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Lessons for the Industrialised World from Development
Economics**

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Abstract

In labour surplus developing countries a strategy based on the application of the Keynesian multiplier to generate employment is constrained by the availability of resources. In some of Keynes's writings in general and those on the post-War employment and commodity policy in particular it seems that Keynes himself became aware of the limitation of the savings investment multiplier in generating and maintaining full employment in industrialized economies. The argues that the time has now arrived for the economic policy makers to wake up to the limitations of expansionary fiscal and monetary policy alone to combat the current downturn in economic activities.

Keywords: wage goods, Commod Control, employment, fix-price, flex-price

JEL Classifications: E12, E24, E32, F01, F53

1 Introduction

This paper builds upon the experience of labour surplus developing economies in their discovery of the limitation of Keynesian policy in underdeveloped economies. The paper first explores the nature of such limitations and then goes on to argue that the industrialized countries can find valuable lessons from the experience of the developed countries in trying to solve the problem of unemployment they are now facing. Further more, the paper shows that after the *General Theory*, Keynes himself became aware of the limitation of the strategy of demand management alone in tackling the problem of economic depression.

After this short introduction, Section 2 discusses the experience of the labour surplus developing countries and the nature of the constraints these countries encountered when attempting to generate employment for their surplus labour. Section 3 presents the theoretical framework which can be a basis of understanding Keynes's views with respect to such constraints as they are encountered by the development economists. Section 4 provides the policy implications of the theoretical framework and the Keynesian perspective on it. Finally, in Section 5 we discuss the lessons the present day industrialized countries can draw from.

2 Development Perspectives

Development economics as a subdiscipline of economics was born following the end of the Second World War, when the process of decolonisation started. By this time the neoclassical orthodoxy was already firmly in place and it is not surprising that the majority of development economists "tried to combine neoclassical and classical economics in an eclectic synthesis, and most refused to see existing societies as riven into classes and driven by their conflicts" (Bagchi, 1982: 3). Neoclassical

development economists such as Ranis and Fei (1961), Fei and Ranis (1964), Jorgenson (1966, 1967) and others¹, devoted their attention to the building of theoretical *closed system*² general equilibrium models which tended to tell how the process of economic development and structural change should work, by making the assumptions needed to close their models, instead of studying the constraints an underdeveloped economy may have to encounter, in real life, in its attempt to industrialize. It is no wonder that during the early 1980s in what has been described as “an obituary of development economics” Hirschman (1982) observed that:

...our subdiscipline had achieved its considerable lustre and excitement through the implicit idea that it could slay the dragon of backwardness virtually by itself or, at least, that its contribution to this task was central. We now know that this is not so.

With reference to the above observation by Hirschman that the failure of neoclassical economics in addressing the problems of underdevelopment, Sen (1983: 746) pointed out that this “need not have caused great astonishment, since neoclassical economics did not apply terribly well anywhere else (either)”.

There, however, were exceptions; development economists like Gerschenkron (1966), Lewis (1954, 1958) and Myint (1968) consciously went back to the classical economists for their inspiration. The seminal article by Lewis (1954) “is widely regarded as the single most influential contribution to the establishment of development economics as an academic discipline” (Kirkpatrick and Barrientos, 2004: 679). Lewis built his model of the dual economy by drawing his inspiration from such classical authors as Smith and Marx. Lewis (1954) formulated his model with reference to countries containing surplus labour in the sense that the population is so large in comparison with capital and natural resources that in a large sector of the economy marginal productivity of labour is negligible, zero or even negative. The existence of this surplus labour implies that the supply of labour is unlimited at the ‘subsistence’ wage. This surplus labour exists in what Lewis describes as the “subsistence sector” or that part of the economy which does not use ‘reproducible capital’ like its counterpart, the ‘capitalist sector’. Average per capita output is, understandably, lower in the subsistence sector than in the capitalist sector. The process of economic development involves gradual transfer of surplus labour from the subsistence to the capitalist sector to accumulate capital to be re-invested in the capitalist sector to help transfer more surplus labour. This process continues until the labour surplus in the traditional sector disappears. For, when this situation is reached, transfer labour from the traditional to the capitalist sector can only be achieved at a cost of output in the traditional sector.

It is important to understand that the concept of surplus labour in Lewis is not the same as the concept of ‘disguised unemployment’³. The term disguised unemployment was first introduced by Joan Robinson (1936) to describe workers in industrialized economies who were compelled to accept less productive hand-to-mouth occupations as a result of being laid off due to lack of effective demand. In her own words:

...a decline in demand for the product of the general run of industries leads to a diversion of labour from occupations in which productivity is higher to others where it is lower. The cause of this diversion, a decline in effective demand, is exactly the same as the cause of

¹ See Dixit (1973) and Kanbur and Macintosh (1988) for a comprehensive list.

² See Loasby (2003) and Chick (2004).

³ Though some neoclassical authors like Jorgenson (1967) treat them as identical

unemployment in the ordinary sense, and it is natural to describe the adoption of inferior occupations by dismissed workers as *disguised unemployment* (Robinson, 1936: 226; emphasis in the original).

Surplus labour in a dual economy, as described by Lewis, is different from the unemployed labour described in the *General Theory*. In the economy Keynes described, 'not only that labour is unlimited in supply, but also, and more fundamentally, that land and capital also are unlimited in supply – more fundamentally both in the short run sense' (Lewis, 1954:140). In this sense the nature of the problem of employment generation in the capitalist sector of a dual economy is essentially different from that of job creation in an economy experiencing unemployment during economic recession or depression.

We have now presented the basic features of Lewis's model of development in a dual economy. Since this model has gone through a number of changes and interpretations in the hands of the neoclassical economists, losing its central message in the process (Ghosh, 2007), it is important to remind ourselves that, unlike the neoclassical development economists, Lewis's intention was not to build a well behaved deterministic closed system theoretical model yielding an unique and stable equilibrium. Lewis's model is an example of an open system where he discussed a number of reasons for which the process of transfer of surplus labour from the traditional to the capitalist sector might be prematurely halted. One such reason is lack of availability of what Sen (1975: 85) calls 'wage goods'⁴. In low income countries these are essentially food (food grains). Lewis observed:

Now if the capitalist sector produces no food, its expansion increases the demand for food, raises the price of food in terms of capitalist products and so reduces profits. This is one of the senses in which industrialization is dependent upon agricultural improvement;...if we postulate that the capitalist sector is not producing food, we must either postulate that the subsistence sector is increasing its output, or else conclude that the expansion of the capitalist sector will be brought to an end through adverse terms of trade (Lewis, 1954: 173).

The implication of this is that the ability to generate employment in the capitalist sector is constrained by the availability of food. And for this reason any attempt to generate employment by creating effective demand, as prescribed by Keynes for the mature industrialized countries, would fail to work for the developing economies. This is because, while attempting to generate employment in the capitalist sector, "...we encounter the bottleneck of supply of necessities which depends on the inelasticity of the agricultural production. Any increase in employment implies generation of additional incomes and thus, if no adequate increase in agricultural output is forthcoming, an inflationary increase in the prices of necessities will be unavoidable"(Kalecki, 1993: 3).

In fact immediately after the independence from British rule, economists in India (e.g., Rao, 1952 and Dasgupta, 1954), who at first sought answers to the problems of economic development from Keynes's writings, came to a similar conclusion as Lewis about the inapplicability of Keynesian economics to the problems of economic development. Rao (1952) observed that Keynes "did not formulate the economic problem of underdeveloped countries, nor did he discuss the relevance to these countries of either the objective or the policy that he proposed for the more developed, i.e. the industrialized countries. The result has been a rather unintelligent application ...of what may be called Keynesian economics to the

⁴ Kalecki (1976) calls these 'necessities'.

problem of underdeveloped countries” (Rao, 1952:206-207). The author went on to argue that in a country like India, in spite of the marginal propensity to consume, and hence the size of the multiplier, being very large, the tertiary and other increases in output, income and employment visualised by the multiplier process do not work. This is due to the fact that for developing countries the most important consumption goods happens to be food (food grains) and, in common with all other primary commodities, the supply curve of food grains is highly inelastic in the short run and can even be backward bending⁵.

Let us try to elaborate. According to Sen (1975: 85) the opportunity for creation of wage employment, E , in a developing country depends on the availability of ‘wage goods’, M , and the real wage rate, w , and can be presented as follows:

$$E = \frac{M}{w} \quad (1)$$

As we have seen above, the wage goods for a developing economy is mainly food (food grains). Indeed Kaldor (1975: 350) calls food “the wage good par excellence”.

The Soviet Union encountered a similar constraint during their early days of industrialization (see Dobb, 1966; Chapters 8 and 9). In a speech, at the July 1928 Plenum of the Communist Party’s Central Committee, Stalin underlined the need for availability of the agricultural surpluses for industrialization. He argued that since the Soviet Union could not follow the examples of the “capitalist” countries, whose industrialization was shaped by resources mobilised from their colonies, the Soviet Union had only internal accumulation to fall back on for industrialization. The two sources of internal mobilization he mentioned were “firstly, the working class, which creates value (for the advancement of the industry)...and secondly, the peasantry”. Stalin observed that the peasantry

not only pays the state the usual taxes, direct and indirect, it also *overpays* in the relatively high prices for manufactured goods – that is in the first place, and it is more or less *underpaid* in the prices for agricultural produce – that is in the second place....This is an additional tax levied on the peasantry for the sake of promoting industry, which caters for the whole country, the peasantry included. It is something in the nature of a ‘tribute’, of a supertax, which we are compelled to levy for the time being in order to preserve and accelerate our present rate of industrial development, in order to ensure an industry for the whole country.... (all quotes of Stalin are from Ellman, 1989: 96).

We may summarise the central message of this section as follows. The experience of economic development shows that the success of the strategy of industrialization via transfer of labour from the agricultural to the industrial sector is constrained by the availability of the supply of wage goods (which determines the cost of living) from the agricultural sector. Since the supply of wage goods is relatively inelastic in the short run, any rise in its demand causes its price to rise and generates inflationary pressure, which may cause to slow down or even halt the process of capital accumulation and hence, generation of employment in the industrial sector. As Kaldor (1975: 350) observed, “the mechanism (of the multiplier) operates by varying the amount of production in *general*. It leads to a situation that is *not* resource-constrained.” The resource constraint that the Indian and the Soviet planners

⁵ See Mathur and Ezekiel (1961) and Ahluwalia (1979)

encountered was that of the supply of wage goods. In the next section we will attempt to discuss the theoretical basis of our findings so far.

3 Cost-based and Demand-based Prices

As far back as in 1943, Kalecki⁶ observed that the “[s]hort-term price changes may be classified into two broad groups: those determined mainly by changes in cost of production and those determined mainly by changes in demand” (Kalecki, 1971: 43; emphasis added). While the changes in the prices of ‘finished goods’ are *cost-determined*, the changes in the prices of the industrial raw materials and primary foodstuff are *demand determined*. Hicks (1965) described the cost-determined prices as ‘fixedprice’ and the demand-determined prices as ‘flexprice’. These two types of price formation are caused by different conditions of supply.

Kalecki (1971) argued that since production (supply) of ‘finished’ (manufactured or industrial) products are elastic “as a result of existing reserves of productive capacity”, any increase in demand for these products can be met by an increase in the volume of production without raising their prices. Hicks (1965: Chapter 7) pointed out that in case of ‘storables’ (manufactured or industrial) the *existence of stocks* has a great deal to do with keeping prices fixed. When there is excess demand for output, additional supply can be thrown in to the market to fill the gap between demand and supply. In the case of products labelled as ‘raw materials’ by Kalecki and as ‘non-storables’ by Hicks, their supply is relatively inelastic in the short run because these type of products cannot include any stock element. “It is ‘flow demand’ and ‘flow supply’ that are equated at the price that is established. If, however, they are only equated at a high price (at a price that is high relative to ‘normal cost of production’) there is a signal for an increase in output; though the increase can materialize at a later date, that is to say, in the long run. If they are equated at a price that is low in relation to cost, output will (similarly) tend to decrease.” (Hicks, 1965: 79). Kalecki (1965: 43-44) observed that any initial price rise for these products in response to an increase in demand may be exacerbated “by the addition of a speculative element ... [and] [t]his makes it even more difficult in the short period to catch up with demand.”

In what ways the prices of demand determined products differ from the prices of cost determined products? The common characteristic of the products whose prices are demand determined is that they are all primary products – such as food, commercial crops, raw materials, energy. Their production primarily land intensive as opposed to the industrial (manufacturing) goods the productions of which do not require land in any significant amount. The prices of these industrial goods are determined by their production cost.

It needs emphasising that the cost-based prices (or fix-prices) do not mean prices which never change. It is just that, in the short run, prices do not have to change whenever there is excess demand or excess supply in the market. Products whose prices are determined by cost their prices changes only in response to changes in the cost of production. The cost of production, in turn, depends on the prices of labour and raw materials. Any short-term disequilibrium in the market for these products is smoothed out by adjustments in stocks. Kaldor (1975) provides the following equation for the price (p) of industrial (fix-price) goods:

⁶ The English version of this paper was published in 1954. The page references are to Kalecki (1971)

$$p = (1 + \pi)wl \quad (2.1)$$

where π stands for the profit mark-up, w denotes the real wage rate and l stands for the labour required to produce one unit of output. Thus, given the profit mark-up and labour productivity, the prices of industrial goods are dependent on the real wage rate of labour.

Let us try and take a look at the significance of real wage or the *price of labour*. As Kaldor puts it:

Whatever the supply of labor (or the potential supply of labor) in relation to demand, the *price* of labor in terms of food cannot fall below a certain minimum determined by the cost of subsistence, whether the cost is determined by custom or convention or by sheer biological needs (Kaldor, 1975: 352).

In other words, there is no such thing as *market clearing* wage rate, without reference to the basic minimum cost of living. Now, if and when the cost of living rises, this gets translated into the rise in the price of industrial goods.

Kaldor (1975) presented his analysis in a simple two-sector framework, consisting of agriculture (A) and industry (B). Production in sector A being predominantly land-based and subject to the law of diminishing returns, its supply in the short run is relatively inelastic. Prices for the products of this sector is, therefore, demand determined or flex-price. Production in sector B depends on the former sector for supply of primary products and wage goods for labour. Prices in this sector are based on the cost of production and a (fixed) profit mark-up or fix-price. This is why the rate of growth in the industrial sector depends on that of the agricultural sector. Kaldor (*ibid*: 354) presents the interrelationship between the two sectors as follows.

$$O_B = \frac{1}{m}O_A \quad (3.2)$$

where O_i = output of the sector i ($i = A, B$) and m = share of expenditure on agricultural products in total income of the industrial sector. He points out that (3.2) is the “doctrine of the foreign trade multiplier as against the Keynesian savings-investment multiplier.”

It is in this sense Lewis (1954), when discussing the scenario where the capitalist sector produces no wage goods and has to depend on the substance sector for its supply, observed that, “it is not profitable to produce a growing volume of manufactures unless agricultural production is growing simultaneously” (Lewis, 1954: 173). Kaldor (1975: 354) wrote, “In some ways I think it may have been unfortunate that the very success of Keynes’s ideas in explaining unemployment in depression – essentially a short-period analysis – diverted attention from the “foreign trade multiplier” which over longer periods is a far more important principle for explaining the growth and rhythm of industrial development.”

Before we leave this section, we must point out that though in our discussion so far, we have been treating wage goods as food (food grain), an appeal to Engel’s law would tell us that the wage goods are really basket of goods for individual consumption by households. Such a basket of goods for OECD countries consists of food, beverages and tobacco, transport services and rent. The first four items of this basket is produced by the primary sector or the ‘agricultural sector’ in equation 3.2 above.

4. A Keynesian perspective and the policy implication

The interdependence between the primary and the industrial sector was the nature of the problem addressed by the Brandt Commission (1983) in the 1980s. Talking about the commodity situation in the 1970s – the harvest failures of 1972, the oil crisis of 1973 and the shortage of industrial raw materials around the same time – Hicks (1977: 98) observed that;

The first of the things which is called in question by this most recent experience is the Keynesian identification of the limit to growth with Full Employment of Labour. What has now to be faced is the possibility that the limit might be set by something else.

He then went on to argue that “in the Bretton Woods period” the rate of growth was indeed constrained by full employment of labour. However, full employment “at the high growth rates of the Bretton Woods period, cannot now be reached, *since the supplies of primary products that would be needed to support it are not available*” (Hicks, 1977: 98; emphasis added).

From Keynes’s writings, however, one can detect that after the *General Theory* Keynes started to investigate the link between the role of the supply of primary products and export demand as well as employment, in a paper published in 1938. However, it was only after 1941 Keynes devoted his attention to drawing up the details of arrangements for a “commodity policy” arguing that such a policy is vital for maintaining “good employment” in the industrialized countries. Below we present a short glimpse of Keynes’s views over the period.

In an essay published in 1930⁷ on the economic pessimism in the United Kingdom at that time, Keynes wrote:

We are being afflicted with a new disease of which some readers may not yet have heard the name, but of which they will hear a great deal in the years to come – namely, *technological unemployment*. This means unemployment due to our discovery of means of economising the use of labour outrunning the pace at which we can find new use of labour. (Keynes, 1972: 325; emphasis in the original)

Keynes, however, was convinced that “this is only a temporary phase of maladjustment” and a solution to this problem of unemployment caused by labour saving technical progress would be found as he went on to add:

...assuming no important wars and no important increase in population, the *economic problem* may be solved, or at least within sight of solution, within a hundred years. This means that the economic problem is not – if we look into the future – *the permanent problem of the human race*. (Keynes, *ibid*: 326; emphasis in original)

Be that as it may, in Keynes (1938) we first come across the mention of the impact of fluctuations in the prices of the “principal raw materials” which can “lead to fluctuations in immediate demand”. In this article we also come across Keynes’s observation that there exist “two major groups of commodities which respond quite differently to the fluctuation of effective demand...” (Keynes, 1938: 453). For one type of commodities “prices (are) comparatively stable and fluctuations in demand (is) met by a centralised control of output and by organised arrangements for the

⁷ This essay was first presented in 1928

withholding of stocks on the part of the producers themselves” and for the other type of commodities “the producers themselves are not in a position to withhold their stocks and the scale of output is governed by price fluctuations.” He then went on to add that “The fact that we have two major groups of commodities which respond quite differently to fluctuations in effective demand is of great importance to the general theory of the short period” (Keynes, 1938: 453). Furthermore, in the same paper we get the first glimpse of his policy of “Commod Control⁸” in his policy proposal to secure “a stimulus to our export industries, an increased control over the trade cycle, and an insurance against having to pay excessive prices (for the primary products) at a subsequent date.” He proposed “that, the Government should offer storage for all Empire producers of specified raw materials, either free of warehouse charges and interest or for a nominal charge, provided they ship their surplus produce to approved warehouses to this country” (Keynes, 1938: 455).

Keynes’s plan for the post-World War II world-wide price stabilization included setting up of an international agency for stabilizing commodity prices by means of buffer stocks of as many commodities as possible. The following quotation from Keynes neatly summarises his thinking in this area:

Superimposed on the fortuitous short-period price swings affecting particular commodities and particular groups of producers there is the fundamental malady of the trade cycle. Fortunately, the same technique of buffer stocks which has to be called into being to deal with the former, is also capable of making a large contribution to the cure of the trade cycle itself. For the maintenance of good employment throughout the world, in industrial countries as well as in those producing primary commodities, this is of the first importance, sufficient by itself to justify the setting up of machinery for buffer stocks (Keynes, 1980: 172).

From our discussion above, it is worth noticing Keynes’s recognition that labour-saving technical progress is not the only reason for unemployment in the industrialized countries as well as Keynes’s awareness of the role of the foreign trade multiplier.

Keynes’s proposal to the Bretton Woods conference for setting up of an international Commodity Control Agency, which would set up buffer stocks for all the main commodities, for stabilizing commodity price and to be financed by a truly international currency was rejected as was the recommendations of the Brandt Commission in the 1980s. As Kaldor (1983) observed, when the developing countries actually asked for a scheme for setting up international buffer stocks (through UNCTAD) they got a cool reception from the rest of the world. In Kaldor’s own words:

Nobody seems to have understood that, while the proposal was promoted by the developing countries, its adoption was in vital interest of the ‘developed’ or industrialized countries, since it is a pre-condition for securing adequate long-term investment necessary for sustained industrial growth (Kaldor, 1983: 34).

Keynes, Kaldor and the members of the Brandt Commission all took it for granted that the non-industrialized or developing countries of the South will be the pre-dominant suppliers of the primary products while the industrialized or developed countries of the North will be the predominant producers and exporters of

⁸ See Chapter 3 of Keynes (1980) which contains materials on Keynes’s war-time plan for commodity price stabilisation. These papers came to be known much later under the 30 year rule as the war-time government papers could not be published when these were written.

manufactured products. In fact, Keynes (1938) referred the primary products as “Empire produce”. However, since the world has now changed considerably we need to up-date our world view. In the next Section we will look at the implication of our analysis for the policy makers in the industrialized countries.

4 Lessons for a globalized world

A number of predominantly commodity producing countries of the earlier period are now enjoying rather healthy rate of industrialization, thus becoming manufacturers and exporters of manufactured goods as well as beginning to consume commodities, which they used to export, themselves. The primary goods supply constraint is no longer relevant for the industrialized countries, of the days of Keynes, Kaldor and the Brandt Commission, but is becoming relevant for the entire global economy.

Though the trend in commodity prices for the last two decades of the 20th century had been relatively stable, with the exception of temporary and mild swings associated with business cycles, since the turn of the new century, however, prices of all major commodities such as energy, metals, raw materials for industrial production, and food grains have been increasing dramatically. Compared to the previous booms in commodity prices, the current upsurge has been considerable for its broad coverage and duration (IMF, 2008: 197). Arguably, the current upsurge is largely explained by the increased demand for commodities from fast-growing Asian economies, especially from economic powerhouses China and India⁹, and to a lesser extent from the economic revival in former communist bloc countries emerging from their deep economic depression in the 1990s. Since some of these countries were major commodity exporters in the past and now gaining momentum to compete with the industrialized countries for these products, increases in the demand for commodities are outpacing increases in its supply.

To quote a few empirical findings, using the Kaleckian pricing framework, Bloch and Sapsford (2000) and Bloch *et al.* (2004) find evidence for the link between the world growth in industrial production and the movement between prices of primary commodities and that of finished goods for the economies of the industrialized countries in general, and the US economy in particular. In a more recent work, using various econometric models of estimation Bloch *et al.* (2005) also find evidence for the positive relationship between growth in industrial output of individual countries and overall demand for primary commodities, which, the study argues, triggers price increases impacting all industrialized countries.

Keynes’s proposal for shaping the post-War world in Bretton Woods in 1944 involved setting up an International Clearing Union – an international central bank, and an international agency for stabilizing commodity prices, which he named the International Commodity Control. While the proposal for this second organization was never seriously considered at the international level, his proposal for the clearing union came into existence only in a much emasculated form (de Cecco, 1979; Kaldor, 1983; Williamson, 1977). As the post-Bretton Woods, most commodities are priced in dollars, since the US abandoned the gold standard in 1973 any hope for the long run stability of dollar price of individual commodity has evaporated. We can now witness that the dollar depreciation (coupled with falling short-term real interest rate) “has

⁹ See Jenkins and Edwards (2006) on African trade with China and India

pushed up commodity prices through a number of channels (Helbling and Blackman, 2008).

In an article surveying the developments of analysis of the monetary and fiscal policy in the OECD countries since 1985, J-P Cotis, a former chief economist at the OECD observed, “(r)ecent developments in oil and commodity prices may ultimately provide a safer test to disentangle whether progress (in these countries) has stemmed from better policy frameworks or from sheer luck.” The time has now arrived for not only the countries in the OECD but the entire global economy to ask the same question. On the basis of the arguments put forward in our paper, it now seems that the time has now arrived for revisiting Keynes’s suggestion at the Bretton Woods – that of having a truly international currency under the supervision of a truly global central bank as well as an agreement for controlling the supply of commodities. The time has also arrived to remind ourselves Brandt Commission’s recommendations regarding the international organisations and negotiations, that “negotiations should look for joint gains, rather than slowly wresting uncertain ‘concessions’. The starting point (of which) has to be some perceptions of mutual interest in change” (Brandt Commission, 1980: 263). And in doing that, we have to keep in mind that the old division of the world between the predominantly industrialized North and predominantly primary producing South of the 1980’s has now changed.

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