

# ECONOMICS



DAVID N. HYMAN

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DAVID N. HYMAN  
North Carolina State University

*with 427 illustrations*

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## About the Author

David N. Hyman is presently Professor of Economics and Business at North Carolina State University. He received the Ph.D. degree in economics from Princeton University in 1969. The recipient of numerous academic honors and teaching awards, Professor Hyman is the author of *The Economics of Governmental Activity*, *Public Finance: A Contemporary Application of Theory to Policy*, and *Modern Microeconomics: Analysis and Applications*. He also is the author of a number of monographs, study guides, and articles published in economics journals and anthologies.

# Preface

Today more than ever, the study of economics is a vital component of any student's education. Knowledge of economic principles is essential for success in dealing with day-to-day affairs in the modern world. The purpose of this text is to explain how the U.S. and world economies function and how their daily operation affects the reader. As newly elected President Bush assumes the leadership of the United States, I want to help students learn to fit together all the pieces of the puzzle we know as the economy.

In the 1990s we no longer can afford to neglect the way our own lives are affected by changes in the world economy. In fact, the rapid evolution of a global interdependence among both highly developed and less developed economies demands a fundamental change in the manner in which we teach this course. To reflect this and to demonstrate the ever-increasing importance of international trade in the U.S. economy, I have attempted to clearly integrate international issues throughout the text.

My goal in writing this book is to communicate the relevance of economics to everyday life by blending examples and applications with economic theory in each chapter. I have sought to show students the power, usefulness, and excitement of economics as a discipline. The text comprises a comprehensive learning resource that I hope students will enjoy reading and using.

## **Style and Level**

This book is intended for use in introductory courses in economics at colleges and universities. Students need not have had any previous training in economics. I have written in a lively style and on a level that is easily understandable to undergraduates.

## **Appendix on Graphs**

Graphs are used extensively throughout the book, and students who need to sharpen their skills in using graphs can benefit from studying the Appendix to

Chapter 1. This appendix develops the basic tools for constructing graphs and defines important analytical concepts that students will find helpful even if they are already accustomed to working with graphs.

## **Flexible Teaching and Learning Resource**

This book is designed to serve as a flexible teaching and learning resource that can accommodate a wide number of approaches to teaching economics. The prologue and first seven chapters comprise Parts I and II of the book's 10 parts and are fundamental to understanding both microeconomic and macroeconomic principles. This is a micro-first text, and Parts II through V cover microeconomic theory and issues. Of course, instructors who wish to cover macroeconomics before microeconomics can easily do so by moving directly to Chapter 25, which begins macroeconomic analysis. Macroeconomic theory and issues are covered in Parts VI through IX. Part X deals with international and world economic issues, and in view of the growing importance of these issues some instructors may wish to cover these chapters earlier.

## **Balance of Applications**

Throughout the text I have developed a careful balance of business, policy, social, and international applications. The coverage of both microeconomics and macroeconomics is interspersed with examples, information, and applications that help bring economics to life for students.

## **Teaching and Learning Economics from This Book: What's Different?**

### *1. More Extensive Development of Marginal Analysis and Supply and Demand Analysis*

Too often introductory economics textbooks gloss over basic concepts without showing students how they are used. I believe it is important to give students a thorough grounding in the use of such concepts as opportunity cost, the production possibilities



curve, and supply and demand analysis. For this reason I have devoted seven chapters to developing and using these basic tools. Chapter 1 details the concepts of scarcity and opportunity cost. Chapter 2 introduces students to model building and the concept of rational behavior by showing how marginal analysis is used to understand and forecast behavior. In Chapter 3 the concept of opportunity cost is further applied in explaining production possibilities and personal budgeting.

In Chapter 4 basic supply and demand analysis is painstakingly developed. Chapters 5 and 6 give students ample opportunity to see how supply and demand analysis can be applied. The applications not only allow students to gain knowledge through practice but also set the stage for the development of microfoundations of macroeconomics by analyzing markets for credit, labor, and foreign exchange. Chapter 7 is devoted entirely to the concept of elasticity and its uses and contains numerous practical applications. A major advantage of this text compared with others on the market is that an instructor who wishes to emphasize the microfoundations of macroeconomics can do so by using the material in the first seven chapters without covering the microeconomic theory portions of the text. I believe this flexibility will prove to be highly beneficial to both students and instructors.

In the introductory chapters you will find applications dealing with economic policies designed to reduce drunken driving, management techniques in Japan, the operation of the stock market, marketing of new products, labor market adjustment, rent controls, and entrepreneurship, to mention just a few.

## *2. Coverage of Microeconomics Provides Extensions and Applications that Use the Theory*

Basic microeconomic theory is used in the book to help students understand business, social, and policy issues. The themes developed in the early chapters are continued. For example, Chapter 8 shows how marginal analysis is used to analyze consumer choices and presents a wide range of examples from selecting items on a menu to deciding whether to have children. You will find a modern approach to the theory of the firm in Chapter 9 where the firm's functions and degree of vertical integration are explained using many examples and where the idea of profit maximization is applied to the timely issue of corporate takeovers. The basic theories of production, cost, and supply are developed in Chapters 10

through 12 with applications on how advances in technology improve productivity and how productivity and cost are related. Students will see how changes in input prices and technology can affect profitability, supply, and price in competitive industries and how limits to entry in the New York City taxi industry have created a valuable asset known as the taxi medallion that currently sells for over \$100,000. They also will see how taxes, license fees, and other government-imposed restrictions affect supply and prices.

Chapters 13 through 15 discuss imperfectly competitive product markets, and the theory is enlivened with applications showing how a syndicate acts to control the price of diamonds and how the theory can be extended to reach some surprising conclusions regarding the behavior of monopoly firms. Chapters 16 through 19 are policy-oriented chapters that develop the concepts of market failure and externalities and discuss social regulation, environmental policy, the economics of special-interest groups, the impact of subsidies and tax breaks to agriculture and industry, and the basics of government expenditure and taxation. These chapters draw on modern developments in the theories of externalities, public goods, and public choice.

The last part of the microeconomics section examines input markets with applications to the issues of wage differentials, comparable worth, signaling, screening, personnel management, and the principal-agent problem. In discussing imperfectly competitive input markets, I present a balanced analysis of labor unions and enliven the theory of monopsony with applications to professional sports. Marginal analysis is used to explain investment decisions, and the concept of present value is carefully developed in a chapter on capital.

Appropriately, I end the microeconomics portion of the text with a discussion of income distribution issues and programs of assistance to the poor in the United States.

You will find the approach to both theoretical and policy issues up-to-date and modern in orientation.

## *3. Macroeconomic Analysis Is Firmly Based in an Aggregate Demand/Aggregate Supply Framework that Considers International Linkages*

In covering macroeconomics I emphasize basic principles using an aggregate demand/aggregate supply framework. To set the stage, the early macroeconomics chapters define such fundamental concepts as

real GNP, the price level, inflation, and cyclical unemployment. The basic identity between production and real income is emphasized in the introductory chapter, and the circular flow analysis of expenditure and income shows students how the financial and international sectors of the economy fit into the picture. Two separate chapters explain why cyclical unemployment and inflation are problems that merit serious concern. These chapters contain a wealth of data and information on prices, inflation, and unemployment.

After the stage is set by defining the problems and their consequences, students are taught how to use aggregate demand and aggregate supply analysis to understand the causes of cyclical unemployment and inflation and the process of economic growth. The general concept of macroeconomic equilibrium is developed early in the macroeconomic analysis. Shifts in various components of aggregate demand, including those affecting net export demand, are analyzed and their possible effects on the economy examined. The impact of shifts in aggregate supply on macroeconomic equilibrium also is explained.

Macroeconomic policy is covered in an even-handed way. First students are shown how the economy can either contract or expand in response to shifts in both aggregate demand and aggregate supply. The consequences of an economy operating below potential or overheating are then explored. Early in the development of the theory the classical model of macroeconomic equilibrium is introduced so students can understand the concept of a self-regulating economy. Then the Keynesian model is developed to show students how economic policy can adjust for the sluggishness of the economy's stabilization mechanism. The importance and sources of economic growth are covered before economic policy is considered.

Students are shown how both monetary policy and fiscal policy can stabilize the economy. Problems in effective use of stabilization policy are also highlighted. The issues of the federal budget deficit and the national debt are discussed in a separate chapter. Throughout the macroeconomics chapters, consideration is given to the impact of shifts in the demand for U.S. exports and in U.S. demand for imports.

The chapters on international trade carefully develop the concepts of absolute and comparative advantage and show how exchange rates are determined. The impact of changes in real exchange rates

on macroeconomic equilibrium is covered using the tools of aggregate demand and aggregate supply analysis. The book closes appropriately with a discussion of socialism vs. capitalism and a view of the rapidly changing Soviet economy under *perestroika*.

### **How to Make the Best Use of This Book**

There are a wide variety of approaches to teaching economics. This book is designed for flexible use. Most instructors will want to have their students read the prologue and the first seven chapters even if they do not cover all of the material in class. A significant advantage of this book is that much of the material is clear enough for students to learn by themselves. Instructors can skip some material or highlight in class the examples and applications that most interest them and rely on the book to provide students with the necessary background. You can use the Principles in Practice features as applications in class or use your own favorite current examples to show students the relevance of economics.

Some instructors will prefer to cover macroeconomics immediately after covering the first six chapters. If you choose this approach, you can move directly to Chapter 25 or first cover the chapter on elasticity. Elasticity is an important topic, but it is also one that students find quite difficult to master. If instructors wish to emphasize macroeconomics, they might prefer to avoid the loss in continuity that would result from taking a week or so to cover elasticity and its applications. The transition from Chapter 6 to Chapter 25 will be quite smooth.

The introductory macro section of the book (Part VI) sets the stage by defining the relevant variables and policy issues. Part VII develops aggregate demand/aggregate supply analysis. Part VIII discusses monetary issues and the banking system, while Part IX brings the various parts of the puzzle together and examines stabilization issues. Note that my monetary policy chapter precedes the chapter on fiscal policy. I believe it is important for students to understand the forces influencing interest rates and the role of money in the economy before coping with issues such as crowding out and the impact of the federal deficit on the economy. However, some instructors may wish to cover fiscal policy first, and this can be done easily. If you want to cover international aspects of stabilization problems, you will find it useful to assign Chapter 40 immediately after your coverage of the stabilization chapters.

Instructors pursuing a micro-first approach will not want to skip Chapter 7. They can, however, choose among the many theoretical and policy chapters included in the microeconomics part of the book to suit their preferences.

One innovative way to teach the course if you wish to emphasize international issues is to cover the last part of the book (Part X) immediately after covering the core material (Chapters 1-6), the basic macroeconomic material (Chapters 25-31), and the chapters on money and financial markets (Chapters 32-35). You can pick and choose among the topics in these chapters and intersperse your lectures with policy issues from Chapters 36 through 38 as you move along.

As you can see, the way an instructor will use this book depends on his or her interests and desired emphasis. This book is a flexible teaching tool, and I encourage instructors to be creative in the way they use it.

### **Distinctive Features of the Book and How They Assist Students in Learning**

Above all, this text and its supplements have been designed to develop complex ideas in a way students can easily understand. An outstanding feature of this student-oriented approach is its user-friendly writing style that helps students see readily how economic problems and issues affect them. I have long maintained that economics is a favorite subject of students and that with the right approach they will enjoy learning and applying economic concepts. A lively prologue points out the benefits of studying economics from the student's point of view and provides information on careers in economics. The prologue also offers students hints about how to succeed in the course through use of the book's pedagogy.

To aid students in learning, I have incorporated the following features in each chapter:

1. **Concept Preview:** The learning objectives of each chapter are listed to aid students in organizing their study sessions.
2. **Concept Checks:** A series of three review questions at the end of each major section is designed to help students test their comprehension and mastery of the main points in that section.
3. **Key Terms and Concepts:** Key terms and concepts are boldfaced and carefully defined as they are introduced. Each definition is highlighted in the margin of the book at the place where it is introduced. This feature helps students learn and

helps them review important concepts when studying for examinations. All key terms appear in an alphabetized glossary at the end of the book.

4. **Principles in Practice:** Each chapter contains one or more real-world applications or perspectives using economic principles that show students how the topics they are studying are relevant to business, financial, personal, social, policy, or international issues. These features bring economics to life by providing up-to-date information and insights on a wide array of topics.
5. **Economic Thinkers:** From Adam Smith to Karl Marx, economists over the years have shaped our thinking and our policies. In selected chapters you will find short sketches that highlight the ideas, times, and lives of important economists and other key figures in economic history.
6. **Career Profiles:** Each of the book's 10 parts opens with a profile of an American who earned a college degree in economics. Students can see how these successful people benefited from studying economics and can gain insights from the experiences of these productive individuals. The subjects of the profiles include people who have continued to pursue economics in their careers, and also people who have chosen to enter other fields. The Career Profiles offer students clear evidence of the many reasons why economics is a valuable course of study.
7. **Boxed Graphs and Tables:** Each graph and related table appear in a self-contained boxed exhibit. Having all the relevant material within a single box aids learning and makes it easier for students to review material while studying for examinations. Each graph has a carefully written legend that appears within the box.
8. **Problems and Applications:** These end-of-chapter questions are more challenging than those appearing in the Concept Checks. Students will find working through the problems a useful way to study and review and to practice and apply what was learned in the chapter.
9. **Suggested Readings:** This feature presents a number of supplementary sources that students can use to extend their knowledge or write term papers. The listings are annotated to show students what they can gain by reading them.



## Supplementary Resources

The book has a number of ancillary materials that have been carefully designed to assist the instructor in teaching the material and the student in learning.

1. **Instructor's Manual:** I have written a comprehensive manual to help instructors organize their lectures. The manual contains conversion notes, instructional objectives, a list of key terms, a point-by-point discussion of chapter contents that includes hints for clarifying difficult material as well as indications of where transparencies will be most helpful, and answers to text problems. The manual includes 160 transparency masters.
2. **Study Guide:** Each chapter of the guide contains chapter objectives, a fill-in chapter summary, vocabulary exercises using the key words in the chapter, and a series of topic-centered modules that include activities designed to reinforce key concepts. Among these activities are additional work with graphs, fill-in charts and tables, completion exercises, and other interactive tasks. The modules are followed by a self-test for understanding, consisting of multiple-choice questions plus one or two short essay questions. To encourage understanding answers are provided for all answers.
3. **Test Bank:** The test bank contains over 4,000 questions, with a significant percentage of items requiring graphical analysis. One hundred items are essay questions; the balance are four- and five-item multiple-choice questions. The test bank also contains a math pretest that allows instructors to assess their students' math skills before getting into the course and provides students with feedback on their readiness to handle the math in the course.
4. **Computerized Test Bank:** The EXAMgen test generation software includes all the questions in the test bank and prints out the graphs required for graphical analysis as the test itself is printed. Items may be edited, added, or deleted; test items may be selected manually or by computer for varying question types, topics, and levels. Choices in multiple-choice questions may be scrambled and up to nine versions of a test produced.
5. **Transparency Acetates:** There are 200 acetates, including many two-color reproductions of key

tables and graphs from the text, and additional overlays illustrating how curves change in response to changes in conditions.

6. **Software:** A set of menu-driven tutorials and simulations was developed by a team of experienced economics instructors who are also experts in the programming and educational use of computer software. This user-friendly software was created on the basis of an extensive review of the strengths and weaknesses of other currently available economics software packages. There are eight MicroVision and MacroVision tutorials. One presents key concepts in graphical analysis, and seven are linked to the text content. Each tutorial includes questions, an "Exploring Possibilities" feature, and a quiz.

## Extensive Development

An unprecedented number of research and development steps were taken to make this the most contemporary and pedagogically effective economics text you will ever use.

A detailed questionnaire was mailed to 4,000 principles of economics instructors to ask their preferences in terms of coverage, organization, pedagogy, and supplements. Additionally, the instructors were asked to comment on the utility and effectiveness of their current text and its supplements.

A panel of 20 reviewers critiqued the first draft. These comments helped identify consensus points and controversial areas that were discussed at a two-day focus group attended by six key reviewers. A second panel of reviewers, two of whom had critiqued the first draft, examined the revised draft.

To enhance the text's student orientation, selected members of the reviewer panel taught from the manuscript for a semester. They and their students provided input on content and pedagogy.

Seven instructors selected from the panel of second-draft reviewers met for another two-day focus group, which covered comments on the first two drafts, results of the class testing, and preferences for supplements.

Three professional, technical experts critiqued the third draft for accuracy, writing style, organization, and clarity of presentation. To further ensure the material's clarity and accuracy, the third draft also was reviewed by 11 instructors with different specialties in the field of economics. During each stage of production, the text was reviewed by experienced in-

structors as additional confirmation of technical accuracy.

Finally, each component of the supplements package was created to enhance the text and make teaching and learning more rewarding. The test bank, study guide, and software were thoroughly reviewed by qualified individuals.

## Acknowledgments

An undertaking of this magnitude requires the skills and efforts of many people. Special credit goes to Glenn Turner, Senior Vice President; Denise Clinton, Acquisitions Editor; Terry Eynon, Developmental Ed-

itor; Elisabeth Heitzeberg, Copy Editor; Jean Babrick, Supplements Developmental Editor; Patricia Tannian, Project Manager; and Kathy Lumpkin, Production Editor.

These publishing professionals and their colleagues put in many hours of effort to help the author produce a polished text. They also helped guide the project to completion by overseeing the many complicated steps necessary to convert a raw manuscript into a finely produced book. John Rokusek provided a practical and pleasing design for the book that facilitates its use.

## Reviewers

The reviewers of the manuscript and supplements provided numerous excellent suggestions. I am indebted to them for their many contributions and insights.

**Curt L. Anderson**  
University of Minnesota at Duluth

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Boise State University

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Virginia Commonwealth University

**Arthur Wright**  
University of Connecticut

**Darrel Young**  
University of Texas at Austin

I regard these reviewers as partners in the development of this text. Their detailed reviews forced me to think carefully about basic issues in economics and guided me to produce a text that I believe is both technically sound and easy to read. I have learned a great deal from the comments of the reviewers listed above, and I thank them for the time and effort they put in.

My colleagues at North Carolina State University were always available to help me sound out my ideas and supply information on their areas of specialization. My students, who participated in a classroom test of the manuscript in the spring of 1988, offered

me encouragement and criticism, and I thank them heartily. Joan Livingood and Carolyn Smith provided expert secretarial assistance at various stages of the project, and I am indebted to them for their highly competent service.

Finally, I must thank my wife Linda for her support during the period I have worked on this project. She certainly deserves a medal for her patience with a writer who had little time to do anything other than write for a period of two and a half years.

*David N. Hyman*

# Contents in Brief

## **PART I Introduction to Economics**

- Prologue, P2
- 1 Economics: What It's All About, 1
  - Basic Tools for Analyzing Economic Relationships, 1A1
- 2 The Economic Way of Reasoning: Models and Marginal Analysis, 11
- 3 Production Possibilities and Opportunity Cost, 24

## **PART II Supply and Demand: Markets and the Price System**

- 4 Market Transactions: Basic Supply and Demand Analysis, 44
- 5 Using Supply and Demand Analysis, 71
- 6 The Price System: How It Functions and When It Fails, 95
- 7 Elasticity of Supply and Demand, 117

## **PART III Product Markets: Microeconomic Analysis**

- 8 Consumer Choice and the Theory of Demand, 145
  - Indifference Curve Analysis, 8A1
- 9 The Business Firm: A Prologue to the Theory of Market Supply, 170
- 10 Production and Cost, 187
  - Isoquant Analysis: Choosing the Method of Production, 10A1
- 11 The Profit-Maximizing Competitive Firm and Market Supply, 212

- 12 Long-Run Supply in Competitive Markets, 238
- 13 Monopoly, 261
- 14 Monopolistic Competition and Oligopoly, 286
  - Oligopoly Strategies and the Theory of Games, 14A1

## **PART IV Government as a Regulator in Markets and as a Provider of Services: Microeconomic Analysis**

- 15 Antitrust Policy and Regulation of Markets, 310
- 16 Market Failure and the Role of Government in Allocating Resources, 331
- 17 Externalities and the Environment: Policy Analysis, 349
- 18 Subsidizing Agriculture and Industries: The Economics of Special-Interest Groups, 368
- 19 The Government Sector of the Economy: Expenditures, Revenues, and Public Choice, 390

## **PART V Input Markets and Incomes: Microeconomic Analysis**

- 20 Input Markets and the Demand for Resources, 412
- 21 Labor Markets, Labor Productivity, and Personnel Management, 436
- 22 Imperfectly Competitive Input Markets: Labor Unions, Monopsony, and Bilateral Monopoly, 454
- 23 Interest, Rents, and Profit, 477
- 24 The Distribution of Income and the Economics of Poverty, 500

**PART VI National Income,  
Production, and the Price  
Level: Macroeconomic  
Analysis**

- 25 Gross National Product and the Performance  
of the National Economy, 524  
Other National Income and Product Account  
Concepts, 25A1
- 26 Business Cycles and Unemployment, 555
- 27 Inflation and Its Consequences, 580
- 28 The Forces of Aggregate Supply and Demand:  
Investigating the Causes of Cyclical  
Unemployment and Inflation, 603

**PART VII Aggregate Demand and  
Aggregate Supply:  
Macroeconomic Analysis**

- 29 The Components of Aggregate Demand:  
Consumption, Investment, Government  
Purchases, and Net Exports, 630
- 30 Aggregate Demand and Keynesian Analysis of  
Macroeconomic Equilibrium, 654  
A Complete Keynesian Model, 30A1
- 31 Aggregate Supply: Its Influence on  
Macroeconomic Equilibrium and Economic  
Growth, 684

**PART VIII Money, Financial Markets,  
and Macroeconomic  
Equilibrium**

- 32 The Functions of Money, 704
- 33 The Banking System, 724
- 34 The Federal Reserve System and Its Influence  
on Money and Credit, 747

**PART IX Stabilizing the Economy**

- 35 Stabilization of the Economy Through  
Monetary Policy, 772
- 36 Stabilization of the Economy Through Fiscal  
Policy: Effects on Aggregate Demand and  
Aggregate Supply, 799
- 37 The Federal Budget Deficit and the National  
Debt, 826
- 38 Tradeoffs Between Inflation and  
Unemployment and the Theory of Rational  
Expectations, 846

**PART X International Economic  
Issues**

- 39 International Trade, Productivity, and the  
Economics of Less Developed Countries,  
868
- 40 The Economics of Foreign Exchange and the  
Balance of International Trade, 896
- 41 Economics and Ideology: Socialism vs.  
Capitalism, 927



# Introduction to Economics

# Prologue

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## **Economics: What's in It for You?**

Do you really understand what happened in the stock market crash of '87?

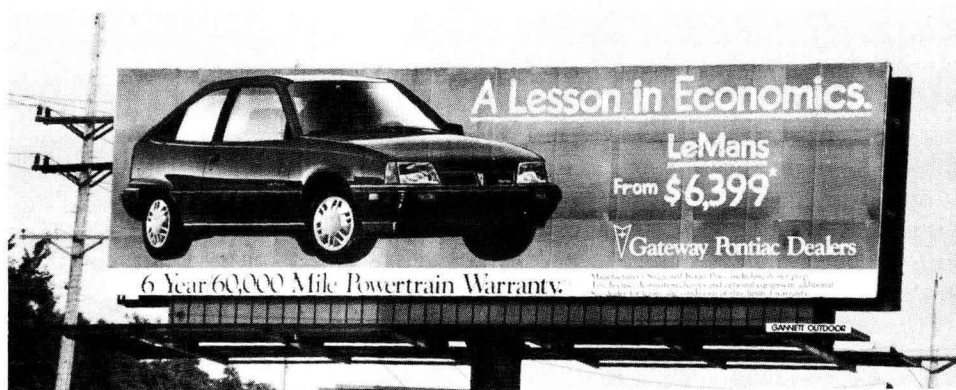
On "Black Monday"—October 19, 1987—Wall Street watched in frozen disbelief as the numbers on its monitors dipped, slid, then plummeted downward. As the sun rose in Europe, Japan, and Australia, their financial communities awakened to the same towering wave of panic selling that had stunned the United States the day before.

In the tense, uncertain days and weeks that followed, questions about what caused the crash by far outnumbered answers—and the answers varied markedly depending on who was asked. Coming in for large chunks of blame were the burgeoning U.S. federal budget and trade deficits, the unchecked fall of the American dollar against foreign currencies, and the relatively new and in some circles suspect phenomenon known as portfolio insurance.

What economists know, and what you as a student of economics have the opportunity to discover, is that there is never a single, clear-cut reason for an event like the stock market crash of '87. The study of economics can help you comprehend the myriad causes of such events and view them in perspective. As you will see, economics is influenced by developments in the diverse arenas of business, politics, sociology, science, nature, religion, and history. Economic trends make headline news almost daily; and whether or not you are aware of it, economics is a vital and pervasive part of your everyday life.

This is one reason why, even if you don't choose it as your major subject, a course in the principles of economics is an essential element of your undergraduate education. In fact, many educators would suggest that this course is among the two or three most important ones a college student will ever take. An understanding of the financial, social, and political context in which the economy operates will help you develop informed opinions on a wide range of business and public issues. You'll also discover numerous ways in which the U.S. economy is linked to the economies of other nations: Japan, the countries of Western Europe, and a host of Third World states in various stages of development. Not only our well-being but our very survival may depend on our relationships with these trading partners.

From a practical standpoint, your study of economics will help you sharpen your decision-making skills by showing you a logical way to evaluate alternative courses



Economics helps you make informed choices in your personal and business life.

of action. As you explore the concept of *opportunity cost*, you'll discover that every choice you make has both a benefit and a cost. For example, suppose you decide to get a part-time job so you can earn money to buy a car. You'll have the benefit of owning the car, but you'll pay a cost in terms of the study and leisure hours you now must devote to working so as to pay for and maintain the car. After weighing your choices in cost-benefit terms, you may decide you don't need a car now after all!

This course in economics also will enhance your analytical abilities in the important area of personal finance. You'll become familiar with the concepts of *rational behavior* and *marginal cost and benefit* as they affect your budgeting decisions. Economic analysis explains why even at bargain prices there's a limit to the quantity of an item you'll choose to buy, be it Taco Supremes or compact discs!

What's more, you'll learn the meanings of some terms you probably hear every day but may not fully comprehend. For example, what exactly is *inflation*? How does it happen, and what causes it to accelerate or diminish? What is a *recession* and what are its warning signs? Why does the government say the economy is operating at *full employment* when the unemployment rate is actually 5.5%? What is the U.S. *trade deficit*, and why is it both good and bad for our economy as a whole or for you personally?

You've seen all of these terms in newspaper headlines and on the nightly TV news, but you may not realize the ways in which you personally are affected by each of these economic trends. This course is your opportunity to find out. You'll gain a thorough understanding of the interplay of economic forces and of your role in our dynamic economy. Although you may not plan to major in economics, this course might cause you to become so intrigued with the subject that you change your mind!

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## Career Opportunities

If you should decide to major in economics, what career possibilities will be open to you?

Armed with a degree in economics, you can seek a career in literally dozens of fields. Economics majors are succeeding as entrepreneurs, diplomats, bankers, journalists, Cabinet heads, corporate leaders, consultants, judges, and politicians.

Because economics is such a wide-ranging discipline, it's an excellent adjunct to

many programs of study. If your major is business administration, political science, or international relations, a minor in economics will provide valuable insights into the contemporary social environment. If you elect to concentrate in marketing or finance, you can profitably pursue economics as a second major or a minor. A pairing of economics and journalism can help you lay the groundwork for a successful career in business communications.

While an undergraduate degree in economics is a prerequisite for advanced studies in the discipline, it also serves as an excellent foundation for graduate work in a variety of other fields: business, law, public administration, and health, to name a few.

Then, of course, you may decide to become a professional economist. In this case you almost certainly will need a graduate degree and will be pursuing career opportunities in business, teaching, research, or government. The National Association of Business Economists publishes a helpful booklet, *Careers in Business Economics*,<sup>1</sup> that describes the responsibilities of economists in government, insurance, banking, consulting, investments, industry, and communications. The booklet also outlines the education requirements for business economists and provides information on salaries.

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## Career Profiles

To give you an idea of the diversity of careers available to students who choose to major in economics, we present in this text a series of Career Profiles. Each of the book's 10 sections opens with a profile of an American whose name or face you may readily recognize. Although there is as much as a 45-year age span among our subjects, and although they are enjoying success in widely different fields, they all have one important thing in common: a degree in economics.

As you study these profiles, don't focus only on the subject's credentials and accomplishments. Take the opportunity to do a little brainstorming about your own future. Ask yourself which of these fields is most appealing to you. Why? Do you want to get on the fast track in a major corporation, with the attendant perquisites and power struggles? Or would you thrive as an entrepreneur, with all the risks and rewards of being your own boss? Do you see yourself as a Wall Street guru, crunching numbers to forecast stock market trends with billions of dollars at stake? How about a position on the trading desk of the Federal Reserve Board's Open Market Committee, executing large-volume sales and purchases of government securities?

The purpose of this exercise isn't to fantasize about a future of wealth and power (although these certainly are valid ambitions). Rather you'll want to consider possible careers in light of your interests, abilities, and temperament, and your willingness to invest time and effort in acquiring the necessary background.

Whether you choose the career path of one of our profile subjects is less important than that you become aware of the exciting and extensive array of options open to you as an economics major. And if you select another field of concentration, you'll find that in all your endeavors you'll be well served by the discipline of the eco-

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<sup>1</sup>Copies of this booklet may be obtained from the National Association of Business Economists, 28349 Chagrin Blvd., Suite 201, Cleveland, OH 44122. Single copies are free of charge; quantity discounts are available.