The relevance of money for economic development

by

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Why are macroeconomic considerations, in particular those about money and currencies, relevant for economic policy if the overall goal of governments is welfare for the majority of the population?

Broadly speaking, economic theory offers two but contradicting views on whether and how money essentially affects economic development: In the neoclassical paradigm money is understood purely as a medium of exchange that enables transactions in the real economic sphere but is neutral to economic development. In this view, the real economy, including investment, production and employment, is not much affected by monetary policy decisions. In the neoclassical approach, investment is the direct result of the propensity to save and the influence of policies on the decision of private households to save or to consume is rather small. Prize stabilization is needed to avoid distortions in the optimal allocation of resources.

In the kind of Keynesian-Schumpeterian perspective that is favoured by UNCTAD, money is not neutral but is a powerful instrument to create or destroy wealth. Creation of money “ex nihilo”, through central bank policy, is the most important mechanism for the creation of credits that are needed to realize investment, thus creating income of workers, employment and profits of companies that can be re-invested. Here sustained income and employment growth needs pro-active management of the economy by macroeconomic policy to achieve investment plans that are exceeding saving plans.

In this setting also the role of stable monetary values should not be underestimated. With wages being the most important determinant of the overall cost level, incomes policy has an important role to play. Countries that are prone to high and accelerating inflation may find it more difficult to start and sustain a process of development and catching up triggered by the creation of money and credit. In other words, without incomes policy that can be used to effectively dampen inflationary dangers, the attempt to spur development by expansionary macroeconomic policy is likely to fail as inflation
rapidly flares up. Conversely, in countries or regions cultivating a highly disciplined attitude towards price stability by means of heterodox instruments monetary and fiscal policy can excessively push for an investment led development process.

The role of currencies and exchange rates in international transactions mirrors the two contrasting standpoints: In the neoclassical world, exchange rates simply reflect the countries' price level, it is assumed that purchasing power parity theory holds. In the non-orthodox view currencies are understood as assets determined by the composition of market participant's portfolio preferences. Shifts of nominal wealth reflect market expectations and short-term speculation may trigger movements in the exchange rate far beyond the fundamentals, the inflation differentials.

The external and internal value of money is of great importance to economic development because they define the level of international competitiveness of the whole economy. In a Keynesian world, the relevance of monetary policy for overall economic growth is reflected in a competitive level of the exchange rate in real terms and in low interest rates. If monetary conditions including the exchange rate restrict growth and fixed investment, all the other ingredients of good governance or market flexibility are not sufficient to overcome this restriction. Monetary conditions, in fact, are crucial for development. That was the main mistake of the past. In aiming to follow slavishly the Washington consensus to "get the prices right", many countries by pursuing the agenda of "market flexibility" got the most important prices, the exchange rate and the interest rate, wrong.

In view of the monetary chaos of the post-Bretton Woods era developing countries have to find adequate instruments to introduce and/or maintain pro-growth monetary conditions. Inter alia this means to avoid frequent currency over-valuation and crisis as well as too high real interest rates. Exchange rate levels need to be supportive of export growth, and interest rates need to be kept at low and positive levels to be supportive of investment in fixed capital. In addition, reducing the risks of currency and financial crises by self-insuring against global shocks is essential. These conditions are required to enable economic growth and to gain space for countercyclical policies. Developing countries' available monetary policy options to achieve these conditions are very limited though: On the one side, flexible exchange rate regimes that are traditionally assumed as freeing monetary policy (as central banks are free to refrain from intervention in the foreign exchange market) have not brought about the effective policy au-
tonomy. Rather, in the case of developing countries that are very often additionally exposed to negative balance sheet effects, exchange rate fluctuations increase the risk of a financial crisis that counteracts any effort of growth enhancing policies. On the other side, rigidly pegged exchange rate regimes, including unilateral monetary integration such as de jure dollarization sacrifices the possibility to initiate a growth enhancing ‘money-profit-investment’ cycle a priori.

The diminished importance of savings

The prevailing thinking shaping economic advice extended to developing countries in general is based on the assumption that investment is financed from a savings pool filled up mainly by private household savings. In this view, entrepreneurial investment is mainly encouraged by policies aimed at increasing household savings rates and capital imports (“foreign savings”), as well as improving the efficiency of financial intermediation by developing a competitive financial system and creating securities markets. This approach, although widely shared in the development community, has to be taken with a considerable dose of caution. The assumptions of this model are heroic and in many respects far from reality. Its predictions have been repeatedly refuted by empirical evidence. For example, many developing countries, particularly in Latin America, failed to achieve higher productive investment despite monetary and financial policies that attracted waves of capital inflows. On the other hand, Asia is the most important global investor with an unprecedented catching-up performance and is able to export capital.

A view that better reflects the complexity and imperfections of the real world emphasises that strong domestic demand and stable enterprise profits simultaneously increase the incentive of firms to invest and their capacity to finance new investments from retained earnings. Thus, a fall in the savings ratio does not lead to a fall in investment; since it implies an increase in consumer demand, it will increase profits and stimulate investment. By the same token, an improvement of the current account as a result of changes in relative prices in favour of domestic producers does not represent a reduction in the inflows of foreign savings that causes a fall in investment; on the contrary, it is equivalent to an increase in aggregate demand and in the profits of domestic producers, and tends to lead to higher investment. Therefore, a fall in consumption or a fall of exports is not at all a prerequisite for higher investment.
Rather, the causality works in the opposite direction: changes in the current account towards lower deficits or higher surpluses lead to growing investment in fixed capital.

The consequences of the latter approach for economic policy are substantial. When investment, output growth and employment are determined largely by profits of enterprises, economic policies have an important role to play in absorbing shocks and providing a stable environment for investment. By contrast, in the neoclassical model there is little room for economic policy, and where it offers economic policy options, they often point in the opposite direction. Where the neoclassical model sees the need for private households “to put aside more money” or for developing countries to attract more “foreign savings” to raise investment in fixed capital, the alternative model emphasizes positive demand and profit expectations as incentives for domestic entrepreneurs, and the need for reliable and affordable financing for enterprises.

The upshot of the heterodox analysis is straightforward: the decisive factor for catching-up is domestic accumulation of capital, which will normally be the result of simultaneous investment and consumption growth in a process of rising real income for all groups of society. The most important obstacle for the realization of such a process is high interest rates or an overvalued currency. In real terms, interest rates should be close to the real growth rate of the economy or below. A vicious circle of excessively high interest rates and a high risk of default call for more pro-active financial policies. Governments can directly restrict the size of bank spreads through the kind of legislation that is used to stop usury in many developed countries. Moreover, public banks offering reasonable rates for private savers as well as for smaller private companies could directly compete with a non-competitive private banking system on a broad scale.

Monetary instability, periods of hyperinflation and frequent financial crises have often forced many developing countries to adopt economic policies that generate the exact opposite of what would be favourable investment conditions. On the other hand, “sound macroeconomic policies” as prescribed by the Washington Consensus, combined with financial liberalization, seldom led to the desired result of higher investment and faster growth because it was based on restrictive macroeconomic policies. The alternative policy approach that helped the newly industrializing economies of East and South-East Asia to accelerate their catch-up process has never been tried consequently elsewhere.
New economic policies for growth and employment

In the new economic policies the role of all the actors of economic policy have to be reconsidered. As mentioned, most important is monetary policy because it controls the short-term interest rate, which is significant for the determination of investment. In a world without automatic adjustment of investment to savings or an automatic increase of investment in cases of underutilized capacities of labour and capital economic policy has to act. Monetary policy in all systems of fiat money is able to do that simply through the process of liquidity provision by the central bank, because the central bank directly determines the short-term interest rate (and the long term rate at least indirectly) according to her evaluation of the economic situation.

In any case, more than anything else, macroeconomic policies determine employment creation through its effects on investment in fixed capital. With macroeconomic policies and monetary policy in particular strongly affecting employment the Washington consensus based assignment of policies and the advocacy of an independent central bank to stabilize the price level by all means reveals its dubiousness. If monetary policy is permanently used to fight protracted or inertial inflation, employment creation and sustainable income growth is made impossible a priori.

In fact, if monetary policy is in charge to stabilize investment, growth and employment the traditional instrument to control inflation is occupied and has to be replaced. With wages being the most important determinant of the overall cost level their importance for the stabilization of the inflation rate can hardly be overestimated. Indeed, it can be shown that for developed and developing economies the growth rates of unit labour costs, the premium of wages over productivity, are extremely closely correlated with the price level movements.

Nominal wages rising in line with the national or regional inflation target and the trend of the productivity growth in the overall economy constitute an institutional arrangement that serves several targets of economic policy at the same time. Firstly, it opens the gate for a growth oriented monetary policy as it warrants price stability (resp. the inflation target set by the government or the central bank) in the medium term. With cost-push inflation excluded monetary policy can spare restriction through interest rate hikes for times of over-utilized capacities of labour and capital where the need to stimulate growth anyway does not exist. Recently central bankers, to describe a regime where
all the economic agents have rational expectations concerning the reaction function of
the central bank, frequently use the term “anchoring the inflation target”. Indeed, by far
the most important variable to be anchored is the growth of nominal wages in relation
to productivity.

Secondly, nominal wages rising on a stable growth path (the productivity trend is
rather stable and the inflation target is given) constitute a regime of rather flexible real
wages if prices are more flexible than nominal wages. Such a regime is extremely im-
portant to smoothly absorb negative supply side shocks. For example, in the aftermath
of the oil price explosions those countries were much better off where the trade unions
did not try to get quick compensation for the negative real income effect of the falling
terms of trade. In these cases with nominal wages sticking to the inflation target and not
to the actual much higher inflation rate, the fall in real wages was larger in the first
round but if the country succeeded to avoid higher long run inflation or accelerating in-
flation the overall effects of the original stickiness of nominal wages was definitively
positive.

The other way round, countries with flexible nominal wages, very often appearing
in form of so-called backward looking indexation schemes, ended up with perma-
nently higher inflation rates and long and costly struggles against this kind of inflation
inertia. In all of these cases the companies were mainly burdened with the unavoidable
loss of real income (vis à vis the producers of oil) and their attempt to pass it on to pric-
es resulted in a new round of distributional struggle.

Thirdly and most importantly, nominal wages rising in line with the inflation tar-
gent and productivity growth are the most important stabilizer of demand and the only
way in which a country can consistently create the demand that is necessary to absorb
the “productivity shocks” that are stemming from the use of new technology, technology
that is meant to reduce the “disutility” of labour but would lead to unemployment if la-
bour would not be put in a position to demand new goods as soon as the old ones are
produced more efficiently than before.

If nominal wages rise in line with the national or regional inflation target and the
trend of the productivity growth in the overall economy it is implied that real wages
grow steadily in accordance with productivity growth excluding supply shocks. Product-
tivity growth has a dual character like wage growth. On the one hand, it is a source of
income, in fact, the most important one for all economies without a rich endowment of
natural resources; on the other hand, it is the destroyer of traditional work places and a potential source of permanent unemployment. However, the destructive part of it can be tamed if the higher proceeds of the new technologies (it is implied here that new technologies are more productive than old ones) find their way to those agents whose needs are unlimited but whose means are limited by the old technology.

In this way, the productivity growth distributed equally between labour and capital will – with unchanged saving behaviour of private households and companies - produce exactly the additional demand that is needed to induce the additional production and the additional demand for labour that, from the point of view of the overall economy, can compensate for the laid off labour in those firms at the origin of the productivity increase.

In developing countries in particular, a rule for wage growth consistent with the inflation target may be an important instrument to stabilize the economy from the real and the nominal side. Many developing countries have a history of very high inflation or even hyperinflation due to the fact that bouts of inflationary acceleration spilled over into nominal wage increases through indexation mechanisms. This has proved to be extremely costly because for central banks to bring inflation down to their target level against permanent cost push means to shock the economy time and again through interest hikes and implies to sacrifice real investment for the sake of nominal stabilization. In these cases the anchoring of nominal wage demand is extremely important but, and this is often forgotten by the advocates of such anchoring in the central banks, it is only consistent with the overall targets of growth, full employment and inflation if nominal wages not only reflect the inflation target but also the trend of productivity growth.

Arguments like the ones brought forward here will be subject to fierce criticism from the advocates of the traditional neoclassical employment theory. For them real wages have to fulfil only one task in a market economy, namely to equalize demand and supply on the labour market. Whenever unemployment is high or rises, real wages must be too high or rising too much. Whenever a country has persistent and high unemployment, an excess of supply, its unions must be too strong and prevent the equilibrating mechanism rooted in the “fact” that flexible prices (falling wages) would remove the excess supply. However, the simple transformation of such microeconomic supply/demand-logic to the overall economy is unfounded. For prices to equal supply and
demand consistently and exclusively at the micro level, the supply and demand functions have to be independent. That is not the case on the labour market.

With supply and demand on the labour market without any doubt being dependent in the overall economy, the simplistic rule of supply and demand does not apply and more sophisticated analysis has to be used to understand the effects of falling or rising wages. But it is obvious, and in particular for developing countries: the idea that the existence of unemployment forbids the application of the wage rules elaborated above is flawed. It may be even the other way round: The fact that unemployment dominates the developing countries for many decades may directly result from this flawed idea. If the power of employers and their ability to dictate low wages is regarded as the “natural” outcome of a market with high unemployment the high unemployment rate may be locked in by the faulty approach. Additionally, if “trade” is looked at being the only force that can move the economy in a sustainable manner to higher income levels, as is the case in many emerging markets, the flawed argument is perpetuated.