**CHAPTER FIVE**

**Post-Keynesian Developments in Economic Thought**

**5.1 Emergence of Macroeconomics**

Another significant development of the period was the emergence of a new branch of economics, viz., Macroeconomics. Macroeconomics is an elaborate version of the 'New Economics'. It may be interesting to note that prior to the beginning of the 'New Economics', economic thinkers had in the main concentrated their efforts on the study of microeconomic problems, viz., and ‘behaviour of the firm or the individual. They failed to explain the behaviour of the economy as a whole, not to speak of dealing with its misbehaviour. The concentration of efforts on we study of microeconomic problems was to such an extent that it led people to think that the economic theory had reached a stage of stagnation. It was exactly at this point that the 'New Economics' began. Economists went on discussing we question of balance between over-full employment and under-employment until the late sixties. The controversy over declining investment opportunities, under the impact of immediate post-war technological advances died out and the questions about the economic growth reappeared, though in a different form.

Macroeconomics owes its origin to 'New Economics' and is a complete departure in economic methodology. It is different from Microeconomics and is 'concerned with the problems of unemployment, economic instability, inflation and economic growth’. Gardner Ackley prefers to describe it as an 'income and employment analysis t; while Professor Samuelson defines it as 'the study of the aggregate performance of the whole GNP and of the general price level' .1 Justas the New Economics rejected the classical assumption of full employment equilibrium, so does the Macroeconomics. Just as the New Economics is quite akin to classicism, so is Macroeconomics, in so far as it deals with the aggregates and the movement of the total economy through time. But, in matters of public policy, it is a complete break from classicism.

Coming to the main elements of Macroeconomics we find that it relents on the use of advanced mathematical tools; it studies aggregates - national income and employment and the equilibrium of the economy by providing a comparative analysis of classical and Keynesian models with particular reference to the classical full employment equilibrium theory. Macroeconomic analysis makes use of the Keynesian terminology. It has had two broad policy implications; first, fiscal policy in relation to employment and stability, and second, policy for maintaining equilibrium in international payments.

To describe it briefly, Macroeconomics is the study of the whole economy. As against the belief of Adam Smith that the national budget can be managed like the budget of any household, Macroeconomic analysis proves that the conduct of the national finances is not easy to manage and they playa positive role in shaping the whole of the nation's economy. The occurrence of inflationary or deflationary gaps, caused by over-full employment or underemployment of resources, can be corrected by making suitable changes in the fiscal policy and through them to make such changes in the aggregate demand as are necessary to correct the situation. A number of new concepts like 'fiscal drag' or 'fiscal dividend', 'full employment budget- surplus or deficit' have been developed. Economists have continued to work on these lines and make extensive efforts to collect data and to undertake empirical studies to refine and modify the theoretical apparatus, not only for studying the effects of fiscal policy in relation to employment and inf1ation but also for dealing with the problems of resource allocation.

Macroeconomics bas been effectively applied in the formulation of policy in the field of foreign trade and international payments. It would be interesting to know that Keynes has not talked about the theory of international economic relations in the General Theory. This attitude could be regarded as a return to the classical system, which considered international economic problems completely separate from the general body of economic doctrines. And it was only in the immediate post-war period that Keynes showed his utmost concern for international economic issues.

However, Keynes' disciples participated in active discussion on the relationship of the new theory of employment to the international economic equilibrium, via the Keynesian multiplier theory. The analysis of these economists showed how the foreign trade multiplier affects the international equilibrium, and how it is restored. It is true that in the beginning, Keynes' followers were mainly concerned with the prevention of short-term deviations from full employment caused by international commodity movements but in the early post war period both policy makers and the theorists had been concerned with the maintenance of full employment in a closed national economy. Their main endeavour in the domain of international economic policy was directed only toward insulating the domestic economy from the changes occurring in the outside economies. And this area of study went on widening and in the late sixties and early seventies it has become more pressing as a matter of policy. The last two decades have produced ample literature on the subject. "The main work ... has been devoted to broadening the analysis considerably, ensuring that it is fully integrated into the general body of macro-economic theory, while at the same time studying more deeply and intensively certain specific aspects of the trade and payments problem ... Not only the basic theory of the 'gains' to be derived from trade and the directions of trade as determined by the original doctrine of comparative advantage, but also the crucial policy questions of 'welfare' Economics as related to interventions through different forms of trade policy has been almost entirely overhauled."

Although the work of economists during these decades has been to a very great extent concerned with the 'abstract models', most of it is devoted to policy problems. In economic theory knowledge on subjects like effects of tariffs, export subsidies, and policies on terms of trade, national incomes, investment and consumption of different trading areas; changes in the rate of exchange, international investments or international capital movements has been widening at a very rapid pace and the concepts now stand better defined and better understood. It must, however, be admitted that there is lack of consensus among economists as well as 'practical' men on the right policy decisions in varying conditions found in the real world, and hence 'disparity between theory and confidence in the efficacy of the practical measures that might be based on it, has been agitating the: mind of many a economist.'

Another technique for studying the behaviour of the aggregates of the economy which has been developed during the last three decades is that of 'Input-Output' Analysis. This technique was developed by Professor Wassily Leontief in 1941. He has mathematically analysed the input-output combinations of different industries and has, thus, tried to discover whether the different resources of the economy have been allocated optimally. This technique is unique in the sense that it can be made applicable both to micro as well as macro economic problems. Leontief has, thus, succeeded in integrating empirical investigations into the general equilibrium system of Walras. This technique has gained wide currency during recent years.

It may be useful for some of us to know that the science of Economics which at one time was considered to be essentially a British science, has strikingly during the last three or four decades, emerged as an American science. It does not, however, mean that Britain has not produced any modem economic thinker during this period. But no oilier country can match the United States in terms of volume or quality of the output in modem Economics, and the reasons for this phenomenal success are not far to seek. The United States has immense wealth which it has been able to devote to scientific research. Moreover, the European scholars, who had to leave their own countries got settled in the United States and finding the climate favourable, put their heart and soul together and produced the best possible results. Britain, on the other hand, neither had the resources nor the vision. Consequently, the British economists remained engaged in fruitless controversies, mostly of the academic type. Even in Cambridge, the home of Keynes, interest in Keynesian economics was not welcome, and the Cambridge School remained engaged in the ideal controversy with the London School of Economics about the latest versions of Austrian Economics. But in the United States the 'New Economics' found a congenial home and once it took roots it engaged the attention of almost every serious-minded economist in the universities and research institutions all over the country. Even in respect of input-output analysis, it was again an American economist, Leontief, who took the lead.

In the preceding chapter we have seen that in the Keynesian system, employment is the function of investment which depends on the marginal propensity to consume and the marginal efficiency of capital. Keynes, however, did not assign much significance to the rate of interest as a determinant of investment, since he considered interest as a function of quantity of money and liquidity preference of people. And, the rate of interest cannot fall to a level which may ensure 'full employment' rate of investment. So, the economy will be in equilibrium at less than full employment, and full employment cannot be achieved automatically. The immediate impact of the Keynesian doctrines was the occurrence of a marked change in the attitude towards the treatment of the major economic problems the problems of the economy as a whole and not only of the individual consumer or producer. They pointed new directions of development not only for the theorists but also for the practitioners.

The last three decades, since the death of Keynes in 1946, have witnessed the development of Keynesian doctrines into a general theory of the economic process and the growing concern of the governments, all over the world for the performance of the economic system in regard to the level of employment and total out-put. Before we take up these developments, it seems appropriate to speak of the most significant development of this period, i.e., the emergence and rise of a new branch of economics, Econometrics, since it helped the growth of the New Economics.

**5.2 The Emergence of Econometrics as the sister Discipline of Economics**

The relationship between statistics and economics has never been so established or marked as it has been after the Second World War, although statistical enquiries were conducted even during the 19th century; for example, Petty's efforts in vital statistics and the English Blue Books. But most of the statistical endeavour was more or less detached from economic enquiries and had not influenced much the development of economics. Not that the need for a close affinity between economics and statistics was not recognised, e.g., the emphasis given by Jevons to such a link between the two and the efforts of the early members of the American institutionalist school to forge such a link are outstanding examples. But these attempts were more or less isolated and throughout the 19th century efforts were made only to collect statistical evidence in support of theoretical propositions, e.g., the collection of statistics by the mercantilists in support of their views on foreign trade and by Veblen, Mitchell and others in developing the theory of the business cycle. The efforts of Mitchell and others in synthesising the deductive and the empirical approaches were no doubt unprecedented but only rudimentary.

The real significant attempt in this direction was the growth of 'national income' analysis. Although the concept of 'national income' and its distribution had been in use since the time of the Physiocrats (e.g., circulation process of the Physiocrats, the annual fund of Adam Smith and the relative shares of the factors of production of Ricardo), the application of quantitative techniques and statistical data to these concepts came much later. Some indications of an appreciation of the specific problem in this field are also available in the works of Fisher, Marshall, and Pigou. The real attempt was however made in the twenties in England. In Germany, Engel did considerable work in this field. By this time other statistical series had been much improved and made more accurate. The publication of the British Census of Production (1924) and the American Production Index is worth noting.

Studies in the field of national income, however, continued to be vigorously pursued in the USA and the UK from the thirties on, the great depression provided considerable stimulus for improvement in the machinery for collecting and arranging data in a more meaningful manner. In the United States the lead was given by the National Bureau of Economic Research. Various new agencies were set up in the USA as the Agricultural Adjustment Administration, National Recovery Administration, etc., the activities of government, the universities and research organisations were co-ordinated and a systematic use of statistics was made in formulating policies, especially the fiscal policy.

In the' UK, an Economic Advisory Council was set up in 1930 to undertake a 'continuous study of developments in trade and industry - and in the use of national and imperial resources, of the effect of legislation and fiscal policy at home and abroad, and of all aspects of national, imperial and international economy with a bearing on the prosperity of the country’. This is a clear evidence of the recognition given to the mutual interaction of the various factors affecting the economy and also to the collection of facts for the purpose of formulating an effective policy. Thus, the study of the central problems of national income analysis and the organisation of suitable governmental machinery for the purpose received a new impetus.

In the late thirties the emphasis was, however, shifted from consumer expenditure to investment by business and hence the importance of data collection was also recognised in the field of monetary policy. With the outbreak of the war a fresh impetus was provided to the improvement of the existing data collecting machinery and major advances in the field of statistical activity were made, e.g. the formulation of estimates of supplies and requirements of various articles like food-stuffs, raw materials, etc., man-power and output forecasts, etc. More important than this was the development at the base at which the estimates of the aggregates of the economic system, in their words, the statistics of the national income were made available to the agencies responsible for taking policy decisions. Once again, Britain took lie lead and in 1941 a Central Office for co-ordinating the statistical activities of various government departments and for publishing central statistics of national income and product was established. From that year onwards, more accurate, refined and wider in scope, estimates of national income and expenditure have been published by tile Central Statistical Office. Similarly, in the United States, a National Income Unit was started in the Department of Commerce which publishes every year in July the Survey of Current Business. Similar organisations have been set up in other countries. In more recent years, various international organisations like the United Nations and its organs, Organisation for European Economic Co-operation and its National Accounts Research Unit have made a significant contribution in the improvement of national income statistics and analysis which has been extremely useful for less developed countries.

The improved statistical techniques also helped a number of economists to refine the concepts used by them. In this connection tile contribution of Kuznets' 'National Income' in Encyclopaedia of the Social Sciences (1933), Volume XI, is of far reaching importance and is indispensable even today. He has defined tile various components of tile national accounts and has discussed various terms used in connection with tile analysis of wages, profits, capital and interest, etc. with great clarity. Similarly, in his National Income and its Composition 1919-1938, Published in 1941, Simon Kuznets has given us a vast wealth of historical material.

In the pre-war period under the impact of the Keynesian analysis statistical activities were directed towards the discovery of the time series for the various aggregates like income, consumption, etc. which would provide quantitative tests to them and would fit into the Keynesian scheme. In the United States as well as in Great Britain various studies were undertaken to examine the effects of war on the economy by the government statistica1 machinery which led to further improvement in the techniques. Various new terms like gross and net national income, national income at market prices or at factory costs, gross and net national product etc became current.

It does not, however, mean that all the problems had been solved and the economists and statisticians had unanimously agreed in all spheres. In a number of areas like index numbers, foreign exchange, treatment of foreign balances in the field of international trade etc., the disagreement was quite considerable. In the field of index numbers the expression of the various magnitudes in monetary terms raised many problems. The treatment of foreign balances in the accounts became highly controversial, particularly relating to the questions of how variations in terms of trade are to be accounted for. Despite these disagreements there is a fair measure of agreement on the general techniques to be used in this field. Besides this, there is a measure of agreement with regard to the use of social accounts for framing economic policies. The important part played in the field of policy making by the national accounts analysis during the war can hardly be over-stated.

Further refinements have been made in the statistical techniques in the post-war period, and detailed studies have been undertaken in various areas of economic analysis and economic policy. However, mention may be made of the two most important developments in the matter of refinement of national accounting, first in the theories of growth and second in regard to short-term cyclical economic fluctuations. We shall take up these in detail a little later. We may, therefore, conclude this section by saying that there might not have taken place any basic change in the methods of data collection and presentation, it remains a fact that statistics not presented are certainly more elaborate and are now available more quickly and better analysed than what they were in the fifties.

**5.3 The Revival of Monetarism**

The monetarists have launched a frontal attack on the existing international financial system and have suggested its reorganisation, since they believe that any international economic financial order can function smoothly only when the fluctuations in a country's economy are consistent with its position internationally. Again, the monetarists have criticised the macroeconomic management because of its emphasis on the control of the economy. Most of the monetarists favour reduction in specific intervention by the 'Authority', and to introduce automatism in the operation of the economy. Similarly, in international sphere they have pleaded for automatism by keeping the rate of exchange flexible. These are the views of the Chicago School, whose leader is Milton Friedman. While criticising the fiscal macroeconomic management the monetarists have given their own prescription for achieving high rate of employment and growth and for eliminating inflation.

The argument of the monetarists is based on the Quantity Theory of Money, generally associated with the name of Irving Fisher, although David Home was its chief exponent in the pre-Smithian era. According to the theory, the general price level is always inversely related to the value of trade transactions and directly related to the quantity of money and its velocity of circulation. Since the velocity of money was considered to be stable, the price level is determined by the quantity of money, i.e., it was dependent on the operations of the monetary authorities. In other words, inflation and deflation are caused by the policy followed by the monetary authorities.

In the beginning Keynes virtually accepted this relationship between money and the price level and differed on one point and that is, that the velocity of money was not a constant factor and that it changed with the change in circumstances. Subsequently, in the Treatise on Money he stated that for a stable price level equilibrium between savings and investment was necessary. It, therefore, follows that it is the use to which the quantity of money is put, which is important and in particular, its investment part. The concepts of multiplier and acceleration and other concepts developed in the General Theory for explaining fluctuations in the general level of economic activity are directly its result.

The monetarists blame the post-Keynesians for their excessive use of fiscal measures in applying these concepts. And they are right, because the existing unemployment-inflation-budget-deficits situation in most of the countries, particularly in the United States and the United Kingdom, is the result of this and of the neglect of the role of monetary policy. Consequently, the monetarists succeeded in the United States and in Britain in influencing opinion in favour of greater reliance on monetary measures. But, some fiscalists have not accepted the significance of the role of monetary policy in regulating the level of economic activity or are not even agreeable to assigning to it a supplementary role along with other policy means. Hence, the controversy between the 'monetarists' and the 'fiscalists'. We also come across certain economists who have attempted to integrate the two at the theoretical level. It is encouraging to note that the controversy which was quite intense in the last decade has now become milder. While the diehard monetarists placed excessive reliance on monetary policy, the moderates led by Milton Friedman advocate a moderate and a steady growth of money supply for the stability of the price level.

Economists have also been busy in debating over the various deficiencies observed in the functioning of the international financial system. The main issues which are being debated relate to the nature of the reserves to be maintained for settling the imbalance in international payments; adjustment of the domestic economy with the fluctuations in international payments position and the role of international organisations in these fields. These issues were essentially raised because of the failure of the international mechanism created at Breton Woods after World War II. The automatism of the gold standard was a great virtue. But, the post-World War II imbalances were so large that it was neither safe nor possible to correct them by adopting the gold Standard: and, therefore, the desire for autonomous domestic economic policy strengthened by the Keynesian revolution and international machinery operating under an international code were thought to be the means to bridge over the problems.

The system worked with varying degrees of success during the first 25 years: in fact, with the support of some other deliberately thought out means. The postponement of the conversion of sterling, the increasing role of dollar, the main reserve currency, the devaluation of currencies in a number of countries, the toleration of restrictive and discriminatory trade practices, and all these happenings proved that the system was cracking. A signal of dissatisfaction about the efficacy of the system pervaded the minds of all serious thinkers and was evident throughout the big literature produced, during the period. The most interesting feature was that politicians, officials and practical men in banking and business circles, all joined hands with academic economists in questioning the benefits of the system on a scale unprecedented in history.

The debate became really intense in the sixties when the United States faced constant balance of payment deficits. Although the problem of international liquidity was eased to a certain extent by the creation of Special Drawing Rights, it posed further problems for domestic adjustment People, therefore, started advocating free floating exchange rates to steer the domestic economy through crises by independent economic policies. Since this process coincided with the strong upsurge of regionalist tendencies in international economic affairs, the debate became all the more sharp and the situation as it stands today is that "Today, uncertainty about the proper manner in which to construct and operate the international monetary system is a particularly striking symptom, not only of the erosion of long-accepted patterns of national and international economic policy, but also of a significant degree of lack of acceptance of the accepted body of economic doctrine.'"

**THE KEYNESIAN-MONETARIST DEBATE**

In Keynesian economics the focus is on *aggregate demand.* Keynesian economics focuses on the rate of spending in the economy. Spending is what pulls forth the output, and thus supports employment and incomes. Keynesian economics tells us that if we can understand what determines the level of spending (aggregate demand), we will know what determines the level of employment and production; i.e., of output and income in the economy.

Keynesian economics tells us that public policies which change the level of spending in the economy will change the level of employment and production, and output and income in the economy. Keynesian economics offers the government a positive approach to overcome depression.

Make total spending increase and the economy will speed up. Increase government spending. Cut taxes so people and businesses will have more money to spend. Permit the money supply to expand. As the government and the businesses and the people all spend more, people will receive more income. As people’s incomes increase, their spending increases. The result will be prosperity. If on the other hand the economy overheats, soon the government will need to cut down on its spending and raise taxes to keep the boom from running away into inflation.

The basic idea of the Keynesian proposal for overcoming unemployment and depression was to unbalance the budget. The government would reduce its “tax withdrawals” from the income stream at the same time that it would increase its “spending injections” into the income stream. The idea was for the government to unbalance the budget, run a deficit, create more money to finance its expenditures, and thereby push more money into the spending and income flow of the economy.

While Keynesian economics was widely accepted in the 40s, 50s, 60s and 70s, a few economists were speaking loud and clear against Keynesian economics. They were arguing and building their case against the whole idea of government fiscal policy (of adjusting taxes and spending to influence the economy). The leading challengers have been Milton Friedman and his colleagues who make up the Monetarist School (or the Chicago school) of economic thought.

According to Miltion Friedman and his followers, the government should never take any kind of direct discretionary action to influence employment or spending or wages or prices. A limit of 4% to 5% on the rate of expansion of the money supply will take care of the problem of inflation; automatic price adjustments and the automatic forces of the market system will take care of unemployment and depression. The government should not do anything to try to make the economy run better than it runs naturally.

To the monetarists, there is just no need to get involved with the Keynesian prescription. To do so would be harmful in the long run. The government’s only economic policy should be to control the size of the money supply and its rate of increase. As total output and trade increase, the money supply should be permitted to increase enough to finance the increasing economic activity. But that is all.

The very basis, or ‘root cause’ of the disagreement between the monetarists and the Keynesians stems from a basic difference in opinion about how to view the economy, and how the macroeconomic forces in the economy actually operate.

The monetarists take a long-run view, and assume that the short-run ups and downs of the economy (inflation, unemployment, etc.) are just short-run conditions which the natural market forces will work out in due time.

The monetarists assume that the economic forces of prices and competition will work more effectively than would any government attempt to stabilize the economy. Because of the great power and effectiveness of the ‘natural market forces,’ these factors should be allowed to control the economy. The government should not try to offset or overthrow the results of these natural forces. In short, the government should never try to achieve short-run price-level or production and employment objectives.

The Keynesian view of the economy is different. The Keynesians accept the proposition that the natural market forces are powerful. But the Keynesians do not believe that these forces are sufficiently powerful to guarantee healthy economy. The Keynesians focus on the fact that the world only operates in the short-run.

Keynes said in this was: “In the long run, we are all dead!” So according to Keynesian economics, whether or not in the long run the equilibrium conditions of full employment and stable prices might arrive, is irrelevant (and certainly should not be used as the only guide to government policy in macroeconomics).

The Keynesian position is that actual conditions in the modern economy are quite different from the assumed conditions in the ‘model economy’ (that the model therefore cannot be relied on as the complete guide to appropriate public policy). Keynesians emphasize the condition of inflexible prices, and the constant upward pressure on prices from business and labour organizations all trying to push their prices up.

The Keynesians would agree with the monetarists that if spending in the economy slows down enough (so that unemployment is very high) it is not likely that prices will be going up under such depressed circumstances. Keynesians also would agree that when the economy is in a depression, some workers would be willing to take jobs for less than their previous wages. Some business would be willing to sell their products for lower prices.

But the Keynesians hold that in order for these conditions to arrive, the economy must be in a serious recession. The Keynesians do not believe that such suffering and misery are necessary. And they do not believe that such misery should be forced on the people; not when appropriate Keynesian-type government policies and programs are available to prevent and/or overcome such depressed conditions.

Those who accept the Keynesian view of the economy see an important role for government in economic stabilization. The government is supposed to maintain a stable, growing economy ***primarily through fiscal policy*** (taxing more and spending less to hold down excess demand; taxing less and spending more to speed up spending when the consumer and business sectors are not spending enough to maintain full employment).

The government is supposed to support its fiscal policy with appropriate monetary policy (tightening money and raising interest rates to help to hold down excess demand; easing money and lowering interest rates to speed up spending when the economy is depressed.)

The monetarists hold that if the government tries to follow these Keynesian policies, not only will it be unsuccessful, it will worsen the short-run fluctuations in employment and prices. The monetarists say that whenever the economy has a problem of either unemployment or inflation, the problem soon will be corrected through natural market foreces.

The monetarists say that if the government tries to come in and offset a ‘too fast’ or ‘too slow’ rate of total spending, it will be adding its ‘corrective’ influence into the econmy at the same time that the natural market forces are exerting their corrective influence. The total effect will be to over-correct and force the econmy to respond too fast. So the economy will overshoot the ‘desired equilibrium’ rate of spending and wind up with the opposite direction.