

Bringing sense back to the theory of aggregate investment

Fabio Petri

Abstract:

Part I argues that marginalist theory before Keynes implicitly determined an investment function decreasing in the interest rate as the flow demand for newly produced capital goods necessary to maintain intact the optimal stock of capital, determined by income distribution and the full employment of labour (Garegnani 1964, 1978). Keynes objected that the full employment of labour could not be assumed, it had to result, if at all, from an analysis where unemployment was possible; but the implications of the absence of full labour employment for investment theory were not discussed in any depth by him, nor afterwards; there resulted a lack of theoretical rigour in investment theory, still evident in current textbooks. A number of textbook presentations are remembered and criticized. Part II notes that, in the recent vogue of real-business-cycle or New-Keynesian macroeconomic models, full employment is again simply assumed, on unclear foundations apart from an indefensible appeal to general equilibrium theory (which makes assumptions, eg. complete futures markets and the auctioneer, not to be found in the macro models, and anyway is undergoing a deep crisis of credibility). Statements can be found in this literature implying that an assumption of stock equilibrium eliminates aggregate demand problems, but it is mistaken: the full employment of factors to-day requires that investment to-day adapts to savings, which is not guaranteed by equilibrium on factor markets to-day. The problem of a theory of aggregate investment where the full employment of labour is not assumed cannot be avoided. It seems then inevitable to admit a role for the accelerator, with the consequence that the neoclassical macroeconomist must adopt the Dornbusch-Fischer approach: the rate of interest determines the desired capital-labour ratio, but desired K results from applying this ratio to the production of (expected) Y , not to full-employment L . This considerably weakens any argument for a significant elasticity of investment with respect to the rate of interest, and opens the door to multiplier-accelerator interactions. Thus the refusal to consider the Cambridge criticisms does not provide neoclassical economics with a convincing argument for a tendency to full employment in any case.