

Keynes after the *General Theory* and the current recession

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- An ongoing research; all ideas, criticisms, encouragements will be greatly appreciated. Please do not use without consulting the author

1. Introduction

Given such observations by Chick and Shackle (1967), that in Keynesian economics “.. there are too many scenes” (Chick, 2004: 9) it is only to be expected that the *GT* is but just one act of the unfolding drama we have come to know as the Keynesian economics. In the *General Theory*, we come across a situation where not only labour but all other factors of production are unemployed simultaneously at a given time. For this reason in general the mechanism of the Keynesian savings-investment multiplier which we find in the *General Theory* operates by varying the amount of production and leads to a situation “that is *not* resource-constrained.” (Kaldor. 1975: 350). It is interesting that only two years after the publication of the *General Theory*, Keynes (1938) devoted his attention to situation which can be resource constrained as well as its policy implication. He then revisited the problem during the war years while working on the policy for post war commodity production and prices as well as its implication for shaping the postwar employment policy. Hicks (1977: 98) observed that;

The first of the things which is called in question by this most recent experience is the Keynesian identification of the limit to growth with Full Employment of Labour. What has now to be faced is the possibility that the limit might be set by something else.

However, as this paper argues, Keynes himself was aware of this aspect of his work and added yet an additional element to the overall system we find in the *General Theory* to address the issue. We will also try to assess the policy implications of our findings for the current state of the global economy.

2. The Journey

About the *General Theory* Chick (2004; 9) writes, “In terms of open systems, however, it is a perfect example of how to handle a complex subject without resorting to reductionism, through the device of taking first one element of the overall system, then another, as the object of analysis, using the method of *ceteris paribus* to provide a closure for each partial system and later removing it”. Viewing from such perspective, it should not be surprising that Keynes would continue to consider reopening the *General Theory*, if and when necessary, to add yet more new elements.

From Keynes’s writings it is clear *General Theory* that after the *General Theory* Keynes started to investigate the link between the role of the supply of primary products and export demand as well as employment, in a paper published in 1938. However, it was only after 1941 Keynes devoted his attention to drawing up the details of arrangements for a “commodity policy” arguing that such a policy is vital for maintaining “good employment” in the industrialized countries. Below we present a short glimpse of Keynes’s views over the period.

In an essay published in 1930¹ on the economic pessimism in the United Kingdom at that time, Keynes wrote:

We are being afflicted with a new disease of which some readers may not yet have heard the name, but of which they will hear a great deal in the years to come – namely, *technological unemployment*. This means unemployment due to our discovery of means of economising the use of labour outrunning the pace at which we can find new use of labour. (Keynes,1972: 325; emphasis in the original)

¹ This essay was first presented in 1928

Keynes, however, was convinced that “this is only a temporary phase of maladjustment” and a solution to this problem of unemployment caused by labour saving technical progress would be found as he went on to add:

...assuming no important wars and no important increase in population, the *economic problem* may be solved, or at least within sight of solution, within a hundred years. This means that the economic problem is not – if we look into the future – *the permanent problem of the human race*. (Keynes, *ibid*: 326; emphasis in original)

Be that as it may, in Keynes (1938) we first come across the mention of the impact of fluctuations in the prices of the “principal raw materials” which can “lead to fluctuations in immediate demand”. In this article we also come across Keynes’s observation that there exist “two major groups of commodities which respond quite differently to the fluctuation of effective demand...”(Keynes, 1938: 453). For one type of commodities “prices (are) comparatively stable and fluctuations in demand (is) met by a centralised control of output and by organised arrangements for the withholding of stocks on the part of the producers themselves” and for the other type of commodities “the producers themselves are not in a position to withhold their stocks and the scale of output is governed by price fluctuations.” He then went on to add that “The fact that we have two major groups of commodities which respond quite differently to fluctuations in effective demand is of great importance to the general theory of the short period” (Keynes, 1938: 453).

This is where, most probably for the first time, we get a glimpse of the literature on cost-based and demand-based theories of price determination which we now describe. As far back as in 1943, Kalecki² observed that the “*(s)hort-term price*

² The English version of this paper was published in 1954. The page references are to Kalecki (1971).

changes may be classified into two broad groups: those determined mainly by changes in cost of production and those determined mainly by changes in demand” (Kalecki, 1971: 43; emphasis added). While the changes in the prices of ‘finished goods’ are *cost-determined*, the changes in the prices of the industrial raw materials and primary foodstuff are *demand determined*. Hicks (1965) described the cost-determined prices as ‘fixedprice’ and the demand-determined prices as ‘flexprice’. These two types of price formation are caused by different conditions of supply.

Kalecki (1971) argued that since production (supply) of ‘finished’ (manufactured or industrial) products are elastic “as a result of existing reserves of productive capacity”, any increase in demand for these products can be met by an increase in the volume of production without raising the their prices. Hicks (1965: Chapter 7) pointed out that in case of ‘storables’ (manufactured or industrial) the *existence of stocks* has a great deal to do with keeping prices fixed. When there is excess demand for output, additional supply can be thrown in to the market to fill the gap between demand and supply. In the case of products, labelled as ‘raw materials’ by Kalecki and as ‘non-storables’ by Hicks, their supply is relatively inelastic in the short run because these type of products cannot include any stock element. “It is ‘flow demand’ and ‘flow supply’ that are equated at the price that is established. If, however, they are only equated at a high price (at a price that is high relative to ‘normal cost of production’) there is a signal for an increase in output; though the increase can materialize at a later date, that is to say, in the long run. If they are equated at a price that is low in relation to cost, output will (similarly) tend to decrease” (Hicks, 1965: 79, parentheses in original). Kalecki (1965: 43-44) observed that, any initial price rise for these products in response to an increase in demand may

be exacerbated “by the addition of speculative element ... (and) this makes it even more difficult in the short period to catch up with demand.”

In what ways the products the prices of which are demand-determined differ from the products the prices of which are cost-determined? The common characteristics of the products the prices of which are demand-determined are that they are all primary products – such as food, commercial crops, raw materials, energy – their production being primarily land-based activities as opposed to the industrial (manufacturing) goods the production of which consists of the processing of basic materials produced by primary sector and does require land in any significant amount. The prices of these industrial goods are determined by their production cost.

It needs emphasising that the cost-based prices (or fix-prices) do not mean prices which never change. It is just that, in the short run, prices do not have to change whenever there is excess demand or excess supply in the market. Products for which prices are determined on the basis of cost prices change only in response to changes in the cost of production. The cost of production, in turn, depends on the prices of labour and raw materials. Any short term disequilibrium in the market for these products is smoothed out by adjustments in stocks. Kaldor (1975) provides the following equation for the price (p) of industrial (fix-price) goods:

$$p = (1 + \pi)wl \quad (2.1)$$

Where, π stands for the profit mark-up, w denotes the real wage rate and l stands for labour required to produce one unit of output. Thus, given the profit mark-up and labour productivity, the prices of industrial goods are dependent on the real wage rate of labour.

Let us try and take a look at the significance of real wage or the *price of labour*. As Kaldor puts it:

Whatever the supply of labor (or the potential supply of labor) in relation to demand, the *price* of labor in terms of food cannot fall below a certain minimum determined by the cost of subsistence, whether the cost is determined by custom or convention or by sheer biological needs (Kaldor, 1975: 352; parantheses in the original).

In other words, there is no such thing as *market clearing* wage rate, without reference to the basic minimum cost of living. Now, if and when the cost of living rises, this gets translated into the rise in the price of industrial goods.

Kaldor (1975) presented his analysis in a simple two-sector framework, consisting of agriculture (*A*) and industry (*B*). Production in sector *A* being predominantly land-based and subject to the law of diminishing returns, its supply in the short run is relatively inelastic. Prices for the products of this sector is, therefore, demand determined or flex-price. Production in sector *B* depends on the former sector for supply of primary products and wage goods for labour. Prices in this sector are based on the cost of production and a (fixed) profit mark-up or fix-price. This is why the rate of growth in the industrial sector depends on that of the agricultural sector. Kaldor (*ibid*: 354) presents the interrelationship between the two sectors as follows.

$$O_B = \frac{1}{m} O_A \quad (3.2)$$

Where, O_i = output of the sector i ($i = A, B$) and m = share of expenditure on agricultural products in total income of the industrial sector. He points out that (3.2) is

the “doctrine of the foreign trade multiplier as against the Keynesian savings-investment multiplier.”

It is, therefore, perhaps not surprising that in Keynes (1938) we get the first glimpse of his policy of “Commod Control³” in his policy proposal to secure “a stimulus to our export industries, an increased control over the trade cycle, and an insurance against having to pay excessive prices (for the primary products) at a subsequent date.” He proposed “that, the Government should offer storage for all Empire producers of specified raw materials, either free of warehouse charges and interest or for a nominal charge, provided they ship their surplus produce to approved warehouses to this country” (Keynes, 1938: 455).

Keynes’s plan for the post-World War II world-wide price stabilization included setting up of an international agency for stabilizing commodity prices by means of buffer stocks of as many commodities as possible. The following quotation from Keynes neatly summarises his thinking in this area:

Superimposed on the fortuitous short-period price swings affecting particular commodities and particular groups of producers there is the fundamental malady of the trade cycle. Fortunately, the same technique of buffer stocks which has to be called into being to deal with the former, is also capable of making a large contribution to the cure of the trade cycle itself. For the maintenance of good employment throughout the world, in industrial countries as well as in those producing primary commodities, this is of the first importance, sufficient by itself to justify the setting up of machinery for buffer stocks (Keynes, 1980: 172).

From our discussion above, it is worth noticing Keynes’s recognition that labour-saving technical progress is not the only reason for unemployment in the

³ See Chapter 3 of Keynes (1980) which contains materials on Keynes’s war-time plan for commodity price stabilisation. These papers came to be known much later under the 30 year rule as the war-time government papers could not be published when these were written.

industrialized countries as well as Keynes's awareness of the role of the foreign trade multiplier.

However, a glimpse of Keynes post-*GT* could be found in Keynes's thinking pre-*GT*. As Skidlsky (2005: 16) observed;

The *General Theory* can be interpreted as a short-run theory of employment in a 'closed' economy, in which the stock of capital, physical and human, is taken as given. But Keynes had written a lot – notably in his *Tract on Monetary Reform* and *Treatise of Money* – about the problems of 'open' economies, particularly the problem of combining internal and external equilibrium. In the later book, and also in his pamphlet *The Means to Prosperity* (1933), he has sketched out plans for a world super-bank to expand world reserves, on which he drew his war time proposals.

Keynes conceived International Clearing Union as a set of interlocking regimes governing money, investment, commodities and trade though only the monetary scheme was worked out in detail; “[h]owever, at Roy Harrod's prodding Keynes did, on 20 January 1942, draft a memorandum on buffer stocks” (Skidelsky, 2000 234). That Keynes (1938) is a key paper is clear when he wrote to Harrod on 6 January, 1942 that he “had dragged out his 1938 article in this area”(CW, xxvii: 105).

As we all know, Keynes's proposal to the Bretton Woods conference for setting up of an international Commodity Control Agency, along with a world super-bank, which would set up buffer stocks for all the main commodities, for stabilizing commodity price and to be financed by a truly international currency was rejected not only by the US negotiators but by the Whitehall as well. For example, the Bank of

England “condemned Keynes’s mixture of private trading and price control as speculators’ paradise” (Skidelsky, 2000: 236)⁴. as was the recommendations of the Brandt Commission in the 1980s.

As Kaldor (1983) observed, when the developing countries actually asked for a scheme for setting up international buffer stocks (through UNCTAD) they got a cool reception from the rest of the world. In Kaldor’s own words:

Nobody seems to have understood that, while the proposal was promoted by the developing countries, its adoption was in vital interest of the ‘developed’ or industrialized countries, since it is a pre-condition for securing adequate long-term investment necessary for sustained industrial growth (Kaldor, 1983: 34).

Keynes, Kaldor and the members of the Brandt Commission all took it for granted that the non-industrialized or developing countries of the South will be the pre-dominant suppliers of the primary products while the industrialized or developed countries of the North will be the predominant producers and exporters of manufactured products. In fact, Keynes (1938) referred the primary products as “Empire produce”. However, since the world has now changed considerably we need to up-date our world view. In the next Section we will look at the implication of our analyses for the policy makers in the industrialized countries.

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⁴ For details see Chapter 7 of Skidelsky (2000),

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