Preface

Feedback from users of our first edition supports our conviction that this textbook provides a different, and better, way to introduce beginning students to economics. This text continues to emphasize: (1) an active, student-centred approach to learning; (2) economic naturalism; (3) the philosophy that evidence matters, and (4) repeated use of core principles.

ACTIVE LEARNING

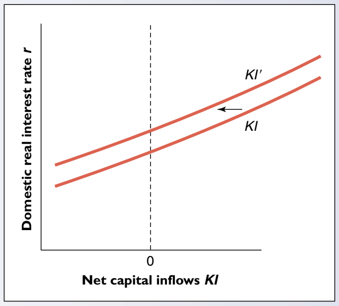
Active learning by students—that is, learning based on applying new ideas until they are internalized—is an essential part of an effective learning process. By "learning" we do not mean being able to answer a test question the next day. By the time they reach university, many students have become quite good at quick memorization—and at forgetting "useless stuff" equally rapidly. But even the brightest students never fully internalize a concept unless they use it repeatedly. This textbook has been designed for instructors who strive to stimulate the intellectual curiosity of their students and thereby have an enduring impact on them. So we think it is useful for instructors to ask themselves: "What do I want my students to retain from this course, five, ten, or twenty years from now?" Education research shows that long-term retention depends on students seeing both the value of a concept and *actively* using it. Throughout the book we use a number of devices to foster active learning.

1. **Worked Examples.** New ideas and concepts are introduced by means of simple examples, usually numerical, which are developed step by step in the text. These examples display the reasoning process used to reach the economic conclusion or insight, and they provide a model for the student to apply when working exercises and problems.

> **How much should you pay for a share of FortuneCookie.com?** EXAMPLE 10.3
>
> You have the opportunity to buy shares in a new company called FortuneCookie.com, which plans to sell gourmet fortune cookies over the Internet. Your stockbroker estimates that the company will pay $1.00 per share in dividends a year from now, and that in a year the market price of the company will be $80.00 per share. Assuming that you accept your broker's estimates as accurate, what is the most that you should be willing to pay today per share of FortuneCookie.com? How does your answer change if you expect a $5.00 dividend? If you expect a $1.00 dividend but an $84.00 stock price in one year?
>
> Based on your broker's estimates, you conclude that in one year each share of FortuneCookie.com you own will be worth $81.00 in your pocket—the $1.00 dividend plus the $80.00 you could get by reselling the stock. Finding the maximum price you would pay for the stock today therefore boils down to asking how much you would invest today to have $81.00 a year from today. Answering this question in turn requires one more piece of information, which is the expected rate of return that you require in order to be willing to buy stock in this company.

2. **Exercises.** Following many examples, and indeed throughout each chapter, we pose exercises in the running text that challenge the student to test and extend his or her understanding of the ideas being discussed. Answers to these exercises are provided at the end of the chapter, allowing immediate feedback.

FIGURE 10.4
An Increase in Risk Reduces Net Capital Inflows
An increase in the riskiness of domestic assets, arising, for example, from an increase in political instability, reduces the willingness of foreign and domestic savers to hold domestic assets. The supply of capital inflows declines at each value of the domestic real interest rate, shifting the *KI* curve to the left.



EXERCISE 10.4 **For given real interest rate and riskiness in the home country, how would you expect net capital inflows to be affected by an increase in real interest rates abroad? Show your answer graphically.**

The flow of saving increases the stock of wealth in the same way the flow of water through the faucet increases the amount of water in the tub.

3. **Anecdotes and Illustrations.** Active learning is more likely to take place when students are engaged and motivated. We begin every chapter with an anecdote that motivates the discussion, and we illustrate the ideas with memorable cartoons, photographs, and original line drawings. Most important, we have striven to minimize jargon and engage the student with direct, friendly writing.
4. **Recap Boxes and Summaries.** To keep students focused on the forest as well as the trees, at strategic points in each chapter we have provided "recap boxes." Recaps summarize the main ideas of the previous section. The recap boxes are also reiterated by bulleted end-of-chapter summaries, which are designed to review the most important concepts presented in the chapter.

RECAP **WHY DO PEOPLE SAVE?**

Motivations for personal saving include saving to meet long-term objectives, such as retirement (life-cycle saving), saving for emergencies (*precautionary saving*), and saving to leave an inheritance or bequest (*bequest saving*). The amount that people save also depends on macroeconomic factors, such as the real interest rate. A higher real interest rate stimulates saving by increasing the reward for saving, but it can also depress saving by making it easier for savers to reach a specific savings target. On net, a higher real interest rate appears to lead to modest increases in saving.

Psychological factors may also affect personal saving rates. If people have *self-control* problems, then financial arrangements (such as automatic payroll deductions) that make it more difficult to spend will increase their saving. People's saving decisions may also be influenced by *demonstration effects*, as when people feel compelled to spend at the same rate as their neighbours, even though they may not be able to afford to do so.

5. **Review Questions and Problems.** Questions for review at the end of each chapter encourage the student to test his or her understanding of the main ideas of the chapter. End-of-chapter problems are carefully crafted to help students internalize and extend core concepts.

ECONOMIC NATURALISM

Economics is fascinating because of its power to explain the world around us. As an extension of the active-learning approach, we encourage students to become "economic naturalists" who use basic economic principles to understand and explain what they see around them in the "laboratory of life."

Studying biology enables people to observe and marvel at many details of the natural environment that would otherwise have escaped their notice. For the naturalist, a walk in a quiet wood becomes an adventure. In much the same way, studying economics can enable students to see the world in which they live and work in a new light. Throughout the text, Economic Naturalist examples show students how economics can help them to understand the world they live in. In this edition we have trimmed the number and retained only the best examples of Economic Naturalist. The following are just some of the issues raised:

- How does comparative advantage arise and why might countries *not* take advantage of it?
- Does GDP measurement by Statistics Canada ignore the underground economy?
- When is a bad time to take out a mortgage?
- Why did the Coca-Cola Company stop testing a vending machine that "knows" when the weather is hot?
- What is the macroeconomic impact of a sharp drop (or rise) in world oil prices?
- Why have 12 European countries adopted a common currency?
- Does a strong Canadian dollar imply a strong Canadian economy?

If students learn to pose and answer such questions on their own, they are likely to use economics long after completing an introductory course.

10.2 ECONOMIC NATURALIST

How could Canada have a current account deficit but a trade surplus?

As shown by Figure 10.2, over the last few decades, Canada's current account balance has tended to be negative even while its net exports have tended to be positive. How can this be?

Recall that the current account balance includes not only net exports, but also net investment income and net transfers. Net transfers represent foreign aid as well as private remittances across borders, and are a small part of the current account. The primary reason for the current account deficits must therefore lie in net investment income, which has been strongly negative for Canada's history, from −\$208 million in 1926 to −\$23.5 billion in 2003.

Investment income is composed of profits, interest, and dividends on *past* investments. If net investment income is negative, then more of these kinds of payments are leaving Canada than are entering. This would occur because of prior sales of Canadian assets to foreign residents. These sales entail the future repatriation of profits, interest, and dividends to the foreign owners of the Canadian assets.

If Canada's net exports are positive but relatively low, then negative net investment income will be sufficient to pull the current account into deficit. However, by the 1999–2003 period, the sharp rise in Canada's net exports was adequate to bring the current account into surplus.

EVIDENCE MATTERS

Getting students to appreciate the power of economic theory is a crucial goal of an introductory course. But if a simple model of supply and demand were all that mattered to understand economic issues, then all problems of economic policy could be solved by anybody who has taken the one all-purpose economics course taught at universities (or high schools). Practising economists, however, know that much of the intellectual fascination of economics comes from the interplay of theory and data. As instructors, we hope to expose students to this interplay, in part because many students (particularly the smarter ones) are turned off by the unrealism of a "one size fits all" approach. That is why we return continually to the theme that "evidence matters."

REPEATED USE OF CORE PRINCIPLES

A few core principles arise again and again in economics, especially in microeconomics, but also in macroeconomics. By repeating these core principles even in the macroeconomic chapters (4 to 17), the text enhances the likelihood that students will leave the course with a thorough appreciation of the principles. A small icon appears in the margin whenever one of the core principles is discussed, thereby reinforcing the principles many times over. The core principles are listed on the inside back cover.

The Cost–Benefit Principle: An individual (or a firm or a society) will be better off taking an action if, and only if, the extra benefits from taking the action are greater than the extra costs.

COST–BENEFIT

WHAT IS NEW AND IMPROVED IN THIS EDITION

- **Introductory Material Shortened and Refined:** The material from the first edition's Chapters 1 and 2 has been rewritten and condensed into one chapter in an effort to launch these important concepts as clearly and efficiently as possible. In Chapter 3, this edition introduces the market for foreign exchange as one of the primary examples of supply and demand in action.
- **Micro Labour Material Deleted:** The labour market chapter from the first edition has been eliminated. Essential macroeconomic elements from the chapter have been moved to the chapters on long-run growth and business fluctuations.
- **Open Economy Model Moved to Earlier Chapter:** Chapter 11 of the first edition dealt with financial markets, money, and central banking; the topic of international capital flows was dealt with as part of a later, international chapter. This edition introduces the market for foreign exchange as one of the primary examples of supply and demand in action in Chapter 3 and provides students with an earlier introduction to international capital flows, by splitting the old Chapter 11 into two chapters titled "Money, Banks, and Central Banking" (Chapter 9, which now includes a short section on the history of money) and "Financial Markets and International Capital Flows" (Chapter 10).
- **Short-Run Coverage Made More Accessible:** The development of the Keynesian Cross in Chapters 12 and 13 places more emphasis on graphs and verbal explanations, with an optional mathematical treatment in the appendix. The new presentation makes it easier for students to understand the basic economic concepts underlying the short-run model. Chapter 13 continues to focus on the Bank of Canada's use of the interest rate (overnight rate target) as the primary policy tool, allowing students to more easily relate economic concepts to the real-world macroeconomic policy decisions reported in the news.
- **New Aggregate Demand–Aggregate Supply Chapter Added:** The first edition of this textbook contained a unique chapter on the new mainstream Keynesian Model relating output to the inflation rate. In this edition, that chapter has been supplemented with a more traditional chapter on aggregate demand–aggregate supply (*AD–AS*) analysis in which output is related to the price level. Reviewers have given this chapter high praise.
- **Trade Chapter Made More Engaging:** Chapter 16 now kicks off with a new section on Canada's role in the international trading system.
- **Textbook as a Whole Streamlined:** This edition has been made shorter by eliminating parts of chapters, combining chapters and by streamlining some of the worked examples and economic naturalist features.

THOROUGHLY CANADIAN MACRO

A macro textbook directed to a Canadian audience must confront head-on the interdependence of national economies. Our book places a strong *emphasis on open economy issues*. It starts with an analysis of international trade (Chapter 2) and progresses to such issues as the historical contribution of non-resident saving to Canadian capital formation (Chapter 8), the open-economy loanable funds model, the connection between the current account balance and international capital flows (both Chapter 10), the role of Canada's flexible exchange rate in amplifying the impact of monetary policy (especially Chapters 13 and 15), the causes and effects of protectionism (Chapter 16; also discussed in Chapter 2), and currency appreciation and depreciation (Chapter 17).

In addition, a Canadian macroeconomics textbook needs to introduce students to Canadian data, institutions, and policies. Beginning in Chapter 4, we introduce macroeconomic data on the Canadian economy through the use of figures and tables. We have carefully documented the sources of data, and in most cases data-based figures and tables provide the relevant data series label, not just the table number from Statistics Canada's CANSIM database. We have also included a data appendix at the end of the textbook, which uses CANSIM time series to show the major trends in the Canadian economy in recent decades. The explanatory notes for the data appendix provide an overview of the meaning and significance of the macroeconomic variables that are key to studying the Canadian economy.

Our discussion in Chapter 6 of the causes and consequences of changes in the rate of inflation draws on the Canadian macroeconomic policy literature. In analyzing saving and investment in Chapter 8, we link the discussion to Statistics Canada data from the "Savings, Investment, and Net Lending" table of the *National Income and Expenditure Accounts*. When we examine net capital inflows in Chapter 11, we link the discussion to data from *Canada's Balance of International Payments* and are careful to highlight the distinction between the current account balance and net exports. We introduce our discussion of international trade in Chapter 16 with an empirical section on Canada's role in the global economy.

Monetary policy is crucial for a trade-dependent nation in a world of floating exchange rates. To understand Canadian macroeconomic issues today, it is essential to understand how the Bank of Canada operates. We emphasize that the Bank's stated goal is to keep inflation in the range of 1 to 3 percent and that the instrument the Bank uses to achieve its goal is the overnight rate target, by changing the overnight rate target in response to changes (or anticipated changes) in inflation.

Relevant examples make the discussion of Canadian data, institutions, and policies come alive for students. Our Economic Naturalist examples dealing specifically with the Canadian economy answer questions such as:

- Why was September 1981 an incredibly bad month for a Canadian family to take out a five-year mortgage?
- Why did the Canadian stock market boom in the latter half of the 1990s?
- Why did the Bank of Canada cut the overnight rate target nine times during the most recent economic slowdown?

ORGANIZATION OF TOPICS

Principles of Macroeconomics is divided into five parts. Part 1 (Chapters 1–3) introduces basic economic concepts, including the core principles. Part 2 then brings the student into the realm of macroeconomics. Chapter 4 gives an overview of the issues that macroeconomists study. Chapters 5 and 6 focus on issues of measurement: Chapter 5 looks at measures of real activity, such as GDP and the unemployment rate, and Chapter 6 considers measures of the price level and inflation. As preparation for our model of output and inflation rate determination, we provide students with a thorough grounding in the terminology they need to discuss changes in the inflation rate.

No topic in economics is more important to living standards than the sources of long-term output and productivity growth. The four chapters of Part 3 therefore focus on long-term economic performance. Chapter 7 reviews Canada's remarkable record of long-term economic growth and discusses the factors (such as rising levels of education, fixed capital formation, and improvements in technology) that have contributed to productivity growth. Chapter 8 analyzes how saving (including non-resident saving) is related to economy-wide investment, and discusses factors affecting savings and investment decisions. Saving and capital investment are mediated by financial markets, which are discussed in Chapters 9 and 10. Chapter 9 introduces the concept of money and discusses how central banks operate. Chapter 10 deals with bond and stock markets and with international capital flows.

With that as background, Part 4 studies the short-run behavior of the economy, including cyclical fluctuations and stabilization policy. Chapter 11 introduces short-term fluctuations in the economy and includes descriptions of Canada's experience with recessions and expansion, the characteristic behaviour of unemployment and inflation during business cycles, and the measurement of an economy's output gap. In the short run, changes in aggregate spending can affect output. Chapter 12 looks at the relationship between planned aggregate spending and output in the very short run, when prices are fixed and firms simply meet the demand for their output. In this setting, government policies that affect planned aggregate spending such as changes in government purchases can help to eliminate output gaps. Maintaining the short-run focus, Chapter 13 adds monetary policy and the Bank of Canada to the story. Chapter 14 dispenses with the assumption of a fixed price level, and considers output and price level determination in the context of a traditional model of aggregate demand and supply. Chapter 15 presents a model according to which the output gap will eventually cause the inflation rate to change. This in turn (via the central bank's policy reaction function) triggers a mechanism that eliminates output gaps over time. Chapter 15 also considers other sources of inflation, notably aggregate supply shocks, and the policy dilemmas these create.

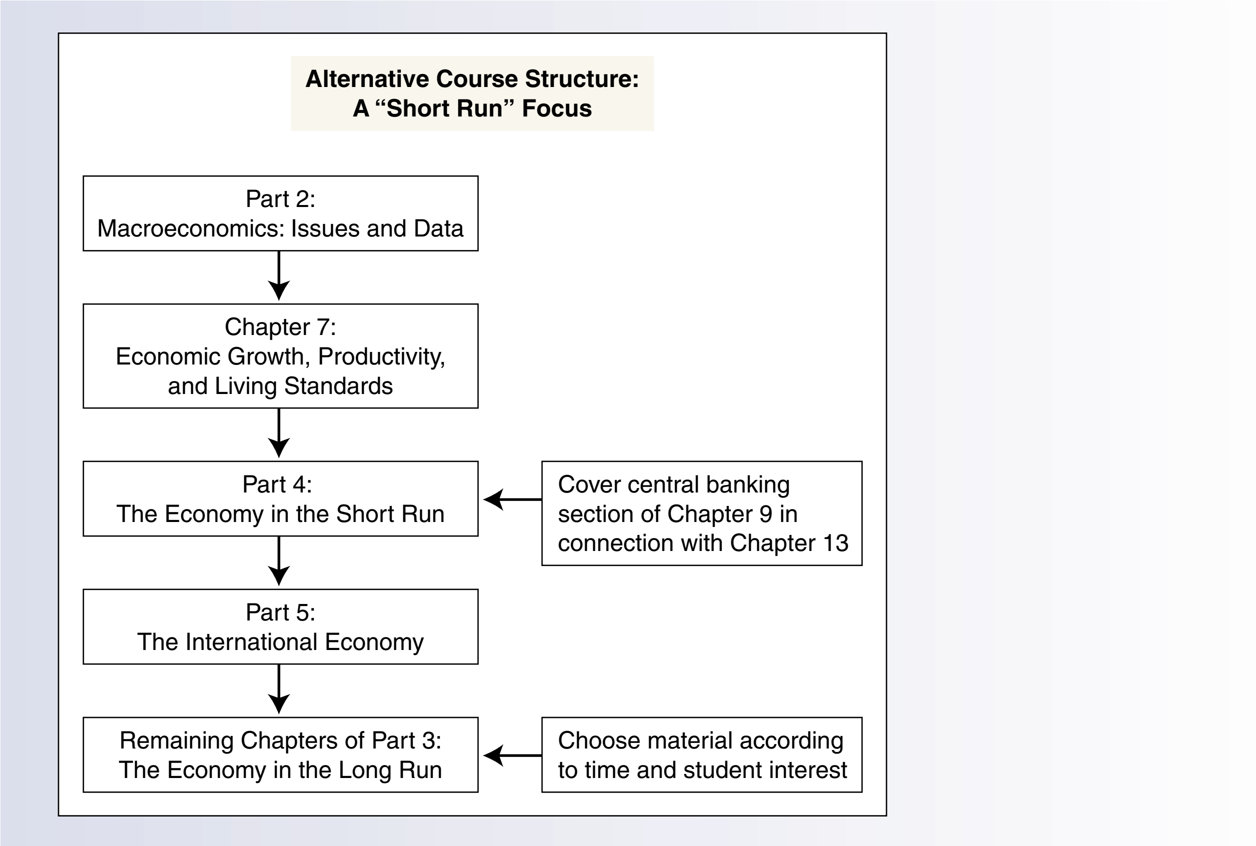
In Part 5 the focus is entirely on the international dimensions of the economy. Chapter 16 extends Chapter 2's analysis of comparative advantage to look at the case for and against freer trade and discusses Canada's role in the global economy. Chapter 17 extends the discussion of exchange rates found in Part 4 and also analyzes the constraints that a fixed exchange-rate regime places on domestic monetary policy.

ALTERNATIVE COURSE STRUCTURES

As our discussion of the organization of topics indicates, there is a well-developed logic to the structure and coverage of this textbook. But naturally each instructor will teach the material a bit differently. Some will decide to cover less material, others may prefer to teach the short-run chapters of Part 4 before the long-run chapters of Part 3, and still others may choose to cover the international chapters of Part 5 before the Part 4 chapters. The textbook lends itself to these and other course structures. The following are options for covering less material, regardless of the sequencing of the chapters. We then discuss two alternative paths through the chapters.

What are the options for covering less material? Part 1 can be skipped, of course, if this textbook is used in the second term of a course that covers microeconomics in the first term. We believe that most instructors should cover Part 2. Otherwise students may fail to develop a good grasp of what the key macroeconomic variables—GDP, the unemployment rate, and the inflation rate—really represent and of how real variables differ from nominal ones. In Part 3, Chapter 7 on economic growth is the most critical chapter. Some instructors may wish to provide abbreviated coverage of Chapter 8, which provides exceptionally thorough coverage of saving and capital formation. Chapter 9 deals with the traditional question of how commercial banks create money, but instructors pressed for time may ask themselves whether the payoff in enhanced student analytical capacity is worth the time and effort. The coverage of bond and stock price determination in Chapter 10 is something many students find both fascinating and practical, but later chapters do not depend directly on this material. In Part 4, Chapter 13 provides two alternative theories of interest rate determination—the vertical money supply theory and the modern central banking theory. We note that both theories come to the same bottom line, but by different analytical routes, so different instructors may make different choices as to which to emphasize. Chapters 14 and 15 provide alternative macroeconomic models—Chapter 14 deals with a traditional aggregate demand–aggregate supply model of output and price level determination whereas Chapter 15 presents a more recent model of output and inflation rate determination. Some instructors will decide to skip one of these two chapters. Finally, some instructors may decide that the coverage of comparative advantage in Chapter 2 is adequate to the needs of their students and will omit the coverage in Chapter 16.

SHORT-RUN FIRST OPTION



Many Canadian instructors like to cover the "short run" material early in the course so they can be sure they have the time necessary to teach it thoroughly. To meet this objective, we would recommend the following sequence of macroeconomics chapters. First, cover Part 2 to introduce students to the subject and to measurement issues. Second, move on to Chapter 7 to give students an appreciation of the importance of long-term growth. Third, jump ahead to the short-run chapters (Part 4) and give them the attention you think they require. Fourth, turn to the international chapters (Part 5). Finally, cover as much of Chapters 8, 9, and 10 as time permits. The only significant adjustment necessitated by this alternative sequence of chapters is that the section on central banking in Chapter 9 should be assigned to students, or summarized for them, in conjunction with Chapter 13 on monetary policy.

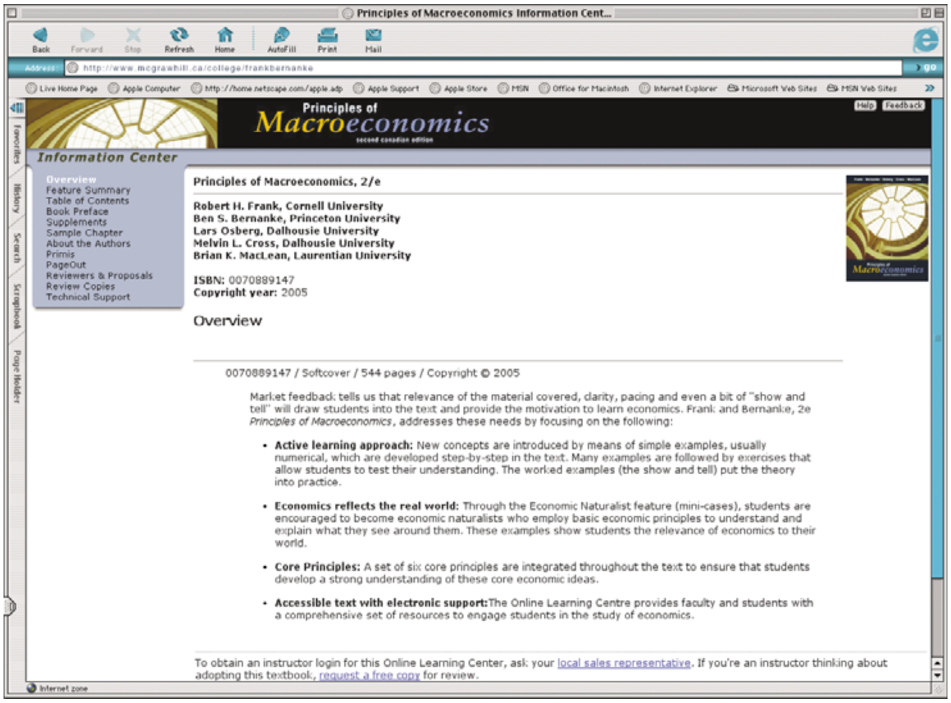
As well, many Canadian instructors like to cover the "international" material early in the course. Chapters 16 and 17 should be taught after Parts 1 and 2. But otherwise they can be positioned as early in the sequence of chapters as the instructor desires. However, instructors should keep in mind that if Chapter 17 is covered before Chapter 13, then the discussion of monetary policy in Chapter 17 should be supplemented by the instructor, as students will have had very little prior exposure to the topic.

TECHNOLOGY SOLUTIONS

ONLINE LEARNING CENTRE

More and more students are studying online. That is why we offer an Online Learning Centre (OLC) that follows *Principles of Macroeconomics* chapter by chapter. You don't have to build or maintain anything and it's ready to go the moment you and your students type in the URL:

www.mcgrawhill.ca/college/frankbernanke



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- Video Cases
- Data Update Links
- Internet Application Questions
- Chapter Outlines
- Glossary and Key Terms
- Chapter Summary
- Practice Activities
- Separate Pre- and Post-tests
- Interactive Graphing Exercises
- Economic Naturalist Exercises
- Sample Exam Questions
- Internet Resource Sites
- Concept Maps
- Study to Go

Remember, the *Principles of Macroeconomics* OLC content is flexible enough to use with any course management platform currently available. If your department or school is already using a platform, we can help. For information on our course management services, contact your *i*Learning Sales Specialist or see "Superior Service" on page xxvii.

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GradeSummit GradeSummit is a self-assessment, diagnostic service helping students make the most efficient use of their study time. This Internet service provides many ways for students to analyze what they know and do not know to quickly discover those subject areas where study time will help most. GradeSummit reveals subject strengths and weaknesses and provides feedback and direction, which enables students to focus their study time.

The ability to create automatically graded quizzes provides a vehicle to you, the instructor, to make accountable homework assignments. GradeSummit's diagnostic reports yield valuable data about student understanding of the course material. In as little as an hour per term, you can create graded homework assignments, use a variety of reporting features, download homework scores to use with your existing grade book, and know you have given your students a service they will thank you for. Try it today at *www.gradesummit.com,* or, for more information, contact us at info@gradesummit.com.

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These landmark reports, undertaken in conjunction with academic and private sector advisory boards, are the result of research studies into the challenges professors face in helping students succeed and the opportunities that new technology presents to impact teaching and learning.

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We believe that an ancillary package is most useful if each element in it is part of a well-considered whole. Each member of this book's development team is committed to the quality and cohesiveness of the supplementary package.

FOR THE INSTRUCTOR

The Instructor's Online Learning Centre The OLC at www.mcgrawhill.ca/college/frankbernanke includes a password-protected Web site for Instructors. The site offers downloadable supplements and PageOut, the McGraw-Hill Ryerson course Web site development centre.

Instructor's CD-ROM This CD-ROM contains all of the necessary Instructor Supplements, including:

- **Instructor's Manual** Adapted by Teresa Cyrus of Dalhousie University, this manual is extremely useful for all teachers, but especially for those new to the job. It offers suggestions for using the Study Guides, the Test Bank, and the Economic Naturalist cases. It supplies sample syllabi with assignments, sample exams, and supplemental material. For each chapter, it provides an overview, an outline, teaching objectives, additional Economic Naturalist discussion questions, answers to textbook questions and problems, homework assignments with answers, and sample quizzes with answers.
- **Computerized Test Banks** The test banks (micro and macro), ensure maximum flexibility in test preparation, including the reconfiguring of graphing exercises. The Micro Test Bank is prepared by Chandan Shirvaikar of Red Deer College and the Macro Test Bank by Akhter Faroque of Laurentian University. Collectively, the test banks contain more than 5000 multiple-choice questions categorized by Learning Objective; Learning Level (knowledge, comprehension, application, analysis); Type (graph, calculation, word problem); and Source (textbook, Study Guide, Web, unique).
- **PowerPoint Slides** Adapted by Lars Osberg, Dalhousie University, this package contains dynamic slides of the important illustrations in the textbook, along with detailed, chapter-by-chapter reviews of the important ideas presented in the text. Carefully prepared concept maps relate the different topics in each of the micro and macro texts.

CBC Video Cases Accompanying the texts is a series of video segments drawn from CBC broadcasts of *Undercurrents*, *The National*, *Current Affairs*, and *Venture*. These videos have been chosen to aid students in relating real-world economic issues to the text, and to illuminate key ideas and concepts presented in the text. A set of instructor notes accompanies the segments available at the Instructor's Online Learning Centre. The video segments will be available in a VHS format for use in class and through video streaming on the Online Learning Centre accessible by both instructors and students.

FOR THE STUDENT

Study Guide Prepared by Linda Nielsen (Mount Royal College), the Study Guide [ISBN 007-0951063] provides the following elements: chapter overview, chapter review, knowledge and skills table, and self-test, (key terms with fill-in-the blanks, multiple choice questions, and short answer problems) with answers.

Student Online Learning Centre Prepared by Sigrid Ewender (Kwantlen University College), this electronic learning aid at www.mcgrawhill.ca/college/frankbernanke is robust enough for any distance-education program. It includes cyber-lectures, quizzes, practice activities, separate pre- and post-tests, interactive graphing exercises, Economic Naturalist exercises, sample exam questions with answers, understanding questions, Internet questions, Internet resource sites, Study To Go, a Math Tutor, EconGraph Toolkit, concepts maps, key terms, chapter outlines, chapter summaries, data update links, CBC Videos and Cases, a searchable glossary and much more!

Online LearningCentre

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Morris Marshall, George Brown College
Frank Millerd, Wilfred Laurier University
Sean Parkinson, University College of the Fraser Valley
Leyland Paul, York University
Marc Prud'Homme, University of Ottawa
Linda Nielsen, Mount Royal College
Brenda Spotton Visano, York University
Mary Ann Vaughan, Wilfred Laurier University
Peter Wylie, Okanagan University College
Xiaopeng Yin, University of Windsor
Graham Voss, University of Victoria