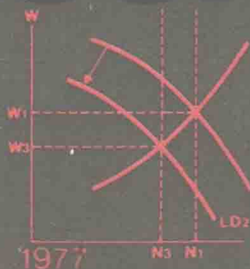
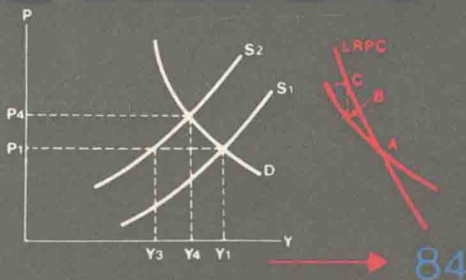
The Economist

ECONOMICS

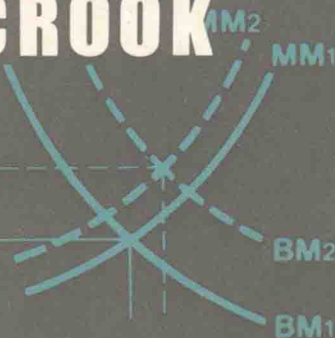




RUPERT PENNANT-REA

AND

CLIVE CROOK



prices

average

LS

T

LD2

PELICAN BOOKS

The Economist Economics

Rupert Pennant-Rea is editor of *The Economist*. He has degrees in economics from Trinity College, Dublin, and the University of Manchester. He has worked for an employers' organization in Ireland and a trade union in Britain. From 1973 to 1977 he worked at the Bank of England, before joining *The Economist* as its economics correspondent. He became the paper's economics editor in 1981, and was appointed editor in February 1986. He has been a regular consultant to the World Bank and principal editor of its *World Development Report*.

Clive Crook is economics editor of *The Economist*. He was educated at Magdalen College, Oxford, and the London School of Economics. He was an official in the monetary policy division of the Treasury, and private secretary to the government's Chief Economic Adviser, before joining the editorial staff of *The Economist* in 1983. After a spell in London as economics correspondent he moved to the paper's Washington office. He was made economics editor in February 1986.

Rupert Pennant-Rea
and Clive Crook

The Economist Economics

Penguin Books

Penguin Books Ltd, Harmondsworth, Middlesex, England
Viking Penguin Inc., 40 West 23rd Street, New York, New York 10010, U.S.A.
Penguin Books Australia Ltd, Ringwood, Victoria, Australia
Penguin Books Canada Limited, 2801 John Street, Markham, Ontario, Canada L3R 1B4
Penguin Books (N.Z.) Ltd, 182–190 Wairau Road, Auckland 10, New Zealand

First published by The Economist Newspaper Limited 1985
Revised edition published in Pelican Books 1986

Copyright © The Economist Newspaper Limited, 1985, 1986
All rights reserved

Made and printed in Great Britain by
Richard Clay (The Chaucer Press) Ltd, Bungay, Suffolk
Filmset in Monophoto Times

Except in the United States of America, this book is sold subject
to the condition that it shall not, by way of trade or otherwise, be lent,
re-sold, hired out, or otherwise circulated without the
publisher's prior consent in any form of binding or cover other than
that in which it is published and without a similar condition
including this condition being imposed on the subsequent purchaser

试读结束：需要全本请在线购买： www.ertongbo

Contents

Preface 7
1 Introduction: Changing times 9
2 Defining demand 20
3 Setting supply 31
4 Supply, meet demand 42
5 Expecting the future 52
6 Beefing up demand 61
7 What deficits do 71
8 Extending supply 81
9 When markets jam 92
10 Why exchange rates change 103
11 How payments balance 112
12 Understanding growth 123
13 The economics of poverty 136
14 Welfare and efficiency 146
15 What it all adds up to 159
Suggestions for further reading 173
Index 191

Preface

Economics is not a settled science with many undisputed truths; some people would argue that it is not a science at all. It reacts to changes in the real world, its theorists refine their theories. New schools of thought emerge to challenge conventional wisdom. Computers and mathematics allow today's economists to do things that their predecessors never dreamt of.

This book describes where economics has got to during the 1980s, and where it seems to be going. It is based on a series of briefs first published in *The Economist* in 1984. Much of the material has been reworked to turn the briefs into a coherent book. We hope it will refresh memories and help newcomers.

Many people have had a hand in producing the book. Our thanks to several colleagues on *The Economist*, who helped with charts and statistical material. We received much useful advice from David Begg of Worcester College, Oxford, who acted as academic mentor.

1 Introduction: Changing times

'Economics,' said the American economist Jacob Viner, 'is what economists do.' His definition is usefully vague, because the subject never stands still. Contrary to popular opinion, economics is not just an ivory-tower preserve. Much of its inspiration comes from changes in the real world, and always has done.

In the eighteenth century, Adam Smith wrote *The Wealth of Nations* in the early years of Britain's industrial revolution, arguing that countries and people would grow richer if only they allowed free markets to work. In the nineteenth century, David Ricardo tried to explain the poverty of the masses. Karl Marx carried the argument through to a vision of 'inevitable' revolution. John Maynard Keynes responded to the mass unemployment of the 1930s, saying that the macroeconomic management of demand was needed to sustain growth and jobs. All of them were influenced by the events of their time: different events, producing different intellectual ideas.

In public at least, economic controversy dies down when economies are doing well. It did so in the 1950s and 1960s, with the apparent success of the Keynesian formula. Most politicians and many economists no doubt oversimplified that formula, but its essence was beguiling. Governments believed they could achieve their goals by the precise use of just a few policies. In particular, they thought that fiscal policy – public spending and taxation – had a direct and predictable effect on output. If growth was flagging and unemployment rising, government should increase its spending and/or reduce taxes.

This approach carried a risk that Keynes himself had well understood: the risk of inflation. To this, Keynesian economists

had a ready response. If the economy overheated and inflation started to rise, the government should tighten its fiscal policy and raise interest rates a bit, and inflation would then subside. If need be, some economists also advocated more direct methods of restraining inflation – wage and price controls administered by the government.

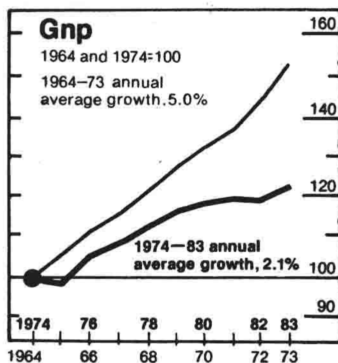
As for that other concern, the external balance of payments, there too economists seemed to provide an answer. Any persistent deficit on the current account was a sign that the exchange rate was overvalued. Faster productivity growth and slower cost inflation at home, if achieved, would justify the exchange rate and restore external balance. Failing that, the government could eventually devalue the currency.

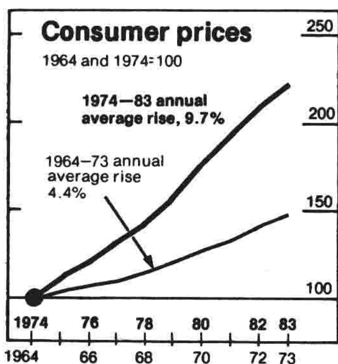
This philosophy was not shared by every economist. Some continued to believe the old religion of classical economics. They stressed the role of monetary policy in determining total spending, and they advocated microeconomic measures to improve the economy's efficiency at the level of its individual markets. In particular they emphasized the need for a flexible labour market; wage adjustments could then be relied upon to hold the economy at full employment. These notions were not altogether ignored by the prevailing orthodoxy. But its emphasis remained heavily macroeconomic, with a bias towards fiscal policy. For as long as it got results, it was hard to challenge.

For roughly twenty years, the results were undeniable. Economies that had suffered mass unemployment in the 1930s found themselves with jobless rates of about 2 per cent, sometimes less. Real incomes grew steadily: 'mass prosperity' moved from being a dream to a cliché. Governments seemed to be munificent, their economic advisers wise.

The fact that government spending was growing rapidly seemed, in the 1960s, to be of little significance. As figure 1.1 shows, public expenditure rose as a proportion of G.N.P. in all the main groups of countries belonging to the Organization for Economic Co-operation and Development (O.E.C.D.). The emphasis that governments in the 1980s place on cutting public

试读结束：需要全本请在线购买： www.ertongbo





* Unemployed as % of labour force; standardized O.E.C.D. rates

† Excludes some small O.E.C.D. countries

Source: O.E.C.D.

Figure 1.1

spending would then have seemed mistaken, even ridiculous. Taxpayers were ready to pay more for many things that governments provided – health and education, roads, pensions and armies. Even after these bills were paid, the average taxpayer was growing richer from year to year. The pace of economic growth meant that there was enough for everybody to increase their real incomes.

The first signs of trouble started appearing in the late 1960s. In the twenty-four rich and largely capitalist O.E.C.D. countries, real gross national product had grown by an average 5.5 per cent a year between 1959 and 1966; in 1967, growth slowed to 3.8 per cent. Unemployment rose to almost 3 per cent of the workforce, having been fairly stable at around 2.5 per cent for the previous five years.

These figures on growth and unemployment look enviable now; at the time they were deeply disturbing. Governments responded on standard Keynesian lines, increasing their budget deficits. The response seemed to work: G.N.P. in the O.E.C.D. countries grew by 5.4 per cent in 1968 and 5.1 per cent in 1969, while jobless rates fell back. By 1970, however, G.N.P. growth had again slowed, to only 3.1 per cent, and the unemployment rate exceeded 3 per cent.

While growth was weakening, economies were showing another symptom of ill health. Inflation was rising. Consumer prices in the O.E.C.D. countries had risen by an average of only 2 per cent a year in 1953–65. By the late 1960s, the idea that slower growth brought lower inflation was starting to disappear. In 1970, when G.N.P. growth slackened, consumer-price inflation in O.E.C.D. countries carried on rising to 5.6 per cent. A new word was added to the dictionary of economics: 'stagflation', the combination of stagnation and inflation that many economists had come to think was impossible.

The stagflationary year of 1970 worried all O.E.C.D. governments. However, they were concerned less about inflation than unemployment. They reflated demand again, and O.E.C.D. G.N.P. growth picked up to 3.6 per cent in 1971, 5.4 per cent in

1972 and 6.1 per cent in 1973. Although that sounds impressive, the consequences were not. Unemployment was slower to respond; in 1973 it was still higher than it had been in 1970. But inflation was quick to rise, even though more governments were trying to contain it with wage and price controls. In the second half of 1973 – before oil prices shot up – consumer prices in O.E.C.D. countries rose at an annual rate of 10.3 per cent.

The end of consensus

The inflationary surge and stubborn unemployment brought the Keynesian consensus to an end. That happened to coincide with two other developments in the real world that were changing the way that economists and governments thought.

The quadrupling of oil prices in the northern winter of 1973–74

The rise was orchestrated by the O.P.E.C. cartel, but market forces were moving that way anyway. Demand for oil had been growing faster than new discoveries for roughly five years, so prices were bound to rise. Economic growth fuelled by cheap energy was no longer possible. And in the short term, the quadrupling of oil prices meant that roughly 2 per cent of gross world product was suddenly transferred from the pockets of consumers in the O.E.C.D. countries to a handful of oil producers who could not spend it so quickly. Real demand was cut even as inflation spurted – stagflation with a vengeance.

The floating of exchange rates

Inflation at anything faster than 2–3 per cent was likely to strain the system of fixed exchange rates agreed at the Bretton Woods conference of 1944. Countries were not all inflating at the same pace, so their costs got out of line – and they did so more quickly when inflation speeded up. In 1967, consumer-price inflation in the seven biggest O.E.C.D. economies ranged from West

Germany's 1.4 per cent to Japan's 4.0 per cent. By 1971 that gap of 2.6 percentage points between the slowest and fastest inflaters had widened to 6.6 points, between Canada's 2.8 per cent and Britain's 9.4 per cent. (Strictly, the prices that matter for exchange rates are those of traded goods: they, too, were rising at increasingly different speeds.)

Governments made one last attempt to keep their currencies fixed. At the Smithsonian meeting in Washington in December 1971, they agreed on a new set of exchange rates. The dollar was devalued by 10 per cent; the D-mark and the yen were both revalued. These changes were widely agreed to be necessary to correct trade imbalances. However, the foreign exchange markets now knew that 'fixed' rates could be changed, provided enough money was pushed against them. The Smithsonian parities were soon challenged. Within two years, the major currencies were all floating.

The switch from fixed to floating exchange rates coincided with a relaxation of controls on international capital movements. The world was suddenly having to cope with the huge financial surpluses of O.P.E.C. oil exporters. These had to be 'recycled' back to borrowers in the O.E.C.D. countries and the developing world. The job was left largely to commercial banks and private markets.

With so much money sloshing about, exchange rates were bound to become more volatile. Money managers realized that they could win and lose millions through hourly movements in exchange rates that had previously not changed for years on end. They became far more sensitive to macroeconomic policies that might cause exchange rates to move. And they were particularly sensitive to inflation, which rose to an O.E.C.D. average of 13.4 per cent in 1974, with a spread among the seven biggest economies that ranged from West Germany's 7.0 per cent to Japan's 24.5 per cent.

Governments also found themselves in a different world. Faster inflation and slower growth made it harder for them to judge the

stance of their policies. Were interest rates rising because inflation was rising, or because monetary policy was tightening? Did a larger budget deficit boost the volume of demand, or did it simply show the differential effects of rising prices on government revenue and spending? The old certainties, brought about by low inflation and financial stability, no longer applied. The times demanded fresh thinking.

New conundrums

The early 1970s marked a break with the post-war past, and O.E.C.D. economies have done much worse since then. As figure 1.1 shows, growth has been slower, inflation faster and unemployment higher. Some economists therefore see the pre-1973 period as a golden age that could be regained if governments reverted to the same Keynesian policies. They believe that governments have generally restrained their fiscal policies too much, and that the widespread adoption of monetary targets since the mid-1970s has been a mistake. Those who take this view tend to see the American boom in 1983–4 as a direct consequence of President Reagan's large budget deficits and the relaxation of monetary restraint in mid-1982.

Other economists disagree. They argue that post-1973 difficulties were the outcome of pre-1973 policies: only when the damage done by those policies has been repaired will economies again blossom. Economists of this persuasion think that governments now play such a big role in economic life that high taxes, controls and regulation have sapped the ability of the private sector to deliver rapid growth. They also believe that the rapid inflation of the 1970s has done harm that it will take many years to eradicate.

This disagreement is usually presented in Keynesian-versus-monetarist terms, with each camp blaming the other for the economic failings of the past dozen years. In fact, neither camp is as monolithic as it is made to sound. Nor are they concerned just

to re-fight old battles. Enough has changed in the real world for Keynesians and monetarists to find some common ground, and for new ideas to emerge that cannot be easily pigeonholed.

Take exchange rates as an example. Until 1973 the world had never known flexible exchange rates coupled with such a volume of internationally mobile money. The switch raised economic questions that had never been asked, and opened up new fields for research. The factors determining exchange rates are still only partly understood. So are the ramifications for trade, interest rates, prices, profits, etc.

Keynesians in particular have had to adapt their views to the new world of floating rates. Keynes's major work, *The General Theory of Employment, Interest and Money*, was couched in terms of a closed economy without international trade. The neo-Keynesian view on capital flows and exchange rates has borrowed from non-Keynesian monetary (though not necessarily monetarist) economists. The use of all these terms to describe various schools of thought shows that the Keynesian–monetarist distinction is usually too simple.

Unemployment is another area where economists have a lot of new delving to do. In virtually every O.E.C.D. country, jobless rates are much higher than they were in the early 1970s. Slower economic growth is part of the explanation, no doubt. But researchers are also looking at the influence on jobs of real wages, state benefits and taxes, information about vacancies, etc. They are treating the labour market as the sum of numerous individual bargains, and then looking at the microeconomic factors which affect such bargaining.

Few if any of the new developments in economics are truly path-breaking. They employ concepts that have been around for years; to that extent they can be understood by people whose economics has grown rusty. But the methods of economics – its language and its analytical tools – have changed in ways that can be perplexing to outsiders. For better or worse these changes have altered the very nature of the subject.

试读结束：需要全本请在线购买： www.ertongbo