WHAT REMAINS OF THE THEORY OF DEMAND MANAGEMENT IN A GLOBALIZING WORLD?

O QUE PERMANECE DA TEORIA DA GERÊNCIA DE DEMANDA EM UM MUNDO GLOBALIZADO?

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RESUMO:

O presente texto faz uma reflexão sobre a utilização do modelo de gerência keynesiano por parte dos governos mundiais num mundo agora ditado pela globalização. A teoria de gestão de demanda keynesiana nasce num contexto em que a situação da economia mundial era evidentemente diferente. Além disso, há uma certa banalização da teoria, e muitos economistas que se dizem keynesianos na verdade buscam soluções dentro de uma lógica neo-clássica. Comparando as visões de Kalecki and Keynes, o texto avalia o estatuto da teoria e discute o recorrente uso da ação governamental e seus bancos para garantir a saúde das instituições financeiras, enquanto a "economia real" e a questão do emprego seguem merecendo uma ação efetiva.

PALAVRAS-CHAVE:

Economia; Teoria da Gerência; Keynes; Globalização.

ABSTRACT:

The present text is a reflection on the use of Keynesian management model by Governments around the world in a world now dictated by globalization. The Keynesian demand management theory is born in a context in which the situation of the world economy was obviously different. Moreover there is a certain trivialization of the theory, and many economists who call themselves Keynesians actually seek solutions within a neo-classical logic. Comparing the visions of Kalecki and Keynes, the text evaluates the status of theory and discusses the applicant use of governmental action and their banks to ensure the health of financial institutions, while the "real economy" and employment follow deserving effective action.

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KEYWORDS:

Economics; Management Theory; Keynes; Globalization.

1 Introduction: A theory throughout history

Even as societies change, powerful social theories survive, not 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 very opposite policies than was 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', i.e. 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. This Keynesian policy is pursued however without any appreciation of the fundamental foundations of the theory even in the academia. Indeed most mainstream academic economists, even those who believe themselves to be 'Keynesians' continue to theorize in their technical works in a neo-classical mode. It is characterized by assumptions like representative maximizing 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 the central mechanism for equilibrating the economy at full employment. 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) are derived from an altogether different set of propositions. The essential propositions are:

1. The analogy between the individual (household) and the economy does not hold due to the circular flow between expenditure and income in the macro-economy where in a double entry national accounting format my expenditure becomes your income. As a result, expenditure injected in the circular flow (as autonomous investment) can generate matching amount of saving by raising income through the multiplier. In this framework higher saving is the consequence of higher investment, and the maximizing principle of the individual agent deciding between present and future consumption (saving) is, to say the least, is an inessential detail.

2. 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.
3. 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 wage bargain is in money terms only the money wage rate can be changed with 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 of inter-war years as they amounted to efforts at exporting unemployment. The focus instead was on national policies directed towards domestic markets.[1] The context of the theory has changed drastically with globalization.

Old trade rivalries has not disappeared in this new setting but has 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 (e.g. 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 the profit margin and share tend to increase weakening consumption demand at home, and net effect is for a desperate zero sum game pushing simultaneously all countries of the single currency area towards export-led growth inside or outside the area to make a return to the 'beggar-thy-neighbour' policies in a different guise. Losers in this game accumulate debt, government debt, commercial debts for individual firms and households which is taken over ultimately as national debt while facing austerity measures in a situation of worsening employment situation at home through shrinking domestic market on account of falling wage share, austerity measure and import surplus. The success of the winners on the other hand manifests in accumulating assets, mostly as government guaranteed liabilities of debtor member countries in the single currency area.

Globally the situation is similar in many ways. The perspective of shifting 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 real exchange rate) at the cost of employment generation at home. A particular national currency (U.S dollar instead of the British sterling) still plays to a large extent 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 to finance its trade deficit and other payments like investments (in real estates, natural resource acquisition etc) by letting debt instruments to accumulate abroad denominated in its own currency. Export surplus countries hold voluntarily these debts as international money. It remains a matter of speculation, how long this international exchange of paper liability for real goods and services would remain a viable arrangement.

However academic discussions usually miss the point that, unlike in the case of Britain's attempt to resurrect (1926) and subsequently abandon in humiliation the Gold Standard (1931) in face of an onslaught of downloading of sterling for gold by France and the United States. The current situation is somewhat different. Apart from providing important export outlet, the defense dependence of the important trade surplus countries (like Japan, Germany, Saudi Arabia) on the U.S. as the military super power 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 the U.S export market, the possible use of massive dollar surplus to challenge the hegemony of the dollar remains an open question.

Globalization has brought about a shift in emphasis with the external market gaining steadily in relative importance of 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. It is also the same engine with drive foreign investment in the creation of new physical assets.

However, far more important has been the globalization of finance by multinational banks and other financial institutions through creating 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 globalization in which trade in financial assets completely overwhelms in quantitative significance all other trade in goods, services and foreign direct investments in physical assets.[2]

They are assets traded as titles and entitlements in secondary (spot and futures) market, 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 specialized institutions of big finance with high financial standing. As a result, 'shadow banking' develops in a thinly supervised financial sector which escapes on the one hand supervision of the monetary authority but foregoes on the other 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. The private debt contracts as credit money is available to meet the demand for financial assets which themselves constitute their debt contracts in a closed self-referential system which becomes pre-disposed towards asset price inflation.

The asset portfolio of a country undergoes changes in composition due to expectations of changes in exchange rate, monetary (e.g. interest rate) and fiscal policy (e.g. corporate tax rate) of the national governments, but most of all by 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 volume of assets can impact significantly on national economic policies 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 the serious binding constraint on traditional demand management policies. Kalecki had foreseen this possibility (1943) while discussing the political viability of full employment policies over time and its impact on the 'investment climate' of a country. He had argued that maintaining the authority structure in a capitalist democracy, requires the capitalists to retain the initiative of managing the economy not only by disciplining the workers but being in a commanding position in relation tothe 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 of job-loss to workers. 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 pro-active budgetary policies in favour of full employment are resisted in the name of 'sound finance' and insistence on the virtues of balanced budget. Denying the basic tenet of demand management, it falls 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 national accounts implies the identity that either an excess of private, corporate or government expenditure (investment) over the saving of that particular sector's income(saving) has to be balanced by a corresponding current account deficit of some other sector.[3] For 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 in this identity for causing current account deficit. With the threat of capital flight looming in the background in a financially globalized settingthis 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.

2. The possibilities for Keynesian demand management

In the changed circumstances of globalized finance and massive capital flows, the theory of demand management apparently loses its potency even policy relevance. But the appearance is not reality! Demand management policies returned in an unrecognizably vulgar form, totally compatible with the authority structure of finance dominated capitalism. An acid test of the truth content of a social theory, Joan Robinson had perceptively observed, can be judged only when it is separated from its ideological rhetoric. Thus a person would continue to make use of the same theory even if (s)he changes political sides, say from the Left to the Right.[4] Recent experiences would suggest that the theory of demand management passes this test well.

Relatively early indications of the change in the direction of policy were efforts at institutionally separating monetary from fiscal policy through the independence of the central bank and targeting inflation rather than employment. Financial globalization 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 harmonization) 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 tax burden fuelled tax payers' dissent which could spill over into dissatisfaction with high taxes which got directed towards inefficiency of public spending 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) became the acceptable strategy even in formal social democracies.

However, such redistribution policies in favour of the rich are flawed from the point of view of sustaining aggregate demand for goods and services because in general rich have a higher 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' of many such assets like mortgage based securities, many collateralized debt obligations etc) were greatly favoured and stimulated through tax cut for the rich who mostly own such assets, cheap money and deregulation helping private debt contracts to explode. Buoyant expectations about asset price rise raised simultaneously 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 effective demand while consolidating the position of authority the financial sector in the economy. The old Keynesian model of cooperative capitalism in which the state helped to sustain sufficient level of demand 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 rise with high profit for financial business. And capital inflow on the lure of high capital gains can hide problems of chronic trade deficit.

The financial sector leads in presenting a show of prosperity increasingly delinked from the working of the real economy so long as prices of financial assets continue to rise. This model of 'great moderation' sustains a reasonable level of demand despite increasing inequality which favours the rich 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.

Sustaining expectations about rising asset prices enabling increased borrowing for consumption becomes the central mechanism on which the model hinges. Unlike public investment through deficit financing by the state, the vulnerability of this model depends on the fragility of expectations about asset price rise. So long as the real economy expands with asset price rise, private more than public debt rises sustained by various new debt instruments derived from private debt contracts of mutual guarantees without either central supervision or a lender of last resort. In this process, the distinction between 'money' guaranteed by the monetary authority and various private credit contracts and insured privately issued by the financial sector becomes increasingly blurred. They are created endogenously by the profit seeking private financial sector to exploit and create demand for assets. This private credit expansion without restraint fuels further asset price rise. 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 to keep the show of rising asset prices going changing the composition continuously from real to financial investment for acquisition of ownership of existing assets. However, financial investment encouraging further financial investment for acquisition of existing assets does not help the real economy in raising demand for goods and services but raises 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 and, even small event of default can suddenly push the fragile financial sector to a crisis. Because 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 it. This triggers the possibility of a chain reaction. Every player in the financial sector now wishes to have their loan secured with adequate liquidity, but liquidity is in short supply all around as everyone had expanded credit contracts through private guarantees. A financial catastrophe due to 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 injecting liquidity into the banks by the central monetary authority and government. Largely deregulated private banking and its private system of credit creation is rescued by a government which otherwise restrains its own budget and reduce social benefits to the poor 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 stagnating economy. There are not many willing to undertake long term investment in such situations. The financial sector is 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 old remedy of massive public investment with deficit financing to restore confidence in the climate for private investment in an economy in the grip of a long recession!

Footnotes:

1. 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.
2. According to BIS statistics, the volume of trade in the foreign exchange markets increased from a daily 60 billion in 1983(when all the capital accounts of OECD countries had been deregulated) to 1490 billionin 1998 and, the ratio of foreign exchange transaction to world export rose from world export 12:1 to 100:1 durin the same period. The central banks together had a reserve of 1550 billion in 1997 hardly sufficient to cover a single day's trade in the foreign exchange. For more details see, D. Nayyar "Globalization, history and development', Cambridge Journal of Economics,2006, 30:139-157.
3. J.Steindl, Collected Papers, Macmillan, London
4. J.Robinson, Economic Philosophy, chapter1.

Recebido em agosto de 2013
Aprovado em setembro de 2013