Two leading economists question the theory underlying the Government's policies 25.2.80

Monetarism: why Mrs Thatcher should beware

The Government's economic policies are now based on monetarist doctrine. Monetarist economists (for example Professor Minford in *The Times*, Feburary 4) are claiming to have achieved an economic counter-revolution, meaning a revolution in our understanding of how the economy works. Yet few people seem to know what is the precise nature of that claim or what are the objections to it.

This is not satisfactory. If there is the possibility of a flaw in the theory on which the Government's policies are based, it is better that it should be aired and recognized early, than that the Government should ride blindly into a crisis and adopt an ill-prepared alternative.

There are three points to consider. First, what precisely is the claim made by the monetarists? Secondly, what is its theoretical basis? Third, is that theory supported by evidence?

The monetarists' position is commonly stated by reference to demand and supply in the market for labour: firms will employ more labour the lower the wage relative to prices (that is, the lower the "real wage"); on the other hand, workers will offer more labour the higher the real wage.

Hence there is a value for the real wage at which demand and supply are matched: everyone who wants a job at the going real wage will then be able to find one, apart from those who are searching for jobs and moving between them. Output will be limited by the full use of the labour force and the level of productivity in the economy; and unemployment will be at its "natural rate".

In a period of inflation, monetary restriction, it is asserted, will retard the general price level but will temporarily cause each employer to think (wrongly) that he faces a fall in the *relative* price of his product; and that will cause him to offer, in some combination, a smaller wage increase and less employment than before.

Workers, for their part, believing that the smaller money wage increase represents a lower real wage, will offer less labour. So *voluntary* unemployment may temporarily rise above the "natural" rate. But soon employers and workers will discover that *all* prices have slowed down; so employers will offer more employment; and workers, discovering that the real wage has not fallen, will offer more labour and will succeed in getting more work until *voluntary* unemployment falls again to the natural rate. Conversely, for monetary expansion. In this world, it is impossible for anyone to be involuntarily unemployed, meaning unable to find a job at the going wage after searching for one.

This claim, though focused on the labour market, implies that, regardless of any changes in demand relative to supply, prices and quantities exchanged in all the markets for different goods and services, as well as the markets for labour and finance, will change in such a way that total output in the economy as a whole will tend to the level which is the counterpart of the "natural" level of unemployment. Monetarists commonly take this for granted or assert it, without offering any theoretical justification.

Equilibrium

If one seeks a theoretical justification one is referred to the theoretical system of the nineteenth century mathematical economist Walras, who explored the conditions under which it is true to say that demand and supply in all the markets which comprise an economy will come into balance ("equilibrium") at a level and pattern of output that cannot be bettered, given the tastes and assets (including the innate skills) of all its members.

To quote Professor Milton Friedman, the natural rate of unemployment "is the level that would be ground out by the Walrasian system of general equilibrium equations, provided there is embedded in them the actual structural characteristics of the labour and commodity markets, including market imperfections...".

In the past decade, Walrasian general equilibrium economics has been the subject of much study and refinement by mathematical economists. In the light of their work, Professor Friedman's appeal to Walrasian economics to support his position does not stand up.

To understand why, it is necessary to consider two distinct questions.

The first one is quite abstract and is of the following form. In a world in which every enterprise or other economic unit is so small that it takes as given the price at which it can buy or sell, can we find a particular set of prices (including wages) such that, if they ruled, the self-interested actions of everyone would be mutually compatible and produce equilibrium?

The answer to this question is "yes", but only provided very strong assumptions are made: for example the absence of significant economies of scale and the supposition that no one can profitably affect the price at which he buys or sells.

Moreover, in order to accommodate the existence of time and the uncertainty about the future which goes with it, one must either suppose that there are many more futures markets and insurance markets than is in fact the case, or suppose that people can foresee the future with such accuracy that nothing surprising can occur. Implicitly the monetarists always adopt these assumptions.

The second question is quite different. Given any initial set of prices, will market forces drive them towards values that ensure equilibrium? To this question, absolutely no satisfactory theoretical answer is available; any trained economist can construct examples with a negative answer. Moreover, the theorist is in a logical difficulty.

Having decided that economic units are so small that they cannot affect prices, he is hard put to it to find any means by which prices actually change. As a way out, a fictitious "auctioneer" has to be introduced into all markets; the whole economy, including the labour market, has to be assumed to resemble a traditional wheat market—or Sotheby's—and further assumptions have to be introduced.

In the theory, the auctioneer always lowers prices in markets where there is excess supply and raises them in markets where there is excess demand. But, in reality, there is no auctioneer; and when actual firms and traders change prices, they may not behave like the theoretical auctioneer: for, if at the going price they cannot sell as much as they want, it is not always profitable to lower the price.

If the auctioneer is abandoned and it is assumed that prices (and wages) are influenced by the actions of firms and trade unions, a new equilibrium concept emerges which is much closer to Keynes. It can be defined as follows: it is a set of prices, and a set of quantities which can actually be sold and bought at those prices, such that no one sees an advantage in price changes and everyone's plans are compatible. In this state there *can* be involuntary unemployment. The question whether an economy tends to such an equilibrium rather than displaying instability is unanswered.

Thus, even if the economy tends to an equilibrium, it need not be the Walrasian one where there is no involuntary unemployment.

Imperfections

It should be noted that Professor Friedman's appeal to a Walrasian equilibrium, quoted above, is flawed. He implies that such an equilibrium will emerge from actual labour and commodity markets with all their "imperfections". Yet imperfections are, precisely, deviations from the conditions necessary for the attainment of that equilibrium.

There is abundant evidence that firms fix prices by adding a mark-up to their normal costs; and that they respond to variations in the demand for their products mainly by changing their output and the number of workers they employ, not the prices they charge or the wages they pay.

The same is broadly true of distribution, banking, insurance and many other services. The difference between the conditions in the real world and those in the Walrasian model is sharply brought into focus by asking the following question: would the typical British firm or shop be willing to sell more at the present price if the demand were there? Walrasian equilibrium, and hence the monetarists' doctrine, require that the answer be no. Manifestly, the right answer is yes.

Flexible prices, with or without auctions, are to be found in the market for financial assets (that is, the stock market) and the markets for raw materials, foodstuffs and fuels. But the instability of free markets has proved to be so disruptive that, increasingly, there is regulation by official intervention.

Even where there is an auction and there are many small producers, the conditions required by Walrasian economics and the monetarists are not necessarily fulfilled. For if stocks are substantial relative to the flow through a market and it is dominated by speculative transactions, there is no guarantee that the price will move to a level which equates the flows of demand and supply.

As for the labour market, it is clear that wages are set by bargaining between trade unions and employees, not by anything resembling an auction; and that unemployment can occur—and is occurring now—because workers, though willing, are unable to get a job at the going wage; it is not caused just by workers (other than those changing jobs) refusing to take jobs that are on offer because they believe that the real wage is too low.

There are neither theoretical foundations nor empirical support for the monetarists' proposition that the real economy is self-regulating and that activity and employment can be relied upon to recover automatically from the present fiscal and monetary squeeze.

It is not our purpose to propound or debate alternative policies here. Indeed we have held different opinions about policy in the past and might well do so again were we to debate it now. Our common concern is that the Government's policy, as well as analysis and debate of alternatives, should not be based on a misleading notion of how the economy works.

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