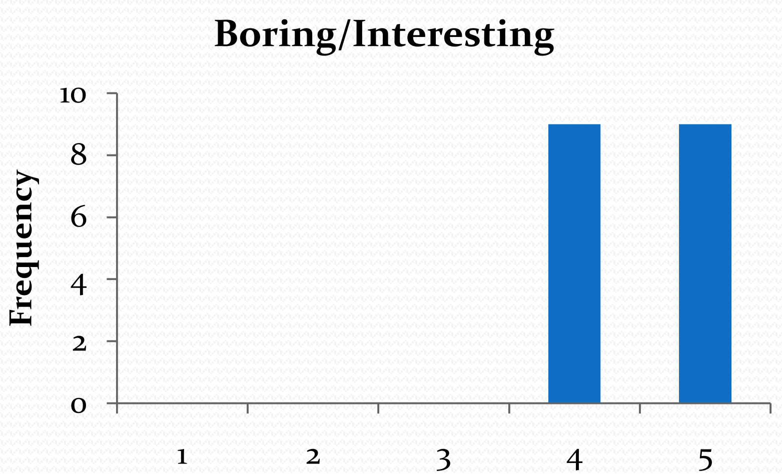
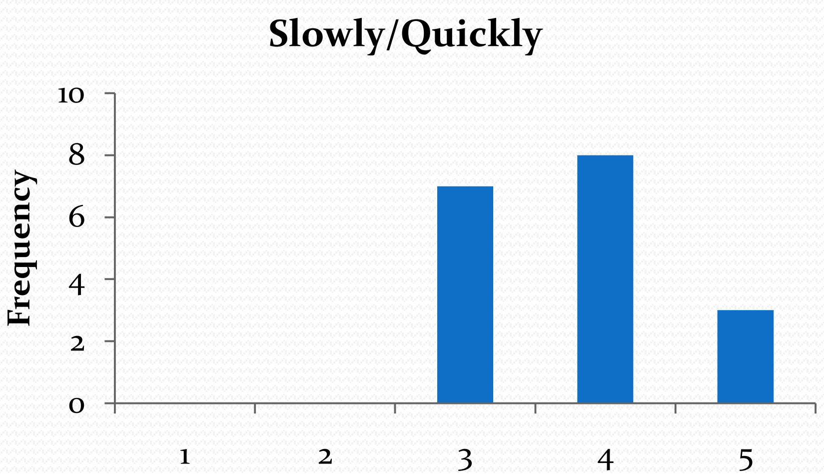
EC1800 ECONOMICS

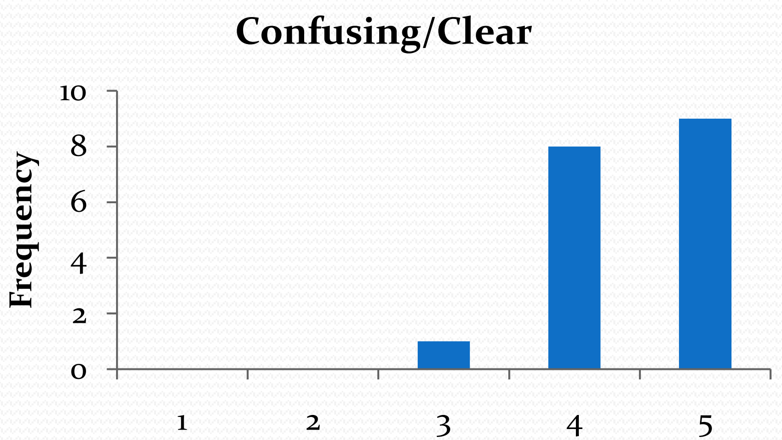
Lectures 4-6

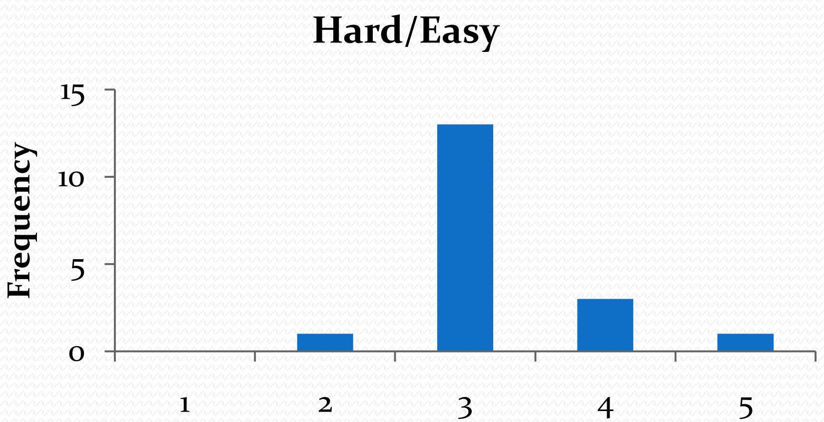
Mr. Niall Douglas MA BSc
NDouglas@bismail.ucc.ie

Last Week's Feedback Form Results









So what did you think about the Reading?

What we covered last week I

- Two Kinds of Wealth:
  1. Relative to Society (Money, Status, Power etc)
  2. Relative to You (Happiness, Friends, Security etc)

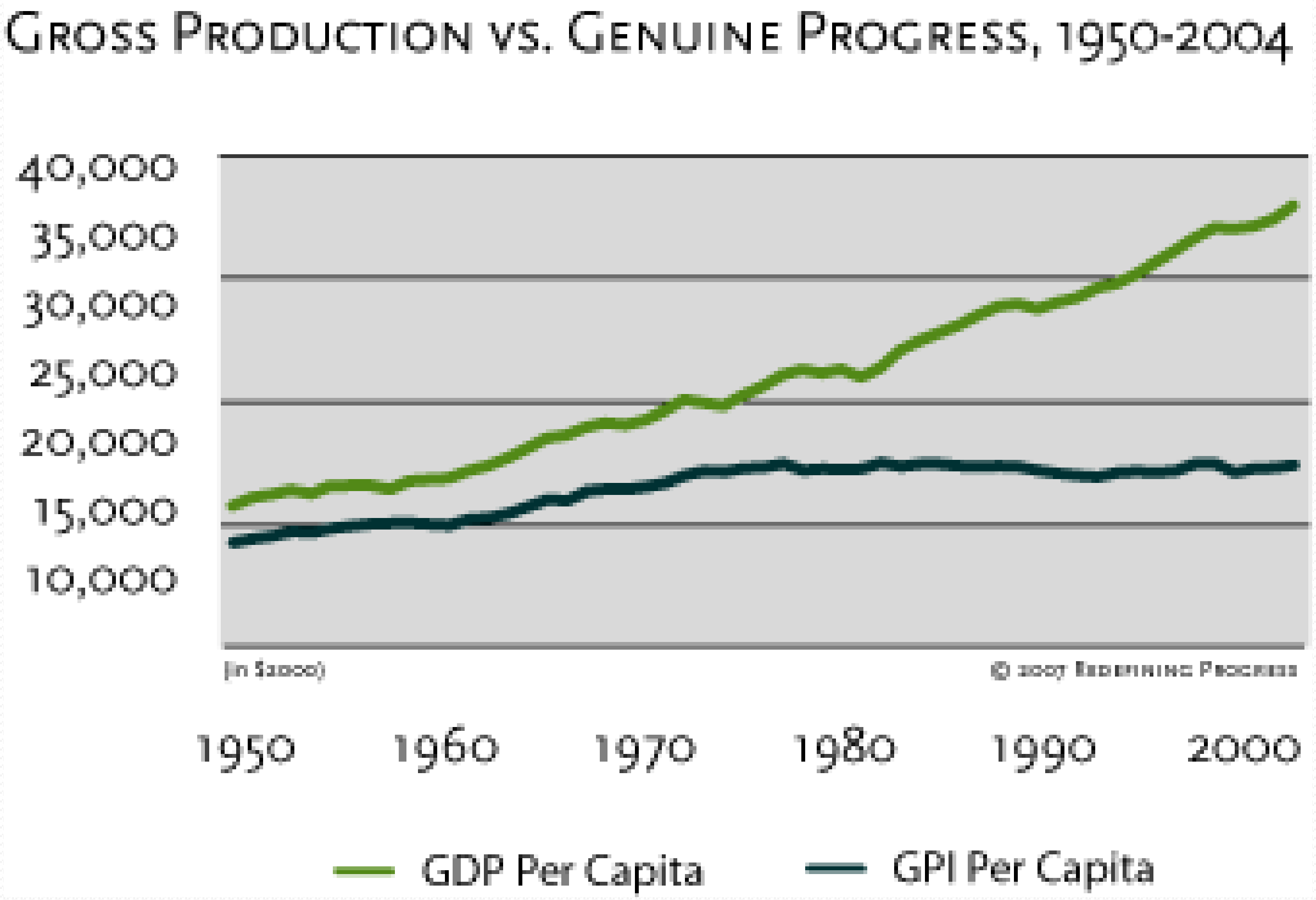
(Note that first kind tends to be associated with hard 'maleness', the second kind with soft 'femaleness')

- There is also wealth and *potential* wealth
  - This explains doing something with worse *opportunity cost* now because it increases your future potential
- Increasing potential wealth is ALWAYS risky
  - No one can predict the future

What we covered last week II

- *Gross Domestic Product* (GDP) is a measure of all spending upon final goods & services in a geographical region
- GDP is a good measure of *activity* which, due to European history, is strongly associated with wealth
- To compare the relative activity of regions, we compare *GDP per capita*. According to this Ireland is the fifth wealthiest in the world!
- The rise in House prices may make many people worth a lot of money, but if you can't access the value then you have *a cash flow* problem which how "rich" people feel. You can be worth millions but still be a pauper

Genuine Progress Indicator
= GDP + “free” work – “bad” GDP



Is GDP a bad measure of wealth?

- As mentioned before, GDP is a much better measure of activity than wealth
- So why do governments still keep using GDP as the wealth measure?
- Are they misleading us?

Wealthiness I

- Comparing money values allowing one person or group of people to compare themselves to another person or set of people
- This is why money is useful
- Generally speaking, **the more money you control relative to someone else**, the more POTENTIAL to direct economic activity relative to someone else
  - E.g. €250,000 can buy you a house. Or it can pay for rearing one child (this is the average in Ireland today!)

Wealthiness II

- Another way is to ask people how wealthy they think they are
- The European Quality of Life Survey determines wealth through measuring:

1. Access to material resources (having)
2. Social relationships and social support (loving)
3. Perceptions of society (being)
4. Time use and work-life balance (time pressure)

Life Satisfaction

Rank	Country	Score	Rank	Country	Score
1	Denmark	8.4	17	Slovenia	7
2	Finland	8.1	18	France	6.9
3	Austria	7.8	19	Greece	6.8
4	Sweden	7.8	20	Czech Republic	6.5
5	**Ireland**	**7.7**	21	Poland	6.2
6	Luxembourg	7.7	22	Romania	6.2
7	Belgium	7.5	23	NMS	6.1
8	Netherlands	7.5	24	Portugal	6
9	Spain	7.5	25	Estonia	5.9
10	UK	7.3	26	Hungary	5.9
11	Malta	7.3	27	Slovakia	5.7
12	EU15	7.3	28	Turkey	5.6
13	Germany	7.2	29	CC3	5.6
14	Italy	7.2	30	Latvia	5.5
15	Cyprus	7.2	31	Lithuania	5.4
16	EU25	7.1	32	Bulgaria	4.4

GDP per capita

Country ↓	Rank	IMF[1] ↓
Luxembourg	1	103,125
Norway	2	83,485
Qatar	3	78,754
Iceland	4	64,548
Ireland	**5**	**60,209**
Switzerland	6	58,513
Denmark	7	57,137
Sweden	8	49,603
Finland	9	46,856
Netherlands	10	46,774
United Kingdom	11	46,099

Wealthiness III

- Did you notice how life satisfaction surveys roughly match GDP per capita?
- For some reason people seem to feel more satisfied when they are more active
  - For example, suicide rates dropped to near-zero all over Europe during World War II – even in countries which weren't fighting!
- People seem to feel wealthier when they feel they have a goal & purpose to life

Are people wealthy just because they *think* they are wealthy?

Is being busy fixing society's ills an indicator of wealth?

Sustainability I

- After all that, the next problem is whether all this economic activity is *sustainable*
- Sustainability means the capacity to keep performing the activity long into the future
- For example, one reason that Ireland has partially become materially rich through a continuing investment in education
  - i.e. People just like you investing in their futures
- What happens if Ireland completely stopped investing in education tomorrow? Would the economy collapse?

Sustainability II

- To be sustainable **requires** investing in the future
  - Into maintenance & repairs of buildings and machinery
  - Into educating future workers
  - Into building new roads and factories i.e. New capacity

- Economics sees saving money for a rainy day as much the same as investing that money into future capacity
  - After all, the bank simply invests your money for you into future capacity

Sustainability III

- The technical term for productive capacity is *capital*
- The technical term for the value produced by productive capacity is *revenue*
- If your revenue is bigger than your costs, you make *profit*
- But if your costs are bigger than your revenue, you make a *loss*

- Sustainability **requires** making a profit over time. You make losses occasionally, but it must be repaid out of profits next time

Sustainability IV

- There are five main types of Capital (from the Sustainability Forum – Jonathan Porritt):
  1. Natural capital
     - The Planet: Environment, Ecosystems etc.
  2. Social capital (= society)
     - Human Social Networks: Institutions, Morality, Charity etc.
  3. Human capital (= individuals)
     - People: Education, Personal Discipline, Aptitude etc.
  4. Manufactured capital (= means of producing what society wants)
     - Means of Production: Buildings, Factories, Machinery etc.
  5. Financial capital (= means of changing relative human-wealth in society)
     - Money: Cash, Shares, Stocks, Insurance, Bonds, Options etc.

Sustainability V

- All types of capital can produce revenue
- Most firms try to combine different kinds of capital in order to produce *added value* which they try to sell in order to make a profit profit
- Initially (before 1950) manufactured capital was expensive relative to social and human capital
- Karl Marx felt that machinery should be subject to humans, not the other way round
- Therefore we have increased human wages relative to the cost of new machinery & infrastructure
  - Trains, Bridges, Roads etc today are far cheaper relative to human labour than they used to be

Sustainability VI

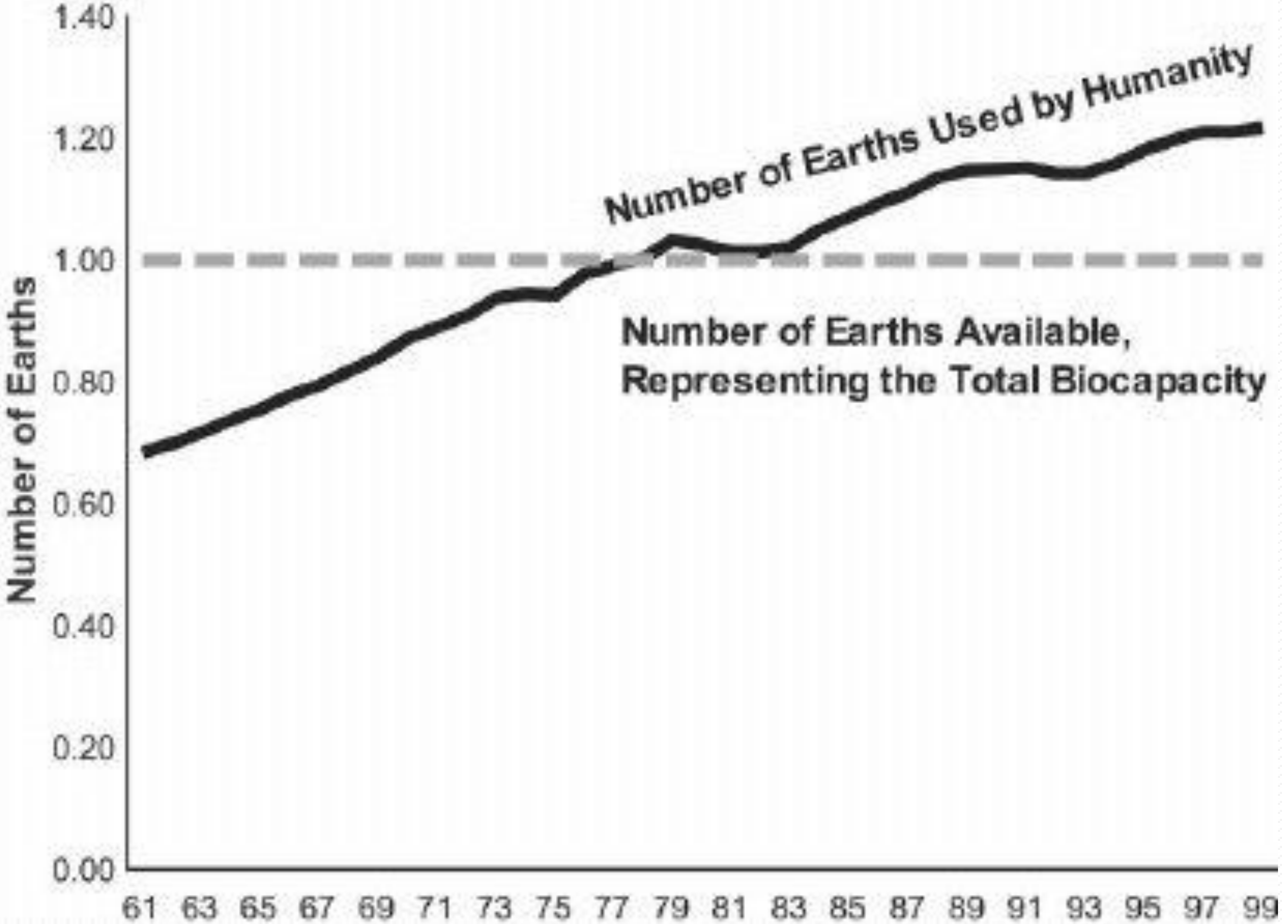
- As a result of constant wage rises in the West, nowadays human capital in the West is vastly more expensive relative to everything else
- This is why we substitute machines for humans wherever possible in the West
- We don't just substitute machines, we also have been substituting natural capital for human capital
  - In other words, wage rises => global warming
- 80% of global warming is caused by richest 20% and poorest 20% of world population
- Therefore, wealth gap = climate change

Sustainability VII

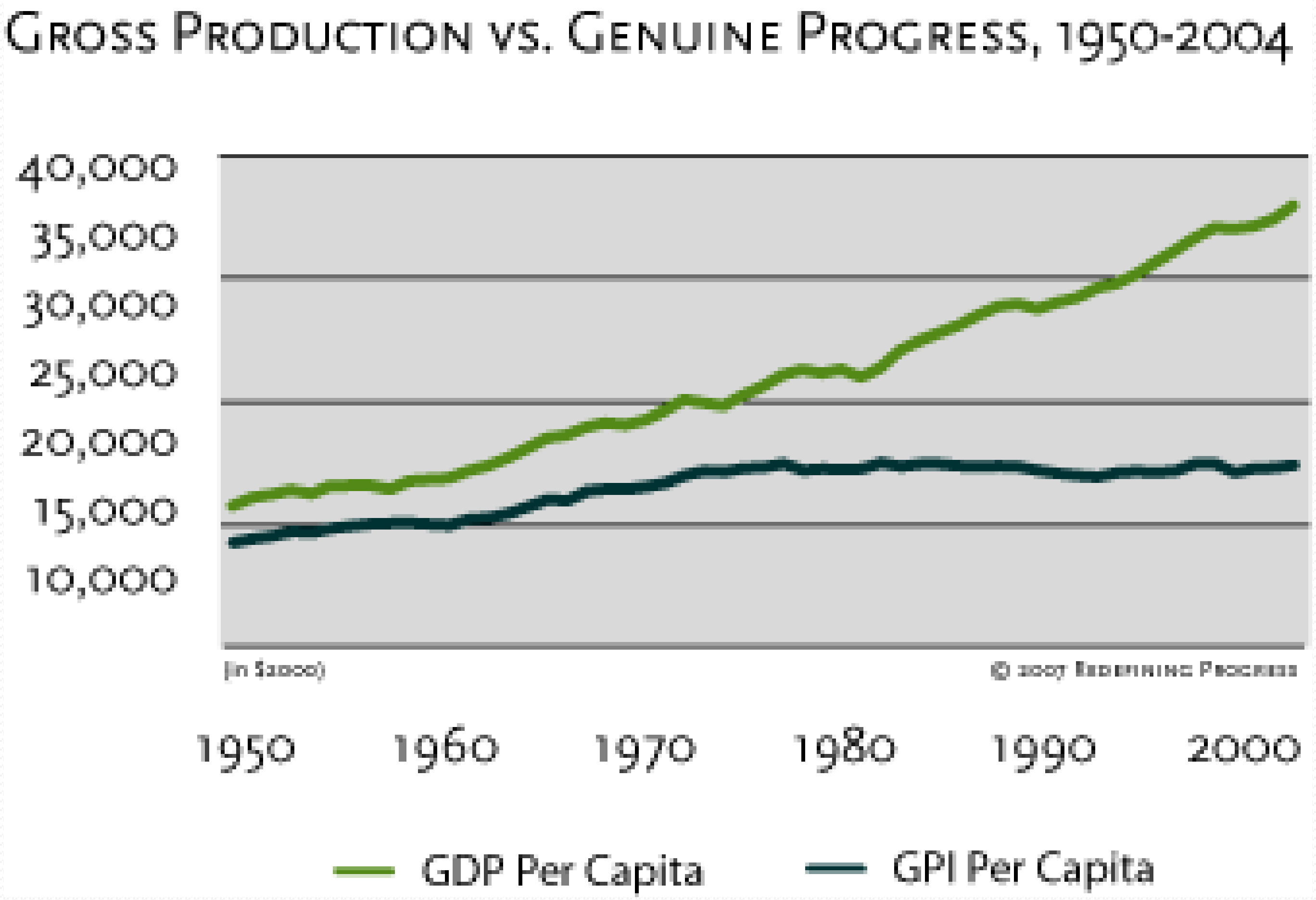
- One HUGE problem is correctly accounting for natural capital
- Conventional Economics treats it as infinitely huge, such that it never runs out. This was a reasonable assumption for most of human history
- Therefore one can infinitely convert natural capital into revenue forever

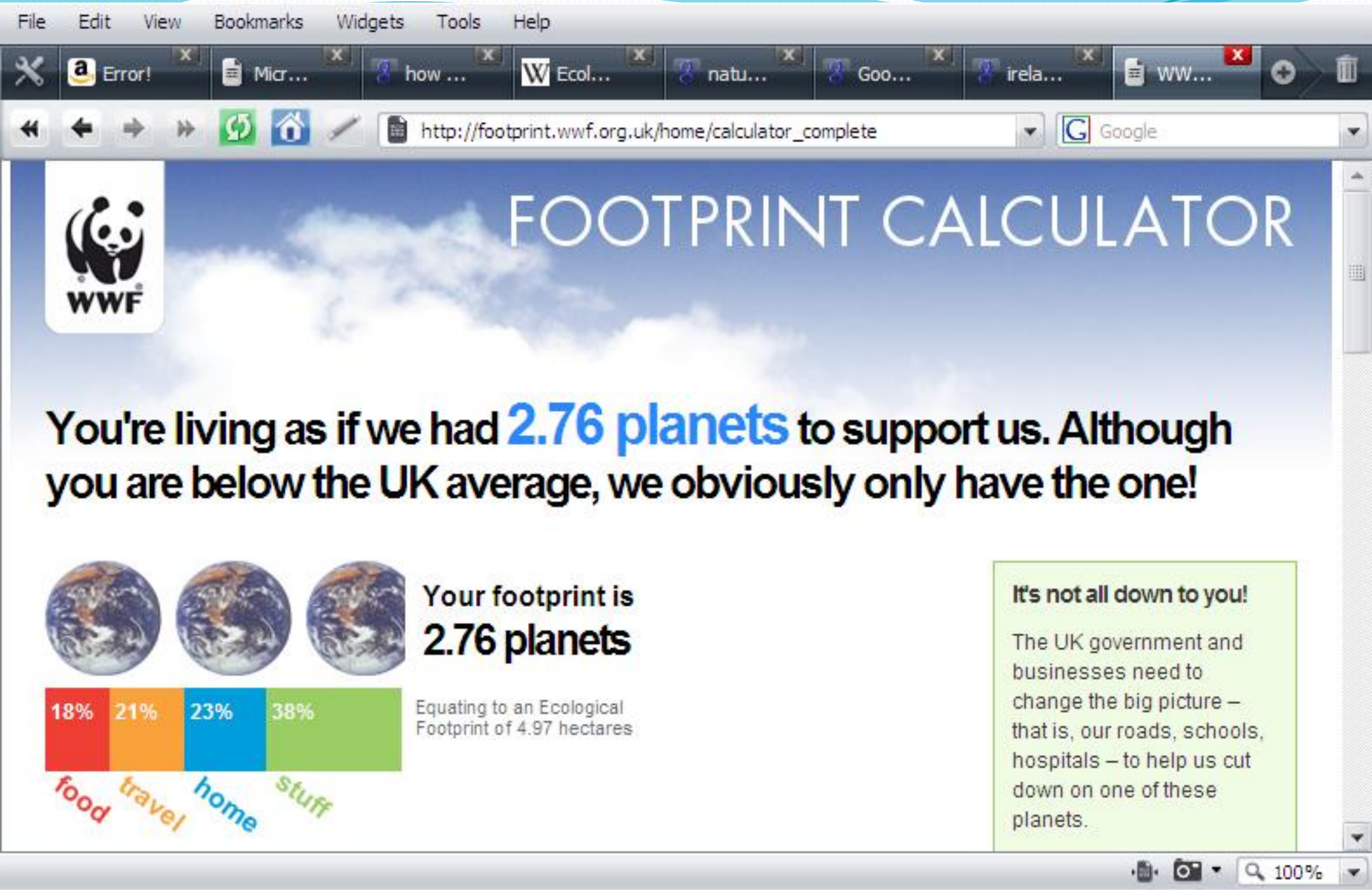
  = free profits!
- Obviously we are running into problems here

Sustainability VIII



Genuine Progress Indicator = GDP + “free” work – “bad” GDP




File Edit View Bookmarks Widgets Tools Help
http://footprint.wwf.org.uk/home/calculator_complete
WWF
FOOTPRINT CALCULATOR
You're living as if we had 2.76 planets to support us. Although you are below the UK average, we obviously only have the one!
Your footprint is
2.76 planets
18% 21% 23% 38%
food travel home stuff
Equating to an Ecological Footprint of 4.97 hectares
It's not all down to you!
The UK government and businesses need to change the big picture – that is, our roads, schools, hospitals – to help us cut down on one of these planets.

HPI Sustainable Wealth Index = Happiness * Longevity / Footprint

1	Vanuatu	68.21
2	Colombia	67.24
3	Costa Rica	66
4	Dominica	64.55
5	Panama	63.54
6	Cuba	61.86
7	Honduras	61.75
8	Guatemala	61.69
9	El Salvador	61.66
113	**Ireland**	**39.38**

How Sustainably Wealthy is Ireland?

Economic Sustainability I

- For the next few lectures, we are going to concentrate on Economic Sustainability:

  Can we maintain sufficient profits to invest into the future in the long term?

- For this we need to understand how an Economy grows and shrinks?
  - What causes Booms and Recessions?
  - How does *potential wealth* and *information asymmetries* affect the Boom/Bust cycle?
  - How much human suffering is caused?
  - How is the planet affected?

Economic Sustainability II

- Looking at Economic Sustainability = Looking at Sustainability *relative* to human society alone
- Why is it that GPI (GDP minus bad activity) flattened out at EXACTLY the same time human society exceeded the requirements of one planet?
- If the entire of human society has true sustainability wrong (and it appears that we do!), then we are doomed to go the way of the Roman Empire
- We will cover the fall of the Roman Empire in *Upside of Down* and hopefully more thereafter

Before all that, Enron!

- This week's reading is on Enron. If you can understand Enron, you will understand the Credit Crunch
- Enron has the big advantage of being a fairly contained single instance of the credit crunch
  - It makes it much easier to study the credit crunch
- Enron never did anything illegal. It merely started doing what we all do now about five years earlier
- What Enron did even back in 1999-2001 was merely "aggressive" corporate behaviour and wasn't (and still isn't) viewed as immoral or unethical

Enron I

- Enron was named "America's Most Innovative Company" by *Fortune Magazine* for six consecutive years 1996-2001
- Was consistently rated in the list of "Best Company to work for in America" and "Most Respected Companies of America"
- Eminently respected by industry insiders and outsiders alike
- Had personal phone number of both Clinton and Bush

Enron II

- Enron was huge – its capitalisation made it America's seventh largest company
- Owned vast tracts of the energy industry all over the world
- It was licensed by the Securities & Exchange Commission (the SEC) to set up an internal marketplace
- It formed an online website where anyone could trade in derivatives in just about anything
  - Nowadays this is normal, then it was "innovative"

Derivatives & Recessions

- The next lecture or two are going to teach you about *Financial Derivatives*. These are considered a very advanced topic because so very few people understand them
- In fact, most people who work in the stockmarket and the banks know *how to do them* but NOT *how they work*. It is like blind people driving a car
- This is why people using derivatives keep increasingly causing recessions:

  2008-?, 2001-2003, 1990-1991, 1980-1982

Recessions I

- However, derivatives are just the modern *mechanism* for invoking a recession
- ANY recession **always** consists of people overvaluing something i.e. its price rises to insane levels, then people realise it's insane and "the bubble" collapses
- This was the case for the Worldwide Panics of 1797-1800, 1837-1843, 1857-1860, 1873-1896, 1929-1939 and so on
- Prolonged Recessions (Depressions) are important because millions of people suffer. In particular, wars tend to start

Back to Enron

- Remember, nothing that Enron ever did was strictly speaking illegal
- Just the same way, nothing any of the banks and hedge funds did to cause the credit crunch was illegal

- Enron ruined the lives of tens of millions of people
  - Hundreds of thousands of people lost their pension
  - Tens of thousands lost their jobs
  - Who knows how many people lost money investing while the Board of Directors were quietly (but legally) selling their shares
- **HOW DID THIS HAPPEN???**

See You Next Week!