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## MARKETS AND THE MEANING OF FLEXIBILITY

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### Abstract

Markets are reputed to be more flexible than other economic arrangements, though the meaning of flexibility remains vague. For orthodox economists, it has a narrow interpretation based on relative price movements within equilibrating markets, leading to allocative efficiency. For heterodox economists and other social scientists, it goes beyond market-clearing equilibrium to take in price setting, non-price adjustments and the institutional background. This paper examines the meaning of flexibility as applied to markets and evaluates the main alternative views. The orthodox approach, which informs most economic commentary, offers a deceptive story of a complete market system with rapid price changes. Actual economies are flexible not through prices alone but through various adjustment methods.

**JEL Classification:** B52, D40, L10

**Keywords:** Markets, flexibility, price setting, relational trade, economic evolution

## 1. INTRODUCTION

Flexibility is a common idea in orthodox economics, seen as a virtue of efficient markets with a capacity for spontaneous adjustment that makes them supremely responsive to events. When markets are comprehensive and price movements unimpeded, the economy should be flexible enough to cope with external changes. Anything that obstructs markets would cause inflexibility, a symptom of market failures. Formal analysis uses neoclassical economic theory to invoke a stylised model of the market, as expounded by economics textbooks (see, for example, Sloman, Wride and Garratt 2012, Chapter 2; Mankiw and Taylor 2014, Chapter 3). The benchmark is perfect competition, which gives free rein to price movements reflecting changes in supply and demand. Curbs on price movements would stifle flexibility and create inefficiencies.

Despite its roots in abstract theory, this narrow view of flexibility has been seized upon as a blueprint for economic policies. References to flexibility, defined in the neoclassical sense, occur routinely in policy advice from the OECD, IMF, World Bank and other organisations (OECD 1994, 2006; IMF 2003, Chapter 4; World Bank 2012). Policy makers in all countries are encouraged to pursue flexibility through neo-liberal reforms that eliminate hindrances to efficient relative pricing. Such advice hails from the textbook models linking allocative efficiency with market-clearing equilibrium and exploits the positive aura of the word ‘flexibility’, suggesting suppleness that can overcome difficulties and ride out turbulence; its absence suggests rigidity that may be prone to breakdown. A flexible economy founded on flexible markets and prices is the overriding goal.

The orthodox view paints the image of a perfectly adjusted economy in continuous market-clearing equilibrium. Any interference with price movements would block the economy’s functioning to leave inefficient outcomes. Flexibility starts with pricing and then reaches out to markets and the economy as a whole, in a unified global vision of the optimum. Flexible prices, flexible markets and a flexible economy become synonymous terms from the same theoretical realm. This unified vision stands or falls

with its neoclassical rationale, collapsing as soon as we query orthodox faith in market-clearing equilibrium and point to the prevalence of market power. Wherever flexibility is not attained by price movements in efficient markets, it will be attained by other means. Markets will not bring flexibility in the neoclassical manner, nor will the economy be a complete, uniform system.

Alternative notions of flexibility, less reliant on neoclassical theory, are adopted outside orthodox economics. ‘Flexible specialisation’, for instance, entails the recent changes to the organisation of production that have permitted faster responses to local variations in demand, greater product differentiation and a more skilled, versatile workforce (Piore and Sabel 1984; Hirst and Zeitlin 1997). The focus is on production rather than resource allocation, and the discussion is set within the history of social and institutional changes. Heterodox treatments of flexibility tend to concern industrial organisation and working practices, not just markets, and make little use of neoclassical theory (Morrone 1991; Figart and Mutari 2000; Glosser and Golden 2005; Peterson and Wiens-Tuers 2014). Assessments of the potential benefits are more nuanced than those expressed in orthodox economics, since comparisons are not being made with the theoretical ideal of efficient markets. Flexibility may have costs as well as benefits for different social groups and carries no guarantee of being advantageous for everybody.

One way to challenge the orthodox view is to ponder the meaning of flexibility and resist a market-centred definition – only in neoclassical theory does flexibility have a special tie with markets, and a more general definition would loosen the tie. The present paper investigates whether markets are indeed a unique medium of flexibility through their price movements. The next section looks at how flexibility should be defined, aiming for a fuller account than usual. With this augmented definition, later sections consider in what sense, if any, prices and markets can be said to be flexible. Like other institutions, markets depend on external and informal variables for their capacity to adjust: examples are drawn from markets for finance, manufactured goods and labour.

## 2. DEFINING FLEXIBILITY

Flexibility, which derives from the Latin ‘flexus’ (bent, winding) and ‘flectere’ (to bend or to bow), referred originally to physical objects capable of bending while retaining their structure and identity. Flexible objects bend when exposed to pressure but stay intact. If flexibility is to be true to its original meaning, then it should protect things from breaking – as a trait of existing structures, it is geared to their maintenance (De Leeuw and Volberda 1996; Golden and Powell 2000; Jackson 2007a). By accommodating outside pressure, flexible structures safeguard their essence. The opposite of flexibility is for objects to be inflexible and rigid. When exposed to pressure they do not bend, and in the long run they will either survive unchanged or be broken and replaced with something new, perhaps entirely different.

Beside the capacity to bend, another quality worth distinguishing is whether, after bending, objects return to their former shape. Flexible objects might bend under pressure and then resume their former shape once the pressure is removed; both their identity and shape would stay intact. Alternatively, they might bend under pressure and remain bent once the pressure is removed; they would then acquire a new shape but still have their identity. Combinations of the capacity to bend and retention of shape yield the four cases in Table 1.

**Table 1: Alternative Versions of Flexibility and Rigidity**

		Retention of shape	
		Yes	No
Capacity to bend	Yes (Flexible)	Elastic	Malleable
	No (Rigid)	Robust	Fragile

Objects that bend or stretch but later return to their former shape can be described as elastic: they have the capacity to bend (flexibility) plus the further capacity to preserve a given shape. Objects that are flexible but do not preserve a given shape can be termed malleable. While their shape changes, they uphold their identity in the face of external pressure.

Rigid objects without the capacity to bend may or may not retain their shape when exposed to pressure. If so, they can be described as robust and have the strength to survive in the long run. Their shape, structure and identity will endure. If not, they can be described as fragile and will break when put under sufficient pressure. A broken object ceases to exist in its erstwhile form and must be reconstituted or replaced by a new object.

Cases in the left-hand column of Table 1 (elasticity, robustness) are associated with stable, unchanging institutions. Current structures can deal with events through elasticity or internal strength – there will be no transformation. Cases in the right-hand column of Table 1 (malleability, fragility) are less static. Malleable objects change shape without losing their identity, so they can evolve. Fragile objects break and do not survive unchanged; new structures may replace the current ones. On the whole, malleability is bound up with gradual evolution and fragility with sudden revolutionary changes. Although the flexible cases (elasticity, malleability) may seem dynamic and progressive, they bolster the status quo through limited or reversible adjustments. Small changes may be continual, but big changes are superfluous.

### **3. FLEXIBILITY OF PRICES**

In orthodox usage, a flexible price – the hallmark of a flexible market – moves swiftly upwards or downwards to equate supply and demand. The stress on price movements comes from the neoclassical model of a competitive market, affirmed by Alfred Marshall and embraced by orthodox economists ever since (Marshall 1920, Book V). With perfect competition the price movements would be fast enough to secure

market-clearing equilibrium at all times. Prices seldom if ever change as fast as this, however, and often seem immobile. Practical definitions of price flexibility rest on three characteristics: the frequency of price changes over a given period; the amplitude of price changes; and the amplitude of price changes relative to the amplitude of quantity changes (Ruggles 1955). A flexible price undergoes regular, substantial changes, both absolute and relative to changes in quantities. This jars with the original meaning of flexibility set out in the previous section, whereby flexible objects have a shape that can bend without losing the object's identity. Prices and wages, on a single dimension and incapable of bending, have no shape or structure and cannot flex; labelling them as flexible goes no further than saying they are variable, which would be better terminology.

According to the orthodox textbook model, price movements induce behavioural responses along supply or demand curves. Strength of response is measured by price elasticity of supply and demand, defined as the proportional change in supply/demand relative to the proportional change in price. Elastic supply and demand involve an adjustment to an external force that would return to the initial position if the force were removed: in that respect they chime with the definition of elasticity in Table 1. When supply and demand are price elastic, implying flat supply and demand curves, only small price movements will be required to restore equilibrium. Large price movements occur when supply and demand are price inelastic and slow to change. The textbook model generates the most variable prices when markets are least flexible, so that large price movements need not betoken a market that adjusts easily.

Arguments about supply and demand elasticity pertain to the ideal case of perfectly competitive markets, which assumes aggregate supply and demand curves with many sellers and buyers who are price takers and trade by price alone. Under imperfect competition, sellers and buyers are no longer price takers and have market power giving them at least partial control over prices. As there are no well-defined aggregate supply or demand curves, one cannot appeal to price elasticities or draw the textbook supply-and-demand diagrams. The market is unable to adjust through elastic behavioural responses to price changes and, if it does possess flexibility, will have to attain this in other ways. Prices under imperfect competition can still vary – they

should not be presumed fixed or rigid – but their movements will be due to deliberate price setting as against the invisible hand of the market. Decisions made by price setters may diverge from the price movements predicted by the textbook model.

Economists have long recognised that some prices are more variable than others. In the 1930s, Gardiner Means studied price movements empirically, distinguishing between ‘market prices’ (highly variable) and ‘administered prices’ (less variable) (Means 1935, 1939; Goode 1994; Lee and Downward 1999). The distinction turned on the frequency of price changes over a given period: neither type of price was fixed or rigid, but administered prices had fewer price movements. During the business cycle, market prices were expected to move procyclically (as the standard textbook analysis would predict), while administered prices would be less variable and even potentially move counter-cyclically. Unlike movements of market prices, movements of administered prices would be proportionally smaller than output changes, as firms holding prices constant might prefer to adjust their activities through output rather than price. Market prices were observed in agriculture and other sectors of the economy comprising many producers with little market power, administered prices in manufacturing and other sectors where firms have market power and set a desired price.

Means’s work prompted an empirical literature that examined the boundary between market and administered cases, together with the causes of price inflexibility (Humphrey 1937; Mason 1938; Tucker 1938; Dunlop 1939; Backman 1940). The market/administered distinction hinted that pricing could be located on a scale of flexibility, with market prices at one end, administered prices at the other, and a dividing line somewhere in the middle. Attempts to apply the scale had only mixed success, thwarted by the problems of categorising prices and specifying a borderline. It proved hard to find continuously variable prices in eternal market-clearing equilibrium – researchers could not pick out ‘pure’ price variation untainted with price-setting decisions. Causes of inflexible prices went beyond the industrial concentration highlighted by Means; among other relevant factors were the nature of the product, relations between buyers and sellers, informational asymmetries, marketing techniques, servicing of products, and the regulatory environment.



Talking about flexible and rigid prices, as is habitual in neoclassical theorising, gives a false impression that prices are either variable or static. Few if any prices are totally flexible, with the smooth, continuous price variation found in abstract models of competitive markets. Likewise, few if any prices are totally rigid, with no changes at all even in the long run. Prices undergo occasional changes between periods of constancy, so they combine features of the flexible and rigid cases. Empirical assessments of degrees of flexibility may be feasible but will not reduce to a dichotomy between flexible and rigid. Outside the perfectly competitive model, the causality underlying price movements is intricate – if imperfect competition prevails, then the usual links between price changes and demand or cost changes can no longer be relied upon (Blair 1959; Means 1972). Price changes may stray from the efficient, equilibrating path foreseen by neoclassical theory and cannot be the sole adjustment method within the market. Totally flexible prices exist only in the rarefied atmosphere of neoclassical theory, bearing scant resemblance to pricing in the real world.

The orthodox tale of flexible prices slurs over the purpose of pricing. A price is a published rate of exchange between commodities, a source of information about normalised trading conditions that should simplify trade and expand its volume (Hodgson 1988, Chapter 8). The informational function of pricing becomes paramount when trade is anonymous, as in the competitive ideal. Prices that vary continuously cannot perform this function, since they provide no stable rates of exchange for trading decisions. Rather than being efficient, ever changing prices would undermine the price stability needed to convey information. Relative prices that never settle down will increase uncertainty and discourage trade, apart from the speculative trading of those who can exploit superior information. The value of stable prices is illustrated by the price fixing within commodity markets that are nominally competitive and open to continuous price changes (Le Clair 2000; Connor 2007). Traders appreciate that they gain a mutual advantage if they preserve calm trading conditions sheltered from volatile prices. Paradoxically, the stable prices in a well established market are due to market power, an imperfection in neoclassical eyes, and short periods of active price setting lead to longer periods of trading norms. Flexibility proceeds from intermittent, conscious realignments that set prices, stabilise them and prevent the disorder aroused by ceaseless price changes.

#### **4. FLEXIBILITY OF MARKETS**

Markets as well as prices are frequently described as flexible. The original meaning of flexibility is more appropriate here, for markets are not single variables but institutions with a structure. Heterodox economists and other social scientists have emphasised the institutional background to markets, their historical specificity, their complexity, and their creation by firms and the state (Rosenbaum 2000; Sayer 2002; Swedberg 2003, Chapter 5; Fourcade 2007; Hodgson 2008; Beckert 2009). Before markets can emerge, the legal basis for voluntary exchange must be set up through property rights and contract law, which do not come about spontaneously and have to be organised (Hodgson 1988, Chapter 8; Prasch 2008, Part I). Traders fulfil the roles of seller and buyer who transfer property ownership upon payment; seller/buyer roles constitute a social structure, in so far that they fit together in pairs (a seller cannot sell without a buyer), independently of particular role occupants (Jackson 2003, 2007b). The roles are incomplete, allowing trading behaviour to vary with the agents involved, sales contracts do not cover every possible event, and relative prices cannot absorb all the information relevant to a purchase. Market flexibility hinges on how traders interact within their social context.

Neoclassical economics plays down the institutional background to markets, regarding flexibility as an offshoot of perfect competition. Even in transaction cost and related approaches, which hope to add some institutional detail, perfect competition remains the reference point (Williamson 2005). In a pure competitive market, trade is impersonal. Participants seeking the best price act as autonomous competitive traders – nobody forms a social relationship with trading partners or cooperates with them. Supply and demand are the sum of separate decisions by traders on each side of the market. A flexible market will ensue only if continuous price variations (flexible prices) bring market-clearing equilibrium. The theory is silent about how markets adjust. Modelling must be static in order to be mathematically tractable, and artificial devices like the Walrasian auctioneer sidestep trade outside equilibrium. With no price setting, the provenance of prices is unspecified, as is the equilibrating mechanism (Lee

and Keen 2004; Hahnel 2007). Existence, uniqueness and stability of general equilibrium have been stumbling blocks, so markets might not clear even if the ideal assumptions held true (Ackerman and Nadal 2004; Kirman 2006). Neoclassical theory has trouble tracing the route by which flexible prices arrive at equilibrium.

Many theorists, noting the paucity of pure price competition, discuss markets that diverge from the competitive ideal. In the structure-conduct-performance framework, market structures lie on a scale from perfect competition at one pole to monopoly at the other, with imperfect competition and oligopoly as intermediate cases (Bain 1959; Scherer 1980). Only the perfectly competitive pole has universal price taking that yields market-clearing equilibrium and Pareto efficiency. Other cases have social interactions among traders and price making by at least some agents. Orthodox economists often admit that perfect competition is hypothetical, far removed from practical experience, and that applied economics must study the imperfect cases (Scherer 1980, Chapter 2). Yet perfect competition somehow retains its place as the reference point for how markets should operate. Heterodox economists reject perfect competition and dispense with the reference point to adopt theories of price setting by firms with market power (Lee 1998; Downward 1999; Lavoie 2006, Chapter 2). Competition then occurs among rival firms interacting consciously, aware that price wars would damage their profits. Firms with price-setting abilities are loath to change relative prices and prefer output changes instead.

Actual markets have a social element acquired from recurrent interactions of traders who come to know each other and undertake relational exchange or contracting (Goldberg 1980). Such relationships abound in market trading: firms communicate with loyal customers, buyers purchase products and patronise shops on grounds other than price, sellers cooperate in setting prices, and consumers share information to act in tandem. Relationships among traders give them the positive option of using 'voice' to influence trade, alongside the negative option of 'exit' from the market (Hirschman 1970). A purist dictum that market traders should be anonymous would exclude much of the trading called a market in everyday language. With relational trade, Seller-Seller (S-S), Buyer-Buyer (B-B) and Seller-Buyer (S-B) relations are between agents who know each other and interact accordingly. Different levels of interaction ensure that

markets are diverse. For S-S and B-B relations we can distinguish three levels of interaction among sellers and buyers: unified (U) if they work as a unit (as in a cartel); rivalrous (R) if they interact consciously and sometimes cooperate but remain competitors; and atomistic (A) if they behave as anonymous individuals without consciously interacting. These three levels of interaction in S-S and B-B relations give rise to the nine cases of S-B relations in Table 2.

**Table 2: Trading Relations within Markets**

Case 1:	S(A) – B(A)	Universal price taking
Case 2:	S(R) – B(A)	Rivalrous price setting by sellers; buyers are price takers
Case 3:	S(U) – B(A)	Monopolistic price setting by sellers; buyers are price takers
Case 4:	S(A) – B(R)	Rivalrous price setting by buyers; sellers are price takers
Case 5:	S(R) – B(R)	Rivalrous price setting by sellers and buyers
Case 6:	S(U) – B(R)	Contested monopolistic price setting by sellers
Case 7:	S(A) – B(U)	Monopolistic price setting by buyers; sellers are price takers
Case 8:	S(R) – B(U)	Contested monopolistic price setting by buyers
Case 9:	S(U) – B(U)	Bilateral monopoly

Anonymous, atomistic trade (Case 1) requires all traders to be price takers – rare at any time, it never encompasses whole economies to bestow a general equilibrium. For many goods, the producers/sellers are better organised than the consumers/buyers, resulting in rivalrous or monopolistic price setting on the producer/seller side (Cases 2 and 3). Consumer durables typically fit this pattern, given the branding, marketing and product differentiation by firms with market power (Steiner 2001; Waldman 2003). Efforts by buyers to coordinate buying would temper the sellers’ dominance and contest their price-setting abilities (Cases 5 and 6). Most consumers are disparate individuals or families buying in small amounts, so their capacity for coordinated action has been limited, although improved communication on the internet may enhance this

(Rezabakhsh et al. 2006; Kucuk and Krishnamurthy 2007). Buyers have the upper hand if they are better organised than sellers, as when large retailers purchasing from smaller producers drive prices down – the retailers’ profits will swell, and consumers too might benefit from lower prices (Cases 4, 7 and 8). Since retailing tends to be dominated by high-street and supermarket chains, the chances of retailer power are sizeable but will vary for different goods (Dobson and Waterson 1999; Bloom and Perry 2001; Steiner 2001). The least competitive case is bilateral monopoly, where both sellers and buyers behave as a single unit, shutting out competition, and bargain over prices (Case 9). Bilateral monopolies are unusual; they may arise in areas such as health care, if a single care provider buys a unique medical product or service from a single producer/seller (Pauly 1998; Herndon 2002). All these cases would be markets in colloquial terms, even though (apart from Case 1) they lack the features of a pure competitive market.

Do the cases in Table 2 demonstrate flexibility? Case 1 alone has the continuously variable prices associated with perfect competition, while the others can be fitted within orthodox analysis (the structure-conduct-performance framework) but are imperfect. On this reckoning, Case 1 is flexible and the rest are inflexible, as they pose obstacles to efficient pricing. Few markets conform to Case 1; so few, in fact, that one struggles to find credible examples. The other cases, which permeate modern capitalist economies, do not adjust exclusively through relative prices. Acknowledging market power and relational trade widens the theoretical perspective of a market and opens up new avenues for flexibility. Trading decisions venture beyond relative prices to cover other issues, including informational matters, product branding, product delivery, payment method, timing of payment, after-sales services, and future trading relations (Shemwell, Cronin and Bullard 1994; Sirdeshmukh, Singh and Sabol 2002; Palmatier 2008). These non-price aspects of trade help to support it and create leeway for readjustments unconnected to price. Markets thereby have the capacity to bend and change shape without losing their identity: they are malleable in the sense of Table 1, but not flexible in the neoclassical sense.

The stable equilibria behind the orthodox notion of flexible markets stand remote from the real world. Elasticity of supply and demand is defined under *ceteris paribus* assumptions that isolate changes in price, income or some other variable. The selected

variable has a precise, enduring relationship with supply or demand, such that the effects of a change are reversed when the change is withdrawn. In practice, *ceteris paribus* does not hold true. Cumulative causation means that history never quite repeats itself and there is no going back to the past (Berger 2009; Pluta 2010). Any reversibility will be illusory, based on counter-factual assumptions; market readjustments cannot restore former states, even if agents try to do so. The upshot is an evolving path of revised trading relations, distinct from a stable equilibrium. Being malleable rather than elastic, markets can change shape in response to events but do not return to their previous shape – the trading partners, prices or non-price characteristics will be different.

Markets adjust during occasional outbreaks of conscious deliberation among traders, interspersed with periods of normalised trade. The adjustment periods call forth the greatest social interaction, until this settles down into stable prices and ongoing relations among traders, either direct or indirect (via product branding, loyalty schemes, customer relationship management, etc.). Normalised trade should not be chided for its inflexibility, as it reduces uncertainty and prevents disturbances from frequent price changes. The logic of an adjustment period is to permit a subsequent normal period with quieter trading conditions. Adjustment and normalisation are a duality and thus inseparable: a flexible market stems from the combination of the two. Markets dismissed as imperfect (Cases 2-9 in Table 2) have flexibilities barred from the pure competitive case by its insistence on price taking and impersonal trade. In a broader account of flexibility, price setting and relational trade are vital for the sustenance of market transactions.

## **5. EXAMPLES OF FLEXIBLE MARKETS**

The orthodox view implies that markets can be flexible in only one way, through relative price movements. The alternative view proposed above implies that markets can be flexible in ways that include non-price characteristics and conscious interaction

among traders. It is worth discussing in further detail some different kinds of market and how they adjust.

### *5.1 Finance*

Financial markets may seem to mirror the competitive ideal depicted in textbooks, for they have numerous sellers and buyers, homogeneous products, free entry and exit, and apparently rational trading decisions. On the surface they tally with perfect competition and could be expected to be Pareto efficient. Prices change quickly, satisfying the criteria for being flexible, and the changes are smooth rather than stepwise. If any markets were to be nominated as being flexible, then financial markets would be obvious candidates. In Table 1 they seem to have the elasticity that could preserve a stable equilibrium over time; in Table 2 they might be assigned to Case 1, where all traders are price takers.

The reality of financial markets has always been somewhat at odds with their competitive facade. Studies of trading behaviour in financial and commodity markets suggest that traders are not just price takers but active in setting prices and spreading information (Baker 1984; Keister 2002; Knorr Cetina and Bruegger 2002; Sassen 2005). With no Walrasian auctioneer to set prices before trading begins, traders themselves must influence the prevailing prices. Social contacts among traders push the market away from Case 1 in Table 2 towards Cases 2, 4 or 5 in which sellers and buyers set or manipulate prices, perhaps for speculative gain. Relative prices cannot provide full information, and other information sources come into play. Price setting may be overt if, say, the central bank in its regulatory role determines the normal interest rate (Itoh and Lapavitsas 1999, Chapter 7; Lavoie 2006, Chapter 3). Financial trading falls short of its competitive promise and sits a long distance from the blanket price taking of the theoretical models.

Deregulation of financial markets from the 1980s onwards has tested their efficiency. Arguments for deregulation were justified by neoclassical theory in the guise of the efficient markets hypothesis – once relieved of government interference, financial

markets were predicted to yield stable, efficient outcomes (Crotty 2009; Kotz 2009; Keen 2011, Chapter 11). Practical experience did not bear this out, after a boom was followed by the global financial crisis of 2008. Reforms touted as creating stability ended up creating turmoil. Instead of a sedate equilibrium, trading decisions led to a feverish expansion with ever more insecure finance, terminated by the crash (Bhaduri 2011; Lucarelli 2011; Palley 2012, Part I). Although the deregulated markets were ‘flexible’, they could not resolve their self-inflicted problems. In Table 1, the financial system would lie in the bottom right category – fragile – because it broke under pressure. A system said to be stable was shown wanting in the flexibility needed to elude crises.

Ultimately, government intervention had to rescue the financial system, whose difficulties were dealt with by state-organised means subsidised through tax revenues (Crotty 2009; Davidoff and Zaring 2009; Mishkin 2011). The flexibility that saved it came not from deregulated markets, which had fuelled the problems and shown that they had little capacity to adapt, but from outside, when ‘impure’ government action intruded upon the ‘pure’ markets. By the impurity principle, economic systems must have impurities if they are to survive and evolve (Hodgson 1988, Chapter 11). They are more flexible if they have multiple adjustment modes – relying on a single mode, such as relative prices, will be a recipe for fragility.

## *5.2 Manufactured goods*

With manufactured goods the accepted opinion among economists, both orthodox and heterodox, is that markets differ from the perfectly competitive case. Orthodox economics uses the structure-conduct-performance framework to place industries on a scale between perfect competition and monopoly (Bain 1959; Scherer 1980). Many are oligopolies in which rival firms partake in collusive relationships that put limits on price variation. Empirical studies within the orthodox tradition have confirmed the existence of slow moving prices (‘price stickiness’) across a wide range of goods (Blinder et al. 1998; Bils and Klenow 2004; Fabiani et al. 2007). Orthodoxy never renounces perfect competition, though, and still upholds it as the paragon of allocative efficiency and price



flexibility. All other cases (imperfect competition, oligopoly, monopoly) are criticised for causing efficiency losses from inflexible prices.

Heterodox economics, by contrast, recognises that invariant prices pervade wholesale and retail markets for consumer goods, with almost every market subject to price setting by at least some of the participants (Lee 1998, 2013; Downward 1999; Gu and Lee 2012). Market power should not be an imperfect special case but the general case at the heart of economic theory. Firms operate with excess capacity, which lets them vary output to meet changes in demand at given average costs, and the resulting slackness stays inside the borders of productive potential. According to neoclassical theory, any slackness would be a blemish on the economic system, a sign of inflexibility. In practice the opposite is true – excess capacity and invariant prices, ubiquitous in manufacturing industries, provide flexibility through easier output adjustments. Avoiding price competition maintains the mark-up of price over cost; firms will not change prices unless external events force them to do so. Competition is among rival firms interacting consciously, wary of price wars that would threaten aggregate profits (Case 2 in Table 2). Frequent price changes happen only when producers have little control over supply and prices are demand-determined: key examples are agriculture and housing. Neither cost-determined nor demand-determined prices fit neatly into the orthodox textbook model.

Price variation for manufactured goods is stepwise, such that prices are stable with occasional adjustments. A firm that faced continuously variable prices would find this awkward from the chronic uncertainty over future revenues and profit, hence the urge to reduce uncertainty by holding prices stable for as long as possible. Because prices are mostly constant, they appear fixed and would be deemed inflexible on orthodox criteria. Firms do, nevertheless, vary prices when so inclined – under cost-determined pricing, changes in costs are the chief reason for price movements (Gu and Lee 2012; Coutts and Norman 2013). Long-term price changes may be as great with the stepwise movements of ‘fixed’ prices as with the smooth movements of ‘flexible’ prices. Markets for manufactured goods possess the malleability of Table 1, where adaptation is ongoing, but no elasticity that brings a return to a former state.

### 5.3 *Labour*

Flexibility of labour markets has a heightened ethical dimension, as it bears upon working conditions and human welfare. Trading in labour is complex, owing to the vast number of working activities, the open specification of jobs and duties, the array of workers' skills, the variability of performance and effort, the scope for market power, and the tensions over management-worker relationships. Employment contracts (like any other contracts) can never be complete and leave gaps between the formal rules (Hodgson 1988, Chapter 7; Kaufman 2007). These gaps, larger than with sales or service contracts, are filled by informal agreements on working methods, with room for manoeuvre that elicits variable productivity and changes of work intensity. Buyers and sellers in a labour market may form an attachment to each other, visible in a gift relationship or loyalty between employers and employees (Hirschman 1970, Chapter 7; Akerlof 1982; Simon 1991). The peculiar features of labour markets cast doubt on whether standard market models will be adequate to analyse them. Orthodox labour economics attempts to keep perfect competition as the ideal but adds imperfections to incorporate the singularity of labour (Borjas 2013; Sloane, Latreille and O'Leary 2013). Heterodox labour economics makes no such attempt and declares the need for institutionally specific methods (Fine 1998; Champlin and Knoedler 2004; Fleetwood 2006). Analysis of labour markets will have to respect their institutional background within a capitalist economy.

Amid the attributes of labour markets are the exposure to external competition and degree of wage variability. Theorists have summarised them in models of dual or segmented labour markets, which differentiate primary and secondary sectors (Gordon, Edwards and Reich 1982; Doeringer and Piore 1985; Leontaridi 1998). Workers in the primary sector have secure, skilled employment on a hierarchical pay scale that offers advancement along a promotion ladder sheltered from external competition. This sector embraces professional and managerial workers who stay with the same employer for long periods. Trading relations are organised and structured: Cases 5, 6 and 8 in Table 2 are the likeliest, depending on the level of organisation among sellers and buyers of labour. Workers in the secondary sector must fend off external competition in

short-term employment too brief to have a definite career structure. Skills are low, jobs insecure and involuntary job changes occur frequently. With weak trade unions the workers may be price takers, so that Cases 4 and 7 are relevant, but no labour markets come anywhere near the competitive ideal of Case 1. Wage cuts are socially sensitive, especially in the primary sector, and wage movements will be small and spasmodic. Empirical evidence attests that wage rate stability is widespread across much of the economy in many countries (Dickens et al. 2007; Holden and Wulfsberg 2008; Barattieri, Basu and Gottschalk 2014). Few labour markets, even in the secondary sector, display rapid and continuous wage movements.

Many labour markets adjust not through wages but through informal changes in working practices, captured in the Marxian concepts of the labour process and the distinction between labour and labour power (Lazonick 1990; Tinel 2012). Without altering wage rates or working hours, firms can vary the intensity of work to cope with business cycles and other events. Flexibility is due to fluid working practices, as against shifts in wages or employment. Only in the long run, if changes in economic activity persist, do firms make formal adjustments. Both short-run and long-run adjustments have distributive consequences: higher work intensity or lower wages, other things being equal, will benefit employers; lower work intensity or higher wages will benefit workers. The relative bargaining strength of the two sides has a big effect on wages and working conditions. Any formal or informal changes must be negotiated, otherwise production will be vulnerable to shutdowns. No invisible hand generates a spontaneous, efficient equilibrium on which the labour market converges; things are decided deliberately, and the adjustment resembles the malleability of Table 1.

Rapidly varying wages across the whole economy would be bothersome, since they would create unpredictable income shifts and volatile aggregate demand (Lavoie 2006, Chapter 1). Limits on wage movements (via minimum wage legislation or other measures) can assist in stabilising the economy (Prasch 1996; Levin-Waldman 2001). Employers wanting to reduce their wage costs are apt to be the loudest advocates of wage flexibility, oblivious of the fallacy of composition: a change that benefits a single employer may, if adopted by all employers, harm their collective interests. Under the paradox of costs, a fall in real wages that seems to boost profitability within a single

firm will restrict aggregate demand and make it tougher for firms to realise profits by selling output – troubles with profit realisation offset a rise in profit share (Lavoie 2006, Chapter 4; Asensio, Lang and Charles 2012). The premise that employers gain from lower wage costs may not be valid when macroeconomics are borne in mind. Employers who champion flexible wages overlook the economy-wide benefits of wages not being too variable.

## **6. CONCLUSION**

Markets and flexibility are often mentioned in the same breath, as if markets have a unique flexibility denied to other economic arrangements. The warrant for this belief comes from neoclassical theory, in which adjustments take place through relative price movements. Flexibility starts with pricing and then extends to markets and the economy as a whole, adhering to a prices → markets → economy sequence. Both links in the sequence are dubious.

The link between flexible prices and flexible markets suffers the immediate problem that describing prices as flexible is a misnomer. Flexibility in its original sense refers to objects that bend and change shape, but prices have no structure capable of bending: they can be variable but not flexible. As well as being more accurate, the term ‘variable prices’ would bypass the positive connotations of an object being flexible and admit that price movements may be detrimental if they stop markets from providing stable trading conditions. A market with variable prices should not be assumed to be adjusting efficiently to changing circumstances.

The second link, between flexible markets and a flexible economy, surmises that a whole economy could be built from efficient markets in the neoclassical vein. This exaggerates the importance of relative prices, while omitting the diversity of modern economies. Markets do not adjust by prices alone and draw on a repertoire of non-price adjustments by traders who interact consciously with their trading partners. Economies never conform to a market-economy template and embody non-market components

through the activities of governments, firms and households. Far from being negligible, the non-market components play a crucial part in how economies respond to events.

Heterodox views on flexibility are almost diametrically opposed to orthodox ones. For orthodoxy, flexibility occurs when markets are complete, as in the neoclassical model of an exchange economy, and relative prices vary continuously. Any flaws in markets or barriers to price movements would hamper the economy and cause inflexibility. The image purveyed is of a complete system dealing optimally with all events but susceptible to disruption if tampered with or diluted. For heterodoxy, the economy is flexible because markets are incomplete and leave space for multiple adjustment modes and non-market organisation. Relative pricing has less significance, and market imperfections that spell inflexibility in orthodox analysis are major contributors to flexibility in heterodox analysis. Following the orthodox advice of removing them would prevent non-market adjustments, close down openings for economic evolution and increase the risk of systemic breakdown.

With its drastic ambiguities, flexibility could be written off as a word best avoided in economics. Heterodox economists might be tempted to drop the word and adopt other concepts with tighter definitions, so as to escape the orthodox bonds between flexibility and relative price movements. Flexibility is ingrained in economic discussion, however, and cannot just be ignored – abandoning the word to orthodox usage would be unwise, as it would perpetuate the myths of flexible prices and markets. A better strategy is to address flexibility directly and promote a more satisfactory account detached from ‘efficient markets’ and awake to the merits of varied market and non-market institutions. Recast in this way, flexibility becomes allied with the case for economic diversity and against free-market fundamentalism.

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