



UNDERSTANDING THE MARKET ECONOMY



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To
Jannike and Elisabeth
Mette, Christoffer, and Tobias
Jóhanna and Bjarni

Preface

THE inspiration to write this book came to us during the conference 'The Baltic Family' held in Kaunas, the old capital of Lithuania, in October 1990. Realizing the enormous challenges facing Lithuania in its transition from plan to market, we decided to try our hands at a book explaining the workings of a market economy. A modest contribution to such an understanding is the purpose of this book.

In the course of writing this book, the Centre for Baltic Business Development has been established at the Norwegian School of Management. The present book is the first contribution in the Learning Library Programme of that centre.

Originally, the book was intended for beginners' courses in economics and business administration. However, since we rely on simple examples rather than mathematical equations, the book should be accessible to a much wider audience than a standard textbook in economics. Through circulating earlier drafts of the manuscript among Scandinavian readers, we have indeed learned that people from different walks of life have got a good grasp of economics from reading it. This makes us believe that business people, academics in other fields, politicians, public servants, and enlightened laymen in general could benefit from reading the book.

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The Danish physicist Niels Bohr once remarked that physics is not about the real world because the world is too complicated for that; no, he said, physics is about what can be said about the world. We take the same

view of our subject: economics is about what can be said about economic life.

Furthermore, to a large extent, economics is concerned with marginal changes. How much will the demand for shoes decline in response to a 10 per cent increase in the price of shoes? What will be the effects of a 5 per cent devaluation of the currency? How will increased taxation of production that causes pollution accompanied by a commensurate decrease in income tax affect the economy?

However, the economic challenges now facing the nations of Central and Eastern Europe are anything but marginal. When considering these challenges, economists therefore have reason to be modest about what they have to say. We do not claim to present unequivocal or simple solutions to the serious problems that we discuss in this book. Our objective is more modest: to present an intelligible account of basic economic mechanisms and relationships and to consider how they can be brought to bear on the transition from plan to market.

Many people consider economics a difficult field. Precisely for that reason, we have endeavoured to keep the text as simple as possible, without, of course, losing rigour. The extent to which we succeed in conveying a basic understanding of economics is for you to decide, after having studied the chapters that follow. We now put our pens to rest and wish you a happy journey.

A.J.I.
C.B.H.
T.G.

Oslo, Stockholm, and Reykjavík
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Contents

<i>List of Figures</i>	xiii
<i>List of Tables</i>	xiv
<i>List of Supplements</i>	xv

I	Introduction	I
1.1.	Efficiency	2
1.2.	The Role of the State	4
1.3.	Economic Justice	4
1.4.	Overview of the Book	5

PART I: THE ECONOMIC PROBLEM

2	Production and Distribution	11
2.1.	Market or Plan?	11
2.2.	<i>The Wealth of Nations</i>	15
3	Supply and Demand	17
3.1.	Demand	17
3.2.	Supply in a Market Economy	18
3.3.	Supply in a Planned Economy	19
3.4.	Shortages	20
3.5.	Rationing of Credit and of Foreign Exchange	23
3.6.	Unemployment	24
4	Economic Adjustment	27
4.1.	Market-Clearing	28
4.2.	Price-Setting in a Planned Economy	30
4.3.	Information Problems under Planning	33
4.4.	Self-Regulatory Mechanisms in a Market Economy	34
4.5.	Consumers in Focus	36
4.6.	'Market Socialism'	36
4.7.	A Centrally Planned Market Economy	38
4.8.	'Economic Man'	39
5	The Interplay of Aggregate Supply and Demand	42
5.1.	Micro- and Macroeconomics	42
5.2.	Aggregate Demand	44

5.3.	Aggregate Supply	46
5.4.	Macroeconomic Equilibrium	50
5.5.	Four Properties of Macroeconomic Equilibrium	52
5.6.	Effects of External Shocks	54
5.7.	Effects of Economic Policies	57
6	The Workings of a Planned Economy	61
6.1.	A Lack of Incentives	61
6.2.	Uncertainty	62
6.3.	The Consequences of Too Low Prices	65
6.4.	Gigantism	68
6.5.	Summary	70

PART II: THE WORKINGS OF A MARKET ECONOMY

7	Prerequisites for a Market Economy	77
7.1.	Private Ownership	77
7.2.	Effective Competition and Free Exchange of Goods	78
7.3.	Bankruptcies and the Reorganization of Firms	81
7.4.	Summary	84
8	Challenges Posed by the Market	86
8.1.	Prices, Information, and Rationing	86
8.2.	Relative Prices and the Absolute Price Level	87
8.3.	Challenges to Producers	88
8.4.	New Profit-Making Prospects	90
8.5.	Reorganization in Enterprises	92
8.6.	Changes in Mentality and Attitudes	93
8.7.	Challenges to the Authorities	96
9	Dilemmas and Problems in a Market Economy	99
9.1.	The Great Depression and Keynes	99
9.2.	Inflation and Unemployment	102
9.3.	Income Distribution and Luck	105
9.4.	Equality and Efficiency	106
9.5.	Stupid Capitalists	108
9.6.	Market Imperfections	110
10	Why the Market Nevertheless is Useful	111
10.1.	The Market Economy in a State of Continual Change	111
10.2.	Prices and Relative Scarcity	113
10.3.	The Fight against Pollution	114
10.4.	Unemployment	116
10.5.	Ways to Handle Unemployment	118

10.6. Individual Freedom and Economic Uncertainty	120
10.7. Summary	123

PART III: PUBLIC FINANCE, MONEY, CAPITAL, LABOUR, AND INTERNATIONAL TRADE

11 The Political Economy of Public Finance	128
11.1. The Economic Role of Government	128
11.2. Externalities	130
11.3. Health Care and Education	132
11.4. Arts and Science	132
11.5. The Inflation Tax	135
11.6. Taxation without Inflation	136
11.7. Deficits and Debts	138
12 The Role of Money	140
12.1. Metal Coins and Paper Money	140
12.2. Money as a Means of Payment	141
12.3. Money as a Store of Value and as a Unit of Account	142
12.4. Internal and External Convertibility	142
12.5. The Gold Standard	144
12.6. Printing Presses as Engines of Inflation	144
12.7. Relative Prices and the Absolute Price Level	146
12.8. Problems with Inflation	147
12.9. Creating a Monetary System	149
13 A Closer Look at the Capital Market	151
13.1. Joint Stock Companies	151
13.2. Saving in Shares and Risk	152
13.3. The Shareholders' Role	153
13.4. Return on Investment	154
13.5. Saving in Banks	157
13.6. The Capital Market Viewed as a Whole	160
13.7. The Role of Banks	161
13.8. Summary	163
14 The Labour Market in a Competitive Economy	165
14.1. Labour Market Organizations	165
14.2. Strikes and Lockouts	166
14.3. Organized Functionaries	167
14.4. The Public Sector	169
14.5. The Rights of Employees	171
14.6. Wage Settlements in Practice	171
14.7. Wage Growth and Competitiveness	172

15 International Trade	175
15.1. Adam Smith on Absolute Advantage	175
15.2. David Ricardo on Comparative Advantage	176
15.3. Whence Protectionism?	178
15.4. Planning-Directed Trade	181
15.5. Trade with Western Countries	183
15.6. Bilateral Balance in Trade	184

PART IV: PRIVATIZATION, ACCOUNTING, AND CHALLENGES FOR THE FUTURE

16 Privatization in Central and Eastern Europe	190
16.1. Three Aspects of Privatization	190
16.2. Small Businesses	191
16.3. Agriculture and Housing	193
16.4. Large Enterprises	194
16.5. A Closer Look at Investment Companies	197
16.6. Distribution	199
16.7. Stability	202
16.8. Summary	203
17 Elements of Accounting	204
17.1. Calculating Profits	204
17.2. Financial Accounting and Cost Accounting	206
17.3. Some Principles of Accounting	209
17.4. Ongoing Bookkeeping	210
17.5. Accruals and Deferrals	213
17.6. An Example from Real Life	214
17.7. Accounts and Budgets as a Basis for Decision-Making	217
17.8. Summary	219
18 From Plan to Market: The Challenges	221
18.1. Gradual Transition: A Poor Alternative	221
18.2. Price Reform and Macroeconomic Stability	223
18.3. The Necessity of Private Ownership	225
18.4. Free Trade	226
18.5. Incomes Policy in a Transitional Phase?	227
18.6. New Relative Prices	229
18.7. Political Legitimacy	232
<i>References</i>	235
<i>Index</i>	239

List of Figures

- 3.1. The demand curve
- 3.2. The supply curve in a market economy
- 3.3. The supply curve in a planned economy
- 3.4. The rental housing market
- 3.5. Supply and demand in the labour market
- 4.1. Supply and demand in a market economy
- 4.2. Supply exceeds demand in a market economy
- 4.3. The market approaches equilibrium
- 4.4. Supply and demand in a planned economy
- 4.5. Supply exceeds demand in a planned economy
- 4.6. Demand exceeds supply in a planned economy
- 4.7. Supply equals demand in a planned economy
- 5.1. The aggregate demand curve
- 5.2. The aggregate supply curve in a market economy
- 5.3. The modified aggregate supply curve in a market economy
- 5.4. Aggregate demand and supply in a market economy
- 5.5. Aggregate demand increases
- 5.6. Aggregate demand increases at full employment
- 5.7. Aggregate supply decreases
- 5.8. Aggregate supply increases
- 8.1. More producers emerge and the supply curve shifts further out
- 9.1. Unemployment in the United States, 1928–1989
- 9.2. The index of development of industrial production in the Soviet Union and the United States, 1928–1936
- 9.3. Phillips curves for the United States, 1954–1969 and 1970–1991
- 17.1. The relationship between the profit and loss account and the balance sheet
- 17.2. Financial statement for Ivan's shoe factory, year 1
- 18.1. Elements of the transition from plan to market

List of Tables

- 4.1. Four ways of *organizing an economy*
- 15.1. Hours of work in England and Portugal: Adam Smith's story
- 15.2. Hours of work in England and Portugal: David Ricardo's story
- 16.1. Three aspects of privatization: efficiency, distribution, and stability
- 17.1. Monthly sales and production budget
- 17.2. Monthly budget and actual outcome

List of Supplements

- 2.1. Prices and incentives
- 4.1. Love, Moscow-style
- 4.2. Millions of goods, billions of orders
- 4.3. What about the 'Scandinavian model'?
- 5.1. The general price level
- 5.2. National income accounting
- 5.3. Is GNP a reliable indicator of economic performance?
- 5.4. Europe 1992: supply management in action
- 6.1. The planned economy requires too large inventories
- 6.2. A hidden economy in both the East and the West
- 6.3. Extensive barter characterizes a planned economy
- 6.4. Small is beautiful
- 7.1. Specialization and trade
- 7.2. 'Hard' versus 'soft' budget constraint
- 7.3. Many new laws are needed
- 8.1. Over a period of time profits in all industries will tend to approach a normal level
- 8.2. American and Soviet attitudes to the market are not so different
- 8.3. Planned economies and negative external effects
- 9.1. The 1930s: plan superior to market?
- 9.2. From the Phillips curve to stagflation
- 10.1. Poor advisers?
- 10.2. Economists versus the prophets of regulation
- 11.1. The expansion of the public sector in market economies
- 11.2. Debt crises
- 12.1. Five ways of eliminating suppressed inflation
- 12.2. Interest and inflation
- 12.3. The Ukraine introduces its own monetary system
- 13.1. A comparison of two projects
- 13.2. Ranking projects in a planned economy
- 13.3. Average returns on shares *v.* returns on bank deposits
- 13.4. What is a stock exchange?
- 14.1. Wages and unemployment
- 14.2. A lesson from Japan?
- 15.1. Comparative advantage in practice
- 15.2. Multiple exchange rates

- 16.1. Privatization in practice
- 16.2. Examples of 'wildcat' privatization: Poland
- 17.1. Some important terms
- 17.2. Examples of bookkeeping
- 17.3. Volvo ran at a loss in 1990
- 18.1. Incomes policy in practice
- 18.2. Aid from the West?

Introduction

Whether you like it or not, history is on our side. We will bury you.

Nikita Khrushchev

IN 1960 Nikita Khrushchev claimed that in the course of the next twenty years the Soviet Union would have caught up with and surpassed the United States in terms of material standard of living. Add on ten years, and you will find an economic system in a state of dissolution: the Soviet system.

In the thirty years that have passed, the system of economic planning has shown itself unable to deliver what its leaders promised. Recognition of this fact has led to the desire to replace that system now. The market economy is generally regarded as the timely solution.

There is scarcely any doubt that the market economy has shown itself superior to the planned economy as far as economic growth is concerned. The material standard of living in Finland today is four times higher than in the Baltic states, despite the fact that at the start of the Second World War national income per head was about the same in all of these countries. In 1940 the economic situation of Hungary was about the same as that of Austria and the standard of living in Czechoslovakia was higher than in Austria. Today, however, the standard of living for the average Austrian is at least twice as high as for the average Hungarian or Czechoslovakian.

A similar story can be told about other continents. In 1960 the material standard of living in South Korea was certainly not significantly higher than in Tanzania; in 1988, however, the average annual purchasing power of income per inhabitant in Tanzania was \$US355, compared with \$US3,056 in South Korea, i.e. more than eight times as high. Compared with North Korea, which at the end of the Korean War some forty years ago was the richer part of the Korean peninsula, South Korea's income per inhabitant today is at least five times as high.

Although development of the material standard of living is difficult to compare from country to country, the conclusion remains: the market economy has shown itself to be vastly superior to the planned economy

when it comes to economic growth. And the revolution in Eastern and Central Europe in 1989–90 could not be easily understood without reference to the stagnating standard of living in these countries.

Amidst the enthusiasm surrounding liberation from the command economy's tight bonds, and the eagerness to start using 'the new system', it might be opportune to focus on the questions that the introduction of a market economy must raise, as well as pointing to the demands and challenges that society, and individual members of society, will face if the new system is to have a chance of functioning reasonably satisfactorily.

To put it in slightly simpler terms, one could say that the two major problems an economic system must solve are to ensure an effective utilization of resources in the short and long term, and a just distribution of the resultant income from production. In any economic system, the state will inevitably play an important part in solving these problems.

1.1. Efficiency

Efficient use of resources means that everyone who wishes to work will have a job. Full employment is an important objective. In the sense that virtually everyone does have a job in planned economies, economic planning has been more successful than the market system in that regard. However, with respect to how efficiently labour is utilized, the market system is clearly superior. This is due among other things to the fact that in a planned economy an unreasonable amount of working time is spent in idleness on the job and in queues outside shops.

Being idle on the job is a way of wasting resources. In a market economy the capital owner receives the *profit*, namely what is left of income after all other costs have been covered; thus, the owner of capital is given a strong incentive to prevent wastage of labour and other resources.

In the longer term, however, full employment is not merely a question of keeping people in work and ensuring that working hours are utilized effectively. At least as important is what they are working at and how. And here the market system has shown itself to be vastly superior to economic planning. This is because the market adapts itself to changes in technology and preferences.

When new methods of production of well-known products are launched, those enterprises that do not adjust to developments will have problems in selling their goods; quite simply, they risk pricing themselves out of the market. In the short term this may lead to the closure of enterprises and higher unemployment. In the longer term, however, it ensures a great degree of flexibility for the system viewed as a whole.

In a market economy enterprises compete in selling their goods and services. Their main concern is to serve the interests of consumers. This

encourages the production of new commodities which better satisfy customers' demands. Innovative enterprises that succeed in this will capture a larger part of the market. Enterprises that are unable to improve the quality of the goods they produce will have to reduce their activity. Despite the fact that the East German Trabant was the cheapest car when East and West Germany were united in 1990, such a poor-quality product was no longer in demand when other cars became available in the eastern part of the country. When the production of poor-quality products falls or ceases, resources are released for expanding enterprises and industries.

If, over a period of time, customers' tastes change, enterprises must quickly make note of this and make every effort to restructure production in the appropriate direction. One of the reasons why Japanese car producers experienced such a great increase in their market share in the United States after the quadrupling of oil prices in 1973-4 was that Japanese manufacturers were much better than their American competitors at meeting people's demands for more fuel-efficient cars. The American car manufacturers needed much more time to adapt to more expensive petrol. Luckily for consumers, there were alternatives to the large American cars in the small cars that were imported from Japan (and also from Europe).

In the long term, then, the market has a built-in mechanism which ensures that the structure of production changes in line with technological progress and with changes in preference among customers.

In a planned economy, production is directed by a central planning body. In principle, this body should be continually revising its plans, on the basis of technological innovations in production and changing tastes of consumers. In practice, it does not work that way. First, the manager of the individual enterprise has little incentive to take the risks involved in introducing new technology. There is no owner or group of owners that harvests the profits of increased productivity. Second, the planned economy is notoriously characterized by queues: the prices of most goods and services are far too low in relation to the demand. This makes it difficult for the planning authority to know how the existing resources can be optimally utilized, in other words what goods and services customers are most interested in obtaining more of.

In practice, economic planning has become a system where realization of the plan *as such* is a prime concern, rather than the satisfaction of customers' demands. Whereas a market economy is consumer-oriented, a planned economy is producer-oriented.

When economic planning managed neither to encourage innovation nor, over a period, to adjust itself to changes in preference among customers, the result was stagnation in economic growth.