NÁRODNÁ BANKA SLOVENSKA

NICHOLAS KALDOR – ONE OF THE FIRST CRITICS OF MONETARISM

doc. Ing. Ján Iša, DrSc.

Known in economic circles as one of the founders of Post-Keynesianism, Nicholas Kaldor (1908–1986) ranks among the world's foremost economists of the second half of the 20th century. Kaldor contributed to the development of modern economic thought in several fields, but it was his work on the theory of distribution and economic growth that stirred the greatest reaction. Less well-known, however, is Kaldor's contribution to monetary theory, which has long been standing quietly in the background.

Nicholas Kaldor was born in Budapest on 12 May 1908. His father was a lawyer and his mother came from wealthy business family. Although his father had wanted him to study law, Kaldor opted for economics. He began his studies at the University of Berlin in 1925 and then after two years moved to the London School of Economics (LSE), from which he graduated in 1930. He remained at the LSE as lecturer until 1947, during which time his colleagues included among others J. R. Hicks and Tibor Scitovski.

Responding to an initiative of Gunnar Myrdal, the future Nobel Laureate, Kaldor worked for the United Nations from 1947 to 1949 as the first Director of the Research and Planning Division of the Economic Commission for Europe. He would later hold similar posts in the United Kingdom and other countries. In 1942, Kaldor helped draft the landmark Beveridge Report on Social Insurance, which post-war Labour governments used as the basis of their social policy. Between 1950 and 1955, he was a member of the Royal Commission on the Taxation, Profits and Incomes, and later served as an advisor on economics and taxation to numerous Third World countries, as well as an advisor to central banks and to the United Nations Economic Commission for Latin America. Most significant, however, was his role as an advisor to Labour finance ministers from 1964 to 1968 and 1974 to 1976. After completing his two-year mission in Geneva in 1949, Kaldor began to work at Cambridge University and became, as John Maynard Keynes had been, a fellow of King's College, Cambridge. In 1966 he was appointed a professor of economics at Cambridge. His work as a professor continued until 1975, and he held the title of emeritus professor until his death in 1986.

Kaldor was the recipient of many honours and various accolades. His greatest honour was undoubtedly the award of a peerage, when he became Baron Kaldor of Newnham.

In his evaluation of Kaldor's work, Professor Luigi L. Pasinetti says that Nicholas Kaldor was probably one of the most original and most thought-provoking theoretical economists of the 20th century, as well as one of the most radical experts in the field of taxation policies and an advisor to many governments.

From Hayek to Keynes

Disregarding the specific influence of Allyn Young, the first years of Kaldor's work at the LSE were influenced by the strict orthodoxy of marginal economics. His main works of the 1930s concerned the economic problems being under discussion at that time, in particular, economic equilibrium, the theory of imperfect and monopolistic competition, the theory of capital, and later, too, the welfare economics. It is interesting to note that Kaldor was the author of the term "cob-web theorem" (1933), which students of economics will usually come across where market stability conditions are clarified using demand and supply elasticities. What was notable about his contribution to the theory of capital (1937) was that it already contained elements of his later break with neoclassical economics.

The development of Kaldor's economic opinions took a decisive turn with the publication of Keynes's General Theory (1936). Although Kaldor's reaction was slow, it was deep-rooted. Its outward expression was a shift in his interest from microeconomics to macroeconomics, though it would later emerge as a radical change in his opinions on almost the whole of economic theory. Kaldor initially addressed macroeconomic issues of stability, full employment, and the business cycle, which were increasingly being understood in Keynesian terms as forces determining changes in the aggregate output and overall employment.

Kaldor's abandonment of the neoclassical tradition was completed after his move to Cambridge University. His authentic contribution to Post-Keynesianism was firstly directed at the theory of economic growth and particularly the theory of distribution, in other words, two fields that represented "blank sheets" within the Keynesian macroeconomic system.

A theory of economic growth, an alternative theory of distribution, and a critique of equilibrium theory

Kaldor's theory of distribution is based on the Keynesian assumption of investment as the source of economic growth and on the independence of investment volume from the amount of savings. According to Kaldor, the amount of savings is in fact set by the volume of investment, which determines the level of income and of unemployment. Like Robinson, Kaldor takes as a basis the distribution of national income between wages and profits and the related division of society into salaried workers and owners of capital. Kaldor's theory of distribution is based on the idea that the recipients of profits (the owners of capital) have a much greater propensity to save than do the recipients of wages (salaried employees). Incidentally, Kaldor considered this relationship between two propensities to save to be a basic condition for the stability of the economic system. It is interesting that Kaldor at the same time accepted the assumption of full employment and not on the Keynesian assumption of underemployment. Therefore, an economic system in which entrepreneurs realize investments corresponding to the level of full employment includes a distribution of income between profits and wages that – given the different propensities to save – creates precisely such a ratio of profits to national income which is required to maintain the predetermined investment.

Along with his distribution theory, Kaldor developed the idea of an "expenditure tax" (1955) as a substitute for income tax. He went on to promote this idea in countries, both advanced and developing, where he worked as an economic advisor. Being radical and also relatively complicated, however, the expenditure tax proposed by Kaldor did not catch on.

It was in the second half of the 1950s that Kaldor turned his attention to the theory of economic growth. His growth model has certain interesting features, including above all its differentiation of two stages in the development of the capitalist economy. The first stage is characterized by a shortage of accumulated resources. For the distribution of national income, wages were the initially determined quantity, their level being dependent on the subsistence minimum. The second stage, on the other hand, is marked by a relative excess of accumulated resources, where profits are the initially determined quantity and wages represent a residual quantity. The ratio of profits to national income depends on the rate of accumulation, on the propensity to save from wages, and, in inverse proportion, on the propensity to save from profits. Restricting its applicability to modern capitalism, Kaldor's growth model includes three basic functions: a) the technical progress function, b) the investment function, and c) the saving function. The main functional relationship is the technical progress function, capturing as it does the dependence of the growth rate in capital and output on the pace of technical progress.

In the 1960s, empirical research and new experiences in the economic-political field made Kaldor doubt the utility of formal growth models and he began to focus on analyzing actual tendencies in economic growth. At the same time, he paid particular attention to the analysis of different industries in terms of returns, sectoral complementarity, cyclical movement, spatial relationship, cumulative process, trade policy, imperfect competition, and the formation of prices, profits and wages.

Kaldor in his neoclassical period was a proponent of equilibrium theory, though naturally he took up the opposite position after switching to the Keynesian camp. In the introduction to his paper "The Irrelevance of Equilibrium Economics" (1972), he argued, for example, that the economics of equilibrium was futile and irrelevant as a tool of thought with which to clarify the functioning of economic forces and to predict the results of economic changes induced by economic policy or other causes. According to Kaldor, equilibrium is rooted in mechanics and is unsuited to the investigation of economic systems. He was more affiliated to a conception in which the economy is analysed as a self-propelled chain of causes and effects.

Kaldor also tackled many economic-political issues, especially in regard to the United Kingdom, regional policy, the economic prospects of the Common Market, and developing countries. To mark the one-hundredth anniversary of Keynes's birth, he made a re-evaluation of the Baron of Tilton's legacy, which led to the publication of an interesting paper entitled "Keynesian Economics after Fifty Years". What interested him most of all, however, was the issue of monetary economics and monetary policy.

The new monetarism

The first step in the broader evaluation of monetarism was Kaldor's polemical article "The new monetarism", published in 1970 in the Lloyds Bank Review. In it, Kaldor identified two crucial issues: a) the direction of causation between money and output, and b) the ability of a central bank to control the quantity of money. He reached the conclusion that the monetarists were wrong on both questions. The explanation for all the empirical findings concerning the "stable money function" is, according to him, that the "money supply" is "endogenous", not "exogenous". The monetarist "evidence" that the changes in money preceded changes in output and employment was, to his mind, irrelevant, since the observed time – lag could be explained in a number of different none of them relying on monetarist theory. The monetarists can be said in this case to have committed an error very common in economic thought, one identified as "post hoc, ergo propter hoc". This error arises when it is assumed that some event (in this instance, the increase in the quantity of money in circulation) caused a subsequent event (growth in prices, output, or employment) simply because the one preceded the other.

The other monetarist error concerns the much praised stability of the velocity of circulation of money, which Kaldor says is actually a consequence of the unstable behaviour of the money supply, which “accommodates itself” to the needs of trade, increasing in response to an expansion, and vice versa. In a later work, "The Scourge of Monetarism", Kaldor described this relationship in such a way that the money stock and changes in the velocity of circulation of money are actually substitutes – if the velocity of circulation appears stable, it is only because the quantity of the money stock is so unstable.

As regards the possibility of using the money supply as an instrument of monetary policy, Kaldor came up with this interesting thought-experiment: Could a central bank prevent the annual Christmas shopping spree simply by reducing the supply of cash? He answered this question with a logical counter-question: In such a case, would it not be far more likely that substitutes of money (such as credit cards) would spring up as merrymakers tried to avoid the financial restrictions? It is interesting that Kaldor did not at that time have any reservations about the "optimal" rule, relentlessly promoted by Friedman, by which the money supply grows by a constant annual x percent. He did, however, express doubts about whether this objective (i.e. constant growth of the money supply) would be at all achievable with the monetary policy instruments at the disposal of the United States, not to mention the United Kingdom.

In Kaldor's 1970 article, there is already thegerm of what would later be described as accommodative money endogeneity, that is, "horizontalism". According to the horizontalists (which besides Kaldor, included among others Sidney Weintraub and Basil J. Moore), the central bank as the lender of last resort must meet commercial banks' needs for the supplementation of reserves. It should also be borne in mind that the failure of the central bank to fulfil this role could give rise to a key factor of the deflationary mechanism, such as happened during the Great Depression (1929–1933). As for what he understood by the character of the money supply, Kaldor said in 1981 that the money supply was "infinitely elastic" (it may be represented on a chart of the money market by a horizontal line – J. I.) or, in other words, it was indistinguishable from the demand for money. The natural conclusion from this is that the central bank does not have full control over the money stock. The options and role of the central bank was similarly understood by Basil J. Moore, who in a paper entitled "Is the Money Stock Really a Control Variable?" proved that (monetarist) theory – which held that the Federal Reserve could control the supply of money by changes in the monetary base – had serious flaws. Friedman reacted to Kaldor's critique with a brief piece in the Lloyds Bank Review (1970) in which he less than convincingly claimed that monetarists had always (!) admitted the possibility of reverse causalition between money and output, though at the same time they had demonstrated it to be empirically insignificant.

The Scourge of Monetarism

During the 1980s, Kaldor produced works elaborating on his critique of monetarism –Origins of the New Monetarism (1981), The Scourge of Monetarism (1982), The Economic Consequences of Mrs Thatcher (1983), and How Monetarism Failed (1985).

In the introduction to his paper "How Monetarism Failed", Kaldor expressed a conviction that the renaissance of monetarism in the 1970s, culminating in the adoption of strict monetarist recommendations by several Western governments (especially the Reagan administration and Thatcher government) would come to an end and be seen as one of the most curious episodes in (economic) history, comparable only with the outbreak of mass hysteria in the Middle Ages. Although Kaldor's assessment was, of course, much exaggerated, his basic prediction for the fate of monetarist doctrine has been confirmed.

The central thesis of monetarism, as propounded by Friedman, is the claim that excessive growth in the money supply brought about by decisions of the central bank is the main cause of inflation, if not the only one, and the cyclical movements in the economy reflect the irregularity and deviations that accompany an increase in the money supply. The monetary authority is, according to Friedman, also responsible for distortions in the structure of production, induced by imperfect anticipation of the lag effects that an increase in the money supply has on prices. Given that these "time lags" are irregular and considerably variable, it cannot be expected that monetary authorities are able to prevent them with well-timed measures or to offset them with timely countermeasures. According to Friedman, the reliable rule requiring the stable and modest growth of the money stock is the only one that needs to be followed. The consistent implementation of this rule will in itself (i.e. without discretionary monetary and fiscal measures) ensure stabilization of the value of money and gradually exclude cyclical movements. However, Kaldor (in contrast to his previous "tolerant" position) came to the conclusion that Friedman's "optimal" rule was unsustainable.

A fundamental flaw in this concept is the assumption that the money supply is the source of demand for goods and services. Kaldor noted in this regard that the extensive history of money indicated otherwise. Writing in 1985, he said that the demand for money from the very beginning, was a reflection a reflection of the demand for commodities, and not the a source of that demand. In normal conditions, an increase in the money supply is always (with the exception of hyperinflation, under which economic relationships degenerate altogether) a reaction to higher demand, and not an autonomous event. The discoveries of gold and silver were, understandably, a specific case, leading the supply of money commodity to grow at a faster pace than the supply of other commodities.

The object of Kaldor's critique are two errors: the exogenous money supply and the stable demand for money. The monetarists proceed on the basis that the monetary authority determines the so-called monetary base (what Friedman would term highly powered money – representing the sum of currency in circulation issued by the central bank and required reserves) and, by means of the money multiplier, the money supply. Like other Post Keynesians, Kaldor nevertheless describes the money supply as an endogenous variable determined by the requirements of economic entities. It should be added that even the Post Keynesians take the correlation between the monetary base and the money stock as a basis, although the correlation in this case (resulting from the assumption of the money stock's endogeneity) is opposite: the causal relationship in fact runs from the money stock to the monetary base.

According to Kaldor, the monetarists (error lies) in their implicit assumption that all money is commodity money to which the vertical curve of the money supply curve logically corresponds. In the case of credit money, however, he maintained that it should be correctly represented by the previously mentioned horizontal curve of the money supply. This though leads to the compelling conclusion that monetary policy is represented not by a given quantity of money stock, but by a given interest rate; and the amount of existing money will be determined by demand. Therefore, as before, demand will vary with incomes, while the central bank's interest rate may rise or fall; this does not, however, alter the fact that the money stock will always be determined by demand and the rate of interest by the central bank (Kaldor, 1982). It naturally follows from this that the rate of interest is not a dependent variable, but an independent one. In this way, Kaldor very clearly defined the basic "parameters" of monetary policy; their full realization in practice has long been illustrated by the monetary policies of the Fed and the European Central Bank.

On several occasions in his "Scourge of Monetarism", Kaldor describes how his opinions on Friedman's innovations developed. When he first heard of Friedman's new empirical evidence at the beginning of the 1950s, he received it with a certain mistrust, but then it suddenly occurred to him that Friedman's results had to be read in reverse: "causation must run from Y to M, and not from M to Y".

Nor did Kaldor avoid a standard component of Neo-Keynesian economics – the LM curve, which along with the IS curve was used by Hicks to illustrate the Keynesian equilibrium. In Kaldor's opinion, the IS-LM model leads to endless complications and erroneous conclusions, especially since these two are not in pari materia (from the same material – J. I.) – one relates to stocks, and the other to flows.

In his critique of monetarism, Kaldor could not avoid Friedman's distinctive ideas on the transmission mechanism from money to income. According to Kaldor (1982), this mechanism remained "a black box" for Friedman, which he neither knew how to explain, nor attempted to explain. Indeed, Friedman evaded giving an answer to this question by using the parable of money being dropped from a helicopter. When asked how monetary authorities increase the supply of banknotes, he said they dropped it from a helicopter over populated areas – he did not, however, as Kaldor says, go into the ultimate consequences of such an aerial Santa Claus. Kaldor probably surprises the reader by attempting to explain the consequences of this strange aerial operation. In so doing, he considers two cases: 1) the money is dropped over a poor area (e.g. the East End of London), where a majority of the people who find the money use it for consumer expenditures; and 2) the money is dropped in a wealthy area (e.g. Kensington Palace Gardens), where it falls into the hands of rich people who either keep it, deposit it in bank accounts, or give it to charity. The initial effects of this curious helicopter operation would therefore depend on where it happened. The other effects would, however, be completely insignificant unless the operation was repeated every night. Kaldor eventually concluded that there was no reason to assume that the ultimate effects on the quantity of money in circulation, or on the level of income would have any close relationship with the original injection.

Kaldor's critique of monetarism was closely connected with his criticism of the British Conservative government – which he reproached for using its economic-political instruments not to ensure full employment, but to create such unemployment that would bring the unions into submission, the purpose being to keep their wage demands below the current level of price inflation and to steadily and gradually reduce the rate of cost inflation.

Although Kaldor was not a revolutionary, he was deeply convinced of the need for reforms. He believed in the ability of individuals to change the economic situation and to have a positive influence on events. It was in this spirit that he himself acted and put forward many reform proposals. Kaldor, who died twenty years ago, was without question among the most original economic thinkers of the second half of the 20th century. It is clear from his outstandingly rich opus that he was always interested in new economic issues and boldly sought non-traditional solutions.

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Major economic works of Nicholas Kaldor:

1. A classificatory note on determinateness of equilibrium (1934)
2. Stability and full employment (1938).
3. Capital intensity and the trade cycle (1939 a).
4. Speculation on economic stability (1939 b).
5. A model of the trade cycle (1940).
6. The relation of economic growth and cyclical fluctuations (1954).
7. Alternative theories of distributions (1956).
8. A model of economic growth (1957).
9. Causes of the Slow Rate of Economic Growth of the United Kingdom (1966 a).
10. Marginal productivity and the macroeconomic theories of distribution (1966 b).
11. The New Monetarism (1970).
12. Origins of the New Monetarism. (1981).
13. The Scourge of Monetarism (1982).
14. The Economic Consequences of Mrs. Thatcher (1983).
15. How Monetarism Failed (1985 a).
16. Economics Without Equilibrium (1985 b).