Title: Circular Flow of Income and the Business Cycle

Subject: Economics

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1.0 Introduction

The IMF (1996, p.4) defines an economy as: "an economic entity having a center of economic interest within a specific territory." To explain them, hypotheses, theories and laws can be used. To understand them they can be conceptualised (and simplified) in various ways, for example through models, systems and networks, through institutions and/or through an evolutionary perspective.

Aim: This paper looks at some aspects of explanation (how we understand the economy): hypothesis – theory and law building, conceptualisation, systems and model building, with the examples of the *circular flow of income* and the *business cycle*.

1.1: Constructing a narrative: A narrative is a 'story', in this case a story about the world economy. Who starts the story and who re-enforces it are interesting questions (the role of global media). Once a narrative become established it becomes difficult to dislodge, even where the evidence appears to contradict it. The challenge is to be constantly critical of prevailing narratives and to be prepared to switch to a new narrative where the evidence no longer supports the existing one. As Mark Twain said: "It isn't what you don't know that gets you into trouble. It's what you know for sure that just isn't so." (Samuel Langhorne Clemens 1835-1910).

1.2: Conceptualisation: Just as a narrative builds a story about the world economy, so conceptualisation involves the way in which we think about things, the mental pictures we have. Narratives, and the conceptualisations associated with them, define the questions we ask about the world economy and our interpretation of it. One test of the value of our conceptualisation is whether or not they lead us to ask questions the answers to which help resolve problems in the economy.

1.3: Hypothesis, theory and law: The practice of scientific investigation and explanation is normally to start with a hypothesis. This is a statement about what you think may be a relationship in the economy. For example: "countries with large public debts grow more slowly than those with low public debts." The next step is to gather evidence to see whether or not this relationship is correct. If extensive study found this relationship to hold, then it would be possible to state the relationship as a theory: "Countries with high public debt grow more slowly than countries with low public debt". Then, if over a long period of time and more evidence that consistently showed this relation to hold, the theory could be restated as a law. In practice, in business studies there are few, if any, laws. Most theories only tend to be reliable for a limited period under certain conditions.

1.4 Models, systems and networks

Models: A *mode*l can be defined as a simplified representation of reality. Models include what are considered to be the most important elements of reality in relation to the purpose for which the model is designed. Model building is part of scientific method, which can be described as: i) *observation and description*; ii) *classification*; iii) *identification of a problem* (derived from a paradigm: or set of theories within which certain questions are posed); iv) *formulation of hypotheses*: assertions about the relationship between events; a set of testable statements; v) *development of theories* (from hypothesis testing) and *laws*.

Systems: A second type of conceptualisation is a system (see Wallerstein 1979). This category of model emphasises *interaction*. A *system* is "a set of objects together with the relationships between the objects and their attributes" (Hall and Fagen, 1956; p.18). The objects in the economic system include all those activities and institutions that perform a role in the operation of the economy: offices, factories, farms, trade unions, multinationals etc; or spatially they may embrace areas demarcated as supranational (trade blocs), national, regional or local (urban sub-systems). Each object itself contains a sub-system (nested systems) and thus the definition of objects in a system depends on the *resolution level* of the analysis. The relationships between the objects are the links that tie the system together: flows of goods, people, money and information. It is also important to understand the 'rules' governing the relationships. Conceptualising the world economy as a system can be particularly useful if the objective is to assess the impact of change in one part of the system (world economy) on other parts. However, the world economy

is a system of human interaction, and is thus different to a physical system. A simple example of an economic system is illustrated by the '*circular flow of income*'. This shows some of the key relationships in an economy.

[Note: Models and systems should be evaluated on whether they make *justifiable assumptions* and provide useful insights. In a *relational* and *dynamic* world economy simple models will always be open to criticism.]

An economy can be conceptualised as a *system*, which itself comprises a set of structurally and geographically *nested open sub-systems*, which interact across their boundaries with each other and across the economic system boundary with social, political and environmental systems. Local economies can also be thought of as comprising different *ecosystems*, for example one area may be characterised by the automobile industry, in this automobile ecosystem top tier car assemblers may be supported by lower tier component suppliers. Through time the world economy may become either more integrated (based on free trade) or more fragmented into sub-systems (*segmented* or compartmentalised).

Interdependence (feedbacks) within the global economic system: A central characteristic of a system is the linkage and interdependence between its parts. Change in one part of the system will have repercussions elsewhere. The impact of a change depends on the nature of the linkages between sub-systems and the *positive* or *negative feedback loops* created by the change (resulting in *deviation amplification* or *deviation reduction*). Examples include: oil price rises following hurricane Katrina in the United States in August 2005; the repercussions of the destruction of the twin-towers in New York on 11 September 2001, and the fall-out from the US sub-prime lending crisis beginning in 2007.

Interconnection across system boundaries: There are also interconnections across the boundaries of economic systems to political, social and environmental systems. These interact and thus in looking at how the world economy operates the interactions with other types of systems cannot be ignored. In geopolitical terms, when the Berlin Wall was dismantled in 1989 and the Soviet Union began to be broken-up, and when China began to embrace capitalism, the old *bi-polar* Cold War struggle slipped into history. The fear of Armageddon associated with a nuclear war was eased. But in its place has come a much more diffuse set of threats, particularly those centred on ideologies and terrorism, drug trafficking and financial fraud. Local conflicts exist around the world, debilitating economies in Africa and South America and threatening the

stability of the world economy. In addition, new types of threat are emerging involving information and communications technologies that span activities from international financial fraud to computer viruses. Finally, there are environmental threats. These include diseases and global epidemics such as 'bird flu' HIV aids and malaria. Global climate change could radically change the environment, with for example changes to sea level that could flood coastal areas around the world, the places where the majority of the world's population live. The melting of ice-caps in the Himalayas could radically change the availability of water throughout South East Asia. Many major economic centres (for example San Francisco and Tokyo) are located on faults in the earth surface and thus face disruption from earthquakes. These and many more events are ever present threats to the world economy.

1.5 Adopting a *network perspective* views the global system as structured into complex and constantly changing networks of flows (Castells 2000): corporate networks (as for example represented by transaction patterns, supply chains and business alliances), political networks, urban networks and knowledge networks. Accessing high quality networks creates *competitive advantage* for both businesses and places. World cities are major nodes in these networks of flows.

The global economy is depicted as incorporating "the complex actions and interactions of a variety of institutions and interest groups – economic, political, social, cultural – which operate at multi-scalar levels and territorialities and through dynamic and asymmetrical power relationships to produce specific geographical outcomes: the material world in which people struggle to make their lives." (Coe et al 2008, 271). Production networks can be defined as: "... at its core, the nexus of interconnected functions, operations and transactions through which a specific product or service is produced, distributed and consumed." (Coe et al 2008, 274).

1.6 From an *institutional perspective* the world economy is made up of actors and social structures – institutions - intricately interconnected into a myriad of institutional networks at many hierarchical (horizontal) levels, all vertically connected as parts of the global whole. The nature of these institutions will play an important role in determining the evolution of economies (Brousseau and Glachant 2008).

1.7 *An evolutionary perspective to economies:* Another approach to thinking about the economy (conceptualisation) is to view it through the prism of evolutionary theory (or Darwinism generalised to the social sciences). Evolutionary theorists tend to be dissatisfied with static or equilibrium-oriented theory that neglects technology and innovation. Theory emphasises the complexity of social phenomena (see also *complexity theory*) and the unpredictability of many processes. It emphasises complex population systems (populations of entities that are similar in key respects, but within each type there is some degree of variation) where the core Darwinian principles of variation, inheritance and selection apply (Hodgson 2009). As in the evolution of species, the most competitive businesses survive while weaker businesses die out. Businesses that gain '*first mover advantage'* must work hard to stay ahead of competitors.

 "Change is one of capitalism's constants. As a mode of economic organization, capitalism never stands still. Its central imperative—the search for profit and wealth creation—drives a perpetual process of economic flux. Every day new firms, new products, new technologies, new industries and new jobs are added to the economy, whilst old firms, products, technologies, industries and jobs disappear. Joseph Schumpeter once famously described this constant flux as a process of 'creative destruction' that 'incessantly revolutionizes the economic structure from within, incessantly destroying the old one, incessantly creating a new one' (1942, 82). The economy, in other words, evolves" (Boschma and Martin 2007, 537).

Evolutionary theorists underline the possibilities for path creation and path destruction and of social agency as opposed to relentless path determinism. The development of an economy can involve many branching points rather than fixed trajectory (Mackinnon et al 2009).

Thus the global economy can be conceptualised in a number of ways. Each can yield valuable insights into how the economy works, each has its own merits and limitations, and each may be more or less appropriate for understanding different aspects of the global economy.

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Essential Reading

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