

ECS 306J:

May/June 2010:

Section A:

1) "Pearls have value because people dive for them"

- Smith said that pearls (goods) have value because people need to dive to get them
- The costs of production determine a good's exchange value or relative price
 - Smith examined exchange value in an economy which he defined as one in which labour is the only scarce resource

cost of production determines a goods value. value in the economy = labour is the only scarce resource.

2) Malthus's explanation for the failure of Say's law:

- They were wrong in assuming that the economy always tends toward full employment
- There is a certain long-run validity to this doctrine
- Underdeveloped economies are characterised by low output and corresponding low income payments to people
- As an economy grows it simultaneously generates an increased supply of goods and increased payments to the factors of production, which in turn generate an increased demand for goods $\uparrow \text{economy} \rightarrow \uparrow S \rightarrow \uparrow \text{payments to FOP} \rightarrow \uparrow D$
- In international trade as a country produces more, it can export more, and it can therefore afford to import more
- Both in domestic and foreign trade, 'supply creates its own demand' in the long run
- This does not hold true – in the short run in market-based economies
- Even though payments to factors of production would be enough to buy all goods produced, there is no guarantee that the recipients of these income payments will spend them on existing output

3) The commonalities of socialism:

- They all repudiated the classicist notion of the harmony of interests
- They view society being composed of distinct classes whose interests were often opposed to one another
- The socialists all opposed the concept of Laissez-faire
- These people rejected Say's law of markets, claiming instead that capitalism is given to either periodic crisis or to general stagnation
- Socialists denied the concept of humanity upon which classical thought was erected, instead believing in the perfectibility of people
- Produced self-interested behaviour through its emphasis on making profits and accumulating wealth
- Each of the various socialist ideologies advocated collective action and public ownership of enterprise to ameliorate conditions of the masses – ownership by the governments or enterprises

4) "Rent is price determined but not price determining"

- Rent is both a differential return and surplus above labour and capital costs
- Rent is price determined but not price determining
- That is, high rents are explained by high grain prices
- High prices cannot be explained by high rents

5) Marginal utility and its role in Marginalist economics:

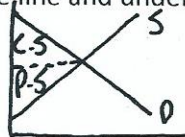
- According to Marshall, demand is based on the law of diminishing marginal utility
- The marginal utility of a thing to anyone diminishes with every increase in the amount of it he already has
→ 2 qualifications =
- Concerns that consumer goods are indivisible *and concerned with a moment in time.*
- The utility approach of the Marshall system dealt with pleasures and pains, desires and aspirations, and incentives to action
- We can measure the utility of such intangibles with money
- How much money a particular group is willing to pay as a measure of the utility of something it desires

MU ↓ ⇒ ↑ amount he already has

6) Consumer and producer surplus:

- The consumer's surplus increases significantly in a productive social environment in which the price of goods falls as they are produced more efficiently
- Utility in excess of price
- The sum of all such differences between marginal utility and price is total consumers' surplus
(MU - P)
- Consumer surplus – the area above the price line below the demand curve
- Producer surplus – the area below the price line and under the demand curve

C.S ⇒ ↓ P



7) Collectivism:

- *emphasises the interdependence of every human in a society*
- *Cultural element that exists as the reverse of individualism*
- *cohesion within social groups*
- *group goals*

8) Partial versus general equilibrium analysis:

- General equilibrium analysis – which considers the interrelationships among many variables in the economy
 Presents a framework consisting of the basic price and output interrelationships for the economy as a whole, including both commodities and factors of production
- Partial equilibrium analysis – as a rock dropped into a pond causes widening circles of ripples, any change in the economy causes further changes that radiate outward with gradually diminishing force

- And just as these ripples sometimes reach shore and rebound eventually to affect the initial point of impact, so too, are there feedback effects of initial changes occurring in single markets in the economy
This process or reverberation continues throughout the entire system until equilibrium is achieved simultaneously in all markets

9) **Friedman's modern quantity theory of money:**

- The demand for money is relatively stable in the short run
- The federal reserve system controls the supply of money
- An increase in the money supply of money will leave people holding cash balances in excess of amounts they want
- They will attempt to rid themselves of these excess transactions assets by spending cash and writing checks
- One person's spending leaves more cash in someone else's hand
- The attempt for people to rid themselves of cash balances will drive up the demand for goods and services and increase output, prices, or some combination of each
- Where economies operate at its natural levels of employment and output, only prices will rise over the long run
- As price level rises, the demand for money increases
- Eventually, equilibrium between quantity of money supplied and demanded is restored, but at a higher price level
- The demand for money is highly stable

$MS \rightarrow$ excess balances

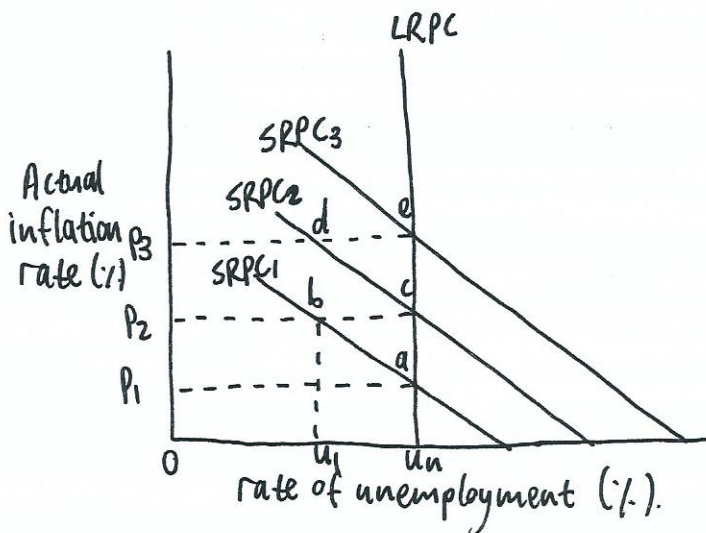
\uparrow spending

$\uparrow D \rightarrow \uparrow P \rightarrow \uparrow$ output

$\uparrow P \rightarrow \uparrow D_m$

10) **The long-run Phillips curve:**

- In the long-run, there is no trade-off between inflation and unemployment
- The long-run Phillips curve is vertical, indicating that any one of several rates of inflation is compatible with the natural rate of unemployment



SRPC: combinations of inflation and unemployment are possible when the actual rate of inflation diverges from the expected rate

• Inflation @ P_2 = Natural rate of unemployment falls from $u_n \rightarrow u_1$.

• P_2 becomes expected rate: $SRPC_1 \rightarrow SRPC_2$ and returns to natural rate of unemployment

Section B:

2) Write an essay on the German historical school and the Institutionalist school:

Major tenets of the historical school:

1. Evolutionary approach to economics:

- dynamic perspective* • The historical school applied a dynamic, evolutionary perspective in its study of society
- development/growth* • It concentrated on cumulative development and growth
- The social organism is born, develops and grows, and finally decays and dies

2. Emphasis on the positive role of government:

- Nationalistic* • The historical school was nationalistic
- industry, transportation, economic growth* • In Germany it was the state that fostered industry, transportation, and economic growth
- state intervention* • The historical school gave great prominence to the need for state intervention in economic affairs and emphasised that the community has interests of its own that are quite distinct from those of the individual

3. Inductive/historical approach:

- study economy historically as part of a whole* • The economists of the historical school emphasised the importance of studying the economy historically, as part of an integrated whole
- economic + social phenomena interdependent* • Because economic and other social phenomena are interdependent, political economy cannot be treated adequately except in combination with other branches of social science
- study all forces of an economic phenomenon* • The school claimed that its historical method allowed it to study all the forces of an economic phenomenon, all the facets of economic behaviour, not merely their economic logic
- No economic laws believed in laws of development* • They denied that there are any valid economic laws, with one exception: they believed that patterns of development are discernible in history and can be generalised into 'laws of development'

4. Advocacy of conservative reform:

- weigh and compare merit of actions and outcomes* • Political economy, said the historical economists, must not merely analyze motives that prompt economic activity but must weigh and compare the moral merit of these actions and their outcomes
- distribution of wealth* • It must determine a standard of the proper production and distribution of wealth so that the demands of justice and morality are satisfied

Whom did the historical school benefit or seek to benefit:

- First, the members of the German historical school benefited themselves
- They enjoyed close and friendly relations with government officials and rose to dominant positions in academic life

- The German government controlled most universities, and Schmoller, known as the 'professor maker,' controlled a majority of the academic appointments in Germany through his influence at the Prussian Ministry of education
- Second, the historical economists served the dominant business, financial, and landowning groups by promoting moderate reforms that frustrated the drive for a more radical democratisation of society

How was the historical school valid, useful, or correct in its time?

- The evolutionary approach to society and to economic thought provided a useful antidote to the abstract thinking of the classical and Marginalist schools
- The historical school was correct in its perspective that economists needed to familiarise themselves with changing history and changing environments, with economic and social evolution, in order to understand the present world
- For this task, inductive factual studies were required

Which tenets of the historical school became lasting contributions?

- The task of the German historical school was completed when economists of various persuasions agreed that historical empirical studies are required to explain the present, to test old theories, and develop new ones
- Today, however, economists generally search for the most recent historical data available to test their theories, as opposed to scrutinising data gleaned from the distant past
- Another lasting contribution of the school was its attack on Laissez-faire
- This theme was the trend of the future
- A final word: The German nationalism advocated by the historical economists overreached itself as it evolved into a frenzied militarism
- Their ideas, perhaps unintentionally, contributed to the climate in Germany that led to World wars I and II

Institutionalist School

The historical background of the School:

- At the time two major methods of achieving social change were recognised:
 1. Reorganise society along socialist lines
 2. Undertake social reform, that is, ameliorate conditions through government intervention in the economy
- The object of the second approach was to save capitalism by improving the conditions of the masses

Major tenets of the Institutionalist School:

1. Holistic, broad perspective:

examined as a whole The economy must be examined as a whole, rather than examined as small parts or separate entities isolated from the whole

2. Focus on institutions:

order of institutions This school emphasised the role of institutions in economic life

- An institution is not merely an organisation or establishment for the promotion of a particular objective, like a school, a prison, a union, or a federal reserve bank
- It is also an organised pattern of group behaviour, well-established and accepted as a fundamental part of the culture

3. Darwinian, evolutionary approach:

- The evolutionary approach should be used in economic analysis, because society and institutions are constantly changing
- This approach requires knowledge not only of economics but also of history, cultural anthropology, political science, sociology, philosophy, and psychology

institutions constantly changing

4. Rejection of the idea of normal equilibrium:

- Rather than the idea of equilibrium, institutionalists emphasised the principle of circular causation, or cumulative changes that may be either salutary or harmful in seeking economic and social goals

principle of circular causation

5. Clashes of interest:

- Instead of the harmony of interests that most of their contemporaries and predecessors deduced from their theories, the institutionalists recognised serious differences of interests. People, said the institutionalists, are cooperative, collective creatures

recognised differences in interests

6. Liberal, democratic reform:

- The institutionalists espoused reforms in order to bring about the more equitable distribution of wealth and income
- They denied that market prices are adequate indices of individual social welfare and that unregulated markets lead to the efficient allocation of resources and a just distribution of income

espoused reforms bring about more equitable distribution of wealth and income

7. Rejection of pleasure-pain psychology:

- The institutionalists repudiated the Benthamite underpinnings of economic analysis. They reached out instead for a better psychology

reached out for a better psychology

Whom did Institutionalism benefit or seek to benefit?

- It represented the needs and interests of agrarian, small business, and labour groups
- Government workers, reformers, humanitarians, leaders of consumers' organisations, and union members were attracted to the institutionalist ideas, which they hoped might alter the orientation of private business enterprise in favour of their own interests

How was the institutionalist school valid, useful, or correct in its time?

- Many of their criticisms of orthodox theory were valid and helped to revise that type of theory to make it more tenable

- The institutionalists' stress on looking at the economy as a whole as part of an evolutionary process and in an institutional setting added elements of realism to economic analysis

Which tenets of the institutionalist school became lasting contributions?

- Modest steps toward national economic planning for limited objectives such as conservation, full employment, and international competitiveness are in line with institutionalist thought
- Legal protection of unionism, social insurance, and minimum wage and maximum hour legislation all are legacies of the institutionalist challenge to orthodox economic thinking
- With greatly expanded interest in problems of economic development, there has been new emphasis in this field of economics on the influence of the institutional environment on economic relations
- By their nature the problems of economic development involve diverse cultural factors and are dynamic and evolutionary
- Lasting contributions of institutionalists are also found in other fields, such as labour relations, law and economics, and industrial organisation
- These new theorists have sought to determine the economic rationality of institutions – the economic logic underlying their emergence and how their presence currently contributes to or detracts from economic efficiency

3) John Maynard Keynes:

The Keynesian System:

1. Consumption function:

- $C = f(Y)$
- There is a positive functional relationship between consumption (C) and national income (Y)
 $C = f(Y)$
- $MPC = \frac{\Delta C}{\Delta Y}$
- The ratio of the change in consumption to the change in income – the marginal propensity to consume (MPC) is positive and less than one
MPC = change in C/change in Y
- $S = f(Y)$
- $MPS = \frac{\Delta S}{\Delta Y}$
- Savings (S) also rises with income, it is a positive function of income
 $S = f(Y)$
- Like MPC, the marginal propensity to save (MPS) is greater than zero and less than one
MPS = change in S/change in Y

2. Investment:

- Keynes defined economic investment as the purchase of capital goods
 - Unintended investment occurs when sales decline and inventories of unsold goods rise
 - The distinction between economic investment and financial investment, which consists of the purchase of stocks, bonds, and other financial instruments
- Economic investment = purchase of capital goods
 - Financial investment = purchase of bonds and stocks

3. Liquidity preference:

• Liquidity preference depends on three motives for holding money and the reluctance to part with it, except insofar as the rate of interest acts as an effective inducement

• The first is the transaction motive – the need for cash to pay for current purchases for consumption and business needs

• The ²nd is the precautionary motive – the desire to keep some cash on hand for unforeseen emergencies

• Finally, there is the speculative motive, the desire to hold cash while waiting for interest rates to rise, or stock and bond prices to fall, or the general price level to fall

• Liquidity allows people to quickly seize financial and economic investment opportunities as they arise

4. Equilibrium income and employment:

• Keynes assumed that there is a high correlation between national income and the level of employment

Which tenets of the Keynesian School became lasting contributions?

- Contemporary economics could be said to be a combination of neoclassical microeconomics and Keynesian-inspired macroeconomics
- Keynesian concepts such as the consumption function; the marginal propensity to consume; the saving function; the marginal propensity to save; the marginal efficiency of capital; the transaction, precautionary, and speculative demands for money; the multiplier; saving and investment; fiscal and monetary policy; IS-LM analysis; and so forth are now standard in economics textbooks

-
- consumption function
 - MPC
 - saving function
 - MPS
 - ~~Keynesian~~ Transaction, precautionary, speculative demands for money
 - multiplier
 - M + F policies

1) The fear of goods:

Duty free importation of raw materials that could not be produced domestically, protection for manufactured goods and raw materials that could be produced domestically, and export restriction on raw materials. This emphasis on exports and a reluctance to import has been called 'the fear of goods.' The interests of the merchant took precedence over those of the domestic consumer. Merchants received inflows of gold in return for their exports, while the restrictions on imports reduced the availability of goods for consumption at home. Gold and silver accumulated, supposedly enhancing the country's wealth and power.

2) The division of labour:

The greatest improvement in the productive powers of labour, and the greater part of the skill, dexterity, and judgement with which it is any where directed or applied, seem to have been the effects of the division of labour.

The division of labour, said Smith, increases the quantity of output produced for 3 reasons:

- Each worker develops increased dexterity in performing one single task repeatedly
- Time is saved if the worker need not go from one kind of work to another
- Machinery can be invented to increase productivity once tasks have been simplified and made routine through the division of labour

Wealth of Nations said how the same number of workers could produce substantially more output by dividing their labour, Smith immediately made it clear that Wealth of nations was a break from the prominent economic notions then in existence.

3) Competition vs cooperation, and the pros and cons of both:

The key to understanding Smith's invisible hand is the concept of competition. The action of each producer or merchant who is attempting to garner profit is restrained by the other producers or merchants who are likewise attempting to make money. Competition drives down the prices of goods and in so doing reduces the profit received by each seller. In situations in which there is initially only single seller, extraordinary profit attracts new competitors who increase supply and erase the excessive profit. Employers compete with one another for the best workers, workers compete with each other for the best jobs, and consumers compete with one another for the right to consume products.

The result is that resources get allocated to their highest valued uses; economic efficiency prevails. Because business persons save and invest (out of self-interest) capital accumulates and the economy grows. The pursuit of self-interest, restrained by competition, thus tends to produce Smith's social good (maximum output and economic growth)

4) Inductive, historical method vs abstract, deductive method:

Inductive/historical approach: the economists of the historical school emphasised the importance of studying the economy historically, as part of an integrated whole. Because economic and other social phenomena are interdependent, political economy cannot be treated adequately except in combination with other branches of social science.

→ ↓ profit
single seller →
its →
attract new
competitors →
→ ↓ Profits

study the
economy
historically,
part of
an integrated
whole

The historical school criticised the abstract, deductive, static, unrealistic, unhistorical qualities of classical and marginalist methodology.

5) Partial equilibrium analysis vs general equilibrium analysis:

Walras developed and advocated general equilibrium analysis, which considers the interrelationships among many variables in the economy. This stood in contrast to the partial equilibrium analysis used by Jevons, Menger, and Marshall.

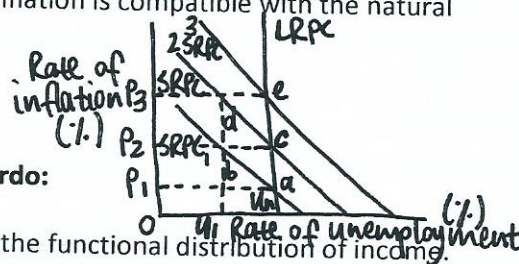
Just as a rock dropped into a pond causes widening circles of ripples. Any change in the economy causes further changes that radiate outward with gradually diminishing force. And as these ripples sometimes reach shore and rebound eventually to affect the initial point of impact, so too are there feedback effects of initial changes occurring in single markets in the economy. This process of reverberation continues throughout the entire system until equilibrium is achieved simultaneously in all markets.

Walras's general equilibrium theory presents a framework consisting of the basic price and output interrelationships for the economy as a whole, including both commodities and factors of production. Its purpose is to demonstrate mathematically that all prices and quantities produced can adjust to mutually consistent levels. Its approach is static because it assumes that certain basic determinants remain unchanged, such as consumer preferences, production functions.

6) The long-run vertical Phillips Curve:

Each short-run Phillips curve shows the combinations of inflation and unemployment that are possible when the actual rate of inflation diverges from the expected rate. When inflation is greater than expected, such as P_2 rather than P_1 , unemployment temporarily falls below the natural rate (from U_n to U_1 (b)). But once P_2 becomes the new expected rate, the short-run Phillips curve shifts from $SRPC_1$ to $SRPC_2$ and the rate of unemployment returns to its natural level (point c). In the long run, said Friedman, there is no trade-off between inflation and unemployment. The long-run Phillips curve is vertical, indicating that any one of several rates of inflation is compatible with the natural rate of unemployment.

(Page 502)



7) Functional distribution of income according to Ricardo:

Ricardo's reference is to factor shares or what today we call the functional distribution of income. His concern was for understanding the forces that determine the shares of the national income accruing as wages, profits, and ~~rest~~ ^{interest} (interest was combined with profits). We must first examine his thinking on each share:

- Wages: Labour, said Ricardo, like all other things that are bought and sold, has its natural price and its market price
- Profits: Ricardo felt that the rates of profit in different field of enterprise within a country tend to equalise
- Rents: Ricardo saw a conflict between the interests of workers and capitalists

Adam Smith's invisible hand theory:

1) Concept of competition:

- Action of each producer or merchant who is attempting to garner a profit is restrained by the other producers or merchants who are likewise attempting to make money

P → ↓ profits • Competition drives down prices of goods → reduces profits received by each seller

• Single seller: extraordinary profit → attracts new competitors → increase supply → erases excessive profit
(↑ Profit → new competitors → ↑ S → ↓ profit)

- Employers compete with one another for best workers

Workers compete with each other for best jobs

Consumers compete with one another for right to consume products

- Resources get allocated to their highest valued uses → economic efficiency prevails

- Business persons save and invest → capital accumulates and the economy grows

- Pursuit of self-interest (restrained by competition) produces Smith's social good, which is maximum output and economic growth

Malthus – Corn Laws:

- Laws placed tariffs on imported grain
- Effectively placed a minimum price on grain imported to England from abroad
- Landlords favoured these tariffs but were under attack as people loved to reap where they had not sown

population → ↑ supply → import food • Growing population was placing pressure on England's food supply, found it necessary to import food.

• Theory of market gluts and the need for unproductive consumption had several policy implications – corn laws must be retained

- Tariffs on imported grain enriched landlords and promoted unproductive consumption

tariffs on grain → ↑ wealth of landlords → unproductive consumption.

Ricardo's theory of distribution of income (wages, profits and rent):

1) Wages:

- Natural price: price that enables workers to subsist and to perpetuate themselves without a change in their numbers

- Depends on the price of the necessities of life required by the labourers and their families

• Increase cost of necessities → Increase nominal wages, workers can maintain their real wages and continue to buy enough to perpetuate the labour force

• Decrease in price of commodities → decrease nominal wages

Market price of labour: depends on supply and demand $Price = X^S_0$

- Fluctuates around the natural price

• Long run: Natural price and nominal wages tend to increase because of the increasing difficulty and cost of producing food for a growing population

Nominal wages must increase → meet increasing costs of food

goods → ↑ nominal wages
goods → ↓ nominal wages

∴ P + W ↑ → difficulty + cost of producing food or an ↑ population

2) Profits:

- Rates of profit in different fields of enterprise tend to equalise
- Entrepreneurs seek maximum rate profit
- Price movements influence rates of profit that in turn direct the flow of capital
- Competitive market \rightarrow produces rates of profit that are equal
- Rate of profit on marginal land (rent is zero) governs the rate of profit in the whole economy
- If rate of profit is higher in industry than farming: K will flow from agriculture to industry
- If agriculture is more profitable than industry: K will flow toward agriculture
- Profits and wages vary inversely
- Rate of profit would decrease because of the increasing difficulty of growing food for an expanding population
- Decreasing rate of profit \rightarrow decreases accumulation and investment of K, producing a stationary state

ice \rightarrow profits
 \rightarrow flow of K

\uparrow profits \rightarrow \downarrow w

\downarrow profit \rightarrow \downarrow K accumulation (I) \rightarrow stationary state

3) Rents:

- Conflict between interest of workers and capitalists
- Increasing population \rightarrow increases demand for food \rightarrow increases the price
- Poorer land will be cultivated, better land cultivated more intensely \rightarrow increasing rents
- Increase in nominal wages \rightarrow decrease profit rates

food \rightarrow \uparrow price

land \rightarrow \uparrow rents

wages \rightarrow \downarrow profits

Friedman:

1) Consumption Function: (not prescribed)

- Suggested that the Keynesian consumption function is too simplistic
- A household's consumption is determined by permanent income rather than current income
Permanent income: defined as the average income that people expect to receive over a period of years
- People attempt to maintain a reasonable standard of living from one year to the next
- Changes in income (temporary) will neither increase nor decrease people's present consumption
- Consumption responds to changes in income that people view to be permanent
- Implication is that the MPC out of changes in current income is smaller than the Keynesian theory would suggest
- Investment multiplier is small – implies that the alleged internal instability in the economy is overstated

2) Monetary Theory:

- Best known for his ideas on the role of money in the economy
Demand for money: Friedman views the demand for money as the demand for cash balances
- Made no distinction between types of money
- 3 determinants of the amount of money households and enterprises will desire to hold
These are independent of factors that influence the supply of money:

- Total wealth – best measured by permanent income
Increase in wealth/increase in permanent income, increases the amount of money people desire to hold as cash balances
- Cost of holding money – higher costs will result in less money being held. Costs vary with the interest rate, expected rate of inflation and price level
- Preferences – preferences remain relatively constant over significant stretches of space and time

wealth → ↑ cash balances
cost of holding → ↓ less money held

Summary:

- Amount of money demand varies
Directly with permanent real income and price level
Inversely with expected rate of inflation
- ↑ D_m → ↑ permanent Y → ↑ P
↑ D_m → ↓ inflation (expected)

3) The modern quantity theory of money:

- Friedman: demand for money is relatively stable in the short run
 - Federal reserve system controls the supply of money
 - Increase in the supply of money – leaves people holding cash balance in excess of amounts they want
 - They will attempt to rid themselves of these excess transaction assets by spending cash
- ↑ M_s → excess balances → ↑ spending → ↑ D → ↑ Prices + output

- Community cannot rid itself of excess cash balance as one person's spending leaves more cash in someone else's hand
- Thus people attempt to rid themselves of cash balances, driving up the demand for goods and services, increasing output, and prices
- Economy is operating at its natural levels of employment and output, only prices will rise over the long run
- As price level rises, demand for money increases, because community desires to hold additional money to buy the higher priced goods
- Eventually equilibrium between quantity of money supplied and demanded is restored, at a higher price level
- Modern quantity theory of money is established
- Assumed demand for money is highly stable
- Relationship between money stock and prices is confirmed by empirical evidence

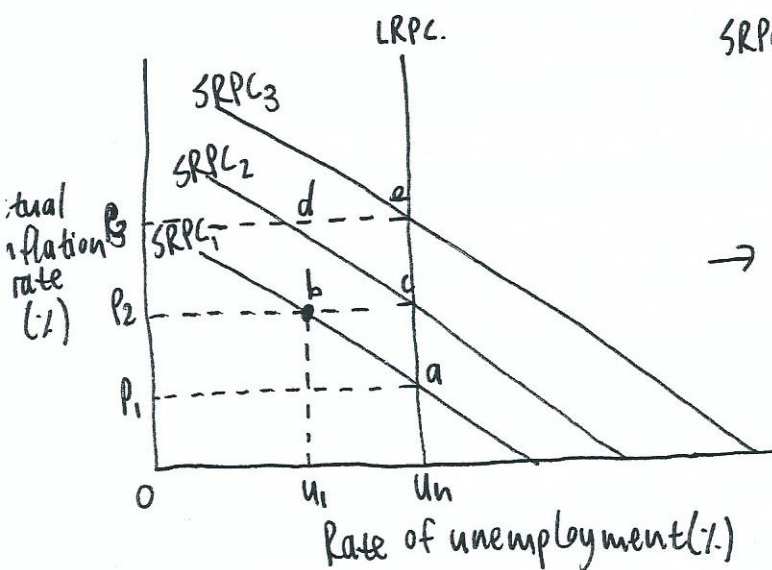
$\uparrow P \rightarrow D_M \uparrow$

4) Cause of the Great Depression:

- Friedman reached the conclusion that monetary policy was responsible for causing the Great Depression of the 1930's

5) The long-run vertical Phillips Curve:

- Natural rate of unemployment is when the actual rate of inflation and the expected inflation are equal



SRPC = combinations of inflation and unemployment that are possible when the actual inflation rate diverges from the expected rate.

→ actual inflation is @ $P_2 = u_n \rightarrow u_1$, natural rate of unemployment is lowered

→ P_2 becomes the expected rate = SRPC₁ shifts to SRPC₂ and moves back to natural rate of unemployment

→ L/R = ~~not~~ No trade-off between inflation and unemployment

→ LRPC, is vertical: indicating that any one of the several rates of inflation is compatible with the natural rate of unemployment

Monetary rule:

- Federal reserve should abandon its use of discretionary monetary policy and adhere to the monetary rule:
Increase the money supply annually at a steady rate roughly corresponding to the long-run rate of growth of capacity *↑MS → L/R rate of growth of capacity*
- 4 reasons such a rule is needed:
 - 1) Past performance of the Fed: has been a source of instability
 - 2) Limitations of economic knowledge: time lags between changes in money stock and changes in output and prices. Time lags are variable
 - 3) Confidence: monetary rule enable workers, businesses and consumers to make contracts with confidence
 - 4) Neutralisation of the Fed:

Economic liberalism:

- We associate with the classical economists who emphasised economic freedom
- Advocated reforms that would place less reliance on government and more reliance on the market
- Market system protects not only economic freedom, said Friedman, but also political freedom
- Examples of his proposals include: an international system of flexible, market-determined foreign exchange rates
- Friedman has helped establish that money matters in the economy

Essay on marginalist-neoclassical economics:

• Reaction against the classical school:

The trend of the 19th century in Europe was to develop 3 approaches of attack on pressing social problems, and all of these flouted classical economic precepts:

Approaches:

- 1) To promote socialism
- 2) Bolster trade unionism
- 3) To demand government action to ameliorate conditions by regulating the economy

The marginalists apposed all three solutions. Marginalists concluded that although the value and distribution theories of the classical economist were inaccurate, their policy views were correct.

Marginalists defended market allocation, and distribution deplored government intervention, denounced socialism, and sought to discourage labour unionism as ineffective.

• Meaning and role of the concept of utility:

Marginalist school – one of their tenets:

- 1) Emphasis on subjective utility: demand depends on marginal utility, which is a subjective, psychological phenomenon
- 2) Its focus on margin: this school focused its attention on the point of change where decisions are made – on the margin
The Marginalists extended to all economic theory the marginal principle that Ricardo developed in his theory of rent

• Marshall's demand and supply framework, and the law of demand:

Utility and demand:

- 1) Marginal utility: demand is based on the law of diminishing marginal utility. Marginal utility of a thing to anyone decreases with every increase in the amount of it he already has

2 qualifications of the law of diminishing marginal utility:

- Concerned with a moment in time
- Consumer goods that are indivisible

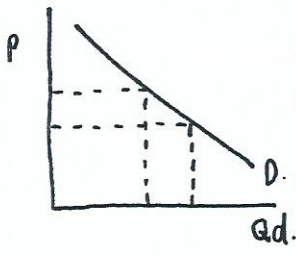
- 2) Rational consumer choice:

- Weighting marginal utilities of two different types of expenditures
- Marshall tied this equimarginal rule directly to the law of demand

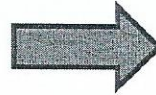
- 3) Law of demand:

- Marshall's law of demand follows from his notions of diminishing marginal utility and rational consumer choice.
Suppose a consumer's expenditures are in equilibrium, such that the last dollar spent on each of several products yields identical marginal utility
- $MU_x/P_x = MU_y/P_y$

u ↓ → ↑ in
amount of
it he already
has



- Decrease in price, increases demand
- Increase in price, decreases demand



This is the law of downward sloping demand

- Differences between the change in quantity demanded and changes in demand (shifts of the curve)
- When the price of a product decreases, two effects that increase the quantity purchased
 $\downarrow P \rightarrow Q \uparrow$ (substitution and income effect)
- Marshall focused on the substitution effect
- There is also an income effect; the consumer experiences a gain in purchasing power

4) Consumer surplus:

Problem with measuring a consumer's surplus is evident in dealing with the market as opposed to individual demand curves.

- Measurement of the total consumer's surplus requires adding together interpersonal units of utility
- Proved to be a valuable tool for analysing economic phenomena – deadweight losses from taxes, monopoly, and tariffs

5) Elasticity of demand:

- Marshall said that it diminishes with every increase in his supply of that commodity
- Lower the price, the more the consumer will buy
- Demand curve slopes down to the right
- Elasticity of demand tells us whether the marginal utility is slow or rapid as the quantity increases



- 1) Marginal utility
- 2) Rational consumer choice
- 3) Law of demand
- 4) Consumer surplus
- 5) Elasticity of demand

Relates to % decrease in Prices to % increase in quantity demanded

- Coefficient of the elasticity of demand ($E_d = \% \text{change in } Q / \% \text{change in } P$)
- Demand is elastic - % change in $Q >$ % change in Price
- Demand is inelastic - % change in $Q <$ % change in Price
- Demand is unit elastic - % change in $Q =$ % change in Price
- Lowering of the price results in more buyers being able to afford the product
- Marshall noted that the demand for a product will be more elastic the more it can serve as a substitute for other goods
- Government tax commodities for which there are inelastic demands (cigarettes) because the revenue yield is greater

Supply:

1) Immediate Present:

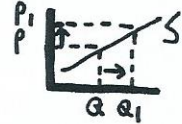


- Market prices refer to the present
- Good is perishable, assume seller is trying to maximise profits, the market supply curve is perfectly inelastic – a vertical straight line
- Good is not perishable, sellers have reservation prices below which they will not sell, market supply curve slopes upward, until it encompasses the total quantity on the market



2) Short run:

- Marshall divided costs into 2 types:
Supplementary costs – fixed costs
Prime costs – variable costs
 - Fixed costs: such as depreciation are constant (cannot be changed)
 - Variable costs: labour and raw materials that change according to changing levels of output
 - Short run: all variable costs must be covered
 - Supply curve sloped upward to the right – (increase in P, increase the Qs)
 - Short run supply curve is viewed as the marginal cost curve
 - Increase in market prices enable firms to profitably expand their output
 - Higher the wage rate – the higher the marginal cost of production
 - Firms increase their work days to increase their production only when the price they receive for their product increases
 - Higher product price means that the $MR > MC$
- Perfect competition: $MR = P$, this entices the firm to expand output until $MR = MC$



variable costs:
= Δ to Δing levels
of output

All v.c covered
↑ P → ↑ output

3) Long run:

- All costs are variable, all must be covered if the firm is to continue in business
- Price increases, such that total revenue > total cost of production, K will enter the industry, through new firms and market supply will increase.
Supply curve shifts right
- Price decreases below average cost of production, K will withdraw, probably from the exit of firms – market supply will decline
Supply curve will shift left

↑ P → TR > TC →
↑ K → new firms →
↑ supply

P → TR < TC →
↓ K → exit of firms
→ ↓ supply

• **Marshall's theory of factor prices and income distribution:**

Marshall said that; demand and supply determine market price

Supply: financial and subjective costs

Demand: utility and diminishing marginal utility

Income distribution: determined by the pricing of factors of production



1) Wages:

- Marshall said that wages are not determined by the marginal productivity of labour alone
- Marginal productivity is the basis for the demand for labour, which is a derived demand depending on the demand by consumers for the final products
- Wages depend on both supply and demand

2) Interest:

- Decrease in i increases capital investments $\downarrow i \rightarrow \uparrow I$
- Interest rate settles as the point of intersection of the demand and supply curves
- The price (interest rate) determines the quantity of the commodity supplied

3) Profits, rent, quasi-rent:

- Marshall said, normal profits include interest, supply price of business organisation, earnings of management
- Earnings of management are a payment for a specialised form of labour
- Supply price of business organisation is a reward to entrepreneurship
- Land and buildings, are both subject to diminishing returns as their owners try to gain additional output from them
- Supply of land is fixed
- Return to old capital investments is something akin to rent – Marshall called it 'quasi-rent'
- Interest is the earnings on new investments of capital, quasi-rent is the earnings on previous capital investments in the short run
It assumes that capital is specialised
- Long run: quasi-rent disappears, because a normal return to the capital investment is essential if the investment is to be renewed and business perpetuated
- Only variable costs influence process in the short run
- Prices determine the earnings of the fixed investment
- Long run: both variable costs and normal returns on the fixed investment must be covered and they both affect price

Land + buildings =
↓ returns