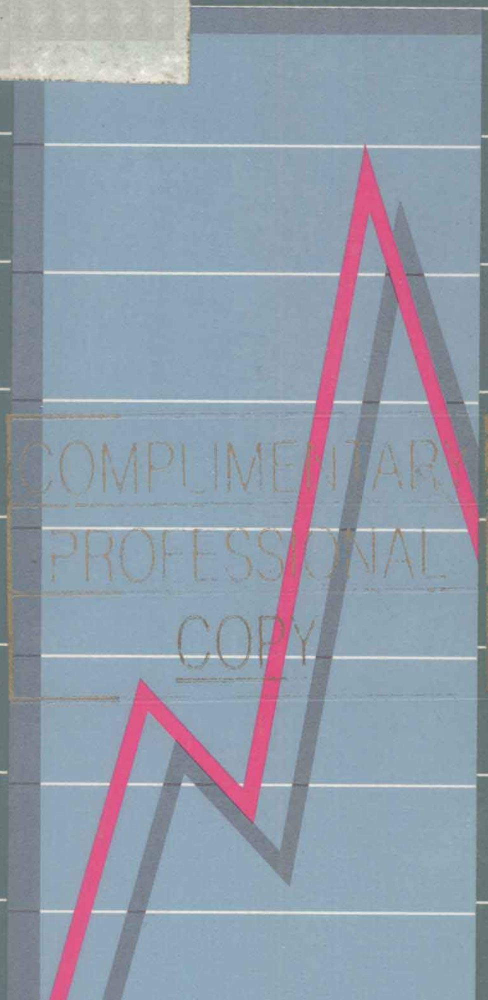
NOMICS

THE MARKET PROCESS



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ECONOMICS

Understanding the Market Process

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HBJ

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For Emily and Brian

The goal of the economist is not merely to train a new generation in his arcane mystery: it is to understand this economic world in which we live and the other ones which a million reformers of every description are imploring and haranguing us to adopt. This is an important and honorable goal.

GEORGE STIGLER, 1982 Nobel Laureate in Economics

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PREFACE

Not long ago, I visited some close friends whose son was home on vacation from college. I knew he had recently completed his first course in economics and I was interested in his reaction. What, I wondered, does a very bright undergraduate attending a college with a national reputation for superior teaching really bring away from his introductory economics course? As it turned out, his strongest impression—and probably his most enduring, for he never took another economics course—was that economics was mainly about graphs and curve shifting!

Needless to say, I was dismayed. But given the increasing incursion of formalism and technique into the teaching of undergraduate economics I suppose I should not have been too surprised. As teachers of economics we can avoid this kind of outcome and provide students with a lasting appreciation for the power of the economic way of thinking if only we would appeal as much as possible to their intuition and to their experience. We need not deny theory its proper role in the introductory economics course; we need only present it as systematic common sense. It is in that spirit that I have written *Economics: Understanding the Market Process* for the first college course in economics. I have sought to show how a few simple but powerful principles can help make sense of the incredibly rich but otherwise mystifying diversity of economic life. I have included numerous examples and applications to support and demonstrate this proposition. Contrary to the current fashion in textbook publishing, however, I have chosen to weave them into the fabric of the text itself rather than pull them out and highlight them in separate boxes. I believe the result is not only sound pedagogy but also a more coherent and readable text. (A list of these examples can be found after the Table of Contents.)

Economics: Understanding the Market Process is divided into three main sections: an introduction (Chapters 1–5), a microeconomics core (Chapters 6–14) and a macroeconomics core (Chapters 15–23). It concludes with a chapter on international economics (Chapter 24). As a relatively short book it can be used in a one-semester survey course covering both micro and macro; but, because it covers all of the essential topics in both areas, it can also be used in place of more encyclopedic principles textbooks by an instructor who wishes to emphasize depth rather than breadth in a two-semester (or two-quarter) course. The text has been constructed to provide the option of either a micro–macro or a macro–micro sequence. Additional flexibility is provided by the fact that some chapters, such as the one on international economics, can pretty much stand alone after the introductory material has been covered. (See the *Instructor's Manual* for more details on coverage and sequence options.)

Chapter 1 introduces the student to the nature of economic problems and methods. In the next three chapters, the standard material on supply and demand (Chapter 3) is preceded by an analysis of the logic of individual specialization and exchange (Chapter 2) and followed by an extensive discussion of the role of market processes in solving the immense coordination problems in a world of continuous change (Chapter 4). By proceeding from the level of the individual to that of the market and on to that of a system of interdependent markets, this arrangement effectively demonstrates the power of the "invisible hand" in coordinating the world's economic activity. Chapter 5 discusses the economic role of the command processes available to governments as an alternative to market coordination. On the normative side, it covers the standard material on market failure; on the positive side, it introduces the economic theory of public choice, which is then used throughout the remainder of the text as a framework for understanding why government does what it actually does (which, of course, is frequently inconsistent with what the normative theory says it should do). Without such a consistent theory of government behavior, the reasons for so many questionable economic policies escape the student. "If economics says trade protection (or rent control, etc.) is so harmful, why does the government do it?" Public choice theory provides a set of consistent answers.

Drawing a line between the introduction and the micro core after Chapter 5 is somewhat arbitrary, for either Chapter 6, or 7, or both can be treated as part of the introductory material. Chapter 6 introduces and applies the concepts of demand and supply elasticity, and Chapter 7 explores the logic and implications of augmenting market coordination with managerial coordination within business firms, focusing particularly on those firms organized as corporations. Chapter 8 considers the firm's production and cost functions as a prelude to the analysis of price and output determination in price takers' markets (Chapter 9) and price setters' markets (Chapter 10). Although the complete models of pure competition and monopoly are developed in Chapters 9 and 10, respectively, theoretical formalism is minimized in coverage of the intermediate cases of "imperfect competition." Instead of constructing elaborate theoretical models of oligopoly and monopolistic competition, the text discusses the nature of rivalrous competition and the conditions necessary for collusion in concentrated markets (Chapter 11) and focuses on the process of innovation, experimentation, and discovery in markets with differentiated products (Chapter 12). Chapter 13 looks at antitrust, regulatory, and environmental policies from both a normative and positive (public choice) viewpoint, and Chapter 14 introduces the general economics of factor markets and income distribution, focusing primarily on the labor market. (Although Chapter 14 concludes the micro core, it is a stand-alone chapter that can be assigned at any time after the introductory material has been covered.)

The macro core begins in Chapter 15 with a general overview of macroeconomic issues that provides the student with a perspective on recent macroeconomic history and a frame of reference for organizing the material that follows. After presenting the standard material on the national income accounts (Chapter 16) and the banking system and money creation (Chapter 17), the book turns to a historical overview of the classical–Keynesian debate in Chapter 18. I believe that an appreciation of the roots of this debate is crucial for understanding the issues of modern macroeconomics. Having illustrated the macroeconomic importance of wage adjustments in Chapter 18, the book goes on to provide a comprehensive overview of the aggregate labor market in Chapter 19 where modern job search and contract theories of unemployment and wage adjustment are developed. These theories are then integrated into the modern theory of aggregate supply and the business cycle in Chapter 20. Together Chapters 19 and 20 provide a firm foundation for the treatment of the monetary (Chapter 21) and income–expenditure (Chapter 22) theories of aggregate demand. Monetary and fiscal policies, the basics of which are introduced in Chapters 21 and 22, respectively, are then subjected to a more critical evaluation in Chapter 23, which concludes with an application of public choice theory to macroeconomic policy.

I have chosen to use the aggregate supply–aggregate demand apparatus (which I take great care to distinguish from the market supply–demand model) as the principal analytical framework throughout the macro core. In so doing, I have confined the Keynesian income–expenditure model, which in some textbooks is still the dominant mode of macroeconomic analysis, to a single chapter (Chapter 22), where I treat it as simply one framework for the analysis of aggregate demand. The equation of exchange is given equal billing as a framework for analyzing the monetary aspects of aggregate demand in Chapter 21.

Chapter 24 covers international economics. I should, however, emphasize that it is not the student's first encounter with the world economy; numerous examples and applications throughout the text highlight the international dimensions of economic issues. The logic of international trade shows up as early as Chapter 2. In Chapter 4 I have deliberately chosen examples of market interdependence that extend across international borders. In Chapter 5 I apply public choice theory to protectionism. Differences in employment practices between American and Japanese firms highlight an example in Chapter 9, which concludes with an application of the purely competitive model to the international market for oil tanker services. Chapter 11 discusses some international cartels. Chapter 16 introduces the concept of trade balances and examines their relationship to domestic saving and investment in the context of national income accounts. Chapter 22 shows how trade flows affect aggregate demand and domestic GNP. Chapter 24 simply wraps the international economy into a single neat package which, as noted, can stand pretty much on its own after the introductory material has been covered.

Economics has changed dramatically over the past quarter century. Transactions costs, incomplete information, efficient capital markets, property rights, public choice, agency costs, search costs, implicit contracts, customer markets, rational expectations, and the political business cycle are all relatively new concepts that have contributed greatly to our ability to make sense of otherwise mystifying economic phenomena. What makes this a truly modern textbook is that it introduces such concepts on the ground floor, making them integral elements of the analysis rather than simply grafting them on as afterthoughts.

Economics: Understanding the Market Process is available in a complete package including the textbook, a *Study Guide* prepared by Saul Kaufler of Los Angeles Pierce College, an *Instructor's Manual* (containing for each chapter an annotated outline, a list of distinctive features and points to emphasize, teaching suggestions, and answers to end-of-chapter questions), a *Test Bank* (in both paperback and computerized versions), and a set of *Transparency Masters*.

This book has been more than eight years in preparation, having been revised and rewritten numerous times. Among those who deserve my thanks for their helpful comments and suggestions on various versions of the manuscript are the following reviewers: Gerald Breger, University of South Carolina; William Davis, Western Kentucky University; Stephen Sacks, University of Connecticut-Storrs; Richard Towey; and Donald Wells, University of Arizona.

Finally, I would like to thank my family for helping me to ride out the many highs and lows that inevitably accompany a project like this, and to survive with my sanity nearly intact.

APPLICATIONS IN ECONOMICS

CHAPTER	SUBJECT
1	Opportunity costs versus monetary outlays. Economic systems and ecological systems.
2	Cartels: the rise and fall of OPEC. Middlemen: supermarkets, department stores, financial intermediaries, business firms in general.
3	Inflation versus relative price changes: nominal and real price changes, 1970–89.
4	Market interdependence: the effects of a rise in the price of crude oil. Risk allocation: hedging in futures markets. Price floors: minimum wages, agricultural crop restrictions. Price ceilings: rent controls, gas lines, WWII ration tickets. Comparative economic systems: the collapse of socialism and the prospects for market capitalism in the Soviet Union and Eastern Europe.
5	Political tradeoffs: regulatory policy; foreign trade policy; environmental policy. Interest groups: the political economy of automobile import restrictions.
6	Price elasticity and expenditure changes: agricultural crop restrictions; the dilemma for drug enforcement policy. Elasticity and tax incidence.
7	Integrated production: how to produce a book. Present value: the determinants of stock and bond prices. Corporate finance. The stock market and capital allocation. The corporate takeover market and its colorful language.
8	Experience effects in the production of microchips.

9 The shutdown decision: car assembly plants during recessions; why Japanese firms continue production while their U.S. competitors shut down.
Entry and exit: competition in the supertanker market.

10 Exclusive monopoly rights and their economic value.
Price discrimination: airline pricing; college financial aid; coupon clipping; NFL season ticket packages; deBeers diamond "sightings."
Monopoly versus competition: the effects of eliminating the NCAA's monopoly over college football telecasts.

11 Rivalrous competition: IBM, Apple, and the microcomputer industry; Coke, Pepsi, and the soft drink industry.
Collusion: OPEC; the International Air Transport Association (IATA); the electrical equipment conspiracy; marketing diamonds through deBeers.
Professional codes of conduct: noncompetition among lawyers.

12 Innovation and imitation: Lite beer and its imitators.
Innovation and risk: RCA's video disk; IBM's PCjr; the "new" Coke.
Planned obsolescence: Does it pay?
Lemons markets: used cars.
Economic functions of brand names: rescuing the Tylenol name.
Advertising and prices: eyeglasses; legal services.

13 Merger policy: the Justice Department's merger guidelines; megamergers of the 1980s.
Antitrust and single-firm monopoly: Kodak, DuPont, and AT&T.
Vertical restraints: resale price maintenance (RPM); exclusive territories for beer and soft drink distributors.
Regulation and deregulation: airlines; broadcasting and telecommunications.
Environmental policy: command and control regulation by the EPA; marketable pollution rights.

14 Comparable worth and the gender gap.
Minimum wage laws.
Economic rent: the earnings of sports and entertainment superstars.
Factor market monopoly: labor unions; occupational licensure.
Monopsony: the reserve system and collusion in major league baseball.
Poverty: the high cost of escaping poverty; the political economy of the welfare system.

15 Economic growth: estimates of contributing factors.
Inflation versus one-shot changes in the price level: the effects of oil price shocks.
Anatomy of the recession of '82.
The Great Depression.
The German hyperinflation.
Stagflation during the 1970s.
What happened to the Phillips curve?

16 Measuring aggregate economic activity: the underground economy; illegal activity.

17 Financial intermediaries and deregulation of financial markets.
Monetizing government deficits.

18 Using Keynesian theory to explain the Great Depression.

19 Why people become unemployed.
Unemployment duration and the natural rate of unemployment.
Recent change in the natural rate of unemployment.
Job search theory and unemployment differentials.

20 Accelerating inflation during the 1960s.
The inflationary recession of 1970.
The supply shock recessions of 1973–75 and 1979–80.
Recession and recovery during the 1980s.
The Phillips curve revisited.

21 Credit cards and the demand for money.
Monetary growth and inflation between 1960 and 1982.
Recent changes in velocity and their implications.

22 Empirical estimates of the autonomous spending multiplier.

23 Information problems for policy makers: the stock market crash of 1987.
Monetary policy in practice.
Government deficits as future taxes.
Fiscal policy: the structural budget since WWII.
Fiscal policy and aggregate supply: the "supply side" tax cuts of the 1980s.
Political business cycles: unemployment, inflation, and the presidential election cycle from 1948 to 1988.

24 Sources and consequences of foreign trade deficits. Measuring the costs of protectionism: estimates for 15 industries.
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