1 Keynes and the Classics

1.1 THE NEOCLASSICAL THEORY OF INCOME AND EMPLOYMENT: AN INTRODUCTION FROM A KEYNESIAN PERSPECTIVE

Neoclassical theory is basically a theory of prices and efficient allocation of resources. Before the Keynesian revolution it did not include a theory of national income and employment. According to Keynes (Keynes, 1936), the neoclassical view of national income and employment was best described as the tendency towards full employment which was demonstrated, or rather justified, by accepting Say's law (Say, 1828). A popular version of this law asserts that 'supply always creates its own demand', meaning that, in general, there can be no overproduction.

The argument for this thesis assumes a barter economy characterised by an extensive division of labour. In such an economy agents act as independent producers. They produce what they can make most efficiently and exchange for other goods the surplus produced. Since production requires work, that is, human effort, the level of production is established at the point where the amount of goods obtainable by exchange compensates, in terms of satisfaction, for the sacrifice necessary to obtain that level of output. Economic agents, therefore, produce the exact equivalent of what they wish to demand and so output is the same as demand for goods. Since nominal demands equal nominal supplies at the individual level, demand equals supply at the aggregate level also.

When this reasoning is applied to a monetary economy, money is regarded as a medium of exchange, an instrument which facilitates transactions; and since money is demanded only in order to be spent, the following argument is justified.

Since the aggregate output value is distributed entirely in the form of nominal income, nominal output equals nominal income. If no rational agent wishes to hold money for the sake of it, desired expenditure will equal income. Therefore, desired expenditure will equal nominal output. This corroborates Say's law, which states that supply always creates its own demand.

Say's law has an important corollary. It implies that demand im-
poses no upper limit to output. Demand adjusts automatically; but output, in principle, can reach any non-negative level. The tendency to increase production caused by forces that push production towards full-employment output if there are unemployed resources, means that the upper limit of output is established in the labour market. Indeed, if we assume that there is price flexibility and maximising behaviour on the part of the agents, output level will be determined by the amount of labour offered. Therefore, employment and output are solved in the labour market, while nominal price level and money wages are determined in the money market. This separation of the roles of the real markets (goods and labour) and the money market is the basis of the classical dichotomy. Classical dichotomy means that, in the classical model, real variables (output, employment and real wages) are determined in the real markets, while money variables (monetary price level and money wages) are determined in the money market.

1.2 A SIMPLE NEOCLASSICAL MODEL

A mathematical model supporting the previous conclusions has been reconstructed *a posteriori*. It takes into account what Keynes said about classics in his *General Theory*. At an early stage, this reconstruction was steeped in Marshall’s methodology of partial equilibrium (Marshall, 1920), which defines the market for each good only in terms of the price of that good. These separate markets are combined into a set of markets and adopted as a general model. This should be kept in mind when the neoclassical model is evaluated.

From Keynes’s point of view, the neoclassical model can be rebuilt on the following hypotheses:

(a) validity of Say’s law;
(b) perfectly competitive markets;
(c) agents’ rational behaviour, that is, agents’ maximising behaviour;
(d) technology is represented by a production function with a fixed capital stock.

The above hypotheses, considered separately or jointly, imply that:

- aggregate demand equals supply at any level of output;
- the level of output is determined at the point where the marginal revenue of product equals the money wages;