HISTORY OF ECONOMIC THOUGHT

Lecture Notes for Week 11

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Table of Contents

Alfred Marshall (1842 – 1924)

We have met with Alfred Marshall in the 6th week already. Let us remind:

"Alfred Marshall (1842 – 1924) graduated in mathematics at Cambridge in 1863 and from 1884 to 1908 was there an elected professor of political economy. His Principles of Economics (1890) served as a basic reference text for generations of students (8th edition in 1920). In 1890, he was one of the grounders of the British Economic Association and the "Economic Journal".

In his Principles of Economics, he uses the "partial analysis". Instead of analyzing a general equilibrium on all markets, he analyzes equilibrium on one market. He uses the ceteris paribus assumption; everything that is not explicitly in the diagram does not change.

Basic questions in partial analysis are: Does an equilibrium exist? Is there only one equilibrium? Is it stable? What mechanism brings the system back to equilibrium if it happens to be out of equilibrium? We distinguish static analysis … and comparative statics that involves comparing the static equilibria before and after a change, e.g. a shift of the demand curve.

In his last work Money, Credit and Commerce (1923), he introduced the Cambridge Equation M=kPY, that looks formally as the Quantity Equation of Money Mv=PQ but is interpreted as money demand. His student Keynes built up on this later."

Why is Alfred Marshall Important

Marshall's importance stems primarily from following:

- His landmark textbook *Principles of Economics* (1890),
- In 1890, he intervened to found the British Economic Association and the Economic Journal,
- As a professor at Cambridge University, Marshall taught and mentored influential economists like John Maynard Keynes, deeply influencing economic thought into the twentieth century,

- Marshall had a significant influence over the teaching of economics in the rest of England,
- He used the Partial Equilibrium Analysis, that is more accessible to students than the General Equilibrium Analysis,
- Marshall influenced selection of people to important positions at universities and elsewhere in England,
- An important component of his legacy is the oral tradition that was kept for decades at Cambridge,
- Cambridge came to dominate in economics among British universities in his time,
- Thanks to Marshall, the name of the discipline changed from political economy to economics.

Life

- In 1842: born into a modest bourgeois family,
- In 1865 graduated in mathematics at Cambridge (he shifted to Cambridge from classical studies at Oxford, thanks to a rich uncle from Australia),
- In the middle of the 1870ies: shift of interest from mathematics and moral sciences towards political economy, teaching of political economy to Newnham Hall´s female students, marriage with his student Mary Paley in 1877,
- 1877 – 1884: University College in Bristol and travelling (because of celibacy requirement at his Cambridge College),
- In 1879: He publishes *The Economics of Industry* (with Mary Paley) with the aim to represent a complex and constantly changing economic reality; he puts no much stress here on a rigorous analytical structure,
- 1884 – 1908: He is elected professor of political economy at Cambridge,
- In 1890: He publishes *Principles of Economics* - the basic reference text for generations of students (8th edition in 1920),
- In 1923: He publishes *Money, Credit and Commerce*,
- In 1924 he dies.

Method

- He brought together two contradictory elements: the static equilibrium analysis and the evolutionary view. He was influenced by Charles Darwin (*The Origin of Species* (1859)), Jean Baptist de Lamarck (1744-1829) and Herbert Spencer (1820 - 1903),
- He was influence by statisticians Carl Frederick Gauss (1777-1855) and Adolphe Quetelet (1796 – 1874). It can explain why he stopped using the classical notion of natural values of different variables and started to speak about normal values,
- It his value theory, he presents a synthesis of subjective approach and cost-of-production approach,
- He stressed his originality in the use of marginalist concepts (in the sense of non-dependence on the "fathers of the marginalist revolution"). This claim is credible, because between 1869-73, two of his essays privately circulated: *The Pure Theory of Foreign Trade* and *The Pure Theory of Domestic Values*. In these essays we find the first formulation of his theories, later elaborated in successive editions of his *Principles of Economics*.

Principles of Economics (1890)

- He was elaborating many concepts during successive editions; it was a living book,
- Basic features:
    - Use of the partial equilibrium method (as contrasted with the general equilibrium method),
    - Introduction of four different time horizons: very short (supply is given), short (capacity is given), long (capacity is variable), very long (variable technology and tastes of consumers),
    - A commodity (good) corresponds to a category which includes objects not identical but similar enough,
    - Each industry includes the firms that operate in one of such commodity categories,

- He distinguished industries with decreasing, constant and increasing returns to scale,
- He used the evolutionary approach in the development of the concept of a representative firm, the latter based on the life-cycle of family firms.

Money, Credit and Commerce (1923)

- He formulates here the Cambridge Equation M = kY for money demand. It is a very important transformation of Irving Fisher´s Quantity Equation of Money. Mv=PQ. Cambridge equation was further elaborated and used by Keynes.
  - Quantity Equation of Money is a technical equation that equates money in circulation and the transactions´ need for money,
  - Quantity Theory of Money says that under the assumptions of constant velocity of money v and exogenously given transactions Q, increase in money increases the price level,
  - Cambridge Equation says that the demand for money depends on income.

The Theory of Market Forms

- Marshal elaborated the classification of costs of firms and classified industries into industries with decreasing, constant and increasing returns to scale,
- His approach to firms and industries was elaborated by Pigou to the textbook form used in current microeconomics,
- Marshall´s approach to firms and industries was criticized by John Harold Clapham 1873 – 1946) and Piero Sraffa (1898 – 1983). Their criticism opened further research about market forms,
  - Among predecessor of the researchers on market forms was e.g. the French Antoine Augustin Cournot (1801 – 1877), who in 1838 presented the first formulation of the demand function and elaborated the theory of duopoly,
  - John Harold Clapham 1873 – 1946) was the first professor of economic

history at Cambridge. In 1922, he published in "The Economic Journal" an article about "empty boxes", with the opinion that it is impossible to identify in reality industries with decreasing, constant or increasing returns to scale,

    - Piero Sraffa (1898 – 1983) published in 1925 an article written in Italian specifying logical inconsistencies in the Marshallian theory of firm. Keynes asked Sraffa to write in English on the same topic; this English article was published in 1926. Sraffa starts from following question: What happens if single firms meet a decreasing demand curve instead of a horizontal demand curve? Sraffa himself did not follow the research analyzing this question,

- Edward Chamberlin (1899 – 1967) made his PhD studies at Harvard and was a full professor there from 1951 to 1966. He was editor of the Quarterly Journal of Economics from 1948 to 1958. His seminal work in the theory of market forms is the *Theory of Monopolistic Competition* (1933, 8th edition in 1962),
- Joan Robinson (1903 – 1987) published in 1933 her seminal work in the theory of market forms under the name *Imperfect Competition.* This book provides the "vulgate" for current textbooks on this topic.

John Maynard Keynes (1883 – 1946)

You can find many videos and texts on John Maynard Keynes on web. You ought to watch the video: "John Maynard Keynes – Life, Ideas, Legacy".

Why is John Maynard Keynes Important?

- He authored the seminal book *The General Theory of Employment, Interest, and Money* (1936), establishing foundations for macroeconomic theory,
- He questioned the classical (under classical he puts both classical and neoclassical economists) view that free markets naturally lead economies to equilibrium and full employment without intervention,
- He introduced the idea that governments should actively intervene to stabilize economies during downturns, which is the basic opinion of current Keynesian Economics,
- He advocated for fiscal policy. He supported increased government spending and reduced taxes during recessions to boost demand and reduce unemployment,
- His theories have directly influenced economic policies worldwide, particularly after major crises like the Great Depression.

Life

- He studied at Eton and at King´s College in Cambridge, where he graduated in mathematics,
- Before 1908: He worked at the India Office,
- After 1908: He worked at Cambridge University,
- In 1911: He became editor of the "Economic Journal ",
- In 1913: He became secretary of the Royal Economic Society,
- In 1913: He published *Indian Currency and Finance*,
- In 1919: He published *The Economic Consequences of Peace*, what made him a public celebrity,

- In 1921: He published the *Treatise on Probability*,
- In 1923: He published the *Tract on Monetary Reform*,
- In 1924: He was elected Bursar of the King´s College, Cambridge. He made a fortune for his college through real estate investments and speculations on the stock market,
- In 1925: He married a famous Russian dancer,
- In 1925: He writes *The Economic Policy of Mr. Churchill*,
- In 1926: He writes *The End of Laissez-Faire*,
- In 1930: He writes *The Treatise on Money*,
- In 1936: He writes the *General Theory of Employment, Interest and Money*,
- After 1936:
    - In 1937: He had his first heart attack,
    - He offers a lot of interesting suggestions for both the domestic and foreign economic policy,
    - In 1944: he plays a leading role at the Bretton Woods Conference,
    - In 1946: He dies.

Comments to the 1st part of the video:

- Mark Blaug (1927–2011) was an economist and historian of economic thought. He was widely recognized for his expertise in the methodology and philosophy of economics, economic education, and the history of economic analysis,
- George Rylands (1902–1999) was a noted British literary scholar, theatre director, and academic. Known particularly for his contributions to Shakespeare studies, Rylands was influential in promoting and directing dramatic productions, especially at Cambridge University,
- The Cambridge Apostles is a prestigious, secretive intellectual society founded at Cambridge University in 1820. Historically composed of influential members from various academic and artistic backgrounds, it is known for its elite membership, confidential discussions, and influence on British intellectual and political life. Notable former members include philosophers Bertrand Russell and Ludwig

Wittgenstein, economist John Maynard Keynes, and novelist E.M. Forster,

- The Bloomsbury Group was a circle of British intellectuals, writers, artists, and philosophers active during the early 20th century. Centered in the Bloomsbury district of London, they emphasized modernist aesthetics, individualism, feminism, and progressive social ideas. Notable members included Virginia Woolf, Leonard Woolf, John Maynard Keynes, E.M. Forster, Vanessa Bell, Duncan Grant, and Lytton Strachey,
- Robert Skidelsky (born 1939) is a prominent British economic historian, academic, and author, renowned primarily for his comprehensive biography of the economist John Maynard Keynes. His influential three-volume work on Keynes is widely praised for its depth and insight,
- Keynes lived in Tilton, Sussex, close to Charlestown, where the house of the Bloomsbury Group was. He married Lydia Lopokova, a Russian dancer. His parents lived at Harvey Road in Cambridge, he had a Victorian education and some Victorian virtues: sense of duty, belief in a disinterested ruling class and in the power of social science. Later in his life, he became the Lord of Tilton.

The Treatise on Probability (1921)

- Keynes wanted to build a general theory of knowledge and rational behavior, where the cases of perfect rationality and full ignorance are the extremes,
- In general, it is not possible to attribute a numerical value to the probability of events. There are three different situations: a certainty of an event, a situation in which it is possible to calculate the probability of an event (a risk situation) and the situation of fundamental uncertainty, when the probability of an event is impossible to calculate,
- Keynes´s approach contrasts with some other approaches (e.g. Frank Ramsey´s and Friedrich von Hayek´s), and has been further elaborated e.g. in Post Keynesian economics.
- Rational behavior without certainty is connected to subjective evaluations based on both experience and intuition,

- Keynes stressed that aside of probability, the „weight of the argument“ must be taken into consideration. When relevant empirical evidence linked with an event increases, then the weight of the argument increases, while the probability of the event may increase, decrease, or stay unchanged.

The Treatise on Money (1930)

Some Post Keynesians believe that what is really path-breaking in Keynes´s thinking is in this *Treatise*, not in the *General Theory*:

- Keynes stresses here the instability of a capitalist economy; no autopilot exists,
- He concentrates on the changes of prices in his analysis of the business cycle,
- He further develops the approach to money demand based on the „Cambridge Equation“,
- He makes a two-sector model of an economy and uses sequential analysis for connecting production levels and realized profits in both sectors.

The General Theory of Employment, Interest and Money (1936)

- He changed from the sequential analysis in the „Treatise on Money“ to an equilibrium analysis,
- He concentrates on unemployment and income in his analysis of the business cycle,
- He develops and uses the consumption function, the principle of effective demand, the multiplier mechanism, and the theory of interest.

Comments to the 2nd part of the video:

- The Gold Standard was reintroduced in Great Brittain in 1925 with the pre-war parity. Keynes warned against it in *The Economic Policy of Mr. Churchill*,
- The Gold Standard was abandoned in Great Brittan in 1931 because of a bad economic situation – compared to countries without the Gold Standard,

- President F. D. Roosevelt in the United States started in the 1930ies his New Deal economic policy that contained huge (for that time) public works,
- In Great Brittain the authorities believed that public employment destroys as much private employment as it creates,
- Frank Hahn (1925–2013) was a British economist renowned for his influential work in economic theory, particularly in general equilibrium theory and monetary economics. He made significant contributions to understanding the role of money, stability, and equilibrium analysis, and held academic positions at institutions such as Cambridge University, advocating rigorous theoretical foundations in economics.

Miscellaneous

- According to Keynes, a deficit financed tax cut raises disposable income and aggregate demand. Keynes appreciated Thomas Malthus´s attitude towards the possibility of "general gluts ". In Keynes´s time, it was against the mainstream opinion,
- Keynes believed that unemployment is an inherent feature of a capitalist economy. Government interventions for keeping low unemployment are necessary.

Comments to the 3rd part of the video:

- Richard Stone (1913–1991) was a British economist who significantly advanced economic analysis through the development of national income accounting. Awarded the Nobel Prize in Economics in 1984, Stone is best known for creating methods that measure economic activity and growth, greatly influencing modern macroeconomic policy and statistical practice,
- During the war, James Meade worked with Richard Stone as a statistician and economist for the British Government,
- Keynes started a new branch of economics, Macroeconomics,
- Quantitative revolution occurred parallelly with Keynesian revolution,
- Friedrich von Hayek testified that Keynes´s theory was a reaction to the worst problem in the 1930ies – to unemployment. If the worst problem were different, e.g. inflation, Keynes would tackle inflation,

- Keynes repudiated socialism, both as a tool and as an end. He was not a welfarist. The focus of public spending should be investments. Redistribution can be done if its target is unemployment,
- Keynes believed in individualism as a basis for personal liberty,
- Attacks on Keynesianism:
    - Alan Walters said that USA, Japan, Germany and some other countries have never operated on Keynesian prescriptions,
        - Alan Walters (1926–2009) was a prominent British economist known for serving as the chief economic advisor to the UK Prime Minister Margaret Thatcher in the 1980s. He significantly influenced Thatcher's monetarist approach and was a strong advocate of free-market economic policies, especially controlling inflation and reducing government intervention in the economy. Walters also had an extensive academic career, writing extensively on monetary economics and economic policy,
    - Keynesianism faded in the 1970ies, because it was not able to explain stagflation and because the monetarist counterrevolution. Monetarists believe that the Great Depression was not caused by the collapse of investments but by a bad monetary policy,
    - Another attack on Keynesianism from the position of the New Classical Economics is that it does not take into consideration the role of price expectations and the effect of a low unemployment policy on expectations,
    - Both James Buchanan and Paul Samuelson were convinced that the policies that use deficit financing lead to unsustainable public debts,
    - Another attack on the Keynesian policy shows that the income multiplier is not stable,
- Paul Samuelson takes Keynes´s approaches as a tool, not as a religion,
- Milton Friedman says that he uses some of the Keynes´s terminology, even if he does not agree with the theory. The fatal mistake of Keynesians is that they stress the inevitable role of government for stabilization policy.