting Structural Inflation /
Supply-Management Policies / Combination of
Policies / Indexing*

EXTENDED EXAMPLE Inflation-Fighting in Great
Britain 326

VIEWPOINT Why Is Inflation So Hard to
Defeat? 330

Summary 333

Key Words and Phrases 333

Questions for Review 334

16 Unemployment 335

- The Problem of Unemployment 336
Types of Unemployment / Defining Unemployment
- The Labor Market 338
The Supply of Labor / The Demand for Labor / Equilibrium in the Labor Market
- Expectations and the Labor Market 341
- The Phillips Curve: The Big Tradeoff 342
Keynesians and the Phillips Curve / Monetarists and the Phillips Curve
- Economic Policy and Employment Problems 344
Unemployment and Fiscal Policy / Problems in Using Fiscal Policy / Unemployment and Monetary Policy / Employment Policy Dangers
- Current Problems 347
Structural Unemployment / Inflationary Recession / The Phillips Curve and Inflationary Recession / The Paradox of Growing Employment
- VIEWPOINT Structural Solutions to a Structural Problem 349
- Trends in Unemployment 351
High Unemployment Groups
- VIEWPOINT Unemployment Statistics Overestimate the Problem 353
- VIEWPOINT Unemployment Statistics Underestimate the Problem 355
- Summary 356
Key Words and Phrases 356
Questions for Review 357

17 The Theory of Growth 358

- Defining and Measuring Economic Growth 358
- Classical Theories of Growth 359
Adam Smith / David Ricardo / Thomas Malthus / Marx's Theory of Growth
- Neoclassical Theories of Growth 361
Technology and Savings / Business Cycles and Growth / The Theory of Secular Stagnation
- Full-Employment Growth 362
- Determinants of Economic Growth 363
Human Resources / Capital Accumulation / Advances in Technology / Division of Labor and Economy of Scale / Natural Resources / Economic Stability

- ECONOMIC THINKER David Ricardo 365
- EXTENDED EXAMPLE Economic Growth and the High Cost of Energy 367
- The Case for Economic Growth 369
- U.S. Growth History 369
U.S. Growth Compared
- The Case Against Economic Growth 371
Growth and Social Ills / Growth and the Quality of Life / Economic Growth and Population / Growth and Ecology
- ECONOMIC THINKER Thomas Malthus 373
- Summary 375
Key Words and Phrases 375
Questions for Review 376

18 Growth and Less Developed Countries 377

- Characteristics of Developing Nations 377
Poverty / Overpopulation and Lack of Human Capital / Lack of Capital / The Vicious Circle of Underdevelopment
- Barriers to Economic Growth 380
Population Problems / Employment and Human Resource Problems / Natural Resource Problems / Technological Problems / Social Capital Problems / Government and Economic Growth / The Problem of Capital Accumulation for Investment / Cultural and Political Problems
- EXTENDED EXAMPLE Oil and Ecuador 384
- EXTENDED EXAMPLE India: A Modest Success Story 386
- ECONOMIC THINKER Sir W. Arthur Lewis 388
- Foreign Investment in Developing Nations 389
Foreign Private Capital Investments / Foreign Government Investment
- EXTENDED EXAMPLE Turkey: Development Failed 392
- Stages of Economic Growth 394
Traditional Society / Preconditions for Growth / Takeoff / Drive to Maturity / High Mass Consumption / Decline and Fall
- In Conclusion 395
- Summary 396
Key Words and Phrases 396
Questions for Review 396

PART 5**International Economics 397****19 International Trade 398**

Beginnings of Trade 399

The Pure Theory of International Trade 399

Micro Aspects of International Trade 401

How Will International Trade Affect Price and Quantity? / What Are the Benefits of Specialization? / How Will International Trade Affect Incomes?

Macro Aspects of International Trade 403

National Income and Trade / The Foreign Trade Multiplier / Resource Allocation

Production Possibilities and Absolute Advantage 406

Comparing Productivity / The Principle of Absolute Advantage / Absolute Advantage of Individuals and Among Nations

Comparative Advantage 409

Opportunity Costs / Combined Production Possibilities / The Rate of Exchange on Traded Goods / Changing Terms of Trade and National Power

EXTENDED EXAMPLE Changing Terms of Trade 413

VIEWPOINT The North-South Dilemma 414

Summary 415

*Key Words and Phrases 416
Questions for Review 416***20 International Finance 417**

A Look at the Past 418

Mercantilism / Gold in International Trade

The Balance of Payments 419

The Balance on Current Account / The Capital Account / Official Settlement Transactions

EXTENDED EXAMPLE International Lending and Debt 422

International Trade Disequilibrium 425

Correcting Disequilibrium Through Flexible Exchange Rates / Correcting Disequilibrium Under the Gold Standard / Correcting Disequilibrium Through Devaluation

ECONOMIC THINKER Robert Triffin 428

EXTENDED EXAMPLE Exporting Monetary Policy 431

VIEWPOINT Problems with Floating Exchange Rates 433

Current Problems and Policies 434

Floating Currencies / Managed Floating / Optimum Currency Areas and the European Snake / Petrodollars and Balance of International Payments

EXTENDED EXAMPLE Dollars and Deficits 437

Summary 438

*Key Words and Phrases 439
Questions for Review 439***21 International Commercial Policies and Institutions 441**

Policies to Protect Domestic Industries 441

Tariffs / Other Barriers to Trade / Efforts to Eliminate Trade Restrictions / Trade and Long-Run Economic Growth

EXTENDED EXAMPLE Pressure for Protection 446

EXTENDED EXAMPLE Exporting Technology 449

EXTENDED EXAMPLE Responding to Import Competition 450

Institutions for International Cooperation 451

International Credit Organizations / Intraregional Trading Organizations

EXTENDED EXAMPLE Aid for Developing Nations 452

International Capital Movements 453

Eurodollars / Multinational Corporations

Summary 455

*Key Words and Phrases 455
Questions for Review 456***PART 6****Consumer Behavior and Elasticity 457****22 Consumer Demand and Utility 458**

The Demand for Goods and Services 459

Characteristics / Choice of Characteristics

The Utility of Goods and Services 460

Marginal Utility / Total Utility / Graphing Utility / Summing Up

Marginal Utility and Consumer Demand	463
<i>The Demand Curve / Using Marginal Utility of Money to Plot Demand</i>	
VIEWPOINT Precision and Utility Analysis	464
EXTENDED EXAMPLE Marginal Utility and Income Taxes	466
Marginal Utility and Consumer's Surplus	468
Using Marginal Utility: Some Applications	469
ECONOMIC THINKER William Stanley Jevons	470
Summary	471
Key Words and Phrases	471
Questions for Review	471

APPENDIX

Another Explanation of Consumer Demand: Indifference Curves 472

A Consumer's Indifference Schedule / Graphing a Consumer's Indifference Schedule / Characteristics of Indifference Curves / The Consumer's Budget / Drawing the Consumer's Demand Curve / Changes in a Consumer's Income / Other Types of Indifference Curves / The Consumer's Budget and Substitutes or Complements / Some Applications of Indifference Curve Analysis

23 Measuring and Using Elasticity of Demand 481

The Demand Curve Again	482
<i>The Substitution Effect / The Income Effect / Influence of Income and Substitution Effects</i>	
Elasticity of Demand	483
<i>The Interpretation of Elasticity / Special Kinds of Demand Curves</i>	
EXTENDED EXAMPLE Calculating Elasticity	484
Elasticity of Demand and a Firm's Revenue	487
<i>Total Revenue / Marginal Revenue / Changing Elasticity to Increase Total Revenue / Revenue Problems in Agriculture</i>	
EXTENDED EXAMPLE Elasticity and Parking Fees	487

Elasticity of Demand: Some Special Features	491
<i>What Determines Elasticity? / Income Elasticity of Demand / Cross Elasticity of Demand</i>	
EXTENDED EXAMPLE Monkey Business	492
EXTENDED EXAMPLE Loss Leaders in Retail Stores	494
EXTENDED EXAMPLE Cross Elasticity and the Law	496
Summary	495
Key Words and Phrases	496
Questions for Review	497

APPENDIX

Elasticity and Indifference Curves 498

Price Elasticity and the Price-Consumption Line / Income Elasticity and the Income-Consumption Line

24 Supply Elasticity and Government Policy 501

Supply Curves: A Review	501
Elasticity of Supply	502
<i>Perfect Inelasticity / Infinite Elasticity / Elastic and Inelastic Supply Curves</i>	
EXTENDED EXAMPLE Calculating Elasticity of Supply	503
What Determines Elasticity of Supply?	504
<i>Time / Technology / Expectations</i>	
EXTENDED EXAMPLE The Green Revolution	506
Market Equilibrium	507
Government in the Market	508
<i>Elasticity and Taxes / Specific and Ad Valorem Taxes / Who Pays the Tax? / Taxes and Disincentives / Subsidies</i>	
EXTENDED EXAMPLE Taxes on Imports: The Case of Oil	512
When Government Sets Prices	513
<i>Price Ceilings and Shortages / Price Floors and Surpluses / Price Fixing and Elasticity</i>	
VIEWPOINT Rent Control	514
Agriculture and Supply Elasticity	516
EXTENDED EXAMPLE Peanuts and Price Supports	517

EXTENDED EXAMPLE Trouble in Poland 519

Summary 518

Key Words and Phrases 520

Questions for Review 520

APPENDIX

Problems in Agriculture 521

PART 7

Costs of Production and Product Markets 527

25 Perfect Competition: Costs and Production Decisions in the Short Run 528

Businesses 528

The Business Hierarchy / Business Organization

VIEWPOINT Corporate Behavior 531

Perfect Competition 532

Four Basic Conditions / Putting the Conditions

Together / Demand Curves in Perfect Competition

Measuring Costs of Production 534

Accounting Costs: The Bottom Line / Economic

Costs: Efficient Resource Allocation / The Costs of College, Strawberries, and Other Things / Defining Profit

Resources in the Short Run 537

Production Decisions in the Short Run 537

Principle of Diminishing Marginal Product / Total, Marginal, and Average Product

EXTENDED EXAMPLE Decision Making at the Margin 538

Costs in the Short Run 541

Total Costs / Average or Unit Costs / Marginal Costs / Cost Data Summary

EXTENDED EXAMPLE Production Costs in the Food Industry 544

Profit Maximization in the Short Run 545

Costs, Revenue, and Profit / Average Cost and Average Revenue / Making Production Decisions at the Margin

Economic Profit and Short-Run

Decisions 549

Measuring Economic Profit / Losses in the Short Run / Shut-Down Point in the Short Run / Equilibrium in the Short Run

ECONOMIC THINKER Alfred Marshall 551

Business Accounting 552

The Income and Expense Statement / The Balance Sheet

Summary 554

Key Words and Phrases 555

Questions for Review 556

APPENDIX

Isoquants and Isocosts 557

Isoquants / Isocosts

26 Perfect Competition: Costs and Production Decisions in the Long Run 562

Long-Run Competitive Equilibrium 563

Plant Size and the Long Run 565

Economies of Large Scale / Diseconomies of Large Scale / Plant Size and Optimum Scale / The Long-Run Planning Curve

EXTENDED EXAMPLE The Bicycle Boom 566

EXTENDED EXAMPLE The End of the Short Run 569

Profit Maximization in the Long Run 570

How Realistic Is This View of the Long Run? / Competitive Equilibrium: A Standard of Efficiency / What Determines the Number of Firms?

EXTENDED EXAMPLE Market Changes in the Long Run 571

EXTENDED EXAMPLE Sugar Elasticity and the Long Run 573

Industry Growth and Changing Costs 574

External Economies in the Very Long Run / External Diseconomies in the Very Long Run / Social Economies and Diseconomies / Internalizing Externalities

EXTENDED EXAMPLE Franchises and Ray Kroc's Burger Stand 575

Summary 579

Key Words and Phrases 580

Questions for Review 580

APPENDIX

The Cobweb Theorem of Agricultural Prices 581

27 Monopoly 584

Efficiency and Equity 584

Defining Monopoly 585

Characteristics of Monopoly / Methods of Monopoly

ECONOMIC THINKER Thorstein Veblen 587

EXTENDED EXAMPLE Monopoly in Dolls 589

Decision Making by the Monopolist 590

The Monopolist's Demand Curve / The Monopolist's Cost Curves / Economic Profit for the Monopolist / Elasticity Again / Price Discrimination

EXTENDED EXAMPLE Shopping Malls and Monopoly 593

VIEWPOINT Do Monopolies Really Maximize Economic Profits? 595

Shortcomings of Monopoly 597

Inefficiency of Monopoly / Inequities of Monopoly

ECONOMIC THINKER Paul Sweezy 598

Government and Monopolies 599

Government Regulation of Monopolies / Regulated Prices / Subsidies / Government Monopolies

EXTENDED EXAMPLE Price Discrimination by a Regulated Monopoly 600

VIEWPOINT Regulation or Strangulation? 602

VIEWPOINT The U.S. Postal Service 604

Summary 605

Key Words and Phrases 606

Questions for Review 606

28 Imperfect Competition: Monopolistic Competition and Oligopoly 607

Monopolistic Competition 608

Demand Curves in Monopolistic Competition / Costs in Monopolistic Competition / Long-Run Equilibrium in Monopolistic Competition

ECONOMIC THINKER Joan Robinson 609

EXTENDED EXAMPLE How to Be Successful in Monopolistic Competition 610

Shortcomings of Monopolistic Competition 612

Efficiency / Equity

EXTENDED EXAMPLE Monopolistic Competition in Ladies' Apparel 613

Oligopoly 614

Price and Output in Oligopoly / Duopoly / Price Rigidity and Kinked Demand Curves / Price Leadership / Mark-Up Pricing / Cartels / The Payoff Matrix / Other Approaches to Pricing

EXTENDED EXAMPLE Oligopoly in Chips? 615

EXTENDED EXAMPLE Concentration in the Aluminum Industry 618

EXTENDED EXAMPLE The Rent-a-Car War 620

Nonprice Competition 621

Advertising / Trademarks / Differentiated and Undifferentiated Oligopoly / Positioning

EXTENDED EXAMPLE Advertising as a Factor of Production 622

EXTENDED EXAMPLE How Sacred Is a Trademark? 624

Pros and Cons of Oligopoly 625

Efficiency / Equity

Summary 626

Key Words and Phrases 626

Questions for Review 626

29 Market Power and Public Policy 628

Our Contradictory Attitudes 628

The First Great Merger Movement 629

Horizontal Mergers / Vertical Mergers / Holding Companies

Antimerger Legislation 631

The Sherman Antitrust Act / The Clayton Antitrust Act / The Federal Trade Commission

EXTENDED EXAMPLE Giant of the Steel Industry 632

The Second Great Merger Movement 634

The Great Depression Antitrust Action / Post-World War II Antitrust Activity

EXTENDED EXAMPLE Menace at the Breakfast Table 635

The Third Great Merger Movement 637

Conglomerate Mergers / The Goliaths / Attacking the Conglomerates / The Changing Philosophy of Antitrust