CHAPTER 4
ECONOMIC SYSTEMS AND DEVELOPMENT

LEARNING OBJECTIVES:
1. Describe what is meant by a centrally planned economy and explain why its use is declining.
2. Identify the main characteristics of a mixed economy and explain the emphasis on privatization.
3. Explain how a market economy functions, and identify its distinguishing features.
4. Describe the different ways to measure a nation’s level of development.
5. Discuss the process of economic transition and identify the remaining obstacles for businesses.

CHAPTER OUTLINE:

Introduction
Economic Systems
   Centrally Planned Economy
      Origins of the Centrally Planned Economy
      Decline of Central Planning
         Failure to Create Economic Value
         Failure to Provide Incentives
         Failure to Achieve Rapid Growth
         Failure to Satisfy Consumer Needs
      Focus on China
         The Early Years
         Patience and Guanxi
         Challenges Ahead
   Mixed Economy
      Origins of the Mixed Economy
      Decline of Mixed Economies
         Move Toward Privatization
   Market Economy
      Origins of the Market Economy
      Laissez-Faire Economics
      Features of a Market Economy
      Government’s Role in a Market Economy
         Enforcing Antitrust Laws
         Preserving Property Rights
         Providing a Stable Fiscal and Monetary Environment
         Preserving Political Stability
      Economic Freedom
Development of Nations
   Productivity
   Role of Information Technology
National Production
   Uncounted Transactions
   Question of Growth
   Problem of Averages
A comprehensive set of specially designed PowerPoint slides (designated ‘PPT’ below) is available for use with Chapter 4. These slides and the lecture outline below form a completely integrated package that simplifies the teaching of this chapter’s material.

**Lecture Outline**

1. **INTRODUCTION**
   This chapter introduces different economic systems and their effect on international business. It explains each type of economic system, economic development, how nations are classified, and how countries implement market-based economic reforms.

2. **ECONOMIC SYSTEMS (PPT #1-3)**
   *Economic system* is the structure and processes that a country uses to allocate its resources and conduct its commercial activities. No economy reflects a completely individual or group orientation; all display a blend of individual and group values.

   A. **Centrally Planned Economy (PPT #4-6)**
      Economic system in which a nation’s land, factories, and other economic resources are owned by the government, which plans nearly all economic activity. Ultimate goal is to achieve political, social, and economic objectives through complete control of production and distribution of resources.
      1. **Origins of the Centrally Planned Economy**
         a. Group welfare is more important than individual well-being, and thus strives to achieve economic and social equality.
         b. Karl Marx in the 1800s argued the economy must be overthrown and replaced with an equitable “communist” system.
c. By the 1970s, central planning was the economic law in Eastern Europe, Asia, Africa, and Latin America.

2. Decline of Central Planning
   a. In the late 1980s, nations dismantled central planning in favor of market-based economics for several reasons.
      i. **Failure to Create Economic Value:** Central planners failed to produce quality products efficiently.
      ii. **Failure to Provide Incentives:** Government ownership limited incentives to maximize benefits from resources, which lowered economic growth and living standards.
      iii. **Failure to Achieve Rapid Growth:** Leaders realized their nations were falling quickly behind other nations.
      iv. **Failure to Satisfy Consumer Needs:** Consumers’ basic needs were not being met.

3. Focus on China
   China’s theme is “Socialism with Chinese characteristics,” and the nation has undergone great economic reform over the past two decades.
   a. Early Years
      i. 1949: communes planned all agricultural and industrial production and schedules. Rural families owned their homes and land and produced particular crops.
      ii. 1979: government reforms allowed families to grow crops they chose and sell produce at market prices.
      iii. Township and village enterprises (TVEs) obtained materials, labor, and capital on open market and used a private distribution system. Legalized in 1984, TVEs laid the groundwork for a market economy.
      iv. Outside companies were allowed to form joint ventures with Chinese partners in the mid-1980s.
   c. Challenges Ahead
      i. Political and social problems loom. Skirmishes between secular and Muslim Chinese, and democracy restricted.
      ii. Unemployment, slow economic progress in rural areas, and misery of migrant workers.
      iii. China’s one country, two systems policy must preserve order, as Taiwan is watching closely.

B. Mixed Economy (PPT #7)
   Economic system in which land, factories, and other economic resources are more equally split between private and government ownership. Government controls economic sectors important to national security and long-term stability. Generous welfare system supports unemployed and provides health care.
   1. Origins of the Mixed Economy
      a. Successful economy must be efficient and innovative, but also protect society. Goals are low unemployment, low poverty, steady economic growth, and an equitable distribution of wealth.
      b. Many mixed economies today are modernizing to become more competitive.
   2. Decline of Mixed Economies
Mixed economies are converting to market-based systems. Government ownership means less efficiency, innovation, responsibility and accountability; higher costs; slower growth; and higher taxes and prices.

a. Move Toward Privatization
   i. Selling government-owned economic resources to private companies and individuals.
   ii. Increases efficiency, cuts subsidies to state-owned firms, curtails appointment of managers for political reasons.

C. Market Economy (PPT #8-15)
Majority of a nation’s land, factories, and other economic resources are privately owned, either by individuals or businesses. Price mechanism determines:
- **Supply**: The quantity of a good or service that producers are willing to provide at a specific selling price.
- **Demand**: The quantity of a good or service that buyers are willing to purchase at a specific selling price.

1. Origins of the Market Economy
   Individual concerns are above group concerns. The group benefits when individuals receive incentives and rewards to act in certain ways.
   a. *Laissez-Faire Economics*
      French: “allow them to do [without interference].” Individualism fosters democracy as well as a market economy.

2. Features of a Market Economy
   - **Free choice**: individuals have purchase options.
   - **Free enterprise**: companies can decide what to produce and which markets to compete in.
   - **Price flexibility**: prices rise/fall reflecting supply and demand.

3. Government’s Role in a Market Economy
   Little direct involvement, but plays four important roles:
   a. **Enforce Antitrust Laws**
      i. Goal of antitrust (antimonopoly) laws is to encourage the development of industries with as many competing businesses as the market will sustain.
         ii. Prevent trade-restraining monopolies and combinations that exploit consumers and constrain commerce.
   b. **Preserve Property Rights**
      i. Encourage individuals and firms to take risks such as technology investments, new product invention.
         ii. Legally safeguards claims to assets and future incomes they generate.
   c. **Provide a Stable Fiscal and Monetary Environment**
      i. Influence inflation and unemployment rates through effective fiscal and monetary policies.
         ii. Stability improves company forecasts and reduces risks associated with future investments.
   d. **Preserve Political Stability**
      i. Market economy depends on a stable government.
         ii. Helps companies avoid worrying about political risk.

4. Economic Freedom
a. Connection between political freedom and economic growth is very uncertain.
b. Yet greater economic freedom tends to coincide with higher living standards (Figure 4.2).

3. DEVELOPMENT OF NATIONS (PPT #16-20)

Economic development is a measure for gauging the economic well-being of one nation’s people as compared with that of another nation’s people. Reflects economic output (agricultural and industrial); infrastructure (power and transportation facilities); physical health and level of education; and cultural, political, legal, and economic differences.

A. National Production
Can classify countries by gross national product per capita, but there are problems using GNP and GDP as indicators of development.

1. Uncounted Transactions
   a. Not counted: volunteer work, household work, illegal or underground deals, and unreported cash transactions.
   b. Underground economy can be so large and prosperous that official statistics are meaningless.
   c. Barter is an alternative for buyers who lack hard currency to pay for imports (e.g., Pepsi-Cola in USSR).

2. Question of Growth
   a. GNP and GDP are a snapshot of one year’s economic output, and do not indicate whether an economy is growing.

3. Problem of Averages
   a. Per capita figures are averages. Urban areas can be more developed than rural areas and have higher per capita income (e.g., Mercedes-Benz in Shanghai, China).

4. Pitfalls of Comparison
   a. To compare gross product per capita, each currency must be translated into a single currency.
   b. Official exchange rates do not show what the local currency can buy in its home country.

B. Purchasing Power Parity
1. Purchasing power is the value of goods and services that can be purchased with one unit of a country’s currency. Purchasing power parity is the relative ability of two countries’ currencies to buy the same “basket” of goods in those two countries.

2. Using purchasing power parity to compare the wealth of nations (e.g., Swiss GDP per capita is $47,900 (but only $34,700 at PPP compared to US at $39,700).

C. Human Development
1. Human development index (HDI) measures extent to which a people’s needs are satisfied and the degree to which these needs are addressed equally across a nation’s entire population. Three dimensions: a long and healthy life, an education, and a decent standard of living.

2. Often disparity between wealth and HDI.

3. HDI demonstrates that high national income alone does not guarantee human progress.
D. Classifying Countries

Classifications normally based on indicators such as GNP per capita, portion of the economy devoted to agriculture, amount of exports in the form of industrial goods, and overall economic structure.

1. Developed Countries
   a. Highly industrialized, highly efficient, and whose people enjoy a high quality of life. People receive the finest health care and benefit from the best educational systems in the world.
   b. Examples are Australia, Canada, Japan, New Zealand, the United States, all western European nations, and Greece.

2. Newly Industrialized Countries (NICs)
   a. Recently increased the portion of their national production and exports derived from industrial operations.
   b. Mainly in Asia and Latin America: Hong Kong, South Korea, Singapore, Taiwan, Brazil, China, India, Malaysia, Mexico, South Africa, and Thailand.
   c. Combining NICs with those having potential to become a NIC forms a category called emerging markets.

3. Developing Countries
   a. Poor infrastructure and extremely low personal income.
   b. Rely on one or a few sectors of production, such as agriculture, mineral mining, or oil drilling. May become newly industrialized countries, but lack resources and skills.
   c. Mainly in Africa, the Middle East, and the poorest nations in Eastern Europe and Asia.
   d. Often are characterized by technological dualism—use of the latest technologies in some sectors of the economy coupled with the use of outdated technologies in other sectors.

4. ECONOMIC TRANSITION (PPT #21-23)

Process by which a nation changes its fundamental economic organization and creates new free-market institutions. Typically involves five reforms:

- Macroeconomic stabilization to reduce budget deficits and expand credit availability.
- Liberalization of economic activity that is decided by prices reflecting supply and demand.
- Legalization of private enterprises and privatization of state-owned enterprises in accord with an effective system of individual property rights.
- Removal of trade and investment barriers in goods and services, and removal of controls on convertibility of the nation's currency.
- Development of a social-welfare system designed to ease the transition.

A. Obstacles to Transition

1. Lack of Managerial Expertise
   Central planners formerly decided nearly every aspect of the nation’s commercial activities. There was little need for: many management skills including how to develop production, distribution, pricing, and marketing strategies; investigating consumer wants and needs and conduct research; competitively pricing products; or advertising.
a. Signs of Progress
The gap in education and experience between managers from the former communist nations and others has narrowed.

2. Shortage of Capital
Transition is expensive, requiring spending to:
- Develop a telecommunications and infrastructure system, including highways, bridges, rail networks, and subways.
- Set up financial institutions, including stock markets and a banking system.
- Educate people in the ways of market economics.

3. Cultural Differences
Economic transition causes cultural change, and replaces dependence on the government with greater emphasis on individuals. Often are cuts in welfare, unemployment benefits, and guaranteed government jobs.

4. Environmental Degradation
Economic and social policies of former communist governments in Central and Eastern Europe were disastrous for the natural environment. Environmental destruction is evident in increased levels sickness and disease, which cause lower productivity in the workplace.

B. Focus on Russia
Russia’s experience with communism began in 1917. For 75 years, government controlled all aspects of production and distribution, including prices of labor, capital, and products.

1. Rough Transition
a. In the 1980s Russia entered a new era of freedom of thought, freedom of expression, and economic restructuring.
b. Except for criminals and the wealthy, people have difficulty maintaining their standard of living and buying necessities.
c. Some Russians survive because they were factory managers under the old system and retained their jobs. Others have turned to the black market or organized crime.

2. Challenges Ahead for Russia
a. Managers must improve skills in every facet of management practice, including financial control, research and development, employee hiring and training, marketing, and pricing.
b. Political instability, especially nationalism.
c. Nuclear weapons sales for cash can be lucrative, despite the clear threat to global security and Russia itself.

3. One Bright Spot
a. Russia needs tax revenue to establish stock markets, a strong central bank, and an effective tax system. Yet before the Russian currency (the ruble) collapsed in 1998, international aid covered up the deficit caused by the lack of tax revenues, which was a result of extensive barter.
b. As the government and energy suppliers demanded that companies pay energy bills in cash, firms demanded cash payments from customers. This removed barter in much of the economy while increasing the number of taxable transactions.
c. There is some uneasiness now in Russia, partly due to incidents such as the 2003 arrest of Mikhail Khodorkovsky, then head of oil giant Yukos, for fraud, embezzlement and tax evasion.

5. BOTTOM LINE FOR BUSINESS
Ongoing market reforms in formerly centrally planned and mixed economies have a profound effect on international business. Freer markets are spurring major shifts in manufacturing activity. Lured by low wages and growing markets, international companies are forging ties in newly industrialized countries and exploring opportunities in developing nations. Global capital markets make it easier to set up factories abroad, and some newly industrialized countries produce world-class competitors of their own.