

THE EMPLOYMENT ISSUE: POST KEYNESIAN ECONOMICS CHALLENGING NEW KEYNESIAN ECONOMICS

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Abstract: This chapter focuses on the reappraisal of the principle of effective demand that is emerging from the Post Keynesian approach, and on what is to be learned from this reappraisal about employment and its cure. What is at stake is the reference that New Keynesians (together with Old Keynesians) make to the process of adjusting aggregate supply and demand on markets. The principle of effective demand actually represents a macroeconomic constraint based on the circular flow of wages (profits are transferred from them) formed in the payment of factor costs by firms and spent on the goods produced. On this view, government action in favor of demand management is in no way intended to compensate for market imperfections, which are what New Keynesians currently blame for causing unemployment in response to shocks in demand. Government action is intended, rather, to compensate for demand deficiency, the origin of which has to be considered on its own and which also paves the way for institutional reforms.

Introduction

New Keynesians are moving Keynes's theory more than ever into mainstream economics. However, this may not be the end of the story. My opinion is based on a wide range of contributions to economic theory labeled 'Post Keynesian economics' that set out an alternative to mainstream economics. These contributions are rooted in the heterodoxy of Keynes, who once called himself a 'heretic' (Keynes, 1934). According to Post Keynesian writers, Keynes's revolutionary message has been neglected and stifled

¹ I thank the participants in the Workshop 'Neukeynesianismus, der neue Wirtschaftspolitische Mainstream?', held in Berlin on October, 25-26, 2002, especially Philip Arestis and Eckhard Hein for helpful comments on a previous version of this paper. The usual disclaimer applies. A revised version of this paper is going to be published in : Eckhard Hein, Arne Heise, Achim Truger (eds): Neu-Keynesianismus - der neue wirtschaftspolitische Mainstream?, Marburg: Metropolis.

by the Neoclassical Synthesis and its extensions, and so it deserves a detailed reappraisal.

‘Post Keynesian economics’ is a label that emerged in the early 1970s, but the Post Keynesian perspective may be traced back to the 1950s when Cambridge economists like Joan Robinson and Nicholas Kaldor developed an incisive critique of Neoclassical economics. This legacy has to be stressed because it explains why Post Keynesians have frequently been described as a rather ‘heterogeneous lot’ (Harcourt, 1982) united around the maxim ‘the enemy of my enemy is my friend’ rather than constructing a positive approach to economics. Post Keynesian economics encompasses distinct groups professing allegiance to Kalecki or Sraffa as well as to Keynes (for a more detailed presentation of these groups see Hamouda and Harcourt [1988] and Arestis [1996]). Thanks to key figures like Eichner, Kregel, Weintraub and Davidson or Victoria Chick, the Keynesian strand has been able, however, to assert itself as the main group of writers in Post Keynesian economics and to move beyond mere criticism of mainstream economics and to start providing a positive alternative to it.

This chapter is aimed at contrasting this Keynesian strand with New Keynesian economics, at least on an issue which is central to both approaches, that is the analysis of the causes of unemployment and the way to combat it. In the next section, I focus on Keynes’s theory of employment as characterized by the principle of effective demand and the reappraisal of it that is emerging from Post Keynesian studies. Then, in the third section, I shall consider what can be learned from this reappraisal with regard to employment policies. The last section will conclude.

Reappraising Keynes’s theory of employment: the principle of effective demand grounded on the circular flow of money wages

It is common knowledge that NKE holds that price and wage stickiness (or fixity) prevents markets from clearing when a shock in demand occurs,² and so allows such shocks to divert output and employment from their equilibrium values. In this, New

² Or even a shock in supply, since demand and supply are, in Marshall’s famous words, like the blades of a pair of scissors.

Keynesians concur with the Neoclassical synthesis. They only diverge from Old Keynesians insofar as they criticize them for merely assuming fixed or sticky prices and wages instead of explaining these features with reference to microeconomic behavior:

According to Keynesian economics, fluctuations in employment and output arise largely from fluctuations in nominal aggregate demand. The reason that nominal shocks matter is that nominal wages and prices are not fully flexible. [...] The research program described here is modest in the sense that it seeks to strengthen the foundations of this conventional thinking, not to provide a new theory of fluctuations. In particular, its goal is to answer the theoretical question of how nominal rigidities arise from optimizing behavior, since the absence of an answer in the 1970s was largely responsible for the decline of Keynesian economics. (Ball, Mankiw and Romer, 1991, p. 149)

Post Keynesians challenge this account. They typically highlight the divergence between Keynes's original theory and its conventional interpretation. Rotheim (1998) provides a very well-documented account of this divergence. His main argument is that price rigidity

is of no help in understanding a *Keynesian* view on fluctuations in macroeconomic employment and output. Keynes rejected approaches which relied on methodological individualist perspectives focusing on output, labour and capital markets, because he believed they were inapplicable to analyses which attempt to understand movements in employment and output *as a whole*. Such heuristical devices would only have theoretical significance if it were assumed that output and employment in the aggregate did not change (see Keynes, 1936, ch. 19; Rotheim, 1988, 1994). (Rotheim, 1998, p. 52)

In support of his claim, Rotheim firstly points to the way in which, at the microeconomic level, NKE examines the causes and the effects of imperfections in goods, labor and capital markets and then generalize their conclusions to the macroeconomic level. From there, he refers to Keynes who rejected precisely this method of analysis and proposed instead to consider the macroeconomic level *per se*, independently of market settings. In chapter 19 of the *General Theory*, Keynes claimed that the classical argument by which 'a reduction in money-wages would stimulate demand by diminishing the price of the finished product, and will therefore increase output and employment' is grounded on the questionable assumption 'that the reduction in money-wages will leave demand unaffected', and so amounts to illegitimately transferring an argument that is valid for any given industry to industry as a whole

(Keynes, 1936, pp. 257-259). I shall not, here, consider anew this criticism that Rotheim goes into in detail. Instead, I propose to inquire further into what it is that makes the macroeconomic level special.

Accordingly, let us consider the principle of effective demand. As we know, Keynes casts entrepreneurs in a crucial role when it comes to determining employment: they offer the volume of employment for which the proceeds they ‘expect to receive from the employment of N men’ (Keynes, 1936, p. 25) meet ‘the expectations of proceeds which will just make it worth [their] while [...] to give that employment’. He calls this particular value of the expected proceeds ‘the effective demand’ (pp. 24-25). As he explains right at the beginning of chapter 3 of the *General Theory*, on the one hand, entrepreneurs incur expenses when they employ a given volume of labor and, on the other hand, they plan to sell the goods produced at a price which will recoup the expenses incurred and also yield a profit. Keynes also makes it clear that this portion of the expenses incurred by entrepreneurs for the payment of the factors of production³ constitutes the factors’ income which, together with profits (i.e. entrepreneurs’ income), is going to be spent on the purchases of the goods produced. In other words, the principle of effective demand is tied in with what French and Italian writers of the Circuit School (Schmitt, Parguez and Graziani), which is part of the Post Keynesian approach,⁴ term the ‘circuit’ or the ‘circular flow’ of wages (profits being derived from wages). This, it may be suggested, is the macroeconomic feature that characterizes Keynes’ theory of employment. There is convincing evidence for this interpretation.

According to standard Keynesian economics, especially NKE, the principle of effective demand consists in a process of adjusting aggregate supply and demand

³ As suggested by Keynes, we will disregard here the other part of expenses, the ‘user cost’, met by entrepreneurs, which relates to the cost of raw material and equipment: ‘The reader will observe that I am deducting the user cost both from the *proceeds* and from the *aggregate supply price* of a given volume of output, so that both these terms are to be interpreted *net* of user cost; whereas the aggregate sums paid by the purchasers are, of course, *gross* of user cost’ (Keynes, 1936, footnote 2, p. 24).

⁴ In the words of Arestis (1996, p. 113), the Circuit school is ‘a strong component of the endogenous money thesis’. Its connection with the Post Keynesian approach is confirmed also by the emphasis it puts on the reference to the concept of the ‘monetary economy of production’ advocated by Keynes.

through variations of quantities instead of prices and wages. Hence the role assigned in the corresponding models to price and wage fixity. But this is a flawed interpretation of Keynes's theory. The principle of effective demand in no way confines itself to the standard theory of supply and demand. Demand schedules, as defined in the latter theory, represent decisions that buyers, individually or as a whole, are prepared to make depending on prices when they enter markets. Not so in Keynes's theory. There, the aggregate demand function, as quoted earlier, represents 'the proceeds which entrepreneurs expect to receive from the employment of N men'. Employment, and so output, is not determined on markets, the scene of some supposed confrontation between sellers and buyers' decisions as to the amount of goods they plan to supply and demand according to prices. Entrepreneurs are the only economic agents who are in a position to make any decisions. In his paper on 'The "ex ante" theory of the rate of interest' published in the *Economic Journal* in 1937, Keynes quite explicitly confirmed his point of view:

There is, however, no such necessity for individuals to decide, contemporaneously with the investment decisions of the entrepreneurs, how much of their future income they are going to save. To begin with, they do not know what their incomes are going to be, especially if they arise out of profit. But even if they form some preliminary opinion on the matter, in the first place they are under no necessity to make a definite decision (as the investors have to do), in the second place they do not make it at the same time, and in the third place they most undoubtedly do not, as a rule, deplete their existing cash well ahead of their receiving the incomes out of which they propose to save [...]. (Keynes 1937b, pp. 216-217)

Thus, according to Keynes and contrary to what standard Keynesian economics argues, there are no separate *ex ante* (aggregate) supply and demand adjusting to each other and so determining the level of employment (and hence of income and output). In Keynes's words, "*Ex ante* decisions in their influence on effective demand relate solely to *entrepreneurs'* decisions" (1937a, pp. 182-83).

The actual sequence starts with unilateral decisions made by entrepreneurs as to the amount of employment they provide. On what ground do they make their decisions? On the one hand, they require that the proceeds of the sales of the goods produced

reimburse the factor cost they paid for and, in addition, earn them a (maximum) profit: ‘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’ (Keynes, 1936, pp. 24-25). Keynes calls these proceeds that entrepreneurs expect, and that are dependent on the volume of employment they provide, ‘the aggregate supply price of the output from employing N men’. It is ‘the expectation of proceeds which will just make it worth the while of entrepreneurs to give that employment’ (p. 24). He writes the relationship between the aggregate supply price (Z) and employment (N) as: $Z = \Phi(N)$. On the other hand, entrepreneurs have to forecast what the actual proceeds of sales are going to be. What then is the basis for their forecasts? Keynes calls the proceeds entrepreneurs expect to receive the ‘aggregate demand function’ and links this amount to N: $D = f(N)$. But, as such, N cannot be the determining factor of the proceeds of sales. What is the connection between N and the proceeds? As mentioned earlier, the wages paid for labor (labor being in fact the sole factor of production in Keynes’s view) form the income that will be spent on purchases. In order to decide on the level of employment they will provide, entrepreneurs compare their expected costs, which, given the level of wages, are dependent on N and the resulting expected demand, which is dependent on the wage bill paid (and thus on N) with the proviso, however, that wage-earners may not spend all their income, given what Keynes calls their ‘propensity to consume’ (p. 28).

The reader may object, however, that we are reformulating Say’s Law which Keynes dismissed: we argue that the payment of factor costs that takes place in the production of goods and so conditions their supply, creates the money income which is going to be spent on purchases.

In order to avoid ambiguity, we may notice that when Keynes dismisses Say’s Law, he refers to aggregate supply and demand *prices*:

The Classical theory assumes (...) that the aggregate demand price (or proceeds) always accommodates itself to the aggregate supply price; so that, whatever the value of N may be, the proceeds D assume a value equal to the aggregate supply price Z which corresponds to N. (Keynes, 1936, p. 26)

Arguing that the payment of factor cost (amounting to wages) forms the income which is going to be spent on goods does not mean that the aggregate demand price necessarily equals the supply price. As we observed earlier, Keynes emphasizes that the incomes (wages) formed in the payment of factor cost and profit are created in different ways. Profit is the excess of the proceeds of sales over factor costs. Although Keynes does not explicitly set out a theory of profit in the *General Theory*, we may infer that in his view profits stem from sales: they are incomes transferred from buyers to sellers, that is from wages. We may argue that the principle of effective demand is tied in with a theory of income distribution whereby profits are a redistributed share of wages, which is transferred from purchasers to firms when prices exceed factor costs (see Gnos, 1998). This means that the wages paid to labour form the money income that is necessary and sufficient to pay for output as a whole. Profits represent an excess of prices over factor costs but not a supplementary income for the economy as a whole. So, fundamentally, the formation and the spending of profits is included in the circular flow of wages paid by firms and spent by workers and profit-earners (who literally take the place of the former insofar as wages are transferred to them) on goods markets. Although employment generates the income (wages) that is necessary and sufficient to pay for output, the profitability of production is then subordinated to the sanction of markets, that is to the actual proceeds from sales. Notably, for a given level of production and thus of employment, and given their propensity to consume, wage-earners are not necessarily prepared to pay a price for the goods produced that will bring in the profits that firms require. In this event, firms will restrict their production in order to secure a more favourable ratio of supply to demand. In referring to the circular flow of wages, we are thus in a position to account for Keynes's principle of effective demand and to confirm his dismissal of Say's law.

It should be noticed that in Post Keynesian and Circuitist literature a number of writers have wondered how wages amounting to, say, $\$W$ in the current period could pay for $\$W+P$, where P stands for profits. But this is a non-issue: the aggregate supply price of the current output, that is $\$W+P$, never has to be paid in one go. Whatever the period of time we consider, entrepreneurs pay wages and sell goods time and again, with

production processes overlapping one another. They earn profits but also spend them on goods. The sum of $W+P$ is, strictly speaking, an ‘aggregate’: it records a series of proceeds that can quite clearly be a multiple of the wages that fuel them.⁵

All in all, we have a confirmation that there is a macroeconomic level, with its own features, which is separate from market workings. To be fair, we should acknowledge that this macroeconomic level is not missing in the Classical theory but, there, it consists in Say’s Law by which, in the aggregate, supply and demand prices are necessarily equal. Then, as argued by Keynes, „effective demand, instead of having a unique equilibrium value, is an infinite range of values all equally admissible; and the amount of employment is indeterminate except in so far as the marginal disutility of labour sets an upper limit“ (Keynes, 1936, p. 26). In other words, positing Say’s Law, the Classical theory has no alternative to seeking for employment to be determined on markets. Keynes’s principle of effective demand, insofar as it is linked to a distribution theory whereby profits are derived from sales and so allows aggregate supply and demand prices to diverge, invalidates Say’s Law and determines the amount of employment in its own way.

Combating unemployment with reference to Keynes

We now understand more clearly why, contrary to its mainstream interpreters, Keynes ignored market imperfections when he stated his theory of employment. As he puts it, ‘The essential character of the argument is precisely the same whether or not money-wages, etc., are liable to change’ (Keynes, 1936, p. 27). However, in chapter 19 of the *General Theory*, he admits that ‘A reduction in money-wages is quite capable in certain circumstances of affording a stimulus to output, as the classical theory supposes’. Of course, there is no contradiction in Keynes’s discourse. He immediately adds: ‘My difference from this theory is primarily a difference of analysis’ (p. 257). The classical argument, he explains, ‘simply is that a reduction in money-wages will *cet. par.* stimulate demand by diminishing the price of the finished output’ (p. 257). As before, here we will not consider the way Keynes criticizes the classical argument. Instead, let

⁵ For a more detailed account of this issue, see Gnos (2003).

us briefly examine his own positive analysis that Post Keynesians currently aim at reappraising.

As might be expected, Keynes invokes the principle of effective demand and its determining factors to examine the possible effect of wage flexibility on employment. Expected demand ‘being the sum of the expected consumption and the expected investment’, those factors are the propensity to consume, the schedule of marginal efficiency of capital and the rate of interest (p. 260). In so far as these factors remain unchanged when money wages are reduced, Keynes is categorical: a reduction in money wages does not increase employment. Let us assume, he argues, that an individual entrepreneur seeing his factor costs reduced will increase his production ‘on the assumption that he will be able to sell at a profit a larger output than before’ (p. 261). What will happen next? This entrepreneur and, more generally, all the entrepreneurs who would expect the reduction in money wages to have this effect, would actually be disappointed:

the proceeds realised from the increased output will disappoint the entrepreneurs and employment will fall back again to its previous figure, unless the marginal propensity to consume is equal to unity or the reduction in money-wages has had the effect of increasing the schedule of marginal efficiencies of capital relatively to the rate of interest and hence the amount of investment. For if entrepreneurs offer employment on a scale which, if they could sell their output at the expected price, would provide the public with incomes out of which they would save more than the amount of current investment, entrepreneurs are bound to make a loss equal to the difference; and this will be the case absolutely irrespective of the level of money wages. (Keynes, 1936, pp. 261-262)

This case study is instructive. First, it highlights the reference to the circular flow of wages we pointed out in the preceding section. We notice that Keynes does not focus on the level of money wages but on the marginal propensity to consume. According to him, entrepreneurs would not be disappointed if the latter variable was equal to unity, that is if all wages paid were to be spent on goods. What matters, thus, is primarily the successive formation and spending of wages, not their level. The comparative figures of marginal efficiencies of capital and of the rate of interest that entrepreneurs typically consider before investing in new equipment are relevant too, but in a second stage: they

determine investment which can absorb the income which has not been spent on consumption goods. It is true, however, that the community's income is composed of wages and profits. Then, the question is whether Keynes considers profits as being additional to wages or, in compliance with Circuit theory, as a part of them transferred from wage-earners to firms in sales. There is, here, further evidence for the second alternative that we have already supported. Since Keynes's analysis is based on the successive formation and spending of incomes, profits, if they were additive to wages, would be part of the factor cost paid by entrepreneurs: how could they be spent on goods if they were not formed previously, i.e. in the payment of factor cost? But this is not Keynes's view (as seen earlier, profits are in excess of factor cost and so are formed in sales). In fact, viewing profits as incomes transferred from wage-earners to firms is the only way to conceive of them as being both formed and spent in sales. It has been suggested also, in the literature (for a detailed account of this approach, see Renaud 2000), that firms earn profits they spend in advance on capital goods. But that is neither a necessary nor a sufficient condition for explaining the formation of profits: being anticipated, the formation of profits is not explained but presupposed.

Second, this case study confirms the divergence between Keynes's method of analysis and the Classical one. Of course Keynes, who had been Marshall's student, was well aware of the role of markets and of the bearing of the law of supply and demand, but he constantly argued for the specificity of macroeconomic phenomena.⁶ Here, all reference to the interplay of supply and demand on markets, and so to wage stickiness, is clearly dismissed as irrelevant.

In the rest of the chapter, Keynes examines the 'certain circumstances' in which a reduction in money wages is able to stimulate production. Naturally, the method of analysis is kept unchanged:

the reduction in money-wages will have no lasting tendency to increase employment except by virtue of its repercussions either on the propensity to

⁶ „The right dichotomy is, I suggest, between the Theory of the Individual Industry or Firm and of the rewards and the distribution between different uses of a given quantity of resources on the one hand, and the Theory of Output and Employment as a whole on the other hand.“ (Keynes, 1936, p. 293)

consume for the community as a whole, or on the schedule of marginal efficiencies of capital, or on the rate of interest. There is no method of analysing the effect of a reduction in money-wages, except by following up its possible effects on these three factors. (Keynes, 1936, p. 262).

However, despite his conclusion as to the possible positive effect of a reduction in money wages on employment, Keynes does not declare himself in favor of a flexible wage policy: ‘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’ (p. 269). He explains that cutting wages has many disruptive effects on the economy. In particular, a policy of wage flexibility would cause price instability: ‘The chief result of this policy would be to cause a great instability of prices, so violent perhaps as to make business calculations futile in an economic society functioning after the manner of that in which we live’ (p. 269). These considerations on the disruptive effect of wage flexibility on prices and so on business calculations is consistent with the role that Keynes attributes to entrepreneurs’ expectations. In chapter 12 of the *General Theory*, he emphasizes that entrepreneurs are faced with uncertainty with regard to the future yields of their investments, and so can do nothing but attach a certain degree of confidence to their expectations. Their confidence is that much weaker when the economy experiences repeated changes. This is an insight that Post Keynesians have developed and elaborated upon. Uncertainty, they say, is radical. To cope with uncertainty and the depressing effect it may have on entrepreneurs’ expectations and therefore on employment, they emphasize the role of conventions that an investor needs in order ‘not to lose his sleep’ (Keynes, p. 153). Consequently, they argue that unemployment can be reduced not by wage and price flexibility but by their stability and also through the creation of institutions to control the environment of economic activity and so reduce uncertainty⁷.

It may be suggested, however, that advocating wage and price flexibility is not a matter of sharing New Keynesian theory but simply a matter of pragmatism. How can entrepreneurs sustain competition in today’s globalized economy if domestic wages are kept higher than wages paid in the rest of the world? Is this not something that Post Keynesians should take into account? Actually, Keynes did not leave us at a loss for an answer. He makes it clear that his conclusion in favor of wage stability applies equally to a closed or an open system, ‘provided that equilibrium with the rest of the world can be secured by means of fluctuating exchanges’ (Keynes, 1936, p. 271). This is actually

⁷ See notably David Dequech (1999).

another piece in Keynes' theoretical jigsaw that we must not overlook, and that some Post Keynesians rightly emphasize. This is notably the case of Davidson (2002) who proposes to 'reform the world's money' with reference to Keynes's 1940s proposal for a Clearing Union, and advocates 'a system designed to, at least, maintain the relative efficiency wage parities among nations' (Davidson, 2002, p. 235). This is also the case of Schmitt (1973), for the Circuit School. All in all, Keynes's and his Post Keynesian interpreters' view of unemployment and its cure is part of a global view of the way the world in which we live works and should be organized.

The case study examined by Keynes and to which we have just referred is typical also of the way he analyses the origin of unemployment. As Stiglitz (1993) points out, New Keynesians are not much interested in examining why demand may be deficient. They simply assume that some 'shock' in demand occurs that will affect employment because wages and prices are sticky. For Keynes, on the contrary, the focus has to be put on the origin of demand deficiency. As mentioned earlier, the proportion in which the income generated by production is spent on consumption and investment goods is crucial, and so the level of aggregate demand may be (and usually is) in itself an obstacle to full employment. Thence the need for State intervention to sustain effective demand while the free interplay of supply and demand should be left to determine the other economic variables (Keynes, 1936, pp. 372-384). The contrast with the New Keynesian approach is clear-cut once more: according to the latter, government demand management policies are needed because of market failings. Post Keynesians naturally endorse Keynes's original argument, which they usually link to uncertainty and the existence of money, holding money (*i.e.* liquidity) instead of spending it on goods being one way of coping with uncertainty. As Davidson (2002) puts it: 'The unemployment problem is basically always a liquidity problem'.

It is worth noticing here that the reference to the circular flow of wages underpinning the principle of effective demand reveals an additional source of demand deficiency. Schmitt (1984, 1996) raises this point (see also Cencini, 1996). As mentioned earlier, entrepreneurs earn profits at the expense of wage-earners. When spending profits in the purchase of goods produced, whether consumer goods or capital goods, the entrepreneurs and the economic agents who benefit from a redistribution of

profits (in the form of interest and dividends) simply obtain goods in the place of wage-earners. That means that wages worth $\$W$ are spent, either directly or indirectly (i.e. in the form of profits), in the purchase of the goods produced. But, instead of spending them on goods entrepreneurs may also keep their profits in the form of cash that they use to pay the wage bill of their employees. Then, profits (P) are prevented from being spent on goods supplied on the market: they form new wages (W') corresponding to the additional goods newly produced. Therefore, profits (P) and wages (W') paid out of profits define a demand equal to W' only, instead of $P+W'$ which is the income that has actually been formed in the economy (P being transferred from wages previously paid to workers). The demand deficiency created in this way is not, as such, irreversible because as soon as wage-earners spend their new wages, entrepreneurs recoup their profits and can spend them on goods. But if profits are given over repeatedly and in increasing proportions to the payment of wages, the demand deficiency becomes more serious and so harmful to employment. Since this dysfunction is basically due to the payment of wages out of profits, Schmitt argues for a reform of the way the banking system manages monetary and financial flows, so as to avoid any confusion between the spending of incomes (profits) and the formation of incomes (the payment of wages). I cannot expand here on this issue. Let me, however, briefly point out that Schmitt's proposal consists in avoiding, in banks' accounts, any direct compensation between the payment of wages and profit deposits. Although, in practice, the payment of wages by banks on behalf of firms could still be secured with profit deposits, the former would be no longer charged to the latter in the books of the banks. To set out his point of view, Schmitt refers to Ricardo:

In his theory, David Ricardo divided the banks into two departments, monetary and financial (a reform which was adopted some twenty years after his death by the Bank of England). The required reform is the institution of a third department in all deposit banks, which will manage all income-expenditure flows relating to profits (...). (Schmitt, 1996, p. 105)

Conclusion

New Keynesian economists put themselves across as the present-day followers of those economists who after the Second World War, especially at prestigious universities in the United States, initiated the 'Neoclassical Synthesis Keynesianism'. Thus, a criticism applies to them that has been addressed to their predecessors and that Davidson puts in a nutshell: 'Prominent academic economists at the Massachusetts Institute of Technology (MIT), Harvard and Yale universities attempted to graft Keynes's macro-policy suggestions for solving the unemployment problem onto the axiomatic foundations of classical microeconomic theory' (Davidson, 2002, p. 5).

While focusing on the reappraisal of the principle of effective demand that is emerging from the Post Keynesian approach, this chapter confirms this criticism with regard to New Keynesians. When advocating government action in favor of demand management, Keynes in no way intended to propose a means to compensate for market imperfections (wage and price stickiness) that New Keynesians currently blame for causing unemployment in response to shocks in demand. Contrary to the accepted view, the principle of effective demand does not consist in a process of adjusting aggregate supply and demand through variations in quantities instead of prices and wages. Instead, as shown here, it stands for a macroeconomic constraint grounded on the circular flow of wages. The Classical theory had denied this constraint when positing Say's Law, and so had had no other alternative but to subordinate the determination of employment to the interplay of supply and demand on markets.

What is to be learned about unemployment and its cure from this reappraisal of the principle of effective demand? The ineffectiveness of wage and price flexibility, that could be expected in view of Keynes's dismissal of the Classical approach, has been confirmed. Keynes acknowledges, however, that in certain circumstances the latter device may not be entirely ineffective. But, this conclusion does not decide him to argue for a flexible wage policy, because the resulting price variations would increase uncertainty, which generally has a negative impact on the level of employment entrepreneurs decide to provide. Post Keynesians have since elaborated upon the role of

uncertainty and so have been able to recommend policies, notably at the institutional level, designed to reduce uncertainty. A further important point concerns the essential cause of unemployment that Keynes attributes to demand deficiency relative to supply, and the correlated intervention by the State, which is supposed to sustain demand. Post Keynesians, especially Davidson, endorse Keynes's arguments, and relate demand deficiency to the liquidity, the form in which people facing 'radical' uncertainty choose to hold their assets. Moreover, with reference to Schmitt, we have noticed that the Circuit approach reveals an additional source of demand deficiency that calls for a reform of the way the banking system manages monetary and financial flows. Such reform would complement, at the national level, the reform of the international system of payments advocated by Keynes in his time and by Post Keynesian writers today.

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