Macroeconomics and the Market

ECONOMICS TODAY Edited by Andrew Leake

The *Economics Today* series surveys contemporary headline topics in applied economics. Each book in the series is written by an expert in the field in a style that is fluently readable. It serves the student of introductory economic principles while also making the subject accessible to a more general reader. The series embraces the problem-solving skills of the new generation of students and stresses the importance of real-world issues and the significance of economic ideas.

Published

Andrew Leake: The Economic Question

Jean-Louis Barsoux and Peter Lawrence: The Challenge of

British Management

Andy Beharrell: Unemployment and Job Creation

Frank Burchill: Labour Relations Kenneth Durham: The New City

S.F. Goodman: The European Community (2nd edition)
Kent Matthews: Macroeconomics and the Market

Charles Smith: Economic Development, Growth and Welfare

Jenny Wales: Investigating Social Issues

John Wigley and Carol Lipman: The Enterprise Economy

Margaret Wilkinson: Taxation

Forthcoming

Nigel Healey and Mark Cook: Growth and Structural Change Ian Hodge and Diane Dawson: Choices for the Environment John Wigley: The Rebirth of Russia

Series Standing Order

If you would like to received future titles in this series as they are published, you can make use of our standing order facility. To place a standing order please contact your bookseller or, in case of difficulty, write to us at the address below with your name and address and the name of the series. Please state with which title you wish to begin your standing order. (If you live outside the UK we may not have the rights for your area, in which case we will forward your order to the publisher concerned.)

Standing Order Service, Macmillan Distribution Ltd, Houndmills, Basingstoke, Hampshire, RG21 2XS, England.

MACROECONOMICS AND THE MARKET

Kent Matthews



© Kent Matthews 1994

All rights reserved. No reproduction, copy or transmission of this publication may be made without written permission.

No paragraph of this publication may be reproduced, copied or transmitted save with written permission or in accordance with the provisions of the Copyright, Designs and Patents Act 1988, or under the terms of any licence permitting limited copying issued by the Copyright Licensing Agency, 90 Tottenham Court Road, London WIP 9HE.

Any person who does any unauthorised act in relation to this publication may be liable to criminal prosecution and civil claims for damages.

First published 1994 by THE MACMILLAN PRESS LTD Houndmills, Basingstoke, Hampshire RG21 2XS and London Companies and representatives throughout the world

ISBN 978-0-333-56282-6 ISBN 978-1-349-23673-2 (eBook) DOI 10.1007/978-1-349-23673-2

A catalogue record for this book is available from the British Library.

Typeset by EXPO Holdings, Malaysia

Contents

List of Tables ix List of Figures x

1 The Market System 1

Macroeconomics 1
The Market Mechanism 2
The Microeconomics of the Market 4
Information and Uncertainty 6
Anatomy of Market Failure 7
A Market with Money 8
Money in the Economy 11

2 The Market Fails: The Birth of an Idea 13

The Classical View 13
The Classical Model 15
The Years of the Waste Land 17
The Birth of an Idea 18
Policy Failure or Market Failure? 20
A Role for the State 23
Macroeconomics and Macroeconomists 25

3 The Market Managed 27

You Never Had it So Good 27
In the Long Run We Are Dead 31
Targets and Instruments – A Balancing Act? 31
Theory and the Real World 35
Hitting a Moving Target 36
Too Many Cooks? 38
A Model Answer 41
Conclusion 44

4 The Gathering Clouds 45

Stop-Go - and Stop Again 45
The Calm of a Straitjacket 46
Rearranging Deck-Chairs 48
The Failure of Supply 51
Bottlenecks 55
Follow My Leader - World Inflation 56
The Revolt of the World Market 58
Evaluation 60

5 The Market Stagnates 61

Keynesians and Classicals: A Shotgun Wedding 61
Classicals Rule OK? 64
The Counter-Revolution 67
Unemployment – A Natural State 70
Inflation – Tail Wags Dog 72
Messing Around with Markets 74
The Sick Man of Europe 76
The Frontier of Production 77
Demand for Labour 78
Supply of Labour 78
Wages – A Sticky Problem 81
Aggregate Supply and Demand 82
Stagflation – A New Economic Disease 84

6 Political Economy Reborn: The Age of the Maggie 86

The Winds of Change 86
A Rational Expectation 87
To Anticipate the Unanticipated 90
The Ineffectiveness of Policy 91
The Games People Play 94
The Economic Consequences of TINA 97
Summary 101

7 Supply-Side Economics – A Revolution? 103

The Age of the Entrepreneur 103
The Unemployment/Poverty Trap 104
Unemployment and the Market for Labour 100
Unions and Labour Sclerosis 110
The External Market 114
The Thatcher Miracle? 116
Conclusion 120

8 The Market and Money 122

Monetarism Gained 122 Monetarism Lost 126 The Lawson Boom 130 The Debt Trap 134

9 Macroeconomics of a Macro-Market 138

Big is Beautiful 138
The Economics of the EMS – A Cooperative Game? 140
The Economics of the EMS – A Leader–Follower Game? 146
The Economics of EMU 148
A Super Central Bank 150
Political Economy of Cooperation 153

10 Macroeconomics: The Epilogue 156

Macroeconomics of the 1990s 156
Did the Market Fail in the 1930s? 157
The Future of Macroeconomics 159
Macroeconomics and the Future 161

Index 163

List of Tables

3.1	Economic Indicators, 1950–73 28
5.1	Growth Rates of Major OECD Countries, 1964-79 76
6.1	Economic Indicators, 1979–83 97
6.2	Causal Indicators 98
6.3	Targets and Outturns 99
	(a) PSBR as a Percentage of GDP
	(b) M3 Growth
7.1	Trends in Productivity Growth 117
7.2	Labour Productivity Growth in Manufacturing 118
7.3	Productivity Growth in Services: Growth in 120
	Output per Worker
10.1	Economic Indicators, 1921–38 158

List of Figures

1.3	Health Insurance for OAPs 8	
2.1	Unemployment and Capacity Utilisation, 1855–1913	14
2.2	Investment and Savings 16	
2.3	Aggregate Demand and Aggregate Supply:	
	Classicals versus Keynes 19	
2.4	Price Stickiness 22	
3.1	Share of Public Spending as a Percentage of GDP,	
	1921–90 30	
3.2	Internal Balance 32	
3.3	External Balance 33	
3.4	Internal and External Balance 34	
3.5	Optimal Policy Choice: Inflation and Unemployment	37
3.6	Intervention in the Business Cycle 39	
3.7	Flow Chart of a Macroeconomic Model 42	
4.1	Exports and Imports 47	
4.2	Uncertainty and Investment 49	
4.3	Output and Absorption 52	
4.4	Internal Equilibrium 53	
4.5	Internal and External Equilibrium 54	
4.6	The Labour Market 57	
5.1	Market Forces and Widgets 62	
5.2	Liquidity Preference 64	
5.3	Excess Supply of Labour 66	
5.4	The Expectations-Augmented Phillips Curve 68	

1.1 Circular Flow of Income and Expenditure 3

1.2 Demand and Supply 4

- 5.5 The Long-Run EAPC 69
 5.6 Cost-Push Inflation 72
 5.7 Demand-Pull Inflation 73
- 5.8 Production Function 77
- 5.9 The Oil Shock and the Labour Market 79
- 5.10 The Demand and Supply of Labour 81
- 5.11 Aggregate Demand and Aggregate Supply 83
- 5.12 Aggregate Supply and Stagflation 84
- 6.1 Aggregate Demand and Supply 90
- 6.2 Anticipated versus Unanticipated Demand Policy 92
- 6.3 Credibility and Anti-Inflation Policy 95
- 7.1 Laffer Curve 105
- 7.2 Income Distribution and Benefit Status 108
- 7.3 The UK Labour Market 109
- 7.4 The Union Decision 110
- 7.5 A Rise in Unemployment Benefits 113
- 7.6 Real Exchange Rate, 1970-80 114
- 7.7 Trade Union Mark-Up 115
- 7.8 Real Unemployment Benefits, 1970-80 116
- 8.1 The Demand for Money 126
- 8.2 Inflation and £M3 Growth, 1979–89 127
- 8.3 Inflation and M0 Growth, 1979–89 129
- 8.4 Current Account Balance, 1979-89 131
- 8.5 Underlying Inflation and Variance of Inflation 132
- 9.1 Non-Cooperative Monetary Policy 143
- 9.2 ERM versus EMU 152
- 9.3 Inflation/Unemployment: West Germany and the EC Some Policy Preferences 153