BOMA 11

Beyond Keynesianism and Monetarism

All businessmen have heard the plea: `Lord give me a one armed economist'; and the joke: `If all the economists were placed end to end they would never reach a conclusion'. Most businessmen are under the impression that economists seldom agree with each other but that is not entirely fair.

Economics is simply a theory which tries to explain human behaviour in relation to acquisition, production, consumption etc. Like any theory the best test of how good it is its ability to predict what will happen in defined circumstances. It does not come near the predictive accuracy achieved by the physical sciences but among social sciences its record is the best.

The discipline is divided broadly into two sub disciplines and an approximately equal number of trees is sacrificed to each.

Micro economics explains how individuals behave when faced with economic incentives and disincentives. Its predictive value is pretty good; people and businesses do buy less when the price is raised and so on. Consequently economists generally agree about micro economics.

Macro economics explains how whole economies behave when the big (aggregated) elements of them such as budget deficits and terms of trade change or are changed. Because there are too few economies and each has too many variables it has not been possible to test macro economics `in the field', in the way micro economics is tested. Not surprisingly economists are less inclined to agree about it.

Macro economic theory divides into several warring schools (sects); it seems to me, as much along political as economic lines. For decades the most vehement debate was that waged between Monetarists and Keynesians attempting to explain unemployment. (Or rather, neo-Keynesians, since Keynes should not be blamed for much that was said in his name.) The warfare has become less intense with the partial eclipse of Keynesianism.

Monetarists, particularly those of the rational expectations variety, suppose an equilibrium in which everyone knows and acts in his own interest. People and capital wanting to be employed will reduce asking prices until the market clears and there is no unemployment. The model thus fails to explain how involuntary unemployment is possible and seems at odds with reality. Why don't the rational people wanting work reduce their asking price right down to the wage which is worth less to them than the value of the food and shelter they can produce for themselves with a Robinson Crusoe lifestyle--- which is very little indeed?

Keynesian economics explains involuntary unemployment in terms of deficient demand but fails to explain in micro economic terms how people cause demand to be deficient. It does not explain how anyone is better off by acting in ways which leave willing workers unemployed. Keynesian models fell into disrepute when stagflation became endemic. Keynesians believed that unemployment was caused by too little demand and inflation by too much. Faced with both at the same time they could not have both ways.

Keynes wrote in *The General Theory*:

> with a given organisation, equipment and technology, real wages and the volume of output (and hence of unemployment) are uniquely correlated so that in general an increase in employment can only occur to the accompaniment of a decline in the rate of real wages.

Both he (but not most of the neo-Keynesians) and the monetarists accepted that in times of involuntary unemployment *real* wages had to fall if the market was to clear. Keynes believed *money* wages were `sticky' downwards and that *real* wages should be cut by allowing firms to raise prices. Firms were allowed to raise prices by the government buying more itself; that is one way of increasing nominal demand. This begs the question, why do real wages `stick' at unemployment levels?---it seems irrational.

Lord Keynes obviously did not believe full employment was consistent with full wage indexation.

The dilemma of wages which `stick' above full employment levels is not avoided, for either school, simply by pointing to employer and union monopolies although, as we shall see, monopolies are an essential part of an explanation. A firm which has a monopoly, like everybody else, tries to get as much profit as possible. Absence of competition allows it to raise the price of what it produces. High price reduces sales but up to a point profits get bigger. (The seamen's' Union have shown that it is possible to go beyond the point where total profits maximise; coastal non-bulk shipping is all but eliminated.)

For instance a monopoly (or tightly organised duopoly) airline might double the price for its tickets; even if traffic fell to half, which it might not, it would still make more profit as it would need to fly fewer aircraft.

Monopolies produce less at higher prices than will maximise the community's welfare but what they produce, they sell. They do not raise prices above those at which all they have produced can be sold or leave expensive aircraft lying idle. Why don't monopoly trade unions avoid idle workers by asking the Arbitration Commission to reduce awards, or do whatever else is necessary, until every member of that union has a job? To explain involuntary unemployment we must not only explain how people are able to raise wages to unemployment levels but we must explain why anyone would want to do such a thing.

Like other monopolies unions raise prices (wages) above free market prices either by fiat or reducing the supply (in this case of labour) and allowing competition to force the price up. In either case less employed people is associated with higher wages. They can do this only if their monopoly is preserved---only if individual workers or other competing unions are unable to undercut them. A rational worker will work for any figure that is less than the value he places on their own leisure.

The unemployed are never union members and those about to become unemployed seldom control unions. They are out-numbered, out-voted and, being mostly the newest and youngest members, out-classed. Those who control the unions, like the owners of polluting factories, do not bear all the cost of their own actions. Economists call situation like this `externalities'.

That sufficiently explains action unions, but why would governments go along with such manifestly unjust outcomes? Unions sometimes resort to baseball bat diplomacy but like most monopolists they mostly rely on the government to restrict competition. The explanation is simply that politicians too look after their own interests. And they have much more to fear from unions which control endorsements, funds for election campaigns, groups of people who might be induced to vote in one way and embarrassing strikes. Concentrated vested interests, such as unions, tend to control democratic governments.

Our explanation has concentrated on labour markets but it is also true of the markets for machines and capital goods generally. We have a micro economic explanation for unemployment of capital and labour which is consistent with the real world we know. What is more the explanation is as relevant to Mr Friedman as to Mr Keynes.