Fiscal policy in fixed price regimes

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This essay is a brief introduction to an area of economic analysis that was rather popular during the late 1960s when Keynesianism was at its height. Fix-price analysis was an attempt to establish solid microeconomic foundations for Keynesian macro-theory. Unfortunately, however, these microfoundations proved to be fertile ground for the resurgence of classical economic conclusions, as the "rational expectations revolution" demonstrates. In the essay, I will follow the particular variant of fix-price theory outlined by Malinvaud (*1), whose book contains a particular emphasis on the policy conclusions that can be drawn.

As its name suggests, fix-price theory involves the assumption that neither price nor wages move to clear markets. Depending on the price and nominal wage levels that the economy finds itself with, it can end up in one of three states (strictly speaking there are four, but the fourth is of little interest). What I propose to do is outline the characteristics of each of these cases, which then makes analysis of the effects of fiscal policy relatively simple. We concern ourselves with a representative firm and a representative consumer and analyse the effects of "disequilibrium" prices and wages. I use the word "disequilibrium" tentatively, because the analysis is equilibrium analysis in so far as a consistency exists between decisions - as Malinvaud says, this is equilibrium analysis with a specific concept of equilibrium. That this is so is illustrated by the nature of the diagrams which are "simultaneous diagrams" - the analysis of the labour market depends on what is happening in the goods market and vice versa. Two things should be noted at this stage. Firstly, given certain assumptions about the form of rationing that will take place at nonequilibrium prices, the short side of the market dominates. Secondly, the wage referred to is the nominal wage, thus the curves are drawn for a given commodity price.

Given our 2 markets there are 4 possible disequilibrium outcomes, which can be neatly summarised in the table below:

Goods Market

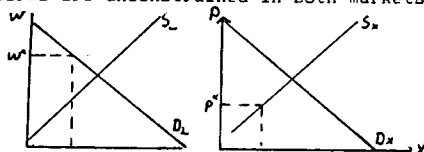|		Excess Supply	Excess Demand
Labour	Excess Supply	Keynesian Unemployment	Classical Unemployment
Market	Excess Demand	-	Repressed Inflation

The reason for the labelling will become clear.

In the Keynesian case, both markets are buyer's markets. P = P* is "high", so there is excess supply in the goods market. Firms are thus rationed in the sense that they can only sell Q*. Q* in turn implies a level of employment L* (through the production function). L* is an "effective" demand for labour since the firm cannot sell all it wants (as opposed to a notional demand/supply where the
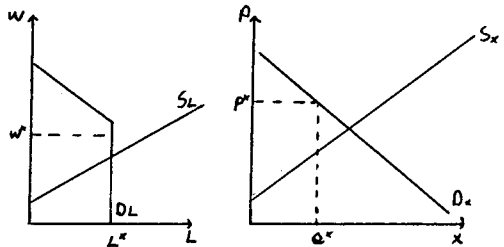
*1   E. Malinvaud, The Theory of Unemployment Reconsidered.

agent is unconstrained on other markets). Workers are unconstrained on the goods market and thus offer a notional supply of labour, and because W* is "high", L* is less than the notional supply. The crucial point is that even if the wage was to fall employment would not increase, because firms are constrained in the goods market. This is why the demand for labour is vertical at L*. At wage levels higher than W* the 'notional' demand for labour is operational. The problem with the system is that given P*, W* is too high and vice versa. Or put differently, the economy is suffering from deficient demand.

In classical unemployment the labour market is a buyers' market but the goods market is a sellers' market - firms are unconstrained in both markets and consumers are constrained in both. P* is "low" so there is rationing in the goods market, causing consumers to substitute consumption for leisure. W* is "high" so that the firms' notional demand for labour is less than the effective supply of labour. The problem now is that given W*, P* is too low, and given P*, W* is too high, i.e. the real wage is too high.

Finally in repressed inflation P* is "low" so there is an excess demand for goods, again causing workers to offer an effective supply of labour. W* is "low" so this effective supply is less than the notional demand for labour. This results in firms being constrained on the labour market. It is this which lies behind the shortage of goods in the first place. The reason for describing this equilibrium is clear - there are excess demands but they are not effective.

Having set out the characteristics of each case, policy analysis is relatively simple. By the very description of the problem in the Keynesian case as "deficient demand" it should be obvious that fiscal policy will have beneficial effects. Fiscal policy relaxes the constraint in the goods market by increasing Q*. L* in turn increases i.e. the firm employs more labour. This in turn relaxes the constraint on workers in the goods market - there is a multiplier effect on output as demands are made effective. Not surprisingly, classical unemployment is not amenable to such a solution. To deal with this case, I will assume that the government is not rationed. There is already an excess demand for goods, so fiscal expansion makes things worse. By assumption, it will displace private sector expenditure by the amount of the fiscal expansion. Workers will thus be even more constrained in the goods market and will reduce their effective supply of labour, thus reducing unemployment. The correct approach in this case is to get the real wage down. So far, I have discussed fiscal policy in terms of an increase in government expenditure. But in the repressed inflation regime a reduction in government expenditure is called for since there is already an excess demand for goods. This raises the amount of goods available to consumers, who therefore raise their labour supply, allowing employment to increase, and in turn the supply of goods.

Finally, some general comments. Firstly, note the similarity between conclusions here and those of the IS/LM unemployment policy debate. In the Keynesian case, the solution is increased government spending, and in the other cases it will not help. But the Keynesian analogy should not be carried too far because in conventional analysis, increased government spending solves the unemployment problem by reducing the real wage. In fix price theory, this, by definition, cannot happen. This analysis was used in some form from the late 50s to the early 70s by economists such as Clower, Patinkin, Barro and Grossman. It is interesting that Barro has

since become a key figure in the rational expectations school, which was born out of the quest for microfoundations. The major problem the theory always had was explaining why prices owuld be so rigid, despite supportive evidence. It is unfortunate that fix-price theory did not focus attention on the wider arguments of Clower and Leijonhufvud, who were basically arguing that the absence of tatonnement in the real world could explain price rigidities, and that this was the message of the General Theory.

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