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Center for International Studies
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**The Narrowing of the Mainstream - Dornbusch/Fischer/Startz, the History
of Economic Thought, and the Russian *Malaise***

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The Narrowing of the Mainstream - Dornbusch/Fischer/Startz, the History of Economic Thought, and the Russian *Malaise*

Wolfgang Zank

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Some textbooks can be seen as representing the 'state of the art'. Of course, also outsiders write textbooks. But if the authors are academics of the highest reputation, and if the textbooks are used in many universities throughout the world, then they represent and shape the 'mainstream', i.e. the intellectual current which has united most brains in academic economics in the Western world. 'Mainstream's' representatives talk and think in very similar ways all around the globe, and many policy recommendations are conceptualized in 'mainstream' terms. This makes 'mainstream' a powerful political force.

Macroeconomics of Rüdiger Dornbusch, Stanley Fischer and Richard Startz¹ deserves particular interest. 'Rudi' Dornbusch holds a chair at the Massachusetts Institute of Technology (MIT), one of the most prestigious institutions in the world, and Stanley Fischer, also of MIT, has for many years been First Deputy Managing Director of the International Monetary Fund (IMF), one of the most powerful institutions in the world. And discussing political power: On several occasions the authors approvingly quote Lawrence H. Summers, of Harvard University, whom we can regard as their intellectual fellow-in-arms. In 1999, Summers has been appointed Secretary of the Treasury of the United States of America.

¹ *Rudiger Dornbusch, Stanley Fischer, Richard Startz, Macroeconomics, 7th edition, Irwin Mc Graw-Hill, 1998.*

'*Macroeconomics*' can boast a global distribution². Furthermore, on the international market it is accompanied by the bulky *Economics*³, which has a large overlap with *Macroeconomics*. In this paper, we relate the book to some milestones in the development of economic thought. As we shall see, there are points of continuity, and of profound divergence. It is also interesting to notice which issues Dornbusch/Fischer/Startz *do not write about*, in contrast to their predecessors. When briefly presenting the main schools in the history of economic thought, we give comparatively ample space to Classical Political Economy, thereby discussing some fundamental problems. Finally, we compare the perspectives which we have encountered with those of Dornbusch/Fischer/Startz. We notice that the intellectual focus of economics has narrowed substantially during the last 150 years. This can be seen as a case of intellectual division of labor which enhances productivity. But it can also constitute the basis of serious errors. Russia in the 1990s, where Stanley Fischer has been involved, is a case in point.

Classical Political Economy

Political Economy was a child of the Enlightenment. Around 1750, traditional forms of economic regulation were increasingly felt to be inadequate. Numerous European authors endeavored to find ways to organize human productive activities in a more rational way. These activities found a first culmination in 1776, with the publication of *An Inquiry into the Causes and the Nature of the Wealth of Nations*, by Adam Smith.

Adam Smith, belonging to the Scottish School of the Enlightenment, was the first author who integrated a wide range of economic reasoning into a coherent system. At the same time he supplied political liberalism with a powerful intellectual weapon. Smith identified the division of labor as the main source of wealth. Human activity is more productive when it is specialized.

² See the preface, *ibid.*, p. xviif.

³ David Begg, Stanley Fischer, Rudiger Dornbusch, *Economics*, 4th edition, McGraw-Hill Book Company, 1994.

But someone who produces just one item (e.g. shoes) can only exist if he/she can exchange his produce with other products (e.g. food). Specialization is only possible if there is a market. Limits to the extent of the market limit the extent of specialization, and thereby of the national wealth. This implies that enlarging markets, removing barriers for the free circulation of goods have beneficial effects. In Smith's view, traditional regulations that, for instance, prescribed that only the members of guilds and corporations were allowed to practice certain trades and crafts, were only introduced in order to secure high incomes for the members of these corporation – at the expense of those who were outside. And those outside were mainly the poor. 'The patrimony of a poor man lies in the strength and dexterity of his hands; and to hinder him from employing this strength and dexterity ... is a plain violation of this most sacred property'⁴. In a similar vein, he criticized the administration of the Poor Laws. Every parish was obliged to feed its poor, and it was therefore interested in restricting the settlement of new poor. 'There is scarce a poor man in England of forty years of age ... who has not in some part of his life felt himself most cruelly oppressed by this ill-contrived law of settlement'⁵. The freedom of circulation was therefore, in Smith's view, also a question of elementary social justice.

Not least human 'self-love' could play a socially very positive role: 'It is not from the benevolence of the butcher, the brewer, the baker that we expect our dinner, but from the regard of their interests. We address ourselves, not to their humanity but to their self-love, and never talk to them of our own necessities but of their advantages. Nobody but a beggar chooses to depend chiefly upon the benevolence of his fellow-citizens'⁶.

If economic liberty was installed, profits would converge to their 'natural' rate, i.e. an average rate. If profits were higher in one trade than in another, capital would flow to the more

⁴ Adam Smith, *The Wealth of Nations Books I-III, Penguin Classics, Harmondsworth, 1990, p. 225.*

⁵ *Ibid.*, p. 245.

⁶ *Ibid.*, p. 119.

profitable one, raising production and depressing prices there, until there would be the same profit in all trades. The wages would converge to a 'natural' average level as well; were the wages higher in one parish than in another one, the workers would move to the occupation that was better remunerated. Also rent, i.e. the income which landowners could demand for the use of their land, would converge to a 'natural rate'.

Profits, wages, and rents were the components of the prices, and if they converged to their natural rates, the prices would be 'natural prices'. In a given situation, the actual price, the 'market price' could of course be higher or lower, but only for a limited time: 'The market price of any particular commodity ... can seldom continue long below its natural price. Whatever part of it was paid below the natural rate, the persons whose interest it affected, would immediately feel the loss, and would immediately withdraw either so much land, or so much labor, or so much stock [*capital*]'⁷ until the natural price was restored. And: 'The natural price, therefore, is ... the central price, to which the prices of all commodities are continually gravitating'⁸. The word 'gravitating' is perhaps no coincidence; the Scottish Philosophers wanted to construct a social science as 'objective' as Newton's physics.

Wages, profits, and rent were the three main sources of income, which accrued to the three main classes of society, the workers, the capitalists, and the landlords. Most capitalists in Smith's system were farmers, who employed laborers, financed the necessary equipment, and held land in tenure from the landlords. This was a reflection of the peculiar British social structure. In 1851 some 4,000 landlords owned perhaps four-seventh of the land, which was cultivated by a quarter of a million capitalist farmers, who employed about 1,25 million laborers and servants⁹. On the Scottish highlands and in parts of Wales (and a few places in England), small-

⁷ *Ibid.*, p. 165.

⁸ *Ibid.*, p. 160.

⁹ Eric Hobsbawn, *The Age of Revolution 1789-1848*, New York and Scarborough/Ontario - London, 1962, p. 182

holders were still numerous, but Smith and most other classical economists excluded them from their reasoning.

In Smith's system, wages were linked to demography: If a country was in progress, as it was the case with England, the wages were comparatively generous and allowed for more than just physical subsistence. The laborers could rear more surviving children, which in the end would lead to a surplus of laborers. Wages, therefore, had a long-run tendency to fall back to subsistence level. But this problem, for Smith, lay far ahead¹⁰.

Smith and other Scottish philosophers saw human society pass through distinct stages: Hunting, pasturage, farming, and commerce¹¹. On every stage, the economy had a decisive impact on the other parts of society. As William Robertson formulated it: 'In every inquiry concerning the operations of men when united in society, the first object of attention should be the mode of subsistence. Accordingly as that varies, their laws and policy must be different'¹². In the *Wealth of Nations*, historical references are frequent. Smith regarded himself as a comprehensive philosophical thinker, for whom the advance of commerce and free competition were driven forward by the laws of history.

Smith's book found a wide readership throughout Europe. In e.g. the German states it made a strong impression on many civil servants and thereby helped to bring about the agrarian reforms in Prussia after 1807¹³. Christian Kraus, Kant's successor at the chair of philosophy in Königsberg, told his students in 1796: 'Seit der Zeit des Neuen Testaments hat kein Werk

¹⁰ Smith, *op. cit.*, o. 172.

¹¹ As quoted by Andrew Skinner, *Introduction to Smith, op. cit.*, p. 31.

¹² *Ibid.*, p. 31.

¹³ Daniel Winch, 'The Emergence of Economics as a Science', Carlo Cipolla (ed.), *The Fontana Economic History of Europe*, vol. 3, *The Industrial Revolution*, Glasgow, 1975, p. 507-573, esp. p. 527.

segensreichere Wirkungen gehabt'¹⁴. [No book since the time of the New Testament has ever produced such benevolent results].

But in 1798, Th. Robert¹⁵ Malthus, curate at the chapel at Okewood, Surrey, published a small book which shook the prevailing optimism: *An Essay on the Principle of Population, as it Affects the Future Improvement of Society, with Remarks on the Speculations of Mr. Godwin, M. Condorcet, and Other Writers*. In a melancholic tone, he drew the consequences of the 'fact' that improved living conditions led to an increase in population. Food production could not be increased at the same rate: 'Population, when unchecked, increases in a geometrical ratio. Subsistence increases only in an arithmetical ratio'¹⁶. This meant that 'the human species would increase in the ratio of – 1, 2, 4, 8, 16, 32, 64, 128, 256, 512, etc. and subsistence as – 1, 2, 3, 4, 5, 6, 7, 8, 9, 10, etc'¹⁷. Food production could not be increased faster because more and more land of poor quality had to be taken into cultivation. Obviously, after a few generations the population would be by far too numerous in comparison to the available means of subsistence.

'Positive checks' such as diseases and famine every now and then cruelly reduced the number of human beings. But there were also 'preventive checks': By behaving prudently, many people restricted the number of births. But this was not sufficient to make humankind escape from the tragic circle of improving living conditions, population increase, and the return of misery. The British Poor Laws made everything worse because parish assistance made the poor multiply imprudently. He repeatedly proposed their gradual abolishment.

¹⁴ Hans-Ulrich Wehler, *Deutsche Gesellschaftsgeschichte. Erster Band. Vom Feudalismus des Alten Reiches bis zur Defensiven Modernisierung der Reformära 1700-1815*, München, 2. Auflage, 1989, p. 405.

¹⁵ His full name was Thomas Robert, but he was always called Robert, or Bob. Patricia James, *Population Malthus. His Life and Times*, London, Boston and Henley, 1979, p. 1.

¹⁶ Thomas Malthus, *An Essay on the Principle of Population, [First Essay]*, Penguin Classics, Harmondsworth, 1985, p. 71.

¹⁷ *Ibid.*, p. 75.

In 1803 Malthus published a considerably enlarged version of the *Essay*; a sixth version was printed in 1826. During the debate, Malthus modified his position. His hypothesis could also be read: 'Population, *when unchecked*, increases in a geometrical ratio'. Malthus thereby became the first author to concentrate minds on the *task* of restricting population growth. According to him, people should marry late, and before marriage live strictly virtuously. Sexual desires were not to be suppressed, only to be regulated: 'Considering then the passions between the sexes in all its bearings and relations, ... few will ... deny that it is one of the principal ingredients of human happiness. Yet experience teaches us that much evil flows from the irregular gratification of it; ...'¹⁸ He was, however - after all a priest by education - against the use of contraceptives. But not many years passed, and the term 'Malthusianism' became the label of a movement for family planning and the use of contraceptives, without Malthus being able to prevent it.

In 1805 Malthus was appointed Professor of General History, Politics, Commerce and Finance at the college of the East India Company at Haileybury, Hertfordshire, thus becoming the first professional economist in the world. But gradually his fame became eclipsed by that of his friend David Ricardo, a London stock broker. With Ricardo, Political Economy gained substantially in consistency, precision, and logical abstraction.

Ricardo's first subject were monetary problems. The exchange rate of sterling notes at financial centers such as Amsterdam or Hamburg was in decline, and internally prices were rising. As many others, Ricardo attributed the depreciation to an excessive emission of paper bank notes by the Bank of England. In 1809 he published his first systematic pamphlet, *The High Price of Bullion, a Proof of the Depreciation of Bank Notes*. Malthus disagreed. In his *Essay*, 1803 edition, he pointed to the country banks which could issue bank notes too (which could be

¹⁸ T. R. Malthus, *An Essay on the Principle of Population; or A View of its Past and Present Effects on Human Happiness; With an Inquiry into our Prospects Respecting the Future Removal or Mitigation of the Evils which it Occasions, [Second Essay] selected and introduced by Daniel Winch, Cambridge University Press, 1992, p. 212.*

exchanged for Bank of England notes). And the country bank emissions were 'rather a consequence than a cause of the high price of provisions'; scarcity and the expenses for the Poor Laws created effects which were 'embarrassing, to a great degree, the operations of commerce'¹⁹. In those debates the foundations of the so-called Quantity Theory of Money were established.

In 1815, when Parliament was about to introduce the Corn Laws, i.e. protective tariffs against the import of cheap foreign grain, Ricardo published a little pamphlet, *An Essay on the Influence of a Low Price of Corn on the Profits of Stock*²⁰. There he sketched a consistent theory of distribution and growth. The capitalist profit was determined by the profits in agriculture: With some degree of abstraction, Ricardo made the agricultural produce consist (only) of grain. With a bit further abstraction, also the wages for the landlaborers, which Ricardo fixed at subsistence level, consisted of grain; at least, wages could be expressed in grain equivalents. So could the other farming expenses. The rate of profit, then, was the relation between the product, expressed in grain, and the expenses for wages, implements, etc., equally expressed in grain.

On poor land, the harvest was just sufficient to secure the ordinary profit rate for the farmer. No rent could be paid. Following Malthus' theory of rent, Ricardo argued that on more fertile or better situated ground, the landlord could demand a higher rent. Also the rent could be expressed in grain units. With the passing of time population would grow, and this meant that more and more land, of an ever declining quality, had to be cultivated. The farmers on those marginal lands inevitably had to face declining profits: They still had to pay subsistence wages to their laborers, but the harvests, and thereby their profits, would decrease. This implied that

¹⁹ *Ibid.* P. 197.

²⁰ Ricardo's writings are easily accessible, thanks to an excellent edition: *The Works and Correspondence of David Ricardo*, edited by Piero Sraffa, with the collaboration of Maurice Dobb, 10 volumes, Cambridge University Press, 1950-1972. Ricardo's *Essay on the Influence of a Low Price of Corn ...* has recently been reprinted in facsimile, together with other pamphlets: Malthus, Ricardo, Torrens, West, *Die 'Corn-Law-Pamphlets' von 1815*, Faksimile-Edition 'Klassiker der Nationalökonomie', Düsseldorf, 1996.

the profit rate was to decline all over, it had to be the same in all branches. But the profits were the source of further productive accumulation, the motor of Britain's progress. Declining profits meant slower progress and eventually a stationary state. Only the landlords had reasons to be satisfied: As it became more difficult to produce grain, corn prices would rise. So, on their fertile lands, they could extract higher and higher rents.

Tariffs on cheap imported corn kept the corn prices at an artificially high level, to the delight of the landlords, but they depressed profits and obstructed Britain's progress. 'It follows then, that the interest of the landlord is always opposed to the interest of every other class in the community'²¹. In other words, Ricardo saw a class struggle.

In his main opus, *On the Principles of Political Economy and Taxation* (1817), Ricardo retained the main lines of argumentation. Grain, however, was replaced by labor as the general measure. 'The value of a commodity, or the quantity of any other commodity for which it will exchange, depends on the relative quantity of labour which is necessary for its production ...', read the title of chapter I, first section²². This was the Labor Theory of Value. Of course, not only 'the labour applied immediately to commodities affect their value'; also the labor 'which is bestowed on the implements, tools, and buildings'²³ must be counted. But seen this way, the prices – of course the 'natural prices' in the sense of Adam Smith – are proportional to the amount of labor which is 'embodied' in the various steps in their production.

The rate of profit occasions, however, a modification. Let us examine a fictive example. We compare two commodities, furniture and knives. In order to make furniture, trees had to be felled (which took 3 hours work); in a second step the wood was cut and assembled (7 hours).

²¹ Ricardo, *An Essay on the Influence ...*, facsimile-edition (see footnote 17), p. 20.

²² *The Works and Correspondence ...* (footnote 17), volume I, *On the Principles of Political Economy and Taxation*, p. 11.

²³ *Ibid.*, p. 22.

All in all 10 hours of work were needed. As to knives, first the iron had to be produced (5 hours), and then the knives could be wrought (also 5 hours). One hour costs uniformly 1 shilling. If there were no profit, the final prices would be 10 shillings in both cases, i. e. they are proportional to the total labor input, as can be seen in the following calculation:

	Furniture		Knives	
	Labor input	Price	Labor input	Price
First step: Raw material	3 hours=3 s.	3 s.	5 hours=5s.	= 5 s.
Final production	7 hours=7 s.		5 hours=5s.	
Total labor input, final price	10 hours	3 s.+7 s. = <u>10 s.</u>	10 hours	5s+5s= <u>10 s.</u>

Table 1: The simple Labor Theory of Value: Final prices in proportion to the total labor inputs. Assumption: No profit

Now we assume that the raw materials were produced in year 1, and the final production took place in year 2. And in the price calculation at every step, we incorporate a profit of 10 percent:

	Furniture		Knives	
	Labor Input	Price	Labor input	Price
Raw material	3 hours=3s.	3,3 s.	5 hours=5s.	5,5 s.
Final production	7 hours=7s.		5 hours=5s.	
Total labor input / Final price	10 hours	(3.3 s.+ 7s) x 1.1= <u>11,33</u>	10 hours	(5,5s.+5s.)x1.1 = <u>11,55</u>

Table 2: Final prices, incorporating 10 per cent profit at every production step: Labor Theory of value modified

As we can see, the knives turn out slightly more expensive. Prices and total labor input are not in exact proportion any more. This effect is caused by the rate of profit, if the time distribution

of the labor input varies. We can also say: When the capital intensities in the final production varies. Consequently, the labor theory of value is, strictly speaking, only valid if the profit rate is zero. Furthermore, if we e.g. lowered the wages and raised the profits, the relative prices between 'furniture' and 'knives' would change even more, as the reader easily can find out by altering the figures in table 2.

The amount of labor inputs can be interpreted as a function of the production techniques at a given time. Prices thus reflect these techniques, and the profit rate. 140 years after Ricardo, Piero Sraffa explored this perspective in a brilliant essay which became the founding document of the neo-Ricardian school²⁴.

Also in his *Principles*, Ricardo saw profits falling because land of poorer quality had to be cultivated. The free trade with consumption goods for laborers (such as grain) could, however, retard the decline of profits because it allowed lower wages. It was in this context that he exposed his famous model of Comparative Advantages.

Ricardo's abstract way of reasoning, isolating a few variables and then exploring them thoroughly, made a profound impact on Political Economy. But some had doubts. Richard Jones, who became Malthus' successor at the professorship at Haileybury, wrote that Ricardo overtook Malthus' theories on rent and population and, 'overlooking altogether the limited extent of the field to which these principles were really applicable, undertook from them alone to deduce the laws which regulate the ... revenue derived from land at all places, and under all circumstances; and ... [he] proceeded from the same narrow and limited data, to construct a general system ... over the surface of the globe'²⁵. A similar critique can perhaps be directed towards many economic works.

²⁴ Piero Sraffa, *Production of Commodities by Means of Commodities*, Cambridge University Press, 1960.

²⁵ Richard Jones, *Essay on Rent*, p vii, as quoted by James, *op. cit.*, p. 286.

Malthus defended the Corn Laws because he saw a danger that Britain might become dependent on foreign deliveries. Furthermore: 'The farmers, in some districts, have entirely lost the little capital they possessed; and, unable to continue in their farms, have deserted them, and left their laborers without the means of employment ... In Ireland, it is quite certain, there are no mercantile capitals ready to take up those persons who are thus thrown out of work, and even in Great Britain the transfer will be slow and difficult'²⁶. Malthus thus did not reject the liberal creed that, if cheap import destroyed occupation, other employment possibilities could be found. But he insisted that the difficulties of the transition must be taken seriously. Furthermore, in his *Principles of Political Economy Considered with a View to their Practical Application* (1820), Malthus attributed part of Britain's economic distress after 1815 to a 'great diminution of the whole amount of consumption and demand'. After the end of the Napoleonic Wars, public demand (for guns, ships etc.) was reduced substantially. The taxes were lowered accordingly, but unfortunately, 'very many persons have taken the opportunity of saving part of their returned property-tax, ...'²⁷ Thus, the money saved was lost as demand. Looking for a solution, Malthus concluded: 'Public works, the making and repairing of roads, and a tendency among persons of fortune to improve their grounds, and keep more servants, are the most direct means within our power of restoring the demand for labor'²⁸. For most of his colleagues, this was a scandal: Malthus expected the remedy to come from the state (and thereby higher taxes), and the landlords (who accumulated fortunes thanks to the Corn Laws).

²⁶ Thomas Robert Malthus, *The Grounds of an Opinion on the Policy of Restricting the Importation of Foreign Corn*, facsimile edition, Düsseldorf, 1996 (Klassiker der Nationalökonomie, see footnote 17), p. 25f.

²⁷ *The Works and Correspondence of David Ricardo, Volume II, Notes on Malthus*, edited by Piero Sraffa, with the collaboration of Maurice Dobb, Cambridge, 1976, p. 442f. This volume contains an almost complete reproduction of Malthus' *Principles*, 1820 edition, with numerous remarks by Ricardo. It is thereby an excellent source for the reconstruction of their discussions.

²⁸ *Ibid.*, p. 446.

Ricardo wrote in the margin of Malthus' *Principles*²⁹: 'Mr. Malthus never appears to remember that to save is to spend, ...' Behind this seemingly paradoxical remark stood the so-called 'Say's Law', named after the French economist Jean-Baptiste Say (*Traité d'Économie Politique*, 1803). According to this 'law', every production creates its own demand. Everyone who offers something on the market, does so only with the purpose of buying afterwards. So, every supply augments demand in the same proportion. Of course, there can be a *partial* oversupply, accompanied by a *partial* lack of demand. For instance, there can be an oversupply of shoes, whereas most people want shirts. But such a situation would not last for long: The prices for shoes would fall, those for shirts would rise, and this would lead to a flow of capital from shoes to shirt production. So, market forces would remedy such a disequilibrium, there was no need for intervention. But what happens, as Malthus has pointed at, if some people saved a part of their income? Isn't saved money lost as effective demand? It is not, said Say's followers. Saved money would be deposited, e.g. at banks, and from there it will be channeled in the form of loans to investments, and thus again be effective on the demand side. The interest rate played a crucial role: If there were more savings than loans, the interest rate would fall. This would simultaneously increase the demand for loans, and discourage saving. This way the rate of interest would bring savings and loans into equilibrium. This was a logically water-tight argumentation. Malthus' objections were dismissed by most economists. More than one-hundred years later, John Maynard Keynes sighed: 'If only Malthus, instead of Ricardo, had been the parent stem from which nineteenth-century economics proceeded, what a much wiser and richer place the world would be to-day!'³⁰.

Ricardo's belief that unrestricted competition would deliver the solution to all social problems, gradually gave way to more doubtful reasoning. He inserted a new chapter, On Machinery, into the third edition of his *Principles*, where his astounded liberal followers could read. '... I am

²⁹ *Ibid.*, p. 449.

³⁰ *The Collected Writings of John Maynard Keynes, Volume X, Essays in Biography, London and Basingstoke, 1972, p. 100f.*

convinced that the substitution of machinery for human labour, is often very injurious to the interests of the class of the laborers'³¹. New machinery could increase profits and at the same time reduce the gross income of the capitalists, of which the wages were paid. This was not a necessity, only a possibility, but ever since economic theory had a new subject to discuss: The threat of technological unemployment.

John Stuart Mill, the last great exponent of British classical economy, vigorously defended the main tenets of liberalism such as free trade or free competition. But he also explicitly marked the limits of *laissez-faire* and compiled a list of tasks for the state to do: Primary education, the protection of children, social policy, lighthouses and geographical expeditions (common goods in modern parlance), or the regulation of 'practical monopolies' such as gas and water works. He thereby expounded the principles of a new branch of liberalism, social liberalism.

As a convinced 'Malthusian', Mill saw the reduction of the population increase as one of the major political tasks. Better education and information of the laboring classes could help, but Mill also underlined the importance of social institutions in this context. For instance, he was a harsh critic of the system of land tenure in Ireland: There the (usually English) landlord could rent the land out to the highest bidder, with a short lease. Under the conditions of a growing population, this meant that Irish peasants were exposed to harsh competition from their neighbors. They had few incentives to improve the land and practically no incentives to keep their own numbers restricted. Whereas e.g. Tuscan *metayers* were protected by customary long leases and 'could not be impoverished by any other improvident multiplication than their own, ... [an Irish] cottier family, however prudent and self-restraining, may have the rent raised against it by the multiplication of other families ... Is it not, then, a bitter satire on the mode in which opinions are formed ..., to find public instructors of the greatest pretensions, imputing the backwardness of Irish industry, and the want of energy of the Irish people in improving their

³¹ Ricardo, *Principles* (footnote 17 and 20), p. 388.

condition, to a peculiar indolence and *insouciance* in the Celtic race?’³². This is one example among many, where Mill integrated economic, sociological and cultural problems.

As Smith and Ricardo before him, he saw the economy gradually approaching a ‘stationary state’. But he saw no reason to worry: ‘It is only in the backward countries of the world that increased production is an important object: in those most advanced, what is economically needed is a better distribution’³³. Humankind should even stop increasing production before all possibilities were used: There is not ‘much satisfaction in contemplating the world with nothing left to the spontaneous activity of nature; with every rood of land brought into cultivation, ... every flowery waste or natural pasture ploughed up, all quadrupeds or birds which are not domesticated for man’s use exterminated as his rivals for food, ...’³⁴.

All in all, by the middle of nineteenth century, Political Economy was a well-established branch of academic and public opinion, and Britain’s role as industrial pioneer seemed to vindicate the claim that the basic tenets of Political Economy were scientifically based. But not all were convinced that liberal industrial capitalism was already the end of history.

Karl Marx

Of the authors discussed here, Karl Heinrich Marx, born 1818 in Trier, was certainly the most ambitious. He intended to deliver an all-embracing analysis of capitalism, its place in history, and a comprehensive critique of all those who wrote on economic matters before him. Also

³² John Stuart Mill, *Principles of Political Economy With Some of Their Applications to Social Philosophy*, edited with an introduction by Sir William Ashley, Reprints of Economic Classics, Augustus M. Kelley Publishers, Fairfield, NJ 07006-0008, 1987, p. 321 and 324.

³³ *Ibid.*, p. 749.

³⁴ *Ibid.*, p. 750.

writing about highly abstract and philosophical problems was for him very practical work, he was going to forge the intellectual weapon for the working class.

The first volume of *Das Kapital* was published 1867 in Hamburg, being the only one which he properly finished. His friend Friedrich Engels published in 1885 and 1894 the second and third volumes, using a huge heap of papers which Marx has left at his death 1883. Marx took his theoretical inspirations mainly from Classical German Philosophy, Classical British Political Economy, and French Utopian Socialism, but also many other thinkers, and he mastered an enormous range of material in almost all kinds of languages.

Das Kapital opens with an analysis of the commodity, i.e. a thing which is produced in order to be exchanged on the market. A commodity combined the qualities of having a concrete value in use (*Gebrauchswert*) and an abstract exchange value (*Tauschwert*). And commodities could be exchanged, and their values could be compared, because they had something in common: They were all the product of human labor. But it is not the labor of individuals. It is the labor of persons who are seemingly independent, but who are all part of a societal organism. Their work is concrete work (*konkrete Arbeit*, producing useful things), but at the same time it is 'societal labor' (*abstrakte, or gesellschaftliche Arbeit*). People perceive commodities as things, but as a matter of fact the commodities are the concretions of their own societal labor. Marx called the habit of seeing things, instead of social relations, 'commodity fetishism' (*Warenfetischismus*).

Commodities had value, *Wert*, according to amount of the labor which was necessary to produce it. 'Value' was the core of the matter (*das Wesen*), prices were the phenomena on the surface (*Erscheinung*). When a producer sells a commodity and buys another one, he owns in the end a commodity of different usefulness, but the same value. 'The same value, i.e. the same quantum of concretized societal labor, remains in the hand of the same commodity owner, first in the form of his own commodity, then of the money, into which it was transformed, and

finally in the form of the commodity, into which this money was transformed³⁵. In other words, there is an equivalence between labor value and price. Market prices can temporarily diverge from the value, but as average rule, as 'blindwirkendes Durchschnittsgesetz', the equivalence holds³⁶.

The cases mentioned above, where peasants or weavers produced commodities by their own labor, sold them and bought commodities of another kind, form a kind of circle, commodity – money – commodity (*Ware – Geld – Ware*), symbolically *W-G-W*. Marx grouped this under the heading 'Simple Commodity Circulation' (*Einfache Warenzirkulation*). In capitalism, however, the circle starts with money: The capitalist has money, buys materials and employs workers, and in the end he sells the final products, receiving more money than he had at the beginning. But here a problem appears: How can we have an exchange, value for value, and in the end have more than before? Symbolically, how can be $G=W=G'$ valid, and at the same time $G'>G$? Of course, in the real world, some people cheat. But Marx analyzed the 'best' capitalism conceivable, where everyone traded honestly under conditions of perfect competition. And even such a system is, as he tried to show (see below), based on exploitation, and therefore inhuman. Cheating and other evil things came on top of that.

G' could be larger than G because the capitalist bought a commodity which had the peculiar capability of creating more value than it contains: Labor power (*Arbeitskraft*). A capitalist does not buy labor, he rents labor power. The value of labor power is determined as that of all other commodities, by the amount of labor which was necessary to produce it, i.e. the labor of raising,

³⁵ 'Derselbe Wert, d.h. dasselbe Quantum vergegenständlichter gesellschaftlicher Arbeit, bleibt in der Hand desselben Warenbesitzers in Gestalt erst seiner Ware, dann des Geldes, worin sie sich verwandelt, endlich der Ware, worin sich dieses Geld zurückverwandelt'. Karl Marx, *Das Kapital. Kritik der politischen Ökonomie. Erster Band. Buch I: Der Produktionsprozess des Kapitals* (Karl Marx, Friedrich Engels, *Werke*, Band 23), Berlin (Ost), 1970, p. 172.

³⁶ *Ibid.*, p. 117. See also p.180, note 37, 'Die beständigen Oszillationen der Marktpreise ...reduzieren sich selbst zum Durchschnittspreis als ihrer inneren Regel'. But see also the addition at the end of this note, where prices were determined by labor values only 'in letzter Instanz', and where Marx states a systematic divergence between price and value. He explores this in the third volume. This correction has, however, not the slightest influence on the reasoning in volume I.

education, feeding, clothing, etc. The capitalist pays a wage which allows for the reproduction of the labor power. The reproduction depends, however, also on the cultural level of a country, and the habits and demands of the workers. In this modified sense, the wages are subsistence wages. The permanent introduction of new machinery and the concomitant unemployment keep the wages down on this level.

The worker, when working for the capitalist, creates more value than he receives as wages. He creates a surplus value, *Mehrwert*. This exploitation of human labor power is the *Wesen* of the capitalist profit. And a capitalist society is characterized by the existence of two mutually dependent classes, the workers who are 'free' to sell their labor power on the market, and the capitalists who own the means of production and can hire labor. And the essence of the historical genesis of capitalist society, as Marx graphically described, was the accumulation of fortunes at one pole, and the often barbarous creation of 'free' laborers at the other, e.g. by the expulsion of peasants from their soil during the enclosures³⁷.

However, two mechanisms will bring capitalism down. On the one hand, the profit rate will decline: Technical progress implies ever bigger installations per labor unit. But only 'living' labor creates *Mehrwert*, which in proportion to the whole capital, shrinks. Capitalism will lose its dynamism, which also undermines it politically. And as Marx demonstrated in his 'reproduction schemes', capitalism grew only smoothly if a set of complicated conditions were fulfilled simultaneously; this implied that recurrent crisis was the norm, rather than the exception, even before capitalism had reached its final stage. Furthermore, capitalism produces an ever larger working class, by ruining the masses of petty-bourgeois craftsmen and peasants. In the end, the large, well-organized and class-conscious working class will down capitalism:

³⁷ See chapter 24, 'Die sogenannte ursprüngliche Akkumulation', *ibid.*, p. 741-791.

‘Die Stunde des kapitalistischen Privateigentums schlägt. Die Expropriateurs werden expropriert’³⁸.

At least in hindsight, it is obvious that Marx’ story contains some flaws. For instance, there was never a working class revolution in a developed capitalist country, and class struggle and class consciousness are mainly phenomena of the past. But on the other hand, for many decades big parties and trade unions discussed matters in Marxian terms; somehow, they must have corresponded to experiences. And if we concentrate on the academic world, Marx’ writings have inspired a huge array of research. Some sociologists, e.g. the Frankfurt School, have explored the problems of commodification and *Warenfetischismus*, others have structured various ‘forms of living’ according to Marxian categories³⁹. Historians studied British economic history in Marxist perspectives, or e.g. the Making of the English Working Class⁴⁰.

Economists have usually been less impressed. They quickly found some inconsistencies in Marx’s presentation. There is, point one, the equivalence between labor value and price. As Marx himself explored in the third volume, commodities cannot be exchanged at their labor values because a uniform profit rate makes prices diverge from it. We met this problem already with Ricardo. Marx tried to integrate these effects and introduced a new category, *Produktionspreise*, according to which commodities were exchanged. This is the famous *Transformationsproblem*: How do labor values get transformed into prices? But Marx’ argumentation in the first volume on *Warenaustausch*, *Arbeitskraft*, *Mehrwert etc.* - see above - rested on the assumption that prices were equivalent to labor values. We can say that his analysis of the capitalist profit rested on a theory which is only valid when the capitalist profit is zero (see above, table 1 and 2). Furthermore, Marx ‘transformed’ only the outputs into

³⁸ *Ibid.*, p. 791.

³⁹ Thomas Højrup, *Det Glemte Folk. Livsformer og Centraldirigering*, København, 1989.

⁴⁰ Eric. J. Hobsbawm, *Industry and Empire*, Harmondsworth, 1979 (first edition 1968); E. P. Thompson, *The Making of the English Working Class*, Harmondsworth, 1991 (first edition 1963).

Produktionspreise, not the inputs. The same machine could enter his calculations at *Produktionspreis*, if it was sold as final product, and at the same time at labor value, when used as input. The last problem is, in principle, solvable by the use of linear algebra.

But before the reader feels like dismissing Marx completely, she should read what Nobel laureate Wassily Leontief said 1937 at the annual congress of the American Economic Association: Marx delivered a 'brilliant analysis of the long-run tendencies of the capitalistic system. The record is indeed impressive: increasing concentration of wealth, rapid elimination of small and medium sized enterprise, progressive limitation of competition, incessant technological progress accompanied by the ever growing importance of fixed capital, and, last not least, the undiminished amplitude of recurrent business cycles - an unsurpassed series of prognostications fulfilled, against which modern economic theory with all its refinement has little to show indeed'⁴¹. Also business cycle analysis was clearly indebted to Marx: '... the three volumes of Capital helped more than any other work to bring the whole problem into the forefront of economic discussion'⁴². And: 'The significance of Marx ... is that of an inexhaustible source of direct observation. Much of present-day theorizing is purely derivative, secondhand theorizing'⁴³. This critique has certainly not lost its relevance to-day.

Marx saw capitalism as a profoundly unstable system, and it was unstable. The almost 'pure' capitalism which he studied was everywhere replaced by mixed economies with an elaborate welfare state. And the major forces to bring this about were, directly or indirectly, workers' parties and trade unions. The working class has downed capitalism. At least the one Marx analyzed.

⁴¹ Wassily Leontief, 'The Significance of Marxian Economics for Present-Day Economic Theory', *The American Economic Review*, Vol. XXVII, No 1, Supplement (March 1938), p. 5.

⁴² *Ibid.*, p. 3.

⁴³ *Ibid.*, p. 9.

Neo-Classical Economics, the 'Marginalist Revolution' and Mathematics

By 1870, many of the key features of classical economics appeared to be obsolete. The Malthusian specter evaporated, birth rates declined, and real wages were rising. A capitalist system seemed to be capable of sustained growth, there were no signs of declining profits, and agriculture, due to the progress in applied chemistry and mechanization, could produce food in ever larger quantities, at systematically falling costs. There were seemingly no natural limits to growth. Furthermore, the advance of positivism made some questions look dubious. Prices could be observed, but 'value' became for many a metaphysical category. All this led to a shift in the priorities of economic research, and it was accompanied by a reformulation of some basic concepts⁴⁴. But economics turned also much more narrower.

Problems of demography vanished from the agenda, and so did many of the sociological questions which Mill, not to say Marx incorporated in their analysis. Economics became divorced from history, and people lost interest in problems of long-term economic growth. Instead, the focus shifted to short-term price movements and market constellations. And since it could no longer be taken for granted that wages were at subsistence levels, the theory of distribution became reformulated. Now income was understood as a price for a contribution to production, and it was analytically determined in analogy to the price mechanism in the market. Most economists could see social problems and conflicts, but no systematic class struggle. Their analytical instruments turned more precise than the classical ones, but their world became also a little bit boring. Prices went up, others went down, but nothing dramatical really happened.

Alfred Marshall, since 1885 at Cambridge, was perhaps the most influential economist of neo-Classicism, as the new school, strangely enough, came to be called. In contrast to Smith and Ricardo, who saw demand as depending on the size of the population, but otherwise as being

⁴⁴ For a comprehensive and graphic overview, see William J. Barber, *A History of Economic Thought*, Harmondsworth, 1991, p. 163-222.

rather stable, in Marshall's presentation demand and supply became *functions* of the price. It could e.g. be supposed that customers demanded a bigger quantity of a certain good, if the price was falling. In principle, a whole row of price-quantity constellations was conceivable, which could be drawn into diagram, with the price on the x-axis and the quantities demanded at the y-axis. The result is a falling line. In analogy, a (usually rising) supply curve could be drawn into this diagram. At the intersection of the two curves we find the price-quantity constellation where supply equals demand. This 'Marshallian cross' has ever since entered practically all elementary textbooks.

The aggregated demand curve for the whole market could be constructed by an horizontal addition of the individual demand curves. The same procedure was applicable on the supply side. And on both sides, the position of the curves could be described in 'marginal' terms. What determines a demand curve? The customer's marginal utility curve. If he owns already two pair of shoes, he buys a third one if, and only if, the marginal utility of the third pair is higher than the price. In the logical extreme, in infinitesimal perspective, price equals marginal utility. And as to the supply curve: A firm increases output if the price is higher than the marginal costs, i.e. the costs of producing the additional unit of output. Again, in the logical extreme, under conditions of perfect competition, price equals marginal costs. Shifting demand curves produce shifting prices, all according to the customers' marginal utilities. And since utility is a highly individual matter, the discussion of 'value' dissolves into subjective perceptions of utility. Many neo-classical authors, in particular William Stanley Jevons, presented this 'subjective' theory of value' explicitly in opposition against the 'objective' value theory of Ricardo, Mill and Marx.

But the 'marginalist revolution', as it came to be called, was much less revolutionary than it often is presented. The idea that prices rise when demand rises, is in fact older than classical economics. Smith and Ricardo insisted, however, that not all price levels have the same stability. As we have seen above: If prices rise, then profits and wages rise above their ordinary levels; and this induces an influx of capital and labor, which enlarges the supply of the

commodity, until the price level is back at the ordinary level. This means, in the longer run, it is the conditions of production plus the rate of profit which determine the price level, *regardless of the position of the demand curve*. In the longer run, with a given technique (and constant returns to scale), a rising demand increases the quantities produced, but not the price. So, in this sense, the classical and the neo-classical position do not exclude each other, they are different perspectives upon the same reality.

The rise of neo-Classicism was accompanied by the increased application of mathematical method. A brilliant achievement in this context was the *Éléments d'économie politique pure*, by Léon Walras (1874-77). Walras analyzed an economy under perfect competition, translating various market constellations into a set of equations. As he could show, there exists a set of prices and quantities where all markets are in equilibrium simultaneously. And as he further showed, the economy, under specified conditions, gradually moves to this 'general equilibrium'. Before Walras, no one had ever shown that the 'partial' equilibrium in one market is compatible with the equilibrium in other markets.

The use of mathematics made it possible to express theorems in a concise way. The interdependence and interplay of a wide range of factors could be cast into models which were far more precise and consistent than those which only were formulated verbally. Furthermore, if models were formulated in the language of mathematics, they were open to further mathematical transformation. This way, many new theoretical aspects could be extracted from them. But there is one big problem associated with mathematics: In order to formulate problems in a formalized way, they must be simplified enormously. One identifies some variables which enter the game, but everything else gets *completely* discarded. Thereby, the spread of mathematics contributed to narrowing the range of economics. Furthermore, many mathematical economists seem to have lost interest in real economic problems, and dwelled instead in mathematical spheres which were superficially disguised as economic ones.

A simple example can perhaps illustrate the problems: We can formulate a Marshallian demand curve by an equation, where p represents the price and q the quantity demanded, e.g. as $p = 10 - 2q$; we can also formulate a supply curve: $p = 2 + 1.5q$. When demand equals supply, both equations must hold, and we can solve them as a system of simultaneous equations. The solutions are $q = 2.29$ and $p = 5.34$. This is a new result. It is an implicit consequence of the formulation of the demand and supply curves. We could bring it into the open because we used mathematics. But have we really learned something new about economics?

There has been a growing tendency in academic economics to regard *only* formalized texts as being 'real economics'. But this implies that many important economic problems, e. g. institutional problems, are disregarded. We shall encounter this problem again, when we discuss Dornbusch/Fischer/Startz at the end of this paper.

Under the auspices of neo-Classicism, academic economics became a truly international discipline for the first time. There were various schools with their particularities each, notably in Cambridge, Lausanne, Vienna, and the USA, but as to the basic methodological concepts and focus of interest, they were united. But they were not without opponents.

The Historical Schools, Institutional Economics, and the Problems of Specialization

In some countries, notably Germany, neo-Classicism hardly made inroads for a long time. Most German economists regarded abstract models, seemingly void of any real life, with suspicion. Around 1840, many of them, notably Friedrich List, perceived the spreading of Anglo-Saxon economics also as a kind of cultural imperialism, and as kind of ideological support for British economic dominance. Something similar happened e.g. in Ireland. Most German economists stressed instead the importance of the detailed study of real situations in their historical development. Instead of drawing diagrams or solving equations, they wrote books about economic and social history, from medieval or ancient times to modernity. Some, e.g. Gustav

Schmoller, had considerable political influence, by educating civil servants and taking a prominent part in the deliberations about the German social security legislation.

The exponents of the German (or Irish) Historical School have often, in comparison to many 'model builders', been vastly superior as to the knowledge of real economic situations. They suffered, however, from the problem that they often were not fully aware of the point that facts do not speak for themselves. If they could observe a fall in the German grain prices, was that due to cheap Russian and American imports? Or to the process of mechanization of agriculture? Or better weather conditions? In order to find out, you have to use an explicit hypothesis, with specified premises (in particular, if several components enter the picture). That is what the 'model builders' deliver. And already the selection of the topics which enter the historical study, involves theoretical questions. These methodological shortcomings made the Historical School die out somewhere between the World Wars.

We can see the split between abstract economic theory and economic history as a kind of division of labor, and according to Smith, more division of labor means progress. But is it really progress, if experts know more and more about fields which turn smaller and smaller? In the end, they might know everything about nothing. Perhaps the solution lies in specialized research, and continuous efforts to synthesize again.

A similar split opened between economy and sociology. Neo-Classical models can only work if a long row of institutional conditions are met. To give one example: Competition produces beneficial results only if property rights are guaranteed. If it were allowed to burn down the competitor's factory, the general welfare certainly would not be enlarged by this kind of competition. Formulated more generally: Capitalism can work only if rule of law and effective legal systems are in place. The same can be said about good banking regulations, accounting rules, an impartial state bureaucracy, a good educational system, and many other institutions. For Mill and Marx these aspects were an integral part of their research program. Later, also the

so-called institutional economists in the USA, or Max Weber in Germany, explored these problems. But many neo-classical economists have had a tendency to overlook their importance, or to take everything for granted. We shall meet this problem again at the end of this paper.

The 'Keynesian Revolution' and the 'Neo-Classical Synthesis'

The economists' faith in the prospects of capitalism was severely shaken by the Great Depression, from 1929 onwards. Under these conditions, *The General Theory of Employment, Interest and Money*, by John Maynard Keynes⁴⁵ (1936), had a colossal impact on Anglo-Saxon economics. Reading the book several decades later, it is perhaps difficult to imagine why it once thrilled its readers to the bones. The book contains, among a few vividly-written parts, many lengthy dry passages, and it is badly organized, with numerous superfluous digressions. Many lines of argumentation are mere speculation. Obviously, Keynes wrote the book in some haste. Or, as one of his former students reports: 'Preparing the *General Theory* for publication, though it was done very quickly, was for him disappointingly slow. He was desperate to present it to the world that, he felt, needed it'⁴⁶.

Keynes presented a theory which explained why capitalism had fallen into a *prolonged crisis*. He directed the focus again on effective demand, a problem which has passed into oblivion since Malthus. Keynes introduced an 'aggregate demand function' which related various levels of demand, consumption in particular, to levels of income. As with Marshall's cross, this function, and the corresponding diagrams, are by now part of most textbooks, including Dornbusch/Fischer/Startz⁴⁷. In 1936 it was a novelty, loaded with consequences. Assuming a

⁴⁵ John Maynard Keynes, *The General Theory of Employment, Interest and Money (The Collected Writings of John Maynard Keynes, volume VII)*, Macmillan, Cambridge University Press, 1986.

⁴⁶ L. Tarshis, 'Keynesian Revolution', *The New Palgrave. A Dictionary of Economics*, edited by John Eatwell, Murray Milgate, Peter Newman, London and Basingstoke, Macmillan, 1987, volume 3, 1987, p.47-50, esp. P. 50.

⁴⁷ Dornbusch/Fischer/Startz, *op. Cit. (footnote 1)*, p.188-210.

'marginal propensity to consume' smaller than one, it followed that a growing economy could meet the problem of an insufficient consumption level. Within the neo-classical world (which Keynes called 'classical'), this was not really a problem; insufficient consumption meant more saving, but saving would be transformed, via loans, into investment. The rate of interest - see Say's Law above - brought investment and saving into balance. But Keynes attacked Say's Law exactly at its central point, the rate of interest. As he pointed out, the economic agents have often good reasons *not* to spend their money, but *to hold it in liquid forms* ('liquidity preference'); and this liquid money was lost for demand. The interest rate, being the result of the supply and demand for money, *including the demand for liquidity*, was thereby usually higher than the 'classics' assumed. It was not the interest rate, but *output* which brought saving and consumption into balance; if output fell far enough, there was less saving, and the excess of saving over demand disappeared. Under these conditions, the economy could easily fall into an *equilibrium with unemployment*: 'Indeed it [the economic system] seems capable of remaining in a chronic condition of sub-normal activity for a considerable period without any market tendency either towards recovery or towards complete collapse. Moreover, the evidence indicates that full, or even approximately full, employment is of rare and short-lived occurrence'⁴⁸.

Wages are rather inflexible, in particular downwards. Also this rigidity obstructed, of course, the functioning of the markets and the return to full employment. But according to Keynes a wage reduction would not help because, among other effects, it would reduce aggregate demand. He concluded: '...I am now of the opinion that the maintenance of a stable general level of money-wages is, on the balance of considerations, the most advisable policy for a closed system; whilst the same conclusion will hold for an open system, provided that

⁴⁸ Keynes, *op. cit.*, p. 249f.

equilibrium with the rest of the world can be secured by means of fluctuating exchanges [*i.e. re-/devaluations*]⁴⁹.

The state had to stabilize aggregate demand at the appropriate level. As an implication of his aggregate demand function, Keynes showed that fiscal expenses could generate income effects that were substantially higher; also this kind of 'multiplier' analysis has ever since become a central part of economic textbooks, including Dornbusch/Fischer/Startz⁵⁰. When it came to the job of stabilizing demand, Keynes regarded fiscal policy (higher government expenses) as being more effective than monetary policy (*i.e.* enlargement of the money supply, in order to generate lower interest rates). Under certain conditions, expansionist monetary policy would have no effect at all, all cheap money would only be hoarded as liquid assets ('liquidity trap').

Formulating it more generally, according to Keynes, money was not just an innocent means of economic exchange. It could produce grave disturbances. But on the other hand, '... if our controls succeed in establishing an aggregate volume of output corresponding to full employment as nearly as is practicable, the classical theory comes into its own again from this point onwards'⁵¹.

His 'revolution' was therefore only partial. Keynes was profoundly influenced by his teacher Marshall, and most of the *General Theory* is written in Marshallian language. That was perhaps a reason for its success; his colleagues could understand Marshallian. On the other hand, Keynes was presumably more open to new developments than many other economists because he worked much outside the academic world. He gave lectures at Cambridge and edited the

⁴⁹ *Ibid.*, p. 270.

⁵⁰ *Ibid.*

⁵¹ *Ibid.*, p. 378.

Economic Journal, but he earned his living by managing the assets of an insurance company. When talking about money and liquidity, he knew what he was talking about.

The *General Theory* inspired, almost right from its publication, a long range of further economic research. Keynesian ideas became quickly popularized, but also modified. Of particular relevance was an article of just twelve pages, by Sir John Hicks: *Mr. Keynes and the Classics*⁵². Hicks integrated some central Keynesian concepts into suggestive diagrams, the famous IS-LM-model (SI-LL, in Hick's original notation), in order to capture the mutual interdependence between monetary phenomena and the sphere of production. Also the IS-LM-model entered the hard core of the textbook-literature, Dornbusch/Fischer/Startz included⁵³, and it has served as a frame for economic research and debate for decades⁵⁴. The IS-LM-model is, however, not without problems. For instance, the IS-curve depicts flow-equilibria, whereas the LM-curve shows *stock*-equilibria, a point that bothered Hicks severely. Another problem is hidden in the assumption that the curves are independent of each other⁵⁵.

Another Keynesian, or perhaps better pseudo-Keynesian, success was the 'Phillips curve'. In its original version of 1958 it depicted a statistical connection between unemployment and wage increases, later between unemployment and inflation. It soon entered the textbooks throughout the world. It was 'Keynesian' in the sense that it supplied the notion of inflexible wages with statistical material. The Phillips curve seemed, however, also to indicate that it was possible to combat unemployment with higher inflation. This kind of policy also became labeled as

⁵² John Hicks, 'Mr. Keynes and the Classics: a suggested interpretation', *Econometrica* 5, April 1937, p. 147-59.

⁵³ Dornbusch/Fischer/Startz, *op. cit.*, p. 211-237.

⁵⁴ Axel Leijonhuvud, 'IS-LM analysis', *The New Palgrave. A Dictionary of Economics*, edited by John Eatwell, Murray Milgate, Peter Newman, London and Basingstoke, Macmillan, 1987, volume 3, 1987, pp. 1002-1004, esp. p. 1002.

⁵⁵ *Ibi.*, p. 1003f. For a newer discussion, see Teodoro Dario Togati, *Keynes and the Neo-Classical Synthesis. Einsteinian versus Newtonian Macroeconomics*, Routledge, London and New York, 1998, p. 91-10.

'Keynesian'. But Keynes took inflation very seriously, he endeavored to show that his policy recommendations had, under the given conditions, no inflationary effects⁵⁶.

To sum up, some Keynesian perspectives soon became an integrated part of academic economics. But Keynes' specter of instability was soon, so to speak, compressed into a bottle which was locked by a cork on which was written: 'Only short-term'. This operation was called the 'neo-classical synthesis', a term coined by Paul A. Samuelson in the 1950s⁵⁷. But there is not much classical in this 'synthesis'. At least, of the richness of the discussions of Classical Political Economy, little is left. 'Classical' is more a label which is glued on to all models that assure us that everything is going to be all-right in the longrun. So, the term 'synthesis' is rather misleading. 'Medley' would perhaps be more appropriate.

The 'synthesis' came under severe attack in the 1970s, but it seemed to have survived, albeit with modifications. It forms the foundation of Dornbusch/Fischer/Startz's presentation.

Monetarism, 'New Classical Economics', Ecologism, and the Present State of the 'Synthesis'

During the 1950s and 1960s, most economists saw no reason for profound worries, so they were busy refining the 'synthesis', e.g. by the elaboration of huge econometric models, basically disaggregations of the IS-LM-schemes. The 'synthesis' had, however, left many loose ends. There was, for instance, a gap between macroeconomics, where instability was admitted, and the neo-classical microeconomic models where markets find their equilibrium automatically.

⁵⁶ Keynes, *op. cit.*, p. 292-312.

⁵⁷ Olivier Jean Blanchard, 'neoclassical synthesis', *The New Palgrave. A Dictionary of Economics*, edited by John Eatwell, Murray Milgate, Peter Newman, London and Basingstoke, Macmillan, 1987, volume 3, 1987, pp. 634-636, esp. p. 634.

The reality of the 1970s, with a combination of high inflation, high unemployment and high budget deficits, paved the ground for two massive attacks on the dominating paradigm, in particular on the Keynesian ingredients of the blend. Blaming Keynes for chronic budget deficits or high inflation rates was as unjust as bringing Malthus in connection with contraceptives, but that's what happened.

The Monetarists, led by Milton Friedman, of Chicago University, endeavored to show, on the basis of much empirical evidence, that monetary policy mattered much more than usually assumed. Business cycles, which Keynes and others attributed to fluctuations in aggregate demand, could in many cases better be explained by monetary contractions. These were substantial findings, and they justly found wide response. Friedman and others proposed, however, a rigorous monetary policy: The authorities should let the money stock grow according to prefixed targets. Apart from that, the government should abstain from any kind of stabilization policy, the markets could do better. If governments wanted to combat unemployment, they could do so by supply-side economics. This was again a substantial proposal because supply-side problems had been neglected by many Keynesians. But according to the monetarists, supply-side policy was the *only* appropriate thing.

The monetarist proposals had severe flaws. Just to mention one point, by arguing for a stably-growing money stock, they used the so-called Quantity Theory of Money, which already Ricardo and Malthus had discussed. This theory can be expressed as an equation:

$$\text{Real GDP} \times \text{Price Level} = \text{Money stock} \times \text{Velocity of Money.}$$

This equation is a kind of tautology. It says, for instance, that the price level will rise if we enlarge the money stock, *real GDP and velocity being stable*. If we let the money stock grow, the GDP being stable, and we *cannot* observe rising prices, then the money velocity has increased. The equation is always right.

Friedman and his followers assumed, however, that the velocity is constant. Under this condition, increases in the money supply necessarily produce inflation. But what happens if we cannot assume the velocity to be constant? That was exactly one of Keynes' issues. And what happens if markets do not exhibit that kind of inherent stability which the Monetarists assumed, when they demanded total neutrality of fiscal policy? Furthermore, the monetary aggregates (M1-M3) often diverge considerably, so which target should be chosen? Some monetarists advocated the monetary base. Dornbusch/Fischer/Startz, presumably Stanley Fischer, comment: 'The problem with monetary-base targeting is that the Fed might be hitting the bull's eye on the money-base target while completely missing the ultimate targets of policy. Unpredictable changes in the money multiplier and in velocity break the tight link between the money base and nominal GDP'⁵⁸.

For a short time, in 1979, when the US Federal Reserve Board accepted monetary targeting, the monetarist cause seemed to be victorious. But this was an illusion. According to Paul Krugman, the Fed practiced 'judo-politics'. The Fed directors thought that a monetary contraction was necessary, which, they knew, would produce a recession. By seemingly taking over monetarist recommendations, they could pass the blame for the recession over to their monetarist critics. As soon as the recession was over, there was no reason for playing this game any more. In Krugman's words: 'From a monetarist perspective, Federal Reserve policy after 1982 was nothing short of scandalous. The rate of money growth shifted erratically, sometimes rising to double digits, sometimes becoming negative [*as it was the case with the Bundesbank, W. Z.*]. For several years after the abandonment of targets, monetarists - Friedman in particular - routinely forecast a disastrous acceleration of inflation and/or a severe recession as a result of monetary instability. Yet the actual result was remarkably smooth sailing, ... Milton Friedman's forecasts of doom were at first taken seriously, then ridiculed, then ignored'⁵⁹.

⁵⁸ Dornbusch/Fischer/Startz, *op. cit.*, p. 384f.

⁵⁹ Paul Krugman, *The Age of Diminished Expectations. US Economic Policy in the 1990s, revised and updated edition*, MIT Press, Cambridge/Mass.-London, 1996, p. 107.

The monetarist offensive had revealed many weak points in the standard 'neo-classical synthesis', and it gave important impulses for the renewed discussion of the role and importance of monetary and fiscal policy under different conditions. But as an all-out offensive against the dominant blend of Keynesian and neo-classical theoretical ingredients, it was a failure. Dornbusch/Fischer/Startz reflects this.

The second great attack on the 'synthesis' came under the banner of 'New Classical Economics' (NCE). In contrast to monetarism, their followers only seldom hit the headlines, but they conquered some strongholds in the academic world. Also the NCE partisans could successfully point at inconsistencies in the standard paradigm, and give impulses to the debate. Robert Lucas, who received the Nobel Prize in 1995, effectively criticized many econometric models for assuming rational agents, but at the same time attributing wrong expectations to them. As the monetarists, the followers of NCE have been highly critical of fiscal policy, but they declared even changes in monetary policy, if anticipated, to be without effects. They explained economic fluctuations instead by sudden contractions on the supply-side ('Real Business Cycles'); the economy could best be understood assuming that markets are always in equilibrium, and that they adjust instantaneously. This assumption has been rather unappealing to most economists. And indeed, it is absurd. The idea of the irrelevance of monetary policy was, for instance, quite effectively falsified by the recession of 1979-81, which was caused by the above-mentioned, pre-announced restrictive policy of the Fed. Other studies show the same.

All in all, NCE has stimulated some interesting academic debates, but it has not revolutionized economics. Dornbusch/Fischer/Startz deems NCE important enough to devote quite some space to it⁶⁰, in order to dismiss it in the end. Obviously, they find Greg Mankiw's models, which try to bridge the gap between Keynesian macroeconomics and microeconomics, thereby closing

⁶⁰ Dornbusch/Fischer/Startz, *op. cit.*, p. 155-180.

an open flank of the 'synthesis', to be far more relevant ('breakthrough', 'milestone in the New Keynesian counterrevolution')⁶⁰.

Finally, the implicit growth optimism of the 'synthesis' has been challenged on ecological grounds. The 'Report to the Club of Rome' in the 1970s postulated 'limits to growth', due to the exhaustion of resources. But in 1999, these limits are further away than ever. Models which postulate limits to growth invariably contain the flaw that they assume that we go on producing exactly the same way. Then, certainly, we run into severe trouble after a while. But the very essence of economic growth is producing *differently*. Ecological problems have to be taken seriously, but there is nothing insurmountable about them. Just to give one example, technically all human energy production could be based on solar energy today. But the high prices prevent that for the time being. There exists by now a vast literature on the economy of ecological problems and policies. But this literature is completely compatible with the foundations of the synthesis. As a matter of fact, already in the 1930s Arthur Cecil Pigou, a neo-classical economist, developed the concept of 'external effects', one of the most important tools for analyzing ecological problems.

Unorthodox writers such as Herman Daly or Nicolas Georgescu-Roegen see humanity completely on the wrong track. Daly wants to introduce a 'stationary state' and quotes, among others, John Stuart Mill, but his line of reasoning has not much to do with Mill. Daly argues that the thermodynamic laws dictate that we cannot create new energy, only transform energy from low to high entropy, where it is less accessible. So our time is running out. Certainly. But the entropy laws do not constitute an economic barrier until the sun stops burning. Without mentioning them by name, Dornbusch/Fischer/Startz had presumably Daly and Georgescu-Roegen in mind when they wrote: '... this seems to be more of a concern for a course in

⁶⁰ *Ibid.*, pp. 183f.

astrophysics, or perhaps theology, than for a course in economics'⁶². So, ecological problems became a new field of economic studies, but they did not shake the theoretical foundations of the 'synthesis'.

Some Concluding Remarks

Arriving, after a voyage through the history of economic thought, at Dornbusch/Fischer/Startz, we observe, point one, that the dominant paradigm seems to have found some kind of equilibrium for the time being. The blend of Keynesian and neo-classical ingredients has survived, with modifications and refinements and more emphasis on monetary problems than some 20 years ago. As to the fundamental structure, the monetarist and NCE attacks have failed. And given the intense political debate about the questions discussed, the wealth of experiences and empirical studies, many of them quoted in the Dornbusch/Fischer/Startz, we may conclude that macroeconomic stabilization policies in countries such as the US rest on a rather stable theoretical basis.

Reading Dornbusch/Fischer/Startz, we observe further that obviously *only* problems that allow for mathematization are allowed to enter the fields of *Macroeconomics*. The reader is spared the technicalities, but almost everything is figures, variables, diagrams. Qualitative reasoning, perhaps on institutions, or mentalities, or human propensities, hardly exists. Ricardo's methodology seems to be uncontested, and for stabilization policy it seems to work.

But Dornbusch/Fischer/Startz displays also a strangely static view of society. When discussing macroeconomics, it should be an obvious problem to discuss why the role of government and public sector has so dramatically increased, up to one third of GDP in the US and two thirds in Sweden and Finland? The welfare state is not their subject, despite of its vast economic

⁶² *bid.*, p. 74.

implications. They discuss, in a way, a fictive market economy where the role of the state consists mainly in ensuring that there is enough good money, and that government expenses and taxes have the right effect on aggregate demand. Otherwise, the content of these government expenses is of no real relevance to them.

When comparing their book with Smith, Ricardo, Marx, over even Marshall, we notice that the range of issues has narrowed enormously. For instance, they seem to be hardly interested in the social consequences of economic policies. Social groups hardly exist, there are mainly households.

In more general terms, society and social and historical change lie outside. The book deals almost exclusively with short-term problems. The long run appears mostly as models postulating that the markets come into balance again by themselves. A few problems of long-term growth are treated in chapters 3 and 4, but they are disappointingly thin. We learn something about savings, investment and growth rates, but the point that longer growth also means profound social (and political) change, from agricultural society to industrial society to service and information society, each with distinct social groups and social problems, does not enter the book. These problems were at the very center of the work of Smith or Marx.

And strangely enough: When comparing growth rates of various countries, Dornbusch/Fischer/Startz approvingly quotes Robert E. Lucas: 'Is there some action a government of India could take that would lead the Indian economy to grow like Indonesia's or Egypt's? If so, what exactly? If not, what is it about the 'nature of India' which makes it so? The consequences for human welfare involved in questions like these are simply staggering. Once one starts to think about them, it is hard to think about anything else'⁶³.

⁶³ *Ibid.*, p. 63.

Right. But then, our authors leave these staggering questions aside, apart from a few pages. The reason for this striking omission lies presumably again in the way Dornbusch/Fischer/Startz defines the area of macroeconomics. It is impossible to discuss the economic perspectives of India without talking about institutions and traditions, about education, rule of law, or demography, all problems which Mill, Marx or Weber debated thoroughly, but which our authors regard as lying outside their field. But what kind of economics is it that is not willing to discuss the most staggering economic problems of the world?

The necessity of discussing institutions is most obvious in the case of developing countries. But it is certainly also important for advanced economies. Between 1970 and 1991, the index of Great Britain's GDP per inhabitant at purchase power parities (OECD-average=100) fell from 93 to 88, whereas Germany's rose from 105 to 110⁶⁴. Has Germany simply been lucky? Or is it the labor market institutions, with a lower conflictuality in Germany than in Britain? Or has Germany's education system been better? According to Dornbusch/Fischer/Startz, human capital is extremely important for long-term growth. But they devote not even one page to this subject⁶⁵.

In 1999 Stanley Fischer had ample opportunities to discuss the economic importance of institutions. The IMF, of which he is first deputy director, has been massively criticized for its handling of the problems of countries such as Russia. Joseph Stiglitz, chief economist of the World Bank, has been most outspoken. As reported by the *Economist*: 'Mr Stiglitz says much of this dismal performance [of the Russian economy] stems from the intellectual inadequacies of the previous approach. There was, he argues, too much emphasis on macroeconomic stabilization at the expense of institution-building ... It would have been better, argues Mr Stiglitz, to have proceeded more slowly – building a regulatory framework before privatization,

⁶⁴ OECD National Accounts, as quoted in *Nya villkor för ekonomi och politik. Ekonomikommisionens förslag, (Staterz's offentliga utredningar 1993:16), Stockholm, 1993, p. 13.*

⁶⁵ Dornbusch/Fischer/Startz, *op. cit.*, p. 46f.

and concentrating on strengthening the rule of law and on creating effective institutions, such as courts. He likens the misguided zeal with which Russian reformers and their western advisors [such as Stanley Fischer, W.Z.] set about changing a society overnight to that of the Jacobins and, yes, the Bolsheviks'⁶⁶.

We are in no position to judge whether the IMF mishandled the Russian problems. But we can state that the same kind of 'intellectual inadequacies', which Joseph Stiglitz sees at the IMF, we can find in reading Dornbusch/Fischer/Startz.

⁶⁶ *The Economist*, September 18th 1999, p. 93. As a matter of fact, Dornbusch/Fischer/Startz, *op. cit.*, pp.72-74, very briefly deal with Russia, and they mention institutional problems too. 'This agenda is overwhelming ... Since all changes are interdependent, ideally they should all take place at once'. So they were 'set about changing a society overnight'? And how come that China could introduce some reforms without changing everything at once? See also Stanley Fischer, 'What went wrong in Russia', *Financial Times*, 27 September 1999, p. 16, and Paul Welfens, 'What went wrong at the IMF', *Financial Times*, 5 October 1999, p. 17.

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