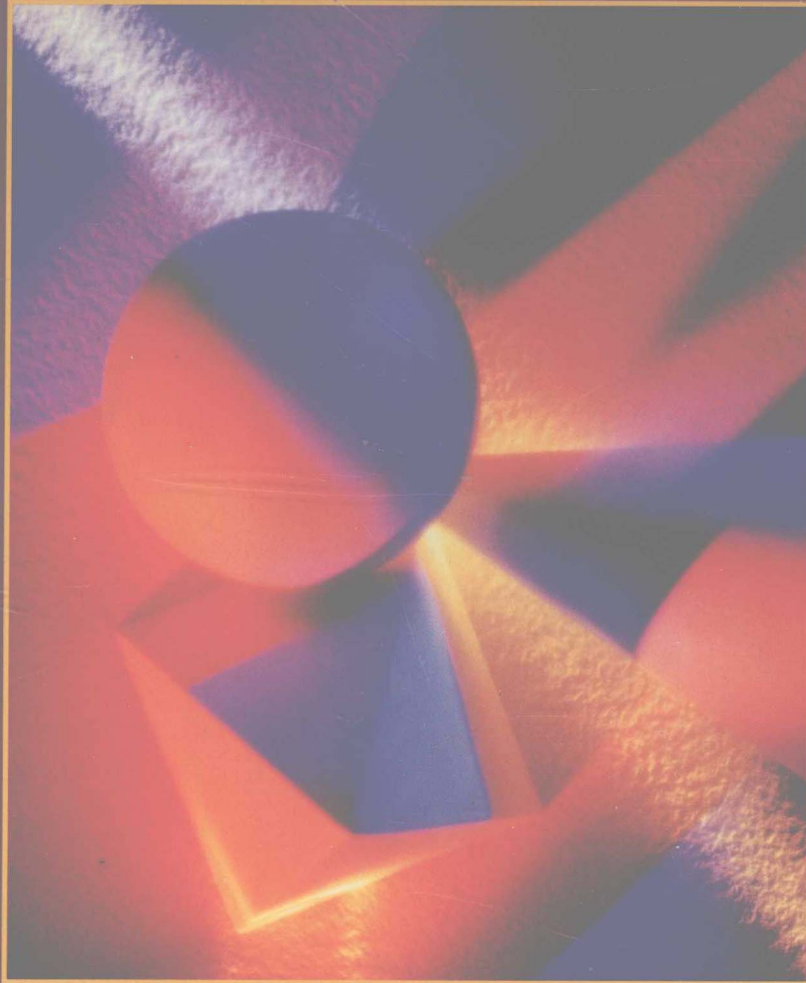


FIFTH EDITION

Macroeconomics

Theories & Policies



Richard T.
Froyen

Macroeconomics

5th edition

Theories & Policies

Richard T. Froyen

*University of North Carolina
at Chapel Hill*



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To Linda

Katherine, Sara, and Andrea

Preface

The past 25 years have been challenging ones for macroeconomists. Key variables in macroeconomics—the levels of output, inflation, unemployment; interest rates; foreign exchange rates—have proved difficult to explain and predict. This period has also been an active one in macroeconomic theory. It has been a period of controversy but also of progress. The 1970s saw a broadening of the issues in the *monetarist–Keynesian* controversy. Additionally, a new challenge to the Keynesian position, the *new classical* economics, emerged. During the 1980s, Keynesian policy prescriptions came under attack from a group called the supply-side economists. The 1980s also witnessed the development of two contrasting lines of research on the business cycle: the *new Keynesian economics* and the *real business cycle theory*. There has, however, been progress as well as controversy. During the past 25 years there have been significant improvements in the handling of expectations, in our understanding of labor market institutions, in accounting for the macroeconomic implications of various market structures, in modeling of open economies, and in accounting for the ultimate sources of economic growth.

In this book I have tried to explain macroeconomics, inclusive of recent developments, in a coherent way, but without glossing over the fundamental disagreements among macroeconomists on issues of both theory and policy. The major modern macroeconomic theories are presented and compared. Important areas of agreement as well as differences are discussed. An attempt is made to demonstrate that the controversies among macroeconomists center on well-defined issues that are based on theoretical differences in the underlying models.

Features

Distinguishing features of the approach taken here are the following:

- An up-to-date summary of the Keynesian position, including recent research that has come to be called the new Keynesian economics.

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- A detailed analysis of the modern challenges to the Keynesian position by the monetarists, new classical economists, and real business cycle theorists.
- An extensive treatment of monetary policy which considers the optimal strategy for monetary policy, including intermediate targeting on aggregates versus targeting on interest rates.
- An analysis of the post-1970 slowdown in U.S. output growth, capital formation, and growth in labor productivity. Within this context of intermediate-run growth the views of the supply-side economists and their critics are examined.
- A consideration of the determinants of long-run economic growth. Both the neoclassical growth model and recent models of endogenous growth are discussed.
- An analysis of the question of rules versus discretion in macroeconomic policymaking. Rules for monetary policy as well as a constitutional amendment for balancing the federal budget are considered. The *public-choice* and *partisan* views of macroeconomic policymaking are examined.
- Consideration of foreign exchange rate determination including discussion of recent proposals for policy coordination and target zones for exchange rates.
- An examination of monetary and fiscal policy effects in the open economy, within the framework of the Mundell-Fleming model.

Organization

The organization of the book is as follows. Part I (Chapters 1–2) discusses the subject matter of macroeconomics, the recent behavior of the U.S. economy, and questions of measurement. Part II presents the major macroeconomic models, beginning with the classical system (Chapters 3–4). Consideration of the classical system at the start is useful because the Keynesian model can then be viewed as an attack on the classical orthodoxy. The recent challenges to the Keynesian position can then be rooted in the parts of the classical model that provide starting points for their analysis: the quantity theory of money for the monetarists, and the classical labor market clearing assumptions and choice-theoretic-based behavioral functions for the new classical economists.

The Keynesian model is analyzed in detail in Chapters 5–8, beginning from a very simple model; more complex models are built up to incorporate monetary influences, wage and price flexibility, changing price expectations, and shocks to aggregate supply. Chapter 9 examines monetarism and the issues in the monetarist–Keynesian controversy. Chapter 10 examines the monetarist view of the unemployment–inflation trade-off, the *natural rate* theory, as well as the Keynesian view on the same issue. Chapter 11 considers the *new classical* theory with its central concepts of *rational expectations* and market clearing. The Keynesian response to the new classical economics is then considered. Chapter 12 examines two recent directions in macroeconomic research. One, very strongly rooted

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Preface

in the classical tradition, is the *real business cycle theory*. The second, the *new Keynesian economics*, is, as its name suggests, firmly in the Keynesian tradition. Chapter 13 summarizes and compares the different models.

Part III presents extensions of the models and considers parts of the models in greater detail. The chapters here and in Part IV are designed to be self-contained so that the instructor can choose topics as time and interest allow. Chapter 14 is a more detailed examination of the components of private sector demand: consumption and investment spending. Chapter 15 considers money demand and Chapter 16 the money supply process. Chapter 17 returns to the supply side of macroeconomic models to discuss long-run equilibrium growth and the determinants of growth over intermediate-run periods, periods too long to fit the short-run framework of the models in Part II, but not necessarily situations of long-run equilibrium.

Part IV deals with macroeconomic policy—fiscal policy in Chapter 18 and monetary policy in Chapter 19.

Part V considers *open-economy* macroeconomics. Chapter 20 focuses on exchange rate determination and the choice of an international monetary system. Chapter 21 considers monetary and fiscal policy in the open economy.

In the section on macroeconomic models, the conceptual approach taken here is to develop each model within the aggregate demand–aggregate supply framework in order to facilitate comparisons among the models. Throughout the book the aim is to provide a clear and rigorous, primarily graphical and verbal, analysis. Other pedagogical features are the explanatory captions provided for the graphs in the text and end-of-chapter questions and problems.

Most chapters also contain one or more *Perspectives* sections, which relate the material in the text to events in the real economy.

New Features in the Fifth Edition

- Chapter 21 is a new chapter dealing with monetary and fiscal policy in the open economy. The framework used is the Mundell-Fleming model and the cases of both imperfect and perfect capital mobility are considered.
- Also to add to the coverage of international economic issues, a number of new Perspectives have been added. These cover such areas as: relative degrees of central bank independence in different countries, supply disruptions in the former soviet republics, the European Monetary System, and deficit comparisons across industrialized countries.
- Throughout, the discussion of both theoretical and policy issues has been updated to take account of developments in the past few years. To give just one example, the discussion of rules versus discretion for fiscal policy takes up the constitutional amendment to balance the federal budget, which came very close to approval by Congress in the spring of 1995.
- As new material is added, some older material must receive less space. In this edition an attempt has been made to streamline the discussion wherever possible. As a result this edition is shorter than any of its predecessors.

Teaching Aids and Supplements

A complete set of supplements to the new edition includes the following:

1. An Instructor's Manual has chapter summaries, answers to all end-of-chapter questions, and test materials that include a greatly increased number of problems, essay questions, and multiple-choice questions.
2. A Study Guide by Lawrence Davidson contains a review outline, problems, multiple-choice questions, and exercises on concepts and techniques for each chapter.
3. In addition, a package of computer software, POLICYMAKER: A Macroeconomic Simulation, allows students to simulate models in the text under various assumptions.

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Reviewers recruited by the publisher provided many useful suggestions for this and previous editions. These reviewers include Ed Day, University of Louisville; Edward M. Gamber, Oberlin College; Gary Gigliotti, Rutgers University; William Goffe, Southern Methodist University; James Keeler, Kenyon College; John Lapp, North Carolina State University; Thomas McCaleb, Florida State University; John Trapani, University of Texas–Arlington; Doug Waldo, University of Florida; Jack Adams, University of Arkansas; Lawrence DeBoer, Ball State University; Mario Pastore, Ithaca College; John Vahaley, University of Louisville; H.W. Whitmore, University of Cincinnati; John A. Orr, California State College–Chico; Jeurgan von Hagen, Federal Reserve Bank of St. Louis; and Subarna Samanta, Trenton State College.

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