History of Economic Thought

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UNIT 1
MERCANTILISM

Historical background:

- Time: around 1500-1776 (publication of Adam Smith's *Wealth of Nations*)
- Increased importance of trade
- Greater economic significance of cities and city merchants
- Money (capital) more important source of economic power
- Development of centralised state: more power to the King at expense of regional/local landlords

Mercantilism (3)

Tenets of mercantilism:

- Wealth = “treasure” (money as gold and silver coin)
- Wealth creation:
  - **surplus on BoP: stimulate exports and restrict imports (“fear of goods”)**
  - **stimulation of handicraft for exportable luxury goods**
  - **extensive regulation to ensure high quality of exportable goods**

  Question:

  How did David Hume later on attack the mercantilist view that BoP surpluses can be maintained indefinitely?

Mercantilism (4)

- Wealth creation (cont)
  - extensive regulation to ensure supply of suitably trained, hard working and low paid workforce
  - tax base: merchant profit, excise tax, agricultural surplus of tenant-cultivators

Question:

Whom did the mercantilist school benefit? How?

PHYSIOCRATS

- Historical background
  - **France in late 1700 before the Revolution**
  - **Situation of France was characterised by:**
    - **Crushing Mercantilist regulation**
    - **Agricultural decline through crushing taxation of tenant farmers (church and landlords tax exempt)**
    - **Enormous government waste through war and court extravagance**
    - **Almost complete economic breakdown; extreme poverty**

Physiocrats (2)

- Physiocrats on the nature of wealth:
  - Wealth consists of goods, but only goods produced in the primary sector (agriculture, mining & fisheries)
    - Hence: value is derived from the raw material provided by nature
    - So: only material goods containing raw material have value
  - No value added by labour when it merely “re-arranges” raw material to improve usefulness of goods
    - Manufacturing is “sterile”: value of output = value of input
    - Utility as source of value disregarded

Physiocrats (3)

- Three classes:
  - **Landowners (provide capital for land improvement and social order)**
  - **Cultivators (only really productive, because they extract raw material from nature)**
  - **Artisans ("sterile", no value added)**

PHYSIOCRATS (4)

- Circular flow of money ("Tableau Economique")
  - Circular flow: e.g. landlord's spending leads to manufacturer's income, which gives rise to spending on farm products, which leads to farmer's income , etc.
  - General idea: channel more income towards cultivators (farmers) in order to stimulate agricultural production, among other things by tax-exempting them. Only landowners pay tax on rent income.

PHYSIOCRATS (5)

- Policy proposals: set agriculture free
  - Tax reform: tax landlords and do not tax land cultivators (single tax)
  - Free international trade in agricultural products; stimulate good price (‘bon prix’) for agriculture
  - Stop subsidy of exported manufactures
  - Minimise government intervention (‘laissez faire’)

Adam Smith (3)

- Natural Order: spontaneous social outcome of free individual action
  - Tends towards the common good: invisible hand
  - Just as the laws of physics create natural order in material processes, so also do laws of economics create natural order in economic processes.
  - Discover these laws and give them free rein: laissez-faire.
- Limited, but still significant government
  - Law and order: protection of property rights (self + goods)
  - Enforcement of contracts
  - Education
  - Defense against foreign aggression
  - Public works

Adam Smith (4)

- Explanation of Wealth Creation
  - Wealth consists of useful material goods, produced in all sectors (not only primary sector)
    - Improvement on mercantilism and physiocracy
    - Smith excludes ***immaterial services*** with no direct contribution to material production: the work of kings, soldiers, churchmen, lawyers, doctors, teachers, entertainers (writers, actors, comedians, musicians, dancers), economists (??) etc.

Adam Smith (5)

- Explanation of Wealth Creation (cont.)
  - Main cause of increasing wealth: increasing **division of labour**
    - product and operation
    - origin of industrialisation (not yet in Adam Smith’s time)
  - Market size as limit on division of labour
  - Importance of transport and communication in a labour-specialised, industrialised economy

Adam Smith (6)

- **Explanation of Value**
  - Exchange Value *versus* Use Value (utility); Water-Diamond paradox
  - Labour theory of (exchange) value
    - Value is determined by labour cost of production measured in labour hours
    - Relative price
    - Long-term “natural” price *versus* short-term market price
  - “Rude and primitive state of the economy”
    - Labour cost the only cost of production
    - No capital and no scarce land

Adam Smith (10)

- Economic development (fig. 5-1 in textbook)
  - Increased division of labour, leads to
    - Increase in productivity, leads to
      - Increase in national output
        - Increase in division of labour
        - Capital accumulation
      - Increase in wealth of nation
    - Capital accumulation, leads to
      - Increase in productivity
      - Increase in wages fund
      - Higher wages, Increase in productivity again

UNIT 3: MALTHUS (1): Population theory

- Population increases geometrically (i.e. exponentially), food production increases arithmatically (i.e. linearly).
- Economic crisis results because production can never satisfy human material needs. Solutions:
  - Preventative checks: reduced birth rate (moral and immoral)
  - Positive checks: increased death rate
    - Poverty and misery “natural” punishments for failure to contain population growth
  - Poor laws should be discouraged
- Why was theory proved wrong?

MALTHUS (2): Market gluts

- Malthus's reason why lack of demand constrains growth (Say's law does fail):
  - Aggregate demand for goods is financed out of wage payments by firms.
  - These wage payments are a cost of production for firms: aggregate demand for goods = cost of producing these goods.
  - If this equality holds and firms can at best earn back what they previously paid in wages, demand is never sufficient for firms to sell enough to make a profit (profit = 0).
  - As a result of not making a profit, firms would not be inclined to invest and economic activity would stagnate.

    Question:

    How does Malthus's theory of market gluts differ from Say's law of markets?

MALTHUS (3): Market gluts (continued)

- Malthus's solution: find a source of demand for their goods, which is ***not*** a cost of production for firms.
  - A good candidate is the demand financed out of the rent income of landlords.
  - Stimulate that demand
  - Reason for opposition to repeal of Corn Laws. (Retain Corn Laws in order to retain tariffs on imported corn → Increase in price of corn→ increase in landlords' income)

DAVID RICARDO

- Historical background
  - Same as Smith but more industrialisation
- Rent Theory
  - Idea of rent
  - Rent at the extensive margin
  - Main point: price determines rent rather than rent determines price

Ricardo (2)

- Theory of Value
  - Labour theory of value: value is determined by labour cost counted in labour hours
    - Relative, comparative value rather than absolute value
    - Long-term natural price rather than short-term market price
  - Other than Smith: some role for utility
    - Is a precondition for value; utility influences exchange value.
    - Determines value of non-reproducible goods e.g. rare paintings and rare coins.
  - Labour theory of value applied to reproducible goods

Ricardo (3)

- Theory of value (continued)
  - Value of goods is determined by *labour time necessary to produce it*
    - Labour time: not only work done in making the good (what Marx called ‘live labour’) but also work embodied in raw materials and capital goods (what Marx called ‘dead labour’)
  - Unrealistic assumptions implicit in LToV
    - Difference in wage rate reflects difference in labour quality (labour skill and effort)
    - Difference in cost of producing the machine (in labour hours) reflects difference in the machine’s productivity
    - If profit rate is the same in all industries, capital/labour ratio must be the same in all industries

Ricardo (4)

- Theory of Value (continued)
  - Ultimate conclusion: exchange price is not influenced by changes in wage rate, profit rate and rent rate
    - Exchange price is determined ONLY by quantity of labour
  - Recall: exchange price is ***relative*** exchange price:
    - price of coffee/price of tea = labour hours necessary to produce 1kg of coffee/labour hours necessary to produce 1kg of tea
      - When wage rate is the same and equally productive in coffee and tea industries, the effect of changes in wage rate cancels out
      - Same applies to profit rate
      - Rent rate is in any case not price determining

Ricardo (5)

- **Theory of distribution**
  - Functional distribution of income: distribution of given income over workers, capitalists and landowners according to the price of their productive contribution
    - Natural Wage: real subsistence wage determined by price of food (agricultural output)
      - Long term tendency towards subsistence minimum: “iron law of wages” (cultural rather than biological)
      - But: possible larger increase in wages fund than in population
    - Natural Profit: equal for all sectors as reward for average risk
      - Profit falls as a result of rising wage (rising basic food prices)
      - Conflict between workers and capitalists
      - Falling profits, falling investments, stationary state
    - Natural Rent: as in rent theory
      - Conflict between landowners and rest of society

Ricardo (7)

- International trade
  - – Absolute advantage (Smith): countries specialise in what they are better at and trade with others.
  - – Comparative advantage: even when a country has an absolute advantage in producing all goods, there still is scope for specialisation and international trade.
    - Differing opportunity cost can justify specialisation

RICARDO (8)

- On unemployment
  - Similar to Say's Law of markets: no demand restrictions on production and employment creation
  - Possibility of technical unemployment and reduced wages
    - Investment out of profit reduces wages fund: lower wages and/or employment (short term)
    - Partially or wholly compensated by increased profits due to increased productivity which would raise wages fund (long term)

Mill: on production

- Land, labour and capital only production factors
- Wealth consists of material products, because only material goods can be accumulated.
- Labour:
  - productive labour: labour which contributes towards material wealth
  - services which indirectly contribute towards material wealth creation can be productive also.

Mill: on production (2)

- Capital:
  - Result of saving: accumulated stock of produce of labour
  - Insufficient capital can, in principle, limit the amount of industry (and employment)
  - Every increase in capital can increase employment without limit (Say’s Law holds)
  - All saving is invested (S = I)

Mill: on distribution

- Same as other classical authors
- For a given wages fund, wage rates cannot increase unless employment decreases; or the wage rate in one sector rises at the expense of wage rate in other sectors

Mill: on exchange value

- Mill started to amend classical doctrine: labour theory of value
- He already had a vision of demand and supply schedules

Mill: on dynamics of the economy

- Mill predicted:
  - increasing growth in production and population
  - technological progress
  - increasing security of property
  - growing role for corporations.
- But: growth in industrial output offset by falling agricultural production

Mill: on government

- “People understand their own business and their own interests better, and care for them more, than the government does, or can be expected to do”.
- Even so, Mill advocated:
  - State education
  - Legal ban on child labour
  - Maximum working hours
  - Government operation of natural monopolies and infrastructural works, etc

UNIT 4: SOCIALISM AND MARX - FORMS OF SOCIALISM

- Utopian socialism
  - Cooperative communities
  - Voluntary solidarity
- State socialism
  - State ownership of most or all of the productive resources
- Christian socialism
  - Mutual love and fellowship rather than class struggle

Forms of socialism (2)

- Anarchism
  - No private property and no government
  - Voluntary cooperation in small communities
- Marxian socialism
  - Class struggle, exploitation of labour by capital
  - Nationalisation of all productive resources
- Communism
  - Marx's vision of the utopia that supersedes Marxian socialism: no private property, no money, and no government (anarchism)

Forms of socialism (3)

- Revisionism
  - No antagonism between classes
  - State is necessary to promote the common good
- Syndicalism
  - Anti-parliamentarian (anti representative democracy); anti-militarism (pacifism)
  - Overthrow government through mass action
  - Establish independent, worker-managed businesses; otherwise anarchistic

Forms of socialism (4)

- Guild socialism
  - Firms must be managed by workers organised as industrial guilds: industrial democracy
  - State necessary to protect interests of workers as consumers + set overall economic policies

Commonalities of Socialism

1. Rejection of classical view about harmony of interest between classes of society
2. Rejection of classical concept of laissez-faire
3. Rejection of classical idea of Say's Law (markets are inherently unstable)
4. Perfectability of people given the right social system; with the right system, people will become good
5. Need for some kind of collective action or state ownership

ALTERNATIVE CATEGORIES OF SOCIALISM

- Alternative categories:
  1. Dogmatic state socialism (collectivism)
  2. Pragmatic state socialism
  3. Interventionalist socialism (includes unionism)
  4. Industrial democracy; worker participation
  5. Welfare state socialism
- The problem of scarcity and anarchism.
- Modern neo-liberal capitalism as a laissez-faire with socialism 2, 3, and 5 mixed in
- Why socialism 4 (industrial democracy; worker participation) is rejected by both laissez-faire and collectivism?

Marxism: Philosophy of history

- Dialectic materialism
  - Hegel: dialectic process (conflicting ideas → historical knowledge and progress).
  - Feuerbach: materialism (importance of material realities).
  - Material forces of production (dynamic) *versus* Social relations of production (static, reinforced by superstructure)
  - Internal contradiction, class struggle, and revolution (as the static conflict with dynamic)

Marxism: fundamental reason for exploitation

- Foundation: only labour is productive
- Entrepreneurship, capital and nature are unproductive
- Exploitative nature of the owner-worker relationship
- Yet, the proposed solution: nationalisation of productive resources

Marxism: theory of value

- Classical tradition of Smith and Ricardo: labour theory of value
- Exchange value is determined by 'socially necessary labour time'
  - Labour time determines absolute value not relative value as in Ricardo
- Socially necessary labour time:
  - labour time under normal production conditions, with average skill and productive effort
- Includes both dead labour (capital) and live labour (current labour)
  - Constant capital (cost of dead labour embodied in machines and raw material) and variable capital (cost of live labour; wages paid)

Marxism: theory of exploitation

- Exploitation: ability of capitalists (business owners) to extract **surplus value** from workers (labour)
  - Capitalists can buy the only commodity (labour) which can create value beyond its own cost of production (surplus value)
- **Labour power** (labour as a commodity) *versus* **labour time** (productive capacity of a worker)

Marxism: theory of exploitation (2)

- Labour power = number of hours in a day to work back wages (cost of production of labour)
- Labour time = total number of hours in the day (productive value of labour)
- Surplus value = product of the surplus hours in the day *minus* dead labour used up in production

Marxism: large profits or no profits?

- Marxian exploitation is thus not indicated by firms making excessively high profits because they pay their workers excessively low wages
- It is indicated by firms making a profit at all (large or small); any amount of profit is exploitative
  - Exploitation can be avoided only by zero profit, by removing all profit from the employer-employee relationship
  - Removal of all incentive to employ anyone at all, because the employer-employee relationship is inherently exploitative
  - Nationalisation cannot be the solution: state becomes the employer

Marxism: some ratios

- Rate of surplus value: $s' = s/v$
  - s = surplus value in labour time (unpaid labour time)
  - v = variable capital in labour time (paid labour time)
  - s + v = total working hours in a day (say, 12)
- Rate of profit: $p' = s/c+v$
  - c = constant capital (part of capital invested in machinery and raw material; dead labour) used up measured in labour time
- Organic composition of capital (measure of capital intensity): $Q = c/c+v$
- Implication: $p' = s' (1-Q)$
- Two effects of increasing substitution of capital for labour (increasing Q): 1. falling profit rate, 2. increasing unemployment

Marxism: revolution

- Result:
  - Increasing concentration of capital in firm sector
  - Increasing unemployment (immiserisation of the proletariat)
- Final result: REVOLUTION (workers overthrow the capitalists!)

  Question:

  Briefly discuss “the law of motion of capitalism” in its various stages.

UNIT 5: MARNINALISM & NEOCLASSISCM – Marginalism:

- Three main characteristics
  1. Recognition of utility in the determination of exchange price – attack to the classicals' labour theory of value
  2. Mathematisation of theory – inspired by demand-supply assumptions
  3. Ideology of minimal government

Marginalism: major tenents

- Focus on the margin (maths optimisation)
- Rational economic behaviour (utility max.)
  - Microeconomic emphasis (individual behaviour as opposed to aggregate decision making)
- Abstract, deductive method (analytical, abstract and <u>not</u> historical)
- Perfect competition emphasis (min. government)
- Demand-oriented price theory (demand)
- Emphasis on utility (demand)
- Equilibrium approach (maths optim, min. gov.)
- Merger of land with capital goods (min. gov.)

Q: In what way did the marginalists attack the classicals' labour theory of value?

Neoclassical economics –
Alfred Marshall (partial equilibrium analysis)

- Neoclassical economics (versus marginalism)
  - Both demand and supply important in theory of market price
  - Greater interest in the role of money
  - Recognition of other market structures besides perfect competition: monopoly, duopoly, etc.

Marshall: utility and demand

- Utility:
  - refers to the subjective enjoyment, pleasure or benefit of a good: immeasurable, incomparable
  - made measurable by expressing the utility of a good as a multiple of the utility of 1 Rand: $Price_x$ (in Rands) = $U_x/U_{1\ Rand}$
- Marginal utility
  - law of diminishing marginal utility
  - If $U_{1\ Rand}$ (= U_{money}) presumed the same for different people, interpersonal comparisons are possible; indicated by price.

Marshall: utility and demand (2)

- Rational consumer choice
  - Consumers optimise utility, producers optimise profit
- Law of demand: negatively sloping individual demand curve
  - Utility optimisation when: $MU_x/P_x = MU_y/P_y = MU_z/P_z = ... = MU_n/P_n$
  - NB: MU_x/P_x is the MU_x per one Rand spent on x
  - MU_x falls as Q_x increases and vice versa
  - P_x falls, Q_x rises (law of demand)

Marshall: utility and demand (3)

- Consumer surplus
  - "Total satisfaction a person gets from purchasing successive units of goods exceeds the sacrifices required to pay for the goods"
- Elasticity of demand

Marshall: supply

- Supply
  - Immediate present
    - Vertical supply curve (fixed supply)
  - Short run: fixed capital cost, variable labour cost
    - SR supply curve: positively sloping part of U shaped SR marginal cost curve
  - Long run: variable capital and labour cost
    - LR supply curve: positively sloping part of the U shaped LR marginal cost curve

Marshall: equilibrium price and quantity

- Both demand and supply determine price
- The shorter the term, the more important the demand factors

Marshall: distribution of income

- Determined by factor prices:
  - Wages:
    - Demand for labour: diminishing marg prod of labour (downward sloping)
    - Supply of labour: number of workers (vertical)
    - Wage = marginal product of labour (profit max)
  - Interest
    - Demand for capital = investment: diminishing marginal productivity of capital (downward sloping)
    - Supply of capital = saving (upward sloping)

Marshall: distribution of income (2)

- Determined by factor prices (continued):
  - Profits, Rent and Quasi-Rent
    - Profit = reward for ownership. It includes:
      - interest (already discussed),
      - earnings of management (special type of labour)
      - supply price of business organisation (entrepreneurship)
    - Rent (adopted from Ricardo)
      - land is in fixed supply for society but in variable supply for individual producer
    - Quasi-Rent
      - in the short run capital goods, like land, are in fixed supply; therefore, return on old capital goods is like rent: “quasi-rent”
      - return on new capital goods (investment): interest

Marshall: life cycle of business enterprise

- Presupposed non-incorporated proprietorship (or partnership) as representative manufacturing firm
  - In the 19th century, incorporation was largely confined to banking, insurance and transport – not yet typical for manufacturing
- Constant rise and fall: like trees in a forest
  - Linked to the drive and genius of individual entrepreneur
- Less so when joint-stock corporation became dominant (from 1880 onwards)

Marshall: internal versus external economies

- Internal economies: savings due to growth in size of individual firm (advantages of specialisation, mass production, raised bargaining power)
- External economies: savings due to growth in size of entire industry from which all firms benefit (advantages of urbanisation, centralisation, raised bargaining power vis-à-vis other industries)
- Growth in industry usually creates internal economies, but always external economies

Q: Distinguish between: (i) external and internal economies; (ii) increasing and decreasing returns to scale.

Marshall: increasing/decreasing /constant returns to scale

- Average cost of production increase, decrease or remain constant, when all production factors (capital and labour) are increased:
  - Long-run average cost curve slopes upwards, downward, or is horizontal
  - Prices rise, fall, or remain constant when production increases
- Marshall predicted a net effect of decreasing returns to scale; in the long run, prices will fall

Neoclassical school- Leon Walras (general equilibrium analysis)

- General equilibrium approach- links numerous markets in the economy
- Interrelationships of variables- implications on quantity demanded and quantity supplied
- Restrictive perfect competition assumptions

Question:

Briefly discuss the nature of Walras's theory as well as its differences and similarities with Marshall's theory.

Unit 6:Historicism and Institutionalism: The German Historical School

- Nineteenth century Germany
- Reaction against classical and neoclassical economics. Major tenets:
  - Evolutionary approach:
    - no universal economic laws applicable to all countries at all times: only time/context dependent tendencies
  - Emphasis on positive role of government
    - Against laissez faire, but not socialist
    - Advocacy of conservative reform: state paternalism (mild welfare statism), nationalism
  - Inductive/holistic approach
    - Empirical-historical analysis, involving all social sciences

The Institutionalist School (American Institutionalism)

- Very much like the German Historical School
- Major tenets:
  - Holistic, broad perspective
    - Study patterns of group behaviour for society in all its aspects (interdisciplinary)
    - Not individual behaviour
  - Focus on institutions
    - *Anything that constitutes or creates a persistent pattern of behaviour*: law, school, firm, corporation, bank, market, monetary exchange, custom, habit, way of thinking, etc.
    - Institutions identify and isolate the regular, generalisable patterns of behaviour. In that way they enable theory.
    - All the rest of history is irregular and random

Institutional Economics (2)

- Evolutionary approach
  - Institutions change, which is why the economic theory of one time/place context need not be applicable to other time/place contexts.
- Rejection of the idea of normal equilibrium
  - Society is not necessarily self-stabilising, equilibrium searching
  - It may be disturbance amplifying, equilibrium fleeing
  - Equilibrium as utility maximisation too one-dimensional: rejection of pleasure/pain psychology
- Clashes of interest
  - Social dynamics are determined by interest clashes
    - Big business *versus* small business, employer *versus* worker, consumer *versus* producer, farmer *versus* urban dweller
  - Government must reconcile

Institutional Economics (3)

– Liberal, democratic reform
  - Free market does not generate fair allocations or solve all social clashes
  - Larger role for government

Questions

1. In what ways can the German Historical School be regarded as a forerunner of American Institutionalism?
2. Discuss the main weaknesses of insitutionalist economics.

Veblen: *Theory of the Leisure Class*

- Conspicuous consumption
  - Leisure class does not consume to meet physical needs but for display and show
- Propensity to avoid useful work
  - Leisure class wealth is obtained through wasteful, useless tasks (predatory) rather than useful work
  - Typical leisure class occupations: government, military, high finance, sport, etc. (supposedly all predatory)
- Conservatism
  - Leisure class obstructs useful institutional change that promotes productivity and justice

Veblen: attacks on neoclassical economics

- Consumers are not sovereign (or supreme): that is, they do not determine the composition of commodities produced like the neoclassical economists believed
- Distribution theory: present power relations only serve business community and not whole society
- Perfect competition: prevented by monopolistic control over market prices

Veblen: instinct for workmanship

- Workers do not regard work as inherently irksome and unpleasant
  - no negative utility as under neoclassical economics
- People want to work and do it well
  - motivated by the pleasure of achievement, and of providing a better life for children
- Handicraft capitalism ("earning a living") is replaced by industrial corporate capitalism ("investment for profit")
- "Making goods" (workmanship) is replaced by "making money".

Veblen: credit and business cycles

- Bank credit allows firms to buy capital goods without first having to save
  - Latest technology can be more quickly applied – advantage over competition
  - Everybody jumps on band wagon
- Bank credit does not add to total real income, which is not true. Veblen overlooks:
  - .. that bank lending expands the money stock and thus boosts money income.
    - but only if it persists, because bank credit repayment shrinks the money stock

Veblen: credit and business cycles (2)

  - .. that increases in the money stock stimulate investment and employment
- Yet Veblen is right:
  - the easier access to credit creates an advantage for big business over small business; big gets even bigger.
  - credit money system tends to create cyclical instability

Veblen: Soviet of Technicians

- Hope lies in technicians and engineers, as the true carriers of the instinct for workmanship
  - Not labour and capital

Galbraith

- General
  - Conventional (neoclassical) economic wisdom is obsolete; circumstances have changed. Survives because of lack of alternatives
- Dependence effect
  - Large enterprises create artificial wants through advertising

Galbraith (2)

  - Big business sovereignty rather than consumer sovereignty
  - Overprovision of private goods, underprovision of public goods (roads, parks, schools, hospitals)
- Theory of the firm
  - Corporate big business (“planning sector”) not controlled by shareholders but by technostructure (elite managers, engineers, scientists, etc)
  - Technostructure pursues more complex purposes than mere profit maximisation

Galbraith (3)

  - *protective purpose*: survival
  - *affirmative purpose*: growth
- To promote competition through anti-trust is futile; no threat to technostructure
- Public control of planning sector:
  - public control of prices, wages and salaries,
  - public planning of production (gov, big bus, lab)

Institutionalism: criticisms

- Consumers not completely powerless victims- they do have power in the market
- Failure to maximise profits makes a firm a target for corporate take-over
- Too much state control has clear problems too; state also becomes a technostructure
- Institutionalism not yet offers credible alternative to neoclassical economics, although all the elements are there

Keynes and Keynesianism: major tenets

- Macroeconomic emphasis
  - Theorising about aggregate rather then individual behaviour (compare institutionalism)
- Demand orientation
  - Effective demand determines output: Say's law does not hold
- Instability in the economy
  - Cyclical instability, mainly because investment is erratic due to erratic profit expectations ("animal spirits")

Keynes and Keynesianism: major tenets (continued)

- Wage and price rigidity: wage contracts, minimum wages
  - Demand↓ → output↓ rather than price↓
- Nominal wage reduction not solution to unemployment:
  1. Even if nominal wages were flexible, nominal wage↓ → labour income↓ → demand↓ → output↓ rather than ↑
  2. Also nominal wage↓ → P↓ → debt deflation → debt repayment ↑ → demand↓ → output↓
- Active fiscal and monetary policies to stimulate demand and output/employment
- Therefore, Keynesianism emerged as a reaction against the classical economists' ideas.

Keynes and Keynesians: criticisms

- Investment stagnation
- Problem of wasteful government underrated
- Wasteful spending (public or private) in general regarded as useful: stimulates total demand and thus employment
- Negative side effect of demand stimulation: inflation
- Demand stimulation cannot resolve all unemployment (e.g. structural unemployment)

Post-Keynesians: major tenets

- Neo-Ricardian view of production, value and distribution:
  - suppliers determine prices (cost-of-production plus mark-up);
  - factor prices do not influence total output
- Endogenous money
  - Not the central bank but the public, through its demand for credit, determines money (demand-driven money supply)

Post-Keynesians: major tenets (continued)

- Cyclical instability;
- Need for incomes policy (compare with Galbraith’s view that wages and prices should be coordinated by some public planning authority)

New Keynesians: why do recessions occur?

- Price and wage levels are inflexible downwards;
  - Aggregate demand↓ → output↓
- Reasons for price/wage inflexibility
  - Menu costs: cost of changing prices
  - Long-term formal and implicit contracts: unions prevent lower wage, both for unionised and implicitly for non-unionised
  - Efficiency wages: fall in market wage below efficiency wage will increase cost of shirking and labour turnover
  - Insider-outsider theory: unemployed outsiders unable to undercut wage of employed insiders

Chicago school - New Classicism; major tenets

- Optimising behaviour
- Market prices approximate long-run competitive prices (monopoly dissipates)
- Mathematical orientation
- Rejection of Keynesian policy activism
  - Market is self-adjusting
- Limited government
  - No policy activism
  - No subsidy/protection for business

Chicago school - New Classicism; major tenets (2)

- Friedman: no long-term trade-off between inflation and unemployment (Phillips curve)
  - Explained by ‘adaptive expectations’
- Lucas: no short-term trade-off between inflation and unemployment: trade-off only when inflationary demand stimulation is random (or unanticipated)
  - Explained by rational expectations
- **Question:** Compare and contrast between Friedman’s adaptive expectations approach and Lucas’s rational expectations approach.

Friedman: major contributions

- Consumption function
  - Consumption determined by permanent income rather than current income
  - Mpc out of current income smaller than what Keynesians suggest
- Monetary theory
  - Demand for money = f(total wealth, cost of holding money, preferences)
  - Modern quantity theory of money
  - Cause of the Great Depression
  - Long-run vertical Phillips curve
  - Monetary rule: fixed monetary growth-rate rule