Logical Structure of *Capitalism: Competition, Conflict, Crises*

This book attempts to offer a coherent alternative to neoclassical *and* post-Keynesian economics. The former begins from perfect competition and the latter from imperfect competition. The book's focus is instead on real competition, which is as different from perfect competition as war is from ballet. The theory of real competition provides an explanation for Kalecki's finding on interindustry pricing and profit margins and a natural foundation for Keynes' theory of effective demand which he famously insisted had to be founded in competition. The Introduction (Chapter 1) explains the project's motivations and its methodological and theoretical foundations, along with a detailed outline of the material in each chapter. In this text, which appears as a preface in various translations of the book, I provide a sketch of the internal logical structure of the book.

Real competition not perfect or imperfect competition

Much of what post-Keynesian economics sees as non-perfect ("imperfect") competition can be shown to be a necessary set of outcomes of real competition, in which price-setting firms seek to undercut their competitors by offering lower prices. The survival advantage in price-cutting goes to firms with lower costs: hence the relentless drive to cut costs, to pursue lower wages, and to develop new lower-cost technologies. The struggles between capital and labor over the length, intensity and remuneration of the working day, the mobility of capital to cheaper regions, and never ending technical change are all grounded here. The corresponding levels and paths of real wages, labor productivity and the capital intensity of production in turn determine those of the average rate of profit rate.

Relative prices, interest rates, profit rates, exchange rates and free trade

Real competition provides a theoretical and empirical explanation of relative prices, stock and bond prices, interest rates and exchange rates. At the microeconomic level, firms continue to invest only if their expected return on investment exceeds the safe yield afforded by the interest rate: i.e. only if the expected net rate of return on investment is positive. This same net rate motivates the flow of capital across industries. When the price in a particular industry is high enough to yield an above average rate of profit on investment, then new investments in the industry accelerate until its supply rises relative to its demand. This drives prices and profit rates down. The opposite occurs when profit rates are below average. The end result is a turbulent equalization of industry profit rates on investment around an economy-wide average rate, with the corresponding regulation of actual market prices by theoretical prices (prices of production) reflecting this economy-wide average rate. The same process operates on banks, since they too are profit-seeking entities. Banks supply loans whose price is the interest rate. When banks are making higher than normal rates of return on investment, new capital flows more rapidly into banking until the loan supply expands relative to its demand and drives the interest rate down; the opposite when banks are profit-poor. Thus interest rates, and a more concrete level their term structures, are regulated by competition. In a comparable manner, real exchange rates (which are relative international prices) are regulated by the relative real costs of exports and imports. Hence higher cost nations will tend to have persistent trade deficits covered by international debt – just as we find in practice. The notion that free trade leads to balanced trade, i.e. makes all nations equally competitive, is one of the great fallacies of conventional economics.

Real competition as a foundation for effective demand

This approach provides a natural foundation for the theory of effective demand. In the same manner as individual investments, aggregate investment driven by the difference between its aggregate expected rate of return (Keynes' Marginal Efficiency of Capital) and the interest rate. Only now the interest rate is regulated by the profit rate and the expectation of profitability is linked to actual profitability in the reflexive manner proposed by Soros. The loop between micro and macro is then closed on the basis of real competition. It should be noted that Keynes insisted that his theory was grounded in "atomistic competition", not imperfect competition, and that Kalecki's original formulation of his own theory of effective demand was based on the notion of "free competition". My book seeks to return the theory of effective demand to its proper ground.

Aggregated supply and demand regulated by profitability

When we speak of aggregate supply and demand, we mean *aggregated* supply and demand, aggregations of the outcomes of millions of decisions taken by individual agents which are themselves regulated by profitability. Individual firms engage in production (supply) on the basis near-term expected profitability of operations, and in the process they pay for materials, labor costs, dividends, rents, and interest payments. Payments for materials generate demand for intermediate inputs, while the other payments become the foundation for personal income from which consumption demand is funded. At the same time firms generate investment demand for new plant and equipment on the basis of their long-term expected net profitability. Hence short-term profitability regulates all of capitalist supply as well as consumption demand, while long-term net profitability regulates private investment demand. Real macroeconomics is neither supply-side nor demand-side: it is profit-side. Of course aggregated supply and aggregated demand never match directly, but instead fluctuate ceaselessly around each other. This is turbulent equalization once again, now at the aggregated level, expressed in business cycles and waves of various durations.

No reliance on rational choice and optimal outcomes

None of the foregoing arguments require so-called rational choice or its attendant bevy of perfect behaviors and optimal outcomes. Hence there is also no need to attribute actual outcomes to deviations from Edenic states supposedly arising from "imperfections" of various sorts. Perfections and imperfections are yoked pairs, simultaneously abandoned. There are, of course, real motivations for actual behaviors. Here, it is important to distinguish gain-seeking behavior from optimizing behavior. Consumers will tend to drift in the direction of sellers that offer lower prices; workers will tend to drift in the direction of higher wages; and employers will drift in the direction of less expensive workers and/or higher profit opportunities. In all such cases, the individual reactions of the heterogeneous consumers, workers and firms will vary according to more concrete factors. Some succeed, some fail, some stop short and some wander off course. Drift and diffusion go hand in hand, in economics as in biology and physics.

Consumer theory derived from socially shaped habits and incomes

Within this frame diverse consumers make personal choices based on socially-shaped habits and income and wealth levels. Class, race, gender, ethnicity, family and personal history all play their roles. Markets

adapt to consumer choices, but markets also create preferences in multiple ways. It is possible on this basis alone to construct a theory of consumer behavior which derives downward sloping demand curves, differential price and income elasticities of necessary and luxury goods (Engel's Law), and the Keynesian consumption function. It should be said that the social and cultural pressures faced by consumers are qualitatively different from the competitive ones encountered by firms for whom extinction is an ever present possibility. Neoclassical theory's symmetrical treatment of consumers and firms is simply false.

Unemployment is self-reproducing unless strictly managed

Involuntary unemployment is a self-reproducing feature of capitalism. Neoclassical theory argues that full employment is the normal state of affairs. Keynesian and post-Keynesian theories admit the possibility of persistent unemployment but argue that it can eliminated by appropriate policies. This book argues that there are intrinsic feedback loops that tend to reinstate a persistent level of unemployment unless explicitly blocked. Here too profitability plays the key role. When for any reason the labor market becomes tight, real wages tend to rise relative to productivity (i.e. real unit labor costs increase) so profitability falls relative to its trend. The decline in profitability decelerates growth and hence the demand for labor. At the same time, it accelerates the displacement of labor by machines, which also decelerates the demand for labor. Finally, rising unit labor costs increase the incentives of employers to induce more workers to join the labor force or to import them from elsewhere, which accelerates the supply of labor. The net result of these reactions is to restore some level of unemployment.

It follows that while stimulus policies can have positive impacts on output and employment in the short run, they can undermine these same effects if they broach the limits of net profitability. In the 1930s Germany eliminated massive unemployment through large budget deficits, while directly controlling prices, wages and interest rate. Real wages fell while productivity increased substantially, so that between 1931 and 1939 the profit rate rose fourfold. In the United States during World War II Federal spending rose six-fold, the public debt relative to GDP rose from 50% to 120%, national output shot up and 17 million new civilian jobs were created. Here too, interest rates were kept low, and wages and prices were regulated so that real wages rose far more slowly than productivity and after-tax corporate profits doubled. Yet in the Post-war era within the context of market determined prices, wages and interest rates, much more modest stimulus policies resulted in a rising wage share and a falling rate of profit. Unemployment crept upward, and each successive stimulus gave rise to more inflation. The Reagan-Thatcher reaction reversed these trends: from 1982-2007 the wage share fell, the profit rate stabilized, interest rates were lowered by more than half so that the *net* rate of profit rose substantially, and unemployment fell from about 10% to 4.6%. Here the unprecedented policy-driven reduction in global interest rates went hand-in-hand with the global spread of deregulated financial activities. The resulting financial and speculative bubble finally burst in 2008. More recently, from 2003-2010 two successive Lula governments in Brazil focused on the salutary task of expanding mass consumption and reducing poverty. Unemployment fell and growth averaged a robust 4%, but the wage share rose and the profit rate fell. By 2011 growth began to fall and in 2015 it went sharply negative. In all of these

cases, the lesson is that successful stimulus policies must also manage the effects on prices, wages, and profitability.

Inflation

Lastly, it is important to note that the theory of real competition addresses *relative* prices. The price level is separate matter. And here, the striking fact is that secular inflation is a modern phenomenon. In the 165 years from the eve of the US Revolutionary War in 1774 to the eve of World War II in 1939, the US consumer price index went from 8 to 14. In less than half that time, in the 71 years between 1940 and 2011 the price index went from 14 to 225. In the first interval, the annual inflation rate was a mere 0.6 percent; in the second, it was 3.8 percent: six-and-a-half times higher. The difference is a reflection of the powers, and risks, of fiat money. In the modern era, public and private credit is able to increase aggregate demand by injecting any desired quantity of new purchasing power into the economy. The question is: how does aggregate supply respond? Neoclassical theory says that capitalism always utilizes all effectively available labor, so that the growth of money supply beyond full employment growth will lead to inflation. Keynesians say that capitalism often exhibits persistent unemployment, so a sufficient expansion of aggregate demand will at first raise employment until labor reserves are thinned and only then generate inflation. In both theories, inflation is viewed as a near-full-employment phenomenon. But if the system automatically reduces the employment rate whenever it gets too high, the supply of labor cannot be the immanent limit. Ricardo and von Neumann long ago showed that the (abstract) upper limit to the balanced growth is when the whole surplus is reinvested, i.e. when the growth rate of capital is equal to the profit rate. Then the ratio of the actual growth rate to the maximum growth rate is an index of the utilization of the system's growth potential, the classical equivalent to the utilization rate of labor (the employment rate) upon which neoclassical and Keynesian theory relies. From this growth perspective, the growth of aggregate demand creates a *pull* on the growth of nominal output, while the tightness of the growth-utilization rate creates a *resistance* in the growth of real output. The rate of inflation is the difference between the growth rates of nominal and real outputs. This argument is able to explain modern inflation in a variety of places and times, and to explain the "puzzle" of rising inflation alongside rising unemployment in the 1970s throughout the developed world.

Institutions and the State

This brings up the general role of social and institutional structures. First of all, how can a system whose institutions, regulations, and political structures have changed so significantly over the course of its history still be subject to the same underlying principles? The answer lies in the fact that the profit motive always remains central and its dominance creates the force field that shapes and channels microeconomic and macroeconomic outcomes. This is the proper meaning of the invisible hand.

The state can certainly influence the course of events, but it always operates on a turbulent profit-driven stage. Competition and conflict are intrinsic features, and over time the state has responded to struggles about working conditions, unemployment benefits, minimum standards of living, socializing benefits and redistributing after-tax purchasing power. Yet government intervention has not abolished

recurrent Depressions. In developed countries just over the last eight-five years there have been three such events: the Great Depression of 1930s, the Stagflation Crisis of the 1970s, and the Global Crisis which arrived right on schedule in 2007-2008. Nonetheless, their effects have certainly been moderated: intervention in the two more recent events contained their financial impact and kept unemployment rates far lower than those in the Great Depression. These are not unalloyed benefits, since repressing symptoms may also suppress the recovery as in Japan in the latter third of the twentieth century. Still, given the cushioning capabilities of institutions and state policies, to the bulk of the population a longer period of stagnation may well be preferable to a sharp collapse. Rising labor productivity due to constant technical change is another characteristic feature of developed capitalism, and here too institutional mechanisms have strengthened to ability of workers to raise real wages. As noted, when real wages rise faster than productivity this raises unit labor cost and stiffens the resistance of firms. Then the institutional balance may shift drastically, as it did when the so-called Golden Age of Labor in 1947-1980 with its rising wage share, rising interest rates and reduced inequality gave way to the Golden Age of Capital in 1980-2008 with its rising profit share, falling interest rates and dramatically increased inequality. The State was involved in both eras, first as the welfare state and then as the neoliberal state. Institutions matter, but they are always subject to contending forces.

Finally, profit-making "neither knows limits nor morality" (Piketty, 2014, p. 6). Capitalism's efficiency consists of creating profit opportunities and cashing them in. It has created great wealth over the long run, but also great inequality. It drives the absorption of some workers and the displacement of others; the dumping of toxins and the cleanup also; the creation of cancer-curing drugs as well as the production of cancer-causing commodities. Heroin production and sale, pornography, and sex-trafficking are well-organized and highly profitable global activities. In this light, one of the great tricks of orthodox economics is the relegation of consequential social interactions to the category of externalities. It is theoretical sleight-of-hand.

Global capitalism

This book is primarily about the economic patterns in the center countries. Here, at a concrete level one must account for the influence of transportation costs, taxes, and tariffs on the mobility of commodities and capital, and of history, culture, and national restrictions on the mobility of labor. On a world scale, these assume even greater importance. Global capitalism went hand in hand with colonization, violence, slavery, slaughters of native peoples, the targeted destruction of potential competitors, and a huge transfer of wealth into the center countries. It is in this context that post-colonial development strategies sought to confront the world market, and successful modern development has often followed a path similar to the earlier times in which the current center countries rose to prominence through trade protectionism and state intervention. But these only lead to success in the world market if they provide some insulation from the pressures of global competition and a space within which to create cost-competitive products that can prosper in international competition. Free trade does not make all nations competitively equal: as with national competition, it favors low-cost producers in keeping with the laws of real competition.