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FROM PRE-KEYNES TO POST-KEYNES

by
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Discussion Paper Series
Number 28 September 1977

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Queens College, CUNY and Florida State University

May 1977

Pre-Keynes: With a stable money supply, economic prosperity and price stability require only that wages (and thus prices) behave themselves and adjust to the money supply.

Keynes: With sticky wages (and thus stable prices), prosperity requires only that the money supply behave itself and adjust to the wage (and price) level.

Post Keynes: Both money supply and wages must behave themselves. For prosperity money must adjust to wages. For price stability average wages must rise only with productivity.

From Pre-Keynes to Post-Keynes

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Stagflation, the simultaneous inflation and depression from which we are now suffering, is seen by many as a "paradox" that demonstrates the bankruptcy of economic science. I see it rather as a confirmation of the deeper economic understanding developed in the last half-century. This development has been from a Pre-Keynesian over-concentration on micro-economics (which deals with the automatic market mechanism), through a Keynesian over-concentration on macro-economics (which deals with government policy), to a Post-Keynesian integration of Macro-economics with micro-economics to deal with the combination of depression with inflation.

The Classicals

The pre-Keynesian economics which, following Keynes, I shall call "classical," was basically micro-economics and had not integrated money into the theoretical system. It took prices seriously only as relative prices--as the rate of exchange of goods for goods in the "real" economy. The "money veil," which had led to mercantilist confusion of money with real wealth, was so perfectly transparent to the classicals that they could look right through it and see only the "real" or barter economy where the only prices are relative prices. The quantity of money in the economy was considered relevant only for the absolute price level.

When unorthodox amateur economists suggested that depression might be due to insufficint total (macro-economic) demand for all the goods and services, because of "over-saving" or "under-investment," they were confronted by the established economists with examination questions in micro-economics like: "Would not an excess supply of savings lower the rate of interest and thereby

cure the excess of supply over demand?" The amateur economists of course always flunked.

In the classical scheme there was no need for government concern about either inflation or depression. There was no danger of inflation as long as the quantity of money was kept relatively stable by the constancy imposed by nature on the total quantity of gold that had been mined over the ages. With the invention of paper and credit money this natural limitation to the quantity of money was replaced by legal limitations to the creation of money by private bankers (the reserve requirements) and by constitutional limits to the creation of money by the government. There was no danger of depression because of the (micro-economic) laws of Supply and Demand. An excess of the supply of anything over the demand for it would cause the price to fall until it brought the two into equality, and the market would be cleared. Involuntary unemployment was an excess supply of labor. It would cause the price of labor to fall relatively to prices. At the lower real wage the market would be cleared, and full employment automatically restored.

Keynes

Keynes' 1936 book, The General Theory of Employment Interest and Money, which inaugurated the Keynesian revolution in economic thought, began by pointing out that in the classical argument the reduction in wages was a reduction in the *real* wage in a barter economy. It meant that less of the product went to the workers and more was left for the employer. That was what made it profitable to employ more workers. But in a money economy it is only the *money* wage, not the real wage, that is subject to negotiation between workers and employers.

This does not matter in micro-economics. A money wage cut in a small (micro-) part of the economy would have no significant effect on the demand for

and the price of the product. More profit would be left for the employer and it would pay him to hire more men and expand his output. But with a general reduction of money wages one cannot expect prices in general to remain unchanged. Competition would reduce prices in proportion to the reduction in costs. The prices of other productive factors competing with the cheaper labor would also be reduced. All costs, all prices, and all income could be reduced in the same proportion as the money wages. There would then be no reduction in the real wage and no increase in employment.

Keynesian Classicalism

This did not destroy the classical conclusion. It only called for a further development of the argument in macro-economic terms. Keynes provided this by turning from the supposed effects on real wages to the effects on real spending. The reduction in money wages leads to reductions in prices. As this does not cure the unemployment, the wages and prices continue to fall. When they have fallen far enough to make the purchasing power of the existing money stock great enough, to make the owners of the money stock flush enough with money (as less and less is needed with the lower prices) they will spend enough (or lend enough to others who will spend enough) to buy enough more goods and services, to call for enough additional workers to restore full employment.

Keynes thus turns out to be not only the supreme classical economist,[1] who put the finishing touches on the classical edifice, but also the supreme monetarist in showing that the completed classical theory is indeed essentially monetary. What happens to real wages plays no part in the completed Keynesian-Classical argument.

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[1]This seems to have been vaguely recognized by those classical economists who (insensitive to the sarcasm in the "enoughs") declared "We are all Keynesians now."

Keynes' purpose in completing the classical micro- argument was of course not to praise it but to bury it. Spelling it out made it clear that the conclusion rested essentially on the increase in the real value of the money stock, and that the practical policy choice was between two ways of achieving this. One way was to suffer depression severe enough and long enough to bring about enough micro-economic reductions of money wages and money prices to bring about the required macro-economic increase in the value of the money stock. The other way was to provide the same increase in the value of the money stock by increasing the number of dollars. The choice was between adjusting the prices to the money and adjusting the money to the prices. The latter method would achieve all the beneficial results of the former while avoiding both the depression and the injustices of the increased burden of all existing monetary obligations. The fundamental Keynesian Revolution was essentially a policy revolution. It consisted of choosing the second method and calling on government ro provide the additional money.

Macro-economics

The Keynesian Revolution thus pushed discussion from micro-economics to macro-economics, and policy from waiting for automatic (micro-) market cures for depression to exercising governmental (macro-) policy to regulate the overall quantity of money (with an assist, in emergencies, from fiscal measures).[2]

This concentration on macro-economics is even more obvious in my own formulation of the Keynesian revolution as "Functional Finance" with its three pairs of governmental instruments for regulating the overall volume of spending in the economy--borrowing and lending, buying and selling, and taxing and subsidizing.

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[2] The highly fashionable contrasting of "Keynesianism" with "Monetarism" arises from a misuse of the term "Keynesianism" for the special fiscal measures prescribed by Keynes (and by no means only by Keynes) in the depths of the depression when investors were afraid to invest. There was such a collapse of confidence that neither method of increasing the real value of the money stock would have helped. Only increased spending by the government, or by the beneficiaries of tax reductions, could be effective in increasing spending and employment until investors' confidence was restored. Hence the call for fiscal measures.

The classical method of increasing the real value of the money stock is spoiled only by the rigidity of money wages. This is what makes the required depression too costly. Nostalgic classical economists are therefore intrigued with the possibilities of reducing the rigidity and letting supply and demand take care of the problem.

Unfortunately, the measures that could in practice be applied to diminish the wage rigidity, instead of making things better, make things worse. Weakening the trade unions, penalizing strikers, reducing unemployment pay, hampering credit to unemployed workers, cutting off school lunches - and other such measures for inducing workers to agree to (money) wage reductions - work slowly and unevenly. The wage and price reductions are scattered and _gradual_. Instead of the _lower_ prices which would _cure_ the unemployment we get _falling_ prices. Buyers _postpone_ their purchases in the expectation of bigger bargains later, _reducing_ the spending and aggravating the depression. Keynes therefore approved of workers' resistance to these measures for lowering wages in general.

Much sport has been made of Keynes' inconsistency in blaming wage _inflexibility_ for the failure of the classical automatic cure for depression, even while blaming wage _flexibility_ for aggravating depression. But the two flexibilities are completely different concepts. _Ideal_ flexibility would indeed yield prices _low_ enough to validate the classical theory, but Keynes used it in his completion of the classical argument only to show its unpracticality. _Practical_ flexibility, the kind that one could reasonably hope to reach in practice, was opposed by him because it could result only in the _falling_ prices which aggravate depression.

An Asymmetry

For upward movements in wages and prices, Keynesianism remained perfectly classical. The laws of supply and demand did not work for a general deficiency of demand, but the law of excess demand lost none of its power to cause wages to rise in response to excess demand - i.e., to an increase in total spending when there already was full employment. This asymmetry--wage and price flexibility upward but inflexibility downward--indicates that something was missing in the Keynesian revolution.

Missing was a micro-analysis of how the determination of particular wages (and prices) is affected by the downward abrogation of the market laws of supply and demand. The answer is that wages are determined not by the market, but by wage administrators--by the wage negotiators representing workers and employers, who have the power to command wages to stay up even when the market is telling them that they should be going down because supply is greater than demand.

Stagflation

Keynesian economic policy to avoid severe depression was beginning to be applied with some success in the 50's and 60's. Then the wage administrators discovered that their power to defy the market was not limited to keeping money wages from falling in the face of depression. They discovered that they could also use their power in the upward direction and get money wages to rise. And so stagflation was born--rising prices together with depression or recession.

What gave the wage administrators this power was something about the laws of supply and demand that had not been fully understood. Like the physical laws of Newton the traditional formulation of the laws of supply and demand turns out to be not quite correct. They also have a "relativity" that had been overlooked.

In the traditional formulation excess demand causes the price to rise and excess supply causes the price to fall, while equality of supply and demand keeps the price where it is. But this is correct only if the initial expectation is one of price stability. If the price has been rising at, say, 10 percent per annum and is expected to continue to rise at that rate, an excess of demand - a shortage of supply - will raise the expectation, replacing it by a higher expectation of price rise, perhaps 12 percent. A deficiency of demand will reduce the expectation, perhaps to 7 percent; while a clearing of the market, equality of supply and demand, would merely confirm and strengthen the previous 10 percent expectation. The price will not stay where it is. It will continue to rise at the previous 10 percent rate. It is only an understanding of this "relativity" that has made it possible for many countries to keep on functioning in the face of continuing inflation.

By the early 1970's extraneous events had brought about a rate of inflation in the U.S. of about 6 percent per annum which was generally expected to continue. It was kept going by the wages rising to keep up with prices, and the prices rising to keep up with costs. The same wage administrators who, with stable prices, had prevented wages from falling, now did exactly the same thing in real terms by preventing wages from falling behind the expected 6 percent rise in prices. And so the stagflation could continue.

Anti-Keynesianism

There were three different responses to the phenomenon of stagflation. The "Keynesian classical" economists, who had absorbed Keynes' completion of the classical argument but were reluctant to accept the Keynesian policy revolution, responded by hailing stagflation as a paradox with which the Keynesian