

ECONOMIC LITERACY

A Complete Guide

EDITOR

Stephanie Schwartz Driver

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Introduction

If the global economic downturn that began in 2008 has taught us anything, it is that world economies are intricately interrelated. Prior to 2008, economists debated the idea of decoupling, or the notion that some emerging economies, especially those in China, India, and Brazil, might be strong enough to develop independently of other nations. However, in the wake of the sharp global downturns of 2008 and 2009, “globally, the idea of decoupling is dead,” said British economist Martin Wolf.

Economic Literacy takes steps to demystify complex global economic issues. It offers the background to events both current and historical, helping to clarify today’s news headlines as well as chapters in history textbooks. It looks at topics such as tariffs, balance of trade, deregulation, inflation, microeconomics and macroeconomics, and income distribution to explain the ways economies around the world are constructed and interrelated. It investigates international organizations such as the European Union, OPEC, OECD, and the World Bank to explain their roles politically and economically.

Articles in this volume also explore the theoretical underpinnings of world economic systems, looking at socialist, communist, and capitalist approaches to economic organization

and also at the tools of monetary policy that governments deploy to steer their national economies.

Around the world, concerns about environmental, social, and governance issues have become paramount. Developing economies confront the social and environmental costs of rapid economic growth. Corporations and governments in more developed countries try to integrate environmental sustainability into their business practices and political policies. In the twenty-first century, the costs of mismanagement and corruption continue to expose the importance of sound corporate governance and business ethics, and the value of an economically literate public.

Economic data change daily. In order to assure the long-term usefulness of this reference work, the citations for further reading and research with each of the 52 articles are reliable, Web-based resources that publish current information on an ongoing basis. The colorful and easy-to-interpret charts and graphs that illustrate most topics are designed to guide students in understanding and interpreting the statistical displays furnished online by governments, financial institutions, international organizations, and other interest groups.

—Stephanie Schwartz Driver

Arbitration

Arbitration is a method by which two parties involved in a dispute agree to have a neutral third party, the arbitrator, hear both sides of the argument, consider the facts, reach a decision and, when appropriate, make a monetary award. As part of the arbitration process, both parties customarily agree to abide by the decision of the arbitrator. While arbitration carries the weight of a legal proceeding, arbitrators

In an 1886 cartoon by Joseph Keppler, two men set the hands (labor) of the clock (business). Arbitration, as the pendulum, swings in between them.



are not necessarily lawyers or judges. Arbitrators may be persons with specialized knowledge in a field pertinent to the particular arbitration hearing.

Arbitration is often used as a way to avoid a long, costly court battle. Rather than have their case heard in a public court of law, the parties agree to have their differences privately arbitrated. Arbitration is usually quicker and less expensive than the trial process.

Sometimes arbitration may be the only available course. For example, credit card companies may ask their customers to sign an agreement that requires the customer to submit disputes to arbitration when differences are not routinely resolved. In some cases, employers ask prospective employees to sign arbitration agreements as a condition of their employment. Arbitration clauses may be included in any contract between two parties; the parties involved can be two individuals, an individual and a company, two companies, a labor union and management, or even two nations.

Although decisions reached through arbitration proceedings are usually binding on both parties, nonbinding arbitration does exist. In nonbinding arbitration, each party retains individual rights to have the case heard in a court of law.

History of Arbitration

Resolving international differences through arbitration dates to the first Hague Conference in 1899. The 26 nations participating agreed to consider questions of disarmament, methods of warfare, and the establishment of a permanent vehicle for the resolution of international disputes. Along with the other participating nations, the United States agreed to the creation of a Permanent Court of International Arbitration. However, arbitration was not made mandatory. In 1907, at the urging of President Theodore Roosevelt, a second Hague Conference was called. The apparatus for voluntary arbitration was enlarged at that time.

In 1925 the United States Congress passed the Federal Arbitration Act. As



originally envisioned, the act addressed arbitration of commercial contract disputes. Over time, however, federal arbitration procedures have been used to resolve civil rights violations, securities fraud, anti-trust claims, and employment disputes. The commercial aspect of the act remains important, however, and enforcement of arbitration agreements and awards, both in interstate commerce and in international contracts, is addressed in the federal act.

The Arbitration Society of America, the Arbitration Foundation, and the Arbitration Conference joined forces in 1926 to form the American Arbitration Association (AAA). That year, the Actors' Equity Association was one of the first organizations to include an arbitration clause in its contracts between actors and managers. Today, the AAA offers a wide range of services for alternative dispute

resolution (ADR). A nonprofit organization, the AAA annually provides assistance to more than 100,000 persons seeking remedies outside the courtroom. AAA handles disputes in business, labor relations, employment, automobile accidents, and in other areas.

Mediation is another approach to conflict resolution. In mediation, a neutral third party hears both sides of the argument and may offer suggestions on better ways to communicate about the conflict, or ways to see the other's point of view, but does not offer a specific, binding resolution. Thus, a mediator helps the parties arrive at their own solution while an arbitrator provides the solution.

Why Arbitrate?

Arbitration or mediation offers many advantages in dispute resolution. For many

Individuals can use an arbitrator to mediate disputes.

people, avoiding the cost and complexity of a lawsuit is advantage enough; but there are others. In addition to the cost of a lawsuit, cases brought before the judicial system can take months or even years to be heard. Once a decision is reached, if a party to the lawsuit chooses to appeal the ruling, still more time may be added to the process.

Unlike a trial by jury, where the parties involved do not choose the members of the jury charged with weighing the evidence, arbitration allows the parties to choose their arbitrators from a pool of neutral individuals who have expertise in the field. Because courts must abide by complex rules of evidence and procedure, an arbitration hearing can seem quite informal. During arbitration, the parties involved in the dispute have the opportu-

nity to present their story in a relaxed and private setting.

Because the hearings and awards in arbitration are kept private, less opportunity arises for the acrimony that sometimes accompanies the publicity surrounding a high-profile court case. This is especially important if the parties involved must continue to work together after the dispute is settled.

Both arbitration and mediation as methods of dispute resolution are gaining more adherents. Arbitration clauses are increasingly being written into contracts of every kind across virtually all industries. The methods of ADR have even made it to the classroom; the value of constructive conflict resolution is being recognized by a growing number of educators in both elementary and high schools. Workshops are being offered, journal articles written, and teachers are using ADR techniques to address conflicts among students.

In some schools, students are being trained in ADR methods to enable them to act as mediators when a conflict erupts among their peers. Before a dispute reaches that step, the students involved in the conflict are encouraged to negotiate their differences in an attempt to reach an understanding. If negotiation fails to produce results, student mediators become involved. Finally, if the situation cannot be resolved through mediation, a teacher is brought in to arbitrate the dispute.

Further Research

American Arbitration Association

www.adr.org

The home page of one of the largest arbitration organizations in the United States provides links to information on all aspects of arbitration and mediation. Its subsidiary, the International Centre for Dispute Resolution, has links with arbitration organizations in 43 countries to help U.S. institutions handle disputes abroad.

Association for Conflict Resolution

www.acrnet.org

The ACR is a professional organizing representing mediators, arbitrators, and other professionals in the field.

—Connie Tuttle

A demonstration by United Farm Workers (UFW) in support of legislation that would give the union greater control during arbitration of contract negotiations. A poster depicting Cesar Chavez is in the background.



Balance of Payments

Individuals produce, trade, and borrow to satisfy their economic needs. These exchanges can become complicated; therefore, many people keep careful records of their transactions. These records tell them how much they have earned, the amount of their debts, what they own, and so on. Reviewing these documents will reveal their financial strengths and will show potential problems. National economies can be understood and evaluated in the same way, in a process economists call the balance of payments. This is the record of all transactions that take place between the residents of one nation (including individuals, businesses, and governmental units) and the residents of all other nations. (A related concept, the balance of trade, focuses more narrowly on goods exchanged between nations.)

The balance of payments has three components: goods, services, and money. All are exchanged with other countries in equal trades. Therefore, if all of one nation's exchanges are totaled, the inflows and outflows must be equal. If one nation buys more goods and services from another nation than it sells to that country, the difference is made up by the second nation gaining assets from the first. For example, if Americans buy computers from Taiwan and make no other exchanges with Taiwan, the Taiwanese retain the dollars that they realized from the sale. They may keep this money in a bank or buy something with it. The result: The United States gains computers and Taiwan gains dollars or property in the United States.

The table shows the different parts of the United States' balance of payments in 2007. The top half of the table is called the Current Account; it records trades in goods and services. It shows that the United States sold \$1,148 billion worth of merchandise and \$497 billion of services to people in other countries. However, after

totaling U.S. imports and other transactions, the table reveals that the United States has a \$713 billion trade deficit; the United States buys far more from other countries than it sells to them.

The bottom half of the table records the Capital Account. It shows the flow of money for the purchase or sale of financial and real assets that occurred in 2007; financial assets include stocks and bonds, while real assets include factories, office buildings, and so on. Many foreigners invest in the United States, buying financial and real assets, and Americans also frequently invest abroad. The Capital Account shows how the United States paid for its trade deficit. Capital inflows—foreign borrowing and purchases—exceeded

The 2007 balance of payments for the United States. Foreign investment makes up for the deficit in U.S. exports.

U.S. Balance of Payments 2007

(in billions of dollars)



THE UNITED STATES OF AMERICA

Current Account

U.S. merchandise exports	1,148
U.S. merchandise imports	-1,968
Balance of trade	-819
U.S. exports of services	497
U.S. imports of services	378
Balance of services	119
Balance of goods and services	-700
Net investment income	82
Net transfers	-113
Balance of current account	<u>-713</u>

Capital Account

Capital inflows into the United States	2,058
Capital outflows from the United States	-1,290
Balance of capital account	
transactions, net	-1,843
Current and capital account balance	-731

Total balance	<u>0</u>
---------------	----------

Note: Numbers are rounded to the nearest billion.

Source: U.S. Bureau of Economic Analysis

capital outflows by \$1,843 billion, more than making up for the Current Account deficit.

This demonstrates one reason why the balance of payments calculations can result in controversy: Overspending on imports by a country results in foreigners owning assets in that country. This became a great concern in the United States from the late 1980s when other countries' nationals bought such properties as Rockefeller Center in New York City and Pebble Beach golf course in California. Many people were also concerned that jobs were leaving the United States as fewer people bought goods produced in the United States.

Another reason why balance of payments calculations can be controversial is related to the concept of national wealth. Eighteenth-century economists, called mercantilists, argued that a nation's wealth should be measured by how much gold and silver it had. Having more specie made a nation more powerful, they reasoned, therefore governments should actively interfere with trade and the economy to create a trade surplus. The result was that European kings frequently attempted to manage their economies by granting monopolies, imposing heavy taxes on trade, and other policies.

The famed Pebble Beach golf course in California was bought by Minoru Isutani in 1990; two years later he sold it to a Japanese golf resort company, the Lone Cypress Co., for approximately \$500 million. A consortium of U.S. investors, including Arnold Palmer and Clint Eastwood, bought the course in 1999.

Adam Smith was the most famous opponent of this view. He convincingly argued that the mercantilists were wrong because increasing the supply of specie resulted in inflation, or an increase in prices. Instead, Smith asserted that a nation's wealth was best measured by what it could produce and proposed a policy called laissez-faire, or hands off. Smith's policy called for minimizing government involvement in the economy and allowing individuals the right to trade freely.

Economists generally agree that a nation's balance of payments is a matter of perspective. A trade deficit suggests that a nation's industries are not competitive and may suffer job losses as a result. On the other hand, consumers gain because they are able to buy foreign goods that are more appealing because of price or quality. Whether deficits are helpful or harmful depends on how long they last and the events causing them.

Further Research

Bureau of Economic Analysis

www.bea.gov/international

The International Investment Division of the BEA compiles data on U.S. direct investment abroad and foreign direct investment in the United States for the U.S. government.

—David Long



Balance of Trade

The balance of trade is the difference between the amount of goods that a country sells to other countries and the amount it imports from other countries. If a country sells more than it buys, it has a trade surplus. If it buys more goods from abroad than it sells, it has a trade deficit. A nation's balance of trade depends on several factors, including the spending habits of its citizens and how competitive its leading industries are.

The consequences of a persistent trade deficit can be serious. One concern is that

such a deficit indicates an economy that is not very competitive. If a country cannot produce appealing goods at reasonable prices or fails to produce new and innovative goods, it will tend to export less and import more. The result: Employment will fall as domestic industries fail, thereby reducing incomes. Another concern is that nations seem to lose wealth when they run consistent trade deficits. Trade deficits result in foreigners gaining assets—money or property—in the deficit nation. This sale of a nation's assets can cause discontent and resentment among voters, because foreigners seem to be buying the country.

**U.S. Balance of Trade
1955 to 2008**
(in million dollars)

	<i>Exports</i>	<i>Imports</i>	<i>Balance on goods</i>		<i>Exports</i>	<i>Imports</i>	<i>Balance on goods</i>
1955	14,424	-11,527	2,897	1982	211,157	-247,642	-36,485
1956	17,556	-12,803	4,753	1983	201,799	-268,901	-67,102
1957	19,562	-13,291	6,271	1984	219,926	-332,418	-112,492
1958	16,414	-12,952	3,462	1985	215,915	-338,088	-122,173
1959	16,458	-15,310	1,148	1986	223,344	-368,425	-145,081
1960	19,650	-14,758	4,892	1987	250,208	-409,765	-159,557
1961	20,108	-14,537	5,571	1988	320,230	-447,189	-126,959
1962	20,781	-16,260	4,521	1989	359,916	-477,665	-117,749
1963	22,272	-17,048	5,224	1990	387,401	-498,435	-111,034
1964	25,501	-18,700	6,801	1991	414,083	-491,020	-76,937
1965	26,461	-21,510	4,951	1992	439,631	-536,528	-96,897
1966	29,310	-25,493	3,817	1993	456,943	-589,394	-132,451
1967	30,666	-26,866	3,800	1994	502,859	-668,690	-165,831
1968	33,626	-32,991	635	1995	575,204	-749,374	-174,170
1969	36,414	-35,807	607	1996	612,113	-803,113	-191,000
1970	42,469	-39,866	2,603	1997	678,366	-876,485	-198,119
1971	43,319	-45,579	-2,260	1998	670,416	-917,112	-246,696
1972	49,381	-55,797	-6,416	1999	684,553	-1,029,987	-345,434
1973	71,410	-70,499	911	2000	772,210	-1,224,417	-452,207
1974	98,306	-103,811	-5,505	2001	718,712	-1,148,231	-429,519
1975	107,088	-98,185	8,903	2002	682,422	-1,167,377	-423,725
1976	114,745	-124,228	-9,483	2003	713,415	-1,264,307	-550,892
1977	120,816	-151,907	-31,091	2004	807,516	-1,477,094	-669,578
1978	142,075	-176,002	-33,927	2005	894,631	-1,681,780	-787,149
1979	184,439	-212,007	-27,568	2006	1,023,109	-1,861,380	-838,270
1980	224,250	-249,750	-25,500	2007	1,148,481	-1,967,853	-819,373
1981	237,044	-265,067	-28,023	2008	1,291,337	-2,112,490	-821,153

Source: U.S. Census Bureau

Economists and politicians therefore try to create trade surpluses to increase the wealth and power of their nation. In the second half of the twentieth century, the world steadily moved toward more open trade. Treaties like the North American Free Trade Agreement (NAFTA) and organizations like the European Union are predicated on the gains expected from free trade. These include access to goods and services that otherwise would not be available, lower prices for consumers, and the chance to create jobs by exporting goods and services to other countries.

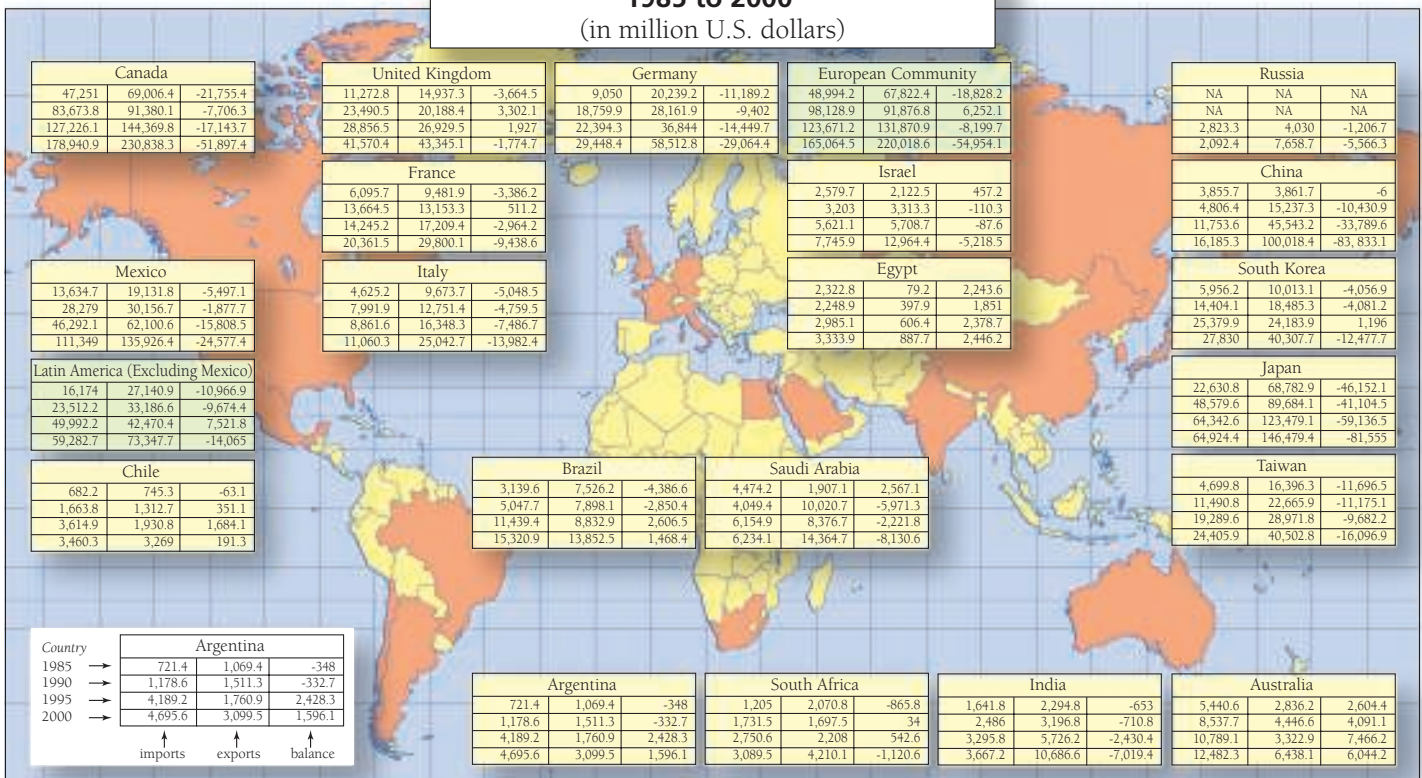
However, free trade is not universally recognized as a positive force because capitalism is based on competition. Businesses that can satisfy consumers on price, quality, and innovation will profit and prosper. Those that cannot will be forced into bankruptcy and their workers into unemployment. Foreign trade increases the amount of competition and therefore presents a threat to both business profits and

workers' jobs. Accordingly, both workers and employers have an incentive to appeal for government action against foreign trade. Consumers, a far larger but less united group, have less incentive to act and are thus less involved.

Almost all nations have trade barriers in place to protect domestic industries against foreign competitors, frequently citing a balance of trade deficit as the reason for government action. Common strategies include tariffs (taxes on imported goods that raise their prices) and quotas (set limits on the amount of goods foreign competitors may import).

These strategies benefit domestic employers and, to a lesser extent, their workers. Their costs can be quite large, however. In various studies of different industries, economists have found that protecting jobs through tariffs costs more than retraining the workers in other fields. This gap between intentions and results leads many economists to conclude that

**U.S. Trade Balances by Selected Country
1985 to 2000**
(in million U.S. dollars)



Note: Some totals may not add up, due to rounding.

Source: U.S. Census Bureau, Foreign Trade Division, Data Dissemination Branch, Washington, D.C.



the costs of protectionism far outweigh the benefits.

A second drawback of trade barriers is that they often result in international friction. Nations commonly accuse each other, often with reason, of cheating and threaten retaliation. Nations commonly subsidize, or give loans or other funds, to producers of certain goods. This allows those companies to offer cheaper prices and reap greater profits, often driving their foreign competition into bankruptcy. Cheating makes sense to politicians because they have more incentive to please their potential campaign donors and voters than the citizens of other countries.

A series of international trade agreements called the General Agreement on Tariffs and Trade (GATT) strives to address these issues. The 1994 GATT agreement called for international reductions in tariffs, quotas, and other trade barriers between 1995 and 2005. The World Trade

Organization (WTO) was created in 1995 to quickly and fairly resolve trade disputes. Formerly, nations had very little recourse to solve trade issues and often resorted to retaliating against tariffs or quotas with similar measures, leading to trade wars and economic losses. Ideally, the WTO acts as a neutral third party to mediate disputes.

Further Research

U.S. Trade Deficit Review Commission

govinfo.library.unt.edu/tdrc/reports/finalreport-contents.html

“The U.S. Trade Deficit: Causes, Consequences and Recommendations for Action.” is a report that examines U.S. trade policy and its ramifications.

World Trade Organization

www.wto.org

The home page of the World Trade Organization offers resources for students, including trade statistics, country reports, news, and other essential information.

Steelworkers in Chile protest U.S. tariffs on steel imports, which were imposed to protect the U.S. steel industry from foreign competition.

—David Long

Business Cycles

Business cycles involve patterns of expansion and contraction in employment, production, and price levels that occur in an economy over time. Consider the biggest dip in U.S. economic history, the Great Depression. Between 1929 and 1932, stock prices as measured by the Dow Jones Industrial Average fell about 89 percent and did not recover their value for many years. Unemployment soared from 7.7 million in 1937 to 10.4 million in 1938, an increase in the unemployment rate from 14 to 19 percent in one year, and this was eight years after the stock market crash. Bank failures climbed from 167 in 1920 to more than 4,000 in 1933. Indeed, the country lost about one-half of all commercial banks to bankruptcy during the Depression. Industrial production also declined sharply. Factories produced at about one-half of their capacity, and investment in new equipment collapsed from \$16 billion to less than \$1 billion.

Business cycles affect the economies of all nations. Since World War II, the United States has experienced nine business cycle contractions and expansions. Fluctuations in

business activity are repetitive, and cycles in the United States affect other economies as well—from Japan, Great Britain, Germany, and Brazil to Canada, Indonesia, South Korea, and Italy.

Debates on Business Cycles

Business cycles have many names and competing explanations for their occurrence: observed patterns include Kitchin's 40-month cycle, Juglar's 8-year cycle, or Kondratieff's 50-year waves. Some experts explain cycles by looking at the fluctuations of inventories; others identify changes in the level of investment in capital technology as the cause. In general, economists rely on two broad schools of thought when trying to understand fluctuations in the business cycle: the classical school and the Keynesian school.

Classical thinkers assume the economy obeys the laws of supply and demand. Markets work to bring themselves into balance. Price fluctuations reflect real changes in the economy and, if allowed to operate freely, provide enough information to savers and investors so that saving and investment decisions promote stability. According to this school of thought, business cycles are



In March 1939, during the Great Depression, people wait in line to receive food from a relief program in San Antonio, Texas.

self-correcting unless misguided government economic policies make matters worse.

The classical formulation holds that economies tend toward long-run stability in employment, prices, and output, because what is manufactured generates sufficient income to be taken off the market. Supply

creates its own demand. Gluts and shortages are temporary and actually perform useful signaling functions in a decentralized, self-regulating system that continuously adjusts itself. Ineffective tax hikes and disruptive tinkering with monetary policy exacerbate the fluctuations in business cycles. The Depression,

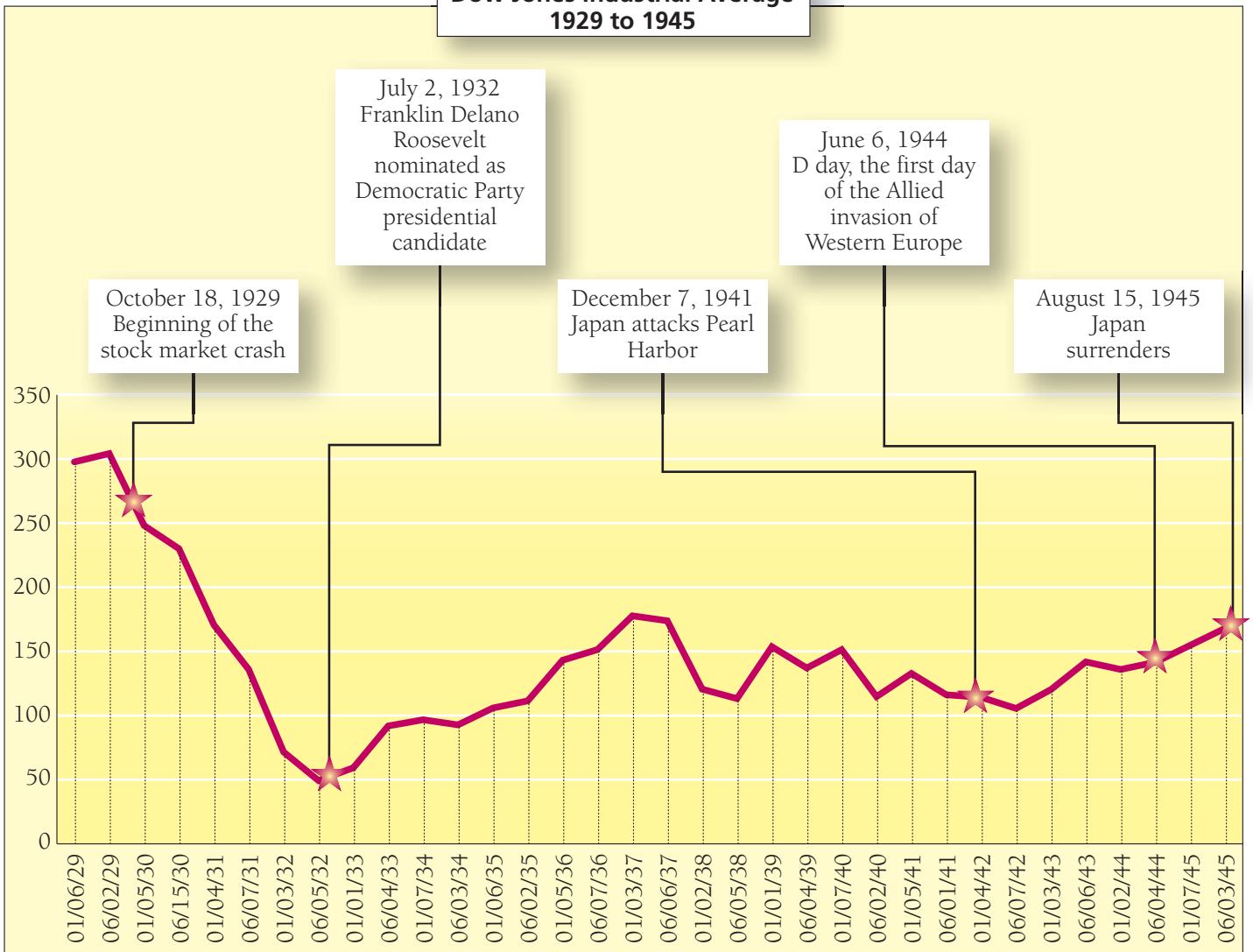
**U.S. Business Cycles
1854 to 2001**

Business cycle dates		Duration in months			
Trough	Peak	Recession	Expansion	Cycle	
		<i>Trough from previous peak</i>	<i>Trough to peak</i>	<i>Trough from previous trough</i>	<i>Peak from previous peak</i>
December 1854	June 1857	–	30	–	–
December 1858	October 1860	18	22	48	40
June 1861	April 1865	8	46	30	54
December 1867	June 1869	32	18	78	50
December 1870	October 1873	18	34	36	52
March 1879	March 1882	65	36	99	101
May 1885	March 1887	38	22	74	60
April 1888	July 1890	13	27	35	40
May 1891	January 1893	10	20	37	30
June 1894	December 1895	17	18	37	35
June 1897	June 1899	18	24	36	42
December 1900	September 1902	18	21	42	39
August 1904	May 1907	23	33	44	56
June 1908	January 1910	13	19	46	32
January 1912	January 1913	24	12	43	36
December 1914	August 1918	23	44	35	67
March 1919	January 1920	7	10	51	17
July 1921	May 1923	18	22	28	40
July 1924	October 1926	14	27	36	41
November 1927	August 1929	13	21	40	34
March 1933	May 1937	43	50	64	93
June 1938	February 1945	13	80	63	93
October 1945	November 1948	8	37	88	45
October 1949	July 1953	11	45	48	56
May 1954	August 1957	10	39	55	49
April 1958	April 1960	8	24	47	32
February 1961	December 1969	10	106	34	116
November 1970	November 1973	11	36	117	47
March 1975	January 1980	16	58	52	74
July 1980	July 1981	6	12	64	18
November 1982	July 1990	16	92	28	108
March 1991	March 2001	8	120	100	128

The duration of the peaks and valleys of business cycles.

Note: Figures printed in red are wartime expansions (Civil War, World War I and II, Korean War, and Vietnam War), the postwar contractions, and the full cycles that include the wartime expansions.
Sources: National Bureau of Economic Research and the U.S. Department of Commerce, *Survey of Current Business*, Washington, D.C., Government Printing Office, 2002.

Dow Jones Industrial Average 1929 to 1945



Experts often look to the stock market when analyzing business cycles. This chart shows the activity of the Dow Jones Industrial Average during the Great Depression and World War II.

according to the classical school, was made much worse by the bad timing of tax increases, cuts in the money supply, and enormous increases in tariffs.

By contrast, British economist John Maynard Keynes claimed that capitalism was chronically ill. The illness predisposed the economy toward instability in prices, output, and employment. The sickness of capitalism was attributable in part to the disconnected nature of the plans of savers and investors. Mismatches in savings and investment decisions could become a source of long-term disruption for the real economy of goods and services and for production, distribution, and consumption. Acknowledging some of the self-correcting market tendencies described by the classical school, followers of Keynes believed that some sort of governmental

demand-management policies were required to keep capitalism healthy. According to this line of thinking, an optimal combination of monetary and fiscal policy would promote stability in the labor and financial markets during periodic imbalances. To make good savings and investment decisions, individuals and businesses needed help and assistance from the public sector.

Stocks and Cycles

An important question emerges in the course of this argument between the classical and Keynesian schools. What is the relationship between stock market fluctuations and the real economy of jobholders who make consumption decisions and savers who make investment decisions? Studies indicate stock prices do affect consumption and investment

decisions, but only slightly. A 10 percent sustained increase in stock market values in one year is associated with a 4 percent increase in consumption spending during the next three years. The connection between investment spending and stock values is even weaker.

Apparently, however, stock market bubbles matter much more. When the prices of shares outstrip the underlying value of the issuer, as happened in the 1990s and in 2007, it can cause serious problems in the real economy. Stock market bubbles are the product of unbridled optimism (reflected in the popular misconception that recessions are a thing of the past in the new economy), frenzied speculation (the dot-com craze or the explosive growth in financial engineering and derivative investment vehicles from 2005 to 2007), or just plain “irrational exuberance,” as Federal Reserve chairman Alan Greenspan asserted. Falling stock prices can wreak havoc as workers are laid off, consumption plans postponed, and investment projects cancelled. The intoxicating euphoria of the run-up is replaced by the hangover of gloom and doom.

Can stock market prices predict changes in the business cycle? The answer is uncertain. Insofar as stock price indexes like the New York Stock Exchange Index or the Standard and Poor’s 500 Index accurately measure the mood of the investment community, they may be said to show some kind of connection between stock market and business cycle fluctuations. However, the precise connection is unclear. Most of the American recessions since 1945 were preceded by general decreases in stock price measures. Yet stock market prices alone do not always predict recessions. Stock market indexes sometimes fall sharply without being followed by a business cycle downturn, as was the case in 1987 when a 508-point drop in the Dow Jones Industrial Average was not followed immediately by a downturn in the economy. Although the exact connection is unclear, the general level of stock prices is deemed important enough to be included in the government’s top 10 leading economic indicators that, taken together, may predict future directions of business activity.



Volatility in the stock market is one indication of economic dislocation.

The economists’ quarrel over the causes of business cycles has become increasingly important. Substantial differences result when the government does little or nothing, on the one hand, or adjusts taxes and spending levels to mitigate the effects of a recession, on the other. These policy choices matter a great deal. Business cycles in the United States, Japan, Venezuela, and the European Union are increasingly interconnected as globalization brings markets closer together. The United States committed itself to achieving full employment and stable prices in the Full Employment Act of 1946 and in its subsequent amendments; dealing with the business cycle is the law of the land. So, in addition to being the subject of debate between economists, the roller coaster ride of the business cycle is important to people concerned with their jobs or with how far their paychecks will take them during the ride.

Further Research

Irrational Exuberance

www.irrationalexuberance.com

Robert Shiller, professor of economics at Yale

University, has studied speculative bubbles in the stock market and in real estate. This Web site explains some of his theories and offers links to information about his research.

National Bureau of Economic Research

www.nber.org/cycles.html

The Business Cycle Dating Committee of the NBER tracks business expansions and contractions (recessions).

—Stephen Haessler