

MACROECONOMICS

Policy and Practice

Second Edition

Frederic S. Mishkin



2nd Edition

Macroeconomics

Policy and Practice

Frederic S. Mishkin

Columbia University

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Chapter 19 Investment	<ul style="list-style-type: none"> • Stock Market Crashes and Recessions 	<ul style="list-style-type: none"> • U.S. Government Policies and the Housing Market 	
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To My Mom

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Brief Contents

PART 1	Introduction	1
	Chapter 1 The Policy and Practice of Macroeconomics	3
	Chapter 2 Measuring Macroeconomic Data	19
PART 2	Macroeconomic Basics	48
	Chapter 3 Aggregate Production and Productivity	50
	Chapter 4 Saving and Investment in Closed and Open Economies	73
	Chapter 5 Money and Inflation	101
PART 3	Long-Run Economic Growth	144
	Chapter 6 The Sources of Growth and the Solow Model	146
	Chapter 7 Drivers of Growth: Technology, Policy, and Institutions	178
PART 4	Business Cycles: The Short Run	204
	Chapter 8 Business Cycles: An Introduction	207
	Chapter 9 The <i>IS</i> Curve	231
	Chapter 10 Monetary Policy and Aggregate Demand	251
	Chapter 11 Aggregate Supply and the Phillips Curve	281
	Chapter 12 The Aggregate Demand and Supply Model	299
	Chapter 13 Macroeconomic Policy and Aggregate Demand and Supply Analysis	327
PART 5	Finance and the Macroeconomy	370
	Chapter 14 The Financial System and Economic Growth	372
	Chapter 15 Financial Crises and the Economy	391
PART 6	Macroeconomic Policy	425
	Chapter 16 Fiscal Policy and the Government Budget	427
	Chapter 17 Exchange Rates and International Economic Policy	450
PART 7	Microeconomic Foundations of Macroeconomics	492
	Chapter 18 Consumption and Saving	494
	Chapter 19 Investment	523
	Chapter 20 The Labor Market, Employment, and Unemployment	544

PART 8	Modern Business Cycle Analysis and Macroeconomic Policy.	571
	Chapter 21 The Role of Expectations in Macroeconomic Policy . .	573
	Chapter 22 Modern Business Cycle Theory.	597
	Epilogue	619
	Web Chapter Financial Crises in Emerging Market Economies Go to the Companion Website, www.pearsonhighered.com/mishkin	

Contents

	Prefacexxxi
PART 1	Introduction	1
	Chapter 1	
	THE POLICY AND PRACTICE OF MACROECONOMICS	3
	PREVIEW	3
	THE PRACTICE OF MACROECONOMICS	3
	The Process: Developing Macroeconomic Models	3
	The Purpose: Interpreting Macroeconomic Data	5
	MACROECONOMIC POLICY	9
	How Can Poor Countries Get Rich?	9
	Is Saving Too Low?	10
	Do Government Budget Deficits Matter?	11
	How Costly Is It to Reduce Inflation?	11
	How Can We Make Financial Crises Less Likely?	12
	How Active Should Stabilization Policy Be?	12
	Should Macroeconomic Policy Follow Rules?	13
	Are Global Trade Imbalances a Danger?	13
	HOW WE WILL STUDY MACROECONOMICS	13
	Emphasis on Policy and Practice	13
	Concluding Remarks	14
	SUMMARY	15
	KEY TERMS	15
	REVIEW QUESTIONS	15
	PROBLEMS	16
	DATA ANALYSIS PROBLEMS	17
	Chapter 2	
	MEASURING MACROECONOMIC DATA	19
	PREVIEW	19
	MEASURING ECONOMIC ACTIVITY: NATIONAL INCOME ACCOUNTING	19
	MEASURING GDP: THE PRODUCTION APPROACH	20
	Market Value	20
	Final Goods and Services	21
	Newly Produced Goods and Services	23
	Fixed Period of Time	23
	POLICY AND PRACTICE: Can GDP Buy Happiness?	23
	Stocks Versus Flows	24
	MEASURING GDP: THE EXPENDITURE APPROACH	24
	Consumption Expenditure	25
	Investment	26
	Government Purchases	26
	Meaning of the Word <i>Investment</i>	26
	Net Exports	27
	Changes in the Spending Components of GDP over Time	27

X CONTENTS

MEASURING GDP: THE INCOME APPROACH 28
 Categories of Income 28
 An International Comparison of Expenditure Components 29
 Income Measures 30
REAL VERSUS NOMINAL GDP 31
 Nominal Variables 31
 Real Variables 32
 Chain-Weighted Measures of Real GDP 33
MEASURING INFLATION 33
 GDP Deflator 33
 PCE Deflator 34
 Consumer Price Index 34
 **POLICY AND PRACTICE: Policy and Overstatements
 of the Cost of Living** 35
 Inflation Rate 35
 Percentage Change Method and the Inflation Rate 36
MEASURING UNEMPLOYMENT 37
 MACROECONOMICS IN THE NEWS: Unemployment and Employment 39
MEASURING INTEREST RATES 40
 Types of Interest Rates 40
 MACROECONOMICS IN THE NEWS: Interest Rates 40
 Real Versus Nominal Interest Rates 41
 The Important Distinction Between Real and Nominal
 Interest Rates 42
SUMMARY 43
KEY TERMS 43
REVIEW QUESTIONS 44
PROBLEMS 45
DATA ANALYSIS PROBLEMS 47

PART 2 Macroeconomic Basics 48

Chapter 3
AGGREGATE PRODUCTION AND PRODUCTIVITY 50
PREVIEW 50
DETERMINANTS OF AGGREGATE PRODUCTION 50
 Factors of Production 50
 Production Function 51
 Cobb-Douglas Production Function 51
 APPLICATION: Why Are Some Countries Rich and Others Poor? 52
 Cobb-Douglas Production Function Characteristics 54
 Changes in the Production Function: Supply Shocks 57
DETERMINATION OF FACTOR PRICES 59
 Demand for Capital and Labor 60
 Supply of Capital and Labor 62
 Factor Market Equilibrium 62
DISTRIBUTION OF NATIONAL INCOME 64
 APPLICATION: Explaining Real Wage Growth 65
 APPLICATION: Oil Shocks, Real Wages, and the Stock Market 66
 Concluding Remarks 68

SUMMARY 69
 KEY TERMS 69
 REVIEW QUESTIONS 69
 PROBLEMS 70
 DATA ANALYSIS PROBLEMS 72

Chapter 4

SAVING AND INVESTMENT IN CLOSED AND OPEN ECONOMIES . 73

PREVIEW 73
 RELATIONSHIP BETWEEN SAVING AND WEALTH 73
 Private Saving 74
 Government Saving 74
 National Saving 75
 POLICY AND PRACTICE: Government Policies to Stimulate Saving 76
 Uses of Saving 77
 The Link Between Saving and Wealth 78
 MACROECONOMICS IN THE NEWS: Balance of Payments Accounts 78
 APPLICATION: How the United States Became the Largest Net Debtor in the World 79

SAVING, INVESTMENT, AND GOODS MARKET EQUILIBRIUM
 IN A CLOSED ECONOMY 81
 Saving and Investment Equation 81
 Saving 82
 Investment 83
 Goods Market Equilibrium 84

RESPONSE TO CHANGES IN SAVING AND INVESTMENT
 IN A CLOSED ECONOMY 84
 Changes in Saving: Autonomous Consumption 85
 Changes in Saving: Effects of Fiscal Policy 85
 POLICY AND PRACTICE: Crowding Out and the Debate over the 2009 Fiscal Stimulus Package 87
 Changes in Autonomous Investment 88

SAVING, INVESTMENT, AND GOODS MARKET EQUILIBRIUM
 IN AN OPEN ECONOMY 89
 Perfect Capital Mobility and the Open Economy 89
 Goods Market Equilibrium in an Open Economy 89

SAVING, INVESTMENT, AND THE TRADE BALANCE
 IN A SMALL OPEN ECONOMY 90
 Goods Market Equilibrium in a Small Open Economy 90
 Connection Between the World Economy and the Small Open Economy 92

RESPONSE TO CHANGES IN SAVING AND INVESTMENT
 IN A SMALL OPEN ECONOMY 92
 Changes in Domestic Saving 92
 APPLICATION: The Twin Deficits 93
 Changes in Investment 94

LARGE VERSUS SMALL OPEN ECONOMIES 95
 SUMMARY 97
 KEY TERMS 97

XII CONTENTS

REVIEW QUESTIONS	97
PROBLEMS	98
DATA ANALYSIS PROBLEMS	100

Chapter 4 Web Appendix

SAVING AND INVESTMENT IN LARGE OPEN ECONOMIES

GO TO THE COMPANION WEBSITE, www.pearsonhighered.com/mishkin

Chapter 5

MONEY AND INFLATION	101
PREVIEW	101
WHAT IS MONEY?	102
Meaning of Money	102
Functions of Money	102
Unusual Forms of Money	103
THE FEDERAL RESERVE SYSTEM AND THE CONTROL OF THE MONEY SUPPLY	104
Federal Reserve Banks	104
Board of Governors of the Federal Reserve System	105
Federal Open Market Committee (FOMC)	105
The European Central Bank	105
Control of the Money Supply	106
MEASURING MONEY	106
The Federal Reserve's Monetary Aggregates	106
Where Is All the U.S. Currency?	107
The Fed's Use of M1 Versus M2 in Practice	107
MACROECONOMICS IN THE NEWS: The Monetary Aggregates	108
QUANTITY THEORY OF MONEY	109
Velocity of Money and the Equation of Exchange	109
From the Equation of Exchange to the Quantity Theory of Money	110
The Classical Dichotomy	111
Quantity Theory and the Price Level	111
Quantity Theory and Inflation	112
APPLICATION: Testing the Quantity Theory of Money	112
HYPERINFLATION	115
POLICY AND PRACTICE: The Zimbabwean Hyperinflation	115
INFLATION AND INTEREST RATES	116
APPLICATION: Testing the Fisher Effect	116
THE COST OF INFLATION	118
Costs of Anticipated Inflation	118
Costs of Unanticipated Inflation	119
SUMMARY	121
KEY TERMS	121
REVIEW QUESTIONS	122
PROBLEMS	122
DATA ANALYSIS PROBLEMS	124

Chapter 5 Appendix

THE MONEY SUPPLY PROCESS 125

THE FED'S BALANCE SHEET 125

 Liabilities 125

 Assets 126

CONTROL OF THE MONETARY BASE 126

 Federal Reserve Open Market Operations 127

 Shifts from Deposits into Currency 127

 Discount Loans 128

 Overview of the Fed's Ability to Control the
 Monetary Base 129

MULTIPLE DEPOSIT CREATION: A SIMPLE MODEL 129

 Deposit Creation: The Single Bank 129

 Deposit Creation: The Banking System 130

 Critique of the Simple Model 132

FACTORS THAT DETERMINE THE MONEY SUPPLY 133

 Changes in the Nonborrowed Monetary Base 133

 Changes in Borrowed Reserves from the Fed 133

 Changes in the Required Reserve Ratio 133

 Changes in Currency Holdings 133

 Changes in Excess Reserves 134

 Overview of the Money Supply Process 134

THE MONEY MULTIPLIER 135

 Deriving the Money Multiplier 135

 Intuition Behind the Money Multiplier 137

 Money Supply Response to Changes in the Factors 138

**APPLICATION: Quantitative Easing and
 the Money Supply, 2007–2013 139**

SUMMARY 141

KEY TERMS 141

REVIEW QUESTIONS AND PROBLEMS 142

DATA ANALYSIS PROBLEMS 143

Chapter 5 Web Appendix

**APPLICATION: THE GREAT DEPRESSION BANK PANICS AND
THE MONEY SUPPLY, 1930–1933**

GO TO THE COMPANION WEBSITE, www.pearsonhighered.com/mishkin

PART 3 Long-Run Economic Growth 144

Chapter 6

THE SOURCES OF GROWTH AND THE SOLOW MODEL 146

PREVIEW 146

ECONOMIC GROWTH AROUND THE WORLD 147

THE SOLOW GROWTH MODEL 148

 Building Blocks of the Solow Growth Model 148

Time Subscripts 149

 Dynamics of the Solow Growth Model 152

 Convergence in the Solow Model 153

The “Bathtub Model” of the Steady State 153

XIV CONTENTS

APPLICATION: Evidence on Convergence, 1960–2012	154
War, Destruction, and Growth Miracles	156
SAVING RATE CHANGES IN THE SOLOW MODEL	156
POPULATION GROWTH IN THE SOLOW MODEL	159
Population Growth and the Steady State	159
Changes in Population Growth	161
Population Growth and Real GDP Per Capita	161
POLICY AND PRACTICE: China's One-Child Policy and Other Policies to Limit Population Growth	163
PRODUCTIVITY GROWTH IN THE SOLOW MODEL	164
Technology Growth and the Steady State	164
SUMMING UP THE SOLOW MODEL	164
Solow Model: The Results	164
Solow Model: Limitations	166
SOURCES OF ECONOMIC GROWTH: GROWTH ACCOUNTING	166
Growth Accounting Equation	166
Growth Accounting in Practice	167
APPLICATION: U.S. Growth Rates in the Postwar Period	168
CROSS-COUNTRY DIFFERENCES IN GROWTH ACCOUNTING RATES	169
SUMMARY	171
KEY TERMS	171
REVIEW QUESTIONS	171
PROBLEMS	172
DATA ANALYSIS PROBLEMS	174

Chapter 6 Appendix

THE ALGEBRA OF THE SOLOW GROWTH MODEL	176
SOLVING FOR THE STEADY STATE	176
SUMMARY AND RESULTS	177
REVIEW QUESTIONS AND PROBLEMS	177

Chapter 6 Web Appendix

THE GOLDEN RULE LEVEL OF THE CAPITAL-LABOR RATIO GO TO THE COMPANION WEBSITE, www.pearsonhighered.com/mishkin	
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Chapter 7

DRIVERS OF GROWTH: TECHNOLOGY, POLICY, AND INSTITUTIONS	178
PREVIEW	178
TECHNOLOGY AS A PRODUCTION INPUT	178
Technology Versus Conventional Production Inputs	179
Technology and Excludability	179
POLICIES TO PROMOTE PRODUCTIVITY	179
Building Infrastructure	179
Increasing Human Capital	180

POLICY AND PRACTICE: Government Measures to Increase Human Capital 180

Encouraging Research and Development 181

INSTITUTIONS AND PROPERTY RIGHTS 183

The Legal System and Property Rights 183

Geography, the Legal System, and Economic Growth 185

Obstacles to Effective Property Rights 185

POLICY AND PRACTICE: The World Bank's *Doing Business* 186

POLICY AND PRACTICE: Does Foreign Aid Work? 188

ENDOGENOUS GROWTH THEORY 189

Allocation of Labor 189

Production Function 190

Production of Technology 190

Sustained Growth in the Romer Model 191

FACTORS THAT AFFECT ENDOGENOUS GROWTH 192

Effects of an Increase in the Fraction of the Population Engaged in R&D, α 192

Effect of Changes in the Productiveness of R&D, χ 194

Response to an Increase in the Total Population, \bar{N} 195

APPLICATION: Does Population Growth Improve Living Standards? 196

The Romer Model and Saving 197

SUMMARY 199

KEY TERMS 199

REVIEW QUESTIONS 199

PROBLEMS 200

DATA ANALYSIS PROBLEMS 201

PART 4 Business Cycles: The Short Run 204

Chapter 8

BUSINESS CYCLES: AN INTRODUCTION 207

PREVIEW 207

BUSINESS CYCLE BASICS 207

Business Cycle Illustration 208

An Alternative View of the Business Cycle 208

Co-Movement and Timing of Economic Variables 209

Dating Business Cycles 209

MACROECONOMIC VARIABLES AND THE BUSINESS CYCLE 211

Real GDP and Its Components 211

MACROECONOMICS IN THE NEWS: Leading Economic Indicators 211

Unemployment 212

Inflation 212

Financial Variables 215

International Business Cycles 216

A BRIEF HISTORY OF U.S. BUSINESS CYCLES 217

Pre–World War I 218

The Interwar Period and the Great Depression 220

Post–World War II 220

The “Great Moderation” 220

The Great Recession of 2007–2009 221

TIME HORIZONS IN MACROECONOMICS 221
 Keynesian and Classical Views on Economic
 Fluctuations. 221
 The Short Run Versus the Long Run 222
 PRICE STICKINESS 223
 Perfect Competition Versus Monopolistic Competition. 223
 Sources of Price Stickiness 223
 Empirical Evidence for Price Stickiness 224
 ROAD MAP FOR OUR STUDY OF BUSINESS CYCLES. 225
 SUMMARY 226
 KEY TERMS 226
 REVIEW QUESTIONS 227
 PROBLEMS 227
 DATA ANALYSIS PROBLEMS 229

Chapter 9

THE *IS* CURVE 231
 PREVIEW 231
 PLANNED EXPENDITURE 231
 THE COMPONENTS OF EXPENDITURE. 232
 Consumption Expenditure 232
 Planned Investment Spending 233
 Net Exports 235
 Government Purchases and Taxes. 236
 GOODS MARKET EQUILIBRIUM 237
 Solving for Goods Market Equilibrium. 237
 Deriving the *IS* Curve 238
 UNDERSTANDING THE *IS* CURVE 238
 What the *IS* Curve Tells Us: Intuition 238
 What the *IS* Curve Tells Us: Numerical Example. 239
 Why the Economy Heads Toward Equilibrium. 239
 Why the *IS* Curve Has Its Name and Its Relationship with
 the Saving-Investment Diagram 240
 FACTORS THAT SHIFT THE *IS* CURVE 241
 Changes in Government Purchases 242
 **APPLICATION: The Vietnam War Buildup,
 1964–1969.** 243
 Changes in Taxes 244
 Changes in Autonomous Spending 245
 **POLICY AND PRACTICE: The Fiscal Stimulus
 Package of 2009** 245
 Changes in Financial Frictions 246
 Summary of Factors That Shift the *IS* Curve 246
 SUMMARY 247
 KEY TERMS 247
 REVIEW QUESTIONS 247
 PROBLEMS 248
 DATA ANALYSIS PROBLEMS 249

Chapter 10

MONETARY POLICY AND AGGREGATE DEMAND 251
 PREVIEW 251
 THE FEDERAL RESERVE AND MONETARY POLICY 251
 THE MONETARY POLICY CURVE 252
 The Taylor Principle: Why the Monetary Policy Curve
 Has an Upward Slope 253
 Shifts in the *MP* Curve 254
 Movements Along the *MP* Curve Versus Shifts in the Curve 254
 **POLICY AND PRACTICE: Movements Along the *MP* Curve:
 The Rise in the Federal Funds Rate Target, 2004–2006 255**
 **POLICY AND PRACTICE: Shifts in the *MP* Curve:
 Autonomous Monetary Easing at the Onset of the
 2007–2009 Financial Crisis 256**
 THE AGGREGATE DEMAND CURVE 257
 Deriving the Aggregate Demand Curve Graphically 257
 Factors That Shift the Aggregate Demand Curve 257
 Deriving the Aggregate Demand Curve Algebraically 259
 THE MONEY MARKET AND INTEREST RATES 263
 Liquidity Preference and the Demand for Money 263
 Demand Curve for Money 264
 Supply Curve for Money 265
 Equilibrium in the Money Market 265
 Changes in the Equilibrium Interest Rate 266
 SUMMARY 269
 KEY TERMS 269
 REVIEW QUESTIONS 269
 PROBLEMS 270
 DATA ANALYSIS PROBLEMS 271

Chapter 10 Appendix

THE DEMAND FOR MONEY 273
 KEYNESIAN THEORIES OF MONEY DEMAND 273
 Transactions Motive 273
 Precautionary Motive 273
 Speculative Motive 274
 Putting the Three Motives Together 274
 PORTFOLIO THEORIES OF MONEY DEMAND 275
 Portfolio Theory 275
 Portfolio Theory and Keynesian Liquidity Preference 275
 Other Factors That Affect the Demand for Money 276
 Summary 276
 EMPIRICAL EVIDENCE ON THE DEMAND
 FOR MONEY 276
 Interest Rates and Money Demand 277
 Stability of Money Demand 278
 SUMMARY 279
 KEY TERMS 279
 REVIEW QUESTIONS AND PROBLEMS 279

Chapter 11

AGGREGATE SUPPLY AND THE PHILLIPS CURVE 281
 PREVIEW 281
 THE PHILLIPS CURVE 281
 Phillips Curve Analysis in the 1960s 282
 **POLICY AND PRACTICE: The Phillips Curve Tradeoff and
 Macroeconomic Policy in the 1960s.** 283
 The Friedman-Phelps Phillips Curve Analysis. 283
 The Phillips Curve After the 1960s. 285
 The Modern Phillips Curve. 285
 The Modern Phillips Curve with Adaptive (Backward-Looking)
 Expectations 286
 THE AGGREGATE SUPPLY CURVE 287
 Long-Run Aggregate Supply Curve 287
 Short-Run Aggregate Supply Curve 288
 **The Relationship of the Phillips Curve and the Short-Run
 Aggregate Supply Curve.** 291
 SHIFTS IN AGGREGATE SUPPLY CURVES. 291
 Shifts in the Long-Run Aggregate Supply Curve 291
 Shifts in the Short-Run Aggregate Supply Curve. 292
 SUMMARY 295
 KEY TERMS 295
 REVIEW QUESTIONS 295
 PROBLEMS 296
 DATA ANALYSIS PROBLEMS 297

Chapter 12

THE AGGREGATE DEMAND AND SUPPLY MODEL 299
 PREVIEW 299
 RECAP OF THE AGGREGATE DEMAND
 AND SUPPLY CURVES 299
 The Aggregate Demand Curve 299
 Factors That Shift the Aggregate Demand Curve. 300
 What Does *Autonomous* Mean? 301
 Short- and Long-Run Aggregate Supply Curves. 302
 Factors that Shift the Long-Run Aggregate Supply Curve. 302
 Factors that Shift the Short-Run Aggregate Supply Curve 302
 EQUILIBRIUM IN AGGREGATE DEMAND AND
 SUPPLY ANALYSIS 303
 Short-Run Equilibrium 303
 **Algebraic Determination of the Equilibrium
 Output and Inflation Rate** 304
 Long-Run Equilibrium. 305
 Short-Run Equilibrium over Time 305
 Self-Correcting Mechanism 307
 CHANGES IN EQUILIBRIUM: AGGREGATE DEMAND SHOCKS . . 307
 **Algebraic Determination of the Response to a Rightward
 Shift of the Aggregate Demand Curve** 308
 APPLICATION: The Volcker Disinflation, 1980–1986 309
 APPLICATION: Negative Demand Shocks, 2001–2004. 310

CHANGES IN EQUILIBRIUM: AGGREGATE SUPPLY
 (PRICE) SHOCKS 311

- Temporary Supply Shocks 311
 - APPLICATION: Negative Supply Shocks, 1973–1975 and 1978–1980** 313
- Permanent Supply Shocks 314
 - APPLICATION: Positive Supply Shocks, 1995–1999** 316
- Conclusions 316
 - APPLICATION: Negative Supply and Demand Shocks and the 2007–2009 Financial Crisis** 318

AD/AS ANALYSIS OF FOREIGN BUSINESS CYCLE EPISODES . . . 319

- APPLICATION: The United Kingdom and the 2007–2009 Financial Crisis** 319
- APPLICATION: China and the 2007–2009 Financial Crisis** 320

SUMMARY 323

KEY TERMS 323

REVIEW QUESTIONS 323

PROBLEMS 324

DATA ANALYSIS PROBLEMS 325

Chapter 12 Web Appendix A

THE TAYLOR PRINCIPLE AND INFLATION STABILITY

GO TO THE COMPANION WEBSITE, www.pearsonhighered.com/mishkin

Chapter 12 Web Appendix B

THE EFFECTS OF MACROECONOMIC SHOCKS ON ASSET PRICES

GO TO THE COMPANION WEBSITE, www.pearsonhighered.com/mishkin

Chapter 12 Web Appendix C

THE ALGEBRA OF THE AGGREGATE DEMAND AND SUPPLY MODEL

GO TO THE COMPANION WEBSITE, www.pearsonhighered.com/mishkin

Chapter 13

MACROECONOMIC POLICY AND AGGREGATE

DEMAND AND SUPPLY ANALYSIS 327

PREVIEW 327

THE OBJECTIVES OF MACROECONOMIC POLICY 327

- Stabilizing Economic Activity 328

- Stabilizing Inflation: Price Stability 329

- Establishing Hierarchical Versus Dual Mandates 329

THE RELATIONSHIP BETWEEN STABILIZING INFLATION AND STABILIZING ECONOMIC ACTIVITY 330

- Monetary Policy and the Equilibrium Real Interest Rate 330

- POLICY AND PRACTICE: The Federal Reserve’s Use of the Equilibrium Real Interest Rate, r^*** 332

- Response to an Aggregate Demand Shock 332

- Response to a Permanent Supply Shock 336

- Response to a Temporary Supply Shock 337

XX CONTENTS

The Bottom Line: The Relationship Between Stabilizing Inflation and Stabilizing Economic Activity 341

HOW ACTIVELY SHOULD POLICY MAKERS TRY TO STABILIZE ECONOMIC ACTIVITY? 343

 Lags and Policy Implementation. 343

POLICY AND PRACTICE: The Activist/Nonactivist Debate Over the Obama Fiscal Stimulus Package 344

THE TAYLOR RULE 345

 The Taylor Rule Equation. 345

The Difference Between the Taylor Rule and the Taylor Principle 346

 The Taylor Rule Versus the Monetary Policy Curve 346

 The Taylor Rule in Practice 347

POLICY AND PRACTICE: The Fed's Use of the Taylor Rule 347

INFLATION: ALWAYS AND EVERYWHERE A MONETARY PHENOMENON 348

CAUSES OF INFLATIONARY MONETARY POLICY 350

 High Employment Targets and Inflation. 350

APPLICATION: The Great Inflation 354

MONETARY POLICY AT THE ZERO LOWER BOUND 355

 Deriving the Aggregate Demand Curve with the Zero Lower Bound 355

 The Disappearance of the Self-Correcting Mechanism at the Zero Lower Bound 357

APPLICATION: Nonconventional Monetary Policy and Quantitative Easing 358

 Liquidity Provision 359

 Asset Purchases. 359

 Quantitative Easing Versus Credit Easing. 360

 Management of Expectations 361

POLICY AND PRACTICE: Abenomics and the Shift in Japanese Monetary Policy in 2013 362

SUMMARY 364

KEY TERMS 364

REVIEW QUESTIONS 365

PROBLEMS 366

DATA ANALYSIS PROBLEMS 368

PART 5 Finance and the Macroeconomy 370

Chapter 14

THE FINANCIAL SYSTEM AND ECONOMIC GROWTH 372

PREVIEW 372

THE ROLE OF THE FINANCIAL SYSTEM. 372

 Direct Finance 373

 Indirect Finance. 374

INFORMATION CHALLENGES AND THE FINANCIAL SYSTEM . . . 374

 Asymmetric Information 374

Financial Intermediaries 375

 Free-Rider Problem. 376

 Financial Intermediaries Address Asymmetric Information Problems . . 377

 Collateral and Asymmetric Information Problems 380

APPLICATION: The Tyranny of Collateral 380

GOVERNMENT REGULATION AND SUPERVISION
OF THE FINANCIAL SECTOR 381

 Government Regulation to Promote Transparency 381

Government-Directed Credit 382

 Government Safety Net 382

The Enron Implosion 383

 Role of Prudential Regulation and Supervision 384

FINANCIAL DEVELOPMENT AND ECONOMIC
GROWTH: THE EVIDENCE 384

**APPLICATION: Is China a Counter-Example to the Importance
 of Financial Development to Economic Growth?** 386

SUMMARY 387

KEY TERMS 387

REVIEW QUESTIONS 387

PROBLEMS 388

DATA ANALYSIS PROBLEMS 389

Chapter 14 Web Appendix

**FREE TRADE, FINANCIAL GLOBALIZATION,
AND GROWTH**

GO TO THE COMPANION WEBSITE, www.pearsonhighered.com/mishkin

Chapter 15

FINANCIAL CRISES AND THE ECONOMY 391

PREVIEW 391

ASYMMETRIC INFORMATION AND FINANCIAL
CRISES 392

 Asymmetric Information Problems 392

 What Is a Financial Crisis? 392

DYNAMICS OF FINANCIAL CRISES 392

 Stage One: Initiation of Financial Crisis 393

 Stage Two: Banking Crisis 396

 Stage Three: Debt Deflation 397

**APPLICATION: The Mother of All Financial Crises:
 The Great Depression** 397

 Stock Market Crash 398

 Bank Panics 398

 Adverse Selection and Moral Hazard Worsen 398

 Debt Deflation 399

 Recovery Begins 400

 International Dimensions 400

**APPLICATION: The Global Financial Crisis of
 2007–2009** 400

 Causes of the 2007–2009 Financial Crisis 400

Collateralized Debt Obligations (CDOs) 401

 Effects of the 2007–2009 Financial Crisis 402

 Residential Housing Prices: Boom and Bust 402

**POLICY AND PRACTICE: Was the Fed to Blame for the
 Housing Price Bubble?** 403

Ireland and the 2007–2009 Financial Crisis 406

Height of the 2007–2009 Financial Crisis 407

WHY THE 2007–2009 FINANCIAL CRISIS DID NOT LEAD TO A DEPRESSION 408

Aggressive Federal Reserve Actions 408

POLICY AND PRACTICE: The Federal Reserve’s Nonconventional Monetary Policies and Quantitative Easing During the Global Financial Crisis 409

Liquidity Provision 409

Asset Purchases (Quantitative Easing) 410

Management of Expectations: Commitment to Future Policy Actions . . 411

Worldwide Government Intervention Through Bailouts. 413

Aggressive Fiscal Policy 413

POLICY AND PRACTICE: Japan’s Lost Decade, 1992–2002 414

POLICY RESPONSE TO ASSET-PRICE BUBBLES 415

Types of Asset-Price Bubbles 415

POLICY AND PRACTICE: Debate Over Central Bank Response to Bubbles 416

Regulatory Policy Responses to Asset Bubbles. 418

SUMMARY 419

KEY TERMS 419

REVIEW QUESTIONS 420

PROBLEMS 420

DATA ANALYSIS PROBLEMS 423

PART 6 Macroeconomic Policy 425

Chapter 16

FISCAL POLICY AND THE GOVERNMENT BUDGET 427

PREVIEW 427

THE GOVERNMENT BUDGET. 427

Government Spending. 427

Revenue 430

Budget Deficits and Surpluses 430

Government Budget Constraint. 431

SIZE OF THE GOVERNMENT DEBT 431

Growth of U.S. Government Debt over Time. 431

POLICY AND PRACTICE: The Entitlements Debate: Social Security and Medicare/Medicaid 433

International Comparison: The Size of Government Debt. 435

SOVEREIGN DEBT CRISES 435

POLICY AND PRACTICE: The European Sovereign Debt Crisis 436

FISCAL POLICY AND THE ECONOMY IN THE LONG RUN. 437

Why High Government Debt Is Not a Burden 437

Why High Government Debt Is a Burden 437

POLICY AND PRACTICE: Tax Smoothing 439

FISCAL POLICY AND THE ECONOMY IN THE SHORT RUN. 440

Aggregate Demand and Fiscal Policy. 440

Expenditure and Tax Multipliers 440

POLICY AND PRACTICE: The 2009 Debate Over Tax-Based Versus Spending-Based Fiscal Stimulus 442

Fiscal Multipliers at the Zero Lower Bound 443

Aggregate Supply and Fiscal Policy 444

Supply-Side Economics and Fiscal Policy 445

Balancing the Budget: Expansionary or Contractionary? 446

POLICY AND PRACTICE: Two Expansionary Fiscal Contractions: Denmark and Ireland. 447

POLICY AND PRACTICE: The Debate Over Fiscal Austerity in Europe. 448

BUDGET DEFICITS AND INFLATION. 449

 Government-Issued Money. 449

 Revenue from Seignorage 450

BUDGET DEFICITS AND RICARDIAN EQUIVALENCE 450

 Implications of Ricardian Equivalence 451

 Objections to Ricardian Equivalence. 452

 Bottom Line on Ricardian Equivalence 452

POLICY AND PRACTICE: The Bush Tax Cuts and Ricardian Equivalence 453

SUMMARY 454

KEY TERMS 455

REVIEW QUESTIONS 455

PROBLEMS 456

DATA ANALYSIS PROBLEMS 457

Chapter 16 Web Appendix

OTHER MEASURES OF THE GOVERNMENT BUDGET DEFICIT

GO TO THE COMPANION WEBSITE, www.pearsonhighered.com/mishkin

Chapter 17

EXCHANGE RATES AND INTERNATIONAL ECONOMIC POLICY. 459

PREVIEW. 459

FOREIGN EXCHANGE MARKET AND EXCHANGE RATES 459

 Foreign Exchange Rates 459

 The Distinction Between Real and Nominal Exchange Rates 460

MACROECONOMICS IN THE NEWS: Foreign Exchange Rates 461

 The Importance of Exchange Rates. 461

 Foreign Exchange Trading 463

EXCHANGE RATES IN THE LONG RUN. 463

 Law of One Price 463

 Theory of Purchasing Power Parity 464

Big Macs and PPP 464

EXCHANGE RATES IN THE SHORT RUN. 466

 Supply Curve for Domestic Assets 466

 Demand Curve for Domestic Assets. 466

 Equilibrium in the Foreign Exchange Market 467

ANALYSIS OF CHANGES IN EXCHANGE RATES. 468

 Changes in the Demand for Domestic Assets 468

APPLICATION: The Global Financial Crisis and the Dollar 471

APPLICATION: Why Are Exchange Rates So Volatile? 473

EXCHANGE RATES AND AGGREGATE DEMAND AND SUPPLY ANALYSIS 473

INTERVENTION IN THE FOREIGN EXCHANGE MARKET. 475

 Foreign Exchange Intervention 475

 Intervention and the Exchange Rate 476

FIXED EXCHANGE RATE REGIMES. 477

 Fixed Exchange Rate Regime Dynamics 477

 The Policy Trilemma 479

 Monetary Unions 480

APPLICATION: How Did China Accumulate Over \$3 Trillion of International Reserves? 481

POLICY AND PRACTICE: Will the Euro Survive? 482

TO PEG OR NOT TO PEG. 482

 Advantages of Exchange-Rate Pegging 482

 Disadvantages of Exchange-Rate Pegging 483

POLICY AND PRACTICE: The Collapse of the Argentine Currency Board 485

SUMMARY 486

KEY TERMS 486

REVIEW QUESTIONS 487

PROBLEMS 488

DATA ANALYSIS PROBLEMS 490

Chapter 17 Web Appendix A

THE INTEREST PARITY CONDITION

GO TO THE COMPANION WEBSITE, www.pearsonhighered.com/mishkin

Chapter 17 Web Appendix B

SPECULATIVE ATTACKS AND FOREIGN EXCHANGE CRISES

GO TO THE COMPANION WEBSITE, www.pearsonhighered.com/mishkin

PART 7 **Microeconomic Foundations of Macroeconomics 492**

Chapter 18

CONSUMPTION AND SAVING 494

PREVIEW 494

THE RELATIONSHIP BETWEEN CONSUMPTION AND SAVING . . 494

INTERTEMPORAL CHOICE AND CONSUMPTION 495

 The Intertemporal Budget Constraint 495

 The Intertemporal Budget Constraint in Terms of Present Discounted Value 497

 Preferences 498

 Optimization 499

THE INTERTEMPORAL CHOICE MODEL IN PRACTICE:

INCOME AND WEALTH 500

 Response of Consumption to Income 501

 Response of Consumption to Wealth 502

 Consumption Smoothing 502

THE INTERTEMPORAL CHOICE MODEL IN PRACTICE:
 INTEREST RATES 502
 Interest Rates and the Intertemporal Budget Line 502
 The Optimal Level of Consumption and the Intertemporal
 Budget Line 502
 Borrowing Constraints 504
 THE KEYNESIAN THEORY OF CONSUMPTION 506
 The Keynesian Consumption Function:
 Building Blocks 506
 Keynesian Consumption Function 507
 The Relationship of the Keynesian Consumption
 Function to Intertemporal Choice 507
 THE PERMANENT INCOME HYPOTHESIS 508
 The Permanent Income Consumption Function 508
 APPLICATION: Consumer Confidence and the Business Cycle 509
 Relationship of the Permanent Income Hypothesis and
 Intertemporal Choice 509
 **MACROECONOMICS IN THE NEWS: The Consumer Confidence and
 Consumer Sentiment Indices** 510
 POLICY AND PRACTICE: The 2008 Tax Rebate 510
 THE LIFE-CYCLE HYPOTHESIS 511
 Life-Cycle Consumption Function 511
 Saving and Wealth Over the Life Cycle 513
 **APPLICATION: Housing, the Stock Market, and the
 Collapse of Consumption in 2008 and 2009** 515
 TWO MODIFICATIONS OF THE THEORY: THE RANDOM
 WALK HYPOTHESIS AND BEHAVIORAL ECONOMICS 515
 The Random Walk Hypothesis 515
 Behavioral Economics and Consumption 516
 **POLICY AND PRACTICE: Behavioral Policies to
 Increase Saving** 517
 SUMMARY 518
 KEY TERMS 518
 REVIEW QUESTIONS 519
 PROBLEMS 520
 DATA ANALYSIS PROBLEMS 521

Chapter 18 Web Appendix

INCOME AND SUBSTITUTION EFFECTS: A GRAPHICAL ANALYSIS

GO TO THE COMPANION WEBSITE, www.pearsonhighered.com/mishkin

Chapter 19

INVESTMENT **523**
 PREVIEW 523
 DATA ON INVESTMENT SPENDING 523
 THE NEOCLASSICAL THEORY OF INVESTMENT 524
 Determining the Level of Capital Stock 524
 User Cost of Capital 525
 Determining the Desired Level of Capital 526
 From the Desired Level of Capital to Investment 527

Changes in the Desired Level of the Capital Stock 529

Summary: Neoclassical Theory of Investment 532

INVENTORY INVESTMENT. 534

 Motivation for Holding Inventories 534

 The Theory of Inventory Investment 535

TOBIN'S q AND INVESTMENT 536

 Tobin's q Theory. 536

 Tobin's q Versus Neoclassical Theory 536

APPLICATION: Stock Market Crashes and Recessions. 537

RESIDENTIAL INVESTMENT 537

POLICY AND PRACTICE: U.S. Government Policies and the Housing Market 538

SUMMARY 540

KEY TERMS 540

REVIEW QUESTIONS 540

PROBLEMS 541

DATA ANALYSIS PROBLEMS 542

Chapter 19 Web Appendix

A MODEL OF HOUSING PRICES AND RESIDENTIAL INVESTMENT

GO TO THE COMPANION WEBSITE, www.pearsonhighered.com/mishkin

Chapter 20

THE LABOR MARKET, EMPLOYMENT, AND

UNEMPLOYMENT. 544

PREVIEW 544

DEVELOPMENTS IN THE U.S. LABOR MARKET 544

 Employment Ratio 544

 Unemployment Rate 546

 Real Wages 546

SUPPLY AND DEMAND IN THE LABOR MARKET 547

 The Demand Curve for Labor 548

 The Supply Curve 549

 Equilibrium in the Labor Market. 549

RESPONSE OF EMPLOYMENT AND WAGES TO CHANGES

IN LABOR DEMAND AND LABOR SUPPLY. 549

 Changes in Labor Demand. 549

 Changes in Labor Supply. 550

APPLICATION: Why Has Labor Force Participation of Women Increased? 551

APPLICATION: Why Are Income Inequality and Returns to Education Increasing? 552

DYNAMICS OF UNEMPLOYMENT. 554

 Flows Into and Out of Employment Status. 555

 Duration of Unemployment 556

CAUSES OF UNEMPLOYMENT. 556

 Frictional Unemployment 556

POLICY AND PRACTICE: Unemployment Insurance and Unemployment 557

Structural Unemployment 558
 Wage Rigidity 558
POLICY AND PRACTICE: Minimum Wage Laws 559
Efficiency Wages and Henry Ford 561
 NATURAL RATE OF UNEMPLOYMENT 561
 The Role of the Natural Rate of Unemployment in the AD/AS Model . . 562
 Sources of Changes in the Natural Rate of Unemployment 562
APPLICATION: Why Are European Unemployment Rates Generally Much Higher Than U.S. Unemployment Rates? 564
 SUMMARY 567
 KEY TERMS 567
 REVIEW QUESTIONS 568
 PROBLEMS 568
 DATA ANALYSIS PROBLEMS 570

PART 8 Modern Business Cycle Analysis and Macroeconomic Policy 571

Chapter 21
THE ROLE OF EXPECTATIONS IN MACROECONOMIC POLICY. . . 573
 PREVIEW 573
 RATIONAL EXPECTATIONS AND POLICY MAKING 573
 Adaptive Expectations 573
 Rational Expectations 574
 Microeconomic Rationale Behind the Theory 575
 Rational Expectations Theory and Macroeconomic Analysis 575
 Rational Expectations Revolution 576
 LUCAS CRITIQUE OF POLICY EVALUATION. 576
 Econometric Policy Evaluation 576
APPLICATION: The Consumption Function 577
 POLICY CONDUCT: RULES OR DISCRETION? 577
 Discretion and the Time-Inconsistency Problem 577
 Types of Rules 578
 The Case for Rules 579
POLICY AND PRACTICE: The Political Business Cycle and Richard Nixon 579
 The Case for Discretion 580
POLICY AND PRACTICE: The Demise of Monetary Targeting in Switzerland 581
 Constrained Discretion 581
 THE ROLE OF CREDIBILITY AND A NOMINAL ANCHOR. 582
 Benefits of a Credible Nominal Anchor 582
 Credibility and Aggregate Demand Shocks 582
 Credibility and Aggregate Supply Shocks 584
APPLICATION: A Tale of Three Oil Price Shocks. 585
 APPROACHES TO ESTABLISHING CENTRAL BANK CREDIBILITY 587
 Inflation Targeting 587
POLICY AND PRACTICE: Ben Bernanke and the Federal Reserve Adoption of Inflation Targeting 588
 Nominal GDP Targeting 589

Appoint “Conservative” Central Bankers 589
POLICY AND PRACTICE: The Appointment of Paul Volcker, Anti-Inflation Hawk. 590
 Increase Central Bank Independence 590
 SUMMARY 593
 KEY TERMS 593
 REVIEW QUESTIONS 594
 PROBLEMS 594
 DATA ANALYSIS PROBLEMS 596

Chapter 22

MODERN BUSINESS CYCLE THEORY. 597
 PREVIEW 597
 REAL BUSINESS CYCLE MODEL 597
 Productivity Shocks and Business Cycle Fluctuations 598
 Solow Residuals and Business Cycle Fluctuations 599
 Employment and Unemployment in the Real Business Cycle Model . . . 599
 Objections to the Real Business Cycle Model. 600
 NEW KEYNESIAN MODEL 601
 Building Blocks of the New Keynesian Model 602
 Business Cycle Fluctuations in the New Keynesian Model 605
 Objections to the New Keynesian Model 606
 A COMPARISON OF BUSINESS CYCLE MODELS 607
 How Do the Models Differ? 607
 Short-Run Output and Price Responses: Implications for
 Stabilization Policy. 608
 Anti-Inflation Policy 612
 SUMMARY 615
 KEY TERMS 615
 REVIEW QUESTIONS 615
 PROBLEMS 616
 DATA ANALYSIS PROBLEMS 618

Chapter 22 Web Appendix

THE NEW CLASSICAL MODEL

GO TO THE COMPANION WEBSITE, www.pearsonhighered.com/mishkin

Epilogue 619

POLICY AND PRACTICE: WHERE DO MACROECONOMISTS

AGREE AND DISAGREE? 619

PREVIEW 619
 WHERE MACROECONOMISTS AGREE 619
 Inflation Is Always and Everywhere a Monetary Phenomenon 620
 The Benefits of Price Stability 620
 No Long-Run Trade-off Between Unemployment and Inflation 620
 The Crucial Role of Expectations 621
 The Taylor Principle 622
 The Time-Inconsistency Problem 622
 Central Bank Independence. 623

Commitment to a Nominal Anchor 623
 Credibility 623
 Institutions Rule 624
 WHERE MACROECONOMISTS DISAGREE 624
 Flexibility of Wages and Prices 624
 How Much Time It Takes to Get to the Long Run 624
 Sources of Business Cycle Fluctuations. 625
 Effectiveness of Stabilization Policy 626
 Cost of Reducing Inflation 626
 The Dangers of Budget Deficits 627
 THE FUTURE OF BUSINESS CYCLE THEORY 628
 SUMMARY 629
 KEY TERMS 629

Web Chapter

FINANCIAL CRISES IN EMERGING MARKET ECONOMIES

GO TO THE COMPANION WEBSITE, www.pearsonhighered.com/mishkin

PREVIEW

DYNAMICS OF FINANCIAL CRISES IN EMERGING MARKET ECONOMIES

Stage One: Initiation of Financial Crisis

Stage Two: Currency Crisis

Stage Three: Full-Fledged Financial Crisis

APPLICATION: Crisis in South Korea, 1997–1998

Financial Liberalization/Globalization Mismanagement

Perversion of the Financial Liberalization/Globalization Process: Chaebols and the South Korean Crisis

Stock Market Decline and Failure of Firms Increase Uncertainty

Aggregate Selection and Moral Hazard Problems Worsen, and Aggregate Demand Falls

Currency Crisis Ensues

Final Stage: Currency Crisis Triggers Full-Fledged Financial Crisis

Recovery Commences

APPLICATION: The Argentine Financial Crisis, 2001–2002

Severe Fiscal Imbalances

Adverse Selection and Moral Hazard Problems Worsen

Bank Panic Begins

Currency Crisis Ensues

Currency Crisis Triggers Full-Fledged Financial Crisis

Recovery Begins

When an Advanced Economy Is Like an Emerging Market Economy:

The Icelandic Financial Crisis of 2008

POLICY AND PRACTICE: Preventing Emerging Market Financial Crises

Beef Up Prudential Regulation and Supervision of Banks

Encourage Disclosure and Market-Based Discipline

Limit Currency Mismatch

Sequence Financial Liberalization

SUMMARY

KEY TERMS

REVIEW QUESTIONS AND PROBLEMS

Glossary G-1

Index I-1

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Preface

There has never been a more exciting time to teach macroeconomics. The recent world-wide financial crisis cast a spotlight on macroeconomics and prompted instructors worldwide to rethink their teaching of the course. Students today enter the intermediate macroeconomics course knowing the relevance of the business cycle—it impacts what is happening in their world *right now*, in the aftermath of the most severe recession since World War II. The silver lining of these trying economic times lies in our ability to draw on this familiarity and the rich tapestry of recent economic events to enliven macroeconomic theory.

Macroeconomics: Policy and Practice, Second Edition, focuses on the policy issues currently debated by the media and the public at large. Building on my expertise in macroeconomic policy making at the Federal Reserve, I highlight the techniques used by policy makers in practice. I ground this applied approach to intermediate macroeconomics with a careful, step-by-step development of all models.




What's New in the Second Edition

In addition to the expected updating of data through 2013 whenever possible, major new material has been added in every part of the text.

Enhanced Pearson e-text with Mini-Lectures: A New Way of Learning MyEconLab

The Enhanced Pearson e-text in MyEconLab for the second edition is available online from MyEconLab textbook resources. Instructors and students can highlight the text, bookmark, search the glossary, and take notes. More importantly, the e-text provides a new way of learning that is particularly useful to today's students. Not only are students able to read the material in the textbook but, by a simple click on an icon, they are able to watch over 100 mini-lectures presented by the author—one for every analytic graph in the text. These mini-lectures build each graph step-by-step and explain the intuition necessary to fully understand the theory behind the graph. The mini-lectures are an invaluable study tool for students who typically learn better when they see and hear economic analysis rather than read it.

Real-Time Data

A high percentage of the in-text data is labeled *MyEconLab Real-Time Data*. This label indicates that students can view the latest data using the e-text to access the Federal Reserve Bank of St. Louis's FRED database. In addition, each chapter now has a whole new class of problems that make use of real-time data analysis. These problems, marked with , ask students to download data from the Federal Reserve Bank of St. Louis's FRED website and then use that data to answer questions about current issues in macroeconomics.

In MyEconLab, these easy-to-assign and automatically-graded Real-Time Data Analysis exercises are linked directly to the FRED site, so that every time FRED posts new data, students can see it. As a result, Real-Time Data Analysis exercises offer a no-fuss solution for instructors who want to make the most recent data a central part of their macroeconomics course. These exercises will help students understand macroeconomics better and enable them to see the real-world relevance of their study of macroeconomics.

Nonconventional Monetary Policy and the Zero Lower Bound

In recent years, monetary policy makers have entered a brave new world in which they have had to resort to nonconventional monetary policy because the policy interest rate, the federal funds rate in the United States, has hit a floor of zero, the so-called “zero lower bound.” The policy rate cannot be driven lower than this bound, making conventional monetary policy infeasible. Nonconventional monetary policy at the zero lower bound, such as quantitative easing, is very controversial and stimulates a lot of interest among students. The second edition contains extensive discussion of this topic, with the following new material:

- A new Application, “Quantitative Easing and the Money Supply, 2007–2013” (Chapter 5)
- A new section on monetary policy at the zero lower bound, which uses the dynamic aggregate demand and aggregate supply model to explain how the zero lower bound affects the conduct of monetary policy (Chapter 13)
- A new Policy and Practice case, “Abenomics and the Shift in Japanese Monetary Policy in 2013” (Chapter 13)
- A new Policy and Practice case, “Nonconventional Monetary Policy and Quantitative Easing During the Global Financial Crisis” (Chapter 15)
- A new section on fiscal multipliers at the zero lower bound that explains why fiscal multipliers are likely to be larger at the zero lower bound (Chapter 16)
- A new section on nominal GDP targeting (Chapter 21)

New Material on Business Cycle Analysis

This edition has substantial new material on business cycle analysis, to make it easier for students to understand the dynamic aggregate demand and aggregate supply model. This new material includes:

- A new section on the alternative view of the business cycle, which distinguishes the long-run trend from deviations in this trend and introduces the concept of the output gap (Chapter 8)
- New material that integrates the concept of financial frictions into the dynamic aggregate demand and aggregate supply model at the outset, by naming financial frictions as an additional factor that shifts the *IS* curve (Chapter 10) and the *AD* curve (Chapter 12)
- A new section that clarifies the difference between movements along the *MP* curve and shifts in the *MP* curve, with two new Policy and Practice cases to illustrate the difference: “Movement Along the *MP* Curve: The Rise in the Federal Funds Rate Target, 2004–2006” and “Shifts in the *MP* Curve:

Autonomous Monetary Easing at the Onset of the 2007–2009 Financial Crisis” (Chapter 10)

- A new box, “What Does *Autonomous* Mean?” (Chapter 12)
- A new box, “The Relationship of the Phillips Curve and the Short-Run Aggregate Supply Curve” (Chapter 11)
- A new box, “The Difference Between the Taylor Rule and the Taylor Principle” (Chapter 13)

The Euro Crisis

The Euro crisis has been a continuing drama since 2010, and so this edition includes the following new material.

- A new section on sovereign debt crises that explains the dynamics of these crises (Chapter 16)
- A new Policy and Practice case, “The European Sovereign Debt Crisis” (Chapter 16)
- A new Policy and Practice case, “The Debate Over Fiscal Austerity in Europe” (Chapter 16)
- A new Policy and Practice case, “Will the Euro Survive?” (Chapter 17)

Economic Growth

To better motivate the discussion of the Solow model, Chapter 6 now begins with an introductory section that examines economic growth around the world. Also, Chapter 6 has been reorganized so that growth accounting is discussed at the end of the chapter, in order to better motivate Chapter 7 on the drivers of economic growth. New figures have been added to Chapter 6 to show how output per worker changes over time when there is a change in the saving rate, population growth, or technology.

Links Between the Microeconomic Foundations of Macroeconomics and the Dynamic Aggregate Demand/Aggregate Supply Model

To illustrate the links between the microeconomic material in Part 7 of the text and the dynamic aggregate demand/aggregate supply model, I have added the following new material:

- A new Application, “Consumer Confidence and the Business Cycle” (Chapter 18)
- A new Application, “Stock Market Crashes and Recessions” (Chapter 19)
- A new section on the role of the natural rate of unemployment in the *AD/AS* model (Chapter 20)



Hallmarks

The five distinguishing characteristics of *Macroeconomics: Policy and Practice*, Second Edition, are: (1) its emphasis on policy and practice, (2) its dynamic approach to macroeconomics, (3) its focus on the interaction between finance and macroeconomics, (4) its focus on economic growth, and (5) its international perspective.

Policy And Practice

This book emphasizes policy and practice in macroeconomics by providing theoretical frameworks that are geared to discussing the most exciting, current, major policy debates in the macroeconomics field. The best way to teach macroeconomics is by continually exposing the student to cases and applications so that he or she *really* understands the underlying theory.

Over 30 in-chapter Applications show students how to apply economic theory to real-world examples. These Applications include discussions of the Great Inflation from 1965 to 1982, the 2007–2009 financial crisis, the impact of oil prices on real wages and the stock market, why income inequality has been growing over time, and why some countries are rich and others are poor. In addition, over 30 Policy and Practice cases explore specific examples of actual policies and how they were executed. These cases include such topics as how the Federal Reserve uses the Taylor rule, the use of nonconventional monetary policy during the 2007–2009 financial crisis, the political business cycle and Richard Nixon, the question of whether the Euro will survive, and China’s one-child policy. These Applications and Policy and Practice cases provide critically important perspectives on current events, domestic and global issues, and historical episodes.

A Dynamic Approach To Macroeconomics

Analyzing today’s hot-button policy issues requires approaching macroeconomic theory using the models that researchers and policy makers employ. The central modeling element in *Macroeconomics: Policy and Practice*, Second Edition, is a powerful, dynamic aggregate demand and supply (*AD/AS*) model that highlights the interaction of inflation and economic activity. In this model, inflation (as opposed to the price level) is plotted on the vertical axis.

Given the vital importance of this model, I build it step-by-step across Chapters 9–13:

- Chapter 9 develops the first building block of the aggregate demand and supply model, the *IS* curve.
- Chapter 10 describes how monetary policy makers set real interest rates with the *monetary policy (MP) curve*, which describes the relationship between inflation and real interest rates. The chapter then uses the *MP* curve and the *IS* curve to derive the aggregate demand curve.
- Chapter 11 uses the Phillips curve to derive the aggregate supply curve.
- Chapter 12 assembles the building blocks from preceding chapters to develop the aggregate demand and supply model, and then puts this model to immediate use with Applications that analyze business cycle fluctuations in the United States and abroad.
- Chapter 13 shifts perspective by showing how the aggregate demand and supply model can help us understand the issues policy makers confront when they attempt to stabilize inflation and output fluctuations.

The aggregate demand and supply model, with inflation on the vertical axis, therefore serves as the sole engine for the analysis of short-run fluctuations. Students benefit from this exclusive focus and the careful development of a single model: Reliance on the dynamic *AD/AS* model continually reinforces their understanding of the model and provides a unified framework for all analysis.

WHY THE DYNAMIC AD/AS FRAMEWORK? The dynamic AD/AS model includes many of the essential elements of the *ISLM* model. It develops the *IS* curve (Chapter 9) and illustrates the determination of interest rates in the money market through the interaction of money demand and supply (Chapter 10). However, the dynamic AD/AS model has several very important advantages over *ISLM* and traditional aggregate demand/aggregate supply frameworks:

- The dynamic AD/AS framework focuses on the interaction between *inflation* and output, which is exactly what the media and policy makers focus on. In contrast, traditional aggregate demand/aggregate supply analysis focuses on the interaction between the *price level* and output.
- The dynamic AD/AS framework characterizes monetary policy easing or tightening as a change in the *interest rate*, which is exactly the way central banks conduct monetary policy. In contrast, the *ISLM* and traditional aggregate demand/aggregate supply model frameworks characterize monetary policy as a change in the *money supply*. No central bank in the world today conducts monetary policy in this way.
- The dynamic AD/AS framework is consistent with modern macroeconomic analysis as it is treated in the academic literature.
- The dynamic AD/AS framework allows for a simple analysis of current monetary policy issues, such as nonconventional monetary policy and the zero-lower-bound problem. In addition, it allows for a modern treatment of such topical policy issues as the recent shift in monetary policy in Japan, referred to as Abenomics, and why fiscal multipliers have become larger in recent years.
- Finally, although the AD/AS framework is a change from the way macroeconomics has been taught in the past, it actually makes it easier for students to learn because they have to master only one model rather than three, as was the case with more traditional approaches that include separate developments of the *ISLM* model, traditional aggregate demand/aggregate supply, and the Phillips curve.

The Interaction of Finance and Macroeconomics

The financial crisis that hit the world economy from 2007 to 2009 made abundantly clear the interaction between finance and macroeconomics. Two full chapters on finance and macroeconomics provide a coherent approach to key topics such as financial system dynamics and asymmetric information, and demonstrate their relevance in macroeconomic analysis. Chapter 14, “The Financial System and Economic Growth,” shows how a well-functioning financial system promotes economic growth. This chapter develops the tools that are then used in Chapter 15, “Financial Crises and the Economy,” to examine how disruptions to the financial system affect aggregate demand and the economy, with a particular emphasis on the root causes of, effects of, and policy responses to the financial crisis of 2007–2009. An additional Web chapter, “Financial Crises in Emerging Market Economies,” expands the analysis of economic fluctuations to economies that have recently opened up their markets to the outside world.

Focus On Economic Growth

The explosion of research on economic growth in recent years is an exciting development in the macroeconomics field, with direct relevance to the question of why some countries suffer slow economic growth and remain poor, while others enjoy rapid economic growth and prosper. I discuss the Solow model in detail in Chapter 6, and present endogenous growth theory and the importance of institutions to economic growth in Chapter 7. As mentioned previously, Chapter 14 includes additional material on economic growth.

An International Perspective

Topical coverage and applications integrate an international dimension throughout *Macroeconomics: Policy and Practice*, Second Edition. For example, Chapter 4's analysis of the interaction of saving and investment discusses open and closed economies together, rather than in separate chapters. International trade and the impact of net exports on aggregate demand are discussed immediately as part of the AD/AS model in Part 4, as opposed to in a separate chapter, and the textbook applies the aggregate demand and supply model to analyze the impact of the 2007–2009 financial crisis in the United Kingdom, Ireland, and China. The Web chapter on emerging market economies provides further international perspective.



A Flexible Structure

Macroeconomics: Policy and Practice, Second Edition, offers a highly flexible structure with many different paths that instructors can take to tailor the book to their course needs. Most instructors will begin by assigning Chapters 1–4. For a long-run emphasis, instructors can then assign Chapters 5–7. Instructors wishing to cover the short run first can instead proceed directly to Part 4.

The core chapters that most instructors will teach in their courses, Chapters 1–13, make up the first four parts of the book. Instructors can assign subsequent chapters as they choose or skip them entirely, allowing them to focus on the particular areas of macroeconomics that match their course goals. Suggested outlines for semester-long courses with varying emphases follow. (Quarter-long courses would typically use three or four fewer of the optional chapters.)

- *Course Starting with Long-Run Analysis*: Chapters 1–13, and up to six of the remaining eleven chapters.
- *Course Starting with Micro Foundations and Long-Run Analysis*: Chapters 1–3, 18–20, 4–13, and up to three of the remaining eight chapters.
- *Course Starting with Short-Run Analysis*: Chapters 1–5, 8–13, 6–7, and up to six of the remaining eleven chapters.
- *Course Starting with Micro Foundations and Short-Run Analysis*: Chapters 1–3, 18–20, 4–5, 8–13, 6–7, and up to three of the remaining eight chapters.
- *Course Focusing on the Micro Foundations of Modern Business Cycle Analysis*: Chapters 1–3, 18–20, 4–5, 8–13, 21–22, and up to two of the remaining ten chapters.
- *Course with International Focus*: Chapters 1–13, 17, Web chapter on emerging market economies, and up to four of the remaining nine chapters.
- *Course with Finance Focus*: Chapters 1–15, and up to four of the remaining seven chapters.

Interest-Generating Features

Motivating the study of macroeconomics means bringing it to life through a wide variety of pedagogical features.

Previews at the beginning of each chapter tell students where the chapter is heading, why specific topics are important, and how they relate to other topics in the book.

Applications apply the analysis in each chapter to explain important real-world situations.

Policy and Practice cases explore specific examples of actual policies and how they were executed.

Macroeconomics in the News boxes introduce students to relevant news articles and data that are reported daily in the press, and explain how to read them.

Boxes highlight interesting material, including historical episodes and recent events.

Summary tables are useful study aids that recap key points.

Key statements are important points set in boldface italic type so that the student can easily find them for later reference.

Graphs with detailed captions demonstrate the interrelationship of the variables and are central to the illustrations of policy analysis. Innovative color-blended arrows guide students' analysis of the meanings of shifting curves.

Mini-Lectures, presented by the author for all of the analytic graphs in the text, are accessible through the e-text, which is available online from MyEconLab textbook resources. The mini-lectures provide a step-by-step discussion of the analysis.

A **Summary** at the end of each chapter lists the main points covered.

Key terms, which are important words or phrases, are boldfaced when they are defined for the first time and listed by page number at the end of each chapter.

End-of-chapter Review Questions, Problems, and Real-Time Data Analysis Problems guide students' mastery of the material, with a particular emphasis on real-world applications.

Supplemental Resources Simplify Teaching and Learning

A variety of comprehensive supplemental resources for professors and students accompany this book.

MyEconLab is the premier online assessment and tutorial system, pairing rich online content with innovative learning tools. The MyEconLab course for *Macroeconomics: Policy and Practice*, Second Edition, includes all the review questions and problems from the textbook. As a special feature, all Policy and Practice cases and Applications are also offered in MyEconLab, along with three to four assessment questions to test students' understanding of the key concepts. Look for these exercises within each chapter in a separate section called "Applications."

STUDENTS AND MYECONLAB The MyEconLab online homework and tutorial system puts students in control of their own learning through a suite of study and practice tools correlated with the online, interactive version of the textbook and other media tools. Within MyEconLab's structured environment, students practice what they learn, test their understanding, and then pursue a study plan that MyEconLab generates for them based on their performance on practice tests.

INSTRUCTORS AND MYECONLAB MyEconLab provides flexible tools that allow instructors to easily and effectively customize online course materials to suit their needs. Instructors can create and assign tests, quizzes, or homework assignments. MyEconLab saves time by automatically grading questions and tracking results in an online grade book. After registering for MyEconLab, instructors also have access to downloadable supplements.

ADDITIONAL MYECONLAB FEATURES

- **Weekly News Updates.** Each week, a relevant and current article from a newspaper or journal is posted, along with discussion questions.

For more information and to register, please visit www.myeconlab.com.

ADDITIONAL INSTRUCTOR RESOURCES *The Instructor's Manual*, an online supplement prepared by Martin Pereyra of the University of Missouri and the author, offers chapter overviews, outlines and objectives, and answers to the end-of-chapter questions and problems including solutions to the Data Analysis problems by Aaron Jackson of Bentley University. Additionally, the Instructor's Manual includes resources for each chapter that tie into the Applications and Policy and Practice features of the chapter, including discussion questions that professors can use in class with students, references to interesting outside materials such as newspaper and journal articles and macroeconomic data, and references to websites containing related real-world examples. The Instructor's Manual is available at www.pearsonhighered.com/irc in Microsoft Word and PDF formats.

The PowerPoint Presentations, prepared by Jim Lee of Texas A&M University–Corpus Christi, provide all figures and tables from the text, as well as brief lecture notes that follow the structure and sequence of the text. They include coverage of the main topics of the chapter, organized by A-head, the key terms and equations from the chapter, and the Applications and Policy and Practice features in the chapter.

Animated PowerPoint Presentations, created by the author, are also available at www.pearsonhighered.com/irc. These PowerPoint slides provide the analytical figures and are completely manipulable by the user. Instructors can custom design their PowerPoint lectures with step-by-step animations of all key text figures.

The Test Item File, originally prepared by Paul Kubik of DePaul University, Victor Valcarcel of Texas Tech University, and Brian Trinqué of the University of Texas–Austin, and updated for the second edition by Brian Trinqué, provides 75 multiple-choice questions and 10 short-answer questions for each chapter. The questions provide a mix of numerical, graphical, and conceptual approaches for all chapter topics. In addition, the questions are MyEconLab-compatible and follow the Association to Advance Collegiate Schools of Business (AACSB) tagging procedures. The Test Item File is available at www.pearsonhighered.com/irc electronically in Microsoft Word format and as computerized TestGen-format files that can be used with TestGen test-generating software. This test-generating program permits instructors to edit, add, or delete questions from the test bank; analyze test results; and organize a database of tests and student results, allowing for flexibility and ease of use.

ADDITIONAL STUDENT RESOURCES *The Companion Website*, located at www.pearsonhighered.com/mishkin, features Web appendices on a wide variety of topics, as well as a Web chapter, “Financial Crises in Emerging Market Economies.”



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I dedicate this book to my mother, who was still sharp as a tack and a lot of fun when she passed away in 2012 at age ninety-one.

Frederic S. Mishkin

About the Author



Frederic S. Mishkin is the Alfred Lerner Professor of Banking and Financial Institutions at the Graduate School of Business, Columbia University. He is also a research associate at the National Bureau of Economic Research and past president of the Eastern Economics Association. Since receiving his Ph.D. from the Massachusetts Institute of Technology in 1976, he has taught at the University of Chicago, Northwestern University, Princeton University, and Columbia. He has also received an honorary professorship from the People's (Renmin) University of China. From 1994 to 1997, he was executive vice president and director of research at the Federal Reserve Bank of New York and an associate economist of the Federal Open Market Committee of the Federal Reserve System. From September 2006 to August 2008, he was a member (governor) of the Board of Governors of the Federal Reserve System.

Professor Mishkin's research focuses on monetary policy and its impact on financial markets and the aggregate economy. He is the author of more than twenty books, including *The Economics of Money, Banking, and Financial Markets*, Tenth Edition (Pearson, 2013); *Financial Markets and Institutions*, Eighth Edition (Pearson, 2015); *Monetary Policy Strategy* (MIT Press, 2007); *The Next Great Globalization: How Disadvantaged Nations Can Harness Their Financial Systems to Get Rich* (Princeton University Press, 2006); *Inflation Targeting: Lessons from the International Experience* (Princeton University Press, 1999); *Money, Interest Rates, and Inflation* (Edward Elgar, 1993); and *A Rational Expectations Approach to Macroeconometrics: Testing Policy Ineffectiveness and Efficient Markets Models* (University of Chicago Press, 1983). In addition, he has published more than 200 articles in such journals as *American Economic Review*, *Journal of Political Economy*, *Econometrica*, *Quarterly Journal of Economics*, *Journal of Finance*, *Journal of Money, Credit and Banking*, and *Journal of Monetary Economics*.

Professor Mishkin has served on the editorial board of *American Economic Review* and has been an associate editor at *Journal of Business and Economic Statistics*, *Journal of Applied Econometrics*, *Journal of Economic Perspectives*, and *Journal of Money, Credit and Banking*; he also served as the editor of the Federal Reserve Bank of New York's *Economic Policy Review*. He is currently an associate editor (member of the editorial board) at five academic journals, including *International Finance*; *Finance India*; *Review of Development Finance*; *Borsa International Review*; and *Emerging Markets, Finance and Trade*. He has been a consultant to the Board of Governors of the Federal Reserve System, the World Bank, and the International Monetary Fund, as well as to many central banks throughout the world. He was also a member of the International Advisory Board to the Financial Supervisory Service of South Korea and an advisor to the Institute for Monetary and Economic Research at the Bank of Korea. Professor Mishkin was a Senior Fellow at the Federal Deposit Insurance Corporation's Center for Banking Research and was an academic consultant to and serves on the Economic Advisory Panel of the Federal Reserve Bank of New York.

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Part

1

Introduction

Chapter 1

The Policy and Practice of Macroeconomics

Chapter 2

Measuring Macroeconomic Data

Part 1 Introduction

We begin with an introduction to the study of macroeconomics. Chapter 1 describes the questions that macroeconomists seek to answer and the data they seek to explain, raising key policy questions that will be the focus of the remaining chapters of this book: How can poor countries get rich? Is saving too low? Do government budget deficits matter? How costly is it to reduce inflation? How can we make financial crises less likely? How active should stabilization policy be? Should macroeconomic policy follow rules? Are global trade imbalances a danger? Chapter 2 examines how economists define and measure the most important macroeconomic data.

In keeping with our focus on key policy issues and the techniques policymakers use in practice, we will analyze the following specific examples in Policy and Practice cases:

- “Can GDP Buy Happiness?”
- “Policy and Overstatements of the Cost of Living”

1

The Policy and Practice of Macroeconomics

Preview

What are your career plans after graduation? Many factors beyond your grades and choice of a major affect the ultimate path you take. When you graduate from college, will jobs be plentiful or will a high unemployment rate (as occurred in the aftermath of the 2007–2009 recession) make it a challenge to find work? Will overall prices be rising rapidly, so you will need more money to pay for your expenses next year? Will the value of the U.S. dollar decline so that it will be more expensive to travel abroad? Should you worry about the current high government budget deficits? Jumping ahead, will the economy grow rapidly over the next thirty years, so your children will be better off than you? We will address the economics underlying the answers to these questions throughout this book.

In this chapter, we set the stage for your exploration of the policy and practice of macroeconomics. We start the chapter by examining what macroeconomists do and what data they seek to explain. We then preview the policy issues that we explore throughout this book.



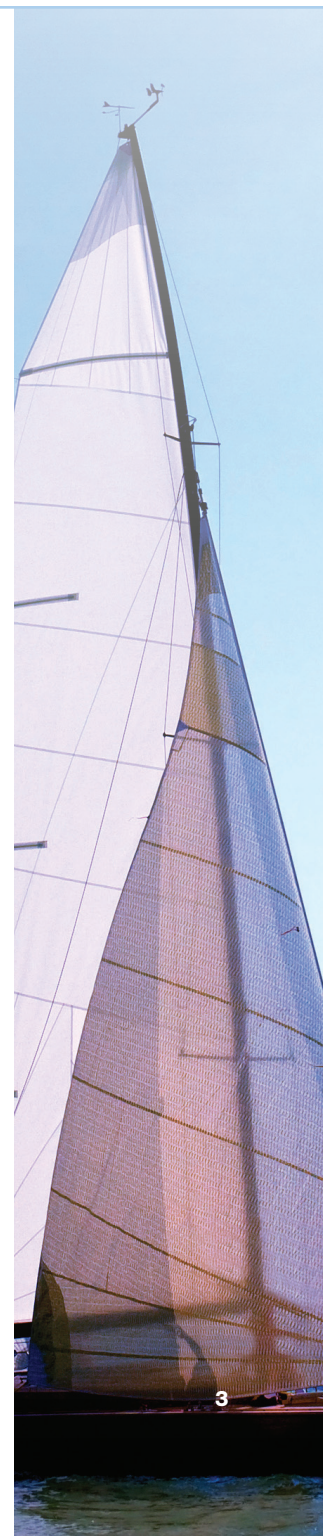
The Practice of Macroeconomics

In formal terms, **macroeconomics** is the study of economic activity and prices in the overall economy of a nation or a region. Macroeconomic research draws heavily on **microeconomics**, which looks at the behavior of individual firms, households, or markets.¹

The Process: Developing Macroeconomic Models

Macroeconomists try to explain how the overall economy works by using an **economic theory**, a logical framework to explain a particular economic phenomenon. Economic theory involves developing an **economic model**, a simplified representation of the

¹We will explore the microeconomic foundations of macroeconomics in Chapters 18 to 20 of this book.



economic phenomenon that takes a mathematical or graphical form. The development of an economic theory or model typically involves five steps:

1. Identify an interesting economic question. For example, a macroeconomist might want to understand why the unemployment rate rises or falls over time, or why workers' wages in real terms (in terms of the goods and services they can actually buy) rise more rapidly during certain periods, but not others.
2. Specify the variables to be explained by the model, as well as the variables that explain them. A variable that a macroeconomist wants to explain is referred to as an **endogenous variable**, because it is explained *inside* the model he or she is building (and thus has the *endo* prefix). She would then identify a set of factors, called **exogenous variables**, that are used to explain the endogenous variable, but are taken as given and thus are viewed as determined *outside* the model. (This is why they have the *exo* prefix.)

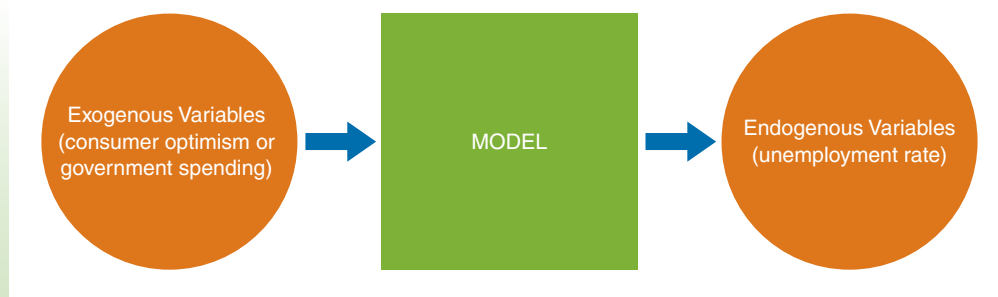
For example, in explaining the endogenous variable (the unemployment rate), the macroeconomist might specify consumer optimism or government spending as exogenous variables that are taken as given. Or if he or she were interested in explaining real wage growth, the endogenous variable, the macroeconomist might choose the rate of technological progress or the power of unions as the exogenous variables. The schematic diagram in Figure 1.1 illustrates the relationship between endogenous and exogenous variables in an economic model.

3. Posit a set of equations or graphical analysis to connect movements in the exogenous variables to the endogenous variables. For example, we might create a formula showing how, all else being equal, a 10% increase in government spending would change the unemployment rate. This formula is our model.
4. Compare the conclusions of the model with what actually happens. For example, if the model is designed to explain the unemployment rate, we

FIGURE 1.1

Variables in Macroeconomic Models

The model is a set of equations or a graphical analysis that explains movements in the endogenous variables—variables that are explained by the model—as a result of changes in the exogenous variables—given factors not determined by the model.



would compare the model's predictions to actual unemployment data in prior years. If the conclusions do not match this historical data, return to step 2 and change the model.

5. If the data are well explained, use the model to make further predictions, say on where the unemployment rate will head a year from now, and suggest policies to lower it.

The iterative process of comparing a model to actual data, making improvements along the way, raises new economic questions and advances knowledge in macroeconomics. We will look at the interaction of data and macroeconomic models as we proceed through this book, highlighting how the field of macroeconomics has evolved over time. We will also see how well macroeconomic models explain the data by looking at numerous applications featuring the U.S. and world economies throughout every chapter.

The Purpose: Interpreting Macroeconomic Data

Macroeconomists, and in turn macroeconomic models, focus in particular on three economic data series: *real GDP*, the *unemployment rate*, and the *inflation rate*. We look at each in turn.

REAL GDP. **Real Gross Domestic Product (GDP)** measures the output of actual goods and services produced in an economy over a fixed period, usually a year. As we will see in Chapter 2, real GDP also equals the total amount of real income of every person and firm in the economy.

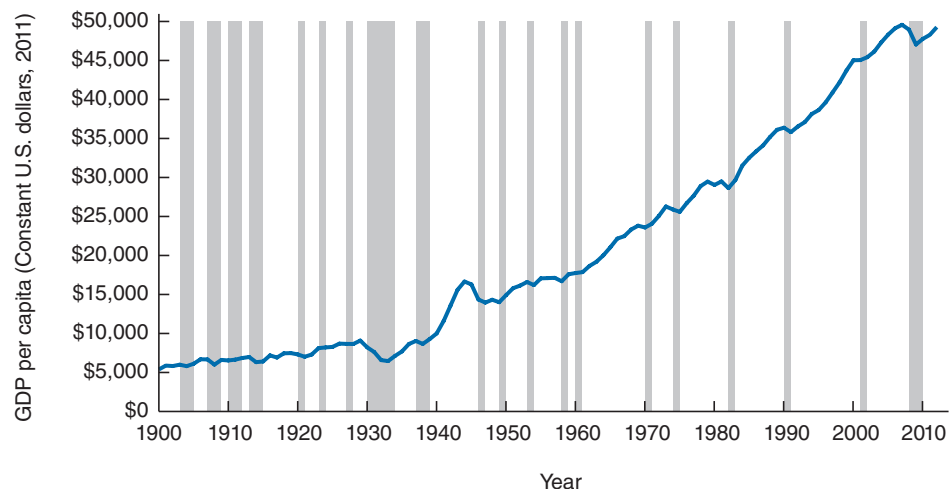
Figure 1.2 shows real GDP per person in the U.S. economy from 1900–2013 and has two important attributes. (To account for changes in the purchasing power of a dollar, we treat all goods and services as if they were sold at prices from the year 2011.) First,

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FIGURE 1.2

U.S. Real GDP Per Capita, 1900–2013

Due to business cycle fluctuations, real GDP per person has grown substantially but not smoothly, over time. We represent recessions with the shaded areas. Depressions are severe declines in real GDP, the most notable being the Great Depression (1929–1933).



Sources: Federal Reserve Bank of St. Louis, FRED Database. <http://research.stlouisfed.org/fred2/>; and for data before 1960, Maddison, Angus. *Historical statistics*. <http://www.ggdc.net/maddison/>

notice in Figure 1.2 that real GDP per person has grown substantially over time. In 1900, the average U.S. person earned nearly \$5,000. Today, this number has risen by more than a factor of nine, to nearly \$50,000. U.S. citizens today have far more income than their great grandparents did, and have been getting richer and richer over time. What explains this rise in income? Economic growth, the subject of Chapters 6, 7, and 14 of this book, is one of the most important topics in macroeconomics.

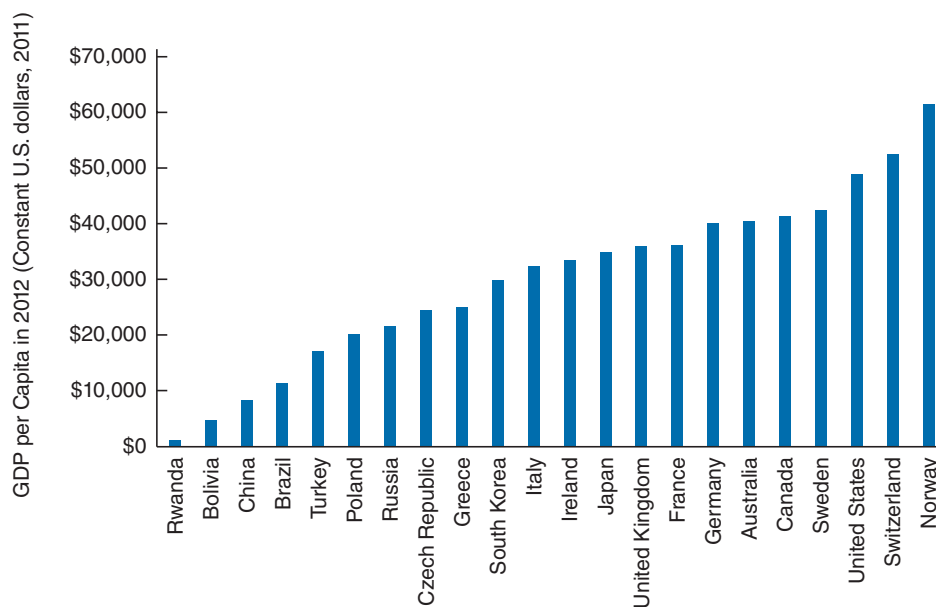
Second, notice in Figure 1.2 that real GDP grows unevenly over time and fluctuates around a trend. Fluctuations in real GDP are called a **business cycle**, which represents recurrent up and down movements in economic activity that differ in how regular they are. When economic activity declines and real GDP per person falls, there is a **recession**. In Figure 1.2, recession periods are marked by the shaded areas—and are frequent phenomena. When the decline in real GDP is severe, a recession is classified as a **depression**. The most notable of these is the Great Depression that lasted from 1929 until 1933. What causes recessions and particularly depressions is another of the most-studied questions in macroeconomics. We study short-run fluctuations in economic activity in Chapters 8–13.

So far we have only looked at real GDP per person in the United States. Figure 1.3 compares real GDP per person in a number of countries. As you can see, there are huge differences from country to country. Rwanda has a real GDP per person of just over \$600, which is less than one-eightieth of U.S. real GDP. Macroeconomists study factors that affect real GDP over time. South Korea, for example, in 1960 had a real GDP per person of \$1,500 that was actually lower than that of Bolivia. Today, Bolivia remains poor, while South Korea has moved into the rich countries' club, with its ranking of per person real GDP in the top quarter of all nations. South Korea turned around its prospects through very high economic growth rates. We focus on why some countries are so rich and others so poor, and how countries can improve their prospects, in Chapters 6, 7, and 14.

FIGURE 1.3

Cross-Country Comparison of Real GDP per Capita in 2012

Real GDP per person varies widely across countries. Rwanda has a real GDP per person of just over \$600, which is less than one-eightieth of U.S. real GDP, which is nearly \$50,000.



Source: World Bank.
World development indicators. <http://data.worldbank.org/indicator/>

UNEMPLOYMENT RATE. The **unemployment rate** measures the percentage of workers looking for work, but who do not have jobs, at a particular point in time. When unemployment is high, households suffer a loss of income and may even find themselves unable to meet basic needs for food and shelter.

Figure 1.4 shows the U.S. unemployment rate from 1929–2013. Notice that the unemployment rate always remains well above zero, indicating that even during good times, there is always some unemployment. In addition, in Figure 1.4 the unemployment rate fluctuates substantially and rises sharply in the shaded areas denoting recessions. In 1933, during the Great Depression, the unemployment rate climbed to 25%. The most recent recession from 2007–2009, which has been dubbed the “Great Recession,” although not nearly as severe as the Great Depression, still resulted in the largest rise in unemployment in the post–World War II period, with the unemployment rate rising by six percentage points, peaking at over 10%. What happens in labor markets to drive up unemployment during contractions in economic activity? We will seek answers to this question in Chapters 9–12 and 20.

Figure 1.5 compares the average unemployment rates over the past decade for different countries. Greece’s over 12% unemployment rate is more than four times that of Switzerland, indicating the wide variation across countries. We will study the characteristics of labor markets that lead to high average unemployment rates in some countries but not others in Chapter 20.

INFLATION. **Inflation** or the **inflation rate** tells us how rapidly the overall level of prices is rising. Notice in Figure 1.6 that up until World War II, the inflation rate was on average about zero, and was often negative, a situation referred to as **deflation**. In the late 1960s, inflation rose and remained quite high for an extended period of time through the early 1980s, a period economists often refer to as the Great Inflation. We will address the causes of inflation and its historical peaks in Chapters 9–13.

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FIGURE 1.4

U.S. Unemployment Rate, 1929–2013

The unemployment rate always remains well above zero, has substantial fluctuations, and rises sharply during recessions, denoted by the shaded areas.

Sources: Federal Reserve Bank of St. Louis, FRED Database. <http://research.stlouisfed.org/fred2/>; and data prior to 1948, National Bureau of Economic Research. *Macro history database, income and employment.* www.nber.org/databases/macrohistory/contents/chapter08.html

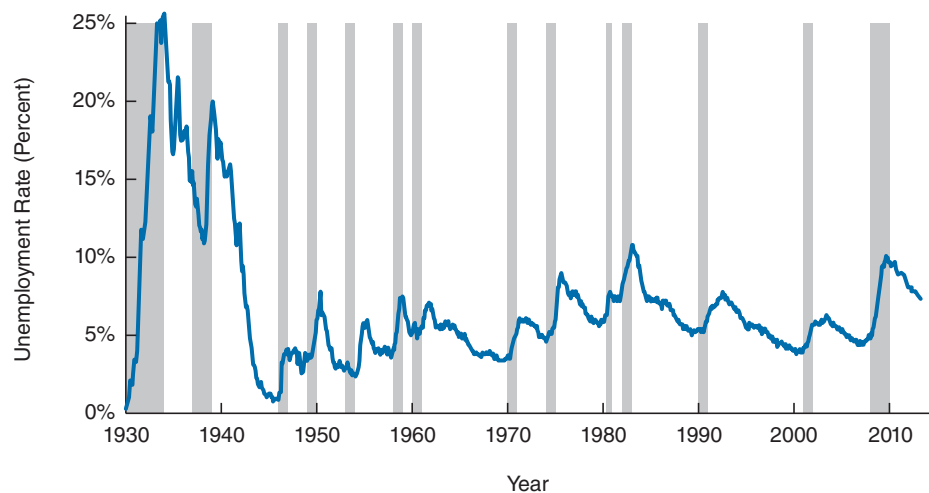
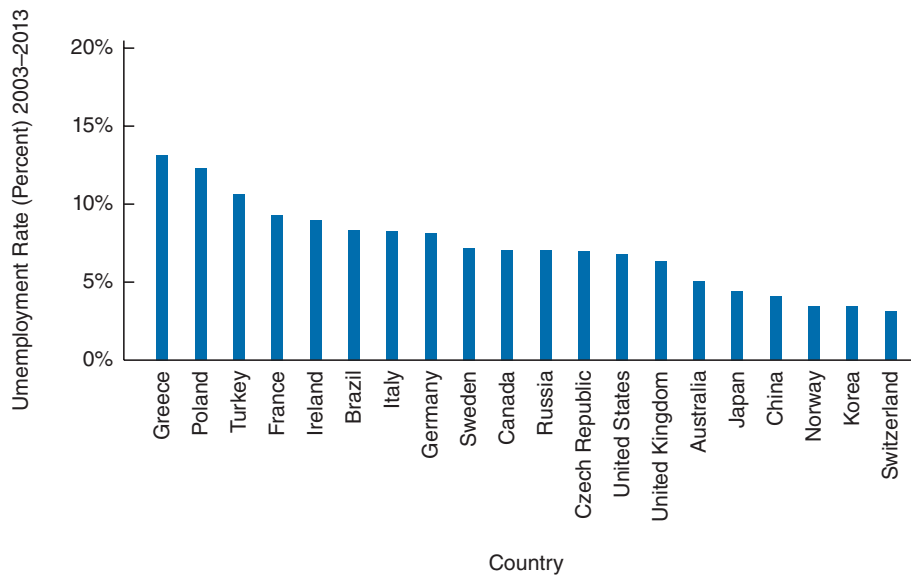


FIGURE 1.5

Cross-Country Comparison of Average Unemployment Rates, 2003–2013

The average unemployment rates over the past decade for a number of countries show much variation. For example, Greece's over 12% unemployment rate is four times higher than Switzerland's 3.1% unemployment rate.

Source: International Monetary Fund. <http://www.imf.org/external/data.htm>



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FIGURE 1.6

U.S. Inflation Rate, 1910–2013

Up until World War II, the average inflation rate was near zero. In the late 1960s, inflation rose and remained quite high for an extended period of time through the early 1980s, the period of the Great Inflation.

Source: Federal Reserve Bank of St. Louis, FRED Database. <http://research.stlouisfed.org/fred2/>

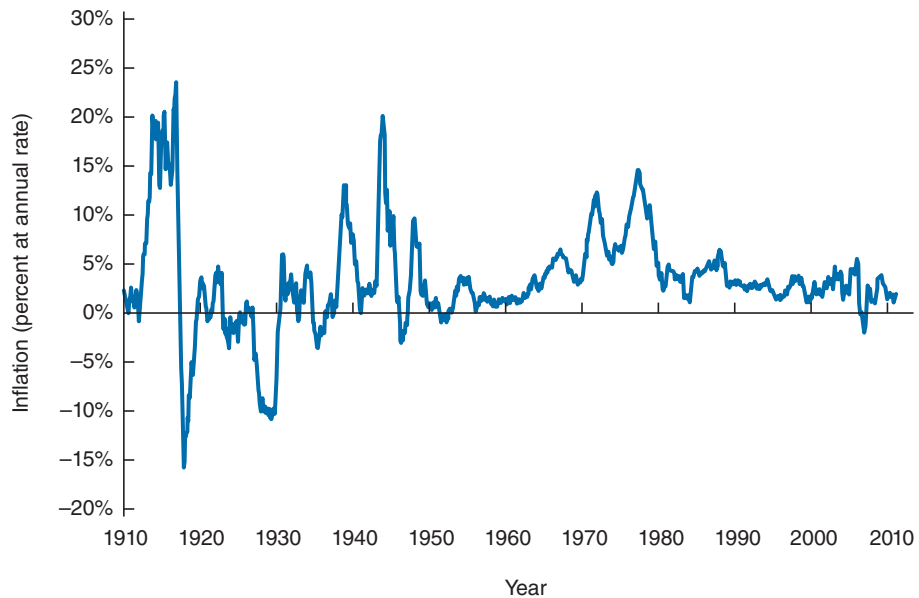
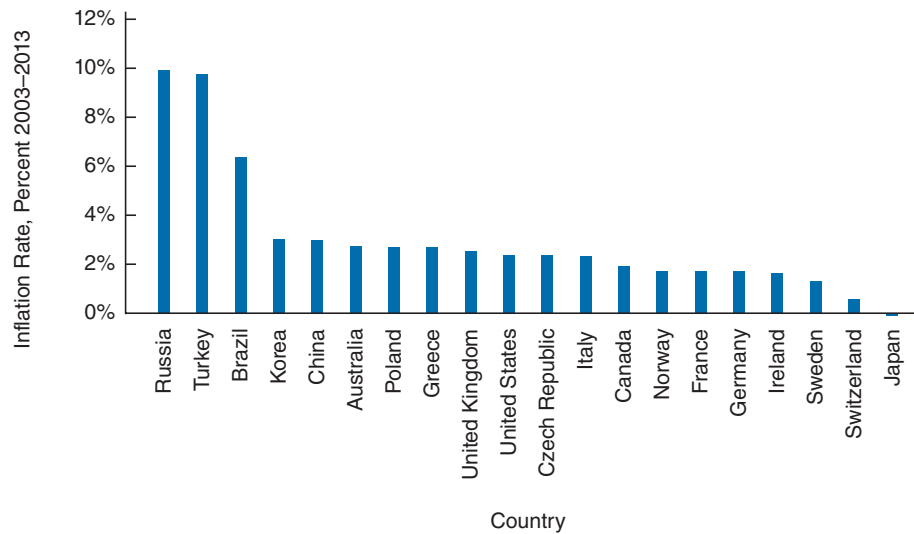


FIGURE 1.7

Cross-Country Comparison of Average Inflation Rates, 2003–2013

Countries' average inflation rates over the past decade have differed, with most countries having inflation rates averaging less than 5% at an annual rate, but some, such as Turkey and Russia, with inflation rates well above that.

Source: International Monetary Fund. <http://www.imf.org/external/data.htm>



A changing price level complicates decision making for consumers, businesses, and government, and this uncertainty can hamper economic growth. Consider a shop owner who finds that he or she can raise prices and make more profit. The owner might conclude that demand for his or her goods is rising and invest in expanding the store. If the overall price level is rising and demand for his or her goods hasn't changed, the decision to expand the shop could backfire.

Figure 1.7 shows that the average inflation rates over the past decade for a number of countries have differed substantially. What makes some countries more prone to inflation than others? Some countries have experienced super high inflation rates, which we refer to as **hyperinflation**. Zimbabwe (not shown in the figure) is the most recent extreme example, with its inflation rate soaring to over two million percent at an annual rate. Why do some countries experience hyperinflation? We will pursue these questions in Chapters 5 and 16.



Macroeconomic Policy

The careful work necessary to develop economic models and analyze key data is not simply an academic exercise: the underlying goal is to determine what policies can produce better macroeconomic outcomes. We will look at numerous specific examples of how macroeconomic policy is practiced in the Policy and Practice cases that appear throughout the text. We now set the stage by previewing several policy issues that are of particular concern to macroeconomists.

How Can Poor Countries Get Rich?

It's a simple insight that high economic growth enables poor countries to become rich. Nonetheless, designing policies to achieve economic growth is one of the greatest