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BUSINESS CYCLES AND NATIONAL INCOME

ALVIN H. HANSEN. *Allen and Unwin; 55s. pp. 639*

IN writing another book on the subject of business cycles, Professor Hansen has intended to make 'a modest contribution to a better understanding of the current theory and historical development of macro-economics'. Without contributing original matter Professor Hansen succeeds in his object of clarification.

The book is divided into four major sections: Part I presents the historical development of fluctuations in the U.S. Part II is devoted to the modern theory of Income and Employment and its relation to business cycle theory. Whereas the first and second parts attempt to give a realistic and concrete, as well as a theoretical picture of the business cycle, Part III provides a survey of the historical development of theory regarding it. This part includes a separately written chapter on the use of econometrics in business cycle research. The final section (Part IV) deals with business cycle policy.

Part I

Professor Hansen attempts in this historical survey of U.S. fluctuations to convince the reader that the business cycle presents a real problem, and indeed with the aid of numerous graphs and considerable data, he succeeds. Unfortunately he proves what most of us already accept. As a result this section contains too many platitudes and is over long, whilst as economic history it is too concise. Readers in this country will also regret Hansen's preoccupation with the domestic cycles of the U.S., with the consequent omission of international aspects, so important on this side of the Atlantic. We do not criticise the use of a factual introduction to this kind of study but rather its length and lack of balance.

This section, however, clearly brings out the part played by the various sectors of the economy, and points to variables which are most significant for the understanding for the cycle. Hansen particularly stresses the part played by external impulses in motivating cycles. He is impressed by the tremendous impulses given to the economy by the eras of great technical progress, as for example the development of communications, especially with the advent of Railways and Steamships. Whilst these are being built the volume of investment is enormous; yet once completed only replacement demand sustains investment; the economy there requires another push forward. The bogey of investment saturation is ever present, and Hansen fears that the long run maintainable rate of investment is insufficient to keep the economy at a full employment level.

Part II

In Part II, Hansen gives one of the best introductions to the modern Keynesian analysis. The controversies preoccupying economists in the late thirties are happily forgotten, as the different approaches put forward by Keynes, Robertson and the Swedish school are again reconciled. The analysis is up to date, but contains little that is new. On the whole in this section Professor Hansen's diagrams are easy to read, clarifying rather than confusing.

The concept of National Income is defined thoroughly and unambiguously, the elements of National Income analysis being briefly stated. Hansen makes clear the Keynesian variables and explains their relations. In his discussion of the elasticity of investment with respect to the rate of interest, Hansen suggests that only about 50% of all investment plans are affected to any considerable degree by changes in the rate of interest. This conclusion is in agreement with the rather crude empirical surveys conducted in this country before the war.

Again the author stresses exogenous 'growth factors', such as population growth and technical change, as the factors responsible for the high United States rate of investment in the past. However, the effect of factor endowments on capital accumulation and the long run maintainable rate of investment is never explicitly mentioned in the discussion of the high United States rate of investment. For example, the relative scarcity of labour in the United States has had an important effect in developing investment in Capital deepening techniques.

Hansen introduces the Keynesian consumption function, and gives statistical evidence to support the shape suggested by Keynes. Following Duesenberry, Hansen formulates that consumption is a function of present income, but in relation to a previous higher level of income; i.e. present consumption depends not on the present absolute level of income but on the relationships this present income holds to the previous higher level. Thus a fall in income of 10% will result in a different consumption function than a fall of 20%, even if the absolute income level is the same in both cases. There is a lag in adjustment to present income dependent on the psychological condition of the previous level, before the proportion of savings to income is adjusted. Once the previous higher income has been restored, the old relationship between consumption and income is re-established; a further rise in income will take place without a change in the existing marginal propensity to consume. This would explain the statistical stability of the consumption function over a long period, as well as integrating it with the cyclical instability.

In a later chapter Professor Hansen examines the interaction of the multiplier and accelerator as was first demonstrated by Samuelson. Using this analysis as a basis, he constructs his own model of a cycle, where investment is split as follows:

1. *Autonomous Investment*—that is investment resulting from technological changes, such as innovations, which allow a 'deepening' of the capital structure. By deepening Professor Hansen means an increase of capital per unit of labour—increasing the round-aboutness of production.

2. *Induced Investment*—that is investment resulting from an increase in final demand, i.e. resulting from the working of the multiplier and accelerator mechanisms. Induced investments leads to a 'widening' of the capital structure, where widening is defined as the increasing use of existing types of capital equipment—as when unemployed labour is re-employed using already existing types of machinery.

Whereas autonomous investment can only result in net investment—additions to capital stock—induced investment can result in both net investment and in investment for replacement.

A boom is ignited when a charge of autonomous investment is sufficiently powerful and well maintained to create induced investment via the multiplier and accelerator. If the autonomous investment does not provide enough impetus to absorb sufficient idle resources, the accelerator cannot induce investment, and the boom never reaches a full employment level—vide 1937 in the United States. Only a high level of autonomous investment—such as results from a war—can bring about full employment. 'Thus it is that every boom rests precariously on a level of investment which cannot for long be maintained.' 'If the autonomous investment is relatively weak . . . the widening process is not likely to occur on an adequate scale. Expansion will not be sufficient to absorb the growing labour force.' As the saturation point is reached and autonomous investment falls off, induced consumption and hence induced investment decline, and the economy descends into depression.

This approach is not so far removed from Hansen's earlier concept of secular stagnation. Implicitly he probably doubts whether, in view of his assumption of investment saturation at the top of a boom, the growth factor and autonomous investment can bring about sufficient

induced investment to re-establish full employment in the normal free market economy. Further work is necessary before we can say whether a model depending upon a high level of autonomous investment—exogenous impulses—to maintain full employment, or a self-propagating (endogenous) cycle model is of more interest.

In a later chapter Professor Hansen analyses the effects of Government outlays: particularly the relation between various forms of taxation and investment. It might help the reader if at this point of the book, he refers to Samuelson's rather neat tax reduction multiplier, which Hansen recapitulates on page 555, in his section dealing with fiscal policies.

Part III

A comprehensive background is given to modern theory, from the early economists to the present day. Once again the continuity and lack of startling innovation in economic theory is forcibly demonstrated—Keynes is only the heir to a whole range of previous theory. It is of particular interest to note Lauderdale's work on aggregate demand, and the vital contribution of Tugan-Baranowsky and Aftalion all relatively neglected in modern English economic literature. Again we see how Professor Hansen examines each of these from the point of view of his own favourite concepts, such as the growth factor and investment saturation.

All in all this may well be the most valuable section of the book, especially in view of the current lack of interest in past economic thinking. It may come as a revelation to many that economic theory and thought about the business cycle had reached a high standard of sophistication long before the era of Keynes.

When dealing with the monetary disequilibrium theorists, Professor Hansen appears to be somewhat less than fair to Professor Hayek; especially in contrast to his long chapter on Wesley Mitchell, who receives eighteen pages of almost biographical review, against Hayek's six pages of stern criticism. A fundamental assumption of Hayek's theory is that at a certain stage of the cycle 'an increase in the purchasing power made available directly to the consumer would cause an increase in the demand for consumers goods in relation to producers goods, more would be consumed and less would be saved, and this would inevitably bring about a shortening in the period of production' (Hansen's words). Now in his early theory Hayek believed that once the full-employment level had been reached, the physical shortage of resources would lead to a decline in investment, because of the increased power of the consumer to bid for productive factors. As planned investment could not be completed, due to this maldistribution between investment and consumption, a depression would follow.

Hansen, however, claims that an increase in consumer demand would stimulate investment via a higher marginal efficiency of capital. This criticism assumes that further unused resources are still available. Yet Hayek clearly had in mind a situation in which these were not available—i.e. a full-employment situation. In other words Hansen attempts to refute Hayek's reasoning by the introduction of a new assumption. In any case Hayek had been forced to abandon this line of reasoning in favour of the Ricardo Effect. In his analysis of this, Professor Hansen fails to mention Tsiang's study 'Variations of Real Wages and Profit Margins in relation to the Trade Cycle' which gives further theoretical and statistical evidence against the Ricardo Effect as used by Hayek—even if that is considered not in terms of Real Wages but in terms of Product Wages in the capital goods industries.

Since this part of the book attempts to survey existing work on business cycle theory, it is only fitting that it should include a chapter on Econometrics in business cycle analysis. Hansen has entrusted this task to Professor Goodwin of Harvard.

Goodwin divides his chapter—which is rather short considering the subject covered—into two parts. The first surveys the method of Econometrics, while in the second he sets up

a simplified business cycle model. Professor Goodwin demonstrates in the first part, in a manner clear even to the non-mathematician, the use of the 'difference' equation, used in the analysis of leads and lags, and the 'differential' equation used in the analysis of rates of change. Usually, in econometric analysis these two types of equation would be combined. Here Goodwin deals only with certain defined relationships, without questioning their underlying behaviour patterns. This part of the chapter then is not an exercise in economics, but rather a survey of certain techniques. With the present state of technique and the lack of reliable data, the econometrician seems unable to make use of any but the most simple economic models. Goodwin cannot dispel the doubt which the criticism by Keynes (quoted by him) throws on the use of econometrics. Econometrics is perhaps most useful in its ability to prove certain models set up by economists as untenable.

In the second half of the chapter, Goodwin himself sets up a simplified model, which would be susceptible to econometric analysis. Again, no mathematics beyond the most simple algebraic equations need deter the non-mathematician. This simple model is once again on the inter-action between the multiplier and accelerator, but in this case it is a closed cycle, oscillating under the power of its own servo-mechanism (a term Professor Goodwin borrows from the natural scientists). He is clearly much influenced by the study of oscillation theory in the natural sciences.

Professor Hansen closes Part III with an examination devoted chiefly to Harrod and Hicks, both of whom have reached positions akin to Hansen's own, and views Harrod's Capital Coefficient and analysis of long run capital requirements with some favour. It is perhaps characteristic of Hansen's thinking that he should find Hicks' 'free cycle'—where autonomous investment is weak, and the multiplier and accelerator are also weak—more likely than his 'constrained cycle'. In practice, Hansen believes, the accelerator will tend to be weak in the early phases of recovery (perhaps because of idle capacity), and, unless autonomous investment is exceptionally powerful, the boom will peter out prior to reaching Hicks' 'full capacity ceiling'.

Part IV

In Part IV Professor Hansen examines the role of policy as a means of counteracting the business cycle, supporting those who believe full employment must be maintained. And fiscal policy is to be the main tool for regulating the economy. The whole section contains no substantially new proposals and little that Hansen himself has not said before.

The analysis of corporate profits and their relation to the business cycle comes as a useful warning to those economists who attempt to draw conclusions from the high correlation of certain aggregates. Thus corporate profits correlate almost perfectly with the phases of the net output cycle; whereas detailed examination of these profits shows that some firms are in advance of the cycle whilst others are lagging, and only a few coincide with it.

It is interesting to note that before the Korean war, the economic indicators seemed to Hansen to foretell a precarious balance which could easily have tottered into depression. In his opinion the rate of investment had far exceeded the long run maintainable rate, so that over-expansion was being generated in the strategic areas of the economy. To counteract any depression, Hansen believes, the United States has sufficient tools at its disposal. But perhaps he is a little too sanguine regarding the ability of the United States Government to apply these, in view of the present reaction to state control. Witness for example the inability of the Government to restrain inflationary pressures effectively.

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Subsequent issues showed little change in editorial policy, until about 1913-14, when a 'humorous' section was added, but issued separately from the main body of 'C.M.R.'. This predecessor of 'Beaver' was entitled 'The Clare Market Seen Through. The Playful Students Magazine of the London School of Economics and Political Science'. In the 'serious' section, another additional feature had already become established: the 'Political and Economic Chronicle', first appearing in 1906, consisted of notes on contemporary events, under such headings as 'Government', '(Parliamentary) Bills', 'Treaties', 'War', 'Strikes' and so forth. One or two extracts from this 'Chronicle', as it appeared in 1911, may be of interest. 'United Kingdom. May 15th—After a motion by F. E. Smith (later Lord Birkenhead) for its rejection had been negatived, the Parliament Bill passed its Third Reading in the House of Commons by 362 against 241; majority 121.' 'Industry—United Kingdom. Employment during this period (April 1st to July 31st, 1911) has been generally good, and most of the big industries have been well employed. A further improvement took place in April and May. But this was followed by a slight setback, partly owing to trade disputes and partly to seasonal causes . . . unemployment percentages in the Trade Unions making returns were (1911) April 2.8%, May 2.5%, June 3%, July 2.9% . . .'

All this may shew the serious nature of the magazine at this period. However, a lighter vein crept in between the wars, side-by-side with the more serious matter that has always been characteristic of 'C.M.R.'. And such the magazine remained, despite many changes in size and appearance (not to mention in the political opinions of its contributors) until recently.

In the present issue, an attempt has been made to strike a balance between these various sections, but it may be stressed that the Editorial Board are always pleased to receive criticisms and suggestions as to possible improvements. Finally, it is also necessary to stress that the Editorial Board is in no way responsible for points of view expressed in 'C.M.R.', and the mere publication of an article is not to be considered to denote either the assent or the dissent of the Board to any views stated therein. It is definitely the policy of the Board to accept articles irrespective of the standpoint from which they are written. Thus the articles in this issue on 'U.N.O. at the Crossroads', 'Idealism, Democracy and War' and 'Democracy: Its Achievements and Prospects' all express highly controversial viewpoints, and it is hoped to publish some articles expressing a different view on these matters in the next issue.

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Articles and other matter for inclusion in the next issue of 'C.M.R.' should reach the Editor not later than January 15th, 1952.

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Continued from page 30

A brief chapter indicates some international aspects of the cycle. Here again Professor Hansen is too hopeful in placing reliance on the international organisations created after the war. One of the organisations he mentions—the I.T.O.—has of course not been ratified, and others lack the resources to deal adequately with major problems. In favouring Triffin's scheme of partial depreciation through exchange auctions for non-essential goods, Hansen ignores other possible solutions. For instance, partial discrimination in cutting imports may be a more effective solution, and one which is less harmful in cutting the total of world trade.

It is a pity that this readable volume should be marred by a certain repetitiveness and lack of balance. The book is too long, whilst parts such as that dealing with the international aspects of the business cycle are glossed over. But judged as a whole, this is a valuable book for the student interested in the business cycle.