

# A SUMMARY OF THE HISTORY OF ECONOMIC THEORIES

Mgt 704: Economics for Managers

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## **Adam Smith and the *Wealth of Nations* (1776)**

The *Wealth of Nations* is the cornerstone of economics. It presents a systematic approach to economic activity based on people acting in their self-interest, thereby, producing self-regulating markets (the invisible hand). The wealth of a nation is based on the productivity of its workers. One source of frustration was the diamond-water paradox.

## **The Neoclassical Economists (19th Century)**

They added two insights to the earlier thinking: decisions are made incrementally and demand is based on utility. Consequently, prices are determined by the interaction of supply--incremental costs--and demand--incremental utility--with markets tending toward equilibrium. Most of the material in microeconomics today was summarized in Marshall's *Principles of Economics* (1890).

## **The Keynesian Revolution (1930s)**

*The General Theory of Employment, Interest and Money* (1936) by John Maynard Keynes was a reaction to the apparent failure of economics to explain the Great Depression. He created the field of macroeconomics by viewing the economy in terms of aggregates rather than as a sum of markets. Prices could be sticky so that aggregate demand determined aggregate supply and there was no reason to expect that aggregate demand would generate full employment. The need for more aggregate demand in an economy was used to argue for a larger presence of the government in the economy. The **Phillips Curve** (1958) was interpreted as arguing that there is a long-term tradeoff between inflation and unemployment. Since it was commonly accepted that government deficits caused inflation, the Phillips Curve was used to justify government deficits.

## **The Neoclassical Counter-revolution (1960s)**

Friedman and Schwartz's, *A Monetary History of the United States, 1867-1960* (1963), provides an important rebuttal to Keynes demonstrating that the primary cause of the Great Depression was the Federal Reserve's mismanagement of the money supply. Friedman argued that private decisions tend to lead to stable outcomes.

## **The Modern Macroeconomic Synthesis (1990s)**

Different perspectives are appropriate for analyzing the short run and the long run. The primary difference is that prices and expectations are flexible in the long run, while they can be sticky in the short run.

## **Economic Imperialism**

Economists have won the Nobel Prize for extending economics into topics traditionally associated with other disciplines: finance (Modigliani and Miller), political science (Buchanan) and sociology (Becker).