

Carl Christian von Weizsäcker –
Max Planck Institut zur Erforschung von
Gemeinschaftsgütern, Bonn, Deutschland

In our discussion in Vienna last Wednesday I made one remark which I want to substantiate by sending you two papers of mine. I said: “price inertia is a necessary assumption if we want to derive “Keynesian” results concerning the (potential) lack of effective demand. There are exegetes of Keynes who say that price rigidity is not a necessary condition for a (potential) lack of effective demand. I believe they are in error.

My proof is this: 1. From the point of view of micro-analysis of markets price rigidity is a necessary consequence of what I call market asymmetry: in our world the supply side of the market tends to be specialized, the demand side is diversified as concerns demand. This market asymmetry is itself a result of the division of labour (which, following Adam Smith, is the main source of national wealth: sentence 1 of Wealth of Nations). The market asymmetry goes together with the following asymmetry: the price tends to be set by the supplier, the quantity of the transaction tends to be set by the customer. The price quite generally is above marginal cost (monopoly, oligopoly, monopolistic competition). Suppliers make an effort by advertising etc. to sell more than they actually sell. (In perfect competition markets there is no advertising). After the transaction between two parties the customer is transaction saturated, the supplier remains transaction hungry. For reasons which I provide in the attached paper on Hayek and Keynes, this market asymmetry leads to price inertia in most markets (I have more on that in other publications which I could provide to anyone who is interested). The market asymmetry leads to reserve capacities as a general rule in most markets. Thus on the macro-economic level a small rise in effective demand can always be accommodated, the price level remaining the same. In this sense effective demand is almost always the short run constraint of national product.

2. Even if it were more of theoretical rather than practical interest could it not be the case that even in an hypothetical economy with universally flexible prices problems of lacking effective demand may frequently arise? My answer is: no, unless you allow for just as many situations where the problem is the lack of what I call “effective supply”. To show this I have developed a little model of a planet in a galaxy far away from us. There the demand side is specialized whereas the supply side (i.e. the production sector) is not. There they don’t have division of labour, but division of consumption. There we also observe price inertia and market asymmetry. But the roles of suppliers and customers are interchanged: the demand side sets the prices; the supply side sets the quantity of the transaction. After the transaction the supply side is saturated whereas the demand side remains transaction hungry. Prices are set below the marginal utility of money, whereas they equal marginal cost. Whereas in our world the Keynes-Hicks IS curve is downward sloping it is upward sloping on this other planet. This other planet never is confronted with a problem of effective demand; but it may frequently be characterized by a lack of effective supply. In our world, if there is a problem of insufficient effective demand it is I that determines S. On the this far away planet: if there is a problem of insufficient effective supply S determines I. In our world, if there is too little effective demand the central bank reduces the rate of interest. On the other planet, if there is a problem of insufficient effective supply the central bank raises the rate of interest.

3. Full price flexibility then is the intermediate case between our real economy and the economy on the other planet. Logically there is no reason why the economy with full price flexibility should be more similar to our real world economy than to the economy on the other planet. If we follow Keynes and consider effective demand to be a problem of the real world, but not “effective supply” then we have to adhere to the logic of the model of the real world which exhibits substantial price inertia.