



UNIVERSITY  
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# PKES Summer School

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## Effective Demand vs Say's Law in Marx, Keynes, and Kalecki

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# Lecture Plan

# Lecture Plan

## Plan for this lecture

1. Definitions: market equilibrium, market clearing, and equilibrium stability
2. Walras' Law, Say's Law, and the Principle of Effective Demand
3. Marx, Keynes, and Kalecki compared
4. Final remarks

# **Market Equilibrium**

## **Market Clearing**

## **Equilibrium Stability**

# Market Equilibrium

Do not confuse **market equilibrium** with **market clearing**

**Market equilibrium** = point of rest = fixed point = stationary state

**Market clearing** = no excess demand = no excess supply  
= supply equals demand

**Stability** = self-correction

Can we have a market equilibrium that is **not** market-clearing?

**Say and Walras:** 'No' → equilibrium is market-clearing

**Malthus, Keynes, Marx, and Kalecki:** 'Yes'  
→ equilibrium is not necessarily market-clearing

# Market Equilibrium

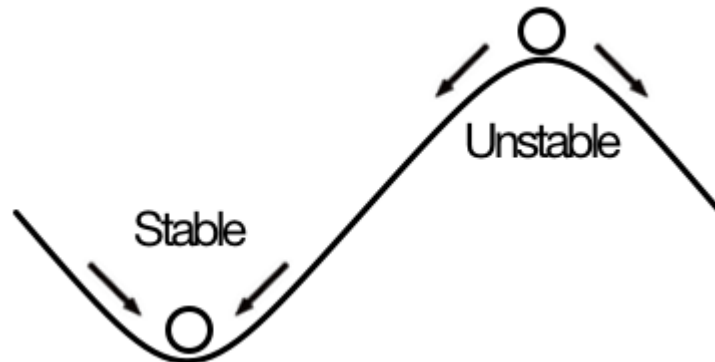
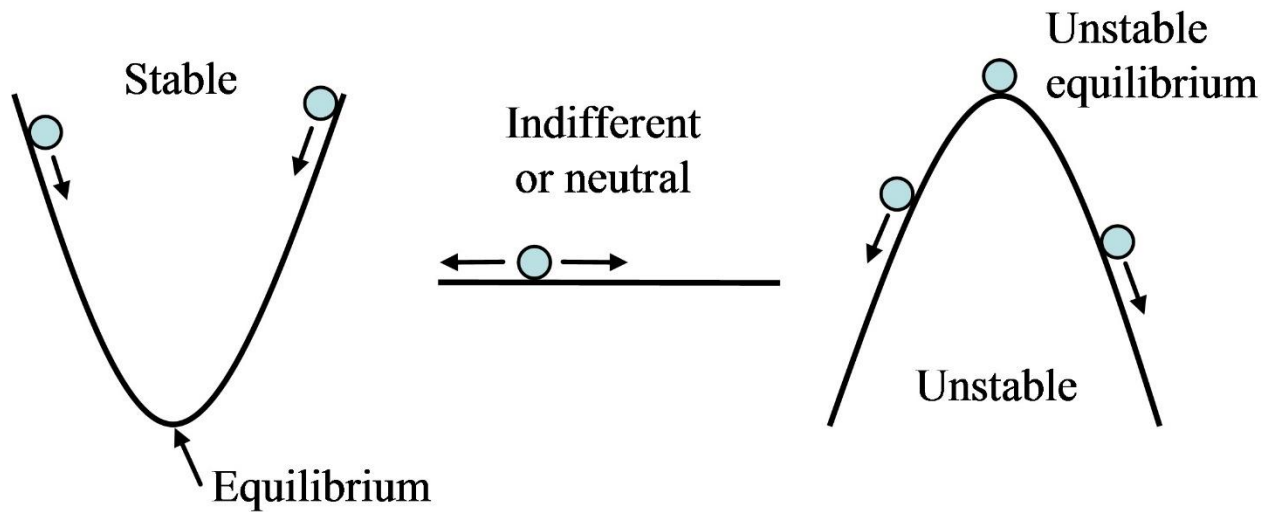
The equilibrium can be either market-clearing or non-market-clearing

Even if the equilibrium clears the market it might still be **unstable**

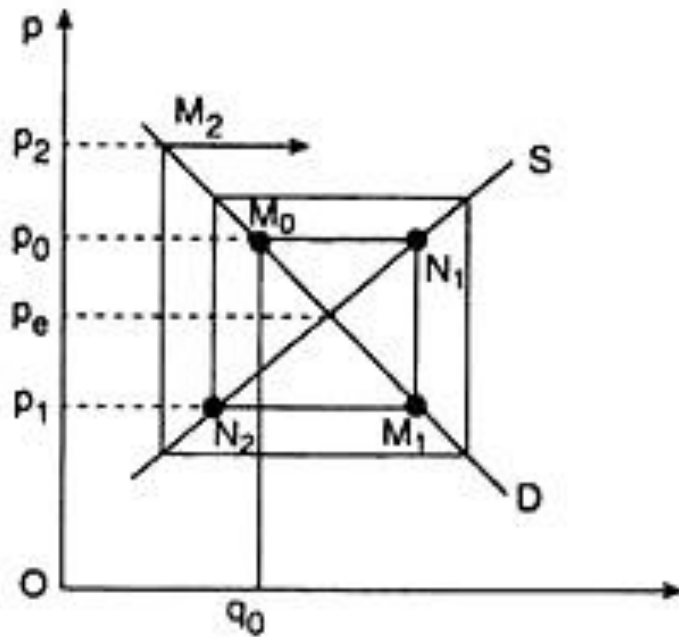
An equilibrium that does not clear the market might be **stable**

There is no reason to believe that the equilibrium is always market-clearing and stable

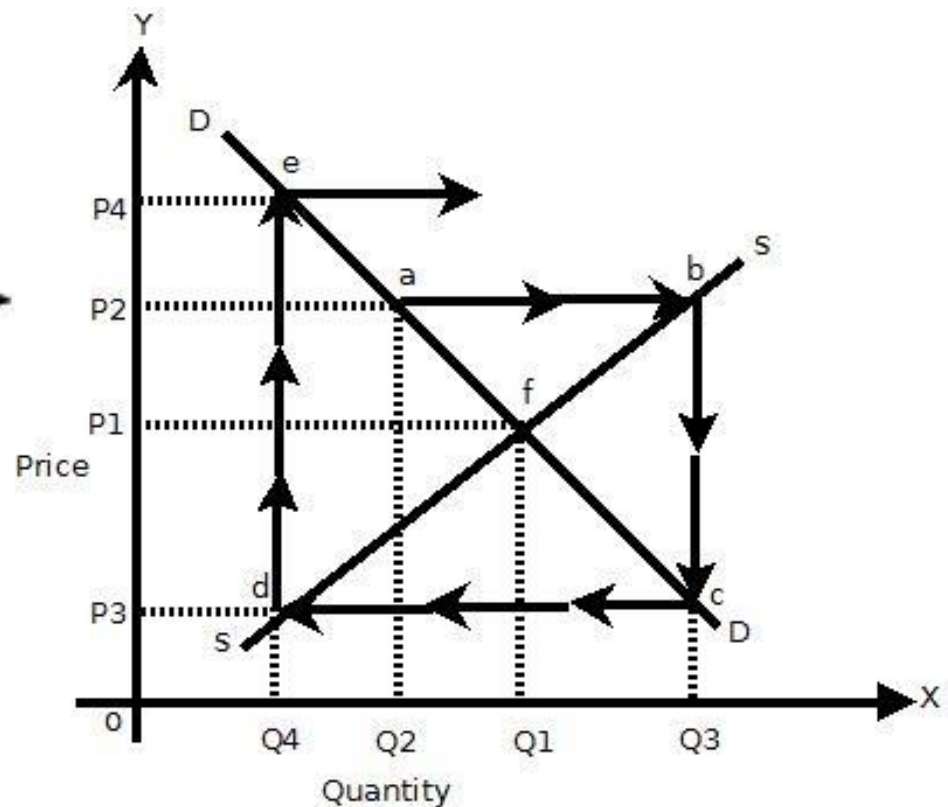
# Market Equilibrium



# Market Equilibrium



**Fig. 4.9** Unstable market with lagged supply





**Say's Law**

**Walras' Law**

**Keynes' Effective Demand**

## Walras' Law

Total demand (including the demand for money) equals total supply (including the supply of money)

This is just a definition

No direction of causality is implied between supply and demand

So there is:

- no excess demand in the aggregate

- no excess supply in the aggregate

# Walras

## Walras' Law

But be careful:

Do not confuse the **aggregate level** with the **disaggregate level**

Walras' Law applies to the aggregate level

So there might be excess demand or excess supply in certain sectors

## Walras' Law

In **General Equilibrium** analysis it is common to assume that “general equilibrium” means:

1. Every single market clears
2. No excess demand and no excess supply in any market
3. Walras' Law applies at the aggregate level

But this is not always the case:

In **New Keynesian DSGE models** the labour market is in short-run equilibrium but it does not clear

## Say's Law

Becker and Baumol (1952) and Baumol (1977):

The term “Say's Law” is ambiguous

Say's Law actually has two versions:

Stronger version: **Say's Identity**

Weaker version: **Say's Equality**

## Say's Law

### Stronger version: **Say's Identity**

Total supply automatically becomes, and is identical to, total demand. This happens because no one ever wants to hold cash, so all sales incomes are immediately spent on other goods and services. The demand for money does not affect aggregate demand, supply, or income. Money is just a veil. Recessions and cycles can happen but are entirely supply-driven.

### Weaker version: **Say's Equality**

Demand is supply-led and the equilibrium between aggregate demand and aggregate supply is stable, such that deviations from it are possible but self-correcting. Because of supply-side issues such as coordination problems and miscalculations, recessions and cycles are possible though brief. Money can be used as a store of value, and as a medium of exchange its supply is determined endogenously.

## Say's Law in Classical Political Economy

Core of Classical Political Economy = Smith, Say, Ricardo, J.S. Mill

Growth, cycles, and recessions are **supply**-driven phenomena

Cycles are **not** caused by **aggregate demand deficiency** but by miscalculations about what to **produce** and in what proportions

The crucial issue is not a lack of aggregate demand but a **temporary mismatch** between the composition of aggregate demand and aggregate supply, solved through the movement of capitals across sectors

Economic crisis occur not because of **oversupply** but because of **underproduction (under-supply)**

## Keynes' Theory of Effective Demand

Not all output will necessarily find buyers

Incomes may not purchase all supply

Possibility of unsold inventories

Market **equilibrium** does not necessarily **clear** the market

**Investment determines savings** ( $I \rightarrow S$ )

Investment is autonomous from savings

No need of prior savings to fund new investment

Money as a **store of value** = money as an end in itself = money is not a veil

Money can be demanded as an end in itself

Capitalism is substantially different from a barter economy

Capitalism is a monetary production system



## Keynes' Principle of Effective Demand

Crucial distinction between:

**Ex ante** plans = decisions made **before** production begins

**Ex post** realised results = outcomes **after** all exchanges are concluded

Aggregate Demand (AD) is **not** identical to Aggregate Expenditure ( $AE = C+I$ )

Aggregate Demand (AD) is **ex ante**

Aggregate Expenditure ( $AE = C+I$ ) is **ex post**

Principle of Effective Demand relates to **AD ex ante**

# Keynes

## Overlapping Production Periods

Ex ante      production (t)      Ex post

AD (expectational)  
AS (notional)  
ED = output and  
employment are  
determined here

Ex post  
 $AE = C + I + G + X - M$   
Expectations are  
revised

Ex ante      production (t+1)      Ex post

AD (expectational)  
AS (notional)  
ED = output and  
employment are  
determined here

Ex post  
 $AE = C + I + G + X - M$   
Expectations are  
revised

## Keynes' Principle of Effective Demand

Principle of Effective Demand relates to **AD ex ante**

Effective Demand is the effective commitment to **supply**

Effective Demand is the effective commitment to **production**

Effective Demand is NOT about what will be demanded ex post:

“effective demand is an unfortunate term, for it really refers to the **output that will be supplied**; in general there is **no** assurance that it will also be **demanded**” (Chick 1983, p.65)

Principle of Effective Demand (**PED**) = Principle of Effective Supply (**PES**)

## Keynes' Principle of Effective Demand

Effective Demand is the **ex ante** effective commitment of firms to production, a decision made before production begins

This **ex ante** decision is made at the **beginning** of the production period

After production has taken place, firms will see how much of their output is actually sold

Revising their **ex ante expectations** in light of the **ex post realized results** in the market

Which will then influence effective demand at the **beginning** of the **next** production period

## Keynes' Principle of Effective Demand

### Effective demand

= firms' effective commitment to **production** so as to maximize **expected** profits

= the point at which AD meets AS

**AD** = aggregate demand = **expected** revenues

**AS** = aggregate supply = **profit-maximizing** level of revenues, given the cost structure and technology

**AD** is expectational (ex ante)

**AS** is notional

**PED** = **PES** = the **ex ante expected** profit rate determines the level of output and employment at the **beginning** of the production period, before production takes place

# Keynes

## **Say:**

GDP level is supply-led

Automatic tendency to market-clearing equilibrium

Market-clearing equilibrium is stable (self-correcting)

## **Keynes:**

GDP level is demand-led

But this demand is ex ante

It is an expectational demand

Ex ante AD might or might not be realised ex post

No automatic tendency towards the market-clearing equilibrium

**$C+I = Y = \text{Profits} + \text{Wages}$**

If  **$C = \text{Wages}$** , then  **$\text{Profits} = \text{Investment}$**

“**Workers** spend what they get, but **capitalists** get what they spend”

Aggregate investment by the capitalist class determines the total amount of **real gross profits** in the system

Firms cannot realise at the aggregate level a greater amount of **profits** than their own **investment** expenditures

Capitalists decide their level of **expenditure** but not their level of **income**

And their level of **expenditure** will determine their level of **income**

# **Marx, Kalecki, and Keynes**



# Marx

## Marx

Say's Law applies to a barter economy, but not to capitalism

Not all output will necessarily be sold

Money can function as a store of value

Instead of purchasing what has been produced, people and companies can just hoard money

Marx wrote this between 1857 and 1880

80 years before Keynes and Kalecki

# Marx

## Source of profit for Marx:

- surplus value

- unpaid labor time

- what workers pay to work

Keynes and Kalecki do **not** explain where profits come from

Investment is not the source of profit

Investment realises the surplus value created in production

‘To realise’ = to covert labor time into money

The **aggregate level of ex post expenditures with C and I** realise the values created **ex ante** in the sphere of production

# Marx

The **aggregate level** of **ex post** expenditures with **C and I** realise the values created **ex ante** in the sphere of production

Two rates of exploitation:

## **Ex ante** rate of exploitation

= 'immediate rate of exploitation'

= rate of exploitation at the point of production, before the output is sold, before the surplus value is realised

## **Ex post** rate of exploitation

= realised rate of exploitation

= rate of exploitation after value and surplus value are realised

# **Final Remarks**

# Final Remarks

Who actually invented Say's Law?

Not J. B. Say, but **Adam Smith**

Then Ricardo and J.S. Mill brought Say's Law into the core of classical Political Economy

“Say, James Mill and Ricardo, **following Adam Smith**, opposed the view that general lack of demand was the prime threat to prosperity, arguing that the main obstacle is **inability or unwillingness to produce**”

“what they had done was to deny flatly that failure of effective demand was a cause of recessions and unemployment”

(Baumol 1999, p.196-197)

# Final Remarks

Political Economy should consistently incorporate the insights of Keynes, Kalecki, and Marx

Keynes and Kalecki did not explain the origin of value or of profits

Kalecki did not explain how profit rates would equalise across sectors over time

Marx died before completing his drafts

In Marx, the financial aspects of capitalism are very underdeveloped

# Final Remarks

Keynes' principle of effective demand (or effective supply) places profit **expectations** at the centre of economic theory

Keynes did not fully develop his theory in the long run

How does the principle of effect demand work in the **long run**?

Keynes did not fully theorise how expectations are formed

What if **profit expectations** are heavily dependent on the **current profit rate**?

Then the main goal should be to explain the behaviour of the **profit rate** over time

The interplay between **expected profits** and **realised profits** is very complex

# Exam Question



# Exam Question

What is the difference between Marx, Keynes, and Kalecki regarding the role of effective demand? Explain the roles of (ex ante) expected profits, realised profits, and the origin of profit.

## **Marx**

The profit rate is the crucial variable

Source of value is labour

Source of profit is surplus value (unpaid labour time)

Expenditures  $C+I$  realise the values and surplus values created

Ex post exploitation  $\neq$  ex ante exploitation

Long run = profit rates are equalized across industries

## **Kalecki**

Total profits match total investment expenditures

Businesses cannot make more profit than their investment expenditures

Source of profit is not actually explained

Does not explain how profit rates equalize over the long run

## **Keynes**

Expected (ex ante) profit rate is the crucial variable

Source of profit is not explained

Principle of effective demand is stated clearly

at least for the determination of output and employment in the short run

In the long run things are not very clear

Slides and papers  
available at:

[tomasrotta.wordpress.com](http://tomasrotta.wordpress.com)