



WIDESPREAD ECONOMIC DOUBTS

Some that we have always had and others we would never had thought about.

By: Julio José Prado

jprado@ide.edu.ec

**Full time Professor and Research Deputy Director
IDE-Business School
Ecuador**

English Translation: Dr Marcus Hunter Champion.

Many people think –perhaps with just reason- that the economy is a boring theoretical science, and that it does not have its feet upon the ground. In order to try to change that perception, we are going to propound for ourselves some day to day questions, to which we can provide an answer (to the extent possible) with a bit of economic “logic”.

INFLATION AND PRICES: WHO IS LYING?

There is an image that is repeated just about every month in the markets of the country. The official figures speak of a reduction in inflation, but journalists are going to the markets and asking the housewives and they are hearing almost in unison the following response: “the government says that the amount of inflation has fallen but it is a lie because one continues to see the prices of things rising”. Is someone lying?

In spite of the fact that many of us would align ourselves in order to say that the Government is lying, in reality the Government is not lying. The root of this dilemma is due to a poor understanding of the concept of inflation, which in a just a few words is the velocity with which the prices in the economy grow. The data that we provide the official agencies with every month is then a measure of the variation (monthly or annually) of the prices. For example, a monthly inflation of 2 percent implies that the prices for this month with respect to the previous month have increased at such a level.

Therefore, if the Government says that the monthly inflation has fallen from 2 percent to 0.5 percent, this signifies that prices continue to increase but at a less rapid rate. Therefore, a minor inflation in the markets is not going to go about reflecting lower prices.

In addition, there is another important consideration. The data on inflation is an average which is based on the figures from a large quantity of products (the so called basic basket). Therefore, there are products whose prices lower or increase every month, but that at the end when we are able to see the data with respect to inflation, we are unable to perceive the change. When we go to the market, in an almost systematic manner, we pay greater attention to the products that have increased in price (especially if they are the most important products for our very own family shopping basket), and that creates the perception of “the things are always more expensive”.

In sum, one must remember... that the inflation does not imply that the prices of all products are going decrease in price (this is known as a “disinflation”). It only means that on the average, the pace of price growth is lower.

WHY IS THERE ALWAYS A “CLEVER ONE” WHO PAYS LESS?

Let’s go to a restaurant with a group of our friends or colleagues from work. We have decided, as is common in these cases, to split the bill between all of us. What a surprise! All of the people at the table end up by paying more than each of them had initially budgeted. Let’s put up some numbers in order to understand better. Let’s suppose that five friends had budgeted spending between 6 and 10 dollars each as a maximum, now we decide to divide the bill and each person ends up paying 12 dollars. Does this seem familiar? Is there a “clever one” that paid less than the rest?

Breaking up the logical assumption that all the individuals have paid the same (but what is the purpose of splitting up the bill?) the numbers just do not add up. What happened? Here is where the economic theory may give us a hand in order to understand what actually happened.

Initially, I had intended to spend \$10 as a maximum. When I received the menu I looked for a dish that was within my budget; in most cases I will look for something that does not reach my maximum figure. I will ask, for example, for the spaghetti carbonara that costs \$6 instead of the chateaubriand that cost \$9. That is normal behavior, if I know that each person is going to pay for what that person consumes. But then, the brilliant idea arises of “let’s split the bill”. What will my reaction be? Do I stay with my initial decision or do I now ask for a more expensive dish?

The carbonara remains the most logical choice if my desire is not to spend my entire budget. But what are the rest of the people at the table going to do? My instincts (and my experiences of past lunches) tell me that they are going to order dishes that are more expensive, thereby taking advantage of the fact that we had agreed to split the bill among all of us. Is it logical for me to stay with the spaghetti carbonara when I know

that all of them are going to choose dishes that are expensive? Well, this type of reasoning, everyone that is seated around the table has. The result is sub-optimal for all, since each one ended up by paying more than would have been desired. And even in extreme cases, we end up by exceeding the established budget. Hasn't it happened, for example, that in the first round of beers someone ordered an imported beer while the rest ordered a national beer? Of course, in the next round, without thinking twice, all of us have asked for the imported beer. The carbonara remains my logical choice if my desire is not to spend my entire budget.

With this simple example, we have learned the basic operation of the theory of games. At times individual decisions do not lead to collective success, as suggested by the classical theory of the economy. This is due to the fact that incentives exist in order to do things that we would not "normally" do. The theory of games allows us to make better decisions not only as it affects my strategy but also as the decision affects the strategy that the rest are going to employ. In our example, what we have to do is that each of us pays only for what that person consumed, period. This removes the temptation to spend more. We are able to keep our friends and we are able to save. That will strengthen the common wellbeing.

WHO INVENTED THE MARKET?

On many occasions (too many) one hears it being said that the market is an invention of the oligarchy in order to control the people. Or that it is a mechanism invented by rich countries to oppress the poor. Nothing could be further from reality. Let us try to understand this with an example taken from real life.

In 1944, a group of soldiers fell into the hands of the enemy and were then taken to a prison camp, where they were united with other captives. Every week, the Red Cross distributed a package to each prisoner that contained: soap, toothpaste, a cheese, various forms of bread, and cigarettes, among other things. Soon, a prisoner who did not like the cheese very much decided to look for someone that smoked in order to exchange the cheese for cigarettes. Some appreciated the soap more than the others and so they chose to "buy it" by an exchange for their toothpaste, or any other product. As usually happens in these cases, the currency that was used was the cigarettes, because the prisoners usually placed a great value upon them and even those who did not smoke accepted them as a means of payment. So up until now it is already clear that even in very complicated conditions, people find ways in which to create markets although they might be in very rudimentary forms.

But the history does not end here, because the market of the prison was prospering, even arriving at becoming a form of foreign trade. A prisoner who had certain benefits and could move around with greater freedom between the different camps realized the various tastes and preferences, that were significantly different between the camp A and the Camp B. In the former the cheese was preferred and therefore a cheese could be exchanged for two packs of cigarettes, whereas in the latter camp, the same cheese was only worth a pack of cigarettes. The exchange between the two camps was thus launched.

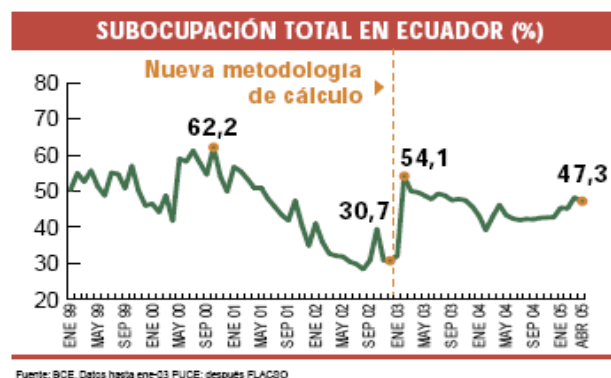
Just as in any market, there were price variations. The day on which the Red Cross delivered new cigarettes the “price” fell because there was a greater supply. As the cigarettes were being consumed, and there was less supply in the market the price began to increase.

We could find hundreds of examples of markets such as this, that in a form that appears to be almost spontaneous arises in order to satisfy the existing needs. Because at the bottom of it all, people have different tastes, preferences and skills. The market is not a deliberate invention, it is a form of relationship between people, to improve the living conditions and to acquire those things that would otherwise be impossible to obtain.

The risk of believing that the market is an “invention” is that is thereby conceived as being a “tool” that Governments have in order to make economic policy, and therefore it is totally susceptible to manipulation. The markets require a clear framework in order to function which is provided by the institutions which is part of the Government, One thing is to smooth out the “roughness” of the Government. Another thing is to “control” the market, claiming that a group of people can make better decisions than the collectivity (represented in the market itself).

THE MYSTERIOUS CLIMB OF UNDEREMPLOYMENT

TOTAL UNDEREMPLOYMENT IN ECUADOR (%)
NEW METHODOLOGY OF CALCULATION



In 1997, underemployment was at 41 percent, if we compare this percentage with the figure from the beginning of the year of 2004, which was 54 percent, what jumps into view is that something bad happened to the economy. For the detractors of dollarization, this is the only thing possible. The problem of this comparison is that is taken in a form that that is (deliberately) wrong. Let us look at the accompanying chart and it can be seen that there is a sudden jump in statistical series of underemployment. In short we can summarize what happened accordingly:

1. During the crisis and the months following the dollarization, the unemployment rate was situated at 17 percent; in the following years and until January of 2003, unemployment was lowering until it was situated at 8 percent. During the same period the rate of underemployment was showing a downward trend, of 60 percent up to 30 percent.

2. What has happened since January of 2003? The methodology for the calculation of the level of employment changed; until January of 2003, the PUCE (Catholic University of Ecuador) was responsible, but since that date the elaboration of the data was the responsibility of the FLACSO (Latin-American Faculty of Social Science). This does not mean that there is an error in the methodology, but yes it does imply a distortion in the series. From a strict technical point of view, the data from before and after 2003 simply are not comparable...and here is the problem!
3. So much so that “miraculously” just after the change in January of 2003 the rate of unemployment rose from 32 percent to 54 percent in only one month (!). And the unemployment rate fell from 8 percent to 11 percent in the same month. This leap does not reflect what happened in the labor market, as it is “simply” a distortion statistic. The only thing we can say is that since February of 2003 until now, unemployment dropped to 10 percent and underemployment has been declining until it reached a level of 40 percent.
4. The tendency in the two different series, before and after 2003, provide for a consideration of underemployment, a direct effect of greater economic stability.

Moral: The figures are very helpful in understanding what is happening in the economy, but we must always look out for the “small print” or we can commit serious errors of judgment.

WHY BEING BLONDE IS NOT SO GOOD AFTER ALL?

According to some Internet pages, 50 percent of the blondes in the United States are not natural. It does not matter if we take this data as real or not, what is certain is that there is a “fashion” (nothing new) in being blonde (perhaps this was initiated by Marilyn Monroe, the most famous “dyed” blonde). Will, as the saying goes, blondes have more fun? Well, if we apply some sort of economic reasoning to this matter, we see that to be blonde is not so good after all, at least if what you want is to have a date.

A group of young men are in a bar. Shortly after arrive 4 young ladies, a blonde and three brunettes. The only blonde in the group is the one that attracts the most attention and the young men begin to think about how they will play their cards to be able to dance with her. Recalling their classes in economics, the young men arrive at the conclusion that “the individual interest serves the common good”. And therefore, they decide that each of them must act according to what is best for each of them individually. What is the problem with this form of reasoning? All of them are going to make a play for the blonde. Thus all of the young men freeze among themselves and run the risk of initiating a discussion that is not necessary. As the strategy of making a play for the blonde does not work, now they will make a play for the rest of the girls of the group, the brunettes. But since no woman likes the idea of being the “second choice” the young men are again rejected.

What is the best strategy in this case? Let us use the analysis of John Nash (Nobel Prize winner in economics). In a case like this it is necessary to do –at the same time- what is best for each of the members of the group. The best strategy is not to by that which seemed to be the best choice, the blonde, but to go directly to dance with the brunettes.

For those of you who have seen the film “A beautiful mind”, this scene must prove to be familiar. And is an excellent way of explaining how to apply the reasoning of the game theory.

Then, if you can look at it from this point of view, the only loser is the blonde. Thus, if you are the only blonde in the group and you live in a society in which gentlemen prefer blondes, you are at a great disadvantage. Of course, the problem is eliminated if the majority of women begin to dye their hair blonde, because the factor of differentiation would no longer be the color but any other trait (personality, intelligence, etc.) but that is another topic...

WHEN MORE SECURITY IS EQUAL TO MORE DEATHS

There is nothing better than good old logical reasoning. Like, for example, this. Babies and children up to 4 years of age, must by law, be placed in a car seat when they are inside of a car. This protects the infants during collisions and reduces the risk of serious injuries. If the car seat is mandatory in vehicles, why is it not mandatory in airplanes? Let us think of this for a moment. The airplanes are exposed to strong turbulence during the flight. They shake a lot on landing and braking. In any of these cases, or even worse in an emergency, children are less protected in a plane than in an automobile, isn't that so? Remember that generally, especially in short trips, infants can go into the arms of their mothers or fathers. Then, by logic, if we make it obligatory -by law- that children use a car-seat (a “flight seat” in this case), we can succeed in reducing the number of deaths or accidents. Does that sound good?

This is precisely what was proposed by Jane Garvey of the Federal Aviation Administration (in news that was published in the New York Times of December 16, 1999). It was implemented as a model for a test for some months. At the end of the experiment the rate of mortality and of accidents occurring among infants was measured. It had increased!

How is it possible that something that sounds so logical can cause the opposite effect? Here is the explication. Children under a certain age (let's say 4 years), do not have to pay for their passage on airlines (or they pay only a fraction), because it enables them to go in the arms of their parents, or to be placed in a small “cradle” in certain selected seats. With the new regulation which required each such child to use a car- seat, the free tickets were thereby no longer issued. Each child occupied a seat and therefore paid for a complete ticket. What was the reaction of the parents? When the distances were short, some parents chose to travel in automobile or in bus instead of paying for an “extra ticket”. As the rate of accidents in vehicles is much higher than the rate of accidents on airlines, that means that more vehicles in the street, more likelihood of accidents.

The “logic” in this case did not take into account the reaction that the parents would have had prior to an increase in costs of traveling by airline. The people respond to incentives and this was an incentive to do exactly the opposite of what was expected. The regulation was withdrawn a short time thereafter.

WHO RAISED THE PRICES IN 2006?

At the end of the year 2005, inflation appeared to be out of control. The year closed with 4.4 percent of annual inflation, when previously the Central Bank had envisaged an inflation rate of 3 percent. And to the astonishment of all, in the first months of the year 2006, the inflation reached to 4.8 percent in January and 5.3 percent in February, so that the most optimistic projections spoke of inflation at the end of the year of 12 percent, while that others spoke of a rate of 25 percent.

There were those who touted the collapse of the dollarization (for the umpteenth time), and blamed this system of uncontrollable climb on inflation. And of course, the result is that when the rate of inflation is very low (2 percent), this was the result of the lack of purchasing power and the “bankruptcy of productive apparatus”, and when inflation grew, it was also because the companies were in crisis, due to the dollarization.

Within some of the explanations that are more sensible, it was attempted to look for the growth of inflation in the delivery of the reserve funds, passing through the high prices at the international level, up to concerns (legitimate) for the uncontrolled public expenditure. Most of these explanations had some level of veracity, but in reality, there was no reason to explain the inflationary upturn that was mentioned by the INEC (National Institute of Statistics and Census). What mystery was haunting the economy?

In April of 2006 the mystery cleared up. The INEC announced that it had committed an error in the calculation of inflation. In short, what happened was that data had been taken from the leases and rents that were biannual and were counted in on a monthly basis. This “small” error caused the data of inflation to begin to be distorted month to month (the cumulative effect of adding error upon error made the gap become larger) and due to the entry of “house and rents” has a high weight in the composition of the basic basket (10 percent), all the data on the inflation of the country increased.

Of course? There were several negative effects. The more palpable was the reduction of the trend of consumption. If people receive information (that is incorrect) that the cost of living will rise, their expectations of consumption is reduced. We believe that this may have meant a reduction of between 30 and 50 million dollars in consumption...all by virtue of a “small” error. This is worthy of the famous phrase of Ripley: “believe it or not”

WHY IS IT SO DIFFICULT TO BUY A “GOOD” USED CAR?

Anyone who has been the owner of a vehicle has had to deal with the tedious task of having to buy or sell a used car. If so, it is quite possible that on more than one occasion it was asked: Why is it so difficult to find good used cars? The problem lies in what is known as “asymmetry of information”, and is one of the most common failures of markets in which people that have information are benefiting from it.

We think of the market for used automobiles. The buyers are disposed to pay; let’s say \$6,000 for a vehicle. The sellers are disposed to sell the car at about \$5,000. In a market where there is good information, there will be a negotiation in which probably the vehicle will sell for \$5,500 (the average). But in the market of used automobiles does perfect information exist? No. The seller always has better knowledge about the state of the vehicle than the buyer. In an attempt to “learn” about the automobile the buyer must take the automobile to a mechanic’s shop, which implies an additional cost for the buyer, and the buyer still does not have a 100 percent certain guarantee as to the state of the vehicle.

In that context, the buyer punishes the aggregate of used cars that exist on the market, because you cannot easily distinguish a used automobile which is in good condition from a used automobile that is in poor condition. Then as an entrance, the buyer will lower his/her readiness to pay the \$6,000 to \$5,500, for example (or even less). How do the sellers of automobiles react to this?

In this market there are two types of sellers: 1) Those who have a used automobile and sell it at a price that reflects the real state of the automobile, 2) and other vendors who use the lack of information to sell an automobile that is in poor condition, at a price that is similar to the automobiles that are in good condition. If you want, put adequate letterheads: there are honest people and there are dishonest people.

But we know that the consumer is going to punish the good people and the bad people, because the consumer cannot differentiate between them. Then the vendors that have good quality automobiles refuse to take their automobiles from the market, because they fell that it is not good business to sell the automobile in those conditions. Meanwhile, the owners of used automobiles that are in bad condition will be more than happy to sell the automobile for the average market price, because this price will always be higher than the value that the seller would have received if the information about the automobile had been perfect. The result is that there are more incentives for the market to saturate itself with automobiles in poor condition, and that the good automobiles are sold more and more among relatives and friends.

This simple example of how the markets may fail also demonstrate for us that there exists opportunities for honest vendors that can sell “guaranteed” automobiles. For this reason there are yards of cars striving to maintain a good name, which allows them to charge more and to attract those have left the market due to the asymmetry of information.

WHO RAISED THE PRICES IN 2007?

There is economic view that has resonated with force in the Medias of communication and in the informal conversations of every kind: the prices of a great quantity of goods have risen (especially in mid-year). For a country that under dollarization has become accustomed to a very low rate of inflation, which is actually has almost been non existent during certain times of the year, this increase is incomprehensible. Before anything else, it is necessary to say that here; we are not dealing with an error in the data like what occurred in the year 2006 (...until we know where)

In order to try and keep our explication short we can try to find four possible scenarios:

- 1) It is a normal phenomenon at this time of the year.
- 2) It is due to the increase in expenditures of the Government
- 3) The entrepreneurs are speculators
- 4) Something strange is happening

1) A normal phenomenon?

This response has been outlined by some analysts and government officials, so it appears to be worthwhile to analyze it. There are certain months in which on a regular basis, the prices of certain agricultural goods tend to rise or to fall. This depends upon the demand, and also it depends upon the climatic conditions, so that one might think that the current rise in prices is mainly due to problems that are associated with the agricultural production. If this is so, we should not worry, because the equilibrium will return soon to the markets, once they are able to overcome the problems of the climate (a very severe summer in the sierra, a lack of rain on the coast, for example), and when the demand begins to resume its upward cycle.

But upon examination of the tendency of monthly inflation, one must appreciate that the months of low inflation historically are precisely May, June, and July. Then the assumption that prices have risen because it is “normal” at this time of the year does not appear to be convincing.

2) More expenditures by the Government

When there is more money in the economy, the aggregate demand rises and this then in turn pushes prices upward. Has this actually happened in Ecuador? In part, it has, because in fact, the economic philosophy of the Government is based upon the fact that the economy is stimulated based upon Spending, and it is for that reason that the Government has injected large amounts of money (in different sectors and in different ways...some of which are more positive than others). Therefore, it can indeed be true that the upturn in the prices of certain products is because the Government has delivered more money. Should we worry?

In principle no, because if this is the case, inflation is due to an increase in demand that should be addressed in the short term by an increase in supply, thereby prices will lower within a couple of months (when the number of companies that sell products increases). What should concern us is what is a sustainable growth in demand? And here we must say that it is only temporal...until the State Budget can no longer stand it.

In short, there is an inflationary component in the Spending of the Government, but that does not explain by itself the increase in inflation at mid-year.

3) Speculators

This is an explanation that is heard enough in certain mediums. Does it have a solid basis? In part it does. Some companies have raised their prices upon seeing that in other markets certain goods and services have become more expensive. In all inflationary processes there is undoubtedly a component of speculation (here and in any country). It is speculation from the economic point of view that it is a “logical” process and passenger. When markets are efficient, the speculator cannot maintain high prices for a long time because the consumers can easily find a replacement and can make a change. But what happens when the markets are not so perfect...that is to say, as in Ecuador? The speculation can have negative effects in certain markets, and even more if the speculation has its origin in some kind of instability whether is be political or whether it is economical.

In short, in spite of the constant temptation to blame the entrepreneurs for the increase in prices, this also is not a complete explanation of the increase in prices. Perhaps it could be certain agricultural intermediaries, if they are speculating in an “exaggerated” manner, but they are not doing it any more than at other times of the year. So the inflation which is targeted on those months does not appear to be attributable “entirely” to the entrepreneurs.

We have provided a review of principal and most common causes of inflation (of course, we have excluded others such as the exchange rate and monetary policy, because we are in the dollarization), and so far we have not found an answer to the increase in inflation. Are there any?

4) Something strange has happened...

Here is our risky hypothesis¹:

It deals with an imbalance generated by having “two countries” during the first months of the year 2007, because while consumers had positive expectations, entrepreneurs were very pessimistic. There was an imbalance between supply and demand, which did not increase prices.

We are trying to understand this matter. Since the middle of last year, the expectations of consumption (measured with the IEC) were growing, until reaching its highest point in the first quarter of 2007. That, in the economy translates into a greater willingness to buy on the part of consumers: that is to say, an increase in demand. On the other hand, entrepreneurs were cautious during the period of the presidential elections, and they were quite negative when Rafael Correa assumed the presidency. In fact, in a survey conducted at the beginning of the year by IDE, we saw that 60 percent of the entrepreneurs said that the country would be “worse” next year, while the people in the street thought that at a 60 percent rate that things would be better in the country (Source: Confidential Report)... two visions totally contrary held by people that live in the very same country.

By having negative expectations, the entrepreneurs lowered their level of investment (or at least they did not invest what they had planned to): this in using good terms is called: reduction of supply.

So, we have already two elements that have been conjugated during these months in Ecuador: a demand with rising expectations and an offer with expectations that are lowering, the result has been an imbalance in certain markets, which resulted in an increase in prices (see the chart).

What is going to happen? What we have seen, is that the expectations of the entrepreneurs became less negative thanks to the sales in various sectors that were maintained. This was good because it meant that an increase in supply and a reduction in prices, but with greater economic activity. Unfortunately, the demand (consumers) has begun to lose momentum, which will cause prices to fall, a balance in the markets will be achieved but at a level of economic activity which is lower.

¹ We recognize that the hypothesis that we explained in this paragraph requires more support and research, for the time being it is one of many possible explanations. From our side, it sounds logical that something can be happening, but we pledge to penetrate more deeply the correlation between inflation and expectations in future studies.

