Finance and Growth under Neo-liberalism

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The post-second world war years had seen systematic intervention by the State to stabilize capitalist economies. In fact State intervention had played the same role in that period that incursions into colonial and semi-colonial markets had played earlier, over much of the nineteenth century, right until the first world war. This role consisted in ensuring that one component of aggregate demand, whether exports to such markets or State expenditure, kept growing even when there was a downswing in the level of activity in the capitalist economy. One component of aggregate demand in other words, which determined the level of activity, was itself independent of the level of activity; it constituted what one may call an "exogenous stimulus" and prevented the system from settling down at a stationary state or a state of simple reproduction where it would otherwise have converged.[1]

Post-war State intervention did not just stabilize capitalism in the sense of providing an exogenous stimulus for growth; it also ensured that the system functioned at a level of activity that was close to "full employment". The State took active counter-cyclical measures: it stepped up its expenditure (or enacted tax-cuts) whenever the economy started slipping into a recession, and thereby prevented any serious downturn. The maintenance of a high level of activity encouraged private investment, caused a high rate of GDP growth and hence a high rate of labour productivity growth, which, because of the high employment rate that strengthened the bargaining power of the workers, also led to an impressive rate of growth of real wages. Not surprisingly the period of the fifties, sixties and the early seventies has been called the "Golden Age of Capitalism".

The period of neo-liberal policies starting in the seventies, which corresponds to the hegemony of globalized finance, has seen the State withdrawing from this role. This is because finance capital is opposed both to fiscal deficits and to taxes upon capitalists; and, when globalized finance faces the nation-State, its writ must run (to prevent large-scale financial outflows). Hence when the economy slips into a recession, State expenditure, which must be financed by one of these means if it is to counter such a recession (as State expenditure financed by taxes on workers whose propensity to consume is high would scarcely add to aggregate demand), cannot be increased to prevent such a fall in the level of activity.

A neo-liberal capitalist economy therefore does not have the instruments that capitalism earlier had for providing a bulwark against its slipping into recession and stagnation; the question is: does it have any instruments at all? This is but another way of asking: are there any components of aggregate demand in a neo-liberal economy which grow autonomously of the level of activity itself, and which constitute therefore "exogenous stimuli", in the way that incursions into colonial markets or State expenditure, whether financed by a fiscal deficit or a balanced budget (but necessarily entailing in the latter case taxes on capitalists) had been?

The immediate answer to this question would be that "innovations" under capitalism always constitute such an exogenous stimulus and neo-liberal capitalism is not without its share of innovations. They prevent the economy's settling into a stationary state and keep its growth-rate positive. Innovations however are not really an exogenous stimulus. It has been theoretically argued that they only affect the form of investment not its amount which is what matters for aggregate demand (Steindl 1976). And economic historians have pointed out how innovations remained unused during the Great Depression of the 1930s because of the depressed state of demand (Lewis 1979), rather than causing a revival from the Depression. Hence the answer that suggests that innovations constitute an exogenous stimulus sustaining a positive trend is not a persuasive answer.

A more pertinent answer is that even though State expenditure no longer plays the role of stabilizing the capitalist economy, with most countries now bound by legislation to keep fiscal deficits to within 3 percent of GDP, and even the U.S., which is not legislatively bound in this manner, also keeping its fiscal deficit in check, State intervention does not cease to exist. It operates instead through monetary policy influencing not just private expenditure decisions but also developments in the world of finance.

The fact that monetary policy ought to play this role was emphasized by Keynes. Against the argument of another Cambridge economist Dennis Robertson who had suggested that to prevent sharp recessions the boom itself must be kept restricted by increasing the interest rate when it really got going, Keynes (1946) had remarked that such a policy would keep the economy in a permanent state of quasi-stagnation; instead he had suggested that whenever the economy tended to slacken in its performance, the interest rate should be lowered and the recession prevented that way, thereby aiming at a high level of activity and employment, though he was not very confident about the efficacy of interest rate policy.

The interest rate however is not the only instrument that the State can use or has been using. It has also been using at least in the neo-liberal era, though in a less obvious manner, another instrument to keep booms going, and this is to socialize capitalists' risks, by which I mean distributing risks, which would normally have been taken by capitalists, among a wider segment of society, which itself is generally unaware that it is taking such risks.

II

Let us first get some preliminaries out of the way. Risks arise because the expected rate of return from any act of investment is not certain; there is a probability distribution around the "best guess", or the mean expected rate of return, and the standard deviation of this probability distribution can be taken as a measure of risk. And the risk premium is the rate at which the capitalists undertaking the investment wish to be compensated for subjecting themselves to risk.

For any firm the investment in any period is determined by the intersection between the curves of marginal efficiency of capital on the one hand, and of marginal interest cost plus marginal risk premium on the other. Even if the interest rate is constant, so that the marginal interest cost does not rise with the size of planned investment, the fact that the marginal risk premium increases with increasing investment, and the marginal efficiency of capital is likely to decrease under imperfect competition (under oligopolistic conditions it would have an inverted L-shape), ensures a ceiling on the planned investment by each firm. The marginal risk premium in turn increases because of the increase in risk associated with a rise in the ratio of borrowed to own funds; in fact the marginal risk premium rises at a faster rate than risk itself, and at an increasing rate as risk increases (Kalecki 1971).

This is what determines investment in any period. But what can we say about the time-profile of investment? I shall not make any specific assumptions here about the investment function. For my present purpose all that is required is the assumption, which is quite realistic, that during the boom the ratio of borrowed to own funds invariably increases. The rise in the risk premium which accompanies this increase ensures that the boom necessarily gets truncated.

Put differently, if we denote the excess of the marginal efficiency of capital over the sum of marginal interest cost and marginal risk premium bye, then e = 0 in every period in equilibrium. Over successive periods the marginal efficiency curve shifts outwards, as does the interest cost-plus-risk premium curve and the shifting points of intersection determine the time-profile of investment. In some period however the increase in investment over the earlier period, i.e. ΔI, becomes non-positive, because of the rise over time in marginal risk premium during a boom; and then begins the downturn. In short, the euphoria that the capitalists develop as the boom progresses eventually gets trumped by the fears they develop over getting deeper into debt.

The way to prolong the boom therefore is either to lower the interest rate or to lower the risk premium or both, at this point of truncation; and one way to lower the risk-premium is to ensure that the risk of failure of an investment project is not borne exclusively by the entrepreneur undertaking the project, but is spread widely.

The reason why risk rises with the size of investment is because in the event of its failure the creditors have nonetheless got to be paid, so that the burden borne by the entrepreneur is all the greater. The individual entrepreneur of course is not the sole bearer of risk since other equity-holders, who provide risk-capital, also share this risk; but creditors are not meant to share risk. But when creditors are also made to share risk, then we have a reduction in marginal risk premium for the entrepreneurs who are the ones taking decisions regarding investment, and hence an increase in investment and a prolongation of the boom.

While banks are the proximate creditors, their being mere financial intermediaries basically implies that vast numbers of people who are the depositors of banks are the real creditors. These innumerable real creditors and the innumerable persons who are sold the loans made by banks to entrepreneurs, do not know the risks to which they are getting exposed. They do not wish to enhance their exposure to risk, they have no desire to share entrepreneurs' risk; but they are made to do so unknowingly, owing to their lack of knowledge about the economic universe facing them. Depositors do not know how banks are lending their resources; and those rentiers who buy asset bundles from banks consisting of loans to entrepreneurs do not have any clear idea of the risks associated with these bundles.

A similar situation also arises with regard to loans made by banks to consumers. The risks associated with default on such loans are not known to the depositors or to the buyers of asset- bundles consisting of such loans, because of which there is an underestimation of risk which prevents the overcoming of the euphoria associated with the boom, and hence a truncation of the boom. In short, the hardening of budget constraints of economic agents, which one would expect to occur in the course of the boom because of the increase in the ratio of borrowed to own funds, gets put off through the spreading, and the associated underestimation, of risks; this contributes to a prolongation of the boom.

The spreading of risk, or the socialization of risk (whereby the risks of the capitalists are passed on to others in society at large), which is the typical means under neo-liberal capitalism for prolonging the boom, is achieved behind the backs of those to whom risks are distributed. The process of socialization of risk is simultaneously a process of camouflaging of risk[2]. And the State plays a major role in this process.

III

The idea that there tends to be a progressive and pervasive underestimation of risk as the boom develops was advanced by Hyman Minsky (1975), who discussed its consequences in terms of the growing fragility of the financial system. Minsky however was visualizing this as a spontaneous development. An initial underestimation of risk in the euphoria of the boom causes a larger investment than would have been otherwise undertaken, and hence larger profits (since, as Kalecki (1971) had shown, the level of profits depends upon the level of investment), which further contributes to the euphoria; and so on.

What we have been suggesting above however pursues a different track. It argues in fact that growing risk would spontaneously trump the euphoria of the boom owing to the increase in gearing ratio; but what prevents such a denouement is State intervention. What the above emphasizes in other words is the deliberate effort on the part of the State to induce in various ways an under-estimation of risk.

In the U.S. itself the repeal by the Clinton Administration of the Glass-Steagall Act, a measure which had been instituted during the Great Depression to separate commercial from investment banking so that depositors' wealth was not exposed to unknown risks, contributed to the formation of bubbles, and can be interpreted as such a deliberate promotion of risk- underestimation. Likewise the Federal Reserve Board's Chairman Alan Greenspan's reducing interest rates when the dot-com bubble had collapsed, in order to start a new bubble, which did indeed get started in the form of the housing bubble, and created a new boom based upon it, can also be seen in the same light. (I use the term "State" to cover the Fed and all other Central Banks, which must be seen as State organs).

In India where the financial system is dominated by State-owned banks, such under-estimation of risk is institutionally ordained by the State itself which has been directing banks to give generous loans to entrepreneurs in infrastructure sectors (Azad et.al. 2017). Where State-owned banks, left to themselves, might have been chary of giving out loans to many such ventures, at least loans beyond a certain limit, they have been more or less pressurized by the government into doing so.

Kalecki had argued in the context of the principle of increasing risk that even if firms themselves did not factor in increasing risk, the creditors would, and therefore deny them loans. The principle of increasing risk therefore operated, if not by the capitalists' own reckoning, then at least according to the reckoning of their creditors, so that what Kornai (1986) was to call a "hard budget constraint" got created. With

State-owned banks however the directive of the State overcomes the spontaneous tendency of banks to be chary about giving loans to stressed or potentially-stressed firms. Underestimation of risk is thus institutionally dictated in a financial system dominated by a bourgeois State that wishes to keep the boom going.

It follows from the foregoing that blaming the “non-performing assets” of banks in India only on willful default on the part of some particularly avaricious and unscrupulous capitalists, though by no means untrue, is inadequate. NPAs become a structural characteristic of a neo-liberal economy because the only way the bourgeois State can intervene to keep the boom going in such an economy, where it cannot intervene fiscally owing to the demands of finance capital for “fiscal responsibility”, is by inducing an underestimation of risk, and even dictating an underestimation of risk where the financial system is dominated by public sector institutions.

The observed phenomenon that “non-performing assets” have been a characteristic more of public sector banks than of private sector banks in India is also explained by this fact.

IV

State intervention in this manner to prolong the boom obviously cannot do so ad infinitum. At the same time the longer the boom is prolonged in this manner, the greater is the threat to the financial system when it does collapse, for the more fragile it becomes as a consequence of this very prolongation. In fact this is also the reason why it cannot be prolonged ad infinitum, for the growing fragility it acquires as a consequence of such prolongation means that the slightest shock to the system, in the form of a loss of confidence arising in any segment of the economy and leading to liquidity-preference or “safety- preference” on the part of those economic agents, has a domino effect.

When such a domino effect sets in, the State has to rescue the financial system by instilling confidence in it, and for this purpose budgetary resources are typically used. The Obama administration in the U.S. had to pledge 13 trillion dollars of support to prevent a collapse of the U.S. financial system (not all of which obviously needed to be actually used). In India the recapitalization of public sector banks with the help of budgetary resources because of their being burdened by the load of non-performing assets, represents a similar effort on the part of the State to rescue a financial system whose fragility it has itself explicitly encouraged, or implicitly permitted, in an effort to prolong the boom.

It can of course be argued in the Indian context that any actual curtailment of government expenditure in other areas, in order to save budgetary resources for capitalizing public sector banks, is not really necessary; that such recapitalization could be undertaken through larger borrowing by the government from the Central Bank which can have no possible ill effects whatsoever. But this argument belongs to a different realm; it still does not negate the fact that budgetary resources, whether garnered through taxation or borrowing, and hence resources which belong to society at large, are used to rescue the financial system that has been undermined through a deliberate underestimation of risk.

This fact however has an important implication, namely that such an effort to stimulate a boom cannot keep getting repeated. Unlike incursions into pre-capitalist markets which constituted the main exogenous stimulus in the years before World War I, and State expenditure which played a similar role in the immediate post-second world war period, stimulation of the economy via arranging easier availability of finance, either by lowering the interest rate or by systematically ensuring an underestimation of risk, cannot per se put a floor to the level of economic activity. It cannot also necessarily bring about a revival, once the downturn has set in, a fact that is underscored by the continuing travails of the current capitalist world economy, which could not be overcome despite the U.S. interest rates being driven down almost to zero. (The fact that the U.S. unemployment rate is down to 4 percent now does not signal any notable new boom, since the labour participation rate there has also gone down relative to 2008; if the same participation rate had prevailed today as in 2008, then the unemployment rate in the U.S. today would have been 8 percent).

What is more, even if perchance the economy does recover from stagnation, and a new boom gets started, a prolongation of this new boom, in the manner in which the earlier boom, prior to the setting in of stagnation, had been prolonged, is no longer possible. This is because the government cannot justify its tolerance towards growing financial fragility a second time, which is why new legislation to take the place of Glass-Steagall has had to be now in the U.S. And private economic agents, having been duped into underestimating risk once, would be more careful the next time and hence be less gullible.

Finance, it has been argued by Chandrasekhar (2016) in a perceptive article, can provide a stimulus reminiscent of what State expenditure had done in the immediate post-war years or pre-capitalist markets earlier; this of course is true, but, as he himself notes, the stimulus provided by finance is not exactly on a par with that provided by pre-capitalist markets or State expenditure. The purpose of the foregoing has been to suggest that it cannot be the cause of a secular trend. The euphoria it sustains and prolongs can be a one-shot affair (or at best a-couple-of-shots affair), but cannot be a regular feature of the system that generates a positive trend. The stimulus provided by finance in short can create a more prolonged boom than would have occurred otherwise, but a transient one nonetheless. It cannot create a secular trend, unlike what pre-capitalist markets or State expenditure in earlier periods had done.

This argument is analogous to what Kalecki (1943) had suggested with regard to the interest rate. If the interest rate is reduced in the slump to start a new boom, but not increased in the boom in order to let it get prolonged, then it will have to become negative in no time. Reliance on monetary policy in short to generate a positive trend will eventually have to push the interest rate into the negative region, which of course is impossible as long as cash which yields zero interest rate can be held in lieu of any negative yielding asset.

The fact that the existence of cash puts a floor to the interest rate at zero, has been called the “curse of cash” by a recent writer (Rogoff 2016), who has argued therefrom that since economic recovery in the present context requires negative interest rates, it becomes essential to promote cashlessness. It is ironical to note that three quarters of a century after Kalecki’s writing, which was meant as a critique of capitalism, the truth behind his analysis is being discovered by defenders of the system and used by them to suggest ways of making it survive.

Finance capital, I mentioned earlier, was always opposed to State intervention through larger expenditure. This is because State intervention in this manner undermines the social legitimacy of capitalism. But it has no objections to the use of interest rate policy for stimulating economic activity, because interest rate policy works through enhancing private expenditure. The use of interest rate policy does not undermine the social legitimacy of capitalism in the way that fiscal policy does (other than that which seeks to stimulate activity by lowering taxes on capitalists).

But monetary policy, and also fiscal policy which tries to work by lowering taxes on capitalists, cannot act as an exogenous stimulus for introducing a positive trend, the way that State expenditure can: interest rates will have to turn negative if they are to work; income tax concessions to capitalists, for the same reasons, have to become income subsidies (i.e. income tax rates have to become negative); and easing the availability of finance by ensuring risk-underestimation which makes the financial system fragile, cannot be repeated again and again.

In other words, the policy instruments that preserve the social legitimacy of capitalism are instruments that cannot work for generating a positive trend, while instruments that could possibly impart a positive trend are disallowed under neo-liberal capitalism because they undermine the social legitimacy of the system. Neo-liberal capitalism in short is intrinsically flawed, in the sense that it does not have an exogenous stimulus for sustained growth, a fact that is becoming increasingly clear of late.

V

Of course preventing the use of fiscal policy is based on a patently illogical argument. To claim that if the State invests by borrowing from the banking system then that is economically harmful, while if the capitalists invest by borrowing from the banking system then that is economically beneficial, is patently illogical. But that has now become ingrained as part of economic wisdom under neo-liberalism.

As a matter of fact however the fundamental difference between the State and the capitalists as spenders, arises for an altogether different reason, namely that the capitalists, no matter how large their operations, necessarily face a budget constraint, while the State, precisely the State as visualized by bourgeois economics, namely one without any class bias whatsoever, does not face any budget constraint because it has the power to tax.

Suppose the capitalists invest an additional Rs.100 collectively; then the additional total profits (assuming that the economy is a closed one, that workers do not save while the capitalists save their entire profits, and that the government budget is balanced) will be Rs.100; but while this amount will accrue to the capitalists collectively (whence Kalecki’s aphorism that “the workers spend what they earn while the capitalists earn what they spend”), each capitalist would not necessarily be earning what he or she has decided to spend. And what is more, each capitalist, not knowing what other capitalists are investing, would have no idea of what he or she would be earning ex post while deciding his or her own investment ex ante. Hence in deciding how much to spend each capitalist will be constrained by his or her budget.

But if the State undertakes an additional investment of Rs.100 by borrowing from the banks to start with, then this amount will accrue to capitalists as profits, which the

State has the power to tax away and return to the banks, so that it does not have to face any budget constraint.

Monetary policy, or easing the availability of finance by deliberately inducing economic agents to underestimate risk, only eases this budget constraint faced by the capitalists; but it does not do away with it. A continuous easing of the budget constraint in this manner by continuously inducing an underestimation of risk makes the financial system fragile; it makes the boom eventually unsustainable, and the crash when it comes becomes even more devastating.

State spending we have seen not only provided an exogenous stimulus for growth but also a counter-cyclical instrument that kept up a high level of activity. In fact State spending (for military purposes), as Rosa Luxemburg had noted (1963), was a source of demand that could be manipulated to suit the needs of the capitalist economy. The same was true of encroachments into pre-capitalist markets. Pre-capitalist markets, as the economic historian S.B.Saul (1960) had noted, were “markets on tap” under the colonial order. Easing of finance however is not only not an exogenous stimulus for growth, but precisely for that reason not a manipulable instrument for keeping up the level of activity. It is hardly surprising then that neo-liberal capitalism, lacking such a manipulable exogenous stimulus, suffers from an immanent tendency towards stagnation.

(This is a slightly revised text of a lecture delivered at the Tata Institute of Social Sciences, Mumbai, on February 11, 2019, in memory of Dr.Vineet Kohli, a brilliant economist who had been my student at JNU and was on the faculty of TISS at the time of his tragic demise at a very young age.)

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[1] The proposition that a capitalist economy without any exogenous stimulus would settle at a state of simple reproduction was established in Kalecki (1962). See also Patnaik (1997).

[2] There is of course, as Chandrasekhar (2016) notes, a reduction of risk through a bundling of claims on different assets and in banks' selling different bundles to different buyers, so that securitization per se even without any camouflaging of risk can prolong the boom. But this has strict limits. Prolonging the boom beyond these limits necessarily requires a camouflaging of risk. The distinction here is between a genuine reduction in the risk premium and an imposed reduction in risk premium through subterfuge. The former prolongs the boom in the normal course. But anything beyond that requires the subterfuge.