

The Fall and Rise of
KEYNESIAN
ECONOMICS



JOHN EATWELL
MURRAY MILGATE

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常州大学图书馆
藏书章

OXFORD
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Published by Oxford University Press, Inc.
198 Madison Avenue, New York, New York 10016

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Library of Congress Cataloging-in-Publication Data

Eatwell, John.

The fall and rise of keynesian economics /
John Eatwell and Murray Milgate.

p. cm.

Includes bibliographical references and index.

ISBN 978-0-19-977769-3 (cloth. : alk. paper)

1. Keynesian economics.
2. Economic history—1918–1945.
3. Economic history—1945– I. Milgate, Murray. II. Title.

HB99.7.E26 2011

330.15'6—dc22

2010032103

1 3 5 7 9 8 6 4 2

Printed in the United States of America
on acid-free paper



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The Fall and Rise of Keynesian Economics

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Preface

The global financial crisis and the world recession it produced were the latest in a series of crises that have come to plague the international economy. Such crises have become increasingly frequent and more intense as the liberalization of financial markets accelerated after the collapse of the Bretton Woods system some forty years ago. That each of them cannot be treated as an isolated event with solitary causes, but were instead events that shared common origins, has become clear to us all. Their origins, we now find, reside in part in the consequences of a process of financial liberalization that was allowed to proceed without sufficient consideration being given to the magnification of systemic risk it entailed, and in part in the consequences of the neoliberal dogmas that came to dominate practical policymaking during those same years.

The almost hypnotic power of these failed dogmas should not be underestimated. There are grown men and women—some even among professional economists—who continue to maintain that there are no multiplier effects to be had from loan expenditure undertaken by governments during a slump. It is still possible to hear the wrong-headed opinion that while an increase in public indebtedness during a recession is to be avoided at all costs, an increase in the aggregate of private indebtedness on a similar scale (supposedly easily engineered simply by getting credit channels flowing) offers an entirely unproblematic solution to our present problems.

There remain a few academic economists continuing to promote the perverse idea that in times of actual or threatened deflation, widespread spare capacity, and involuntary unemployment—with world growth, effective demand, and investor and consumer confidence all fragile—we should focus all our attention on the remote possibility of inflation “down the line.” There are politicians who warn us that by borrowing for current spending we are transferring the burden of repayment to future generations, apparently not noticing that if we actually had such magical powers, future generations would simply use them to do the same thing when the time came.

There are authorities and policymakers urging us to do something about “the huge” budget deficit; and there are not a few European governments actually instituting swinging cuts in public spending to reduce the ratio of the deficit to GDP (some of them, admittedly, against their will)—seemingly without any discernable concern for the economic consequences of what they are saying and doing. Even when schoolchildren begin to learn about fractions, one of the first things they are taught is that a fraction can be lowered either by reducing its numerator or increasing its denominator (or by doing a bit of both). But when that fraction is the ratio of the budget deficit to GDP, it is surprising how many seem to forget entirely their elementary arithmetic and proceed to speak as if the only way to reduce that ratio is to cut the deficit. This would be misleading enough—since the objective might just as well be achieved by thinking of ways of increasing GDP—but it is positively crazy if cutting expenditure may *decrease* GDP. This is a lesson that the European Union has chosen to learn the hard way—as governments from Greece and Ireland, through to Italy, Spain, Portugal, Germany, and Britain, are slashing public expenditures to reduce “the deficit.” The U.S. administration is understandably concerned.

Then there is the national debt to be considered. Should this be as worrying a thing in our present circumstances as we are led to believe it is? Those who urge us to think so, often speak of it as a “mountain of debt.” They mention, for example, that in the United States during 2010 it was increasing by \$3.8 billion every day—not noticing that without some point of reference, this number on its own is completely meaningless. Or they talk about the ratio of debt to GDP and “the mess we are in” because of it—forgetting that “the mess we are in” is the result of a global recession (caused by a financial crisis) from which recovery appears to be slow at best. Moreover, just what this particular ratio actually tells us about how vulnerable we are, since it is the ratio of a stock to

a flow, is difficult to say. If we imagine that it has reached, say, one to one (100%), what would that mean? Before answering, it is well to remember that for most ordinary citizens with a mortgage, the ratio of their *stock* of debt to their *flow* of income ratio is usually about two or three to one (200–300%)—and for some corporations it can be several hundreds to one. Yet they are all perfectly solvent. Our vulnerability might, therefore, be more meaningfully captured by looking at the ratio of a stock to a stock—say, public debt to private net wealth. In the United States in 2009, for example, this was a little under a rather more prudent 23%. Or one might look at the ratio of a flow to a flow—say, the ratio of annual debt servicing charges to GDP. In Britain in 2010, for example, this was just over a rather insignificant 2%. In the United States in 2010, it was a little less than this. Even if we add a charge against current income to allow for the retirement of existing debt, that figure goes up only slightly.

The only thing that the public debt to GDP ratio actually tells us at a glance is roughly how many years (and what average annual tax revenue) would be needed to redeem it—and the answer is “not many” (and “not too much”). Furthermore, even a quick glance at the level this misleading ratio for the last hundred years in the UK, for example, reveals that current-level debt to GDP looks rather more like a molehill than a mountain. It moved above one to one (100%) in 1918, peaked at above two to one (237%) in 1947, and did not again fall below one to one until 1962. The reality is that the truly alpine levels of UK public debt persisted for the better part of half a century, during which governments were following exactly the wrong-headed fiscal policies recommended by the purveyors of debt-crisis talk of today. The mountainous regions were left behind only once the economic policies of the Keynesian Consensus took full effect over fifty years ago. The message of experience is simple and compelling: reduce public spending and one thing is bound to follow—effective demand will fall and exert a dampening effect on growth. If the economy is operating with spare capacity and unemployment, as it normally is, this in turn will lead inevitably to more unemployment, more business failures, and possibly even *higher* ratios of deficit and debt to GDP in the medium term, not lower ones.

Nevertheless there are powerful vested interests, economic and political, devoted to preserving these and other failed dogmas. The facts of experience are not allowed to stand in the way of their propagation. Contrary evidence is either ignored or taken as providing exceptions that prove the rule. But sometimes when things sound like nonsense, they are just that.

900 A tendency just as unhelpful was going on in the tabloid press: to go after the culprits. They demand to know *who* was to blame—and given the widely reported size of bankers' bonuses, it was hardly surprising to find a strong public sentiment, coupled with a remarkable political consensus, ready to blame greedy bankers for all that they are going through. The unedifying spectacle of bankers (whose annual bonuses often exceeded the prospective lifetime earnings of ordinary citizens) defending obscenely large bonuses was not well designed to win favor in the public eye. When the public was told by those very bankers that, without such mammoth bonuses the world as they knew it would come to an end, the public had apparently not forgotten that the world almost *did* come to an end when those very bonuses (and the kind of incentives they created) went unquestioned. When bankers warned that they might pack their bags and leave town if their bonuses were curtailed, the numbers who might have joined a line at the airport to wave them goodbye would likely have stretched for miles. In these circumstances, the public disgust at the money-grubbing behavior of bankers, the vilification and sense of moral outrage that accompanied it, was understandable. But while many individuals certainly behaved recklessly, and many were driven by raw greed, an explanation of the crisis based on that fact is not at all satisfactory. Nor is it a sound starting point from which to draw any moral, social, or economic lessons from what has happened.

100 Fortunately, however, there are wiser and more considered voices to be heard. They can be heard in business, in government, in finance, and in academia—all advocating a return to a sounder, tried-and-tested set of ideas. They have exerted a salutary influence on the framing of policy responses to the global financial crisis, recession, and recovery that may just save the day. But the climate of opinion is in a state of flux in more ways than one. Politicians are listening increasingly to the sectional interests when they would be better advised to focus on targets for growth and jobs rather than targets for borrowing and the debt. Unlike growth and unemployment, the levels of borrowing and the debt can be left to take care of themselves if economic growth picks up. Hitting ill-judged targets for borrowing and the debt is likely to leave growth and unemployment either unchanged or permanently worsened. The one thing we have learned from our experience is that it is an error to think that growth and unemployment can be left to "take care of themselves" if deficit targets are actually achieved.

38 There is also another danger with this perverse but growing fashion for fiscal austerity—namely, that we will overlook the fact that what is

urgently needed is reform of the international financial system, which delivered us into the recession, rather than the immediate downsizing of public finances. That recession has taught us nothing if not that the idea that real economy invariably takes care of itself, and that markets for financial assets (money and securities) merely reflect those real “fundamentals,” needs modifying. What economists call “the neutrality of money” and “the classical dichotomy” are dangerous doctrines—something John Maynard Keynes pointed out many years ago. It always comes as something of a shock to think that many apparently sensible people believed in these fictions. In the 1980s, central bankers believed them when they convinced themselves that by restricting monetary growth and creating independent central banks they had brought oil-shock inflation down to single digits—when inflation was actually halted by the crash in the real economy that their monetary policies induced. In the 1990s, subscribers to the efficient-markets hypothesis continued to believe them even in the face of the collapse of Japanese asset markets and the bursting of the dot-com bubble. That the idea still has adherents, even after the global financial crisis of 2008 produced the biggest collapse in real economic activity across the world since the Great Depression, is positively mind-boggling.

In this volume, we have brought together in one place some of our own attempts to understand what has gone wrong, why we have regularly found ourselves in such predicaments, and how the situation might begin to be remedied. Some of these essays are newly written and are published here for the first time, while others are newly revised versions of previously published work. A few appear as originally written. The central theme of all of them, collectively, is not only that it is time to act boldly but that it is time to think boldly as well. Acting boldly in the face of a crisis is admirable and to be welcomed. But without thinking boldly too, we may well find ourselves, in not too many years from now, being seduced by the same old and failed economic dogmas that landed us in the mess in the first place.

We have organized the chapters that follow under four themes. The first theme is practical: the role of liquidity in financial crisis; the problem of systemic risk and its regulatory implications; the framing of appropriate fiscal and monetary policies in the face of recession and a fragile recovery; the consequences of financial liberalization on world development; and the effectiveness of the various policy responses to the financial crisis and world recession that have been tried so far, and some suggestions for reform. The second theme is analytical: the foundations

of both the theoretical ideas that appear to inform past dogmas and those of an alternative framework that seems to offer a more solid analytical basis from which to proceed. The third theme is critical of the orthodox approaches to theory and practice that have contributed to our current difficulties. The last theme is historical. With the name of Keynes now appearing with greater frequency in the media than at any other time in the last forty years, we must ask not only what we might and might not have to learn from Keynes but also how his legacy has been transformed in the process of attempting to accommodate some of his more challenging analytical innovations within the mainstream of economic thinking. Whether and how what Keynes had to say in the context of the interwar economic crisis might apply to us today is an important question to be answered. The answer is not straightforward.

Some of these chapters focus on a range of issues that have arisen since the fall of Keynesian economics—but they do so from a consistently Keynesian perspective. We seek to highlight the possibility that different and compelling interpretations are available to explain what were, and are, often believed to be anti-Keynesian “facts.” Different national experiences of unemployment (and the phenomenon of jobless recovery), for example, may be better understood by reference to a slackening of global effective demand, and as a consequent increase in disguised unemployment, than by reference to the operation of labor-market inflexibilities. Or, to take another example, the poor macroeconomic performance of certain economies after the imposition of externally formulated crisis-resolution measures (usually by the IMF) may similarly be better understood as a consequence of the negative impact on aggregate demand (and growth) of those very measures than by reference to incomplete or inadequate structural reform. Other chapters attempt to show how Keynesian ideas might fruitfully be applied to a variety of contemporary economic problems to yield not only a better understanding of their nature and causes but also a better guide to the remedies we might seek to apply in our efforts to solve them. However, together with the welcome rise of Keynesian economics in the face of the global financial crisis and world recession, where its practical insights have saved us much pain and suffering, has come a potential threat to its persistence. The danger is that Keynesian economics may yet come to be viewed as nothing more than the “economics of crises”—to be put aside “when things get better.” It is our contention that there is (and was) much more to it than that.

The chapters attempt to illustrate how powerful Keynesian ideas can be when applied to our past and present economic and financial

predicaments, and how helpful they are in explaining how we came to be in the mess we are in; they seek to reveal the analytical and methodological foundations of the conventional macroeconomic wisdom and to highlight where and how they may be wanting; they discuss an alternative analytical and conceptual framework drawing on the original Keynesian theoretical insights; and they highlight some of the interpretative weaknesses that have come to characterize Keynesian scholarship itself.

Taken together, these chapters suggest some of the concrete ways in which Keynesian economics might have much more to offer, both practically and analytically, to the serious study of the global economy. If these suggestions do no more than induce the reader to think again, we should regard our efforts as worthwhile. Acknowledgment is due to Academic Press, Duckworth, Elsevier, M.E Sharpe, Macmillan, Oxford University Press, Polity Press, the UNDP/ODS, and the editors of the *Cambridge Journal of Economics*, *Contributions to Political Economy* and the *History of European Ideas* for permission to use material by us previously published.

John Eatwell and Murray Milgate
Cambridge
July 2010

Preamble

The fall of the Keynesian Consensus may be dated from Milton Friedman's Presidential Address to the 1967 meeting of the American Economic Association. The main target of Friedman's critique was an adaptation of the Phillips Curve, which began as an empirical observation but had by then been transformed into an analytical function—a precise and stable trade-off between inflation and unemployment that served to close the familiar four-quadrant relationship among money markets, investment and output, and output and employment. It completed the Keynesian model, creating a satisfying closed system within which the impact of the levers of monetary and fiscal policy on output, employment, and inflation might be analyzed.

Friedman argued that the trade-off could only be a short-run phenomenon. In the longer run, once actors in the economy had fully absorbed and could anticipate the rate of inflation, the Phillips Curve would be vertical at a given level of employment—the natural rate. Hence, monetary policy might affect the employment–inflation trade-off in the short run, but in the long run it could not influence the level of employment that is “ground out by the Walrasian system of general equilibrium equations” (Friedman, 1968, p. 8). Similarly, fiscal policy could have no permanent effect on output. An increase in government spending would result in a higher rate of interest, “crowding out” private-sector investment.

The events of the 1970s, in particular the coexistence of high rates of inflation and rising unemployment following the oil crisis of 1974,

suggested that Friedman's critique of the Phillips Curve was well founded and that expansionary fiscal policy was not effective as a means of increasing output and employment. The simple verities of the era of Keynesian demand management had gone. Attention switched to the monetarist approach advocated by Friedman: free markets would ensure that the Walrasian equations had full scope to grind out the long-run equilibrium, and monetary policy would determine the rate of inflation. The financial liberalization that followed the collapse of the Bretton Woods system in 1971 reinforced the emphasis that policymakers now placed on financial stability ("sound monetary policies").

A wide variety of analytical developments followed. These ranged from real-business-cycle models that attributed fluctuations in economic activity to real shocks to the rise of New Keynesian Economics—models that studied the impact of market rigidities on macroeconomic outcomes. In real-business-cycle theory, recessions are the outcome of changes in the real economy, not the result of "sticky" nominal variables. Business cycles are "real" in that they do not represent a failure of markets to clear, but instead reflect the most efficient possible operation of the economy, given its structure. Governments should therefore concentrate on the long-run structural policy changes and not intervene actively to smooth short-term fluctuations.

What is remarkable is that all these models, from that embodied in Friedman's address to all the models that have followed, presume that the economy has a tendency to operate at a position in which all markets clear at full employment. Equilibrium prices and equilibrium quantities are determined simultaneously. What differentiate the models are the assumptions made about the formation of expectations (rational or otherwise), the nature of nominal and/or real shocks, and the modeling of price and quantity rigidities. Macroeconomic models are therefore catalogues of imperfections and shocks.

Nonetheless, all of these models assume that the economy tends to exhibit a market-clearing equilibrium. Without this assumption, none of them have analytical substance; yet few of them bother to consider whether that assumption is valid.

Market-Clearing Equilibrium and Macroeconomic Models

The only proof of market-clearing equilibrium is that provided by Arrow and Debreu (1954), and it is therefore on that analysis that macroeconomic

modeling rests. However, no such link can be shown to exist. The so-called Sonnenschein-Mantel-Debreu theorem demonstrates that well-behaved microfoundations may be associated with *any* arbitrary market aggregate excess-demand function, thus effectively ruling out the possibility of uniqueness and stability. Equilibria exist, but they are totally arbitrary. As Mas-Collell, Whinston, and Green put it, "Anything goes" (1995, p. 598). This result is robust even in the face of major simplifications, such as the assumption of homothetic utility functions. Therefore, "every theorist who wants to argue that a change in some price variable (a wage, interest or exchange rate, for example) affects a corresponding quantity aggregate in a definite direction cannot base this argument on general equilibrium theory" (Rizvi, 1994, p. 363).

These results are devastating for any macroeconomic theory based on the presumption of a market-clearing equilibrium, since no such presumption can be made. In fact, all models based either on imperfections and rigidities or on shocks, financial or real, are otiose. Given that Sonnenschein-Mantel-Debreu results were developed by distinguished analysts working within the core of neoclassical theory, the systematic neglect of their implications is, to put the matter politely, extraordinary.

It worth emphasizing that the Sonnenschein-Mantel-Debreu results exist for an exchange economy. They derive essentially from the implications of wealth effects on the aggregation of individual excess-demand functions. The extension of the model to production from nonreproducible factors (land and labor, say) does not introduce any further complications (as if any were necessary), but removes any sense from the assumption of gross substitutability—one of the mathematical "escape routes" with, even in the pure exchange case, negligible economic rationale.

The further extension of the analysis to include reproducible means of production—that is, the extension to some relevance to real economic problems—creates yet more problems. As is now well known, it is not possible to prove an existence theorem for the long-run equilibrium of an economy that includes reproducible means of production. In this case, the problem arises from the fact that it is not possible to specify the endowment of reproducible means of production in a manner that is compatible with the determination of an equilibrium in which there is a uniform rate of profit on the value of each set of capital goods. The association of the uniform rate of profit with long-run equilibrium is exactly the same as the proposition that, in equilibrium, the supply of reproducible commodities (whether consumer goods or capital goods) will be adjusted to the demand for them. This conception of equilibrium is

inherited from Adam Smith's definition of "natural price" and Marshall's "long-run"; it is intuitively powerful as a "centre of gravitation" of the economy, whether in prices or quantities.¹ The idea of long-run equilibrium is therefore unavailable to neoclassical analysis.

The Arrow-Debreu equilibrium is different. Each potentially producible commodity is listed in the endowment as a fixed quantity, and prices clear markets for those quantities. Suppose, then, that there is a relatively large quantity of capital good *A* in the endowment. Its price will tend to be low relative to its cost of reproduction (its production would result in a return lower than that on other capital goods), and instead of being produced, the stock will be run down. But this below-"normal" price is the equilibrium market price. And for each arbitrary set of initial endowments there will be a different set of market-clearing prices. The whole idea of equilibrium being associated with the *adjustment* of supply to demand is lost, as is any meaningful sense of a center of gravitation.

These overwhelmingly negative results suggest that it is not possible to construct macroeconomic analysis on neoclassical microeconomic foundations. In particular, the assumption that the normal position of the economy may be characterized as a market-clearing, and hence full-employment, equilibrium is totally unwarranted. A different approach is needed.

The Rise (Again) of Keynesian Analysis

At first sight, Keynes's analysis of effective demand eschews any consideration of the theory of value and distribution. But given that the essence of the principle of effective demand involves a link between monetary expenditures and the determination of levels of real output and employment, prices must be a necessary component of the analysis—including the relative prices of commodities and labor. This, then, poses the question of what the relationship is, if any, between the determination of relative prices and the determination of the level of effective demand. Simply taking prices as given opens the theory to criticism that the role of prices in a market economy has simply been assumed away.

However, an alternative approach to price determination is available. Piero Sraffa presented an analysis of the relationship between the distribution of income and the conditions of production of commodities in the determination of normal prices that is totally different from

neoclassical theory. Instead, his analysis is akin to the classical theory of price associated with Ricardo. In classical theory, the question of the relationship between aggregate capacity and demand is subsumed in the *assertion* that saving is investment. Demand could not set a permanent limit to production or, as Ricardo put it, “demand is only limited by production” (Ricardo, 1951–1973, vol. 1). The link to the demand for individual commodities is characterized as an adjustment of supply to the given “effectual demand.” There was, of course, no presumption of full employment of labor.

In contrast to this assertion of normal equality between capacity and demand, neoclassical writers presented a *theory* to explain how the balance of capacity and demand is established in the long run. The demand for factors is equated to the given quantities of factors of production as the counterpart of the determination of prices by supply and demand. The competitive tendency of prices to gravitate to normal levels determined by utility maximization subject to the constraints of technology and endowments would be accompanied by a tendency toward levels of output consistent with the full utilization of all factors of production (other than free goods). The aggregate adjustment of capacity to demand is the summation of the general equilibrium adjustment of the demand for individual goods and services to the capacity available to produce them. Unfortunately, as already explained, the summation does not result in a credible analysis.

Keynes also presented a *theory* of output. In the simplest version of Keynes’s analysis, the level of aggregate demand is determined by investment and the multiplier. What is the relationship between demand and capacity? It might be argued that Keynes’s theory is essentially a theory of capacity *utilization*—capacity is simply given by history, and the level of effective demand determines the level of utilization, including, of course, the level of employment. As such, Keynes’s theory is susceptible to interpretation as a short-run version of neoclassical theory, with the long-run tendency to full-capacity utilization being inhibited by imperfections—sticky wages, sticky prices, inappropriate monetary policies, or the impact of uncertainty disarming the price mechanism. Indeed, that is the direction that the Neoclassical Synthesis and various versions of New Keynesian Economics have taken.

Yet Keynes presented his theory as something more—as a theory of output determining a center of gravitation: “we oscillate, avoiding the gravest extremes of fluctuations in employment and prices in both directions, round an intermediate position appreciably below full employment

and appreciably above the minimum employment a decline below which would endanger life" (Keynes, 1936, p. 254). The language is clearly reminiscent of Smith's "centre of gravitation." Keynes is suggesting that his theory defines the normal positions of the economy: "the mean position determined by "natural" tendencies, namely by those tendencies which are likely to persist" (Keynes, 1936, p. 254).

Two important points should be noted. First, if Keynes has indeed established a long-run or normal theory of output in which labor, and perhaps other means of production, are not fully utilized, and not free goods, then that theory would necessarily be incompatible with neoclassical analysis. Second, if the classical approach to the determination of normal prices is to be relevant within the Keynesian context of a less-than-full-employment "equilibrium," then to what extent is it presumed that productive capacity is adjusted to demand—that is, fully utilized? The answer to the conundrum rests in two empirical characteristics of price formation.

The first characteristic is that changes in the forces that determine normal prices "if continuous, would be sufficiently slow as to not endanger the gravitation toward the (slowly moving) long-period values. That same persistence would ensure that, should the changes be rapid, they would be once-for-all changes, and that, after a period of transition, gravitation to the new long-period values would again assert itself" (Garegnani, 1976, p. 28). The forces determining normal prices in the classical approach are the conditions of production of commodities and the distribution of income.

It might be reasonably assumed that the conditions of production change relatively slowly in so far as those conditions are not themselves functions of capacity utilization. Changes in demand are likely to result not only in changes in unit inputs associated with one technology as it is used more or less intensively but also in the use of different vintages of technologies (fossils) that co-exist with the competitively dominant technique. Moreover, in a dynamic setting, the dominant technique may co-exist with new, technically and economically more efficient techniques that, for the moment, earn super-normal profits. But the key to price determination is the notion that there will be a dominant or normal technique that is the determinant of normal price in competitive markets.

The second characteristic is that such a normal technique might be reasonably presumed to exist, as suggested by the study of price formation in industrial economies. It is found that normal capacity utilization does not involve the total utilization of capacity but, instead, is a level of