Finance, Stagnation and Poverty in the World Economy

Prabhat Patnaik

The fact that the era of hegemony of finance is marked by a tendency towards stagnation in the world economy is well-known. This is because demand management through State intervention, of the sort that had characterized the so-called "Golden Age of Capitalism", can no longer be undertaken under the hegemony of finance. Since the State happens to be a nation-State, while finance is globalized, if the State deviates from the principle of "sound finance" that is approved by finance capital, i.e. the principle of balancing the budget, or at best having a small pre-determined level of fiscal deficit relative to GDP, then finance will simply express its displeasure by migrating out of the country; this forces the nation-State to fall in line by pursuing "sound finance". Likewise if a particular nation-State has a higher tax rate than others then finance is likely to express its displeasure by quitting its shores; or, at the very least, starting from some base vector of tax-GDP ratios which finance capital may have found "acceptable" to start with, any *increase* in this ratio decreed by any nation-State will induce finance to quit its shores. All this precludes the possibility of Keynesian demand management through State intervention.

These arguments of course do not hold for the leading capitalist power, the U.S., which, because its currency is considered "as good as gold", is likely to be free of the prospects of such potentially debilitating capital flights. But here another important factor intervenes which also keeps its fiscal deficit (and its government expenditure) in check.

The hegemony of international finance capital entails the removal of barriers against the free global movements not only of finance but of goods and services as well, which means that low-wage countries like China, India or other Asian economies, can out-compete high-wage countries like the U.S. even in the latter's market. This means that the brunt of any deficiency of world aggregate demand falls primarily on the high wage rather than on the low wage economies. Now, if the U.S. enlarges its fiscal deficit to boost its own, and hence world, demand, then much of it will leak out as import demand for goods and services from low wage countries. The latter, which in any case were not victims of recession or deficient world aggregate demand to start with, will therefore experience *excess demand pressures*. To counter such pressures, there would be the tendency for a reduction in government expenditure in the low-wage countries, and more generally in their domestic absorption. It follows then that *the net boost to world demand will be quite small, much smaller than the original boost imparted by the increase in U.S fiscal deficit.* Putting it differently, the original boost to world aggregate demand imparted by the U.S. will be significantly nullified by the opposite tendency to curtail domestic absorption by the low wage countries in the event of such a boost.

In this case an increase in the U.S. fiscal deficit, while it will increase its current account deficit substantially, and hence its net indebtedness, will have a much smaller effect on its domestic employment and output. The U.S. in short would have increased its net indebtedness for rather paltry benefits to its own economy. This consideration will tend to dissuade the U.S. State from undertaking an enlarged fiscal deficit, since the U.S. State, despite being somewhat free of the shackles that bind other States, namely the threat of "loss of confidence" of international finance capital in the event of violating "sound finance", is nonetheless after all a

"nation-State" which is not committed to attempts at expanding global demand for altruistic reasons.

Since other nation-States are bound by the principle of "sound finance", while the U.S., despite not being so bound, is unlikely to increase its net indebtedness for little gain to itself, and since economies with current account surpluses are in any case under no obligation to increase domestic absorption, the level of world aggregate demand is likely to remain constricted in a regime of hegemony of finance (i.e. one characterized by unrestricted global financial flows), compared to a regime where financial flows are controlled by nation-States (i.e. where the hegemony of international finance capital is not established). In the latter, nation-States can push their domestic demands close to "full employment" (leaving aside problems of inflation and balance of payments deficits of individual countries); in the former this is not possible. Government expenditures within the former regime will be tied, in general, to government revenues, leaving no scope for the use of what Kalecki had called the "budgetary trick" for curbing "involuntary unemployment".

The generally lower level of aggregate demand, compared to the regime of State intervention in demand management, should not be taken to mean that world economy under the regime of hegemony of finance will be a stagnant one. On the contrary, under such a regime the world economy can experience, on the basis of occasional "bubbles", episodes of extraordinarily high rates of growth, just as the collapses of such "bubbles" would plunge it into deep recessions. But through such "bubble"-based fluctuations, it will have a secular growth rate that will be positive, dependent upon the growth of autonomous components of consumption and investment, but lower than under the State-interventionist regime.

Taking recourse to an old-fashioned Kalecki-type growth model we can illustrate the point as follows. Let us assume that all wages are consumed and all profits are saved, and that the investment function of the capitalists is given by

$$I/K\ (t) = I/K\ (t\text{-}1) + b.\ I/K\ (t\text{-}1)[P/K\ (t\text{-}1) - P/K^*] + e \qquad \text{(i)}$$

where I denotes net investment, b is a constant, P/K* denotes some "normally-desired" net rate of profit, and e is a term depicting the exogenous influence, say of process and product innovations, upon the rate of accumulation in any period. Such an economy will have a stable uniform trend g in net investment, given by the smaller of the two positive roots of the following quadratic equation (the trend given by the larger positive root will be unstable):

$$bg^2 - b.g.P/K^* + e = 0 \qquad \text{(ii)}$$

If the share of profit in output, and hence the value of the Keynesian multiplier, remains unchanged then this will also be the stable uniform trend in output.

On the other hand if there is State intervention in demand management, and the State wishes to stabilize the economy such that the net rate of profit P/K* prevails, then it can easily do so: on the assumption that its expenditure is devoted exclusively to investment, that it balances its budget and that it taxes profits exclusively, it can establish a uniform trend growth rate of P/K*. It is obvious that this latter growth rate is higher than the former. It follows then that if we take this simple imaginary capitalist economy as a rough representation of the world economy, a regime of hegemony of finance leads on average to a comparatively lower level of activity in any period and to a lower secular growth rate over time.

All this is quite obvious. The purpose of the present paper, however, is to argue that in addition to this reason for stagnation, there is a further reason as well, which arises from the tendency towards global under-consumption within a regime of hegemony of finance. And this tendency has a very important bearing on world poverty.

II

The free movement of goods and services across borders in the regime of hegemony of finance, which enables low wage countries to out-compete high wage countries in the international market, also has the effect of making the wage rates in the latter exposed to the baneful consequences of the vast labour reserves in the former. One reason why the advanced capitalist world could witness an increase in domestic wage rates along with the increase in labour productivity in the past was the fact that manufactured good imports from the third world were more or less restricted, being subject to heavy duties. This meant that a pattern of international division of labour was more or less imposed upon the world, with the third world being confined to the production of primary commodities for the advanced country markets (and manufactured goods at best for their own domestic markets), and the advanced countries producing manufactured goods for themselves and for the third world. The world economy in short was segmented and this ensured that, notwithstanding substantial labour reserves located in the third world, the advanced country workers could bargain for and obtain higher real wages as their productivity increased.

The end of this segmentation, in the neo-liberal regime ushered in under the auspices of international finance capital, means that advanced country workers have to compete with much lower-paid workers from the third world and hence cannot enforce wage increases even as their labour productivity increases. As for the third world workers themselves, as long as there are substantial labour reserves in their economies, their wages are more or less tied to some historically-experienced subsistence level (not necessarily a biological one) despite increases in their labour productivity which occur as they produce more and more goods for the advanced country markets. Hence the vector of real wages of workers across the world does not increase even as the average labour productivity in the world economy increases, giving rise to an increase in the *ex ante* share of surplus in world output.

One of the problems with the under-consumption theories developed for the advanced countries, such as the theory of Baran and Sweezy, is that they lacked any analytical explanation for why the real wages in these economies did not increase with productivity. In fact a persistent criticism of the Baran-Sweezy theory has been the absence of any explanation of wage determination in their work, and hence the absence of any explanation of why the tendency towards an increasing share of surplus should occur at all. (Some have even suggested that they had drafted a chapter on wages but could not finalize it, leaving their book analytically incomplete). But once we enter the neo-liberal era, where the third world labour reserves exert a downward drag on the vector of real wages everywhere, not just in the third world countries themselves that are physically saddled with such reserves, but even in the advanced countries whose workers have to compete against the lower wages of third world economies, a tendency towards a rise in the share of *ex ante* surplus in world output, and hence a tendency towards global under-consumption, becomes a necessary occurrence.

What is more, the capacity to ward off the *ex ante* tendency towards under-consumption through State intervention, which was one of the highlights of the Baran-Sweezy theory, no longer exists under the neo-liberal regime. The nation-States, for reasons already discussed, can neither take recourse to fiscal deficits nor use the balanced budget multiplier (increased State expenditure financed by an equivalent increase in tax revenue which comes wholly or partly from private savings) to ensure that the *ex ante* tendency towards under-consumption does not get translated into an actual reduction in the degree of capacity utilization.

Such an actual declining tendency in the degree of capacity utilization will entail not only that for any given time-profile of investment there is a time-profile of output that bears a decreasing ratio to investment (i.e. there is a decline over time in the value of the Keynesian multiplier), but also that this in turn will react back upon the time profile of investment itself, as Josef Steindl had argued. But in the investment function we have taken above, capitalists' investment depends *not upon the degree of capacity utilization but upon the rate of profit*; with our classical savings assumption this means that despite the tendency towards a declining value of the Keynesian multiplier there is no decline in the time profile of investment and hence of profits (which in turn is what prevents a decline in the time-profile of investment).

It is of course unrealistic to assume that the tendency towards under-consumption even when confined no longer to an *ex ante* tendency but converted to an *ex post* phenomenon, will have no effect on the time profile of investment. But to simplify our discussion and to understate deliberately the stagnationist tendency under neo-liberalism, let us assume that the capitalists' investment function is what is given above and that the time-profile of government expenditure (such expenditure, let us assume, is not on investment) remains unchanged despite the tendency towards under-consumption. *In such a case taking the world economy as a single entity, the tendency towards under-consumption simply takes the form of a decline in the value of the Keynesian multiplier over time, with the trend of investment and capital stock being exactly what it would have been in the absence of this tendency towards under-consumption.* The investment trend in other words remains unchanged by the tendency towards under-consumption, while the trend of output keeps slowing down over time.

This tendency towards under-consumption will of course persist as long as the labour reserves do not get exhausted. But a consequence of the combination of a slowing down of output growth (owing to the tendency towards under-consumption), and the persistence of productivity growth despite such slowing down of output growth, may be the fact that these labour reserves never get exhausted. Let us see how.

III

While in the real world there is a vector of real wages, no element of which, for reasons discussed above, moves up as labour productivity rises in the world economy, we shall for simplicity assume a single real wage which remains tied to the historical subsistence level as long as the labour reserves do not get substantially used up. Let us denote it by w^*. Let β denote the level of labour productivity. The value of the Keynesian multiplier in any period, in the light of our classical savings assumption, is given by $\beta/(\beta-w^*)$. Since w^* is fixed, while β rises over time, the value of the Keynesian multiplier keeps declining over time, which is how the tendency towards under-consumption manifests itself. This means that while investment continues to grow at the uniform trend g (the smaller of the two roots of the quadratic equation (ii)), the rate of growth of output keeps slowing down even on this uniform-trend-of-investment path.

The crucial question is: what determines the rate of labour productivity growth over time? Obviously, the rate of labour productivity growth will depend upon the rate of accumulation; on the uniform-trend-of-accumulation path it will depend upon g. We can, for simplicity, visualize investment occurring in new vintages of equipment each of which produces one unit of output with less labour per output and that depreciation takes the form of a certain proportion of equipment dying at the end of each period *irrespective of age.*

In addition however, the decline in aggregate demand relative to full capacity output (caused by the tendency towards under-consumption) will mean that less efficient equipment, i.e. equipment with lower labour productivity, will be getting scrapped. Labour productivity in short will be rising *ceteris paribus* as the gap between the rate of growth of investment and the rate of growth of output increases, i.e. as the value of the Keynesian multiplier declines.

There is an additional element that works in the same direction and hence strengthens this second determinant of labour productivity growth, and this consists in the fact that with the rise in the share of profits (which is what causes the Keynesian multiplier to fall), the demand for "sophisticated goods", which are likely to be those with lower labour coefficients, i.e. with higher labour productivity, tends to increase in relative terms. We can therefore depict the rate of growth of labour productivity as follows:

$$(d\beta/dt)/\beta = \alpha \,.\, (dI/dt)/\, I + \mu.\, [(dI/dt)/I - (dY/dt)/Y] \ldots \qquad \text{(iii)}$$

where α and μ are positive constants, and Y denotes the level of output. It can be easily checked in this model that the rate of growth employment

$$(dE/dt)/E \leq 0 \text{ if } \beta\,(1-\alpha) \leq w^*\,(1+\mu) \ldots \qquad \text{(iv)}$$

Now, α captures the effect of accumulation on labour productivity growth in a world where no tendency towards under-consumption exists and μ captures the effect on labour productivity growth arising from the fact of the existence of the tendency towards under-consumption. In the absence of under-consumption, where the capital-output ratio will remain constant over time, the elasticity of labour productivity with respect to investment, which will be the same as the elasticity of labour productivity with respect to output, is likely to be quite close to 1, as we find, for instance, in post-war Germany or contemporary China. Condition (iv) therefore may not be a difficult one to satisfy almost in perpetuity (even though β is growing).

If condition (iv) is satisfied, then we find a vicious circle of the following sort: with real wages tied to subsistence level, productivity increases bring about an increase in the share of profits, and hence a decline in the rate of growth output for a given steady rate of growth of investment and capital stock. This however has the effect of further raising productivity growth, and further lowering the rate of growth of output, in a cumulative spiral, *which also ensures that the labour reserves never get used up because the rate of growth of employment is negative or zero.* Under-consumption also has the effect therefore of accentuating the problem of lack of absorption of labour reserves.

Of course, the way we have presented this vicious circle, it would appear that with the tendency towards under-consumption, there would be no new state of rest, that the economy would simply experience an *instantaneously explosive outburst of productivity growth*, with real wages remaining constant, which is patently unrealistic. But this is not a serious problem, since with suitable assumptions the vicious circle can be made to operate in a more realistic, stretched-out fashion over historical time.

Even if condition (iv) is not satisfied in perpetuity, the vicious circle may still operate if there is positive work-force growth. If the natural rate of growth of the work-force is n, then there will be a vicious circle, with labour reserves remaining unexhausted, provided that

$$\beta (1- \alpha- n/g) \leq w^*(1- n/g)(1+ \mu) \ldots \qquad (v)$$

Condition (v) is naturally weaker than (iv) and may be satisfied almost in perpetuity even when α is distinctly less than 1, as long as it is close to 1- n/g.

There is however an additional factor of great importance that contributes to such a *denouement* of a vicious circle, to which we now turn.

IV

We have so far been looking at a simple capitalist economy in isolation, which we take to be a representation of the world economy. And even in such an economy we find that the existence of labour reserves may cause real wages everywhere to remain fixed even as labour productivity rises, resulting in a tendency towards under-consumption, which in turn may ensure that the labour reserves increase even with a fixed population. Of course, if the population, and hence the work force, grows over time, then the increase in the labour reserves will be even more substantial (or alternatively, the conditions under which such a vicious circle will hold can be further relaxed from (iv) to (v)). But even more important than the increase in the work force is the fact that the capitalist economy, which never exists in isolation, tends to destroy the pre-capitalist setting within which it is invariably ensconced. And this keeps adding to the work-force available for capitalism, despite the fact that it absorbs little of this addition, leading to an expansion of the reserve army of labour.

Of course the term "reserve army" used here needs an explanation. Typically, these days, capitalism does not have a reserve army *distinct from its active army.* On the contrary, it takes advantage of the existence of the reserve army, to pass on to members of this reserve army a whole lot of jobs that it would otherwise have entrusted to its active army, paying an amount that is a mere fraction of what it would otherwise have paid. *It blurs to its advantage the distinction between the two categories*, which means in effect that it further *lowers its unit wage costs, strengthening the tendency towards under-consumption even further.* Since the analytical effects of such blurring strengthen our argument, we shall ignore it and continue to assume that capitalism employs an active army at a historically-given subsistence wage rate, as long there are substantial labour reserves, and that these reserves are visualized as existing as a distinct category.

This tendency towards the destruction of the surrounding petty production gets vastly accentuated in the regime of the hegemony of finance capital, for the following reason. The struggle for decolonization in the third world had got a tremendous boost from the radicalization of the peasantry hat had taken place as a consequence of the distress it had to endure during the Great Depression of the thirties. The protection of petty production, including of the peasantry, had therefore become a part of the programme of the anti-colonial struggle, and the *dirigiste* regimes that came into being after decolonization took a number of steps in accordance with this promise to protect and promote this sector, which also fitted in with their general agenda of pursuing a trajectory of relatively autonomous *national* capitalist development. The post-colonial State in short, even while promoting capitalist development, looked after, to an extent, the

interests of the other classes and projected itself as an entity standing above classes, arbitrating between them and not tied exclusively to any particular class.

With the end of *dirigisme* and the ushering in of the neo-liberal regime, this role of the State gives way to one where, for reasons discussed earlier, it gets exclusively tied to the interests of the big corporate and financial interests. The interests of society are projected as being synonymous with the interests of finance, and big corporates; the stock market becomes the key indicator of the health of the economy; and stoking the stock market for creating the "right climate" for investment becomes the exclusive objective of economic policy.

This entails a withdrawal of support and protection of the State from the petty production sector: protecting this sector from the vicissitudes of world market conditions through tariffs and quantitative restrictions ceases to be a priority as trade liberalization gets introduced; the interposing of the State between this sector and the multinational corporations, if not the outright proscription of MNCs from entering this sector, gives way to a regime of free run for them as the State winds up its extension activities; subsidies to this sector, including in the form of cheap credit, are whittled down leading to a rise in input costs; the system of assured remunerative prices and public procurement at such prices is progressively wound up; the privatization of healthcare and education raises the cost of living of these producers; State-sponsored research activities of potential benefit to them get reduced in scope as State funding dries up under the pressure of "sound finance"; and public investment in irrigation and other infrastructure facilities for this sector gets reduced for the same reason. The net effect of all these measures is to make this sector unviable, to a point where even simple reproduction often becomes impossible (as shown for instance by the suicides of over two hundred thousand peasants in India over the last decade).

The reduction of this sector to un-viability, which is an instance of what Marx had called "primitive accumulation of capital", is an extremely important hallmark of the regime of hegemony of finance. It directly strengthens the tendency towards under-consumption in the world economy; in addition it swells the numbers looking for work even as the scope for recruitment into the active army of labour remains limited, leading to an increase in the relative size of the reserve army of labour. Since the existence of substantial reserves is what underlies the tendency towards under-consumption in the first place, the increase in the relative size of the reserve army perpetuates this tendency towards under-consumption.

It may be thought that the destruction of petty production itself creates scope for accumulation in the capitalist sector, as Rosa Luxemburg had argued, and therefore acts as an antidote to the tendency towards under-consumption. But this is not the case; the effect of such encroachment into the pre-capitalist sector on the rate of accumulation in the capitalist sector, like the effect of innovations, is already taken into account in the investment function given above through the term e, which itself forms the basis upon which the under-consumption argument is developed. Destruction of petty production therefore strengthens rather than offsetting the tendency towards under-consumption.

V

This has a direct bearing on the question of poverty. Let us consider as a benchmark a situation where, within the capitalist sector, the ratio of labour reserves to the active army of labour remains constant over time, as employment grows at the natural rate of growth of the work-force.

If this is the same as the rate of population growth in the economy as a whole, taking capitalist and pre-capitalist sectors together, then the work-force in the petty production sector too would be growing at the same rate; if we assume that the per capita income in the petty production sector remains unchanged then the absolute incomes per head of workers, petty producers and even the reserve army (whose per capita income, lower than the wage rate but greater than zero, may be taken as a constant) would remain unchanged over time. The proportion of the population which is in absolute poverty, defined as those below some benchmark level of income, will then be constant over time.

But if petty production is becoming progressively unviable over time, so that the per capita (real) income of petty producers is *decreasing over time*, then the proportion of population in absolute poverty, i.e. below the benchmark level of real per capita income, will rise over time, even as the economy continues to experience growth. The process of primitive accumulation of capital which increases the ratio of the reserve army to the active army is, in short, absolute-poverty-enhancing. The vicious circle we have been talking about will then be poverty-enhancing even if the tempo of accumulation does not slacken and the economy remains on the uniform-investment-growth trend.

VI

Even if this tendency towards absolute-poverty-enhancement may be a characteristic feature of the world economy as a whole, it may be thought that the low-wage, competitive, economies which would be experiencing continuously high output growth rates (since the burden of declining aggregate demand, owing to the shrinking value of the Keynesian multiplier in the world economy as a whole, would not be falling upon them, because of their capacity to out-compete high wage countries) would be free of it. In their case in other words, there should be no reason to expect a secularly increasing ratio of absolute poverty, since they should not have a problem of an increasing ratio of the reserve army to the active army of labour.

But this is not true. Of course the aggregative model we have been working with till now cannot be used to demonstrate the changing distribution of world output across countries. But as long as α which is the elasticity of labour productivity with respect to investment, and, in the case of low-wage economies not subject to the tendency towards under-consumption, is identical with the elasticity of labour productivity with respect to output, is not less than $(1-n/g)$, then *no matter how g is determined and what its value may happen to be*, their labour reserves relative to the work-force available to their capitalist sectors, even in the absence of any primitive accumulation of capital, will not diminish. When the effects of primitive accumulation of capital, reducing the per capita incomes of petty producers and throwing them to the ranks of the reserve army of labour are additionally taken into consideration, these economies too will experience a tendency towards an increase in the ratio of the absolutely poor relative to the total population.

Such a tendency is manifest in India notwithstanding the supposedly high GDP growth rate it is experiencing; and it would not be surprising if a similar tendency exists in other fast-growing third world economies as well. It is significant that the per capita absorption of foodgrains, taking both direct and indirect absorption into account (the latter through processed food and animal products), was lower in India in 2008 than at the end of the 1980s; and it was lower than in 1996 for every subsequent year in China.

VII

Let me sum up the argument. The era of hegemony of finance capital brings about a major change in the role of the capitalist State, which foregoes its traditional image of being an entity apparently standing above classes, not tied exclusively to promoting the interests of any particular class, and becomes instead an exclusive upholder of financial and large corporate interests. Finance capital's approval of the principle of "sound finance" together with its aversion to the State's raising taxes on the rich, spells an end to Keynesian-style State intervention in demand management. Even the State of the leading capitalist country, which in principle should not be as vulnerable as other States to the caprices of globalized finance, becomes reluctant to stimulate economic activity for the fear *inter alia* of widening its current account deficit for meagre gains in employment and output. All this entails a tendency towards stagnation in the world economy.

This tendency is further strengthened by a global tendency towards under-consumption arising from the very fact of de-segmentation of the world economy that trade liberalization brings about, which exposes real wages everywhere to the baneful consequences of the vast third world labour reserves. Under-consumption in turn serves to prevent the absorption of labour reserves, creating a vicious circle, whose consequence is that even when there is growth in the world economy, the magnitude of absolute poverty in the world economy still increases secularly over time, i.e. taking the average between booms and slumps.

What is more, even fast-growing economies which are relatively free of this tendency towards under-consumption, cannot shake off this tendency towards an increase in the ratio of the absolutely poor in their population. This is because of the process of "primitive accumulation of capital" that is unleashed in the era of hegemony of finance, which succeeds only in enlarging the relative size of the reserve army of labour. In short, whether we look at the rich or the poor countries, the era of hegemony of finance is one of distress for the working people.