By: Lenore E. Hawkins May 21st, 2010

To be able to invest successfully, one must understand the major schools of economic thought and how they impact national and global economies.

I like to break economic theory down into seven schools of thought: fascism, neoclassical economics, socialism, Keynesianism, monetarism, Austrianism, and supply-side economics. Economic theory is really just a set of beliefs concerning individual and group behavior. There is no consensus about which model is correct, but the one most used by governments is Keynesianism. Schools primarily teach neoclassical with a Keynesian slant, which is sometimes referred to as the neoclassical synthesis. The following is a very high level overview of these different schools of thought. Keep in mind as you read these that since the study of economics is a ñsoft scienceò these theories donôt have perfectly clear definitions with uniform consensus and tend to evolve over time. They are a bit like religion, where for example Lutheran, Episcopalian, Protestant, and Catholic all are variations of Christianity. Since we arenôt talking about something objective like $E=MC^2$, these definition are of course subject to my interpretation.

The oldest model is **fascism** which contends that all truth is just a matter of opinion thus we cannot really know anything useful. With this base premise, governments are free to do whatever they deem necessary. There are no limits. The most extreme example of fascism is Nazi Germany. The core of fascism is so simple and can be so deceptively seductive, thus it is usually found weaving its way through other schools of thought, particularly in challenging times. At the end of WWII, the ultimate consequence of this model was made heartbreakingly clear, but remnants of it can still be seen today as political leaders proudly claim they will ñdo whatever it takes,ò to which I often sarcastically add ñand be damned the consequences as Iôll most likely be out of office when they arrive!ò

Neoclassical economics was developed in the 18th and 19th centuries and is a very broad term, lacking agreement on what it encompasses. It includes the works of Adam Smith, David Ricardo, Thomas Robert Malthus, John Stuart Mill and Karl Marx. It holds that the value of a product depends on the costs involved in producing the product and according to E. Roy Weintraub, rests on three assumptions:

1. People have rational preferences among outcomes that can be identified and associated with a value.
2. Individuals maximize utility and firms maximize profits.
3. People act independently on the basis of full and relevant information.

This approach focuses on the determination of prices, outputs and distributions through supply and demand.

Socialism believes that the free economy is inherently unfair and prone to disaster. Implicit in these assumptions is the belief that an individual or a group of people can and should decide what is more ñfairò than would be without intervention and that manipulation to bring about a more ñfairò state is a moral imperative. This also assumes that more ñfairò is an objective truth, rather than a subjective opinion developed by those in power. This paradigm requires that masterminds control the money supply, interest rates, production, employment, basically every aspect of the economy. Implicit in this is the belief that these masterminds are capable of running thing better than would otherwise be the case and that such omniscient and benevolent masterminds will be in continual supply.

Keynesianism is named after the British economist John Maynard Keynes (June 5th, 1883 ï April 21st, 1946) who was an advisor to Franklin Roosevelt. His economic theories were developed primarily in the 1930s, during the Great Depression. Keynesianism overturned the older ideas of neoclassical economics and were widely adopted by leading Western economies after WWII. Keynes was even included in *Time* magazineǒs list of the 100 most influential people of the 20th century. His theories propose that governments are obligated to use monetary policy, (meaning money supply) and fiscal policy, (meaning government spending) to alter the economy from how it would otherwise behave. He strongly supported government deficit spending as a way to solve unemployment, (remember his theories were developed during horrific levels of unemployment in the Great Depression) and provided the theoretical basis under which sovereign debt has grown to its current levels.

I like to sum up Keynesianism this way, ñThe free market is volatile and doesnǒt produce the greatest ógeneral goodô possible. Governments ought to and are able to manipulate economic factors to provide a less volatile economy and make everyone better off than they would have been without the intervention.ò There is an underlying assumption here that an objective state of highest ñgeneral goodò exists as a singular Truth and that individuals in government are able to consistently identify that state and alter conditions to move towards this Truth. Keynesianism is somewhat a lighter version of socialism in that it focuses more on altering economic factors where socialism looks at both economic and social issues. While Keynesianism often gets the lionǒs share of the blame for the recent global financial meltdown, governments world-wide have relied heavily on it to justify their responses to the crisis.

Monetarism is sometimes also referred to as the **Chicago School** (of economic thought). Monetarism is most widely associated with Milton Freidman and supports primarily a free market economy with little government intervention save for, as the name would imply, monetary policy, (money supply). The concern of the monetarists is that as productivity increases, without an increase in the money supply prices will fall. Think of a simple economy that produces 10 items this year and has $100 as the total money supply. Over the year those 10 items are produced and exchanged, but the supply of money remains $100. Next year due to productivity gains, (in general people are able to produce more as they get better as what they do) 12 items are produced in this society. The price of all 12 items still can only add up to $100, thus a fall in some if not all prices must occur. This theory assumes that chronically falling prices are a bad thing as it will deter buying, with the buyer asking the question, ñWhy buy today when the price will be lower tomorrow?ò If all buyers were to behave in this way, the economy would come to a standstill.

The goal of a monetarist is to keep the money supply growing at roughly the same pace or slightly faster than the economy so that in general prices remain relatively stable or increase just a little bit year after year. Think monetarist when you hear talk of a ñtarget inflation rate.ò This assumes that if you think the price of something will increase in the future, you are more likely to buy it today. Implicit in this theory is the assumption that individuals are able to predict with reasonable accuracy the growth in productivity over time and can also accurately expand the money supply to match increases in productivity. It also assumes that individuals in this position of considerable power will be able to resist pressures to waver from this goal. Recall the recent massive expansion in the money supply in response to the financial meltdown of 2008.

An interesting challenge for the Monetarists is malinvestment. The additions to the money supply are not evenly injected into the economy. I donôt get my ñinflation checkò every year, do you? Thus these additions to the money supply tend to be highly concentrated, resulting in cones of malinvestment ï think housing bubble!

Austrian economics gets its name from its founders and early supporters, who were citizens of the old Austrian Habsburg Empire. Best known Austrians are the 1974 Nobel Laureate Friedrich Hayek and his mentor Ludwig von Mises. In economics, the Austrian paradigm is the philosophical descendant of Adam Smith and the other so-called classical liberals, today referred to as libertarians. In politics, Austrianism is often considered the descendant of Patrick Henry, James Madison, Thomas Jefferson and the other American founders. The Austrian school has received greater attention in recent years as many proponents of this school predicted the financial crisis years in advance. Contrast this to an interview with Ben Bernanke, (monetarist with I believe Keynesian leanings) in July 2005 in which he stated that the global economy fundamentals were extremely strong and expected continued strong growth. Arthur Laffer (a supply-sider) in a 2007 video claimed the US economy had never been in better shape.

Austrians view the economy as a living ecosystem rather than a machine. They believe the mastermind concept implicit in every other doctrine is deeply flawed and contend that it is not possible for political leaders to know what is best for each individual and that any manipulations in an attempt to produce a ñgreater goodò will only cause harm. Thoreau summed up the Austrian perspective when he said, ñIf I knew for a certainty that a man was coming to my house with the conscious design of doing me good, I should run for my life.ò

Supply-side economics developed during the 1970s during a period of stagflation, (a period of inflation and stagnant economic growth) and as a response to the perceived failure of Keynesian economic policy. It is a mixture of Austrian and neoclassical economics and proposes that production or supply is the key to economic prosperity and that consumption or demand is only secondary. This idea is summarized by Sayôs law of economics which states: ñA product is no sooner created, than it, from that instant, affords a market for other products to the full extent of its own value.ò The theory focuses on low taxes and less regulation in order to stimulate the supply side of the economy. It also strongly supports the theories of Arthur Laffer, who is given credit for the Laffer curve, which states that tax rates and tax revenues are separate and that increasing tax rates above a certain level leads to decreasing tax receipts. This theory was supported by the drop in capital gains tax rates from the late 1970s and into the 1980s during which time each drop was met by an increase in tax receipts. This theory gained notoriety under President Ronald Reagan, who lowered income tax rates with the theory that a drop in tax rates would result in increased economic growth, which would then lead to increased tax receipts.

So how do all these theories compare?

I like to compare the Austrian perspective to the other schools of thought, with the exception of neoclassical and supply-side, using an ecosystem analogy. Austrians look at a forest and say it is complicated, messy, occasionally unpredictable and doesnơt consciously follow any concept of fairness. That being said, any manipulations will only do harm. The forest system is too complicated for any human intervention to be able to consistently improve what exists naturally without eventually causing great harm, often through unintended consequences. Fascists, Socialists, Keynesians, and Monetarists look at the forest and say, I can do better. They just differ on what needs to be improved and what tools they are willing to use.

A primary difference between Austrian and neoclassical concerns the relationship between cost and price. Recall that neoclassical economics holds that the price of a good is based on the costs incurred to produce it. An Austrian would say thatơs all well and good when deciding whether or not it is worth your while to produce something, but once the good is produced, costs have no relevance and the only thing that determines price is what someone is willing to pay for it. Imagine you build a house with the intent of selling it once itơs built. The neoclassical economist would say that your price will be based on your costs plus some target profit. The Austrian says once it is built, youơll end up selling it for the best price you can get, regardless of cost. That price may be above your costs, generating a profit that exceeds your expectations, or below your costs, generating an unanticipated loss. Thus cost and price are in the end, independent.

While Austrian economist and supply-side economists often end up in the same place, Austrians criticize the supply-siders for not being more critical of government spending. The two schools are quite similar however, with slight differences in the areas they emphasize.

The way an Austrian economist thinks can be best summarized using a quote from the libertarian author P.J. OơRourke, ñGiving money and power to government is like giving whiskey and car keys to teenage boys.ò For some reason that analogy really tickles my funny bone.

Supply-side focuses on the, big surprise here, supply/production side of the economy while Keynesian focus on the demand side in terms of fiscal policy to generate higher employment rates, thus more consumption/demand.

What does it all mean?

The world is a complicated place and we humans have so very much to learn. All these schools of thought were developed through the work of exceptionally intelligent individuals who were usually well-intentioned, but like the rest of us fallible humans who couldnơt possibly be expected to get it all right. Personally I like to tread slowly and cautiously, with awareness of all that we do not yet know, but still are required to make decisions in the face of such uncertainty.

As an advisor and an investor, I attempt to maintain awareness of the implications of all these varying schools of thought, of the malinvestments that can often occur as governments attempt to improve upon what would otherwise occur, and take advantage of those opportunities as they arise, while avoiding the hubris of overconfidence. For the active investor, a portfolio ought to be designed to take advantage of trends you see coming, while maintaining a level of protection just in case you are wrong or if something unexpected occurs. We live in dynamic times, where seemingly impossible events, Nassim Talebôs black swans, occur more often than expected. Ask your advisor about their views on the different economic theories. This will give you valuable insight into how they develop their investment strategies. Be wary of any advisor who *knows* with certainty what is coming next.