Written Exam Economics Summer 2018

History of Economic Thought

May 18 at 10.00 to May 25 at 10.00

Indicative answers

1. Ricardo's theory of international trade is the foundation of trade theory. That is at least what many people claim!

   This must mean that Ricardo's understanding of trade was more sophisticated than Adam Smith's. Do you agree? It must also be the case that Ricardo' version of trade theory is close to modern, neoclassical trade theory, known as the Heckscher-Ohlin model. Is that true?

   Remarks. Let us start by revisiting slide "Lecture 3" and by rereading Sandmo ch. 4. Several issues are relevant here:

   i. It is often believed that Adam Smith argued for the benefits of international trade by referring to absolute advantages, while Ricardo understood that even with relative advantages, trade is beneficial to all; it is relevant to have these concepts explained. Sandmo is by and large in favour of the narrative that Ricardo had a more advanced theory than Smith and understood relative advantages. As one can see from my slide, doubts remain. It is possible to read in relative advantages in Smith and Ricardo may not have understood this concept completely anyway. Ricardo wrote 7 pages about international trade, while Smith spent more than 300 pages on that subject.
   ii. For Ricardo to be the founding father of trade theory, it will be natural to see similarities between his model and e.g. the Heckscher-Ohlin model. A "yes" or a "no" is not so relevant, however arguments related to factor mobility and technology are what matters.
   iii. One problem with Ricardo is that he had to argue – strongly – that a theory that explains domestic trade cannot explain international trade. "80 Englishmen cannot substitute 100 Englishmen" Behind this strange argument lied his theoretical starting point: the Labour Theory of Value. Smith may never have seen the limitations imposed by the nonsensical LTV, however Ricardo may have understood this without being able to do something constructively.
   iv. A good paper may explain LTV and Ricardo's 93% exercise.

2. Why is capitalism doomed according to Karl Marx?

   Remarks.

   i. We have the exploitation argument. Workers cannot accept the capitalists' exploitation meaning that they are prevented from receiving the full value of their work effort. This in combination with some version of the iron law of wages places workers in a perpetual state of misery. LTV, the capitalists' managerial and entrepreneurial activities may be discussed – is the efforts of the capitalists worth nothing?
   ii. Then the macro-crisis arguments related to the falling rate of profits should be discussed. The entire model may be sketched. An investment boom based on the lust for profits among capitalists, triggers an employment boom. This is being terminated when capacity is raised too much – a devastating downturn follows. The assumptions (workers cannot save, and capitalists are irrational in their investment behavior) should be discussed.
   iii. The supplementary assumption that concentration rises and makes exploitation even worse – "monopoly capitalism" – is there as well. With a reference to q. 8 below we see that a capitalism that remains perfectly competitive is more acceptable than a capitalism that degenerate into monopoly. This is In line with Schumpeter and Joan Robinson, and at

odds with Chamberlain. If we assume that good and innovative firms make old capital obsolete through monopolistic behavior, what happens then?

3. Is it fair to see Jevon's sun spot theory as "the most ridiculed idea of his life"?

Remarks

i. Notice that the word in the quote is "ridiculed" and not "ridiculous". As we see in Sandmo, Jevons was mucked, however was it fair? One thing is to criticize his primitive econometrics, another thing is to blame him for arguing that exogenous factors must be the cause of the business cycle. Remember that at Jevons' time no one had been able to explain the ups and downs. The classical writers neglected the issue (Say and others may have had vague references to less perfect market clearing) while Mill gave up. On the other hand, the business cycle was there! Arguing for exogenous factors is a time-honored position!
ii. Good answers may reflect upon Jevons' methodological difficulties (measuring the length of the solar cycle and finding indices for economic activity), for not providing a solid link between agricultural prices and domestic economic activity and for assuming without further arguments that markets cleared perfectly. References to modern theories stressing exogenous factors are welcome (RBC).
iii. We may see Jevons' sun spot as an interesting shot at a puzzling question! However, it is of course possible to see the idea as too far-fetched.

4. Present Wicksell's cumulative process and the Quantity Theory of Money. Are the two models telling the same story? How would you relate the two models to modern discussions on the design of monetary policy?

   Remarks

   The two models are presented in "Lecture 13" and "Lectures 10 and 14" respectively.

   i. The cumulative process focusses on the banking system (perhaps including the central bank) setting a wrong lending rate. Too low a rate will create a demand pressure that increases the inflation rate. Now, a rising inflation, lowers the real borrowing costs even further when the nominal lending rate is maintained, so the inflationary process becomes cumulative as the real borrowing costs go on falling.
   ii. The quantity theory tells us that an injection of more (central bank?) money creates extra demand for the available, exogenous output; we only reach a new equilibrium when the price level has adjusted upwards to accommodate for the increased money supply.
   iii. Basically, the two stories are close – monetary factors disturb the economy and either the central bank or the banking system are to blame.
   iv. The Wicksell story may appear superior as it deals with the inflation rate and not the price level; however, the quantitative theory leads on to modern explanations of policy makers trying to by extra output (and extra voters etc.) – and that is persuasive! In the cumulative model we experience inflation due to errors, why aren't they corrected? On the other hand, the implicit transmission mechanism in Wicksell's model is more modern and sophisticated than – say – mysterious "helicopter money". The theoretical distance between Wicksell's model and something like the Taylor rule is small!

v. In both models, output is exogenous. However, in modern monetarism (2nd generation quantity theory) a Philips curve realistically makes output flexible in the short run.
vi. Again, it is the quality of the arguments, not the final verdict that counts.

5. In his *Economics of Welfare* (1920), A.C. Pigou argued for taxes or subsidies to adjust market equilibria in the case of externalities. Explain his arguments!

   The British-American economist Ronald Coase (1910 – 2012) published a paper in 1960, *The Problem of Social Cost,* Journal of Law and Economics 1960, where he criticized Pigou harshly. Explain Coase's arguments. When doing so, you may decide to read *The Problem of Social Cost*, however what you must read is the paper by Herbert Hoovenkamp, *The Coase Theorem and Arthur Cecil Pigou*, The University of Pennsylvania Law School, 2008 enclosed with this exam set.

   Explain Coase's critique of Pigou and discuss whether it appears justified.

   Remarks

i. Full marks will be given for a complete presentation of Pigou's treatment of externalities – taxes / subsidies can adjust the equilibrium so that we get back to something like a competitive equilibrium. Taxes will also bring in some revenue. Likewise based on Hoovenkamp, Coase's arguments should be explained.
ii. When considering Pigou, what we have in the back of our heads is pollution – a tax on CO_2 remedies the situation! Coarse also speaks of externalities, however not in quite the same way as Pigou. We have Coase-externalities when someone is affected by an allocation of resources without being part of the decision. While Pigou's solution was taxes, Coase's argues in favour of legal negotiation with private settlements. Farmer A has removed water from farmer B's field without permission. Farmer A must then compensate farmer B.
iii. Interventions by the public sector could work badly as taxes / subsidies may be ineffective; the generalized version of Coarse is that (high) transaction costs points in the direction of marked oriented solutions.
iv. Hoovenkamp argues persuasively that the two writers deal with different cases and that their toolboxes are complementary. That is a convincing case! However, Coase obviously believed that market-oriented solutions should be preferred as markets in principle were better than government interventions and that (more) taxes were bad.
v. As is often the case with Pigou, ideology is below the surface, one of the founding fathers of the welfare state. Coarse, obviously is in the opposite ditch.

6. Keynes and Friedman
   Why is it that Milton Friedman remained convinced that monetary policy should be preferred to fiscal policy as the major tool for economic stabilization, while John Maynard Keynes meant the opposite?

   Remarks

   Ref. table in slide 16 in "lecture 18".

i. In Keynes, we can have unemployment equilibria, while unemployment in Friedman is a temporary phenomenon. Keynes had to recommend fiscal policy, as monetary policy may not work – little interest rate elasticity in real demand, instability in investment function, MEC unstable. On the other hand, multiplier high. So fiscal policy is needed and possible.

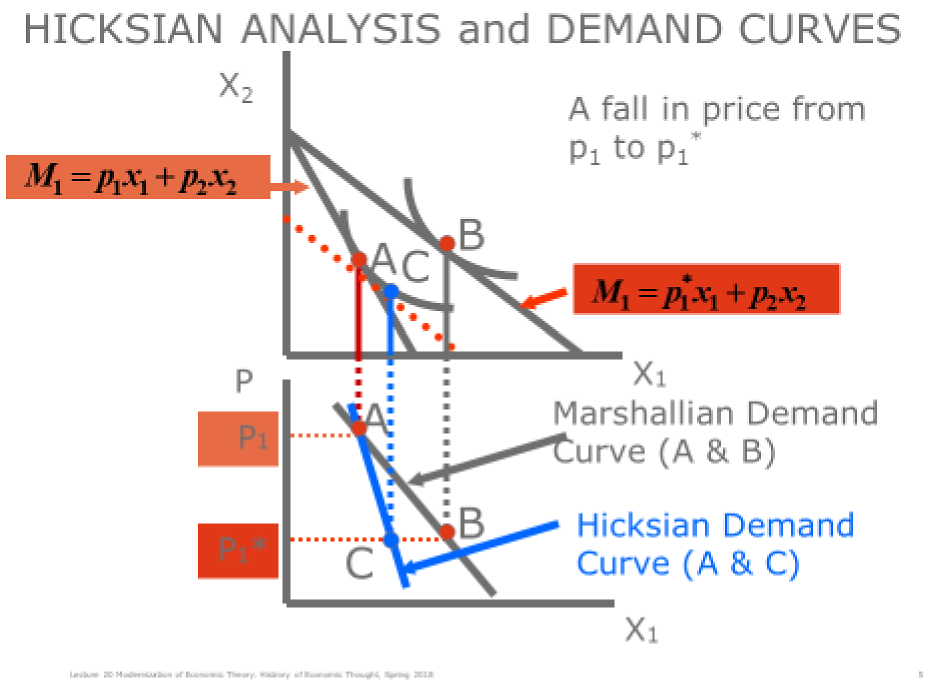
ii. Friedman had exactly the opposite set of assumptions – again ref. slide 16 – making monetary policy the natural choice. So fiscal policy will not be needed and not be possible.

iii. The Friedman Phillips curve may be sketched, however that needed.

iv. A good paper will bring in summaries of empirical results, a discussion of permanent income, suggestions related to the stability of the demand for money function and Keynes' ideas about the propensity to consume in the short and long run.

v. If you end up by saying that Friedman won the debate, why then is no one running their monetary policy based on monetary aggregates? Financial innovation!

7. Marshall's and Hicks' demand curves. Revisit this diagram from slide "lecture 20"



Here we analyze the consequences of a fall in one of the two prices (p_1) and derive two demand curves. One called the Marshallian demand curve and one called the Hicksian demand curve. How are these curves derived, how do they differ and why is the Hicksian curve steeper than the Marshallian?

Remarks.

i. When the price of one good is lowered, that good becomes cheaper and substitution will work. However, the purchasing power of the consumer also goes up – the consumer is richer! Marshall lumps together – or does not understand the distinction – substitution and income effects. Given this "mistake", the Marshallian demand curve becomes more elastic than the proper – Hicksian – demand curve that only relies on substitution.

ii. Good papers may excuse Marshall by referring to his partial equilibrium method. When we only consider small markets, the income effect is neglectable. However, many markets are not small – the critical issue here is whether papers discuss the effects and eventually mention the Slutsky equation.

iii. Some may say something about the difference between Marshall more practical approach – we cannot deal with all markets at a time – and Hicks insistence on General Equilibrium.

8. Joseph Schumpeter wrote his *Capitalism, Socialism and Democracy* in 1942. The world was at war and in America – as in the other belligerent countries – the economy was managed by planning au-

thorities to maximize war production. A market economy was not considered relevant or possible. Did this mean that capitalism was obsolete? This is what Schumpeter analyzed in his book.

He begins by explaining on p. 78:

“Neither Marshall and Wicksell nor the classics saw that perfect competition is the exception and that even if it were the rule there would be much less reason for congratulation than one might think.”

And continues p. 81:

“The theories of monopolistic and oligopolistic competition and their popular variants may in two ways be made to serve the view that capitalist reality is unfavorable to maximum performance in production. One may hold that it always has been so and that all along output has been expanding despite the secular sabotage perpetrated by the managing bourgeoisie. Advocates of this proposition would have to produce evidence to the effect that the observed rate of increase can be accounted for by a sequence of favorable circumstances unconnected with the mechanism of private enterprise and strong enough to overcome the latter’s resistance.”

And on p. 112:

“There is surely no such gulf between Marx and Keynes as there was between Marx and Marshall or Wicksell. Both the Marxist doctrine and its non-Marxist counterpart are well expressed by the self-explanatory phrase that we shall use: the theory of vanishing investment opportunity.”

However, he also has some arguments in favor of capitalism and is dynamics, e.g. on p. 82-83:

“The fundamental impulse that sets and keeps the capitalist engine in motion comes from the new consumers’ goods, the new methods of production or transportation, the new markets, the new forms of industrial organization that capitalist enterprise creates.”

Present a sketch of Schumpeter’s version. Bring in Edward Chamberlain’s idea of monopolistic competition. Is capitalism as sick as Schumpeter claimed?

Remarks

i. In class we repeatedly discussed the relationship between markets and politics. Critical Voices argued that capitalism degenerated – we have Marx and Veblen telling us that perfect competition is not here to stay. Pigou would argue that there could be externalities and Joan Robinson saw her imperfect competition as a market failure. Edward Chamberlain saw on the other hand his monopolistic competition as a sign of capitalistic vitality. Firm build up temporary monopolies that soon is broken by new competitors.

ii. Socialistic writers – e.g. Oskar Lange – argued that socialism and central planning was a necessity; too much crisis and waste under capitalism. However perfect competition should be imitated under socialism to maintain optimum.

iii. Nothing much about the arguments we to have today about Chamberlainian capitalism: all the new products and technological progress. Where would the world be without Apple and Novo? And haven’t we seen how hopelessly ineffective centrally planned economies work?

iv. Add to this that the world has become more and not less capitalistic since World War II.

v. A good paper goes through all Schumpeter's arguments:

vi. Is it true that perfect competition is so unusual? Microsoft may have appeared invincible but then came Apple and Google. The struggle may appear nasty; however, the system may work?

vii. Is it true that [capitalism is] "unfavorable to maximum performance in production"? Maybe during a war, otherwise no one would say that, why?

viii. The idea that there is a Marx-Keynes line of argument for investment opportunities under capitalism being emptied. Rather one would say that technological renewal is so wild that we spend to many resources on new iPhones that aren't needed. Interestingly, that argument the argument for perpetual capitalistic renewal is often called Schumpeterian!

ix. The argument that with non-capitalism comes non-democracy. Not so easy, we obviously are having more capitalism and less democracy!

x. A paper may or may not sympathize with the book, what matters is a critical evaluation of the arguments. Is capitalism much stronger than Schumpeter imaged while at the same time in need for some taming – rather the opposite of what Schumpeter believed?