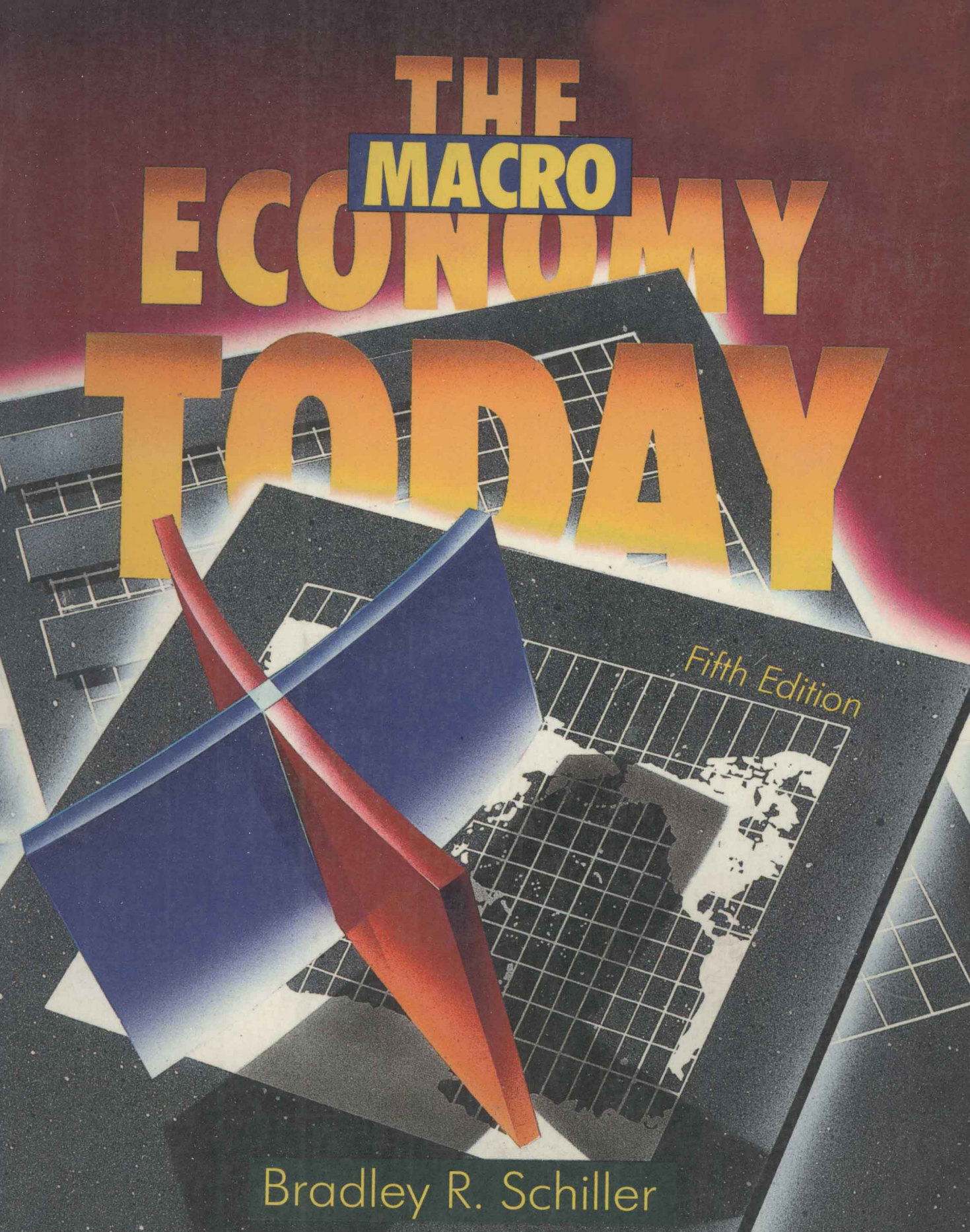


THE **MACRO** ECONOMY TODAY

The background of the cover features a complex, abstract geometric design. It consists of several overlapping, semi-transparent planes in shades of blue, red, and black. A white grid pattern is visible on some of these planes, particularly on the one that also contains a map of the United States. The overall effect is a sense of depth and modernity, with a color palette dominated by deep reds, blues, and oranges.

Fifth Edition

Bradley R. Schiller



THE MACRO ECONOMY TODAY

Fifth Edition

Bradley R. Schiller
The American University

McGraw-Hill, Inc.

New York St. Louis San Francisco Auckland Bogotá Caracas Hamburg
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THE MACRO ECONOMY TODAY

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P R E F A C E

The economy today doesn't stand still. Within a year of publication of *The Macro Economy Today's* fourth edition, the foundations of communism began to tremble. By the time most students got to the chapter on socialist planning, central planners were looking for new jobs. And teachers of introductory economics were looking for new textbooks. Today's students want explanations for the collapse of communism. They are newly motivated to understand how the "invisible hand" of the marketplace works and why central planners look with envy at its efficiency. This changing world requires a new approach to economics, going "back to basics" and highlighting the comparative appeal of free markets.

The collapse of communism was not the only headline story of recent years. The financial markets have also figured prominently in the news. First there was the crash of 1987. Then came the tremor of October 13, 1989, which sent the Dow Jones Industrial Average plunging 190 points. In 1990 the Japanese stock market also took a tumble, dropping more than 40 percent. Continuing volatility along with insider trading scandals raise basic concerns about the stability and integrity of all financial markets. The growth of the financial services sector, together with the central role of financial markets in allocating resources, makes these concerns important *economic* issues that can no longer be ignored in a principles course.

The Iraqi invasion of Kuwait in August 1990 also pushed oil prices onto the front pages. Higher oil prices, it was feared, might slow world growth and even cause economic recessions in the United States and elsewhere. Reacting to such fears, the Dow Jones Industrial Average fell by 25 percent in two short months. The "oil crisis" also awakened student interest in how supply-side shocks alter macro outcomes.

This fifth edition of *The Macro Economy Today* responds fully to these challenges. Both the appeal and the shortcomings of central planning are vividly assessed in a new chapter on the collapse of communism. Market and command economies are compared throughout the text, in areas as diverse as commodity pricing, money convertibility, and trade. These perspectives are reinforced with a basic issue that recurs through the entire text, namely, the alternate risks of *market failure* and *government failure*. This same theme is apparent in the new chapter on financial markets, which focuses on the economic functions of stock, bond, and futures markets.

The Macro Economy Today doesn't just follow the headlines. Pedagogy changes as well. We all try to make every lecture a little better, every test a bit more discriminating. The fifth edition strives for the same kinds of improvement. *The Macro Economy Today* seeks to make the study of economics as dynamic and exciting as the world economy itself.

PRODUCT DIFFERENTIATION

What most clearly differentiates *The Macro Economy Today* from other texts are the following features.

Global Vision To understand economics today, students must learn to think in global terms. In *The Macro Economy Today* this global vision is manifest in

World views Interspersed throughout the text are boxed illustrations of economic issues in a global setting. Many of the World Views offer comparative perspectives on key economic indices (e.g., debt, GNP growth, labor productivity). Others provide current or historical illustrations of core ideas (e.g., the role of markets in financing Columbus's voyages, the role of central planning in creating a shortage of soap in the Soviet Union). All World View boxes have a distinctive logo and light blue background (e.g., see p. 17) and are explicitly referenced in the body of the text.

Global macro Chapter 18 provides an opportunity to introduce students to the realities of internationalized economics, without the necessity of first studying trade and finance theory. This “one-stop shopping” innovation has proven to be particularly valuable to instructors who are pressed for course time but want to offer some global insights in the macro sequence. This policy-oriented chapter can also be used as a capstone to the more traditional (and extended) sequence of trade theory (Chapter 20) and international finance (Chapter 21).

Real-World Relevance The global vision of *The Macro Economy Today* is an integral part of the “real world.” In addition to international illustrations, the relevance of economic principles is demonstrated through examples of today's policy debates, current institutional structures, and real firms and industries.

Actual case studies Fanciful stories about widget production won't motivate students who are mastering high-tech and wondering how software prices are determined; the real-life applications of economic principles featured in *The Macro Economy Today* will. Chapters 1 and 10 examine the dimensions of the elusive Peace Dividend created by the end of the Cold War. Chapter 11 discusses the continuing struggle to narrow the U.S. budget deficit. And Chapter 17, Theory and Reality, offers students a meat-and-potatoes explanation of why economic performance doesn't always measure up to the expectations of economic theory. Every chapter of *The Macro Economy Today* conveys the conviction that economic principles are important and relevant to what's happening in the world today.

In the news This second set of boxes has its own distinctive logo and design; thus each box is instantly distinguished from World Views and the body of the text (e.g., see p. 4). The purpose of these brief news stories is to illustrate specific principles while underscoring the real-world relevance of economic theory. In the News applications are explicitly referenced in the body of the text and are often the subject of questions at the end of a chapter or in the accompanying *Study Guide*. In the brief period between the last edition and this, nearly half of the In the News and World View boxes were replaced or updated.

Policy insights Every chapter in the theory sequence includes a final section on Policy Insights. These sections, identified by a distinctive red banner, apply basic principles to actual policy issues. These applications test student ability to think critically about the relevance and validity of economic concepts.

Hot Issues Given the real-world orientation of this text, readers can expect the most widely discussed issues of the 1990s to command substantial attention. They won't be disappointed. Among the "hot issues" are

The collapse of communism The emerging transition from "command-driven" to "demand-driven" economies in Eastern Europe, the Soviet Union, and China is the most significant economic event of the 1990s. Two years ago this cataclysmic change was unforeseen; today everyone is trying to explain it. *The Macro Economy Today* offers a new chapter that looks at the promise of communism, the defects of central planning, and the continuing difficulties of the transition to freer markets. Chapter 23 explains these revolutionary changes succinctly and contrasts market and centrally planned economies perceptively. Many instructors may want to assign this chapter immediately after Chapter 2, thereby highlighting the unique (but often mysterious) character of the market mechanism.

Discussion of the collapse of communism is not confined to Chapter 23. The contrast of East German prices and West German prices at the time the Berlin Wall was dismantled introduces the basics of supply and demand (Chapter 2). The resultant shifts in the demand and supply of Deutsche marks and Ostmarks are a good starting point for consideration of foreign-exchange markets (Chapter 21).

The cold war peace dividend The collapse of communism has led to a worldwide reassessment of the "guns vs. butter" decision. As the cold war dwindles, demands for a military build-down intensify. The resulting "peace dividend" will create unparalleled opportunities for new investment, consumption, or other (nonmilitary) public-sector activity. David Wyss of Data Resources, Inc., developed expressly for *The Macro Economy Today* some illustrative estimates of the actual terms of the guns vs. butter tradeoff (see p. 7).

Financial markets One of the fastest growing sectors of the global economy is financial services. Yet introductory courses, following the cursory descriptions of corporate structure, stock market averages, and stock market quotations of other textbooks, have largely ignored this industry. *The Macro Economy Today* offers a more compelling alternative. Chapter 19 emphasizes the basic *economic* functions of the financial markets in mobilizing and allocating real resources. Illustrations include the financing of Columbus's exploration, the new EuroDisney World outside of Paris, and the new interest expressed in the Soviet Union and Eastern Europe in this fundamental tool of capitalism.

The oil crisis The Iraqi invasion of Kuwait sent world oil prices skyward. This sudden price hike rekindled fears of stagflation. Chapter 18 reviews the nature of such "oil shocks" in the context of aggregate supply and demand shifts.

Government failure vs. market failure At the core of most policy debates is the question of market failure. If unregulated markets always generated the

optimal mix of output, full employment, and an equitable distribution of income, there would be no need for government intervention. In reality, of course, markets do fail and the government is called upon to move the economy closer to desired outcomes.

But does government intervention succeed? Does intervention move us closer to the optimal mix of output or the optimal distribution of income? If not, government intervention fails as well. In the real world, the choice is not between imperfect markets and perfect intervention, but between imperfect markets and imperfect policies. The nature and cost of these real-world choices is a unifying theme throughout *The Macro Economy Today*.

Balanced Macro Theory

The *Macro Economy Today* offers no simple answers. Indeed, a familiar lament of students who read this text is that they don't know which theory is the correct one. This is particularly evident in macro, where students are exposed to the competing advice of Keynesians, Monetarists, Supply-siders, and the new breed of Rational Expectationists. Rather than try to "sell" one of these theories, *The Macro Economy Today* presents and discusses each of these perspectives. Students are introduced to the controversies of economic theory and policy at the outset. They are also shown how the different schools of thought would respond to specific policy questions. In this way, students gain not only a sense of major theoretical debates, but also an appreciation for conflicting policy advice. This is part and parcel of critical thinking.

This macro balance is first evident in Chapter 5, where competing explanations of the business cycle are introduced. In Chapter 14, separate sections are provided for Keynesian and monetarist views of monetary policy. Tables 14.1 and 14.2 offer explicit, contrasting interpretations of both fiscal and monetary policy. A graphical contrast of fiscal, monetary, and supply-side perspectives is offered in Chapter 15. Finally, Chapter 17 provides a roster of competing theories (p. 432) and their differing prescriptions for our economic ills (pp. 410–417). This capsule summary is an excellent review tool.

Careful Pedagogy

Economic principles were put to use in designing *The Macro Economy Today*. The opportunity cost of trying to cover everything was crystal clear. Encyclopedic texts leave the average student floundering. The choice made here was to cover less material but cover it thoroughly. The emphasis is on step-by-step development of core concepts, with a generous dose of real-world illustrations.

The emphasis on *teaching* basic principles is evident in an assortment of pedagogical features, including

- **Clear Graphs** All of the graphs are clearly labeled, fully annotated, and highlighted with colors. The time dimension is always included when *flows* are being examined.
- **Annotated Tables** This shouldn't be a differentiating feature but it still is. All of the tables in *The Macro Economy Today* include self-contained explanations.
- **Running and Repeated Glossary** Most other texts have now adopted *The Macro Economy Today*'s pioneering in-margin glossary. This remains, however, the only text that *repeats* in-margin definitions in subsequent chapters. Unfortunately, few people grasp and retain core concepts after only one exposure. *The Macro Economy Today* recognizes this real-world limitation

and offers students some additional support. Learning and retention are further encouraged by end-of-chapter key-term reviews and a complete glossary (with chapter references) at the end of the book.

- **Motivating Questions** Every chapter starts out with a few questions to pique student interest. A brief introduction highlights the general coverage of the chapter. This is followed by key questions, which forge a direct link between the introductory illustration and the core objectives of the chapter.

Lively Style Pedagogy is more than just technique and organization. Style is also important. Dull writing dulls the learning process. The *motivation* to learn must be reinforced with interesting examples, sharp wit, and clever phrases. This isn't a novel, but it is a very readable economics text—students actually *enjoy* it.

MACRO HIGHLIGHTS

There are several important changes in the macro portion of this fifth edition. Among these are

Unifying Model of Aggregate Supply and Demand A new diagrammatic summary of the macro economy has been introduced as a unifying framework for the entire macro sequence. An overview of the model—depicting the major determinants, mechanisms, and outcomes of the macro economy—is introduced in Chapter 5 (see figure on p. 109). This diagram is then used with appropriate color highlighting to introduce each part of the macro sequence. Notice in the figure on p. 181, for example, how the Keynesian focus on aggregate demand, fiscal policy, and jobs and output is highlighted. The accompanying annotation gives students a sense of how the subsequent four chapters relate to the general model. Similar introductions are provided for monetary policy, supply-side approaches, policy issues, and international economics. These unifying diagrams should help students see how all the pieces of the macro puzzle fit together.

A succinct overview A riveting account of the Great Depression introduces students to the business cycle—the core concern of macro theory. Chapter 5 also provides “previews” of macro policy options and the theoretical controversies about their use. Separate chapters on unemployment (Chapter 6) and inflation (Chapter 7) can be used either at the outset of the course or later. These chapters are designed to increase student awareness of why unemployment and inflation are major policy concerns; explanations for these macro ills are contained in the theory sequences.

Repositioning of debt and deficits The chapter on debt and deficits has now been placed immediately after the discussion of fiscal policy (Chapter 10). This facilitates a more complete discussion of budget policy while providing a smoother transition to monetary issues. This chapter still traces the origins of the national debt, examines its current dimensions, and assesses its real costs. The Policy Insights section assesses the nature and appropriateness of debt- and deficit-limitation legislation.

Short-vs. long-run aggregate supply More space is devoted in this edition to the nature and position of the aggregate supply curve. The distinction between short- and long-run aggregate supply is made in Chapter 5. The

“eclectic” aggregate supply curve—an amalgam of Keynesian, monetarist, and supply-side perspectives—is also introduced at the outset as a practical reconciliation of competing views. Chapter 16, Economic Growth, now immediately follows the supply-side chapter and is more closely integrated with it.

Capstone chapter on theory vs. reality Students never fail to recognize that the world doesn’t work nearly so well as theory. Indeed, they often raise the question “If economic theory is so good, why is the economy so messed up?” There’s usually an unstated implication that our theories are wrong, or worse still, irrelevant.

Chapter 17 addresses the apparent gap between theory and reality. It starts with a summary of the major macro theories and a review of their potential use in different economic settings (recession, inflation, stagflation). Then the discussion turns to real-world impediments, including measurement, design, and implementation problems. The message of this chapter is there is no *ceteris paribus* in the real world—economic policy is not as easy as economic theory often seems. The chapter deals with a discussion of policy expectations and the Bush administration’s emphasis on policy credibility.

A global perspective The global vision of *The Macro Economy Today* has already been noted. Some further explanation of Chapter 18, Global Macro, is called for, however. This chapter was expressly written for instructors who want to cover some international topics in macro but don’t have time for chapter-length treatments of trade theory and finance theory. Chapter 18 offers a shortcut. This is a self-contained explanation of how international markets impinge on macro policy (and vice versa). The chapter may be used as the only discussion of global macro, without first mastering trade and finance theories, or used as a capstone to the traditional trade and finance sequence.

INTERNATIONAL HIGHLIGHTS

The global vision that epitomizes *The Macro Economy Today* is apparent throughout the text. The final four chapters, however, focus exclusively on international topics. In this revision, highlights for these chapters include

United States as a net debtor In 1987 the international position of the United States was reversed, making this country a net debtor in the world economy. This change in investment flows has been accompanied by increasing anxiety over foreign investments in the United States. Indeed, in a recent Harris poll for *Business Week*, two out of three Americans said they expected foreign companies to dominate the American economy in the 1990s. These concerns are addressed in Chapter 20 and 21. In addition to developing and illustrating basic trade and finance theories, these chapters discuss the competing interests that seek to alter trade and finance outcomes.

Eastern Europe and Third World development The consequences of slow growth became apparent when the Iron Curtain was dismantled. Like the Third World, the countries of Eastern and Central Europe are desperately seeking mechanisms that will accelerate growth. Although Eastern Europe enjoys much higher living standards than the Third World, both groups of nations face common obstacles (e.g., bloated state enterprises, weak currencies, consumer subsidies, and high debt). Chapter 22 examines these common growth barriers and alternative strategies for overcoming them.

Collapse of Communism The final chapter provides a cautious, analytical assessment of the revolutionary changes taking place in the Eastern bloc. In addition to spotlighting the defects of central planning, Chapter 23 emphasizes the political, social, and economic forces that are setting the pace of transition. Examples are drawn from Eastern Europe, the Soviet Union, China, and Cuba. The chapter was designed for use either as a capstone to the macro sequence or, alternatively, as an earlier contrast to the robustness of the market mechanism (e.g., after Chapter 2).

PEDAGOGICAL HIGHLIGHTS

The fifth edition of *The Macro Economy Today* is a bit more rigorous than earlier editions. This added rigor has been made possible by the deletion or consolidation of secondary topics, with more space devoted to the development of basic principles. Revisions to the pedagogy include

- **Chapter-Opening Questions** As noted earlier, every chapter now starts with questions designed to guide and stimulate the learning process.
- **More End-of-Chapter Problems** Additional numerical problems have been included, giving instructors more choices of homework or in-class assignments. Answers to all problems are in the *Instructor's Manual*.
- **Greater Integration of Tables and Graphs** *The Macro Economy Today* was the first book to tie tables and related graphs closely together by synchronizing the labeling of table rows and points on corresponding graphs. The fifth edition takes this innovation a step further by incorporating more tables and graphs into the same figure (see, for example, p. 37).
- **Functional Use of Color** This is the first edition of *The Macro Economy Today* to be published in four colors. The goal of this “colorization” has been *functional*, not merely aesthetic. Consistent use of color screening and logos sets off key features (e.g., World Views). Consistency in the use of broken and smooth curves, together with color screening, highlights shifts of supply and demand curves (e.g., p. 128).
- **Integrating Theme** The various sections of the text are explicitly related to the overriding issue of government intervention. Can markets do the job? Or is government intervention needed? This broad issue is restated repeatedly throughout the text, giving students a consistent framework in which to learn and apply economic principles.
- **Critical Thinking** By confronting students with the recurrent use of market vs. government failure, *The Macro Economy Today* stimulates students to apply economic principles. Rather than just memorizing terminology, students are encouraged to think critically about the use of economic theory in the world today.

A COMPLETE TEACHING AND LEARNING PACKAGE

The various parts of the teaching and learning package to accompany *The Macro Economy Today* have been closely coordinated with one another and include a new and unique focus on critical thinking through reading news-

papers and periodicals. In addition, painstaking efforts were made to keep *The Macro Economy Today* error-free, from beginning to end, with a consistency of style, level, and approach throughout the text.

STUDENT LEARNING AIDS

Study guide Several supplements accompany the text. From the student's perspective, the most important of the supplements is the *Study Guide*, prepared by Professors Michael Tansey at Rockhurst College and Lawrence Ziegler at the University of Texas (Arlington). There is a full-text *Study Guide* and, once again, macro and micro versions are also available. The *Study Guide* develops skills in mathematics and the use of economic terminology and enhances critical thinking capabilities. Each chapter of the *Study Guide* contains these features:

QUICK REVIEW Key points in the text chapter are restated at the beginning of each *Study Guide* chapter. The reviews are parallel to and reinforce the chapter summaries provided in the text.

LEARNING OBJECTIVES The salient lessons of the text chapters are noted at the outset of each *Study Guide* chapter. These objectives focus the student's study and help to ensure that key points will not be overlooked. The objectives are keyed to the exercises in the *Study Guide* to help reinforce learning.

KEY-TERM REVIEW Early in each chapter the students are asked to match definitions with key terms. This relatively simple exercise is designed to refresh the student's memory and provide a basis for subsequent exercises.

TRUE-FALSE QUESTIONS Twenty or so true-false questions are provided in each chapter. These questions have been class tested to ensure their effectiveness in highlighting basic principles.

MULTIPLE-CHOICE QUESTIONS Approximately fifteen multiple-choice questions per chapter are provided. These questions allow only one correct answer and also focus on basic principles.

PROBLEMS AND APPLICATIONS There are more than twenty exercises in the macro version of the *Study Guide*, most of which stress current issues and events.

MEDIA ASSIGNMENTS Refined from the previous edition and with extensive classroom testing, media assignments have been included for most chapters in the textbook. Each assignment requires the student to find and copy a newspaper or magazine article, and then underline a few words that illustrate the required economic idea. Because each assignment is carefully and precisely specified following an example provided in the *Study Guide*, the assignments require a minimum of explanation, and grading is fast and easy.

COMMON ERRORS In each chapter of the *Study Guide*, errors that students frequently make are identified. The bases for those errors are then explained, along with the correct principles. This unique feature is very effective in helping students discover their own mistakes.

ANSWERS Answers to *all* problems, exercises, and questions are provided at the end of each chapter. Difficult problems have annotated answers. These answers make the *Study Guide* self-contained, thus allowing students to use it for self-study.

Student software For those interested in computer-assisted instruction, several economic software programs are available.

INTERACTIVE GRAPHICS TUTORIAL II Interactive Graphics Tutorial II is an upgraded version of McGraw-Hill's very successful economics software program developed by H. Scott Bierman at Carlton College and Todd Proebsting (University of Wisconsin). Thousands of students have used the Interactive Graphics Tutorial to learn, understand, and reinforce their study of economic graphics. This updated and technically advanced version includes microcomputer simulations.

GRAPHICS TUTOR The Graphics Tutor is available in three packages: microeconomics, macroeconomics, and principles of economics. Each package presents tutorials that help students learn fundamental ideas in economics through the extensive and dynamic use of graphs.

VIZECON For users of Macintosh computers, there is an exciting new tutorial program, *VizEcon*. Developed by Professor William A. Phillips at the University of Southern Maine, this innovative package uses Apple's HYPERCARD programming environment to produce an extremely interactive learning experience. Dynamic shifts of curves, screen animation, sound effects, and simple-to-use command keys are features of this program. Its development was underwritten by grant funds and consultation from Apple Computer Inc.

Instructor Teaching Aids

Why not try to make the learning process easier for teachers as well as students? To this end, the teaching package includes several items valued by instructors:

News flashes As up-to-date as *The Macro Economy Today* is, it can't foretell the future. As the future becomes the present, however, Bradley Schiller writes News Flashes describing major economic events and relating them to specific text references. For this edition, adopters of *The Macro Economy Today* have the option of receiving News Flashes nearly instantaneously via FAX. Four to Six News Flashes are sent to adopters each year.

Instructor's resource manual Donald Pearson at Eastern Michigan University has fully revised his *Instructor's Resource Manual* for this edition, with new sections designed to make the text more effective and easier to use. It has several innovations. First, an introductory chapter is devoted entirely to instructional tools and contains references to instructional handbooks, workbooks, newspapers, magazines, student subscription programs, and customized readings. Second, a chapter-by-chapter review of the text provides tools, suggestions, and hints for effective use of classroom time devoted to each chapter. Features include

CONTENTS IN BRIEF A brief outline gives a quick overview of the chapter.

WHAT IS THIS CHAPTER ALL ABOUT? New and unique features of each chapter are explained and key critical thinking goals are stressed.

LECTURE SUGGESTIONS General suggestions for the direction lectures might take and one or more *lecture launchers* for introducing the material are offered.

SOME COMMON PROBLEMS Topics in each chapter which tend to be problematic for students are reviewed. The section has drawn on the expertise of

instructors who have used previous editions of the text in both small classes and large lectures.

ANNOTATED CONTENTS IN DETAIL An outline of the text chapter is completely annotated. It can be used for building lectures or it can be distributed to students as a study guide.

TAKE A STAND A controversial question is posed about one issue in the chapter which is illustrated by either an In the News or World View box. The question is followed by one paragraph in support of the issue and one paragraph in opposition. No resolution of the issue is offered. Take a Stand is intended to motivate classroom discussion or to form the basis for essay questions.

QUESTIONS FOR DISCUSSION The questions from the end of the text chapter are repeated and answers or guidelines for answers are provided to all questions.

ANSWERS TO PROBLEMS Here you will find the answers to problems at the end of the text chapters.

SUPPLEMENTARY RESOURCES This final section provides two kinds of information. First, it contains annotated references of videotapes or films relevant to the text chapter. Second, it contains a brief bibliography of articles and books that can be used for additional reading assignments or suggestions for students. These also provide a quick guide of sources to use for expanding lecture materials.

MEDIA EXERCISES These tear-out assignments require the student to find an example from the media to illustrate an economic concept. There is approximately one per chapter. After each exercise, professor's notes and lecture opportunities are provided.

Test bank The Test Bank to accompany *The Macro Economy Today* follows the lead of the textbook in its application of economic concepts to worldwide economic issues, current real-world examples, and the role of government in the economy. Now prepared by the *Study Guide* authors, Michael Tansey and Lawrence Ziegler, together with Bruce Kelley at Florida International University, the Test Bank has been significantly strengthened. The new authorship team helps assure not only a high level of quality and consistency of the test questions, but the fullest possible correlation with the content of the text and *Study Guide*. The Test Bank will be published in two separate volumes, each with over 3,000 objective, predominantly multiple-choice, questions; either volume can be used to construct tests to cover all the material in a chapter.

Computerized testing Computerized versions of the Test Bank are available for both IBM-PC computers and compatibles and Macintosh computers. The programs allow instructors to view, edit, and test questions to create exams.

Customized test Instructors may have tests custom prepared by the publisher by calling the publisher's special test service. Masters prepared from the Test Bank will be mailed out within seventy-two hours.

Overhead Transparencies One hundred of the key tables and graphs in the text have been reproduced as full-color overhead transparency acetates. These are made available to adopters by the publisher.

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Bradley R. Schiller

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