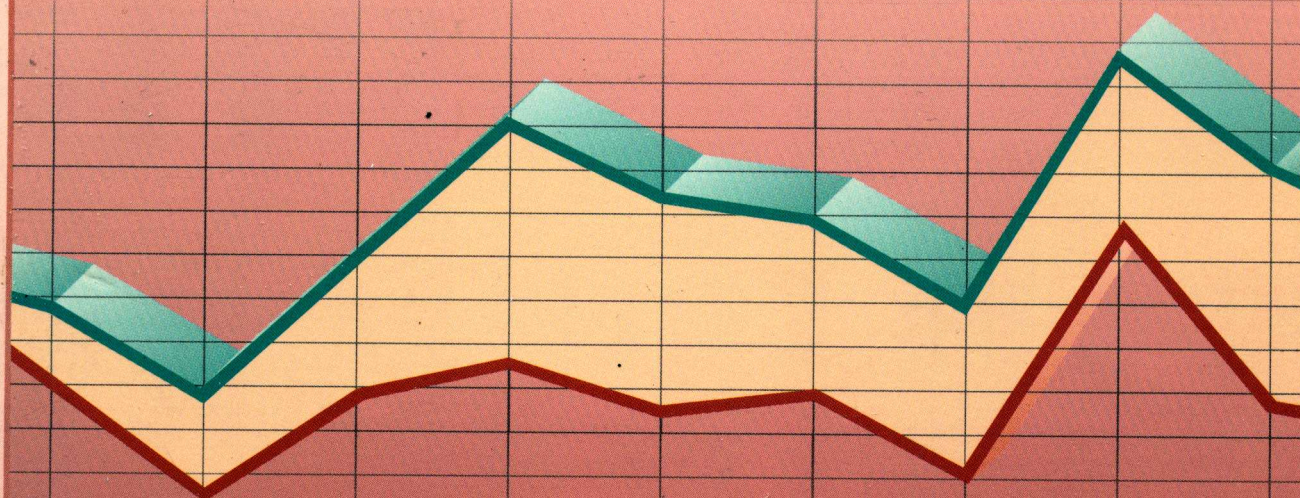


**BRADLEY R. SCHILLER**

# THE MACRO ECONOMY TODAY



**SIXTH EDITION**



# THE MACRO ECONOMY TODAY

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SIXTH EDITION

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**BRADLEY R. SCHILLER**

THE AMERICAN UNIVERSITY

**McGRAW-HILL, INC.**

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## **THE MACROECONOMY TODAY**

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# THE MACRO ECONOMY TODAY

## ABOUT THE AUTHOR

**Bradley R. Schiller** has over two decades of experience teaching introductory economics at The American University, the University of California (Berkeley and Santa Cruz), and the University of Maryland. He has given guest lectures at nearly 100 colleges ranging from Fresno, California, to Istanbul, Turkey. Dr. Schiller's unique contribution to teaching is his ability to relate basic principles to current socioeconomic problems, institutions, and public policy decisions. This perspective is evident throughout *The Macroeconomy Today*.

Dr. Schiller derives this policy focus from his extensive experience as a Washington consultant. He has been a consultant to most major federal agencies, many congressional committees, and political candidates. In addition, he has evaluated scores of government programs and helped design others. His studies of discrimination, training programs, tax reform, pensions, welfare, Social Security, and lifetime wage patterns have appeared in both professional journals and popular media. Dr. Schiller is also a frequent commentator on economic policy for television, radio, and newspapers.

Dr. Schiller received his Ph.D. from Harvard in 1969. His B.A. degree, with great distinction, was completed at the University of California (Berkeley) in 1965. He is now a professor of economics in the School of Public Affairs at The American University.

# PREFACE

The economy doesn't stand still. The global economy has been transformed in just a few years' time by the unraveling of the Soviet Union, the unification of East and West Germany, the economic surge of the Pacific Rim, and the creation of free-trade blocs in Europe, North America, and Southeast Asia. The domestic economy has been transformed by recession and corporate restructurings, and by President Clinton's "vision of change" policies.

As always, *The Macroeconomy Today* tries to keep up with the forces that are changing the economic landscape. This requires more than simply reporting recent events. The real challenge is to integrate economic transitions into basic models of how the economy works. The collapse of communism, for example, raises in the most vivid terms the classic debate about market-driven vs. government-directed economies. We must not only tell the story of that collapse but also use it to highlight the unique features of the market mechanism. It is no small irony that Russian and Eastern European reformers have embraced the tenets of a market system that so few American students understand.

President Clinton's vision of change creates similar opportunities for highlighting the key features of economic models. The "Rebuilding America" program, for example, combines traditional fiscal stimulus with longer-term aggregate supply options. The reordering of spending priorities and tax burdens offers new opportunities to illustrate how government policy can alter the WHAT, HOW, and FOR WHOM outcomes of the economy.

This sixth edition of *The Macroeconomy Today* tries to bring to the classroom the excitement of these changes. In the process, there is a lot of new material in macro theory and applications, in international, and in pedagogy.

## WHAT'S NEW IN MACRO

**Integration of Keynesian and AS/AD Models.** The sixth edition has taken a quantum step in the integration of the Keynesian and AS/AD models. For the first time, the Keynesian multiplier is illustrated explicitly in the AS/AD framework. A distinctive terminology (e.g., "AD shortfalls") is used to show how the spending "gaps" in the Keynesian model apply in a world where price levels change. Once these links are established (see pages 202–204), the macro analysis is carried on within the AS/AD framework. The advantage of this distinctive approach is twofold: It provides students with an evolutionary view of macro theory while exploiting the most useful analytical and pedagogical features of both models.



**Profile of the American Economy.** Repeated surveys have confirmed that students have very little knowledge about the dimensions of “the economy.” Indeed, surveys by the Gallup Organization and the National Council on Economic Education reveal that far more Americans are opposed to budget deficits than know what budget deficits are (see *In the News*). People know that America produces a lot of output but few realize that we produce one-fourth of the entire world’s output. With so few hard facts at their disposal, students (and their parents) are easy prey for false and misleading characterizations of America’s economic problems. The all-new Chapter 2 tries to establish an empirical foundation for the principles course by providing a sketch of the American economy today. This descriptive portrait is organized around the core WHAT, HOW, and FOR WHOM issues. America’s unique answers to these issues are also put into a global perspective. Chapter 2 should help anchor abstract principles to a solid empirical base.

**Focus on Saving and Investment.** Saving and investment have always been integral parts of the macro model. In view of the increasing policy focus on these activities, however, they are given more prominence in the sixth edition. Chapter 9 includes new illustrations of the saving–investment equilibrium as well as the paradox of thrift and a new discussion of the optimal saving rate (long-run vs. short-run goals). A new cartoon (page 332) highlights the conflict between advocates of more saving and advocates of more spending. The role of saving and investment is also highlighted in the treatments of supply-side policy (Chapter 15) and economic growth (Chapter 16).

**Clintonomics.** President Clinton has proposed substantial changes in fiscal and supply-side policies. Investment in both human and physical capital is emphasized, along with deficit reduction. In tying these policies together, Clinton was the first president to refer explicitly to “crowding out” in a State of the Union message. Although not everything is *new* in the “new directions” of the Clinton administration, there’s a lot of fresh material for enlivening discussions of macro theory. In-text discussions and boxed news stories about President Clinton’s “vision of change” maintain the currency of the macro discussion.

**Bank Failures.** The federal government has spent over \$100 billion to “bail out” the banks in the last five years. In the process a whole new lexicon of acronyms (RTC, SAIF, etc.) has been created. Students can hardly relate to theories of money and banking without some explicit discussions of these bail-outs. Chapter 12 offers a new perspective on bank failures and a global look at currency collapse (the Russian ruble).

**Global Macro.** President Clinton summed it up nicely in a February 1993 speech at American University: “In this global economy, there is no such thing as a purely domestic policy.” Alan Greenspan said much the same in explaining to Congress why the Fed can’t lower interest rates faster while German rates are so high. We’ve got to inject this global dimension into the principles course. To facilitate this, *The Macroeconomy Today* is still the only principles text to offer a self-contained and abbreviated discussion of how global interactions constrain domestic macro policy. This discussion—repositioned to Chapter 17 and updated—is especially designed for use as a single exposure to global macro for instructors who are short on time.



## IN THE NEWS

### Americans Flunk Econ 101

#### *Study Finds Basic Grasp of Terms, Concepts Lacking*

Americans have strong opinions on economic matters. The problem is, many of them lack basic economic knowledge on which to base those opinions, according to a national survey of economic literacy. . . .

The survey, done last March for the council by the Gallup Organization, found that "many people do not understand the meaning of basic economic terms," said William B. Walstad, director of the National Center for Research in Economic Education at the University of Nebraska. "In contrast, they have very strong opinions about things about which they have no underlying knowledge."

—John M. Berry

*The Washington Post*, September 10, 1992. © 1992, The Washington Post, Reprinted with permission.

### E Is for Economy

Percentage of Correct Responses

Response	General Public	High	College Seniors
		School Seniors	
Unemployment rate	22%	10%	26%
Inflation rate	11	4	12
Budget deficit definition	51	38	66
Budget deficit size	19	22	24
Federal Reserve purpose	46	38	58
Economic policy	48	39	55
Productivity/wages	68	69	77
Purpose of profits	36	42	52
Supply and demand	64	72	79
Value of dollar/exports	50	38	61
<b>Average</b>	<b>39%</b>	<b>35%</b>	<b>51%</b>

Source: National Council on Economic Education.

**Analysis:** Most Americans cannot identify basic economic concepts or the dimensions of economic problems. We teachers have our work cut out for us.

## WHAT'S NEW IN INTERNATIONAL

**Crosscurrents of Global Trade.** "EC 92" has become a reality and NAFTA is emerging. GATT agreements are extending trade liberalization to services, intellectual property, and, grudgingly, to agriculture. At the same time, the Clinton administration and the EC commissioners are manifesting increasing interest in managed trade policies that promote certain export industries and protect specific import-competing industries. The sixth edition describes these crosscurrents and pushes the subject of trade into the center of macro and even micro discussions.

**Gyrating Currencies.** Gary Becker admits to a lapse in his applied microeconomics. Had he hedged the value of his 1992 Nobel Prize in the currency futures market, his prize would have been worth \$242,000 more on the day he accepted it (see World View on page 464). But who would have guessed that the Swedish central bank would raise the discount rate to 75 percent (!) to keep the value of the krona from plummeting? Students of the economy today can't help but hear stories about the weak dollar, the strong yen, or the currency crises in Europe, Russia, and South America. The sixth edition includes more discussion of international money flows and their implications for economic outcomes.



**The “Other Path” to Development.** Strategies of economic development are changing. Less emphasis is being put on physical resources and more on human resources. Governments are ceding more control to markets. The collapse of communism was one catalyst for these changes; another was Hernando de Soto’s acclaimed *The Other Path*. De Soto emphasized that even poor countries have organized markets (often “underground”) and a rich store of entrepreneurial talent. The “other path” emphasizes the need for developing nations to facilitate entrepreneurship by reducing regulatory barriers; guaranteeing the security of people, profits, and property; privatizing more enterprises; and promoting competition. In a world of declining real transfers, de Soto’s call for internal reform is all the more pressing. The “other path” provides a splendid opportunity to integrate micro principles into development discussions.

**World Views.** Nearly every chapter includes boxed applications of basic principles in international settings. These have been updated to today’s headline stories.

## WHAT’S NEW IN PEDAGOGY

*The Macroeconomy Today* strives to stay at the forefront not only of the news, but of the pedagogy as well. The running in-margin glossary, the boxed news stories, and the synchronized tabular and graphical displays introduced in previous editions of *The Macroeconomy Today* have become industry standards. The sixth edition pushes the frontier a bit further out, with the following features:

**Built-In Problem Set.** *The Macroeconomy Today* has always distinguished “questions for discussion” from “problems” that require mathematical or graphical solutions. In this edition the numerical problems have been expanded and moved to the end of the text. The new problem sets are designed to be detached (perforated pages) should instructors decide to assign them as homework. Each core chapter offers three to five problems, including at least one requiring graphical analysis. The detachable problem pages include fully calibrated graph grids and blanks for inserting solutions. These features will facilitate grading for instructors who choose to assign homework. All answers are provided in the new *Instructor’s Resource Manual*.

**The Economy Tomorrow.** Each chapter now ends with a challenging application of basic principles to emerging problems. The goal of these Economy Tomorrow sections is to challenge the student to apply core concepts. A sampling of these discussions conveys the scope and flavor of these sections:

### In Core Chapters:

- *How to Spend a Peace Dividend* (Chapter 1) examines alternative uses of planned cutbacks in defense spending, highlighting public- vs. private-sector options.
- *Rent Controls in New York and Moscow* (Chapter 3) illustrates the inevitable shortages that accompany rent controls and assesses policy options.

**In Macro:**

- *A Growing Skills Gap?* (Chapter 5) looks at how structural unemployment has increased and assesses President Clinton's training proposals.
- *The End of Inflation* (Chapter 6) is an essay reprinted from *The Economist* that discusses how the politics of anti-inflation policies are changing.
- *Should We Save Less?* (Chapter 9) contrasts the Keynesian call for more spending with the long-term need for more saving. A great cartoon (p. 332) and Clinton's "New Directions" policies highlight the issue.
- *Our Grandchildren's Burden?* (Chapter 11) ties the analysis of deficits and debt to the popular notion that we are "mortgaging our children's future."
- *When Banks Fail* (Chapter 12) summarizes bank bailouts and examines implications for future credit activity.
- *Rebuilding America* (Chapter 15) examines the effect of infrastructure investment on macro outcomes.
- *Sustainable Development?* (Chapter 16) assesses the conflict between economic growth and environmental protection, as formulated in Agenda 21 of the 1992 Earth Summit in Rio de Janeiro.

**In International:**

- *Lowering Trade Barriers* (Chapter 19) assesses the impact of emerging trade blocs (EC, NAFTA) and GATT agreements on world trade and global output.
- *A Single Eurocurrency?* (Chapter 20) examines the problems the EC confronts in forging a monetary union with a single currency.
- *Unleashing Entrepreneurship* (Chapter 21) introduces Hernando de Soto's "other path" strategy for economic development

These and other discussions are intended to emphasize how economic decisions made today shape the economy of tomorrow.

**Integrated News Boxes.** Most of the In the News and World View boxes have been updated, of course. In addition, all of the boxed inserts have been augmented with a new "analysis" caption that provides a succinct (one- or two-sentence) spotlight on core concepts. The boxed material is also the subject of end-of-chapter Questions for Discussion and numerical Problems. These changes make the boxed case studies an integral part of the core presentation.

**Consolidated Tables and Graphs.** *The Macroeconomy Today* introduced the device of explicitly synchronized tables and graphs (with lettered rows and corresponding points). That feature has been further developed in this edition with fully consolidated tables, graphs, and annotations. For example, see Figure 3.2.

## WHAT'S OLD BUT WORTH SAVING

Although there are lots of new features in the sixth edition, the essential character of *The Macroeconomy Today* remains intact. The distinguishing features of this character are the following:

**Real World Applications.** *The Macroeconomy Today* has never been a repository of fanciful stories about widget manufacturers. In this text, students encounter the real world of business and government decisions. They even get

some insight into why President Clinton can't fully implement his "vision of change" (see Chapter 18 on "Theory vs. Reality"). *The Macroeconomy Today* is serious about explaining economic principles in real-world settings. That is the acid test of "relevance."

**Global Vision.** The global perspective of *The Macroeconomy Today* is a natural extension of its real-world orientation. Indeed, it is hard to imagine how a text could be relevant to today's economic agenda without explicit and continuous reference to international developments. This global perspective is evident in the World View boxes, many of the *Macroeconomy Tomorrow* sections, the unique Global Macro chapter (17), and the complete international section (Chapters 19–22).

**Careful Pedagogy.** Economic principles were put to use in designing *The Macroeconomy 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 Macroeconomy Today* include self-contained explanations.
- **Running and Repeated Glossary** Most other texts have now adopted *The Macroeconomy 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 Macroeconomy 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.

## A COMPLETE TEACHING AND LEARNING PACKAGE

*The Macroeconomy Today* offers a complete and integrated package of tested supplements for teaching and learning. Professors Michael Tansey at Rockhurst



College and Lawrence Ziegler at the University of Texas (Arlington), authors of the *Study Guide*, have been an integral part of the Schiller team for over twelve years. To coordinate with the many changes in the textbook, Professors Tansey and Ziegler have updated their very effective *Study Guide*. In addition, they have assumed authorship of the all-new *Instructor's Resource Manual* and the fully expanded *Test Bank*. Their hard work, extensive teaching experience, and close work with the textbook author ensure both superior quality of the supplements and total integration with the text. The various elements of *The Macroeconomy Today* teaching package include:

## For Students

**Study Guide.** From the student's perspective, the most important of the supplements is the *Study Guide*. The *Study Guide* helps students develop skills in mathematics and the use of economic terminology with the goal of enhancing critical thinking capabilities. Each chapter of the *Study Guide* contains these features: Quick Review; Learning Objectives; Key-Term Review; True-False Questions; Multiple-Choice Questions; Problems and Applications; Media Assignments; Common Errors; and Answers.

**Student Software.** For those interested in computer-assisted instruction, the following economic software is available:

*Macroeconomics: A Lab Course* Professor Norris Peterson of Pacific Lutheran University, working with the talented staff at Intellipro, Inc., has created an innovative software package, *Macroeconomics: A Lab Course*, to be used in macroeconomics courses. *Macroeconomics: A Lab Course* builds the basic macroeconomic framework in sequential, "building block" laboratory simulations that allow students to grasp the fundamental concepts of macroeconomics in a dynamic and creative manner. The companion software, *Microeconomics: A Lab Course*, is available as well.

*Interactive Graphics Tutorial IV* is an updated version of McGraw-Hill's successful economics software program developed by H. Scott Bierman at Carleton College and Todd Proebsting at the University of Arizona. Thousands of students have used the Interactive Graphics Tutorial to further their understanding of basic economic concepts.

## For Instructors

Why not make the learning process easier for teachers as well as students? To this end, the following items are available for instructors:

**News Flashes.** As up-to-date as *The Macroeconomy Today* is, it can't foretell the future. As the future becomes the present, however, the author writes News Flashes describing major economic events and relating them to specific text references. Again for this edition, adopters of *The Macroeconomy 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.** The *Instructor's Resource Manual* has undergone extensive revision. First, it has been produced in a three-ring binder, with software diskettes also available. This will make it easy for users to insert their own class notes and additional materials provided by McGraw-Hill. In-

structors also have the option of generating their own outlines for class lectures. Second, the authors have provided a slimmed-down list of annotated references and other instructional aids which may be useful. Third, the new *Instructor's Resource Manual* includes full discussions on how to integrate computer-assisted instruction into the principles course. For each chapter instructors will find:

- A detailed outline of each chapter including all headings, accompanied by page numbers, definitions, titles to tables and titles to figures, as well as brief comments as to the contents of each section.
- A complete list of the Student Learning Objectives which is presented in the *Study Guide*.
- Brief suggestions and materials with which to introduce each chapter and promote student interest.
- A list of the most COMMON ERRORS made by students for each chapter and suggestions for how to avoid them.
- Suggested answers to all discussion questions provided at the end of each chapter in the text.
- Annotated answers to all of the problems provided at the end of each chapter in the text.
- A ready-to-hand-out media exercise which reinforces the CRITICAL THINKING approach emphasized in both *The Macroeconomy Today* and the *Study Guide*.
- A ready-to-hand-out quiz based on the learning objectives for the chapter.

**Test Bank.** The Test Bank to Accompany *The Macroeconomy Today*, sixth edition, has been reworked and revised in response to reviewers' suggestions. It contains roughly 5,000 classroom-tested multiple-choice and true-false questions. In this edition, all of the questions involving CRITICAL THINKING have been placed in one section at the end of each chapter. All questions are coded as to type and where the topic is covered in the text. Professors Tansey and Ziegler have worked especially hard to ensure that this *Test Bank* is the best ever.

**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 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.

**Videodisks.** New to this edition are videodisks designed to harness this exciting new technology for classroom presentation. These videodisks offer an array of graphical illustrations of key economic concepts to further student understanding.

**Videos.** New videotape materials have been assembled for this edition to illustrate fundamental concepts and economic issues in a manner that will be equally effective in classroom settings or media resource centers. Among these materials is the “McNeil/Lehrer Quarterly Report on Economics,” a new series of excerpts from the acclaimed PBS news program, “The McNeil/Lehrer Newshour.” Your local McGraw-Hill representative can provide details on the video ancillaries for the text.

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**Publishing Team**

This edition of *The Macroeconomy Today* would not have been as good, as attractive, or as timely without the dedication of the McGraw-Hill publishing team. Leading the team was Jim Bittker, who has helped develop two editions. The editorial supervisor, Elaine Rosenberg, kept all the pieces together and made sure the book kept on schedule. Hermann Strohbach contributed a fresh new look to the design and kept the pages rolling on weekends. Rich Ausburn was the production supervisor. Once again, Carole Schwager did a great job of copy-editing. My heartfelt thanks to all of them and their support staffs.

Bradley R. Schiller

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