contents

Preface xxiv Companion Website Resources xxxiv	
par	t 1 Introduction 1
Chap	oter 1 The Science of Macroeconomics 3
1-1	What Macroeconomists Study 3 CASE STUDY Inflation and Unemployment: Some European Comparisons 6 CASE STUDY The Historical Performance of the UK Economy 9
1-2	How Economists Think 12 Theory as Model Building 12 ► FYI Using Functions to Express Relationships among Variables 16 A Multitude of Models 16 Prices: Flexible versus Sticky 17 ► FYI Nobel Macroeconomists 18 Microeconomic Thinking and Macroeconomic Models 19
1-3	How This Book Proceeds 20
Cha	pter 2 The Data of Macroeconomics 23
2-1	Measuring the Value of Economic Activity: Gross Domestic Product 24 Income, Expenditure and the Circular Flow 24 FYI Stocks and Flows 26 Rules for Computing GDP 26
	Real GDP versus Nominal GDP 31 The GDP Deflator 32 Chained-Volume Measures of Real GDP 32
	► FYI Two Arithmetic Tricks for Working with Percentage Changes 33 The Components of Expenditure and the National Income Accounts 34 ► FYI What Is Investment? 37 CASE STUDY GDP and Its Components 37
	Other Measures of Income 42 CASE STUDY Real GDP per Person across the European Union 42 Seasonal Adjustment 44
2-2	Measuring the Cost of Living: The Consumer Price Index 45

The Price of a Basket of Goods 45
The CPI versus the GDP Deflator 46

	 CASE STUDY The Consumer Price Index and the Retail Price Index: A Study of European Harmony 48
2-3	Measuring Joblessness: The Unemployment Rate 52
	CASE STUDY Trends in Labour-Force Participation in the UK 54
2-4	Conclusion: From Economic Statistics to Economic Models 56
pai	rt 2 Classical Theory: The Economy in the Long Run 59
Cha	pter 3 National Income: Where It Comes From and Where It Goes 61
3-1	What Determines the Total Production of Goods and Services? 63 The Factors of Production 63 The Production Function 63 The Supply of Goods and Services 64
3-2	How Is National Income Distributed to the Factors of Production? 65 Factor Prices 65 The Decisions Facing the Competitive Firm 65 The Firm's Demand for Factors 67 The Division of National Income 70 CASE STUDY The Black Death and Factor Prices 72 The Cobb-Douglas Production Function 72 FYI The Growing Gap between Rich and Poor in the US 75 CASE STUDY UK Labour Productivity as the Key Determinant of Real Wages 76 What Determines the Demand for Goods and Services? 77 Consumption 77 Investment 79 FYI The Many Different Interest Rates 80 Government Purchases 81
3-4	CASE STUDY Consumption, Investment and Government Purchases in European Countries 81 What Brings the Supply and Demand for Goods and Services
	into Equilibrium? 83 Equilibrium in the Market for Goods and Services: The Supply and Demand for the Economy's Output 83 Equilibrium in the Financial Markets: The Supply and Demand for Loanable Funds 84 Changes in Saving: The Effects of Fiscal Policy 86 FYI The Financial System: Markets, Intermediaries, and the Crisis of 2008–2009 87

Does the CPI Overstate Inflation? 47

	 ▶ CASE STUDY Wars and Interest Rates in the United Kingdom, 1730–1920 88 Changes in Investment Demand 90
3-5	Conclusion 92
Chap	pter 4 The Monetary System: What It Is and How It Works 97
4-1	What Is Money? 98 The Functions of Money 98 The Types of Money 99 ➤ CASE STUDY Cigarette Money 99 How Fiat Money Evolves 100 ➤ CASE STUDY Money and Social Conventions on the Island of Yap 100 How the Quantity of Money Is Controlled 101 ➤ FYI How Do Credit Cards Fit into the Monetary System? 102 How the Quantity of Money Is Measured 102
4-2	The Role of Banks in the Monetary System 105 100 Per Cent Reserve Banking 105 Fractional Reserve Banking 106 Bank Capital, Leverage and Capital Requirements 108
4-3	How Central Banks Influence the Money Supply 109 A Model of the Money Supply 109 The Three Instruments of Monetary Policy 111 CASE STUDY Quantitative Easing and the Exploding Monetary Base in the US 113 Problems in Controlling the Money Supply 115 CASE STUDY US Bank Failures, the Money Supply and the Great Depression 116
4-4	Conclusion 117
Cna	pter 5 Inflation: Its Causes, Effects and Social Costs 121
5-1	The Quantity Theory of Money 122 Transactions and the Quantity Equation 123 From Transactions to Income 124 The Money Demand Function and the Quantity Equation 124 The Assumption of Constant Velocity 125 Money, Prices and Inflation 126 CASE STUDY Inflation and Money Growth 126
5-2	Seigniorage: The Revenue from Printing Money 128
5-3	Inflation and Interest Rates 130 Two Interest Rates: Real and Nominal 130 The Fisher Effect 130 CASE STUDY Inflation and Nominal Interest Rates 131

	► CASE STUDY Nominal Interest Rates in the 19th Century 133
5-4	The Nominal Interest Rate and the Demand for Money 134
	The Cost of Holding Money 134
	Future Money and Current Prices 134
5-5	The Social Costs of Inflation 136
	The Layman's View and the Classical Response 136
	CASE STUDY What Economists and the Public Say about Inflation 137
	The Costs of Expected Inflation 138
	The Costs of Unexpected Inflation 139
	One Benefit of Inflation 140
5-6	Hyperinflation 141
	The Costs of Hyperinflation 141
	CASE STUDY Wars, Economic Disruption and Hyperinflation 142
	The Causes of Hyperinflation 143
	CASE STUDY Hyperinflation in Interwar Germany 144
	CASE STUDY Hyperinflation in Zimbabwe 146
5-7	Conclusion: The Classical Dichotomy 147
	Appendix: The Cagan Model: How Current and Future Money Affec
	the Price Level 150
Cha	pter 6 The Open Economy 153
	CASE STUDY The Increasing Globalization of the World Economy 155
6-1	The International Flows of Capital and Goods 156
	The Role of Net Exports 156
	International Capital Flows and the Trade Balance 157
	International Flows of Goods and Capital: An Example 159
	GDP, GNP, the Trade Balance and the Current Account 160
	► FYI The Irrelevance of Bilateral Trade Balances 161
	► CASE STUDY The Current Account Balance and the Trade Balance in Some European Countries 163
6-2	Saving and Investment in a Small Open Economy 164
	Capital Mobility and the World Interest Rate 164
	The Model 165
	How Policies Influence the Trade Balance 166
	Evaluating Economic Policy 169
	CASE STUDY The US Trade Deficit 169
	CASE STUDY Why Doesn't Capital Flow to Poor Countries? 172
6-3	Exchange Rates 173
	Nominal and Real Exchange Rates 173
	The Real Exchange Rate and the Trade Balance 175
	The Determinants of the Real Exchange Rate 176

Two Real Interest Rates: Ex Ante and Ex Post 132

	CASE STUDY Wars and Interest Rates in the United Kingdom, 1730–1920 88
	Changes in Investment Demand 90
3-5	Conclusion 92
Cha	pter 4 The Monetary System: What It Is and How It Works 97
4-1	What Is Money? 98
	The Functions of Money 98
	The Types of Money 99
	CASE STUDY Cigarette Money 99
	How Fiat Money Evolves 100
	CASE STUDY Money and Social Conventions on the Island of Yap 100
	How the Quantity of Money Is Controlled 101
	► FYI How Do Credit Cards Fit into the Monetary System? 102
	How the Quantity of Money Is Measured 102
4-2	The Role of Banks in the Monetary System 105
	100 Per Cent Reserve Banking 105
	Fractional Reserve Banking 106
	Bank Capital, Leverage and Capital Requirements 108
4-3	How Central Banks Influence the Money Supply 109
	A Model of the Money Supply 109
	The Three Instruments of Monetary Policy 111
	CASE STUDY Quantitative Easing and the Exploding Monetary Base in the US 113
	Problems in Controlling the Money Supply 115
	CASE STUDY US Bank Failures, the Money Supply and the Great Depression 116
4-4	Conclusion 117
Cha	pter 5 Inflation: Its Causes, Effects and Social Costs 121
5-1	The Quantity Theory of Money 122
	Transactions and the Quantity Equation 123
	From Transactions to Income 124
	The Money Demand Function and the Quantity Equation 124
	The Assumption of Constant Velocity 125
	Money, Prices and Inflation 126
	CASE STUDY Inflation and Money Growth 126
5-2	Seigniorage: The Revenue from Printing Money 128
	CASE STUDY The Inflation Tax and Money Growth on the Island of Yap 129
5-3	Inflation and Interest Rates 130
	Two Interest Rates: Real and Nominal 130
	The Fisher Effect 130
	CASE STUDY Inflation and Nominal Interest Rates 131

	Two Real Interest Rates: Ex Ante and Ex Post 132
	t- CASE STUDY Nominal Interest Rates in the 19th Century 133
5-4	The Nominal Interest Rate and the Demand for Money 134
	The Cost of Holding Money 134
	Future Money and Current Prices 134
5-5	The Social Costs of Inflation 136
	The Layman's View and the Classical Response 136
	CASE STUDY What Economists and the Public Say about Inflation 137
	The Costs of Expected Inflation 138
	The Costs of Unexpected Inflation 139
	One Benefit of Inflation 140
5-6	Hyperinflation 141
	The Costs of Hyperinflation 141
	CASE STUDY Wars, Economic Disruption and Hyperinflation 142
	The Causes of Hyperinflation 143
	CASE STUDY Hyperinflation in Interwar Germany 144
	CASE STUDY Hyperinflation in Zimbabwe 146
5-7	
	Appendix: The Cagan Model: How Current and Future Money Affect
	the Price Level 150
Cha	pter 6 The Open Economy 153
	CASE STUDY The Increasing Globalization of the World Economy 155
6-1	The International Flows of Capital and Goods 156
	The Role of Net Exports 156
	International Capital Flows and the Trade Balance 157
	International Flows of Goods and Capital: An Example 159
	GDP, GNP, the Trade Balance and the Current Account 160
	► FYI The Irrelevance of Bilateral Trade Balances 161
	CASE STUDY The Current Account Balance and the Trade Balance in Some European Countries 163
6-2	Saving and Investment in a Small Open Economy 164
	Capital Mobility and the World Interest Rate 164
	The Model 165
	How Policies Influence the Trade Balance 166
	Evaluating Economic Policy 169
	: CASE STUDY The US Trade Deficit 169
	CASE STUDY Why Doesn't Capital Flow to Poor Countries? 172
6-3	Exchange Rates 173
	Nominal and Real Exchange Rates 173

The Real Exchange Rate and the Trade Balance 175
The Determinants of the Real Exchange Rate 176

6-4	How Policies Influence the Real Exchange Rate 177 The Effects of Trade Policies 180 The Determinants of the Nominal Exchange Rate 181 CASE STUDY Inflation and Nominal Exchange Rates 182 The Special Case of Purchasing Power Parity 183 CASE STUDY Big Mac PPP 185 Conclusion: Exchange Rates, the Trade Balance and Capital Flows 187 Appendix: The Large Open Economy 191 Net Capital Outflow 191
	The Model 193
	Policies in the Large Open Economy 195
	Conclusion 199
Chap	ter 7 Unemployment 201
7-1	Job Loss, Job Finding and the Natural Rate of Unemployment 202
7-2	Job Search and Frictional Unemployment 204
	Government Policy and Frictional Unemployment 205
	CASE STUDY Unemployment Benefit and the Rate of Job Finding 206
7-3	Real-Wage Rigidity and Structural Unemployment 207
	Minimum-Wage Laws 208
	CASE STUDY The Secrets to Happiness: Some European Evidence 210
	Unions and Collective Bargaining 211
	Efficiency Wages 212
	► FYI The Natural Rate of Unemployment and the NAIRU 213
7 1	CASE STUDY Henry Ford's \$5 Workday 214
7-4	Labour-Market Experience: The United Kingdom 215
	The Duration of Unemployment 215 Variation in the UK Unemployment Rate across
	Demographic Groups 216
	Trends in UK Unemployment 217
	Transitions Into and Out of the Labour Force 220
7-5	Labour-Market Experience: Continental Europe 221
	The Rise in European Unemployment 221
	Variation in European Unemployment Rates across Demographic Groups 224
	CASE STUDY The European Social Model: Must It Necessarily Raise Unemployment? 226
	> CASE STUDY Reforming French Labour Markets: I Predict a Riot 226
7-6	Conclusion 227

part 3 Growth Theory: The Economy in the Very Long Run 231

Chapter 8 Economic Growth I: Capital Accumulation and Population Growth 233

8-1	The Accumulation of Capital 235
	The Supply and Demand for Goods 235
	Growth in the Capital Stock and the Steady State 237
	Approaching the Steady State: A Numerical Example 240
	CASE STUDY The Miracle of Japanese and German Growth 242
	How Saving Affects Growth 243
	CASE STUDY Saving and Investment around the World 244

8-2 The Golden Rule Level of Capital 246

Comparing Steady States 246
Finding the Golden Rule Steady State: A Numerical Example 249
The Transition to the Golden Rule Steady State 251

8-3 Population Growth 253

The Steady State with Population Growth 254

The Effects of Population Growth 255

CASE STUDY Population Growth around the World 257

Alternative Perspectives on Population Growth 258

8-4 Conclusion 260

Chapter 9 Economic Growth II: Technology, Empirics and Policy 265

9-1 Technological Progress in the Solow Model 266 The Efficiency of Labour 266 The Steady State with Technological Progress 267

The Effects of Technological Progress 268

9-2 From Growth Theory to Growth Empirics 269

Balanced Growth 269 Convergence 270

Factor Accumulation versus Production Efficiency 271

CASE STUDY Is Free Trade Good for Economic Growth? 272

9-3 Policies to Promote Growth 273

Evaluating the Rate of Saving 274

Changing the Rate of Saving 275

Allocating the Economy's Investment 276

Establishing the Right Institutions 278

CASE STUDY The Colonial Origins of Modern Institutions 279

Encouraging Technological Progress 280

	CASE STUBY The Worldwide Slowdown in Economic Growth: 1972–2011 281 > CASE STUBY A Tale of Two Growth Experiences 283
0.4	Beyond the Solow Model: Endogenous Growth Theory 285
9-4	The Basic Model 286
	A Two-Sector Model 287
	The Microeconomics of Research and Development 288
	> CASE STUDY Economic Growth as a Process of Creative Destruction 289
0.5	Conclusion 290
9-5	
	Appendix. Accounting for the Sources of Leavesting
	Increases in the Factors of Production 294
	Technological Progress 296
	The Sources of Growth 298
	CASE STUDY Growth in the East Asian Tigers 298
nar	t 4 Business Cycle Theory: The Economy
PCI.	in the Short Run 301
	in the chort itali
Chap	oter 10 Introduction to Economic Fluctuations 303
10-1	The Facts about the Business Cycle 305
	GDP and Its Components 305
	Unemployment and Okun's Law 307
	Leading Economic Indicators 310
	CASE STUDY The Conference Board Index of Leading Economic Indicators 310
10-2	Time Horizons in Macroeconomics 312
	How the Short Run and Long Run Differ 312
	CASE STUDY Why Are Prices Sticky? 313
	The Model of Aggregate Supply and Aggregate Demand 313
10-3	Aggregate Demand 314
	The Quantity Equation as Aggregate Demand 315
	Why the Aggregate Demand Curve Slopes Downward 315
	Shifts in the Aggregate Demand Curve 316
10-4	Aggregate Supply 317
	The Long Run: The Vertical Aggregate Supply Curve 317
	The Short Dun. The Head of the Short Dun.
	From the Short Run to the Long Run 320
	PASE STUDY Cold the Develop
10-5	Stabilization Policy 323
	Shocks to Aggregate Demand 323
	Shocks to Aggregate Supply 324
	CASE STUDY How OPEC Helped Cause Stagflation in the 1970s
	and Euphoria in the 1980s 326

10-6 Conclusion 328

Chapter 11 Aggregate Demand I: Building the IS-LM Model 331

11-1 The Goods Market and the IS Curve 333

The Keynesian Cross 333

► CASE STUDY The Dwindling Popularity of Fiscal Policy as a Means to Fine-Tune the Economy 340

▶ CASE STUDY Increasing Government Purchases to Stimulate the Economy: The Obama Spending Plan 342

The Interest Rate, Investment and the IS Curve 343

How Fiscal Policy Shifts the IS Curve 345

A Loanable-Funds Interpretation of the IS Curve 345

11-2 The Money Market and the LM Curve 348

The Theory of Liquidity Preference 348

CASE STUDY Does a Monetary Tightening Raise or Lower Interest Rates? 350

Income, Money Demand and the LM Curve 352

How Monetary Policy Shifts the LM Curve 353

A Quantity-Equation Interpretation of the LM Curve 354

11-3 Conclusion: The Short-Run Equilibrium 355

Chapter 12 Aggregate Demand II: Applying the IS-LM Model 359

12-1 Explaining Fluctuations with the IS-LM Model 360

How Fiscal Policy Shifts the IS Curve and Changes the Short-Run

Equilibrium 360

How Monetary Policy Shifts the *LM* Curve and Changes the Short-Run

Equilibrium 361

The Interaction between Monetary and Fiscal Policy 363

Shocks in the IS-LM Model 365

CASE STUDY The International Decline in GDP Growth in 2001 366
What Is the Central Bank's Policy Instrument: The Money Supply

What Is the Central Bank's Policy Instrument: The Money Supply or the Interest Rate? 367

12-2 IS-LM as a Theory of Aggregate Demand 368

From the IS-LM Model to the Aggregate Demand Curve 368

The IS-LM Model in the Short Run and Long Run 371

12-3 The Great Depression 373

The Spending Hypothesis: Shocks to the IS Curve 374

The Money Hypothesis: A Shock to the LM Curve 376

The Money Hypothesis Again: The Effects of Falling Prices 377

Could the Depression Happen Again? 379

CASE STUDY The Japanese Slump of the 1990s 380

CASE STUDY The Financial Crisis and Economic Downturn of 2008 and 2009 381

► FYI The Liquidity Trap 382

12-4 Conclusion 384

Appendix: The Simple Algebra of the IS-LM Model and the Aggregate Demand Curve 388

	The LM Curve 389 The Aggregate Demand Curve 390 The Aggregate Demand Curve 390
	CASE STUDY The Effectiveness of Monetary and Fiscal Policy 391
Chap	nter 13 The Open Economy Revisited: The Mundell-Fleming Model and the Exchange-Rate Regime 393
13-1	The Mundell-Fleming Model 395 The Key Assumption: Small Open Economy with Perfect Capital Mobility 395 The Goods Market and the IS* Curve 395 The Money Market and the LM* Curve 396 Putting the Pieces Together 399
13-2	The Small Open Economy under Floating Exchange Rates 399 Fiscal Policy 400 Monetary Policy 401 Trade Policy 402
13-3	The Small Open Economy under Fixed Exchange Rates 404 How a Fixed-Exchange-Rate System Works 404 CASE STUDY The International Gold Standard 406 Fiscal Policy 407 Monetary Policy 408 CASE STUDY Devaluation and European Recovery from the Great Depression 409 Trade Policy 409
	Policy in the Mundell-Fleming Model: A Summary 410
13-4	Interest-Rate Differentials 411 Country Risk and Exchange-Rate Expectations 411 Differentials in the Mundell-Fleming Model 412 CASE STUDY International Financial Crisis: Mexico 1994–1995 414 CASE STUDY International Financial Crisis: East Asia 1997–1998 415
13-5	Should Exchange Rates Be Floating or Fixed? 416 Pros and Cons of Different Exchange-Rate Systems 416 CASE STUDY The Debate over the Euro 417 Speculative Attacks, Currency Boards, 'Dollarization' and 'Euroization' 419 CASE STUDY International Financial Crisis: The Speculative Attack on the European Exchange Rate Mechanism, 1992 420 The Impossible Trinity 422 CASE STUDY European Monetary Union: Squaring the Triangle? 423 CASE STUDY The Chinese Currency Controversy 424
13-6	From the Short Run to the Long Run: The Mundell-Fleming Model with a Changing Price Level 425
13-7	Conclusion 428
	Appendix: A Short-Run Model of the Large Open Economy 431

The IS Curve 388

Fiscal Policy 433

Monetary Policy 434 A Rule of Thumb 434

Chapter 14 Aggregate Supply and the Short-Run Trade-Off between Inflation and Unemployment 437

14-1 Three Models of Aggregate Supply 438

The Sticky-Price Model 439

The Sticky-Wage Model 440

- CASE STUDY The Cyclical Behaviour of the Real Wage 443

The Imperfect-Information Model 444

CASE STUDY International Differences in the Aggregate Supply Curve 446

Summary and Implications 447

14-2 Inflation, Unemployment and the Phillips Curve 449

Deriving the Phillips Curve from the Aggregate Supply Curve 449

► FYI The History of the Modern Phillips Curve 451

Adaptive Expectations and Inflation Inertia 451

Two Causes of Rising and Falling Inflation 452

CASE STUDY: Inflation and Unemployment in the United Kingdom 453

The Short-Run Trade-Off between Inflation and Unemployment 455

Disinflation and the Sacrifice Ratio 456

► FYI How Precise Are Estimates of the Natural Rate of Unemployment? 457

Rational Expectations and the Possibility of Painless Disinflation 458

CASE STUDY The Sacrifice Ratio in Practice: The Thatcher Disinflation 460

Hysteresis and the Challenge to the Natural-Rate Hypothesis 461

14-3 Conclusion 462

Appendix: A Big, Comprehensive Model 466

part 5 Macroeconomic Policy Debates 469

Chapter 15 Stabilization Policy 471

15-1 Should Policy Be Active or Passive? 472

Lags in the Implementation and Effects of Policies 472

The Difficult Job of Economic Forecasting 474

CASE STUDY Mistakes in Forecasting 475

Ignorance, Expectations and the Lucas Critique 477

The Historical Record 478

CASE STUDY The Remarkable Stability of the Modern Economy 478

15-2 Should Policy Be Conducted by Rule or by Discretion? 480

Distrust of Policy Makers and the Political Process 480

The Time Inconsistency of Discretionary Policy 481

Rules for Monetary Policy 483

The Taylor Rule of Monetary Policy 484

15-3	Inflation Targeting: Rule or Constrained Discretion? 485 The Taylor Rule and Inflation Targeting 486
	The rayior rate and instances and b
15-4	Central Bank Independence 487
15-5	inflation largeling and Central Bank machemania
	The European Central Bank 489
	The Bank of England 490
	The Riksbank 491
	The Norges Bank 492
	The US Federal Reserve System 492
15-6	Conclusion: Making Policy in an Uncertain World 493
	Appendix: Time Inconsistency and the Trade-Off between Inflation and Unemployment 496
Chap	oter 16 Government Debt 499
16-1	The Size of the Government Debt 501
16-2	Problems in Measurement 503
	Measurement Problem 1: Inflation 503
	Measurement Problem 2: Capital Assets 504
	Measurement Problem 3: Uncounted Liabilities 505
	Measurement Problem 4: The Business Cycle 505
	► FYI Measuring National Indebtedness: General Government Gross Debt or Public Sector Net Debt? 506
	Summing Up 507
16-3	The Traditional View of Government Debt 508
	CASE STUDY The Laffer Curve and Supply-Side Economics 509
	► FYI Taxes and Incentives 510
16-4	The Ricardian View of Government Debt 512
	The Basic Logic of Ricardian Equivalence 513
	Consumers and Future Taxes 514
	CASE STUDY Why Do Parents Leave Bequests? 516
	Making a Choice 516
	► FYI Ricardo on Ricardian Equivalence 517
16-5	Other Perspectives on Government Debt 517
	Balanced Budgets versus Optimal Fiscal Policy 518
	Fiscal Effects on Monetary Policy 519
	International Dimensions 520
	CASE STUDY Indexed Bonds 520
16-6	Fiscal Sustainability, Budget Deficits and the Debt-to-GDP Ratio 523
	CASE STUDY The Stability and Growth Pact: A Sneak Preview 526
	CASE STUDY The 'Golden Rule' of UK Public Finance 527
	► FYI Ponzi Finance 528

16-7 Conclusion 529

Chapter 17 Common Currency Areas and European Economic and Monetary Union 533
17-1 Common Currency Areas 534
17-2 The Benefits of a Single Currency 535
Reduction in Transactions Costs in Trade 535
Reduction in Price Discrimination 536
Reduction in Foreign-Exchange-Rate Variability 537
17-3 The Costs of a Single Currency 537
Loss of Monetary Policy Sovereignty 537
Asymmetric Demand Shocks 537
Asymmetric Supply Shocks 541
Loss of Fiscal Policy Sovereignty 541
17-4 The Theory of Optimum Currency Areas 543
Characteristics that Reduce the Costs of a Single Currency 544
Characteristics that Increase the Benefits of a Single Currency 547
17-5 Is Europe an Optimum Currency Area? 548
Summing Up: Is Europe an Optimum Currency Area? 553
17-6 Fiscal Policy and Common Currency Areas 554
Fiscal Federalism 554
National Fiscal Policies in a Currency Union: The Free-Rider Problem 555
The Stability and Growth Pact 557
CASL STUDY The Euro Area Crisis 559
17-7 Conclusion 560

part 6 More on the Microeconomics behind Macroeconomics 565

Chapter 18 Consumption 567

18-1 John Maynard Keynes and the Consumption Function 568
 Keynes's Conjectures 568
 The Early Empirical Successes 570
 Secular Stagnation, Simon Kuznets and the Consumption Puzzle 570

18-2 Irving Fisher and Intertemporal Choice 572

The Intertemporal Budget Constraint 572

► FYI Present Value, or Why European Lottery Prizes Are Worth More than US Lottery Prizes 575

Consumer Preferences 576

Optimization 577

How Changes in Income Affect Consumption 578

	How Changes in the Real Interest Rate Affect Consumption 579
	Constraints on Borrowing 581
	CASE STUDY The High Japanese Saving Rate 583
18-3	Franco Modigliani and the Life-Cycle Hypothesis 584
	The Hypothesis 585
	Implications 585
	CASE STUDY The Consumption and Saving of the Elderly 587
18-4	Milton Friedman and the Permanent-Income Hypothesis 589
	The Hypothesis 589
	Implications 590
	© CASE STUDY The Contrasting Effects of Permanent and Temporary Tax Changes 591
18-5	Robert Hall and the Random-Walk Hypothesis 592
	The Hypothesis 592
	Implications 592
	► CASE STUDY Do Predictable Changes in Income Lead to Predictable Changes in Consumption? 593
18-6	David Laibson and the Pull of Instant Gratification 594
	CASE STUDY How to Encourage People to Save More: A Proposal from the Field of Behavioural Economics 595
18-7	Conclusion 596
Chap	pter 19 Investment 601
19-1	Business Fixed Investment 602
	The Rental Price of Capital 603
	The Cost of Capital 604
	The Determinants of Investment 606
	Taxes and Investment 608
	The Stock Market and Tobin's q 609
	CASE STUDY The Stock Market as an Economic Indicator 610
	Alternative Views of the Stock Market: The Efficient Markets Hypothesis versus Keynes's Beauty Contest 612
	Financing Constraints 614
	CASE STUDY Banking Crises and Credit Crunches 615
19-2	Residential Investment 615
	The Stock Equilibrium and the Flow Supply 616
	Changes in Housing Demand 617
19-3	Inventory Investment 618
	Reasons for Holding Inventories 618
	The Accelerator Model of Inventories 619
10 -	Inventories and the Real Interest Rate 620
19-4	Conclusion 620

Chapter 20 The Financial System: Opportunities and Dangers 623	
20-1 What Does the Financial System Do? 624 Financing Investment 624 Sharing Risk 625 Dealing with Asymmetric Information 626	
Fostering Economic Growth 628 Microfinance: Professor Yunus's Profound Idea 629	
20-2 Financial Crises 630 The Anatomy of a Crisis 630 ► FYI The TED Spread 632	
Who Should Be Blamed for the Financial Crisis of 2008 and 2009? 635 Policy Responses to a Crisis 636	
Policies to Prevent Crises 639 ► FYI CoCo Bonds 640	

The European Sovereign Debt Crisis 642

20-3 Conclusion 643

Epilogue What We Know, What We Don't 647

The Four Most Important Lessons of Macroeconomics 647

Lesson 1: In the Long Run, a Country's Capacity to Produce Goods and Services Determines the Standard of Living of its Residents

Lesson 2: In the Short Run, Aggregate Demand Influences the Amount of Goods and Services that a Country Produces 648

Lesson 3: In the Long Run, the Rate of Money Growth Determines the Rate of Inflation, But It Does Not Affect the Rate of Unemployment 649

Lesson 4: In the Short Run, Policy Makers Who Control Monetary and Fiscal Policy Face a Trade-off Between Inflation and Unemployment 650

The Four Most Important Unresolved Questions of Macroeconomics 650

Question 1: How Should Policy Makers Try to Promote Growth in the Economy's Natural Level of Output?

Question 2: Should Policy Makers Try to Stabilize the Economy? 651

Question 3: How Costly Is Inflation, and How Costly Is Reducing Inflation? 653

Question 4: How Big a Problem Are Government Budget Deficits? 654

Conclusion 655

Glossary 657 Index 669