

Economic Theory

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1. Introduction

This paper examines some of the fundamental issues in economic theory. It looks at some of the most popular concepts and theories that have been originated by various schools of thought in the study of economics. Thus, the paper examines the following:-

- a) The Mercantilists School
- b) The Physiocrats
- c) **The Classical/Neo-Classical School**
- d) The Marginalist School
- e) The Marxist School
- f) The Institutional School
- g) **The Keynesian School**
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Economic theory has evolved over many years, and continues to influence government economic policies all over the world. The main discussion in this chapter will be focussed on the principles and concepts introduced by the:

- a) The Classical/Neo-Classical School;
- b) The Keynesian School; and
- c) The Monetarists School.

2. The Mercantilists School

Originated by merchants and statesmen, mercantilists economic theory dates back to the **16th and 17th centuries** (between 1550 and 1776).

Some of the core philosophies in mercantilism are:

- National self-sufficiency is encouraged
- That the wealth of a nation is determined by how much gold and silver it has accumulated
- That the only way that countries can accumulate gold and silver is when its exports exceed its imports
- Trade surplus is encouraged
- Trade protectionism is also encouraged, by restricting imports, imposing tariffs on foreign imports and granting subsidies to local producers
- That when a trade surplus is achieved, the foreign country with the deficit is compelled to ship gold and silver to the country with the surplus, in order to cover the trade deficit that has occurred.

One of the leading pioneers of the mercantilists movement was **Thomas Mun (1571-1641)**. He was a wealthy merchant who was involved in international business and trade. He was also a director of the East India Company.

3. The Physiocratic School

Physiocracy as an economic theory, had its origins from France in the 18th Century. The physiocratic movement was founded by **Francois Quesnay (1694-1774)**, who was a doctor of medicine at the Royal Court of King Louis XV of France.

The physiocrats who were sometimes referred to simply as “**the economists**” or “the sect”, were opposed to the mercantilists philosophy. They were seen to be a better alternative to mercantilism.

Some of the core beliefs of the physiocratic school are:

- That accumulation of gold and silver is not the source of true wealth
- That only wealth generated from land and agriculture could increase and multiply wealth
- That industry and commerce could never generate enough wealth
- That agriculture should be given priority and that scientific agricultural methods should be applied
- That free trade should be encouraged in order to obtain fair prices
- That since only land and agriculture produce wealth, they alone should be taxed

The Physiocratic School originated the concept of Laissez-Faire economics (see the Classical School below).

4. The Classical/Neo-Classical School

Writers discussed under this school are some of the earliest contributors to modern day economic theory. Their brand of work is known as classical economics. The classical theories were very popular in the **18th and 19th centuries**. The neo (new) classical theories are an extension of the classical theories.

The classical school believed:

- In free trade and free markets
- That governments should not intervene in the workings of the economy.
- That the economy would adjust itself without intervention.
- That anything that interferes with the free workings of the financial markets should be eliminated.
- That free trade and free market will result in economic prosperity.

This classical approach in economics is known as a **Laissez Faire** approach.

Some of the best known contributors to classical economics are:

- Adam Smith
- David Ricardo
- Jean-Baptiste Say
- Thomas Robert Malthus
- Alfred Marshall
- Irving Fisher

a) **Adam Smith (1723 – 1790)**

Adam Smith is generally regarded as the father of economics. He was a philosopher and an economist who became well known after the publication of his famous book “**An enquiry into the Nature and Cause of the Wealth of Nations**” in 1776.

Adam Smith was born in Scotland and studied at both Glasgow University and Balliol College, University of Oxford. At Glasgow University, he was appointed Professor of Logic (1751), then Professor of Moral Philosophy (1752) and lectured on natural theology, ethics, jurisprudence and economics.

The basic principles that underlined the study of the free market economy as we know now, were originated by Adam Smith, where he advocated for free trade, free markets and lower taxes.

Below is an extract from ‘The Wealth of Nations’:

“By restraining, either by high duties, or by absolute prohibitions, the importation of such goods from foreign countries as can be produced at home, the monopoly of the home-market is more or less secured to the domestic industry employed in producing them. Thus the...high duties upon the importation of corn, which in times of moderate plenty amount to a prohibition, give a like advantage to the growers of that commodity. The prohibition of the importation of foreign woollens is equally favourable to the woollen manufacturers. The silk manufacture, though altogether employed upon foreign materials, has lately obtained the same advantage. The linen manufacture has not yet obtained it, but is making great strides towards it. Many other sorts of manufacturers have, in the same manner, obtained in Great Britain, either altogether, or very nearly a monopoly against their countrymen...”

That this monopoly of the home-market frequently gives great encouragement to that particular species of industry which enjoys it...cannot be doubted. But whether it tends either to increase the general industry of the society, or to give it the most advantageous direction, is not, perhaps, altogether so evident....

The natural advantages which one country has over another in producing particular commodities are sometimes so great, that it is acknowledged by all the world to be in vain to struggle with them. By means of glasses, hotbeds, and hotwalls, very good grapes can be raised in Scotland, and very good wine too can be made of them at about thirty times the expense for which at least equally good can be brought from foreign countries. Would it be a reasonable law to prohibit the importation of all foreign wines, merely to encourage the making of claret and burgundy in Scotland? But if there would be a manifest absurdity in turning towards any employment, thirty times more of the capital and industry of the country, than would be necessary to purchase from foreign countries an equal quantity of the commodities wanted, there must be an absurdity, though not altogether so glaring, yet exactly of the same kind in turning towards any such employment a thirtieth, or even a three hundredth part more of either...as long as the one country has those advantages, and the other wants them, it will always be more advantageous for the latter, rather to buy of the former than to make. It is an acquired advantage only, which one artificer has over his neighbour, who exercises another trade; and yet they both find it more advantageous to buy of one another, than to make what does not belong to their particular trades.

Merchants and manufacturers are the people who derive the greatest advantage from this monopoly of the home market. The prohibition of the importation of foreign cattle, and of salt provisions, together with the high duties upon foreign corn, which in times of moderate plenty amount to a prohibition, are not near so advantageous to the graziers and farmers of Great Britain, as other regulations of the same kind are to its merchants and manufacturers. Manufacturers, those of the finer kind especially, are more easily transported from one country to another than corn (2) or cattle. It is in the fetching and carrying manufacturers, accordingly, that foreign trade is chiefly employed. In manufactures, a very small advantage will enable foreigners to undersell our own workmen, even in the home market. It will require a very great one to enable them to do so in the rude produce of the soil. If the free importation of foreign manufacturers were permitted, several of the home manufacturers would probably suffer, and some of them, perhaps, go to ruin altogether, and a considerable part of the stock and industry at present employed in them, would be

forced to find out some other employment. But the freest importation of the rude produce of the soil could have no such effect upon the agriculture of the country."

Basically, Adam Smith was the one who **founded Capitalism**.

Many subsequent economists were influenced and inspired by the work of Adam Smith.

b) David Ricardo (1772 – 1823)

Another British economist, David Ricardo, who was the third son of his father's seventeen children, was one of the most influential figures in classical economic theory. Ricardo's parents descended from orthodox Iberian Jews who fled to Holland as a result of severe persecution. Ricardo's father was a stockbroker, who later migrated to England shortly before Ricardo was born. Ricardo had a brief study in Holland at the age of 14, but was later employed by his father to work at the London Stock Exchange, where he excelled at his job.

At the age of 21, Ricardo was completely disowned by his father for marrying a Quaker, against his father's wishes and his Jewish faith. He set up his own business that dealt with government securities and became rich and successful. He became excited about economics after reading Adam Smith's work on the "Wealth of Nations".

Naturally, Ricardo supported Adam Smith's ideas of free trade and free market without protectionism. Some of Ricardo's immense contributions to economic theory are:

- He linked inflation with excessive money supply, when in 1809 he wrote that England's inflationary problems were caused by the excessive bank notes issued by the Bank of England.
- In his "Essay on the Influence of a Low Price of Corn on the Profits of Stock" (1815), he originated the "Law of Diminishing Returns" in economics.
- It was Ricardo who also originated the concept of comparative costs, now known as the "Law of Comparative Advantage" in International Trade.

David Ricardo became a Member of Parliament in 1819 as an independent candidate, representing Ireland.

c) Jean-Baptiste Say (1776 – 1832)

Another follower of Adam Smith and a supporter of free market and trade is French economist, Jean-Baptiste Say. Though born in Lyon France he spent most of his early life in Geneva and London. When he went back to France, he worked for a life assurance company in Paris, where he became very influential. He later held a chair of Political

Economy at the Conservatoire des Arts et Metiers and later at the College de France. Say's contributions to economic theory include the following:

- He classified the factors of production into three different areas, namely:
 - Land
 - Labour
 - Capital
- His later contributions in including entrepreneur as one of the factors of production.
- He is however, best known for what is called **"Say's Law"** or the "Law of Markets".

The basic premise of Say's law is that:

"Supply creates its own demand".

The law states that any increase in the supply (production) of goods and services will lead to an increase the demand (expenditure) of those goods and services; and that there will be no shortage of demand, but full employment for all workers. If there happens to be unemployment, it would be temporary, as a result of changes in demand pattern. The economy would later readjust itself to an equilibrium, as it had been. Basically, that total demand in an economy cannot exceed or fall below total supply in that economy. This is because, even where supply exceeds demand, suppliers will reduce prices to the point where it will lead to an increase in demand until and equilibrium is achieved. Thus, supply is creating its own demand.

d) **Robert Thomas Malthus (1776 – 1834)**

A full and detailed discussion of Robert Malthus is contained in the chapter on "Population, Development and the Environment".

In his famous "Essay on Principle of Population" (1798), Malthus predicted a gloomy future for humanity. By using David Ricardo's concept of diminishing returns, he felt that the available resources (food) would not be enough to cope with an uncontrolled population rise. He said, this is because the population was increasing in a geometrical progression i.e. 1,2,4,8,16,32,64, etc, which food production was increasing in an arithmetical progression i.e. 1,2,3,4,5,6,7,8, etc.

To overcome this 'nightmare' scenario, he suggested radical ways of controlling the population rise.

Malthus also disagreed with the general classical theory that a market economy can automatically create full employment. Rather, he believed that unemployment was caused by too much savings and not enough spending.

e) **Alfred Marshall (1842 – 1924)**

An important neo-classical British economist who was the most prominent in his time, and contributed enormously to the development of economics is Alfred Marshall. Born in London, Sir Alfred Marshall was educated at Merchant Taylor's School and later at St John's College, University of Cambridge. He was principal of University College, Bristol and later became a lecturer and fellow of Balliol College, University of Oxford, between 1883 and 1884.

He became professor of political economy at University of Cambridge from 1885 – 1908 and was a member and fellow of the Royal Commission on Labour in 1891 and the British Academy in 1902 respectively. He founded the Cambridge School of Economics where John Maynard Keynes (see Keynesian School below) was one of his pupils.

Alfred Marshall wrote several works, but by far his most prominent was his book "Principles of Economics" which was published in 1890.

Some of the main contributions of Sir Alfred Marshall are that he introduced the following:

- The concept of elasticity of demand and supply
- The supply and demand curve
- Partial equilibrium analysis
- A shift on the demand and supply curves
- The concept of consumer surplus
- Concept of producer surplus, this is the amount the producer is actually paid, minus the amount that he is willing to accept

There is no doubt that his contributions tremendously influenced economics.

f) **Irving Fisher (1867 – 1947)**

Another respected and influential neo-classical economist, Irving Fisher was an American who was born in New York. Fisher had a first degree in Mathematics at Yale University and later studied economics and graduated with a doctorate degree (PhD).

Fisher held several posts at Yale, including the following:

- Instructor of mathematics (1890 – 1891)
- Tutor in mathematics (1891 – 1893)
- Assistant professor of mathematics (1893 – 1895)
- Assistant professor of political and social science (1895-1935)
- Professor emeritus (1935-1947)

Some of Irving Fisher's contributions to economics include the following

- He introduced the index number system. This system is now used in the measurement of several things, including inflation (the retail price index).
- In his publication, titled "The Purchasing Power of Money" (1911), Fisher postulated the famous "Equation of exchange" also known as the Fisher's equation.
- His equation of Exchange was the foundation stone to his "Quality Theory of Money".

The Equation of Exchange

The equation of exchange is presented in several slightly different formats, but the most commonly presented format is:

$$MV = PT$$

Where:

- **M** is the amount of money circulating in the economy
- **V** is the velocity (speed) of circulation of that money
- **P** is the average price level in the economy, and
- **T** is the number of transactions that are taking place in the economy.

By using a simple example to explain the equation, let us assume that an economy's total money supply is £100. Assuming that this total money supply was on average, used 200 times in the year, it would amount to £2,000 (i.e. £100 x 200) worth of expenditure in the economy, in that year.

Remember that in this example:

$$M = £100$$

$$V = 200$$

$PT = £2,000$

The belief is that, on the long-term V and T would continue to remain stable, but any increase in M , would lead to a proportionate increase in P , leading to inflation.

The Quantity Theory of Money

The quantity theory of money is a derivative of the equation of exchange. The theory holds that inflation is caused by a rapid increase in the quantity of money (the money supply) in circulation. On the other hand, deflation is caused by a decrease or a very slow increase in the money supply. Thus, inflation can be kept under control by controlling the money supply.

5. The Marginalist School

A French economic movement, The Marginalist School was founded in the 19th Century.

Acknowledged as one of the most important pioneers of the marginalist school, **Antoine Augustin Cournot (1801 – 1877)** contributed enormously to the study of economics in his most popular work “Researches into the Mathematical Principles of Wealth” (1838).

Some of the contributions of the marginalist school are:

- That prices of goods and services are dependent on the level of demand. Compare this with the classical theory that prices are determined by the cost of production.
- That the level of demand for goods and services is determined by the level of satisfaction consumers attained from the goods and services.
- That the factors of production receives proportionate returns (factor returns) for their contributions towards the production of goods and services.
- The marginalist school provided the basic analytical tools of demand and supply, consumer utility and the mathematical framework for the use of these tools.

6. The Marxist School

The Marxist school was completely opposed to the capitalist free market economic theories that were promoted by the classical school.

The founder of this movement, **Karl Marx (1818-1883)** is generally regarded as the father of socialism and communism. Born in Trier, Germany, Karl Marx was a radical philosopher, social scientist, historian and revolutionary. Marx went to Paris to publish his radical philosophy, but was banned from Paris in 1845, as he was considered too dangerous. He then went to Belgium and with others joined a secret society called the 'Communist League' under which he propagated Marxism. He was again banned from Belgium in 1848. In 1849 Marx finally headed for London where he lived and carried out his activities for the rest of his life. In 1864, Marx, coupled with others, founded the "International Working Men's Association" in London.

Karl Marx predicted that Capitalism would in the end, destroy itself as a result of its inherent contradictions. In one of his writings, in 1844, he said:

"The labour theory of value, the exploitation and alienation of the worker, a falling rate of profit ensure an inevitable crisis, leading to revolution and eventually to the socialist state. The worker becomes all the poorer the more wealth he produces, the more his production increases in power and range. The worker becomes an ever cheaper commodity the more commodities he creates".

In another of his statements he said:

"the crisis of capitalism were certain to manifest themselves in falling rates of profit, mounting hostility between workers and employers, and ever more severe depressions. The outcome of class warfare was fated to be revolution and progress forward, first socialism and ultimately communism. In the first stage a strong state would still be required in order to eliminate the remnants of capitalist opposition. Each person's work would be rewarded to the value of his or her contribution. Once communism was achieved, the state, whose central purpose was class domination, would wither away, and each individual would in the utopian future be compensated according to need."

Some of the main areas of Marxist economic philosophy are:

- That all production belongs to labour as it is the worker that produces all the goods and services in society.
- That the free market economic system encourages the exploitation of the workers, as they are denied a fair share of what they produce.

- That the Capitalist system will continue to create misery for workers, as increased competition would make capitalists to replace workers with machines in order to save costs.
- That capitalism creates unemployment.
- That the frustrated and deprived workers would eventually rise up and seize the means of production and liberate the masses.

Marxism influenced the development and rise of the trade union movements.

7. The Institutionalist School

Founded in the United States in the **19th Century**, the institutionalist school disagree with the classical view of completely free, non-government controlled and laissez-faire system of economic theory. They believe that government should have more control in the economic activities and to make social reforms, in order to bring about a more equitable distribution of income and wealth.

And that the individual's economic behaviour was influenced by the country's laws of living and modes of the thought in society.

Some of the core beliefs of institutionalism are:

- More government control in the economy to redress inequality.
- Rather than individuality, group behaviour should be at the core in society.
- That individuals are influenced by motives that cannot be measured quantitatively.
- The encouragement of uniformity of laws, customs and habits in order to be effective in organising economic activities.
- That sources of conflict of interests in the social structure should be identified and corrected.

One of the founding fathers of institutionalism is an American economist and social critic, of Norwegian descent, **Thorstein Veblen (1857-1929)**.

8. The Keynesian School

Keynesian economics got its name from the originator **John Maynard Keynes (1883 – 1946)**.

The rise of Keynesian economics was precipitated by the great economic depression in the 1930s, as classical economists could not provide credible answers to the persistent and unrelenting economic woes at that time. Thus, Keynesians had their opportunity to provide an alternative explanation to the economic problems.

(a) John Maynard Keynes (1883 – 1946)

John Maynard Keynes is generally accepted as one of the most important contributors in the development of economics.

Born in Cambridge, England, to a Cambridge economist and logician John Neville Keynes, John Maynard Keynes was educated at Eton, and won scholarship to study classics and mathematics at King's College, University of Cambridge. After taking up a career in the Civil Service, Keynes gained a fellowship at King's College in 1909 and started writing on economic issues.

He later joined the Treasury Department of the UK government, dealing with financial issues relating to the First World War. As a senior Treasury official, Keynes was sent as one of the British delegates to the **Versailles Peace Conference** in Paris in 1919. He made public his opposition against the very harsh conditions that the victorious allied forces imposed on Germany at the conference. He resigned and wrote "The Economic Consequences of the Peace" (1919). He felt that the harsh war reparations imposed on Germany would not work and that this would lead to future conflict in Europe.

An extract of "The Economic Consequences of the Peace" is as follows:

"The power to become habituated to his surroundings is a marked characteristic of mankind. Very few of us realise with conviction the intensely unusual, unstable, complicated, unreliable, temporary nature of the economic organisation by which Western Europe has lived for the last half century. We assume some of the most peculiar and temporary of our late advantages as natural, permanent, and to be depended on, and we lay our plans accordingly. On this sandy and false foundation we scheme for social improvement and dress our political platforms, pursue our animosities and particular ambitions, and feel ourselves with enough margin in hand to foster, not assuage, civil conflict in the European family. Moved by insane delusion and reckless self-regard, the German people overturned the foundations on which we all lived and built. But

the spokesmen of the French and British peoples have run the risk of completing the ruin which Germany began, by a peace which, if it is carried into effect, must impair yet further, when it might have restored, the delicate, complicated organisation, already shaken and broken by war, through which alone the European peoples can employ themselves and live.

In England the outward aspect of life does not yet teach us to feel or realise in the least that an age is over. We are busy picking up the threads of our life where we dropped them, with this difference only, that many of us seem a good deal richer than we were before. Where we spent millions before the war, we have now learnt that we can spend hundreds of millions and apparently not suffer for it. Evidently we did not exploit to the utmost the possibilities of our economic life. We look, therefore, not only to return to the comforts of 1914, but to an immense broadening and intensification of them. All classes alike thus build their plans, the rich to spend more and save less, the poor to spend more and work less.

But perhaps it is only in England (and America) that it is possible to be so unconscious. In continental Europe the earth heaves and no one but is aware of the rumblings. There it is not just a matter of extravagance or 'labour troubles'; but of life and death, of starvation and existence, and of the fearful convulsions of a dying civilisation.

For one who spent in Paris the greater part of the six months which succeeded the armistice an occasional visit to London was a strange experience. England still stands outside Europe. Europe's voiceless tremors do not reach her. Europe is apart and England is not of her flesh and body. But Europe is solid with herself. France, Germany, Italy, Austria, and Holland, Russia and Romania and Poland, throb together, and their structure and civilisation are essentially one. They flourished together, they have rocked together in a war which we, in spite of our enormous contributions and sacrifices (like though in a less degree than America), economically stood outside, and they may fall together.

In this lies the destructive significance of the Peace of Paris. If the European civil war is to end with France and Italy abusing their momentary victorious power to destroy Germany and Austria-Hungary now prostrate, they invite their own destruction also, being so deeply and inextricably intertwined with their victims by hidden psychic and economic bonds. At any rate an Englishman who took part in the Conference of Paris and was during those months a member of the Supreme Economic Council of the Allied Powers, was bound to become – for him a new experience – a European in his cares and outlook. There, at the nerve centre of the European system, his British

preoccupations must largely fall away and he must be haunted by other and more dreadful spectres. Paris was a nightmare, and everyone there was morbid. A sense of impending catastrophe overhung the frivolous scene; the futility and smallness of man before the great events confronting him; the mingled significance and unreality of the decisions; levity, blindness, insolence, confused cries from without—all the elements of ancient tragedy were there. Seated indeed amid the theatrical trappings of the French saloons of state, one could wonder if the extraordinary visages of Wilson and of Clemenceau, with their fixed hue and unchanging characterisation, were really faces at all and not the tragic-comic masks of some strange drama or puppet show..."

Although he published several articles and books, including "A Treatise of Money" (1930), by far his most important book was "A General Theory of Employment, Interest and Money" (1936). He argued that unemployment was caused by lack of demand for goods and services in the economy and that the government can reverse the problem by increasing its spending to stimulate increased demand and economic activities.

(b) **Keynesian Economics**

John Maynard Keynes believed that classical economic theories did not fully reflect what happens in the real world. Thus, in his 1936 book, he began to explain the causes of the depression, the theory of aggregate demand and its effects on output and inflation.

Also that, contrary to what classical economist believed, there is no automatic tendency for the level of output and employment in the economy to move toward full employment.

The main conclusion of Keynesian economic theory is:

- That the government should increase spending to take the economy out of recession. This is vital in cases of recession that is caused by a deficiency in aggregate demand in the economy.
- That aggregate demand is influenced by several different factors, which includes spending and taxation policy.
- That changes in aggregate demand have their greatest short-run on real output and employment, but not much on prices.
- That prices, but in particular, wages respond slowly to changes in supply and demand, which results in the shortages and surpluses, particularly of labour.
- That the typical level of unemployment is never ideal. This is partly because unemployment is subject to the state of aggregate

demand, and partly because they believe that price do not respond immediately to changes in aggregate demand, but adjust gradually.

- Some Keynesians argue for drastic economic stabilisation policy to reduce the impact of the economic cycle (the boom and burst effects). Many consider this as the most serious of all the economic problems.
- That lower taxes will lead to inflation, as consumers have greater purchasing power as a result of the lower taxes. This increased purchasing power will make consumers spend more, which will lead to higher prices (inflation).
- That unemployment and inflation are trade-offs. This was explained by the use of the **Phillips Curve**.
- Many Keynesians believe that fighting unemployment is more important than fighting inflation.

There is no doubt that many aspects of Keynesian economics continue to influence government policy in many parts of the world.

9. The Monetarists School

The Monetarists school was founded by **Milton Friedman**. Monetarism gained popularity during the global economic problems in the 1970's when both interest rates and the level of unemployment were rising concurrent and Keynesian economic theory could not convincingly explain why the economy was behaving the way it was. Thus, monetarist economic theory became much more plausible for many governments.

This school, got its name from the fact that it is preoccupied with controlling the money supply.

a) Milton Friedman (1912)

Milton Friedman was born in New York in 1912 and is regarded as one of the greatest economists of our time. He is regarded as laissez-faire economist who believes greatly in the free market economy. He studied at Rutgers University (1932), University of Chicago (1933) and completed a doctorate degree (PhD) at Columbia University in 1946. He later became Professor Emeritus of Economic, University of Chicago, where he carried out most of his work. Thus, many describe his movement as the Chicago School of Monetary economics. Milton Friedman received the Nobel Prize for economic science in 1976 and also became a research fellow at the Hoover Institution in 1977. He received several awards and

honorary degrees and became a member of President Ronald Reagan's Economic Advisory Board in 1981.

b) **Monetarism**

Monetarists are a derivative of the neo-classical school and monetarist economic theory is a more sophisticated extension of Irving Fisher's Quantity Theory of money.

If we go back to the Equation of Exchange (which is the foundation to the Quantity theory of money), which states that:-

$$MV = PT$$

That **V** would be relatively stable and **T** would tend towards full employment, Milton Friedman extended this by saying that on the long-run, both **V** and **T** are determined independently.

Therefore:

$$\uparrow M \rightarrow P \uparrow$$

Meaning that inflation occurs when the growth of the money supply is faster than the growth of production output in the economy. That inflation would adversely affect the economy as it creates uncertainty. This in turn could lead to:

- A reduction in spending
- A reduction in the level of investment
- A reduction in international competitiveness, as goods and services at home becomes too expensive for foreigners to buy.

As we have seen earlier, Keynesians (as expressed in the Phillips curve) believe that there is a trade-off between inflation and unemployment. Meaning that a government's fight to reduce unemployment would create inflation and a fight to reduce inflation would create unemployment.

However, this assertion was thrown into confusion when Keynesians had no concrete explanations to what was happening in the 1970's when both inflation and unemployment was rising concurrently (**a stagflation**).

Milton Friedman (though a monetarist) sought to adapt the Phillips curve to explain why stagflation was occurring. He explained that expectations were influencing the Phillips Curve, thus, his enhanced curve was named "**expectations-augmented**" Phillips curve, which takes into account the effects of inflationary expectations on the curve. Basically, Friedman believed that if people expects inflation to rise, they would expect a higher rise in wages and acts accordingly.

Thus, on the short-run, an increase in the growth of the money supply would lead to an increase in aggregate demand, which will lead to higher rate of employment.

However, people will act out their inflationary expectations, by expecting higher wages, which in turn leads to inflation. A further persistent expectation could lead to further inflation.

Some of the main characteristics of monetarists policies are:

- That the economy is inherently stable
- The belief in free market and trade
- Proper control of the money supply
- Control inflation
- Government intervention to reduce unemployment by way of fiscal policy is discouraged as the economy is expected to go back automatically to the national rate of unemployment.
- The only acceptable way to change the acceptable rate of unemployment is by using supply-side policies.

While monetarists policy still exists, monetarism lost its appeal in the early 1980's when contrary to monetarists theory the British economy went into deep recession, with high inflation and economic instability. As a result, the government abandoned monetarism and reverted more towards Keynesian economic policies.

10. Supply Side Economics

a) Introduction

A lot of economic theories, including that of Keynesian, emphasised on demand based economics (which ignores the supply side of the equation). For example, Keynesian theory states that unemployment is caused by insufficient aggregate demand in the economy and that the government can increase aggregate demand in the economy by increasing spending.

Supply side economics on the other hand, looks primarily at the supply aspects (producers/suppliers of goods and services) of economic policy. Supply side economics was developed in the 1970s by the following:

- i) Robert Mundell

Robert Mundell is a Canadian economist who studied at the University of British Columbia in Vancouver, Canada and at the Massachusetts Institute of Technology (MIT), USA.

He won the Nobel Prize in Economics in 1999.

ii) Jude Wanniski

Jude Wanniski was an Associate editor of the Wall Street Journal and the founder of "supply Side University", which is an on-line learning centre. He is also the author of the book "The Way the World Works".

iii) Arthur Laffer

An economist, Arthur Laffer developed the "Laffer Curve" to justify supply side economic principles.

b) Principles of Supply Side Economics

The principles of supply side economics are quite straight forward, namely that there will be greater economic prosperity by cutting taxes on producers (suppliers), businesses and individuals. This will reduce the cost of production of suppliers and also increase the purchasing power of consumers.

Thus, supply side economics advocate the following:

- Reduce or cut taxes (remember that Keynesian believe that tax cuts will lead to inflation).
- Fewer restrictions, rules and regulations imposed on producers/suppliers, as such regulations can be very expensive for producers.
- Less government control on producers and suppliers.
- Government should allow producers and suppliers to get on with their job, without unnecessary interference.

By cutting taxes, it is believed that the supply of labour (employment) and investment will increase, which in turn will lead to economic growth. Basically that high taxes are bad for the economy, as they will discourage investment and entrepreneurship, which leads to slow economic growth and unemployment. It is believed that lower taxes will not only increase investment but also that it will encourage more people to work, which will in the end, result in increased tax revenue for the government.

The underlying principle of supply side economics is derived from the classical school, who advocated trade that is free from government interference. To some extent, supply side economics is a derivative of Say's Law (see classical school above).

c) **Origin of Supply Side Economics**

Supply side economics was developed to explain the stagflation of the 1970s, when both unemployment and inflation was high, contrary to Keynesian economics that they were trade-offs. Keynesian economists were unable to convincingly explain the economic phenomenon.

That period also witnessed very high taxes. Supply side economists believed that the high taxes were the main problem as:

- They reduced incentive to work and save.
- They were leading to cost-push inflation. This is inflation caused by high costs of factors of production.
- There were too many government regulations and laws that restricted producers.
- High transfer payments (e.g. social welfare) was a disincentive for people to work.

Conclusion

Government economic policies are normally influenced by the contributions of almost all the schools that have been examined in this chapter.

Self-Assessment Questions

1. *What are the fundamental principles behind classical economics?*
2. *To what extent does keynesian economics differ from classical economics?*
3. *To what extent does monetarism differ from classical economics?*
4. *In your opinion, which of the economic theories discussed in this chapter is the most important? Justify your opinion.*

