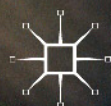


POST-KEYNESIAN ESSAYS FROM DOWN UNDER

VOLUME II: ESSAYS ON POLICY
AND APPLIED ECONOMICS

Theory and Policy in an Historical Context

Joseph Halevi
G. C. Harcourt
Peter Kriesler
J. W. Neville



“The 29 incisive essays in this book will be of great interest not only to Australians but also to everyone concerned with the constraints on progressive economic policy in a small, open economy. The four distinguished authors cover a wide range of topics, from unemployment and inflation to financial crises and the economics of imperialism. In an age when old truths have been forgotten, and ancient fallacies revived, the lucid post-Keynesian arguments of Halevi, Harcourt, Kriesler and Nevile deserve to reach a very wide audience.”

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“With this second volume of *Post-Keynesian Essays from Down Under* Halevi, Harcourt, Kriesler and Nevile have provided us with yet another marvel of collective brilliance ‘made in Australia’. Spanning core policy debates across several decades and four continents, these influential papers are a *tour de force* in what sets apart post-Keynesianism, at its best, from presently dominant economic paradigms. Policy analysis properly grounded in theory, theory properly grounded in history and both, applied and theoretical analyses, stringently focused on how best to improve the lives of ordinary people. A wonderful and inspiring read all around, full of small gems of historical detail and as utterly relevant now as at the various times of writing the individual contributions.”

—**Stephanie Blankenburg**, *Department of Economics, School of Oriental and African Studies (SOAS), University of London, UK*

Post-Keynesian Essays from Down Under Volume II: Essays on Policy and Applied Economics

Theory and Policy in an Historical Context

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Softcover reprint of the hardcover 1st edition 2016 978-1-137-47534-3

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First published 2016 by
PALGRAVE MACMILLAN

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Palgrave Macmillan in the US is a division of St Martin's Press LLC, 175 Fifth Avenue, New York, NY 10010.

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ISBN 978-1-349-56950-2 ISBN 978-1-137-47535-0 (eBook)
DOI 10.1057/9781137475350

This book is printed on paper suitable for recycling and made from fully managed and sustained forest sources. Logging, pulping and manufacturing processes are expected to conform to the environmental regulations of the country of origin.

A catalogue record for this book is available from the British Library.

A catalog record for this book is available from the Library of Congress.

Typeset by MPS Limited, Chennai, India.

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Preface

Geoff Harcourt intended to put together one more volume of selected essays in order to reach double figures. But then Peter Kriesler reminded him that since he joined the School of Economics at the University of New South Wales, Australia in August 2010 as a Visiting Professorial Fellow, they, sometimes with J. W. Nevile, had published several joint papers. Moreover, Peter and John, and Peter and Joseph Halevi, had also been publishing joint papers for many years. All their works, whether as sole author or jointly, had important common themes. The underlying theoretical framework was essentially post-Keynesian.¹ They all stressed the importance of the underlying institutional framework, of the economy as an historical process and, therefore, of path determinacy. Money and finance were an integral part of the economy, with monetary variables affecting real variables and vice versa at all stages of analysis. In addition, all the works saw the ultimate goal of economics as being a tool to suggest policy – even the theoretical works were motivated by the desire to make the world a better place, with better being defined by an overriding concern with social justice.

So arose the proposal we made to Taiba Batool that we put together four volumes of “Post-Keynesian Essays from Down Under,” subtitled “Theory and Policy in an Historical Context.” She enthusiastically accepted the offer, ably assisted by Ania Wronski. We therefore set about putting the selections together. When Taiba left Palgrave Macmillan for pastures new, she passed the project onto Laura Pacey and Rachel Sangster who, just as enthusiastically, oversaw the bringing together and publication of the four volumes. Laura, in particular, has been extremely helpful and patient in our journey from idea to manuscript.

Our grateful thanks go to Joan Harcourt for forgiving Geoff for breaking the promise never again to undertake a major research project, witnessing yet again her love and support of over 60 years; to Teresa, Peter’s wife, for her continual love and support; and to Fay, John’s wife, who, in the absence of a secretary, typed much of his introductions to chapters (and commented that the names had not changed much since the last time she did this when, as a young wife, she typed drafts of John’s PhD thesis).

We would also like to thank Roni Demirbag for his help in getting Joseph’s papers in order, and Jason Antony for his gracious and good-natured multi-dimensional expert help in assembling the volumes.

Note

1. For an overview of what we consider to be post-Keynesian economics see Harcourt, G. C. and Kriesler, P. 2015 "Post-Keynesian Theory and Policy for Modern Capitalism," *Journal of Australian Political Economy*, No. 75, Winter 2015, 27–41.

Acknowledgements

The authors and publishers wish to acknowledge with thanks the following for either previously publishing their articles, or granting permission to reproduce copyright material:

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SAGE Publications for publishing “Exchange rates and the macroeconomy in an era of global financial crises, with special reference to Australia,” *Economic and Labour Relations Review*, Vol. 24, No. 1, 2013, pp. 51–63.

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About the Authors

Joseph Halevi, alma mater University of Rome La Sapienza, began teaching economics at the New School of Social Research in New York and later at Rutgers University. He has a permanent appointment at the University of Sydney. He was Visiting Professor at the University of Connecticut and regularly in France at the Universities of Grenoble, Nice and Amiens. He has authored many books and contributed to the first edition of *The New Palgrave Dictionary of Economics* in 1987 and co-edited *Beyond the Steady State* with Macmillan in 1992, among others.

G. C. Harcourt is a graduate of the Universities of Melbourne and Cambridge. He has worked mainly at Adelaide (1958 to 1985) and Cambridge (1964 to 1966; 1972 to 1973; 1980; 1982 to 2010). He is now Visiting Professorial Fellow at UNSW Australia. He is Emeritus Reader in the History of Economic Theory at Cambridge University; Emeritus Fellow of Jesus College at Cambridge; and Professor Emeritus at the University of Adelaide. He has authored or edited 29 books and over 380 articles, notes, chapters in books and reviews. His books include *Some Cambridge Controversies in the Theory of Capital* (1972), *The Structure of Post-Keynesian Economics* (2006), (with Prue Kerr) *Joan Robinson* (2009) and (jointly edited with Peter Kriesler) *The Oxford Handbook of Post-Keynesian Economics*, 2 vols (2013).

Peter Kriesler currently teaches in the School of Economics at the University of New South Wales. He organises the Annual Australian Society of Heterodox Economists Conference, which is now in its fourteenth year. Peter's main publications are in the areas of history of economic thought, heterodox economics, the Australian economy, labour economics, and economic perspectives on human rights.

J. W. Neville is Emeritus Professor at the University of New South Wales in Sydney, Australia. He has published extensively on fiscal policy, macroeconomic policy in general, economics and ethics, and the history of economic thought. He has served on a number of statutory authorities and government enquiries. He was the Recipient of the Economic Society of Australia Distinguished Fellow Award for the year 2000.

Introduction

Joseph Halevi

It is interesting to note that in *the Economic Record* symposium on the old and new political economy in 1975 around a review article by Geoff Harcourt, John Hicks referred to his 1969 book, *A Theory of Economic History*, as the work that expressed his break with Neoclassical economics. In the introduction to our final volume I pointed out that the separation from equilibrium theory actually occurred in 1965 in *Capital and Growth*. However, Hicks's choice of the second book is not irrelevant. *A Theory of Economic History* aims at telling a market-based story as an alternative to the Marxian class and production focused narrative. Hicks openly states that in matters of historical analysis there has been too much dominance from the Marxian side and that, therefore, market-orientated narratives are needed as a counterweight. So why is the 1969 book taken by its author as symbolising the break with the Neoclassical tradition where that whole body of thought is wrapped around price *cum* market theory? A closer look at *A Theory of Economic History* reveals that the book is based on the premise that Neoclassical economic theory cannot be contextualised. In other words, it cannot say anything about actual markets. Hicks's stance is very interesting indeed. A major founder of modern market theories who, in order to build a case for the market as a reference point for economic history, finds himself compelled to jettison market centred theories. Hicks's sensitivity acquires added significance when gauged against the complete numbness in regard to orthodox Marxist economists' view of history, which is fixated on the falling rate of profits, and of a high-minded Italian post-Sraffian group which congregated around the personality of the late Pierangelo Garegnani. For both of these "fundamentalist" strands, although they are indifferent to each other, the economy's path is fully predictable. It is governed by the falling rate of profits for the Marxian group, and by the long-period tendency towards normal positions for the Garegnani group. The irony is that these two pre-Copernican groups present themselves, separately, of course, as the only alternative to Neoclassical economics.

In relation to my own intellectual trajectory, Marxism always presented itself to me as a theory of history. This is particularly true of Marx's emphasis on the transition from manufacturing to machinofacturing. To assess it Marx studied the engineering features of machine tools. His famous schemes of reproduction are also historically grounded. Their formulation derives from Marx's studies of modern industry and the realisation that the scale of the industry no longer allowed for the tools to be manufactured on the premises of the firms producing the final apparel or footwear items: hence the rise of a separate capital goods sector which changed, also theoretically, the character of capitalist accumulation. It is Russian, Polish and German Marxism before the First World War that best understood the role of machinery in shaping society.

Most of the essays included in this volume constitute attempts to put Peter Kriesler's and my theoretical thoughts within an historical context. As far as I was concerned I was helped by a 25-year-long relation with a number of French institutions such as the Universities of Grenoble, of Nice and of Picardie (Amiens), as well as by my association with the Parisian Institut des Sciences Mathématiques et Economiques Appliquées (ISMEA) – whose Director, the late Professor Gérard de Bernis, invited me to join the Institute – while organising also my regular stays at the University of Grenoble – and its two journals *Economie Appliquée* and *Economies et Sociétés*. ISMEA has been for me the most open and forward-looking place I have ever frequented in the academic world (a rare thing in academia), until it went into terminal decline because of the dominance in government funding of conformist thought regarding economics. At ISMEA Alain Parguez, an uncompromising revolutionary Keynesian theorist, edited within *Economies et Sociétés*, a series called *Monnaie et Production* that for us was perfect as it combined the threads of our research.

The essay on the EMS and the Bundesbank (Chapter 27) was the outcome of more than year's stay in France in 1992–3 working at the University of Grenoble and at ISMEA. It was presented at a workshop in London organised by the post-Keynesian Study Group at the then Economic and Social Research Council. Its explicit purpose was to outline the history of Germany's integration in Europe after 1945 using Kaleckian criteria. The article analyses how and why Europe became the space of profitable demand for German industry. Hence Europe systematically generated surpluses for German trade. This kind of trade was made possible by the role of the capital goods and machine tools industries in Germany, the products of which found their way into the whole network of Europe's input–output relations. These are the reasons for the German oligopolistic position in the European context. It explains also why Germany cannot sustain European growth and has a parasitic relation with it determined by its structural neomercantilism.

The essay on Germany stemmed from a previous paper on Japan's position in Asia given at a Sorbonne workshop in 1992. In 1994, Peter Kriesler and I presented two papers on Asia and Japan at a conference at the Maison des

Sciences de l'Homme in Paris. One of the essays is historical (Chapter 23). Its title, "History, Politics and Effective Demand in Asia", argues that the pre-Chinese growth of that area was the direct result of political considerations, linked to the Korean War and the Vietnam War, and not to some spontaneous endogenous process. The role of Japan is then studied in the essay on Japan and the internationalisation of effective demand which was published in the Parguez series at ISMEA in 1996 (Chapter 22). We maintained that Japan's oligopolistic control over East and Southeast Asia, again thanks to its heavy industry machine sectors, was then a major source of Japan's external surpluses. We concluded that the relations between Japan and its area of hegemony were not sustainable unless the countries of the area found permanently expanding external markets such as the USA and, today, China. In the course of my research on Japan and East Asia, I found that historians and political scientists understood the picture in a much deeper way than economists. Historians and political scientists understood rather quickly that the main factor propelling that area was US public expenditure undertaken for military and political purposes. Without knowing it, they were confirming the historical validity of Kalecki's and of the Baran-Sweezy-Magdoff conception of modern capitalism.

The article on the accumulation process in Japan and East Asia compared to that of Germany in Europe (Chapter 26), was read at a conference organised by Riccardo Bellofiore at the University of Bergamo in 1999. It brings together the two main areas centred on countries, Japan and Germany, accumulating external surpluses. These are viewed as contractionary for the reasons put forward by Keynes at the Bretton Woods negotiations. During the decade prior to the 2008 crisis Japan's surpluses have been replaced by China's with an even bigger contractionary impact. World economic growth has greatly depended upon military expenditure and on the external deficits sustained by the hegemonic country, namely, the United States. The essay on imperialism today (Chapter 29), given at a Bellofiore Conference on Rosa Luxemburg at the University of Bergamo in 2004, confronts this situation with the view of imperialism as a means to gain external markets. I argue that the latter was the position taken by Rosa Luxemburg and was consistent with the German historical experience. Lenin looked at imperialism as the product of the expansion of foreign investment and of stagnation at home. Today it is the financial form of imperialism that prevails and it is predicated upon the freedom to run external deficits at will.

In the early 2000s with the establishment of the European Monetary Union we turned our attention to Europe once more. Peter Kriesler and I wrote an essay dealing with stagnation and economic conflict (Chapter 24). It tries to explain historically why the EU has fallen into a stagnation trap with high unemployment since the 1980s. It points at the straightjacket represented by the subordination of fiscal to monetary policies and at the complete absence of awareness regarding the contractionary and deflationary nature of the intra-European balances, with the surpluses concentrated in German, Dutch and Scandinavian hands. However, we do not think that the European

situation is simply the result of policy mistakes. They would not be corrected even if the four of us were to be appointed European commissioners arising from a jolt of mad sanity in Brussels. Those “mistakes” reflect both internal class relations as well as common European perspectives like the desire to form a large integrated market for the oligopolistic corporations. Furthermore, Euro-austerity unites the capitalist classes around the policies of competitive wage deflation. In the interplay between the national and the European levels, there re-emerge conflicts that express different economic strategies by the leading groups. Thus Germany does not want to “help”, not because of a national attitude, but because its economic structure is geared towards external surpluses. Likewise France is not more moderate than Germany by choice. It simply cannot be as austere as Germany on intra-European matters because in the Godley accounting relations France is on the losing side which shows up as a combined budget and external deficit. Whenever possible, though, France outdid Germany in domestic budgetary contraction.

The volume also contains an essay on Argentina published in the *Monthly Review* in 2002 (Chapter 28), just after the devastating crisis which, for a while, that is until the government decided to abandon the fixed institutionalised parity with the US \$ and defaulted on its external debt, led almost to the disappearance of the national currency. I found it a very interesting case of hyperdeflation causing currency destruction and a social catastrophe much greater than the periods of hyperinflation which the country had experienced before. In none of the previous hyperinflationary episodes had 50 per cent of the population found itself destitute in a very short period of time. Argentina never suffered hunger, a word that in Argentina should not make sense. Instead hyperdeflation destroyed the currency thoroughly, thereby blocking capitalist transactions. The essay traces step by step Argentina’s path towards the final collapse by analysing hyperdeflation through the lenses of the theory of monopoly capital.

In the volume there are also joint papers on corporatism, buffer stock employment policies and on the structure of the Australian economy (Chapters 9, 13, 14 and 15). Corporatism (Chapter 14) was in vogue around 15 to 20 years ago among social democratic circles in Europe, who were looking to the Northern countries as an example of social and employment protection. We criticised that view, arguing that the social democratic compact does not escape from the clutches of crises if it uses corporatist arrangements to mask austerity policies. My contributions to this volume can be summed up by saying that they represent an attempt to write a theoretically informed economic history.

Geoff Harcourt

I have three essays in the present volume of selected essays on policy. I am the sole author of two of them, “The systemic downside of flexible labour

market regimes: Salter revisited” (2012) and “The ABC of G and T” (2013). The third essay, “Exchange rates and the macroeconomy in an era of global financial crises, with special reference to Australia” has three authors, Peter Kriesler, John Nevile and myself as a very junior author, so I leave my seniors to introduce it.

The first essay arose from a conversation I had in Cambridge with my long-time friend and two times colleague, Tony Cockerill, at a Feast in Jesus (as is well known, scholarship at Oxbridge is born in food and drink). We were discussing the recent, well not really so recent, emergence of what are euphemistically called “flexible labour markets” and what their systemic effects are likely to be in both short and longer runs. We developed an argument that comes from the work of the late Wilfred Salter, an economist whose contributions both of us admire immensely and who has greatly influenced my own work since I wrote a review article of what was to become his much admired classic, *Productivity and Technical Change*, (1960) for the *Economic Record* in 1962.¹

One of Salter’s most important policy proposals arose from his 1960 book and also from the work he did with Eric Russell in preparing their evidence to the Australian Arbitration Commission for the hearings of the 1959 Basic Wage case. Called as expert witnesses for the Trade Unions’ case (by Bob Hawke), they argued that as an essential ingredient of a package deal of policies, the most basic requirement of which was sustaining full employment without accelerating inflation, was that as a first step money incomes should be adjusted periodically for the growth in *overall* productivity and prices. Such a rule would be both equitable and efficient: equitable, because at the level of the economy as a whole, capital and labour are complements so that the rule would allow income receivers to share in the potential increases in real income that capital and labour together had brought about; efficient, because such a rule would knock out low productivity, often declining industries and encourage high productivity, often expanding industries, so making growth in real incomes as high as it could possibly be without raising the rate of inflation.

In contrast, flexible labour markets lead to adjustments of specific money incomes by specific rates of growth of productivity, so prolonging the lives of the first group and hampering the growth of the second, resulting in much lower growth of overall productivity and potential real incomes. This outcome reinforces the adverse effects of what I have called the Kaleckian dilemma, see Kalecki 1943, Harcourt 2006,² Chapter 14, that sustaining full employment without accelerating inflation over time in the face of the cumulative shift of economic, political and social power from capital to labour becomes more and more difficult. The details of this argument are set out in the essay. A corollary of its conclusion is that permanent incomes policies are indispensable parts of package deals of policies aiming to secure sustained full employment with non-accelerating rates of inflation i.e., to

secure internal and to have a chance of securing external balance too, as we used to argue.

I wrote the second essay, “The ABC of G and T”, because I was in despair at the appalling ignorance shown in public discussions about budget deficits, surpluses and debt-to-income ratios, especially that of the politicians whose task is to take decisions on these matters. Coupled with the discussions has been the implementation of so-called austerity regimes after the brief implementation of Keynesian-type stimulation measures following the onset of the Global Financial Crisis (GFC). I hoped the essay would be acceptable as, say, an op-ed piece in the so-called quality press in Australia but my attempts to place it there reminded me of the response to similar efforts at the beginning of the anti-Vietnam War protests era, i.e., it was virtually impossible then to have letters to the editor published or get onto the radio or tele. So I published it in the *Economic and Labour Relations Review*, a journal of the Business School at UNSW that punches well above its weight, in a section devoted to policy discussions.

In the essay I tried to set out as simply as possible the proper interpretation of the roles of government expenditure (G) and taxation (T) in the running of the economy, and the criteria that are relevant for assessing the systemic effects of the debt-to-income ratio. I concentrated on the equity and stimulation effects of the *structure* of tax rates, arguing that the public accumulation portion of *G* should be determined by the long-term needs of the economy with regard to establishing especially green-friendly infrastructure.

Total taxes should be raised or lowered according to the expected levels of aggregate demand coming from its other main components so that the relative structure of taxes continues to express equity considerations and hypothecation is put where it belongs i.e. it doesn't. I refute the mantra of “balance the budget over the cycle” on the grounds that it embodies an implicit assumption that the economy is a stationary state. I draw on Evsey Domar's article dating from the 1940s³; to argue that it is possible to have sustained deficits (if necessary) provided that the economy is growing so that debt-to-income ratios approach reasonable limits. The ghost of Abba Lerner's functional finance hovers over the discussion.⁴

Peter Kriesler

Much of the writings of all four of us on economic policy has been aimed at highlighting the importance of fiscal policy relative to monetary policy. This flies in the face of the received wisdom of the profession, which significantly downplays the relevance and efficacy of fiscal policy – with, at one extreme, new classical economists believing that it is completely impotent. Mainstream economists believe that, due to the long-run neutrality of money and the efficiency of markets, no macroeconomic policy can affect

the real economy in the long run, while monetary policy is more potent than fiscal policy in the short run. In the first two chapters, John Nevile and I evaluate the arguments for using fiscal policy versus those for using monetary policy for alleviating recessions. John Nevile has, for a long time, been the Australian expert on fiscal policy, having produced much important work in the area since his path-breaking 1970 book. I have learnt a lot from him, and the sections on fiscal policy are mainly his contributions. After examining the channels of monetary influence, we consider how globalisation has changed these and reiterate the conclusion that monetary policy is a blunt, coarse and uncertain instrument. With respect to fiscal policy, we survey the traditional arguments about the limitations of fiscal policy, but argue that it is still an important policy tool for alleviating unemployment and stimulating growth, even in the environment of increased globalisation. In Chapter 16 we consider the history of Keynesian expansionary policies in Australia, arguing that fiscal policy was more effective in the fifties and sixties than it is currently because the main aim of policy was the alleviation of unemployment (which is as it should be) rather than the current view which puts fighting inflation first. In all of our work discussing fiscal policy, we argue that this change in emphasis is a mistake – the costs imposed by inflation on society are small compared with those imposed by unemployment. Contrary to the rhetoric, there is little evidence that inflation below very high levels has any adverse impact on other aspects of economic activity.

Chapter 3 is the result of the first collaboration between Geoff, John and I. For a long time we had been discussing the issues raised in the chapter – namely, the way in which the international financial system made global financial crisis more likely, and, at the same time, made it increasingly difficult for governments to manage their macroeconomies. We consider a number of possible policy recommendations, with the simplest and best known being a Tobin tax.

Chapter 4 is a collaboration resulting from my delightful stay as a guest of Marc Lavoie and Mario Seccareccia at the University of Ottawa. At that time, a new consensus was emerging among mainstream economists both as to the best way to analyse the macroeconomy, and to the best policy to control the economy. The essence of the latter was a monetary rule obliging the central bank to tie changes in the interest rate to deviations of inflation from its target, and output from potential output. According to this model, monetary policy was to be the major macroeconomic policy instrument, under the control of independent central banks. Marc and I provide a post-Keynesian critique of the model and its underlying assumptions. In particular, the vertical long-run Phillips curve, which, because of the assumption of long-run market clearing, meant that in the long run, unemployment was always at its “natural rate” and output at its maximum, is rejected. Instead, post-Keynesians would suggest that, as there was no mechanism which

would enable markets to avoid unemployment, there is an important role for fiscal policy.

Chapter 5 looked at the causes of and policy options for the global financial crisis. Two important differences with previous crises – the record level of household debt and the problem with “toxic assets” – made recovery much more difficult than for previous economic downturns. Recovery always requires increased aggregate demand, and these factors, in addition to the global nature of the crisis, reduced the potential sources for an increase in demand to the government in the form of fiscal policy.

In Chapter 9, Joseph Halevi and I consider a policy proposal that has become popular among some heterodox economists – namely, that the government should act as an employer of the last resort, treating employment like a buffer stock and absorbing any excess labour. This contrast with the Keynesian/Kaleckian solution which is more reliant on government expenditure, particularly on infrastructure, for creating jobs. We evaluate the proposal in terms of Kalecki’s analysis of the political limitations of full employment policy, arguing that these policies are a bandage covering the real problems, and, if implemented in isolation, will lead to significant political resistance.

Much of Joseph’s and my theoretical work was concerned with the way in which the structure of the economy imposes limitations to growth and employment. Chapters 13 and 15 apply this analysis to the Australian economy, considering ways in which changing structure, in particular with respect to the declining industrial sector, has made the health of the economy extremely dependant on raw material exports, which has increased the country’s vulnerability to international influences.

In the mid-1990s, I was employed by the Federal Airports Authority to help with its evidence to a government inquiry as to whether it should be privatised. Despite clear evidence (which has been proven correct by subsequent events) of the costs this would impose on society, political imperatives overcame economic wisdom and Australia’s airports were privatised. Chapter 21 is a paper I wrote on this issue, which is of interest not only because of the discussion of airports, but also because of the more general analysis of the general case for privatisation.

John Nevile

In the introduction to my contributions to the theory volume in this series of books, I singled out the publication in 1970 of *Fiscal Policy in Australia: Theory and Practice* as marking a turning point in my confidence in using the economic theory I was developing to put forward policy recommendations. This does not mean that I did not do any applied work on this topic before 1970. I did. The most significant was the first published macroeconomic model of the Australian economy which appeared in 1962 in the inaugural

issue of *Australian Economic Papers*, and is Chapter 11 in this volume. But, as pointed out in the conclusion to the article, the purpose of the article was to elucidate the nature of the Australian economy. It pictured that economy of the time as one with the behaviour of an economy on Harrod's warranted growth rate. Unsurprisingly, the estimate of this growth rate was low enough for the expansionary forces to dominate, but the conclusion to the article warned not to put too much weight on the exact value of the warranted rate as small changes in the parameters of the model could produce large changes in the estimate of this rate. For about 10 years this was the only published macro-econometric model of the Australian economy.

In 1965 a version of the model was estimated with two additional years of data and with two extra equations, one for imports and the other for fixed capital investment in the farm sector. It was written with Jack Duloy and published in the *Economic Record*. The article was a contribution to the debate at the time on the effects of a reserve price for wool on national income and the balance of payments. It is mentioned because of its interest to two groups: to historians of economic thought as the first simulation study of the Australian economy and to economic historians as a picture of potentially important dynamic forces in the Australian economy 50 years ago. However, the details of the data and analysis are very dated and the article itself has not been included in this volume.

Despite any misgivings I may have had, a substantially expanded and improved version of the 1962 model was estimated in 1963–64 at the request of J.G. Crawford. Crawford had moved from the public service in 1962 to the School of Pacific Studies at the Australian National University. When Menzies almost lost the 1961 election he set up a Committee of Economic Enquiry into economic institutions and policy in Australia (usually known as the Vernon Committee after its Chairman). Crawford, who was Vice-Chairman, wanted more “firepower” on the Committee in his battle against the influence of the Treasury. (The differences between Crawford and the Treasury were partly due to differences in views about the priorities to be given to different goals of economic policy and partly to an ongoing turf war between Treasury and Trade, of which Crawford had been the Head from the establishment of the Department until he left the public service.) The econometric model estimated for the Vernon Committee predicted that inflation would be less of a problem in the 1960s than it had been in the 1950s and this proved to be the case. As I had more research assistants than usual it was the largest econometric model I have ever estimated and was close to the limit imposed by my overriding principle that a model has to be small enough so that it is possible for an individual to trace through causal mechanisms. Although this model was never published as such, it did have a significant influence on my later econometric work, e.g. Chapter 10 in this volume. Moreover, the whole experience of working in that environment taught me a lot that influenced most of my contributions in this

volume and indeed in the other volumes as well. A good example of this is Chapter 12 in this volume, which does not have a single equation in it but reviews econometric work by myself and others to build a case for using fiscal policy to increase economic growth and reduce unemployment. There will be a further discussion of this chapter later in these introductory comments.

By and large the Vernon Committee did produce the sort of recommendations that Crawford wanted, but they were rejected by Menzies. However, in subsequent years a number of important ones were implemented, notably those relating to tariffs, an issue always dear to Crawford's heart. In particular, the Vernon Committee emphasised the importance of the effective rate of protection as opposed to the nominal rate. Max Corden's path-breaking and influential article on this was published in 1966.

The other publication that was written before 1970 specifically to influence policy is Chapter 17 in this volume. It was written at the request of Bob Hawke who was the Australian Council of Trade Unions (ACTU) advocate in national wage cases at the time. As well as theoretical arguments about the ideal relationship between the wage and profit shares, statistical material had been put forward but this was very aggregative. Bob thought that if one went behind the aggregative data, the results would be more favourable to the union case and asked me to do this. The results confirmed Bob's intuition, helped him get a favourable outcome at the next national wage case and started my continuing interest in measuring wage and profit shares.

Over the years I have been invited to give a relatively large number of addresses to the State Branches of the Economic Society of Australia in New South Wales and Victoria. These were all on current policy issues and were published in *Economic Papers*. Perhaps the best was that given in Sydney in 1973 which benefited from a very fruitful study leave at Southampton University earlier in that year. It is Chapter 18 in this volume.

Towards the end of the 1980s, in commenting on productivity growth I pointed out that a trend of rapid population growth reduced physical capital per head and that this reduced the rate of productivity growth, other things being equal. However, in the conditions of the 1980s and much of the 1990s, either a low or a very high trend of population growth seemed to increase unemployment with consequential effects on the average level of output per head and hence living standards. In countries such as Australia, where immigration levels have a major effect on population growth and are, in effect, a policy variable, the optimum rate of immigration was an important but unresolved question. Chapter 19 uses an econometric model to answer this question by examining how three influences on living standards – capital growth, unemployment (the effect of which was measured in the model by the growth rate of employment) and technological change – interact and together determine growth in living standards. The result surprised me. According to the model, in Australia over the period

1974–75 to 1988–90, technical change was easily the most important factor in increasing output per head. Chapter 19 speculates on some possible reasons for this, though it makes clear that the econometrics gives no grounds for distinguishing between different reasons. Nevertheless, it is a question of considerable interest if, as I do, one suspects that the result may often be relevant in later periods. Chapter 20 subjects the model to a severe test to see how it performs in predicting outcomes in 1988 and it performs well.

Chapter 12 was written during the early years of my collaboration with Peter Kriesler and he undoubtedly had an influence on the published version. Be that as it may, this chapter could be used as an outline of the major themes of our joint research for the next 15 to 20 years, except that some issues are dealt with very briefly because they are dealt with in separate chapters in what is a carefully planned and well-integrated book. Most of Chapter 12 is positive, outlining typical Keynesian policies to reduce unemployment and examining evidence drawn from both experience in Australia and overseas countries to build a strong case that they can be successful in both increasing the rate of growth and reducing unemployment. The most important single factor in maintaining this success is maintaining expectations that governments can and will maintain growth and full employment. In this volume Chapter 16 gives a much more up to date account of this and other factors discussed in Chapter 12.

Chapter 12 also examines the arguments against Keynesian policies mounted by neoclassical economists. It is shown that the theory underlying some contradicts that underlying others and there is no strong supporting evidence for any of them. The chapters by authors other than myself mentioned above are identified in the concluding section of Chapter 12 except that human rights do not get an explicit mention. They do implicitly through references to Australia's 1945 *White Paper "Full Employment in Australia"*, and more obliquely by the book's editor in his concluding chapter. Moreover, although the editor does not state this explicitly, the whole book can be seen as a response to the statement in the *White Paper* that "the maintenance of conditions which will make full employment possible is an obligation owed to the people of Australia by Commonwealth and State Governments⁵" (p. 3).

Chapter 6 is the remaining chapter in this volume with my name as the sole author. However, the acknowledgements point out that the material on fiscal policy, which constitute the major part of the chapter, draws heavily on a paper given by Peter Kriesler and myself at a conference two years earlier. After two brief introductory sections to set the scene, the rest of the paper discusses the role of fiscal policy, first in the short term and then in the long term. It is the latter which contains the most challenges. Two are most important. One is to take a leaf out of Friedman's book and mount a vigorous public education campaign, albeit in the opposite direction, about the importance of policy to restore full employment in the long

term through demand management. The second is to increase money spent helping the long-term unemployed find permanent jobs rather than cutting such expenditure to achieve a balanced budget over the cycle.

Notes

1. Salter was only 34 when he died in Pakistan in 1963. In his obituary note in the *Economic Record* in 1964, Trevor Swan, with whom Salter had worked closely at the ANU while writing the book, fittingly described his work as “unfulfilled renown.” His death was a personal and professional tragedy.
2. Kalecki, M. (1943) “Political Aspects of Full Employment” *The Political Quarterly*, 14: 4, 322–330; Harcourt, G.C. (2006) *The Structure of Post-Keynesian Economics: The Core Contributions of the Pioneers*. Cambridge: Cambridge University Press.
3. Domar, E.D. (1944) “The ‘Burden of the Debt’ and the National Income”, *The American Economic Review*, 34, 4, 798–827.
4. I am delighted to say that when I sent these arguments to *The Conversation*, an influential independent media outlet in Australia, my essay received over 14,000 hits in August 2014 alone, most of which were favourable.
5. Full employment was named as the governments’ obligation because of cultural values of the time and because it was thought that the government should progressively accept responsibility for providing a “safety net” that had been provided largely by families before the Second World War.

Part I

Policy

1

Tools of Choice for Fighting Recessions

J. W. Nevile and Peter Kriesler

“Many economists think that using monetary policy in a recession is like pushing on string.” Howard S. Ellis, 1954 (from lecture notes taken by J.W. Nevile at the University of California at Berkeley)

“Almost all economists agree that monetary policy, not fiscal policy, is the tool of choice for fighting recessions.” (Paul Krugman, *Sydney Morning Herald*, 12 January 2001)

1.1 Introduction

Policy makers are perpetually reinventing the wheel. Before the First World War, monetary policy was the sole tool used for macroeconomic stabilisation. The ‘Keynesian’ revolution heralded a major change, so that in the first twenty five years after World War II, fiscal policy became the primary tool for economic stimulation. After the experience of stagflation in the 1970s, fashion changed, and monetary policy came into its own. Its perceived importance for policy continually increased until, during the 1990s, it had totally replaced fiscal policy in the minds of policy makers and business interests.¹ There has been a major swing in the views of economists interested in and knowledgeable about macroeconomic policy. The majority of such economists now look to monetary policy to cure recessions, whereas fifty years ago the majority thought monetary policy was of little use by itself, though it had a supporting role to play to fiscal policy. Has the world changed, or were most economists mistaken either fifty years ago or now?

This chapter argues that while it may be much harder to cure recessions now than in the 1950s, the reasons that led economists to downplay

Revised from *The Urgency of Full Employment*, 73–94, 2002, ‘Tools of Choice for Fighting Recessions’, by Nevile, J. W. and Kriesler, P. With kind permission from The Centre for Applied Economic Research. All rights reserved.

monetary policy then are still valid today. Moreover, the arguments that have been advanced against the use of fiscal policy over the last thirty years are not convincing. The next section gives our arguments for this assessment of monetary policy and Sections 3 and 4 discuss fiscal policy². However, our conclusion is not that fiscal policy alone should bear the weight of fighting recessions. We suggest Tinbergen (1952) has much more to commend it in today's conditions than the modern conventional wisdom of assigning policy instruments to targets. Moreover, in the context of ensuring that recessions are short and as shallow as possible, it is unwise to ignore the current account on the balance of payments. Neither monetary nor conventional fiscal policies are much help here. Other policies are needed.

1.2 On the Efficacy of Monetary Policy

Keynes thought that monetary policy had an important role to play in economic stabilisation. However, his followers severely underplayed its significance and advocated expansionary fiscal policy to cure recessions. As is well known, this view of policy, although extremely popular during the 1950s and 1960s, was rejected in favour of Milton Friedman's brand of monetarism, as a reaction to the stagflation of the early 1970s.

Friedman rejected any role for macroeconomic policy in stabilising real variables, such as output and employment. Fiscal policy, he argued, was impotent, and the illusion that it had influenced the economy came, in fact, through the monetary impact of the manner in which it was financed. Since the economy always tended towards the natural rate of unemployment unless interfered with, the best the government could do was to run a balanced budget and not attempt to influence the level of economic activity. We discuss this view more fully in the next section. More relevant here is Friedman's argument that, although monetary policy was the only effective tool of macroeconomic policy, it could not have any long run impact on the level of economic activity. Following his restatement of the quantity theory, Friedman argued that the only impact of monetary policy was on the inflation rate, except that in the short run unanticipated inflation could influence the decisions of economic actors, until expectations are revised. This was reinforced by the "long and variable lags" which meant that policy makers could never be sure of when the monetary impulse would impact on the economy. Friedman therefore advocated a rule for monetary policy which limited the discretionary ability of government to use it to stabilise the economy. Although some of the details of Friedman's recommendations were not widely accepted, his arguments for making monetary policy the prime tool for macroeconomic policy became the accepted wisdom for the remainder of the twentieth century.

In order to evaluate the relative efficacy of monetary policy, it is necessary to examine the channels by which monetary policy is thought to influence the economy. The main instrument of monetary policy has changed

markedly since the post war period. Initially, control of the money supply (monetary stock) was seen as the tool of monetary policy. The debates between ‘monetarists’ and ‘Keynesians’ from the 1960s, although multi-dimensional, involved this question of the appropriate policy instrument. Keynesians argued that governments could not control the money supply, and, in any case, should target interest rates as the most efficacious instrument. Despite an extensive debate, no definitive answers emerged, and an impasse resulted.

The situation was resolved with the deregulation of domestic and international financial systems including exchange rates. The resulting highly mobile capital combined with a deregulated banking system meant that governments had to give up any attempt to control monetary aggregates. Monetary policy instead, shifted to targetting interest rates. For example, the Reserve Bank of Australia (RBA) sets monetary policy via its influence on the cash rate (overnight rate). Following Milbourne (1990: 241) the transmission mechanism for monetary policy is summarised in Figure 1.1.

Many economists now think that monetary policy is a blunt and uncertain instrument.³ Partly as a result of financial and exchange rate deregulation, the transmission channels have become increasingly unreliable, firstly in terms of the lag between when the Reserve Bank implements changes in interest rates and when these, in turn, impact on the economy and, secondly, in terms of the size of that impact. In the famous analogy, quoted at the beginning of the chapter, monetary policy was compared with string due to the fact that is better able to pull an economy out of a boom, than push it out of a recession. Not only, then, is monetary policy associated with “long and variable lags”, but there is significant uncertainty as to the size of its impact. To understand why, we need to consider the channels summarised in Figure 1.1.

The initial influence is from the RBA’s control over changes in the cash rate, and the effect of the announcement of any changes, on other interest

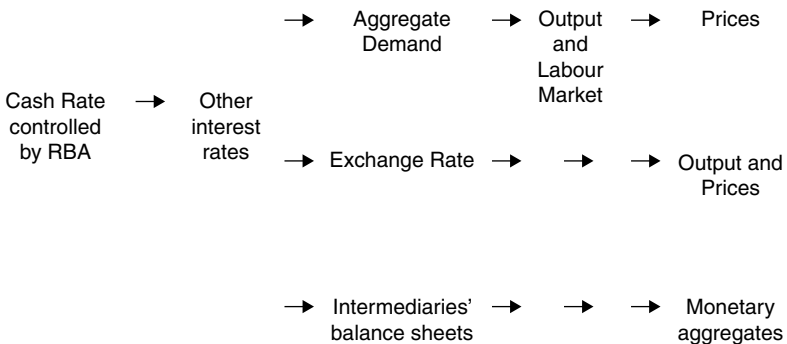


Figure 1.1 The transmission mechanism of monetary policy
 Source: After Milbourne (1990: 241)

rates in the economy. Although it is generally accepted that this link is quite robust, financial deregulation has weakened some of the effects. The increased encroachment of non-bank financial intermediaries into some financial markets, particularly the mortgage market, means that there is something like a kinked-demand curve effect operating in those markets. Banks, in those markets particularly susceptible to competitive pressures, will follow the cash rate for reduction in interest rates, but are much slower to follow increases. However, this does not appear to have significantly weakened the link between cash rates and other interest rates.

Changes in interest rates will, it is argued, affect the economy through three main channels. The most important, and most direct effect, is through the interest elastic components of aggregate demand. Here, certain types of expenditure, particularly private sector investment and consumption, are held to be directly and negatively influenced by interest rates. A rise in interest rates causes these expenditures to fall and, via a multiplier process, further reductions in aggregate demand, output and employment occur. Hence, tight monetary policy associated with higher interest rates leads to reduced levels of demand, output and employment which also reduce (demand-pull) inflationary pressure.

A second, less direct transmission mechanism results from the impact of changes in interest rates on the exchange rates. Since mobile international capital is seeking the highest expected return, it will act positively to increases in the interest rate differential between Australia and the rest of the world. Other things equal, tight monetary policy, by increasing that differential, will lead to appreciation of the currency. By reducing the domestic price of imports and increasing the overseas price of exports, this will reduce cost and demand inflationary pressures, as well as output and employment.

Finally, there is the impact of changes in the rate of interest on the value of bank monetary assets. A rise in the interest rate reduces these and may make banks more cautious in their lending.

However, a close inspection of these supposed channels of influence shows that the issue is more complex than initially considered. Monetary policy may have some influence on tightening the reins on an overheating economy. A more careful examination of the transmission mechanism reveals, however, that monetary policy is impotent with respect to stimulating demand during a recession.

The main economic variables thought to be influenced by interest rate changes are the level of private sector savings and private sector investment. With respect to consumption, since, in neoclassical theory, the rate of interest represents the reward for foregoing consumption, the higher the interest rate, the higher will be the economy's saving and the lower its consumption. However, as has been known since before Keynes (1936), the effect of a change in interest rates on saving will be ambiguous. As with any "price" change, the overall impact on quantity depends on the direction and

relative size of the income effect and this is an empirical question. Empirical evidence suggests that there is no significant relation between interest rates and saving, although changes in interest rates may influence the assets in which people save.⁴

Similar ambiguities lie in the relation between interest rates and investment. Investment activity is undertaken when it is profitable to do so. Profits, of course, are the difference between revenues and costs. Interest rates enter into the calculation as part of the cost (actual or opportunity) of financing the project and investment will not respond unless there is an expected revenue gain from a new investment project, no matter how low interest rates are. In other words, we expect investment to be interest inelastic when business does not expect to be able to sell the output of the investment project as in times of recession. If a company does not expect to generate any increased sales from a new project, then even if the interest rate is zero, it is unlikely to invest in that project.

When the economy picks up, sales and expected revenue, the perceived profitability of investment, will improve. Increases in interest rates, under these circumstances, will, by increasing costs, influence profitability and hence will impact on the level of investment. What we would expect, therefore, is that the interest elasticity of investment is a non-linear function of the level of economic activity (Stegman, 1994). Even in a boom, however, investment may not be particularly interest elastic. When output is increasing, and entrepreneurs are optimistic, they may expect revenue to increase more than any reasonable increase in interest rates. It is only after the turning point is reached, and the economy's rate of growth begins to decline that interest rates may influence investment. Of course then they are no longer needed.⁵

The indirect impact of interest rates through exchange rates is also questionable. By influencing the interest rate differential between the home country and the rest of the world, changes in domestic interest rates will influence international capital flows subject to two important provisos: (a) that the change in domestic interest rates does change international interest rate relativities, which is not always the case; and (b) that market expectations, particularly with respect to future exchange rate movements are of equal importance in influencing such flows.

Although exchange rate changes directly influence domestic inflation rates through their impact on the domestic cost of imported goods and perhaps exports, the impact on output and employment depends on the price elasticities of exports and imports. In a small open economy, like Australia, which exports mainly raw materials and imports mainly intermediate goods, neither exports nor imports are likely to be price elastic. This means that the main impact of interest rate changes through the exchange rate will be on the price level rather than on output/employment.⁶

The final channel by which monetary policy may influence the economy is through bank balance sheets. Changes in interest rates lead to changes in

the value of bank's net assets, which, in turn, influence their willingness to extend credit. Loose monetary policy increases their willingness to extend credit. The reverse is true with tight monetary policy, where increasing interest rates are associated with a tightening of credit. Many economists believe that it is through the impact on the availability of credit that the effect of monetary policy is felt on the economy. However, this channel will also mainly be effective in dampening booms, where tightening the availability of credit may discourage investment by reducing firms' ability to finance. Furthermore, the relation is not symmetric: easy credit is unlikely to be taken up during downturns.

In short, the efficacy of monetary policy depends on fairly high values for the interest elasticity of investment and/or on the price elasticities of imports and exports. We have cited evidence to suggest that, at least in Australia's case, none of these are large.

1.3 Traditional Arguments Against the Use of Fiscal Policy

This section considers the major arguments put forward in the 1970s and 1980s against the use of fiscal policy, as opposed to monetary policy, to increase economic activity. It is included for the sake of completeness and will be brief since the ground has been well covered over the last twenty five years.⁷ Two quite different, indeed mutually incompatible, arguments had an influence not only in academia but also in the world of practical affairs. The first was crowding out theory and the second the twin deficits hypothesis.

Crowding-out theory maintains that an increase in the deficit will cause a fall in private investment expenditure of (almost) the same size as the rise in the deficit.⁸ Accordingly, it is argued that if the government finances the deficit through borrowing, interest rates are forced up and private investment falls. Moreover, even if the various multiplier effects are such that economic activity increases, more money will be demanded by the public to carry out this increased economic activity. They will try to borrow this extra money, forcing up interest rates further until the increase in output is reversed.

Underlying the crowding out thesis is the assumption that monetary authorities are successful in maintaining a constant stock of money. This assumption is necessary if interest rates are to rise. It is not clear, however, why the monetary authorities would want to reduce the effects of expansionary fiscal policy in a recession by allowing interest rates to rise. Moreover, the analysis that shows increased government expenditure leading to higher interest rates if the stock of money is held constant, applies equally to any expenditure increase. For example, increasing investment or foreign expenditure on Australian exports, will also push up interest rates in Australia if the monetary authorities are successful in preventing changes in the stock

of money. In this respect expansionary fiscal policy is no different from any sort, of stimulus that might lift the economy out of recession.

In any case the monetary authorities in Australia and elsewhere do not maintain a constant volume of money. After financial deregulation, the volume of money is endogenous.⁹ In effect, those supporting crowding out in today's world of deregulated financial markets are arguing that, whenever government expenditure increases, the central bank actively tightens monetary policy to the extent necessary to reduce private investment by an amount equal to all, or most of, the increase in public expenditure.

There is one qualification that should be made to this conclusion. Short-term interest rates are the monetary policy instrument and private sector investment decisions may be more influenced by long-term interest rates. It is possible that large budget deficits might increase the spread between short-term and long-term interest rates. For example, if inflationary expectations rose, the spread between short- and long-term rates could rise and crowd out private investment. However, there is no evidence of this happening in Australia. There is virtually no correlation between budget deficits for all levels of government in Australia combined, as a percentage of Gross Domestic Product (GDP), and the spread between long- and short-term interest rates. Over the period from the floating of the exchange rate to 1996/97 the adjusted squared correlation coefficient is 0.07 which is nowhere near being statistically significant.

Hence, if a bigger deficit leads to higher interest rates in Australia, it must be because monetary authorities increase short-term interest rates. If one examines changes in the size of the deficit and changes in short-term interest rates in Australia, it is hard to find a relationship, but if anything the relationship is inverse (Neville, 1997: 101–103).

Thus, the crowding out argument fails in Australia. There is also no international evidence that larger deficits cause a rise in interest rates. For example, Heilbroner and Bernstein (1989) (quoted in Pressman, 1995) carried out a cross-sectional analysis of the G7 countries and found no evidence that increases in the public debt were correlated with rises in interest rates.

The second influential argument, the twin deficits hypothesis, maintains that if a budget deficit is created or increased the balance of payments on current account will increase by a similar amount so that all the expansionary impact will go overseas through increased imports. The social accounting identities ensure that this will happen if other things do not change, but this is irrelevant unless one has a theory to support any *ceteris paribus* assumption. Perhaps the best attempt at such a theory was put forward by Godley and Cripps (1983), but their theory only suggests that the twin deficits relationship holds in very long run equilibrium situations, making it largely irrelevant to anti-cyclical policy making. In any case, empirical evidence does not support the twin deficits hypothesis. For example, from 1990 to 1993 in the G7 countries as a whole, budget deficits more than doubled and

the current account deficits fell to zero. This was not an isolated incident. A similar story applies to the years 1980 to 1983.

Although the twin deficits theory is contradicted by experience in most G7 countries (and Australia) in most recessions, the point, that when an economy expands imports also usually rise, still stands. This does not matter in a recession, when the level of economic activity is low and imports are likely to be low. It could cause problems for a country if fiscal policy gives a substantial boost to economic activity while a country's trading partners are still in recession. However, this would be the case whether it is fiscal policy or monetary policy or both which has caused the increase in economic activity.

Other arguments against the use of fiscal policy were put forward in the 1980s and 1990s, notably the so-called Ricardian equivalence theorem at a theoretical level and timing problems at a practical level. Barro (1974) revived interest in the so-called Ricardian equivalence theorem which asserts that an increase in the budget deficit will be matched by an increase in private-sector savings as households try to increase their wealth in order to cover the increase in tax liabilities that they expect in the future. This proposition, rightly, has had few committed supporters among Australian economists or policy makers. It is likely that any debt will be repaid, not by those increasing their savings, but by their children or grand-children. Some will not have children and others may not care overly much about their children's tax liabilities. Many, perhaps most, may not even think about future tax liabilities in this way.

Moreover the empirical evidence, both in Australia and overseas, is against the Ricardian equivalence theorem. Edey and Britten-Jones (1990) found that private savings ratios were quite stable in Australia despite major swings in public savings. In the United States, Summers and Carroll (1987) found a clear inverse relationship between private savings rates and budget deficits and Pressman (1995) notes similar relationships in Canada, France, Germany and Japan.

There is one final very important point why the Ricardian equivalence theorem is not an argument against effective fiscal policy. Deficits can be used to finance public investment which produces a return enough to pay off any debt incurred in financing it or increases the tax base enough so that even if households act according to the principles underlying the Ricardian equivalence theorem, they will not have to increase their savings rate.

Another argument against the use of fiscal policy to fight recessions is that it takes too long for the decision to make a fiscal policy change to be translated into effective action. Hence, when the stimulus occurs the economy may be already growing strongly and it may do more harm than good. This has more validity in the United States than in countries governed under the Westminster system. Nevertheless, it does point to the need to have a stock of planned projects ready to be implemented to get the widest benefits from

the expenditure side of expansionary fiscal policy. Even if there is a stock of projects ready to be commenced, it may still take a long time to gear up new projects, although it may be much quicker to speed up ongoing projects. However, cutting tax rates also gives a boost to the economy. Adherents of the permanent income theory of consumption may think this does not hold for income tax cuts perceived to be temporary, but temporary cuts in indirect taxes should be very effective if they are enacted as temporary cuts only.

Towards the end of the 1980s the implications for the size of the national debt were used as an argument against the use of fiscal policy to stimulate the economy. Assuming that a country's national debt is held by its own citizens, the liability (to taxpayers) is balanced by the assets of those who hold the debt. Nevertheless, the consequences for income distribution may be important and a large national debt relative to GDP reduces the freedom of action with respect to fiscal policy and may impose other burdens. Some have argued that the budget should be balanced over the business cycle, but if nominal GDP is growing there can be a positive budget deficit on average over the business cycle without any upward trend in the ratio of national debt to GDP. In any case the discussion is academic in the case of Australia where the total of Commonwealth Government securities and Treasury Notes on issue is around 10 percent of annual GDP.

In summary, convincing refutations have been made over the last twenty years against the arguments put forward in the 1970s and 1980s against the use of fiscal policy to stimulate economic activity in a recession. The problems that arise when one country tries to 'go it alone' were only briefly mentioned. These have become more severe with globalisation and are considered in the next section.

1.4 Fiscal Policy with Global Financial Markets

New arguments in the 1990s against the use of expansionary fiscal policy relied not on analytical economic arguments leading to hypotheses that can be tested by standard methods but on arguments about how business persons, especially those in financial markets, would react to the use of fiscal policy. The arguments stressed the effects of the financial deregulation and globalisation. Globalisation is a term coined to describe the greater interdependence, even integration of national economies. It is most obvious in financial markets. Vast sums of money cross national boundaries each day. Computers link institutions around the world and professionals can deal as easily in a country on the other side of the world as in their own city. The consequences of this virtual integration of financial markets around the world are seen every day, for example, when Australian share prices fall soon after interest rates rise in New York.

Although this integration may not be the most important manifestation of globalisation, it is the aspect that is important in the present context.

Globalisation has given financial markets considerable influence on government policy. In an influential book, Friedman (2000) coined the term 'golden straitjacket'¹⁰. He argued (Friedman, 2000: 101–111) that to have access to international financial markets a country has to follow a set of rules which make up this straitjacket and if a country breaks these rules it is "disciplined" by financial markets either avoiding or withdrawing its money from that country. The golden straitjacket has in all sixteen rules. Some of these, such as eliminating government corruption, are motherhood statements in a country like Australia. The three that directly affect fiscal policy are maintaining a low rate of inflation, shrinking the size of the government sector and maintaining as close to a balanced budget as possible. These limit the use of fiscal policy to stimulate economic activity.

Giving complete priority to price stability over full employment as a goal of macroeconomic policy clearly limits the use of fiscal policy to fight recessions. A rule that requires a continual reduction of the size of the government sector is presumably hyperbole, but a small government sector reduces the size of the effects of automatic stabilisers. Due to our high marginal propensity to import, automatic stabilisers are generally small in Australia. However, there are two other important influences on their size: (a) the average rate of taxation; and (b) the effect at the margin of changes on the rate of economic growth on the level of transfer payments. The larger these impacts, the greater will be the automatic stabilising effects. In principle, the size of these parameters need not depend on the size of the general government sector, but in practice they do. The aim of always achieving a budget balance obviously limits the use of fiscal policy though it does not neuter it altogether. The balanced budget multiplier can still operate and government expenditure can be biased towards labour intensive areas. Such a bias will both maximise the increase in employment and usually increase the size of the balanced budget multiplier with respect to GDP. Thus, the golden straitjacket severely limits the use of fiscal policy to stimulate the economy, though it does not remove any use of fiscal policy at all.

As Friedman is a journalist it is not reasonable to expect him to present detailed research to support his views. He is only reporting the factors that allegedly influence financial market participants and making a judgement that these reported beliefs are correct. We will look at both these links in the chain of his arguments. Financial market economists frequently make statements about the importance of price stability as against reducing unemployment which are echoed by financial journalists. Some go as far as to assert that price stability is usually virtually all that macroeconomic policy need be concerned about. For example, P.P. McGuinness wrote in the *Sydney Morning Herald* (15 May 1997) that "the chief task of normal macroeconomic policy [is] the control of inflation."

Given the price stability emphasis, it is not surprising that financial market economists eschew fiscal deficits. Conventional wisdom still holds that

deficits are inflationary, although this is quite illogical if those holding this belief also believe that deficits crowd out an equivalent amount of private sector expenditure. However, assuming that deficits do increase economic activity they are likely both to reduce unemployment and increase the current account deficit which puts downward pressure on the exchange rate. Each of these will increase inflationary pressure.

A desire in financial markets to reduce the size of the government sector would not be surprising given that financial institutions make large profits by arranging privatisation of government businesses. However, it is not clear cut that financial market economists argue strongly for smaller government. The point is moot given that financial market institutions continually deal with countries that have moderate (Germany) to large (Norway) government sectors. Rodrik (1996) shows that, in general, those countries that are most open and integrated into the global economy have large government sectors.

With respect to the other two rules, it is more difficult to assess the strength of the second link in the chain, the extent to which the actions of financial markets are influenced by whether or not countries follow the rules which make up the golden straitjacket. Common to his genre, Friedman tends to use supporting anecdotes, which certainly show that on occasion financial markets do 'discipline' countries in the way he asserts. However, they do not show how systematic this is. Anecdotes in favour of Friedman's position can be countered with anecdotes against it. Other evidence is needed.

Starting with *a priori* arguments, there are good reasons why financial markets would be cautious in investing in countries where the rate of inflation is rising. An increasing inflation rate is usually followed by interest rate rises. It has already been argued in Section 2 that rises in interest rates are detrimental for profits. In a speech to the National Press Club, just before his retirement as Governor of the RBA, Bernie Fraser said that monetary policy was becoming the hostage of influential financial markets with a vested interest in making the Reserve Bank give greater weight to inflation than employment. He explicitly believes that "Most financial market participants rate low inflation ahead of the Reserve Bank's other objectives. This reflects a number of factors but the financial harm that is done to the holders of bonds when inflation and interest rates rise is the main one" (*Sydney Morning Herald*, 16 August 1996).

However, there seems little reason why financial sector economists should be worried by stable inflation. High inflation rates may be inherently volatile, but this is not obvious in the case of moderate rates of inflation (say 4 to 10 percent). In fact, international financial markets invested heavily in Australia in the 1980s when inflation, as measured by the implicit gross national expenditure deflator, ranged between 6 and 10.7 percent and the prices of some classes of assets rose more rapidly¹¹. For financial markets, inflation stability seems to be more important than price stability but the operative word is seems.

If stable inflation is the important goal, then financial markets may still be heavily influenced by large or continuing budget deficits since these often add to inflationary pressure. In addition to anecdotes, which go either way, there is some systematic research. This suggests that while the freedom of action of national governments has been circumscribed it has not been removed. Keohane and Milner (1996: 248) conclude that "governments still have policy choices and fiscal policy may be the most important instrument for choice." This quotation sums up the chapter written by Garrett, in the volume they edited. After a careful cross country study of fifteen countries, Garrett (1996) concludes that monetary policy is constrained by increasing capital mobility, but that only weak evidence exists to show that fiscal policy is constrained. Moreover, Moore (1998) shows that much of the evidence found to support the loss of national autonomy in policy making is based on the experience of members of the European Economic Community who have gone much further along the road of integration of their economies than is generally the case.

Even for cautious responsible governments, national sovereignty in economic policy making need not be superseded by tailoring policies to please financial markets. Governments must certainly consider the likely effects of their policies on the actions of financial markets, but experience of the last twenty years suggests that this does not take away all freedom of action.

It is noteworthy that there is no mention of the current account deficit in Friedman's description of the golden straitjacket. In countries like Australia, with a large foreign debt and a current account deficit that is a high proportion of GDP, problems with financial markets could well arise. If Australia continually borrows large amounts from abroad, sooner or later foreigners will wonder if we will be able to service the debt and cease lending to us. This may precipitate a depreciation of the Australian dollar and require some adjustment in our economy. This adjustment may be painful if the depreciation is large and rapid. Moreover, the depreciation may be precipitated by currency speculators before it would occur if foreign investors were left to make the judgement themselves. However, how large is large is not immediately apparent. In the 1990s, Australia had a series of years in which the current account deficit was between 5 and 6 percent of GDP without causing any massive devaluation. Also, current account deficits are usually relatively low during a recession. The current account deficit may well be a problem in the context of maintaining a boom until full employment is reached. In the early recovery it is less likely to be a problem. However, this does not mean that it can be ignored all together, as concern about the current account deficit in the previous boom may have led to policy changes that precipitated the recession or made it more severe.

There is increasing evidence that international financial markets now pay less attention to economic fundamentals, which, it could be thought, would

be influenced by the golden straitjacket.¹² This provides another reason not to avoid otherwise desirable policy moves so as not to upset financial markets. The point is not that changes in the fundamentals lead to rapid herd-like movements in an exchange rate which overshoot any equilibrium level. It is that relatively small random shocks can set off herd-like behaviour. For example, between December 1999 and October 2000, the value of the Australian dollar fell by 20 percent against the US dollar and 15 percent against the trade weighted index at a time when the 'economic fundamentals', that the financial market supposedly give weight to, were sound. The budget was in surplus. Apart from a once-off effect of the introduction of the Goods and Services Tax, the rate of inflation was 2 percent and not expected to rise significantly. Even the current account deficit was relatively low. Over the next five months the exchange rate fell by a further 5 percent before returning to the October level and fluctuating about it for the next eighteen months. The motivation for the herd-like behaviour can be neatly summed up in the words of one US analyst "Who cares if the economy is sound? The trend is down. So traders short the currency. It is that simple." (*Sun Herald*, 22 October 2000).

This type of attitude reduces the value of following any systematic rules to keep the approval of international financial markets. In recessions, even when Australia is going it alone, rises in the inflation rate do not seem to be likely in today's economy. The last example of a rise in inflation during a recession was in 1974–75, and that is the only example since the Second World War. However, while budget deficits are usually appropriate in a recession it would be prudent to avoid continuing large budget deficits once the economy starts to emerge from a recession.

While the current account deficit is unlikely to be a problem in the depth of a recession or at the beginning of an upturn, it may have been an important reason for the severity of a recession or even for its occurrence in the first place. It has been argued that, for many countries, the major constraints on domestic economic activity are external sector factors, especially the current account position.¹³ The problem is essentially a structural problem, which macroeconomic policy can do little to cure.¹⁴

Nevertheless, when balance of payments problems arise, countries often rely on contractionary macroeconomic policy as a cure. There are extremely important drawbacks to such a strategy. As well as causing increased unemployment, contractionary policy, while treating the symptoms, makes the underlying cause worse. Any long-term solution requires increased exports and/or a reduced reliance on imports as a result of domestic import substitution. Both of these require investment in the tradeables sectors. Short-term contractionary solutions in the form of high interest rates impede investment and the growth of domestic capacity. In turn, this increases reliance on imports and reduce export competitiveness, which makes the problem worse in the longer term. Like a drug addict, the more a country relies on

the short fix of tight monetary and fiscal policy, the more dependent it will become on them as the only cure for the problem.

1.5 Fiscal Policy: The Tool of Choice?

Fiscal policy should be centre-stage in policies to boost the economy out of recession. Since 1945, it has been so used in Australia in every instance when a major recession was short-lived (Neville, 2000). Moreover, even apart from its greater and more immediate effect on output in a recession, fiscal policy has a number of advantages over monetary policy, which are important in today's circumstances. Not the least of these is that the various tax rates and the size and types of expenditure, which are the components of fiscal policy, affect almost all facets of economic activity including the distribution of income.¹⁵ This is sometimes thought of as a disadvantage, leading at best to thinly disguised pork-barrelling to win votes and, at the worst, to outright corruption. Nevertheless, in a country like Australia with strong democratic traditions, these adverse attributes should be kept in check and fiscal policy can be used, not only to boost economic activity, but also to achieve social justice/equity aims. It is important that these are realised both because ultimately economic policy is not about increasing efficiency but about increasing the well-being of those in the economy. Neville (1994) argues that in the long run, policies that directly increase efficiency will face a growing and destructive backlash if they take no account of adverse income distribution issues.

Nevertheless, relying on fiscal policy alone is like fighting a recession with one hand tied behind one's back. Tinbergen (1952) argued that the best approach to macroeconomic policy making was not to use one policy instrument to achieve this goal and another to achieve that. Instead one should consider the effect of all policy instruments, working together, on all the goals of policy, or more precisely, on the target values of the variables policy is trying to influence. Using Tinbergen's procedures it is still necessary to have as many policy instruments as target variables, but policy is more flexible and more likely to be successful if policy instruments are not assigned to particular targets. In fighting recessions monetary and fiscal policies should both be used. Other policies can also play a role as, for example, incomes policy was important in 1983–84. There should be no single policy instrument of choice for fighting recessions.

1.6 Conclusion

In Section 2 strong arguments were made as to why monetary policy should not be the main policy used to fight recessions. Sections 3 and 4 presented evidence to refute the arguments that have been put forward against using fiscal policy to stimulate economic activity during a slump. However our

conclusion is not that fiscal policy should be the instrument of choice, but that as many policy instruments as feasible should be used to fight recessions. This conclusion is even stronger if one widens the task from not only stimulating economies during a recession, but also to avoiding recessions in the first place.

In a small open economy, like Australia, where the current account is often a major constraint on the level of economic activity, both monetary policy and conventional fiscal policy are limited in their ability to facilitate growth and avoid recessions. Policies designed to affect output and employment levels have little influence on the underlying problem, which is related to structure. To influence effectively the brakes on the economy imposed by the current account, the economy needs to change the nature of what it produces, so that it can significantly increase both import-competing goods and exports. What is needed, therefore, are policy tools which can be aimed at specific sectors to encourage this type of structural change.

Notes

1. There is evidence that the fashion is changing again, with an increasing number of economic commentators praising the virtue of fiscal policy (for example, Fraser, 2001).
2. All data used are from OECD, *Main Economic Indicators*, and Reserve Bank of Australia, *Bulletins*.
3. See, for example, Milbourne (1990).
4. See, for example, Edey and Britten-Jones (1990) and Honohan (1999) especially p. 98.
5. This has been reinforced by the empirical evidence which has struggled to find any link between interest rates and the level of investment. See, for example, Edey and Britten-Jones (1990: 246–8), Milbourne, (1990: 246–248), Eisner (1991) and Bernstein and Heilbronner (1991).
6. It could even have a perverse effect on employment if labour intensive industries are relatively disadvantaged. There is evidence that this happens to some extent in Australia (Pope, 1981).
7. For a more detailed discussion see Nevile (2000).
8. While many proponents of crowding out talk as if there were 100 percent crowding out, it is a simplification to ascribe to all holding this view a belief in complete crowding out, but they do hold that it approaches 100 percent (Mayer, 1978).
9. This is now accepted by almost all economists. For example, the current Governor and Deputy Governor of the Reserve Bank of Australia have said: For all intents and purposes, the quantity of “money”, defined as M1, M3 or some other “M” will be determined endogenously: there is no thought of the central bank actually directly controlling the supply of this “M”. (Macfarlane and Stevens 1989: 5).
10. Page references in this paper are to the 2000 revised edition. The first edition was published in 1999. The book is important precisely because it has been so influential. A quick search using Alta Vista produced over 6,000 references to it.
11. Net foreign debt was 6 percent of GDP in 1981 and 36 percent in 1990.
12. See, for example, Shiller (2000).

13. See, for example, McCombie and Thirlwall (1994) and Andersen and Gruen (1995).
14. Macroeconomic policy can, and does influence the exchange rate and a fall in the value of the real exchange rate will help. However, if as seems to be the case in Australia the price elasticities of exports and imports are relatively small, the required change in the real exchange rate needed may be much larger than is feasible (or desirable given the income distribution effects). See Kriesler and Halevi (1995).
15. We are indebted to Fraser (2001) for reminding us of this point.

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2

Macroeconomic Impacts of Globalization

Peter Kriesler and J. W. Nevile

With floating exchange rates, high capital mobility may render expansionary fiscal and monetary policy ineffective (or even counterproductive) . . . Internationalization will undermine the autonomy and efficiency of government macroeconomic policy. (Milner and Keohane, 1996, p. 18)

2.1 Introduction

Globalization has led to substantial changes to the economies of many nations. The contemporary form of globalization has substantially increased the degree of openness of most economies, both in terms of international capital flows and in trade, and it represents an almost overwhelming force impacting on all countries. This paper considers some of the implications of the macroeconomic impact of globalization on nation states within an explicitly Keynesian/Kaleckian framework. Two interrelated forms of macroeconomic impact are considered. Initially, the general implications of globalization for the output and growth of national economies are examined, before turning to the constraints imposed on the ability of governments to influence the macro-economy via traditional policies.

In terms of macroeconomic outcomes, a major impact of globalization is on the level of employment and output through the balance of trade. Increased openness increases reliance on international trade. This, of course, need not be, *per se*, a problem. Difficulties arise due to the lack of effective instruments to deal with balance of trade imbalances, particularly deficits. The implications of this lack of instruments are to establish a deflationary/contractionary bias in the international monetary system, with important implications for the growth of output and employment.

Revised from *Growth and Development in the Global Economy*, 173–189, 2003, 'Macroeconomic Impacts of Globalization', by Kriesler, P. and Nevile, J. With kind permission from Edward Elgar Publishing. All rights reserved.

The problem is exacerbated by the limitations on macroeconomic stabilization policy resulting from globalization. Many economists and policy analysts argue that globalization, particularly the increased mobility of international financial capital, has undermined the ability of countries to engage in independent macroeconomic policies, whether fiscal or monetary. The implications of this are that governments are less able to insulate their economies from the adverse effects of trade.

The next section outlines Keynes' and Kalecki's arguments that trade imbalances are the result of countries shifting their own unemployment problems elsewhere. High saving countries tend to have problems maintaining levels of domestic demand high enough to fully employ their workforce. Surpluses are a way of exporting unemployment to deficit countries. The international monetary system, by putting the onus of adjustment on the deficit country, introduces a deflationary bias to the international system, which has been reinforced by recent movements towards increased globalization.

Conventional neoclassical economics does not agree that trade imbalances are undesirable or place constraints on the domestic economy. According to this view, trade balances do not matter since surpluses, which are the result of high saving ratios, allow those savings to finance economic activity in low saving countries. The neoclassical arguments are briefly outlined in the section entitled 'The neoclassical view of trade imbalances' and the weaknesses in this position are pointed out.

Globalization reduces the ability of macroeconomic policy to stabilize the economy at an acceptable level of employment. The paper outlines the reasons for this, and the implications, in the case of both monetary policy and fiscal policy.

2.2 Keynes and Kalecki on International Trade and the Payments System

International trade . . . is . . . a desperate expedient to maintain employment at home by forcing sales on foreign markets and restricting purchases, which, if successful, will merely shift the problem of unemployment to the neighbour which is worsted in the struggle. (Keynes, 1936, pp. 382–3)

Within the Keynesian/Kaleckian framework, full employment is not the normal state of affairs in capitalist economies, with the main determinant of the level of output and employment being the level of effective demand. Within this framework, a higher saving ratio is likely to lead to lower growth rates and relatively higher levels of unemployment. This is due to the role of saving as a leakage, so that any attempt to increase saving (reduce consumption) will lead to a multiplied reduction in income (The Paradox of Thrift).

This leads to an association between high savings ratios and low levels of output and employment. One way for a nation to overcome this problem is

to export unemployment, in other words, to overcome the domestic shortage of demand by substituting export demand for domestic demand. In this case, since one country's surplus is another country's deficit, the leaking of demand from the deficit country will reduce demand and employment there.

Keynes clearly understood the importance of international trade as a mechanism for exporting unemployment between developed nations (Keynes, 1936, Chapter 16). According to Keynes, the primary condition for stability is the attainment and maintenance of full employment by means of domestic policies. If developed countries failed to use domestic policy to maintain full employment, then, to the extent which they could maintain a trade surplus, they could export unemployment problems to countries with resultant deficits. The international battle for markets was seen by Keynes as being a battle caused by countries abdicating their domestic responsibility to maintain full employment. He also warned of the dangers of such battles:

The fact that the advantage which our country gains from a favourable balance is liable to involve an equal disadvantage to some other country . . . means not only that great moderation is necessary, so that a country secures for itself no [more] . . . than is fair and reasonable, but also that an immoderate policy may lead to senseless international competition for a favourable balance which injures all alike. (Keynes, 1936, pp. 338–9)

Keynes realized the importance of an international system of payments that would ensure such 'reasonableness'. However, during the Bretton Woods conference, which developed the postwar payments system, his suggestions were not adopted (see Skidelsky, 2000, Chapter 10). The resulting system and its contemporary offspring have no mechanism to ensure 'reasonableness' and therefore contain the seeds of an international tendency towards stagnation.

According to Keynes the ability of countries to influence their balance of trade came mainly through influence on imports. He saw devaluation/depreciation as of limited efficacy in influencing trade. On the other hand, trade protection had political limitations, and was likely to lead to retaliation. So the main mechanism to improve the balance of trade was a reduction in domestic income, as a means of reducing imports. In this way, increased unemployment was seen by Keynes as the only mechanism capable of restoring international balance to deficit countries. Of course, the unemployment and fall in income would reduce investment via the accelerator, which, in turn, reduced future productivity, capacity and so on.

Kalecki reached similar conclusions about the importance of domestic full employment policy for the viability of an international system of trade based on multilateralism: 'Multilateralism is certain to realize its advantages only if full employment based on domestic expenditure is maintained in

all countries. It is certainly unworkable if employment in major industrial countries is subject to fluctuations' (Kalecki, 1946, p. 413).

For Kalecki, the key determinant of output was the expenditure decisions of capitalists, in particular their investment decisions, which was related to expected profits, which were in turn determined by both current profits and by levels of capacity utilization, both of which were determined by changes in the level of income. Abstracting from government, Kalecki argues that:

In fact, aggregate profits are equal to the capitalist consumption plus investment plus the balance of foreign trade. Profits of a given year were either consumed, invested in the construction of capital equipment and in increase in inventories, or, finally, used for repayment of foreign debts or granting of foreign credits. (Kalecki, 1933, p. 164)

Kalecki argues that an increase in an economy's balance of trade surplus will lead to an equivalent increase in aggregate profits, which will stimulate investment and employment. However, there is a feedback effect from this subsequent increase in economic activity to an increase in imports, which will reduce the trade surplus.

Kalecki then considers the capital account implications of the trade surplus. An increased surplus in the current account will lead to an equal increase in outflow on the capital account. This outflow may be in the form of debt or equity. In either case, there is no change to the initial increase in domestic investment and economic activity. However, 'foreign countries' will become indebted to the capitalists of the surplus country to the extent of the surplus.

Although neither Keynes nor Kalecki analyzed the next round effects, these effects reinforce the initial problem. For the surplus country, the foreign exchange surplus increases both domestic profits and the level of economic activity. These will in turn, according to both Kalecki and Keynes, generate increased investment. The increased level of domestic investment will increase both capacity and productivity within the country therefore reinforcing its trade advantage, which will further improve its current account. Thus the initial balance of trade surplus will lead to a virtuous circle of cumulative causation further increasing its advantage over its trading partners. This is reinforced by the implications of the offsetting capital flows. Regardless of whether the capital flows take the form of equity or debt, they have a dual role:

[T]he export surplus enables profits to increase above that level which would be determined by capitalists' investment and consumption. It is from this point of view that the fight for foreign markets may be viewed. The capitalists of a country which manages to capture foreign markets

from other countries are able to increase their profits at the expense of the capitalists of the other countries . . .

(Foreign lending by a given country need not be associated with exports of goods from that country. If a country A lends to country B, the latter can spend the proceeds of the loan in country C, which may increase *pro tanto* its stock of gold and liquid foreign assets. In this case foreign lending by country A will cause an export surplus in country C accompanied by an accumulation of gold or liquid assets in that country . . .)

The above shows clearly the significance of 'external' markets . . . for a capitalist economy. Without such markets profits are conditioned by the ability of capitalists to consume or to undertake investment. It is the export surplus and the budget deficit which enable the capitalist to make profits over and above their own purchase of goods. (Kalecki, 1965, p. 51–2)

In addition, the capital flow in one direction will, in later periods, lead to income flows, either in the form of dividends and profits, or in the form of interest repayments in the opposite direction, reinforcing the initial effects of the trade flows. In the deficit country, on the other hand, the deficit reduces domestic profits, investment and output, unless foreign investment fills the gap. The lower levels of investment further reduce future productivity and capacity and, therefore, the country's ability to compete on international markets. This problem is reinforced by the movements on the capital account. To pay for the deficit, the country relies on capital inflows. However, today's solution adds to tomorrow's problem as those capital flows are subsequently associated with current account outflows in the form of interest or profit payments. Just as with the surplus country, so too with the deficit country a process of cumulative causation is set up, but this time it is encapsulated in a vicious circle of increased indebtedness and reduced competitiveness. 'Only to the extent to which the capitalist system lends to the non-capitalist world (or the latter sells its assets) is it possible to place abroad the surplus of goods unsold at home. Only in this way do 'external markets' solve the problems of the world capitalist system' (Kalecki, 1967, p. 456).

The fundamental problem of the present payment system is that the burden of adjustment lies with the deficit country. Adjustment requires either a devaluation/depreciation of the value of the currency, or tight government policy to reduce income, so as to directly reduce imports. Limits to the efficacy of devaluation/depreciation were noted by both Keynes and Kalecki. Both noted the importance of the static elasticity conditions [the Marshall/Lerner condition], which were unlikely to be met in the case of raw material imports.¹ In addition if successful, a depreciation will invite retaliation. Furthermore, such policies are likely to be resisted due to their inflationary consequences. This leaves policy induced recessions as the main mechanism for adjustment via the effects on imports. However, this is likely to cause balance of trade problems in other countries. At the same time, the policy will cause a reduction in investment.

Both Kalecki and Keynes argued that if the burden of adjustment was on the surplus country, this would require either an appreciation or an expansion of income, in order to increase imports. In both cases effective demand and profits would be augmented elsewhere. So other countries would also expand.² This would change the bias of world trade from its current contractionary tendency towards an expansionary one.

In any case it should be noted that it is difficult for a country to run a persistent trade deficit (unless they have net income flows generated through previous trade surpluses). Financing it requires capital inflows, either in the form of equity or debt, which will lead to income outflows in future periods. This will reinforce the current account deficit, requiring further capital inflows and so on, in which case either the country's foreign debt or foreign owned equity in the country will have to increase. However, both of these depend heavily on the expectations of overseas investors on that country's future rate of return and exchange rate movements. A permanently increasing ratio between the current account deficit and foreign debt to GDP are unlikely to be sustainable due to the effects on the confidence of foreign lenders and/or investors, so that the capital inflows necessary to finance the current account deficits may not be forthcoming.

All of these problems have been amplified, in recent years, by increased openness resulting from globalization. The more open an economy, the less it is able to protect itself from the ramifications of trade deficits. In addition, international financial markets are more likely to 'punish' trade deficit countries via capital flight, or by imposing extremely restrictive conditions on the issue of credit. Each of these will reinforce the contractionary bias of the system.

2.3 The Neoclassical View of Trade Imbalances

The main alternative to the view discussed above comes from neoclassical theory, according to which trade imbalances are the result of insufficient domestic savings and are not important if other countries are prepared to invest on reasonable terms in countries with a negative trade balance. Given the key position such analysis occupies, both in the economics profession, and in its influence over policy makers, it is important to examine it carefully.

According to this view, investment in a closed economy is limited by the savings decisions of the private sector. In an open economy, this savings bottleneck can be alleviated with the use of investment funds from abroad, either in the form of debt or equity. As a result, high savings levels in one country, far from being the problem envisaged by Keynes and Kalecki, are seen as being advantageous to other countries, which are able to tap into these 'loanable funds' in order to finance their own investments.³

There are serious logical and theoretical problems with these arguments. They rest on the loanable funds model, where savings constitute loanable funds used for investment, and must, therefore, precede that investment.

As a result, savings causally determine investment, with the rate of interest equating the two. This idea, of course, is the one which Keynes, in *The General Theory* (and subsequently) attacked. It will be recalled that for Keynes, it is the level of income which equated saving and investment, with the rate of interest being a monetary phenomenon determined by liquidity preference. Subsequently, non-neoclassical economists have identified three serious shortcomings of the loanable funds theory.

First, as changes in the rate of interest will have income and substitution effects with a great probability of them being in opposite directions, it is not possible, *a priori*, to determine the direction or the size of the effect on saving. In other words, it is not possible to describe theoretically any type of function relating saving to the rate of interest. This is reinforced by empirical evidence, which suggests that there is no significant relation between interest rates and saving, although changes in interest rates may influence the specific assets in which people save (Edey and Britten-Jones, 1990 and Honohan, 1999, especially p. 98). Rather, saving is mainly determined by the level of income. As a result, because increased investment leads to increased income, this generates the saving necessary to finance it. Any attempt to increase saving will reduce aggregate demand, and reduce income, via the paradox of thrift. According to Chick, 'Until Keynes, investment was assumed to be dependent on saving as the source of finance. Keynes reversed this causal ordering, arguing that investment, financed independently of saving, created additional income adequate eventually to generate an equal volume of investment' (Chick, 1987, p. 337).

The second problem with the loanable funds story is the assumption of an interest elastic demand for new capital stock, or the investment function, which was shown to rest on unsound theoretical foundations in the debates known as the capital controversies (Samuelson, 1966 and Harcourt, 1972). These showed that the inverse relation between the rate of interest and the level of investment does not hold up to theoretical scrutiny. In fact, the analysis leads to the rejection of any systematic relationship between the rate of interest and the level of investment.

In any case, even heuristic analysis suggests rejection of a simple systematic relationship between the rate of interest and the level of investment. Investment activity is undertaken when it is profitable to do so. Interest rates enter into the calculation as part of the cost of financing investment. This means that unless there is an expected revenue gain from a new investment project, it does not matter how low interest rates are, investment will not respond. In other words, we would expect investment to be interest inelastic when business does not expect to be able to sell the output of the investment project, that is in a recession. If a company does not expect to generate any increased sales from a new project, then even if the interest rate is zero, it is unlikely to invest in that project. When the economy picks up, as it moves into boom, sales and expected revenue, the perceived

profitability of investment, will improve. Increases in interest rates, under these circumstances, will, by increasing costs, influence profitability and hence are more likely to impact on the level of investment. This suggests that the interest elasticity of investment is a non-symmetric, non-linear function of the level of economic activity (Stegman, 1994). This story is reinforced by the empirical evidence on the interest elasticity of investment which suggests little if any responsiveness (see, for example, Milbourne, 1990, pp. 246–8, Bernstein and Heilbroner, 1991 and Eisner, 1991).

Finally, the loanable funds analysis breaks down if there is any financial asset in addition to money, except in the limiting case of an economy in stationary state equilibrium (see Kriesler and Nevile, 2002).

Underlying all these problems with the neoclassical approach is the assumption of full employment of resources in a non-monetary economy. If this is the case then, by definition, investment can only be increased if resources from elsewhere in the economy are freed. Hence, the necessity for saving, not as some sort of financial requirement, but to free resources. However, in an economy with unemployed or underemployed resources, there is no necessity for an increase in savings to precede an increase in investment as there are resources not being fully utilized. Even in a world of international capital movements, increases in investment will generate the increased saving necessary to 'finance' them (Dalziel and Harcourt, 1997).

2.4 Monetary Policy in a Global Economy

Given the contractionary bias imposed by the international monetary system, domestic macroeconomic stabilization policy should play a more prominent role in attempting to achieve full employment and reasonable output growth. However, certainly in the case of monetary policy, and to a more limited extent for fiscal policy, globalization has also eroded their effectiveness, as the next two sections will demonstrate.

It is generally accepted that monetary policy is a blunt and uncertain instrument (see, for example, Milbourne, 1990). Partly as a result of financial and exchange rate deregulation, the transmission channels have become increasingly unreliable, first in terms of the lag between when the central bank implements changes in interest rates and when these have an impact on the economy, and, secondly, in terms of the size of that impact. Not only is monetary policy associated with 'long and variable lags', but there is significant uncertainty as to the size of its impact.

Changes in interest rates will, it is argued, affect the economy through three main channels. The most important, and most direct effect, is through the interest elastic components of aggregate demand. Here certain types of expenditure, particularly private sector investment and consumption, are held to be directly influenced by the rate of interest. As a result, tight

monetary policy associated with increases in interest rates immediately lead to reductions in these components of demand. This, via a multiplier process, leads to further reductions in aggregate demand, output and employment, reducing (demand-pull) inflationary pressure. However, the lack of any deterministic relation between interest rates and the main components of domestic private expenditure has been discussed above, and suggests that this channel is of dubious efficacy.

A second channel by which monetary policy may influence the economy is through bank balance sheets. Changes in interest rates will lead to changes in the value of bank's net assets, which will, in turn, influence their willingness to extend credit. Loose monetary policy, associated with falling interest rates will, *ceteris paribus*, improve the value of bank assets, and will increase their willingness to extend credit. The reverse is true with tight monetary policy, where the increasing interest rates will be associated with a tightening of credit. Many economists believe that it is through the impact on the availability of credit that the effect of monetary policy is felt on the economy. However, the increased mobility of international capital flows has, to a large extent, undermined the efficacy of this channel. With the increased mobility of international capital, enterprises are no longer limited to domestic markets in their quest for financial resources. Tight monetary policy may lead to domestic credit rationing, but this is likely to lead to an increase in offshore borrowing, which will, therefore, undo the effect of monetary policy.

The final, less direct transmission mechanism results from the impact of changes in interest rates on exchange rates. Since mobile international capital is seeking the highest expected return, it will act positively to increases in the interest rate differential between countries. Other things being equal, tight monetary policy, by increasing that differential, will lead to appreciation of the currency. By reducing the domestic price of imports and raising the overseas price of exports, this will reduce both cost and demand inflationary pressures, as well as output and employment.

The indirect impact of interest rates through exchange rates is also not as tight as is sometimes argued. By influencing the interest rate differential between the home country and the rest of the world, changes in domestic interest rates will influence international capital flows subject to two important provisos. The first condition is that the change in domestic interest rate does change international interest rate relativities, which is not always the case, for example, where the central bank changes interest rates purely as a reaction to changes in international rates. The second is that market expectations, particularly with respect to future exchange rate movements, will be of equal importance in influencing such flows.

Although changes in the exchange rate will directly influence domestic inflation rates through their impact on the domestic cost of imported goods and perhaps exports, their impact on output and employment will depend

on the price elasticities of exports and imports. In the case of a relatively small open economy, like Australia, which exports mainly raw materials and imports mainly intermediate goods, neither exports nor imports are likely to be price elastic, so that the Marshall/Lerner conditions may not be satisfied (see, for example, Kriesler and Halevi, 1995). This means that the main impact of interest rate changes through the exchange rate will be on the price level rather than on output/employment.⁴

However, globalization has eroded the efficacy of even this channel of monetary policy. 'Enormous movements of speculative capital . . . seem to inhibit autonomous monetary policies as governments find it hard to set independent interest rates or control their country's exchange rate' (Helleiner, 1999, p. 145).

Even in those countries where monetary policy may have some impact, it is argued that globalization has rendered governments incapable of operating an independent monetary policy. Interest rate is most effective as a macroeconomic policy instrument when it is targeted to the exchange rate. However, interest rate parity theory suggests that countries are unable to have an interest rate significantly different from the 'world rate' for any reasonable period of time, and accordingly, cannot target the exchange rate. Although it is well known that empirical evidence does not support uncovered interest rate parity nevertheless, there is strong evidence that increased capital mobility has substantially reduced interest rate differentials, and, therefore, substantially reduced the scope for autonomous monetary policy (see Garrett, 1996 and Lavoie, 2000).

2.5 Fiscal Policy in a Global Economy

In recent years critics of fiscal policy have stressed the problems that arise when one country tries to 'go it alone', which have become more severe with globalization. Arguments in the 1990s against the use of expansionary fiscal policy relied not on analytical economic arguments leading to hypotheses that can be tested by standard methods but on arguments about how businessmen, especially those in financial markets, would react to the use of fiscal policy. The arguments stress the effects of financial deregulation and globalization. In this context the worldwide integration of financial markets is particularly important. Vast funds cross national boundaries each day. Institutions all around the world are linked by computers and professionals can deal as easily in a country on the other side of the world as in their own city. Even from the point of view of fiscal policy, not all the effects of this are bad. Globalization can reduce constraints of government fiscal policy, in the same way in which it can ease the financial constraints on firms, by enabling them to finance expanding expenditure and fiscal deficits by borrowing from international capital markets (Garrett, 1996 and Helleiner, 1999). On the other hand, given that international capital seeks the highest

rate of return, the ability of governments to raise certain taxes has been impeded, particularly taxes on capital (Garrett, 1996, p. 88).

The major effect of globalization of financial markets is to give these markets considerable influence on macroeconomic policy. In an influential book, Thomas Friedman (2000)⁵ coins the term 'golden straitjacket'. He argues (pp. 101–11) that to have access to international financial markets a country has to follow a set of rules which make up this straitjacket and if a country breaks these rules it is 'disciplined' (his word, p. 110) by financial markets either avoiding or withdrawing money from that country.

The golden straitjacket has in all 16 rules. The three that directly affect fiscal policy are maintaining a low rate of inflation, shrinking the size of the government sector and maintaining as close to a balanced budget as possible. Giving complete priority to price stability over full employment as a goal of macroeconomic policy clearly limits the use of fiscal policy to reduce unemployment.

A rule that requires a continual reduction of the size of the government sector is presumably hyperbole, but a small government sector reduces the size of the effects of automatic stabilisers. Two important influences on the size of those stabilisers are the average rate of taxation and the effect, at the margin, of the changes on the rate of economic growth on the level of transfer payments. The bigger these are the larger the automatic stabilising effects. While the size of these parameters need not depend on the size of the general government sector, they almost always do.

The aim of always achieving a budget balance obviously limits the use of fiscal policy though it does not neuter it altogether. The balanced budget multiplier can still operate and government expenditure can be biased towards labour-intensive areas. Such a bias will both maximise the increase in employment and usually increase the size of the balanced budget multiplier with respect to GDP.

Overall, if all three rules are followed, the use of fiscal policy to stimulate economic activity is severely limited. Therefore, the validity of Friedman's assertion, that the golden straitjacket must be observed to pacify financial markets, is crucial in evaluating the effects of globalization on fiscal policy.

As Thomas Friedman is a journalist, it is not reasonable to expect him to present detailed research to support his views. What he is doing is reporting what people say about what governs the actions of financial market participants and making the judgement that these reported beliefs are correct. We will look at both these links in the chain of his arguments as they crucially impact on the question of the efficacy of fiscal policy, though it is the second argument that is the most crucial. Like many other writers in this area, Thomas Friedman tends to support his statements about the actions of financial markets with anecdotes. These certainly show that on occasion financial markets do 'discipline' countries in the way Friedman asserts. However, they do not show how systematic this is. Anecdotes in

favour of Friedman's position can be countered with anecdotes against it. Other evidence is needed.

Although there are good reasons why financial markets would be cautious in investing in countries where the rate of inflation is rising, there seems little reason for them to be worried by a stable rate of inflation. High inflation rates may be inherently volatile, but this is not obvious in the case of moderate rates of inflation (say four to 10 per cent). The Australian experience in the 1980s was that inflation between six and 10.7 per cent, as measured by the implicit gross national expenditure deflator, was no barrier to substantial investment from overseas.⁶ Accelerating inflation appears to be the actual concern of financial markets rather than a stable rate of inflation, at least if that rate is moderate.

Given the priority given to price stability, it is not surprising that financial markets spokesmen argue against fiscal deficits. Assuming that deficits do increase economic activity they are likely both to reduce unemployment and increase the current account deficit which puts downward pressure on the exchange rate. Each of these will increase inflationary pressure.

Do financial markets follow rhetoric with action? It is possible to cite individual cases in which financial markets have reacted badly to large or continuous budget deficits and cases where they have not. While the picture is not completely clear cut, the overall picture arising from systematic research is that 'governments still have policy choices and fiscal policy may be the most important instrument for choice' (Milner and Keohane, 1996, p. 248). This particular quotation draws heavily on the cross-country study by Garrett (1996), which concludes that monetary policy is constrained by increasing capital mobility, but that the evidence that there are important constraints on fiscal policy is weak. Moreover, Moore (1998) has shown that much of the evidence found to support the loss of national autonomy in policy making is based on the experience of members of the European Economic Community who have gone much further along the road of integration of their economies than is generally the case.

A desire in financial markets to reduce the size of the government sector would not be surprising given that financial institutions make large profits by arranging privatisation of government businesses. However, despite Friedman, it is not clear cut that those in the financial sector argue strongly for smaller government. In any case, whatever the rhetoric, financial market institutions are happy to deal with countries, such as Germany, with a moderate government sector, and even countries such as Norway, with a large government sector. Rodrik (1996) has pointed out that in general those countries that are most open and integrated into the global economy have large government sectors.

Thus, of the three of Thomas Friedman's rules relating to fiscal policy only one appears to be of importance. Financial markets do not appear overly concerned either with the size of government or about the rate of inflation

as long as that rate is relatively stable and only moderate in size. There are many reasons, apart from the reaction of financial markets, to avoid a continuously accelerating rate of inflation. The rule that needs serious consideration is the one relating to budget deficits. Even in this case, the rule is not a cast iron one that should never be broken. There should be no ban on deficits in times of recession. However, it would be prudent to avoid continuing large deficits in times of an adequate level of economic activity.

It is noteworthy that there is no mention of the current account deficit in Friedman's description of the golden straitjacket. In countries like Australia, with a large foreign debt and a current account deficit that is a high proportion of GDP, problems with financial markets could well arise and add to the pressure not to break the golden straitjacket rules on fiscal policy. If the ratio of foreign debt to GDP continues to rise, sooner or later foreigners will wonder how much longer the country will be able to service the debt and cease lending to it. This will precipitate a massive depreciation of the country's currency on foreign exchange markets and hence a rapid, painful adjustment to its economy. Moreover, the devaluation may be precipitated by currency speculators before it would occur if foreign investors were left to make the judgement themselves. Nevertheless, there is no clear point or range of values beyond which it is dangerous to go. In the 1990s Australia had a series of years in which the current account deficit was between five and six per cent of GDP without causing any massive devaluation.

There is one final reason not to avoid otherwise desirable policy moves so as not to upset financial markets. Events in the last few years suggest that international financial markets now pay less attention to economic fundamentals,⁷ which it could be thought would be influenced by the golden straitjacket. Movements in the exchange rate for the Australian dollar in the year 2000 are a good example. From December 1999 to October 2000 the value of the Australian dollar fell by 20 per cent against the US dollar and 15 percent against the trade weighted index at a time when the 'economic fundamentals', that the financial markets supposedly give weight to, were sound. The budget was in surplus. Apart from a one-off effect of the introduction of the GST (a value added tax), the rate of inflation was two per cent and not expected to rise significantly. Even the current account deficit was relatively low. Over the next five months the exchange rate fell by a further five per cent before returning to the October level and fluctuating about it. The whole episode is a clear example of some temporary shock to the exchange rate causing a reinforcing downward trend which overshoot any equilibrium level.

This type of example reduces the value of following any systematic rules to keep the approval of international financial markets. Nevertheless, it would be foolhardy for any government (except that of the United States) to ignore the attitudes of financial markets altogether when framing fiscal policy. The modified rule against large budget deficits in times of adequate economic

activity should be observed. This may prevent some otherwise desirable policies, but it will not hinder the use of fiscal policy to move an economy out of recession. The major constraint it implies on the use of fiscal policy would occur when what is conventionally considered a boom is not in fact a sufficiently high level of aggregate demand to reduce unemployment to an acceptable level.

2.6 Conclusion

Both Keynes and Kalecki argued that in the conditions of the 1930s, the international payments system gave a contractionary bias to the world economy. The increased integration of international capital markets in the last 20 years has greatly increased this and reduced the scope for independent macroeconomic policy to reduce unemployment. Increased mobility of financial capital has substantially reduced interest rate differentials and hence the scope for autonomous monetary policy. There is more scope for autonomous fiscal policy, but in this area of policy too, governments cannot ignore the reactions of financial markets. However, even for cautious responsible governments, national sovereignty in economic policy making need not be superseded by tailoring policies to please financial markets. Governments must certainly consider the likely effects of their policies on the actions of financial markets, but experience of the last 20 years suggests that this does not take away all freedom of action.

Nevertheless, the current structure of international financial payments creates a contractionary bias because it puts all the weight of adjustment on countries with current account deficits. Globalization has increased the pressure on such countries. Hence when balance of payment problems arise, countries often rely on contractionary macroeconomic policy as a cure. There are extremely important drawbacks to such a strategy. As well as causing increased unemployment, contractionary policy treats the symptoms but makes the underlying cause worse. Any long term solution requires increased exports, and/or a reduced reliance on imports as a result of domestic import substitution. Both of these require investment in the tradables sectors. The solution for the short term crises in the forms of high interest rates and contractionary policy, does not provide a conducive environment for investment, in fact it positively discourages it. In other words, the more today's problems are solved by such policies, the less will be investment, and so the less will be domestic capacity. This, in turn will increase reliance on imports and reduce export competitiveness, so making the problem worse in the longer term. Hence it is not surprising that commentators like McCombie and Thirlwall (1994) and Gruen (1997) see external sector factors as the major constraints on domestic economic activity.

Globalization has both increased the contractionary bias in the current structure of international financial payments and reduced the ability of

national governments to use monetary and fiscal policy to insulate their countries from this deflationary bias. A change in the 'international financial architecture' is necessary to reduce the risk of world wide increased unemployment.

Notes

The authors wish to thank Harry Bloch and Geoff Harcourt for their helpful comments.

1. See Kalecki (1946, p. 412). The dynamic elasticity conditions are given by Thirwall's law, see Davidson (1994, pp. 220–2), and McCombie and Thirwall (1994).
2. As noted above, Kalecki believed that this was sufficient to guarantee 'its advantages' only if it was coupled with the requirement that all countries maintained full employment.
3. The argument has been reformulated as the neoclassical 'twin deficit' view, and as 'crowding out'.
4. It could even have a perverse effect on employment if labour-intensive industries are relatively disadvantaged. There is evidence that this happens to some extent in Australia (Pope, 1981)
5. Page references in this paper are to the 2000 revised edition. The first edition was published in 1999.
6. Net foreign debt was six per cent of GDP in 1981 and 36 per cent in 1990.
7. For a sceptical view of the concept of 'economic fundamentals', *per se*, see Harvey (2001).

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Exchange Rates and the Macroeconomy in an Era of Global Financial Crises, with Special Reference to Australia

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Unless the global financial system is radically reformed – and the necessary reforms are looking increasingly unlikely to occur – it will continue to be conducive to financial crises. Government rhetoric and actions can often influence in desirable ways both the speculative actions that now determine the exchange rate and the effect of exchange rate movements on the domestic economy. Managing the exchange rate should start with Australian support for measures such as the Tobin tax that dampen speculation. In 2008 and 2009, exchange rate changes were helpful in reducing the impact of the global financial crisis on Australia, largely because of a very clear commitment by the Australian government to make preservation of jobs its top priority. In 2009, a rapid rise in the exchange rate was unhelpful. In the short run, little can be done about this, but in the longer run, it is possible to offset the adverse effects.

3.1 Introduction

Macroeconomic policymakers did not learn nearly enough from the global financial crisis (GFC). In many Organisation for Economic Co-operation and Development (OECD) countries, their actions have shown that the most important lessons have not been grasped. This is especially true in the largest countries. Since these have the biggest effect on the global economy, the prospects for the world are not rosy. The international financial system in its present form is both conducive to GFCs and accentuates the effects if such crises are triggered by other factors. In the United States and the United Kingdom, a mixture of ideology about the relative roles of the private market sector and the government in longer run and short-run domestic political

Revised from *Economic and Labour Relations Review*, 24(1): 51–63, 2013, 'Exchange Rates and the Macroeconomy in an Era of Global Financial Crises, with special reference to Australia,' by Kriesler, P., Nevile, J. W. and Harcourt, G. C. With kind permission from SAGE Publications. All rights reserved.

rhetoric has undermined any chance of appropriate reform. The Eurozone, which must be regarded as a single economic policy area, is in an even worse position given the restrictions on monetary and fiscal policy laid down in the Maastricht Treaty and associated agreements. In the following section, this article sets out the types of radical reforms the authors consider necessary and evaluates the arguments for and against such reforms. This section concludes that without such reforms, the first quarter of the 21st century will be an era of GFCs and that such reforms are indeed a forlorn hope.

One reform to the international financial system that has very widespread support among economists is to impose a very small tax on turnover in foreign exchange markets, the so-called Tobin tax. This would impose a small cost on sales of foreign exchange to finance transactions but a large cost on speculators who trade in large amounts every day. The Tobin tax and more are discussed in section 'Sand in the gears: The Tobin tax and more'.

During the GFC, output and employment levels fell. Australia's Federal Government and the (independent) Reserve Bank of Australia (RBA) each expressed strong commitments to try to restore both output and employment. Their policy responses were, respectively, fiscal expansion and monetary loosening. The influence of both these actions on expectations as well as on interest rates caused a depreciation of the Australian dollar, which helped mitigate some of the impact of the crisis on the tradables sector. This is discussed in section '2008 and 2009 – Making speculators work for you'.

The strength of the mining sector has led many to worry about the 'Gregory effect' (also known as the 'Dutch disease'). This is a situation where strong exports from the mining sector lead to an appreciation of the Australian dollar, which, in turn, causes a reduction in manufacturing competitiveness and hence output and in employment generally through the economy. The Gregory effect works mainly through appreciations in the exchange rate. Much of this effect is caused by policy interventions aimed at preventing inflation due to the expansion of the mining sector. However, in section 'Adverse exchange rate movements: Avoiding unnecessary interest rate rises and finessing the Gregory effect', we argue that inflation should not be as important a policy target as is unemployment. In any case, the evidence suggests that there is no trade-off between unemployment levels and inflation until the economy approaches full employment and full capacity.

It is important here to pause to look at the theory of exchange rate determination, since it is desirable to have a theoretical structure underlying discussions of policy formulation.¹ Speculative demand is the dominant consideration in a world in which financial markets have led the growth of globalisation. In the case of Australia, in 2004, a ballpark figure of the ratio of total annual foreign exchange transactions in Australian dollars to exports plus imports was about 115, that is, 11,500% (Nevile and Kriesler, 2008: 318). Using the same method, a similar figure for the world could be calculated for as recent a year as 2010.² At the whole world level, the

procedure is much more unreliable, but any plausible estimate is larger than the figure calculated for Australia.

Speculators will have some idea of what they expect the value of the exchange rate to be or at least in which direction they expect it to move. Some economists believe that this expectation is based on 'economic fundamentals', which are then seen as playing a key role in the determination of exchange rates through their influence on expectations. However, this need not be the case. Harvey (2001) and Taylor (2004) both question the existence of any such fundamentals, suggesting that in fact, they represent nothing more than an *ex post* justification for actual movements, having no independent existence and, therefore, explanatory power. As Taylor (2004: 307) argues, 'For all practical purposes fundamentals do not exist – except when market participants convince themselves that one or another of the many candidates truly matter'.

Exactly as in the case of the Keynesian determination of the interest rate, where the rate of interest is determined by convention and by beliefs, rather than being anchored to any real factors, so too with exchange rates. Thus, 'exchange rates are determined not by so-called market fundamentals, but rather by investors' expectations and conventions as they interact in cross-border forward markets for exchange rates and other asset prices' (Taylor, 2004: 347).

In normal times, we have Keynes' view that people rely on the convention that the future will be like the past. This convention will tend to anchor the exchange rate at its current level and provide some stability to the system. However, we argue that because the present period is subject to periodic financial crises, no such anchor is available. The heterodox literature on uncertainty and the determination of expectations in a world of imperfect information will take a central role in the explanation of exchange rates. Harvey (1999) highlights the importance of bandwagon and cash-in effects. The important feature for speculators is not their own beliefs as to likely movements in exchange rates, but, rather, like Keynes' beauty contest, what they believe about the beliefs of other speculators. However, since the major speculators are all professionals in the finance industry with similar education, training and cultural background, the 'herd' effect is likely to be strong (Harcourt and Kriesler, 2011).³

Moreover, the case for the floating exchange rates regime in which we now live is that there is, 'out there', a set of stable, long-period equilibrium exchange rates, which a float under competitive conditions will establish and sustain. Furthermore, speculators are systemically beneficial as, with their expert knowledge, they facilitate and hasten the process of economies' exchange rates achieving and staying at their equilibrium values. However, if, as heterodox economists argue, foreign exchange markets and, indeed, whole economic systems, are characterised by cumulative causation processes (either virtuous or vicious) and fundamental uncertainty, the observed

volatility of these regimes and the systemically harmful behaviour of speculators are only to be expected and have, in fact, been experienced (Harcourt and Kriesler, 2011).

3.2 Radical Reform: A Forlorn Hope

We argue that radical reform is needed to escape from an era of financial crises. In particular, the almost complete deregulation of the international financial system in the Western world must be reversed. Arguments in support of this necessity to reverse the deregulation of the international financial system can be made at various levels. They can range from informed judgements about current institutions and practices to the construction of complex theories about how a capitalist economy works and its implications for the international financial system, and then an evaluation of the evidence supporting such theories.

The first approach is not atheoretical. Rather it needs to be informed by a theoretical system. This must ultimately rest upon a model of capitalism such as those discussed in the second approach. However, a much simpler model will suffice based on noting both the low level of regulation in the international financial sector and the intense pursuit of profits (some would say excessive greed) in that sector and then considering the likely effects of this combination. The conclusion is that emphasis on free markets at any cost, which became the mantra of highly paid participants in the finance sector, was both self-serving and bad economics.

In 2000, a Special Session of the United Nations (UN) reviewed and appraised the implementation of the commitments and programme adopted by the World Summit for Social Development. As part of the preparation for the meeting, 30 experts from around the world were invited to speak at a UN seminar on how the values underlying social development and those of the market economy fit together. One of the authors of this article (J.W.N.) attended and predicted that the lack of regulation in the global financial system, together with the belief that the market itself was better able than any intervention by government to cure problems as they arose, was a recipe for a severe crisis in the whole world economy. The seminar as a whole agreed with this prediction and indeed went further. Reversal of deregulation was considered essential for a healthy society, not just a healthy economy. As one participant put it 'When the logic of market transactions invades most spheres of social life, everything becomes a commodity and ultimately nothing is worthy of respect' (UN, 2000: 9). Although this perspective was not debated owing to lack of time, the seminar made a number of recommendations about international economic institutions. These included 'increasing regulations particularly to hinder deliberately destabilising speculation by hedge funds and others ... [and] putting more of the costs of international financial crises on international lenders' (UN, 2000: 14). If these or even

less radical suggestions are ignored, and the belief that the international financial sector needs to be subject to no constraints beyond those imposed by the market again holds sway, the world economy will remain in an era of financial crises.

This conclusion is reinforced when more complex analyses are examined and evaluated. The precipitating factor in the 2007 downturn is widely accepted. Financial crises are often precipitated by banks reassessing their liabilities and requiring repayment of large loans. Businesses, in order to meet those demands, start selling assets, reducing their prices. This leads to re-evaluation of the balance sheets of companies, with many more being driven into serious debt problems, leading to further sales of assets and to significant asset price falls (Minsky, 1985).

The current crisis followed the same basic pattern with two important differences. First, households, as well as firms, went into significant debt, and second, there was the role of so-called toxic assets, in particular those associated with subprime mortgages. The role of credit-rating agencies exacerbated the second factor. The new and very complex instruments were given triple A ratings, although, in fact, they were anything but triple A. When it became apparent that, contrary to the credit-rating agencies' statements, the assets held by many enterprises were in fact worth substantially less than their current valuations and that many financial institutions were heavily exposed to such assets, the whole house of cards came tumbling down (Kriesler and Nevile, 2009).

A conclusion on what precipitates a crisis does not answer the question about why crises occur. This requires analysis of the nature of a capitalist economy. We will look at two competing theories: the first, Keynesian, and the second, the efficient market hypothesis. The Keynesian theory is *The General Theory* itself updated to take account of the changes in institutions and knowledge that have occurred since 1936. As the resulting theory is well known, we will not attempt to spell it out in detail but just summarise two features that are the hallmarks of Keynesian economics.

The first feature is that Keynesian economics is a macroeconomics in which the level of output and income are determined by effective demand. The second is that we cannot reach a useful macroeconomics by building on microeconomic foundations. This is more than an aggregation problem, severe though that problem is, because a belief in the fallacy of composition is fundamental to macroeconomics.

While Keynesian theory has developed considerably since *The General Theory*, in that book, Keynes put his finger on the issue, which in the context of this article is decisive in choosing between the two theories. This is whether there is an adequate explanation of 'the crisis – the fact that the substitution of a downward for an upward tendency [the upper turning point in a trade cycle] often takes place suddenly and violently whereas there is no such sharp turning point when an upward is substituted for a

downward tendency' (Keynes, 1936: 314, italics in the original). Keynesians do have a convincing theory of the existence of crises, whereas, as we shall see, the efficient market hypothesis cannot give any explanation. Moreover, Keynes' own explanation of what occurs could have been written as a description of the events of 2007–2008. For Keynes (1936),

It is the nature of organized investment markets, under the influence of purchasers largely ignorant of what they are buying and of speculators who are more concerned with forecasting the next shift of market sentiment than with a reasonable estimate of the future yield of capital-assets, that, when disillusion falls upon an over-optimistic and over-bought market, it should fall with sudden and even catastrophic force. (pp. 315–316)

The efficient market hypothesis may be less well known and a brief exposition follows.⁴ There are three forms of the theory. One, known as the weak form, is that prices in financial markets follow a 'random walk' in the very short run. In less technical language, this means that on average, the best prediction of tomorrow's (or perhaps next minute's) price is the current price. It is widely accepted that this holds in normal times, but, as we have seen, it can be overwhelmed by the herd instinct in times that are anything but normal.

The more stringent, or stronger, version applies the same idea more widely. If traders know all the publicly available information about the likely future earnings of companies, they will take this information into account when buying or selling on the stock exchange. Therefore, the prices at which they trade will be the best judgment about the future values of the stocks traded. A 'Chicago School' economist and noted finance theorist, Eugene Fama, went one step further and argued that the prices of stocks incorporate all information known to traders even if some is not known to the public (Quiggin, 2010: ch. 2).

If either of these more stringent forms of the hypothesis is correct, crises could only occur in very unusual circumstances in which the information known to traders changed substantially and dramatically.⁵ The dotcom bubble of the later part of the 1990s was only the most convincing of a number of demonstrations that crises could and did occur where these conditions were not present (Quiggin 2010: ch. 2). The continuing defence of the strong version of the efficient market hypothesis by Fama and others is a triumph of ideology over decades, or rather centuries, of experience.

3.3 Sand in the Gears: The Tobin Tax and More

In *The General Theory*, Keynes (1936) suggested that a substantial transfer tax on securities transactions could reduce speculation in financial markets (pp. 104–105). In 1972, Tobin proposed a tax on foreign exchange transactions.

The proposal did not attract much interest for many years, but the UN Human Development report for 1994 took up the idea and included a contribution from Tobin explaining it and suggesting a tax of 0.5%, with the proceeds used to finance development (Langmore, 2010). The UN organised a conference on the issue in 1995 and the papers presented at this conference were published in the book by Mahbub ul Haq et al. (1996).

The Tobin tax proposal was raised again during the Special Session of the UN General Assembly on Social Development in June 2000. Canada proposed a study of the proposal. Owing to opposition, especially from the United States, where Republicans were fiercely opposed to a Tobin tax, a compromise was reached, based on agreement to a study of 'innovative sources of funding for development' (Langmore, 2010). The eminent British economist, Sir Anthony Atkinson (Tony to his friends), agreed to lead the project, which was carried out at the UN University's World Institute for Development Studies. The results were published in the book by Atkinson (2004).

With the GFC, support for a Tobin tax blossomed in European countries. Taxpayers had financed expensive bailouts of banks, fuelling demands for taxes on financial institutions. In August 2009, the then British Prime Minister, Gordon Brown, adopted, in principle, a proposal from his most senior financial regulator to tax all financial transactions, not just those on foreign exchange markets. He presented this proposal for a financial transactions tax (FTT) to the Group of 20 (G20) meeting in November 2009. This attracted interest among other European governments as a means of reducing the activities of the financial sector, thought to have grown larger than its useful size, as well as of reducing speculative activities and raising revenue – although the more successful the FTT, the smaller the revenue raised. In June 2011, the European Commission announced plans to introduce an FTT (Langmore, 2011). President Sarkozy and Chancellor Merkel advocated adoption of an FTT at the meeting of the G20 in Paris in November. The most recent Working Paper from the International Monetary Fund (IMF) on the subject, which assesses the administrative feasibility of an FTT, concludes that 'In principle, an FTT is no more difficult and, in some respects easier, to administer than other taxes' (Brondolo, 2011: 5).

Many years ago, one of the authors (G.C.H.), in complete ignorance of the existence of the literature on the Tobin tax, published an article in the *Economic and Political Weekly* (EPW), which he was later informed was a generalisation of the Tobin tax (see Harcourt, 1994; 1995). As we noted earlier, the traditional case for speculation was that it reduced the amplitude of fluctuations in prices and helped markets reach their equilibrium levels more quickly than otherwise would have been the case. If, however, we have to deal with cumulative causation processes, either virtuous or vicious, there will be no equilibrium 'out there' waiting to be found. We have already mentioned that the market for foreign exchange is dominated by speculative forces. Moreover, recent technical progress has reduced the

short period to a length of historical time, which is probably even shorter than the corresponding length of Marshall's market day.

Now, these phenomena are spread, if not worldwide, at least over most of the developed world, so we need to think about international agreements through which to tackle their effects, as well as attempting to reintroduce controls, for example, on international capital flows, even though the ideological climate and recent technological advances make this unrealistic. There is a lot to be said for getting agreements on some 'Marshallian-Pigovian' carrot-and-stick measures, that is to say, while not directly stopping anyone from doing anything, yet indirectly giving them incentives radically to change their behaviour.

If we want exchange rates to reflect real economic forces – trading prospects and real investment opportunities – we need greatly to reduce speculation and thereby its effects on the determination of exchange rates in both the short and the longer terms. Neither in the short term nor on average over longer periods, do exchange rates at the moment reflect these economic activities. This is especially so if we accept that there is no underlying set of long-term equilibrium exchange rates, reflecting a long-term equilibrium of an interrelated system, but, rather, changing structures that reflect the appreciation and depreciation of individual rates because of the underlying differences in the growth rates of productivity and national products.

One way of tackling speculation and its effects is through the taxation systems of the various countries. The taxation authorities would require that the turnovers of the foreign exchange dealers who pay tax in their countries be classified into three broad categories: foreign exchange bought and sold for purposes of trade (and consumption, e.g. tourism) or for long-term investment either in securities or directly. (Insofar as the traders were concerned with the sale or purchase of commodities, spot or future, a case would have to be made by the taxpayers that these were to help production, or that they were legitimate sales, rather than for speculation.) This would leave a residual third category that would be mainly accounted for by speculative activities. Then, the proportions of each category in total turnovers would be used to assess the total taxation paid on the profits of the dealers. There would be a much higher rate for the third category than for the first two, so that the larger the amount of speculation that was financed by foreign exchange purchases or sales, the greater would be the taxation on the profits of the dealers.

Similarly, the purchasers or sellers for whom the dealers were acting would have their business or private incomes taxed at different rates according to the categories into which their transactions fitted. For companies, a higher rate of taxation would be levied in relation to their speculative purchases or sales. For individuals, a surtax on their income tax would be levied, according to the extent of their speculative activities.

We still think that there is merit in raising the ideas again, even though we doubt that they would be taken on board in Australia's current present

political climate. Given the unlikelihood of the adoption of a Tobin tax in the near future, however, the next section considers ways in which the current exchange rate system can contribute to improvements in the domestic employment situation.

3.4 2008 and 2009 – Making Speculators Work for You

As the foreign exchange rate directly affects the prices of exports and imports, it therefore affects the price of all goods and services that either use imports as inputs or compete with imports and exports. From the point of view of employment, it is particularly export industries and import-competing industries that are important, although importers also employ people in Australia. Employment in actual or potential export and import-competing industries (usually called ‘tradables’) is about two-thirds of total employment.

In Australia, the GFC caused a substantial rise in unemployment rates, from 4.0% in February 2008 to 5.9% in August 2009. Growth in gross domestic product (GDP) fell substantially over the same period. As shown in Figure 3.1, in the same period, there was a significant fall in the value of the Australian dollar. The Rudd Government, elected in November 2007, made very clear its commitment to using fiscal and other policies to minimise the effects of the GFC on employment. Furthermore, the Reserve Bank made a series of cuts in interest rates. Australian interest rates probably would have fallen in any case because of the effect of the GFC on commodity prices, but these strong policy moves reinforced the view that the Australian dollar would fall

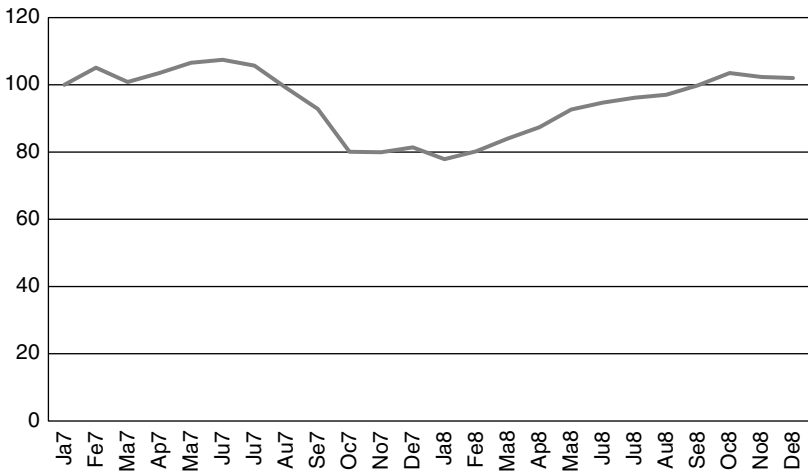


Figure 3.1 Exchange rate – Australian dollar/TWI (real)

Source: Calculated from data in the Reserve Bank of Australia (various years) *Bulletin*.
TWI: trade weighted index.

and speculators acted accordingly. The resulting sharp fall in the value of the Australian dollar helped moderate the effects of the crisis in the tradables sector of the Australian economy.

3.5 Adverse Exchange Rate Movements: Avoiding Unnecessary Interest Rate Rises and Finessing the Gregory Effect

Over the last 25 years, as the importance of the financial sector has grown, there has been more emphasis on keeping inflation low compared to keeping unemployment low. Given orthodox economic theory, this has resulted in an upward bias to interest rates with resulting impacts on the exchange rate. The Reserve Bank has explicitly adopted a form of inflation targeting, where interest rate settings are closely linked to expected inflation. This has led to higher interest rates, which have tended to lead to a more highly valued Australian dollar. In a speech to the National Press Club, just before his retirement as Governor of the RBA, Bernie Fraser said that monetary policy was becoming the hostage of influential financial markets with a vested interest in making the Reserve Bank give greater weight to inflation than employment. In Australia and many other countries, governments have defended a concentration on keeping inflation at a very low rate with the claim that high rates of inflation adversely affect longer run growth in output and employment. There is no doubt that this is true for very high rates of inflation, but there is substantial evidence that it is not the case when the rate of inflation is below, say, 10%. For example, in a study of the experience of more than 100 countries over 30 years, Barro (1996) found that there was evidence of

causation from higher long-term inflation to reduced growth and investment [but immediately commented that] it should be stressed that the clear evidence for the adverse effects of inflation comes from the experience of high inflation. (p. 168)

The general tenor of Barro's article suggests that he had inflation rates above 20% a year in mind when he used the term 'high'.

Many media commentators and some academics have countered the argument for a reduction in the priority given to fighting inflation with the claim that such a reduction runs the risk of making inflation harder to contain, whereas pre-emptive interest rate rises add credibility to policy, which, in turn, lessens the risk of an increase in inflation. This is true but the argument is completely symmetrical with respect to unemployment. Pre-emptive increases in policy to expand employment equally lessen the risk of an increase in unemployment.

In any case, there is serious doubt about the association of higher employment levels with inflation, at least at levels of capacity utilisation below

full capacity of the labour force or of the capital stock. Most contemporary arguments about the dangers of inflation associated with low levels of unemployment rest on the foundations of economic theory based on the non-accelerating inflation rate of unemployment (NAIRU). However, work by heterodox economists has questioned the basis of this theory and has argued that reasonably low levels of unemployment are possible with few, if any, inflationary implications.⁶ In this case, inflation only becomes a potential cost of reducing unemployment at low levels of unemployment, and other policies, such as income policies, may further alleviate the problem.

These findings have been replicated in more conventional economic research by the Federal Reserve of New York (Peach et al., 2011). Their results support the idea of a 'threshold Phillips Curve', where the Phillips curve 'relationship is relevant only when conditions in the economy are either extremely slack or extremely tight' (p. 6). They do not, however, suggest theoretical explanations for this relationship. Nevertheless, they provide additional support for the idea that over large ranges of output associated with the normal operations of the economy, there is no relationship between unemployment levels and inflation. In other words, policies to reduce unemployment, especially when the latter is at high levels, will not be associated with increases in inflation until the unemployment rate is quite low.⁷

In the light of these arguments, policy aimed at keeping unemployment at or above NAIRU in order to avoid inflationary consequences is misguided. In particular, the higher interest rates associated with tight monetary policy, with resulting higher values of the Australian dollar, impose unnecessary costs on the economy.

3.6 Conclusion

The article contains several recommendations to reduce the constraint that today's globally integrated financial sector imposes on the ability of national governments to promote the health of their own economies. Probably, the easiest of these to achieve would be the financial institutions tax discussed in section 'Sand in the gears: the Tobin tax and more'. However, the time and energy spent on a political campaign to achieve this might be better spent on changing the world view that provides the foundations for today's global financial industry and much in our domestic economy as well. At various places in this article, we have identified three major problems: the emphasis in policy-making on maintaining a stable rate of inflation rather than reducing unemployment, the lack of recognition of cumulative causation processes and the belief that a largely unregulated market will not produce systemic risk in an exchange rate dominated by speculation. These beliefs are all aspects of the market liberalism, which Milton Friedman advocated so successfully and which is espoused by so many in the economics

profession. Perhaps, the last word should be given to someone looking at the situation from the outside. Rowan Williams (2010), who was then the Archbishop of Canterbury, has remarked that ‘the temptation is to drift towards the default system of modern liberal capitalism ... this would be monumentally irresponsible; as immoral as it is unintelligent’ (p. x).

Funding

This research received no specific grant from any funding agency in the public, commercial, or not-for-profit sectors.

Notes

1. We do not consider the neoclassical approaches to exchange rate determination. They are well criticised in Taylor (2004: ch. 10) and Harvey (2009: ch. 2).
2. The key source of data is the Bank for International Settlements (various years) *Triennial Central Bank Survey* on global foreign exchange market activity.
3. An anonymous referee has pointed out that these effects are reinforced by automated trading technology and so-called ‘technical’ trading practices.
4. Those who would like a fuller description and evaluation of the efficient market hypothesis are referred to the excellent account in the book by Quiggin (2010), which is not overly technical. For a superbly clear technical exposition, see the ‘tome for our times’, Taylor (2010).
5. Although it not relevant to our contention that the efficient market hypothesis contradicts the possibility of crises, in two crisp sentences, Quiggin (2010) outlines another well-known problem:

[t]he Black-Scholes pricing rule shows how an option price ought to be determined in an efficient market. But traders can only make a profit using Black-Scholes and similar rules to value derivatives if the market price deviates from the ‘correct price’, that is, if the Efficient Markets Hypothesis is not satisfied. (p. 40)

6. See, for example, Kriesler and Lavoie (2007).
7. Stanley (2004, 2005) uses meta-regression analysis to reject the natural rate hypothesis and support unemployment hysteresis.

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4

A Critique of the New Consensus View of Monetary Policy

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This paper seeks to look at the underlying framework of the New Consensus models of macroeconomic policy for inflation and unemployment, providing a post-Keynesian critique. In the light of this critique, the model is reformulated, with its basic structure intact, but with alternative post-Keynesian specifications of the Phillips curve being considered. It is shown that such modifications, either allow a long run trade-off between the rate of inflation and the level of output, the rate of capacity utilisation and, therefore, unemployment, or, in our preferred specification, changes in output and capacity have no implications for inflation over a large range of capacity utilisation. In either case, macroeconomic policy is restored to its role in maintaining full employment.

4.1 Introduction

Macroeconomic policy has been subject to phases of fashion, as different policy instruments have been in and out of favour since the second world war. Initially, the favoured instrument in the post-war period was fiscal policy, which was used to fine tune economies, in order to minimise cyclical influences. Following the stagnationary periods of the early 1970s, monetarist doctrines came into favour, and these emphasised the importance of monetary policy, particularly with respect to the fight against inflation. This version of monetarism, championed by Friedman, advocated a rule for monetary policy, with the main policy variable being growth in money supply, which was to be tightly controlled according to a rule. Fiscal policy according to this doctrine is impotent in the long run, and of little influence in the short run. However, the attempt to control monetary aggregates proved to be unsuccessful, as a result of which this version of monetarism was rejected by policy makers.

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Recently, a New Consensus with respect to macroeconomic policy has arisen among neoclassical economists (aka the New Neoclassical Synthesis), which has been defined by a number of New Keynesian economists (such as Romer 2000, Taylor 2000, and Woodford 2002), and has been generally accepted by policy maker and economists. This new view seeks to redefine the way in which government should direct its policy in attempting to alleviate both unemployment and inflation. In particular, this new view considers the application of monetary policy by respecifying the most appropriate monetary rule. In other respects it represents a return to the original Friedman analysis of the expectations augmented Phillips curve. This paper seeks to look at the underlying framework of the New Consensus model, providing a post-Keynesian critique. In the light of that critique, the model is reformulated, with its basic structure intact. It is shown that such modifications either allow a long run trade-off between the rate of inflation and the level of output, the rate of capacity utilisation and, therefore, unemployment, or, in our preferred specification, changes in output and capacity have no implications for inflation for a large range of capacity utilisation. Both of these open the door for the view that governments have a role in applying macroeconomic policy in order to reduce levels of unemployment.

4.2 The “New Consensus”

The irony of calling the emerging view a “new” consensus is extremely strong. The underlying vision of the economy is, in essence, the same as for Monetarism Mark 1 associated with Milton Friedman. Like Friedman, adherents of the new consensus see the self-adjusting forces of a market economy as imposing full employment of all resources in the long run, though these forces may be impeded in the short run. So they accept an upwards sloping short-run Phillips curve but view the long-run Phillips curve as being vertical at NAIRU, or at some similar supply-side determined concept, with monetary policy having no impact on real activity in the long run:

There is substantial evidence demonstrating that there is no long-run trade-off between the level of inflation and the level of unused resources in the economy – whether measured by the unemployment rate, the capacity utilisation rate, or the deviation of real GDP from potential GDP. Monetary policy is thus argued to be neutral in the long run. An increase in money growth will have no long-run impact on the unemployment rate; it will only result in increased inflation (Taylor 1999 pp. 29–30).

In other words, the inflation rate falls when unemployment is above NAIRU, and increases when unemployment is below it. This, then, is incorporated as the basis of the upward sloping short-run Phillips curve and the vertical long-run Phillips curve, where any deviation of capacity, real GDP or

unemployment from their normal levels leads to *changes* in the inflation rate. If capacity utilisation is kept above its normal level, this will quickly lead to accelerating inflation. In other words, according to this view, there is no long-term trade-off between inflation and either output or employment.

The Phillips curve is one of three relations which define the new consensus.

The New Consensus view accepts a conventional IS schedule reflecting the view that monetary policy can have real effects in the short run. This is the second important relation of the New Consensus. As in most macro-economic models, the New Consensus assumes that investment is inversely related to changes in the rate of interest, leading to an inverse relation between the rate of interest and the level of economic activity.

So far there is no real difference between the analysis of Monetarism Mark 1, associated with Friedman, and the New Consensus. However, although both Friedman and the New Keynesian authors strongly argue the need for monetary policy rules, the choice of instrument through which the rule acts differs. For Friedman the rule sets optimal money supply growth, while for New Consensus authors “the interest rate rather than the money supply is the key instrument that should be adjusted” (Taylor 1999, p. 47). The proposed rule would have the central bank responding to both price and aggregate demand shocks (or expected such shocks), and provides the final New Consensus defining relation. Interest rates should be changed if inflation deviates from its target or, as an indicator of inflationary pressure if real GDP deviates from potential GDP. In other words, the main target for policy remains the inflation rate, although now it is accepted that inflation need not be zero. Instead, a target inflation rate is set by the central bank, with any deviation of inflation from its target leading to the central bank changing interest rates, according to the rule. However, in addition, because of its impact on future inflation, changes in GDP, as proxied by the level of capacity utilisation away from potential or normal levels, are also targeted.

In summary, New Consensus authors rely on a vertical long-run Phillips curve that prevents the possibility of any level of economic activity in the long run bar that corresponding to potential output or normal use of capacity. Although monetary variables play a role in the determination of the level of economic activity in the short run, they have no real effects in the long run. The basic role of monetary variables is to push the economy to its long-run equilibrium, though they play no role in the determination of that equilibrium. In other words, we have the long-term neutrality of money, and the long-run efficacy of markets, which combine to undermine any role for macroeconomic policy for long-run stability.

4.3 A Post-Keynesian Critique

Post-Keynesian economists are critical of a number of important features of the New Consensus model described above. We can divide these criticisms

into two distinct areas. Firstly, many post-Keynesians are critical of the manner in which it is assumed that the interest rate influences the level of economic activity, a relation which underlies the analysis, and of the related assumption of the efficiency of monetary policy in the short run and monetary neutrality in the long run. Secondly, all post-Keynesians reject the concept of a vertical long-run Phillips curve. Points 1–3 below deal with the first of these issues, while the second is the subject of the remaining points.

1. Many Post-Keynesians reject the simple interest rate/investment relation implied in the IS model, where many of the components of aggregate demand, and, therefore of output, respond in a simple and predictable way to changes in the interest rate. There are a number of reasons for this rejection. Firstly, most post-Keynesians believe that the relation between interest rate and investment is more complex than the simple functions (linear or otherwise) assumed in the IS relation. In addition, many economists do not think that there is a one for one relationship between the short-term interest rate set by the central bank, and the long-term interest rate which affects the components of aggregate demand (see, for example, Pollin 2003, Villieu 2004). In fact, Kalecki argues, partly for this reason, that it is the quantity of credit rather than its price which influences investment (Kriesler 1997). Nevertheless, tight monetary policy associated with increased short-term rates will also be associated with increased credit tightening and a corresponding fall in the animal spirit of banks, so that, at least with contractionary monetary policy, it may be reasonable to assume that there will be some effect on aggregate demand. (Wolfson 1996)
2. Empirically, evidence suggests that the interest elasticity of investment is non-linear and asymmetric (Taylor 1999). While an increase in interest rates is likely to reduce investment in times of economic booms, the reverse is not true. Reductions in interest rates are unlikely to stimulate investment in times of recession. In the words of the old adage: you can lead a horse to water but you can't make it drink. Many economists think that using monetary policy in a recession is like pushing on a string (See Nevile and Kriesler (2002).
3. Partly for this reason, post-Keynesians, as do many monetary economists, believe that monetary policy takes a considerable amount of time to have any effect, unless interest rates are changed by drastic amounts (that may jeopardise the stability of the financial system). Monetary policy is known to be a particularly blunt instrument, with long and variable lags. Several post-Keynesians believe that, before high rates take their toll, real interest rate hikes lead to higher inflation rates, through interest cost push (Galbraith 1957, pp. 130–1; Taylor 2004, pp. 88–90). It can be shown that this effect may jeopardise the neat converging features of the New Consensus (Hannsgen 2004).

4. In contrast to some New Keynesian authors who believe that “short-run non-neutrality and long-run neutrality are ... as well accepted as any proposition in monetary economics” (Mankiw 1999, p. 72), post-Keynesians reject the so-called neutrality of money in the long run as well as in the short run. In other words, they argue that monetary variables will influence real variables in both the short and long run. The main reason for this is that post-Keynesians reject the notion of a supply-determined natural growth rate. They believe that if the concept of a natural growth rate is to be of any assistance, it is determined by the path taken by the actual growth rate, as pointed out very early in Kaldor (1960, p. 237). “In sum, the natural rate of growth is ultimately endogenous to the demand-determined actual rate of growth The natural rate is not an attractor in demand-led growth models” (Setterfield 2002 p. 5). Post-Keynesians reject the vertical long-run Phillips curve.
5. In addition, many post-Keynesians are even sceptical about short-run trade-offs between GDP/capacity and inflation. There are two reasons for this. First, there is a large range of capacity utilisation rates which are consistent with an absence of demand-led pressures, for reasons tied to the absence of decreasing returns over a large range of production levels (Lavoie 2004, p. 24). Second, it is believed that with “co-ordinated wage bargaining a constant inflation rate becomes compatible with a range of employment levels, and the NAIRU as the short-run limit to employment is no longer unique” (Hein 2002, p. 314).

A number of ways of modifying the New Consensus analysis to incorporate explicitly post-Keynesian considerations have been suggested.

Setterfield (2004) emphasises an important post-Keynesian modification in his critique of the New Consensus. He concentrates on the nature of the Phillips curve, pointing out that demand-type considerations are not the only influence on the inflation rate, as the neoclassical Phillips curve suggests. Cost considerations, as well as institutional variables reflecting the wage and price setting process will have significant influence on the inflation rate. As a result, he replaces the vertical Phillips curve with one augmented by these more intricate explanators of inflation. With this kind of Phillips curve, a multiplicity of possible long-run rates of growth and levels of output and employment result. Comparisons of long-run positions show that higher inflation targets allow for higher growth rates and higher levels of employment.

However, further modifications need to be made in order to more fully capture the essence of post-Keynesian analysis, and the policy implications. In particular, many post-Keynesians (but not all) are dubious of the notion that inflation needs to rise with all increases in output. As mentioned in point 5, they argue that, for large ranges of output, there seems to be little impact on inflation. This is compatible with post-Keynesian pricing models

of mature economies. In these economies, for most sectors, price is determined as a mark-up over costs. Regardless of which notion of cost is used, prime, variable, normal or full, cost pressures will remain constant over a large range of output levels. So with labour productivity constant, and with mark-ups also tending to remain constant, there need not be any increased pressure on prices with expansions of capacity over that range. In other words, changes in capacity utilisation need only be inflationary at levels of capacity near full utilisation. Similarly, only at very low levels of capacity would we expect some reduction of the inflation rate. In other words, there would only be a tradeoff between inflation and unemployment at very low and very high levels of capacity utilisation, with the inflation rate constant for levels of a large intermediate range of capacity. In this case, the Phillips curve would be horizontal for large ranges of output and employment (Freedman, Harcourt and Kriesler 2004).

This would lead to the replacement of the vertical long run Phillips curve of neoclassical theory with the following Phillips curve:

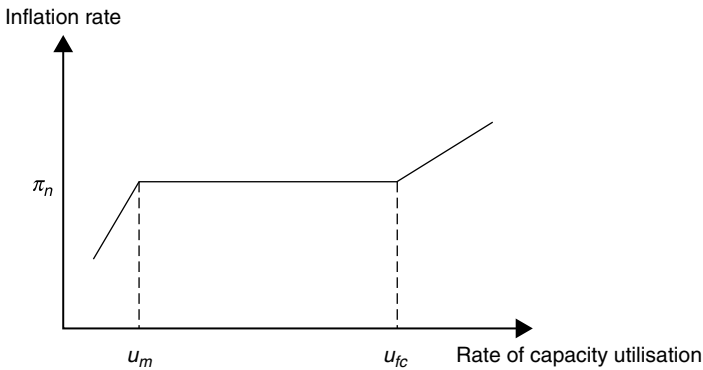


Figure 4.1 Post-Keynesian Phillips curve

where: u_{fc} represents full capacity utilisation

u_m is some low level of capacity utilisation, below which the inflation rate falls

$\bar{\delta}_n$ represents the rate of inflation associated with the normal range of output, subject to supply side shock.

For a large range of capacity utilisation u such that $u_m < u < u_{fc}$, we have that $\Delta\bar{\delta} = 0$, as shown in Figure 4.1. In this case, if the current inflation rate is the target rate, central bank policy should set the interest rate at a *fair* rate, based on income distribution considerations, in particular the distribution between debtors and creditors, and allow fiscal policy to set the output/capacity level, as more recently recommended by Arestis and Sawyer (2003). The other possibility, in line with the analysis is that monetary policy

should be maintained as an instrument in manipulating effective demand to acceptable levels. In this case, the argument for the efficacy of fiscal policy also enters the picture, and so there is a strong case for re-establishing the Keynesian view of the appropriateness of fiscal and monetary policy in achieving and maintaining full employment levels of output.

4.4 Conclusion

The policy implications of the New Consensus flow from their two key relations: the underlying IS curve and the vertical long-run Phillips curve. The second is the most important. This paper has shown that accepting all the basic equations of the New Consensus model amended with the suggested post-Keynesian modifications with respect to the Phillips curve equation, will fundamentally change the model's conclusions. In particular, our amended Phillips curve will yield Kaleckian results, with important roles for fiscal and monetary policy in influencing the level of output, capacity utilisation and employment. In other words, the government will again have an important role in terms of both fiscal and monetary policy, for the maintenance of reasonable levels of employment. Unlike the New Consensus Model, accepting a Phillips curve amended as above means that we can no longer claim that the market will set the long-term unemployment rate, which cannot be influenced by macroeconomic policy.

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5

The Current Financial Crisis: Causes and Policy

Peter Kriesler

The driver of the current crisis is the collapse in domestic aggregate demand, originating from international factors. It is important, therefore, to consider potential areas where aggregate demand can be expected to increase in order to understand the possibility of recovery. The current crisis was preceded by an unprecedented increase in the level of household debt, which will hinder the recovery of consumer expenditure. Consumption is also being affected by uncertainty with respect to both income and employment. Similarly, the outlooks for investment and net exports suggest that they are unlikely to contribute to the initial phase of recovery. This leaves the important area of government expenditure. It is argued that government expenditure, particularly on infrastructure and capital, is particularly important as in the short run it contributes directly to demand, while, in the longer run it boosts growth and productivity. Finally, approaches to financing the implications of increased government expenditure are examined.

5.1 Background

The main impact of the current economic crisis on the Australian economy has been through rising unemployment rates and falling growth rates. There can be little doubt that the driver of the crisis is a collapse of domestic aggregate demand. The impetus for this was initially from international factors, translating into the domestic economic environment. It is important, therefore, to consider the likely scenarios for an increase in aggregate demand in order to understand the possibility of recovery.

As in previous international downturns, the current global financial crisis was preceded by a long period of increasing asset prices, particularly in property and stock markets. These, in turn, played a significant

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role in increasing demand from both households and business. Business balance sheets improved as a result of the increased value of their assets. This improved business confidence, encouraging investment. Banks, at the same time, were increasingly happy to lend money for these investments. Simultaneously, since the asset prices affected were both shares and house prices, consumers became wealthier. This increased wealth boosted their confidence, leading to substantial increased expenditure, often financed by debt. One distinguishing feature of the boom which preceded the crisis was that households borrowed record amounts on the basis of their increased asset prices, leading to record levels of household debt, as Figure 5.1 shows.

Financial crises are often precipitated by banks reassessing their liabilities, and requiring repayment of large loans. Businesses, in order to meet those demands, start selling assets, reducing their prices. This leads to re-evaluation of the balance sheets of companies, with many more being driven into serious debt problems, leading to further sales of assets, and to significant asset price falls (Minsky 1985).

The current crisis followed the same basic pattern with two important differences. Firstly, as noted above, households, as well as firms, went into significant debt; and secondly, there is the role of so-called 'toxic assets', in particular, those associated with subprime mortgages. In this case, the crisis was triggered by an evaluation that the assets held by many enterprises were, in fact, worth substantially less than their current valuation.

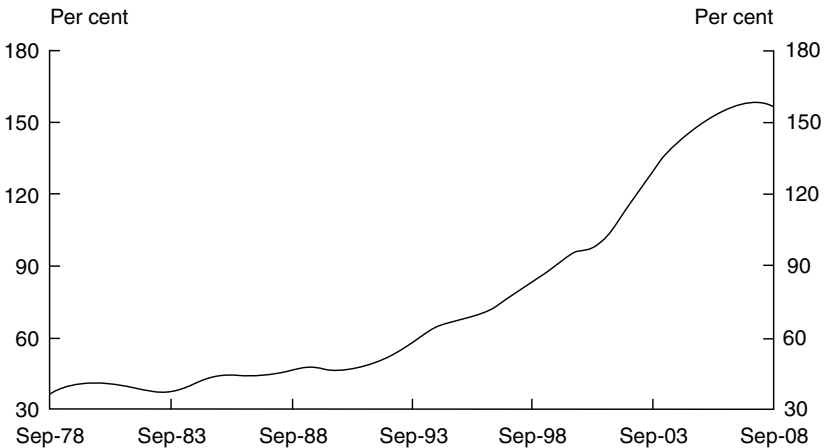


Figure 5.1 Household debt-to-income ratio in Australia

Source: Reproduced with permission of Australian Treasury.

In Australia, the crisis has been associated with a substantial rise in unemployment rates, from 4.2 per cent in April 2008 to 5.7 per cent in May 2009, and substantial falls in GDP as indicated in the Figure 5.2.

Associated with this fall in output growth have been a fall in investment and a substantial slow down in consumption expenditure. Prices similarly have reflected the fall in demand, with the CPI falling in the December 2008 quarter by 0.3 per cent, and rising in the quarter to March 2009 by only 0.1 per cent. The annual rise in the CPI was 2.5 per cent for the year to March 2009, compared to an annual rise of 3.7 per cent to December 2008 (Australian Bureau of Statistics 2009b).

The falling CPI, falling growth rate and increasing rates of unemployment indicate that the underlying cause of the current situation is a substantial fall in aggregate demand. Any recovery program would, therefore, need to stimulate some of the components of aggregate demand.

The next section will outline the major components of aggregate demand, and consider what has happened to each of them during the crisis. It also considers which of these is most likely to be able to generate the increased demand needed to move the economy out of the downturn. Investment, in



Figure 5.2 GDP growth rates: Australia (volume measures, quarterly change)
 Source: Australian Bureau of Statistics 2009a.

particular, has a key role, as in the short run it stimulates demand while in the long run it sustains growth and boosts productivity.

5.2 Aggregate Demand

Total demand in the economy comes from four main sources:

- Consumption demand
- Investment demand
- Net exports and
- Government demand.

So, we need to consider why these have fallen, and what policies can be enacted to reverse that decline. In order to understand this, the global and domestic economic environment are important considerations. Here, the most salient features are the global contraction of economic activity, the underlying problems with financial institutions, and the general high level of uncertainty.

5.2.1 Consumption

With consumption, there are a number of forces operating, not all in the same direction. One important factor to consider is that, as discussed above, coming into the present crisis, household debt in Australia was at a record level as a proportion of household income. In other words, households had borrowed, mainly to pay for houses, but also for other large items. Coming into the downturn, the Reserve Bank had been increasing interest rates for some time. This meant that households' real disposable income after debt repayment had been falling. This was reinforced by large increases in petrol prices, which are a vital part of household expenditure, and left less income for other expenditures.

Some of this debt was the result of asset bubbles, though most of the evidence suggests that this is a lot less of a problem in Australia than elsewhere.¹ In particular, there was a prolonged period of increase in housing prices, which provided the security for households to borrow against.

The recent reductions in interest rates have had a positive effect on households, increasing their disposable income as their debt repayment fell. However, given existing levels of debt coupled with the increased uncertainty and general lack of confidence, it is no surprise that households have been reducing consumption, being more worried about repaying debt, and saving for future eventualities than using any increased income to finance consumption. This has been reinforced by the growing levels of unemployment, which leads to job as well as income insecurity.

As a result, the ratio of consumption to GDP has been falling, perhaps temporarily offset by some of Prime Minister Rudd's cash handout, but we can expect it to continue to fall, and certainly not be a major contributor

to the early phase of any recovery. In fact, consumption in the consumption ratio is unlikely to rise until both employment and output recover significantly, so that consumers have both the means and the confidence to increase their expenditures:

The large falls in household wealth stemming from the collapse in global stock markets, combined with concern about rising unemployment, are expected to continue to weigh heavily on household confidence and consumption. Helping to moderate these negative effects is substantial assistance to the household sector from government stimulus packages, cuts to interest rates, and falls in oil prices. While this assistance has helped support economic activity, it cannot fully offset the negative effects of the global recession (Commonwealth Government 2009).

5.2.2 Investment

Investment, despite low interest rates, is falling, and is expected to fall by 18.5 per cent this financial year (Commonwealth Government 2009). Investment is mainly about building capacity, and given falling levels of demand, both domestically and globally, it is no surprise that there is little incentive to invest. This is reinforced by the nature of the current crisis, in particular the collapse of confidence in the financial sector. Even if business was prepared to borrow to finance investment, there is a great reluctance by financial institutions to lend, as they do not know which firms may have problematic assets in their portfolios, so that who are safe and reliable borrowers is no longer clear. This represents a double squeeze on investment, as both the motive to invest and the potential to finance any desired investment are being simultaneously squeezed. Investment activity is undertaken when it is profitable to do so. Interest rates enter into the calculation as part of the cost of financing investment. This means that unless there is an expected revenue gain from a new investment project, it does not matter how low interest rates are, investment will not respond. In other words, we would expect investment to be interest inelastic in a downturn as then business does not expect to be able to sell the output of any investment project. If a company does not expect to generate any increased sales from a new project, then even if the interest rate is zero, it is unlikely to invest in that project. When the economy picks up, as it moves into boom, sales and expected revenue, the perceived profitability of investment, will improve.² This explains why, despite the current record low interest rates, investment is not expected to recover.

We know that Australia has traditionally relied on global capital to finance domestic investment, increasingly so in recent years. However, in the current situation, this source of funding is drying up with the general reluctance of financial institutions to lend.

Again, it would appear that investment will not be a major contributor to the early phase of a recovery, as investors will have neither the will nor the means.

5.2.3 International Demand

For Australia, reliance on international trade as a major source of demand has been increasing substantially since the opening of the economy initiated by the Hawke government. As a result, the importance of net exports to the domestic economy has grown enormously. We know that much of the strong economic growth for the last decade was due to the global resources boom, which has now been very much reversed and is a major cause of our problems. In fact, the role of international factors in Australia's current downturn cannot be stressed enough. Although international factors could help Australia recover, given the current international environment, to say that this is unlikely is an obvious understatement. The prognosis for a recovery of global demand is not good. Europe and North America are experiencing negative growth, and the expectation is for little change. Although China—currently Australia's main trading partner—is still growing, its growth rate has fallen substantially, and again is unlikely to recover for a while.

This suggests that waiting for the international economy to recover is likely to take a long time.

5.2.4 Government Demand

This leaves the role of the government sector. For the last few decades, economists in academia, business and policy advising positions have been pushing a neoliberal agenda, with an underlying ideology that sees markets as being efficient at delivering optimal outcomes, and governments as being impediments. From the 1970s, neoclassical economics reasserted its view of the superiority of markets, and has dominated economic policy with an emphasis on smaller government and lower taxes. Since that time, as a result of that rhetoric, governments have been reducing their contribution to demand in the economy by decreasing both their spending and their investment. Budget surpluses and shrinking public sectors have been seen as good things in their own right (Bell 1997). The current global financial crisis is partially the result of that policy regime.

However, following the important work of Keynes and Kalecki, we know that capitalist economies only generate enough demand to fully employ the labour force by fluke. There is no mechanism within the economy that pushes it to full employment. This means that there is, and always has been, an important role for governments to supply aggregate demand to the economy in order to ensure that the labour force is fully employed.

5.3 Policy Options

This leads to the question of what policies the government should utilise in the current situation.

1. Not monetary policy. Globalisation has also eroded the effectiveness of monetary policy (Kriesler and Nevile 2003). Also, it is generally accepted

that monetary policy is a blunt and uncertain instrument. Not only is monetary policy associated with long and variable lags, but there is significant uncertainty as to the size of its impact.³ In particular, monetary policy mainly operates through the impact of interest rates, and as has been argued above, these are not very effective in economic downturns.

2. The government can increase domestic demand via tax cuts or one-off payments. Tax cuts and one-off payments, although increasing take home income, may not have the desired effect on domestic employment, either because the extra income is saved or because it is spent on imported items (such as plasma televisions) which do not generate many jobs in Australia. In addition, tax cuts reduce the government's ability to raise revenue in future years. Often tax cuts are heavily skewed towards cuts for high income earners, rather than those who really need them at the bottom end of the income distribution. Higher income earners tend to both save more out of each additional dollar, and have a higher import component.
3. Most importantly, government can increase demand by their expenditure, particularly on infrastructure and government investment in both physical and human (education, health) capital. The importance of expenditure on capital cannot be stressed sufficiently: not only does it directly create jobs by employing people to work on infrastructure programs, or increase employment in education and/or health, but it also has important long-term benefits for the economy in the form of increased productivity. So government expenditure of this type both increases demand and employment in the short run, while increasing productivity and hence competitiveness in the longer run.

5.4 Governments and Deficits

The recommendation of increased government expenditure is often met with the question of how that increased expenditure will be financed.

The first point to note is that governments are not like households in many important aspects relating to their budgets and expenditures. Households, in order to increase their spending, need to reduce their saving rate, run down their previous savings or borrow. In other words, their expenditure needs to be financed: the money needs to come from somewhere. If the financing is from a loan, then this leads banks to create deposits in the borrowers' accounts, which they can then use to pay for their expenditure. The deposit is created electronically, and the payment may also be electronic. So, money is created, but not in the sense of an increase in notes and coins, but rather as electronic ledgers with financial institutions. Modern money is increasingly associated with electronic holdings and transactions without any necessary change in what the public associates with money: that is, notes and coins. It is important to realise that when economists talk about changes to the money supply, it is not the actual quantity of notes and coins in

circulation that is being referred to. This is a small part of the whole. By far, the most important part is deposits with banks. Nowadays, these are created and moved electronically, and form the largest part of the money supply. It is now generally agreed that the money supply responds to changes in prices and transactions, rather than vice versa.⁴

The government, unlike households, simply does not 'finance' its expenditure. When it spends more, the Reserve Bank creates a deposit on an electronic ledger, which the government then 'spends'. It is this spending which increases the money supply, and is referred to as printing money, if not balanced by borrowing from the public (Bell 2000). In current circumstances, any deficit should be financed by a loan from the Reserve Bank, not by borrowing from the public at all.

There is never a need to 'finance' a government deficit (Bell 2000; Hart 2009). Rather, the government may increase taxes—which reduces the deficit—or borrow from the public to reduce the impact on demand of the increased spending, particularly if it is worried about inflation. Inflation is not currently a problem. A loan from the Reserve Bank need never be repaid. Whether or not it should be depends on the economic circumstances of the time. Often it should never be repaid, though in some circumstances there may be political advantages in doing so (Nevile 2009).

If a country's public debt is held by its own citizens, the liability (to taxpayers) is balanced by the assets of those citizens who hold the debt. Nevertheless, the consequences for income distribution of a continually growing public debt may be important. In theory, these could be overcome through taxation and other fiscal measures for redistribution, but if the interest bill is large, this may not be feasible for political reasons. Even so, the widely cited rule that the budget should be balanced, not over a year but over the business cycle, is too strict as it ignores the effects of inflation and economic growth. If nominal gross domestic product is growing, there can be a positive budget deficit on average over the business cycle without any upward trend in the ratio of public debt to gross domestic product. However, in the case of Australia this discussion is purely academic since our public debt—net of debt between different levels of government—is close to zero.

5.5 Conclusion

This article has argued that the main consequence of the global financial crisis has been a significant collapse of demand in the Australian economy. In particular, all of the components of private demand, consumption expenditure, investment and net exports have fallen. None of these are likely to recover in the foreseeable future. As a result, the only way of preventing slow growth in output, and further increases in the unemployment rate, is for government expenditure to take up the 'slack'. In particular, government expenditure on infrastructure and capital serves the function of increasing

demand in the short run, while increasing productivity and growth in the longer term. Finally, the objection to this policy that the increased expenditure must be 'financed' was examined and, it was argued, was not a substantial problem, particularly in the current circumstances.

The importance of the role of public investment and spending in generating employment and growth are a central theme of this article. It is argued that in the current economic downturn, unless they take a central role, unemployment is likely to rise substantially.

Acknowledgements

I wish to thank, but not implicate, two anonymous referees for their helpful comments.

Notes

1. See Stapledon (2009).
2. This story is reinforced by the empirical evidence on the interest elasticity of investment which suggests little, if any, responsiveness (see, for example, Milbourne 1990: 246–248; Eisner 1991; and Bernstein and Heilbroner 1991).
3. See Kriesler and Neville (2003).
4. See Hart (2009).

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6

The Current Crisis Has a Silver Lining

J. W. Nevile

Capitalism has had many crises and often they have led to improvements in the way it has operated. Two related improvements are predicted as a result of the current crisis. One is the hastening of the decisive defeat of market liberalism. The other is the rehabilitation of fiscal policy as part of the tool kit used to minimise the inherent instability of capitalist economies. After a brief exposition of the core aspects of market liberalism, this article considers the use of fiscal policy in each of the short run and the long run. Policies around the OECD in the last 16 months have already embodied both these improvements, but a similar achievement in the long run will be more difficult. The crowding-out thesis has more appeal when applied to the longer run. However, the empirical evidence does not support crowding out. More generally, economic orthodoxy relies on neo-classical growth theory to support a belief that longer run trends in real economic variables such as output and employment are determined solely by supply side factors. The article uses the authority of Solow and Swan to emphasise that this is an assumption, not the result of any analysis, and that neoclassical growth theory itself assumes that fluctuations in investment over the business cycle will necessarily affect the path of potential output. Moreover, not only is the NAIRU (Non-Accelerating Inflation Rate of Unemployment) determined by the path of investment in physical and human capital, but at a much lower level of unemployment than the conventional wisdom believes.

6.1 Introduction

Capitalism has had many crises in its centuries-long history and in many cases the crisis has led to improvements in the way capitalism has operated—for example, the improvement in central bank institutions and policies in

Revised from *Economic and Labour Relations Review*, 19(2): 27–38, 2009, ‘The Current Crisis Has a Silver Lining,’ by Nevile, J. With kind permission from SAGE Publications. All rights reserved.

a number of countries that resulted from the Depression of the 1930s. This article predicts that the cloud of the current crisis will have a silver lining with two interrelated aspects. One is the bringing forward in time of the decisive defeat of the view of the role of government held by Hayek and popularised by Milton Friedman. The other is the rehabilitation of fiscal policy as an important part of the tool kit used to minimise the inherent instability of capitalist societies—usually called the business cycle. Both of these outcomes can be considered in the short run or longer run contexts. Policies around the OECD since August 2007, and more particularly over 2008, have already embodied these two outcomes. A similar achievement in the long run will be more difficult and may require a public education campaign similar to that mounted by Hayek and his disciples, albeit in the opposite direction.

The next section of this article very briefly outlines the position held by Hayek and Milton Friedman, and their resort to a public education campaign to convince policy makers and voters to adopt their ideas. Then in the following two sections, the role of the government in managing a capitalist economy and the part to be played by fiscal policy are discussed in short run and long run contexts respectively. The final section replaces the conventional conclusion with one that suggests which of the issues discussed in the article are likely to cause problems in the future.

6.2 Market Liberalism

The essence of Hayek's position on the role of government was that there are very few exceptions to the rule that the market is the best way of deciding what is to be produced and how it is to be produced. Moreover, even when market failure exists (that is, when the market is not the best way of deciding what is to be produced and how it is to be produced), the consequences are usually of less importance than those of the government failing in this respect, and are easier to correct. This is the core of what is generally known as market liberalism but usually called economic rationalism in Australia.

Hayek's classic book in political philosophy, *Road to Serfdom*, was published in 1944. In the next few years, Hayek saw that post-second-world war society was indeed moving away from individualism, and lamented that:

under the sign of “neither individualism or socialism” we are in fact rapidly moving from a society of free individuals towards one of a completely collectivist character (1949: 1).

Hayek acknowledged that this movement away from individualism was due to politicians implementing what the public desired, but argued that

therefore public opinion should be changed through the writings of himself and like-minded economists and political philosophers:

... what to the politicians are fixed limits of practicability imposed by public opinion need not be similar limits to us. Public opinion on these matters is the work of men like ourselves, the economists and political philosophers of the past few generations who have created the political climate in which the politicians of our time must move (1949: 108).

He therefore set up a club of like-minded individuals with the aim of changing public opinion. The most influential of these was Milton Friedman whose numerous magazine articles and TV appearances together with the famous book written with Rose Friedman, *Free to Choose* (1980), proved very effective in influencing public opinion, not least in Australia.

The market liberalism espoused by Hayek and Milton Friedman is clearly a descendant of classical liberalism as espoused, for example, by Locke. It too has primary emphasis on the freedom of the individual from constraints imposed by other individuals and the state. Friedman makes it clear that, for market liberals, freedom has nothing to do with freedom from hunger, the right to employment (freedom from unemployment) and similar freedoms that were stressed after the Second World War—for example, in Articles 23 and 25 of the Universal Declaration of Human Rights. Constraints imposed by lack of means do not constitute a lack of freedom. Robinson Crusoe could have no problem of freedom while he was alone on his island, even if he starved to death (Friedman 1962: 12).

For market liberals, the major function of government is to protect freedom from the actions by one's fellow citizens as well as from actions by those outside the country. This involves preserving law and order, enforcing contracts and encouraging competitive markets. Friedman also acknowledges that government can, on occasion, help to achieve goals that would be very difficult or expensive for individuals to achieve, even though to some extent they could be achieved through the working of the market. However, he argues that governments should be very cautious in this sphere. He is not as radical in this respect as Hayek. For example, Friedman believes that central banks, as statutory corporations, have an important role to play in implementing appropriate monetary policy. Hayek considers that an economy would be better off without a central bank.

Part of the Friedman gospel was to decry the use of fiscal policy, which involved government expenditure, and to urge tax cuts whenever possible. Taxes, he thought, both interfered with the working of the market as well as enabling bigger government. Friedman, at least in his popular

writings, also argued that government should not be involved in income distribution:

The ethical principle that would directly justify the distribution of income in a free market society is “ To each according to what he, and the instruments he owns, produced” (1962: 162).

However, this principle was not widely accepted in Australia.

6.3 Economic Management and Fiscal Policy in the Short Run

The extent to which fiscal policy was used in many OECD economies in 2008 to stimulate the economy was unprecedented in recent decades but, despite Milton Friedman, it did not involve any break with current economic orthodoxy. For at least the last 20 years, economists from a wide spectrum of schools of thought have held that fiscal policy can be a helpful tool in increasing output and employment when there is unused capacity in an economy. In a symposium at the 1997 Annual Meeting of the American Economic Association, five eminent but diverse economists, who among them had considerable experience on bodies concerned with official policy making or advising, discussed whether there is a core of practical macroeconomics that could be confidently used, especially to underpin macroeconomic policy. Their articles were published as Blanchard (1997), Blinder (1997), Eichenbaum (1997), Solow (1997) and Taylor (1997). Given the diversity of the five, there is a remarkable degree of agreement between them.

They all agree that in the short run, due to wage and price rigidities, knowledge deficiencies and perhaps expectation factors, fiscal policy as well as monetary policy can influence output, employment and unemployment, though their detailed theoretical reasons for this differ. This belief in the ability of fiscal policy to have the traditional effect on macroeconomic variables in the short run is not confined to academics. It has been affirmed in an official publication of even such a conservative institution as the IMF, which stated that:

Most economists argue that in the right circumstances, fiscal expansion can be an effective tool to stimulate aggregate demand and revive a stagnant economy (Gupta and Clements 2005: 10).

Back in 1997, Blinder questioned the idea that tight fiscal policy could stimulate the economy, presumably through its effect on expectations about interest rates. The events of 2008 have demolished any belief in this theory, but in the media and among politicians, there is still undue attention paid to whether expansionary fiscal policy will result in a budget deficit and what should be done if it does. For example, the Leader of the Opposition

has stated that if there is a deficit, the government should outline its plans for repaying the money borrowed. In reality, in the current circumstances any deficit should be financed by a loan from the Reserve Bank, not by borrowing from the public at all. A loan from the Reserve Bank need never be repaid, and usually should not be repaid, though in some circumstances there may be political advantages in doing so. This is not a short-run issue and will be taken up again in the section on the longer run context.

The five economists cited above were typical of academic orthodoxy in that they all thought that, except at fairly high levels of unemployment, there is a trade-off between inflation and unemployment in the short run. This is irrelevant in current circumstances, but unemployment can be much lower than orthodoxy suggests. Neville and Kriesler (2008) set out the arguments supporting this position. In the situation at the beginning of 2009, a more worrying possibility is that even with relatively high unemployment, expansionary fiscal policy may need to be used in a sophisticated way and be supported by other policies if adverse side effects are to be avoided. Otherwise, it could lead financial markets to act in ways that lead to a rapid and large depreciation of a country's currency. The inflationary consequences of this could lead to an inflation-devaluation vicious circle.

The possibility that a large budget deficit may lead to a large fall in the value of a country's currency on foreign exchange markets has been stressed more by journalists than by academic economists. The most influential book arguing this is by Thomas Friedman (2000).¹ He coined the term 'golden straitjacket' for his argument (2000: 101–111) that, to have access to international financial markets, a country has to follow a set of rules which make up this straitjacket and if a country breaks these rules it is 'disciplined' (2000: 110) by financial markets either avoiding lending to, or withdrawing money from, that country. The golden straitjacket has in all 16 rules, one of which is maintaining as close to a balanced budget as possible. Thomas Friedman's position certainly became part of the orthodoxy among writers in the media, in Australia as well as overseas. But among academic economists there is no widely agreed position on this issue. However, if an inflation-devaluation vicious circle is feared, incomes policy and expanded labour market programs can reduce inflationary pressures and help prevent any vicious circle developing.

It is true that since the 1997 *American Economic Review* symposium, a so-called 'new consensus on monetary policy' received some prominence in the academic literature and even among central banks. The 'new consensus monetary policy' has rather dubious theoretic foundations (Kriesler and Lavoie 2007) and shows a remarkable ignorance of the history of economic thought and recent United States economic history (Galbraith 2008). However, all that matters in this context is its primary policy recommendation—inflation targeting as the major guide to implementing monetary policy—and its claim that targeting inflation 'makes actual output conform to potential

output' (Goodfriend 2007: 61) where potential output is defined as the level of aggregate output determined by the real business cycle. Claims are made, not only that 'as an operational matter a central bank can make the economy conform to its underlying core', but also that 'monetary policy should not try to counteract fluctuations in employment and output due to real business cycles' (ibid). Goodfriend (2007) was published in the issue of a journal dated Fall, 2007. Whether one regards this as an example of hubris or merely irony, there is no doubt that the events in the US in (their) autumn of 2007 effectively ended any claims to real world relevance by the 'new monetary consensus'.

There is one more point to be made in the discussion of issues in the short run. Except for its importance, this would be a footnote. It does matter what government expenditure is spent on. In many countries, including Australia, spending on infrastructure is a very valuable way to increase government spending and, less obviously, this includes spending on human capital as well as physical capital. For humane, social and economic reasons, spending on human capital should include measures to help the most vulnerable such as the long-term unemployed and those who drift in and out of employment who, while not technically long-term unemployed, share many of the same characteristics and are just as vulnerable members of the labour force. It is also important to help those, who hitherto have had continuous but casual employment, so that they avoid joining the ranks of the long-term unemployed or of those who drift in and out of employment.

If one gives a high weight to concern for the less well-off in our community, spending on human capital is clearly of prime importance. There are also strong arguments that it also may be at least as important in raising productivity as investment in physical infrastructure. Vocational training can help overcome skill bottlenecks. From a longer term point of view, Heckman and Kreuger (2003) have shown the importance of early intervention programs for disadvantaged children.

6.4 Economic Management and Fiscal Policy in the Long Run

Once the context shifts to longer run issues, the analysis in this article departs from what is generally considered economic orthodoxy, especially the dominant view among economists that trend movements in real variables such as output, employment and unemployment are determined by the supply side. Current conventional wisdom holds that fiscal policy and other tools for managing aggregate demand have little place in long-run analysis. As Solow put it, 'the appropriate vehicle for analysing the trend motion is some sort of growth model, preferably mine' (1997: 230).

In the case of fiscal policy, the argument that it cannot affect long-run output and employment has been put at two levels. There is analysis that specifically relates to fiscal policy and argues that the stimulus it provides

will, in the longer run, crowd out an equivalent amount of private sector economic activity. In addition, there is the more general belief that the longer run growth path of an economy is determined by supply side factors. Hence, fiscal policy, like any other policy instrument designed to influence aggregate demand, has no effect on real variables in the longer run, unless it has side effects which affect supply-side variables.

Crowding-out theory maintains that an increase in the deficit will cause a rise in interest rates, and this will reduce private investment expenditure. If increased public expenditure increases economic activity, more money will be demanded by persons and corporations in the private sector to carry out this increased economic activity. They will try to borrow this extra money, forcing up interest rates. This argument has been applied even in a short-run context. In this context, it rests on an invalid assumption that the monetary authorities are successful in maintaining a constant rate of growth of the money supply. This operational rule for monetary policy is necessary if interest rates are to rise. Moreover, the analysis that shows increased government expenditure leading to higher interest also shows that any increase in private expenditure, for example, on investment or even foreign expenditure on Australian exports, will also lead to a rise in interest rates in Australia.

The underlying assumption is invalid because the monetary authorities, in Australia and elsewhere, have not maintained a constant rate of growth of the money supply. Even before widespread financial deregulation, targeting the volume of money was remarkably unsuccessful. Now, after financial deregulation, the volume adjusts endogenously to whatever size is desired by those with an effective demand for money. Monetary authorities operate directly on interest rates, and the rate of growth of the money supply is only one of many factors that they take into account when determining interest rates. In the case of Australia, this has been documented by Reserve Bank officers, for example in Macfarlane and Stevens (1989: 5–6). In effect, those supporting the crowding-out thesis in today's world of deregulated financial markets are arguing that, whenever government expenditure increases, the central bank actively tightens monetary policy to the extent necessary to reduce private investment by an amount equal to all, or most of, the increase in public expenditure.

Empirical evidence in Australia does not support the crowding-out thesis. If one examines changes in the size of the deficit and changes in short-term interest rates in Australia, it is hard to find a relationship, but if anything the relationship is inverse (Nevile 1997: 101–103). This is also the case overseas. Heilbroner and Bernstein carried out a cross-sectional analysis of the G7 countries. Pressman summarised their findings as follows:

[T]hose countries whose public debt increased most during the 1980s did **not** also experience the largest increases in real interest rates. In fact, if

anything the actual relationship seemed to be the reverse. Canada, whose public debt increased the most among G7 countries between 1980 and 1986, experienced the smallest increase in real interest rates among the G7 countries over the same time period. Conversely, the United Kingdom experienced the smallest increase in government debt and the largest increase in real interest rates (1995: 215).

Once crowding-out theory is rejected, there is no reason not to return to something like Lerner's (1943) functional finance, in which government revenue and expenditure are determined so that economic activity is at the rate which produces full employment without inflation and without any concern about whether the resulting budget, or a series of budgets, are in surplus or deficit. However, the straightforward argument in favour of functional finance, for however long the period, should not be taken to dismiss any problems generated by a rising public debt, if this is necessary to maintain full employment without inflation. Also, maintaining full employment without inflation is a much more complex problem than is suggested by Lerner's 1943 article, and this issue will be taken up later in this section.

If a country's public debt is held by its own citizens, the liability (to taxpayers) is balanced by the assets of those citizens who hold the debt. Nevertheless, the consequences for income distribution of a continually growing public debt may be important. In theory, these could be overcome through taxation and other fiscal measures for redistribution, but if the interest bill is large, this may not be feasible for political reasons. Even so, the rule that the budget should be balanced, not over a year but over the business cycle, is too strict as it ignores the effects of inflation and economic growth. If nominal gross domestic product is growing, there can be a positive budget deficit on average over the business cycle without any upward trend in the ratio of public debt to gross domestic product. In the case of Australia, however, this discussion is purely academic since our public debt—net of debt between different levels of government—is close to zero.

However, most academics and even many bureaucrats probably have long-run macro neoclassical theory (growth theory) in mind when asserting that in the long run output, employment and unemployment are determined by supply-side factors, not due to a deficiency in demand and cannot be reduced given the institutional structures of society. It is not possible to analyse the economic theory supporting this conclusion since there is not any. Neoclassical growth theory, based on the Solow/Swan model just assumes full capacity of physical capital and full employment. Swan (1956) made this clear from the start. Before a fixed factor of production—land—is introduced, Swan's model spells out what happens in Harrod's growth model if interest rate policy ensures that the warranted rate of growth is always equal to the natural rate of growth.

Solow is explicit in assuming full employment and tends to discuss what happens in an economy in which in the long run ‘the real wage adjusts so that all available labour is employed’ (1956: 68). Nevertheless, Solow is not completely happy with the unrealistic nature of this neoclassical assumption (see, for example, footnote 7) and even goes so far as to talk about ‘the basic equation which determines the time path of capital accumulation that must be followed if all available labour is to be employed’ (1956: 67).

In an article published 44 years later, Solow was forthright. Neoclassical growth theory, he says, supposes:

the available supply of labour always to be fully employed and the existing stock of productive capital goods always to be fully utilized ... This assumption of full utilization could better be made explicit by introducing a government that makes (useless) expenditure and levies (lump-sum) taxes in order to preserve full utilization but this is rarely done ... Full employment/utilization is usually just assumed (2000: 350).

Moreover in the following paragraph, Solow makes an even more damaging statement as far as the conventional view of neoclassical growth theory is concerned:

The neoclassical model allows in one important effect for the interaction between fluctuations and growth: fluctuations will surely perturb the rate of investment and that will necessarily affect the path of potential output (*ibid*).

As Solow discusses later in his article, this is true of investment in human capital as well as investment in physical capital. In other words, if there is such a thing as a NAIRU, or non-accelerating inflation rate of unemployment, it is path-determined and is smaller the greater amount of government expenditure on physical and human capital.

This raises the issue of the Phillips curve. This is based on a belief in the self-adjusting forces of a market economy, which will lead to market clearing in all markets—including the labour market—in the long-run, though these forces may be impeded in the short run due to rigidities and stickiness. If this belief is correct, while the short-run Phillips curve is upwards sloping, the long-run Phillips curve is vertical at NAIRU. If unemployment is kept below NAIRU for any length of time, this will lead to accelerating inflation. Related to this is the belief in the neutrality of money, so monetary policy will have no long-run effect on the level of employment.

The rationale for this is that at the macro level, employment and wages are determined in the labour market, where the wage rate is seen as the price which equates the demand and supply for labour. Assuming that demand and supply schedules behave in the conventional ways, a market clearing

wage will be established so that there would be no involuntary unemployment at that wage. Unemployment can only be the result of an impediment to the market mechanism, which prevented the wage rate from adjusting to the equilibrium level. Such rigidities or wage stickiness are assumed to be only short-run phenomena, so that the labour market will always clear in the long run.

There is little evidence to support a belief in the ability of markets to clear so that there is no under-utilisation of resources, particularly in the labour market. It is not the wage rate which determines employment, but rather the level of aggregate demand in the economy. There is nothing inherent in capitalist economies which pushes demand to the full employment level. The short-run trade-offs between unemployment and inflation which underlie the Phillips curve usually do not work for a number of reasons. In particular, if prices are set on a cost plus mark-up model and there are constant or decreasing costs, there is no need for increased output to be associated with increased prices up to the level of full employment or full capacity utilisation. Moreover, with appropriate policies in place, the level of full employment that can be reached without inflationary consequences is higher than that usually assumed.

In Australia, and many other countries, governments have defended a concentration on keeping inflation at a very low rate with the claim that high rates of inflation adversely affect longer run growth in output and employment. There is no doubt that this is true for very high rates of inflation, but there is substantial evidence that this is not the case when the rate of inflation is below, say, 10 per cent. Those who support fighting inflation as the over-riding goal of macroeconomic policy claim the support of the current dominant school of thought in economics. Professor Robert J. Barro is one of the most respected members of this school. In a study of the experience of more than a hundred countries over thirty years, Barro found that there was evidence of 'causation from higher long-term inflation to reduced growth and investment', but immediately commented that 'it should be stressed that the clear evidence for the adverse effects of inflation comes from the experience of high inflation' (1996: 168). The general tenor of Barro's article suggests that he had inflation rates above 20 per cent a year in mind when he used the term 'high', although anyone less sympathetic to the argument that inflation has adverse effects on growth might maintain that his empirical work shows that 'high' should be taken to mean more than 50 per cent a year. Barro's general result has been supported by numerous other studies.

Many media commentators and some academics have countered the argument for a reduction in the priority given to fighting inflation with the claim that such a reduction runs the risk of making inflation harder to contain, whereas pre-emptive interest rate rises add credibility to policy which lessens the risk of an increase in inflation. This is true, but the argument is completely symmetrical with respect to unemployment. Pre-emptive

increases in spending policy to expand employment equally lessen the risk of an increase in unemployment. In the Australian case, this is illustrated by the experience of the 25 years following the Second World War. No one doubted the commitment of successive governments to maintain full employment. Both monetary and fiscal policy reacted quickly to the first signs of any looming decline in the rate of economic growth and minimised departures from full employment growth. The most spectacular example was the 1952 recession precipitated by the virtual halving of the price of wool that occurred as a result of the cessation of hostilities in the Korean war. The value of wool exports fell by about a half while that of all other exports increased slightly. Real gross national product declined by over 10 per cent in 1951/52, but both aggressive monetary and fiscal policy halted the fall after that one year. Unemployment rose in 1952/53 but by a relatively small amount and the rise did not last long.

6.5 Looking Ahead

The two aspects of the silver lining of the current crisis are inter-related, in that it is somewhat easier to use fiscal policy as a major part of a package of policies to minimise fluctuations in economic activity, if budget expenditures bear a greater ratio to gross national expenditure. While the Howard Government accepted the principles of market liberalism, in practice this did not have much effect on the level of government expenditure in Australia.² Since December 2007, this level has increased partly due to the recession-induced decline in government revenue and partly to increases in expenditure. Market liberalism is not a problem in an Australia in the grip of a severe recession. Moreover, the policies of the Rudd Government in Australia are the correct short-term policy response to a severe recession. Luckily for the rest of the world (including us), so are the Obama policies in the United States.

The problem is in the longer run and revolves around the emphasis by the Federal Opposition on the growing deficit and the obsession of the media with this issue. The Opposition claims that Government policies will mortgage our children's future. The truth is exactly the opposite. If we finance with current taxes things which will bring benefits for many years to come, we are being generous to our children who will reap benefits they have not paid for. Borrowing is the obvious way to finance such things. Using resources—many of which would otherwise be lying idle—to build roads, railways and other physical infrastructure, will add to the productivity of the economy our children will inherit and raise their standard of living. It will also increase their ability to pay taxes, and hence the ability to reduce the public debt if that is thought desirable.

In any case, the whole issue of paying off the public debt is misguided. As noted earlier in the article, a loan from the Reserve Bank need never be

repaid. It only should be repaid when the economy is operating at more than full capacity with inflationary consequences. A large public debt can, in certain circumstances, limit government policy options, but in Australia public debt is currently close to zero, and even if pessimistic forecasts of how big it will become are accepted, it will still be among the lowest in the western world.

Earlier in the article, the importance of helping the long-term unemployed gain the skills to help them get a job was emphasised. If, or when, the economy starts to grow rapidly and the government puts priority on restoring a surplus and reducing the public debt, many of the long-term unemployed will miss out on gaining a job. In general, the long-term unemployed are the last that employers consider when hiring new staff. Often correctly, employers believe that these staff need to relearn skills and even basic habits required to be a productive employee. The best chance long-term unemployed have of getting a job is when rapid growth is restored, and every effort should be made to help them achieve this, rather than cutting expenditure to restore a budget surplus.

Acknowledgements

This article has benefited from the comments of two anonymous referees. The sections on fiscal policy in the short run and the long run draw heavily on J. W. Neville and Peter Kriesler, 'Decent work for all, with no inflation', a presentation given at the Centre of Full Employment and Equity conference at the University of Newcastle in December 2008.

Notes

1. Page references in this article are to the 2000 revised edition. The first edition was published in 1999.
2. There was a very slight upward trend in the ratio of Commonwealth Government taxes to Gross Domestic Product over the period from the December quarter 1996 and the same quarter in 2007 (the trend was calculated by the author from figures in Australian Bureau of Statistics (2009)).

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7

The ABC of G and T

G. C. Harcourt

In the run up to the 2013–14 Federal Budget in Australia, discussion in the public domain was intense, polemical and sometimes hysterical. Most commentators, either explicitly or implicitly, argued that the principal criteria by which the Budget proposals should be judged are, first, how do they contribute to returning the budget to balance or, preferably, a surplus; and secondly, to reducing the debt to income ratio. Other criteria include matching particular expenditures by particular taxes or cuts elsewhere in expenditure and an emphasis on the need for expenditure to be targeted rather than universal, so overlooking the demeaning effect of means testing. (This way of accessing budgets is not, of course, confined to Australia but is near universal in the advanced capitalist world.) I believe that these criteria are wrong, that they distort what should be aimed at in budgets and that they have serious negative effects on equity, efficiency and levels of activity and employment.

In their place may I suggest the following criteria would be more relevant and systemically beneficial? I set these out as an antidote to the decades of two fetishes: deficit size and aversion to debt, period.

First, when considering government expenditure (G) a clear distinction needs to be made between current expenditures and capital expenditures. Secondly, when considering taxation (T), the two main purposes of taxation need to be clearly demarcated. First, the overall structure of tax rates should reflect philosophical views on equity and incentives designed to affect the structure of the economy. Secondly, the other principal role of taxation is to affect the level of overall demand, having taken into account the other sources of demand which arise from the private and overseas sectors, that is to say, expected expenditures on consumption, investment, exports (less imports) and known expenditures on G. The complete structure of tax rates

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should be jacked up or down according to the expected levels of expenditures from these other sources so as to help to achieve desired levels of overall activity and employment. Whether G exceeds or falls short of T will reflect this prior judgement.

Turning now to debt to income ratios, it is vital, first, to distinguish between external debt and internal debt. The first does imply a real burden in the sense that exports will need to be higher than they otherwise would have been in order to service the debt with interest payments and repayments of principal. These are not necessarily “bads”, it all depends on how the proceeds when spent contribute to overall growth in the economy.

Servicing internal government debt constitutes transfer payments between those who hold it and those whose taxes are used to pay it (there is, of course, an overlap). The impact on activity depends directly on any difference in the spending patterns of those who hold debt and those who don't, so that the “burden” is different in kind from that of external debt. The redistribution of income implied may not necessarily be regarded as equitable or desirable but off-setting measures in the overall tax system can be used to tackle this. Indirectly, there may be negative feedbacks on the confidence of especially those responsible for private investment expenditure, particularly if they have been conned by the two fetishes mentioned above, as indeed they have.

As to the debt to income ratio: by world standards, Australia's position is nothing to worry about. (Nor is the corresponding ratio for the UK, as many of the UK's leading economic historians and economists have pointed out.) In any event, if the overall effect of the budget is to bring about and/or support agreeable rates of growth of GDP, it is well known that even sustained deficits do not necessarily increase the debt to income ratio over the long term. A glaring weakness of the current debate is the implicit assumption that we live in stationary states. Moreover, if government capital expenditure is principally decided by what medium- to long-term needs are to be met by the creation of suitable infrastructure, it does not seem irrational that parts of this at least be financed by borrowing. Indeed, as Ross Gittins pointed out to me, the great bulk of capital works spending in Australia is done by the states, a significant proportion of which is financed by borrowing.

If these criteria were included in an overall package deal of government policies, both our understanding and outcomes would be much more sane than those with which we are afflicted today.

If these criteria correspond to what Ross Gittins¹ recently dubbed Rip van Winkle Keynesianism, so much the better for that. The only point on which Ross Gittins and I disagree is that he is a symmetrical Keynesian who thinks there should be a balanced recurrent budget over the cycle. I think this implicitly assumes that a trendless cycle rather than a cyclical growth process characterises capitalism ancient and modern. As for the claim that monetary policy by independent central banks should be the principal

instrument of policy, it would be well to remember that two great monetary theorists told us that the bank rate is not a beautiful and delicate instrument but coarse and blunt (Dennis Robertson) and that the effects of monetary policy are subject to long and variable lags (Milton Friedman).

Notes

I thank but in no way implicate Ross Gittins, Raja Junankar, Peter Kriesler and John Nevile for their comments on a draft of this paper. This is a revised version of a paper with the same title that appeared in the *Economic and Labour Relations Review*, 24, 3, September 2013, 456–7 and is printed here with the kind permission of the journal's editors.

1. Ross Gittins is Australia's most respected economics journalist, our answer to Samuel Brittan, Larry Elliot and William Keegan.

8

The Systemic Downside of Flexible Labour Market Regimes: Salter Revisited

G. C. Harcourt

Over 50 years ago Wilfred Salter published *Productivity and Technical Change* (1960 [1966]), a book which quickly became a classic. I have never met anybody who has read it who has not said it is one of the most influential, impressive and enjoyable books in economics that they have ever read.¹ The book itself grew out of Salter's Ph.D. dissertation at Cambridge which was supervised by Brian Reddaway and submitted in 1955. Tragically, Salter was only to live another three years after the book was published.² In addition to the book, his legacy to the profession includes a number of fine articles, mostly published in the *Economic Record* (Salter was a West Australian and worked with Trevor Swan at the ANU (and in the Department of the Prime Minister) after he returned from Cambridge and before he went to Pakistan where he died.)

The articles were concerned with refining and extending the themes of his book. After his death, in an IEA (International Economic Association) volume edited by Austin Robinson, Robinson (ed.) (1965), there is a most important chapter by Salter. It is entitled 'Productivity growth and accumulation as historical processes'; it extends Salter's analysis of firms and industries to the economy as a whole. Salter and Eric Russell appeared for the Trade Unions in the 1959 Basic Wage case in Australia. They presented empirical evidence and theoretical arguments based on the themes developed both in Salter's book and articles and, independently, by Russell.

I argue here that Salter's arguments, and the policy proposals derived from his work, are still, as befits a classic, of major relevance for some of today's most pressing economic and social problems.

So what were the issues that Salter investigated and what were his major policy proposals? The principal puzzle that Salter tackled was how was it possible for the latest vintages, which incorporated the 'best-practice'

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combinations of the services of labour and capital goods, and older vintages, which were installed when what are now inferior 'best-practice' combinations ruled, to exist side by side in firms and industries? His answer was clear and definitive: for the older vintages to survive, they only had to expect to cover their immediate *variable* costs—their expected quasi-rents only had to be positive (at the margin, non-negative). By contrast, the new vintages had to expect to cover their *total* costs, including (at least) normal profits. This meant that current rates of output could be supplied from both newly installed 'best-practice' machines and from fossils in capital stocks, the earlier vintages installed in past periods. Gross investment expenditure was the means by which new ways of doing things were introduced into the stock of capital goods.

In a competitive setting for an industry (Salter's work initially was a Marshallian partial equilibrium analysis), if we also assumed that technical advances do not occur continuously but, rather, periodically, the firms and the industry would approach an equilibrium level. At the equilibrium level, the combined outputs of new and old machines in the industry would have so risen that the price of the product of the industry set in the competitive market would allow only the normal rate of profit to be expected to be received on the latest 'best-practice' vintages. Accumulation then would come momentarily to a halt until the next wave of technical advances occurred. Which older vintages operated and provided part of current overall output would be determined by those whose expected quasi-rents were positive (at the margin, non-negative, ignoring complications associated with scrap value). In this manner Salter combined the characteristics of Marshall's short-period and long-period analysis to explain his original observations.³

The process of embodiment through gross investment had implications for the level and rate of growth of productivity in firms, industries and the economy overall (this last was the subject of his 1965 IEA volume chapter). Salter argued that if the economy was kept at full employment, overall productivity would be higher and would grow faster, the more investment in high productivity and/or expanding industries was encouraged and investment in low productivity and/or declining industries, discouraged. Such an outcome was most likely to be achieved in an economy which encouraged flexible resource movements and where changes in money wages reflected changes in *overall* productivity (plus prices, if the economy was experiencing overall inflation). As Salter (1960: 153) wrote:

... it is particularly desirable that the market for labour should cut across inter-industry boundaries, thereby ensuring that comparable labour has the same price in expanding and declining industries. The argument that an industry cannot 'afford' higher wages is, in the long run, extremely dangerous. If it were accepted and wages were based on the 'capacity to pay', employment would be perpetuated ... in industries which should

properly decline to make way for more vigorous industries. Equally dangerous is the argument that industries which are prosperous because of new techniques have the 'capacity to pay' high wages. This would penalise the expanding industries on which so much depends.⁴

Higher rates of gross investment also are a necessary condition for these desirable changes to be achieved.

It was these policy proposals that Russell and Salter advocated in the 1959 Basic Wage case and, in Russell's case, throughout the 1960s and 1970s until his untimely death in 1977. Kaldor independently advocated similar policy proposals from 1940s on, as John King documents tellingly in his recent admirable biography of Kaldor (King 2008).

In a series of papers, I have argued that the Kaldor, Russell, Salter approach could be a successful way of tackling what I call the Kalecki dilemma—the cumulative difficulty of sustaining full employment (as opposed to reaching it from a deep slump) mooted by Kalecki in his extraordinary 1943 (!) paper, 'Political aspects of full employment' (see, for example, Harcourt 1997, 2001, 2010). Here I wish to take up another issue which follows from Salter's analysis and which is set out in the quote above. What Salter describes there is, in effect, the objective of the concerted efforts in recent decades to create in advanced capitalist economies what are euphemistically called flexible labour markets. I conjecture that if we examined the postwar experiences of the United Kingdom and Australian economies, for example, by classifying them into periods which either had or did not have flexible labour markets, we would detect in the evidence outcomes which Salter's analysis predicted would occur.

Major changes have occurred in the United Kingdom and Australian economies since Salter wrote. Of special importance, as I noted, is the much larger role that services, especially financial services in the UK, play in generating the national product and income; and the change over from the Bretton Woods regime of fixed exchange rates and capital controls to a regime of freely floating exchange rates and free capital movements. In my view, because the narrative that Salter told in terms of the manufacturing sector applies in principle to the services sector as well, his analysis remains as relevant now as when his book and articles were first published.

I now sketch out conjectures and the puzzles that we face.

I conjecture that the following would be the characteristics of three 'long runs' in the postwar period in the UK

1. **The Golden Age of Capitalism**—*the end of 1950s–1973 or so*: Full employment, high rates of accumulation in many industries, average wages in most industries increase in line with overall productivity (plus prices), growth of productivity the greatest in UK history (though relatively down on those of its main competitors).

2. **Stagflation—1973–1983 or 1984:** Lapses from full employment, average wage increases in most industries ahead of overall productivity plus prices; lower rates of accumulation, lower rates of growth of overall productivity.
3. **Flexible labour market era—1983–present:** Considerable periods well below high (let alone full) employment; much greater variation in changes of average money wages by industry; above the Salter rule in relatively high productivity, expanding industries; below the Salter rule in relatively low productivity, declining industries. Overall productivity growth disappointing relatively to that of the Golden Age; accumulation in many industries sluggish.⁵

Finally I itemise problems and suggestions for further work:

1. Does the increasing importance of services fundamentally alter the Salter story? My provisional answer in principle is ‘no’.
2. How do we measure whether accumulation is dynamic or sluggish when there are different I/Y and I/L ratios in different industries? Salter analyses embodiment in terms of both how much and what sort of investment to do (choice of technique)? Should we average these ratios for the three periods for all the industries we examine? Should they be supplemented with measures of volatility around the averages?
3. What is (are) the best measure(s) of deviations from the Salter norm rate of change? Average deviation? Standard deviation? Both.
4. Should we measure the Salter norm rate of change for each of the three periods? And/or the entire postwar period?
5. I would characterise the strength of competition in the three periods as follows:

The Golden Age was characterised by price-leading oligopoly in many industries (Kaldor’s stylised fact).

Stagflation: an intermediate regime.

Flexible labour markets: a cumulatively increasing competitive environment, nationally and internationally, making Salter’s competitive model more and more applicable.

I write this paper in part as a set of speculative conjectures in the hope that others (younger and better equipped) might expand and provide empirical support (or rejection) for the Australian, United States and United Kingdom economies.

Notes

1. I wrote a review article of Salter’s book in the September 1962 issue of the *Economic Record*, Harcourt (1962 [1982]). I concluded that Salter’s book ‘set an

example which other books on applied economics could follow profitably. The main problems ... are kept clearly before the reader, and the theory ... developed with these ends and the limitations of the ... data in mind' (1982: 136). In my entry on Salter in King (ed.) (2007), I wrote that Salter's 'researches and writings provide superb examples of how to fashion elegant and relevant theory, which at the same time is in the appropriate form to provide inferences which can be tested through careful empirical studies' (Harcourt 2007: 245).

2. See Trevor Swan's obituary of Salter in the December 1963 issue of the *Economic Record*, Swan (1963).
3. Salter also showed that similar processes could, but not necessarily would, occur with monopoly, and in imperfectly competitive and oligopolistic industries (see Salter 1960: 90–93).
4. He adds: 'Ideally, the only means by which the wage structure should be linked to the fortunes of particular industries are through skills and incentives to transfer from one industry to another. As industries decline, specialised skills become obsolete ... Closely related is the need for an expanding labour force in progressive industries ... These industries may need to offer higher than average wages (though not necessarily a higher than average rate of increase in wages)' (Salter 1960: 153–154).
5. I was comforted to see that the late Kurt Rothschild in a recent article (2009) which examines the EU's experience from 1960 to 2007 adopts a not dissimilar periodisation.

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9

Political Aspects of “Buffer Stock” Employment

Peter Kriesler and Joseph Halevi

9.1 Introduction

Despite co-discovering, with Keynes, the theoretical framework for the principle of effective demand, Kalecki was dubious about the ability of governments in capitalist economies to use macroeconomic policy to create full employment in the longer term. This is not due to any economic limitations on the efficacy of these policies, but rather to more fundamental political ones which ensure that, unless the underlying institutions of capitalism are changed, full employment cannot be maintained. The next section of this paper shows that Kalecki drew an important distinction between achieving full employment, which was possible with the aid of government fiscal policy increasing effective demand, and the maintenance of that employment.

According to Kalecki, political pressure ensured that full employment was incompatible with capitalist economies, unless there were fundamental changes. Section three of this paper argues that, without such changes, full employment can only ever be a temporary achievement.

Recently, some non-orthodox economists have proposed a solution to the problem of unemployment in capitalist economies referred to as either buffer stock employment¹, or as the employer of the last resort. In essence the models treat employment like the stock of goods, with build up of inventories associated with economic downturns becoming the equivalent of unemployment. The underlying idea is that the government should “buy” up this excess stock by offering employment to the “surplus” labour during downturns, so that the government effectively acts as an employer of the last resort. These “stocks” are then returned to the private sector when the economy picks up.

Section four examines the important question of whether such a scheme, on its own, represents the types of changes which Kalecki had in mind. In other

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words, can the implementation of such an employment program, by itself, change the dialectics of capitalist economies, reforming class relations, so that full employment becomes permanently achievable. Or do these schemes merely act as bandages, as temporary solutions to the deeper problems.

9.2 Attaining Full Employment

According to Kalecki, the contradictory nature of capitalist dynamics is not the result of the classical inverse relation between the wage rate and the rate of profits. The existence of excess capacity destroys any direct relation between the two, so that changes in the wage rate, under contemporary capitalism, do not impact on aggregate profits, but merely on the level of employment and output in the opposite manner to that proposed by neo-classical theory. The aggregate level of profits, as well as the level of output, is determined by capitalist expenditure decisions, that is, by their consumption and investment. Investment plays a key role in the determination of the level of effective demand. However, investment also plays a role in determining the size of the capital stock and the productivity of labour. It is with this dual function of investment, as both a form of expenditure and an addition to the existing stock of capital that the underlying contradiction of capitalism is most evident:

We see that the question, "what causes periodic crises?" could be answered briefly: the fact that the investment is not only produced but also producing. Investment considered as capitalist spending is the source of prosperity, and every increase of it improves business and stimulates a further rise of spending for investment. But, at the same time investment is an addition to the capital equipment, and right from birth it competes with the older generation of this equipment. The tragedy of investment is that it calls forth the crisis because it is useful; I do not wonder that many people consider this theory paradoxical. But it is not the theory which is paradoxical but its subject – the capitalist economy. (Kalecki, 1936–37, p. 554).

Investment as expenditure and therefore as a source of profits, is an important component of effective demand. The crisis is caused when that investment manifests itself as new equipment, so significantly increasing capacity. Unless effective demand grows at the same pace as the growth in capacity, the extreme case of balanced growth, it is likely to generate unused capacity with negative repercussions on future investment decisions and profits. So the key to the achievement and maintenance of full employment requires measures aimed at stimulating overall investment.

As this can come from either private or public investment, full employment can be achieved via fiscal stimulus. In this case, Kalecki argues, contrary

to contemporary neoclassical opinion, that the burden of the national debt will not constitute a significant problem. Obviously, a constant proportion of debt to national income does not create any problem in financing interest payments. If, by contrast, full employment has to be maintained through a rising budget deficit as a proportion of national income, then an appropriate tax will have to be devised in order to finance the increased interest burden. Kalecki recommends a capital tax, as this, unlike income tax, will not affect the profitability of investment if it is levied on all forms of wealth (including money balances), and hence is likely to leave investment unchanged. In the aggregate, government expenditure financed by a capital tax will not affect the income of capitalists as a class. The increase in income generated by the government expenditure will be offset by the tax, so that some capitalists will be better off while others are worse off². In other words, it is possible to maintain levels of effective demand sufficient to generate full employment, without substantial domestic problems for the domestic economy³.

9.3 The Political Obstacles

Although it is possible to achieve full employment, its maintenance is likely to run into insurmountable problems. In 'Political aspects of full employment' Kalecki appeared relatively optimistic about the efficacy of fiscal policy in achieving full employment. However, he believed that there were fundamental "*political problems*" which make full employment incompatible with capitalism, arguing that "there is a political background in the opposition to the full employment doctrine." (Kalecki 1943 p. 349). Kalecki highlighted three main "reasons for the opposition of 'industrial leaders' to full employment achieved by government spending" resulting in class/political pressure being brought to bear [ibid.]:

1. General dislike of government intervention, especially with respect to employment creation. This is reinforced by the power of industry over government in the absence of such intervention. In this case, employment and the level of economic activity is extremely responsive to the "state of confidence" of the "captains of industry". This gives them significant power over government policy which fiscal intervention would blunt.
2. Dislike of the specific composition of government expenditure, especially with public investment and subsidisation of mass consumption.
3. Dislike of the social and political consequences of the long-term full employment:

We have considered the political reasons for the opposition to the policy of creating employment by government spending. But even if this opposition were overcome – as it may well be under the pressure of the masses – the maintenance of full employment would cause social and political

changes which would give a new impetus to the opposition of the business leaders. Indeed, under a regime of permanent full employment, the 'sack' would cease to play its role as a disciplinary measure. The social position of the boss would be undermined, and the self-assurance and class-consciousness of the working class would grow. Strikes for wage increases and improvements in conditions of work would create political tension. It is true that profits would be higher under a regime of full employment than they are on the average under *laissez-faire*; and even the rise in wage rates resulting from the stronger bargaining power of the workers is less likely to reduce profits than to increase prices and thus adversely affects only the rentier interests. But 'discipline in the factories' and 'political stability' are more appreciated than profits by business leaders. Their class instinct tells them that lasting full employment is unsound from their point of view, and that unemployment is an integral part of the 'normal' capitalist system. (Kalecki 1943 p. 351)

As a result of these considerations, Kalecki argues that the maintenance of full employment is incompatible with capitalism, without fundamental changes to the underlying institutions.

'Full employment capitalism' will, of course, have to develop new social and political institutions which will reflect the increased power of the working class. If capitalism can adjust itself to full employment, a fundamental reform will have been incorporated in it. If not, it will show itself an outmoded system which must be scrapped. (Kalecki 1943 p. 356)

In other words, problems with effective demand are only symptoms of the underlying problem. The use of fiscal policy to increase demand will provide a temporary solution, but what is needed are more fundamental changes to the socio-economic and political structure of society.

Kalecki's explanation, which stresses the viewpoint of capitalists, can be reinforced by the Marxist stress from the viewpoint of workers. Workers, under capitalism, are alienated within the production process, during which it is their exploitation which allows capitalists to earn profits. As a result, they will, whenever they have the power to do so, strive to improve both their working conditions and their pay. In other words, according to the logic of capitalism, capitalists are right to fear full employment. Empowered workers will use that power to improve their lot.

For Marx, unemployment was essential for the survival of capitalism. During the accumulation process, profits drove capital accumulation, increasing the demand for labour until all the excess labour was absorbed into the work force, and wages rose. This put pressure on profits which, as a result, fell. The resulting crash both led to structural change in the economy and regenerated the reserve army of the unemployed, which then put downward

pressure on wages, allowing profits to rise; hence starting the cycle again. This was reinforced by investment in labour saving technology, which increased stagnationist/unemployment tendencies. The relation was based on the inverse relation between the wage rate/rate of profits, which was the foundation of classical analysis⁴.

Although Kalecki took from Marx the idea of the incompatibility of capitalism and full employment, he saw it operating via a very different mechanism. As Kalecki rejected the vision of competitive capitalism with little excess capacity, he developed a model where an increase in the wage rate, and in the level of wages would, in fact, increase profits. As a result of the stagnationist tendencies which he identified in capitalism, he believed that increases in wages would increase effective demand and thereby move in the same direction as profits. In other words, for Kalecki, wages and profits were no longer antagonistic.

The incompatibility of capitalism and full employment results from a more fundamental aspect of the class relationship. As the above discussion indicates, unemployment was the means by which the capitalist class asserted its control over the working class. Without unemployment, the inherent contradictions of the system would exasperate the underlying social and political tensions resulting in problems of discipline and instability. Either the institutional base of the economy would need to change, or full employment would have to be sacrificed. In retrospect we know that almost all capitalist economies took the easy way out, and abandoned the commitment to full employment. This was sanctioned, in exactly the manner predicted by Kalecki, by economists who argued the impotence of fiscal policy and for the need for “sound finance”.

9.4 Political Aspects of ‘Buffer Stock’ Employment

We are now in a position to ask the question of the degree to which the suggestions of governments acting as employers of the last resort (ELR) or of buffer stock employment as in a Job Guarantee (JG), would constitute the “fundamental reform” which would allow capitalism to save itself⁵. In answering this question, we need to consider the degree to which ELR can alleviate class conflicts, in other words, the extent to which it can reconcile the opposing interests of capital and labour in capitalist economies.

As discussed above, unemployment serves an important function in capitalist economies, mainly to provide a discipline on workers, both on wage demand and on their labour effort. The major part of this discipline comes, of course, from the loss in income, but a further substantial cost of unemployment is the loss of social as well as economic identity associated with joblessness. Concentrating on the lost income aspect, it is well known that the cost of job loss to a worker depends both on the likelihood of getting another job and of the loss of income associated both with unemployment

and with the new job (Shapiro and Stiglitz 1984). 'Buffer stock' employment eliminates the first part of this income related cost. There is no job loss. This also means that the likelihood of regaining private sector employment must also be higher for these workers, as there are none of the negative effects on employability associated with joblessness. Therefore, for 'the sack' to maintain its power of discipline over workers, and to reduce inflationary pressure, the movement from private sector employment to 'buffer stock' or JG employment must present a cost to the worker in terms of income loss. This sets a maximum level to the 'buffer stock' wages.

Inflation control under contemporary capitalism is through restrictive fiscal and monetary policy building up the reserve army of unemployed, reinforced more recently by industrial relations policies which significantly erode the bargaining power of labour. The increased unemployment both reduces demand pressures and reduces the power of workers to maintain real wages. As a result, just as in Marx, unemployment causing falling real wages maintains the stability of the system. In the JG model, this role is played by the movement of workers into JG. As Mitchell (1998) argues:

As the BER (ratio of buffer stock employment to total employment) rises, due to an increase in interest rates and/or a fiscal tightening, resources are transferred from the inflating non-buffer stock sector into the buffer stock sector at a price set by the government; this price provides the inflation discipline. (p. 551)

In the advent of inflation, without the scheme, people dropping from employment to unemployment reduce inflationary pressure both by reducing demand and by reducing the militancy of the labour force (like the reserve army). With a 'buffer' scheme, people will drop from employment to 'buffer' employment. Since the loss in wages and status, etc. is much reduced, this means that more people will have to change state in such a scheme. NAIBER (the "Non-accelerating inflation buffer employment share, (which) is the ratio of buffer stock employment to total employment that is required to stabilise inflation." (Mitchell 1998 p. 547n)) must be higher than NAIRU. This means that there is a clear opportunity cost of the scheme. Namely, that x percent of the labour force, where x percent = NAIBER - NAIRU, will now be in 'buffer' employment whereas previously they were 'fully' employed.

This means that the scheme imposes a cost on some workers. In order to act as a discipline on inflation, workers do not fall as far as they do currently, that is, from full employment to unemployment; rather they fall from full employment to 'buffer' employment. However, the cost of this is that many more workers need to fall. In other words, the contraction in the private sector needs to be much more severe to have the same impact on inflation. Of course, this will also have serious implications for private sector profitability, and growth⁶.

A related problem is the reaction of capitalists to the scheme. If the scheme succeeds, then it will reduce the control of the “captains of industry” in much the same way as would a period of prolonged full employment. We should expect the same reaction to the scheme as Kalecki noted would face any commitment to full employment. In other words, if capitalists perceive such schemes as threats to their profits or economic power – which is extremely likely considering the increased government expenditure and reduced levels of unemployment with which they are associated – then we would expect them to react. At the very least, if one country adopted such policies in isolation, capital flight would be a global way of disciplining the offending government.

The JG proposals make implicit assumptions about the ways in which governments act, as well as to their benign motivations. When examined carefully, the idea that otherwise unemployed workers can be employed by the government – presumably in public works and the like – until effective demand picks up as to reabsorb those workers in the private sector at higher wages, is more than unrealistic: it is positively worrisome. The economy is, of course, assumed to remain fully capitalistic in its social relations of production. The State therefore will not have a neutral role. In this context the extreme case of the structuring of the unemployed in a de facto State managed consortium occurred in the Arbeiter Front which existed in cartelised capitalist Germany in the 1930s, that is during the regime of the national socialists, Nazis. In Germany the economic recovery initiated by the rearmament process was so strong as to generate quite rapidly a situation of virtual full employment, also thanks to the increase in military expenditure. Yet, formally, the role of the Arbeiter Front was precisely to marshal labour according to the priorities of the State. Although it is not suggested that this extreme would be repeated, nevertheless, it provides an important lesson. Only with very strong trade unions can this system be given some consideration but certainly this is not the case in the USA where they are trying to export this idea. It will therefore lead to a super corporatist State without the countervailing powers that exist in Northern Europe (See Kriesler and Halevi, 1995). Indeed, looking at past, (and the current) Presidents of the USA, it is easy to envisage the conscription of any ‘buffer’ employment into military services.

Consider in this context Chomsky’s recent analysis according to which modern capitalism is a system of large corporations whose technostructure is strictly interwoven with the bureaucracy of the strong states of the planet; the State managed labour consortium would accentuate the state monopolistic elements outlined by Chomsky and before him by Baran and Sweezy. When Galbraith wrote *American Capitalism* in the mid 1950s he had a firm view about the necessity of countervailing powers. There are none, of any significance, today in the USA and this a structural phenomenon not just a passing one. Hence, given that the State is not neutral and given the validity

of Chomsky's analysis, a State guided labour consortium will strengthen the monopolistic features of contemporary capitalism in an institutional way.

We should also note that such a scheme goes against the basic insight of both Kalecki and Keynes who saw the key to achieving full employment in capitalist economies as being control over investment. The State should target investment, not labour alone. Employment comes from investment and its composition in the way seen by Kalecki in 1943, who argued that investment must be based on social priorities in a consistent manner with full employment. JG does not address this issue at all. In fact, as has been pointed out above, the private sector contractions necessary to maintain a discipline on inflation need to be much higher under such schemes. The likely impact of this, independent of any further problems arising from the general capitalist reaction to the scheme itself, will be a severe dampening of investment.

9.5 Some Conclusions

The discussion above has reiterated Kalecki's distinction between the possibility of achieving full employment in capitalist economies, and the overwhelming difficulty of maintaining it. As has been pointed out, governments can, through the use of policy – fiscal rather than monetary – achieve full employment without major problems to the economy. Kalecki showed that the traditional objection focussing on the problems of financing fiscal policy are easily overcome. However, although the achievement of full employment is essentially an economic matter, its maintenance becomes a political one. Full employment conflicts with the interests of capitalists as a class. As a result, they will bring great pressure to bear on governments, which will make the maintenance of that full employment extremely problematic. The main concern of capitalists is that full employment lessens their power in the class struggle with workers, to impose conditions and wages which are favourable to them. Without changes to the fundamental institutions of capitalism, which will enable the resolution of some of this conflict without the cost of unemployment, the maintenance of full employment remains an unachievable goal in capitalist societies.

The JG or ELR proposals for long-term solutions to the problem of full employment in capitalist economies are not the fundamental reform in the Kaleckian sense. Rather than dealing with the underlying contradictions in capitalism by addressing aspects of class struggle, these solutions really only bandage over the problem. By focussing on labour and ignoring investment, it is not clear what they can achieve, although the likely outcomes are a decline in the economy's rate of growth due to lower level of investment over the cycle.

However, this does not mean that such schemes have no place. In the unlikely eventuality that capitalism can reform itself in the manner suggested

by Kalecki, or if we can get investment policies “right”, then JG/ELR schemes would have an important role in dampening the effects of cyclical variations in income and employment. All economies, even planned ones, are subject to such cyclical influences, and the strength of the proposed schemes is that they can quarantine the most severe effects of these cyclical movements from the workforce.

Notes

We would like to thank the participants of the Second Annual Path to Full Employment Conference, University of Newcastle, December 2–3 1999, for their helpful comments. We would also like to thank an anonymous referee for helpful suggestions.

1. The term Buffer Stock Employment was used at the time of the Conference. Such models have since been referred to as the Job Guarantee – see for example Mitchell (1998, 2001).
2. Kalecki, 1944, pp. 362–363 and Kalecki, 1937.
3. Elsewhere we discuss the additional complications to the achievement of full employment caused by structural factors: Halevi and Kriesler (2000).
4. Marx (1977) chapter 25. cf. “Unemployment is therefore a necessary condition for accumulation and it is created by accumulation itself” (Sylos-Labini, 1983 p. 133)
5. It should be noted that we will not consider the important benefits which such a scheme will bring. There can be no doubt that elimination of unemployment in any manner, no matter how temporary, will reduce the heavy social costs of unemployment associated with increased crime, health problems and other serious social problems. (See, for example, Wray (1998) and Nevile and Kriesler (1998)) However, the particular concern of the paper is with the longer term implications of such schemes.
6. In a small open economy, like Australia, unemployment not only serves to provide a discipline on wages, but also serves to maintain balance of payments stability. Contractionary economic policy restores balance of trade equilibrium by reducing demand for imports. With a ‘buffer stock’ or Job Guarantee type program, the reduction in the aggregate income of workers as a result of such contraction will be smaller, and so the net effect on imports will also be smaller. This means that contractions will have to be more severe in order to have the same effect on imports.

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10

How Voluntary Is Unemployment? Two Views of the Phillips Curve

J. W. Nevile

10.1 Introduction

Much of the search theory literature implies that all unemployment is voluntary unemployment. It is assumed that the individual cannot search for a job and work at the same time, so that while a person is job seeking, he or she is unemployed. Individuals have an “acceptance” wage in mind and search until they find a job at that wage or a higher one. When they are offered such a job, they accept it and cease to be unemployed.¹ This kind of theory can explain Phillips-curve-type phenomena if the individual’s perception of the rate of inflation is assumed not to adjust instantaneously to changes in the actual rate. In such a case, when the rate of inflation rises, individuals are more likely to receive what they perceive as high wage offers, and unemployment falls.

Other theorists who do not necessarily follow search theory also explain the Phillips curve in a way which implies that all unemployment is voluntary. If individuals think that the real wage has changed, then there is a change in the quantity of labor supplied. Given that individuals learn immediately of changes in the nominal wage rates and only slowly of changes in the general level of prices, this theory also gives rise to a Phillips curve that, in effect, is a supply curve of labor. Perhaps the clearest exposition of this view of the Phillips curve has been given by Milton Friedman, and it is worth quoting him:

Suppose to start with, the economy is at a point . . . with both prices and wages stable (abstracting from growth). Supposing something, say a monetary expansion, starts nominal aggregate demand growing, which in turn produces a rise in prices and wages at the rate of say two per

Revised from *Journal of Post Keynesian Economics*, 2(1): 110–119, 1979, ‘How Voluntary Is Unemployment? Two Views of the Phillips Curve,’ by Nevile, J. W. With kind permission from Taylor and Francis LLC. All rights reserved.

cent per year. Workers will initially interpret this as a rise in their real wage—because they still anticipate constant prices—and so will be willing to offer more labor (move up their supply curve), i.e., employment grows and unemployment falls. Employers may have the same anticipations as workers about the general price level, but they are more directly concerned about the price of the products they are producing and are far better informed about that. They will initially interpret a rise in the demand for and price of their product as a rise in its relative price and as implying a fall in the real wage rate they must pay measured in terms of their product. They will therefore be willing to hire more labor (move down their demand curve). The combined result is a movement . . . to a point which corresponds with “overfull” employment with nominal wages rising at two per cent per year. (1975, pp. 20–21)

A completely different theory which also can be used to underpin the Phillips curve is that much unemployment is involuntary, and that the Phillips curve exists because, the lower the level of unemployment, the stronger the bargaining position of the unions and the weaker the bargaining position of the employers. When there are very high levels of demand, both labor and businessmen believe that wage and price rises are not likely to lead to unemployment and unsold products. In fact, businesses may have a positive incentive to give wage rises, both to keep (or attract) scarce labor and to prevent strikes, which are especially costly to a firm if they occur when there is a high level of demand that may not be permanent. In this type of theory, the chain of causation runs from unemployment to inflation. If all unemployment is voluntary, on the other hand, the chain of causation runs from the rate of inflation (or, more accurately, changes in that rate) to the level of unemployment. Friedman recognizes this, and in the work from which I have already quoted, castigates Phillips for having the causation the wrong way around (while he praises Irving Fisher for having it correct).

It is a matter of some significance which view of the Phillips curve is more in accord with reality. Quite apart from any policy implications (and both views of the Phillips curve can give a tradeoff in the short run, but vertical Phillips curves in the long run), whether unemployment is predominantly voluntary or involuntary makes a difference to one’s views about the costs and benefits of different positions on the short-run Phillips curve and about the speed at which the economy should move toward an acceptable rate of inflation.

If there are no lags in the relationship between inflation and unemployment, it is very difficult to distinguish between the two theories. In his original article in *Economica*, Phillips took the average values of dw/dt for six unemployment intervals. Thus, his results could be explained by either of the opposing theories. Lags exist in most economic relationships, however, and can be measured if we observe the data over short enough time periods.

It ought to be possible to evaluate the two opposing theories by looking at the lag structure of Phillips curves. That is what the present article does, using Australian data.²

10.2 An Involuntary Unemployment Model

Under the model, prices are determined by a markup process, and wages are determined partly by the legal arbitration system and partly by the relative bargaining strength of unions and employers. First, the model assumes that pricing decisions are based on costs at normal levels of output and that, while the most common method of pricing by firms is the use of some form of markup procedure, the possibility of discounting when demand is slack or adding to the markup in the face of considerable excess demand is not excluded.

Second, it assumes that wages are determined in a two-stage process. Award wage rates (or the minimum rates legally payable in each of a large range of occupations and industries) are set by the arbitration system, and the actual wage paid is determined by bargaining between unions and employers about the size of the overaward payments. Unions are concerned as much with real wages as with money wages. Hence, the smaller the rate of growth of award wage rates compared with the expected rate of growth of prices, the more they strive for increases in overaward payments. Their success in this, however, is strongly influenced by the strength of their bargaining position, which at a macrolevel is determined by the level of aggregate demand. Two further factors affect the rate of inflation. First, the prices for some goods and services sold in Australia are determined overseas, and this must be taken into account. Second, so far we have been talking about prices net of indirect taxes. It is reasonable to assume that if indirect tax rates are changed, these changes are passed on in price changes.

More rigorously, the model of inflation starts with the truism that a certain proportion of prices in Australia are determined in the first instance by overseas prices and the rest are determined in the first instance by domestic factors. In symbolic terms,

$$(1) \quad P = hPF + (1 - h)PD,$$

where P is the rate of growth of the general price level; PF is the rate of growth of overseas prices; and PD is the rate of growth of prices determined by domestic factors. As a first approximation, h is assumed to be constant.

The equation for domestically determined prices is

$$(2) \quad PD = WEN - Q + aD,$$

where WEN is the rate of growth of average weekly earnings net of changes in overtime earnings; Q is the long-run rate of productivity growth; and D is

the level of excess demand. Changes in the weekly earnings net of changes in overtime earnings and the long-run rate of growth of productivity are used because of the belief that pricing decisions are made on the basis of costs at normal levels of output.

Changes in weekly earnings net of changes in overtime earnings are determined by changes in award wage rates and the factors already mentioned that determine changes in overaward payments. Hence, the equation for *WEN* is

$$(3) \quad WEN = bWA + c(PE - WA + Q) + dD,$$

where *WA* is the rate of growth of award wage rates and *PE* is the expected rate of growth of prices, *b* may not equal unity. If all increases in award wage rates are passed on in percentage terms, *b* would be equal to one. If in some firms or industries the absolute amount of an increase in award wages is passed on, *b* will be somewhat less than one.

Combining equations (1), (2), and (3) and adding an extra term to allow for the existence of indirect taxes gives

$$(4) \quad P = hPF + (1 - h)(b - c)WA + (1 - h)cPE \\ - (1 - h)(1 - c)Q + (1 - h)(a + d)D + fT,$$

where *T* is the rate of change of an index of indirect tax rates.

In estimating equation (4), *P* was measured by changes in the implicit gross national expenditure deflator; *PF*, by changes in the import price index;³ *WA*, by changes in a weighted average of male and female award wage rate indexes; *D*, by the reciprocal of the level of unemployment;⁴ and *T*, by changes in the index of indirect taxes used in Nevile (1975); *Q* was assumed to be constant and its effects included in the constant term.

The series used for *PE* needs to be described in somewhat more detail. I have a very strong belief that little more than simple rules of thumb are used to measure price expectations for decision making in the real world, at least in Australia. In the 1960s, when the annual rate of inflation fluctuated between 0 and 4 percent and was usually 2 or 3 percent, it is probable that most decisions were taken on the assumption that the future rate of inflation would equal a "normal" rate somewhere between 2 and 3 percent a year. In the 1970s, this assumption became untenable. Instead, people probably looked at inflation in the recent past and, in particular, at the rate of growth of the consumer price index, which receives wide publicity in the media. Hence, *PE* was set at 2.5 percent for the years prior to 1970–71 and made equal to the June on June rate of growth of the consumer price index in the previous year for 1970–71 and subsequent years.

One further complication was added to equation (4) before it was estimated empirically. The Labor government introduced a Prices Justification

Tribunal. Its first full year of operation was 1974–75. It is likely that a Prices Justification Tribunal will have an effect on the rate of inflation when it is introduced (even if its operations only postpone price rises) but that this will be a once-and-for-all effect, not a continuing effect. Hence, a dummy variable was used with a value of one in 1974–75 and zero in other years.

The equation was estimated from annual data for twenty-three years ending in 1976–77. The equation was estimated with unemployment lagged six months, unlagged, and advanced six months. The results are reported in Table 10.1.

Inspection of Table 10.1 shows that the equation with unemployment lagged is to be preferred to the unlagged case, and is clearly better on statistical criteria than the case where unemployment is advanced six months. This suggests strongly that the good results obtained when lagged unemployment is used do not really reflect a relationship between unemployment and lagged inflation. It might be objected that the expectations mechanism used in the equations in Table 10.1 is a particularly crude one. This is true, though I believe it is the one which gives the closest approximation to reality. If, however, one assumes that in the period since 1970 expectations have been formed by more sophisticated mechanisms, the results are unchanged in the sense that the t statistic for the coefficient of lagged unemployment is always greater than that for the coefficient of advanced unemployment. If one uses a distributed lag function of past rates of inflation, only the first term is significant, and the other coefficients and statistics are almost identical to those in Table 10.1. If one assumes some form of rational expectations and proxies the expected rate of inflation by immediate past movements in overseas prices and the rate of growth of M_3 , the statistical properties of the estimated equations are almost as good as those in Table 10.1, and the t statistic for the coefficient of the unemployment term declines from 3.1 in the lagged case to 1.1 in the case where unemployment is advanced.

If unemployment really depends on the lagged rate of inflation, estimating inflation on the advanced rate of unemployment involves a bias. Since, however, in this hypothetical situation the coefficient of unemployment is biased away from zero, our conclusion that the best statistical result occurs when inflation depends on lagged unemployment is strengthened, rather than weakened, by the possible existence of such a bias. Nevertheless, as a further test, it is desirable to estimate a voluntary unemployment model in which unemployment depends on the rate of inflation. This is done in the next section.

10.3 A Voluntary Unemployment Model

The model used is a formalization of the theory in the passage above quoted from Friedman. Unemployment is assumed to be inversely related to the difference between the rate of growth of wage rates paid and the expected

Table 10.1 Inflation as the dependent variable: Australia, 1954–55 to 1976–77

Equation estimated with:	Percentage changes in the implicit GNE deflator regressed on:							R^2	DW
	Constant	Expected rate of inflation	Growth of award wage rates	Growth of indirect tax rates	Growth of import price index	PJT dummy	1/ U		
U lagged six months	-1.22 (2.0)	.468 (6.5)	.353 (9.4)	.123 (3.3)	.128 (2.6)	-2.51 (1.9)	2.14 (3.5)	.9926	2.34
U unlagged	-.845 (1.9)	.444 (5.7)	.343 (8.5)	.159 (4.2)	.137 (2.6)	-1.99 (1.4)	1.63 (2.8)	.9912	2.19
U advanced six months	-.534 (1.0)	.409 (4.8)	.342 (7.6)	.180 (4.4)	.155 (2.6)	-2.19 (1.3)	1.24 (1.8)	.9890	1.97

Figures in parentheses are t statistics; U = unemployment.

inflation rate. In periods of relative stability, the expected inflation rate is assumed to be constant, the 2.5 percent in the real world, rather than the zero percent in Friedman's hypothetical world. In the post-1970 period, when the rate of inflation was anything but stable, workers' views on real wages are assumed to be determined by comparison of the rate of growth of wages paid with the perceived rate of inflation in the immediate past. Thus our previous measure of the expected rate of inflation PE is again appropriate, and the equation to be estimated is

$$(5) \quad U = K + g(WE - PE),$$

where U is unemployment and WE is the rate of growth of average weekly earnings. Unfortunately, there is no reliable series for average hourly earnings in Australia. If demand increases, the average number of hours worked per week and total wages paid are likely to increase and unemployment is likely to fall. Hence, the estimate of g is likely to be biased downward if g is considered an estimate of the slope of the supply curve of labor in a Friedman-type Phillips curve. Again this bias favors the voluntary unemployment hypothesis. Since the sign of the coefficient g is negative, a downward bias will increase its absolute size. As before, the equation was estimated with the independent variable lagged six months, unlagged, and advanced six months. The results are shown in Table 10.2.

It will be noticed that all the equations in Table 10.2 have very poor statistical properties. This could be due to the need to include some additional variables. In particular, while Friedman maintains that voluntary employment is important and is related to the rate of inflation, he also believes that involuntary unemployment can exist if minimum wage rates are set too high. Minimum wage rates, in the form of award wage rates, are very important in Australia. However, when an index of award wage rates, corrected for

Table 10.2 Unemployment as the dependent variable: Australia, 1954–55 to 1976–77
The percentage level of unemployment is regressed on the difference between changes in wages paid and the expected rate of inflation.

Equation	Constant	$WE - PE$	R^2	DW
$(WE - PE)$ lagged six months	2.48 (6.3)	-.075 (0.8)	.032	.32
$(WE - PE)$ untagged	2.62 (7.6)	-.116 (1.5)	.100	.43
$(WE - PE)$ advanced six months	2.88 (10.1)	-.204 (3.1)	.320	.58

Figures in parentheses are t statistics.

productivity changes, was included in the equations in Table 10.2, in every case its coefficient had the wrong sign.

While all the equations in Table 10.2 are unsatisfactory, the least unsatisfactory is the one in which unemployment is related to wages and inflation advanced six months. This suggests that all that is being picked up is a reflection of the relationship between inflation and lagged unemployment. This conclusion remains unchanged when different expectations mechanisms are substituted for that used in the equations in Table 10.2. All the different expectations mechanisms described earlier were used in turn and, though no equations were satisfactory, in each case the most satisfactory, by the usual statistical criteria, was the one in which the rate of growth of wages and expected inflation were advanced.

10.4 Conclusion

A Phillips curve based on an involuntary unemployment model fits the Australian data well. It fits best when unemployment is lagged six months, which strengthens the belief that the chain of causation runs from unemployment to inflation and not vice versa. This, in turn, implies that unemployment is involuntary, not voluntary. A Phillips curve based on a voluntary unemployment model gave very poor results when estimated from Australian data. Moreover, the best results were for the case in which inflation was advanced six months, implying that the equation was simply a poor reflection of the involuntary unemployment case in which inflation depends on lagged unemployment. The evidence presented suggests that, in Australia at least, unemployment is predominantly involuntary.

Notes

1. See Santomero and Seater (1978, pp. 518–24) for a survey of this literature as it relates to the Phillips curve.
2. I have already estimated a Phillips curve based on an “involuntary unemployment” type theory in which the rate of inflation was the dependent variable and the aggregate demand variable was lagged six months (see Nevile, 1975). However, many economic series, including unemployment, show strong auto-correlation. Lagged unemployment may have been acting as a proxy for future unemployment, and the equation could be reflecting a relationship between unemployment and lagged values of the rate of inflation. Certainly, when I originally estimated a Phillips curve for Australia, no thought was given to testing the direction of causation.
3. The import price index of the Reserve Bank of Australia was used, but it was reweighted to allow for the change in the importance of oil imports following the discovery of oil in Australia.
4. The figures from the quarterly labor force survey were used. The series had to be extrapolated backward, and this was done on the basis of figures for registered unemployed.

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Part II
Australia

11

A Simple Econometric Model of the Australian Economy

J. W. Nevile

11.1 Introduction

Econometric models can be designed to serve any or all of three purposes; to increase understanding of the structure and of the underlying characteristics of an economy, to aid in forecasting, and to help evaluation of policy measures. The model described in this paper was specifically designed for the first purpose, but it is useful for forecasting, and gives some help in judging quantitatively the likely effects of fiscal policy changes—it is no help at all in evaluating monetary policy. The model was designed to give insight into the nature of the post-war Australian economy. In 1961 this economy came of age, as it were, in experiencing its first independent slump.¹ Yet, apart from hunches based on casual empiricism, our knowledge of its dynamic characteristics is slight. Is it an economy which, in the absence of outside shocks or constant vigorous government action, is itself naturally buoyant with strong growth forces? Is its structure such to produce cyclical fluctuations about an upward trend, or is it in itself a stagnant economy needing constant government measures to keep it on the upward path? The model presented here is intended to help answer these and similar questions. The answer that the model suggests is set out in detail in Section IV. Briefly it is that the Australian economy is a “Harrod type” economy. There is a critical rate of growth, approximately $3\frac{1}{2}$ per cent. per annum, of real gross national product which corresponds to Harrod’s warranted rate of growth. When gross national product grows at a faster rate than this, there is a strong tendency towards constantly increasing rates of growth, and the consequent inflationary pressures once full employment is reached. If the rate

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of growth of gross national product is less than $3\frac{1}{2}$ per cent. per annum, the rate of growth will decline and in many cases quickly become negative unless the endogenous forces are counteracted by government action or a fortuitous outside shock.

The economic theory underlying the econometric model is conventional macro-economic theory. It consists of a consumption function and two investment functions: one for investment in inventories and the other for investment in fixed capital equipment. Investment in stocks is governed by the acceleration principle and that in fixed capital by the level of profits. When these are combined with the other obvious equations required to complete the system, the resulting model is characterized by steady growth (or decline), or cycles, depending upon the size of the parameters.² If the theory is to have any content, and if one is to have a sound basis for distinguishing between the *a priori* claims made by different theorists, one must make statistical estimates of these parameters. This is done in this paper. The result is the nine-equation econometric model of the Australian economy set out in Section III.

The model is called simple for two reasons. First, the parameters are estimated by least squares and not by the more usual limited information maximum likelihood method. Least squares is used in the belief, supported in Section II, that it is the better method of the two in most cases arising in econometrics. Secondly, the model is simple in that it consists of nine equations instead of the usual 25 to 35. The small number of equations arises from the construction of a model corresponding to aggregative theory; but it may well be that this is the best way to start any econometric investigation of a particular economy. Professor Johnston recently remarked that:

“It is questionable whether one should attempt a complete system all at once. . . . An alternative approach to writing down a system with thirty or more equations is to start with the simplest possible aggregative systems and gradually to extend to more complicated systems noting carefully which aspects of performance improve and which deteriorate, and using this as a guide in the development of the system.”³

One final introductory point should be made. The estimates of aggregative functions that follow cannot be justified by any sophisticated theorems on aggregation. They rest on the simple proposition that there is some, apparently stable, averaging process going on which makes it both plausible and useful to assume that magnitudes such as aggregate investment or consumption behave as if they were determined by a few other aggregate variables. It is assumed that the myriad of other factors involved in determining investment or consumption expenditures cancel out enough in the aggregate to enable one to safely ignore them. There is no implication in the analysis that the aggregate parameters are the same size as the typical

micro-economic parameters, only that the aggregative process is such that the aggregative parameters are stable. It is the size of the aggregative parameters themselves which is of interest.

11.2 Data and Methods of Estimation

The basic data used are the tables published in the *White Papers* on National Income and Expenditure. The figures used were taken from the 1961, 1959 and 1955 *White Papers*. The year 1947–48 was the first year included in the analysis, as earlier, war-time controls were not dismantled. The year 1959–60 was the last year used in estimating the equations due to the tentative nature, when the analysis was made, of many of the figures published for 1960–61. A few minor changes and one major change were made to the *White Paper* figures. Using the method developed by Grant and Mathews⁴, stock appreciation was subtracted from the published figures for both investment in non-farm stocks and gross national product. The method used by Arndt and Cameron⁵ was used to divide income tax into tax on farm and tax on non-farm incomes. Fifteen million pounds were added to the published figure for gross national product in 1947–48, to make it more comparable with the revised figures published for later years; and an adjustment was made to the published figures for expenditure on motor vehicles for the years before 1953–54 to shift expenditure on station wagons from the “trucks” category to the “motor-cars” category.

The major adjustment was to deflate the *White Paper* estimates, which are of course in current value terms. It is obviously necessary to correct the published figures for price changes when, as in the case of investment in stocks, an acceleration principle is used. The view of the writer is that it is also necessary in general. The real relationships, not the relationships distorted by price changes, are the ones described by the theory upon which our model is based. There are two possible methods of deflating. One is to deflate each component of income and expenditure by a price index appropriate to itself. The other is to deflate all components by the same index of general price changes. For the present purposes the second method seems superior.⁶ If, for example, profits are deflated by one index and investment in fixed capital by another, a distortion is introduced into the relationship between profits and investment. Suppose the price index for investment goods rises more rapidly over the whole period than the price index used to deflate profits. Then a false upward trend in profits is introduced. All the current value figures have been deflated by the same index. This is a composite index which is a weighted average of the consumer price and the basic materials and foodstuffs wholesale price indexes published in the *Monthly Review of Business Statistics*. The consumer price index was given twice the weight of the wholesale price index.⁷ The values of the composite index and the deflated figures used in estimating the parameters of the model are given in Table 11.1.

Table 11.1 Components of gross national product, Australia, 1947-48 to 1959-60 (deflated £Am)

Year	Composite Index	Gross National Product	Investment in Fixed Capital Equipment	Investment in Non-farm Stocks	Consumption Expenditure	Expenditure on Motor Cars	Expenditure by Financial Enterprises	Company Income	Unincorporated Farm Income	Non-farm Disposable Income	Non-farm Personal Income
1947-48	53.6	3671.6	313.1	168	2375.0	63.4	33.6	354.5	653.0	2070.7	2291.2
1948-49	59.4	3717.2	414.1	42	2486.5	90.1	35.4	360.3	537.0	2446.1	2673.4
1949-50	65.3	3972.3	506.9	-23	2577.3	147.0	38.3	387.4	652.4	2581.9	2777.9
1950-51	75.2	4598.4	611.8	86	2715.4	154.3	38.6	513.3	940.2	2763.3	2968.1
1951-52	92.0	3982.6	642.4	190	2608.7	154.4	41.3	413.0	582.6	2720.7	2977.2
1952-53	100.0	4193.0	546.0	-190	2540.0	110.0	40.0	378.0	596.0	2661.0	2948.0
1953-54	101.3	4527.1	588.4	84	2752.2	142.2	41.4	466.9	519.2	2861.8	3132.3
1954-55	102.0	4772.5	672.5	127	3024.5	177.5	46.1	507.8	457.8	3135.3	3397.1
1955-56	106.2	4941.6	707.1	61	3100.8	174.2	50.8	515.1	412.4	3270.2	3563.1
1956-57	111.3	5160.8	689.1	55	3127.6	161.7	52.1	533.7	462.7	3284.8	3591.2
1957-58	111.6	5255.4	744.6	95	3325.3	183.7	52.9	520.6	332.4	3393.4	3707.9
1958-59	112.4	5522.2	762.5	29	3442.2	192.2	56.0	565.8	404.8	3548.0	3854.1
1959-60	115.6	5847.8	852.9	10	3705.9	237.0	66.0	645.3	408.3	3756.9	4096.9

Sources: *White Papers on National Income and Expenditure* and *Monthly Review of Business Statistics*. See the text for the methods by which the series in the table were constructed from figures published in these sources.

Least squares has been used throughout to estimate the regression equations in preference to the limited information maximum likelihood method. This is not because least squares is simpler and those not versed in the mysteries of econometrics can understand what is being done, though this is a considerable advantage. Least squares was used because the writer is not convinced of the advantages of the limited information maximum likelihood method. Practitioners of this method maintain that least squares is biased whenever unlagged endogenous variables appear in the right hand side of a regression equation. This is true, though the bias is smaller when the correlation coefficient is high. On the other hand, limited information maximum likelihood estimates have greater variances than the corresponding least squares estimates. Moreover, limited information maximum likelihood estimates are themselves only unbiased when the sample size is large (strictly speaking infinite). For small samples there is no *a priori* reason for the bias of a limited information maximum likelihood estimate being small enough compared with the bias of a least squares estimate, to compensate for the larger variance of the limited information estimate. Such empirical evidence as there is suggests that this will not be the case.⁸

11.3 The Model

The complete model is set out in Table 11.2. In this section some comments are made about the individual equations. Fixed capital equipment is related to profits rather than to changes in output through a fixed capital accelerator. In a previous paper the present writer has used an accelerator relating total investment to changes in output.⁹ In this paper the acceleration principle has been retained in the inventory investment function, but in the fixed capital equipment investment function it has been discarded for both empirical and theoretical reasons. The theoretical arguments for the influence of profits on investment, through the availability of funds, as well as through expectations and the inducement to invest, have been set out in various articles in the last few years.¹⁰ The previous paper was not concerned with determining the best investment function, but with ascertaining if one particular theoretical function, that of Professor Hicks, fitted the facts in Australia and the United States. The paper concluded that a modified form of Hicks' theory did fit the facts, but that the acceleration principle explained a much smaller proportion of investment than Hicks assumed. The implication was that a theory should be found for the other part of investment—so-called autonomous investment. This conclusion was greatly reinforced by the publication of a note by D. J. Smyth, which showed that two-thirds of acceleration induced investment was inventory investment, and that the fixed capital accelerator was extremely small.¹¹ A theory of investment in fixed capital equipment which does not explain the major part of such investment but merely assumes it increases constantly

Table 11.2 A simple econometric model of the Australian economy

The figures in the first column are the multiple correlation coefficients of those equations that were estimated statistically. The figures under the coefficients are their standard errors.

R	Equations
	Investment
.995	$I_t = -31.9 + 1.448P_{t-1} + .705(P_t - P_{t-1})$ <div style="display: flex; justify-content: center; gap: 20px; margin-top: -10px;"> .050 .058 </div>
.955	$S_t = -4.6 + .310(Y_{t-1} - Y_{t-2})$ <div style="display: flex; justify-content: center; gap: 20px; margin-top: -10px;"> .045 </div>
	Consumption
.992	$C_t = -28.2 + .978D_t$ <div style="display: flex; justify-content: center; gap: 20px; margin-top: -10px;"> .041 </div>
.983	$V_t = -198.4 + .130D_t - 2.134T_t$ <div style="display: flex; justify-content: center; gap: 20px; margin-top: -10px;"> .014 .757 </div>
	Income
.967	$P_t = -228 + .139(Y_t - F_t) + .244F_t$ <div style="display: flex; justify-content: center; gap: 20px; margin-top: -10px;"> .012 .053 </div>
	$D_t = (1 - .083)N_t$
.992	$N_t = 855.9 + .587(Y_t - F_t)$ <div style="display: flex; justify-content: center; gap: 20px; margin-top: -10px;"> .025 </div>
	$Y_t = I_t + S_t + C_t + V_t + A_t + G_t + B_t + FS_t$
	Other
.966	$A_t = -3.5 + .0126(Y_{t-1} - F_{t-1})$ <div style="display: flex; justify-content: center; gap: 20px; margin-top: -10px;"> .0011 </div>

Endogenous Variables

I_t —gross private investment in fixed capital equipment (excluding cars).

S_t —Private investment in non-farm stocks.

C_t —consumption expenditure (as defined in the *White Papers*).

V_t —expenditure on "cars" (i.e., cars, station wagons and motor cycles).

P_t —company income.

D_t —disposable non-farm personal income.

N_t —non-farm personal income.

Y_t —gross national product.

A_t —expenditure by financial enterprises.

Exogenous Variables

F_t —unincorporated farm income.

G_t —government expenditure on goods and services.

T_t —sales tax on private motor cars, expressed as a percentage, e.g., $T_t = 20$, not 2, when there is a 20 per cent, sales tax.

B_t —balance of trade (exports minus imports, both as defined in the *White Papers*).

FS_t —investment in farm stocks.

over time, is unsatisfactory to the present writer. Moreover, an examination of Smyth's equation for investment in fixed capital equipment gives rise to misgivings that the statistically significant acceleration coefficient may reflect the influence on investment of some variable excluded from the analysis, e.g., due to the strong growth trend in output, a variable highly correlated with the level of output would have statistically significant regression coefficients in an equation relating it to time and changes in output.

The actual equation for investment in fixed capital equipment:

$$I_t = -31.9 + 1.448P_{t-1} + .705(P_t - P_{t-1})$$

is interpreted in the following way. Decisions about investment in period t are made in the previous period (year) on the basis of the level of profits in that year. However, if, when the investment is being made, profits are higher than anticipated (i.e. higher than those ruling when the investment decision was made) investment is increased, largely by speeding up existing investment plans. Similarly, if profits prove lower than anticipated, investment is kept below that originally planned. In estimating the function, expenditure on motor cars, cycles and station wagons was excluded from investment as most of it is better regarded as expenditure on consumer durables.

Company income was taken as a measure of profits rather than non-wage income. Unincorporated income includes both profits and wages. The profits part of unincorporated income probably behaves in the same way as company income, so that differences between the behaviour of corporate and unincorporated incomes are due to movements in professional income which for our purposes are best considered as wages. It is true that this is not the case in the farm sector. A large part of the movements in unincorporated farm income must be considered as changes in profits. However, there is likely to be a weak link between changes in farm income and recorded farm investment except for disastrous declines in farm income.¹² When farm investment is encouraged by high levels of farm income it tends to be disguised, for income tax purposes, as current expenditure, and does not enter into recorded farm investment. There is undoubtedly some part of recorded farm investment sensitive to changes in the level of farm income, but it is a very small part of total investment, and is swamped in an aggregative function by changes in the other components of investment. This has been ignored and company income has been taken as the relevant measure of profits. Profits are defined as a businessman would define them, not as an economist would define them. Gross national product and investment in stocks were corrected for stock appreciation, but no similar correction was made to company income. Similarly, company income is measured net of depreciation as allowed for income tax purposes, and no attempt is made to correct for the difference between historic cost depreciation and replacement cost depreciation. No correction is made even for the distortions

caused by the special allowances for depreciation introduced from time to time into the current income tax laws. The reason for not making all these corrections is obvious. The theory embodied in the statistical regression equation relates investment to what the businessman thinks his profits are, not to what his profits are as measured by an economist. It could be argued that after so many years of inflation, businessmen are aware of the errors in the figures for profits presented by accountants. Perhaps many are in a general way, but it is unlikely that many businessmen have any idea of the size of the error for their own firm or of what changes occur in that error.

In the case of special depreciation allowances, whose initial effect at least is clear, it is plausible to assume that businessmen take them into consideration when calculating their profits. However, no sign of this could be found in the empirical data. Correcting the figures for company income for the effects of special depreciation allowances reduced the goodness of fit of the regression equation rather than increased it. If the equation for fixed investment is re-estimated with company income corrected for the effects of special depreciation allowances, the multiple correlation coefficient is reduced to .965, though the size of the parameters is not significantly changed.

Farm stocks are excluded from the analysis as they are largely determined by forces exogenous to the Australian economy. The equation for investment in non-farm stocks is a variation of the Metzler model of inventory investment.¹³ *Ex ante* investment in stocks is equal to the acceleration coefficient times the expected increase in output, *plus* the size of the deficiency in stocks at the beginning of the period; and the expected increase in output is equal to the immediate past increase in output times the (Metzler) coefficient of expectations:

$$S'_t = am(Y_{t-1} - Y_{t-2}) + X_{t-1} \quad (1)$$

where a is the acceleration coefficient, m the coefficient of expectations, and X_{t-1} the deficiency in stocks at the end of the previous period. The difference between *ex post* and *ex ante* inventory investment is proportional to the difference between the expected increase in output and the actual increase in output:

$$S_t - S'_t = b[m(Y_{t-1} - Y_{t-2}) - (Y_t - Y_{t-1})] \quad (2)$$

b may be either positive or negative, but is more likely to be positive. The positive element in b represents the unintended inventory investment (disinvestment) which occurs when the actual increase in output is less than (more than) that expected. The negative element in b occurs if we interpret *ex ante* investment as the investment originally planned. The negative element in b is then the amount by which some entrepreneurs at least are

able to reduce (increase) their inventory investment in the light of the unexpectedly small (large) increase in output.

X_{t-1} is the difference between the level of inventory investment appropriate to the previous period and that which actually occurred. Thus its value in terms of Y is given by:

$$X_{t-1} = a(Y_{t-1} - Y_{t-2}) - am(Y_{t-2} - Y_{t-3}) - b[m(Y_{t-2} - Y_{t-3}) - (Y_{t-1} - Y_{t-2})] \quad (3)$$

Equations (1), (2) and (3) together give the following equation for *ex post* inventory investment:

$$S_t = -b(Y_t - Y_{t-1}) + (1 + m)(a + b)(Y_{t-1} - Y_{t-2}) - m(a + b)(Y_{t-2} - Y_{t-3}) \quad (4)$$

Equation (4) is not entirely satisfactory as the basis for a regression equation as the theory underlying it is explicitly non-stochastic. The definition of X_t in equation (3) only holds if all equations are exact. If not, and if there is an error term in equation (4) the error terms will also affect X_t . In an econometric model designed for theoretical insight this does not matter as long as the effect of this is small, which it is if the errors in the final fitted regression equation are small. In a model designed, e.g., to forecast inventory investment, equations (3) and (4) would have to be recast to take the error terms into consideration when defining X_t .

The parameters of equation (4) were estimated by multiple regression. One would expect that, in the estimating equation, the coefficient before the first term to be small and probably negative, the coefficient before the second term to be positive and its absolute value to be the largest of the three coefficients, and the coefficient of the third term to be negative and its absolute size less than that of the second and greater than that of the first coefficient. These expectations are all fulfilled, but not very satisfactorily as only the second term has a coefficient larger than its standard error. Equation (5) is the actual regression equation obtained. It has a multiple correlation coefficient of .961.

$$S_t = \underset{.0415}{.0293}(Y_t - Y_{t-1}) + \underset{.0444}{.02830}(Y_{t-1} - Y_{t-2}) - \underset{.0401}{.0385}(Y_{t-2} - Y_{t-3}) + 12.7 \quad (5)$$

Setting the coefficient of the first term equal to zero still does not make that of $(Y_{t-2} - Y_{t-3})$ as large as its standard error.

The more or less zero coefficient before $(Y_t - Y_{t-1})$ implies that aggregate *ex ante* and *ex post* inventory investment are more or less equal. That is, on an aggregate level there is never any significant unintended inventory investment or disinvestment.¹⁴ This does not follow solely from the particular structure of the model we have used. A zero coefficient for the first term in equation (5) would imply this in any acceleration inventory model.

If one takes the theory behind equation (5) seriously and if one accepts the absence of unintended inventory investment in the aggregate, this is presumably because unintended inventory investment suffered by some entrepreneurs is offset by changes in the plans of other businessmen. To some extent it is possible to see a mechanism which would bring this about, e.g. a downward revision of wholesalers' inventory investment plans causing unintended inventory investment at the manufacturing level. The length of the period (a year) may help in this cancelling process. In some years, at least, unintended inventory investment at the beginning of the year may have been offset by a planned reduction of stocks at the end.

As the coefficients of $(Y_t - Y_{t-1})$ and $(Y_{t-2} - Y_{t-3})$ are statistically indistinguishable from zero, we may just as well estimate S_t as a function of $(Y_{t-1} - Y_{t-2})$ alone, resulting in the equation:

$$S_t = -12.5 + .310(Y_{t-1} - Y_{t-2})$$

An acceleration coefficient of around .3 is consonant with other information about the capital-output ratio in inventories.

The consumption function is of the type proposed for Australia by Arndt and Cameron.¹⁵ Consumption is related to non-farm disposable income. Expenditure on motor cars, cycles and station wagons is considered expenditure on consumer durables, though expenditure on trucks and utilities is included in investment. Expenditure on motor cars, cycles and station wagons is important and distinctive enough to warrant a separate equation. In this equation the percentage rate of sales tax is included as an explanatory variable as well as non-farm disposable income. Because of shortages in supply in the early post-war years, the first three years of our period were excluded when the equation for expenditure on cars was estimated. The smaller sample size explains the relatively larger standard errors of the coefficients in this equation.¹⁶

Theory holds that profits tend to vary with the level of income—in many macro-economic models income is used as a dummy variable for profits. In the case of Australia changes in income in each of the two sectors distinguished in the model are likely to affect company income differently. Company income was estimated as a function of farm income and gross national product *minus* farm income. The resulting equation has the large negative intercept that theory would lead one to expect. Since, in the model, farm income does not directly affect either investment or consumption it may seem inconsistent to include it as a determinant of company income. However, it is argued that in years of high farm income there is considerable farm investment disguised as operating costs, so that farm income may, to some extent, directly affect company income.

The equation for disposable non-farm income is based on the definition, $D_t = N_t - (R + rN_t)$, where R and r are parameters reflecting the existing

structure of tax laws. It is inappropriate to fit this statistically over any great number of years as the tax structure is constantly changing despite the constant table of tax rates. This is partly due to changes in the laws relating to allowable deductions, partly due to changes in the pattern of income distribution and partly due to the fact that the tax laws are in current value terms so that their effect in real terms changes with changes in the general level of prices. The equation, $D_t = N_t - .083N_v$, was fitted by eye through the figures for recent years. It is in a form such that the type of across the board reduction or increase in tax rates used in recent years can easily be incorporated, e.g., a 5 per cent, reduction in tax is shown by reducing the parameter, .083, by 5 per cent.

The equation relating non-farm personal income to gross national product minus farm income reflects the institutional factors, such as pension laws and indirect taxation laws. The stability of the effect of these institutional factors is shown by the high correlation coefficient, .992, of this equation.

In the equation for gross national product the balance of trade is included as an exogenous variable. It would be better if only exports were exogenous and imports were an endogenous variable. But it is impossible to estimate statistically an equation for imports over a period during a large part of which import controls were operative.

There is not much theory behind the equation for expenditure by financial enterprises. Such as it is, the theory is that one would expect this category of expenditure to follow with a lag the level of gross national product, but not to be affected by the large changes that occur in farm income.

One general comment should be made about all the equations in Table 11.2. They were estimated from data for a specific period and relate only to that period. The relationships they show can not be expected to hold if the Australian economy enters a phase with markedly different characteristics to those of the last fifteen years.

11.4 Dynamic Characteristics of the Model

Combining the equations in Table 11.2 gives the following equation for the behaviour of gross national product:¹⁷

$$Y_t = 3.2798(273 + G_t + B_t + FS_t) + 1.3988Y_{t-1} - 1.0180Y_{t-2} - 1.7159Ft + .2130F_{t-1} - 6.9993T_t \quad (6)$$

The behaviour of Y_t that is given by this equation, when there are no large exogenous shocks, will reveal the basic dynamic characteristics of the model. The first step is to determine either "normal" values or "normal patterns of change" for the exogenous variables G_v , F_v , B_v , FS_t and the tax rates. Government expenditure is assumed, in the absence of deliberate expansive or deflationary policy, to be a constant percentage, $18\frac{1}{4}$ per cent., of gross

national product. In fact, despite policy changes in recent years, government expenditure has been a remarkably constant proportion of gross national product, varying only between 18.1 per cent, and 18.6 per cent, (except in the year 1956–57 when it was 17.6 per cent.). It would be comforting also to assume farm income is a constant proportion of income, but in the light of the experience of the last decade, it would be grossly unrealistic. Deflated farm income is assumed to be “normally” constant and equal to £A400 million. Personal income tax rates are assumed constant at their pre-February, 1962, levels. Sales tax on cars is assumed to be 20 per cent. The balance of trade is assumed to be a small negative amount (minus £A50 million in deflated terms) and deflated investment in farm stocks is assumed to be a very small positive amount (say £A3 million).

If these assumptions¹⁸ are incorporated into equation (6), that equation becomes:

$$Y_t = 3.4845Y_{t-1} - 2.5359Y_{t-2} \quad (7)$$

Equation (7) has the solution:

$$Y_t = 1.0355^t K_1 + 2.4489^t K_2 \quad (8)$$

where K_1 and K_2 are constants depending on the initial conditions. K_1 is positive for any remotely feasible initial conditions. The pattern of change of Y_t will depend on the sign of K_2 . If K_2 is positive the rate of growth of Y will constantly increase, and eventually approach 145 per cent, per annum. Of course, long before this astronomical rate of growth is reached the rise of gross national product will be checked by the full employment ceiling. But as long as that ceiling allows a growth rate of 3.55 per cent, or more, gross national product will continue to push against the full employment ceiling with the consequent inflationary pressures. If K_2 is zero Y will grow at a rate of 3.55 per cent, for ever, or more realistically until the system is disturbed by an outside shock. If K_2 is negative the rate of growth of Y_t will constantly decline and in many cases quickly become negative. It will always become negative eventually, if the system is left undisturbed.¹⁹

K_2 is positive, zero, or negative according to whether the rate of growth of Y given by the initial conditions is respectively greater than, equal to, or less than 3.55 per cent. 3.55 per cent, is thus a “Harrod type” equilibrium rate of growth. If it is exactly achieved it will perpetuate itself until the system is disturbed by an outside shock. If the rate of growth rises above 3.55 per cent., the endogenous forces will cause the rate of growth to increase continually till stopped by the full employment ceiling, and then to press against that ceiling, as long as it allows gross national product to grow at, at least, 3.55 per cent. If the rate of growth falls below 3.55 per cent., it will continually decline.

Equation (7) exaggerates somewhat the degree of instability arising from the exogenous forces in the Australian economy. Not only does the model rightly abstract from deliberate changes in policy but it also ignores such automatic stabilizers that exist. These will undoubtedly moderate the decline in the rate of growth when the rate of growth is small, but, by their nature, they cannot reverse the direction of the movement in the growth rate. Similarly, when the rate of growth rises much above 3.55 per cent, the automatic stabilizers will tend to lessen the rise in the growth rate, but cannot prevent the increase in gross national product accelerating until full employment is reached. If imports were included as an endogenous variable, they would also lessen the speed with which the rate of growth of gross national product departs from its equilibrium value.

The exact value for the critical rate of growth of gross national product is determined by the size of the parameters in the various equations in Table 11.2, and it is fairly sensitive to changes in the values of some of those parameters. Of these key parameters, only one is not ten, or more, times as large as its standard error. This is the acceleration coefficient in the inventory investment equation. If this coefficient is raised to .333 (its largest plausible value) the critical rate of growth between boom and slump is 3.15 per cent. If the inventory acceleration coefficient is reduced to .275 the critical rate of growth is 4.45 per cent.

The critical rate of growth is also sensitive to changes in the ratio of government expenditure to gross national product. Given the present tax structure the government can change the economy from a buoyant one to a stagnant one or vice versa by changing its spending habits. If government expenditure were always 19 per cent, of gross national product, the equilibrium rate of growth would be almost exactly zero. This implies a buoyant economy, since if gross national product grows at all it will grow at a faster rate in the next period. 19 per cent, is a higher ratio of government expenditure to gross national product than any since the 1952 recession, but it is not much higher. If government expenditure is always 17 per cent, of gross national product (a lower ratio than any since the 1950–51 boom) the critical rate of growth is 13.6 per cent. This is such a high rate that it could never be maintained at levels of income approaching full employment. Consequently the economy would tend towards a slump as soon as full employment was reached.

Equation (6) is also interesting in showing the total short-run multiplier effect of government expenditure. If government expenditure is increased by £10 million by how much will this increase gross national product in the year of the increase in government expenditure? This involves more than the conventional consumption multiplier which is the reciprocal of the marginal propensity to save. The total multiplier takes into account the effects of the increase in government expenditure on investment as well as on consumption, the effect of the resultant increase in consumption, and so on. The total multiplier which can be read off from equation (6) is 3.2798.

This multiplier relates only to the year in which the increase in government expenditure is made. The long-run effects of an increase in government expenditure will depend on whether gross national product consequently increases by more or less than 3.55 per cent. Short-run total multipliers for other variables can also be read off from equation (6), e.g., according to the model a reduction of 10 per cent, in the sales tax on cars will, *ceteris paribus*, increase gross national product in a full year by £69.99 million. However, it is important to remember that the model ignores automatic stabilizers, and hence exaggerates multiplier effects somewhat.

11.5 Forecasting

Although the model was not designed for forecasting it can be used to forecast the levels of gross national product and its main components. Table 11.3 shows the forecasts made by the model for 1960–61, and for 1961–62. The actual deflated values for 1960–61 are also shown, and for convenience the forecasts for 1961–62 are changed into current terms and stock appreciation added to non-farm inventory investment and gross national product, so that the forecasts can be directly compared with the figures published in the *White Paper* when these become available.

Using the model for forecasting necessitates one change. If the equation for inventory investment in Table 11.2 is to be used for forecasting, allowance must be made for the sum of the errors in previous forecasts of inventory investment by the equation. This has been done in the forecasts set out in Table 11.3. The forecasts for 1961–62 are based on the following assumptions about the size of exogenous variables. The sum of $G_t + B_t + FS_t$ is assumed to be £1475 million, and farm income £490 million, both in current value terms. The average rate of sales tax on vehicles throughout the

Table 11.3 Forecasts made by the model

Variable	Deflated Figures			1961–62 Forecasts in current terms
	Actual Values for 1960–61	Forecast Values for 1960–61	Forecast Values for 1961–62	
	£m.	£m.	£m.	£m.
Y_t	6028.3	5881.0	6289.2	7337.5 ^a
S_t	210.5	156.5	-16.5	-109.4 ^a
I_t	883.5	895.0	894.0	1055.8
C_t	3707.2	3617.8	3836.6	4531.0
V_t	230.4	218.0	259.5	306.5
A_t	68.2	65.2	67.1	79.2

^a—including stock appreciation.

year is assumed to be 26⅓ per cent. To change the 1961–62 forecasts to current terms and to add in inventory appreciation requires assumptions about the consumer price index and the basic materials and foodstuffs: wholesale price index. The former has been assumed to be 124.3 for 1961–62, while the latter is assumed to have a value of 338 for 1961–62, and 340 for the June quarter of that year.

The forecasts for 1960–61 are generally good. The recession is accurately forecast. In fact, the forecast recession is slightly more severe than the actual one, as the forecast value for gross national product is 2.4 per cent, less than the actual value of gross national product. The forecast for inventory investment is badly astray, but the forecast levels of the other components of gross national product are close to the actual levels. The largest absolute error is in the consumption forecast which is out by £89.4 million; but this is only 2.4 per cent, of the value of consumption.

11.6 Conclusion

This paper has presented a simple econometric model of the post-war Australian economy. Despite, or perhaps because of, its simplicity the model does well by the usual criteria. To take the simplest criterion of all, every equation estimated statistically has a high correlation coefficient. All the multiple correlation coefficients are above .95. This is hardly surprising in view of the strong trends which existed in most of the variables; but it compares favourably with the goodness of fit of equations in other econometric models estimated over periods with similar trends, e.g., in the recent model of the United Kingdom, constructed by Klein and others,²⁰ only fourteen out of the thirty-two multiple correlation coefficients are as high as .95. When one engages in the usual trick of examining the data beforehand to determine part of the form of the equation,²¹ the standard tests of significance are inappropriate; but all the estimated coefficients are satisfactorily high compared with their standard errors. 60 per cent, are ten times their standard error, and the lowest relative to its standard error is nearly three times its standard error. Although the model was not designed for forecasting, the forecasts set out in Section V are as good as, or better than, those made by most econometric models.

The model was designed to increase theoretical insight into the structure of the post-war Australian economy. It depicts an economy in which the exogenous forces are either expansionary or depressive, depending on whether the rate of growth of gross national product is above, or below, 3.55 per cent, per annum. This critical rate of growth is low enough for the economy usually to be buoyant, though not too much weight should be attached to the exact value found for the critical rate of growth, as small changes in the parameters can produce large changes in the size of this rate.

Notes

1. Cf. H. F. Lydall, "The Australian Economy, February, 1962", *Economic Record*, vol. XXXVIII (March, 1962), p. 1.
2. This is hardly surprising as the model is typical of modern macro-economic theory. Pasinetti divides modern theories into two groups, according to whether the parameters are those which give long growth or cyclical fluctuations as the basic endogenous characteristic. See L. L. Pasinetti, "Cyclical Fluctuations and Economic Growth", *Oxford Economic Papers*, vol. 12 (June, 1960), pp. 215–241.
3. J. Johnston, "An Econometric Model of the United Kingdom", *Review of Economic Studies*, vol. XXIX (October, 1961), p. 38.
4. J. McB. Grant and R. L. Mathews, "Depreciation and Stock Appreciation Adjustments in the National Income Accounts", *Economic Record*, vol. XXXV (April, 1959), pp. 105–117.
5. "An Australian Consumption Function", *Economic Record*, vol. XXXIII (April, 1957), pp. 108–115.
6. For a discussion of this point see C. F. Christ, "Aggregate Econometric Models", *American Economic Review*, vol. 46 (June, 1956), pp. 395–397.
7. The weights given to these two indexes are arbitrary. The ones used were chosen on the assumption that the prices of roughly one-third of the goods making up gross national product move more in accordance with changes in wholesale prices than with changes in retail prices.
8. See, e.g., C. F. Christ, *loc. cit.*, pp. 397–401.
9. "Professor Hicks' Theory of Investment and Post-war Investment Figures in Australia and the United States", *Economic Record*, vol. XXXIV (August, 1958), pp. 249–253.
10. See, e.g., A. Smithies, "Economic Fluctuations and Growth", *Econometrica*, vol. 25 (January, 1957), pp. 10–14.
11. "The Inventory and Fixed Capital Accelerators", *Economic Record*, vol. XXXVI (August, 1960), pp. 414–418.
12. Cf. Campbell's statement: "That capital outlay in the agricultural sector has been maintained at a high and relatively stable level during the past four years in spite of quite considerable fluctuations in aggregate income", in "Current Agricultural Development and the Utilisation of Resources", *Economic Record*, vol. XXXII (May, 1956), though later in the same article Campbell suggests that the growth of farm investment "is likely to be determined by the trend in farm income".
13. For a description of Metzler's model, see, L. Metzler, "Factors Governing the Length of Inventory Cycles", *Review of Economics and Statistics*, vol. 29 (February, 1947), pp. 1–15.
14. *Ex ante* investment equals $(am + a + b)(Y_{t-1} - Y_{t-2}) - (am + bm)(Y_{t-2} - Y_{t-3})$ so that when b , the coefficient of $(Y_t - Y_{t-1})$ is zero, *ex ante* investment equals *ex post* investment.
15. *Loc. cit.*
16. The higher standard errors may also be a result of the "impact effect" of tax rate changes. A change in the rate of sales tax on motor vehicles is likely to have an impact effect when it is first introduced, and a relatively smaller effect when the new rate is maintained in subsequent periods.
17. Equation 6 was calculated from equations in which the coefficients were given to five decimal places. These coefficients have been rounded to three decimal places in the equations in Table 11.2.

18. If different assumptions are made about farm income and the balance of trade there may be a constant term in equation (7) and hence a constant term in equation (8). The latter constant is the stationary solution for the level of income. If Y is interpreted as the deviation of income from this stationary solution one can rewrite equation (7) without the constant term, but otherwise unchanged. The analysis in the text then holds unchanged, except that rates of growth must be interpreted as rates of growth of the deviation of income from the stationary solution.
19. This analysis is similar to that of Alexander in "The Accelerator as a Generator of Steady Growth", *Quarterly Journal of Economics*, vol. LXIII (May, 1949), pp. 174–199, where he discusses how the characteristics of a second-order difference equation in income determine the behaviour of income over time.
20. Klein, Ball, Hazelwood, and Vandome, *An Econometric Model of the United Kingdom* (Blackwell, Oxford, 1961).
21. This was done, e.g., in determining the lag in the equation for fixed investment. Arndt and Cameron followed the same procedure in determining the form of their consumption function—a form which has been adopted in this paper.

12

Can Keynesian Policies Stimulate Growth in Output and Employment?

J. W. Neville

There is widespread agreement that a faster, sustained rate of growth of the Australian economy is required to achieve a substantial lasting reduction in unemployment. As Burgess and Green (2000) argue, on current estimates of the relevant variables, including productivity growth and labour-force growth, GDP growth of around 4.3 per cent per annum is required to reduce unemployment by 1 per cent per annum. It is abundantly clear that such a level of GDP growth is much bigger than the trend rate of growth, of about 3 per cent a year, achieved over the last 25 years. It is also higher than the average rate of real GDP growth achieved in the 1990s of about 2.9 per cent. The required increase in the medium-term trend rate of growth is large enough to require a major change in the overall policy mix. This chapter argues that Keynesian policies can increase the growth rate by the required amount, but that it will not be easy and will entail some cost, in the form of higher taxation, to those already employed or receiving a comfortable income from rent, interest or dividends.

The next section very briefly outlines the main types of Keynesian policies. Then follow two sections: the first reviews historical evidence about the effectiveness of Keynesian policies in Australia and the second considers the major theoretical arguments that have been mounted against Keynesian policies. These two sections together provide a convincing case that Keynesian policies can increase the rate of growth of output and employment, by making business cycle recessions shallow and short. While Keynesian policies generally act on the demand side of the economy, short shallow recessions will also help increase supply by reducing the deterioration of the quality of the labour force caused by long-term unemployment and increasing the rate of growth of the capital stock by fostering more optimistic expectations about future output levels which

Revised from *The Unemployment Crisis in Australia: Which Way Out?*, 149–174, 2000, 'Can Keynesian Policies Stimulate Growth in Output and Employment?', by Neville, J. W. With kind permission from Cambridge University Press. All rights reserved.

will increase the amount of investment. Successful Keynesian policies will both increase the capital stock so that workers drawn from unemployment to employment can be more productively, and more profitably, employed and also reduce the number of workers suffering from the barriers to re-employment that are caused by long-term unemployment. In addition, when there is substantial unemployment, Keynesian policies can increase the trend rate of growth directly by raising aggregate demand, as long as there are also policies which ensure adequate supply, especially labour-market programs.

However, successful Keynesian policies to reduce unemployment will have undesirable side-effects, if they cause balance of payments crises and increased inflation. The trend to globalisation makes these side-effects more likely and more serious if one economy, other than an extremely large one, raises its rate of growth substantially while the rest of the world grows at the same rate as before. This is the biggest problem in using Keynesian policies to reduce unemployment substantially. However, the section devoted to these side-effects concludes that, despite globalisation, it is possible to avoid balance of payments problems and keep any rises in the rate of inflation relatively small. An outline of a policy package which could achieve this is set out in the penultimate section before the threads are drawn together in a brief conclusion.

12.1 The Nature of Keynesian Policies

There are many varieties of Keynesians. The one thing that unites them is a belief that if left to itself, a free-market economy will not automatically tend towards a situation in which there is no involuntary unemployment – a situation in which everyone who wants a job can find one within a reasonable length of time. Keynesians believe that there is an important role for government, or economic policy, in keeping economic activity close to the desirable level so that there is neither substantial involuntary unemployment nor excess demand in the economy as a whole leading to accelerating inflation.

Although Keynes himself thought that both aggregate demand and aggregate supply were important (1973, p. 513), the central Keynesian policy instruments are those that operate on aggregate demand, or the total amount of goods and services demanded in the economy as a whole. In particular, fiscal policy and monetary policy have been the most discussed in the literature and the most used in practice. Fiscal policy is concerned with the effects of government expenditure and revenue on the economy at an aggregate or economy-wide level. It is not concerned with effects on individuals, on individual industries, or on particular classes of people, such as old age pensioners.¹ The key to fiscal policy is that, in both direct and indirect ways, government expenditure increases aggregate demand, at least according

to Keynesians, and government receipts reduce aggregate demand. When governments increase spending, this immediately increases the demand for those things the money is spent on, from the construction of roads to the labour of tax collectors. If governments increase spending on pensions or unemployment benefits, it is a reasonable assumption that the recipients spend the increase in their incomes or at least a large part of them. These first round effects are not the end of the increase in aggregate demand. There will be a rise in the incomes of those who produced the goods and services sold because of the first round increase in demand. They in turn will spend more, increasing others' incomes, and so on. Each subsequent round the expenditure will be less because of leakages into saving, taxes and imports, until additional expenditure is insignificant. In a country like Australia, with a high propensity to import, successive rounds will peter out quickly, but nevertheless the total increase in aggregate demand will be greater than the initial increase in government expenditure. Similarly, a cut in tax rates will increase households' income and increase their expenditure, at least to some extent. Again this initial increase in expenditure will be followed by second and higher round effects. In the case of both expenditure and revenue, the effects work in reverse when government expenditure is cut or tax rates increased.

Monetary policy operates on the quantity of money circulating in the economy and on interest rates. One of the revolutionary claims in (1964 [1936]) Keynes' *General Theory* was that these monetary variables affect 'real' variables like output measured in constant prices, whereas neoclassical economists argue that, except in the very short run, monetary variables affect only prices. By its very nature the major effects of monetary policy are economy-wide² and they too operate primarily on aggregate demand. Monetary policy has its major initial impact on investment expenditure, both by firms and by households investing in dwellings. As consumer credit becomes more important, there may also be a direct effect on consumption expenditure. In addition, falls in interest rates increase the prices of financial assets and this spills over to a greater or lesser extent to the prices of other assets such as shares and property. Those owning such assets may increase their expenditure as they become wealthier. As in the case of fiscal policy, the various first round effects are followed by second and higher round effects on expenditure.

However, governments must be concerned about inflation as well as unemployment. If inflation increases, monetary and fiscal policies can only reduce inflation by reducing the growth in demand and increasing unemployment. Incomes policies, such as the Accord under the Hawke and Keating governments, were designed to try to overcome this problem by reducing inflationary pressures through consensual wage moderation. Incomes policies operate on the supply side, seeking to influence wages, or the prices of one class of productive inputs. They also often seek to influence profits and

rents as well. While necessary, if the cost of controlling inflation is not to fall on the most vulnerable in society, incomes policies come and go. Monetary and fiscal policies are always central in Keynesian economic policy-making. Both have been used extensively in Australia in the last 50 years, and this history is reviewed in the next section to see what lessons can be learnt.

12.2 Learning from the Past

The first 25 years after World War II were a 'golden age' in which the average rate of growth of the Australian economy was high, unemployment was very low, even in recessions, and inflation was under control though somewhat precariously at times. Similar conditions prevailed in most other OECD economies. Some believe that this was largely due to adoption of Keynesian macroeconomic policy. If so, this suggests strongly that the question posed in the title of this chapter should be answered in the affirmative.

An alternative point of view has been put, among others, by Ian Macfarlane (1997c). Partly because of Macfarlane's position as governor of the Reserve Bank of Australia, the article has proved influential, and his arguments are worth close attention in an assessment of the implications of the golden years experience for current policy.

Macfarlane (1997c, p. 1) throws cold water on two propositions. The first and most important is that activist and expansionary macroeconomic policy was the major, if not the sole, cause of the excellent economic performance in the golden age. The second proposition Macfarlane rejects is that what brought this golden age to an end was an OPEC-induced oil price rise in 1973 and consequent cost-push inflation, reinforced by a second oil price shock in 1979.

An impartial review of the period provides a great deal of evidence to support both of these propositions and, in my view, in rejecting them Macfarlane downplays the role of Keynesian policy far more than is justified.

As Macfarlane mentions, two factors were of considerable importance in explaining the good economic performance in the 25 years following World War II. One was the large gap in fixed capital (both public and private) to be made up after the Depression of the 1930s and the war years. The second was the low level of inflation expected by most people. This was a result of decades of low inflation, apart from a brief interlude of high inflation in some countries caused by the Korean War. Macfarlane also mentions liberalisation of international trade, to which I would add the certainty generated by exchange rate stability.³ Both these features of policy encouraged high levels of investment.

However, macroeconomic policy also had an important role to play, and not just by not being over-ambitious, as suggested by Macfarlane. A major problem with Macfarlane's analysis is his use of the budget deficit as one of

his major indicators of the stance of fiscal policy. Although widely used in the media, the budget deficit is a deeply flawed indicator of fiscal policy. It is true that in part it reflects fiscal policy decisions, but it also reflects the level of economic activity in an economy. Without any change in fiscal policy, a boom will reduce the budget deficit substantially, since tax receipts rise with rising income and payments by the government to those in need decline as under-employment declines. When unemployment is low, other things being equal, the budget deficit will be low. In Australia, and in a number of OECD countries, fiscal policy was far more activist than Macfarlane acknowledges.

In the 20 years 1954/55 to 1973/74, Commonwealth tax rates were changed in all but five years (Neville 1975, p. 128). In seven years they were reduced and in eight years they were increased. This of course was apart from increases in tax revenues due to fiscal drag, as inflation pushed individuals into higher tax brackets. Similarly, there were frequent and substantial changes in the rate of growth of government expenditure.

Moreover, and more importantly, macroeconomic policy reacted relatively quickly with Keynesian expansionary measures whenever there was a significant recession and also sometimes when there was just a faltering in the rate of growth of the economy. There were only two significant recessions in the golden years,⁴ one in 1952/53 and one in 1961/62. The 1952/53 recession was countered by a notable easing of monetary policy, a substantial cut in Commonwealth tax rates and a large rise in government expenditure. The last mentioned included money given to the states by the Commonwealth to supplement funds raised in the loan market to finance public works. The value of this supplementary finance was greater than 1.5 per cent of the value of total output or gross domestic product!

Again in the 1961/62 recession the federal government pursued very active macroeconomic policies. It instituted the biggest tax cut since the 1952/53 recession and the largest percentage increase in government expenditure over the same period (Neville 1975, p. 129). Monetary policy was also eased. With expansionary macro policy, both recessions were short lived. The Australian economy grew by 6.3 per cent in 1953/54 and 6.8 per cent in 1962/63.

This success of macroeconomic policy in overcoming the two significant recessions of the period was important because it sustained the belief that the government was in control and, not only was it committed to full employment, but it also had the power to ensure that recessions were very brief. To some extent this was a self-fulfilling belief. If recessions are always brief, it makes very good sense to increase spending on capital equipment during a recession while prices are stable or discounted and there are no bottlenecks. Also, the belief that the government could and would keep recessions short and small reduced uncertainty. In my judgement, this confidence that recessions would be short lived and growth would soon be

back to around 5 per cent, or more in the short run, was very important in keeping entrepreneurs optimistic and thus sustaining private investment and the growth process.

Macroeconomic policy was not, of course, always expansionary. Restrictive policy was used when there were fears of rising inflation, notably in 1956, and when there were substantial concerns about the balance of payments as in 1960 (Neville 1975, pp. 128–9).

It is instructive to look at the response of policy to the significant recessions that have occurred in Australia since the golden age. There have been two such recessions: the first occurring in the year 1982/83 and the second in the two years 1990/91 and 1991/92. In both cases monetary policy was eased. However, the fiscal policy response to the 1982/83 recession was far more expansionary than it was eight years later. The Labor government, elected in March 1983, followed an aggressive policy of expanding government expenditure, both on its own account and in state jurisdictions. After allowing for inflation, government expenditure on goods and services increased by 3.7 per cent in 1983/84,⁵ the largest increase for eight years. Transfer payments to households (or pensions and cash benefits) increased by 9 per cent but some of this would have been due to the higher level of unemployment over the year 1983/84 as a whole than in 1982/83.⁶ There was a small fall in tax rates. With this expansionary fiscal policy, output increased by 6.1 per cent in 1983/84.

Over the final years of the 1980s, macroeconomic policy became more and more restrictive. Then in the recession that started in 1990/91 monetary policy was the principal policy instrument used to try to stimulate the economy again. The official cash rate had fallen by 2 percentage points in the first half of 1990, but was still 15 per cent at the beginning of the 1990/91 financial year, an extraordinarily high figure for an economy no longer in a boom. There was a further fall of 4 percentage points in 1990/91 followed by another fall of 4 percentage points in 1991/92. Little more than a quarter of these falls merely matched the fall in the inflation rate.

However, interest rates were so high at the beginning of the recession that, even with a fall of 4 percentage points, monetary policy in 1990/91 could be judged as still tight. Fred Argy (1998) has commented:

The evidence suggests that . . . both the RBA [Reserve Bank of Australia] and the Treasury (with the tacit acceptance of the Treasurer and his personal advisers) decided it was worth taking a risk with unemployment in order to entrench low inflation in the medium term. (p. 41)

Argy goes on to quote Ian Macfarlane as saying that, in order to reduce the inflation rate greatly, 'we had to run monetary policy somewhat tighter than in earlier recessions and take the risk that the fall in output would be greater than forecast'.

In addition to this caution in easing of monetary policy, fiscal policy was much less expansionary than it had been in response to the early 1980s recession. In 1990/91, after allowing for inflation, government expenditure on goods and services rose by only 0.6 per cent. In 1991/92 it rose by a further 1.9 per cent. The total rise over the two years was much less than the rise in the single year 1983/84. Pensions and cash benefits increased substantially each year, but part of this could be accounted for by increased unemployment benefits. Tax rates were cut in 1990/91 but not by a large amount.

Not surprisingly the recession dragged on. In 1991/92 output increased by only 0.25 of a percentage point. In 1992/93 it grew by 3.3 per cent, or virtually the same as the average rate of growth since the slump year 1982/83. Relatively rapid growth, though still only 4.9 per cent, was finally restored in 1993/94.

The length of the 1990–92 recession and the slow recovery may reflect not only the cautious and tardy approach to expansionary policy but also in part the old adage that using monetary policy to cure a recession is like pushing on a piece of string. Expansionary monetary policy makes it easier and cheaper for firms to increase expenditure on equipment and construction but, if there is little incentive to invest, this does not increase spending. For reasons already discussed, this was not important in the golden years when rapid growth was expected to be the norm. However, all that changed after the mid-1970s. In the decade starting in 1973/74 growth was anything but rapid, unemployment rose greatly and uncertainty about the future was much greater.

In any case, no matter what may have happened had monetary policy been eased more rapidly, what did happen is clear. The macroeconomic policy response to the 1982/83 recession was very expansionary and along traditional Keynesian lines with an emphasis on fiscal policy to cure the recession and an incomes policy, in the form of the Accord, used to control inflation. Output grew by 15.6 per cent in the three years following 1982/83. The response to the recession which bottomed in 1990/91 was much less expansionary. Output grew by 8.6 per cent in the three years following 1990/91. Not only the experience of policy reactions to recessions in the golden years, but also experience in the period since then suggests that Keynesian macroeconomic policies are potent in boosting output and employment in an economy undergoing a recession.

Macfarlane discounts the importance of fiscal policy in the golden years by pointing out that government expenditure was larger, as a proportion of output, after 1973/74 than in the years before. However, as argued above, fiscal policy helped keep recessions short, and this in itself was important in maintaining the high rate of growth. Moreover, in the context of growth, a focus on the level of government expenditure is misdirected. The rate of growth of government expenditure is more important. Government

expenditure grew strongly in the 20 years to 1973/74. It is true that government receipts also grew rapidly, but an extra dollar spent by the government normally gives more boost to the economy than is offset by an extra dollar of tax revenue. When tax revenue goes up, the effect is split between reducing aggregate demand and reducing saving in the private sector. All of an increase in government expenditure is an addition to aggregate demand.⁷ As the Americans say, with expenditure you get a bigger bang for your buck (see Nevile 1997, pp. 96–9).

The steady rise in government expenditure in the golden years was a major source of economic growth, even though it was largely matched by rises in tax receipts. Nevile (1975, p. 129) shows that fiscal policy was responsible for over half of the growth in output in Australia over the 20 years starting in 1953/54. Thus it was more important than all the other sources of growth combined, i.e. it was more important than growth in exports, autonomous investment resulting from technological change and the effects of population growth on private-sector expenditure.

Of course this impetus to long-run growth operated largely on the demand side, not the supply side, and would have led to rising inflation (as it did in the first half of the 1970s) if aggregate supply had not matched the growth in aggregate demand. However, growth in demand as well as in supply is important, and fiscal policy also contributed on the supply side through increasing public and private investment in fixed capital.

After 1973/74, government expenditure grew noticeably less rapidly in Australia. This was despite a slight rise in the rate of growth of social security payments due to the rise in unemployment and unemployment benefits. The rate of growth of government expenditure on goods and services (after corrections for inflation) fell from 4.8 per cent a year over the 20 years to 1973/74, to only 2.7 per cent a year over the next 20 years. Expenditure on goods and services has, dollar for dollar, a bigger effect in stimulating economic activity than do social security payments (Nevile 1975, p. 114). The fall in the rate of growth of government expenditure on goods and services was one of the important factors reducing the rate of growth of the Australian economy after 1973/74.

Macfarlane's second major point, that it was not the first oil shock that caused the end of the golden age, is well taken. The very large inflationary pressures, which originated in the United States and were rapidly transmitted to other OECD countries under the Bretton Woods system, combined with mounting domestic wage pressures in a range of countries, were what brought the golden age to an end. The US inflationary pressures that were transmitted overseas had their genesis in President Johnson's determination to finance his Great Society programs, as well as fight an expanding war in Vietnam, despite the delay by Congress in allowing a substantial increase in tax rates (Okun 1970, ch. 3).⁸ The inflationary pressures were well entrenched *before* the first oil shock.

The general picture that emerges from this review of economic policy and growth over the last 50 years in Australia is that Keynesian policies can be remarkably successful in reducing the size of fluctuations in economic activity. In the context of concern about unemployment, in the three recessions in which vigorous Keynesian policy was used to stimulate the economy the recessions were brief. In the one recession, in which policy was much more hesitant, the recession dragged on. Moreover the rapid rise in government expenditure on goods and services was a major source of growth in the golden years.

While the review of historical experience in this section has concentrated on Australia, its conclusion is confirmed by overseas experience. The most obvious example in overseas evidence is the varying experience of countries after the 1982 recession. In general, the countries in which unemployment fell substantially were those with expansionary Keynesian policies. In those with much less expansionary policies, unemployment fell very slowly. Perhaps the two most extreme cases were the United States and Germany. In the United States, President Reagan's policies provided, perhaps inadvertently, a massive Keynesian stimulus and unemployment fell from 9.6 per cent in 1983 to 5.5 per cent in 1988. In conservative Germany, unemployment was 6.9 per cent in 1983 and still 6.2 per cent in 1988.⁹ On a more formal level Boltho (1989) carried out a statistical study showing that the period 1950–79 had much smaller business cycles than the interwar period or the 44 years before World War I. Boltho attributes this to 'the greater influence of government which operated via automatic and discretionary policies and by changing expectations' (p. 1709). Boltho's article contains an extensive list of references on the topic. It is clear that overseas evidence confirms the conclusion that Keynesian macroeconomic policies can reduce the size of the business cycle. As pointed out above, this in itself will increase the longer run growth rate.

Also interesting in this respect is a cross-section regression study of 20 OECD countries by Boltho and Glyn (1995) that is specifically concerned with the medium-term relationship between various macroeconomic policy measures and growth in output. They find that the measure most likely to increase economic growth is growth in government expenditure on goods and services. However, their method assumes, rather than demonstrates, the direction of causation. Consequently they are careful in the way they present their results and it is worth quoting their own summary of their empirical findings on this question. These they say:

provided some evidence that countries in which government spending (on goods and services) increased faster after 1973 recorded a higher growth rate of GDP. Two points are worth emphasising. First, the effect does not seem to have depended on budget deficits, since the impact of the rapid growth of expenditure was almost as great when the structural

deficit was controlled for. These results represent, therefore, the effects of a positive balanced budget multiplier process rather than those of a traditional deficit-financed expansion. Public spending directly generated more output within the government sector and in those private industries supplying it, whilst the additional taxation choked off any increase in consumption.

Second, however, this impact weakened through time. Not only did public spending growth slow down (from some 3 per cent per annum on average in 1973–79 to barely 2 per cent per annum in 1982–93), but the size of the coefficients and their statistical significance diminished. (p. 462)

The weakening of the relationship in more recent years could be due to a number of causes. The most plausible is that when, following financial deregulation, fiscal consolidation (or the reduction of government deficits) became fashionable, governments in countries where output was growing more strongly felt more able to pursue fiscal consolidation so that there was some causation in the opposite direction. At least, in the regressions for the 1980s the coefficients were still positive even if they were statistically significant at about the 15 per cent level.

12.3 Arguments Against Keynesian Expansion: Crowding Out and Related Issues

The previous section gave examples where expansionary Keynesian policy was associated with brief recessions and where lack of expansionary fiscal policy was associated with recessions that dragged on. This is important because we now know from experience that recessions are a major factor in driving unemployment. The cumulative effect of these examples of expansionary policy is very convincing, but does not constitute an incontrovertible proof that Keynesian policies can stimulate growth and reduce unemployment, at least in an economy in a recession. The case for this will be further strengthened if an examination of the arguments designed to show that Keynesian policy is ineffective finds that these arguments lack conviction or supporting empirical evidence.

The four major arguments against the effectiveness of Keynesian policies go back at least 20 years. Perhaps the most important argument is that expansionary policy, operating through increased government expenditure, will not work because any increased government expenditure will 'crowd out' private investment expenditure, so that there will be no net increase in aggregate demand and no stimulus to output and employment.¹⁰ An increase in government expenditure can be financed by increasing taxation or increasing the budget deficit. It was argued in the previous section that an increase in both government expenditure and revenue will provide

a stimulus to the economy. This proposition is usually ignored by proponents of crowding out, who focus on deficit-financed increases in public expenditure.

Crowding-out theory maintains that an increase in the deficit will cause a rise in interest rates and this rise in interest rates will reduce private investment expenditure. If increased public expenditure increases economic activity, more money will be demanded by the public to carry out this increased economic activity. Purchasers will try to borrow this extra money, forcing up interest rates. As long as economic activity is above the level holding before the increased government expenditure, there will be upward pressure on interest rates.

This argument is of particular importance because, unlike others examined later in this section, it is not just an interesting intellectual proposition argued about by academics. It has been held by many policy advisers and has been put strongly in the media, both influencing public opinion and placing pressure on politicians to take note of it. For example, in his 17 June 1993 column in the *Sydney Morning Herald*, Max Walsh talks of the capacity of the public sector 'to undermine the private sector by confronting it with a high interest rate regime as a consequence of large structural deficits' and concludes that, despite the depressed state of the economy, expansionary fiscal policy will not be effective because 'further expansion of the public sector deficit will simply create higher hurdles for private sector investment'.

An implicit, or often explicit, assumption underlying this crowding-out thesis is that the monetary authorities are successful in maintaining a constant stock of money. This assumption is necessary if interest rates are to rise. It is not clear, however, why the monetary authorities would want to reduce the effects of expansionary fiscal policy in a recession by allowing interest rates to rise. Moreover, the analysis that shows increased government expenditure leading to higher interest rates if the stock of money is held constant also shows that any increase in private expenditure, for example, on investment or even foreign expenditure on Australian exports, will also lead to a rise in interest rates in Australia if the monetary authorities are successful in preventing changes in the stock of money. In this respect, expansionary fiscal policy is no different from any sort of stimulus that might lift the economy out of recession.

In any case, the monetary authorities in Australia, and elsewhere, do not maintain a constant volume of money. Even before widespread financial deregulation, targeting the volume of money was remarkably unsuccessful. Now, after financial deregulation that volume adjusts to whatever size is desired, in total, by all those with an effective demand for money. Monetary authorities operate directly on interest rates and the rate of growth of the money supply is only one of many factors that they take into account when determining interest rates. In the case of Australia this has been documented by Reserve Bank officers, for example in Macfarlane and Stevens (1989, pp. 5–6).

In effect, those supporting crowding out in today's world of deregulated financial markets are arguing that, whenever government expenditure increases, the central bank actively tightens monetary policy to the extent necessary to reduce private investment by an amount equal to all, or most of, the increase in public expenditure.

There is one qualification that should be made to this conclusion. It is short-term interest rates that are the monetary policy instrument. Long-term interest rates may be more relevant to investment decisions in the private sector. It is possible that large budget deficits might increase the spread between short-term and long-term interest rates so even if short-term interest rates were held constant, long-term rates could rise, crowding out private investment. However, there is no evidence of this happening in Australia. There is virtually no correlation between the budget deficit for all levels of government in Australia combined, as a percentage of gross domestic product, and the spread (or gap) between long-term and short-term interest rates. Over the period from the floating of the exchange rate to 1996/97, the adjusted squared correlation coefficient is 0.07 which is nowhere near being statistically significant. In theory the spread should be bigger when short-term interest rates are expected to rise in the future (because of increased inflation or because they are unusually low as a result of easy monetary policy, or other factors). If larger deficits lead to expectations of greater inflation in Australia, this change in attitude could lead to a rise in long-term interest rates, but there is no evidence that large deficits have affected expectations in this way.

Hence, if a bigger deficit leads to higher interest rates in Australia, it must cause monetary authorities to increase short-term interest rates since it does not affect the gap between long-term and short-term interest rates. If one examines changes in the size of the deficit and changes in short-term interest rates in Australia, it is hard to find a relationship, but if anything the relationship is inverse (Nevile 1997, pp. 101–3).

Thus, in Australia the crowding-out argument falls down at the first step. There is no evidence that larger deficits cause a rise in interest rates. This is also the case overseas. Heilbroner and Bernstein carried out a cross-sectional analysis of the G-7 countries. Pressman (1995, p. 215) summarised their findings as follows:

those countries whose public debt increased most during the 1980s did *not* also experience the largest increases on real interest rates. In fact, if anything the actual relationship seemed to be the reverse. Canada, whose public debt increased the most among G7 countries between 1980 and 1986 experienced the smallest increase in real interest rates among the G7 countries over the same time period. Conversely the United Kingdom experienced the smallest increase in government debt and the largest increase in real interest rates. [Emphasis in the original]

So far, discussion has been about the possibility of increased public expenditure crowding out private investment expenditure through a rise in interest rates. Another possibility is that it may discourage private consumption. Barro (1974) revived interest in the so-called Ricardian equivalence theorem, the name given to the assertion that an increase in the budget deficit will be matched by an increase in private-sector saving as households try to increase their wealth in order to cover the increase in tax liabilities that they expect in the future. This proposition, rightly, has had few committed supporters among Australian economists or policy-makers. It is likely that any debt will be repaid, not by those increasing their saving, but by their children or grandchildren. Some will not have children and others may not care overmuch about their children's tax liabilities. Many, perhaps most, may not even think about future tax liabilities in this way.

Moreover the empirical evidence, both in Australia and overseas, is against the Ricardian equivalence theorem. Edey and Britten-Jones (1990), in their study of saving and investment in Australia, comment that Australian experience in the second half of the 1980s is close to a natural experiment for the purpose of testing the Ricardian equivalence theorem. They conclude that the theorem fails the test. Among the points that they note are:

Between 1985/86 and 1989/90 the public sector deficit was reduced by 5 per cent of GDP and public savings was dramatically increased from 1.1 to 6.6 per cent of GDP . . . private savings fell only 1.2 percentage points over the period . . . private savings ratios were quite stable throughout the 1960s, 1970s and 1980s despite the major swings in public savings after the mid-1970s. (p. 121)

Overall, overseas evidence is also unfavourable to the Ricardian equivalence theorem. In many countries, saving rates fell while deficits rose. In the United States Summers and Carroll (1987) found a clear inverse relationship between private saving rates and budget deficits and Pressman (1995) notes similar relationships in Canada, France, Germany and Japan.

There is one final very important point why the Ricardian equivalence theorem is not an argument against effective fiscal policy. Unlike almost all supporters of the theorem, Edey and Britten-Jones are careful to talk about public-sector saving rather than budget deficits. The budget deficit is not a measure of public dissaving. Saving is the difference between income and consumption, not the difference between revenue and expenditure. Public savings is the difference between public revenue and public current (or non-investment) expenditure. Public investment should produce a return in the future, just as private investment should. This return should be enough to pay off any debt incurred in financing it, as well as interest on that debt. Increases in government expenditure on capital equipment and construction, as well as on human capital such as education, should increase the tax

base so that even if households act according to the principles underlying the Ricardian equivalence theorem, they will not have to increase their saving rate.

A third theory, the twin deficits theory, implies what could be called international crowding out. If expansionary policy increases aggregate demand, some of the extra demand will be spent on imports. This leakage into imports is uncontroversial and is not an argument against the effectiveness of Keynesian policies. It occurs because policies are effective and do increase aggregate demand, though it is one of the factors that determine the extent to which aggregate demand is increased (Nevile 1975, ch. 4). The twin deficits theory goes much further and argues that if the budget deficit is increased, either because of an increase in expenditure or because of a cut in revenue, the balance of payments current account deficit will increase by the same or very similar amount so that all or nearly all of the expansionary impact will go overseas. The twin deficits theory is the exact opposite of crowding out and Ricardian equivalence. While these last two see an increase in the budget deficit causing a decline in private expenditure, the twin deficits theory argues that private expenditure and saving are very stable and not affected by what happens in the public sector. Thus, for example, if public expenditure increases and the increase is deficit financed, neither private-sector expenditure nor saving is much affected. The deficit must be financed by selling bonds to foreigners and the current account deficit rises by the same amount as the budget deficit, with the resources to meet the demand coming from the additional expenditure being provided by imports.

Empirical evidence does not support the twin deficits theory. Many studies, cited to support it by those opposed to Keynesian economic policy, show the current account deficit increasing by up to one-third of a change in the budget deficit (e.g. Berheim 1987, and Sachs and Roubini 1988). This is not empirical evidence in favour of the twin deficits theory but merely shows that imports increase when aggregate demand increases because of effective macroeconomic policy. A simple test of the twin deficits theory is the experience in OECD countries in the early 1990s. From 1990 to 1993 in the G-7 countries as a whole, budget deficits more than doubled and the current account deficits fell to zero. This was not an isolated incident. A similar story applies to the years 1980 to 1983. The twin deficits theory fails this test conclusively.

Although the twin deficits theory is contradicted by experience in most G-7 countries (and Australia) in most recessions, the Keynesian point, that when an economy expands imports also usually rise, still stands. This does not matter when the level of economic activity is low, but may cause problems in the context of longer run growth. We will return to this point in the next section.

So far we have considered arguments about the effectiveness of fiscal policy. The next proposition applies equally to monetary and fiscal

policy. A school of economics, known as new classical economics, holds that macroeconomic policy is ineffective except for the short period when people are surprised by it and do not take it into account in their decision-making. A completely fair exposition of new classical economics would be more technical than is appropriate in this context, but the following gives the flavour of the arguments.

The key assumption, from which all else flows, is that wages and prices adjust rapidly enough so that labour and product markets clear with virtually no delays. That is, everyone who wants a job at the going wage can find one and every firm can sell as much as it wants at the going price. Given this, and abstracting from economic growth, the amount of output and employment will only change when there are unexpected changes in the general level of prices. At the level of the individual worker or firm, the amount of labour or goods supplied depends, it is asserted, on the perceived real wage or real prices – that is, on the wage or price received relative to the general price level. At the macro level, in the words of a prominent new classical economist:

Unexpected rises in the price level . . . boost aggregate supply, because suppliers (of which suppliers of labour are one important example) mistakenly interpret surprise increases in the aggregate price level as increases in the relative prices of the labour or goods which they are supplying. (Sargent 1973, p. 435)

The next question, of course, is what determines the expected price level. The assumption of rational expectations begins with the belief that the public cannot form their expectations in a way which would lead to a permanent bias in one direction or another, because if it did, sooner or later people would notice this and correct for it. If people are rational, in the way the new classical school assumes, they will use the best information possible in forming their expectations and assume that everyone else does the same. That is, they will use the best economic theory or econometric model available (which the new classical economists immodestly assume is their own). If the government acts in such a way as to increase the general price level, and people realise that this is happening, then there will be no effect on supply or on unemployment. The level of unemployment is determined by unexpected inflation (and is lower the higher the unexpected inflation). Unexpected inflation can result only from unexpected and unnoticed actions by the government (or unexpected changes in other exogenous variables). Thus the government can affect real output and unemployment only in a time period so short that its actions are unexpected and unnoticed.

For many, the market clearing assumption, on which the whole edifice of new classical economics rests, is so absurd that little further discussion is needed. However, empirical evidence does not support new classical

economics either. There are many econometric studies which demonstrate that Keynesian policies have been effective (e.g. Boltho 1989) and a number that do not. These studies have given rise to arguments about technical econometric points. There is an easy way to cut through all these arguments about technicalities and, in a straightforward way, to test new classical economics empirically. A prediction at the core of new classical economics can be shown not to hold. New classical economics holds that economic policy can affect the general price level and the rate of inflation but that, except in the short period when people are taken by surprise by policy changes, variables such as output, employment and unemployment cannot be changed through economic policy actions. If this is so, tight monetary policy, well heralded in advance so that it surprises no one, will stop inflation immediately without affecting output and employment. This has not happened and experienced central bankers believe that it is most unlikely to happen in the future. On his retirement, as governor of the Reserve Bank of Australia, R.A. Johnston said 'To deal with inflation in a permanent way is to accept a fairly great deal of pain' (*Sydney Morning Herald*, 19 June 1998). In more formal language, Max Corden, in summing up the conclusions of a Reserve Bank conference, stated: 'Consensus did exist on three crucial matters . . . [of which the first was] you cannot disinflate without some cost' (1992, p. 341). With this refutation of new classical economics, none of the theories discussed in this section are supported by the empirical evidence.¹¹

12.4 Inflation, The Current Account Deficit and Globalisation

While arguments that Keynesian policies cannot stimulate growth in output and employment have been refuted by empirical evidence, the argument that they have potentially disastrous side-effects must be taken more seriously. Anything that raises the growth of output sufficiently to reduce unemployment substantially will usually increase inflationary pressure. Unless the source of growth is an export boom, it will also usually cause a deterioration in the current account deficit on the balance of payments. Unfortunately, these two side-effects are likely to interact, each making the other worse. Even in the golden years they caused problems from time to time. The response was unusually tight macroeconomic policy, as occurred in 1956/57 and 1960/61.

Inflation is not a problem in Australia at the moment, being at the lowest level for 25 years. This does give room to manoeuvre, but the very low inflation rate was bought at considerable cost in terms of a recession that was both deep and long. This occurred even though the recession came after seven years of a successful incomes policy had reduced the inflation rate while unemployment was also falling. Given that inflation is currently at extremely low levels, the first priority now must be to reduce unemployment and under-employment. Nevertheless, policies should be devised

which will do this without throwing away the benefit of low inflation, which was obtained at such a high cost.

In the short to medium term the rate of inflation rises as the unemployment rate falls unless incomes policies such as the Accord are put into place to prevent this from happening. This trade-off between inflation and unemployment has been well documented empirically and is widely accepted by Keynesian and neoclassical economists alike. Not quite so uncontroversial but still widely accepted is that there is a rate of unemployment (or narrow range of unemployment rates) below which the inflation accelerates, or increases even if the rate of unemployment is constant. When unemployment is above this rate, inflation declines. This rate of unemployment is known as the NAIRU or non-accelerating inflation rate of unemployment.

It is important to realise that the NAIRU is not a number set in stone. It can be changed by policies, especially incomes policies and labour-market policies. In many countries it is not independent of the actual rate of unemployment and grows over time when unemployment is high. Hence, overall macroeconomic policy can influence the NAIRU by influencing the level of actual unemployment. Australia's experience in the 1980s shows that it is possible to have lengthy periods of growth without the rate of inflation rising. From 1982/83 to 1989/90 output grew at an annual rate of 4.3 per cent in Australia and unemployment fell from 9.0 per cent to 6.2 per cent. Over the same period inflation fell from 10 per cent to 6 per cent.¹²

A tendency to rising rates of inflation may interact with current account deficit problems. In the past 25 years in Australia, whenever output and employment have grown fast enough to significantly reduce unemployment, and this rate of growth is sustained, the leakage of aggregate demand into imports causes uncomfortably high current account deficits on the balance of payments. If consequent market forces, or even government policy, result in a devaluation of the value of the Australian dollar against foreign currencies, imports will become more expensive adding to inflationary pressure. A rising rate of inflation will put further pressure on the foreign exchange rate and it is easy to slip into an inflation–devaluation vicious circle. This can be prevented, though often at the cost of a fall in real wages,¹³ if wages are not allowed to rise to offset the increased cost of living caused by higher import prices.

It is easier to stop an inflation–devaluation vicious circle, even without increasing unemployment, than it is to cure the underlying problem with the current account deficit. Some academic economists have argued that large current account deficits are more of a perceived problem than a real one. The current account deficit is Australia's net borrowing from foreigners over the relevant period. If imports rise, and nothing else changes, we have to borrow more to pay for the extra inputs. Some academic economists argue that since this borrowing from foreigners is largely done by firms in the private sector, who presumably believe that it is profitable to do so, it is not something to be concerned about (see Pitchford 1995). The majority of economists, and virtually all of those responsible for policy advice to

government, disagree. The basic reason is that Australia already has a large foreign debt, and the amount we are already borrowing from abroad is a high proportion of our output (or GDP). If we continue to borrow increasing amounts from abroad (i.e. if the current account deficit increases as a proportion of GDP), sooner or later foreigners will wonder if we will be able to service the debt and cease lending to Australia. Moreover, Australia confronts a volatile external environment, especially in terms of potentially large swings in commodities prices. As Sjaastad (quoted in Grattan and Gruen 1993, p. 168) has pointed out,

the basic reason for concern about the large build-up of private Australian debt is that some unexpected events can lead to a sudden and pronounced change in overseas investor sentiment about their exposure to the excessively high levels of (private) debt of Australian firms.

This can precipitate a massive devaluation of the Australian dollar on foreign exchange markets and hence large falls in real consumption and a rapid, painful adjustment in our economy. Moreover, the devaluation may be precipitated by currency speculators before it would occur if foreign investors were left to make the judgement themselves. If currency speculators have reason to think that signs of weakness will cause investors to stop lending, a speculative attack is likely to be successful. Although the circumstances are different, the East Asian crisis of 1997/98 is an outstanding example of what can happen when financial markets take fright. It is, at the least, only prudent to have policies that address current account deficit problems.

If rapid growth in the Australian economy occurs when there is also rapid growth around the world, any current account deficit problems are not likely to be severe. Not only will the volume of Australian exports increase but their prices are likely to rise, even compared to the prices of Australian imports. It is when Australia tries to go it alone that the current account deficit can raise severe problems.¹⁴ The following analysis assumes that growth in output is greater than growth in exports.

The current account deficit is equal to the difference between imports and exports (the trade gap) plus the net amount that Australians pay to foreigners in dividends, interest and gifts. It is also equal to the difference between investment and saving (the saving gap) plus again the net amount paid to foreigners in dividends, interest and gifts. This follows from the definitions of the various items in the national accounts so that when the statistician measures what has happened in the economy, the saving gap is the same as the trade gap and must be so by definition. But what if the trade gap which would result from the plans of participants in the economy does not equal the saving gap which would result from those plans? Will the trade gap change or will the saving gap adjust? If with a rising rate of economic growth there is a surge in imports, in the short run the saving gap will adjust through an increase in trade credit. The extra imports will not encourage

foreigners to lend to Australian institutions, on the contrary. Hence, in the somewhat longer run the inflow of foreign financial capital will decline unless interest rates rise to make lending to Australia more attractive. The decline in foreign lending to Australia will cause the value of the Australian dollar to fall on the foreign exchange market. If, for fear of inflationary consequences or some other reason, the government wishes to avoid this devaluation, the usual response is to raise interest rates enough to sustain the flow of foreign lending. Policy-induced rises in interest rates will encourage foreign lenders not only because of the higher interest returns, but also because it may reassure them that the government is determined to avoid a substantial devaluation which would cause losses on loans denominated in Australian dollars. However, the higher interest rates will discourage investment by private firms. This will reduce the saving gap, but it will also reduce growth of output and any fall in unemployment.

If interest rates do not rise and the Australian dollar's value falls on foreign exchange markets, exports and import-competing industries will be encouraged, but only in the very short run unless, as discussed before, real wages fall. Otherwise an inflation–devaluation vicious circle will be set up. Even if this does not occur, a substantial devaluation may make foreign investors more nervous than is necessary leading to a further devaluation. While a small devaluation can be helpful, it is not likely to be enough by itself and it is hard to make a large one successful. It requires a strong incomes policy and perhaps other policies also which reassure foreigners that the Australian dollar has underlying strength. Rather than devaluing, it is almost always easier to tackle the saving gap, not by reducing investment, but by increasing saving in Australia. To some extent, saving increases automatically as output and income rise, but in the absence of policies to increase saving this is not enough to match the rise in imports. Although increasing saving is only part of the solution, it is probably a necessary condition for Keynesian policies to increase growth in output and employment in the long run, in a country like Australia.

This conclusion is made much stronger when account is taken of the effects of the financial deregulation and globalisation that have occurred over the last two decades. Globalisation is a term coined to describe the greater interdependence, even integration of national economies, which, in part, has been facilitated by the computer revolution in the transmission of information. It is most obvious in financial markets. Vast sums of money cross national boundaries each day. Transactions are made by computer, institutions all around the world are linked by computers and professionals can deal as easily in a country on the other side of the world as in their own city. The consequences of this virtual integration of financial markets around the world are seen every day in our newspapers, e.g. when Australian share prices fall, the day interest rates rise in New York.

The globalisation of financial markets has given these markets considerable influence on government policy. Financial markets now have great power

in determining the exchange rate for an economy, and the exchange rate has such a widespread influence on the economy that, in many countries, governments must be constantly looking over their shoulder with concern about the effects of policy actions on financial markets (Nevile 1996, p. 323).

The practical effect of this globalisation is not necessarily that national sovereignty in policy-making has been superseded by tailoring policies to please financial markets. While there have been assertions that this is the case, careful empirical studies suggest that 'governments still have policy choices and fiscal policy may be the most important instrument for choice' (Keohane and Milner 1996, p. 248), to quote from the conclusion of a major book on the extent to which domestic policy-making has been constrained by globalisation. Keohane and Milner certainly do not argue that choices in macroeconomic policy-making have not been reduced. The quotation is largely based on the chapter by Garrett in their book. After a careful cross-country study of 15 countries, Garrett (1996) concludes that monetary policy is constrained by increasing capital mobility, but that the evidence that there are important constraints on fiscal policy is weak. Moreover, Moore (1998) has shown that much of the evidence found to support the loss of national autonomy in policy-making is based on the experience of members of the European Economic Community who have gone much further along the road of integration of their economies than is generally the case.¹⁵ Nevertheless, the problems of inflation and current account deficits, which always were important when Australia tried to grow faster than the rest of the OECD, have become even more important, with less margin for error in policies designed to overcome them.

It is difficult to strike the correct balance between blithely ignoring the financial markets' reactions to macroeconomic policy changes on the one hand, and giving up independent macroeconomic policy for fear of those reactions on the other. The reason for financial markets' concern about the size of current account deficits is obvious. Anything which suggests that a currency may be about to fall in value on foreign exchange markets is likely to lead to actions that precipitate a devaluation. Financial markets also give great weight to keeping inflation low as this is good for their profits. In a speech the former governor of the Reserve Bank of Australia, Bernie Fraser, commented that 'monetary policy was becoming the hostage of influential financial markets with a vested interest in making the Reserve Bank give greater weight to inflation than unemployment' (quoted in the *Sydney Morning Herald*, 16 June 1996). Financial institutions have a vested interest in keeping inflation low because a rise in interest rates reduces the value of the fixed interest securities that they hold. Also, and perhaps of more importance to foreigners investing in financial assets in Australia, a rate of inflation that is consistently above that in most other countries is a reliable sign that sooner or later the currency will be devalued. Financial markets also seem to be worried by large budget deficits which they fear may lead to a rise in interest rates

or devaluation. However, there is little or no evidence that the size of the public sector is a matter of concern if expenditure is balanced by revenue.

Financial markets have, no doubt, always been concerned about inflation and the current account deficit. Globalisation gives them much more power to make their wishes prevail in that it makes a disastrous outcome much more likely if they decide that the exchange rate for a country's currency is unsustainable. While governments do not have to make the desires of financial markets their first priority in economic policy-making, at least those in countries with a large foreign debt have to convince financial markets that their actual (or potential) policies will prevent a large devaluation.

12.5 Policies for a Sustained Large Fall in Unemployment

The previous sections have indicated that, if Keynesian policies to raise the rate of growth of output and employment are to be successful in producing a sustained fall in unemployment, more than expansionary monetary and fiscal policies are required. The following package of policies is put forward:

- an effective incomes policy;
- substantially expanded and better designed labour-market programs;
- a substantial increase in government expenditure, especially on economic infrastructure, education, training and labour-market programs and on labour-intensive socially useful community services;
- an equally large, or even larger increase in taxation revenue;
- measures to increase savings in the private sector;
- measures to increase net exports.

Incomes policy and expanded labour-market programs are necessary to reduce inflationary pressures and to help prevent any inflation–devaluation vicious circle developing. The incomes policy will have to be strong enough to withstand the strain put on it by increases in tax rates as well as by falling unemployment. Successful incomes policy and labour-market programs are needed to reduce the NAIRU, not only to reduce inflationary pressures, but also because while the exact level of the NAIRU in Australia at present is not clear, it certainly is above any socially acceptable long-run goal for the unemployment rate. Labour-market programs are an important complement to Keynesian macro policies.

The increase in government expenditure is necessary to stimulate growth in aggregate demand and private investment. Expenditure on economic infrastructure, education, training and labour-market programs should also increase both labour and capital productivity and help offset to some extent the fall in the real value of take-home pay caused by the rise in taxation rates. There is mounting evidence that in many countries, increased public investment in economic infrastructure increases the productivity of private-sector investment. Otto and Voss (1994) document this for Australia. Using

Australian data, Kearney, Chowdhury and Fallick (1996) find that public infrastructure investment has positive externality effects and 'crowds in' private investment (see also Dowrick 1994a). Making private investment more productive will normally increase the rate of private investment which will help increase aggregate demand. Education, training and labour-market programs obviously increase labour productivity, but indirectly can also contribute to increasing capital productivity.

Because of the need to avoid large government deficits (if only to avoid negative financial market sentiments), increasing taxation revenue is at the heart of the expansionary policies advocated here. It almost certainly would involve some new taxes and these would have to be introduced with careful consideration of both equity issues and effects on private-sector savings. This is not the place for a detailed discussion of tax reform but a couple of unusual suggestions can be put forward for consideration. The first is the imposition of a uniform tariff, say at 5 per cent on all imported goods, and on as many imported services as it is reasonably convenient to catch in the tax net. Revenue tariffs are not meant to be part of a policy of protection and are allowed under World Trade Organization rules when a country faces current account deficit problems. Any effect on the price of imports would be smaller than those of acceptable fluctuations in the exchange rate, partly because the exchange rate will be a little higher than it would be in the absence of a revenue tariff.

The second suggestion relates to the merits of a goods and services tax versus Australia's present wholesale sales tax. It is desirable to tax consumption of services as well as consumption of goods. The equity problems involved in the introduction of a goods and services tax could be overcome by zero rating food, housing and health expenditures and by retaining the wholesale sales tax on some luxury items, for example expensive cars.

Taxation revenue will have to increase sufficiently to increase national saving to such an extent that the current account deficits are not unduly high. Equally important, it will have to ensure that, despite increases in government expenditure, the budget deficit does not become large enough to alarm financial markets. In the short to medium term, it is essential that financial markets do not have undue concern about the Australian dollar. This rules out budget deficits that are large and increasing. There is scope to increase taxes in that Australia has one of the lowest ratios of taxes to income and output in the OECD (see table 10.1).

In the longer term, solving the current account deficit problem will be eased by measures that increase private saving without reducing private-sector investment or public-sector saving. One possibility is to increase the superannuation levy, but thought should be given to other measures.

Increasing net exports will also ease current account problems. There are numerous examples where Australian governments have not proved good at picking winners. Nevertheless, policies that encourage export and import-competing industries across the board can be devised.

Keynesian policies to increase the rate of growth of output and employment can be successful, but they do not provide a free lunch. Even in the short term, they are likely to increase income per head as the unemployed are drawn back into productive activity. However, at least in the short term, the increased taxation required will reduce a little the incomes of those already in steady full-time employment and those with comfortable incomes from rent, interest and dividends or profits. How big is the required rise in tax revenue? It is impossible to be precise. It will depend in part on what is happening in the rest of the world. The faster economies overseas are growing, the faster the volume and value of Australian exports will grow. Thus, fast growth in the rest of the world will both stimulate output and employment growth in Australia and help prevent the current account deficit growing too rapidly. However, the prospects for rapid growth in the world economy over the next five years are anything but good.

The size of the required increase in taxation will also depend on how rapidly unemployment is to be reduced. Over the eight years to June 1998 the unemployment rate in Australia averaged 9.3 per cent. This period roughly covers one complete business cycle of boom and slump. An ambitious, but not completely unrealistic, target would be to reduce unemployment by half in five years so that after that five-year period the average level of unemployment over boom and slump is 4.7 per cent.

Given this target, and assuming that the world economy will grow slowly over the next five years, a ball-park figure for the increase in the ratio of tax revenue to GDP is 10 per cent. Current government revenue, which includes dividends from government business enterprises and fees and fines as well as taxation, would have to rise from a little over 34 per cent of GDP to around 38 per cent of GDP. This rise will be needed to cover the increase in government expenditure. The low rate of growth of the world economy will make it unlikely that the current account deficit will fall as a proportion of GDP. To reassure financial markets, it will be necessary to finance increases in both current and capital expenditure by increases in current revenue. At least on average over boom and slump, all government expenditure must be balanced by current government revenue.

The rise in government expenditure and current revenue should be sustained, as a percentage of GDP, over the whole five years. Obviously, those who move from unemployment, or under-employment, to full employment will have a rise in real income. On average other Australians will suffer a short-run decline in real income because of the increase in taxation. This will be greatest (3 to 4 per cent) at the beginning of the period, but will become progressively smaller because of the more rapid rate of growth of GDP. By the end of five years, the higher rate of growth will have completely offset the increased tax rates so that the real incomes of those already fully employed will be just as high as they would have been if the policy package had not been implemented.

12.6 Conclusion

Both a review of past experience and an examination of the theoretical arguments of those opposed to Keynesian economics suggest that Keynesian policies can stimulate growth in output and reduce unemployment. Even if policy does no more than make recessions shorter and not so deep, the average level of unemployment will be reduced. However, this chapter argues that Keynesian policies can do more than this. Well-chosen policies can significantly increase the trend rate of growth of output and employment, reducing unemployment substantially. Halving the rate of unemployment in five years time is quite possible.

However, halving unemployment five years hence, or even seven or eight years hence, cannot be done without short-run cost to the majority of Australians. While the package of policies outlined in the previous section will increase the average income of Australians as a whole, it will increase greatly the incomes of those unemployed or substantially under-employed but reduce slightly the average income received by other Australians. This reduction is because of the increase in taxation which is an integral part of the policy package. It will be about 3 or 4 per cent at the beginning of the period and will steadily decline over time.

The question is how much do Australians wish to reduce unemployment substantially and relatively rapidly. How much are we prepared to pay in higher taxation to achieve this? The cost, in the form of a fall in after-tax income, will only be short lived. The more rapid rate of growth of GDP will, despite higher tax rates, restore real income: after about two years to the level that held in the year before the policies were implemented, and after about five years to the level that they would have reached at the slower rate of growth which would have occurred without the policy changes. Is this too big a sacrifice for the majority of Australians to make to halve the unemployment rate?

Notes

1. These effects are taken up in the broader subject of public finance.
2. In heavily regulated economies, monetary policy may use quantitative regulations and restrictions on interest rates which relate to particular classes of borrowers, but this is no longer the case in Australia or most OECD countries.
3. For most OECD countries exchange rates remained fixed for decades.
4. A significant recession is defined as occurring in a year in which output (gross domestic product measured in constant prices) declines or rises by less than a quarter of its trend rate of growth.
5. Rates of growth of government expenditure quoted in this chapter exclude expenditure on inventories.
6. Changes in unemployment lag behind changes in output.
7. In most circumstances the bigger the first round effect the bigger the total effect. Nevile (1975, chapter 4) sets out the theory why this is not always the case.

8. As more and more of the workforce were younger, with no memories of the 1930s depression, the Kaleckian argument, that full employment removes the power to discipline workers, leading to declining efficiency and inflation, was no doubt becoming more important, but the Vietnam war spending was the inflationary trigger.
9. These unemployment rates are standardized by the OECD. Both countries had structural deficits in this period, but that in the U.S. averaged 2.9 per cent of GDP, less than 1 per cent of a slower growing GDP.
10. The argument also applies to an increase in private consumption expenditure brought about by a cut in tax rates, but it is usually expressed in terms of increased public expenditure crowding out an equal amount of private expenditure. It is a simplification to ascribe to all holding this view a belief in 100 per cent crowding out, but they do hold that it approaches 100 per cent (Mayer, 1978).
11. Neville (1983) contains a longer and more technical survey of earlier empirical evidence which comes to the same conclusion.
12. Inflation is measured by the implicit deflator for gross national expenditure. These figures start in a recession year and end in a boom year, but the recession which followed did not owe its length to the factors that enabled the simultaneous fall in inflation and unemployment. As was shown earlier the major reason for the severity of the recession was a policy gamble which tried to entrench a much lower level of inflation without undue cost in higher unemployment and only succeeded in the first of these two aims. The speculative excesses of the late 1980s also probably contributed to the severity of the recession.
13. Real wages need not fall if productivity gains are big enough to offset higher import prices.
14. Hence, the calls for major countries to co-ordinate domestic macroeconomic policy and to work together to assist those of their number that have low levels of economic activity.
15. This reduces the force of the French experience in the early 1980s as an example of the reduction in national policy making power. In any case the major problem in this case was basically domestic: a high level of inflation which led to expectations of a devaluation. The current account deficit was only 2.2 per cent of GDP.

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13

Australian Economic Growth: A Structural Perspective (A Preliminary Report)

Joseph Halevi and Peter Kriesler

In this paper we argue that Australia's current economic problems are not just the result of our being at the bottom of the cycle, but rather reflect a longer term decline. The reasons for this decline are located in structural problems relating to the decline of the industrial sector and the increasing unreliability of the export sector. We view industry as the core sector which generates technology and growth. Within the industrial sector, capital goods producing industries are the 'hot bed' (so to speak) of structure change and technical progress. Australia has let these industries decline. As a result, traditional remedies in the form of either demand management policies or 'waiting for the world recovery' will not be enough. In fact, recent economic policies, rather than being a panacea, have exacerbated the problem.

13.1 Introduction

It is widely asserted that structural change is necessary before the Australian economy can enjoy sustained economic growth at a satisfactory level. In this paper, we examine the question of why structure is important, before looking at the general structural constraints which impinge on the Australian economy, concentrating on the inadequate development of the capital goods sector. Finally we consider the ways in which the Labor Government's policies have influenced the structure of the Australian economy. It is our argument that these policies have had an inhibiting effect on the economy, as they have adversely influenced investment decisions, so increasing Australia's reliance on international forces.

13.2 Traditional Views

Most analysis of Australia's economic growth has focussed on supply side factors. In particular, analysis has concentrated on issues associated with

Revised from *Economic and Labour Relations Review*, 2(2): 131–142, 1991, 'Australian Economic Growth: A Structural Perspective (A Preliminary Report),' by Halevi, J. and Kriesler, P. With kind permission from SAGE Publications. All rights reserved.

allocative efficiency such as the role of price signals on productivity and thrift. It has often been argued that growth has been hampered by low savings and by policy induced market imperfections- tariffs in the product market and the effects of arbitration in reducing the flexibility of the labour market.¹ Gruen, in an important article on Australia's economic performance (Gruen (1986)), clearly blames our low growth rate on these later factors. He accepts that Australia has had relatively low productivity growth, but argues that this is the result of immigration. This is a difficult position to sustain given that he also acknowledges our low per capita investment over the same period (p. 185). Similarly the EPAC growth papers emphasise allocative efficiency. However, as has been noted by Aspromourgos and White (1990):

At the deepest theoretical level, EPAC's treatment of efficiency in relation to growth may be construed as a corollary of its lack of interest in the problem of the relation between demand and productive capacity. (p. 18)

It is the argument of this paper that it is this latter factor which explains Australia's poor performance; and that underlying structural problems, associated with the failure to develop a capital goods sector, explain Australia's relatively low growth performance.

13.3 Historical Overview

Historically, it has been a characteristic of the left to focus on issues of structure. The economy is conceived in terms of sectors which can generate growth and accumulation and can, endogenously create new technologies which then affect the rest of the economy. At times this approach was very reductionist, in the sense that it identified only very specific branches of industry such as steel and so called heavy industries as the main engines of growth. Yet, it had some sound basis, at least conceptually, in the sense that it had a clear view of the hierarchical structure of production. Perhaps too much constrained in its own reductionist approach and becoming aware that it was no longer workable, the labour movement in the last ten years in Europe (except Scandinavia and Germany) and Australia all too quickly accepted the tenets of monetarism and post industrialism, abandoning the notion of structure all together. The years of the crises for the labour movement were also the years in which labour lost its structural perspective.

For Australia, as well as for the labour movement, it is important to return to a structural perspective. In our view, the starting point requires an analysis of the break down of the system of regulatory forces which governed the Australian economy until the early 1970s, i.e. until the end of full employment. More specifically, is it true that during the 1950s and 1960s Australia could sustain full employment and high GDP per head as well as serving

domestic demand through domestically produced output? In other words, is it the case that during this time, Australia had a substantially larger industrial base than it has today? So the question becomes, what were the structural features of accumulation in Australia? In particular, which were the sectors which pushed accumulation of physical capital and which were the sectors which were towed by it?

As has been well documented, it has been the primary goods sectors, especially wool, wheat and coal which have provided the main basis for expansion, while the manufacturing sectors have played a secondary role. Unfortunately, these foundations have not significantly changed, so that, with the long term decline in agricultural terms of trade, Australia's potential for capital accumulation has been significantly eroded.

Historically Australian economic growth showed unique weaknesses for a high per capita income economy. Growth rates are only meaningful in comparative terms. Maddison (1989) has measured long term growth from the middle of the last century to 1987 and what emerges is that the growth rate of per capita GDP in Australia has been, in the 1900–1987 period, 1.4% per annum on average, which is equivalent to the British growth rate, the lowest of the 16 OECD countries he examined. The turning point in the case of Australia was the Depression which followed the First World War (1914–1920), highlighting the high cost of the war for Australia. This, combined with the Great Depression brought for Australia a 1900–1950 growth rate of GDP per capita of 0.8% as compared to an equivalent OECD average of 1.3%, and the British average of 0.8%. If we look at the post war, 1950–1987 period, Australian GDP growth rate at 2.1% per capita was slightly below the British 2.2%. However in the post war period Australian growth per capita was slightly above that of Canada 2% and USA 1.9%.

An important question then is why has the growth rate hovered around this relatively low rate? The clue must lie in the nature of long term investment. Can we say that, for example, like post world war USA, there were stagnationist factors at work? There should not have been, due to immigration plus policies to sustain growth such as large capital schemes like the Snowy Mountain Scheme. Instead, should we look at the structure of industry? Has investment caused endemic unused capacity due to actions by large multinationals, so that sectors were born on an oligopolistic basis? A highly monopolized/concentrated sector need not necessarily be subject to unused capacity, if the surplus is used for capital accumulation (investment) or exports as was the case in the early phase of post war growth in Japan and current phase of growth in South Korea. Concentration was used, in such instances, to obtain economies of scale, and high domestic profits were used to subsidize exports, to allow exports to penetrate foreign markets. This contrasts with multinational investment in Australia which was not dynamic, the domestic market generated levels of demand way below that of the expertise and technical level of those firms. The multinationals'

aim was never to use Australia as an export base, but rather production was aimed exclusively at the small domestic market, so there was never any intention to generate economies of scale. Rather than being part of an overall production strategy by these companies, multinational investment in Australia was merely an attempt to exploit quasi rents resulting from domestic tariffs. The tariffs were unable to engender a local capital goods industry, of specialized machine tooling. All of this occurred within a period of fixed exchange rates, so that there were none of the problems caused by exchange rate volatility of the 1980s, so the potential was there to build a strong local capital goods industry. Especially since, at that time, Australia had reached a higher stage of development than its Asian neighbours and so had potential export markets. The conditions for sustained economic development were never taken advantage of, in the Australian economy in the post Korean War (1953–1973) period, despite the fact that the period was characterized by full employment. Australian per capita growth rates at the time were similar to that of UK. The low full employment growth rate can be explained by the maintenance of the importance of the primary goods sector in the structure of the economy. Initially this was related to our ties to the United Kingdom, which was the main importer of our goods until the mid 1960s. This role was then taken over by Japan.² At the same time there was a switch from rural exports as the main category of exports to minerals.³ Notwithstanding the fact that the Asian expansion absorbed some of our surpluses, this left our exports in a weak position, at ever unstable and deteriorating trend terms of trade.⁴

When the full employment period broke down with the collapse of the Breton Woods system, and therefore the collapse of the fixed parity system, Australia was in a double bind over the future of exchange rate movements. Whatever the direction of exchange rate changes, there would be net negative effects on the domestic economy. The movement of exchange rates cannot be explained by equilibrium theory, as it is the result of disequilibrium movements in capital. Given that peculiar nature of Australia's imports and exports, exchange rate movements are unlikely to lead to improvements in the balance of trade. As most of our exports are primary commodities, they adjust more to changes in world income than to prices, so that they are relatively price inelastic. Imports are mainly intermediate and final manufacturing goods. Demand for these is income elastic, but will display asymmetry with respect to price elasticity. Due to the limited nature of import competing domestic industries, there is a low supply elasticity of import replacement. As a result, a real exchange rate depreciation would hit the industrial base by causing increased cost of imported capital goods, without bringing forth domestic substitutes. So the likely impact would be inflationary. A revaluation, on the other hand, would have a more ambiguous effect on the industrial base. It would hit the industrial base by increasing imports of consumer manufactured goods, whose demand is relatively price elastic

for reductions in price, while at the same time it would reduce the costs of imported inputs.⁵ In either case it is likely that the industrial base will be squeezed. This is because the industrial base is too weak to regenerate itself. Instead of becoming stronger during the 1950–1973 period, the structure of the local economy became less adaptable as it still relied heavily on a declining primary sector. So, it absorbed passively the negative effects of exchange rate changes. This may be contrasted with Sweden and Finland who actively used exchange rate policies to restructure the economy, eg. by combining devaluation with retraining programmes and investment programmes to retrain and re-equip the economy for the new conditions, so making the economy more flexible.

Given these questions, we would like to start by focusing on the manner in which the full employment phase was brought to an end. It is true that unemployment started growing in the late 1960s in all OECD countries. On this basis we have the following typology. Some countries, such as Sweden, accepted the cost of the international crisis without creating mass unemployment and later undertook restructuring without substantial increases in unemployment. Sweden was able to achieve this due to its advanced machine tool industry which allowed the core of the economy to survive. Japan reacted to the crisis by slowing down its growth rate and expanding its exports, while at the same time increasing its degree of specialization and sophistication in its production of capital goods, and introducing specific import constraints. The same can be said about Germany, with the important difference that they did not eschew mass unemployment. However, this mass unemployment was felt most by the “guest workers”, who, in effect, constitute a disenfranchised group within the population, and who became the catalyst for the frustrations created by the dangers of unemployment.

An intermediate situation occurred in France and Italy where some sectors were made efficient while others were retrenched, with little concern about unemployment. Nevertheless, even in these cases, the structure of the economy was not allowed to deteriorate too much. That is, the capacity of the economy to accumulate was not reduced, so net investment in productive capacity was maintained. As a result, the potential exists, in the face of a change in the balance of political power towards labour, for the economic machinery being sufficiently strong to *allow* the economic transition to alternative policies.

Finally, there is a fourth case of countries under-going severe deindustrialization, especially the USA and Great Britain. The former is still the largest single capitalist unit in the world economy and its analysis would require a separate discussion. Australia followed the path of Britain, with two important differences. Firstly it has much less industrial capacity than Britain, making it more difficult to reverse the trend. Secondly, the importance of financial capital in Britain has led to a conflict between financial and industrial capital which has hastened the decline of the latter.

Australia was hit by the changes of the seventies on two fronts: firstly the initial increase in the price of raw materials raised the cost of production causing a cost push inflation, as was the case in all other industrialised countries. This took place in an environment characterised by extreme competition in manufacturing products coming from South East Asia and Japanese economic areas where development was showing much greater scale economies than anywhere else in the world. Secondly, since Australia's position in the world economy was determined by primary products, their increase in price crowded out the manufacturing sector eventually leading to a Gregory effect by the late 1970s and early 1980s. From a rational perspective increases in raw material prices and in the exchange rate should have helped modernize the economy as capital goods became relatively cheaper. Australia could have built a sophisticated and specialized industrial structure. However, due to the Gregory effect the increase in raw material prices had the opposite impact via an over-valued exchange rate leading to serious contractions in the manufacturing sector rather than to expansion. This further led to speculative gains in the raw materials sector, and a standard recession in the industrial sectors.

That there has been no transition to a more sophisticated manufacturing export base, and no fundamental change from Australia's traditional reliance on raw material and commodities exports is well documented. In addition, there are indications of a long term decline, of at least 20 years, in our terms of trade, which are likely to continue for some time.⁶ Given the fact that the potential for the development of a sophisticated manufacturing base is waning, and given the fact that SE Asia has become a pole for capitalist development in its own right which implies the creation of large productive capacities and sectors, it will be very difficult to restart the industrial development of Australia. It is far easier for a country like Switzerland to find a place in an international division of labour alongside South Korea as it produces engines, turbines etc. That is, it has industrial structure typical of a very advanced country, whereas Australia will play typically the role of perimeter producer at the periphery of an industrial pole.

Overall, what we see is the tremendous importance of international forces for Australia's growth.⁷ This is reinforced by historical evidence which shows a strong correlation between world economic activity and Australia's growth. It is our contention that demand factors originating from overseas have provided the main restraints to domestic growth. In particular, the structure of the domestic economy limits its ability to respond to increased aggregate demand without either domestic bottle-necks or balance of trade constraints. These constraints are reinforced by the nature of our exports and imports.

13.4 Structural Problems Under Labor

Against this background, we can evaluate the policies of the Labor Government since 1983. Instead of being concerned with long term questions of

the structure of the Australian economy, the Labor government has been more concerned with short run problems relating to maintaining steady macroeconomic performance so as to ensure electoral victory. In particular their policies have led to an over-valued exchange rate, so as to ease inflationary pressure. This, coupled with the effects of financial and exchange rate deregulation, in turn reinforced short and long run balance of payments problems. The net effect of this is to augment long run pressures which tend to reduce the size of the industrial sector. To combat these, especially the effects on the balance of payments, the government has attempted to reduce the level of domestic demand. The main instrument for this has been high interest rates, which also serves to maintain a high exchange rate. This has been reinforced by deregulation of both the exchange rate and of financial markets. The cumulative effect of these is to make any long term investment less attractive, and make the market more myopic. This has manifested itself in a decline in private fixed investment expenditure (except in building and construction), and a shift towards the acquisition of financial assets.⁸ The deregulation of the exchange rate has led to greater volatility, and this has had serious implications for investment. Great variability in the exchange rate discourages long term investment for a number of reasons:

1. variability in the price of imported inputs leads to variability in costs
2. variability in price of imported substitutes, makes it difficult to predict future demand
3. variability in the exchange rate itself encourages investment in short term, liquid projects as this increases the ability of business to take advantage of exchange rate fluctuations, or to bail out if it looks like the currency is sinking
4. variability in export prices discourages investment in export industries.

On top of this the deregulation of financial markets and the high interest rates have led to a strong bias towards investment in financial assets and to an increase in the number of mergers and takeovers as substitutes for investment in industry.

One of the main arms of government policy was The Accord, which essentially enabled the reduction of real wages, in return for a trade off for higher growth and employment. However, this did not lead to a strengthening of industry. Despite the fact that there was a substantial increase in corporate profitability during the 1980s, for all the reasons we have discussed, real fixed capital expenditure investment did not increase.⁹ As a result, the gains from The Accord were short term, in terms of employment during the 1980s, with no implications for long term growth, employment or structure.

This has been reinforced by the level playing fields view, which has led to reduced government involvement on the rationale that it would allow market forces free play. However, all this has done is to reinforce the power

and monopoly elements that already exist. Level playing fields only advantage those who already have power. The emphasis on “market forces” and (so-called) “level playing fields” are ideological rather than aimed at any real benefit to efficiency. “Market forces” are the sum total of different balance of powers, they do not themselves guide things but are the outcome of processes which are at the level of decision making. So these forces are the sum total of the relation of the market and the state, and are often the result of previous intervention. This is shown very well by the experience of many of the countries of East Asia (particularly Japan and South Korea) where the development of capitalism has been the result of deliberate interventionism. In no way do their capitalist successes correspond to the blue print of a free market.

In Australia the deindustrialization gave power (social and economic) to those sectors, like finance, which are relatively free from the industrial base, and which have been motivated by the characteristics of the free markets i.e. short term interests. The issue of world markets will become a battle of productive capacities, fortresses of productive capacities. In Australia there has been a prevalence of those groups which call for a total hands-off policy, ignoring the implications for the domestic economy. For example, such policies will lead to further worsening of raw materials terms of trade, as strong countries like US impose their conditions on Asia, as they are forced, increasingly, to rely on the export of primary goods.¹⁰ Australia cannot compete as an equal in such an arena.

This approach should be rejected, as indicated by the failure of the market orientated policies. Such policies as devaluation and deregulation have been tried and shown not to work.

As we have argued, the result of these policies has been an effective deindustrialization of the economy, a winding down of the manufacturing sector; which has been reinforced by the resource boom. The result of this has been that, for any given level of demand, our balance of payments is in a worse position than it would otherwise have been. This can be illustrated by an examination of import penetration, defined as “the ratio of the real value of imports to real sales to the domestic market” (Bureau of Industry Economics, 1989, p. xv). The figures reveal a definite upward trend in both real and nominal import penetration during the 1980s. From the late 1960s until the early 1980s, real import penetration before duty was around 20%, and after duty around 22%, while nominal import penetration after duty was about 18% until the mid 1970s, and around 23% for the rest of the 1970s. All of these rose in the 1980s. Real pre-duty import penetration was around 24%, post-duty import penetration around 26% and nominal post-duty import penetration around 28.5% from the mid 1980s on. (Bureau of Industry Economics, 1989, Appendix 3) While these data should be interpreted cautiously, they lend support to the view that there has been a greater than trend increase in reliance on imports during the Labor years.

This has led to a vicious circle, where the deterioration in the balance of payments has led to the government applying contractionary policy to dampen demand. However, the main instrument for this contraction has been the interest rate, which merely accelerates the problem by reducing long term investment, while, at the same time, inducing capital inflows to keep the exchange rate artificially high.

What is needed are policies specifically designed to promote industry, especially import competing and export industries, that is, to encourage some sort of switching of resources to the manufacturing tradeable sector of the economy. Here we should distinguish between the traditional tradeable sector of the Australian economy, the rural sector, and the possibility of encouraging manufacturing tradeables. It is to the latter of these that we believe policy should be specifically aimed. In Australia's case, it has been shown that the response of structure to changes in price is extremely weak,¹¹ so that other forces will be needed to induce structural change.

13.6 Conclusion

The above analysis raises some important questions and issues. Firstly, it is an attempt to raise awareness of the dangers stemming from the weakening of the productive base, as well as the problems inherent in relying on traditional sectors. At the same time it is an argument against dismissing Australia's current problems as being due to our being at the bottom of a cycle. Rather, it identifies the current situation as resulting from longer run structural problems. We stress the fundamental weaknesses to the economy resulting from deindustrialisation,¹² coupled with the increasingly dominant role of financial capital. From the structural approach we can deduce the movement of capitalist groups towards finance; leading towards a euthanasia of the industrialists. This creates major problems as it eliminates the possibility of an accord between industry and labor. This was precisely the philosophy behind the Accord; however, the very policies of Hawke's government helped create the environment in which financial capital took centre stage, thereby rendering The Accord impotent.

Therefore, given increasing importance of financial capital, and the weakening of the industrial sector, reindustrialization will be an uphill battle.

Notes

We wish to thank, but in no way implicate, Ian Inkster, Greg Mahony, John Nevile and Trevor Stegman of the University of New South Wales, Bruce MacFarlane of Macquarie University and Harry Bloch of the University of Tasmania.

1. For an alternate view of the flexibility of Australia's labour market see Withers (1987) and Nevile (1990).
2. See Foster and Stewart (1991) p. 11.

3. Ibid p.10.
4. See Gruen (1986) FitzGerald and Urban (1989) and Abelson (1989).
5. See Pope (1981).
6. See references for footnote 4.
7. See McLean (1989).
8. The evidence for these empirical observations can be found in Stegman (1990).
9. See Stegman (1990).
10. Ermini and Halevi (1989) argue that the US, which is now the biggest debtor nation in the world, will only be able to address its trade deficit problems by an aggressive export policy. They further argue that, because of the loss of technological edge in manufacturing, such a policy "can only rest on raw materials and agricultural products", (see pp. 10–11).
11. See Dixon (1989).
12. We have taken the importance of the industrial sector as the main vehicle for growth as granted. See, also, Eatwell (1982) and Rowthorn (1989).

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14

Corporatism in Australia

Peter Kriesler and Joseph Halevi

The paper looks at the development of corporatism, first in terms of its European antecedents, then in terms of its adoption in Australia in the 1980s. The historical development of European corporatism is outlined from its formulation within Catholic social thought. Two variants of corporatism are identified. The first, which was closely associated with fascism, aimed at institutionalisation of industrial relations within government departments as a way of controlling labour organisations. This can be contrasted with the second form of corporatism, essentially a post-war European (especially Swedish) phenomenon, which brings labour organisations into the decision process.

After examining recent developments in European corporatism, the relevance to Australia is examined. Corporatism was explicitly taken up by the Australian trade union movement in the 1980s as a result of the breakdown of post-war economic consensus following economic instability in the late 1970s and early 1980s. The Labor Party, which became the government in 1983, had stressed consensus as the basis of its policy making and in this environment corporatism was perceived as a desirable program. It was manifest in the various Accord agreements between the labour movement and the government, which determined the basis of industrial relations via agreements on work practices and wage outcomes. In the light of these agreements, Australia's economic performance from 1983 is evaluated in terms of the success of corporatist strategies. It is argued that these strategies did not succeed in generating the structural changes necessary for the domestic economy to maintain its international competitiveness, mainly due to the failure of any investment policy.

14.1 Introduction

This paper will deal with the question of corporatism¹ in Australia. At the outset it should be noted that economists tend to pay very little attention

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to the conceptual meaning of the term which has a much wider dimension than a purely economic one and originates from a complex historical process. This is particularly true for the issue of corporatism as it is meant today. Hence the second section will deal with the evolution of the notion of corporatism. Since corporatism is a wholly European phenomenon, the section will be concerned with experiences emanating from European countries. The evaluation of the corporatist project will be conducted by identifying two forms of corporatism. The first pertains to the inter-war period, while the second refers mostly to the system of industrial relations in place in the Scandinavian countries as well as in Germany and Austria. Its existence dates basically from the end of the Second World War.

As far as Australia is concerned, reference to Europe is essential. Indeed, Australia has had – and still has – a number of institutional arrangements bearing a strong resemblance to the inter-war conceptions of European corporatism. More importantly, however, post-war corporatism has become an explicit reference point in the Australian trade union movement during the 1980s. The manner in which corporatism has been incorporated into the Australian economy is examined in Section 3, while Section 4 attempts to evaluate the implications of corporatism for the Australian economy.

14.2 Two Corporatisms

Up to the early 1970s, anyone with a minimal political culture would have associated the term corporatism with fascism, and would have agreed that the elements of corporatism present in the post-war period in Europe represented a form of continuity with the fascist regimes of the inter-war years. Not surprisingly, therefore, a regular stream of studies on corporatism flowed from Italy and France, and from the small, but intellectually powerful, German critical thought. Gradually, during the 1970s, a different conception of corporatism emerged. This was related to a notion of industrial relations based on strong and centralised unions having an institutionalised role in their respective societies.

The first of the two variants of corporatism (henceforth, M1 and M2 corporatism) also gave unions an institutionalised role. However, this institutional role was based on the physical elimination of the pre-existing, autonomously structured, socialist and communist labour organisations. In the M1 framework, industrial relations are governed, principally, by the Ministry of Labour. The unions become, therefore, instruments of mediation and of implementation of the directives springing from the ministry. The juridical and technical forms of M1 corporatism are characterised by a system of arbitration tribunals which, on one hand, absorb the bulk of the energy of the functionaries of the official unions, and on the other, put the unions in a subordinate position. This is so, because the bodies envisaged by corporatism M1 are staffed by lawyers and ‘experts’ of all sorts, i.e. by social

figures belonging to the classes for whom corporatism is a political instrument necessary to anchor the position of the working class at the bottom of the social hierarchy.

Fascism did not invent corporatism, nor did it devise its juridical form. In Europe, corporatist ideas are found first and foremost in Catholic social thought. In countries where Catholicism strongly influenced, directly and indirectly, the formation of political parties corporatism became a central component of a political and economic discourse in opposing the socialist movement² (Germany, Bavaria in particular, Austria, Italy are all examples of this). In Europe, M1 corporatism signified the elimination of the organisations produced by the history of the working class itself. In Latin America, especially in Argentina and in Brazil, it had a more ambivalent role. Corporatist forces in Latin America took from Italian fascism the notion that labour unions should be subordinated to the Ministry of Labour. At the same time, Latin America corporatism represented the institutionalisation of the populist strands emerging from within the labour movement. Thus, as shown by Brazil's political history, corporatist institutions were used by labour leaders to expand their influence while the conservative forces used the same institutions to tighten the controls over labour organisations.

The above situation may be contrasted with M2 corporatism, which is essentially a post-war European phenomenon and remains confined to a relatively small number of countries. It builds upon, rather than rejecting, the autonomy of labour organisations vis-à-vis the state. But the term corporatism does not appropriately convey the character of class relations in the countries described as ruled by the M2 system.

The most important example of M2 corporatism is the Swedish system, which was based on the particular role of the metalworkers connected with a profit squeeze notion of economic progress. The metalworkers would set the pace of wage demands, while the central union would ensure the spreading of those gains to the rest of the workforce. Sustained by appropriate policies by the state – such as retraining programs and taxation policies – the weaker sectors would be induced to react to the profit squeeze by means of technological restructuring. The Swedish case can hardly be called a model, if by model we mean something that can be reproduced regardless of its historical specificity. It took nearly twenty years to materialise in the form of the famous Rehn plan in 1951. It began to unravel in the mid-1970s³, precisely when sociologists and economists in the Anglo-American world started to consider it as a viable alternative model.

Austria and Germany are perhaps closer to a corporatist setup, not so much because of the unions' strategic decisions, but because of the historical conditions which marked the evolution of class relations. In Austria, during the inter-war period, corporatist orientations came from conservative Catholic forces who allied themselves with the fascist Heimwehr. This process was crowned by the corporatist constitution passed under the government of

Chancellor Dolfuss in 1934. The stabilisation of the Dolfuss regime was predicated upon the destruction of the social democratic movement, as shown by the military repression of the Vienna pro-democratic uprising in 1934. After the war, Austria underwent a long phase of occupation which lasted till 1955. In this period the Soviet Union pushed for the nationalisation of the heavy industries, while the British, thanks to the farsighted vision of Bevin, pushed for a strong institutionalisation of the reborn social democratic unions. This was done with the objective of limiting the power of the conservative – mainly Catholic – forces who did not shed their traditional corporatist orientations. Hence, if, after 1955, the Austrian labour movement found itself endowed with a greater sphere of institutional influence, it was due to the limits imposed upon the traditional conservative forces of the country.

In Germany, by contrast, the unions found themselves, right from 1949, under the pressure of the old corporatist forces now under the umbrella of the Christian Democratic Party, CDU, and of its Bavarian ally the Christian Socialist Union, CSU. As against the wide ranging reform proposals advanced by the labour movement in 1949, the CDU proceeded to shape the new Bonn republic on the principles of traditional corporatism adapted to a parliamentary regime. The two main aspects of this strategy, were the links between the core firms and the state (Reich, 1990) and the notion of a social market economy. The latter is nothing but a prescription for a tightly hierarchically structured society where the fruits of growth are supposed to be filtered from the top down. The hegemony of the CDU-CSU in shaping the institutions and the priorities of post-war Germany, compelled the labour movement to accept the surrounding economic environment as expressed by the notion of social partnership developed by the German Trade Unions or DGB in the early 1960s.

The common characteristics of the Swedish, Austrian and German experiences in labour relations lie in the sectoral basis of trade unions, relatively centralised wage systems, and the existence of a significant cooperative sector, with its own banks and credit institutions, attached to the social democratic parties. These three elements form the foundations of the politics of class compromise in those countries. Sociologists and economists became attracted by these experiences because, as the post-war boom ended, they appeared to show a greater degree of social equity and economic rationality than the purer forms of capitalism of North America and Britain. Economists have usually taken the first two of the above three elements as hallmarks of the post-war corporatist model M2, forgetting that – as Eduard Bernstein clearly realised at the beginning of the 20th century – the creation and expansion of the cooperative movement was to act as a prime mover in the transformation of labour's politics from class confrontation to social participation.

There are some crucial problems in transforming M2 corporatism into a normative model. The main limitations lie in that M2 experiences are all

strictly determined by the nature of class and social relations prevailing during the formative years of each of the corporatist M2 experience. In matters related to the political economy of the state in the post-war period, as well as to the institutional behaviour relatively to the appearance of economic crises, the historical specificity of each of these cases overwhelms the imputed normative value which, at any one time, can be ascribed to any of the above mentioned experiences.

In Sweden, the labour movement gained the upper hand in 1932 and produced its Rehn model only after many years of social democratic government. This model governed Sweden's political economy for three decades, even the conservative government of the 1976–1982 period was not interested in undoing the institutional structure which sustained it. It is, therefore, understandable why its modification in the 1980s did not entail the outright abandonment of the goal of full employment. To undo it much more systemic forces had to be in operation. Those systemic trends gathered momentum during the 1980s. The core of the Swedish system is represented by the alliance between the large firms and the respective unions, which are structured by industrial sectors. Within the alliance the metal-workers played the crucial dynamic role. They set the pace for wage negotiations and imposed the criteria for achieving international competitiveness. The alliance worked as long as the international expansion of Swedish capitalism did not conflict with the creation of jobs at home. During the 1970s, however, some basic changes took place. Firstly, the share of industrial employment over total employment declined very sharply, more than in the other industrialised countries of Western Europe, with the exception of Britain.

In Germany, on the other hand, it was not business who had to mediate with the position of the labour movement, but the other way around. Like the Social Democratic Party, SPD at Bad Godesberg in 1959, the trade union confederation DGB accepted, in spite of the strong reluctance of the IG Metall, the framework laid down by the CDU leadership. The idea of social partnership was an attempt to mediate with the idea of a social market economy emanating from the traditional corporatism of the CDU. The objective was really to link up wage bargaining and macroeconomic employment policies. In this respect, the German trade unions had a strikingly different impact on society when compared to their Swedish colleagues. Indeed, unlike the Swedes, they never succeeded in linking together those two elements. By the end of the 1960s, the unions put much faith in Karl Schiller's brand of Keynesianism. Schiller's technocratic Keynesianism contrasted with any autonomous wage push by the union movement, even if the latter was the result of the profit explosion following the recovery from the 1966 recession (Hennings, 1982). The unions viewed Keynesianism as a way to shift the pattern of capitalist accumulation in Germany from investment goods and exports to more domestic oriented activities. Instead, Schiller's approach was to combine Keynesianism with an export oriented effort obtained by

means of greater concentration, which, in the eyes of the SPD technocracy, would bring about greater efficiency. Thus in the wake of wage increases, the SPD government did not recoil from enforcing tight fiscal policies leading to very un-Keynesian results: an export surplus combined with a fiscal surplus.

In the 1968–1973 period – the phase in which conditions were, politically and economically, most favourable to the labour movement in Germany's post-war history – the unions failed to bridge the gap between the strategies related to wages and working conditions and those related to employment oriented macroeconomic policies. This failure is not so much due to 'errors' on the part of the DGB, but to the fact that in order to establish that link effectively the whole nature of the German corporatist – CDU inspired – relations had to be challenged. The virtual impossibility of breaking out of a purely industrial relations framework has been confirmed and, indeed, strengthened during the 1970s and the 1980s. In these two decades Germany's unions had to accept the supremacy of the Bundesbank and its prerogatives, although they periodically aired Keynesian alternatives. The most important of these was the so-called **Keynes plus** plan launched in 1981. The **plus** element of the plan consisted in tying employment policy to a comprehensive reformulation of the manpower policy of firms. This plan was never to be heard of again.

The subaltern position of West German trade unionism – institutionalised during the roll back period of the 1950s – led, especially since 1974, to a redefinition of the social basis of the labour movement itself. In other words, Germany's unions, might have been relatively successful in preventing a widening of the wage dispersion but, they had to submit themselves to the deliberate formation of a reserve army of the unemployed, something unthinkable in the Swedish context. The *de facto* acceptance of unemployment produced, in the process, a redefinition of the social basis of the labour movement. The creation of mass unemployment hit, principally, the immigrant workers who, early in the 1970s, emerged as a particularly militant segment of the working class. During the rest of the decade, however, due to unemployment and to the ensuing policies by Bonn's authorities, many immigrants left the country, in total more than 600 thousand of them. In practice the labour movement, although reluctantly, acquiesced to the new situation by concentrating mostly on the defence of German workers. This was nothing but an expression of impotence relatively to the employment issue. In the 1980s, with the **Keynes plus** plan silenced, unions showed the cooperative attitude in relation to industrial restructuring (Katzenstein, 1989), by subordinating themselves to the export oriented priorities of Germany's monetary authorities and business in general. In the end, labour virtually abandoned any idea of reflationary policies and agreed to subject employment prospects to the growth of exports (*Die Zeit*, 1985, Nos 28 and 49). The role of unions, sustained by corporatist arrangements, was seen by the DGB leadership as contributing to the retraining policies necessary to keep up German competitiveness.

The second line of defence adopted by German unions did not lead to significant gains on the unemployment front, but yielded some important results in relation to the composition of employment. During the 1980s, unemployment peaked at 8 per cent in 1985, then easing to 6.2 per cent in 1990. In the second half of the decade, the 'participation' in retraining policies aimed at expanding Germany's export drive, contributed to safeguarding the position of male industrial workers. The share of industrial employment over total employment declined, by 1990, to 39.8 per cent from a post-war peak of 47.1 per cent attained in 1968. This represents the slowest decline among the European countries. Most of the reduction occurred in the ten years spanning from 1974 to 1983, thereafter the fall in the industrial share was only 1.3 per cent. In this context, the slow fall in unemployment rates after 1985 benefited chiefly male workers. Unemployment rates for women remained steady at 9-8.8% from 1983 to 1989. Employment prospects for women improved somewhat only after the growth rate of the German economy increased significantly in the 1988-1990 period.

Thus, in the 1980s German unions did go through a marked corporatist transformation in the traditional meaning of the word corporatism. At its face value, corporatism M1 recognises the validity of defending the interests of wage earners not in class terms, but purely in sectional terms. The road travelled by German unions points to a corporatist M1 transformation in the sense that, after the spate of workers' militancy in 1969 and 1972, which involved many immigrants and women, the unions witnessed a systematic restriction in their social sphere of action. Initially, they *de facto* de-linked themselves from immigrant labour, then, during the stagnation of the 1980s, they concentrated on industrial, mostly male, workers. This was not the result of a deliberate strategy. The unions of the Federal Republic of Germany (FRG) did not decide to abandon immigrant workers, nor did they deliberately choose to defend male over women workers. Instead, the sectionalism, hence corporatism, of the unions' sphere of action was the result of the prerogatives imposed on them by the policies of the monetary authorities and which, in their drive for exports, tended to favour the capital and investment goods industries. Of the two forms of corporatism, the inter-war variant – that is the fascist variant – is closer to the status of a model in a legal sense. This is so because the juridical and technical norms regulating M1 corporatism were consistent with the declared objective of eliminating the socialist movement from the body politic and of relegating the working class to a subordinate position. Corporatism was, in this sense, genuine since it institutionalised a tight hierarchy of class relations without establishing any formal wage productivity links or employment objectives. M2 corporatism is a hybrid collection of experiences resulting, mostly, from the post-war situation. Just as M1 corporatism was the expression of the political and economic crises of the inter-war period, M2 corporatism was sustained by the determination shown by European governments in the first

two decades after 1945 to maintain high growth rates. When this determination began to fade (as predicted by Kalecki in 1943) the parameters of M2 corporatism were also affected, including those of Sweden.

14.3 The Aussies: nach Europa und zurück

This brings us to the important question of where Australia fits into the picture. Given the importance of the Catholic church in the evolution of corporatism as well as its role in the development of Australia, it would be surprising if there had been no attempt to reproduce corporatism. In particular, the Catholic church has played an important part in both the union movement and in the Labor party. In fact, during the McCarthy years, the vehement anti-communism of the church led to the split in the Labor party which kept the conservatives in power, at the Federal level, until 1972.⁴

Australia's early history had elements of M1 corporatism without fascism. This early form of corporatism was centred on a number of policy imperatives. The most important of these was the general acceptance, from Federation until the early 1980s, of protectionism as a national economic strategy by all players in the economic and political spheres. In addition, until the 1970s, there was general agreement as to the nature of immigration policy.

European corporatism was explicitly taken by the Australian trade union movement as a reference point for reconstructing Australian industrial relations in attempting to develop a full employment economic policy for the 1980s. Before this explicit adoption of M2 corporatism by both the Federal Government and the union movement, the unions maintained centralised control over the wage decision process. In addition, for historical reasons, the process of arbitration of wage decisions was also conducted at a centralised level, with representatives of employers, unions and the Federal Government making their case before a federal court. This court set minimum award wages, which were also suggestive for the majority of workers who received over award payments. As a result, labour relations were – and still are – governed by a system based on the Conciliation and Arbitration Tribunals, the legal configuration of which bears a strong resemblance to the corporatist code formulated by the Italian nationalist jurist, and Mussolini's minister of justice, Alfredo Rocco. In these bodies unions are relegated to a subaltern role. The outcome of wage negotiations is decided on a pre-eminently legal basis in which judges and lawyers play a dominant role in what are, in fact, economic decisions.

The important point to note is that, despite the centralised wage system, the union movement, before the 1970s did not have macroeconomic policy objectives. The high levels of employment in the post war period meant that these were taken for granted so that union activity focused on the question of wages and conditions. This partly explained the lack of any discussion of the need for structural policies, which was reinforced by the fact that,

with the important exception of capital goods and some final consumption goods, Australia produced nearly everything which it needed. In terms of the economic debate, it was argued that the main fetter on growth was the need to import financial capital and services.

Thus, the conversion of the Australian unions to corporatism M2 is to be explained by two facts, one concrete and one idealistic. The material one is represented by the breakdown of the economic stability which allowed Australian early corporatism to survive, while the second is related to the explicit import of ideas derived on the basis of the Swedish experience.

14.3.1 The Breakdown of Economic Stability

For almost the whole period of 1949 to the beginning of 1980, Australia had a surplus in its trade account, while a substantial deficit in the income and services account led to a current account deficit for most of that time. Throughout that period, Australia had a net surplus on private sector capital inflows. This was put down to the country's relative youth, which was used to explain the scarcity of capital. The situation changed with the deregulations of the 1980s, which had substantial impacts on the domestic economy. Before then, Australia's economic growth had been based on the primary goods sector, while the manufacturing sector played a secondary role. Despite the substantial inflow of foreign capital, as well as direct investment by multinational companies, the secondary role of the manufacturing sector has not changed. This is because foreign investment in Australia was not dynamic; the domestic market generated levels of demand below that of the expertise and technical level of those firms. The multinationals' aim was never to use Australia as an export base; production was aimed exclusively at the small domestic market, so there was never any intention to generate economies of scale. Rather than being part of an overall production strategy by these companies, multinational investment in Australia was merely an attempt to exploit quasi-rents resulting from domestic tariffs. Tariffs were unable to engender a local capital goods industry of specialised machine tooling.

During this time, Australia's growth rate, although allowing the maintenance of full employment, was, nevertheless, relatively low. This was due to the maintenance of the importance of the primary goods sector in the structure of the economy. Initially this was related to Australia's ties to the United Kingdom, which was its main importer until the mid-1960s. This role was then taken over by Japan (see Foster and Stewart, 1991: 11). At the same time there was a switch from rural exports as the main category of exports to minerals (Foster and Stewart, 1991: 10). Notwithstanding the fact that the Asian expansion absorbed some of the surpluses, this left exports in a weak position, at ever unstable and deteriorating trend terms of trade (see Gruen, 1986; FitzGerald and Urban, 1989; and Abelson, 1989). That there has been no transition to a more sophisticated manufacturing export base, and no fundamental change from Australia's traditional reliance on raw material

and commodities exports is well documented. In addition, there are indications of a long term decline, of at least 20 years, in the terms of trade, which are likely to continue for some time (see Gruen, 1986; FitzGerald and Urban, 1989; and Abelson, 1989).

When the full employment period broke down with the collapse of the Bretton Woods system, and therefore the collapse of the fixed parity system, Australia was in a double bind over the future of exchange rate movements. Whatever the direction of exchange rate changes, there would be net negative effects on the domestic economy. The movement of exchange rates cannot be explained by equilibrium theory, as it is the result of disequilibrium capital flows. Given the peculiar nature of Australia's imports and exports, exchange rate movements are unlikely to lead to improvements in the balance of trade. As most of Australia's exports are primary commodities, they adjust more to changes in world income than to prices, so that they are relatively price inelastic. Imports are mainly intermediate and final manufacturing goods. Demand for these is income elastic, but will display asymmetry with respect to price elasticity. Due to the limited nature of import competing domestic industries, there is a low supply elasticity of import replacement. As a result, a real exchange rate depreciation would hit the industrial base by causing increased cost of imported capital goods, without bringing forth domestic substitutes. So the likely impact would be inflationary. A revaluation, on the other hand, would have a more ambiguous effect on the industrial base. It would hit the industrial base by increasing imports of consumer manufactured goods, whose demand is relatively price elastic for reductions in price, while at the same time it would reduce the costs of imported inputs. In either case it is likely that the industrial base will be squeezed. This is because the industrial base is too weak to regenerate itself. Instead of becoming stronger during the 1950–1973 period, the structure of the local economy became less adaptable as it still relied heavily on a declining primary sector. So it absorbed passively the negative effects of exchange rate changes. This may be contrasted with Sweden and Finland where active exchange rate policies were used to restructure the economy, e.g. by combining devaluation with retraining programs and investment programs to retrain and re-equip the economy for the new condition, so making the economy more flexible.

Australia was hit by the changes of the seventies on two fronts: firstly the initial increase in the price of raw materials raised the cost of production causing a cost push inflation, as was the case in all other industrialised countries. This took place in an environment characterised by extreme competition in manufacturing products coming from South East Asia and Japanese economic areas, where development was showing much greater scale economies than anywhere else in the world. Secondly, since Australia's position in the world economy was determined by primary products, their increase in price crowded out the manufacturing sector. The main

mechanism through which this occurred was through the appreciation of the exchange rate which reduced the ability of the limited manufacturing sector to compete with imports. This influence was especially strong in the late 1970s and early 1980s, leading to deindustrialisation. From a rational perspective increases in raw material prices and in the exchange rate should have helped modernise the economy as capital goods became relatively cheaper. Australia could have built a sophisticated and specialised industrial structure. However, due to these effects, the increase in raw material prices had the opposite impact via an overvalued exchange rate leading to serious contractions in the manufacturing sector rather than to expansion. This further led to speculative gains in the raw materials sector, and a standard recession in the industrial sectors.

The crisis of the 1970s, just outlined, brought about the collapse of the division of tasks between unions, firms and the government which had dominated Australian economic life since the 1945. According to this implicit arrangement, unions would be concerned with wages and conditions with no involvement in investment decisions, which were deemed to be the exclusive domain of management. Employment, on the other hand, was thought to be a matter for government policies. The conservative governments of the 1950s and 1960s operated well within these parameters.

The crisis shattered the post-war consensus. During the first half of the 1970s Australia was governed by a very advanced Labor Government under the leadership of Gough Whitlam. On the social plane it was the Whitlam Government, rather than that of Hawke which represented the first attempt to introduce elements of Scandinavian reformism, through the introduction of universal health care and free tertiary education. Whitlam also attempted to defend the bargaining power of labour by setting up, in a period of mounting economic difficulties, retraining programs. It is safe to say that neither labour nor capital were in a position to respond constructively to the crises. The former was still too fragmented in many craft unions and too locked up in a 'wages and conditions' mentality, to shift its emphasis to social policies. The latter, by contrast, saw in the deliberate creation of a reserve army of the unemployed, the most appropriate response to the crisis. From 1976 to 1983 Australia was ruled by a conservative coalition which, while operating on the basis of traditional protectionist principles, attempted to discipline capital against labour through the use of the corporatist legal framework. The threat of the price justification tribunal was used in order to stiffen managements' resistance to unions' demands. This was coupled with the government threatening to take unions to court in order to deregister them. Thus, the institutional framework of mediation – which legally had many elements in common with M1 corporation – was being turned into an instrument of confrontation.

Labor's ascendancy to power in 1983 was mostly due to the high level of unemployment (10 per cent) which set in from 1980 onward.

Hawke stressed the idea of reducing unemployment with a policy based on compromise, in direct contrast to the confrontational policies of Fraser. Its first task was to disentangle labour from capital and to create a climate where – to use a phrase of the then treasurer Paul Keating – those who rule wages rule the country. The Accord constituted, in effect, the basis for both the disentanglement and the implementation of the second task. However, the Accord did not represent a sufficient condition: as such it did not reflect any specific union strategy, thereby appearing as a government directive. Furthermore, its implementation required a consolidation of the multitudes of Australian unions into a smaller number of larger organisations, which became an explicit policy requirement. The only large organisation which could act as a gravitational force was the left wing Metalworkers' Union, always used to concerted forms of action.

In this context, the Communist led metal workers union was coopted into the Accord platform as the crucial force which was supposed to provide the union specific input to the policy framework.

14.4 The Import of the Swedish Model

It is important to realise that the introduction of the corporatist policy by the Labor party occurred in two stages. On the political front, Hawke explicitly adopted a conciliatory and consensus approach to economic policy making as a reaction to the confrontationist regime of Fraser. Part of this policy, devised before the election of the Labor Government in 1983, involved an agreement between the Labor Party and the union movement, subsequently called the Accord. The unions, under the leadership of the metal workers union, later, after research into European models, published a document called *Australia Reconstructed* which explicitly proposed a Swedish type corporatism with centralised wage fixing and an agreement with the government linking productivity and employment in exchange for wage indexation.

The underlying idea of the Accord was a commitment to full wage indexation and an alternative to the confrontationist policies of the previous conservative government. The first Accord was aimed at achieving full employment growth without, at the same time, contributing to inflation, as the following extract from its introduction indicates:

It is extremely significant that the countries which have managed to fare better in this time of economic adversity, particularly by keeping unemployment to relatively low levels, have been notably those countries which have eschewed monetarism and have instead placed substantial importance on developing prices and incomes policies by consultation.

It is with this experience in mind that both organisations [the Australian Labor Party and the Australian Council of Trade Unions]

have seen fit to try to develop a mutually agreed policy on prices and incomes in Australia for implementation by a Labor Government. Such a policy offers by far the best prospect of enabling Australia to experience prolonged higher rates of economic and employment growth, and accompanying growth in living standards, without incurring the circumscribing penalty of higher inflation, by providing for resolution of conflicting income claims at lower levels of inflation than would otherwise be the case. With inflation control being achieved in this way, budgetary and monetary policies may be responsibly set to promote economic and employment growth, thus enabling unemployment to be reduced and living standards to rise. (*Statement of Accord by the Australian Labor Party and the Australian Council of Trade Unions Regarding Economic Policy*, 1983, Appendix A in Stilwell, 1986: 160)

In the early years of the Accord, the union movement had no explicit model of what they were trying to achieve, other than a general commitment to wage restraint and full employment, identified in this agreement. This brings us to the second stage of the Accord, which was the result of the unions studying Sweden in 1986. In the early 1980s, the ACTU sent a delegation to Northern Europe and Germany, to study their experiences of corporatism and to prepare a report of the applicability of these experiences to Australia. The unfortunate upshot of this was that the specific history and social institutions of the Australian economy were ignored in the recommendations. Rather, the report implied that the outcome of the Swedish case was desirable, and assumed that to achieve the same results all that was needed was to implement the same policies thus ignoring both fundamental differences between the countries, and the changes in the world economy which undermined the Swedish and German strategies.

Australia Reconstructed (ACTU/TDC, 1987), the report of the ACTU mission to Scandinavia and Germany, took the Swedish system, which was based on their metalworkers, as well as the German retraining system, as the basis of an attempt to shift the Australian labour movement's outlook away from a purely wages and conditions approach. However, they did this without any realistic idea of the direction in which they were leading. In particular, two major shortcomings of the blind absorption of the Swedish system must be pointed out. The first relates to the character of Australian unionism and to the role of the government, while the second relates to the evaluation of the economic situation in both Sweden and Australia.

The problem which led to the abandonment of the Swedish model as a policy option in the Australian case was the different nature of the structure of unions. In the European example, unions were sectorially based, so that union policies implied sectoral policies. In Australia, by contrast, unions were trade based, and so crossed over many sectors. This meant that there was no logical benefit from union wide retraining programs as these crossed

many non-intersecting skill requirements. In Sweden and Germany the capital goods sector was nurtured by capitalists independently of unions, and there are highly specialised technical skills schools. There is no equivalent in Australia, where education tends to be unrelated to skills. In Germany and Sweden the relation between the importance of metal workers and the importance of the capital goods sectors meant that there was an important related role for technical skills. In Australia, highly skilled tradesman replaced the capital goods sector, so skills, and hence retraining, was not attached to individual sectors. This makes the Swedish/German model of retraining inapplicable to Australia.

There was an additional consideration from the macro-side, related to the role of the government. In Sweden the public sector maintained a significant role in terms of spending, particularly on infra-structure. This did not happen in Australia, where, on the contrary the Federal Government intentionally changed policy to generate a budget surplus in the late 1980s. In order to consider the question of the stance of government policy, it is not sufficient to merely analyse the size of its deficit as is well known, the size of the government sector deficit is determined not only by its policy stance, but also by the state of the economy. Therefore to consider the underlying policy intention, it is important to discuss the 'structural' deficit, that is, the deficit corrected for cyclical effects⁵. Both the actual and the structural deficits are shown in Table 14.1.

To understand the second aspect of the inapplicability of the Swedish model to Australia, we need to look more closely at what happened in Sweden. In a recently published paper Rudolf Meidner (1993), the father, with Rehn, of the Swedish model, identified the failure of the Swedish experiment in two inter-related phenomena which occurred in the last two decades: the growth of white collar employment and of the financial sector.

Unlike Germany, Sweden experienced a very steep decline in the share accruing to industrial employment. The concomitant rise of white collar employment, Meidner argues, brought to the fore other types of unions which were politically neutral and not interested in centralised wage fixing. As a result, 'the homogeneous union movement became fragmented and conflicting interests debilitated Lo's fight for egalitarian wage structure' (Meidner, 1993: 223).

Alongside this phenomenon the economic transformation of Sweden was no longer allowing the implementation of a profit squeeze strategy to sustain the egalitarian wage structure. The other side of the coin is that the more efficient firms actually obtain extra profits. As long as production was essentially domestically based and legal controls inhibited the free movement of international capital, profitable firms tended to reinvest the extra profits in the domestic economy. All this started to wane with the transnationalisation of Swedish firms and with the lifting of financial controls. Today, Swedish capital is free from restrictions and can flow out of Sweden

Table 14.1 The structural deficit Australia: 1973–74 to 1993–94

	Actual Deficit (\$m)	Structural Deficit ^(a) (\$m)
1973–74	1.4	-3.0
1974–75	4.1	-3.1
1975–76	4.2	-1.3
1976–77	3.6	-0.6
1977–78	5.1	0.5
1978–79	5.1	1.6
1979–80	3.8	-0.9
1980–81	3.3	-1.3
1981–82	3.6	-1.0
1982–83	6.1	-0.9
1983–84	7.4	2.9
1984–85	5.7	2.1
1985–86	5.7	1.5
1986–87	4.8	0.4
1987–88	1.3	-1.7
1988–89	-0.7	-2.9
1989–90	1.1	-0.5
1990–91	2.6	-0.4
1991–92	5.6	2.0
1992–93 ^(b)	5.7	1.8
1993–94 ^(c)	6.0	1.8

Notes: a) Rows may not add to total due to rounding.

b) Based in part on preliminary data.

c) Based on forward estimates and estimates by the author.

Source: Nevile, 1995.

in search of better financial returns or for cheaper labour. In Sweden, as well as in the UK, the decline in manufacturing jobs has not been compensated by the rise of services.

When Australian unions were studying the Swedish experience they were looking, in 1986, at something which was passing away, because it was not compatible with Swedish capitalists' interests. However, one finds no hint in the Australian report of the dire straits in which the Swedish economy was finding itself.

The attempt to copy Sweden blindly could have been mitigated by a sober comparison with the Australian situation. In terms of the composition of employment, similar trends as in Sweden prevailed. Yet, in Australia's case, the rise in the service sector – mostly banking, finance and tourism – the decline in industry and the formation of a plethora of small technologically primitive business (especially in NSW) did not mean the growth of another form of unionism. Instead, the shrinking of industry meant the exit from unionism altogether. Thus, precisely when, under the leadership of the

metalworkers, Australian trade unions was trying to counter the negative influences of the 1970s by means of the Accord and of a Swedish inspired form of centralisation, their social basis was being pulverised. The 1980s represent indeed a decade of sharp decline in union membership and in the social basis of centralised wage fixing: from August 1986 to August 1992, trade union membership fell six percentage points, from representing 46 per cent of full time employees, to representing only 40 per cent (ABS, 1993b).⁶

Structurally, Australia has been experiencing since the early 1970s a decline in the role of industry and a formidable expansion of finance. Unlike Sweden, industry in Australia has not played a dynamic role as it was a passive importer of capital goods, often using already obsolete production lines. As a result of the industrial crisis in the 1979–83 recession, manufacturing began to be perceived as dwindling and sectors like finance and tourism were portrayed as being the saviours of the economy. The Australian Labor Government *de facto* accepted this view, while deriving its stability from an agreement with a predominantly industrial union movement, soon to be marginalised.

The basic agreement between the Labor Government and the union movement, the Accord, underwent many important changes as a result of the changing economic environment. So far there have been seven different versions of the Accord. The earlier versions of the Accord were mainly restricted to agreements about the level of wage increase. Initially, full wage indexation was agreed upon. However, Accord Mark 2 eroded this, as a result of the major depreciation of the value of the currency in 1985. The inflation rate was discounted for the effects of the depreciation, so that partial indexation resulted. It was the later versions of the Accord, from Mark 3 on, which explicitly incorporated the corporatism M2 considerations derived from the Swedish model. As a result, considerations other than wage setting entered into these later agreements, in particular measures aimed at inducing productivity growth, such as retraining and reskilling, as well as measures aimed at changing the nature of industrial relations, such as reductions in the number of unions, and a shift towards enterprise agreements.

These recent changes to the basis of Accord agreement have had two significant effects on the labour market and on the potential of corporatism. The first of these has been the push to reduce the number of unions. This has been extremely successful, with the number of unions falling from 326 in June 1986 to 188 in June 1993 (ABS, 1993 a,c). Although this has tended to increase the centralisation of wage bargaining decisions, it has not solved the fundamental problem of Australian unionism, that, rather than industry or firm based unions, they are occupationally based so that agreements within an industry still involve many different unions. The other, more recent, policy push has had the opposite effect. This has been the attempt to decentralise the main elements of corporatism by the implementation of enterprise bargaining. In other words, instead of the main agreements affecting labour coming from an agreement at the economy wide level, enterprise bargaining would break this

down so that each enterprise would be required to enter its own agreement, although the agreement must be made through existing unions.

14.5 Corporatist Policies under Labor

Against this background, we can evaluate the corporatist policies of the Labor Government since 1983, to see whether there has been the necessary change in the underlying structure of the economy to allow the return of full employment. Instead of being concerned with long-term questions of the structure of the Australian economy, the Labor Government has been more concerned with short-run problems relating to maintaining steady macroeconomic performance so as to ensure electoral victory.

One of the main uses which the government made of the Accord was to legitimise a reduction of real wages, in return for a trade-off for higher growth and employment. However, this did not lead to a strengthening of industry. Despite the fact that there was a substantial increase in corporate profitability during the 1980s, real fixed capital expenditure investment did not increase (see Stegman, 1993). As a result, the gains from the Accord were short term, in terms of employment during the 1980s, with no implications for long-term growth, employment or structure.

The fundamental problem with corporatism is that, instead of being a basis for a program of economic reform, with agreements not only in the labour market but also with both financial and industrial capital, the lack of involvement of capital has reduced its effectiveness. Instead of encouraging investment, the Accord has proved to be a way of reducing real wages in order to provide short term gains in employment⁷. With no investment policy, there was no discussion as to required change in the structure of the economy. As a result, the serious deterioration in Australia's current account throughout the late 1980s meant that any gains were quickly reversed.

The essential problem has been the lack of involvement of capital as part of the Accord. This may not have been important, if it had brought a stable economic environment and encouraged investment. However, this has not been the case, due to the victory of financial capital at the expense of industrial capital.

This has been reinforced by the level playing fields view, which has led to reduced government involvement on the rationale that it would allow 'market forces' free play. However, all this has done is to reinforce the power and monopoly elements that already exist. Level playing fields only advantage those who already have power. The emphasis on market forces and (so-called) level playing fields are ideological rather than aimed at any real benefit to efficiency. Market forces are the sum total of different balance of powers, they do not themselves guide things but are the outcome of processes which are at the level of decision making. So these forces are the sum total of the relation of the market and the state, and are often the

result of previous intervention. This is shown very well by the experience of many of the countries of East Asia (particularly Japan and South Korea) where the development of capitalism has been the result of deliberate interventionism. In no way do their capitalist successes correspond to the blueprint of a free market. In Australia there has been a prevalence of those groups which call for a total hands-off policy, ignoring the implications for the domestic economy. For example, such policies will lead to further worsening of raw materials terms of trade, as strong countries like the USA impose their conditions on Asia, as they are forced, increasingly, to rely on the export of primary goods. Australia cannot compete as an equal in such an arena.

Overall, what we see, then, is the tremendous importance of international forces for Australia's growth. This is reinforced by historical evidence which shows a strong correlation between world economic activity and Australia's growth (see McLean, 1989). It is our contention that demand factors originating from overseas have provided the main restraints to domestic growth. In particular, the structure of the domestic economy limits its ability to respond to increased aggregate demand without either domestic bottlenecks or balance of trade constraints. These constraints are reinforced by the nature of Australia's exports and imports.

This, coupled with the effects of financial and exchange rate deregulation, in turn reinforced short- and long-run balance of payments problems. The net effect of this is to augment long-run pressures which tend to reduce the size of the industrial sector. To combat these, especially the effects on the balance of payments, the government has attempted to reduce the level of domestic demand. The main instrument for this has been high interest rates, which also serves to maintain a high exchange rate. This has been reinforced by deregulation of both the exchange rate and of financial markets. The cumulative effect of these is to make any long term investment less attractive, and make the market more myopic. This has manifested itself in a decline in private fixed investment expenditure (except in building and construction), and a shift towards the acquisition of financial assets.⁸ The deregulation of the exchange rate has led to greater volatility, and this has had serious implications for investment. On top of this, the deregulation of financial markets and the high interest rates have led to a strong bias towards investment in financial assets and to an increase in the number of mergers and takeovers as substitutes for investment in industry.

In Australia, deindustrialisation gave power (social and economic) to those sectors, like finance and recreational services, which are relatively free from the industrial base, and which have been motivated by the characteristics of the free markets i.e. short-term interests. In addition, both finance and recreational services have an extremely low proportion of union membership,⁹ so that this structural change contributed to the decline in unionisation of the work force discussed above.

One of the main consequences of deregulation of financial and exchange markets has been the massive blow out of Australia's foreign debt, as indicated in Figure 14.1.

The size of the foreign debt has had major implications for the current account balance. As can be seen from Figure 14.2, since 1983, the net income component has been growing, and has come to dominate the current account, being the main reason for it being in deficit in the early 1990s. Net income has been mainly determined by the repayments of foreign debt.

This has led to a vicious circle, where the deterioration in the balance of payments has led to the government applying contractionary policy to dampen demand. However, the main instrument for this contraction has been the interest rate, which merely accelerates the problem by reducing long term investment, and, at the same time inducing capital inflows to keep the exchange rate artificially high.

The failure of corporatist policies to lead to the desired restructuring of the economy has meant that it has also failed in terms of its major goal, namely employment. Initially, Australia's record on the employment front, from 1983, was extremely good, with respect to other OECD countries. However, as is demonstrated in Figure 14.3, this position deteriorated significantly at the end of the 1980s, when unemployment peaked at its highest level since the second world war. This deterioration was the result of contractionary government policy specifically aimed at alleviating the current account problems identified above. In other words, corporatism in Australia has had little influence on the underlying structure of the economy, leaving it susceptible to the same international forces that have always played a role.

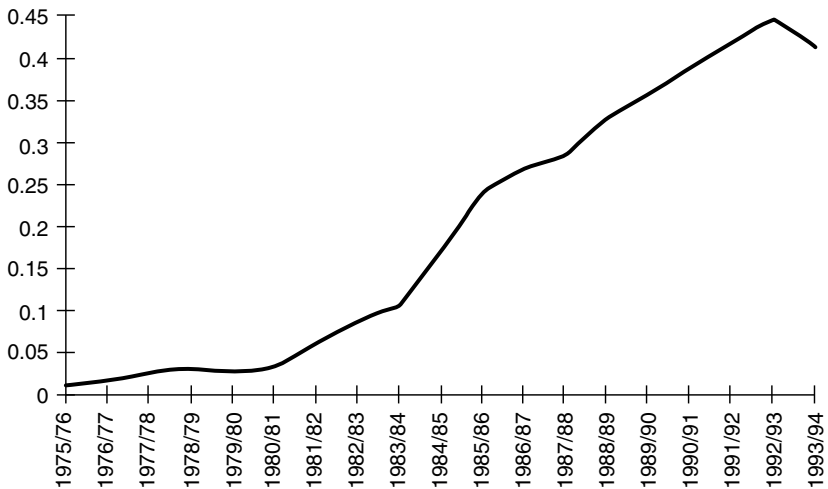


Figure 14.1 Ratio of net foreign debt to GDP

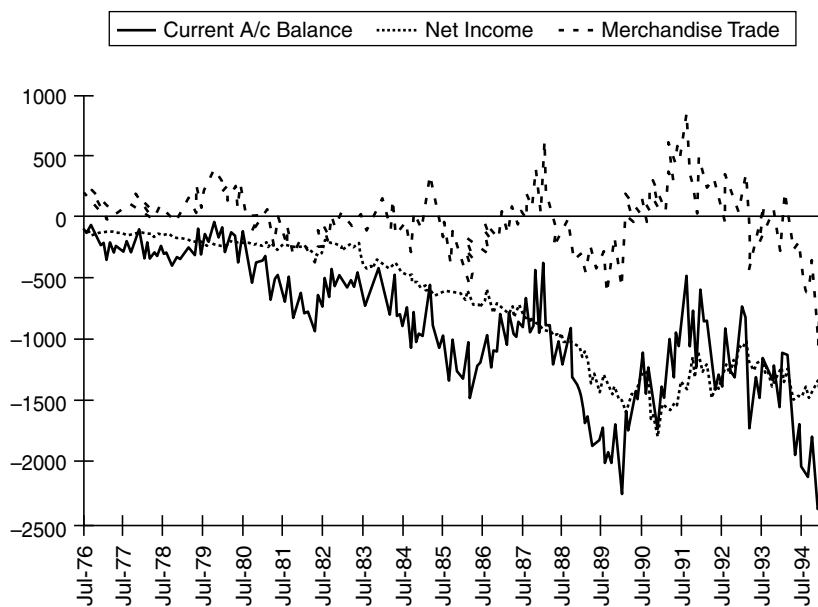


Figure 14.2 Australia's current account (seasonally adjusted \$M)

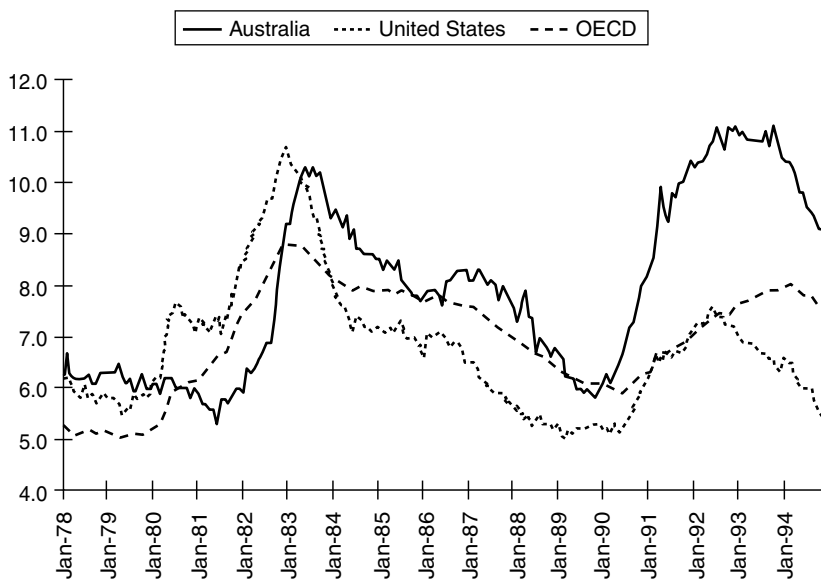


Figure 14.3 Unemployment rates

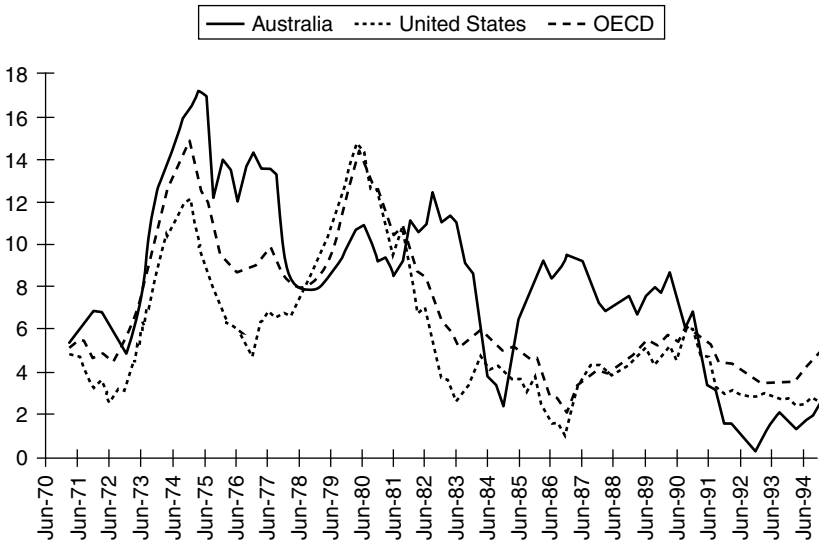


Figure 14.4 Inflation rates (percentage change in CPI)

The one major macroeconomic variable which appears to have performed well in the early 1990s is the rate of inflation. Certainly there was a significant downward trend in Australia's inflation rate for much of the early period of the Labor Government. However, this needs to be put into perspective compared to the inflation rates of her major trading partners. In this respect, Australia's performance only improved relatively, as a result of the **recession** and the consequent fall in aggregate demand, as is illustrated in Figure 14.4.

Although the relatively low level of inflation is a positive outcome, there are two important considerations which mitigate that result. Firstly the low inflation rate is associated with high social costs in terms of record levels of unemployment. Secondly, there is some debate as to whether the reduction in inflation is, in fact, permanent, or whether it is simply the result of a postponing of wage and price increases until recovery.

14.6 Conclusion

The above discussion has illustrated that the corporatist experiment has not been successful for the Australian economy. The Swedish model, and the main characteristics of M2 corporatism on which the Australian post-1986 experience was based, was not appropriate for Australian conditions. The extent to which connections can be found to M2 Swedish corporatism and the Australian situation, these relate to the same forces which have undone

the structural basis of the full employment polity of Sweden, namely internationalisation of capital and the spread of finance. The fundamental problem facing the Australian economy in the 1980s and 1990s was structural, based on the inadequacy of the industrial base. The declining world importance of raw materials, which had been the traditional base of Australian growth, meant that there was a need for other sectors to emerge. Partly as a result of policy, particularly deregulation, the emerging sectors, finance and recreation, were heavily service orientated, and undermined the basis of corporatism, which required a dominant union movement.¹⁰

Notes

1. For a discussion of the meaning and history of corporatism see Halevi (1987).
2. In Australia the Catholic church has, historically, played a significant political role. Since the second world war, it has been associated with anti-communist movements in the Labor party. Hence, there are important connections, in Australia with M1 corporatism.
3. For reasons discussed below.
4. According to Professor Bruce McFarlane (personal communication) of the University of Newcastle, part of the agenda behind the split was an attempt to change the direction of the Labor party in order to change its ideology into that of an agrarian corporatist culture.
5. Nevile (1994) contains an excellent discussion of the principles behind the derivation of the structural deficit, as well as an explanation of how the values for Table 14.1 were derived.
6. Peetz (1990) argues that structural change changing the composition of employment accounted for over half the decline in union density from 1980 on.
7. See Flatau et al. (1991) who argue that the Accord increased the influence of 'outsiders', particularly the unemployed, and, as a result, employment levels were higher than they otherwise would have been.
8. The evidence for these empirical observations can be found in Stegman (1993).
9. In August 1992, 28.4 per cent and 21.8 per cent respectively (ABS, 1993b).
10. For an overview of recent developments in the Australian economy see Kriesler (1995).

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15

Structural Change and Economic Growth

Joseph Halevi and Peter Kriesler

15.1 Introduction

It has been widely asserted that structural change is a necessary condition for the Australian economy to enjoy sustained economic growth at a satisfactory level. In this chapter, we examine the question of why structure is important, before looking at the general structural constraints on the Australian economy, concentrating on the inadequate development of the capital goods sector. Finally, we consider the ways in which the Labor Government's policies have influenced the structure of the Australian economy. It is our contention that these policies have had an inhibiting effect on the economy, as they have, *inter alia*, adversely influenced investment decisions, thereby increasing Australia's vulnerability to international trends.

15.2 Traditional Views

Most analysis of Australia's economic growth has focused on supply-side factors. In particular, analysis has concentrated on issues associated with allocative efficiency such as the role of price signals on productivity and thrift. It has often been argued that growth has been hampered by low savings and by policy-induced market imperfections, e.g. tariffs in the product market and the effects of arbitration in reducing the flexibility of the labour market.¹ Gruen, in an important article on Australia's economic performance, (Gruen 1986) clearly blames our low growth rate on these factors. He accepts that Australia has had relatively low productivity growth, but argues that this is the result of immigration. This is a difficult position to sustain given that he also acknowledges our low per capita investment over the same period (p. 185). Similarly, the EPAC (Economic Planning Advisory Council) growth

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papers emphasise allocative efficiency. However, as has been noted by Asproumouros and White (1990):

At the deepest theoretical level, EPAC's treatment of efficiency in relation to growth may be construed as a corollary of its lack of interest in the problem of the relation between demand and productive capacity (p. 18).

This paper argues that it is this latter factor which explains Australia's poor performance, and that underlying structural problems, associated with the failure to develop a capital goods sector, explain Australia's relatively low growth performance.

15.3 Historical Overview

Historically, it has been a characteristic of the Left to focus on issues of structure. The economy is conceived in terms of sectors which can generate growth and accumulation and can endogenously create new technologies which then affect the rest of the economy. At times this approach has been very reductionist, in the sense that it identified only very specific branches of industry such as steel and so-called heavy industries as the main engines of growth. Yet, it had some sound basis, at least conceptually, in the sense that it had a clear view of the hierarchical structure of production. Perhaps too much constrained in its own reductionist approach and becoming aware that it was no longer workable, in the last ten years in Europe (except Scandinavia and Germany) and Australia the labour movement all too quickly accepted the tenets of monetarism and post-industrialism, abandoning the notion of structure all together. The years of the crises for the labour movement were also the years in which labour lost its structural perspective.

For Australia, as well as for the labour movement in general, it is important to return to a structural perspective. In our view, the starting point requires an analysis of the breakdown of the system of regulatory forces which governed the Australian economy until the early 1970s, i.e. until the end of full employment. More specifically, is it correct to argue that during the 1950s and 1960s Australia could sustain full employment and high gross domestic product per head as well as serving domestic demand through domestically produced output? In other words, was it the case that during this time, Australia had a substantially larger industrial base than it has today? So the question becomes: what were the structural features of accumulation in Australia? In particular, which were the sectors which pushed accumulation and which were the sectors which were towed by it?

As has been well-documented, it has been the primary goods sectors, especially wool, wheat and coal which have provided the main basis for expansion, while the manufacturing sectors have played a secondary role. Unfortunately, these foundations have not significantly changed, so that

with the long-term decline in agricultural terms of trade, Australia's potential for capital accumulation has been significantly eroded.

Historically, Australian economic growth has shown unique weaknesses for a high per capita income economy. Growth rates are most meaningful in comparative terms. Maddison (1989) has measured long-term growth from the middle of the last century to 1987 and what emerges is that the growth rate of per capita GDP in Australia in the 1900–87 period was 1.4 per cent per annum, on average, which is equivalent to the British growth rate, the lowest of the 16 OECD (Organisation for Economic Cooperation and Development) countries. The turning point for Australia was the depression which followed the First World War, highlighting the high cost of the war for Australia. This, combined with the Great Depression, resulted in a growth rate of GDP per capita in the 1900–50 period of 0.8 per cent, compared to an equivalent OECD average of 1.3 per cent, and the British average of 0.8 per cent. If we look at the post-war (1950–87) period, the Australian GDP growth rate of 2.1 per cent per capita was slightly below the British at 2.2 per cent, but slightly above that of Canada (2.0 per cent) and the United States (1.9 per cent).

An important question, then, is why has the growth rate hovered around this relatively low rate? The clue must lie in the nature of long term investment. Can we say, for example, that like post world war USA, there were stagnationist factors at work? There should not have been, due to both immigration and policies designed to sustain growth, such as large capital schemes like the Snowy Mountains Scheme. Instead, is the clue in the structure of industry? Has investment caused endemic unused capacity due to actions by large multinationals, so that sectors were born on an oligopolistic basis?

A highly monopolised/concentrated sector need not necessarily be subject to unused capacity, if the surplus is used for capital accumulation (investment) or exports, as was the case in the early phase of post-war growth in Japan and current phase of growth in South Korea. Concentration was used, in such instances, to obtain economies of scale, and high domestic profits were used to subsidise exports and help them penetrate foreign markets. This contrasts with multinational investment in Australia which was not dynamic; the domestic market generated levels of demand way below that of the expertise and technical level of those firms. The multinationals' aim was never to use Australia as an export base. Rather, production was aimed exclusively at the small domestic market, so there was never any intention to generate economies of scale. Instead of being part of an overall production strategy by these companies, multinational investment in Australia was merely an attempt to exploit quasi-rents resulting from domestic tariffs and quotas. The tariffs were unable to engender a local capital goods industry of specialised machine tooling. As all of this occurred within a period of fixed exchange rates, where there were none of the problems caused by the exchange rate volatility of the 1980s, the potential was there to build

a strong local capital goods industry. This is especially true as, at that time, Australia had reached a higher stage of development than its Asian neighbours and so had potential export markets. The conditions for sustained economic development were never used to advantage in the Australian economy in the post-Korean War period (1953–73), despite the fact that the period was characterised by full employment. Australian growth rates at the time were similar to those of the United Kingdom. The low full employment growth rate can be explained by the maintenance of the importance of the primary goods sector in the structure of the economy. Initially, this was related to our ties to the United Kingdom, which was the main importer of our goods until the mid-1960s. As is indicated in figure 15.1 below, this role was then taken over by Japan.

At the same time, there was a switch from rural exports as the main category of exports to minerals.² Notwithstanding the fact that the Asian expansion absorbed some of our surpluses, this left our exports in a weak position, with an ever unstable and deteriorating trend in the terms of trade.³

When the full employment period broke down with the collapse of the Bretton Woods system, and therefore the collapse of the fixed parity system, Australia was in a double bind over the future of exchange rate movements. Whatever the direction of exchange rate changes, there would be net negative effects on the domestic economy. The movement of exchange rates cannot be explained by equilibrium theory, as it is the result of disequilibrium movements in capital. Given the peculiar nature of Australia's imports and exports, exchange rate movements are unlikely to lead to improvements in

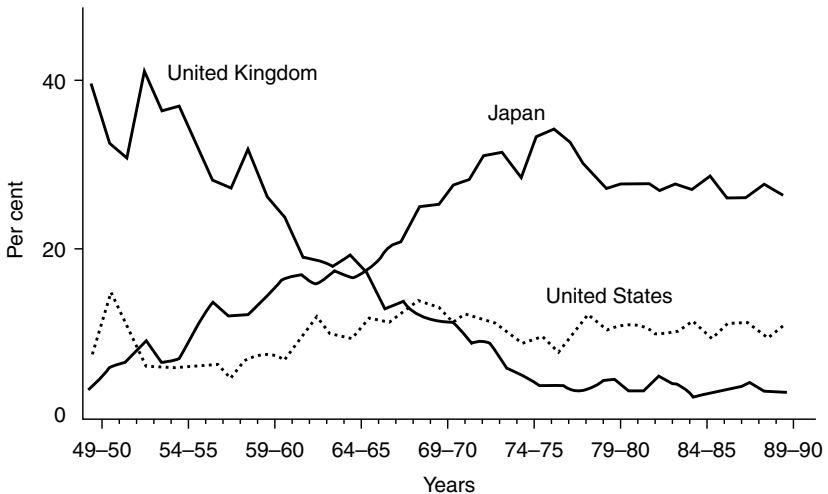


Figure 15.1 Exports by country (per cent to total)

Source: Reserve Bank of Australia, occasional paper, no. 8, 1991, p. 11.

the balance of trade. As most of our exports are primary commodities, they adjust more to changes in world income than to prices, and so are relatively price inelastic. Imports are mainly intermediate and final manufacturing goods. Demand for these is income elastic, but will display asymmetry with respect to price elasticity. Due to the limited nature of import competing domestic industries, there is a low supply elasticity of import replacement. As a result, a real exchange rate depreciation would hit the industrial base by increasing the cost of imported capital goods, without bringing forth domestic substitutes. So the likely impact would be inflationary. A revaluation, on the other hand, would have a more ambiguous effect on the industrial base. It would hit the industrial base by increasing imports of consumer manufactured goods, whose demand is relatively price elastic for reductions in price, while at the same time it would reduce the cost of imported inputs.⁴ In either case, it is likely that the industrial base will be squeezed. This is because the industrial base is too weak to regenerate itself.

Instead of becoming stronger during the 1950–73 period, the structure of the local economy became less adaptable as it still relied heavily on a declining primary sector. So it passively absorbed the negative effects of exchange rate changes. This is in contrast with Sweden and Finland where active exchange rate policies were used to restructure the economy, e.g. by combining devaluation with retraining programs and investment programs to retrain and re-equip the economy for the new conditions, so making the economy more flexible.

Given these questions, it is appropriate to focus on the manner in which the full employment phase was brought to an end. It is true that unemployment started growing in the late 1960s in all OECD countries. On this basis we have the following typology. Some countries, such as Sweden, accepted the cost of the international crisis without creating mass unemployment and later undertook restructuring without substantial increases in unemployment. Sweden was able to achieve this due to its advanced machine tool industry which allowed the core of the economy to survive. Japan reacted to the crisis by slowing down its growth rate and expanding its exports, while at the same time increasing its degree of specialisation and sophistication in the production of capital goods, and introducing specific import constraints. The same can be said about Germany, with the important difference that it did not eschew mass unemployment. However, this mass unemployment was felt most by the 'guest workers', who, in effect, constitute a disenfranchised group within the population, and who became the catalyst for the frustrations created by the dangers of unemployment.

An intermediate situation occurred in France and Italy where some sectors were made efficient while others were retrenched, with little concern about unemployment. Nevertheless, even in these cases, the structure of the economy was not allowed to deteriorate much. That is, the capacity of the economy to accumulate was not reduced, so net investment in productive

capacity was maintained. Since these economies maintained their capital goods sectors they retained the ability to overcome economic crisis and to accumulate. However, the overcoming of the crisis still required a change in the balance of political power and today this change has to be in favour of labour, which is the only social class interested in real growth; the capitalist class is increasingly interested in financial accumulation.

Finally, there is a fourth case of countries undergoing severe de-industrialisation, especially the USA and Great Britain. The former is still the largest single capitalist unit in the world economy and its analysis would require a separate discussion. Australia followed the path of Britain, with two important differences. Firstly, it has much less industrial capacity than Britain, making it more difficult to reverse the trend. Secondly, the importance of financial capital in Britain has led to a conflict between financial and industrial capital which has hastened the decline of the latter. This conflict has only become important in Australia in recent years, especially following financial deregulation.

Australia was hit by the changes of the seventies on two fronts. Firstly, the initial increase in the price of raw materials raised the cost of production causing cost-push inflation, as was the case in all other industrialised countries. This took place in an environment characterised by extreme competition in manufacturing products coming from South-East Asia and Japan where development was showing much greater scale economies than anywhere else in the world. Secondly, since Australia's position in the world economy was determined by primary products, the increase in their prices 'crowded out' the manufacturing sector, eventually leading to a Gregory effect (Gregory 1976) by the late 1970s and early 1980s. From a rational perspective increases in raw material prices and in the exchange rate should have helped modernise the economy as capital goods became relatively cheaper. Australia could have built a sophisticated and specialised industrial structure. However, due to the Gregory effect, the increase in raw materials prices had the opposite impact as an over-valued exchange rate led to serious contractions in the manufacturing sector, rather than to expansion. This led to speculative gains in the raw materials sector, and a standard recession in the industrial sectors. The long-term decline in the manufacturing sector is illustrated in figure 15.2 where the dramatic fall in the share of employment in manufacturing since the mid-1960s is shown.

That there has been no transition to a more sophisticated manufacturing export base, and no fundamental change from Australia's traditional reliance on raw material and commodities exports is well documented. In addition, there has been a long-term decline in our terms of trade for at least 20 years, which is likely to continue for some time.⁵ So the potential for the development of a sophisticated manufacturing base is waning. In addition, South-East Asia has become a centre for capitalist development, resulting in large productive capacities which are capable of supplying world markets.

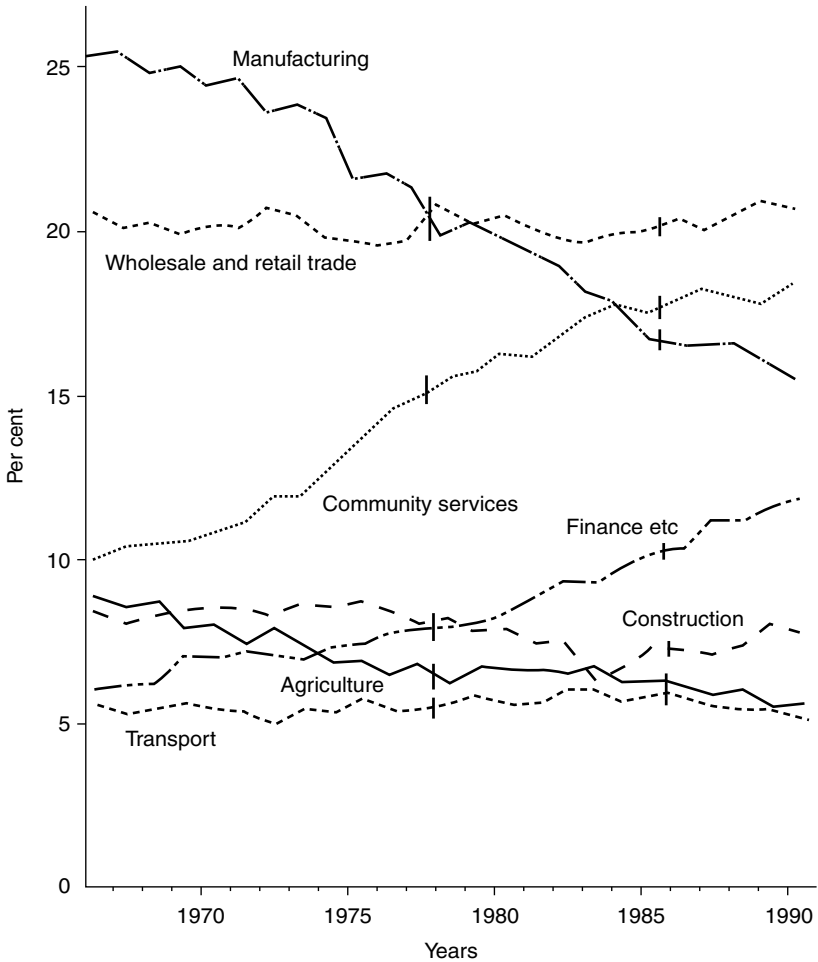


Figure 15.2 Employment by Industry (per cent to total)

Source: Reserve Bank of Australia, occasional paper, no. 8, 1991, p. 165.

These factors make it very difficult to re-start the industrial development of Australia, since the possibility of finding sectors in which to obtain economies of scale are limited. A small country like Switzerland has an industrial structure typical of a very advanced country, whereas Australia will play typically the role of perimeter producer at the periphery of an industrial centre. Switzerland can find its markets in specific branches of sophisticated production such as turbine engines, alongside a mass producer like Korea.

Overall, we believe international forces have had a significant bearing on Australia's economic growth. This is reinforced by historical evidence which

shows a strong correlation between world economic activity and Australia's growth.⁶ It is our contention that demand factors originating from overseas have provided the main constraints to domestic growth. In particular, the structure of the domestic economy limits its ability to respond to increased aggregate demand without either domestic bottlenecks or balance of trade constraints. These constraints are reinforced by the nature of our exports and imports.

15.4 Structural Problems Under Labor

Against this background, we can evaluate the policies of the Labor Government since 1983. Instead of being concerned with long-term questions of the structure of the Australian economy, the Labor Government has focused on short-run issues such as the maintenance of a steady macroeconomic performance to boost their re-election prospects. In particular, their policies have led to an over-valued exchange rate, so as to ease inflationary pressure. This, coupled with the effects of financial and exchange rate deregulation, reinforced short and long-run balance of payments problems. The net effect of this has been to augment long-run pressures which effectively reduce the size of the industrial sector. To combat these effects, especially on the balance of payments, the Government in the mid-1980s and early 1990s attempted to reduce the level of domestic demand. The main instrument for this has been high interest rates, which also serves to maintain a high exchange rate. This has been reinforced by deregulation of both the exchange rate and of financial markets. The cumulative effect of all of these policies has been to make any long-term investment less attractive and the market generally more myopic. This has manifested itself in a decline in private fixed investment expenditure (except in building and construction), and a shift towards the acquisition of financial assets.⁷ The deregulation of the exchange rate has led to greater volatility, as is illustrated in figure 15.3 below.

Greater variability in the exchange rate discourages long-term investment for a number of reasons:

- it increases variability in the price of imported inputs which leads to greater variability in costs for domestic producers;
- it leads to greater variability in the price of imported substitutes, so that it is difficult for domestic competitors to predict future demand;
- it becomes more rational to invest in short-term, liquid projects as this increases the ability of business to take advantage of exchange rate fluctuations, or to bail out if it looks like the currency is sinking; and
- it discourages investment in export industries, as it leads to greater variability in export prices.

In addition, the deregulation of financial markets and high interest rates have led to a strong bias towards investment in financial assets and to an

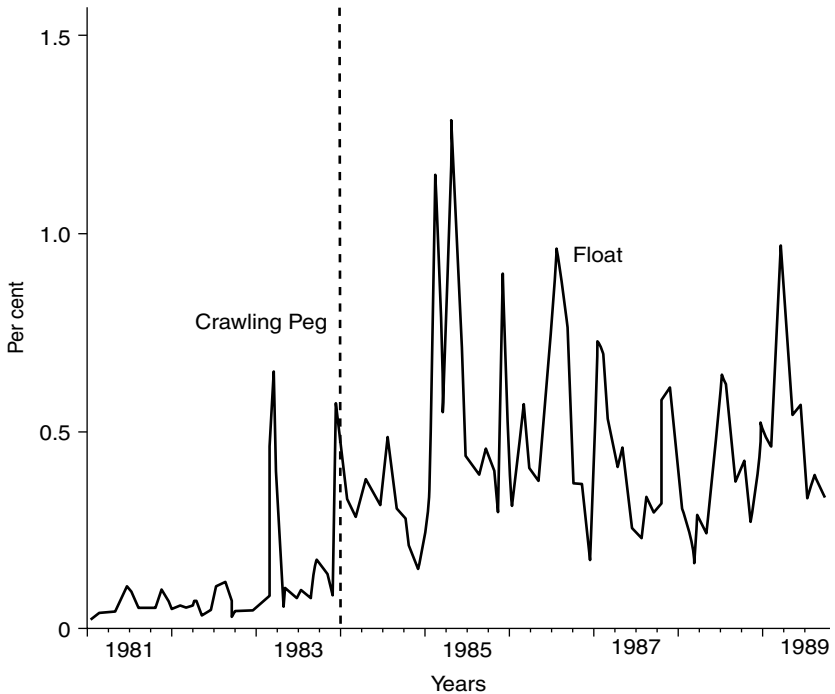


Figure 15.3 \$A TWI volatility (absolute average of daily % change)

Source: Reserve Bank of Australia Monthly Bulletin, Sept. 1989, p. 14.

increase in the number of mergers and takeovers as substitutes for real investment in industry.

One of the main arms of government policy was the Accord, which essentially enabled the reduction of real wages, in return for a trade-off for higher growth and employment. However, this did not lead to a strengthening of industry. Despite the fact that there was a substantial increase in corporate profitability during the 1980s, for all the reasons we have discussed, real fixed capital expenditure investment did not increase.⁸ As a result, the employment gains from the Accord were short-term with no positive implications for long-term growth, employment or industry structure.

This has been reinforced by the 'level playing fields' view, which has led to reduced government involvement with the rationale that it would allow 'market forces' free play. However, all this has done is reinforce the power and monopoly elements that already existed. 'Level playing fields' only advantage those who already have power. The emphasis on market forces and (so-called) 'level playing fields' are ideological rather than aimed at any real benefit to efficiency. Market forces are the sum total of different balances of power. They do not guide outcomes but are merely the results of decision-making

processes. These forces are the sum total of relations between the market and the State, and are often the result of previous intervention. This is illustrated by the experience of many of the countries of East Asia (particularly Japan and South Korea) where the development of capitalism has been the result of deliberate interventionism. In no way do their capitalist successes correspond to the blueprint of a free market.

In Australia, de-industrialisation gave power (social and economic) to those sectors, like finance, which are relatively free from the industrial base, and which have been motivated by the characteristics of the free markets, i.e. short-term interests. The issue of the size and structure of world markets is really a question of the size of different productive capacities, which act like fortresses from which 'attacks' on each other's markets are made. In Australia, those groups which call for a total hands-off policy have dominated, ignoring the implications for the domestic economy. Such policies will lead to a further worsening of the raw materials terms of trade, as strong countries like the USA impose conditions on Asia, because they are forced, increasingly, to rely on the export of primary goods.⁹ Australia cannot compete as an equal in such circumstances.

This approach should be rejected, as indicated by the failure of market-oriented policies such as financial and exchange rate deregulation.

As we have argued, the result of these policies has been an effective de-industrialisation of the economy, i.e. a winding-down of the manufacturing sector, which has been reinforced by the resource boom. The result has been that, for any given level of demand, our balance of payments is in a worse position than it would otherwise have been. This can be illustrated by an examination of import penetration, defined as 'the ratio of the real value of imports to real sales to the domestic market' (Bureau of Industry Economics, 1989, p. xv). A definite upward trend in both real and nominal import penetration is evident during the 1980s.¹⁰ Similarly, the imports to sales ratio has increased beyond its trend level over the Labor years. See, for example, Australian Bureau of Statistics (ABS) Catalogue no. 5206.0, *Australian National Income Accounts*, Main Features. While these data should be interpreted cautiously, they lend support to the view that there has been a greater than trend increase in reliance on imports during the Labor years.

This has led to a vicious circle, where the deterioration in the balance of payments has led to the Government applying contractionary policy to dampen demand. However, the main instrument for this contraction has been tighter monetary policy causing higher interest rates, which aggravates the problem in combination with the dampened demand by reducing long-term investment and, at the same time inducing capital inflows to keep the exchange rate artificially high.

The policies which are needed are those specifically designed to promote industry, especially import competing and export industries, to encourage a switching of resources to the manufacturing tradeables sector of the economy.

In Australia's case, it has been shown that the response of the economic structure to changes in price is extremely weak,¹¹ so that other forces will be needed to induce structural change.

15.5 Conclusion

The above analysis raises some important questions and issues. Firstly, it is an attempt to raise awareness of the dangers stemming from the weakening of the productive base, as well as the problems inherent in relying on traditional sectors. At the same time, it provides an argument against dismissing Australia's current problems as being merely cyclical. Rather, it identifies the current situation as resulting from longer-term structural problems. We stress the fundamental weaknesses in the economy resulting from de-industrialisation,¹² coupled with the increasingly dominant role of financial capital. The movement of capitalist groups to finance has been at the expense of industry, which, therefore, has shown signs of serious contraction. As a result, there has been an effective euthanasia of the industrialist. This creates obvious problems for the possibility of any accord between labour and industry. However, the creation of such an alliance was the keystone of the Labor Government's economic policy, as formally embodied in the Accord. The policies of the Labor Government, which helped create an environment in which financial capital took centre stage also, inadvertently, rendered the Accord impotent. Therefore, with the increasing importance of financial capital, and the weakening of the industrial sector, reindustrialisation will be an uphill battle.

Notes

An earlier version of this *The Australian Economy Under Labour* paper appeared in *The Economic and Labour Relations Review*, volume 2, December 1991. We wish to thank, but in no way implicate, Ian Inkster, Greg Mahony, John Nevile and Trevor Stegman of the University of New South Wales, Bruce MacFarlane of Macquarie University and Harry Bloch of the University of Tasmania.

1. For an alternative view of the flexibility of Australia's labour market see Withers (1987) and Nevile (1990).
2. Foster and Stewart (1991) p.10.
3. See Gruen (1986), FitzGerald & Urban (1989) and Abelson (1989).
4. See Pope (1981).
5. See references for footnote 3.
6. See McLean (1989).
7. The evidence for these observations can be found in Stegman, chapter 6, of this volume.
8. *ibid.*
9. Ermini and Halevi (1989) argue that the USA, which is now the biggest debtor nation in the world, will only be able to address its trade deficit problems by an aggressive export policy. They argue further that, because of the loss of

technological edge in manufacturing, such a policy 'can only rest on raw materials and agricultural products' (see pp. 10–11). Their predictions are increasingly being realised.

10. From the late 1960s until the early 1980s, real import penetration pre-duty was around 20 per cent, and post-duty around 22 per cent. However, nominal import penetration post-duty was about 18 per cent until the mid-1970s, and around 23 per cent for the rest of the 1970s. All of these rose in the 1980s. Real pre-duty import penetration was around 24 per cent, post-duty import penetration around 26 per cent and nominal post-duty import penetration around 28.5 per cent from the mid-1980s on (Bureau of Industry Economics 1989, appendix 3)
11. See Dixon (1989).
12. We have taken the importance of the industrial sector as the main vehicle for growth as granted. See also Eatwell (1982) and Rowthorn (1989).

16

Why Keynesian Policy was More Successful in the Fifties and Sixties than in the Last Twenty Years

J. W. Neville and Peter Kriesler

In the 1950s and 1960s unemployment averaged about 2 per cent. The lowest level of unemployment in the last twenty years was double that and long term unemployment, virtually unknown in the 1950s and 1960s, has been a severe problem. In each period there were two major slumps. We examine the progress of each slump and macroeconomic policy responses in each case, in order to search for reasons for this contrast. The priority given to minimising unemployment rather than restraining inflation is the most important difference between the two periods. Other major principles stand out, the most important of which are that in response to a downturn a fiscal policy stimulus is essential and must play the major part of any response; and that implementation must be swift and then followed up by further measures if necessary.

16.1 Introduction

The focus of this paper is firmly on unemployment. Underemployment, which is people working fewer hours a week than they would wish, is also a problem but generally is well correlated with unemployment. As is documented below, in the nineteen fifties and sixties even in periods when there was a major down-turn in economic activity policy, unemployment was much lower than was the case in the last twenty years. In the 1950s and 1960s unemployment averaged about 2 per cent. The lowest level of unemployment in the last twenty years was more than double that figure. Moreover, long term unemployment was virtually unknown in the 1950s and 1960s but has been a severe problem in the last 20 years. In each period there were two major slumps. This paper examines the macroeconomic

Revised from *Economic and Labour Relations Review*, 22(1): 1–16, 2011, 'Why Keynesian Policy was More Successful in the Fifties and Sixties than in the Last Twenty Years,' by Neville, J. W. and Kriesler, P. With kind permission from SAGE Publications. All rights reserved.

policy responses to each of the four slumps in order to search for reasons for the contrast.

The major conclusion is that the priority given to minimising unemployment, rather than restraining inflation, is the most important difference between the two periods. In the first period maintaining full employment was normally the priority in aggregate demand policy: in the second with few exceptions 'fighting inflation first' was the priority. The clear cut commitment to maintaining full employment in the first period was associated with greater optimism about future prospects among entrepreneurs. Surveys of business expectations are not available for this period, but the results of the optimistic outlook can be seen in the behaviour of entrepreneurs. In addition to this overriding finding, other principles emerge from mistakes as well as successes in each period.

Both 20 year periods¹ contained one very large slump and another slump which although smaller was still very significant. Section 2 describes the two biggest slumps and the policy responses they evoked and Section 3 does the same for the two smaller slumps.

Fighting inflation first was originally adopted when inflation was at a relatively high level due to supply side shocks culminating in the first oil price shocks, and continued with the invalid justification that if inflation was any higher than the current level, it would cause increased unemployment, though why this should occur was never clearly explained. The effect of inflation on unemployment is one of two issues that emerge when the policy implications of the different approaches are examined. This effect is discussed in Section 4 of the paper. The second issue is the importance, or otherwise, of an increasing public debt. This is examined in Section 5 of the paper. Finally, a concluding section draws the threads together.

16.2 The Slumps of 1951–53 and 2008–10

The 1951–53 slump occurred against a background in which there was a widespread belief that the government both could and would keep departures from full employment brief. At the end of the Second World War memories of the depression of the 1930s were still strong and there were fears that, unless policy measures were taken to prevent it, large scale unemployment might reappear. However, at least in English speaking countries there was confidence that economists now knew what to do to prevent this (Colander and Landreff 1996). A belief both in the importance of full employment and the ability to keep departures from it brief was manifest in the White Paper in Australia in 1945 (Commonwealth of Australia 1945). Unlike both the United Kingdom and the United States, Australia had no dip in real gross national product when the economy changed from producing for fighting a war to producing for peace, though there was a small blip in unemployment in 1946–47.² This uninterrupted growth in the Australian

economy no doubt helped entrepreneurs and Australians in general to accept the view that the government could and would keep brief any departures from full employment.

The slump that occurred in 1951–53 was caused by an external shock to the Australian economy. It followed a very strong rise in the price of wool. The price of wool in 1950–51 was double the price in 1949–50. Since the exchange rate was fixed to the pound sterling and other major currencies under the Bretton Woods arrangements, this produced an important increase in national income in Australia. The value of wool exports rose by 347 million pounds in 1950–51 compared to a National Income of 3129 million pounds. The next year the value of wool exports fell by 314 million pounds, precipitating a major slump. There are no official quarterly national income and expenditure accounts for this period but judging by the (lagged) changes in unemployment and other data with a cyclical pattern, the fall in economic activity started around the middle of 1951 and continued until at least the end of 1952. On an annual basis current value gross national product deflated by the Consumer Price Index (CPI) fell by 14 per cent in 1951/52 and was virtually unchanged in 1952/53. If composite indexes are used the story is much the same. It is exactly the same, if the most popular of such indexes, a combination of the CPI and the food and basic materials wholesale price index, is used.

As is typical, the change in the unemployment rate lagged behind changes in deflated national income and product. The number of persons receiving unemployment benefits is shown in Table 16.1. The unemployment rate started to rise slowly in the first half of 1952 then rose rapidly to peak at the end of that year and started to decline in 1953. The Conservative Federal Government acted promptly as soon as there was a significant rise in unemployment, mainly through fiscal policy but also through aggressive relaxation of monetary policy. Tax rates were cut in 1952–53 but the main weapon of fiscal policy was government expenditure. Including special grants to the states to support public works, total Federal Government expenditure increased by virtually one third in 1952–53.³ This was in current value terms but the rate of inflation though still high had fallen to around 10 per cent.

The stance of monetary policy changed even before that of fiscal policy. Under the institutional arrangements current at the time the central bank required commercial banks to lodge money in Special Accounts with the Commonwealth Bank (a special section of the Commonwealth Bank acted as the central bank until 1960). Money in these accounts was in effect frozen and could not be used to support lending. Over the financial year 1951–52 the amount in Special Accounts was more than halved. This was the first time the value of the holdings in Special Accounts had declined in any year. The central bank also purchased government securities on the open market and relaxed the directions it could give to private banks, under the *Banking Act* (1945–1953), about the general nature of their lending.

Table 16.1 Unemployment in the two bigger slumps

Quarter	Persons receiving unemployment benefits (000)
1950-51	
September	0.6
December	0.7
March	0.9
June	0.6
1951-52	
September	0.5
December	1.1
March	3.2
June	5.7
1952-53	
September	21.9
December	36.2
March	35.4
June	26.7
1953-54	
September	21.8
December	12.7
March	11.4
June	6.8
1954-55	
September	4.6
December	3.3
March	4.0
June	3.0
Unemployment rate (%)	
2008-09	
September	4.0
December	4.3
March	5.8
June	5.7
2009-10	
September	5.5
December	5.3
March	5.8
June	5.3
2010-11	
September	5.0
December	4.9
March	5.4

Note: For various reasons not all the unemployed received benefits but two reasons dwarfed the rest. Eligibility for benefits was subject to an income test and benefits were not normally paid to married women. Despite this, changes in the number of persons receiving benefits is a good indicator of changes in unemployment. Data is not seasonally adjusted.

Sources: Quarterly Summary of Australian Statistics and ABS 6202.0 Labour Force, Australia.

Further relaxations were made in October 1952. There were also further, fairly modest, reductions in the amount held in Special Accounts and the Commonwealth Bank increased its lending to local government and semi-governmental authorities.

One further point should be made about the use of monetary policy. The boom in 1950–51 was accompanied by a very high rate of inflation. When the stance of monetary policy started to be relaxed, inflation was still over 20 per cent (as measured by the CPI). The central bank moved very early when it would have had good reason to worry about inflation. Yet despite easy monetary policy and explosive fiscal policy the CPI was only 3.9 per cent (or 0.54 percentage points) higher in June 1953 than its value in June 1952. This followed an increase of 20 per cent from June 1951 to June 1952.

The aggressive fiscal and monetary policy kept the rise in the unemployment rate small and remarkably brief. Over the 20 year period as a whole the unemployment rate averaged about 2 per cent. At its peak at the end of 1952 it was probably barely 1 percentage point above that and then fell rapidly, so that in 1953–54 it was below its average value. Entrepreneurs did reduce expenditure on fixed capital equipment a little, but not by much. The big falls were in export income, in 1951–52, and inventory investment in 1952–53. It appears that a belief that departures from full employment would be brief was a self fulfilling prophecy.

The slump of 2008–2010 was also the result of events external to the Australian economy. In view of the 2010 election campaigns waged by those on both sides of the political fence it is worth reminding ourselves that the crisis in the global financial sector did cause a major world-wide slump of a magnitude not seen since the 1930s and that there is the strong possibility that it will cause a large ongoing increase in structural unemployment.

The cause of the slump can be epitomised in a comment by Krugman (2009) that the financial sector had forgotten the old truth that markets can stay irrational longer than many financial institutions can stay solvent. Global financial crises follow a typical pattern. They are preceded by a period of increasing asset prices. Business balance sheets improve as a result of the increased value of their assets. This improved business confidence encourages investment. Banks, at the same time, are increasingly happy to lend money for these investments.

Financial crises are often precipitated by banks reassessing their liabilities, and requiring repayment of large loans. Businesses, in order to meet those demands, start selling assets, reducing their prices. This leads to re-evaluation of the balance sheets of companies, with many more being driven into serious debt problems, leading to further sales of assets, and to significant asset price falls (Minsky 1985).

The current crisis followed the same basic pattern with two important differences. First, households, as well as firms, went into significant debt; and secondly there is the role of so called 'toxic assets', in particular those

associated with subprime mortgages. The role of credit rating agencies exacerbated the second factor. The new and very complex instruments were given triple A ratings, although in fact they were anything but triple A. Credit rating agencies are paid by those seeking to have assets rated. Credit rating agencies often provide other services for such clients. Either the relevant firewalls were not as good as they might have been or the credit rating agencies were remarkably bad at making rating judgements. In any case, the crisis was triggered by an evaluation that the assets held by many enterprises were, in fact, worth substantially less than their current valuation.

In Australia, the crisis has not only been associated with a substantial rise in unemployment rates, from 4.2 per cent in April 2008 to 5.8 per cent in August 2009, but a significant part of this was long term unemployment. This increased by 50 per cent in the year following its trough in June and July 2008. The following year it was higher again. This contrasts greatly with 1951–53, when total unemployment rose by just over half as much and long term unemployment was virtually unknown.

Substantial falls in GDP occurred too, though not in successive quarters. Prices, especially of staples, also fell, for example the CPI fell by 0.3 per cent in the December 2008 quarter rising in the quarter to March 2009 by only 0.1 per cent. The annual rise in the CPI was 2.5 per cent for the year to March 2009, compared to an annual rise of 3.7 per cent to December 2008.

The Rudd Government's response to this was timely and at first exemplary, but needs to be set in context. In Australia the effects of the global financial crisis were much less serious than in most developed countries. This is largely due to two reasons. First, both the Government and the Reserve Bank acted quickly to stimulate the economy. The speed and size of the increase in government expenditure was the most important part of the stimulus, but the large rapid cut in interest rates also helped. Secondly, our banks were much better supervised than were the banks in many other countries. The high quality level of bank supervision is many decades old but the establishment of the Australian Prudential Regulation Authority in 1998 improved the supervision of other financial companies. Also, the strength both in volume and price of our exports due to the continuing demand for minerals, especially from China, was helpful in containing the recession, though not as important in our judgment as the first two reasons. In short, although increased government expenditure was the most important single thing leading to Australia's excellent record in moderating the recession, a number of other factors made the government's task easier.

Moreover, in 2008 and 2009 the Rudd Government did all the right things in using government expenditure to counter the recession. It started with a \$10.4 billion package, 85 per cent of which flowed to low income families. Virtually all of the rest was a grant to first home buyers which started immediately and finished on a date which was included in the announcement of the grant. Then only a year later almost all the extra government expenditure was switched to a range of investment projects which increased

potential output as well as increasing demand. The total package for the first half of 2008 was roughly equal to 1 per cent of GDP.

In a very useful paper, Gruen (2009) both details the size and the nature (personal transfers or investment) of expenditure and of planned expenditure till the first half of 2012, and also gives the Treasury estimates of the multiplier effects. The Treasury concluded that if it were not for discretionary fiscal policy real GDP would have continued to fall in the first and second quarters of 2009 and the peak unemployment rate would have been 1.5 percentage points higher. Although himself a senior Treasury officer, Gruen thinks this an underestimate because conservative values for multiplier effects were used to estimate it and also because it ignored the feedback effects of better macroeconomic outcomes on business and consumer confidence.

As we noted above, not only did overall unemployment increase substantially in Australia, but much of the increase was structural unemployment, measured as unemployment lasting more than one year. An OECD report (2009) contains valuable empirical material on the extent to which recessions cause long term unemployment.

The limited empirical literature examining the long-run implications of recessions suggest that they result in permanent output losses, and that losses from recessions associated with financial crises are even larger. For example, Kim *et al.* (2005) consider the output response to recessions in Australia, Canada, the United Kingdom, and the United States, and estimate that permanent losses to output range from 1¼ to 5¼ per cent. ... Recent OECD research also finds evidence of persistent output losses from financial crises. Furceri and Mourougane (2009) estimate that financial crises permanently lower potential output by 1½ to 2½ per cent on average, and by up to 4 per cent for severe crises. (OECD 2009: 234)

Of course not all of this output loss is due to structural unemployment, but the OECD notes that a 'particular concern is that much of the substantial increase in unemployment is transformed into higher structural unemployment' (OECD 2009: 239). This was certainly true in Australia. Moreover, the present government's plans to start the process of restoring the federal government budget to a surplus now the economy has started to grow, will help entrench structural unemployment. When healthy growth in economic activity is restored is when the least employable, in the eyes of employers, have the best chance of getting a job. Every effort should be made to help them at this time, particularly through active labour market policies, rather than putting priority on beginning the process of restoring the budget to a surplus.

16.3 The Slumps of 1960–62 and 1990–92

The 1960–62 slump was, at the time, the biggest slump since the 1930s if the size of a slump is measured by the peak value of the unemployment rate.

Many would say that it was a self inflicted disaster, but the original decisions to tighten monetary and fiscal policy, which precipitated the slump, do not appear all that inexcusable given the information available at the time. The fault was the tardiness to recognise the effect of these decisions and to take prompt action to correct them.

In February 1960 the government removed nearly all the import restrictions still in place. This seemed a sensible move designed to reduce inflation. Export prices were rising (or so it was thought). Unemployment was falling and the economy was growing at a satisfactory rate. However, export prices actually fell by 4 per cent in February 1960 and continued to fall for another 11 months. On the other hand, imports in current value terms rose more than expected. Most of this was due to a record increase in the volume of imports, which was even higher than expected, but there was also a modest growth in import prices.

When the budget was brought down in August 1960, unemployment was still falling as shown in Table 16.2, inflation was a little high (around 4 per cent) and was accompanied by a speculative boom. In the June quarter preceding the budget (then in August) the economy was growing rapidly. The budget was a very tight one. Unusually small increases in expenditure were combined with a rise of 5 per cent in the rate of personal income taxation. This tight budget was made tighter by supplementary measures in November, the most important of which were an increase in the sales tax on cars from 30 per cent to 40 per cent and associated changes to tax laws. These measures had the effect of increasing monetary tightness especially in the case of hire purchase companies. It was later realised that the boom had peaked a little before November 1960 and that month passed into mythology as a byword for government incompetence. The tax increase on cars was also particularly unfortunate from the point of view of household expenditure, since many people believed the increase could not be permanent and postponed buying a car. In the event the increase only lasted three months and was reversed in February 1961. The budget for 1961–62 gave a substantial boost to the economy, but not a dramatic one despite the high levels of unemployment. It was made much more expansionary by supplementary measures taken in February 1962, which cut both personal income tax rates and indirect taxes and authorised additional government expenditure. Monetary policy was relaxed in 1961–62 but, despite the consequent fall in interest rates, this had no effect until the following year. This was largely due to uncertain expectations about the future.

The boom had reached its peak in June 1960. In the September quarter real GDP barely rose. Seasonally adjusted, it fell by 1 per cent in the December quarter (i.e. close to 4 per cent at an annual rate) and did not begin steady growth again until the December quarter of the following year. However on a year by year basis output did not fall, it only suffered a sharp decline in the rate of growth which fell in both the years 1960–61 and 1961–62.

Table 16.2 Unemployment in the two smaller slumps

Quarter	Persons receiving unemployment benefits (000)
1960	
March	20.7
June	16.9
1960-61	
September	11.9
December	12.0
March	20.9
June	39.9
1961-62	
September	60.5
December	50.2
March	53.0
June	47.5
1962-63	
September	43.2
December	35.5
March	42.5
June	37.6
1963-64	
September	34.0
December	23.7
March	26.5
June	19.5
1964-65	
September	16.0
December	11.9
March	14.5
June	12.6
Unemployment rate (%)	
1989-90	
September	5.9
December	5.6
March	6.8
June	6.4
1990-91	
September	7.0
December	7.5
March	9.4
June	9.5

(continued)

Table 16.2 Continued

Quarter	Unemployment rate (%)
1991-92	
September	9.7
December	9.9
March	11.2
June	10.6
1992-93	
September	10.6
December	10.7
March	11.8
June	10.7
1993-94	
September	10.6
December	10.5
March	11.2
June	9.8
1994-95	
September	9.2
December	8.8
March	9.6
June	8.2

Note: See note for table 16.1.

Sources: Quarterly Summary of Australian Statistics, and ABS 6202.0 Labour Force, Australia.

Gross private fixed capital formation did fall by 3.3 per cent in 1961-62 but bounced back to rise by 8.1 per cent in the following year. Unemployment was still low in the middle of 1961 but then rose rapidly and subsequently fell slowly. The unemployment rate peaked in 1962 somewhere between 3 and 3.5 per cent but did not fall to an acceptable rate by the standards of the time until the middle of 1964. There was a very widespread belief that the Federal Government had failed badly in its conduct of macroeconomic policy. Menzies only just scraped home in the 1961 election and felt it necessary to set up a Committee of Economic Enquiry (the Vernon Committee) to placate the voters.

There was a large slump in 1982-83 in the 30 years between our two twenty year periods, but more important from the perspective of this paper was the reversal of the priorities given to minimising unemployment and fighting inflation. 'Fighting inflation first' became the policy mantra of the Conservative Fraser government which took office in 1975. Its Treasurer,

Philip Lynch, explicitly rejected 'Keynesianism' and argued for expenditure cuts. Not surprisingly unemployment increased substantially even before the recession mentioned above. However, inflation also remained a problem. After an initial fall from a very high rate, inflation started rising again in 1979–80 and by the end of Fraser's term of office was much the same as in 1976–77. The implicit deflator for gross national expenditure increased by 11.1 per cent in 1976–77 and 10.6 per cent in 1981–82. 'Fighting inflation first' was not a success, partly because contractionary fiscal policy had relied to a substantial extent on raising indirect tax rates and cutting subsidies. Nevertheless, the reversal in policy priorities remained.

The Hawke/Keating economic strategy gave an important role to the Accord, as part of a corporatist model which was meant to deliver to the economy similar benefits to those that corporatism had delivered in the Scandinavian countries. However, there was a fundamental problem in that the business sector did not actively participate in the agreement. This meant that while the Accord delivered short run benefits in terms of lower inflation and unemployment, and at the same time increased the profit share, this did not result in increased investment in real capacity. The overall result was a serious deterioration in Australia's current account balance during the late 1980s.⁴ The problem of the deteriorating current account deficit was compounded by significant increases in foreign borrowing as a result of the Hawke government's 1983 deregulation of the financial sector and of the exchange rate. As a result, Australia's net foreign debt rose from 6.2 per cent of GDP in 1980 to 34 per cent in 1990 (Kryger 2003). Already in 1986 the trend rise in foreign debt had caused Keating to warn that Australia was in danger of becoming a 'banana republic'. It was the net income outflows associated with the foreign debt that were driving the current account deficits. Towards the end of the 1980s these contributed to record current account deficits.

The Reserve Bank, with the encouragement of Treasurer Keating, responded to this by significantly tightening monetary policy. The cash rate reached 18 per cent in the second half of 1989, the mortgage rate rose to 17 per cent and many loans to businesses were well in excess of 20 per cent. The result was a significant increase in the size of the recession at the beginning of the 1990s⁵, culminating in an unemployment rate in 1992 of 10.9 per cent, which was (and still is) the highest since the depression of the 1930s. The depth of the slump was in large part because The Reserve Bank and bureaucrats in Canberra took the opportunity to squeeze inflation out of the economy. The consumer price index was 99.2 in December 1989 and only 110.0 in December 1993.

The size of the government deficit is not a good measure of the stance of fiscal policy. Automatic stabilisers, especially the decline in tax revenues as income falls, have a significant ameliorating effect on the decline in economic activity. If the effects of automatic stabilizers are subtracted from

the total deficit, the resulting deficit called the structural deficit (or surplus) indicates the stance of discretionary fiscal policy. For Australia⁶ there was a structural surplus in 1990–91, virtually the same size as in the previous year. The next year there was a small structural deficit but it was not until 1992–93 that there was a large structural deficit (Neville 1999). Thus, it was two years before fiscal policy gave a significant boost to economic activity.

Changes in monetary policy occurred much more promptly. The (nominal) cash rate began declining in the first half of 1990 and fell rapidly until it levelled out at around 5 per cent in 1993–94. This overstates the effect since it is the real rate (the nominal rate less the expected rate of inflation) that is important in making investment decisions. As we noted above the actual rate of inflation measured by the rise in the consumer price index was less than 2 per cent a year over the period compared to 7.8 per cent in 1989. However, there is evidence that the expected rate of inflation did not fall as much as this, levelling out at around 4 per cent at the end of 1992 (Junor 1999). Many believe that private sector investment is not interest elastic, however the interest rate is measured. In any case, it takes about 18 months before changes in the cash rate are reflected in the level of economic activity (Milbourne and Crosby 1999). Thus, in the absence of aggressive fiscal policy in the first two years, the slump was not only deep, as noted above, but prolonged. Unemployment was still around 8 per cent in the mid 1990s.

16.4 The Effects of Inflation on Unemployment

Partly because of the growth in the financial sector, in the last 25 years or so, more emphasis has been put on keeping inflation low compared with keeping unemployment low. In a speech to the National Press Club, just before his retirement as Governor of the Reserve Bank of Australia, Bernie Fraser said that monetary policy was becoming the hostage of influential financial markets with a vested interest in making the Reserve Bank give greater weight to inflation than employment. He was quite explicit about the reason for this.

Most financial market participants rate low inflation ahead of the Reserve Bank's other objectives. This reflects a number of factors but the financial harm that is done to the holders of bonds when inflation and interest rates rise is the main one. (Fraser 1996: 19)

In Australia, and many other countries, Governments have defended a concentration on keeping inflation at a very low rate with the claim that high rates of inflation adversely affect longer run growth in output and employment. There is no doubt that this is true for very high rates of inflation, but there is substantial evidence that this is not the case when the rate of inflation is below, say, 10 per cent. Those who support fighting inflation

as the over-riding goal of macroeconomic policy claim the support of the current dominant neoclassical school of thought in economics. Professor Robert Barro is one of the most respected members of this school. In a study of the experience of more than a hundred countries over thirty years, Barro found that there was evidence of 'causation from higher long-term inflation to reduced growth and investment' but immediately commented that 'it should be stressed that the clear evidence for the adverse effects of inflation comes from the experience of high inflation' (Barro 1996: 168). The general tenor of Barro's article suggests that he had inflation rates above 20 per cent a year in mind when he used the term high, although anyone less sympathetic to the argument that inflation has adverse effects on growth might maintain that his empirical work shows that 'high' should be taken to mean more than 50 per cent a year. Barro's general result has been supported by numerous other studies.⁷

Many media commentators and some academics have countered the argument for a reduction in the priority given to fighting inflation with the claim that such a reduction runs the risk of making inflation harder to contain whereas pre-emptive interest rate rises add credibility to policy which lessens the risk of an increase in inflation. This is true but the argument is completely symmetrical with respect to unemployment. Pre-emptive increases in policy to expand employment equally lessen the risk of an increase in unemployment.

In any case, there is serious doubt about the association of higher employment levels with inflation, at least at levels of capacity utilisation below full capacity of the labour force or of the capital stock. Most contemporary arguments about the dangers of inflation associated with low levels of unemployment are based on the neoclassical model with its emphasis on the non-accelerating rate of inflation or NAIRU. However, heterodox economists have questioned the usefulness of this concept, arguing that levels of unemployment well below current estimates of the NAIRU are possible with little if any inflationary implications—see for example Kriesler and Lavoie (2005, 2007). In this case, unemployment can fall significantly below current levels before inflation becomes a potential cost of reducing unemployment further. Moreover, other policies, especially incomes policies, may reduce the extent of any rise in inflation.

16.5 The Debt Issue

How important is ratio of public debt to GDP? A strong case can be made for borrowing, in response to substantial rises in unemployment, in order to finance improvements in physical and human capital and especially for 'borrowing' from the Reserve Bank. This will increase the productivity of employed workers in the future. This will also reduce the numbers of unemployed. Both these things will increase the productivity of the economy and

raise living standards. They will also increase the capacity to pay taxes, and hence the ability to reduce the public debt if that is thought desirable.

How important is it to pay off the public debt or at least to prevent it from rising? In the case of Australia not at all. A large public debt can, in certain circumstances, limit government policy options, but this not a relevant consideration in Australia. Apart from that of Luxemburg, Australian public debt is the lowest in the OECD. In 2008 it was less than 10 per cent of GDP, or total production. Compare this, for example, with the case of Canada, another Western country where commodity exports are a high proportion of total exports. In Canada the ratio of public debt to GDP was 60 per cent in 2008. Because Australia has such a low level of public debt, it has more ability than the large majority of Western economies to use deficit financing to fund desirable educational and physical infrastructure with no need ever to pay back any borrowing involved, though this may be desirable to reduce aggregate demand in a situation of over full employment. Not only are the claims that this will place a burden on future generations false, but exactly the opposite is true. If the federal government finances desirable infrastructure from taxation, this puts a burden on the present generation who will be paying now to finance completely expenditure which will benefit future generations. Moreover, expenditure on improvements in physical and human capital will increase the future productivity of workers employed as a result by maintaining or even increasing their skills. It will also reduce the numbers of unemployed. Both these things will increase the productivity of the economy and raise living standards. The consequent increase in GDP will raise taxation revenue even if rates remain unchanged, and hence the ability to reduce the public debt if that is thought desirable.

16.6 Conclusions

The dominant lesson to be drawn from our historical comparisons is the major thesis of the paper as set out in the introduction. The fifties and sixties as a whole were marked by active fiscal policy, often tight to restrain strong inflationary pressures, but generally very quick to change its stance when unemployment increased significantly. Monetary policy also had an important but subsidiary role. Overall, the widespread belief that the Federal Government's overriding priority was to keep any departures from full employment brief was a major factor in helping to achieve this and it is notable that slumps in private fixed capital formation were brief as well as rises in unemployment. In short, the more the government can create a belief that it will ensure that any slump will be of short duration, the more successful it will be in achieving that aim.

The historical comparisons also point to major principles which should always underlie counter cyclical policy and guide the selection of the detailed measures whose exact nature will depend on the character of a slump and on the state of the economy before that slump.

These underlying principles are:

- in response to any downturn a fiscal policy stimulus is essential and must play the major part;
- fiscal policy measures at least must be implemented quickly and then followed up promptly by further measures if necessary;
- not only in response to downturns, but in good times as well the government must convey the impression that it will act decisively to minimise any decline in economic activity below the full employment level or rise in unemployment above its full employment level;
- it is possible to devise policies which will reduce both unemployment and inflation in the longer run as well as in the short run.⁸

Overall, the key is to minimise any decline in 'animal spirits' by effective policy measures and the first two principles are the most important in this respect.

Although it is not so obvious as these principles, the allocation of increased government expenditure is also significant. Usually, personal transfers, which can be implemented quickly, are important at the start of a slump. Then the emphasis should shift to investment. Investment in physical and human capital is valuable on both the demand and supply side. The need to increase aggregate demand during slumps is obvious, but until we reach a sustained period of genuine full employment there will be a need for supply side policies to stop structural unemployment rising and to incorporate more securely into the labour market those on its fringes.

16.7 Data Sources

Except where otherwise referenced, data for the more recent period is taken from the Excel spreadsheets on the Australian Bureau of Statistics web site, especially from tables in catalogue items 5204, 5206, 6202 and 6401. For periods before this data became available, data are taken from the Quarterly Summary of Australian Statistics, and the White Papers on National Income and Expenditure, the annual reports of the Commonwealth Bank and later the Reserve Bank and the Commonwealth Year Book. There are now quasi-official data for the earlier period, for example in Foster and Stewart (1991), but if one is comparing the success of policy making at disparate periods of time it is better only to use the data available to policy makers at the time their decisions are made.

Acknowledgements

The authors wish to thank Geoff Harcourt and P. N. Junankar of UNSW, and two anonymous referees for their helpful comments.

Notes

1. The last 20 years should be interpreted to include the slump of the early 1990s, which actually started at the very end of 1989.
2. See the note on data sources before the list of references for the information on the sources of data used throughout this paper. In fact, in 1946–47 there were no estimates of real gross national product but nominal gross national product increased by 9.5 per cent, the C series measure of retail prices by 2.3 per cent and the food and basic materials index of wholesale prices by 1.4 per cent.
3. Not all the money in the special grants to the states for public works was necessarily spent in 1952–53, but the knowledge of its existence would have increased the confidence of businessmen in maintaining their own spending on fixed capital.
4. See Kriesler and Halevi (1995, 1997).
5. The recession itself was triggered by events overseas.
6. That is combining all three levels of government and removing any consequent double counting.
7. For example, see Ericsson, Irons and Tryon (2001) and Kyriakopoulos (1991).
8. This should not be taken to mean that what worked so well in 1952–53 will work now, nor that the task is not harder now.

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17

The Share of Wages in Income in Australia

J. W. Nevile

In recent years many Australian economists have advocated a policy of gearing wages to productivity or output per man. To give but one example, Downing and Isaac recommend that the Commonwealth Conciliation and Arbitration Commission “anticipate a steady annual increase in productivity of, say, something over 2 per cent and, on the basis of this, ... grant automatically every quarter a cumulative increase in all award wages of $\frac{1}{2}$ per cent.”¹ Assuming constant export and import prices, and constant indirect tax rates, gearing wages to productivity will lead to stable prices if, and only if, profits are proportional to wages, i.e. only if wages are a constant proportion of gross national product at factor cost. Consequently, there has been considerable discussion, before the Commission and elsewhere, about whether or not Australian social accounts show wages as a constant proportion of gross national product. Almost all of this discussion has been based on figures for the proportions of wages and profits in the economy as a whole, or in the whole economy excluding certain industries. Moreover, profits have been defined as the gross operating surpluses of both incorporated and unincorporated enterprises. For example, Hawke, in arguing before the Commission that there had been a drift to profits, pointed out that in total in all industries excluding primary production, mining and quarrying, the share of wages fell from 65 per cent in 1953/54 to 61 per cent in 1963/64.² Those who believe that there has not been a drift to profits also look at aggregate figures, though excluding more industries than Hawke does. Hall, in the *Australian Financial Review*, after arguing that certain industries should be excluded, considered the rest of the economy and found that over the same period “the share of wages in domestic product ... did not fall but rose slightly from 64.8 per cent to 65.1 per cent”.³

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This procedure of considering the share of wages in gross national product aggregated over industries can be seriously misleading for two reasons. First considering the aggregate is misleading if different industries differ in labour intensity and grow at different rates. It is possible for the share of wages to decline in every industry, but to increase in the economy as a whole. This will happen if the wage share is declining in all industries, but, the most labour intensive industries are growing much more rapidly than the others. What is relevant is the weighted average of the wage shares in all industries (or firms) not the aggregate figure. Secondly the procedure commonly adopted treats all unincorporated income as profits. Thus, if there is a trend for a diminishing proportion of workers to be self employed this will give an upward bias over time to the trend in the proportion of income recorded as wages.

Let us first look at the aggregation problem. It can be shown, e.g. by a simple arithmetical example, that gearing wages to productivity will not necessarily produce stable prices if industries with different labour intensities grow at different rates, even if aggregate profits remain proportional to aggregate wages. Consider an economy consisting of two industries A and B which, in successive years have the employment, wage, profit and output figures shown in Table 17.1. Assume that there are no indirect taxes so that price per unit is equal to wages per unit plus profits per unit. In Table 17.1 in each industry wages per man increase by $2\frac{1}{2}$ per cent which is exactly equal to the increase in productivity.⁴ In the economy as a whole wages are a constant share of income, being 72 per cent in each year. Yet prices rise in this economy by about one per cent over the year. This example is not meant to be realistic, but it does make the point that what is relevant is the weighted average of the wage shares in all industries, or firms, and not the aggregate figure.

An examination of Australian statistics shows that considering the aggregate wage share is misleading. For example Hall found that there was a slight rise between 1953/54 and 1963/64 in the sector of the economy that he considered relevant. If one calculates a weighted average of the wages

Table 17.1 Illustration of the aggregation problem

	Industry A		Industry B	
	Year 1	Year 2	Year 1	Year 2
Output	100	123	100	102.5
Number employed	100	120	100	100
Wages per man	20	20.5	16	16.4
Wages	2000	2460	1600	1640
Profits	500	650	900	944.4
Price	25	25.3	25	25.2

shares in the various industries in this sector the rise is transformed into a decline from 66.0% to 65.3%.⁵ Let us look at the statistics in more detail. Like all others who have examined this problem we will exclude the primary industries and mining and quarrying as the level of profits in these industries is largely determined by factors exogenous to the Australian economy. Public administration and ownership of dwellings are excluded, as by definition, wages share is always 100% in the first and zero in the second. Electricity, water, gas, transport and communication are excluded as the level of profits in these industries is largely determined by the pricing policies of governments. (Indeed in many of these industries there is a case for regarding a large part of profits as an indirect tax, or subsidy where profits are negative.) The industry group called community and business services is also excluded. The behaviour of wages and salaries in this group of industries is dominated by trends in the government wage bills in the fields of law, order and public safety, health, and education. By definition there are no profits corresponding to these wages and the wage share for this group of industries is as irrelevant as in the other, industries already excluded. Table 17.2 gives for each of the remaining industries, or industrial groups, the percentage share of wages in gross national product at factor cost, and the weighted average of these percentages. The weights used were determined by the relative sizes of the wages bill in 1953/54 in each sector. If a different year is used to determine the weights it makes little difference to the trend. The weighted average was also calculated using 1948/49 weights and 1963/64 weights but, in each case the trend in the weighted average was the same as that shown in Table 17.2. It is clear that, although there are cyclical variations in the share of wages there is a very gentle downward trend over the whole period. It is interesting that this downward trend is far more marked if one compares slump years than if one compares boom years. The share of wages in income was virtually the same in 1950/51 as in 1959/60 but declined noticeably from 1952/53 to 1961/62. If "normal" years are compared, the decline is not very great.

Looking at Table 17.2, one is struck by the fact that commerce is the only industry in which the share of wages rose, and that of profits declined. But the gross operating surplus of companies in commerce as a percentage of gross national product did not decline over this period. It was only the share of gross operating surplus of unincorporated enterprises that declined and gave an apparent upward trend to the wage share. This suggests that all the figures show are tendencies such as that for corner grocers to be taken over by chain stores. It is of course impossible to tell from the published statistics exactly how much of the decline in the share of profits is due to a decline in the number of working proprietors.⁶ A rough approximation could be made by dividing unincorporated income in each year between wages and company income in the proportion these two are to each other in that year. If this is done or (what amounts to exactly the same thing) if the wages share

Table 17.2 Wages, salaries and supplements as a percentage of gross national product at factor cost

Industry	Wt.	1948/49	1949/50	1950/51	1951/52	1952/53	1953/54	1954/55	1955/56
Manufacturing	.505	69.7	68.2	67.0	69.9	70.2	67.8	67.5	67.8
Building and Construction	.147	78.4	77.8	76.8	77.8	77.2	75.7	75.8	75.0
Commerce	.221	51.8	50.0	46.3	52.9	54.4	51.3	51.0	52.6
Finance and Property	.056	82.4	81.3	77.3	85.5	83.2	83.4	82.9	84.2
"All Other"	.070	59.1	57.1	56.6	60.8	62.1	58.8	56.7	57.9
Weighted Average		66.9	65.5	63.6	67.5	67.8	65.5	65.1	65.7

Industry	1956/57	1957/58	1958/59	1959/60	1960/61	1961/62	1962/63	1963/64	1964/65*
Manufacturing	67.0	65.5	64.9	64.4	66.2	65.7	64.4	63.9	64.6
Building and Construction	75.4	75.3	75.3	75.4	75.7	75.2	75.5	74.2	74.0
Commerce	52.6	53.2	53.1	53.6	56.6	55.9	55.4	55.3	55.8
Finance and Property	83.1	79.0	79.4	78.6	80.1	78.0	79.4	80.9	80.6
"All Other"	58.4	56.9	56.1	54.4	54.8	54.7	54.7	54.0	54.4
Weighted Average	65.3	64.3	64.0	63.7	65.4	64.8	64.1	63.7	64.2

* Preliminary figures.

Source: Calculated from figures in *Australian National Accounts, 1964-65 and 1965-66 editions*.

Table 17.3 Wages as a percentage of wages plus gross operating surplus of companies

Industry	Wt.	1948/49	1949/50	1950/51	1951/52	1952/53	1953/54	1954/55	1955/56
Manufacturing	.505	76.4	73.8	72.3	74.8	74.9	72.2	72.1	72.1
Building and Construction	.147	97.4	97.5	96.7	96.9	97.0	96.9	96.6	94.8
Commerce	.221	71.0	67.7	62.1	72.0	74.0	68.9	68.6	69.6
Finance and Property	.056	83.3	81.4	77.8	86.0	84.1	82.6	83.0	84.3
"All Other"	.070	89.4	89.9	89.2	90.1	90.3	88.1	86.9	86.0
Weighted Average		79.5	77.4	75.1	79.1	79.5	76.7	76.5	76.5

Industry	1956/57	1957/58	1958/59	1959/60	1960/61	1961/62	1962/63	1963/64	1964/65*
Manufacturing	70.8	69.3	68.4	67.8	69.6	69.1	66.9	67.1	67.8
Building and Construction	94.8	95.3	94.8	93.8	93.5	93.0	93.0	92.1	91.8
Commerce	69.6	70.3	70.2	69.4	72.8	71.8	70.2	69.4	69.7
Finance and Property	83.2	80.3	79.7	78.8	80.1	78.5	79.6	81.1	80.6
"All Other"	86.4	85.9	85.3	84.0	83.4	82.6	82.1	82.2	82.2
Weighted Average	75.8	75.1	74.4	73.7	75.3	74.6	73.2	73.1	73.4

*Preliminary figures.

Source: Calculated from figures in *Australian National Accounts, 1964-65 and 1965-66 editions*.

is calculated as a percentage of gross national product less gross operating surplus of unincorporated enterprises and public enterprises, the share of wages in the commerce sector declines from 71.0% in 1948/49 to 68.9% in 1953/54, and rises slightly to 69.7% in 1964/65. If this procedure is applied to all sectors the weighted average is 79.5% in 1948/49, 76.7% in 1953/54 and 73.4% in 1964/65. The figures for each sector and year are given in Table 17.3. Table 17.3 may exaggerate the decline in the share of wages in income, but it probably gives a more accurate picture than does Table 17.2.

At a cursory glance, in the market sector of the Australian economy, the share of wages in income seems to have neither an upward nor a downward trend. Properly examined, there is a slight but distinct downward trend in the share of wages in income.

Notes

The opinions expressed are those of the author and are not necessarily shared by the Council of the Society.

This monograph has benefited from comments on a draft made by Professor Whitehead, although he may not necessarily agree with the argument in its final form.

1. "The 1961 Basic Wage Judgment and Wage Policy". *Economic Record*, Vol. 37 (Dec., 1961) p.491.
2. See e.g. Basic Wage, Margins and Total Wage Cases of 1966, Transcript p. 1859.
3. *Australian Financial Review*, June 9, 1966.
4. In Table 17.1, productivity is the same in each industry, and increases at the same rate in each industry. Thus the question of how the rate of productivity increase should be calculated is sidestepped. In fact, just as the share of wages should be calculated as a weighted average of the share of wages in each industry, productivity growth rates ... should be calculated as a weighted average of productivity growth rates in each industry.
5. The weights used are determined by the size of the wages bill in each industry in 1953/54.
6. In 1954 78.5 per cent of those at work in commerce were employees, but by 1961 the percentage had risen to 79.9 per cent.

18

Inflation in Australia: Causes and Cures

J. W. Nevile

I was asked to speak on the causes of and remedies for inflation in Australia. The first point that I want to make is both very simple and very important. Your committee, in asking me to speak on the causes (plural) of and remedies (plural) for inflation in Australia, embodied this point in their request.

There is no single cause of inflation in Australia. Neither is there any single, or even simple, remedy for inflation in Australia. There are many causes of inflation in Australia, ranging from very tangible and visible things such as the unusually large increases in award wage rates, or a high level of excess demand, to quite intangible things such as people's expectations of future movements in prices and the effect of inflation in England or America on these expectations. Not surprisingly, Australian economists first focused attention on the more tangible factors which might be thought to cause inflation. Their explanations worked fairly well for the twenty years ending about 1969. Perhaps over these twenty years the intangible factors did not change a great deal. But the explanations of inflation put forward in the sixties are not capable of explaining the inflation experienced in Australia in the last three years. Either the earlier explanations focused on the wrong factors, or, more likely, additional factors came into play in the last few years. With increasing interest in, and understanding of, inflation, it is clear that the second explanation is the correct one. Inflation in Australia cannot be attributed to one or two simple causes.

Similarly there is no one simple remedy for inflation in Australia. This is partly because inflation has many causes and no one remedy can be expected to cope with all of them. It is also because moderating inflation is an exercise in political economy as much as in economic science. Cures for inflation must be politically and socially acceptable to the majority of those in the community, as well as being based on valid economic reasoning.

Revised from *Economic Papers*, 5(14): 6–16, 1974, 'Inflation in Australia: Causes and Cures,' by Nevile, J. W. With kind permission from John Wiley and Sons. All rights reserved.

As any measure that is likely to have a significant effect on moderating inflation will hurt the interests of some groups in the community, no single simple remedy for inflation will have much chance of being politically and socially acceptable.

18.1 Causes of Inflation in Australia

Although there are many causes of inflation, it is possible to isolate and discuss the major factors causing inflation in Australia. The list that follows is not meant to be in order of importance, if only because the importance of different factors varies from year to year.

One factor causing inflation in Australia is increases in award wage rates. Of all the studies known to me, only one, that by Nieuwenhuysen and Norman,¹ does not find that the rate of growth of award wage rates has a significant effect on the rate of inflation in Australia. There are two links in the chain between increases in award wage rates and inflation. First, an increase in award wages causes an increase in average earnings. Second, increases in average earnings, at least if they are above a certain minimum size, contribute to inflation.

Numerous studies testify to the fact that an increase of 10% in award wage rates leads to about an 8% increase in average earnings. Professor Parkin interprets the effects of increases in award wage rates as the effects of price expectations with people expecting large price increases when there are large increases in award wage rates. I'll return to this view later when discussing price expectations. But, although there is probably truth in the treatment of award wage rate changes as an indirect measure of price expectations, I prefer the more straightforward view that increases in award wage rates are simply passed on, mainly as an absolute amount and not as a percentage increase, as increases in average earnings. This would result in the proportional increase in average earnings being about 80% of the proportional increase in award wage rates.

The link between changes in average earnings and changes in prices is not so clearcut. In normal circumstances, if average earnings increase by 10% prices in general only seem to increase, as a direct result of this factor alone, by roughly 4%.² This is partly because a significant proportion of prices, e.g., import prices, are not affected by changes in average earnings in Australia. Also, some increases in average earnings are absorbed and not passed on in higher prices. In the long run, the amount thus absorbed is more or less equal to the increase in productivity, but this equality does not hold in the short run.

To say that increases in award wage rates cause increases in the general level of prices is not to say that award wage rate increases are initiating forces. Award wage rates may merely be increasing in response to previous increases in prices. Except for very short periods, one is in cloud cuckoo land

if one does not expect award wage rates to increase at least as fast as prices. Sometimes unduly large increases in award wage rates may be an initiating factor in inflation. I think that the increase in 1970 is a case in point.

A second factor influencing the rate of inflation in Australia is the level of unemployment. To say this, is to say nothing about whether there is a long-run trade-off between unemployment and inflation. There may, or there may not be. Even if there is not, the level of unemployment will determine whether the rate of inflation decreases, is constant, or accelerates. In any case, there is a short-run trade-off between inflation and unemployment. In the short run, the level of unemployment is an important factor in determining earnings drift, or the difference between the proportional rate of growth of weekly earnings and that of award wage rates. A low level of unemployment also may cause prices to increase faster for a given rate of growth of weekly earnings. Even taking both these factors into account, the reduction in the rate of inflation gained by increasing unemployment is not great. In the short run, an increase in the level of unemployment from 1% to 2% seems to reduce the rate of inflation, other things being equal, by about one percentage point.³

A third contributing factor to inflation is increases in indirect tax rates. These work in two ways. On the one hand, since they are almost always immediately passed on, they immediately increase prices. On the other, by withdrawing spending power from the community, they tend to reduce demand and increase unemployment, which in turn will reduce the inflation rate. Unfortunately the first effect on the rate of growth of prices is likely to be greater than the second. A 10% increase in indirect tax rates will raise prices in general by approximately 1%, and will increase unemployment above the level it otherwise would be at by about $\frac{1}{4}$ of one percentage point.⁴ Since, in turn, this will reduce the inflation rate by $\frac{1}{4}$ of one percentage point, the disinflationary effect is only about $\frac{1}{4}$ as large as the inflationary effect. The effects of increases in indirect tax rates on inflation have not been of great importance in Australia, but they were significant in the fiscal years 1970–71 and 1971–72.⁵

A fourth factor, or group of factors, contributing to inflation in Australia, is overseas influences. There are four ways in which inflation can be imported from abroad:

1. through the impact on income and demand via export multipliers,
2. through monetary effects resulting from balance of payments surpluses,
3. through psychological effects if price expectations are influenced by international prices or if wage demands are influenced by wage bargains achieved in other countries, and
4. through cost-push effects with rising export and import prices directly causing price rises and leading to wage increases in exporting and import-competing industries.

Item number (1) on this list works through the level of demand, and its effects on inflation are subsumed under the effects of the level of unemployment. I would expect monetary effects to also work through aggregate demand. Psychological effects will be discussed shortly. This leaves cost-push effects. These have clearly been of considerable importance in recent Australian experience. The rise in meat prices alone, due, at least in the case of beef, to rises in export prices, has accounted for one-third of the rise in the consumer price index over the last financial year. The best defence against imported inflation is appropriate exchange rate and/or tariff policies.

Another factor influencing the rate of inflation, which must be mentioned, is expectations of rising prices. If there is a pronounced change in the rate of inflation which is sustained for any length of time, the rate of inflation that is generally expected to occur in the future will also change in a similar fashion. In Australia, award wage rates do adjust more or less annually at least to cover recent rises in the general price level. Hence the effect of expectations on inflation in Australia may be allowed for in the award wage rate variable. When overseas prices rise rapidly and visibly, much more than do prices in Australia, this may have an additional effect on expectations.

These seem to me the major factors that have been responsible for inflation in Australia in the post-war period. In the last few years, although inflation has accelerated, not all of them have been operative. For example, in 1971–72 and 1972–73 excess demand was not a factor contributing to the rise in the rate of inflation.

I would judge that the main reasons for the high rates of inflation in Australia over the last three years are:

1. the failure of the previous government to revalue when such a move was appropriate in 1971 and 1972,
2. the unduly large award-wage rate increases in 1970,
3. the increases in indirect-tax rates in 1970–71 and 1971–72,
4. the direct effects of rising export prices over the last year,
5. the compounding of all these effects as inflation feeds on itself, with price rises caused by the first four factors leading to wage rises, leading to further price rises and so on.

18.2 A Prices and Incomes Policy for Australia

Unless we are prepared to accept substantial increases in unemployment, lasting for years not months, I see little chance in the near future of reducing the rate of inflation to socially acceptable levels without the adoption of a prices and incomes policy. A substantial increase in the number of unemployed does not merely mean that the typical person unemployed is out of work for three or four weeks, rather than one or two weeks. In August, 1972, the average duration of unemployment was ten weeks, or twice the figure

that held during the previous boom. I have no doubt that we should seek to control inflation by methods other than creating the level of unemployment that held in 1972.

Opponents of prices and incomes policies often argue that the long-run Phillips curve is vertical, so that in the long run we can have whatever rate of inflation we choose (including a zero rate) as long as unemployment is kept at the so-called natural rate, or stabilising level. Even if one grants this argument, there is still a role for a prices and incomes policy. First and most important, such a policy may reduce the transition costs, in terms of unemployment, of getting from a higher to a lower rate of inflation. This role calls only for a temporary policy, which can be phased out when the lower rate of inflation has been maintained long enough to reduce inflationary expectations to the appropriate level. Any phasing out must be done in a way that will not itself cause expectations of a rise in the rate of inflation.

Secondly, a prices and incomes policy may be able to reduce the stabilising rate of unemployment. A short-run Phillips curve is not something fixed inexorably, purely by factors on the union side. Otherwise why would not unions ask for much more? The short-run Phillips curve results from a balance of forces with the unions pushing in one direction and employers in the opposite. By stiffening employers' resistance to wage rises, a prices and incomes policy may shift all short-run curves (and hence the long-run curve) closer to the origin, and thus reduce the stabilising rate of unemployment. This is a real and permanent gain, but a permanent prices and incomes policy may be required to obtain it.

Thirdly, a prices and incomes policy may be able to reduce the rate of inflation slightly by slowly reducing the share of profits in income. However, any reduction in profits large enough to have a noticeable effect on the rate of inflation would probably have a disastrous effect on investment. This objection does not hold in the case where a prices and incomes policy prevents a drift to profits increasing the rate of inflation, but again effects on the rate of inflation are likely to be very small.

Opponents of prices and incomes policies argue that they have been tried in many countries and have been unsuccessful. It may be, as the O.E.C.D. puts it, that no major country has "pursued a coherent price-incomes policy for long enough to permit a proper judgment".⁶ This does not seem to me a satisfactory answer to the opponents of prices and incomes policies. Instead I prefer to point to specific factors which have caused the failure of specific prices and incomes policies. Today, I will do this more generally by listing a set of rules which must be followed if prices and incomes policies are to have a chance of success.

1. External balance should be maintained by changes in the exchange rate, and without these it is unlikely that in the long run a country will be able to maintain a rate of inflation markedly different from its trading partners.

2. Incomes policy must not take measures that arouse deeply held feelings of injustice among workers. In practice, this means that it cannot be too ambitious about changing the distribution of income between different groups of workers. "Experience has continuously illustrated the tenacity with which existing wage differentials are defended".⁷ Traditional parities are also fiercely defended, as the strikes by the gas workers and hospital employees in England early this year illustrated. Similarly, incomes policy cannot be too ambitious in trying to change the distribution of income between wages and profits. This point implies that an incomes policy which does not allow earnings to increase at something like the same rate as prices plus productivity will fail in the not very long run, both because the drift to profits will be observed by the unions and lead them to regard incomes policy as a capitalist plot, and more fundamentally because the apologists of the capitalist system have sold it so well to the unions that they believe it is capable of giving them increases in their real standard of living equal to productivity rises and feel a deep sense of injustice if it does not.
3. Thirdly and fairly obviously, as far as possible nothing should be done to increase inflationary expectations and everything possible should be done to neutralise them. Clearly this rules out the type of fiscal policy produced in Australia in 1971, which resulted in significant rises in the consumer price index. Paradoxically it can be an argument for automatic cost-of-living adjustments which may be an effective way of neutralising inflationary expectations on the part of the workers.
4. In order to gain acceptance by the unions, incomes policy must apply to all incomes, and hence prices as well as wages. This is widely accepted overseas. I have argued elsewhere that it is true in Australia,⁸ so I will just say it now as a bold assertion. It does create considerable difficulties for those like myself who believe that price control leads to inefficiency. I'll return to this point later.
5. Prices and incomes policy will not stop price rises in the face of significant excess demand (except perhaps in a national emergency such as a war when people voluntarily accept rationing). In view of the pressures on governments to expand public expenditure, it is important to stress that prices and incomes policies do not remove the need for restraint in fiscal policy. A prices and incomes policy may enable a reduction in the rate of inflation for a given level of unemployment, if that level is not abnormally low. No prices and incomes policy can be expected to work if there is considerable excess demand.⁹ If one accepts the concept of a stabilising level (or zone) of unemployment this point can be made more precisely. A prices and incomes policy can reduce inflation without increasing unemployment if unemployment is in the stabilising zone. It cannot prevent rising rates of inflation if the level of unemployment is much below that zone.

One final point must be made before I outline my prescription for an Australian incomes policy. Any incomes policy has more chance of success if both employers and unions consider it reasonably equitable and agree to support the criteria for price and wage rises embodied in it. Hence, a slightly more inflationary policy than mine might have more success in countering inflation if it were devised and agreed to in outline by unions and employers.

On the wages side, my prescription is simple. Average earnings should increase at the same rate as prices plus national productivity. Hence the various arbitration bodies should act in such a way that award wage rates increase at a rate equal to prices plus productivity less earnings drift. In principle earnings drift should be corrected for changes in overtime worked, but I do not think that the present data is adequate to do this. Actual earnings drift in the year just ended would have to be taken as a measure of earnings drift.

While they should follow this rule quite rigidly, arbitration bodies would still have an important function in wage determination in determining parities and differentials, though in view of what I have already said I would urge them to "make haste slowly" in this area. Obviously, the system would work best the more power and influence is given to the Federal as opposed to State arbitration bodies. The National Wage Case would automatically increase wages across the board by the increase in productivity less earnings drift and less any increases already given throughout the year. Hence, all consent awards would have to be carefully scrutinised. In addition, every six months, all award-wage rates would increase automatically with increases in the consumer price index, net of any changes due to changes in indirect-tax rates. In the perhaps unlikely event of the index—so corrected—decreasing, wage rates would also decrease.

This last point of automatic cost-of-living adjustments every six months is likely to be the controversial aspect of my wage recommendations, so let me concentrate on that. If earnings do not increase at the same rate as prices plus productivity, the share of wages in income declines. There may be some non-economic arguments as to why the share of wages in income should decline—though it is hard to state one without it sounding ridiculous. The only economic argument for a declining wage share is that the profit share is too low to stimulate the desired level of investment. But, by world standards Australia has a high investment ratio. It is difficult to argue that more profits are needed to stimulate investment.¹⁰ Cost-of-living adjustments will obviously help to prevent the rise of deeply held feelings of injustice. They are necessary, either formally or informally, to prevent the share of wages in income falling, and there seems to be no argument to support the proposition that the share of wages in income should fall. Moreover, they may help on the side of inflationary expectations. Giving automatic wage increases as prices increase will be anti-inflationary whenever the rate of inflation

generally expected is greater than that which will actually occur, or is most likely to occur. At the moment, the situation in Australia is one in which this condition is likely to be true.

Another argument for automatic cost-of-living adjustments is that compensation for price increases is bound to occur one way or another. It is better if it is given regularly in small amounts rather than in large amounts at irregular intervals.

The argument against cost-of-living adjustments is that they intensify the wage-price spiral. This is the reason why I only suggest adjustments every six months, and not quarterly. If prices take six months to adjust to wage increases, then cost-of-living adjustments to wages every six months will have no more effect on spiralling inflation than cost-of-living adjustments every year, which we more or less have at present. In Australia, some prices take more than six months to adjust to wage changes and some take less. The average length of time is between three and six months.¹¹ With the price surveillance I will suggest as the other half of my incomes policy, the average can be made at least six months. In fact, I would make it a part of policy that prices should normally only be allowed to adjust annually for cost-of-living adjustments to wages. If productivity rises by 3% a year, prices (and hence wages at the half-yearly adjustment) would have to rise by more than 3% in the first half-year, i.e. by more than a 6% annual rate, before the gains to the employer from adjusting wages to productivity only annually were offset from the losses of adjusting them to prices twice a year. If prices only rise at an annual rate of 3%, the employers will always be ahead when cost-of-living adjustments to wages take place twice a year, but prices are only allowed to be put up once a year. And this system will have no greater effect in intensifying the wage-price spiral than the present.

It is necessary to define more precisely what I mean by productivity. I would advocate that the concept of productivity used be a long-term one—say the average rate over at least the last business cycle. It should be corrected for changes in the terms of trade, but again I would urge a moving-average correction be made to avoid, if possible, large temporary fluctuations. However, productivity should not be defined as increase in real gross national product per head. This is one place where, at least until recently, the unions have been selling themselves short. By definition, from the way the Statistician measures productivity in the financial sector and the public sector, productivity change is always arbitrarily virtually set equal to zero in these sectors. It might just as well be set equal to 1.5% or 3% or any other arbitrary small figure. In any case, what is relevant from the point of view of prices is the market sector, and productivity should be taken as the increase in output per head in this sector. This would raise the long-term trend-rate from about 2.5% to something over 3%. To be on the safe side, I would settle for 3% until it is proved to be something different.¹²

So much for wages, what about prices. I would not advocate complex and detailed price controls of the sort set out in the British Green Paper. I agree with the O.E.C.D. that "experience has tended to confirm the judgment that a comprehensive system of price control, in the strict sense, raises almost insuperable administrative difficulties; and over a number of years it would have harmful effects on efficiency".¹³ Nothing that has happened in the U.S.A. or the U.K. in the last few years would cause one to change that judgment.

Instead of a system of comprehensive price controls, I would suggest a scheme of price surveillance, imposed in the first instance on the corporate sector. The present Prices Justification Tribunal could carry this out, but some sanctions would need to be imposed against companies who increased prices in defiance of the Tribunal. Irrespective of the outcome of the prices referendum this could perhaps be done through tax powers. For example, the rate of company tax could be raised to 60%, with a $33\frac{1}{3}\%$ rebate for all companies which did not fall foul of the Prices Justification Tribunal. The Tribunal should lay down clear guidelines about the extent to which increases in wage rates would justify price rises. Award-wage rate increases should be allowable grounds for a price rise to the extent that they are greater than the rate-of-productivity growth which could reasonably be expected in the industry in question. As a general rule only one price adjustment a year should be allowed in response to wage rate changes.

On the other hand, a rise in earnings drift should not be allowed as a reason for increasing prices, unless it could be convincingly demonstrated that the rise was necessary to obtain workers, who could not be attracted at the normal wage rate, and that there was in fact a demand for the product which could not be met if squeezed profits resulted in lesser investment in the industry. This type of earnings drift should be rare, and would be a sign that the arbitration authorities had got the differentials wrong, or that monetary and fiscal policy had allowed significant excess demand to develop.

If the Prices Justification Tribunal should be short of resources, I suggest that it make a small number of investigations in depth as well as a larger number of more superficial investigations. On the retail side, it might be wise to reframe the criteria so that profit margins, not prices, were the subject of investigation.

Prices surveillance need not be perfect. Indeed it probably should not strive to be, since such striving would probably result in rigidities leading to distortions in resource allocation. One advantage of automatic cost-of-living adjustments is that one does not need, for political, economic or equity reasons, the complex system of price controls which must accompany effective, absolute wage controls. If some unjustifiable price rises slip through, workers are automatically compensated, whereas with fixed-wage increases—even if they include a generous allowance for inflation—workers tend to feel that every price increase is robbing them of their just rewards.

This price surveillance must be complemented with a vigorous policy to increase competition and improve efficiency throughout the economy. As this is uncontroversial, I will not expand on it except to point out that over half the chapter on "Policies against Inflation" in the O.E.C.D. report *Inflation the Present Problem* is devoted to ways to reduce protection, increase competition and increase efficiency in both the public and private sectors. It is also worth noting that manpower policies are also an important weapon against inflation, especially since large wage increases given to overcome bottlenecks often lead to other large wage increases elsewhere.

A prices and incomes policy that is too perfectionist will break down under its own weight. There must be some "safety valves" to release the pressures on the system—especially pressures brought about through shifts in demand. On the wages side, earnings drift provides this safety valve.¹⁴ On the prices side the surveillance must not be so rigid as to shut all safety valves. At the same time the surveillance must be real. This is important since the incomes policy must be sold to the unionists—not just the union leaders, but the unionists at large, since full employment erodes the leadership powers of union leaders.

The section on remedies for inflation in this paper has concentrated on a prices and incomes policy, but it must be remembered that demand management and exchange rate policy are no less important than prices and incomes policies in an overall strategy against inflation.

This collection of policies to counter inflation may sound complex, even "messy". It is. But economic realities are often complex, and inflation is one of those economic problems which is unlikely to be solved by any easy simple solution.

Notes

1. J. P. Nieuwenhuysen and N. R. Norman, "Wages Policy in Australia: Issues and Tests", *British Journal of Industrial Relations*, Vol. IX, No. 3.
2. This is implied by the equations in J. D. Pitchford, "An Analysis of Price Movements in Australia, 1947–1968", in J. W. Nevile and D. W. Stammer (eds.), *Inflation and Unemployment*, Penguin, Ringwood, Vic., 1972, and by the price equation in J. W. Nevile, *Fiscal Policy in Australia, Theory and Practice*, Cheshire, Melbourne, 1970.
3. See, e.g., J. D. Pitchford, *op. cit.*, and J. W. Nevile, *op. cit.*
4. See J. W. Nevile, *op. cit.*
5. See J. W. Nevile, "Options for Internal Economic Policy", *Economic Papers*, September 1972.
6. *Inflation the Present Problem*, p. 37.
7. *Inflation the Present Problem*, p. 39.
8. See "Options for Internal Economic Policy", *Economic Papers*, September 1972.
9. This paragraph appears to ignore the econometric work by Lipsey and Parkin, but this work has been severely criticised. See M. Parkin and M. T. Sumner (eds.), *Incomes Policy and Inflation*, Manchester, 1972, for both Lipsey and Parkin's work and criticisms of it.

10. Over the trade cycle as a whole. Private investment in machinery and equipment is still depressed as a result of the (lagged) effects of the 1972 recession, as a result of the uncertainties engendered by having a Labor Government for the first time for 23 years, and as a result of a desire for liquidity because of the fear (due to inflation) of an extremely severe credit squeeze.
11. See J. D. Pitchford, "An Analysis of Price Movements in Australia", in J. W. Nevile and D. W. Stammer (eds.), *Inflation and Unemployment*, Ringwood, 1972.
12. It might be argued that my wage rate recommendations are unrealistic because they do not leave a large enough role for unions. Union leaders still have their traditional roles in protecting members and improving conditions of work. They still have a role in determining relativities and in cases where firms are making above average profits, union leaders would presumably try to convert some of these to wage payments through over-award payments.
13. *Op. cit.*, p. 38.
14. This is not to say that increases in above-award payments should not be scrutinised. They would be a useful signal to the Prices Tribunal that here is an industry whose prices would bear investigation.

19

The Effects of Immigration on Unemployment

J. W. Nevile

19.1 Introduction and Summary

A major argument against immigration in the Australian literature has been that it reduces the rate of growth of output per head, and hence of living standards, by reducing the amount of capital that is available for the average worker to use. This argument goes back, at least, to the (Vernon) Committee of Economic Enquiry (1965), and has been used by many economists since. Even the present author, while sympathetic to immigration, recently argued that it did reduce the growth of productivity by reducing the rate of growth of capital per worker (Nevile 1989, p. 155).

There is good reason for this pessimistic view about the effects of immigration. Some authors have argued that immigration increases investment and hence the capital stock (see e.g. Kmenta 1966 or Baker 1987); but if immigration is not to reduce the rate of growth of the capital stock per head, not only must investment increase, it must also increase as proportion of output, and do so substantially. While immigration will probably increase investment, there is no reason to believe that it will substantially increase the ratio of investment to output. Hence, there is every reason to believe that immigration reduces the rate of growth of capital per head, and this is confirmed later in the paper.

However, in the conditions prevalent in the last 15 years in Australia, and in most other OECD countries, immigration has another effect which is beneficial to the rate of growth of output per head. In Australia (and in some other countries such as Canada) immigration is a major factor in population growth. A rapid rate of population growth stimulates the level of economic activity and reduces the level of unemployment. In the period between 1945 and 1973, when economic activity was almost always very close to full

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employment in Australia, this effect of immigration and population growth was unimportant and largely forgotten. However, since 1975 there has usually been so much slack in Australian and other OECD economies that the stimulating effect of population growth has been important in those OECD countries where population grew rapidly. It is an important and hitherto unresolved question whether the beneficial effects of immigration in reducing unemployment in Australia are large enough to outweigh the effects on output per head that result from the lower growth in capital per head.

Immigration, and the consequent increase in population, also affect the rate of growth in output per head in other, less tangible, ways. There is no doubt that, whether immigration raises or lowers the rate of growth of output per head of the population, it certainly raises the rate of growth of output as a whole. There is a substantial literature in economics which argues that a faster rate of growth of total output will increase the rate at which new technology is adopted and hence increase productivity growth and growth in output per head.

The author has developed a model to determine the rate of growth of living standards. In the model the three influences on living standards listed above (on capital growth, unemployment and technological change) interact, and together they are the three factors determining growth in living standards. The model is set out in the mathematical appendix. The key assumptions used are described and discussed in chapter 2. At this point it is sufficient to note that it is a macro model. Hence, it assumes that on average, immigrants have the same levels of education, training and skills as native born Australians. In fact, immigrants have a slightly higher level of skills, training and education than native born Australians. In any case the composition of the migrant intake is largely determined by policy. This paper starts with the assumption that the present mix of different types of immigrants has been policy determined and is the result of weighing up the priorities to be given to different objectives, some economic and some humanitarian. It is concerned to examine the effects of immigration on living standards if past and present policies on migrant mix are not drastically changed, and the composition of the migrant intake is largely unchanged. From this perspective the decision to treat population growth as homogeneous, irrespective of whether it comes from natural increase or immigration, is conservative. If a decision was made to increase substantially the proportion of immigrants with scarce skills, then this would increase the beneficial effects of immigration on living standards and increase the optimum rate of immigration above that suggested by this paper.

The model providing the theoretical basis of the paper is not designed to explain the effects of year to year changes in the rate of immigration and population growth, but is concerned with the medium run time horizon of three to four years, in which the effects of the business cycle are averaged out. Living standards are defined conventionally, distinguishing the

material goods that make up living standards from the intangible things that are included in the broad concept of quality of life. A key assumption is made of constant returns to scale.

Each of the determinants of living standards—changes in employment per head of population, technical change, and changes in the size of the capital stock per head of population—are examined in chapters 3 to 5. Chapter 3 uses a cross country study to examine the effect of population growth on employment and unemployment. It concludes that zero or low rates of population growth cause unemployment to increase, as do very rapid rates of population growth. If one's sole concern is to minimise unemployment and to maximise the rate of growth of employment per head of the population, the optimum rate of population growth is about one per cent a year.

Chapter 4 shows that, in Australia, the amount of technical change is sensitive to the rate at which the economy as a whole is growing, and increases as the rate of economic growth increases. This paper does not explore the reasons for this but the most likely one is a 'Salter' effect. The more rapidly an economy is growing the greater the proportion of the capital stock which is new, so that the best techniques known are spread throughout industries more rapidly. In any case, whatever the reason, technical change in Australia is greater when the population, and hence the economy, is growing more rapidly, so that immigration is unambiguously beneficial from this point of view.

Unfortunately, as we have already noted, immigration has an equally unambiguous negative influence on growth in living standards through its effects in reducing the rate of growth of capital per head. Chapter 5 suggests that the rate of population growth has little effect, one way or the other, on the ratio of investment to output. If this is the case, it can be shown that each extra percentage point of population growth reduces the rate of growth of capital per head by one percentage point. The results in chapter 5 hold for population growth in general. If a more disaggregated study found that immigration, rather than population growth in general, does tend to increase the ratio of investment to output, then this would be a reason to increase the target rate of immigration above that recommended in the conclusion to this study. However, any such increase in the target rate of population growth (and hence immigration) would be small.

The results obtained in chapters 3, 4 and 5 are combined in the concluding chapter. When the three influences on the rate of growth of output, or living standards, are considered together, the rate of population growth which maximises the rate of growth of living standards is 1.36 per cent a year. Not much weight should be placed on the last decimal place in this figure. Moreover, small variations around the population growth rate of 1.36 per cent make only minor differences to the speed at which living standards increase. Indeed, in the range of 1.1 to 1.6 per cent a year for population growth, differences in that rate of growth only affect the second

decimal place in the rate of growth of output per head. However, outside this range the effects of changes in the rate of population growth soon have a major impact. For example, if population grows at either 1 percentage point more or 1 percentage point less than the optimum rate of 1.36 per cent, the rate of growth of living standards is reduced to zero.

Thus, the major conclusion of this study is that, at least as far as growth in living standards is concerned, immigration into Australia should be used to keep the rate of growth of population between 1.1 and 1.6 per cent a year. Within this range economic considerations are not important and more weight should be given to other criteria in determining the precise size of immigration targets. However, the economic costs rise rapidly as the rate of population growth moves away from this range.

19.2 Nature of the Model Used and Assumptions Made

The paper adopts the conventional measure of living standards, namely the level of output per head of population. This statistic does not take into account the degree of pollution in the atmosphere or oceans, the amount of leisure time available, the likelihood of becoming unemployed and a host of other things that are often summed up in the phrase 'quality of life'. The paper makes use of this distinction between living standards and quality of life, and focuses on the narrower term.¹ It accepts the usual way of measuring living standards and could equally well have been titled 'The Effect of Immigration on Output Per Head of Population in Australia'. Given this focus, the phrase 'optimum rate of population growth' is used as a convenient shorthand for the rate of population growth which maximises the growth in output per head. It is not intended to imply that this is necessarily optimum from every point of view.

This paper takes an aggregate approach. Obviously, the purely economic benefits from immigration to the existing Australian population can be increased if the immigrants are carefully selected. This may clash with other humanitarian goals of the immigration program, though, which are enshrined in the family reunion and refugee categories. However, the analysis in this paper is not concerned with differences in the characteristics of immigrants and native born Australians. It assumes that, on average, immigrants have the same levels of education, training and skills as the native born population. This enables population increase to be treated as homogeneous, whether it comes from immigration or natural increase. In fact, at present Australians born overseas have a slightly higher level of education and training than do the native born (see e.g. Tran-Nam and Neville, 1988). Hence, if anything, this assumption underestimates the economic benefits from immigration.

In order to consider the contribution to national output of additional people employed, some assumptions regarding the value of that contribution

must be made. The paper assumes that this contribution is correctly measured by the wages paid to employees. In turn this implies either that the Australian economy is competitive enough to make it appropriate to assume the text book model of pure competition, or, more likely, that monopolistic elements in the economy are not confined to any particular sector or institutions. Thus, overall, the effects of various monopoly powers on the share of output going to wages would roughly cancel out.

One of the parameters in the model in the mathematical appendix is the share of total income that is in the form of wages or payment for labour input. Unfortunately this share can not be read straight off the national accounts as the income of unincorporated trading enterprises contains returns to both capital and labour. However, this is not a major difficulty. If all the income of unincorporated trading enterprises were labour income, the share of wages in total income would be approximately 80 per cent; and if all the income of unincorporated trading enterprises were returns to capital, the wage share would be approximately 70 per cent. Clearly neither of these extreme cases is true, and it is unlikely much error is introduced if we assume that the wage share is 75 per cent.

There has recently been some controversy about whether the Australian economy is subject to increasing returns to scale: that is, whether the economy as a whole operates more efficiently as it grows (Centre for International Economics, 1988). One would have to say that there is not enough evidence to establish either that increasing returns to scale *do* hold in Australia or to show definitely that they do not.²

This paper assumes constant returns to scale in the strict sense, i.e. if we compare two economies and one employs twice as much labour and capital as the other it will produce twice as much (constant returns to scale) neither more (increasing returns) nor less (decreasing returns).

This assumption, of constant returns to scale, might be thought to have a critical effect on the conclusions reached in this paper. As noted above, it is not supported by much hard empirical evidence. Neither is there empirical evidence to reject this assumption. However, universally in economic growth literature, technical change is measured as a residual. If there are in fact significant increasing returns to scale in the Australian economy as a whole, these will show up as additional technical progress occurring as the economy grows. Similarly, if there are decreasing returns to scale, these will be taken into account as a reduction in technical progress.

One final rather technical assumption is made, that technical change is 'Hicks-neutral'. In intuitive terms this can be defined as a situation in which technical change increases the productivity of both capital and labour in the same proportion.

It seems unlikely that when all the assumptions discussed above are considered together they impart a large bias one way or the other into estimates of the effect of immigration on the rate of growth of output per head or

living standards in Australia. If anything the assumptions may give a small downward bias, mainly because immigrants will probably continue, on average, to have more education and training than native born Australians.

Also, as a matter of policy, whenever econometric analysis gives no strong reason for distinguishing between alternative estimates of a parameter, the value less favourable to the economic benefits of immigration has been chosen. There is value in being consistent in this way, so that the direction (if any) of any bias is known. The decision to impart a downward rather than an upward bias was chosen deliberately to test how strong a case could be made for immigration on economic grounds using *conservative* assumptions and procedures. If anything, therefore, this paper underestimates the optimum rate of population growth and immigration.

19.3 The Effects of Immigration on Employment and Unemployment

In Australia immigration is the policy variable which determines the rate of growth of population. Because of immigration, Australia has the second highest rate of population growth of any country in the OECD. It is noteworthy that the United States, Canada, Japan and Australia, which all had relatively rapid rates of population growth, have been much more successful in restraining the rise in unemployment in the 1980s than have the countries of Western Europe, which generally had low or even negative rates of population growth.

Reddaway (1939) argued that a stagnant or declining population increases unemployment. His arguments work equally well in reverse, leading to the conclusion that population growth stimulates the economy and reduces unemployment or increases employment per head of population, which is the relevant variable as far as growth in living standards is concerned. However, it is unlikely that there is a linear relationship between growth in population and growth in employment per head. After some point is reached it is difficult for an economy to absorb quickly extra labour. This section investigates the relationship between population growth and growth in employment per head by means of a cross section study of OECD countries.

Not all OECD countries, but only the 16 largest, are taken as the sample.³ Extremely small countries, such as Iceland or Luxemburg, may have economies that are dominated by some completely exogenous factor. In the 1980s this was true for a country as large as Norway, where the development of North Sea oil had a strong influence throughout the economy. None of the countries excluded from the sample had a population as large as that of New South Wales. Also, as a check, the regression equation used was estimated from a sample of 24 countries which included an additional 8 very small or extremely small countries.⁴

Data for the regression analysis was obtained from OECD *Labour Force Statistics*. The last year for which data was readily available for all countries was 1987. The first year for the analysis was 1980, in which a large proportion of countries in the sample were at about the same stage of the business cycle as they were in 1987.

We know, a priori, that employment per head can not increase indefinitely as the rate of population growth increases. At some point the rate of growth of employment per head must start to fall, as indeed must the level of employment per head if the rate of population growth is very large. The simplest mathematical form that enables this result is the quadratic function. Hence, we hypothesise that the relationship has a quadratic form. A scatter diagram for the 16 largest OECD countries is given in Figure 19.1,

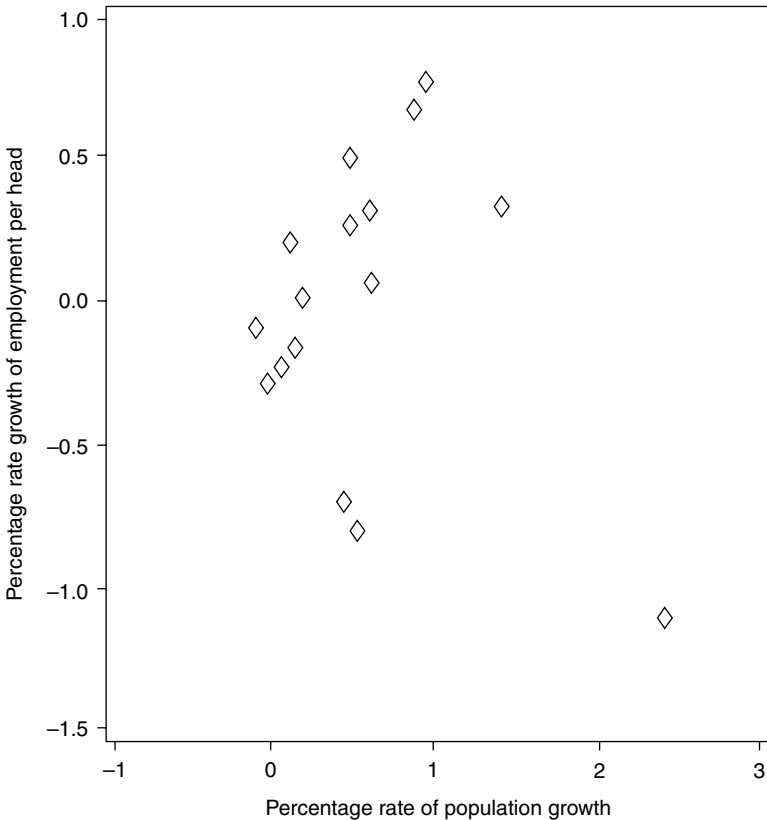


Figure 19.1 Population growth and employment growth per head (in 16 OECD countries)

and confirms that a quadratic function will fit the data. The function was estimated, using ordinary least squares analysis, with the following result:

$$l = -0.29 + 1.22N - 0.63N^2 \quad (1)$$

$\begin{array}{ccc} .19 & .49 & .22 \end{array}$
 $R^2 = .41$

where l is the percentage rate of growth of employment per head and N the percentage rate of growth of the population. The figures under the coefficients are their standard errors, so that the coefficient on N is significant at the three per cent level and that on N^2 at the one per cent level. Moreover, the major influence of this equation on the optimum rate of population growth is given by the ratio of the coefficient of N to the coefficient of N^2 . (See the mathematical appendix.) If the equation is estimated over different time periods, or for different sized samples, the value of the ratio is more robust than the value of either of the parameters. Similarly in Figure 19.1 the rate of population growth which maximises the rate of growth of employment per head is more clearly defined than the slope of the sides of the implied quadratic function.⁵

When the sample is extended to include 24 countries, the resulting regression equation is

$$l = -0.13 + 1.31N - 0.68N^2 \quad (2)$$

$\begin{array}{ccc} .30 & .78 & .35 \end{array}$
 $R^2 = .15$

The a priori reasoning which led to restricting the original sample to 16 countries suggests that extending it to include very small countries will reduce the value of the correlation coefficient and increase the size of the standard errors of the coefficients. This has happened, but it is encouraging that the size of the coefficients of N and N^2 has changed very little and the ratio of the two coefficients has changed only from 1.94 to 1.93.

As can be observed from Figure 19.1, there are two outliers in the sample of 16 countries. These two countries are France and Spain with the latter being the more extreme outlier. While I do not wish to argue that either or both outliers should be dropped from the sample, a case can be made for dropping Spain. Bentolila and Blanchard (1990) argue that the Spanish labour market is a special case and that the 'specificity of the Spanish experience comes from the Franco legacy, which left Spain ... with both an archaic system of labour relations, and a thoroughly inadequate production structure' (p. 234). If Spain is excluded from the sample then the coefficients on N and N^2 are both significant at the 0.5 per cent level. The absolute value of each of the two coefficients is about 10 per cent higher than in equation (1),

but their ratio changes only to 1.95—confirming the robustness of the estimate of this ratio.

It could be argued that specification of the equation for the rate of growth of employment per head should be slightly different. There are many things beside the rate of population growth which affect the dependent variable. If these things affect all countries to the same extent, this effect will, of course, be included in the constant term. Otherwise, the specification so far adopted assumes that any additional causal influences will have a random effect across countries. One important factor reflected in the rate of growth of employment per head is the increasing participation of women in the workforce. One hypothesis is that participation by women is stronger in the more modern and sophisticated societies. The level of gross domestic product per head may be a reasonable proxy for this attribute of society. When this variable is included the resulting regression equation is

$$l = -0.97 + 1.01N - 0.48N^2 + 0.65PCY \quad (3)$$

$$\begin{matrix} & .39 & .46 & .21 & .034 \\ R^2 = & .55 & & & \end{matrix}$$

where PCY is per capita gross domestic product measured in thousands of United States dollars (converted by purchasing power parity using as a data source Australian Bureau of Statistics, *Gross Domestic Product at Purchasing Power Parity in OECD Countries, 1985*, Cat. No. 5226.0).

Perhaps because PCY is not a very good proxy, the coefficient on PCY is not significant at the 5 per cent level though it is at the 10 per cent level. Also, the coefficient may be biased upwards through simultaneous equation bias. Thus, it is perhaps an open question whether or not to include this variable. We have not. If one does, the implied optimum rate of population growth is increased by 0.2 of a percentage point.

There are two reasons why faster population growth may increase employment per head. The first is the Reddaway reason that population growth stimulates aggregate demand and reduces unemployment. The second is that demographic changes introduced by population growth may, up to a point, reduce the proportion of the population in those age groups too young or too old to be in the workforce. It is completely immaterial for the purposes of this paper whether one or the other or some combination of these reasons is the cause of the relationship we have discovered between the rate of population growth and the rate of growth in employment per head. However, whether or not moderate population growth does reduce unemployment, compared to the situation with little population growth, is an interesting question in its own right.

There are pieces of evidence suggesting that a reduction in unemployment is much more important than changes in the dependency ratio.

The casual empiricism which suggested in the first place that countries with more rapid population growth were more successful in reducing unemployment can be backed up with more formal analysis. Accurate internationally comparable figures for the change in unemployment are not available for 4 countries (Greece, Portugal, Spain and Turkey) of the 16 in our original sample, but reliable data are available for the others, at least for years up to and including 1985. This data shows a strong inverse correlation between the rate of population growth and the percentage increase in unemployment between 1975 and 1985. In a regression equation in which population growth explains the proportional rise in unemployment, the negative regression coefficient on the independent variable is significant at the 1.1 per cent level.

As well as cross section analysis one can look at time series data for Australia over a very long period. Pope and Withers (1990) examine the effect of immigration on the rate of unemployment in Australia and find a negative relationship over the period 1880–81 to 1980–81. However, their regression equation includes the unemployment rate lagged one and lagged two years. The coefficients on these lagged variables are 1.35 and -0.59 respectively. Given the high level of correlation between the two variables, the significance of the negative coefficient on the unemployment rate lagged by two years is overstated. If this variable were to be dropped from the regression equation, it is probable that the coefficient of the unemployment rate lagged by one year would not be significantly different from one, suggesting that the correct specification is to regress the change in the unemployment rate on immigration.

There is a final reason for thinking that changes in unemployment are more important than demographics in the relationship between population growth and the rate of growth of employment per head: natural increase and immigration have different demographic effects. However, there is no evidence that the different components of population growth have different effects on the rate of growth of employment per head.

Some people may wish to argue that the causation runs the other way from that assumed in this paper, since countries where unemployment is increasing relatively slowly may be attractive to immigrants. There are three separate points which together make a strong case for rejecting this interpretation of the relationship underlying the regression equations in this section.

First, while in some cases immigration into countries with rapid rates of population growth was substantial, in other cases it was small or negligible. But in all cases moderately rapid population growth tended to limit the rate at which unemployment increased. Moreover, if the reverse causation hypothesis is correct, one would expect countries where immigration was large relative to natural increase to have large positive residuals in the regression equation. This is true in some cases but not in others, and overall

there is no relationship between the size (or even the sign) of the residuals and the division of population growth between migration and natural increase.

Secondly, it is more likely that the *level* of unemployment makes a country attractive to migrants rather than changes in that level. A country with unemployment at 3 per cent will appear more attractive to migrants than one with 10 per cent, even if unemployment is increasing more rapidly in the first country. This section examines the relationship between population growth and changes in unemployment (or more accurately changes in employment per head of population).

Finally, while it may well be true that the government of a particular country will allow more immigration when unemployment is low or falling, the study in this section is a cross section study, not a time series one. The level of immigration into a country is decided by many factors. It is not true that immigration is larger, relative to population, in countries where unemployment is low or falling than it is in countries where unemployment is high or rising. Australia had a much higher rate of immigration relative to population growth in 1982, when the unemployment rate was 7 per cent and rising, than the United States did in 1988, when the unemployment rate was 5.5 per cent and falling.

19.4 Conclusion

In addition to the direct effects, reported on above, immigration also increases the rate of growth of population and of output per head. In 1949 Verdoorn put forward a 'law' that the rate of growth of labour productivity depends on the rate of growth of total output. Of the many reasons for this probably the most important is the Salter effect (see Salter, 1960). However, the section on technical change does not investigate causes. It finds that in Australia over the period 1974–75 to 1988–89 technical change contributed more than double to the overall increase in output than did the increase in employment per head and the reduction in unemployment. This may seem implausibly high, but if the size of the relevant coefficient is reduced by its standard error the optimal rate of population growth is reduced by 0.17 of a percentage point, and is still within the 'comfort' range of 1.1 to 1.6 per cent a year. One standard error is a reasonable reduction as unlike the equations in Section 3 the relevant equation was estimated by the method of generalized least squares set out in Kakwani (1977).

The third way immigration may influence output, employment and unemployment is by reducing the stock of fixed capital per head. The section of the original paper discussing this argued that in the relevant period in Australia immigration had no effect on the ratios in the private sector of investment to output per head, employment and unemployment. Investment in the public sector was taken to be a policy variable.

Thus, overall immigration does reduce unemployment in Australia. The effect is not large but neither is it insignificant. Moreover, Australia is one of the countries in the sample with a relatively large random error term in equation 1 above suggesting that the estimated value is a lower limit for the actual value. Be that as it may, it is safe to claim that in the 1980s and 1990s, on average over a business cycle, immigration reduced unemployment by 0.3 of percentage point and perhaps a little more.

19.5 Mathematical Appendix

The framework of analysis is an adaptation of the Solow-Swan growth model, which produces a Keynesian rather than a neo-classical model. Technical change is not exogenous, and wages are not flexible. However, it should be noted that three of the key Solow-Swan assumptions are used in our model, namely constant returns to scale, that factors are paid their marginal products, and that technical change is Hicks-neutral.

Using Swan's framework (Swan 1956) we start with a Cobb-Douglas production function:

$$Y = AK^{\alpha}L^{\beta} \quad (1)$$

where the symbols have their usual meaning.

Since we have assumed constant returns to scale we can divide all variables by the number in the population, N , to get an equation for per capita output:

$$y = Ak^{\alpha}l^{\beta} \quad (2)$$

where y is output per head of population.

k is capital per head of population, and

l is employment per head of population.

The rate of growth of y is given by

$$\gamma = A + \alpha k + \beta l \quad (3)$$

where γ is the rate of growth of y (or more formally the first derivative of y with respect to time, divided by y)

A is the rate of growth of A ,

k is the rate of growth of k , and

l is the rate of growth of l .

It is assumed that:

$$l = a + bN - cN^2 \quad (4)$$

where N is the rate of growth of N

$$\text{and that } A = g + hY \quad (5)$$

where Y is the rate of growth of Y

$$\text{Since } Y = y + N \tag{6}$$

$$A = g + h(y + N) \tag{7}$$

$$\text{Since } k = s \frac{Y}{K} - N \tag{8}$$

where s is the ratio of net investment to output, we can write y as a function of N by substituting equations (4), (7) and (8) into equation (3). Thus

$$(1 - h)y = g + hN + \alpha \left[s \frac{Y}{K} - N \right] + \beta(a + bN - cN^2) \tag{9}$$

y is a maximum when

$$\begin{aligned} \beta b + h - \alpha - 2\beta cN &= 0 \\ \text{or } N &= \frac{b}{2c} + \frac{h - \alpha}{2\beta c} \end{aligned} \tag{10}$$

From chapter 2 we know that $\alpha = 0.25$ and $\beta = 0.75$: from chapter 3 that $b = 1.22$ and $c = 0.63$ and from chapter 4 that $h = 0.62$. Thus y is a maximum when $N = 1.36$ percent.

Notes

This is taken from the report on a project commissioned by the Federal Government's Bureau of Immigration Research. The original publication acknowledged my debt to Ken Rivett and Eric Sowe for helpful comments at many stages and to Lyle Baker, Ross Chapman, Nanak Kakwani, Neville Norman, John Piggott and Bill Rao for commenting on a draft. However, no one but myself can be held responsible for any errors of omission or commission.

The section of the original work on the effects of immigration on employment and unemployment was central, and is reproduced here largely unchanged. The previous three pages are also included as they both put this section into context and spell out the assumptions underlying the regression analysis in various parts of the report.

1. While no apology is made for this, I do not wish to imply that the 'quality of life' is unimportant. However, it is necessary to learn to walk before one can run, and hence the circumscribed focus of the paper. Moreover, not only is the level of resources available to satisfy needs an important part of the quality of life, but also with greater output per head, the more resources are available to reduce such things as pollution.
2. Goodwin (1970, pp. 2–3) gives a brief outline of the theoretical arguments for assuming constant returns to scale. Baumol (1977, pp. 272–274) gives a more extended discussion with reference to empirical studies supporting constant returns to scale. For the opposing case, see Baldwin (1989) which argues that increasing returns to scale are typical in capitalist economies.

3. These countries are: Australia, Austria, Belgium, Canada, France, Germany, Greece, Italy, Japan, Netherlands, Portugal, Spain, Sweden, Turkey. United Kingdom and United States of America.
4. The additional eight countries are: Denmark, Finland, Iceland, Ireland, Luxemburg, New Zealand, Norway and Switzerland.
5. Some might argue that the maximum value of the quadratic is not well defined because there are only two countries with rates of population growth significantly above the rate at which the function is a maximum and the one with very rapid population growth may have an undue influence on the position of the turning point. Two points can be made in reply to this. First, if one alters the data for this country and changes substantially the value of the dependent variable (which is measured less accurately than the rate of population growth), it makes little difference to the position of the turning point. Secondly, we know a priori that the function must turn down. The data makes it very clear that this turning point cannot be much before a 1 per cent rate of population growth. The only possible significantly different result would be to have a turning point at a greater rate of population growth. Thus, adopting the equation used in the paper is consistent with the principle of using the specification less favourable to immigration.

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20

The Effects of the Immigration of Low-skilled Workers on Unemployment

J. W. Nevile and Peter Kriesler

It has been common to argue that the immigration of low-skilled workers will mainly add to unemployment. We take issue with this conclusion from a Keynesian/Political Economy position. Rather than the level of employment being determined by the wage rate, the alternate view is that employment is determined by the level of effective demand. In this case, immigration, by adding to effective demand, may increase employment levels, rather than decrease them.

20.1 Memories of Warren Hogan and Introduction

Both authors regarded Warren Hogan as a colleague and a friend. Peter Kriesler was taught by him, and owes him a student's debt of gratitude. He has a particularly fond memory of a small honours seminar being taught by Professor Hogan. In that far off time, smoking was permitted in class rooms. Warren, an inveterate smoker would commence smoking cigarettes, and graduate to a pipe, filling the room with thick clouds of smoke. During a particularly heated discussion amongst the participating students we turned to ask Professor Hogan's opinion on the issue, only to discover that he had left the room under the cover of the smoke cloud. This illustrates Warren's sense of humour, which helped make him such an agreeable colleague and mentor.

Warren's contributions to economics covered an extraordinary range of theory and policy (Lodewijks 2007). Immigration issues were clearly an important area of interest to him. Not only was he involved in the Australian Population and Immigration Council, but he also published an significant paper on "Issues in immigration and migrant settlement problems" (Hogan 1984). In that paper, Hogan challenges many of the issues

Revised from *International Journal of Applied Economics and Econometrics*, 18: 58–68, 2010, 'The Effects of the Immigration of Low-skilled Workers on Unemployment,' by Nevile, J. W. and Kriesler, P. With kind permission from *The International Journal of Applied Economics and Econometrics*. All rights reserved.

related to immigration which, due to the bipartisan nature of support at that time, were not held up to "critical scrutiny." The paper examines the impact of the changing sources of immigration to Australia on unemployment rates of the migrants, and the question of the ability of the country to absorb vast numbers of culturally diverse migrants both economically and culturally. In particular, the paper points to the problems associated with the impact of the decline in the manufacturing industry on the employment of unskilled migrants.

Since Hogan's article, the issue of immigration into Australia has become a controversial one, in which much heat has been generated but little light. While many of the subsequent contributors to the debate acknowledge the importance of an economic evaluation of the costs and benefits of immigration, most of these have been in terms of conventional/neoclassical economic theory. In particular, this has been used to argue that the immigration of low-skilled workers will mainly add to unemployment, and so is unlikely to have major benefits to the Australian economy. This was the main conclusion of the report by Ross Garnaut (Garnaut 2003). We take issue with this conclusion from a Keynesian/Political Economy position. Rather than the level of employment being determined by the wage rate, as is the case in the neoclassical analysis and in the Garnaut report, the alternate view is that employment is determined by the level of effective demand. In this case, immigration, by adding to effective demand, may increase employment levels, rather than decrease them.

The next section presents the neoclassical view, as embodied in the Garnaut Report, which is critically evaluated, while section 3 presents an alternate Keynesian view.

20.2 The Garnaut Report

This section of the paper considers the neoclassical treatment of the question of the impact of the immigration of low skilled-labour into Australia on the level of unemployment. Neoclassical theory sees the wage rate as the main determinant of employment, ignoring the contrary insights of Keynes, Kalecki and political economy. We take as typical of this view the Garnaut Report (Garnaut 2003). This view argues that, effectively, the labour market divides into a number of separable markets, in each wages and employment levels are determined by demand and supply. So, in times of full employment: "In general, an increase in the amount of a certain kind of labour skill ... reduces relative incomes of established Australians with similar skills ... and raises relative incomes of other types of labour" (Garnaut 2003 p. 21)

However, Australia's labour markets are seen as relatively inflexible, in the sense that increased supply of any type of labour does not lead to the required fall in its real wage. As a result, increased supply of a particular type of labour is, according to this view, associated with a reduction in that type of labour's

level of employment. This is contrasted with the position in the USA, where flexible labour markets mean that any increase in supply of a particular type of labour leads to a fall in that labour's real wage, and so an increase in employment. In other words, according to this view, increased labour supply is either met by a fall in wages and an increase in employment, or, in the case of wage rigidities, an increase in unemployment: "In Australia, with high and rigid minimum wages for low-skill workers, increased supply of low-skill relative to high-skill labour would lead to increased unemployment. By contrast, in the United States, with more flexible labour markets, it would lead to a fall in wages of unskilled labour." (Garnaut 2003 p. 21)

The implications of both of these is that an increase in low-skilled labour supply through immigration will lead to a decline in their relative position in the distribution of income in both countries, though through different channels:

Different labour market institutions cause tendencies towards greater inequality in labour incomes in Australia and the United States to be reflected in very different ways. In the United States, they are reflected in relatively low wages for low-skill workers. In Australia they are reflected in relatively high unemployment for low-skill workers. The differences derive from the greater rigidity in Australian wages, associated with the large regulatory role played by public institutions (Garnaut 2003 p. 50)

It is our contention that this view is fundamentally flawed. The empirical evidence which is used to support it is ambiguous at best, while its theoretical underpinnings are extremely problematic.

Problems with cross country comparisons of unemployment rates are well known. There is much evidence showing that there is significant understating of the "true" level of unemployment in most countries. There are also suggestions that this problem is worse for the US for a number of reasons, including the significantly higher incarceration rates (Galbraith 2009 p. 110). In other words, the empirical comparisons of unemployment rates which Garnaut uses to support his theoretical analysis must be considered to be unreliable.

Further, if we accept the analysis of political economists, that the main determinant of the level of employment is not the wage rate, but rather the level of effective demand, then most of Garnaut theoretical analysis must also be seen as being suspect. The view that the main determinant of the level of employment is the real wage has been shown to have fundamental logical problems in the Cambridge Capital Controversies and elsewhere (Harcourt 1972, 1975). There it was shown, and major neoclassical economists including Samuelson accepted, that there was no theoretical justification for the supposed inverse relation between the wage rate and the level of employment (Samuelson 1966). As a consequence, we reject this relation and, therefore, Garnaut's conclusions.

Increased low-skilled immigration is likely to have a significant impact on the level of effective demand, and hence have a positive impact on the level of employment. This will be reinforced by the fact that the typical consumption basket of low-skilled labour will contain consumption goods produced by less skilled labour than the equivalent basket for skilled labour. So, every new migrant will require resources including housing, food and transport, which will, in turn lead to increased effective demand and increased employment. The neoclassical analysis ignores the feedback from increased immigration to increased effective demand, which will have the effect of increasing employment. The fact that low skilled labour may be adding to demand means that it may be increasing, rather than decreasing employment, by increasing the demand for labour. So that the overall impact on the unemployment rate will depend on how the creation of new employment from immigration compares to the impact of immigration on labour supply.

Further, there are likely to be cumulative effects, as the increased levels of employment and output lead to higher levels of investment, and to economies of scale, which increase international competitiveness further boosting growth with substantial positive impacts on employment. There is a strong relation between the level of skilled employment created this way, and demand for unskilled labour: "Employment opportunities for the relatively unskilled depend upon the activities generated by the professional and technical members of the workforce, all the more so if the Australian economy is to adapt to an internationally competitive stance throughout its productive structure." (Hogan 1984 p. 67)

This later considerations reinforces another problem with neoclassical analysis associated with path determinacy. For neoclassical economics, the equilibrium achieved by the economy is independent on the path taken by the economy outside equilibrium, that is, on its traverse. However, there is strong evidence that any properly specified model must exhibit path dependency, which is an essential feature of political economy theory (Kriesler 2003). In other words, a general analysis of the impact of immigration of any type, independent of the current economic situation and the domestic and international economic environment and institutional framework, will miss many of the most important features. It was just such an analysis of the impacts of immigration in terms of the then current economic and social situation that was a major feature of Hogan (1984) discussed above. As such, we reject the notion that there is a determinate impact of low-skilled migration on the level of unemployment.

20.3 A Keynesian View

As we have seen, the neo-classical approach typified by Garnaut is flawed in its disregard of any link between population growth and effective demand.

This link was recognised immediately after the publication of the *General Theory*. In his review of that book in the *Economic Journal* Hicks (1930) commented:

It does become very evident, when one thinks about it, that the expectation of a continually expanding market, made possible by increasing population, is fine for keeping up the spirits of entrepreneurs. With increasing population investment can go roaring ahead even if invention is rather stupid; increasing population is therefore actually favourable to employment. It is actually easier to employ an expanding population than a contracting one, whatever the arithmetic would suggest – or at least this is so when the expansion or contraction is expected, as one may assume generally to be the case. (p.252)

At the time the population of England was declining rather than growing and the population of her trading partners was more or less stationary. Hicks expressed his fears that this would make it more difficult to reduce unemployment.

Three years later one of Keynes' brightest students Brian Reddaway (1939), devoted a whole book to the tendency for a stagnating or declining population to increase the level of unemployment. He spelt out the details and implications of what a declining population meant if one accepted the analysis of the determinants of employment set out in the *General Theory*. However, Reddaway's arguments were essentially symmetrical, and can be applied in reverse to show that population growth reduces unemployment.

Reddaway started by considering frictional and structural unemployment. He pointed out the difficulties when there was a decline in absolute demand for a product, which were likely to occur when population was stagnant. These would not exist if, due to population growth, there were only a relative decline in demand for that good or service. He also pointed out the difficulties for those losing a job of finding one through reskilling when demand in general was stagnant, coming to the conclusion that "a declining population both increases the amount of adjustment which is necessary and reduces the ability of the system to affect it smoothly" (p.67). However, most of his discussion is about "general" or "cyclical" unemployment. His arguments are the mirror image of those in, or implied by, the Hicks quotation. He stresses the importance of a growing population in creating a climate conducive to investment citing housing as only the most obvious example. But once the population stops growing, new investment will be much less to produce goods that are staples and become "directed largely to luxury and semi-luxury industries" (p. 117). Demand for these is much more volatile. Investment becomes more a matter of faith and animal spirits are much more important leading to a lower level of investment over the cycle. Like Hicks, Reddaway was very clear that population growth made it easier to maintain full employment.

However, what was very evident 65 years ago is no longer evident at all to neo-classical economists today. The belief that, in the medium to long run, the economy tends strongly towards a supply determined equilibrium, combined with a belief that this equilibrium is not path determined has led to the neglect of influences of population growth on aggregate demand. If equilibrium is indeed path determined, population growth affects variables such as employment, output and living standards in the longer run, whether or not equilibrium is reached. Our objections to the neo-classical approach have been set out in the previous section. Whether or not one agrees with it, the Keynesian view is well supported. Instead of spelling out the Keynesian view in detail, we will turn to empirical analysis. It is an opportunist piece of analysis, which makes use of an existing data set. If one was starting from scratch or presenting more than a preliminary examination of the problem, a more complex analysis might be preferred. But since we are concerned with broad tendencies, the simplicity of the model used does not diminish the interest of the result.

Over two decades ago one of the authors of this paper (Nevile, 1990) developed a model to examine the effects of population growth on employment, productivity and living standards. One part of that model was a cross section equation which estimated the relationship between population growth and growth in employment. In that equation the explanatory variable was the rate of population growth and the dependent variable was the rate of growth of employment per head of population. About the time the analysis was published the effect of demographic change on the ratio of working age population to total population started to be discussed. The original equation was re-estimated from exactly the same data set,¹ except with an additional year added, to see if changing the dependent variable to the rate of growth of employment per head of population aged 15 to 64 inclusive made any difference. It did not.

We have used the equation fitted from data for the years 1980 to 1988, to predict the level of employment in Australia in 1999. This is a very severe test. It is not only over a decade after the end of the period to which the data used for the equation was estimated, but also the overall participation rate may be affected by such things as the tendency for increasing participation in the labour force by women, changes in the number of young people remaining at school after reaching the age of fifteen and voluntary retirement before the age of 65. To the extent that trends in these have changed substantially in the last decade or so, the equation estimated with data finishing in 1988 will not predict so well employment growth since that time. Most important of all many would argue that there was a major break in the factors determining employment between the boom in both output and employment in the 1980s and what is often described as the employmentless growth of the 1990s.

The equation is estimated from a cross section study of OECD countries. Both the dependent and the explanatory variables are average annual rates

of growth over the period 1980 to 1988. The equation is not intended to represent an equilibrium situation, but an economy out of equilibrium or moving from one equilibrium to another in what Hicks called the traverse. The shape of the function has to be determined. There is a strong *a priori* presumption that the rate of growth of employment per head does not increase indefinitely as the rate of population growth rises. After some rate of population growth is reached, it is difficult for the economy to absorb quickly the extra labour, and growth in employment per head may be expected to fall off. The simplest mathematical form which enables this result is the quadratic form, and that is used in the regression analysis.

The regression equation is a cross section equation. In the first instance the 17 largest OECD countries are taken as the sample.² Extremely small countries, such as Iceland or Luxemburg, may have economies that are dominated by some completely exogenous factor. In the 1980s this was true for a country as large as Norway, where the development of North Sea oil had a strong influence throughout the economy. As a check, the regression equation used was also estimated from a sample of 24 countries which included an additional 7 very small or extremely small countries.³ Data for the regression analysis was obtained from OECD Labour Force Statistics. In the case of two countries (Germany and the Netherlands) there was a break in the series for the whole population in 1987, and in each case the figures for 1988 were adjusted to make them consistent with those for 1980. This was easy to do, at least in a rough and ready fashion, since the figures for 1987 were published on both the old and the new basis. The same adjustments were made to the 1988 figures as the published adjustments to the 1987 figures.

The first equation in Table 20.1 is the regression equation for the sample of the 17 largest OECD countries. The coefficient on both population growth and the square of population growth have the predicted signs and

Table 20.1 Regression equations

The dependent variable is the rate of growth of employment per head of working age population

Sample	Constant	Rate of Growth of Population	(Rate of Growth of Population) ²	Adjusted R ²
17 Largest OECD Countries	-0.795	2.120	-1.015	.49
	0.214	0.556	0.243	
24 OECD Countries	-0.619	2.006	-0.972	.22
	0.284	0.738	0.335	

Figures under the coefficients are their standards errors.

All variables are percentage rates of growth over the period 1980 to 1988.

are significant at the 0.2 per cent level and 0.1 per cent level respectively. The second equation in Table 20.1 shows the result of extending the sample to all the 24 OECD countries. As one would expect the fit is not so good, but it is comforting that the values of the regression coefficients have changed remarkably little and (except for the one on the constant) are significant at about the 1 per cent level.

How well does the first equation in Table 20.1 predict the rate of employment in 1999, the last year that the standardised OECD data are available. The predicted value of the rate of growth of the ratio of employment to population aged 15 to 64 is 0.26% a year.⁴ The actual rate of growth of this ratio was larger 0.97% a year. If changing trends in the average number of hours worked are taken into account the ratio is reduced a little but not dramatically. The discrepancy between the actual ratio and the predicted one, 0.77 of a percentage point, is 1.7 times the standard error of the regression. We judge this a good result for a prediction 10 years into the future. The Keynesian view that, except for very large rates, population growth increases employment per head is supported.

20.4 Conclusions

Warren Hogan, in 1984, complained that due to the bipartisan nature of support for immigration, there was a lack of critical debate both as to its merits and to the appropriate structure of immigrants. Certainly, since that time, both globally, and for the Australian economy, immigration has become an area of controversy. In Australia's case, much of the argument has been about the both the number and the type of migrants which are appropriate. The contribution of economics to the debate is in terms of its ability to gauge the economic consequences of different sizes and types of migration. Much recent debate has considered the implications of the immigration of unskilled labour for the Australian economy. The analysis has, typically, been in terms of neoclassical theory which sees the wage rate as being the main determinant of the level of employment. As such, any increase in the supply of a particular type of labour will put downward pressure on wages. The reduction in wages will increase demand, and, therefore employment. If, as in the Australian case, wages are downwardly rigid, then the burden of adjustment to the higher level of labour supply will be on the unemployment rate. According to this view, if wages do not change, the demand for labour will remain constant, and so the new labour will not be able to find work, increasing the unemployment rate.

For a number of reasons, outlined in the paper, we reject this view of the determination of employment in favour of the Keynesian explanation, according to which the level of employment is determined by the level of aggregate demand. Unskilled immigration adds to the demand for labour, and therefore creates employment.

Notes

1. Except that an additional year was added.
2. These countries are: Australia, Austria, Belgium, Canada, France, Germany, Greece, Italy, Japan, Netherlands, Portugal, Spain, Sweden, Switzerland, Turkey, United Kingdom and United States of America.
3. The additional 7 countries are: Denmark, Finland, Iceland, Ireland, Luxemburg, New Zealand and Norway.
4. The equation for the whole of the 24 countries actually predicts slightly better (with a predicted rate of growth of 0.35) but in principle the first equation is the one that should be used.

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21

Why Privatize Airports?

Peter Kriesler

This paper examines the arguments for the privatisation of airports in Australia. The general arguments for privatisation are evaluated and found not to be universally applicable. There is no a priori argument in that all activities operate optimally in the private sector. Rather, the costs and benefits of each particular case need to be examined. This is then done with respect to airports. Firstly, the question of whether airports should be operated as networks or as individual optimizing entities is considered. It is shown that with respect to both pricing and investment decisions, efficiency requires retention of the network. Due to the nature of the product, the market will not deliver an efficient, competitive outcome. In this light the specifics of the Australian privatization proposals are examined and found wanting. The case for privatization of airports is extremely weak.

“I have come to bury Caesar, not to praise him”

21.1 Introduction

The debate about the pros and cons of privatization have been raging for some while, and, as is usually in debates where politics, economics and special interests all clash, much heat has resulted, and little light. Rather than rehearse the whole debate, this paper presents some of the key issues relevant to the question of privatization of airports in Australia. In doing so, it first considers the general arguments for privatization, before concentrating on the specific arguments for airports. In discussing the privatization of airports within the context of the current Australian debate the arguments for network versus individual ownership need to be evaluated, as this is an important issue within the policy suggestions, as well as the economic and political arguments on privatization.

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21.2 Privatization: The General Case

In recent years, microeconomic reform has become the buzz word for 'fixing' the problems of the Australian economy. Although there is no agreement as to exactly what this may entail, the one aspect of microeconomic reform which appears to have gained wide approval is that of privatization of much of the public sector. There seems to be a mystical belief that by moving operations into the private sectors, the efficiency of markets will infect these bodies. Implicit in this is the belief that it is primarily the ownership of an asset which influences its efficiency. While it may be true that in some case efficiency can be improved by such transfers, it is by no means apparent that this is true in general.

In evaluating this position, it is important to realize that economic policy follows fashion. After the second world war, fashion dictated that any market failure was met by nationalization, and economists oversold the efficacy of government intervention. In the 1970s, there was an overreaction in discarding these ideals, with economists now overselling the efficacy of markets. The state came to be seen as a liability, with the general rule becoming the less state intervention, and the smaller the role of the public sector, the better. This has come to be the creed for much policy throughout the OECD, with Australia being no exception. In other words, privatization seems to be pursued for its own sake, rather than in order to achieve specific aims.

At this stage it is important to note that there is no evidence, theoretical or empirical, to back the view that privatization will guarantee enhanced economic performance.¹ Quite the opposite. When the economic performance of all countries is examined we see that there is no definitive relation between the size of a country's public sector and its performance.² The Asian tigers provide a perfect example, with some relying on heavy government intervention to promote growth, while others have relied equally on markets.

Similar arguments are relevant to the question of privatization. Certainly there are no conclusive theoretical or empirical arguments which consistently show privatization as improving the allocation of resources.

To understand why this may be the case, it is important to examine the reasons why certain activities have come into the public sector. There have been two main types of enterprises which economists have argued should be considered for public ownership, those involving monopolies and those where community/social services may lead to benefits accruing to the community if alternatives to private sector profit-maximizing principles are adhered to.

In the case of monopolies, which is of particular relevance in the discussion of airports, the argument for privatization rests on extremely shaky foundations, since the benefits are supposed to flow from increased competitiveness. Since, due to the nature of the beast, competition can not be

encouraged, problems arise. Economic theory maintains that there are conflicts between monopolies and economic efficiency. As a result, privatization of monopolies is usually associated with a regulatory body. This means that resources are being wasted monitoring and regulating an activity that previously did not need this.³ The position seems to require a contradictory assumption, namely that although governments are not good at managing these enterprises they are good at regulating them.

In any case, this loses sight of the main point, which is that it is not ownership, *per se*, that is important, but the state of competitiveness in the market. Competitiveness can be encouraged within public sector enterprise, as has been shown in the fact (discussed below) that many have experienced increased efficiency and profits just prior to privatisation!

The supposed benefits of privatization are dubious. If markets are efficient, then the government should not make any profit on the sale. All it is doing is selling future income streams at their current price, to improve the current budgetary position. This is assuming that the price of the asset has been correctly determined, so that it is not undervalued (as was the case with much of the privatization in both the UK and in New Zealand).⁴ In fact there is strong evidence of bias towards selling public assets for less than their market value due firstly to the 'political imperative associated with privatisation, and because of moral hazard problems associated with the sale of a regulated monopoly'.⁵ This latter refers to the perception that the higher profits associated with the private sector monopoly may lead the government to tighten regulations. In addition, the transaction costs associated with the transfer of the asset from the public to the private sector, may be substantial,⁶ reducing the realized value of the sale. In other words, there are costs associated with privatization, these are the transaction costs involved in the whole process of the sale, coupled with the costs of regulation. Additional problems associated with the impact of privatization include the negative impact on financial markets and the resultant fall in private sector savings available to finance private sector investment.⁷ These are two effects which the Australian economy can ill afford.

In any case, the government is often unclear about what benefits it expects to flow from privatization. In many cases, it is the one-off revenue gain, rather than any long-run improvements to efficiency. This has been compared to selling the family jewels, which leads to the question of why privatize unless there is some gain to the economy as a whole from the sale?

When pushed, supporters of privatization will answer in terms of an improvement in efficiency from privatization. However, this is far from clear. While it is true that many public sector enterprises have not been run at maximum efficiency, this is a problem with management practices rather than with ownership. Experience has shown that, prior to privatization, in order to make sale attractive, these same enterprises have been made

profitable while still in the public sector.⁸ In other words, it is not the question of who own the enterprise which determines efficiency, but rather how they are run.

The public sector has also been important in the provision of infrastructure and of certain services which benefit the whole community. In these cases economics has shown that the private sector is bad at allocating these efficiently.

Problems with private sector allocation have been reinforced by recent developments associated with deregulation of the financial sector, which have meant that private sector enterprises in general, and the financial sector in particular, have become much more myopic. As a result, there is a lack of desire to undertake and fund long-term projects within the private sector. However, it is precisely these projects which have spillover effects on efficiency and growth and which must form the basis of any macroeconomic reform.

What we are arguing is that there are no general rules. Just as there are some activities which produce a socially optimal outcome in the private sector, so there will be others which will do so within the public sector. Rather than espouse a naive belief in general rules, it is much more appropriate to consider the arguments for privatization or nationalization in each individual case, evaluating the likely costs and benefits. The important question, then, is whether privatization of the airports represents a net benefit to society.

21.3 Why Privatize Airports?

There are two related areas which need to be discussed when considering the question of privatization of airports.⁹ The first is the question of whether they should be privatized at all. The second, and related question, is the form such privatization should take. Clearly these questions are related, as the form of privatization will vitally influence any potential gains. In the next section, the nature of airport interrelations will be considered, and it will be argued that it is socially desirable to keep them together as a network. This result will be used to throw some light on the desirability of privatization.

21.4 Airports As Networks

Elsewhere it has been argued that pricing and investment decisions of aeronautical services by airports can only be made efficiently when the individual airports do not act as separate optimizing agents; but rather act as elements within a network.¹⁰

Relationships between airports are extremely complex, they are both 'complements of and substitutes for each other' [Woods, 1971: 298]. As (almost) all flights involve flying from one airport to another, individual

airports must be considered to act as complements to each other. On the other hand, to the extent that the purpose of a flight can be achieved via a choice of airports, then the potential competitors are substitutes. Clearly though, the relationship between airports is more often that of complements. The related question of whether the correct unit of analysis for the purposes of investment decisions is the individual airport or the network depends, to a large part, on the exact nature of the product. In other words, is what is being analyzed air transport as a whole, or is it flights to a particular airport? To answer this question, it is helpful to differentiate domestic and international flights. In doing so we can introduce the distinction between open and closed aviation systems. An open system is one where either flights originating from outside the system arrive into the system or where flights originating from within the system have a destination outside it. Within a closed system all flights both depart from and arrive to destinations within that system. With respect to the Australian airline system, international flights represent an open system while domestic flights represent a closed one.

With respect to international flights, to a large extent the product being sold is travel to or from Australia. As it is an open system, the international airports act as gateways for entry to or exit from the country. In Australia's case, the fear of competition from outside the system, from other international airports, is not a concern, as it would be, for example, for a European country. Although this has important implications for both pricing and investment decisions, I will concentrate on the latter. With respect to investment, taking this into consideration, and given the earlier argument that the demand for international air travel is exogenous, allowing investment decisions to be taken on the basis of individual airports will lead to over investment. If each airport acts as an isolated individual in making their investment decisions, then they will tend to expand facilities in order to attract demand, as a form of strategic behavior. However, as total demand is fixed, the airports are involved in a zero sum game, so that any airports gain will be at the expense of another airport. Consider the following example:

If we assume that investment decisions are now taken by individual airports and that Melbourne International Airport wishes to expand its facilities in order to reduce costs and capture a larger share of international travel. If other international airports believe that such an expansion will give Melbourne a relative advantage, then they are likely to follow suit. Each airport in attempting to expand or maintain their share of international flights will increase their investment. However, notwithstanding this total increase in investment, there will be no resultant increase in total flights. So, the increased investment will not generate any increased revenue for the system as a whole.

This example allows consideration of the essence of the problem. Individual airports are concerned both with the total number of international flights

but also, importantly, with their share of that total. It is in their interest to try to maximize both of these, although they can really only influence share. As it is a zero sum game, attempts by individual airports to increase their share will lead to over investment. Such investment will not increase overall usage, but, rather will lead to switch effects between airports. Total international traffic will, however, remain unchanged. From the social viewpoint, the resultant over-investment is inefficient.

In addition, there are clear welfare advantages from investment decisions for overseas services being taken on the basis of a network rather than individual airports. With networks, peak loads can be spread, therefore reducing the total capacity (and, therefore, investment) requirements.¹¹ As well, there are clear informational advantages from the size and resources of a network unavailable to individual airports.

We can contrast this discussion of international flights, with domestic flights. As noted above, domestic flights form a closed system. Any such flight will be from one airport within the system to another one, also within it. As a result, neither the demand for nor the supply of flights or airport facilities within one airport can be independent of the whole system. The implications of this is that it will not be rational for investment decisions with respect to airport capacity to be made at the level of the individual airports. Without the pooling of information implicit in network decisions, individual airports may reach incompatible investment decisions on the basis of less perfect information. If decisions were made at the level of individual airports, then, for example, one airport could decide to expand, even though no other airport within the system expected any expansion in the demand for their services. Clearly this indicates incompatible expectations as any increase in the demand for the services of any one airport must be matched by an equal increase in demand for services over the rest of the system. In other words, because the demand for the services of any one domestic airport is linked to the demand for services of other airports within the system, it is not rational for investment decisions to be made at the level of individual airports, thereby ignoring the interdependent nature of those demands. Rationality would require investment decisions to be made on the basis of network considerations.

To measure values of individual airport improvements within the framework of a general aviation airport *system*, benefits must be quantified in such a manner that *incremental* improvements at individual airports can be evaluated with respect to the contribution they make to the entire system. [Woods, 1971: 295, emphasis in original]

In addition, there is the possibility, as with the case of international facilities, that individual airports will expand in order to increase their attractiveness in terms of both cost and non-cost factors. As such expansions are

unlikely to change the total volume of air transport, the only likely effect is to induce switching behavior:

On the one hand, it is quite often alleged that variations in the landing fee will have little or no effect on the demand for runway capacity, since the landing fee is but a small fraction – perhaps about 2% or at most 7% – of the total cost of the trip. On the other hand, one hears, often in the same speech and sometimes in the same sentence, that, if landing fees are increased too much at Heathrow, London will lose much valuable traffic to Paris Thus, while it is quite sensible to conclude that if *all* the competing airports in a region raised landing fees there would be little effect on air transport movements, it is misleading to suppose that there would be no effect on the demand for a particular airport's operation if it, and it alone, put up its fees. [Walters, 1978:133, emphasis in original]

This indicates that the only likely effect of changes in airport charges come from switching behavior. In other words, an individual airport *may* generate increased air traffic by a reduction in fees but only at the expense of air traffic to other airports.¹² In this case, other airports will also expand their facilities as defensive measures. The net result of this will be a bias within the system for the generation of inefficient excess capacity as a result of the competition between airports.

So far we have considered both domestic and international travel, but not the link between them. The argument for network considerations to dominate investment decisions is reinforced by the interrelation of these types of travel. To a large extent domestic and international travel are inter-related. The international airports serve as gateways to the domestic system. Residents in order to partake of international travel must first get to an international airport. Non-residents rarely stay the full length of their visit in their initial city of arrival.

In other words, there are important interdependencies in all types of air travel. These may be the interdependencies where one type of flight acts as a service link to others, or they may be more direct, where routes involve many airports:

Th[e] viewpoint of airports and air transport as an ever-widening circle of inter-acting consequences is compounded by the need for compatibility of airports and airplane schedules. The planning unit in airline economics is the route. Airports on the route must satisfy minimum requirements in terms of runway length, navigation aids, etc. Hence there is a powerful motive to 'keep up with the Joneses' so that a country or city is retained on the route. If a route is fixed, then upgrading one airport on the route will usually mean that all the others should be considered for upgrading

also. **Piecemeal investment is likely to be inefficient;** and this applies *a fortiori* to navigation systems. [Walters, 1978:127, emphasis added]

The above analysis suggests that the interrelations and linkages between airports within a country like Australia are so strong that airport investment decisions are unlikely to be efficient if they are taken in isolation of the rest of the network. The strong links indicate that the capacity decision of any individual airport will have important implications for the other airports in the network. Economic efficiency would require that investment decisions be made on a network basis.

21.5 To Privatize Or Not To Privatize, That Is The Question

I should note at the outset that the evidence suggests that airports in Australia in general, and the FAC in particular, are extremely efficient. One report concludes that:

The FAC is a highly efficient enterprise, both compared with other airports and airport systems, and relative to its past performance. There is little scope for gains in operational efficiency. (Paddon and Carman, 1992: 3).¹³

The main economic argument in favour of privatization of economic assets is that an increase in efficiency will result. An important requirement for this is that there be an increase in the level of competition, particularly when the government asset was run as a monopoly. Monopolies result from barriers to entry in the market. Where the barriers to entry are not caused by government license or regulation, serious doubts exist as to the possibility of competitive gains. In such cases, privatization will simply be associated with the monopoly moving from the public sector to the private sector. In the case of airports, the large capital expense of setting up and maintaining them means that they are virtually natural monopolies. The lumpy and indivisible nature of the investment decision, alluded to above, implies high fixed costs with relatively low marginal costs. The net result of these are decreasing costs per unit, so that the output can most efficiently be delivered (that is, at least cost) by a single producer. This is reinforced by the fact that airports do not compete, rather it is destinations which do. This has been reinforced by the Department of Prime Minister and Cabinet who, in a leaked Cabinet submission, admitted that there is 'little scope for effective competition between airports, even those as close as Brisbane and Coolangatta'.¹⁴

Due to the nature of demand for aeronautical services, which is extremely price inelastic, economic theory tells us that a profit-maximizing private sector airport will radically increase price and, therefore profits. The higher price will enable excess investment, which will result in a tendency for excess capacity. The net result will be a substantial reduction in welfare

and efficiency. In other words, due to the monopolistic nature of airports, public sector ownership has served as a way of preventing them from reaping the excess profits that the noncompetitive nature of the market would otherwise allow.

Privatization [of airports] is unlikely to achieve much; it would enhance the incentive to abuse monopoly power and while it would also enhance the incentive to produce efficiently, there is no evidence that productive efficiency is much of a problem. (Dwyer and Forsyth, 1992: 235)

To overcome the increased inefficiencies associated with this would require the formation of a regulatory body. The problems and ironies associated with this have been discussed above.

In addition to these considerations is the problem associated with externalities. Airports create both positive and negative externalities. Although at present most concern is on the negative externalities, especially given the problems with noise pollution associated with Sydney's third runway, there are also positive externalities related to the benefits of transport and communications systems at the local, regional and nation levels.¹⁵ Where such externalities exist, private sector decisions, which operate on the basis of private benefits and costs cannot provide socially effective outcomes, as they do not deal with the social content required for efficient decision making.

As a final consideration, it is important to note that the sale of airports will reduce the net worth of government assets. As was noted above, assets tend to be undervalued during the privatization process due both to the political imperative and to moral hazard.¹⁶ In the case of airports this undervaluation is likely to be more significant for two additional reasons. Firstly, the valuation of the large capital assets associated with airports is extremely difficult to calculate. Given the traditional problems associated with valuing such assets, reinforced by the fact that their value outside the aviation industry is likely to be low, it is likely that it will be undervalued. Secondly, the value of the airports as a network is much greater than the sum of the value of the airports sold individually. Given the Federal government's commitment to sell them as separate units, this will result in their sale value being lower than the market value of the network.

21.6 The Political Argument

One of the important arguments raised, both in the economic literature and the media for privatization, is that it will reduce the incidence of 'pork barreling'. The argument is best summarized as follows:

Airports seem to breed effective lobby groups, which succeed in blocking good proposals and getting poor proposals accepted. Building or expansion of airports involves gains and losses to geographically

concentrated groups (who could be voters in marginal electorates).... In some areas, airports for which economic justification has been dubious have been constructed. (Dwyer and Forsyth, 1992: 226)

In other words, the argument seems to be that political considerations may sometimes overcome economic ones. There are two responses to this charge. The first is that this sort of decision making is part of the democratic process, and that the alternative is that the decision is made by a private corporation, and there is no guarantee that they will choose more appropriately. The second, and related response, points to the fact that privatization will not remove the role of noneconomic factors it will merely change the nature of them. In the USA, for example, where airports are not run by the Federal government, municipal governments compete, in terms of tax subsidies, cheap energy, and so on, to attempt to attract airports. The impact of a major airport to a particular region may be very great, and, as a result, local communities, local government, business and other regional interests will intervene in order to attract the investment. The important question is the degree to which the effects and costs of this differs from the situation where it is a government agency which is making the decisions.

21.7 Conclusions

When examining the arguments for privatization of airports, the potential benefits are unclear. There is unlikely to be any gain in efficiency resulting from increased competition. If the aim is to improve the Federal budgetary position, then privatization will have the exact opposite effect. As the sale value is likely to be significantly lower than the market value, the impact will be to impoverish the government, by adding to current income an amount less than the current value of the asset.

This paper asks the question: why privatize airports? The answer is that there is no good reason for doing so.

Notes

1. cf. Rowthorn and Chang (1992) and Williams (1992).
2. Saunders (1993).
3. Williams (1992). For a discussion of the English example of privatisation and ineffective regulation of water, see Johnson (1992).
4. See Rowthorn (1989) and Williams (1992).
5. See Quigin (1994).
6. It has been estimated that the total costs associated with the privatisation of British Airways and the British Airports Authority was £158 million [Paddon and Carman (1994) p. 12].
7. See Williams (1992), Quiggin (1994) and Paddon & Carman (1994).
8. See Rowthorn (1989) and Rowthorn & Chang (1992).

9. There is the further question of the impact of the manner in which airports are to be privatized on the effect of privatization. Space prevents me from dealing with this, but interested readers are referred to Paddon and Carman (1994).
10. See, for example, Favotto, Kearney, Kriesler & Stegman (1994), Kriesler (1994), Paddon & Carman (1994) and Stegman (1994).
11. Similar comments on the benefits of 'pooling' with respect to energy generation is made in Industry Commission (1991) Appendix 10.
12. In the Australian case, with large distances between airports, it is unlikely that small differences in prices will lead to any switching effects.
13. See also Dwyer and Forsyth (1992).
14. Cited in Paddon and Carman (1992) p. 22.
15. See Stegman (1994).
16. See Quiggin (1994).

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Part III
World Economy

22

Asia, Japan and the Internationalization of Effective Demand

Peter Kriesler and Joseph Halevi

This paper examines the implications of Japanese relations with the growing economies of East and South East Asia. It is shown that, in macroeconomic terms, these relations are characterized by persistent and expanding current account surpluses in favour of Japan. Indeed East and South East Asia is becoming the area with which Tokyo obtains the largest current account surplus. The implications of these surpluses for the area are examined. In particular, it is argued that Japan's persistent surpluses constitute an implicit factor of stagnation. Drawing on the analysis of Keynes and Kalecki, it is the contention of this paper that unless Japan and the rest of Asia maintain surpluses with the rest of the world, especially the USA, then the region will experience real anti-Keynesian tendencies. This view is contrasted with the orthodox view, as manifested in a recent OECD report, according to which Japan's surpluses not only do not represent a problem, but also aid development elsewhere by providing much needed capital to countries where it is supposed to be scarce.

Cette étude analyse la nature des relations économiques entre le Japon et l'Asie orientale et du Sud-Est. Nous montrons que sur le plan macroéconomique ces relations sont dominées par la croissance des excédents de la balance des paiements courants du côté japonais. En effet la plus large composante du surplus de ce pays provient du commerce avec l'Asie orientale et du Sud-Est. En examinant les implications du phénomène, on découvre que le surplus de Tokyo avec le reste de la région constitue un facteur implicite de stagnation. A partir des analyses faites par Keynes et Kalecki, l'étude développe ainsi des considérations visant à montrer que, sans un excédent commercial permanent avec le reste du monde et, en particulier, avec les Etats-Unis, la région, y compris le Japon, aurait été soumise à des tendances anti-keynésiennes. Nous soulignons aussi la différence entre notre démarche conceptuelle, fondée sur le principe de la demande effective, et les conclusions

Revised from *Économies et Sociétés*, Serie MP, No. 10: 303–322, April 1996, 'Asia, Japan and the Internationalization of Effective Demand,' by Kriesler, P. and Halevi, J. With kind permission from *Institut de Sciences Mathématiques et Economiques Appliquées*. All rights reserved.

d'une récente étude de l'OCDE, d'après laquelle les excédents japonais jouent un rôle positif dans le développement puisqu'ils représentent une source de capital dans une région où celui-ci est rare.

22.1 Introduction

The continuing deterioration in economic relations between Japan and the USA, has been viewed as a potential source of crisis for the world economy. The origin of the dispute lies in American concern with its long term trade deficit with Asia, particularly with Japan. The situation is complicated by the surplus Japan has with the rest of East Asia. In fact, there are strong arguments that these trade patterns are related.

In order to examine the implication of these relations, this paper will first outline the links between Japan and the growing economies of East and South East Asia. It will be shown that, in macroeconomic terms, these relations are characterized by persistent and expanding current account surpluses in favour of Japan. Indeed East and South East Asia is becoming the area with which Tokyo obtains the largest current account surplus. However, the implications of these surpluses for the area have been less well discussed. In particular, the fact that Japan's persistent surpluses constitute an implicit factor of stagnation and of rent accumulation has been ignored. Drawing on the analysis of Keynes and Kalecki, it is the contention of this paper that unless Japan and the rest of Asia maintain surpluses with the rest of the world, especially the USA, then the region will experience real anti-Keynesian tendencies. This view is contrasted with the orthodox view, as manifested in a recent OECD report, according to which Japan's surpluses not only do not represent a problem, but also aid development elsewhere by providing much needed capital to countries where it is supposed to be scarce.

22.2 Asia's Growth: The Formation of AJA

The level of international public expenditure generated by the United States in the Asia-Pacific region has been a crucial factor in the whole process of Japanese reconstruction and further industrialization (Borden, 1984; Calder, 1986; Schaller, 1985). After the Korean War and, particularly, during the Vietnam War this role has been extended to other countries, most notably Taiwan and South Korea (Lanzarotti, 1993). At the same time however there is an important difference between Japan's experience and the rest of East Asia which seems to be replicated for countries like Thailand, Malaysia, Indonesia and also China.

In the case of Japan, the system of financial and juridical protection given by the United States expanded the country's capacity to concentrate on its own process of domestic growth. In other words, the system of Special Procurements payments devised during the Korean War, but continued till

the second half of the 1960s, as well as other similar arrangements, allowed Japan to cover its balance of payments deficit while lifting its import ceiling by 80%. Thus, Japan could afford not to be worried about imports except for cyclical adjustments. This represented a remarkable change vis-à-vis the pre-war period. During the 1930s the central problem facing Japan was the balance of payments constraint which favored an imperialist cum export oriented push (Nakamura, 1983). The estimated share of exports in Japanese GDP in the late 1930s was around 18% as opposed to the 8 to 10% share during most of the post Korean War period (Itoh, 1990). Hence, Japanese growth was mostly inward oriented and exports grew because of the high rate at which the whole economy expanded.

American international public expenditure also sustained the industrialization of East and, in part, of South-east Asia, but with a totally different mechanism as far as the growth process is concerned. In addition to US aid, which received a new boost during the Vietnam War (Naya, 1971), a complex system of interlinkages was set up during the heydays of the conflict. For example US spending on the South Vietnamese government allowed the payment for Saigon's imports from South Korea, Taiwan and Hong-Kong. As detailed by Naya's solitary and rare study, Korean and Taiwanese exports to South Vietnam absorbed something like 94% of steel and 70% of cement, chemical and other crucial sectors' total exports. At the same time the development of the productive capacities of both countries took place via imports from Japan financed by means of loans and, later, also by means of direct investments. The two regional conflicts led, in successive steps, to the formation of a small Americano-Japanese Asia (Aja), formed by South Korea, Taiwan, Thailand, Malaysia and Singapore with Indonesia as an outlying area. Hong Kong should also be included here but, for accounting purposes, it will be treated as a part of the People's Republic of China.

Prior to the Vietnam War, Aja was formed only by South Korea and Taiwan, which, along with Japan, heavily relied on imports from the United States. Japan represented then the most important export market of Aja.

Industrialization was initiated by the policies of the United States, and not by any natural Japanese spillover effect. The role of Japan emerged later, roughly around 1965 following Washington's pressures on Seoul to normalize relations with Tokyo. With industrialization sustained, or even conceived, by Washington's decision to expand American involvement in East Asia, Aja's trade flows underwent a sharp change. For both Aja and Japan, the United States became the main export markets, whereas Ajan countries imported mostly from Japan. Thus, from the second half of the 1960s onward a dynamic process began in which Japan moved from a deficit to a surplus position in its current accounts and Aja accumulated a structural deficit with Japan. Indeed the global deficit position in Aja's current accounts has, ever since, been determined by the deficit vis-à-vis Japan.

Given the initial small size of the Ajan economies the deficit was important for them but it did not represent a significant component in Japan's incipient surplus which, instead, came mostly from the trade with the United States.

With structural deficits governing the pattern of capitalist accumulation in Aja, relief from the debt burden was provided by means of politically induced packages. This is particularly true for South Korea, the largest and the most debt crippled of the whole lot. These packages included not just standard aid and special loans but the creation of a political will to lend. Thus, after the first oil crisis Washington ventilated the possibility of asking Congress to pass a special appropriation bill to absorb South Korea's external debt. As pointed out by Woo (1991), this factor signaled to the American and Japanese financial institutions that Korea was a safe bet. It constituted a precedent reiterated in the second financial crisis occurring after 1979. In her excellent book, Woo has detailed the nature of such operations which were combined with a specific policy by Washington to secure wider markets for the then still fledgling Ajan economies (Yoshihara, 1988).

The institutional opening up of markets, with politically backed financial support, enabled the accumulation process to continue after the end of the Vietnam War. This occurred despite a global slow down in the growth of domestic demand in the major country on which the process depended, *i.e.* the USA. In this context the mechanism of accumulation can be portrayed as follows: Japan has acted, and still acts, as a poor buyer, as evidenced by the declining share of Aja's exports absorbed by Tokyo. Japan's weak role in generating regional effective demand manifested itself rather quickly. As industrialization proceeded and Aja's size expanded, the latter's exports could not find a growing market in Japan, while Japan became the major exporter to each of the Ajan countries. Interestingly enough, the entrance of China into the Aja system has not modified the situation.

With China fully contributing to capitalist accumulation, the transformation of Aja into East Asia took place without altering the previous mechanism. The consolidation of the trade account positions of the geographical area spreading from Thailand to China shows a growing deficit with Japan, for whom the region has become the largest source of surpluses. At the same time the United States is still an expanding market, in terms of the share of exports absorbed, for China (including Hong Kong), Thailand, Singapore and Malaysia. Although China, including Hong Kong, has drastically reduced its import dependency vis-à-vis Japan, the trade deficit with Tokyo has been widening (UNCTAD, 1993; IMF, 1995). Thus, with China playing the most dynamic role, the mechanism of accumulation is subject to the same structural imbalances which characterised Aja's growth but without the full financial coverage provided by successive US administrations.

22.3 The Problem of Japanese Surpluses: The Neoclassical View

Given that the Asian region has a deficit against Japan, this paper will now investigate the implications of these surpluses, and will consider the question of whether or not they are sustainable. Two approaches to this question can be identified. The first, which we associate with neoclassical theory, argues that capital outflows linked to Tokyo's surplus can be used in the form of foreign investment to boost the Asian economies. The second approach, linked to the ideas of Keynes and Kalecki, stresses the role of effective demand. In the case of East Asia this means that Tokyo's surplus position constitutes a drain on East Asia's effective demand. This situation is seen as being unsustainable without an external source of demand for the Asian economies. It is argued that, within this context, the USA serves this function.

In the neoclassical model, the savings/investment relation is determined within the market for loanable funds, where savings are the supply of loanable funds, and investment the demand, and both are well behaved functions of the rate of interest. It is in this market that the division of the output between the production of investment goods and consumption goods is determined. The rate of interest is seen as the price which equates the demand and supply of loanable funds. Importantly, it is savings which lead investment, as savings determine the size of the pool of loanable funds, and investment can never exceed this pool of funds. According to this view, investment in a closed economy is limited by the amount of loanable funds available, given by the savings decisions of the private sector. In an open economy, this savings bottleneck can be alleviated with the use of investment funds from abroad, either in the form of debt or equity.

The argument is reinforced by the "twin deficit" view, which draws causal inferences from the national income accounting identity:

$$X - M \equiv (T - G) + S - I$$

Where: X is exports, M imports, S domestic savings, T taxation, G government expenditure and I domestic investment.

This is used to show that a balance of trade deficit is the result of investment being greater than total national savings [$S + (T - G)$], with the policy implication that to reduce that deficit it is necessary either to increase domestic savings or government savings.

These views, in the context of government expenditure, are associated with the notion of "crowding out". That is, that savings determines a certain loanable fund which is available to finance investment, and government expenditure merely crowd out private expenditure by reducing this investment fund. The notion that Japan's trade surplus can fund capital outflows

to finance development in other countries is merely an open economy version of this story. Now, the stock of loanable funds can be supplemented by foreign investment.

An important example of this type of reasoning, as applied to the question of Japanese surpluses and Asian development is Healey (1991), an influential OECD report. The argument is summarized as follows:

It is argued in this study, however, that policies designed to reduce or eliminate Japan's balance of payments surpluses (sic) would be misconceived. The essential reasons why it would be undesirable to reduce them is that these surpluses represent saving and it is saving – the difference between production and consumption – which is essential for the growth process of countries outside Japan, in particular those of the developing world... Given the worldwide demand for investment, it is surely ludicrous to advocate policies that would reduce or eradicate saving (Healey (1991) p. 21).

(T)he current surplus in the Japanese balance of payments ... is a *beneficial* feature of the world economy, and ... Japanese savings, as manifested in the country's balance-of-payments surplus, can be used for Asian economic development (Healey (1991) p. 25. Emphasis in original).

Healey then uses a variant of the twin deficit relation as an explanation of Japan's trade surpluses:

It is stressed in the study that it is the conjuncture of the macroeconomic variables which is at the root of Japan's balance of payments (sic) surplus, not simply trade factors... "National savings" have been greater than domestic investment, thus generating an equivalent surplus in the balance of payments [sic]. This surplus has been lent abroad (Healey (1991) p. 23¹).

So, we see that there are two aspects to the traditional interpretation of Japanese trade surpluses. The first locates those surpluses, from the twin deficit argument combined with a loanable funds analysis, in Japan's high level of national savings. The second aspect argues that these savings are beneficial to the world economy, in general, and have the potential to be beneficial to Asia in particular, as Japanese savings can finance investment elsewhere via capital outflows.

It is important to note that there are serious logical and theoretical problems with both of these arguments. Consider first the loanable funds idea that savings constitutes a stock of loanable funds for investment, and that savings must precede investment, so that savings causally determine investment, with the rate of interest equating the two. This idea, of course, is the one which Keynes, in the *General Theory* undermined. It will be recalled that

for Keynes, it is the level of income which equated savings and investment, with the rate of interest being a monetary phenomenon determined by liquidity preference. Keynes' main criticisms of the loanable funds doctrine were based on his rejection of both the interest elasticity of savings, and of the argument that savings determined investment. For Keynes, because changes in interest would have both income and substitution effects, it was not possible, *a priori*, to determine the direction or the size of the effect on savings. Rather, savings were mainly determined by the level of income. As a result, because increased investment leads to increased income, this would generate the savings necessary to finance it. Any attempt to increase savings would reduce aggregate demand, and reduce income, via the paradox of thrift. This can best be summarized as follows:

Until Keynes, investment was assumed to be dependent on saving as the source of finance. Keynes reversed this causal ordering, arguing that investment, financed independently of saving, created additional income adequate eventually to generate an equal volume of investment (Chick, 1987, p. 337).

Although Keynes accepted the other tenet of the loanable funds analysis, the interest elasticity of investment, this was subsequently shown to rest on unsound theoretical foundations in the debates known as the capital controversies². These showed that the inverse relation between the rate of interest and the level of investment does not hold up to theoretical scrutiny. In fact, the analysis leads to the rejection of any systematic relationship between the rate of interest and the level of investment, therefore undermining the theoretical foundation of the loanable funds view.

Furthermore, the neoclassical view is heavily reliant on the assumption of an exogenously determined money supply and bank credit, so that banks cannot increase finance to meet investment demand. Even with exogenous money, the government could, presumably, finance investment without a prior increase in savings by "printing" money. The underlying problem, with this approach is with the assumption of full employment of resources in a non-monetary economy. If this is the case, then by definition, investment can only be increased if resources from elsewhere in the economy are freed, hence the necessity for saving, not as some sort of financial requirement, but to free resources. However, in an economy with unemployed or underemployed resources, there is no necessity for savings to precede investment as there are resources not being fully utilized.

The other part of the argument, that relating to "twin deficits", which Healey refers to as the "macroeconomic variables... at the root of Japan's ... surplus", represents a mistaken identification of a national income accounting identity with a causal equation. The accounting statement does not tell us anything about cause and effect. An attempt to improve the balance of

trade by increasing domestic saving or reducing the government deficit may be self defeating as both will lead to falls in domestic income which may exasperate the problem.

In addition, empirical evidence does not support the causal interpretation of the twin deficit view, nor is there any evidence of interest elasticity of savings being greater than zero. Nor does the evidence on the interest elasticity of investment suggest any responsiveness³.

We are now in a position to understand the flaw in the OECD study. Only if a non-monetary economy has fully employed all its domestic resources does it need to generate forced savings in order to facilitate increased investment. In the specific context of Japan's surpluses towards East Asia, the mechanism, being a monetary one, is of an altogether different nature. It can be synthetically presented as follows. If Japan's industrial apparatus displays unused capacity, exports can be increased through commercial loans abroad and/or by direct foreign investment. In the latter case, capital outflows from Japan simply mean that the financial capital sent by the company making the decision to set up plants abroad will be spent to purchase Japanese equipment and other commodities. In both instances credit precedes investment and both precede savings. In fact savings are nothing but the *ex post* accounting result of the operation.

The same holds if the (Japanese) economy is at full capacity and its credit system receives a request for a loan from a foreign entity. Assuming, as has been the case in practice, that the foreign entity applies for the loan to import Japanese equipment, then, under full capacity, the Japanese economy will have to reappportion some of its investment to the sectors supplying the required equipment. In a dynamic context, that is in a growing economy, this is not at all difficult to do since it would require a marginal change in the apportioning of the newly produced equipment. Hence, also at full capacity, credit precedes investment and investment precedes savings (Halevi, 1985). By contrast, if the economy is not subject to growth it is likely to display unused capacity thereby bringing us back to the first case. As a consequence, while it is true that a developing country must import means of production, the exporting country need not generate a prior pool of savings. If it were to do so irrespective of the demand for investment goods from the developing country, the industrialized country would simply reduce the level of its own domestic demand.

It becomes clear at this point that, contrary to the OECD position, a persistent surplus from the exporting country will, in the end, require a downward adjustment in the importing country. There is, however, another option, if the importing country has access to a third country with which it can obtain a trade surplus. To examine this, consider a tripartite scheme, with *J* exporting to both of the other "groups", *K* the developing "group" imports from *J* and exports to *A*; while *A* imports from both *J* and *K*, with *A* being a very large developed economy displaying unused capacity and

unemployment. In this context, if *K* clears its deficit with *J* by means of a surplus with *A*, it is as if *J*, which is assumed to be at near full employment, exported its potential unemployment to *A*. The nature of the problem is compounded, but not altered, if *A* has a deficit with both *J* and *K*. This point has been well captured by Keynes for whom:

International trade... is... a desperate expedient to maintain employment at home by forcing sales on foreign markets and restricting purchases, which, if successful, will merely shift the problem of unemployment to the neighbor which is worsted in the struggle (Keynes, 1936, p. 383).

22.4 Keynes and Kalecki on International Trade and the Payments System

Keynes clearly understood the importance of international trade as a mechanism for exporting unemployment between *developed* nations, *i.e.* between countries where the level of the stock of capital can, more or less, absorb the whole of the working population without needing a major rate of accumulation (Keynes, 1936, ch. 16; Kalecki, 1976; Halevi, 1984). In such structural configurations, the primary condition for stability is the attainment and maintenance of full employment by means of domestic policies. According to Keynes, if developed countries failed to use domestic policy to maintain full employment then, to the extent which they could maintain a trade surplus, they can export unemployment problems to countries with resultant deficits. The international battle for markets was seen, by Keynes, as being a battle caused by countries abdicating their domestic responsibility to maintain full employment. Keynes also warned of the dangers of such battles:

The fact that the advantage which our country gains from a favourable balance is liable to involve an equal disadvantage to some other country... means not only that great moderation is necessary, so that a country secures for itself no (more)... than is fair and reasonable, but also that an immoderate policy may lead to senseless international competition for a favourable balance which injures all alike (Keynes, 1936, p. 338–339).

Keynes realized the importance of an international system of payments to ensure such “reasonableness”. However, during the Bretton Woods conference, which developed the post war payments system, his suggestions were overlooked. The resulting system, and its contemporary offspring have no mechanism to ensure “reasonableness”, and, therefore, as we will see below, they contain the seeds of an international tendency towards stagnation.

According to Keynes the ability of countries to influence their balance of trade came mainly through control of imports. He saw devaluation/depreciation as of limited efficacy in influencing trade. On the other hand, trade

protection had political limitations, and, was likely to lead to retaliation. So the main mechanism to improve the balance of trade was a reduction in domestic income reducing imports. In this way, increased unemployment was seen by Keynes as the only mechanism capable of restoring international balance to deficit countries. Of course, the unemployment and fall in income would reduce investment via the multiplier, which, in turn, reduced future productivity, capacity and so on.

Kalecki, in a paper titled "Multilateralism and full employment" reached similar conclusions about the importance of domestic full employment policy for the viability of an international system of trade based on multilateralism:

multilateralism is certain to realize its advantages only if full employment based on domestic expenditure is maintained in all countries. It is certainly unworkable if employment in major industrial countries is subject to fluctuations (Kalecki, 1946, p. 413).

For Kalecki, the key determinant of output was the expenditure decisions of capitalists, in particular their investment decisions. This, in turn, was related to expected profits which were determined by both current profits and by levels of capacity utilization, both of which were, in turn determined by changes in the level of income. We can derive the determinants of current profits from the national income accounts, by equating the income and expenditure side of GDP:

$$W + \Pi = C + I + GD + TS$$

Abstracting from workers' savings, this becomes:

$$\Pi = C_c + I + GD + TS$$

where: C_c is capitalists' consumption.

Abstracting from government, Kalecki concludes:

In fact, aggregate profits are equal to the capitalist consumption *plus* investment *plus* the balance of foreign trade. Profits of a given year were either consumed, invested in the construction of capital equipment and in increase in inventories, or, finally, used for repayment of foreign debts or granting of foreign credits (Kalecki, 1933, p. 164).

Kalecki argues that an increase in an economy's balance of trade surplus will lead to an equivalent increase in aggregate profits. This, in turn, will stimulate investment and employment. However, there is a feedback effect from this subsequent increase in economic activity to an increase in imports, which will reduce the original trade surplus.

Kalecki then considers the capital account implications of the trade surplus. An increased surplus in the current account will lead to an equal increase in outflow on the capital account. This outflow may be in the form of debt or equity. In either case, there is no change to the initial increase in domestic investment and economic activity. However, "foreign countries" will become indebted to the capitalists of the surplus country to the extent of the surplus.

Although neither Keynes nor Kalecki analyzed the next round effects, they reinforce the initial problem. For the surplus country the foreign exchange surplus increases both domestic profits and the level of economic activity. These will in turn, according to both Kalecki and Keynes, generate increased investment. The increased level of domestic investment will increase both capacity and productivity within the country therefore reinforcing its trade advantage, which will further improve its current account. Thus the initial balance of trade surplus will lead to a virtuous circle of cumulative causation further increasing its advantage over its trading partners. This is reinforced by the implications of the offsetting capital flows. Regardless of whether the capital flows take the form of equity or debt, they have a dual role.

It follows directly from the above that the export surplus enables profits to increase above that level which would be determined by capitalists' investment and consumption. It is from this point of view that the fight for foreign markets may be viewed. The capitalists of a country which manages to capture foreign markets from other countries are able to increase their profits at the expense of the capitalists of the other countries. Similarly, a colonial metropolis may achieve an export surplus through investment in its dependencies*.

The above shows clearly the significance of "external" markets... for a capitalist economy. Without such markets profits are conditioned by the ability of capitalists to consume or to undertake investment. It is the export surplus and the budget deficit which enable the capitalist to make profits over and above their own purchase of goods.

The connection between "external" profits and imperialism is obvious. The fight for the division of existing foreign markets and the expansion of colonial empire, which provide new opportunities for export of capital associated with export of goods, can be viewed as a drive for export surplus, the classical source of "external" profits.

*Foreign lending by a given country need not be associated with exports of goods from that country. If a country A lends to country B, the latter can spend the proceeds of the loan in country C, which may increase *pro tanto* its stock of gold and liquid foreign assets. In this case foreign lending by country A will cause an export surplus in country C accompanied by an accumulation of gold or liquid assets in that country. In the case of colonial dependencies, this situation is not apt to arise, *i.e.* the amount invested will normally be spent in the metropolis (Kalecki, 1965, p. 51–52).

In addition, the capital flow in one direction will, in later periods, lead to income flows, either in the form of dividends and profits, or in the form of interest repayments, in later periods. These serve the same role as a trade deficit, directly increasing the profits of the capitalists in the surplus country while depleting the profits of the capitalists in the deficit country.

In the deficit country, on the other hand, the deficit has the effect of reducing domestic profits, and, hence reducing investment and output. The resultant lower levels of investment further reduce future productivity and capacity and, therefore, the country's ability to compete on international markets. This problem is reinforced by the movements on the capital account. To pay for the deficit, the country relies on capital inflows. However, today's solution adds to tomorrow's problem as those capital flows are subsequently associated with current account outflows in the form of interest payments. Just as with the surplus country, so too with the deficit country a process of cumulative causation is set up, but this time it is encapsulated in a vicious circle of increased indebtedness and reduced competitiveness.

Only to the extent to which the capitalist system lends to the non-capitalist world (or the latter sells its assets) is it possible to place abroad the surplus of goods unsold at home. Only in this way do "external markets" solve the problems of the world capitalist system (Kalecki, 1967, p. 456).

So far we have ignored longer term problems associated with running chronic current account deficits, in other words, we have ignored the question of international adjustment mechanisms. A country cannot persistently run an accelerating deficit in its current account with an associated acceleration in its level of foreign debt. The nature of the international payments system will, therefore, have a profound effect on a country's level of investment and demand. Therefore it is necessary to analyze the international system in order to evaluate its impact on demand.

The fundamental problem of the present payment system is that the burden of adjustment lies with the deficit country. Adjustment requires either a devaluation/depreciation of the value of the currency, or tight government policy to reduce income, so as to directly reduce imports. Limits to the efficacy of devaluation/depreciation were noted by both Keynes and Kalecki. Both noted the importance of the static elasticity conditions (the Marshall/Lerner condition), which were unlikely to be met in the case of raw material imports⁴. In addition, the devaluation/depreciation mechanism would reduce the ability of exports to purchase imports and, if successful, will invite retaliation. Furthermore, such policies are likely to be resisted due to their inflationary consequences. As noted above, this leaves policy induced recessions as the main mechanism for adjustment via the effects on imports. However, this is likely to cause balance of trade

problems in other countries. At the same time, the policy will cause a reduction in investment.

Both Kalecki and Keynes understood that if the burden of adjustment was on the surplus country, this would require either an appreciation or an expansion of income, in order to increase imports. In both cases effective demand and profits would be augmented elsewhere. So other countries would also have to expand⁵. This would change the bias of world trade from its current stagnationist tendency towards an expansionary one.

In any case it should be noted that it is difficult for a country to run a persistent trade deficit. Financing it would require capital inflows, either in the form of equity or debt, which will lead to income outflows in future periods. This will reinforce the current account deficit, requiring further capital inflows and so on, in which case either the country's foreign debt or foreign owned equity in the country will have to increase. However, both of these depend heavily on the expectations of overseas investors on that country's future rate of return and exchange rate movements. A permanently increasing current account deficit and foreign debt are unlikely to be sustainable due to the effects of these on the confidence of foreign lenders and/or investors in that country, so that the capital inflows necessary to finance the current account deficits may not be forthcoming. South Korea, which in early 1980s had a very large deficit entailing a rapid rise in its international level of indebtedness, was salvaged by a special set of Japanese loans, the political basis of which was negotiated between Tokyo and Washington (Hart-Landsberg, 1993).

22.5 Rentier's Income and the Triangular Links Between Japan, America and Asia

The above discussion can now be tied to the case of Japan, America and Asia along the lines outlined earlier. If Japan were a closed economy, given the present distribution of income and the size of public expenditure, there would have been insufficient effective demand to sustain the level of investment that Tokyo had till the end of the 1980s. This would have led to high levels of unemployment, unused capacity (high real savings) and to lower levels of real investment. In actual fact, foreign effective demand enabled Japan to run trade surpluses thereby exporting part of its potential unemployment. Contrary to the neoclassical view, as espoused by Healey, Japan's surpluses are not the result of macroeconomic relations, that is, they do not stem from a supposedly *ex ante* high saving ratio. Rather, they are the direct result of Japan's unique institutional position in the world economy as summarized in the second section of this paper. As far as Asian countries are concerned, the institutional position of Japan is characterized by its hegemony as a supplier of capital goods. A role which in the last ten years Tokyo has been extending to China as well. Such a situation has led

to a tight structural interconnection between Japan and the rest of East and Southeast Asia which gives to Japanese corporations an oligopolistic position in the region (Steven, 1991).

With relatively little to fear from outside competitors, unless entrants are brought in by means of American political pressures, Japan could organize its outflow of capital towards the region in such a way as to tie the growth rate of the Asian economies to the demand for Japanese products. Thus, Tokyo's capital flows to the area actually contribute to strengthen Japan's current account surplus, the largest share of which comes from trade with Asia. It is important to observe that capital outflows generate, in the context of a persistent trade surplus, net income flows back to the metropolitan countries. The OECD study admits that income flows into Japan have been the fastest rising component of Tokyo's current account surplus⁶. Thus, attempts to reduce Japan's trade surplus would have little impact on the current account due to the increasing importance of net income. The picture which is emerging is an unambiguously deflationary one: Japan is not a dynamic importer, the rigidity of its current account position is also determined by a rising rent component represented by net income flows.

We can now treat the relation between Japan and the rest of Asia as if they were two areas with Japan enjoying current account surpluses with the rest of Asia, which it uses to invest in Asia in such a way as to further increase their imports from Japan. In a two area framework, the relation corresponds to that of colonial metropolis and dependencies in that the capital flows from Japan to the rest of Asia, are associated with increased demand for Japanese exports. For the reasons discussed above, the deficit is capable of being financed in the short run by capital flows from Japan. In the longer run, the trade deficit with Japan would not be sustainable, leading to recessionary adjustments in the Asian countries. This would, in turn, have repercussions for Japan, in eroding the level of foreign effective demand it enjoys. This means that if, for the purposes of trade, Asia and Japan were the only entities, then growth would eventually be halted due to these trade imbalances.

Contrary to conventional wisdom, Japan is not a factor of growth. When the issue is looked at from the stand point of the principle of effective demand, Japan turns out to be a factor of transformation in purely technical terms. Yet, in terms of demand creation Tokyo is a factor of stagnation. The solution comes, *à la* Kalecki in the form of an external, exogenous source of effective demand for Asian exports. In this case, those external markets are provided mostly by the USA. Without American demand, Asia would be subjected to the problems identified above, which would promote stagnation due to lack of profits and effective demand reducing the incentive to invest. In other words, the stagnationist tendency caused by Japanese surpluses in Asia is broken by the external demand caused by Asian exports to the USA which serves the function of an external market as described by Rosa Luxemburg and Kalecki.

An important question relates to the implications for the USA of these deficits with Asia, as well as its deficits with Japan. Immediately it should be noted that the USA is in a very different position from that of all other countries. The US\$ serves *the* role of the international currency. This means that all countries in the world have large holdings of American dollars, as part of their foreign reserves. As a result, the world has an interest in maintaining the stability of the currency. For this reason, the crises of confidence with the resultant disruptions to the domestic economy which may beset a debtor country is less likely to occur for the USA. Nevertheless, given the US trade deficit, we would expect the economy to be in a state of chronic recession. That this is not the case is the result of, what Kalecki has called, the “internal” external market, that is, the net budget deficit. As was noted above, the government is a source of external demand in the same way as the international sector. Net expenditure by the government sector has the same effect on the domestic level of effective demand and domestic profitability as a trade surplus. For most of the post war period, the US government funded armaments expenditure, either as part of direct war involvement, in the cases of Korea and Vietnam, or indirectly in the case of the cold war which was an important determinant of American policy until the late 1980s.

22.6 Comparison with Western Europe

By way of conclusion it might be helpful to compare the situation prevailing in East and South East Asia in the 1965–1990 period with that ruling in Western Europe in the 1946–1960 years. Indeed, if the 1965–1990 period is the phase in which Japan consolidated its position as the core surplus country in Asia under conditions of high regional growth, the 1946–1960 years denote the reappropriation by Germany of her role as the major European exporter. The dynamic process was however radically different. As pointed out by Alan Milward in his historical masterpiece on European expansion during the 1950s (Milward, 1992) German growth was much higher than European growth. Thus, even if Germany tended to obtain surpluses with the rest of Europe, German effective demand for European products increased rapidly, thereby setting in motion an adaptation (accelerator) process on the side of European industry. The low levels of real interest rates, compared to the growth rates, enabled surpluses to be quickly transformed into commercial credits. This mechanism came to a halt in the early 1960s, few years after the return in 1958 to currency convertibility and the appearance of the first American current account deficit.

In our view, the crucial factor which pushed the European economy out of a full employment path was the absence of a rational, *i.e.* Keynesian, intra-European mechanism of settlements. As EEC and European countries experienced balance of payments difficulties, the authorities reacted by

making net exports into the determining component of employment and investment in a context in which intra – European trade was rapidly growing as a share of total European trade. Except for Germany, which during virtually the whole of the 1960s saw her surpluses eroded in favour of European (EEC) imports, all countries set policy objectives aiming cumulatively at a positive target level in the current account (Halevi, 1995)! When the German counteroffensive, aimed simultaneously at restoring a substantial current account surplus and at a strong currency, came in two successive steps in 1967 and 1969, the positive cumulative causation which sustained European growth throughout the 1950s was broken for good (Halevi, 1995; Valli, 1981).

In East Asia the cumulative causation had, and still has, very little to do with Japan except for the technology used in the engineering processes. But this is a technical, not a strictly economic, element. The crucial factor which sustains regional growth, in terms of the positive investment expectations it induces, is the willingness by the United States to act as the major external market and as a major provider of liquidity, both institutionally and privately. It is important to observe that the shift in the direction of exports away from Japan and towards the United States by the countries forming the small Americano-Japanese Asia (Aja) took place already in the second half of the 1960s, when Japan's growth was many times higher than that of the USA. In principle, Tokyo's high growth rates should have provided *the* growing market for Aja's products, more or less like German growth did for European exports.

With countries like Japan unable or unwilling to quickly dispose of the surpluses by generating either loans at low interest rates or by drastically raising their own propensity to import, the capacity of the United States to function as the main creator of effective demand is limited and diminishing. Under conditions of unused capacity, unemployment and substantial under-employment, the American national productive system cannot systematically support the level of employment in Japan. Indeed, periodically the monetary authorities of the United States push for a further devaluation of the dollar. In the case of East and South East Asia such a policy has a dubious effect. The currencies of these countries are pegged to the American dollar. Thus when the Yen is revalued, the countries from East and South East Asia aim at expanding their exports to the USA also in products in which Japan had absolute supremacy. To do so they have to import additional machinery and technology from Japan itself. As a consequence, the revaluation of the Yen tends to change the composition of Tokyo's surpluses towards Asia. At the same time however, the higher value of the Yen vis-à-vis the East and South East Asian countries' currencies creates a rentier like pressure on the foreign payments of those countries due to the appreciation of Yen denominated loans. Exports will have to be increased further and in so far as the process is common to the whole area, China included, the exports

which count are not those arising from intra Asian trade but from the trade with Japan, the USA and Europe. In this context, once more the burden is and will be shouldered by the United States. Japan is an institutionally weak buyer while Europe is a reluctant importer, so that North America remains the only really dynamic area of effective demand for Asian exports.

22.7 Conclusion

According to Schaller's classical study on the American occupation of Japan (Schaller, 1985), Washington's top policy makers, like secretary Forrestal, thought, as early as 1947, of a tripartite capitalist world formed by two areas and one central power linked to both. Europe, with Germany at its core, represented the Western pole while East and South East Asia, with Japan at its centre, constituted the Eastern pole. The USA was supposed to function as the central hegemonic power with strong ties to both. In the minds of those policy makers the two areas were supposed to become economically self-sustained. Hence the importance assigned to Germany and Japan as the workshops of each respective pole.

The historical development of this strategy did bring about the formation of the two areas, albeit not by design but by means of conflict. Yet, as far as the Asian pole is concerned its productive capability has turned out to be crucially dependent on the United States as a market and as a source of finance. This is a role which America can no longer play because the very seignorage of the US dollar undermines, in the long run, the productive basis of the national economy. The history of the conflicting economic relations between Washington and Tokyo has turned out to be the most striking nemesis of Keynes's proposal, made at Bretton Woods and defeated by the bureaucrat Harry Dexter White, to denationalize international payments in order to prevent destabilizing adjustment processes.

The underlying reason for this lies in the nature of Japan's surpluses from international trade. On the one hand, these have been interpreted by some economists as having a benign influence on world economic activity due to the mistaken belief that the surpluses allow funding of development in other countries. By contrast, the view of Keynes and Kalecki is that these surpluses are malignant, reducing growth and employment in other countries. Due to the nature of the international monetary system, it is difficult for debtor countries to adjust except through deflation. This exasperates their underlying problem, as well as leading to stagnationist tendencies in the world economy.

Notes

1. See also, p. 38–39.
2. See Harcourt (1972).

3. See, for example, Eisner (1991) and Bernstein & Heilbroner (1991).
4. See Kalecki (1946 p. 412). The dynamic elasticity conditions are given by Thirwall's law, see Davidson (1994) p. 220–222.
5. As noted above, Kalecki did not believe that this was sufficient to guarantee “its advantages” only if it was coupled with the requirement of all countries maintained full employment.
6. See Healey (1991) p. 32.

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23

History, Politics and Effective Demand in Asia

Joseph Halevi and Peter Kriesler

23.1 Introduction

Most of the literature on the growth of the Japanese economy as well as on the transformation of Northeast and Southeast Asia is centred on supply conditions, ignoring the fundamental role played by demand. In fact, it is possible to detect a remarkable conceptual convergence between those who claim that accumulation and growth were oriented to, and driven by, market forces (Hughes, 1988) and those who stress the role played by the State (Amsden, 1989). Both concentrate on supply factors, arguing about the sources of improved productivity in the area. However, this perspective ignores the important question of where demand for the output of the area originated. It overlooked the fact that the question of markets is a crucial one in understanding the development of the region, which is the main concern of this paper. However, as argued below, the issue of markets cannot be understood in purely economic terms, as the underlying forces are political in nature.

In historical terms the dichotomy drawn between market driven and state driven forces is of little importance as it fails to grasp the international political dimension of the process. Historians, rather than economists, have provided the best work on the area. Their studies have succeeded in producing a genuine political economy of Japanese and East Asian growth. The dialectical relationship between economic liberalism and institutionally guided interventions is well captured in the conclusions of an excellent study on Southeast Asian post war history:

Most ironic was the American determination that the production and protection of Southeast Asia were of such paramount importance to the

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ultimate success of liberal capitalism that the tactics temporarily used to attain these goals might themselves be illiberal or protectionist. (Rotter, 1987, p. 220).

This article will maintain that the industrial transformation which has engulfed the Eastern part of Asia cannot be separated from US sponsored international arrangements which, more than anywhere else, enabled the area to find market outlets, hence ensuring adequate demand for their output. Interestingly enough, the non-orthodox approaches focusing on the role of the state seldom, if ever, raise this issue. It is simply taken for granted that the ingenuity of industrialization policies has overcome the question of the market.

The first and crucial step towards an all-pervasive role for the United States was the Kennan–Forrestal line elaborated in the wake of the British currency crisis of 1947. As documented by Michael Schaller in his definitive study on the American occupation of Japan, the crisis had direct and swift repercussions on the US government's conception of the post-war capitalist order (Schaller, 1985). From that moment onward, Kennan and Forrestal, the two major foreign policy-makers in Washington, saw the future of the capitalist world as based on the United States, flanked by two growth poles: West Germany in Europe and Japan in the Far East. That Europe was to provide the economic space of German capital was obvious, the hurdle being only of a political nature concerning the elimination of the sources of the Franco-German conflict. It was Japan which represented the most severe economic difficulties since it had no economic space left, unless it was allowed to gravitate towards China. By the very end of the 1940s the United States identified an economic space for Japan, nicknamed the Asian Crescent, stretching from the archipelago to India via Vietnam. The problem with that vision was that since such a space did not exist, it had to be structured.

The implementation of the Kennan–Forrestal approach was made possible by three factors. The first was the closure by the US government of any open option towards the People's Republic of China (Blum, 1982). Drawing the line against China implied a very strong commitment to the economic viability of Japan, which boiled down to a search for markets for its industry. Eventually, these markets were found, not in Asia, but in the United States itself. Just the same, Washington's protracted involvement in Asia created a Japanese economic zone but only in so far as the latter became import dependent upon Japan and export dependent upon the North American market. This, as we shall see, is the crux of the problem of effective demand in Japanese and East Asian post-war accumulation. The second factor was the Korean War, the economic aspects of which will be discussed in the second and third sections of the paper. The third, and perhaps the most significant, factor was France's defeat in Vietnam, since it permitted Washington

to tie together the two components of the strategy. According to Rotter's detailed archival study:

For nearly ten years American policy makers had tried to convince the French to fight on in Vietnam; in that way, the departure of the French and the breathtaking ease with which the United States assumed the burdens of battle suggested that the policy had failed and foretold grave danger. But the Eisenhower administration, like its predecessor, understood that the approach of French withdrawal created at last an opportunity to rearm West Germany. (Rotter, 1987, p. 217)

The transfer, in 1956, of South Vietnam to American influence seemed to vindicate the strategy which saw in the preservation of Southeast Asia from third world independist movements the essential condition for the economic recovery of Japan. It also gave renewed importance to the position of South Korea. Within the American establishment the developmentalist current, represented by Walt Rostow, argued that the United States should tackle directly the two critical points of the confrontation in Asia: economic growth and the armament race. Its implementation required, in effect, the normalization of relations between South Korea and Japan. It took, however, the Vietnam War to create the momentum for such a normalization and for putting an initially very reluctant Seoul regime firmly onto an export-led growth path. The industrialization of South Korea on an export basis constituted the formation of a Japanese economic zone in East Asia. The extension of the zone to other countries during and after the Vietnam war has not altered its basic features: structural dependency *vis-à-vis* Japan and, therefore, a compelling necessity to expand exports outside the area itself.

Japan began to reenter Asia only in the early 1960s. Yet, the Japanese economic zone, brought about essentially by the Vietnam war and the collateral activities of the United States, such as the formation of the Association of South East Asian Nations (ASEAN), turned out to be very different from the vision of Kennan and Forrestal, for whom West Germany, with Europe, and Japan (with a still to be defined Asia) were supposed to act as regional powers, each dominating a relatively coherent region. In Asia American intervention has led to the formation of an area virtually glued to the United States, thereby making Washington the catalyst of its own problems.

23.2 From the Pre-War to the Post-War Period

In his seminal study on the role of the Ministry of International Trade and Industry (MITI) in Japan's post-war growth Chalmers Johnson observed that the structural foundations of that growth were laid down in the 1930s with the rise of heavy industry paralleled by the formation of the main guiding institution: the Ministry of Munitions which later was to be transformed

into the well-known MITI (Johnson, 1982). The Japanese economist Kiyoshi Kojima coined the term *full range industrialization* to define a strategy aimed at building all the fundamental sectors of the economy (Kojima, 1979). This definition lacks, however, a dynamic dimension. It is the concept of *vertical integration*, developed by Luigi Pasinetti, which allows us to see the links between the structure of the economy and the composition of demand (Pasinetti, 1973; 1981; 1993). A country is in a position to develop all the sectors as it grows, when the benefits of technical change are retained within the country itself. This requires that productivity gains be systematically translated into higher overall real wages so that the ensuing changes in the composition of per capita demand determine a more advanced composition of output.

There is nothing automatic in this process. Situations may arise in which the country cannot retain the fruits of technical progress within its own system. After 1945 and especially after 1953, the whole web of political and financial institutional relations created by the United States *vis-à-vis* Japan enabled the latter to proceed through its full range industrialization strategy, combining productivity gains with the rise in domestic demand and the consolidation of a powerful oligopolistic bloc, stretching from industry to the whole political spectrum (Johnson, 1995).

In the pre-war period, the Great Depression highlighted the disproportion between the economic objectives of Japan's fledgling capitalism and the still too limited scope of its imperialism. The solution sought through the war against China, that is, through an extra-economic factor, was the complete integration between markets and raw materials on one hand, and the creation of a large enough yen trading area on the other, so as to compel the dollar and sterling areas to trade with it. The yen area was supposed, in the end, to clear Japan's balance of payments deficits with the advanced capitalist countries. In spite of the expansion of chemical and heavy industries, the developmental strategy ran into difficulties well before the war against the United States. Japan consistently realized a trade surplus with its exploited areas, but experienced growing difficulties with the rest of the world. Trade with its areas was in yens, whereas Tokyo had to pay its deficit with third parties in gold or in foreign currencies. As a consequence, the problem was not alleviated even when the surplus with the yen bloc surpassed the deficit with the rest of the world (Nakamura, 1983). During the 1930s the share of exports over Japan's GDP was much higher than that prevailing in the first two decades of the post-war period (18 per cent against 10 per cent, Itoh, 1990). Tokyo failed to establish a system of trade relations capable of sustaining long-term accumulation in the core country.

The necessity to find an anchor for Japan was a priority the US authorities were fully aware of even before the end of the Second World War. As Schaller has so convincingly argued in his definitive study, the issue was not just one of rebuilding but rather of creating an American alliance in Asia within

which the Japanese recovery 'appeared to rest on the reconstruction of a highly centralized, regionally predominant economy'. Thus, 'conservative political forces within Japan joined with their American sponsors to rebuild a nation in ways that bore an uncanny resemblance to the pre-war order' (Schaller, 1985, p. 55). Imperialism failed to consolidate a productive space for Japanese capital, and the plans worked out by the United States occupation authorities did not, as such, provide the thrust needed to attain the objectives expressed hitherto.

Until the Korean War, the United States directed its action towards a revival of Japanese trade with East and Southeast Asia with rather ingenious means. Washington distributed dollars against yens to Japan so that the latter could purchase industrial goods from the United States. Meanwhile, the useless yens obtained by Washington were distributed as grants to the countries of the area so that they could spend them on Japanese commodities (Nester, 1990). This tended to push the Japanese economy towards non-dollar-based imports. By contrast, the new role assigned to Japan required a massive capacity to import from the United States in order to modernize its industrial system relative to the pre-war structure. The inconsistent trade strategy was coupled by the domestic crisis induced by the anti-inflationary stabilization plan enforced by Dodge (Yamamura, 1967). What, initially, got the Japanese economy out of the crisis is the special demand engendered by the Korean War. Its aftermath proved still more significant. Thus, on two crucial occasions, in 1931 and in 1950, the forces which led to a drastic transformation of Japan's economic structure were not economic but socio-political.

23.3 The International Framework of Japan's Sheltered Growth

The importance of the Korean War in Japan's post-war history is not disputed (Kosai, 1986). However, its significance tends to be treated just as a quantitative, albeit very important, impulse. The Korean War had long-term effects and widespread ramifications from an institutional point of view. By 1952 it was already clear that the impulse of the war was not sufficient to guarantee Japan's growth. Thus the crucial problem for Tokyo was how to restart trade with the People's Republic of China. It was this preoccupation that led the American authorities to renew, after 1953, their drive for an Asian Crescent stretching from Japan westward encompassing Vietnam (Rotter, 1987).

During the decade separating the Korean from the Vietnam War, the United States created the financial and diplomatic conditions for the opening up of an economic space for Japan. Washington initiated a form of international public expenditure aimed at Japan as well as at other East and Southeast Asian countries. US transfer payments to Tokyo lasted well into the 1960s

enabling Japan to cover the trade deficits stemming from its high growth policies. The most important form of transfer was the Special Procurements programme devised at the onset of the Korean conflict. From the end of the war till the end of the 1950s, Special Procurements expenditures lifted Japan's import ceiling by nearly 80 per cent (Nakamura, 1981). The US transfer programme allowed Japan to get over the fall in demand caused by the end of the Korean War precisely when business and government were undertaking two major rationalization plans in the steel and heavy industry, both requiring large amounts of imports (Kosai, 1986). Special procurement transfers had also an important structural implication. They insulated the economy from international competition, allowing higher prices to be set consistently with the aim of developing a capital goods producing economy. The significant relief obtained in relation to the search for outside markets, coupled with the price protection effect, meant that the Japanese economy could retain domestically a much greater share of its own productivity gains than would have otherwise been the case (Pasinetti, 1981). The breathing space given to the Japanese economy empowered the larger Japanese corporations to 'normalize' labour relations, so that, by 1960 these were firmly secured within the institutional framework of company unions. The loss of autonomy by the Japanese labour movement should be seen as the main factor accounting for the systemic faster growth in productivity relative to real wages.

Internationally, the United States acted as the main sponsor of the interests of the Japanese system. Even before the end of the occupation, the US administration allowed the retention of the laws restricting foreign investment. In this context, the case of the automobile industry is particularly illuminating. Until the early 1930s the Japanese domestic market was supplied overwhelmingly by foreign companies, the largest share accruing to American producers. The Americans were shut out in the second half of the 1930s and this state of affairs was *de facto* institutionalized when, in the wake of the Korean War, the automobile industry received a new boost. Thus, by 1954, when Japan was applying to join GATT, Tokyo drastically curtailed the allocation of foreign exchange for the importation of vehicles, virtually closing its domestic market to foreign cars. Furthermore, during the negotiations leading to Japan's membership of GATT, in order to stem the opposition to Tokyo's import restrictions, Washington signed 14 trilateral agreements on the basis of which third countries were given greater access to the American market provided they accepted Japanese exports (Nester, 1990; 1991). Lastly, the Korean War gave birth to a regional form of American public expenditure. Until Washington's war against Vietnam, the United States covered more than 70 per cent of South Korean and Taiwanese trade deficits, indirectly subsidizing Japan's exports to these countries.

Under these circumstances, and with the ability to exercise total control over their own productive strategies Japan's corporations – in conjunction

with the bureaucratic apparatus – could concentrate first and foremost on the internal process of accumulation, while expanding exports by means of industrial targeting. Thus, compared to the inter-war period, a remarkable change occurred in Japan's pattern of growth. The current account balance lost its connotation of being a structural constraint becoming, instead, a matter of cyclical concern. The United States absolved Japan from the preoccupation of finding an area of economic influence, which had contributed so significantly to its outward and imperialist orientation during the 1930s.

The inward-oriented character of the process of accumulation in the first two decades of the post-war period (Itoh, 1990) gave to the oligopolistic bloc several important permanent features. In industry a dual structure exists, the pinnacle of which is represented by a limited number of large industrial groups (*Keiretsu*). The Japanese system favours the formation of cartels according to specific economic circumstances. These can be formed for rationalization purposes, because of recessionary conditions, or for the promotion of exports including agreements aimed at ensuring favourable input prices (Yamamura, 1967). In branches where cartel policies could not be implemented because of excessive fragmentation, such as in the machine-tool industry, the state, through MITI, identified market niches and, through its licensing powers, tried to obtain the best agreements in relation to the transfer of technology (Nester, 1991). These policies continued during the 1980s, becoming part of the normal working of the system.

The period of sheltered growth permitted a smooth functioning of the dual structure of the economy. In particular, the method of subcontracting gave rise to a system called 'ordering externally on unequal terms' so that in adverse conditions large firms 'would drop subcontractors and postpone payments on their accounts, while in good times [they] would increase subcontracting. Then, citing the need for rationalization among subcontractors, they would beat down prices to low levels' (Nakamura, 1981, p. 175). By the same token, the labour market acquired the characteristics of a buyer's market for the large firms, which could force unfavourable conditions on their temporary workforce while the workers in the small units experienced significant wage differentials *vis-à-vis* the tenured workers of the large companies. During the *era of high speed growth*, the gap between productivity and wages, translated into rising industrial profits, financed investment projects leading to large economies of scale at home. These allowed companies to plan expansion into export markets. Thus, the era of high speed growth was based mostly on the domestic retention of productivity gains.

Companies could flexibly organize their strategies of competition and collusion among themselves, as well implementing policies of cooperation and rationalization *vis-à-vis* the small business sector. In sectoral terms, export growth has often been obtained through industrial targeting which implied a phase of market flooding to break entry barriers, and a subsequent phase of voluntary restraints. This sort of strategy requires a strict

link between markup policies at home and the barrier breaking price to be charged externally, as well as the ability to prevent the reentry into Japan of the low priced exported goods. Such a strategy is conceivable only if the export policies of Japanese firms included a target market share, which was made to appear as resulting from voluntary restraints (Nester, 1991). It must be pointed out that there is a profound conceptual and concrete difference between Japanese industrial targeting of foreign markets and similar policies followed in other East and Southeast Asian countries in the last two decades. *Full range industrialization*, and its necessary corollary represented by the internal retention of productivity gains, always remained the central pillar of Tokyo's growth policies. Other countries, by contrast, by relying heavily on the importation of Japanese technology and capital goods, had to make industrialization a strict function of external growth and, as a consequence, their pricing policy, on the surface similar to Japan's, implied that part of their own productivity gains were leaked abroad.

Japan could implement its export strategies, because, in addition to the role played by its institutions, the political relations established by Washington towards Tokyo gave access to the American market without equivalent reciprocity. At the same time it would be misleading to conclude that the policies eliminated macroeconomic Keynesian uncertainty as to the prospects of future investment. Macroeconomic uncertainty surfaced strongly in the first half of the 1960s when the results of the income doubling plan became clearer, and Tokyo's export policies began to encounter severe external criticism. The fear was allayed by other, mostly external, forces. As noted by Calder, 'Japanese growth of the postwar period, particularly in the 1950s and 1960s, typically came in surges. Many of these volatile surges were totally unanticipated, arising as they did from sudden overseas stimulus. ... growth was strongly stimulated by American offshore procurements to support wars in Korea and Vietnam whose scale and substantial economic benefits to Japan were previously unanticipated' (Calder, 1988, p. 52). The American role was therefore that of providing a covering shield, an umbrella under which Tokyo could organize both its domestic expansion and its export plans. In the rest of Asia, such as in South Korea, the picture would turn out to be quite different. The United States would provide markets, financial coverage and salvation from extreme crisis, but in structural terms output and investment had to be determined first by export priorities, which, in their turn, were governed by the structural dependency *vis-à-vis* Japan.

23.4 Japan's Reentry into Southeast Asia: The Role of South Korea

The expansion of Japanese exports and, later, of direct investment into East Asia was not entirely a natural process nor was it just a consequence

of deliberate policies. According to the historian Michael Schaller '[t]he Japanese, at least through the 1960s, were far more interested in commerce with China and with the West (for which they needed hard currencies) than in barterlike arrangements Washington hoped to foster with Southeast Asia. To assuage Japanese resentment and meet their dollar needs, the United States had to continue a variety of expensive military procurement programs for many years' (Schaller, 1985, p. 297).

The role played by the economies of the area until the early 1960s is evidenced by the type of trade flows that prevailed between Japan and South Korea and Taiwan. For these countries Japan was, then, the major export market while the United States was the principal source of imports. The situation changed, almost abruptly, from the early 1960s onward when Tokyo became the dominant source of imports and the USA the most important area of destination of exports. This change had its root cause in the fact that 'America's huge escalation of the Vietnam War ... actually helped Japan reenter the Southeast Asian economy' (*ibid.*, p. 298).

The strategic objectives pursued by Washington gave rise, alongside the military intervention, to the approach called 'the double hegemony' which assigned to Japan the dominant economic role, while the United States provided military and financial coverage and access to North American markets (Woo, 1991). In this context, South Korea became the linchpin of the double hegemony theory requiring a tight integration with American foreign policy, expressed by Seoul's participation in the Vietnam War. The export-oriented policies of South Korean industrialization, were also the product of American thinking which feared that a domestic growth strategy would involve persistent US aid. The diplomatic document which formalized the content of the links between Seoul and Washington was the 1966 Brown Memorandum, named after the US Ambassador to South Korea. The memorandum connected Seoul's participation in the Vietnam War with Washington's commitment to promote South Korean exports (Landsberg, 1993). Furthermore, the 1969 Nixon-Sato communiqué institutionalized Seoul's position within the framework of US-Japanese relations. Thus, in the case of Northeast Asian industrialization, the diplomacy of 'security' has become, more than in Europe, a codeword for economic policies and for social restructuring.

At the productive level, the Vietnam War, financed by American public expenditure, generated a hot-house effect for those industries which were to gain dominance in the subsequent decade. By 1967, the share of South Korean exports, as a share of total exports by sector, going to South Vietnam was 94.29 per cent in steel (72.48 per cent for Taiwan), 51.75 per cent in transport equipment (Taiwan: 36.5 per cent), non electrical machinery 40.77 per cent (Taiwan: 47.45 per cent). South Vietnam also absorbed more than 85 per cent of Taiwan's cement exports and about 74 per cent of the export value of chemical fertilizers (Naya, 1971, p. 43). The implications

of these developments for Japan's own exports to those countries are self evident. More importantly, the industrial spurt engendered by the Vietnam War permitted, for countries like South Korea, the transition towards export-oriented industrialization by providing institutional channels to the American market as well as a secure cushion of dollar earnings. Yet, the South Korean experience differs substantially from that of Japan. The latter could shelter itself for quite a long time from foreign competition by focusing on domestic full range industrialization, whereas the former was literally thrust onto foreign (US) markets.

The defeat of the United States in Vietnam led, well before 1975, to a decline in aid and transfer payments to the region, thereby reducing the level of effective demand generated within the area by Washington's public expenditure. The South Korean strategy of embarking on an accelerated process of heavy and chemical industrialization was, to a significant extent, a response to the loss of the safety net represented by American public expenditure. From the 1970s onward, Seoul's export strategy can be defined as chasing the composition of per capita demand of the United States, by moving from, say, textiles, to goods for which per capita demand is more dynamic. A similar strategy characterized Tokyo's external policies, except the range of commodities belonged to a higher category. At this point it is important to stress the hierarchical order defining South Korea's heavy industrialization path. The Japanese participated in the drafting of the third and fourth five-year plan, stretching from 1972 to 1982, by targeting the sectors towards which Japanese industries could be transferred (Landsberg, 1993, p. 153). Yet Tokyo did not provide an expanding area of demand for South Korean products. The share of South Korean exports going to Japan tended to decline. More specifically, the possibility of sustaining a growing deficit with Japan came to depend on a large export surplus with the United States. This situation has not changed since then.

The history of the links between South Korea and Japan raises two issues. The first is financial, its relevance being the determinant role played by political considerations prior to the economic ones. The second is structural and has a more long-term character. In the situation prevailing during the 1970s the heavy industry pattern of growth gave rise, in South Korea, to two deficit crises, the most important of which was that occurring in the triennium 1979–81 (Lim, 1985). The solution of the Korean crisis of 1979–81 stemmed from the strong linkage between foreign policy and finance. South Korea became an important terrain for undoing Carter's foreign policy based on trilateralism and arms control.¹ The new line 'sought to counter the Soviets in the Far East through tight US economic *and* security ties with Japan, Korea and the People's Republic of China and – what is much more problematical – among these nations themselves' (Woo, 1991, p. 183). With the ascendance of Reagan to the presidency, Washington took the political lead in securing Seoul's financial position. In this context the Japanese

followed suit by providing South Korea with a \$4 billion loan making sure that a significant part of it would be turned into purchases from Japanese industry. The dynamic export markets came from the United States, thanks to Reagan's policies based on the revaluation of the dollar and on military driven budget deficits. Seoul's trade with Washington, while mildly in deficit throughout the 1970s, swung to a surplus in 1982 which continued to rise, in tandem with a rise in the deficit with Japan, till 1987. Thereafter, the surplus with Washington declined to end up in a deficit in the early 1990s but the deficit with Japan kept growing.

The structural aspect of the links between South Korea and Japan lies in the different role played by domestic growth in the economic history of the two countries. In an excellent study of South Korea's industrialization Mario Lanzarotti (1993) has quantified the contribution to overall growth stemming from expansion towards the domestic and the foreign markets. It seems that the latter had a greater impact than in the other industrialized countries. Therefore, it stands to reason that productivity in the exporting industries in South Korea has grown more than in the developed countries, Japan included. Although such a conclusion must be corroborated by deeper studies, its tentative acceptance would bring us directly to Pasinetti's principle of comparative productivity change advantage (Pasinetti, 1981). In a nutshell, Pasinetti's principle shows that if the ratio between the rate of productivity growth of the exporting to the domestic industries is higher, as in say, South Korea, than the equivalent ratio in the rest of the industrialized world, the real terms of trade of South Korean exports will worsen. The ensuing fall of export prices implies that part of productivity gains are leaked abroad to the benefit of foreign consumers.

For more than two decades following the end of the Second World War, Japan obtained from the United States a political and economic umbrella enabling it to pursue a determined strategy of full range industrialization. High productivity growth and a small ratio of exports to GDP meant unambiguously that productivity gains were retained domestically. Such a route was not open to either South Korea or to most of the rest of East and Southeast Asia, not because Washington did not 'help' but because of the ties established with Japan. What matters is the structural aspect of the surpluses that Japan obtains with countries like South Korea, requiring maximization of exports rather than concentration on product development. The dependency, which *mutatis mutandis* operates even more strongly in the rest of East Asia, of South Korea *vis-à-vis* Japan, revolves around issues determined by its high external exposure: heavy subordination to Japan in relation to machines and parts, discretionary transfer of technology by Japanese firms, relocation of Japanese firms operating in South Korea. In the first case, the large share occupied by Japan in supplying machines and parts to Seoul creates structural, non-substitutable links between the South Korean and the Japanese industries. When South Korean products

end up competing against the Japanese ones, especially during the phases of the appreciation of the yen, Japanese firms were able to select and reorient the transfer of technology precisely because such a large part of South Korea's stock of capital remained tied to Japan's (Landsberg, 1993).

The South Korean case is the most significant in the capitalist development of Asia outside Japan because it was based on a deliberate linkage between the objective of creating a national capital in the country and the role of both Japan and the United States which accepted and sustained the above objective. In many other East Asian countries such as Thailand, Malaysia and, eventually, Indonesia, industrial accumulation takes place via multinational investment of which Japan's corporation are the strongest component. The local ruling classes retain strong comprador elements giving high speculative features to their financial markets and institutions.

23.5 Conclusions

The observations made above have both a developmental and an effective demand implication. From the point of view of development paths, it is likely that East Asia is, for the time being, locked in a situation in which it keeps surrendering an important part of productivity gains abroad, with specific industries displacing the corresponding ones in the more advanced countries. The competitive international position of specific industries will improve insofar as their own rate of productivity growth relatively to the country's overall productivity growth, is greater than the corresponding ratio in the advanced countries (Pasinetti's industry specific principle of comparative productivity change advantage). The persistence of this trend may well generate further protectionist reactions from the advanced countries. However, Japan is in a different position from the rest of the industrialized world, and it is unlikely to be crucially affected by displacement effects. As aptly described by a former Japanese Ambassador to Thailand:

Japan is creating an exclusive Japanese market in which the Asia-Pacific nations are incorporated into the so-called 'keiretsu' system. The essential relationship between Japan and Southeast Asia is [one of] trading captive imports, such as products from plants in which Japanese companies have invested, for captive exports, such as necessary equipment and materials. (Tabb, 1994, p. 32)

This brings us to the second implication concerning the problem of effective demand. The surplus with Asia has become for Japan the main source of profitable external demand. Although trade between East and Southeast Asia is growing, the clearance of the deficit with Japan requires a third external market, as suggested by Kalecki. Such a market is provided mostly by the United States, rather than by Japan. Unless the United States is willing to

fund this deficit indefinitely, through imports, thereby accepting the necessity of sustaining the industry-specific displacements, an immanent problem of effective demand emerges. The rest of Asia must keep exporting but Japan is not taking the onus of getting rid of their surplus. Indeed, the whole post-war history of Japanese growth can be read as building an institutional oligopolistic position in its area of dominance. In other words, the problem facing the rest of Asia is significantly different from that which Japan faced at the end of the war. For the political reasons outlined earlier, Japan was guaranteed markets by US actions. As a result, current account problems did not constitute any fetter to economic growth. This is in marked contrast to the rest of Asia, which is characterized by deficits with Japan. In order for the current account no longer to fetter growth, the USA has absorbed much of their output, enabling some balance. This has alleviated potential demand problems enabling these countries to concentrate on the supply factors which most commentators have focused on. However, this is only because the question of markets has been relieved by US actions, as discussed earlier. There is a further important link between the two sides of the discussion, often called the 'Verdoon Law' (Kaldor, 1966) whereby rises in the gross level of output allowed by the extension of demand and markets itself induces increased productivity, leading to a virtuous circle of development. This, however, is a matter beyond the scope of the current chapter.

As a concluding remark, it is important to observe that due to the strict interconnection between Japan's economic expansion and the role of the United States in the area, the formation of an East Asian zone of capitalist accumulation has altogether different characteristics from the European one. The role of Germany – both positive and negative (Halevi, 1995) – in the dynamics of Europe's effective demand has been such that the Continent's monetary system gravitated towards that of the Federal Republic, especially from the end of the 1970s onward. In fact, Germany is both the largest exporter to and the biggest importer from the rest of Europe. If Germany reflatates, the rest of Europe will follow suit. At the same time if, say, Italy reflatates, Germany is likely to benefit more than the other European countries given the dominant role of the FRG in providing capital goods to each country of Europe.

In East Asia by contrast, from the Plaza Accords in 1985 until Thailand's financial crisis of spring-summer 1997, currencies other than Japan's were pegged to the US dollar. Under conditions of a prolonged revaluation of the yen *vis-à-vis* the American currency (1985–95), the *de facto* existence of a *dollar standard* in East Asia helped those countries expand exports by passively relying on Japanese technology and direct investment. At the same time it was also a cause of systemic imbalances in the current account position of those countries leading to endemic financial instability. The specific oligopolistic nature of Japan coupled with the reliance on the *dollar standard* has put the burden of adjustment on the United States and has actually prevented Japan from acting as a reflationary factor.

Note

1. Carter's foreign policy was consistent with the attempt to stem the decline in the international position of US manufacturing by allowing the dollar to float downward. The best account of the changed power relations within the monetary system, as well as the best argument on the nature of the monetary conflicts and the international level is still that of Parboni (1981).

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24

Stagnation and Economic Conflict in Europe

Joseph Halevi and Peter Kriesler

If we compare Europe to established federal systems, as those of the United States, Canada, and Australia, fundamental differences are immediately apparent. Existing federations have emerged historically as a result of material forces. Federation has been the result of strong economic and political ties. In all these cases, fundamental political and economic power—particularly fiscal and monetary—has gravitated to the central authority, while the states retain lesser discretionary power. Such separation of roles is vital to a viable federal system. This is not the case in Europe.

Although large sections of Europe now share a common currency, and a central bank, other aspects of federalism are absent. There is no common language or culture. All nonmonetary economic policy, including fiscal policy, is decentralized, as is state provision of infrastructure, welfare, education, health and so on.

As a result, the issues pertaining to the European Union (EU) express themselves directly as questions of international politics and economics. This is because the EU is not a naturally federal entity, nor is it an economically unified space. Each country has a bloc of trade flows locked up in the proximity areas and with Germany, while the residual is dispersed over the rest of the EU and the rest of the world. But all this is completely normal. Except for raw materials and food staples that are traded on a global basis,¹ specialized industrial production follows the patterns of history, in which proximity looms very large.² The same can be said about financial flows and capital movements. Research in France has shown the distinctive regional and proximity patterns of financial flows. Normally the importance of local and proximity flows are obscured, as in the press the issues of international economics are framed in relation to some core centers such as Frankfurt,

Revised from *International Journal of Political Economy*, 34(2): 19–45, 2004, 'Stagnation and Economic Conflict in Europe,' by Halevi, J. and Kriesler, P. With kind permission from Taylor and Francis Ltd. All rights reserved.

London, New York, and Tokyo. But in Western Europe quantitatively and qualitatively regional proximities dominate.

The fact that the European Union is not a true federal entity is the crucial factor making the EU an international one so that what happens in it is not a domestic or an internal affair. Any difference between Germany and France, for instance, becomes a matter of international relations requiring the maneuvering of the other countries' governments. In this maneuvering extra EU factors come into play, such as the relations of the individual countries with the United States or with Russia or with other areas such as the Balkans.

The major change in the profile of the European Union, then called the European Community, occurred without the participation, contribution, and advises of the member countries, and without the formal participation of the institutions of the European Union, as a unilateral action. In 1990 Germany absorbed the former German Democratic Republic in the East. The EU institutions of today were already in place, namely: the European Parliament in Strasbourg—elected since 1979 every five years by all the eligible voters of the member countries—as well as the European Commission and its Council, in existence since the early days of the European Economic Community (EEC). These institutions had no part in shaping what turned out to be the most important event in post 1945 Europe. The whole process was led by consultations and agreements between the Government of the Federal Republic of Germany in Bonn, and the Governments of the USSR and of the USA. Brussels, as the seat of the European Union's Commission and Strasbourg, as the seat of the much-marginalized European Parliament, had nothing to do with it, and played no formal role consistent with their institutional functions. Yet Bonn's decision to bring East Germany into the Federal Republic had momentous economic and political significance for Europe and the world.

Economically, the absorption of the former GDR into the Federal Republic of Germany led to the end of the German mechanism of accumulation and changed the profile of German industrial capitalism. It therefore modified the pattern of capital accumulation in Europe and made it increasingly dependent on exports to areas outside Europe. Thus, rather paradoxically for anyone not blinded by the economic jargon of flexibility and competitiveness, the more the European Union grew in size, by adding new countries to it, the more it pinned its faith on an export led growth process. Even the policies of financial deregulation were conceived in relation to international competitiveness to achieve further rises in export surpluses with the rest of the world. The paradox arises because logic dictates that the bigger an area becomes the less significant are its international trade and capital flows. For Belgium, exports and imports are everything; its total trade being much bigger than its GDP. But an area as big as the EU, which by itself is a big chunk of the world economy, cannot depend upon net exports to generate growth in

incomes and employment. The crucial variable is Europe's effective demand. The latter has been increasingly stagnant over the last decades with a major factor in the worsening stagnation being the German economic stalemate.

Institutionally, the events of 1989–90 led in 1992 and 1993 to the end of the European Monetary System (EMS). This event unleashed an economic conflict of interests between three countries, Germany, France and Italy, which threatened the very existence of the EU and of a common ground for the many different European capitalist interests. Stagnation and intra EU economic conflict thus became intertwined largely as a result of Germany's unilateral handling of its relations with the USSR concerning the GDR. It is in this context that the French authorities, from Mitterrand to Chirac, became determined to reign or box in Germany by imposing an accelerated transition to the Euro, something that in the Jacques Delors Single Market program of the second half of the 1980s was mentioned in more tentative terms. The euro, and especially the convergence toward it, blocked the collision course simply by trapping each country of the Eurozone into a frozen ocean thereby enshrining stagnation and making external growth even more important than before. However, given the present size of the European Union and also of the Eurozone, external growth can do very little to take the largest economic area in the world out of stagnation, and of the ensuing social decline.

24.1 Oligopolistic Dynamics

Politically and historically the formation of the Common Market, which later became the EEC and transformed itself into the European Union is explained as a policy aimed at avoiding conflicts and wars in Europe. In plain language this means avoiding a new war between Germany and France. There is a strong element of truth in this if we think that the wars between Germany and France were determined by the conflicting imperialisms of their respective capitalisms. In the age of industry and empire the prowess of each of the two capitalisms and the capacity to expand internationally depended on hegemony on the European continent and, more specifically, on control over the coal and steel making areas. So it is not at all surprising that prodded by the United States, whose main objective immediately after 1947 was to reconstitute the legitimacy of European, and especially German, capitalism at the expense of the British, French leaders such as Jean Monnet and Robert Schumann and West Germany's Konrad Adenauer moved in 1952 toward the creation of a common market for steel and coal, known as the Steel and Coal Economic Community (SCEC).

In truth the SCEC reflected the pattern of the steel cartel officially set up among European countries in the 1930s to shield their respective steel companies from the danger of price wars in the wake of the Great Depression. The novelty of the SCEC was that its objective was not just the coordinated protection of monopolistic interests. It was a strategy of dynamic

oligopolistic growth. The formation of a common market in coal and steel, with its corollary of SCEC-based support systems, and in the context of the Marshall Plan and NATO (U.S.)-funded expenditure programs, meant that the steel companies of every single country of the SCEC (which happened to be exactly the same six countries giving rise in 1957 to the Common Market) could buy coal from any of the SCEC countries and sell steel to any of them. This arrangement eliminated one of the main sources of economic conflict that marked the history of industrial Europe.

Recall now that the Bretton Woods system of fixed exchanged rates prevailed, that SCEC programs of public subsidies were available for the restructuring and what you have of the respective coal and steel sectors, and that Marshall and NATO plans were in place;³ remember also that steel has always been one of the most concentrated, hence oligopolistic, sectors in the world. Thus the SCEC program implied the creation of a regular and non-conflicting oligopolistic structure in the main industrial sector feeding both reconstruction and expansion, for the six European countries participating in it. Prices were set by mark-ups, and these were not altered by exchange rates risks since parities were fixed. Restructuring towards a Euro 6 market was aided by subsidies, and the growth of the market was guaranteed by the expansion engendered by the Marshall + NATO plans and national policies. There was no need to fight or to occupy militarily steel and coal areas. It took a lot of American prodding to bring all this about, yet the formation of the SCEC was not fully guaranteed. France withdrew its forces from the Saar, a major German steel and coal area, only in 1957, the same year that the Common Market was formed.

The Steel and Coal Economic Community case is a good blueprint for the understanding of the dynamics of the Common Market until 1971. Essentially the dynamics can be characterized as the formation of a European wide system of oligopolistic capitalism in which firms upgraded their productive capacities to service the expanding level of demand stemming from the "Euro 6." Interestingly, U.S. multinationals played a pivotal role in this since in their expansion and location decisions they tended to treat the European market as a single whole. U.S. multinationals, especially in the automotive sector, set up intra-firm networks that stretched across national borders and also across the boundaries of the EEC itself. Throughout the 1960s for instance, the Ford plant in Dagenham near London, when the UK was not yet a member of the ECC, supplied parts to the Ford plants in Cologne (Germany) and in Charleroi (Belgium). European companies by contrast tended to remain relatively more nationally focused even in the case of major exporters such as the German ones.

The regime of fixed exchange rates was crucial in allowing for the smooth unfolding of the oligopolistic dynamics since with fluctuating exchange rates neither mark-ups nor oligopolistic market shares can be stabilized because of the risk of competitive devaluations, something that, as we shall

see, happened in the 1970s and, unwittingly, in the 1990s. But the fixed exchange rates regime was not a product of European policymaking as it arose from the U.S. role at Bretton Woods in 1944. Indeed when in 1971 President Nixon ditched the Bretton Woods system, intra-EEC economic and monetary relations became very tense and tended to worsen. Hence the question arises of whether the oligopolistic dynamics of the EEC was, until 1971, the product of the ECC or of mostly external circumstances.

During the 1950s, before the formation of the Common Market, European integration, stimulated by reconstruction programs which then turned into a long boom (Milward 1992), proceeded at a high pace with Germany acting as the major exporter and as the factor revamping the whole interindustry matrix of the Continent (Halevi 1995). In that decade there was an institution that operated as close as one could imagine to Keynes' idea of an international clearing union that the US Government rejected at Bretton Woods. That institution was the European Payments Union (EPU), formed in Europe in 1949 by the United States in order to receive the counterpart funds of the Marshall Plan. The latter was based on aid in kind, which the recipient countries paid, but only to themselves, by issuing counterpart funds in national currencies that were deposited at the EPU. As reconstruction and economic activity picked up and as European currencies were not directly convertible, nor were capital accounts open to international transactions, the countries in surplus—usually Germany—would deposit their surpluses in the EPU, which would then quickly recycle them into commercial credits. Fixed exchange rates, closed capital accounts, nonconvertibility and the fact that national money interest rates were not much above the rate of inflation, meant that the sure way to make profits was to lend and invest for productive purposes.

All this was occurring before the creation of the Common Market and the process involved the whole of Europe. The EPU allowed the smoothing out of the balance of payments constraint of the European countries. Just imagine what would have happened without EPU in the light of the mounting German surpluses with the rest of Europe. Other countries, such as Italy, would have had to forgo part of the expansion programs. Yet even the mechanics of EPU would not have been sustainable without crucial support from the U.S. Congress. Thus when the outbreak of the Korean War, by causing a steep rise in raw materials prices, threatened Germany's balance of payments, the U.S. government quickly injected half a billion dollars into EPU. The Korean War expenditure then became an important factor in the revitalization of Germany's capital goods industry that sustained the process of Europe's industrial renewal. In other words, without the United States injecting money into the EPU Germany would not have been able to surmount the balance of payments difficulties caused by the rise in raw materials prices and the Korean War would not have become such a strong stimulus for German production of capital goods.

In 1957 the Common Market came into being and on January 1st 1959 EPU ceased to function because currencies became convertible again. From that year onward there was no cushioning mechanism against balance of payments shortfalls. Surely and systematically the balance of payments constraint began to manifest itself in this or that country. With fixed exchange rates the way to deal with a balance of payments deficit is to reduce domestic demand that will reduce employment and imports. Meanwhile the lower rate of job creation will mitigate wage increases relatively to productivity. Firms could then both strengthen profit margins and reduce export prices. This was Keynesian economics in reverse based on the deliberate periodic creation of some kind of unemployment. British economists even invented a term for it: stop-go. Invariably, countries adopting stop-go policies would be pulled out of a recession by an export expansion increasingly directed towards Europe itself. However if every country were to adopt this policy the risk of all of them converging toward the same wait and see position would be high. When West Germany decided in 1965–66 to prevent a feared balance of payments crisis, simply because its surpluses were somehow dwindling, by creating a domestic recession and generating an export drive, the era of mutually compatible full employment growth for Europe and the Common Market countries was, in practice, over; quite independently from the 1971 events.

Thus we see that that in the 1950s prior to the formation of the Common Market there were elements that sustained the European-wide process of accumulation and growth in a way that ceased to exist in the 1960s. By the second half of the 1960s the major European economies were willing to ditch full employment objectives in favor of stop-go policies. Four main factors prevented this stance from turning into a systemic pro-recessionary orientation. Firstly, the existence of built in countercyclical programs due to the determination of the Common Market countries to expand their infrastructure, secondly the parametric role of development and income support policies for lagging regions and rural areas, thirdly, the world impact of US military spending mostly connected to the Vietnam War and NATO programs, and fourthly, the general wage rise that swept throughout Europe from the second half of the 1960s to early 1970s.

Contrary to ad hoc theories of the profit squeeze the general wage rise propelled the growth of the whole EEC economy.⁴ Such a big burst in demand created investment which, as we know from Kaleckian theory, expanded profits. The general wage rise was the single most significant factor that prevented the EEC economies from implementing the stop side of the stop-go policies and it compelled them to adjust to a go-go stance.

24.2 The Breakdown of Growth and the Onset of Eternal Stagnation

It is the crisis in the global world economy that brought about the end of the growth boom in Europe, not some alleged profit squeeze. What made

Europe vulnerable was that it did not have an institutional mechanism to deal with balance of payments issues, just as it does not have it today under the Euro-Maastricht regime. The absence of an institutional agreement about balance of payments adjustments is not due to policy failures. Europe is made of several different capitalisms with similar but also highly specific and nationally shaped interests. The common institution known as the EPU worked in the 1949–59 decade because it was imposed upon the Europeans by the United States and it alleviated the European economies from the dollar shortage syndrome while enabling them to trade without being conditioned by external deficits. But these arrangements, essentially based on preventing international moneys from becoming a source of gains from purely financial transactions and hedging activities, rational as they may be, work under emergency conditions only. With the dollar shortage over by the end of the 1950s and with capitalist profits back onto a high growth path, Europe's capitalists wanted their money in the appropriate form of, as Keynes put it, abstract wealth. In a legally unified federal system this is possible, but Europe is not a federal system. There are no forces working toward it at the economic level. European capitalists were definitely willing to operate at the Continental level and wished to have equal access to the whole of the European market, but no firm would have given up the priorities it obtained or could try to obtain through national institutions.

Thus after the United States made EPU system was closed down, no movement towards a common EEC management of the balance of payments occurred. By the same token, today, despite the creation of the Euro, there is no movement toward a common management of fiscal transfers. The European Union's budget, being minimal in proportion to the GDP of the Eurozone, cannot replace the role of national budgets. But these are now increasingly divorced from the requirements of providing the fiscal transfers needed to avoid negative real adjustments when intra EU payment deficits occur. Hence the European Union is, from the economic point of view, in the same, albeit modified, institutional limbo as it was when the Bretton Woods agreements were jettisoned by President Nixon in 1971.

The fact that European politicians and business leaders—let us not forget that the process leading to the creation of the Euro has been shaped by the European Business Roundtable which is an informal but very real decision making body consisting of the major monopolistic corporations (Carchedi 2001)—can agree to a single market and to a common currency but cannot find a firm agreement on fiscal and balance of payments matters shows where the line in the sand is. In other words, it shows the European Union is a desired area for accumulation (Lucarelli 1999), but it is not seen as a space requiring mutually non-negative coordinated adjustments. The essentially neo-mercantilist nature of the old intra EEC relations, in place since the closure of the EPU and rendered more acute after the end of Bretton Woods, has not been removed by the creation of the eurozone. Thus the trajectory

from 1971 to 1999, the year of the euro, is also the trajectory of the failure to establish a consistent system for Europe's oligopolistic capitalism. It is not by chance that although by 1973 the EEC was already not much smaller than the United States, the unraveling of the coherence of the common oligopolistic framework, for the construction of which the United States dictated fixed exchange rates were paramount, began with Nixon's decision.

The European predicament can be understood by looking at the relation between the growth rate of GDP and the data on the share of fixed gross capital formation over GDP. More or less compatible data are provided by the *OECD Historical Statistics* updated every two years. That publication gives data for real growth rates as well as for the annual share of gross fixed capital formation over GDP which can be taken as a proxy of the share of investment over GDP, i . Consider now two periods with dramatically different growth rates but with similar values for the share of investment i . Are we allowed to conclude that all that happened is a fall in the technical efficiency of investment, because of a rise in the capital intensity of production? In part this may be, albeit not systematically. Being rational, capitalists will realize that the rise in the capital output ratio is not producing the required growth rate, thereby reducing the rate of profit. Hence they will try to modify the situation and lower the capital intensity of production again. Thus the fall in the growth rate, despite the stable value of the share of the gross fixed capital formation over GDP, is ascribable to the accumulation of unused capacity.

We can thereby define a trajectory of how successful are economies in adjusting capacity to demand under varying growth rates. Taking the golden age growth as a reference and using OECD data it is possible to split the 1960–2000 period into a golden age one spanning from 1960 to 1973 (no OECD data are available before 1960) and the post 1973 period when the break in the growth rates occurred. Over the 1973–2000 period, the least successful has been Japan who experienced the greatest fall in the growth rate and the smallest fall in the share of gross fixed capital formation. But Japan is followed closely by the EU as a whole, although much less by Great Britain. The same picture is obtained if we deduct from the share of gross capital formation the part going to residential construction. Private homes do not contribute to the production of tradeables. We are left therefore with the data for nonresidential construction and a big unspecified residual.⁵ Thus on the basis of the data provided by the OECD, the European Union has been accumulating excess capacity much more than the United States and less than Japan. However, if we exclude Great Britain and treat only the Eurozone, the difference with Japan is not very large.

On this basis we can identify the set of conflicting forces that emerged after 1971 and after the oil price increase at the end of 1973, which for Europe, but not for the United States, was a true external shock. The first element to point out is the difference in the behavior between Britain and

the rest of the EEC. The Common Market was constructed as an industrialized and industrializing area with neomercantilist features towards itself. Until the formation of the Common Market for instance, Germany's exports towards the rest of the world grew more than toward Europe. After 1957 intra-European trade, including the gravitation of Scandinavia, Austria, and Switzerland toward Germany, grew more than trade with the rest of the world. In the following decades Europe increased its role as the main area of German surpluses with which German corporations financed their international investments.

In this context Britain joined the EEC in 1973 with the Kaldorian objective of embarking on an export led growth in manufacturing.⁶ But, no sooner did the UK plan on becoming part of the area with the fastest growing internal exports, than the fixed exchange rate regime collapsed. If guessed properly variable interest and exchange rates allow for speculative gains to be made on international transactions. The private banking and financial sector becomes more interested in moving capital around to grab these casino-like gains than in providing finance for real investment. The UK had the misfortune of harboring one of the world's most powerful sets of rentier interests centered on the City of London. The end of Bretton Woods in 1971 opened the way for a big come back of those interests rather, but not altogether, dormant during the long boom. Furthermore with the increase in oil prices and the beginning of the exploitation of the oil fields in the North Sea trading on futures expanded bringing many gains to the City while North Sea oil became the main area of new investment and the rest of the industrial production and investment stagnated. Thus as far as industry was concerned the causes of the slow growth rate became more acute, external markets could not be gotten and the whole game was centered on who would beat inflation first: firms by raising prices, or workers by raising wages?

Thus throughout the 1970s the UK showed the worse relationship between GDP growth and the share of fixed capital formation (excluding residential construction) over GDP, a fact that suggests a dramatic accumulation of mostly unwanted unused capacity. The only effective benefit from being part of the EEC was not in a Kaldorian sense but in a financial one, since the planned liberalization of intra-EEC relations, as outlined in the Treaty of Rome, increased, under conditions of forex and interest rates variability and petrodollar creation, the significance of the City of London for Europe's financial processes.

While Britain battled its two and a half class struggle (on one hand the capitalists versus workers via the inflation struggle, on the other hand the City against productive capitalist investment and workers but eventually joined by the capitalists themselves thanks to Margaret Thatcher), two other main European countries were selecting the most congenial neo-mercantilist path vis-à-vis the EEC. Germany and Italy expressed two

polar strategies reflecting the industrial strength of the former and the oil induced balance of payments weakness of the latter. Even before the end of the dollar convertibility into gold Germany opted in 1969 for a revaluation of the deutsche mark to boost exports. This strategy was reinforced by the end of Bretton Woods and by the subsequent oil price increase leading to further revaluations of the West German currency. A stronger nominal mark, it was officially argued, would compel overall restructuring, which, given the capacity of the German capital goods industries to supply all the newer inputs and technologies, would result in significant productivity gains. Tight monetary policies would result in a level of unemployment, which would then discipline wages. The rise in productivity unmatched by an increase in wages would reduce the costs of production. Furthermore, revaluation would mitigate the rise in the cost of imported inputs such as oil and would lower the price of the intermediate products imported from the rest of Europe.

Hence, given the markups, prices would decline and exports would expand. The German strategy was therefore oriented towards using nominal revaluation to attain real devaluation. But this result could be achieved only if a thick interindustry network of capital goods industries was in place without any other European country or group of countries having the structural capacity to outdo German equipment. This condition was easily met since there are very few firms in Europe that can do without German machinery, whereas many German firms do not need as much machinery from the rest of Europe. However, the success of the policy of exporting via real devaluation required also that other countries would devalue their currency less than in proportion to the rate of inflation. In other words, the German strategy was predicated on a real structural hegemony towards the rest of Europe, and on the condition that the other currencies would undergo real revaluation.

Italy's own neomercantilist path torpedoed the German strategy. After the oil price increase the Bank of Italy devalued the lira in tandem with inflation that was fueled by both the increase in energy prices and in wage costs. The central bank however made sure that the currency would fall relatively to the mark but rise relatively to the U.S. dollar, thereby reducing the impact of energy prices. Since the bulk of Italy's exports were directed toward Europe, the devaluation of the lira relatively to the mark unambiguously helped Italian exports at the expense of Germany's. By the end of the 1970s Italy attained a strong overall export surplus in merchandise, also in the balance of trade with Germany, and the highest growth rate in Europe. The implications of Italy's strategy were bad for Germany but potentially disastrous for France with ominous implications for Germany's export oriented pattern of accumulation.

In France the wage increases obtained through the strikes of May 1968 sustained not just a boom in demand, but pushed the Gaullist government

of President Georges Pompidou, elected in 1969 after de Gaulle's decision to retire in the wake of the strikes of 1968, to embark on an intense infra-structural development. This was consistent with de Gaulle's idea of a strong France, both economically and militarily, as a prerequisite for a special axis between Paris and Bonn. It is on this basis that Charles de Gaulle succeeded in re-composing the consensus and interests of France's bourgeoisie toward Europe and away from the colonial interests which mired the country in the wars of Vietnam and Algeria. In other words, for France the construction of a European space with West Germany—but also by staring at Germany straight in the eyes with nuclear armaments, while developing warm relations with the USSR—and the possession of a strong industry, were the only ways to expand the dominance within France of French capitalism and to overcome all the socialistic—by then mostly represented by the Communist Party, which polled above 20 percent—and Jacobin elements present in France's polity since 1789. Thus de Gaulle's strategy toward Germany and Europe entailed a profound restructuring of France's capitalist groups and of the social orientations of the rather fascistic French bourgeoisie. Western Europe was to be the terrain for engendering the political victory of the bourgeoisie, this time once and for all, in the class struggle within France.

The events of May 1968 weakened the all-embracing confidence in the hegemonic power of the Gaullist project, but they did not derail it. Unsure of their absolute control over the domestic scene and witnessing Germany's growing economic prowess and Bonn's new openings to the USSR, the Gaullists dropped their opposition to Britain's entry into the EEC. At the same time, sustained by the wage-induced boom, they expanded the infra-structural modernization of France. As a result, after the collapse of Bretton Woods in 1971 and even after the oil shock in 1974 France's share of investment over GDP rose. Yet, the growth rate fell (although till the end of the 1970s it remained above the EEC average and above Germany's but lower than Italy's). This means that from a structural perspective France struggled to keep its rate of investment and modernization up succeeding also in achieving a surplus in the current account. However France's policies were also profoundly deflationary spreading their effects throughout Europe.

The policies of the Gaullist governments of the 1970s can be seen as a Maastricht-euro process *avant la lettre*. In addition to being rooted in the ideology of France's financial conservatism, France's policies reflected the view that along with a strong industry and a strong nuclear military industrial complex, French capitalism would have to have a currency not inferior in terms of its value and of its acceptance to the mark. The French franc and the mark should converge towards a stable parity. These ideas were already expressed in one of the first blueprints for a European common currency known as the Barre report of 1970 after France's prime minister Raymond Barre. But the revaluation of the mark in 1969, the further revaluations following the collapse of Bretton Woods and the oil shock, were pushing

the objective of stability in the parities into the high seas. Thus France was caught between the need to defend the parity and the necessity to let it fluctuate. The instruments used were those practiced two decades later during the convergence process toward the euro. France implemented a budget austerity program which kept the deficit in proportion to GDP, inevitable given the impact of the falling growth rate on the rate of unemployment, at almost one-fourth the level of Germany's.⁷ On the whole France's contribution to Eurostagnation was no smaller than that of Germany and perhaps even higher. Germany had a bigger external surplus but a much bigger domestic deficit as a percentage of GDP.

With Italy undermining the German strategy of nominal revaluation to achieve real devaluation, France's ruling classes could not possibly stabilize the value of the franc relatively to the mark. This is because Italy's devaluations also affected French exports; especially since there were then many sectors where the two countries overlapped and competed directly on the European markets. It therefore follows that the more the Italian strategy of devaluation was successful the more difficult would it have been for France to avoid similar devaluations. And had France embarked on the systemic devaluation path, Germany would have found itself facing two monetary fronts: the depreciation of the U.S. dollar after 1971 and the competitive devaluations of its two major trading partners. Thus, couched in the grand rhetoric of *la construction européenne*, Chancellor Helmut Schmidt and President Valéry Giscard d'Estaing decided in 1979 to launch the European Monetary System (EMS).

24.3 Institutionalizing Oligopolistic Financial Capitalism in Europe

24.3.1 The EMS

The EMS was set up to avoid a currency war between France and Germany and, in the process, to protect Germany's main space of profitable realization. The story of the EMS is known. It collapsed in 1992 and 1993 in the wake of the effects of unification upon Germany's interest rate policies. The demise of the EMS reopened the situation frozen upon its formation in 1980 but in a context in which the German process of capitalist accumulation stalled without being superseded by the rest of Europe.

The expansion of the EEC/European Union to Spain, Greece and Portugal in the early 1980s and, during the first half of the 1990s to Austria, Finland, and Sweden did not change the basic axis of the evolution of Western Europe's political economy. The three Southern European economies have a weak autonomous basis of accumulation, being mostly characterized by a weak balance of payments and by sectors which are not central to accumulation on the world scale.⁸ In general therefore these three countries benefited significantly from their membership of the European Union by going into overdrive and undertaking profound progressive transformations.

Austria entered the European Union after the end of the Soviet Union and the consequent end of the special neutral status it had since 1955 when the USSR and the other allied powers withdrew from its territory thereby restoring its sovereignty. The terms of the agreement between the USSR and the Western powers over Austria contemplated strict neutrality preventing it from participating in political, military and economic blocs. However, by mid 1960s, if not earlier, Austria's industrial and financial system was fully integrated with that of Germany. Furthermore, still in the 1960s a series of agreements with Italy concerning the normalization of the status of Süd Tirol/Alto-Adige, institutionally anchored Austria to both Italy and Germany (the State of Bavaria was involved in the normalization process). One could therefore argue that by joining the EU Austria formalized a *fait accompli* while accepting unnecessary additional constraints.

Deep economic integration among themselves and with Germany and Britain characterized the Scandinavian countries well before they joined the EU in the 1990s. Norway stayed out but the country is also fully integrated with the rest of Europe.⁹ Moreover Sweden's position in the world economy was already well established both macroeconomically as an export oriented industrial economy, and in terms of its brand names: from Saab planes to Volvo cars, to electronics. For Sweden joining the EU had more a political than an economic significance. Perhaps the EU mattered for Finland because the end of the USSR, which used to mop up a great deal of Finland's otherwise unsold output, produced a major recession. But the high-tech path to recovery and growth taken by that country would have been achieved even without membership in the EU. Thus the dynamics of European capitalism still depends on the same three old guys plus Britain playing the *libero* through the City of London.

In this context it is important to recapitulate the main significance of the EMS and why its collapse reopened the situation of the 1970s but with Germany in a profound crisis of direction.

The EMS did exactly what Italy was trying to avoid. The high inflation countries experienced real revaluation. Since budget expenditures were high, demand expanded but imports increased even more. For a while this process was concealed by high U.S. interest rates and high military budget deficits that generated a growing deficit in the U.S. balance of payments. The EMS countries had their currencies tied to the value of a common accounting unit called Ecu, which effectively meant that their currencies were tied to the mark. After 1985 following the Plaza accords in New York, the U.S. dollar began a decade long decline induced by interest cuts from the Federal Reserve. The decline in international interest rates did stimulate expansion in Europe but it also highlighted the sensitivity of European exports to the value of the dollar. The degree of that sensitivity differed however from country to country. It was less for Germany than for France. But the currencies of the EMS were tied to each other by virtually fixed

parities. By 1989 Germany accumulated the largest current account surplus in its post war history being above 4 percent of GDP, 60 percent of which stemmed from trade with the rest of the European Community. But unlike the 1950s when surpluses were quickly recycled through the EPU and the German economy was growing more than the rest of Europe, the accumulation of German surpluses occurred with Germany's growth being among the slowest in Europe.

In the 1960s, with the EPU shut down, balance of payments deficits were adjusted by betting on the success of stop-go policies. But in those years institutionally fixed exchange rates prevailed. The EMS was not a system of institutionally fixed parities. The agreement to set it up was political but its maintenance required economic measures. Hence the way in which the deficit countries could sustain their external deficits was to attract capital by means of higher interest rates. Furthermore the higher the inflation differential, the higher was the real revaluation of the country's currency, the higher the external deficit and the higher would have had to be the interest rate needed to attract the required capital. The reappearance of the German surpluses in a context of slow growth in Germany, and with capital mobility, induced by high interest rates, adjusting the external deficit made the EMS into a disaster waiting to happen. And happen it did.

Romano Prodi, today known to the wider public as the head of the European Commission until the end of 2004 but originally a professor of industrial economics at the University of Bologna, published in 1990 a very good essay on German surpluses as blocking the whole macrodynamic process in Europe (Prodi 1990). He also pointed out that the hefty balances strengthened the integration between banks and industrial concerns reinforcing the oligopolistic power in the German economy. Clearly written before the fall of the Berlin Wall, Prodi's essay worked on the assumption that Germany's slow growth and its balances would eventually drive Europe to a complete halt, unless external markets were found. But China was not yet around, not for Europe at least.

To be sure something of a boom was occurring in the German economy that may have helped the rest of Europe. The German growth rate picked up substantially rising from 1.7 percent in 1987 to an annual average of 3.5 percent for 1988–90. An even stronger increase took place in France although limited to the 1988–89 biennium. We will never know whether it could have continued because the whole process was broken down by the drastic deflationary policies implemented by Germany after the unification leading to the collapse of the EMS. It is likely that the German and European mini-boom of 1988–90 had some of the main features of the Japanese stronger boom also occurring in the same years. To sustain the US financial and stock market system which was being deflated by the post-Plaza fall in U.S. interest rates and in the U.S. dollar, both Europe and Japan created a great deal of liquidity which found its way into real estate speculation. By 1991 the

bubble was being pricked by the Bank of Japan, starting the endless Japanese stagnation. The same might have happened in Europe, who knows, suggesting that the boom of the last years of the 1980s did not have lasting features.

At any rate the German unification put an end to all this. Why? Official explanations center on the rising inflation rate. They are not wrong but not for their stated monetarist reasons. The EMS allowed Germany to protect its exchange rate against European competitors. Countries with higher inflation rates, all of them except Belgium, the Netherlands, and Luxembourg (Benelux), saw their currencies subjected to real revaluation vis-à-vis the mark. In real revaluation there is a kind of Argentine effect, a sort of exhilarationist boom. People buy more, travel more, and spend more. In Argentina this process, albeit circumscribed to a limited section of the population, initially generated domestic growth. Countries like Italy and Spain experienced the same phenomenon on a much larger basis. Real revaluation caused imports to rise and at first it also sustained growth. By the end of the day German exports soared and the deficit countries had to finance their shortfalls through capital movements offering lucrative interest rates. With German inflation rising under the miniboom, the real devaluation of the mark was reversed. The unification made things worse, not so much via inflation, but because it involved a shift from exports to more domestic demand. By the end of 1990s Germany's current account surpluses, for the expansion of which German authorities and German corporations labored indefatigably for four decades, were dwindling and by 1991 they were in the red. They were to rise back to a surplus position only in 2003. Thus from the end of 1990 the Bundesbank stepped in by increasing interest rates blocking expansion and destroying the EMS.

We come here to a crucial point. The German pattern of capitalist accumulation pitted—from the big export counteroffensive of 1966 and the mark revaluation of 1969—the internationalization of German capital against domestic demand. That was and still is the German model of accumulation. The reason why domestic demand is seen to be clashing with exports and the reason why export growth is privileged is to be seen in the political economy of German foreign investment and of German money. Foreign investment obviously expands the world oligopolistic power of Germany's big corporations and, unlike the American case, it is also viewed as a way to fuel German exports. The financing of this process is considered to depend upon the accumulation of German surpluses and not upon the issuing of liabilities. The German banking system *de facto* operates on the basis of credit rationing favoring the international investment of those companies that can pay for it via their export surpluses.

Hence the picture of German capitalism can be evinced quite straightforwardly. A nominally strong currency based on price stability is the best condition to obtain a real devaluation of the currency through the mobilization of Germany's prowess in the capital goods and technology sectors. German

policies of implicit, but very visible, credit rationing constitute also a pistol pointed at the head of the unions inducing them to come to productivity enhancing agreements. Germany then minimizes the issuing of liabilities against itself while the banking sector finances international investment via the surpluses. Thus even if domestic demand generates stronger growth it may be viewed as a bad thing compared to guaranteeing exports and foreign investment outflows into the wider world. The miniboom of the late 1980s and the absorption of the GDR threatened to kill this strategy and indeed they killed it. Since then German policymakers and managers are at a loss but they absolutely do not want to give greater room to domestic demand expansion as they still believe in the old model of accumulation which gave so much power to their large corporations.

24.4 The Interregnum: 1993–1998 Convergence to a Common Currency via Eastern Europe

Having lost their surpluses Germany began to behave like the deficit countries by increasing interest rates, thereby raising abruptly the value of the mark, but with the specific objective of smothering domestic growth. So, high interest rates yes, exhilarationist growth no! The end of the Eastern bloc generated a new set of objectives that required a lot of money. Thus the world had to consolidate its faith in the strong mark and had to throw money onto Germany. The authorities, government and businesses alike would invest and open up Eastern Europe, the Balkans and even the Ukraine. The surpluses would not have sufficed anyway but now that there weren't any, money had to be attracted by appealing to both lucrative and confidence instincts. The first would be served by high interest rates, the second by deflationary policies. Meanwhile it was believed that the powerful German industry would do its job by turning out newer machinery and technologies and with the pistol of unemployment aimed directly at the head of the workers, wage bargaining would be subdued. It was hoped that productivity would rise and price stability would ensure real devaluation once more. The export surplus would then be back with Germany, which had now acquired a whole new area of economic and political influence stretching from the Baltic states to Turkey. Clearly the surpluses had to come from Western Europe while the East was being conquered. However, it did not happen that way.

The collapse of the EMS—in two steps in 1992 and 1993—opened up a process that nailed down Germany even more than the competitive devaluations of the 1970s. The following factors determined the worsening of the German crisis. The first was the burden of East Germany, the impact of the absorption resulted in a very rapid deindustrialization of the East and the transformation of that area into a destination of transfer payments estimated at around 4 percent of German GDP. The second factor was the

repetition within the European Union of the 1970s as far as Italy was concerned. Until 1992–93 under the EMS Italy experienced a worsening balance of payments because of the real revaluation of the lira, but after 1993 with the collapse of the lira exports soared, as did those from Spain. But the major beneficiary was Italy. The third factor resulted from other countries, especially France, undertaking systematic restructuring so that Germany's effort to regain ground became more costly. The fourth factor was Germany's inability to mitigate the deficit with Asia.

By contrast, the elements that helped the general European performance were located in the growth of the United States as well as in the revaluation of the U.S. dollar in 1995, undertaken to save Japan from the collapse of its U.S. dollar denominated asset structure as well as from the squeeze on the profit margins on its exports. Finally the exhilarationist growth in Brazil and Argentina, which pegged, albeit differently, their currencies to the U.S. dollar resulted in current accounts deficits primarily oriented towards the European Union. However all these elements did not help restore European growth which remained, for self-evident reasons, tied to the state of demand in each country. Furthermore, the positive international factors did not help Germany's balance of payments as much as one would have thought given the immediate responsiveness of German export production to the expansion of international demand.

The country's current account balance remained in deficit until 2002 mostly because of the insufficient export expansion toward the European Union and because the economic situation in Eastern Europe turned out to be very different from what had been dreamed about. With the end of the USSR, German corporations and the German government looked at Eastern Europe as an area to restructure in order to expand the domain of German exports and increase the export capacity of those countries in sectors deemed redundant in Germany. In this way a low wage German-controlled Eastern Europe could have become a source of net exports to the rest of the world, including to the rest of the European Union, while being in deficit with Germany. For what they are worth, the international accounts of the Eastern European countries do show a deficit with Germany, but that's about it. The desired synergies did not happen except with smaller countries, and in very specific sectors, such as Hungary, the Czech Republic and Slovakia. On the whole the impoverishment of Eastern Europe and the consequent fall in local demand rendered the German surpluses with that area very secondary, incommensurably smaller than the importance assigned to the area by German policymakers and corporations.

It must be observed that in the same way as Germany engineered a change in the whole posture of Western Europe without involving the institutions of the EU, Germany also developed the economic strategy all by itself, although the monetary policies attached to it affected the whole of Europe. This aspect was not lost on the country that had most at stake: France.

Here it must be recalled that on the equivalence between France and Germany rests the cohesion of French capitalism and of the French bourgeoisie with the French state. This cohesion was restructured and reshaped by the Mitterrand presidency that moved France from the state to the market, as it were (Schmidt, 1996). From the nationalizations, which reorganized France's big business into the private corporations and banks of today, to the tight integration of the elite schools (*grandes écoles*) with the high ranking functionaries of the state, and the latter's transformation into CEOs of the major public as well as private companies, Mitterrand's two presidencies played a role that was by far more in continuity with de Gaulle's strategy than were his followers Pompidou and Giscard d'Estaing. The parity or, rather, the equivalence with Germany was at the basis of all that and marked France's position in Europe including the military one. And on this last aspect it should be noticed that France has the most complete military industrial complex in Europe which operates as a mesosystem being the operational junction between the state, the civilian economy and the major industrial groups (Chesnais and Serfati 1992).

We can now appreciate how Germany's unilateral decision to absorb the GDR, and the almost concomitant and fateful decision to support, in 1990 and 1991, the unilateral secession of Slovenia and Croatia from Yugoslavia, a move opposed but not resisted by both Britain and France, cut deeply into the view of the world of France's ruling groups and classes and dented the way in which they perceived their own position in the world and, above all, in Europe. Germany was therefore not to be allowed to go alone. That is the crux of the acceleration in the tempo and the doggedness regarding the formation of the euro.

The Bundesbank believed that by enforcing a policy of high interest rates, entailing a high mark, German industries, would forthwith undertake the needed restructuring which would eventually restore the conditions for a persistent external surplus. Although after 1993 merchandise exports did move back to net surplus this was due more to a fall in German demand than to the success of restructuring. Just the same the outflow of money from Germany increased more than improvements in the merchandise balance so that the deficit kept worsening.

To defend the parity of the French franc with the mark France followed the policy of the Bundesbank raising interest rates from 1990 throughout 1992–3. But this situation was exposing France to two intertwined pressures. The first was that interest rates had to be higher than in Germany because France has a big financial sector much less tied to industry than the German counterpart. This sector always whipped up the fairy-tale that France is more inflation-prone and less reliable than its neighbor. But this very characterization of France, engineered by the financial sector itself, was a factor reducing the credibility of the policies. Hence France began to experience a net outflow of investment income, contrary to the earlier steady build up of

inflows from investment undertaken abroad. The second source of pressure was that maintaining the parity with the mark was exposing many French companies, especially the small and medium ones, to the competition arising from the countries whose currencies devalued; mainly Italy and Spain.

For the above reasons the situation after 1993 was perceived in France as becoming increasingly unbearable. But also in Germany, precisely because merchandise net exports were not growing fast enough to make up for the outflows, the high value of the mark was attracting growing criticism, in particular from the small companies hard hit by Italian competition based on a low lira. As detailed by Marcello de Cecco in an international symposium (de Cecco 1998) and in a number of articles in the Italian daily *La Repubblica*, a de facto coalition emerged between the disgruntled German industrialists and a wide array of economic forces in France led by the quintessential synthesis of French capitalist interests, the former president Valéry Giscard d'Estaing. The most significant pressure came from the French side, which put pressure on Chancellor Helmut Kohl, although the French government remained silent being wedded to the policies of the Banque de France. It was made clear unless Bonn reversed the Bundesbank's stance, France would have to abandon the parity with the mark.

That old fox of French politics and, more recently, the head of the EU committee drafting the European Constitution won the gamble with Chancellor Kohl, and the Bundesbank's policies were abruptly reversed starting a devaluation of the euro parities. Coming from a coalition headed by Giscard d'Estaing the threat was more than credible and sent a frisson down the spine of Germany's establishment. The truth is that without the equivalence between France and Germany Europe ceases to be the safest area of effective demand and surplus accumulation for German capitalism. Germany could cope with a dancing lira, as they used to say in Italy, but it could not cope with a serious devaluation of the French franc because of the much wider industrial structure of France.

24.5 Eurostagnation

If a proof is needed that lowering interest rates does not necessarily call forth investment, it comes from the European events following the 1996 decline in the mark and the formation of the euro in 1999. After 1995 the surplus of Germany's external balance in goods and services grew steadily as a percentage of GDP, never however reaching the pre-1990 level. But by 2000 it collapsed again and recovered massively from 2002 to 2004. What was the role of the currency realignment towards the Euro lock-in exchange rates in all that? Not so clear because German exports started to boom after the end of the U.S. expansion and with Europe in greater stagnation. Thus the rise of German exports after 1995 was due only in part to the intra-European realignment. U.S. growth, the dollar revaluation to save Japan, and the

exhilarationist growth in East Asia, as well as in Argentina and Brazil played a role too. But Europe remained in stagnation with growth picking up a bit from 1997 to 2000. In other words the realignment towards the Euro and the decline in interest rates did not stimulate much activity within Europe, which tends to become increasingly dependent upon external markets, a rather bleak prospect given the combined size of the economies concerned.

Europe seems to confirm Rosa Luxemburg's point that capital accumulation cannot hang from its own bootstraps. The Maastricht criteria, enforceable only in the eurozone, have got a lot to do with it, but they are not the most significant part of the story. The crux of the matter is that Europe is not a single entity and the process of economic integration was based on oligopolistic neo-mercantilist criteria of a *de facto* beggar-thy-neighbor attitude. Only during the EPU period did neomercantilism recede into the background.

The currency realignment toward the euro changed however the composition of the balance of payments of the other two major economies, France and Italy. As the lira rose towards the lock-in exchange rate Italy quickly saw its current account surplus dwindle and becoming negative in 2000, with a growing deficit as share of GDP. The same phenomenon happened with Spain only in a more marked way, considering that Spain never had significant surpluses. This brings us to suggest that the currency realignment and the decline in interest rates did very little for the European macroeconomy, but they did change the intra-European picture.

Initially it was thought that France was the big winner. The Socialist government of Lionel Jospin even boasted that France was the new economic anchor of Europe, and they also issued a report about nearing permanent full employment when unemployment was still at 9 percent. Indeed France reached a large surplus in the current account, while in the 1980s it tended to be in deficit. The self-assured attitude of French authorities was due to the fact that all the main branches of the French economy were gaining from their international transactions. The goods and services sectors were in surplus as well as the inflows of incomes from investments undertaken by French companies abroad. Germany by contrast, while struggling to reach a positive trade account, could not stem the negative flow of investment income. In France this situation, regardless of stagnation and persistent unemployment, was viewed as positive. The attainment of external surpluses on industrial and financial fronts strengthened the institutional cohesion of France's capitalist classes measured in relation to the German stalemate. It strengthened their confidence in the technocratic capacity of the French state and its ability to exercise greater influence in European matters. The issues of unemployment and of what was then called "social exclusion" did not count except in periods of elections.

But most of the feeble dynamics of the 1997–2000 period were due to external factors located in the United States, South America, and East

Asia, with China becoming a growing pole of attraction. Yet by 2001 the European Union was mired in an unprecedented state of stagnation with growth below the insignificant 1 percent of GDP. It is in this context that German surpluses made their reappearance in full. With a growth rate not much above zero Germany achieved a surplus in the current account of similar proportions to the share attained during the 1980s. But clearly with a much lower growth rate a bigger external surplus is an even stronger factor of stagnation and demand deflation for Europe as a whole. To the resurgence of German surpluses corresponded a loss up to negative levels for France and Italy, while Spain and Britain saw their deficits widening still further.

Thus Romano Prodi's views expressed in 1990 are valid again only that now in the Eurozone there is no transfer mechanism to deal with the issues. Furthermore the cumulative stagnation in which Europe finds itself prevents the reappearance of the surpluses from acting as a force of cohesion for German capitalism. Prodi's argument was that while the German surpluses of the 1980s were a problem for Europe they were also the expression of the strong integration and cohesion between banks and industry in Germany. German surpluses were therefore a weakness for Europe but a manifestation of the prowess of German capital. This dichotomy is no longer applicable. Germany is unable to restart its process of accumulation via exports. This is the main reason why despite the net surplus, investment income remains negative. Why should German companies investing abroad bring back their money when Germany is stuck in stagnation?

At present there is no way out from European stagnation, including trade with China since its impact will be uneven. Although the European Union has become its number one trading partner, China's economy is smaller than France's. Moreover China tends to privilege imports from East Asia and Japan. It is with this area that China shows a trade deficit. Hence Europe and the United States must be a source of surpluses. Within Europe China privileges imports, often undertaken by the respective multinationals, from countries with high technology sectors such as Germany, Scandinavia, Austria, and Switzerland. Countries like Italy and Spain do not have multinational companies using their home base to supply equipment and technologies to their affiliates in China. Hence those countries, like Britain, tend to be more exposed to deindustrialization and to a growing deficit with China. China's growth cannot be the panacea for Europe's stagnation. European companies have always been dynamic and innovative and still are. It is the European macroeconomy, hence Europe's capitalism, which is stuck and cannot get out of the morass by itself.

24.6 Has Monetary Union Helped?

Previous sections have shown the necessity of some sort of monetary union for Europe, as all attempts at reducing exchange rate volatility between

European nations were defeated by speculators. In addition, flexible exchange rates, due to the dangers of competitive depreciations, had negative implications for European stability. It is clear that in the current international environment, with the sheer volume of speculative capital flows, it is impossible for any such stability except in the situation where intercountry exchange rates are abolished, which, of course, is the main idea of the EMU.

With monetary union has come a single monetary policy for the Euro area, which is a "one size fits all policy," as there can be only one monetary policy for the whole area. At the same time national fiscal policy has been severely constrained via the Stability and Growth Pact (Lucarelli 2004). In addition the possibility of using the exchange rate to deal with inter European differences has been eliminated.

At this stage we need to consider the implications for effective demand of these arrangements. We have already argued that effective demand from external sources cannot solve Europe's stagnationist tendency, so that any solution must be internal.

Under a true federation, macroeconomic policy, monetary, fiscal and exchange rate policies are centralized, under the control of the federal authority. The combination of policies allows the authority to influence effective demand at both the federal and regional levels. The latter is the result of the possibility of regional variations in taxes or, more importantly, of public expenditure to compensate any region disparities in growth rates.

Unlike a true federation, Europe lacks any central macroeconomic policy making body that can either stimulate effective demand in times of recession, or can deal with regional differences. Monetary policy operated "independently" by the European Central Bank is a blunt instrument, which can only deal with Europeanwide issues. Even then, there is strong evidence suggesting that monetary policy is more effective at containing booms than it is with dealing with low levels of demand, as most of the components of aggregate demand are interest inelastic in time of recession (Kriesler and Nevile 2003).

In most federations, the policy of choice for dealing with insufficient effective demand problems, as well as dealing with interregional issues is fiscal policy. However in the eurozone there is no central fiscal authority, so that it is clearly a matter for individual member states with little co-ordination between national fiscal policies; and between fiscal and monetary policy. Of course this situation is worsened by the Stability and Growth Pact, which severely limits any individual country's ability to use fiscal policy to alleviate effective demand problems. These shortcomings are amplified by the limitations inherent in a single currency regime dealing with what are effectively a number of separate economies at quite diverse levels of economic development, with wide differences in institutional arrangements and in economic structure. As a result, there are wide differences in the appropriate economic policies for these countries in both short and long run. In fact, the single

currency/single monetary policy regime, supported by the Stability and Growth Pact are likely to lead to centrifugal forces cumulatively pushing the economies of the eurozone further apart, amplifying any instability.

The European Union is constructed in such a way that it has policy for dealing with general levels of inflation, but nothing which can really impact on unemployment at the European level, much less allowing for intercountry differences. Since the problem is one of insufficient aggregate demand, fiscal policy is needed, and especially policy which allows for differential impacts on different regions. However, individual countries are caught in a double bind on the issue of independent fiscal policy. The limitation imposed by the Stability and Growth Pact is reinforced by the lack of any possibility of independent monetary policy, which means that countries need to worry both about financing fiscal expansion, and, at the same time are severely limited in their ability to do so by the pact. So basically as well as the overall level of unemployment being unacceptable, we also have the problem of lack of regional policies, which will lead to increased regional inequality.

24.7 Conclusion

We are left with a pessimistic conclusion about the future of the euro economies. Historically, due to the dominance of Germany, Europe has been torn between the stagnationist tendencies imposed by that country and the more expansionary policies of its traditional rival. However, the imposition of the eurozone, with a central bank dedicated only to inflationary targeting with no reference to unemployment in its charter, coupled with the Stability and Growth Pact, which tie the hand of individual countries in their ability to use fiscal policy to combat either cyclical or chronic problems of stagnation, have changed the balance.

Paradoxically, monetary union has made the possibility of fiscal expansion easier, as it has reduced the constraint on the international account, as most European trade is intra eurozone. An economy the size of Europe's, with its productive capacity and structure allowing it to fill all stages in the productive process, relieved of any serious balance of payments problems should be a significant factor for internal and global accumulation. This has put Europe as a whole in a very strong position to become an engine of growth, both for itself and for the world economy. Unfortunately, this potential does not appear to be realized.

Notes

1. Hence countries like Argentina and Australia are *ipso facto* global traders in, mostly, missing future markets.
2. Proximity would have prevailed as in the case of Japan after 1945 had the United States allowed Tokyo to trade with the People's Republic of China. But it did not

thus Washington had to open its own markets to Japan as well enable Japan to sell globally without reciprocity (Forsberg 2000; Borden 1984).

3. It was the merit of Charles Kindleberger to have pointed out that the Marshall Plan never ended as it became the NATO plan (Kindleberger 1970).
4. From 1960 to 1968 the annual average GDP growth rate of the EEC was 4.5 percent but in the 1968–73 period it was 4.9 percent. France's post 1967 strong growth, the highest among the big economies of Europe, created a minor deficit in the balance of payments—but only for the years 1968 and 1969 since afterwards till the oil crisis of 1973–4 the current account returned to a surplus. In Italy, which experienced the greater wage rise, the current account remained in a hefty surplus till 1972 while the growth rate stayed high but with cyclical fluctuations due to both the end of Bretton Woods and the social struggles without which wage increases would have been truncated. West Germany showed the most significant increase in the growth rate as well as a sustained surplus. If the EEC were a single country the outcome of the wage rise would have been unambiguously positive as the balance of payments constraint would have been less significant (*OECD Historical Statistics 1960–1981* 1982).
5. The residual is recent since until the mid 1990s the OECD divided the share of gross fixed capital formation into total, residential construction, nonresidential construction, machinery and equipment. Having stopped providing data for machinery and equipment the residual can be treated as a rough proxy but, given the problems of calculating hedonic prices, it is better to lump together as productive investment all that is left after deducting residential construction. We are taking the OECD data at their face value but in all honesty we should reject them and elaborate our own data instead. This is because OECD growth data are vitiated by estimating false production functions (see Rymes 1971).
6. Nicholas Kaldor, the well-known Cambridge University economist and founder of the post-Keynesian theory of growth and distribution, was a leading economic advisor to the Labor Prime Minister Harold Wilson. In his 1966 inaugural lecture he argued that Britain's low growth rate was due to a low share of investment and to a low rate of export growth in manufacturing (Kaldor 1966). Britain could join the EEC because France lifted the veto over it.
7. From 1974 to 1979 the average annual government deficit to GDP ratio was a paltry –0.8 percent in France as opposed to a –3 percent in West Germany.
8. Excluding the European multinationals owning the Spanish automotive industry and excluding also Spain's participation in the Airbus Industries consortium.
9. As shown by the general strike of few years ago that blocked the production of BMW cars in Germany because of the high-technology components produced in Norway.

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25

The Changing Patterns of Accumulation and Realization in East Asia since the 1990s

Joseph Halevi and Peter Kriesler

25.1 Introduction

In order to understand current developments in Asia, particularly the pattern of growth and accumulation, it is necessary to consider the historical development of the region. In this chapter we attempt to understand these recent developments from the stagnationist tradition in Marxist literature which is discussed in the next section. Using the stagnationist framework, three distinct phases of Asian capital are identified. The early phase was characterized by European interest in the region and with the start of Japanese industrialization, while the second phase is marked by the rise of Japan as the oligopolist power in the region. Finally, the rise of China as a significant economic force leading to structural change in the region is considered.

25.2 Historical Background

There is an important stagnationist tradition in the Marxist literature which goes back at least as far as Rosa Luxemburg. In the twentieth century it culminated in the writings of Kalecki and Baran and Sweezy. The essence of this view is that there are long run stagnationist tendencies in capitalist economies caused by the fact that the growth rate of productive capacity (ie. the rate of accumulation) is faster than the growth in the level of effective demand.

These stagnationist tendencies are reinforced with the development of the monopoly phase of capitalism. Oligopolistic corporations are associated

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with both a rise in the share of profits at the expense of labor's share, as well as a reduction in the drive to accumulate. As the propensity to save from profits is higher than from wages, this redistribution is associated with lower levels of effective demand, further exasperating the problem.

This is well summarized by Baran and Sweezy:

Under monopoly capitalism.... The normal condition is less than capacity production. The system simply does not generate enough 'effective demand'...to ensure full utilization of either labour or productive facilities (Baran and Sweezy, 1966, 146).

The stagnationist tradition acknowledges that these tendencies may be postponed by a Schumpeterian process of creative destruction in times of profound technological change. External markets can also act as exogenous sources of effective demand which can mitigate the stagnationist tendencies. External markets refer to demand from markets external to the sphere of production. These external markets can be either domestic or foreign. By domestic external markets, we refer, in the tradition of Baran and Sweezy, to a number of possible external sources of effective demand including advertising, finance, insurance, real estate, government expenditure and expenditure on the military¹.

Foreign external demand is the result of net exports. Countries can increase domestic demand at the expense of their trading partners, by increased exports, a point noted by both Keynes and Kalecki, who also stressed the global limitations of such policies. Keynes and Kalecki clearly understood the importance of international trade as a mechanism for exporting unemployment between nations (Keynes, 1936, ch. 16; Kalecki, 1976; Halevi, 1984). In other words, the balance of payments may become an important constraint on the growth of effective demand if countries maintain chronic deficits.

This problem was specifically addressed by the successful development of East Asia in the post-WW2 period, which relied on external markets with the newly industrializing economies (NIE's) growth strategies explicitly focused on exports.

However, even in these cases, the balance of payments may be problematic as the level of the productive stock of capital is deemed low relative to population, particularly where capital goods – including intermediate industrial products – are mostly imported. Even if a country has a large productive capacity its accumulation may be constrained by the balance of payments bottleneck which will arise when factories and services are near full capacity. If capital goods including intermediate products have to be imported, then any increase in investment will increase the size of the external deficit, which may then become an obstacle to full employment policies even if the economy is an advanced one in terms of per capita income. This is the result

of fundamental problems in the international monetary system which has always placed the burden of adjustment on the deficit country, so reinforcing the stagnationist tendencies already inherent in the system (Kriesler and Halevi 1996; Halevi and Kriesler 1998).

This view should be contrasted with the dominant neoclassical view, according to which any increase in saving is a benefit to the economy rather than the burden that Marxist economics in the above traditions see it as. The reason for this is that with an underlying loanable funds vision of capital markets, the increased saving – supply of loanable funds – immediately translates into an increase in investment demand for loanable funds. It is this view, associated with the Washington Consensus, which argues that policies are needed to increase national savings as the only way of both improving growth rates and addressing current account imbalances. Similarly, according to this position, Japanese current account surpluses, post-1970, have led to capital outflows which, in turn, have funded investment elsewhere:

[T]he current surplus in the Japanese balance of payments ... is a *beneficial* feature of the world economy, and ... Japanese savings, as manifested in the country's balance-of-payments surplus, can be used for Asian economic development (Healey, 1991, 25 *Emphasis in original*).

Elsewhere we have discussed this position in full noting that there are serious logical and theoretical problems with these arguments (Halevi and Kriesler 1998; Kriesler and Halevi 1996) The loanable funds idea underlying it is based on the view that saving constitutes a stock of loanable funds for investment, and that savings must precede investment, so that savings causally determine investment, with the rate of interest equating the two. This idea is rejected by most heterodox economists, for reasons outlined in our earlier chapters. Rather than being of benefit to other nations, large current account surpluses are merely ways of exporting unemployment, and lead to severe contractionary pressures in the deficit countries.

25.3 Capital Accumulation in Asia: Growth to the 1990s

From the 19th century until the launching in China of the Four Modernizations program in 1979, the process of capitalist accumulation in (East) Asia had gone through two phases. In 1979 it entered a crucial third phase which started to have a significant extreme impact by the end of the 1980s and gathered momentum after the Asian crisis of 1997. Thus it can be said that only around and after the 1997 financial crisis did the new regime of accumulation which was incubating in China change and sweep aside the previous one based on Japan's hegemonic role in the East Asian zone bordering China.

We can now summarize the main features of the phases of capitalist accumulation in East Asia:

25.3.1 Phase 1

The first phase of accumulation is characterized by both the European imperialist encroachment upon China and the industrialization of Japan strictly connected to its imperialist expansion into China, including formerly Chinese Manchuria under Tsarist Russia and into Korea. This imperialist expansion by both Europe and Japan into China and by Japan into Korea was a factor of grave retardation of the development of both countries. The logic was that of subordinating the economic structure of East Asia to capitalist accumulation in the respective metropolis. The expansion of Japan into China and Korea (1895, 1905 and 1910) was based on an alliance, both political and financial, with Britain which sustained Japan's expansion and extended large loans to Tokyo, thereby turning Japan into a major debtor.

World War 1 (WW1) solved the external debt problem of Japan, thanks to the alliance with Britain. WW1 acts as a classical external market and as an import substitution device. The search for markets restarted in earnest with the Great Depression and the related Manchuria incident in 1931. This event, which started the long war against China and, in appropriate historical terms, WW2, is the factor which propelled the heavy and chemical industry process of capital accumulation in Japan, operating therefore, in an eminently Kalecki/Rosa Luxemburg form of imperialism *cum* accumulation. At the same time however, the imperialism of Japan's capitalism had one crucial weakness regarding the structure of the balance of payments. While the Yen area was generating a surplus for Japan it was not doing so in terms of the trade with the dollar and sterling areas (Nakamura, 1983). Japan's imperialism towards China clashed more and more with the role ascribed to China by the United States (US) – defined by the open door policy elaborated in the years leading to the war against Spain in 1898 which brought the US to Asia through the conquest of the Philippines. Washington's move towards sanctions and oil embargo against Japan turned the dollar and sterling components of the balance of payments of Japan into an insurmountable obstacle out of which grew the conditions for total war. Thus Phase 1 ended in practice in 1937 when the all out war against China encroached directly on US interests in China and compelled a rather reluctant US government to set up an oil embargo against Japan which then led to Japan's decision to attack the United States.

25.3.2 Phase 2

What remained of Phase 1 was the structural change caused by the heavy and chemical industrialization of Japan. Kosai Yutaka has presented convincing estimates regarding the extent of the war damage (Kosai, 1986). While the damage was extremely severe in shipbuilding it turned out of

to be milder in the machine producing capacity of the economy, although more serious than in the case of Germany. But Japanese capitalism lost the functional connections between markets and raw material supplies that it has been establishing through imperialism for half a century up to 1945. Thus Phase 2 can be seen as formed by three sub-periods. The first sub-period is centered on creating the conditions for an economic anchor for Japan and the second is marked by the formation of a Japanese oligopolistic zone in the East and Southeast part of Asia. The third begins in 1971 with the US abandonment of the dollar-gold convertibility. Both periods up to 1971 are characterized by US public expenditure connected – in a pure Baran-Sweezy fashion – to military expenditure and to the special institutional arrangements made by the US to have Japan quickly accepted within the General Agreement on Tariffs and Trade (GATT) in 1955. These included the signing of 13 trilateral trade treaties offering to third countries greater access to US markets provided they forwent the use of clause 35 of GATT which allowed setting up trade barriers against any country not accepting trade reciprocity (Forsberg, 2000). US policies allowed Japan to lift, the balance of payments ceiling which is another way of saying that the limited availability of internationally profitable effective demand was less of a constraint on decisions concerning investment and accumulation.

Why was the United States interested in uplifting and protecting Japan even at the expense of the penetration of its own multinationals into Japan? There was indeed a grand design of reshaping world capitalism with the United States at its core flanked by two growth poles: Europe with West Germany at its center and Japan in Asia. The difference between these two poles resided in the fact that while Europe was the economic hinterland of Germany, Japan could not be ensconced in Asia because of the Chinese revolution and the national liberation movements in the region, including the VietCong led by Ho-Chi-Minh. Thus there was no natural area for Japan in the region. Japan had to be taken on board by Washington in a much more direct way than was the case with Germany, while, at the same time, the United States took upon itself the task of fighting the national liberation movements. This fact led Washington to transform the Korean War into a roll back war, and to get involved in Vietnam. Such a strategy was part and parcel of US policies to control raw materials through its own multinationals and to control world liquidity through the dollar supremacy which then was connected to a US surplus in the current account. With hindsight it seems clear that US authorities did not foresee the costs, in terms of the current account, of their own imperialism and were convinced that American technological superiority and sheer economic size would carry the day. US policies created a shelter for Japan in which the *keiretsu* could organize the much needed retooling in order to fan out into world markets without reciprocity from the Japanese side. American special procurement payments during the Korean War were the most noticeable example enabling Japan

to overcome balance of payments constraints. But as shown by US historian Michael Schaller, US war expenditure in Vietnam had an equally important impact on Japan.

The second sub-phase is that of the Vietnam War which Schaller has characterized as Japan's re-entry in Asia (Schaller, 1985). Propelled by US war expenditure the area becomes structurally dependent upon Japan, first in terms of imports. The crucial pillars of the area of Japanese oligopolistic hegemony are The Republic of Korea (hereafter Korea) and Taiwan notwithstanding that, unlike later Thailand, Malaysia, and Singapore, the two countries did not develop solely and not even principally on the basis of direct multinational investment. Yet it is in relation to Korea and Taiwan during the years of the Vietnam War that the model of structurally dependent accumulation was fashioned and it has been this model, rather than the so-called "flying geese" paradigm, that continued after the end of the second sub-phase shaping capitalist power relations in East Asia (Lim, 1985; Hart-Landsberg, 1993). This factor has been recognized also by economists involved with establishment institutions and policy making bodies, but precisely for this reason they have smoothed out the implications regarding the fundamentally asymmetrical and contradictory forces at work (Hatch and Yamamura, 1996). The essence of the asymmetries lay in the role of Japan as a poor buyer but as a strong oligopolistic seller, while solutions to financial crises had to be undertaken by the US (Woo, 1991).

In this context the third sub-phase is represented by the sharpening of US disengagement as the global coordinator of developed capitalism which began in 1971 with President Nixon's declaration of the abandonment of the Bretton Woods parity between the US dollar and gold, made Japan into the adjustment variable of US monetary and exchange rates policies. The ensuing sharp revaluation of the Yen, transformed the part of East Asia under US geopolitical and military control, into an increasingly important area for the dominance of Japanese monopoly capital. Japan countered the devaluation of the US dollar in the 1972–79 period by further tying Asia to itself. Technology transfers to Korea for instance meant a widening trade gap in favor of Japan and an increased structural dependence of Korea. In countries – such as Thailand, Malaysia and Indonesia – structural dependence was brought about by the dominant role of the Japanese *keiretsus*.

The third sub-phase – which is specific to the American-Japanese Asia – ran for a while parallel to the beginning of the third big phase in the history of Asian capitalist development. That is, parallel to the inception and incubation of the Deng Xiaoping reforms in China. Indeed during the 1980s the events in China, while momentous in social, political and geopolitical terms, were relatively separate from the macroeconomic trends occurring in the rest of American-Japanese zone of East Asia. The impact of the Chinese situation became apparent by the end of the decade and by the time of the East Asian crisis of 1997–98 China became the real center of gravity of the Asian

continent. This means that the disengagement of the US from its role as global coordinator of world capitalism must as far as the American-Japanese East Asia is concerned, be seen as part of the third and final sub-phase of Phase 2.

We have seen that the third sub-phase begins in 1971 with the ditching by the US of the dollar-gold parity and with a sharp devaluation of the US dollar against the Yen thereby pushing Japan to further extend its economic domination over non-communist East and Southeast Asia. By 1979 with the loss of Iran to the United States and the ensuing rise in oil prices US policy makers decided to fence off any threat to the dollar and enacted a high interest rates cum large military spending deficit policy. This set of policies led to a revaluation of the US currency – albeit well below the pre 1971 level – to a military led growth revival in the United States and to the opening up of an unbridgeable deficit in the current account, in which Japan and the rest of East Asia had a big share.

By 1985 the policy became unsustainable as it was generating tensions within US capitalism and also with the Europeans who, already mired in high unemployment, were witnessing a flight of capital towards the United States. On the 22nd of September of 1985 in the Plaza hotel in New York an accord was reached between the United States and the major capitalist countries on lowering US interest rates starting a steep devaluation towards the Yen which lasted till May 1995. In that monetary context, Japan's strategy towards Asia aimed at recouping – through Asia's growth and exports and Japan's own economic hegemony – the squeeze in profit margins of Japanese corporations on their exports to the US and also on the activities of transplants.

The US market has for Japan greater competition than the Asian one so that it was impossible to transfer fully the increase in the value of the Yen onto Japan's exports towards the USA. Furthermore, for the same reasons, the transplants could not pass fully the increased dollar costs of imported technologies and machinery onto their final US prices. It is in this context that East Asia, whose currencies were pegged to the US dollar, became a very important source of Japan's net balance of payments position. The Asian crisis of 1997 was a real crisis of capital accumulation determined by the dynamics of structural asymmetries and not by the factors usually mentioned in traditional studies. With the collapse of little capitalist American Japanese Asia Phase 3 of the history of Asian capitalism which had already begun in China with Deng Xiaoping reforms came to the forefront of world development.

25.4 Post Asian Crisis: Phase 3

It would be difficult to address exhaustively in this chapter the reasons why China has become the anchor of capitalist accumulation in Asia. This would require full research on why the capitalist world trusted the intentions of Deng Xiaoping's policies. Our own view is that in the case of China's entrance into the capitalist world the old Mao adage "politics in command" actually operated from the US side. Consider that when the *4 Modernizations*

were launched in 1979, China and the United States were together on all the main international issues in Asia and shared opposition to the Soviet Union. They agreed in supporting the ousted Khmer Rouge in Cambodia, both vehemently opposing Vietnam's intervention there; they agreed in supporting the armed opposition to the Soviet Union in Afghanistan and they also agreed in supporting Pakistan relatively to India. Given that throughout most of the 1980s the cold war had been revived by the presidency of Ronald Reagan, the China card played a crucial role in US policy. Hence Washington was willing to grant credibility to China's capitalist reforms particularly as they were intended not just to open China to some kind of local ersatz capitalism, but especially to the multinational companies, both directly and indirectly through outsourcing.

Moving now back to economic reasoning, once this process of development of Chinese markets kick started the new industrialization, owing to the size of its internal markets, the process of structural adjustment spread throughout the economy, leading to the development of many of the stages of production involved in manufacturing. As a result of these structural changes, inter industry linkages were kept domestic, so that expansion in one sector fed through to increased demand for other developing sectors. As a result any improved export performance fed into a cumulative process spreading the benefits of industrialization through the economy, with minimal leakages abroad. (Kaldor 1989)

The first step to take for the assessment of the role that the PRC has been acquiring in influencing the tendencies in world capitalism will be to ascertain the degree of sustainability of accumulation process in China, not in relation to some normative objectives but in relation to the Marxian and post-Keynesian notion of profitability and effective demand. This requires the analysis of dualism based on the following criteria which cannot be obtained from orthodox economics.

To what extent does China's accumulation validate or not the conditions of *comparative productivity change advantages* (Pasinetti, 1981)? These have nothing to do with the static fixed factor endowments theory of comparative advantages. Instead it is a rather Smithian dynamic principle according to which if productivity increases are not retained within the same economic system (defined in terms of its polity, currency and institutions), but are instead leaked abroad mostly through fall in export prices, the country will develop in a dualistic manner without an adequate growth of domestic demand. The adequacy of the growth of domestic demand is not measurable by aggregate GDP figures but by whether or not the growth of productivity in the leading sectors flows back in roughly equivalent increases in wages and productivity in the domestic sectors. While such a gap cannot be avoided its systemic persistence and widening will set a limit to the expansion of per capita demand of wage earners creating conditions of chronic underutilization of capacity. The *principle of comparative productivity change advantages* has a special corollary which works in reverse. We

have seen that the country as a whole may find itself on an unwarranted accumulation path if the productivity of the dynamic, say exporting, sectors does not flow back as greater domestic purchasing power but is instead leaked abroad through persistently lower export prices. The corollary lies in that whenever the growth of productivity of the dynamic export oriented sectors exceeds significantly the growth of productivity of the equivalent sectors abroad, the sectors in the foreign countries cannot hold onto their own productivity growth and must shed workers as well as undertake capital flows externally. The paradox is that a less advanced industrial country has a much greater chance of developing sectors whose productivity growth is both much higher than that of the rest of the domestic economy and that of the corresponding sectors abroad.

The PRC is a unique case in the world of the transfer of global capital towards an economy which in absolute terms is now bigger than France's but in relative per-capita terms is so much lower than any of the advanced OECD countries. And this situation is likely to last for quite a long period. There have been other cases of industrial development for large countries such as Brazil, Mexico and India but neither in per capita nor in absolute terms have they ever surpassed any of the big capitalist countries of Europe and of course Japan. Japan, when it began to outgrow in absolute terms the large Western European countries did so when it reached the stage of industrial maturity with a high wage level per unit of labor. The PRC by contrast can stay for a long time on the lower end of the scale with the dynamic sectors operating according to the *principle of comparative productivity change advantages* and its reverse corollary for the industrialized world. The PRC can therefore be in absolute terms bigger than, say, Germany, while remaining in per capita terms below Turkey.

International oligopolies have here a double edged role. On one hand by investing in productive facilities they expand the array of sectors having dynamic productivity growth, but on the other hand, they tend to reinforce the dualistic features of that growth domestically and the corollary internationally. Let us make the following cases.

- a. A multinational company invests in China for the local market as is now the case for autos. In this instance the capital goods will be provided by the parent company and the domestic Chinese economy will supply the basic commodities. Profits will spring mostly from the low wage costs and from productivity gains. By contrast if after a while the foreign company starts ordering its capital goods from Chinese industries, then there is a structural flow back both in terms of productivity growth and in terms of the expansion of the array of domestic sectors. But, and this we know from advanced economic theory, even orthodox, there is no guarantee that market mechanisms will ensure such a transition. It will more likely depend on the determination of the central authorities to

steer investment of multinationals into developing the capital goods sectors in China.

- b. Assume a foreign multinational invests in order to export by supplying itself with capital goods ordered from the home country or from any of the high wage countries of the US/Europe/Japan "Triad". Then this means that the foreign multinational is only interested in using the lower wage costs coupled with its own price making capacity in the developed countries (markets). This case, which according to research seems to be quite significant as only 15% of the total value added of China's exports is from domestic production, just perpetuates dualism while hollowing out the corresponding sectors abroad.
- c. Assume a foreign multinational subcontracts/outsources its orders in China. There may be then a greater use of domestic inputs, but the entire operation is based on the principle of maximizing the "benefits" stemming from low wages and from the price making powers of the multinational in question.

Both in the case of (b) and of (c) the expansion of per-capita income and demand in China is constrained by the strategic role played by low wages, so that demand may expand absolutely but less so in per capita terms, while at the same time hollowing out the productive basis of the advanced countries. Cases (b) and (c) are for the long term objectives of the PRC's authorities to transform China into a significant industrial and military power to be discarded. Yet they may nest into the Chinese political economy thereby creating a permanent structural fault or weakness in the way per capita income and demand progress in the country. Given the Communist Party of China's orientation to have a sort of "new economic policy" (NEP) with world capitalism, the best solution is to have multinationals which (i) invest in China for both the domestic and the export markets and (ii) produce in China the capital goods and the required technologies or at least a growing part of them. This eventuality however does not solve the question of the hollowing out of the advanced countries. At the same time however even for China, reliance on foreign multinationals cannot continue for too long a period because the crucial decision making processes and crucial technological development will occur outside it. Thus only by creating its own oligopolistic multinationals will China find itself in a position of being on the path to becoming an advanced industrial and military power. But if China does not get substantial technological transfer to be incorporated into its own corporations, that is, not just for the foreign corporations operating in China, the country will not escape easily from dualism and technological dependency, while at the same time generating a hollowing out of the productive system of other economies.

Let us now consider the gravitation of foreign direct investment to China coupled with the corollary of the special principle regarding productivity

change advantages. The corollary establishes the case for the hollowing out process and this leads to insurmountable problems of effective demand for the advanced countries. At this stage in what way is the link between the State and capital accumulation modified? According to the Marxian view the State defends the interests of capital in a sometimes complex process of mediation but also sometimes quite straightforwardly. Since the so called globalization cum privatization phase set in, we are in the straightforward phase and the State only mediates between the different capitalist groups. But if productive bases are hollowed out and the interests of US/Europe/Japan based multinationals and outsourcing companies resides in China, the material ground of the advanced states weakens. A contradiction develops between what is required from the State and its material capacity.

The Chinese State cannot be a substitute for the global role that the State of the advanced capitalist countries is for world capital and for the reproduction of capitalist relations: First, because it does not have the power to play that role. Secondly, and because of the first reason, the Chinese State if it really intends to stay on an advanced capital accumulation path must strengthen the material basis of its own political capacity. This will make it privilege Chinese corporations and support them in the competition on foreign markets against the very foreign companies that are investing in China. Hence lured by the Chinese State but not necessarily defended by it, the gravitation of world capitalism towards China creates a conflict between the multinationals of the Triad and their respective states in Europe, Japan and the US. In general there is no political or economic solution to this type of conflict which is already manifesting itself since the EU has defined a red danger zone encompassing the sectors which are exposed to the hollowing out process.

The US is the most vulnerable country, and this is well known. The US is counting on two factors:

1. The military one which brings about the control of crucial energy areas and prolongs the dollarization of energy products.
2. The willingness of the PRC's central bank to refinance US external deficits. Yet this second aspect contains a major inconsistency. In order to secure beyond any doubt the refinancing of its external deficits by Beijing's Central Bank US authorities must accept the institutional politicization of their external deficits. In other words the clearance of the deficit becomes a political not an economic issue. If it were left to economics the refinancing would not be guaranteed. This explains why the US monetary authorities while favoring the opening and liberalization of the capital accounts in the balance of payments of the Asian countries under direct US influence, are quietly supportive of the Chinese position of keeping their own capital accounts closed. And recently, the previous Federal Reserve chairman, Mr. Greenspan, also came out against freeing the exchange rate of the Yuan. But this factor weakens the state capacity of the US in favor of China.

The contradictions between China and the US can be understood by referring to the different strategic view about China in the world economy held by US multinationals and the Chinese Communist Party. For the former China's position is simply that of a low cost producer, for the latter the inflow of capital and direct investment is part of a policy with world capitalism and therefore it is supposed to be just a stage in the transformation of China into a leading industrial and military power. In the long term these two views are not compatible while at the same time the actual role of China contributes both to the profits of, say, Walmart, and to the hollowing out of the US and of its State capacity.

Europe is in an intermediate position which reflects also the contradictions within Europe. The countries with heavy machinery sectors and telecommunications technologies (Germany with Austria and Switzerland, Sweden and Finland) whose trade balance in those sectors is highly positive are supportive of the Chinese pattern of growth. Financialized economies like the UK are also but for altogether different reasons. By contrast countries with a large consumption goods sector such as Italy, Spain, Greece and France are increasingly at odds with China and they were behind the move to define a red zone of danger in terms of sectors vulnerable to being hollowed out. In this context the case of France is interesting because France is poised to sell to China its advanced weapons as well as public sector goods such as railway technologies. Yet clearly they think that the hollowing out process is stronger than the expansion into China despite the fact that their automotive companies are heavily involved in the PRC.

At first sight East Asia and Japan are the least vulnerable because they have a substantial surplus with China. But these aspects will have to be explored in more details because reliance on exports towards China may actually create the conditions for their subsequent hollowing out. In fact a great deal of these are made by Japanese and Korean multinationals for investment purposes which will translate into a growing flow of exports from China back into Japan, Korea etc. There would be nothing wrong if the present flows of net exports were to be accompanied by significant export led growth in those countries. So that by the time exports from China become positive, those countries will have already achieved a high level of utilization of their own productive capacities. But this is not case especially for the most important of them: Japan. Furthermore exports towards China depend very much on the trade patterns between China and the US and between China and Europe. While China has changed the direct dependency of Japan and East Asia on net exports towards the US, the process of integration is not China-centered since the effective demand loop is closed by China's net exports to the US. In this sense the PRC growth and the greater gravitation of East Asia's trade flows towards China do not change the basic picture of the US as defining the perimeter of realization.

Europe's stagnation is unlikely to be solved through the domestic boosting of effective demand. This phase is over in Europe since it is difficult in Europe to increase demand without empowering wage earners as there is

much less room to channel the surplus towards sectors, such as the military industrial complex, which remain outside the range of wage earners. Hence Europe will require an increasing amount of net exports, a paradoxical situation since the greater an economic area becomes the smaller should be the importance of net external flows. But this is not the case for Europe where stagnation has acquired chronic features. Coupled with the increased importance of Chinese net exports towards the US, the problem of the refinancing of US external deficits is likely to become the catalyst of the various crisis tendencies operating in the present phase of capitalism.

In earlier work (Kriesler and Halevi 1996 and Halevi and Kriesler 1998), we considered the implications of Japanese surpluses for Asian development from the beginning of the post war period up to the beginning of the 1990s, concentrating on the role of effective demand. There we concluded that Japanese surpluses with the rest of Asia created an effective demand sink, leaking demand from that region and promoting strong stagnationist tendencies. Had the region been autarchic, the effect of this would have been to lead to low growth levels, with high levels of unemployment. The tendency was counteracted by the region's strong trade surpluses with the US, which acted as an external source of effective demand. An important additional consideration, which needs to be incorporated into this thesis, is the implications of the rise of China as a major international trading partner for effective demand in the region. As Hart-Landsberg and Burkett (2007) make clear, the emergence of China has effectively changed the structure and destination of Asian trade, but has not changed its reliance on the US as an external source of demand necessary to alleviate the region's stagnationist tendencies. In other words, the loop has changed, to incorporate China, but still ends in the US, so that there is the same problem with just one additional major link in the chain. This has been manifest by a number of important changes to trade. "China has increasingly reorientated its exports of manufacturing away from East Asia (minus Japan) and towards the two most important international markets, those of the US and the European Union" (Hart-Landsberg and Burkett (2007)). As a result of the substantial increase in Chinese exports to these markets, exports from the rest of East Asia, the Association of South East Asian Nations (ASEAN), and the NIEs included, have fallen dramatically. In other words, Chinese exports to those areas have replaced those of the other Asian nations. On the other hand, East Asian exports have been reorientated towards China, so that over the 1990s, China's deficit with the area increased a thousand fold (Hart-Landsberg and Burkett (2007)).

The capitalist development of China introduced new contradictions into the world system of accumulation. During the US-Japanese hegemony in the little Asia bordering China the contradictions were mainly connected to the neomercantilist orientation of Asian growth, a neomercantilism supported by the US itself over almost 40 years. The contradiction was mostly between the

states involved, their national companies and the US and its multinationals. Now the contradiction is within the capitalist economies investing in China, and operates directly on the scale of the advanced capitalist world. Increased reliance on production stemming from branches operating in China undermines the connections between the State and the respective capitals in a fundamental way. How it will pan out we cannot tell as processes are always path determined. If, for example, there is a change in the willingness of America to absorb the trade surpluses of China, thus acting as an external source of effective demand then it is clear that the underlying stagnationist tendencies for the area will manifest themselves in the form of crisis lowering growth and employment throughout the region. However, it is not possible to forecast the actual outcomes, since they are dependent on economic, social and political factors which themselves will be determined by the paths of events. In particular, political attitudes in America and Europe are currently in a state of flux, and it is unclear what shape any emerging consensus, if there is one, will take. Clearly, however, it is the political consensus of these areas which will play a vital role in the economic future of Asia.

25.5 Conclusion

We can conclude by considering the significance of the emergence of China for the underlying, structural forces at work in the Asian region. As we have argued, these forces have reinforced domestic stagnationist tendencies, particularly due to the role of Japanese surpluses as a further leaking of effective demand from the other Asian economies. In the initial stages of growth and accumulation, it was the foreign external markets provided, in particular, by the US which prevented the region from collapsing due to long run problems with effective demand. The emergence of China has not essentially changed the stagnationist tendency of the Asian region. Rather it has led to changes in the structure and direction of Asian trade, but it has not changed the reliance of the region on external sources of demand (mainly the US) so as to prevent a slow down of growth and the emergence of mass unemployment. Although China has introduced new links into the chain of demand, it is not in itself an adequate source of effective demand for the region.

As a result, the underlying stagnationist tendencies of the region would lead to low growth and employment levels, except for the external sources of effective demand, dominated by America. Given the political climate in America, it is not clear whether, or for how long, it will continue serving this role, and, therefore, how long crisis in the area can be averted.

Note

1. Kalecki also acknowledges the importance of the last two sources of expenditure.

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26

The Accumulation Process in Japan and East Asia as Compared with the Role of Germany in European Post-war Growth

Joseph Halevi

26.1 Stagnation in Europe

This chapter maintains that East Asia and Japan are now reaching the same situation as that prevailing in Europe which is characterized by prolonged stagnation. However, the historical process towards the state of stagnation has been very different. Hence this section will discuss the European case, while the remaining ones will outline the evolution of the East Asian economic zone.

The restrictive economic policies followed by the Federal Republic of Germany represent one of the most important causes of the European stalemate. The German stance has been made even more deflationary by the French authorities, whose degree of inflexibility is greater than that imputed to Germany (Parguez, 1998). Just the same, it must be pointed out that the Federal Republic acted for more than 20 years – from the late 1940s to the first significant revaluation of the D-mark in 1969 – as a growth pole for Europe's effective demand.

As in the case of Japan, the Korean War, financed by American public expenditure, gave a big impulse to the recovery in German production of capital goods. Furthermore, as the outbreak of the war led to a rise in raw material prices, the initial adverse effect on West Germany's balance of payments was cushioned by a large loan from the European Payments Union financed by the USA. The European recovery was helped by the USA through measures aimed at preventing balance of payments crises as well as by allowing Europe to protect its own industries. In this context, overall European growth came

Revised from *Global Money, Capital Restructuring and the Changing Patterns of Labour*, 86–98, 1999, 'The Accumulation Process in Japan and East Asia as Compared with the Role of Germany in European Post-war Growth', by Halevi, J. With kind permission from Edward Elgar Publishing. All rights reserved.

to depend crucially on West German accumulation. Throughout the 1950s, the Federal Republic expanded faster than the rest of Europe. This factor increased Germany's demand for imports, stimulating the modernization of many sectors in Europe's industry. The other European countries tended to expand exports to Germany more than to the rest of the world (Milward, 1992). Although Bonn ran balance of trade surpluses with the rest of the continent, the low level of the rates of interest relative to the growth rates stimulated a quick transformation of the surpluses into commercial credits. The high German growth was the main factor for the creation of a Europe-wide inter-industry structure and for focusing this growth on Europe itself.

This process continued also during the 1960s when, with the full currency convertibility having been re-established in 1958, balance of payments concerns began to dominate economic policies. In this phase the stop-go policies periodically undertaken by the countries of the then European Common Market ended up eroding Bonn's surpluses. Under the fixed exchange rate regime prevailing at the time, a policy-induced recession in any one European country would slow down wages in relation to productivity. Since the exporting firms were largely of an oligopolistic nature, a faster increase in productivity than in wages enabled those firms to be price-competitive without endangering their desired mark-up (Sylos-Labini, 1974). German export surpluses with the rest of Europe were significantly reduced because Bonn remained on a high wage and high employment path for most of the 1960s.

The role of Germany within the Common Market, and later within the European Economic Community, was absolutely essential for the formation of a Europe-centred productive apparatus based on the dynamic of European effective demand and not, as in earlier periods, on the existence on the continent of multiple conflicting imperialisms. At the same time, such a role would not have been possible without the accommodating attitude of the USA which allowed its current account surpluses to be transformed into deficits, or without the regime of fixed monetary exchange rates in relation to the US dollar (Davidson, 1997). The stability of the exchange rates permitted European countries and Japan to expand exports on the basis of productivity increases rather than by means of cheapening the money price of exports.

The process of cumulative causation broke down after 1969. In the second half of the 1960s, Germany's authorities embarked on policies aimed at conquering export markets through the restructuring of industry induced by a deliberate revaluation of the D-mark in 1969. Such an orientation was later facilitated by the collapse of the fixed exchange rate system. The abrupt devaluation of the American dollar in 1971 imposed on German capital the necessity to compete internationally on the basis of foreign direct investment flows rather than on the basis of a perceived favourable exchange rate. Bonn's monetary authorities, in conjunction with the banking system, adamantly resisted the financing of foreign outflows by issuing liabilities against Germany itself. Restructuring had to be financed therefore by the

current account surpluses with the rest of the world. Europe turned out to be the most secure area for the realization of export surpluses provided its main economies were anchored to Bonn by a series of quasi fixed exchange rates (Halevi, 1995).

The European Monetary System (EMS) did just that. It was brought about in 1979 by the action of the German social-democratic (SDP) government of Helmut Schmidt, being initially resisted by the Bundesbank. But it was the SPD which identified correctly the long-run interests of German corporations in building current account surpluses (Parboni, 1981). Throughout the 1980s, in spite of weakening European growth, Germany accumulated a current account surplus, reaching by 1990 4 per cent of GDP. These surpluses provided the financial means for the internationalization of German capital. In this framework the role of Europe appears in its full dimension if account is taken of the fact that Germany's current account position with the USA began to deteriorate after the Plaza accords of 1985 – which started the long devaluation of the US dollar – while the deficit with Japan kept expanding. Hence the high share of the current account surplus over GDP is a measure of the surplus pumped from Europe under conditions of stagnant growth. Such a surplus acted unambiguously in a deflationary direction and was made possible by the parities imposed by the EMS regime.

The EMS virtually fixed exchange rates, coming in a context of strong and non-uniform inflation rates, and compelled the weaker countries to finance the external deficit by attracting short-term capital via high interest rates. Such a situation applied to countries like Britain, Italy, Spain and France. Thus, along with traditional stagnationist factors represented by slow growth and large German surpluses, the European stage was set for the outbreak of financial instability in its weakest components, which should have included France. The fixed parity between the French franc and the D-mark was, however, the main pillar of the protection of Germany's export-oriented economy so that any threat to the franc's parity with the D-mark would have entailed an immediate support from the Bundesbank. The conditions for financial instability existed therefore prior to the absorption of the German Democratic Republic (GDR) into West Germany.

After the absorption of the GDR in 1990, Bonn's authorities wanted to acquire a greater degree of freedom in Europe in order to tap the international capital markets to finance the external deficits arising from the cost of unification, the continuing expansion of foreign direct investment and the new activities in eastern Europe. In the short run these multiple objectives pushed Germany to privilege the international strength of the currency, thereby jettisoning the EMS system in 1992. In the longer run, however, Bonn's policy-making bodies had to confront the conflict between the dollar and the yen without having a secure rear in the former fixed parities of the EMS. Perhaps this is the single most important economic factor which led Bonn to accept the Maastricht convergence criteria for the single European

currency, although neither the government nor the Bundesbank wished to relinquish sovereignty over monetary policies.

Indeed, German stagnation in the period 1990–94 was characterized by a slow growth of exports up to the point where it called forth drastic cuts in domestic output and employment levels (Nardozzi, 1997). The poor German performance was due, not only to the devaluation of currencies like the lira, but also to the restructuring induced in countries such as France by the policy of high interest rates aimed at sustaining parity with the D-mark. Thus, if after 1990 German unemployment was caused by slower exports not being counterbalanced by higher domestic demand, European countries like France experienced positive export performances at the expense of domestic demand growth. The gains in productivity generated by restructuring enhanced competitiveness and exports but, as such, did not generate jobs because of the deflationary scenario of fiscal and monetary policies.

The stagnation in export performance convinced Germany's authorities of the need to stem the negative impact of the devaluation of currencies like the Italian lira, given Italy's status as the second largest trading partner. Furthermore, a persistently undervalued lira would have eventually compelled France to abandon parity with the D-mark, setting the stage for competitive devaluations. As a consequence, the German authorities used the Maastricht objectives to force a currency realignment closer to the D-mark. As of 1996, Germany's export position improved significantly, but the mechanism of upward realignment was based, in accordance with Maastricht convergence criteria, on very restrictive fiscal policies in all European countries. Europe moved from the high level of unemployment together with high interest rates of the 1980s to a still higher rate of unemployment with tight fiscal policies in the 1990s.

The solution to the stalemate is now being sought in increasing the rate of exports, a most remarkable neomercantilist attitude in a period of alleged European unification. An external outlet did come about from the second half of 1995 through the revaluation of the US dollar relative to the Japanese yen and the European currencies. Without the boost to exports provided by such a revaluation, Europe's rate of unemployment would have been even higher. The rise in the value of the American currency occurred chiefly in response to events in East Asia and Japan: it had little to do with European affairs. Thus the growth of European exports to the dollar area was stimulated by processes which depended upon the relations between East Asia, Japan and the USA. The next sections will therefore present an historical interpretation of the evolution of the economic ties between the USA, Japan and East Asia.

26.2 The Dollar and the USA in Asia

During the discussions between the USA and Great Britain leading up to the Bretton Woods agreement, the American geopolitical orientation was

predicated upon the strict cooperation between two partners, one senior (the USA) and one junior (Great Britain). In this framework, the pound sterling was supposed to act as a reserve currency sharing with the US dollar the task of creating international liquidity in a world of non-convertible currencies. Yet the British balance of payments crisis in 1946 and 1947 pushed Britain in the opposite direction, since it compelled London to declare its currency non-convertible on a par with those of the defeated/occupied nations such as Germany, France, Italy and Japan. As pointed out by Michael Schaller in his masterpiece on the American occupation of Japan, Britain's impotence in the face of the strategic objectives assigned to it by the USA determined a change in the American conception of world politics. The main intellectual actors in this change were James Forrestal and George Kennan (Schaller, 1985).

According to the Forrestal–Kennan view, the British failure required the restructuring of the world economy on the basis of one central power flanked by two regional centres. The USA would be the central power, with strong links to West Germany to the east and to Japan to the west. The Federal Republic was deemed to act as a regional economic powerhouse in Europe, while Japan was supposed to become the workshop of a non-existent Asian region.

As far as Europe was concerned, such a vision did not represent any particular problem, except for the practical question of how to iron out Franco-German differences, thereby enabling the rearmament of West Germany. For Washington the real problems were to arise in Asia since the American decision to isolate the People's Republic of China all but eliminated the possibility of forming a Japanese economic zone. Thus the Forrestal–Kennan idea of making Japan into the workshop of Asia was hanging in mid-air without a real hinterland to operate upon. In the end, that hinterland did come about, but in a way totally unforeseen by the two architects of the strategy. In the wake of the British crisis of 1947, the dollar remained the only international currency. Under the assumption of a persistent dollar shortage, the American authorities favoured the continuation of the traditional economic dependency of South-East Asia on the (sometimes former) colonial powers. The exports of raw materials to the world markets by colonies like Malaysia and Vietnam, or by independent nations like Indonesia, were supposed to create a dollar-based balance of payments surplus to be immediately lost to the European powers via the current account deficit of the exporting areas with the old continent (Rotter, 1987).

However, favouring the retention of the role of the colonial powers had two major shortcomings. The first was that, given the exclusion of China, those very areas were chosen by Washington to act also as the hinterland of Japan. As a consequence, the colonial economies of south-east Asia were given the impossible task of sustaining the dollar requirements of two large industrial centres. The second shortcoming lay in the specific role of

France. In the eyes of Washington's policy makers, the presence of France in Vietnam had the dual function of contributing to the policy of containment towards China and other Third World movements, as well as securing the dependency status of the area. Yet, as long as France had its army tied down in Vietnam, the European side of the strategy could not be implemented in full since Paris would refuse any rearmament of West Germany.

Politically, as argued by Rotter (1987), the French defeat at Dien Bien Phu lifted one obstacle to the USA sealing both the European and the Asian strategies. Economically, the end of the dollar shortage, induced by the new form of institutional spending engendered by the Korean War, enabled Washington to untie south-east Asia from the old colonial powers. In relation to the European theatre, the departure of the French from Asia gave the green light to the rearmament of West Germany while firmly ensconcing it within the polity of western Europe and especially of the (soon to be) European Common Market. In Asia, US policy was based on the confrontation with Third World nationalist movements and with the need to provide a hinterland to Japan (Borden, 1984). In this context, American public expenditure and military intervention became the two interwoven instruments of the policy. But the policy could materialize only via a prior military intervention against Third World movements. Thus military intervention became the *long-term* policy and public expenditure its offshoot.

26.3 Vietnam: America Takes Japan to Asia

American confrontation with China and Third World movements did not create a hinterland for Japan, whose relations with South Korea and Taiwan were still of a colonial nature. South Korea and Taiwan exported to Japan mostly raw materials and staples, receiving industrial goods in return. Although relevant to Japanese trade, such a pattern contained no synergies. Importantly, therefore, until the Vietnam War there was no Japanese economic zone in Asia. The content of Tokyo's trade with South-East Asia was inconsistent with the import requirements of Japan's reindustrialization.

In this context the financing of Japanese imports of technology and of capital goods from the other capitalist countries – especially from the USA – occurred by overstepping Asia. In practice, this was due to the American decision to relieve Japan of a structural balance of payments constraint while allowing Tokyo's government agencies and the transformed *zaibatsus* (*keiretsus*) to undertake a domestic oriented *full-scale industrialization*. The insulation of Japan was obtained by extending the Korea-based special procurement programme, albeit at a diminishing rate. On the whole, American transfer payments lifted Japan's import ceiling by more than 80 per cent in the years preceding the Vietnam War and covered Japan's current account deficit until the second half of the 1960s. With the USA guaranteeing the external environment, Japan's industrialization was freed from the historic

structural balance of payments constraint. During the 1930s, with limited markets, the share of exports in GDP was around 18 per cent, but from the second half of the 1950s that share hovered between 9 per cent and 11 per cent (Itoh, 1990).

Full-scale industrialization gave priority to domestic investment while exports were sought on the basis of industrial targeting. Here too, however, the USA was of crucial importance. Before the signing of the 1952 San Francisco Treaty, which returned Japan to the status of a sovereign country, Washington approved the continuation of the wartime laws shutting out foreign investors. Likewise, it supported the use of foreign exchange regulations to stop imports of industrial consumption goods which, as the case of the car industry shows, permanently closed the Japanese market to foreign producers. The USA even went so far as to lobby other countries to accept Japan's lack of reciprocity. Such diplomatic activity occurred on the occasion of Tokyo's application to join both GATT and the OECD (Nester, 1990a; 1990b). The full-scale industrialization strategy and the asymmetrical institutional arrangements enjoyed by Tokyo explain today's oligopolistic position of Japanese companies in Asia. The possession in the home country of all the crucial technology-producing sectors made it possible to plan and select the stages in which Asian networks had to be set up. Likewise, the possession of a complete industrial structure allowed Japan to produce and export all the basic industrial inputs. A further and wider oligopolistic factor lies in that even firms which do not belong to Japanese networks, such as the Korean Chaebols, are vitally dependent on Japanese machinery in a way which is not symmetrical for Japan (Hatch and Yamamura, 1996).

The factor which brought Japan back into Asia was the Vietnam War and the consequent need of the USA to establish a system of alliances around its South-East Asian policies. The expansion of Japan into the region was the consequence of the public expenditure that Washington systematically poured into the area. American military-motivated expenditure generated demand directly as well as cushioning the countries of South-East Asia against chronic deficits. Yet US public expenditure would not have sufficed by itself to build a set of strong states from a productive point of view. American policy makers saw a further condition in the formation of technocratic states (South Korea, Taiwan) backed economically by Japan. This approach meant that the USA would give financial aid and open up its markets, while Japan would export technology and undertake FDI projects (Woo, 1991).

The phase in which American policy seemed to succeed was the 1961–67 period centred on events in South Korea and Indonesia. In the former case, the military regime, which initially aimed at a Japanese type of self-sustained industrialization, was pushed towards export-oriented policies and a heavy reliance on Japan in every institutional and technical aspect of the development process. In the early stages of industrialization up to 1970, the Vietnam War and direct US transfers rather than access to American

markets sustained the exports of the nascent advanced sectors of Taiwanese and South Korean industries. These exports went overwhelmingly to South Vietnam, whose current account deficit was cleared by the USA.

The productive transformation of South Korea and Taiwan changed altogether the nature of trade flows between those countries, on the one hand, and Japan and the USA, on the other. Until the early 1960s, the bulk of South Korean and Taiwan exports went to Japan, while their imports came mostly from the USA. With Washington they tended to have a current account deficit, whereas with Tokyo they sometimes had current account surpluses. With the Vietnam War and the industrialization which ensued, the current account position of American Asia started to swing the other way. It became normal to have a deficit with Japan, while surpluses were sought by exporting to the USA. In this context, the USA became the main area for the exports of Japan and the rest of Asia.

26.4 Structural and Monetary Asymmetries

The Vietnam War transformed American Asia into American Japanese Asia (AJA). It remained so throughout the 1970s and it collapsed with the revaluation of the yen following the Plaza agreements in 1985. The fact that Japan acted as the capital goods sector of the region, but not as a buyer of the region's products, implied greater exchange rate and market dependency upon the USA.

The structural asymmetry between Japan and its periphery lies in that no other country has followed a full-scale industrialization strategy – not even South Korea. In fact, its growth depended crucially on building up the heavy-industry sectors, without a sufficiently vast corresponding network of local suppliers. The firms supplying Korean conglomerates are Japanese. The structural asymmetry implies that East and South-East Asian countries must be, unlike Japan, very open economies. At the same time, Japan is not a major buyer of their outputs. The share of their exports going to Japan is either stable or declining, whereas a period of systemic rises has yet to appear. It follows that Japan is not a dynamic factor in the creation of effective demand for the area as a whole. Japan acts as a force of technological transformation, the price of which is the oligopolistic position of Japanese corporations in the area. Consequently, Tokyo does not create a large enough effective demand to free the region from a structural balance of payments constraint. In other words, without the external markets represented by exports to the USA and Europe (although the latter absorbs a much smaller amount of East Asian exports) the structural deficit of the region with Japan would have required a negative adjustment process. Growth itself would have been stunted, regardless of the Japanese-induced modernization (Halevi and Kriesler, 1996).

Modernization was made possible by the relative certainty concerning the access to the external markets represented mainly by the USA. Initially,

access to export markets was institutionally arranged by Washington. At a later stage, once American public expenditure dried up with the end of the Vietnam War, the export drive depended on the prevailing monetary conditions. During the first Reagan presidency, the rise in the value of the dollar helped both Japanese and East Asian exports, although the high interest rates policy of the Federal Reserve created serious debt-financing problems for South Korea. It was after the 1985 Plaza agreements, leading within a short lapse of time to a doubling in the value of the yen relative to the dollar, that a new asymmetry set in. The countries of East and South-East Asia increasingly pegged their currencies to the dollar, expecting a long-term revaluation of the yen. This policy was implemented in strict (and silent) coordination with Japanese monetary authorities as well as Japanese corporations. Although pegging the East Asian currencies to the dollar led to a real revaluation – because of the much lower rate of inflation in the USA – it was assumed that the productivity increases generated by Japanese FDI (or, as in the Korean case, by the acquisition of Japanese technology) would win in the end.

Hence the productivity increases induced by Japanese investment in the area were supposed to counter both the real revaluation against the US dollar and the sharp devaluation *vis-à-vis* the yen. The first phenomenon was easier to fend off, at least until 1995. The second aspect turned out to be uncontrollable. The devaluation of the East Asian currencies relative to the yen increased the unit cost of imports. The high growth rate of those economies increased the demand for Japanese imports. Since imports from Japan also went to sustain domestic oriented activities, import dependency on Japan increased more than the ability to find foreign markets. The other side of the coin was in fact the rapid rise in Japan's current account surplus with East and South-East Asia which became the largest source of Japan's external balances.

This state of affairs worked generally in favour of Japanese corporations: the lower growth rate in Japan, eventually reaching total stagnation, was compensated by the profits represented by the surplus with Asia and the rest of the world. From the Asian perspective, this situation would have been sustainable as long as enough pressure could have been brought to bear upon wage-earners. In other words, the sustainability of the external aspects of the East Asian growth process depended upon the ability to keep wage rises below those of productivity. Yet this is precisely what cannot be taken for granted in any long-term growth situation. The East Asian growth mechanism has, therefore, a major difficulty in accommodating systematic increases in wages.

In this aspect the East Asian case reproduces a trait common to all East Asian development, including Japan's. This trait has to do with the extreme rigidity against any wage increase equal to or above the prevailing rise in productivity. In Japan during most of the growth years, wages rose somewhat

less than productivity (Itoh, 1990). From the late 1970s, wages became virtually stagnant. The purchasing power of the wage-earners expanded thanks to the revaluation of the yen, which enabled households to buy consumption goods reimported by Japanese multinationals (Steven, 1996). In East Asia, given the huge balance of payments deficits that those countries have with Japan, a deficit governing the whole spectrum of their export and financial activities, the pressure on wages is significantly stronger than in the case of Japan itself. The subordinate role of wages and of the demand they generate has been rendered more acute by the structural dependency upon Japan and by the inability of the latter to act as a strong source of regional demand. Thus exports of East Asia as a whole, inclusive of China, must rise chiefly outside the regional markets. In practice, this means exports to the USA.

26.5 The Convergence of Asia and Europe with the USA

The long phase of the revaluation of the yen following the Plaza agreements may be considered a political turning point, as it defined Washington's desire to withdraw American institutional support for Japan and East Asian growth. At the same time, however, the absorption of the East and South-East Asian economies into the national American market continued and became more pronounced with the rapid emergence of the People's Republic of China, which swiftly integrated itself into a system initially conceived against it. The pegging of East Asian currencies to the dollar was made possible by the fact that Washington did not exercise pressures to deregulate too quickly the capital and foreign exchange markets of the area. These factors permitted a continuing expansion of East and South-East Asian exports, as well as a rise in intra-Asian trade. Given Japan's position as a major producer of capital goods for the whole region, Japanese corporations did not mind, up to a point, the monetary asymmetry based on a system of dollar-pegged currencies, on the one hand, and a revaluation of the yen, on the other. As long as Japanese corporations could reasonably expect an expansion of profit – through their net exports to Asia and their Asian-based production (both export and intra-Asia oriented) – at least equal to the expected losses induced by the revaluation of the yen, the adjustment to a lower value of the dollar appeared feasible.

Yet the deepening of the devaluation of the dollar during the period 1992–95 eliminated the possibility of finding a profitable strategy of adjustment. The sharp rise in the value of the yen destabilized the relationship between Japanese transplants in the USA and the value of their importation of goods from Japan. It also negatively affected the value of dollar-denominated financial assets, while the 'no growth' situation led to an internal crisis of the banking system. It is mostly for financial rather than for productive reasons that, in July 1995, American policy underwent a sudden reversal. Fearing a financial meltdown of Japan, the US authorities engineered, in

agreement with the Bank of Japan and the Bundesbank, a long-term controlled devaluation of the Japanese currency. Had the devaluation of the dollar persisted or just stabilized over a longer period, segments of Japanese industry would have been relocated in East Asia and China, and eventually Japan itself would have become a major importer of regional industrial commodities.

The rapid reversal in the value of the dollar led instead to a revival of Japan's exports, very much at the expense of countries like South Korea. Furthermore, the yen devaluation slowed down the flow of foreign direct investment as industrial relocation became less profitable. It is clear, in this context, that this sort of decision reflected the well-informed expectation that American willingness to increase the value of the dollar to rescue Japan was a long-term strategy. In this way, the synergies which tied East Asia to Japan were broken and Tokyo started to compete for third markets against the area of its own hegemony. Therefore the pattern of the Japanese crisis emerges as comprising two components. In the phase of the revaluation of the yen, the links between home production and transplants in the USA were damaged, but capital goods exports to East Asia were stimulated and sustained Japan's current account surplus. In the phase of the devaluation of the yen, competition against the East Asian countries has been a prime structural factor in the overall financial crisis of the area.

In the process, Japan's capacity to generate domestic expansion without having to rely heavily on outside markets has become much weaker when it is much more needed. Large unused capacities in equipment and advanced consumption goods industries, tied to strong domestic oligopolistic structures, created a bias in which foreign markets are seen as the solution to the lack of profitable effective demand. Thus, during the revaluation of the yen, Japan's dynamics depended on East Asia's export drive and on American disposition to support it. Following the devaluation of the yen after 1995, Japan's dynamics have come to depend on the rise of direct exports to the other industrialized countries to the detriment of those of East Asia. The absence of automatic stabilizers both in Japan and in East Asia makes the dependency on foreign markets even more severe.

26.7 Conclusions

The reconstruction of the capitalist system after the Great Depression and the Second World War started with a strategic conception of the USA to structure the world around a central power flanked by two autonomous regional poles. This strategy did not materialize. American international public expenditure, especially on wars and armaments, sustained the recovery of both Japan and Germany. Furthermore, overall Asian capitalist accumulation started in earnest when the area got embroiled in a second and much more comprehensive American war in Vietnam. When the USA began, after

the defeat in Vietnam, to withdraw its institutional and financial support, the continuation of the process of accumulation depended increasingly on the capacity to exploit contingent situations such as a more positive US disposition towards the smaller East Asian economies and – for political reasons – towards China. During the years of the revaluation of the yen, the willingness to absorb imports from the rest of Asia sustained the pegging of that region's currencies to the dollar and allowed Japan to build its own economic zone. Since then the zone has been severely shaken by the US decision aimed at helping Japan by revaluing the dollar against the yen. In both cases, dependency on the USA dominates any other element.

Europe does not appear to be as glued to the USA as Japan and East Asia are, yet the central role of Germany in the European Union does not invest it with any expansionary impulses. The restrictive attitude of European policy makers is not due to a constitutional design aimed at making all European countries converge in order to formally unify the continent. Rather, it is due to the fact that German authorities, banks and corporations, see Europe as their base for accumulating surpluses with which to finance the international drive of German capital. German priorities moulded, with France's surrender to them, Europe's contractionary fiscal stance.

Neither East Asia and Japan nor Germany and Europe are capable of internally generating dynamic demand. Both depend on net exports to the USA. Yet per capita productive capacity and per capita income differentials between Europe, Japan and the USA are negligible, whereas the combined absolute size of Japan and Europe is greater than that of the USA. America is therefore too small an economy to be the catalyst of external demand for those two poles. Yet Europe's and Japan's dependency on this external factor traps the bulk of the world economy in a state of long-term stagnation.

Note

An early draft of this chapter was read at the conference, 'Which Labour Next? Global Money, Capital Restructuring and the Changing Pattern of Production', Università di Bergamo, 3–5 December 1997.

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27

The EMS and the Bundesbank in Europe

Joseph Halevi

27.1 Introduction

This essay deals with the financial position of Germany in Europe and the role of Europe in Germany's economic strategy. The central argument of the paper is that the German orientation is structurally, institutionally, as well as philosophically, anti-Keynesian orientated, so that the Federal Republic¹ has become the source of strong deflationary impulses for Europe as a whole. Germany conquered the role of being Europe's deflationary factor in the course of a long historical process from which Bonn emerged not just as the largest economy of the continent but also as the political hegemon. Except in the 1990s, German hegemony has been explicitly used to strengthen the economic position of German capital in Europe.

The present essay intends to highlight the mechanisms and the factors which, in historical time, transformed Germany from a force of economic growth into a force of economic deflation.

Section II sets out the conceptual framework forming the basis of the study, along with the description of the main phases and of the central institutional features of postwar German capitalism. The postwar period will be divided into three main phases. The first, from the reconstruction years till the very beginning of the 1960s, is characterized by a process of cumulative causation for Europe as a whole. The second phase, lasting until the second half of the 1960s, is described as an interlude period, in which the political economy of the EEC is dominated by the interaction between the balance of payments constraint and export-led growth. Finally, the third phase, starting with the revaluation of the Deutschmark in 1969, covers the 1970–90 period during which Germany emerged as a deflationary factor for Europe as a whole.

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Section III analyses the financial and real aspects of the first phase of accumulation. It is argued that in this phase Germany's economic growth acted favourably on the economic expansion of the rest of Europe in spite of the highly oligopolistic nature of industry in the Federal Republic.

The subsequent phases are analysed in the remaining sections. The fourth one attempts to show how the export bias of the Federal Republic is tied to the role played by the large industrial groups and to the functioning of the Bundesbank. The fifth section argues that Bonn's hegemonic tendencies surfaced particularly during the stagnation of the 1970s. Finally, in the sixth section it is maintained that during the 1980s the EMS has become the institution of Germany's hegemony. Conclusions are drawn in the seventh and last section, where it is argued that German capitalism is now facing the prospects of stretching beyond Europe while having to confront the impact of the economic crisis.

27.2 The Conceptual Framework in Historical Perspective

For nearly the entire period from the 1950s to 1990 Germany's position in Europe is characterized by its balance of payments surpluses, the most important component of which is net manufacturing exports.² Such a situation justifies taking a Keynesian perspective, which consists in viewing the accumulation of current account surpluses as deflationary and inimical to full employment. At Bretton Woods, Keynes argued against the imposition of the burden of adjustment on the deficit countries, since this would cumulatively move the international economy away from full employment. Analytically, Keynes's position has been lucidly demonstrated in a little-quoted paper by Kalecki (1946), where it is shown that automatic flexibility in exchange rates cannot be relied upon to restore balance-of-payments equilibrium simultaneously with full employment. Kalecki's approach makes the whole adjustment process dependent upon the willingness of the strong countries to dispose of the surplus by means of lower interest rates and of a higher propensity to import. Methodologically, the novelty in the Keynes–Kalecki approach lies in having tied the question of possible balance of payments disequilibria to the issue of how not to sacrifice full-employment objectives.

In the economic and political literature, the problem of Germany's persistent surpluses has been treated mostly as a policy issue rather than as a specific dimension of the process of capital accumulation (in the Marxian and Classical sense). It is here that a second perspective – represented by the works of Kalecki, Sylos-Labini and Sweezy – may be brought in. It is well known that for this group of authors the consolidation of oligopolistic formations implies, at the macroeconomic level, the weakening of the endogenous impulses to investment. Throughout the essay the German economy will be portrayed as the most coherent oligopolistic unit among the Continental economies. Sporadic references to the oligopolistic nature of

the FRG's economy can be found also in mainstream literature. For instance, Steinherr and Morel (1979) attempted a formal explanation of the ability of German industry to expand exports in the wake of substantial appreciations of the Deutschmark. The authors assumed exporting firms to be pricemakers operating with a given mark-up. In this way, exporters would not be compelled to bear the full brunt of a revaluation because of the lower prices of imported inputs. By contrast, competitive producers, by being pricetakers, would become more exposed to international competition, thereby witnessing a decline in the profitability of their own operations. Consequently, resources would be shifted to the oligopolistic, export-orientated sectors.

This approach, with its emphasis on large firms, can be combined with an institutional characterization of the hierarchical relations underlying the working of the German economy. Institutionally, the focus of attention becomes the ownership structure of German industry centred around the links between the large companies and the banking system. Until now, the ownership structure of the big companies has not been much affected by the instability of financial markets, since:

Its essential point of reference lies in a delicate balance between foundations, institutions linked to company employees, and public agencies, all of which are coordinated by the all-powerful and ubiquitous presence of the large banks. (Prodi, 1990, p. 147)

In this way, the distribution of resources needed to feed the process of accumulation is not determined exclusively by the pricing policies of individual units, but by a whole network of institutional relations. Historically, the integration between banks and industry was not due to purely institutional factors; rather, it was connected to the fact that Germany's industrialization followed the pattern of investment priority in the capital goods sectors and in heavy industry, all being projects where large start-up capital is needed.

In the postwar period, the heavy industry and the capital goods sectors continued to play the most important role both in the growth process and in the accumulation of external surpluses. The FRG receives the bulk of its surpluses through manufacturing exports. In this context, during each of the four decades from 1950 to 1988, the investment goods sector always grew more than the other industrial branches of the economy (Schneilin and Schumacher, 1992).³ This structural evolution – which enabled Germany systematically to accumulate surpluses – has been sustained by a banking system characterized by the universal bank, whose role is to provide firms with a whole range of financial services. In practice, the German economy is governed by the level of integration between the large industrial groups, which are also the main exporters, and the three largest banks.

The institutional links between the banking system and industrial enterprises imply that the latter tend to use bank credits rather than going directly

to the 'public'. Firms are therefore sensitive to the recommendations made by the banks, which have also a virtual monopoly of the operations of the stock exchange. In turn, banks take a keen interest in the objectives pursued by firms. The preoccupation with price stability is rooted in the above institutional nature of the German financial-industrial complex.

The universal bank borrows funds on a short- and medium-term basis and supplies long-term financing to firms, including participation in share ownership, which, beyond the threshold of a 'blocking minority', is legally treated as a form of credit. In this context, inflationary conditions would tend to shorten the term structure of borrowed funds, thereby compelling the universal bank to shift to more conservative policies. Hence, a firm stance against inflation by the Bundesbank constitutes a guarantee of the stability of Germany's financial-industrial complex. Thus, monetary policies orientated towards price stability become an inherent feature of the system (Nardozi, 1983). The nature of the ownership structure of German capitalism implies that there has to be a consistent relation between the policies of the universal banks and the large companies grouped around them. This consistency depends upon the position of the Bundesbank. The latter acts as the body *de facto* entrusted to safeguard the relations between banks and big industrial concerns, which are also the major exporters.

A clear example of how the Bundesbank safeguarded the stability and credibility of the financial-industrial complex is given by the events of the 1970s. After 1972, the Bundesbank sustained – following the revaluation of the DM – the structural transformation of the pattern of accumulation from an extensive to an intensive one. The economy moved from a pattern based on exports of industrial goods and imports of labour and money capital into one based on exporting advanced industrial goods and money capital while importing industrial goods.

The importance of the Bundesbank's role in those years can be summarized as follows. During the phases of restrictive monetary policies, firms were induced to acquire external financing, thereby reducing the pressure on domestic financial markets.⁴ The inducement to use the external channel came from the universal banks, whose bodies participate directly in the decision-making process of firms. The action of the universal bank implied that the large firms were in the best position to use the external channel, since the minimum size of each single operation is quite large relative to the operations of the small firms. Furthermore, restrictive monetary policies, when interpreted as a credible stance against inflation, were meant to modify the liability structure of the banking sector from short- to longer-term denominations. This is precisely what the universal banks need in order to keep financing the investment projects of firms. As Nardozi has pointed out, the objective of monetary stability and the pragmatic character of monetary policies – which took into account the profitability of banks – contributes 'to explain the connections between the monetary behaviour

and the structural features of the German economy'. Consequently, the possible weaknesses of the economy are located 'not so much in the financial system but rather in the pattern of industrial growth based on high levels of concentration' (Nardozi, 1983, p. 119; my translation from Italian).

The connection between banks and industry worked very well during the growth years following the reconstruction process up to the formation of the EEC, as well as during the last two decades, which have been characterized by persistent unemployment. Thus, it would be misleading to associate the integration between the two main components of modern capitalism, industry and finance, with the maintenance of a stable level of activity relative to the requirements of full employment. In the past, the mistake of confusing the productive power of German capitalism with a normative evaluation about its inherent stability has been made by the Marxist thinker Rudolf Hilferding, author of *Das Finanzkapital*, who was the first to develop a theory of the relations between banks and industry in a cartelized economy. Impressed by the degree of integration between those two elements of economic activity, Hilferding argued – shortly before the outbreak of the Great Depression – that financial capitalism would by now be crisis-free. The same attitude was expressed also by Schumpeter (1928). Their thesis is that large industrial concerns, by controlling their markets, can plan and stabilize production at the desired level, while integration with the banking system frees large industries from liquidity crises as well as from monetary fluctuations.

It is not difficult to see that this very specific German economic culture also found its way into the theories of the social market economy propounded by the ruling Christian Democratic party. In the Hilferding–Schumpeter conception, the relation between large industrial groups and finance are put explicitly at the very heart of the behaviour of what Schumpeter called trustified capitalism; whereas in the social market conception the links between industry and finance are hidden behind the institutionalist and unanalytical form of reasoning adopted by that school. Both approaches, however, view the integration between finance and industry as yielding economic stability, which, in the social market approach, is ensured by a corporatist social hierarchy.

In the interwar period, contrary to the Hilferding–Schumpeter view, the system of trustified capitalism did not shelter the economy from the Great Depression, which in fact, hit Germany particularly hard. By the same token, the system of universal banks and high capital concentration did not save the FRG from the regime of low growth rates and high unemployment of the last two decades. However, the institutional structure of West Germany did enable its economy to strengthen its position amidst growing stagnation in Europe. Exports surpluses, heavily orientated towards capital goods, were the factors which enhanced the position of the FRG over the last twenty years. Yet, before reaching a situation in which the relative power of West German

capitalism could benefit from stagnation, the economic relations between the FRG and the rest of Europe went through a phase of positive cumulative causation, followed by a short interlude before the beginning of a long and drastic process of structural change.

After the Second World War, Germany's economy acted dynamically for the whole of Europe till the early 1960s. As will be argued in the next section, this positive cumulative causation was made possible by the existence, at the European level, of US-sponsored institutions which mitigated the cleavage between industry and finance by keeping interest rates low and by softening the balance of payments constraint. In this framework, Germany's economic expansion and Europe's growth were not mutually inconsistent, although Bonn established, right from the early 1950s, a systemic trade surplus with its European partners.

It was during the 1960s that the regime of high accumulation of the 1950s started to break down, rather than being transformed into a regime of permanent full employment. At the roots of the change lay the emergence of the balance-of-payments constraint as an instrument with which to enforce wage policies in order to obtain export-led growth. For a while, this policy orientation implied a *de facto* tug-of-war with the FRG, whose surpluses declined substantially from 1960 to 1966.

The German counter-offensive came in the late 1960s. It was propelled by a sharp change in the pattern of accumulation based on the combination of export growth with the outflow of direct investment. This change was inaugurated by the 1969 revaluation of the DM and continued during the 1970s through successive revaluations. The remarkable feature of the FRG's economy after 1969 lies in the ability to transform the appreciation of the currency into an active instrument of industrial restructuring. Hence, while the balances of the other European countries were burdened by the increase in oil prices, Germany maintained and even increased its own surpluses till the very end of the decade.

The reason for this behaviour is not political but purely economic, and can be explained in Kaleckian terms. For Kalecki, a mature capitalist economy would tend towards stagnation without exogenous increases in demand. Such increases would have to come from public expenditure, from military expenditure and finally from exports.⁵ The avenue represented by military expenditure was not of economic interest to Germany because of the changes – to be discussed in the next section – in Europe's political economy engendered by the United States. Thus, exports became the main instrument for the profitable absorption of the surplus.

In the course of time, German industry has achieved an oligopolistic position throughout the Continent. This can be explained by the fact that the corporatist character of German capitalism is connected to its specific sectoral coherence. Sectors are not allowed to decay, those in decline are themselves subjected to modernization policies, so that they do not lead to

the formation of industrial wastelands with negative effects on the other branches as well (Katzenstein, 1989). In this manner, the industrial prowess of German industry is kept up relative to that of the rest of Europe. Because this process occurred in the 1970s and 1980s, under conditions of stagnant growth, the maintenance of trade surpluses was a crucial factor in the profitability of German firms.

Western Europe is the heart of Germany's effective-demand space. Europe's high growth rates, following the reconstruction period, enabled German industry to fan out over the whole network of Europe's intersectorial relations. In this respect, Germany's trade surplus with the EEC is particularly illuminating. The US\$50 billion of net exports obtained in 1989 were formed by a \$13 billion deficit in agricultural products, by a \$15 billion surplus in intermediate industrial goods and by a \$48 billion surplus in investment goods (Dal Bosco, 1992). Only a long historical process, in which priority is given to the capital-goods sectors, can explain the overwhelming role of investment goods in the FRG's exports. This also means that German industrial goods are necessary inputs in just about every branch of Europe's productive apparatus. The transformation of Europe into the area of profitable effective demand for German production is the result of strategic decisions concerning sectorial developments, rather than the outcome of competitive tendencies.

Today the role of Western Europe in Bonn's political economy is strengthened by the need to compete internationally against Japan and the United States, while it is rendered more problematical by the opening up of Eastern Europe.

Until 1990, Germany's strategy was to accumulate surpluses – mostly from its trade with the rest of Europe – regardless of the economic needs of the other European countries. This was necessary in order to finance exports and direct investment abroad, especially since Germany has been experiencing a growing deficit with Japan and the industrializing countries of the Far East, that is not offset by the (declining) surplus with the United States. To become active in that part of the world, Germany has to invest a large amount of financial capital, but Bonn's financial institutions and monetary authorities are extremely reluctant to see Germany's international position change by issuing liabilities against Germany itself. Therefore, trade surpluses become the key to Bonn's international strategy. Given that at present Germany cannot reverse the negative trade balances with Japan and East Asia, Bonn's surpluses must come from its trade with the rest of Europe. In other words, the competition between Japan and Germany pushed Bonn to augment its hegemonic position within Europe.

After 1990, the annexation of East Germany and the prospects of expanding into Eastern Europe have altered the dimension of the strategic choices facing the German authorities. This will be discussed in greater detail in the last section of the paper. Here, suffice it to say that neither East Germany

nor Eastern Europe are strong sources of profitable effective demand. There are, however, important areas for the development of productive activities which, on the one hand, are not profitable in West Germany, and, on the other hand, can compete against the exports coming from the newly industrialized countries of the Far East. Yet, as the East German case has shown, the costs of operating in the East have caused the loss of the surplus position enjoyed by the FRG. As trade with Europe is no longer sufficient to generate the desired financial flows, Germany must resort to the financial markets in order to pursue its objectives. The implementation of such a strategy from a position of strength requires the defence of the confidence in the value of the currency bestowed by the international financial institutions. This is achieved by means of a new spate of restrictive monetary policies based on relatively high rates of interest.

In practice, Germany is not interested in putting forward a Keynesian-type solution to Europe's rising rate of unemployment. It follows that Europe has to bear the burden of financial adjustment in a negative way, thereby sharpening the deflationary bias which has been sealing the whole Continent in a situation of rising unemployment for well over a decade.

27.3 The Financial and Real Character of the First Phase of Accumulation

The first phase of accumulation in postwar Europe can be looked at as a period in which the real dynamics of output had priority over financial interests, in the sense that the latter were subjected to the former. This period, although stretching into the early 1960s, goes from 1946 to 1958, which are also the years during which currencies were not convertible. With the return to convertibility after 1958, balance-of-payments relations began to govern the growth pattern of EEC countries.

For Germany's position in Europe, the importance of those 12 years consists in the fact that the economic dominance acquired by its industry did not come about through the link between industry and imperialism which marked the previous phases of German capitalism. The possibility of moving away from the imperialist connection between markets and raw materials, which defined so strongly the political economy of Europe right up to the Second World War, was a direct result of the financial and monetary decisions taken for strictly political reasons by the US authorities (Marshall Plan, government aid and relief in occupied areas (GARIOA) and the European Payments Union (EPU)). The role played by these institutions in removing the traditional economic sources of inter-capitalist conflict in Europe hastened a crucial transformation in the technological basis of the Continental economies. Now that the control and acquisition of areas producing steel and raw materials was no longer critical to the process of accumulation, growth could be obtained through the extension of the scale of output by

adopting mass-production techniques on a wide variety of consumption and intermediate goods. Such a process required a considerable period of retooling, in order to proceed to the construction of altogether new productive facilities.

The nation state in each of the European countries was given the responsibility of providing the structural framework for the reconstruction programmes, which, meanwhile, were unwittingly transformed into programmes of long-term structural change. The domestic role of the state did not clash with its European role, because the financial institutions which they had to manage in common (with the assistance of the United States) were orientated towards the expansion and restructuring of production rather than towards the acquisition of profits from purely financial transactions.⁶ As Milward (1984, 1992) has shown, the hallmark of the 1950s was the organization of European institutions around the productive role of the nation state. This required devising a system of international relations limiting the autonomy of finance and allowing the easy transformation of export surpluses into commercial credits. Thus, the growth objectives pursued by the governments and the industrialists in each nation state were not in conflict with the expansion of intra-European trade on a completely different basis from the imperialist one of the pre-1939 period. The interplay between the institutional and the structural role of the state was made possible by the pre-eminently functional tasks assigned to financial agencies.⁷ This in turn permitted the implementation of policies in which domestic wage deflation did not contradict domestic expansion based on retooling and restructuring, nor did the latter contradict export and import expansion.

German economists do recognize the role played by the American-sponsored institutions in the creation of favourable financial conditions for development. Yet the institutions of the reconstruction period are often seen as extraordinary steps, justified only by the need to create a new non-conflicting form of economic relations in Europe, the implicit assumption being that after a certain period things would proceed smoothly in a world of free multilateral trade and of equally free financial flows.⁸ In reality, shortly after the return to convertibility in 1958 and the freezing out of most of the safeguards of the 1950s, the policy preoccupations of EEC countries were increasingly centred on how to control domestic demand in relation to perceived current account constraints. By contrast, the main feature of the 1946–58 period lies in the intensity of the structural transformations and their relative consistency at the Continental level. This process would have been impossible without accommodating financial institutions, in particular, as noted by Milward, those enabling the financing of imports through the transformation of surpluses into credits.

In redesigning the pattern of European capitalism, Germany acted as the most dynamic force of European integration. The FRG functioned as the fastest-growing source of effective demand for the other European

countries and as the major supplier of capital goods to the rest of Europe. The latter element enabled German industry to attain an oligopolistic position throughout the Continent.

During the 1950s, Bonn's rate of accumulation was higher than that of the other Western European countries. Germany's volume of imports increased, therefore, far more than the volume of exports, setting in motion a virtuous circle. Germany's high growth rate gave rise to an expanding demand for imports which induced other European countries to transform their industries to suit the requirements of German demand. In turn, the modernization of the industry of the rest of Europe boosted the demand for German capital goods (Milward, 1992).⁹ For Germany, this meant that its productive apparatus was finding its way through the whole network of the interindustry relations of Europe.

Germany's position in 1950s European growth is easily explained by the role of the heavy industrial complexes in the German economy itself. The oversized nature of the FRG's mechanical and capital goods industry gave Bonn a structural advantage over other industrialized countries such as France and Britain. Among the factors which enabled the German economic structure to play such a significant role during that crucial phase of the long postwar boom was the specific form of continuity which the Christian Democratic party (CDU) established with the National Socialist regime. That continuity can be identified in the triad forming the core of German capitalism, which acquired an institutionalized dimension even before the Bonn Republic was a state.

The first component of the triad is the preferential system of links between the state and core firms. Without such links the dynamic transformation of the postwar economy would not have been possible to the same extent, because in a number of very important sectors the state guaranteed the financial stability of firms. As a recent study on the German motor car industry has pointed out:

Core firms were favored because they shared interests with the state. The firms wanted to maximize profits; the state wanted them to remain competitive in order to earn foreign currency and, later to maintain German technological development. As a result the firms and the state cooperated, benefiting from the advantages denied to other firms such as sharing technological information. Core firms were protected by the state in that they were less subject than peripheral producers to the vagaries of the marketplace. The state has been prepared to underwrite the financial stability of core auto firms in postwar Germany. (Reich, 1990, p. 65)

The Federal Republic took from the Third Reich the principle of preferential relations with specific segments of the large industrial groups. At the same time, it metamorphosed the public discriminatory controls of the previous

regime into quasi-public ones (this is the essence of the well-argued thesis by Reich, 1990). The second component of the triad is the large firms, in particular the core ones. But this factor immediately brings in the third component, represented by the banking system and financial institutions.

German economic growth in the 1950s can be viewed as being selectively oligopolistic – given the system of preferential relations between core firms and the authorities – and expansionary at the European level because of the higher growth experienced by the FRG. The high growth rate was not pursued for full-employment objectives. It was, rather, guided by the need of German capitalism to reconstitute a secure space of accumulation and of effective demand within the polity of Western Europe. The interrelationship between the banking sector and industry allowed accumulation to proceed according to a set of sectorial priorities, which enabled German industry to penetrate virtually every major segment of Europe's interindustry matrix. Later, in the last decade with the expansion of financial liberalization, that early accumulation of resources acted as a major barrier to entry against competitors and/or potential raiders.

27.4 General Features and the Export Bias of the FRG

The structural and institutional evolution of the German economy, during the 1950s and partly also in the following decade, gave rise to a number of basic characteristics which have marked the asymmetry between the FRG and the rest of Europe in the last two decades.

The first, and by far the most important, is the organization of the financial system. The banks' exemption from the *Kartellgesetz*, the anti-monopoly law of 1957, their legal power to own and issue shares (the latter is treated as a form of credit), their control of stock exchange operations, make takeover operations impossible unless there is a political consensus around them. In the later 1980s and early 1990s, some European companies had direct experience of the barriers which spring up against unwanted takeovers, such as the failed attempt by Pirelli to absorb Continental (Prodi, 1990).

The second aspect is related to the role of the Bundesbank which, as already noted, must ensure the stability and viability of the system of universal banks. Given the integration between the large banks and the large firms, the Bundesbank must know the perceived impact of its policies on at least the system of large firms. Consequently, what externally appear as purely macroeconomic deflationary policies concerned with price stability contain, in fact, a structural component related to the responsibility towards the financial-industrial complex, as well as towards the regional configuration of the FRG's productive apparatus.

The structuralist – rather than purely monetary – objectives embodied in the Bank's policies found their expression in the Bundesbank's contribution to the radical modification of the German model of accumulation in the 1970s. As

will be argued in the next section, the Bundesbank was fully aware of the discriminating impact of restrictive policies, as well as of the direct connection between the desired structural change – aimed at expanding exports and direct investment abroad – and the rise of unemployment, especially among immigrant workers. The lack of interest in reflationary policies derives, to a great extent, from the Bundesbank's conception of the position of the German economy in the world, according to which the accumulation of export surpluses is a central instrument in strengthening German capitalism at the international level. During the celebrations of the thirtieth anniversary of the Deutschmark in 1978, Otmar Emminger, Governor of the Bundesbank, stated, quite correctly, that:

The strength of our currency is above all a political asset of major importance. We should try to think what the FRG would have been today on the international level, if we had a weak currency as is the case with some European countries, or if we had to depend significantly on foreign aid credits! The fact that the FRG is no longer a dwarf politically is also undoubtedly due to the strength of our currency, to its high level of international reserves, to the healthy position of the balance of payments. (Emminger, 1978, quoted in Italian in Ciocca and Colonna, 1981, p. 134; my translation)

The Bundesbank, however, has not always been accurate in identifying the appropriate strategy for strengthening Germany's hegemony in Europe. For instance, it did not look favourably on the formation of the European Monetary System (EMS), fearing it would weaken the autonomy of Germany's policymaking. It was the government, and the SPD's Helmut Schmidt in particular, who understood that the EMS could shelter Germany from the competition stemming from other European countries and would institutionalize Bonn's hegemony in a context of stagnant growth.

27.5 After 1973: Hegemony Through Stagnation

In the 1960s the Federal Republic was the largest economy in Western Europe, but not an outrightly hegemonic one. Some authors maintain that, in the early 1960s, among the large European countries there were three economies of a roughly equal size: the British, the French and the German, followed by an underdeveloped one: the Italian economy. Today, it is claimed: 'we have a European structure with Germany in a position of pre-eminence followed by France, Great Britain and Italy on practically the same footing'. (Prodi, 1990, p. 139). This statement is correct from the point of view of the political-economic power of Germany *vis-à-vis* the other large European countries, but it is not to be confused with the evolution of the actual size of the economies concerned.

According to OECD statistics, the 1960–90 period puts the real GDP per capita growth rate of Italy at 3.4 per cent, of France at 2.9 per cent, of Germany at 2.6 per cent, and of Britain at 2.1 per cent per annum. The same ranking obtains in relation to the growth rate of manufacturing production, the mainstay of Bonn's international prowess, the difference being that the gap between Italy and France, and between France and Germany is wider than that shown in the data of aggregate GDP (total and per capita). Consequently, the difference between France, Germany and Italy has narrowed during the last 30 years, while Great Britain now has the status of being the true laggard.

The rise of Germany as the hegemonic country in postwar Europe is a phenomenon which gathered momentum from the 1970s onward; and, unlike the 1950s, it is not related to a more pronounced dynamism of its productive capabilities. The origin of the link between slow growth and the economic supremacy established by Bonn over Europe lies in the change in the mode of capital accumulation which had already started in the late 1960s. The economic trends prevailing in those years pointed to a situation in which the previous form of accumulation, based on importing labour and money capital while exporting commodities, was no longer feasible. The impossibility of following the previous pattern of growth manifested itself in the social cleavages connected with recovery from the 1966 recession. The ensuing strong export boom led to a veritable profit explosion also because of very moderate wage increases (Hennings, 1982). The excellent export performance generated expectations about the revaluation of the DM, giving rise to an inflow of speculative capital which the Bundesbank could not stem, even after the revaluation of 1969. The industrialists' opposition to revaluation, which brought them into brief but sharp conflict with the government, constituted an example of the inadequacy of the older mode of growth. The industrialists wanted, in essence, social peace with stable wages and a profit explosion, monetary stability and an export boom, based on what was perceived to be a favourable exchange rate.

During the same years, the SPD technocracy, and Karl Schiller in particular, for whom greater concentration was associated with greater efficiency (Valli, 1981), began to think in terms of a far-reaching restructuring of the German economy. The SPD technocracy favoured concentration of capital in order to foster both exports and German direct investment abroad. Revaluation was then seen as a necessary instrument to achieve these objectives, while it would have reduced the short-term impact of capital movements. Concomitantly, the SPD put forward a corporatist-cum-Keynesian social platform. Concerted Action, involving the unions and the employers, would allow workers to share productivity increases and Keynesian demand management would guarantee full employment. The technocratic project of the SPD did not materialize, since the profit boom – taking place under conditions of high employment levels – set in motion a Kaleckian political

business cycle. Spontaneous strike movements began, in which immigrant workers played a relevant role. The unions, for their part, in order to regain control over the workers, were compelled to launch a wage offensive.

The collapse of Concerted Action, not formally abandoned until 1977, also implied the whittling away of the Keynesian elements inherent in the SPD's platform. More specifically, the objective of restructuring acquired dominance over that of the maintenance of full employment, so that the forces in the driving seat of the restructuring process were those close to the monetary authorities, around which coalesced the consensus of the large firms and their respective financial institutions.

After 1972, the FRG underwent a deep process of industrial transformation which continued into the following decade. The early 1970s were also the years during which the Bundesbank emerged as the major political force in decision-making. In practice, through its monetary policies, the Bundesbank added a very important corollary to the technocratic vision of restructuring: the profound alteration of the German labour market by means of a deliberate creation of a reserve army of the unemployed skewed towards immigrant labour. In this context, the weakening, through unemployment, of the position of labour became an instrument for stemming the rise in the share of wages in national income.

In a period when the Bundesbank emerged as the central policymaker of the country, the German economy, thanks to the process of economic transformation, won the gamble with its European competitors. The appropriation of revaluation as an active instrument of restructuring was the specific German response to the overall decline in economic activity, turning it to its own international advantage. The orientations emerging in Germany throughout the 1970s can be described as a form of neomercantilism, where the defence of export surpluses was being linked to the internationalization of the investment strategies of German companies (Valli, 1981).

This approach required the knowledge of whether or not the productive capacity of the economy was in a position to absorb the impact of the appreciation of the currency and to start the process of restructuring. This means that behind the aggregate monetary and fiscal objectives, the monetary authorities must have had a definite set of hypotheses about what kind of economic structure, in sectorial terms, they started from and about what kind of structure they wished to achieve. The vision of economic transformation under conditions of currency appreciation necessitated a declared objective of long-term price stability. Indeed, revaluation was undoubtedly a cost in terms of exports and in terms of the vulnerability to imports of the more-exposed sectors.

The industrial sophistication and sectorial completeness of the German productive apparatus lent to the objective of price stability a direct structural connotation. Large-scale industrial capacities and advanced technological know-how, fed by the sectorial interconnections between the different

industries, allowed revaluation to be countered by means of industrial restructuring aimed at improving the relationship between productivity gains and unit labour costs. In turn, the very process of restructuring under declining growth rates created mass unemployment, thereby stemming further increases in the share of wages. The downward flexibility in the share of wages helped profit margins, while productivity gains, *under price stability*, helped the international competitiveness of German firms. The permanent, and thus long-run, goal of price stability became interwoven with the creation of a persistently high rate of unemployment, the latter acting as an instrument in the regulation of the distribution of income in favour of profit shares (Ciocca and Colonna, 1981; Frateschi, 1981). After 1973, Germany succeeded in reversing the trend in the growth of unit labour costs. At the same time, however, the frequent implementation of restrictive monetary policies inhibited the expansion of domestic demand. This process was sharpened during the 1980s (except for the 1988–90 period), when the improvement in unit labour costs was accompanied by a further decline in the growth rate of output per person employed, thereby making the FRG one of the slowest-growing countries in Europe.

Bonn's increased hegemony over Europe's economy and polity was also largely related to the consistency between the objectives of the monetary authorities and the international aspects of the restructuring process. In the wake of revaluation, foreign investment was aimed at making German firms benefit from the level of demand in the areas where it was being directed. This was done not only through productive investments, but also by setting up banking and service facilities. Non-price factors, such as commercial credits and continuous technical assistance, became crucial elements in this strategy. Furthermore, foreign investment in energy and oil extraction activities was expanded, as well as investment in production where cost advantages could be obtained. On the internal level, the internationalization of the economy was accompanied by a shift of investment resources towards more advanced means of production and by a profound transformation of the more exposed sectors such as textiles and apparel (Capitani, 1981).

Contrary to the experience of other industrialized countries (Britain, but also France), where the drastic fall in growth conditions entailed the decay of large segments of industry, in Germany the process of internationalization was characterized by a significant degree of complementarity between the acquisition of external resources and the internal transformation of the productive apparatus. The framework within which the monetary authorities were pursuing their restrictive policies was not that of abandoning entire branches to their own fate but, rather, one in which the German economy was undergoing a process of vertical integration at the international level, giving rise to a mechanism of cumulative causation. Direct investment abroad was indeed also considered to be an important element in supporting German exports over the long run. Direct investment abroad

expanded the sphere of German firms, helped the exports of advanced capital goods and high-technology products, and allowed domestic restructuring, thereby aiding the other sectors to withstand international competition under conditions of declining overall growth.

The transformation of the German mode of accumulation from an extensive into an intensive one, centred on exporting capital and advanced products, could have taken place only if the domestic productive structure was in a position to react in sympathy with the objectives pursued by the monetary authorities. In this context, the existence in Germany of a multilayered capital-goods industry represented an essential element in turning the severe atmosphere generated by the restrictive policies of the Bundesbank into a factor of strength for German capital in Europe. The capital-goods industries – the ramifications of which are extremely wide in German society (Harrigel, 1989) – sustained the successful export drive over two decades of declining European growth by being themselves exporters as well as by providing inputs for the modernization of other industries. Investment goods industries were considered to be particularly favoured during the years in which the DM was perceived to be undervalued, as the 'low' value of the fixed exchange rate protected the German capital goods sectors from British competition. Later, when successive revaluations were turned into an active instrument in the modification of the pattern of capital accumulation, the presence of a vast network of investment goods industries became a necessary condition for the implementation of the new strategy.

If the capital-goods industries constitute the core of German industrial power, the position of the large firms has been an equally crucial aspect of the international adjustment of the economy. As mentioned at the beginning of the second section of this essay, Steinherr and Morel (1979) suggested that the large firms, assumed to be also the major exporters, tended to benefit from revaluation because of their position as price-makers. More importantly, however, the role of the large firms is enhanced, through the working of the universal bank, by the nature of credit flows under conditions of restrictive monetary policies. Officially, the Bundesbank has always argued that it maintains a non-discriminatory stance since it uses purely market-orientated instruments. However, if the domestic channels to credit are limited, the transmission of the necessary funds to firms will take place via external channels, through the foreign branches of Germany's large banks. In the 1970s, more than 20 per cent of total credit to firms was provided in this way. In the same period, the share of credit financing accruing to specialized financial institutions, servicing mostly small and medium-size firms, actually declined (Nardozi, 1983). The negative impact of restrictive monetary policies on this class of firms was admitted by the then Vice-President of the Bundesbank, Helmut Schlesinger (1977).

The consistency between structural transformations and the policy adopted by the monetary authorities explains the nature of the German deflation,

which, although the product of the conditions of the 1970s, subsequently determined the philosophy with which Bonn's authorities conceived Germany's international position.

Unlike the United States, the FRG does not issue an international reserve currency. The internationalization of German capitalism required, therefore, large surpluses in order to finance capital exports and commercial credit abroad. As already noted, the revaluation of the currency became an important factor in fostering structural change. The negative impact of revaluation on profitability was mitigated by price stability and by regulating, through mass unemployment, the distribution of income to wage earners. Reflationary policies would, by contrast, have hampered the strategy towards internationalization and would have created the room for a revival of the social conflict over working conditions and income distribution (Parboni, 1981).

In the 1970s Germany did not reflate because, given the strategic orientations of its business groups and the monetary authorities, it could not do so in any fundamental way. The absence of a substantial recovery in Germany caused a lack of recovery in Europe, thereby reversing the European role of the FRG relatively to the 1950s and the early 1960s.

27.6 The 1980S: The Ems as the Institution of German Hegemony

Germany's economic strategies during the 1970s were conducted with a firm eye on the fluctuations of the US dollar. The devaluation of the American currency brought to the fore the sharp differences between the approach followed by Washington and that pursued by Bonn. Through devaluation, the US authorities sought to halt the decline in the international competitiveness of the country's production. By the end of the decade Washington did manage to reduce its trade deficit as well as to achieve a tiny surplus in the current account balance. In the FRG the process of restructuring and of direct investment abroad allowed the economy to counter the devaluation of the dollar. At the same time, however, this very devaluation threatened to open up a second front for the German economy.

For many European countries the accumulation of surpluses by the Federal Republic meant that in addition to the deficit arising from the oil and energy imports, they also had a structural deficit with Bonn. It is true that the depreciation of the US dollar tended to reduce the cost of oil imports, but it also exposed those countries to the American drive aimed at regaining international competitiveness. Given the weakness in their balance of payments position, countries like France and Italy could not eschew the issue of whether or not to devalue also their own currencies. Now, Europe's external trade has a marked intra-European dimension in which Germany is by far the largest importer of the products of each single country. In these circumstances, the option to devalue depended on the probability of

succeeding in outcompeting Germany. The type of policies involved is well represented by the Italian case. The Bank of Italy favoured a revaluation of the lira against the dollar, thereby reducing the cost of oil, and a devaluation against the other European currencies, thereby enhancing Italy's exports *vis-à-vis* Germany's. This strategy was indeed successful as it allowed Rome to achieve a balance of trade surplus with Bonn (Parboni, 1981).

The tendency towards a form of competitive devaluation did not escape the attention of the SPD-led government and, especially, of Helmut Schmidt. Faced with the multifaceted effects of the devaluation of the US dollar under the Carter Administration, the SPD government began to worry about how to link European currencies together in order to prevent the creation of a monetary front in Europe. Schmidt's advocacy of a European monetary system, although cast in the grand vision of a unified Europe centred on Franco-German co-operation, is a testimony to the faith that successive German leaders had in the role of industry in maintaining hegemony. They did think that with controlled exchange rates, the productive, non-price efficiency of German industry would eventually carry the day, leaving the others to undertake the required adjustments. With the EMS, Germany acquired the freedom to fight the fluctuations of the dollar through internally co-ordinated restructuring. At the same time, Bonn prevented the other European countries from using the exchange rate instrument to undercut its policies.

Conceived in a period in which the dollar was depreciating, the European Monetary System served Germany well during the phase of the appreciation of the US currency (1980–5). Thanks to the restructuring and foreign investment policies adopted in the preceding decade, the FRG very quickly overcame the current account deficit caused by the second oil shock in 1979. By 1982 Bonn re-established its trade surplus with the oil-producing countries, while the rise of the dollar and the American recovery generated an expansion of the surplus with North America, safeguarding, at the same time, the surplus with the rest of Europe. The majority of the other European countries, by contrast, benefited chiefly from the surplus obtained from the United States. The external position of the rest of Europe, measured in terms of the surplus of current transactions over GDP, did become positive, but only briefly. After 1985, conjointly with the resumption of the downward trend of the dollar, the rest of Europe began to lose the surplus with the United States, while the deficit with Germany stayed, along with a growing deficit *vis-à-vis* Japan and the Far East. During the second half of the 1980s, Europe became even more important as a terrain for the implementation of the FRG's export-orientated strategies, because of the decline in Bonn's surplus with the USA and the expanding deficit with Japan and the Far East.

On the whole, the two phases of the 1980s augmented Europe's dependency on Germany. In the first phase, the improvement in Europe's external position was due mostly to the purely contingent factor represented by the policies of the Reagan Administration. No significant amelioration took place

on the German front. Furthermore, the negative effects on investment caused by the American policy of high interest rates, leading to the revaluation of the dollar, necessarily had a more detrimental effect on the weaker countries than on Germany. The weaker countries would have needed a comparatively greater dose of investment in order to undertake the restructuring necessary to face up to German competition. In the second phase, those countries found themselves with at least one hand tied behind their back by the EMS, thereby failing to identify a favourable terrain on which to compete against Bonn.

German economists have praised the EMS on the ground that it showed greater flexibility than the Bretton Woods system (Giersh *et al.*, 1992). A closer look at their arguments reveals that their preference for the EMS is based on the fact that it preserved the Bundesbank's freedom of movement in a context in which the other countries 'did more or less adopt the anti-inflationary stance of West Germany's central bank' (Giersh *et al.* 1992, p. 254). The EMS in fact magnified the limitations of the European Snake by tilting the system of payments in a very anti-Keynesian direction (Parboni, 1981; Samuelson, 1991). This is because the technical innovation brought about by the EMS, the ECU, does not constitute the creation of an international currency. Interventions are based on EEC currencies and on the dollar; external deficits are largely financed by borrowing dollars. Countries can avail themselves of substantial intra-EMS credit facilities, but the amounts borrowed have to be repaid within a very short period of time, thereby putting on the deficit country the pressure of adjustment. Within the EMS there is no institutional mechanism by which the weak countries can compel the strong ones to weaken their position, which is precisely what Keynes attempted to avoid at Bretton Woods. A weak currency country must deflate and/or strengthen its currency relative to those of the other members of the system.

The convergence towards the Bundesbank's monetary policies is, therefore, a built-in characteristic of the system in the light of the inflexibility of Bonn's attitude, which, as argued earlier, stems from a structural conception of the international position of the German economy. On the other side of the fence separating Germany from the rest of Europe, economists have tried to rationalize the asymmetric balance of power by means of the hypothetical advantages which would be earned by pegging one's currency to the DM (Giavazzi and Pagano, 1988). The argument runs entirely in terms of the credibility to be gained in terms of future inflation rates, relative to a long-run position characterized by the so-called natural level of unemployment. Even leaving aside the dubious notion of a natural level of unemployment, the credibility approach does not allow any room for a discussion of the implications of such an exchange rate regime for countries having an economic structure and financial organization vastly different from the German one.

The institutionalization of the FRG's degree of freedom through the EMS had, for some major countries, either a straight deflationary effect or a perverse one. France falls within the former category while Italy belongs to the

latter case. The impact of the EMS regime on these two countries is important in order to grasp the ramifications of Germany hegemony within the EEC. Together, France and Italy represented by the end of the 1980s 22 per cent of the FRG's world trade and 41 per cent of its EEC trade. Moreover, in the light of the deindustrialization of Great Britain and of the still-wide gap separating Spain from the other large economies of Europe, France and Italy are the only two large countries with the potential to challenge Germany in a relevant range of industrial products. The argument which follows will maintain that the EMS regime has actually weakened such a potential.

As is well known, in the early 1980s the French socialist government was faced with the conflict between the social objective of reducing mass unemployment and the altogether different orientations of financial institutions, which were more concerned with inflation and the preservation of the value of the currency. The government opted for the second approach by means of a policy based on fiscal restriction and on the defence of the exchange rate of the French franc *vis-à-vis* the DM. The level of the exchange rate turned out to be the most important cause of the growing trade deficit, in a phase when the overall growth rate of the economy began to slow down towards that of Germany (Parguez, 1992). Slow growth in Germany and slow growth in France meant, however, two different things. The privileged position enjoyed in Germany by the capital-goods industry (Harrigel, 1989) allowed the FRG to attain large export surpluses. By contrast, the picture that emerged in France is that of a stalled economy with unemployment hovering around 10 per cent from 1985 till the eruption of the present crisis (Cotta, 1991). Indeed, while Germany during the 1980s increased its dominant role in Europe as a producer and exporter of capital goods, France lost ground to countries like Italy in many consumption goods, as well as in investment goods servicing directly the consumption-goods industries. The growth of services and of electronic industries could not offset the negative impact of the relative decline of the core industrial sectors.

On the opposite side of the spectrum, Italy represents a case of perverse adjustment to the exchange rate mechanism inaugurated by the EMS. Italy's growth rate remained during the 1979-90 period significantly above that of the other large European economies, although it declined more sharply than in the rest of Europe, if measured against the 1973-9 period. The country's participation in the EMS involved a process in which the devaluation of the lira, relative to the ECU, was less than the inflation differential *vis-à-vis* the other countries, thereby causing a real appreciation of the currency. Recalling now that the EMS regime compels the weak countries to strengthen their own currency, Italy's way of adjusting to the EMS seemed reasonable to avoid a harsh disinflation, because the economy was coming from much higher inflation rates than the rest of the EEC.

The real appreciation of the currency compelled Italian firms to undertake a radical restructuring in technological terms. Yet, given that Italy's industrial

structure is very different from Germany's, the real appreciation of the lira, taking place under conditions of relatively high growth rates, led to persistent external deficits. Italy's growth benefited the FRG more than any other European country, as Bonn's trade surpluses with Rome showed a strong expansion throughout the 1980s.

As noted by Graziani (1991), the Bank of Italy confronted this situation by means of capital inflows attracted by a policy of high interest rates. As a consequence, the ratio between the external debt and GDP rose from 8.7 per cent in 1982 to 15.19 per cent in 1990. Furthermore, since Italy did not enjoy German-type export surpluses (which represent an essential source of profits for German companies), restructuring alone was not a sufficient condition for restoring the profitability of firms, which had been dented by the crisis of the 1970s and the recession of the early 1980s. The crucial factor which brought profitability back was the flow of transfer payments by the public sector to firms (Graziani, 1991; Bank of Italy, 1988). Italy's monetary authorities fostered restructuring by combining fixed exchange rates with inflation, while using public expenditure to help the profitability of firms. In this context, the country's macro-economy was locked into a situation of high interest rates and rising foreign and public debt.

For both France and Italy, the end result of tying their monetary policies to the stability of the exchange rate system had negative effects. In France, these effects manifested themselves chiefly through the weakening of its industrial structure and the persistence of a high rate of unemployment hovering around 10 per cent. In Italy, as argued by Graziani, the effects have been felt mostly by the public sector through its transfers to firms, in order to finance restructuring, and to individuals, in order to mitigate the impact of unemployment. The combination of high interest rates with a rising foreign debt, while imposing on the public sector the task of restoring the profitability of firms, has led to an intractable situation in Italy's public finances. By the end of the 1980s, both Italy and France found themselves with a much reduced degree of manoeuvrability relative to Germany.

27.7 The New Position of Germany

The acceptance of the EMS by countries like Italy and France represented an institutionalized acceptance of the hierarchical relations which characterize Europe's political economy. During the last decade Europe has had to comply with Bonn's use of the EMS according to Bonn's priorities (Kennedy, 1991). Europe, by being the FRG's main area of effective demand, became also the periphery of German capitalism. The share of the FRG's surpluses obtained within the EEC increased from about 44 per cent in 1985 to more than 62 per cent in 1989, a period in which governments strengthened their resolve to adhere to the EMS. The peripheral character of Europe manifests itself in that, if any of the large countries reflate, its impact on the rest of

the EEC will be limited, while German industry, present in the whole spectrum of Europe's interindustry matrix and capable of quickly generating commercial credits, is poised to benefit significantly.

The acceptance of this state of affairs led to the formation of two myths within business and dominant political circles in the rest of Europe. The first concerns the expansionary effect of a speedy institutional unification of the EEC. The second relates to the supposedly beneficial, but longer-term, impact of the collapse of the political regimes in Eastern Europe and in the former Soviet Union.

As to the expansionary impact of European unification, it is important to remember that virtually identical arguments were voiced during the phases leading to the formation of the Common Market in 1957. Those expectations turned out to be correct because industries were then operating mostly from and within a domestic framework. Furthermore, the high growth rates and the correspondingly high levels of capacity utilization prevailing at the end of the 1950s meant that national industries had to plan for further expansion in order to be able to operate at the level of the newly born Common Market. In fact, industries had ten years to adjust their productive capacities, since barriers to movements of industrial goods were formally abolished in 1968.

A totally different situation prevailed in the mid-1980s. Export and direct investment networks had already been in place for nearly 20 years. Productive capacities were, by and large, already adjusted to the size of the, much larger, EEC market. In this context, the decline of the growth rates of the economies forming the EEC implied that the European productive apparatus tended to display not insufficient, but excess, capacity. As such, the prospect of European unity was unlikely to stimulate a significant expansion in overall investment. Only a common reflationary policy could have initiated a new investment wave. Yet, with the FRG sitting tight on its surpluses and with currencies pegged to the DM, the process towards European unity was taking place within an unambiguous scenario marked by real deflation.

The truly novel element of the post-1985 situation has been the liberalization of capital movements. Given the autonomy conquered by the FRG's monetary authorities, financial liberalization implied adopting a policy of high interest rates in order to maintain the exchange rate with the ECU.

At the same time, it should be pointed out that the pressure towards financial liberalization was an objective one, rooted in the financial aspects of the process of capital accumulation at the European level. The 1980s have been marked by a very rapid increase in the number and size of acquisitions across Europe. Germany was at the very centre of the process. Unlike elsewhere in Europe, the strategy followed by German companies has been orientated more towards acquisitions which enhanced their market share than to short-term financial gains (Prodi, 1990). German companies benefited from three factors: the accumulation of external surpluses by the banking

system; industrial strength; and ownership structure. The latter factor introduces a crucial asymmetry in the mechanism of acquisitions and mergers. The close interconnection between banks and industries makes it very difficult for foreign companies to acquire a German one, whereas no parallel obstacles exist for German companies investing abroad.

Thus, the expectations generated by the goal of European unity were, as far as the rest of European capitalism is concerned, largely mythical in nature. The existence of unused capacity ruled out an investment boom, the monetary arrangements ruled out a common reflationary policy, capital mobility expanded the sphere of action of German firms in a context of a slow growth in aggregate European demand.

A similar fate awaited the expectations raised by the end of the previous regimes in Eastern Europe and in the former USSR. In the wake of the dissolution of East Germany, many European companies thought that the former German Democratic Republic (GDR) could be used as a means to penetrate more decisively into the German market. This possibility vanished within a very short period of time as the space of the GDR was quickly taken by German companies. As for the rest of the Eastern European and Russian front, suffice it to say that Germany now provides nearly 50 per cent of total exports to the former Comecon countries as against 41 per cent in 1980. The increase in the FRG's export to Eastern Europe and Russia is, however, taking place under conditions of negative growth in that part of the world. Therefore, very little room is left for the rest of Europe which, by and large, does not possess the financial means to meet the German hegemony in the East.

By the end of the 1980s, the two myths ended up mutually reinforcing each other, only to unravel together at the onset of the new decade. The systematic decline in the consensus sustaining the identity between European integration and European monetary union originates in large part from within business circles. This is particularly true of France. One source of the political crisis lies in the fact that, faced with the profound transformation undertaken by the German economy from the early 1970s onward, large segments of Europe's industrial and financial groups accepted German hegemony, hoping to join forces with the FRG and its institutions. In reality, they had to confront German competition in an environment of low growth rates in Western Europe and of economic implosion in the East.

The situation which matured at the very end of the 1980s also generated for Germany a different set of objectives relatively to the other components of European capitalism. These objectives relate to competition with Japan and the Far East and to the issue of the annexation of the GDR.

By 1990, the Federal Republic was the only European economy with a productive capacity able to function at the world level. On the basis of the IMF classification, Bonn had 17 per cent of the total value of exports of the industrial countries, far above Japan's (8.5 per cent). The model of accumulation followed by Bonn, led by exports and direct investment, looked

to the EEC as its main area of effective demand. In 1970 the FRG's trade with the rest of the EEC was nearly balanced. Twenty years later, in spite of steadily declining growth rates, the EEC provided the vast majority of the FRG surpluses, the main source of which are net exports of investment and capital goods. During the same period the United States, due to the heavy fluctuations of the dollar, proved to be a rather volatile area in which to obtain surpluses. In particular, the export surplus with the USA shrank from 1985 onward, while the overall share of the surplus on current transactions over GDP jumped from 2.4 per cent in 1985 to a peak of 4.9 per cent in 1989. The institutionalized nature of the relations linking Germany to the EEC through the EMS, sheltered Bonn from the effects of the devaluation of the US currency.

Japan, by contrast, bore the brunt of Washington's exchange rate policies, which are usually accompanied by direct political pressures. The share of Japan's surplus relatively to GDP peaked in 1986 at 4.3 per cent, only to descend to 1.3 per cent in 1990 (the German share was then 3.2 per cent). This factor, coupled with fresh pressures by the United States on other East Asian countries as well, compelled Japan and the East Asian economies to accelerate the expansion of exports and direct investment towards Western Europe. In this context Germany, while deriving its strength from Western Europe and the EEC, showed, like the rest of the Continent's economies, a growing deficit with Japan, the Far East and China. Thus, by the end of the 1980s the necessity to confront the Far Eastern competition, coupled with the need to counter further fluctuations in the US dollar, became more urgent. Other European countries also faced this problem, but their weaker situation has brought them to see the EEC as a place of safety. This explains the opposition by Italy, France and Spain to the imports of Japanese cars, even when produced in the UK.

Germany, on the other hand, had, as in part still has, a wider set of instruments at its disposal. The accumulation of surpluses, the ensuing strength of its currency, the world-wide nature of its productive capacity, allow the FRG to confront the matter differently. In a situation of stagnant demand, expansion into the Far East is becoming absolutely essential for Germany, especially in the light of China's high growth rate, the only significant bright spot in the present situation. The penetration into the Far East, China included, imposes a form of managed trade and investment relations with Japan, for whom this area is becoming the major source of net exports. Germany, therefore, is not as adamantly opposed to Far Eastern exports as are France, Italy and Spain. The FRG's strategy appears to be more orientated towards a form of economic diplomacy based on reciprocity and on mutual links between German and Japanese firms. In the final analysis, however, the capacity to expand into the Far East will depend on the flows of direct investment and commercial credits that Bonn can generate. Yet the financial means to undertake this strategy must come from a continuing German

hegemony in Western Europe, because the latter provides the overwhelming majority of the surpluses from which Bonn's financial institutions derive their leverage over international capital markets.

Western Europe and the EEC, now the EU, must play an even greater role in financing the FRG's efforts in the Eastern part of Europe. The opening up of an Eastern European sphere of influence has been the decisive factor which has pushed Bonn to firm up and even increase its degree of freedom within the EEC, in consequence scuttling the process towards European monetary union. This problem, with its multifaceted aspects, is worth considering in some detail.

The type of German hegemony prevailing in Europe till 1989–90 was predicated upon Adenauer's conception of ensconcing the FRG firmly within Western European polity. Having obtained through the EMS a degree of freedom not available to the other European countries, Bonn could deal more effectively with the fluctuations of the US dollar. Consequently, it also found itself better endowed to meet the competition coming from Japan and the Far East. This deeply asymmetrical situation brought other European countries to express concern as well as political dissent. The rest of Europe is, however, too weak to negotiate a change in the rules of the game, so that the manifestations of dissent became a major factor in the internal political crisis of the countries concerned (France, Britain). The change in the rules of the game came from Germany itself; that is, from the body that shaped them in the first place.

The opening up of the East gave rise to an ambiguous attitude on the part of Bonn's authorities. German industrialists, bankers and policymakers knew very well that the East is not a wasteland. In terms of technical capabilities, of the level of scientific and technical education of its population, Eastern Europe is far from being underdeveloped. It is its internal division of labour, the composition and specification of its output, which does not, as yet, suit the requirements of capitalist competition. The new situation in Eastern Europe made it possible to envisage, in the longer run, the creation of a German economic zone dependent on the FRG in relation to the transfer of technology and capital goods, but also capable of acting as a recipient of the restructuring processes taking place in Germany itself.

The creation of such an area would also be consistent with the need to compete against the Far East. Once restructured under German technical, managerial and financial supervision, large parts of Eastern European industry could, in fact, become exporters of products which are not the dominant ones in the FRG and which compete directly with those of Far Eastern countries. According to this scenario, Eastern Europe would have a persistent current account deficit with Germany that would have to be financed by means of export earnings with the rest of the world. The strong interest shown by Germany towards Eastern Europe is proved by the favourable attitude adopted by Bonn in relation to Eastern European exports to the

EEC. By contrast, Italy, France and Spain have shown much greater caution on this issue.

The Eastern European pull has changed in a very complex way the role played by Western Europe in Germany's political economy. The formulation of a long-term strategy towards the East imposes an inward-looking approach on Bonn's authorities. The destructuring of the old economic and social system, a necessary political condition in order to open up that part of the world, has brought about a process of economic implosion in those countries. This means that whichever of the present forces happens to hold political power there, it will not be able to devise a meaningful strategy of integration into the world capitalist economy. Such a strategy will have to come from external interests, with the local power groups operating in a satellite fashion. Germany is the only European country which has a global interest in redesigning the position of the East. This interest has been vastly augmented by the annexation of the former GDR. The annexation could have allowed for the full exploitation of the channels linking the former GDR to the rest of Eastern Europe. However, the process of destructuring has tended to undo the aforementioned links. It follows that, in order to take advantage of its privileged position in Eastern Europe, the FRG must concentrate on a comprehensive strategy of restructuring, beginning with East Germany and moving outward to the former Czechoslovakia, Hungary, Poland, the Baltic states, Slovenia, Croatia and also Ukraine. Over these countries – but not over Russia – Bonn can expect to exercise strong political influence.

The costs of the Eastern pull – highlighted by the East German case – involve a prolonged loss of the current account surpluses which Bonn has so painstakingly accumulated, to the point of dragging the whole of Europe on to a deflationary path. It is at this point that the relations between Germany and the rest of the EEC take on an altogether new dimension. The EEC must remain the FRG's dominant area of profitable effective demand. Yet the surpluses obtained from the EEC and the rest of Western Europe are not enough to finance the multiple objectives of Germany's institutions and corporations. The financing of these objectives must come, therefore, also from the financial markets. In the absence of the previous surpluses, Bonn's leverage over financial markets depends on the stability of the real value of its currency. Restrictive monetary policies under recessionary conditions (1992) mean that Western Europe is being called upon to finance Germany's way out of the balance of payments difficulties caused by the Eastern factor, presently embodied in the problems caused by the annexation of East Germany.

The formation of 'Great Germany' and the necessity to intervene in Eastern Europe has led Bonn's authorities to defend at all costs their degree of freedom in matters of monetary policies. This is the source of the ambiguity in relation to the now defunct process towards a European monetary union. Even the minimal requirement of a voluntary transfer of international

reserves to a common European body became a matter of disagreement between the Bundesbank and the European Community, in spite of the fact that the EMU project has been largely structured around Bonn's needs.

Bonn's determination to shift the burden of adjustment on to the other European countries is based on the implicit assumption – strengthened by the experience of 20 years of monetary policies accompanied by economic restructuring – that German industry has the technical capacity to undertake a new wave of transformations under the severity of high interest rates.

However, the present situation is very different from that of the 1980s, when, along with mass unemployment, there existed significant, albeit contradictory, elements of dynamic change. The early 1990s, when all the contradictory aspects of the previous decade came to a head, were characterized by a rise in the degree of unused capacity and by falling profitability. As shown by the crisis of Japan, the growth rates of the East Asian and the Chinese economies, although impressive, are not sufficient to act as a strong counterweight to the recession in the rest of the industrialized world. In these circumstances, it is much more difficult to rationalize production, since the persistent downward tendencies leads to the appearance of new and undesired excess capacities. Therefore, it is by no means certain that Germany can use restructuring as in the past. Thus, Germany's attempt to maintain its hegemony under much-deteriorated conditions, rather than leading to a new set of rules, may simply mean a new step in the evolution of the crisis with its long-term negative consequences on employment.

Notes

1. Since our period ends in 1990, we should use the terms 'Germany' and 'Federal Republic' interchangeably. For the same reason, the European Union will be referred to as the EEC.
2. It is true that Bonn has lost such a surplus in 1991. However, this was neither due to a spontaneous adjustment, nor to a policy-induced correction inspired by the need to help European recovery programmes. The German deficit was, rather, caused by the virtual impossibility of achieving simultaneously the objective of incorporating a formerly independent state and holding onto current account surpluses.
3. Taking 1970 = 100, the production index for the main industrial sectors of the FRG was:

	1950	1960	1980	1988
Mining	80	106	82	65
Basic industries	21	54	117	123
Investment goods	18	58	122	149
Durable consumption goods	28	65	114	115
Food industries	29	64	121	129

Source: Schneilin and Schumacher (1992, p. 123)

4. As Nardozi (1983) shows, this was achieved by means of restrictive policies which created an interest rate differential between the Euromarket rate and the domestic rate. With the former lower than the latter, firms were pushed by the banks themselves to obtain credits on the Euromarket.
5. According to Kalecki, 'The export surplus enables profits to increase above the level which would be determined by capitalists' investment and consumption. It is from this point of view that the fight for foreign markets may be viewed. The capitalists of a country which manages to capture foreign markets from other countries are able to increase their profits at the expense of the capitalists of the other countries' (Kalecki, 1971, p. 85).
6. In the above context the function performed by the European Payments Union (EPU), can be taken as an example. It allowed the European economies, and Germany in particular, to take full advantage of the expansion of effective demand for capital goods created by the Korean war. In fact, while the Korean war generated a capital-goods boom for the Germany economy (Carlin and Jacob, 1989), it also caused, initially, a severe balance of payments crisis for Bonn. The balance of payments constraint was then relieved by a US loan especially approved by EPU.
7. The structural role of the state consisted in that it acted directly on the creation of positive long-term expectations (in the sense of chapter 12 of Keynes's *General Theory*).
8. This view is still presented today without the benefit of historical hindsight (Nolling, 1993).
9. Milward (1992) has shown that Europe's exports to West Germany increased during the 1950-8 period more than Europe's total exports. In the same years, the FRG exports to Western Europe expanded less than total German exports.

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28

The Argentine Crisis

Joseph Halevi

28.1 The Conceptual Setting

Historically, monetary crises have been related to hyperinflation, from which Argentina has often suffered. Hyperinflation is generally viewed as a calamity leading to the destruction of the capitalist monetary system of circulation. In the present Argentine crisis, however, there has been a complete implosion of economic and monetary relations due to hyperdeflation. This is the strangulation of the economy by the requirement to pay an unsustainable debt.

There is a substantial difference between hyperinflation and hyperdeflation. In hyperinflation, prices race endlessly forward at ever-increasing speed. Those classes whose incomes are not fully indexed to prices and who do not own houses and other fixed assets quickly lose ground. In hyperdeflation, however, prices will not race backwards. Today, in just about any part of the world, the system of monopoly capital prevails. Large corporations, large retail companies, and concentrated financial capital are its hallmarks. As a consequence of monopoly capital, deflation, even when made so severe as to become hyperdeflation, will not result in falling prices. Prices will keep rising, albeit at a moderate pace. In this context, the prices of public services (transportation, medical fees, municipal rates, etc.) are actually increased to raise revenues for budgetary purposes. The national government's budget has to be austere, with little or no deficit, especially in matters not related to capitalist interests, such as social security expenditures—thus a deflation policy is officially dictated by the need to pay the external debt. Meanwhile, on the very same austerity principle, a wage freeze is imposed upon workers. Wage earners now lose, because their wages are frozen while prices grow slowly and social services are curtailed. Therefore, hyperdeflation does not imply a dramatic fall in prices but rather a collapse of real demand, production, and employment.

Revised from *Monthly Review*, 53(11): 15–21, April 2002, 'The Argentine Crisis,' by Halevi, J. With kind permission from the editors of *Monthly Review*. All rights reserved.

The Argentine hyperdeflation is the direct result of attempting to integrate the economy into the international financial capitalist system by permanently enforcing an anti-inflationary and anti-expansionary policy. In so doing, Argentina's capitalist class, supported and prodded by the U.S. Treasury and by the International Monetary Fund (IMF), first destroyed the domestic social security system and welfare network and, in the last two years, engendered a total breakdown in the economy up to the point of blocking currency circulation. The entire episode constitutes an important historical case in which domestic class interests converged with international financial interests, eventually leading to the destruction of the livelihood of the bulk of the Argentine people, 50 percent of whom are now living below the poverty line.

28.2 The Mechanics of the Crisis

The political crisis of this important South American country formally erupted when, in the first week of December 2001, the IMF decided to withhold a \$1.3 billion loan approved for servicing the country's \$142 billion external debt. The IMF claimed that the government, then led by President Fernando De la Rúa of the Radical Party, was not meeting its commitment to further cut its spending. This claim was false. From the fall of 2000, when the Argentine government entered yet a new round of negotiations with the IMF, until the Buenos Aires uprising of last December, the government has systematically cut spending. It privatized social security and cut the provinces' funds, forcing many of them to use surrogate (scrip) money to meet their payments. During the summer, the economic minister, Domingo Cavallo—a darling of the IMF who, by the way, was undersecretary of the interior (Federal Police Department) during the bloodthirsty military dictatorship in 1981—set the goal of a zero budget deficit. If the target was not attained, it was not for lack of trying, but because of the galloping social crisis, with unemployment reaching 18 percent and an equal percentage classified as underemployed. Immediately after the withholding of the loan by the IMF, the government embarked on an even tougher round of cuts, which included freezing people's bank accounts and limiting withdrawals to \$250 a week. It was at this point that the people of Buenos Aires rose up against the government.

28.3 The Argentine Debt

The explosion of the country's debt began with the military regime in power from 1976 to 1983. Overall, external debt rose nearly four times, from \$9.7 billion in 1976 to \$35.7 billion in 1981. The public component of the debt was significantly expanded by armament purchases, to the great pleasure of the U.S. government, which supported the repression of the popular forces by the Argentine military and wanted the dictatorship's participation

in repression and torture in Central America. However, despite the increase in government spending, the private sector was the primary external borrower. The public component of the external debt was actually smaller in 1981 (56 percent) than it was in 1976 (68 percent). It follows that the expansion of the debt was more pronounced on the private than the public side.

In Argentina, the military dictatorship of 1976–1983 was the *avant garde* of neoliberalism. It introduced a new foreign investment law facilitating acquisitions and financial investment while freeing the exchange rate from government controls. Forshadowing what would come two decades later, these measures attracted capital from abroad while international financial companies and banks, awash with money from oil price increases, were aggressively pushing loans onto third world countries. Though not a traditional third world country, Argentina was no exception. It must be stressed, however, that the neoliberal orientation of the military would not have been possible without the physical extermination of the activists of the popular forces. The military dictatorship led to a tight alliance between multinationals, financial capital, and local business elites, an alliance which became dominant throughout the 1980s. This bloc reversed the import substitution strategy that characterized Argentina's substantial industrial growth in the 1960s. It was under this alliance that the external debt explosion occurred, while the productive system started to suffer from chronic deindustrialization.¹

By 1981, the military regime undertook the task of absorbing the private external debt, obtaining, in the process, the support of the International Monetary Fund. After the fall of the dictatorship, the policy of debt socialization was continued by President Raul Alfonsín of the Radical Party, under the explicit request of the creditor countries. As detailed by Eduardo Basualdo¹, the Central Bank and private companies would agree on a particular exchange rate, relative to the dollar, for the reevaluation of the dollar denominated external debt in the steadily devaluing local currency. At the moment of the transfer of the debt to the state, companies would then receive a subsidy corresponding to the difference between the agreed and the actual (and now depreciated) exchange rate. Thanks to various schemes, all based on this principle, private companies were relieved of most of their debt. Initially, the main beneficiaries were the multinationals, which had also been the main borrowers, but the policy was subsequently extended to Argentine businesses as well.

This socialization of private debt had harmful consequences for the economy. Before the U.S.-supported military dictatorship of 1976–1983, Argentina's external economic relations were characterized by cyclical balance of payments crises. In a semi-industrialized country, bouts of growth generate a rise in imports of industrial products greater than the exports of primary products. The ensuing external deficit then compels the authorities to slow down the economy (to reduce imports) by engineering a domestic recession.

However, the private-turned-public debt incurred during the military regime changed the nature of the problem. The external problem was no longer cyclical but permanent, while the link with the domestic economy became much more malignant as the debt burden caused the disruption of public finances and the drift towards hyperinflation, as the government printed money to pay for its domestic expenditures.

By the end of the 1980s, the new president, the Peronist Carlos Menem, vowed to end hyperinflation and stagnation through a plan that would also bring Argentina's capitalist classes back into the fold of international finance. Very quietly in 1991, the Menem government passed a law, designed by the aforementioned Domingo Cavallo. It legislated a monetary reform whereby the new money unit, the peso, was legally linked to the U.S. dollar on a one-to-one basis. The need to fight the vicious cycle of hyperinflation-devaluation-hyperinflation was taken as the justification for the strict dollar-peso parity. The ensuing stabilization was supposed to stop the endless revaluation of the dollar-denominated external debt, thereby allowing Argentina's ruling classes to become citizens of the world "financial community."

Since the 1991 law, private debt expanded about eleven times, while the public debt grew by less than 60 percent, totalling together \$142 billion by the end of 2001. In essence, during the last twenty years, the Argentine population has been subjected, in sequence, to the following mechanism. The state takes upon itself the burden of the private external debt. The private sector keeps running up additional debt, while the state sells out its public activities through privatization policies, thereby generating financial profits (rents) for the private corporations whether national or international. The state then unloads the burden of debt onto the whole economy, especially the working population, by compelling the population to deliver a financial surplus at the expense of wages, social services, and public investment.

28.4 Stabilization and the Collapse into Hyperdeflation

The economic validation of the law passed in 1991 depended on an automatic mechanism whereby domestic monetary creation had to correspond to the net amount of dollars entering the country. Theoretically, the balance between the net inflow of dollars and domestic monetary creation can be guaranteed through (a) large surpluses in the current accounts (exports greater than imports) or (b) net capital inflows. To make the current account sustain the whole process of monetary creation is impossible as it would require a very big surplus in relation to national income. Furthermore, throughout its post-war history, Argentina tended to have a surplus in the balance of trade but a deficit in the balance of payments. This is a common situation for countries whose productive links with the rest of the world are through the raw materials sector.² The surplus in the trade sector is more

than offset by the payment abroad of interest, dividends, insurance, and other services. As to capital inflows, they can be stimulated by (1) the buoyancy of demand so that foreign companies want to invest there; (2) the transformation of the country into a cheap export platform like Mexico; (3) privatization of public activities such as utilities where a steady flow of rents is always guaranteed; and (4) borrowing on international financial markets. The first condition, the buoyancy of demand, was nonexistent, as the country had been mired throughout the 1980s in an economic crisis with hyperinflation. The fixed parity between the dollar and the peso reduced the attractiveness of the country as an export platform, so that the implementation of the stabilization program based on dollar-peso parity depended on privatization and further borrowing.

Menem's monetary reform sat very well with the interests, views, and aspirations of private financial institutions, both local and international, and his policy received full backing from Washington, without which implementation would not have been possible. Privatization and budgetary austerity attracted capital, thereby expanding domestic monetary creation and leading to a euphoria that, between 1991 and 1995, generated a growth rate in excess of 4 percent per year, among the highest since 1945. The Argentine ruling classes thought that they were truly back in the fold of the advanced capitalist world. But as soon as the monetary reform got underway, the country lost its traditional surplus in the balance of trade, although not in a dramatic way. However, it kept showing a growing outflow of investment income for payments on interests and dividends abroad. As a consequence, the overall current account balance deteriorated sharply, so that reliance on capital inflows increased. The flimsy nature of the growth phase has been underscored by the recession caused by the Mexican crisis of early 1995; in its wake, the Argentine economy contracted by 3 percent.

Fearing a fate similar to that of Mexico, financial capital became apprehensive, but the crisis was temporarily overcome due to trade expansion within the Mercosur area (a common market integrating Argentina, Brazil, Paraguay, and Uruguay), where Brazil is by far the largest economic unit. The government of that huge country was also following a policy of deregulation and of anchoring the local currency (the real) to the dollar, although not as strictly as Argentina's peso. This kept the value of the real high, while Brazilian inflation remained high relatively to Argentina's. This factor entailed a revaluation of the Brazilian currency, thereby stimulating Argentina's (now cheaper) exports. In 1989, around 11 percent of Argentina's exports went to the Mercosur area. By 1995, that percentage had risen to 31.7, and by 1998, just before the inevitable Brazilian crash, Mercosur absorbed 35 percent of Argentina's exports. International financial companies were treating both Brazil and Argentina as emerging markets, with highly-valued and high-risk currencies. Thus, on one hand, they were pushing loans onto them—which the voracious and rapacious local capitalists were quite willing to

see granted, since it would be left to the wage and salary earners to pay anyway—but on the other hand, they wanted to protect themselves against so-called country risk. Financial companies and security houses are no fools. They know that Brazil and Argentina are not the United States, whose external deficit can be financed by issuing bonds which will be accepted by the rest of the world without placing limits on U.S. monetary authorities. In the case of peripheral countries, a persistent and rising external deficit is immediately translated into a threat of insolvency. In both Argentina and Brazil, external deficits were rising because the stabilization of the currency involved loss of domestic production in favor of imports. Hence, with the Mexican crisis of 1995, the additional “country risk interest rate” charged on Argentine borrowing increased considerably. When Brazil collapsed in 1998, leading to a 40 percent devaluation of the real, the game was up also for Argentina.

The Brazilian crisis put to rest any illusion regarding the possibility of long-term growth in the Southern Cone countries of Latin America. It also highlighted a fundamental truth for those not blinded by the mirage of spectacular gains from financial speculation: real production could not possibly sustain the enormous debt and interest burden of Argentina. This is indeed the crucial point. No reasonable level of net exports could have sufficed to help the country out of the debt trap. Without the debt burden, Argentina’s deficit, while getting worse, was not dramatic, especially in merchandise trade. Most of the damage was done by the outflow of financial payments on interests, repatriation of dividends, and services. To this one must add the export of capital engaged in by the Argentine capital-possessing classes. After the Brazilian crisis, the country risk interest rate shot up and kept growing when it became clear that Argentina would not be able to generate even a minimal net flow of funds from its operations with the rest of the world. As a consequence, the peso-dollar parity which sustained the new wave of privatization and financial speculation could not be maintained much longer. The U.S. treasury and the IMF knew this all along but insisted on austerity plans, the real purpose of which was to put the country’s assets on sale.

The class-based connection between international and local finance capital can be seen from the fact that the entire adjustment of the external debt burden was imposed on the real economy, while capital was enticed with promises of easy gains through privatizations, monopolistic rates indexed to the dollar in the event of devaluation (in utilities, for example), and the freedom to exit the country quickly. The debilitating and, indeed, devastating effects of these policies are evident in the persistent deindustrialization and increased exploitation of workers, which affected the country even during the years of the growth euphoria. From 1992 to 2000, hourly labor productivity increased about 45 percent, while money wages stagnated and real wages fell. During the same period, unused productive capacity remained high, at around 30 percent of potential capacity. It increased further as

growth stalled and the crisis deepened. These factors taken together created, from the period of the growth euphoria onward, a persistently high rate of unemployment and underemployment now affecting more than 40 percent of the active population. Furthermore, the structural impact of the financial liberalization period is jeopardizing the possibility of some kind of recovery, even assuming the rise to power of a progressive alliance. The value of imported capital goods and spare parts for machinery rose from 25 percent of total imports in 1991 to 45 percent in 1998. This means that deindustrialization has gone so far as to prevent the establishment of a minimal autonomy in the working and planning of the productive apparatus. In this respect, Argentina has moved further down the ladder of undeveloping economies and is now in a much weaker position to undertake programs aimed at ending poverty and recession.

The year 2000 witnessed the formation of a large social front against the alliance of the government, the IMF, and financial traders. Mass demonstrations occurred against negotiations with the IMF, which were correctly seen as leading to further austerity and economic crisis. But neither the government nor the Peronist opposition, which went so far as to suggest a total dollarization of the economy, were interested in getting out of the mechanism of financial dependency. The IMF tried to open the door to financial liberalization still further. Each round of talks involved new austerity measures, and, as if the whole thing was actually stage-managed, international lenders increased the pressure by jacking up the risk interest rate on loans. Thus, financial institutions—national and international—were the usurers, and the IMF was the debt collector empowered with strangulation techniques. Yet the loan package negotiated during the fall of 2000, which brought about the explosion of the crisis, shows the tight linkages between local capital and international groups. The privatization of the social security system was the most important and explosive component of the deal with the IMF. This measure was not in the original package, but the De la Rúa government wanted it in order to give a huge gift to private insurers. Too cowardly to present the measure directly before Congress, the government asked the IMF to include privatization as a condition for new loans. The bonanza for private companies is evident from the 30 percent commission they get for managing the funds that they then transfer to the government at risk-adjusted, exorbitant interest rates!

For the comprador classes and government of Argentina, the only way to maintain the currency agreement with the dollar—on which the entire domestic monetary creation depended—was, after having sold all possible national assets, to borrow more. However, each additional borrowing augmented the risk premium demanded by lenders. In July 2001, the routine issuing of three-month treasury bills turned into a crisis when the requested interest rate was increased from 9 to 14 percent, despite the ongoing deflation, which makes the real burden of interest payments much worse.

The government's response was to introduce additional restrictions, with Economic Minister Cavallo announcing an impossible zero budget deficit policy. Obviously unable to achieve this objective, the government was notified by the IMF in early December 2001 that a \$1.3 billion loan was being withheld (exactly the same sum in exactly the same period was granted to strategically pivotal Turkey). The IMF decision led the government literally to steal the money from the public by blocking checking accounts and bank deposits. This was the last straw and brought a rather diverse array of classes onto the street, chasing De la Rúa from office. But even in the hours of agony, the political establishment wanted to benefit the wealthy classes and the financial companies by temporarily keeping the peso-dollar parity while inventing a new currency, the *argentino*, not tied to the dollar. Prices, rents, and interests were supposed to stay in dollars or pesos, whereas pensions and wages were to be paid in *argentinos*, whose value was suspected to collapse relative to the dollar or the peso. The population caught on immediately to the swindle engineered by the interim president, the Peronist Rodríguez Saa, and chased him out in turn. The present president, Eduardo Duhalde, is now walking a tight rope between re-establishing ties with the IMF and avoiding the next explosion of popular anger.

From adjustment to adjustment, from deflation to deflation, the Argentine authorities and the IMF have succeeded in imploding the currency, without which a capitalist economy cannot function. However, a stable restoration of capitalist relations in Argentina is unlikely in the current climate of world financial crises. It would be much more practical to abandon any connection with the IMF and its clients and proceed directly towards the construction of a planned economic system based on social needs.

Notes

The author wishes to thank the CEMAFI (Centre Études en Macréconomie et Finance Internationale) of the Université de Nice for hosting and supporting him while writing this paper.

1. Fernando Hugo Azcurra, *La "Nueva" Alianza Burguesa en Argentina* (Buenos Aires: Dialectica, 1988); Eduardo M. Basualdo, *Deuda Externa y Poder Economico en la Argentina* (Buenos Aires: Editorial Nueva America, 1987).
2. The U.S. current account deficit is of a totally different nature. The United States has a deficit in the balance of trade and a surplus in services, most of which are financial. Moreover, the origin of the U.S. deficit is not in structural dependency relative to other industrialized countries. It is rather the outcome, as Paul Sweezy put it, of the costs of imperialism, including the necessity of supporting Japan and Eastern Asia during the wars in Korea and Vietnam.

29

Imperialism Today

Joseph Halevi

29.1 Introduction

Economic theories of imperialism were developed when (i) large corporations began to dominate production and markets, thereby bringing to an end the vision according to which economies expand endogenously by means of competitive accumulation in the Smithian and early Marxian sense (Sylos Labini, 1993), and (ii) the issue of surplus production and capital, connected to the phenomenon described in (i), began to seriously occupy the minds and action of policy-makers and related institutional bodies. In this respect the USA occupies a special place as it was a trail blazer in imperialism and its manifestation as a quest for markets and capital outlets. By the end of the nineteenth century Britain was already on its way to becoming a rentier-oriented economy and its main concern was how it could, using the crucial role of Indian net exports to the world in order to effect a transfer back to the British metropolis, manage international capital flows in order to deal with a deepening balance of payments deficit. In the same period, however, the USA's concern centred on how to guarantee an appropriate level of international demand for its output. The latter was deemed to be chronically in excess of that required to meet domestic demand. The preoccupation was best expressed by the State Department in a memorandum dated 1898, the year of the American–Spanish War, which was to bring Washington into Asia through the occupation of the Philippines.

It seems to be conceded that every year we shall be confronted with an increasing surplus of manufactured goods for sale in foreign markets if American operatives and artisans are to be kept employed the year

Revised from *Rosa Luxemburg and the Critique of Political Economy*, 117–129, 2009, 'Imperialism Today', by Halevi, J. With kind permission from Taylor and Francis LLC.

around. The enlargement of foreign consumption of the products of our mills and workshops has, therefore, become a serious problem of statesmanship as well as of commerce.

(quoted from Zinn, 1998: 5)

In Europe the conceptualization of the political economy of imperialism is ascribed to Hobson, Hilferding, Luxemburg, and to Lenin via Hobson and Hilferding. But in the USA the process started earlier and involved, in a fashion sympathetic to imperialist expansion, especially towards Asia, economists of an institutionalist orientation. Charles Conant, for instance, theorized both the system of administered prices in industry and the open door policy towards China. He did so to counter the strategy pursued by the Continental powers and by Britain involving the carving out of special areas of control within that country (Sklar, 1988). Cognizant of the devastating effects of price wars during the early stages of the rise of large corporations, Conant argued that investment can be expanded only by securing stable prices. To a very large extent his approach is more advanced than that of Hilferding. For Conant the internationalization process is not the autonomous by-product of private decisions. Instead it must go through state relations, otherwise the appropriate mechanisms required to enable international investment would not be set in place. In practice, and with both eyes on China, he advocated direct intervention to bring about the modernization of non-capitalist areas in order to usher in an expansion of investment and exports from the industrial centres. Such an intervention should be agreed upon by all the industrial countries, which should also cooperate to allocate to themselves shares of world development in proportion to their own productive capacity. Needless to say, the largest share would have had to accrue to the USA.

Those ideas were part and parcel of the mind-set of the political and economic establishment in the USA, caught between the intense expansion of the nation's productive capacity since the end of the Civil War and the persistence of excess capacity expressed in the long depression of the 1890s. China became the concrete target and terrain of the above economic, political and institutional views, thereby starting, slowly but surely, the trajectory leading to the clash with Japan (LaFeber, 1997). The USA did, in fact, reach the status of a superimperialist power, but not until 1945 and only in such a way as to systematically undo its coordinating role for the world capitalist system. More than a century after the American Spanish War – which saw the emergence of the USA as a world imperialist country motivated to create market outlets for its surplus capacity – the USA's predicament is closer to that of Britain one hundred years ago. It is governed by the necessity to deal with its growing balance of payments deficit lest the country be plunged into a debt deflation crisis. Yet the world cannot be to the USA what India was to Britain. India produced primary commodities and exported them, and was

kept in a state of underdevelopment. Britain used the Home Charges (taxes paid by India to London), protectionism against Indian exports to the UK, free access to the Indian market by British industries and, last but not least, control over the London discount rate to siphon off the Indian external surplus and Indian capital in general (Sen, 1992).

By definition, the rest of the world has no external surplus with a third party to be siphoned off to the USA unless it has net exports to the moon or to some other planet. The only way in which the USA can avoid drastic deflation to adjust the external balance is by compelling the rest of the world to keep rechannelling the surplus it earns with the USA to the US financial system itself. During the last decades of the Gold Standard-based British Empire the position of the metropolitan core was secured by political and institutional mechanisms at least as important as the so-called economic ones. The gap between political instruments and economic mechanisms is much, much wider in the USA than in Britain and the refinancing of the US external deficit and the sustainability of the debt economic factors – or ‘laws’ – are of secondary importance. Thus, the instruments used to guarantee the international financial position of the USA are primarily political and military.

29.2 From pre-Second World War imperialisms to post-Second World War US imperialism

In the light of the transformations induced by post-war capitalism, which in reality is centred on what French writers have called ‘la Triade’ comprising the USA, Western Europe and Japan, it would be legitimate to ask what remains of the economic theories of imperialism listed above. An attempt in this was made in 1971 by Michał Kalecki and Tadeusz Kowalik in a paper published in the, long defunct, economic quarterly of the Communist Party of Italy, *Politica e Economia* (Kalecki and Kowalik, 1971). By reviewing the Marxist streams about imperialism, Kalecki and Kowalik argued that capitalism had attained a state similar to the superimperialism outlined by Karl Kautsky in which intracapitalist violent confrontations were unlikely to occur. The crucial reform which stabilized capitalism was due to the applications of a Keynesian ‘financial trick’ based on military expenditures which provided an outlet for the surplus in the pure Baran-Sweezy sense. The financial trick, coupled with an increase in wages along with productivity, stabilized and absorbed the working class into the system.

Another attempt to look historically at the economic transformation of imperialism surfaced barely a year later in a book written by former Chase Manhattan Bank’s economist Michael Hudson (1972, 2nd ed. 2003). Hudson captured the novel nature of US imperialism before its essential features were fully detectable. US institutions operate politically and militarily not to expand the production and exports of US-based corporations but to

make more room for the operation of those very corporations outside the USA regardless of the effects on the American territorial productive system. Furthermore, the USA as an institutional body appears as a surplus collector not as a surplus distributor via capital exports. This is connected to what Hudson called monetary imperialism. In both the Baran–Sweezy–Magdoff (see Magdoff, 1978) approach and in the Hudson writings superimperialism is specifically American and it is the product of the historical process that led to the Second World War and to its outcome. Rather than a convergence of multiple and potentially conflicting imperialisms, contemporary superimperialism would be based on the disintegration of the geo-economic spheres of the conflicting imperialisms and the emergence of one hegemonic, single state-centred, imperialist country.

The economic interests prevailing in this kind of country, that is in the USA, do not tend towards exports. Thus, its imperialism cannot be ascribed to the wish to find profitable external markets for its own internal potential surplus capacity as thought by Rosa Luxemburg. Nor is the viability of the economy of the country based on securing investment outflows reflecting the need to place somewhere the surplus of money capital (Hobson and Lenin). Indeed, the macroeconomic viability of the country as a set of institutions protecting the interests of its own global capital depends much more on the ability to generate (compel) an influx of money from the rest of the world. This is the crucial flow that must be guaranteed at all costs, hence, and especially, by non-economic means. Certainly, once the crucial influx is secured, the moneys can then be redirected elsewhere abroad. This is how the British metropolis operated (Bagchi, 1982).

In my opinion, the revolutionary Marxists of the *belle époque* looked at Britain but had Imperial Germany in mind. Hence, they saw surplus money capital and surplus capacity in a combined manner. By taking on board Hobson's Britain-centred view of imperialism, Lenin viewed Britain as bent on exporting its domestic surplus capital. Rosa Luxemburg, for her part, looked at Germany which – via the Berlin Conference of 1884 and through its export drive, well detailed in Marcello De Cecco's classic work on the Gold Standard (De Cecco, 1974) – tried to exports its surplus capacity. Both approaches fitted quite well in the Hilferding-type framework of the struggle for economic cartelization both within each industrial country and internationally.

I will now present what I believe to have been the characterization of imperialism during the *belle époque* until the Second World War.

Let us start with Britain. That was the most accomplished form of imperialism as it exploited India to generate financial surpluses for the City of London while the Empire provided a preferential system for British products. But, as De Cecco pointed out, overall British exports as part of total exports were on the decline in third markets because of the rise of Germany and the USA. Beyond the captive markets of the Empire, the issue of

effective demand/realization was not the major concern of British imperial institutions as the economy ran a growing trade deficit. Rather these institutions were preoccupied with guaranteeing a steady influx of capital, relying on India and also control of the international monetary system known as the Gold Standard but, in fact, a pound sterling standard. The whole British geopolitical strategy, including that towards the Middle East, was organized around the economic role of India as a source of international surpluses for British financial imperialism.

We now move to the USA and Imperial Germany. These were the two countries seriously concerned with market outlets. The main plank of the US stance was the open door policy towards China. Although Japan was Asia's main importer of US products, the myth of China's market determined US policy towards Japan. The USA sought to combine direct investment flows to China with US exports. Note that US institutions thought that the amount of 'capital' needed to develop China would be greater than what the USA could supply. Thus, they viewed New York as the conduit of 'capital' from the rest of the world to China. And they considered that the spending of that 'capital' would materialize in demand for predominantly US products.

Imperial Germany, by contrast, although quite successful in exporting from its own domestic basis, wanted to create an integrated hinterland of raw materials and markets also outside Eastern Europe, on the very turf of the British and the French in Africa. Hence, the myth of *Mittle Afrika*, striding mostly French-dominated Central and West Africa and the Cairo to Cape Town axis. Germany never obtained much from these imperialist aspirations. It had a much more effective centre-periphery relation with Eastern Europe and parts of the Tsarist Empire such as Poland and the Ukraine. By 1914, Imperial Germany was the largest holder of bullion, mostly because of net exports and of non-gold arrangements with Eastern Europe. Its extra-European economic relations worked much better with Latin America, both for exports of industrial products and for imports of raw materials, than with Tanganyika in Africa and other colonies such as Papua New Guinea in Oceania. But the drive towards British-type imperialism produced a Bismarckian-Luxemburgian effect: the formation of a strong steel-based army and navy, which expanded the heavy, mechanical and chemical industries in a highly cartelized framework (Berghahn, 1996). Thus, for German capitalism, imperialism meant preparing for war, and this had a positive impact on profits and accumulation.

Japan's imperialism was centred on the integration of markets and raw materials for the metropolis. Japan proceeded following a virtual and original Marxist textbook on imperialism where the latter constituted a necessary condition for industrialization. This happened even before the transfer of industry from the State to the Zaibatsu families was completed. Japan invaded Formosa (Taiwan), transforming it into a source of rice. It established a foothold in Manchuria, a centre of iron ore and a relatively

important market, after the war against Tsarist Russia in 1905, and occupied Korea in 1910. All this was accomplished with a strong support from London and a nod from the USA, which did not mind seeing a local power unsettling the European strategies of carving out parts of China. But Japan's objective, in systemic conflict with the USA, was China, and the impact of the Great Depression on the political make-up of the country was so strong as to give a major impulse to the conquest of the whole of China through the Manchuria incident of 1931. After devaluing the yen, Japan combined monetary Keynesianism, through budget deficits and low interest rates (Nanto and Takagi, 1998), with Baran–Sweezy military spending for the war against China, initially directed to affirm its position in Manchuria but later extended to the entire country. For Japan the 1930s was a period of 'chemical and heavy industrialization', without which the Japanese brand names of today would not have seen the light. But again the impact was mostly through the Keynesian effect of military spending since Japanese imperialism failed dramatically in the other British Empire type of task. As pointed out by Takafusa Nakamura in his two magnificent books on Japanese economic growth (Nakamura, 1981, 1983), Tokyo failed to have the yen area operate like a financial lung machine for metropolitan Japan. The yen area was supposed to have a current account deficit with Japan but to generate surpluses with the dollar and sterling areas to alleviate Japan's own deficit with those two areas. Nakamura showed that, although the deficit of the yen area with Japan was bigger than the deficit of Japan with the dollar and sterling areas, the external surpluses of the yen area, earned in dollars, sterling and gold, were not sufficient to settle, in hard currencies or gold, the external deficit of metropolitan Japan. The more Japan tried to bridge the gap by extending its conquest of China, the more the USA tightened its control on Japanese imports of oil, and the more Japan expanded its operations, the more oil it needed. By 1939 the balance of payments position of Japan was no longer manageable. What followed is known. It should be noted that, although military spending had a standard Kalecki–Baran–Sweezy impact, Japanese imperialism was original in its kind. It aimed at conquering resources for the development of additional productive capacity. It did not reflect actual surplus capital and unused capacity.

The elements common to the US, German and Japanese imperialisms relate to the central function played by oligopolistic/monopolistic corporations. Considering, however, the different dynamics of these imperialisms and the fact that by the end of the day (1945) they were squashed by the USA, courtesy of the USSR, the only element of continuity between the Marxian conceptions and the post-war situation is the prevalence of oligopolistic capitalism. In this context, François Chesnais (1997) has produced the most recent work focusing on the contemporary global economy as a system of world oligopolies. However, Chesnais does not pay much attention to the geopolitics of the process, virtually assuming that the action

of world oligopolies is naturally abetted by the capitalist countries. It, therefore, misses the crucial functions of politics and institutions in shaping the hierarchical configuration of the post-war capitalist world economy.

29.3 Post-war imperialism: the USA

In my view, an understanding of the US imperialist trajectory depends on an awareness of both the international economic relations linking the USA to Asia, and to China in particular (Gallicchio, 1988; LaFeber, 1997), and the role of the energy and finance sectors. The first aspect is what put the USA and Japan on a slow but sure collision course. The force pushing towards the clash was, from the US perspective, quintessentially a fear of lack of markets. The economic method was partly consistent with Lenin's view: capital exports will generate import demand for US products. The second aspect will be discussed later.

No sooner had the USA attained its full global projection in 1945–46 than it was compelled to undertake measures that led it to relinquish the search for market outlets. It is an example of an attempt to implement a grand design that generated, bit by bit and through geopolitics, unintended consequences of an opposing nature. The grand design was hammered out by Secretary Cordell Hull during the Second World War and especially during the lend and lease programme with the UK, undertaken with the specific post-war objective of conquering the markets of the British Empire. Quite simply, Washington told London that Britain could pay later by opening the markets protected by the system of imperial preferences devised at the Ottawa Conference in 1932. By the early 1950s, the USA was busily dismantling the remnants of those preferences in order to open up markets for... Japan! Furthermore, the creation of markets for Japan did not mean that the capital investment would come from the USA so as to enable US multinationals operating in Japan to export to those markets. The opening up of markets for Japan went hand in hand with closing the window for US multinationals in Japan and East Asia. US multinationals only entered Asia much later, in the early 1970s in Malaysia, Singapore and Thailand and, from the mid-1980s, in China, always, perhaps unwittingly, as trail blazers for the Japanese *keiretsus*. This is a story which, very little known in Continental Europe, is worth summarizing because it highlights the contradictory nature of post-Second World War imperialism in relation to the other capitalisms.

To avoid any misgiving, it is important to understand that the actions undertaken by Washington were not a response to a Soviet threat. Gabriel Kolko has written extensively about this, demolishing the orthodox view (Kolko, 1988). Rather, these actions were the product of the grand design itself conceived because a major piece on the chess board was no longer there the way Washington wanted it to be: China. The end of the nationalist regime in China highlighted the issue of the Third World as a crucial

strategic question for the USA and it guided the US-sponsored reconstruction of world capitalism. Kolko's studies are well synthesized by Chomsky (1992).

The basis for U.S. policy in the Cold War era is outlined with considerable clarity in the internal record of planning. With unprecedented economic and military preeminence, the U.S. prepared to become the first truly global power. Not surprisingly, corporate and state managers hoped to use this power to design a world order that would serve the interests they represented.

During the war, US planners developed the concept of a 'Grand Area', a region understood to be 'strategically necessary for world control', subordinated to the needs of the American economy. In its early stages, the Grand Area was conceived as a US-led non-German bloc. It was to incorporate the Western hemisphere, the Far East and the former British empire, which was to be dismantled along with other regional systems and brought under US control. Meanwhile, the USA extended its own regional systems in Latin America and the Pacific on the principle, expressed by Abe Fortas in internal discussion, that these steps were justified 'as part of our obligation to the security of the world... what was good for us was good for the world.' British officials were unimpressed, denouncing 'the economic imperialism of American business interests, which is quite active under the cloak of a benevolent and avuncular internationalism' and is 'attempting to elbow us out.' As it became clear that Germany would be defeated, the Grand Area concept was extended to include the Eurasian land mass as well, as far as possible. These general plans were applied to particular regions with much consistency.

With regard to the Soviet Union, the doves were reconciled to a form of 'containment' in which the Soviet Union would control most of the areas occupied by the Red Army in the war against Hitler. The hawks had broader aspirations, as expressed in the roll back strategy of NSC 68. U.S. policy towards the Soviet Union has fluctuated between these positions over the years, reflecting in part the problem of controlling the far - flung domains 'defended' by U.S. power, in part the need for a credible enemy to ensure that the public remains willing to support intervention and to provide a subsidy to advanced industry through the military system.

The Grand Area was to have a definite structure. The industrial societies were to be reconstituted with much of the traditional order restored, but within the overarching framework of U.S. power. They were to be organized under their 'natural leaders,' Germany and Japan. Early moves towards democratization under the military occupation caused deep concern in Washington and the business community. They were reversed by the late 1940s, with firm steps to weaken the labour movement and ensure the dominance of the traditional business sectors, linked to U.S.

capital. Britain was later to undergo a similar process, as did the United States itself.

Moves towards a European economic community, it was assumed, would improve economic performance, reconcile all social sectors to business dominance, and create markets and investment opportunities for U.S. corporations. Japan was to become a regional leader within a U.S.-dominated global system. The thought that Japan might become a serious competitor was then too exotic to be considered: as late as the 1960s, the Kennedy administration was still concerned with finding means to ensure Japan's viability. This was finally established by the Vietnam war, which was costly to the United States but highly beneficial to the Japanese economy, as the Korean war had been.

(Chomsky, 1992)¹

Let us now consider more closely, through the Japanese case, why second postwar USA imperialism does not correspond to the various characterizations given to it by the Marxists of the Second International.

Until 1937, the USA was a major exporter to Japan and displayed a monopolistic domination in some crucial markets. For instance, around 90 per cent of the Japanese automotive market was supplied by American companies both locally and through imports from the USA. That year Tokyo extended its war in China to the whole country and expelled all foreign automotive companies, thereby requisitioning their plants and facilities. In 1940, the imperial government passed very strict anti-foreign investment laws for virtually every sector of the economy. Ten years later, in 1950, the new Japanese government reiterated those very laws with the support of SCAP,² which remained in charge of Japanese affairs even though the country had regained its formal independence in 1952 with the San Francisco Treaty. Not only did Washington, as the highest authority in Japan, approve the discriminatory measures of the Tokyo government, but it embarked on a consensus-seeking campaign within the USA. American businesses were sold the Marshall Plan – to which, initially, both companies and politicians were opposed – on the premise that it would increase essential US exports to Europe. Furthermore, unlike the case of Japan, US multinationals were not touched during the war: they continued to operate as US property both in the UK and in Germany. But when Japan reiterated the anti-foreign investment laws, it became very difficult to sell Japan to large sections of American businesses. The consensus was obtained by a combination of *fait accompli*, subsidies to the most fearful sectors, such as textiles, security-based arguments, and finally, a not so implicit assumption that Japan was bound to have a persistent deficit with the USA. Hence, if American banks and exporters wanted to be repaid they should allow Japan to again develop its own industries in order to be able to export and earn foreign currencies. Failing that, Japan, given its crucial security role, was destined to become a

bottomless pit of US aid, a scenario that scared not only conservative bankers but also businesses (Forsberg, 2000).

Things came to a head again during the negotiations for Japan entry into the General Agreement on Tariffs and Trade (GATT), which occurred in 1955. Tokyo refused to abide by reciprocity in trade relations and France and Britain stated that they, and the countries over which they had influence, such as Australia in the case of Britain, would use clause 35 of GATT's statute which allowed tariffs and other retaliatory measures against the countries refusing to implement reciprocity. To forestall such a move, the USA signed 13 trilateral trade agreements with the countries that together accounted for more than 50 per cent of Japan's trade. Those agreements stipulated that countries would accept Japan's non-reciprocity in return for greater access to US markets. But, domestically, in order to placate US capitalists, Washington had to embark on a new round of subsidies and of cajoling activities (Borden, 1984; Forsberg, 2000). And, as noted by Forsberg, the whole strategy of making France and Britain accept the non-reciprocity of Japan and forgo the use of clause 35 was to open up South-East Asian markets and Australia and New Zealand to Japanese exports. Yet, these were also areas falling under the system of imperial preferences, renamed Commonwealth preferences. Hence, what, under Cordell Hull, had started as a US plan to dismantle British-controlled areas in favour of US exports and investments became instead a US policy directed towards the recreation of a Japanese economic zone against American exports and American foreign direct investment (FDI).

Mutatis mutandis, asymmetrical relations were established, in the domain of trade, and in relation to Europe, but here the space open to US industrial multinationals was very wide, especially in Germany, Belgium, France and, of course, Britain. Thus, if we look comprehensively at the 1945–71 period we see that US multinationals had quite limited room for operation in Asia, especially in Japan but also later, in the 1960s, in South Korea and Taiwan, as a result of exactly the same policies of asymmetrical relations. US multinationals, in sectors consistent with the objectives of the five-year plans, were more accepted in India, whose government followed a foreign policy line that Washington disliked. By the end of the 1950s, US multinationals were welcomed in Latin America, supported by Prebisch-inspired policies of import substitution. Yet the growth of these markets was not strong so that the only area where mass profits could be obtained was Western Europe.

Thus, after the Second World War, the USA squashed the other imperialisms, but its geopolitics, inspired by grand strategies of economic hegemony, led to constrain the space of US multinationals, explicitly favouring rival companies. The Vietnam War made sure that Japan would still be sheltered and given the specific and most profitable task of building up Korea, which, in its turn, was sheltered by the USA but always open to Japanese dominance without any concession.

So how did US imperialism manifest itself? Looking for answers in Rosa Luxemburg, or Lenin will not suffice. The central feature of US imperialism was its relationship to the Third World. The Third World was supposed to remain in a situation of neocolonial dependency. Production costs had to be kept really low in order to allow raw material-exporting corporations – mainly US but with a sprinkle of British ones – to charge a good profit margin on them, as exemplified by the tight oligopolistic structure of the Seven Sisters in the 1950s. In this way the USA ended up clashing with Third World developmentalist movements, from Iran to Indonesia, and from Vietnam to the Belgian Congo.

This outlook unified the interest of finance with those of multinational companies in the energy sector and tied them both to the military-industrial complex. As long as the USA ran a net export balance, domestic producers went happily along with those policies although some branches such as textiles and apparel grumbled, especially in relation to Japan. Raw materials played an important part in this strategy (Rotter, 1987). Indeed, the raw material question paved the road to war in Asia and to intervention in the Middle East.

The financial role inherent in the control of oil emerged also in relation to other capitalist countries but mostly after 1971, when the USA abandoned the dollar–gold convertibility, thereby giving a unilateral answer to the eventuality of a dollar–gold realignment caused by the systematic appearance of a deficit in the US external current accounts. The aim of the US government and business was to defend, by means of dollar devaluation, US domestic markets while keeping the international role of the currency. The rest of the world had to accept dollars while Washington could freely fix the central bank's rate and, by implication, the exchange rate. In this context, the oil shock was not an external event as it originated from the very entrails of corporate powers within the USA (Spiro, 1999). On 8 August 1974 Henry Kissinger signed the agreement forming the US–Saudi Arabian Joint Commission on Economic Cooperation, the main task of which was in the financial field. In fact, it coordinated the purchases of US securities by Saudi Arabia. Shortly afterwards, members of the Organization of Petroleum Exporting Countries (OPEC) decided to accept only US dollars for their oil. These events brought about the recycling of petrodollars into the US banking system at the expense of the European and the Japanese. It marked a change in the US stance from supporting global capitalism to clashing with other capitalisms. And that attitude widened in the 1980s when the USA became a globally importing economy generating a systemic external deficit and with growing gaps in its own industrial base.

So what remains of the Luxemburg-inspired view of imperialism? The countries interested in the external markets as a sphere of realization are those of the European Union and Japan. But they are impotent as they do not have the geopolitical capacity to implement a drive towards realization

and must adjust to what comes from the USA. The dominant country is not concerned with realization. What matters is the position of its leading corporations in the world. These may be mostly domestic, like Walmart, but big importers of consumption goods whose production they themselves subcontract to China. Hence, China must remain in the role of cheap producer. Given the disarticulation of the US productive system, the most significant corporations are in the military-industrial complex, highly protected by policy and by federal law, in the resource-based sectors and in finance. The crucial question for the USA is how to compel the others to come to the rescue without questioning US international privilege. But the difference in interests between the USA and the two poles of world capitalism should not be understood as a crucial intercapitalist rivalry as all three are fundamentally united in relation to the Third World. A much greater clash may occur between China and the USA. The interests of those two countries conflict on many different levels and a separate study would be needed to elaborate these; however, the situation has been clearly described by the congressional subcommittee on US–China relations. Note how these scenarios, while throwing into doubt the Marxian theories of the early twentieth century, are compatible with the Baran–Sweezy–Magdoff approach. They explicitly rejected the role capital exports as a way of absorbing the surplus and they did not view exports as a central feature of US capitalism and as a means of surplus absorption. By contrast, military expenditure and actual warfare seems to be fundamental to US corporate interests, as portrayed in *Monopoly Capital* (Baran and Sweezy, 1966).

29.4 Conclusions

The challenge for imperialism today is how to manage US external deficits in conjunction with the growing indebtedness of US households. This indebtedness, combined with the systemic Baran–Sweezy military Keynesianism, is what allows the US economic system to remain socially coherent domestically, in spite of falling real wages. The governance of the deficit, implying a freedom, relative to the rest of the world, to set monetary interest rates, is the crucial element by which US corporation and the US financial system freely acquires world resources. Such a situation brings up again the question of superimperialism raised by Karl Kautsky. He viewed it as a convergence between the then dominant European powers. Contemporary superimperialism does not imply convergence of interests among the advanced capitalist countries. It implies a specific hierarchy that finds its point of equilibrium in treating the Third World as an area of financial rents in addition to its traditional role as supplier of raw materials. It is the Third World that has to (a) undergo the privatization of its national assets to resource and finance multinationals and (b) generate – through the indebtedness that the privatization policies bring about – financial flows

towards the central countries. It is, therefore, not surprising, for instance, that European states directly intervened to protect the interests of their own multinationals after the Brazilian and Argentinian crises of 1998 and 2001. They did so in a much tougher manner than Washington, although the entire process of currency stabilization, leading to hyperdeflation, was conceived by Washington with the ruling technocratic groups of those two countries.

At the same time, however, the largest sections of European capitalism can get only the crumbs of US superimperialism, mostly in the form of net exports to the USA directly, and by outsourcing to China. Yet European capitalism cannot systemically reflate its economies even if it wanted to as its task is to generate the financial surpluses needed to sustain US deficits and the expansion of US international activities linked to them. From this angle, the view that the USA is free from the external constraint – since it issues the international currency par excellence and the holders of that currency have no other option but to recycle their dollar holdings to the USA – is not altogether acceptable. If this were so, a governance problem would not have arisen. In other words, Washington would not have opposed the creation of an Asian monetary fund, as suggested by Japan during the Asian financial crisis of 1997–98, nor would it have expended so much effort in attempting to dollarize Latin American economies. It follows that the persistence of the US hegemonic position requires a subdued economic performance, in terms of capital accumulation, in the other countries of the imperialist centre.

Notes

1. Quoted from: <http://www.zmag.Org/chomsky/dd/dd-c01-s14.html#FN65> (accessed 7 July 2008).
2. Supreme Command Allied Powers, which means the USA.

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