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

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Preface

In our era of global finance, the theory of aggregate demand management is alive and unwell, says Amit Bhaduri. In this policy brief, Bhaduri describes what he regards as a prevalent contemporary approach to demand management. Detached from its Keynesian roots, this "vulgar" version of demand management theory is being used to justify policies that stand in stark contrast to those prescribed by the original Keynesian model. Rising asset prices and private-debt-fueled consumption play the starring roles, while fiscal policy retreats into the background.

Returning to foundations laid down by Keynes and Kalecki, Bhaduri sets out to clarify whether there is any place for traditional demand management policies—featuring an active role for deficit spending and public investment—in the context of financial globalization, and he concludes that such policies are ultimately unavoidable if we are to revitalize the real economy and achieve stability.

This policy brief emphasizes not only that globalization has elevated the relative importance of the external market, but also that we are living through a period in which trade in financial assets, enabled by multinational banks and other financial institutions, overwhelms, in terms of quantitative significance, trade in goods and services and foreign investment in physical assets. This era of financial globalization is marked by layers of private debt contracts that are generated at will by financial institutions—a system of private credit creation that is increasingly centered on a shadow banking system that exists largely beyond regulatory and supervisory control, and (at least formally) without the support of a lender of last resort.

While some might insist that the age of global finance leaves little room for the idea of demand management, Bhaduri contends that the theory survives, but that it does so in a form that is nearly unrecognizable from the original. This contemporary model of demand management receives its inspiration from the presuppositions of neoclassical economics, and its policy emphasis is often the very opposite of the old Keynesian model. In the context of the mobile and short-term nature of contemporary financial investment, the perceived need to maintain a healthy climate for finance and protect against the risk of capital flight disciplines and constrains fiscal policy, while elevating the status of price-stability-focused monetary policy. Instead of public investment aimed at full employment, policymakers pursue restrictions on government spending and a shifting of the tax burden away from corporate profits and toward wages and salaries. Bhaduri argues that such policies exacerbate inequality and thereby suppress aggregate demand. To support demand, the "vulgar," or "Great Moderation," model hinges on the interplay between expectations of ever-rising asset prices and a consumption boom driven by private debt.

Bhaduri cautions, however, that a model centered on private credit creation is prone to instability. More and more financial investment is needed to produce greater returns and boost asset prices, continually shifting the composition of investment from the real to the financial and creating the conditions for a delinking of finance from output and employment. When the paths of the financial and real sectors of the economy diverge, when incomes stagnate while debt and asset prices continue to rise, this creates the conditions for a financial crisis. At that point, the government is called upon to inject liquidity into the financial system. But this is not enough, says Bhaduri: it saves the financial sector, but not the real economy. Ultimately, he suggests that a revival of traditional Keynesian demand management, including large-scale, deficit-financed public investment, is needed to return the real economy to a state of health and stabilize the system as a whole.

As always, I welcome your comments.

Dimitri B. Papadimitriou, *President*
January 2014

Even as societies change, powerful social theories can often survive, not as a coherent body of reasoning, but in a "vulgar" form. The vulgar version is not mere simplification but more like dogma without a foundation in reasoning. And when this vulgar version enters political discourse, it undergoes yet another mutation. It can be used to justify policies that are the very opposite of what was originally intended.

The vulgar version of Keynesian demand management theory—to which almost all politicians, irrespective of their political color, turn in times of recession—revolves around what one might call the stimulus doctrine: that is, stimulating the economy with liquidity from the government and the central bank to primarily save financial institutions. It is hoped that this will also revive aggregate demand sufficiently to save not only banks but also the real economy, which is suffering from unemployment and excess capacity. This Keynesian policy is pursued, however, without any appreciation of the fundamental foundations of the original theory—even in academia. Indeed, most mainstream academic economists, including those who believe themselves to be "Keynesians," continue, in their technical works, to theorize in a neoclassical mode. This mode 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" issue; and perfect flexibility of prices and wages, with substitution between capital and labor induced by relative prices to reflect relative scarcity—the central mechanism for bringing the economy into equilibrium at full employment. The only deviations allowed in this neoclassical scheme are short-term failures of the price mechanism due to incomplete information.

And yet, the core theories of Michal Kalecki and John Maynard Keynes (despite some differences, especially in dealing with money and income distribution) derive from an altogether different set of propositions. These essential propositions are:

> (1) The analogy between the individual (or household) and the economy does not hold, due 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 into the circular flow (as autonomous investment) can generate a matching amount of saving by raising income via the multiplier effect. 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 (or saving) is, to say the least, an inessential detail.
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> (2) In a recession, the generation of additional income in response to higher expenditure is mostly brought about through increases in production, as quantities respond more vigorously and with greater speed than prices, even in the short run, to higher demand caused by higher autonomous expenditure. This inverts both Marshallian and Walrasian presumptions that prices, rather than quantities, adjust in the short run.
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> (3) In this scheme, prices respond to money wages and the level of output responds to the level of demand (expenditure), allowing independent price and quantity determination. More important, 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 indeterminate effects on the extent of change in the price level and the real wage rate.

The theory of demand management was deliberately set in the context of a closed economy without foreign trade, to avoid unnecessary debates and detours about the unfortunate experiences of the "beggar-thy-neighbor," competitive devaluation policies of the interwar years, which amounted to efforts at exporting unemployment. The focus instead was on national policies directed toward domestic markets.[1] The context of the theory has changed drastically with globalization.

Old trade rivalries have not disappeared in this new setting but rather have reappeared in different guises, as national economies have to varying degrees lost direct control over their exchange rates in a flexible exchange rate regime dominated by private traders. In single-currency areas (e.g., the eurozone), 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 enhancement of labor 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. The net effect is a desperate zero-sum game pushing all countries of the single-currency area simultaneously toward export-led growth, inside or outside the area—marking a return to beggar-thy-neighbor policies in a different guise. Losers in this game accumulate debt—government debt and commercial debts for individual firms and households that are ultimately taken over as national debt—while facing a situation of worsening employment through a shrinking of the domestic market, due to a falling wage share, austerity measures, and import surpluses. The success of the winners, on the other hand, manifests itself in the accumulation of assets, mostly in the form of the 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 the real exchange rate) at the cost of employment generation at home. To a large extent, a particular national currency (the US dollar instead of the British sterling) still plays the role of "international money," as a medium of exchange (e.g., in oil and major international insurance contracts) and 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, like investments (in real estate, natural resource acquisition, and so on), by letting debt instruments denominated in its own currency accumulate abroad. 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 will remain a viable arrangement. However, academic discussions usually miss the point. The current situation is somewhat different from the case of Britain's attempt to resurrect the gold standard (1926), which was subsequently abandoned in humiliation (1931) after rival economic powers (France and the United States) rushed to liquidate sterling for gold. Apart from providing an important export outlet, the defense dependence of the important trade-surplus countries (like Japan, Germany, and Saudi Arabia) on the United States as the military superpower 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 into the system. While China also depends substantially on the US export market, the possible use of massive dollar surpluses to challenge the hegemony of the dollar remains an open question.

Globalization has brought about a shift in emphasis, with the external market steadily gaining in importance relative to the internal market. This means not only greater openness to trade in goods and services and direct foreign investment, but also 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 that drives foreign investment in the creation of new physical assets.

Far more important, however, has been the globalization of finance by multinational banks and other financial institutions through the creation of an ever-increasing volume of debt contracts, in the form of over-the-counter derivatives claims and insurance on the same set of "underlying" physical assets, especially 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 investment in physical assets.[2] These financial assets are traded as titles and entitlements in secondary (spot and futures) markets, arising from different layers of claims of indirect or partial ownership, insurance, 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. The center of gravity in international finance gradually shifts as "shadow banking," trading heavily in private debt instruments, develops in a thinly supervised financial sector that, on the one hand, escapes supervision by the monetary authority and, on the other, foregoes any formal guarantee provided by the lender of last resort. It instead creates its own extensive network of mutual private debt contracts, guarantees, and insurance.

In "normal" times, the trust in large, private financial institutions is high and the debt contracts circulate as privately guaranteed "credit money." However, somewhat like in an explosive chemical reaction, they not only act as catalysts, speeding up the reaction, but also produce even more catalysts, thereby accelerating the process. In a closed, self-referential system that includes private credit-rating agencies, massive amounts of private debt contracts become available on demand as credit money, fueling demand for financial assets—assets that are merely other forms of private debt contracts repackaged for financial investment. This system works well and is predisposed toward asset-price inflation to keep expectations of capital gains alive.

The asset portfolio of a country undergoes changes in composition due to expectations of changes in the exchange rate and monetary (e.g., the interest rate) and fiscal (e.g., the corporate tax rate) policies of the national governments, affecting 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, with the result that expectations of capital gains and losses significantly impact the composition of existing portfolios of assets. This is a two-way process: while national economic policies affect expectations of capital gains and losses, these expectations in turn affect national exchange rate policies through the channel of international capital flows.

The fear of capital outflow that may be induced by government fiscal policy puts a serious constraint on traditional demand management policies. Unless the sentiments of the financial market are respected sufficiently to keep "high finance" happy, capital flight becomes a threat to a stable economic environment. Kalecki (1943) had foreseen this possibility while discussing the political viability of full employment policies over time and their impact on the "investment climate" of a country. He argued that the compulsion to maintain the authority structure in a capitalist democracy requires capitalists to retain the initiative of managing the economy by disciplining workers and having a commanding position in relation to the state. Continuous high employment attained through budget deficits and public spending allows the initiative of policymaking to pass from the captains of industry to the hands of the government. Full employment also weakens the threat of job loss to workers. If demand management is made to rely on creating a favorable climate for private investment, the authority structure of a capitalist democracy flourishes instead. Therefore, proactive budgetary policies in favor of full employment are resisted and, denying the basic tenet of demand management, the false analogy between the individual and society is deployed in the name of "sound finance" and an insistence on the virtues of a balanced budget. Given his historical context, Kalecki emphasized the climate for long-term industrial investment. In contemporary circumstances, it would be more relevant to talk of a climate for financial investment that is highly mobile and typically short term. This makes the constraint of capital flight even more acute, as national economic policies have even less maneuverability and must keep the financial sector happy almost on a day-to-day basis.

In the context of an open economy, the circular flow between total expenditure and income in the national accounts implies the identity that an excess of private, corporate, or government expenditure (investment) over its income (saving) has to be balanced by a corresponding current account deficit in some other sectors to maintain overall income–expenditure balance. The excess of government expenditure over revenue is singled out by bankers and their allied academic economists, without any convincing economic reason, as the main cause of current account deficits in this identity, on the assumption that other sectors are in balance (Steindl 1990). Since persistent current account deficits can set off a downward spiral of expectations of capital losses on financial assets, leading to capital flight far beyond the initial current account or government budget deficit, they threaten a national currency with the specter of uncontrollable depreciation.

In the changed circumstances of globalized finance with massive capital flows, the theory of demand management appears to lose its policy relevance. But appearance is not always reality. Demand management returns, but in an unrecognizable, "vulgar" form that is compatible with economic austerity measures in the name of "sound finance," which restricts government spending and helps establish the authority structure of finance-dominated capitalism. As Joan Robinson (1962) perceptively observed, an acid test of the validity of a social theory can be judged only when that theory is separated from its ideological rhetoric. A theory passes this test when a person changes political orientation (say, from the Left to the Right) but continues to make use of the same theory. Recent experience would suggest that the theory of demand management passes this test.

Financial globalization and the possibility of interest-induced movements of international capital flows increased the importance of monetary policy. With that came a change in the direction of policy: the institutional separation of monetary from fiscal policy through the independence of the central bank, and an emphasis on inflation targeting rather than employment creation. Multinational firms with subsidiaries in many countries steadily weakened the ability of governments to collect taxes, as footloose corporations showed their profit in the countries with lower tax rates through "creative transfer pricing," subcontracting, and threatening to move to more hospitable investment climates. A competitive reduction in corporate tax rates (followed by later attempts at tax harmonization) under a regime of mobile capital and relatively less mobile labor steadily increased the ratio of taxes on wages and salaries to taxes on corporate profits. The uneven sharing of the tax burden fueled taxpayers' dissatisfaction with high taxes; that dissatisfaction, with considerable help from the corporate-controlled media, was redirected toward the alleged inefficiency of public spending and the welfare state. Against this background, rolling back the state sector through greater tax cuts for the rich became a politically more acceptable strategy, even in former social democracies.

However, such redistribution policies in favor of the rich are flawed from the point of view of sustaining aggregate demand, insofar as the rich have a higher propensity to save. Rising asset prices provided a way of reconciling Keynesian demand management with fiscal-policy-induced inequality. The high-income-bracket tax cuts particularly benefited those who own most of the financial assets, strengthened the alliance between the rich and the financial sector, and thus reinforced an authority structure in which financial capital and rentier interests dominate those of industrial capital. Cheap money and deregulation helped sustain high prices for financial assets as private debt contracts. Buoyant expectations about rising asset prices 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 increased both the volume and the margin of lending. A debt-driven consumption boom seemed to resolve the nagging problem of effective demand while consolidating the financial sector's supreme position of authority in the economy. The old Keynesian model of cooperative capitalism, in which the state helped to sustain a level of demand sufficient to maintain both high employment for workers and high profits for industrial capitalists from a high volume of sales, gave way to the Great Moderation model, which celebrated the supremacy of the financial sector. Capital inflow, lured by high capital gains on financial assets, added to the celebration by hiding problems of chronic trade deficits caused by high private expenditure fueled by borrowing.

The financial sector can continue to put on a show of prosperity largely delinked from the workings of the real economy only so long as financial asset prices continue to rise. And sustaining expectations about rising asset prices through increased borrowing for consumption becomes the central mechanism on which this model hinges. Unlike public investment through deficit financing by the state, which is meant to lift the economy out of a depressed state of private expectations about profits, this Great Moderation model is subject to the fragility of high expectations about private profits from asset price increases. So long as the real economy expands as asset prices rise, private debt, sustained by various new debt instruments, might be expected to rise faster than public debt. These new debt instruments may even be multiplied by various derived private debt contracts of mutual guarantees from the shadow banking sector, 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 issued and insured by the financial sector becomes increasingly blurred. These private credit contracts are created endogenously by the profit-seeking private financial sector to exploit as well as create new demand for financial assets. This expansion of private credit without restraint fuels further asset price increases. It offers the lure of exceptional returns, especially from esoteric assets, while a self-referential private credit-rating system (a creature of the financial system) gains importance in underplaying risks in order to keep the show going. Private credit-rating agencies become the guardians legitimizing the system, rating not only private credit but also sovereign risk, where the latter is meant to rate government fiscal policy in terms of its impact on financial markets.

As this process continues, the financial system increasingly tends to delink itself from the performance of the real economy in terms of employment and output. The turning point may come in a manner similar to that of a Ponzi scheme, but on a macroeconomic scale. It is reached when even higher returns have to be promised on financial investment to keep asset prices rising, which also continuously diverts the composition of total investment from real to financial investment. However, financial investment encouraging further financial investment for the acquisition of claims (and derived counter-claims) on existing assets does not help the real economy to raise demand for goods and services, but rather 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.

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 when stagnant incomes combine with rising debt and high asset prices. At this point of the Ponzi game, even a small default event can suddenly push the fragile financial sector into a crisis. Loans in default have to be covered by infusions of liquidity guaranteed by the central monetary authority as lender of last resort (money), and private unguaranteed credit is no substitute: the elaborate network of expanded private credit contracts is incapable of providing the required liquidity. Every player in the financial sector now wishes to have their loan secured with adequate liquidity; but liquidity is in short supply, since everyone had expanded credit contracts through private guarantees. 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 through an injection of liquidity into the banks by the central monetary authority and government. Largely deregulated private banking and its system of private credit creation have to be rescued by a government that otherwise has been restraining its own budget by reducing social benefits for the poor. Stimulation through the injection of liquidity is the prescription offered by the captains of both industry and finance for improving the climate for private investment—but they now need the government to deficit finance their proposed rescue package.

However, even this might not be the final irony. Flooding banks and the financial sector with liquidity is of limited use when the private investment climate remains depressed in the aftermath of a financial crisis. In a stagnating economy, there are not many willing to undertake long-term investments in real assets. The financial sector is salvaged with liquidity but the real economy continues to stagnate, with high unemployment and excess capacity. In an economy in the grip of a long recession, the ultimate irony may turn out to be in the endgame. Under the compulsions of growing unemployment and stagnating wages, resorting to the old Keynesian remedy of massive, deficit-financed public investment might become the only option left to restore the confidence of private investors.

Notes

1. Based on recollections of two separate conversations with Josef Steindl, a colleague of Kalecki at Oxford, and Joan Robinson, a colleague of Keynes at Cambridge.
2. According to Bank for International Settlements statistics, the volume of trade in the foreign exchange markets increased from a daily $60 billion in 1983 (when all the capital accounts of Organisation for Economic Co-operation and Development countries had been deregulated) to $1.49 trillion in 1998, and the ratio of foreign exchange transactions to world exports rose from 12:1 to 100:1 over the same period. The central banks together had a reserve of $1.55 trillion in 1997, hardly sufficient to cover a single day's trading in the foreign exchange market. For more details, see Nayyar (2006).

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