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Limitations of Monetary (and Fiscal) Policy in an Age of Financial Instability

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limitations ?

Monetary (and Fiscal) Policy in an Age of Financial Instability

by

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Economic policy is always multidimensional, which corresponds with the complexity of the economy. Policy interventions aim to achieve a state of the economy that is preferred to what it is believed would rule in the absence of intervention. Policy interventions are not just monetary and fiscal policy "moves" but they also include legislative and administrative decisions that affect the institutional structure. Thus in the recent past legislative and administrative decisions under the quite empty slogan of "deregulation," together with profit opportunities due to the level and swings of interest rates, have led to some significant changes in the efficacy of monetary and fiscal measures and the problems monetary and fiscal policy needs to confront.

In as much as the economy is a complex intertemporal dynamic system, policy interventions will be successful only as they are compatible with the endogenous processes of the economy.[1] Furthermore each economy, each society has a capacity to administer as well as propensities to avoid and evade measures policy may put in place. It seems clear that in most western economies except in time of serious wars, incomes policies are beyond their capacity to administer. The basic truth that the supply-siders in the United States siezed upon is that taxes and subsidies affect behavior. Tax avoidance, tax evasion and the emergence of black markets and black economies are ~~most various~~ examples of a society's propensity to avoid and evade. Policy makers and economists who analyze policy must appreciate that while policy may propose, it is the economy and society that disposes.

The "preferred" state that policy aims at is not an unambigious concept.

Jean and Peter Gray have drawn the useful distinction between the allocational and the stabilization efficiency of policy and institutional regimes.[2] We could also add a "distributional efficiency," recognizing that much of the policy debate in the United States (and I venture to say in all our economies) is about the poorly understood "who pays and who benefits" dimensions of policy.

Every theory is based upon abstractions and views as to what are the important problems that needs to be addressed. Abstraction means that some facets of the economy are knowingly ignored or misspecified in the set up that leads to the set of interrelated propositions that constitutes the theory. The use of a theory as the basis for policy rests upon the implied assumption that the abstractions upon which the theory is based do not so violate reality that operations or institutional changes indicated by the theory will not be counter-productive. Thus, in examining the allocational efficiency of competition and monopoly, the nature of the banking system may be ignored and policy interventions to affect allocational efficiency may be made without paying explicit attention to financial matters. However, it would not be warranted to ignore the financial structure if the stabilization efficiency of a policy is to be examined. But to examine the stability efficiency of even say, a structure of industry problems, the impact of the policy moves must be examined within a model in which endogenous instability is possible.[3]

Post-Keynesian economics of the kind represented at the Centro emphasizes the financial, investment and price level determining aspects of Keynesian theory and is designed to answer why our economy is "so given to fluctuations," i.e., why market capitalism with our type of sophisticated financial structure is stability inefficient.[4] In as much as the problem examined by Post-Keynesian analyse is stability efficiency, the Post-Keynesian view of the economic process is in the tradition of Smith, Ricardo and Marx in that accumulation (the generation and allocation of a surplus) is taken to be the primary problem.

Post-Keynesian economics is explicitly a theory of a capitalist economy with a sophisticated and evolving financial structure. The function of the financial structure is not, as neoclassical theory supposes, to allocate given savings among alternative claimants but rather to force and allocate a surplus. Bankers as they lend and channel funds, are financing demands that assure that income exceeds consumption. Wages paid to workers in investment goods production assure that the workers who produce consumer goods cannot buy back what they produce.

Although the subject is clearly capitalism, Post-Keynesian theory is not apologetic, capitalism is shown to be an inherently flawed system. Furthermore, Post-Keynesian theory recognizes that there are varieties of capitalism and the inherent flaw, due to the necessary financial parameters, is not as strong or equally evident in these different varieties. This is taken to imply that there are institutional and policy interventions that can affect the cyclical and distributional characteristics of a capitalist economy, if not forever, then for a substantial period of time. One striking proposition in the Post-Keynesian view is that big government capitalism is superior to small government capitalism with respect to its susceptability to deep and protracted recessions. It is also argued that the particular "big government," financial interventions, industrial structure, financial structure and labor market organizations we have, make our economy susceptible to inflation. Inflation is the price we have been paying for success in avoiding deep depressions.

While big government capitalism is stabilization efficient when it comes to the susceptability of an economy to deep recessions, the structure of institutions and policy interventions we have had is stability inefficient when it comes to inflation. Furthermore, big government capitalism requires a tax structure that takes significant proportions of income. Due to this, wedges between wages received and labor costs and between prices paid by households and prices received by business exist. Such price wedges lead to allocational inefficiencies, for marginal rates of substitution are not the same to the parties to exchange. The contrast between small and big government capitalism shows that an allocation efficient system may well not be stabilization efficient and a stabilization efficient system may not be allocational efficient.

The most significant success the Reagan Administration has had is in constraining inflation after November of '82, when the economy entered upon the current recovery. This "success" reflects the weakening and breaking of unions by a combination of large and protracted unemployment, industrial contraction, and government anti-union interventions. Unions in the "Rust-belt" clearly are being given the choice of protected jobs at constant or slowly rising nominal wages or mass unemployment and higher nominal wages: the administration is using quotas, tariffs and the prices and wages government pays to keep wages "in line." A further cause of the success in constraining inflation is the vertible flood of bargain imports reflecting the "favorable" exchange value of the dollar.

One of the policy dilemmas faced by Post-Keynesian economics has its source in Keynes' chapter 24. On the one hand he wrote, "I conceive, therefore, that a somewhat comprehensive socialization of investment will prove the only means of securing an approximation to full employment;"[5] and on the other he remarked, "If we suppose the volume of output to be given, i.e., to be determined by forces outside the classical scheme of thought, then there is no objection to be raised against the classical analysis of the manner in which private self-interest will determine what in particular is produced, in what proportions the factors of production will be combined to produce it and how the value of the final product will be distributed between them."[6] The interpretation of "the socialization of investment" and how to fit market determination of detail into a regime where a comprehensive socialization of investment exists is a topic that needs further analysis.

As an example of how orthodox neoclassical theory is counter productive, we can cite the proposition advanced by neoclassical "Keynesian" thinkers from Patinkin through Friedman that price flexibility which leads to money wage declines, will, through a combination of Keynes, Pigou and Patinkin effects, lead the economy from unemployment to full employment. This theorem is derived in a theory that abstracts from the financial structure of capitalism, in particular in this theory debt financing of business and banks (money creating institutions), whose assets are private debt, does not exist. In the Post-Keynesian versions of Keynesian theory, businesses finance their position in capital assets by means of complex liability structure. The value of assets and the quantity of money are linked to expected profit flows which in turn are linked to the expected price levels of current output. In this theory, a central theorem is that in a situation of unemployment, downside price flexibility will make things worse (increase unemployment), not make things better.

The two theories are diametrically opposed one to the other. Whereas the Pigou and Patinkin effects are arguments for letting unemployment and price deflation run their course, for the economy is self-equilibrating, the Post-Keynesian analysis indicates that interventions to sustain asset prices and aggregate, though not particular, profits is necessary if recovery is to be prompt. Furthermore, the Patinkin/Pigou effects indicate that institutions such as trade unions and agricultural price supports are bad because they impose barriers to downward price rigidity, the Post-Keynesian analysis indicates that a lack of price flexibility can be good, for it minimizes the adjustments that are necessary when the requisite fiscal ~~expansion takes~~ sustaining of profits place.[7]

Post-Keynesian theory has the behavior of banks, financing arrangements and the prices of financial and capital assets as integral parts of the processes that determine the path of the economy through time. The price level deflation that is viewed as the savior of the aggregate properties of the market economy by Friedman and Patinkin among ~~others is~~ in fact destructive of the value of bank assets and equity. This implies that a thorough going price level deflation will lead to a collapse of investment and a flight from debt. From a Post-Keynesian perspective, a price level deflation of the kind contemplated by Patinkin et al is the path to disaster, not a means of demonstrating the strength of the self-adjusting properties of a market economy. Misspecification of the economic process leads to policy recommendations that are perverse.

A peculiar characteristic of orthodox economics, whether it be conservative monetarist or traditional Keynesian, is that there is no strong place in their thinking or in their policy recommendations for profits.

Keynes supply functions of output and the demand for investment are both phrased in terms of profit expectations. Production takes place because the managers or entreprenuers -- and their bankers -- believe it will be profitable. Investment takes place because to the entrepreneur "demander" and the banker "financeer" it is evident that the investment goods in place will yield profits for a sufficient period so that the finance invested and the interest as written in the contract will be validated.

However, profits are not determined by the productivity of capital as given by a product of the marginal product of capital and capital in some function of labor and capital that carries the name of Paul Douglas and his mathematician friend Cobb. "Capital is profitable not because it is productive but because it is scarce" paraphrases Keynes; and capital is scarce exactly as aggregate demand makes it scarce.

Profits, like Janus, has two faces ~~in Economics~~: expected profits determine the demand for investment output and realized profits is the current flow that validates business debt and indicates whether the price paid in the past for capital assets was correct, too high or too low. The determination of the aggregate of profits is the appropriate or critical point of policy intervention in a capitalist economy. Policy if it is effective, will sustain profits in a contraction and constrain profits in an inflation. Appropriate policy in a capitalist economy must center around the determination of profit flows.

As Kalecki showed, profits in a capitalist economy arise out of the mechanism by which a surplus is forced.[8] In the neoclassical vision, incomes which reflect endowments and productivity are allocated to consumption and savings by households.

In neoclassical theory, the function of the financial structure is to allocate a prior determined supply of savings -- which may be a function of interest rates -- whereas in Post-Keynesian theory the function of the financial structure is to finance investment and thus force savings. It is true that investment is financed because of expected profits, but the profit expectations that lead to investment are based upon the expectation that there will be a mass of profits that will be of the order of magnitude of current profits. The newly created capital is to compete with other capitals for a share in this mass of profits. Whereas we, as economists, know that in the simple model, investment forces profits and that investment takes place because it is expected that profits (i.e., investment) will take place in the future, the individual entrepreneur and his banker financeer think of future profits in the aggregate as being more assured than the dependence upon investment would suggest. In our more complicated world where government deficits, the foreign trade balance and shifting propensities to consume out of wage and profits incomes impinge upon profits, banks and business may rely upon a more stable flow of profits than was true in the earlier simpler capitalist economy.[9] What is gained in the stability of investment performance may be lost in the assumed greater debt carrying capacity that ~~flows~~ follows from the stability of profits.

In this vision of a surplus being ~~formed~~ forced by way of the financing of investment, it is financed investment that leads to profits and profits are the major source of savings. This relation is best stated by Kalecki, but to understand the operations of our capitalist economy, the fully extended profit generation function, in which profits depend upon not only investment, but also the government deficit, the export surplus (shades of mercantilism), the consumption behavior of profit income recipients and the savings behavior of wage earners, has to be analyzed. In a world where wage and salary incomes are increasingly removed from the technical conditions of production but reflect social structure and business style, the Kalecki profit generation function has to be reformulated to take into account the role of wages and salaries that are mainly distributions of the "surplus" in an extended sense. The proposition that consumption out of profits will increase profits has as its implications that if overhead wages are fully spent on consumption then in the aggregate, markups will rise to finance such overhead expenditures. The ability of industry in America to support the ever heavier advertising, business bureaucracies and financial services industries indicates the validity of some of Kalecki's views about mark up pricing.[10]

It is customary in orthodox policy analysis to think of industrial structure and external financing of business as "separate compartments", whereas in a Post-Keynesian perspective, they are intimately linked. As was indicated, aggregate profits are determined by "policy" determined parameters but the distribution of profits among capitals is determined in the market. If external financing is required for investment and the owning of capital assets, then the financing agency will require assurances that the terms on the financing contract will be fulfilled. But the assurance that an appropriate share of aggregate profits will be earned is enhanced if the organization that is borrowing to finance has market power. Bankers abhore competitive markets for their borrowers; they much prefer borrowers to have market power. This applies not only to business borrowers but also for household borrowers. Union membership, agricultural price supports and oligopolistic market structure all enhance borrowing power.

Although Keynes wrote in terms of the "Socialization" of investment, the post-war era has been characterized by a socialization of consumption. If we look at the non defense government spending of the United States in the post war period, it is evident that Social Security and the provision of medical care is the largest category of expenditures. We live not in a Keynesian but rather in a Beveridge world. Transfer payments have become the major non-military government spending device.[11]

As far as the Kalecki profit equation is concerned, ($\Pi = I + Df$ for a closed and high abstract economy) the impact of the deficit is independent of whether spending is for goods and services or whether it is a transfer payment. However, if we exclude defense, government expenditures for goods and services can provide useful outputs. It is necessary to devise schemes and techniques that substitute useful employment for today's wide array of transfer payment schemes. These employment schemes may very well emphasize the creation of resources. Each generation need adopt resource development projects -- either the development of human or physical resources -- that are too high risk for private schemes. In addition, the maintenance of infrastructure and the provision of services that have value ~~that~~ which cannot be paid for through private "fee for service" receipts are necessary. The deeper significance of the socialization of investment is not that industry or a sector of industry is nationalized but that there is social control over the aggregate of profits available for business. These profits will not collapse when private investment collapses nor explode when private investment expands.

But control over the government deficit is not enough, for stability of aggregate profits leads to increasing indebtedness. The fundamental instability of capitalism may very well not be the interaction that leads to a big depression but rather the way stability leads to increases in debt carrying capacity, which in turn leads to more debt, higher asset prices and increasing investment. Good times -- the full employment of economic theory -- is a non sustainable state for it will lead to liability adventuring and an explosion from full employment to a boom time inflationary expansion.

In a world with "euphoric" behavior, liability structures are transformed so that an increasing proportions of units can meet contract terms on their liabilities only by issuing new liabilities. In fact, units become "Ponzi" financing operations as they can meet their interest commitments only by issuing debt. Using debts to pay interest -- or dividends -- creates fictitious assets and the laws of compound interest indicate that in time such assets will not be an acceptable basis for liabilities. When this happens as a systemic affair, the entire financial structure, and with the financial structure investment, can collapse.

In a modern economy when such a collapse is threatened, the central bank -- which may be a consortium of financial institutions, a deposit guaranteeing organization, the Treasury of a national state, an actual Central Bank, or a combination of the above-will impose its guarantee on the liabilities of the financial structure or will refinance threatened organizations by accepting their debts which the market is now rejecting. These lenders-of-last-resort interventions are a partner with the government deficit in sustaining the financial structure.

The success of the capitalist economies during the first twenty or so years after World War II rested upon the success of the United States in maintaining a close approximation to full employment at stable prices in the context of a robust financial structure. However, this financial structure was being transformed over these years of high prosperity from being robust to being fragile as the proportion of speculative (roll over) and Ponzi (capitalizing of interest) financial structures increased. The good times led to the development of complex financial structures that not only absorbed a greater proportion of aggregate profits but also had increased layering, so that organizations which received profit incomes (broadly conceived) in order to pass these incomes through to other organizations increased their weight in the economy. A greater proportion and closer articulation of money flows due to debt leads to the emergence of liability structures that can collapse because of a variety of causes, including a spiking of interest rates. In such an economy mere stability of aggregate profits is not sufficient to prevent serious downside instability; in such an economy there is a need for interventions that sustain, may ~~may~~ guarantee asset values and cash flows. The lender of last resort does just that -- as long as its liabilities remain acceptable.

The combination of lender of last resort interventions and ~~profit~~ deficits that increase profits, so that previously unsustainable liability structures can now be funded, guarantee that inflation and/or accelerating inflation over a number of such cycles, will occur. In this system, untenable liability structures are floated off by inflation. But this system works only as long as the liabilities of the Central Bank or the Treasury are acceptable, albeit at high and rising interest rates. However, if the deficit becomes chronic and there is no believable scenario which leads to a government surplus, then in time the deficit plus lender of last bail outs will lead to a flight from the "currency;" a flight from the dollar such as occurred in 1979 will occur in these circumstances.

Post-Keynesian economic analysis leads to the conclusion that even the policy regime of big governments with cyclical profit sustaining deficits and lender of last resort interventions which prevent financial collapses is not a failure proof system. Unless government maintains a discipline so that its liabilities are made valuable because at some date and state there will be a surplus that makes government liabilities scarce, there will be a flight from the currency (dollar). A peculiar back door validation of some of the theorems of orthodox conservative finance follows from Post-Keynesian economics.

However, the need for an in fact government surplus under reasonable conditions does not mean that a government surplus must be achieved. If government spending creates useful resources or output, the rising incomes make surpluses more likely and decrease the burden of any existing liability structure.

The lessons from experience and the theorems of post-Keynesian economics alike indicate that the Welfare State, as erected in response to the great depression, was successful in generating a set of economic miracles in the 1950's and 60's but that this variety of big government ran out of steam in the past decade and a half. The policy challenge is to develop an alternative structure which provides an equivalent protection against downside instability even as it is less prone to inflation and financial disruption. One course is to replace the income maintenance schemes that lead to transfer payments by employment schemes that lead to useful outputs. Full employment, tax and regulatory constraints over liability structures of corporations and capital adequacy requirement in banks may be the ingredients in a policy structure which leads to our economies doing better. In the tired and cynical 80's doing better, rather than utopia, is all we can hope for.

Footnotes

[1]Richard H. Day "Irregular Growth Cycles," American Economic Review, Vol. 72, No. 3, June 1982, pp. 406-414 shows that if a system is nonlinear, time dependent and multidimensional then the time series it will generate, will be complex in that periods of irregular (chaotic) behavior will be mixed with periods of regular behavior. The Day models and earlier papers by Minsky ["Monetary Systems and Accelerator Models," American Economic Review, Vol. 47, December 1957; (Reprinted in Can "It" Happen Again, Armonk, New York, M. E. Sharp, Inc., 1982) and "A Linear Model of Cyclical Growth," Review of Economics and Statistics, Vol. XLI, No. 2, Part 1, May 1959 (Reprinted in Gordon and Klein eds., A.E.A. Readings in Business Cycles, Homewood, IL, R. D. Irwin 1965)] indicate that apparent coherent behavior can be generated out of endogenous processes that lead to incoherence by the imposition of new initial conditions (floors, ceilings and policy interventions in general).

[2]Jean M. Gray and H. Peter Gray, "The Multinational Bank; A Financial M.N.C.?" Journal of Banking and Finance, 5, (1981), pp. 33-63.

[3]In the neoclassical analysis as exemplified by D. Patinkin, Money, Interest and Prices, 2nd Edition, Harper and Rowe 1965 and M. Friedman, "A Theoretical Framework for Monetary Analysis ," in R. J. Gordon ed., Milton Friedman's Monetary Framework: A Debate With His Critics, Chicago, University of Chicago Press, 1974 endogenous instability is not possible.

[4]Paul Davidson, Money and the Real World, New York, Wiley, 1972; J. A. Kregel, The Reconstruction of Political Economy: An Introduction to Post-Keynesian Economics, London and Basingstoke MacMillan, 1973, ~~Sidney Weintraub and~~ H. P. Minsky, John Maynard Keynes, New York, Columbia University Press, 1975, and Can "It" Happen Again, Armonk, NY, M. E. Sharpe and Company, 1982, represent a this tradition.

[5]John Maynard Keynes, The General Theory of Employment Interest and Money, New York: Harcourt Brace 1936, p. 378.

[6]Ibid. p. 376-377.

[7]The debt deflation process was well described in Irving Fisher, "The Debt Deflation Theory of Great Depressions," Econometrica 1933, Vol. 1, No. 4, October, pp. 337-57. James Tobin, Asset Accumulation and Economic Activity, Chicago, University of Chicago Press 1980, introduces a Fisher process but then reverts to an orthodox view of macroeconomic relation.

[8]Michal Kalecki, Selected Essays on the Dynamics of the Capitalist Economy: 1933-1970, Cambridge (England), Cambridge University Press, 1971.

[9]H. P. Minsky, "Finance and Profits, the Changing Nature of American Business Cycles," in *The Business Cycle and Public Policy 1929-80: A Compendium of Papers Submitted to the Joint Economic Ecommittee, Congress of the United States* (Washington, D.C., U.S. Government Printing Office) 1980. Reprinted in *Can It Happen Again*, op. cit.

[10]During my last conversation with Joan Robinson, in the summer of 1981, she was concerned with who would purchase the output of industry when manufacturing was carried on by "chips on chips." After I left, I found the answer I should have given her: everyone will work in advertising. If we look at the changes in the structure of employment in the United States advertising, financial services and corporate bureaucracies are the leading sectors.

[11]William E. Beveridige, *Report on Social Insurance and Allied Services*, U.S. Government Printing Office, November 1942 and *Full Employment in a Free Society*, New York, W. W. Norton and Company, 1945.