

# **Economics 1: Introduction to Economics**

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# **Administrivia**

April 11, 2016 8-9 AM  
Wheeler Auditorium, U.C. Berkeley

# Meta-Announcement

- We are moving announcements and administrivia out of lecture time and onto the “announcements” bCourses page...
- That is all...

# For the Rest of the Course...

- 2016-03-28 Mo - 2016-04-06 We: Measurement, Growth, and the Circular Flow (FBAH chs. 15-21)
- 2016-04-11 Mo - 2016-04-20 We: The Keynesian Approach (FBHA chs. 22-25)
- 2016-04-25 We - 2016-05-09 Mo: Yet More Issues, Final Review, and Exam (FBHA ch. 26)

# For the Rest of the Course...

- Measurement, Growth, and the Circular Flow:
  - 2016-03-28 Mo Lecture: Measuring the Macroeconomy (Read Frank et al. chs 15-17)
  - 2016-03-30 We Lecture: Economic Growth in the Very Long Run (Read Frank et al. ch 18)
  - 2016-04-04 Mo Lecture: Saving, Investment, Finance, Money, Prices, and Banking (Read Frank et al. chs. 19-20)
  - 2016-04-06 We Lecture: Business Cycles (Read Frank et al. ch 21)
    - 2016-04-06 Wu/-07 Th Assignment: Problem Set 5 (growth and the circular flow)

# For the Rest of the Course...

- The Keynesian Approach:
  - 2016-04-11 Mo Lecture: Income and Spending (Read Frank et al. ch 22) (2016-04-11 Mo)
  - 2016-04-13 We Lecture: The Federal Reserve and Monetary Policy (Read Frank et al. ch 23) (2016-04-13 We)
    - 2016-04-13 We/-14 Th Assignment: Problem Set 6 (the Keynesian model) due
  - 2016-04-18 Mo Lecture: Aggregate Demand and Aggregate Supply (Read Frank et al. ch 24)
  - 2016-04-20 We Lecture: Macroeconomic Policy (Read Frank et al. ch 25)
    - 2016-04-20 We/-21 Th Assignment: Problem Set 7 (macroeconomic policy)

# For the Rest of the Course...

- Yet More Issues:
  - 2016-04-25 We Lecture: The International Economy (Read Frank et al. ch 26)
- The Wrap-Up
  - 2016-04-27 FINAL REVIEW
    - 2016-04-27 We/-28 Th Assignment: Problem Set 8 (international and other issues)
  - 2016-05-04 We/-05 Th Section Review Meetings
    - 2016-05-04 We/-05 Th Assignment: Problem Set 9 (final review) due
  - 2016-05-09 Mo: FINAL EXAM

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- 2016-05-09 Mo: FINAL EXAM

# **Explaining the Business Cycle**

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# Why the Business Cycle?

- A “Great Forgetting”? (Edward Prescott)
- A “Great Vacation”? (Casey Mulligan)
- A “Great Rusting”? (Ambler and Paquet)
- A “Great Exhaustion” (of Resources, That Is)?
- A “Great Cautioning”?
- A “Great Overtaxing”?
- A “Great Unionizing”?

# Strong Business-Cycle Theories: Some Examples

- **Casey Mulligan:**
  - “Are Employers Unwilling to Hire, or Are Some Workers Unwilling to Work?” *New York Times*: “Employment has been falling over the past year.... [Today s]ome employees face financial incentives that encourage them not to work.... [T]he decreased employment is explained more by reductions in the supply of labor (the willingness of people to work) and less by the demand for labor (the number of workers that employers need to hire)...”
- **John Cochrane:**
  - “We should have a recession. People who spend their lives pounding nails in Nevada need something else to do...”
  - John Lippert: “John Cochrane was steaming as word of U.S. Treasury Secretary Henry Paulson’s plan to buy \$700 billion in troubled mortgage assets rippled across the University of Chicago in September.... ‘We all wandered the hallway thinking, How could this possibly make sense?’ says Cochrane, 51, recalling his incredulity at Paulson’s attempt to prop up the mortgage industry and the banks that had precipitated the housing market’s boom and bust...”
- **Chari, Christiano, and Kehoe:**
  - “One view of the current situation that might justify intervention is that projects that are well understood not to be risky cannot get funding... because the weak balance sheets of the bank force them to pass on what otherwise would be very profitable loans.... [D]ocumenting this view will be an uphill battle because many versions of this view would imply large profit opportunities for the subset of banks with relatively healthy balance sheets...”
- All of these people are very clever, but not wise...

# Say's Law

- Jean-Baptiste Say:
  - “I shall not attempt... [to point] out the just and ingenious observations in your book[, Mr. Malthus]; the undertaking would be too laborious.... I should be sorry to annoy either you or the public with dull and unprofitable disputes. But, I regret to say, that I find in your doctrines some fundamental principles which... would occasion a retrograde movement in a science of which your extensive information and great talents are so well calculated to assist the progress.... If certain goods remain unsold, it is because other goods are not produced; and that it is production alone which opens markets to produce.... Whenever there is a glut, a superabundance, [an excess supply] of several sorts of merchandize, it is because other articles [in excess demand] are not produced in sufficient quantities...”

# The Say-Ricardo-Malthus Debate

- Thomas Malthus:
  - “We hear of glutted markets, falling prices, and cotton goods selling at Kamschatka lower than the costs of production. It may be said, perhaps, that the cotton trade happens to be glutted; and it is a tenet of the new doctrine on profits and demand, that if one trade be overstocked with capital, it is a certain sign that some other trade is understocked. But where, I would ask, is there any considerable trade that is confessedly under-stocked, and where high profits have been long pleading in vain for additional capital? The [Napoleonic] war has now been at an end above four years; and though the removal of capital generally occasions some partial loss, yet it is seldom long in taking place, if it be tempted to remove by great demand and high profits...”

# Jean-Baptiste Say Abandons “Say’s Law”

- Jean-Baptiste Say:
  - “The Bank [of England]... forced the return of its banknotes, and ceased to put new notes into circulation.... Commerce found itself deprived at a stroke of the advances on which it had counted, be it to create new businesses, or to give a lease of life to the old. As the bills that businessmen had discounted came to maturity, they were obliged to meet them.... They sold goods for half what they had cost. Business assets could not be sold at any price. As every type of merchandise had sunk below its costs of production, a multitude of workers were without work. Many bankruptcies were declared among merchants and among bankers...”

# John Stuart Mill's 1829 Insight

- John Stuart Mill:
  - “In order to render the argument for the impossibility of an excess of all commodities applicable... money must itself be considered as a commodity.... Those who have... affirmed that there was an excess of all commodities, never pretended that money was one of these commodities.... What it amounted to was, that persons in general, at that particular time, from a general expectation of being called upon to meet sudden demands, liked better to possess money than any other commodity. Money, consequently, was in request, and all other commodities were in comparative disrepute.... The result is, that all [non-money] commodities fall in price, or become unsaleable.... [A]s there may be a temporary excess of any one article considered separately, so may there of commodities generally, not in consequence of over-production, but of a want of commercial confidence...”

# What Can You Do After You Sell?

- You can buy a useful commodity
  - In this case, Say's Law would apply—supply does create its own demand
- You can be happy with the extra cash money you have
- You can lend the cash to somebody else (or pay down your debts)—deleverage
  - And hold on to your cash until you find a counterparty
- In these last two cases, Say's Law does not necessarily apply...

# Rules for "General Gluts"

- Excess demand for money is excess supply of currently-produced commodities
- Excess demand for savings--excess desire to deleverage--is excess supply of currently-produced commodities
- Excess supply of money is excess demand for commodities, etc.
- Aside from those...
  - Supply creates its own demand
  - Lack of supply creates its own lack of demand

# How About Flexible Prices?

- Wages are not terribly flexible downward
  - So prices cannot be
- And wage flexibility would not help us
  - Debt
  - Zero Lower Bound

# What Is “Money”?

- What indeed...

# Aggregate Demand

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# Income and Spending: The Basic Idea

- Let's look at how people in the economy decide how much to spend...
  - Four sets of decision-makers—households, business investment committees, foreigners, and the government
  - The government is different, but the rest all have incomes and all have to decide how much they want to spend
  - You don't have to spend your entire income—you can “hoard” it instead.
  - And you can spend more than your income—if you run down your liquid financial-asset balances
- We want a situation in which...
- Income is at a level consistent with full employment and potential output
- Anybody who wants to hoard some of their income is offset by somebody else who wants to do the opposite

## CHAPTER 22

### Spending, Output, and Fiscal Policy



HOW ARE CONSUMER SPENDING AND GDP RELATED?

**W**hen one of the authors of this book was a small boy, he used to spend some time every summer with his grandparents, who lived a few hours from his home. A favorite activity of his during these visits was to spend a summer evening on the front porch with his grandmother, listening to her stories.

Grandma had spent the early years of her marriage in New England, during the worst part of the Great Depression. In one of her reminiscences, she remarked that, at that time, in the mid-1930s, it had been a satisfaction to her to be able to buy her children a new pair of shoes every year. In the small town where she and her family lived, many children had to wear their shoes until they fell apart, and a few unlucky boys and girls went to school barefoot. Her grandson thought this was scandalous: “Why didn’t their parents just buy them new shoes?” he demanded.

“They couldn’t,” said Grandma. “They didn’t have the money. Most of the fathers had lost their jobs because of the Depression.”

“What kind of jobs did they have?”

“They worked in the shoe factories, which had to close down.”

“Why did the factories close down?”

“Because,” Grandma explained, “nobody had any money to buy shoes.”

The grandson was only six or seven years old at the time, but even he could see that there was something badly wrong with Grandma’s logic. On the one side went boarded-up shoe factories and shoe workers with no jobs; on the other, children without shoes.

#### LEARNING OBJECTIVES

After reading this chapter, you should be able to:

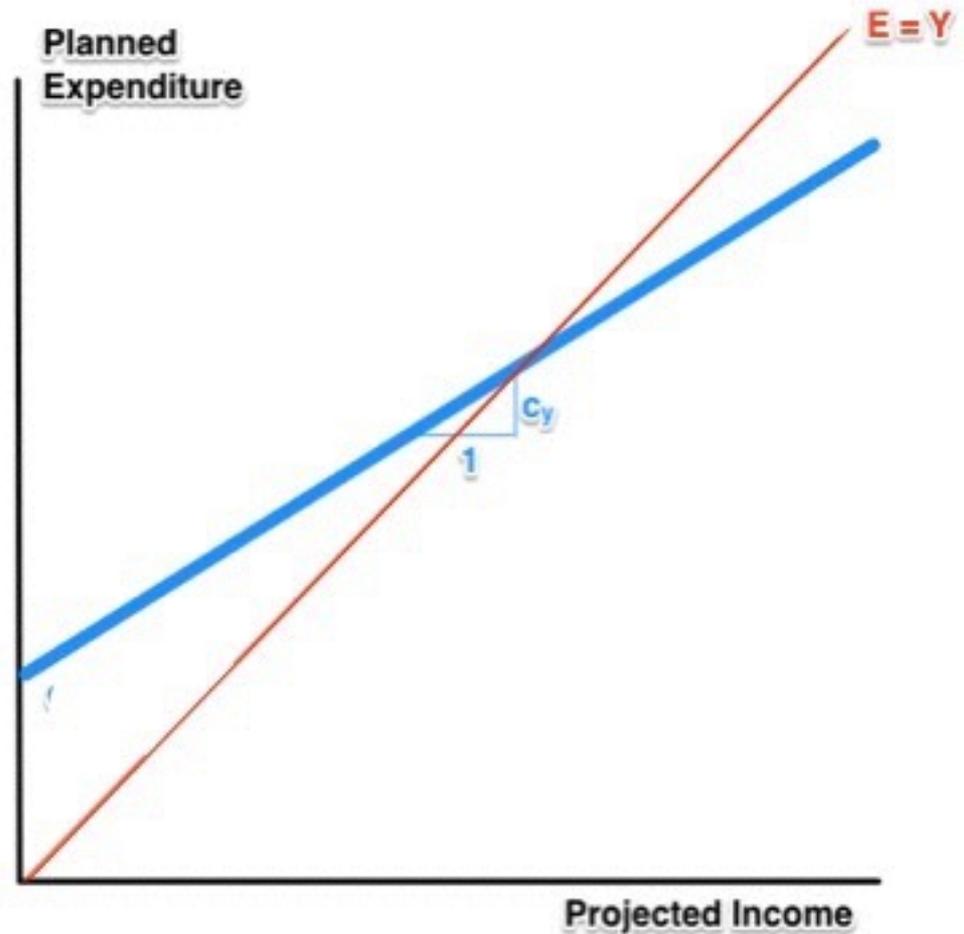
- LO1 Identify the key assumption of the basic Keynesian model and explain how this affects the production decisions made by firms.
- LO2 Discuss the determinants of planned investment and aggregate consumption spending and how these concepts are used to develop a model of planned aggregate expenditure.
- LO3 Analyze, using graphs and numbers, how an economy reaches short-run equilibrium in the basic Keynesian model.
- LO4 Show how a change in planned aggregate expenditure can cause a change in short-run equilibrium output and how this is related to the income-expenditure multiplier.
- LO5 Explain why the basic Keynesian model suggests that fiscal policy is useful as a stabilization policy, and discuss the qualifications that arise in applying fiscal policy in real-world situations.

# Four Sets of Decision-Makers

- Different groups:
  - Foreigners: sell us our imports and then decide to spend on our exports, net amount  $NX$ , and save/hoard the residual
  - Banks and businesses: that take the savings of households and foreigners and commit it to expanding their capacity, and try to hoard the residual, and so we have investment spending  $I$
  - Governments, that spend  $G$  on government purchases
  - Households: receive income  $Y$ , decide to spend  $C$  on consumption goods and save/hoard the rest:
    - $C = c_0 + c_y \times Y$
- Total expenditure:  $Y = E = C + I + NX + G$

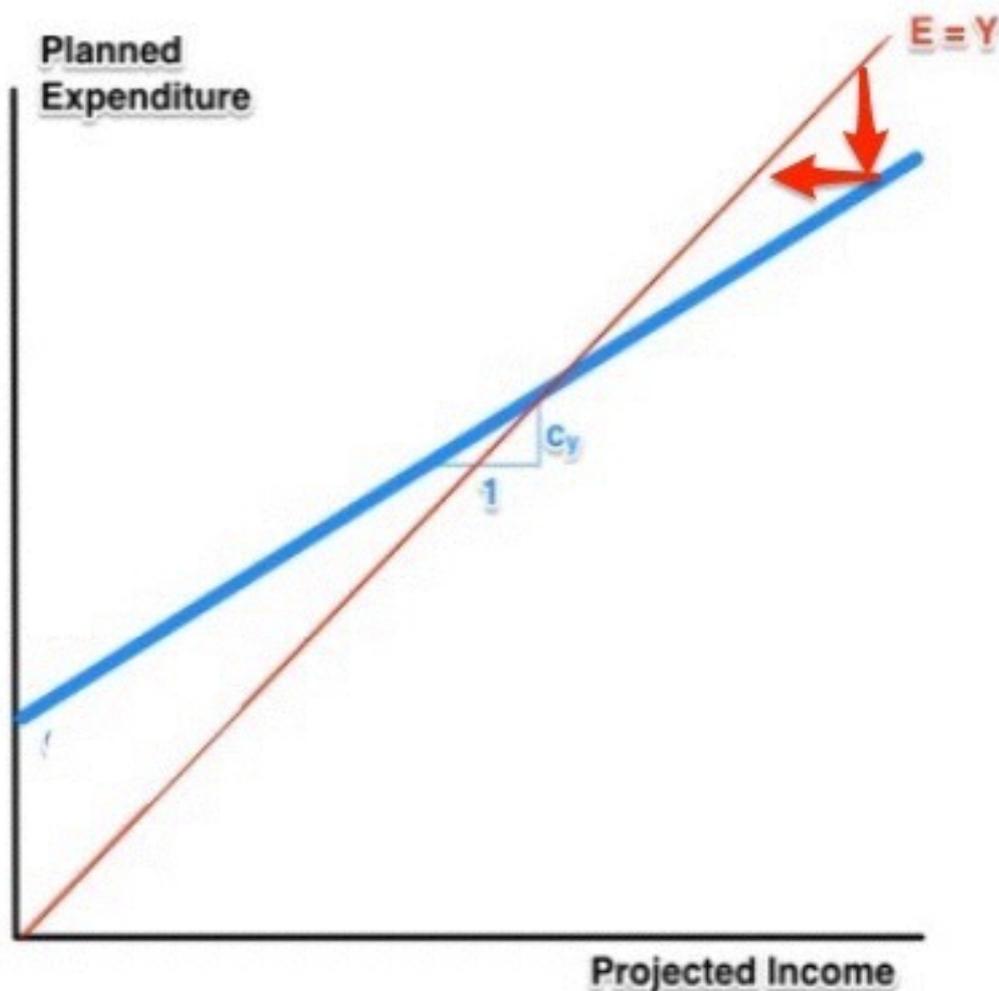
# Expenditure and Income

- Expenditure”
  - Total expenditure:  $E = C + I + NX + G$
  - $C = c_0 + c_y \times Y$
  - $E = (c_0 + I + NX) + (c_y Y) + G$
- Equilibrium
  - $E = Y$
- What happens if planned expenditure  $E$  is less than expected income  $Y$ ?



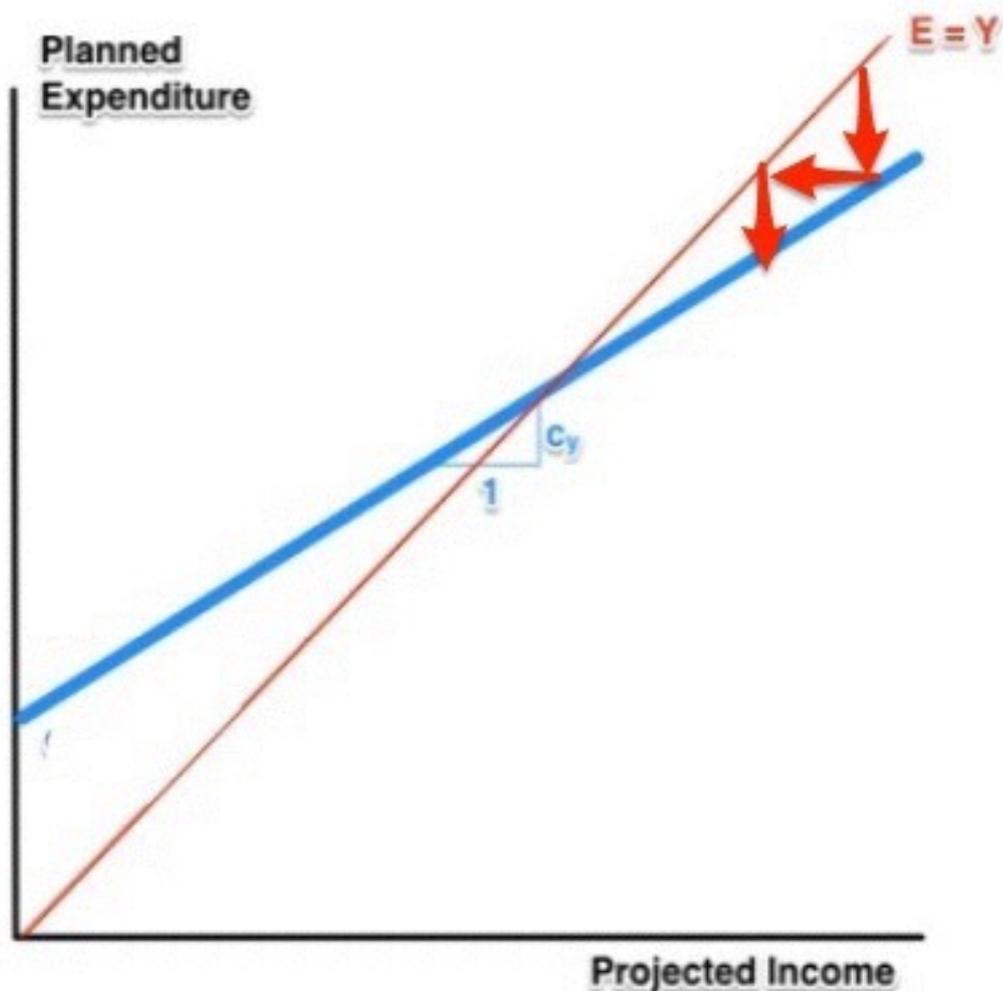
# Expenditure and Income II

- $E = C + I + NX + G$  — behavioral rules
- $E = Y$  — equilibrium condition
- What happens if planned expenditure  $E$  is less than expected income  $Y$ ?
  - People make stuff, expecting to sell it
  - It doesn't sell
  - So income comes in lower than people and expected
- What happens next?



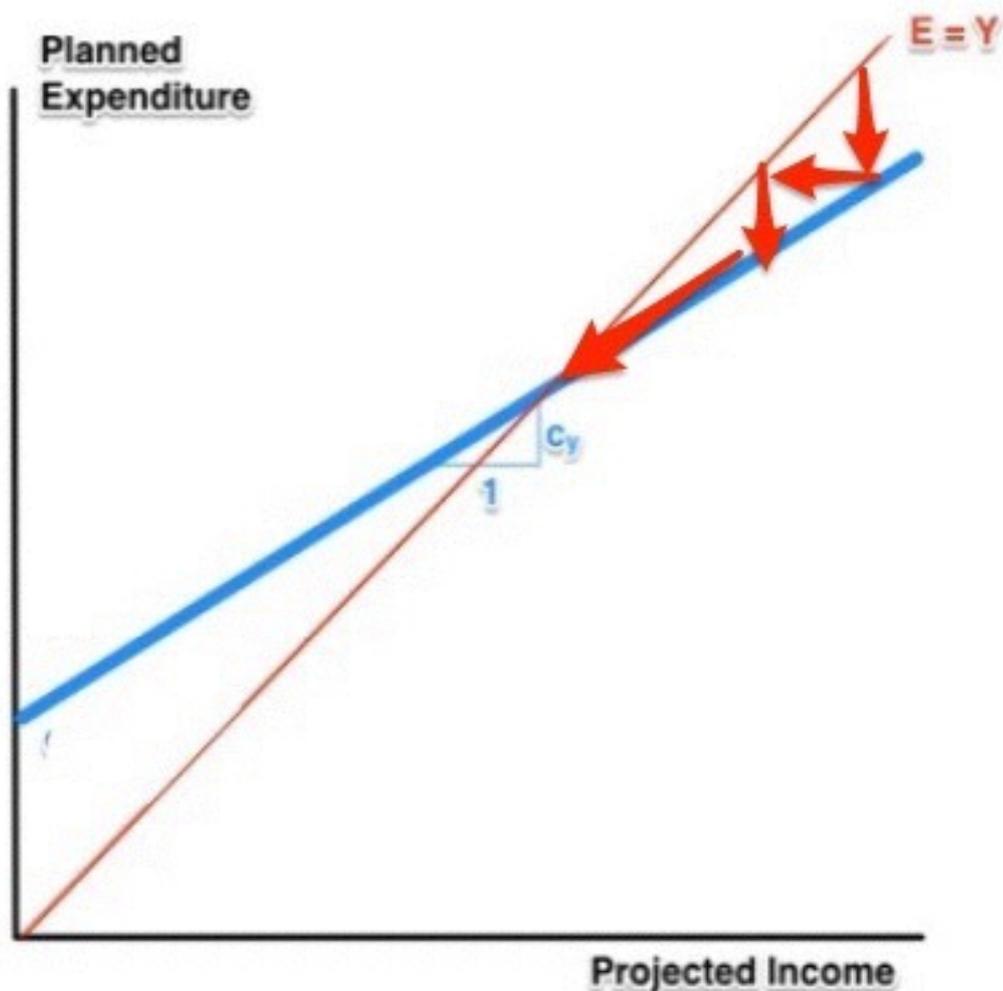
# Expenditure and Income III

- What happens next?
- Businesses go bankrupt, people get fired, and income falls...
- And as income falls, planned expenditure falls further...
- Where does the process stop?



# Expenditure and Income IV

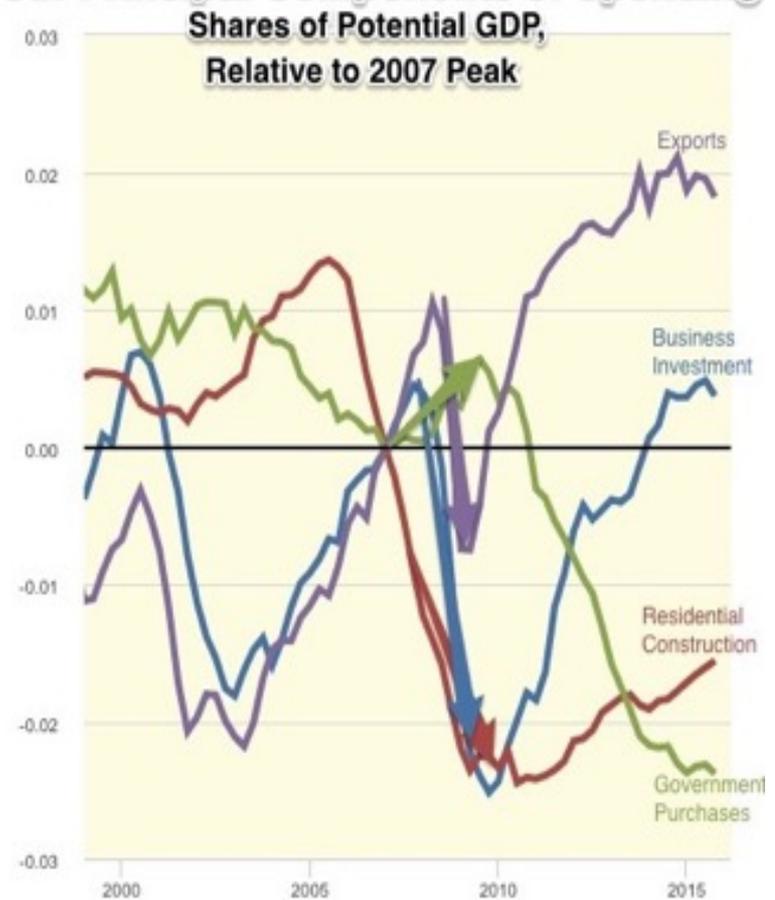
- The math tells us:
- $E = (c_0 + I + NX) + (c_y \times Y) + G$
- $E = Y$
- $Y = (c_0 + I + NX) + (c_y \times Y) + G$
- $(1 - c_y)Y = (c_0 + I + X) + G$
- $Y = [(c_0 + I + NX) + G]/(1 - c_y)$
  
- Changes have a multiplied effect on Y
  - changes in consumers' expectations, business animal spirits, net exports, and government purchases...



# Expenditure and Income V

- $Y = [(c_0 + I + NX) + G]/(1-c_y)$
- $\mu = 1/(1 - c_y)$
- $Y = \mu[(c_0 + I + NX) + G]$
- Know the multiplier
- Track what happens to consumers' expectations, business animal spirits, net exports, and government purchases
- And you can track the economy

**Four Principal Components of Spending**



# To Your i>Clickers...

- Intel spends \$6B to build a 14nm Fab 42 Manufacturing Facility
  - A. Definitely in GDP
  - B. Definitely not in GDP
  - C. It could go either way—there is a hole in the classification system here
  - D. Not sure

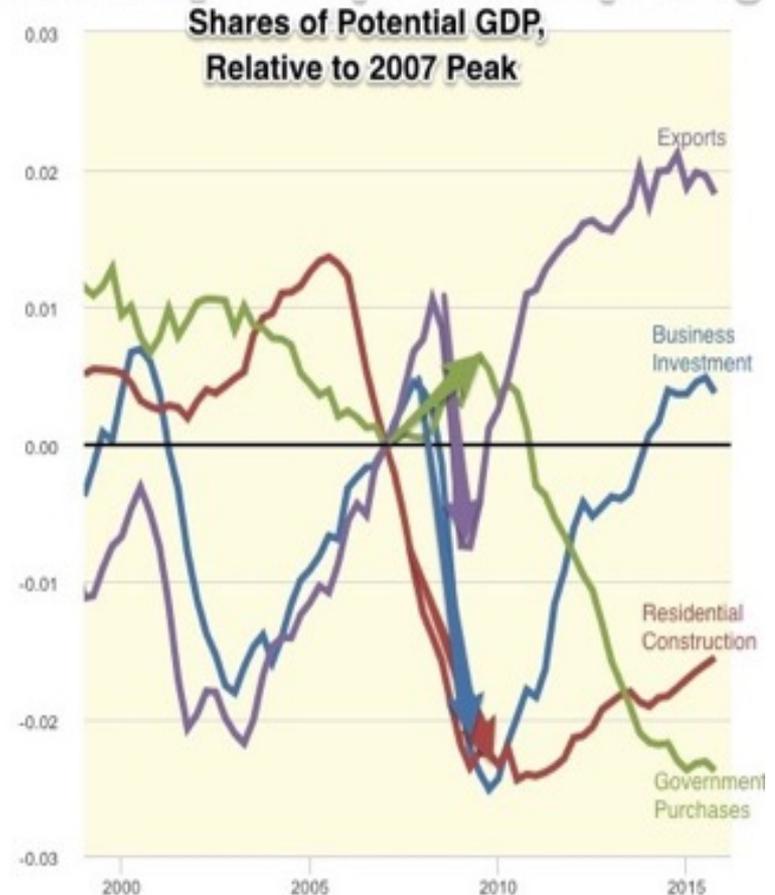
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  - D. Not sure

# The Multiplier $\mu$

- $Y = \mu (C_0 + I + NX) + G$
- $\mu = 1/(1-c_y)$
- The multiplier  $\mu$  is the inverse of one minus the marginal propensity to consume, the mpc (more complex in more complex models)
- We have raised our estimate of the multiplier from 1.5-2 to 2.5-3.5 over the past decade
- It tells you by how much to *multiply* a change in other kinds of spending in order to take account of how much consumption spending moves in the same direction
- And so determine the effect of a change in spending on GDP

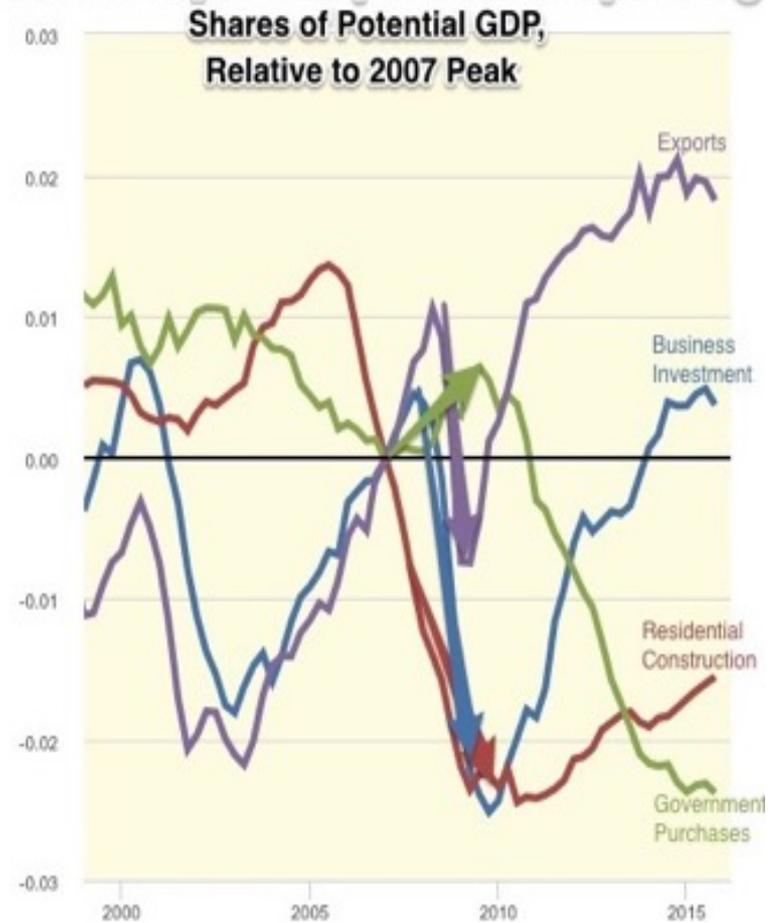
## Four Principal Components of Spending



# Consumer Confidence $c_0$

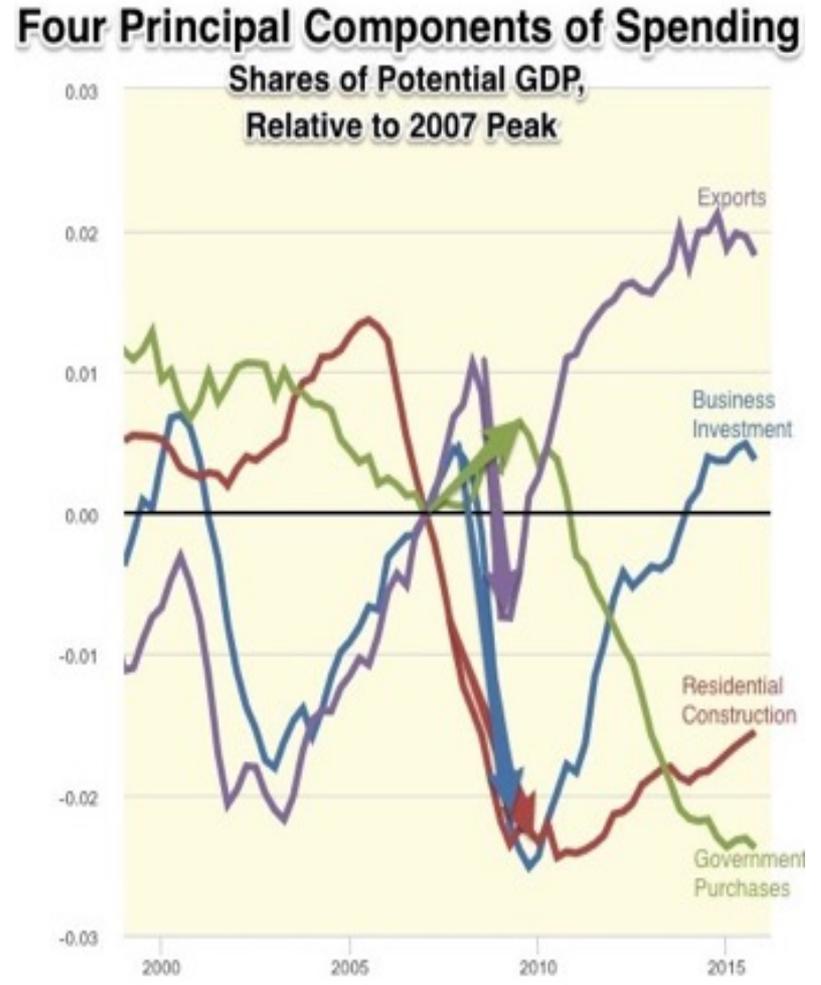
- $Y = \mu[C_0 + I + NX) + G]$
- How willing are consumers to extend themselves, and how much would they run down their financial asset stocks even if they were to have no income?
- Also includes “wealth effects” as well as “confidence”
- Not a huge player in the business cycle since 2005...

Four Principal Components of Spending



# Investment Spending I

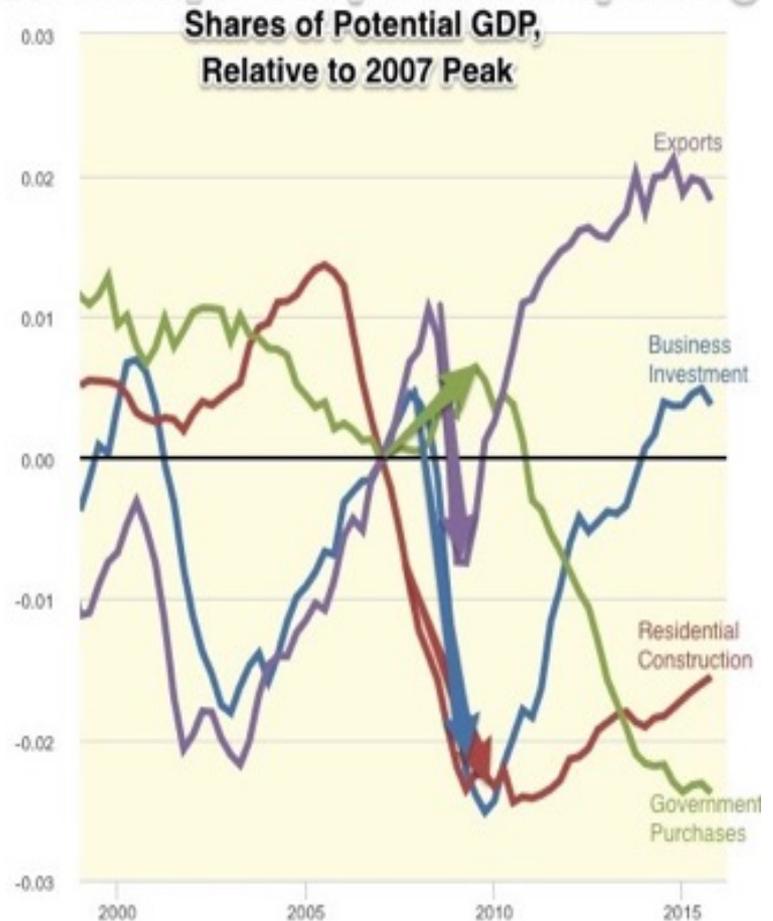
- $Y = \mu[(C_0 + I + NX) + G]$
- How much businesses are willing to borrow (or retain earnings and not pay profits out to shareholders) to boost their capacity
- Depends on calculation by businesses
- But also on “animal spirits”
- And also on real interest rates



# Net Exports NX

- $Y = \mu[(C_0 + I + \text{NX} + G)]$
- Foreigners sell us goods...
- And then take the dollars they earn...
- And decide how much of them to spend on *our* exports and how much to invest in \$\$ \$\$ financial assets
- Another spending decision...

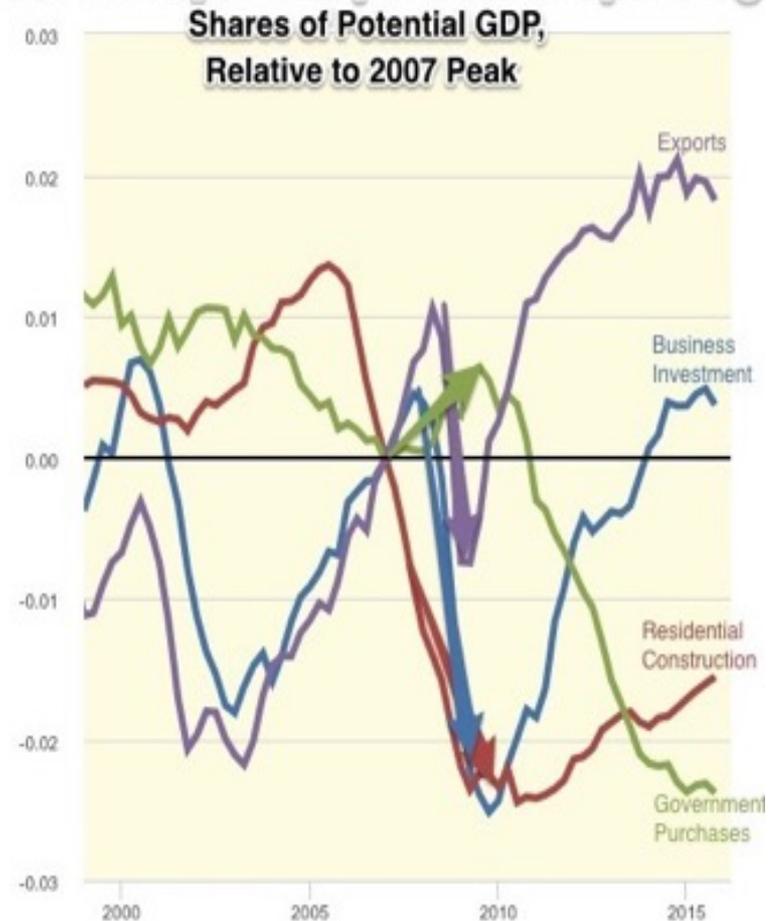
Four Principal Components of Spending



# Government Purchases G

- $Y = \mu[(c_0 + I + NX) + \text{G}]$
- Another flow of spending...
- Another source of demand for US-made products
- Spending is spending, and the government's spending is as good as anyone else's...

Four Principal Components of Spending



# To Your i>Clickers...

- We have our very simple toy model of the macroeconomy
  - $Y = E$  (equilibrium condition);  $c_0$ ,  $I$ ,  $G$ ,  $NX$  determined by consumer confidence, by business investment committees and bank loan officers, and by foreigners;  $C = c_0 + c_y \times Y$ ,  $E = C + I + NX + G$ ...
- $Y = \mu[(c_0 + I + NX) + G]$
- Suppose  $c_0 + I + NX = \$4T$ , suppose the multiplier  $\mu$  is 3. Suppose  $G = \$2T$ , what is GDP  $Y$ ?
  - A. \$18T
  - B. \$12T
  - C. \$6T
  - D. \$9T
  - E. None of the Above

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- $Y = \mu[(c_0 + I + NX) + G]$
- Suppose  $c_0 + I + NX = \$4T$ , suppose the mpc  $c_y = 2/3$ . Suppose  $G = \$2T$ , what is GDP  $Y$ ?
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  - A. \$18T <<**
  - B. \$12T
  - C. \$6T
  - D. \$9T
  - E. None of the Above
- $\mu = 1/(1 - c_y)$  — inverse of one minus the mpc

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- $Y = \mu[(c_0 + I + NX) + G]$
- Suppose  $c_0 + I + NX = \$4T$ , suppose the mpc  $c_y = 2/3$ . Suppose that  $G = \$2T$ . If we increase  $G$  from  $\$2T$  to  $\$2.5T$ , what will happen to GDP  $Y$ ?
  - A.  $Y$  will go from  $\$18T \rightarrow \$19.5T$
  - B.  $Y$  will go from  $\$12T \rightarrow \$13T$
  - C.  $Y$  will go from  $\$6T \rightarrow \$7.5T$
  - D.  $Y$  will go from  $\$9T \rightarrow \$10.5T$
  - E. None of the Above

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- $Y = \mu[(c_0 + I + NX) + G]$
- Suppose  $c_0 + I + NX = \$4T$ , suppose the multiplier is 3. Suppose that we want output to be at full employment, which is  $\$21T$ . At what level should we set government purchases  $G$ ?
  - A.  $\$17T$
  - B.  $\$9T$
  - C.  $\$3T \ll$**
  - D.  $\$6T$
  - E. None of the Above

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- $Y = \mu[(c_0 + I + NX) + G]$
- Suppose that it is mid-2008, that  $Y = \$15T$  and that the multiplier is 3. Suppose that we learn that  $I + NX$  for the next year—2009 is going to fall by  $\$1.5T$  as a result of the financial crisis. What should the government do to  $G$  in 2009 in order to maintain full employment?
  - A. boost  $G$  by  $\$0.5T$
  - B. boost  $G$  by  $\$1.5T$
  - C. shrink  $G$  by  $\$1.5T$
  - D. boost  $G$  by  $\$4.5T$
  - E. None of the Above

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  - $Y = E$  (equilibrium condition);  $c_0$ ,  $I$ ,  $G$ ,  $NX$  determined by consumer confidence, by business investment committees and bank loan officers, and by foreigners;  $C = c_0 + c_y \times Y$ ,  $E = C + I + NX + G$ ...
- $Y = \mu[(c_0 + I + NX) + G]$
- Suppose that it is mid-2008, that  $Y = \$15T$  and that the multiplier is 3. Suppose that we learn that  $I + NX$  for the next year—2009 is going to fall by  $\$1.5T$  as a result of the financial crisis. What should the government do to  $G$  in 2009 in order to maintain full employment?
  - A. boost  $G$  by  $\$0.5T$
  - B. boost  $G$  by  $\$1.5T$  <<**
  - C. shrink  $G$  by  $\$1.5T$
  - D. boost  $G$  by  $\$4.5T$
  - E. None of the Above

# Orientation

April 11, 2016 8-9 AM  
Wheeler Auditorium, U.C. Berkeley

# “The Market” as an Institution

- We start from what look like to us deep truths of human psychology
  - People are *acquisitive*
  - People engage in *reciprocity*—i.e., want to enter into reciprocal gift-exchange relationships in which they are neither cheaters nor saps
  - With those they *trust*...

# “The Market” as an Institution II

- We devised property as a way of constructing expectations of trust...
- We devised money as a substitute for trust...
- And so, on the back of these human propensities for acquisition and for trusted gift-exchange, we have constructed a largely-peaceful global 7.4B-strong highly-productive societal division of labor:
  - Built on assigning things to *owners*—who thus have responsibility for stewardship and the incentive to be good stewards...
  - And on very large-scale webs of *win-win exchange*...
  - Regulated by *market prices*...
- This is a very valuable and important societal institution...
- Economics is the study of how it—what we usually call “the market”—works...

# “The Market” as an Institution III

- In analyzing the market as an institution, we need to cover:
  - The success of the market
  - The failures of the market
  - The political-economic-sociological-historical context of the market
  - The impact of a market economy on the other institutions and practices of society
- Plus there is the peculiar domain of “macroeconomics”

# The Market Balance Sheet: Pro

- The market failure-free competitive market in equilibrium, from the perspective of a utilitarian seeking to achieve the greatest-good-of-the-greatest-number, accomplishes these goals:
  1. It produces at a scale that exhausts all possible *win-win exchanges*—and is “efficient” in that sense.
  2. It allocates the roles of producers and sellers to those who can make and sell them in a way least costly to society’s overall resources—to those with the lowest *opportunity cost*.
  3. It rations the commodities produced to those with the greatest *willingness-to-pay*—to those who, by the money standard, need and want them the most.

# The Market Balance Sheet: Con

- Markets can go wrong. They can:
  1. not fail but be failed by governments that fail to properly structure and support them—or that break them via quotas, price floors/ceilings, etc.
  2. be out-of-equilibrium
  3. see actors have market power
  4. be afflicted—if that is the word—by non-rivalry (increasing returns to scale; natural monopolies)
  5. suffer externalities (in production and in consumption, positive and negative; closely related to non-excludability)
  6. suffer from information lack or asymmetry
  7. suffer from maldistributions—for the market will only see you if you have a willingness to pay, which is predicated on an ability to pay...
  8. suffer from non-excludability (public goods, etc.)
  9. suffer from miscalculations and behavioral biases
  10. suffer from failures of *aggregate demand*