

# A Macroeconomics History Lesson by C. Kohn

---

## Economic Systems

In economics, there are several ways in which an economy can be set up. In pure capitalism, individuals own the resources and have the right to use their time and resources in any way they choose. Capitalism in its most pure form is self-regulating, with only market prices determining the value of goods and services. The desire for profits drives economic players to make good trades where both sides benefit from the trade. *Competition* and *individual benefit* are the driving forces of capitalism.

Socialism is where the public owns all private resources and there is no private ownership. The government directs all decisions in the economy and determines who is employed where, what products are made, and how much those products are sold for. There are little or no profits or economic incentives, and the production of goods and services in socialism tends to be inefficient because there is no incentive or bonus for producing a superior good – the outcome is the same regardless of input (unlike capitalism where only the best products and goods are bought and sold). Communism is an extreme form of socialism where the government has complete control over the economy with no input from the citizenry.

Fascism is similar to socialism in that the government has complete control, but also is similar to capitalism in that property is owned by individuals. However, private businesses only receive economic power if they support the central government powers. Those that oppose the government lose economic control.

## A Challenge to the Classical Economic Theories.

In the 1930's, the world was in the midst of an economic depression. *Depression* was a new term at the time – it was originally coined by President Herbert Hoover, who when asked if the economy was in a recession, replied that it was merely in a depression. When Hoover first said it, it was to imply that the economic problems were small in nature – depression being just a bump in the road. However, it later became synonymous with an economic meltdown of catastrophic proportions.

At this time, the economic rule of thumb was Adam Smith's *Invisible Hand* theory. Simply put, the Invisible Hand theory implies that markets will work best if governments do not interfere. The Invisible Hand refers to the idea that if everyone works in their own self-interest when trading, the economy will fix itself when it has problems. Adam Smith envisioned an economy with many firms, rather than few. This way, if profits increased a lot for one product or service, more businesses

### Economic Systems

Capitalism – goods and services are controlled by individuals. Their prices are determined by the market.

Socialism – goods and services are owned by the public. Prices are determined by controlling agencies (e.g. the government).

Communism – a form of socialism in which goods and services are controlled by the government without input from the citizenry.

Fascism – goods and services are owned by individuals, but their success is determined by the government.

### The Invisible Hand Theory –

Markets will perform most efficiently and effectively if the government does not interfere or try to determine prices.

would provide that product or service and increased production would decrease profits. This process, according to Smith, would level the economic playing field<sup>1</sup>.

The opposite of this idea would be socialism – that the government is best capable of deciding economic trades and leveling the playing field. This idea, simply put, is rather ridiculous. There is no way that the government can predict how much of what products will be needed at any given moment.

---

<sup>1</sup> This is why monopolies, or the control of a product by only one firm, are so bad. It makes it so that the normal economic regulators become powerless, and the flow of money becomes uneven. A monopoly faces no competition and can then charge whatever it wants for a product. If the product is a luxury, people can choose not to buy it. However, if that product is a necessity, people will have to buy it regardless of price, and the flow of money will be changed so that more goes unfairly to one company.

From their publishing in 1776, Adam Smith's ideas became the bedrock economic principle for two hundred years, and the rise of the United States as the world's greatest economic power was in large part because of its unrestricted economy. In fact, six characteristics in particular made the US a strong economic power:

- 1) Little or no government intervention or control – the government of the United States originally existed only to keep peace and for national defense with few exceptions.
- 2) Freedom of enterprise-individuals control the factors of supply and demand
- 3) Freedom of choice and the freedom to fail – the success or failure of a good or service depend on individuals freely choosing what they want and don't want.
- 4) The right to own property – you are free to buy whatever you can afford and can control how, when and by whom your property is used
- 5) Profit Incentives – money is spent by businesses with the sole intent to make a profit. Profits are the sole motivation to spend money to produce goods and services
- 6) Competition – you will get better service at McDonald's from a teenager working part time than from a college-educated employee of the government at the DMV making much more money. This is because the teenager is working in a competitive capitalistic environment where if that business does not perform as well, they will lose money. Whereas the DMV has no competition

You will get better service from a teenager at McDonalds than from a college-educated adult at the DMV because of the principles of competition and profit incentives. The better your product, the more money you make.

and no business to lose – if you want a driver's license, you have to go to the DMV to get it.

The 1930's challenged the usual ideas about the role of the government in economics. Herbert Hoover is often blamed for the Great Depression, but in all actuality, he was doing what 200 years of economic theory had said to be correct – he simply waited for the economy to fix itself like it had in previous recessions. Economic theory believed at the time that government intrusion would only make matters worse, and Hoover was simply doing what the top economic minds believed to be correct at the time.

However, in the midst of this, the economic situation for the entire world worsened. It is said that in economics, when the US sneezes, the rest of the world catches a cold too, and this was no different. There was one exception, however. In Europe, the country that was most ravaged by economic failure after World War I suddenly became the model of how to succeed economically in the midst of a monetary meltdown. Their leader was still largely unknown but helped revolutionize how the economy is affected by governments today.

### Hitler's New Germany, FDR's New Deal, and Keynes' New Ideas

When Adolph Hitler assumed control of Germany by force, he wanted as large of a military as possible. Germany was as affected by the economic situation as any country, and Hitler realized that he would have to 'cheat' in order to bring the cash in that Germany needed to build its war machine. Simply put, Hitler decided that Germany would spend money that it didn't have to build the military it would need. It would go into debt to become rich.

Hitler's Germany borrowed money that it didn't have to build factories it didn't need to employ people who didn't have any jobs. Of course, the main objective in this act was not lowering the unemployment rate, but rather building an industrial military machine. However, Hitler's *de facto* economic policy unwittingly turned Germany into the poster child of how to end a recession – spend money to create jobs. Hitler's poor understanding of economics and eventual transition to fascism helped destroy what was one of the world's first examples of modern macroeconomic policy.

### Six Characteristics of American Economic Power

Little or No Government Intervention

Freedom of Enterprise

Freedom of Choice

Property Ownership

Incentives of Profit

Competition

However, prior to this eventual demise, Hitler's model became an example of what political leaders across the globe were looking for. In 1936, a British economist named Keynes wrote a publication in which he argued that economic systems are not completely self-sufficient (as was the belief of the *Classical Economic Theory*) and that sometimes the economy needs outside help. The only power great enough to create an impact was the government, but Keynes maintained that government interferences should always be temporary. *Keynesian economics* refers to the belief that the *government should play whatever role necessary to accomplish economic goals*. This belief also became the ideological basis for Franklin Roosevelt's *New Deal* programs during the Depression. However, while Keynesian economics argued that this intervention should be temporary, Roosevelt's programs became permanent and the argument shifted from *whether* the government should be involved in the economy to *how much* it should be involved.

### Keynesian Economics

The government should play whatever role necessary to accomplish economic goals such as low inflation, high growth, stable currency, and low unemployment. Once these goals are accomplished, the role of the government should be ended.

Hitler and FDR's economic ideas were a challenge to every macroeconomic idea of the time. It was previously thought that governments should always balance their budgets so that they only spent what they took in from taxes. Hitler spent money that he didn't have to build a giant military and in the process created the jobs needed to end Germany's recession. Through the New Deal, FDR spent money the US didn't have to create jobs and to help lower the 30% unemployment rate.

### Unemployment Rates

When people refer to an unemployment rate, many may not understand exactly what they are talking about. Unemployment is a measure of the number of people seeking jobs divided by the number of people in the workforce. Not

$$\text{Unemployment} = \frac{\text{No. of people looking for a job}}{\text{No. of people who have a job.}}$$

everyone wants a job; those that do but can't get one are what create the unemployment rate. In the 1930's, almost one in three people seeking a job couldn't get one. However, when FDR decided to create a *budget deficit* by having the government spend

money it didn't have, he helped create jobs. Basically, FDR was looking for any way in which we could pay Americans to simply do something. He created the Civilian Conservation Corps, whose members were paid for the time they spent individually planting native vegetation and restoring wildlife habitat. In other programs, dams were built, bridges were raised, and artists were hired to decorate government buildings. FDR searched for any way possible in which the government could give money it didn't have for services it probably didn't need in order to provide money to people who otherwise wouldn't have jobs.

### The Value of a Dollar is Not Always a Dollar

Until 1914, the economic world operated on the gold standard, where the value of the dollar was tied to the price that gold was sold for on the market. After 1914, the US went off the gold standard, meaning that it had the power to decide what its dollar would be worth. For example, the US could decide that ten US dollars would be worth 5 British pounds so that if we went to Britain, our money could buy twice as many goods than their money. More likely, however, a country would decide to *devalue* its money so that its money would be worth less than other countries (e.g. one dollar in the US would be worth two British pounds).

This might seem stupid, but it actually makes good sense. If your money is worth less, your products will sell for less overseas. If you products sell for less overseas, more people will buy them and more money will flow into the US. Want to sell more American cars?

#### Weak Dollar (low in value)



#### Strong Dollar (high in value)



Then lower the value of the US dollar so that they are more affordable to people overseas. However, if every country does this, then the global economy will shut down, and that is exactly what happened during the Depression. Every country kept competing to make their currency worth less and less, and as a result the world's economy collapsed.

### Bretton Woods Conference

In 1944 FDR met with the leaders of 45 other countries in Bretton Woods, NH to decide how to make this non-gold standard system actually work. In a nutshell, it was decided that the gold standard wasn't so bad, but it wasn't perfect. Something was needed that was more flexible than gold to determine the value of each country's money. It was decided that the US Dollar would be the standard by which all other country's money would be valued. The International Monetary Fund (IMF) stated that countries were allowed to adjust the value of their currency, but only within a limited range.

This system began to fail when West Germany and Japan refused to raise the value of their money after WWII because of the competitiveness it gave to their products. Everyone wanted Japanese electronics because they were cheaper and Japan knew this. German luxury cars were highly sought in the US because they were affordable. The Bretton Woods system was eventually ended, and now there are multiple ways in which the value of a country's currency can be determined. The main point is that a country cannot just decide to devalue their currency - there are regulations to prevent the excessive currency devaluation that helped cause the Great Depression. Because of these regulations, the world has a more stable currency.

### The Fed - A Bank's Bank

FDR's third and final macroeconomic tool was the Federal Reserve System, or better known as *The Fed*. The Fed was created in 1913 to bring banks under a single system of regulation. The Fed is basically a bank for banks. When a bank borrows money to a customer, it has to get that money from somewhere. The Fed is the base from which all banks borrow their money so that they can in turn loan money to lenders like you and me.

One of the most important functions of The Fed is to determine interest rates.

I loan you \$20. You later have to pay me back \$21. The extra \$1 is for the right to borrow *my* money. Because \$1 is 5% of \$20, I charge a 5% interest rate.

Interest rates are what lenders receive for giving out money. It's the

extra you have to pay when you borrow money solely for the right to borrow money. If you want to borrow \$20 from me, I may expect you to pay back \$21 for the privilege of using my money. This would be a 5% interest rate - I expect that when you repay me, you give me 5% extra for the right to borrow that money.

### A Recession = Too Little Money to Buy Goods and Services

When a country is facing a recession or depression, it is facing a shortage of available money. This means that we want more money allowing for more economic trades. When the government pumps money into the economy through public works projects, it is increasing the supply of money. When the value of the dollar is lowered so that more people overseas buy our products, it is increasing the flow of money into our economy. And when The Fed lowers interest rates, there is less of an incentive to put your money in a bank because you will get less money in interest. If you have a choice between spending the money or saving it (and letting it collect interest), you are more likely to spend it if interest rates are low.

#### The Federal Reserve System (The Fed)

I want to borrow money for my farm



The Bank Needs to Get Money To Give Me Money



Banks Can Get Money for Lending from The Fed



This Process Creates Money and Allows the Economy to Grow

Because The Fed determines the interest rates by which all other banks operate, it can be a powerful player in the success or failure of an economy. The chairman of The Fed, Ben Bernanke, effectively has the power to decide if money will be more likely put into savings or if it will be spent.

### Inflation = Too Much Money Chasing Too Few Goods

When a country is facing inflation it means that there is too much money in the economy. When there is too much money in the economy, the prices of goods increases without an increase in demand. A can of Coke goes from 50 cents to 75 cents. A Thanksgiving meal becomes more expensive each year because of inflation. A little inflation is normal and ok; it means that the economy is working. However, too much inflation is bad because it means that your wages will be able to buy fewer and fewer goods and services than it previously could. When inflation is too high, we need to do the opposite of what we would do for a recession. We have to lower government spending, increase the value of the dollar, and raise interest rates so that people are more inclined to put their money in savings. The macroeconomic tools for solving inflation are the same, but the way they are used is different (in fact, just the opposite) from a recession.

### The Three Tools of Macroeconomic Policy



Fiscal Policy - the government can spend money to create jobs and pump more money into the economy. One way it can do this is by paying people to do jobs that it otherwise wouldn't need them to do (e.g. hiring artists to paint murals).



Monetary Policy - The Fed can change interest rates to increase or decrease the amount of money put into the economy or into savings. If the economy faces a recession, or period of reduced economic activity, interest rates can be lowered so that people are more inclined to take their money out of savings and spend it.



Exchange Rate Policy - the value of the dollar can be changed to affect the amount of money that comes into the country from other countries. The stronger the dollar, the more goods we can buy from other countries, but the weaker the dollar, the more of our goods other countries are willing to buy.

#### How To End a Recession



Fiscal Policy - the government spends more money to create more jobs to increase spending by consumers



Monetary policy - decrease interest rates so that less money is put into savings and more is spent.



Exchange Rate Policy - decrease the value of the dollar to increase the number of goods sold overseas. The more goods sold overseas, the more money that comes into the US economy.

*A recession is when too little money is available for consumers to buy goods and services.*

#### How To Stop Inflation



Fiscal Policy - the government spends less money to reduce the flow of money into the economy



Monetary policy - increase interest rates so that more money is put into savings.



Exchange Rate Policy - increase the value of the dollar to increase the flow of money into other countries from the US. The more goods bought from overseas, the more money that goes out of US economy. This also means that consumers will be able to buy more overseas goods with less money.

*Inflation occurs when there is too much money in an economy chasing too few goods and services.*

# Questions to Test Your Understanding By C. Kohn

---

Name: \_\_\_\_\_ Hour \_\_\_\_\_ Date: \_\_\_\_\_

Date Assignment is due: \_\_\_\_\_ Why late? \_\_\_\_\_  
Day of Week                      Date                                              If your project was late, describe why

1. Describe how a typical farm would look under *capitalism*, *socialism*, *communism*, and *fascism*.
  - a. *Capitalism*
  - b. *Socialism*
  - c. *Communism*
  - d. *Fascism*
2. In your own words, define *recession* and *depression*.
  - a. *Recession*
  - b. *Depression*
3. What is the Invisible Hand Theory?
  - a. Who created it?
4. What were Adam Smith's beliefs about the appropriate sizes and numbers of firms in an economy?
5. What is a monopoly and why is it bad for an economy?
6. Can the impact of a monopoly change depending on whether it sells a luxury or necessity? Why or why not?
7. Define the Six Characteristics of American Economic Power and give a hypothetical example of what each would look like in an agricultural business.
  - i.
  - ii.
  - iii.
  - iv.
  - v.
  - vi.

8. Why can you get better service from a teenager at McDonalds than from a college-educated adult at the DMV? What compels the teenager at the counter to do a better job?
9. Why didn't President Hoover do more to end the recession?
10. What German leader helped change ideas about macroeconomic policy? How did he do this?
11. Define Keynesian Economics in your own words. If you were President, how would your administration handle economic issues if it *precisely* followed the Keynesian model? How would this differ from Classical Economics?
12. How did Roosevelt both follow and not follow Keynes' economic ideas?
13. How do we calculate unemployment?
14. How did FDR use government spending to end the Great Depression?
15. During a recession, would we want a strong US Dollar or a weak one? Why?
16. How did currency devaluing help cause the Great Depression?
17. What was the major outcome of the Bretton Woods Conference in 1944?
18. Can any country decide to change its currency to any value at any time? Why or why not?
19. In a nutshell, what is the Federal Reserve, or The Fed? What does it do?
20. If I loan you \$50 at a 10% interest rate, how much money would I make when you pay me back?

21. **ESSAY:** The class decides to conduct a write-in campaign for you for President in November. As it turns out, a really good episode of *House, MD* was on that night and we were the only ones that voted. Congratulations on winning the White House! How will you use the three macroeconomic tools to end this recession? Give specifics!