

*The M. L. Qureshi Memorial Lecture*

## **Missing Basic Issues on Credit Money: On the Role of Money in Removing World-wide Growth Barriers**

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Kalecki identifies demand restraint in industrialised and capital restraint in developing countries as the decisive barriers of world-wide growth. Thus, beyond others, it is a matter of financing to foster employment in both types of countries: a rational use of credit money on the international scale could finance additional imports of capital goods by developing countries, whereas industrialised countries could increase their output by trade balance surpluses. This question has been largely debated under various aspects, from the Stamp plan (1958) to the programme of the Commission on International Development Issues (1980). Even if this debate has been superseded by questions of the process and the institutions by which capital is allocated, of the appropriate business management and screening and monitoring, declining growth rates in the last twenty years show that the basic issue of production and distribution of additional real capital remains at stake. Besides institutional obstacles, capital restraint still remains the main bottleneck for development. Basic questions as how to create and use world-wide credit money has to be reconsidered instead of taking backfiring actions to manage actual financial crises. Additional international money supply by planned trade balance deficits of developing countries contributes to world-wide growth, whereas trade balance deficits of the United States are likely to prepare the next financial crises by an excessively increasing dollar supply. A revival of the debate of how to link SDR's and development financing surely requires to tackle a great number of additional questions, such as how to allocate trade balance deficits and surpluses and how to ensure the acceptance of this world credit money. All in all, it would be a serious attempt to break the money away from the handing down tradition and to transform it into a rationale by abstract reasons and well-founded instrument for economic development.

### **1. THE COEXISTENCE OF CAPITAL AND DEMAND RESTRAINT**

Welfare in developing countries is an issue of employment and labour productivity, which both depend on capital formation: the capital stock has to grow to create more employment opportunities and to increase capital intensity. Hence, the classical question of capital formation remains the crucial point in the debate of

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economic development. Statistical evidence shows that in the last twenty years, less progress has been made than before: in developing countries taken as a whole, the average growth rate fell around two-thirds as compared with the sixties; this slow-down is accompanied by a marked fall in capital formation. This is not inconsistent with observations according to which a certain number of developing countries realised a marked increase in labour productivity due to capital deepening [Kumar and Russel (2002), p. 536]. If output per worker increases due to capital deepening, and if, furthermore, employment and economic growth is as low as the investment ratio, then investment has been used to create some ‘world-class’ firms—many of them subsidiaries of multinationals—[Ocampo (2002), p. 404]. But net capital formation was too low to allow for more employment.

Thus, the situation in developing countries has not improved in principle: capital restraint remains the barrier to economic development. Apparently, the catching-up process has experienced a setback during the last two decades, which are marked by an increase in free world-wide trade and capital movement. Apparently, “the longest-lasting episodes of rapid growth in the developing world (...) did not coincide with phases of extensive liberalisation”. Neo-classic hope—that under conditions of a more perfect international market the higher marginal productivity of capital in developing countries would automatically attract real capital—has not been fulfilled. This disappointment has led to the following alternative explications: Liberalised markets fail because of (1) inadequate institutional development or human capital or (2) a lack of full-fledged ‘mesoeconomic policies’ such as active competition policies, the correction of market failure in the markets for long-term capital, technology, labour training, and the like [Ocampo (2002), p. 400]. These explanations, even if the one or the other is true, raise a more fundamental question: obviously it is extremely difficult to fulfil condition (1) or (2) so that liberalised markets develop their full efficiency. As experience shows, the international economic order of the after-war period (when developing *and* industrialised countries performed better) required conditions for their functioning which were easier to accomplish. Thus there are in fact reasons enough to rethink the whole body of development strategies and—from a theoretical point of view—to put the old questions once more. It is surely important, as a lot of recent literature in the above context does, to analyse “the process and institutions by which capital is allocated” [Stiglitz (1989), p. 55], but before doing so, it is worthwhile to come back to the traditional topics of surplus and accumulation, and in particular of financing. In detail this means to answer the questions, whether there is a world-wide (potential) surplus enough to alleviate capital scarcity in developing countries and whether there is a mode of rational financing of accumulation by credit money. That there is potential, but not produced surplus, is illuminated by the fact that industrialised countries experienced a similar cut-back in economic performance as the developing countries.

In his noteworthy article, “The Difference between Crucial Economic Problems of Developed and Underdeveloped Non-socialist Economies”, Kalecki (1993) summarises that the main obstacle for economic growth in industrialised countries is the lack of effective demand. In contrast to this, in developing countries the classical capital restraint remains the principal barrier for growth. This need for real capital stands for potential demand, which could increase output and employment in industrialised countries, and thus their production of surplus. This increase of output in the form of capital goods, if exported to developing countries, would enlarge their capital stock. Thus capital *and* demand restraint could be removed at one stroke: an increasing production of investment goods solves the general unemployment question by more effective demand in the industrialised countries and by capital formation in the developing countries.

To specify the question, it is worthwhile to discuss briefly where the demand restraint in industrialised countries stems from and how, if at all, policy tries to settle the question. When discussing the under-consumption theory of Hobson, Keynes argues that Hobson “laid too much emphasis (...) on under-consumption leading to over-investment, in the sense of unprofitable investment, instead of explaining that a relatively weak propensity to consume helps to cause unemployment by requiring and *not* receiving the accompaniment of a compensating volume of new investment, which, even if it may occur sometimes temporarily through errors of optimism, is in general prevented from happening at all by the prospective profit falling below the standard set by the rate of interest” [Keynes CW VII (1973), p. 370]. The weak propensity to consume in turn depends, among other factors, on “the principles on which the income is divided between the individuals” [Keynes CW VII (1973), p. 91], or, more precisely: “People’s propensity to spend (as I call it) is influenced by many factors such as the distribution of income, their normal attitude to the future and—the probability in a minor degree—by the rate of interest” [Keynes CW XIV (1973), p. 119]. In terms of classical political economy, the underlying question is best described by the relation between the forces of production and of the mode of production: productive forces have led to a high labour productivity and hence to a high surplus per worker, but the state of technical development prevents a part of *potential full employment surplus* from being absorbed and thereby produced in the form of investment goods. (Schumpeter called it decreasing investment opportunities). The outcome is the production of less than potential surplus, which means less than full employment surplus, which in turn is synonymous with unemployment. The solution could be found in diminishing full employment surplus by increasing profit taxes or wages—in order to increase mass consumption. (One form of more mass consumption is the welfare state). In principle, the mode of production conflicts with such a change in income distribution: the required distribution can only be realised by political forces such as parliaments or trade unions—and not by market forces. Policy is also required to increase investment demand by a low rate of interest. This, too, interferes with income distribution: it decreases the income of the rentiers.

If income policy in favour of mass consumption is not at stake, a solution can be found by replacing the required investment expenditures “by government expenditure which is financed by loans, so that no reduction of any incomes by taxation is involved” [Kalecki (1993), p. 14]. The solution is a sort of financial trick. This financial trick concerns, in the first instance, the traditional deficit spending, but it is obvious that trade balance deficits of the foreign sector lead to the same result for the domestic economy of industrialised countries. This implies two basic questions: (1) Are balance-of-trade deficits a positive issue for developing countries or is free and balanced trade sufficient for economic development? (2) How to finance, if at all, trade balance deficits of developing countries?

## **2. WORLD-WIDE GROWTH AS LED BY INDUSTRIALISED COUNTRIES**

When Stiglitz (2002, p. 51) describes the working of international monetary institutions, he qualifies their policy various times as “ideologically motivated measures”, as “market economy fundamentalism” and the like. The main feature of modern market fundamentalism is its extreme addiction to unregulated commodity and financial markets, and by this the disregard of basic facts in the area of macroeconomics. One of these facts is that in practice free trade has fostered the already existing tendency towards north-south trade. Even in the ideal case, where export revenues of developing countries are entirely used to import capital goods (which, in practice, is not the case because of the debt service), the speed of capital formation and growth in these countries is determined by the economic growth in industrialised countries, which is restricted by insufficient demand. This restriction transfers the demand restraint of industrialised countries as barrier of growth into developing countries. If it is not removed, free trade simply fosters world-wide competition, without expanding, in the longer run, the export market for developing countries. Only in the short run, free trade can alleviate the capital restraint: it only increases the market share of developing countries on a restricted market. And even this is not certain. If there is cut-throat competition amongst developing countries, export income will not grow because of falling prices. This possible result has to be added to political obstacles for free trade: it is used as a weapon in distribution disputes. Thus it contributes to keep down wages in industrialised countries, and thereby effective demand and growth. And beyond this, growing segments of public opinion see developing countries as responsible for low wages and unemployment. The reaction very often is an alliance between threatened business and workers, followed by government-imposed tariffs, quotas, and the like.

Thus, even if there is a strong belief in the advantages of free trade, the prerequisite for its success is not only an open but also a continuously increasing market. This means higher growth in industrialised countries. Consequently, the traditional question of how to come to more growth in these countries remains on the

agenda, i.e., (1) increasing consumption along the line of Keynes' determinants of the propensity to consume by interfering with the income distribution—this was the after-war solution, or (2) solving the problem by deficit expenditures, which is the rather sporadic and unsystematic actual approach. Under given conditions, world economic growth depends to a great extent on U.S. foreign deficits. The corresponding trade balance surplus of, mainly, industrialised countries then fosters world-wide growth. The financing of these deficits is assured as long as the US dollar is accepted as international money. But critics are right in saying that from a certain point on, cumulated U.S. deficits will end in a dollar crisis with the common effects on real economy. Although these deficits, up to now, create world-wide output, they are absurd because they do not reflect a necessary division of labour; most of the excessive imported goods could easily be produced by the US herself. This raises the question, whether instead deficits as international growth incentives should be realised by developing countries, which are in urgent need of real capital and which are not able to produce it themselves.

Developing countries dispose of a smaller range of possibilities to finance trade balance deficits: direct investment linked with capital import (no increase in external debt) or credit. International indebtedness is a matter of serious risks. Debt service depends on export, which in turn is mainly determined by the growth of industrialised countries.<sup>1</sup> Direct investment as the non-debt creating form of capital formation has its well-known disadvantages such as the loss of national sovereignty or uncontrolled outflow of surplus. Moreover, under the regime of demand restraint, other objections have to be added. Given restricted world-wide markets, direct investment often takes the form of buying existing firms and thereby markets (very often former state enterprises) instead of building up new production capacities. Thus it is doubtful whether direct investment supports research and development in the host countries, albeit it may improve labour productivity by modernising the firms in question, which means creating highly productive islands without backward linkages.

<sup>1</sup>The years after 1979 are a good example for this realisation problem. At the end of the Carter administration, the beginning cyclical downswing in the USA was accompanied by a policy of extremely high interest rates. (The justification for this was to fight inflation, but also to lower wages by a revaluation of the Dollar. —Economic Report of the President 1983, p. 59). The consequence was a long and very marked downswing—in the USA as well as in the other industrialised countries, which followed the US example. By this, export markets for developing countries shrank, whereas high interest rates increased the debt service [Schui (1988), p. 20]. To make matters worse for oil-importing indebted countries, the oil price rose in this period. There are good reasons to suppose that the former Shah government of Iran as a close ally of the USA had made a special effort that the price increase was higher than initially planned by OPEC countries; in the 1980s oil companies made the most of the strikes in Iran—the oil exports of this country declined sharply in this period—and of the oil reserve policy of the USA—as they increased their reserves during this time instead of selling oil to stabilise prices. OPEC then followed with price increases to appropriate a part of the growing profit of oil companies [Terzin (1983), p. 231, p. 311].

International indebtedness as well as direct investment are, if at all, second-best solutions to accelerate accumulation in developing countries. This leads to the question if modern credit money could be used to foster accumulation in developing countries. The monetary solution is to finance trade balance deficits of developing countries by money creation in order to increase their import of capital goods. This would contribute to increasing the world-wide demand and output. Developing countries would take over the role of the United States in leading international economic growth. The analysis of this issue is, in the first instance, a question of clear understanding of the nature of modern credit money and its objective function. Or in other words: Can we imagine a rational international monetary system which contributes to removing the barriers of growth in developing as well as in industrialised countries? If such a draft is possible, we can obtain criteria to judge the effectiveness of the international monetary system with respect to this objective. This may help to review international monetary policy, carried out by the monetary institutions such as the IMF, the World Bank, and various creditor clubs.

### 3. THE OUTLINES OF A RATIONAL MONETARY SYSTEM

The first coherent draft for a rational monetary system to meet the requirements of capitalist accumulation stems from John Law (1705).<sup>2</sup> Law's system is a serious attempt to break the money away from tradition, from the directness in the sense of the non-abstract understanding of money as having a value in itself, and to transform it into a rational instrument for economic development. The outlines of Law's draft are as follows: the parliament of the absolutist state installs a commission as bank of issue and a controlling committee. The commission supplies paper money according to the demand of the landowners, i.e., the owners of the prevailing means of production at this stage of economic development. A cross-entry comes into being as a loan, which may be paid off by paper money whenever desired. The loans are interest-bearing—to prevent landowners from making non-productive expenditures. The interest is public income.

The important aspect of Law's paper money is less historical than analytical. It shows the basic properties of credit money in a one-step banking system, with bank credit as the only means of financing investment. Basically, Law's outline of a monetary system as the precondition for economic dynamics is identical to Schumpeter's ideas of the role of money and credit. Thus, his comment on Law is very positive: "(...) one great plan was behind all this, in fact well-advanced in the

<sup>2</sup>Law's paper money was first introduced in France late in the reign of Louis XIV at the end of the Spanish war of secession. It failed mainly for reasons of confidence: before Law's money, French government issued another type of paper money during wartime, which served as a means of payment to French troops in France. But the state authorities did not accept this money to pay taxes. Voltaire's comment on Law's money was positive, but he remarks that this paper money should have been introduced in times of prosperity in order to stand firm in an unhappy time [Voltaire (1881), p. 411].

road to success: the plan of controlling, reforming, and leading on to new levels the whole of the national economy of France. This is what makes Law's 'system' the genuine ancestor of the idea of managed currency, not only in the obvious sense of that term but in the deeper and wider sense in which it spells management of currency and credit as a means of managing the economic process" [Schumpeter (1959), p. 322].

From this basis the main characteristics of a rational monetary system can be derived. (1) In the first instance, credit money is purely national money, the purpose of which is to put domestic economic resources into use. It replaces commodity money and cuts financing off the supply of precious metals, the production (or the import) of which absorbs domestic resources. It should be noted that—from the angle of a country, the currency of which is not international money—foreign currency is equivalent to commodity money. Hence, if local currency is freely convertible currency, the freedom to select between financing by credit in local or international currency may cause an avoidable loss of domestic resources by debt service. Free trade of goods and (financial) services should be reviewed under this aspect, too. It follows that the international coexistence of different local credit moneys requires careful international management. (2) The rate of interest is a means of allocation, which is administered by public authorities. Its existence is a characteristic of a price-controlled system. Thus the logic of interest is its quality to be a price for credit as a licence to use resources. This price has prohibitive properties. The scarcer the resources, the higher the price. This involves the question of information. If monetary authorities mainly administer the rate of interest, it may be concluded that the trust in the market for generating information is low. (Note that even monetarists do not trust in the market forces when fixing the quantity of money by political institutions.) (a) Under the regime of capital restraint, the level of the rate of interest has to ensure that all these economic resources, which are not used for consumption, are put into use for the production of capital goods. This includes also forced saving as set off by monetary means. Accumulation thus is not limited by any shortage of financing (for instance by an inadequately high rate of interest), but by the availability of physical resources. This contrasts with a regime of pure commodity money: here the stock of precious metals, the readiness to coin it, and further hoarding and liquidity preference of the money owners, i.e., their readiness to contract at the credit market, decide the credit supply and hence accumulation, which all in all does not provide adequate information on the scarcity of physical resources. To a certain extent this is also true for international lending. It is not unlikely that foreign credit supply is subject to the same restrictions as atavistic lending of commodity money. (b) Under the regime of demand restraint, the rate of interest has to ensure "the financial trick" to bridge the gap between full employment output and insufficient effective demand. In this case, its allocation function is not to reconcile scarce resources with the need for real capital but to encourage

investment expenditures and to allow for public deficit spending at a low debt service. In this case, the rate of interest has to be low and even zero: if investment at a zero interest rate does not bridge the gap, there is no reason why public debt should bear a positive rate of interest. In terms of time preference, resources left idle at a zero interest rate mean that there is no social preference for present consumption for which compensation is needed. (3) Interest payment is a rent. With commodity money, it reflects the scarcity of *credit* and not of *physical economic resources*. Money owners appropriate it. Thus it stems from property of money and not from property of physical economic resources. With a rational credit money, interest as an *active means* of resource allocation remains necessarily a positive rent as long as physical resources are scarce. But as interest is neither a reward for waiting and abstinence—saving is not determined by interest—nor a reward for forsaken liquidity—the creation of credit money can compensate for any hoarding—interest payment can be appropriated by public administration.<sup>3</sup> This implies that monetary authorities can generate information. If not, private credit supply, and by this private appropriation of interest payment, is unavoidable to generate information. In this case, private interest income is a by-product of the information-generating process. The rent quality of interest generates rent-seeking. This explains the pronounced interest of international financial institutions in free movement of capital and free service transactions. (4) The appropriation of interest payment as public income requires the non-existence of securities as alternative means of credit financing and a one-step banking system. If these conditions are not fulfilled, the competition amongst banks for deposits and between the bank credit market and the security market will necessarily be followed by interest payments to depositors and security owners: in this case public authorities and the private sector share the interest income. (5) Credit has to be a reliable means of financing expenditures. For creditors, but in particular for debtors, it is extremely important that financing is secure. This does not only concern projects under way, but also the continuous financing of investment at a suitable rate of interest. In the case of capital restraint, suitability means, as mentioned above, that accumulation does not fail because of prohibitive credit costs. Reliability also means that there is widespread credit supply, which includes smaller investment projects and remote areas. This is important for backward linkages and a well-structured development.

<sup>3</sup>As long as in a pre-capitalist formation there is no systematic accumulation, there is no need for interest to ensure the entire use of physical resources. With consumer credit, the allocation function of interest concerns only the redistribution of consumption goods amongst different individuals or social groups. Then the readiness to borrow and to pay interest is often enough the result of the threat of starvation. Hence canonical prohibition of interest as endorsed by Islamic divines or by Thomas Aquinas is a —well-founded—moral issue. If in a price-controlled system interest is unavoidable, moral standards with respect to undesired effects on distribution could, among other means, be maintained by the appropriation of interest payment by public authorities.

#### 4. THE MAIN FALLACIES OF THE EXISTING FINANCIAL SYSTEM

At present, the discussion of international finance and lending deals less with “macro-economic co-ordination as stressed in the earlier development literature, but with microeconomic problems of selecting (quite specific) projects and choosing good managers to manage these projects.” So emphasis is given “to channel funds to the most profitable opportunities (the selection or screening function) and to ensure that those funds are well used (the monitoring function)” [Stiglitz (1989), p. 66]. This is certainly of importance, but emphasis should also be given to the short- and the long-term aspect of profitability. Furthermore, the production and the appropriation of surplus have to be discussed. This is decisive, if the market structure does not allow that surplus is appropriated where it is produced. (These externalities are in particular likely for public investment: the estimate of overall benefit of an investment should be included). [Stiglitz and Weiss (1981)]. After all, there “is no clear evidence from experience that the investment policy which is socially advantageous coincides with that which is most profitable” [Keynes CW VII (1973), p. 157]. This leads to two more questions of particular interest: (1) Do the criteria of financing of a project correspond with the basic grounds for free trade? And (2) is there a systematic difference between financing a private investment project, on the one hand, and a country’s economy as a whole, on the other hand?

The first point concerns the fact that Ricardo’s criterion for foreign trade is comparative advantage. Thus, there is a rationale not to select only projects with absolute cost advantages. Will international financial investors allocate their funds according to this criterion? Or are there good reasons for them to choose the project with the absolutely lowest costs and highest profitability? And further, if they do so, is there a reliable financing of a firm’s and a country’s economy?

If solvency, credit worthiness, and a renewed access to international financial markets is at stake, it has to be considered that countries do not go out of business as firms do.<sup>4</sup> “They may be happy or unhappy with their economic performance, but they have no well-defined bottom line. As a result, the concept of national competitiveness is elusive” [Krugman (1997), p. 6]. Not only this, the concept of credit worthiness is elusive, too, because the criteria for the international financier to

<sup>4</sup>Similarities exist when neo-classic is treating the labour market. If the full employment wage rate (i.e., the corresponding marginal productivity of labour) is too low even to make a bare living, starvation of the overpopulation is the only issue, if there is no social security. A negative income tax is proposed to prevent starvation. Something similar is provided for nations as a whole in the form of, for instance, structural adjustment facilities of the IMF or low-interest loans of the World Bank and its affiliates. The price for this stand-by is the *de facto* surrender of the state sovereignty in economic affairs to international financial institutions. The treating of the unemployed in industrialised countries is not unlike: by struggling for a job they have to prove continuously with sufficient servility that they are worthy poor. It would surely be interesting to continue this reasoning by trying to predict whether and how long the unemployed, and those whose (flexible) wages and social benefits show a marked downward tendency, will accept this loss of livelihood—and dignity.

provide or to withdraw his funds are rational for him, but not necessarily with respect to economic performance of the country in question. Consequently, there are two objections against free private international lending: a nation is not an enterprise and the aim and rationality of the borrower and the lender are not identical, even if financial crises are often hailed as the objective judgement and severe punishment of the market, as a means of education for obstinate governments and politicians. It is Keynes who has very clearly described what the very ground of the market reaction in financing is. To avoid losses on financial markets with flexible prices for equities, foreign currency and the like, the essential objective for the financial investor is not simply to be informed about the economic performance (the profitability) of the firm or the country, but in particular to know the assessment of other investors. Even secure information of good performance is no reason to finance or to maintain financing, if others believe the contrary. Another reason for withdrawing funds is a change in the rank of the project in question, even if its absolute performance remains unchanged.

Keynes describes this circumstance with the following metaphor: “(P)rofessional investment may be linked to these newspaper competitions in which the competitors have to pick out the six prettiest faces from a hundred photographs, the prize being awarded to the competitor whose choice most nearly corresponds to the average preference of the competitors as a whole; so that each competitor has to pick, not those faces which he himself finds prettiest, but those which he thinks likeliest to catch the fancy of the other competitors, all of whom are looking at the problem from the same point of view. It is not a case of choosing those which, to the best of one’s judgement, are really the prettiest, nor even those which average opinion genuinely thinks the prettiest” [Keynes CW VII (1973), p. 156].

Surely, this can be elaborated in a more sophisticated way in terms of likelihood, dilemmas, and the like, but the mere basis remains the metaphor above. Thus, there is no reason for trust in the information-creating capacity of the market: with respect to economic performance, the judgement of the market is rather arbitrary. Common theory is debating this outcome in terms of global public goods or externalities, which could, among other matters, lead to an analysis of alternative mechanisms—so as to supply them in appropriate amounts [Kruger (1998), p. 2005]. Besides this liturgical terminology of modern economics, it is the point for policy. “The introduction of a substantial government transfer tax on all transactions might prove the most serviceable reform available, with a view to mitigating the predominance of speculation (...)” [Keynes CW VII (1973), p. 160]. So why not the Tobin tax, as actually claimed by anti-globalisation movements like “attac”? The main obstacle surely is that such a rule would restrict the opportunities of international financial investors. Apparently, the advantages of credit money as briefly outlined at the outset require that this money be embedded in a system of institutions and rules. Only then can it develop its advantages such as the

independence of credit supply on hoarding, on the production or the import of gold (as equivalent to foreign currency), i.e., its quality to be the adequate *financial* means for economic development. These necessary rules are in conflict with the interest of financial business. The underlying ground is that price-governed economies need the rate of interest as a means of allocation, that interest payment is a rent, and that obviously there is a common interest of the financial sector to appropriate this rent as private income. Hence there is competition amongst the various financial institutions for this rent: freely convertible currency and free trade of services describe in this context the desire of foreign financial investors to participate in the rent allocation of a country.

In principle, the inadequate management of modern credit money causes the shortcomings of the existing world monetary system. As already outlined, the purpose of credit money is to enable investment (here on the international scene) up to the point where all physical resources are under use. In this context, adequate financing means more effective demand, and by this the creation of income and saving—if there are no impediments in the realm of social institutions organising accumulation; furthermore adequately skilled labour, and the like. But experience of the last half-century obviously shows that the monetary system to finance investment and the institutions to carry out accumulation are interrelated with each other. The period of more intensive political regulations apparently went hand in hand with the building up of adequate institutions for development—but the present institutions with their specificity to finance and to manage international indebtedness and to organise accumulation (the emphasis of the private sector, the importance of multinationals herein) do not do this. Under the aspect of financing, the main reason for this failure is that the level of interest does not reflect the scarcity of physical capital but the readiness to contract at the credit market, which in turn is determined by the estimates of professional financial investors according to their rationality. The role of the state in development and the need for financing development is rather disregarded; the narrow sense of private investor's profitability leads to ignore the long run, to neglect the necessity of backward linkages. The analysis of how to come to a well-balanced development in all facets of the economy, including forestry and agriculture to assure feeding, sheltering, and clothing by the generation, or the use of domestic resources, which could alleviate pressure on trade balance, is replaced by hailing the forces of a free markets.

##### **5. THE MISMATCH OF INTERNATIONAL FINANCE AND EXTERNALITIES**

When Knapp (1905) calls money a creature of the legal system, he is right insofar as credit money as an artefact requires public administration, which in the first instance is limited by the range of state authority. This range is determined by state territory, but also by the capacity to manage credit money adequately—which is

jeopardised by internal *and* external factors, such as IMF conditionality. The territorial aspect confines credit money in the national realm. The international functioning of credit money requires agreements of states. As long as these agreements are imperfect or inadequate relative to the nature of credit money, the rational solution for an individual state is to use its local currency for development whenever possible and to make a sharp distinction between local and foreign currency. This is not to advocate autarky, but to argue for an *international* legal system to administer international credit money.

In any case, national development requires careful consideration so that domestic resources can be mobilised by local currency, and foreign credit by unavoidable. This involves once more the question of saving and financing. As financing enables investment, which in turn creates income and savings, it is not precise to say that financial institutions “collect” savings to make possible the financing of investment. As financing creates savings, mobilising domestic resources creates domestic savings, and financing by local currency avoids losses of the domestic economy in the form of interest payment. To come close to this goal, national monetary policy must be sovereign enough to fix the rate of interest at a sufficiently low level—without fearing capital outflow and undesired devaluation. For example, if an entrepreneur plans to build a new hall and if construction material can be produced by the domestic economy, and if further additional workers can be nourished by domestic agrarian production, and if, furthermore, an increase of the production of food can be secured by domestic production, then it is not rational to raise foreign loans to finance this investment. Or, more specifically, investment along the line of the input-output matrices avoids increasing input prices, food production included. Thus, low interest rates, an appropriate distribution of credit and the encouragement of even small investment (once more the agrarian sector included) helps to avoid inflation.<sup>5</sup>

It is evident that private investors do not take into account the implications of foreign or domestic lending. With freely convertible currency and the absence of capital controls, they tend to cause externalities: if firms are free to choose between domestic and foreign credit, the domestic central bank with its currency

<sup>5</sup>The writings of Kaldor (1978) and Kalecki (1993) give a good insight into what the dominant reason for inflation in developing countries is: agrarian production falls behind the growth of the industrial sector. A shortage in food, hence increasing prices for livelihood, and by this increasing money wages, lead to higher prices in the industrial sector, which in turn makes the input for the agrarian sector more expensive. A recession as brought about by advice of the IMF dampens inflation by the shortcoming of demand for food. As a result, industrial growth is adapted to the low effectiveness of the agrarian sector. At bottom this is not an anti-inflationary but an anti-growth policy. High interest rates as further results of IMF programmes hinder the agrarian sector to increase its output and productivity. Similar effects occur if cash crop production is promoted to foster export and if foreign banks dominate credit supply. These are less interested in developing remote agrarian areas. Property in the agrarian sector is another issue. Which form of property fosters agrarian output best? Thus the choice may be to maintain large estate holdings or to create family-owned farms with an optimal area.

reserves—and not the borrower—is obliged to ensure the debt service in foreign currency. If the bank is unable to do so, austerity programmes are likely to enforce more exports. Hence the final price for foreign lending may be higher than its specific rate of interest. In other words: externalities express in retrospect that the relative prices of financing by foreign or domestic credit were not exactly expressed by the rates of interest. This is certainly one of the reasons why, in “Keynes’ proposals, the Fund would have been able to require countries to impose capital controls” [Kruger (1998), p. 1995)]. But these regulations, as necessary as they are, do not conform to the abstract logic of globalisation. Thus one does not only require freely convertible currency and free services: the more the world-wide economy comes closer to a national economy, the higher the need for a unique currency and for only one responsible lender of last resort—and not a variety of currencies within an hierarchy of quickly changing ranks. (The history of the European Union shows that economic integration requires, from a certain point on, one unique money). Such logical requirement seems to be the mere reason for the creation of currency boards. But this arrangement has two serious defects: in the case where the US Dollar is the local currency, the US Federal Reserve nevertheless does not serve as the lender of last resort for local banks; in both cases local banks have to compete for the Dollar which leads to a higher rate of interest than in the United States; if investment is more expensive, economic activity slows down. Furthermore, international companies realise advantages by this arrangement relative to their local competitors. They can use their traditional channels for cheaper financing; in addition, in most cases, their self-financing is higher. The mere reason for this outcome is that within such a mismatched structure, the rate of interest does not fulfil its function, i.e., to indicate the scarcity of physical resources. Instead, it informs about the scarcity of foreign currency, just as the rate of interest in a commodity money regime informs about the scarcity of gold and the readiness of money owners to contract at the credit market. In this case, the advantages of credit money are not taken—in contrast to Schumpeter’s idea of “currency and credit as a means of managing the economic process”.

## **6. DEVELOPMENT FINANCING BY THE CREATION OF INTERNATIONAL MONEY: THE LINK DISCUSSION**

The formation of real capital by unbalanced trade and its financing by the creation of international money is not a new idea: in the last version of his plan for international finance of 1943, Keynes provides a method of international money management, where, as Keynes writes, “it would be possible to avoid asking any country to assume a burdensome commitment for relief and reconstruction, since the resources would be provided in the first instance by those countries having clearing

accounts for which they have no immediate use and are voluntarily leaving idle, and in the long run by those countries which have a chronic international surplus for which they have no beneficial employment" [Horsefield (1969), p. 33]. This was certainly the thought for postwar reconstruction, but the outlines can easily be generalised for universal development purposes. Chronic trade balance surplus is one remedy for unemployment in industrialised countries; by analogy, relief and reconstruction is what developing countries need. Thus it is not surprising that in the later years this idea has largely been discussed as the link between special drawing rights and development financing. The Stamp-Plan (1958) is the first attempt, followed by Triffin (1959); the UNCTAD (1964), and Scitowsky (1965) [see also IMF (1985), Vol. I, p. 199, Vol. III, p. 69]. If we dismantle these plans of booking procedures and the inclusion of international non-private credit institutions, they have one common outline: financial deficits create credit money. For a national monetary system, the business sector's deficit is typically financed by money creation, followed by deficits of the state and the foreign sector. An international central bank can choose trade balance deficits of developing countries as cross-entry for its money creation.

The creation of this particular international money is not different from the principles of credit money creation in general. The peculiarity is that this money serves only to finance trade balance deficits of developing countries. The quantity of additional money is the object of two restrictions: deficit financing has to be kept in line with potential production of industrialised countries or with the capacity of developing countries to absorb the imported capital goods. Another serious question is the mode of distribution of money (or credit, respectively). In principle, there are two modes of allocation: the price, i.e., the rate of interest or the political decisions according to quotas that may be determined by a mix of different development indicators. But as price mechanism is not in favour of the less developed countries, political decisions may be preferred. A further point of decision is the distribution of trade balance surpluses. As the purpose of the system is to remove capital *and* demand restraint, trade balance surplus has to be allowed these industrialised countries which suffer unemployment. As market mechanism may fail with this aspect of allocation, too, once more political decision is necessary. This is a point for serious objections: Is there a link between the trade balance of a country and its ability to produce high standard capital goods (its competitiveness), or is the deficit rather due to a higher growth? In any case, there are good reasons for international money management, which includes developing as well as industrialised countries. A further question is: Who or which institution should dispose of the money and carry out investment? The state in developing countries, domestic firms, or direct investors? (There will be less opposition in industrialised countries if the funds are provided for direct investors.) In all cases, the utilisation of the funds has to be controlled. But as there is now widespread consent that the IMF has the right to set

up conditions for its assistance and to control their realisation [Driscoll (1998), p. 3], the reproach of misallocation can be refuted. A last point concerns the acceptance of this special credit money. Two conditions are essential: the money has to be a means to settle the exporter's claim, and central banks have to accept the money as freely convertible currency. This raises the question of the exchange rate of this currency: as the cross-entry is the currency of developing countries, it is likely that without further precautionary measures the new international currency will devalue. Surely, existing international money such as the US dollar is a matter of risk, too. But a new money requires more stability than that already existing. And finally, a renewal of the link between the SDRs and development financing has to be discussed in the context of international indebtedness of developing countries.

Without any doubt, using money to settle the world-wide unemployment question is a formidable task. Given credit money, the choice is to take up the challenge of its rational use or to muddle though as the actual management of the international currency does. At present, the actions of international monetary institutions are rather dominated by the worry of the handling of credit crises and of stabilising the *status quo* by patchwork than by developing solutions on the ground through any real or deep understanding of the working of credit money: "The long-run matters, because policies designed with only short-run problems and consequences in mind are all too likely to backfire once the immediate crisis is past" [Baumol (1986), p. 1084].

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## Comments

### 1.

I am grateful to Professor Schui for an insightful paper. The main idea, if cast in a mild form, is uncontroversial, namely, the judicious use of expansionary monetary policy in mature economies under conditions of excess capacity can raise production and income in these economies, which in turn fosters export-led growth in developing countries, providing them the foreign exchange to expand their productive capacity. Indeed, it is for this reason that the IMF, in fulfilment of its mandate, at present urges Japan to apply additional monetary stimulus—and to implement the banking reforms required to make that stimulus effective. Cambridge School theoreticians of an earlier generation are credited with this insight.

The paper in front of us, however, will likely stir controversy, because it pushes this benign idea towards a more extreme version. Specifically, the paper underplays the economic costs of a prolonged overdose of monetary or fiscal stimulus. And by ignoring the array of structural reforms that can raise the productivity of capital, the paper overrates the role of demand management among the tools available for achieving sustained economic growth.

The one-sidedness of the conclusions follows directly from the highly restrictive assumptions of the model elucidated in the paper. Thus, a first recommendation to the author would be to make those limiting assumptions explicit. The thinking underlying the paper is comparative statics and the horizon is short-term. The dictum “in the long run we are all dead” may have been useful in underscoring the need for policy reversal in the depths of the Great Depression, but ignoring nowadays the long-term consequences of a string of large annual budget deficits in the name of pump-priming or kick-starting the economy, or of allowing public enterprises to lose money indefinitely because they add to physical capital formation, has led to unsustainable public debt levels and subsequent reversal of economic growth.

Another limiting assumption is that the structure of the economy depicted in this paper is frozen over time. Factories in mature economies cannot migrate to developing countries. Hence, the author’s policy recommendation to increase real wages and tax away profits in the mature economies is a means to stimulate aggregate demand by redistributing income to social classes with a high propensity to consume. Yet, in today’s world, we see enterprises leave Western Europe increasingly for China. Professor’s Schui’s misgivings about foreign direct investment are understandable if industries depart. Yet most countries vie to receive such investments. Equally, in the model underlying this paper, countries do not compete for market share: each economy continues to produce the same single good.

This assumption precludes the welfare gains of opening up the markets of today's rich countries for textiles or agricultural produce from developing countries. Also, nowhere in this model is there room for human capital development or for improved institutions that raise the productivity of capital or encourage savings or capital formation in developing countries.

In short, the very limitations, in fact otherworldliness, of the assumptions of the model lead by design towards exaggerating the relative importance of monetary stimulus among the instruments available for fostering economic growth.

My second suggestion to Professor Schui is to take advantage of available empirical evidence. Today, ample econometric evidence refutes the views of Nicholas Kaldor and others of several decades ago that attributed inflation in Latin America to supply-side constraints. Granted, adverse shocks to harvests do impact overall price levels, but it is excess money supply growth that has been identified the world over as the dominant explanatory variable behind prolonged inflation. Equally, on IMF-supported economic programmes, detailed information is now available on the websites of the IMF and of the governments with whom we work. Actual examination of these stabilisation and economic reform programmes will lead to a much more nuanced assessment than the commonly voiced criticisms. Thus, in Pakistan, the IMF has supported the recent reduction in interest rates and an increase in broad money in excess of nominal GDP growth, allowing the financial sector to deepen throughout the IMF programme. Prudent policy, of course, requires that the authorities put in place the regulatory and institutional improvements that will expedite the development of sound financial intermediation, and thus underpin demand for the growing money supply.

In conclusion, Central Banks can indeed use money as one among several tools that are available to policy-makers in the pursuit of higher economic growth. They can do so, by exploiting short-run flexibility in coping with business cycles, but only within the confines of monetary discipline aimed at attaining long-term price stability, and also by fostering a regulatory environment conducive to sound financial intermediation. The work of the Cambridge School theoreticians, as laid out by Dr Schui, makes only a limited contribution nowadays towards the goal of sustained economic growth. By contrast, for that group of earlier economists, to their enduring credit, reaching the full potential of the unemployed stood at the centre of public policy.

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## 2.

As a second discussant of this paper my task is relatively easier as Henri has already dealt with a number of substantial points in his discussion.

Professor Schui's paper "On the Role of Money in Removing World-wide Growth Barriers" is a very interesting work which deals with a number of important issues in international finance, trade, investment, and growth, and has considerable relevance to the theme of this conference: *Regulation, Competition, and Information*.

The starting-point of the paper is the co-existence of capital restraint in the developing world and inadequate effective demand, *à la* Keynes, in industrialised countries. Both of these Schui considers as barriers to economic growth. Based on this simple premise, he asks the question if some imaginative financing in a rational international monetary system can solve both these problems simultaneously.

Based on a two-sector model, in which the advanced countries produce only investment goods and the less developed countries (LDCs) produce only consumer goods, he maintains that under balanced trade the volume of foreign trade between the two groups of countries equals the wage bill of industrialised countries. This wage bill also determines the rate of accumulation in developing countries. From this reasoning, he concludes:

"It follows that increasing domestic investment of industrialised countries increases their wage bill, by this their import of consumer goods, and hence the export of developing countries and their import of capital goods".

It is therefore argued that a low rate of investment in industrialised countries dampens the speed of industrialisation in developing countries. Furthermore, it is maintained that the international division of labour and international trade transfers the demand restraints of industrialised countries as barriers of growth to developing countries. All this implies that the low growth in the LDCs is simply a result of demand restraint in industrialised countries, and is the main obstacle for accumulation in developing countries. The solution thus can be either through fiscal stimulus *à la* Keynes, or through expansionary monetary policy in industrialised countries. The author seems to prefer the monetary solution. The proposal of money as credit, or national money and the removal of the link *vis-à-vis* commodity money can be analysed in a traditional macro model. However, the results envisioned by the author may not occur and instead the result may be higher inflation. Here one may think of the recent episode of the so-called Asian Financial crisis and its devastating effect.

I find this analysis very problematic on numerous grounds. First, the outcome foreseen would only be possible in the short run, while the question of growth deals with the long-run. Second, the growth in the LDCs is not simply a question of physical capital; the development of human capital is of crucial importance. Third, the proposed model completely ignores the price effects and adjustment in the labour markets. Here one can note the huge economic damage that occurred during the Asian financial crisis. Fourth, regarding trade issues between the LDCs and advanced countries, the author is sceptical about the potential growth through trade. On this point I suggest that the advanced countries must lower tariff- and non-tariff barriers on imports from the LDCs. This benefits both the LDCs and the advanced countries. It is well-established that there are huge economic costs because of such barriers and protection.

Finally, I would like to comment on Dr Schui's plea regarding the need of reform of the international monetary system in a way that promotes capital accumulation in the LDCs. While no one denies that there is always a need to improve the domestic and international monetary system, he fails to provide an explicit framework for such a system. In devising any such system one must be careful in selecting the criteria for such a system. One could propose three elements: *confidence*, *liquidity*, and *adjustment*.

With reference to the LDCs and *liquidity*, one can imagine something similar to the Stamp-Plan, whereby the new liquidity can simply be passed on to the LDCs to meet their trade deficits, which are like foreign investments. Such a proposal in theory is practicable and indeed desirable, but requires acceptance by the advanced countries that have not shown much interest in it in the past. Regarding the issues of *confidence* and *adjustment*, one could also pose a number of questions, which the paper has ignored.

Finally, the paper is silent on the topic of technical change and productivity, which are crucially important if we want to improve wages in the LDCs. The policy implications of the paper are neither practicable nor acceptable in the current international environment, where most countries have now rejected expansionary fiscal policies entailing deficits. To the degree that deficit financing and expansionary monetary policies are not a serious option, the main argument of the paper is weakened by proposing them.

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