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History of Economic Thought

XV. Post-War Economics

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XV. Post-War Economics

1. Positivism vs. Praxeology
2. Monetarism vs. Keynesianism
3. Neoliberalism
4. Modern Growth Theory
5. Conclusion

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1. Positivism vs. Praxeology

Key Questions from Interwar Years

- What is economics?
- What is the proper method of economics?

Two Traditions from the 19th Century

- Economics is a deductive, a priori science
  - Verbal-logical method, "praxeology"
  - French ideologues, JB Say, Whately, Cairnes, Senior to the Austrians – culminating in Mises
- Economics must conform to scientific method of natural sciences
  - Positivism, hypotheses and mathematical method
  - Ricardo (implicit), Gossen, Dupuit, Walras and Marshall

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Mises and Praxeology

Developing the Austrian View

- Mises worked on the epistemology / methodology of economics from the 1920s on
- Economics is a *qualitative* science – but it can still explain social phenomena

Praxeology

- Economics becomes *praxeology*: the science of human action
- It describes the logical structure of human action

Methodological Dualism

- Economics and social science cannot be reduced to the methods of the natural sciences
- We cannot explain the ultimate data of economics – value, human choice – as determined by natural causes

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Praxeology and History

Praxeology

- The science of human action – describes all human action
- Must be understood teleologically: in terms of means and ends

Catallactics

- Human action within the cash nexus
- The hitherto best-developed parts of economics, economics in the narrow sense
- Cannot be clearly demarcated – but this is unproblematic, since the fundamental praxeologically laws always hold

History

- History is the empirical side of the sciences of human action
- Insofar as quantitative methods are applicable, they are tools of historical research
- The main "organ" of the historian is his *Verstehen*, understanding
  - The ability to understand the motives and ideas guiding human action
- The historian is the entrepreneur of the past – the entrepreneur is the historian of the future

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Catallactics

Development of General 19th Century Economics

- Mises took the term from Whately
- Close to Marshall's definition of economics
- Mises laid these ideas out in the journals in the 20s and 30s, then in *Human Action*, *Theory and History* (1956) and *The Ultimate Foundations of Economic Science* (1962)

Several Problems Solved

- We don't need to make any *homo economicus* or rational man assumptions
  - All action is rational and profit-seeking, purpose-driven
  - Profit does not equal monetary profit
- Some actions fall outside the scope of catallactics
  - That does not invalidate catallactics, these actions are still explained in the wider field of praxeology
- ~~Mises had little audience; the profession had taken a different turn~~

Positivism Triumphant

Positive Economics

- Milton Friedman in 1953 published *Essays in Positive Economics*
- The lead essay on methodology became the guiding light
- Friedman emphasized the normative/positive distinction

Positive Method

- When theorizing, economists should not build a logical structure from first principles
- They should set out hypotheses and test them against empirical reality
- It does not matter if the assumptions one makes are realistic
- All that matters is the predictive power of one's hypothesis

The Quantitative Turn

Positive and Quantitative Economics

- Quantitative and mathematical economics reigns supreme
- E.g., the *homo economicus* assumption is not true
  - But theories derived from it track empirical reality pretty closely (except when it doesn't)
- Simplified assumption allow for the full panoply of mathematics
  - From indifference curves over macroeconomic functions to econometrics
- The subjective utility objection was seemingly overcome by von Neumann and Morgenstern in the 1940s
- Game-theoretic expected utility was seen to prove that calculation of quantitative utility is possible

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2. Monetarism vs. Keynesianism

Keynesianism Conquers the World

- The employment of economists in government bureaus during the war probably gave a boost to Keynesian thinking
  - Laissez-faire is no good if you do that kind of work!
  - Harvard the American centre of Keynesianism
- Social democrats and labour parties had soured on socialism, but did not accept free markets. Keynesianism an acceptable compromise

Monetarism and the Chicago School

- Earlier Chicago School of the 1920s and 30s
- Milton Friedman and the younger school

The Keynesian System

Development of the System

- The Keynesian system developed over the 15 years or so to 1950
- This is when the system of equations and graphs were formulated
  - In an attempt to figure out what Keynes really said
- Hicks's 1937 *Econometrica* article 'Mr. Keynes and the "Classics"'
  - The IS-LM diagram is introduced

Early Problems in the System

- Modigliani 1944 *Econometrica* article 'Liquidity Preference and the Theory of Interest and Money'
  - Keynesian system requires sticky wages

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Neo-Classical Synthesis

Development

- An attempt to integrate Keynes and neoclassical economics
  - Walrassian and Marshallian economics
- John Hicks, Modigliani and Paul Samuelson important
- Ruling orthodoxy until about 1970

Key Ideas

- IS-LM model describing the economy
- Development of consumption, investment function
  - E.g., Modigliani's life-cycle hypothesis
- Money demand as a function (of income, wealth, interest rates)
- The methodological tools of economics are mathematical

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The Chicago School

The Older Chicago School

- Frank Knight, Henry Simons and Aaron Director in the 30s and 40s
- Generally free market, disciples of Irving Fisher in monetary theory
- Suggested various managed money schemes (like Fisher)

The Younger Chicago School

- formed around Milton Friedman (1912-2006) and George Stigler (1911-1991) in the 1950s
- Generally free market, advanced price theory
- Made several important critiques of the Keynesian system
  - E.g., Friedman and the investment multiplier
- Focus on the problem of inflation: always a monetary phenomenon

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The Problem of the Investment Multiplier

Keynesian Multiplier

- A company produces 100,000 widgets per year using ten widget making machines
  - Lifetime of machine is ten years
  - Investment demand is one machine per year
- Consumption demand rises to 110,000 widgets per year
  - A ten per cent increase
  - Investment demand rises 100 per cent, 1 → 2 machines

Critique

- Why focus on the year? Only non-arbitrary time period: lifetime of machines
- Over ten years, consumption demand rises ten per cent
- Investment demand over this period rises 10 → 11 machines – ten per cent

The Problem of Stagflation

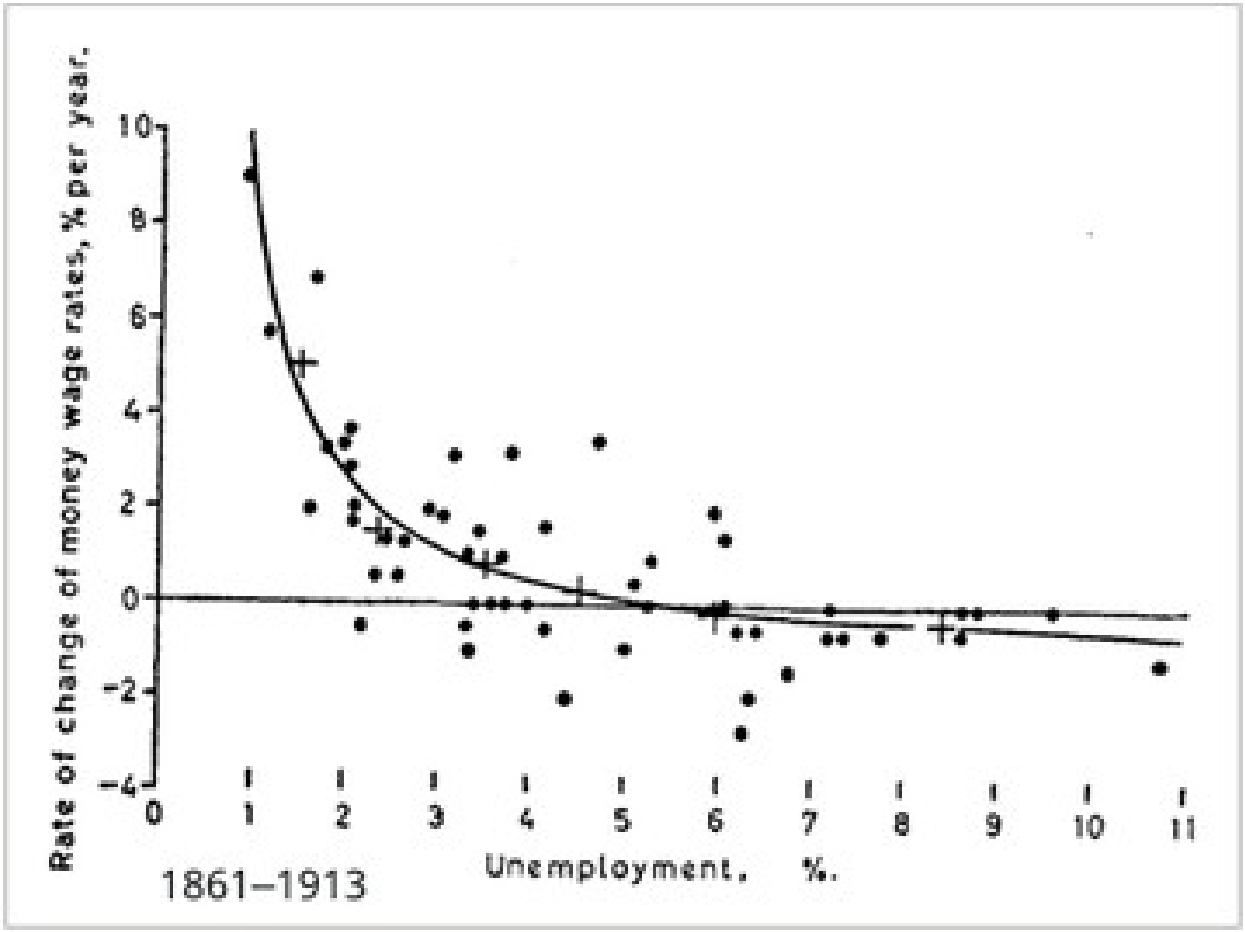
Background: High Inflation

- High inflation throughout the western world for practically all of the post-war years
- Due to Keynesian policies: credit expansion and fiscal policy to ensure economic growth

The Philips Curve

- There is a clear trade-off: high inflation or high rates of unemployment
  - First suggested by William Philips in *Economica* 1958
- Consonant with basic Keynesian policies
  - If unemployment emerges, you "step on the speeder" and pump in liquidity
  - If inflation rises, then you suck money out (via taxation, usually)
- However, according to the Keynesian system and the Philips curve, you cannot have unemployment and inflation at the same time
  - Yet this was what happened in the recession of the early 1970s
- Both therefore discredited by the facts, since these so clearly contradictory

The Philips Curve



The Monetarist Programme

Policy and Low Inflation

- No or only a small increase in prices per year the policy goal
- Inflation is a monetary phenomenon: when the money supply increases, so does the price level

Interventionism in Monetary Policy

- Monetary policy should be conducted to maintain stable prices
  - Some stable growth rate consonant with the growth of real income
- Remnant of stabilization ideal prevalent in the early twentieth century
- Critical of any kind of fixed rate regime in international economics
  - Fluctuating currencies the best international policy
- Against the gold standard: simply a kind of price fixing
  - In any case outdated, cannot achieve any goal that enlightened monetary policy cannot do

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3. Neoliberalism

Origins

- Emerged 1930s and 40s as the new liberalism
  - Less "extreme" than classical liberalism
- Colloque Lippmann 1938
- Mont Pèlerin 1947

Positions

- Partial compromise with interventionist ideas
- Some regulation etc. is necessary
- Today, neoliberal close to being a meaningless slur

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Response to Interventionism

Interventionism Dominant

- Among economists from at least 1920s
  - Despite classical inheritance of liberalism
- Government jobs
- General trend in thinking toward interventionism

Keynesianism Dominant

- Keynes ideas entail interventionism
- Economic equilibrium requires the government to manage the economy
- Large role for economists in planning the economy

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The Ordoliberal School

German Liberalism

- Emerged after World War 2
- The journal ORDO founded 1948
- Key ordoliberals: Walter Eucken, Wilhelm Röpke, Alfred Müller-Armack
- Through influence on Ludwig Erhard led to the German "Economic Miracle"

Positions

- For free markets, but rejected the idea that regulation is unnecessary
- The state must create and enforce the proper rules of the market
  - beyond simply right to property and contract
  - Monopoly regulation a key example
- Some degree of social redistribution, minimum wage laws also a positive good (social justice)

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The Chicago School (again)

Liberal Positions

- Against many key interventions accepted around the world
- Against rent ceilings, occupational licensing
- Some Austrian influence on *some* Chicagoans: Alchian on property rights and Henry G. Manne on insider trading
- If Hayek became the mascot of Margaret Thatcher, then Milton Friedman was connected (rightly or wrongly) to Reagan in the US

Interventionist Positions

- Chicagoans favoured managed money
- Against the gold standard, for freely floating fiat currencies
- Key in abandoning the gold standard
- Chicago economists prominent in designing the policy measures when Nixon "closed the gold window" in 1971 – including price controls

"We're All Keynesians Now"

Famous Friedman Quote

- Friedman did say this – but he did not endorse Keynesian policies
- The point: all economists accept the Keynesian tools of analysis
  - Aggregate demand and aggregate supply
  - IS-LM and so on
- However, no one any longer accepts the Keynesian conclusions

Unity in Method

- Chicagoan or monetarist macroeconomics, in other words, is Keynesian macroeconomics
- In basic theory and method, Chicagoans and Keynesians unite

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Mises and the new Austrians

The Misesians

- Mises remained true to his extreme convictions
- Attracted and inspired liberal economists outside the neoliberal category
- Teaching in New York, Mises attracted disciples both to his economic philosophy and his intransigent or hardcore liberalism
- Israel Kirzner developed the theory of entrepreneurship
- Murray Rothbard developed Mises's praxeology in his *Man, Economy, and State* (1962)
  - Followed Mises in his economic liberal views (or libertarian)

Friedrich Hayek

- Always more moderate than Mises – closer to the neoliberals
- Wrote more widely on liberal philosophy – *Law, Legislation and Liberty* 1970s
- Hayek had an influence on British politics in the Thatcher years – at least, so Thatcher claimed at one point

Denationalization of Money

Key Question on Money

- Should money production be a government monopoly?
- Practically everyone always thought so
- Only a question of the degree of management, the rules of policy

Hayek's Challenge

- *Denationalization of Money* (1976) and other writings in the period
- Key claim: governments have always managed the currency badly
- There is no economic reason for government monopoly – and very good reasons against
- Private production of money and competition between currencies the way to prevent inflation, ensure good money

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4. Modern Growth Theory

Classical Growth Theory

- Two key causes of growth
- Capital accumulation
- Division of labour

Modern Growth Theory

- Modern economics has deviated significantly in this field
- Some kind of Solovian growth model dominate
- Technological change is the key factor explaining growth

Harrod-Domar Growth Model

The First Modern Growth Model

- Roy Harrod and Evsey Domar in 1939 and 1946 respectively
- Keynesian model: natural growth is the rate of growth needed to maintain full employment
  - There is no inbuilt mechanism in the market to ensure this growth rate
  - Wage rates are rigid, or specifically, relative price of labour and capital is fixed and the proportions of each employed are also fixed
- Output depends on capital: growth requires increasing the savings rate, or raising the marginal product of capital

Solow Growth Model

Robert M. Solow (1924-)

- Presented an alternative growth model in 1956
- Extension of Harrod-Domar model
- In the long run, any economy converges to its steady-state equilibrium

Causes of Growth

- Capital and population growth does not cause growth
- Poorer countries should catch up to rich countries
- Long-term growth is only achievable through technological progress
  - By increasing total factor productivity

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Solow and Cobb-Douglas

Key to Solow's Model

- Macroeconomic Cobb-Douglas Production function
  - $Y=AL^{\beta}K^{\alpha}$
  - Y is output, L is labour input, K is capital input and A is total factor productivity (TFP)

Problems

- It is not clear what these terms refer to in the real world
- K is some kind of physical capital
  - Böhm-Bawerk and Menger: we need to clearly distinguish between capital goods and capital
- Dynamic factors such as a greater division of labour, a longer, more capital-intensive structure of production are not captured by the model
- TFP in effect becomes the black box that explains the growth in Y
  - Technological change is assumed to drive the growth in TFP

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Kremer (1993) in the *QJE*

"Population Growth and Technological Change"

- This paper has been very influential in recent decades
- It sets out a model relating population growth to technological change
  - Pop. growth is limited by the state of technology
  - Innovation is proportional to population
  - Research productivity increases with income

Causes of Growth according to Kremer

- The more people, the more inventions, the greater population can grow
- Increasingly, income growth outstrips population growth as source of new inventions

Problems

- There is no mention of capital – little economic theory at all in this paper
- Builds on assuming mutual dependence of tech and population and then working out the implications in a model

Modern vs. Classical Growth Theory

Modern Growth Theory

- Key cause is technological change
- There is only a marginal role for capital accumulation and more labourers as causes of growth
- In most accounts, growth depends on institutions fostering innovation and the spread of new technologies

Classical Growth Theory

- Focus on capital accumulation: more capita per person → higher living standards
- Austrian economists worked out a more satisfactory capital theory
  - What matters is an increase in the amount of *capital goods*
  - Technological change is secondary: it depends on capital accumulation
- Institutions also important on the classical model
  - Good institutions foster the division of labour and capital accumulation
  - The allocation of capital to the most profitable uses

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5. Conclusion

- Modern economics – where are we at?
- Fracturing of economics into many schools, with little mutual debate
- Historicism back, now in more advanced clothing?
- Is there a core of economic propositions to which all economists agree?