

CHAPTER ONE

ECONOMY

ORIGIN AND DEFINITION

The word "economy" can be traced back to the Greek words οἰκονόμος (i.e. "one who manages a household"), a composite word derived from οἶκος ("house") and νέμω ("manage; distribute") by way of οἰκονομία ("household management").

The first recorded sense of the word "economy" is in the phrase "the management of economic affairs", found in a work possibly composed in a monastery in 1440. "Economy" is later recorded in more general senses, including "thrift" and "administration". The most frequently used current sense, denoting "the economic system of a country or an area", seems not to have developed until the 19th or 20th century.

THE CONCEPT OF AN ECONOMY AND ECONOMIC SYSTEMS

An economy consists of the economic system in a certain region, comprising the production, distribution or trade, and consumption of limited goods and services in that region or country. In other words, an economy is the total sum of product and service transactions of value between two economic agents in a region, be it individuals, organizations or states. Transactions only occur when both parties agree to the value or price of the transacted good, commonly expressed in a certain currency.

In the past, economic activity was theorized to be bounded by natural resources, labour, and capital. This view ignores the value of technology (automation, accelerator of process, reduction of cost functions), and creativity (new products, services, processes, new markets, expands markets, diversification of markets, niche markets, increases revenue functions), especially that which produces intellectual property.

Today the range of fields of study examining the economy revolve around the social science of economics, but may include sociology (economic sociology), history (economic history), anthropology (economic anthropology), and geography (economic geography). All professions, occupations, economic agents or economic activities, contribute to the economy.

A given economy is the result of a set of processes that involves its culture, values, education, technological evolution, history, social organization, political structure and legal systems, as well as its geography, natural resource endowment, and ecology, as main factors. These factors give context, content, and set the conditions and parameters in which an economy functions. Some cultures (economic system) create more productive economies and function better than others, creating higher value, or GDP.

To understand how the economy works, we must identify its major working parts and see how they interact with each other. The working parts of an economy fall into two categories: Decision makers and Co-ordination mechanisms which are known as the economy system.

A. Decision Makers in an Economy

The decision-making structures of an economy determine the use of economic inputs (the means of production), distribution of output, the level of centralization in decision-making, and who makes these decisions. Decision makers are persons or organized groups of persons that make choices. Decision makers fall into three (3) groups: households, firms and governments.

A household is any group of people living together as a decision-making unit. Every individual in the economy belongs to a household. Some households consist of a single

person while others consist either of families or groups of unrelated individuals, such as two or three student sharing an apartment.

A *firm* is an organization that produces goods and services. All producers are called firms, no matter how big they are or what they produce. Car manufacturers, farmers, banks and insurance companies are all examples of firms.

A *government* as an organization has two functions: the provision of goods and services to households and firms and the redistribution of income and wealth. Examples of the goods and services supplied by government are national defense, law enforcement, public health, transportation and education.

B. Co-ordination Mechanisms/ Economic system

There are several basic questions that must be answered in order for an economy to run satisfactorily. The scarcity problem, for example, requires answers to basic questions, such as: what to produce, how to produce it, and who gets what is produced. An economic system is a way of answering these basic questions, and different economic systems answer them differently. Economic systems can be divided by the way they allocate economic inputs (the means of production) and how they make decisions regarding the use of inputs. An economic system can therefore be define as a set of mechanism and institutional arrangement for decision making concerning allocations of resources, production, income distribution and consumption within a geographic area. Basically, we have three types of economic systems which are:

1. Command Mechanism

A command economy is a society where the government makes all decisions about production and consumption. In other words, a command-based economy is where a central political agent commands what is produced and how it is sold and distributed. A government planning office decides what will be produced, how it will be produced, and for whom it will be produced. Detailed instructions are then issued to households and firms.

It is an economic system based on the state ownership of capital and land, on central planning and on distribution income in accordance with the principle of “from each according to his ability, to each according to his contribution and need”.

Individuals are permitted to own their human capital and capital equipment used for consumption purposes such as consumer durable goods. All other capital is owned by the state. Thus the state owns all factories and farms and the plant and equipment to operate them. All labour works for the state and all consumption goods and services are produced by and bought from the state.

Shortages are common problems with a command-based economy, as there is no mechanism to manage the information (prices) about the systems natural supply and demand dynamics.

The best example of a command mechanism is in the USSR (before 1987), North Korea, Libya, China, Cuba and some other Eastern European Countries.

2. Market Mechanism

It is an economic system base on the private ownership of capital and land and on market allocation of resources. A market-based economy is where goods and services are produced without obstruction or interference, and exchanged according to demand and supply between participants (economic agents) by barter or a medium of exchange with a credit or debit value accepted within the network, such as a unit of currency and at some free market or market clearing price. Markets in which there is very little government intervention are also called free

markets. The basic underpinning of capitalism is that each individual's judgment about his own well-being is paramount in determining what economic actions take place.

Individuals in free markets pursue their own interests, trying to do as well for themselves as they can without any government assistance or interference. Adam Smith argued that individual pursuing their self-interest would be led by "an invisible hand" to do things that are in the interest of society as a whole.

Recourses can move freely to any area of emerging shortage, signaled by rising price, and thus dynamically and automatically relieve any such threat. Market based economies require transparency on information, such as true prices, to work, and may include various kinds of immaterial production, such as affective labour that describes work carried out that is intended to produce or modify emotional experiences in people, but does not have a tangible, physical product as a result.

The market mechanism has been proved to be superior in resources allocation nonetheless due to monopoly and externality the market may fail to lead society to allocate resources efficiently. So government intervention may then be justified.

3. *The Mixed Economy*

While the free market allows individuals to pursue their self-interest without any government restrictions, the command economy allows a little scope for individual economic freedom since the government takes most decisions centrally. Between these two extremes lies the mixed economy.

In a mixed economy the government and private sector interact in solving economic problems. The government controls a significant share of output through taxation, transfer payments and provision of goods and services such as defense and police force, hospitals, education etc. It also regulates the extent to which individuals pursue their own self-interest. Even countries such as the United States which espouse more enthusiastically the free market approach, still have substantial levels of government activity in the provision of public goods and services, the redistribution of income through taxes and transfer payments, and the regulation of markets.

In summary

Economic Systems	
Traditional	<ul style="list-style-type: none"> • Based on agriculture • Limited barter trade • Neolithic Civilizations • Early River Valley Civilizations
Market	<ul style="list-style-type: none"> • Based upon Supply and Demand • Usually focus on consumer goods • Little government control
Command	<ul style="list-style-type: none"> • Controlled by strong, centralized government • Usually focuses on industrial goods • Little attention paid to agriculture and consumer goods
Mixed	<ul style="list-style-type: none"> • Combination of Market and Command economic systems • Market forces control most consumer goods • Government directs industry in need areas.

THE DOCTRINE OF MERCANTILISM

Mercantilism is the economic doctrine that says government control of foreign trade is of paramount importance for ensuring the prosperity and security of a state. In particular, it demands a positive balance of trade. In thought and practice it dominated Western Europe from the 16th to the late-18th century. Mercantilism was a cause of frequent European wars in that time. It also was a motive for colonial expansion. Mercantilist theory varied in sophistication from one writer to another and evolved over time. Favours for powerful interests were often defended with mercantilist reasoning. Mercantilist policies have included:

- High tariffs, especially on manufactured goods;
- Monopolizing markets with staple ports;
- Exclusive trade with colonies;
- Forbidding trade to be carried in foreign ships;
- Export subsidies;
- Banning all export of gold and silver;
- Promoting manufacturing with research or direct subsidies;
- Limiting wages;
- Maximizing the use of domestic resources;
- Restricting domestic consumption with non-tariff barriers to trade.

The theory of mercantilist

Most of the European economists who wrote between 1500 and 1750 are today generally considered mercantilists; this term was initially used solely by critics, such as Mirabeau and Smith, but was quickly adopted by historians. Originally the standard English term was "mercantile system". The word "mercantilism" was introduced into English from German in the early 19th century.

Smith saw English merchant Thomas Mun (1571–1641) as a major creator of the mercantile system, especially in his posthumously published *Treasure by Foreign Trade* (1664), which Smith considered the archetype or manifesto of the movement. Perhaps the last major mercantilist work was James Steuart's *Principles of Political Economy* published in 1767.

"Mercantilist literature" also extended beyond England. For example, Italy, France, and Spain produced noted writers of mercantilist themes including Italy's Giovanni Botero (1544–1617) and Antonio Serra (1580-?); France's, Jean Bodin, Colbert and other physiocrats precursors; and the Spanish School of Salamanca writers Francisco de Vitoria (1480 or 1483–1546), Domingo de Soto (1494–1560), Martin de Azpilcueta (1491–1586), and Luis de Molina (1535–1600). Themes also existed in writers from the German historical school from List, as well as followers of the "American system" and British "free-trade imperialism," thus stretching the system into the 19th century. However, many British writers, including Mun and Misselden, were merchants, while many of the writers from other countries were public officials. Beyond mercantilism as a way of understanding the wealth and power of nations, Mun and Misselden are noted for their viewpoints on a wide range of economic matters.

The Austrian lawyer and scholar Philipp Wilhelm von Hornick, in his *Austria Over All, If She Only Will* of 1684, detailed a nine-point program of what he deemed effective national economy, which sums up the tenets of mercantilism comprehensively:

- That every inch of a country's soil be utilized for agriculture, mining or manufacturing.
- That all raw materials found in a country be used in domestic manufacture, since finished goods have a higher value than raw materials.
- That a large, working population be encouraged.

- That all export of gold and silver is prohibited and all domestic money be kept in circulation.
- That all imports of foreign goods be discouraged as much as possible.
- That where certain imports are indispensable they be obtained at first hand, in exchange for other domestic goods instead of gold and silver.
- That as much as possible, imports are confined to raw materials that can be finished [in the home country].
- That opportunity is constantly sought for selling a country's surplus manufactures to foreigners, so far as necessary, for gold and silver.
- That no importation be allowed if such goods are sufficiently and suitably supplied at home.

Other than Von Hornick, there were no mercantilist writers presenting an overarching scheme for the ideal economy, as Adam Smith would later do for classical economics. Rather, each mercantilist writer tended to focus on a single area of the economy. Only later did non-mercantilist scholars integrate these "diverse" ideas into what they called mercantilism.

One notion mercantilists widely agreed upon was the need for economic oppression of the working population; laborers and farmers were to live at the "margins of subsistence". The goal was to maximize production, with no concern for consumption. Extra money, free time, or education for the "lower classes" was seen to inevitably lead to vice and laziness, and would result in harm to the economy.

The mercantilists saw a large population as a form of wealth which made possible the development of bigger markets and armies. The opposing doctrine of physiocracy predicted that mankind would outgrow its resources.

Historical promotion of mercantilism

Arguments have been made for the historical promotion of mercantilism in Europe since recorded history, with authors noting the trade policies of Athens and its Delian League specifically mention control of value of trade in bullion as necessary for the promotion of the Greek polis. Additionally, the noted competition of medieval monarchs for control of the market town trade and of the spice trade, as well as the copious documentation of Venice, Genoa, and Pisa regarding control of the Mediterranean trade of bullion clearly points to an early understanding of mercantilist principles. However, as a codified school, mercantilism's real birth is marked by the Empiricism of the Renaissance, which first began to quantify large-scale trade accurately.

England began the first large-scale and integrative approach to mercantilism during the Elizabethan Era (1558–1603). An early statement on national balance of trade appeared in Discourse of the Common Weal of this Realm of England, 1549: "We must always take heed that we buy no more from strangers than we sell them, for so should we impoverish ourselves and enrich them." The period featured various but often disjointed efforts by the court of Queen Elizabeth to develop a naval and merchant fleet capable of challenging the Spanish stranglehold on trade and of expanding the growth of bullion at home. Queen Elizabeth promoted the Trade and Navigation Acts in Parliament and gave orders-in-council to her Admiralty for the protection and promotion of English shipping. A systematic and coherent explanation of balance of trade was made public through Thomas Mun's c.1630 "England's treasure by foreign trade or, the balance of our foreign trade is the rule of our treasure"

These efforts organized national resources sufficiently in the defense of England against the far larger and more powerful Spanish Empire, and in turn paved the foundation for establishing a

global empire in the 19th century. The authors noted most for establishing the English mercantilist system include Gerard de Malynes and Thomas Mun, who first articulated the Elizabethan System, which in turn was then developed further by Josiah Child. Numerous French authors helped cement French policy around mercantilism in the 17th century. This French mercantilism was best articulated by Jean-Baptiste Colbert (in office, 1665–1683), though policy liberalised greatly under Napoleon.

In Europe, academic belief in mercantilism began to fade in the late 18th century, especially in England, in light of the arguments of Adam Smith and the classical economists. The repeal of the Corn Laws by Robert Peel symbolised the emergence of free trade as an alternative system. Mercantilism never returned to popularity among economists as the principle Comparative Advantage shows the gains from international trade. However, during the Great Recession countries raised tariffs in an attempt to protect their industries, sharply reducing world trade.

Jean-Baptiste Colbert's work in seventeenth century France exemplified classical mercantilism. Currently, advocacy of mercantilist methods for maintaining high wages in advanced economies are popular among workers in those economies, but such ideas are rejected by most policymakers and economists.

Why mercantilism dominated economic ideology for 250 years

Scholars debate over why mercantilism dominated economic ideology for 250 years. One group, represented by Jacob Viner, argues that mercantilism was simply a straightforward, common-sense system whose logical fallacies could not be discovered by the people of the time, as they simply lacked the required analytical tools.

The second school, supported by scholars such as Robert B. Ekelund, contends that mercantilism was not a mistake, but rather the best possible system for those who developed it. This school argues that mercantilist policies were developed and enforced by rent-seeking merchants and governments. Merchants benefited greatly from the enforced monopolies, bans on foreign competition, and poverty of the workers. Governments benefited from the high tariffs and payments from the merchants. Whereas later economic ideas were often developed by academics and philosophers, almost all mercantilist writers were merchants or government officials.

Monetarism offers a third explanation for mercantilism. European trade exported bullion to pay for goods from Asia, thus reducing the money supply and putting downward pressure on prices and economic activity. The evidence for this hypothesis is the lack of inflation in the English economy until the Revolutionary and Napoleonic wars when paper money was extensively used.

A fourth explanation lies in the increasing professionalisation and technification of the wars of the era, which turned the maintenance of adequate reserve funds (in the prospect of war) into a more and more expensive and eventually competitive business.

Mercantilism developed at a time when the European economy was in transition. Isolated feudal estates were being replaced by centralized nation-states as the focus of power. Technological changes in shipping and the growth of urban centers led to a rapid increase in international trade. Mercantilism focused on how this trade could best aid the states.

Criticisms

The first school to completely reject mercantilism was the physiocrats, who developed their theories in France. Their theories also had several important problems, and the replacement of mercantilism did not come until Adam Smith published *The Wealth of Nations* in 1776. This book outlines the basics of what is today known as classical economics. Smith spends a

considerable portion of the book rebutting the arguments of the mercantilists, though often these are simplified or exaggerated versions of mercantilist thought.

Adam Smith and David Hume were the founding fathers of anti-mercantilist thought. A number of scholars found important flaws with mercantilism long before Adam Smith developed an ideology that could fully replace it. Critics like Hume, Dudley North, and John Locke undermined much of mercantilism, and it steadily lost favour during the 18th century.

In 1690, John Locke argued that prices vary in proportion to the quantity of money. Locke's Second Treatise also points towards the heart of the anti-mercantilist critique: that the wealth of the world is not fixed, but is created by human labour (represented embryonically by Locke's labour theory of value). Mercantilists failed to understand the notions of absolute advantage and comparative advantage (although this idea was only fully fleshed out in 1817 by David Ricardo) and the benefits of trade.

For instance, suppose Portugal was a more efficient producer of both wine and cloth than England, yet in England it was relatively cheaper to produce cloth compared to wine. Thus if Portugal specialized in wine and England in cloth, both states would end up better off if they traded. This is an example of the reciprocal benefits of trade due to a comparative advantage. In modern economic theory, trade is not a zero-sum game of cutthroat competition because both sides can benefit.

Hume famously noted the impossibility of the mercantilists' goal of a constant positive balance of trade. As bullion flowed into one country, the supply would increase and the value of bullion in that state would steadily decline relative to other goods. Conversely, in the state exporting bullion, its value would slowly rise. Eventually it would no longer be cost-effective to export goods from the high-price country to the low-price country, and the balance of trade would reverse itself. Mercantilists fundamentally misunderstood this, long arguing that an increase in the money supply simply meant that everyone gets richer.

To a certain extent, mercantilist doctrine itself made a general theory of economics impossible. Mercantilists viewed the economic system as a zero-sum game, in which any gain by one party required a loss by another. Thus, any system of policies that benefited one group would by definition harm the other, and there was no possibility of economics being used to maximize the "commonwealth", or common good. Mercantilists' writings were also generally created to rationalize particular practices rather than as investigations into the best policies.

Mercantilist domestic policy was more fragmented than its trade policy. While Adam Smith portrayed mercantilism as supportive of strict controls over the economy, many mercantilists disagreed. The early modern era was one of letters patent and government-imposed monopolies; some mercantilists supported these, but others acknowledged the corruption and inefficiency of such systems.

THEORIES OF INTERNATIONAL TRADE

Mercantilist regulations were steadily removed over the course of the Eighteenth Century in Britain, and during the 19th century the British government fully embraced free trade and Smith's laissez-faire economics. The neoclassical economist Adam Smith, who developed the theory of absolute advantage, was the first to explain why unrestricted free trade is beneficial to a country. Smith argued that 'the invisible hand' of the market mechanism, rather than government policy, should determine what a country imports and what it exports. Two theories have been developed from Adam Smith's absolute advantage theory. The first is the English neoclassical economist David Ricardo's comparative advantage. Two Swedish economists, Eli Hecksher and Bertil Ohlin, develop the second theory. Another theory trying to explain the failure of the

Heckscher-Ohlin theory of international trade was the product life cycle theory developed by Raymond Vernon.

The theory of Absolute Advantage

The Scottish economist Adam Smith developed the trade theory of absolute advantage in 1776. A country that has an absolute advantage produces greater output of a good or service than other countries using the same amount of resources. Smith stated that tariffs and quotas should not restrict international trade; it should be allowed to flow according to market forces. Contrary to mercantilism Smith argued that a country should concentrate on production of goods in which it holds an absolute advantage. No country would then need to produce all the goods it consumed. The theory of absolute advantage destroys the mercantilistic idea that international trade is a zero-sum game. According to the absolute advantage theory, international trade is a positive-sum game, because there are gains for both countries to an exchange. Unlike mercantilism this theory measures the nation's wealth by the living standards of its people and not by gold and silver.

There is a potential problem with absolute advantage. If there is one country that does not have an absolute advantage in the production of any product, will there still be benefit to trade, and will trade even occur? The answer may be found in the extension of absolute advantage, the theory of comparative advantage.

The theory of comparative advantage

The most basic concept in the whole of international trade theory is the principle of comparative advantage, first introduced by David Ricardo in 1817. It remains a major influence on much international trade policy and is therefore important in understanding the modern global economy. The principle of comparative advantage states that a country should specialize in producing and exporting those products in which it has a comparative, or relative cost, advantage compared with other countries and should import those goods in which it has a comparative disadvantage. Out of such specialization, it is argued, will accrue greater benefit for all.

In this theory there are several assumptions that limit the real-world application. The assumption that countries are driven only by the maximization of production and consumption and not by issues out of concern for workers or consumers is a mistake.

Heckscher-Ohlin Theory

In the early 1900s an international trade theory called factor proportions theory emerged by two Swedish economists, Eli Heckscher and Bertil Ohlin. This theory is also called the Heckscher-Ohlin theory. The Heckscher-Ohlin theory stresses that countries should produce and export goods that require resources (factors) that are abundant and import goods that require resources in short supply. This theory differs from the theories of comparative advantage and absolute advantage since these theory focuses on the productivity of the production process for a particular good. On the contrary, the Heckscher-Ohlin theory states that a country should specialise production and export using the factors that are most abundant, and thus the cheapest. Not produce, as earlier theories stated, the goods it produces most efficiently.

The Heckscher-Ohlin theory is preferred to the Ricardo theory by many economists, because it makes fewer simplifying assumptions. In 1953, Wassily Leontief published a study, where he tested the validity of the Heckscher-Ohlin theory. The study showed that the U.S was more abundant in capital compared to other countries; therefore the U.S would export capital-

intensive goods and import labour-intensive goods. Leontief found out that the U.S's export was less capital intensive than import.

Product life-cycle theory

The product life-cycle theory is an economic theory that was developed by Raymond Vernon in response to the failure of the Heckscher-Ohlin model to explain the observed pattern of international trade. The theory suggests that early in a product's life-cycle all the parts and labour associated with that product come from the area in which it was invented. After the product becomes adopted and used in the world markets, production gradually moves away from the point of origin. In some situations, the product becomes an item that is imported by its original country of invention. A commonly used example of this is the invention, growth and production of the personal computer with respect to the United States.

The model applies to labour-saving and capital-using products that (at least at first) cater to high-income groups.

In the new product stage, the product is produced and consumed in the US; no export trade occurs. In the maturing product stage, mass-production techniques are developed and foreign demand (in developed countries) expands; the US now exports the product to other developed countries. In the standardized product stage, production moves to developing countries, which then export the product to developed countries.

The model demonstrates dynamic comparative advantage. The country that has the comparative advantage in the production of the product changes from the innovating (developed) country to the developing countries.

Summary

Mercantilism proposed that a country should try to export more than it imports, in order to receive gold. The main criticism of mercantilism is that countries are restricted from import, a prevention of international trade. Adam Smith developed the theory of absolute advantage that stressed that a country should produce goods or services if it uses a lesser amount of resources than other countries. David Ricardo stated in his theory of comparative advantage that a country should specialise in producing and exporting products in which it has a comparative advantage and it should import goods in which it has a comparative disadvantage. Heckscher-Ohlin's theory of factor endowments stressed that a country should produce and export goods that require resources (factors) that are abundant in the home country. Leontief tested the Heckscher-Ohlin theory in the U.S. and found that it was not applicable in the U.S. Raymond Vernon's product life cycle theory stresses that a company will begin to export its product and later take on foreign direct investment as the product moves through its life cycle. Eventually a country's export becomes its import.