High Wages, Credit Rationing and Unemployment in a Monetary Economy

Guglielmo Forges Davanzati,
University of Salento
g.forges@sesia.unile.it

Andrea Pacella,
University of Salento
apacella@unina.it

Abstract: *The aim of this paper is to analyse the theoretical links between a policy of high wages and the level of employment in the theoretical framework of the monetary theory of production (MTP). The 'high wage effect' will be assumed to be operating, i.e. a rise in wages via external intervention, by temporarily reducing the rate of profits, induces firms to react via technical advancement, which, in turn, increases the quantity and the quality of capital and hence the level of employment. Credit rationing will also be taken into consideration. Insofar as high wages increase profits, smaller firms facing credit rationing make lower profits than bigger firms, thus resulting in a potential process of raising the industrial concentration ratio. The bankruptcies of the smaller firms generate a greater demand to the benefit of the bigger firms, thus giving rise to a theoretical solution of the so-called paradox of profits.*

Keywords: monetary theory of production, credit rationing, wages, profits, employment.

1. Introduction

The European Central Bank reports that, in the Euro Zone, negotiated wages declined from 2,66 in 1996 to 2,16 in 2007 and that, in the same period, labour productivity fell from 1,26 to 0,5. This figure appears to be in sharp contrast with the mainstream view that – due to the operation of a "discipline device" – policies of labour market deregulation should increase the level of employment and stimulate workers' effort, thus increasing labour productivity. Heterodox economists support the opposite view that the reduction of labour productivity as well as the slow growth of employment rates in Europe can be properly explained by the policies of labour market deregulation, insofar as they reduce workers' 'morale', and – by reducing wages – bring down aggregate demand and employment. Moreover, the lack of innovation supposedly explains a large part of the phenomenon. Starting from the latter idea, this paper aims to show that the decline in wages can be considered a major cause of the fall in labour productivity, in view of the so-called high wage effect, so that labour market deregulation reduces employment and the GDP. The 'high wage effect' is based on the idea that policies designed to increase wages produce positive social outcomes, insofar as they encourage capitalists to innovate, thus increasing labour productivity and enhancing economic growth. This gives rise to a wages-led growth regime operating on the supply side. Moreover, the bankruptcies of the smaller firms generate a greater demand to the benefit of the bigger firms, thus resulting in a theoretical solution of the so-called paradox of profits. This approach has been taken into consideration within the Post Keynesian theoretical framework[1]. In

[1] Post Keynesian economists have mainly stressed that a wage-led-growth regime is possible in contexts where high wages promote high levels of consumptions and, as a result, high aggregate demand and employment. See Marglin and Bhaduri (1990).

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particular, Lavoie (1992) emphasised that the employment level is likely to increase when wages are high, due to what he calls the "Webb effect"[2]. He also remarks that: "higher real wages also induce management to search for more efficient methods of production and to cut down on wasteful processes". He adds that, as a result, "higher real wages may lead to the elimination of firms or plants which have low productivity" (Lavoie, 1992, p.259). The paper is organized as follows. Section 2 approaches the nexus between wages, labour productivity and employment in recent contributions in the theoretical framework of the MTP. Section 3 provides a theoretical model, where a positive relation between wages and employment is shown, and section 4 concludes.

2. Wages, productivity and employment in the MTP

The MTP describes a sequential economy involving three macro-agents: banks, firms and workers. For the sake of our argument, it is important to stress that – in this theoretical framework – the unitary money wage is assumed to be exogenous, depending on the relative bargaining power of firms and workers. This is a crucial difference between the MTP and the standard neoclassical view, where *i)* workers are assumed to bargain the real wage directly and *ii)* the unitary real wage depends on the marginal productivity of labour. Moreover, since it is maintained that firms as a whole are able to establish the quantity and the composition of output, the level of employment depends on firms' decision about how much and what to produce. Also in this case, circuitists reverse the basic principle of the neoclassical approach, by emphasising that in capitalist economies the 'producer's sovreignty principle' is in operation, and income distribution is not based on the marginalist distributive rules but on power relationships (see Graziani, 2003). Importantly, the exogeneity of the money wage and of employment derives from a *possible* methodological view which excludes the analysis of the behaviour of individual agents (i.e. holism). However, the MTP does not *necessarily* presuppose this methodological view, and many attempts to build it on the macrofoundations of microeconomics have been made. The analysis of individual behaviours – driven by their class affiliation – allows the basic schema of the MTP to be used in order to provide answers to two crucial questions, namely: the relation between wages and employment, and the solution of the so-called paradox of profits. a) With reference to the first point, circuitists have devoted little attention to the effects of labour market deregulation on the level of employment, although it is a widespread view – within this theoretical framework – that wage flexibility is counterproductive for the sake of increasing the rate of employment. Forges Davanzati and Realfonzo (2004) stress that, under the assumption that – in a Post Keynesian world – labour market deregulation increases uncertainty, it reduces the present propensity to consume, thus generating a reduction of aggregate demand and of employment (see also Pacella, 2008). b) With regard to the second point, the basic schema of the MTP suggests that the money supply is endogenous and demand-driven. The demand for money on the part of firms – so-called initial finance – equals the money wage bill that firms bargain for with workers. In the event workers express a propensity to consume equal to 1, aggregate money revenues equal aggregate money costs, and firms as a whole are unable to pay interest to the banks. This gives rise to a paradox, if one beliefs that the description of the functioning of a monetary economy cannot be reduced to the case where the monetary circuit does not close with payment in money. Different solutions have been put forward. First, some authors argue that a 'normal' degree of indebtedness on the part of firms is a crucial feature of contemporary capitalism, so that no paradox arises within the MTP (Graziani, 2003). Second, it is suggested that firms reimburse banks in real terms and/or the reimbursement in money terms is made possible via public expenditure or a surplus in the balance of payments. Third, when expenditure for consumption goods on the part of bankers in admitted, an additional flux of money allows firms to obtain a monetary surplus

[2] The idea that economic growth can be lead by a high-wage regime has a long tradition in the history of economic thought (see Forges Davanzati, 1999).

(Chapman and Keen, 2005; Forges Davanzati and Realfonzo, 2008). Fourth, under the assumption that workers become indebted with the banking system, consumer credit may generate money profits (Forges Davanzati and Pacella, 2008). Finally, as suggested by Messori and Zazzaro (2005), in an economy where heterogeneous firms exist, the bankruptcies of the less efficient firms generate additional demand to the benefit of the more efficient firms, who gain money profits. Starting from these contributions, a theoretical model will be provided where individual behaviours are taken into consideration, focusing, on the one hand, on the link between wages, production and employment, and, on the other hand, on the possibility of realization of a monetary surplus. Specifically, the high wage effect will be inserted in the basic schema of the MTP, with heterogenous firms, and it will be assumed that smaller firms face credit rationing.

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