



EVROPSKÁ UNIE
Evropské strukturální a investiční fondy
Operační program Výzkum, vývoj a vzdělávání



5RE254 Regional Economics – handouts k přednášce:

**„General economic theories
Neoclassical regional economics
Keynesian regional economics“**

5RE254 Regional Economics

Ing. Hana Černá Silovská, Ph.D.

Hana.silovska@vse.cz

University of Economics, Prague

Sn. č. 1: **Evolution of Economic-Political Theories and Thinking**

Sn. č. 2: **Grafické znázornění obecných historických vynálezů**

- Pro ilustraci, co vše bylo vynalezeno ještě v období před začátkem tzv. moderní ekonomie (pol. 18. století)
- Flough=pluh
- 1st agricultural revolution – changeover from hunting to agricultural society
- 1760-1840 – industrial revolution – transition to new manufacturing processes, new methods, mechanization, began in the UK
- The use of energy (close to the sea) – easy to carry – need to extract – motivation for solutions – inventions (Thomas Newcomen – engine, James Watt)
- Evolution Theory (1859) – Charles Darwin- impact on religions
- Penicilin – A. Fleming (1928); automobile (Germany) 1885-1886 Bent
- Contraception – independence of women, feminism movement (USA 1960s), emancipation
- First contraception pill – 1961 – Uk, 1967 - France, Czech Republic – 1965

Sn. č. 3: **Hodiny (clock)**

- what all has happened before the period when we start talking about „modern economics“ (1750 – A. Smith)
- this does not mean beginning of all economic thinking, much was said before, modern economists draw inspirations from their ancestors (ancient Greece, christian philosophers and others)

Sn. č. 4: **Tree Life of Economics**

- an original chart – shows many theories, change in time, they are interconnected
- how to read it – 2 colours (blue, orange/brown) – they represent two categories of economics streams (approaches) – mostly interventional and market conformal
- there is not a sharp line between those – they mix, combine their findings and key elements
- arrows represent their interconnections (direct or indirect influence)

Sn. č. 5: Shrnutí (summary)

- ▶ Many theories, changes in times – *each of the theory has been somehow popular at certain time, under certain circumstances – then something new happened and they stopped working, so another theory came....*
- ▶ Can be divided into two branches:
 - mostly interventional (state-paternalistic) concepts
 - mostly market-conformal concepts

Sn. č. 6: Why we should study economic theories (especially those old ones)?

- There are theoretical and practical reasons
- Theory is a background for practical implementations
- We study the patterns in human behaviour in certain time periods, what do they have in common
- A solid knowledge of economic theories is necessary for a potential critics and debate

A study of the history of opinion is a necessary preliminary to the emancipation of the mind.

John Maynard Keynes

Sn. č. 7: A quote of Adam Smith – a quiz question

“Every individual... neither intends to promote the public interest, nor knows how much he is promoting it... he intends only his own security; and by directing that industry in such a manner as its produce may be of the greatest value, he intends only his own gain, and he is in this, as in many other cases, led by an invisible hand to promote an end which was no part of his intention.”

- Who said this famous quote?
- Adam Smith (1723, 1729)
- Generally accepted as the founder of modern economics
- Concepts – invisible hand of the market, spontaneous order, division of labour
- Works: An Inquiry into the Nature and Causes of Wealth of Nations – 1776 (Wealth of Nations)
 - Theory of Moral Sentiments (1759) – critics of moral thinking of his times – missing mutual sympathy in the society – basis for functioning
- Interesting personality – shy, single, he stuttered....

Sn. č. 8: Classical Political Economy

- ▶ Adam Smith: *Invisible market hand, Laissez faire; Theory of Moral Sentiments)*
- ▶ Thomas Malthus: *Population Theory*
- 1766-1834, influenced by industrial revolution
- Emphasized the danger of population growth, he denied social legislation, fast uncontrolled population growth is the source of poverty and hunger – he promoted different ways of birth control...
- Sources are limited (hint: sustainable development concept)
- Was inspired by J. M. Keynes

▶ Jean B. Say: *Say's Law of Market*

- Clarified the relation between aggregate demand and supply – production is the source of demand
- Follower of Adam Smith
- Lately his rule was accepted of all the members of classical political economics as a basic rule
- 1767-1832

▶ David Ricardo: *The Law of Comparative Advantages*

- 1772-1823, **comparative advantage** – perhaps the most important concept in the theory of international trade
- = ability of someone (producer), state or a company to produce a particular good/service at lower marginal and opportunity costs than another product/service – through more effective allocation of means of production
- Because of comparative advantage, international trade becomes advantageous also for countries that do not have any „absolute advantage“ (Adam Smith)

▶ John Stuart Mill: *Theory of International Trade*

- Expanded Ricardo's theory by analysis of the division of the gains from international trade among countries
- Tarriffs, protectionism

Sn. č. 9: Neoclassical Economics

▶ Cambridge school, Lausanne school, Marginalism

▶ Alfred Marshall: ***marginal utility, marginal costs, consumer and producer surplus***

- From Cambridge school
- Very influential, his theory is still used in teaching courses for undergraduate students
- Marginal utility/costs – gains from an increase or loss from a decrease/increase in a consumption of a good/service by one unit

▶ **Arthur C. Pigou:** *private/social benefits and costs, externalities*

- Follower of A. Marshall

Sn. č. 10: Neoclassical Economics - Assumptions

- ▶ Microeconomic basis – individuals' (human or enterprise) behaviour – not studying economy as a whole
- ▶ Mathematization of economics (symbols, variables, exact definitions)
- ▶ Rationality (homo economicus)
- ▶ Perfect mobility of factors of production (unrealistic)
- ▶ Perfect competition, perfect information (unrealistic)
- ▶ Population size and technology are constant and exogenous

- ▶ Methodological individualism
- Methodological individualism-economic results are results of activities of individuals that only try to maximise their benefit and satisfy their preferences

Sn. č. 11: Neoclassical Economics and regional economics

- ▶ No consideration of regional disparities (not in case of general theories, but there exist theories of regional development that are influenced by neoclassical economics – see below)
- ▶ State interventions not effective (selfregulation of economy – at least in the long term period) – fiscal policy is ineffective, so are interventions such as subsidies, regulations, restrictions etc.
- ▶ Path dependence theory – lock in effect
- ▶ Growth accounting
- ▶ Localization theories – von Thunen
- ▶ New economic geography - Krugman
- ▶ New growth theory – different types of convergence

Sn. č. 12: From Smith to Keynes

- ▶ UK in the 1920s and 1930s – an „experimental laboratory“ of economic theory and economic policy
- In the beginning of the 20th century economic policy gets more space and attention, theories are tested in practical economy
- ▶ Great Depression (1929 – 1933 (1939) – 25% unempl. rate
- October 1929 – The Wall Street Crash, the most devastating stock market crash in the US history
- 10years depression in the US and other western economies
- Financial and later economic crises
- Effects – mass unemployment, 1933) 25% in the USA
- Europe was hit later (Germany, Poland – in 1934 – 43,5% unemployment in industry)
- It enabled extreme groups (communists, fascists) to become popular and slowly very powerful – Great Depression was one of the reasons of WWII
- After this nobody believed in the free market, calls for strong state, stability, interventions

From the „invisible hand of the market“ to the „visible hand of the state“.

Sn. č. 13: Quote of John Maynard Keynes

„Capitalism is the extraordinary belief that the nastiest of men, for the nastiest of reasons, will somehow work for the benefit of us all.“

- JMK – 1883 – 1946
- British economist, professor of Cambridge University (same school as Marshall), governor of Bank of England

Sn. č. 14: John Maynard Keynes

- ▶ Economic Consequences of Peace (1919), Treatise on Money (1930), The General Theory of Employment, Interest and Money (1936)
- ▶ the principle of effective demand (non-sufficient demand is a source of unemployment),
- ▶ the multiplier (increase in investment causes multi-increase in national income)
 - supportive argument for public investments, strong fiscal policy
- ▶ liquidity preference (demand for cash)
 - determination of the interest rate, supply and demand for money
 - explains what are the motives for cash keeping
- ▶ liquidity trap – when monetary policy fails
 - Central Bank injects money into the economy in order to lower interest rates
 - It happens when the interest rates are close to zero
- ▶ consumption function – consumption depends only on current income – the higher the income, the higher the consumption and vice versa

Sn. č. 15: The General Theory and Economic Policy

Visible hand of the state – effective demand and full employment

- ▶ Progressive income taxation
- ▶ Monetary policy – low interest rate
- ▶ Government spendings

Sn. č 16: Keynesian Economics - assumptions

- ▶ No selfregulation capability of economy
- ▶ The cause of disequilibrium – divergence between savings and investment
- ▶ Analyses of macoeconomic quantities – rate of unemployment, interest rates, production, aggregate demand
- ▶ High level of uncertainty
- ▶ Inflexibility of prices and wages
- ▶ Distaste to mathematization

Sn. č. 17: Keynesian Economics and regional economics

- ▶ High level of public sector interventions
- ▶ High level of redistribution
- ▶ Export base theory
- ▶ Harrod-Domar growth model
- ▶ Growth poles theory

- ▶ Theory of cumulative causation
- ▶ Theory of unequal development
- ▶ Theory of polarized development

Sn. č. 18: From stable growth into the oil crisis

1970s – stagflation – crisis of Keynesian economics

- What is stagflation? – inflation and unemployment rates are increasing at the same time (economy stagnation + inflation) – new phenomenon in 1970s
- It raises dilemma for EP
- Cause – supply shock, secondary reason – expansive monetary policy
- 1973 – OPEC countries significantly decreased oil extraction in order to manipulate prices and also imposed embargo on countries supporting Israel (USA, Netherlands)
- Prices went up 4 times
- 1979 – after Iran revolution – Iran reduced oil export, another increase in prices
- Oil – strategic raw material – affects prices of production

New economic streams:

- ▶ New Keynesian Economics
- ▶ Post Keynesian Economics
- ▶ New conservative streams (Anti-Keynesian revolution)

Sn. č. 19: Chicago school

- ▶ Absolute belief in free markets
- ▶ Liberalism
- ▶ Scepticism to state interventions
- ▶ Low effectiveness of fiscal policy, High effectiveness of monetary policy
- ▶ Methodological positivism – theory has to be in accordance with reality, theories need to be empirically tested and proved
- Lot of empirical studies were prepared

Members: Frank Knight, Milton Friedman, George Stigler, Henry Simons, Gary Becker, Theodore Schultz

Sn. č. 20: Milton Friedman and Monetarism

Milton Friedman (1912-2006)

- US economist, Nobel Prize Winner (1976), professor of Chicago University, key advisor of president Ronald Reagan (but unofficial, he refused to work in the White House not to lose the possibility to speak independently)
- ▶ A Theory of the Consumption Function (1957), Inflation Causes and Consequences (1963), Capitalism and Freedom (1962), Free to Choose (1980)
- ▶ Consumption Function + Permanent Income Hypothesis – relate closely

- Consumption function dependent on long term expected (permanent) income
- People disregard short-term changes in income, so i is stable – so stable i also the M_d (money demand) – this means that money is neutral in the long term period
- ▶ New Quantity Theory of Money – stable M_d , money neutral only in long term period
- Inflation is purely money phenomenon – can be manipulated through M_s (money supply) – monetary policy is effective
- ▶ Natural rate of unemployment – Phillips curve is not functioning, there is no trade-off between rate of inflation and rate of unemployment (remember stagflation), it works maximally in the short term, but then later unemployment tends to reach its natural level no matter, how inflation we decide to trade it for
- Later it was renamed to NAIRU

If you put the federal government in charge of the Sahara Desert, in 5 years there'd be a shortage of sand.

Milton Friedman

The government solution to a problem is usually as bad as the problem.

Milton Friedman

Sn. č. 21: Monetarism „money matters“

- It is not an economic school in proper sense, it is an economic movement that connected more schools together
- ▶ Differentiated stream that refuses Keynesian economics (oldest)
 - ▶ Quantity Theory of Money
 - ▶ Stable private sector
 - ▶ Flexible market and long-term period
 - ▶ Transmission Mechanism
 - ▶ Rational expectations

A. Meltzer, K. Brunner, J. Jordan, L. Metzler, T. Mayer, H. Frisch

- ▶ *Governments never learn. Only people learn. – Milton Friedman*

Sn. č. 22: https://www.youtube.com/watch?v=RWsx1X8PV_A

- ▶ Milton Friedman - Greed

Sn. č. 23: Theories of Economic Regulation

- Directly linked to economic policy, theories that refer specifically to government interventions and their impacts
- ▶ From the 1960s market failures were used to legitimise direct government involvement to the free market environment.
- ▶ **„Public interest theory“**: regulatory intervention occurs in the interest of the public at large (Joskov and Noll 1981)

- Intervention are the way to insure competition, impact externalities, stabilize the economy, introduce social objectives in economic policies
- Economic regulation is important especially where the monopoly exists and conditions make sustained collusion
- ▶ **„Private interest theory“: „regulatory capture“** (George Joseph Stigler), Peltzman 1976, Becker 1981
- They adopt different attitude
- George Stigler argues that regulation is led mostly by lobbyist who will push on legislators to pass such regulation that will bring them benefit
- „capture theory“ – based on empirical data
 - Firms put pressure on legislators, general public is less organized – big corporations – they have sources, motivation to invest in lobbying
 - Argument to support this theory – „revolving doors deals“ – politician, high-level regulators find often jobs in the same industry they used to regulate (after their political career)

Sn. č. 24: Mostly interventional (state-paternalistic) concepts - applications

- ▶ New Deal (USA – 30ties of the 20th century)
 - A series of domestic programs enacted in the US, in respond to Great Depression
 - 3R program – Relief, Recovery, Reform
 - Relief for unemployment and poor
 - Recovery of the economy
 - Reform of the financial system to prevent another depression
 - Glass-Steagal Act (1933) – The Banking Act – separated commercial and investment activities
 - Was dissolved as anti-constitutional
 - NIRA – authorization for president to regulate industry
 - Public works program
 - Lot of regulation – labour, prices, minimum wage
 - AAA – subsidies for farmers to reduce production to reduce surplus of crops in order to increase prices
- ▶ Stop and go (GB 50ties-60ties of the 20th century)
 - To avoid economic cycle (expansions, recessions)
 - To smooth economic cycle
 - Labour party – prime minister Harold McMillan
- ▶ Indicative planning (France - after WWII)
- ▶ New Economics (US 60ties)
 - 1961 – Fair Labour Standards Act – increase in minimum wage
 - JFK + Johnson- strong focus on social policy – benefits, security
 - Johnson – Great Society (1965) – federal funding of education
 - Healthcare – cheaper for elderly
 - National poverty decreased
 - 1964 – economic opportunity act – part of War on Poverty
 - 1973 – Paris Peace Accord – end of Vietnam war - Nixon

- ▶ USSR (2nd part of the 80ties of the 20th century)
 - Perestroika – political movement for reformation within the SSSR
 - Gorbačov implemented and enforced reforms that were supposed to end up cold war – it was not to end the command economy, but rather to make socialism work more efficiently
 - Economic reforms followed by wider changes in the society heading to democratization and policy transparency
 - He tried to implement several procedures from market economies – some market like reforms
 - Partial independence of state corporations – they failed usually, not prepared for
- ▶ Macroplanning, government industrial politics (Japan – Japanese Economic Planning Agency)
- ▶ Industry nationalization after 1948 (Czechoslovakia)

Sn. č. 25: Mostly market-conformal concepts - applications

- ▶ Socially-market economy (Germany 50ties of the 20th century)
 - Form of market capitalism combined with strong social policy
 - „coordinated market economy“, „social capitalism“
 - Combines private enterprise with regulation and state intervention to establish fair competition
 - Key to success in Germany – strong industrial tradition and long-term oriented society, innovative family business, hardworking inhabitants
- ▶ Reagenomics (80ties of the 20th century)
 - 1981 – The Economic Recovery Tax Act – lower taxes
 - Freezing minimum wage
 - Military expenditures – Reagan did not believe in „policy of detente“ (cold war)
- ▶ Thatcherism (80ties of the 20th century)
 - M. Thatcher (1925-2013)
 - „iron lady“ – a nickname from USSR
 - Prime minister in the UK (1979-1990) – longest serving prime minister in the UK history
 - Committed to reduce power of Trade Unions
 - Influenced by monetary thinking
 - Distrust in communism, socialism
- ▶ Rogereconomics (New Zeland – 80ties of the 20 th century)
- ▶ Beginning of the transformation period (Czech Republic and other post-communist countries - 90ties of the 20th century)

Sn. č. 26: Neoclassical approach to the differences in regional economic potential

- Videa
- ▶ https://www.youtube.com/watch?v=b5zp_EJ4LY4
- ▶ https://www.youtube.com/watch?v=Xt_L8WFKvLc

Thanks for your attention!



EVROPSKÁ UNIE
Evropské strukturální a investiční fondy
Operační program Výzkum, vývoj a vzdělávání



Národohospodářská fakulta VŠE v Praze



This work is licensed under the Creative Commons Attribution-ShareAlike 4.0 International License. To view a copy of this license, visit <http://creativecommons.org/licenses/by-sa/4.0/> or send a letter to Creative Commons, PO Box 1866, Mountain View, CA 94042, USA.