NWU ®

MBAA 813 EC

MANAGERIAL ECONOMICS

Faculty of Economic and Business Sciences

Study guide compiled by: Prof A Heymans

North-West University

It all starts here

- Ranked in the top 5% of universities globally by the QS-rankings
- Contributes the second largest number of graduates annually to the labour market

Dit begin alles hier

- As een van die top 5% universiteite wêreldwyd deur die QS-ranglys aangewys
- Lewer jaarliks die tweede meeste graduandi aan die arbeidsmark

Gotlhe go simolola fano

- Re beilwe mo gare ga diyunibesiti tse 5% tse di kwa godimo go ya ka peo ya maemo ya QS
- Ngwaga le ngwaga go abelwa palo ya bobedi ka bogolo ya badiri mo maketeng ya badiri

MODULE CONTENTS

Module information

Module code	MBAA 813
Module credits	12
Module name	Managerial economics
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Consulting hours	

Word of welcome

The Theory of Economics does not furnish a body of settled conclusions immediately applicable to policy. It is a method rather than a doctrine, an apparatus of the mind, a technique of thinking which helps its possessor to draw the right conclusions.

John Maynard Keynes.

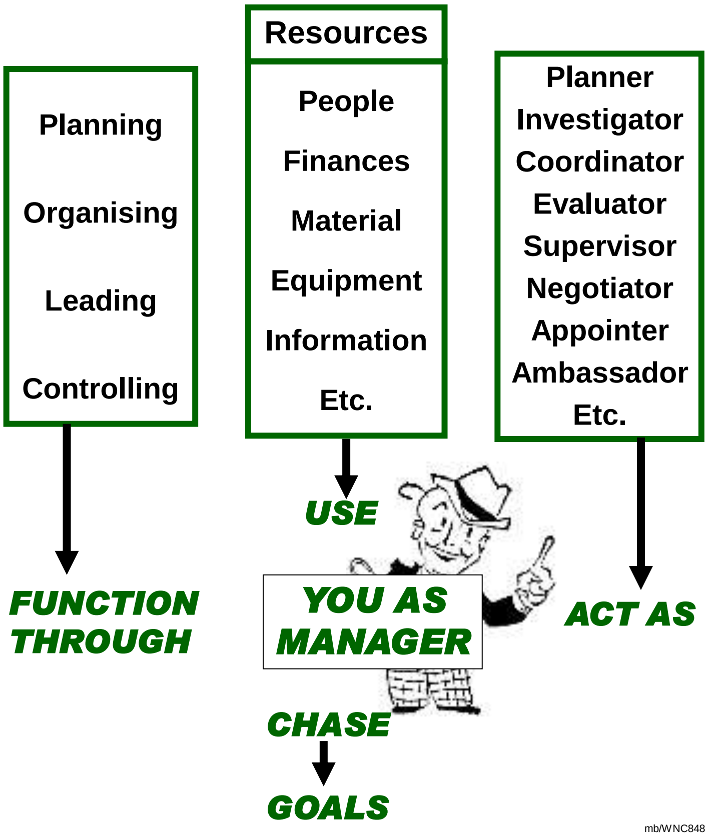
Economic problems are some of the most serious problems modern communities have to deal with. Demands for higher wages, constant price increases prices and rising cost of living, balance of payment uncertainties, et cetera, present all types of economic agents with constant and pressing problems. Worldwide the past year has been characterised by a rapid growth in management education. Economics has always played an important role in the education and development of future managers. Business managers should set objectives en design strategies in order to achieve these objectives. To do this effectively, the manager should understand the *internal environment (*consisting of components such as facilities, personnel and management and which is complex, though manageable) as well as its external environment, and then facilitate a match between these two environments. The *external environment* is obviously more complex and much less controllable. The better known elements of this environment are the suppliers, government regulations and competitors. However, it also includes the legal system, government regulations and the *overall economy.* **The manager's interaction with the overall economy forms the focus of this module.** *An insufficient understanding of and reaction to this part of the company's environment makes it difficult for managers to succeed in their strategic initiatives.*

Managers are by nature decision makers and they all have a limited number of production factors at their disposal. A Key challenge is the allocation of these resources to maximum advantage of the business unit. In other words, it is all about *scarcity*, where exchange takes place – and which resulted in the study of economics. The current economic environment is subject to an ever increasing rate of change and the task of the manager to have the organisation (be it big or small) adapt to this change, is becoming more and more difficult. These days a manager is not only concerned with the traditional business decisions of finance, production and marketing. Practical decisions are being complicated; there are so many variables that it becomes impossible to solve problems without the HULP aid of sociology, psychology, statistics, etc. *After all, management is the process of deciding what the best way would be to se an organisation's resources in order to produce goods or provide services.* To take effective steps to solve problems, everyone's available knowledge should be combined. **Decisions can only be effective if they are based on an understanding of the economic tenets upon which all business activities are based, and a knowledge of the business environment in which the business functions.** The manager should also be able to apply that knowledge. This module concentrates on conveying that knowledge which a manager should possess.

"Management is getting things done through people!"

Individual activity

- Relate the message in the diagram below to the context of this module and to you as a manager.
- Does the diagram make any appeal DOEN BEROEP to you to make changes, either with regard to yourself or the way in which you are currently doing things?



The value of studying economics is found in decision making through logical and methodological thinking. Managerial economics can thus be described as the use of economic logic and principles to assist management with their decision making. This implies micro and macro economics, although as such it cannot be a comprehensive course in economics. In *micro-economics* it concentrates in particular on those aspects that assist in economic decision making, such as the law of diminishing returns, opportunity costs, etc. As regards *macro-economics,* we may conclude that the correct internal decisions can only be made if the external forces affecting the business are fully understood – such as a deficit on the current account of the balance of payments, which can ultimately have an effect on financing costs.

This module in managerial economics should help you to acquire a clearer understanding of the myriad of problems the business world has to deal with. I hope that this course will help explain the importance of the subject field and will help you to increase your appreciation for the dynamics and its action-reaction nature – which will hopefully lead to a lifelong interest in and appreciation of economics.

Enjoy this dynamic subject!

Prof. André Heymans

Module outcomes

The art of economics consists in looking not merely at the immediate but the longer effects of any act or policy; it consists of tracing the consequences of that policy not merely for one group but for all groups ...

After you have studied the relevant material, you will realise that any economic system is about *people*: people's activities, people's energy, people's objectives, people's achievements, people's failures, people's decisions, people's outputs, etc. And because ECONOMICS is about PEOPLE, it has been said that economics is similar to raising children: very few people are really experts in the field, but everyone regards his or her theories and perspectives as absolute indisputable!

Because of the human factor, economic is mainly a *subjective social science.* Opinions and interpretations play a crucial role in any economic analysis and projection – hence the saying: *"Wherever you have two economists, you will have three opinions."*

Managerial economics is the study of how to use scarce resources in such a way that a management objective is achieved in the most efficient way.

It is a very wide discipline that describes methods that can be used to utilise something – from a household's resources to maximise national wealth, to a business's resources to increase profits.

The **overall objective** of this module in economics is to provide the basic reference and application framework so that you acquire a wider understanding of the economic issues that apply to this management area.

Outcomes

Upon completion of this module you should be able to do the following:

- Demonstrate a systemic knowledge of macro- and micro-economics;
- Apply the general principles of economics on business models;
- Analyse contemporary economic phenomena in the market and evaluate these against the existing knowledge (theories or norm). This implies the ability to make interpretations based on that phenomenon (explanatory ability);
- Apply research skills when solving specific empirical problems in the South African economy, as well as particular identified international economic events;
- Communicate effectively in individual as well as syndicate groups the results of any selected and prescribed assignments;
- Demonstrate the ethical principles implied in most of these management issues;;

- Illustrate value judgements relating to economic decision making and normative economic enquiries; and
- Apply the concept of the so-called triple bottom line in practice.

Assessment criteria

You will have mastered the module outcomes when you are able to do the following:

- Explain what economics as a scientific discipline deals with;
- distinguish between macro-economics and micro-economics;
- practically apply the concepts of positive and normative economics;
- explain the "economic problem" in all its applications;
- distinguish between the different role players, participants and agents in the circular flow of money-goods-services and the related interdependency between sectors and markets in the economy;
- explain the relevant theories, concepts and factors that have an impact on the behavioural patterns of the various market participants in economic activities;
- distinguish between the ways in which an economic problem can be managed *vis-à-vis* an economic system;
- discuss the different economic laws of and participants in supply and demand, pricing and the related elasticity;
- prepare a business plan and utilise it as an instrument through which market forces meet (as a practical application);
- evaluate the current economic situation in the South African context;
- explain a number of ways that can be used to measure economic performance;
- apply and discuss the Keynesian macro-economic equation in income determination;
- analyse the basic economic-theoretical explanations of business phenomena such as economic activities, economic/business cycles and set out the practical implications of these;
- write explanatory notes on the economic significance of the GDP variable;
- analyse economic growth and unemployment;
- analyse economic policies such as those if the monetary, fiscal, labour and international markets and put the implications and impacts thereof in a business context;
- recognize the different markets in an economy and identify the different drivers in each market;
- discuss the merits and implications of the competitive market structures that can be identified;
- explain the micro-economic factors of the firm from a costing, production and profit perspective;
- conduct a fundamental analysis of economic phenomena in the context of decision making on managerial/executive level;
- derive and apply the principles from the field of economics;
- design a macro-economic framework; and

- conduct successful research about any specified group activities and present a concise account of the main viewpoints or findings.

Prescribed books

- JANSE VAN RENSBURG,J, MCCONNELL, CR & BRUE, SL. 2015. Economics – second South African edition. McGraw-Hill.

and;

- A recent copy of the Quarterly Bulletin of the SA Reserve Bank

ADDITIONAL LITERATURE

A comprehensive variety of study material is available for your to consult, e.g:

- BESANKO, D & BRAEUTIGAM, RD. 2008 Microeconomics. John Wiley & Sons.
- BRADLEY, T. 2008. Essential Mathematics for Economics & Business. 3rd Edition. Wiley Publishers.
- BROWNING, EK. & ZUPAN, MA. 2009. Microeconomics: Theory & Applications. Wiley & Sons Publishers.
- COLANDER, DC. 2008. Economics. Seventh Edition. McGraw-Hill. Irwin: Boston. 819p.
- FROEB, LM & McCANN, BT. Managerial Economics – A problem Solving Approach. South-Western, Cengage Learning.329p.
- GOOSEN, W, PAMPALLIS, A, VAN DER MERWE, A & MDULI, L. (Latest Edition). Banking in the New Millennium. Juta: Kenwyn.
- HALL, RE & LIEBERMAN, M. (Latest edition). Economics – Principles and Applications. South-Western: Australia.
- HIRSCHEY, M. Managerial Economics. International Student Edition (12th). South-Western, Cengage Learning. 833p
- HIRSHFSTEY, M, PAPPAS, JL, & WHIGHAM, D. (Latest Edition). Managerial Economics. European Edition. Dryden Press: London
- KEAT, PG & YOUNG, PKY. Managerial Economics – International Edition. Economic Tools for Today's Decision Makers. New Jersey. Prentice-Hall.
- KRUGMAN, P & WELLS, R. Economics. New York: Worth Publishers.
- LOTRIET, RA. Economics, *Ceteris Paribus*. Potchefstroom.
- LOTRIET, RA et al. Basic Macro & Micro Economics. Potchefstroom.
- MANKIW, G. (Latest edition). Principles of Macroeconomics. (Harvard): Fort Worth. Harcourt Publishers.
- MANSFIELD, E. Microeconomics. Norton Publishers: London.
- MOHR, P & FOURIE, L & Associates. 2008 (Fourth Edition). Economics for South African Students. Van Schaik Publishers: Pretoria. 534p.
- MOSS, D.A. 2007. A Concise Guide to Macro Economics. Harvard Business School Press.
- PETERSON, H.C., LEWIS, W.C. (Latest edition). Managerial Economics, McMillan Co.
- PUG, I & LEHMAN, D. 2007. Managerial Economics. Blackwell Publishing. Hong Kong.

- SMIT, PC, DAMS, D.J., MOSTERT, J.W., OOSTHUIZEN, A.G., VAN DER VYVER, T.C. en VAN GASS, W. Economics: A Southern African Perspective, Juta & Co. Ltd. Latest edition.
- VAN ZYL *et al*. 2009. Understanding South African Financial Markets. 3rd edition. Van Schaik Publishers: Pretoria
- WILKINSON, N. 2008. An Introduction to Behavioural Economics. Palgrave Macmillan. New York. 511p.
- BAYE, MR. 2010. Managerial Economics and Business Strategy. McGraw-Hill International Edition. 621p.
- THOMAS, RC & MAURICE, SC. 2011. Managerial Economics. Foundations of Business Analysis and Strategy. McGraw-Hill International Edition. 747p.
- MANKIW, GN & TAYLOR, MP. 2011. Economics. South-Western, Cengage Learning: United States. 902p.
- The Quarterly Bulletin of the South African Reserve Bank
- Regular publications of financial service institutions
- Finweek; The Economist; Business Week, Financial Mail, Finansies en Tegniek and other business journals

Suggested study process

The **prescribed material** will provide you with basic information, and this study guide will help you and add constructive value to your learning process. Studying your prescribed handbook will help you to understand the dynamics of economics and the challenges it has to overcome in this part of the world. However, I suggest that you also look daily at the additional literature that w mentioned in the previous section. This will serve to enrich yourself, **expand** your knowledge of the field of Managerial economics and add significant momentum to your learning process.

You have enrolled for this MBA degree with the aim of becoming a "master in business administration". This program was not designed to develop you into a super theoretical economist, but rather to synthesise and enable you to master your business within the context of a constantly changing and dynamic economic environment. This is why i suggest that you get constant exposure to the abovementioned and also other business-related publications. It will help you to acquire an understanding of the dynamics of this discipline and also *to formulate answers to contemporary issues, since many of these will be of an empirical nature* – which means that you will also have to do some research.

Economics is a subject that cannot be viewed in isolation: it is a multi-disciplinary en multi-facetted terrain that can be applied everywhere. To illustrate this: Throughout this module we refer to GDP – which is of course the variable that we use to measure economic growth.

In addition to all the normal requirements that apply to individual and group assignments, we will also expect you to prepare a short research document in writing (2 copies), that will serve as a group discussion document about a specific topic. The different topics will be provided in class or in the study guide. The contact lecturer will **start** with a short discussion session, during which all the groups (designated group leaders) will have to give feedback. To ensure effective participation, you should bring two copies to the sessions (one for your group and one to hand in during the class session). **No excuses** will be accepted if you do not have your copy available in class! These copies should certify that EVERYONE has participated in preparing the assignment and that it can be used as part of your final module participation mark. In any event, it forms part of the prerequisites for you to qualify for admission to writing the final paper in managerial economics. The maximum length is three typed A4-pages.

Assessment criteria

Formative assessment

Participation mark

- You will need a participation mark of at least 40% to gain admission to the examination.
- **Participatory assignments during the contact sessions:** During the contact sessions you will be expected to complete assignments either individually or in groups, which will then be handed in and assessed. *You will be expected to present business case studies or assignments to the rest of the class.*
- **Assignment(s)**: You will also be expected to submit formally scheduled assignments. The dates of these assignments are not negotiable and MUST be completed according to the instructions in your module plan.

☞ **VERY IMPORTANT:** If you do not submit any of these assignments you will be awarded a ZERO mark. NO late assignments will be accepted and participation in social, sport or cultural activities and work-related matters will NOT be considered valid excused for not submitting assignments on time!

The composition of your participation mark

The information below is only a *preliminary* suggestion on how weights may be awarded to the different formative assessments, and the lecturer may adjust these at any time.

Criteria	Weight in %
Assignments during contact sessions	10
Scheduled assignment(s): Individual	40
Scheduled assignment(s): Group	50
TOTAL	**100**

Summative assessment

Examination mark

You will write an open book examination during November. The question paper will count out of 100 and be four hours long. You will need a sub-minimum of 45% for the examination in order to pass the module. So, say your participation mark is 75% and you obtain 35% in the examination – you will then receive a mark of 51% (75 = 40% + 35 = 60%). However, you will still *fail* the module, as you did not obtain the sub-minimum of 45% in the final (examination) paper.

Module mark

Your final module mark is calculated by combining your participation mark and examination mark. The marks are calculated in the following ratio:

Participation mark 40%

Examination mark 60%

In order to pass the module, you require a module mark of at least 50%.

- Furthermore: A learner on this programme has six months to complete a particular registered module (excluding the dissertation).
- Admission to the examination in a specific registered module is subject to *satisfactory progress* (your participation mark) in the required learning content of a module.
- *The final examination on this management training programme is an open-book examination,* which implies that you are allowed to bring additional learning material into the examination room – your lecturer will provide you with more information about this. However, you should still prepare yourself thoroughly based on your study guide, the class contact sessions presentations and the specific outcomes of the learning units (which you can also find at the beginning of each chapter in your prescribed book).

Assignments

“Knowledge, like any other scarce and precious possession, does not come of its own accord. You will have to look for it” – Faith Forsythe

Individual assignment

Submission date:

Will be announced by the module lecturer.

Group assignment

Submission date:

Will be announced by the module lecturer.

Credits and notional academic hours

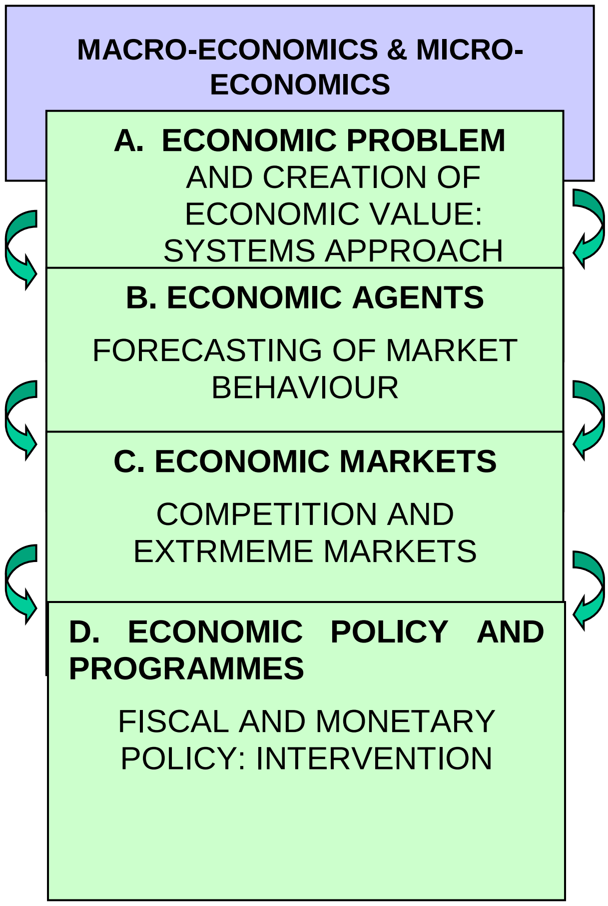
Each module has a specific number of credits. MBAA 813 is a *12-credit module*.

Notional hours refer to the number of hours that an average student has to spend on a specific module in order to pass that module. These notional hours include the time that the student is engaged in the module, that is, by attending contact sessions, studying for tests and examinations, group work, preparation, research for module assessments, etc. It thus refers to all the time that is spent on the module.

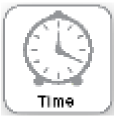
The notional hours are calculated by multiplying the number of credits by 10. It implies that you have to spend 120 hours on this module in order to be successful. Remember that we refer here to the *average* student, and that the time required by each student to master the learning content will vary.

Themes for contact and group interaction sessions

MODULE STRUCTURE



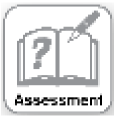
Icons



Time allocation

Learning outcomes

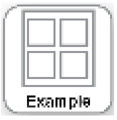
Study material



Assessment / Assignments

Individual exercise

Group Activity



Example

Reflection

Warning against plagiarism

ASSIGNMENTS ARE INDIVIDUAL TASKS AND NOT GROUP ACTIVITIES. (UNLESS EXPLICITLY INDICATED AS GROUP ACTIVITIES)

Copying of text from other learners or from other sources (for instance the study guide, prescribed material or directly from the internet) is **not allowed** – only brief quotations are allowed and then only if indicated as such.

You should **reformulate** existing text and use your **own words** to explain what you have read. It is not acceptable to retype existing text and just acknowledge the source in a footnote – you should be able to relate the idea or concept, without repeating the original author to the letter.

The aim of the assignments is not the reproduction of existing material, but to ascertain whether you have the ability to integrate existing texts, add your own interpretation and/or critique of the texts and offer a creative solution to existing problems.

Be warned: students who submit copied text will obtain a mark of zero for the assignment and disciplinary steps may be taken by the Faculty and/or University. It is also unacceptable to do somebody else's work, to lend your work to them or to make your work available to them to copy – be careful and do not make your work available to anyone!

Plagiarism is a serious offence and you should familiarise yourself with the plagiarism policy of the NWU. http://library.nwu.ac.za/copyright-and-plagiarism

Please refer to the *Policy on Academic Integrity* which is found on the following website: http://www.nwu.ac.za/content/policy_rules

Learner activities

Individual activity

THEME: Create economic value and economic reasoning

The one lesson for business: The art of business is found in the identification of assets in low value uses and the designing of ways to move those to higher valued uses in a profitable manner.

YOUR COMMENTS?

If we analyse the different elements of the economy, we acquire an insight into the basic background of a number of specific characteristics of the South African economy. It involves a few of the challenges of the South African economy, key objective and role players that are in constant **interaction** with one another.

Important information

Remember that interaction is an important characteristic of economic variables – for example; the value of the rand has an impact on the inflation rate and eventually also the interest rates in the economy.

Group activity

The state of the South African economy

*	Do research on the current performance of the South African economy an d report back on your findings to the rest of the class.

**	Which inter-dependencies did you discover in the course of your research?

***	Based on the above, forecast the immediate future for your particular industry. (If you are involved in more than one industry, choose the most representative one).

Important information

Various measures may be used to *assess the performance of an economy over time.* The performance can then also be compared to that of other countries. The point here is that the dynamics of the international economy has an enormous impact on the South African household, as illustrated by the following letter to *Business Day*:

Individual activity

CEO Confidence Remains Unchanged in Second Quarter

The Conference Board ***Measure of CEO Confidence™***, which had increased marginally in the first quarter of 2019, was unchanged at 43 in the second quarter of 2019 (a reading of more than 50 points reflects more positive than negative responses).

“CEO Confidence was unchanged in Q2, and remains at a moderately pessimistic level,” said Lynn Franco, Senior Director of Economic Indicators at The Conference Board. “CEOs’ expectations for growth prospects in mature and emerging economies remain subdued, with no pickup anticipated in the short-term. CEOs’ profit expectations have weakened compared to last year, with trade and tariff uncertainties and signs of a slowing global economy the likely causes of the deterioration.”

CEOs remain moderately pessimistic about current economic conditions, with 13 percent saying conditions are better compared to six months ago, down slightly from 14 percent last quarter. However, only 42 percent say conditions are worse, down from 46 percent in Q1. CEOs were less negative about current conditions in their own industries compared to six months ago. Currently, 21 percent say conditions are better, up from 12 percent last quarter.

Looking ahead, CEOs’ expectations regarding the economic outlook also remained relatively pessimistic. About 13 percent anticipate economic conditions will improve over the next six months, compared with 14 percent in the first quarter. Meanwhile, 44 percent expect economic conditions will worsen, up from 42 percent last quarter. CEOs’ expectations regarding short-term prospects in their own industries over the next six months were somewhat more pessimistic. Now, only 17 percent anticipate an improvement in conditions, down from 19 percent last quarter.

Global Outlook Still Pessimistic

CEOs’ assessment of current global conditions remains negative. Sentiment about current conditions declined further for the US. Europe and China saw an uptick, but overall, sentiment was still very downbeat. Sentiment for Japan and Brazil remained relatively neutral for both countries, though Japan saw an uptick. Sentiment regarding current conditions in India improved and were the most favorable.

Looking ahead, CEOs are still pessimistic about global growth prospects. India, however, remains an exception with short-term expectations improving marginally. Growth expectations for Japan, Brazil and the US were moderately negative, while CEOs viewed growth prospects in Europe and China the least favorably.

Profit Expectations Declined Considerably Compared to 2018

CEOs remain generally optimistic about profit expectations for the next twelve months, though much less so than last year. Now, about 69 percent expect profits to increase, compared to 91 percent last year. Executives in the durables industries are the most optimistic, with 75 percent expecting profits to increase, followed closely by CEOs in the nondurables industries, at 70 percent. Close to six out of ten CEOs in the service industries expect an increase in profits. Among chief executive officers who expect profits to rise, 43 percent say market/demand growth will be the primary driving force, down from 62 percent last year. One third cited cost reduction, up from only 15 percent in 2018. Price increase was cited by 18 percent of CEOs, followed by new technology (cited by 8 percent) as the primary source of improvement in profits.

Source: The Conference Board ***Measure of CEO Confidence™ (***https://www.conference-board.org/data/ceoconfidence.cfm)

Important information

The **AS/AD-model** is the macro-economic demand and supply model that explains how macro-economic equilibrium is achieved, and how movements in the total demand curves and total supply curved change the macro-economic equilibrium.

The "**Bathtub-statement** has to do with the leakages and injections in the circular flow. The leakages and injections represent the changes in total spending. *Leakages* are uses of household income, excluding consumption of the GDP. It includes taxes (to the government), savings (by definition this is non-consumption), and imports ("lost" GDP as a result of the purchasing of outputs of foreign economies. *Injections* are spending by the government on foreign goods and services (also exports).

According to the Bathtub statement an economy grows when injections are bigger than leakages. The economy shrinks KRIMP when leakages are bigger than injections.

Important information

Read the following article by Amar Bhide (University of Colombia) about the strategic importance of market demand for any organisation or business – *Meeting needs is the key to growth!*

THEME: Demand and Supply -

MEETING NEEDS – THE KEY TO GROWTH

How concerned should advanced nations be about the outsourcing of manufacturing to China or software development to India?

Fear of jobs lost to low-wage nations strikes a populist chord, but misses a vital point: developed nations' prosperity hinges primarily on entrepreneurship.

After all, no economy can raise living standards forever through innovations that make production of existing goods more efficient. ***In the short run, more efficiency reduces the cost of a good or service, so people consume more of it****.*

Eventually though, consumers refuse to buy more even if prices continue to fall. After that, further efficiencies require the shedding of workers.

Creating and satisfying new consumer desires keep the system going by absorbing the labour and purchasing power released by the increasingly efficient satisfaction of old ones

At the other end of this process, producers who satisfy old desires continue economising, because they compete for employees and consumers with producers who satisfy new desires.

Similarly, outsourcing to low-wage countries improves living standards only if the human capital released can be used to make new goods and services. Otherwise, outsourcing merely reduces demand for domestic labour, just like other efficiency gains.

For many advanced economies, expansion of markets for new goods and services facilitates – and has been facilitated by – imports from low-wage economies. More than half of all manufactured goods consumed in the USA, for example, are made abroad, especially low technology, mass-produced labour intensive products.

Virtually all toys and shoes sold in the USA are made in the Far East. China alone makes up 86% of the USA bicycle market.

Resources released by these imports fostered the growth of industries that satisfy new needs. Cheap Asian televisions gave Western households the wherewithal to purchase PCs powered by Intel microprocessors and Microsoft software, which are designed by engineering graduates who would otherwise have worked for television manufacturers. To be sure, the speed and magnitude of the integration of nearly 1 billion Chinese and Indian workers into global labour markets is unprecedented and will hurt some workers in developed nations.

However, as long as these economies churn out new desires, outsourcing represents an opportunity for prosperity on both sides.

The problem is of course, that producers of new goods and services do not create new jobs at exactly the same rate as efficiency gains or imports reduce the demand for labour. Following the Internet boom of the late 1990s, job creation slowed, while efficiency improvements continued to reduce the labour required by the "old" goods and services.

Nor does the usual argument for free trade apply. Low cost call centres in India or Chinese made bicycles do not reflect any "natural" comparative advantage. Rather, costs are low because for almost two centuries colonial powers and then domestic governments hobbled markets and restricted international trade, leaving a legacy of wages so low that they offset weaker productivity.

Moreover, exports to low-wage countries cannot compensate for job losses. A Chinese worker simply cannot buy the same goods and services as a worker in the European Union; and workers in low-wage economies spend only a small portion of their incomes on EU products.

As incomes in China grow, imports from other low- or middle-income economies rise faster than imports from high-wage economies. China's trade surplus with the USA exceeds $100 billion, but it runs a deficit with India.

Uncertainty about jobs breeds anxiety, which stokes protectionist sentiments. **Apart from a few industries, such as toys and bicycles, far fewer jobs are lost to imports than to improvements in efficiency**.

Manufacturing employment in the USA fell to its lowest level since 1964, but thanks to a tripling in output per worker, total manufacturing output was about three times larger. **Pressure to reduce costs in the recent downturn** may have accelerated the movement of jobs to low-wage locations, but this accounts for only 15-35% of the decline in employment since the downturn began.

Austrian economist Joseph Schumpeter attributed the boom-and-bust cycles of the 19th century to periodic bursts of "creative destruction", followed by lulls in innovative activity. More effective use of countercyclical policies may have subsequently smoothed out the economic cycle, but this cannot explain why productivity and incomes also grew more rapidly than in the 19th century.

Standard supply-side arguments fare no better. After all, tax rates were higher in the previous century and regulation more extensive.

A critical factor is large-scale, non-destructive creation. Inventions from 1850 to 1900 may well overshadow those of the entire 20th century, but they were the result of a few inventors, such as Thomas Edison, who satisfied a small wealthy clientele. In the 20th century, many entrepreneurs, large companies, financiers and inventors developed products and services for the masses.

Moreover, their innovations created and satisfied many new consumer desires. Aeroplanes, for instance, did not reduce the demand for cars; people fly when they would not otherwise have driven. **These new mass markets sustained a steady increase in average incomes and total employment**.

Simply put, the long-term prosperity of developed economies depends on their capacity to create and satisfy new consumer desires. Provided this capacity remains in good repair, job “losses” – through improvements in the efficiency of domestic production or through outsourcing to low-wage economies – will enhance living standards.

If, however, this capacity is impaired, neither the low road of protection nor high road of free trade can do much good.

In the first part of your work schedule we referred to the fundamental economic challenge that faces both individuals and households, namely to satisfy UNLIMITYED NEEDS with LIMITED RESOURCES. We also investigated ways in which consumers and producers display rational behaviour based on sound economic principles in order to overcome the obstacle of GROWING NEEDS and UNFULFILLED MEANS. The analysis of consumer and producer behaviour in the market results in the DEMAND and SUPPLY curve, which will be discussed in MICRO- and MACRO-ECONOMICS.

Important information

We can summarise the rational behavoiour of consumers and producers as follows:

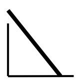
THEME: MICRO-ECONOMICS – INDIVIDUAL RATIONAL ECONOMIC AGENTS		
CONSUMER (Demand)	**vs**	**PRODUCER (Supply)**

Strives to optimise the satisfying of needs	vs	Strive to optimise profit
Employ the power of: Supply of labour Demand for products and services	vs.	Employ the power of: Demand for labour Supply of products and services
Strive to maximise reward for labour **and** to buy at the lowest prices	vs.	Strive to minimise reward for labour **and** to sell at the highest prices
CONSUMER	vs.	PRODUCER

SO WHAT BRINGS HARMONY, ORDER AND DISCIPLINE TO THIS UNUSIUAL BATTLE FIELD, THE MARKET?

The Law of Marginal Utility	vs.	The Law of Return

Demand

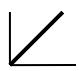


vs.

V A

The market:

Supply



vs.

A "battle field" of needs satisfaction

A "war" to maximise profits

Individual activity

Complete the table below and explain the economic significance of the variables in the table.

Income(y)	Consumption (C)	APC	APS	MPC	MPS
R40	R47				
R60	R58				
R80	R69				
R100	R80				
R120	R91				
R140	R102				

Important information

The annual budget represents **fiscal policy in action**, which is one of the key pillars of economic policy formulation. The other fundamental pillar is the way in which we manage our money in the economy – the **monetary policy**. The framework for the monetary policy as it is applied in South Africa is strongly based on a market economy. Policy is applied mainly by the financial markets. The Reserve Bank therefore has a established interest in the development and protection of sound financial instututions and efficient financial markets that operate effectively.

Do the following individual activity about the macro-economic equation.

Individual activity

Do not continue with the next section until you have at least tried to answer these questions!

1. Based on the following information, calculate the government spending:

C = R200m;

I = R100m

X = R60m

Z = R20m

GDP or Y = R400m

2. For each of the following deficiencies, state whether it over or under-estimates the wealth and GDP in an economy:

Deficiency: Impact on the GDP

* Only market-orientated goods and services
* Price increases
* Statistical calculations (errors)
* Free time not taken into account
* Unfavourable side-effects (*externalities*)
* Higher defence spending

Answers

From the facts above: Government spending is R60 million.

Do the following learner activity about the macro-economic multiplier:

Individual activity

The multiplier in economics measures the:

(a) rate of change in consumption resulting from a change in income

(b) rate of change in supply resulting from n a change in income

(c) rate of change in income resulting from a change in spending

(d) rate of change in investment resulting from a change in income; and

(e) change in prices relative to the change in production levels.

Choose the best answer from the following:

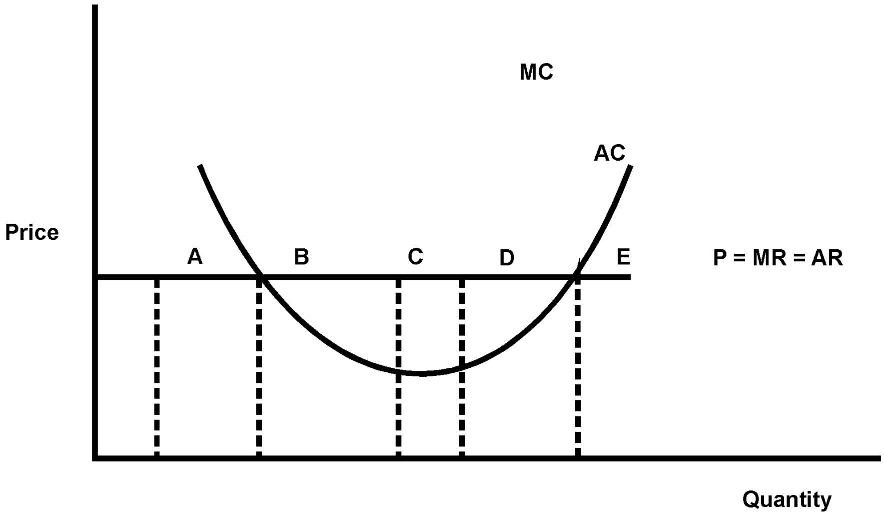
1. a, b & c
2. Only d
3. Only e
4. Only c
5. a, b, d & e

Important information

Micro-economic applications – The individual business

In this module you look at associated costs as part of the risk in a production enterprise. The question is: When will the entrepreneur (producer) *in general* be in an equilibrium position, thus, maximize (optimise) the company's profit and minimise its losses. Study the relevant section in your prescribed book (Chapter 12 in Mohr *et al.*) to find answers to this important question. Work through the next couple of pages about micro-economics.

Figure: Production: A cost-income perspective



Let's first analyse the corresponding figures (find the relevant topics in your textbook). We have learnt that the entrepreneur (producer) in the perfectly competitive market may find itself in various conditions of cost/income behaviour or profit/loss situations (various states of solvency).

Individual activity

Individuele aktiwiteit

Before you continue, first write down briefly what you believe the profit/loss situation (solvency status) is of the entrepreneur in situation A-E in the figure above:

Situation A: ____

Situation B: ____

Situation C: ____

Situation D: ____

Situation E: ____

Do not continue with the next section until you have at least tried to answer this question!

Answers

When we analyse the figure from a producer-equilibrium perspective (i.e. from an optimum or maximum profit angle), the "solvency character" of situations A-E is as follows:

Situation A: The producer is in big trouble; he/she has suffered only losses since the beginning (MC > MR) and is thus *technically insolvent.*

Situation B: The producer is at *breakeven* (AC = AR). What happened, when we compare situations A and B, is that the producer has started utilising economies of scale (MR > MC).

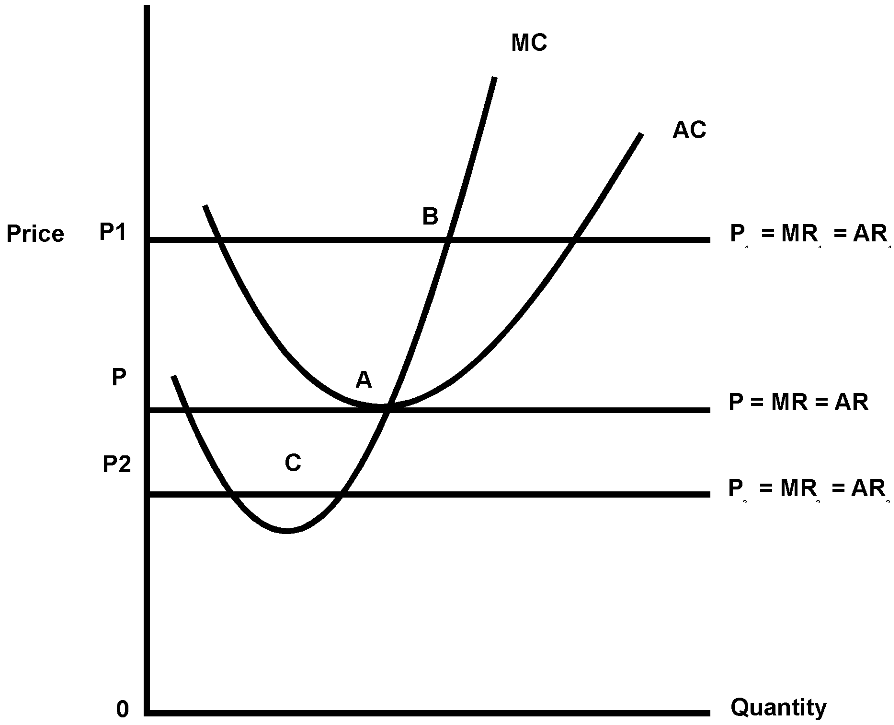
Situation C: In his/her utilisation of economies of scale the producer has reached the point where he/she has reached the *biggest positive difference* between average income and average costs (AR > AC). But you have also learnt from the prescribed book that the entrepreneur may continue producing even more units.

Situation D: The producer has now reached the point where the last unit produced has generated an income (MR) that is equal to the cost thereof (MC). In this situation it means that, when we compare the income/cost behaviour from zero to D, the producer has benefited fully from the LAW of RETURN by optimally utilising the ECONOMIES OF SCALE

Situation E: Again, the producer is at the breakeven point (AR = AC). But now, in contrast to situation B, the reason is that he/she has gone further than the law of return and has eroded the profit to zero.

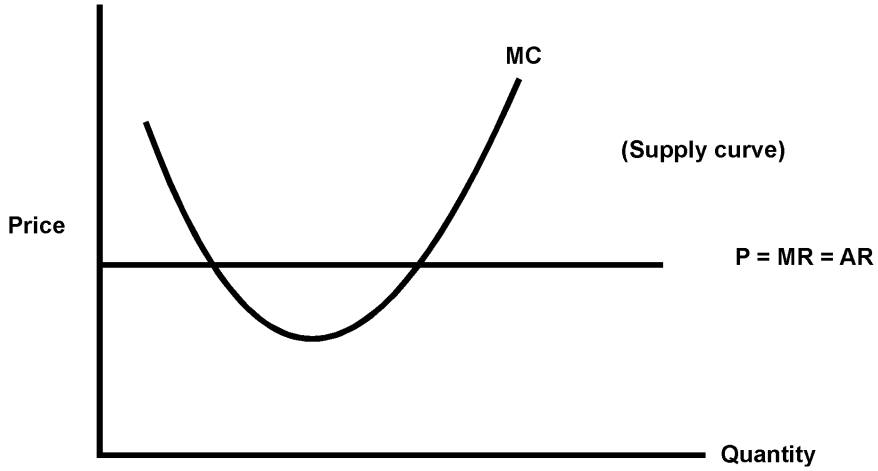
In the following figure, let's experiment with various prices that occur in the perfectly competitive market, but with the same cost structure for the producer.

Figure: The producer and different price levels



It is clear from the figure that is discussed in the previous chapters as well as the figures above that the producer wants to reach an equilibrium position (i.e. maximum profit) alongside the UPWARD RISING LEG OF THE MARGINAL COST CURVE (equilibrium points A, B, C).

Figure: Marginal cost and supply



We mentioned before that the producer is faced with the fundamental challenge of combating high costs (and thus limiting risk) by organising his production in such a way that it observes the law of returns by utilising economies of scale. The RISING LEG OF THE MARGINAL COST CURVE represents the RATIONAL BEHAVIOUR of the SUPPLIER (PRODUCER); that is, endeavouring to supply more products at higher prices, and fewer products at lower prices. The rising tendency (or rational behaviour) of the producer, as reflected by the SUPPLY CURVE (see the figure) to optimise profits.

The study guide concludes with a number of insights and additional learning material in SEMINAR FORMAT.

Study unit 1

THE "MIRACLE" OF ECONOMIC GROWTH

Based on global economic successes and failures, the Wolrd Bank has compiled the following "miracle of growth" framework:

POLICY CHOICES

- Fundamentals
  - Stable macroeconomy
  - High human capital
  - Effective and secure financial systems
  - Limiting price distortions
  - Openness to foreign technology
  - Agricultural development policies
- Selective interventions
  - Export push
  - Financial impression
  - Directed credit
  - Selection promotion
- Institutions
  - Technocratic insuration
  - High quality civil service
  - Monitoring

COMPETITIVE DISCIPLINE

- Market based
  - Export competition
  - Domestic competition
- Contest based
  - Export credit
  - Investment co-ordination
  - Information exchange

GROWTH FUNCTIONS

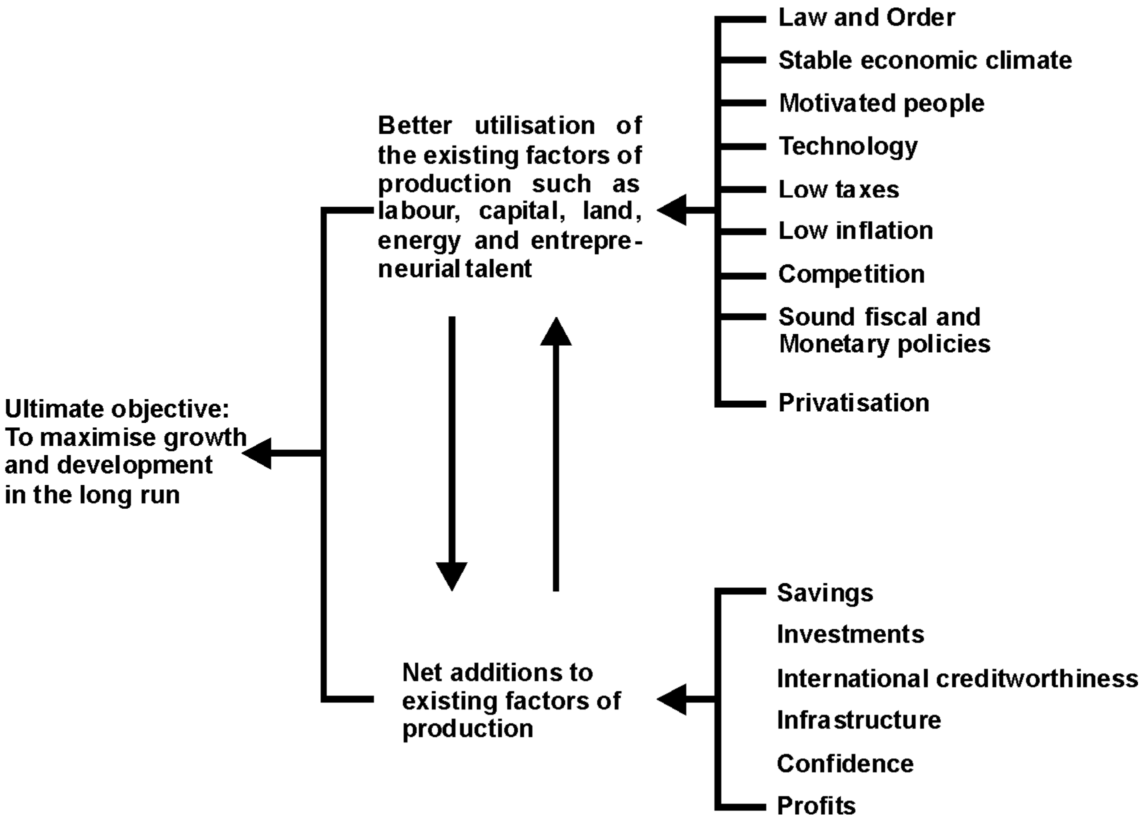
- Accumulation
  - Increasing human capital
  - High savings
  - High investment
- Allocation
  - Effective use of human capital in labour market
  - High returns on investment
- Productivity change
  - Productivity based catching up
  - Rapid technology change

Rapid and sustained growth

Equal income distribution

From this framework we can conclude that successful economic growth, from a macro-economic perspective, is based on factors such as a stable economic environment, quality of human capital, openness, sound financial structure, good corporate governance, market-orientation, savings, investment and productivity.

The prerequisite for economic growth and development:



The diagram above emphasises the importance of increasing productivity in the economy.

☞ ***Productivity*** can basically be increased in the following five ways:

$$\frac{\text{Output}>}{\text{Input}+},\quad \frac{\text{Output}=}{\text{Input}<},\quad \frac{\text{Output}>}{\text{Input}<},\quad \frac{\text{Output}>>}{\text{Input}>},\quad \frac{\text{Output}<}{\text{Input}<<}$$

Study unit 2

COMPETITIVE DIMENSIONS AND MACRO-ECONOMIC REAL/FINANCIAL VARIABLES

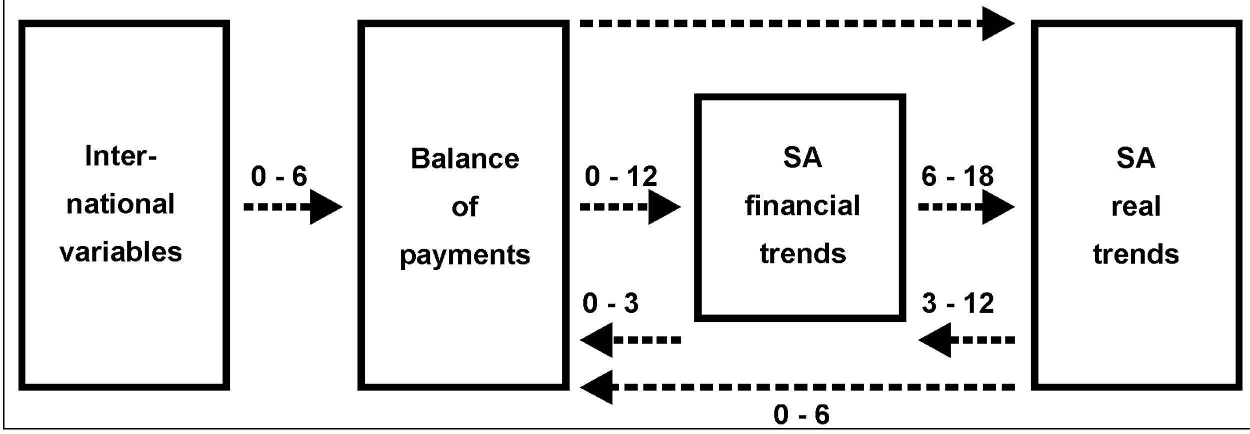
You will remember from the Study School that we referred to the issue of real and financial variables as macro-economic indicators: the influence of the international economy on domestic economic variables is achieved by means of the Balance of Payments (BoP), which measures South Africa's foreign transactions and their net effect. The BoP also has a significant impact on domestic financial variables such as the exchange rate, interest rates and inflation. It also affects domestic real variables, since exports – usually the biggest component of the BP- comprise one third of domestic production.

☞ The interaction between the variables can be illustrated as follows:

<u>Diagram</u>:

<u>Macro-economic framework</u>

(Average response time in months)



Inflation	**Exports**	**Exchange rate**	**Income**
Economic growth	**Imports**	**Inflation rate**	**Consumption**
Exchange rates	**Services**	**Interest rate**	**Production**
Gold and oil	**Capital flows**	**Money and credit**	**Investment**
Interest rates	**Reserves**	**Wage tariff**	**Employment**

(Source: Barnardt, N, du Toit, J. Understanding the South African Macro-Economy.)

Before we provide you with a definition of competitiveness, I want to share with you a number of universal competitiveness dimensions. The annual Global Competitiveness Report, which is compiled by an international research team based in Lausanne, Switzerland, uses the following PRINCIPLES OF GLOBAL COMPETITIVENESS to evaluate a country's competitiveness:

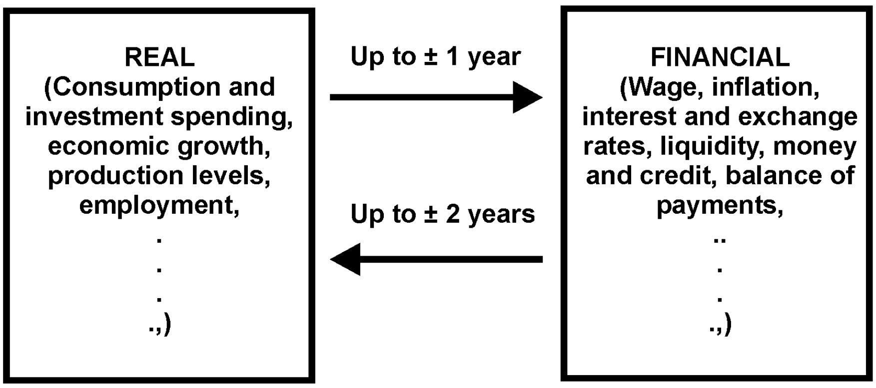
- Domestic economy
- Globalisation
- Government
- Finances
- Infrastructure
- Management
- Science and technology
- People

I am quite certain that you have already learnt in this module that a "variety of dynamic forces" (variables) form part of the South African economy (as in any other economy). These variables are integrated, interdependent and have an impact on one another. They are MACRO-ECONOMIC INDICATORS and can be broadly divided into "REAL" variables and "FINANCIAL" variables:

- The REAL variables consist mainly of production, income and spending totals, of which the most obvious examples are economic growth, balance of payments, consumer and investment spending, exports, imports, manufacturing production, personal income, retail sales, motor vehicle sales, employment, unemployment, et cetera.
- FINANCIAL variables, on the other hand, consist of average or price changes of goods, services, funds, assets and foreign exchange as well as a variety of financial flows or totals. A few obvious examples are inflation, interest rates, wage rates, exchange rates, gold price, money supply, savings, government debt, the balance of trade and the net surplus or deficit on the balance of payments. Generally speaking, most financial variables move together as a group in a positive or negative direction.

The most important feature of this distinction (see the diagram below) is the CONTINUOUS UNDERLYING INTERACTRION, with certain TIME LAGS, between the group of real variables on the one hand, and the group of financial variables on the other. In fact, this is the key to a better understanding and forecasting of economic and business tendencies.

Diagram: Interaction between real and financial variables:



(Source: Barnardt, N. Understanding the South African Macro-Economy.)

Upswing and downswing phases in the real variables and associated business conditions are caused and preceded, with a time lag of approximately two years, mainly by favourable or unfavourable movements in financial indicators such as the balance of payments, the rand exchange rate, inflation and interest rates. Movements in the real variables generate and precede financial tendencies, with a time lag of approximately one year. Therefore, a continuous mutual interaction!

3

Study unit 3

BUSINESS CYCLES

Application of the concepts Growth and Business Cycles

The two central issues in macro-economics is evident from time-series graphs of real GDP over a number of years. GDP is a measure of total production of goods and services in the economy. Two characteristics that can be derived from these statistics are an upward tendency in the GDP and short-term fluctuations of "waves" in line with a generally upward curve. We refer to these two issues as **economic growth** and **business cycles** respectively.

If you look at the data over long periods, the fluctuations do not seem all that important, and in a sense they really are not: **the short-term fluctuations are but a small part of nations' wealth.** <u>But. seen from a micro-economic (personal) perspective, these cycles can be very important, as businessmen and workers who had to survive the 1992 recession will surely attest to.</u>

The classic question of economic growth is why some countries are richer and/or grow quicker than others (there is a clear correlation between these two issues, as countries that grow quicker will ultimately also be wealthier). **Production can also be expressed per capita by dividing the GDP by the population.** It provides a more significant comparison between countries, since countries with more people do not automatically have a bigger income.

These figures are averages and therefore ignore many differences on an individual level – but is does give you a good idea of the position of the different economies. For example, when one compares the USA with Argentina on this basis, you will find that there are enormous differences between rich and poor countries. However, Argentineans are still relatively wealthy, approximately five times more than the average person in India. But the really outstanding country is Japan. In 1913 Argentina was approximately three times wealthier than Japan, but now the situation has been reversed. Japan's exceptional performance continued for more than a century. In contrast, Argentina's position has weakened from one of the richest countries in the world to an economically average Latin-American country. Nowadays China is also among the fastest growing regions in the world.

But back to the cycles: from a business perspective, these short-term movements in the economy are of more immediate importance:

- You may want to know whether the economy will be in a better state by the time you have completed your MBA, or
- whether your airline shares will be worth more in 12 months' time?

✋ Why are airlines so particularly sensitive to recessions?

You will be able to get a much better idea of the short-term fluctuations by looking at the graph that shows the annual growth rates of an economy's GDP.

Annual growth rate refers to the "year-on-year" growth rate in quarterly data:

(GDPt – GDPt-4) / GDPt-4

where:

* GDP is the GDP in quarter t (eg the 3rd quarter of 2015);

** and GDPt-4 the GDP four quarters earlier (eg the 3rd quarter of 2014).

In this kind of graph any downward sharp increases may be regarded as recessions – which are simply two successive quarters with a decreasing GDP. Always distinguish between the downward and upward phases in the data base (the duration is very important!)

Please note that there is an alternative way to determine the economy's growth rate: it is the way in which the press reports on the growth rate. It consists of the measurement of the growth rate of GDP in a specific quarter relative to the previous quarter and annualises that growth rate by multiplying it by four. Consequently, the quarterly growth rate of the economy at an annual rate is as follows:

4 X [(GDPt – GDP t-1) / GDPt-1]

This second method of expressing the growth rate of the economy implies a more volatile growth in production, since quarterly changes in the growth rate is reinforced when measured against annualised rates.

However, the year-on-year definition provides a better measure of the economy over a longer period, i.e. how the economy has really grown over the past four quarters.

Recessions are a reality! Business cycles have been a characteristic of all economies from the first time someone decided to collect data. And despite what the politicians would like us to believe, recessions will always be with us. First world economies such as Germany and Japan have also been characterised by considerable fluctuations, despite their higher average growth rates. So declining and recovery phases occur worldwide over time!

A great deal of strategic information can be derived from this economic instrument – for example: the economic performance of Japan in the 1990s and especially in 1997 exacerbated the economic crisis in 1997 in East-Asia. Because Japan is an important export market for many East-Asian economies, the stagnation in growth in Japan during the 1990s has lead to a decrease (since 1995) in the export growth rate of many east-Asian countries.

We regard business cycles as macro-economic phenomena, but very little research has been done on the micro-economic foundations of business cycles. The following research by Debacker (2009) illustrates the underlying complexities with regard to the cyclical movements in economic activities.

Important information

The micro-economy of business cycles

(Jason DeBacker; April 7, 2009)

Gjerstad and Smith give an explanation of how the increase in consumer debt due to a decline in house prices has resulted in big losses for the financial sector and heavy recessions. They demonstrate how the losses of the stock market could not have led to the Great Depression (the timing was wrong), but how the decline in house prices did result in the demise of many banks. They asked the big question – how did a $10 trillion dollar decline in equity values from the *dotcom* bubble not result in the same magnitude of financial problems as those the world faced after a $3 trillion decline in property values? Their conclusion was that houses make use of financial gearing to a much greater degree and that the financial sector therefore suffers big losses when house values decrease.

Rizzo discusses the *allocation* aspects of business cycles. The primary driving force behind most economic fluctuations is not a change in total demand, but rather a sectoral movement. The micro-economy of the economy – changes in relative prices – is thus of crucial importance. Rizzo of the New York University emphasises the fact that policy makers should keep these allocation effects in mind when prescribing stabilisation policies.

After reading Rizzo, DeBacker wanted to write down a complex multi-sector economic model in terms of which a shock in one sector can lead to an economic decline phase when resources move to more productive areas. But it is actually really difficult to develop such a model with the necessary frictions to obtain the co-movements that we see in the data. In other words: how do you cause a decline in all sectors after a bad shock in only one?

Researchers still do not know how to reduce this model to writing. But according to DeBacker the ideas in the work of Gjerstad and Smith point in the right direction – the financial sector. Unfortunately current macro-economic models deal with the financial sector in a rather primitive manner. Let's hope that researchers (and also policy makers) learn from this experience and try to understand the micro-economy of business cycles.

A number of ideas to consider for this kind of model: Two productive sectors, households, financial sector. Households own shares in firms, lend to firms and may hold a risk-free asset. Each sector consists of an infinite number of firms, each producing a homogeneous product and financing capital purchase with debt, equity and earnings. There is a cost involved in adjusting capital and also costs associated with external financing (these frictions will be important because they prevent capital being reallocated too quickly). There will be sectoral and idiosyncratic shocks for the firms in all sectors. Entry and exit are possible (insolvency will probably be important). The financial sector links the two goods-producing sectors by means of equilibrium conditions in the prices of debt and equity. This is the difficult part. But think of something like a negative shock for a sector that leads to a sudden increase in bankruptcies. The frictions (eg to adjust the cost of capital) presupposes that these bankruptcies will result in capital losses being realised. It pushes up the cost of capital, thereby damaging the other sector.

Study unit 4

AN ABRIDGED OVERVIEW ON ECONOMIC THOUGHT – ECONOMIC THEORIES AND MACRO-ECONOMIC POLICY

An abridged overview of economic thinking – economic theories and macro-economic policy

(W B Vosloo; PHD. Cornell University)

In 1936, the foremost British economist John Maynard Keynes wrote that ideas "are more powerful than is commonly understood. Indeed, the world is ruled by little else. Madmen in authority, who hear voices in the air, are distilling their frenzy from some academic scribbles of a few years back."

During the 19th century the old "Utopian Socialists" were replaced by the "Marxist Socialists", who in turn in the 20th century were toppled by a variety of "Communist Socialists": Leninists, Stalinists and Maoists. In the Western World the original 18th century "laissez-faire liberalism" was replaced by the Keynes-inspired "New Liberalism", which became the motto of the expanded government interventionism of the era of Franklin D Roosevelt. After the Second World War the "mixed economy" became the generally accepted view in the form of "regulated capitalism' in the USA and variations of "democratic socialism" in Europe. By the 1980s, with the communist world disappearing, "free market" capitalism enjoyed overwhelming popularity en unparalleled extended on a worldwide scale.

The start of the **economic implosion in 2008 introduced yet another paradigm shift.** In the current chaos it is still not clear what labels would be assigned to the new macro-economic theories. It could very well be a choice between 'neo-socialism" and "socialism with Chinese features" – therefore, a combination of crony capitalism and communist party domination.

1. The legacy of John Maynard Keynes

The current economic crisis has once again sparked interest in the theories of John Maynard Keynes (1883-1946). However, it is important to realise that Keynes's most important works should be understood against the background of the economic requirements and limitations that existed during his lifetime. Laissez-Faire and Communism was published in 1926, when the Western world was in the clutches on the speculative excess of the twenties, as well as the increasing importance of Soviet-Communism. His second big work, The General Theory of Employment, Interest and Money was published in 1936, when the Western world was involved in a drawn out struggle to escape the effects of the Great Depression that was caused by the collapse of Wall Street in 1929..

Keynes' father was a leading economist and philosopher, and his mother was the mayor of Cambridge. After two years in the Indian office he returned to Cambridge, where he lectured economics and was the editor of the Economic Journal. He also represented the British treasury at the Paris Peace Conference in 1919. Between the First and Second World War Keynes concentrated on his academic work at Cambridge, but he was also the chairperson of a large insurance company. He operated an investment company, through which he earned a sizeable fortune. During the Second World War he again served in the Treasury and made a significant contribution to the Beveridge Report, upon which Britain's long-term financial plans and policies were based. In 1945 and 1946 he helped to negotiate American loans and participated in preparations for the establishment of the International Monetary Fund and the International bank for Reconstruction and Development. He also managed to find time to serve as the chairperson of the *Council for the Encouragement of Music and the Arts* and later the *Arts Council*. In 1942 Keynes was knighted.

- <u>Laissez-Faire and Communism</u> (1926), Keynes's first big work, is based on the premise that "... a study of the history of opinion is a necessary preliminary to the emancipation of the mind". Consequently, he started a comprehensive survey of the most important standards, including those of Locke, Hume, Burke, Bentham, Mills, Adam Smith, Malthus, Ricardo, Marshall, Spencer, Darwin, Rousseau, Bastiat and those of the Marxist Socialists. Unfortunately he often misrepresented differing views and portrayed them as caricatures.

He investigated the optimistic assumptions of the free market capitalism, namely that unrestricted, enlightened self-interest is always in the public interest. He came to the conclusion that self-interest is not an enlightened viewpoint. The world is also not controlled from the top in such a way that private and social interests always match up. In addition it is also not managed in such a way that it corresponds in practice. Because we cannot determine on an abstract basis, according to Burke "*what the state ought to take upon itself to direct by public wisdom and what it ought to leave, with as little interference as possible, to individual exertion*", we have to treat these questions on merit. Keynes thus came to the conclusion that "*the chief task of economists at this hour is to distinguish afresh the Agenda of Government from the Non-Agenda … and the companion task [of political scientists] is to devise forms of Government within a Democracy which shall be capable of accomplishing the Agenda*."

The rejection of *laissez-faire* did not mean that Keynes accepted socialism as an alternative, mainly because he regarded socialism as yet another dogma – that of state control of the economy – just as *laissez-faire* supported the dogma of no interference in the economy. Furthermore, the state should not interfere in any activities that can be executed more effectively by private enterprises. Keynes, however, did mention *three areas* in which government intervention is preferred: first, the intentional control of credit and the currency by a central institution; second, the determination of the scale of savings and investment for society as a whole; and, third, the formulation of a public policy on the problem of population growth.

From a contemporary perspective, the first two areas are obviously important, but the third one is often ignored. Keynes was strongly influenced by the Malthu theory, namely that population numbers increase by geometrical increases, while resources only increase mathematically as a result of the law of diminishing returns.

Keynes's heaviest criticism, however, was aimed at Marxist Socialism. His view was that "*Marxian Socialism must always remain a portent to the historians of opinion – how a doctrine so illogical and so dull could have exercised so powerful and enduring an influence over the minds of men, and, through them, the events of history*". In 1926, Keynes came to the conclusion that capitalism, *"wisely managed, can probably be made more efficient for attaining economic ends than any alternative system yet in sight*". Seventy years later Soviet-Communism collapsed.

Keynes' also remarked that war is an example of centralised socialist behaviour. In 1927 he said that "*War Socialism, unquestionably achieved a production of wealth on a scale far greater than we ever knew in peace, for though the goods and services* *delivered were destined for immediate and fruitless extinction, none the less they were wealth"*. When he wrote these words, he clearly did not expect that the start of the Second World War in 1939 would bring an end to the Great Depression of the 1930s.

- The General Theory of Employment, Interest and Money (1936). This publication quickly became known as a pioneering work in the same class as Adam Smith's Wealth of Nations and Karl Marx's Das Kapital. In as far as Adam Smith applied the principle of capitalism, and Karl Marx the opposite thereof, Keynes in a way offered a new synthesis in a new approach, in which private and public initiative and responsibility were combined in a mixed economy.

Keynes' contended that the primary weakness of the capitalist society is found in "*its failure to provide for full employment and its arbitrary and inequitable distribution of wealth and income*". But how far should governments go to improve a capitalist society's achievements of the past? Keynes had a pragmatic answer to this complex question. In his General Theory he declared that only experience can show how far the state should go to stimulate investment and increase the effective purchasing power of consumers. In particular, Keynes believed that the state should exert a significant influence on the scale of consumption by means of tax and other methods in order to distribute the national income.. Keynes did not suggest that the state itself should make all these investments, but that it should encourage and facilitate private investment b y means of flexible credit and interest policies. The government should also supplement private investment so that private investment does not result in the full employment of all available manpower and resources. As soon as the investment policies have been determined by public policy, the economy should remain in the hands of private business. Keynes regarded decentralisation and the associated exercising of self-interest as the two biggest advantages of private business, which is more effective than public ownership and operation as means of production.

- **Impact**

Keynes's theories had a huge impact on the subsequent development of macro-economic doctrines and public policy. In the UK, governments committed themselves to policies aimed at "full employment", and in the United States Roosevelt's *New Deal* was strongly influenced by Keynes' ideas. At Harvard University, Keynes's theories were strongly supported by Alvin Hansen, Paul Samuelson and a myriad of new recruits. Democratic socialists in Europe and America mostly agreed with Keynes, but they also criticised him for not moving far enough to the left. Marxists regarded Keynes as just another kind of bourgeois political economist who used the state as an instrument of the capitalist class. However, Keynes, emphasised that his reliance* on the state meant that the public interest in a liberal democracy could be approached through processes of rational investigation and dialogue.

2. Economic theories in historical perspective

The suffering caused by the Great Depression of the 1930 was followed by an almost universal disillusionment with the free-market system. Intellectuals and policy makers regarded this massive economic collapse as proof of market failure, which required corrective government intervention. This led to a paradigm shift in macro-economic theory.

The perceived success of state planning to facilitate rapid industrialisation in Nazi-Germany and the Soviet Union as well as the perceived success of Roosevelt's *New Deal* interventionism – including the egalitarian attractiveness of the programme – led policy makers to believe that the supreme enlightened states had all the answers.

This belief in policies as the primary source of human economic fortune found expression in totalitarian as well as social-democratic versions. The subsequent economic recovery at the start of the Second World War was attributed to government intervention. Government allocation of resources and the rationing of essential consumer goods during the war was, on the face of it, a confirmation of the effectiveness of government action. The general view was that some form of collectivism in the form of more government intervention, government ownership and government control would be the economy of the future.

The period of the Cold War (1946-1989)

This period was characterised by an intense and cut-throat battle between the Western World under the leadership of the USA and the Communist World, under the leadership of the USSR and China. Not only the national strategy and safety concerns were at stake, but rather an all-encompassing conflict of the socioeconomic-political structures of these super powers.

At the end of the Second World War, the Soviet Union occupied the whole of Eastern Europe, except for East-Germany. The USA accepted leadership of the Free World in his efforts to restrict the expansion of the Communist World. A long list of military confrontations followed: Berlin, Korea, Vietnam, Cuba, Hungary, Angola and Afghanistan. These were accompanied by an arms development and space discovery race, which required astronomical amounts in government spending. Other allied powers, such as the UK, Germany, France and Japan also participated, although the American government carried most of the financing costs of these endeavours. The strengthening of the role of the USA increased public sector's hare in the GDP from 14% in 1940 to 26% in 1990. The annual budget of the American Department of Defence rose to levels that were allegedly higher than Great Britain's <u>entire GDP</u>. The rise of the public sector in the Free World is also partially the result of the population increase that lead to the development of large urban complexes, and partially from greater government involvement in education, health, welfare, communication systems and other spheres of collective human existence.

At the end of the Second World War, socialist ideas have clearly spread throughout most of Europe. Even before the end of the war, the Labour Party took over power in England and nationalised the Bank of England, the coal and electricity industry as well as the steel industry. Labour unions became the dominant force in British politics. The socialist spectrum spread over the entire Europe, from Scandinavia through the Netherlands* and France to Italy. The "welfare state" became a widespread phenomenon.

The European consensus in the 19500s and 1960s was founded on the belief that political leadership (subject to periodic elections) could manage their <u>mixed economies</u> through a combination of resources – regulation, planning, state ownership, industrial policy, Keynesian fiscal management and monetary policy. The specific combinations differed according to the various countries, depending on their history and traditions. However, all governments produced large and inefficient bureaucracies, heavily taxed private sectors and the prelude to endemic inflation. In most of the wealthier countries contra-cyclical policy became the norm. Keynesianism was the macro-economic orthodoxy.

At the end of the 1960s most Western economies struggled with the problem of "*stagflation"*, which was characterised by stagnant growth, mounting unemployment and continuously price increases. The traditional Keynesian methods to stimulate economies through spending or by increasing the money supply did not bring an end to slow growth and unemployment – rather, it contributed to additional inflation, stagnation and a suffocating bureaucracy.

The Keynesian influence on policy came to an end after the emergence of **supply-side economics** – in particular around 1980 after Margaret Thatcher took over as Prime Minister of the UK, and Ronald Reagan became the President of the USA. In both countries government a tight rein was kept on spending and tax and the role of government restricted. The market-friendly theories of Von Hayek and Friedman restored the job and wealth-creating role of the private sector and curbed the power of the labour unions, which enforced wage increases without a corresponding increase in productivity. Von Hayek alleged that the Keynesian approach is based on a paradoxical error – although it may temper the deadlock of economic collapses, it will unavoidably institutionalise inflation.

In the UK, Prime Minister Thatcher did not only curb public spending, but also established a privatisation programme under the auspices of the institution of a "capital-owning democracy". She believed that citizens should own houses, shares and an interest in society. By 1990 the supply-side Thatcher/Reagan-model has lead to a new economic agenda across the world.

The upswing period (1989-2008)

The year 1989 (200 years after the outbreak of the French Revolution) commemorated the collapse of Soviet-Communism – the end of a defective system that embodied the belief that societies perform at their best in a strictly controlled collective situation, rather than in an open society that allows them to pursue their best interests in a relatively free manner. Communism as well as planned social democracies believed that government bureaucrats are able to manage an effective egalitarian economy. The collapse of Soviet-Communism introduced a new political-economic order, which became the generally accepted development model internationally.

In most of the free world countries the Keynesian economies were the main actor on the macro-economic scene through the free market theories of Friedricht von Hayek and Milton Friedman. Although most countries were still running mixed economies, the new approach heralded an increased tendency towards private enterprise.

Even left-wing Labour parties of countries such as New Zeeland, Australia and the UK, as well as social-democratic parties such as the American Democratic Party and similar relatively left-wing parties in Europe, have started revising their policies to reduce the role of the state, and to maximise individual freedom, deregulation, dependence on the market and decentralised decision making. The traditional meaning of liberalism once again prevailed – less government involvement, not more.

It is important to note that Franklin D Roosevelt, during the "*New Deal*"-era in the thirties, hijacked the word 'liberal" to describe his policies in an effort to circumvent accusations of being "left-wing". According to him liberalism is "*plain English for a changed concept of the duty and responsibility of government towards economic life*". Ironically enough, in the USA the concept of "liberalism" has since been associated with an expansion of the role of government in the economy. In the rest of the world "liberalism" means exactly the opposite – i.e. a smaller role for the state and maximising individual freedom, economic freedom and reliance on the market and decentralised decision making. People who are not familiar with the history of political thinking often fail to differentiate between the different uses of the word "liberal" – not to mention the incorrect uses of the concept of "conservatism"!

The collapse of communism brought statism in whatever form in disfavour. The 1990s were characterised by rapid economic growth, job creation and higher standards of living. The transformation did not spread only throughout Western and eastern Europe, but also infiltrated India and China.

Deng Xiaoping was the first prominent leader in China who replaced Maoist structures with market-friendly reform measures and instituted a so-called "socialist market economy". Over the ten year period 1985-1995 the Chinese economy grew at an average annual rate of 9.3% – and directed more than 200 million people out of a decade of poverty. The first steps were taken to open the door to private ownership of property and enterprises and reducing the high levels of public ownership. This lengthy process is still continuing today, but is regrettably not accompanied by the expansion of human rights.

The market-based system that has spread to large parts of the world over the past three decades resulted in unparalleled wealth and freedom. Hundreds of millions of people were uplifted from abject poverty – the fastest growth in international income per person in history. In popular parlance this new system became known as the Washington consensus (based on deregulation, innovation and privatisation). It is also sometimes called Anglo-Saxon capitalism (high financial gearing, limited regulation and globally mobile) with financial services being provided from New York, Chicago and London.

In the 1990s the Western world experienced an unprecedented expansion of the information technology driven "new economy". The IT-revolution caused a total transformation in the way business was done, unlocked new opportunities for growth and helped business reduce their costs by way of increasing productivity. This upward tendency was most visible in the USA> Since 1996 America's non-agricultural activity has grown by an average of 2.8% per year. Share prices reached new heights with regard to traditional measures of value. The number of American adults who invested in shares increased from 21% in 1990 to 43% in 1997, with 60% of all household assets allocated to equities. The Chairperson of the Federal Reserve, Alan Greenspan, referred to this speculative madness an "*irrational exuberance*" – quoting Robert Shiller. The collapse of the Asian and Russian markets at the end of 1997 caused a decline of 20% in the USA share market at the end of 1997. Japan, South Korea, most of East-India, Latin-American and East-European economies that were responsible for 40% of the world's production, fell into a recession.

After the American government in 1998 signed surety for Long-Term Capital Management, a hedge fund with enormous hedge ratios, the American economy managed to survive the economic recession that has engulfed a large part of the world at the end of the century.

During the first few years of the new millennium the Anglo-Saxon macro-economic model surged ahead. The annual growth rate in the USA and the UK was increasing at an uncontrollable pace.

Following the introduction of the Euro as currency and the admission of a number of new members to the European Community, growth rates started to slow down. By 2004 The Economist estimated that the average person in the Euro-zone was still 30% poorer than the average American (measured in GDP at purchasing power parity). This situation was attributed to various factors: the burden of the unification of Germany, inflexible labour markets that made it difficult to dismiss unproductive workers and appoint new workers, shorter working hours, the bloated bureaucracies and the welfare state mentality that repressed work ethics. However, these comparisons were concealing the fact that the Euro-zone was less driven by a housing and consumer credit bubble, income imbalances and extremely unstable and obscure financial practices.

In the USA traditional commercial banks were gradually being surpassed by a new type of financial institution investments (or merchant banks). New names came to the fore – Bear Stearns, Lehman Brothers, Merrill Lynch, JP Morgan, Goldman Sachs, Morgan

Stanley, Solomon Brothers, LTCM, GE Finance – and quickly became the main role-players in the "shadow banking system". They functioned mainly outside the radar screen of the traditional regulation system in the murky world of money market funds, private equity funds and hedge funds that trade in obscure effects such as futures, options, exchange transactions and so on.

Most of the large variety of very complex financial instruments that were developed did not exist on balance sheets. For example, the CDOs (collateralised debt obligations) are sophisticated instruments combining packages of different stocks (securitisation) and then selling these to external investors (including commercial banks and investors all over the world). These instruments were developed to spread the risk. However, some CDOs held sub-prime mortgage assets and sold these to Fannie Mae en Freddie Mac in terms of the Community Reinvestment Act of 1977, that compelled banks to allocate community-based quotas. And so the seed was planted of the sub-prime crisis that distributed these toxic assets all over the world. The investors in these assets were too far removed from the original clients (who were often unemployed or too poor to be creditworthy) to evaluate the quality of their investments. These dubious assets quickly gave rise to a confidence crisis.

Bear Stearns was the first investment bank that went under in 2007. Next in line was Lehman Brothers in September 2008. By the end of 2008 the domino effect of the toxic assets has spread and has become so intense that money markets across the world came to a standstill. Various banks collapsed and forced governments to try and rescue their banking systems by way of business rescues and sureties.

Only two of Wall Street's big five securities forms survived the crisis – Goldman Sachs and Morgan Stanley. Markets for securitised debt were replaced by a new focus on "emergency debt" asset management and presented new opportunities for countless litigation attorneys specialising in debt instruments.

By the start of 2009 it was clear that the financial crisis has been caused by the American housing and credit bubble bursting, leading to a global confidence crisis and failure of the entire international financial system. This financial crisis plunged the global economy in its biggest crisis since the Great Depression.