Keynes and the Economics of Enough

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Preliminary. Not to be quoted.

This is not a paper in the usual sense but rather an extended synopsis of an intended book. Therefore the level of demonstration of its propositions which the reader would normally expect is not typically present; there will be a good many *obiter dicta*. The purpose of presenting this synopsis as a conference paper is to expose the general shape of the argument to an audience and see whether it stands up (and if so where it could be amended and improved).

Introduction

The financial origins of the present crisis have been much rehearsed and policies to deal with them have commanded our immediate attention, but it is the contention of this paper that there are underlying causes which have not commanded as much notice (with the exception of (v) below). These are (i) a falling rate of profit in the developed world, (ii) a widening of income distribution in the developed world and (iii) the disparity between the first and third worlds' prosperity. On account of (i) it is not surprising that (iv) finance, once the handmaiden of industrialisation and capitalist growth, became a largely speculative enterprise, and it is partly a consequence of the apparent success of finance before the crash that (v) financial flows moved perversely from the less developed to the developed world. The policies of liberalisation and globalisation, which were supported in the first world as the only way to go, were the engine of these trends. Once the fragile financial system collapsed, all these factors, once thought of as natural products of the market system, are exposed as the underlying imbalances that have produced the position in which we now find ourselves. The first section of the paper will elaborate these points.

The second section looks at how these problems might be addressed. Again, much energy is, quite properly, being applied to the question of re-regulating the financial system, but if our analysis is correct, even if that is done appropriately, the other problems just outlined will remain. The most difficult problem to tackle is, perhaps, the matter of the falling rate of profit. The dot.com boom was the last 'new idea' of capitalism. The success of capital in reducing the relative importance of wages led in the developed world to the consumer-led growth of the 1990s and early 2000s, financed by debt rather than increasing labour income, and the third world had a spurt of export-led growth, but the financial collapse has put paid to these. Here the problem that hovers over all the other difficulties, namely climate change, may provide an opportunity, as does the question of the disparity between the prosperity of

[1] Although the outline of this paper was developed in conversation with Studart and the book will be written with him, this elaboration of the outline has been written by Chick. Thus any defects in the present argument are attributable to Chick alone. Nor are the views expressed attributable to the World Bank.

the first and third world. But in the end we in the first world must learn to substitute the economics of excess with the economics of enough, and to realise that a more equal distribution of income between and within countries may be to our advantage. That needs a great deal of new thinking, as well as a change in values. More immediately, investment in activities which ‘do not stale with abundance’ (Keynes 1936: 131) - health, education, the arts – and in green infrastructure are at least as important as fixing the financial system.

Origins of the present crisis

The transformation of the banking system from the supporters of real investment and growth into institutions making money through unwise and even predatory lending supported by a panoply of financial engineering techniques is the proximate cause of the present crisis, but there are other problems underlying the banking crisis that have received less attention.

(i) *A falling rate of profit on first-world investment*

Although Keynes prescribed ‘public works’ to deal with the unemployment problem of the 1930s, he gave a warning which Keynesians in the era of ‘fine tuning’ universally ignored: ‘Each time we secure to-day's equilibrium by increased investment we are aggravating the difficulty of securing equilibrium tomorrow (1936, p. 105).

Very little of the *General Theory* (GT) is concerned with the long period. (in the technical sense of what happens when the effects of investment on the supply of output and the incentive to invest in future are considered); its analysis in mainly in Chapter 17, of which many savage things were said in early reviews and other assessments (perhaps it was the own-rates of interest which put them off). It is the analysis of the effect of investment on the marginal efficiency of capital (mec) as capital accumulates which is important for our story. Recall that in the GT as a whole there is neither population growth nor technical change and the composition of demand (though not of course its level) is constant. These assumptions allow Keynes to use the concept of ‘output as a whole’ where it is convenient, as it is in Ch. 17. Now allow for the effect of investment on the capital stock, an effect forbidden in the short-period analysis of other chapters. Each increment of capital, while it makes production cheaper (a move from the short- to the long-run average cost curve, if you like) reduces the mec unless offset by a rise in demand. Such a rise is likely if the improvement in productivity is shared with labour, though even then it is unlikely to be a total offset. The best that can be hoped for given the assumptions is a slowing down of the falling mec. This process is the falling rate of profit of Marx, reached by other analytical means.

Whether slowed by a rise in demand or not, eventually the long period mec will meet the rate of interest at which no further saving is forthcoming, and there, investment and saving will be zero: the classical stationary state. Keynes’s concern was that that this point would be reached at a level of income only consistent with underemployment. But about reaching the stationary state he was far from alarmed. Indeed he looked forward to capital satiety:

> I am myself impressed with the great social advantages of increasing the stock of capital until it ceases to be scarce. (Keynes 1936: 327)

> [A] little reflection will show what enormous social changes would result from a gradual disappearance of a rate of return on accumulated wealth. A man would still be free to accumulate his earned income with a view to spending it at a later date. But his accumulation would not grow. He would simply be in the position of Pope's father, who, when he retired from business, carried a chest of guineas with him to his villa at Twickenham and met his household expenses from it as required. (Keynes 1936: 221)

For a society (and an economics profession) which takes interest on savings for granted (even if sometimes it turns out to be negative in real terms), this is alarming; yet we know that even when real rates are negative, as they were in the 1970s, people still save.

The possibility of an end to capital accumulation is not debated. Economists and policy-makers are conditioned to think in terms of steady-state growth, not the stationary state. The stationary state is of course abhorrent to capital, whose mantra is 'accumulate, accumulate; this is the law and the profits' – yet it is only population growth or technical change that will ultimately forestall it.

The reason that Keynes was unperturbed lies in his understanding of what economics was for. To neoclassical economists, as well as to capitalists, economic growth is almost an end in itself. At best it is 'good' because it provides employment. But Joan Robinson long ago reminded us (Robinson 1972: 8) to ask 'what is employment for?'. What is economic activity for? First to provide food, clothing and shelter, but after that? To Keynes, economic activity was merely a means to the end: a good life, where there is time for 'friendship and the contemplation of beautiful objects'. He was content with the economics of enough – enough to provide for needs so that the good things of life could be enjoyed.[2]

His prediction was that capital satiety, while not yet experienced anywhere in 1936, could, if conditions of full employment were prolonged over a period of years 'in countries so wealthy as Great Britain or the United States', bring those countries to that situation 'comparatively soon – say within twenty-five years or less' (Keynes, 1936: 323-4). That would be 1961, but the devastation of the war intervened, drastically reducing the useful peacetime capital stock. After the war, rapid technical change and some population growth also acted to forestall capital satiety. However, full capital satiety is not necessary for the falling rate of profit to cause trouble. In Chick (1978) it was argued that the policy of continued fiscal stimulus in the face of a falling rate of profit was responsible for the ratcheting up of inflation in the 1960s and 70s. Others have dated the beginning of the decline of profit in the 1980s, reckoning the dot.com boom to be productive capitalism's last hurrah. Alan Freeman (2009)

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[2] In his own life, he earned for more than was 'necessary'. But he spent much of it on cultural pursuits, including treats for his friends, and he worked for Cambridge University without pay after the first few years.

has a nice graph of what he calls the maximum profit rate, i.e. what the rate would have been if wages had been zero. This shows that after a sharp fall following the wartime peak, this measure rose a little to the mid-60s, fell to a low in 1981, recovered slightly until 1999 and has been falling since. The weakened position of labour income as compared to income from capital since about 1973 would ameliorate the fall in the actual rate of profit, so this measure of maximum is quite useful in exposing the underlying position.

Precise timing is not the issue. What can be said with some confidence is that the engine of growth and development, productive investment in the time of the GT, has given way in the first world to growth fuelled by consumer spending on both current output and property. Consumption expenditure has been chiefly financed by borrowing rather than, as assumed in the GT, coming out of labour income. This and expenditure on property, always largely financed by borrowing, should properly be treated as the ‘exogenous variables’ – i.e. expenditures not financed out of current income – of a modern Keynes-inspired approach to macroeconomics.

There is a good reason for this substitution of debt-fuelled consumer expenditure for investment. Capital, feeling the profit squeeze, has managed to weaken the position of labour in the developed world. The Thatcher government in Britain severely weakened the unions, and ‘flexible labour markets’ (i.e. easy dismissal) were promoted. Monetarism was adopted, ostensibly to ‘fight inflation’ but it also caused unemployment, which weakened labour (Turner, 2008, Fforde**). In the U.S. both the unions and the minimum wage have come under attack. Beyond the attacks on labour institutions and regulations such as the minimum wage, globalisation, which put first-world workers in direct competition with the cheaper labour in the third world, was instrumental.

Many have commented on the increasing disparity of income within the United States since 1970. The Gini Coefficient has risen from its lowest estimate[3], that for 1968: 38.6 (the lowest index reported) steadily to 2006: 47.0. It rose particularly sharply between 1990 and 2000 (from 42.8 to 46.2). It fell back very slightly in 2007.

Liberalisation in financial markets coupled with high interest rates as an anti-inflationary measure have also meant that rentier income has risen while wage income has been under attack. Indeed a critique of the Washington Consensus (Cornia 1999) has laid the change in income distribution since the mid-1970s at the door of the twin policies of globalisation and liberalisation. In the light of the problem posed by the falling rate of profit, these policies can be interpreted as stemming from capitalism’s difficulties, as ways of opening up markets, engineering a shift of income away from labour, and turning from real investment to financial engineering, where the possibilities of profit seemed endless – until they ended.

[3] US Bureau of Census, as reported in Wikipedia, Gini Coefficient.

(ii) *The failure of the banking system in the U.S. and U.K.*
Financial systems have a property not shared by the processes of real production: costs do not vary with output. It costs no more, or very little more, to ‘produce’ £1m. of loans as it does to ‘produce £100. The constraints on the banking system are liquidity – itself a slippery and volatile property – and, since the Basle Accord, capital. The origin of banking lies in the discovery that their liabilities (notes or deposits) were generally acceptable as a convenient substitute for money. From this, a pyramid of credit was gradually built. This credit was instrumental in financing the industrial revolution (Cameron, Pressnell) and continued to support firms’ working capital and investment needs for credit. Studart (1995) has called this ‘functionality’: the banks perform a useful macroeconomic function.

Personal loans rose in importance after the war and banks went into mortgage lending after the savings-and-loan crisis in the US and Competition and Credit Control in the UK These activities began to dominate bank lending as the prospect for profit on manufacturing faltered. The capacity for financial invention, supported by a determined policy of liberalisation, allowed banks to increase their lending with virtually no liquidity and on a tiny capital base. For present purposes, securitisation, itself a way to make illiquid loans liquid, shifted banks’ interest from ensuring that their borrowers were sound and their loans were performing to originating as much business and they could, taking fees.

There is no need for much further detail about what happened: the development of the shadow banking system to make sure that securitised loans could remain off the banks’ balance sheets, and the further development of securitisation (e.g. CDOs[2]) are only elaborations of the main point, though these elaborations compound the problem in which we find ourselves. This orgy of lending, much of it irresponsible, collapsed in 2007. Now, the banks will not lend to each other and so, starved of the interbank borrowing which had taken much of the place of deposit funding, the banks will not lend to anyone else, either. Firms cannot find working capital and so lay off workers, and a financial collapse becomes a real recession.

Freeman (2009a) maintains that this spectacular failure is a symptom, that the underlying failure of the profit rate is the cause. We find it more difficult to disentangle cause and effect here. But it is beyond doubt that the financial crash and consequent scramble for liquidity is the proximate cause of the current recession. It was In the US and UK (and Iceland) that the banking system pushed their luck the hardest. It is no accident that it was also in these countries that liberalisation and ‘light regulation’ had been taken furthest.

Financial liberalisation also succeeded in raising interest rates, thus contributing both to the difficulty of finding profitable investment opportunities and also to a redistribution on income away from labour to the rentier. The shift to non-labour incomes occurred in five of the G7 countries (Cornia 1999, quoting a then-unpublished paper by Atkinson).

(iii) *The third world*

Inequality of income has increased between the first and third worlds. The average income of the global South, including China, was about 7.5% of that of the global North (IMF's 'advanced countries') in 1980. By 2000 the percentage had fallen to 4.5% (Freeman 2009b, from World Economic Outlook and World Bank data). There has been a bit of improvement from 2004 to 2008, back to just over 6%, presumably mainly because of the tremendous growth in China and the downturn in the first world, but it is still a miserable ratio.

It is hardly surprising that the Human Development Index correlates well with income: the average for high-income countries is 0.942, medium-income 0.774 and low-income 0.564 (United Nations 2008: Table 1). The countries in the lowest category are those in sub-Saharan Africa and other least-developed countries. This has remained true over time (1975-2005) despite most countries' indexes having improved over the period (*ibid.* Table 2).

The disparity persists, and indeed has worsened, despite the success of the BRICs, especially China. It is notable, too, that Chinese development in particular has been damaging to the environment. There is nothing new here: first world industrial production was very dirty in the beginning and the former communist countries also polluted massively. It is just that now, the environment has become a crucial issue. Dirty development shows up in the Human Development Index as contributing to human mortality, but it is even more important than that.

(iv) *Capital flows*

The flow of funds from China for investment in US financial assets is a strong feature of the last decade. This flow has financed a large part of the US balance-of-payments deficit. Thus the flow has been perverse: the less-developed country is financing the consumption of the first world. This goes against all conventional economic theory, but not against the financial counterpart of dependency theory, cumulative causation theory and the international application of liquidity preference pioneered by Sheila Dow (Chick and Dow 1988). Her argument, which is the most important strand in this context, is that centre countries typically offer more liquidity, in the sense of broader, more active markets, than peripheral countries, and also less risk; therefore mobile capital is likely to gravitate to the centre. The fact that capital flows toward assets with a lower rate of return than is available elsewhere is understandable when these factors are taken into account. from a development point of view, it is, of course, perverse, and is one strand of the case for capital controls (see Desai 2009).

These flows have been blamed by some, notably Bernanke (2005), for creating the banking situation that collapsed. The influx of Chinese funds, the argument goes, meant that the US banks, awash with liquidity, had to find outlets for their loans, and this sparked the decline in the quality of lending. On this 'global savings glut' theory, 'solutions to the continuing meltdown are to be found in making the Asian nations use their savings more efficiently and develop their financial markets domestically.' (Nesvetailova 2009: 5). It will be seen from the section on banking, above, that we do not subscribe to this explanation (neither does Nesvetailova).

What is to be done?

There is no doubt that the banking system in the first world needs radical reform, and much energy is being devoted to the question of how it should be done. The point of this paper is to insist that, even if re-regulation is well done and the banking system gets back on its feet (which we think will be a longer process than is widely predicted) problems will remain. One might argue, and some have, that the creation of 'bubbles', whether on the real side (e.g. dot.com – though it is debatable whether anything electronic is 'real') or in finance, in the short-run interest of many people: the dot.com entrepreneurs and the bankers that financed them did well out of their symbiosis for quite a time. There are those who emphasise the beneficial effects that the run-up to this financial debacle has had, most notably the extension of home ownership (Goodhart 2008). The balance between short-run benefits and long-term costs is to some extent a matter of personal preference, but it seems to us that the long-term costs, which we believe involve a far deeper recession than anyone is forecasting, and the structural damage to financial institutions, far outweigh any short-term benefits. We do not share Alan Greenspan's earlier optimism about bubbles, though we acknowledge that they are difficult to identify as they are inflating and that pricking them requires not only superb judgement but also moral courage: who wants to be a spoilsport when all seems to be going well? We would agree with those who say that it is impossible to legislate against bubbles, but the exercise of judgement at an early stage in this particular debacle would almost certainly have mitigated the extent of the collapse: it is not as if the disaster was not predicted (Pettifor 2006, Tily 2007, references to the BIS and the Bank of England in Chick 2008: 123).

Saving and re-regulating the banking system and preventing mass unemployment are the first priorities. But that it not the end of the crisis. The vital point to recognise is that capitalism, on its own, cannot deal with a falling rate of profit. It is ingenious in finding ways around the problem, but the problem remains. It is remarkable that none of the energy that previous generations of economists spent on the stationary state was devoted to this question. Government, which has (or, rather, ought to have) a long-run perspective, should know this and be prepared for it. Instead, economists have fed them the doctrine of steady growth as the norm. And this scenario looked plausible in the 'golden years' from the war to the mid-1970s.

But surely after more than 30 years when the economy has been far from golden, doubts should have crept in (and if the arguments of Chick 1978 are correct, governments should have worried about it even when things were looking bright). In the neoliberal years they have been taught by mainstream economists that markets will solve all problems, and now they even share the neoliberal belief that governments – they themselves - are hopelessly inefficient at providing economic goods: 'government bad, private sector good' has been a mantra in the UK since Thatcher and the US since Reagan. Governments have also confused gains from financial activity with wealth-creation. And they have backed the debt-led consumer boom. This is the

Economics of Excess, and we call for its substitution with the Economics of Enough as the longer-term objective.

Meanwhile, there is much that governments can do. The first priority in the advanced economies, after the re-regulation of the banks, is to find something for capitalist enterprise to do. The obvious first step is to stimulate investment in green technology, including research, to subsidise the insulation of older buildings and so on: to implement ‘A Green New Deal’ (2008). The next step is to tackle the question of income distribution, both within the first world and between it and the third world, so that the poor everywhere can aspire to Enough. To raise the third world economies to the level of the first world by the same means as the first world has used would, with the present let alone the projected population, use the resources of three Earths. So that is not an option. In the end, therefore, raising the standard of living of the third world requires a reorientation in the first world. But in the shorter term, the first world has much to gain from a fairer distribution of income between themselves and the third world. The other direction for expenditure should be on those things which add to the quality of life but ‘do not stale with abundance’: the arts, education and health. There is no way to measure the total pay-off of these (though economists working in the economics of education have had a go), but their contribution first to the pleasure of living and later to improvements in health and productivity, are clear.

Conclusion

The present conjuncture is not just a banking crisis, though that is real enough. The world economy is marked by a large and growing disparity of income between the developed and developing countries, despite the impressive growth of the BRICs, especially China. The continued, though weakening, dominance of the dollar has led to financial flows running, perversely, from the less developed to the richest country, allowing US consumers to continue their Economics of Excess – this despite, or perhaps because of, the increasing inequality of US incomes. And underlying all this, the first world is approaching, or perhaps has reached, a sufficiency of capital, so that economic growth, even if it were environmentally supportable, is getting more difficult for private sector capital to produce profitably.

We propose a series of solutions having different time horizons. In recession, governments should lower interest rates, provide liquidity and spend. This is Keynes’s lesson and it has been reasonably well taken in both the US and the UK. But spend wisely. The days when it is legitimate to argue, as Keynes did, that even wasteful and misdirected expenditure is better than nothing in a slump are over: the environment is having its revenge. So expenditure should be on green infrastructure first. The falling rate of profit can be further forestalled by promoting income redistribution internally and with the third world. Finally, a long-term programme of state expenditure on the arts, education and health will both improve the stock of human capital and its quality of life. This is what economics should be all about.

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