

Principles of Economics

Fourth Edition

Elbert V. Bowden



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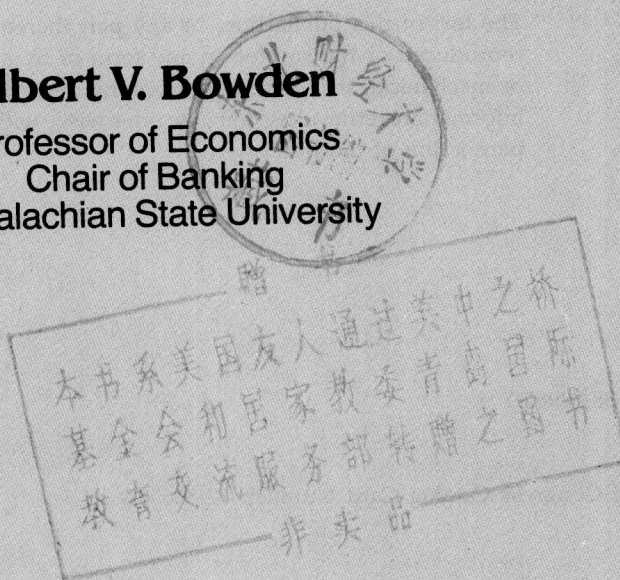
Principles of Economics

Theory • Problems • Policies

Fourth Edition

Elbert V. Bowden

Professor of Economics
Chair of Banking
Appalachian State University



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Preface

What's the purpose of a principles text? Should *efficiency* as a teaching-learning tool be one of the essential criteria? Should the principles text try to minimize the effort and frustration required to learn economics? I think so.

STUDENT-IDENTIFIED CHARACTERISTICS OF AN EXCELLENT ECONOMICS BOOK

What do students choose as the essential characteristics of *an excellent text in economics*? My students insist (and this is confirmed by student surveys elsewhere) that an outstanding economics book:

1. must be Easily Readable! Understandable!
2. must be Interesting! Not boring!

On these two criteria, all three of the previous editions of this book have scored higher than any other principles text. I'm especially happy about that because these were my primary objectives in writing the book.

But what about *the other desiderata*?—the *other characteristics* which students say are essential for an outstanding economics book? On some of those my previous editions have not scored as high. So what's my paramount objective in this Fourth Edition? Just this: *To try to make this book truly outstanding on each of the other student-identified characteristics of "excellence"*—while maintaining the previous standards of readability and interest.

What are these additional criteria? And how does this Fourth Edition respond to the need? All of that is explained in the following paragraphs.

Students say that an excellent economics text:

3. must be Current! Relevant!

- This Fourth Edition has an entirely new first chapter (Ch. 1, "Economic Principles and the Crisis Issues of the 1980s") which establishes *the reality and critical importance of economics* right at the start.
- New real-world examples have been introduced at several places throughout the text.
- There's an entirely new chapter (Ch. 17, "The Keynesian-Monetarist Debate, Rational Expectations, Supply-Side Economics, and Macro Policies for the 1980s") which explains and illustrates important macro issues and policies and some of the theoretical conflict among economists during the early 1980s.

Students say that an excellent economics text:

4. must have for each chapter a Clear, Understandable Statement of Objectives! and a Comprehensive Summary!

- In this Fourth Edition each chapter begins with a precise, easily understandable statement of objectives.
- Each chapter in this book ends with a "Summary and Synthesis"—a summary restatement and synthesis of all the key information in the chapter. It is, in fact, *a complete and self-contained abstract* of the chapter itself. I'm sure

that the addition of these "Summary and Synthesis" sections will add significantly to the efficiency of this book as a teaching-learning tool.

- The inclusion of these "Summary and Synthesis" sections has had the important side-effect benefit of permitting the elimination of intra-chapter summary statements and repetition. The exposition within the chapters now moves along more efficiently than before, and without any loss of readability.

An excellent economics text:

5. must have Clearly Explained Graphs! Easily Understandable!

- In this book, *all graphs* are clearly drawn—large, open, and easy to work with; and
- Each graph is *carefully and thoroughly explained* right on the page on which it's located.

An excellent economics text:

6. must have within each chapter Good Logical Organization! Frequent Headings! Headings which Say Something!

- In this Fourth Edition I have found many opportunities to improve chapter organization, to eliminate some unnecessary repetition, and to insert additional headings.
- Most headings in this Fourth Edition are designed to *say something*—e.g., "The Opportunity Cost Is the Opportunity Lost"; "Bonds Paying Lower Interest Sell for Lower Prices"; "Factor Prices Influence Production Techniques"; "The Key to Macroeconomics Is Total Spending"; etc., etc.

An excellent economics text:

7. must have Clear, Unmistakable Identification of the Key Points!

This Fourth Edition achieves this objective through the use of *six techniques*:

- Emphasis right in the beginning in the *chapter objectives*;
- Use of *frequent sub-headings* which state and/or emphasize key points;
- Use of *color, italics, and boldface type* to emphasize key words and phrases;

- Re-emphasis of all key points in the *chapter summary and synthesis*;
- Listing of all important principles, concepts and terms in the *end-of-chapter review exercises*; and finally
- Use of *cartoon characters* to make the very most important points *unforgettable*.

An excellent economics text:

8. must provide ample opportunity for Efficient Review! and Efficient Self-testing!

- In this book the review exercises at the end of each chapter cover all of the important *principles, concepts, terms and graphs* in the chapter. Also included are several *essay questions* designed to stimulate thought and discussion.
- The *Study Guide* which I have prepared to accompany this text contains in each chapter more than 60 questions—fill in, true-false, multiple choice, essay, graphs—together with answers to all questions—including the *essay questions*.

Very few textbook authors prepare their own study guide. Truly, *it's a chore*. But I have prepared the *Study Guide* to make sure that it's a "perfect pair" with the textbook—in *style, emphasis, interest, and readability*. The widespread use of the *Study Guide* (even sometimes with other texts!) attests to its usefulness and efficiency as a teaching/learning tool.

An excellent economics text:

- 9. must include an **Efficient Glossary!** The important terms must be explained for understanding, with no need to go to the dictionary or to look up other terms in order to understand.
 - This Fourth Edition contains a glossary—expanded, updated, and revised from the Third Edition—which I believe will thoroughly meet the student's requirements for *completeness, clarity, and efficiency*.
- An excellent economics text:
- 10. should have a **Complete and Efficient Index!**

- This Fourth Edition contains a thoroughly complete and highly efficient index. It now includes every term that any student may seek. And each term is referenced in as many different ways as any student might choose to look it up. (An index may be “a little thing.” But as all economic educators know, in learning economics, “little things can mean a lot.”)

Should an excellent economics text:

11. include some **Mathematical Applications**? Some easily understandable illustrations of the **Use of Equations** in economic analysis? Some introductory examples to generate an awareness of the **Power and Usefulness of Math** in economics?

People disagree on this. Some fear that the use of equations at the principles level will impede the learning of basic principles by many students. Others insist that some equations should be introduced in the principles course. So, what to do? Include some equations? or not?

- This Fourth Edition includes a brief mathematical appendix at the end of the book. It's there for those who desire it. And it's out of the way where it won't bother anyone who would rather not use it.
- The math appendix is written so that any student (math weaknesses notwithstanding) will be able to understand it and begin to appreciate the usefulness of math—the power of equations—in economic analysis. I believe this easily understandable math appendix can make a significant contribution by giving students an easy, pleasant introduction to this (often frightening) area.

THE EVOLUTION AND CONTENT OF THIS BOOK

This book started out more than a decade ago as a collection of mimeographed pages—handouts for my students—explanations my stu-

dents could understand. Now it's the Fourth Edition of a complete and conceptually rigorous principles text. It includes a sound and thorough treatment of economic principles, applications, problems, and policies.

Explanations Which Students Can Understand

Years have passed, but the original purpose of those mimeographed handouts has not changed. This book still consists of: *explanations which students can understand*. This book is based on a basic theory of economics: that people (including students) will try to be *efficient*—will try to achieve their objectives with minimum cost—in money, time, effort, frustration, whatever.

Recent studies have shown that the student's *concentration span* and *depth of comprehension* diminish rapidly as the readability level approaches the student's maximum comprehension level.* So an economics book from which students can learn *efficiently* must be written at a level at which the exposition itself is not frustrating to the average student.

Contains More Theory and Applications

This book reflects my philosophy that the principles of economics course provides the only

*See, for examples:

- John Guthrie, “Learnability versus Readability of Texts,” *The Journal of Educational Research*, vol. 65 (1972), pp. 273-79.
- Walter Kintsch, E. Kozminsky, William Streby, Gail McKoon, and Janet Keenan, “Comprehension and Recall of Text as a Function of Content Variables,” *Journal of Verbal Learning and Verbal Behavior*, vol. 14 (1975), pp. 196-214.
- Maurice Kurtzmann, “The Reading Ability of College Freshmen Compared to the Readability of Their Textbooks,” *Reading Improvement*, vol. 11 (1974), pp. 13-25.
- Carol M. Santa, and Joan N. Burstyn, “Complexity as an Impediment to Learning: A Study of Changes in Selected College Textbooks,” *Journal of Higher Education*, Vol. 48 (1977), pp. 508-518.

opportunity most students ever will have to acquire a functional understanding of economic principles and issues. Therefore this book contains more theory and application of theory than the “easy” principles books which recently have been appearing.

I think it’s unfortunate that the trend seems to be toward “easy economics by omission.” The approach of this book is: *easy economics by explanation and by the use of relevant examples and applications*—not by the omission or watering down of essential principles.

Easy Exposition Can Be Deceptive

Because of the intuitive approach of this book, the easy exposition, conversational style, and use of familiar down-to-earth examples, students will find this an easy book to read and understand. Some students may be deceived into thinking that learning economics is relatively easy and effortless.

Some students may read and understand and assume that’s the end of the learning process, when in fact it’s only the beginning. They may not discover their error until they get the results of their first exam.

The fact is that there’s more conceptual depth and rigor in this book than in most of its “apparently more formidable” competitors. But it takes a good economist to see that. Certainly the beginning principles student can’t be expected to be aware of it!

For a highly successful course, the instructor who uses this book will need to ensure that the students do more than just read and understand—that they take the time to work with and thoroughly learn the concepts and principles. Instructors may find it necessary to use frequent testing and/or written assignments. Students may find it necessary to use the *Study Guide* to practice with and to test themselves as they go along.

“Easily Understandable Economics Without Omission” Is Not Easy to Write

It is not easy to achieve the expository objectives set forth in this preface. Explain the complex principles of economics in such a way that no paragraph in the book approaches the frustration level of readability of the average college student? That requires repeated rewriting of the entire book, chapter by chapter, section by section, paragraph by paragraph.

Some economists might believe that the expository objectives of this book can’t be achieved without the loss of some of the rigor and precision which are the essence of sound economic theory. But I don’t think that’s true. I hope that anyone who is skeptical about this will look up one of the more difficult principles and see how it is treated in this book.

THE SUPPLEMENTS: ALL PREPARED BY THE AUTHOR

I have (personally) prepared all of the supplementary materials for this book: the *Study Guide* (mentioned previously), the *Instructor’s Manual*, and the *Test Bank*. Each of these has been significantly improved for this Fourth Edition.

The Instructor’s Manual. The instructor’s manual has been expanded. It now contains

- many specific suggestions (with alternatives) for planning and conducting a *highly successful principles course*.
- alternative course outlines* designed to meet the needs of a wide variety of alternative academic schedules, course objectives, and various other special circumstances.
- answers to all of the discussion questions in the text.

- additional essay questions for each chapter to be used in class discussion and/or for testing.
- a complete outline (including *all headings*) for each chapter in the text, to be used in preparing lectures and as a checklist during class discussions.
- transparency masters for the graphs in the text, to be used to prepare transparencies for the overhead projector.

The Test Bank: Expanded. Completely Revised. Computerized! For this Fourth Edition, all of the questions in the Third Edition *Test Bank* have been re-analyzed. I have rewritten many and replaced several. In addition, the total number of questions has been increased by 50%—from an average of 30 to 45 per chapter.

Now you can be *fully confident* that when you use the questions in this *Test Bank* you will have a testing instrument which is *efficient, fair, and reliable* for almost all students. (Unfortunately there are always a few students who will score unfairly low on M/C exams). Using these questions with my students the computer-scored reliability coefficients are *consistently* in the 80s—that's about as high as you could hope to get on this kind of a test, in moderate-sized classes.

The *computerized testing program* contains all of the questions in the *Test Bank*. It will be made available to all institutions where this textbook is adopted. *Now your computer can make up your multiple-choice exams for you!*

ACKNOWLEDGEMENTS

How does an author "fine tune" a textbook as it goes through its various editions? One thing is sure: It isn't something the author can do alone! It requires a lot of help from students, colleagues and friends.

There's hardly a sub-section in any chapter of this book which doesn't in some way reflect a helpful idea or suggestion from someone. Many have volunteered comments. Many more have helped by their thoughtful responses to questionnaires. And several of my former and present colleagues—at Texas A & M, SUNY-Fredonia, Duke, Appalachian—have read and offered helpful suggestions. Many of the new features in this Fourth Edition reflect the suggestions of students. To all of you I am sincerely grateful—for myself, and for the thousands of students who will have a better book because of your help.

There's one person who must be singled out and mentioned by name: Dr. Caroline Swartz, Department of Economics, Emory University. Dr. Swartz has worked with and assisted me throughout the preparation of this Fourth Edition. Her perceptive touch has had its good influence throughout the book—from the new Chapter 1 on "Crisis Issues" all the way to (and including) the new Math Appendix. For your excellent help Carol, thank you.

Also, my sincere appreciation to Katsuhiko (Ken) Otsuka for his tasteful and sensitive cartoon characters which enliven these pages, and to Marie-Louise van Laarschot Bowden (my wife) for her care and accuracy in drawing many new captions for the cartoons.

During the preparation of this edition and for each of the previous editions, I have been very lucky to have had the help of several outstanding secretaries. My sincere thanks to:

Margie Bailey (College Station, Texas);
 Mary Ann Burgess (Fredonia, N.Y.);
 Carolyn Champion (Boone, N.C.);
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 Candy Hall (Boone, N.C.);
 Rosemary Jones (Suva, Fiji);
 Dinah Lanning (Boone, N.C.).

It has been a privilege and a pleasure to work with each of you.

A FINAL WORD

No student is going to succeed in learning the principles of economics without considerable study and effort. It's a complex and demanding subject. And that's exactly the reason why, for most students, an easily comprehensible text is an essential part of a *successful* principles course.

This book is designed to carry its fair share of the burden of instruction. Students using this book will not find it necessary to rely on their instructor for detailed, repetitive explanations of everything. Less class time is required to generate functional understanding of the principles so more time is available for class discussion and

for the application of principles to current issues.

This book will maximize the efficiency of the student's study time and efforts (and minimize the student's frustration) in learning economics. Easy exposition can't make all of the principles of economics easy to learn. But it certainly can help.

Experience with the three previous editions has shown that many professors and a great many students appreciate this book's informal style and easily understandable exposition. I hope you'll find that this Fourth Edition succeeds as well on the other student-desired "characteristics of excellence." If you think so (or even if not!) I'd appreciate your comments.

Elbert V. Bowden
Professor of Economics
Chair of Banking
Appalachian State University
Boone, NC

To the Student: A Few Words of Advice

No professor and no textbook could ever *teach you* economics. All they can do is *help you to learn it*. Much of the learning process is *up to you*.

Understanding Is Only the First Step

If you study the chapters of the textbook and attend all classes, be carefully attentive, take good notes and study your notes, you will learn a lot of economics. *Maybe that's good enough for you.*

But consider this: *This textbook* has been carefully designed to be *easy to understand*. Usually as you read the text you won't have to struggle to get the meaning of a concept or principle. But *understanding is one thing. Learning it well is something else.*

Economics Is a Way of Thinking

Economics isn't a "kit of tools" which you can box up and carry along with you—or leave at home tucked away in the closet. No. *Economics is a way of thinking*. It's something that must be with you all the time. If you're a student of French, you haven't really learned French until you have learned to *think* in French. It's the same way with economics.

In some ways, *learning to think in economics* is easier than learning to think in French. You have been "thinking in economics" to some extent all your life.

But in other ways, learning to think in economics is more difficult than learning to think in

French. Sometimes *the concepts and principles of economics can be quite complex.*

This Textbook Is Deceptively Easy

This textbook is written in a style which explains the most difficult parts of economic theory in ways that you can easily understand. But, in a way, *the textbook is deceptively easy*. A careful reading of the text will give you the feeling that you understand a principle even though *you may have missed some of the subtle shades of meaning*. But when you begin to apply the principles and test yourself you'll find that *the precise meanings and distinctions are quite important—in fact, absolutely essential.*

Precise Understanding Requires Practice and Self-Testing

To really understand economic theory, you need to get it *all*. Not just a "general awareness" but *an accurate understanding of all of the precise distinctions*. It isn't likely that you will be able to do that without spending a lot of time *working with the principles and testing yourself*.

Only through *exercises and self-testing* will you develop the *precise understanding* which you must have if you're really going to learn economics. No matter how clearly you may understand the explanations in the text you still will need to do a lot of thinking and rethinking and self-testing before the principles become *a permanent part of your way of thinking* about economic issues.

The end-of-chapter review exercises give you a lot of opportunity for self-testing. Be sure that you can draw each graph and explain it to yourself without looking in the book. It's also a good idea to read each heading in the chapter and see if you can explain what that section is about. Also I have written a *Study Guide* (workbook) to go with this textbook.

There's a Wealth of Self-Testing Materials in the Study Guide

The *Study Guide* has a chapter corresponding to each chapter in the textbook. Each chapter in the *Study Guide* gives a further explanation of the objectives of the chapter, followed by further explanations of important concepts and principles. Then the remainder of each *Study Guide* chapter consists of a wealth of self-testing materials: fill-in, true/false, multiple choice, and essay questions, and exercises with graphs—more than 60 questions on each chapter.

The answers to all of the questions and exercises are given at the end of each chapter. The answers to the essay questions and graph explanations provide concise summary explanations of the most important concepts and principles in the chapter.

Many students find that the *Study Guide* is

the key to their success in learning economics. Perhaps you should go to your bookstore and take a look at it.

Study and Practice! Go For An A!

You've probably heard that economics is a tough subject. That's true—but only if you try to get through "the easy way." So do it the hard way!

Follow these suggestions: *Read and study and practice and self-test. Then do more of the same until you can do it all very well. And do all of this regularly. Don't let it slide until the exam is coming up. By that time, it's too late.*

Do It the Hard Way! It's Worth the Effort

I'm urging you to *do it the hard way*. If you take this advice, economics still will not be "easy." But it will not be confusing or frustrating, either. You'll understand it and it will have an important influence on your way of thinking. And on your life. Also, you'll probably make an A in the course. Isn't all that *enough reward to be worth the effort*? Think about it.

Prologue: Why Economics?

Why should anybody want to learn economics? Several reasons. There's a lot you just can't understand until you learn some economics. When you get to the end of this book you'll realize just how true that is.

And another thing. Learning economics is a good exercise in mental development. It leads to new ways of thinking about things. You don't understand what that means, yet, either. But soon you will.

You Can't Escape from Economics

Economics is everywhere. It's at work all the time, in everything. Once you learn to recognize it you can never escape from it.

When you're doing things or making things, cooking breakfast or washing your car, going places, studying math, playing basketball, using up your time and energy and money and things to do one thing or another—all those things involve economics. If economics is involved in everything, then how can you ever get away from economics? That's the point. You can't. You just can't.

Economics is involved in all the things you've been doing all your life. So how have you been able to get along all these years without knowing any economics? You haven't. The fact is, you know quite a lot of basic economics already. Everybody does.

You already know, right now, 40 or 50 or maybe 70 or 80 percent of the economics you will know when you get to the end of this book. But right now you don't call it "economics." You call it "common sense."

Economics Can Sharpen Your Common Sense

So should you study economics because it can expand and sharpen your common sense? Yes! You're going to be surprised how much it can do that. But it can do much more than that. It can let you see much more deeply into so many things that are going on around you.

This book starts with sharpening your own common sense—talking about how you solve your own personal "economic problem." Then it expands the horizon more and more until the first thing you know you'll be working with and understanding the "economic problem" from the point of view of the society, the nation, the entire world.

You're Always Facing an Economic Problem

I suppose you already know that when you're trying to decide if you'll save your money or spend it, you're facing an "economic problem." Or whether to pay your tuition or go to Ft. Lauderdale or someplace, that's an "economic problem" too.

But what about deciding whether to study math or play basketball? or cook breakfast or wash the car? an "economic problem" too? Sure. An economic problem is a problem of having to choose—like whether to have your cake or eat it.

When are you facing an economic problem? All the time! Every moment of every day of your life you're having to decide what to do with yourself—with your time and energy and

thoughts—and what to do with your possessions—your money and your things.

Right now you're reading this book. But there are a dozen other things you *might have* been doing right now. Right? Sure.

So many, many choices we all have! We're choosing all the time: to do this or that, to make this or that, to use up this or that, to save this or that. There's just no end to it! And now, already, just from reading this first couple of pages you can see your own personal "economic problem." It's your problem of choosing—of deciding what to do with all the different things available to you. That's *your* economic problem.

Does your family have an economic problem? Like who will wash the dishes or the car and who will get to use the car and who will get to spend how much of the money? Sure. What about your church? Your club? Any organization? Do they have an economic problem? Sure.

What about your city? Your local school board? The corner grocery? The burger drive-in? Your college? Do they have an economic problem too? a problem of deciding what to do with what they have? and of who will get to use how much of what? Of course they do.

Every Society Is Always Making Choices

What about the whole society? Does it face a problem of choosing? of deciding who will do what, who will get to have how much of what, which things to use up and which to save and all that? Of course it does!

It's pretty easy for you to see how you decided to spend your time right now, getting started in this book. It isn't so tough seeing how each person decides.

All of us think about the different things we might do and then we try to make the best choices from our own points of view. But what about the society? How does the society decide

what to do and what to make? and what to use up and what to save? and who will get to have how much of what?

Seeing how the society solves its economic problem is not obvious. Not unless you understand economics. That's one of the things you'll learn in the chapters coming up.

Society's Problems Are Economic Problems—and More Than That

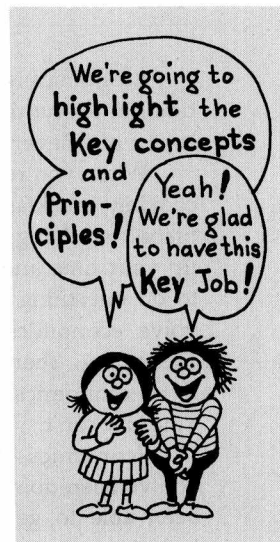
Every society has always faced problems. As times change the problems change, but some problems always seem to be there. These days people are concerned about the population problem and about environmental destruction.

Are problems of this sort economic problems? Yes. They're economic problems—but not just economic problems. They're economic problems and more than that.

All real-world problems—all the problems that face the human race—are economic problems. Sure. But they're more than that. You'll never find a real-world problem that isn't both an economic problem and more than an economic problem.

Pick any current problem you're concerned about: the crime rate, inadequate housing, drug abuse, unemployment, poverty—all economic problems? Yes. All economic problems and more than that.

What about the problem of international tensions? wars? rising prices? school integration? urban blight? Are these economic problems? Of course. Not *just* economic problems, but economic problems to be sure. *Economic problems and more than that.*



Without "Scientific Economics," Common Sense Can Mislead You

In many chapters throughout this book you'll be reading about real-world problems. When you do, you'll learn to see each of the problems in a new and different light. Each problem will be more clear to you than ever before. That's one of the important reasons why it's a good idea to study economics.

The study of economics is going to let you

really understand many things that will concern you all your life—things which your common sense alone couldn't explain. Sometimes your common sense might even mislead you! There are so many things a person really can't understand without some "scientific-knowledge" of economics.

If the study of economics is so important, then it's worth some effort. Right? But what if it would turn out to be fun too? Impossible you say? Not at all. Just you wait and see.

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