KALDOR AND THE MONETARISTS, REAL AND IMAGINARY:

A REVIEW OF A REVIEW

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R. L. Harrington has recently reviewed two books about Monetarism in this journal.[1] The first book, by Nicholas Kaldor, is an attack against orthodox monetary theory and Monetarism's policy proposals.[2] It also presents a revived and modernized version of the monetary economics of the Radcliffe Report, better known in the United States as Post Keynesian monetary theory.[3] The second book is David Laidler's account of Monetarism, where the author attempts to show that there are no major theoretical differences between Monetarism and mainstream economics, only practical ones (namely, the conduct of monetary policy).[4]

Contrary to the reviewer, I shall not discuss whether Kaldor has "a decidedly selective knowledge of the literature" or whether Laidler shows "an enviable grasp of the literature". Such a discussion would require a definition of what is exactly meant by literature (the dominant views?), and it would entail a further discussion on the relevance of this literature for understanding the functioning of modern economies. Also, I shall not discuss whether or not evidence provided by econometrics on monetary macroeconomic questions can be at all considered as legitimate evidence.[5] What I shall argue is that Harrington (not Kaldor) is the one who should be accused of attacking a strawman, i.e., Harrington's criticisms of Kaldor are ill-founded. I take these criticisms one by one, starting with those pertaining to Kaldor's interpretation of Monetarism.

According to Harrington, Kaldor makes a caricature out of Monetarists. I doubt many Monetarists would feel caricatured by Kaldor's three main Monetarists' premises (1982, p. 45): (a) The economy left to itself is self-regulating; (b) Modern money is the result of open-market operations by the central bank; (c) The proper control of the money supply exerts direct downward pressures on prices. Indeed no respectable Monetarist would attempt to refute these three hypotheses. Whether they are beliefs or theoretical approximations does not make any difference. Their theoretical model is used to draw inferences about the real world. Present-day neoclassical Keynesians, on the other hand, would probably only question assumption (a) on the grounds of frictional rigidities.

Harrington also claims that Kaldor's polemics are dated and irrelevant. As an example, he accuses Kaldor of still attributing to the Monetarists the belief that the demand for money is interest-inelastic. Harrington implies further that "interest-inelasticity" means zero-elasticity for Kaldor. Of course, Harrington is wrong on both counts. First, the word "inelastic" implies (for Kaldor as well as all other economists) an elasticity which is less than one, not necessarily of the value of zero. No one ever thought that the Monetarists believed there existed no relationship between the demand for money and interest rates. Second, for Kaldor (1982, p. 74) as well as for other scholars such as Leijonhufvud (1981, p. 183), the elasticity or non-elasticity of the demand for money function cannot be the distinguishing feature of Keynesian versus non-Keynesian

economics. Indeed Kaldor was the first to recognize that those who attempted to divide the Monetarists from the Keynesians according to their views on the empirical measure of the interest elasticity of money demand miss the main point (as the great surveyor of economics, Harry Johnson (1962, p. 343) once did).

Harrington also criticizes Kaldor for his refusal to concede that the Monetarist transmission mechanism has been explained. It is true that Kaldor twice refers (1982, pp. 28 and 54) to the Monetarist Black Box. But one must also admit that it took Milton Friedman a long time (with the help of James Tobin) to develop his portfolio-based transmission mechanism. Such a mechanism is not even unique, as Laidler points out: "The contents of the famous 'black box' have no unique structure; which certainly would explain the difficulties we have encountered over the last two decades in trying to discover what that structure is" (1982, pp. 151-2). As a matter of fact, it is now agreed by all that the transmission mechanism provided by the Monetarists is no different from the one propounded by modern-day neoclassical Keynesians (Johnson 1962, p. 344; Laidler 1982, pp. 4-5; Purvis 1980, p. 97). Thus, unless Harrington initially <u>assumed</u> that Kaldor knows nothing about the monetary literature of the past twenty years, he could not have interpreted Kaldor in the way he did.

When Kaldor refers to "black boxes", he is in fact criticizing the orthodox hypothesis of exogenous money supply (the vertically-given supply of money), the assumption that monetary authorities can increase or decrease the stock of money at their will. Money does not fall from the sky, nor is it thrown out of

an helicopter. Nor does money appear as a consequence of some irresponsible behaviour of the Central Bank on the open-market. In fact, as is suggested by John Hicks (1982, pp. 264-6), modern economies must be looked upon as overdraft economies which could function with little or no money.

For Kaldor, as Harrington has correctly understood, modern money is credit-money. Production decisions and the associated disbursements require loans, or increased overdrafts, which are provided by the commercial banks. Increased credits lead to increased incomes, and hence to increased savings part of which are ultimately held in bank deposits or in cash. The central bank then provides the high-powered money, cash plus reserves, which the banking system needs in a given situation and at the given rate of interest. The appearance and the creation of money is not the result of some static (asset) portfolio behaviour of the public, which would be induced by some non-explained increase in the supply of money (the black box). The integration of money into economic analysis is explained by Kaldor by the decisions of borrowers who are willing to increase their liabilities in order to expand the value of production. This is a dynamic view of the creation of money which does not confuse commodity-money with credit-money (cf. Cramp 1971, p. 65).

Thus, for Kaldor, money is endogenous. There is reverse causation to that assumed by the Monetarists. Kaldor and post-Keynesian economists assert that income determines credit (and money), just as Keynes and the early Keynesians claimed that investment determines savings. The omission by Keynes (at least

in the General Theory) to recognize the endogenous character of the money supply facilitated the abandonment of causality (or proper causality) between investment and saving, and the reconciliation between Monetarists and neoclassical Keynesians which appears to have followed the so-called income-expenditure model that arose out of Hicks' famous IS/LM diagram.[6] This is explained by Kaldor in his book (1982, pp. 20-6), as well as the fact that Friedman recognized from the onset that his own position only made sense if money were exogenous.

But Monetarists usually attach little importance to the reverse causation argument or to the Keynesian causality which runs from investment to savings. When they do, they are forced to admit that reverse causation cannot be excluded on empirical grounds (Laidler 1982, pp. 115-6). But when Monetarists consider the possibility of endogenous money, they refer to a very peculiar version of it. In their view, there is endogeneity of the money supply because the central bank must finance part of the central government deficit or because, in small open economies, high-powered money is determined by exchange rate policies (Laidler 1982, pp. 142-50).[7] This sort of endogeneity is not really linked to the reverse-causation argument or to Kaldor's theory of endogenous money where credit-money appears for production purposes, not for exchange.

In Harrington's view, however, Kaldor's theory of money is unconvincing. Kaldor would be confusing the short run and the long run. In the short run, Harrington recognizes that the supply of credit (and hence of money) can be considered infinitely

elastic at the given interest structure. But in the long run, says Harrington, "the argument that in a credit-money economy the money supply cannot but be endogenous is false". This follows from the fact that the central bank is able to limit the supply of money by setting higher interest rates.

But this is precisely the point made by Kaldor. Harrington is fighting windmills. According to Kaldor and the post-Keynesians, central banks cannot control directly either the supply of money or that of high-powered money. They can change the money interest rate and estimate the extent of this change on the demand for money. A sufficient increase in interest rates should discourage any rise in production and hence in borrowing (and, as a consequence, incomes and effective demand). On Kaldor's graph (1982, p. 24), the combined income and substitution effect of this increase in interest rate can be represented by a shift inwards as well as a movement along the money demand curve. The supply of money is still infinite at the new interest rate, but the existing stock of money is smaller. The supply of money is not fixed by the monetary authorities. It adapts to changes in the demand for money. There is no supply of money as such, determined independently of demand.[8]

Harrington seems to be playing with semantics. He makes fun of Kaldor because the latter simultaneously claims that the control of the money stock is ineffective and that Monetarism is a scourge. But these two statements are not contradictory. Monetarism is a curse because the desire to fight inflation by controlling monetary aggregates has led central banks to impose

absurdly high interest rates which have resulted in senseless cash-flow situations for most firms, many households and several countries. Monetarist policies have provoked a world-wide recession, not as a consequence of reduced rates of growth of the money supply, but as a consequence of high interest rates (as well as restrictive fiscal policies which accompanied them) and the resulting diminution of borrowing for production purposes.

On the other hand, the control of the stock of money is useless since the stock of money, as such, is of no causal significance. The stock of money is one among many other assets. These assets (savings) can only be augmented if there is previous borrowing (investment). This depends, all other things being equal, on the "whole liquidity position", as emphasized by the Radcliffe Committee. The stock of money is a residual, so to speak.[9] This is true even in the United States, although its banking system is considered by all as providing a textbook example of an exogenously-controlled money supply (Kaldor 1982, p. 25). Thus speaks Albert Wojnilower, who acted for both commercial banks and the Federal Reserve: "I can testify that to all ... the money stock - in contrast to oil or credit - is a meaningless abstraction ... If there were to be promulgated a permanent zero money-growth target, hardly anyone would regard himself as constrained" (1980, p. 324).

Much more could be said, in particular about the relation between the theory of inflation advanced by Kaldor or the other post-Keynesians and the theory of endogenous money. But such an analysis would carry us too far. I must conclude by conceding

that Harrington is right on one point. Reading both Laidler's and Kaldor's books allows one to understand what is "the main divide between contemporary macroeconomists".

NOTES

1. "Monetarisms: Real and Imaginary. A Review Article". Manchester School of Economic and Social Studies, March 1983.

2. The Scourge of Monetarism, Oxford, Oxford University Press, 1982.

3. See Basil Moore (1983) and Lavoie (1984).

4. Monetarist Perspectives, Cambridge (Mass.), Harvard University Press, 1982. See mainly pp. 24, 35.

5. See Meghnad Desai (1982) for an excellent survey of this question.

6. See Hicks (1937). For Leijonhufvud (1981, p. 179), the abandonment of the causality from investment to savings has precipitated the unchallenged success of Monetarism.

7. According to orthodox economists, government deficits and a favourable balance of payments generate excess reserves which allow banks to increase the money supply. Credit-money economists argue that the inflow of excess reserves does not change the creation of credit (and hence of money) which

still depends on demand. Therefore either free reserves accumulate, the government sterilizes, or banks use them to pay back their debt to the central bank. This is the compensation theory of Jacques Le Bourva (1962, pp. 48-50). Kaldor expresses the same idea when he argues that if an "excess" of money supply were created, it would be extinguished by the reimbursement of previous debts (1982, p. 70). Thus there <u>cannot</u> be any excess supply of money. This argument destroys those theories of inflation which are founded on the hypothesis of some excess stock of money which would entail an investment which is too high with respect to desired savings and interest rates which are too low (cf. Harrington 1971, p. 274).

8. In his critique, Harrington (1983, p. 66) seems to confuse the demand for and the supply of money. This is the famous identification problem: supply is not separate from demand.

9. Contrary to what is argued by Laidler (1982, p. 12), the views of Cambridge economists have not changed since they were incorporated in the report of the Radcliffe Commission (see Harrod 1965, pp. 796-7). Kaldor (1982) is developing today, albeit in more detail, the intuitions presented in 1958 by himself (1964) and Richard Kahn: the supply of money does not have a significance of its own, "apart from its relationship with rates of interest and bank advances" (Kahn 1972, p. 147).

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