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Time, Inventories, Profits and Pricing

8.1 The role of time

We shall not present a model in this chapter. Instead the chapter will be entirely devoted to the measurement of profits, costs and inventories, together with an analysis of the way in which firms’ pricing decisions distribute the national income. The subject matter is intricate and potentially controversial because there are so many ways in which accounts are kept. Our guiding light will be that the concepts and definitions will always meet the consistency requirements of the double entry matrices which underlie all our work. In particular, the definition of profits and the way in which appropriations are recorded must fit into a transactions matrix describing a whole economy so that all rows and all columns sum to zero. This will guarantee that our concepts are sufficiently good even if they are occasionally controversial since we shall ensure that the sum of all inflows will always be equal to the sum of all outflows.

The behavioural and accounting problems we shall encounter stem largely from the fact that, in contrast with all the models so far presented, we shall not assume any more that whatever is being produced will be sold within the accounting period. We now deal with the more general case where, except in the stationary state, the amount of goods produced in a given period will be different from the amount sold in the same period. This will allow us to take the concept of time much more seriously. Introducing time in economic models forces the economist to take into account aspects of the economy which are often brushed aside, such as uncertainty, credit finance and inventories. The following is a good statement of that claim.

1 Some economists argue that this concern with time is a defining tenet of post-Keynesian economics (Davidson 1982: 14; Henry 1993).
Firms require revolving finance from banks, not only because production and distribution take time while wages have to be paid in advance of sales being made, but also because they cannot know exactly what their sales are going to be ... It is unrealistic to suppose ... that what is produced in one period will automatically be sold in the next. (Godley 1999a: 396)

It will be a very important part of our story that firms initiate production, that the production process takes time and therefore that firms need finance in advance of their receiving anything from sales. Firms engage in production in the expectation that they will be able to set a price and achieve enough sales at that price to generate some target level of profits.

In each period, there is thus a possibility that what has been produced will not be sold. This can arise for three major reasons. First, production takes time, and hence what has been produced during the accounting period may yet be unfinished and not ready for sale. The unfinished product will thus be added to the stock of goods that are carried by the firm – it will be added to the inventories of the firm. Second, the product may be finished within the accounting period, but it may require some time to be distributed and sold (the market period is not simultaneous with the production period). Our model will underline a third cause of the discrepancy between production and sales within a period, which is uncertainty.

Because production takes time, firms must anticipate their sales for the current or the next period. They can only rely on their best estimates of these sales, and they cannot forecast them with perfect certainty. Because production takes time, the goods that they expect to sell must be produced in advance. Because demand by customers may exceed production, firms must set aside stocks of produced goods that will generally make it possible to satisfy demand whenever it exceeds production. These precautionary stocks of goods are the inventories of the firm. Based on their past experience and best-practice management techniques, firms will set a target inventories to sales ratio, which should allow them to respond fully to any peak in demand, while minimizing the costs which are associated with the carry of finished but unsold goods. Consumers see examples of these every day: in grocery shops, in furniture stores, in the lots of auto dealers.

In any period, except in a stationary steady state, even without forecasting mistakes, there will be a discrepancy between the production and the sales of the period. This is because firms are continuously building up or reducing

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2 Some economists (e.g. Shaikh (1989); Smithin (1986)) assume that goods produced at time $t - 1$ are all sold at time $t$. We are uncomfortable with this assumption because part of what is sold in period $t$ may also have been produced in period $t$. Also the assumption denies to inventories their ‘buffering’ role to which we attach so much importance.