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A CRITICISM OF MONETARISM—WITH SOME POINTS FROM THE JAPANESE EXPERIENCE

Serguey BRAGUINSKY*

Abstract. The paper attempts at unifying the criticism of “classical dichotomy” made by J. A. Schumpeter and J. M. Keynes. Though Schumpeter’s vision was that of the developing economy, with money being an important source of that development, while Keynes dealt primarily with an economy in a state of depression, Keynes’s criticism is conjectured to presuppose the existence of the Schumpeterian world in the background, because only in this case can money play an active role by linking the past, present, and future. When the situation is that of Schumpeterian “circular flow”, there is indeed a case for “classical dichotomy”. Examples from the Japanese economy are cited to illustrate the theoretical points.

“We consider the assertion that money is no more than a means of circulation of goods and cannot in itself bring about essential phenomena to be false . . . it’s beyond doubt that purchasing power is the engine of an important economic process.”

J. A. Schumpeter.

“The division of economics between the Theory of Value and Distribution on the one hand and the Theory of Money on the other hand is, I think, a false division.”

J. M. Keynes.

During at least 40 years of the so-called “Keynesian paradigm” it seemed as though the Quantity Theory of Money was, to use Schumpeter’s expression, “dead and buried”. In the last decade, however, it has staged an impressive comeback under the new guise of Monetarism. The literature on the subject has been really vast in recent years, so here we shall just briefly sum up some of the most essential features in Monetaristic theoretical thinking.¹ Starting from the formula $MV=PT$ (which is interpreted *ex ante*), a link is assumed only between M (standing for money supply) and P (standing for the absolute price level). No link in the “long term” is admitted between M and T (which stands for the volume of real transactions), and possible shifts in V (the velocity of circulation of money), too, as dismissed as insignificant. Furthermore, any changes that might be caused in the volume of T by an increase in M in the short run are attributed solely to workers being “decieved” about the true rate of

* The author would like to thank Prof. Fukuoka and Prof. Ohyama for valuable comments.

¹ The presentation below aims at describing the essential features of some “standard” version of monetarism omnipresent in more popular literature. The more academic works by M. Friedman, etc. should be treated with much greater respect.

inflation caused by the new level of money supply (the “Theory of Rational Expectations”, which is the most extreme version of Monetarism, goes so far as to reject even this possibility). Money is thus basically treated, in Friedman’s words, as a “veil”, with an equilibrium in “real economy” (or a potential real growth rate in some versions) existing independently of monetary factors.² Behind the recent resurrection of such thinking lay many factors primarily of pragmatical and populist nature concerning which we’ll have more to say towards the end of the present article. But the controversy has also sparked off renewed debate among theoretical economists, leading to the reexamination of many models.

In the system of general equilibrium analysis the idea of divorcing its “real” and monetary parts has been utterly discredited at least since the time of Patinkin. But a completely disaggregated general equilibrium model is sometimes an unwieldy tool, especially for the purpose of empirical analysis. So the controversy has managed to survive, not least because the framework of a static aggregated macroeconomic model envisaged by too many of the so-called “Keynesians” is in fact an ideal battle-ground for Monetarists (and leaves out many of the most valuable ideas contained in the original works by Keynes, as it has been frequently pointed out). In the present article we wish to explore one possible line of argument which in our opinion is very important as a criticism of “classical dichotomy”-version-Monetarism (as well as in its own right) but to which not too much attention has been paid so far. It is the line connecting criticisms of “money as a veil” made by such seemingly antagonistic writers as Schumpeter and Keynes. The basis for such an exploration is to be found in what we believe to be a remarkable degree of complementarity between the visions of these two great economists both of whom thought of an essentially evolutionary economic process (though in the works of Keynes this is somewhat disguised by his ambiguity and emphasis on short-term analysis). The situation envisaged by naive monetarists can then be shown to be that of the Schumpeterian “circular flow”, or stationary state. In the course of our exposition we shall be making use of some empirical material from the experiences of post-war Japanese economy. This would also serve to discharge claims which have been made by some monetarists that though an important role for monetary factors is a theoretical possibility, for all practical purposes it can be disregarded almost entirely.

What we shall henceforth be calling the “Schumpeterian” criticism of “classical dichotomy”-version-monetarism is based on the idea that supply of new money plays an important role in determining the pace of economic growth and the structure of relative prices (not just their absolute level).³ The volume of real transactions in this thinking cannot be treated independently of the supply of new loans (which contribute money for growth) and thus no estimation of the potential growth rate of an economy can be accomplished which fails to take account of

² This is nothing else but the case of the so-called “classical dichotomy” which should be distinguished from several more complicated cases of the “neutrality of money.” Cf. footnote 1.

³ J. A. Schumpeter, *Theory of Economic Development*, Ch. 3, Part 1.

monetary factors. The best way to bring home this point is to take a particularly transparent, as it will be presently shown, case of the Japanese economy in late 1950's–early 1970's. A few facts about this most fascinating piece of recent economic history still relatively unknown to non-Japanese readers will be not without value at this stage.

Japan emerged from the turmoil of the war economy in total disarray. The financial sphere had suffered most. Between 1940 and 1950 GNP in current prices increased 100 times, the GNP deflator 127 times, while the nominal value of financial assets owned by the private sector rose only 23.5 times. Thus they had declined by 81.5 per cent in real terms, while real GNP decreased by about 21 per cent, almost 4 times less. The value of financial assets vs. the nominal GNP ratio decreased from 2.17 to 0.51.⁴ This created enormous dependence of industrial development on the availability of loanable funds. Though the value of financial assets gradually picked up, the astonishingly high speed of economic growth had been permanently recreating this dependence. It was not until 1970's that the ratio of the value of financial assets to nominal GNP became anywhere near the prewar level.⁵ Throughout the whole period of rapid economic growth firms in the nonfinancial sector were in the state of “overborrowing” and funds for their growth had to be supplied primarily by city banks.⁶ Those, in their turn, were in the state of permanent “overloan” leaning heavily on the Bank of Japan's (the Japanese central bank) loans.⁷ The financial market was virtually nonexistent, all loanable funds were being created and distributed under strict administrative control by the Bank of Japan which replaced the market mechanism of flexible interest rates.⁸ The condition of utmost importance which made this whole system workable was the possibility of almost boundless economic growth with non-increasing or even decreasing marginal costs in main industries and the absence of “bottle-neck” factors.⁹ High rate of return on real investment induced firms to seek as many loans as the banking system was willing to supply and the system of effective rationing of those loans enabled the financial equation of the general equilibrium system to be solved independently of and prior to all the others. Since it were big firms in top priority industries (especially those producing for export) to

⁴ D. Teranishi, *Nihon-no Keizai Hatten-to Kinyu*, Tokyo, Iwanami, 1982, pp. 415–416.

⁵ *ibid.*

⁶ For the details see an excellent work by Yoshio Suzuki, *Money and Banking in Contemporary Japan*, New Haven, London, 1980. The share of external funding of the nonfinancial corporate sector activity ranged from 50 to 60 and more per cent throughout the whole period under consideration; more than 85 per cent of those were supplied through channels of bank loans.

⁷ As a result, loans to private financial institutions accounted for more than 40 per cent of the Bank of Japan's total assets in late 1950's and 1960's, a striking contrast to the situation in the US economy.

⁸ Those have been kept artificially low under the never-repealed “Emergency Law” of 1948. Administrative control was enforced to prevent what Wicksell had called “cumulative process.”

⁹ Certainly this is not the case of full-employment equilibrium usually envisaged in macroeconomics. The essence of the “Schumpeterian” approach which we are discussing here is in the emphasis placed upon economic development in the process of which bottle-necks are being constantly removed. We shall have an opportunity to look at the “full-employment” situation from another view-point later on.

whom the funds were supplied in the first place, there is no doubt that the Japanese economic achievement would have been much less impressive were it not for this system of providing cheap and ample "money for growth."¹⁰ Just one illustration of this will be presented here.¹¹ In 1950 the ratio of long-term funds (including long-term bank loans, bonds and stocks issued) to total value of fixed assets in two of the Japanese industries, steel and food industries, were at the same level of 57 per cent. Labor productivity calculated as value added per unit of employment used to be higher in the food industry (417 thousand yen a year) than in the steel industry (385 thousand yen). By 1970 the picture was entirely different. The steel industry which was a top priority one and was accordingly favoured on the bank loans "market" had increased its ratio of long-term funds to total fixed assets to 74 per cent, while in the food industry, which was a non-favoured one, it had even dropped slightly to 53 per cent. Corresponding to this, labor productivity in the steel industry had risen to 2,571 yen, greatly overtaking that in the food industry 1,652 yen. Thus the availability of long-term loanable funds (a purely monetary phenomenon) can be seen to be at least a major factor behind changes in labor productivity in these two industries. This being just one of many instances, one might even be justified in concluding that easier and cheaper access the firms in top priority industries (constituting a greater weight in the wholesale prices index than in the consumer prices index) had to loanable funds needed for expansion and cost reduction can to a large extent explain the discrepancy between rising consumer and virtually stable wholesale prices which had been observed throughout the period.

The situation is becoming slightly more complex in the present day Japanese economy. The surpassing of the full-employment ceiling in the labor market in late 1960's coupled with the emergence of other bottle-neck factors in the first half of 1970's made the whole previous system unviable. After the initial period of high inflation, caused, among other things, by the failure of monetary authorities to take proper account of new realities facing the Japanese economy,¹² the pace of real investment stumbled,¹³ and the tendency toward market equilibrium between supply and demand for loanable funds asserted itself strongly. Prompted by this tendency and also by soaring government debt a real market for securities and money began to grow and diversify at a very high rate. The sphere of government intervention has also been gradually reduced. Putting this into theoretical language, the changes amounted to, first, transition to endogenous determination of "the monetary equation" within the general equilibrium system instead of its

¹⁰ See, e.g., Y. Suzuki, D. Teranishi, *op. cit.* Certainly the situation described is not typical for a market economy, but precisely due to its special features the "Schumpeterian" case appears to be particularly clear-cut.

¹¹ D. Teranishi, *op. cit.*, pp. 620–621.

¹² This point cannot be adequately discussed here. See, e.g., H. Kato, *Manetarisuto-no Nihon Keizairon*, Tokyo, 1982.

¹³ The financial deficit of the corporate sector used to range from 5 to 7 per cent of the country's GNP but in late 1970's and early 1980's it dropped to below 2 per cent.

exogeneous determination as before, and, second, to the emergence of multiple monetary equations enabling choice among different financial assets instead of a single one.¹⁴

As the financial market tended toward equilibrium, selective regulation of the pace of investment became more difficult.¹⁵ Under these conditions (more normal for a market economy), the mechanism of equating the marginal efficiency of investment (the essence of which is the expected profit of an innovation) to the prevailing interest rate can be thought to be automatically channelling new capital into industries with the highest real growth potential. It remains basically true, however, that new opportunities for “real” investment can be realized only when they are taken in conjunction with money capital to finance them, so they still depend on the situation on markets for loanable funds or money (one of them but not both being redundant for the determination of the Walrasian system). Thus we can know the potential growth rate of economy and say at which level money supply really ceased to matter only *ex post* but not *ex ante*.¹⁶

So far so good. But we still have to face situations which may be approximated by “full-employment equilibrium” scheme. The point will be that such situations even when they do occur are just temporary halts on the never ending way of economic development, and this is what makes Keynes stand true against “classical dichotomy”. Here is what Keynes himself has to say.

“We might make our line of division between the theory of stationary equilibrium and the theory of shifting equilibrium... *for the importance of money essentially flows from its being a link between the present and the future.*” (*General Theory*..., p. 293, italics by Keynes.)¹⁷

The importance of taking this role of money into account not just for theoretical but also for practical purposes can again be readily illustrated on the Japanese experience, this time of very recent years. During the period of 1982–1987 Japan’s real GNP grew at an annual rate of 4 per cent, which is fairly low by the country’s standards. The labor market was relatively easy but unemployment never exceeded 3 per cent of the labor force. With no visible signs of depression but rather sluggish aggregate demand this is perhaps one of the best approximating cases for “full-employment equilibrium” one may hope to find in the real world. The

¹⁴ Up until very recently both the households and the firms kept their savings almost entirely in the form of banking or postal service accounts. The situation is rapidly changing nowadays especially in the nonfinancial corporate sector.

¹⁵ It has not disappeared completely, though. As recently as in summer 1987 the Bank of Japan reintroduced partially its mechanism of “moral suasion” to curb a surge in land prices. This time financial institutions were administered to stop providing loans for real estate operations.

¹⁶ Referring to what “other things” must be assumed equal in order for the Quantity Theory to hold true, A. Marshall pointed out that those necessary assumptions would reduce the theory to “almost a truism” (*Money, Credit, and Commerce*, p. 48). “Truism” is the most proper word for *ex post* statements; what a workable theory needs is something which can be analyzed *ex ante*.

¹⁷ And also “a link between the past and the present,” as Arrow and Hahn add to this quotation (*General Competitive Analysis*, Ch. 14).

picture emerging from the comparison of some most basic statistics is, however, totally different from what could have been expected were we to believe what the Monetarists say. Indeed, money supply was increasing at an annual rate of 6.1 per cent (M1) or 8.6 per cent (M2 + CD) over 1982–1987 while the price-level changes were 2.5 per cent annual *fall* rate of wholesale prices and a mere 1.6 per cent annual growth rate of consumer prices over the same period. Not even did the rise of GNP in current prices match the increase in money supply, for it was no more than 5.3 per cent per annum on the average. Certainly, a period of 5 years cannot be dismissed as “short term”, so we are left with the conclusion that money which ought to have been raising the general level of prices was disappearing in some “black hole”. This “black hole” is nevertheless easily discovered as soon as we shrug off Monetaristic thinking. The possibility of choice among financial assets which has been emerging for the first time in post-war Japan’s economic history since late 1970’s is producing the strongest boom of demand for all those assets. This is being further accelerated by the process of rapid internationalization of the Japanese financial markets following the fundamental revision of the Foreign Currency Control Act which came into force in 1981. Enough to say would be that the Nikkai average of stock prices rose 3.4 times between years 1982 and 1987, while the volume of GNP in current prices increased merely 30 per cent.¹⁸ Most other financial markets saw a similarly rapid expansion, and so did the money market, where the Marshall coefficient rose from 87.3 in 1982 to 103.6 in the third quarter of 1987 in a single upward trend.¹⁹

Deviating slightly from the main theme, it is interesting to note that big industrial firms took a very active part in these developments. In the mid 1980’s more than half of their profits came from financial investment; in fiscal 1984 1/4 of nonfinancial companies registered on the Tokyo stock market were receiving more interest payments than paying out themselves.²⁰ Thus the diversity of financial assets has become relevant not so much for consumers’ choice, as might be expected (individual shares and bonds holdings are on the increase, too, but not yet on the scale which can be compared to that of firms), but as an attractive form of alternative investment.

Picking up the thread of the main argument again, this tendency can be

¹⁸ For the previous 5 years the figures were, respectively, 61 and 52 per cent.

¹⁹ *Monthly Digest of Statistics*, Yamaichi Research Institute, 1988, January, p. 3, 47. The rise in Marshall’s *k* is detected when one takes the M2 + CD statistics of money supply and not M1. The liberalization of the financial markets is once again behind this trend with demand concentrating on new forms of deposits and certificates yielding high interest rates and retaining almost perfect liquidity.

²⁰ *Nihon-no Kinyu-to Ginko*, Tokyo, 1986, pp. 47–48. This rather abnormal situation is explained perhaps not just by the increase in internal accumulation as “real” investment was cut, but also by the uneven progress of the financial market liberalization making interest arbitration possible. For instance, the prime lending rate of major banks has until very recently been (and still very much is) strictly tied to the official discount rate, making it profitable in many cases to borrow on this market and invest in domestic financial assets, whose interest yields vary freely, or in overseas assets. Again big firms which only could qualify for those liberalized markets were the main beneficiaries.

characterized theoretically as a major shift in the distribution of aggregate demand within the Hicksian “triangle” (three markets for commodities, securities and money) the implications of which have been under scrutiny in economic theory ever since the publication of *Value and Capital*. In particular, the case observed in the Japanese economy fits in exactly into one of the hypothetical cases drawn by Hicks: an increase in the demand for securities in terms of commodities raises the price of securities relative to the price-level of commodities, and money being a substitute for securities, the price-level of commodities in terms of money falls.²¹ The question however remains about the root causes for such shifts, for the liberalization of Japanese financial markets was as much the consequence of this shift as its driving force. The same “animal spirit” of entrepreneurs which was stressed, though in different contexts, by both Schumpeter and Keynes is obviously responsible, and this spirit, in its turn, is caused by anticipation (or rather by different anticipations) of future economic development which would break the present day “full-employment equilibrium” ceiling.²² Thus as long as opportunities for real investment are ample we are in the world of Schumpeter; when the wave of expansion has temporarily worked itself out, we find ourselves in the world of Keynes. The latter is hence dependent on the former; indeed, the link between the past, the present, and the future is important if and only if there’s essential difference among the three. Money which provides this link enables transition from one Schumpeterian world to another, and the transition period is covered by the analysis of Keynes. Only in a stationary state (which is by definition also *expected to remain stationary*), can money become not more than a veil, and the “classical dichotomy” will stand true, but we hardly need Monetarists to tell us that.²³

Some concluding remarks now about practical reasons which brought about the Monetaristic counterrevolution. No economist in his good senses would ever attempt to deny that at money supply growth rate running almost 25 per cent a year and serious bottle-necks blocking the way for rapid economic expansion in real terms (such, for instance, was the situation in Japan at the beginning of 1970’s) the world very close to that described by “classical dichotomy”-version-Monetarists would emerge. So as an antidote to happy “Keynesian” policy of expanding effective demand beyond all reasonable bounds the counterattack worked. Monetarists, however, can hardly be credited with providing any really new theoretical backing for what is just sheer common sense, neither can serious

²¹ J. R. Hicke, *Value and Capital*, p. 275, et al.

²² We may note here how Monetarists, while emphasizing workers’ expectations, don’t feel any qualms about leaving out the much more important factor of entrepreneurs’ expectations as to the rates of future profits.

²³ See the analysis of “circular flow” in J. A. Schumpeter, *op. cit.*, Ch. 1. In this truly great work, which gets nowadays much less attention than it really deserves and the depth and originality of the ideas contained in which are still awaiting time when they are integrated into the main body of economic analysis, he also explains how this state of affairs can never become reality without profits and even interest rate disappearing.

economic analysis accept the blame for the irresponsible policies which brought about running inflation in most industrialized nations in 1970's. The success in curbing inflation and laying the ground for economic recovery in Japan, as well as in the U.K. and USA, was made possible not because the new economic and political authorities were believers in Monetarism but just because they managed to display much more common sense than did their predecessors. Now that the situation in the major economies is back to normal, the period of Monetarism ought to be nearing its end (which can of course by no means result in a revival of primitive "Keynesianism"), and the task of all those out in economic research field is to concentrate on what can really be regarded as the advancement of their science.

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