ECONOMICS I.

Tamás Tánczos

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1. INTRODUCTION

1.1 OBJECTIVES, COMPETENCES, CONDITIONS OF COMPLETION OF THE COURSE

1.1.1 Objectives

The objective of the course is to familiarize the students with the development and processes of economics, and the position and role of micro and macroeconomics within the science of economics, as well as with those basic concepts and equations that form an indispensable part of developing an economic mindset and awareness. The knowledge gained here will facilitate orientation in everyday economic life and substantiate the knowledge of the course entitled “Economics II.”

1.1.2 Competences

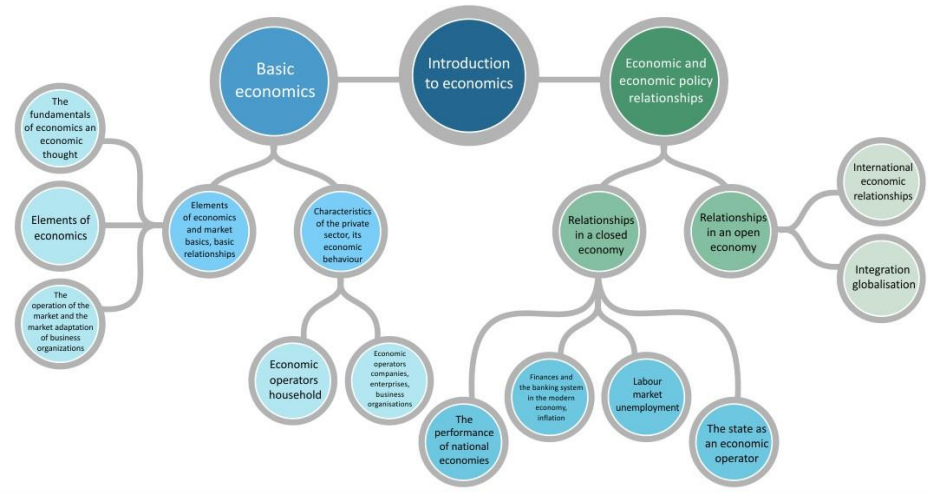
After successful completion of the course, the student:

- Knows the terminology used for presenting economic processes.
- Knows the coordination mechanisms of the economy; is aware of the basic context of market operation and the main features of the functioning of a modern mixed economy.
- Identifies economic operators, knows the main features of their behaviour and adaptation.
- Knows the cornerstones of macroeconomic analysis; determines the factors influencing macro processes. Matches current economic policy implications to his/her macroeconomic studies.
- Improves awareness in managing personal finances.
- Based on the studies, he/she exhibits a growing awareness in evaluating environmental issues, and that in his/her behaviour he/she endorses the principles of sustainability, and he/she is able to carry conviction through deeds.
- Is able to pursue independent economic studies, He/she is able to combine the lessons learned with economic information from his/her environment.
- Is interested in economic phenomena, Looks for the relationship and roots among economic and social problems.
- Is characterized by social sensitivity, He/she is aware of social problems and is characterized by an attitude of solidarity which also reflects in his/her deeds.

1.1.3 Conditions of completion of the course

The course can be regarded as completed if the student holds all the competences in respect of each lesson which have been stated in the above subchapter.

1.2 CONTENTS OF THE COURSE



Graph 1: Mind map

1.3 LEARNING ADVICE AND THINGS TO KNOW

When we consider the curriculum was created for scientific minded students attending technical training, acquiring the knowledge contained within should not cause serious difficulties. Studying is made easier by the fact that the material can be readily linked to practice and their everyday life. It is practical to interpret the scholarship in our own life situations, as well as through economic policy news that can be heard, seen, and read in the mainstream media. Great emphasis is given to the interpretation of the written material; pure mechanical memorization of the knowledge should be thus avoided; with emphasis on its application being stressed. If you are uncertain about the interpretation or the exact definition of an economic category, you may consult the following address:

1. http://www.dictionaryofeconomics.com/dictionary

The curriculum was created by the employees of the Eszterházy Károly College Institute of Economic Science.

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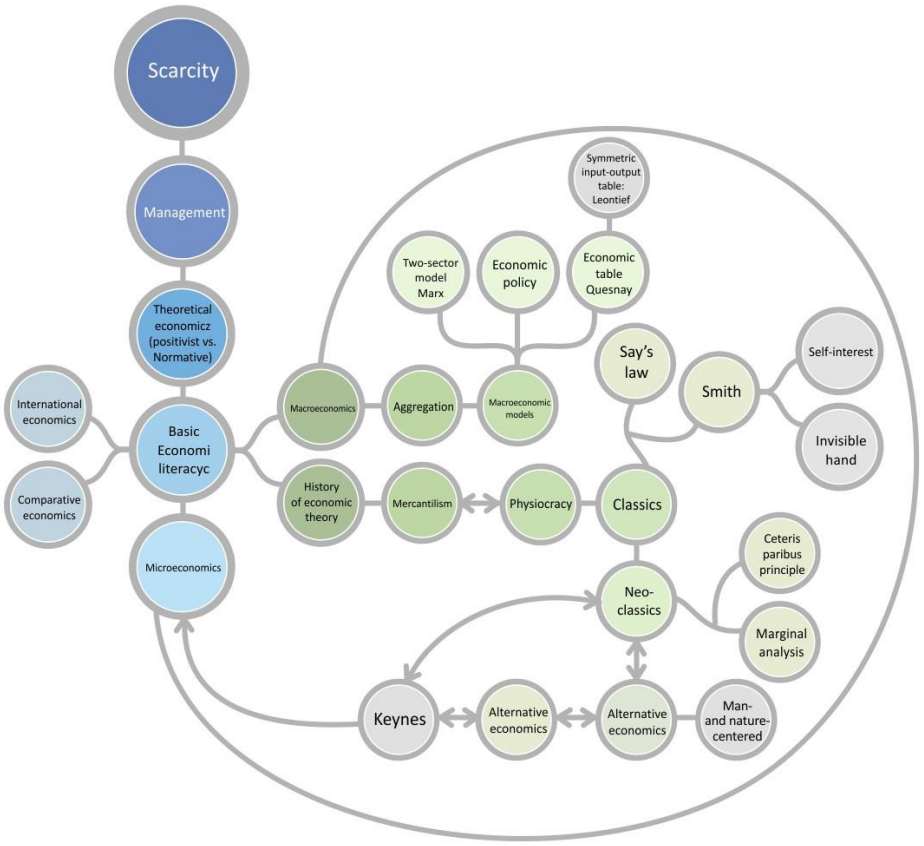
2. LESSON: THE BASICS OF ECONOMICS AND ECONOMIC THOUGHT

2.1 OBJECTIVES AND COMPETENCES

The objective of this chapter is to ascertain the basics of economic thought and the discovery of the development of economics, thus grounding the scientific environment in which we will travel during the discussion of the curricula of “Economics I and II.”

After acquiring the knowledge of the lesson, we will get to know the historical background of the development of economics and also the framework in which the context of theoretical economics can be understood. Furthermore, we will also learn why it is necessary for us to know and understand economic context and processes.

2.2 CURRICULUM



Graph 2: Mind map

2.2.1 Why do we study economics?

When we study economics our aim is to acquire useful knowledge and skills applicable to our everyday life, and to acquire competences which will help us make our lifestyles more rational, more affluent, and more comfortable. In brief: it is our aim to form the pillars of basic economic literacy.

What is basic economic literacy? There exists an internationally accepted definition for this:

> **Basic economic literacy denotes the faculty to identify, analyse and assess the consequences of the decisions of the individual and the community.**

Basic economic literacy involves the understanding of the following:

- the limits of decision making because of the limited available means, the decisions made within these limits and the possibilities for substitution;
- the operation of economies and markets, also the place and role of the individual in them;
- the costs and utility of economic interaction and interference among people and economies.

As well as these criteria, basic economic literacy **involves holding skills which make it possible for people to effectively function in their roles as consumers, producers, savers, investors and responsible citizens.** These skills involve economic reasoning, problem solving and decision making, as well as the skills necessary for the analysis of real life situations.[1]

Based on all these we can say that economics is the science of choices and decisions. But why are we constantly forced to choose and to also ponder those choices?

Why does such a science have to develop to treat systematically the review of our opportunities, the deliberation of the sacrifices and benefits related to our decision? A science which – based on a suitable methodology – is capable of modelling the operation of individual economic operators but also that of complex national economies and the analysis of the levers of their operation? When did this science form and how has it developed? We aim to answer these questions in the following subchapters of this lesson.

We will point out the state of being that made the birth of such a science necessary. Then we will provide a glimpse into the history of the development of economic theory (we note here that an independent discipline, the history of economic theory treats the scientific history of economics.) Thereafter, we will mark off the two main branches of theoretical economics. One of the branches – as we will see – views economic processes from a worm's eye view, from the level of individual economic operators. The other branch views it from a bird's eye view, looking at large economic systems – on the scale of national economies, groups of countries – it examines the most important economic phenomena, issues and the tools of solution. In this context, a few comments will be formulated on economic policy.

[1] Péter Bárczy quotes the definition in his article entitled *'A „tábla-bla" jövője'* (Future of the table) See: Vezetéstudomány (Management Sciences), 2004/12. pp. 21-22.

Finally, we will mention a particular branch of present-day economic theory, so-called 'alternative economics'. In relation to all this, the question arises: what shall the task of economic science be? Is it sufficient to thoroughly describe the observed economic operation, interpret economic phenomena and reveal substantial correlation? Or: should it offer applicable recipes and suggestions for solutions to the problems identified?

2.2.2 Why did economics come to be?

What is the basic situation that perpetually forces us to make choices and decisions? The basic reason: **scarcity**! We are floundering in the trap of permanent pressure to make decisions because the majority of the goods we wish to use are only available in a limited quantity compared to the needs.

A commodity is scarce when people cannot get as much as they wish without sacrificing some other commodity It follows that if a commodity is scarce, we have to economize with its use; more precisely: we have to look for the most practical usage of the commodity in question with the most beneficial consequences. In other words: **we should manage** it!

2.2.3 The development of economic thought – a bit of the history of theory

Scarcity has accompanied the history of human society from the beginning. We have always had to manage commodities – it follows that we have always had to deal with the questions of management (everyday needs – satisfaction) on the level of everyday life, with practicality. But this is not yet a scientific approach. If we are looking for the birth of economics as an independent scientific discipline, we do not have to go back far in time. It is a tacit consensus that the 'birth' of economics is calculated from the publication of the work of Adam Smith: *The Wealth of Nations* (1776.) Of course, we have since come a long way and the past two and a half centuries have brought many new insights, while naturally, the old theories have been reborn in slightly different wordings.[2]

[2] Several sources deal with the presentation and interpretation of 'old theories.' In this topic, Todd G. Buchholz's work: *New Ideas from dead Economists an Introduction to modern Economic Thought* is an instructive and entertaining read. (Új ötletek halott közgazdászoktól. Európa Könyvkiadó, Bp., 1998.)

Economic thoughts of ancient and medieval philosophers and theologians

Analyses of scientific history often begin like this: 'already the ancient Greeks…'! Indeed: the great thinkers of ancient Greece treated economic questions in their works. These were not economic creations but works on ethics or the theory of politics. And this was not unintentional! After all, **economic issues have always been questions relating to the relationships among people and groups of people, the interests of individuals and groups.** Thus it is natural that **these problems can be tackled from an ethical side** (from the side of correct activity, the just and good decision, good government). This is exactly what the ancient and medieval thinkers did: they raised some of the eye-catching problems of management as a fundamentally ethical question. So it is understandable that **economics seceded from philosophy, more properly from moral philosophy**, and developed into an independent science (Adam Smith lead the moral philosophy department at the University of Glasgow).

Going back to the ancient Greeks: **Plato** approached the topic from the side of political theory. In several of his works[3] he wrote about the ideal organisation of the city-state. According to his vision, the inhabitants of the city-state arrange into three groups: leaders (they are the philosophers carrying the virtue of wisdom), guards (they are the brave soldiers) and the workers (attesting reasonable restraint): farmers, craftsmen, merchants. According to Plato, the leaders and guards cannot deal with money management, they cannot even touch money (they live in a commune style community; they are catered for by the city.) They are not allowed to follow their individual interests – they are equipped with everything to the necessary extent, but they cannot strive to accumulate private wealth – this is the price they pay for being the leading officers of the city-state. In other words: this is about the drastic elimination of corruption from influencing political decisions.

2. Plato: http://www.ehow.com/info_8402465_were-contributions-plato-field-economics.html

Plato's disciple, **Aristotle** chose an opposing approach: he articulated economic questions starting from the aspect of the household. He thought in pairs of opposites: he made a distinction between natural and unnatural management. He regards management natural until the aim is to satisfy real needs on a normal level. However, when the aim is

[3] See: Plato: *The Republic* and *Laws* Available in Hungarian: Az állam. Összes Művei II., Európa, Bp., 1984. ; Platón: Törvények. Összes Művei III., Európa, Bp., 1984.

to produce for sale and through this, to accumulate wealth, – according to Aristotle – management becomes unnatural, a self-generating process without end. Namely there is no limit to wealth accumulation: however big someone's fortune is, he could own even more! Here, it is impossible not to notice the 'crosstalk' of the problem of our time: that infinite growth in a finite world can lead to catastrophe; we can drown in trash and our own waste!

3. Aristotle: http://www.quebecoislibre.org/05/050915-11.htm

The great thinkers of the Middle Ages seized economic problems from the side of justice and ethical life. Here we should remember the wise man from the 13th century who tried to connect the teachings of Aristotle with those of Christianity: he is **Thomas Aquinas,** the 'Doctor Angelicus' as he was called by his contemporaries. He stressed the principle of equality in exchange and the aspects of proportionality in the distribution of goods and income. In other words, justice and Christian morality require that the parties shall exchange values equal to each other. However, the distribution should happen according to the proportion of dignity and merit. Thomas' theory of usury is very instructive: in his view interest is the price of the time for which the original owner of the money renounces the use of the money he lends. In the continuation of his theory he is lead by his religious conviction. Namely he says that since TIME belongs to God and the 'price' of time is interest, God should be entitled to the interest should – ergo: earthly mortals cannot demand interest for the money lent. Or rather yes, in one case: if the debtor is late with paying back. Because for God TIME is infinite, but for an earthly mortal it is not: if someone abuses the time of his fellow, he deserves the 'punishment', the payment of interest.

4. Thomas Aquinas: http://www.acton.org/pub/religion-liberty/volume-8-number-4/saint-thomas-aquinas

This same topic – the problem of the morality or immorality of collecting interest – also appears in the reflections of religious reformers (Luther, Calvin). But – and take note of this – this is the age (16th century) of the evolution of capitalist relations. And this fact also leaves its mark on general thinking and the formation of the views of great thinkers. The religious reformers (especially Calvin) recognize collecting interest as completely natural and permissible. But how do they reconcile this with the teachings of the Gospel? Calvin does it in the following way: he differentiates between two types of loans: he talks about consumer loans and productive loans. In the first case he thinks of emergencies, when a sudden disaster (flood, fire) threatens one's daily livelihood. He has to

take a loan from his fellow man out of necessity in order to survive. This type of loan is charitable and in this case, according to Calvin, collecting interest is not possible (you cannot aggravate someone's misery with further demands.) The Scripture refers to cases like this – Calvin argues – that is why the ban on collecting interest becomes more emphatic. The other type of loan is when someone borrows money from others to invest it, to start a profitable enterprise. This is how money becomes capital – we can use modern terminology: this is the productive loan – says Calvin. In this case, collecting interest is naturally rightful, because the person without whose capital the enterprise would not have been created rightfully requires part of the profit.

5. Martin Luther and John Calvin: http://sbcvoices.com/john-calvin-vs-martin-luther-similarities-and-differences/

Practical questions of the emerging bourgeoisie

16th – 17th centuries: The enriching of the bourgeoisie raises practical questions related to management – and whilst the answers are also practical, they still do not combine as a comprehensive theoretical system, but we are close to the birth of a new science. This is the age of the **mercantilists**: how does a merchant become rich, how does a country become rich? These are really profound questions, but the character of the answer is not indifferent as decisions of monarchs, the situation and livelihoods of occupational groups depend on it! The answer, of course, also depends on how the question is interpreted. What do they consider richness? The then questioners **understood richness as accumulated financial assets: silver or gold.** Ergo the question: how can a country become richer? – equals: how can a country increase its gold holdings? Primarily, through acquiring gold from abroad. In other words, **foreign trade has great significance in the enrichment of a country** (and consequently a merchant). Namely, active foreign trade (that is, showing an export surplus). Through export gold flows into the country (as quid pro quo for the exported products) while import 'sucks' the gold out of the country. So the solution is not to import anything (or only at a minimum rate) and to export more and more. What can be sold abroad at a good price? Primarily manufactured goods! However, in order to boost industrial production, **it is necessary to establish manufactories.** We can thus state (using modern terminology): mercantilism is an economic policy which supports foreign trade, stimulates export and advocates industry. And what is necessary for all this? A tariff policy that pushes foreign trade to active, supporting the founding of manufactories, the construction of transportation

infrastructure (roads, docks), and the protection of commercial routes. All this should be achieved and backed up by the wise measures of the monarch. Thus, mercantilism is an economic policy which demands the active intervention of the state.

To exaggerate and to overexert something is always a dangerous thing! In turns this is exactly what happened in France at the end of the 1600's: Colbert, the Sun King's finance minister increasingly made agriculture impossible with his one-sided measures. This was shown directly by famines and indirectly by the drastic decrease in the purchase of manufactured goods by the peasants.

6. Colbert: http://www.britannica.com/EBchecked/topic/124928/Jean-Baptiste-Colbert/1401/Financial-and-economic-affairs

Among the thinkers of the period a growing number dispute the bias of mercantilism; more and more of them take the stand to develop agriculture. A new trend is being formed in the dispute: this ideology considers agriculture the determinative sector. Not only because the products ensure the satisfaction of basic human needs: foodstuffs, but also because of that basic thought that is seemingly rational and plausible – but one-sided – that in agriculture (but only there, according to them!), nature also helps man's productive work. Economic processes are also dominated by strong correlations and natural law type effects. This is where the name of this trend comes from: the rule of nature, nature-rule, physio-cracy, that is: **physiocratism**. We are in 18th century France, this is the age of Louis XV. The leading proponent of the trend is one of the monarch's physicians: François Quesnay.

7. Quesnay: http://www.britannica.com/EBchecked/topic/487095/Francois-Quesnay

Creating models and macro correlations

Quesnay was a conscientious doctor – he followed up on the new revelations of his profession; so he was also aware of the precept of blood circulation. When he was thinking about economics he did not renounce his profession as a doctor: he imagined the processes taking place in economics on the analogy of the circulation of the blood. As flowing blood connects the vital inner organs, the flow of money and products create a connection among the great sectors of the economy in the same way. Thus a cycle process takes place in the economy and as long as strong shocks (which may also be caused by the misguided measures of the monarch) do not offset it from its normal 'bed', this process is self-supporting – thus **the economy is capable of normal**

operation according to its own laws. In order to make it more graphic **Quesnay** also **constructed a plate** with simple fictitious figures to convey the comprehensive economic processes of the contemporary French economy. (1758: Economic chart) The analysis of this chart, the enumeration of its virtues and defects would lead far. But it is not our task here. However, we have to stress its significance in the history of science: this is the first **macro model!**

And now we shall push a switch on our time machine: let us jump forward! The economists of later ages also conducted macro analyses, creating their own models. So did **Marx** in the 19th century, who **started with the two-sector model** when examining overall processes. A macro analysis (although it was not so named at the time) can only be carried out if we bracket and group the many operators of a national economy (using terminology, we perform aggregation) and with this we simplify the multifactorial economic system which looks uninterpretably complex at first sight into the clear combination of a few operators (sectors.) **Marx says that the angle of aggregation is the nature of the product:** if the manufactured product is a tool of production used in further economic processes, he classified in sector I. of production. However, if the output has the nature of consumer goods, he classified the productive unit in sector II. So **in his model, he distinguished the manufacture of the means of production and consumer goods.** Marx shows with simple logical deduction, with formulas created by himself: in order to maintain economic balance, what kind of value creating proportions must be realized in the production of the two sectors.

In the 20th century, Russian born American economist, Wassily Leontief reached back to Quesnay's train of thought.

8. Leontief: http://www.econlib.org/library/Enc/bios/Leontief.html

He also carried out the analysis of macro processes, but not with illustrations, not with a simplified schema. He used a special table fillable with real figures. Its name is **Symmetric input-output table.** In this **table he indicates the data of the output and input of all the productive sectors.** Thus, the total output value of every sector will appear in two ways: as the value of the available product set and as the sum of the input used in production. (As if we visualized the total sum of the production of a pastry shop on one hand as the daily proceeds from the delicacies sold on that day, and on the other hand as the amount of all the input of the production used [flour, sugar, margarine, ... the wear and tear on the ice-cream machine and the oven, the daily wages of the people working there, the profit of the confectioner.] This **table is** the visualisation of **the so-called input-output analysis** – it can be used for

several reasons: for comprehensive production-structure analysis, for grounding the creation of prognoses and production plans.

Nowadays, every secondary economics student learns about the macroeconomic circular income flow graph – essentially, it is also a modernised version of Quesnay's graph.

A man revered by everyone: Adam Smith

Few have the honour to have their names sincerely revered in their own time as well as for posterity; **Smith** is one of the few. Again, we are in the 18th century, but over the English Channel: in Scotland. We are talking about the earlier mentioned head of department at the University of Glasgow. Smith was beloved by his students, just as surely he was beloved by his subsequent private student, and for him he gave up his job at the university: he became the private tutor of the little prince. He also accompanied him on his French study trip; on this trip he met Quesnay, and there he started writing the book which entered public consciousness as the first real basic work on theoretical economics. This book was *'The Wealth of Nations'* published in 1776. This book, while listing the main factors of the enrichment of a nation (in modern parlance we would say, those of economic growth), highlights one thought: **economic activity is based on a strong motive, the driving force of self-interest**. The sentence we quote has become famous: "It is not from the benevolence of the butcher, the brewer, or the baker that we expect our dinner, but from their regard to their own interest. We address ourselves, not to their humanity, but to their self-love." In order for this driving force to expand, the realization of the society of free enterprise must happen. We should not be afraid that following self-interest will bring anarchy forth: **things will get organised, while each forges his own interest and success, commonweal will be realized, the nation as a whole will grow and become stronger.** As if an invisible hand organised things behind people's back, while in reality this is the organising force of the free market mechanism.

9. Smith: http://www.britannica.com/EBchecked/topic/549630/Adam-Smith

Classics and neo-classics

At the turn of the 1700/1800's, many people embraced this optimism. They are the great men of their age (they are real economists!): **Ricardo, Malthus, Say** and their fellows, the **classic economists.** They consider the free-market economy beneficial or even if they see problems, they believe to see the compensative mechanisms as well. Basically this optimistic mood characterised the neoclassical

economists who appeared in the last third of the 19th century (their forerunner who worked in the middle of the century was Gossen, who was unfairly overlooked at the time.)

10. Ricardo: http://www.britannica.com/EBchecked/topic/502193/David-Ricardo
11. Malthus: http://www.britannica.com/EBchecked/topic/360609/Thomas-Robert-Malthus
12. Say: http://www.britannica.com/EBchecked/topic/526095/J-B-Say

But before we go on with the presentation of the activities of the neoclassic, let us stop for a moment! Previously we mentioned Ricardo and Malthus as classics. They were contemporaries in England, acquaintances, friends, but also fierce debating partners. They were very different from each other considering their provenance and mentality. Ricardo was the son of a stockbroker, and he was disinherited by his family because they did not like his bride. However, out of a few hundred pounds he amassed an enormous fortune at the stock market. Malthus was the son of a landlord but he was not the first-born, so he did not inherit. He needed a profession that ensured a livelihood – he studied to become an Anglican priest. **Ricardo is the ambitious, bold, fortune collecting bourgeois, while Malthus is an aristocrat.** This also left its mark on their bonding, commitments and views. And of course it inspired their debates: Ricardo for example wanted to have the grain duties abolished. Let the cheap grain flow into the island nation, so food will be cheaper and the wages paid by the capitalists may be lower, consequently the benefit rate (expertly: profit rate) of the capitalists will increase. It is not by chance that they call **Ricardo an English classical bourgeois economist!** Malthus – in contrast – argued in favour of the grain duties. In the island country they should produce the necessary quantity of grain. It is true that it means that poorer quality land must also be brought under cultivation which increases the costs of production, but it also increases the ground rent that the landlords can pocket! Thus, from a different point of view, explaining through different interests, the interpretation of the same phenomenon and the formulation of the conclusions can also be different.

Ricardo created several theories that still have their effect. Among these, one of the most famous theories is the **theory of comparative expenses.** He explained foreign trade with it, proving that not only countries at approximately the same level of development can trade with each other in a mutually beneficial way. Exchange can possibly be useful for both parties even if a developed country exchanges goods with a country which is less developed comparatively in every aspect. The less

developed country is in a more disadvantaged situation in terms of the production of any product. Efforts should be made for this country to specialise in products where its disadvantage is relatively the least. The developed country should choose the product to specialise in where its advantage is the highest.

Malthus was primarily concerned with the **questions of population**. He believed that the population is growing with explosive speed and that food production cannot keep up with it. With his own words: 'The natural inequality between the two forces of population growth and production causes the great difficulty which I think is insurmountable through the perfection of society.' (This quote from Malthus can be found in the book entitled 'Great economists from Antiquity to the present day' „Nagy közgazdászok az ókortól napjainkig" Kossuth Kiadó, Bp., 1997., p. 34.) In this 'view' epidemics and wars almost seem beneficial since they help restore the disrupted harmony of population and production. Malthus was often criticised by many for his theory. He was reproached that he did not take technical progress into consideration. It is true that many things were omitted from his formula and in later editions of his book he refined his statements, he softened striking wordings. Despite this, again and again, the Malthusian doctrine has been used and nowadays it actually seems as it was living its Renaissance. The population of humankind is rushing towards 7 billion and according to environment researchers; we are already more than what the planet can bear in a sustainable way in the long term. Our combined ecological footprint already exceeds the biologically active surface of Earth!

The theoretical work of Malthus was not constrained by far to the development of the population principle. He treated several problems of economic life, among others the **market problem** as well. He thought that even the capitalists and the workers together will not be able to purchase the dynamically growing mass of products. The only reason why confusion does not arise is the intervention of a third party: the aristocracy. They are wealthy; they spend money thus creating a market. Remember this theory of the third party! A century later, a famous author will talk about this again, but of course the third party will be someone else… But let us not rush forward now. Let us stay in the 19th century but jump to the end of it: this is really the time of the neoclassical economists.

The **neoclassics** (Walras, Menger, Jevons and many more, but the leading figure is Marshall) brought several new ideas into economic theory. Most of them are methodological in nature.

13. Marshall: http://www.policonomics.com/lp-neoclassical-economics-alfred-marshall/

    Their method is the marginal analysis: it is the examination of what happens when we change consumption or production by a single unit – what will be the consequences of this? They introduced the research method in which **we only change one factor always**, and examine what the consequence is; assuming that the other factors remain unchanged ('ceteris paribus' principle.) And **they were the first to extensively use the mathematical apparatus to illustrate economic context.** Basically, they studied the behavioural regularities of individual economic agents, so we can say that they emphasised microeconomic analysis. With their new methods the neoclassic represent a basically well-functioning economic world; minor imbalances and temporary disturbances may occur – but they come right soon. They say that there cannot be major issues because Say's law prevails. Remember that the French economist of the turn of the 18^{th}/19^{th} century, **Say stated that** the there cannot be a general overproduction crisis in a capitalist economy. It cannot occur because through growing production, more and more income flows out. The owners of this income will spend it practically immediately. The growing mass of products meets solvent demand: the products are purchased. Thus **growing production creates its own market!**

Say's law can be disproved theoretically and life overrode it cruelly with the lingering and further deepening crises. It became utterly untenable after the global economic crisis of 1929/33. The theoretical fault in the law and the striking severity of the socio-economic effects of the Great Depression led Keynes to create his great work, *The General Theory (The General Theory of Employment, Interest and Money* – 1936.)

2.2.4 Micro- and macroeconomics

Keynes (English economist) was Marshall's disciple. They argued a lot in Marshall's flat, drinking tea in front of the fireplace. Later he turned sharply against his teacher's views.

14. Keynes: http://www.britannica.com/EBchecked/topic/315921/John-Maynard-Keynes

Keynes did not accept Say's law. He could see that those with an income do not only spend money – but they also create savings (they

have several reasons for this.) Of course this in itself would not necessarily cause problems of realisation (sales of goods) because the savings could finance investments and it would contribute to the expansion of demand. However, this is often not the case, because the pessimism of the investors discourages investment demand. Investments only grow dynamically if the vision of the future is positive. However, this positive vision is often missing. If the economic actors curb their spending for whatever reason, it starts a downward spiral in the economy. ('If anyone cuts back on expenses, let it be an individual, a municipality or a government agency, the following day someone will wake up and realise that he has been deprived of something, and this is not the end of the story. The person who wakes up in the knowledge that his income has been reduced or that he has been made redundant… will be forced to keep his expenses down whether he wants it or not… if the rot starts, it is very difficult to stop' – wrote Keynes.) This process of decay can only be reversed by a third player (I mean a third player other than the capitalists and the employees.) This player is none other than the state. With conscious spending, the artificial creation of demand and its economic policy supported by the central bank's interest policy, it is the task of the government to invigorate the economy, thus facilitating the increase in employment. **According to Keynes modern economy cannot be left alone. Properly targeted government interventions are necessary.** However, this must be based on macroeconomic analyses and must be executed through the formulation and implementation of economic policy that is adequate for the situation.

We have talked a lot about micro- and macroeconomics so far. Here we are talking about the separation and differentiation of the two main branches of theoretical economics. The previous references and the interpretation of the names also suggest the difference in approach. **Microeconomics views the economy at the level of individual economic agents. This approach tries to uncover the specificalities of conduct of economic agents.** What are their motives and what goals do they try to achieve? How do they react to the effects of the market environment? How do they react to the decisions and activities of other economic agents? What strategies do they create? What do they do to strengthen their positions? Microeconomics looks for the answer for these and similar questions.

The macro approach examines the national economy as a whole; it analyses how the actions of individual economic agents come together into overall processes. It examines several phenomena that cannot be interpreted at the micro level. Such an economic phenomenon is inflation for example. After all, we are talking about the

changes, the continual growth, of the average price in the national economy - this can only be interpreted in terms of its effects on the micro level. The phenomenon of unemployment is also such a problem. It does not matter if we know that an observed company has increased, kept it at the same level, or decreased employment. The question is in what kind of processes do the decisions of actual employment economic agents sum up on the national level. **It is the task of macroeconomics to analyse what kind of shifts are caused by government decisions on the processes of the total national economy** – through the reactions induced on the side of economic agents. It is this latter study that gives the theoretical basis of economic policy. Thus, the concept of economic policy is strongly tied to macroeconomics. **Economic policy is the sum of the principles, decisions and interventions of the government and the central economic management bodies (as well as the individual political parties) that pertain to the objectives of the development of the economy, and to the designation of the tools used in the achievement of said objectives.** Economic policy thus designates the objectives of the development of economy and their tools – and in the case of actors in positions of power – also implements these decisions. Everybody can have their notions and rating opinion concerning economic policy. Every group (political party) with serious ambitions of earning power has an economic policy concept. But only the government forces in power have real economic policies implemented in everyday practice. Economic policy coordinates ambitions of power, social expectations, group and individual interests and creates a connection between them. It is a very complicated web which forms and pushes economic processes in a specific direction through a series of decisions steered by the interests of power and is constrained by economic reality. It must be realistically well-founded and it must take economic context into consideration, but it is not purely an economic phenomenon. It is also a category of power, politics and society. The formulation of economic policy must be based on scientific foundations, but it does not only measure economic requirements and effects. This is often expressed in a way that the formation of economic policy is not only a professional economic task, but also an art! (Based on a good dose of intuition.) [In the further parts of this material we will talk a lot about economic policy.]

It was Keynes who suggested the thematic separation of economics into micro and macro economics. He also stressed the importance of economic policy, pointing out that in a modern, mixed economy the government with its regulatory interventions consciously forms the medium in which the economic agents make their decisions.

Thus, the state indirectly influences the development of macroeconomic processes. One of the decisive measures for the efficiency of the performance of the government is whether the macroeconomic indicators change in a positive way. Do the overall economic performance and its competitiveness improve by international standards? With its conscious interventions is the government capable of remedying the problems of the modern economy? According to the unanimous opinion of experts, modern economies are affected by seven ailments. These are: inflation, unemployment, the deficit, the excessive growth of foreign debt, the disturbance of economic growth, harmful inequality and bureaucratisation. The famous contemporary Hungarian economist, János Kornai writes concerning these: '…there is no perfectly healthy socio-economic order. However, you can choose your ailment! Let us rejoice, if we can create a social order that is only tormented by two or three of the above mentioned ailments. In the worst cases four or five of them may torture us at the same time.' (Kornai, 2005; p. 391.) Economic policy has recipes for the treatment of certain economic issues. (It was Keynes who elaborated a significant part of the intervention proposals.) However, the problem is these treatments work in a similar way to real medicine: the 'medicine' does not treat every problem; they only give a solution for one or another problem. Furthermore: economic interventions also have side effects. Some of these are known, but other side effects occur unexpectedly – the reactions of the economic agents cannot always be precisely foreseen after the introduction of an economic measure. The measure taken to mitigate inflation will contain economic growth and – indirectly – it will intensify the difficulties of employment. The intervention stimulating growth will often push the state budget into a deficit. Declining interest rates may strengthen the momentum of the economy but at the same time they may induce inflation… Thus, it is rather difficult to develop an economic policy which is successful from every aspect – this can only happen rarely, in the case of an extremely fortunate combination of consequences!

- It should be noted that apart from the above mentioned **micro and macroeconomics, theoretical economics** contain further, individual disciplines. One such discipline is **history of economic thought** which studies the development of economic thought (above we got a little taste). Today, **international economics** is an independent science which examines the international interconnection of economic processes, global economic developments and the reactions of national economics to external environmental effects. A number of analyses examine the operation of different economic systems, their similar and

markedly different traits. Historically vanishing economic systems are compared with those of the present day (see for example János Kormai's analyses of the socialist economic system.) Also, the comparison of present day economic systems living side by side provides interesting lessons. American capitalism does not exactly work like capitalism in Western Europe. The emerging economies of Central and Eastern Europe show a series of unique traits. Also, the Swedish solution is special as is the British economic model. These exciting analyses are performed by **comparative economics.**

In addition, there also exists another large group of economic sciences. The disciplines that examine the solutions to the questions of daily management issues are called **applied economics.**

Let us return to the theoretical economic sciences. The 19th century witnessed an ongoing methodological dispute. This methodological question also affected the basic task of economic science. Namely, it was about to what extent it is permissible and appropriate for economic analysis to apply the construction of abstract schemas in the solution of its research task. In plain English, when for example they examine the operation of private economy based on free enterprise, how should they do it? With the meticulous analysis of the economic history of the 19th century British free-market economy, or with the creation and examination of the perfect competition model? Is it right that the researchers strive to establish relationships and general principles by creating theoretical models? Is the task their research or the analysis of factual situations in economic history? Towards the middle of the century this debate was sharpening, so much so that a substantial stream totally turned away from the theory creating, abstract analysis, and made it its exclusive principle to work on the detailed description of economic history. This was the German historical school (its leading figure was Wilhelm Rosher, who had a great effect on the mentality of several Hungarian economic professionals and scientists who studied at German universities.) This debate flared up again at the turn of the 19th/20th century and the Hungarian Farkas Heller clearly argued for economic research using abstract methods and creating a comprehensive theory as its objective. It is now clearly recognised that economic science reveals objective, long-term relationships, but these relationships prevail statistically (as the average of numerous specific cases.) Abstract models help in the exploration of economic correlations. Mostly, the revealed correlations can be mathematically formalised and they can be displayed

with such tools. The reality of the correlations can be justified based on economic databases and with mathematical-statistical methods. With this, economics took its rightful place in the system of modern sciences. However, an important momentum cannot be forgotten: the relationships and bonding formed among economic events, economic phenomena, people and groups of people. They are also connected to human intentions, but not only rational considerations, but also taste and individual decisions. Several consequences stem from these. One of them is the close relationship that economics has with sciences studying human behaviour (psychology, ethics – for this latter relationship the references of theoretical history offered examples.) The other consequence is in turn the fact that economics will never be completely exact. No, it will not be exact because it is human – and man is a complicated but at the same time, a wonderful being!

2.2.5 The different styles of economic approach

What is the task of economics? The presentation of the operation of economic systems? Drawing a comprehensive but at the same time detailed image of the operation; thus, demonstrating what is experienced in the economy here and now? The analysis of the specificities of operation? Creating such an image is a serious scientific accomplishment. This type of scientific interpretation of tasks is the **positivist approach: the presentation of the factually observable operation.**

Could there be a different task for scientific research? Yes! We can also examine how we could modify operation. **How could we achieve changes in the social consequences of economic operation? Could we approach objectives developed along social interests? If the researcher regards the latter as his task, we are talking about the normative approach.**

In summary, the description of the operation of an economic system means the validation of the positivist approach in economic research. The declaration of economic development goals and the research of the system of tools designed to achieve the goals mean a normative approach.

The individual researchers occupy different positions in the aforementioned approaches. However, we can say that the modern trends (especially the ones inspire by Keynes) are normative. It is their declared intention to provide theoretical foundations to the economic interventions of the government. Sometimes an economic researcher changes his approach during his lifetime. We can mention the Hungarian János Kornai as an example. He was the positivist analyst of the socialist

economic system for decades. Since the publication of his first famous work (The over centralisation of economic management – 'A gazdasági vezetés túlzott központosítása' – 1956; his main work, which deepened this same analysis: The deficit – 'A hiány' – 1980.) he researched the operation of the system, its basic characteristics and the causes of its bureaucracy. He declared that he did not give recipes and did not offer suggestions for economic policy. It was his aim to reveal the operation and specifics of the system. After the occurrence of the regime change, however, he changed his approach. He felt that it was the time to formulate recommendations and economic tips. He published these recommendations in his short, but the more famous book (Angry pamphlet in the matter of economic transition – 'Indulatos röpirat a gazdasági átmenet ügyében' – 1989.)

Beginning in the 60's and 70's of the 20th century an entirely new economic trend started unravelling. This economic trend, called alternative by many, proceeds from the fact that the then conditions of human existence were undergoing radical transformations. This is a negative turn; a triple crisis plagues mankind. What are these tensions? 1. Man rebels against oppressive power structures. 2. Nature rebels against its despoilment and pollution. 3. There is a danger of the depletion of non-renewable resources. These three crisis symptoms indicate the threats to our existence. The criticism of alternative economists is serious: they are of the opinion that economic theory itself can also be blamed for this negative turn. They argue that economics so far has followed false principles. They believe that it is a serious mistake to target the increase of material production at all costs. However, this is what the prevailing economic views see as the main objective of the operation of economic systems. This targeting includes a logical error. It encourages infinite growth in a finite world. This leads to catastrophe! They contrast the cowboy approach with the thinking of an astronaut. The cowboy roams the endless prairie; he does not perceive barriers. However, the astronaut knows all too well: the key to his survival is the sparing management concerning living conditions, the recycling approach instead of the disposable approach. Earth is an enormous spaceship. If we do not embrace the astronaut mindset, we will deplete our living conditions. What follows from all this? A radically different approach, a new mentality! The limitation of unnecessary and exaggerated desires; production by the masses instead of mass production; harmonious coexistence with nature.

The advocates of **alternative economics** contrast the fundamental with the traditional methods. They emphasise that economic analyses do not only have to examine the activities in business organisations; they

have to review management in full and the economic activities of the households have to be taken into account as well (at least by estimation.) **Growth cannot be the target at all costs** – they say. **Environmental awareness, management based on recycling is their guiding principle. Furthermore: human scale!** People only feel at ease in an organisation where everybody is familiar. The gigantic organisations where the individual has no chance to understand processes or to get acquainted with the leaders are alienating. And also, it is only possible to live in human-scale houses. Based on all these, alternative economists inscribe two words on their flag, ecologisation and humanisation.

Man is a small-scale being, but at the same time the most wonderful creature in the world. The title of the monograph *Small Is Beautiful,* written by their leading representative, Ernst Schumacher refers to this. The book is also available in Hungarian translation.

Alternative economists also introduced methodological innovations: we have to break with tradition – they claim – daring completely new solutions to be constructed. This is the **constructivist method**.

The above issues are addressed in ecological economics and environmental economics.

The alternative approach has had a powerful impact on conventional economics. Today the principle of sustainability (which means that the satisfaction of needs in the present should happen in a way that it does not compromise the satisfaction of the needs of future generations) is generally accepted; it is a requirement voiced by traditional economics as well.

Currently, a growing branch of alternative economics is Buddhist economics. This is an economic philosophy in which the sober self-control of desires and needs, respect for life and the principles of not harming others and ourselves are extended to the world of economy as well.

The principles of alternative economics play a major role in that today education marks the development of environmentally conscious attitudes and the shaping of the lives of youngsters along the principles of environmental awareness as fundamental tasks. And the corporate sector develops a business behaviour which goes beyond mere compliance with the law; they take responsibility for their employees and partners – with environmentally friendly products, by participating in voluntary actions, by improving the employees' sense of comfort; they consciously try to move towards human-scale humanisation. This is the content of corporate social responsibility (CSR is a well-known abbreviation.)

Economics is a modern science; it is open to innovative approaches and it is able to reinvent itself. Economic researchers and business professionals have a huge responsibility: they have to establish a correct diagnosis of the operation of the economy and they have to suggest a suitable therapy. But also the individual has great responsibility: the protection of our environment and the shaping of our own life chances also depend on everyone's right or incorrect analysis of situations and decisions. This subject intends to offer help for all this.

2.3 SUMMARY, QUESTIONS

2.3.1 Summary

In this lesson we learnt about the history of the development of economics. In this context we entered into the scientific medium in which the knowledge acquired during our further studies can be placed in a consistent system. In relation to the above, we also clarified the purpose of the expansion of our economic knowledge.

2.3.2 Self-check questions

- What is the content of basic economic knowledge?
- Which one was the first economic macro model? Whose model is mentioned in this material from the 19th century?
- What is the symmetric input-output table? Who created it? What can we use it for?
- What is the difference in approach between micro and macroeconomics?
- Why do the advocates of alternative economics confront the proponents of traditional views?

2.3.3 Practice tests

- What is the essence of basic economic literacy?
  - ability to analyse the consequences of the decisions of individuals and groups
  - management of finances
  - knowledge of the biographies of great economists
  - knowledge of savings opportunities

- When did economics become an independent science?
  - Antiquity

- the Middle Ages
- parallel to the development of capitalism
- the 20th century

? Which book is considered the first scientific economic work?

- Thomas Aquinas: Summa Teologicae
- F. Quesnay: Economic Table (1758.)
- A. Smith: The Wealth of Nations (1776.)
- Keynes: The General Theory of Employment, Interest and Money (1936.)

? What does the abbreviation SIOT stand for?

- Symmetric International Output Table
- Symmetric Input-Output Trade
- Symmetric Input-Output Table
- Symmetric Interest Output Table

? What are the main objectives to be pursued according to the alternative economic trend?

- the constant increase of the production of material goods
- ecologisation and humanisation
- active foreign trade balance
- the constant expansion of services

3. LESSON: THE BASIC CONCEPTS OF ECONOMICS

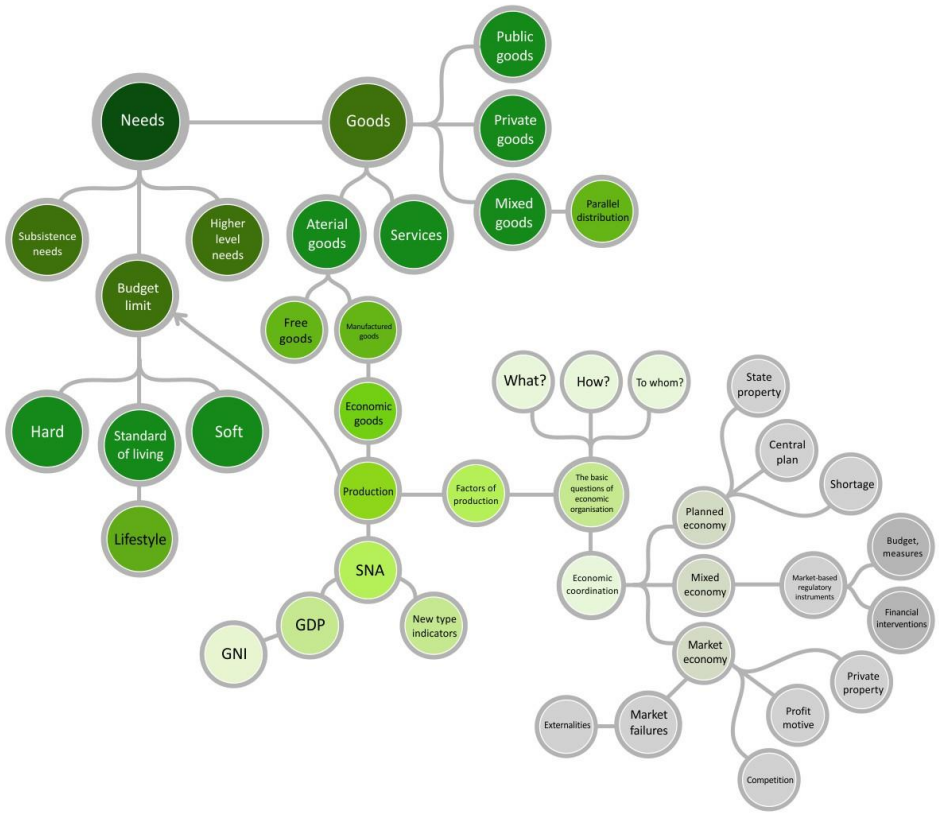
3.1 OBJECTIVES AND COMPETENCES

In the introductory chapter we clarified that management pressure leads to the development of economics. We have to manage it because scarcity is ever present: neither the goods we want to acquire nor the factors necessary for their production are available in unlimited quantities.

In the following we will discuss the basic concepts of economics. We will determine more precisely what the needs are: how we can aggregate them. In which groups can the tools (the different commodities) of the satisfaction of needs be classified? What is production, and which factors help them?

We will formulate the basic questions of economics: and present the basic types of economic systems. We shall also touch upon the question: how can we form an image of the total output of a national economy?

3.2 CURRICULUM



Graph 3: Mind map

3.2.1 The needs and the possibilities of their satisfaction

Needs are man's different claims waiting to be satisfied.[4] These are defined by several factors. Claims are influenced by objective circumstances, for example the climate of one's habitation. Individual desires, and also taste, have of course a great role. While this latter factor appears at first to have a decisive role, it is reasonable to say that needs are socially determined. What we desire, or what we want to obtain, depends strongly on the habits and patterns experienced in our

[4] The above definition treats the terms demand and lack as synonyms. In some literature, the term demand is used with a tighter content: they only consider those needs as demand, whose satisfaction has been decided upon and where the conditions are given to meet it (for example, the correct amount of disposable income.)

environment, as well as on the development of the society and on the opportunities specified by the income status of the family. Needs are constantly renewed. Thus, we have to adjust continuously for the satisfaction of claims.

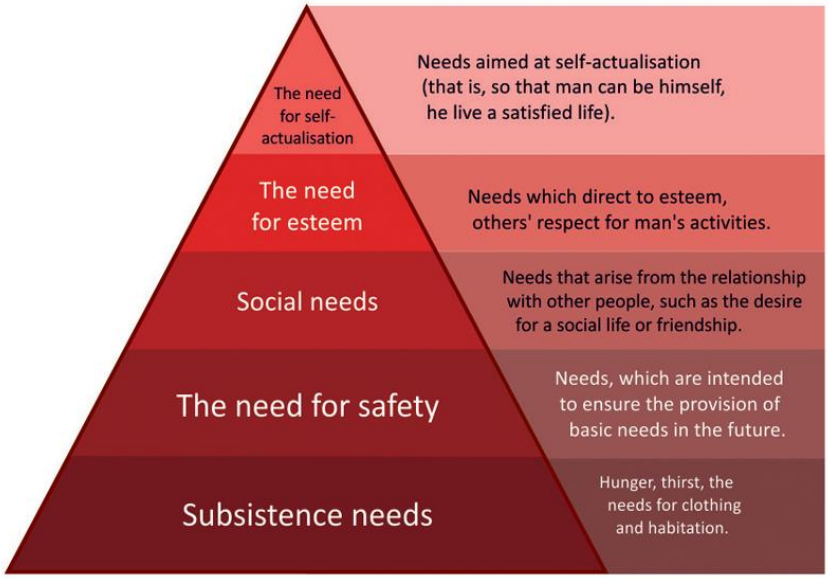
Needs are varied: they can be classified in groups based on different criteria. According to the nature of the needs, we can talk about subsistence needs and higher level needs. The satisfaction of subsistence needs is the condition of the biological existence of man. To maintain our existence we need fresh air, potable water, food, clothing, habitation. In addition to the basic needs people have intellectual, aesthetic and moral needs as well: for example we want to have fun with our friends, we will gladly read a good book; we go to the theatre and to the museum. The latter belong to the group of higher level needs.

According to the preceding, our claims can be organised into a kind of pyramid. This is the Maslow pyramid, named after its creator. First of all, we need to ensure the satisfaction of our subsistence needs, since they are the most basic. This is followed by the need for safety.

Without social relationships our human existence is unthinkable. We require being together with our relatives, friends and other people, and also that they listen to us, recognise and appreciate our deeds, successes, jokes and wittiness.

We also have a need for the self-actualisation of our personality, to realise our talents, to achieve our goals.

Have a look at the model below. The above listed need categories are graphically illustrated by the pyramid.



Graph 4: Planes of needs

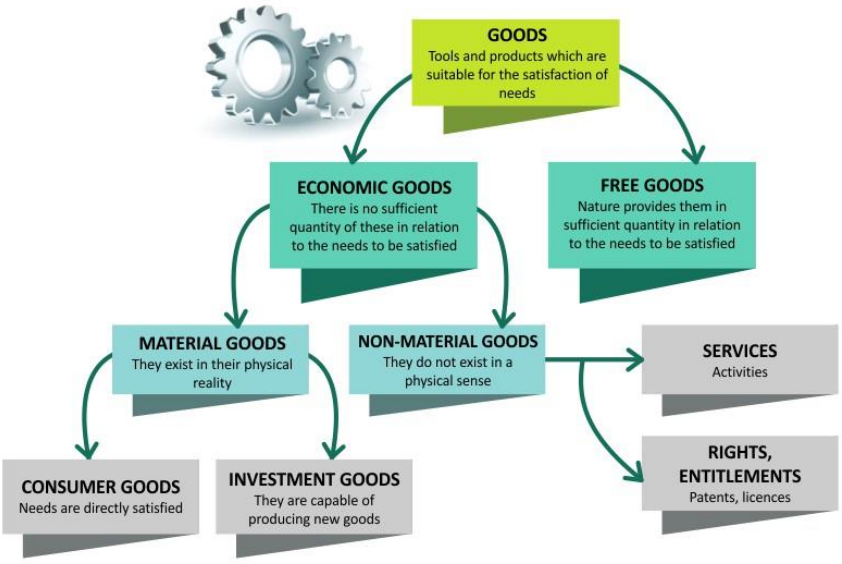
Source: based on Rolf Dubs1993.p. 9.

Needs can also be categorised in terms of the method of satisfaction. To satisfy certain needs, we need object, material goods. In other cases we require that some people deal with us and help us solve our problems directly (for example in case of a toothache we will see a dentist who will treat us properly; at school the complicated mathematical correlations become understandable for the student through the teacher's explanation.) In the above cases the needs are satisfied through the use of services.

Thus, to meet our needs we have to have all kinds of useful things and well-intentioned activities, in other words: we use commodities. The commodities do not only make direct, personal consumption possible, but also help the satisfaction of needs indirectly, through helping the production of new commodities.

Some of the commodities are provided by nature in sufficient amounts (air, sunlight, forest fruits – we only have to take them, or use them.) Other goods however, are scarce compared to the needs. Their propagation, (increasing their quantity) is only possible if to this end, we use our own strength, time, different materials and tools, that is, we produce them.

The below graph (with suitable explanations) summarises the types of commodities.



Graph 5: Types of goods

Source: based on Rolf 1993. p. 12.

The possibilities for the satisfaction of needs are different. With the development of production more and more needs can be satisfied in various social dimensions. We can also word this in the following way: through the development of production, consumer options widen. However, even within a given society, the ability for the satisfaction of needs (consumer options) varies according to the differing layers of society. The differences primarily come from their different income situations. A family with a low income will have a scarcer consumption and they will be less able to augment their wealth or intellectual capital. Thus, their possibility to break out from the low income cycle is also weak. That is exactly the problem: poverty breeds poverty; this is a recurrent cycle. It is be the task of modern governments to dissolve this magic circle through various effective social programs and interventions – however, in reality, very few governments have succeeded in doing do.

The possibility of the satisfaction of needs, the consumption, depends on current disposable income. It is easy to understand that this is a combination of two items: on the one hand on the accumulated

cash reserve and on the other hand on the recently earned income. **If the family** in question **cannot spend more than this in any way, the income limit**[5] **is considered hard. If** this limit may be exceeded, so it **is possible to overspend, we are talking about the softening of the income limit.** But why does it soften? Because somebody exempts us from the consequences caused by overspending (for example well-off parents help a young couple cope with their financial issues, or that certain American uncle exists…)

The standard of living of a family is decisively determined by their income situation. We often hear the concept 'standard of living', but in everyday speech it is often mistaken for lifestyle. Yet the two concepts do not necessarily mean the same thing.

Standard of living is the financial coverage level, which refers to a given society, one of its layers, or an observed family. The concept of lifestyle however reflects the way people live. On roughly the same level of financial coverage it is possible to realise different lifestyles, to live according to differing habits and patterns. Thus, lifestyle is not only a question of finances; it is also a question of refinement, intensity, habits, good or bad patterns.

3.2.2 The factors of production, limit of production opportunities

Now let us have a look at the problem of the satisfaction of needs on a national level. In order to satisfy the needs of the population, material goods must be produced and services must be provided. But naturally, productive and service activities must be carried out to maintain and expand production.

- **Production therefore is an activity aimed at the satisfaction of human needs in the course of which material goods are produced and services are performed.**[6]

[5] Since the disposable income determines the spending possibilities and the predictable expenses of the household (or company, institution, etc.), economists call this financial limit the budget constraint.

[6] In the economic sciences the concept of production is often interpreted in a narrow meaning as material production. In this sense, production is such a series of activities in which man appropriates the objects of nature, transforms them with his work thereby making it suitable to meet human needs. The final result of the production process either serves human consumption specifically, or forms part of a new production process either as the subject of the work or as a working tool. The production process involves all the activity which serves to make the product consumable or usable and that the product can reach the place of consumption or use.

A country can do a lot to expand the capacity and conditions of production. It can build power plants and factories; it can change outdated production lines to more modern and powerful ones. But at any given time, it can only operate and use what it has.

In economics, the elements that can be used and operated for the sake of production are called *factors of production.* They include the following:

1. the **natural resources** of the country (farmland, mineral deposits, forests, thermal waters that can be used for touristic purposes, landscapes, etc.),
2. available **labour force** – distributed according to defined professions
3. machinery, equipment and facilities, with economic terminology: **capital goods**
4. those people with ideas and innovative intentions who handle the organisation and management of production, they are the **entrepreneurs**.

In successive years, the factors of production can be expanded and enriched. New mines can be opened, more and more young people can be taught foreign languages or computer technology, entrepreneurial willingness and skills can also be enriched. However, at a given time, the factors of production can be accurately assessed and are available in a limited amount for the national economy. These factors limit the opportunities. (Today, Hungary cannot create conditions, circumstances and material prosperity for its citizens similar to those of Switzerland because our economy is not that developed; in our country, the quantity and quality of production factors are more limited.) It also matters how we appropriate the production factors. We may increase mining, we may force the construction of large dams, and power plants, but then other activities (such as car manufacturing, growing fruits or even education) will get less strength, material and intellectual energy. The problem is similar on the family and the national level. Since these possibilities are limited, we have to decide how to use our facilities. In economic language we say: **the possibilities, the available factors of production are scarce. We must constantly search for the best uses of our facilities and possibilities.** This is management.

In the Garden of Eden, the world of wonders, management is not necessary because under the circumstances of unlimited abundance all our wishes are fulfilled in the blink of an eye. But only there. In the real world – both on the level of the family and the nation – we have to size

up our options and we have to choose: how and for what do we use the time, money, energy and our talent. We must decide carefully, because the possibility we have already used (a tied up production factor) cannot be used for anything else in the short term. If you start planting fruit trees, tomorrow you cannot open a boutique! Either one or the other. If we buy a computer, we cannot go on holiday because we only had money for one of the two. If I have enrolled to an intensive English language course, I cannot go to an aerobics course because I have neither the time nor the money for both. The options must therefore be reasonably managed. Essentially, this is the most important message of economics.

3.2.3 Private goods and public goods in the economy

A significant percentage of the goods and services produced in the economy according to their nature cater for individual (personal) consumption. In a market economy, these goods can be acquired through purchase. We can enumerate a great many examples from our everyday life: car, flat, clothes, foodstuffs, hairdresser, etc. The characteristics of these **private goods** (with an economic term) can be summarised in the following way:

- they serve the satisfaction of personal needs;
- the consumer can be identified (he turns up personally in the shop, at the sales outlet, the service centre);
- the consumers compete with each other (because the supply of the goods and services is finite, the consumer who arrives late will be left out from consumption);
- the consumer can be made to pay the price or the fee directly;
- in the circumstances of a market economy, the supply of these goods and services is mostly provided by private producers (services.)

There are goods that behave in an entirely different way. As examples, let us consider the operation of a lighthouse, street lighting and the military. Economic literature calls these **public goods**. Their main characteristics are the following:

- their use is not personal, anyone can use them individually or as a group (but even in the case of individual use, they are not to be shared: I cannot take a part of street lighting home);
- the consumer cannot be identified (we have to consider the entire society as the consumer);

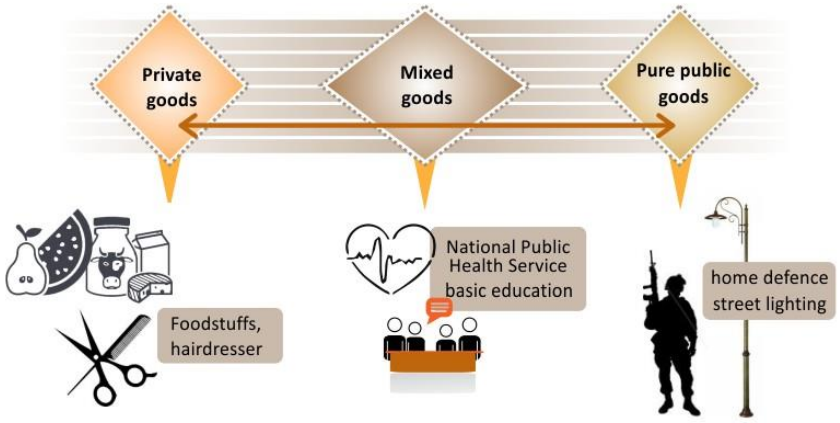
- the consumers (users) do not restrict each other, a larger number of consumers can enjoy the goods as well as a few people; nobody can be excluded from consumption;
- the consumers or users cannot be made to pay for the price or fee of these goods and services directly;
- private companies do not undertake to create these goods based on the initiatives of their self-interests; the state has to intervene so that these goods and services are established; the state has to solve the question of financing. Funding is done through the state budget, essentially from tax revenues. The state orders these services from private providers or from its own government institutions.

For the sake of accuracy, here we still have to make two additions. There are such provider systems that form a transition between the two groups of private and public goods. These are activities which can only be provided successfully through indivisible networks, but their use – at least occasionally – can also be possible in a split form. For example, let us consider the operation of the National Public Health and Medical Officer Service. It is a well-organised, standardised system with a national network. Its services are extremely important. We know specifically who used some of its services (for example, in which homes it carried out disinfection) but its operation cannot be imagined in a market system, in a profit oriented way. In these cases, we talk about **mixed goods.**

It is also possible that an important service is available as a public and as a private commodity. For example, if a company wants to guarantee its safety, it may be satisfied with the services of the police available to all, with regular security patrols. However, if the company desires a more customised security service, it must purchase it from a private company specialising in this service. In this latter case, it buys the security service as a private commodity. Using economic terminology, **parallel distribution** is realised because the same service (or at least similar) is already provided by a government institution, but it can also be purchased as a private commodity within the market system.

Examples can be cited from the area of education. Basic education (schooling for the years of compulsory education) in itself is a public good: serious societal interests suggest that basic education be available for everyone (that is why this segment of education is called public education.) However, this does not preclude the presence of parallel distribution. There are non-government schools with special services that must be paid for. In many cases children take additional private tuition – this method of parallel distribution exists not only now and in the recent

past in our educational system. However, this does not reduce the responsibility of the state: it must ensure the proper functioning and the quality of the public educational system.



Graph 6: Classification of goods

Source: based on Kádek et al. 1997. p. 18.

3.2.4 How much?

The performance of the national economy is a combination of the result of material production and all of the services rendered. It is obvious that the well-being of the population is based on economic performances. A higher standard of living cannot be sustained without permanently increasing economic performance. Temporarily, it is possible to live well using external sources, but it will later backlash as the debt burden becomes more and more depressing.

Economic clairvoyance, the enumeration of the results and problems, the establishment and development of economic policy corrections require that we have a realistic overview of the evolution of the overall performance of the national economy. In some way we have to form a picture of the magnitude and changes of the total product of the national economy.[7] In this, statistical methods and procedures help. The

[7] We have to apply data and properly designed indicators. These could be absolute or relative numbers. Absolute numbers are numbers per se which serve to demonstrate the actual size of a value (HUF, pc, metre.) However, they do not express anything concerning the meaning of the value (we do not know if the observed value is high or

difficulties of measuring the national economy are obvious. The overall performance of the national economy is embodied in several thousand types of products and services. They cannot be added up using their natural units. Aggregation is only possible using prices, with economic terminology: using value. However, this immediately raises a series of problems. After all, it is not clear what kind of prices we should use for the aggregation: using calculated prices or the real market prices? With the prices of which period? Other types of problems are also raised. How shall we treat free benefits and services (which have no price)? Shall we include the activities carried out by foreign-owned companies operating within the country? Shall we take into account the value of the activities carried out abroad by Hungarian citizens? These questions only represent a brief illustration of the multitude of accounting problems. In international statistical practice two accounting systems developed in the past decades to assess the performance of the national economy. From these, today the SNA (System of National Accounts) system is consistently used.

The most commonly used indicator of the **SNA system** is the **GDP**[8] (Gross Domestic Product.) Sometimes it is called added-value indicator. This statistical indicator **shows the total value of the products and services produced in the country in a given year without the value of the materials used.** In other words, it summarises the value that producers and service providers add to the value of the materials and parts used in their own activities (hence the second name of the indicator: added value.) This indicator is accurate enough and it gives an overview of the results of current economic activity in the country suitable for international comparison. This indicator can be interpreted in such a way that it shows the gross income generated in the country but not only by its own citizens. If we want to get a more accurate picture of the national income, two corrections must be carried out. We have to subtract the income generated in our country by foreign companies, joint ventures and foreign citizens. However, we should add to the value of the GDP the income generated abroad by Hungarian owned companies, subsidiaries and Hungarian citizens (Hungarian citizens residing abroad for a short period of time only.) The thus adjusted total income is the so-

low, and also: why is it that high or low?) Relative numbers are ratios formed by two absolute numbers. They express important correlations because they characterise the relationship of different things.

[8] GDP is the indicator most commonly used for the measuring of the total performance of the national economy. They use it as an absolute number (the value of GDP at current prices in a given year), and the so-called GDP index is calculated which compares the performance of the given year to that of an earlier period (usually the previous year.)

called gross national income marked as the **GNI**-indicator (Gross National Income).

Economists are aware that these indicators for the assessment of the performance of the national economy are far from accurate. They cannot accurately reflect the extent of production and service provider activities either (consider that the manufacturing and service work done in the household is left out from the assessment of the national economy, because these statistical indicators only aggregate the activities in business organisations.) They are even less suited for functioning as the indicators of well-being. For example, military production is also a result of the national economy; however, it increases the well-being of the population very little. Also, pollution and urban congestion do not belong to the welfare-enhancing factors either. These welfare-reducing factors are not reflected in these indicators. At the same time, however, the growing amount of free time made possible by more efficient production increases welfare, while this is not reflected in the numerical value of the indicators. The welfare indicator is yet to be constructed. A group of economists is experimenting with the creation of such an indicator. New types of indicators have been created (NEW – net economic welfare, ISEW – index of sustainable economic welfare, GPI – genuine progress indicator.) Many deal with the calculation of estimated data representing the actual development of welfare, but this issue has not yet been satisfactorily solved by economics.

3.2.5 Coordinating mechanism in the economy

Coordination in the economy

The economy is a complicated system. A lot of economic issues arise daily in a society or even in a community living in a smaller area (in a region, a settlement) or in an institution. They bring forth a plethora of economic decisions on different levels. It is an economic decision when Parliament votes on the state budget of the following year or when a higher education institution decides to reduce the number of teaching and support staff. But it is also an economic decision when I invest my quarter of a million forints I saved in buying treasury bills. Indeed! It is also an economic decision when I buy the cheaper bread in the corner shop. Although these randomly enumerated examples, economic decisions have been created completely independently from each other, there is still a connection. The current state and situation of the economy is reflected in the resolution of the Parliament. It is not far from the truth if we declare that the motives for this decision are the same – naturally at a different level and in a broader context – as the motives for buying the

cheaper bread. It is possible that the financial rigor of the parliamentary resolution compels the above mentioned higher education institution to economise, which is realised at that level in downsizing manpower (here we are not analysing the long-term effects and expediency of the decision.) The root of family savings and prudent financial provisioning can come from the fear that I may be the instructor who is made redundant. And if this actually happens, it does not only mean that education services will become narrower and less colourful – but on my own individual level – also that I cannot afford the more expensive bread for a while. Economic decisions are not only linked but they also have a mutual effect on each other: they amplify or buffer each others' effects; they move the national economic situation in several directions by linking together to form macro movements.

The intentions and aspirations expressed in economic decisions are thus linked and arranged together and finally they designate a definite direction for the development of the economy (this direction of course can be stagnation or even retrogression.) So somehow the interconnection and arrangement of the economic decisions, acts and transactions between economic operators is realised: this is coordination. The main function of this alignment is – as we have already said – that economic development takes a specified direction. It should be clear **what** the economy **will produce** in the current period (what products and services will make up the total output.) **How** will we create this output, with the mobilisation of which economic resources? And finally: **who will be able to acquire** and use the performance of the economy? Or more precisely: who, how and to what extent will share the created mass of material goods and services? The three previous questions (what, how, to whom) can be regarded as the basic problems of the organisation of economy. The method of answering them, of making decisions is considered as the coordinating mechanisms of the economy.

Several types of coordinating mechanisms have formed in history to solve the problems of economic organisation, to synchronise economic decisions and transactions. Below we will mention the two most important mechanisms.

Coordinating mechanisms: 1. PLANNED ECONOMY

One possible solution is when the state and its economic management institutions keep the economy under full control. They determine the nature of the economic system and the operation of its processes in detail. This – sometimes extremely centralised – bureaucratic coordinating mechanism was based on **state-owned material conditions of production**. It **played down** market type

relationships and **the economic organising role of money**. Profit-oriented private production was replaced by **state production** based on the central planning and regulation of economic processes. Looking back at the operation of the system, today we can clearly ascertain that the consistent system of bureaucratic coordination did not entail the socio-economic advantages associated with it. Viewing from the perspective of two decades after the regime change, the problems and self-contradiction of this coordinating mechanism are more and more clearly visible. One of its most problematic aspects is its antidemocratic nature: no state authority or organisation knows better what is good for the citizen than the citizens themselves: nobody else can make a statement about it. The state-organised total, societal assessment and representation of the needs is an untenable assumption.

The **elimination of private property** and making state property all-inclusive under the marker societal is problematic. Feelings of ownership cannot be simulated. If something belongs to everyone, it does not belong to anyone in fact. Individual responsibility which stems from private ownership was replaced with the collective irresponsibility of state ownership. The socialist era was characterised first by an artificially incited war psychosis and also by a compulsion to catch up with the capitalist economies. This caused a **forced strategy of economic development.** The real facilities were ignored and the economic policy that supported the heavy industries alongside with the economic structure that was unable to function resulted in an economy that suffered from constant **shortage situations.** In the so-called socialist economies – in a paradoxical way – exactly the scarcity and shortage situations lead to squandering and to damaging the state assets that nobody felt they owned. The economic management which aimed for forced economic growth postponed the development of human infrastructure and in many cases, culpably missed.

The operation of the economy was based on the **central plan** designed by planners. In it they identified the tasks of production in the coming period, calculated the necessary expenditures, and made decisions on the planned sales to other companies and also on the purchases from them.

They measured the results of the activities of the companies' managers on to what extent the company fulfilled the plan. They were rewarded if the plan was realised and an important decoration if they topped the planned task. However, if the company managed by them failed to achieve the planned performance, they could be dismissed. This system was designed to achieve the goals of the planners and the political leaders.

Bureaucratic coordination is rigid, **unable to adapt** fast and flexibly. It was unable to follow the rapid changes and transformations of the needs of the various groups of the population. This would have entailed the frequent revision of the finalised plans, the constant modifications of the planned figures and the instructions associated with them, which would have rendered the system dysfunctional.

The bureaucratic coordinating mechanism is not only a theoretical model: it was a system that operated for decades. It did not only shape the economic processes and the structure of the economy, but it also formed the behaviour of the economic actors and our way of thinking about the economy as well. Its impact –whether we want it or not – is still present in our minds in our everyday life today.

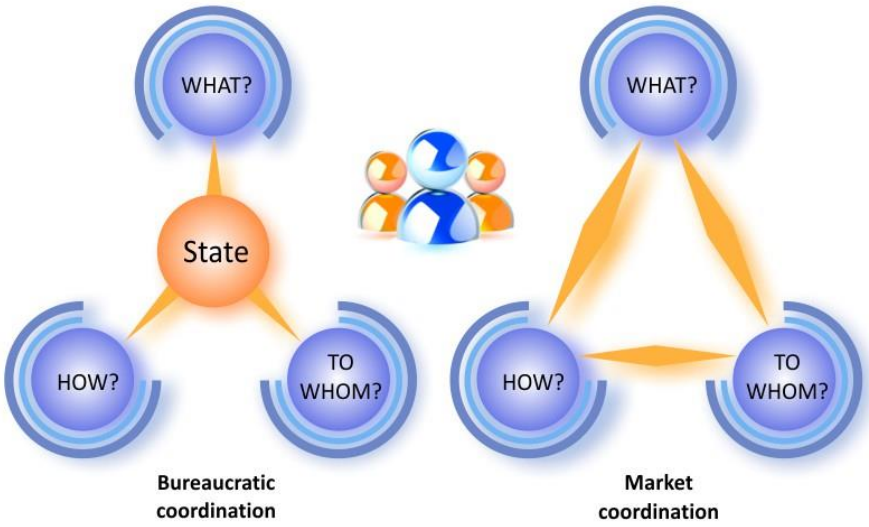
Coordinating mechanisms: 2. MARKET ECONOMY

Market coordination is a very tenacious and persistent coordinating mechanism that was created by historical development. This is **management based on private property** and the economic actors are fundamentally **profit-oriented.** Their relationship is mediated by cash **flow.** Everyone is independent: the economic decisions and actions of the economic subjects are either not restricted by government regulations, instructions and prohibitions or they are only minimally restricted by them. The economic **actors base their decisions on market information.** The producers make decisions on their output fundamentally based on **price signals**, but they also make decisions concerning the applicable technologies, the combination of available production resources. The sellers follow the needs of the customers, and they themselves generate customer needs as well. **Adaptation** on the market is **fast.**

There is **competition** among market players. This extorts efficient production because those who produce at a higher price or those who apply costly solutions will lose ground and will be forced out of the market: they will fail at the market. This may mean the liquidation of the enterprise and possibly personal losses to the entrepreneur.

Thus market coordination has several advantages. However, market coordination is not perfect either. The market distributes the goods according to solvency and not based on neediness or worthiness. In many cases it violates social justice. In a pure market economy nobody cares about those who are forced out of the market or those who cannot enter. One can be forced out of the market not only because of clumsy and bad decisions or choices! In the market, competition is not always fair; those in a dominant position will abuse their position. The automatisms of the market cannot solve all the problems. Environmental

pollution is typically such an impact which is unmanageable by the market. In economics this phenomenon is called external economic impact, or with our terminology (in this case) negative externality[9]. The market finds this unmanageable. Thus, pure market coordination can be associated with problems and failures!



Graph 7: Coordinating mechanisms

Source: Kádek et al. 1997. p. 7.

The coordinating mechanism used by developed economies today is neither the market nor the bureaucratic coordination. Today's modern economies are so-called mixed economies.

Coordinating mechanisms: 3. MIXED ECONOMY

First of all, we have to prevent a possible misunderstanding: the adjective 'mixed' should in no way be interpreted as if it was the mixture of the bureaucratic and the market coordinating mechanisms at a fixed

[9] Outside (external) economic impact occurs when the action of an economic actor provokes permanent changes in the circumstances of another uninvolved actor, but without being paid or paying for the suffered impact. The external impact can be positive or negative depending on whether the circumstances of the actor involved improve or the opposite: it damages the economic subject observed.

ratio. The concept envisioning a half-and-half mixture is particularly inappropriate. That is not what it is all about! **Modern, developed economies are fundamentally market economies. The profit-oriented private sector is determinative in them** but they also have non-profit organisations as well. Partly or entirely state-owned producers and service providers also operate in these economies, but state property is not large-scale.

Undoubtedly, the state is present in modern economies. But it is not only distinguished from bureaucratically coordinated economies by the rate of state presence but rather how state presence is realised. Namely, the official magisterial role of the state does not dominate in the economy.[10] **The state influences the economic processes with market conform tools.** These tools do not command a specific behaviour, but they motivate certain economic behaviours. They are budgetary and financial interventions which modify and shape the macroeconomic framework of economic activity. This triggers the suitable reactions of private producers and service providers. The bottom line is that the state does not want to stand in for the market as in the bureaucratic coordinating mechanism, but it is an active participant in it with its interventions and – occasionally – it subsequently modifies the distribution of income developed on the market. **The state does not become total; it does not absorb the economy!** The interests of the different societal groups can be freely articulated. The state does not suppress them, and does not try to guess instead for the stakeholders what their interests are. However, it naturally tries to harmonise interests by openly revealing and contrasting them in interest reconciliation forums and negotiations.

John Maynard Keynes (1883-1946) an English economist is considered the **founder of the theory** of the modern mixed economy. As we emphasised in the previous chapter, he considered the state interventions in the market economy indispensable from the point of view of the stabile operation of a modern economy. Analysing the experience of the Great Depression he took the view that a modern economy can only avoid the obligate large-scale, long periods of unemployment with the artificial creation of demand by the state. In his economic policy recommendations **he suggested that the state should try to influence market conditions primarily with budgetary interventions** (by applying a properly designed or modified tax system and through public

[10] Of course, sometimes it does! The prohibition of drug production and distribution, the control of compliance with environmental regulations, the enforcement of sanitary and technical standards implies the need for the official action of the state. But in the influence on the economic processes the instructive tools are not decisive.

spending.) [His main work: *The General Theory of Employment, Interest and Money* – 1936.]

In summary: in a mixed economy, the management and coordination of economic processes are based on the combined effects of the laws of the market and government control. The questions 'what, how, to whom' are answered fundamentally by the market; the state is also a market actor and only intervenes in the market processes in case of disturbances.

Its characteristics are therefore:

- coordinating, the market mechanisms play the main role;
- government intervention is carried out with market tools (monetary policy, fiscal policy, intervention policy);
- the state primarily carries out tasks incumbent upon it (public services, the supervision of competition, public investment in infrastructure...)

3.3 SUMMARY, QUESTIONS

3.3.1 Summary

The lesson clarified those basic economic concepts and basic relationships which we will use in subsequent studies and which are essential for acquiring further, deeper knowledge. In addition, the knowledge gained here forms a good basis for the understanding studying of economic thought.

3.3.2 Self-check questions

- ? Classify the commodities used for the satisfaction of needs!
- ? What is production? What kinds of factors are needed for this process?
- ? What do economists call budget constraint? When can we talk about its softening?
- ? What is GDP? Because of which problems are they trying to construct new statistical indicators?
- ? Compare the bureaucratic and the market coordinating mechanisms!
- ? Characterise the modern mixed economy!
- ? Distinguish between private and public goods illustrated with examples!

3.3.3 Practice tests

? The Maslow pyramid offers help to organise needs. The individual levels of the pyramid...
- show the needs associated with different life activities
- provide a systematic overview going from the physical requirements for human survival towards higher level needs
- classify needs according to the method of the satisfaction of the needs
- compare the needs of groups with different levels of income

? Economic goods
- are gifts of nature
- are available in unlimited abundance
- can be propagated through production activities, but they are still only available in limited quantities compared with the needs waiting to be satisfied
- signify investment goods and services

? Street lighting is a public good because...
- anyone can use it
- the consumer cannot be identified, the user cannot be made to pay for the costs
- the consumers do not limit each other in its use
- all three statements are true

? Choose the correct list of the factors of production from below!
- natural assets, energy, materials, machines
- developers, workers, white-collar workers, administrative employees
- natural assets, work force, capital goods, entrepreneur
- natural assets, work force, land, entrepreneur

? GDP
- the most commonly used indicator of the SNA system
- Gross domestic product
- added value indicator
- all of the above

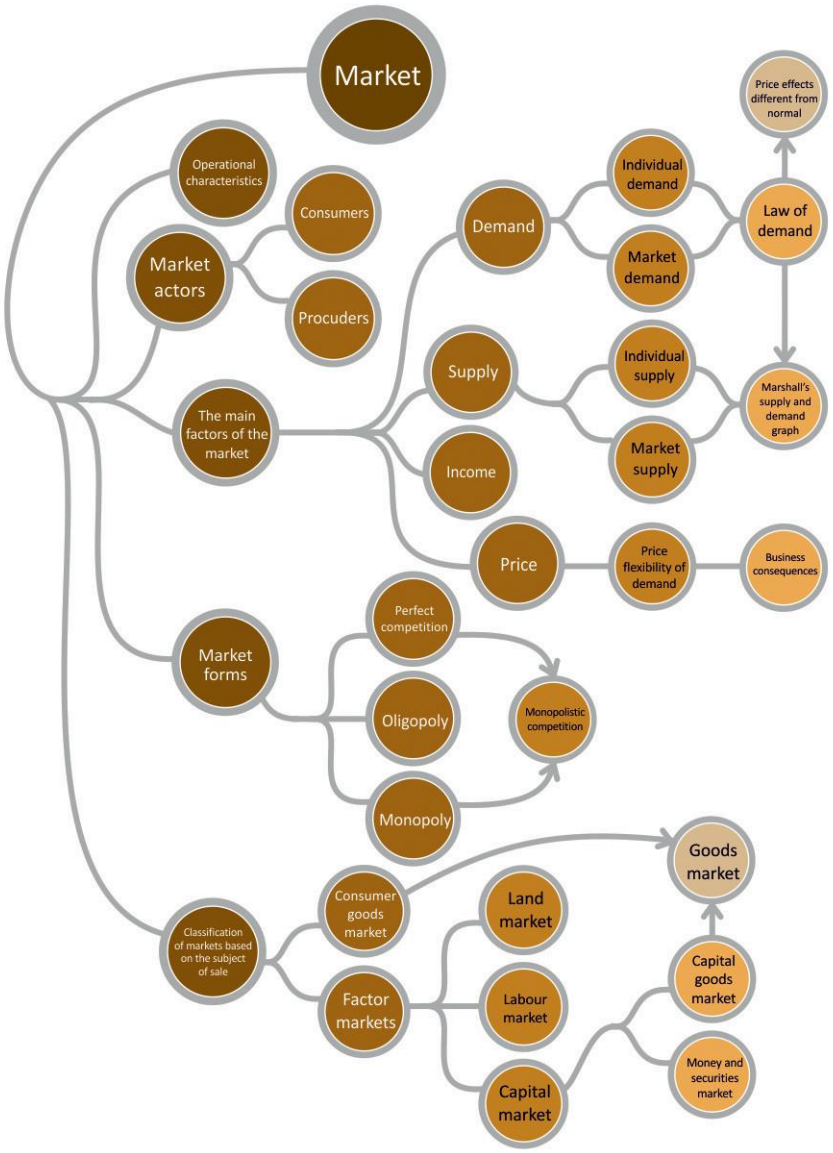
4. LESSON: THE OPERATION OF THE MARKET AND THE MARKET ADAPTATION OF BUSINESS ORGANISATIONS

4.1 OBJECTIVES AND COMPETENCES

The objective of this lesson is to clarify the basic concepts of a market economy, basic principles related to the operation of the market, and the companies' rules of adaptation to particular market forms which are essential for acquiring knowledge of the deeper relationship in economics.

By studying the curriculum, we will get to know market actors, elements, forms, particular types, and which basic market mechanisms influence the behaviour of the individual market actors.

4.2 CURRICULUM



Graph 8: Mind map

4.2.1 The market: a changing and evolving business form

Market economy was either a complementary or the main management framework of numerous societal formations. 'The market subsisted on the mould of society based on slavery as well as in the feudal system. The first thing that becomes conspicuous is its extraordinary flexibility and adaptability. Through history, the market took root in the most diverse economic media. It is this extraordinary ability to germinate and survive is the basis for considering the market to be an eternal economic phenomenon. The market conditions, however, which sprouted in the land of ancient Rome, are not comparable to today's market. The market could only be the constant companion of economic forms that it changed constantly.

As with all things in the world, the market rises and evolves. Obviously, it does not show itself much less when it is undeveloped, immature, an incidental form in the economy than when it seizes the entire society. Free-competition capitalism was the era of unbridled power and omnipotence.' (Szabó, 1970; p. 7.) From our historical studies, this economic system of 19th century England is well-known with its social consequences. But the market – as highlighted above – constantly changes. Free competition engenders monopoly (giant companies); the market economy was transformed. The market of the developed economies in the period between the two world wars was dominated by large companies which were becoming more and more international. But the modern market economy differs significantly from this formula. What is it like then? Let us enumerate some of its characteristic features.

- today's developed market economy admits government intervention (see what was written above on the mixed economy);
- international corporations have a dominant role in the economy;
- these corporations are bound to smaller companies with a thousand threads (suppliers, the so-called small businesses sector), as well as to research and development institutions, universities. Nowadays, more and more often organised networks of these are formed;
- companies strive to do personalised satisfaction of the (manipulated) needs of customers;

This recently termed phenomenon is called *mass customisation*. Numerous examples can be cited to demonstrate that large companies provide their customers the opportunity to customise the product or service to their individual needs. (Szabó – Hámori,

2006) We might think that personalising the product will make it significantly more expensive, however, this is not the case. The parts and fixtures of the product are produced on a mass scale, making full use of the advantages of high volume large-scale mass production. The final design or assembly is made according to the individual wishes of the customer. The possibility of mass customisation was thus created by modular production and the widespread use of information technologies, because the thousands of customer wishes must be recorded and stored in databases.

- today the role of market research and market manipulation is enormous. In order to strengthen their market positions, the companies employ a variety of practices from advertising campaigns to attractive packaging to regular contact with their customers. With specialised terminology, we would say that they carry out thoughtful and consciously planned marketing activities.

Hereinafter, we will learn about the basic concepts of the operation of the market. We will learn more about the mathematical apparatus that allow for the modelling and presentation of the operation of the market.

4.2.2 The concept of the market

We use the concept of the market in several ways. In its everyday sense we understand the market hall, the place where the individual small farmers sell their produce.

Economics extended the interpretation of this concept: it signifies the sum of transactions. In an economic sense, shopping at a store, trade conducted via fax, stock market transactions, and even job search are market operations (this latter is regarded as a labour market operation, saying that the job-seeker wishes to sell his ability to work, his craftsmanship and his skills.)

The market: the totality of actual and potential buyers and sellers, and the system of exchange relationships taking place between them.

In discussing the previous chapter we decided that when the market transactions (sales and purchases) are dominant in an economy, it is a market economy. If the operation of the market is suitably complemented by the activities of the state, we are talking about a mixed economy. Most of today's modern economies – as we have already pointed out – are mixed. As such, ours is a mixed economy as well.

4.2.3 Some of the features of the operation of the market

Below, we will highlight some of the features of the operation of the market and its important categories with short explanations.

- The central category of the market is commodities. Commodities are objects (or services) which are suitable for the satisfaction of human needs. They were not produced for the satisfaction of the producer's needs, but for sale. Goods have a dual nature. It has utility, because if it were not useful, it could not satisfy human needs. At the same time, it is exchangeable, saleable and we can get remuneration for it. In economic terminology we say that it also has exchange-value. It is a good because it is an exchange item. It can be exchanged because it is useful. [It is interesting to note that already Aristotle drew attention to this duality of goods. Later, the economists of the 19th and 20th centuries mentioned this dual nature repeatedly.]
- It is possible to have a market (and it actually existed in historical development) where goods are exchanged directly for other goods. (In special cases this type of sale still exists today; its name is: barter.) However, in developed market economies, money mediates the exchange of goods. It is therefore correct to say that for the smooth functioning of the market, it requires extensive cash flows and a supportive financial system.
- In a market economy, most of the producers are private owners, who
  - economically operate separately from each other (i.e. the freedom of decision and enterprise is realised);
  - follow their own self-interests;
  - act based on a profit motive (thus their objective is to reach a business profit – this is a strong objective, associated with other goals as well);
  - generally make rational economic decisions in which they basically align with the indicators of the price system;
  - seek to function effectively in order to do well in market competition.

4.2.4 The main factors of the market: demand – supply – price – income

There are many things we would like to acquire for ourselves; our needs are different. However, the needs themselves have no effect on management, on our economic activities. They only have an effect on the

economy if we decide to satisfy our needs and if we are able to do it (we have enough money.) In this case needs become solvent claims that are perceptible economically. This also means a demand for goods and services which influence the market in a market economy. We can differentiate three groups of the consumers emerging with solvent claims:

- Households (private consumers)
- Enterprises
- State

All these consumers represent demand for goods and services. The goods and services for which there is demand must be first produced. This is the task of **enterprises** (companies) – and to a lesser extent – of the **state.** The enterprise and the state appear on the market as producers with a certain supply of goods and services.

The producers and the consumers meet on the market where goods and services are exchanged.

The decisions of the buyers or consumers are limited by the extent of their previously acquired income. (We already talked about this limit in the first chapter.) The producers on the selling side of the market acquire their own income through market sales. If they manage well, the income from the market – in addition to the reimbursement of expenses – ensures their income which they can spend according to their own objectives.

The price of the goods that are the subject of the sale is an important market factor. **The price is the value of the product (or service) expressed in money.** The price offers information for market actors to make their economic decisions. It affects supply and demand and supply and demand also influence the price itself – thus helping to maintain market balance.

In the following, we will examine more closely supply and demand, and we will illustrate the changes in market trends in an exact way with the help of mathematical tools.

Demand

When we analyse demand we differentiate between consumer (individual) and market demand (the symbol of the former is ‘d’ and that of market demand is ‘D’.)

- **Consumer demand is the amount of product that the consumer is willing and able to buy in a given time and at a given price.**

- **Market demand is the amount of consumer demand occurring in connection with a product at a given price.**

Thus, market demand is the amount of product that the consumers are willing and able to buy in a given time and at a given price.

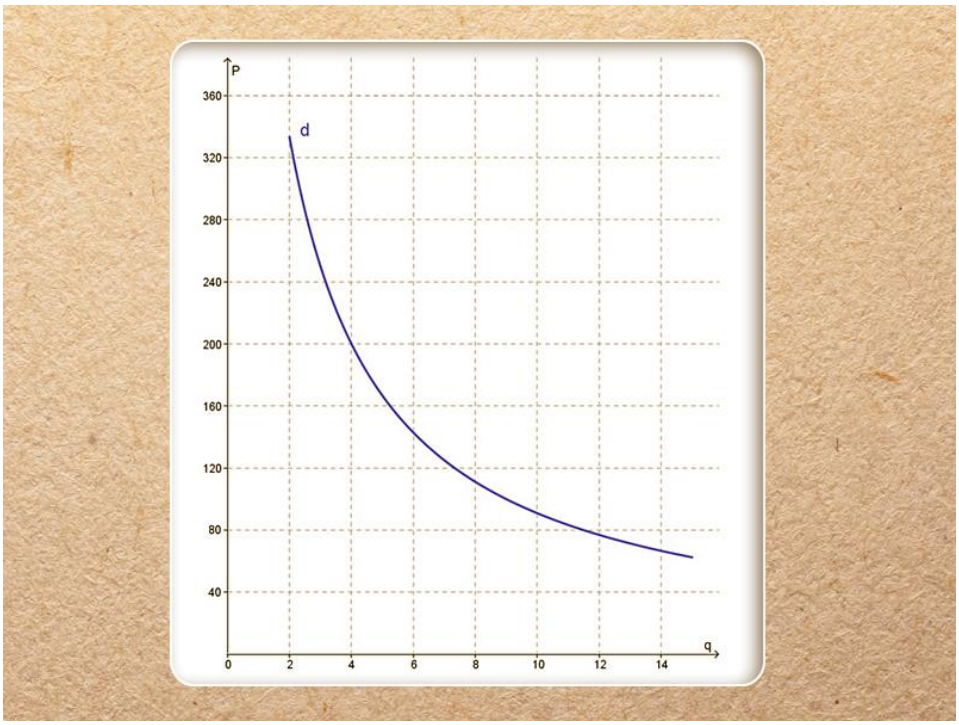
We can see from the above definitions that in a fixed time, demand is influenced by the consumers' willingness and ability to buy, and by the price of the product. The consumer's willingness to buy depends on his need for the product and also on how badly the consumer needs that product. In summary we can say that the consumer's willingness to buy is determined by his needs in connection with the product. In turn, the consumer's ability to buy depends on the consumer's income.

If we plot demand as a function of the price, we obtain the demand curve. In the sense of the above, we distinguish between the individual and the market demand curve.

- **For different unit prices (that is, depending on the price), the individual demand curve shows the amount of product that the observed consumer is willing and able to buy.**
- **For different unit prices (that is, depending on the price), the market demand curve shows the amount of product that the all of the consumers appearing on the market are willing and able to buy.**

Using mathematical terminology: the market demand curve is the horizontal sum of the individual demand curves. We can illustrate this with the graph of the demand curve. In the graph you can see the individual demand curve. The vertical axis shows the price (P), the horizontal axis shows the demanded quantity (q). In the case of the demand curve the unit price is the independent variable, so along the demand curve the unit price determines the amount demanded, and not the other way around.[11]

[11] Note that differently from the usual mathematical practice; in this case, the price as an independent variable is located on the vertical axis.



Graph 9: Individual demand curve

This function shows growing demand in case of a decreasing unit price. This is the law of demand and its truth can be understood without theoretical economic studies, based on our everyday experiences and our common sense. It should be noted, however, that situations arise in life where this relationship does not work and we experience an opposite effect which at first glance would seem to contradict the requirements of rational consideration. If we thoroughly examine these abnormal price effects, they prove to be explainable. What kind of cases are we talking about?

- In the case of fashion items, we often witness that many keep buying them even at rising prices. The cause of the purchase is that others also buy the product because it is fashionable, it is considered trendy. This is the **flock effect;** so essentially the consumer decides to purchase the expensive product allowing for a kind of social pressure.
- When someone wants to stand out from his environment, to show off his (real or imaginary, or desired) rising social position he will

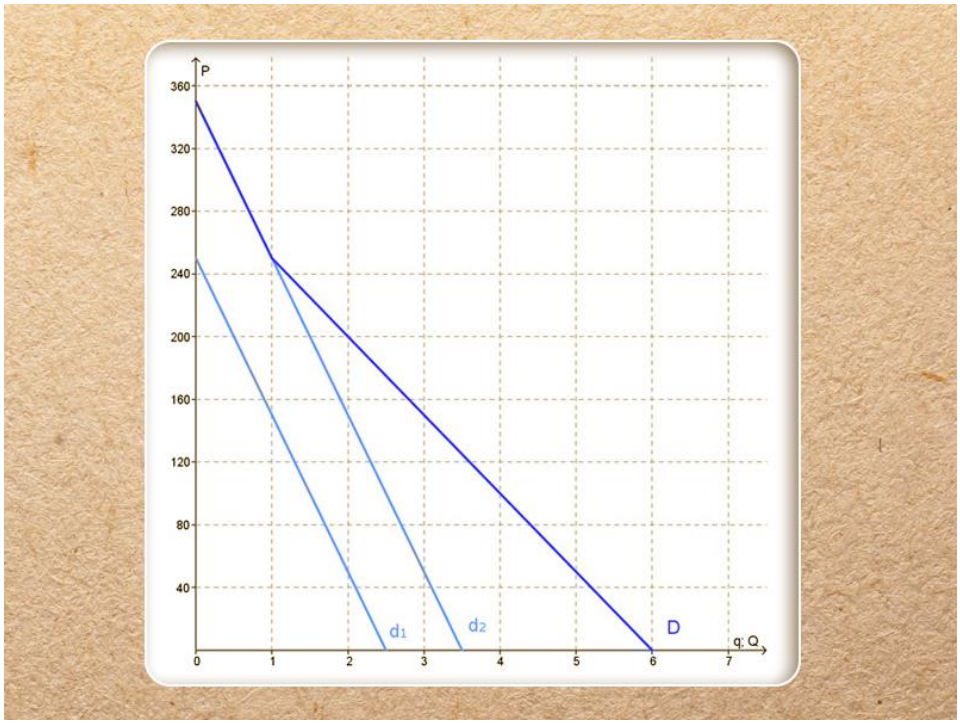
deliberately buy the expensive or more expensive product. This phenomenon is the **snob effect**.

- The quality of the product – especially with non-wasting electronic products – is a decision-based purchase consideration. However, the lay consumer cannot judge the quality based on the technical characteristics and parameters. He tries to obtain information about them indirectly. He assumes that the price is also an indicator of quality. He considers the higher-priced product to be of better quality at the same time. This explains why significant numbers of consumers tend to opt for a more expensive product range when buying electronics. This phenomenon is called **Veblen effect** in economic theory.
- At a time of rising prices, it occurs that the customer buys the product which is getting more expensive because he expects the prices to rise further so if he does not buy the expensive product now, he will only be able to buy it at an even higher price in the future. This behaviour is the manifestation of the so-called **speculative effect.**
- Scottish economist Robert Giffen studied the poor in Ireland in the second half of the 19th century and discovered that in the event of an increase in the price of potatoes also increased the demand for them. When its price fell, demand for it also fell. The reason for this strange movement in demand is that potatoes were a staple item so when the price dropped, the population had the opportunity to buy other foodstuffs, for example, meat which decreased the demand for potatoes. And when potato prices started to rise, the consumers had less money to buy other foodstuffs and made up for the loss with more potatoes. This phenomenon is the **Giffen effect.** This special price effect in particular can be observed with low-income social classes and with simple staple food groups.

Returning to the examination of the demand curve, note the following: the demand function can reach, but it cannot exceed the axes. The vertical intercept could indicate what would be the market price at which the consumer would no longer be willing to buy the product. The horizontal intercept would show how many products the consumer would demand if they gave it away free of charge.

When we defined the market demand curve we said that it is the horizontal sum of the individual demand curves. The graphs below show what this means.

(For the sake of simplicity, let us assume that there are only two consumers at the market.)



Graph 10: The connection of the individual and the market demand curves

We can see that the market demand curve is formed by adding up the individually demanded quantities for each price.

Supply

In case of supply we can also make the distinction between producer's (individual) supply („s"), and market (industry) supply („S").

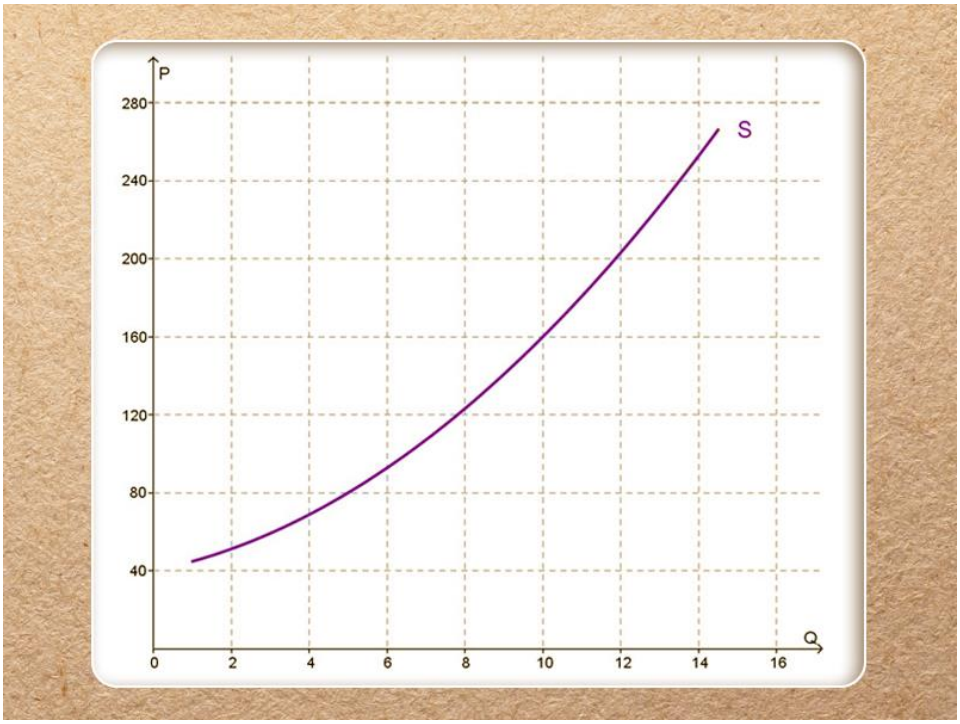
- **Producer's supply is the amount of product that the producer offers for sale in a given time at a given price. The market supply of a product is the sum of the producer's supply in connection with a product at a given price.**

The supply of a product depends on the price of the product and the costs of production.

If supply is plotted as a function of the price, we get the supply curve. There are individual and market supply curves.

- **In the case of different unit prices (that is, as a function of the price) the individual supply curve shows the quantity of products which the observed company (producer) offers for sale. In the case of different unit prices (that is, as a function of the price) the market supply curve shows the quantity of products that all of the sompanies present on the market offer for sale.**

The market supply curve is the horizontal sum of the individual supply curves. In the case of the supply curve, the independent variable is also the price.



Graph 11: Individual supply curve

In this graph we can see an individual supply curve. The vertical axis represents the price, while the horizontal axis represents the quantity supplied. In case of increasing unit prices, the function exhibits

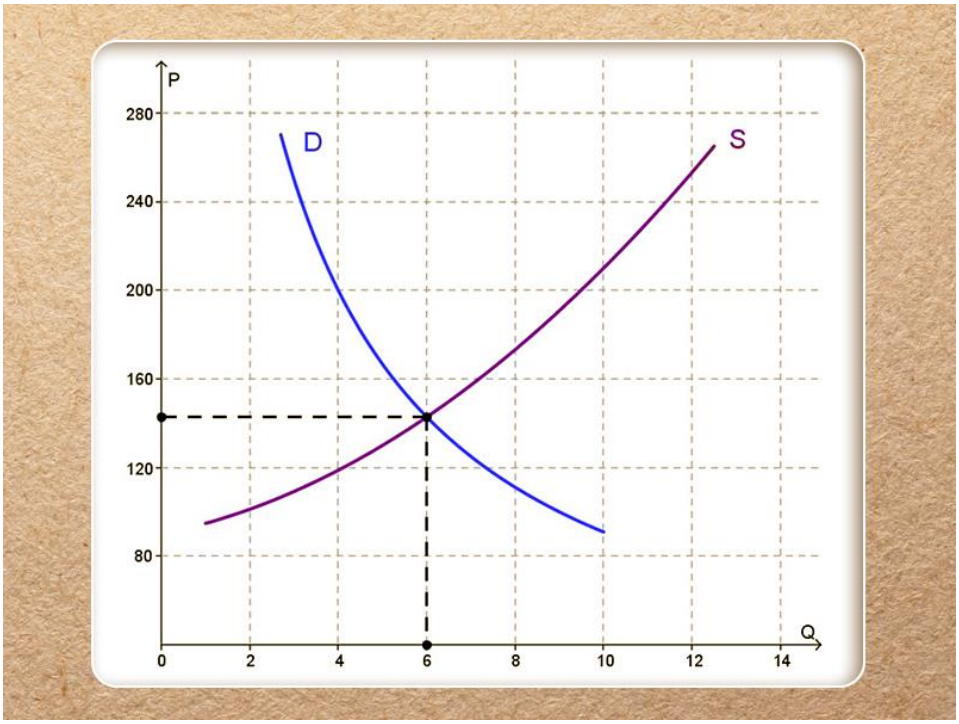
increasing supply. This is the law of supply. It is easy to understand that it is true.

In practice, the supply curve cannot reach either of the axes: obviously, the company will not give away anything for free, and also it will not charge you money for nothing.

The horizontal addition of the individual supply curves happens in the manner described in the case of the demand curve (but we will not discuss it in detail here now.)

Marshall's supply and demand graph

- **If the demand and the supply curves are represented in a common coordinate system, we obtain the so-called Marshall's supply and demand graph.**



Graph 12: Marshall's supply and demand graph

The intersection of the two functions illustrates the commodity equilibrium. The related price is the equilibrium price.

In the present case the equilibrium price is 143 HUF. This is the price level at which the producers offer as many products (6 units) as the consumers are willing to buy. This quantity is the equilibrium quantity.

It is expedient to note here the following concerning the equilibrium price: In the course of our investigations we always consider the equilibrium price to be the current market price. This is possible because the price on the market always hovers around the equilibrium price.

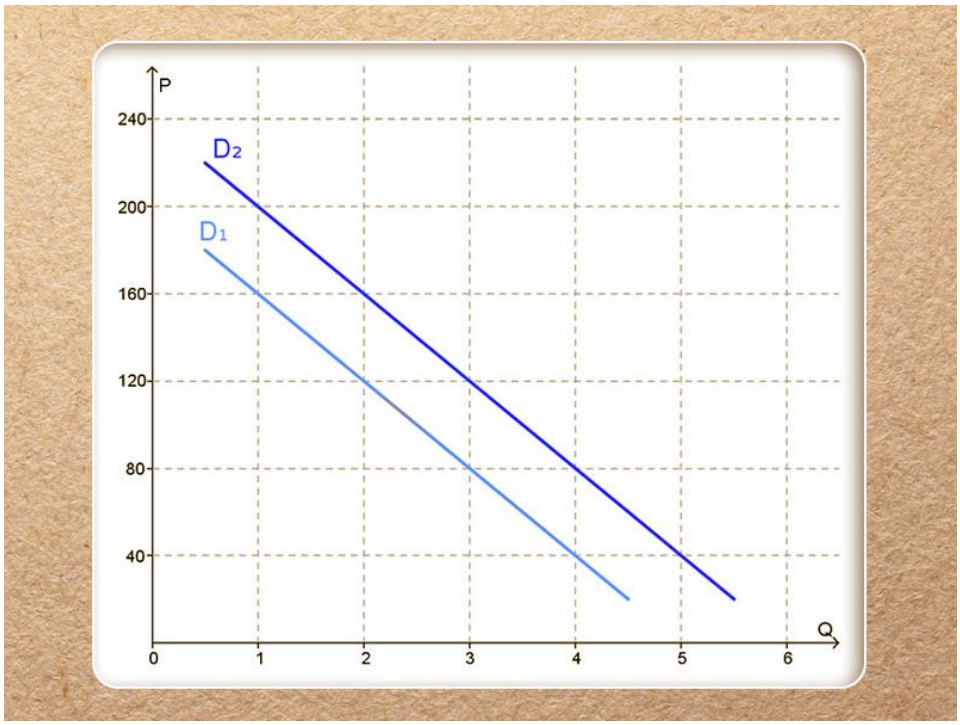
On the market, the price is affected by a lot of constantly changing factors (e.g.: the weather, government intervention, the current state of the world economy, changes in consumer tastes, fashion, etc.) As a consequence of these influences, the price constantly fluctuates. Let us examine now what happens on the market when the price goes above or under the equilibrium price.

In the graph you can see that if the price forms anywhere above the equilibrium price, excess supply arises on the market. In the graph you can also see that if the price forms anywhere below the equilibrium price, excess demand arises.

Thus, we can see that the price on the market regularly fluctuates around the equilibrium price, so we are not making a mistake if in our analyses we consider the equilibrium price to be the current market price. **The companies consider the current market price as a market parameter, as a market factor, which helps them in shaping their own activities, economic behaviour and market strategy. Thus, the current market price is a very important indicator for the companies.**

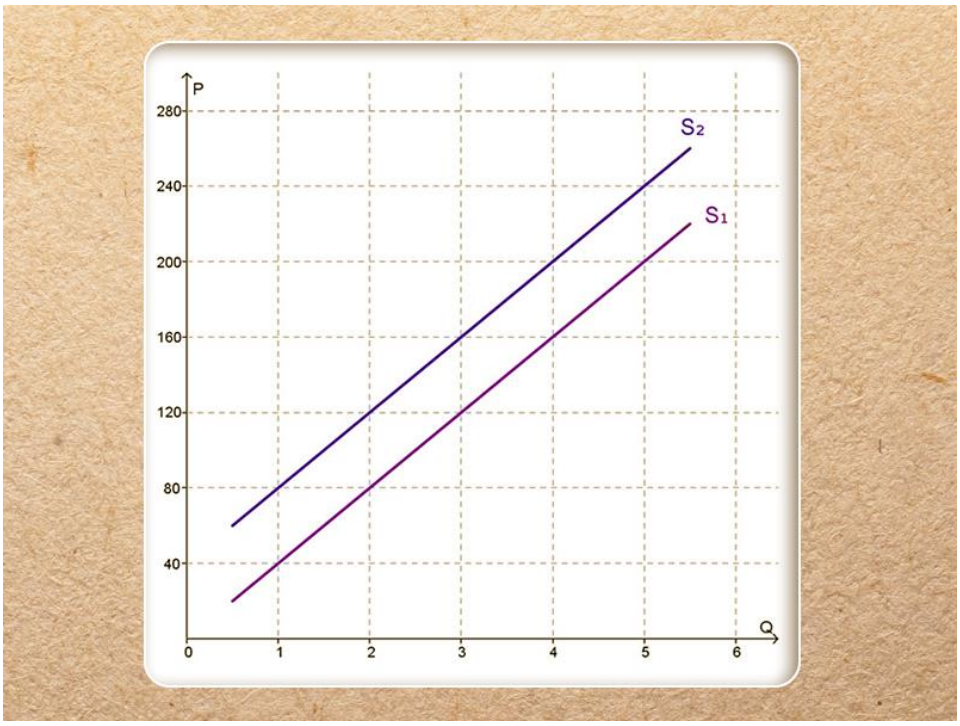
The shift of the demand and supply curve

If a factor other than the price has an impact on supply and demand, we never move along the functions, but rather the supply and demand curves shift.



Graph 13: The shift of the demand curve

In the graph you can see that the demand curve has shifted outwards parallel with itself. This means that the consumers are willing to buy more products at the same price. This may occur when the consumers' income has risen, or the number of consumers on the market has grown, the companies have conducted successful advertising campaigns about the product, etc. Obviously, otherwise, the function shifts inwards, parallel with itself.



Graph 14: The shift of the supply curve

In the graph you can see that the supply curve has shifted inwards, parallel with itself. This means that the producers are willing to produce fewer products and offer them for sale at the same price. This may occur for example, when the costs of production have risen or the number of producers present on the market has decreased, in the case of agricultural production unfavourable weather may have such an effect, etc. Obviously, otherwise, the function shifts outwards, parallel with itself...

If we examine the shift of the functions in Marshall's supply and demand graph, we can also see that the above shifts of the functions modify the equilibrium price, that is, the market price as well.

The price elasticity of demand, business consequences

Demand reacts to changes of the price. We know that normal reaction would be if the quantity of the goods demanded decreases if the price increases, and a decrease in price would entail a growth in demand. (We already know that there are abnormal price effects and reactions – we are not discussing them here.) Thus, demand reacts to

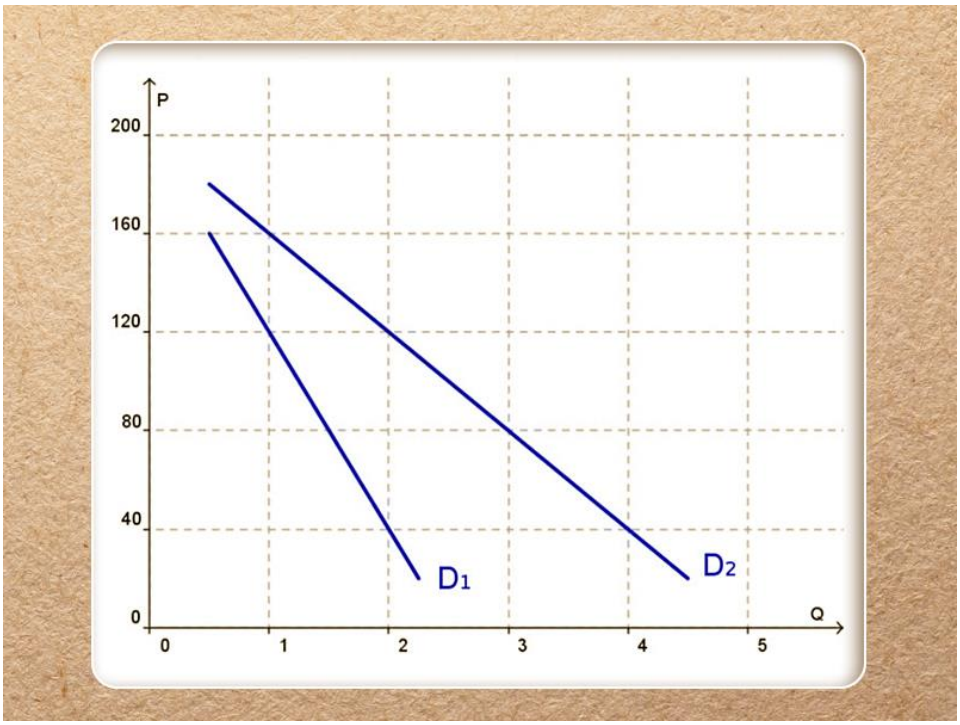
changes of the price, but with different intensity for each product. The intensity of the resulting change in demand is called the price elasticity of demand.[12]

Salt is important and indispensible for cooking. The household cannot run out of salt. However, it is not worth accumulating too much because it sticks together; it almost fossilizes. Every practising housewife knows how much salt to keep at home. This quantity must always be ensured, it cannot fluctuate (at most, slightly.) Thus, the usual occasional purchase of salt will not react or will only slightly react to the changes occurring in its price. „In economics we say that the elasticity of demand of salt is small, in other words, salt is a product with rigid demand.

A holiday in the Canary Islands is different. A lot of people desire it, they would love to go, but they worry whether they should they spend so much money on such a holiday? If they get a little boost, a little encouragement, they will book the holiday. This encouragement is very often a simple reduction of the price and demand starts to grow quickly. This changes the willingness of a lot of people. It is enough to have a small reduction of the price and demand starts growing quickly. Here, demand reacts to the occurring price changes with great intensity; using an economic term we say that the demand for the dream holiday has high elasticity. The demand for the holiday is flexible.

The different steepness of the two demand curves clearly shows the different price elasticity of demand. The demand curve of a product with rigid demand is steep, approaching the vertical, while the function of a product with elastic demand is flat, approaching the horizontal.

[12] Demand does not only react to the changes in price but also to the changes in the consumer's income. We know from experience that when our income increases, we tend to increase our purchases as well. The development of demand and the changes of income are far from changing at the same pace in the case of every good. Indeed! In some cases, when the income grows, the demand will not increase, but actually it will decrease. Consider, for example, that the happy gambler who has just become a millionaire will not increase his purchases of meat products manifold. At the same time, however, he will spend disproportionately more on luxury goods than before. (To continue the previous example, he will consume caviar and champagne in amplified quantities compared to the previous level.) The phenomenon presented here is treated by theoretical economics under the heading 'income elasticity of demand.'



Graph 15: The relationship of price elasticity and the demand curve

The above rationale has business consequences as well. What happens if the travel agency slightly reduces the price of the advertised holiday in the Canary Islands? We assume that demand start growing immediately. What happens? Although the income collected from individual traveller will be smaller than the original, the total income will be significantly higher than the previously calculated, because much more people have paid for the holiday compared to the original. So in the case of elastic demand goods (products or services) a discount can be applied because it will increase business results. In the case of rigid demand goods, demand would not grow significantly due to the reduction of the price, which means that the total income would not change favourably.

4.2.5 Market competition – market forms

As we already said in the earlier part of this chapter, there is competition on the market. Market competition is a struggle for benefits acquired from economic relations among market actors. The two extreme

points of the competitive nature of the market are (the two distinctly different market forms):

- the perfectly competitive market,
- the monopolistic market.

In reality, markets are different ratio mixes of the characteristics of the perfectly competitive and the monopolistic market. However, monopolistic markets can also be observed. For example, in Hungary, rail transport can be considered a monopolistic market; agricultural production and sale stand very close to the purely free competition market (e.g.: vegetables, fruits.) Government regulation tries to appease the negative effects of the purely monopolistic and the free competition market.

The factors determining the nature of market competition:

- number of market actors;
- conditions of entering the market;
- nature of the product;
- influence of the market actors on price formation;
- opportunities to access information;
- intensity of the competition.

It is a characteristic of the ***perfectly competitive market*** that the number of sellers is very high. **The actors on the supply side individually only give a very small percentage of supply, so individually they are not able to influence market processes.** Entry to and exit from the market is unrestricted for everyone. The difference between the qualities of products coming to the market is negligible, so the product is homogeneous. It is very easy to replace products with others. As the number of market participants is very high, **the individual market actors are unable to influence prices, thus, the market actors are price takers.** The information flow is free on the market (we are talking about technological and market information.) The market competition is strong.

On a ***monopolistic*** market **there is only one company on the supply side, so it has a very large influence on the supply side.**[13] Other companies are unable to enter the market, usually because of the high capital requirements. The produced product cannot be replaced by anything else. The business organisation in the monopolistic position

[13] There is also a mirror image of this form, a market situation, when there is a monopoly on the side of the buyer, meaning that the sellers are faced with a single buyer. Economic literature calls this situation a **monopsony.** An example would be the case when small agricultural producers can only sell their produce to a single buyer (a large cannery for example.)

alone determines the price. The company in the monopolistic situation alone possesses the economic information. There is no competition on the market.

Today's markets are usually dominated by a few corporations; these are called ***oligopolies*** in economic literature. But these giants are connected to a multitude of small and medium sized companies (this was discussed at the beginning of this chapter.) However, we cannot forget that on **monopolistic and oligopolistic markets, large companies (taking advantage of their dominant position on the market) may modify the price upwards and the volume of sales downwards from the quantities of the equilibrium** (in modern economies they often reduce the quality as well.) In modern markets the behaviour towards the customers has also been modified. "The politics of large companies is partly real market shaping, that is, they do not want to learn about the market, but rather they strive to change it. To put it more sharply, we could say that they do not produce products for the customer, but rather *they create customers for their products. ..."* "The old-fashioned sales methods which offered products to directly satisfy some obvious needs were not sufficient any longer... In order to eliminate the saturation observed on the market they chose the method of creating the voracious consumer." (Szabó, 1970; p. 17.)

- Nowadays we can also meet a specific market form, the so-called **monopolistic competition.** It seems like an impossible task, since the lesson learned so far is that we are either on a competitive market or on a monoploised market where there is no (or hardly possible to have) competition. It is a characteristic of the market situation discussed here, that in spite of the high number of actors, the competition is limited and the producers are able to influence the market conditions. An economics lexicon puts it this way: "Monopolistic competition is a market structure where there are a lot of sellers offering goods that are close but not complete substitutes for each other. **On such a market each and every company can exert some influence on the price."** (Samuelson – Nordhaus, 1992; p. 1287.) So the producers have a quasi-monopolistic position due to the specific and unique nature of their products.

4.2.6 The most important markets

It is important to classify markets depending on the object of the sale on a given market. Based on this we can differentiate between the consumer goods market and factor markets. So far our commentaries

(implicitly) related to the consumer goods market. Here we are talking about the distribution of goods and services necessary for everyday life.

But what are the market factors? As we learned in the previous lesson, we need economic resources (essential personnel and material conditions) for production. When we mention market factors we are essentially talking about the sales, the demand and supply of the conditions of production. What do they include?

- market for natural resources (especially land)
- labour market
- capital market (capital goods, and money as capital).

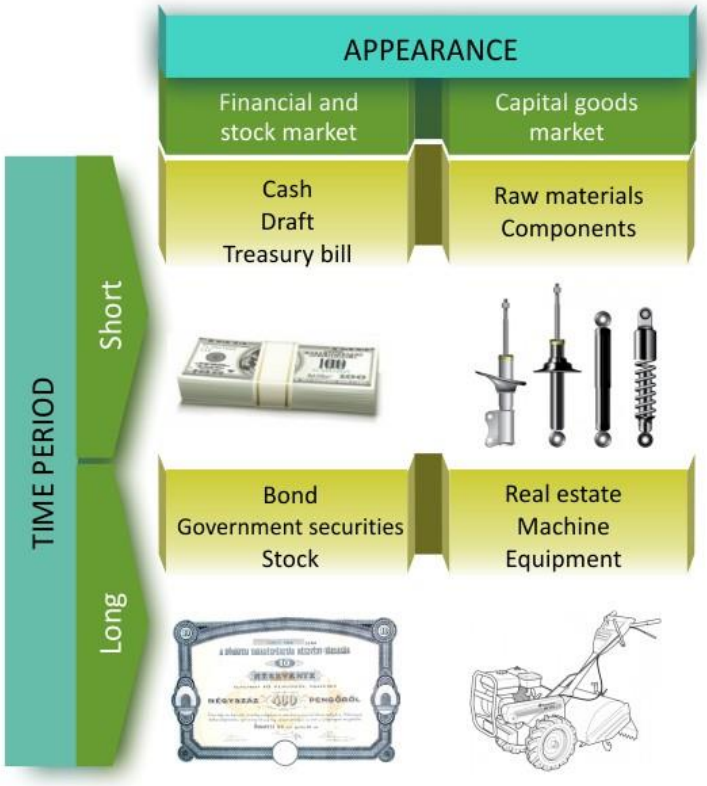
These markets will be discussed in greater detail in further studies. Here, we are only going to highlight a few thoughts, and their most important special characteristics.

The most important specific of the land market is its limitations. After all, we are talking about a factor which cannot be propagated; its different quality areas are available in specific quantities. After the better quality lands (if the demand for the production requires) only poorer quality lands are available. But at least the average rate of profit must be generated on poor quality lands, because otherwise it would not be placed under cultivation and the supply of agricultural goods would be insufficient. This necessity leaves its mark on the development of the price of agricultural produce – the land rent theory explains how.

A lesson can be drawn from the above which can be generalised to the operation of markets factors: the demand for the factors of production is always dictated by the needs of production at all times, so the demand for factors of production is derived demand.

The labour market is possibly the most special and flexible factor of production. It concentrates the supply and demand of labour (more precisely, the skill set of the individual performing the work.) Without ignoring the details here we would like to immediately draw attention to the fact that enterprises stand on the demand side of this market because they need this special factor of production. The supply side is represented by the individual performing the work (and seeking a job at the moment), because he wants to offer his work (and along with that, his talent, diligence, skills and expertise.) On this market the state and official intervention is very strong: a multitude of labour rules apply to the establishment of employment and the situation of the individual performing the work. But this market is also special because the price is the wage: the price of the work is the wages paid by the entrepreneur. Wages very rarely decrease in a modern economy; in economics we say that wages are rigid downwards. This fact is also a feature of this market.

Under the concept of the ***capital market*** we essentially understand two markets. We can talk about the market of capital goods and the market of money moving as capital, the market of financial assets. Here, we have to understand that in a modern economy, capital property on the side of the households will appear in the form of cash or securities. The investor offers his financial assets (he wishes to exchange his current financial assets to a future growing amount of money.) Naturally, there are some people (entrepreneurs) who use this money – in addition to ensuring personal conditions – in order to exchange it to real capital (machines, equipment, building materials, vehicles, IT equipment, raw materials and components) that is, the necessary materials of production. Thus, the **Capital market** is the cash and securities market, while the **capital goods market is the market where the sales of the elements of real capital is realised.** (The following chart is the review of all this.)



Graph 16: The interpretation of the capital market

		Appearance	
		Financial and stock market	**Capital goods market**
Time period	**Short**	Cash Draft Treasury bill	Raw materials Components
	Long	Bond Government securities Stock	Real estate Machine Equipment

In this subject, many interesting things will turn up since the stock market is linked to this topic, which is the concentrated market of modern economies. We will mention the criteria of investments, the financing issues of enterprises, and the operation of the entire financial intermediary sector and the influence of this operation on the processes of the national economy.

Finally, we note that the market of capital goods and the market of consumer goods are together called commodity market.

4.3 SUMMARY, QUESTIONS

4.3.1 Summary

The market is an overall economic category; it offers a framework for the transactions, conflicts of interest and cooperation of economic actors in modern times as well. The market is not only the place for the sales of objects - services and information are also sold on the market. Here we can see what the actors accept as economic value. It is also decided here which economic actors are able to do well, strengthen and grow and which ones will be marginalised and peripheral in economic life. Competitiveness is a key market category, interpreted on the level of a product, an industry and also a country. Welfare depends on maintaining and promoting competitiveness – this is not only the moral of this lesson, but also that of the further parts of our curriculum.

As a summary, watch the below video extract and listen to the main ideas formulated!

Source: The bases of prosperity – An educational video of ten episodes; The market – extract (broadcast by Duna Television, 1986) A jólét alapjai – Tíz részes oktató videofilm; A piac – részlet

4.3.2 Self-check questions

? How does theoretical economics interpret the concept of the market?

- Present the market mechanism with the help of Marshall's supply and demand graph!
- How can we classify markets on the basis of the object of sales?
- List some of the characteristics of today's markets mobilising your own experiences!
- Define individual and market demand! What is the law of demand?

4.3.3 Practice tests

Watch the video extract below and answer the questions!

Source: www.heviz.hu; Hévízi Televízió

What do the buyers think of the Hévíz market?
What do the sellers think of the Hévíz market?
What factors influence the development of market turnover?

Answers formulated based on the video:

What do buyers think of the Hévíz market?
- good quality products, special flavours
- wide range of products
- special crafts market
- a lot of sellers
- prohibition of shoddy products (effective market monitoring)
- real values

What do sellers think of the Hévíz market?
- good turnover, a lot of buyers
- spa town nature, the guests also visit the market (composition of consumers: 1/3 locals and Hungarian guests, 1/3 Russian guests, 1/3 German guests)
- accommodation providers suggest visiting the market
- suitable infrastructure, but it would be necessary to build a covered area

What factors influence the development of market turnover?
- size of the settlement, its tourist traffic
- frequency of local market attendance (a wide variety of possible reasons)
- effect of the market on its environment

product range of the market
qualitative factors

Look at the pictures below and answer the questions related to them!

Picture 1: Price development on the market of gardening products

What factors explain the price differences of the same products (peppers, grapes) on the same market at the same time?
What may have prompted one of the pepper producers to announce a discount price?
What kind of pricing considerations prevailed when calculating the price of plums?

Answer the questions based on your practical experiences and theoretical knowledge!

Possible answers:

What factors explain the price differences of the same products (peppers, grapes) on the same market at the same time?
quality
variety
origin

freshness
seasonal effects
demand

2. What may have prompted one of the pepper producers to announce a discount price?

He is offering ratatouille peppers at a discount price and they are visibly lower quality. We can say that this is the last portion of the product in the pepper season. It is important to sell the product quickly because the threat of it going bad is a real danger. Thus, the producer is forced to apply a loss reducing strategy. The lower price probably does not provide him with a profit, but helps him avoid further losses.

3. What kind of pricing considerations prevailed when calculating the price of plums?

The seller incites buyers to buy larger quantities by offering discount prices. Being a seasonal and perishable product, the producer has a strong interest in speeding up sales. (In trade it is a usual custom to reward a larger volume purchase with a discounted price. This type of discount is professionally called bulk purchase.)

5. LESSON: ECONOMIC ACTORS - HOUSEHOLD

5.1 OBJECTIVES AND COMPETENCES

In the introductory chapter we already talked about the fact that the two branches of theoretical economics, *micro and macroeconomics communicate complementary information* about the economy operating as a whole. As a reminder: *macroeconomics analyses the problems of the overall operation of the economy, while microeconomics* examines the operation of the economy *from the point of view of individual economic actors.*

The first objective of this lesson is to *establish the students' macroeconomic approach, the short description of the actors of the national economy, through tracing the relations among them.* We present the simplified macroeconomic schema of modern (mixed) economies, the so-called macroeconomic model, in order to render the situation of the main economic actors, their relations and the income flows among them comprehensible for the students.

Given that the overall objectives of the economics curriculum include the presentation of the decisions of all of the market actors, the backgrounds of their decisions, and their economic behaviour, first the *household* will be highlighted in the chapter. This is the traditional and oldest economic actor, which is at the same time closest to the students' mindset. *The main objective* of this lesson *is to draw attention to the fact* that *the students* as one of the leaders or as the primary leader of their future household *will have to become capable of making decisions defining the operation of the micro-level actor* of the economy. The successful operation of their household partly depends on them. *It is our educational objective to reveal connections by examining the operation of the economy from the point of view of the household and the surfacing of experiences gained as a member of the household* with which the students will have an influence regarding the successful operation of the household.

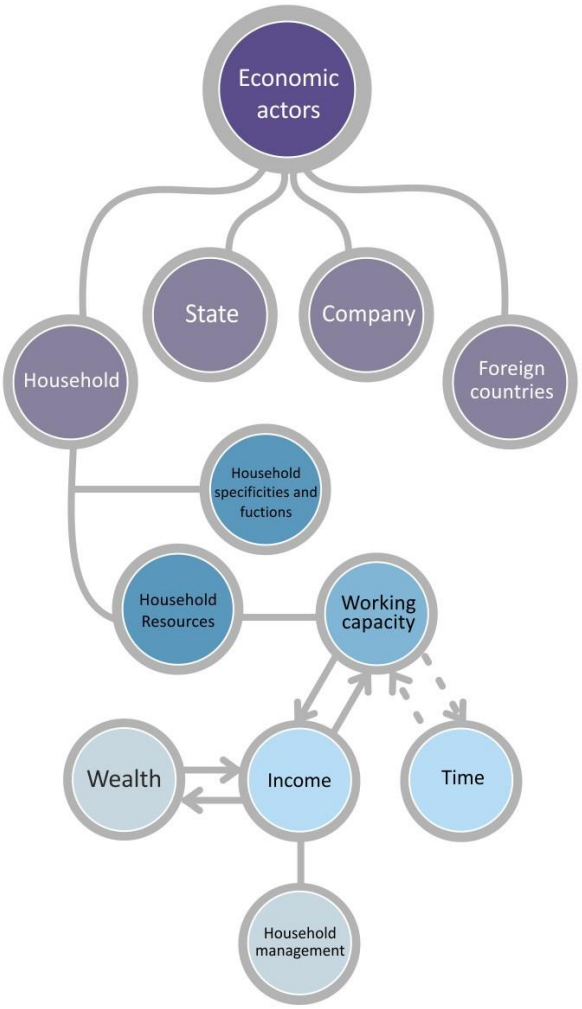
Through the study of this topic, the *competences to be developed are*: reviewing and organising ability, the ability to make calculations, analytical and decision making skills.

5.2 CURRICULUM

From our introductory economic studies we already know that economics deals with economic processes (with the production cycle in its broad sense), namely with the processes of production, distribution, exchange (distribution) and consumption.

In this chapter we will briefly present the *organisation structure of the economy,* that is, *the basic units of economic processes* and *reveal the relations amongst them, in the present case, with a focus on the household.*

- It should be noted that later we will refer to the relations of economic actors several times, mainly during the presentation of the individual actors, and during the inventory and evaluation of the macroeconomic performances.



Graph 17: Mind map

5.2.1 The economic actors – the relationships of economic actors

Economic processes (production, distribution, exchange, and consumption) have many actors, but *main groups* may be formed which *behave approximately the same way;* their situation is similar. ***The economic actors*** *performing the same functions* (with other names: economic subjects, basic economic units), assuming an open national economy are the following:

- households
- **companies** (enterprises)
- **state** (government institutions, government and public administration organisations)
- foreign countries.

In macroeconomics, the actors of the economy are also called economic sectors.

An **economic sector** is the sum of those economic subjects that

- want to achieve similar economic goals,
- have the same resources and limiting factors, and
- based on all these, make economic decisions of the same nature.

The corporate and the household sectors are collectively called *private sector* to differentiate it from the state or the public sector. The private and the state sectors together create the *domestic sector. Foreign countries* signify the non-domestic economic actors which are associated with a domestic economic actor.

- It should be noted that the *banking system is a specific sphere of the macroeconomy,* which deals with the financial transactions of the economic actors. In certain models – apart from the ones we have mentioned – they are indicated as an independent actor.

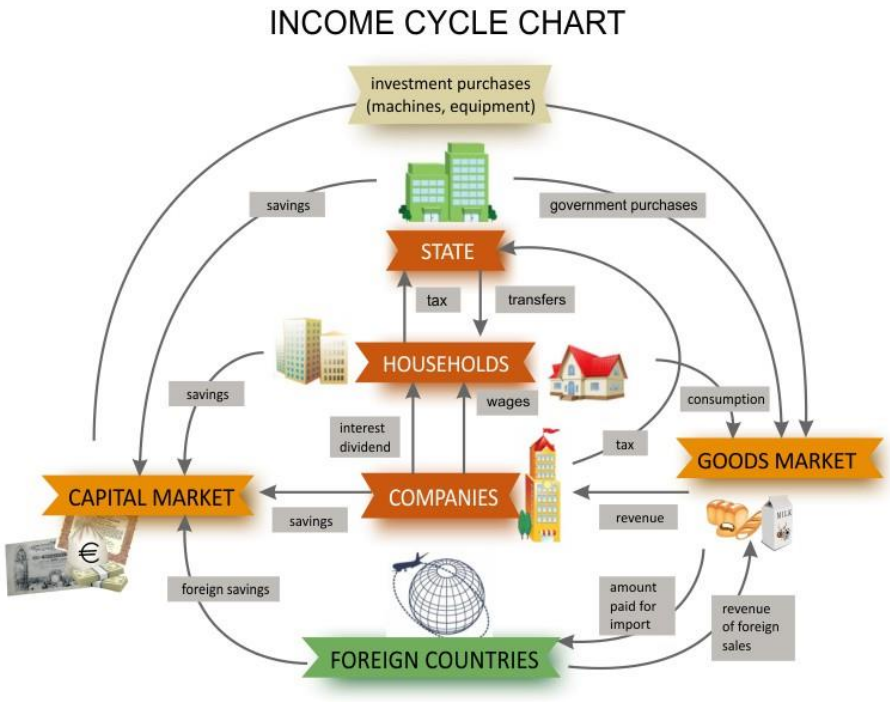
The economic actors are *connected by markets,* namely: *the goods, labour, capital and financial markets.* (These are the basic markets of the macro economy.) The sectors are connected to these markets with their supply and demand. The economic transactions of the actors partly aim at the *sales of goods* (consumer goods and/or investment goods) (goods market), partly at the *investment or borrowing of the financial funds* they have saved (financial and capital market.) Partly, they signify *the sales of work* (labour market.)

The basic relations among the economic sectors are continually repeated considering that after satisfying the needs, they will occur again, so production must continue. **Reproduction is the ceaseless cycle of production. Reproduction includes production, distribution, exchange, and consumption** in their narrow sense, and their constant circulation. **The continuous repetition of the economic process is called the economic cycle.**

Since every act of exchange is a two-sided movement, the movement of goods and money, **the manifestation of reproduction is also twofold.** The flow of products is accompanied by the movement of money (income) in the opposite direction, so **the real processes and the income processes** are two aspects of economic processes. At the same time, income carries out independent movement as well, for example, when taxes are paid. The flow of income plays a defining role in market movements, in the definition of demand.

The following model illustrates the most important cash flows among the main actors of the economy, so it focuses on the relationships of income.

- When studying the model, it is expedient to observe the inflow and outflow of income from the perspective of individual actors: what kind of income they get and what do they spend it on? The revenues and expenditures of the individual actors, the sum of the influx and efflux of income, are necessarily identical. It is noticeable that every income movement can be viewed doubly: the expenditure of an economic actor becomes the income of another, either directly or through one of the markets. We would like to emphasise that the income flow models – including the cycle graph – in order to increase transparency and to better illustrate and understand the processes only illustrate the income flow of the most important incomes, closely connected to economic performance (production and use.) For example, the interest income that the state pays after its domestic or foreign loans is not indicated. The borrowing costs of companies are only partly displayed visibly in the form of payments to households. The items mentioned are present but hidden in the model. These items obviously either decrease the savings of the given sectors (in case of expenditures) or increase them (in case of revenues.) We also note that the labour market in missing from the model for the sake of simplicity, because the wages only flow through this market from the corporate sector towards the household sector.



Graph 18: Income cycle chart

The source of the schema: Hollóné Kacsó Erzsébet – Kádek István (2002): Agóra p. 18.

Regarding the income flow of individual actors, we can make the following *observations:*

- Before and after studying the observations on income flows, it is worth to watch the following animation:

Household incomes come from several sources. The most important source of income is the wages of the earning family members which originate from the enterprises (companies, institutions) operating in the corporate sector. These wages are supplemented with **transfer incomes** received from the state (such as pensions, social welfare, various grants), and also with **incomes** (interests, dividends) **originating** from different term **investments in securities** (bonds, shares.) **Households have expenses;** above all they have different **tax payment obligations** towards the state. However, they spend a great part of their income on buying goods and services necessary for livelihood, so they

spend it on **consumption** on the goods market. **They save the money they do not spend on consumption***;* they deposit the money in bank accounts or place it in different term securities on *the financial or capital markets.*

The income of the corporate sphere comes from the goods market. Through sales, the companies obtain **revenues** – and as the difference of their revenues and expenses – income, from all of the actors of the economy. **State transfers to companies** also form part of the income of the corporate sphere (grants that do not have to be repaid); but these are common and they are not determinative in magnitude. A significant portion of the **companies' money outflow** is the **wages** paid to the employees, that is, actors of the household. Obviously, the companies also pay for other factors of production apart from work. They use capital factors (money) originating from the households through issuing securities (bonds, equity) for which they pay **interests and dividends.** The factors of production bought from other companies are considered intermediate consumption, their value flows within the corporate sphere, so it does not cause income flow leaving the sphere. Besides paying wages, the companies have different **tax and contribution payment obligations.** If the sphere has temporarily free financial funds, they can find suitably lucrative investment possibilities in the form of **savings,** on the *capital market.*

The most important income of the state is tax revenue, which it collects from households and companies. Part of the **budget expenditure** goes to the micro-level actors of the economy, primarily to the households, in the form of **transfers.** The state makes significant **so-called government purchases** on the *goods market.* These include products that are typically bought by governments (e.g.: fighter jet) but may also include investment goods (roads, public lighting, and other public goods) and also ordinary consumer goods (office equipment, mineral water) as well. Sometimes, the state also has temporarily unused free financial funds which it places as **savings income** on the *capital market.*

- It should be noted that a budget deficit is typical, in which case the state uses the money of those who have savings, primarily the households, with the intermediary financial and capital market. In this case, the arrow indicating income flow is reversed in the model.

The schema only highlights the **export-import relationships** realised on the goods market from the diverse relationships of **foreign** economic actors and domestic ones, more precisely, their related cash

flows. Namely: for the export, the income flows in, for the import, the money flows out of the given country. The volumes of export and import typically differ from each other. **If import exceeds export, foreign countries have savings domestically.**

- To understand the processes it is advisable to consider the follwing: If *import exceeds export,* there are more products present on our domestic *goods market than the domestic production.* At the same time, less income stays in the economy with the domestic income owners, because more payments were done for the import than for the realised export. *Thus, this means that the country consumes more than its income,* and foreign countries acquires more income and has less products. It follows that *the foreign countries save their income surplus, they lend it to the domestic economy,* and the domestic economy borrows this income surplus to realise higher income use than its own income. *That is the savings of foreign countries equals the difference of import minus export, which means foreign loans for the examined economy.*

Naturally, **if the import is smaller than the export,** the domestic economy spends less, lends money abroad, so in this case **the savings of foreign economies are negative.**

With the income flows presented, the cycle is not yet closed. What happens to the savings collected on the financial and capital market? This money can be used to cover the credit needs of the economic actors. Companies typically appear as borrowers in the economy and they spend the money acquired from the financial and capital market on buying investment goods. **That is, on the level of the national economy, the savings turn into investments.** These purchases provide an income for companies producing investment goods. From these they realise the previously mentioned payments to the households and the state, and also create savings. The state also spends money from the collected taxes. Households do the same, which get their income from the companies, while paying taxes and creating saving themselves. This is how the income cycle continues endlessly in the economy.

5.2.2 The characteristics and functions of the household as an economic actor

Households are the scenes of the management of the family. The definition of the household is different in the different scientific disciplines. Most of the time it is characterised as the synonym for family.

Economics argues that *family and household cannot be considered identical categories.* Belonging to a family is based on blood relations, but direct blood relations or other legal bonds are not necessarily present among the members of the household.

- "In many cases, obviously, the household coincides with the family, as in a one person household, the individaul coincides with the household. However, the concept of household better expresses the concept of co-management within the household, but stresses blood relations less." *(Sik Endre* [1984] p. 338.

An important feature of the assessment of the household: co-management.

The objective of the household is to better meet the needs of its members - living together and co-managing the resources.

The households are the final consumers of the goods and services produced in the national economy. In this sense – differentiated from the other actors of economic life – households are also called ultimate consumers. At the same time we have to emphasise that the household is not only a consumer unit! The moments of production, distribution, exchange and consumption are also characteristics of the household – just like all the other managing units. These elements of the economic process referring to the household have special contents which also indicate the typical roles and functions associated with it.

The producing and service processes going on in the household can be divided into two categories: income generation (primarily) and production to satisfy its own needs (subsistence production.)

- **Income generation** is clearly outlined in the analysis of the relations of economic actors. The adult members of the household usually do some kind of work, and they receive wages (income) in return. *(This usually dominant element of income appears on the revenue side of the family budget,* and largely defines the spending potential.)
- **Production and services for one's own needs**, (DIY, vegetable production, cleaning, cooking) can substitute for goods and services available on the market, their costs can be saved. From this point of view they are not negligible. According to the modern views of household economics, the household functions as a production facility with the difference that the product created or the service provided does not enter market sales.

- Production for one's own needs (or household production), in the case of the narrowing of the possibilities of income generation (e.g.: unemployment) has growing significance. "*Household production is the unpaid activity that a family member carries out for another member of the family, which could be substituted by market products and services, if the circumstances (income, market conditions, personal ambitions) make it possible to acquire from outside the household group."* (Reid. 1934; p. 11.)
- Researchers used *two main methods to assess* the value of this work: the market substitution cost and the opportunity cost methods. *The market substitution cost method* accounts for the value of the result of the household production or its input at the price at which the products can be acquired on the market. *The opportunity cost method* counts with the own labour market wages of the persion doing the chores. Estimates by the two methods *give nearly identical results.* Attempts were made in Hungary to determine these values in our country at the turn of the millenium. (Szép – Sík; 2002)

The distribution of the produced income and goods is also an important momentum of the process of household management. **The distribution signifies decisions and the ranking of different needs.** Since the resources are limited compared to the needs to be satisfied, during distribution the family has to make decisions concerning the order of the satisfaction of the common needs of said family (language course or bicycle.) They also have to make decisions about the reasonable distribution of goods among the family members. The choices are especially difficult when the income is low and one has to rank the products satisfying basic needs.

The exchanges occurring in the household do not have the same content as the market (usually equivalent) exchange. **In the family relationships exchanges are not equivalent (not market exchanges.)** Within the household, individual goods and services do not have market prices. The members of the household do not measure who owes what. Within the framework of the family distribution of chores a special exchange takes place, the exchange of activities among the members and also the generations.

- For example, a typical division of labour among the adult members of the family is when the mother cooks, the father does the gardening but the children also have chores suitable and changing for their age, from watering the plants to cleaning. A classic example of the exchange of activities between generations would

be helping the children with the redeployment of income, or assuming a large part of the household chores. But with the passing of time, the younger generation also helo the older one in different ways.

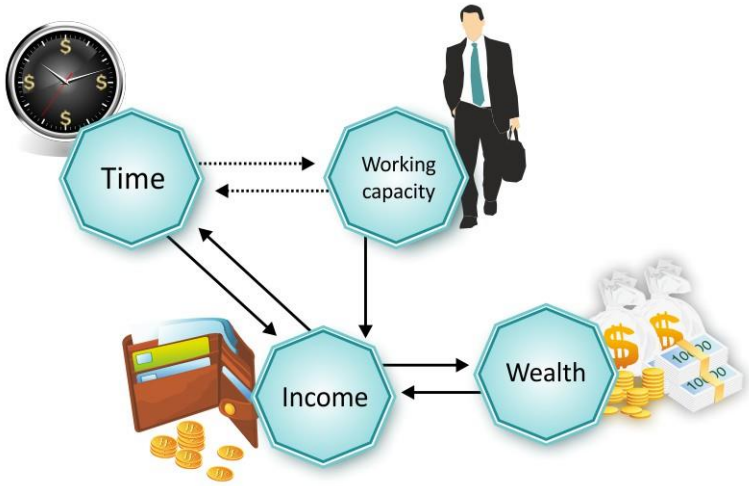
The household is an important scene of consumption. **The consumption done in the framework of the household is final consumption,** which we have to differentiate from productive consumption, from the consumption which forms part of a production process (for example, the consumption of materials, of electricity.) At the same time, **the final consumption in the household also means production:** the reproduction of man – the work force – is done in the household. **The household provides the most important resource of the economy.**

So far, we mentioned the economic functions of the household, **but households are not only economic functions.** Apart from the economic functions, literature has highlighted functions related to the reproductive, socialisation, emotional and psychological needs (children's education, common hobby, emotional stability.)

Thus, household functions are diverse. It can be shown with examples taken from experience that the actual tasks and their solution methods are different for individual households, and they also change because of the changes of circumstances (the environment.)

5.2.3 The resources of the household, the household income

We defined the objective of the household as the better satisfaction of its members' needs. To this end, it **has to manage successfully the scarce resources that are available.**



Graph 19: The resources of the household and the relationships of the resources

It is clear from the graph that **among the resources, income is in the centre.** Money as income is directly suitable to acquire goods for the satisfaction of needs. (That is why we will discuss the origin and use of this resource in detail after the presentation of the individual resources.)

Working capacity is the combination of man's knowledge, practical experiences, physical strength and personal traits. The working capacity of the family members is mainly important for acquiring income, but also for doing household chores and the organisation of the family division of labour.

Many consider **time** to be the most essential resource; because they say that time wasted cannot be made up for. In our accelerated world time management is extremely important because in order to maintain working capacity (in addition to physical fitness, to accommodate new knowledge), relaxation is needed. Furthermore, the magnitude of the attainable income is strongly influenced by the chosen proportion of the working and leisure time. (With extra work you can acquire more income, but the quality of life may deteriorate.)

Wealth is the sum of accumulated income and long-term assets acquired with the accumulated income (real estate, movables.) *Income can be exchanged for wealth and this conversion is also true in the opposite direction:* by using the assets one can acquire income. (Real estate can be leased; securities are movables that typically ensure different incomes.)

- The above listed *resources can be supplemented with the so-called social capital.* This refers to a kind of friendly business connection through which the household acquires information used to enlarge its classic resources (for example income generation) or we receive advice (which help us in our decisions) or simply learning about others' lifestyle can provide us with good examples for managing our own household.

The starting point and also the limit of the management of the household is the **income.** The income may come from different sources depending on what kind of factors of production the household has. The household may have all of the factors of production, but the most typical is the work force. Therefore, **among the incomes of the household, the wages or employment income has a decisive effect. Income is remuneration received in return for a factor of production.** This is a specific, common and essential feature of the income (wages, annuity, rent, interest, dividends, entrepreneurial income) connected to any factor of production (work force, land, capital, entrepreneur.)

The principle of direct "service – remuneration" is not applicable in the case of every element of household income. The transfers (pensions, family allowances and different benefits) are not remunerations; they are an important part of the household income through the state redistribution of income.

5.2.4 The household management: income assignment, the household budget

The essence of the household management of income is continuous assessment: what does the household need, what should be the order of the satisfaction of the needs?

In the decisions related to household management, the fundamental question is how it is possible to satisfy more and more needs of the members of the household from a given amount of net income. Or in reverse: how is it possible to satisfy a definite need from the least amount of money?

In order to budget the income, **it is expedient to rank the needs of the household and group them according to the following points:**

- What should we absolutely spend income on? **Absolutely necessary expenses** belong to the group organised according the above point, which can be subdivided into permanent and variable parts.
  - Expenses which occur regularly belong to the *permanent part*. They are stable and they tie down the income of the

family before all other expenses. Such expenses are the gas, electricity, phone bills, the day-care fee, repayment of loans previously recorded. *The possibility of their decreasing is small.*

- Expenses related to our everyday life belong to the *variable part.* For example, the costs of food, washing, and cleaning which are more flexible; *they can be modified within narrow limits.*

- What else can we spend on? The groups organised according to this point these are the **necessary but postponable expenses.**

- After completing the necessary expenses, there is generally some household income left, for example, to pay for clothing or education according to the agreement within the household.

- *What would* the members of the household buy *later,* if there is enough money available? According to this viewpoint, *more expensive, rarer purchases are outlined.*

- For these one-time large expenses (buying a flat, a car or a fridge) the necessary amount of money can be provided in two ways: with savings or from a loan. Savings decrease the amount in the present available directly for consumption, the loan increases it.

The following relationship can be demonstrated between the main groups of expenses and the size of the household income:

- At a lower income level, a significant portion of the income is tied down for covering the expenses of the absolutely necessary expenses. There is no or little money is available for more expensive rare purchases (or for savings aimed at them.)
- At a higher income level there is proportionately more money for the necessary but postponable expenses, or for the more expensive rare purchases (the proportion of savings and great investments financed from savings grows.)

Household budgets are used for the itemised inventory of revenues and expenses and for the reconciliation of magnitude. The budget is the balance of the household revenues and expenses. It includes the typical list of revenues and expenses, their quantified contrast for e defined period of time (usually 1 month, maximum 1 year.) The income surplus appears as savings (it will appear on the expenditure side); the deficit can be financed by borrowing money (the loan taken appears as income on the balance sheet.)

- For the main rule of the equivalence in magnitude of the revenue and expenditure items we may recall the well-known proverb: “Don’t have too many irons in the fire.” In this case the irons are the expenses, of which we should not have more than we can pay for from our income, that is, the limit of our expenses. There may be exceptions to the general rule: the income of the household may be temporarily supplemented by borrowing money. However, the repayment of the loan – together with its interests – causes the decrease of disposable income in the following time period. At the same time, for a future greater consumption, it is not necessary to use up all of the disposable income in the present; it is expedient to make savings.

It is not only necessary to compare the magnitude of the household’s revenues and expenses, but their temporal synchronisation is also important. Besides the budget, it is also expedient to make a cash flow plan as well. Even with an adequate budgetary balance, there may be disruption in the management of family income. The problems stem from the fact that the revenues and expenses of the households do not occur at the same intervals and not according to the same schedule. *The reconciliation of revenues and expenses in time* can only be done with the exact knowledge of the dates and amounts, and also with the adjustment of the timing and magnitude of the expenses that are not tied to a certain time. The solution of this difficult management task also assumes at the same time that the income is not spent right away, but they save it until the occurrence of the necessary expenses.

The planning of the household budget and cash flow assumes a certain level of financial literacy. In general, under financial literacy we understand financial knowledge, awareness, and financial decision making ability. The practice acquired in the family has a strong effect on the financial behaviour and management of the younger generation. (According to certain researches it has a greater effect than the financial knowledge acquired at school.) Ignoring the views regarding prioritisation, acknowledging the role of both the school and the family, we can state that the method when all of the members of the household make decisions jointly in more important management questions, affects the individual in a positive way. Thus, for the *development of management skills, it is important* to include the *youngest (pupil) members* of the family in designing the household budget. Besides, he should have *his own pocket money; he should be free to decide on its use.*

The amount of pocket money depends on several factors (age, factors belonging to independent decisions) but mostly on the financial opportunities of the family. It is essential – apart from the regular standard part of the pocket money – that the frames can be widened along with the assumed duties, with the increase in responsibility (for example, not regular, larger scale household chores, picking fruit, or the remuneration of walking the dog.)

The first important decision regarding the *use of the pocket money is the disposition* even in primary school: the dilemma of spending or saving. As a secondary school student, the young generation may gain familiarity in the management of the bank account opened by the parents, or in bank card use (online shopping, mobile subscription.) The university or college student will learn new concepts when he takes a student loan (interest on debt, mortgage payment) or he may tie up his temporarily free financial funds hoping for yields.

Overall, the motivation of the family joined with suitable knowledge acquired at school, has a positive effect on the management and financial culture of the young generation.

5.3 SUMMARY, QUESTIONS

5.3.1 Summary

The lesson, starting from the macroeconomic relations of economic actors, focused on the presentation of the features and the specifics of the management of one of the micro-level actor – the household.

The economic actors performing the same functions: the households, companies, the state and the foreign countries. These actors *are connected by the basic markets of the macro economy, namely: the goods, labour, capital and financial market.* With their demand and supply, the actors are connected to these markets and eventually to each other. We presented the *macroeconomic cycle* through the constant income flow among the main actors of the economy. Assuming perfect balance, the income revenues and the income use coincide exactly in the case of each and every economic actor.

The income flow of the household sector (which is in the focus of our analyses) can be described schematically as follows: its income is the wages, and the transfers received from the state; and the titles of income outflow are: consumption, taxes and savings.

The specific role of households in the nation’s economic system can be summarised in the following factors:

- *they are the final consumers* of the produced goods (consumer unit, but it also produces for its own needs;
- they create *labour supply* (they give the labour basis of the economy);
- they save some of their income, thus creating credit supply in the economy.

The household – just like all other economic actors – has to manage its scarce resources. Its most important resource is the income, and its division, the definition of the order of the satisfaction of the needs require decisions based on competence from the actors of the household.

5.3.2 Self-check questions

? What are the main sectors and markets of the macro economy?

? What is the macroeconomic cycle?

? What are the titles of the household's income flow and who are the concerned economic actors?

? What are the functions of the household? What is their specific role in the economy?

? Why do households have to manage?

? Why is it prudent for households to prepare a budget and cash flow plan?

5.3.3 Practice tests

☸ Decide whether these statements below are true or false! Make the false statements true!

? The economic actors and economic sectors are synonymous categories.

TRUE

? The elements of the economic process are: production, distribution, exchange, and consumption.

TRUE

? Transfers are incomes flowing from the state to the micro-level actors of the economy.

TRUE

? The able members of the household search for work on the labour market.

FALSE, because the able members of the household **offer work** and ask for remuneration in return.

? The principle of "service-remuneration" prevails in the case of every element of household incomes.

FALSE, because the household has incomes without consideration, **Transfers** are such elements (pensions, benefits.)

6. LESSON: ECONOMIC ACTORS – ENTERPRISES, BUSINESS VENTURES AND BUSINESS ORGANISATIONS

6.1 OBJECTIVES AND COMPETENCES

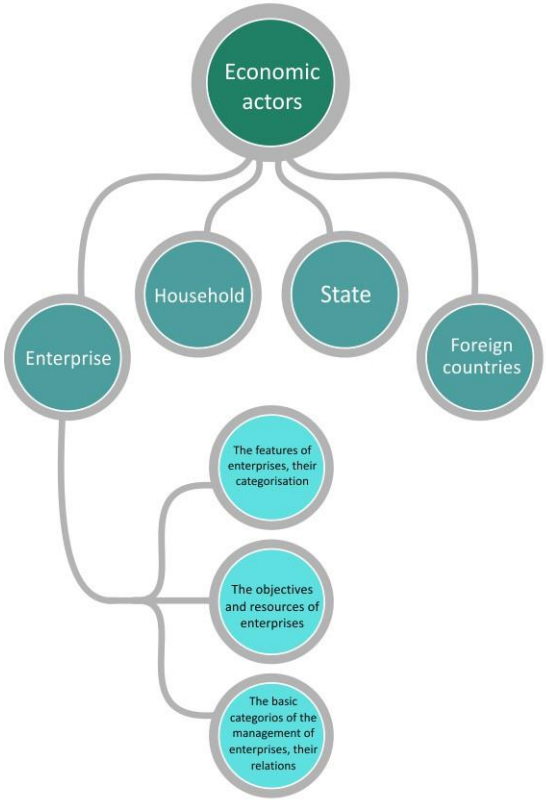
In the previous part, during the presentation of the main features of economic actors and their relations – and the income flow among them – the main directions of the income flow of companies (enterprises) inevitably became visible. After the recognition of the operating features of the traditional actor of the economy – the household – we will focus on the other main micro-level actor of the economy, the company, in our examinations. *The main topic of this lesson is constituted by the features of the companies as business organisations, the background of their decisions and the main features of their operation.*

It is our fundamental goal to synthesise the knowledge about the operation of markets, and through recognising the management of the household, the essence of management. At the same time, from a different viewpoint – the viewpoint of production – we will highlight operational motivation, the viewpoints of management and their features.

It is also our aim to *attract interest to entrepreneurial activities,* not necessarily for future entrepreneurs (the knowledge acquired in this course is not sufficient to manage an enterprise) but at least to become competent *by understanding the behaviour of the actors. Businesslike, entrepreneurial thinking and action pervades* everyday life. Their understanding and knowledge *are indispensible for the successful operation of the household and other non-business organisations.*

The *competences to be developed* through the study of this topic: *the development and shaping of business thinking and entrepreneurial attitudes, the ability to recognise relationships* of content of the categories determining business, systematic thinking, creativity, the development of risk-assessment, analytical and decision making skills.

6.2 CURRICULUM



Graph 20: Mind map

6.2.1 The features of enterprises and their categorisation

The corporate form in the modern sense – as an independent business organisation – developed in the 19th century. In the previous time period, the determinative organisational framework of economic activities was the household, where – as we elaborated in the previous chapter – production and consumption were organisationally intertwined. As a result of the socio-economic development, these two functions gradually separated; production separated from the household and became an independent organisational form.

In this chapter we will talk about enterprises, as a characteristic form of business enterprises. First of all, it is expedient to clarify the following categories: enterprise, entrepreneurship, and business. In

Hungarian everyday speech and in many cases in professional economic discourse, the categories of company and enterprise are used as synonyms.

- In international literature, the English translations of these two categories are not interchangeable; their usage is more consistent. The expression “enterprise” refers to an independent economic organisation, while the word “entrepreneurship” marks economic activities. (Papanek ed. 2007)

  The consistent validation of the demarcation of the organisational framework and activity is difficult with Hungarian terminology: for example, the name “individual entrepreneurship” is used to refer to both an organisational framework and activity in different professional economic materials. In the following, we will base the presentation of the system and content of the above mentioned categories on the most well-known Hungarian textbook of the topic, which has been published several times (Chikán, 2005)

Business entrepreneurship: *is a human activity* ***with the fundamental aim of satisfying needs with gaining profit.***

This simple definition refers to the fact that ***the aim of business organisations is to gain profit, but at the same time, the condition of reaching positive results is the knowledge of consumer needs and their satisfaction.*** *The definition also indicates that business organisations primarily differ with regard to their fundamental operational objective from non business organisations, that is from non-profit organisations.*

- Non-profit organisations are primarily the organisations belonging to the non-profit sector and they typically include the institutions of the state (government, public) sector. Naturally, the institutions belonging to this sector can also create enterprises, but their operational principle, the meaning of their existence, is not the acquiring of profit. Operation with non for profit objectives does not prohibit acquiring positive performance, it only prohibits the allocation of profit. (The addditional revenue must be rotated back to development, the higher level realisation of the activities.)
- As an amendment, it is noted that according to their main characteristics, *the sectors of a mixed economy* can be classified in three groups (with different names):

Business (market, private, for profit) sector – this includes *profit oriented* entrerprises which carry out regular economic activities (they are the "main characters" of this chapter);

State (government, public) sector – this includes the sum of institutions operating under direct state control which satisfy the common needs of society, they typically produce public goods, *without the objective of making a profit;*

Nonprofit (or with similar main features: civil) sector – it includes social and economic organisations which are not profit oriented, they are not state-run, and they are charcetrised by a certain level of institutionalisation, volunteering, and the service of the public good… (Kuti. 1996.)

An organisation can be considered a business if the conditions below are fulfilled:

- **it is profit oriented** (their revenues exceed their expenses in the long run);
- **it is capable of independent decisions** (it manages independently, it is separated economically from the other actors of the economy);
- **it takes risks** (mobilises its resources in order to obtain a profit, it transforms the resources into products and services, but there is also a possibility of failure in its operation);
- **its performance is qualified by the real market** (its input-output prices are defined by the market.)

Business is a wider category than enterprise. The enterprise:

- **is the organisational framework of a business having a legal personality,** a form of business,
- an organisation, which **transforms resources into output**
- **seeks to acquire and increase profit.**

Thus, *not every business is an enterprise,* but *only the organisations having independent legal personality.* Companies having a legal personality have their own property separated from that of its members, they acquire rights and assume obligations on their own behalf.

- The typical forms of *companies having a legal personality* are: A j*ogi személyiségű gazdasági társaságok* jellemző formái: the limited liability company (Ltd.), the joint-stock company and according to the Civil Code in force since March 2014, also the general partership and the limited partnership!

Business ventures or the narrower circle of enterprises *can be classified according to different viewpoints.* The distinction between the concepts of business and enterprise *is a classification based on a legal point of view, a distinction according to the business form. Further major grouping criteria:*

- *the forms of ownership* (private, state, municipality, joint ventures);
- *the nature of the activity* (producing or service providing enterprises); as well as
- *the size* (micro, small, medium, and large enterprise)

6.2.2 The objectives of enterprises, their resources and environment

In the case of the "classical enterprise" of the 19th century, the definition of the basic objective is relatively easy: achieving and increasing profit. In the case of the modern enterprise, the objective is more complex, more factors influence it: external environmental factors, conditions within the enterprise and also interest relations. (For example, in a crisis situation, survival may overshadow all other objectives, or in the short-term, increasing market share or the acquisition of a new market may become more important than acquiring profit.)

The main feature of the corporate system of targets is its multidimensional nature. One part of the structure of objectives is hierarchic (a condition of reaching higher level objectives is reaching the lower level objectives), but other objectives work in a juxtaposed manner (the functional objectives attached to different areas of corporate activity, for example, marketing, financial, informational and innovative objectives.)

Given that the enterprise is not only an economic, but also a social unit, there are other fundamental objectives apart from the profit objective. There are ethically based objectives stemming from environmental and social responsibility. These are complementary, but very important ones (for example, the avoidance of environmental pollution, the introduction of cleaner production processes, the reduction of input, or the recycling of waste.) Responsible management "means decision making in which the decision makers choose rationally from morally acceptable alternatives" (Zsolnai [1989] p. 38.) Corporate Social Responsibility (= CSR) play a more and more important role in the increase of corporate competitiveness, in achieving competitive advantage. (Competitive advantage is the unique ability of the given enterprise to achieve a better performance than its competitors.)

Since the mid-1980s, *increasing the proprietary value and the shareholder value* has become more emphasised as a corporate objective. According to the representatives of the shareholder value maximisation theory, everybody involved (in the broad sense the entire society) will be better off if the management of the enterprise keep the owner's interests at the forefront in market economies. *Increasing the proprietary value is realised if the enterprises* (by the reinvestment of profits or borrowing money among others) *realise such investments that, after the capital, will yield higher returns than the cost.* That is, profitable operation is essential, but calculating with the capital cost (the price of funding sources) *long-term, strategic objectives* include through the operation of the enterprise, *the increase in the wealth of the owners and the value of the enterprise.*

- It is disputed whether the above mentioned corporate objectives are compatible or not. We summarized the exposition of the above mentioned objectives, and the arguments for the comptability and the resolution of the contradictions among them in an audio material.

The compatible and coherent system of corporate objectives is depicted in the graph below

Graph 21: Pyramid of corporate objectives

Source: Könczöl, 2007; p. 24.

In order to achieve corporate objectives, resources are needed. The objectives of the enterprise and its resources are in a close relationship with each other. The essential point is that the resources must be assigned to the objectives, but the resource constraints may hinder the realisation of the objectives.

Resources signify the factors of production necessary for the operation of the enterprise, which do not create value on their own, but through their complicated interconnections.

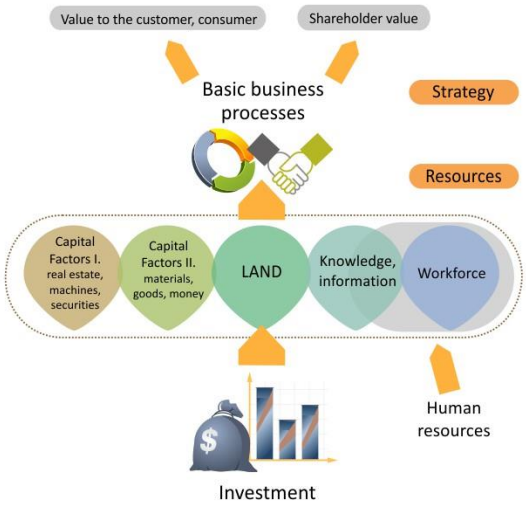
- The main groups of the factors of production were explained when learning about the essence of management. As a reminder: the classical representatives of economics of the 18th century (Adam Smith, David Ricardo) distinguished three basic factors of production: *capital* (physical capital goods, and financial capital)*, work* (workforce), *land* (including all other natural ressources). During the development, in the 20th century, the factors of production (resources) expanded to include *entrepreneurial skills and information.* Entrepreneurial skills include the ability to successfully combine factors of production; it is special professional knowledge on corporate management, risk taking, etc. The entrepreneurial ability – as a resource – is the sum of management functions in their present-day sense (planning, organisational, managment knowledge and skills), and proprietary functions (responsibility) through which the unificitian and systematical organisation of the other factors of production occur in an organisational framework. Today, the factors of production are comlemented by a newer factor, a specifically named element: *knowledge and information* in the service of production. (We do not distinguish here between knowledge and information, however, we accept the idea that knowledge is based on onformation and in this sense we regard knowledge as information interpreted and used in a given situation.) Knowledge or information revalues the role of traditional factors of production, it closely interconnects with them, and nowadays it is one of the most valuable factors of production.

The factors of production – the natural factors (land), the work (workforce), the capital (real or physical or financial), the entrepreneurial skills and the information – can be methodised in different ways. The best known method is the breakdown to primary, non-produced factors of production (it includes the natural factors and work), and produced factors of production (see: further factors of production.)

In terms of our topic, we may distinguish the factors depending on whether we can regard them as independent from the enterprise (limited by external factors) or as factors of production dependent on the enterprise. In the case of the application of the latter the enterprise has free (freer) decision possibilities. The factors that are independent from the enterprise are clearly the natural factors and in case of the workforce, the composition and educational level of the population, as well as the information of external origin (legal rules.) The factors dependent on the enterprise are the capital used, the number of workers employed, the composition and quality of the workforce, the management of the information, the entrepreneurial facilities and skills which signify the ability to join, operate and control all of the factors of production.

The resources of the enterprise signify the input of the "production" and creation of goods and services designed for the satisfaction of consumer needs. Through its operation, the enterprise transforms inputs (resources) into outputs (sellable products, services) while creating value for the consumers and the owners equally.

The following graph shows the relationship of the resources and objectives of the enterprise. Note that capital, as a resource, does not appear in the schema in its manifestations (real capital, financial capital) but it is depicted according to the period of investment.



Graph 22: The process of corporate value creation. The duplicity of value creation

Source: Juhász Péter, 2004; p. 4. graph 1. with modifications

The schema of the corporate operation refers to the *relationship of the objectives and resources,* and shows the *special role of human resources* among the resources (in the 21st century.) It also draws attention to the fact that human resources have a different content form that of workforce. “Human resources provide at least two types of resources for the enterprise: on the one hand, the physical ability to work and on the other hand, their knowledge. In the case of certain employee, one or the other factor may become extremely important (stevedore or senior consultant), but typical, the role of neither of the components can be neglected.” (Juhász Péter, 2004 p. 4.)

The business performance of the enterprise is fundamentally defined by its environment. The enterprise, as an independent economic actor, connects in many different ways to its environment. **The factors making up the environment of the enterprise change dynamically, they influence its possibilities; they promote or restrict it in achieving its objectives.** Obviously, the enterprise affects its environment directly or indirectly.

The factors of the external environment of the enterprise can be classified in two main groups according to the viewpoint of their influence on the enterprise: Macro environment and micro environment. **The macro environment** is the wider environment of the enterprise, which affects the activities of the enterprise indirectly; it includes factors, which affect every enterprise to varying degrees. In contrast, the **micro environment** is the narrower environment of the enterprise, with which the enterprise has a direct connection during its operation; it includes the factors specific to the same industry.

The main elements of the macro environment:

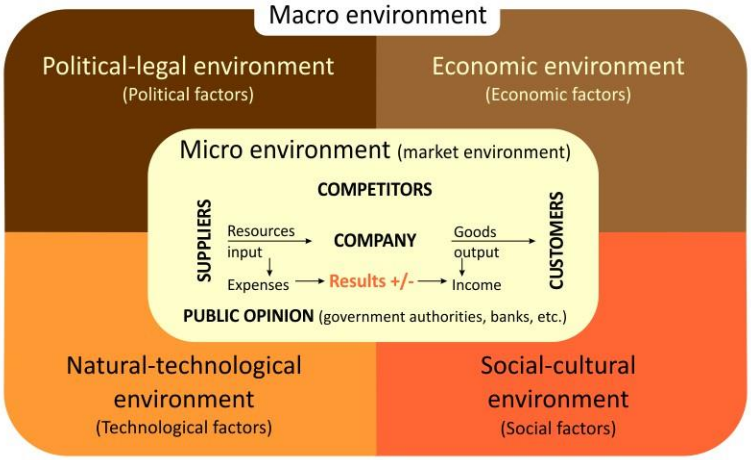
- *the natural environment* is partly signifies a resource, the possibility of resource combination and at the same time a constraint for enterprises. The rapid transformation of the *technological environment* (the effects of scientific and technological development, the rapid changes in IT and computer science) influences the management of enterprises in different ways (it may mean a competitive advantage, it may cause the rise of the research and development costs, etc.)
- the elements of the *social, societal and cultural environment,* for example, traditions, customs, values preferred by society define the economic thinking of people; furthermore, the *demographic environment* (or in a more detailed breakdown, it can be mentioned as an independent element) which equally affects the enterprise from the viewpoints of the

quantity and quality of the workforce, and the characteristics of its final consumers;
- *the political and legal environment,* which define the frameworks of corporate management and predictability through legislation;
- *the economic environment,* the state of the macro economy influences mostly the operation of enterprises in a mixed economy; among others, such factors include boom, recession, the changes in unemployment and inflation.

The main factors that make up the micro environment of the enterprise:

- suppliers, those individuals and/or organisations which provide the materials and services necessary for the operation of the enterprise, that is, the inputs;
- market intermediaries (traders, freight forwarders) who / which contribute to the delivery of the products and services to the consumers, or take care of the sales;
- customers, the target markets of the enterprise, for whom it produces the goods and services (the outputs);
- competitors, those organisations which compete to satisfy the needs of and to obtain the income of the same clientele;
- within the category of public opinion, there are countless, heterogeneous organisations connected to the enterprise, among others, government authorities (tax office), banks, insurance companies, interest groups and the media.

The following graph *synthetically shows the main factors of the corporate environment* and *highlights that through its operation, the enterprise transforms resources into goods for sale (into products and services.)* It acquires its input from suppliers on the market of the factors of production; it sells its goods to its customers on the goods market.



Graph 23: The environment of enterprises and the factors influencing business results

Source: Based on microeconomic and enterprise management textbooks, edited

The corporate system of relationships is characterised by financial processes in the opposite direction of real processes on the markets. The enterprise pays its suppliers in money for their inputs; this means *cash outflows,* typically *expenses* from the viewpoint of the enterprise. It receives money from its customers for the goods (outputs) created by the use of resources; for the given enterprise it means *revenues.* It is the fundamental objective of the enterprise that its *revenues exceed its expenses, thus acquiring return, profit.* It is possible, however, that because of the changes in the environment or internal operational malfunctions, expenses exceed revenues, and in this case the enterprise will become loss making

6.2.3 The basic categories of the management of enterprises and their relationship

In the following, we will try to clarify the meaning and the content of some basic categories necessary for the assessment of the management of the enterprise (expense vs. cost, types of costs, return categories.) Afterwards, we will explore the relations of revenues, costs, and result with the method of break-even analysis.

The costs of the enterprise are connected to the use of the factors of production. They signify monetary sacrifices in order to achieve the planned output level. **The costs and the expenditure of an enterprise**

are not the same order of magnitude taking into account a given period of time. For example:

- the money spent on the costs of fixed assets (procurement of machinery) signify expenditure in a given year (but not entirely), however,
- amortisation occurs as a cost in a given year, but not as expenditure.

The difference is caused by the fact that physical means – the machines, equipment, facilities – take part in production for a longer period than 1 year, they do not wear out in a year. For the given year only their wearing can be recognised as cost. Amortisation does not cause money flows, thus it does not signify newer expenses annually. The purchase of the machines at the same time in a given year, however, signifies large sums of cash outflows. In the interval of a year, the difference in magnitude between revenues and costs defines the result of the enterprise. The time difference of the revenues and the expenditures gives the opportunity to assess the cash flow, the continuous money supply necessary for the operation of the enterprise.

You can learn about the different interpretations of costs and expenses from the following audio material:

The costs of the enterprise are varied; they are classified according to several viewpoints. All of the costs of the enterprise that incurs during a period of time can be seen as a set of costs, which can be broken down into parts based on different criteria, into analysable cost categories.

We present the possibilities for the classification of costs, the cost categories belonging to a given group and their features in a table below.

1. *The classification of the costs (according to some of the major aspects)*

Classification criteria	Cost categories	Specifications / attributes
1. According to the type of costs	***material costs labour costs charges on wages depreciation and amortisation other expenses***	*Cost types,* the grouping of costs according to their *form of appearance* in production. (In accounting, the cost allocation used in the profit-and-loss statement created with the total cost procedure)

Classification criteria	Cost categories	Specifications / attributes
2. **According to the accountability of costs**	***directly attributable*** costs ***indirect, general*** costs	Grouping according to whether a cost can be directly attributed to a product or activity *(cost bearer)* or not. (In accounting, the breakdown used in the creation of the profit-and-loss statement with the method of cost of sales process)
3. **According to its relation to volume**	***constant (fixed)*** costs (Fixed cost = FC) ***variable costs*** (Variable cost = VC) ***Total cost*** *(Total cost = TC) TC = FC + FV*	Grouping based on which costs – assuming a defined capacity – *are independent of the volume of production and sales, or which costs change* (in most of the cases, linearly) *together with the volume of production.* (see: break-even point)
4. **According to production viewpoints, "derived costs"**	***Average cost*** *(= AC)* ***Marginal cost*** *(= MC)*	*Average cost* is the magnitude of the total cost counted for one product. *Marginal cost* is the *change in cost per unit of production.*
5. **According to economic-financial viewpoints**	**explicit** (showing on account) **costs** **implicit** (is not shown as cash payment) **costs** eligible not eligible	The grouping based on economic viewpoints is justified by the fact that *in accounting, not every cost is eligible.* For example, accounting does not take into account the missed profit, sacrificed for the sake of an activity, *the normal profit. (see: accounting vs. economic profit.)*

- In economic literature several other classifications exist according to other viewpoints. For example, they can be broken down according to their composition (*simple and complex costs),* furthermore, according to the phases of corporate activity *(procurement, production and sales costs.)* Furthermore, *in the course of making corporate decisions they pay attention to timeliness,* so *sunk costs* are significant, that is those past costs whcich cannot be changed any more, and alternative costs or *opportunity costs,* which cannot be decided upon yet. Accounting

studies provide an opportunity to learn about relative costs in a deeper and more detailed way. In macroeconomic studies, the average and the marginal costs play a central role. In the following, we will only focus on two classifications of costs: based on production volume and economic costs.

We stated that the fundamental objective of the enterprise is achieving profit, more precisely, the maximalisation of the difference of the total revenue (TR = Total Revenue) and the total cost (TR – TC.) **Break-even analysis is based on the relationship of the revenue, the costs and the result.**

We will explore the relations of these three basic categories of corporate management with the brief description of a simplified version of the break-even analysis.

Determining the break-even point is extremely important in order to assess the limits of the actions of an enterprise in advance in adverse market conditions. The enterprise must seek to avoid losses: the revenues should cover the costs. The enterprise must prepare for the possibility of decreasing sales at a previously calculated unit price, or it can sell the planned quantity of products, but at a lower unit price. In the first case, they have to size up how much they have to produce and sell at least to avoid losses, so the task is to determine the break-even quantity. (The unit price (p) necessary to reach the break-even point can be calculated with the same logic, we will disregard its introduction here.)

The calculation of the break-even point is based on the following significant relationships: **The break-even point is where the total revenue just covers the total cost.** (Total revenue = total cost, that is, TR – TC = 0.)

The assumptions applied for the determination of the break-even quantity:

- the company only produces one type of product;
- the revenues fundamentally depend on two factors: the product quantity produced/sold and the unit price (revenues = product quantity x unit price)
- the classification of costs is done based on their relationships to the volume of production. (total cost = fixed cost + variable cost)

The names fixed cost and variable cost graphically illustrate their behaviour in relation to the production quantity. It is important to emphasise that fixed cost is only fixed assuming a given capacity. Consider, for example, that in the event of doubling the production,

it becomes necessary to rent larger premises, to spend more on heating and lighting, etc. The variable costs do not necessarily grow liearly in conjunction eith the volume of production. They may grow progressively and degressively; the various versions of performance pay are examples of this.

However, there are typically fixed and variable costs:

- the following are generally considered as fixed costs:
  - amortisation, and the
  - range of costs associated with business operation (interests on loans, overhead, advertising, insurance, rents),
- the following are typically variable costs:
  - material costs and
  - part of the labour costs.

Assessment is difficult because in practice the wages of administrative employees is a fixed cost, while the wages of those participating in production are usually considered variable costs, except if they have agreed on fixed wages. Similarly, depending on the nature of the activity, a part of the overhead cost may be variable if the production is energy-intensive.

The “basic formula” applicable to calculate the break-even volume can be easily derived from the connection of the annual *total revenues* = *total cost.*

quantity x unit price = ∑ fixed cost + ∑ variable cost

$$Q_f \times p = FC + (Q_f \times v)$$

$$(Q_f \times p) - (Q_f \times v) = FC$$

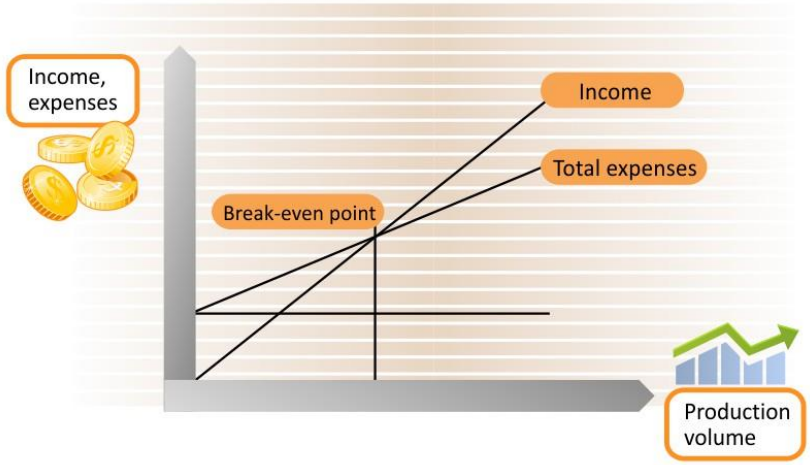
$$Q_f \times (p - v) = FC$$

$$Q_f = \frac{FC}{p - v}$$

Where:
Q_f: break-even quantity
FC: fixed costs
v: variable cost per production unit
p: unit price

Thus, the break-even quantity is determined by projecting the annual fixed costs on the difference of the unit price and the variable cost

per product. In the case of the volume defined by the break-even point, the enterprise is not profitable but it does not make any losses either. These relationships are shown in the following graph:



Graph 24: The break-even point

Source: (Papanek ed. 2007; p. 12.)

- It should be noted that break-even anlysis is an applicable method in tha case of the risk analysis of high-vlaue investments, although with some corrections. The fundamental difference between the above presented acounting break-even point calculation and the financial break-even point calculation is that the time value of money is taken into account when financial desicions are made. Thus among the fixed costs, in lieu of amortisation, the "annualised value" of the initial capital investment appears. So the value includes the capital investment interests (as sacrificed profit), which the investor could have acquired if he had not invested in physical means, but in other things (bank deposits, or other interest-bearing securities.)

Returning to break-even analysis, the question arises as to how to determine the break-even point if the enterprise produces a variety of products or provides a variety of services. In these cases, the break-even quantity, the "number of items" cannot be determined, or it cannot be interpreted. In such cases, the task is to determine the revenues

necessary to reach the break-even point. Thus, it is a fundamental question to ask: how much revenue is necessary to cover the costs?

The revenue necessary to reach the break-even point or in other words, the break-even value, can be determined based on the above mentioned correlations. The difference is that instead of categories of the unit price, we use the revenue; instead of the variable cost per product we use the total annual variable cost, because the number of items cannot be interpreted in the present cases.

Logically, the difference of the revenues and the variable costs should just cover the total costs. (Revenues – variable costs = fixed costs)

The break-even point (break-even value) = Fixed costs / (Revenues – Variable costs)

As a result of this calculation, we get the percentage of revenues we need to reach in order to cover the variable cost incurred.

The revenues necessary to reach the break-even point can be determined as a sum (in HUF) as well:

$$\text{Revenues necessary to reach break-even point} = \frac{\text{fixed costs}}{\text{variable cost per unit of revenues}}$$

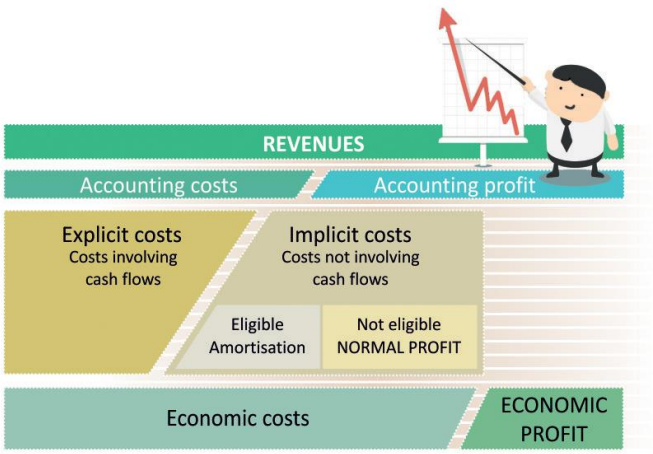
All of the methods of the break-even analysis can be performed *apart from the profit based break-even analysis, based on cash flow.* In the latter case, we are looking for the answer to the questions how much must be sold and how much revenue is needed so that the enterprise is not insolvent. Considering that not every element of the fixed costs of the company involves cash outflows (as a reminder: amortisation means costs but not expenditure) it is possible that the company can meet its payment obligations even in a loss-making phase.

- Profit means positive results. The content of the profit category is interpreted as accounting profit (as the difference of the revenues and the eligible accounting costs.) The content of the profit category of theoretical economics corresponds to the business (operating) results category applied in accounting. It is important to remember that *in accounting there are several categories of results* (business results, financial results, usual results, exceptional results, results before taxation, taxed results, results accordin to the balance sheet.) It is especially important in the case of the calculation of corporate performance indicators to

precisely name the applied result category, in order to interpret it correctly.

Apart from the accounting profit indicating the result of the activity, we need to know the content of another profit category in order to assess the real, positive business performance of the enterprises in the economic sense. During the economic-financial classification of costs we indicated that there are some costs that accounting ignores. Accounting recognises explicit costs (costs appearing on invoices and involving cash flows) and a part of the implicit costs (which does not involve cash flows), namely, the costs of amortisation. In an economic sense, apart from eligible accounting costs, we can consider the lost returns of opportunities (that we had to give up for the sake of a given activity) as costs. (For example, in case of savings invested in the enterprise, we have to renounce the bank interests.) This is called the normal profit attainable with the usual investment. Normal profit is considered ineligible implicit cost in accounting. The explicit and implicit costs together constitute the economic costs. Thus, the economic profit is the difference between the revenues and the economic costs. In another approach: the economic profit is the surplus over normal profit. The economic profit shows the economic value created by the enterprise in a given year.

We summarised the difference between accounting profit and economic profit in the following graph:



Graph 25: The difference between accounting profit and economic profit

Source: Based on Macroeconomics and Enterprise rating textbooks, edited

6.3 SUMMARY, QUESTIONS

6.3.1 Summary

In this chapter we presented the enterprise as the determinative micro-level actor of the economy. We presented the management objectives and the conditions of their realisation, namely, the structured depiction of the resources and the operational environment determining the economic performance. We referred to the fact that the fundamental objective of the enterprise – maximising profits – is compatible with other strategic objectives: as the increase of the value of the enterprise, and acquiring a competitive advantage. Furthermore, we highlighted that the realisation of business and moral objectives may strengthen each other. In our age, the resources of business organisations are the same as the resources usually necessary for management; there are differences only in regard to the decision possibilities concerning their usage. The framework of conditions of the operation of enterprises – the opportunities and threats – are indirectly influenced by the elements of the macro environment (technical, technological, social, political-legal, and economic environment) and directly influenced by the main factors of the micro environment (customers, suppliers, and competitors.)

Among the basic categories characterising the management of enterprises, we dealt with the systematisation of costs in detail. We used the categories of the fixed and the variable cost in the break-even analysis based on the relationships of the revenues, costs and profits. With the interpretation of the economic cost (explicit and implicit cost) we justified the difference between the accounting and economic profit.

6.3.2 Self-check questions

- Describe the common and different features of the enterprise and the business venture!
- Argue for the compatibility of profit maximalisation goals and the objectives resulting from social responsibility and also the proprietary objectives (increasing the value of the company)!
- List the factors of the macro and micro environment of the enterprise and give examples for the opportunities and threats arising from the environment!
- Break down the set of corporate costs with a help of some grouping criteria! Describe briefly the cost categories according to the specific criteria!

- On the relationship of which category of corporate management is break-even analysis based? What is the essence of break-even analysis? What versions are there?
- Describe the difference between accounting profit and economic profit!

6.3.3 Practice tests

Decide whether the following statements are true or false! Correct the false statements!

- Business ventures are enterprises at the same time.

FALSE, only business venture having a legal personality are considered enterprise.

- The fundamental objective of an enterprise is to make profits by satisfying consumer needs.

TRUE

- Achieving a profit is the condition of the increase of the enterprise value.

TRUE

- Profit goals and moral objectives are not compatible.

FALSE, because the “decision makers can rationally choose among morally acceptable alternatives.” There is evidence that there is a positive relationship between taking on social responsibility and financial performance (profitability.)

- In the 21st century, the role of human resources has strengthened among the resources of the enterprise.

TRUE

7. LESSON: THE PERFORMANCE OF NATIONAL ECONOMIES

Motto: … *"every development, progress, strength, value and luck has its cornerstone in the educated man."*

Széchenyi István: Credit (Hitel). Petrózai - Trattner. Pest. 1830.
Quote from page 178.

7.1 OBJECTIVES AND COMPETENCES

In lesson 7 we describe some basic information on macroeconomics, the concept of the national economy, and the most important correlations regarding the performance of these economies.

In the introduction we emphasise that the performance of the national economy is the fundamental determinant of the standard of living, therefore, the highest possible level of this performance is in the interest of every citizen. We attach utmost importance to clarifying how this particular performance can be measured. The most important indicator, the GDP is an everyday topic in the press and the media; however, most of the people do not know the key principles of its calculation. This gives way to misunderstandings in assessing performance. Furthermore, we point out the limits of the calculation, and we refer to more detailed performance evaluation techniques as well.

In the focal part of the lesson we will review what the progress of certain national economies depend on – in other words: why are certain countries poor, and why are others rich? Technical managers have to know that according to economists, both the good performance of the national economy and the dynamic progress depend greatly on management, often especially on technical management. Namely, the basic requirement for economic success is that the managers working in the economy are well aware of modern management methods and that they apply them in the widest possible range. Naturally, we will refer to the workforce and capital needs of development, and the financing possibilities of the use of these resources. To finish the topic, - striving for objectivity – we will briefly refer to the current debates on the state of the world economy and its perspectives.

We hope that through all these, the technical managers mastering the material of this lesson will be able to properly evaluate the significant national economic context of their activities, and to promote the development of our economy.

7.2 CURRICULUM

Graph 26: Mind map

7.2.1 The concept of the national economy and the assessment of its performance

We do not wish to give a hair-splitting explanation of the well-known concept of the national economy. We briefly record that this expression refers to the economy developed in the area of a given country (where the country is the area where a certain person or institution has independent power – especially political freedom), and immediately we turn to the substantive information.

The national income and its main indicators

After M. Porter (1990), it is generally accepted that the performance of national economies can be best characterised by the size of the gross domestic product (the total added value produced in a year in the area of a national economy) (Samuelson – Nordhaus 1993.) The most important indicator of this income is the **GDP** (Gross Domestic Product.)

- The added value is the sales revenue minus the value of the goods and services purchased. Thus the GDP in national economy total is the value of the gross output minus the productive consumption. For details see: 3.2.4.

The calculation of the GDP is the task of statistical offices. Generally, they create a double estimate (so-called GDP balance sheet.) On one side they add the added value – separated for different industries – produced by the economic actors, primarily the enterprises (to put it simply. the revenues minus the goods and services purchased.) Secondly, they calculate the value of the goods and services consumed by the population and the government or spent on investments. These two sums of the balance sheet must be the same (after the added value correction of the export-import difference and stock changes.)

What we have said about the GDP clearly signifies the importance of the indicator. After all, approximately two thirds of the GDP are used for private consumption, from which it follows that "**GDP/number of population" indicator is an important characteristic of the standard of living.**

- However, the view according to which the standard of living can be raised by raising wages in order to raise consumption is incorrect. The starting point of the calculation of the GDP (more precisely: the added value) is the revenue of the enterprises, and it is obvious that enterprises can only raise wages without the risk of bankruptcy if their revenues allow it.

At the same time, experts often warn about the limitations of the calculation of the GDP. The justification for this is indicated by the fact that the GDP is calculated in the currency of the given country (in Hungary in HUF), in the course of which the items realised in foreign currencies are also calculated at the official exchange rate and at the rate calculated with the consumer basket (purchasing power parity, PPP.) The value of the second is lower in Austria and much higher in Hungary than the first, that is, the margin of error of characterising the performance through the GDP is very significant.

2. *The value of the two different calculations of the GDP/capita, 2011, 1000 USD*

Calculation method	LU	NG	AT	DE	CZ	GR	HU	PL	US
Official exchange rate	114	97	50	44	20	26	14	13	48
PPP rate	87	57	41	39	25	26	21	21	44

LU: Luxembourg, NG: Norway, AT: Austria, DE: Germany, CZ: Czech Republic, GR: Greece, HU: Hungary, PL: Poland, US: USA

Source: IMD (2013), pages 312-313.

- The calculation is criticised, however, beacuse it also takes into account the reuslts of certain unnecessary, black, even illegal activities (Széchenyi published in 1830 on page 102 the pretence work when ditches were dug and then refilled, moonshine making, and even illegal drug production.)

Furthermore, it is a generally accepted view that when we want to make a more nuanced characterisation of the national economic performances, we need calculations beyond the GDP data. That is why the indicators below were created:

- GNI (gross national income) = GDP + foreign factor incomes of the actors of a given country – the factor incomes created in the given country by foreign actors
- GNDI (gross national disposable income) = GNI + transfers received from abroad (aid, gift, membership fee) – transfers paid abroad
- NDP (net domestic product) = GDP – amortisation
- NNI (net national income) = NDP +/- flowing factor incomes
- NNDI (net national disposable income) = NNI +/- transfers.

Certain authors recommend that we should use e.g.: the GNI indicator instead of the GDP to evaluate the performance of the Hungarian national economy. The author of this lesson, however, (without questioning that taking into account all of the indicators will make the analyses more nuanced) does not agree with replacement of the GDP. Firstly, because the values of all of the mentioned indicators of income differ equally depending on the exchange rate type used, as the GDP indicators. The differences between the values of the different indicators are comparably low (that is: the latter differences are within the margin of error.) On the other hand, very rich databases have been prepared – involving a lot of work – about the evolution of the GDP. Without these databases prepared for the other indicators, they are far from offering similarly rich possibilities for analysis.

As point 3.2.4. already referred to it, other approaches expect an increase not only in GDP/capita, but also in the *quality of life, the common good, and even happiness.* This is a wider requirement than economic results, this also requires the evaluation of such factors as for example, health, the cleanliness of the environment, culture, and freedom. However, the control of the fulfilment of the given expectations is the source of problems. Researchers of the topic have devised rich indicator systems for the measurements, e.g.: with the UN Human Development Indexes, they make experiments, in which – apart from the assessment of the GDP/capita calculated on purchasing power (standard of living) – they evaluate life expectancy at birth, the proportion of those participating in education, and the literacy skills of the adult population. However, their attempts have not produced really convincing results, yet.

National wealth

Some argue that (similarly to that of the enterprise) the performance of the national economy cannot be only characterised by the data of income; we must strive to assess the temporal changes in order to measure national wealth.

- The national wealth is the value of all of the assets owned by the given country.

In developed countries, statistics show the value (by owner group) of national wealth and its changes; these data are unfortunately not available in several Central European countries, including for example, Hungary. After the war, the inventory of the national economy used between the two world wars was terminated and it has not been reinstated since. That is why – maybe not by chance – we cannot even give approximate answers to questions regarding the effects of for

example, nationalisations, or privatisations on the value of the wealth (on the wealth of certain owner groups.) How much actual wealth growth did the major investments create, what are the sources of origin of certain assets, etc?

The concepts of growth and development and the methods used to measure them

Growth is a basic concept of modern economics. It is the change of the real value of gross domestic product (GDP) in a given region – which can also be negative (that is, the name of retrogression is development as well!)

(Economic) **development** (progress) is a more complex concept. In addition to the quantitative approach viewpoints of growth, its interpretation also takes into account the deliberations of qualitative development – such as sustainment, the possibilities of self-esteem and freedom, and the guarantees of sustainable (sustainable pace over a longer period of time) progress.

The definition also refers to the method of *measuring economic growth.* However, the quantification of the measurement of economic development interpreted in the above way has not been fully resolved yet. The UNDP (United Nations Development Programme) has published for example the annual so-called Human Development Reports for more than a decade. In it, it also publishes the HDI – Human Development Index – providing the opportunity to analyse economic progress in a more detailed way, than by using simple growth statistics. This indicator system can only approximately quantify certain important development criteria – for example, the changes in the level of self-esteem, freedom, etc.

3. *Ranking of examined countries according to the Human Development Index*

LU	NG	AT	DE	CZ	GR	HU	PL	US
24	1	18	8	26	28	33	34	4

Source: IMD (2012), page 461.

- Another problem with the definition of progress is the question of its sustainable nature. According to the definition of the UN World Commission on Environment and Development, “sustainable development is development which satisfies the needs of the present without jeopardizing the chances of future generations to satisfy thier own needs.” Sometimes this requirement is narrowed

down to “only” signify environmental protection, other times, it is also supplemented with further, sometimes obscure requirements (for example, the fight against poverty.)

The terminology is made even more complicated by the fact that the best known distinction between developed and developing countries is not (only) based on the above mentioned interpretation of growth. It is common usage to refer to developed countries as “northerners” and to the poorest developing countries as “southerners.” Although this classification is based on the GDP/capita indicator, it also takes into account several further (sometimes subjective, e.g.: cultural) deliberations.

- Nowadays, the best known “high-tech” products that carry economic progress forward can be found in the nuclear industry and electrotechnics, etc. As an example we can mention the small drones (unmanned aerial vehicles) delivering mail to French farms.

Picture 27: Postal delivery with the help of a drone

Source: index.hu (2013); photo: laposter.fr

Competitiveness

The research of the past decade pointed to the close relationships of economic development and competitiveness – referring to the close relationship of the two concepts.

According to the theory, **market competition takes place among the producers of a certain branch.** However, we must know that in the SME sector, the participants of the competition are not companies, but so-called value chains (groups of companies cooperating in the production of the same end products.) Furthermore, M. Porter also warns that **among potential competitors** – in addition to the producers in the branch – **we may not forget the suppliers and the customers, the newcomers to the branch, and the substitute goods.**

Competitiveness does not have a generally accepted definition, but there is agreement in that this concept must be interpreted differently in the case of enterprises, or larger geographical units (regions, national economies.)

- In the corporate sector, the most common indicators of competitiveness are the high market share and favourable profitability (as well as the significant enterprise value.) According to the theory of marketing, the main tool for improving competitiveness is improving the 4 P's (product, price, place, and promotion.) Empirical examinations of successful Central European enterprises (e.g.: Papanek, 2010) also suggest that at least in this region, the most important prerequisite for success is the good manager.

However, the competitiveness of the regions and national economies can be primarily attested (also according to M. Porter) by a high GDP/capita and especially its most important element, the well-being of the population. However, Porter's so-called "diamond model" draws up the set of actual factors in a more graphic way. It also emphasises the occasional key role of the following: /1/ corporate strategies, structure, rivalry, /2/ demand, /3/ factor conditions (that is, the resource supply), /4/ related industries, /5/ the government and /6/ chance.

In order to quantify the above outlined factor group, in the decade following the year 2000, certain institutions, such as the Swiss IMD and the World Bank also compiled rich systems of indicators. The IMD system takes into account 329 indicators classified into 4 groups. The results of the 2012 ranking of 59 countries are the following:

4. *IMD ranking of examined countries, 2012*

Indicator groups	LU	NG	AT	DE	CZ	GR	HU	PL	US
Economic strength	6	16	21	5	29	58	35	30	1
Government efficiency	16	6	33	19	30	58	51	36	22
Business efficiency	12	8	20	17	41	56	49	39	11
Infrastructure	23	9	16	7	30	34	35	36	1
Total	12	8	15	9	33	58	45	34	2

Source: IMD (2013), pages 50-51.

- We must realise that according to the examination, government efficiency is the biggest problem in a wide range of countries. In Central Europe, competitiveness is rather weak, which is explained by weak buiness efficiency (according to more detailed information: primairly by poor management.)

7.2.2 Factors affecting growth and development

The "sources" and "factors" of growth/development are the reasons which shape the directions, the pace and other specificities of economic progress. We can quote a wide variety of viewpoints from literature on these drivers.

The main factors determining economic dynamism

The early classic of economics, Adam Smith e.g.: considered the increase in the amount of *work* and land *(capital)* as the main motors of economic development. He also mentioned the expansion of the *division of labour.* He also considered an immeasurable factor, the *"invisible hand"* as an important source of progress. This is the effect of encouraging free enterprise, the development of competition and increasing production. At the beginning of the 20th century, J. Schumpeter complemented the previous list and marked *innovations* as the main drives of development. Later, M. Weber pointed to the importance of (protestant) *ethics* which evaluates work successes in a positive way, etc.

- Innovation is not the same as reasearch and development. Research is ... regularly performed creative work with the aim of *broadening* knowledge, including knowledge about man, culture and society ... However, innovation is the *usage* of new knowledge

(OECD, 2002). That is: the essence of research and development is the broadening of the knowledge base, while the essence of innovation is the actual application, the economic practice.

Adam Smith illustrated the affect of labour division on the development of technology with the example of needle production. He pointed out that if someone makes a needle only for his own purposes, it is a whole day's work (wire cutting, pointing, drilling holes for the fixing of the thread.) However, if someone specialises in the manufacture of needles, the time needed for the making of a needle can be reduced to only a few minutes by practicing and making a few simple tools. M. Ridley highlighted the affects of labour division on human relationships, and the complex affects of trade which made the exchange of goods produced by specialisation possible (among them: the affects helping in the spreading of innovations to large distances.) He referred to the fact, that according to the archaeological findings, commerce sent North Sea amber to the Mediterranean Sea already in the Stone Age, around 20,000 BC. In the 3rd millennium BC, the Sumerians traded briskly with the cities of the Indus Valley. Nowadays, the news of a new idea (supply) is delivered everywhere around the world in minutes via the Internet where there is solvent demand for the given topic. He also indicated that he believed that the division of labour thus established was the main source of economic progress.

The advocates of modern theories, e.g.: the so-called institutional economics agree with the importance of the above factors listed by the "classics" but emphasise the more effective effects of certain "non-material" factors. Present-day "development economics" attributes a significant role to knowledge, and especially the flow of knowledge (similarly to the Széchenyi István quote in the motto.) Acemoglu – Robinson (2012) highlighted the importance of quality economic policy – and especially receptive policy (offering the opportunity to all potential competitors.) However, Ridley (2012) returned to the principles of A. Smith and considers the division of labour, which makes specialisation possible and innovation as key elements. In Central European public life, under the influence of the earlier Soviet approach, the "vulgar-materialist" approach (only recognising "material" factors, i.e., recognising the effects of work and capital.) is still the most common.

The cyclical nature of progress

According to statistics, in the temporal changes of economic performances (such as the GDP) we can identify different term cycles (fluctuations, undulations, sometimes booms, sometimes economic

stagnation, other times crises.) According to research, we can differentiate several types of fluctuations based on their time scale (wavelength.) The knowledge of and the forecast of the fluctuation caused by the effects of these is often important for economic policy as well.

The long term “wave” is the 40-year so-called **Kondratiev wave.** We only know uncertain assumptions about the reasons of these cycles. According to one of the assumptions, the explanation may be found with the changing of the generations. There are certain age groups who are youngsters during economic crises and they get used to difficulties and the efforts to correct them, so when they constitute the work force, the economy booms. Their children, however, grow up when their parents are earning well.

The best known cycles can be identified in periods of 6-8-10 years; they are called **business cycles.** The crises forming during these cycles sometimes cause tremendous damage (bankruptcy wave, unemployment) occasionally triggering revolutions.

There are many theories on the causes of the business cycles. The cyclical nature of investments is an important explanation. E.g.: as a result of the multiplication effect they cause shock-like growth in demand, their completion, however, causes a rapid drop in demand. Undoubtedly, the reason of the crises may be the fluctuating intensity of exploitation affecting the solvent demand and especially the impoverishment of the population, and because of this, the narrowing of demand, etc.

- The multiplicator effect of invesments is that they increase the perforamnce of the national economy, the GDP and their influence is significantly higher than their volume. The value of the investment is also GDP but the investor spends much of the money he receives on wages, thus increasing the demand for consumer goods. The production of the goods sold in this way is also GDP. The producers also spend most of their money on wages, etc.

For example, the business cycles can also be identified in the Hungarian economy. After the change of regime, at the beginning of 1990s, the collapse of Comecon caused a great 20% drop in performance which was even bigger than that of 1929. Then, basically due to world economic processes a boom developed at the turn of the millennium and after 2008 a strong crisis emerged (resulting in approximately a 10% decline so far.)

The possibilities of supporting development

Economic development is usually the result of the innovative activities of enterprises or the "households." Most people do not dispute, however, that this activity can be supported by further institutions (research institutions, non-profit organisations, sectoral, regional associations, or even the government as well.)

However, the fundamental source of the conflicts of views is the question regarding what types of economic development measures are expedient to apply. The advocates of today's main stream theory (the monetarists) believe that nowadays economic development can be effectively assisted primarily with **competition-neutral tools** (that is, if we treat every group participating in the competition in the same way.) Others, – e. g.: the advocates of the New Széchenyi Plan – consider the use of selective tools desirable for a lot of goals. This means that some groups are favoured or preferred while others are punished.

- The classics listed the competition-neutral techniques of economic development and primarily included the demand-stimulating (or restraining) measures of state monetary, financial, social and foreign trade interventions, which we covered in lesson 10. These, of course, have been widely applied in the Hungarian economy as well.

Important elements of a "more modern" toolbox are *legal certainty* and *education.* We should also mention the fight against the black economy, because its insufficiency has caused serious damage recently in several European countries. **The effective domestic methods of constraining the black economy have not been developed until today.** Several Hungarian institutions tried e.g.: rigour in vain (municipalities, chambers of commerce and industry – and of course the government itself) in the trade of fuel, wine, red paprika, and tobacco. The measures have had little results maybe because they did not aim at the "big fish." Experts sometimes recommended the mitigation of charges, but this recommendation has not been considered yet.

The selective methods of economic development are even more varied. The preferred groups can be e.g.: some size groups of enterprises, certain **sectors,** certain **regions, other** groups.

In our time almost every self-respecting institution declares its intention to support the **SMEs (small and medium enterprises.)**

- An SME employs less than 250 employees, the value of its annual turnover and of its balance sheet toral do not exceed 250 thousand euros. It is not directly or indirectly owned by a large

enterprise, a municipality or the state to a higher extent than 25% - either based on capital or voting rights.

One explanation for the frequent insistence on the support for the SMEs is the change of the nature of successful enterprises. Until the middle of the 20th century, primarily the *large* enterprises (able to exploit the economies of scale) were the most successful, while in the past decades the so-called **gazelles,** the fast growing SMEs, started to play a determinative role in the increase of both employment and the GDP because as a result of the accelerated technical progress, the flexibility of the enterprises has greatly increased the chances of success, and here, SMEs have significant advantages. (Drucker 1985, Papanek 2010).

- Here we would like to indicate that in our chapter – similarly to international parlance – the words "enterprise and "entrepreneurship" are not synonyms. The **enterprise** iss an independent business organisation, while **entrepreneurship** is action – either the establishment of an enterprise, or innovation within the enterprise, e.g.: the market introduction of a new product. Only with the distinction between the two concept can we direct the spotlight to the fact that the Hungarian slogan of supporting "small businesses" actually signifies the support of enterprises and that there is no support for entrepreneurship in our economy at all.

The veracity of the declarations on SME support is also questioned by the fact that the appropriate methods of assistance are rather unsettled. A wide range of experts believe that the *most important* tools of encouraging entrepreneurship and promoting the development of gazelles are competition-neutral techniques. Among them, the restriction of unfair competition, and to this end, the elimination of monopolies has top priority. **Even more efficient assistance is the training of the workforce and the support for innovation.** Some selective methods, such as the training of (potential) managers of SMEs, the establishment of business incubators, helping the development of a **cluster** (enterprises of a region, working in the same profession), etc. can also be efficient.

Unfortunately, in European (and especially: Hungarian) economic development practice none of the above listed techniques can play a really significant role. However, some decision makers often experiment with tools preferring certain smaller groups of SMEs – and usually with little social success.

Economic developers often strive to support **branches** with R & D, or by offering "industrial" zones, etc.

Statistics dispose of the sectoral distribution of the economy. **The main branches of the national economy are agriculture, industry and services.**

According to many experts, the determination of branch preferences is the administrative designation of the "winners" and the "losers" thus; this practice is incorrect and disrupts competition. However, there are exceptions. Most of the Hungarian experts agree with the support of e.g.: newly appearing branches and the three large "public" sectors, education, healthcare and public administration.

In our time, the ground for economic development is often the development of **regions.**

- The designation of the regions was different in the USA and in Europe. In the USA they tried to designate the regions in a way that they correspond to areas forming an economic "unit" so the borders of the regions were drawn where the inter-region workforce flow was smallest. All of the regions created in this way have a population of at least 3 million people and a **centre** develops everywhere, that is, a city, where most of the financial, higher educational and administrative institutions have concentrated. Around the centre there is the **periphery** where the agricultural product are produced to satisfy the needs in the region. In the EU, however, the content and the structure of the regions are not that clear. Their borders have been drawn by taking into account existing administrative units (in Hungary, e.g.: 3-3 counties were combined.) Economically their areas are not unified and often they lack a definite centre.

  It can be concluded that the "production" structure of the economic regions is mostly different, and **certain regions have specialised in the branches corresponding to their aptitudes.**

According to economic research, **region development is mostly efficient where they are trying to develop economically uniform regions.** It is also desirable that region development does not take on certain activities of the business sphere, but that it increases the region's attractiveness, to strengthen the weak links of business environment (building roads, railways, and utilities, developing education and business services, rolling back bureaucracy, intensifying environmental protection.) Another prerequisite for the success of the efforts is that a significant proportion of the resources should develop the centre and within the centre, it should focus on the modernisation of the regional (service) institutions. It should **foster the specialisation of the region – that is, the development of branches adequate for the region's aptitudes,**

especially it should promote the (further) training of the potential workforce and innovation. It is advantageous if development focuses significant efforts on the building of clusters, because innovation spreads faster if the companies are close together, so the cluster becomes the key in the modernisation of the sector.

Hungarian regional development does not follow the theoretical recommendations. In the past two decades several Hungarian municipalities have achieved successes by the mitigation of local taxes thus creating incentives, with the establishment of industrial zones. However, in general, the areas appointed for development are not economic units, but administrative regions which therewithal try to create similar economic structures (e.g.: the development of tourism.) They primarily call for obtaining selective grants.

Many **other** types of preferences are known. There are e.g. certain teachers who focus all their strength to educate youth for the better future of a certain country, religion, etc. Business angels, the venture companies undertake the financial, informational, etc. assistance of promising business opportunities.

The limits of progress

At the same time, it is well known that economic progress is far from being continuous; moreover, sometimes even significant development efforts do not bring about progress. For example, around 1000 AD, China was the most promising economy of the world, in the light of which, it is expressively surprising that in the following centuries a remote “peninsula,” Europe and within this one, an underdeveloped small island, England became the ruler of the world. Nowadays, it is difficult to explain how it is possible that China, one of the most backward countries is buying several corporations of the USA, the world’s leading economic power, and its main innovation centre.

There are also several theories trying to explain what constitutes the barriers to progress and the reasons for the differences in the rate of development. The following examples illustrate the most important ones.

- In the USA, at the turn of the 19th and 20th centuries, most of the industry settled into the so-called North-Eastern parallelogram, e.g.: in Chicago and they tried in vain several times to industrialise the Western Coast. Research has shown however, that the main reason for the failures is the low population density of the Western Coast, e.g.: the consequent *insufficient labour supply.*

- In the 1960s the Hungarian government developed tractor production in a special ten-year development programme and immediately afterwards they shut down production. The minimum scale of economic production was indeed higher than the entire Hungarian tractor *demand.*
- Many experts and publications (e.g.: Acemoglu, D. – Robinson, J. A. (2012) claim that *power,* afraid of every type of change is the preventer of – sometimes very promising – developments. So the conservative emperor, and the irresponsible bureaucrats, the corrupt courtiers are responsible for the slowing down of the Chinese economy around 1000. The present problems of the USA can be traced back to similar reasons: the protection of world power in excess of budgetary revenues, the policies accepting indebtedness for the sake of power.

7.2.3 Longer term trends of the development of the world economy

Today, the situation of economies and their short term perspectives are usually classified on a short time horizon, with the examination of the GDP and the balance of the economy. Some of the typical results of such examinations are presented in point 12.2.3. Longer term analyses are rare, and authors sometimes publish contradicting views on the trends of the development of the world economy. Catastrophic forecasts for example, are very fashionable about the destruction of Earth because of a collision with an asteroid, or because of global warming, etc. We do not wish to undertake the assessment of these views so far from economic deliberations. However, in the following, we will refer to M. Ridley's (the world famous economic historian) opinion – to illustrate the methods for exploring possible visions of the future. The author regards the future of mankind with some optimism (invoking the improving standard of living in the past millennium and the improvement in magnitude in the last century – e.g.: GDP/capita.)

- M. Ridley (2012) emphasises that although in the past decades several very pessimistic scenarios became well-known about the future of the world economy, e.g.: referring to wars fought with nuclear weapons and then the depletion of fossil energy (especially oil), however, the predicted catastrophes have not happened yet. This increases the likelihood that humanity will find a way to avert the catastrophy variants related to population explosion or the warming climate or a possibility to survive the unavoidable problems. However, of course, we wish to

complement the opinion of the author quoted because similar "adjustments" to earlier periods in the history of Earth brought about dramatic events, sometimes the extinction of a large proportion of species and the occurrence of similar events in the future cannot be ruled out.

In the topic of the catastrophe variants, the most serious economic questions are raised by the future of the North-South poles of the world economy. These visions are widely disputed by political scientists. Demographic forecasts indicate the aging of the "northern" peoples and the rapid growth of "southern" populations and promise migrations from the South towards the North. However, there are no clear ideas for the expedient methods for the treatment of the growing differences in the standard of living. This is why the northerners try with all their strength to stop the (illegal) immigration of southerners unsuccessfully. The question is how long they can keep this up.

The so-called **European paradox** (paradoxon /Latin/: contradict-tion) formulates the gap in competitiveness which became obvious in the EU in the 1990s. It states that, although the performance of European scientists is indisputable, (e.g.: the number of quality publications is high) this is not reflected in the economic performance of the EU and in the most important index of the national economy, the GDP. The practical implementation of scientific results is disputed, which is also attested by the low numbers of patents. So the future of Europe is uncertain.

It is also difficult to forecast the future of the USA. Today, this economy is (still) competitive, but its growing indebtedness worsens its perspectives day by day.

We cannot forecast which countries will be the great powers of the future – or if humanity survives the challenges at all, and if it will have states.

7.3 SUMMARY, QUESTIONS

7.3.1 Summary

As a starting point, the chapter indicates the quantitative (statistical) indicator of economic growth and the complex nature of development including qualitative features. Later, the lesson, referring to the one-sidedness of domestic public thinking, highlights the importance of the "institutional" sources of economic growth (the division of labour, specialisation, and innovation.) Furthermore, it emphasises that among the several techniques designed to support progress, primarily the

competition-neutral ones are the most effective (education, development of the business environment, and the suppression of bureaucracy.)

In order to demonstrate economic development, and the empirical examination methods of progress, following the theoretical topics, we also characterised international and the Hungarian economic performance with certain data.

7.3.2 Self-check questions

- How does KSH calculate the GDP?
- How can we evaluate the Hungarian GDP/capita in international comparison?
- In your opinion, what are the main factors determining economic dynamism (growth)?
- How do we interpret the concepts of growth and development today? Which questions does this distinction highlight as important for the developers of the economy?
- What kind of data would you use to characterise the competitiveness of enterprises and national economies?
- Which two factors can help us explain the level of the Hungarian GDP/capita? In your opinion, what are the main effects influencing them?
- According to your estimate, how large are the corporate administrative burdens in our economy? In your opinion, where would it be possible to reduce them?
- What do you think of the selective tools of economic policy and their effectiveness?
- How can we promote enterprises and the development of SMEs?
- What is a cluster and why is it important in a modern economy?
- What is the essence of the North – South difference? Outline some of the scripts for the future development of the difference!
- What are the Maastricht criteria? How are we doing in their fulfilment?
- What is a double lag? And what is the European paradox?

7.3.3 Practice tests

- Which of the following indicators may best characterise the performance of national economies? population – gross output –

GDP – GNI/capita – export volume – total population consumption – other

? What does statistics calculate when it defines the GDP? the total added value produced on the area of the national economy

? Which of the following is added value? total revenues reduced by the price of the purchased products and services – total EBIT – the performance of the subcontractors – other

? How can we define the GDP from a national economy level viewpoint? the value of the gross output reduced by productive consumption

? Which of the following items appear on the two sides of the GDP balance sheet? budgetary revenues – total corporate revenues – total profit – total added value – budgetary costs – total corporate cost – tax and interest rate costs – consumption plus the value of investments – other

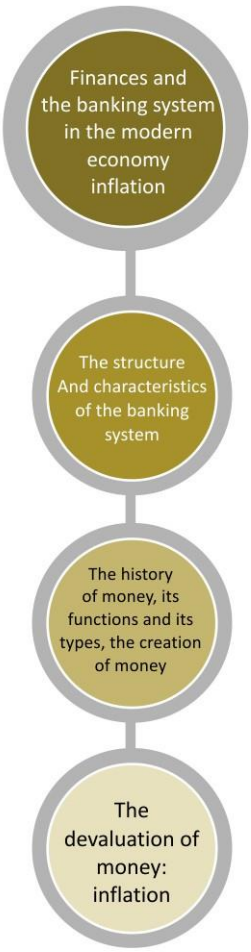
8. LESSON: FINANCES AND THE BANKING SYSTEM IN THE MODERN ECONOMY, INFLATION

8.1 OBJECTIVES AND COMPETENCES

The objective of the lesson is to clarify the basic financial relationships characteristic of the national economy, and to show how the decline in purchasing power appears in everyday practice, what economic consequences it brings about and how we can handle them.

The possession of the knowledge presented here will help us navigate through the world of the banking system and money; we will better understand the macroeconomic role of the central bank, and the national economic effects of the monetary tools used by the central bank. In addition, it will also become clear that the increase in the price level will modify the behaviour of the economic actors, and in turn it will cause certain macroeconomic consequences. We will also understand what kinds of tools are applied in response and which ones are beneficial for the national economy.

8.2 CURRICULUM

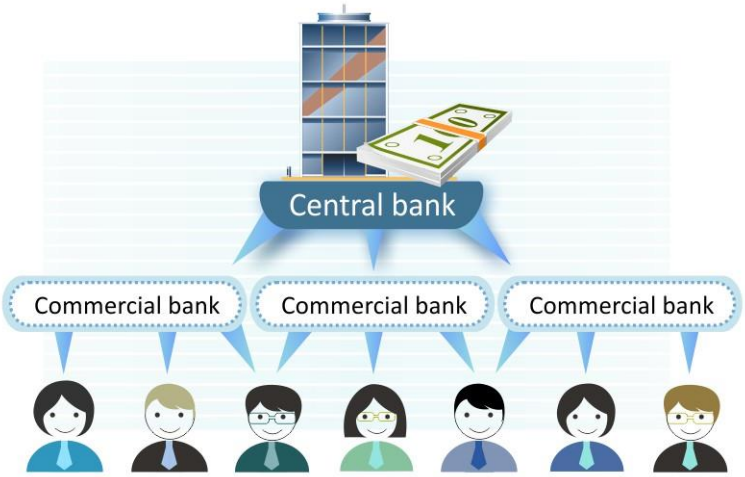


Graph 28: Mind map

8.2.1 Finances and the banking system

The banking system

The modern banking system is a two-tier system. The central bank stands on the upper level, while the commercial banks are located underneath.



Graph 29: The structure of the banking system

Characteristics of the central bank:

- Its primary purpose is to achieve and maintain price stability.
- It guards the exchange rate of the national currency.
- It has the monopoly on issuing banknotes and coins. In addition to cash, it can also create account money; this is the central bank account money.
- It adjusts the volume of money in circulation.
- It is the state bank, that is, it manages the state's revenues, and it grants its payments. It does not provide the state with a loan.
- It is the bank of the commercial banks, it provides them with loans (for which it collects refinancing interests from the commercial banks), and it collects deposits from them (for which it pays central bank base rate.)
- The central bank prescribes mandatory reserves for the commercial banks. The *mandatory reserve* is the prescribed (by the central bank) amount of mandatory central bank money for commercial banks; its size is determined as a percentage of the commercial bank's deposit portfolio; its value is expressed in the mandatory reserve rate.

The *mandatory reserve rate (t)* is the figure which shows what percentage of the deposits held by the commercial banks they have to reserve at the central bank in the form of central bank money.

The objectives of creating mandatory reserves:

- Ensuring that the payments among commercial banks are free from disruptions. Among commercial banks, all transfers are done in central bank money.
- The regulation of the money supply, that is, the regulation of the M1 money in circulation.
- The protection of the depositors of commercial banks. This role of the mandatory reserve rate is not that important, this function is primarily performed by the deposit insurance fund.

You can learn more about the practical manifestation of the monetary policy controlled by the central bank on this professional page:

15. http://www.economicsonline.co.uk/Managing_the_economy/Monetary-policy.html

Characteristics of commercial banks:

- They collect deposits from the actors of the economy (except for the state) and provide them with loans.
- Manages the accounts of the actors of the economy.
- Commercial banks are also able to create money (because they manage the current accounts), but this money can only be account money (commercial bank account money.) Its characteristic is that it is only suitable for payment within the customer base, that is, in the case when the two actors of the financial transaction both have an account at the same commercial bank. In inter-bank transactions, only central bank money can be used.

Money

Money is a modern medium of exchange, a standard unit, which reflects the value of goods, the claims and liabilities.

The banking system creates money out of nothing through a lending operation; it has no intrinsic value, that is, why it is liable to inflation (depreciation.)

The short history of the development of money

Money appeared when the simple exchange of goods failed in our history. This happened during the time of the separation of agriculture and crafts. Money has appeared in very diverse form throughout history, it can be hard as a rock, or light as a feather. In certain tribal societies,

they used objects that they attributed value to: jewellery, tools, food products (salt and grain), fabrics; and when they paid, they counted these objects. Even in the tribal societies strict rules guarded the value of money and payments; among others, they used money to pay for redemption upon marriage, compensation or penalties.

It is noteworthy that the initial money was suitable for consumption literally: farmers used grain, pastoral people used cattle! It is interesting to mention the phenomenon that the word “money” contains references to live animals in several languages, such as to cattle. For example, the Latin name for money: pecunia is very close to the word pecus, which means beast. In our language the expression “golden cattle” lived long, indicating that shortly after the conquest of Hungary, the four-legged animal functioned as money. The commodity money had advantages but most importantly serious disadvantages. It cannot be divided, it is difficult to move, it is perishable, its quality is not permanent, etc.

In order for one product to emerge from the world of goods and function as money, two conditions are necessary:

- the goods in question should have the necessary characteristics;
- some kind of social agreement must be created as to which goods to accept as money.

After these, we can easily prove that it is not a coincidence that by the 19th century, because of the beneficial properties, commodity money was almost exclusively limited to metals, precious metals, especially gold. Precious metals are rare enough and sought after so that there were no doubts about their durability, transportability and divisibility.

Gold emerged from among the other precious metals because it is rare and difficult to forge. Most of the forms of commodity money possessed some intrinsic value at some time, they were used for themselves, and that is, they possessed internal utility.

The confidence in the gold money was either strengthened or weakened by the confidence in the person with the right to mint coins – usually, the monarch. The monarch (the state) living with the monopoly right to mint coins provided the profit of the chamber for himself in order to cover his expenses. Initially, he simply reduced the amount of money in circulation, that is, he minted less money than he collected. Later he acquired the same income by worsening the money: he minted less precious metal in the coins than necessary but made it obligatory to accept the coins at their original value. The coins with a lesser gold content, that is, of lesser value were available along with the original full value coins, so the lesser value coins represented the full value.

From here it was only a small step until the emergence of money substitutes. The essence of the money substitute is that it is accepted as

money. The acceptance may be strengthened by law, but its base is social public agreement.

Two types of money substitutes existed side by side for a long time:

- the banknote, which had gold backing (ore backing) represented metal money, coins;
- the state bill, which was purely fiduciary money, it did not have gold backing; it was only covered by the revenues of the state.

The two types of money substitutes gradually merged together. Even though the fiduciary nature of the money was becoming more and more important, the ore backing of the money substitutes was considered important for a long time. The convertibility of paper money to gold was discontinued in the 1920s for private people, and in the 70s it completely ceased to exist. There was no connection between money and gold (something with intrinsic value) any more.

Money without intrinsic value appeared. The fact that we accept the intrinsically worthless piece of paper is based on social public agreement.

The functions and types of money

The functions of money:

- *Settling tool function:* it measures and expresses the value of goods, the claims and the liabilities, thus helping the economic actors' orientation in the economy.
- *Medium of exchange function:* money mediates the movement of goods during purchases.
- *Payment tool function:* this occurs when the cash flow and the movement of goods are separated in time, for example, when we buy something on credit or we pay taxes to the state.
- *Storing tool function:* money is a means of keeping wealth.
- *International or world money function:* the currency of certain nations functions as money in international trade (e.g.: USD; EUR)

Types of money according to liquidity (the liquidity of an asset depends on how fast and with what kind of losses it can be exchanged for another asset):

- M1 money: cash (banknote and coin) and the current account money (money disposable on the bank card),
- M2 money: M1 money and term deposits,
- M3 money: M2 money and the securities

Liquidity decreases from M1 towards M3.

Types of money according to their form of appearance:

- Cash: money appearing in its physical for, that is, the banknote and the coin. Cash can only issued by the central bank.
- Account money: this only appears on the account, so it does not appear in its physical form. Account money can be created by the central bank (this is the central bank account money) or by commercial banks (this is the commercial bank account money.) The money created by the commercial banks can only be used for payments within the bank, that is, in only that case when both the buyer and the seller have accounts at the same bank.

As we have already mentioned, modern money is created in the banking system through a lending operation out of nothing. Because of this, when we discuss money, we also have to talk about the structure and characteristics of the banking system as well.

Creatng money

The amount of money that can be created by the banking system is determined by the mandatory reserve rate and through this the size of the money creation multiplier.

The money creation multiplier is the number which shows what factor of their central bank money reserves commercial banks can create in the form of commercial bank account money. Its formula is: $\frac{1}{t}$

The simplified process of money creation is illustrated by the following example:

Initial state:

- In the given economy there is a central bank, one commercial bank and two enterprises (“A” and “B”).
- Both enterprises have current accounts at the commercial bank.
- At the commercial bank there is a deposit of one banknote with the value of 1000 money units. There are no other deposits in the bank.
- The mandatory reserve rate is 20%.

Enterprise “A” would like to purchase goods with the value of 4000 money units from enterprise “B” and for this reason, it asks the bank for a

loan of 4000 money units. The question is: is the bank able to satisfy the credit needs of enterprise “A”?

Since the deposit portfolio of the commercial bank is 1000 money units in central bank money, and the mandatory reserve rate is 20%, the commercial bank has to reserve 200 money units at the central bank, so its free central bank money reserve is 800 money units. Based on this the commercial bank can create

$$800 * \frac{1}{0{,}2} = 4000$$

money units which it loans to enterprise “A” which transfers it to enterprise “B” as the offset of the goods purchased. As the final result of the process, the 4000 money units appear as the deposit of enterprise “B” at the commercial bank. After all this the total deposits at the commercial bank amount to 5000 money units. Based on this, and considering the mandatory reserve rate of 20%, it must reserve 1000 money units in central bank money. The commercial bank has exactly 1000 money units of central bank money. Based on the above, in the present circumstances, the commercial bank can only create 4000 money units of account money, not more. With this money, the actors of the economy – in the present example, enterprises “A” and “B” – can pay each other through money transfers.

The tools of the regulation of the amount of money in circulation:

- Changes in the mandatory reserve rate: in the case of the increasing of the reserve rate the amount of money in circulation will decrease, because the commercial banks have to reserve a higher proportion of the money deposited with them in the form of central bank money, so their free reserves decrease. Because of this they will only be able to multiply less money and place it in the economy in the form of loans. Besides, the value of the money creation multiplier also decreases which further decreases the amount of money in circulation. Thus, in the present case the commercial banks will only be able to create less money and multiply it fewer times.
- Refinancing rate change: in the case of an increase in the interest rate, the amount of money in circulation decreases, because the commercial banks will get less central bank money to place it as loans in the economy after multiplication.

- Open market operations: in this case the central bank sells or buys securities. If it sells securities the amount of money in circulation decreases, because the commercial banks pay for the securities with their free central bank money reserves, so they will only be able to multiply less central bank money. On the other hand, not only the commercial banks can buy the securities sold by the central bank, but also other actors of the economy (households and enterprises) which means that the amount of money in circulation directly decreases.

8.2.2 Inflation

Inflation is the regular decrease in the purchasing power of money, which usually manifests by a sustained increase of the price level. If inflation only appeared in the increase of the price level, the problem could be easily solved by the freezing of prices. In this case, however, the decrease in value would manifest by product shortages. The rate of inflation is determined as a percentage of the price level of the previous period (usually a year earlier).

You can read more about the practical manifestation of the measurement of inflation at the following address:

16. http://www.economicsonline.co.uk/Managing_the_economy/Measuring_inflation.html

Types of inflation

- Based on its rate
  - Creeping or slow inflation: from 0% to 9%, it is usually a necessary corollary of economic growth; it is manageable, so it does not cause serious problems.
  - Galloping inflation: from 10% to 99%, it increases economic uncertainty, so it runs counter to economic growth.
  - Hyperinflation: above 100%, it disrupts the economy.

In the case of small rate inflation the economic actors invest their money in productive assets, in order to make up for the money lost through its loss of value. This may cause the increase of the performance of the economy.

In case of high rate inflation the economic performance decreases because the economic actors invest their money in assets of lasting value (gold, paintings, etc.)

- Based on prognostibility:
  - Foreseeable inflation: since the economic actors can prepare for it, it causes less of a problem.

  - Unforeseen inflation: the economic actors cannot count with them in advance, so those who jeep their wealth in money will suffer from the loss of value, those who have it in real assets (e.g.: gold, property, paintings, etc.) will see asset growth.
- Based on their appearance in prices:
  - Balanced inflation: the prices of the products increase in nearly equal proportions.
  - Unbalanced inflation: the prices of the products increase in different proportions. It causes distortions in the structure of the economy and the income relationships, because in the industries where prices are increasing faster, the producers become richer while in other industries, the produces become relatively poorer.

Winners and losers of inflations

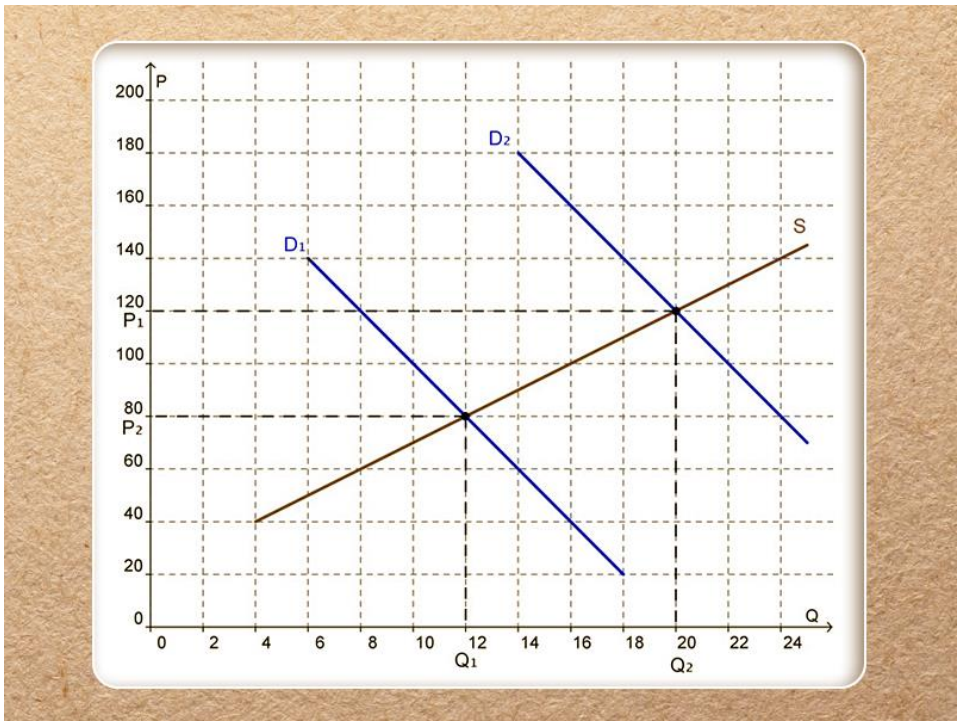
Because inflation means the increase in the prices of production, maintenance and livelihood, every economic actor suffers losses. In the case of fixed interest rates the lenders lose because they get back their loans in money which has lost some of its value. The owners of fixed interest financial investments also lose, just like the employees and people living on allowances or benefits, the retired, because wages, allowances and pensions generally increase at a slower rate than that of inflation.

The owners of real assets win and debtors also win in case the interest of the loan is fixed.

Basic types of inflation and its reasons

5. Demand pull inflation

The increase in demand causes the increase of the price level (equilibrium price) when the supply in constant, independent of the price.



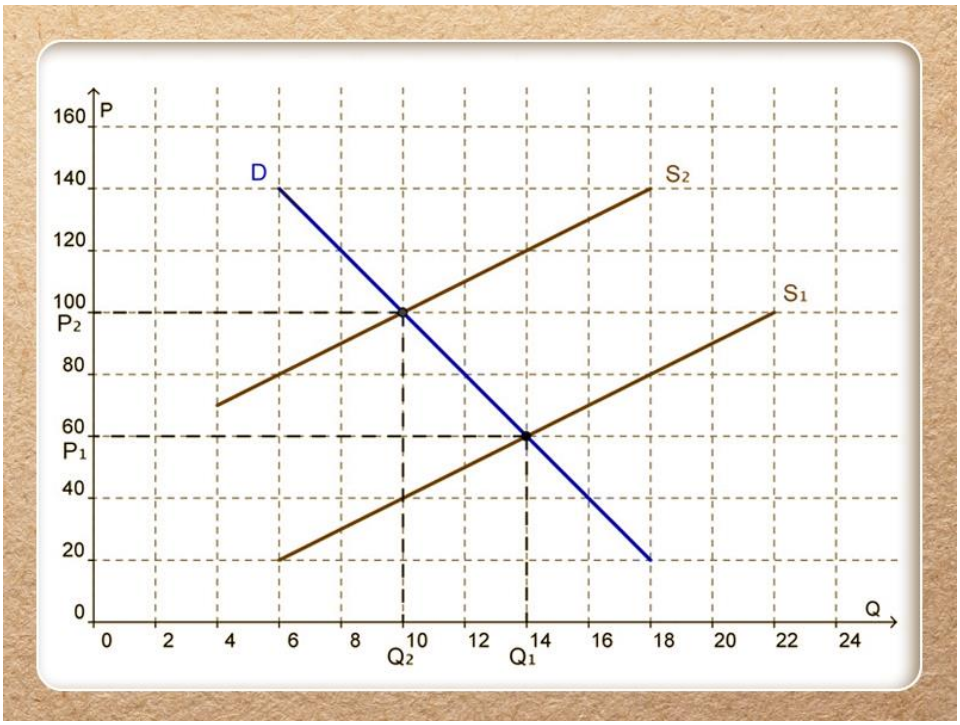
Graph 30: Demand pull inflation

Reasons:

- Because of the inflation the economic actors bring their purchases forward, so autonomous demand elements (C; I; G) increase.
- If the central bank badly regulates money production and it creates too much money, the economic actors have bigger incomes and this causes growing demand.
- In the case of the devaluation of the national currency export becomes cheaper, so the foreign demand grows for these products.

6. Cost push (supply) inflation

The decrease of supply – and the same amount of products sold at a higher price – with a constant demand independent of the price causes the increase of the price level (equilibrium price.)



Graph 31: Cost push inflation

Reasons:

- The input price increases so the costs increase and with higher costs the enterprises sell the same amount of products at a higher price.
- After the devaluation of the currency the price of imported commodities increases so the costs increase which brings about the decrease of supply. The devaluation of the currency also causes the increase of prices in relation to demand, because if the expansion of production is unable to follow the growing foreign demand, the internal product base (internal supply) decreases, which leads to the increase of the price level.
- The trade unions obtain a rise in wages, so the costs grow, so prices also grow, another wage-war, another price-wage spiral.

You can learn more about the relationship of unemployment and inflation at the following address:

17. http://www.economicsonline.co.uk/Global_economics/Phillips_curve.html

Anti-inflation tools

- With the decrease of money supply (refinancing interest rate raise, central bank interest rate raise, mandatory reserve rate raise) the amount of money owned by the economic actors decreases which leads to the moderation of inflation. Its disadvantage is that the performance of the economy falls back.
- With tax cuts and subsidies given to enterprises, the supply can be expanded. Its disadvantage is that the budgetary incomes decrease which may cause a deficit.

You can learn more about inflation at the following address:

18. http://www.economicsonline.co.uk/Global_economics/Inflation.html

You can learn about processes contrary to inflation on the following professional page:

19. http://www.economicsonline.co.uk/Managing_the_economy/Inflation_and_deflation.html

8.3 SUMMARY, QUESTIONS

8.3.1 Summary

In this lesson we learnt about the national economic correlations which determine financial processes and about the economic actors who have an effect on the above mentioned processes, and they have significant tools in order to moderate the value loss of money. Furthermore, we clarified the behaviour of rational economic actors in case of the value loss of the currency, and the economic consequences and central bank tools, which become important in this case.

8.3.2 Self-check questions

- Describe the characteristics of the central bank!
- What is inflation and how can we determine its size?
- Describe and explain the reasons for the “demand pull” and the “cost push” inflation!
- Describe the anti-inflation tools and their effects!
- Describe the tools and effects of the regulation of the amount of money in circulation!

8.3.3 Practice tests

? In case of immediate payment for a product or service, money:
- functions as a payment tool
- functions as a medium of exchange
- functions as a storing tool
- does not have any of the above functions

? M2 money:
- only includes term deposits
- only includes demand deposits and term deposits
- only includes cash, demand deposits, and term deposits
- only includes term deposits and securities

? M1 money:
- is the most liquid category of money
- is the least liquid category of money
- is the only tool that functions as a payment tool
- is the only tool that functions as a storing tool

? The central bank:
- can only create banknotes
- can only create coins
- can only create account money
- can create all of the above mentioned forms of money

? Commercial banks:
- are able to create money, because the central bank permitted them to print banknotes
- are able to create money, but only coins
- are able to create money, because they manage current accounts
- are unable to create money

9. LESSON: LABOUR MARKET – UNEMPLOYMENT

9.1 OBJECTIVES AND COMPETENCES

Labour management was always important in every society and in our time it has also become a key question of economies especially because of the increased importance of the knowledge of the work force. Therefore, we will discuss this topic in detail in this lesson. In the introduction we clarify the statistical definitions of the employed, the unemployed, and the inactive. Then we will discuss the most important tasks of corporate workforce management, performance measurement and incentive, the workforce development, hiring and laying off in detail. Furthermore, we will discuss the macroeconomic problems of labour shortage and unemployment and the ways of their treatment by the government. Finally, we will comment on the labour market situation of catching-up Central European economies and its main problems.

We strongly recommend Central European technical managers to learn what is ascertained in this chapter. In this region, inefficiencies are especially common because HR management does not use modern and effective methods designed to support its activities. Therefore, local managers in their work will often need to improve the effectiveness of their employees using their own knowledge.

9.2 CURRICULUM

Graph 32: Mind map

9.2.1 Labour demand and supply

Macroeconomic introduction

Labour demand and supply are basic concepts of the labour market. According to certain macroeconomic viewpoints, workforce (in other words: HR, human resource) – interpreting its market supply widely – is the population of an area able to work, and in its narrow sense, the proportion of the population who has had a job, or is seeking employment.

- European statistcis usually consider people between the ages 15-65 to be able to work (while in the USA this age limit extends to 15-74.) The above supply in its narrow sense is the so-called active population, which divides into two groups: the employed and the unemployed. With some simplification, **those people are employed who worked at least *an hour* during the week of the survey – either legally or illegally,** or did not work, but had a workplace and they were away on leave or they were off sick, etc. Those people who did not work and did not have a job, **but *they were looking for a job*** are **unemployed.** The employed ***and*** **the unemployed** are called the active, and those who are not employed and not looking for a job are called **inactive.**

Naturally, macroeconomics is also aware of the fact that employers do not look for employees in general, but for a specific task. Thus, we can only consider employees with the sufficient competences (skills and abilities) for the given task to be potential workforce. Therefore, statistics usually provide data concerning the distribution of working-age people based on education and vocational qualifications, etc. as well. Labour demand does not have a definition and measurement methods comparable in precision to the above. The most common view is that this demand can be determined (obviously only approximately) by taking into account the people employed by institutions employing workforce and vacant posts on the other hand. However, statistics of the above are rare, and it has further problems as well: it does not take into account the demands of the black economy. So, we can obtain often more reliable information from the opinions of experts and press releases concerning unmet labour demand.

The tasks of corporate HR management

The tasks of corporate HR management are complex; they go far beyond the administrative tasks of the previously known personnel work; the tasks have multiplied parallel with economic development.

- The modern managerial principles of human resources (HR) were first defined by F.W. Taylor; in his views, very participant of the economy is a homo oeconomicus (that is, he adjusts his performance to his remuneration), the manager knows everything, it is the task of the workers to carry out the manager's instructions. The main task of workforce management is the designation of the tasks on a more objevtive (technical) basis and monitoring implementation. These principles, however, were also refined by E. Mayo. He emphatically called attention to several further – human – factors influencing the behaviour of people and their groups.

Nowadays, the decisions of HR work and their validation have generally become the key questions of strategies. Fombrun, Tichy and Devanna **classified the tasks of HR management into four groups** in their so-called "hard" (similar to that of Taylor) or **Michigan model:** /1/ *hiring* workforce, /2/ regular *measurement* of performance, /3/ performance *incentives* and /4/ the increasingly important workforce development. The complementation of the above listed elements is also widespread. /5/ Many (e.g.: Beer, Spector and Lawrence in their so-called "soft" **Harvard model**) consider it important to establish the *commitment* of the workforce, that is, the employees should feel that they are treated well, and that they work on a "team" with their co-workers, and in order to achieve this e.g.: the management should make it possible for the employees to *participate* in the decisions (taking their opinion into account.) Furthermore, /6/ it is the special task of the HR management to establish the ethical nature of corporate activities – in the case of large corporations, the compilation of the *code of ethics* as well. There are several reasons /7/ e.g.: (peaceful) *quitting* because of retirement.

During the overview of the above listed tasks – assuming that the details are known – we have to mention a preparatory, foundation type activity. In the case of larger enterprises, this type of task is the recording of the *job descriptions.* In the case of smaller enterprises it is unnecessary because the boss can flexibly decide on what kind of tasks to give to whom. However, in the case of the larger enterprises, it is expedient to record job descriptions which include the employee's necessary qualifications for certain posts, what their tasks are, what are the performance requirements and what they are responsible for.

- The compilation of these descriptions is often responsible work creating a multi-purpose information base (although in many economies only formal significance is attributed to it.) We can use several different databases for their foundation: e.g.: observing employees in their job (recording the working day even), asking the employees, asking them to fill in a questionnaire, etc. In more dtails, see, e.g.: Elbert, N.F.'s chapter in the work by Farkas – Karoliny – Poór (1997.)

In the following, we will turn to the elements of the above outlined toolbox (but we will only deal with recruitment and dismissal in the next point.)

The classical method of measuring performance (e.g.: it can be traced back to the activities of Taylor) is the establishment of norms and the comparison of the performance of the employees to these norms. It is applied in the case of employees (mostly blue collar workers) whose performance can be easily quantified. However, the performance of people doing more complex work (especially: managerial work) can only be assessed by taking into account many-sided viewpoints. In such cases, the starting point of the evaluation is provided by what is recorded in the job description. During the evaluation, rating scale (e.g.: high, medium, low) classifications or written evaluations can be done.

A wide variety of techniques has emerged for incentives (remuneration.) The most important one is the determination of the wages and the regular payment, but we may include here the rewards, praise or criticism, and financial penalties – as well as the specific tools of the soft model.

- The well-known requirements of wages are the "competitive wages" principle and the "equal pay for equal work" slogan. In both subjects a nuanced approach is necessary because **when the wages are determined, the employer must take into account the competences required from the employee, the performance provided and the responsibilities to be taken.** The competitiveness of the wages is rather obscure in its content, so it is often disputed. In order to correctly assess it, the companies must continually monitor the wages emerged on the labour market. The equalisation of the wages in the case of employees doing approximately the same work is simpler in the case of performance pay (e.g.: in the case of the so-called piece wages which is in proportion with the quantity produced by the employee.) In the time wages system (e.g.: hourly wages or monthly wages) the equlaisation is mostly difficult even if the

employer relies on job decsriptions and accomplished performance measurmenets.

The incentive power of wages can be ruther enhanced by rewards and other benefits, an, if necessary, by withdrawing rewards (fining.)

Praise and *criticis* complements financial rewards and it often becomes very important. We should also note that **the most important incentive of the non-financial toolbox,** is "team building" and ***the creation of*** **training and** ***advancment opportunities*** – as well as the dismissal of those who do not meet the requirements.

In connection with the question of incentives we have to point out one of the traditional problems of Central European economies, the employees' dissatisfaction with their workplace. It strongly impairs the performance of these economies that – according to certain research – a large proportion of the employees (possibly a greater part) is dissatisfied with the supply of the labour market, and although they have jobs, they wish to leave the country and they keep looking for another job, etc. This problem is a clear sign of poor HR work on the part of the responsible managers, especially: they neglect the soft methods or they apply it incorrectly (instead of building a team, they create factions.)

The *development* of the workforce is maybe the most demanding task of the HR work. In workplaces requiring considerable knowledge, e.g.: the training of new employees to operate CNC machines (the description of the work tasks) is also a professional peak performance. In many jobs, a similarly difficult task is the periodical further professional training necessitated by "technical" progress. Therefore, large companies often maintain their own educational institutions. In other places, the companies enrol their employees at schools. Also, competence development trainings are spreading. It is also an effective technique applied in many workplaces when the company supports the employees' participation in conferences, exhibitions, international exchanges of experience, and study trips. For more details, see, e.g.: Bakacsi et al. (1999).

- The Japanese kaizen is essentially different from the above listed methods, but it is a rather thought-provoking HR rechnique, it is the method of continuous improvement or perfecting. The point is that the employees imrpove their skills and knowledge at the workplace: the management sets targets, the employee attempts to realise them, the management checks the result and if needed, recommends corrections.

In the middle of the 20th century a lot of companies made it possible for the employees to *"participate"* in strategic decisions (to study the problems that need to be solved, and to express their opinions on the expedient outcome.) In companies where employees were broadly satisfied with their workplace, the technique also revealed significant reserves and increased the employees' motivation.

In several jobs, the **code of ethics** also helps the development of the desirable behaviour of the employees (Pálinkás, 1999). This code can record what relationships are desirable among the staff, how to serve customers / clients, what is the correct behaviour in the area of corruption, etc.

Nowadays, it is a generally accepted view that the outlined and further **HR activities should always be adjusted to the nature of the strategy.** For example, Ch. Farkas – Ph. deBacker (2002) widely investigated how successful American managers implemented the objectives of their companies. They found five types – with fundamentally different HR (human resource) management techniques (at all times, the actual management applied a mix tailored to the specificities of the industry and the manager – with special emphasis on one or two.) These basic types are the following:

- S*trategy based* management primarily concentrates on the definition of long-term tasks e.g.: it is widespread in energetic
- The *HR based* management seeks to develop the commitment of the staff, their love of work, and their social skills. This is important e.g.: in retail, and in the case of personal services.
- *Expert based* management of e.g.: a high-tech company seeks to maximise the utilisation of a certain competence of the company, and the labour (creative) skills of the employees.
- **The box-oriented approach** is the characteristic method of conveyor belts and banks. Here, the management defines values, rules, procedures and behaviour patterns prescribing every employee activity in detail.
- **Exchange management** prepares the organisation for continuous adaptation, e.g.: research institute.

According to the quoted investigation it is very important to choose the HR strategy that best suits the facilities of the company. The company should align with the specificities of the chosen type during the execution of its tasks. However, according to research, Central European managers often ignore this principle (as well.)

The determination of "corporate" workforce demand and the satisfaction of the need

In the micro-sphere the concepts of macroeconomics related to labour demand and supply are inadequate. The enterprises and institutions demand more precise requirements than those of the macro economy for competences of the workforce they are looking for and the workforce that can be acquired. After all, most of the time, they do not need skilled workers or engineers in general, and not even turners or electrical engineers, but professionals who know, and are good at operating the specific machinery and equipment that they have. And they only employ those, who have the means to work for them.

- We would like to note here that in our time the scope of possible employment forms has expanded significantly. The following, for example, are considered as forms of the so-called ***atypical* emloyment:** seasonal, casual or fixed-term employment, part-time employment or project work, remote (home-based) business, outwork, hiring workforce from an employment agency.

The definition of labour *demand* is a planning task in the micro-sphere. The long-term "prognosis" relating to this subject is necessarily approximate. It is based on the more or less uncertain forecast of the future tasks of corporate strategy (and future methods of implementation.) The preparation of these may be helped with expert opinions, brainstorming, the Delphi method, and in the case of larger enterprises with job descriptions and the job analysis used in the preparation of these latter documents. Afterwards, the operational plan for the near future can be refined based on data relating to the "productive" (service) programs. Planning is rather difficult also in the latter case – and it is a mostly "technical" task.

But the enterprises can only establish an uncertain picture of the labour *supply* as well. Existing institutions can examine the employment prospects of their existing employees (who can they count on in a few years' time and what are their competences.) The enterprise can also reckon with their retraining or further training, with the possibilities of their "dismissal" (hiring freeze, early retirement) in case they estimate a significant surplus of employees. In respect of "external" options (or in the case of a new company) they only have access to the rather general data of labour supply in the given region. So, if hiring new workforce becomes necessary, it is the task of labour management to organise *recruitment* and to *choose* those who will be hired.

Hiring workforce is a rather difficult professional task with a lot of possible mistakes. The analysis of N. *Parkinson* (1964) warns (pages 41-

58.) that **there is no sure method in this HR task.** Recruitment is difficult, that is the mobilisation of the range of potential candidates, e.g.: internal candidate search, press or Internet *advertising,* requests to *employment agencies* (as they often do not transmit the information on the work opportunities to really promising persons, other times they send too many candidates), and hiring a *head-hunter* company may be expensive. Selection is even more difficult, because the candidates should have competences that are not checked during the selection process. The procedures based on *interviews* (the so-called British procedures) have often led to failures because earlier good family relations were highly valued, but today they prefer e.g.: (sport) activities carried out in good company instead of the specificities needed in the work. The procedures based on *exams* (the so-called Chinese procedures) are not more successful. The candidates have to take tests, write studies (earlier they had to write poems as well) but after hiring the employees do not have to take tests in their jobs. The differences between the expected and measured knowledge cause problems even in the case of the modern *intelligence tests* and the *psychological tests as well.* A more successful selection technique (if possible) is hiring someone for a *trial period*, etc.

In the case of (mostly large) companies where the manager is not the owner, the selection of the manager is a fundamental question. The working methods are not different in principle from the above mentioned ones, however, in practice, there are several special tasks occur worldwide. In Germany for example, they tried to encourage (larger) family companies to hire professional managers, because they thought that the validation of family interests did not correspond to the interests of society. In Central Europe, however, it is still very common – despite the tragic consequences we learnt about in the past decades – to appoint the managers of state-owned companies based on political considerations, which continues to bring about tragic consequences.

Sometimes enterprises may be forced to *dismiss* some of their existing employees either because certain jobs become unnecessary or because they have to cut back on production. This task must be done with special caution because otherwise both the “commitment” of the workforce that we would like to keep and the corporate goodwill deteriorate. That is why we have to strive to keep the employment status of the best performing employees and to help those who are dismissed to find another job as soon as possible.

The labour market imbalances

The principles of Marshall's demand and supply graph also prevail in the labour market: demand and supply fluctuate continuously, both labour shortage and unemployment are common phenomena, and the imbalances appreciably affect the level of wages.

However, it is obvious that the imbalances mentioned cause fundamental problems in the totality of the relevant economies, so their prevention or "treatment" **widely requires government actions.** One of the important groups of tasks is the creation of labour supply suitable for labour market requirements. The other belongs to the group of changes shaping labour demand (mostly technological-organisational.) The third may help the "survival" of those who are unemployed (with socio-political measures.)

The (public) tasks related to the development of the *labour supply* can be classified in five groups according to the work of T. Schultz (1983), the pioneer of the studies on human "capital." These tasks are related to health preservation / recovery, public and higher education, adult education, workplace training and the regulation of migration.

- The task of *healthcare* (formulated from the point of view of the labour market) is to compel potentional workforce – that is, the population – to live a healthy lifestyle, the prevention of disease, and the treatment of the sick. We will not go into details regarding this task, we only wish to mention that the effectiveness of the activity can be checked with statistics related to e.g.: life expectancy, prevalence of diseases, and becasue if these, the working time losses.

  The main task of *public and higher education* (also from the point of view of the labour market) is to develop competences and knowledge among potential employees, appropriate for the needs of the employers. We will not discuss the methods for the realisation of this task, either. We can evaluate its effectiveness either with the help of statistics showing qualifications, or interviews and questionnaires examining the experiences of employers.

  The main task of (public) *adult education* is to adjust the preparedness of the workforce to the changes occuring on the market (which is complemented by – especially in economies where the educational system is weaker – the correction of the errors in the training). These tasks are especially significant in the sectors (e.g.: the ICT sphere) where the technical-social progress

is fast, and the knowledge of the workforce may become obsolete in a few yaers' time. However, nowadays, the workers of every profession must accept that once or twice during their lifetime they will have to "go back to school."

The basic task of *workplace training* is the help given in the acquisition of the special competences and knowledge necessary at the given enterprise (e.g.: for the operation of the machinery and equipemnt at the given enterprise.) In the case of weak – or expensive – public and higher education, however, it may help employees to liquidate the lack of knowledge and it may also help retrainings as well.

Migration – e.g.: commuting or moving far in search of jobs – may significantly influence the labour supply of a given region. Influencing these movements give significant possibilities for the government to "treat" labour market imbalances. The workforce attractiveness of a region can be primarily increased by increasing the (civilised) possibilities of accommodation, the housing supply, with an orderly environment, and settlement grants. Sometimes it can be reinforced with further allowances. But commuting from areas where there is a workforce surplus towards areas where there are shortages can also be supported by e.g.: the acceleration of transport, fare discounts and felxible working hours, etc. In certain economies it is timely to contain emigration, especially that of highly qualified employees.

Labour demand can also be regulated. Its size can be diminished with the support for technical-organisational changes that increase productivity, by diminishing bureaucracy, but it can also be moderated by increasing wage contributions. It is also possible to introduce labour intensive technologies or the production of more labour intensive products or it can be intensified by decreasing contributions. If the modifications are carefully chosen, the competitiveness of the economy can be increased with both types of actions. However, it is a common error when a decision is made to introduce low efficiency technologies in order to create jobs. This type of worsening competitiveness will also threaten existing jobs as well.

When the tools intended to influence labour demand and supply are applied it is important to take into account that the problems of labour market imbalances can also be different. Certain problems are structural in nature; they can only be moderated by the – usually slow – modification of the economic structure. Other problems may have conjectural causes, that is, they can be traced back to the cyclical nature

of economic processes. These may cease to exist in a few years' time. Moreover, these may change direction completely. The government can only use the (high-impact) tools of influencing the labour market in the case of structural problems. It may also treat the effects of the business cycle with the monetary braking of the cycle or with socio-political measures.

Social policy is a type of policy which seeks to create equality of opportunity for the disadvantaged members of society. Although most of its tasks are related to the young, the sick and the old, we will not deal with these here. However, we highlight the tasks aiming at helping the *unemployed.* This task becomes especially important in the crisis periods of the 6-10-year long business cycles. This is the time when there are large numbers of people temporarily in hopeless situations because of conjectural reasons (because of externalities, market failures.) These people are employees who wish to return to the world of work as soon as possible. It is a fundamental societal interest to help them – and their families – with unemployment benefits. At the same time, the burden of the implementation should not be charged on the corporate sphere which is fighting the difficulties of the crisis. But politics must treat the problems of structural unemployment (e.g.: with retraining) caused by the declining phase of the "life curve" of a profession. The companies of the given profession are unable to cope with the task alone.

9.2.2 Labour market in Central Europe

It is with great caution that one can formulate general statements about the different Central European economies. Looking at the data below it seems that the activity of the age group 15-64 in the region is lower than elsewhere (the proportion of those who are not working and not looking for a job.) The governing data in the USA, the ones describing the activity of the age group of 15-74 year-olds are even more unfavourable.

5. *Main data characterising activity in the year 2011.*

	LU	NG	AT	DE	CZ	GR	HU	PL	US
activity rate of 15-64 year-olds, %	67,9	77,8	75,3	77,2	70,5	67,7	62,7	66,1	73,7

AT: Austria, CZ: Czech Republic, DE: Germany, GR: Greece, HU: Hungary, LU: Luxembourg, NG: Norway, PL: Poland, US: USA.

Source: http://www.ksh.hu/stadat_eves_3_7

Furthermore, we can state that most of the time, the main reason of the problems is in the structural capability of the labour supply. In most of the economies of the region, the most important problem is the large number of **functionally illiterate** people (who cannot understand the text they read letter by letter.) This group is in the working age group but most of them do not wish to enter the labour market at all. It developed 30-40 years ago and has been reproducing and sometimes growing since then. These people cannot be employed in modern workplaces. Although, the problem has several social causes, public education has done nothing effective to change the situation. The regular reports of OECD, the so-called PISA (Programme for International Student Assessment) reports found that among 15-year old youths, even reading difficulties are significant and **education has largely failed to neutralise the lag of those coming from families with disadvantaged backgrounds** (e.g.: OECD, 2010).

- In the past years the Hungarian government has attempted to decrease this problem with the organisation of public works (and educating some of the public workers.) The results are disputed. It is obvious that this solution offered the possibility to re-enter the "world of work" and sometimes the possibility to study for people who had not worked for years, or even decades, but it is highly questionable whether they can successfully enter the business sphere after doing a certain amount of public works.

The fact that the practice of HR management is not problem-free in several of the economies of the region exacerbates the problems. Although, after the change of regime, the earlier politicised personnel work was widely replaced by workforce management oriented towards corporate interests, the modernisation is slow both in the SME and the state sector. Internet based recruitment is spreading, but for higher positions recruitment is often "inbred." Modern measurement of performance and performance-oriented pay are rare. Lifelong learning and career planning are exceptional.

The government development of labour supply is also problematic. There is no standard overview of the labour demand and supply of people with *secondary level qualifications*; however, we know that there are a lot of problems. There are fundamental problems in vocational training as well: a lot of vocational schools that operated successfully a few decades ago have been closed, **there is no training in several vocations,** and there are more and more skill shortages. There are further problems with certain parts of regional economies where grammar

school graduates have very low foreign language skills even after many years of studies, etc.

In many places, *higher* education is not on top of things. In certain countries the number of college or university graduates is also lower than the level in developed countries. Structural problems are also significant. In most of the countries of the region there are not enough engineers, doctors, professional managers, while in other professions there is significant overtraining (e.g.: communication majors, librarians.) According to the international rankings of universities, the level of education is not reassuring either. In several branches the competitiveness of new graduates is insufficient – despite the "Bologna" attempts of the past years, or maybe exactly because of that. According to the opinion of Hungarian employers about the preparedness of entrant graduates e.g.: **workplace managers are widely dissatisfied with the foreign language skills and the practical skills of young graduates**, and often also with their commitment ("work morals") and e.g.: with their calling as well. (Kádek - Zám, 2008).

6. *Percentage of college and university graduates, number of foreign students, management skills and the level of foreign language skills*

	LU	NG	AT	DE	CZ	GR	HU	PL	US
% of graduates	44	47	21	26	20	29	25	35	41
Number of foreign students**	2,4	3,6	7,1	2,4	2,9	1,9	1,5	0,4	42,2
Management skills, score***	5,8	7,1	6,8	7,0	5,5	4,9	5,2	5,3	7,5
Foreign language skills, score***	8,4	7,7	6,6	7,2	5,0	7,5	3,8	6,3	4,4

*In the 25-34 age group, 2009
**per 1000 residents, 2009
*** compared with business needs, 2012

Source: IMD (2012), pages 472, 473, 476, 477.

The performance of health care providers has also been disputed for decades in the region.

9.3 SUMMARY, QUESTIONS

9.3.1 Summary

As a starting point of the lesson, we first outlined the definitions of the main concepts of the topic of the labour market: the specific statistical definitions of who is employed, unemployed, or inactive. Later – assuming that the details are known – we summarise the tasks of

corporate HR management and through this, we refer to e.g.: performance measurement, remuneration, career planning, recruitment and selection of employees. In case of labour market imbalances we talk about the tasks of the government primarily in the treatment of unemployment. Finally, we present some of the problems of HR management are the catching up Central European economies.

With these, we would like to support those professionals, technical managers who will take on HR management tasks during their work. We hope that this lesson will help them in their difficult and responsible work.

9.3.2 Self-check questions

- According to statistics who is employed? And who is unemployed?
- Explain why the application of the soft methods of HR management is preferred in most of the modern enterprises!
- List the strategic types enumerated by Farkas – deBacker, name a profile where you would apply them, and briefly justify your choice!
- How would you assess the reliability of Parkinson's recruitment and selection techniques?
- What is the PISA report? What findings does it contain regarding the knowledge of Central European youths?
- What problems can you see regarding the profession structure of the workforce on the Central European labour market?
- To what extent do the skills and knowledge of Hungarian graduates comply with the expectations of employers?

9.3.3 Practice tests

- Is a person employed if a) he does not have a job, b) he worked a few hours illegally in the given week, c) he was on sick leave during the given week so he was not at the workplace?

  a) we do not know, b) and c) yes
- Is a person unemployed if a) he does not have a job, b) he worked a few hours illegally in the given week, c) he does not have a job, but he was looking for one, d) he did not work during the given week, but he was looking for a job?

  a) and c) we do not know, b) no, d) yes
- Give two examples of HR management tasks according to the hard (or Michigan) model! workforce *recruitment*, performance *measurement,* performance *incentives,* workforce *development*

? What is the main task of HR management according to the soft (or Harvard) model?

demanding the fulfilment of the required norms – development of the employees' well-being at the workplace – strengthening the employees' commitment – developing the knowledge of the workforce – other, namely:

? Would you use the hard or the soft methods of HR management if the employee a) is a turner in a workshop producing medium-sized series of metal components; b) is a salesperson in a grocery store?

a) hard, b) soft.

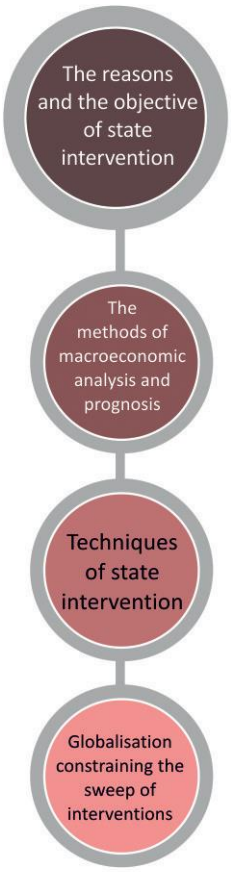
10. LESSON: THE STATE AS AN ECONOMIC ACTOR

10.1 OBJECTIVES AND COMPETENCES

The lesson looks at the issue of state influence of economic processes. The authors first present the most important views on the reasons and objectives of the influence. They also draw attention to the fact that technical managers often have an important role in the preparation of state economic development decisions. In order to make this role effective, they discuss the diverse toolbox of influencing in detail. Finally, they have a brief look at the aspiration of certain international institutions to constrain the sweep of national economic policy. Through all this they do not wish to suppress that several elements of this topic are highly disputed, there are no best solutions for every case, the expedient tasks have to be found with the careful examination of the possibilities – and if possible, the authors seek to help the students navigate in the given complicated systems of correlations.

We hope that the students studying this lesson will be able to understand the objectives of state interventions and especially the hidden "messages" in them. In connection with certain topics the acquisition of this is important for every citizen and it is especially important among corporate managers. Those who participate in the preparation of central measures will get some help so that they can see the correlations of their tasks at a suitable level.

10.2 CURRICULUM



Graph 33: Mind map

10.2.1 The state in the market economy

As we already mentioned in lesson 9, the state – to put it simply – is a region, where a person or an institution in principle exercises independent power (especially political freedom.) Of course, in lesson 10 we are not talking about an arbitrary geographical area and its market economy relationships. We outline why, in which topics, and how the "central" institutions of the state (the parliament, the ministries, the central bank, etc.) influence the economy (market processes) developing in the given state.

The reasons for state intervention

The interventions of the "state" – in other words: the **economic policy** – its nature and desirable scope is the constant topic of economic disputes.

- It should be noted that economic policy which is not recorded in documents and declarations, but validated in practice, is still economic policy.

Nowadays "main-stream" economic policy theories are based on **market economy** conceptions. According to their extremist (so-called liberal) formulation, the market competition (more precisely: the invisible hand) usually creates balance and the role of the state – in addition to the establishment of an institutional system creating the proper functioning of the market – is only the treatment of **"market failures"** (in other words: the elimination of the problems arising from the existence of the so-called externalities.)

- We should remember that the early calssic of economics, Adam Smith, considered the growth of work and land (capital), the expansion of the division of labour as the motors of "economic" development. He also considered certain "invisible" (unmeasureable) factors, free enterprise and the regulatory effects of the market, its performance increasing effects as important factors controlling progress. Externalities, however, are (e.g.: environmental) factors whose viewpoints must also be taken into account for the sake of the protecton of social interests – even is they are ignored in corporate calculations.

This view is the antithesis of the (full) *central economic control* theory which failed in the Eastern Bloc in the recent past and at the moment it is only advocated perhaps in North Korea.

In reality, today, the economic policy of every developed country follows some kind of intermediate principle. This can also be said about the so-called present Hungarian **unorthodox** policy, which applies competition-neutral tools widely, but has also undertook several measures which "selectively" influence the operation of the market (mostly tax measures.)

- About the concepts of competition-neutral and selective tools, see lesson 9.

It indicates the importance of our topic that according to the world famous analysis of e.g.: Acemoglu – Robinson (2012) the level of the economic policy is the most important determinant of the effectiveness

(wealth) of national economies. They classified the host economic policy to be the most effective (giving opportunities to every potential competitor.)

The objectives of interventions

The experts cannot agree on the desirable and actual "final" objectives of (economic) policy (the motivations of the policy makers.

- It is a common declaration (and illusion?) that this policy serves the interests of the *well-being* of society (and we can also consider non-material factors to be important.)
  - The experts who agree on the objectives of social well-being disagree in their views on the subgoals necessary to achieve this well-being. Generally, however, they acknowledge the importance of a high level of employment, but many of them find job creation, others the training of the workforce and others work incentives desirable. The necessary actions in order to raise wages are even more controversial. Several trade unions simplify the question and calls for a managerial decision to raise wages, while emloyers consider an increase in their competitiveness as a prerequisite of wage raises, and sometimes the necessary investments. Mayn economists recommend structural transformations, e.g.: increasing knowledge-intensive production, etc. Further approaches find the enforcement of considerations extending to the requirements of a high quality of life necessary, etc.
- N. Machiavelli, however – and already in the Middle Ages – found that the main motivation controlling the actions of princes was obtaining and retaining *power,* and according to experiences similar considerations often prevail in the decisions of today's politicians.
  - Some of today's empirical examinations e.g. found that the decisions of politicians are often motivated *by considerations related to their re-election.*
  - The analysis of further government decisions found prestige to be important, and also the role of the protection of honour.
- But experience has shown that there are always *politicians* who only aspire to quick enrichment and only mind their own *pockets.*
  - In our time the interest conflict of the "owner" and the "agent" is further comlicated the question of "state" objectives. However, it is

one question what the top management of the state wants and it is a totally differnet question what kind of considerations lead the masses of public servants.

As we already said in lesson 9, according to the recommendations of M. Porter, today it is generally believed that the level of social well-being can be characterised by the size of the *national income* (the added value produced on the area of a given society in a year.) It's most important indicator is the GDP/capita (about its concept see lesson 9.) Many experts therefore consider it desirable that **economic policy should consider the increase of GDP/capita as its main task.** Naturally though, they also recommend that we take into consideration the other indicators (lesson 9) of the national economic performance as well.

- When we clarify the content of the objective of the economic policy, we notice that the objective of increasing the GDP/capita (that is, the added value) is not consistent with the corporate profit objectives because the largest item of the GDP (total added value produced) is the wage.

As an example of the group and individual goals prevailing in politics N. Parkinson (1964) refers to the staff expansion efforts of certain English ministries and officials, highlighting that no relationship could be detected between their realisation and the volume of the work. The TV series "Yes, minister" – highly appreciated by M. Thatcher – (see e.g.: Lynn – Jay, 2008) referred to the distorted behaviour patterns of public administration. It also highlighted the not uncommon demagogic objectives of state administration, the self-interest obstruction of rational changes, and the practice of regular concealing of errors.

10.2.2 The development of economic policy, macroeconomic analysis, forecasting methods

The need for national economic forecasts, forecasting techniques

Since economic policy decisions shape the future, we can only draw conclusions of their (expected) effects and effectiveness based on the analysis of the future. **We cannot have knowledge of the future**, so for these analyses always, and in the case of compiling (national) economic visions of the future, we need forecasts (prognosis.) For this reason, several techniques have been developed.

Certain procedures start from the data of the past. In case of economic processes, which can be characterised by numerical timelines, or ones whose tendencies can be characterised by approximate data with the help of benchmarking, e.g.: *mathematical trend extrapolation* can be successfully used for shorter term (maximum one year) economic prognosis.

There are some effective techniques to reduce the lack of information about the future as well. The corporate **expectation examinations** are representative surveys which orientate corporate managers about information on future events, tendencies (e.g.: stat related to orders) and assumptions, and also about the objectives and efforts of the company. *Brainstorming* is a group method of asking for opinion, where people are gathered in a meeting, the interviewer asks questions about the missing information and the answers given are – later – evaluated. The *Delphi method* is an iterative process, where experts are asked questions in writing, and they ask for the answer also in writing. The evaluation of the latter is sent back to the respondents who now have the chance to supplement or modify their positions. They continue the supplementation and evaluation until the positions become stable. Often the result of corporate (questionnaire based) expectation examinations can be effectively utilized. But forecasters often use their own estimates and they strive to outline e.g.: the expected changes in the "behaviour" of the state, based on the information published in official statements. In addition, a mathematical procedure, *simulation* is also available. The inputs are the characteristics of the possible state of factors influencing the future, and their probability of occurrence. The computer algorithm outlines a vision of the future from these inputs and provides the probability of the realisation of the latter.

The reliability of (macro) economic forecasts is disputed. According to the examinations, however, **private consumption, the GDP and inflation can be accurately predicted for a period of one, one and a half years.** Future visions of the structure of the GDP (its internal distribution) can only be outlined uncertainly for such a period of time, the reliability of foreign economic relations is extremely low; the national economy prognosis is often clearly unrealistic (see: Papanek – Petz, 2014).

In the case of the majority of longer term (more than a year) macroeconomic forecasts, there is no chance to estimate the values of the indicators characteristic of the economy with more or less reliability. It is more expedient – following the recommendations of the EU – if we strive to create so-called **scenarios.** In this work, first we have to explore the *driving forces* in a given question shaping the future, and

then in the case of the latter we have to mark the possible changes (axes) and we have to develop estimates on the expected processes in case of their various combinations (certain scenarios.) E.g.: in the forecast of the GDP for the factors of the expected number of working hours we have to take into account the expected demographic processes and government measures. Then the four scenarios are an improving demographic situation with an effective employment policy, an improving demographic situation with an ineffective employment policy, a deteriorating demographic situation with effective employment policy and finally, a deteriorating demographic situation with an ineffective employment policy. The main task of the forecasters is to give a prognosis for the expected number of working hours in each of the four scenarios, and to illustrate the different possible visions of the future on a so-called *fan* graph (by presenting the possible bands of future data.)

The typical error of longer term forecasts is the so-called hockey stick effect. It is common that the designers – sometimes also because of political interests related to it – take into account regarding the near future the problems complicating management in a given point in time, but count on the quick solution of these problems.

The documents of economic development and the methods of their preparation

The determination of the appropriate economic policy in a given case – this is the so-called planning task – is a complex task. The document recording the results of the work gives a schematic overview of the economic *situation* and designates a limited number of *specific* goals (because when too many goals are set, there is a higher risk of making mistakes in the coordination of conflicting goals) and in greater length, it describes the *tasks* of realisation in detail (designating deadlines and responsible people.)

- We wish to remind you that regarding the tasks of realisation, according to the “classic” of the topic, Henry Fayol, the main *functions* of every management (also economic policy which manages the economy) are planning, organisations, provision, coordination, and control.

A key element of outlining the economic situation and perspectives is the recognition of the expectations and efforts of the (important) *stakeholders* of the economy. This is how we can ascertain which objectives “society” would agree with, where we need to increase the chances of success even through compromises, which efforts would

encounter strong opposition, and with this examination we can explore potential allies, and counter interests as well.

The stakeholders of economic policy are the government and political party organisations, and especially their experts, and also the enterprises and the population, the organisations protecting the interests of the latter (the industrialists' federation, trade unions – and the teachers who know the points of views of the young best.)

The designation of *specific* economic policy tasks is a decision among the possible variants of action. In this decision, the expected yields and the necessary expenses of the realisation of the variants must be compared. Since the given variants cause e.g.: social changes, a very sensitive element of the calculation to be prepared is the determination of the value of the yields and the expenses. The difficulties are supplemented by the fact that the external effects (e.g.: in case of the installation of a new industry, the expenses necessary to neutralise the potential environmental damage) must also be taken into account when we prepare the evaluation.

A specific moral problem of the choice of the economic policy toolbox is whether the end justifies the means. There is no uniformly accepted answer to this question so we can only make a decision about the application of a generally condemned technique by analysing the specific situation and comparing the attainable advantages and the occurring disadvantages.

- According to research, however, planning does not often follow the principles above.
  - Although (or exactly) the development of Central European economic policy has decades of experience, **after the change of regime, several of the processes of planning were haphazard,** sometimes plans were not prepared at all, at other times the document recording the findings and the measures differed in several points from theoretical recommendations.
  - The group of people trusted with the planning work can also often be criticised. Several times the planners organised consultations but they did not invite certain groups of stakeholders, others were not allowed to speak, and they did not find strong compromises among declared interests.
  - Sometimes experts do not agree with the recorded content of the prepared documents, either. In the prepared (longer than necessary) situation and perspective analyses we can often detect the hockey stick effect, that is, the optimism of the

government. **A high number of goals are set,** but the analysis of their conflicts is missing (thus, the solutions for the conflicts cannot happen.) The tools for the realisation are only broadly outlined and the designation of deadlines and responsible people is also missing oftentimes.

In addition, this is supplemented by the fact that the objectives of the policy in practice are very different from the ones in the declared plan (about the Hungarian practice, see: e.g.: Papanek, 2006).

10.2.3 "Techniques" used to implement economic policy and their limitations

The competition-neutral techniques of economic influence

According to the "classical" (after J. M. Keynes) market economy theory the state economic management should influence the economy fundamentally in order to equalise the effects of business cycles (see: lesson 9) – to neutralise these market "failures" – with primarily "competition-neutral" methods. **It has tasks primarily in four areas: monetary, fiscal, social and foreign trade policy.**

The financial or monetary policy is the tool of the national banks, which mainly influences the amount of money (in circulation) functioning in the economy (see: lesson 8).

The budgetary or **fiscal policy** (with some simplification) determines the revenues and expenses of the so-called government budget.

- The **government budget** is a financial system, its subsystems are the government budget, the social security funds, the budgets of the municiplaities and the special funds. The main revenues of the system are the taxes (and e.g.: social security contributions), the most important expenses are the costs of the state administartion (public adminsitration, educational, defence, etc.) organisations, and the different (among them healthcare and pension) "expenditures."

The **foreign trade policy** exercises influence on the one hand by the determination of the quotas and tariffs, on the other hand, by the influence of currency exchange rates (see: lesson 11).

As we highlight it in the following chapters, every element of the outlined toolbox has multi-sided economic effects. They influence the amount of money, and through this, inflation, and also the dynamism of the economy (because the abundance of money encourages spending,

e.g.: buying, investing, and expanding production, so it has price and economic dynamism increasing effects, while tightness has opposite effects.) Both taxes and subsidies modify the amount of money in circulation and besides they influence the economic (government budget) balance, the economic structure because of their differing branch and regional importance, etc. Foreign trade policy primarily affects export and import (if e.g. the foreign currency is getting more expensive, the exporter's domestic revenues increase, and this encourages export, but at the same time the domestic price of import also grows which retracts import. Besides the increasing import prices may have significant inflation increasing effects as well, etc.)

Following the Great Depression of 1929 the governments of developed countries applied counter-cyclical state **cycle regulation** in practice (in times of boom, they cut back "demand" that is, they narrowed the amount of money, and in times of crises, they increased government spending in order to expand demand.) After the Second World War the developed countries which accepted the recommendation avoided the development of larger crises for a long time. Nowadays, several countries do not follow the recommendation, in times of boom, they spend all the available resources, so during difficult times it is forced to realise significant constraints. This leads to indebtedness which may cause an economic crisis. This is why experts all over the world are looking for an effective solution.

- Another question is the competition-neutral nature of the above listed techniques. Monetary policy steps that increase the money supply are generally e.g. most of the time are really approximately competition-neutral. However, certain budgetary allocations can be just as selective as e.g. the strongly selective sectoral supports (since for example the easing of home buying will mainly effect the construction industry while the support for the replacement of used cars will affect the automative industry.)

At the same time, the governments of catching up countries have understood for a long time that in their economic policy the intensification of legal certainty and the effectiveness of public administration (that is **institutional development**) are urgent tasks (often more urgent than the application of the classical toolbox.) We can cite the – sometimes fundamental – modification of a lot of types of "institutions" (organisation, law, behaviour, etc.) Some countries developed e.g. their banking system; others their competition rules, still others transformed their tax system, and the financing of public institutions, etc. But in our time, the developed countries – based on the principles of the so-called

institutional economics (see: Hodgson, 2003) – often attempt the application of the latter toolbox, so today they expect positive results from the development of international cooperation as well.

- The **legal certainty** of management can be primarily intensified by increasing the effectiveness of public administration – especially with the expansion of the validation possibilities of rights related to property and contracts, with the supression of bureaucracy and corruption, and with related tasks.

  The most important possibilites for the *validation of rights related to property and contracts* can be created by passing laws protecting these rights, and organising effective law enforcement and judicature. However, the damages caused by inadequate protection can be compounded by *corruption* and *unpredictable economic policy* (its nature of arousing undue risks for enterprises, especially the political determination of decision making.) The prescription of excessive public burdens can also result in the strong restriction of the rights related to porperty (such as the current tax burden which is widely considered to be unberable.)

  The efficiency of public administration is just a simple matter of work organisation either. It can be primarily threatened by **bureaucracy** (the imposition of unnecessary or unnecessarily complicated administration), which, according to the calculation of the European Union, increases the costs of SMEs by at least 10% (!) – and those of the budget in the member states. Curbing raampant administration makes it necessary to simplify legislation, and suppress corruption which has interests in the development of chaotic administration.

  The three key criteria of **corruption**: the perpetrator /1/ out of direct or indirect self- or group interest /2/ violates one or two rules of community coexistence for which he is responsible, in the course of which /3/ he cahoots with at least one more party, an individual or the represantative of an instutution.

The fight against bureaucracy and corruption is (would be) an especially effective economic development measure because it requires the utilisation of relatively modest government resources and among SME managers it does not cause the feeling that their chances of success depend on strengthening their government relationships, and not on their own management efforts.

The selective methods of economic development

The methodological arsenal of selective state intervention is also very rich.

The willingly cited examples of the techniques are the efforts aimed at averting the market failures related to *environmental* damages. Preventing the opening of (e.g.: gold) mines (with a risk of lead contamination) or cleaning up the crude oil spill in the sea, the organisation of selective waste collection often (justifiably) come into the spotlight.

Governments (although sometimes they deny it) actually widely promote the development of certain product groups and *sectors* in the whole world. About the methods of influence see lesson 9.

- For example, the case of Japanese video recorders was a success. When development started, only large and very expensive studio recorders existed which had a necessarily tight market. However, the developers believed that if they could create a small, and relatively cheap devise, it would have an enormous market. The costs of powerful development were very soon confirmed by the explosively expanding video market. Among the Hungarian selective development attempts we can judge the support of e.g.: the automative industry successful; in contrast, the Hungarian tractor production development program of the 1960s was unsuccessful, becasue after 10 yeras of efforts they shut down production in the entire profile.

Over the past decade the EU spent considerable strength on the mitigation of the development gap among its *regions* as well in the framework of so-called convergence programs. But since it did not follow the theoretical recommendations of this kind of work outlined in lesson 9 in its attempts, the differences among the economic performance of the areas did not decrease despite the efforts, moreover, in some cases they increased.

Certain governments have used further selective techniques:

- In Central Europe, after the change of regime of 1989-1990, the majority of governments intensively supported e.g.: (with tax cuts) *capital imports*. As a result of this, a significant quantity of capital flew into certain sectors of the region (e.g.: the automotive industry) and in certain foreign-owned companies (sectors) they really eradicated the previously enormous “technological” lag (especially related to managerial skills.) The expediency of sustaining the support is disputed nowadays because of the

emerging problems in the case of several investments and because of the excessive preference accorded to large enterprises.

- In the past one or two years – in order to lead the inactives back to the "world of work" (according to others: to buy votes) – in certain countries employment in *public works* has spread. This solution was also criticised by many because according to experience, often the work "done" in this way does not avail. We can also state, however, that elsewhere they could make people work who have never worked before in their lives.

Typical errors of economic policy

Sometimes it also happens in our age that the competent institutions and persons in the area of economic (central) management do not in fact strive to do this task. A good example of this behaviour is the so-called **ostrich "policy"** (when the management knows that the appearance of serious problems is imminent, it does not do anything to avert them.)

- A famous historical example of the phenomenon was provided by the French king shortly before the French Revolution. Although, Louis XV clearly saw the increasing poverty and the consequent radicalisation of the public mood, he did not care about these and (allegedly) stated: "After me, the deluge."

There are also examples for politicians, afraid of all types of change, striving to preserve their power, who will hinder the success of even the government (possibly only announced to increase their popularity) development actions. (Lynn – Jay, 2008).

But since the rapid development of technology and the (world) market are unpredictable, development is always risky. **The failure of "state" – imposed from "above" developments is more common than the average.** There are several reasons for this:

- Sometimes, the method of the decision preparation already foreshadows the failure of the implementation. We can scarcely expect success in the eyes of society from a project (e.g.: motorway, underground construction) which was decided upon with the exclusion of a significant group of the stakeholders, which has as its aims the acquisition / conservation of power or prestige, and which was decided upon using distorted analyses of the perspectives and without the clarification of the method of implementation.

- Issuing instructions without the organisation of the verification of the implementation leads to similar "results." It is an often criticised typically Central European practice to adopt high tax rates, pass anti-corruption regulations, etc. and (according to the interests of the "elite") at least in certain circles, refrain from verifying their implementation.
- Failure can often be explained with the political disputes related to the implementation, with the nomination of managers according to political viewpoints, and consequently with the incompetent (sometimes corrupt) management of the work.

10.2.4 National economic policies and globalisation

In our age, some "national" powers are transferred to international institutions.

We have to see that the outlined process signifies certain restrictions on the discretion of national economic policy as well. In the following we will outline two very different types of this change.

Financial "recommendations"

Contrary to the 2010 expectations, several countries of Europe could not recover by 2014 from the economic crisis that began in 2008. That is why several international (financial) institutions, including the World Bank, the European bank for Reconstruction and Development (EBRD), and the competent persons of some countries in a favourable economic situation, e.g.: Germany and numerous experts believe that the European Union should establish the financial balance of primarily the severely indebted member states fundamentally with cutting budgetary deficits, with *restrictions*. They forced their views on a few countries (e.g.: Greece) by holding back the loans given to the indebted states,

However, implementing the political recommendation has causes social conflicts in the majority of the countries concerned.

Europe 2020 strategy

The starting point of the EU's "recommended" economic policy for member states is the **European paradox** (paradoxon /Latin/: contradiction) which highlights the competitiveness lag of the EU, obvious since the 1990s. It states that, although the performance of European scientists is indisputable, (e.g.: the number of quality publications is high) this is not reflected in the economic performance of the EU and in the most important index of the national economy, the

GDP. The practical implementation of the scientific results is slow, e.g.: the number of patents is also low.

The current 10-year long EU economic policy aiming at the eradication of this backwardness, the **Europe 2020** strategy, subordinates community policy and budget as well as the related **tools of the member states to the objectives of "smart, sustainable and inclusive" economic growth.** The document does not envisage new development and support programs or budget, the adoption of its guidelines did not require the modification of regulations or directives either. It appoints the direction in which the European Union and its member states will progress in the next 10 years.

- In order to achieve the (growth) objectives, the tasks were classified into seven "flagships" and 5 numerical targets were also set. These are the following:

  for the sake of smart growth:
  - innovative Union: improvement of the environmental conditions and financing possibilities of research and innovation in order for them to materialise in the creation of goods and services resulting in higher employment; the costs of research and development should reach 3% of the GDP
  - the mobilisation of youth: improving the performance of the educational system and the job opportunities of youth; as well as reducing the share of early school leavers from 15 to 10 %, and increasing the share of graduates to 40%
  - digital Europe: speeding up the roll-out of high-speed Internet and the creation of a digital single market,

  for the sake of sustainable growth:
  - resource efficient Europe: supporting resource-efficient, low carbon economy, supporting the use of sustainable energy, the modernisation of transport, supporting energy efficiency; reducing greenhouse gas emission by 20% increasing the share of renewable energy to 20%
  - an industrial policy for the globalisation era: to improve the business environment, especially for SMEs, and to support the development of a strong and sustainable industrial base,

  for the sake of increasing inclusion:
  - workforce with new skills and workplaces requiring them: modernisation of the labour market, the development of skills throughout the lifecycle, better matching of demand and supply even with labour mobility; raising the activity rate from 69 to 75%

- Europe fighting against poverty: social and territorial cohesion such that the benefits of workplaces and growth are widely shared and people experiencing poverty and social exclusion to live in dignity and take an active part in society, this results in lifting 20 million European citizens living below poverty lines.

Although the outlined strategy was accepted, and certain European Union tenders help member states to progress, a lot of experts dispute the objectives assuming that **several member states will not make sufficient effort.** The economic situation of the member states is very different. Undoubtedly, the most advanced members struggle for world market competitiveness, but Southern Europe spends all its energy on the reconstruction of the financial balance. In Central Europe the member states have to carry out the tasks of economic recovery which Western Europe did a long time ago (e.g.: the problem of the Roma must be settled, civic infrastructure should be constructed, - and in some cases, the democratic state must also be strengthened.) It is doubtful whether every country will have the capacity to reach the innovative or environmental objectives for example.

10.3 SUMMARY, QUESTIONS

10.3.1 Summary

As a starting point, the lesson quotes views of disputes regarding the reasons and objectives of state “intervention” – economic policy. It also highlights their colourfulness. Then, it briefly outlines the typical methods of creating the documents of economic policy and especially the creation of macroeconomic forecasts. After this, the lesson has a look at the possible techniques of the implementation of the objectives in detail. It emphasises the advantages of competition-neutral methods, but also talks about the fact that in certain well-defined cases, the selective methods are also needed. Finally, taking the European Union’s Europe 2020 strategy as an example, we refer to the economic policy of international institutions and the problems of the implementation of these strategies.

10.3.2 Self-check questions

? What kind of views do you know regarding the reasons (types of) for government intervention?

- What concepts do you know regarding the theoretical and actual objectives of economic policy?
- What tools can the government deploy to achieve the objectives of its economic policy?
- According to the recommendations in economic literature, what steps should be taken during the development of economic policy documents?
- What is the possible accuracy of macroeconomic forecasts?
- What errors could jeopardize the achievement of the economic policy objectives?
- What are the main objectives of the Europe 2020 strategy?

10.3.3 Practice tests

- Can we consider economic policy practice different from the ones written in documents “economic policy”? yes – no
- Is it true that liberal market economy concepts do not find the state influence of any economic process expedient? yes – no
- Which of the following do we consider market failures?

  a customer cannot buy the goods he wants – a company introduces an environment polluting production procedure – customers do not buy the goods of a seller – a merchant goes bankrupt
- Does the Hungarian so-called unorthodox policy seek to ensure full central economic management? yes – no
- Is it the objective of economic policy to serve the interests of social well-being? necessarily – sometimes – never

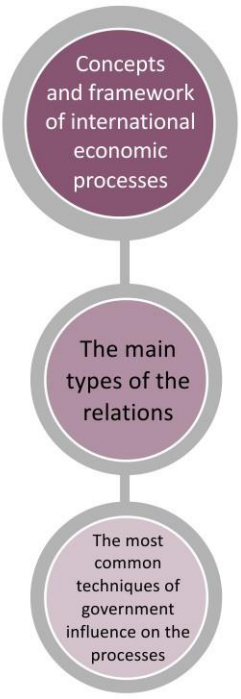
11. LESSON: INTERNATIONAL ECONOMIC RELATIONS

11.1 OBJECTIVES AND COMPETENCES

The objective of this lesson is to demonstrate how national economies are integrated into global economic systems and processes. Learning the content discussed here is of particular importance in countries which are fighting to eliminate their backwardness. Many of their economists are still not sufficiently informed about this important issue as a result of their historical heritage. In our discussion, first, we will stress the openness of smaller economies and its significant advantages. We will discuss the usual forms of international relations in detail, the importance of their free shaping – the so-called four freedoms – and the possibilities of their (state) influence. We will highlight the international financial effects of the processes, and we will review their registration methods (the balance of payments.) We will make reference to the international regulation of the discussed relations. In every question listed, we will summarise the main views of economic literature, but we will not avoid referring to the severe problems in the current crisis.

We are trying to help the technical managers, who are learning this lesson, to understand the outline of the international correlations of their immediate environment. At the same time we will sharply emphasise that knowledge acquired in this way is far from sufficient to work with a potential for success in this subject – because in this particularly complex subject, one has to study many more textbooks and one needs significant time as a trainee.

11.2 CURRICULUM



Graph 34: Mind map

11.2.1 Open economy

Advantages of (international) cooperation

Trade – since its formation a few tens of thousands of years ago – has always created methods for the exchange of goods created by producers who are far from each other. After the formation of countries, trade did not stay within their borders. In our age, international cooperation has become more and more important, which publications explain with the **so-called comparative advantages occurring with both parties in trade (more precisely, in the division of labour.)**

Authors have revealed several types of the sources of the above mentioned advantages in the past centuries:

- Ricardo accounted for the existence of the given advantages with the relative *differences in productivity* among the countries. The

procurement (and the market expansion on the vendor's side) of *materials* and products (earlier for example: North Sea amber, Chinese silk, today: oil) that cannot be found in a given territory or country, or can only be produced with great difficulty is an explanation which speaks for itself. For the same reasons, England sold textiles to Portugal in exchange for wine. In this way, both countries acquired goods that it could only produce expensively, and in return sold goods that it could produce relatively cheaply.

- E. Heckscher and B. Ohlin (H-O) pointed out that it is logical if developing countries offer labour intensive products for the capital intensive products of developed countries.
- However, W. Leontief, after famous statistical examinations, stated in his paradox that in the export of developing countries – in contrast with the assertions of H-O – capital intensive mining, and heavy industry products usually play an important role and they import a lot of labour intensive goods. The paradox is solved with the explanation that most of the labour intensive goods the developing countries import from the only producers, the developed countries are *high-tech* products; while the mining and metallurgy products produced in developing countries also use rather capital intensive technologies in production.
- Finally, a significant part of trade between developed countries is the exchange of goods within the same product category, which is explained by the *specialisation* of the countries and the larger attainable batch sizes.

It is generally true that comparative advantages – and the desirable yields of the division of labour – are the sources of significant advantages for both parties when they exchange goods (because they both acquire the goods with less effort than as if they themselves had produced them.)

Foreign trade

The two basic transactions of foreign trade are export and import. Since in these transactions the parties are from different cultural backgrounds, their implementation requires more significant commercial skills than transactions in domestic trade. Namely:

- When asking for an offer or bidding (to avoid unnecessary work) we should select the potential partner(s) with great care and we have to describe what we would like to buy and with what kind of conditions. We also have to describe what we would like to sell and with what conditions – in an attractive way.

- In the contract, the contractors have to describe the subject of sales and its conditions in detail, most importantly: who pays for the shipping costs, which may be significant in certain cases, and what payment method the buyer uses.
- During the fulfilment, we have to pay careful attention to the fact that both parties retain their property.

With some simplification, the size of the exporter's sales can be determined with the multiplication of the export price and the **exchange rate** of the currency. The quantity of the importer's costs can be determined with the quotient of the import price and the exchange rate. The ratio of the export and the import price of an institution is the so-called *exchange rate.*

The exchange rate is the value of a currency expressed in another (e.g.: HUF/EUR.) **Nowadays, the exchange rate of most of the currencies, including Hungarian forint, fluctuates according to the effects of supply and demand on currency exchanges.** Simple purchase and sale transactions are common. However, speculation has also spread.

Its better known types are the following:

- *arbitrage*; if we take advantage of the different exchange rates developed on different stock exchanges, we buy a currency where it is cheap and at the same time we sell it where it is more expensive. Because many try to utilise this type, exchange rates level off quickly on the world's stock exchanges and thus, they are very alike.
- *forward transaction*; when we agree to buy or sell currency at a later developed exchange rate
- *swap*; the interconnection of the immediate sale of the currency and its later repurchase.

On monopolistic and oligopolistic markets the companies will sometimes establish so-called **dumping** prices on their export products, which are lower than domestic prices. Under certain conditions (e.g.: a substantial saving on volume) this can be a profitable business, but most often it is used primarily to displace competitors from the market.

Several factors influence the strength of the incentive for foreign trade – the profitability of export and import:

- The traditional explanation of foreign trade is that the *comparative advantages* (see above) appear on both sides in the division of labour.

- In foreign trade decisions, apart from the advantages mentioned above, the *shipping costs* are also taken into account, because the products that can only be shipped at a high price can only be profitably shipped to a certain distance. This is the reason why although the comparative advantages incite countries to specialise and exchange specialised goods, the actual level of international specialisation is lower than what comparative advantages might suggest.
- Changes in the *exchange rate* of the currency significantly affect the volume of export and import. The rise in the exchange rate will encourage export and decrease import, a decline in the exchange rate has the opposite effect. The export contract value is paid in foreign currency, but the exporter exchanges (mostly) it for forints to cover its domestic costs. In the case of a rise in the exchange rate, he will get more, in the case of a decrease, he will get less forints. The importer, however, in order to pay for the goods imported, has to buy foreign currency, but sells the products for forints. He has to pay more for the foreign currency when the exchange rate is high (or if it is rising), but if the exchange rate is low, or if it is decreasing, he will get the foreign currency for less forints.
- But in the case of foreign trade, *state regulation* is also strong (in the following points more detailed information is available on this subject.)

Other forms of international relations

The range of international economic relations is far beyond the scope of trade. This has been significantly enriched in the past decades with the relations becoming closer – with so-called globalisation.

- **Globalisation** is the process in which international economic relations have spread to many areas of life, as well as economics, and they expand to the *whole world.* In the course of this, these relations and the exercise of power have created *intercontinental networks.* All this results in the restriction of national economic policies and the transfer of certain state powers to supranational institutions. This process will be discussed in detail in the following chapter.

In the following we will highlight some more important types of some of the non-commercial economic relations.

7. Individuals also create remarkable international relationships with effects on the national economy, for example, tourism, or in the framework of *foreign employment.*
8. Companies may introduce organisational innovations in their international system of relationships – often using the possibilities of modern info-communication technologies. These are for example:

- Regular cooperation with a fixed content described in the outsourcing contract between the company producing a product (service) and the company shipping material, components, part, etc. It is also a step towards global integration if there is cooperation between small and medium enterprises and a multinational company operating in our country (because it is also necessary to meet the exact quality and shipping requirements.) A more advanced form is when the SME's establish relationships with several multinational companies or, moreover, they can also export.

- Supplying is a sure market for the supplier, and it also makes it possible to reduce the costs of market research and storage. The company receiving the supply has the advantage of reducing the acquisition cost and the purchase price. However, the real advantage is the introduction of TQM and JIT, that is, the opportunity to reduce the cost of quality control and storage. A further opportunity to mutually mitigate the unavoidable costs and risks in this field is the R & D cooperation.

- In the case of foreign direct investment (FDI) the investor buys or creates a company (companies) abroad. The investment can be motivated by the economic specifics of the host country (e.g.: low wages), the fact that the opportunities of ownership are better than those of exporting, the advantages of internationalisation (e.g.: greater market) (Dunning, 1998), or the possibilities of the transfer of knowledge (Hodgson, 2002).
- The so-called multinational companies have subsidiaries in numerous countries and they control numerous companies there. The subsidiaries are created by foreign direct investment (FDI) (Krugman – Obstfeld, 2003). Their role is rapidly growing, today there are almost 100,000 international companies and they employ almost 100 million people (UNCTAD, 2012).

- The emergence of multinational companies may have a variety of reasons. Previously, the basic motive was to acquire raw material

resources but nowadays it is to acquire markets, the expansion of sales. The latter may be encouraged by a number of considerations:

- volume yield is a natural incentive,
- it is often important for the company to use the opportunity to expand the use of its intellectual properties (technical, managerial skills, reputation), to reduce specific transaction costs,
- the companies operating in developed countries will often outsource certain phases of their production in order to pay lower wages in the developing countries (also because of their supplier network),
- the subsidies offered by the host country (where the capital import goes) can be attractive,
- the possibility of defininining a monoploistic price in the host country (Krugman – Obstfeld, 2003, Dunning, 2009), and furthermore,
- buying out competitors can be an attractive solution.

- A specific type of international companies are the so-called *offshore* companies which are not engaged in economic activity in the host country. They are often established in tax havens in order to avoid taxation; in some countries they are not even obliged to record registers.

  - The *joint venture* is the opportunity of a company to expand its market. The company has significant competitive advantages, but because of a limited capacity (e.g.: lack of resources, lack of market knowledge or management experience) it is not capable of conquering a market.
  - A **strategic alliance** is the agreement of the world's largest companies operating on an oligopolistic market for common R&D. Such agreements have been made by for example, certain car industry giants, because individually they could not finance the enormous costs of R&D necessary in the industry.

Naturally, the changes in the exchange rate motivate the above described types (just like the ones we listed related to foreign trade) of international relations for example, in the case of the foreign direct investment or foreign employment, etc.

- Here we discuss the micro-sphere effects of the often disputed international movement of labour. Krugman – Obstfeld (2000, p.

182.) convincingly demonstrate that this movement will approximate the wage level of the two countries involved and it will increase world production (output.) However, it also causes losses in both countries, the poor sending country's company owners will lose employees, and the host country's local work force will also experience losses.

1. International corporate relations have basically changed with foreign economic integration – in Europe, above all, with the creation of the EU. For the companies the most important economic regulations that have been accepted by all of the member states are the following:
   - the competition law regulating free trade, and
   - the so-called four freedoms principle (according to which the free movement of goods, services, capital and labour must be created.)
   - However, the broader political and especially legal harmonisation has results as well. They have harmonised corporate law, there are common environmental, agricultural and regional aspirations; indirect taxation has become general (VAT, although at significantly different rates.)

In addition to the above, some of the member countries renounced their own currency in 1999 and adopted the single currency, the euro.

- The conditions of joining the euro zone (the so-called **Maastricht criteria**) inspects the balance of the economy based on inflation, interest rate, budget deficit, government debt and the stability of the exchange rate of the national currency.
- Companies have to be aware of this, and they have to validate it in their decisions – at the same time they expect that their business partners and other economic actors to observe the common regulatory requirements.

In the next lesson we will come back to this topic.

2. Over the past few decades, the system of international relations with a meaningful impact on companies has developed widely also because of the development of the so-called *global capital market*, the worldwide cooperation of banks. The proliferation of bank cards has strongly expanded the banking clientele. The creation of the unified network radically shortened the time

necessary for money transactions. The creation of certain securities products has multiplied the markets of the banks. Moreover, as the latter change has led to bankruptcies of financial institutions that endangered the stability of the whole world economy, work has begun to create worldwide regulation of these institutions.

At the same time, new types of global troubles have emerged. *Environment pollution,* for example, carries the danger of the destruction of mankind, which started a global movement to keep the requirements of sustainable development. This movement was influenced by a report by the well-known group of scientists, the so-called Roman Club. Thus, for the sake of the protection of the natural environment, responsible corporate management has to strive on one hand for the prescient use of natural treasures, primarily energy resources, on the other hand for the minimization of environment pollution. (See lesson 12.)

11.2.2 Governmental influence on foreign economic relations

The influence on international relations

Nowadays, developed countries are usually advocates of *free* (restriction-free) trade.[14] According to most of the political forces of the EU *not only* the free trade of goods and services is desirable, but the principle of the *four freedoms* should also prevail. That is, in addition to the preceding, the free flow of capital and labour is also important.

At the same time, although foreign trade offers comparative advantages to every country, these can only be used by the producers of individual industries. The companies of several other profiles face the sharp competition of import. Therefore, the latter often demand the restriction of import, in order to create economic self-sufficiency, the so-called **autarchy.** The implementation of these claims however – today – mostly has little result. Of course, there are special cases. It is general opinion for example, that for the protection of new industries, sometimes certain restrictions would be justifiable. Some suggest similar measures to improve the balance of the foreign trade balance.

In some case the exporters demand the subsidizing of their export – although they know that the principles of international agreements, GATT for example, prohibit it, and the host countries of the export would also compensate for them.

[14] On the traditional theory of foreign trade, see for example Heller (1947).

Import restrictions are the traditional and direct tools of foreign trade interventions. It has several techniques:

- *Quotas* are quantitative import restriction for different commodity groups, which are often established by national authorities. But since the establishment of certain quotas may trigger a commercial war (similar counter-interventions may be created in the concerned exporting countries), they usually carry out prior consultations with the partner countries.
- Sometimes idea-rich **administrative protectionism** is established (obligatory and very complicated import administration, e.g.: masked as health conditions, or authorisation prescribed in out-of-reach locations.) Most of the time, these restrictions also trigger counter-steps.
- A more modern method of restricting import is the imposition of *duties.* (The price of the product is increased by the duties.) Its imposition and change also require international consultation.
- There are also tools to protect ourselves from the subsidised export of other countries as well. The Union can help the producers of its member states with so-called TDI's (Trade Defence Instruments) against non-EU countries' /1/ dumping, /2/ subsidies /3/ massive and destructive export (Papanek – Papanek, 2011).
- Sometimes, more sophisticated tools – e.g.: the "Buy local products!" movement – are also effective.

Only a few countries decide to directly subsidise export (in the past years China has been accused of it most of the time, but since they have central price regulations, the accusation is difficult to prove.) More sophisticated indirect (e.g.: educational, innovative, environmental, etc.) subsidies are common in turn.

Apart from import and export quotas, duties, administrative brakes, etc., several other factors influence the volume of foreign trade. Hungarian exporters can often count on e.g.: the support of *economic diplomacy.* In EU member states the fact that there are no export quotas or duties on the European markets also has a significant effect.

The *indirect* tools of foreign trade influence are also varied. Options include: subsidising exporter industries or companies, improving the labour supply of these industries, promoting innovations in order to improve competitiveness, etc. However, the scope of these techniques is highly contested. Kozma (2001) suggests that governments should create their competitive export industries with their utilisation. Others

believe, however, that governments should let future successful profiles and companies (the winners) to develop in the framework of market competition, because they will not be viable if they are selected in an administrative way.

The balance of payments

International economic relations necessitate a wide range of cross-border cash flows. This are summarised in the so-called balance of payments.

- The **balance of payments** provides a picture of the international cash flow in a given country – in foreign currency. Its main items are: the value of the export and import of goods (their balance, the so-called foreign trade balance), the value of the exported and imported services, income paid abroad or received from abroad, current transfers (the balance of these items is the so-called current account balance), capital export and import, chnages in foreign exchange reserves.

The development of the balance of payments is influenced by the sheet items, and the effects of the exchange rate motivating them and other factors as well. Thus, the development of inflation also exerts a significant effect on it. More precisely: the interest rate – in the given country as well as in the country where the comparative currency is in use (because the stock exchanges promise the same yields for the investors, that is, they equalise the different interest levels.) On the other hand, the confidence in the economy of the given country also has an influence (which is also modified by the country's balance of payment, because surplus is interpreted as security and deficit as risk.)

The deficit of the balance of payment can primarily be financed with international loans, that is, indebtedness. Most countries try to have a favourable balance of payment, or at least to avoid large international (external) deficit. For this, governments have a variety of opportunities:

- It may apply e.g.: the more sophisticated method of import restriction, or
- a technique of export subsidy.
- It may encourage or hinder the foreign capital import (with high or low interests, investment benefits, or with a lack of these.)
- It may reduce domestic use of import with the reduction of household consumption and investments.
- But also the strengthening of the confidence in the country may also be effective.

In recent years, the experiences of the large European financial crisis show that these may be insufficient in the case of serious debt. And there is no unequivocal recipe for the solution either. Recently, the international financial institutions have made recommendations for restrictions, the reduction of household consumption (with a significant import content) and (public) investments. Sometimes it was effective, other times it was not. The effectiveness of the Hungarian "unorthodox" policy of for example, taxing the multinational companies (and thus the significantly deteriorating exchange rate) can only be justified by the future.

11.3 SUMMARY, QUESTIONS

11.3.1 Summary

In this lesson the so-called comparative advantages of (international) economic cooperation are highlighted. Afterwards, we mentioned the two subtypes of foreign trade transactions: export and import, indicating that the exchange rate has a fundamental effect on their profitability. We also present the non-commercial types of international relations, such as supplying, foreign direct investment, and the multinational company – as well as the development of economic integration, that of the EU and the global capital market. We also talk about the questions of the regulations of international economic relations, the dilemma of free trade and autarchy, and the techniques of state intervention, the quotas and duties. We finish our discussion with the presentation of the main items of the balance of payments.

11.3.2 Self-check questions

- List 3 examples of the sources of comparative advantages.
- Name a few factors influencing the strength of the company's pursuit of foreign trade.
- What forms of international economic cooperation do you know apart from commercial ones?
- What is the so-called principle of four freedoms?
- What are the most common techniques of import constraints?
- List the main items of the balance of payments.
- What tools can a government use to reduce external debt?
- What is supplying? What are its most important advantages?
- How do exchange rate fluctuations influence export and import?

? List the trade defence instruments of the European Union.

11.3.3 Practice tests

? List 3 examples for the sources of comparative advantages: natural conditions, products, work, and their capital-intensive nature, the high-tech nature of products, the specialisation of countries

? How does the exchange rate of the currency of an EU member country develop?

– the Union defines it
– the national bank of the given country regulates it
– fluctuates according to market supply and demand
– the exporter and the importer agree on it

? What is arbitrage? when we buy foreign currency where it is cheap and at the same time we sell it where it is more expensive

? Name two examples for the types of non-commercial economic relations of companies: supplying, foreign direct investment, multinational company, joint venture, strategic alliance

? What is an offshore company? they establish them in tax havens usually to save on taxes, and it does not carry out economic activity in the motherland

12. LESSON: INTEGRATION, GLOBALISATION

12.1 OBJECTIVES AND COMPETENCES

In the 12th lesson we strive to present today's most important world economic processes. We emphasise that the enrichment of international relations is a seemingly inevitable phase of the modern techno-economic development. We will review the most important organisations taking on the control of the processes. We will analyse the main advantages of the processes (especially: the opportunities for improving the quality of life), but we will not hush up the risks brought about by the changes (e.g.: environmental.)

We are confident that the students studying the lesson will understand the most important techno-economic tendencies of our age and that while on the one hand they will try to explore future opportunities in their work and on the other hand they will try to avoid - or at least mitigate - the threatening hazards of the development.

12.2 CURRICULUM

Graph 35: Mind map

12.2.1 The concept of globalisation

Although large-distance, cross-border international economic relations have a long tradition – as we emphasised in lesson 11 – and whilst there are historical examples of the attempts to regulate them,[15] the so-called **globalisation** is a phenomenon of our time. The expression denotes the process in which international economic relations have spread to many areas of life, as well as economics, and they expand to

[15] Several authors have researched the history of globalisation from the age of discoveries and colonisation. However, it is obvious that the roots of the process can be traced back farther; we have a lot of information, for example, on the competition of Phoenician and Greek city states for the trade in the Mediterranean (where the main questions, just as in our time, were decided with weapons) etc.

the whole world. In the course of this, **these relations and the exercise of power have created intercontinental networks.** All this results in the restriction of national economic policies and the transfer of certain state powers to supranational institutions.

Research suggests that globalisation is the inevitable moment of humanity's modern history. **The globalisation processes are extorted by technical-economic reasons, and make it possible.**

Perhaps the most important reason is that demographic trends have been alarming for decades. Namely, the population of Earth did not yet reach 2 billion in 1900 (according to estimates it was 1,7 billion) – but it has grown at an accelerated pace ever since. The population reached 2 billion in 1927, 3 billion in 1960, 4 billion in 1974, 5 billion in 1987, it surpassed 6 billion in 1999 and at present it is higher than 7 billion. Forecasts are predicting an approximate population of 10 billion by 2050, and most of them also predict further growth. This trend is already pushing the limits of Earth's supporting capabilities (energy, water and food capacities.) The individuals of humanity are forced to live in increasingly smaller areas so they are encouraged (forced) to keep intensive contacts with each other and find ways of problem-solving.

The strength of the above mentioned stimulation is significantly increased by the fact that **changes in population numbers differ sharply depending on the type of the country and the settlement.** Growth has primarily occurred in certain developing countries and almost always among urban populations. This causes fundamentally different economic consequences in developed and developing countries. In "rich" developed countries the populations are not growing any more. In some cases they are actually decreasing and the results of economic development raise the standard of living of the existing (aging) population. In developing countries the dynamics of the population explosion is occasionally faster than the pace of economic progress. Thus, some of the nations concerned are fighting with the final effort of their strength to solve food and housing problems, the education of more and more children, creating employment for the growing number of young job seekers, and for the suppression of environment pollution. In their respective areas, the proportion of the people living in inhuman conditions in the slums around large cities is also growing.[16] The

[16] However, some forecasts assume that with increasing the level of education, population numbers will stabilise also in developing countries. The reality of this hope is questionable based on the nightmare of the propagation of slums.

resulting “North-South” conflict (and thus the associated environmental problems) can only be resolved with global cooperation.

Opening opportunities through technological progress

Over the past decade, **the progress of globalisation has been significantly supported by certain technical factors, such as the expansion of effective information and communication technology (ICT) and the development of transport.**

Modern ICT inventions offer previously unimaginable opportunities to mankind as a whole.

- The *telegraph,* capable of transmitting data over long distances (via wire) was invented in the 1830’s,
- The *telephone,* that is, sound transmission, with its much higher capacity of information transfer was invented in the 1870’s,
- At the turn of the 19th and 20th centuries, the so-called wireless telegraph was also invented.
- In 1920, the first *radio broadcasts* were transmitted, capable of informing the masses,
- In 1930, the first pictures were transmitted; the first *TV* programmes were broadcast.
- The first real successes of ICT were the spread of desktop *computers* first produced in 1981, and
- the establishment of the large ICT *network* – with its present-day name: the Internet started around 1960 and expanded globally in the years around 1990.

The effects outlined above were complemented by the development of the means of transport, the establishment of the possibilities of fast intercontinental locomotion (and delivery of goods) – within 24 hours.

All this has fundamental significance in the life of most of the inhabitants of Earth: it offers almost the entirety of mankind the possibility to learn about the world, to expand relations, and it has made everyday life significantly easier for almost everybody. It offers some people the possibility to work from their homes – that is, it has created a real way of improving our lifestyles.

12.2.2 The institutions of globalisation

In recent decades, numerous elements of the institutional system of international relations have been formed in the corporate and also in the supranational spheres. In lesson 11 we talked about foreign direct investment, supplying, multinational companies, European integration, and the global capital market, etc. In the following we will expand on what we said there.

Multinational companies

As we pointed out in lesson 11, multinational companies have subsidiaries in numerous countries, and they control a lot of companies there. At the beginning of the 20th century, the parent company of early multinationals was usually a company in the USA. Later, the companies of the United Kingdom, Japan, Germany and France – moreover, in the recent past, those of China – asked for a part of the profit of the business. A significant proportion of the money flowed to developed countries, the EU, and North America, but East and South Asia also received a lot.

The settling of multinational companies often resulted in significant modernisation of the economy of the host countries. In this effect the flow of knowledge (**transfer of technology,** especially the transfer of managerial knowledge) was often more important than the capital received. However, the reception of the managerial skills, in addition to the effect of economic development, has also helped the acceleration of globalisation and the establishment of further international relations – but not infrequently; it has also intensified the exploitation of the host country. (Stiglitz, 2002)

It is also a highly important economic effect of the multinational companies that the processes have multiplied the volume of world trade, and parallel to raising the technological levels of developing economic participants, they moved the wages towards equalisation globally. And since this latter effect caused rising unemployment and decreasing wages in the most developed economies, it also encouraged there the efforts to raise competitiveness, to intensify deregulation and innovations, etc. (See, e.g.: Schmidt, 1998).

The success of European integration: the EU

The first step of European integration was the establishment of the *European Coal and Steel Community* in 1951. 6 member countries founded it for the common management of the two previously state

managed industries. Later, in 1958, the same countries widened their economic cooperation with the establishment of the *European Economic Community.* From 1973 the Community steadily expanded (at first with Western European countries.) The Schengen Agreement, signed in 1985, made it possible for the citizens of the Community to cross borders without passport control. The expansion of the integration continued from 1990 with Central European countries.

With the Maastricht Treaty coming into force in 1993, the Community changed into the **European Union** – with the promise of financial cooperation – and after this, 12 member states replaced their respective currencies with the Euro. At the beginning of 2014 **the EU has 28** and the so-called *euro zone* has **18 members.** There has been a decade-long dispute over the possibilities of further expansion, especially regarding the accession of both Turkey and the Ukraine (since 2014) and also regarding the expediency of the euro zone.

The principle of the management of the European Union is subsidiarity, that is, the Union only makes decisions in questions which cannot be decided at the national level. Its legislative body is the European Parliament and the Council of the European Union. Its executive body is the European Commission which is made up of one commissioner per each member country. Its court of justice is the Court of Justice of the European Union (and the Tribunal.)

The most important guidelines, adopted by the member countries so far, are the principle of the four freedoms (see: lesson 11) **and the competition law regulating free trade.** However, the broader political and especially legal harmonisation also has results. Corporate law has been harmonised, there are common environmental, agricultural and regional aspirations; indirect taxation has become general (VAT, although at significantly different rates.)

The competence of the EU is the subject of continuous disputes. Certain countries (Denmark, the United Kingdom, and Sweden) believe that it is practical if the decisions are made by the governments of the member states unanimously. While others (Benelux, France, Germany, and Italy) would rather pass resolutions with the majority decisions of the EU delegates and with this they would force those in the minority to execute the decisions they do not support. However, the actual processes have pointed towards centralisation (often with steps in the opposite direction, especially in parallel with the expansion of the role of the regions.)

A few important supranatural institutions

At the end of World War II the victorious powers have made an influential attempt to regulate global economic processes. At first, the system tried to establish the unified organisational principles of major balance of payments problems. Then, it also attempted to solve the common problems of economic progress. To this end, the so-called Bretton Woods Agreement (1945) established two regulatory institutions – formally fitting into the United Nations framework – the IMF and the World Bank. In 1947 they adopted GATT and the gold exchange standard and later they also established further institutions to assist the progression of developing countries.

The task of the **IMF** (International Monetary Fund) is to observe the national balances of payments – and in case of *temporary* deficits – to provision (short-term) loans. Over the years, the Fund has granted loans primarily to developing countries – with increasingly tough and often-criticised conditions.

Further information:

20. http://www.imf.org/external/index.htm

The **World Bank** (WB, its exact name is International Bank for Reconstruction and Development) primarily assists international investment with *long-term* loans.

Further information:

21. http://www.worldbank.org/

GATT (General Agreement on Tariffs and Trade) recorded three basic principles. The signatories have committed themselves to:

- **apply the principle of most favoured nation in foreign trade for every country,** that is, they levy the lowest duty on the products of every country, that they have already granted to any state, their most favoured nation;
- eliminate non-tariff barriers to trade (primarily the quotas);
- to negotiate in order to solve disputed commercial questions.

The *gold exchange standard system* operated from 1947 until 1971 and in order to settle the deficits of balances of payment, the USA took on the gold convertibility of the dollar, and the other countries obliged themselves to buy or sell its own currency to stabilise it in case it fluctuates. According to what we have outlined, it was an important specificity of the system that it was partial: it only sought to regulate international trade in goods, and it did not function in the Eastern Bloc countries at all (because they did not adopt it.)

However, in 1971, due to the deficit of its balance of payments, the USA was forced to suspend the operation of the system; since then, exchange rates are formed on the currency exchanges (they float.) Other elements of the regulation have of course developed a lot, the above restrictions have been essentially suspended, and further institutions have been established as well. In 1995 the organisation was replaced by WTO.

Further information:

22. http://www.wto.org/english/docs_e/legal_e/06-gatt_e.htm

The **OECD** (Organisation for Economic Co-operation and Development) was established in 1948 to carry out the Marshall Plan, and nowadays, it assists in the resolution of certain important economic issues.

Further information:

23. http://www.oecd.org/

The **EBRD**-t (European Bank for Reconstruction and Development) was established in 1991. Its task is to help previously centrally managed economies in their market economy transformation with advice and capital.

Further information:

24. http://www.ebrd.com/pages/homepage.shtml

The **WTO** (World Trade Organization) was established in 1995 to promote international free trade and trade negotiations.

Further information:

25. http://www.wto.org/

12.2.3 The main trends of world economy of our time

As a result of the above described processes, there have been fundamental changes in the world economy in the past decades. In the following we will highlight the most important ones.

Experiment of financial stabilisation

Among economists, the cyclical nature of commodity producing economies has long been known, and following the enormous detriments of the crisis of 1929-33 (and the recommendations of J.M. Keynes) the crisis response efforts have also become increasingly strong. After World War II, in the framework of the above mentioned regulatory efforts of international relations, experiments were done to eliminate economic disruptions caused by the over-indebtedness of certain countries.

The gold exchange standard created by the Bretton Woods agreement and credit system made the management of international finances without great (foreign currency) crises. The system worked relatively successfully between 1945 and 1971.

The weakening of the dollar before 1971 and the so-called oil crisis of 1973 caused the establishment of a new system. It evolved over continuous, non-harmonised corrections and its operation is characterised by insufficient coordination, and the lack of control or unified central management. (Szentes T. – Blahó A. in: Blahó, 2002). The practice of aiding developing countries and the bridging of payment problems with granting loans (sometimes by rescheduling or remitting debts) has significantly expanded.

The seriousness of the problems is increased (multiplied) by the development of the so-called *capital market* (lesson 11.) After three decades, in the first decade of this millennium, it became more and more difficult to maintain financial stability using traditional methods. The ENRON scandal[17] shook the confidence in the financial system of

[17] ENRON was an enormous IT company in the USA. Its 'smart' management, collaborating with the auditors, overstated profits and paid executive bonuses. The

institutions as early as 2002. In 2007, a serious world economic crisis erupted which pushed several countries to the brink of state bankruptcy. The IMF, the World Bank, and the EU all attempted to resolve the problems in the usual way, with debt rearrangement, debt remission, budget cuts, etc. but mostly it proved inefficient. The consequences are still unpredictable in 2014.

Urbanisation

In the last century, the way of life of the Earth's population changed fundamentally. While 100 years ago only a small percentage of them were urban dwellers, today, over half of them live in cities. The system that developed has obvious advantages, and in addition to these, there are significant downsides.

The inhabitants of the ever growing (nowadays in some cases with populations of 20 million) mega-cities have a unique way of life.

- More and more people live in high rise buildings (sometimes in buildings of 100 storeys) – elsewhere they live in favellas (slums) or in tents of refugee camps – all of them living in ever decreasing areas per capita.
- In growing proportions they acquire energy and food from long distances, sometimes from other continents, but a sizeable proportion of them suffer from inhuman circumstances, and sometimes even die of starvation.
- Almost all of them receive wide ranging – but sometimes distorted – information concerning all the major global events (sometimes also about the events in the solar system); but their rights connected to the respect of their privacy are increasingly violated.
- Most of them are able to immediately contact their friends (on Skype for example) wherever they may live on Earth.
- The majority of them have access to a variety of educational, healthcare, commercial, banking, transport, etc. (electronic) services.
- More and more work from home (sometimes in luxury apartments, but e.g.: in India, they work literally in the streets.)

global crisis was caused by the rapid impairment of the company's stock after the real situation had become public knowledge.

Future perspectives of the outlined trends in privacy have hardly been analysed; we can only read literary fiction about the compromise of democracy.[18] One of the exceptions is Rodrik (2014).

Knowledge society

Primarily, works on the world of work discuss this fine sounding slogan given in the title, and its content. According to their starting point, "work" (the population) in modern economies can only be increased in exceptional cases, and capital is only missing from narrow and less promising circles, so the expansion of these resources will not offer great dynamism. Therefore, **growth can primarily be generated by the enrichment of the knowledge base and the use of the knowledge that** is innovations, and its market expanding and productivity improving effects.

Innovation – as we already highlighted in lesson 9 – according to the globally accepted definition of the OECD, is the *introduction* of new or significantly improved product (goods or services) or process, or a new marketing method, or a new organisational technology in business practices, the workplace organisation or external relations (OECD, 2002).

A significant proportion of innovative knowledge is born at companies in the USA where the managers of the companies doing the research ensure that the researchers work in topics according to the needs of the company and that their results are implemented in practice. However, in Europe, innovative knowledge comes from certain "independent" higher education institutions or research institutions (in some sectors in the USA the situation is similar to that in Europe.) However, in such research institutions, the economic correlations of the research depend greatly on the considerations of the institute in question.

The fundamental incentive of the creation of new economically valuable knowledge is the protection of this knowledge. The tools used to protect this so-called **intellectual property** are: patent, the utility model, the trademark, the design right, know-how – and copyright law.

The **patent** gives the exclusive right to exploit, produce and distribute the invention for a maximum of 20 years (in some specified cases for 25 years in the chemical and pharmaceutical industries) in the

[18] Greek philosopher, Plato also sketched the image of a perfect state run by wise philosophers in his work entitled The Republic. However, this type of perception has been pushed into the genre of sci-fi, and among more demanding reads, some pessimistic works proved to be vendible: e.g.: Brave New World by A. Huxley, a novel, which depicts the future majority of people as dumb conveyor belt countermen; or 1984 by G. Orwell, a vision featuring the dictatorship of the Big Brother who controls everything.

area of the given country(s). For its transfer, or for the use of the knowledge recorded in it, others have to pay.

Inventions are patentable from any area of technology if (1) it is new, (“) it is based on inventive activities, and (3) based on its description, it is industrially applicable (reproducible.) (Pintz, 2005)

Under globalisation, the protection of intellectual property has substantially strengthened. Also, developing countries accepted that they have to pay for the patents. Namely, they experienced that the lack of them significantly impedes technological transfer. The changes in the recent past testified that in innovation the knowledge applied is not new, but it comes from a transfer of knowledge. So success is not caused by the creation of some new knowledge, but by knowledge diffusion.

Sustainable development

The requirement for the sustainability[19] of economic growth became well-known in 1972 – after the publication of the report entitled “The limits to growth” by the Club of Rome. This report pointed out that **due to the depletion of the resources of Earth and increasing environmental pollution, it is not possible to continue the rapid economic growth of the past century(s)** and that the management of the emerging troubles requires global action. The experts accepted this diagnosis but the therapy recommended for averting the troubles is not unified. Some of the adherents of these views only call for the protection of the natural environment, while others also find it necessary to set targets beyond these (e.g.: the fight against poverty.)

The protection of the natural environment seeks on the one hand to use the natural treasures, today the primary sources of energy, in a sustainable way, to minimise environmental pollution (Szlávik, 2013). According to the authors, the cause of the problem in both cases is that the pollution of the environment is an externality (that is, corporate calculations do not reflect that with the used or polluted resource we consume the supply available to mankind; see: lesson 10.)

In the case of natural resources, the objective is to moderate the use of non-renewable energy and materials

- with frugality,
- increasing the proportion of the use of renewable sources (e.g.: water, wind, and solar),
- recycling waste.

[19] Concerning the concept of sustainability, see point 7.2.1.

In the case of pollution, the basic task is

- creation of cleaner technologies, and
- preparation for the expected climate change, sea level rise.

However, the method to achieve the objectives indicated is uncertain. In each subject, e.g.: progress is significantly more difficult because it conflicts with the interests of certain very influential and strong interest groups who wish to preserve the status quo (e.g.: oil exporting countries.)

The agenda of suppressing poverty – and especially the resolution of the North-South conflict – is even more controversial. Birth control is a traditional recommendation (and existing practice in e.g.: China.) Providing developing countries with aid is also widespread. In some cases these were successful, as with the East-Asian Tigers but elsewhere, in most African and several South American countries, they were not, and the differences in the standard of living are still growing. Most of the experts believe that **the problems in these latter regions cannot be solved without cultural preparation and, especially, effective education.** In this, companies (more precisely the corporate HR management) have a lot to do. Another point is that in order to close up culturally, the countries concerned would have to eliminate their democracy deficit and their rampant corruption. The good example of Singapore shows that this is not impossible (however, we do not know the recipe of their success.)

Despite these and the present-day visions of catastrophes, M. Ridley judges the foreseeable future of humankind with sober optimism in his world-famous book (2012.) He bases his views on trends of the past millennia of improving standards of living (e.g.: GDP/capita) which have grown in order of magnitude in the past centuries. As we already highlighted in lesson 9, it assumes that humankind, maybe after significant catastrophes, will find the possibility to resolve troubles and to survive unavoidable problems.

12.3 SUMMARY, QUESTIONS

12.3.1 Summary

Lesson 12 sharply emphasises that in the 21st century, humankind with its population reaching about 10 billion is surely forced to resolve its main troubles with global cooperation. This cooperation is aided by modern information and communication technology. The lesson presents the emerging institutional system of the global administration of the world

economy. It reviews the evolving main trends of global economic processes: outlines the attempts for international financial stabilisation, points out the improving standard of living of the population of Earth, analyses the prospects for knowledge based productive activities, and assesses the perspectives of sustainable development with sober optimism.

12.3.2 Self-check questions

? What changes make globalisation possible and necessary in our time?

? How does the settling of a multinational company affect the economy of the host country?

? What is the gold exchange standard system?

? What kind of changes has globalisation cause in the everyday life of people?

? Why don't developing countries reject their payment obligations on patents?

? What long term views on the future development of the world economy do you know?

12.3.3 Practice tests

? Is it true that globalisation developed because of the pressure of the most powerful interest groups of the world economy? yes – no

? How many people are living on Earth in 2014?

3 – 5 – 7 – 10 – 12 – 15 – 18 – 20 billion people

? What is the essence of the North-South conflict?

- abolishment or the preservation of slavery in the US Civil War;
- fight between the colonial powers and their colonies;
- differences in wealth between developed and poor countries;
- differences in astronomical navigation in the two hemispheres.

? Give examples of inventions that permitted the creation of modern ICT.

telegraph, telephone, radio, TV, computer, Internet

? Is it true that the parent company of a multinational company is always American or Western European? yes – no

13. SUMMARY

13.1 CONTENT SUMMARY

During the discussion of the curriculum we emphasised the basic concepts and basic economic correlations which will be essential in subsequent economic studies and contribute to the development of an economic approach necessary in corporate practice.

We discussed the microeconomic correlations from the point of view of the market and the market actors. We got acquainted with the fundamental market motivations of the producers and the consumers. With this we created the possibility to adapt to the satisfaction of the consumer needs in our future practical activities in a way that it will result in the highest possible profit for the entrepreneurship that we represent.

We discussed the economic questions related to the national economy from a practical point of view, along the lines of economic policy, with the aim of learning about the macroeconomic environment in which the actors of the national economy operate. With this we clarified the environmental factors in which we will have to move in the course of our work and life. We also created the possibility for us to adapt to these environmental factors favourably, and to exploit the economic advantages that the above mentioned economic environment provides.

13.2 CLOSING THOUGHTS

The creators of the curriculum hope that the knowledge acquired here will base future economic studies, supplement the knowledge gained so far and that they can be successfully utilised in practical work as well.

14. SUPPLEMENTS

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14.2 INVENTORY OF MEDIA ITEMS

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