CHAPTER 3

Economics

This chapter examines some fundamental concepts in economics and some of the key economic developments that have shaped American history and politics.

Foundations of Economics

As long as people have organized themselves into groups, some type of economic activity has existed. People have always produced, consumed, and traded goods not only in order to survive but also to create wealth. People living in ancient times relied heavily on **bartering**, or trading goods for other goods or services. As societies became larger and more complex, **currency**, or money, was invented. Currency could be used to buy goods and services without having to trade goods or services in return. The earliest currencies were grains or other trade goods that were small and easily carried.

The earliest currency-based economies were centered around **markets**. Farmers, artisans, and craftspeople would bring their goods to the market in towns or cities, where people would gather to make purchases. The money earned by the producers of goods could then be used to produce even more goods, thus growing the economy, the market, and the cities that housed them. Cities grew because goods and services could more easily be concentrated in one place. In the cities of ancient Mesopotamia (modern Iraq), for example, temples became the first money-lending institutions, allowing people to borrow money at interest, or money paid for the use of money lent.

By the late Bronze Age (1500–1200 BC), trade had become multinational, taking place among many countries. Goods produced by one society were now traded for goods produced by other societies. This trade led to the development of trade routes, or pathways used for the transportation of goods. By 650 BC merchants had developed coins, made from precious metals such as gold and silver, which could be exchanged across borders.

The ancient world was also witness to the first developments in economic awareness and thought. Beginning with the ancient Greeks and philosophers such as Plato and Aristotle, people began to examine the ways in which trade and business were conducted and how those interactions could be improved. The first economist is considered to be a Greek poet named Hesiod, who, in an 800-line poem titled *Works and Days*, wrote that labor, or work performed by people, was the source of all good.

After the fall of Rome, the world's economy grew slowly. New trade routes were established. The most famous among them was the **Silk Road**, which extended more than 4,000 miles and connected Europe and China. Silk and spices traveled west, while horses, fruits, and jewels flowed east. The trade along the Silk Road helped transform Europe from relatively poor to rich, with cities such as those in Italy emerging as rich trade centers. It was in these trade cities that the first modern accounting systems were developed to help people keep track of goods being transported and the wealth they were earning.

EXERCISE 1

Foundations of Economics

Directions: Choose the best answer to each question.

1. What were the first money-lending institutions?

A. Banks
B. Temples
C. Markets
D. Palaces

2. Which describes multinational trade?

A. Trade within a country
B. Trade controlled by one company
C. Trade among many countries
D. Trade conducted in a city market

3. What was the Silk Road?

A. An overland trade route from Europe to Asia
B. A sea trade route from Europe to Asia
C. An overland trade route from Europe to America
D. A sea trade route from Europe to America

Question 4 is based on the following passage.

Excerpt from *The Politics* by Aristotle, around 340 BC

Property should be in a certain sense common, but, as a general rule, private; for, when everyone has a distinct interest, men will not complain of one another, and they will make more progress, because every one will be attending to his own business.

4. Based on the passage, what is Aristotle's idea about the importance of private property in regulating human behavior?

   A. Private property will make society less productive.
   B. Private property will encourage society to progress.
   C. Private property will make people more greedy.
   D. Private property will make people happy.

Answers are on page 848.

The First Global Economic System

Throughout much of the Middle Ages, Europeans did not travel far beyond their small corner of the world. Trade with Asia along the Silk Road had encouraged some Europeans, such as Marco Polo in the late 13th century, to travel east, but with the conquests of the Ottoman Turks in the 14th century, Europeans found themselves restricted from travel by land to Asia. The closing of land routes to China also meant that the silk and spices that had fueled economic growth for almost a thousand years all but stopped flowing west. Thus, European merchants, adventurers, and state officials began looking for new ways to grow wealth. This desire for new trade opportunities, along with a religious zeal to expand Christianity and recent advances in sailing technology, all made it possible for Europe to enter an age of exploration.

Beginning in the early 1400s, Portuguese explorers sponsored by Prince Henry the Navigator and equipped with a new ship, the caravel, began to probe the western coast of Africa. Encouraged by an abundant spice trade, Portuguese ships charted new routes along the southern tip of Africa to India and captured several trading cities to serve as waypoints for the passage east. Eager to share in the wealth of its neighbor, Spain agreed to sponsor expeditions of its own. Christopher Columbus, who sailed from Europe in the fall of 1492 to reach the Americas, led the first of these trips. Columbus believed that he had found a westerly route to Asia. It took later explorers to realize that he had instead discovered a new world in the Western Hemisphere.

The 1500s saw the mass expansion of European power. Spanish conquerors, known as **conquistadors**, flooded the Americas in search of "gold, God, and glory." Relying on superior technology such as gunpowder, these Spanish profiteers were able to conquer several civilizations, including the Aztecs and Incas, enslaving the populations and looting their cities for precious goods. The flood of gold and other precious metals from the Americas quickly made Spain the dominant power in Europe and motivated other nations to send expeditions of their own. Although the Dutch failed at their attempts at colonization, the British and French had established control over most of the eastern seaboard of North America by the 1600s.

Dominating the rush to colonize the Americas and to establish centers of trade was the theory of **mercantilism**, which held that the prosperity of a nation depended on a large supply of gold and silver. Mercantilists believed in creating balanced trade, which favored exports over imports. It was the role of government to create this favorable balance by building bridges and roads and by stimulating the growth of businesses through subsidies, or payments made to support industries. Governments also placed **tariffs**, or taxes, on foreign imports to make foreign goods more expensive and thus less attractive to consumers. Colonies were crucial to this new economy as they provided raw materials and import goods.

All of the economic activity between European governments and their colonies created the world's first truly global trade network. Goods, plants, and animals flowed across the Atlantic Ocean in what became known as the **Columbian Exchange**. Colonies in the Americas established plantations, or large agricultural estates, to grow cash crops such as sugar, cotton, vanilla, and tobacco for export, while bringing in imports such as wheat, citrus, and horses. The exchange not only created wealth and new markets for goods on both sides of the Atlantic but also transformed the ecology of both the Americas and Europe.

The Columbian Exchange also proved to be deadly. Diseases from Europe devastated Native American populations. Europeans enslaved people from Africa and brought them to work on colonial plantations, where they provided the labor to produce crops. Millions of people died or were forcibly relocated as a result of the Columbian Exchange and what became known as the **triangular trade**, a flow of goods and slaves connecting Europe, Africa, and the American continents. In this system, European goods were traded for African slaves, who were then sold in the American colonies in exchange for cash crops that were then shipped back to Europe. The results of this system were devastating to some of the people. Native Americans were all but wiped out, while parts of Africa were depopulated and suffered culturally, politically, and economically. Slavery as an institution endured well into the 1800s, and in some parts of the world it continues even until this day.

EXERCISE 2

The First Global Economic System

Directions: Choose the best answer to each question.

1. What was the primary motivation of European explorers?

A. Converting people to Christianity
B. Establishing new colonies
C. Mapping the world
D. Finding new trade routes to Asia

2. Which is the BEST definition of *mercantilism*?

A. "The belief that a nation's wealth is directly linked to its supply of gold and silver"
B. "The belief that an economy functions best when it is free of government controls"
C. "The belief that trade should be free of tariffs and taxes"
D. "The belief that societies only advance through the building of new markets"

3. What was a major positive effect of the Columbian Exchange?

A. It halted the spread of disease.
B. It brought an end to slavery.
C. It provided labor for plantations.
D. It created new markets for goods.

Question 4 is based on the following map.

4. What evidence does the map give to show a negative effect of the Columbian Exchange?

A. People on both sides of the Atlantic learned to use new crops.
B. More nutritious food was available worldwide.
C. New diseases were introduced to the Americas.
D. People in Europe discovered they could eat corn.

Answers are on page 848.

The Rise of Modern Economics

The greatest changes to the ways in which people thought about labor and the creation of wealth came in the Enlightenment of the 1700s and from the Scottish philosopher Adam Smith, considered to be the father of modern economics. Smith believed that if individuals were free to pursue their own economic self-interest, then all of society would benefit. The government should leave the economy alone. This doctrine became known as **laissez-faire**, a French term roughly translated as "to let people do what they want." In his book *The Wealth of Nations*, Smith argued that the state had only three basic roles. Those roles were to protect society from invasion, defend citizens from injustice, and maintain public works—such as roads and canals—that individuals could not afford but that were necessary for trade.

While Smith was developing his ideas about modern economics, a major event was transforming the way economies functioned. Beginning in the 1780s in Great Britain, the **Industrial Revolution** was beginning to take place. It began with major advances in agriculture that dramatically increased food supplies, allowing more people to eat at a lower cost with less labor. As the population grew, more people moved to towns and cities looking for work, while the government and wealthy individuals began to invest in machines and factories. Britain was especially well positioned to take advantage of these changes as the country had abundant natural resources and a vast colonial empire hungry for manufactured goods.

Machines quickly transformed first the cotton industry and then industries based on coal and iron. Raw materials fed factories, thus growing the demand for more raw materials. Labor became highly systematized, with workers working in shifts to keep machines producing at a steady rate. Conditions in factories were harsh. Workers had few rights or protections and could be fined or even beaten for poor performance or bad behavior.

With the expansion of the industrial economy, more efficient means of moving resources and goods needed to be developed. In 1804 the first steam locomotive was invented. Within a hundred years, vast railway systems were being constructed across Europe and America. The building of the railroads created new jobs. Lower transportation costs led to more affordable goods, thus creating larger markets and more demand. The new industrial economy became self-feeding, ensuring steady growth and greater wealth than had ever been known before.

Society was forever transformed as a result of the Industrial Revolution. Cities grew as never before. In 1800, for example, London's population was about one million. By 1850 that number had more than doubled. A better-fed population meant the decline of famine and disease and an increase in life span, which only added to the population boom. Soon reform movements sprang into existence calling for greater political participation and better sanitation.

Perhaps the most important result of the Industrial Revolution was the development of a new middle class. Throughout history, society was chiefly divided between a small, wealthy upper class and a large, poor lower class.

Doctors, lawyers, bankers, and teachers, and also the people who built and ran the factories, made up the new industrial **middle class**. The middle class did not have enough wealth to be considered rich but had just enough wealth to afford bigger homes and some luxury goods. As this new class grew, so did new industries, most notably businesses that provided entertainment, such as theaters and restaurants.

However, as some people prospered under the Industrial Revolution, many others struggled with poverty and harsh working conditions. This gave rise to a political movement favoring the establishment of **socialism**, a system in which society, usually the government, owns the means of production, such as factories. Developed chiefly by a German philosopher named Karl Marx, socialism maintained that the industrial economic system was essentially unfair, with only a few getting rich at the expense of the majority. Socialists believed that only government-controlled industry could promote true and fair economic equality. The conflict between capitalism and socialism would become the defining struggle for the next one hundred years.

EXERCISE 3

The Rise of Modern Economics

Directions: Choose the best answer to each question.

1. What conclusion BEST supports the idea that Adam Smith is the father of modern economics?
   - **A.** Most people work to earn their living.
   - **B.** Today most developed nations practice some form of *laissez-faire* capitalism.
   - **C.** Developing nations such as India and China have growing economies.
   - **D.** Western governments routinely regulate their economies.

2. What conclusion can BEST be made about the Industrial Revolution?
   - **A.** It changed the way governments interact with their citizens.
   - **B.** It heavily influenced art and music.
   - **C.** It was not very long or meaningful.
   - **D.** It transformed the economies of most Western countries.

3. What conclusion BEST supports the claims of socialism?
   - **A.** The Industrial Revolution gave people new economic opportunities.
   - **B.** As a result of the Industrial Revolution, cities grew larger.
   - **C.** The Industrial Revolution made some people very rich and many more very poor.
   - **D.** The Industrial Revolution led to the spread of reform movements.

Answers are on page 848.

Developments in American Economics

The American Revolution was fought in part as a protest against unfair taxation of the American colonies by Great Britain. Once the colonies gained independence and established the United States of America, the country was formed as a common market with no internal tariffs or taxes restricting trade between the states. Although this system encouraged the free and open exchange of goods and services, it did nothing to regulate and fund the new, struggling federal government.

Alexander Hamilton, the first US secretary of the treasury, proposed the creation of a government-sponsored bank and tariffs on foreign imports to encourage economic growth. Furthermore, he consolidated the debt amassed by the colonies during the Revolutionary War, building national credit and encouraging investment in the federal government through the sale of bonds. There was much resistance to Hamilton's ideas of a strong central bank to regulate the economy, most notably from Thomas Jefferson, who favored a smaller, weaker federal government. However, conflict between France and England, and later the War of 1812, forced many opponents of the national bank to support the institution as a stabilizing force in times of crisis. Thus, the American economy became a compromise, in which states were encouraged to trade goods freely and without restriction, while the federal government, through the national bank, would regulate the economy overall.

When the Industrial Revolution spread to the United States from England, the American government invested millions in infrastructure improvements. These included building the **intercontinental railroad**, a railway linking the eastern and western halves of the United States, and the building of canal systems throughout the East Coast and Great Lakes region. The US economy was further improved in 1793 when Eli Whitney invented the cotton gin, a machine that could quickly and easily separate cotton from its seeds. Suddenly the cost of cotton production dropped, and Southern plantations, worked by slaves, began exporting enormous amounts of cotton to mills in Europe. The boom in cotton production led to a land rush into the West while greatly increasing the demand for slave labor. Disputes over the spread of the slave labor system to the western territories led directly to the Civil War in the 1860s.

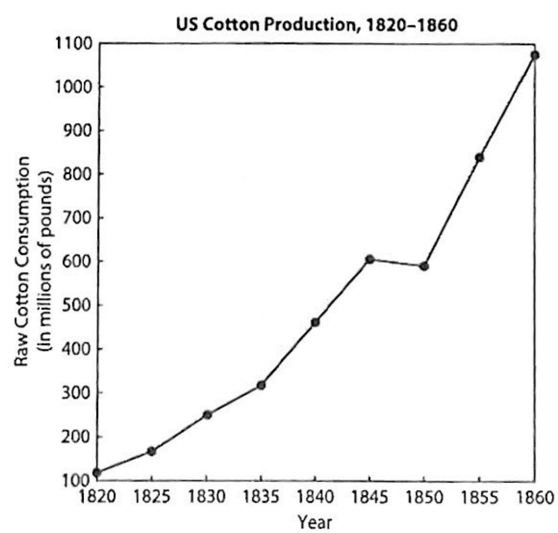
After the Civil War and the collapse of the Southern plantation system, the North ramped up manufacturing. Immigrants flocked to the North in search of jobs. Cities grew rapidly. New factories sprang up to meet growing demand for goods by European nations and a fast-growing American middle class. When the Civil War ended in 1865, the United States began a period of rapid economic growth. By 1890 the United States surpassed Great Britain to become the world's largest manufacturer. New discoveries and inventions exploded on to the American scene, including electricity, the light bulb, the telephone, the phonograph, and the typewriter. The automobile began to replace the horse-drawn carriage, slowly at first, until in 1913 Henry Ford installed the first **assembly line** to manufacture cars. Mass production, or the production of goods in large quantities, usually by machinery, made the automobile affordable for most Americans. As a result, the US government invested heavily in roads and oil exploration.

This was the Gilded Age, a period of time lasting into the early 1900s, when the economy of the United States created more wealth than all the nations that came before. Wealthy individuals, known as **tycoons**, built vast fortunes. Among them were John D. Rockefeller, who built a vast oil empire; J. P. Morgan, who did the same in banking; and Jay Gould, who dominated the railroad industry. Individuals such as these created **monopolies**, industrial or commercial organizations with complete control over the production or sale of a specific commodity. Monopolies stifled competition, thus eliminating choice and increasing prices. Angry over monopolies and poor working conditions, workers began to organize **unions**, organizations of workers formed to protect and expand their rights and interests. At the same time, progressive politicians and reformers began to call for the break-up of monopolies to encourage greater competition. The result was not only greater economic equality but also increased political participation.

EXERCISE 4

Developments in American Economics

Directions: Study the graph and then answer the questions that follow.



1. Based on the graph, what was the trend in cotton production following the invention of the cotton gin in the late 1700s?

   A. Cotton production increased.
   B. Cotton production decreased.
   C. Cotton production remained relatively unchanged.
   D. Cotton production stopped altogether.

2. Based on the graph and what you learned from the reading, what conclusion can be made about slavery from 1820 to 1860?

   A. Demand for slaves decreased.
   B. Demand for slaves increased.
   C. Demand for slaves stayed the same.
   D Demand for slaves stopped altogether.

Answers are on page 848.

The Globalized Economy

Between 1914 and 1918 much of the world was engaged in World War I. Although the United States participated in the fighting, no actual combat took place in America. The war devastated countries such as France and Germany, and it led to the rise of a socialist government in Russia, which was renamed the Soviet Union. The United States remained strong and was in a good position to lend money to other countries for postwar rebuilding. The Dawes Plan, for instance, named after American banker Charles G. Dawes, was a plan in which the United States lent money at interest to Germany, which was forced to pay reparations (money paid to make amends or pay for war damages) to France and England. This loan opened the door to heavy American investment in Europe and made the dollar the international currency of choice.

As a result of the Dawes Plan, a period of economic prosperity followed in Europe and the United States. This period was known as the **Roaring Twenties**. It was a time of excess when the US stock market boomed. Americans invested heavily in **stocks**, or shares in companies issued to raise capital, on the promise of quick riches. Buyers engaged in **speculation**, or betting that the market would continue to climb. Many investors bought stocks on margin, making only a small cash down payment, with as much as 90 percent of the stock bought on credit. Some people, including President Herbert Hoover, believed that the period of postwar prosperity would never end. Then in 1929 the US stock market crashed. As stock prices plummeted, panicked investors tried to sell their stocks before prices dropped too far, which drove the market even lower. After the crash, banks and companies closed, unemployment soared, and the world found itself in the grip of the **Great Depression**.

There were many factors for the Great Depression beyond stock speculation and overinvestment. Overproduction of goods was an important factor. Supply outpaced demand, meaning that there were more goods than people to buy them. Another major factor was the uneven distribution of income. While the wealthiest Americans saw their incomes increase, the majority of workers dealt with wages that remained low.

The Great Depression devastated the globally connected economy. Trade and investment slowed as unemployment spread across Europe and America. In response, countries such as the United States, Great Britain, and France invested heavily in social relief programs. American president Franklin Roosevelt, for example, led the passage of a series of sweeping reforms called the **New Deal**, which included public works programs such as the Works Progress Administration and welfare programs such as Social Security. The idea was to put able Americans back to work while providing protections for Americans who could not work. At the same time, the response to the Great Depression in countries such as Italy, Germany, and Japan was a political shift toward dictatorship. Germany, for instance, saw the rise of the Nazi Party in the 1930s. Adolf Hitler, a former German soldier, promised to restore the country to economic prosperity through a campaign appealing to German militarism and nationalism. Hitler blamed Jews, Communists, and other minorities for Germany's defeat in the war and subsequent economic collapse.

World War I led to the Great Depression, which in turn led to World War II, as the dictatorships in Europe and Japan began an aggressive campaign of conquest and expansion. The war, which lasted from 1939 to 1945, devastated most of Europe and much of Asia, but just as in the previous conflict, it left the United States relatively undamaged. As a result of this, as well as the nation's unmatched industrial output, the United States became the leading global economic power. The US dollar became the monetary standard for the world. American investment and American-made goods dominated international trade. Although the Soviet Union (formerly Russia) tried to challenge American dominance, the global economy continued to grow ever more connected, fueled by US capital.

By the 1990s the Soviet Union had collapsed and the world had firmly entered an age of globalization, defined as the movement toward a more integrated and interdependent world economy. Under the direction of the World Bank and International Monetary Fund (IMF), two organizations set up after World War II to help prevent economic crisis, multinational corporations rose to dominate economic activity. Multinational corporations are companies that operate in more than twc countries.

While economic prosperity has increased and global conflict continues to decline, globalization is not without problems. Poverty and income inequality remain major concerns, especially as most wealth is concentratec in Europe and North America. Critics of globalization have accused multinational corporations of putting profits ahead of worker safety and wages. In addition, companies have been accused of ignoring environmenta concerns. Despite these issues, one point remains clear: the world's econom is more connected than ever before.

EXERCISE 5

The Globalized Economy

1. Circle the benefits of a globalized economy.
   - decline in global conflicts
   - the rise of new superpowers
   - an increase in shared prosperity
   - decrease in third world education
   - increased interconnectedness of the world
   - a rise in European nationalism
2. Circle the negative consequences of a globalized economy.
   - Asia rising in political power
   - poverty
   - income inequality
   - the US dollar is the monetary standard
   - corporations putting profits ahead of safety
   - corporations ignoring environmental issues

Answers are on page 848.