Schools of Economic Thought

Vladan Hodulak

This powerpoint serves as a study material for the students of the course Introduction to economics (MEB435) at FSS MU in Fall 2018. Using this presentation for other purposes without consent of the author is prohibited.

Introduction

- Theory
  - A construct of thought that abstracts the relevant information and relationships from the reality
  - A tool that enables us to recognize the essence of the problem
  - A tool to organize our thoughts
  - And finally a tool that gives us solutions to the problem at hand
- Positive vs normative theory
- Economics has gone through a turbulent development with several paradigmatic shifts.
- Apart from the dominant neoclassical theory there are several recognized schools of economic thought.

Mercantilism

- International trade is a zero-sum game.
- 16th-18th century
- Widespread economic policy (in Europe)
- Key concepts
  - Money is wealth
  - Positive balance of payments
  - Added value
- Relevance and shortcomings

The Classical School

- The market keeps all producers alert through competition, so leave it alone.
- Late 18th – late 19th century
- A. Smith, D. Ricardo
- Key concepts
  - Invisible hand
  - Say’s law
  - Comparative advantage
  - Class analysis
- Relevance and shortcomings

The Neoclassical School

- Individuals know what they are doing, so leave them alone – except when markets malfunction.
- Since late 19th century
- L. Walras, A. Marshall
- Key concepts
    - Rational individuals
    - Subjective theory of value (utility)
    - Marginal analysis
    - Pareto criterion

Internal divisions among NC economists

- Various labels (saltwater vs freshwater, new Keynesian vs new classical etc.), the basic model, different additional assumptions (or frictions)
- Liberal (Krugman, Stiglitz)
  - Market failures, externalities, asymmetric information, oligopolies, sticky prices
- Conservative (Friedman, Lucas)
  - Rational expectations, efficient market hypothesis, government failures, flexible prices
- Relevance and shortcomings

The Marxist School

- Capitalism is a powerful vehicle for economic progress, but it will collapse, as private property ownership becomes an obstacle to further progress.
- Since the second half of 19th century, K. Marx
- Key concepts
  - Labor theory of value
  - Historical materialism (modes of production; base × superstructure; forces × relations of production)
  - Class conflict
- Relevance and shortcomings

The Developmentalist Tradition

- Backward economies can’t develop if they leave things entirely to the market.
- Very old, important after the Second World War
- A. Hamilton, F. List
- Key concepts
  - Focus on practical problems of development
  - Production capabilities
  - Infant industry argument
- Relevance and shortcomings

The Austrian School

- No one knows enough, so leave everyone alone.
- Late 19th century
- C. Menger, L. Mises
- Key concepts
  - Uncertainty
  - Spontaneous order
  - Free markets
- Relevance and shortcomings

The (Neo-)Schumpeterian School

- Capitalism is a powerful vehicle of economic progress, but it will atrophy, as firms become larger and more bureaucratic.
- First half of the 20th century, J. Schumpeter
- Key concepts
  - Innovations (creative destruction)
  - Role of the entrepreneur
  - Bureaucratization of the economy
- Relevance and shortcomings

The Keynesian School

- What is good for individuals may not be good for the whole economy.
- Since 1930s, J. Keynes
- Key concepts
  - Full employment
  - Uncertainty
  - Animal spirits (liquidity preference)
  - Demand management
- Relevance and shortcomings

The Institutionalist School

- Individuals are products of their society, even though they may change its rules.
- Old – since late 19th century, T. Veblen
- Key concepts
  - Formal and informal institutions
  - Conspicuous consumption (importance of status)
- New – since 1980s. D. North
- Key concepts
  - Transaction costs
  - Property rights
- Relevance and shortcomings

The Behaviouralist School

- We are not smart enough, so we need to deliberately constrain our own freedom of choice through rules.
- Since late 20th century, H. Simon, D. Kahneman
- Key concepts
  - Bounded rationality
  - Heuristics
  - Altruism
- Relevance and shortcomings

European monetary integration

Gold standard

- Fixed exchange rate system, most important currencies pegged to gold
- Europe-led system, Bank of England as the most important element
- Governments sacrificed internal balance to maintain an external one

Interwar system

- Attempts to restore gold standard, problems with parities (undervalued×overvalued)
- Great depression – beggar thy neighbor policy (competitive devaluations)

Bretton Woods system

- Fixed but adjustable exchange rate system, currencies pegged to US dollar that was convertible to gold at $35 per ounce
- Provided stability for the post wwii world, mounting instability since the end of 1960s

First attempt at establishing EMU

- 1969 The Haague summit
- The Werner report
- Snake in the tunnel
- Nixon shock, first oil shock, enlargement

The European Monetary System

- Since 1979
- New accounting unit – European Currency Unit (ECU) – the basket of all EC currencies
- Exchange rate mechanism (ERM) – allowed exchange rate variation 2,25% from the ECU
- Qualified success
- 1992 crisis

EMU

- Delors report
- Three-stage timetable
  - First stage – intensify economic cooperation, all countries in ERM
  - Second stage – European Monetary institute (later European Central Bank), convergence tests, permanent peg
  - Third stage – the transition to full EMU, introduction of the euro
- Treaty on European Union
  - Opt out for the United Kingdom and Denmark
  - All other countries have to join when they are ready

Maastricht criteria

- Government deficit: the ratio of the annual government deficit to gross domestic product (GDP) must not exceed 3% at the end of the preceding financial year
- Government debt: the ratio of gross government debt to GDP must not exceed 60% at the end of the preceding financial year
- Exchange rates: participation in the exchange-rate mechanism of the European monetary system without any break during the two years preceding the examination of the situation and without severe tensions
- Price stability: the inflation rate of a given Member State must not exceed by more than 1½ percentage points that of the three best-performing Member States in terms of price stability
- Long-term interest rates: the nominal long-term interest rate must not exceed by more than 2 percentage points that of, at most, the three best-performing Member States in terms of price stability

EU member states’ performance with regard to the convergence criteria

	deficit 95	deficit 96	deficit 97	debt 95	debt 97
Belgium	4,1	3,3	2,1	133,7	122,2
Denmark	1,6	1,4	+ 0,7	71,9	65,1
Finland	5,2	3,3	0,9	59,2	55,8
France	4,8	4,0	3,0	52,8	58,0
Ireland	2,0	1,6	+ 0,9	81,6	66,3
Italy	7,1	6,6	2,7	124,9	121,6
Luxembourg	+ 1,5	+0,9	+ 1,7	6,0	6,7
Germany	3,5	4,0	2,7	58,1	61,3
Netherlands	4,0	2,6	1,4	79,7	72,1
Portugal	5,1	4,0	2,5	71,7	62,0
Austria	5,9	4,3	2,5	69,0	66,1
Greece	9,1	7,9	4,0	111,8	108,7
Spain	6,6	4,4	2,6	65,7	68,8
Sweden	8,1	3,9	0,8	78,7	76,6
Great Britain	5,8	4,6	1,9	54,1	53,4

Stability and Growth Pact

- The most important instrument of coordinated economic policy
- Adopted in Amsterdam, 1997; in force since 1999
- Reason: fiscal discipline in the EMU as the stability factor of single currency
- Criteria:
  - an annual budget deficit lower than 3 % of GDP
  - a public debt lower than 60 % of GDP or approaching that value
- Excessive budget procedure–proposal of Commission, decision by Council (including sanctions)
- Problems: Germany, France (no sanctions against them in the Council)→changes in the rules since 2005 (moderation of rules)