CLOWER ON EFFECTIVE DEMAND

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INTRODUCTION

In a paper published recently in this journal Clower (1994) claims that "Keynes' account of The Principle of Effective Demand merely restates in aggregative form a Marshallian partial equilibrium demand and supply model, and so adds nothing (other than empty polemics) to classical theory" [ibid., 377]. He suggests, in particular, that the possibility of short-run equilibrium below capacity "calls for no comment on the level of employment of factor services" [ibid., 351]. Clower goes on to argue that traditional Keynesian doctrine owes little or nothing to Keynes' original theory, and that indeed there is an "inconsistency between Keynes' formal treatment of the theory of effective demand, which implies clearing output markets, and Keynes' ex cathedra polemics about effective demand failures" [ibid., 383, italics in original]. This alleged inconsistency and "the analytical irrelevance of the effective demand theme in Keynes' analysis" [ibid., 383; italics in original] is reflected in the title of Clower's paper: "The Effective Demand Fraud".

In this note we argue that although some of Clower's observations are correct, his reconstruction of Keynes has serious weaknesses. Moreover, the observations which are correct are well known and do not have the implications that Clower suggests. Keynes' insights may sometimes be forgotten or distorted but he most definitely did add to classical theory and there is no effective demand fraud.1

CLOWER'S CLAIMS

We list four claims made by Clower, and evaluate each in turn.

Claim 1: Keynes' principle of effective demand "merely restates in aggregative form a Marshallian partial equilibrium model, and so adds nothing (other than empty polemics) to classical theory" [ibid., 377, italics added].


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In his Marshallian model, by contrast, Clower merely assumes that aggregate demand price is a downward sloping function of aggregate output [1994, 378] and then suggests in a footnote that the curve may shift depending on "such imponderables as the state of confidence, 'automatic expenditure', uncertainty about future economic conditions", etc. [1994, 384]. That is all very well as a summary presentation of some Keynesian insights. But this summary presentation is inadequate when it comes to analyzing the determinants of possible shifts in the curve (cf. the discussion below of claim 2) and, without the intervening work by Keynes and subsequent Keynesians, Clower's construction would, we submit, appear quite undeveloped. Since Keynes' analysis, itself, informs and gives meaning to Clower's stylized model, his claim that Keynes added nothing seems incomprehensible.

Claim 2: "If output equilibrium occurs in the Marshallian output market at a level of output below capacity [JMKVII, 26], as it certainly may, that calls for no comment on the level of employment of factor services", [1994, 381, italics added]

This claim, especially the wording at the critical point italicized, is quite opaque. If, however, the statement—and Clower's article in general—is to be meaningful, then presumably Clower disputes Keynes' own "comment," that is, Keynes' analysis of the implications of his theory for the level of employment of factor services.

Keynes' comment can be paraphrased quite briefly. The determination of the short-run equilibrium level of output and employment by effective demand—that is, by the intersection of the aggregate demand and supply functions—can lead to involuntary unemployment in the following sense: the real wage rate at the equilibrium may exceed the marginal disutility of work, and when this happens, an increase in aggregate demand (e.g., through expansionary fiscal or monetary policy) can generate a new equilibrium with a higher level of output and employment and a lower real wage rate. Thus, however, is not the full story.

The analysis of short-run equilibrium in chapters 4-18 of the General Theory takes as given the money wage rate. This procedure can be questioned: the equilibrium level of employment is conditional on the money wage rate and wage flexibility (rather than aggregate demand policy) could be the key to full employment. This standard neoclassical position could explain Clower's cryptic claim. Whether in fact Clower endorses this neoclassical position is unclear to us. However, the General Theory explicitly rejects the neoclassical view. This rejection, which is the central message of the General Theory, is made clear in the early chapters (see e.g., pages 10-12) and argued more fully in Chapter 19, which opens with the following paragraph:

If it would have been an advantage if the effects of a change in money-wages could have been discussed in an earlier chapter. For the Classical Theory has been accustomed to rest the supposedly self-adjusting character of the economic system on an assumed fluidity of the money-wages... [1936, 207]
The classical analysis was based on a false analogy between the partial analysis of a single industry and the analysis of the system as a whole:

For the demand schedules for particular industries can only be constructed on some fixed assumption as to the nature of the demand and supply schedules of other industries and as to the amount of aggregate effective demand. It is invalid, therefore, to transfer the argument to industry as a whole unless we also transfer our assumption that the aggregate effective demand is fixed. Yet this assumption reduces the argument to an ignoble shriek. For, whilst no one would wish to deny the proposition that a reduction in money-wages accompanied by the same aggregate effective demand as before will be associated with an increase in employment, the precise question at issue is whether the reduction in money-wages will or will not be accompanied by the same aggregate effective demand as before measured in money... [1938, 259]

This is where the careful analysis of the determinants of aggregate demand and supply becomes important. Using the apparatus developed in chapters 4-18, Keynes identified a number of channels through which changes in money wages would affect the equilibrium level of output and employment. Some of the effects are expansionary but others tend to reduce aggregate demand (e.g., redistributions of income and wealth and changes in inflationary expectations). Keynes concluded that, on balance, far from stabilizing the system, flexible money wages would be a source of instability [1936, 260]. Hence, the maintenance of a stable general level of money-wages is, on a balance of considerations, the most advisable policy for a closed system... [1936, 270]

Most so-called Keynesian models deviate from the economics of Keynes on this issue. Thus, the textbook Keynesian model suggests that demand policies may help alleviate unemployment problems but that the stickiness of nominal wages and prices are to blame for unemployment. Even in the absence of intervention the problems will be temporary in the textbook model unless it is assumed (implausibly) that money-wages are completely rigid in the face of involuntary unemployment. This result and the stabilizing effects of wage flexibility are obtained by emphasizing (and exaggerating) the expansionary effects of wage reductions and ignoring the adverse effects. One may, of course, question Keynes' assumptions and disagree with his theory. But Clower raises neither theoretical nor empirical objections of this kind. His criticism appears to concern the logic and/or interpretation of Keynes' system. As such the criticism appears to us unfounded: Keynes' analysis of the determination of output and employment by the principle of effective demand does have important implications for the level of employment of factor services.

Claim 3: Keynes "insinuated" that unemployment derived from the non-clearance of the market for output and in doing so "committed a (probably intentional) fraud" [1994, 381]. Furthermore, the "effective demand theme" is analytically irrelevant in Keynes' analysis [ibid., 383].

Keynes' determination of short-run equilibrium at the intersection of the aggregate demand and supply functions has several implications. Producers are on their supply curve and no individual producer therefore "feels sales-constrained" [Clower, 1994, 380]. Furthermore, shifts in aggregate demand or supply will in general affect both the equilibrium output and the equilibrium price. These two implications of the theory are straightforward, and Keynes was absolutely clear on both issues. We therefore find this third claim by Clower highly surprising. In support of his claim, Clower merely refers to chapter 3 of The General Theory, and we are not sure what he may have had in mind. Chapter 3 clearly and unambiguously states that the short-run equilibrium is at the intersection of the aggregate supply and demand functions, and that by construction, if firms are on the aggregate supply function, the first-order conditions for profit maximization are satisfied.

Clower's comments on the analytical irrelevance of effective demand may simply reflect a terminological confusion. Keynes' terminology may, in the light of later usage, give the impression that the supply side is being ignored when one refers to effective demand. However, effective demand is defined by Keynes as the value of aggregate demand "at the point of the aggregate demand function, where it is intersected by the aggregate supply function" [Clower, 1994, 25]. Hence, a determination of the level of employment by effective demand implies neither a neglect of the supply side nor a claim of non-clearing output markets.

Since we find no evidence of fraud, the question of intent does not arise. But even if Keynes had been guilty of fraud, Clower's conclusion [1994, Note 12] of intentional falsity seems farfetched: the only evidence presented by Clower is a letter to Harrod in which Keynes comments that his new theory will become understood only through controversy.

Claim 4: What presently passes for Keynesian economics "owes nothing but its initial inspiration to Keynes' General Theory" [1994, 377], and the "Keynesian" fix-price assumptions (i) are incompatible with profit maximization and (ii) eliminate business price-making decisions [ibid., 382].

As indicated above, we agree that Keynesian economics differs from the economics of Keynes. The key difference, however, concerns the effects of money-wage flexibility. This difference is not, it seems, what Clower has in mind. Instead, he stresses the fact that some versions of Keynesian theory assume fixed prices, and that this assumption may involve inconsistencies, violate profit maximization, and imply a neglect of price-making decisions.
CONCLUSION

In The General Theory Keynes extended the partial-equilibrium Marshallian approach to the examination of general equilibrium for the economy as a whole. Given the enduring popularity of Walrasian fix-price interpretations, this simple observation is worth making, and we fully agree with Clower on the Marshallian roots of Keynes' analysis (but not with Clower's claim that the extension was trivial). Unfortunately, Clower's subsequent analysis contains, we believe, serious errors and misinterpretations.

Keynes' theory of effective demand does not depend on non-clearing output markets, and we fail to understand Clower's claim that Keynes instated it as much. Even more importantly, Clower's suggestion that Keynes' analysis carries no implications for an understanding of unemployment is, we argue, incorrect (and his reasons for making this claim seem incomprehensible). Keynes argued, convincingly in our view, that increased wage flexibility would fail to stabilize a closed economy at full employment. Policy recommendations that focus exclusively on wage (and price) flexibility are thus fundamentally flawed. The failure to grasp this point -- or even address the issue -- unites most "love-child" Keynesians, monetarists, "new" (and old) Classicalists and "new" Keynesians, and sets them apart from "old" Keynesians like Tobin (1993), the post-Keynesians, and Keynes himself.

REFERENCES


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OTHER THINGS EQUAL

Love or Money

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One more thing about gender, with apologies. Apologies because I don’t plan to make this column into an account of the Perils of Deirdre (for that you’ll have to read the forthcoming book—a very, very exciting book, I promise, from a major publisher, soon to be a motion picture, or at least a TV mini-series). Anyway the Perils have turned out to be a bit boring lately. Tolerant Holland is just the place to “transition,” in contrast to the bushybody state violence and macho inconsiderateness of the good old US of A. I’m able to focus for the year on my topic, the history and philosophy of “bourgeois virtue” (another forthcoming book, but not, I’m afraid, a motion picture). The Dutch ease and tolerance reduces the gender task to finding walking shoes in European size 43 and learning the local customs of internation among women. Believe me, size 43 is rare, so you have to search; and Dutch women are not as effusive as are American women, so you have to turn down the heat. Wonderfully boring, this business of being Mevrouw professor McCloskey.

The one more thing about gender I’d ask you to think about a little is perhaps the most embarrassing word to economists, especially men economists: love. The word is “about gender” just because women think about it more than men do. I mean think about it, not need: we all need it, but for a thoughtful analysis you’ll probably do better talking to your sister than to your brother. Not always, but usually.

By “love” I mean Aristotle’s third and highest form of friendship, the part that cannot be explained in turn by interest alone. The other two are friendship for pleasure and friendship for utility (we would combine them). The third kind is friendship for the friend’s own sake. I do not claim that such love is always a good thing. Having been the subject recently of some very bad love by an economist I caused to be hired at the University of Chicago and in other ways loved well, I should know. After all, Hitler loved Germany, but look what his love did to it. People don’t always know what’s best for their friend. Jack Hyde at George Mason University points out to me that love may have a comparative advantage in small scale rather than in large, a mother’s love rather than German nationalism or Russian socialism, two excesses of love.

The word is embarrassing to a profession dominated by men. A male economist once called economics the “science of conserving on love,” by which he meant that society must depend mainly on selfishness, not altruism, in the style of Paul Samuelson’s selfish maximiser or Gary Becker’s loveless “family.” It was not always so in the science of scarcity. Economics drops love early, but not as early as you may be thinking. It’s customary to think of Adam Smith as a sort of neo-conservative in