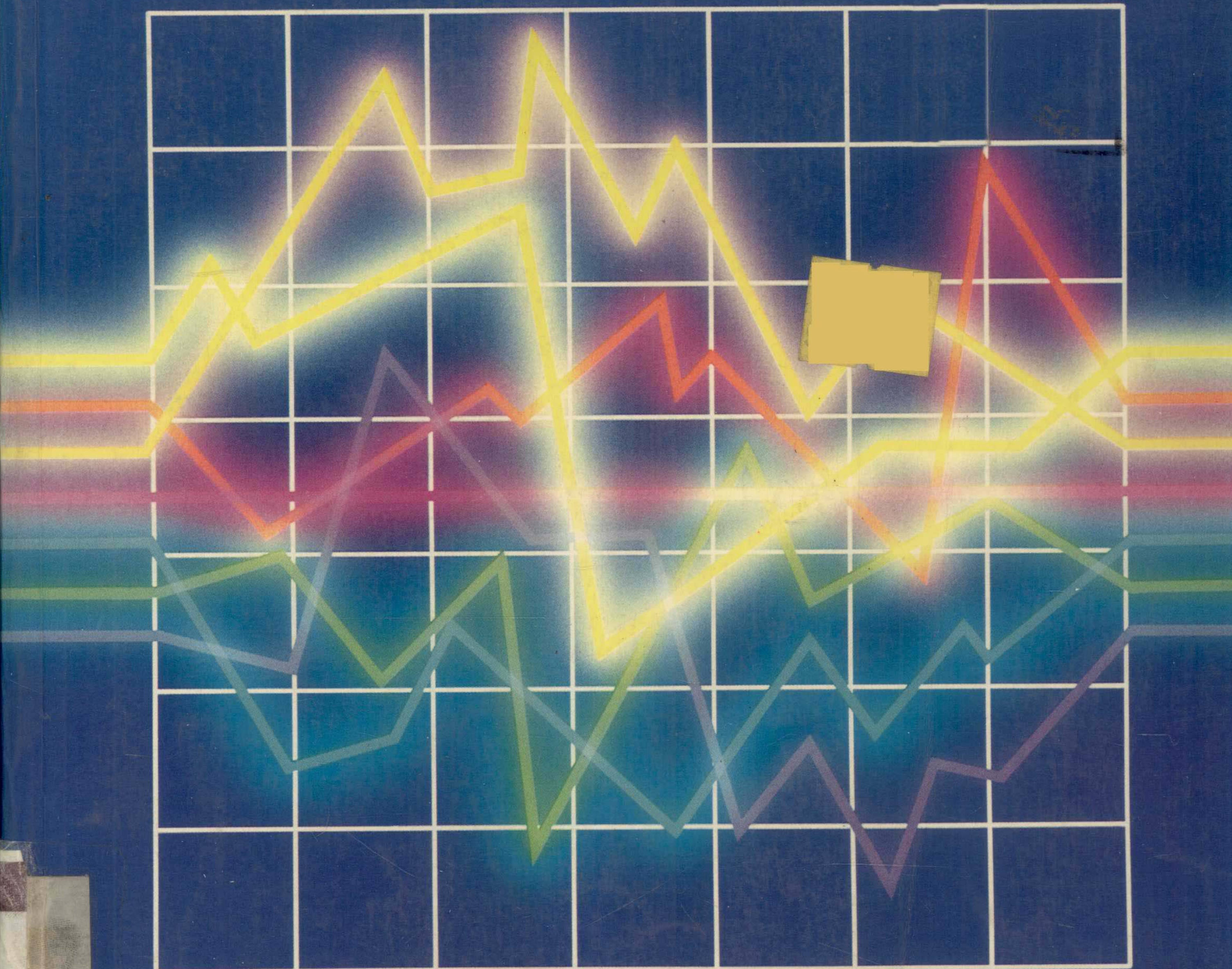
AN INTRODUCTION TO

MACROECONOMICS



PAUL WONNACOTT / RONALD WONNACOTT

THIRD EDITION

AN INTRODUCTION TO

MACROECONOMICS

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McGRAW-HILL BOOK COMPANY
New York St. Louis San Francisco Auckland Bogotá Hamburg Johannesburg
London Madrid Mexico Montreal New Delhi Panama Paris
São Paulo Singapore Sydney Tokyo Toronto

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1 2 3 4 5 6 7 8 9 0 HALHAL 8 9 8 7 6

ISBN 0-07-071620-X

See Photo Credits on page 430.

This book was set in Times Roman by York Graphic Services, Inc. (ECU).
The editors were Paul V. Short and Alison Meersschaert;
the designer was Nicholas Krenitsky;
the production supervisor was Joe Campanella;
the drawings were done by J. &. R. Services, Inc.
Halliday Lithograph Corporation was printer and binder.

Library of Congress Cataloging-in-Publication Data

Wonnacott, Paul.
Introduction to macroeconomics.

Selections from: Economics. 3rd ed.
Companion to: An introduction to microeconomics.
Includes bibliographical references and index.
1. Macroeconomics. I. Wonnacott, Ronald J.
II. Wonnacott, Paul. Introduction to microeconomics.
III. Title.
HB172.5.W662 1986 339 85-23693
ISBN 0-07-071620-X (pbk.)

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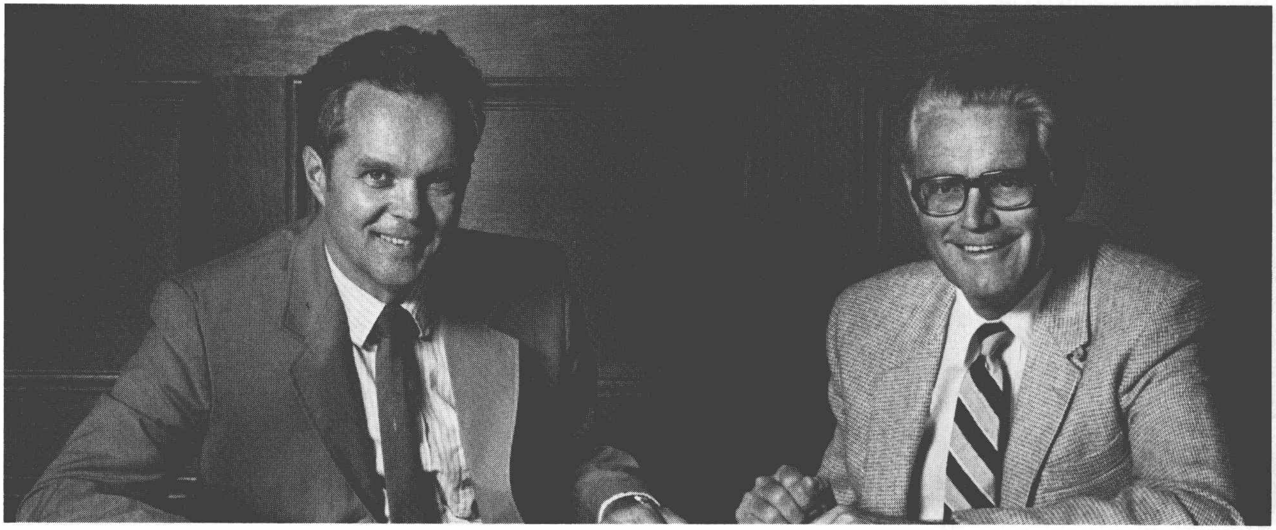

Paul Wonnacott studied history as an undergraduate at the University of Western Ontario. He then switched to his second and greatest academic love—economics—receiving his Ph.D. from Princeton. He taught four years at Columbia University before taking up his present post at the University of Maryland. Most of his scholarly work has focused on international economics, including studies on U.S.-Canadian trade (with Ron Wonnacott) and on exchange rate flexibility. He has a keen interest in economic policy. While with the Council of Economic Advisers, he participated in work which led to the decision to adopt exchange rate flexibility in the early 1970s. His extracurricular activities include skiing and tennis.

Ronald J. Wonnacott received his Ph.D. in economics at Harvard in 1959, and has taught at that university, the University of Minnesota, and the University of Western Ontario. He has written widely on the subject of U.S.-Canadian trade relations, and on the economics of customs unions and free trade areas—much of this with his brother Paul. Their joint book, *Free Trade between the United States and Canada: The Potential Economic Effects* has contributed to the recent discussion of a possible free trade arrangement between the two countries. Ron Wonnacott has also co-authored books on statistics and econometrics with a third brother, Tom. He is a past president of the Canadian Economics Association and a Fellow of the Royal Society of Canada. He shares an enthusiasm for music, tennis, and skiing with Paul, and is a member of the Honourable Company of Edinburgh Golfers.

TO

Les Chandler

PREFACE

An understanding of economics has never been more important than it is today. Because of new technology, we produce many goods that were unheard of a few decades ago. And we produce old products in new ways. Changes in government policies have opened new opportunities for some, and have constrained others. Changes in economic conditions have created new and difficult problems.

This third edition of *An Introduction to Macroeconomics* represents a major revision and update. We have made every effort to present current material on the major policy issues of our time, while continuing to build a solid foundation of basic economic ideas.

THE CHALLENGE OF ECONOMICS

Economics is like the music of Mozart. On one level, it holds great simplicity: Its basic ideas can be quickly grasped by those who first encounter it. On the other hand, below the surface there are fascinating subtleties that remain a challenge—even to those who spend a lifetime in its study. We therefore hold out this promise: In this introductory study, you will learn a great deal about how the economy works—the basic principles governing economic life that must be recognized by those in government and business who make policy decisions. At the same time, we can also promise that you won't be able to master it all. You should be left with an appreciation of the difficult and challenging problems of economics that remain unsolved.

Perhaps some day you will contribute to their solution.

HOW TO USE THIS BOOK

Our objective has been to make the basic propositions of economics as easy as possible to grasp. As each new topic is encountered, essential definitions are printed in red type, and key steps in the argument are emphasized with boldface type. These highlights should be studied carefully during the first reading, and during later review. (A glossary is provided at the end of the book, containing a list of definitions of terms used in this text plus other common economics terms that you may encounter in class or in readings.) The basic ideas of each chapter are summarized in the Key Points at the end of the chapter, and new concepts introduced in the chapter are also listed.

When you read a chapter for the first time, concentrate on the main text. Don't worry about the boxes, which are optional. They are set aside from the text to keep the main text as simple and straightforward as possible. The boxes fall into two broad categories: *First* are the boxes that provide levity or color—for example, Boxes 3-1 and 3-2 describing elementary monetary systems in two small communities. *Second* are the boxes that present detailed theoretical explanations that are not needed to grasp the main ideas in the text. If you want to glance at the boxes that are fun and easy to read, fine. But when you first read a chapter, don't worry about those that contain more difficult material. On the first reading, you may also skip footnotes and appendixes; these also tend to be more difficult. Particularly challenging are the footnotes marked (*). Come back to them later, after you have mastered the basic ideas.

Economics is not a spectator sport. You cannot learn just from observation; you must work at it. When you have finished reading a chapter, work on the problems listed at the end; they are designed to reinforce your understanding of important concepts. [The starred (*) problems either are based on material in a box, or are more difficult questions designed to provide a challenge to students who want to do more advanced work.] Because each chapter builds on preceding ones, and because the solution to some of the problems depends on those that come before, remember this important rule: Don't fall behind in a problem-solving course. To help you keep up, we recommend the *Study Guide* (third edition) which is designed specially to assist you in working through each chapter. It should be available in your bookstore.

TO THE INSTRUCTOR

As we have revised and updated this text, we have continued to keep in mind the question posed in the first edition. Our uneasiness regarding the answer provided a major reason for writing this book.

The question was this: After studying introductory macroeconomics, are students able to understand public controversies over such topics as the level of government spending and taxation, monetary policy, and the desirability of price controls? Are we training our students to understand the front pages of the newspaper? For many years, the introductory course was aimed at teaching students how policy should be run; that is, at providing a cookbook of "right" answers. While many books express more doubts and qualifications than was the case a decade ago, we have altered the focus of the course even more by building up to the six controversial questions in Part 4: Is fiscal or monetary policy the key to aggregate demand? Should the authorities attempt to "fine-tune" aggregate demand? How can inflation exist at the same time as a high rate of unemployment? How does the economy adjust to inflation, and what complications does inflation present to the policymaker? Why have productivity and growth been disappointing since 1973? Should exchange rates be fixed or flexible?

While there are no simple, indisputably "correct" answers to these questions, we believe that the major issues can be presented clearly to beginning economics students, thereby providing them with an understanding of important, recurring public debates over macroeconomic policy.

Major Revisions

Like the world of high technology, the world of economics is changing rapidly. Huge pools of internationally mobile capital have led to fluctuations in currency values and third-world debt problems far beyond our experience of just a few years ago. The United States seems committed to spending and taxation policies which imply large budget deficits as far as the eye can see. Even after adjustment for inflation and the size of the economy, these deficits are unprecedented, except for wartime periods.

In these circumstances, professors may expect substantial updating of any economics text. We have responded by revising every chapter to some degree; in most cases, the revisions have been substantial. Here are some of the main changes.

Two new chapters have been added. Chapter 8, "Fluctuations in Economic Activity: Unemployment and Inflation," reviews the major developments and problems in the U.S. economy. Two points are emphasized. (1) We have been successful in preventing a repeat of the Great Depression. Our greater understanding of macroeconomics has had a payoff in terms of better policies. (2) However, cycles have not been getting milder and milder; the recessions of 1973–1975 and 1981–1982 were more severe than those of the fifties and sixties. Macroeconomics is not a simple subject, with simple solutions to our problems. This theme provides the background for the later study of major unsettled questions in macroeconomics (Part 4).

Chapter 9, "Explaining Unemployment and Inflation: Aggregate Supply and Aggregate Demand," is designed to give students a broad overview before the detailed study of macroeconomics. In introducing the concepts of aggregate supply and aggregate demand, we have taken care to explain why we cannot simply assume that the aggregate curves slope the same way as the curves for an individual product. When drawing a demand or supply curve for an individual product—such as hamburgers or shoes—we consider the responses of buyers and sellers to changes in relative prices; they respond by switching to (or from) other products. For aggregate demand and aggregate supply, there is no such switching, because we are dealing with the overall price level, not changes in relative prices. Chapter 9 also provides an introduction to the differences between the Keynesian and classical schools. Although there are many points of agreement among macroeconomists, substantial areas of disagreement remain.

Other third-edition changes include the following:

1. Much more attention is now paid to budget deficits and the growing national debt. There are major new sections on these topics in the chapter on fiscal policy (Chapter 11), and in the chapter on the relative importance of fiscal and monetary policies (Chapter 14). In this latter chapter, the new edition includes a discussion of the relationship between government deficits, interest rates, exchange rates, and trade deficits. At the same time, some dated topics have been dropped. For example, in a period when the government is having great difficulty in gaining control of the budget, it no longer seems necessary to have a section on fiscal drag.

2. The discussion of growth and productivity in Chapter 18 has been extensively rewritten and updated, with a major change in emphasis. No longer is the question simply one of why growth and productivity were disappointing in the 1970s. The new chapter also includes a discussion of growth and productivity in the early 1980s, and explores whether we are solving our productivity problems. We do not offer a categorical answer; sufficient information is not yet available. (There is an important relationship between productivity and the business cycle, and the strong cycle of the early 1980s has made it difficult to identify underlying trends in productivity.) This chapter includes a discussion of the supply-side strategy of the Reagan administration.

Other Points of Interest

Finally, we draw your attention to a number of ways in which our treatment differs from that of many other economics texts.

- We consider the problem of financial instability in more detail than most other books. (For example, see the discussion of the instabilities of the monetary system during the Great Depression in Chapter 13, and the overview of financial instability in recent recessions in Box 13-2.) In our opinion, the Keynesian revolution resulted in too little attention to the financial side of the economy.
- We discuss the gold standard—and the problems which it raises—in more detail than most other books (pages 260 to 264). This topic is important for an understanding of history, particularly the problem of bank instability. Many students are fascinated by the gold standard. Like most economists, we believe that it would be a mistake to go back to the gold standard—particularly in its classical version, with the quantity of money determined by the quantity of gold. But we also believe it is important that students of economics know *why*.
- Because of our emphasis on major themes and problems, our discussion of international economics is organized differently from that in most books. The gains from trade and the effects of protection fit into the topic of efficiency, and therefore they are included in a companion volume, *An Introduction to Microeconomics*. But exchange rate arrangements are most closely related to such issues as inflation and unemployment, and they are therefore included with other macroeconomic topics, in Chapter 19. By keeping international topics next to the related domestic topics, we hope to counteract the neglect of international economics in many introductory courses.

WE WISH TO THANK . . .

In developing this third edition, we have shamelessly accumulated intellectual debts to our colleagues and coworkers. We should like to thank our editor, Alison Meersschaert, for her insistence that every sentence be comprehensible to the undergraduate, and Michael Hartman, whose comprehensive review of the second edition provided a starting point for our revisions. We are particularly indebted to teachers of economics who have advised us or reviewed the text in its various drafts, and have provided a wealth of suggestions. These contributors—to this third edition as well as to earlier editions—are acknowledged on the following pages. To all, we express our sincere thanks.

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ACKNOWLEDGMENTS

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