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Notes on "Effective Demand"
[a Comment on Professor Krishna Bharadwaj's
On Effective Demand: Certain Recent Critique]

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Professor Krishna Bharadwaj's paper is both an admirable presentation of and commentary on some critiques of the neo-classical theory by Clower and Leijanhufud, Pasinetti and Garegnani and a strong argument for a generalized surplus approach to economic theory. I find Professor Bharadwaj's comments on the "limited and flawed" resurgence of the economics of Keynes at the hands of Clower and Leijuhufud, Pasinetti's emphasis upon the primacy of investments in the investment-savings equality and Garegnani's critique of Keynes for accepting too much of neo-classical theory congenial and I will not comment on these.

The main significance of Professor Bharadwaj's contribution rests upon her explanation and advocacy of the surplus approach to economic theory and presumably to the theories of effective demand and of effective demand failures. I will focus my remarks upon the surplus view of the economy and how it needs to be adjusted if we are to understand the determination of effective demand and the mechanisms by which effective demand failures occur in our economy. My perspective is that we should think in terms of accumulation forcing the surplus and in particular the way in which accumulation does this forcing in a capitalist economy with complex, sophisticated and evolving financial institutions.

Ever since Smith, economics as a discipline has been concerned with two questions which can be conveniently identified as resource utilization and resource creation. The problem set in the economics of resource utilization is to explain why a large measure of coherence can be observed to emerge out

of the "anarchic" organization that is a market economy. Modern price-theory has quite precisely delimited the domains of decisions for which the 'supply and demand' analysis of markets can confidently assert that market processes lead to coherent results.[1] These results make it quite clear that the neo-classical synthesis, which aimed at constructing "macroeconomics" on a base of Walrasian price theory, has little of significance to say about accumulation under capitalist conditions. In particular, if the economy is opened to include money, finance and capital assets (the "ingredients" of a truly dynamic analysis) then the main propositions of static price theory -the existence of coherence and the efficiency of outcome -do not carry through. The famous "Two Cambridge debate" which showed that neo-classical growth theories assumed the existence of equilibrium when the depreciated initial cost of capital was taken as the value of capital at every moment of time (thereby implicitly assuming that the present value of future profits were always as anticipated at the moment of the investment decision) effectively banished neo-classical theory from the analysis of resource creation.[2]

The explanation of resource creation--of accumulation--was the second problem set by Smith. This became the main concern of the classical economists. Resource accumulation naturally takes place in historical unidirectional time. What exists at any time is a result of past decisions and outcomes and what is done now will leave legacies and affect the future. The economics of resource creation examines how decisions to use resources to create resources are based upon the present views of the future, how the use of resources to create resources affects the current performance of the economy, and the effect of today's performance of the economy on the commitments entered in the past which became current commitments with the passage of time.

The economics of resource creation is inescapably institutional economics. Of necessity decisions to create resources involve quite different considerations under capitalist and socialist arrangements. We have had enough experience with variants of capitalism to know that the considerations that affect resource creation (investment) decisions and activity differ quite markedly among the various forms that capitalism has taken. However, the considerations that affect the utilization of given resources and the impact of preference upon consumption patterns are not different in any essential way in socialist and capitalist economies. Thus a general and abstract theory of resource utilization is possible and perhaps even desirable but no such institution free theory of resource creation is possible. [3]

If our theories of resource creation and resource utilization are to be consistent, then the 'results' of one aspect of the theory must not preclude behavior and phenomena that quite clearly exist in the other "domain". In this sense the neo-calssical theory of resource utilization, which assumes the dominance of market clearing processes that lead to and then sustain full or a natural rate of employment, proves too much, for it leads to a conclusion of sustained stability in investment and financing markets which are not observable. The resource utilization theory that is consistent with an emphasis upon resource accumulation and a recognition of observed aggregate instability must be such that it explains prices and outputs when aggregate parameters within which relative prices and specific outputs are determined are introduced from outside. Instead of particular markets aggregating to some macroeconomic relations, consistency requires a price theory that adjusts to variables determined in the resource creation process. Aggregate profits - not the profit rate - is the appropriate parameter to be brought over from resource creation to resource utilization.[4] Given that current costs of

production reflect current wages, the profits available from using resources is determined by how employers see the aggregate profits distributed among productions. Profits are the carrot that induces resources utilization even as short falls of current profits are the "shock" that disciplines past investors.

In the view of the neo-classical synthesis, that Americans such as Friedman, Samuelson, Modigliani and Patinkin[5] promote, the market mechanism and interactions lead to an equilibrium in which the availability of resources determined resource utilization. With the full employment or natural rate of unemployment determination of income there is no problem of effective demand; questions of effective demand failure are foreign to the neo-classical synthesis. In this theory resource creation is just the result of another set of markets clearing, no different than any other set of markets. In some later versions of neo-classical theory the distinction between investment demand and consumption demand is dropped. By ignoring the special problems involved in transforming the demand for future resources into a demand for labor now, present day neo-classical economists are unable to understand the sources and the potential consequences of our current threatening instability. Today's potential financial breakdowns are causing continuous downward pressures on effective demand. It is only the massive government deficits, which are sustaining profits, that prevents a massive collapse of effective demand.[6]

If I am to be pointed in my comments on Professor Bharadwaj's admirable paper -and we can progress only if friends and allies offer pointed comments -then I must begin by noting that her positive analysis of Section V as well as the literature she reports on in Sections II, III and IV approach the problem of effective demand and of resource creation on too great a level of abstraction. In the first sentence of her exposition of the surplus approach

she notes that in the hands of Smith, Ricardo and Marx it "... was concerned particularly to answer questions pertaining to the process of generation, distribution and accumulation of surplus in a competitive capitalist economy". Of course, our economies are far from competitive, the corporate form of capitalism has taken on dimensions unthought of in the days of Smith, Ricardo and Marx and government, inspite of the Reagan and Thatcher administrations, has become interventionist. Nevertheless, inspite of these changes, the economy remains capitalist. Any understanding of the generation of effective demand and the possibility of effective demand failures in our economies in our time must take the specific nature of our big government capitalism into account.

I believe that the emphasis upon the surplus rather than accumulation is misplaced. It is the desire to accumulate, in the sense of creating resources, and the ability to finance accumulation that is central to the behavior of a capitalist economy. It is the financed spending on accumulation (investment demand) that determines the level of today's effective demand for labor. In particular a marginal productivity theorist can make the institutional identification that workers spend their income on consumption goods and capitalists save all their income. This will lead to the result that aggregate profits equals aggregate savings. However, to the neo-classical economist profits equal the marginal productivity of capital times capital, so that, within the dominant assumption that labor market equilibrium always rules, savings leads to investments by way of interest rate adjustments.

Under capitalist conditions effective demand is financed demand. For households the theory of effective demand is the theory of the determination of household budget constraints. The relation between household wage income and the household budget constraint depends upon the supplements to wage income that may exist, not only through the welfare state but also through the

disbursement of part of gross capital income as wages, and the ability of households to hypothecate future wage income or to pledge assets to finance spending. Savings out of wage income - as well as debt financing of spending by wage earners - breaks the institutional specification which leads to the simple Kalecki consumption wage relation. It allows short run deviations from the Keynes view that investment determines effective aggregate demand.

The focus of any analysis that emphasizes resource creation has to be investment. It is impossible to discuss effective demand under capitalist conditions without examining demand for investment and developing explanations of how investment demand becomes effective because it is financed. In my writings about Keynes I argue that Keynes' theory can be characterized as an investment theory of business cycles and a financial theory of investment. If aggregate income and output are growing, investment demand in the aggregate requires external financing. An implication of this requirement is that under modern conditions money, as the liability of the banking or financing systems, is a product of the investment process. It is not possible to analyze the determinants of effective demand without considering the behavior of the economy's institutions that select and finance investment and in the process determine the price level of existing capital assets. Furthermore, if one wants to take a 'surplus' approach, then the issue is how is the surplus generated and allocated to alternative uses. In a capitalist economy the forcing and allocation of the surplus involves the external financing of business, government and some variants of household spending. This financing under capitalist conditions involves the banking systems. Thus any serious theory of the resource creation process needs to examine how banking and finance do in fact operate. Unfortunately the level of abstraction of Bharadwaj's work precludes such detailed analysis.

Profits are the main signalling devise in an accumulating capitalist economy. The effective demand for labor at any time reflects the current profit expectations from utilizing existing capital assets. However, because part of the current demand for labor is derived from the current expected profits from using resources to produce investment output, the expected selling price for investment output has to exceed the out of pocket costs of producing investment output by a margin sufficient to activate production. This demand price for investment output, as well as the explicit or implicit market price of capital assets inherited from the past that are expected to be useful in future productions, reflects the profits that are expected to be earned in the future. Thus "profits" has two meanings in the analysis of effective demand. One meaning is the profits that can be earned by utilizing existing capital assets, which reflects the demand for output that is expected to rule in the "short run", the second is the profits that will be earned in the more distant future that are transformed into demand prices for capital assets and investment outputs. The second profits "reflect" long run "expectations."

Effective demand for labor depends upon profit expectations in the short run. Effective demand fails when the effective demand for labor is too small (or too large) for the available labor force and the market reactions to the shortfall (excess) of labor demand leads to ineffective or even perverse reactions. In particular too small a current investment demand will lead to aggregate nominal profits being short of target even as excess labor exists. For aggregate effective demand to increase then either the expected future profits need increase, the capitalization rate on expected profits need increase or wages in investment output need fall so that the demand price of

investment output rises relative to the supply price. However such a rise in relative prices need not draw forth an increase in investment unless external financing increases. If current profits have fallen so far that the ability of existing debtors to validate the payment commitments on their debts is compromised, then even an increased demand price relative to the supply price of investment outputs will not necessarily draw forth the financing that would increase current profits.

Thus if current profits are insufficient to readily validate the past price of capital assets and outstanding financial contracts, the market mechanism reactions to inadequate effective demand will not lead to an increase in effective demand. Furthermore, with a compromised financial structure and declining prices the impact upon long run expectations of the profit and financial market consequences of a given shortfall of effective demand will only make things worse, not better. Thus the views that the economy is a self-correcting or equilibriating system are shattered when the intertemporal generation of profit expectations are taken into account. Aggregate demand failures do not depend upon the "collapse" of the productivity of investment in any technical sense, rather, they depend upon the "collapse" of profit expectations by both business men and bankers.

Big government, with it's massive counter-cyclical deficits, sustains profits. Since World War there has not been a significant failure of effective demand because of the way government has effectively although usually unintentionally sustained profits. However, because profits sustained by private investment are associated with resource creation whereas profits sustained by the deficits of a government that is big because of transfer payments and defense spending are not associated with resource creation,

chronic and then accelerating inflation has been a side effect of the process by which effective demand has been sustained.

Perhaps we pay too much attention to the literature of our discipline -not only to what our great predecessors said but also to what our contemporaries are saying -and not enough to what happens in the economies we study. One great advance that I have always associated with Keynes is that he held that we cannot dichotomize the financial and the "real" when it comes to understanding capitalism. Instead of trying to say general things about economies we should concentrate on understanding the range of behavior which economies exhibit as institutions as well as the relations among variables change. In particular, if we are emphasizing the accumulation process under capitalist conditions we cannot consider financial relations in asides -no matter how important we assert these relations to be in these asides.

FOOTNOTES

[1] F. H. Hahn has been clearest in this sense. See K. Arrow and F. Hahn, "General Competitive Equilibrium", [San Fransisco, Holder Day, Inc., 1971], especially chapter 14.

[2] G. C. Harcourt, Some Cambridge Controversies in the Theory of Capital, [Cambridge: Cambridge University Press, 1972.]

[3] An interpretation of O. Lange, On the Economic Theory of Socialism, Minneapolis, The University of Minnesota Press, 1928 (edited by Benjamin Lippincott) is that socialism is a way of separating the resource creation and the resource utilization aspects of the economy: Resource utilization can be left to market forces whereas resource creation requires socialism.

This is also a way of interpreting the structure of the economy message of The General Theory [see H. P. Minsky, John Maynard Keynes, New York, Columbia University Press, 1975, Chapter 9].

The citation from Keynes in Bharadwaj's footnote 3 is best interpreted as acknowledging that what goes wrong in capitalism are repercussions of the resource creation process and not the result of how markets take care of the details of resource utilization, once the overall volume of effective demand is given.

[4] Inasmuch as Sraffian economics of resource utilization explains how coherence in details of the economy can be achieved given "outside" determination of parameters, the Sraffian view is consistent with an integratation of macro and microeconomics which accepts the prior determination of gross aggregate profits to be earned from using resources by the resource accumulation processes. In this view the Kalecki (and the later day Hick's views of price formation are relevant).

Sraffa, P., Production of Commodities by Commodities, Cambridge, Cambridge University Press, 1960.

Kalecki, M., Selected Essays on the Dynamics of the Capitalist Economy, Cambridge, Cambridge University Press, 1971.

Hicks, J. R., Capital and Growth: Oxford, Oxford University Press, 1965.

[5] Patinkin, D., Money Income and Prices, New York; Harper and Row, 1972, (Second Edition), is the classic reference for the neo-classical synthesis.

[6] Minsky, H. P., Finance and Profits: The Changing Nature of American Business Cycles, in the Business Cycle and Public Policy, 1929-80. Joint Economic Committee Congress of the United States, (Washington D. C: U.S. Government Printing Office, 1980, pp 230-244.