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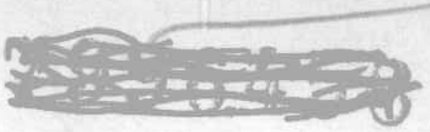
Modern Economics

J. Pen



MODERN ECONOMICS

Jan Pen was born in 1921. He studied economics at Amsterdam University, where he received a doctorate in 1950. Until 1956 he worked in the Ministry of Economic Affairs, finally as Director of General Economic Policy. Since 1956 he has been Professor of Economics at Groningen University, and from 1960 until 1967 he was Visiting Professor of Macro-economics at the Free University of Brussels. He is a Fellow of the Royal Netherlands Academy of Sciences.

He has published several books in Dutch; these include *The Joy of Economics* (1963), *A Hard World* (1964) and *Economic Actualities* (1967). *The Wage Rate under Bargaining*, written in 1949, was translated and published by the Harvard University Press in 1959; the author is still not sure why. *Harmony and Conflict in Modern Society* (1966), which contains a good deal more sociology than the present volume, and *A Primer on International Trade* (1967) were also published in English. *Income Distribution* has also been published in Penguins.

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Preface to the 1974 Reprint

MODERN economics may quickly turn into old-fashioned economics. Though the main body of economic theory has not changed substantially since the first edition of this book was published, there have been shifts in accent and new developments. The main shift was a conspicuous come-back of classical theory, which made itself felt in the field of economic growth; and a new development concerns the limits and the dangers of growth. These issues are incorporated in this new edition. It also discusses the pros and cons of floating rates of exchange in the light of the experience of the seventies.

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CHAPTER I

Three Trends in Modern Economics

1 · WHAT IS MODERN ABOUT MODERN ECONOMICS?

The object of this book is to describe a number of the main aspects of modern economics. More precisely, its aim is to give the reader an impression of what is modern about modern economics by surveying the development of the subject in the last twenty-five years. This is really a rather precarious undertaking. For what is modern? We tend to describe as modern something that happens to have caught our eye, forgetting that our hobby-horses may have been ridden by others long before. For this reason it is as well to bear in mind that some economists do not rate the progress of their science particularly high. Half in jest, the proposition has occasionally been defended that every fancied new feature can already be found in the work of Alfred Marshall, the great exponent of the classical tradition, who published his *Principles of Economics* towards the end of the last century (1890).

And, apart from the question whether the modern aspects of a science can be easily picked out or not, the difficulty remains that many new finds are less important than they appear at the time. If we search only for what is modern, we run the risk of overlooking truths which have stood the test of time and which are more important than the passing whims of fashion.

But if I nevertheless go in search of the modern elements in economic thought, the reason and the justification for this are that I really do believe that there is something new about it. 'It's all in Marshall' is amusing and provocative, but it is not true. Marshall's view of the relations between important economic quantities such as consumption, investment, taxes, and national income differed from ours. The examination of these relations is called 'macro-economics'. In Marshall's view the national economy functioned differently from the way we see it. And this modification in economic theory, which for the greater part dates

from the 1930s, has meanwhile had sufficient time to prove its *raison d'être*. Modern macro-economics is not a whim of fashion, although of course it is not an eternal truth either.

Today, in the seventies, there are three trends predominating in economic theory. In the first place there is Neo-Keynesianism, called after John Maynard Keynes (1883–1946). His contribution consisted in resolving the impasse that classical economics had reached in the thirties. In those days the economists were almost heedless of the possibility of general overproduction. They believed that certain mechanisms attended to a general balance between supply and demand; the Depression forced them to face facts, such as mass unemployment, for which they had no answer. Keynes supplied an explanation of these symptoms of paralysis, but his theory goes much further than an explanation of unemployment. It grew into an analysis of the interplay of income and expenditure. Pride of place is given to national income: how it comes into being and how it is spent. This analysis still occupies an extremely important place in economics, as the following chapters will show. There Neo-Keynesian theory is confronted with the older, classical theory, which believes essentially in the equilibrium of supply and demand. But Keynesian theory is also confronted with another, and very old, interpretation of the economic process: monetary theory. The latter assigns a strategic role to the stock of money. In the Neo-Keynesian theory of circulation money exerts a more modest influence. This difference of opinion dominates many modern discussions. The conflict between Keynesians and monetarists will be discussed below. And yet both have much in common; they are both interested in signs of trouble, such as inflation and deflation.

A second trend in modern economics is the renaissance of the classical theory. Just after Keynes it looked as if classical was synonymous with old-fashioned, but the theory's adherents did not take this lying down. And it soon proved that the Keynesian and the classical approaches supplemented rather than excluded one another. Keynesian analysis considers the creation and spending of money income at a given productive capacity; classical theory is interested above all in the volume of productive capacity. That stands us in good stead if we study economic growth. In the fifties and sixties growth came increasingly into the limelight,

which led to a renewal of interest in classical thought. True, a kind of Keynesian growth theory had also developed, but at the end of the fifties this was swamped by the classical revival. The repercussions are still noticeable in modern economics, and this is reflected in what follows, notably in Chapter X, which is devoted entirely to growth.

In the course of the sixties a new, gloomy view of industrial growth emerged. It came to be asked whether mankind will not founder in dreadful pollution and destruction of the natural environment. These discussions became particularly timely in the seventies, notably through the research work of pioneers like J. W. Forrester and D. L. Meadows. They predict doom and ruin unless we put a rein on population growth and industrial expansion. This pessimism is also a characteristic aspect of modern economics. It may be regarded as a rethinking of the classical growth theory; it is discussed at the end of Chapter X, and when economic policy is under consideration (Chapter XII, section 4).

A third characteristic of modern economics is the pursuit of quantification through the use of statistics and statistical techniques. This tendency is of course not a new one. In the year 1679 Sir William Petty endeavoured to launch a new science, which he called 'Political Arithmetic', and which had the object of collecting quantitative knowledge on economic, social and political life. But in the last few decades the technique of measurement has advanced so considerably, and the set of concepts required for a quantitative theory has been improved so greatly, that we may speak of a new and striking development. Moreover, it has been found that a number of important qualitative problems can only be solved quantitatively, through statistics. These problems are to be found particularly in the province of macro-economics. There is a fairly close connexion between the development of Keynesian theory on the one hand and modern quantitative economics on the other. But the classical revival at the end of the fifties, too, profited a great deal from these statistical techniques. As will be shown later, the strategic determinants of economic growth proved to be different from what was believed earlier, and this insight was the result of econometric work. Moreover, the typical modern growth pessimism of the late sixties was the out-

come of quantitative research; pollution, the depletion of natural resources, overcrowding and disaster were predicted by sophisticated econometric methods, aided by computers. It can be said that economists nowadays think in terms of models. This is true of the Neo-Keynesians, a little less so of the monetary school, very much so of the Neo-Classical theory and particularly so of the growth pessimists. Forrester claims that his 'multi-loop non-linear system' produces outcomes that could not otherwise have been discerned by the human mind. Reasons enough to consider model building as an important, separate subject.

As I see it, these three trends give modern economics its present-day look: Keynesianism (and its controversy with the monetary school); the Neo-Classical revival in the study of economic growth (including the recent concern about the limits to growth); and the search for quantitative relations. Around these three streams are grouped other 'modern' pieces of theory: about wages, prices, government expenditure and taxation, and they certainly deserve to be dealt with; but the next sections will start with a general impression of these three themes of modern economics. Before we try to present this bird's eye view an important distinction must be clarified: that between macro- and micro-problems. The distinction is vital to everything that follows.

2 · MACRO VERSUS MICRO

This book deals with macro-economics. That is to say, it speaks of the 'great variables' or 'aggregates', such as national income, total production, total consumption, the price level, government expenditure. Micro-economics, on the other hand, studies the behaviour of small entities: business firms, households and branches of industry, and considers their interrelation. It is important briefly to describe here the relation between micro- and macro-economics, so that the reader knows what he can count on and what not.

It was already suspected in the eighteenth century that there had to be a meaningful connexion between the decisions of entrepreneurs and consumers; the French physiocrats supposed that the 'natural order' would attend to the coordination of

individual behaviour. This somewhat metaphysical idea was later defined by Adam Smith (1776), who indicated the market mechanism as the establisher of equilibrium between micro-economic units. Supply and demand, or in other words the price mechanism, thus became the central subject of classical economics. Economic life was regarded not as a chaos but as a price-regulated system.

This is the basic idea of micro-economics and it is still accepted, though with certain restrictions. At the end of the last century Alfred Marshall stated the ideas of Adam Smith more explicitly. For instance, he cast supply and demand in the form of curves; the quantity demanded depends on the price, and the same applies to the quantity supplied. The equilibrium price is located at the point of intersection of both curves. In addition Marshall made a clear-cut distinction between competition and monopoly. This is of importance to the allocation problem: the assignment of factors of production to branches of industry. Some (for instance Vilfredo Pareto) believed that perfect competition would lead to an allocation in perfect agreement with the consumer's wishes. This is the classical idea of harmony, which consequently does not hold good in the case of monopoly. This distinction between the market forms was elaborated in the thirties: concepts such as monopolistic competition and oligopoly (few suppliers) put in an appearance. It came to be doubted whether the market mechanism also operated perfectly in the absence of monopoly, and the answer was: sometimes it does, sometimes it doesn't. There is a lot of literature on this, but we shall not bother with it.

All this is micro-economics. It dominated economics textbooks up to and including the thirties. Of course, some attention was paid to national income and its fluctuations, and to money theory, but this was more of an afterthought. In this book the opposite applies – micro-economics stays in the background. The allocation of the factors of production to the various uses (i.e. cars against bicycles, butter against plastics), and the distribution of income among individual recipients are not discussed.* All 'small' things are compressed into large aggregates.

There is an obvious difference in atmosphere and habits of

* The latter subject, though, is close to my heart, which is why I have written a separate book about it: *Income Distribution* (Pelican, 1974).

thought between micro- and macro-economics. The typical supply and demand curves barely occur in macro-economics. And, come to that, there is much less said about prices. Why?

The reason is that the regulating effect of prices in macro-economics is swamped by the consequences of changes in national income. By the way, these changes in income are not independent of the changes in price; they are systematically bound up with them, for incomes *are* prices. The reader can best see this truth by seeking a case in which a price increases without anyone's income having risen – he will not find one (if at least he is prepared to accept that taxes form the income of the State and that increased prices of imported goods point to increased incomes abroad). For this reason it is not correct to say: suppose that all prices rise while incomes remain the same. That is impossible. A general price increase is a macro-problem.

We can also put it this way. In micro-economics the effect of supply and demand is studied within a given framework of 'large variables'. Marshall looked at what happened when people wanted more butter, assuming their income remained the same. That is a legitimate question if the branch of industry concerned is small. But if the market that we have in mind becomes too great, the question is no longer correct. In a small oil-producing country income is not independent of the volume of oil production. A feedback occurs from production to income. If we ignore this feedback we make a mistake. This mistake is also made by those who believe that a country becomes poorer through a general price increase. They then tacitly assume that incomes remain the same, but that cannot be correct.

Macro-economics concerns itself precisely with these income effects. That gives it a different nature from micro-economics, where the causalities operate more in one direction. No wonder that in macro-economics so much stress is laid on the circulation of income: incomes become expenditure, and expenditure in turn becomes incomes. Complications occur to which micro-economics deliberately turns a blind eye.

In fact these income effects provide a way of making a sharp distinction between micro- and macro-economics or, in other words, of answering the question: when is small small? The answer is that an aspect of the overall economy is small when the