

HOW OUR ECONOMIC SYSTEM WORKS

by

William G. Tapply

The Lincoln Filene Center for Citizenship and Public Affairs
Tufts University
Medford, Massachusetts 02155

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Undated work, inspiration for “Wally and the Walnuts”

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INTRODUCTION: WHAT IS ECONOMICS

We study the political process in the belief that it is desirable for as many Americans as possible to participate in some way in politics. At the same time, we recognize that more than 30 percent of the qualified citizens choose not to vote in presidential elections. Fewer than half vote in local elections. The citizen may consciously decide for himself whether or not he will vote, or aid the candidate of his choice, or run for office himself.

We study the legal process with the understanding that many Americans will never require the protections this process offers. Due process of law is a safeguard, a very important one that sets our society above other less democratic ones. It is there to be called upon if necessary. The less often this necessity arises, the better.

Economics differs from both politics and law. Everyone participates in economics; one may not choose whether he will or will not take part in the economic process. Every time you purchase a new shirt, a candy bar, or a magazine you are actively contributing to the American economy. You are acting as a consumer. When you receive money for helping to make something, you are participating in economics. In this case you are a producer.

Consuming and producing are the two processes we study in economics. These processes are not limited to items such as food, clothing, toys, or books. Goods are not the only things produced or consumed in our economy. We may also go to the dentist to have our teeth filled. Or we may hire a man to paint our house or repair our television set. We say the dentist and the house painter and the TV repairman produce services. Whenever we pay an individual to perform a service, we are consuming a service. When we study economics then, we study the production and consumption of goods and services.

In addition to the processes of production and consumption, it is important to examine the ways in which goods and services are distributed. How much does each of us have of the goods and services produced in the economy? How do the goods and services move from the producer to the consumer? When we study the allocation of wealth, whether measured by income or by the possession of goods and services, we are studying the process of distribution.

Just as it may truly be said that every individual is an important part of the American political process, so too is every individual in a position to influence the course of the American economy. In our economy, unlike the economies of the Soviet Union or Sweden, where most economic decisions are made by the government, many of the great economic questions are answered largely by the whole body of citizens. What goods and services shall be produced? How shall they be produced? What shall be their price? To whom and in what manner shall they be distributed? The economic decisions you and millions of others make help to determine the answers to these and other questions.

Of course, in an economy as large and complex as ours, many other forces are at work. The American government is an enormously powerful consumer. Monopolies and near-monopolies can and often do act without regard to private citizens. But the individual does retain some power. Just as the individual votes in an election to determine who shall make the political decisions, so too his "votes" help to decide economic questions. Your vote in the economy when you decide where to spend--and equally important, where not to spend--your money. The greater the amount of money, the greater number of votes you will have.

You probably never have stopped to think that the economic decisions you make are actually decisions at all. You perhaps have not been aware of your influence on the economy. Take the simple act of buying a pound of butter. What sort of decisions are you making? Let's say you decide to go to Maxie's corner grocery store rather than the big supermarket. Because you and others like you patronize Maxie's store, Maxie can stay in business. In order to keep you coming to his store to buy your butter, Maxie must keep his store attractive, his clerks friendly, and his prices reasonable. The supermarket tries to lure you away from Maxie's perhaps by charging slightly lower prices for a pound of butter, or by offering a greater variety of kinds of butter, or by providing better service. Thus Maxie and the supermarket compete with one another for your patronage, and each tries to make his store more appealing to you. If you are a wise consumer, you buy your butter and other groceries at Maxie's not simply out of habit, but because you find the service, or the prices, or the quality of goods at his store better than those at the supermarket. You therefore can help to determine which businesses will be successful and which will fail by the way that you spend your money. You help to decide whether Maxie will get rich or go broke, or whether he will simply continue to make enough profits to stay in business.

So the act of walking into Maxie's store is an economic decision. When you get there, of course, you must make another decision. Should you buy a pound of Mrs. Brown's Home Style Butter, or should you purchase a pound of Lucky Star? Or possibly you might decide to buy Golden Oleomargarine. Your decision might be determined by the taste of this butter, or you might compare prices and buy the cheapest brand. Frequently such decisions are made on the basis of the attractiveness of the package or an advertising slogan. Whatever your decision, your purchase becomes a "vote" for one brand of butter over another. As millions of shoppers cast their votes, many effects follow. One company makes greater profits, while another may lose money. A third may continue at the same rate. The people responsible for advertising the butter of your choice are considered successful and probably get more business. They may then hire more people and perhaps pay higher salaries. Even the dairy whose cows produced the milk from which the butter was made finds itself profiting from your vote.

Since every person is a consumer, then, everyone has a vote in the economy. Even small babies and pets, by expressing preference for one brand of baby food or dog biscuits, participate. Economics certainly affects us all. For this reason, it is vitally important that we understand how the economy works.

Today we hear a good deal about inflation and the possibility of recession. What do these terms mean? How does inflation affect us? What would a recession mean for you personally? These terms describe the American economy as a whole and concern millions of people and billions of dollars. Yet every vote counts. How you and millions like you make your economic decisions helps to determine what happens to our economy.

The American economy is large and complex, but it can be understood because its operation is based on logical principles. The purpose of this narrative will be to help you to understand these principles. Then you can cast your economic votes more wisely and will understand the consequences of your economic decisions.

I. LEARNING TO WORK TOGETHER

In early times, a tribe of very poor people lived in a remote valley. This valley was blessed with fine, rich soil, great herds of wild beasts, and groves of straight, tall trees. Clear, cool water bubbled from numerous springs. Amid this plenty, the valley dwellers remained poor. They struggled to satisfy their basic needs for food, shelter, and clothing. They knew nothing of luxuries and therefore had no real desires for them. Every day of their lives they devoted to survival. The valley had no schools, no theaters, no libraries. The inhabitants knew nothing of baseball or football, chess or poker. Each generation lived as did the one before it, scrabbling for food in the soil with crude handmade tools and hunting the wild animals with primitive weapons. The sad little huts that served as homes let in the rain, sun, wind, and snow. Often a violent storm would destroy all the huts of the village. The people of this valley clothed themselves in smelly animal skins or bark torn from the trees.

Each person who lived in the valley was totally independent of the others. He produced only the goods that he himself needed and consumed only the goods that he had produced himself. Any job that he needed done, he did himself. He constructed his own little hut, planted his own garden, hunted animals for his own food and made his own clothing. He could depend on no one but himself to perform the services he required. Each villager was self-sufficient. No goods were traded among these people. Cooperation on difficult tasks was unheard of.

These were an industrious people. Yet their lot in life never seemed to improve. With all the resources available, the people remained poor. Progress was unknown.

One day, Charles and John were weeding their respective gardens, which happened to be adjacent to each other. Neither seemed to be progressing very rapidly, for the weeds, too, grew fast in such a fine climate, and both men had been forced to spend much time away from the fields repairing their huts, hunting and fishing, and making clothing. Neither Charles nor John was really very skilled at gardening, for they had not the time to devote to practicing the best methods or studying the problems or making efficient tools.

Charles paused in his work, and, leaning on his crude hoe and wiping his brow, spoke to John. "You know, John, I'll bet that if we helped each other we could weed both of our fields much faster and better. If you went along with the hoe digging out the weeds, and I followed behind putting them in a basket, we could really do a better and faster job."

Charles and John tried it, and sure enough. While it had taken each man working separately a full day to weed his field (and doing a poor job at that), both men working together, each doing a different task, were able to weed both of the fields in a little more than half a day. Charles and John were so pleased with their discovery of cooperation and specialization that they spent the rest of the day repairing their huts together.

Both had sustained holes in their roofs from a storm and had to patch them with bark. Working alone, a man would have to cut a piece of bark from a tree, carry it to the hut, climb up on the roof, secure the piece of bark, climb back down, cut another piece of bark, and so on. But Charles and John divided the work and cooperated, cutting enough pieces of bark and carrying them to their huts together. John, who was quite agile and very adept at securing the bark to the roof, would then climb up on the hut, while Charles, who was tall and strong, would remain on the ground and hand up the patches. By nightfall, not only had the gardens been weeded, but both huts also had been repaired neatly.

For the first time in their memories, Charles and John had some spare time after supper. They met in John's hut and talked long into the night, something they never before had the leisure to do. When they said good night, they decided to form a partnership. They would combine their two fields into one big garden. They would plant all the potatoes in one corner of John's plot, where they seemed to grow especially well. The cabbage and corn they would grow in another corner. Because they would be using each section of the field for the crop it grew best, they would be able to grow more and larger vegetables. They even would have room left to experiment with radishes and tomatoes, which they both liked, but which in the old separate gardens neither had dared to waste the space on.

As time passed, the rest of the villagers began to look enviously at the garden of Charles and John. Their corn grew the tallest, their potatoes were the fattest, and their tomatoes the reddest. Yet they seemed to work less often in the fields. Charles and John began to apply the principle of cooperation in their hunting. The two of them, hunting as a team, brought back more game in an afternoon's hunt than any four of the villagers, hunting separately, could bag. They still were able to keep their huts in perfect repair, and they even found the time to add a small room to the back of each hut. With all this great progress, both men nevertheless seemed to spend more time sitting and talking.

Soon other villagers began to emulate Charles and John. They formed partnerships. In groups of three, four, and even more, the villagers began to cooperate with one another. In each case, they produced more goods, men worked more efficiently at the tasks they could perform best, and the villagers enjoyed more leisure time. They began to make musical instruments, and after supper the village no longer saw men still toiling in the fields or repairing their huts. Men found time to relax and play their instruments, or to gather together to discuss ideas. They began to compare the progress each had made and to share new experiences.

At one of these meetings, one young man made a startling proposal: "Suppose we let Charles and John take charge of all the gardening for the whole village. They both prefer gardening to the other tasks and are the best farmers in the village. And then Bill and Mike can devote all their time to hunting, for we all recognize that they are the best hunters in the valley. They can hunt for all of us. I like to make shoes, and I think that if I could spend all my time just making shoes, I could make excellent ones and enough for everyone. Sam could make shirts, and Hank could repair huts."

The villagers talked excitedly about this idea long into the night. They decided that the division of labor would benefit everyone. Soon everyone in the village worked at one task only. Some, such as Sam, the shirtmaker, produced goods. Others, like Hank, who repaired huts, produced services. All of the inhabitants of the valley were consumers, taking the goods or services of others in return for the goods or services they themselves produced.

The people of the valley still had a difficult problem to solve, however. How could all the goods and services that the villagers produced be distributed among themselves? For example, Hank needed shirts, shoes, and food. How could he exchange the one service he performed for the various goods he needed? And how could Charles and John get their huts repaired if they spent all their time working in the fields? The villagers solved this problem by a process of bargaining. John offered Hank a bushel of potatoes in return for having the roof of this hut repaired. Hank felt that his service was more valuable, so he asked John for two dozen tomatoes in addition to the bushel of potatoes. Finally Hank and John agreed on a compromise: Hank would repair John's hut in exchange for a bushel of potatoes and one dozen tomatoes. Soon all the villagers had adopted this system of barter for exchanging goods and services. With this system, everyone could produce that which he produced best, while he could still consume the goods and services produced by the others.

I. Learning to Work Together: Questions on Reading

1. What is meant by the term self-sufficient?
2. What are the disadvantages of being self-sufficient?
3. What is specialization?
4. How does specialization benefit everyone?
5. What kind of conditions give people leisure time?
6. What is a partnership?
7. What are the advantages of partnerships?
8. Why did the villagers begin to make musical instruments? What other things might they have done instead?
9. Explain the idea of the division of labor.
10. What are goods? What are services?
11. What is production?
12. Why was it true that “all inhabitants of the valley were consumers”?
13. Why was the problem of distribution difficult?
14. What is barter? Under what conditions might you use barter?

II. COMPETITION AND MONOPOLY

One of the young villagers, Pete, thought that he could make better shirts than Sam. Pete felt that Sam had become careless, using poor skins and stitching the seams badly. Pete had an idea that if he made better shirts than Sam, the villagers would want his shirts, and he could get many vegetables and other goods. So Pete began making shirts in competition with Sam. He developed a new kind of needle that enabled him to stitch seams more neatly and securely and to sew faster. Soon Pete was making better shirts than Sam and making more of them in a shorter time. In order to sell his shirts, Pete would ask for only nine tomatoes instead of the dozen that Sam had wanted. And he would give Hank five shirts for repairing his hut, instead of the three that Sam had offered.

Sam, of course, had to do something, for Pete soon was taking all his business from him. So Sam thought and experimented and soon devised a new way of preparing animal skins that was better than Pete's way. He continued to ask more for his shirts, but all the villagers conceded that Sam's shirts had now become better than Pete's. Those who wanted high-quality shirts began to trade with Sam, while those who wanted to get them for as little as possible continued to trade with Pete.

Meanwhile, Dave began to compete with Don in the making of shoes. But Dave and Don made shoes in essentially the same way, and there was little to choose between the quality of Dave's and Don's shoes. In order to get the goods and services they needed, therefore, Dave and Don would each try to ask less than the other for a pair of shoes. If Dave asked for ten bunches of carrots, Don would ask for eight bunches. If Don offered five pairs of shoes to have his hut repaired, Dave would offer six pairs. Soon it became evident to both Dave and Don that they couldn't make enough shoes to trade for the goods and services they needed. The competition was hurting both of them. So one day Dave approached Don with a new idea.

"Suppose you and I make shoes together. We will be making all the shoes for the village. If anyone wants shoes, he will have to get them from us. We can then ask anything we want for a pair of shoes. We will have all kinds of things. Of course, we can't ask too much for a pair, or else people will go back to making their own or will just go barefoot. But with a monopoly like this, we can be very successful. Also we won't have to worry about thinking up new and better ways to make shoes. If we are the only ones making them, we can afford to be a little sloppy. If someone else should try to compete with us, we can offer our shoes for very little for a while and drive the other guy out of business."

The villagers, who had to have shoes, weren't too happy about the arrangement Dave and Don had worked out, but there was really nothing they could do about it. Because they needed shoes, they were willing to pay anything reasonable. They had discovered that in most cases when the demand for an item is high, the value of that item will also be high.

They also learned that when Charles and John had a particularly large potato crop, the value of potatoes had dropped. There had been more potatoes than anyone could use, so Charles and John had been forced to reduce their price in order to sell all their potatoes. In other words, when the supply of an item increased, the price usually decreased. Thus the villagers began to understand the law of supply and demand. After a severe storm, Hank, the hut builder, found the villagers offering him a great deal for repairing huts, for there was a high demand on his services while there was a low supply--Hank was the only villager able to repair huts well. But when no huts needed repairing and there was no demand for Hank's services, he had trouble getting enough goods to live on.

II. Competition and Monopoly: Questions on Reading

1. What is competition? Give examples.
2. What are the benefits of competition?
3. What are the harmful aspects of competition?
4. What was the difference in the type of competition between the shirtmakers and the shoemakers?
5. What is monopoly? Give examples.
6. How is monopoly related to competition?
7. How does monopoly affect the consumer?
8. How does monopoly benefit some producers while hurting others?
9. How does the “law of supply and demand” work?

III. BUYING AND SELLING GOODS AND SERVICES

Part of Hank's problem was that he couldn't store the goods he received for his services. When business was heavy, he had more things than he needed, but when there were no huts to build or repair, he lived very poorly. Charles and John, too, found that when they had no harvest to barter with they could not get the goods and services they needed. All the villagers resented the time they had to spend in bartering their goods and services, time they would have preferred to spend in doing their own jobs. How awkward it was for Sam, when he needed corn, to have to trudge to the fields, find Charles or John, and sit down to bargain. And when Bill, the hunter, came in with some ducks, he had to go around to all the villagers trying to exchange his ducks for items he needed. All the time he was doing this, of course, he was not hunting, and therefore his production was lower than he knew it could be.

Willy, who was a particularly enterprising villager, thought he had a solution to the problem and one by which he too could earn some goods. So he hired Hank and worked hard and long with him building an especially large hut. When he had completed his task, he announced to the rest of the villagers that he was opening a storehouse where all of them could store their surplus goods. Will would, of course, trade this service for goods or services produced by others. Now when Bill came in from the hunt with many ducks, he would take them to Willy's storehouse. Charles and John would bring their harvest to the storehouse, too, while Sam would bring his shirts, and Dave and Don would bring their shoes. This innovation, all agreed, was an improvement, and they all willingly paid a small amount of goods to Willy for the use of his storehouse.

But Willy, who always had an eye out for a profit, thought of an even better idea. Why not do all the bartering himself? Instead of Sam's having to be present whenever anyone wanted shirts, Willy would carry out the transaction for him. Then Sam could stay in his shop and devote his full time to making shirts. Willy thus became a middleman, taking the goods from a producer and exchanging them with a consumer. He performed the valuable service of distributing goods and services for the village. For every barrel of corn traded at Willy's storehouse, Willy himself took a cupful. For every dozen shirts traded, Willy took one.

After a short period of time, Willy had accumulated many of his own goods. He was a wealthy man. Now he had a new idea. Instead of trading other people's goods, why not trade his own? So Willy became a merchant. He bought all the shirts Sam made, and in turn sold them for a bit more than he had paid Sam. Sam was happy, because he could concentrate on making shirts, and he knew that he could sell them. The villagers were happy, for they knew that they had only to go to the storehouse--which became known simply as The Store--and they could buy the shirts they wanted. Willy, of course, was happy, for every time he sold a shirt, he made a profit and thereby became even richer.

The more trading Willy did, the more convinced he became that it could be done more easily. He got confused trading ducks and shoes and shirts and tomatoes and hut repairs for each other, particularly since the value of each of the goods and services seemed to vary according to the supply and demand. Besides, often the farmers would bring in a large crop, but would not want to collect the full value of it in goods or services all at once. Willy thought and thought. What was needed was something durable and valuable and fairly abundant that could be exchanged for any item, something that the farmer or the repairman could keep and spend a little at a time as his needs arose.

It happened that Walter, one of the villagers, owned a large grove of walnut trees. Walter had bartered his walnuts with Willy and the other villagers just like any other product. The villagers valued walnuts. So Willy contacted Walter, and suggested that thereafter Wally bring all his walnuts to Willy, to be stored or exchanged for other goods. Walter was quite agreeable.

So one day when The Store opened, the villagers found all the items for sale priced according to bucket of walnuts. One shirt cost seven buckets of walnuts. For a pair of shoes, Willy charged ten buckets of walnuts. Now when Charles or John would bring in a few bushels of corn or a couple of baskets of tomatoes, Willy would give them a couple of buckets of walnuts. Charles and John knew that they could later bring in the walnuts and with them buy the items they needed. They were especially pleased that they could now save and store their wealth. The villagers found that they could buy and sell more easily with walnuts, for everyone accepted them as a medium of exchange, and walnuts worked well as a standard of value.

While walnuts were a vast improvement, the villagers began to complain that it was awkward to carry around many buckets of walnuts each time they wanted to buy something. Willy recognized that this system could be improved. "What we need," he thought, "is something that represents a bucket of walnuts, but that can be more easily used for exchanging goods and services." So one night he stayed up late and cut many small pieces of wood into little square shapes. On these pieces of wood he burned a special mark. Then he announced to the villagers that each piece of wood represented one bucket of walnuts. Whenever anyone brought a bucket of walnuts to The Store, Willy gave a piece of wood in exchange. The piece of wood, Willy explained, was his personal I.O.U. and could be exchanged at any time for a bucket of walnuts. "The piece of wood isn't really worth a bucket of walnuts. You can't do much with it. But bear in mind that it represents a bucket of walnuts, so that it has value in exchange for goods and services." Since everyone knew that the piece of wood represented a bucket of walnuts, the villagers agreed to accept the piece of wood just as they had accepted the walnuts. Now the village had a form of money--something that represented something else of value and was accepted as a medium of exchange.

III. Buying and Selling Goods and Services: Questions on Reading

1. How did Willy's storehouse help the villagers?
2. How did the supply of goods and demand for them cause their value to vary?
3. What was the advantage of using buckets of walnuts?
4. What is a "medium of exchange"?
5. What is a "standard of value"?
6. Why was it important that the villagers trusted Willy?
7. How did the use of pieces of wood make the distribution of goods and services easier?
8. What is money?
9. Why did Willy make a special mark on the pieces of wood?
10. The pieces of wood had more value in exchange than value in use. What does this mean?

IV. PUTTING MONEY TO WORK

As the villagers found new and better ways to perform their services or produce their goods, they earned more pieces of wood. They acquired so many pieces of wood that they could not spend them all on their basic needs. The people of this valley began to develop new wants. They had more leisure time. So some of the creative villagers began to dream up games which they manufactured and sold.

As their spare time increased, the people could think and plan even easier and more efficient ways of performing their tasks. They invented tools and simple machines. Some of the successful producers began to hire the younger villagers to work for them, teaching them their trades and thus manufacturing more goods. The standard of living in the valley rose. The huts were kept in good repair, and there was always ample food and clothing. More babies survived. People lived to grow older. So there were more consumers and therefore a greater demand for goods and services.

A few of the villagers had become very wealthy. They had acquired more pieces of wood than they could or wanted to spend. Since they didn't want to lose their wealth or have it stolen, they asked Willy if he would provide a safe place where they could deposit their extra pieces of wood. They would, of course, pay Willy a small fee for keeping their wealth secure. Willy, ever on the alert for a way to become wealthier, readily agreed and began a safe-deposit system for the village.

One day a group of villagers approached Willy with an unusual proposition. Bob, their leader, spoke for them. "Willy, we need your help," Bob said. "When we were exploring, we discovered on the other side of the mountain large herds of cattle. We would like to travel to this land and see if we can capture some of these cattle. With them, we could set up a new enterprise and earn many pieces of wood. But we don't have the capital with which to finance such an expedition. We wondered if you would like to risk some of your wealth on the chance that we might be successful. If you will provide us with the supplies for the expedition, we will share the profits with you."

Willy thought and thought. He did have enough wealth so that he could afford to lose some of it. And there was the possibility that by investing his wealth he might be able to create more wealth, not only for himself but also for these boys and for the village itself.

"All right, boys, I agree. I will provide all your supplies. If the expedition is successful, I will take one third of the profits from the cattle you bring back. If you fail, I will have lost my investment. Since we all stand to profit from this venture, I know that you will work hard and will use the supplies wisely. I am willing to take the risk, because the possible reward is worth it."

In this way, Willy acted as a capitalist, risking his wealth, in the hope of creating more wealth. The boys were gone many days, and Willy worried for fear that they had become lost, or that some accident had befallen them, or that the cattle had moved on. But when the boys returned bringing many fine cattle, Willy was rewarded. Seeing the success of Willy's venture, many of the other villagers were eager to invest their wealth also. But most of them weren't as wealthy as Willy and couldn't afford to take as large a risk as Willy had taken.

Meanwhile, Willy was thinking about the wastefulness of his safe-deposit system, where all the extra pieces of wood were being stored and not being put to use. "There should be some way that this wealth could be used to create more wealth and make profits for those to whom it belongs," he said to himself.

One day a new sign appeared outside Willy's establishment:

I WILL PAY YOU FOUR PIECES OF WOOD IF YOU DEPOSIT
ONE HUNDRED PIECES WITH ME FOR A YEAR

The villagers curiosity was aroused. "You mean you will pay us while you store our spare money? This is just what we always wanted--a way that we could make a profit from our extra money."

They noticed another new sign, too:

I WILL LOAN PIECES OF WOOD FOR NEW ENTERPRISES.
YOU PAY ME BACK SIX EXTRA PIECES PER YEAR FOR
EVERY ONE HUNDRED YOU BORROW

So Willy became a banker, paying people a small percentage for the privilege of investing their money at a slightly higher rate of profit. Everybody benefited from Willy's new idea. Those villagers with a few extra pieces of wood could keep them safe in Willy's bank and at the same time make four percent profit. Those who wanted to start new businesses could borrow money from the bank at six percent. Willy profited, of course, for he had made two percent on the money he loaned. The village as a whole prospered. New businesses sprang up rapidly, adding to the well-being of the community. The standard of living continued to rise.

Of course, Willy would not extend credit to everyone. Some people asked to borrow money for schemes that Willy did not believe would succeed. In such cases, Willy simply would refuse to lend money. Even so, he occasionally lost an investment. New businesses unexpectedly failed, or shops burned down. But Willy made certain that his bank always had enough funds available so that a depositor might withdraw his money if he so desired. Willy never loaned out all the money that had been deposited in the bank, for he felt a responsibility to keep depositors' money safe. If people should go to the bank to withdraw their money and be told there was no money in the bank, they certainly would not deposit money there again.

IV. Putting Money to Work: Questions on Reading

1. How does the presence of leisure time contribute to economic progress?
2. How is population growth related to economic prosperity?
3. What is a safe-deposit system?
4. How could Willy “create more wealth” by investing his own?
5. What is capital?
6. What is a capitalist?
7. What does a banker do?
8. Why did the creation of a bank benefit the whole village?
9. How did Willy decide to whom he would loan money?

V. INVESTING ON A LARGER SCALE

The village prospered. In fact, there came a time when the shops and gardens were not able to supply all the goods that the villagers demanded and could consume. The hunters were so skilled that game in the valley became very scarce. Bill and Mike had to travel farther from the valley to find the animals and birds that formerly lived right outside the village. Charles and John, the farmers, complained that they didn't have space to plant enough crops to meet the demand of the village. And the shops, although working overtime, still could not produce enough goods to meet the demand of the villagers. The population had simply outgrown the valley.

So concerned did the villagers become that they called a meeting which all attended. After many speeches and arguments, they decided that the only solution to the problem would be to explore and settle new territory. Many young men, who felt they were not getting ahead fast enough in the village, expressed great enthusiasm about the idea of traveling to a new land. There would be danger and adventure and great opportunity. Perhaps, like the boys who had discovered the herd of cattle, they might find a new source of wealth and make a fortune.

So a large group of young men and women decided to make an expedition westward beyond the valley to the unknown land. They faced the problem, however, of financing this venture. Their leader approached Willy. "Willy, when the young men wanted to go over the mountain to bring back cattle, you bought part ownership in their venture. They shared their profits with you. We, too, need money. We expect eventually to make profits. In the new territory, there will be unused soil and great forests. There will be game that has never been hunted. We will gladly share our wealth with you, if you will share in our risk. Or perhaps the bank can buy a share of our enterprise."

"How much do you need?" asked Willy.

The leader began to list the needs of the expedition. Willy shook his head sadly. "I'm afraid that I don't have enough extra money to invest in this venture, nor can the bank risk that amount on this one expedition. I personally would be glad to buy a few shares, and the bank can buy some, as well. But that will still not be enough. Why don't you approach some of the other villagers and see how many can invest something? I'll bet you can finance your expedition through selling shares to many different people."

So Willy invested one hundred pieces of wood, and the bank invested two hundred. They still needed two thousand more pieces of wood with which to purchase the supplies they would need. But many of the villagers were eager to see the new venture succeed, and to share in its rewards. They, like Willy, risked some of their wealth to finance the expedition. Soon the young men had enough money with which to purchase supplies and begin their journey.

Those who had invested in this expedition looked upon themselves as owners of the venture, since they had provided the money for it. Of course, many villagers shared ownership. The extent of ownership was determined by the amount invested. Each man had received a receipt for every one hundred pieces of wood invested, which he referred to as a "share." The agreement stated that if the venture had made profits at the end of a year, each owner of a share would receive a percentage of the profit. The greater the profit of the venture, of course, the more a share owner would receive.

After a few months, reports from the expedition were especially encouraging, and it became clear that shareholders would receive a small profit in the very first year. Many of the villagers who had refused to invest their money originally now were sorry. They were anxious to own a share in the new venture, for they were confident that they would make profits. Dave, who had not bought a share, went to Willy and said, "Willy I will give you one hundred and seven pieces of wood for one share in the new venture. Since you only paid one hundred for it, you will make a profit, regardless of whether the expedition succeeds or fails. I will take the risk that the expedition will succeed. If it does not, I shall lose."

Since the bank needed some money to invest in another small venture, and since the profit from such a sale would be good, Willy sold one of the bank's shares to Dave. Many of the other villagers saw what Dave had done. Some of the share owners, or, as they came to be called, "stockholders," wanted to make a quick profit and offered their stocks for sale. Others who had not originally invested were eager to buy. Soon shares were being bought and sold regularly. A few months later, the word from the expedition was not encouraging. A bad storm had destroyed many huts and ruined the crops. Those who owned stocks felt that they would not make a profit and were anxious to sell their shares. Others felt that the new settlement would recover and eagerly bought shares at reduced prices.

The idea of selling shares enabled many of the valley's businessmen to borrow large amounts of money. Now they could purchase new machines or make additions to their shops. The wealthy villagers began to accumulate stocks in many different businesses, and the buying and selling of shares in businesses became a popular way to invest money and to make profits. Soon it became necessary to build a special hut where stocks could be bought and sold, where anyone who wanted to buy or sell stocks could go to meet others. This new hut was called the Stock Market. On its wall was a large blackboard where all the ventures for which shares had been sold were listed. Beside each venture was listed the price that stockholders were asking for their stocks. Also listed was the price that buyers were willing to pay. Buyers and sellers met and bargained. Many men made their living through the profits they were able to earn by wise buying and selling of stocks.

Some imaginative men began to offer their services as brokers performing the transactions for others. They studied the way that the value of stocks fluctuated, and offered advice on the buying and selling of shares of stock. They earned a small percentage for each transaction that they made for their clients. This percentage was called a "commission."

V. Investing on a Large Scale: Questions on Reading

1. How does the growth of population and production increase the need for conservation of natural resources?
2. In what way could those who invested in the expedition consider themselves owners?
3. What is a share?
4. Why did the villagers begin to buy and sell shares among themselves?
5. What is a stockholder?
6. What causes the value of a stock to fluctuate?
7. How does the sale of shares in a private company help the economy to grow?
8. What is a stock market?
9. What is a broker?
10. What is a commission?

VI. TOO MUCH MONEY

One day one of the young men who had joined the big expedition to the new territory returned to town with bad news. The venture was not doing well and would need more money. None of the villagers wanted to buy shares in the venture now, for it did not appear profitable. On the other hand, it became clear that if the expedition did not have more money, all the shares that already existed would be worthless. In desperation, the young man went to Willy.

“Willy, we must have more money,” he begged.

“But it would be an unwise investment. I personally will not risk my money, nor can I risk the bank’s,” answered Willy.

“But if you don’t give us money, the whole expedition will end in failure, and all the shares that people have purchased will become worthless. We don’t need too much money, and I can guarantee that we can repay it very soon. The success of the expedition and of the whole investment that so many villagers have made depends on our getting some money fast.”

Willy thought and thought. Suddenly he had an idea. “How many pieces of wood do you think you will need?” he asked.

“Only five hundred,” replied the young man.

“See me tomorrow morning, and don’t say anything to anybody,” said Willy.

That night, Willy stayed up late. None of the villagers saw him, but if they had, they would have seen Willy feverishly cutting up little squares of wood and burning strange marks on them. After a while, Willy had before him a pile of five hundred pieces of wood identical with those in circulation around the village. Willy had for some time been introducing pieces of wood into circulation as the amount of goods and services in the village’s economy increased. But he had always done this gradually, and never worried about it. As long as the villagers had faith in the pieces of wood, Willy knew, no harm would be done. However to suddenly put 500 pieces of wood into circulation was different. Willy didn’t know what might happen. But he was worried.

The next morning, the young man from the expedition arrived at Willy’s bank, where he was presented with a sack full of pieces of wood. “You must pay me back as soon as possible,” said Willy. “I am very worried.”

The young man nodded gratefully, smiled, and left. Willy, however, did not smile. Instead he busied himself making a new sign which he hung outside the bank:

NO MORE LOANS FROM THIS BANK UNTIL FURTHER NOTICE

"I must get five hundred pieces of wood out of circulation as quickly as possible," muttered Willy. He set out to visit the villagers who had received loans from his bank. Each villagers he saw he pleaded with to repay his loan.

Now the villagers observed many strange happenings. The young man from the expedition, entering the village to plead for money, suddenly was going around to all the shops, buying supplies and spending brand new pieces of wood. Willy suddenly refused to lend the bank's money. Instead, he seemed very anxious to collect his debts.

"Wonder where that young man got the money," mused one villager.

"Does seem odd. Suppose there could be any connection with the strange way Willy is acting?" asked another.

"Bet Willy made those pieces of wood for him. Know what that means? It means that there are no walnuts backing them up. It means that if you take one of those pieces of wood, it's worthless. You take it to the bank, and you'll get nothing for it. I know I wouldn't accept one. Trouble is, how can you tell the new ones from the old ones? You really can't trust any of those pieces of wood. I don't care what you do, but I'm taking all my pieces of wood and buying goods. I'm going to the bank, too, and get my buckets of walnuts back. I know they will always be accepted, because they have real value.

The little knot of men broke up. Soon the word spread throughout the village: "Pieces of wood are no good. Don't take any. They don't represent buckets of walnuts anymore." Soon Willy's store was swarming with anxious villagers, exchanging all their pieces of wood for goods. Willy kept raising the prices of the goods. Still the villagers kept buying. They were desperate to exchange their pieces of wood for something that they valued. Before long Willy had to announce that The Store had run out of goods. Still villagers had pieces of wood. They rushed to the bank, demanding their buckets of walnuts. Willy gave out all the buckets of walnuts he had. When night fell, the bank had no buckets of walnuts left. Willy had only an immense pile of pieces of wood.

"I'm ruined. I am the poorest man in the village," moaned Wally, staring at his huge pile of money. "No one will accept these pieces of wood. I can buy nothing."

The villagers, meanwhile, stayed close to their homes. Those who had been fortunate enough to exchange all their pieces of wood for goods or walnuts gloated over their possessions. They knew that they would not go poorer. But those who still had pieces of wood shared Willy's feelings. What good was money no one would accept? They, too, had been ruined.

VI. Too Much Money: Questions on Reading

1. What are the arguments for and against Willy's making additional pieces of wood?
2. Why was Willy worried?
3. Why did Willy decide to make no more loans?
4. Why was Willy so anxious to get the extra pieces of wood out of circulation?
5. Were Willy's new pieces of wood worthless? Why or why not?
6. Why did the villagers stage a run on the bank?
7. Why was Willy poor when he had all those pieces of wood?

VII. THE GOVERNMENT AND THE ECONOMY

At this point, we must pause in our story and go back to the time when the valley had begun to cooperate and specialize in the production and distribution of goods and services. As the villagers had learned to cooperate and had formed a society, they had recognized the need for some authority to keep peace and harmony in the village. Some of the people had preferred to steal and cheat rather than to work honestly. A police force and a system of justice were needed to protect the village. Frequently decisions had to be made that affected the whole village. Some lawmaking body was required to represent the wishes of the majority of the villagers. So the village elected a legislature to make laws and decisions that everyone in the valley had to obey. A mayor was elected who would put the laws into effect. Judges were selected to interpret the laws and decide punishments.

The government of the valley, following the wishes of the people, engaged in some enterprises that benefited the whole village. Roads were built to make the passage of carts through the village easier. Policemen were hired to prevent crime and catch criminals. The river that ran through the valley was widened and dammed up, assuring a constant water supply. The disposal of waste materials was taken care of by the government. Those who threw waste in the river were punished.

In order to accomplish all of this, of course, the government needed money. This it got in two ways. First it taxed each family according to the money the family earned and the property it owned. Since each villager profited from the activities of the government, it was felt that each villager should contribute to the running of the government. Second, the government borrowed money from the people. A villager might lend the government some pieces of wood. In return he would receive a receipt from the government promising to repay the loan with interest after five or ten years. So well respected was the word of the government, and so prompt was it to repay its loans on request, that loaning money to it became for the people a popular way of investing. The I.O.U.'s, or promissory notes, from the government became known as "bonds."

It was natural, then, for the people to turn to their government after they had, in a panic, run on Willy's bank and withdrawn all the buckets of walnuts. Commerce in the village had virtually stopped, for without the convenient pieces of wood, it was difficult to buy or sell goods. So the legislature called a special meeting. Many suggestions were made.

"I say we throw Willy in jail," shouted one representative. "It's all his fault. If he hadn't given out the worthless pieces of wood, this never would have happened."

"What good would that do? It won't solve the problem. Willy didn't break any law. I think the fault is ours for not preventing the situation from arising in the first place," said another legislator.

"I agree," said a third man. "The people trust us. The government must do something to restore the people's faith in their money. We just can't have an individual in control of the currency. It's too important. It affects the whole village. We can't blame Willy. He did what he thought best. Now it's up to us to do something. We can't sit around here talking aimlessly."

The representatives calmed down a bit after this speech and began to examine the problem that faced them. All agreed that it was their responsibility to restore faith in the currency. Many ideas were discussed.

"Let's pass a law that everyone has to use the pieces of wood as currency," suggested one man.

A second said, "Why don't we go around to all the huts and make everyone give up their buckets of walnuts in exchange for the pieces of wood? Then they'll have to use pieces of wood."

"Let's make the pieces of wood ourselves and have the government keep control of them. We can make them different from those Willy made. Since his old ones are useless, we can pass a law declaring them worthless. I think if the government makes the money, the people will accept it." The third legislator's idea was greeted enthusiastically.

Another man added, "Yes, and we can buy back buckets of walnuts with the pieces of wood we make. If the people know that these pieces of wood will be accepted, they will gladly exchange their walnuts for them. In that way they will know that the pieces of wood in circulation have walnuts backing them up."

"This should solve our problem," summarized one man. "In this way, people will have faith in the money. As long as this faith exists, we will not have a repetition of this panic."

A vote was taken. It was decided that the government would take control of the currency, making all the pieces of wood. People could exchange their buckets of walnuts for pieces of wood. Willy would continue to operate his bank, but he no longer could make pieces of wood. While it didn't seem necessary to have a bucket of walnuts for every single piece of wood in circulation, the government realized that at least for a while, it should control the ratio between pieces of wood and buckets of walnuts. The important thing, the legislators knew, was that the government would guarantee the value of the pieces of wood. As long as the people had faith in the government, they would have faith in the money.

The decision was announced to the villagers, who greeted it warmly. They felt that they could trust pieces of wood if the government was in charge. The money once again had value for the villagers, because they trusted it. They gladly turned in their buckets of walnuts for pieces of wood.

Soon the new money was circulating freely. The Store opened again. Shops began once more to produce goods. People again deposited their extra money in Willy's bank. Others then were able to borrow, and the economy grew. Willy once again began to acquire wealth. Before long, the economy of the village had been completely restored. Once more prosperity reigned in the valley.

VII. The Government and the Economy: Questions on Reading

1. How is the creation of a government related to the development of the economy?
2. What sort of economic activities can best be performed by the government?
3. What are taxes?
4. What are government bonds?
5. What do you think of the various proposals made by the legislators to deal with the crisis?
6. What do you imagine would have happened to the village's economy if the government had failed to act?
7. Why wasn't it necessary to have a bucket of walnuts for every piece of wood?

VIII. LABOR PROBLEMS

As businesses prospered in the village, many businessmen hired large numbers of the younger men to work in their shops and factories. Some of these hired men performed difficult tasks skillfully, such as stitching shirts or painting pottery. Others had jobs that were quite dangerous, such as digging coal from the deep mines in the side of the mountain. Some workers had jobs that required little skill at all, such as carrying logs from the forest or digging holes for fence posts. In general, these men were paid according to the difficulty or danger of their job. The jobs considered easy could, of course, be performed by almost anyone. Since the supply of such workers was large, the price they received for their service was small.

For the difficult jobs, on the other hand, a much smaller supply of qualified workers existed. The value of their services was considerably higher. The wages the workers received depended also on the demand for the service they offered. Because not many of the men wanted to work in the coal mines, those who did were able to ask for a high pay. The law of supply and demand therefore helped to decide the pay the workers would receive, just as it helped to determine the value of goods in the market.

It happened that one day a few of the workers in Sam's shirtmaking shop began to grumble. "We work hard, and Sam doesn't pay us enough," muttered one young man.

"Yes, and I don't like working on Saturday afternoons. I think Sam makes us work too many hours, particularly for the wages we make," said another.

"Well, if you ask me, I think we should have at least two weeks of vacation a year with pay. I'd like to have some spare time to spend with my family and perhaps travel across the mountains," added a third worker.

"While you're on the subject, I don't think it's fair that Sam doesn't pay us something when we're out sick. I jabbed a needle into my finger and missed three days when it got infected. You'd think Sam would have paid me something, especially since I injured myself on the job." This fourth speaker threw down the shirt he had been working on and began to pace the floor angrily.

Suddenly he stopped and turned to the other workers. "I have an idea. Since none of us is satisfied with the way Sam pays us, why don't we ask him to raise our pay and add some other benefits that we feel we deserve. Let's draw up a list of complaints and requests right now." So Sam's workers did just that, and the next day when Sam walked into his shop, he was startled to see all his workers standing around rather than making shirts.

“Hey, what do you think you’re doing? If you don’t get to work, you can’t expect to make any money.” Silently one of the workers handed the list of grievances to Sam. Sam read through it quickly, and then angrily tore up the list.

“If you think you can pull this on me, you had better think again. If you don’t like working here, you can all leave. There are plenty of men who would love to work for me. You don’t know how lucky you are, having such a great job.” Sam turned and stalked out of the room. The workers looked slowly at one another, shrugged, and one by one returned to their places and began to work.

But that night after work, they met again. One thoughtful man, who had until now remained silent, spoke up. “I’ve been thinking. Sam may be right. Maybe he can get other workers to take our places. If he can, then we are out of luck, because he certainly won’t give us any more pay or benefits if he doesn’t have to. But we know that without workers in his shop, he will go broke. If we stop working and no shirts are made, he will have to give us what we want. I think we ought to quit and tell Sam that we won’t come back to work until he meets our demands.”

The following day when Sam walked into his shop, it was empty. He waited and waited, but his workers did not show up. “If they think they’ll get a raise out of me, they’re wrong.” So Sam posted outside his shop a sign which read:

WORKERS WANTED -- APPLY TO SAM

Within a few days, Sam’s shop again hummed with activity. Meanwhile his old workers were grumbling. “Those new workers don’t realize how badly Sam will treat them. Besides, it’s not fair for them to have our jobs.”

“Yes,” added another, “and I think we should make Sam do something for us. If we just sit around not working, we’ll go broke in no time. I say that we should go to Sam’s shop and not let his new workers in tomorrow.”

“Darn right,” growled a third. “I’m going to bring a club. Then let them try to get in there to work.”

“If we can’t get what we want, I’ll burn Sam’s shop down!” yelled an angry worker.

“I think we should try to convince the villagers that they shouldn’t buy any of Sam’s shirts until he has given us what we ask for,” added another.

The next morning, all the old workers lined up outside Sam’s shop. Many carried signs declaring “Sam Unfair” and “Shirtmakers on Strike.” Others carried clubs and heavy sticks. When Sam’s new workers arrived, they faced a solid wall of men standing in front of Sam’s

door. The strikers called this a "picket line." One worker tried to push his way through and retired hastily with a bloody nose. Others talked with the strikers and seemed to find their arguments reasonable. Soon the old shirtmakers and Sam's more recent workers had all joined and marched around the streets of the village with their signs.

They stopped at The Store, where they talked to customers, trying to persuade them not to buy Sam's shirts. Many of the customers felt sorry for the workers and agreed to boycott Sam's shirts. Others expressed sympathy for Sam: "You men should be grateful to Sam for giving you work. He is a fine man, not only making wonderful shirts which we all wear but also providing employment for many of the villagers. You all have plenty of money to spend, which means that we all prosper in the long run. We'll never go along with you ruffians, running around the streets beating people up and carrying signs when you should be working."

Sam, of course, was very upset. If he didn't produce shirts, he would make no profit. He hated to see his shop empty and the tools lying unused on the tables. He had to tell Bill, the hunter, that he could buy no more skins until his shop was back in business. He told Ted, the toolmaker, that he couldn't buy any more needles. He also reluctantly told Willy that he couldn't pay back his loan on time. So both Bill and Ted had less money to spend. Willy, with the payments of Sam's loan no longer coming in, couldn't loan out as much money as before. Soon everyone in the village found himself affected in one way or another by the strike for the shirtmakers. And no one, of course, could buy shirts, for they were no longer being manufactured.

Yet the strike continued. Although he was losing money every day, Sam would not talk with his workers. "I refuse to be bullied," he declared. Meanwhile, the workers, although living without income, felt that their principles had become involved. They would never return to work for Sam unless he agreed to discuss their grievances and negotiate some settlement with them.

The rest of the villagers, who were not so personally involved in the dispute, thought it was silly that Sam and his workers would not sit down and settle the problem. Someone, they decided, should do something. So a group of the villagers approached Walter, whose wisdom was respected by all of the villagers.

"Walter," said the spokesman, "we feel that if you talked to Sam and his workers you could show them how desirable it would be for them to discuss their problem together. Possibly you might even investigate the problem and make some sort of proposal that would please both sides. Both Sam and his workers have too much pride to propose a compromise, but if you suggested one, they probably would be delighted to agree to it. Then they would have work, Sam could make his profit, and would have shirts."

So Walter tried to act as mediator, talking to both sides in an effort to bring them together to settle their problems by themselves. He was able to convince them that they should sit down together, but after a few hours, the meeting broke up with no settlement being reached.

Walter, in desperation, decided to try a different approach. He attempted to arbitrate the dispute. He talked with the workers and learned what their demands were. He talked with Sam to get his side of the story. He asked both Sam and the workers if they would accept a proposal made by himself, Walter. Both sides agreed that they would at least consider such a proposal. So, acting as arbitrator, Walter brought about a solution to the strike that had so seriously hurt the village's economy. Sam accepted Walter's proposal, despite the fact that it required an increase in the workers' pay and a one-week paid vacation. The workers accepted it, although they still had to work on Saturdays and did not get reimbursed for days not worked due to sickness.

Soon The Store once again had many good shirts in stock. Bill, the hunter, again was able to sell his fine animal skins to Sam. Sam submitted a large order for needles to Ted and shortly caught up on his repayments to Willy. The village again prospered and the economy once more continued to grow.

VII. Labor Problems: Questions on Reading

1. How does the law of supply and demand affect the wages workers receive?
2. What do you think is meant by the term “market for productive services”?
3. What sort of factors produce labor disputes?
4. In a labor dispute, what are the weapons of the workers? Of the employer?
5. Who do you think was right in this dispute, Sam or the workers? Explain?
6. What is a strike?
7. What is a picket line?
8. What is a boycott?
9. How did the strike affect the rest of the economy?
10. What did the man mean when he said, “You all have plenty of money to spend, which means that we all prosper in the long run”?
11. What is the difference between a mediator and an arbitrator?
12. How was the strike settled? Why did both Sam and the workers come to terms?
13. Do you think the final settlement was fair?

IX. FOREIGN TRADE

One day a strange group of men entered the village. They were dressed differently from the villagers and spoke with a curious accent. Government officials hastily ran to the village square to meet the strangers. The police gathered around cautiously. The leader of the strange group spoke.

"We come from a land far down the river and beyond this valley. We have from time to time explored the mountains and recently we came upon your valley. We noticed many things here, especially your fine huts with sturdy roofs. In our land, we have no such trees as you do that provide such excellent bark for roofs. We noticed also that grain seems to grow poorly in this valley. Your climate is not good for growing grain, nor is your soil. We thought it would be desirable for both your village and ours if we should trade our grain, which grows plentifully on our land, for your bark."

Some of the older villagers who had gathered around nodded wisely. Charles and John had discovered that two men both profit by trading what they produce best. Wasn't this the same thing? Wouldn't it be to the advantage of both the village in the valley and the strange village beyond to trade goods?

The villagers decided to trade with the strangers. They met and began to bargain. They soon discovered that it was difficult to determine the relative value of bark and grain. One could not simply trade bark for grain. Some standard of value had to be devised. One of the strangers took from his pocket a handful of unusual pieces of stone. "This is what we use for currency in my village," he stated.

The mayor of the village showed the stranger some pieces of wood. "And this is our money," he said. "Will you accept it in trade? May we use it for buying grain? It is backed up with buckets of walnuts."

"Our currency is backed up with gold," declared the stranger proudly, "and gold is better than walnuts. We will accept only gold for our grain."

"What good is gold?" asked the mayor. "We know you can make attractive jewelry with it. But why aren't walnuts just as good?"

"Gold, like walnuts, has intrinsic value," stated the stranger. "Like walnuts, it is useful. But it is better than walnuts, for it lasts indefinitely, while walnuts eventually dry out. Also the supply of it is more consistent. Walnuts are common in the fall, but hard to find at other times of the year. When there is bad weather, walnuts may be scarce. Therefore the value of gold remains more consistent, which in turn means that the coins it backs up are also of more consistent value."

“Why doesn’t your village use gold?” he then asked. “I know you can find it in the mountains surrounding this valley. Then it would be very easy for our two settlements to trade goods.”

The strangers departed, but promised to return in a week. The mayor consulted with the legislature. They invited Willy and some of the other villagers. All agreed that the stranger had spoken the truth. The villagers thought highly of gold, and all recognized it would make an excellent standard of value. Of course, it also would enable the village to trade with the strangers and bring further prosperity to the valley. In addition, storing gold would require less space than storing the cumbersome buckets of walnuts.

The next day the villagers were told that from that time on, ten buckets of walnuts would be equal to one ounce of gold. Gradually the buckets of walnuts in the bank would be replaced by gold.

When the the strangers returned, they brought with them carts full of fine grain. They also bought gold. When they left, their carts had been loaded with bark for hut roofs. They also took with them more gold than they had brought, for they had sold more value in grain to the villagers than they had bought bark.

Soon the two villages were trading often. The villagers made fine bread with the grain from the strangers and gladly traded gold for it. The strangers, in turn, bought much bark. Of course the price of bark increased greatly as a result of this new demand for it. But even so it seemed that the village spent more gold for grain than the strangers did for bark.

Before long, the government of the village noticed a disturbing trend. Less and less gold was coming into the bank. As a result, the new pieces of wood that were continually being put into circulation were backed by less gold. The government could not maintain the ratio between gold and pieces of wood. The pieces of wood gradually lost their value. Prices rose alarmingly. The legislature decided that the problem lay with the unequal balance of trade between the villagers and the strangers. “We must not trade away fewer goods than we buy. If we do, we shall slowly lose our gold, and our money will once again become worthless,” declared the mayor. He urged the legislature to pass a law regulating the trade between the villagers and the strangers. He also urged the producers in the village to try to sell their products to the strangers. “If they buy more from us than we do from them, we will bring in more gold than we spend. Our trade will then be in favorable balance, and the wealth of our village will increase.”

The villagers greeted this idea enthusiastically. They liked the idea of a new market for their goods. They could produce more and thereby make more profits. So the next time the strangers came, the village shopowners urged them to buy from them. The prices for those items that the strangers wanted to buy began gradually to increase. The strangers bought many goods from the village, and the villagers exchanged their new gold for pieces of wood.

As the villagers increased their earnings, of course, they bought more goods from one another. They hired extra workers and increased their pay. They deposited more in the bank, which in turn loaned more out. The favorable balance of trade meant greater prosperity for the village.

The strangers, of course, were in turn eager to improve their own balance of trade. They wanted to increase the flow of gold to their village. So they began to bring their own products to the village to sell. They offered excellent shoes, for example, and at a price lower than that charged by Dave and Don, the shoemakers in the village. The villagers bought their shoes from the strangers. After all, they were as good as those made by Dave and Don, and cheaper. Since Dave and Don didn't have the tools that the strangers had, the cost of producing a pair of shoes was greater. Thus they had to charge more to make a profit. Without a profit, of course, they would go out of business.

Dave and Don went to the mayor of the village. "We can't compete with the strangers, for they can make shoes cheaper than we can. We have already reduced our prices as much as we can. We shall soon go out of business. We have worked hard and faithfully here in the village. We hire many men to work in our shop. We deposit money in the bank, which is invested by Willy in other enterprises. We have contributed greatly to the prosperity of the village. If we go out of business, the whole village will suffer along with us. Can't the government do something?"

"Well," replied the mayor, "we can't forbid the strangers to bring their shoes here to sell. That wouldn't be fair. But I agree that the competition hurts us all. Perhaps we shall charge a small tax on every pair of shoes the strangers bring to the village. This will provide the government with additional income. It will also force the strangers to charge more for a pair of shoes if they want to make a profit. We will make this tax high enough so that the strangers will charge as much as you do for shoes. Then you will be competing fairly. This tax, or tariff, will protect you. I'm sure the legislature will agree."

The legislature did agree and passed the first protective tariff on shoes. As the village and the strangers continued to trade goods, more items were protected. The strangers were discouraged from trading shoes with the village. But they in turn charged a tariff on shirts from the village. Soon each group was trading only goods that the other needed. Gold flowed freely between the two places. The prosperity of both increased.

IX. Foreign Trade: Questions on Reading

1. Why is it that when two countries--or two individuals--trade with each other the items that each produces best, both seem to benefit? Why do you think the term competitive advantage is applied to this situation?
2. What is intrinsic value?
3. What was the advantage of gold over walnuts as a backing for the currency?
4. Why is it helpful for two countries to have the same standard of value--such as gold--if they are going to trade with each other?
5. What is meant by the phrase balance of trade?
6. What happens to the economy when the balance of trade is unfavorable?
7. What is a favorable balance of trade?
8. What is a tariff?
9. Is a tariff a wise idea?
10. Who benefits from a tariff? Who suffers from it?

X. INFLATION

The villagers had never felt more prosperous. Dave and Don, the shoemakers, hired more men to work in their shop. They even built an addition onto their shop. They increased their orders for leather, thread, and machinery. As Dave said to Don, "If we produce more shoes, we surely will sell them. While increased production will raise our costs, I am confident that our increased sales will mean greater profits for us in the long run."

Everyone in the village seemed to share Dave's optimism. The farmers expanded the size of their gardens, and they hired additional men to help them. Sam, the shirtmaker, followed the course taken by Dave and Don. Jobs in the village became plentiful. Everyone, it seemed, could take his choice from among many different jobs. As the demand for workers increased, the workers began to ask for higher wages. If one employer couldn't pay them what they asked, they would go to another businessman who wanted more workers. Just about everyone in the village had a good job. Not only did wages increase, but also employers began to run their shops overtime in order to produce more goods. Working overtime, the workers earned more and more money.

As the workers' wages increased, so did their purchasing power. They had more money to spend. The village businessmen recognized this fact. "Everyone, it seems, wants shoes," Dave observed. "No longer are people satisfied with one pair. Now they want different styles. We can raise our prices a little and people will still buy shoes. Besides, our workers are demanding higher wages all the time, and we must continue to make profits. If we increase our prices, we will cover the increased costs of production brought about by higher wages. And people will still buy shoes, because the demand is high."

While the shoemakers were increasing their prices, of course, other manufacturers in the village were doing the same thing. No one seemed to mind, however, since everyone had more money to spend. What did it matter if prices were going up? Weren't wages increasing even faster?

Willy noticed the trend, too. More businessmen were coming to him to borrow money for their expansion. At the same time, more villagers brought their extra money to deposit in the bank. Willy said to himself, "It seems that I can lend money very easily. Everyone wants to borrow. If I increase my interest rates on loans a little, people will still want the money. I'll make greater profits. And I can encourage people to deposit money with me by offering higher interest rates on savings."

One group of businessmen was particularly affected by what was happening in the village's economy. The toymakers and others who produced luxury items found that the demand for their products had increased dramatically. More and more money was being spent on entertainment.

To meet this demand, some men built new factories to manufacture special toys and games. Of course, they had to borrow money to do so, but they were confident that they would soon be making profits. They hired many workers, and offered excellent wages. The games and toys in the village stores sold quickly.

The toymakers offered shares of their businesses on the stock market, and the villagers greedily bought them. Indeed, trading on the stock market became very active. Many people were anxious to invest, as the value of shares of stock kept increasing. Soon men of even moderate means were buying and selling stocks, hoping to get rich quickly and easily. Many were successful.

The government had also expanded its activities. The legislature voted to build new roads, and to construct a new, modern school. The government hired men to work on these projects. It placed orders for the necessary materials. In order to finance these projects, the government sold bonds. Bankers, businessmen, and even the general public recognized government bonds as a good investment, so many people used their extra money in this way. The government also increased taxes a little. But the legislators were afraid to take too much money out of the hands of the people, for they knew that would be unpopular.

One day a group of women were shopping at a dress shop. One of them complained to another, "Dresses are a lot more expensive than they used to be. I can remember when we could buy two dresses for what we now pay for one. Of course, I don't really mind, since my husband is making much more money now. But it seems that every time he gets a raise the prices go up. He earns more money, yet we can't buy any more goods. This just doesn't seem right."

The other women murmured agreement. The shopkeeper, who had been listening, explained, "Well, I have to pay more money for the material. I also built an addition on my shop, and hired three more men to make dresses. My operating costs have increased tremendously. I have to raise my prices. Besides you all seem to want dresses, and you haven't complained about the prices."

There seemed to be little reason for the women to complain. Hadn't their husbands' wages kept increasing at about the same rate as prices? Weren't they still able to buy as much as they had before prices had begun to rise?

But there were others in the village who were concerned., A number of older folks, for example, had retired from work. They lived on pensions provide by their former employers. A pension was a monthly sum of money that the retired worker received. It was all he had to live on. The sum had been decided at the time of his retirement. It did not change. Although prices throughout the village began to increase, the monthly pension stayed the same. Pensioners began to discover that it grew increasingly difficult to buy all the things they needed with their pensions. They could satisfy fewer and fewer of their wants with their fixed income.

Soon people on pensions, and others in the village who lived on fixed incomes, complained to the legislature. "This inflation is hurting us," they said. "We seem to have less purchasing power as the value of our money decreases. If this inflation isn't stopped, we simply won't be able to make ends meet."

The legislators didn't hear any complaints from those villagers who owed money, however. Sam, the shirtmaker, for example had borrowed 500 pieces of wood from Willy's bank to build the addition on his shop. This debt was to be paid back in five years at 6% interest. When Sam borrowed the money, the inflation had not even begun in the village. Five hundred pieces of wood could buy many goods and services. But within a couple of years, as the purchasing power of the money started to decrease, and as wages and profits in the economy increased, each piece of wood grew to be worth less. So while Sam still had to repay the 500 pieces of wood, with the interest, he was really repaying less value than he had borrowed. "This inflation," Sam declared, "is great for us debtors. We borrow when money is worth a lot, and pay it back when it's worth less. I hope they don't do anything to stop it."

Of course, there were those who loaned money, and they had a different point of view. Willy was as displeased with his loan to Sam as Sam was delighted. "When I loaned Sam the 500 pieces of wood, that amount of money would buy many goods and services," Willy said. "Now he pays me back with money that isn't worth as much as it was. I keep trying to raise my interest rates, but even by doing that, I still can't seem to keep up with this inflation. When I lend money really am giving away purchasing power." So Willy joined the pensioners in appealing to the legislature to do something about the inflation.

Some of the men in the legislature had already begun to worry. At one meeting, a young legislator stood up and declared, "You know, even with all the great increase in wages, and with everyone having jobs, I don't really think that our economy is healthy. Things seem almost out of control. It seems that prices will keep going up forever. Wages, too, keep rising. Our money is losing its value. One needs more pieces of wood just to keep buying the same amount of goods and services. It's very nice that business is expanding and that we have full employment. But this is inflation, and I think it's dangerous."

"What's dangerous about it?" inquired another legislator. "Everybody's happy. There's no unemployment. Just because people can't seem to get all the goods and services they want doesn't mean that we're in trouble. Businessmen are catching up with the demand by expanding their production."

"Wait a minute!" yelled one young legislator. "Already many people on pensions have complained to me. Willy, the banker, doesn't think this inflation is fair to creditors like him. It's just not true that everybody's happy. Our money is losing its value, and that doesn't seem right. Moreover, it isn't affecting everybody equally."

Another legislator agreed. "Sure, a lot of people don't suffer. Some people are better off than before. But others, like the old people and those on fixed incomes, are suffering severely. Inflation is like a very unfair tax--a tax that is heaviest on the poorest people. I, for one, think that it is our responsibility to do something about this inflation. We can't just sit back and watch it happen."

"Now just a minute," interrupted still another legislator. "What's happening is natural. The economy goes up and down. Now it's going up. Whether it's good or bad isn't really the question. The point is that we should keep our noses out of it. There's nothing wrong with a little inflation. And anyway, the economy will straighten itself out if we leave it alone."

The legislators nodded their agreement with this last speech. They recognized that their economy was experiencing a period of inflation. But they did not feel that they, as legislators, should interfere. They were confident that the demand of the consumers, and the supply of goods and services available to them, would always tend to even out in the end. So the legislature adjourned. Some men felt slightly uncomfortable, however, as the word "inflation" still rang in their ears.

X. Inflation: Questions on Reading

1. Why did the village businessmen decide to expand their production?
2. Why were workers able to receive the higher wages that they demanded?
3. What effect did the increased purchasing power of the villagers have on the following, and why?
 - a. prices
 - b. variety of items produced
 - c. interest rates
 - d. the stock market
4. What is a pension?
5. Why did the pensioners suffer during inflation?
6. How does inflation affect debtors? Creditors?
7. What is a fixed income?
8. What did the legislator mean when he said, "Our money is losing its value"?
9. What is inflation?
10. What do you think is meant by the phrase "cost-push inflation"?
11. Do you agree that inflation is dangerous? Why?
12. Do you think that inflation is natural? Why?
13. Was the legislature correct in not taking action against the inflation?

XI. DEPRESSION

For a while it seemed that the village's economy would prosper indefinitely. Businesses continued to produce large quantities of goods. Wages became increasingly higher.

It soon became apparent, however, that all was not well in the village. Although prices for goods and services kept increasing, the shopowners soon realized that they were selling fewer goods. In their efforts to take advantage of the spending during inflation, they had expanded their production at a rate too great to enable them to sell all their goods. At the same time, the villagers had reached the point where they could not afford to pay the prices that the producers were asking. So while Sam's shop, with its new addition and extra workers, manufactured many shirts, the shelves of the stores kept accumulating shirts that no one would buy. "Too expensive," complained the shoppers. "We don't need shirts--especially at prices like that. We have enough shirts for now."

In order to sell their goods, Sam and the other manufacturers in the village tried reducing their prices. As they did so, of course, they reduced their profits at the same time. One morning Sam called his workers together and spoke to them. "I'm afraid I have some bad news. I've had to reduce my prices in order to sell all the shirts we've made. I guess we have overproduced, because there is a surplus of shirts that nobody seems to want. Now if I don't slow down production here in the shop, I'm going to go bankrupt. Already my profits have dropped dangerously. Willy at the bank is demanding that I repay my loan, which I can't afford. The only thing I can do is to cut my production costs. To do this, I'm afraid I'm going to have to let some of you men go. I hate to do it, but I can't afford to keep paying you, and I can't sell all the shirts you make. Those of you that I keep on will have to accept lower wages. I'm sorry."

The same sad story was told in many of the village shops. An increasing number of workers found themselves without jobs as the producers cut back production. Some shops closed down completely. As the number of unemployed workers increased, of course, there were fewer people with money to spend on goods and services. With this reduced demand, the surplus of goods increased even more. Shopowners lowered their prices still further. Nevertheless, the economy seemed to be grinding to a halt.

Soon the streets of the village were filled with listless men, men without work and therefore men without money to spend. The shops and stores found fewer and fewer customers. The shopowners could not sell their goods. If the producers continued to manufacture goods, they simply built up a larger surplus of unwanted goods. Many shopowners reduced their prices in an attempt to encourage people to buy their goods. Others decided that they must reduce or stop their production altogether, so they fired more of their workers. These workers joined the others in the streets with no money to spend.

The demand for goods and services plummeted rapidly. The surplus of goods increased, with no one to buy them. Willy found that no one wanted to borrow money from his bank, even when he reduced his interest rates. No one was interested in borrowing to increase production.

Those who had invested their money in stocks soon found that the enterprises that they had invested in no longer were making profits. Many such enterprises, in fact, had gone bankrupt, and their stocks were worthless. The investors tried desperately to sell their stocks. Few people were interested in buying them, however, for few had money to invest and few felt confident that the village enterprises would be profitable. The values of stocks, like the prices of goods, sank rapidly.

To a stranger, the village would have been a doleful sight. Sad-eyed little groups of people sat or stood around the quiet streets. Shop after shop carried a "Closed" sign on its door. Men occasionally wandered into a store. But they only gazed wistfully at items, stuck their hands into empty pockets, and wandered outside again. No matter how low the prices, warehouses and stores remained filled with unwanted goods. Children cried from hunger. The lips of many men carried the ugly words "recession" and "depression."

Once more the government of the village met. Men talked anxiously. They listened eagerly for encouraging words. One man declared, "This is just a temporary thing. Our economy has always fluctuated. Sometimes prices have been high, production has gone ahead at full steam, and everyone has had jobs. We have experienced great prosperity. Sometimes, too, price have gone down and men have lost their jobs. The economy runs in cycles. This is natural. We must not lose confidence in our system. We must be patient and have faith that we will recover. This is not a problem for the government. Perhaps we can loan some money to businesses so they can keep producing goods. Maybe we should loan debtors money so they can pay off their debts. But let's not do anything drastic. Let's wait and see what happens. I'm sure all will soon be well."

This man was cheered loudly. The government decided that it should do nothing, that it should let the business cycle follow its natural course. But while the government waited, the recession became a depression. As the situation continued to worsen, the people of the village clamored for their representatives to do something to help them.

Once again the government convened. This time a representative spoke in a new tone: "We have a real problem. We must face this fact. We must act. Let's try something. If it doesn't work, all right, we'll admit it and try something else. But people are going hungry. They cannot get clothes. Houses are falling apart. More shops are closing down every day. We must get money into circulation. We must get demand up so that goods can be consumed. If we can do this, then shops will reopen, men will find jobs, and money will once again circulate freely."

Another representative had an idea. "I propose that we, the government, create jobs," he said. "The government can hire many men to work on our roads. We need better roads anyway. We will pay these men, and they will have money to spend. They will go to stores and shops and buy goods. Storekeepers and shopowners will then have money, so they will begin to produce again. They will hire back their workers, whom they will pay. These men, too, will have money to spend, and more shops will open up. Soon we will not have to hire men for the road, for there will again be a demand for the workers."

This speech was met with great enthusiasm and hastily approved by a vote. The very next day, a sign announced the opening of jobs for men on the road project. The unemployed of the village flocked to the job, and soon the road was ringing with the sounds of shovels and picks. Men once more worked happily. They brought home money, which found its way to the shops and stores of the village. Soon producers began to advertise for workers. Eventually, just as the legislator had predicted, the government was able to reduce the number of men working on the road, for jobs became abundant in the valley. Shops again hummed with activity. Stores buzzed with the voices of buyers. The village was on its way to recovery.

Never again, however, would the government sit idly by and watch the economy collapse. Specialists were hired to advise the legislators about the condition of the economy. The government kept a careful watch on the unemployment rate of the village. If it got too high, government projects were begun. The government watched prices and wages and tried to keep them in line with what it felt to be reasonable. There was trading with other villages, but the government always tried to maintain a favorable balance between the gold flowing out and the gold flowing in. It watched the interest rates Willy's bank charged and felt it necessary to raise or lower them from time to time. It taxed the people's incomes. It taxed the profits of the shops. If people were spending too much, the government raised taxes; if they spent too little, the government reduced taxes. The government kept a careful eye on the currency.

Many of the villagers felt the government had taken on a job that it shouldn't have. Shopowners complained that the government wouldn't let them make decent profits, because they were taxed too heavily. Nor could the shopowners pay their workers what they wanted, for the government regulated the wages. Men should be free, felt many, to take risks. They were entitled to the profits that resulted. If they failed, it was their own fault. They should be permitted to act on their own in bargaining with their workers. If only the government would keep its nose out, nature would take care of things. Things would balance out.

Other villagers, however, hailed the new role of the government. They felt that now they were better protected from depressions and inflation. Their jobs were more secure. Their wages were guaranteed to provide them with a decent living. No longer could wealthy people selfishly take advantage of the less fortunate for the sake of profits. The government would protect the less fortunate.

These arguments about the proper role of the government did not die out. Indeed, arguments for both sides continued even within the government itself. People in the government began to group together according to their beliefs about the relationship of the government and the economy. Men of one belief ran in elections for government offices against those who believed differently.

Yet the government survived, and the village prospered, for there was strength in disagreement, and the freedom openly to disagree produced more wisdom. The economy in a free society prospered because the truth could always be found and, once found, would be heard with an open mind.

XI. Depression: Questions on Reading

1. Describe a recession.
2. Describe a depression.
3. Why did the manufacturers reduce their prices?
4. Why did the manufacturers fire some of their workers?
5. What is overproduction?
6. What causes a surplus?
7. What are the effects of a surplus on:
 - a. prices
 - b. employment
 - c. production
 - d. profits
8. Why did people try to sell their stock?
9. What do you imagine it would be like to live during a depression?
10. What are the different stages of the business cycle?
11. Do you think the business cycle is natural?
12. What are the good and bad points of the argument, "Let's wait and see"?
13. Evaluate the argument that advocated "Let's try something."
14. How did the action of the government help to cure the depression?
15. What indicates a period of economic recovery?
16. How did the job of the government change as a result of dealing with the depression?
17. What do you think should be the job of the government in relation to the economy? Do you feel the new role was an improvement?