Edited by Johan Deprez
and John T. Harvey

Foundations of International Economics

Post Keynesian Perspectives

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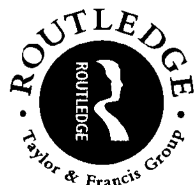

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Foundations of International Economics

Foundations of International Economics is a state-of-the-art collection of articles by leading Post Keynesian scholars on international finance and trade. All major areas in international economics are covered, with the Post Keynesian approach giving a welcome fresh perspective.

The chapters feature studies of payment schemes, exchange rate determination, open economy macroeconomics, developing country issues, capital flows, balance of payments constraints, liquidity preference, Fordism and the role of technology in trade. Beyond the specifics of each contribution, this collection as a whole suggests the usefulness of the Post Keynesian paradigm in addressing complex issues of global interdependence.

Representing cutting-edge research, this is the only collection of its kind. Whilst *Foundations of International Economics* is intended for both advanced and undergraduate use, it will also be a useful reference tool for scholars.

The Contributors: Philip Arestis, Robert Blecker, Paul Davidson, Sheila C. Dow, Bruce Elmslie, Ilene Grabel, John S.L. McCombie, Eleni Paliginis, A.P. Thirlwall, Flavio Vieira, L. Randall Wray.

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1 Introduction

Johan Deprez and John T. Harvey

It is difficult today to read any economic literature, popular or scholarly, without soon encountering references to 'globalization,' 'transnationals,' 'multinationals,' and the like. As we are reminded every day, the world is getting smaller and smaller and, in the process, more interdependent. A financial crisis in East Asia can be a cause of genuine concern to farmers in Iowa. Chinese labor laws significantly affect the economic and social status of workers (employed and unemployed) in Birmingham. The prospect of a European central bank has ramifications well beyond the borders of the European Union. All of this is increasingly evident to both participants and bystanders in this process.

What is not evident, however, is how to fully explain the effects, present and future, of these developments. In fact, one of the chief concerns of the authors in this volume is that a number of dangerously misleading 'truths' have arisen in the subject of international economic relations. Especially frightening is the fact that these myths are not confined to the financial pages or the after-hours conversations of business professionals; instead, they inform and guide public policy. Policy cannot be designed in the absence of theories that adequately explain the underlying relationships. Little wonder so few years pass between crises in the international monetary system.

The chapters in this book offer 'Post Keynesian' perspectives on international economic issues. It is our contention that these essays, because they are based on a more realistic view of the nature of economic activity, are better able to explain the character of the contemporary world economy. Though this Post Keynesian literature has been growing rapidly in recent years, the present volume is the first attempt to assemble the views from the leading Post Keynesian scholars in one work. The chapters address a variety of theoretical, applied, and empirical issues ranging from exchange rates and capital flows to trade and development. Our hope is that this book can serve as a comprehensive reference to others interested in the current state of Post Keynesian research and that it may stimulate other explorations and policy discussions in this direction. The book is also aimed at upper-level undergraduate and graduate students in order that their interest can be stimulated, as well.

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We believe that the reader will find that the foundations of Post Keynesian theory are not opaque or mysterious (in fact, to us they seem like common sense), and that the policies Post Keynesians recommend are very reasonable. Indeed, while the programs advocated often require substantial overhauls of existing institutions, they call neither for the collapse of capitalism nor the privatization of all economic functions. Such extremes are not necessary to correct the flaws of our system. The particular topics addressed by the authors are such that the reader should finish this book with an understanding of the theoretical bases of Post Keynesian international economics, an appreciation of the policies those theories would suggest, and a grasp of how the structure of the current system is bound to lead to instability and deflation.

What is Post Keynesian economics? Though there are several strands of thought, a number of commonalities can be identified. First, economic agents are understood to operate in an environment of uncertainty. This creates the conditions that make money important in the macroeconomy, thereby invalidating Say's Law. No other characteristic of Post Keynesian modeling has more far-reaching effects. When money plays a causal role, full employment is no longer guaranteed by free markets. As a consequence, the government plays an important, even vital, role in the economy and microeconomic issues become clouded as the concept of opportunity cost becomes irrelevant. 'Free Traders' can no longer argue that workers whose jobs are destroyed by foreign competition will, after a short period of adjustment, find themselves automatically employed in industries that better reflect their economy's comparative advantage (in the process raising world welfare). Without Say's Law, nations accumulating balance of payments surpluses become antisocial drains on the level of world production and employment, rather than international role models for aspiring capitalists. The whole array of policy choices and consequences is changed when money matters.

Second, Post Keynesians believe that the economy is best modeled as existing in historical rather than logical or mechanical time. This means that they believe that the past has a real, qualitative impact on the future, that economic agents' decisions are affected by past events. As economic outcomes are realized, so market participants take these into account and their behavior is thus changed. When time is important in this way, the general equilibrium framework is not appropriate. At the very least, it must be used with great care, for general equilibrium models typically assume that everything happens simultaneously. That is, prices are set, contracts are struck, wages are earned, inputs are purchased, capital is built, incomes are spent, and output is produced all at the same instant. The economy reaches a state of equilibrium and stays there until one or more parameters change (until a function shifts, for example). The realized equilibrium does not somehow affect future ones by changing parameters (and therefore the underlying behavior). The parameters, the outcome, the equilibrium, and, therefore, the economy are assumed stable in the general equilibrium approach. Not so in the Post Keynesian.

In terms of market structure, Post Keynesians realize that oligopolies play a terribly important political and economic role in the real world. Oligopolists (or 'megacorps') have market power. They set price by marking up over cost, and they use the funds so generated to finance investment. Oligopolists compete with one another not through price, but via purchases of new plant and equipment, product differentiation, erection of barriers to entry, and public relations efforts (Eichner1976). Because of the nature of the industries that tend toward oligopoly (manufacturing and mining in particular), 'the production subsystem of the economy is essentially dominated by the megacorp' (Arestis 1992: 89).

The fourth distinguishing characteristic of Post Keynesian economics is the recognition of the importance of income distribution in explaining the macrodynamics of modern economies, as well as the socially determined nature of the distribution of income. The split between wages and profits and the rates of each are seen to be determined by investment, growth, historical circumstances, power relationships, institutional conditions, expectations of firms and households, and social policy. The distribution of income and wage and profit rates are not seen as physically determined and to be functions of the marginal products of labor and capital, even if one assumes these are identifiable concepts. While the specific justification for arguing that income distribution is socially determined may vary within Post Keynesian economics, all agree on its general nature and that it is a very appropriate realm for socioeconomic policy.

This book is divided into four parts: Balance of Payments Issues; Open Economy Macroeconomics; International Money and Exchange Rates; and Real and Portfolio Capital Flows and the Role of Technology. The individual chapters run the gamut from theory to empiricism to policy. Whenever possible, technical detail has been kept to a minimum in the hope that this text will be accessible to both scholars and students.

The opening chapter is, appropriately, from the editor of the *Journal of Post Keynesian Economics*: Paul Davidson. Professor Davidson's theme is one that is repeated throughout this volume: capital market activity aimed at earning speculative profits is only coincidentally beneficial to output and employment growth. Indeed, the opposite is far more likely. His specific focus is international portfolio capital movements, and it is his contention that the progressive post-war liberalization of markets, including especially the collapse of the Bretton Woods exchange rate agreement, has created an international economic system with a deflationary bias (that is, a tendency toward economic stagnation and unemployment). What is required is both a reform of the payments system such that surplus countries are punished for the drain they create on world economic activity and a conscious recognition on a national level that governments must work to maintain full employment. Until that is achieved, trade is far more likely to play a predatory role than a constructive one.

The next chapter, by John S.L. McCombie and A.P. Thirlwall, is an

excellent review of the literature related to balance of payments growth constraints, or Thirlwall's Law. Their basic premise is that, just as Post Keynesians argue that the gap between desired investment and full-employment saving is an obstacle to economic growth, so is that between export earnings and full-employment imports. They begin with an outstanding historical overview of the theory, then work through a theoretical exposition, and close with implications and empirical evidence. The lesson learned from this chapter is that closed economies exist only on paper and that, in our increasingly interdependent world, the maintenance of full employment requires careful analysis of balance of payments issues in addition to domestic macroeconomic considerations.

The next part of the book is entitled Open Economy Macroeconomics. Johan Deprez's chapter takes Keynes' aggregate supply and demand as it has been articulated and developed by Sidney Weintraub and Paul Davidson for closed economies and extends it to deal with open economies. This model reaffirms the basic Keynesian conclusion that production and employment is constrained by the effective demand that exists in an economy and the role of exports in this. The model is articulated in such a way as to highlight the rarely understood role of firms' expectations in determining employment, output, and patterns of trade. In a manner that is consistent with Post Keynesian explanations of the determination of exchange rates, it is also argued that there is no tendency within modern economies towards a balance of trade. Finally, by having an explicit supply side in the model, it is capable of addressing a wide range of other issues. Specifically, the question of cost reductions as a means of expanding exports is addressed and is found to be much more problematic than usually assumed.

Robert Blecker follows with a Kaleckian open-economy model. While both reviewing Kalecki's contributions to international economics and extending that work, Blecker makes three main points: (a) trade in the presence of oligopolistic industries can be conflictive; (b) in contrast to the implications of closed-economy Kaleckian models, it is possible when a foreign sector is introduced for a redistribution of income from wages to profits to be contractionary rather than expansionary; and (c) the relative effects of a currency devaluation on the trade balance and national income are not clear without taking into account the impact on income distribution. Though he finishes by cautioning the reader that the model needs to be extended, the preliminary results are nonetheless thought provoking. They serve to remind us that however well designed a domestic macro model might be, adding international trade and investment often involves more than simply a new variable or two.

Sheila Dow's chapter opens the next part of the book, International Money and Exchange Rates. She develops a Post Keynesian international finance theory in which liquidity preference and endogenous credit creation play a central role. Dow argues that, though all economic units have balance of payments problems the 'solutions' to which are likely to be deflationary, that

bias is made worse in the international context by currency speculation. The solution is to provide financial stability and low interest rates, which may be possible on the necessary scale only given a truly international money.

L. Randall Wray's chapter addresses similar concerns from a different direction. He starts by outlining the orthodox view of money, capital flows, and exchange rates, wherein free markets ensure independent domestic macro policies and rapid adjustments to optimal equilibria. He then presents the Post Keynesian view, which leads him to Keynes' famous bancor proposal for the international monetary system. Wray argues that while the latter is appropriate in a world where money matters, Keynes' original justification for it was flawed. Wray remedies this and thus provides additional support.

In his chapter, John Harvey explains the exchange rate volatility and misalignment characteristic of the post Bretton Woods era. He sees these as a function of the spectacular growth of short-term capital flows and the fact that portfolio investment now, for all intents and purposes, determines exchange rates. He concludes that the effect of this transformation has been payments imbalances, resource misallocation, reduced government policy autonomy, and wasted entrepreneurial skills.

The last part is Real and Portfolio Capital Flows and the Role of Technology. There, Philip Arestis and Eleni Paliginis examine recent economic developments on the periphery of the European Union and the North American Free Trade Area. Their thesis is that these economic unions have not created the institutions necessary to promote convergence, and that as a consequence the peripheral economies remain at a significant disadvantage. Though orthodox theorists and policymakers have argued that multinational capital will be attracted to these regions and therefore spur their development, the reality is that it is too volatile and generally unreliable to be of much help. Arestis and Paliginis suggest that though multinational enterprises could play a positive role if properly controlled, the best solution would be encouragement of indigenous capital accumulation.

Ilene Grabel shows that the pitfalls of dependence on international capital for development are not limited to those described in the previous chapter. Third World reliance on portfolio investment, she shows, tends to adversely constrain macro policy choices and increase risk. Grabel both makes this argument on a theoretical level and uses the 1994–6 Mexican financial crisis to illustrate her points.

The last contribution is from Bruce Elmslie and Flavio Vieira. Unique in the volume, their chapter is the only one to take a closer look at the determinants, rather than the effects, of foreign trade. In particular, they focus on the role technology plays in generating trade patterns, an approach consistent with the Post Keynesian emphasis on the megacorp as the most important representative firm. They start by reviewing the history of technology gap theory, beginning with the mercantilists. They then review modern attempts to reconcile technology gap theory within the framework of both comparative and absolute advantage, discuss testing issues, and review

the empirical literature. Their theme is that though technology gap theory is difficult to operationalize, the fact that it is a much more powerful explanation of the real world than the orthodox alternatives more than justifies the efforts to do so.

We hope that the eleven chapters in this volume give the reader a fresh perspective on the international economy. As the world shrinks and nations become more and more interdependent, so the need for penetrating analyses of those conditions becomes more pressing. We believe that the Post Keynesian approach – relying on the non-neutrality of money, the oligopolistic nature of industry, and the existence of the economy in historical time – is best poised to offer these analyses.

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Part I

Balance of payments issues

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