Keynes and economic crisis: some reconsiderations*

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Abstract

In this paper we read Keynes’s “General Theory of Employment, Interest and Money” from the point of view of the main causes of the economic crisis in general and particularly the present world economic crisis. We compare Keynes’s approach to the crisis with the work of contemporary distinguished economists. We conclude that a drop of marginal efficiency of capital is the main cause of the economic crisis and depression, and that such a drop is an unavoidable consequence of functioning of a market capitalist economy. Such a view differs significantly from the deliberations of many economists who hold insufficient demand as the main cause of the crisis. We think that insufficient demand appears on the surface as a cause of the crisis. However, insufficient demand is just a consequence of a previously overheated economy faced with the drop of MEC. Consequently, a crisis cannot be prevented by expansive financial policy. Therefore it should come as a surprise that Keynes in the last year of his life retreated from his ideas expressed in “General Theory” and declared himself as not Keynesian any more (Hutchison, 1981). We think that major systemic, institutional as well as structural changes need to be taken in majority of developed economies in order to cope efficiently with present and future crisis.

Key words: Keynes, crisis, demand, MEC, economic policy

JEL classification: B 10, E 12, E 3

1. Introduction

Insufficient aggregate demand is taken by the administrations of many countries and many economists, as the main cause of the current world economic crisis. Therefore, economic thought of J.M. Keynes has come again to the forefront of economic

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On the other hand, a few economists such as J. Taylor, (2009), or K. Rogoff-Reinchart (2008), point out that recession is usually preceded by aggregate over absorption.

Different interpretations of the causes of crisis require different economic prescription. If we take insufficient demand as the most important disease of an economy, does it mean that the crisis might be fixed (prevented) by additional demand? Or does the crisis fixing require more deep systemic changes in times of severe crisis such as the present recession often compared to the Great Depression, as we suggest?

Since the crisis can hardly be solved and depressions prevented by monetary and fiscal relief measures, it is high time politicians were at work on national and worldwide level searching for a new political-economic solution.

In the paper we try to follow the main thought on economic crisis offered by Keynes himself. We extensively use Keynes’ quotes because of the delicate subject matter of the paper and different approach to Keynes’ thought. We offer our understanding of Keynes’ thought on economic crisis and its causes. Then we deduce his mechanism from economic crisis and depression. Finally, we conclude, on the basis of comparison of Keynes’ economic deliberations and the economics facts expounded by Taylor, Rogoff, Ellsworth, and Marx that throughout history, deep economic crises have been caused mainly by a drop of MEC. Hardly might a drop of MEC be tackled efficiently from the ‘centre’ without provoking lasting stagflation, exactly as Keynes did conclude in 1937 (Hutchison, 1981). Rarely may stagflation be a lasting solution to any crises. Consequently, reflecting to the new crisis situation in G. Britain in 1937 Keynes pointed out that budget deficit became useless remedy for a stagnant economy. He concluded that for a new stage of economic dynamics stimulation from the centre becomes counterproductive. Therefore, Keynes suggests that a new stage of economic recovery requires a new technique (Hutchison, 1981: 115-116).

Our opinion is that the present world financial crisis is both financial and structural-functional crisis of the capitalist way of production. The present crisis, expressed in Marx’s language, might be depicted as a crisis in which “global material productive forces of society (have) come into conflict with existing relations of production(…) from forms of development of the productive forces these relations turn into their fetters”(Buzaglo, 2009). The dynamics of MEC is closely connected with the dynamics of a reproduction process. MEC is an expression of business climate of an economy at a given stage of a business cycle. The stage of a business cycle reflects relations of productive forces and productive relations. Therefore, we think that
MEC deserves a particular attention to be paid in giving explanation of an economic crisis both from a micro and macro-economic perspective. Consequently, we think that deep and structural changes need to be made in the present system of a market capitalist economy in order to avoid the possibility of a great economic crash in the future. Hardly might the measures of an economic policy directed to increase the alleged insufficient demand be welcomed as a lasting solution to a systemic, structural and functional economic crisis.

2. Controversial issues of insufficient demand approach

In an attempt to trace thoughts of economists on insufficient demand, we have found that the main causes of insufficient demand might be classified as follows:

- Insufficient demand is caused by both low level of personal and investment spending in relation to GDP (Krugman, 2006, 2007; Stiglitz, 2007; Vade, 2008; Bernanke, 2002).

- Insufficient demand is primarily caused by wrong macroeconomic management-restrictive monetary policy (Bernanke, 2002; Romer, 2002; Friedman in Swartz-Nelson, 2007; Swartz-Nelson, 2007).

- Insufficient demand is caused either in a two-class model by inadequate consumption of workers or in a three-class model by insufficient consumption of financial reinterst (Crotty, 2006, 2008; Pitelis-Argities, 2006, 2008; Orhongazi, 2007).

- Insufficient spending is a consequence of asymmetric information, moral hazard and inadequate systemic regulation (Stiglitz, 2007).

It sounds highly surprisingly that between afore mentioned economist no one has pointed out to marginal efficiency of capital as a main cause of economic slump stressed out by Keynes theory and confirmed by economic reality of 1861 (Marx), or 1929 (Ellsworth, 1950).

Should we, for a moment, take the thesis of insufficient demand as correct, we may pose the following question in order to test the validity of the proposition of insufficient demand:

- How is it possible for an economy to be confronted with the balance of payments deficit and inflation if under-consumption in the economy persists and precedes the crisis, (see data for the USA and other developed economies prepared by Rogoff-Reinchart, 2008 and Taylor, 2009).

- How is it possible that an economy faces a sudden drop in assets prices just by changed expectations? How comes that the expectations are suddenly changed?
- How is it possible that personal consumption drops in time of full employment bearing in mind that according to all economic schools of thought full employment provides the highest level of wages? Where does demand deficiency come from: workers (citizens), investors, renters?

- Why does an economy experience a drop in investment unless it is caused by fall in marginal efficiency of capital (MEC)?

- What factors bring about a fall in MEC: is it insufficient demand or eventually an overheated economy as suggested by Keynes himself?

On the other hand, J. Taylor in his article (2009) deliberates on the main causes of an economic crisis as follows: “The classic explanation of financial crises, going back hundreds of years, is that they are caused by excesses—frequently monetary excesses—which lead to a boom and an inevitable bust. In the recent crisis we had a housing boom and bust which in turn led to financial turmoil in the United States and other countries. I begin by showing that monetary excesses were the main cause of that boom and the resulting bust” (Taylor, 2009).

A similar thought to Taylor’s has been expressed by Rogoff-Reinchart (2008). They wonder whether the 2007-2008 U.S. sub-prime mortgage financial crisis is truly a new and different phenomena. Our examination of the longer historical record finds stunning qualitative and quantitative parallels to 18 earlier post-war banking crises in industrialized countries. Specifically, the run-up in U.S. equity and housing prices (which, for countries experiencing large capital inflows, stands out as the best leading indicator in the financial crisis literature) closely tracks the average of the earlier crises. Another important parallel is the inverted v-shape curve for output growth the U.S. experienced as its economy slowed on the eve of the crisis. Among other indicators, the run-up in U.S. public debt is actually somewhat below the average of other episodes, and its pre-crisis inflation level is also lower. On the other hand, the U.S. current account deficit trajectory is worse than average.”(See graphs 1 and 2)

Our understanding of Keynes’ theory of business cycles, Keynes (1964), and the empirical data from the XIX century (Marx, Vol.III :448, 426), and from the economic crash of 1929 (Ellsworth,1950) suggests that the crisis can hardly be cured by increasing demand. Moreover, increasing demand might provoke worldwide stagflation. In this respect let us mention some relevant observations pointed out by P.T.Ellsworth which support an attitude that the 1929 economic crisis was provoked by a drop of MEC rather than by a drop of demand: “The whole economy has been saturated. Capacities of auto industry in 1929 were developed far above sale possibilities. Industry of gum has been overheated also. The whole range of consumer durables such as washing machines, vacuum cleaners, radio apparatuses, were confronted with the problem how to sell the goods. (…) Investment were almost stopped” (Ellsworth, 1950:496).
Graph 1: Real Housing Prices and Banking Crisis

Source: Rogoff, K-Reinhart, C (2008) is the 2007 US. Sub-prime financial crisis so different? An international historical comparison, NBER, working paper No.13761

Graph 2: Current Account Balances /GDP on the Eve of Banking Crisis

Bearing in mind all that we have stated so far, we dare propose the following hypothesis: credit–debt financed consumption and investment (high leverage) contribute to hyper absorption in an economy before an economy faces an economic downturn. Insufficient demand, therefore, is a consequence of both a previously overheated economy and a consequent drop of MEC. Once the MEC drops to a low level, interest rate must follow the suit. As long as MEC is higher than interest rate (i) investments are profitable. Once investment becomes unprofitable, asset prices are endangered and expectations fall apart. Factories close down and we get a drastic fall in consumption both with: investment and personal. Depression follows.

3. Keynes on economic crisis and business cycle

Keynes was very much concerned with economic crises because he was afraid of such socio-economic changes which could eventually lead to development of a completely different type of society – socialism. Keynes explained economic crises as crises of insufficient demand but not in such a way as theoreticians of under-consumption had done before him. Investment consumption plays a decisive role in Keynes’ economic system. Investment consumption must compensate for insufficient personal consumption. Investment consumption (spending) could be influenced by monetary policy and interest rate policy. However, there is a tendency for marginal efficiency of capital to decline. Marginal efficiency of capital declines due to: over-supply of capital that is over-supply of goods, continuing price increase during the prosperity phase of a business cycle, and an increase of cost of production at the same time.

Keynes’ view was that the decline of marginal efficiency of capital is the main cause of economic crises, i.e. e. that it provokes a trade cycle. “By a cyclical movement we mean that as the system progresses in, e. g. the upward direction, the forces propelling it upwards at first gather force and have a cumulative effect on one another but gradually lose their strength until at a certain point they tend to be replaced by forces operating in the opposite direction…. we mean also that there is some recognizable degree of regularity in the time-sequences and duration of the upward and down-ward movements… There is, however, another characteristic of what we call the Trade Cycle which our explanation must cover if it is to be adequate; namely, the phenomenon of the crisis - the fact that the substitution of a downward for an upward tendency often takes place suddenly and violently, whereas there is, as a rule, no such sharp turning-point when an upward is substituted for a downward tendency.”(Keynes, 1964:322)

Thus, according to Keynes, prosperity suddenly changes the face and violently converts into a crisis. The market mechanism does not function the other way around so quickly, if it does at all automatically.
Crises are a consequence of suddenly declining marginal efficiency of capital. “The later stages of the boom are characterized by optimistic expectations as to the future yield of capital-goods sufficiently strong to offset their growing abundance and their rising cost of production and, probably, a rise in the rate of interest also. It is in the nature of organized investment markets, under the influence of purchasers largely ignorant of what they are buying and of speculators who are more concerned with forecasting the next shift of market sentiment than with a reasonable estimate of the future yield of capital-assets, that when disillusion falls upon an over-optimistic and over-bought market, it should fall with sudden and even catastrophic forces” (Keynes, 1964:314).

“At the outset of the slump there is probably much capital of which the marginal efficiency has become negligible or even negative. But the interval of time, which will have to elapse before the shortage of capital through use, decay and obsolescence causes a sufficiently obvious scarcity to increase the marginal efficiency, may be a somewhat stable function of the average durability of capital in a given epoch. If the characteristics of the epoch shift, the standard time-interval will change” (Keynes, 1964:316).

In addition Keynes underlines that duration of a slump has a definite relationship to the ‘normal rate of growth in a given epoch’ (Keynes, 1964:318).

In times of slump, assets are sold off. Goods are sold off regardless of prices. A decline of marginal efficiency of capital badly affects propensity to consume both by lowering investment drastically and downsizing companies. “Serious drop in marginal efficiency of capital also tends to affect adversely the propensity to consume. For it involves a severe decline in the market value of Stock Exchange equities. Now, on the class who take an active interest in their Stock Exchange investment, especially if they are employing borrowed funds, this naturally, exerts a very depressing influence…With a ‘stock-minded’ public as in USA today, a rising stock market may be an almost essential condition of a satisfactory propensity to consume; and this circumstance, generally overlooked until lately, obviously serves to aggravate still further the depressing effect of a decline in the marginal efficiency of capital.”(Keynes, 1964:318) Crises cannot be softened by lowering interest rate. “I conclude that the duty of ordering the current volume of investment cannot safely be left in private hands,” concluded Keynes in his ‘General Theory’ (Keynes, 1964:320).

According to Keynes, crises represent the process of capital depreciation. The process of depreciation of the value of capital creates a precondition for capital shortage and thus for an increase in its marginal efficiency. A crisis can hardly be avoided or made softer automatically by the automatic functioning of market forces. Under such circumstances the policy of relatively high interest rate increase could be particulate destructive. Keynes did want to prevent crises and save capitalist’s
system. Therefore it is clear why he pleads for an expansive financial policy during the stage which precedes the crisis. He wants to convert the boom into a lasting quasi-boom. However, he was aware of class reality in capitalist society. Therefore, Keynes concluded his book by the following words: “Is the fulfillment of these ideas a visionary hope? Have they insufficient roots in the motives which govern evolution of political society? Are the interest which they will thwart stronger and more obvious than those which they will serve?” (Keynes, 1964:383)

What Keynes really had in mind pointing out to the need for changes in society is not too hard to detect if one carefully reads ’The General Theory’ throughout. Keynes, we believe, demanded such changes in the socio-economic system which remind us of today louder claims of those who would like to guide the development of our present society in the direction of creation of what might be called a ’civil society’. A civil society requires co-existence of three economic sectors: private sector, public sector and the sector of civil economy. In fact, the questions arise whether development of such a society could lead to a post-capitalist type of society, and should an animal spirit be replaced by the ideas of the Commons and how such a society might be constructed.

4. Keynes’ economic mechanism

One of the building blocks of Keynes’ economic system is MEC. It is interesting to note that the term MEC is more complex than the term MPC (marginal productivity of capital). Moreover, Keynes expressed doubt whether capital should be correlated with productivity. If such a remark is correct, then a serious question arises: where does profit come from if capital has nothing to do with productivity? This intriguing and far reaching issue is why we have paid a special attention to an in-depth analysis of Keynes’ economic mechanism. Namely, contemplating about productivity of capital, Keynes wrote that it was “much more preferable to speak of capital as having a yield over the course of its life in excess of its original cost, than as being productive. For the only reason why an asset offers a prospect of yielding during its life services having an aggregate value greater than its initial supply price is because it is scarce… If capital becomes less scarce, the excess yield will diminish without its having become less productive - at least in the physical sense” (Keynes, 1964:213)

Keynes here joins a big party of three: Smith, Marx and Schumpeter, who held that capital did not have productivity and subsequently did not produce profit. “I sympathize, therefore, with the pre-classical doctrine that everything is produced by labor, aided by what used to be called art and is now called technique, by natural resources which are free or cost a rent according to their scarcity or abundance, and by the result of past labor, embodied in assets, which also command a price according to their scarcity or abundance. It is preferable to regard labor, including of course,
the personal services of the entrepreneur and his assistants, as the sole factor of production, operating in a given environment of technique, natural resources, capital equipment and effective demand…. This partly explains why we have been able to take the unit of labor as the sole physical unit which we require in our economic system, apart from units of money and time” (Keynes, 1964:213) May we conclude that lack of productivity of capital has turned Keynes’ attention to the second factor of production-labor?

Keynes’ economic mechanism was created by Keynes in order to fight against depression. The mechanism is more easily understood if one tries to draw a parallel with both the process and manner of functioning of national economies in the XIX century.

According to Keynes, the economy was able to perform well at that time due to the facts that “during the nineteenth century, the growth of population and of invention, the opening-up of new lands, the state of confidence and the frequency of war over the average of (say) each decade seem to have been sufficient, taken in conjunction with the propensity to consume, to established a schedule of the marginal efficiency of capital which allowed a reasonably satisfactory average level of employment to be compatible with a rate of interest high enough to be psychologically acceptable to wealth-owners. There is evidence that for a period of almost one hundred and fifty years the long-run typical rate of interest in the leading financial centers was about 5 per cent, and the gilt-edged rate between 3 and 31/2 per cent; and that these rates of interest were modest enough to encourage a rate of investment consistent with an average of employment which was not intolerably low”(Keynes, 1964:308).

Analyzing the last 150 years, Keynes noticed that ‘wage units’ were increasing. But, at the same time, productivity of labor was increasing too. Convergence of these factors permitted stability of prices to exist throughout this period. Keynes underlined: “Today and presumably for the future the schedule of the marginal efficiency of capital is, for a variety of reasons, much lower than it was in the nineteenth century. The acuteness and the peculiarity of our contemporary problems arise, therefore, out of the possibility that average rate of interest which will allow a reasonable average level of employment is one so unacceptable to wealth-owners that it cannot be readily established merely by manipulating the quantity of money. So long as tolerable level of employment could be maintained on average for one, or two, or three decades merely by assuring adequate supply of money in terms of wage-units, even the XIX century could find the way. If this was our only problem now – if a sufficient degree of devaluation is all we need today, we would certainly find a way… To return to our immediate subject, the long-run relationship between national income and the quantity of money will depend on liquidity-preferences. And the long-run stability or instability of prices will depend on the strength of the upward trend of the wage-unit (or, more precisely, of the cost-unit) compared with the rate of increase in the efficiency of the productive system.”(Keynes, p.309)
By quoting extensively from Keynes’ book, we wish to turn the attention of the reader to one of the most important but, we believe, still often least understood elements of the entire Keynesian system and mechanism: that is to the ‘wage-unit’ or, put more simply, the role which the cost of labor (wages) have in the whole process of socio-economic reproduction. We would say that the entire complexity and strength of Keynes’ economic thought is based on this category and its proper understanding. MEC derives its strength from a relation between productivity of labor and labor costs.

Besides, we would like to propose a hypothesis that the essentially same relationship between marginal productivity of labor and marginal costs of labor constitutes the fundamental basis of a classical and neo-classical economic thought.

Having the ‘wage-unit’ as the basis of the system, Keynes built his ‘castle’, whose main building blocks were: marginal efficiency of capital, interest rate and propensity to consume. These building blocks had to be laid on the foundations called the wage-unit. Therefore, it is clear why Keynes, at the very beginning of his book, sought to define fundamental accounting categories of his system. To this end Keynes suggested the introduction of two accounting units: money value and quantity of employment (Keynes, 1964:245).

Proceeding in the same direction and in order to make the analysis as simple as possible, Keynes converted complex labor into simple labor. Simple labor is a basic accounting unit, whereas complex labor is multiplied simple labor. The unit which measures quantity of employment Keynes entitled ‘labor-unit’. The monetary expression of a labor unit he calls ‘wage-unit’. Therefore, if (E) denotes total amount of money available for wages, and if (W) is wage-unit, bearing in mind that (N) represents quantity of employment we have:

\[ E = NW \]

If we try to interpret Keynes categories differently, we may, possibly, say that a wage-unit could be comparable to the cost of labor employed. Within such a context a wage-unit could and should be related to both productivity of labor and money wage. Every move to increase money wage above productivity of labor, that is, to increase the costs of production, causes inflationary effects and decreases demand for labor at the same time. The relationship between money-value of wages and productivity of labor, keeping in mind the state of unchanged technology, leads the economy towards full employment only insofar as wages lag behind an increase of productivity of labor.

The relationship between wage-unit (real wage), and marginal productivity of labor is one of the most fundamental relationships, as far we are able to understand, of the neo-classical school of economic thought. According to the rules of the game of the neo-classical economy, demand for labor increases as long as marginal revenue
outstrips marginal cost of production, or (which is almost the same) until marginal productivity of labor does not equate with marginal cost of labor, or until marginal productivity of labor becomes equal to real wages. Demand for labor is determined by both factors: marginal productivity of labor and marginal cost of labor.

With respect to the most essential part of neo-classical economics Keynes did not retreat at all!

Therefore, one can say that the Keynesian revolution is much less of a revolution but more of an interventionist anti-deflationary mechanism. With regard to the same essential moment of neo-classical economics, Keynes accepts one of the axioms of Marx economics which is differentia specifica of capitalist production. Labor power is sold today, not with a view of satisfying, by its service or by its product, the personal needs of its buyer. His aim is augmentation of his capital, production of commodities containing more labor than he pays for, containing therefore a portion of value that cost him nothing, and that is nevertheless realized when the commodities are sold.

Production of surplus value is the absolute law of this mode of production. Labor power is only saleable in so far as it preserves the means of production in their capacity of capital, reproduces its own value as capital, and yields in unpaid labor a source of additional capital...

Wages, as we have seen by their very nature, always imply the performance of a certain quantity of unpaid labor on the part of the laborer. Altogether, irrespective of the case of a rise in wages with a falling price of labor, such an increase only means at best a quantitative diminution of the unpaid labor that the worker has to supply. This diminution can never approach the point at which it would threaten the system itself. An increase of price of labor resulting from accumulation of capital implies the following: the price of labor keeps on rising as long as its rise does not interfere with the progress of accumulation.

We consider this remark and causality very essential for all brands of economics thought, whether it is neo-classical economics, Keynesianism, Post-Keynesians, Monetarism, Supply- Side economics, or Rational-expectations school. The remark seems to express the very same relationship from the microeconomic sphere of economic activity emphasized definitely as an axiom by all schools of thought as a relationship between marginal productivity (revenue) of labor and marginal cost (wage) of labor. But, to differentiate himself from classical economists (the same is valid in comparison to the neo-classical economists), Keynes constructed the ‘point’ by applying monetary policy in order to make a difference between ‘money value’ of labor cost and ‘real’ wages.

When real wages (marginal cost of labor) exceed marginal productivity of labor, investment activity decreases, demand for labor declines and supply of labor outstrips demand for labor - unemployment increases. Supply of labor and demand
for labor could be brought into the equilibrium again through the interplay of supply and demand forces which is supposed to produce a decrease of money wages. Keynes’ fear from a worldwide deflation originated just at this point. He was afraid of Gibson’s paradox not in the sense of inflation, but in the sense of deflation and its attendant effects. Deflation caused by decline of wages could provoke deflationary expectations. A deeper deflation could, in turn, lead to further decrease in prices and ever-increasing supply of unemployed labor. A crisis, i.e. e. depression becomes unavoidable. In the book ‘Treatise on Money’ (while Keynes still was a neoclassical economist) he wrote: “the market interest rate declines but not as quickly as is necessary to match with the natural rate of interest, therefore leading to de-stimulation of profit which, per se, leads to further deflation and price decrease. If that happens, our present system of capitalist individualism will be substituted by far-reaching socialism.”(Hadjimichalakis, 1982:346).

In times of crisis, preferences towards liquidity strongly increase. Keynes called such a preference - liquidity trap. The economy is in a state of stalemate. Mass unemployment follows. The so-called ‘Pigou’ effect is insufficient to bring in investment and production again. Similarly, as much as inflationary expectations can stimulate consumption, deflationary expectations can stave off consumption due to the fact that consumers expect lower and lower prices.

Bearing in mind the effects of the liquidity trap and being afraid of socialism, Keynes wanted to prevent wages from further decline. Keynes created the thesis about the real life existence of fixed (inflexible) money-wages and a possibility of flexible real wages. Under the circumstances of inflexible money wages, inflation can cause the same effect as deflation can cause under circumstances of a decline of money wages. We would like to introduce the following thesis as the essence of Keynes’ economic mechanism: real wages should be decreased by increasing inflation in order to propel the economy up from the state of deflation (depression). As stated before, the building blocks of Keynes’ economic mechanism are: consumption, marginal efficiency of capital and interest rate. By increasing money supply, with money demand being constant, or by varying relationship between money supply and monetary demand, Keynes influences: consumption, marginal efficiency of capital (influencing both: revenue and costs) and interest rate. Ever decreasing marginal efficiency of capital requires ever decreasing interest rate in order to keep wealth-owners in the field of investment instead of stimulating them to proceed with the process of portfolio selection and substitute bonds for production.

Stressing the essence of his work, Keynes underlined that ‘the volume of employment in equilibrium depends on (1) the aggregate supply function, (2) the propensity to consume and (3) the volume of investment. This is the essence of the General Theory of Employment. (Keynes, 1964:17)
“For every value of (N) there is a corresponding marginal productivity of labor in the wage-goods industries; and it is this factor which determines the real wages. The volume of employment in equilibrium is, therefore, subject to the condition that (N) cannot exceed the value which reduces the real wage to equality with the marginal distillate of labor. This means that not all changes in (D) are compatible with our temporary assumption that money-wages are constant. Thus it will be essential to a full statement of our theory to dispense with this assumption.”(Keynes, 1964:29)

It means that Keynes had flexible wages, just as neo-classical economists. Money-wages can even increase, but real-wages must lag behind the increase of labor productivity. Keynes substituted the drop of nominal wages and fear of deflation by decreasing real wages and intentionally ‘producing’ inflation.” If the reduction of money-wages is expected to be a reduction relative to money-wages in the future, the change will be favorable to investment, because as we have seen above, it will increase the marginal efficiency of capital, whilst for the same reason it may be favorable to consumption.”(Keynes, 1964:29)

Keynes formulated a thesis which even today has significant relevance, especially for those countries which have to follow the rules inflicted upon them by the IMF. Keynes wrote: “To suppose that a flexible wage policy is a right and proper adjunct of a system which on the whole is one of laissez-faire is the opposite of the truth. It is only in a highly authoritarian society, where sudden, substantial, all-round, changes could be decreed that a flexible wage-policy could function with success. One can imagine it in operation in Italy, Germany or Russia, but not in France, the USA or Great Britain.”(Keynes, 1964:269).

Further, Keynes wrote: “In particular, it is an outstanding characteristic of the economic system in which we live that, whilst it is subject to severe fluctuations in respect of output and employment, it is not violently unstable. Indeed it seems capable of remaining in a chronic condition of sub-normal activity for a considerable period without any marked tendency either towards recovery or towards complete collapse. Moreover, the evidence indicates that full, or even approximately full, employment is of rare and short-lived occurrence.”(Keynes, p.269) Such a state of economic system Keynes has observed in practice. It is not system which cannot be changed.

Full employment in an economy, which neo-classical economists take for granted, is an exception. It is not the rule and hardly can be. Keynes’s task was to figure out such a system’s parameters which can be consciously managed in order to guide the economy successfully towards the level of full employment and far away from economic crises. Therefore, we would like to nominate the Keynesian economics as an anti-deflationary, anti-crisis, demand-managed economic policy. Reminding us often of Marx’s thought, it is not surprising that Keynes spoke about the necessity of substituting the capitalist way of production by the society embracing to a greater
extent elements of social solidarity and ethics. Keynes thought: “Moreover, the richer the community, the wider will the gap between its actual and its potential production tend to be; and therefore the more obvious and outrageous the defect of the economic system… A wealthy community will have to discover much ampler opportunities for investment if the saving propensity of its more wealthy members is to be compatible with the employment of its poorer members… But worse still, not only is marginal propensity to consume weaker in a wealthy community, but, owing to its accumulation of capital being already larger, the opportunities for further investment are less attractive unless the rate of interest falls with sufficient rapidity.”(Keynes, 1964:249)

A major factor that stimulates production is profit. In deciding about production, an entrepreneur wishes to maximize profit. Therefore: “It follows that in given situation of technology, resources and factor cost per unit of employment, the amount of employment, both in each individual firm and industry and in the aggregate, depends on the amount of the proceeds which the entrepreneurs expects to receive from the corresponding output. Entrepreneurs will endeavor to fix the amount of employment at the level which they expect to maximize the excess of the proceeds over the factor cost… Now if for a given value of (N) employment the expected proceeds are greater that the aggregate supply price there will be an incentive to entrepreneurs to increase employment beyond (N) and, if necessary, to increase costs by competing with one another for the factors of production, up to the value of (N) for which (Z) has become equal to (D). Thus the volume of employment is given by the point of intersection between the aggregate demand function and the aggregate supply function; for it is at this point that an entrepreneur’s expectation of profit will be maximized“(Keynes, p. 31)

When an economy reaches the level of full employment investments are equal to saving; money supply equals money demand, whereas marginal revenue equals marginal cost. Goods’ markets and capital markets are in equilibrium. The economy is in a stand-still condition. Marginal profit equals zero. Any resumption of the production above that point ‘produces’ loss for an entrepreneur. Eventual financial injection by a state in order to create necessary demand becomes contra productive. Stagflation comes on horizon. Thus, the stock of capital and the level of employment must decrease to such an amount which is necessary for a community as a whole, to be impoverished enough in order to get aggregate saving to zero point and society to face lack of capital again. “Thus, for a society such as we have supposed, the position of equilibrium, under conditions of laissez-faire, will be one in which employment is low enough and the standard of life is sufficiently miserable to bring saving to zero.”(Keynes, 1964:25)

Simply speaking, both the abundance of goods supply as well as abundance of capital supply makes additional production unprofitable. Overproduction of goods and attractive profit do not go hand in hand. In the long run, capital must not be abundant factor of production if an economy wants to keep marginal efficiency of capital at the
level which is at least as high as interest rate (Keynes, 1964:218). “At the outset of the slump there is probably much capital of which the marginal efficiency has become negligible or even negative. But the interval of time, which will have to elapse before the shortage of capital through use, decay and obsolescence causes a sufficiently obvious scarcity to increase the marginal efficiency, may be a somewhat stable function of the average durability of capital in a given epoch. If the characteristics of the epoch shift, the standard time-interval will change.”(Keynes, 1964:316).

Finally, one important remark concerning Keynes’ economics needs to be recalled and remembered. Namely, in the article “The Balance of Payments of the USA 1946”, Keynes admitted that the classical knowledge in economics has certain permanent truths with high role in economics. “In those things there are invisible strengths that can be called the invisible hand driving an economy into equilibrium.” (Hutchison, 1981:122-123) Keynes was a brilliant economist who did want to preserve his own economic system-capitalism. Therefore, he invented state intervention as a remedy against depression in his General Theory of Employment, Interest and Money. However, once he discovered that stagflation threatens as soon as the country reaches full employment, he retreated back into invisible hands.

5. Closing observations

Keynes’ economy attempts to cure depression, caused by a drop of MEC. In an overheated economy, capital becomes a superabundant factor of production confronted with a lack of profitable investment.

A drop of MEC leads to factory closure, causing rising unemployment and a consequent drop of personal consumption. New relations between capital and labor must be established. Labor must become cheaper factor of production. Consequently, insufficient demand results out of structural transformation of an economy. However, insufficient demand is not a cause of economic crisis. Insufficient demand is a consequence of economic crisis. The main cause of an economic crisis is a drop of MEC.

Depression requires a pro inflationary economic policy. The role of the state becomes highly important in keeping demand increasing. However, demand managed economic policy sooner or later brings about full employment and inflation including stagflation. An obvious case in point is economic development since the Second World War until the end of the 1960s. At the level of full employment of an economy, expansive financial policy contributes to stagflation. Stagflation cannot be considered as a lasting solution of crisis. It may only buy time in search for proper economic and political solution for a society.

At present the globalised world economy and economies of the most developed countries are faced with both financial and structural crisis. The Keynesian economics
is static as long as the state of technology and structure of economy is concerned. Therefore, we can conclude that in the long run and for a successful solution of world economic crisis, the world needs a new social fabric to be developed and followed by a suitable economic paradigm particularly in the process of globalization of the world economy...

New times ask for a new economic and social solution. Are the Commons an alternative solution?

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Sažetak


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