

# Introduction: post-Keynesian economic policy – a post-crisis view

**Claude Gnos, Louis-Philippe Rochon and  
Domenica Tropeano**

---

Whether the worldwide crisis is over is a question that is not easy to answer. After all, economic performances have differed considerably from one country to another, and while banks, where the crisis originated, are now doing much better, the lingering macroeconomic effects are still being felt. Nowhere is this more evident than in the USA, where there is increasing talk of a second recession, and within Europe, where some countries, such as Greece, Ireland, Portugal and Italy, are approaching a catastrophic end, exacerbated no doubt by the strict austerity measures now being contemplated by the European Parliament.

And while it has already been almost four years since the crisis began, the prospects for sustained growth seem far away, leading some now to be openly discussing the industrialized world's own 'lost decade'. Indeed, it is surely legitimate to ask: where will growth come from? On the consumption side, consumers do not seem to be in any hurry to spend; rather, they seem unable to spend. With historic levels of debt, consumers will more probably be busy reducing those debt levels than consuming. Indeed, in most countries, growth in nominal wages has been flat, resulting in decreasing wage shares. In addition, income distribution has become even more skewed, with the top 1 per cent of income earners increasing dramatically their share of total income and total wealth. In the end, consumers are being squeezed and are unlikely able to contribute much to the growth process.

Investment is stagnant in many countries, and governments generally are now adopting austerity measures in an effort to eliminate deficits and reduce debt/GDP ratios. In other words, with  $(C + I + G)$  growth probably minimal, the prospects for growth will rely on exports. This means an increasing number of industrialized countries vying for markets abroad, such as developing countries like China, India and Brazil. But will this be sufficient to sustain worldwide growth?

On the financial side, banks everywhere seem to be doing better (passing

the so-called stress test); even European banks and markets appear to be doing better, although they are only cautiously optimistic. And yet lending has not resumed sufficiently to sustain the growth process. In an endogenous money framework, growth arises from aggregate demand, and is sustained through new bank loans to the private sector, allowing them to hire labour, pay wages and begin production.

Moreover, while inflation remains low in many countries, in contrast unemployment remains stubbornly high. Many economists and policy advisers are urging a second round of fiscal expenditure in order to prevent a further decline in economic activity. However, one thing is certain: signs keep changing from one quarter to another. The crisis was surely no ordinary crisis; it was a crisis of capitalism. And this 'great crisis' certainly has led to some new thinking about economic policy. Governments and central banks around the world adopted a panoply of innovative and rather unorthodox policies.

## STRUCTURE OF THE BOOK

In the first part of the book the chapters deal with issues related to employment policies, economic growth and development, while the second part is dedicated to development and growth issues in open-economy developing countries.

In Part I some major issues of capitalism are analysed from different perspectives. For example, the first chapter discusses economic policy choices to be made in an environment where the solution to the realization problem is damaging to the workers. Two other chapters deal with the different forms of financial capitalism in European countries, such as France and Italy. Another chapter discusses the relation between employment and neoliberal policies in the labour market. The attempts to give a meaning to some familiar concepts such as the concept of the labour market itself as the NAIRU (non-accelerating inflation rate of unemployment) are also enlightening from a heterodox perspective.

In Part II the same problems are discussed from the point of view of a small open developing economy, whose growth is constrained by several factors relating to its type of foreign exchange rate regime, its type of approach regarding movements of capital and the way in which monetary policies are realized. In these chapters, contrary to pure theoretical standard models, the real policy issues faced by some countries are presented as well as the consequences of these decisions. In this context alternative recommendations based on Keynesian ideas are made, in contrast with the Washington Consensus view.

Riccardo Bellofiore and Joseph Halevi outline in their chapter the conditions of contemporary capitalism and present suggestions as to how economic policy should work to modify these conditions. Having given an answer to the problem in respect of the realization of profits, the authors go on to give advice for a leftist economic policy. Capitalism is based on scared workers, terrorized savers and indebted consumers. Furthermore, capitalism has been able to create precarious part-time employment by boosting military spending and debt-financed consumption. Even if there is a sort of Keynesianism now, the current asset-based Keynesianism is predicated on the ability of monetary authorities to support and even to produce financial bubbles. Thus a redefinition of the composition of spending is necessary in order to change its created employment. Bellofiore and Halevi argue that monetary and fiscal policies alone will not work in the present form of capitalism. Due to this, a radical redefinition of the content and composition of governmental spending is needed. The authors argue that to modify income distribution in real terms, it is necessary to generate an active demand policy with the structure of investment. As a result, Bellofiore and Halevi warn that no such policy can be implemented without introducing the segmentation of capital markets and further controls over capital flows.

The chapter by Mehdi Ben Guirat and Corinne Pastoret deals with the economic development pattern of the Maghreb countries. They discuss data based on the composition of GDP and on the economic specialization of these countries, stating that their development is limited by their dependence on foreign imports and by the exclusive production of a few export goods. Ben Guirat and Pastoret conclude that a closer integration into the Mediterranean area might favour a different type of development.

Mickaël Clévenot and Yann Guy develop the idea that the passage from the 'Fordist regime' to a finance-dominated regime may not be easy for countries like France, which do not have the necessary institutional complementarities. The authors use to this end a set of equations describing the balance sheets of different institutional components of the French economy and build a model resembling the one put forward by Lavoie and Godley. The authors argue that the Fordist crisis, which started in the late 1960s, gave rise to significant economic, institutional and political modifications. During the crisis all institutions were affected: state interventions, competition, international regime, the monetary system and wage relations. The authors build a closed-economy model that focuses on the monetary system and wage relations; they then examine the effects of some changes, such as a rise in wages and in dividends. Their conclusion is that from an economic viewpoint, France has indeed entered into a financialization regime but institutions have not kept pace with the new

economic development. This explains the low rate of accumulation of the French economy. Thus firms profit from financial dynamics as shareholders rather than as capitalists. The institutions have to adapt to the new regime as a sustained accumulation pattern must follow.

Domenica Tropeano investigates whether the current decline of the Italian economy can be traced back to financialization. In principle, financialization is not so important for an economy in which many firms are not quoted on the stock exchange and in which shareholders' interests should not matter. The author argues that financialization may have deep effects in such an environment by changing the perceived financial norm and the target return on capital. The author draws on a model by Lavoie (1995a), extending it to an open economy. She uses this model to look at the effects of an appreciation, thus replicating the appreciation of the euro in recent years and its possible effects on the Italian economy. The results of such an appreciation would be a fall in the rate of growth and accumulation, and in the realized rate of profit. This picture, however, does not fit well with some stylized facts. In Italy, the rate of growth and capital accumulation have slowed down while the rate of profit and profit share have clearly increased. The increase concerns average profit share and average profit rate, while indeed the profit rate is declining in the manufacturing sectors but rising in the services sector. At this point a different interpretation is presented, which is no longer based on the financialization hypothesis but rather on the increase in the degree of monopoly power in the Italian industrial sectors, given the increase in mark-up. This process would have been favoured by the privatization process of previously public enterprises. The author shows what might have happened by using a model by Dutt (1995) with two sectors. In this model, in the long run the accumulation of capital is still governed by aggregated utilization and profitability, but the allocation of capital among sectors and their growth depends on the profit rate differential. The profit rate differential might have shifted resources to the service sectors, which would have been favoured by the privatization process. In this case, financialization would be a consequence of the increase in monopolistic competition, which in turn could be responsible for the decline.

In their chapter, Dany Lang and Mark Setterfield show the many weaknesses that the empirical literature on NAIRU still presents. As already stated, the NAIRU includes a pre-Keynesian vision of the economy in which money is neutral and aggregate demand is irrelevant at least in the long run. Now Lang and Setterfield start looking at the methods used in empirical literature to estimate a value for the NAIRU. The first attempts in this direction start from a Phillips curve equation that should be homogeneous of grade one for lagged or expected inflation. A more recent strand of literature focuses instead on measuring the trend

rate of unemployment from time series data. In the plain version this involves calculating a moving average of the unemployment data and labels it NAIRU. The second, more sophisticated, strand employs filters to extract a trend rate of unemployment from an unemployment time series generated by a statistical model. This method is used by Ball and Mankiw. Its main drawback is that they assume homogeneity of grade one to exist while not testing for it. Their results are therefore questionable. As the authors put it, 'the designation of trend unemployment as a unique and stable supply-determined equilibrium rate of unemployment consistent with stable inflation is nothing more than that – a designation'. The NAIRU then passes from a testable hypothesis to an article of faith. Research on NAIRU not relying on testable hypotheses and being just measurement without theory is defined as degenerative.

Engelbert Stockhammer's chapter aims to establish a link between the economic policies carried out in Europe and their different national employment situations. After changes to an increasingly flexible labour market, according to the neoliberal ideology an increase in employment should have been warranted. But these changes notwithstanding, Stockhammer argues that unemployment is still as high in Europe. Furthermore, he examines the effects of monetary and fiscal policy as the fall in the wage share on unemployment. Stockhammer argues that monetary policy should not be considered as truly relevant to that issue, while restrictive fiscal policy due to the implementation of the Stability and Growth pact carries a major responsibility. The decline in the wage share, which may be a consequence of deregulated labour markets and financialization, might have contributed to the fall in aggregate demand and thus in demand for labour as well.

In Chapter 7 Vincent Vernay first criticizes the neoclassical microeconomic foundation of the labour market, in particular the idea that labour is a commodity and is exchanged on the market for money. He argues that labour is a flow and exists economically only in respect of the utility form in which it is embodied. It logically follows that it cannot be exchanged on a market. Vernay asserts that the formation of wages is not a relative exchange but an absolute exchange. Wage earners receive the entire output they gave rise to in money form (the physical output being deposited in firms). Along the same lines, the payment of wage earners cannot be defined as a purchase of labour since money only exists in society as it is attached to the real objects produced. Money has no purchasing power unless associated with physical output, so it cannot be used to buy anything. The author concludes that the formation of wages is by no means the result of a market process.

In Part II Mohamed Alsam discusses the determinants of exchange rate regime/(policy) choice for developing countries. The author argues that

the choice must be based on the characteristics of each individual country rather than on abstract theoretical prescriptions. As to the experience of Asian countries, he reminds us that before the financial crisis of 1997–98 those countries were recipients of capital inflows to a great extent. This has led to an appreciation of the currency and to an expansion of internal credit supply given the inability of central banks to properly sterilize the inflows. This inability in turn was due to the lack of a wide enough pool of state bonds (deficits were small) in which open-market operations could be conducted. Therefore, to avoid the bad consequences of inflows, developing countries should use some form of capital control.

Julio López and Fernando J. Cardim de Carvalho argue that a short-run macroeconomic policy with the aim of increasing growth in countries with an unemployed labour force and idle production capacity along Keynesian/Kaleckian lines is possible. The basis of such a policy should be the increase in aggregate demand, the direction of credit supply towards selected sectors and the improvement of the competitiveness of domestic products. This requires, however, a careful management of the exchange rate, which allows a moderate devaluation to increase competitiveness. The losses to real wages and to firms for the increase in the cost of servicing debt and importing intermediate products should be compensated by taxes on the sectors that enjoyed high profits before the devaluation took place. For example, the depreciation may involve a dual or multiple exchange rate system. In other cases, the depreciation might be accompanied by subsidies to domestic production, provided that firms pass on lower costs to prices, and measures are taken to ensure that subsidies are indeed passed on to consumers. Alternatively they argue that a country could lower the value added tax rate for basic consumption goods, or make money transfers to lower-income groups. Another important point is that the authorities should be able to regulate capital movements and, as a consequence, restrictions to the full capital mobility should be enforced if necessary.

The chapter by Taha Chaiechi deals with the economic development of Hong Kong from a post-Keynesian point of view. The author takes a standard post-Keynesian macroeconomic model inspired by Stockhammer's work to test some propositions/assumptions. In particular the author analyses the dynamic relationship between financial development, accumulation (of what?), income distribution and employment in a way that considers simultaneous interaction (within a systems approach). Chaiechi deconstructs the response of Hong Kong's economy to the shocks based on financial development indicators. The macroeconomic model seems to improve as the financial sector is included. The empirical results of the SVAR (structural vector auto regression) and the impulse response function suggest that there is a short-run, a long-run, and mostly

positive relationship between financial development and economic growth indicators in Hong Kong.

The main thesis of the chapter by Eugenia Correa is that debt inflows/increase to developing countries are the consequence of bank-led monetary expansion while borrowers must settle the debt with surplus and wealth transfers. The author argues also that there is an inherent tendency to overindebtedness in developing countries. This is caused by a greater increase in the cost of credit for corporations, governments and other local entities than the growth of income that must be used to service this debt. Correa argues, furthermore, that monetary and financial liberalization were not a suitable means to increase resources for local investment, but rather mechanisms to achieve the export of local and foreign investors' surpluses. Moreover, Correa analyses the potential effects of the economic policies based on the Washington Consensus. The author strongly advocates the view that the Washington Consensus policies have dismantled the endogenous growth capacity of Latin American economies. Financial liberalization and the region's capital outflows have restricted growth and have undermined profits of domestic companies, depending mainly on the domestic market. The model proposes a new financial structure able to rebuild the relationship between banks, firms and the government. In order to disrupt the causal chain leading to increased inflows, increased indebtedness and increased outflows, the author thinks that it is essential that money is not managed by private conglomerates. Deposit banks must be regulated by new social institutions so that money expansion is directed towards employment and growth.

In her chapter, Noemi Levy Orlik argues that the rate of interest is a distributional variable as a result of social conflicts among the ruling sectors of the society (entrepreneurs, *rentiers* or financiers and workers). In order to reach such a conclusion the author first reviews the history of thought debate on the nature of the interest rate and thereafter the current discussion within both the new classical macroeconomics and the post-Keynesian field. As to the latter, the author concludes that there is a wide agreement that the rate of interest is determined by the central bank. Furthermore, the rate of interest does not affect investment, but the distribution of income. The author then uses the different positions in the theoretical literature to establish whether they may be applied to a developing economy such as Mexico. For Mexico the author finds that a lower monetary rate of interest does not induce higher investment spending or higher credit volumes. Also monetary interest movements do not cause over(under)indebtedness. She argues further that the Mexican central bank reaction function is non-neutral and it favours financial capital (*rentiers* or financiers). The external dependence of the Mexican economy requires

an overvalued exchange rate. Thus the exchange rate needs to be overvalued for external capital flows to finance current account disequilibria and finance external inputs for economic growth to take place. As a result, in the case of devaluation, the central bank raises the interest rate to compensate foreign portfolio investors for the losses incurred and thus worsens the condition of wage earners.

Wesley C. Marshall argues that financial liberalization and its related reforms have failed to generate their (publicly stated) objectives. They have succeeded instead in achieving a hidden objective, namely the expansion of American and European multinational corporations (MNCs) that has undermined the fulfilment of explicit objectives. As a matter of fact, a large part of foreign direct investments has taken the form of mergers and acquisitions, most of them directed towards publicly owned companies in Mexico, Brazil and Argentina. In these three countries the rates of gross capital formation/growth/creation have fallen instead of increasing; in contrast, profit remittances have greatly increased. In Mexico, profits earned by the banks after privatization and foreign ownership through the interest rate spread as a proportion of total performing loans have exhibited a constant increase, growing from 18.63 per cent in 2002 to 28.26 per cent in 2006. Foreign banks operating in an oligopolistic market keep interest rate spreads and commissions at higher levels than those of their home countries. The author concludes that without substantial changes in their domestic economic policies, the dominance of foreign capital in local economic structures will lead to stagnation and balance of payments disequilibrium.

Etelberto Ortiz argues that the current inflation-targeting regime in the context of a small open economy requires the central bank to act as a 'tyrannical auctioneer' that sets a vector of prices enclosing the exchange rate, the interest rate and the wage rate. The central bank is able to act as the 'tyrannical auctioneer' as it recognizes that there are disequilibria associated with its choice of price vector related to a growing disequilibrium in the balance of payments and in the financial condition between commercial banks and firms. The author considers that hindering the more important source of adjustment for economies facing long-run or structural inflationary pressures such as its productivity growth is one of the major failings of the central bank as a tyrannical auctioneer. This is caused by the impossibility of firms to introduce technological, organizational and financial innovations to respond to disequilibria. Finally, Ortiz Cruz argues that this failing destroys the virtuous circle of productivity and accumulation.