

ECONOMICS EXPLAINED

EVERYTHING YOU NEED TO KNOW ABOUT
HOW THE ECONOMY WORKS AND WHERE IT'S
GOING

*Robert Heilbroner
and Lester Thurow*

NEWLY REVISED AND UPDATED

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TWELVE

How Markets Work

It seems crazy that economics should come in two "parts"—microeconomics and macroeconomics. And it is a little crazy, for there is only one economy. Yet it is a fact that certain kinds of problems, such as those we have been looking into, reveal themselves most clearly from a macro perspective that stresses the large flows of total saving and investment and government spending, but that the same macro perspective sheds very little light on other types of economic activity, especially those having to do with the kinds of output we produce. These questions about the choices we make as producers or consumers—questions that have immense consequences for our economic life—require a different vantage point, one that highlights the activities of buyers and sellers, of consumers and businessmen. This is the vantage point of the marketplace—the grocery store, the wheat pit, the buying office—where the interaction of buyers and sellers provides the flesh-and-blood encounters we lose sight of in studying GDP.

THE PRICE SYSTEM

The micro point of view brings us immediately to look into the question of prices, a question we have ignored entirely except insofar as we talked about the level of prices when we looked into inflation. But microeconomics wants to explain how particular individual prices are determined in the arena called the marketplace. Hence, microeconomics

begins with a study of supply and demand, the words we hear and use all the time, without a very clear idea of what they mean.

Often we speak of supply and demand as if the phrase meant some general law of economic life such as the "law" that "what goes up must come down." But there is no such law, and if there were, it would not be the law of supply and demand. Instead, supply and demand is a way of understanding how the clash (competition) of buyers and sellers in the marketplace brings about prices that "clear" the market—a word we will immediately investigate—or why the clash sometimes fails to bring about such prices. *Supply and demand, in other words, inform us about how markets generate a kind of order in the system, keeping the different actors in the economy together in ways we caught a glimpse of in Chapter Two when we looked at Adam Smith's conception of the economic world.*

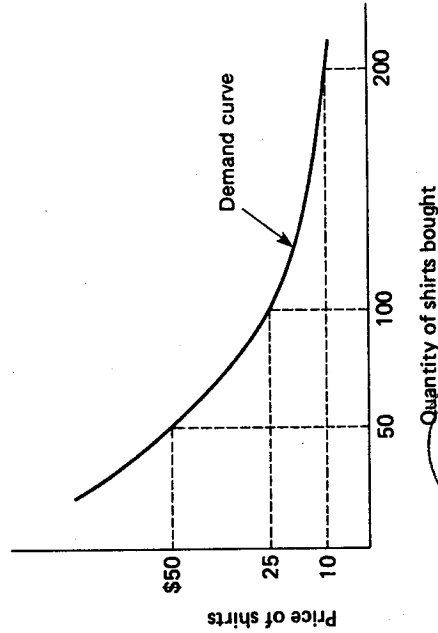
So we shall begin by clarifying what we mean when we speak about demand. Most people think the word just means a certain volume of spending, as when we say that the demand for automobiles has fallen off or the demand for gold is high. But that is not what the economist has in mind when he defines demand as part of his explanation of markets. Demand means not just how much we are spending for a given item, but how much we are spending for that item at its price, and how much we would spend if its price changed.

Furthermore, economists make an important generalization about the behavior of our buying in the face of changing prices. It is that we tend to buy less when prices rise and more when they fall. This sounds like an awfully simple generalization, but as we shall see, a great deal can be built on it. There are two reasons why economists believe it to be true. First, as prices fall we are able to buy more, because our incomes stretch further. Second, as prices fall we are willing to buy more because at its cheaper price the commodity looks more attractive compared with other commodities.*

*We can easily understand why our ability to buy will increase as prices fall, but why our willingness? The answer lies in what economists call the "utility," or pleasure, we get from most goods. Generally, as we add more and more units of one good during a given period, the addition of our pleasure diminishes. One steak dinner in the week is wonderful; two are fine; three okay; seven a bore. These diminishing increments of pleasure are called diminishing marginal utility. Because each successive steak dinner brings less pleasure, we are willing to buy more of them only if their price falls. We may be willing to pay a lot for the first (and only) steak dinner of the week, but we will certainly not pay much for the seventh one.

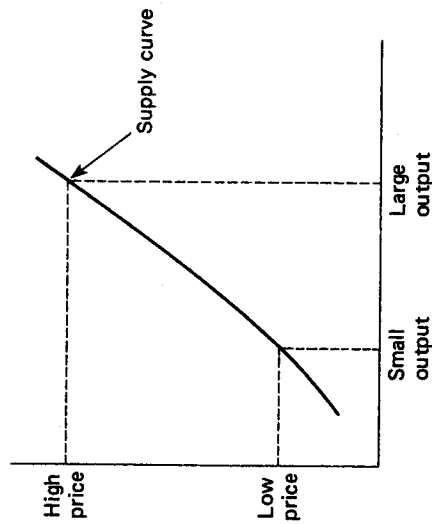
Utility maxim (self-int, rationality)

From this plausible reasoning, economists construct a widely used and very helpful representation of our market behavior, called a demand curve. The diagram following shows such a curve. Let's suppose it is designed to show how many shirts will be bought in a department store over a period of a week at different prices. If we look at the dotted lines on the graph, we can see that this (imaginary) example shows that if shirts are priced at fifty dollars, only fifty will be bought. If they are priced at twenty-five dollars, one hundred will be bought. If they are reduced to ten dollars, two hundred will be bought.



Now what about supply? As we would expect, sellers also react to price changes, but in exactly the opposite direction from buyers. The higher the price, the more sellers are able and willing to put on the market; the lower the price, the less. Sellers are after all presumed to be profit maximizers and there are larger profits to be earned when prices are high. We're not talking about whether a manufacturer might not be able to produce more cheaply at high volumes. The question, rather, is whether General Motors or the local farmer will be willing and able to offer more output to buyers *right now*, with their existing land and equipment, if the price is high rather than low. The answer is obviously yes.

Therefore we can depict a normal supply curve as rising, instead of falling the way a demand curve does. How steeply it rises depends on how much a supplier can bring to market quickly if the price goes up. A farmer may be stuck with a given crop. General Motors may be able to jam a lot of cars through by running three shifts. Here is what a typical short-run supply curve might look like:



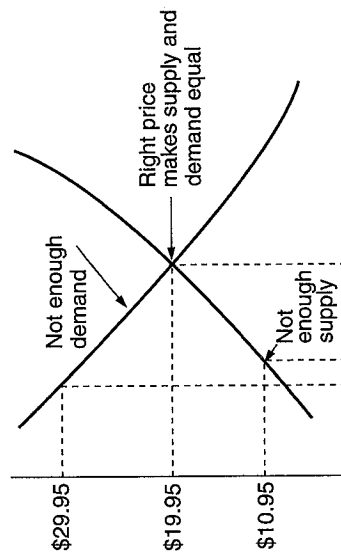
BALANCING SUPPLY AND DEMAND

We are now ready to understand how the market mechanism works. Undoubtedly you've seen the point. The fact that supply and demand behaviors are different and opposite for buyers and sellers allows the system to find a price that will "clear" the market—that is, a price at which buyers will want to purchase exactly the amount that sellers want to sell.

The best way to grasp the supply-and-demand mechanism is to run an imaginary example in our heads. Suppose that a store is selling blouses at \$29.95. It has an inventory of a hundred dozen blouses, and it expects to sell its stock out in a month. The buyer reports that the blouses "won't move." What she means is that the demand for blouses at \$29.95 isn't enough to get the merchandise into customers' hands. Since the store cuts its losses by getting rid of the blouses it has bought already, the buyer cuts the price of blouses to \$10.95 to reduce inventories and possible losses. Now the blouses start to sell. In fact, they go so fast that the buyer tries to reorder, but at much lower prices than before, so that she can continue to price them at \$10.95 and still make a profit. What she finds, however, is that the manufacturer can't fill her orders at the lower price she wants. There is a lot of demand for cheap blouses, but no supply.

The question is: Is there a price that will make both the supplier and the customer happy? The answer is yes—the price that will equate the

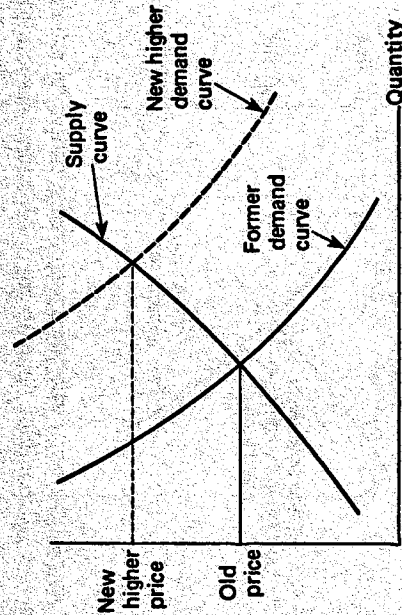
quantity of blouses demanded to the quantity supplied. We can see that in the next graph, below, where the "equilibrium" price is \$19.95.



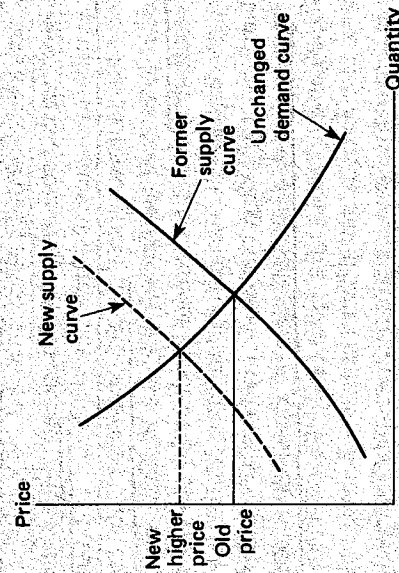
The point is not to get too hung up on the curves, which can be drawn in all sorts of shapes. It is to remember that the curves represent the differing ways we behave as buyers and sellers; and the point of the diagrams, with their crossing curves, is to make clear that as prices change, these differing behaviors can be made mutually compatible, a remarkable fact, when you think about it.

What we have learned so far is that markets, left to themselves, will arrive at an equilibrium price at which they will clear. But markets are rarely, if ever, left to themselves. Buyers and sellers are constantly changing their tastes or experiencing changes in their incomes and costs. As a result, they will bid for more goods at the old price, or will not be willing to buy as much as before. Sellers, too, find themselves willing and able to supply larger or smaller quantities to the market at each price. No supplier or demander actually knows the shapes of the neat supply and demand curves that we so easily draw. What then?

The answer, of course, is that prices change. When we are willing and able to buy more, we say that demand rises, and everyone knows that the effect of rising demand is to lift prices. We can see this in the first simple graph following. The solid lines show supply and demand and equilibrium price before some change—say, higher incomes—has boosted demand. The dashed line shows what happens to demand when incomes rise, and what happens to price as a result. It goes up. Of course the mechanism also works in reverse. If incomes fall, so does demand—and so does price.



Just to round the thing out, we can also show in a graph what happens when sellers are less willing to supply goods at the same quantities, perhaps due to a rise in costs. When supply decreases, prices rise, as the second figure following makes plain. If supply increases, prices fall, as we can also see.



THE MARKET AS A RATIONING SYSTEM

Now look at what this shows us. All the buyers and sellers who can afford and are willing to pay the equilibrium price (or more) will get the goods they want. All those who cannot, will not. So, too, all the sellers

who are willing and able to supply the commodity at its equilibrium price or less will be able to consummate sales. All those who cannot will not.

Thus the market, in establishing an equilibrium price, has in effect allocated the goods to some buyers and withheld it from others. It has permitted some sellers to do business and denied that privilege to others. Note that the market is, in this way, a means of excluding certain people from economic activity, namely customers with too little money or with too weak desires, or suppliers unwilling or unable to operate at a certain price. It is, in fact, a rationing mechanism!

Our view of the price system as a rationing mechanism helps to clarify the meaning of two words we often hear as a result of intervention into the market-rationing process: shortage and surplus.

In everyday language we often say that there is a shortage of housing for low-income groups—meaning that poor people cannot find housing that they can afford. Yet as we have seen in every market there are always some buyers who are unsatisfied. We have previously noted, for instance, that in our market for blouses, all buyers who could not or would not pay \$19.95 had to go without. Does this mean there was a shortage? In economic terminology, no. A shortage in economic terminology does not mean there are no unsatisfied people in a market. It means only that no one who is willing and able to meet the going price is unable to get the goods he or she wants.

In a market that “clears,” no such buyers exist. To be sure, there may be many would-be buyers happy to buy blouses at, say, \$16.95, but there are none for sale at that price. Thus “shortage” only refers to buyers who are willing and able to pay the going price but who cannot get their demands filled at that price.

Why not? The answer must be that some nonmarket agency—in medieval times, perhaps the Church; in our day, more likely some government agency—has set the price below the equilibrium level. Now buyers who could not get blouses at \$16.95 come crowding into the store—only to find that there are not enough blouses to meet the swollen demand. Who will go without—the buyers who were willing and able to pay the higher price, or the new “lucky” buyers who are now able to pay the lower price? The answer is queues in stores to buy things before they are gone, under-the-counter deals to get on a preferred list, or black or gray markets selling goods illegally at higher prices than are officially sanctioned.

The opposite takes place with a surplus. Suppose the government sets a price floor above the equilibrium price, for instance, when it supports the price of corn above its free-market price. In this situation, the quantity supplied is greater than that demanded. In a free market, the price would fall until the two quantities were equal. But if the government continues to support the commodity, then the quantity bought by private industries does not have to be as large as the quantity offered by farmers. Unsold amounts—the surplus—will be bought by government.

Thus the words “shortage” and “surplus” mean situations in which sellers and buyers remain active and unsatisfied *because the price mechanism has not eliminated them from the marketplace*. This is very different from a free market where buyers and sellers who cannot meet the going price are not taken into account. Most people, who have no demand for fresh caviar at eighty dollars per tin, do not complain of a caviar shortage. If the price of fresh caviar were set by government decree at one dollar a pound, there would soon be a colossal shortage.

What about the situation with low-cost housing? Essentially what we mean when we talk of a shortage of inexpensive housing is that we view the outcome of this particular market situation with noneconomic eyes and pronounce the result distasteful. By the standards of the market, the poor who cannot afford to buy housing are only one more example of the rationing process that takes place in every market. When we single out certain goods or services (such as a doctor's care) as being in “short supply,” we imply that we do not approve of the price mechanism as the appropriate means of allocating scarce resources in these particular instances. Our disapproval does not imply that the market is not as efficient a distributor as ever. What we do not like is the outcome of the market-rationing process. In other words, for all its worth, efficiency is not the only criterion by which we judge the market system.

That word efficiency brings us to the last and perhaps most important aspect of how markets work. This is the ability of markets to allocate goods and services more effectively than other systems of rationing, particularly planning in one form or another.

There is no question that the market is one of the most extraordinary social inventions in human history. If we recall the attributes of the pre-market societies of antiquity we may remember that they typically suffered from two difficulties. If they were run mainly by tradition, they tended to be inert, passive, changeless. It's very hard to get things done

in a traditional economy if anything has to be done in a new way—if, for instance, a change in climate forces a search for new ways of growing food or catching game.

A command system, ancient or modern, has a different inherent problem. It is good in undertaking big projects but not in running a complex system. In addition, the presence of political power in the economic mechanism, either as a large bureaucracy or as an authority capable of sticking its nose into daily life, becomes an endless source of inefficiency and irritation.

Against these two difficulties, the price system has two great advantages: it is highly dynamic, and it is self-enforcing. That is, on the one hand it provides an easy avenue for change to enter the system, as imaginative or ambitious individuals try new approaches or invent new goods. In addition, it allows these individuals to get a fair trial without first getting anyone's official permission: all you have to do is to sell your product!

The second (self-enforcing) attribute of the market is especially useful with regard to the rationing function. In place of ration tickets, with their almost inevitable black markets or cumbersome inspectorates or queues of customers trying to be first in line, the price system operates without any kind of visible administrative apparatus or side effects. The energies that must go into planning, or the frictions that come out of it, are alike rendered unnecessary by this remarkable self-policing mechanism. With all its difficulties, which we have by no means fully enumerated or examined, it is this capacity for self-adjustment and self-correction that sets economics apart from—although by no means above—its sister social disciplines.

That always comes as a surprise. We think of rationing as a formal, inflexible way of sharing goods—one ticket, one loaf of bread. This seems just the opposite of the free, unimpeded flux of marketplace. And in some ways it is indeed as different as can be. Just the same, the price mechanism performs a rationing function, exactly as do ration tickets. Money can be thought of as a system of flexible ration coupons. Indeed, there is nothing more important to grasp than this central purpose that markets serve. They are simply sophisticated rationing mechanisms.

On the other hand, the system has the defects of its virtues. If it is efficient and dynamic, it is also devoid of values. It recognizes no valid claim to the goods and services of society except those of wealth and

income. Those with incomes and wealth are entitled to the goods and services that the economy produces; those without income and wealth receive nothing.

This blindness of the market to any claim on society's output except wealth or income creates very serious problems. It means that those who inherit large incomes are entitled to large shares of output, even though they may have produced nothing themselves. It means that individuals who have no wealth and who cannot produce—perhaps simply because they cannot find work—have no way of gaining an income through the economic mechanism. To abide just by the market system of distribution, we would have to be willing to tolerate individuals starving on the street.

Therefore, every market society interferes to some extent with the outcome of the price-rationing system. It does so when an "economic problem" crosses the line to become a "social problem." In times of military emergency the nation issues special permits that take precedence over money and thereby prevents the richer members of society from buying up all the supplies of scarce and costly items. In depressed areas, it may distribute basic food or clothing to those who have no money to buy them. Historically speaking, it has used taxes and transfers to an ever-increasing extent to replace the ration tickets of money in accordance with the prevailing sense of justice, rather than by the standards of efficiency. It is, in fact, in the tension between the claims of efficiency and those of justice that much of the division between conservative and liberal points of view is to be found.

THIRTEEN

Where Markets Fail

Up to this point we have been concerned with how markets work. Now we must look into some situations where they don't. One of these has to do with instances where marketers lack information and have no way of making intelligent decisions and where, therefore, the results of the market will reflect ignorance, luck, or accident rather than informed behavior. A second case involves what are known as "pure public goods"—goods whose intrinsic characteristics mean that they cannot be allocated efficiently by private markets. Closely related in a third category of goods whose purchase, or failure to purchase, affects third parties' welfares and not just those of buyers or sellers. Market economies also need some social investments with longer payback periods than private markets are prepared to endure. Finally, there are some goods, health care being an example, which the public simply wants to see more equally distributed than goods and services in general. We'll take these up, one at a time.

THE PREVALENCE OF IGNORANCE

The whole market system is built on the assumption that individuals are *rational* as well as acquisitive—that marketers will have at least roughly accurate information about the market. A good example of the importance of information is the situation faced by the tourist in a bazaar of a country where he or she doesn't know a word of the lan-