FIFTH EDITION

Economics
A Student's Guide

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The impossibility of exit

The problem that the ferries face in this situation is the impossibility of the tunnel ***exiting*** the market. If Eurotunnel goes bankrupt, the tunnel will still exist and could be sold by the liquidator to a new business. It would then only have to cover its variable costs. The tunnel's costs are nearly all ***sunk*** costs and the variable costs are quite small by comparison.

The competitive response

The ferries have responded by introducing so-called superferries on to the route achieving economies of vessel size, faster turnarounds and a better quality service on board. The longer crossing time is being marketed as an advantage, allowing drivers to relax and take a break. The ferry is reconstructed as a resort in itself. Profits from duty-free sales have been eroded by competition from Eurotunnel and are due to be phased out in any case as a result of the single market. The *Herald of Free Enterprise* disaster of 1987 made some people concerned about ferry safety. The fire in the Channel tunnel has now worried some people about safety in the tunnel. The effect of these two events probably cancel each other out. There remains excess capacity on the route and the competitive position of the ferries has been much weakened. After the initial price war, both sides accepted the other is there to stay, and we have now returned to a period of more sensible pricing which may return profitability to the ferries and give the bankers some of their money back. For the consumer, who has enjoyed very low prices, the party may be over.

STUDENT ACTIVITY 14.9

(a) Using the ideas developed in the other case studies, suggest ways in which the ferries could increase their load factors by offering special deals.

(b) If prices rise, how could the government tell if the operators were simply using more sensible prices to cover their costs, or whether they were engaging in covert collusion to exploit the consumer?

Summary

1 The combination of non-storable outputs and peak and off-peak demand in transport industries results in considerable price variations.

2 Price differences between the peak and off-peak also allow transport to shift demand away from the peak and economise on capital expenditure.

3 Congestion can be dealt with by pricing, investment or rationing, or a combination of these three methods.

4 Subsidy of the railways has been continued after privatisation. This policy can be explained in terms of environmental objectives, congestion reduction and equity considerations.

5 Deregulation of European airlines is facing difficulty from loss-making nationalised airlines and 'ownership' of slots.

6 When considering competition, exit is as important as entry as in the case of the Channel tunnel.

SECTION IV

The national economy

Let us beware of this dangerous theory of equilibrium which is supposed to be automatically established. A certain kind of equilibrium, it is true, is re-established in the long run, but it is only after a frightful amount of suffering.

Simonde de Sismondi

15 What is the macroeconomy?

Learning outcomes

At the end of this chapter you will be able to:

- Define **macroeconomics**.
- Describe the historical and theoretical background to the development of **macroeconomics**.
- Explain how the insights of Keynes's *General Theory* changed economic policy.

Pre-Keynesian attitudes

With the exception of Marxists, few economists in the latter half of the nineteenth century or at the turn of the twentieth century questioned the ***overall*** stability of capitalism. Indeed, there was little, if any, distinction made between how individual markets work and how the economy as a whole functions. It was believed that if there were any overall imbalances in the economy supply and demand would simply adjust to remove them, in exactly the same way as markets clear in microeconomics. For example, unemployment was believed to be the result of wages being too high in exactly the same way as a surplus occurs in any other market when the price is above the equilibrium. Such analysis based on demand and supply clearing markets across the economy belongs to the ***neo-classical*** school. This school of thought is today again the dominant school of economics, although its macroeconomics is now more developed than in its former pre-Keynesian form.

This belief in the self-righting mechanisms of capitalism was deeply held. It was thought that if there were genuinely unemployed people looking for work their efforts would create an excess supply that would cause wages to fall hence eradicating unemployment. If the 'so-called' unemployment persisted then it could not really be unemployment at all! Some workers might band together in unions, or trades guilds, and hold wages above the equilibrium in some labour markets, but this would simply tend to divert those seeking work to other markets where there were no such restrictions on opportunity.

STUDENT ACTIVITY 15.1

Draw a single supply and demand diagram for the total market for labour (hint: the wage is the price of labour, and the quantity axis can be the number of workers). Show that wages being too high could cause unemployment in terms of an excess supply of labour, i.e. people looking for jobs who cannot find work. Explain how microeconomics predicts that this labour market would move to an equilibrium where everybody who wants to work at the going wage could find work. Demonstrate that not all those workers previously unemployed are now employed in equilibrium. Why are these people regarded as unemployed at the higher wage not now regarded as unemployed even though they do not have jobs?

The great depression and Keynes

Looking at Figure 15.1 you will see that it is difficult to square the microeconomic explanation for unemployment with the history of unemployment. We see that in Victorian times up until the First World War there were regular trade cycles of strong magnitude, in the interwar years and 1980s and 1990s there were very high levels of chronic unemployment. Although in the interwar years some may have blamed emerging unions or 'welfare' pay-

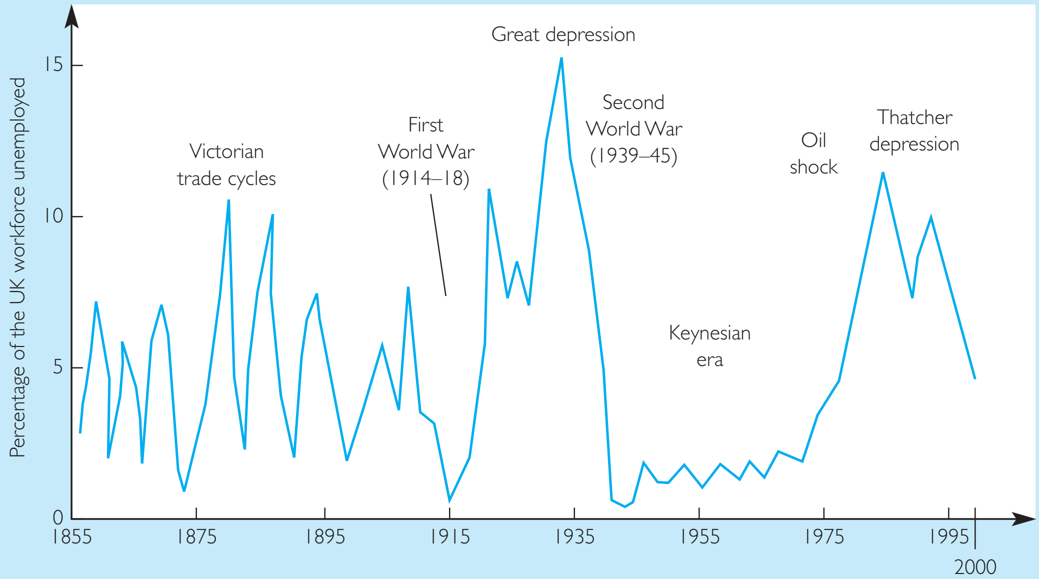

Figure 15.1 **Unemployment in the UK: 1855–2000**

ments for causing unemployment, there was no convincing and 'respectable' alternative theory to explain chronic involuntary unemployment.

The economic depressions of the interwar year, however, raised doubts about whether capitalism was, after all, a stable system. The over-riding problem of the 1920s was mass unemployment and it seemed that rather than market failure being confined to individual markets, the economy as a whole was failing. Millions of people found themselves involuntarily unemployed. Output fell and poverty and misery grew.

The severe economic depressions between the two world wars in Western economies forced economists and politicians to consider a new type of question 'Is capitalism as an economic *system* stable?'

When economists look at how the whole economy responds to changes, they are looking at how ***aggregates*** behave rather than at how individuals or individual markets behave. This approach owes much to the work of the Cambridge economist John Maynard Keynes (1883–1946). He wrote one of the most influential of all books of the twentieth century – *The General Theory of Employment, Interest and Money* (1936). This book, usually called simply *The General Theory*, led to what is often described as the Keynesian 'revolution' in economics. Indeed, from the mid–1940s until the early 1970s Keynes's economics was the foundation stone of macroeconomic policy making.

Macroeconomics

In macroeconomics we are concerned with the behaviour of broad aggregates in the economy, e.g. the total level of investment or the volume of employment for the economy as a whole.

In microeconomic theory we are concerned with such things as the determination of employment in particular industries, but in macroeconomics we are concerned with the general level of employment in the economy. Similarly, a microeconomic view can be used to explain the determination of the relative prices of products, i.e. the price of one product in terms of other products, whereas in macroeconomics we are concerned with the general level of all prices in the economy. Keynes's *General Theory* clearly used a macroeconomic approach.

Demand management

Keynes argued that although the forces of supply and demand work well to establish equilibrium in individual markets, the economy as a whole could experience periods of severe instability.

In *The General Theory*, Keynes analysed the workings of the economy and put forward his solution to unemployment. In contrast to microeconomic models of supply and demand he emphasised fluctuations in the levels of aggregate flows around the economy.

Keynes maintained that it was not the demand for individual resources which was important but the level of total (aggregate) demand in the economy.

He argued that a fall in the level of demand would mean that there was over-production; this would lead to the accumulation of stocks (inventories). Employers would not wish to go on producing more than they could sell and so would begin to cut back on production. As this happened, people across the economy would lose their jobs and hence be thrown into unemployment. The unemployed would also lose their purchasing power and therefore the level of demand would sink still further, and so on in a vicious circle. Cutting wages, advocated by the conventional wisdom of the time, would not therefore cure unemployment but it could actually make it worse by further reducing purchasing power.

Keynes seemed to have presented a convincing and comprehensive explanation of how a collapse in demand in the economy as a whole could throw millions of workers out of work and into chronic unemployment, even though they were eager to work. But his theory was in stark contrast to the prevailing economic orthodoxy of the time which emphasised market equilibrium and that therefore seemed to have no convincing explanation for how such steep increases in mass unemployment could occur. It is important, however, to understand the context of Keynes's work as a response to the problems of his day, modern macroeconomics has moved on but the debate between Keynesians and neo-classical economists concerning the overall stability of the economy is still very much alive.

If, as Keynes maintained, the economy is not self-regulating, then there is a clear case for government intervention. Keynes's solution was that, if there was a shortfall in demand in the economy, the government should make it up by public spending. In order to do this the government would have to spend beyond its means, i.e. spend more than it collected in taxes (i.e. a ***budget deficit***). In the 1930s this solution was not politically acceptable. There was a firm belief in sound public finances and balancing the books. If anything the conventional wisdom suggested 'tightening belts' in hard times and spending less. As Galbraith has written: 'To spend money to create jobs seemed profligate; to urge a budget deficit as a good thing seemed insane.' It took the Second World War to bring Keynes's ideas into the operation of government policy.

● *Common misunderstanding*

Students sometimes confuse Keynes's ideas with socialism. Keynes was not a socialist. He was a supporter of capitalism and wrote enthusiastically about market forces. He was not a supporter of the common ownership of the means of production and certainly was not advocating a command system to replace market forces.

The social and economic background to *The General Theory*

In order to understand the context and impact of Keynes's *General Theory* it is necessary to know something of the economic and political events of the times. Keynes was responding to the experience of the interwar depression in the Western economies that had seen unemployment reach levels perhaps as high as a quarter of the workforce. This had caused much accompanying misery, poverty and loss of dignity for millions of people. In the UK there was also widespread social unrest such as the general strike of 1926. Perhaps because free market capitalism appeared to be in crisis, working class political movements and the trade unions were growing in strength.

Although things were not as politically dangerous as before the revolution in Russia of 1917, the belief in *laissez-faire* capitalism was shaken by these events. Then in 1929 the USA stock market on Wall Street saw share prices crash. Many had their wealth, held in stocks and shares, wiped out, there followed a spate of bank failures. The Wall