Section 11.7 Labour Supply and Keynes' Rejection of Loanable Funds Theory

Inflation has been left out for analytical convenience above. However, the economy is overheated since aftOR exceeds 100. The inflationary process kicks in above from Period 3 onwards. The central bank is forced to raise the policy rate to prevent inflation from accelerating and the economy expanding unsustainably. By period 5, the economy returns to a 4% real and nominal rate, and Investment = 52 and Consumption = 48 in the example above.

The full employment constraint is not an immediate physical bottleneck, but a gradually emerging constraint, not directly obvious or observable. Keynes rejection of the classical theory was based on rejecting this full employment constraint. He inferred from the prolonged weak economy of the late 1920s and 1930s that there was always excess labour supply over what was then called the trade cycle, based on the observed range of unemployment and output variations:

"All these points of agreement can be summed up in a proposition which the classical school would accept and that I would not dispute; namely that if the level of income is assumed to be given, we can infer that the current rate of interest must lie at the point where the demand curve for capital corresponding to different rates of interest cuts the curve of the amount saved out of the income corresponding to different rates of interest (pg 178/The Classical Theory of Interest)……It may appear extraordinary that a school of thought should exist which finds the solution for checking the boom in its early stages by a higher rate of interest….I can make no sense of these schools of thought, except, perhaps by applying a tacit assumption that aggregate output is incapable of change. But a theory which assumes constant output is obviously not very serviceable for explaining the trade cycle." (pg 328/329 "Notes on the Trade Cycle", underlining added)

Indeed, although much of the General Theory of Employment, Interest and Money is about interest and money, which Keynes had been writing about for twenty years, it should be noticed from the title that the first topic mentioned is employment, followed by interest and money. Conversely, but similarly, when reviving the classical theory in 1967, Milton Friedman

first introduced the natural rate of unemployment concept as the basis of the aggregate output constraint to explain the links between monetary policy and interest rates.

In an economy with bank credit, credit cards and other sophisticated financing methods, the concept of the natural rate of interest (corresponding to the intersection of pure savings and investment curves) has limited validity, as Dennis Robertson himself emphasized. The analysis of this and previous chapters is based on the premise that the critical variable and underlying constraint is the natural rate of unemployment U^*, a fairly operational concept. The natural rate of interest r^* should be thought of as the subsidiary variable - that real rate r that prevails when U is at U^* (there is no operational definition of r^* based on financial variables).

Total loanable funds at r^* is comprised of not just savings out of current income but repeated ('artificial') injections of net credit or money from the banking system. As long as there is labour supply available, investment can always be financed somehow and there will always be savings forthcoming to match it.