Charter House Essays in Political Economy

Inconsistencies in macroeconomic theory & derived practice

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Inconsistencies in macroeconomic theory & derived practice

In the third Economic Brief, "Technology, technique and real incomes" two fundamental gaps in Keynesian and monetary theory and, indeed, practice, were identified. These are:

- Operation structures: no structural relationship to innovation, technology and productivity
- Human capital: no connection to the enormous significance of learning in bringing about innovation in technology and techniques.

Historic gaps leading to an intellectual deficit

These two undisputed facts can be understood from the standpoint of history.

Monetarism arose in the distant past and was never intended to have any regard for the human dimension other than imposing lower wages across the board, if the national economy was out of balance. This enabled interest rates and exchange rate adjustments to bring the country "back into balance". So far, monetarism has not adjusted to the fact that we now live in a country that has universal suffrage, so treating labour as just another factor of production needs to be replaced by a system that recognises the role of individuals in a democracy[1].

Although some politicians have stated that there is no such thing as society, all constitutions of merit make this assumption in order to establish guidance in ways and means to uphold the common good.

Keynesian fixation with employment , the major issue at the time of his publication of his "The General Theory" has created a mindset that, even today, transitions into a "New Deal" mentality of generating employment through public works on just about anything.

In both monetarist and Keynesian standard texts the issue of the levels of competence of each individual as contributors to productivity and the nature of technologies in complementing human effort remain completely ignored.

In spite of excellent work by economists in the areas of learning and the role of technology in improving economic productivity, the failure of the mainstream macroeconomic theories and practice to incorporate this work has resulted in monumental intellectual gaps which have created significant practical inconsistencies between policies and fundamental economic and social objectives.

This has been caused, to a large degree, as a result of a failure to apply a systems approach in economics teaching in universities, including post-graduate work. This has hobbled the development of relevant macroeconomic theory and policy advances as a result of functional gaps creating incoherence between operations in the real economy and representations in macroeconomic models. Mainstream macroeconomic theory and practice has not advanced sufficiently to accommodate the existing knowledge concerning the potential of intellectual and practiced competence and contributions of constituents and of technologies to community wellbeing.

This dumbing down of macroeconomics has been apparent since around 1971 when the gold standard collapsed. How this has happened and the remedies are the topic of a future paper in this series.

Nominal economic growth

Both monetarist and Keynesian metrics of the size of the economy and economic growth are expressed as monetary units. There is a growing association of "economic growth" with changes in "cash flows" such as GNP or even "cash equivalent holdings" in shares, gold or Bitcoin. So, the common determinant

[1] The troika management of affairs in relation to the situation of Greece was a case in point of imposing prejudice on the people of Greece for the sake of the satisfaction of actions to transfer assets to financial agencies and companies.

here is unit prices. What is exchanged for these prices, the missing determinant, is quite often not discussed in detail. This gap is evident in exchanges in high profile forums concerned with macroeconomics reflected in the constant rotation of the same theories and propositions but which remain irrelevant to the resolution of common economic challenges facing humanity and the planet.

Real economic growth

Constituents and businesses have a direct interest in what they can purchase for the nominal amount of cash they have on hand – their disposable funds. For individuals, this includes satisfying a range of needs and for companies satisfying a range of inputs and capital equipment. Lower prices mean the purchasing power of disposable funds is higher. For consumers this means their real incomes are higher because for a fixed sum of nominal currency units they can purchase more real goods and services to satisfy their needs. For businesses lower input and capital equipment prices mean reduced input and operational costs and as a result the possibility of raising margins as well as saving funds to invest while earning the same income. Real growth, being able to purchase more "real objects", therefore is not the same as growth in nominal cash flow. Indeed, real growth can involve lower nominal cash flow combined with lower unit prices

Real incomes

Therefore, real growth, which is of fundamental interest of constituents and businesses is not nominal cash flow growth, but rather a growth in real income. Real incomes are the collection of goods, services, inputs and capital equipment that become accessible by a given quantity of nominal currency.

Innovation

Innovation has a very simple definition[2]. Innovation takes place when something it done in a specific location in a different way for the first time. Innovation can be original in the sense no one has applied resources in this way anywhere else before its introduction or it can be the result of transfer, being imported from another location where it is already applied.

These facts are known and normal purpose is to identify technologies that can improve the performance of processes in any particular location by investing in longer term "basic" research to develop knowledge that can contribute at some time in the future to possible innovations in given domains. It is quicker, in terms of economic growth, and more common, to invest in technology transfer. This is less risky because the technologies concerned have been "proven" and the risk of failure in a new location can be assessed.

Financialization

Financialization is a process that has evolved from dominating trading activities to one that has become dominant in production and services activities. This transition was noted by Thorstein Veblen in 1921:

> *"Half a century ago it was still possible to construe the average business manager in industry as an agent occupied with the superintendence of the mechanical processes involved in the production of goods and services. But in the later development the connection between the business manager and the mechanical processes, has on average, grown more remote; so much so, that his superintendence of the plant or of the processes is frequently visible only to the scientific imagination... His superintendence is a superintendence of the pecuniary affairs of the concern, rather than of the industrial plant; especially is this true in the higher development of the modern captain of industry."*

[2] Mansfield, E., "The economics of technological change", Chapter IV, "Innovation and the diffusion of new techniques", pp.99, W. W. Norton & Co., Inc., 1968.

Financialization has been driven not only by changing priorities in corporate microeconomic objectives of financial performance but increasingly by the rise of changes in monetary policies following the collapse of the gold standard in 1971.

Not only have corporate objectives become dominated by financial performance the performance of the macroeconomy is increasingly measured in terms of the value of goods in circulation and the general profitability of business. How gross national product and corporate performance is actually achieved have become secondary concerns to those dealing in liquid and semi-liquid assets from money through a range of instruments as opposed to production of goods and services. Such a system feeds off any form of available funds whose price or interest rate cause asset holding to be a profitable activity. Macroeconomic policy increasingly dominated by monetary policy has contributed to the increasing role of money in the form of policies that concentrate on maintaining the state of asset values through inflation.

Financialization has come to dominate Keynesianism and monetarism because since the mid-1970s monetarism became the dominant force in macroeconomics. This is why there has been an accelerating disconnect between a general concern for managing unemployment and the contributions of learning, innovation, changes in technology and techniques in expanding employment. Similarly, there is a disconnect between the general concern with inflation and the contributions of learning, innovation, changes in technology and techniques in moderating prices.

Production and consumption or supply and demand?

As described by Veblen there has been a distancing of management and policy from the production processes of goods and services resulting in a confusion between production and consumption, on the one hand, with supply and demand, on the other.

Production involves a process of optimization between input costs, process efficiency and unit price-setting. Included in this calculation is the payment of labour inputs in the form of wages. Linked to worker competence or productivity the level of wages affordable is linked to overall process efficiency. The balance of production and consumption is therefore a dynamic equilibrium between aggregate production of all products, services and capital goods and the aggregate purchasing power of wages from all types of employment and monies saved, resulting in the purchase of all production. Thus, the value of wages paid and corporate investment constitutes the value of consumption[3]. Production affording wages and savings for investment therefore aggregate into total consumption. This is the idealised Say Model of economic equilibrium.

Modern macroeconomic theory and practice do not refer to production and consumption which is intimately linked to human and technological productivity, but rather reference is made to supply and demand. The problem here is that there is an important semantic issue which masks the underlying mechanisms that create monetary aggregates used to quantify supply and demand. Both supply and demand are monetary aggregates. Therefore, a decline in the monetary aggregate or value of market turnover is confused with a fall in supply which is equated with a decline in aggregate demand and a fall in "economic growth". In other words, quite often, a fall in unit prices resulting from competition and rising productivity can achieve a situation that satisfies consumption needs more easily and have money left over. But this can be interpreted to be a decline in conditions or, at least, of "deflation" which is beneficial to consumers of goods and services but very much considered to be a situation to be avoided by monetarists.

Goods and service price inflation, deflation and the currency

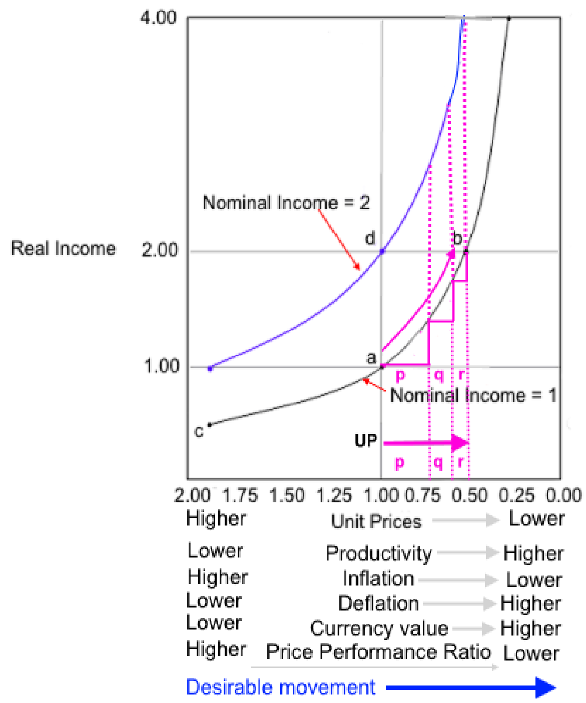
The purchasing power of the currency is determined by its innate exchange value for goods and services and this is determined by the movements in prices. Thus, if prices of goods and services are in general falling the value of the currency rises because more real products and services can be

[3] The role of the price elasticity of consumption (pEc) that varies with products, services and disposable incomes is important in securing the balance between production and consumption.

purchased for a given nominal sum. If prices of goods and services, in general rise, then the value of the currency falls because fewer real products and services can be purchased for a given nominal sum.

Therefore. inflation lowers the value of the currency and real incomes and deflation raises the value of the currency and real incomes. This is summarised in the graph on the right.

Real incomes - prices of goods & services

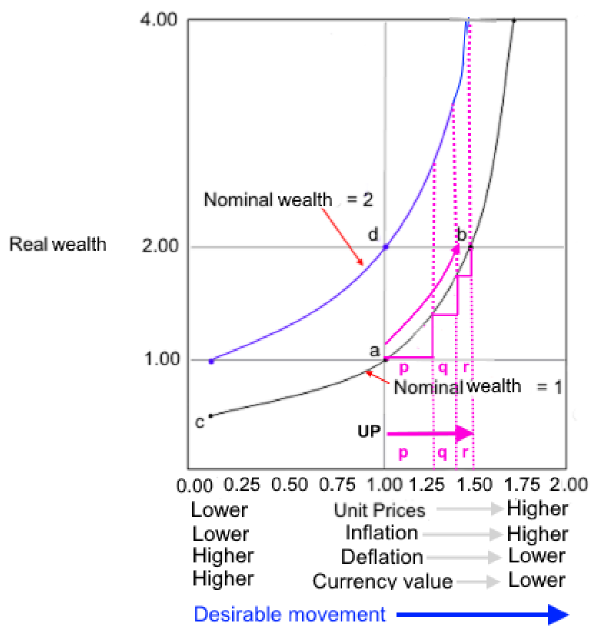


Assets price inflation, deflation and the currency

As explained in the paper entitled, "*Why monetarism does not work*" excessive amounts of money at low interest rates generally flow away from goods and services markets into encapsulated asset markets. The basic reason for this is because such monetary flows encourage a speculative rise in asset prices. As a result, the participants in these markets can make significant margins on transactions within these markets or by simply holding on to the assets.

As can be readily appreciated the participants in these markets, which are quite separate from the markets supplying products and services, gain no advantage from falling prices is assets. Therefore, contrary to the state of affairs in goods and services markets the purchasing power of the monetary value of the asset holding is determined by an inverse relationship between assets and its innate exchange value. Thus, if prices of assets are in general falling the value of the currency to asset holders falls because the wealth of those holding assets falls. On the other hand, more assets can be can be purchased for a given nominal sum. On the other hand, if the prices of assets, in general rise, then the monetary value and wealth of those holding assets also rises because less assets can purchase for a given nominal sum. This is summarised in the graph on the left.

Real wealth - prices of assets



The real income effects of income sources

Therefore, inflation raises the value of assets-based wealth and deflation lowers the value of assets-based wealth. Therefore, the relative benefits of price movements to the participants in the asset markets, on the one hand, and the goods and services markets, on the other, have an inverse relationship.

In social terms the real incomes of the majority of the population are safeguarded by stable or falling price in goods and services. For those who deal in assets, their real incomes are safeguarded by rising prices of assets.

The differential impacts of monetarism

General experience with money injections and, in particular, the experience following 12 years of quantitative easing (QE), has been that the financial services sector has not played a role of distributing money injections in accord with the national interest. This is served by guiding funds into investment in the supply side production of goods and services so as to lower costs, moderate or reduce prices so as to augment the real incomes of wage-earners.

In constitutional terms monetary policy has proactively supported an abuse by banks of the privilege of receiving discounted funds but using them to purchase and transact assets to the benefit of their own shareholders. This may be misunderstood to be an ethical position but it is, in reality, an unacceptable constitutional position. That all constitutions of merit, accept that the purpose is to serve society by establishing policies that promote and providing guidance in ways and means to uphold the common good.

Policy failures

Macroeconomic theory in its monetary and Keynesian variants are devoid of any societal considerations. In practice such theories demonstrate the serious inconsistencies, which prejudice the majority. This is because the significance of the need to equate consumption with production of goods and services through judicious investment, changes in technologies and technique and innovation, is seriously disrupted by excessive amounts of injected money. This money combined with low interest rates has been used by those who manage financial services to direct funds into assets to bolster their own “performance” which sacrificing the performance of the economy and wellbeing of the majority.

Prudential regulations

The very same organization that drives this policy of excessive QE, the Bank of England, is also charged with overseeing financial conduct on the part of financial services and treatment of consumers. Clearly if the theory is flawed and the execution so prejudicial in practice, it becomes evident that with such degrees of distortion in the economy such an income disparity and lack of investment, any “authority” over financial conduct is compromised by the very logic of the system that is administered.

Towards a constitutional economics?

By far the most significant problem is that the benefactors of political parties tend to be corporations and banks who have become increasingly influential over media content and economic policy decision making. The main dealings of this small group of constituents is in financial instruments and assets. However, the majority of the constituency in the United Kingdom are wage-earners whose main interest lies in maintaining accessible prices for goods and services for normal living and for basic survival.

Monetarism, as well demonstrated by monetary theory in practice and, in particular, QE, has intensified a division within the country between asset holders who in pursuing their interests create a state of affairs that is diametrically opposed to the legitimate interests of the majority of the population. Therefore, the adoption of monetarism by any political party, purposefully or inadvertently prejudices a significant portion of the population.

Monetary policy is never brought into the public arena as a subject considered to be worthy of participatory decision making. This has been the state of affairs since feudal times. Britain pays a high price for not having a constitutional economy so as to improve the functioning of the democracy by operating on the basis of a foundation of public choice.

This topic is of such significance that all political parties need to evaluate how they can attempt to convince the electorate that they will act in the interests of the country when conventional macroeconomic theory and derived practice make this impossible.