

7 Revisiting and developing macroeconomic theory

Case studies

Case study 7.1

There are no questions at the end of Case study 7.1.

Case study 7.2

- 1 The Beveridge definition, namely that full employment occurs when 3% of the working population is unemployed, is in an important sense a Keynesian definition. The Conservative government elected in 2015 and its chancellor, George Osborne, are anti-Keynesian and supply-side focused. They seem to define full employment in the free-market way, as occurring at the market-clearing real wage rate at which the number of workers whom employers wish to employ equals the number of people who wish to sell their labour. In the *Guardian* in April 2014, John Henley wrote:

two cheers for the chancellor, George Osborne, for promising to restore Britain to 'full employment' — because it turns out that doesn't, in fact, mean 0% unemployment. Contemporary economists mostly define full employment as an unemployment rate that includes no cyclical (also known as deficient-demand, or Keynesian) unemployment — in other words, when there is enough overall demand in the economy for everyone who wants a job to have one.

- 2 Writing this answer in January 2016, the most recent information provided by the ONS for July to September 2015 was that there were 31.21m people in work, 177,000 more than for April to June 2015 and 419,000 more than for a year earlier; there were 22.8m people working full time, 273,000 more than for a year earlier; there were 8.42m people working part time, 146,000 more than for a year earlier; the employment rate (the proportion of people aged from 16 to 64 who were in work) was 73.7%, the highest since comparable records began in 1971; and finally there were 1.75m unemployed people (people not in work but seeking and available to work), 103,000 fewer than for April to June 2015 and 210,000 fewer than for a year earlier. You can update the statistics by accessing on the ONS website the *Statistical Bulletin: UK Labour Market*, which is regularly updated. Although there is full employment in parts of the southeast of England, regional variations mean that the UK, taken as a whole, is not fully employed.

Case study 7.3

- 1 Market liquidity, which is the ease with which one asset can be traded for another, enables the efficient allocation of financial capital in the economy through bringing savers and borrowers together in a cost-effective way. For a modern advanced economy to function properly, it must possess an efficient financial and banking system. This is because firms and other producers require a reliable supply of credit or bank lending in order to remain in business. In normal circumstances, the banking system provides this liquidity, which businesses, consumers and governments usually take for granted. Historically, the source of this liquidity stemmed from banks borrowing household savings, which the banks then lent on for others to spend. If liquidity breaks down, the economy is threatened by systemic collapse, which can lead to recession and, indeed, to deep depression.

- 2 A major feature of the credit crunch which hit the UK economy in August 2007 centred on banks suddenly calling in loans they had granted to both business and household customers, and refusing to grant any new loans. At the worst, this forced many companies into receivership and individuals into bankruptcy. The firms which did survive often had to cancel their investment plans, while households reduced their spending on less essential consumer goods. The resulting collapse of investment and consumption shifted the economy's *AD* curve inward, leading in 2008 to the so-called 'great recession'.

Case study 7.4

- 1 In 2012, the TUC reported that 1 million more people had joined the under-employed workforce since the beginning of the recession in 2008. (This was quite early in the period of recovery from recession and it is probably the case that the number of under-employed workers is now in decline.) According to the TUC, women are more likely to be under-employed than men, with around one in eight employed women finding themselves without enough hours. This is partly because under-employment is most common amongst people working in sales and customer services and amongst nurses. Very often these are women. Women are also likely to work in part-time jobs, not out of choice, but because full-time work opportunities are not available.
- 2 Well-known companies, including McDonald's, JD Wetherspoon, Cineworld and Sports Direct, employ most of their staff on zero-hours contracts. Sports Direct hit the headlines in December 2015 for the exploitation involved in the way it treated its workers. For employers, zero-hours contracts are often justified on the ground that the advantages of zero-hours contracts create much more flexibility in the workplace, though this flexibility is often at workers' expense through the driving down of wage costs. For firms, zero-hours contracts allow them to offer more work when new orders arrive, and to scale back when little work is available. Workers may sometimes also benefit from the flexibility of not working when they don't want to work, but overall workers find themselves not working even when they want to work. Overall, I believe that zero-hours contracts benefit employers but not workers, who end up being treated as commodities in the production process.

Test yourself

Test yourself 7.1

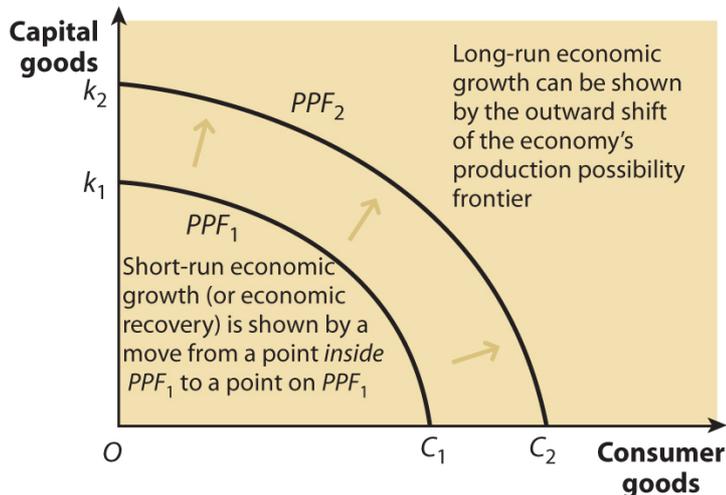
This question is inviting you to confuse changes in *levels* with changes in the rate of increase (or decrease) in levels. Statements A and C are incorrect because the data show the price level rising, albeit at a slower rate of increase in 2016 compared to 2010. Similarly, statement D is incorrect because the level of earnings rose, albeit by only 9.2% in 2016 compared to 9.4% in 2010. Note that the first part of statement C is correct, but not the second part. This leaves statement B as the only correct statement: the first column tells us that the economic growth was positive in both years and the fourth column indicates that the *rate* of unemployment fell between 2010 and 2016.

Test yourself 7.2

Ignoring the change in population, the growth of real GDP was approximately 2.5% (the growth of nominal GDP minus the growth in the price level). But as population also grew by 2.5%, the growth in real GDP per capita was approximately zero.

Questions

- 1 The economy's production possibility frontier shown below illustrates the difference between short-run and long-run economic growth. Short-run growth, which occurs when there are unemployed resources (including labour) or 'slack' in the economy, is shown by a movement from a point *inside* the economy's production possibility frontier (PPF_1), to a point *on* the frontier. Long-run growth, by contrast, results from an outward movement of the production possibility frontier, from PPF_1 to PPF_2 in the diagram below.



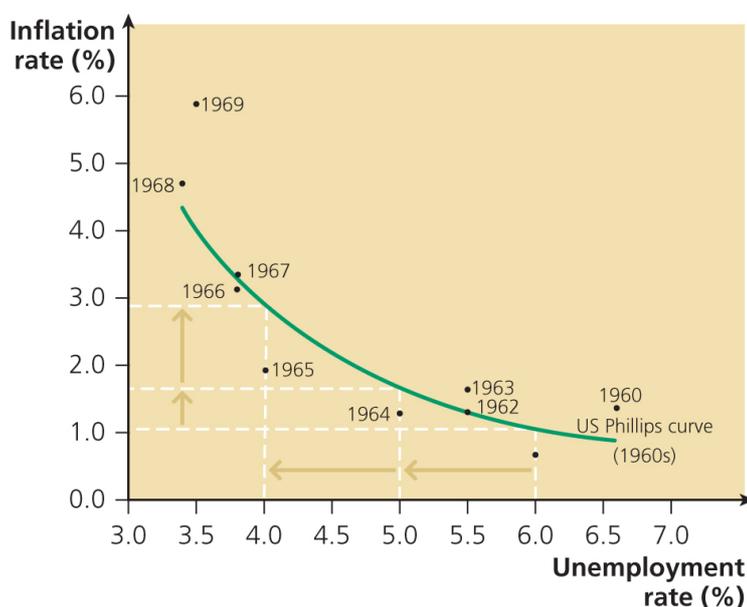
- 2 The position of the vertical $LRAS$ curve represents the normal capacity level of output of the economy, with the economy producing at full potential. The position is determined by the same factors that determine the position of the economy's production possibility frontier. As we stated in Book 1, these include:
- the state of technical progress;
 - the quantities of capital and labour and other factors of production in the economy;
 - the mobility of factors of production, particularly labour;
 - the productivity of the factors of production, particularly labour productivity;
 - people's attitudes to hard work;
 - personal enterprise, particularly among entrepreneurs;
 - the existence of appropriate economic incentives;
 - the institutional structure of the economy, involving such factors as the rule of law and the efficiency of the banking system.

If there is an improvement in any of these factors, the $LRAS$ curve shifts to the right and long-run economic growth occurs. Many of the factors are outside the direct control of government, though a number of government policies can encourage long-run economic growth. Appropriate policies include supply-side fiscal policy, such as tax cuts to improve personal incentives, and the use of monetary policy to promote macroeconomic stability. The government could also encourage supply-side reform, which many regard as essential for a more efficient and competitive economy to emerge. These days, Keynesian economists also advocate the use of supply-side policies, though these may be interventionist policies aimed at improving the economy's infrastructure rather than policies which roll back the size and functions of the state.

- 3 In terms of the short-term causes of unemployment, I disagree with the assertion in the question. I base my disagreement on the evidence that the main cause of high UK unemployment in the years between 2008 and the present day has been deficient aggregate demand, which caused cyclical unemployment. However, if the question had been posed in terms of the longer-term causes of unemployment, it could have been argued that

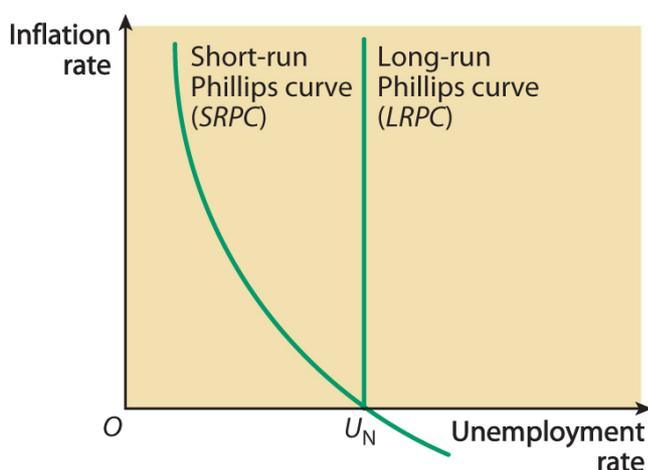
unemployment is caused by the economy's natural rate of unemployment being too high, and that this is the result of the inadequacies of the supply side of the UK economy. If this has been the case, supply-side policies implemented by government and supply-side reforms within the private sector of the economy are needed if the causes of long-term structural and frictional unemployment are to be reduced, with the natural rate of unemployment then falling.

- 4 The answer to this question is:
- **Inflation** is a persistent or continuing tendency for the average price level to rise and for the value of money to fall.
 - **Disinflation** is a slowing down of the (still positive) rate of inflation.
 - **Deflation** is a persistent or continuing tendency for the average price level to fall and for the value of money to rise.
- 5 At the height of the Keynesian era, two or more generations ago in the 1950s, the New Zealand economist A. W. Phillips argued that a stable inverse statistical relationship exists between the rate of wage inflation and the percentage of the labour force unemployed. (More usually these days, the Phillips curve measures the inverse relationship between unemployment and the rate of price inflation.)



In the 1950s and 1960s, statistical evidence — for example, the evidence shown in the graph above, concerning price inflation and the rate of unemployment in the USA in the 1960s — gave support to the arguments, first, that a downward-sloping Phillips curve exists, and second, that by managing aggregate demand governments can trade off between the two macroeconomic policy objectives of controlling inflation and achieving low unemployment.

However, in the stagflation of the 1970s, accelerating inflation and growing unemployment occurred together. The breakdown of the original Phillips curve relationship was a major cause of the free-market counter-revolution that replaced Keynesianism. Economists now generally recognise that the Phillips curve drawn above is a short-run Phillips curve (*SRPC*), representing the short-run relationship between inflation and unemployment. In the following diagram, a vertical long-run Phillips curve (*LRPC*) has been included, cutting the short-run Phillips curve where the rate of inflation is zero. The rate of unemployment at this point is called the natural rate of unemployment (*NRU*), depicted by the symbol U_N .



- 6 The view that the avoidance of inflation should always be the major macroeconomic objective came to the fore at the time of the crisis in Keynesian economics in the 1970s when the breakdown occurred in the apparently stable downward-sloping Phillips curve (see the answer to the previous question). Before this breakdown, the noted American economists Paul Samuelson and Robert Solow had reputedly said that governments could trade off along an allegedly stable downward-sloping Phillips curve. Implicit in this argument was the view that controlling inflation was just one, and not necessarily the major, macroeconomic policy objective. However, when in the 1970s and 1980s monetarism and pro-free-market ideas replaced Keynesianism as the dominant economic ideology in the USA and the UK, control of inflation was elevated to pole position as the main macroeconomic policy objective. This was a resurrection of the old pre-Keynesian view that a government's main objective should be to create and maintain 'sound money', and that it should leave everything else to market forces.

However, with inflation having been kept more or less under control since the 1990s, economists of different economic persuasions now often agree that the main policy objective should be to maintain macroeconomic stability and the conditions in which sustained economic growth and low unemployment are possible.

In conclusion, attitudes towards the view that the avoidance of inflation should always be the major macroeconomic objective have tended to vary according to how significant the rate of inflation has been in preventing the attainment of other policy objectives. A low and controlled rate of inflation is best regarded as a necessary condition for the achievement of other desirable policy objectives such as growth and low unemployment.