A REFORMULATION OF MACROECONOMIC THEORY

By

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INTRODUCTION

This paper is a reformulation of macroeconomic theory designed to overcome four basic difficulties in received theory.

The primary difficulty is the logical inconsistency between macroeconomic theory and the marginal productivity theory of factor pricing. Since received macroeconomic theory is characterized by diminishing marginal productivity of labor, and the marginal product of labor is equal to the real wage, there must be another factor present to absorb the surplus product. We call this factor "capital" and, to maintain an economy of variables, assume it to be physically homogeneous with the produced output. Simple marginal productivity theory then says that the marginal product of capital is equal to its real rental rate. This rate, plus capital's expected rate of price appreciation, is equal to the money rate of interest. But there is no reason for this money rate of interest to equal the money rate of interest obtained from the liquidity preference and expenditures functions of received theory! An inconsistency thus appears within the received theory once we recognize the necessity of a market for the services of a non-labor input, a recognition which amounts to adding an independent equilibrium equation without adding a corresponding variable.¹

¹Numerous authors have pointed out the inconsistency of Keynesian interest theory with neoclassical marginal productivity theory. But they have not seen the need for the extra equation describing equilibrium in the capital services market, and

The author is indebted to Jack Hirshleifer for several helpful comments on an earlier draft.
We shall reformulate macroeconomic theory to remove this basic inconsistency. Our resulting macroeconomic model is protected against this kind of inconsistency as it is derived as a special case of a general model of temporary competitive equilibrium. It is the special case in which there is a single money market and production of a single output with two factors. Our derivation implies the irrelevance of Keynesian spending functions in determining a macroeconomic equilibrium for a given rate of expected inflation. In order to determine such an equilibrium, one need know only an aggregate production function, the factor supply functions, and an excess demand function for money. Keynesian spending variables are relevant only as parameters in determining the parametrically given, expected rate of inflation. This result reveals the second basic logical defect in Keynesian theory: an equilibrium rate of aggregate spending (i.e., an equality of ex ante savings and investment) is a logical possibility only thus they have not regarded the inconsistency as a direct logical threat to Keynesian models. Rather, they have unfortunately been satisfied, at least since the classic paper of Lerner, with a conjecture that the difference in interest rates vanishes when there are increasing costs of producing capital relative to consumption goods. The error in this conjecture, an error first suggested by Stockfish and fully exposed very recently by Floyd and Hynes, is simply that increasing costs of producing investment goods will not generally permit the interest rate determined by marginal productivity theory to vary in a Keynesian fashion.

A legitimate way to account for the difference in interest rates would be to follow Patinkin in assuming the presence of "bonds" which receive the "rate of interest" referred to in the standard theory, a rate of interest which differs from the money rate of return on real capital because of positive transaction costs in the process of lending to owners of capital. But received macroeconomic theory would still be inconsistent with marginal productivity theory because of arbitrage between the two interest rates, where the transaction costs in the process of lending to capital owners will determine the relationship between the rates. This arbitrage would provide a constraint on the behavior of the bond rate which, as shown in Section III of this paper, is generally not satisfied in standard formulations.

Finally, there would be no difference in interest rates, and no extra equation, if the implicit market excluded with Walras' law in a Keynesian model were simply a capital services market. However, this interpretation of a Keynesian model is inconsistent with the rest of the model, as we shall see in Section II of this paper.
in a model which also determines an equilibrium rate of inflation! Suggestions of the same proposition are also found in Foley and Sidrauski.

Correcting the two basic logical errors in Keynesian theory -- a theory which requires an equilibrium rate of spending -- thus requires adding to a standard Keynesian model: (1) a new independent equation describing equilibrium in the market for capital services and (2) a new equilibrating variable, the rate of inflation. Although most macroeconomists, this one included, are unwilling to admit sufficient foresight to allow an equilibrating rate of inflation for empirical business cycle analysis, we shall examine such an environment sufficiently to show that key, Keynesian, comparative-static conclusions cannot hold even when we permit an equilibrium rate of aggregate spending in a model consistent with marginal productivity theory.

Besides consistency with elementary capital theory, the important advantages of our basic macromodel over the received models in describing a modern money economy are that:

- It is relatively easy to estimate;
- It explains Gibson's Paradox, the observation that interest rates and prices move together over business cycles even though at least some of the cycles have monetary causes;
- It reveals the existence of a dangerously unstable equilibrium (or the non-existence of an equilibrium with a positive price level) that does not appear in received models, showing at the same time the desirability of secular inflation in reducing the chances of a vicious plunge toward a zero price level.

The third basic difficulty with macroeconomic theory is its inability to evaluate the relative dynamic efficiency of alternative monetary systems. By describing how various competitive monetary institutions enter into a macroeconomic model, we are able to specify a type of competitive monetary
system which is both statically and dynamically superior to both a classical, commodity standard system and the modern system in which there is an exogenously controlled money supply and a constraint on the payment of interest on money.

The fourth difficulty with received theory (where "received theory" includes the recent models of rational unemployment based upon the pioneering work of Alchian and Allen, 1964) is its inability to explain several obvious empirical observations concerning unemployment. First, it fails to explain why many developed countries have imposed a secular subsidy to unemployment, observed in the United States in the form of mandatory, fixed-premium, unemployment insurance. Second, the received theory of unemployment fails to explain the behavior of employment and real wages in the U.S. during the Great Depression; it explains neither the persistence of the high level of unemployment throughout the Great Depression (1930-1936), the absence of any significant increase in real wages during the rapid decline in output from 1930 to 1933, nor the ensuing dramatic increase in real wages from 1933 to 1936. Our reformulation of macroeconomics contains a theory of rational unemployment which can explain these observations.

The paper will proceed as a reconstruction of simple macroeconomic theory which, in the process of reconstruction, overcomes these four basic difficulties in the received theory.

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2 These observations on real wages would be consistent with current macroeconomic thought if employers were unduly pessimistic about output prices during the period of decline, which would make realized competitive wages fall short of expected marginal products during that period, and if employers were unduly optimistic about output prices during the period of advance, which would make realized competitive wages exceed expected marginal products during that period. However, such an expectation hypothesis is the opposite of what appears to be reasonable.
I. A TEMPORARY EQUILIBRIUM WITH KEYNESIAN UNEMPLOYMENT

The Definition of Temporary Equilibrium

Let $X_{tj}$ be the excess market demand in the $t^{th}$ period for the $j^{th}$ commodity and $P_{tji}$ the $i^{th}$ individual's expected money price of commodity $j$ in period $t$ (where $t = 1, \ldots, T; i = 1, \ldots, N;$ and $j = 1, \ldots, M$). $P_t$ is a vector of current prices for all goods when $P_{tji} = P_{tjk}$ for all $i, k (k = 1, \ldots, N)$. Following Arrow and Hahn, a temporary equilibrium is a non-negative set of present prices, $P_1^*$, such that

(1) $X_{1j} [P_1^*, P_2^*(P_1^*), \ldots, P_T^*(P_1^*)] \leq 0$ for all $j$.

All possible temporary equilibrium prices are the same to all individuals; hence, an admissible, temporary equilibrium price for commodity $j$ can be described by $P_{1j} = P_1^j$ for all $i$. It also follows from the fact that all possible temporary equilibrium prices are the same for all individuals that the aggregate of the individual budget identities for the first period yields Walras' Identity for the period. Hence,

(2) $\sum_{j=1}^{M} P_{1j} X_{1j}(P_1^j) = 0$.

The existence of a temporary equilibrium, given (2) and the continuity of $X_{1j}(P_1^j)$, follows from the general existence theorem of Arrow and Hahn.

Inefficient Temporary Equilibria

If individuals are all rational, risk-neutral, and share the same, correct, future price expectations, and if contract costs cannot be reduced for a given set of transactions, then the resulting sequence of temporary equilibria, which can be called a "full equilibrium," is still not generally a Pareto optimum. This has been shown by several writers in various special cases involving interpersonal information differences concerning the technology as well as contract costs. (E.g. the models of Hirshleifer and Spence.) We shall
specify another such inefficiency case in Section IV below. However, economic policies can be designed to achieve a Pareto optimal full equilibrium. (E.g., our own non-optimal full equilibrium in Section IV is corrected with a policy of unemployment insurance.) Once such policies are adopted, the policy goal to achieve Pareto optimality is simply to alter the parameters of a temporary equilibrium in order to induce behavior equivalent to that which occurs in a full equilibrium. That is, the policy goal is to alter parameters so as to remove systematic errors in future price expectations. It is this policy framework that motivates our construction of simple macroeconomic models.

One might, however, reasonably doubt that government policy makers have systematically better information than private decision makers regarding future prices. Such doubting would be particularly strong for commodity markets, where, in the real world, market specialists normally arbitrage between present and future markets. This will be reflected in our subsequent assumption that commodity prices are a martingale. But laws prohibiting long-term labor contracts have effectively prevented human capital from coming under the control of market specialists. As a consequence, the typical laborer, who is not naturally an expert in the market for his kind of service, makes his own employment decisions despite his relative ignorance about this market.  

A Temporary Equilibrium with Keynesian Unemployment

In a temporary equilibrium with Keynesian unemployment, laborers are overly optimistic regarding their future job opportunities within their present occupations and thereby devote too much present time to resting or searching for high-wage jobs and too little time to present employment (as originally described

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3We are not implying any criticism of the observed government policies. The deadweight social losses in terms of transaction costs resulting from ownership transfers between parties with different information may not be worth the possible allocative improvement resulting from such transfers [see Hirshleifer or Thompson (1966)]. Government restrictions on such transfers are then in order.
by Alchian and Allen). Obversely, in a temporary equilibrium with "Keynesian" overemployment, laborers as a group are overly pessimistic about their future wage offers in their present occupations and thereby spend too little present time resting or searching out other employment opportunities.

Starting from a position of full equilibrium, an exogenous shift creates a temporary equilibrium with Keynesian unemployment when there is an overall excess supply of labor at the original wage rates and some laborers mistakenly believe that the resulting lower wage offers from their present employers may be a result of a shift which lowers the value of their products in their present firms relative to other firms who hire workers in their occupations. As a consequence, some of these laborers refuse the lower wage offers from their present employers and spend their present labor service inefficiently searching for higher-wage jobs in their present occupation or resting in wait for what they expect to be the higher future wages. [See Lucas or Thompson (1973)]

Since monetary shifts, which are apparently observed to induce inefficient adjustments in employment, also change the temporary equilibrium level of prices of current outputs, we must assume that some workers do not know of the present change in the price level. Otherwise, all workers, in responding to a monetary shift, would be able to observe the price level change which accompanied the change in their wage offers and would not make the mistake of assuming that wage offers elsewhere have not similarly changed. An additional indication of the accuracy of this assumption can be found in the widespread impression that workers feel worse off in recessions and better off in booms.

While this perhaps should be called "Alchianian unemployment," we can see no other rationale in a competitive temporary equilibrium for what Keynes considered to be inefficient unemployment.

It is conceptually possible for an inter-firm shift to lower the wage of a particular class of workers while lowering the price level in the same proportion. Nevertheless, the probability of such a non-monetary shift is negligible compared to the probability of a monetary shift.
If workers did not systematically undervalue price level changes during normal business cycles, they would feel better off in a normal recession than in a normal boom.

Corresponding to the above discussion, a function determining the supply of current labor to a given occupation appropriate to a model of temporary equilibrium admitting Keynesian unemployment is

\[(3) \quad L_S = L(W_1, W_2(W_1), \ldots; P_1^{-W}(P_0, W_1), P_2^{-W}(P_0, W_1), \ldots) = L[W_1],\]

where \(L_S\) is the current quantity of labor supplied, \(W_t\) is the expected wage in period \(t\), and \(P_t^{-W}\) is the set of expected prices other than wages in period \(t\).

Assuming a positive derivative of \(L[W_1]\), this can also be written as

\[(3') \quad W_1 = W[L],\]

where \(W[\cdot]\) defines a supply-price function.

The price level of current outputs is only an expectation function for these laborers, as they cannot be assumed to know the actual price level in the current period. This is represented in (3) by allowing laborers' perception of current non-labor prices to depend only on last period's prices, which are parameters rather than variables to be determined, and on current wage offers.6

The fact that workers believe that an overall shift in demand for labor may be only an inter-firm shift is expressed in an inelasticity of expected future wages, and other expected prices, with respect to \(W_1\). Since the effect of

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6 This could be weakened to allow laborers to know some current prices (especially the prices of goods they may buy in the current period), but we retain the unnecessarily strong specification to facilitate later aggregation to a single output. We could also allow some workers to know the current price level. But such a generalization would add nothing but notational complexity to our subsequent model.
a change in $W_1$ on non-labor price expectations and the effect of a change in non-labor prices on $L_S$ are both likely to be fairly small, we can ignore the effect of a change in $W_1$ on $L_S$ through the effect which $W_1$ has on expected non-labor prices. But because the percentage change in the expected wage, $W_t$, $t \geq 2$, is significantly less than the percentage change in $W_1$ for several workers, a decrease in $W_1$ will induce, rather than the insignificant effect on $L_S$ which would occur if all workers knew that the shift were overall, a significant increase in several workers' expected values of future work relative to present work and thus a significant substitution of expected future work for present work. Thus, from the standpoint of labor's reaction to overall shifts in demand for labor, the supply of labor is too elastic.

A Digression on Walras' Identity and the Keynesian Model

Several influential writers, notably Clower, Leijonhufvud and Arrow-Hahn, have denied (2), applying Walras' Identity only across several or all time periods. This has led to an interesting interpretation of Keynes' "equilibrium" as admitting an excess supply of labor at the existing wage with no corresponding current (or effective) excess demand. This in turn has led to an approach to macroeconomics which does not allow all current markets to clear, even for a short period of time. We believe this line of reasoning is economically incorrect because Walras' Law for each period follows from the simple fact that the total value of the assets or individual plans to buy in a given period must equal the value of the assets (including financial assets) he plans to sell in the same period. Hence, at existing prices, an effective excess supply implies an effective excess demand. Thus Keynes' "equilibrium," which contains no excesses other than a literally possible excess supply of labor, cannot logically contain an excess supply of labor. So we must interpret the Keynesian model as an attempt to represent a certain kind of temporary equilibrium.
II. TEMPORARY EQUILIBRIA RESULTING FROM A KEYNESIAN LEVEL OF AGGREGATION

We now aggregate our temporary equilibrium model to a Keynesian level to facilitate comparisons with standard Keynesian models. Besides money, the model so aggregated contains a single labor aggregate which produces a single capital output. Also, as noted in the introduction, the diminishing marginal product of labor essential to any Keynesian environment implies the existence of a non-labor input, which, for an economy of variables, we take to be the services of capital. Thus, imposing a Keynesian level of aggregation, the minimum number of goods in the model is four, money \((M)\), capital goods \((C)\), labor \((L)\) and capital services \((K)\). There is a current market and price for each good. The price of current money is set at unity, the price of current labor is \(W\), the price of renting capital is \(R\), and the price of current capital goods, the "price level," is \(P\). Using Walras' Law to eliminate the market for \(C\), and assuming that all equilibrium prices are positive, we can use the following three equations to determine competitive prices:

\[
\begin{align*}
(4) & \quad X_K(W, P, R) = 0 \\
(5) & \quad X_L(W, P, R) = 0 \\
(6) & \quad X_M(W, P, R) = 0.
\end{align*}
\]

Our four equation system differs from the standard, abstract, four-equation representation of the Keynesian system, as described by Patinkin, in that it replaces the standard bond market with a market for capital services. Since there are no compelling a priori restrictions on the nature of the excess demand function for bonds, the usual formulation omits the bond market with Walras' Law and retains the market for capital goods—representing equilibrium in this
commodity market with an equality between savings and investment. Thus, the above set of three equations which we use to solve our system differs from the standard, three-equation set simply in that ours replaces the savings-investment equality with an equality of the demand and supply of capital services. Our recognition of the necessity of a capital services market thus allows us to substitute the powerful prior economic restrictions on input markets implied by neoclassical production theory for the familiar Keynesian conjectures regarding savings and investment behavior. Later, in attempting to resolve the difference between our results and Keynesian results, we shall find a major capital theoretic fallacy in Keynes' treatment of savings and investment. This will indicate that a second distinguishing feature of our temporary equilibrium model is that the commodity market describes a market for commodity stocks rather than flows as long as the rate of inflation remains a parameter rather than an equilibrating variable.

Equilibrium in the Factor Markets

Assuming that the markets for the factors of production are perfectly competitive and that the aggregate production function, \( F(K, L) \), has positive first derivatives and negative second derivatives, we can represent equations (4) and (5) by

\[
(4') \quad R = P \frac{\partial F(K^*, L)}{\partial K} \\
(5') \quad W(L) = P \frac{\partial F(K^*, L)}{\partial L},
\]

where \( K^* \) is the fixed endowment of capital and \( \frac{dW(L)}{dL} > 0 \), which reflects the presence of sticky, and possibly rigid, money wages resulting from the erroneously inelastic future wage-level expectations discussed in Section I.
The one-period money rate of interest is given by

$$ r = \frac{R}{P} + \frac{P^e - P}{P}, $$

where $P^e$ is the expected level of prices in the next period.\textsuperscript{7} We assume, as is conventional, that $P^e$ varies in proportion to $P$ so that $\frac{P^e - P}{P}$, the expected rate of inflation, is constant.\textsuperscript{8}

Using (5'), a given $P$ will determine an equilibrium level of $L$; then, using (4'), this level of $L$ will determine an equilibrium $R$ for the given $P$. In this manner equilibrium $R$ is determined for each possible level of $P$. Hence, we can construct the following curve, the FF curve, describing equilibrium in the factor markets:

![Figure 1. Equilibrium in the Factor Markets](image)

\textsuperscript{7} Equations (4'), (5'), and (7) are familiar, simplifying approximations to the economically correct conditions. (4') and (5') are approximate because the output of a production process comes after the inputs are employed so that a slight, possibly arbitrarily small, discount factor should be applied to $P$ in computing the values of the marginal products. (7) is an approximation of the money rate of return on capital because $R$ is received in the beginning of the period and may be reinvested for compound interest, adding a "second order of smalls" term, $\left(\frac{R}{W}\right)r$, to the definition of $r$ in (7). None of these simplifications is crucial to our argument.

\textsuperscript{8} More generally, $(P^e - P)/P$ is a wealth-weighted average of individual inflationary expectation rates. The assumed absence of any significant effect of present prices on this average rate of expected inflation is a reflection of a world in which, roughly speaking, the number of times that a given commodity price change is followed by another step in the same direction is not significantly different than the number of times that the given change is followed by a step in the opposite direction. Evidence for this property of commodity prices is abundant (See, for example the review of Fama).
That \( r \) rises with \( P \) is due to the fact that when there are only two factors of production and a linearly homogeneous aggregate production function with a diminishing marginal product of labor (i.e., \( \frac{\partial^2 F}{\partial L^2} < 0 \)), the factors of production must be complementary. Under these conditions the increase in \( L \) induced by an increase in \( P \) will, by increasing \( \frac{\partial F(K^*,L)}{\partial K} \), increase \( R \) more than in proportion to the increase in \( P \). Since it is plausible that there is some positive money wage at which no labor will be supplied and an upper bound to the marginal product of labor, it is plausible to assume that marginal costs (i.e. marginal labor costs) are positive even at zero outputs. It follows that the FF curve approaches the horizontal axis at a positive price level, indicating that real wages become so high when prices fall to a sufficiently low, positive level that no production is profitable. Also, a physical limit to the quantity of labor service possible during the time period implies that the FF curve reaches or approaches an upper bound as \( P \) increases.

**Equilibrium in the Money Market**

We turn now to the combination of \( P \) and \( r \) that will produce an equilibrium in the money market. In a Modern Money Economy, money is a non-interest bearing asset whose supply may be taken as an exogenously determined constant. With such monetary institutions, the greater \( P \) and higher demand for money implies an excess demand for money. Therefore, a higher interest rate is required to reduce the demand for money sufficiently to restore equilibrium in the money market.\(^9\)

The curve showing the levels of \( r \) and \( P \) consistent with equilibrium in the money market, the standard LM curve, is as shown in Figure 2.

\(^9\)We may adopt here the standard simplification that the aggregate demand for money is insensitive to the wage rate. Without this assumption, and without a rigid money wage, the \( r-P \) combination generating "equilibrium in the money market" should be interpreted as the \( r-P \) combination generating equilibrium in both the money and labor markets. And the conceptual experiment described in the text would be more completely described as follows: A greater \( P \) implies a greater \( W \) to achieve equilibrium in the labor market. The greater \( P,W \) pair then implies a greater \( r \) in a Modern Money Economy in order to reduce the demand for money back to the original supply of money. The result is again an LM curve with the standard curvature.
Figure 2. Equilibrium in the Modern Money Market

This curve displays the values of P and r which simultaneously satisfy equations (6) and (7) (and also equation (5') if $X_M$ is sensitive to W and W is not rigid). The curve shows a positive lower bound on r because of the plausibility of a liquidity trap and is drawn convex from below because of the weight of numerous theoretical and empirical studies.

In a Classical Money Economy (Thompson, 1973), money is competitively supplied and varies with the demand for money so as to keep the price level constant at a predetermined conversion rate of money into commodities. The resulting LM curve is shown in Figure 3.

Figure 3. Equilibrium in the Classical Money Market
Temporary Equilibrium for a Modern Money Economy

1. Graph of the Solutions

The FF curve and the LM curve for a Modern Money Economy are superimposed in Figure 4 to determine the pairs of \( r \) and \( P \) that are consistent with a temporary equilibrium in all markets in a Modern Money Economy.

The equilibrium points in the commodity market for a Modern Money Economy, the CC curve (as implied by Walras' Law), are also shown in Figure 4. By Walras' Law, the curve must connect the equilibrium points and stay between the FF and LM curves, the latter following from the fact that the excess demand for both money and resources are of the same sign for points which are not between the LM and FF curves. The economic rationale behind the positive slope of the CC curve is that, starting from a commodity market equilibrium, a higher price level will reduce the demand for the existing stock of commodities so that a higher rate of return to owning commodities will be required to restore the original level of demand for them. Our CC curve contrasts sharply with the familiar IS curve in conventional macrotheory, a curve which has a negative slope and is generally supposed to represent points of equilibrium in the
commodity market. The source of the difference is that the conventional IS curve is an attempt, albeit misplaced, to determine an equilibrium flow rate of spending on commodities rather than an equilibrium in the market for owning a stock of commodities. While equilibrium in the latter market is described by our CC curve, equilibrium in the former, flow market requires that we go beyond a simple, single-period, temporary equilibrium model with a parametrically given rate of inflation, which we do in Section III.

2. The role of aggregate spending and the Keynesian Stock-Flow Fallacy

All of this is not to say that the flow of aggregate spending is irrelevant to our temporary equilibrium. The expected rate of inflation may depend parametrically upon the expected rate of spending. Then, an increase in the expected rate of spending on consumption or investment (or, more generally, an increase in the expected future excess demand for goods at the originally expected prices) would, by increasing $P^e$ and thus $r$ for a given $R/P$, shift up the FF curve. In a Modern Money Economy, this shift induces a movement out of money in the current market (a movement along the LM curve) and a higher current price level. This exogenous treatment of expenditures variables, while perhaps most practical from the standpoint of business cycle policy, does not capture the Keynesian concept of an equilibrium rate of expenditures.

In order to obtain an equilibrium rate of expenditures — and thus an equilibrium rate of capital accumulation — a corresponding price variable must be added. The only economically natural price to introduce to equilibrate the demand and supply of next period's capital goods is the price of next period's capital goods. This converts $P^e$ into an equilibrating variable. Indeed, Section III below will show that if $P^e$ is made the equilibrating price variable, making the rate of inflation an independently equilibrating variable rather than an expectations parameter determined by other variables in the system and extending the
temporary equilibrium to a two-period equilibrium model in which only prices in the third and later periods may be incorrectly expected in the current period, the Keynesian expenditures condition, the equality of ex ante savings and investment, is indeed achieved. However, Section III will also show that the familiar Keynesian comparative-static results that are based upon a negatively sloped IS curve fail to hold in the extended model just as they fail in the above, single-period model.

3. Stability

In Figure 5, \( E_s \) denotes a "stable" equilibrium, and \( E_u \) denotes an "unstable" equilibrium.

An equilibrium is "stable" when any sufficiently small change in prices away from the equilibrium implies prices changes which return the economy to that equilibrium. The dynamic price adjustment conditions are:

\[
(7) \quad \frac{dp}{dt} = f_c(x_c), \quad f_c(0) = 0 \quad \text{and} \quad f'_c > 0, \quad \text{and}
\]

\[
(8) \quad \frac{dr}{dt} = f_k(x_k), \quad f_k(0) = 0 \quad \text{and} \quad f'_k > 0,
\]
where the labor market is assumed to remain in temporary equilibrium, as necessarily occurs when the supply price of labor is constant, indicating rigid, rather than just sticky, money wages. The possible dynamic paths are indicated by the arrows in Figure 5. There is an unstable equilibrium at low output prices and interest rates which points out the dangerous possibility of a vicious decline toward zero production in a Modern Money Economy. When output prices fall, capital rentals fall, which induces increases in the demand for money which makes output prices fall even faster, etc.

4. A Dynamical Advantage of Secular Inflation in a Modern Money Economy

The above analysis can be used to establish a dynamical advantage of secular inflation in a Modern Money Economy. Suppose we reduce the rate of secular inflation, shifting down the FF curve by the reduced rate of inflation (and then shifting it part of the way back up, because of the induced reduction in full equilibrium money wages, so that employment and thus real interest rates remain unchanged). Since the distance between the stable and unstable equilibrium points is now smaller, and the danger zone of Figure 5 in which prices and production plunge toward zero is now larger, the likelihood of the plunge towards zero is increased. Furthermore, a sufficiently large reduction in the rate of secular inflation in a Modern Money Economy will shift down the FF curve to where it will not touch the LM curve. The dynamic adjustment conditions in (7) and (8) then imply an inevitable decline towards zero output prices and production.\(^{10}\) This is illustrated in Figure 6.

\(^{10}\)If our aggregative model allowed the possibility of some zero prices, as admitted in our general temporary equilibrium model specified in part I, there would be a stable equilibrium at a zero \(P\) and positive \(r\), where the LM curve would cross the vertical axis. The FF curve would move left along the \(P\) axis until it hit the origin, at which point it would rise to meet the LM and CC curves at a stable equilibrium.
Figure 6. The Extreme Danger of a Sufficiently Low Rate of Secular Inflation

Our assumption that there is a stable temporary equilibrium at strictly positive prices implies that the rate of expected inflation in a Modern Money Economy is sufficiently high that the FF and LM curves intersect. Our subsequent discussion of comparative statics in a Modern Money Economy will assume that this stable equilibrium is achieved.

5. Comparative Statics and Gibson's Paradox

Our temporary equilibrium model implies that a leftward shift of the LM curve, which occurs in a Modern Money Economy when there is a shift up in the excess demand for money, will lower both the stable equilibrium price level and interest rate. In contrast, in a standard Keynesian model, a leftward shift in the LM curve will increase the equilibrium interest rate while it lowers the equilibrium price level because of the negatively sloped IS curve. Of course, a downward shift in the FF curve, like a downward shift in the Keynesian IS curve, will reduce both the price level and interest rate in stable temporary equilibrium. Our model thus implies that the stable equilibrium interest rate
and price level will be positively related for all business cycles while the Keynesian model implies that business cycles induced by monetary shifts will be characterized by opposite movements of the equilibrium interest rate and the price level. "Gibson's Paradox" is the historical observation that interest rates are low during all periods of low prices and high during all periods of high prices while the observed fluctuations are at least sometimes due to monetary shifts. This observation is implied by our model of temporary equilibrium but is inconsistent with, and is indeed a "paradox" within, conventional Keynesian Models.

Temporary Equilibrium in a Classical Money Economy

1. Graph of the solution with a Classical Money Economy

Figure 7 shows the solution \( r, P \) for a Classical Money Economy.

![Figure 7. The Temporary Equilibrium in a Classical Money Economy](image)

Market adjustments in the classical model are simple. Convertibility of money into commodities insures a given price level \( P^* \); this \( P^* \) is taken over to the real markets to determine employment and then the interest rate. As illustrated in Figure 7, there is no possibility of an unstable equilibrium in this model.
2. The superiority of the Classical Money Economy in a single output economy

So far, two kinds of dynamical superiority of a single-commodity, Classical over a single-commodity Modern Money Economy are readily apparent. First, the Classical Model has no unstable equilibrium. Second, the Classical Economy does not admit the unsystematic welfare losses due to errors with respect to forecasting future price-levels. These price-levels are given by the conversion rate in a Classical Money Model. A third kind of dynamical superiority also exists. This single-commodity Classical Money Economy also has superior overall responses to exogenous shifts.

In a Classical Money Model, any upward shift in the excess demand for money induces an equal increase in the competitive supply, with no resulting change in the LM curve. The same upward shift in a Modern Money Economy shifts the LM curve to the left, inducing lower prices, interest rates, and employment in the stable temporary equilibrium. A downward shift in the marginal product of capital, which shifts down the PF curve, produces no change in the price level or employment in the Classical Money Economy (See Figure 7) but lowers the stable equilibrium price, interest and employment levels in a Modern Money Economy (See Figure 4). Finally, a reduction in the marginal physical product of labor or an increase in the supply of labor (given the laborers' future wage expectations) will increase unemployment in both types of economies and yield no systematic difference in the magnitudes of the induced unemployment in the two types of economies. Also, shifts in the capital stock produce no unambiguously superior employment response in one system over the other.

Ruling out these latter shifts in order to clearly exclude these unsystematic differences from our formal analysis, we find an unambiguous dynamical superiority of Classical over Modern Money Economies in a single-output, temporary equilibrium model. That is, the Classical temporary equilibrium is
uniformly superior with respect to both stability characteristics, price-level
certainty, and employment responses to exogenous shifts. \(^{11}\)

3. The failure of the Classical commodity standard

However, when another output is added to the economy, the unemployment
induced by certain exogenous shifts, those which alter relative output prices,
may be substantially greater in a Classical Money Economy than in a Modern Money
Economy. This occurs when private money suppliers make money convertible into
a single real output, say gold, at an intertemporally fixed conversion rate
rather than into a price-weighted index of real outputs. Then a shift up in
the demand for gold lowers the money prices of all other outputs and employment
more than would occur in an economy with a fixed money supply (Thompson, 1973).
In terms of our graph, such a shift in gold demand shifts the Classical LM
curve defined for the price of non-gold assets to the left. An example of
such a shift was the large increase in gold demand in 1926–28 which accompanied
the gradual return of Europe to the gold standard at the pre-WWI conversion
rate despite the approximate 50% jump in non-gold prices and money supplies which
had occurred since they had abandoned the gold standard during the war. The
restoration of the traditional, pre-war demand and relative price of gold thus
implied a return to the pre-war level of non-gold prices, and thus a huge,
33%, shift back in the LM curve defined in terms of non-gold prices. The
resulting depression in the gold-standard countries led to the final abandonment
of the Classical gold standard, despite its otherwise salutory properties,
and to the birth of the modern monetary system.

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\(^{11}\) This complements the statical superiority of the Classical Money Economy, a
superiority which arises from the fact that a full competitive equilibrium in
a Classical Money Economy is Pareto optimal, while a full equilibrium in a
Modern Money Economy is generally Pareto nonoptimal (Thompson, 1973, 1974).
The general nonoptimality of the latter equilibrium results both from the
well-known "tax on money balances" (Bailey, Friedman) implied by the modern,
legal restriction that no interest be paid on money and from the fact that
any Modern Money Economy admits a full equilibrium with a zero price of money.
Another disadvantage of the Classical gold standard relative to a Modern Money Economy is its relative inflexibility in altering prices and employment with monetary policy. The money supply in a Modern Money Economy is an easily controlled variable while there is no corresponding variable in an economy with a Classical gold standard. (Central banks during the gold standard era had some effect on the price of non-gold commodities relative to gold by altering the transaction costs of private borrowing or lending, but clearly the effect was limited in scope and costly to achieve.) A reduction in the conversion rate, since it is known with certainty to the laborers, is ineffective: The FF curve shifts down with the shift out in the LM curve so as to leave the rate of interest unchanged.

4. **The gradually emerging Classical Money Economy**

The modern monetary system is itself, fortunately, being gradually replaced by a new kind of Classical Money Economy, one without the critical, dynamical defects of the earlier Classical system. In the emerging Classical Money Economy, costlessly produced, non-interest-bearing, government currency, rather than gold, is the backing for competitively produced money. Currency in the emerging system, which is frequently labelled "the cashless society," receives no premium for its ability to serve as a medium of exchange; it acquires positive value, even though it has no real social cost of production and no consumptive or productive value, by way of a non-monetary function contrived by the government. In particular, the government limits the supply of currency and requires individuals to pay taxes -- we assume proportional income taxes -- with currency. Thus, the government controls the demand for currency by controlling the tax rate and the supply of currency by controlling the government's cumulative rate of currency expenditure. The price levels at some tax payment
dates are then determined by

\[ c = tPF(K^*, L) \]

and \((5')\), where \(c\) is the supply of government currency immediately before tax collections at those dates, \(PF\) is national income over the tax period, and \(t\) is the income tax rate. The real value of money is thereby determined by the private non-monetary value of currency as an asset required for paying taxes, and money receives no premium for its liquidity because sufficient quantities are always costlessly and competitively supplied.

Since currency bears no direct interest, receives no liquidity premium, and generates no real services prior to tax-payment dates, individuals must be given a discount to induce them to purchase currency with productive real goods before a tax-payment date. That is, a holder of currency prior to a tax-payment date must gain through the real appreciation of his currency relative to capital goods at a rate equal to the rental rate on capital, \(\frac{R}{P}\), in order to induce them to hold the currency. The resulting expected short term deflation makes the money rate of interest, as defined in equation (7), equal to zero. Money thus receives no liquidity premium reflecting a contrived scarcity of money in this, as in any, Classical Money Economy. When the upcoming date of tax payment satisfying the above equality arrives, the government will receive all of the currency. Hence, a jump in the entire price level (including wages) immediately following such dates implies no cost

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12 Equation (9) should not be taken to represent a "currency-quantity theory" because: (1) It only holds at certain dates so that the "velocity" term does not represent a rate of turnover of a given stock of money over time (currency supplies between tax collection dates are irrelevant), (2) the "velocity" term is set by the government (as the income tax rate) rather than determined by the complex workings of the private economy, and (3) quantity theories -- whether represented by price-specie-flow mechanisms, the English Currency School, or the monetary theories of Marshall, Fisher, or Friedman -- all assume away any independent, non-monetary determination of the price level or aggregate income; our causal relation is from the independently determined price level to the total money supply rather than vice versa.
to anyone since no one is a net owner of currency when the price jumps.
(Competitive suppliers of money which is convertible into currency at a
fixed intertemporal rate must, however, compensate anyone who holds their
monies through such periods with an interest payment equal to the percentage
jump in the price level.) Such jumps in the entire price level are generally
required in order to climb onto a new deflationary price path to the price
level which is expected satisfy (9) and (5') at the next relevant tax payment
date. Thus, the price (and wage) level solution to this model is a function
over continuous time which falls at a rate equal to the marginal product of
capital up to a certain tax payment date, at which time it jumps discontinuously
and then again follows the deflationary path to the price which is expected to
rule at the next tax payment date for which the equality will again hold.\footnote{13/}

It is apparent from our equation describing equilibrium in the currency
market (which is not the money market) that equilibrium income is determined by
(5') and the currency supply and tax rate as long as all taxes are income taxes.
This is a direct way of showing that the Keynesian shifts, shifts in the excess
demand for money, in the marginal product of capital, and in aggregate expendi-
tures and thus the expected rate of inflation, have no effect on equilibrium
income in this model.

\footnote{13/} This continues on until the last date of tax payment, when the equality must
hold because there is no use for currency beyond this date. Assuming a full
equilibrium, the tax payment date at which the equality must hold immediately
preceding the last tax payment date is, moving backwards in time, the first
date for which the currency supply is less than the taxes which would be pay-
able if we used the price level implied by the deflationary path to the last
tax period — i.e., for which the rate of growth of aggregate real taxes to
the last tax date exceeds the sum of the corresponding real rate of interest
and the growth rate of the currency supply. If such a tax date exists, then
the immediately preceding tax date at which the equality must hold would be
the first tax date, again moving back in time, for which the growth rate of
real taxes is this date exceeds the sum of the corresponding real rate of
interest and the growth rate of the currency supply. This procedure continues
on back to the present period to determine all of the dates in which the equal-
ity must hold. For any other date, the supply of currency is greater than or
equal to the demand for currency to pay current taxes given the price level
function derived above.
To construct a vertical LM curve for this model, which is necessary for us to represent it as a Classical Money Model, first use equation (9) to construct a negatively sloped curve relating the price level to the employment level. Then use equation (5') to construct a positive relation between the price and employment levels. The intersection of these curves determines the price level used in constructing the vertical LM curve. (Recall that an LM curve is properly derived as a curve representing equilibrium in both the money and labor markets.)

This Classical Money Economy does not have the pair of dynamical weaknesses of the Classical system with fixed convertibility into a particular commodity in that: (1) A price index rather than a particular price is being exogenously determined so that shifts which alter relative output prices do not create systematically higher or systematically lower money prices, such as occurred in the 1920's, and (2) the currency supply or tax rate may be controlled by the government in order to freely combat changes in employment due to shifts in the marginal physical product or supply of labor. Yet this gradually emerging Classical Money Economy has all of the important strengths of Classical systems: stability, imperviousness to Keynesian shifts, and static efficiency.
III. A TWO-PERIOD GENERALIZATION OF THE TEMPORARY EQUILIBRIUM MODEL FOR A MODERN MONEY ECONOMY

We now allow all individuals to have perfect foresight of the price which will equilibrate the demand and supply for commodities and money in the second period. This gives us a solution price of goods in the second period which is perceived in the present (first) period and, thus, an equilibrium rate of inflation. That is, we add

\[ X_{20}(W,R,P,P_2) = 0 \]

to the above system, as described in equations (4), (5'), (6), and (7), replacing \( p^e \) in this system with \( P_2 \).\(^{14}\) Walras' Law for period 2 is used to omit the money market for this period. The reason for this is that we wish to employ the a priori information contained in the Keynesian view of the world, a priori information regarding the time rate of change in commodity demands and supplies rather than in money demands and supplies.

Consumption is the source of decreased commodity supply and net output is a source of increased supply. For an equilibrium in the period 2 commodity market as well as the current-period market, the planned increase in commodity supply, net output minus consumption, must equal the planned increase in commodity holdings. In other words, planned savings must equal planned investment in a two-period generalization of our temporary equilibrium model. To illustrate the workings of the model, consider an increase in planned consumption or investment. This shift

\(^{14}\)For the sake of simplicity and realism — and in order to better approximate a Keynesian view of the world — we are not assuming a second round of equilibrating production decisions. We thereby assume neither an equilibrating market for labor in the future nor an equilibrating future interest rate. It is only our attempt to better approximate a Keynesian view that motivates our current assumption of an equilibrating future price-level; we do not believe this assumption to be a useful one for practical macroeconomic analysis.
will equivalently increase the excess demand for capital goods in the second period and, since this market equilibrates, will raise the price level in the second period. This in turn produces a shift up in the initial-period FF curve and thus also raises the present price level and rental rate.

While this extended model has a more Keynesian flavor than our basic temporary equilibrium model above, the necessity of an endogenous inflation rate and a parameter representing the rate of growth of the money supply, together with the necessity of a capital services market, make it distinctly non-Keynesian, both in form and in spirit. Nevertheless, this model enables us to employ the Keynesian concept of an equilibrium rate of spending. So we shall pursue the model a bit further to see whether its comparative static properties match those of our basic model or those of the standard Keynesian model.

The Effect of a Monetary Expansion on the interest rate

Suppose now there is a shift producing larger money supplies in both periods which increases the successive output prices in the two-period equilibrium by the same percentage, thereby leaving the inflation rate unaffected. We then can use our basic one-period model to show that the shift only moves the initial-period LM curve to the right. This implies an increase in the interest rate as well as the above increase in the initial period's output price. In contrast, in the standard Keynesian model, a uniform increase in the money supply lowers the interest rate. Thus, the standard Keynesian model, by failing to be disciplined by the implied market for capital services, and correspondingly failing to allow for the determination of an equilibrium rate of inflation, produces economically incorrect comparative statics.
Loanable Funds Theory

Like the Keynesian equality of savings and investment, the pre-Keynesian equality of the supply and demand for "loanable funds" occurs in a special case of an extension of our basic model to two periods. Adding either equality, in our world where bonds and capital goods act as perfect substitutes, amounts to simply adding an equality of the demand and supply for capital goods in the next period. As above, such an equilibrium serves to determine an equilibrium rate of inflation and thus an equilibrium money rate of interest. From our standpoint, then, loanable funds theory is neither the competitor to, nor the equivalent of, liquidity preference theory that it is represented to be in the conventional macroeconomics literature. Rather, the loanable funds equality is a substitute for the savings-investment equality as a representation of the equality of the demand for and supply of commodities in the following period. Either equality, if used, complements liquidity preference theory in it gives us an equilibrium inflation rate -- in place of a parametrically given inflation rate -- to add to the capital rental rate in determining the interest rate.

One might have expected the stock-flow literature of the 1950's to discover that an equilibrium inflation rate is implied in a Keynesian equilibrium consistent with capital thoery, just as it is implied in any stock-flow equilibrium. But the literature stopped short of this, arguing through an unfortunate misapplication of stationary equilibrium analysis that a stock-flow equilibrium requires a zero rate of price appreciation.

The Effect of an Imperfect Capital Market

It might appear that the Keynesian comparative static result that an increase in the money supply decreases the rate of interest could be
recovered by the introduction of a bond market whose interest rate, \( i \), is less than \( r \) by the cost of borrowing per dollar, a cost which rises with the amount of borrowing and lending in the period. Then we could make the increased money supply go into bonds, increasing the volume of lending and widening the spread between the two rates of interest, \( r - i \). This could, conceivably, reduce the rate of interest on bonds even though it increased \( r \). But the reduction would apply only to the initial temporary equilibrium. Since the additional loans contracted in the initial period would rationally extend through at least two production periods, the amount of new lending in the second period would not expand. Hence, \( r - i \) would return to its pre-shift value in the second period. Extending the second period to allow production, both \( r \) and \( i \) would increase in the second period by an amount equal to the increase in the marginal product of capital induced by the higher price and employment levels. Viewing the first period as merely a transition period, we would still be left with the non-Keynesian conclusion that a one-shot increase in a stationary supply of money will increase equilibrium interest rates.

On Related Models in the Literature

Several capital-theory-oriented macromodels — notably those of Tobin, Foley-Sidrauski, and Floyd-Hynes — have incorporated an equality of the marginal product of capital with the real interest rate and noted at least the possibility that increases in the money supply would increase the interest rate. However, minor technical defects in each of these models prevented these authors from recognizing that the Keynesian equality of ex ante savings and investment implies an equilibrating rate of inflation. As a result, their models, which are all
implicitly single-period temporary equilibrium models, suffer from an irrelevant (in Tobin's case) or misleading Keynesian inclusion of consumption functions.\textsuperscript{15}

\textsuperscript{15} Foley-Sidrauski and Floyd-Hynes use the consumption function to determine the split between consumption and investment in a two-sector, one-period model. This is misleading because Keynesians do not use the consumption function this way. They use it to obtain an ex ante equality of savings and investment. The authors do not recognize, although Foley-Sidrauski certainly come close, that their equilibria are not Keynesian as ex ante savings are not generally equal to ex ante investment in their equilibria.
IV. EXTENSIONS OF THE TEMPORARY EQUILIBRIUM MODEL OF INEFFICIENT EMPLOYMENT

Non-Keynesian Inefficient Unemployment and the Great Depression

The bulk of the inefficient unemployment during the Great Depression was clearly not the searching and resting of overoptimistic workers. If workers become unduly pessimistic about their future productivity in their initial occupations relative to other occupations, they will accept low-paying jobs as trainees in other occupations in the hopes of relatively rapid advancement, perhaps trying out several occupations. This inefficient occupation switching not only increases unemployment rates during the switching process, it reduces the real product of the employed labor force and produces relatively long periods of learning and readjustment. The behavior of employment and real wages during the Great Depression appear to fit this pattern. That is, during the output decline of the Great Depression, aggregate real wages barely rose whereas they would have increased significantly if there were merely Keynesian unemployment; similarly, real wages rose dramatically during the upturn whereas they would have fallen if the unemployment were merely Keynesian. This inefficient employment pattern was greatly exacerbated by President Hoover's policy of influencing many large firms to maintain the previous level of money wages. This policy led to a rationing of the higher-paying jobs and an influx of workers into lower-paying jobs in the same occupation. The resulting widening of the intra-occupational wage differential induced many of the unfavored workers to inefficiently switch occupations as their relatively low wage within the occupation deceived them into the belief that they had a substantial productive inferiority in their current occupation, and their relatively low wage compared to the average wage level in the economy made other occupations appear relatively attractive.
Competitive Inefficiencies Resulting From Inter-Firm Shifts

In Parts I - III, Keynesian unemployment stems from labor's confusion of aggregative changes in the labor market with inter-firm changes. While only aggregative changes in the labor market have been considered since early in Section I, as is traditional in macroeconomic policy discussions, the necessary inability of some laborers to distinguish an aggregative change from an inter-firm change also has implications for efficient economic policy in response to the necessarily present, inter-firm shifts in the demands for or supplies of labor.

Some of the laborers in firms which offer lower wages as a result of an inter-firm shift, believing erroneously that the lower offers may be the result of an aggregative shift, will search too little. But the laborers who are employed in the firms which are now offering higher wages will not quit. Thus, the net value of resources devoted to job search is secularly too low as the workers affected by an inter-firm shift, those who should be induced to search by inter-firm shifts away from their current employments, erroneously believe that the reduction in their current wage offers may be the result of an economy-wide shift.

A policy to combat such an inefficiency is one which subsidizes a worker to quit his current job and search for another when he is faced with a reduced demand for his services from his current firm. Such a subsidy actually does appear in numerous modern economies in the form of "unemployment compensation." Since unemployment compensation is often regarded as "merely an insurance plan" even though it is involuntary, we should compare the implications of this view to that of our own. First, since job search normally results in re-employment, or at least gives the searcher an almost complete view of the market in a few months' time, a subsidy which compensates a worker according to our theory for
time spent between jobs would normally end after a few months' time. But an insurance plan to protect a worker against extreme variations in wealth would not be so limited. In fact, observed unemployment compensation plans end the subsidy after a few months. Second, since our insufficient job search results from some workers' placing too high a value on work relative to search, an efficient system of unemployment compensation will tax work income in order to subsidize search. But contributions into an efficient insurance plan would be lump-sum payments rather than payments which further reduce one's incentive to work through their dependence on income from employment. In fact, observed unemployment compensation is financed by employment taxes. Finally, an insurance plan would increase the premiums to those individuals who are most frequently unemployed while a subsidy program would levy a fixed charge independent of his past unemployment record. In fact, observed unemployment compensation plans do not substantially punish a worker who is frequently unemployed with a relatively high insurance premium.
SUMMARY

Section I presented a general description of any competitive economy with an underemployment equilibrium. In this description, any underemployment equilibrium is a "temporary equilibrium" (see, for example, Hicks, 1965, or Arrow-Hahn, 1971).

Section II used the general, temporary equilibrium model to derive the model which follows logically from a Keynesian level of aggregation and neoclassical production. The derived model with modern, or Keynesian, monetary institutions turned out to be a familiar Keynesian model with the important exception that the familiar equality of savings and investment, with all of the psychological conjecture underlying the savings and investment functions, was replaced with a simple equality of the demand for and the supply of capital services, which is derived from standard marginal productivity theory. The derived model was used to:

- Contrast the comparative statics of the derived model with those of the standard Keynesian model, noting the superior ability of our model to explain Gibson's Paradox;
- Contrast the stability characteristics of economies with modern and classical monetary institutions, noting a dangerous instability at low levels of interest rates in a modern money economy, a problem absent in the standard Keynesian misformulation;
- Contrast the appropriate macroeconomics under competitive and modern monetary institutions, noting the existence of a financial system which is superior to both modern and classical monetary systems;
- Expose a basic stock-flow fallacy in Keynesian models, a fallacy due to the fact that a savings-investment equilibrium is not possible without an equilibrating future price level and thus an equilibrating rate of inflation.

Section III briefly outlined a generalization of the temporary equilibrium model to a two-period equilibrium where equilibrium rates of expenditures and inflation can occur. There we showed that key, comparative-static results of
standard Keynesian theory fail even when we allow the inflation rate to vary in order to achieve an equilibrium rate of expenditures.

Section IV elaborated the basic, temporary equilibrium model of unemployment sufficiently to rationalize unemployment insurance as a possibly efficient government policy and to develop an explanation of the peculiar pattern of real wages and unemployment during the Great Depression.
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