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Macro- Economics

W.H. LOCKE ANDERSON · ANN PUTALLAZ · WILLIAM G. SHEPHERD

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◀ University of Michigan ▶

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Macroeconomics

Preface

Teachers know, and their students soon learn, that economics is an evolving field. Yet the basic concepts are relatively stable. In this book we present those concepts, as they are shared and used by economists. We try to convey both the simple beauty of economic logic and the complex variety of its practical uses in the world.

Economics is exciting and important, but parts of it can also be puzzling and genuinely difficult to master. Some students approach economics as a duty: a hard subject that's sure to be dull and not very rewarding. Yet economists know it instead as a fascinating field, which can clarify an astonishing range of topics with a few tools.

To help students advance from reluctance to enjoyment, we present logic, facts, policies, and other materials both in good balance and in an effective sequence. We stress *logic* because economics is above all a connected set of logical concepts and hypotheses. But logic alone is not enough. We must also emphasize

the *matters of degree*, which good economists learn to judge carefully. Logic and degree—hypotheses and facts—are a two-sided theme for students to watch as they learn both to grasp the tools and to evaluate real conditions.

Beyond that, we have another paired goal for students: first, to learn economics as it is, but also to acquire a healthy skepticism about economists' work and advice. Because economics is a human creation, it involves human errors and contradictions. By learning this, students come to understand that economic knowledge always has gaps and soft spots as it evolves, and that it cannot accomplish all—or even half—of the tasks we ask of it.

This sort of sympathetic realism need not undercut students' motives to learn the analysis. Instead, by gently dispelling students' hopes of finding something that is infallible, it encourages them to take a sensible view of the whole world. This demystifying process can in turn make it easier to learn.

Students often resist this balanced treatment, asking instead just to be told what material they "have to learn." We think that all students can learn both the basic ideas and the economist's skeptical, independent-minded approach. That is the spirit which we have tried to convey.

The text We have labored long to make this book short. Despite its substantial size, the volume is a compact presentation of principles and examples. Every line reflects difficult choices we have had to make about depth and detail. Our choices have been guided by three main goals. The first is to be *clear*, using plain English concisely. The second is to be *complete* on technical analysis, making sure that the prose is thorough, step by step. The third is to give sufficient *variety* of "real" illustrations and cases, showing readers the important practical uses of the concepts.

The format The order of topics has been carefully chosen to provide a progression from basic concepts to more advanced issues. The chapters proceed generally from fundamental analysis to more complex, applied, and policy-oriented issues. The whole sequence of topics allows for flexibility in emphasizing some topics or omitting others, even among sections within chapters.

Distinctive features Apart from its whole approach, we have built into the book a number of special features, large and small, including the following: Chapters 1 to 3 provide a thorough foundation of concepts and methods, rather than just an introduction. Special features beyond the standard topics include:

Chapter 1 Economic goals. The economic literature and the development of economics. The economist's approach.

Chapter 2 Microeconomic principles (opportunity cost, marginal conditions, diminishing marginal effect, scarcity, equilibrium, public choice). Macroeconomic principles.

Chapter 3 The linkage of diagrams, hypotheses, and models. Organizing and presenting data. Stocks and flows.

Chapter 4 A focus on supply and demand concepts. Thorough treatment of elasticity.

Chapters 5–16 survey macroeconomic and monetary analysis. They contain a thorough, careful exposition of the standard theoretical tools, extensive historical instances of their application, and numerous unique features.

Chapter 5 Trends in output and prices. Fluctuations in employment. The growing federal government

share. Stock prices and the business cycle. The pervasiveness of cyclical fluctuations.

Chapter 6 Visualizing the economic system as a whole. National accounts. Value added, final demand, and gross national income. How the input-output structure ties industries together. Sectoral receipts and expenditures. Price indexes and real output.

Chapter 7 The consumption function. Planned and unplanned investment. Business saving. Equilibrium in a two-sector economy. How the government and foreign sectors fit in.

Chapter 8 The multiplier as theorem, process, and number. Expansion and contraction in a two-sector economy. The four-sector economy. Limits, uses, and misuses of the multiplier.

Chapter 9 Cost push, input prices, and productivity. Final demand, GNP, and input markets. The Phillips curve. Persistent inflation. Expectations. The shifting Phillips curve. (The role of money in the inflationary process is deferred to Chapter 12.)

Chapter 10 An introduction to money and monetary institutions. Definitions of money. Financial assets. Commercial banks, thrift institutions, and security markets. The flow of funds.

Chapter 11 The creation of bank money. The Federal Reserve and the banking system under the 1980 banking law. Assets and liabilities of the Fed and the banking system. How banks expand and contract the money supply. Open market operations and their impact on the monetary base. Reserve requirements. Federal Reserve lending.

Chapter 12 The level and structure of interest rates. How interest rates affect the velocity of money. The equilibrium interest rate. How the Fed influences

interest rates. Interest rates and final demand. The monetary feedback. The Keynesian-monetarist debate in detail. Money and inflation. The real rate of interest. Is money neutral?

Chapter 13 The institutional framework of stabilization policy. Potential GNP, the gap, unemployment, and inflation. Costs of falling short of potential. Costs of exceeding potential. Persistent inflation again. Indexing. Direct controls. Strategies of stabilization policy: rules versus discretion.

Chapter 14 Fiscal and monetary policy in action. The federal budget. Built-in stabilizers. Interpreting the federal deficit. The national debt: Who owns it? The burden of the debt. How monetary policy is conducted. Controlling the money supply versus controlling interest rates. Policy coordination and conflict.

Chapter 15 The history of stabilization policy under the Kennedy, Johnson, Nixon, Ford, Carter, and Reagan administrations, with particular emphasis on the relative impacts of fiscal and monetary changes.

Chapter 16 An historical approach to American economic growth. Demographic changes and their effects on growth. Capital accumulation and technical change. Agriculture and industry.

Chapters 17–19 turn outward. They cover the theory and practice of international trade and finance, and the problems of Third World development in a world dominated by developed countries.

Chapter 17 Comparative advantage. The gains from trade and their relationship to demand. The pattern of world trade. Protectionism: tariffs and quotas. The case for protection. Export

restrictions. The OPEC cartel. Recent U.S. trade history. Comparative advantage and the pattern of U.S. trade.

Chapter 18 International exchange markets. The balance of payments: current and capital accounts. Determination of exchange rates in the current institutional context. The gold standard and the Bretton Woods system versus the system of floating exchange rates.

Chapter 19 What is economic life like in the Third World? Contrast between the Third and First Worlds. Why is the Third World underdeveloped? Capital, population, education, subsistence agriculture, colonial history. Underdevelopment and international trade. Specialization in primary products. Development strategy. Import substitution versus export promotion. The question of foreign aid.

Throughout much of the world, economics is predominantly Marxist. Chapter 20 presents some of the main elements of the Marxist critique of capitalism. Chapter 21 describes Marxist economic practice in the Soviet Union and China.

Chapter 20 Value and surplus value. The origin of the surplus. Transformation of the surplus into capital. Forces and relations of production. The class structure of capitalism. The reserve army. Capitalist crises. Contradictions and the collapse of capitalism.

Chapter 21 The Russian Revolution. Early failures and successes of socialism. Stalinism, collectivization, and forced industrialization. The structure of the modern Soviet economy. Planning and efficiency. Is Russia socialist? The Chinese Revolution. Reconstruction. The Great Leap. Transformation of the forces of production versus

transformation of the relations. The Cultural Revolution. The future of China.

Throughout, there are “boxes” presenting unusual topics, special cases, or extended discussions. Also, each concept is printed in boldface type when it is first presented, and definitions of the concepts are gathered in a glossary at the back of the book.

Teaching aids Each chapter begins and ends with a brief summary of its main points. End materials also include a list of key concepts in the chapter, plus questions for review.

To complement this textbook, there is a set of additional materials: The *Study Guide* (which, along with the test bank, was written by Ann Putallaz with the assistance of Therese Mendola) is designed to help students identify and resolve areas of confusion, and to develop their ability to apply theoretical concepts in solving problems. For each chapter, true-false and multiple choice questions and applied problems are presented. The questions focus on concepts with which students frequently have difficulty. Detailed explanations of answers to the questions are provided to ensure that students do not answer a question correctly without understanding why it is correct, and that they are not unduly frustrated by having answered a question incorrectly and not knowing why. The problems help students learn to apply theoretical concepts correctly. Students who work with the study guide will be able to identify sources of confusion, and can build confidence in their ability to apply the material through problem solving. Throughout, an attempt is made to keep students’ attention focused on core material, and to encourage them to feel at ease with the subject matter.

The *Test Bank* (available only to in-

structors) contains multiple choice questions for each chapter. The questions vary considerably in difficulty. Within each chapter, questions are generally arranged sequentially according to the location of the relevant material in the text. Frequently, more than one question is available for a given topic to allow instructors flexibility in designing tests. The test bank is stored in a computer file so that the publisher can provide instructors with individually tailored semester exams. The procedure for ordering these exams is described in the introduction to the *Test Item File*.

The *Instructor's Manual* (prepared by the authors and available only to instructors) is written with the needs of the instructor in mind. It emphasizes the goals of the text, chapter by chapter, and calls the instructor's attention to crucial concepts and diagrams and to areas that students may find particularly difficult. It also gives answers to selected review questions that appear at the end of the text chapters.

A *Transparency Package* containing the most important analytical diagrams is also available from Prentice-Hall.

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Finally, our children have sacrificed to make this book possible, by doing without our attention from time to time. We thank them, too, with hopes that they will some day learn from reading it for themselves.

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