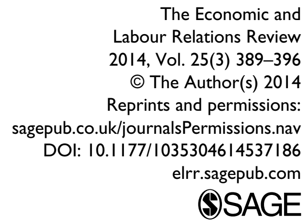
Keynote Article



What remains of the theory of demand management in a globalising world?

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Amit Bhaduri
Jawaharlal Nehru University, India

Abstract
This article explains a curious redirection of economic policies that uses the policy framework of Kalecki and Keynes only to undermine it. It does not negate their theory of demand management, but reformulates it to serve the powerful interests of finance in the era of financial globalisation. As a result, accountability to finance rather than to the citizens becomes more important for democratic governments, and credit rating dominates democratic performance.[1]

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Income distribution

Even as societies change, powerful social theories survive, not as a coherent body of reasoning but in a 'vulgar' form. The vulgar version is not mere simplification but more like a dogma without foundation in reasoning. And, when this vulgar version enters political discourse, it undergoes yet another mutation. It can be used to justify the very opposite of the policies that were originally intended. The vulgar version of Keynesian demand management theory to which almost all politicians, irrespective of their political colour, turn in times of recession is known currently as the 'stimulation doctrine', that is, stimulating the economy with liquidity from the government and the central bank to save primarily financial institutions. However, it is hoped this will also revive aggregate demand sufficiently to save not only banks but also the real economy suffering from unemployment and excess capacity.

Corresponding author:
Amit Bhaduri, Jawaharlal Nehru University, New Delhi 110067, India.
Email: amit.bhaduri@gmail.com

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This Keynesian policy is pursued, however, without any appreciation of the foundations of the underlying theory, even in academia. Indeed, most mainstream academic economists, even those who believe themselves to be 'Keynesians', continue to theorise in their technical works in a neo-classical mode. Their approach is characterised by assumptions such as representative maximising agent(s), long-run equilibrium positions from which the problem of effective demand has been banished as a 'short-term' problem and perfect flexibility of prices and wages with substitution between capital and labour induced by relative prices to reflect relative scarcity as the central mechanism for equilibrating the economy at full employment. The only deviations allowed in this neo-classical scheme are short-term failure of the price mechanism due to incomplete information.

And yet, the core of the theories of Kalecki and Keynes (despite some differences especially in dealing with money and income distribution) is derived from an altogether different set of propositions. The essential propositions are as follows:

1. Saving is first a decision not to spend and then a decision how to hold this withheld spending – that is, a financial portfolio decision rather than a decision to invest in expanding productive capacity.
2. The analogy between the individual (household) and the economy does not hold, owing to the circular flow between expenditure and income in the macroeconomy where, in a double entry national accounting format, my expenditure becomes your income. As a result, expenditure injected (as autonomous investment) in the circular flow can generate a matching amount of saving by raising income through the multiplier. In this framework, higher saving is the consequence of higher investment, and the maximising principle of the individual agent deciding between present and future consumption (saving and related financial portfolio choice) is, to say the least, an inessential detail.
3. In situations of recession, the generation of additional income in response to higher expenditure is mostly brought about through increase in production, as quantities rather than prices respond more vigorously at higher speed, even in the short run, to higher demand caused by higher autonomous expenditure. This inverts both Marshallian and Walrasian presumption that prices rather than quantities adjust in the short run.
4. In this scheme, prices respond to money wages and the level of output responds to the level of demand (expenditure) to permit an approximate separation between determination of prices and quantities. More importantly, the real wage rate becomes an endogenous outcome of the interaction between the price level and the money wage rate which makes the real wage rate an unsuitable policy instrument. Since the wage bargain is in money terms, only the money wage rate can be changed with an indeterminate effect on the extent of change in the price level and the real wage rate.

The theory of demand management was set deliberately in the context of a closed economy without foreign trade to avoid unnecessary debates and detours about the unfortunate experiences of 'beggar-thy-neighbour' policies of competitive devaluation

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in the inter-war years, as these amounted to efforts to export unemployment. The focus instead was on national policies directed towards domestic markets.[2] The context of the theory has changed drastically with globalisation.

Old trade rivalries have not disappeared in this new setting, but have reappeared in different guises as national economies lost direct control to varying degrees over their exchange rates in a flexible exchange rate regime dominated by private traders. In single currency areas (such as the European Union), no space is left for competitive devaluation, and trade rivalry takes the form of competitive unit cost reduction through national policies for real wage restraint and enhancing labour productivity, the former reducing the size of the domestic market and the latter producing more output at the cost of employment. As a result, profit margins and the profit share tend to increase, weakening consumption demand at home. The net effect is a desperate zero sum game, simultaneously pushing all countries of the single currency area towards export-led growth inside or outside the area.

This results in a return to 'beggar-thy-neighbour' policies in a different guise. Losers in this game accumulate debt – government debt. The commercial debt of individual firms and households is taken over ultimately as national debt, in a context of austerity measures and a worsening employment situation at home. The latter is produced by a shrinking domestic market on account of falling wage share, austerity measures and import surplus. The success of the winners on the other hand manifests itself in accumulating assets, mostly in the form of government-guaranteed liabilities of debtor member countries in the single currency area.

Globally, the situation is similar in many ways. The shifting of emphasis from the foreign to the domestic market proposed originally in the theories of demand management is reversed everywhere. Trade rivalry takes the form of targeting competitive unit cost reduction (including lower inflation to improve the real exchange rate) at the cost of employment generation at home. A particular national currency (the US dollar instead of British sterling) still to a large extent plays the role of international 'money' as a medium of exchange (e.g. in oil and major international insurance contracts) as well as a store of value. This bestows on the concerned debtor country issuing the 'international money' the privilege of financing its trade deficit and other payments such as investments (in real estate, natural resource acquisition and so on) by letting debt instruments accumulate abroad denominated in its own currency. Export surplus countries voluntarily hold these debts as international money. It remains a matter of speculation, how long this international exchange of paper liability for real goods and services is likely to remain a viable arrangement.

Nevertheless, academic discussions usually miss the point that the current situation is somewhat different from the case of Britain's attempt to resurrect (1926) and subsequently abandon in humiliation the Gold Standard (1931) in the face of an onslaught of downloading of sterling for gold by France and the United States. Apart from providing an important export outlet, the defence dependence of the important trade surplus countries (like Japan, Germany, Saudi Arabia) on the United States as the military super power has virtually ruled out such aggressive financial diplomacy. And yet the emergence of China as a massive trade surplus country with independent military power has introduced an unknown variable in the system. While China too depends substantially on

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the US export market, the possible use of its massive dollar surplus to challenge the hegemony of the dollar remains an open question.

Globalisation has brought about a shift in emphasis with the external market gaining steadily in relative importance over the internal market. This means not only greater openness to trade in goods and services, and in direct foreign investment, but openness to trade in financial assets. Countries are more tightly linked through a denser network of trade in goods and services, driven to a significant extent by multinational firms. The same engine drives foreign investment in the creation of new physical assets. However, far more important has been the globalisation of finance by multinational banks and other financial institutions, creating an ever increasing volume of debt contracts as derivative claims and insurances on the same set of 'underlying' physical assets for trade in foreign exchange denominated assets. Indeed, because of its sheer quantitative importance, this demarcates a new period of financial globalisation in which trade in financial assets completely overwhelms in quantitative significance all other trade in goods, services and foreign direct investments in physical assets.[3] These are assets traded as titles and entitlements in secondary (spot and futures) markets, arising from different layers of claims of indirect or partial ownership, insurances and guarantees derived from existing 'underlying' assets. These derived claims can be created and multiplied as debt contracts almost at will by the specialised institutions of big finance with high financial standing, because 'securitisation' proceeds increasingly in a self-referential way through the use of 'underlyings' created by the private financial institutions and favourably rated by credit rating agencies.

As a result, 'shadow banking' develops in a thinly supervised financial sector, which, on the one hand, escapes supervision by the monetary authority but, on the other, foregoes the guarantee provided by a 'lender of last resort'. It creates instead its own network of mutual private debt contracts, guarantees and insurances. In normal times, these debt contracts act as privately guaranteed 'credit money'. Somewhat like in an explosive chemical reaction, they act not merely as catalysts speeding up the reaction, but produce even more catalysts to accelerate the process. It is a closed self-referential system which becomes pre-disposed towards asset price inflation because it gains from the expansion of its financial market brought about by the lure of higher capital gains.

The asset portfolio of a country undergoes changes in composition owing to expectations of changes in the exchange rate, in monetary (e.g. interest rate) and fiscal (e.g. corporate tax rate) policies of national government, but most of all as a result of expectations of capital gains and losses on asset prices. Since assets are denominated in different currencies and held by nationals of different countries, portfolio changes entail cross border and cross currency transactions. As a result, expectations of capital gains and losses on existing volumes of assets (e.g. currency or interest rate swaps) can impact national economic policies significantly, mainly through the channel of international capital flows.

The fear of capital outflow that may be induced by the fiscal policy of the government places a serious binding constraint on traditional demand management policies. Kalecki (1943[1990–1997]) foresaw this possibility while discussing the political viability of full employment policies over time and its impact on the 'investment climate' of a country. He argued that maintaining the authority structure in a capitalist democracy requires

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capitalists to retain the initiative of managing the economy not only by disciplining workers but by being in a commanding position in relation to the state. Continuous high employment attained through resorting to budget deficit and public spending allows the initiative of policy making to pass from the captains of industry to the hands of the government. It also weakens the threat to workers of job loss. The authority structure of a capitalist democracy flourishes instead, if demand management is made to rely on creating a favourable climate for private investment. Therefore, proactive budgetary policies in favour of full employment are resisted in the name of 'sound finance' and insistence on the virtues of a balanced budget. Denying the basic tenet of demand management, the arguments for sound finance fall back on the false analogy between the individual and the society.

In the context of an open economy, the circular flow between total expenditure and income in the national accounts implies that an excess of either private, corporate or government expenditure (investment) over saving of that particular sector's income (saving) has to be balanced by a corresponding current account deficit in some other sector.[4] For the purpose of developing an argument in favour of the private investment climate, the excess of government expenditure over its revenue is singled out without any convincing economic reason as the main causal factor generating a current account deficit. With the threat of capital flight looming in the background in a financially globalised setting, this is a potent threat. It can set off a downward spiral of expectations of capital losses on financial assets and further capital flight far beyond the initial current account or government budget deficit. It threatens a national currency with uncontrollable depreciation especially in developing countries.

In the changed circumstances of globalised finance and massive capital flows, the theory of demand management apparently loses its potency, and even its policy relevance. But the appearance is not reality! Demand management policies returned in an unrecognisably vulgar form, totally compatible with the authority structure of finance-dominated capitalism. The acid test of the truth content of a social theory, as Joan Robinson (1962, Chapter 1) perceptively observed, can be judged only when it is separated from its ideological rhetoric. Thus, a person will continue to make use of the same theory even if (s)he changes political sides, say from Left to Right. Recent experiences would suggest that the theory of demand management passes this test well.

Relatively early indications of the change in policy direction were efforts at institutionally separating monetary from fiscal policy through the independence of the central bank and targeting inflation rather than employment. Financial globalisation and the possibility of interest induced movements of international capital flows increased the importance of monetary policy. Multinational firms with subsidiaries in many countries weakened considerably the ability of governments to collect taxes, as foot loose corporations could show their profit in the countries with lower tax rates through 'creative' transfer pricing, sub-contracting and threatening to move to more hospitable climates for investment. A competitive reduction in corporate tax rates (and later attempts at tax harmonisation) under a regime of relatively mobile capital in relation to less mobile labour steadily increased the ratio of tax on wages and salaries corporate profit. The uneven sharing of the tax burden fuelled tax payers' dissent which could spill over into dissatisfaction with high taxes which became directed towards inefficiency of public spending

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by the welfare state. In this background, rolling back of the state sector through tax cut for the rich rather than collecting greater revenue for government spending (even with a balanced budget multiplier of unity), as shown first by Haavelmo (1997 [1947]), became the acceptable strategy even in formal social democracies.

Such redistribution policies in favour of the rich are, however, flawed from the point of view of sustaining aggregate demand for goods and services because in general the rich have a higher marginal propensity to save. The compromise between Keynesian demand management and growing inequality could be resolved through rising asset prices. Enhancing the emerging authority structure of financial capital, the market for financial assets, including housing and real estate (as important variable, 'underlying' many assets such as mortgage based securities, a range of collateralised debt obligations or CDOs etc.), was greatly favoured and stimulated through tax cuts for the rich who mostly own such assets. Cheap money and deregulation helped private debt contracts to explode. Buoyant expectations about asset price rises simultaneously raised borrowers' credit worthiness and improved lenders' balance sheets. Indeed, with expectations of continuing capital gains, borrowers could service their growing debt from capital gains while lenders could increase both the volume and margin of lending. A debt-driven consumption boom seemed to resolve the nagging problem of deficient effective demand while consolidating the position of authority of the financial sector in the economy. The old Keynesian model of cooperative capitalism, in which the state helped to sustain a sufficient level of demand in order to maintain both high employment and high profit from a high volume of sales, was replaced by a model of 'Great Moderation' in which the financial sector replaced the state in maintaining demand through asset price rises with high profit (including bonuses from the 'originate and distribute' model of investment banking) for financial business. And capital inflow, lured by high capital gains, can hide problems of chronic trade deficit.

So long as prices of financial assets continue to rise, the financial sector leads in presenting a show of prosperity, increasingly delinked from the working of the real economy. This model of 'great moderation' sustains a reasonable level of demand despite increasing inequality. This growing inequality favours the rich who spend their excessive income on buying financial assets which reinforces further asset price rises, while creating the illusion of a better life for the poor on borrowed money through capital inflows and deregulated credit contracts created by the private banks and shadow banks.

The central mechanism on which the model hinges becomes the sustaining of expectations about rising asset prices, enabling increased borrowing for consumption and easy credit created endogenously by private finance. Unlike public investment through deficit financing by the state, the vulnerability of this model depends on the fragility of expectations about asset price rises. So long as the real economy expands with rising asset price, private debt increases more than public debt, sustained by various new debt instruments. These are derived from private debt contracts of mutual guarantees, without either central supervision or a lender of last resort. In this process, the distinction becomes increasingly blurred between 'money' guaranteed by the monetary authority and various private credit contracts, insured privately and issued by the financial sector. Such instruments are created endogenously by the profit-seeking private financial sector in order to exploit and create demand for assets. This unrestrained private credit expansion fuels further

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asset price rises. It raises the lure of exceptional returns especially from esoteric assets while a self-referential private credit rating system, as a creature of the financial system itself, underplays risks to keep the show going.

As this process continues, the financial system tends to delink itself increasingly from the performance of the real economy, in terms of employment and output. The turning point similar to the manner of Ponzi finance on a macroeconomic scale is reached when even higher returns have to be promised on financial investment, in order to keep the show of rising asset prices going. This continuously changes the balance from real to financial investment, the purpose of the latter being acquisition of ownership of existing assets. However, financial investment encouraging further financial investment for the purpose of acquiring existing assets does not help the real economy in raising demand for real goods and services: it simply raises the price of assets. In a more extreme case, the real economy may stagnate or even decline, while the prices of financial assets and the stock market continue to rise for a time, delinked from the state of the real economy. This is the prelude to a financial crisis as the divergence grows between the real and the financial sector of the economy. The probability of default in the real sector increases with stagnant income but rising debt. Even a small default event can suddenly push the fragile financial sector to a crisis. This is because the defaulted loan has to be covered by liquidity guaranteed by the central monetary authority as lender of last resort (money), but the elaborate network of expanded private credit contracts is incapable of providing such cover. This triggers the possibility of a chain reaction. All players in the financial sector now wish to have their loans secured with adequate liquidity, but liquidity is in short supply all around as everyone has been expanding credit contracts through private guarantees (of derivatives like loan swaps or two way counter party guarantees on collateral values). A financial catastrophe due to a sudden freeze of credit looms large.

The irony of the situation is that such a collapse of the private financial system can be avoided only by injection of liquidity into the banks by the central monetary authority and government. Largely deregulated private banking and its private system of credit creation is being rescued by a government which otherwise restrains its own budget and reduces social benefits to the poor, in order to create a better climate for private investment. However, even this might not be the final irony and the end game of debauching deliberately Keynesian style demand management. Flooding banks and the financial sector with injected liquidity is of limited use when the private investment climate is depressed in the aftermath of a financial crisis in a stagnating economy. In such situations, there are not many willing to undertake long-term investment. The financial sector may be salvaged, but the real economy continues to stagnate with high unemployment and excess capacity. Under the compulsions of democracy, the ultimate irony may even turn out to be the old remedy of massive public investment with deficit financing, in order to restore confidence in the climate for private investment in an economy in the grip of a long recession!

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Notes

1. An earlier version of this article was originally published by Wiener Institut für Internationale Wirtschaftsvergleiche (The Vienna Institute for International Economic Studies) *wiiw Policy Notes and Reports* 12 December 2013. Available: http://wiiw.ac.at/wiiw-policy-notes-and-reports-ps-25.html (accessed 1 April 2014).
2. Based on recollections of two separate conversations with Josef Steindl, a colleague of Kalecki in Oxford and, with Joan Robinson, a colleague of Keynes in Cambridge.
3. According to BIS statistics, the volume of trade in foreign exchange markets increased from a daily USD60 billion in 1983 (when all the capital accounts of OECD countries were deregulated) to USD1490 billion in 1998, and the ratio of foreign exchange transaction to world export rose from 12:1 to 100:1 during the same period. The central banks together had a reserve of USD1550 billion in 1997, hardly sufficient to cover a single day's trade in the foreign exchange. For more details, see Nayyar (2006).
4. Steindl (1941–1988), chapter 16.

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Author biography

Amit Bhaduri holds degrees from Calcutta and MIT and a PhD from Cambridge. He has held professorial/visiting professorial positions at the Delhi School of Economics and Jawaharlal Nehru University, Delhi, as well as in Mexico, Austria, Germany, Italy and Norway, and at Stanford. He divides his time between Pavia University, Italy, where he is internationally selected Professor of Distinction, and the Council for Social Development, Delhi. He has worked on various expert bodies of the United Nations, and other national and international commissions. He has published more than 60 journal articles and 6 books, including *Macroeconomics: The Dynamics of Commodity Production* (1986, Macmillan, London), *Unconventional Economic Essays* (1993, Oxford University Press, Delhi), *An Intelligent Person's Guide to Liberalisation* (co-authored with Deepak Nayyar, 1996, Penguin, India), *On the Border of Economic Theory and History* (1999, Oxford University Press, Delhi) and *Development with Dignity* (2006, National Book Trust, India).

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