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ABSTRACT

The instructor's guide for economics, one of seven courses that cover the six parts of the Certified Professional Secretary (CPS) examination, is intended to provide organization for a review course preparing secretaries for Part III of the CPS examination, as well as for secretaries wishing to update their knowledge in economics. The course generally can be covered in 10 three-hour sessions. Each of the lessons lists objectives and presents content outline and teaching suggestions/references in corresponding columns. The 10 lessons are: The Need for an Economizing System; Capitalism and the Market System; Organizing and Financing Business; Financial Reports of a Business; Securities Markets; Risk and Protection; Measuring National Income; Determinants of National Product and Income; Fiscal Policy and the Level of National Income; Monetary Policy in Our Economy; International Trade; and Problems in International Trade. (EA)

Part IIIA of a Series
Preparation for Certified Professional Secretary Examination

Economics

A Suggested Adult Business Education
Course

The University of the State of New York
THE STATE EDUCATION DEPARTMENT
Bureau of Continuing Education Curriculum Development
Albany, New York 12234
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Foreword

The course described in this booklet, *Economics*, is intended as a review of the economics material in Part III of the Certified Professional Secretary (CPS) examination. This part of the examination, which is given by the National Secretaries Association (International), is entitled, *Economics and Management*. This course can also be used for those secretaries wishing to update their knowledge in the subject matter.

Information about the CPS examination can be obtained from the headquarters office of the Institute for Certifying Secretaries, National Secretaries Association (International), 2240 Pershing Road, Kansas City, Missouri 64108.

Six courses to cover the six parts of the CPS examination were planned by a committee. Later the decision was made to prepare two courses to cover Economics and Management, bringing the number of courses in the series to seven. The committee consisted of the following: Marion N. Batten, CPS, secretary to the manager of Nonexempt Compensation and Benefits, General Electric Company, Schenectady; Hobart H. Conover, chief of the Bureau of Business Education; Carla V.R. Delray, CPS, manager of Office Services and Corporate Planning Administration, Mohasco Industries, Amsterdam; Adrian C. Gonyea, dean, School of Business, Hudson Valley Community College, Troy; E. Noah Gould, associate, Bureau of Continuing Curriculum; Florence E. Graham, chairman, Business Education Department, Draper High School, Rotterdam; Margaret A. McKenna, associate professor of business education, State University of New York at Albany; B. Bertha Wakin, professor and chairman, Department of Business Education, State University of New York at Albany; and Eugene Whitney, associate, Bureau of Business Education. Mr. Gould and Mr. Whitney were cochairmen.

This course, *Economics*, was written by Edwin J. Holstein, professor and chairman, Economics Department, Rensselaer Polytechnic Institute, Troy. Miss Wakin directly supervised the writing and coordinated the content among the courses in the series. Mr. Gould, who is in general charge of producing the series, did the final editing of this manuscript.

HERBERT BOTHAMLEY, *Chief*
Bureau of Continuing Education
Curriculum Development

GORDON E. VAN HOOFT, *Director*
Division of Curriculum Development

Message to the Instructor

This instructor's guide is intended as an aid in the presentation of a well-organized course. Since it is a review course, those taking it are expected to have a good background in the subject content. Upon completion of the course the student will, we hope, have improved and refined her knowledge of economics and will be better equipped to take Part III of the CPS examination.

While intended primarily as preparation for the CPS examination, the content of this booklet is also suitable for use in the adult education programs of school districts and of Boards of Cooperative Educational Services (BOCES), and in the secondary schools and community colleges of New York State. Instructors should urge the students to bring in current items from newspapers and other sources which might have bearing on course content.

This course can generally be covered in 10 sessions of 3 hours each, but this pattern is by no means universal, nor is it mandatory in any sense. For those students who wish to cover some topics in greater depth, the instructor may wish to suggest materials for independent study.

The instructor for this course must have a good background in economics. Such a person might be an economics faculty member of a college or university, a practicing economist, or possibly a high school social studies teacher.

An instructor or administrator who needs help in planning or conducting a course using this publication may contact the Bureau of Business Education.

HOBART H. CONOVER, *Chief*
Bureau of Business Education

Robert H. Bielefeld, *Director*
Division of Occupational Education Instruction

Contents

Lesson 1

The Need for an Economizing System

OBJECTIVES

To give an overview of economics and help the student understand:

1. Why societies must economize
2. How this leads to basic questions which must always be answered
3. The ways societies may organize to answer these questions

CONTENT OUTLINE	TEACHING SUGGESTIONS AND REFERENCES
I. Introduction to the Course	After introductions, ascertain and discuss students' backgrounds in economics. Try to overcome the idea that it is a "dismal" science. It deals with how we make personal and business decisions and with lively social issues which are on the front page every day. Show a few headlines from today's newspaper to illustrate the point.
A. Reason for the course	Discuss recent *personal* economic decisions. Secretaries are generally part of an organization producing some good or service. Like everyone else they are also consumers. Economics can help them relate the roles they play as producers and consumers to the larger system within which they live and work.

B. Textbooks

Students should have readily available an introductory textbook. Any of the following would be appropriate: Bach, McConnell, or Samuelson.* Basic references for Lesson 1 are Bach, Chs. 1,2,3,; McConnell, Chs. 1,2; Samuelson, Chs. 1,2..

C. Basic Concepts

The truly basic concepts in economics are *scarcity* (we cannot have everything we want) and *choice* (we must therefore choose which things we want most).

II. Economics System Provides Goods and Services

A. Goods

A good is anything that satisfies a human want or desire. Note that this does not mean something must be wanted by everyone to be a good.

Have students suggest some goods for sale that do *not* seem "useful" to them. Are there such things as "bads"? If so, are they thrust upon us or do we create them? The answer is: "Both," for example, storms and floods vs. air and water pollution. Have students suggest others.

B. Types of goods

Classifications of goods include:

- *Free* (superabundant) vs. *Economic* (scarce) goods, for example, air vs. color TV sets.
- *Tangible* (storable) vs. *Intangible* (nonstorable) goods, usually called *Services*. Examples: autos vs. dental work.
- *Consumer* (direct-want-satisfying) vs. *Producer* (used-in-further-production) goods. Examples: ice cream cones vs. steel mills.

(Can students think of other classifications? Examples: necessities vs. luxury goods, hard vs. soft goods, convenience vs. shopper's goods, etc.)

C. Utility

The capacity of a good to satisfy a want is called *utility*. This does not necessarily mean "generally regarded as useful"; it is a subjective concept. It measures the intensity of attraction

*Full reference citations are given in the bibliography.

between a particular good and an individual. For one who has just eaten a meal has no utility.

D. Kinds of utility

Goods have utility because they have the right form (shape or physical and chemical consistency), are available at the right time and place, and can be possessed (legally owned) by an individual.

E. Production

Production can be defined as the creation of utility. A good is not fully produced until it has all four kinds of utility. Note that we now have not only a definition of production but we can also classify various kinds of productive activities. The creation of form utility is called manufacturing; distribution (transportation, wholesaling, etc.) creates time and place utility; retailing—— creates ownership or possession utility.

F. Consumption

Consumption can be defined as the destruction or dissipation of utility. We get satisfaction from consuming food, wearing out automobiles, clothing, and housing. Discuss: What is the ultimate objective of all economic activity? Production is a means to an end—consumption. Ultimate objective is to destroy goods and services to sustain and enjoy human living.

III. The Law of Scarcity

A. Limitless needs and wants

Our needs and wants for goods and services seem limitless. Individuals and societies seem always to feel they need something more. Satisfaction of one want generates more wants. If I get a car, I want a garage. If I get a garage, I want a black-topped driveway. If I get a driveway I need "black top sealer," etc., etc. Students can suggest numerous other examples of such want "chain-reactions."

B. Limited resources

At any given time the resources to produce goods and services are limited. There is just so much of each of the

factors of production—land, labor, capital (goods used in production), and entrepreneurial (or enterprising) skill. Also, at any given time, our store of technological know-how is limited, though it seems to have increased markedly in the past century. Each factor is paid for its contribution to production. Land gets rent, labor a wage, capital receives interest, and enterprising activity gets what is left over from sales, that is, profit.

C. Production possibility frontier

Since productive resources (or factors) are limited, there is an upper limit on the total goods and services an economy can produce. This upper, or outer, limit is often called the *production possibility frontier* and can be depicted as a graph. (Bach, pp. 27-29; McConnell, pp. 27-32, and Samuelson, pp. 19-26) Such a curve is a picture of the law of scarcity. We can't produce combinations of goods *outside* the curve (more than our resources allow). If we produce combinations *inside* it, we are not producing all that we could—some of our resources are unemployed.

D. True cost is a sacrifice.

If we are producing some combination of, say food and clothing, which is our maximum production possibility—we are somewhere on the curve of full employment—and we now want more clothing, we can not have it unless we give up some food. Thus the cost of more clothing is the sacrifice of the food we must give up to get it. The same would be true if we wanted more food. The cost of the additional food would be the clothing sacrificed to get it. The truly fundamental nature of cost, therefore, is what we must give up of one good to get more of another.

Have students discuss whether they have a *consumption* possibility frontier. They do! With a limited budget, if they spend more on one good, they must pay the cost by spending less on other goods. An extra movie might cost three paperback books, or two pairs of nylons.

IV. Problems from the Law of Scarcity

A. *What* to produce

Since we can not produce everything we want, we must choose among various combinations of goods, that is, pick some point on our production possibility frontier. We have to decide whether we should produce a good at all and, if so, how much of it. This is a timeless question which had to be answered by the ancient Egyptians and must be answered today by all societies. Under ideal conditions of full employment if we decide we want to start to produce some new good (or more of one we already produce), we must *pay the cost*, that is, give up something we now produce.

Have students identify some goods which people might want, which we do not now produce. Examples: three-dimensional television, fuel-cell home power generators, etc. Help students identify situations where a new good or more of a present good can be produced without giving up something. Examples: unemployment, sudden technological change, etc.

B. *How* to produce

A somewhat more complicated question also confronts all societies. Since goods can be produced by mixing land (basic raw materials), labor, and capital equipment in different ways, how should we do it to obtain goods most efficiently? Basically, since labor and machines can most often be sustituted for each other, the question boils down to how to mix labor and capital.

Have students discuss how 100 miles of concrete highway might be produced in China, the Soviet Union, and the United States in terms of the relative use of labor and capital.

C. *For whom* to produce

An even more perplexing question must also be answered by all economic systems. Once we have decided what goods will make up the total of production (the Gross National Product)

and how to mix labor and capital to produce them, we must also decide how much of the goods produced will go to landlords who furnish basic raw materials, to labor, to capital, and to the enterprisers who organized the production process. Or, put another way, what will be the relative shares of rent, wages, interest, and profit?

Ask students to mention some social problems which stem from the answer to this question. Examples: strikes, shutdowns, consumer boycotts, and sometimes revolutions!

V. Kinds of Economic Systems

A. Tradition-directed

Societies which are not subject to rapid technological and social change solve the *What*, *How*, and *For whom* questions in a rather simple way. In the feudal system of the middle ages, and the tribal life of the American Indian, people simply kept on producing the same things in the same way. Such societies always develop rigid rules which indicate who will get how much of the goods produced. In some primitive societies, for instance, all production is given to the chief who then distributes it according to commonly accepted principles.

Have students speculate whether custom or tradition plays any role in our economic life. For instance, weddings, funerals, and some holidays demand that certain goods and services be produced.

B. Central planning

Some industrialized societies use central planning and government decrees to answer the problems of *What*, *How*, and *For whom*. Here a group of experts sets the goals of production and a plan for meeting them. After suggestions from lower levels, an official 5-year plan is adopted which specifies how much of each good should be produced and how. Since the planning group also sets prices and wages it can determine what groups will get how much of the final goods

produced. In such systems many services such as medical and dental care are provided by the government. Since the government owns most of the producer goods (capital) and other resources, we usually call such systems socialistic.

1. Examples

Have students suggest countries which stress this form of economic organization. Examples: USSR, Mainland China, Sweden, Cuba, etc.

C. The market system

1. Consumer role

A third way of answering the central problems of *What*, *How*, and *For whom* is the market system. In such a system consumers are regarded as having dollar "votes." Those with high incomes have many votes; those with lower incomes, few. They indicate how much they want a good by "voting" for it, that is, by paying a higher or lower price for it. Only those goods which get enough votes will be produced. Producers are free to produce those goods and services which command the best prices relative to their cost of production, and to switch from producing one good to another.

2. Producer and government

Since the votes are cast in markets and producers are free to shift from selling in one market to another, such a system is called a *market* or *free enterprise* system. The role of government under this system in its pure form is to not interfere at all in the selling and buying process—a philosophy known as *laissez faire*.

3. Discussion

Have students discuss whether any country uses any one of the three economics systems exclusively. Bring out the fact that in the real world elements of all three systems may be found in a given country, but that in modern industrial societies either central planning or free enterprise is strongly emphasized. Examples: central planning in the USSR, free enterprise in the USA. Also stress that the central problems of *What*, *How*, and *For whom* are always the same; it is the way they organize to solve the problems that makes one economy different from another.

Lesson 2

Capitalism and the Market System

OBJECTIVE

To describe capitalism, the market system, and the process of competition

CONTENT OUTLINE	TEACHING SUGGESTIONS AND REFERENCES
I. Unique Institutions of Capitalism	Basic references for Lesson 2 are: Bach, Chs. 5,6,23,24,25,26; McConnell, Chs. 3,4,5,6,23,35; Samuelson, Chs. 3,4,20,26.
A. Private property	Private property is not a tangible thing; it is an intangible, personal right like the right to vote. It is the personal right to possess, use, enjoy, and dispose of goods, both consumer and producer. It is the private ownership of producer goods (capital) from which the name *Capitalism* derives.
1. Role of government	Note that the role of government (federal, state, and local) is crucial; unless it is backed by law, this right has no meaning. Ask students to give examples of this. EXAMPLE: "If my car is stolen I fully expect that the police will make every effort to return it to me."
2. Document needed	Note also that a good is not private property unless the owner has a *document in evidence*. My auto belongs to me rather than a thief because I have the registration. Students can suggest other examples, such as, deed to property, "no goods returned without sales slip," etc.

3. Control

One further thing should be noted about private property. If one owns, one controls. No one may drive my car without my permission.

4. Risks

But I also bear the risks of ownership. I must pay the insurance premium which protects me if my car does damage to persons or property owned by others. A fundamental rule of private property is: "Where lieth the control, there also lieth the risk."

5. Socialism, etc.

One final point: the abolition of private ownership of capital (producer goods) is a basic principle of socialism. One who advocates that all producer *and* consumer goods be publicly, or collectively, owned is communistic.

B. Freedom of enterprise

Capitalism demands there be personal freedom of enterprise. The institution of private property makes this possible. Since individuals can legally own sewing machines and brewing equipment, they are free to enter the garment or beer industries. Incidentally, under the law corporations are often regarded as *fictitious individuals*. (More about this is in Lesson 3.)

1. Discussion

Ask students to suggest some restrictions on free enterprise in our economy. EXAMPLES: Public utilities are granted exclusive territories, many states do not allow privately owned liquor stores, distribution and sale of heroin is illegal, many states have Sunday closing laws.

C. Competition and self-interest

Private property makes free enterprise possible. Free enterprise, unless restricted, leads to large numbers of producers of goods which many buyers want, since producing such goods is likely to be profitable. Large numbers of sellers striving for the business of large numbers of buyers generate vigorous competition which regulates the self-interest (maximum-profit-seeking) of sellers and maximum-satisfaction-seeking of buyers. When buyers and sellers are numerous enough

and the product is completely standardized (the product of each seller is a perfect substitute for that of all other sellers) we say we have pure competition. These conditions are rarely met in the real world but some examples come close.

1. Discussion

Can students suggest some? Best examples are the exchange of widely held issues of stock and the buying and selling of wheat and other grains.

D. The market: demand, supply, and price

1. Definition of *market*

When buyers and sellers of goods are in communication and facilities for the exchange of a good are present there is a *market*. Notice that a market is *a set of conditions*, not a geographic area. It applies to a certain period of time; it can change from minute to minute in one case, or stay in effect for years in another case. A market can exist in an area as small as the corner grocery store or as large as the worldwide market for rubber, tin, or petroleum.

2. Forces in the market

At any given time buyers make up the demand force in a market; sellers are the supply force. Buyers are willing to *buy* more at *low* prices; sellers are willing to *sell* more at *high* prices. Economists define a market with a demand curve (which shows what quantity of a good buyers are willing to buy at each potential price) and a supply curve (which shows what quantity of that good sellers are willing to sell at each potential price). (References: Bach, p. 68; McConnell; p. 66; Samuelson, p. 64.)

3. Effect of demand and supply on price

At low prices buyers are willing to buy more than sellers are willing to sell. At high prices sellers are willing to sell more than buyers are willing to buy. At a low price, buyers seeking the restricted amount available will bid the price up. At a high price, sellers trying to get the relatively small amount of business available will bid the price down.

4. The price at which sales take place	Only at the *one price* where buyers and sellers of a good agree on the amount they will buy and sell (where demand and supply curves intersect) will sales take place. This price, which *clears the market,* is the "no-tendency-to-change" or *equilibrium* price of the good in that market at that time.
5. The nature of demand and supply	Stress the fact that *demand* and *supply* are independent forces which determine *price* and *quantity exchanged.* The *demand force* stems from the mind and pocketbook of the buyer; the *supply force* from the mind and cost situation of the seller.
a. Demand, supply, and price	Demand and supply determine the selling price; price does not determine demand or supply. But *potential prices* (plural) of a good and the quantity sellers will offer at each price define the supply curve (or supply schedule) for that good. Potential prices and the quantity of that good buyers are willing to buy at each price define the demand curve (or schedule). The interaction of these two curves determines the actual price at which sales are made.
6. Discussion	Students are often troubled by this distinction. Have them speculate about what might increase or decrease demand or supply, that is, shift curves to the right or left, and thus change selling price or quantity sold. EXPLANATION: Shifts in demand result from changes in buyers' price expectations, incomes, tastes, or the prices of substitute goods. Supply curves may shift because of changes in sellers' cost expectations, need for cash, estimate of perishability of the good, and ability to store the good, as well as other factors.
E. Other kinds of markets	As indicated, real examples of purely competitive markets are rare.

1. Monopolistic competition

Most markets are imperfectly competitive in that one or more of the conditions for pure competition are not met. For instance, in some markets there are a *great many sellers,* but the products they offer are *slightly different* from each other. Sellers' products carry brand names and they use advertising to convince buyers that their brand is the real product and other brands are inferior substitutes. This kind of market is called *monopolistic competition.*

a. Discussion

Have students suggest examples of monopolistically competitive markets. Examples include: small electrical appliances, retailing outlets, aluminum pots and pans, and small electric motors. Discuss how difficult it might be for a new seller to enter such a market. EXPLANATION: Barriers to entry must be moderate in monopolistically competitive industries since there are so many sellers present.

2. Oligopoly

Some markets are even more imperfectly competitive because there are only a *few sellers* in the market who sell identical or almost identical products. Such a market is called an *oligopoly.* A *monopolistic competitor* sets his price without considering the reaction of his competitors, but an oligopolist must always consider the probable price reaction of his few rivals. Generally, unless there is collusion (which is illegal) or price leadership, he can assume that a drop in price will be matched by other sellers but a rise in price will not.

a. Discussion

Have students mention industries which suggest this model. EXPLANATION: Many basic industries seem to, for example, autos (the Big Three), steel (the Big Eight or Nine), aluminum (the Big Three), etc.

Explain that many oligopolies have persisted over long periods of time. This means that the freedom of new firms to enter the industry must be

significantly restricted by patent rights, high initial fixed investment, or control of sources of raw materials.

3. Monopoly

The fourth kind of market, which is at the opposite end of the scale from pure competition, is *pure monopoly*. Here only one seller in a market offers a product, and there are no good substitutes. Up until World War II, the aluminum industry came close to matching this model. Obviously if such a one-firm industry persists over a long time, barriers to the entry of new firms must be very high indeed and free enterprise must be severely restricted.

4. Longrun profit

Have students discuss what the probable longrun profit tendency would be in each of the four kinds of markets. Generally speaking profits tend to be *normal* (high enough to keep firms in business) in pure and monopolistic competition, but may be persistently and significantly higher than normal in oligopoly and monopoly situations.

II. Other Characteristics of Capitalism

A. Roundabout production

The name *Capitalism* stems from the heavy emphasis on *capital* (producer goods) in free enterprise systems. A large portion of productive resources (factors of production) is used to produce capital equipment, semi-finished goods, etc. Thus we produce steel to produce steel plants, to produce steel to produce machines, to produce parts, which are finally assembled into automobiles. Such a system is called *roundabout production*. At first this means fewer consumer goods, since we must use some resources to produce capital which could have been used to produce consumer goods. But once the system "gets rolling" and machines are operating, we are able to produce more consumer goods than before.

B. Use of money

Roundabout production obviously means that many more exchanges will be made than in a simpler system which applies labor directly to raw materials to produce consumer goods. To facilitate these many transactions a highly developed money-credit system is needed as a medium of exchange.

If an economy uses money does this mean it is capitalistic? Not necessarily. Ancient societies like the Roman Empire used money as does the Soviet Union today. But these economies lack one or more of the unique elements of capitalism.

C. Specialization and interdependence

Modern industrialized economies which use roundabout production also use *specialization* of labor and capital, and include *interdependence* of factors. Modern mass production techniques break the production of a good into several distinct steps with workers or machines performing only one of the steps. This means that no single auto worker (or machine) can make a whole car—they specialize in tail-lights or seats or batteries. Thus an auto worker, or anyone else who wants to buy a car, depends on all auto workers to do their jobs. Industrial workers depend on farmers to grow food. Farmers depend on industrial workers to produce tractors. We all depend on each other—we are mutually interdependent.

1. Discussion

Discuss whether specialization and interdependence are also found in the Soviet Union and China. EXPLANATION: Yes, they are, but perhaps not to the same degree as in the U.S. Even in primitive societies some specialization and interdependence are found, but individuals are much more nearly self-sufficient than we are.

III. How Prices Solve the *What*, *How*, and *For Whom* Questions

A. *What* to produce (and how much)

Deciding *what to produce* is fairly simple. Unless demand and supply yield a market price for a good which

will cover the cost of production in the longrun, the good will not be produced. Production cost here includes a *normal profit*—enough to keep firms in the industry. If people signal they want more of a good (that is, if demand increases) the price will rise, profits will increase and, under competitive conditions, new firms seeking these profits will come into the industry and more of the good will be produced.

1. Discussion

Discuss what would happen if consumers want less of a good. EXPLANATION: Demand would decrease, price would fall, profits would shrink, some firms would leave the industry, and less of the good would be produced.

B. How to produce

The way the price system determines *how to produce* is a little more complicated. Since we are trying to decide how to mix labor and capital we have to know something about the relative amounts of output more labor or more capital would produce. Production engineers figure this out.

Using the two special prices, *wages* for labor and *interest* for capital, a firm can figure out the extra output per dollar from extra labor and extra capital. Insofar as labor and capital can be substituted for each other, if the extra output per dollar of labor is higher than for capital, more labor will be used. If the reverse is true, more capital will be used. In other words, the firm will tend to use those amounts of labor and capital which would make the extra output per dollar the same for each. If they do this they are using labor and capital in just the right amounts.

C. *For Whom* to produce

Three special markets which set three special prices answer the question of *for whom* to produce. The land (basic raw materials), labor, and money markets each sets its special price: rent, wages, and interest rates. When firms produce goods and services their costs are the rents, wages, and interest they pay out. When they

sell the goods, the total sales revenue minus production costs leave their profits. Hence the total value produced must always generate an equal amount of income in the form of rents, wages, interest, and profits. (Look up Say's Law in the index of your text.) The percentages of total income which go to rents, wages, interest, and profit determine the relative shares of the total production which can be bought by those who furnish basic raw materials (landlords), by labor (workers), by capital (savers and lenders), and by enterprisers (stockholders and small business owners). Note that to bring out the principle involved here we have ignored government activity. In the real world we spend something like a third of our income for public goods (that is, education, highways, defense, etc.) through government units—Federal, state, and local.

1. Discussion

This would be an excellent place to discuss the simple model usually called the Circular Flow of Economic Activity. See Bach, p. 80; McConnell, p. 49; Samuelson, p. 46.

IV. Government and the Market System

A. Maintaining competition

Since competition tends to keep profits at normal levels, attempts are often made to interfere with it. That is, firms try to monopolize to obtain higher profits. To protect the process of competition, which is essential to a free enterprise market system, some states (in the 1880's) and the Federal Government (in 1890) passed *antitrust laws*. We call them *antitrust* because the trust company was widely used as a device for eliminating competition at that time. However, many different techniques have been used over the years.

1. Sherman Act and Clayton Act

Generally speaking, the Sherman Act (1890) and the Clayton Act (1914) make combinations, monopolies, attempts to monopolize, holding companies, and several other arrangements illegal

where the effect "may be to substantially lessen competition or tend to create a monopoly...."

2. Enforcement

These laws are enforced by the Antitrust Division of the U.S. Justice Department and by the Federal Trade Commission, an agency created by Congress in 1914. The FTC also is charged with preventing unfair and deceptive business practices, such as fraudulent advertising. The effectiveness of these laws in preserving competition is often questioned. But there have been some important legal victories by both the Antitrust Division and the FTC and our economy would certainly be less competitive if not for the activities of these agencies over the years.

Note: A current issue of the *Wall Street Journal* or *New York Times* might well have stories relating to Antitrust or FTC activities which could be discussed.

B. Moderating competition

In some instances, as a society, we have agreed that markets do not set prices which are "fair" to certain groups. In the case of wages of some workers, for instance, we have passed minimum wage laws to insure a "living wage." Our policy toward agriculture has been to moderate competition and to support farm prices so that farmers would get a "fair share" of income. In other cases, where technology demanded huge firms, or competition would inconvenience the public, (as with electric power, telephone, etc.) we created legal monopolies whose prices, outputs, and profit levels are regulated. Competitive markets could not work here so we created public utilities.

1. Examples and discussion.

Have students suggest other examples of public policies which modify the operating of free competitive markets. EXAMPLES: *fair trade* laws, licensing of liquor stores, wage and price controls. In the latter instance we think market-determined prices are too high.

Discuss whether we have been inconsistent in sometimes maintaining and sometimes moderating competition. SUGGESTION: The anology of temperature is helpful here. We don't like a temperature as hot as pure competition or as cold as pure monopoly and have tried to maintain a comfortable living temperature somewhere in between.

SUMMARY

INSTITUTIONS OF CAPITALISM
- Private property
- Freedom of enterprise
  - Includes competition and self-interest

ELEMENTS OF A MARKET
- Demand
- Supply
- Price

KINDS OF MARKETS
- Pure competition (rare in the real world)
- Monopolistic competition
- Oligopoly
- Monopoly

OTHER CHARACTERISTICS OF CAPITALISM
- Roundabout production
- Use of money
- Specialization of labor and capital
- Interdependence of factors

Lesson 3

Organizing and Financing Business

OBJECTIVES

To describe how businesses are organized
To identify the advantages of various types of organization
To explain how corporations are financed

CONTENT OUTLINE	TEACHING SUGGESTIONS AND REFERENCES
I. Forms of Business Organization	Basic references for Lesson 3 are: Bach, Ch. 4; McConnell, Ch. 8; Samuelson, Ch.6.
A. Single proprietorships	Proprietorships are businesses (or firms) which are owned and operated by a single individual who has sole authority and bears the ultimate risk of success or failure. Legally the owner and the business are one. The owner bears unlimited liability for the debts of the business even to the full extent of his personal assets such as his house, car, TV set, etc. Some assets, such as the basic tools of trade, may be exempted from this liability.
1. Advantages	The *major advantages* of the proprietorship are: • The proprietor is "his own boss." • Direct personal supervision and risk make for efficiency. • It is easy to organize (little legal red tape or expense). • With one owner, policy disagreements are not possible.
2. Disadvantages	The *major disadvantages* are: • It cannot raise large amounts of capital; thus its size is limited. • The owner must be a "jack-of-all trades."

- The management can not specialize.
- The life of the business is limited to the lifetime of the owner. This makes its credit rating relatively low and the cost of capital high.
- The unlimited liability means high personal financial risk.

3. Number of

In spite of these drawbacks, more than 9 million firms out of a total of about 11.6 million are proprietorships.

B. Partnerships

As a business grows, a proprietor, to obtain additional capital and perhaps additional business expertise, may bring other people into it making it a general partnership. Such a business is now "jointly and severally" owned with partners pooling their capital, knowhow, and expertise, and sharing the authority and risks of the business. Except for *silent* partners in a *limited partnership*, who contribute capital only and do not participate in management, all partners have unlimited liability as in a proprietorship. Also, any general partner can legally bind the partnership to an agreement with outsiders.

1. Advantages

Major advantages of the partnership include:

- Larger size because of the pooling of resources.
- Formation is relatively easy, though a partnership agreement involves some legal expense.
- Some specialization of management is possible.
- It has a higher credit rating and lower cost of capital.

2. Disadvantages

But *major disadvantages* of the partnership are numerous:

- The life of the business is unstable—death of a partner means reorganization.
- A new partner must be acceptable to all others, hence sale of a share of ownership may be very difficult.

- Financial resources, though generally greater than for a proprietorship, are still limited.
- The unlimited liability of partners is fraught with the danger that an affluent partner may "lose all" because of a poor decision by another partner.

3. Number of

Perhaps because of these disadvantages, only about 900,000 of 11.6 million businesses are organized as partnerships.

C. Corporations

During the latter part of the 19th century, to overcome the disadvantages of the proprietorship and partnership, a new kind of business organization—the corporation—came into being.

1. Definition

Legally a corporation is a fictitious *person* which, in its own name, can do anything a natural person can legally do in business. This includes owning property, signing contracts, suing, and being sued. A corporation is usually created by a state government which issues a "birth certificate," called a charter, describing the activities the corporation may engage in and how it may raise capital.

2. Number of

The advantages of the corporation are so great that it is now by far our most important form of business organization. Though our 1.5 million corporations represent only about 13 percent of all firms, they account for about 67 percent of all income generated by business.

3. Advantages
a. General

Major advantages of the corporation are:

- The concept of limited liability: the owners (stockholders) are liable for the debts of the business only up to the amount they invested in the business.
- The ability to raise large amounts of capital by selling securities which can be made attractive to all kinds of investors.

- The ability to operate on a large scale and to hire specialized, efficient managers to whom authority can be delegated.
- Can exist in perpetuity—are independent of the lives of natural persons.
- Can raise capital on favorable terms and plan for long-range growth.
- Owners can easily sell their shares of ownership in organized stock exchanges.

b. Social

Social advantages of the corporation are:

- It permits the aggregation of small individual savings into the large capital investments necessary for building large, efficient production units.
- Limited liability promotes the testing of new ideas and new technology.

4. Disadvantages

a. General

Disadvantages of the corporation, though far outweighed by advantages, do exist. They include:

- Red tape, special taxes, and legal expense for formation.
- Special taxes on corporation income which may involve double taxation of that portion of income paid out to owners.

b. Social

Also certain social problems can be cited:

- Unscrupulous manipulators may try to conceal illegal or unethical activities behind the cloak of corporate entity.
- Corporations distort the institution of private property in certain cases where owners have no real control over management. This results in separation of ownership from control. How serious such problems are is under continuing study by interested scholars.

5. Discussion	Discuss with students the kinds of things to consider in deciding the kind of business organization to select. EXPLANATION: If the capital requirements for successful operation are very large, the corporation is a must. If not, a proprietorship or partnership may do. If a business needs the personal touch, (as in law, medicine, investment counseling, or a beauty shop) the corporation, which tends to be impersonal, is inappropriate.
II. Financing Corporations	
A. Common stock	When a corporation is formed, its charter authorizes it to sell stock for money to buy the assets (land, buildings, equipment, etc.) to produce goods or services. Common stock is sold at a price people are willing to pay for a share of ownership in the corporation.
1. Gives ownership	If I buy 100 out of a total of 1000 shares, I own one-tenth of the corporation. Common stock gives ownership. Generally each share carries one vote. Those who own more than half of the shares can control the corporation because they can elect the board of directors, which in turn hires the top management people.
2. Can be paid dividends	If the business makes money, the board of directors can use the earnings to declare *dividends*. So many dollars per share is paid to the common stockholders, usually on a quarterly basis. However, ownership of common stock can be risky. If the business has no earnings, not only will common stockholders get no dividend but they will undoubtedly find that the value of their shares has gone down. Thus the dividend income of common stock owners fluctuates with the earning performance of the company. Incidentally, not all earnings are used to pay dividends, usually some are plowed back to expand the business.

3. But carries risk

If the corporation gets into deep trouble (goes bankrupt), its assets may have to be sold to pay off the creditors (those who have lent to the corporation). This may make the common stock worthless. Thus the common stockholders bear the ultimate risk of the business.

B. Preferred stock

Corporations also often issue *preferred stock*. *Preferred* means that if bankruptcy occurs this stock has a preferred claim on money from sale of assets. Owners must be paid the full (*par*) value of their shares before common stock gets anything. Also before common stock receives any dividend, preferred must be paid its full stated dividend.

1. Does it have preference?

However, some scholars question the name *preferred* because the stated dividend is usually an upper limit. Common stock often gets a higher dividend than preferred. Also, if common gets no dividend, preferred does not have to get any. Thus it tends to share the bad, but not the good, of the business.

2. Often has no vote

Besides, preferred stock generally does not have a vote for the board of directors. This is a clear-cut deviation from the conventional notion of private property because preferred stock represents ownership.

3. Kinds of preferred stock

If you buy preferred stock, you should check to see whether it is (1) *cumulative* or *noncumulative* and (2) *participating* or *nonparticipating*. *Cumulative* preferred stock provides that dividends not paid in the past must be made up before common can get a dividend. Missed dividends on *noncumulative* are "lost and gone forever." *Participating* preferred may share some in earnings in a particularly good year. For instance, it might provide that before common stock can get a dividend or more than $6 per share, preferred stock getting $4 per share must be given an additional $2 per share. *Nonparticipating* never gets more than its stated amount.

Obviously there are many, many different kinds of preferred and the buyer should be sure he knows what he is buying.

C. Bonds

Holders of common and preferred stock are part owners of a corporation. They have *equity* in the business. (Raising money by the sale of stock is called *equity financing*).

1. A form of borrowing

But corporations can also raise money by borrowing, either short-term or long-term. A short-term loan is repaid quickly (usually in less than a year) is generally for smaller amounts, and is usually obtained from a bank. Long-term larger scale borrowing, where the loan may run for 5, 10, or 20 years or more, is accomplished by selling *bonds (floating* a bond issue). Borrowings of $100 million are not uncommon. Since no one lender would lend this much, the loan is broken up into smaller pieces, say 100,000 bonds, each one representing a $1000 loan.

2. Definition

A bond is a legal promise by a corporation to pay back the *face amount* on a specified date, and to pay a specified rate of interest, usually semiannually. Note that if a corporation issues bonds for $100 million bearing 10 percent interest, it is committing itself to paying $10 million a year in interest. If it should have a very bad year with earnings less than $10 million, it could not pay this interest. Bondholders would then have the legal right to foreclose and demand that they be paid the principal amount of the loan and any interest due. It is this threat which prevents manufacturing corporations, which have occasional bad years, from going very heavily into bond financing.

3. Kinds of bonds

Bonds are of many kinds. Some, *mortgage bonds*, are backed by a specific pledge of assets as collateral. Others, *debenture bonds*, are secured only by the general credit rating of the corporation. Some have first claim

	(senior lien) on certain assets. Others have second claim *(junior lien)* etc.
D. Discussion	Have students discuss the kinds of securities. EXAMPLES: common stock for the more venturesome who want gains in value, preferred stock for the middle-of-the-road investor wanting income over a longer term and perhaps some appreciation of value, and bonds for the conservative investor who wants long-term income and maximum security of investment.

Lesson 4

Financial Reports of a Business, Securities Markets, Risk and Protection

OBJECTIVES

To describe and explain the need for the Balance Sheet and Income (or Profit and Loss) Statement

To explain the operation and functions of securities markets, especially stock markets

To explain how business risks are minimized

CONTENT OUTLINE	TEACHING SUGGESTIONS AND REFERENCES
	Basic references for Lesson 4 are: Bach, Appendix of Ch. 4, pp. 174-175, 425-426; McConnell, pp. 129, 287-88, 573-75; Samuelson, Appendices of Chs. 4, 6, 21. Recommend that students study Samuelson for this lesson.
I. Financial Reports A. Balance sheet	Because decisions must be made daily, information about the financial operation of a business must be readily available to management. In corporations it must also be reported periodically to stockholders. One thing which must be known is just how the business stands *at some particular instant of time* on what it owns *(assets)* and what it owes *(liabilities)*. Obviously, only if assets are greater than liabilities will the value of the business *(net worth)* be positive. The financial statement which records the values of assets, liabilities, and net worth (ownership equity) is the *Balance Sheet*.
1. For corporation, must balance	And the Balance Sheet of a corporation must always *balance* because it can buy assets only with money contributed by owners (part of net worth) or lent to

it by creditors (liabilities). Thus the total asset value of a corporation must equal what creditors and owners have contributed, that is, assets must equal liabilities plus net worth.

2. Assets

Assets are typically classed as *current* (will become liquid cash within a year) or *fixed* (will become liquid cash over a longer period). Examples of *current assets* are: cash on hand, accounts receivable (business credit extended to customers), inventories of finished goods, and marketable securities owned by the corporation. *Fixed assets* consist of such things as land, buildings, and equipment. Buildings and equipment are listed at purchase value minus appropriate allowance for wear and obsolescence (that is, depreciation). Some balance sheets also include *intangible assets*, that is, estimated value of patents or trade marks (goodwill).

3. Liabilities

Examples of *current liabilities* (those which will be met within one year) are accounts payable (credit extended by sellers to the corporation), notes payable (short-term borrowing from banks), and taxes payable. *Fixed* (long term) *liabilities* usually consist of bonds outstanding.

4. Owner contributions

The record of owner contributions (net worth, or equity) records capital stock outstanding (number of shares of common and preferred multiplied by par, or stated value), capital surplus (money realized from sale of stock over and above par value), and earned surplus (the cumulative amount of earnings retained in the business to date, that is, not used to declare dividends.)

5. Summary

Thus the Balance Sheet is a complete listing at some instant of time of what a corporation owns, owes, and is worth to its owners.

6. Discussion

Discuss with students: Since some values, for example, depreciation and

goodwill are estimates, the balance sheet is like a map. It is not *reality* but a *best attempt* to depict reality. Discuss the use of one or two ratios on the balance sheet, for example, the ratio of current assets to current liabilities *(current ratio)* as an index of ability of the business to do additional short term borrowing. Ask students how a balance sheet can tell how well the business is doing. EXPLANATION: It can't! It tells nothing about the flow of revenues and costs—therefore, nothing about profit or loss.

B. Income (Profit and Loss) Statement

Since the Balance Sheet is a picture of a business at one instant of time (like a single frame of a moving picture), it can not tell us what happened over a period of time. Another financial report is needed to depict the flow of revenues (sales receipts) and costs to indicate whether the business made a profit or loss. Thus the *Income Statement* lists Net Sales (after rebates and discounts) for a period, say January 1 to December 31, and compares them with Cost of Goods Sold.

1. Cost of goods sold

One problem arises because when all materials, labor, depreciation, and miscellaneous costs are added up, this is really the Cost of Goods *Manufactured* during the year. Since, during the year, the goods sold may be greater than goods manufactured (some came out of inventory) or vice versa (inventory increased), Cost of Goods manufactured is transformed into Cost of Goods *Sold* by adding beginning inventory and subtracting closing inventory.

2. Profit

Net Sales minus Cost of Goods Sold gives Gross Profit (or Margin). When administrative and selling costs are subtracted from Gross Profit the result is Net Operating Profit.

3. Earnings

But other costs such as fixed interest charges and State and Local Taxes must be subtracted. When this is done we have Earnings Before Income Taxes.

When the Corporation Income Tax (usually about 48 percent of earnings) is deducted, we finally arrive at Earnings After Taxes. It is from this amount that dividends may be declared on preferred and common stock. Any Earnings After Taxes not used to declare dividends are Retained (plowed-back) Earnings and would be added to the Earned Surplus account on the Balance Sheet for December 31.

4. Discussion

Have students discuss the significance of such ratios as

- Earnings After Taxes *to* Net Sales. This tells how much of each sales dollar goes to earnings.
- Earnings After Taxes *to* Net Worth. This gives rate of profit on owner equity.
- Net Sales *to* Average Inventory. This tells rate of inventory turnover, which usually is high in a prosperous business.

Also speculate about the objectivity of the final Earnings After Taxes figure. SUGGESTION: Since depreciation charges and inventory valuation are estimates, total cost is an estimate and so is Earnings After Taxes. Different accountants using the same data might get somewhat different answers.

II. Securities Markets

A. Organization

Securities markets (stock and bond exchanges) are many and widespread throughout the world. Most of them are good examples of highly competitive markets. In the U.S., in addition to several regional exchanges, the two most important are the New York Stock Exchange (NYSE) and the American Stock Exchange (Amex). The NYSE, on which the stocks of about 1500 companies and bonds of about 1000 companies and governments are traded, is the largest.

1. New York Stock Exchange

The NYSE is a nonprofit corporation governed by a board of directors consisting of 10 Exchange members, 10 public representatives, and a full-time paid chairman. To trade in the

Exchange one must be a member, or have a seat. Because commissions are charged for buying and selling securities for others, seats on the Exchange are valuable and are bought and sold for hundreds of thousands of dollars. There have been 1366 such seats on the New York Exchange since 1953.

a. Trading

Stocks are traded on *the floor* of the Exchange. Transactions are very quickly consummated and recorded, and within a minute or so each transaction is electronically reported to the people on the floor and to brokers' offices throughout the country. All transactions are by verbal contract. An interesting feature of the exchange is a *quote room* where members can quickly get the latest price of any stock listed.

2. Statistics

On an average day on the New York Exchange, some 17 million shares of stock and bonds valued at about $22 billion are exchanged. On a busy day like August 16, 1971, almost 32 million shares changed hands. In 1972 a total of about 6.3 billion shares were sold on registered exchanges: 71.4 percent of them on the NYSE, 17.5 percent on Amex, and 11.1 percent on regional exchanges.

3. Round lots and odd lots

Most stock is exchanged in *round lots* of 100 shares, but *odd lot* dealers will break up such blocks and sell any number of shares at a slight premium, usually 1/8 of a *point* (or 12 1/2 cents) per share. With the lion's share of the business, it is easy to see why the NYSE is often referred to as "The Big Board."

4. Over-the-Counter Market

Not all corporate stock is listed on an exchange. Some is traded in the *over-the-counter* (OTC) Market. Although accurate data are not available, a very large volume of securities of small companies, banks, new companies, and municipal bonds are exchanged in the vast network of securities dealers who make up this market.

5. New issues

Stock exchanges deal only in stocks and bonds already issued. New issues of securities are marketed in the OTC market usually by groups (syndicates) of investment bankers.

6. Financial pages

Ask students to bring the financial pages of the *Wall Street Journal* or another paper and discuss the meanings of the columns: High, Low, Stocks and Div in Dollars, P/E, Sales 100s, High, Low, Last, Net chng, found in the NYSE Transactions.

B. Economic functions

The stock market should not be mistaken for the economic system, that is, ups and downs in stock prices are not ups and downs in real economic activity. However, the stock market performs at least three important economic functions:

1. Sets stock prices

- It sets prices for stocks by a continuous process of evaluation of a share of ownership in a business. To some extent it rates the performance of a corporation.

2. Provides ready market for securities

- It provides ready marketability for stocks and bonds at known prices. People are more willing to help finance a corporation if its securities can be quickly converted to cash or used as collateral for a loan.

3. Promotes productive use of capital

- It helps promote the flow of capital toward the most productive uses. This comes about because the stock of the more profitable companies tends to go up in price, thus encouraging buyers.

4. Discussion

Discuss with students the effect of changes in the interest rate on stock prices. SUGGESTION: If interest rates rise, bonds become more attractive. People sell stock to buy bonds. This makes stock prices go down.

C. Stock market problems

1. Rigging the market

The market for most stocks is highly competitive. But unscrupulous

manipulators can sometimes *rig* the market for a stock to cheat others for their own gain. For instance, they can circulate unfavorable rumors about a company while they sell and resell shares of stock among themselves to make it appear that most holders of this stock want to sell. As other owners become jittery and begin to sell, the price goes down. When the price is low, the group buys a large amount of the stock. By reversing the process (using *dummy* purchases) they now drive the price *up* and sell their stock at a big profit. Such "shenanigans" are, of course, violations of the constitution and bylaws of stock exchanges. Participants run the risk of suspension or expulsion from exchange membership, and prosecution under Federal law.

2. Unfair use of inside information

Another problem which sometimes arises is that corporate *insiders* (members of the board and top management) use their intimate knowledge of corporate affairs to make personal profit in the market. Suppose these insiders know that the corporation has just discovered a new deposit of a valuable mineral and that this information has not been announced to the public. Knowing that open disclosure of the discovery will bring a jump in the price of the company's stock, these men secretly buy heavily. When the news breaks and the stock rises they stand to make a handsome profit. Strangely enough it is very difficult to prosecute this kind of thing.

3. Other problems

Other general problems associated with the stock market include inadequate public information on the conditions of corporations whose securities are exchanged, and buying stock on credit.

4. Securities and Exchange Act

In the belief that self-regulation by stock exchanges was not strict enough to curb such abuses, the Federal Securities and Exchange Act was passed in 1934. Under this law, the Securities and Exchange Commission has power to

set up regulations designed to

- Prevent manipulation and unfair practices on stock exchanges and in the OTC market
- Provide adequate and accurate information about the companies whose securities are listed on registered exchanges
- Regulate the amount of credit used in securities trading

III. Risk and Risk Avoidance

A. Risk

Risk is, of course, a fact of life. It has been said that the only thing certain is that there is always uncertainty. Every entrepreneur assumes the ultimate risk that his business will fail and that he will lose his personal resources.

1. Related to profit

It is for assuming this risk that he receives a profit. Profit may come as a windfall—just being in the right business at the right time—or because of innovative activity—being first with a much-wanted good or service. Under competitive conditions such abnormal profits tend to be short-lived and are competed away. In all businesses then, there is a basic unavoidable risk.

B. Risk avoidance

But some risks are insurable and can be avoided or minimized.

1. Based on prediction

Thus, although no one can predict whether a particular building will burn, it can be predicted statistically (on the basis of past experience) that out of 1000 buildings of a particular type, a certain number, say five, will indeed burn. On the basis of this information, we can calculate how much each owner would have to contribute to reimburse the owners of the five that do burn, and pay the expenses of those who administer the insurance service. Moneys paid into a pool for this purpose are called premiums. Whenever statistical predictions can be made, a risk is said to be insurable and appropriate premiums can be calculated.

2. Examples of insurable risks

Have students identify and discuss as many insurable risks as possible. EXAMPLES: Auto collision, auto fire and theft, hospitalization, life insurance, etc.

3. Hedging

Another sort of service which permits a business to avoid risk on certain kinds of losses is performed by professional speculators. Often a manufacturing business must keep considerable quantities of raw materials on hand. If the price of this material should drop sharply, the business would suffer a loss on these raw materials. Such losses can be avoided, however, by a process known as hedging.

a. Example

An example will help to explain this. Suppose a flour manufacturer has just bought 10,000 bushels of wheat at $4.00 per bushel and that it will be 90 days before the wheat is milled and sold as flour. If the price of wheat dropped to $3.50 during this period the manufacturer would lose $5,000 (10,000 bushels times $.50 per bushel). But he could avoid this loss!

(1) Futures contracts

In the wheat market there are professional speculators. At any given time some of them think the price will fall; others think it will rise. As a result they can deal in *futures contracts*. Speculator Jones, who feels the price will fall, will sign a contract with speculator Smith, who thinks the price will rise, to deliver wheat at today's price, in say 90 days. If the price does go down, Jones buys wheat at the lower price, delivers it at the end of 90 days at the higher contract price, and pockets the difference. If the price goes up, however, Jones must buy wheat at the higher market price and sell it at the lower contract price. In this case, Jones loses and Smith gains.

(2) Gain and loss cancel

The miller who buys 10,000 bushels at $4.00 per bushel for making flour, can

simultaneously sign a contract to sell 10,000 bushels at $4.00 per bushel in 90 days. If price goes down $.50, he will lose $.50 a bushel on the wheat he has in inventory, but he can fulfill his futures contract, at a profit of $.50 per bushel. This cancels out his loss on the wheat in inventory. He has protected himself from the risk of loss on the wheat for milling into flour; he has executed a perfect hedge.

b. Discussion

Have students explain what would happen if the price went up to $4.50 per bushel. EXPLANATION: The miller would make $.50 a bushel on the wheat in inventory, but would lose $.50 a bushel on his futures contract. In a perfect hedge he can neither lose nor gain. He has completely insulated himself from price fluctuations in the market.

IV. Federal Loan Insurance

The Federal Government, particularly since the 1930's for social reasons, has attempted to reduce risks on various types of loans. This may involve direct lending at lower-than-market interest by Federal agencies like the Small Business Administration. But it often takes the form of underwriting a loan, for example, guaranteeing to the lender repayment of say 90 percent of the principal amount of the loan. With such a guarantee the lender is more willing to make a loan and charge a lower rate of interest.

A. Promotes residential housing

This technique has been widely used by the Federal Government to promote the flow of capital investment into residential housing. Thus in the decade 1964-73 about 3.3 out of 16.3 million (a little over 20 percent) of privately built housing units were financed by loans underwritten by the Federal Housing Authority and the Veterans Administration.

B. Discussion

Ask students to suggest other Federal agencies they know which underwrite

loans or sell insurance. EXAMPLES: National Service Life Insurance sold by Veterans' Administration, Social Security, Federal Deposit Insurance Corporation, Federal Crop Insurance Corporation, etc. Incidentally, FCIC can be the basis of a discussion on whether there is an insurable risk here. (See "Risk avoidance" above). Experience indicates it is a doubtful case.

SUMMARY

FINANCIAL STATEMENTS
- Balance Sheet
- Income Statement

SECURITIES MARKETS
- Organization
  - Stock Exchanges
  - Over-the-counter markets
- Economic Functions
  - Sets prices of securities
  - Provides ready market for securities
  - Promotes productive use of capital
- Problems
  - Rigging the market
  - Unfair use of inside information
- Securities and Exchange Act

RISK AND RISK AVOIDANCE
- Insurance
- Hedging

FEDERAL LOAN INSURANCE

Lesson 5

Measuring National Income

OBJECTIVES

1. To distinguish among various measures of overall economic performance
2. To distinguish between monetary and real income per capita
3. To define the concepts of aggregate demand and supply
4. To look at the record of growth and stability in our economy

CONTENT OUTLINE	TEACHING SUGGESTIONS AND REFERENCES
	Basic references for Lesson 5 are: Bach, Chs. 7, 8, 14; McConnell, Chs. 10, 11; Samuelson, Ch. 10 and Appendix, Ch. 14.
I. Measures of Performance	
A. Gross National Product	Fifty years ago economists (and government leaders) had no clear idea of how well our economy as a whole was performing. Since then, however, measures of performance have been developed which, though not perfect, do enable us to keep an up-to-date record of just how well we are doing. Central to these measures are the concepts of *Gross* (and *Net*) *National Product*. *Gross National Product* (GNP) is the total *market value* (in current prices) of all *finished goods* and *services to consumers* produced in a year.
1. Market value is basic.	*Market value* is used because data on these values are readily available. (How we handle changes in the price level will be explained later).
2. Finished goods counted	We measure only *finished goods* to avoid double-counting. If we counted a million dollars worth of tires sold to General Motors and also counted the value of the new cars on which they were

installed, we would be counting the tires twice. Thus we only count the value of the finished automobile as it is sold to the final user. Similarly, we count only services to consumers because the value to producers of services of lawyers, plant doctors, and nurses is included in the value of the finished product. And we don't want to count these twice.

3. GNP for 1973

Thus when we add up all new value produced in a year, taking care not to double-count, we have the value of the Gross National Product. This figure for 1973 is $1,289,100,000,000 (about $1.3 trillion)!

4. Discussion

Ask students to suggest examples of value produced not included in GNP, such as services of housewives and home improvements made by do-it-yourselfers.

B. Net National Product

In the process of producing the GNP we know that there is *wear and tear* on the basic capital (buildings and equipment) of our economy and that some of the GNP must be used to replace what we wear out. This means all new value is not a net gain. Therefore, to calculate our net gain, which we call *Net National Product* (NNP), we must subtract the value of capital used up. When we make allowance for capital consumption of $110 billion, Net National Product in 1973 was about $1.18 trillion.

1. Discussion

Raise the question with students about other things we probably should subtract, if we could estimate them, to get a better measure of net gain. EXAMPLES: depletion of nonrenewable resources, wear and tear on the environment (air, water, scenic beauty), and industrial diseases.

C. Aggregate supply and demand

So far we have looked at the economy from the viewpoint of total output, or total value produced, or aggregate supply of goods and services measured at current market prices. But the selling price of a good must be equal to the wages, interest, and rents paid out to produce it plus any profit realized. Profit is a residual (elastic) amount that will

always equal the difference between production cost (wages, interest, and rent) and selling price. Also note that wages, interest, rents, and profits are the only forms of income that can come from current production (See Lesson 1, IIIB.)

1. Say's Law

It follows from this that for every dollar of aggregate supply (value produced) there is generated a dollar's worth of income to someone--a dollar's worth of potential aggregate demand. This is a statement of Say's Law (after J.B. Say, a French economist of the early 19th century). Thus if we speak of the Net National Product, we may also speak of a Net National Income of the same dollar amount--a potential ability to buy goods and services (aggregate demand) of the same dollar amount. The economic importance of whether aggregate demand is equal to (or temporarily greater than) its potential will be explored in Lesson 6.

D. National Income

There is a difference between national income in a general sense and *National Income* as a specialized concept in economics where it means the total income to persons and property from contributing to current production, that is, the sum of wages, interest, rents, and profits. For various reasons we want to know what this value is, and, if we have the value of NNP, it is not difficult to calculate. First, we ask the question: Is there any part of the final selling price of a good after allowance for depreciation, which is not paid out as wages, interest, or rent, or left over as profit? If there is and we know its dollar amount, all we have to do is subtract it from NNP and we will have National Income. (The latter is the sum of wages, interest, rents, and profits.) And there is such an item: indirect business taxes on many manufactured items from cigarettes and beer to autos and bread. Such taxes amounted to $117.8 billion in 1973 and when we subtract this (and other small miscellaneous items) from the $1.18 trillion NNP, we get a National Income of $1.05 trillion.

About 74.5 percent of this was wages and salaries, 4.8 percent interest, 2.4 percent rent, and 18.3 percent profit.

1. Discussion

Ask students if National Income could have been calculated in another way other than getting GNP and subtracting capital consumption to get NNP, and then subtracting indirect business taxes to get National Income. SUGGESTION: It could also be calculated by getting the figures on total wages, interest, rents, and profits and *adding them up*. Point out that this could be used as an internal check on our value of National Income.

E. Personal Income

National income does not necessarily represent the actual amount of money people get as income in a year. For instance, part of wages goes to Social Security contributions, substantial portions of corporate profits go to pay the Corporation Income Tax, and some of the rest is not paid out as dividends. On the other hand, various transfer payments are made to individuals by government (and to some extent by business). Examples include Social Security payments, relief and unemployment benefits, net interest on the public debt. When proper additions and subtractions from National Income are made, the resulting figure is called *Personal Income*, the actual income of households before personal taxes. When all such adjustments are made for 1973, Personal Income amounted to about $1.035 trillion.

F. Disposable Income, Consumption, and Saving

But Personal Income is still not the amount that individuals and households have discretion over because they must pay personal income taxes. In 1973 such tax payments amounted to $152.9 billion, leaving $882.5 billion of *Disposable Income*--income which households could spend or save as they saw fit. Any part of Disposable Income not spent for consumer goods and services is called *Personal Saving*. In 1973 households decided to spend $827.8 billion. Thus Personal Saving amounted to $54.7 billion ($882.5 minus $827.8 billion).

1. Discussion

Discuss: Which income concept still has all government income in it? ANSWER: NNP. Which has all government income taken out? ANSWER: Disposable Income. Which concept would you be most interested in if you were a retail seller? ANSWER: Disposable Income. A tax forecaster? ANSWER: Personal Income. An economist? ANSWER: All of them. Can Personal Income be greater than National Income? ANSWER: Yes, in bad years; in 1933 PI was $47 billion, NI was $40.3 billion.

II. Money GNP vs. Real GNP

Originally GNP is measured at market prices in current dollars. If I notice that GNP increased by 10 percent over last year, can I conclude that we produced 10 percent more real goods and services? No, not unless I know that the general level of prices has not changed.

A. Effect of changes in price level

Thus, since the economist measures values in dollars and since, because of inflation or deflation the purchasing power of the dollar may change, he has a problem. He is measuring with a unit which in real terms may change over time. Therefore, if he wants to measure the real (goods and services) world, he must keep track of these changes in his measuring unit and make adjustment for them.

1. Index numbers

He does this by the use of *index numbers*. Actually the basic procedure is fairly simple. He periodically calculates a weighted average of all prices, that is, an average where each price is given a weight commensurate with the economic importance of the good or service. Then he selects a *base year* and arbitrarily sets the weighted average of prices that year (call it Year 1) equal to 100. If in the following year (Year 2) he recalculates the weighted average of prices and finds it has risen by 10 percent, his index number for the Year 2 reads 110.

2. How to apply the index number

Now he is in a position to say whether or not an increase in money GNP is an increase in real GNP. If money GNP in Year 1 was $1.0 trillion and $1.1 trillion in Year 2, this 10 percent increase is due wholly to increased prices--the production of real goods and services did not increase at all! However, if the general price index in Year 2 is still 100 (as it was in Year 1), then the 10 percent increase in GNP is real.

B. Discussion

Ask students what conclusion should be made if the price index in Year 2 read 105. EXPLANATION: The 10 percent increase in money GNP was half real. That is, 5 percent of the increase was an increase in real GNP, and 5 percent was due to inflation. Thus although money GNP in Year 2 was $1.1 trillion, real GNP was only $1.05 trillion. In this way, so long as they have the appropriate index numbers, economists can always transform money GNP into real GNP. That is, they can express money GNP in dollars of standard (or constant) purchasing power and thus keep track of the real performance of the economy over the years.

III. Real GNP Per Capita

Of course steady increases in real GNP are generally regarded as desirable (though people are beginning to question the wisdom of our past use of nonrenewable resources).

A. Does an increase mean we're better off?

But even if we have such steady increases are people really better off? This, of course, depends on what is happening to population. Clearly, if real GNP is increasing at 2 percent per year and population is increasing at the same rate, the real GNP *per person* is staying the same and, *on the average*, people are no better off. Thus real GNP per capita, which can be easily calculated for each year by dividing real GNP by population, is a better measure of economic performance than real GNP alone.

1. Distribution must be considered.

And even with increasing real GNP per capita we are not certain that people are generally benefiting unless we take a close look at what is happening to the *distribution* of income and wealth. If high income groups are getting a larger and larger proportion of increased income and the poor a smaller and smaller share, people *in general* could be getting worse off. Measuring economic performance can become pretty complicated if one is really conscientious about it!

2. Discussion

Students could look up some of the facts about income distribution in the U.S. Refer them to Bach, Ch. 33; McConnell, Ch. 38; or Samuelson, Ch. 5.

B. Growth and stability: The record

1. Economic growth

For many years a major unquestioned goal of industrialized countries has been economic growth, that is, real GNP increasing faster than population, yielding an ever increasing standard of living.

a. In U.S.

And the long-term record has been phenomenal for the United States. During this century real GNP in the U.S. grew at an average rate of 3.1 percent per year. Population meantime was increasing at an average rate of a little under 1.5 percent per year. This difference of 1.6 percent has permitted us a more than threefold increase in real GNP per capita in this century.

b. In other countries

Other countries which have done very well include Germany, Great Britain, the Soviet Union, and Japan in that order.

c. Problems

One of the problems facing the world to come, however, is the fact that since 1960 the increase in real GNP per capita has been 3-4 percent per year, but only 2-3 percent for less developed countries. The *haves* are getting more faster than the *have-nots!*

d. Discussion

The students may wish to explore some of the implications of this phenomenon. Discussion might also include: Should

economic growth retain its *top priority* status? Rapid growth and high environmental quality are not always compatible. Japan, where oxygen vending machines are part of the urban scene, might be a good case study.

2. Economic stability

Of course, when we say that the *average* U.S. growth of real GNP was 3.1 percent per year in the 1900's this does not mean that 3.1 was the rate every year.

a. Some wide swings

In fact, we have seen wide swings above and below this average. In the Great Depression (1929-1936) real GNP fell to about 75 percent of its previous level. Since 1900 real GNP fell distinctly below "normal" in 1907, 1920-21, 1929-1940 (with a special dip in 1937-38), 1949-50, 1953-54, 1957-58, 1960-61, 1969-70, and 1973-74. Such downturns, always marked by rising unemployment, are part of the fluctuations in economic activity. Although there have been several *recessions* since World War II with unemployment ranging above 6 percent, they have been mild compared to the Great Depression when unemployment reached 25 percent (in 1932-33). Reasons for these *ups and downs* will be explored in Lesson 6.

b. Discussion

Discuss with students the characteristics of depression and prosperity. SUGGESTIONS: Depression: high unemployment, low industrial production, falling prices, low interest rates, low bank deposits, etc. Prosperity: low unemployment, high industrial output, rising prices, high interest rates, high level of bank deposits, etc.

C. Current performance: sources of information

Nowadays it is not difficult to find information about how well the economy is doing. The mass media do a good job of keeping us up to date on the latest changes. More detailed information can be obtained readily from the *Survey of Current Business* published monthly by the U.S. Department of Commerce and the *Federal Reserve Bulletin* published monthly by the Federal Reserve System (the "Fed"). Historical data are available in the *Historical Chart Book*

also by the Fed, and *Statistical Abstracts of the U.S.* published annually by the U.S. Department of Commerce. Though many other sources are available these will suffice to answer most questions of fact.

TERMINOLOGY OF NATIONAL INCOME

TERM	SYMBOL
Gross National Product	GNP
Net National Product	NNP
National Income	NI
Personal Income	PI
Disposable Income	DI
Consumption	C
Savings	S
Government Spending	G
Investment	I

Lesson 6

Determinants of National Product and Income

OBJECTIVES

To identify and explain the major causes of economic fluctuations

CONTENT OUTLINE	TEACHING SUGGESTIONS AND REFERENCES
	Basic references for Lesson 6 are: Bach, Chs. 10, 11; McConnell, Chs. 21, 13; Samuelson, Chs. 11, 12.
I. Aggregate Supply--Income Generated	As discussed in Lesson 5 in the act of producing value an equivalent dollar flow of income (generally stated in $billion per year) is generated in the form of wages, interest, rents, and profits. Looked at from the income viewpoint, only three things can happen to this flow of income: part of it is taxed away (T), part is spent for consumer goods (C), and part is saved (S). That is, income received must equal the sum of total consumption expenditures plus saving plus taxes: National Income = Y = C + S + T
II. Aggregate Demand--Total Spending	Looked at from the *total spending in the economy* viewpoint, only three kinds of spending to buy the GNP are possible: for consumption goods (C); business spending for plant, equipment, increased inventories, etc., called investment (I); and spending by government for public services, defense, subsidies, etc. (G). Thus, from the spending viewpoint Y = C + I + G.
III. Equality of Aggregate Demand and Supply?	Since things equal to the same thing are equal to each other, it appears that: C + S + T = Y = C + I + G Aggregate Supply = Aggregate Demand

and indeed this may be the case.

A. Are they equal?

Let's look at this situation first. If we are producing value (generating income) at the rate of $1 trillion per year, and if investment and government spending are the same as saving and taxes, then aggregate demand (total spending) will be $1 trillion per year. If this is the case, services to consumers would be bought as they are produced (as indeed they must be) but, more important, goods would be coming out of inventory at the same rate they are being produced and put into inventory. If business is satisfied to keep inventories at current levels, there would be no tendency for GNP to either rise or fall. Thus a GNP of $1 trillion per year would be an equilibrium (no-tendency-to-change) GNP. How likely is such a situation?

B. Are S + T equal to I + G?

Remember that the crucial question is whether (S + T) is equal to (I + G). (C is always equal to itself).

1. T and G

First, let's talk about T and G. Both the level of taxes (T) and the level of government expenditures (G) can be set by governmental units. In any given year governments can be taking in more than they are spending, (that is, T > G); or they can be spending more than they are taking in, that is, G > T. In the real world, we have no assurance that T will equal G in any given year. (The full implications of these possibilities are explored in Lesson 7.)

2. Are S and I equal?

Whether saving (S) will equal investment (I) is also highly problematical. The decisions about how much to try to save out of current income are made by some 65 million households. There is a wide variety of reasons for saving such as funds for emergencies, a down payment on a house or car, a vacation trip, or for the interest received. On the other hand, decisions about how much to try to invest in a given year are made by the more than 11 million business units on the basis of potential return on invested funds compared with interest charges (the cost of investment funds). Thus,

since decisions to save are made by one group of people for one set of reasons, and decisions to invest are made by another group for a different set of reasons, it is highly improbable that savers would be trying to save exactly the same number of dollars that investors are trying to invest in a given year.

In the light, therefore, of very probable differences between T and G, and between S and I, the possibility of aggregate demand (C + I + G) and aggregate supply (C + S + T) being equal in any one year is rather remote.

C. Relationships between aggregate demand and aggregate supply

Let's see what inequalities between aggregate demand and supply are likely to do to both, that is, how will they affect the level of GNP?

1. If (I + G) < (S + T)

First, assume that (I + G) is less than (S + T). This means that aggregate demand is less than aggregate supply. To put it another way, all income being generated is not being spent. This in turn means that some of the goods being produced are not being sold. Inventories are piling up. What will be the likely reaction of producers? Not wanting to tie their money up in inventories, they are very likely to cut back on production levels. This means they will reduce aggregate supply, reduce income generated, reduce GNP. Thus if I + G < S + T we would expect GNP to fall.

2. Discussion: If (I + G) > (S + T)

Trace through with students what would tend to happen if I + G were greater than S + T. EXPLANATION: Aggregate demand would be greater than aggregate supply, spending would be greater than income being generated by production. (This could happen by borrowing from the banking system, for instance.) Inventories would begin to dwindle, production levels would be stepped up to replenish inventories, aggregate supply would be increased, GNP would rise.

D. Some elements of up and down movement

Note that if we want to explain why economic activity moves up or down we have to explain why, at various times people want to save more or less, (or buy more or less), why businesses decide to invest more or less, and why governments decide to tax or spend more or less.

IV. Saving and Investment.

The concepts of saving and investment as used in economics frequently give students trouble. Common usage often implies that they are just about the same thing, but in economics they are quite separate and distinct.

A. Difference between them

Saving is *refraining from spending* for consumer goods and services. Investment is *spending* for business purposes. If I save money ~~with~~ an insurance company (or savings bank) I am *not* investing.

1. Investment is business spending.

Investment does not take place until business borrows from the insurance company (or bank) and *spends* it for new plant, equipment, increased inventory, etc.

Similarly, if I buy 10 shares of AT&T in the stock exchange, I am not investing in the economic sense, because the person who sells to me is disinvesting the value of the stock; that is, no new business spending takes place.

B. Planned vs. actual

Also, one must distinguish between *planned* saving and investment and *actual* saving and investment. I may plan to save 10 percent of my $10,000 income during the coming year, that is not spend $1,000. However, if my income turns out to be only $9,000, I will end up actually saving only $900. This is why the phrases *try to save* and *try to invest* were used in the previous section. It is the difference between planned saving and planned investment which makes for a difference between aggregate demand and supply, which in turn makes GNP rise or fall.

1. Bring inventory into the discussion.

As a matter of fact, since inventory is a form of investment (sometimes involuntary), *actual* savings and *actual* investment will always be equal at the end of a year. If, as the last transaction of the year (late on December 31st), one decides to buy a $100 watch, the effect on the year's accounts would be: C up $100, S down $100 and (since the watch came out of inventory) I went down $100. If one suddenly changes his mind and returns the watch, the effects would be: C down $100, S up $100; and (since the watch goes back into inventory) I would go up $100. Thus *actual* savings and *actual* investment will be equal at the end of the year, but the final level of both will be determined by the relative levels of *planned* savings and investment during the year. That is, a persistent planned I greater than planned S during the year will increase final GNP and bring actual S and I to a higher level than they would otherwise have been.

2. Discussion

Ask students to give illustrations from personal experience where planned and actual saving were different.

V. Gross and Net Investment

It will be remembered that the only difference between GNP and NNP is capital consumption, that is, wear and tear on plant and equipment.

A. Definitions

The terms *gross investment* refers to the *total* amount spent on plant and equipment during the year including that used to replace wear and tear. *Net investment* refers to spending on new plant and equipment over and above that used to replace wear and tear. Thus, in the equation GNP = C + I + G, I is *gross investment*. But in the equation NNP = C + I + G, I is *net investment*. Note that new investment must be positive if an economy is growing.

B. Discussion

Discuss with students the implications of net I being equal to zero. EXPLANATION: In such a case the economy is stagnant; if population is growing, the standard of living is falling. What if net I is negative? In this case, the economy is not replacing what is wearing

out--it is shrinking, that is, living off its capital.

VI. Income Multiplier Effects

A. MPC and MPS

Economists assume, and the real world confirms, that when people get additional income they do not normally spend it all. The economists say their *marginal propensity to consume* (MPC) is less than 1. If, when they get $100 of increased income, people typically spend $90 and save $10, we say the MPC is .9 and the *marginal propensity to save* (MPS) is .1. This concept leads to an important principle: the *income multiplier effect*.

B. Example

Let's trace what happens when an injection of new consumer, business, or government spending takes place. Suppose, for instance, that a Mr. Hoarder digs up $100 which he buried in his back yard during the Depression and decides to spend it now. For all intents and purposes this is new spending.

1. MPC applied

When he spends it, someone (say Mr. Smith) gets $100 of new income. But this is not the end of the matter. If the MPC is .9, this means that Smith will spend $90 and say Jones will get $90 of new income. Now $190 of new income has been generated. Following the rule of the MPC, Jones now spends $81 and say Thompson gets $81 of new income. Now $271 of new income exists. And so it goes, each income recipient spending 90 percent of what he gets.

2. Income and saving generated

If we did all of the arithmetic for this process, that is, took .9 of .9 of .9 of .9, etc., we would find that $1000 of new income had been generated. And, of course, since MPS is .1, we would also find that $100 of new saving had accumulated. Thus new spending of $100 generated $1000, or 10 times as much new income. The income multiplier has a value of 10 if the MPC is .9.

3. MPC + MPS = 1

Note that the value of the multiplier is 10 when the MPS is .1. This relationship always holds; for example, if MPC is 4/5, then MPS is 1/5 and the

multiplier is 5. MPS is always 1 - MPC and the multiplier is always the reciprocal of the MPS.

C. Discussion

Have students figure the value of the multiplier if MPC is: 2/3, (ANSWER: 3); 1/2, (ANSWER: 2); 3/5, (ANSWER: 2.5). Discuss with students whether new spending by business and/or government would have the same multiplier effect on income. EXPLANATION: It would--any new spending generates a multiple amount of income depending on the values of the MPC and the MPS.

VII. Accelerator Principle

Under certain circumstances the $100 injection of new spending, which generated $1000 of new income via the multiplier effect, might have had an even greater impact. Picture a situation where the economy is operating at or near full capacity. If new spending is in the hundreds of millions, and multiplied new income is in the billions, management will sense the faster tempo and will very likely decide to expand plant capacity to meet growing demands. In other words, they may be induced to *invest* more than they had originally planned. If this happens, the additional investment will now represent *additional* new spending which will then be multiplied into additional *new income*. This we call the *accelerator principle*.

A. Effect on original increase in spending

Thus in our previous example, if the new income of $1000 generated by $100 of new spending induced some businessman to invest $10 additional in his business, this too would be "multiplied up" by the multiplier effect. The total effect of Mr. Hoarder's action might have been $1100, rather than $1000, of new income. If this happened, the $1100 would be the result of a *combined multiplier-accelerator* effect.

B. Discussion

Ask students why the accelerator principle works only at or near full employment. EXPLANATION: If business has idle capacity, as it would have at

less than full employment, it would react to new business, not by building new capacity, but by putting existing capacity to work. New investment would not be induced and the accelerator principle would not operate.

SUMMARY

ELEMENTS OF NATIONAL PRODUCT AND INCOME

Aggregate supply

Aggregate demand

National Income = Y

= C + S + T

= C + I + G

TOPICS DISCUSSED

Relationships between aggregate demand and aggregate supply

Saving and investment

Gross and net investment

Income multiplier

Marginal propensity to consume (MPC)

Marginal propensity to save (MPS)

Accelerator principle

Lesson 7

Fiscal Policy and the Level of National Income

OBJECTIVES

To define and describe the nature of fiscal policy
To explain its effects on the level of aggregate economic activity

CONTENT OUTLINE	TEACHING SUGGESTIONS AND REFERENCES
	Basic references for Lesson 7 are: Bach, Chs. 13; McConnell, Chs. 9, 14, 15; Samuelson, Chs. 9, 19, (8, 13 optional).
I. Fiscal Policy A. Definition	A policy is a set of principles which guides decisionmaking. Fiscal policy consists of those principles which at any given time are guiding political decisions about the level and nature of taxation and Government expenditures.
B. State and local also important	For a full understanding, one should explore fiscal policy at the state and local levels as well as the Federal. However, because of its overriding importance in determining the level of economic activity, Federal policy should be emphasized.
C. Alternate policies	Basically the Federal Government can follow one of three policies: surplus financing ($T > G$), a balanced budget ($T = G$), or deficit financing ($T < G$). Fiscal policy should be carefully distinguished from monetary policy which will be discussed in Lesson 8. Monetary policy guides the decisions which determine the *quantity of money* available for use in the economy. Fiscal policy is set by joint action between the executive and legislative

branches of Government. Monetary policy is formulated by an "independent" Board of Governors of the Federal Reserve System created by Congress and supervised by the President.

II. Main Elements of Fiscal Policy

A. Taxation

From time immemorial governments have levied taxes to carry out activities which they deemed necessary. Over the years economists have speculated about taxation—especially the qualities of a "good" tax. Current thinking identifies three major criteria for judging taxes:

- A tax should distribute its burden justly.
- It should be administratively feasible.
- It should be socially expedient.

1. Justice in taxation

Justice in taxation has long been a matter of controversy. An older theory of justice is that the burden ought to be distributed in accordance with the benefits the taxpayer receives. Examples of such distribution of burden are real estate taxes and excise taxes such as gasoline taxes earmarked for highway construction. However, pushed to the extreme such a theory would have the orphans supporting the orphanages.

a. Benefit theory

A *benefit theory* tax usually has a proportional rate, that is, the rate of taxation (say 10 percent) is the same regardless of the size of the tax base. EXAMPLES: a real estate tax is $60 per thousand of assessed value regardless of the amount of the assessment; or a sales tax is 7 percent regardless of the price of the good being taxed.

b. Ability to pay

A newer theory is that the burden of the tax ought to be distributed among taxpayers according to their ability to pay. The *ability-to-pay* theory holds that the payment of a tax ought to bring forth an *equal sacrifice* by each taxpayer. Accordingly, since the utility (want-satisfying power) of

extra dollars of low-income families is assumed to be greater than that of high-income families, to obtain equal sacrifice more dollars in proportion to income should be taken from high incomes than from low incomes. This leads to a progressive rate of taxation, that is, the higher the tax base the higher the *rate* of taxation.

(1) Examples

Our progressive income tax is an outstanding example of this kind of tax. The corporation income tax is also progressive.

Few taxes are officially *regressive*, though many taxes which are nominally proportional do take a higher percentage of low incomes than of high incomes and are therefore regressive in their impact. In this century, the ability-to-pay theory has gained widespread acceptance in Western countries. But in spite of our progressive income taxes, the overall impact of all taxes (Federal, state, and local) is sharply regressive on incomes up to about $10,000 and only slightly progressive on higher incomes.

2. Administrative feasibility in taxation

A good tax is also administratively feasible. It is certain as to amount, time, and manner of payment; hard to evade (or avoid); and inexpensive to collect.

3. Social expediency

Also a good tax is socially expedient, that is, it does not interfere with the attainment of the goals of society. For example, if full employment is a national goal, a tax which creates unemployment is *bad*. Similarly, if more even distribution of income is a goal, a tax which takes from the poor and gives to the rich is likewise bad.

4. Discussion

Discuss with students which taxes are best and worst in the light of these criteria. SUGGESTION: Most authorities give high ratings to an appropriately progressive income tax and low ratings to real-estate taxes.

5. Kind of tax used on each level

Discuss the kinds of taxes used by various levels of government. Localities rely very heavily on property taxes, with some use of sales and income taxes. States rely heavily on sales and individual income taxes with some attention to corporation income taxes and death and gift taxes. The Federal Government gets most of its revenue from personal income taxes, corporation income taxes, and employment or payroll taxes. Only a little over 10 percent comes from excise taxes on goods, inheritance taxes, and taxes other than income tax.

B. Expenditures

1. By local governments

Something like one-third of all spending in our economy is done by government. Local governments spend most heavily for education, health, urban renewal, and sanitation. Lesser, but substantial amounts go to highways and transportation; welfare, old age, and unemployment; police and fire protection; administrative, legislative, and judicial activities; and natural resources and recreation.

2. By states

The lion's share of state spending is for education; highways and other transportation; and welfare, old age and unemployment. Lesser amounts are spent for functions similar to those of local governments.

3. Federal spending

Federal spending reveals a somewhat different pattern. National defense accounts for about a third and social security about a fourth of Federal expenditures. About one-tenth is interest on the national debt while other expenditures (in the 2 to 7 percent range) include health, education, transportation, space travel, agriculture, and international affairs and finance.

4. Discussion: Growth of governmental spending

Government expenditures at all levels have grown markedly since World War II. Discuss with students reasons for this. Suggest

- Cold and hot wars, the arms race, more sophisticated weapons

- Growing urbanization and interdependence with increased need for more services
- The quest for security from unemployment, sickness, and old age
- Education—the need for highly trained workers in a technological society
- A growing affluence (we can afford more and better government services) and humanitarianism (the desire for better mental institutions, prisons, etc.)
- Inefficiency and waste as government bureaucracy gets larger

III. Fiscal Policy for Stability

A. Countercyclical policy

Until the Great Depression in the 1930's annual balancing of the Federal budget (that is, keeping T equal to G) was an objective hardly ever questioned. However, as the theory of income determination (relation between aggregate demand and supply) was developed during the 1930's, the idea gradually grew that central governments could and should pursue *countercyclical fiscal policies*.

1. How it works

If GNP was too low for full employment, and falling, it was because C + I + G was too low and less than C + S + T. Appropriate fiscal policy in such a situation, aside from measures to stimulate C and I, perhaps by lowering T (and other measures discussed in Lesson 8), would be to increase G. This would increase aggregate demand, bring inventories down, stimulate production, and decrease unemployment. Note that this implies a Federal deficit (G > T) and an increase in the national debt.

2. How long to use such policy

Discuss with students how long such fiscal stimulation should be employed. Until full employment is reached. To persist with deficit financing beyond this point would increase *money* $C + I + G$ beyond the upper limit of *real* $C + S + T$. The same *real* $C + S + T$ would be getting a higher

and higher price tag on it, that is, inflation would result.

If such a situation should develop, that is, if full employment and aggregate demand-pull inflation are present, it would be because *money* $C + I + G$ is greater than full employment, *real* $C + S + T$. Now the opposite fiscal policy should be pursued. Lower G and increase T. Lower G would itself lower C + I + G and higher taxes would discourage C + I, thus easing the dollar pressure on real GNP. Note that this policy implies a Federal surplus (T > G) and a decrease in the national debt.

a. If ups and downs are symmetrical

If the ups and downs of the economy were symmetrical, that is, the deficits and surpluses equalled each other over the whole cycle, the national debt would be the same at the end of the cycle as it was at the beginning. Thus, the budget would have been balanced, not every year as previously thought necessary, but over the cycle. For this reason countercyclical finance is sometimes called *functional finance*.

B. The National Debt

It is appropriate here to discuss the national debt which is now more than $450 billion. It is not like private debt:

1. Not debt between economic units
   - It is *not* debt between economic units, but debt *within* an economic unit. We owe it to ourselves.
2. Redistributes income when paid back
   - When paid back it redistributes income within the economy—money is taken from taxpayers and given to bondholders.
3. Need not be paid back
   - Nations more than corporations, are "immortal" and debt need not be paid back. New bonds can be issued to replace old ones as they become due.
4. Measured in terms of GNP
   - Size of the debt should be measured in terms of GNP.

Debt as a percentage of GNP fell from a high of 124 in 1946 to 40 in 1970.

5. No loss of real wealth when repaid

- If held by Americans, no loss of real wealth takes place when debt is retired.

6. Not a burden to our grandchildren

- We are not passing a burden on to our grandchildren. They will pay taxes for the interest and for repaying principal, say in the year 2050, but they will pay it to *themselves*. Note here, however, that if there is a "bad" tax system in 2050 and bonds are mostly held by the very wealthy, we might be taking money from the poor and giving it to the rich which could cause serious political problems.

IV. Fiscal Policy for Growth

Fiscal policy has also been suggested as a tool for compensating for chronic lack of satisfactory economic growth (secular stagnation) or chronic inflationary pressures (secular exhilaration).

A. Economic growth too slow

If growth rates are not high enough to keep unemployment down to acceptable levels (a situation that characterized the decade of the 1950's), deficit financing could be pursued more enthusiastically than surplus financing over the longer term. This would result in an increasing national debt over time (that is, deficits would be larger than surpluses). But if it is successful, the GNP would grow faster than the debt and the size of the debt as a percentage of GNP would fall.

B. Inflation

If the chronic problem is inflation, the policy would be reversed. That is, surpluses would be greater than deficits over time, some spending pressure would be thus relieved, and the debt would grow smaller over the years. Since such a policy is designed to compensate for both cyclical ups and downs and the longer term trend, it is sometimes called *fully compensatory finance*.

C. Discussion

Discuss with students the Kennedy-Johnson tax cut of 1964 which was intended to stimulate economic growth. SUGGESTION: The average annual rate of growth of real GNP, which was 3.2 percent in the 1950's was raised to 4.5 percent in the 1960's but was considerably higher than this in some years in the middle 60's.

Discuss with students some of the problems in implementing fiscal policy. EXAMPLES:

- Politicians like to lower taxes but not to raise them, as they should from time to time.
- Similarly they like to increase Government expenditures, but not to cut them.
- State and local governments may be using surplus financing when the Federal government is using deficit financing.
- Many people have irrational fears about the national debt.
- Good public works plans must be on hand so that if Government increases expenditures the money will be spent on worthwhile projects.

Also note that to get around the first and second problems above some have suggested that the President, or some fiscal board like the "Fed," be empowered to raise and lower taxes within limits set by Congress. But this has not been done.

Lesson 8

Monetary Policy in our Economy

OBJECTIVES

To explain what monetary policy is
To show how it can be combined with fiscal policy to stabilize the economy

CONTENT OUTLINE	TEACHING SUGGESTIONS AND REFERENCES
	Basic references for Lesson 8 are: Bach, Chs. 12, 13, 16, 17, 18; McConnell, Chs. 16, 17, 18, 19; Samuelson, Chs. 15, 16, 17, 18.
I. Kinds and Nature of Money	Many things have served as money over the years--commodities such as gold and silver, tobacco warehouse receipts, beads, and even stones (on the Isle of Yap). Modern economies use *managed* paper money, not *backed* by any specific commodity like gold. Money, which is an arbitrarily selected measure of value, serves three functions: a medium of exchange, a store of value, and a standard unit of account for recordkeeping.
A. Two major components	Our money supply (and that of most other countries) has two major components: *currency and coins* outside of banks, and *demand deposits* of commercial banks (often called *checkbook money*). Of the two, demand deposit money is by far the most important. For instance, in March 1972, currency and coinage amounted to $46.7 billion while demand deposits were $177.7 billion, almost four times as large. Government bonds and deposits in savings institutions, which amounted to $661.1 billion, are known as *near money*. They cannot be used as a medium of exchange, but their existence cer-

tainly has an effect on how fast we spend money.

II. Sources of our money supply

Our money supply is provided by a two-layered banking system consisting of some 13,000 commercial banks (which handle checking accounts) and a central bank known as the Federal Reserve System.

A. The Federal Reserve System

There are 12 Federal Reserve Districts each with a Federal Reserve Bank. This system is a banker's bank and does not do business with the public. The operation of the system is supervised by the Board of Governors of the "Fed" in Washington. Currency, which is really the *pocket money* of the economy, is issued by (and is a liability of) the Federal Reserve System. All currency eventually (because silver certificates, etc. are being retired) will be Federal Reserve Notes. Currency comes into existence and moves out of and into the banking system (and the Fed) as the public decides it wants more or less cash.

B. Demand deposit money

Demand deposit money is a different story. Our private banking system is a *fractional reserve system*. For that reason this system can create new demand deposits in the process of making short-term loans to its customers, mainly businesses.

1. How it is created

Suppose our Mr. Hoarder digs up $1000 of his currency hoard, and having overcome his distrust of banks, opens a checking account for $1000 in Bank No. 1. The money supply, let's call it M, does not change by this transaction. M goes down $1000 as the currency goes into the bank, but the new checking account (a demand deposit) of $1000 increases M by $1000.

a. Reserve requirements

The Fed sets the *reserve requirement* for banks, that is, the minimum percentage of each new deposit which must be kept by the banks in liquid form, ready for use at an instant's notice. In the case of banks which are members of the Fed (and such banks do about 80 percent of all banking business)

these *reserves* are kept on deposit with the Federal Reserve Bank in their district. The reserves thus are checking accounts with the Fed against which the member bank can write checks at any time to meet everyday demands for liquid money. Let's say the Fed has set the reserve requirement at 20 percent. (Actually, the figure is more like 16 percent, which is more than enough to meet ordinary situations, but 20 percent makes arithmetic easier.)

b. Loan made to businessman

Assume that right after Mr. Hoarder deposited his $1000, Businessman 1 wants to borrow money for a short time to stock up his store. Bank 1 can readily lend him $800 (out of the $1000) since it has to keep in its reserve only 20 cents out of each dollar deposited. Businessman 1 writes out a promissory note (an IOU) pledging to repay the loan when due. The bank keeps this note as an asset.

It then adds $800 to Businessman 1's account permitting him, in effect, to overdraw his account by $800. Its balance sheet balances!

c. He writes check, spends it, etc.

Businessman 1 now buys the goods he needs with a check to Businessman 2, who deposits it in his bank, Bank 2.

d. More loans can be made.

Bank 2 now has a new deposit of $800 and can lend out (create a new demand deposit) of $640. If this amount is loaned, a check could be written for $640 against this deposit and deposited in Bank 3, Bank 3 can now lend out $512, and so on and so on.

e. Total of new loans possible

Again, as in the case of the income multiplier, if we do all the arithmetic, taking 80 percent of 80 percent, of 80 percent, etc. and add up all the possible new loans (demand deposits) we will get $4,000. Thus an initial deposit of $1,000 in a checking account makes possible the creation of $4000 of new demand deposits. In our example the money supply has been increased $4000 by borrowers and individual banks interacting

within the banking system.

2. Confusion between money and wealth

Students may be confused here because they mistake money for wealth. They may think the banking system is creating wealth out of thin air, which they know is impossible. Money *may* represent wealth to an individual, but for society it is merely a *bookkeeping* system. If I have $10 (cash or check), this means that out of all the goods and services available I have a claim on $10 worth of them at current prices. If money were wealth, after World War I, in which Germany had enough money to inflate prices more than 100 billion times, it would have been a very wealthy nation which of course it wasn't.

3. Discussion

Discuss with students what the total effect of Mr. Hoarder's $1000 would have been if the reserve requirement had been only 10 percent.
EXPLANATION: Potentially, if business is in a borrowing mood and banks are in a lending mood, his deposit could have resulted in a $9,000 increase in M!

III. Monetary Policy

A. Control of reserve requirements, a major tool

Note that the power of the Fed to raise and lower reserve requirements within limits is a major tool of monetary policy. Raising the requirements, (a tight money policy), reduces the banking system's ability to create money. Lowering them, (an easy money policy), has the opposite effect.

If the banking system is *all-loaned-up*, that is, total reserves are exactly 20 percent of total demand deposits, and the Fed thinks more money is needed, they may permit member banks to borrow additional reserves from them for a short time.

B. Raising and lowering discount rate

The interest rate the Fed charges (known as the *discount rate*) can be raised or lowered to discourage or encourage such borrowing. Thus the Fed has another tool by which it may affect the money supply. Lower discount rates signal an easy money policy; higher rates mean a tight money policy.

C. Open-market operations

A third instrument of monetary policy, perhaps the most important one, is *open-market operations*. Both member banks and the Fed own substantial amounts of Government securities (bonds, etc.).

1. For an easy money policy

If the Fed wants to pursue an easy money policy, it can buy U.S. securities in the open (nonbanking) market on Wall Street. The Fed pays the bondholders with checks against Federal Reserve Banks. These bondholders (who have sold their bonds to the Fed) deposit the checks in member banks. Thus new reserves are *pumped* into the banking system from *outside* the system. A $1 billion purchase of government securities would furnish the banking system with a like amount of additional reserves. Assuming a 20 percent reserve requirement, this could add $5 billion to M.

2. For a tight money policy

Discuss with students the reverse procedure: EXPLANATION: The Fed sells $1 billion of U.S. securities. Buyers pay with checks against member banks. The Fed, to receive payment, deducts $1 billion from member bank reserves. Member banks, if they are *loaned-up* must retire $4 billion in loans. Demand deposits come down by $5 billion lowering M by $5 billion.

IV. Money and the Price Level

The *size* of M is very important, but it is not the only determinant of the price level. To explain this, economists use a concept known as the *equation of exchange*. Even though it is not an equation in the mathematical sense, it is helpful in relating the price level (P) to the money supply (M).

A. Equation of Exchange

What it says is that in a given year:

$$\begin{bmatrix}\text{Average price per transaction}\end{bmatrix} \times \begin{bmatrix}\text{No. of transactions}\end{bmatrix} = \begin{bmatrix}\text{Quan. of money}\end{bmatrix} \times \begin{bmatrix}\text{Velocity of money}\end{bmatrix}$$

$$P \times t = M \times V$$

In this equation, P, the average price per transaction, can also be thought of as the price level.

Also, V = Velocity of money
= No. of times per year a dollar changes hands .

1.- Amount of money spent

It says in effect that the total amount of money spent, looked at from the real flow of goods viewpoint (P x t), must be equal to the total amount of money spent, looked at from the flow of money viewpoint, (M x V).

In the equation

$$Pt = MV$$

if we divide through by t, we get

$$P = \frac{MV}{t}$$

From this we can see that the price level (P) is the value of a fraction with a numerator (MV), the flow of money, and a denominator (t), the need for money to perform transactions.

3. Determinants of V

Factors which determine M have been discussed. The magnitude of the velocity of money (V) is largely determined by levels of income and how consumers and businessmen assess the prospects for future income. Optimism speeds up V, pessimism slows it down.

4. Determinants of t

The number of transactions (t), is mostly determined by the level of production of goods and services. The number of middlemen between producer and final user is also a factor here, but this changes rather slowly.

B. Applications of the equation

With the expression:

$$P = \frac{MV}{t}$$

one can predict the effect on P of a number of things. If the Fed stimulates M and V, and t doesn't change, this should increase P. If production of goods increases, increasing t and M and V don't change, this should lower P, etc. If one assumes that $\frac{V}{t}$

is a constant value, then changes in P will be directly proportional to changes in M. This is a statement of a crude *quantity theory* of money.

Discuss with students the effect on P of an increase of 10 percent in MV and a simultaneous increase of 10 percent in t. EXPLANATION: P would remain unchanged. Point out that in a free enterprise system V and t are not controlled for philosophical reasons. But if changes in V and t bring undesirable changes in P, the Fed (as discussed above) can try to adjust M up or down to compensate. For example, if increased V is causing inflation, reduced M can help ease the situation.

V. Monetary and Fiscal Policy Combined

Suppose we are confronted with a full employment situation with aggregate demand-pull inflation beginning, that is, P is beginning to rise too fast.

A. Monetary policy

Appropriate monetary policy is tight money. The Fed should raise the discount rate, sell securities in the open market, and if necessary, raise reserve requirements. This should reduce M and slow the rise in P. Since the interest rate is the price paid for the use of money, and since money is now scarcer, this should also push interest rates up. This should discourage consumers, and especially businesses, from borrowing and spending thus lowering the C and I part of aggregate demand.

B. Fiscal policy

Simultaneously, a *surplus financing* fiscal policy can be implemented. Increasing T will further inhibit C and I spending. Cutting G expenditures should further reduce aggregate demand (C + I + G). An appropriate combination of monetary and fiscal policy, therefore, should cure the inflationary pressure.

C. Curing a recession

Trace through with students steps to cure a recession-deflation situation with rising unemployment and a falling P. Fed monetary policy should be easy

money, that is, lower the discount rate, buy securities in Wall Street, and lower the reserve requirements. Lower interest rates should stimulate C and I. Fiscal policy should aim at increasing (C + I + G) by lowering taxes (which also stimulates C and I), and increasing G expenditures. C + I + G demand should increase, unemployment should drop, and P should rise.

D. Discussion

Discuss with students the relative effectiveness of monetary and fiscal policy. EXPLANATION: Monetary policy may not be very effective against deflation since increasing M depends on banks wanting to lend and borrowers wanting to borrow. The Fed can only urge, not force, banks to lend and business to borrow. On the other hand, if banks are loaned-up a tight money policy can force them to reduce demand deposits and lower M. Fiscal policy should be fairly effective in either direction though large deficits may be necessary in serious depression situations.

Lesson 9

International Trade

OBJECTIVES

To explain why international trade takes place
To describe how such trade is carried on

CONTENT OUTLINE	TEACHING SUGGESTIONS AND REFERENCES
	Basic references for Lesson 9 are: Bach, Chs, 38, 40; McConnell, Chs. 42, 43; Samuelson, Chs. 33, 34.
I. Nature of International Trade	Trade *between* countries does not differ fundamentally from trade *within* a country. Whether between California and New York State or between U.S. and Japan, trade takes plade because sellers and buyers both sense a gain in utility as a result of the exchange. Or, to put it another way, the buyers and sellers feel that the true cost (sacrifice) of what they give in exchange is less than what they receive. Thus, trade takes place because it is mutually advantageous.
A. Difference between domestic and foreign trade	But there is one big difference between domestic and foreign trade. In foreign trade, since sellers generally want to be paid in their own money, an additional transaction is necessary. If I sell to a Californian, he pays me in U.S. dollars which I freely accept because I can readily spend them. However, if I sell to a German, I will not usually accept German marks because it is difficult for me to spend them.
1. Additional transaction needed	Thus domestic trade involves turning goods into U.S. money, into goods, into U.S. money, etc. Foreign trade, however, means an additional transaction whereby dollars are exchanged for marks or vice versa.

2. Foreign exchange market needed

To carry on foreign trade, there must be additional markets where one currency can be exchanged for another. Such *foreign exchange* markets, which exist in all major financial centers, set the prices of all currencies in terms of each other. On August 8, 1974, for instance, if I wanted to buy in England, I could have had my U.S. dollar bank deposits transferred to a British bank deposit in pounds at a rate of about $2.37 per pound (or to a German bank at 38.7 cents for each mark). (Bring a financial page to class and read off some of the current exchange rates.)

B. Discussion

Discuss with students the effect on the dollar-pound exchange rate if Americans begin to buy a lot more British goods. SUGGESTION: First remind the students that if the demand (in the U.S.) for an American good increases, its price to Americans will go up. In the same way, if American demand for British goods increases: the demand for pounds in the U.S. increases, their price in dollars goes up, it takes more dollars to buy a British pound, and the price of British goods to Americans has risen.

II. Law of Comparative Advantage

A. Principle involved

International trade takes place because of the *law of comparative advantage*. The word *comparative* is important here because even if the U.S. had an *absolute* advantage in every good, that is, could produce every good with less labor and other resources than any other country, it would still pay the U.S. to produce those goods where it has the *greatest* absolute advantage, and import some things where its absolute advantage is somewhat less. By producing with resources where it does best *comparatively* and importing goods where it produces less well *comparatively*, the U.S. (or any other country) can increase its GNP and thus its standard of living. Perhaps a simple example will illustrate this rather subtle point.

B. Example of comparative advantage in an office

Suppose a certain woman is not only the best administrative assistant available,

but is also a better typist than anyone who can be hired. That is, she has absolute advantage in both activities. Common sense tells us that the total productivity of the office will be greater if she specializes in administration, where the greater absolute advantage lies, and if somewhat inferior typing ability is "imported." Ask the students to give other illustrations of this principle.

C. Internal cost ratios in nations

In the case of national economies this principle shows itself as internal cost ratios between goods. Suppose Country A can produce an additional 10 units of food by giving up only 3 units of cloth, while Country B, because of different natural endowments, can produce an additional 10 units of food only by giving up 8 units of cloth. The cost-ratios of food to cloth (10-to-3 in A and 10-to-8 in B) are different.

1. Other factors unimportant

This is all that need be true for trade to be mutually advantageous. The relative levels of wages, standards of living, etc. in Countries A and B are really of no consequence.

2. Further illustration

Suppose that demands and supplies in international markets for food and cloth yield prices such that 10 units of food can be exchanged for 5 units of cloth. Country A can now specialize in food production and for each 10 units it exports it can now get 5 units of cloth, 2 more units than if it tried to be self-sufficient and produce its own cloth. Similarly, Country B can now specialize in cloth and for each 5 units it exports it will get 10 units of food. Remember that if B tried to be self-sufficient it would have to give up, not 5, but 8 units of cloth to get 10 of food. As a result of such trade both countries are able to consume more of both food and cloth.

3. Specialization is applied

Both enjoy higher standards of living as a result of specialization and international exchange. Interferences with freedom of such exchange would deny these potential increases in standards of living. Such barriers to exchange

are discussed in Lesson 10.

D. Discussion

Have students speculate about what would happen if the international exchange ratio, because of worldwide supply and demand, turned out to be 10 food for 2 cloth. EXPLANATION: Assuming that the production ratios of food and cloth for Countries A and B remain the same as given above, no trade between A and B would take place. They would both try to export cloth. There would be no buyers unless another country's production ratio was say, 10 food for 1 cloth.

III. Balance of Trade and Payments

As a result of comparative advantage, nations export and import a wide variety of goods and services.

A. Favorable balance of trade

If a nation exports more value to other nations than it imports from them, it is said to have a *favorable balance of trade*. The U.S. has, until recent years, usually enjoyed such a favorable balance. However, in 1971-72, the U.S. imported sustantially more than it exported. Moreover, because of our need to import energy resources in the coming decades, we may have to learn to live with even more unfavorable balances of trade.

1. Payment for imports

Of course, even if a nation imports more than it exports in a given year, it must somehow pay for everything it buys. When a nation exports goods and services it gets a credit on its international payments accounts; when it imports it chalks up a debit.

B. Unfavorable balance of trade and payments

A nation with an *unfavorable trade balance* will, as a result of these exchanges, end up with a debit. But the *balance of payments* must be achieved and this debit must be *covered*. This can be done either by exporting gold to cover the difference, or by *borrowing* to cover the debit, which is the same as "exporting IOU's."

C. Favorable balance of trade and payments

On the other hand, a nation with a *favorable balance of trade* (exports greater than imports) would find that

gold would flow in, or it would be *lending* to other countries (that is, importing IOUs) to achieve balance of payments. (Tables showing the U.S. balance of payments are in McConnell, p. 748 and Samuelson, p. 657).

D. Discussion

Discuss with students the impact on U.S. balance of payments of the following:

1. Americans send gifts of money to relatives in Europe. EXPLANATION: This is a debit and acts as an import.
2. An Israeli student pays his way through an American medical school. EXPLANATION: This is a credit, acts as an export.
3. American army officers in Germany switch from German beer to canned Budweiser (American beer). EXPLANATION: This is a credit, acts as an export.
4. An American pays insurance premiums to Lloyds of London. EXPLANATION: This is a debit, acts as an import.
5. Argentina ships wheat to India in an American ship. EXPLANATION: A credit, acts as an export.
6. U.S. sends free wheat to famine-stricken Africa. EXPLANATION: This has no effect, it is as though we sent American dollars to Africa, a debit, to buy the wheat which we exported, a credit. Debit and credit cancel each other.

IV. International Movements of Capital

A. Short-term capital

Movements of short term capital to settle a balance of payments have been discussed. Short term capital also moves from one country to another seeking higher interest rates. This can be a problem when a country faces a balance of payments deficit. When investors lend short term in foreign countries that is, import IOU's, it worsens the payments deficit. This was a problem in the U.S. in the 1960's when we were trying to keep our interest rate down to stimulate economic growth. (See Lesson 8.)

B. Long term capital	International investment, that is, purchases of long term securities such as stocks and bonds is growing in importance. When Americans make such long term investments overseas this has the immediate effect of an import. (We are importing long term IOU's.) When dividends and interest begin to be earned on these investments, these payments have the effect of an export on our balance of payments--we are exporting enterprising activity and the use of capital.
C. Discussion	Discuss with students the short and long term effects when the Japanese invest in business in the U.S. EXPLANATION: The effect is just the opposite of what is described above.
D. Effects of movements of long term capital	In general, international movements of long term capital among industrialized countries is beneficial overall since capital is seeking its most productive uses. However, on a large scale, it does make the highly developed nations economically interdependent, that is, severe inflation or recession in one country will have repercussions in all others. One serious global problem is the promotion of movements of long term capital from developed to developing nations. This is discussed in Lesson 10 in connection with the World Bank.

Lesson 10

Problems in International Trade

OBJECTIVE

To identify and describe problems in international trade and some attempts to solve them

CONTENT OUTLINE	TEACHING SUGGESTIONS AND REFERENCES
	Basic references for Lesson 10 are: Bach, Chs. 39, 41; McConnell, Chs. 44, 45 (pp. 796-800); Samuelson, Chs. 35, 36.
I. Barriers to International Trade	Barriers to international trade are of many varieties. However, three stand out as most important: *embargoes*, *quotas*, and *tariffs*.
A. U.S., a free trade area	One of the secrets of American economic success is that the Constitution forbids the states to erect barriers to trade against each other. This makes the United States a *free trade* area. The comparative advantages of various areas of the country have been exploited with astounding success by use of regional specialization and free exchange.
B. Policy on protectionism 1. Protected home industry	However, the U.S., like most other trading nations, operating with the half-truth that nations should always protect *home* industries and strive for a favorable balance of trade, has pursued a policy of *protectionism*. That is, it has used *embargoes* (flat prohibitions on imports and exports), *quotas* (limitations on the amount of imports or exports) and *tariffs* (taxes levied on imported goods). Since its beginning and up until 1934, the U.S. followed a longrun policy of higher and higher tariffs. This was especially true in the 1920's.

2. Protectionism eased off

The trend *peaked-out* in 1930, and with the Reciprocal Trade Agreements Act of 1934, American policy began a general lowering of tariffs. The President was empowered to negotiate reductions of our tariffs up to 50 percent with nations willing to offer similar concessions. Also, *most favored nation* clauses in such agreements—by which the U.S. offered similar concessions to other cooperative nations—were an attempt to promote wider tariff reductions.

3. GATT

After World War II, to lessen chances of a new outbreak of *economic warfare* (which almost destroyed international trade in the 1930's), 23 nations, including the U.S. signed the General Agreement on Tariffs and Trade (GATT). Since then other nations have joined the agreement which pledges equal treatment of all members, the reduction of tariffs by multilateral negotiation, and the elimination of import quotas.

a. Not fully successful

Some removal of trade barriers has been brought about by GATT, but it has not been an unqualified success. For instance, in the late 1950's, the U.S. imposed quotas on imported crude oil and in August, 1971, raised tariffs 10 percent.

II. Effects of Barriers to Trade

A. Arguments to defend barriers

Many arguments have been advanced in defense of barriers to international trade such as: attainment of national self-sufficiency, protection of *infant* industries, protection from the competition of cheap foreign labor, keeping money in the country, protecting domestic employment, etc. However, economic analysis suggests that most of them interfere with free trade and the possibility of exploiting comparative advantages and are fallacious in that they lower standards of living everywhere.

1. Self-sufficiency and infant industry

The national self-sufficiency argument may have validity, but it is a political, not economic, validity. The infant

industry argument may be partially valid, because new industries may have to be protected from established industries elsewhere to explore the potentials of comparative advantage. This industry might bring benefit to all trading nations.

B. Discussion: Total protectionism

Discuss with students the total effect of all countries putting tariffs on all goods so they sell for the same price in all countries. EXPLANATION: The effect would be that consumers everywhere would have to pay a price which would cover the costs of the *least efficient* producer in the world!

C. Discussion: An inefficient home industry

Discuss with students the effect on the price and consumption of oranges in New England if New England could levy tariffs and decide it should promote a New England orange industry by exercising this power. To protect the "home industry" a tariff would have to raise the price of "imported" oranges high enough to cover the cost of growing hot-house oranges; the price would be phenomenally high and consumption very low. Moreover, since California and Florida would now not be able to export as much to New England, they could not afford to buy the exports of New England. Put in these terms, the bad economic effects of very high protective tariffs are thrown into bold relief.

III. Common Markets

A. Mercantilism in Europe, etc.

Europe and other parts of the world were not as lucky as the U.S. during the 19th century and first half of this century. Mercantalist thinking (which holds that complex barriers to trade are necessary to insure a favorable balance of trade and bring gold and silver into a country) dominated the 17th and 18th centuries. This thinking and political fragmentation made sensible economic unity and unhindered trade virtually impossible. Many small soverign states erected all kinds of barriers to trade with each other.

B. European Common Market

However, after World War II, from the small beginnings of the Benelux Plan (freer trade among Belgium, the Netherlands, and Luxembourg) and the Schumann Plan (freer trade in coal and iron ore between France and West Germany) there grew the European Common Market, established in 1952.

1. Purposes

The members (France, West Germany, Italy, Belgium, the Netherlands, and Luxembourg) pledged themselves to:

- Gradual elimination of all trade barriers among themselves on all goods
- A common system of tariffs on imports from nonmembers
- Free movement of labor and capital within the European Economic Community
- Adoption of common policies toward atomic energy, anti-monopoly laws, transportation, and other matters

2. A successful organization

Judged in terms of results, such as increased growth rates, the Common Market is generally regarded as an outstanding success.

C. European Free Trade Association

Similarly, in the 1950's England (which has since joined the European Common Market) and several Scandinavian (and other) countries formed the European Free Trade Association, a somewhat looser organization dedicated to freeing up trade among themselves.

1. Reasons for less success

The success of EFTA has been decidedly less spectacular. This can be traced in part to the unwillingness of the member countries to surrender any of their sovereign powers. This was not the case in the European Common Market, where some supranational agencies were permitted. Since Ireland and Denmark have also joined the European Common Market, the secondary free trade area (as of 1974) consists of Austria, Norway, Portugal, Sweden, and Switzerland.

D. Organization in other areas

Other areas of the world, such as Central and South America, are also

planning for and implementing their own *common markets* with varying degrees of progress.

E. Problems of common markets

But still a serious problem exists. Though common markets *free up trade* within the areas they include, they also *erect tariff barriers* around this area. Thus, though more and more areas of free trade are being formed throughout the world; the problem of lowering and eliminating barriers *between* free trade areas remains to be solved. GATT has already made progress on this problem, notably in the "Kennedy round" of negotiations begun in 1962.

F. Discussion

Discuss with students long term global implications of this trend and recent efforts of the U.S. to open up trade with the USSR and Mainland China. SUGGESTION: There is great potential for exploitation of comparative advantage on a global scale with resultant increases in economic productivity. Speculate about increasing population pressures in the future forcing us toward free trade on a global scale.

IV. Severe Adjustment Problems

A. In 1930's depression

During the 1930 depression years many nations, in the hope of increasing exports to ease domestic unemployment, devalued their currencies.

1. Example of devaluation

For instance, if the U.S. decreed that the British pound, which had been worth 3 dollars were now worth 4 dollars, Englishmen would be able to buy American goods with fewer pounds than before. In effect the prices of all U.S. goods to foreign buyers would be lowered. This would stimulate exports and put Americans to work. The U.S. would be "exporting" its unemployment.

a. Retaliatory devaluation

Since no country wants to "import" unemployment, retaliatory devaluations would probably be initiated by other nations to cancel the U.S. advantage in international markets. Such economic

warfare was common in the 1930's, and the uncertainties all but dried up international trade.

B. After World War II

A. Economic difficulties in Europe

After World War II, England had to import some of its food to survive. Because of war damage, that country found it hard to produce and export to pay for its food, and ran short of U.S. dollars and other currencies to settle its international accounts. Other European countries had similar problems.

1. Temptation toward devaluation of currency

Note that England might have been tempted to devalue its money and to put stringent restrictions on imports.

V. International Monetary Fund Established

To ease postwar problems and prevent a return of the "dog-eat-dog" policies of the 1930's, the allied countries of World War II established the International Monetary Fund (IMF) in 1944, to manage a relatively fixed exchange rate system.

A. How it works

Member countries pledge to keep their exchange rates from fluctuating more than 10 percent from par values by establishing *stabilization funds* of their own. Such funds could be used to buy and sell various currencies to keep exchange rates within the agreed limits. Also gold and domestic currencies were contributed by member nations to IMF.

1. Nations can borrow.

Thus a nation faced by a temporary shortage of a foreign currency could borrow, pledging its own currency as collateral.

2. Helps problems of fluctuating exchange rates

This helped solve the problems of drastic fluctuations in exchange rates and of temporary shortages of foreign currency.

3. Chronic balance of payments deficits in England

In 1949 and 1967 England had a chronic problem with balance of payments deficits. This was solved by allowing England, after appropriate negotiations, to devalue with assurance of nonretaliation. This international monetary

system permitted trade to expand greatly in the postwar decades. It worked pretty well—for a while.

VI. Need for International Monetary Reform

A. U.S. balance of payments deficits

During the past two decades, as a result of the growing productivity of other nations, domestic inflation, and large outflows of investment funds and economic and military aid, the U.S. faced persistent and substantial deficits in its balance of payments.

1. Background: After World War II

At the end of World War II, the U.S. held something like half of the known gold supply of the world. The dollar overseas could be freely converted to gold and our Government kept the price of gold at $35 an ounce. We could do this because we controlled the supply. Moreover, since American dollars overseas were "good as gold," they often performed the functions of gold, that is, became the basic reserves of various monetary systems. However, as the U.S. balance of payments deficits accumulated, as claims against our gold increased, and as our gold reserves decreased, we could no longer maintain this stance.

2. Suspended convertibility of dollar into gold

The U.S. Government finally, in August 1971, took action on this problem by suspending international convertibility of dollars into gold. The dollar was allowed to *float*, that is, to have its value in other currencies determined by demand and supply in international exchange markets.

a. Caused devaluation of dollar

This action permitted the U.S. dollar, which was overvalued at $35, to be devalued. It made American goods relatively cheaper in international markets, stimulating U.S. exports (and inhibiting imports) and easing our payments deficit problem.

B. Shortage of international media of exchange

Another problem which has grown increasingly acute, is that international trade has grown much faster than the supply of *international moneys* such

as gold, the old convertible U.S. dollar, and various credit instruments. Trade is hampered by a shortage of media of exchange. Because of this, more barter (goods for goods) exchanges are being used. Thus the U.S. inconvertibility and *free float* policy, and the shortage of international media of exchange have made the old IMF semipegged exchange rates and short term lending obsolete. Trading nations are temporizing with "paper gold" *(special drawing rights)* created by the IMF, as they strive to design a new viable international monetary system.

C. Discussion

Discuss with students the obstacles in the way of establishing a single international currency and credit system, with fractional reserves as in the U.S. and other developed countries. SUGGESTION: The basic obstacle is sovereignty. Nations are unwilling to give up any of their powers in the face of international political anarchy. More specifically they are reluctant to surrender the power to control their money supplies and pursue domestic monetary policies for full employment, growth, and price stability.

VII. The World Bank

At the conference which set up the IMF (Bretton Woods, 1944) the International Bank for Reconstruction and Development (the *World Bank*) was also established.

A. Purposes

As the name implies it's purpose is two-fold. Initially, it was to supplement the United Nations Relief and Rehabitation Administration (UNRRA) and the Marshall Plan to help finance the reconstruction of production facilities in war-torn Europe. And it was to begin what has now become its major activity—helping under-developed nations to grow economically.

B. Make loans and guarantees loans

Some 113 nations have purchased (in proportion to their economic importance) about $23 billion in capital stock which can be lent out on favorable

terms to developing nations. The World Bank can sell highly rated bonds in affluent countries and lend out the proceeds and, for a small premium, it can guarantee private loans to developing countries. Thus it not only lends its own money for such basic projects as railroads and power plants, but can also stimulate the flow of private capital from developed to less developed nations.

C. Activities expanded through IDA and IFC

Generally speaking, the World Bank is judged as a success, though critics might add the word *modest*. In recent years, under the leadership of Robert McNamara, its activities have been expanded through the International Development Agency (which makes loans to improve social capital such as education and hospitals), and the International Finance Corporation (which lends to special foreign *banks* to finance private investment projects).

D. Discussion

Show students price quotations of World Bank Bonds in the *NY Times* or *Wall Street Journal*. Discuss with students the obstacles to the free flow of private capital from developed to developing nations. SUGGESTION: Mention fear of political instability and expropriation, worry about special new taxes, anti-colonial feelings, etc.

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