Claude Diebolt

Business Cycle Theory before Keynes

www.aracneeditrice.it
info@aracneeditrice.it

via Raffaele Garofalo, 133 A/B
00173 Roma
(06) 93781065

ISBN 978–88–548–2780–6

1st edition: October 2009

Content

Chapter I

The Classical Pattern

Classical economics paid little attention to business fluctuations. Some of the distinguished early classical economists recognized the possibility of overproduction and economic crisis but, in general, the causes of such fluctuations were placed outside the economic system.

1.1. Say's law

The theorem that a natural harmony characterized the functioning of the new liberal economic system dominated the thinking of the classical economists. Where natural harmony is assumed, there is little concern with developing explanation of gluts and economic crises. The existence of a natural harmony in the new liberal economic order found concrete expression in Say's law of markets. This held general overproduction to be impossible.

In his *Treatise on Political Economy* Jean Baptiste Say asserted the following: every supply involves a demand; product exchanges for product; every product put on the market creates its own demand; every demand exerted in the market creates its own supply. These statements simply enunciate the interdependence of an economy where exchange is logically associated with specialization and the division of labor.

If in such an economy aggregate supply and demand are entirely dependent one upon the other, then one may deny the possibility of a general commodity glut. Say was quite willing to recognize that gluts could occur in the market for particular commodities. In other words, partial overproduction was possible, with one product being produced in excess of demand. Costs may be incurred in the production of this product that cannot be covered by market price, owing to the transfer of demand to other commodities. Say suggested that a circumstance of overproduction of one commodity meant simply that other product have not been produced in a sufficient quantity to meet the new higher level of demand for them.

The price mechanism is the means by which resources are transferred from production of the commodity in excess supply to the output of that which is deficient relative to demand. The lower market price resulting from reduction in demand makes these goods less profitable than usual to produce, while the higher market price reflecting expanded demand makes the newly favored goods more profitable than before. Entrepreneurs are quick to recognize these changing opportunities, transfer resources into more profitable channels, and so correct the inequalities in profit rates that had arisen. It goes without saying that a very high degree of resource mobility is implicit in these formulations.

1.2. Ricardo

David Ricardo, who employed a vigorous deductive approach to economic theory, accepted Say's law of markets. His position was that no one produced except for the purpose of consuming either currently or out of future production. That is, humans sell with the intention of purchasing some other commodity to be currently consumed, or with the purpose of facilitating future production through capital formation. If individual supplies and demands are in balance, there can be no imbalance in aggregate demand and supply. Like Say, he pointed out that a surplus of one commodity resulted in withdrawal of capital, labor, and materials from it into the production of goods whose demand had increased. Negotiating the transfer of these resources to supply the new product adjusted temporary dislocation.

In his *Principles* Ricardo did have one chapter entitled “On Sudden Changes in the Channels of Trade”. In this the possibility of overproduction and crisis was recognized. How can this be squared with acceptance of a natural harmony within the economic system, implicit in the law of markets? The answer is found in Ricardo’s belief, that general overproduction reflected the impact of powerful exogenous forces upon the economic system. Living during the Napoleonic Wars, he saw their impact upon economic and financial conditions in England. Wars, taxes, and changes in fashion could drastically and quite suddenly alter the profitability of different branches of industry, forcing a period of adaptation in the economic system. If the country concerned is relatively wealthy, with reasonably abundant supplies of capital and some specialization in the labor force, the adjustment to the new circumstances may be difficult.

The significant fact is, however, that Ricardo placed the causes of economic crisis completely outside the functioning of the economic system. This makes the existence of general overproduction consistent with an inherent harmony.

1.3. Malthus

Thomas Robert Malthus, Ricardo’s contemporary, advanced the concept of effective demand and questioned the law of markets as enunciated by Say and accepted by Ricardo. Mathus defined effective demand as that which enables the producer to recover his costs. Costs included payments to the factors of production, plus the prevailing rate of profit. His position was that the basic condition for stabilizing output is the producers be able to sell their output at a price that covers factor costs, plus a profit. Mathus questioned how this could be done. He argued that the capitalist will pay less to productive labor than he expects to obtain when he sells the product of this labor. This means that the sum of wages paid to productive labor is less than the value of the products placed upon the market, and it follows that the effective demand from productive labor can never be great enough to clear the market of goods at a price to permit the capitalist an acceptable rate of return. The excess of product might conceivably be consumed by the capitalists themselves, but such conspicuous consumption by this class Malthus held to be unlikely.

This potential source of conflict in the economic system is overcome by the contribution to effective demand made by the unproductive classes (landed gentry, domestic servants, and the like). The unproductive consumers enable the capitalist to obtain the profit without which a cessation of production would be necessary.

Another source of effective demand outside the market place was also stressed by Malthus. That was public works, which can strengthen the demand for goods should the private components of effective demand slacken in intensity. Public works add to the demand for goods without increasing the available supply within the nexus of the market economy. For example, when public road construction is undertaken, Malthus pointed out the producers receive income without placing the products for sale through the market place.

One other aspect of the economic writings of Malthus is significant for the study of business cycles. This concerns the question of capital formation. Ricardo took the position that, if general overproduction was impossible, it followed that excessive accumulation of capital was also out of the question. In other words, capital, no matter how rapidly it accumulated, could always be employed productively.

On this matter Malthus raised serious doubts and suggested the possibility of an imbalance between savings or capital formation on the one side and current consumption on the other. He argued that attempts at rapid capital accumulation must imply a diminution in unproductive consumption. Obviously, the consumption of productive labor cannot be reduced in these circumstances. But if unproductive consumption is checked, one of the sources of effective demand is weakened and with it one of the incentives to production.

Inherent in this formulation are the possibility of an imbalance between savings and consumption and the beginnings of the simple underconsumptionist explanation of economic crisis. Thus, effective demand may be insufficient to absorb the larger volume of goods flowing from an enhanced productive capacity.

Malthus had doubts concerning the inherent harmony of the economic system and hence raided the possibility of instability by pointing up possible areas of conflict. These included the relation between the capitalist and productive labor regarding product shares, the role of unproductive consumers and of public works in maintaining effective demand; and the possibility of the development of an unsustainable relation between the rate of saving and the rate of consumption.

1.4. Marx

In contrast to his elaborate theoretical structure that predicted the eventual disintegration of the capitalist economic system, Marx had no well–defined and clearly enunciated explanation of business cycles. Yet, together with Clément Juglar he was one of the earliest to discern the existence of a rhythmic pattern to business activity.

His work *Das Kapital* is interlaced with numerous observations concerning the recurring pattern of business change. Joseph Schumpeter has indicated some of the comments made by Marx that were taken up and amplified by later students of the business cycles. These include the manner in which the use of money may impede the working of Say's law of market; the manner in which the availability of loanable funds at low interest rates may explain disproportionately heavy investment outlays in the durable goods industries; the effects of special stimuli, such as the opening of new markets or the emergence of new social wants, in motivating sudden spurts in capital formation, and the nature of expansion and contraction in production.

Many scholars have indicated Marx's tendency to link the recurring decennial business crisis that he, like Juglar, observed with the long–run crisis that would eventually lead to the evolution of capitalism. However, he did not elaborate on what precise relation existed between cyclical crisis on the one hand and the crisis of capitalism on the other. Other scholars have suggested that Marx should ranked, like Malthus, with theorists who offer an underconsumptionist explanation of the business cycle. This is an inference that can be drawn from portions of Marx's writings and from those whose position bears comparison with that of Marx, such as Sismondi and Rodbertus. A possible cyclical element in Marx's theory is his suggestion of the impact a declining average rate of profit would have upon the actions of the capitalist.

A theoretical explanation of business crisis may be derived from Marx's classification of industry into (I) industries producing producer's goods (goods used in the production of other goods), and (II) industries producing goods currently consumed.

This is a division of industry found in many business cycle theories. The product of each section of the economy is equal to the value of used–up materials, capital equipment, and business profit (surplus value). These segments of the economy, though they may be distinguished conceptually, do not in actual practice exist in isolated states. Obviously, in a society characterized by specialization and the division of labor they are interdependent.

The problem is to find and to maintain equilibrium conditions in the interchange of machines and materials produced in producers' goods industries and wanted in consumers' goods industries, and of consumers' goods produced in consumers' goods industries and wanted in producers' goods industries.

This is an equilibrium that could be easily maintained in a stationary circular–flow economy, that is, on in which there is no growth and in which capital formation takes the form of replacement.

Under these circumstances the production of producers' goods is simply geared to the replacement of capital facilities in both producers' goods and consumers' goods industries. However, where net capital formation is occurring in both sectors of the economy, complications are introduced.

Producers' goods industries must expand more rapidly than the consumers'–goods sector in order that capital may be accumulated. But equilibrium conditions of economic growth are difficult to achieve, and any number of factors may intervene to impede smooth development. Too rapid accumulation of capital may occur in the producers'–goods sector. Or, for example, the rate of annual replacement may exceed or fall below the rate of depreciation allowances and disturb the smooth course of business activity. The point is that in an interdependent, capital–using economy imbalances in the relation between producers' — goods and consumers' — goods industries are likely, and, where the economy is divided into these two departments, the simple type of factor adjustment implied by Say's law of market simply is not possible.

There are in Marx's work the seeds of several well–established business cycles theories. Even though he never formally advanced a theory of business crises, Marx's real significance in this field of knowledge is that, like Juglar, he was among the first to recognize and comment upon with considerable perception the rhythmic nature of business activity.