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SEEP Bridging Course

Lecture 1: Intro to Economics

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What is Economics?

In your opinion…

- What is the economy made up of?
- The most important part of an economy is?
- How do economies grow?
- How important is the government?

Thinking like an economist

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- Are you describing:
- How you think the world functions? (Positive)

or

- How you think it should function? (Normative)

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Understanding Economics

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What is economics?

- Most books start with the following premise:
- Economics is about scarcity
- Individuals have limited resources and unlimited wants
  - How to “optimize” based on “constraints”
- How “individuals” make “rational” decisions
  - Individuals as systematic decision makers who know what is best for them
- There is a lot of talk about “money”

What is money?

- A medium of exchange
  - Is money “neutral”?
- Provides a value of goods, services, labor
  - How is “value” determined?
- Something you can hold now or in the future
- Usually more money is preferred to less
- How do you get money?

How do you get money?

- **Jobs**
  - What determine how much you earn?
  - What are the conditions under which an individual is hired?
  - Labor markets, unions, employment

- **Inheritance**
  - Transfer across generations

- **Production**
  - Sell goods and services

What is done with money?

- **Consumption**
  - Goods
  - Services
  - How is money allocated across different types of goods and services?

- **Production**
  - What is consumed is also produced somewhere
  - Requires inputs: **Labor**, **Capital, Energy?**
  - Are Labor and Capital substitutable?
  - What determines how much is produced?
  - Production chains: Raw materials, intermediate products, final products

Demand and Supply side

- Demand vs supply side economies:

  Does demand or supply determine the level of economic activity?

- Who should be taxed?
- Who should innovate?
- One producer or many?
- Who should invest?

Economics

- Deals with all of the above

- Some topics central to current policy debates
  - Growth
  - Unemployment
  - Taxation

What is not sufficiently discussed

- **Distributions**
  - Should societies be equal?
  - How does one make them equal?
  - What services should be provided by the public sector?

- **Climate**
  - Does human activity cause climate change?
  - If so how?
  - How does it feed back into economics?
  - What can be done about it?

- All of the above are policy questions, with no easy answers

School of Economic thought

- What you prescribe depends on the economic school of thought you ascribe to
- The dominant discourse of economics is neo-classical
  - But there are several schools of thought
- Lets compare the schools

Schools of Economic Thought

Comparing Economic Schools

Schools of economic thought (Chang 2014):

▪ Classical	C
▪ Neo-classical	N
▪ Marxist	M
▪ Developmentalist	D
▪ Austrian	A
▪ Schumpeterian	S
▪ Keynesian	K
▪ Institutionalist	I
▪ Behavioralist	B

Classical (C)

- Adam Smith – Wealth of Nations (1776)
  - Ricardo, Say, Malthus (early 19th century)
  - Hicks, Hollandor, Pasinetti, Kaldor, Samuelson (later)

- Core principles
  - *Laissez-faire* – free market economics
  - Invisible hand: Competition will lead to equilibrium
  - Say’s Law: Supply creates it own demand (Ford example)
  - Free trade: Comparative advantage

- Believe in the class structure (political economy)
- Prices are determined by the “labor theory of value”
  - Amount of labor time required to produce a good

Neo-classical (N)

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- Some key principles
  - Agents have full information
  - Agents have rational preferences that they can rank
  - Agents are fully independent (methodological individualism)
  - Agents optimize subject to constraints
  - Markets determine prices through demand and supply equilibrium

- Key contributors
  - Veblen (coined the term neo-classical economics)
  - Jevons, Menger, Walras (marginalists)
  - Marshall (consolidated Marxian economics with marginalists)
  - Edgeworth (applied statistical theory to formalize utility theory)
  - Arrow, Debreu, Hahn (contributions to general equilibrium analysis)

Neo-classical (N)

- There is no class structure
- Inequality can be a fair outcome
  - Individuals are paid their fair share
- Unemployment is a result of government intervention
  - In a perfectly free market all unemployment is voluntary
- Market failures can exist in public good provision
  - Some government intervention is acceptable
- High formalism of mathematics

Marxist (M)

- Karl Marx: Capital (1867)

- Classes are defined by the relationship with modes of production
  - Capitalists (owners of capital)
  - Workers (owners of labor)
  - There is a class conflict between the two

- Capitalism is driven by accumulation
  - Drive for more capital by capitalists to survive
  - Growth is a requirement for survival of capitalism
    - Preference for higher productivity
    - Will always unemployment (surplus army of workers)

Marxist (M)

- Results in exploitation of workers
    - Workers are not paid their due share (constant wage squeeze)

- Growth will result in over accumulation
  - Result in a “falling rate of profit”
  - Investment will no longer yield return
  - Some capitalists go bankrupt or are taken over by others
  - Economy will collapse

  - The cycle repeats
    - Investment makes profitable again

- Did not account for rise of financialization and globalization

Developmentalists (D)

- 18th century mercantilists
  - 1950s 60s: Hirschman, Kuznets, Lewis, Myrdal

- Gold determines success and not output (Gold standard)
  - Fixed exchange rate between currency and gold
  - Imports devalue currency
    - Counter results to the trade surplus argument

- Trade surplus is better
  - Exports > Imports (get more Gold inflow)
  - Generate positive balance of trade

Developmentalists (D)

- Nuanced trade policies:
  - Protectionism of infant industries (import tariffs)
    - Against free trade
  - R&D research
  - Productivity

- Early impact
  - Pro-colonialization
  - Colonies only trade with each other (UK, France)
  - Developing ports, creating colony monopolies
  - Low wages, high R&D investment

- Neo-mercantilist economies (Germany, Japan, China)
  - Increase exports, reduce imports
  - Create a surplus of foreign reserves
  - Centralize monetary and fiscal policy

Austrians (A)

- Pre-cursor to neo-classical economics
  - Currently Libertarian economics in the US
- Menger, von Mises, von Hayek (early 19th century)
  - ONLY free markets
  - Fundamental individual liberty
  - NO government intervention
  - NO central bank
- World is unordered with limited information
  - Let individuals self organize
  - Markets are spontaneous
  - Markets find optimal allocation of goods and money
- Decentralize everything

Schumpeterian (S)

- Joseph Schumpeter (1942)
  - Neo-classical foundations
  - “Creative destruction”: theory of capitalist development
    - Results to innovation
    - Can only be done by the entrepreneur (risk takers)
    - Innovation drives economies

- Let capitalists earn exceptional profits for innovation
  - Some will fail but some will not
  - Drive for efficiency might force some firms to go out of business

Keynesians (K)

- John Maynard Keynes (1930s)
  - Redefined macroeconomics post 1930 financial crisis
  - Helped set up World Bank (IBRD) and the IMF

- Fundamental uncertainty
- Liquidity preference

- Individually rational choices are irrational in the aggregate
  - Paradox of aggregation
- Government intervention is required

- Speculation is bad
  - Makes markets unstable, betting
- Money is not neutral
  - Money impacts the real economy

Keynesians (K)

- Keynesian policies post Great Depression
  - Say’s law failed (supply did not create demand)
    - Paradox of thrift: Workers become too risk averse and save, reduction in demand, get laid off
    - Firms lay of workers to become competitive, reduce demand for own goods, cut more workers
- Government needs to spend money to
  - Generate demand
  - Reduce unemployment
  - Stabilize markets
  - Increase the flow of money in the system
- Post 2008 financial crisis
  - Some Keynesian policies have been adopted
  - Fiscal stimulus packages: bank bailouts
  - Reduction in interest rates (in the US but not in the EU)
    - US is growing out of the crisis but EU is not

Post-Keynesians (PK)

- Money is endogenous
  - Created by commercial banks according to the demand for money

- Economies can be:
  - Wage led (increase wages to determine demand)
  - Profit led (increase profits to determined demand)

- Strong focus on formalism of macroeconomics
  - Do not believe in micro-foundations
  - Macro is more than the sum of its parts

Institutionalists (I)

- Old: Veblen (1900s), Mitchell (1940s)
  - Marxist roots
  - Individuals are shaped by society
  - Institution are greater than the individuals
  - Path dependency, change is slow
  - Regulation school (post WWII US, France)

- New: North, Coase, Williamson (1980s)
  - Neo-classical roots
  - Some path dependency
  - Transaction costs
    - search costs, cost of participating in a market
  - Property rights
    - use, earn, transfer, enforce of assets

Behaviorialists (B)

- Herbert Simon (1970s)
  - Bounded rationality: limited processing capability
  - Decisions are based on local environment
  - Adaptive capability: Pattern recognition
  - Agents evolve “short-cuts” (rules of thumbs)
    - Heuristics
    - Might not be optimal solutions

- Bottom-up approach
  - Agent-based modeling
  - Experimental economics

Which school to follow?

Depends on what you believe in or what you want to study

- Capitalism (C M S I)
- Individuals (N A B)
- Classes and groups (C M K I)
- Economic systems (M D K I)
- Individual interaction with society (A N I B)
- Want to defend free markets? (C A N)
- Want to defend government intervention? (N D K)
- Unemployment and recession (C K)

- **Environment**
  - **How would each school respond to the environment issue?**

Course outline

Course outline

- Lecture 1: Introduction to Economics

- Lecture 2: Microeconomics
  - Neo-classical theory - Households, Firms, Markets
  - General and partial equilibrium
  - Inter-temporal decision making

- Lecture 3: Macroeconomics
  - Growth
  - Neo-classical vs Post-Keynesian theories

- Lecture 4: Financialization
  - History and rise of financialization
  - Financial crisis 2008

- Lecture 5: Distributions and the Environment
  - Unemployment, distributions, emissions, climate

Course objectives

- Familiarity with terminology, concepts, disputes
- Understand where the concepts and debates are coming from
- Ability to discuss salient issues
- Basic algebra knowledge
- Intermediate level of economic understanding

Relevance for SEEP program

- Growth vs the Environment
- Poverty, Inequality, Distributions, Development
- Government, unemployment
- Finance and financial crisis
- Climate change policies

SECTORS

At the core of economics

- The economics spectrum is huge
  - Micro ↔ Macro
  - Far left (Marxists) ↔ far right (Austrian)

Regardless...

- Some consensus on the relationships of different parts of the economic society

- All economic activity is interconnected
  - Circular flow of money and goods

- Some identities are not contested
  - Savings = Investment (direction is debated)

- Accounting issues
  - Financial flows between sectors need to balance out

Economy is made up sectors

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- Households
- Firms
- Banks
- Central Bank
- Government

Micro

Financial

Macro

Environment

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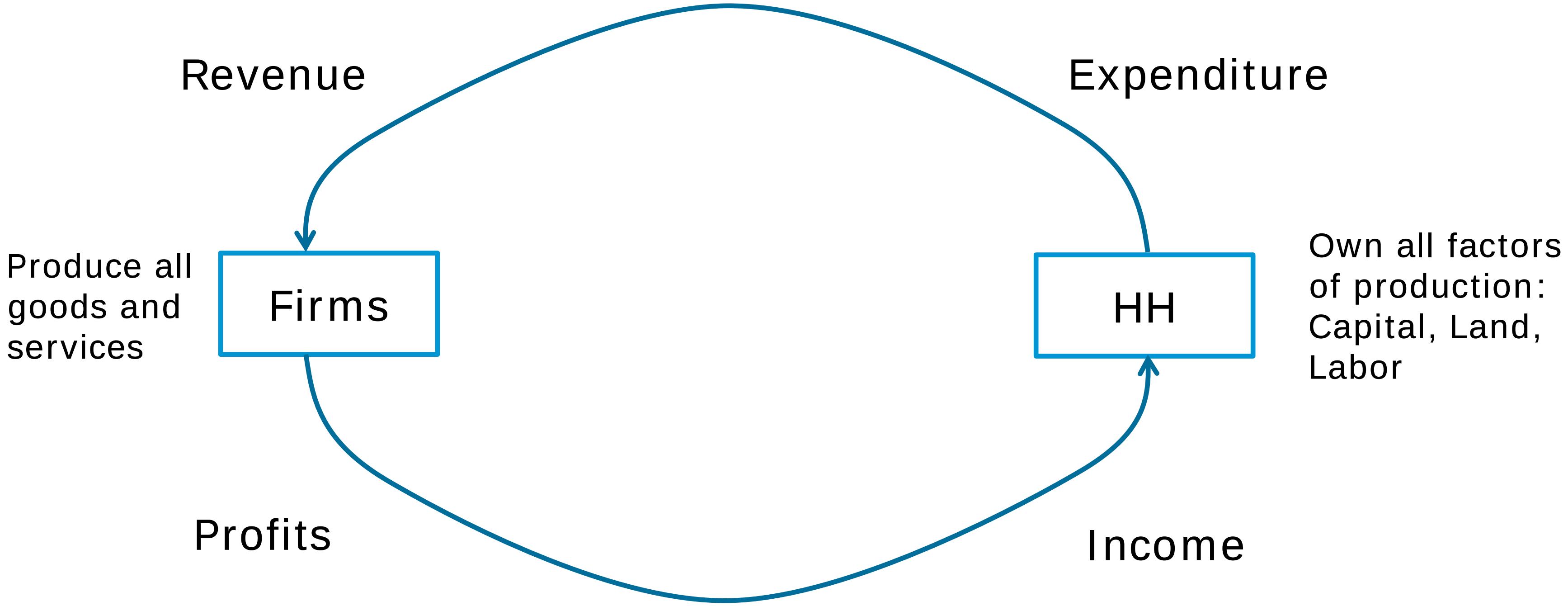
Circular Flows

- A simple circular flow economy:



Households

- Earn wage or profit income
- Consume part of the income and save the rest
- Savings are usually of three types:
  - Deposits in banks
  - Investment in financial assets
  - Investment in physical assets

Firms

- Produce goods using inputs (Labor, Capital, Energy?)
  - Consumption goods
  - Capital goods
- Sell goods in the market
  - Would like to make the highest possible profit
- Invest in capital stock
  - Own funds
  - Loans from banks

Banking sector

- Different types of banks

- Commercial banks
  - Households deposits, loans

- Corporate banks
  - Large business loans

- Investment banks
  - Investment in financial products

Commercial Banks

- Hold household deposits
- Issue loans to households and firms
- Pay interest of deposits and earn interest on loans
- Investment in financial assets
  - Depositors and own-investment

The Government

- Public sector investment
  - Roads, street lights, public transportation, electricity, water, defense, etc
- Some governments also provide
  - Unemployment benefits
  - Child/Maternity support
- Government can raise money through
  - Taxation
  - Taking money from the central bank
  - Issue government bonds
  - Creating and selling “rights” (e.g. phone licenses for 4G)
  - Providing services (public housing)

Central Bank

- Prints money
  - How much is printed?
  - Endogenous vs exogenous money
- Monetary policy
  - Now mostly controlling interest rates
- Hold bonds and treasury bills
- Regulates reserve requirements for commercial banks
- Lender of last resort: bail outs, credit lines to banks

Next lecture

Tomorrow we continue with neo-classical micro foundations of:

- Households
- Firms
- Markets