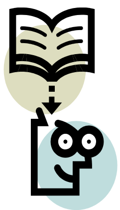
Introduction to Economics

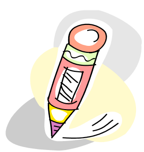
Timeframe:	Minimum of 14 hours
Learning Outcome:	• Evaluate the different types of economic systems, the ideologies on which they are based and their application to an organisation
Recommended Book:	• Chapters 1, 2 and 21 in Parkin, M. 2014, *Economics*, Global Edition, 11^{th} ed., England: Pearson Education Limited.
Recommended Articles:	• Trainer, F. 2014, 'Ethics and the Economy', *Humanomics*, 30 (1), 41-58.
Section Overview:	This section looks at the definition of economics and the fundamental principles of economics. It also examines the three central economic questions and how they are solved by the major economic systems.

What is Economics?



Reflect on your understanding of the term "economics". You may have studied economics in matric – or in further studies. In your own words, define what you understand by "economics".

In the 1930s, prominent 20^{th} Century British economist, Lionel Robbins (1898-1984) set the tone for most modern definitions of economics as the science that studies human behaviour as a relationship between ends and scarce means that have alternative uses (van Schaik, 2008:5).



"Economics is the social science that studies the choices that individuals, businesses, governments, and entire societies make as they cope with scarcity and the incentives that influence and reconcile those choices."

(Parkin, 2014:2)

The definition above develops Robbins' idea by bringing to fore the fundamental issues of individuals, businesses, governments, societies and choices, scarcity, and incentives (a broader, more systemic view of economics).

Fundamentally, we have unlimited wants on the one hand and limited resources on the other.

Distinguishing between “Wants”, “Needs” and “Demand”

Choices have to be made with regard to which wants to satisfy using the limited resources. A want is a human desire for goods and services, it is unlimited and you can do without it. A need is a necessity; it is essential for survival and is not absolutely unlimited. A demand is only made for a good or service if the necessary means to purchase it are available.

Scarcity, Choice and Opportunity

The term “scarcity” means that the resources available are simply not enough to satisfy the human wants; i.e. the basic fact of economic life. Choice is concerned with the decisions that are made in the allocation of limited resources to competing alternatives. In the process of resource allocation, some alternatives are preferred over others. The opportunity cost of a choice is the value of the best-foregone alternative. Every time a choice is made, opportunity costs are incurred.

Task Questions

1. After reading Pages 32-33 of your prescribed textbook (Parkin, M. 2014, *Economics*, Global Edition, 11th ed., England: Pearson Education Limited), explain why the production possibility frontier (PPF) in a simple two-commodity world is conventionally depicted as “bulged out” or concave to the origin.
2. Under what circumstances might a linear PPF be plausible?

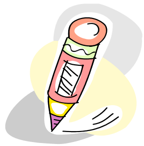
The Production Possibilities Curve

The concepts of scarcity, choice and opportunity costs can be illustrated using the production possibility curve as shown in the figure that follows.

The production possibilities curve indicates the combinations of any two goods or services that are attainable when the available resources (e.g. in a business) are fully and efficiently employed. In the diagram that follows, movement to the right from A to C illustrates an increase in the production of Product B, while the production of Product A decreases. There is a trade-off between Products A and B (we must give up something to get something else). This implies that, at points A, B and C, different levels of Product A and B can be produced. Point Y is unattainable and point X shows that the business is not at full capacity.

FIGURE 1: THE PRODUCTION POSSIBILITIES CURVE (REFER TO FIGURE DOCUMENT)

Parkin (2014:33) explains production efficiency as follows:



> "We achieve production efficiency if we produce goods and services at the lowest possible cost. This outcome occurs at all the points on the PPF."
>
> (Parkin, 2014:33)

The Three Central Economic Questions

Task Questions

What do you understand by the basic economic questions of "what", "how" and "for whom" to produce goods and services? Refer to Pages 3-6 in Parkin, M. 2014, *Economics*, Global Edition, 11th ed., England: Pearson Education Limited.

The three central economic questions are:

What goods and services will be produced? (Output Questions)

Goods – such as houses, cars, food etc. – are tangible, and services – such as legal services, financial services, medical services etc. – are intangible. The goods can be categorised into consumer or capital, final or intermediate, private or public, economic or free, and homogeneous or heterogeneous (Mohr and Fourie, 2008: 18-19). Goods and services are produced to satisfy human wants.

How will each of the goods and services be produced? (Input Questions)

The production of goods and services requires resources. These resources (factors of production) can be grouped into four categories: Natural resources, labour, capital, and entrepreneurship and technology. The natural resources consist of the free gifts of nature such as water, land, minerals, vegetation etc. Labour is the human effort in the production of goods and services. Capital refers to all the man-made resources that are used in the production of other goods and services such as machines, tools, buildings etc. Entrepreneurship involves the identification of opportunities and a combination of labour, capital and natural resources to produce the desired goods and services. The person who drives the process of entrepreneurship is called an entrepreneur. Technological advancement improves the entrepreneurship process.

For whom will the various goods and services be produced? (Distribution questions)

The goods and services are produced mainly for those who have the means to demand them. The goods and services are distributed to various sectors and participants in the economy. The distribution issue is a highly emotional question, especially in societies where the distribution is unequal.

Task Questions

To what extent can the solutions to the "what" and "for whom" questions be seen as interdependent in a market economy?

Economic Systems

There are basically three economic systems that are used to solve the central economic questions.

The traditional system

This involves the production of the same goods and services that are distributed in the same way by each successive generation. This system is slow to change, rigid and resistant to innovation. Very few economies are still using this economic system – countries still using this type of system are often rural and farm-based (the Inuit tribe of northern Canada is an example of a society that still uses a traditional economy).

The command system

The economy is controlled by a central authority, which decides what to produce, how to produce and to whom to distribute (factors of production are government owned). It is argued that this system is one of the more 'inefficient' systems and within it there is much waste. Present day examples of this are North Korea and Cuba.

The market system

This is the most commonly applied economic system to the economic problem. A market is any contact or communication between potential buyers and sellers of a good or service.

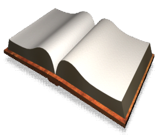
Some characteristics of a market are listed below:

- There must be at least one potential seller and one potential buyer
- The seller must have something to sell
- The buyer must have the buying power
- The market price must be determined
- The agreement must be guaranteed by law or tradition

In a market system, only those goods and services with a market value will be produced. The goods and services are produced in the cheapest possible way. The goods and services only go to those who have the means to buy them.

Most modern economies are mixed economies and have a market that has a degree of government intervention. If the market economy is allowed to function freely, it will only produce those goods and services for which a market value exists and which can be sold at a price; but what about other goods, for example, street lights or unpolluted air and clean beaches? All consumers want to enjoy these goods and services but, because these are public goods and not exclusive ones, the market system will not produce them. Hence the need for government interference.

Read the following case study and then answer the questions that follow.



Case Study: The Collapse of Lehman Brothers

On September 15, 2008, Lehman Brothers filed for bankruptcy. With $639 billion in assets and $619 billion in debt, Lehman's bankruptcy filing was the largest in history, as its assets far surpassed those of previous bankrupt giants such as WorldCom and Enron. Lehman was the fourth-largest U.S. investment bank at the time of its collapse, with 25,000 employees worldwide. Lehman's demise also made it the largest victim, of the U.S. subprime mortgage-induced financial crisis that swept through global financial markets in 2008. Lehman's collapse was a seminal event that greatly intensified the 2008 crisis and contributed to the erosion of close to $10 trillion in market capitalisation from global equity markets in October 2008, the biggest monthly decline on record at the time.

The History of Lehman Brothers

Lehman Brothers had humble origins, tracing its roots back to a small general store that was founded by German immigrant Henry Lehman in Montgomery, Alabama, in 1844. In 1850, Henry Lehman and his brothers, Emanuel and Mayer, founded Lehman Brothers.

While the firm prospered over the following decades as the U.S. economy grew into an international powerhouse, Lehman had to contend with plenty of challenges over the years. Lehman survived them all – the railroad bankruptcies of the 1800s, the Great Depression of the 1930s, two world wars, a capital shortage (when it was spun off by American Express in 1994), and the Long Term Capital Management collapse and Russian debt default of 1998.

However, despite its ability to survive past disasters, the collapse of the U.S. housing market ultimately brought Lehman Brothers to its knees, as its headlong rush into the subprime mortgage market proved to be a disastrous step.

The Prime Culprit

In 2003 and 2004, with the U.S. housing boom well under way, Lehman acquired five mortgage lenders, including subprime lender BNC Mortgage and Aurora Loan Services, which specialised in Alt-A loans (made to borrowers without full documentation). Lehman's acquisitions at first seemed prescient; record revenues from Lehman's real estate businesses enabled revenues in the capital markets unit to surge 56% from 2004 to 2006, a faster rate of growth than other businesses in investment banking or asset management. The firm secured $146 billion of mortgages in 2006, a 10% increase from 2005. Lehman reported record profits every year from 2005 to 2007. In 2007, the firm reported net income of a record $4.2 billion on revenue of $19.3 billion.

Lehman's Colossal Miscalculation

In February 2007, the stock reached a record $86.18, giving Lehman a market capitalisation of close to $60 billion. However, by the first quarter of 2007, cracks in the U.S. housing market were already becoming apparent as defaults on subprime mortgages rose to a seven-year high.

On March 14, 2007, a day after the stock had its biggest one-day drop in five years on concerns that rising defaults would affect Lehman's profitability, the firm reported record revenues and profit for its fiscal first quarter. In the post-earnings conference call, Lehman's chief financial officer (CFO) said that the risks posed by rising home delinquencies were well contained and would have little impact on the firm's earnings. He also said that he did not foresee problems in the subprime market spreading to the rest of the housing market or hurting the U.S. economy.

The Beginning of the End

As the credit crisis erupted in August 2007 with the failure of two Bear Stearns hedge funds, Lehman's stock fell sharply. During that month, the company eliminated 2,500 mortgage-related jobs and shut down its BNC unit. In addition, it also closed offices of Alt-A lender Aurora in three states. Even as the correction in the U.S. housing market gained momentum, Lehman continued to be a major player in the mortgage market. In 2007, Lehman underwrote more mortgage-backed securities than any other firm, accumulating an $85-billion portfolio, or four times its shareholders' equity. In the fourth quarter of 2007, Lehman's stock rebounded, as global equity markets reached new highs and prices for fixed-income assets staged a temporary rebound. However, the firm did not take the opportunity to trim its massive mortgage portfolio, which in retrospect, would turn out to be its last chance.

Hurtling Toward Failure

Lehman's high degree of leverage – the ratio of total assets to shareholders equity – was 31 in 2007, and its huge portfolio of mortgage securities made it increasingly vulnerable to deteriorating market conditions. On March 17, 2008, following the near-collapse of Bear Stearns – the second-largest underwriter of mortgage-backed securities – Lehman shares fell as much as 48% on concern it would be the next Wall Street firm to fail. Confidence in the company returned to some extent in April, after it raised $4 billion through an issue of preferred stock that was convertible into Lehman shares at a 32% premium to its price at the time. However, the stock resumed its decline as hedge fund managers began questioning the valuation of Lehman's mortgage portfolio.

On June 9, Lehman announced a second-quarter loss of $2.8 billion, its first loss since being spun off by American Express, and reported that it had raised another $6 billion from investors. The firm also said that it had boosted its liquidity pool to an estimated $45 billion, decreased gross assets by $147 billion, reduced its exposure to residential and commercial mortgages by 20%, and cut down leverage from a factor of 32 to about 25.

Too Little, Too Late

However, these measures were perceived as being too little, too late. Over the summer, Lehman's management made unsuccessful overtures to a number of potential partners. The stock plunged 77% in the first week of September 2008, amid plummeting equity markets worldwide, as investors questioned CEO Richard Fuld's plan to keep the firm independent by selling part of its asset management unit and spinning off commercial real estate assets. Hopes that the Korea Development Bank would take a stake in Lehman were dashed on September 9, as the state-owned South Korean bank put talks on hold.

The news was a deathblow to Lehman, leading to a 45% plunge in the stock and a 66% spike in credit-default swaps on the company's debt. The company's hedge fund clients began pulling out, while its short-term creditors cut credit lines. On September 10, Lehman pre-announced dismal fiscal third-quarter results that underscored the fragility of its financial position. The firm reported a loss of $3.9 billion, including a write-down of $5.6 billion, and also announced a sweeping strategic restructuring of its businesses. The same day, Moody's Investor Service announced that it was reviewing Lehman's credit ratings, and also said that Lehman would have to sell a majority stake to a strategic partner in order to avoid a rating downgrade. These developments led to a 42% plunge in the stock on September 11.

With only $1 billion left in cash by the end of that week, Lehman was quickly running out of time. Last-ditch efforts over the weekend of September 13 between Lehman, Barclays PLC and Bank of America, aimed at facilitating a takeover of Lehman, were unsuccessful. On Monday September 15, Lehman declared bankruptcy, resulting in the stock plunging 93% from its previous close on September 12.

Conclusion

Lehman's collapse roiled global financial markets for weeks, given the size of the company and its status as a major player in the U.S. and internationally. Many questioned the U.S. government's decision to let Lehman fail, as compared to its tacit support for Bear Stearns (which was acquired by JPMorgan Chase) in March 2008. Lehman's bankruptcy led to more than $46 billion of its market value being wiped out. Its collapse also served as the catalyst for the purchase of Merrill Lynch by Bank of America in an emergency deal that was also announced on September 15.

(Investopedia, 2012a)

Task Questions

Assume you were the chief economist advising CEO Richard Fuld in August 2007. What advice would you have given him, taking into consideration the given economic system, the company's financial position and the investment portfolios?