Embassy Information Update

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In this issue:

Welcome to the first issue of the U.S. Embassy Kabul Information Update

Happy New Year! Our January issue focuses on the market economy. We lead this issue with the concept of price controls and why most economists oppose them. We define 'market economy,' and tie it to individual consumer freedom. We follow by comparing and contrasting market and command economies. The final focus is on the importance of the role of consumers and consumer spending.

A 'market economy' is then defined and tied to individual consumer freedom. Comparing and contrasting market and command economies follows with the final focus on the importance of the role of consumers and consumer spending.

Price Controls

The appeal of price controls is easy to divine. Even though they fail to protect many consumers and hurt others, controls hold out the promise of protecting groups of consumers who are particularly hardpressed to meet price increases. Thus the prohibition against usury—charging high interest on loans—was intended to protect someone forced to borrow by desperation; the maximum price for bread was supposed to protect the poor, who depended on bread to survive; and rent controls were supposed to protect those who rented at a time when demand for apartments appeared to exceed the supply and landlords were able to "gouge" tenants.

But despite the frequent use of price controls, and despite the superficial logic of their appeal, economists are generally opposed to them, except perhaps for very brief periods during emergencies. The reason is that controls on prices distort the allocation of resources. To paraphrase a remark by Milton Friedman, economists may not know much, but they do know how to produce a surplus or shortage. Price ceilings, which prevent prices from exceeding a certain maximum, cause shortages. Price floors, which prohibit prices below a certain minimum, cause surpluses.

Suppose that the supply and demand for automobile tires are balanced at the current price, and that the government then fixes a lower ceiling price. The number of tires supplied will be reduced, but the number demanded will increase. The result will be excess demand and empty shelves. Although some consumers will be lucky enough to purchase tires at the lower price, others will be forced to do without.

Excerpt from "Price Control" by Hugh Rockoff.
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What is a Market Economy?

Introduction

Throughout history every society has faced the fundamental economic problem of deciding what to produce, and for whom, in a world of limited resources. In the 20th century, two competing economic systems, broadly speaking, have provided very different answers: command economies directed by a centralized government, and market economies based on private enterprise. At the end of the 20th century, it is clear that, for people throughout the world, the central, command economy model has failed to sustain economic growth, to achieve a measure of prosperity, or even to provide economic security for its citizens.

Yet for many, the fundamental principles and mechanisms of the alternative, a market economy, remain unfamiliar or misunderstood -- despite its demonstrable successes in diverse societies from **(con't)**

… Western Europe to North America and Asia. In part, this is because the market economy is not an ideology but a set of time-tested practices and institutions about how individuals and societies can live and prosper economically. Market economies are, by their very nature, decentralized, flexible, practical and changeable. The central fact about market economies is that there is no center. Indeed, one of the founding metaphors for the private marketplace is that of the "invisible hand."

Market economies may be practical, but they also rest upon the fundamental principle of individual freedom: freedom as a consumer to choose among competing products and services; freedom as a producer to start or expand a business and share its risks and rewards; freedom as a worker to choose a job or career, join a labor union, or change employers. It is this assertion of freedom, of risk and opportunity, that joins together modern market economies and political democracy.

Market economies are not without their inequities and abuses -- many of them serious -- but it is also undeniable that modern private enterprise and entrepreneurial spirit, coupled with political democracy, offers the best prospect for preserving freedom and providing the widest avenues for economic growth and prosperity for all.

Command and Market Economies

Products such as bread, meat, clothing, refrigerators, and houses are produced and sold in virtually every country of the world today. The production methods and resources used to make these products are often very similar in different countries -- bread, for example, is made by bakers using flour and water, often with salt, sugar, and yeast added, then baked in ovens. Once the bread has been baked, the loaves are sold to consumers in stores that, at least superficially, can look very much alike, even in countries with very different kinds of economic systems.

Command Decisions About Clothing

Despite those apparent similarities, if we compare such market economies as those of North America, Western Europe, and Japan to the command economies found in the former Soviet Union, Eastern Europe, and parts of Asia over the past half century, the processes used to determine what products to make, how to make them, what prices to charge for them, and who will consume them are starkly different. To see those differences more clearly, consider how production and sales decisions are made in the two kinds of systems for a specific kind of product, say shirts and blouses.

In command economies, government committees of economic planners, production experts, and political officials establish production levels for these goods and designate which factories will produce them. The central planning committees also establish the prices for the shirts and blouses, as well as the wages for the workers who make them. It is this set of central decisions that determines the quantity, variety, and prices of clothing and other products.

Predictably, the products from this limited number of choices sell out quickly, disappearing from store shelves. Why? Because factories failed to meet their production quotas, perhaps, or because the central planning group underestimated how many shirts people want to buy at the prices they set. In either case, unless the planners take steps to increase production, raise prices, or both, the shortages will continue.

As the number of people living in the command economies increases, along with the number and sophistication of new products, it becomes harder and harder for central planners to avoid or eliminate shortages of the many things consumers want -- or surpluses of the products they don't. With more products, more people, and rapidly changing production technologies, the central planners face an explosion in the number of decisions they have to make, and in the number of places and ways where something could go wrong in their overall plan for the national economy.

This phenomenon doesn't happen in the market economies, because that kind of economic system works in a very different way. To begin with, no government ministry decides how many shirts or blouses to manufacture, or what styles and colors. Anyone -- individual or company -- can decide to produce and sell shirts and blouses in a market economy, and many **(con't)**

… will do just that if they believe they can sell these products at prices high enough to cover their production costs -- and earn more making such clothing than they can doing something else. This leads to direct competition between different firms making and selling these products, and that competition is one of the basic reasons why there are generally so many different styles, fabrics, and brands of clothing for consumers to choose from in market economies.

Of course, if consumers decide to buy just one kind of shirt and blouse month after month and year after year, producers would soon learn that there was no reason to produce any other kind. But that simply hasn't happened where people are allowed to choose from a wide selection of clothing products.

The Price of Shirts

Another key point about market economies is that the prices for shirts, blouses, and other products sold in stores aren't set by a government planning committee. Instead, every seller is free to raise or lower prices according to changing market conditions. For example, if one kind of shirt becomes very popular for a time, and stores are worried about running out until they can get more, the price of such shirts will usually rise, at least until new shipments arrive. This price increase accomplishes two things at the same time: first, by making this kind of shirt more expensive compared to other shirts and products, some consumers will choose to buy fewer of them and more of other items. Second, because the higher price goes directly to those who produce and sell the shirts -- not the government -- the higher price increases the profits of firms that make and sell this shirt, enabling them to produce and sell more units.

Firms that make other products also see those higher profits going to the shirt producers, which leads some firms to stop making something else and start making those popular shirts. For all of these reasons -- consumers buying fewer shirts, current shirtmakers producing more shirts, and other firms deciding to begin making shirts -- any shortage will soon be eliminated. Notice that it doesn't take a central planning committee to make any of these decisions. In fact, the process happens faster, and in some sense automatically, precisely because consumer and producer decisions are decentralized.

Markets

The higher prices for shirts give every consumer and producer incentives to respond this way, because they are allowed to reap the benefits of their own decisions, while also bearing the associated costs and risks. For example, consumers willing to pay the higher prices can still get the most popular shirts, but they have to give up more money (and therefore other goods and services) to do so.

On the production side of the market, firms making shirts that are popular with consumers can sell them at competitive prices and earn profits. But producers who make unwanted products, or operate inefficiently and pay too much to make their products, will incur losses. Eventually, they must either learn to produce and compete efficiently -- making products consumers want at competitive prices -- or they will go out of business, and someone else will take over their factories, machines, and other resources. In a nutshell, that's how economic incentives work in a market economy.

The same basic process operates in many different kinds of markets -- literally wherever any kind of price is free to rise and fall, including prices for the work people do, for the food they eat, and for the money they save in or borrow from banks.

Market economies provide no magic solutions, however, and government plays a critical role in helping correct problems that can't be fully solved by a system of private markets. Moreover, market economies are by no means immune to pressing public policy issues in today's global economy -- issues such as inflation, unemployment, pollution, poverty, and barriers to international trade. Nevertheless, in comparison to the chronic shortages and inherent inefficiencies of command economies, a free-market economic system offers greater opportunities for economic growth, technological progress, and prosperity.

Consumers in a Market Economy

Consumers in both market and command economies make many of the same kinds of decisions: they buy food, clothing, housing, **(con't)**

… transportation, and entertainment up to the limits of their budgets, and wish they could afford to buy more. But consumers play a much more important role in the overall working of a market economy than they do in a command economy. In fact, market economies are sometimes described as systems of consumer sovereignty, because the day-to-day spending decisions by consumers determine, to a very large extent, what goods and services are produced in the economy. How does that happen?

Buying Oranges and Computer Chips

Suppose a family -- Robert, Maria, and their two children -- go shopping to buy food for a family dinner. They may originally be planning to buy a chicken, tomatoes, and oranges; but their plans will be strongly influenced by the market prices of those goods.

They may discover, for example, that the price of oranges has increased. There are several things that might cause those higher prices, such as freezing weather in areas where oranges are grown, which destroys a large part of the crop.

The effect of the freeze is to leave the same number of consumers trying to buy a smaller number of oranges. At the old -- lower -- price, therefore, sellers would soon run out of oranges until the next harvest. Instead, by raising the price, all consumers are encouraged to cut back on the number of oranges they buy, and producers are encouraged to grow more oranges as fast as they can.

There is another possibility: suppliers could choose to import a larger number of oranges from other countries. International trade, when it is permitted to operate with relatively few barriers or import taxes (called tariffs), can give consumers wider choice and allow producers to offer more competitive prices for a wide range of products, from oranges to automobiles.

On the other hand, the orange crop might be spared freezing weather, but instead consumers decide to start buying more oranges and fewer apples. In other words, instead of the orange supply shrinking, demand increases. This, too, will drive up the price of oranges for a time, at least until growers have time to bring more oranges to market.

Whatever the reason for the higher price, Robert and Maria will probably respond in a predictable way once they discover that the price is higher than they anticipated. They may well decide to buy fewer oranges than they had planned, or to buy apples or some other fruit instead. Because many other consumers make the same choices, oranges won't disappear from store shelves entirely. But they will be more expensive, so only the people who are willing and able to pay more for them will continue to buy them. Shortly, as more people start buying apples and other fruits as substitutes for oranges, the prices of those fruits will rise as well.

But the response of consumers is only one side, the demand side, of the equation that determines the price of oranges. What happens on the other side, the supply side? A price increase for oranges sends out a signal to all fruit growers -- people are paying more for fruit -- which tells the growers it will pay to use more resources to grow fruit now than they did in the past. It will also pay the fruit growers to look for new locations for orchards where fruit isn't as likely to be damaged by bad weather. They may also pay biologists to look for new varieties of fruit that are more resistant to cold weather, insects, and various plant diseases. Over time, all of these actions will increase the production of fruit and bring prices back down. But this whole process depends first and foremost on the basic decision by consumers to spend some part of their income on oranges and other fruits. If consumers stop buying, or if they decide to spend less on a product -- for whatever reason -- prices will drop. If they buy more, increasing demand, the price will rise.

Keep in mind that this interaction of supply, demand, and price takes place at every level of the economy, not just with consumer goods sold to the public. Consumption refers to intermediate goods as well -- to the inputs that companies must purchase to provide their goods and services. The cost of these intermediate, or investment, goods will ripple throughout a market economy, changing the supply-and-demand equations at every level.

Let's take the example of the semiconductor chip that is at the heart of the modern computer revolution. As with the case of oranges, higher prices **(con't)**

… will tend to reduce demand for computer chips and, consequently, for computers themselves. Over time, however, the higher price will signal manufacturers of computer chips that it may be profitable to increase their production, or for new suppliers of chips to consider entering the market. As chip prices come down, so eventually will the cost of computers (assuming that the cost of other inputs remains unchanged), and demand for computers will grow.

That demand for computers will do more than simply spur suppliers to increase their output. It will also encourage innovation, which will result in computer chips and computers that are more powerful and efficient than earlier models -- a competition of progress and price that occurs in virtually all genuinely free markets.

Prices and Consumer Incomes

The other economic factor that consumers must consider carefully in making their purchases of goods and services is their own level of income. Most people earn their income from the work they perform, whether as physicians, carpenters, teachers, plumbers, assembly line workers, or clerks in retail stores. Some people also receive income by renting or selling land and other natural resources they own, as profit from a business or entrepreneurial venture, or from interest paid on their savings accounts or other investments.

We later describe how the prices for those kinds of payments are determined; but the important points here are that: 1) in a market economy the basic resources used to make the goods and services that satisfy consumer demands are owned by private consumers and households; and 2) the payments, or incomes, that households receive for these productive resources rise and fall -- and that fluctuation has a direct influence on the amount consumers are willing to spend for the goods and services they want and, in turn, on the output levels of the firms that sell those products.

Consider, for example, a worker who has just retired, and as a result earns only about 60 percent of what she did while she was working. She will cut back on her purchases of many goods and services, especially those that were related to her job, such as transportation to and from work, and work clothes -- but may increase spending on a few other kinds of products, such as books and recreational goods that require more leisure time to use, perhaps including travel to see new places and old friends. If, as in many countries today, there are rapidly growing numbers of people reaching retirement age, those changing spending patterns will affect the overall market prices and output levels for these products and for many others that retirees tend to use more than most people, such as health care services. In response, some businesses will decide to make more products and services geared toward the particular interests and concerns of retirees -- as long as it is profitable for firms to produce them.

To summarize: whether consumers are young or old, male or female, rich, poor, or middle class, every dollar, peso, pound, franc, rupee, mark, or yen they spend is a signal -- a kind of economic vote telling producers what goods and services they want to see produced.

Consumer spending represents the basic source of demand for products sold in the marketplace, which is half of what determines the market prices for goods and services. The other half is based on decisions businesses make about what to produce and how to produce it.

(Source: http://usinfo.state.gov/products/pubs/market/)

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