

Understanding
MICROECONOMICS

THIRD EDITION



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PREFACE



THE MOST RELIABLE constant of life in a market economy is constant change. Sitting down to work on this new edition of this textbook has brought many changes to my attention.

Some of them are trivial. One chapter mentioned some authors who were on the best-seller list at the time of the last edition—good books they wrote, but just as the market economy is in constant change, so is the publishing industry. Out they go, to be replaced by J.K. Rowling and Dan Brown.

Other changes are much more fundamental, such as the trend toward globalization of both the macro- and micro-economy. Professional economists will know that this trend is not really new. If one looks at the data, trends in imports and exports, integration of labor and financial markets, and global brand penetration started long ago. Yet, although statistically well established, these trends have clearly hit a new threshold of public awareness in the first decade of the 21st century. For that reason alone, a modern textbook must reflect the global nature of the economy.

One of the signs of its increased global outlook is the disappearance of a separate chapter on foreign exchange markets and international monetary policy. Because these topics are more important than ever, it is no longer appropriate to isolate them in the last chapter of the macroeconomics course, too easily skipped in the rush toward final exams. Instead, topics like the effects of exchange rates on aggregate demand and the relationship between price stability and exchange rate policy are now integrated directly into the various macro chapters that deal with related issues for the domestic economy. The result is a book that is both more up-to-date and more streamlined. Numerous globally-oriented cases and topics appear in the micro chapters as well.

One final change is in the textbook market itself. Earlier editions of this book reflected the college publishing world of the past: Fat, heavy volumes with fat, heavy price tags that, over time, came to be one of the most resented financial burdens of a college education. And students didn't even get their money's worth from those texts of an earlier era. The technology of the day meant long lead times and the sheer costs

of production meant substantial intervals between revisions, so that textbooks were often several years out of date before they hit the classroom. Things were even worse for students who, because of financial pressure, depended on lower-cost used copies of earlier editions. Happily, that model of publishing is now in retreat.

It is a great pleasure to me to see this new edition come out through Horizon Textbook Publishing. The advantages of working with a publisher who uses the latest technology to bring the book to market just a few months after final revisions are made makes the pleasure all the greater. I hope you, as a user of the book, will complete the cycle by providing me, as author, with your feedback so that your suggested changes can be quickly incorporated in future editions.

Acknowledgments

My first thanks must go to my long-time co-author, David E. Lindsey, with whom I worked on earlier editions of this text over a period of many years. During his years as Deputy Director of the Division of Monetary Affairs of the Board of Governors of the Federal Reserve System, David was able to find the ideal balance between the theory and practice of economics. Although he did not contribute directly to preparation of this new edition, his strong influence can still be seen in both the macroeconomic and microeconomic chapters.

Second, I would like to thank Kristin van Gaasbeck, Ph.D for her innovative work in updating data sources, news items, and many other elements for the new edition. Her work has made a big difference in keeping the content of the book fresh and up to date, and in bringing it to market faster than could ever have been done without her able contribution.

Finally, I thank the entire publishing and editorial staff of Horizon Textbook Publishing for introducing me to this great new concept in college publishing. I hope you, the user, benefit as much as I have.

EDWIN G. DOLAN
Lopez Island, Washington

The last few months have been one of the most exciting time of my life. I got the basic book form that I worked further on developing and changing the way I thought will be most suitable for undergraduate students. The original format was created by Edwin Dolan and after making changes, I am satisfied by the final product which makes me very eager to take this book to students and improve it further based on their comments. I am quite sure that the book will be successful in clarifying microeconomic concepts in the most understandable way. There is a little mathematics used, only as much as is necessary. Abundant examples of real world make the matter very applied and interesting.

I thank the wonderful staff of Horizon Textbook Publishing for making this project possible in such a short time. Their efficiency and timeliness also helped make this experience so smooth. My special thanks to my wonderful wife, Jayashree, who

understood my absences from family responsibilities. I dedicate this edition to her unending energy and cheerfulness. Our daughters Lina and Aditi deserve appreciation for making living so worthwhile.

I also thank John Cochran at the Metropolitan State College of Denver, Rod Eggert (Colorado School of Mines), Robert McNown (University of Colorado-Boulder) and Haider Khan and Tom Farer (University of Denver) who have always offered help when I needed it.

I am happy to see that several of my colleagues have already adopted this book for their classes. Notable amongst them are Debasri Mukherjee, Western Michigan University, Vijay Sharma, University of Colorado-Denver, Geetha Rajaram, Washington College, Vani Kotcherlakota, University of Nebraska-Kearney and Jesus Valencia, Slippery Rock University. Most of all, hundreds (and probably thousands) of students who would attend my classes and would read this book deserve a pat on the back too. Teaching is a delight when student show enthusiasm, willingness and ability to work hard. I consider myself fortunate to have had some of the most enjoyable classes to teach. Readers and students are invited to send their comments to me.

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Features of This Edition

- *State of the art pedagogy.* An abundance of case studies introduce and illustrate the subject matter of every chapter.
- *Integrated international economics.* As the world economy itself comes closer together, international economics must be more closely integrated into the principles course. Accordingly, topics in international economic theory and policy, ranging from balance of payments accounts to the foreign exchange operations of the Fed, are introduced in the chapters in which they occur naturally, rather than presented separately in a single chapter.

Supplements

Test Bank

The accompanying Test Bank contains over 2,000 questions in a variety of formats including multiple choice, true/false, and essay questions.

Instructor's Manual

The expanded Instructor's Manual contains material which can be easily included in lectures. The manual also includes all of its traditional elements, including instructional objectives, lecture notes, and suggestions.

Study Guide

The Study Guide has hands-on applications and self-testing programs. It is available in two versions, *Macroeconomics*, and *Microeconomics*. Students can gain an advantage by reinforcing their reading and lecture notes with the following study guide features:

- *Where You're Going*. The objectives and terms for each chapter are recapped to tie concepts together.
- *Walking Tour*. The “Walking Tour” section provides a narrative summary of the chapter and incorporates questions on key points. Answers are given in the margin.
- *Hands On*. Geographical and numerical exercises clarify concepts and better prepare students for tests and quizzes.
- *Economics in the News*. A news item illustrates how concepts covered in the chapter can appear in the real world. Questions and answers reinforce the concepts.
- *Questions for Review*. These questions and answers follow the key chapter concepts, preparing students for the self-test.
- *Self-Test*. Extra test preparation increases a student's understanding and ability to succeed.
- *Careers in Economics*. Formerly an appendix in the text, this material provides students with an understanding of where the study of economics could lead them.

Online Student Tutorial

Created to support and enhance the student's comprehension of the economic principles discussed in the textbook. The online tutorial includes chapters objectives and study questions. To access the tutorial please visit our Students section on our Web site www.htpublishing.com. Username: Economics Password: DolanLindsey

Economic PowerPoint Transparencies

This PowerPoint slide set combines graphics and text to further illustrate the economic principles discussed in the text.

Transparencies

Graphs, charts, and illustrations from the text creates additional in-class support for the instructor and students.

About the Authors

PROF. KISHORE G. KULKARNI has been teaching in Economics Department at the Metropolitan State College of Denver for numerous years. He has taught on a visiting (or Adjunct) basis at the University of Colorado-Boulder, Colorado School of Mines and University of Denver. After being a top ranked student in B.A. and M.A. degrees at the University of Poona, (India), he completed M.A. and Ph.D. degrees from University of Pittsburgh. He has received several awards including Distinguished Service to the College, Outstanding Teacher, Outstanding Researcher/Scholar and Outstanding Contributions to the Professional Development (8 times) from different institutions. An author of 4 other books and 75 journal articles, Prof. Kulkarni enjoys teaching and research. His unending love for the profession makes his classes exciting, rewarding and entertaining. He has taught on the Semester at Sea Program as well as visited several other countries on research missions.

EDWIN G. DOLAN was born in Oklahoma and grew up in a small town in Oregon. He attended Earlham College and Indiana University, where he majored in Russian Studies and received the Certificate of Indiana University's famed Russian and East-European Institute. After earning a doctorate in economics from Yale University, he taught at Dartmouth College, the University of Chicago, George Mason University and Gettysburg College. In 1990, he began teaching in Moscow, Russia, where he and his wife founded the American Institute of Business and Economics, an independent, not-for-profit MBA program. Since retiring as President of that institution in 2001, he has lectured on global macroeconomics and managerial economics in Riga, Latvia; Budapest, Hungary; and Zagreb, Croatia. When not lecturing abroad, he makes his home in Washington's San Juan Islands.

