Communication

Keynes versus Krugman: A Discussion on Increasing Returns & Monetary Policy Perspectives

Satya Prasad Padhi

A debate that Keynes's focus is on demand stimuli to actualize savings-led expansions, and such Keynes versus classics distinction, could be much misplaced. Perhaps, fiscal deficits and other demand stimuli have no role to play in savings-led expansions. Savings, as aspects of greater skill and dexterity and foresight, etc. target some specific contract-based expansions, and the expansions would target substitution-led reallocation of resources. Demand stimuli, then, can translate into higher demand-led inflation (facing the supply constraints) and can negate the desired contracts and substitution-led expansion or the resultant forced savings negate the loans and other contracts underlying the bank credits (Robertson, 1961).

Keynes started with a particular criticism of pure savings-led expansions. An increase in income can generate savings that may not face any new investment opportunities-based expansions. Does the indicated periodic over-savings outcome, inducing demand constrained unemployment, require the demand stimuli? This could be a neo-classical focus that would underpin how to formulate fiscal and monetary incentives that can translate into a higher *(real savings in line with money savings-linked)* investment prospect (Blinder & Solow, 1973; Tobin & Buiter, 1974; Tobin, 1980).

__Satya Prasad Padhi__ is Professor, Department of Economics, Panjab University, Chandigarh (India). satyaprasadpadhi@gmail.com

However, Keynes was speaking of an over-saving situation that is caused by the lack of increasing returns and such macro expansions. He provides an entirely novel solution that aims at increasing returns in production possibilities. Expansion in one line of production would be associated with such expansions elsewhere. That is, a situation in which higher savings, or increases in it, would also face the expansion of consumer goods industries and, then, could negate the unemployment situation. Keynes (2013: 16-17), in correspondence with Hawtrey, notes how a scheme to increase the propensity to consume does not in the least will have the effect of

diminishing savings. Further, to quote, "That you should be capable of confusing measures to increase the propensity to consume with measures to diminish saving seems to show that on the whole of this vital part of my theory our minds have still not met." He goes on to argue (:26), to quote (with restructured paragraphs), "I am not sure that the following is not the best definition of full employment in my sense: 'There is less than full employment if, the propensity to consume being assumed unchanged, an increase in investment will cause an increase in consumption.' As against this the normal assumption of the classical theory is that an increase in investment will involve a *decrease* in consumption." In a similar vein, in correspondence with Hicks, he (: 71) points out, to quote, "I should say that my theory provides for the supply of consumption goods and of goods in general having, or being capable of having, some elasticity, whereas the classical theory assumes that the supply of output as a whole is wholly inelastic; increase in one direction being necessarily offset by a decrease in another. If I were writing again, I should indeed feel disposed to define full employment as being reached at the same moment at which supply of output in general becomes inelastic."

The investment need desired for the increasing returns cannot be met by savings-led investment and reallocations. The periodic investments would exceed savings in the period and they have to be finance-based (independent of savings), but that would bring forth an increase in income that could allow for increases both in consumption and real savings.

Beyond the seminal contribution towards the short run income determination process, which otherwise suggests that expansions of savings and consumption goods complement one another with feedback effects and the need for the related policies for overcoming oversavings situations, Keynes's General Theory did not directly address the issue of the conditions or monetary production underpinning of market processes under which individual initiatives can open up an economy to increasing returns and such macro expansions. What kind of isolated individual initiative reinforces the tendency towards increasing returns and macro expansions and elucidates alternative, proper growth prospects? An important question at hand is: do the expansions necessarily underscore Keynes's monetary policy suppositions?

Kaldor (1972)'s insight into the processes that constitute "macro" expansions assumes importance. He relies on Young (1928) to show how isolated individual initiative that brings in some newness, innovations, provides the incentive that create external economies and permits increasing returns embedded in greater supply dynamics. Kaldor also argued, isolated innovations permitting a substitution-led reallocation of resources, and income in favor of the initiative (aggregate demand (and income) remaining the same), would at best mimic savings-led expansions embedded in classical monetary economics with-

out any further growth propensities. Young's increasing returns, therefore, anticipates Keynes's insight into how the innovation is an act of finance-led investment that can support such investment elsewhere and define macro investments. It also fits into Keynes understanding of how the investments taking place in an environment foreign to the existing state of affairs would face fundamental uncertainties and demand stimuli plays an important role in supporting the macro investments.

In this perspective, Keynes's independent investment versus classic savings-led expansions has to bring in Krugman (1991)'s contribution that elucidates how savings-led expansions also permit increasing returns. Supposing one starts with Kaldor's discussion of how innovation can permit higher market share to innovating firms through the principle of substitution and would take place in a situation of a given aggregate demand (and perhaps with price stability), Krugman would hold the outcome also provides the incentive for further innovations and real savings. In a specific sense, the savings-led expansions, embedded in greater innovation and dexterity, can translate into an advanced status that comes with a higher share of manufacturing and the coming up of varieties of goods. Key to this advanced status would be higher share and scale of specialized employment opportunities embedded in intermediate goods specialization (that can capture Youngian developed status). If the developed status embedded in the constant elasticity production function shows an elasticity of substitution parameter greater than one, a love for the varieties of goods that the varieties of intermediate goods specializations permit, Krugman discusses how the existence of specialized labor force can, under specific and reasonable conditions, attracts a reallocation of foreign savings aimed at specialization-related advantages. The reallocation can add to the developed status with higher (real) income to the specialized inputs. As the share of specialized inputs (and greater varieties of goods) goes up, so should the real income in the aggregate.

If so, the savings-led reallocations could permit increasing returns. One basic difference between Krugman and Keynes, interpreted in a Young-Kaldor way, is that savings-led increasing returns would at best permit some transitional growth dynamics, whether discussed in an open economy framework, or in a closed economy, as discussed in literature dealing with inter-generational saving-led mobility (see, Banerjee and Newman, 1993). If one takes into the mobility would show some advantage to a scale factor or an initial higher developed status (Krugman, 1991), there would be some limits to the dynamic evolutions.

A Young-Kaldor-Keynes focus would, more so in a closed economy framework, underpin how the dynamic interplay between aggregate supply dynamics and aggregate demand can permit an endogenous cumulative causation growth (Padhi, 2019). Is this growth perspective, the connection between macro

investment and better supply dynamics important?

II How Monetary Perspective Stands

Keynes's General Theory primarily remains a contribution to monetary economics concerning how an increase in supply of money can correlate with macro investment-led increasing returns. The issue is how the debates and controversies surrounding Keynes's monetary suppositions stand when they are seen as promoting Keynes's increasing returns in contrast to savings-led expansions. The latter would still give primacy to price stability to achieve financial stability. Price stability, perhaps in an open economy framework, and the resultant realization of the investments and increasing returns, would maintain the contracts embedded in real savings (and savings-led) bank credits that achieve financial stability.

At first sight, Keynes's focus could be more on financial stability, how increases in investment bring in the corresponding savings, to achieve the crucial savings and investment identity. An argument could be supposing an economy comes with some savings decisions, real savings, finance-led investment and increasing returns embedded in new resource creations would put some pressure on prices. Macro expansions, as Robertson (1961: 81-2) noted, banks credit allowing for the increasing returns, would cause a forced savings situation. Hick's ISLM general equilibrium framework (fitted onto the increasing returns perspective!)[1], argues how the increasing returns can put pressures on prices, transaction demand for money, and rate of interest that can choke off the expansion.

Is it back to square one? Not necessarily, first, Keynes (2013: 91), would hold, as his discussion in correspondence with Robertson shows, how a higher level of activity carries within it the seeds of its own destruction if it causes a raise of the rate of interest. The measures to sustain the high level of activity therefore would be important. To elaborate further, Keynes (2013: 80), in discussions with Hicks, holds how in terms of ISLM apparatus, the General Theory's percept is an increase in inducement to invest need not raise the rate of interest.

Investment-led increasing returns should provide a context and clarity to such Keynesianism monetary policy suppositions. If investment in a period exceded savings, the investment and increasing returns prospect should be facing a higher money supply that can absorb both an increased transaction demand for money and an increased bond purchases (also see, Davidson, 1968). That is, a shift of the IS curve (or a IS curve that traces out the shift and is more elastic, see Padhi, 2018a) would be facing a flat LM curve. More so, when the

[1] Hicks (1937)'s purpose could be a reformulated Marshall's classical tradition that has been qualified to bring in how changes in money supply can explain some expansions. However, Keynes (2013: 79) cautions how a strict classical tradition cannot admit this role of money or admit it without realizing how inconsistent it would be with other premises.

higher investments are guided by innovations and such higher profit expectations, and the increased money supply should be aligned to the macro investment that also relate to supply dynamics [and the investor would anticipate a fall in the (bond) rate of interest].

However, simply incorporating increasing returns and supply dynamics, as in Krugman's case, would be inconsistent with this role of money supply. A savings-led perspective, embedded in ISLM logic, cannot incorporate how better supply responses can permit periodic investments more than savings or the freedom of individual initiatives to invest to expand production of goods in general, and such sustenance of growth. As Keynes (2013: 79; also see, footnote 1) cautioned, the role of money discussed in the General Theory would be inconsistent with the savings-led classical economics premises. Keynes's monetary perspective assumes importance only when the focus is on the finance-led investments that come with increasing returns and supply dynamics.

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The discussion of price stability takes a different form. The increase in money supply at a given rate of interest, in response to investment, adapts both to higher income and transaction demand for money, allowing for the short run increases in prices (or whatever would be how the mobility adjusts to the prevailing supply conditions) and the need for money to adjust the bond market to the higher profit expectations.

The focus then shifts to whether inflationary (or price increase) expectations are anchored or not. Investment would add to supply dynamics, and even if wages adjust to short run price increases, perhaps in a staggered way, a higher wage could form the basis of new contracts aligned to supply dynamics that could maintain a higher labor productivity to wage ratio even at the prevailing price expectations. If the bond rate is higher (or monetary authorities allow for a lower rate of interest), the money supply aligned to the bond market would underpin the coming of supply dynamics (and new contracts) that can absorb the transitional increases in prices. Growth always involves some increases in prices, but inflationary expectations would be anchored. The goal of financial stability can ensure both price stability and, perhaps more importantly, growth.

Liquidity preference theory of rate of interest, guided by the factors that influence investors' views concerning the relationship between current and future rate of interest, looks both ways, allowing for transaction demand for money-specific MV and PT remains a stable function with a given V. A higher money supply, or lower rate of interest or both, not aligned to revival of bond market (and financing of macro investment based on higher long run expectations) can be problematic. It can translate into higher

liquidity preference. On the other hand, allowing for independent influence of a revival prospect (and higher profit expectations), and if this prospect of a lower rate of interest guides investors' sentiment (in the bond market), a higher money supply can translate into a lower rate of interest that captures the future actual growth prospects with stable prices (also see, Padhi, 2018; 2019a).

Therefore, to conclude, unlike Hicksian ISLM logic's role in savings-led increasing returns, it is Keynes's generalized increasing returns expansions, i.e., expansions in many without contractions in other lines of production, that make clear why the "macro investments" would have to be associated with a higher money supply. The considerations of inflation or price stability parameters and contracts relating to previous periods, as held above, would remain unimportant. The monetary policy intent zeros in on how the increased money supply brings to fruition the desired macro investments, and both, as independent influences, should come with a lower rate of interest. This is especially when Keynes's increasing returns would be embedded in greater supply dynamics, and the supply dynamics would support further such generalized expansions. The resultant growth and generation of periodic savings matching the investments ensures financial stability. If monetary policy aims at this goal of financial stability, it can ensure both price stability, of course, with new contracts situated in new products, industries, sub-tasks, and such prices, and perhaps more importantly, such growth prospects. In increasing returns and cumulative causation, financial stability achieves the price stability that confirms the growth prospects, not the other way around. In this, monetary economics in General Theory has to incorporate supply dynamics-led increasing returns. As Keynes (2013) responded to Hicks, his thesis does not ignore inventions. Kaldor (1972) mentions how Youngian cumulative causation has to incorporate the key insight in to Keynes's finance-led investments and the aggregate demand supports in macro expansions. Young's discussion of how individual initiatives to bring some newness, division of labor, and higher profits via cost reduction that accompanies production of a larger volume of output creates external economies and learning by doing dynamics also becomes important building block for Keynes's increasing returns. It can make clear Keynes's conception of macro investment that can have the propensity to grow with periodic investments that outpace savings. Therein, Keynes's perspective on the monetary support system can provide alternative insight into increasing returns growth prospects.

The monetary policy intent zeros in on how the increased money supply brings to fruition the desired macro investments.

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