Macmillan Publishing Co., Inc.

RIFUT VOICE

Collier Macmillan Publishers

GERTREN

contents

part one introduction and measurement

à

INTRODUCTION

- 1.1 What Is Macroeconomics? 2
- **1.2** Post-World War II U.S. Economic Performance **4**
- 1.3 Central Questions in Macroeconomics 10
- 1.4 A Preview of the Text 11
- 2

MEASUREMENT OF MACROECONOMIC VARIABLES

- 2.1 The National Income Accounts 12
- 2.2 Gross National Product 13
- 2.3 National Income 18

- 2.4 Personal and Personal Disposable Income
- 2.5 Some National Income Accounting
- Identities 21
- 2.6 Measuring Price Changes: Real Versus Nominal GNP 23
- 2.7 The Consumer Price Index and the Producer Price Index 26
- 2.8 Measures of Cyclical Variation in Output 27
- 2.9 Conclusion 31

part two macroeconomic models

34

56

CONTENTS



- 3.1 The Starting Point 34
- 3.2 The Classical Revolution 37
 - 3.3 Production 39
 - 3.4 Employment 41
 - 3.5 The Determinants of Output and Employment in the Classical Model 47

THE CLASSICAL SYSTEM (II): MONEY, PRICES AND INTEREST

- 4.1 The Quantity Theory of Money 56
- 4.2 The Classical Theory of the Interest Rate 64
- 4.3 Policy Implications of the Classical Equilibrium Model 68 Fiscal Policy 68
 - Monetary Policy 71
- 4.4 The Classical System with Rigid Money Wages—One Explanation of Unemployment 71
- 4.5 The Classical Equilibrium System: Conclusion 76

xiv

APPENDIX THE CLASSICAL SYSTEM: DISEQUILIBRIUM ANALYSIS

- A.1 General Features of Classical Disequilibrium Models 80
- A.2 Fisher's Model of the Transition Period 81
- A.3 Classical Disequilibrium Analysis:

Conclusion 89

5

THE KEYNESIAN SYSTEM (I): THE ROLE OF AGGREGATE DEMAND 92

- 5.1 The Problem of Unemployment 92
- 5.2 The Simple Keynesian Model: Conditions for Equilibrium Output 97
- 5.3 The Components of Aggregate Demand 102 Consumption 102 Investment 105
 - Government Spending and Taxes 107
- 5.4 Determining Equilibrium Income 107
- 5.5 Changes in Equilibrium Income 111
- 5.6 Fiscal Stabilization Policy 117
- 5.7 Summary 118

THE KEYNESIAN SYSTEM (II): MONEY, INTEREST, AND INCOME

6.1 The Role of Money in the Keynesian System 122 Interest Rates and Aggregate Demand 123

The Keynesian Theory of the Interest Rate 126

- Rate 126
- The Keynesian Theory of Money Demand 128
- The Effects of an Increase in the Money Stock 134
- 6.2 The IS-LM Curve Model 136 Money Market Equilibrium: The LM Curve 136

Product Market Equilibrium: The IS Curve 148

The IS and LM Curves Combined 161

122

THE KEYNESIAN SYSTEM (III): POLICY EFFECTS IN THE IS-LM MODEL

7.1 Factors Affecting Equilibrium Income and the Interest Rate 166 Monetary Influences: Shifts in the LM

. **.**

Schedule 166

Real Influences: Shifts in the IS Schedule 168

- 7.2 The Relative Effectiveness of Monetary and Fiscal Policy 175 Policy Effectiveness and the Slope of the IS
 - Schedule 176
 - Policy Effectiveness and the Slope of the LM Schedule 182
- 7.3 Summary 188

2 - 4 A

THE KEYNESIAN SYSTEM (IV): AGGREGATE SUPPLY

166

8.1 The Keynesian Aggregate Demand Curve 194

- 8.2 The Keynesian Aggregate Demand Curve Combined with the Classical Theory of Aggregate Supply 200
- **8.3** The Keynesian Model with a Flexible Price Level and a Fixed Money Wage **204**
- 8.4 Labor Supply and Variability in the Money Wage 211 The Classical and Keynesian Theories of

The Classical and Keynesian Theories of Labor Supply 211

The Keynesian Aggregate Supply Curve with a Variable Money Wage _ 215

- Policy Effects in the Variable-Wage Keynesian Model 215
- 8.5 The Effects of Shifts in the Aggregate Supply Function 220

The Recent Behavior of Price and Output 221

Factors that Shift the Aggregate Supply Schedule 221

- 8.6 Supply Shocks and Aggregate Demand Policy 228
- 8.7 Keynes versus the Classics 230

xvi

Keynesian Versus Classical Theories of Aggregate Demand 231 Keynesian Versus Classical Theories of Aggregate Supply 233 Keynesian Versus Classical Policy Conclusions 235

MONETARISM (I): THE IMPORTANCE OF MONEY

238

9.1	Intro	oduction	238
-----	-------	----------	-----

9.2 The Reformulation of the Quantity Theory of Money 241Money and the Early Keynesians 242

Friedman's Restatement of the Quantity Theory: The Weak Form 247

Friedman's Restatement of the Quantity Theory: The Strong Form 252

9.3 Monetary and Fiscal Policy: Monetarists versus Neo-Keynesians 256 Fiscal Policy 256 Monetary Policy 260 Summary 266

MONETARISM (II): THE NATURAL RATE OF UNEMPLOYMENT 270

10.1 The Role of Monetary Policy: A Monetarist View 272
Monetary Policy in the Short Run 272
Monetary Policy in the Long Run 274
Policy Implications of the Natural Rate
Hypothesis: The Monetarist View 279
10.2 A Keynesian View of the Output-Inflation Trade-off 281

The Phillips Curve: A Keynesian Interpretation 281

- Stabilization Policies for Output and Employment: The Keynesian View 286
- 10.3 The Monetarists Versus the Keynesians: A Summary 289 Monetarist Versus Keynesian Theories of

Aggregate Demand 289

D

xvii

Monetarist versus Keynesian Theories of Aggregate Supply 291

THE NEW CLASSICAL ECONOMICS 294

- **11.1** The New Classical Attack **296** A Review of the Keynesian Position 296 The Rational Expectations Concept and its Implications 297
- The New Classical Policy Conclusions 304 11.2 A Broader View of the New Classical Position 307
- 11.3 The Keynesian Response 310 The Question of Persistence 310 The Extreme Informational Assumptions of Rational Expectations 312 The Auction Market Characterization of the Labor Market 314
- 11.4 The Current State of the Debate 316



5

MACROECONOMIC MODELS: A SUMMARY

12.1 Theoretical Issues 322 12.2 Policy Issues 328

part three extensions of the models

CONSUMPTION AND INVESTMENT SPENDING

13.1 Consumption 332 Early Empirical Evidence on the Keynesian Consumption Function 332 The Life Cycle Theory of Consumption 338 Policy Implications of the Life Cycle Hypothesis 344 The Permanent Income Hypothesis 347

CONTENTS

322

332

xviii

∾ v(2
	13.2 Investment Spending 349	
	Business Fixed Investment 350	
	Other Components of Investment 359	
	13.3 Conclusion 369	
	MONEY DEMAND:	
	THEORY AND EVIDENCE	374
•		
	14.1 The Definition of Money 377	
	The Functional Definition of Money 377	
-	Innovations in the Deposit Market 379	
	The Redefined Monetary Aggregates 381	
	14.2 The Theory of the Transactions Demand for	
	Money 382	
2 m 2 m	The Inventory-Theoretic Approach to	
	Money Demand 383	
	The Inventory-Theoretic Approach to	
	Money Demand Continued: The Case of	
· ·	Uncertainty 393	
e M	Summary 396	
· v	14.3 Extensions of Keynes's Theory of the Demand	
	for Money as a Store of Wealth 397	
¢ .	The Demand for Money as Behavior	
х. + ¹	Toward Risk 399	•
х.	Money Demand and the Rate of	
	Interest 402	:
	Is Tobin's Theory a Theory of Money	
	Demand? 404	
	14.4 The Case of Missing Money 405	
	14.5 The Current State of the Theory of Money	
ବ [ି]	Demand 409	
· · ·		
	THE MONEY SUPPLY PROCESS	412
· ·		
	15.1 The Federal Reserve System 413	•
•	The Structure of the Central Bank 413	
· · ·	Federal Reserve Control of the Money	
	Stock 414	
• •	The Tools of Federal Reserve Control of	
- -	Bank Reserves 416	
	15.2 Bank Reserves and Bank Deposits 418	
	A Simple Model of Deposit Creation 419	
	Deposit Creation: More General Cases 424	
• •	CONTENTS	*-
	CONTENŢS	XiX
	•	

15.3 Who Controls the Money Stock? 42815.4 Summary 432

6 THE SUPPLY SIDE: **INTERMEDIATE- AND** LONG-TERM ECONOMIC GROWTH 436 Long-Run Steady-State Growth 437 16.1 Growth and the Aggregate Production Function 437 Sources of Economic Growth 440 16.2 Determinants of Output Growth in Intermediate-Run Periods 446 Recent U.S. Economic Growth 447 The Supply-Side Position 449 Supply-Side Policy Recommendations 459 The Neo-Keynesian Critique of Supply-Side Economics 461 Summary 465 16.3 Reaganomics: An Application of Supply-Side Theory 467 Elements of President Reagan's Economic Recovery Plan 468 Neo-Keynesian Doubts about Reaganomics 470 Reaganomics: Some Early Evidence 472

MACROECONOMICS OF OPEN ECONOMIES

476

- 17.1 The U.S. Balance of Payment Accounts 477
- 17.2 Exchange Rates and the Market for Foreign Exchange 482

The Foreign Exchange Market 482 Exchange Rate Determination: Flexible Exchange Rates 484

Exchange Rate Determination: Fixed Exchange Rates 486

Exchange Rate Determination: A Managed Float 490

17.3 The Balance of Payments and the Level of Economic Activity 492

The Effects of Imports and Exports on Equilibrium Income 492

The Level of Economic Activity and the Trade Balance 496

Capital Flows and the Level of Economic Activity 498

17.4 The Relative Merits of Fixed Versus Flexible Exchange Rates 499

APPENDIX AN OPEN ECONOMY MACROECONOMIC MODEL

- A.1 An Open Economy IS-LM Model 507
- A.2 Monetary and Fiscal Policy in an Open Economy: Fixed Exchange Rates 510
- A.3 Monetary and Fiscal Policy in an Open Economy: Flexible Exchange Rates 514
- A.4 Insulation of the Economy from Foreign Shocks under Flexible Exchange Rates 517

part four economic policy



FISCAL AND INCOMES POLICIES

522

- 18.1 The Goals of Macroeconomic Policy 523
- **18.2** The Goals of Macroeconomic Policymakers **524**
- 18.3 The Federal Budget 528
- 18.4 The Economy and the Federal Budget: the Concept of Automatic Fiscal Stabilizers 531
- 18.5 Discretionary Fiscal Policy and the Choice of a Fiscal Instrument 536
 - Measuring Discretionary Fiscal Policy Actions 538
 - The Choice of a Fiscal Instrument 542
- 18.6 The Neo-Keynesian Objection to Constitutional Budget Balance Amendments 545
- **18.7** Incomes Policies **546** The Case for Incomes Policies 546

The Case Against Incomes Policies 549 The 1971–74 Price Stabilization Program 551

19 MONETARY POLICY

554

- **19.1** The Monetary Policymaking Process **554**
- **19.2** The Strategy of Monetary Policy **557** The Concept of Intermediate Targeting **557** The Inefficiency of Intermediate

Targeting 558

The Case for Intermediate Targeting on a Monetary Aggregate 567

- **19.3** The Tactics of Monetary Policy: Interest Rate Versus Reserve Control **569**
 - Monetary Control with an Interest Rate Instrument 570
 - Monetary Control with a Reserve Instrument 572
 - A Comparison of the Two Operating Procedures 574
- 19.4 Monetary Versus Fiscal Policy as Stabilization Tools 577

The Side Effects of Monetary Policy, 578 The Policy Mix in Practice 580

19.5 Rules Versus Discretion in Monetary Policy **582**

APPENDIX A RETURN TO THE GOLD STANDARD: THE SUPPLY-SIDER'S PRESCRIPTION FOR MONETARY POLICY

586

A.1 The Workings of a Gold Standard 587A.2 Should We Return to the Gold Standard? 589

HISTORICAL APPENDIX

INDEX

÷ .

599

CONTENTS