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Introduction

This book is presented as a book about monetary theory, but even more importantly it is a book about economic policy. It seeks to resolve a basic question in economic policy where it should be resolved, through monetary theory. It is important because it is a question of policy that has divided economists since the beginning of formal policy discussion. Most recently it has been at the heart of the debate between monetarist and Keynesian economists over monetary policy and was at the heart of Keynes' *General Theory*. That basic question is whether it is possible for a capitalist economy to have sustainable full employment with price stability – whether active economic policy can improve on the results produced by the operation of the free market – or as Keynes put it, “is the economic system self-adjusting” at full employment?. It has traditionally been argued that any attempt to use fiscal and monetary policy to increase the level of employment will produce partial or general excess demand for goods, leading to excess derived demand for labor that will produce a wage price spiral of inflation that can only result in welfare and output losses and unemployment. Thus the traditional monetarist position that living with the natural rate of unemployment is the best that economic policy can achieve in conditions of price stability, and that only with price to attain the maximum sustainable growth of output. Thus the traditional neoclassical, Marshallian and Walrasian, position that the free and unfettered operation of supply and demand in labour and commodity markets will lead to the maximum level of employment of productive resources with price stability. Indeed, in this approach, the creation of unemployment is only conceivable economic policy and the best anti-inflation policy. It was Keynes's

contention that the economy could achieve an equilibrium state at any level of output, so in monetarist terms the natural rate of unemployment was not unique, just as the natural rate of interest was not unique. If output was constrained by demand, then policy could improve the outcome of the market without necessarily creating an impact on prices.

Rejecting Supply and Demand

Professor Patnaik follows in this tradition, noting that the initial recognition of a demand constraint was not common to all classical economists, but was put forward in Marx's criticism and elaboration of the model of the classical economists. It was subsequently refined by Piero Sraffa in his 1925 criticism of Marshall and the theoretical foundations of the supply curve in neoclassical economics. This called into question not only the determination of goods prices by means of supply and demand, but even more importantly of factor prices. While much of the subsequent discussion has centred on capital, it applied with even more force to labour. In Keynes we find the same point in his attack on the foundations of the supply curve for labour, noting that it was impossible for labour to determine its position on the supply curve. It was as if the supply of labour was horizontal and employment solely determined by demand. Thus the tradition is the one that rejects the use of supply and demand to determine prices and quantities at both the individual and aggregate level.

For Money as well

On this basis the underlying criticism that Patnaik raises against traditional neoclassical and mainstream monetary theory is that it determines the value of money in exactly the same way as it determines the value of any other commodity, that is, by means of supply and demand. However, he notes that this leads to a basic inconsistency, for if the operation of supply and demand achieves equilibrium in commodity markets, the value of money should by theoretical logic be zero. Not only would money have no value, no one would be willing to hold it. The innovation here is not the difficulty in explaining why individual agents should hold money if its value in equilibrium is zero -- this is a difficulty that has been well recognized by most practitioners of neoclassical and general equilibrium theory -- but in locating the difficulty in the application of supply and demand to the determination of the value of money. This leads to the major conclusion of the book, that if the value of money is to be positive, its value must be determined independently of supply and demand. In essence, the point is that the

economic system cannot be looked upon as a closed system fully specified by supply and demand equations such as those found in a Walrasian equilibrium or that lie behind Hicks's ISLM curves. For an answer to the question of the value of money Patnaik is thus led back to the pre-Walrasian theories of the classical economists and to Marx, and to the post neoclassical theories of Keynes and his followers.

The Labour Tradition

In this quest it is important to note the early contribution of the Scottish Enlightenment on economics, and in particular the contributions of Locke and Hume. Reacting against both the Mercantilists and naturalists, they argued against the idea that national wealth was represented by gold, or by the natural productivity of the soil, but rather that the true wealth of a country lay in its laboring population. Although their arguments were turned into a basis for monetarism, the argument that wealth was produced by human labor also led to the idea that the worker had a natural right to the output of his efforts and reappears in Marx's theory of exploitation. But, in Marx it is not a question of human rights of philosophy, is the result of the operation of the capitalist mode of production.

Although Keynes interpreted the mercantilist insistence on the accumulation of gold through an export surplus as recognition of the role of demand on output, he also accepted the idea that labor was the source and the most appropriate measure of value. Although, it is now often forgot, the unit of measure the Keynes adopted in the *General Theory* was the money wage unit, because, probably following Sraffa's difficulties in deriving a standard commodity, he considered this the least theoretically flawed approach to the aggregation problem that he faced in this exposition of the determination of aggregate supply and demand prices. This decision was also coherent with Keynes's view that the stability of money wages was one of the main causes of the liquidity premium on money and on the stability in the value of money.

It is perhaps unnecessary to point out the affinity between Keynes and Marx in looking at the capitalist system as a monetary production system – indeed, Keynes credits Marx's M-C-M' as an expression of this approach. And although Keynes, and certainly not Joan Robinson, did not accept the labour theory of value, nor Marx's theory of exploitation, the use of labour as the measure of value is certainly common to both.

Beyond Supply and Demand

Thus Patnaik finds the answer to the determination of the value of money, outside supply and demand, in the determination of money wages and in particular in the stability of money wages. The stability of the value of money is thus dependent on the stability of money wages. He thus notes that if money wages were subject to rapid increases, or to rapid decreases, the resulting inflation, or deflation, would lead to instability in the value of money, which would eventually destroy money in its role as a store of value and store of wealth, functions that are crucial for the success of the capitalist system.

Why Does Capitalism Survive?

This leads to a further question that emerges from both Marx and Keynes, both of whom believed that there were limits of the operation of the capitalist system – although certainly for different reasons. Since capitalism has been relatively stable over time an explanation of that stability must be offered. For, if wages tend to rise in excess of productivity and push up against what Joan Robinson called the “inflation barrier”, then profits will be squeezed and the rate of accumulation will fall, leading to recession and crisis, alternatively if wages do not rise sufficiently rapidly, demand will be deficient and the same result occurs (this in contrast to the traditional approach which presumes that lower wages will automatically lead to higher profits and accumulation). Thus, the historical persistence of capital, as well as the relative stability of the value of money, must be linked in some sense to the stability of wages.

Another “external’ factor

Patnaik notes that neither Marx nor Keynes provided a clear explanation of why the money value of labour should be sticky in terms of money. In order to resolve this question he again draws on factors that are formally “external” to the specification of the system. He argues that both the Keynesian system and the Marxian system have tended to consider the system as self-referential, as self-contained, or closed. Instead he argues that historically it is the penetration by industrialising capitalist economies of pre-capitalist economies that provides the answer to resolving both the demand constraint facing capitalist economies and the stability of money wages that allows their persistence. Thus he argues that the success of capitalism depends on its being embedded in a global economy in which it is able to benefit from external demand and external supplies of labor as a result of processes of deindustrialization in the peripheral economies.

Thus we reach a preliminary insight into the initial question – Patnaik’s approach would seem to

imply that it is impossible to have full employment with price stability in one country, or in one group of capitalist countries, without creating unemployment and deindustrialization in the rest of the global economy. To the extent that domestic policy to support demand substitutes for foreign demand, it is possible for policy to improve employment levels, but price stability will in all cases depend on the presence of a global labour supply that acts as a constraint on domestic wages and prices.

Full Employment and Price Stability in One Country

At this stage in the argument it is appropriate to note that there is alternative approach to this question given by employer of last resort programmes, or guaranteed employment schemes. While they are designed to solve the problem of unemployment at a stroke so to speak, but offering employment to anyone who is will and able to work at the ELR wage, the second and perhaps most important aspect of these programmes is that they purport to provide price stability. And the argument that is given is that in difference from traditional Keynesian demand management wielding fiscal policy as a blunt instrument, it avoids sectoral bottlenecks and shortages, since the amount of government expenditure is made in precisely the areas in which unemployment occurs and in precisely the right amount to keep the system running at full employment. But more importantly, by fixing a base for the wage, it sets a base for the price system. It is much more difficult for a wage price spiral to break out if it is always possible to find labour in the ELR pool at the going wage, without having to bid up wages. Thus it shares with the propertyist approach the belief that the money wage is the key to stability of the system, but instead of looking to competition from foreign labour to keep wages stable it is an implicit attribute of the programme design.

Further, price stability can be enhanced by appropriate government expenditure policy. In the ELR pool the government sets the price (wage) at which it is willing to buy labour. It can also do this for its other expenditures – by fixing the prices at which it is willing to contract which sets the base price at which producers can sell their output. These replace the role of foreign production from the periphery in controlling goods prices. This is a programme that is designed for a single country, on the condition that it is subject to monetary sovereignty, i.e. the government taxes in and produces its own currency, without setting an external value of the currency. Instead, by setting the ELR wage and government purchase prices, it sets the internal value of the currency. This may provide a better answer to the question of

whether it is possible to have full employment with price stability and it seems much more appropriate for the countries in the periphery.

Where should the analysis start?

In addition to rejecting the application of supply and demand, this approach also departs from traditional theory by arguing that it is impossible to understand the evolution of the capitalist economy without direct references necessary to undertake the analysis of an economy that is closed to international trade and international capital flows. This of course, simply reflects the historical development of capitalism. Indeed, most currently industrialized countries, have accumulated their wealth and based their industrialization on commercial “interaction” with less advanced or in many cases, more advanced, economies. This is particularly true of the development of economies in South America, where trade with colonial powers was a crucial influence on the development as a precapitalist periphery to the capitalist center in Europe.

Thus, proposing answers to the two basic questions that Patnaik poses, the solution is found by reference to economic forces outside the specification of traditional economic theory – the determination of the stability of the value of labour by international capitalist accumulation.

By emphasizing the role of money and the value of money determined by the value of labor in creating a demand constraint, the role of government is also directly introduced. Indeed, Patnaik suggests that in some stages the role of government spending could be considered as a substitute for the existence of a deindustrialising periphery. Thus in addition to rejecting the supply and demand approach and relying on a dual interpretation of the role of external factors in determining the value of money, the analysis suggests that if we are to understand the processes that link the growth of output and employment and inflation, we must start with the role of government in the economy and the role of international trade and finance in the economy, rather than the more traditional approach which starts by specifying individual private agents in a closed economy, or in the neoclassical synthesis approach of specifying the role of households and the role the firms is an economy in which government and international trade and finance are only included as an adjustment to the basic consumption and investment functions.

The Propertyist Approach—Some Perplexities

Patnaik identifies this Classical-Marxian-Keynesian approach to the value of money as the "propertyist" approach, to contrast it with the traditional mainstream or Walrasian supply and demand approach. This nomenclature is a bit perplexing because it emerges as a reflection of the mainstream approach, rather than being positively built on its own foundations. As already noted, the traditional approach cannot explain the existence of money, or the fact that money is held over time outside of equilibrium. In the traditional approach money arises because of the inefficiencies caused by barter and the difficulties of the double coincidence of wants, but once it has been created there is no further use for it. As Hicks has pointed out, a central clearing house could work as well. Thus if money is to be held it can only be in conditions of disequilibrium, during a Hicksian week, which by definition is not an equilibrium state of affairs. Or in the overlapping generations models, we require an infinite future, or else someone will end up holding the bag of worthless money with no future generation to accept it.

Thus if money exists, it must be held, and if it is held it must be considered on the same grounds as any other form of property. Thus this nomenclature does create in the reader a sense of paradox, since property would seem to suggest real property, but money is usually in fact just "worthless" bits of paper. This raises the question of how modern money can be considered as property and whether money can be subject to the same laws of scarcity as other types of produced goods.

For example, Keynes distinguishes his position in the *General Theory* from those writers who preceded him, by noting that in the capitalist system money is a "real" factor, in that it is the behavior of money that determines the behavior of the real factors such as output and employment in the economy. Indeed, he went so far as to argue that it was only in a "monetary production economy", that equilibrium could exist at less than full employment. Here it is important to note, that Keynes allows for the possibility, or better, left open, the definition of just exactly what would serve as money in such a system. Not only bits of worthless paper, but actual physical property, even including the possibility that land could serve in the role of that which prevented the economy from reaching full employment. In this context he defined a "nonmonetary economy" as one in which there was no asset whose liquidity premium exceeded its carrying cost. Thus, Keynes placed great emphasis on the role of liquidity in determining what would serve as money, and also in determining the evolution of the system. Whether money was "real" property or a real factor, or was the asset whose liquidity premium relative to its carrying costs declined the least

rapidly with an expansion in output does create differences in the analytical framework. Thus, in Keynes's approach, money does not necessarily have a concrete referent, it is an analytical condition that can or cannot be met by any liability.

It is here that the propertyist approach has the potential to create confusion. Patnaik argues that at the international level we are still employing a system of "commodity" money. In particular he suggests that it is not commodities in general that serve today as the international money, nor gold, but rather oil. The discussion thus moves from what will be the value of money in a national system embedded in a global economy, to what will be the dominant international money for the global system of trade and finance. The answer to this question of what will serve as international money is very similar Keynes's definition cited above: that is, the commodity whose return exceeds its carrying cost by more than any other commodity. It is suggested that gold originally played this role in the international system because of its extremely low carrying costs. But this approach brings us dangerously close to the physical characteristics approach to the definition of money used by the Classics, and to the neoclassical idea that while a national economy may be a monetary economy, all international transactions are implicitly barter transactions because debts are resolved through the transfer of goods, of which gold is one because of its physical properties.

Thus, the first problem with this approach from the point of view of Keynes's definition is that the physical nature of what serves as money should be irrelevant; as pointed out above a physical commodity just as well as a worthless piece of paper representing a future claim can be compatible with the monetary production economy that is demand constrained. Secondly, there's very little historical evidence that gold ever served as money in the sense of serving in money of transactions at either the national or the international system when it was functioning under the gold standard. It is now well documented that stability of exchange rates under the gold standard was determined by short-term capital flows, along with the fact that Great Britain was the financial centre of the world because it ran a surplus on invisibles and the capital services account that was kept on deposit in London. Thus the statement that the global economy continues to run on the commodity standard does not seem to be consistent with the approach to national monetary conditions, nor does it seem to contribute to our understanding of the role of money in the international system.

It would seem that the basic reason for this diverse approach – from worthless money to commodity money, is due to the fact that Patnaik, following similar reasoning by Ricardo, rejects the possibility of using money wages as the determinant factor in the value of money at the international level because there is no way to represent or compare money wages at the international level. It is also for this reason that when he approaches the question of what currency will be the international currency discussion shifts from the stability of money wages to the stability of the currency in terms of an individual commodity, in particular in his presentation of the value of the dollar in terms of oil.

Patnaik builds the Keynesian part of his approach on a particular interpretation of the role of money found in Keynes *General Theory*. This analysis is found in Chapter 17 that deals with “own rates of own interest” and the “essential properties” of money – aspects of Keynes’s theory that many believe to be either inessential or irrelevant. However, they have a particularly important position in the exposition. While Keynes makes extensive use of supply and demand in the *General Theory* it is noteworthy that in the Chapter 17 discussion he does not use these instruments. Indeed the Marshallian elements used in much of the rest of the book such as aggregate supply and demand, the supply and demand for money, and the supply and demand for investment, were all introduced as the result of the urging of economists brought up on Marshall's *Principles* such as Joan Robinson, Richard Kahn and Roy Harrod.

However, the approach in Chapter 17 more closely reflects the approach of Piero Sraffa and in particular builds on elements of Sraffa's 1932 critique of Hayek's critique of Keynes's *Treatise on Money*. But these instruments were first employed by Keynes in his *Tract on Monetary Reform*, and in particular his analysis of the reform of the international monetary system to introduce a replacement for the gold standard. As a complement to his recommendations for a system of “managed money” based on purchasing power parity, Keynes derives the interest-rate parity theorem. It is noteworthy that Keynes refers directly to this analysis in determining equilibrium at less than full employment in Chapter 17 of the *General Theory*, telling the reader that he can substitute the return on all assets in the system for the return on all currencies in the international system, and equilibrium will be established internally in exactly the same way as it is determined in international currency futures markets. Thus, one wonders why, having made the analogy from international to national, it could not have been profitably reversed to determine equilibrium of the international system at less than full employment, as well as what would play

the role of money in that system. This appears to be what Keynes did when he approached the question of international equilibrium in proposing an international clearing Union, and the creation of an international means of payment that would act as a store of value only for nation states rather than individuals.

Current Account Surplus and Deficit

In his discussion of international equilibrium and international imbalances Patnaik also makes the general affirmation that the country whose currency becomes the international store of value and means of payment will generally have a current account deficit, if not initially, at least eventually if it is to play the role of international currency. This is justified by the argument that newly industrialized countries have a relatively small and newer capital stock so that their costs are lower and their returns higher, giving them current account surpluses. But this seems to go against the experience of foreign direct investment and the generalized absence of technology transfer – it is cheap labor working on existing or outmoded technique that seems to be the rule, at least in Latin America. To the extent that there are surpluses in developing countries these are commercial account surpluses, which are more than offset by capital services account deficits and capital account deficits. Obviously, the way in which Britain's Imperial accounting was done was different from that in Latin America, but even then, Britain continued to run current account surpluses, well into the end of the 19th century, largely due to the fact that invisibles – British Bottoms, more than offset its goods deficit.

It is also suggested that the current account was used as a means of diffusion of the capitalist means of production into the periphery. But this seems to ignore the means by which Great Britain penetrated the South American continent, in particular, the symbiotic relationship that was built up in British trade in that region. In addition to the important role of indirect settlement highlighted by S B Saul, Prebisch has pointed out how European demand for Latin America's primary materials allowed it to meet the debt service on European lending used to import manufactured goods, avoiding the traditional external constraint. Thus the economic openness of the 19th century primary commodity production served as a basis for industrialization until the United States, a competitor in primary commodities, replaced Great Britain as a major international source of capital exports, interrupting the stable international settlement flows. It is not clear that referring to the existence of a current account surplus or

deficit as a condition of the diffusion of capitalist means of production is particularly helpful in understanding this process.

Minsky has also noticed that the composition of the British balance of payments was much like a bank, taking deposits from the Empire, and lending them out to finance British exports of manufactured goods, with the net interest margins sufficient to offset the deficit on commercial account. Here an increase in the interest rate not only brought an increased demand for sterling, supporting the exchanges, but it also increased invisible earnings offsetting any deterioration in the external accounts. And during most of the period with current account surpluses.

This suggests a very important aspect of the interrelationship between finance and trade that is that in general in the international economy is financial flows which tend to determine the trade flows, and even more importantly, the composition of domestic production and the composition of international trade. Thus, while it is quite correct to look at gross rather than net trade as it means of offsetting the demand constraint as Patnaik notes, but an even more important impact is on the composition of output, and in particular on the level of industrialization in developing countries. Thus, even if the goods and services balance is in equilibrium, this will in general be offset by disequilibrium in the capital services account, reflecting the disequilibrium in the capital account that is characteristic of the development process. Simply looking at the current account as a whole does not tell us much about this process.

On the other hand, the position of the United States in support of international currency was produced by just the opposite composition of its balance of payments. The United States had a global surplus on goods and services account in the postwar period – reflected in the famous problem of the “dollar shortage”. While the expectation was that this would eventually be turned to deficit by increased foreign investments abroad, in fact it was eliminated by transfers and invisible account charges, all within the current account of the balance of payments. Of course, the immediate post-war Bretton Woods system was not one that encouraged private capital flows. Thus the United States position did not become dominant because it was creditor to the rest of the world through foreign investments, but because it was creditor to the rest of the world because it was the monopoly supplier of goods and services to the rest of the world in the postwar period. While Britain could force an increase in demand for sterling through an increase in interest rates on sterling deposits, the US could only do so by selling more,

and the system prevented the US from using exchange depreciation to do that. With European recovery this creditor position would eventually have come to an end, and instead the United States became the exporter of financial intermediary services for international capital flow loans and the dollar became the unit of account to intermediated these loans. Thus it was the United States as the centre of production for international financial products, rather than as centre production of international capital goods, that determines its dominant position. This would suggest that this long as the United States remains the dominant financial market US dollar will remain the dominant currency.

International Commodity Money and Geopolitics

Now Patnaik provides an alternative explanation of the dominance of the US, and that is based on the international financial system as being intermediated by commodity money, in particular oil. He predicts the downfall of the dollar as international currency as a result of the decline of the value of the dollar in terms of oil. Although he suggests that the US policy in the Middle East, in particular in Iraq, has been due to an attempt to stabilize the value of the dollar in terms of oil, there is no attempt to explain the recent changes in the value of the dollar in terms of petroleum, except that it represents a departure from the relative stability of commodity prices other than oil, and of the dollar over time.

First, it seems a highly implausible, knowing the decision-making process that took place within the US government, that the invasion of Iraq was determined by an attempt to preserve the role of the dollar in the international financial system. Henry Kissinger may have thought in these terms when considering policy in Iran, and Churchill thought in strategic terms when first Admiral of the Navy, but it is not clear that this was a major element in the current administration which only looks at oil as a source of personal gain.

At the same time it is important to note that the increase in the value of petroleum could have been approached in exactly the same way as Patnaik approached the value of the dollar, that is by rejecting the explanation that is given by most market participants that it has been due to increases in real demands in the newly industrialized countries in Asia and the lack of investment in creating new supplies – that is by simple supply and demand. There is evidence to suggest that the increases in demand have not been substantial and certainly not sufficient to move the average price of petroleum from a range of \$25-\$30 a barrel to arrange of 130 hundred and \$150 a barrel. On the other hand there is also substantial

evidence that a majority of the increase in prices been due to financial speculation. This would suggest that US financial interests, whom it would seem should have a clear interest in supporting the value of the US dollars and international currency, did not recognize that their actions would eventually undermine the position according to Patnaik's interpretation. Again it would seem that short-term interests in general tended to predominate over long-term strategic decisions, but in any event it is still not clear that there is any alternative to the dollar as the role of the major international currency. At one point in his presentation Patnaik notes that any change from current conditions would require an alternative candidate to the dollar as global currency, and that there is none, yet he subsequently argues that the fall in the value of the dollar in terms of oil would inevitably lead to the demise of the dollar. The basic point is that there is no clear alternative, nor does it appear to be in the interest of major US dollar holders to seek an alternative. The major US creditors China and Japan and the oil producers depend on US markets in order to support their domestic economies, -- the are demand constrained – and in the short term there is no alternative goods market that can provide this for them. At the same time there's no alternative market that can provide sufficient liquidity that is offered by the US dollar financial services market, so that if we look at the position of the dollar as Patnaik suggests in terms of its return measured by its liquidity premium relative to its carrying costs, liquidity that is offered by the extremely large US capital market relative to the potential loss due to depreciation obviously still gives the US dollar a premium that is superior to that can be offered by any other currency. This would suggest that the dollar will remain as the international currency until Japan finds an alternative method of offsetting the internal demand constraint and until China manages to expand domestic demand sufficiently to provide full employment for the rapidly expanding labor force and the transfer of labor from the rule to the sectors.

A final reflection, on the stability of the wage rate. In the US, nominal wages have tended to be stable despite falling real wages, and part of that stability is clearly due to the role of external factors, in particular the shift of manufacturing to lower wage areas outside the US, which has brought declining manufactured goods prices in the presence of rising profits. This has been reinforced by the increase in household borrowing to increase real consumption and profits independently of wages. It is clear that higher wages would have been much more stable in supporting profits than household borrowing domestically and internationally. Thus, a major factor in keeping wages within acceptable levels is also to

be found in the operation of the financial sector, a condition that is not in general to be found in the periphery.