THE KEYNESIAN THEORY OF PRICES

Şerban-Oprescu George-Laurentiu

Academy of Economic Studies of Bucharest, Faculty of Economics, Romana Square no.6, Room 0318
george.serban@economie.ase.ro, 0723203472

Şerban-Oprescu Anca-Teodora

Academy of Economic Studies, Bucharest, Faculty of International Business and Economics, Romana Square no. 6, teodora.oprescu@ase.ro

Every time when a crisis casts shadow over the economy, all the economists seem to remember about "long forgotten" Keynesian theory. Although just a few economists think about themselves as traditional Keynesians, the economic policies inspired by Lord Keynes are still alive. For instance, the fundamental goal of any central bank is to avoid inflation which means to assure prices stability. Is not this the Keynes ideal: economic progress with full employment and fixed prices? Let's take a look of the current subprime crisis. The best solution found by FED is to cut the interest rate and to cheapen the loans. If Keynes will be alive he surely would be delighted by the FED's acts. The purpose of this paper is to analyze the Keynesian theory of prices in order to find the extent in which the solutions found by Keynes are still valid.

Key words: macroeconomics, theory of prices, liquidity, interest rate, economic crisis

Introduction

Few were the theories that had a sufficiently strong impact to change the course of economic thought and to create what Shumpeter called „classic situations" in Economics. The last „classic situation" in the history of economic thought was created by the „general theory" elaborated by John Maynard Keynes in 1936. This theory was proposed by the most famous British economist of those times, the one that had acquired a star status once with the publication of a shot work [Keynes, 1919] about the „Cartagena peace" brought about the Versailles treaty, a status that the economist maintained and never abandoned. This is only one of the arguments that explain why Keynes' theory was received and readily adopted by the majority of the economists with a speed and openness never met before. Another reason is obviously linked to the historic context in which Keynes published *The General Theory of Employment, Interest and Money*. His theory had been launched at the best time possible, immediately after the great economic crisis 1929-1933, when the specter of depression had not yet been completely erased from the memory of people, and the negative consequences of the crisis had not yet totally disappeared from economic activity. Having at disposal the case study offered for free by the Great Depression, Keynes makes an analysis of the phenomenology of the economic crisis in order to offer solutions by means of which to avoid the re-occurrence of such episodes in the economic activity.

In Keynes' vision, the most serious consequence of the economic crisis was represented by the fast growing rate of unemployment which directly affected the welfare and peace of society. For this reason, the main purpose of Keynes was to solve once and for all the problem of occupation and the solution proposed was a bold one and apparently, innovative: the state had to indirectly intervene in the economic activity by stimulating aggregate demand by means of manipulating the interest rate and control of monetary mass. Moreover, the Keynesian analysis proposed a total separation from what Keynes called classic economy. The new economic theory was base on a holistic approach of economic activity and introduce in the economic language original terms such as: investment multiplying, preference for liquidity, cash trap, aggregate demand, aggregate offer, anti-cycle fiscal policies etc. In this context, it is no surprise the fact that Keynesian theory was regarded by many generations of economists as the solution to all economic problems.

Relevant for the peak and decline of the doctrine initiated by Lord Keynes if the affirmation of Milton Friedman – otherwise a moderate critic of Keynesianism - in 1968: „In a certain way we are all Keynesian now, on the other way, nobody is Keynesian now. We all use the Keynesian analytical language but none of us is still accepting the primary conclusions of Keynesians."[Friedman, 1968:15].

Significance and role of price in the Keynesian macroeconomics

The fundamental hypothesis of Economics presupposes that there is a reciprocal determination between prices and the whole economic activity: on the one side current prices offer fundamental information to economic agents because based on the comparison between current prices and estimations regarding future prices, individuals decide about activities they are going to start, and, on the other hand, the decisions and activities of economic agents influence, by means of supply and demand, the price. So, any economic theory can only be coherent under the circumstances that it succeeds in funding itself on a coherent theory of price, something that the Keynesian theory did not manage to accomplish.

Being perfectly aware of the role that prices play in the economic system, John Maynard Keynes devotes an entire chapter out of *The General Theory of Employment, Interest and Money* to the theory of price. The British economist proposes a new theory of price, different from the classic one, one that would bring arguments in support of his new general economic theory. In the theory of price advanced by Keynes, the level of prices on one market is determined by the cost of production factors and production level. The extension of the proposition from a microeconomic level to a macroeconomic level brings about a modification determined by individual demand and aggregate demand. The latter obeys to the law of „macro psychology" issued by Keynes – marginal inclination towards consumption. Consequently, the British economist adopts an economic analysis borrowed from classic economy of which he so much wanted to be separated. Much like the supporters of the objective theory of value, Keynes pays attention to the way in which the cost of production factors influences the final price of goods. Keynes' innovation in this domain is to propose a simplification which he himself considers unrealistic, but which is very suitable to support his conclusions. The simplification proposed by Keynes says that the retributions of all the factors of production modify in the same proportion the marginal cost [Keynes, 1970:303]. If this hypothesis is accepted, then one may say that the level of prices is directly related to the level of wages and employment. In this way, the level of wages, that is, the price of labor becomes an essential factor in establishing final price.

From this perspective, one may easily observe that Keynes' vision does not essentially differ from that of the marxists. Yet, the purpose of Keynes differs from the one of Marx. If Marx uses this premise to justify the necessity to replace one economic system with another, Keynes appeals to the above mentioned hypothesis to sustain an expansionist monetary policy meant to reduce unemployment rate because for Keynes „..for Keynes the unemployment cause was not the wrong employment policy but the problems of the monetary and loan system."[Mises, 1980]. Keynes argues that: Thus if there is perfectly elastic supply so long as there is unemployment, and perfectly inelastic supply so soon as full employment is reached, and if effective demand changes in the same proportion as the quantity of money, the Quantity Theory of Money can be enunciated as follows: "So long as there is unemployment, *employment* will change in the same proportion as the quantity of money; and when there is full employment, *prices* will change in the same proportion as the quantity of money" [Keynes, 1970:304]. This way, Keynesian offers a new monetary theory according to which, as long as there is unemployment, the growth of monetary fund does not influence price, only employment. If full employment is not achieved, the growth of monetary mass will not have any effect upon the level of prices, but merely a beneficial effect on the rate of unemployment. Thus, monetary policy may decisively contribute to the accomplishment of every government's fundamental objective – full employment. This conclusion is crucial, it offers the best theoretic argument for an active monetary policy which, by expanding credit produces what Ludwig von Mises called: „the stones into bread miracle"[Mises, 1980].

Nevertheless, Keynes had enough analytic sense and economic knowledge to realize that the simplifications to which he had appealed were sufficiently significant to put to doubt the relevance of his new theory. This is why the British economist felt the duty to improve the model by adding a few essential restrictions: 1) the effective demand does not modify proportionate to the monetary quantity; 2) as the level of employment rises, there will be declining or not constant output; 3) resources are not perfectly inter-changeable; 4) wages will incline to rise before full employment; 5) remuneration of production factors does not always modify in the same proportion [Keynes, 1970:304].Examining the extent in which these restrictions are modifying the initial model, Keynes reaches to the following conclusion: the increase of the quantity of money when the employment is not full is influencing the level of unemployment and also the level of prices. In this context, the role of prices theory, Keynes argues is "the analysis of the relation between changes in the quantity of money and changes in the price-level with a view to determining the elasticity of prices in response to changes in the quantity of money" [Keynes, 1970:305]. Hence, the

monetary theory is incomplete in absence of an analysis of the extent in which the monetary expansion spread through the interest rate to the aggregate demand level.

Interest rate as liquidity price

Keynes attitude on savings and loans marked the point of separation between Keynesian and classical economics. While traditional economists such as first Austrian school of thought assumed that savings are a trade off between present consumption and future consumption in order to obtain a higher utility, for Keynes the abstain from consumption is just a waste of present resources. This point of view is clear state by Keynes at the beginning of the XVIth chapter of The General Theory: “An act of individual saving means—so to speak—a decision not to have dinner to-day. But it does not necessitate a decision to have dinner or to buy a pair of boots a week hence or a year hence or to consume any specified thing at any specified date. Thus it depresses the business of preparing to-day's dinner without stimulating the business of making ready for some future act of consumption. It is not a substitution of future consumption-demand for present consumption-demand,—it is a net diminution of such demand.” [Keynes, 1970:226]. By presenting such a familiar image Keynes is trying to argue that, mostly, the individual decision to save is not *a priori* determined by the individual decision to invest. Thus, an important quantity of money is redrawn from the economic circuit determining a decrease of the aggregate demand. Individuals do not save money in order to trade off a present satisfaction foe a future higher satisfaction as the traditional economics states, they are saving just because they refuse, from various reasons, to spend money now. In this context, savings and consumption (or investments) are two clear separated acts, distanced in time which is connected only through the interest rate. When the savings are not equal with consumptions and investments, there is disequilibrium between aggregate demand and aggregate supply and the economic crisis is about to start.

In this way, the interest rate becomes the essential element of the economic activity. This interest rate is considered by Keynes as a pure financial variable which level is determined not by the supply and demand of loans (as the traditional economics assumes, because the supply and demand are not linked) and rather by the supply for money and the demand for liquidities. Consequently, the interest rate is transforming, according to Keynesian theory, from a price determined by the trade off between present and future, in a price of money or, in other words, a price of liquidity. In this context, a decrease in interest rate is the same with an increase in the quantity of money and because “free market economy is like a broken car or a car without a driver” [Skousen, 1997], interest rate variation is a very subtle and efficient method to control maladjustments of the capitalist system. The interest rate level will determine the level of aggregate demand and will spread itself along the entire economic system through three ways: the preference for liquidities, marginal efficiency of investment, investments multiplier. Since a laissez-faire economy could not guarantee the level required level of investments needed for a full employment, Keynes created, using the interest rate theory, an alternative mechanism which assumes the indirect intervention of the state in economic activities. This mechanism is functioning like this: the central bank (controlled by the State) controls the interest rate level; a decrease of the interest rate will determine a diminishing price of loans; this diminishing price of loans will produce an increase of the demand for liquidities; the increased demand for liquidities will be covered by an increase in the quantity of money; the newly created liquidities will increase the level of consumption and investments; the increasing of the investment level will eventually determine a decrease of unemployment. This mechanism is functional because, Keynes argues, “Unemployment develops, that is to say, because people want the moon;—men cannot be employed when the object of desire (i.e. money) is something which cannot be produced and the demand for which cannot be readily choked off. There is no remedy but to persuade the public that green cheese is practically the same thing and to have a green cheese factory (i.e. a central bank) under public control.” [Keyens, 1970: 249].

But this intervention mechanism was not invented by Keynes; he just refined it and gave it a theoretical background. The cheap money policy was already at its height even before the economic crisis of the 30’s when Great Britain as well as the US central bank, FED, set as a goal to increase the loan possibilities by reducing the interest rate. In other words, the state assumed itself the moral right to set the just price on the money market. Thus, FED always undertook a cheapen money policy which reached its height in July 1927 when FED president, Benjamin Strong cut the interest rate to 3, 25 in order to give “a little *coup de whiskey*” to the economy [Johnson, 2003:235]. Despite this new credit expansion the crisis still occured. Keynes finds the explanation of this paradox by condamning the stock market – the main defendent of the

economic crisis. The cheap money were consumed in stock speculations instead of real investments. Hence, the keynesian mechanism is efficient only when the stock exchange is not developed and when the prices are fixed at least for a short period of time.

Short term and price theory

The traditional microeconomics assumes prices flexibility as an essential characteristic of general equilibrium. The Walrasian general equilibrium model is based on the prices ability to freely float until the supply and demand are met on each particular market and, thus, the entire economic system is in an equilibrium status. From a marginalist perspective, prices are the first variables which react to the various changes on the market, sending valuable information to the individuals regarding the market status. Once more, Keynes will criticize this traditional assumption arguing first that on a short term prices are not as flexible as the traditional economics assumes and, second, prices flexibility is not by far the most important condition for general equilibrium. In his earlier writings, such as *Treatise on money* published in 1923, Keynes talks about a state controlled monetary system as the most important condition for a stable level of prices. Governed money and price stability should maintain an optimum wage level in order to keep the social peace [Johnson, 2003: 230]. In addition, Keynes argues in *The General Theory* that prices fluctuation is a very severe economic problem and this fluctuation is, in the most cases, the sign of recession [Keyens, 1970: 281].

Keynes does not loose too much time to explain why the prices are fixed for a short term. This explanation should be offered by microeconomics rather than macroeconomics and Keynes only find time to explain the more complex issues of macroeconomics. The only explanations offered by Keynes are concerning the rigidity of wages and his argument that nominal wages never fall. The point of departure for this demonstration is, of course, is the traditional economics which, according to Keynes, "has been accustomed to rest the supposedly self-adjusting character of the economic system on an assumed fluidity of money-wages; and, when there is rigidity, to lay on this rigidity the blame of maladjustment" [Keynes, 1970: 269]. For the classical economics, a nominal wage falling will produce, according to Keynes, a cost cut and, consequently, a price reduction which will determine the employment to soar. Keynes is yet skeptical on this theory which is, for him, too simplified. The main fallacy of this theory is determined, according to Keynes, by the incompatibility between the microeconomic and macroeconomic behaviors. If, at the microeconomic level, the demand for labor curve is resulted from a combination between market demand and supply curves, at the macroeconomic level, a demand or supply curve for a particular market can not be transferred to a whole economy l[Keyens, 1970: 271]. At the macroeconomic levl, the classical assumption will be true only if the effective aggragate demand will be fixed. But as long as the aggregate demand depends on revenues i.e nominal wages, such a condition could not be meet. This is the sort Keynesian demonstration for the rigidity of wages. In addition, Keynes will try to argue that not even flexible wages are not desirable for the health of economy.

For Keynes, a flexible wage policy will produce, in the best case, the same effects as a policy of money increasing. If, from the governor's perspective, there is, at least theoretically, the possibility to choose between the two options, for Keynes there is only one option – the monetary policy. To strengthen his point of view, the British economist will use an ethical argument. Fixed nominal wages, he states, can assure, when the prices are changing, the equity in distribution of income between the means of production and labor because the price soaring is determined by the fall of productivity when production is increasing [Keyens, 1970: 271].

All these arguments are meant to give a solid background for one of the most important assumption of Keynesian theory: the wages and prices are not quickly decreasing to a new equilibrium level when there is a supply surplus on the market. For this reason, market equilibrium is not accomplished through prices, as the classical economics states, and rather through quantity. Hence, the production level is determined by the aggregate demand and not by the supply, money are not neutral and the money fluctuations produce real effects and, thus, the monetary and fiscal policies are important for the economic welfare [Barro, 1997:523].

Analyzing Keynesian assumptions and arguments we are strike by the following observation: Keynes treats only half of the wage flexibility. For Keynes, the wages flexibility is defined as the possibility of wages to fall and not to soar. So the question appears: why Keynes ignored the wage soaring possibility? The answer is simple and is derived from the Keynesian vision: the wage soaring is a built-in feature of the economic

mechanism and, thus, de facto assumed. For Keynes a healthy economic system means an increase of production, wages and employment while prices are fixed

Conclusions

Claiming and assuming the prices rigidity, Keynes, as Robert Barro states [Barro, Grossman, 1976], defines and analyzes only a particular case of economic theory, i.e. the prices are fixed for a convenient term so the results of his theory not to be influenced. Hence, although Keynes considers, as he states in the title of his book, that he created a general economic theory, in reality he only studied and theorized a particular case. The question is obvious: it is possible that his conclusions to be applicable when the prices are fluctuating?

The Keynesian doctrine produced a serious impact on the way in which the economic system is built and perceived. Although, nowadays, just a few economists are willing to take for granted Lord Keynes initial conclusions, at least at the level of economic policy, a series of Keynesian assumptions are still considered to be valid. For instance, the fundamental goal of any central bank is to avoid inflation which means to assure prices stability. Is not this the Keynes ideal: economic progress with full employment and fixed prices?

References

1. J M Keynes, The Economic Consequences of the Peace, Macmillan , Londra, 1919
2. M Friedman, "Why Economists Disagree" în Dollars and Deficits, New York: Prentice-Hall, 1968, pg. 15
3. J M Keynes, Teoria generală a folosirii mâinii de lucru, a dobânzii şi a banilor, Editura Ştiinţifică, Bucureşti, 1970
4. L von Mises, "Stones Into Bread", în Planning for Freedom,South Holland, Illinois: Libertarian Press, 1980
5. M Skousen, "The Perseverance of Paul Samuelson's Economics", The Journal of Economic Perspectives 11, No. 2 (Primăvara 1997), pg. 137-152.
6. Barro, Macroeconmics 5th Edition, MIT Press, Cambridge, 1997, pg. 523
7. R J Barro, H Grossman, Money, Employment and Inflation, Cambridge University Press, 1976
8. J A. Schumpeter, History of Economic Analysis, Oxford University Press, 1996
9. W M Corden, „Keynes and Others: Wage and Price Rigidities in Macro-Economic Models", Oxford Economic Papers, Vol. 30, No. 2, 1978, pg. 159-180