A HETERODOX ANALYSIS OF INTERNATIONAL EXCHANGE AND EMPLOYMENT POLICIES

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ABSTRACT

The refugee crisis sourcing from the Middle East has been haunting Europe. Although the warfare caused this crisis, well-directed and well-timed international exchange and employment policies can be the solution. The aim of this thesis is to analyze three heterodox approaches to the international trade, exchange rates, prices and employment policies, and try to find a path to the solution of the refugee crisis. The Institutional and Post-Keynesian approaches, the Modern Monetary Theory and the Marxian economics have different perspectives and policy recommendations to the international exchange and employment policies. After analyzing these approaches, I conclude that the open economy models can be beneficial and create a solution to the refugee crisis if full employment can be achieved and sustained. Because of the limited scope of this thesis, I could only reach for a certain depth of each school of economic thought.

APPROVAL PAGE

The faculty listed below, appointed by the Dean of the School of Graduate Studies, have examined a dissertation titled "A Heterodox Analysis of International Exchange and Employment Policies," presented by Cigdem Ates Saygili, Candidate for the Master of Arts degree, and certify that in their opinion it is worthy of acceptance.

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CHAPTER 1

INTRODUCTION

The aim of this thesis is to analyze international exchange and employment policies from the perspective of some of major heterodox schools of economics in order to understand their own theories based on what they see as the problems, and what solutions can be in a capitalist economic system. The Institutionalist – Post-Keynesian theory, the Modern Monetary Theory, and the Marxian theory based on views of their leading theorists to international exchange are analyzed by especially focusing on roles of prices, exchange rates and interest rates, and deconstructing the suggested policies in each school of thought.

There is a significant refugee crisis spreading from the Middle East to Europe. It will most likely affect most countries around the world. State of warfare, destruction of the economies, unemployment and starvation have all visited the lands of ancient civilizations, so people try to find a way to survive and to live humanely.

Perhaps governments and peoples of the countries that decided to take up their conflicts, disagreements and wars in battlefields in their own lands decades before have yet to face the tragic outcomes of these ongoing conflicts in other countries. However, they have been dealing with the problems associated with the people that leave their countries, seeking employment and struggling to survive elsewhere. The refugees seek a life that is worth living and need jobs help them stay alive in the developed capitalist western world.

Most of these refugees employed when they were living in their home countries. Some were employed with high-earning jobs while others were making just enough to earn a living. Some are well educated with undergraduate or graduate degrees while some were

less educated but contributed to the community in different ways. Some were very rich that is independent from their education level, and some were very poor. These types of people from different classes may sound familiar to anybody, not only from countries in war, but also from other developed capitalist countries, because these differences do still exist in their countries too. In all capitalist societies, there are classes of people, and there are minor or major differences of class structures depending upon that particular country's economic, political and social characteristics.

Even though there is no warfare in such countries, even though there are wealth and welfare, there are people that do not have a chance to take a share of them. For example, there are people who are unemployed, voluntarily and involuntarily. The involuntary unemployment is inherent to these countries, because it is inherent to the capitalism itself, and they are inherent results of especially neoclassical economic policies. Indeed, unemployment is usually a preferable result of maintaining price stability based on theories such as monetarist and neoclassical economic theories.

In addition to domestic policies, there are given international economic facts and outcomes of international integrity, such as free trade, free capital flows and instability of exchange rates that affect economic welfare and are affected by domestic economic policies. Although international integrity is beneficiary in most ways, many countries have to deal with negative side effects of open economy economics under the neoliberal policies. There are a number of ways of avoiding negative outcomes and suggested economic policies depending upon economic approaches to the economic realities such as unemployment, output level and growth rate, price stability, etc. Exchange rate regimes,

employment policies and trade regulations are open to discussions, and must be reviewed and reanalyzed based on current conditions.

Exchange rates are one of the most controversial issues; there are many explanations about how they work, but none of them is fully accepted by majority of economists. Mainstream economics provide some approaches such as The Purchasing Power Parity (Cassel, 1918), The Monetary Model (derived from Fisher, 1892), The Mundell-Fleming Currency Substitution (Mundell and Fleming, 1962, 1963), The Dornbusch Model (Dornbusch, 1976) and so on, but there are some problems associated with their applications to real world. This is because the underlying assumption generally is that flow of goods and services determine exchange rate, and capital flows have some effects in the short run, but no effects in the long run. The underestimation of real effects of capital flows across the countries without looking at the structural differences between countries cause unreliable theoretical implications.

CHAPTER 2

KEYNESIAN TRADE THEORY

In this approach, it is widely accepted that capitalism can function in a way that brings prosperity to the states with international trade and capital movements. However, there must be some changes in the assumptions of how economies function.

2.1. Neoclassical Approach vs. Keynes's Views

Stephanie Bell (Kelton) and John Henry (2003) discuss two sides of the free trade: on one side are the institutions and people support free trade and globalization, and on the other side are the ones who think free trade and globalization deteriorate economic welfare in some (especially more disadvantaged developing or underdeveloped) countries. They approach to free trade from Keynes's monetary production framework, and show that the opponents are not wrong intuitionally, although their arguments are not very well developed and they do not provide a real-world application of free trade, which must not be in favor of only developed or more advantageous countries. Also, they specify "the institutional prerequisites that would allow the benefits of free trade to be discovered". (Bell and Henry, 2003, p. 4)

In the neoclassical framework, the international exchange theory in a capitalist society is built on Say's Law. Jean Baptiste Say (1964) basically says that production necessarily generates enough income to buy the products that are produced. Therefore, producers produce to consume other products they do not produce, and produced by others.

John Henry (2003, p. 3) says that this is correct for a barter economy. He explains that "the scenario that captures this view of the economy is C - C', where C and C' represent commodities of different use values" (Henry, 2003, p. 8). He shows that use value of C' is greater, which is why it is better off. "This must be the case, for money is introduced only as a medium (or "intermedial object") of exchange that is invented to overcome the limitations imposed by barter—the double coincidence of wants and divisibility." Henry says (2003, p. 3). Therefore, this view of the economic relationships does exist in a barter economy. In this type of economy, money is a medium of exchange, a lubricate, has no real value, and is neutral. It only exists to solve problems in barter economy. Therefore, the economic transaction becomes C-M-C'. There is not and cannot be excess supply or excess demand in such an economy.

On the other hand, there is another part in Say's Law that Henry and Bell (2003) and Henry (2003) discuss. All income generated in the production process will be spent buying back the goods and services that have been produced. Say's basic postulate of "... products are always bought ultimately with products" (Say, 1964) (Bell and Henry, 2003, p. 4) not only covers the economic relationships in a barter economy, it is also used in the neoclassical approach to explain economic transactions in a monetary economy. In this approach, money is still only a medium of exchange.

Bell and Henry (2003, p. 6) say "The problem arising from the mismatch of supply and demand in this framework are prevented by postulating a loanable funds market." It is guaranteed that no matter how much saving is there, all the savings will be borrowed in this framework. The supply of loanable funds from households is a function of the rate of interest. Interest is reward for saving, or abstaining from present consumption. A decrease

in the rate of interest due to an increase in the savings is enough to stimulate the economy. In the neoclassical international economics, international capital flows determine the transfer of the savings from a country to another. Bell and Henry (2003, p. 6) explains the internal and external mechanisms below:

> In an international setting, this may require transferring those savings to foreign markets (international capital flows), but the equality of aggregate supply and demand would be ensured – internally, through domestic market forces, and externally, through the price- specie-flow mechanism. Thus, as trade relations evolve into the international arena, the efficiency gains from trade are extended across national frontiers so that free trade is beneficial to all.

In such a world, there is full employment and there may only be voluntary unemployment based on personal preferences. Individuals determine the hour of work for them based on the cost-benefit calculation (Bell, and Henry, 2003, p. 6-7). Also, the resources are fully utilized and "the well-being is maximized somewhere along the Production Possibility Curve" (Bell, and Henry, 2003, p. 7). There is always "a comparative advantage in the production of some good, both countries will benefit from specialization and trade since each will reach a point lying beyond its Production Possibility Curve (a point previously unattainable due to resource and technological constraints) (Bell, and Henry, 2003. p. 7). As a result, output, efficiency, income growth and poverty reduction are the results of free trade, and every country engaged to this "exchange" is better off.

However, monetary production type of economy is very different than it is explained in the neoclassical framework. In Chapter 3 of the General Theory of Employment, Interest and Money, John Maynard Keynes (1964) discusses that firms are trying maximizing their profit in a world where they cannot control the costs, what the

costs will be when production continues, and what the revenues will be. They produce in a fundamentally uncertain world. Additionally, the purpose of production is profit. The formulation that can be used to describe a monetary production world is M - C - M', so the motive for the production is not the use values like it is accepted in the neoclassical theory; that motive is profit. Also, in Chapter 11 of the General Theory, Keynes (1964) shows that the capitalists do not have a control on the costs or revenues. They can control only wages and salaries, and the prospective yield depends upon revenues and costs. Bell and Henry (2003, p. 9) adds that entrepreneurs make investment decisions based on the relationship between "the marginal efficiency of capital – which reflects the degree of optimism –" and the current rate of interest. When "the marginal efficiency of capital exceeds the rate of interest" the entrepreneurs decide to make the investment. However, all decisions are made under fundamental uncertainty.

Also, in Chapter 13 of the General Theory, Keynes (1964) shows that combinations of the money supply and liquidity preference determine interest rates. Because investment depends upon both interest rate and marginal efficiency of capital, investment inherently depends upon liquidity preference too. Also, the rate of interest on money determines the employment level. Actually, in an economy, the MEC, liquidity preference and marginal propensity to consume have effects on the level of employment. Bell and Henry (2003, p. 10) show their relationship in a closed economy.

> Thus, even in a closed economy, a host of purely psychological variables – e.g. the marginal propensity to consume, the marginal efficiency of capital and the state of liquidity preference – are likely to take on values incompatible with full employment. If, for example, private sector confidence is shaken, liquidity preference may increase and the marginal efficiency of capital may fall. As interest rates rise – in response to increased liquidity preference – fewer investment projects will be undertaken – since the interest rate is rising and the marginal efficiency of capital is falling.

> Declining investment spending will reduce aggregate output and employment, and the situation will be exacerbated through the multiplier effect, which is driven by the marginal propensity to consume. (Bell and Henry, 2003, p. 10)

On the other hand, in a closed economy, leakages are savings and tax payments, and injections are investment and government spending. The circular flow of income needs to be balanced. In an open economy, imports are added to leakages, and exports are added to injections. In both cases, there needs to be equilibrium. In an open economy, a trade deficit that is the difference between exports and imports can create imbalances even though there is an internal equilibrium in the country. Bell and Henry (2003, p. 11) points out, "since output and employment are the adjusting variables in the Keynesian framework, a trade deficit is likely to produce declining GDP and rising unemployment even with domestic balance". Therefore, a trade surplus is a necessary condition in order to maintain the employment and output level at a desired level.

Until this point, it is explained that the neoclassical framework based on Jean Baptiste Say's postulates suggest that trade can be seen as barter exchanges, and the economy as a whole functions as a world of petty producers. In addition, Keynes's views on monetary production economy are discussed and he shows that the world economies function very differently than they are shown to do in the neoclassical framework. Money has a real value, and the goal of production is profit. Also, trade surpluses are necessary to maintain economic stability.

2.2. Keynes and the Comparative Advantage Theory

Before looking at the international exchange and exchange rate regimes in this framework in detail, it is important to understand Keynes's ideas about the neoclassical approach to the free trade. Basically, Keynes rejects the idea of comparative advantage as the determinant of the direction of trade. (Milberg, 1996, p. 239) His ideas are opposed to the ideas of Marshall and Heckscher. For Keynes, comparative advantage is a special case.

In 1920's, Keynes's ideas were in favor of free trade and he supported that the comparative advantage had real life applications. In 1930's, Keynes's ideas changed due to global economic conditions and the conditions that Britain faced, so he thought that a tariff's benefits outweigh potential costs. "In an economy with a high level of unemployment, the case for free trade is no longer valid." Milberg says that Keynes argued (Milberg, 1996, p. 240).

The assumption behind the theory of comparative advantage is that a nation must produce for being able to export. Milberg says that it is not possible for a nation to produce nothing for export, according to the comparative advantage theory (1996, p. 240). He adds, "The importance of relative costs and prices mean that a nation always has a comparative advantage in, and export, something."(Milberg, 1996, p. 240).

Also, under the economic conditions in 1930s, it is absurd to spin theories based on the assumption of full employment, for Keynes (Milberg, 1996, p. 240). In addition, "Keynes rejected the likelihood and efficiency of the classical adjustment mechanisms of wages and exchange rates under the persistent unemployment", Milberg says (Milberg, 1996, p. 241). Depending on the exchange rate system (fixed or flexible), level of

efficiency of the adjustment mechanisms can vary. For example, in a fixed exchange rate system, Keynes thinks that devaluation is not a key for sustaining trade balance. This is because of "the devaluation's contractionary implications, and the misplaced notion that the deficit country should bear the entire burden of adjustment" (Milberg, 1996, p. 242). Also, "Keynes rejected the assumption of such an automatic adjustment mechanism, arguing instead the interest rates –not prices- do the adjusting, and that a persistent trade imbalance –not balanced trade- is the likely outcome." (Milberg, 1996, p. 239). Keynes views that the trade imbalance causes a liquidity problem for the deficit country, so it is not a reason for a change in the price level. A change in the trade imbalance will cause a change in the monetary base, and it will change the rate of interest. Therefore, the result will not be a change in the wages, but a change in the interest rates. For example, an improvement to surplus on current account will not cause an increase in the wages, but it will cause a decrease in the interest rates (Milberg, 1996, p. 242).

Milberg (Milberg, 1996, p. 242) summarizes the results below:

> In fact, Keynes argued, under certain conditions, balance of payments is the main determinant of the rate of interest. In this case, efforts to improve the balance of trade are crucial to the achievement of full employment.

According to Milberg (1996, p. 242), liquid assets that the trade surplus country accumulate cannot be assumed that they will be converted into non-liquid assets, or much less into foreign-produced non-liquid assets. It is important to understand that saving mechanism can create the possibility of both underemployment equilibrium and persistently unbalanced trade, so the law of comparative advantage is the international analogue of Say's Law for Keynes (Milberg, 1996, p. 242). "The principle of comparative advantage assumes full (or at least constant) employment and a price adjustment

mechanism sufficient to convert comparative cost differences into absolute money cost differences and bring balanced trade." (Milberg, 1996, p. 239). Lack of price adjustment mechanism and full employment or a natural tendency for the full employment, the comparative advantage theory is not valid. "The logic of comparative advantage implies continually balanced trade, and trade imbalances can only be transitory." (Milberg, 1996, p. 243) What can be understand from this assumption is that a change in imports, for instance, will and should cause the same amount of change in the exports in the same direction, on average. Imports and exports are "causally related".

A wider explanation for the relationship between exchange rates and elasticities of demand for export and demand for import can be provided by mentioning the Marshall-Lerner condition. What the Marshall-Lerner condition tells that at least in the long run, if sum of the demand for export elasticity and the demand for the export elasticity is greater than 1, changes in the exchange rates will affect volume of exports in the opposite direction, on average. Also, changes in the exchange rates will affect the volume of imports in the same direction, on average. As a result, a lower rate of exchange for a country will cause a rise in the exports, and it will diminish the imports, on average (Van den Berg, 2010, Kindle Location 5654). However, Milberg states, "Keynes argued that an import reduction would allow the central bank to lower interest rates, depending on the international capital mobility, and the import responsiveness in the rest of the world to interest rate and investment changes. The result could be either an increase or a decrease in exports." (Milberg, 1996, p. 243). As a result, there is no direct causal relationship between exports and imports through price adjustments.

CHAPTER 3

INSTITUTIONAL AND POST – KEYNESIAN APPROACH

In the Institutional and Post-Keynesian frameworks, the perspective on the world and economy is different from the neoclassical approaches. In institutional approach, the economy and markets are social institutions and Thorstein Veblen (1898, p. 393) says that "the cause of the change of the economics is the institutions; so economic action must be the subject-matter of the science of economics if the science is to fall into line as an evolutionary science". What has changed and what is the cause of the change should be the main questions for economists. For example, Institutional Economics deals with the consumer choices by going steps back and researching the human behavior in detail, instead of making assumptions about rational calculating consumer as in the Neoclassical Approach. Therefore, the Institutionalist school of thought approach to the economy, society and individual very differently than the standard approach. Economies do not function very similarly everywhere around the world. This is a result of different cultures and its sub-parts that create different societies and economies.

Contrary to the separation of the culture and the economic activity, how the economy functions, how the firms and individuals behave, and how the government takes action directly depend upon the culture. Veblen dichotomizes the culture into two branches: technology and ceremony (Waller, 1982, p. 757). The technological side has the cause and effect relationship and knowledge in the society, so it is the dynamic part of the culture. On the other hand, the ceremonial side of the culture is traditional; it is sum of the myths and traditional habits of thought in a society. The ceremony is the source of norms, beliefs

and knowing while technology is the source for experimentation and doing. The enduring tension between the ceremony and technology is the cause of the change and it is unique for each culture (Sturgeon, 2010, p. 9-10). For example, the idea of "a new stage is better than the previous one" is a teleological assumption for Veblen. Smith's "invisible hand" suggests that if we follow our instincts and take care of our own interest personally, because God made us in this way, our society will get its best out of its capacity, so this is a teleological way to explain the change. However, Veblen claims that change does not have to move toward something good or for that matter anything particular, based on the Darwinian Theory. Social systems are not teleological; they are results of adaptations resulting from problem solving or attempts to solve them. As a result, national or local economies and markets do not have a universal nature or features. Hence, "A valid way of thinking in economics must derive from a valid conception of human nature." (Ayres, 1944), and it is necessary to look at the culture, habits of thoughts and institutions at each country, region or economic unit in order to understand how the economy really functions there.

Post-Keynesian international exchange theories are based on the Institutionalist assumptions (Harvey, 2010, p. 4). They see market as a social institution, and markets reflect the society. Because their discussion of markets is constructed based on the Institutionalist approach, they are analyzed together in this chapter.

3.1. Flexible vs. Fixed Exchange Rates

Due to differences between the levels of endurances of the economies to the business cycles and the unexpected outcomes of domestic or foreign economic activities, Post-Keynesians suggest that having a flexible exchange rate regime will deteriorate the economic well-being. In a flexible exchange regime, capital flows are very problematic for countries. Paul Davidson (2003, p. 261) says that there are inelastic and elastic expectations for currency weaknesses. Some think that the weakness is temporary (inelastic) and some think it will be worse in the near future (elastic). Davidson points out that elastic expectations will increase the instability, and there will be cumulative exchange rate depreciation; also the public will reject to hold national currency based on the transactionary and precautionary purposes. As a result of the elastic expectations, there will be an outflow from that country and a fast exit strategy of the asset holders.

In a fixed exchange rate system, however, if there is a confidence to the Central Bank that can maintain normal rates even there is depreciation, then the imbalances that are caused by international capital flows can be removed. However, this is only possible within the range of the reserve volume of the central banks. Davidson (2003, p. 262) suggests a system of guaranteeing continuity and orderliness from state-sponsored institutions, which will reduce the uncertainty and positively affect the psychology of the market participants. In an entrepreneurial economy, "Expected stickiness of exchange rates over the life of the production period is a necessary condition to encourage entrepreneurs to engage in long-term production and investment commitments that cross national

boundaries. And in a global economy, that is a necessary condition for promoting economic growth" (Davidson, 2003, p. 267).

The floating exchange rate regimes after the Bretton Woods let countries have relative policy independency and free trade (except all of the restrictions in the GATT and other tariffs and quotas) by keeping the exchange rates unpegged. This brings some advantages and disadvantages at the same time. Active monetary policy gives policy flexibility for the countries, but they are open to speculative portfolio movements, which makes them vulnerable to attacks, which is the major concern for the Post-Keynesians. Since the Bretton Woods breakdown, there are many financial crises in both developed and developing economies due to the huge volume of unregulated and uncontrolled capital flows across the countries. On the other hand, some countries attempted to have fixed exchange rates in order to keep themselves a little bit safer. Since 2002, there has been the Euro Zone for the European Union countries; it has some advantages and disadvantages at the same time. Lack of active monetary policies makes banking system restricted with monetary expansions or contractions due to expectations, uncertainty and economic cycles. Some Eurozone countries have already experienced the disadvantages, and have great crises because of the monetary policy dependency. Short-term regulations for short-term disturbances may be better alternatives for countries and their exchange rate regimes, instead of long-term boundaries.

3.2. Decision Making Process and Exchange Rate Determination

From history, we learn that there are several attempts in order to control or liberate the exchange rates. In both cases, what is underestimated is that there are some rules or preconditions that should be understood before doing either. John Harvey (2009, p. 65-66) summarizes important points for the process of exchange rate determination as such below:

- There is no reason to expect exchange rates to move in a way that restores balanced trade.
- A combination of psychological theory and Keynes' insights into asset markets suggests that currency prices go through cycles of volatility.
- Bandwagon effects exist because of availability, anchoring, representativeness, increasing confidence, and credit/blame issues.
- It is because bandwagons exist that technical analysis is useful/profitable.
- People's attitude toward risk creates the whipsaw pattern Schulmeister (1987, 1988) describes.
- Psychological theory shows that expectations and decisions naturally include forecast-construction bias.
- How confident agents are in their forecast is a critical issue that cannot be ignored.

In the Institutionalist and Post-Keynesian framework, currency prices are determined based on today's forecast and today's realized prices – not next week's (Harvey, 2009, p. 44). Agents adapt their expectations and make their decisions based on every new outcome. They do not make decisions and then wait until seeing what is happening; news or new information make them decide what to do next and adjust their actions. People's minds are not static, and they do not response to every stimulus in the same way, so they adjust their decisions each time. As a result, it can be said that currency prices are the weighted (by liquidity and confidence) average of market participants' expectations of tomorrow's price (Harvey, 2009, p. 42).

However, there are other tendencies and heuristics that effect the decisions and expectations. According to Harvey (2009, p. 46-48) these are availability, representativeness, anchoring, wishful thinking and framing. What humans remember, what they find familiar and what they know are always the tools that humans use when they forecast. These usually cause forecast construction bias, and in foreign exchange markets, agents may steer the market by overrating or underrating the importance of news and events (Harvey, 2009, p. 47-48). As a result, the confidence levels of the agents to their forecasts are the causes for weighing their decisions.

In addition, uncertainty, convention, low confidence, desire for quick results and animal spirits are Keynes's observations of the asset markets, which are important to the Post-Keynesian approach (Harvey, 2009, p. 50). The psychological explanations provided above and Keynes's insights, together, demonstrate some key features in the foreign exchange markets that Harvey (2009, p. 51) puts together in order to show their roles in the decision making process:

> The combination of the psychological view and Keynes' observations offered here yields a description of a decision making process that includes inherent forecast-construction biases, tends to create price volatility and bandwagons, and leads agents to employ technical analysis, take risks, and engage in periodic profit taking.

Forecast construction bias as explained above, is associated with the heuristics. Price volatility is a cause for decreasing the confidence level (Harvey, 2009, p. 49) and volatility itself is a cause for volatility. Stability increases the level of confidence, but this is a reason for taking more risks while there is uncertainty. Arbitrage, which is trading money for money for almost no costs and no diversity of products, and gains money from the differences between the values of the currencies one exchange (Van den Berg, 2010,

location: 2696), is an example for creating volatility while there is no reason, and it is sometimes also a behavior based on the volatility of currency prices. There are no rules that prevent banks or individuals from doing foreign exchange market activities, so arbitrage is fully available. Money moves quickly and very efficiently. One currency is related with (n-1) currencies, and any change in one of them affects all of the currencies and the system as a whole (Van den Berg, 2010, location: 2471). It is nearly impossible to control one exchange rate independently in a flexible exchange rate regime. This generates problems for the volatile exchange rates and uncertainty. Hyman Minsky (1992, p. 6) suggests that the volatility and uncertainty together cause depressions that are destructive to the economies.

> A main theorem of the financial instability hypothesis is that the internal dynamics of capitalist economies leads over a period dominated by the successful operation of a capitalist economy, to the emergence of financial structures which are conducive to debt deflations, the collapse of asset values and deep depressions.

3.3. Veblen's Discussion of Prices, Instability and Depression

In the Institutionalist perspective, it is essential to look at Veblen's contribution to the literature regarding the role of prices, instability and depression in an economy. Veblen's analysis of the theory of the business enterprise provides a discussion of how the economies evolve resulting from the business cycles. Also, this discussion includes the degrees of separations in economy, which has been pointed out in Erik Dean's (2013) work.

Veblen starts with pointing out the differences between the time when there is a handicraft economy and the time when the machine process advanced. Veblen shows the role of prices in these two regimes by looking at what they indicate and how they affect

the economy. In the old regime of handicraft and petty trade, the role of prices and what prices indicate about the economy was very different from the new regime of industrial economy. Veblen (1904, p. 59-60) tells:

> Under the old regime of handicraft and petty trade, dearth (high prices) meant privation and might mean famine and pestilence; under the new regime low prices commonly mean privation and may on occasion mean famine. Under the old regime the question was whether the community's work was adequate to supply the community's needs; under the new regime that question is not seriously entertained.

Veblen continues (1904, p. 60):

> Under the old order, industry, and even such trade as there was, was a quest of livelihood; under the new order industry is directed by the quest of profits. Formerly, therefore, times were good or bad according as the industrial processes yielded a sufficient or an insufficient output of the means of life. Latterly times are good or bad according as the process of business yields an adequate or inadequate rate of profits. The controlling end is different in the present, and the question of welfare turns on the degree of success with which this different ulterior end is achieved. Prosperity now means, primarily, business prosperity; whereas it used to mean industrial sufficiency.

After the industrial revolution, the standardization of the industry in both machine and business processes and improvement of the individual rights with the institution of ownership turned the economy into a money/credit type economy, and it translated the units into money terms, because the money becomes the standard of value. Veblen sees that as much as the economy is transformed into a purchase and sale economy, the capital and monetary gain, which is basically called profit, becomes the ultimate goal, and ownership shows up in money value. Gain or profit is a must and there is a steady rate of profit, while loss is an unexpected outcome for the businessmen. Prices are so important, and ordinary or normal profit is the goal; so an economy that functions under the force of capitalization, based on money values and credits, loses its fundamentals such as

productivity and efficiency of labor, virtue of competition and only aims for more output in real terms.

3.4. Material Assets, Immaterial Assets and the First Degree of Separation

Productive efficiency is a consequence of the productive (capital) goods and productive labor, according to the standard economic theory. This is basically an individualistic and hedonistic approach. However, Veblen tells that productivity and efficiency are neither the results of individual success, nor due to the nature of the capital goods. Productivity and efficiency come with the idea of being groups and communities, and knowledge of ways and means embodied to the capital goods (Veblen, 1908a, p. 518-519). The means, habits of thought and cumulative knowledge based on community's skills, experiences, past, etc. create ends (Veblen, 1908a, p. 521). Veblen calls this knowledge of ways and means as "immaterial equipment" or "intangible assets" which are "immaterial items of wealth, immaterial facts owned, valued and capitalized on an appraisement of the gain to be derived from their possession" (1908b, p. 105). Without immaterial assets, an individual has no ability to survive in the society; also immaterial assets determine the level of technology and development in the society, because they are embodied with material assets and together they create advancements. Veblen makes observations about primitive groups of people, and he shows that this is true for even the pre-historic ones; also this is true for the current stage of industrial arts (1908a, p. 523-524).

The difference between the pre-historic economic structure and the industrial economy shows itself through the ownership, possession and control of the immaterial assets. After larger scale of technological developments occur and need for material assets become remarkable, the ownership of the material assets and immaterial assets, more definite property rights, state intervention and accumulation of the capital become subject matters (Veblen, 1908a, p. 524). The material assets, including tools, vehicles, buildings, land, etc. and the ownership, possession and control of them are not left to the whole group of the society who creates and develops them with their joint stock of knowledge. Veblen (1908a, p. 521) says that experience, experimentation, habit, knowledge and initiative of individuals are sources of the accumulation of the joint stock of knowledge and immaterial assets for the community. Better ways of doing, technological efficiency and "material contrivances" are the means and ends of the immaterial assets (Veblen, 1908a, p. 521-522), and the immaterial assets are under the control of a small distinguished group of people. This brings the first degree of separation, which separates the immaterial assets and the society as a whole from each other. The producers of the immaterial assets are no longer the owners of them. There is the business enterprise that controls, possesses and owns the immaterial assets.

Veblen deals with the positions of the individual and the business enterprise in the capitalist system by looking at the levels of efficiency and productivity. Individual capacity of making is a right and it is possible in theory and in an assumed free competitive system; also, equal opportunity is the main assumption in theory. However, this cannot be true for any economy exists after the Industrial Revolution. This is a monopolistic type of production; going concerns become together and create monopolies or trusts (Veblen,

1904, p. 82), so it is no longer possible for an individual to produce enough with the knowledge of ways and means to fulfill the need for the industrial production (Veblen, 1908a. p. 533).

The unit the individual produces and/or makes use of is very much less than the unit required in the industrial regime. In addition, the individual's role compared to the business enterprise's is so limited. Handicraft production and natural rights of the older system of production and trade disappear. Under the new conditions, the ownership and control of the industrial assets and equipment belong to the business enterprise. Bargaining between people who supply their labor and who control the industrial production and accumulation depend upon the forces of supply and demand and competitiveness, and it sets the price of labor and what is left to accumulate (Veblen, 1908a, p. 534-535). Bargaining power of the business enterprise is what brings the accumulation of the capital and wealth in this system. Requisite material and equipment is totally under the control of the business enterprise, but the immaterial equipment necessary for the production, comes with the ones whom the owner bargains with (Veblen, 1908a, p. 535). Veblen describes the workmen as the industrial community, the bearers of the immaterial, technological equipment. As much as they are more skilled, production becomes more efficient, and the capital goods become more productive. Veblen says that this going concern is separate from housekeeping activities and body of knowledge of ways and means embodied to these routine works (Veblen, 1908a, p. 539). Production other than monopolistic type still produces ways of knowing that business enterprise cannot own or control. People can survive without engaging to the large scale of production. This is why it neither adjusts the

wages in the level of minimum of subsistence nor leaves immaterial assets totally under control of owners of the material assets.

3.5. The Second Degree of Separation and the Credit System

From a handicraft and trading system to a machine process system, money and credit together form business capital; so there is a simple version of a credit system and investment based on lending and borrowing, at the first stage. Veblen describes the difference between "the handicraft and petty trade" and "the machine process" systems based on the perspective of what indicates the good times and the bad times in them.

In the first degree of separation, it happens to be that the vendibility of goods becomes more important than the serviceability of goods. This means that production and consumption are separated from each other. Also, there is the intangible property that is a "goodwill" based on reputation, and it becomes the basis for credit. Intangible property and goodwill begin to create the financial capital after this separation. This first type of system of credit based on goodwill gives a differential advantage to the capitalist (Veblen, 1908b, p. 114-115); the amount of credit used in the economy increases in the brisk times and that encourages others to come into the same business (Veblen, 1904, p. 63 - 64). This is an era of prosperity when the prices are rising, Veblen tells (1904, p. 65). On the other hand, the cost of production, wages, do not rise as much as prices do, so low wages are the causes for this differential advantage of the businessmen (Veblen, 1904, p. 65).

After the first degree of separation, the control of the immaterial assets is under the going business, and they are available to be capitalized just like the material assets (Veblen,

1908b, p. 111). The immaterial assets become tradable and available to be "capitalized based on their income-yielding capacity" (Veblen, 1908b, p. 113). The intangible properties, especially the "goodwill" serves only for the pecuniary aims, no longer serves for technological advancements (Veblen, 1908b, p. 117). The intangible assets under the control of the going concern no longer create any additional income to the society, but the usage of them determines the distribution of the income in that society (Veblen, 1908b, p. 117). This brings the second degree of separation: the immaterial assets are tools for maintaining pecuniary gains and going business.

Therefore, in the second degree of separation, "the speculation in business capital" replaces "borrowing for investment", so prices begin to increase (Veblen, 1904, p. 65). Lower wages and higher prices keep the profits high, and this is the time of prosperity (Veblen, 1904, p. 65). Additional credit based on the higher prices of business capital creates the second kind of credit (Veblen, 1904, 73). This is an example of the behavior at the time of the depression: for example, instead of investing with new ideas on new businesses and making new investments, it turns out that capitalists are investing on already existing papers for only pecuniary gains. Also, the major issues for the economy in this stage are purchase and sale of securities based on expected earnings in the future (Veblen, 1904, p. 65). However, there are no end consumers for the securities or papers; so what is produced in this stage in the economy is produced only to be sold, so the prices go up and speculation is driven up.

3.6. High Level of Production and Prices

In the "new regime" of the machine process, the new kind of investment and industries begin to increase the level of production (Veblen, 1904, p. 60). With the technological improvements based on the joint stock of knowledge in the machine process, production increases more and more, and becomes unleashed.

However, the advancement in the level of production with the machine process creates some consequences meanwhile: the prices of goods are driven down, and the actual profit decreases eventually. Low prices indicate bad times, so the decline in the prices is an indication of a "chronic" recession (Veblen, 1904, p. 74). A speculative kind of credit and the advanced machines increase the level of output; decrease the prices, and profits become not as high as expected. More companies get lower than expected level of profits that causes a decline in the value of business capital, and a decline in the value of intangible property and goodwill. The intangible property has no use for the larger community in the second degree of separation; it has use for only the business, so the result is the liquidation of the business capital.

Near the very end of the era of the prosperity, the wages increase, but this is a sign that indicates, "the era is about to close" (Veblen, 1904, p. 68). Because higher wages mean the loss of the differential advantage for the "business" activity, it is not sustainable for the businessmen to maintain the economic activity as it was before. Veblen summarizes dull times and crises by saying; "An industrial crisis is a period of liquidation, cancelment of credits, high discount rates, falling prices and forced sales, and shrinkage of values." (1904, p. 63). The prices are now decreasing, profits are decreasing, the volume of loans

decreasing, and there are a readjustment of capitalization and a redistribution of ownership (Veblen, 1904, p. 66).

The recessions and depressions are usually known as the results of overproduction or underconsumption. However, "overproduction" or "underconsumption" is only business phenomena according to Veblen, so what happen are the "excessive competition" and the fall of profits (Veblen, 1904, p. 69). Veblen summarizes this below (Veblen, 1904, p. 70):

> Excessive competition is an alternative phrase. There is an excess of goods, or of the means of producing them, above what is expedient on pecuniary grounds, − above what there is an effective demand for at prices that will repay the cost of production of the goods and leave something appreciable over as a profit. It is a question of prices and earnings.

Producing more than enough to maintain "fair" prices and "reasonable" profits cause what is called "overproduction", and it is actually only a pecuniary phenomena. In addition, in a credit based operated system, there are interest bearing obligations that must be met, and lower profits make conditions worse in dull times (Veblen, 1904, p. 70). Also, investments depend upon the interest rates, so the relationship between "prices and profits" and "interest rates" is an important one in this system. Veblen says, "New investments are made on the basis of current rates of interest and with a view to securing the differential gain promised by the excess of prospective profits over interest rates." (1904, p. 70). In dull times, lower prices and profits may be considered as the cause for less lending and less investment, but Veblen says that in a situation of high interest rates, the expectations of higher future yields will keep the economy alive. Liquidity preference is important, but it is not vital for the economy (Veblen, 1904, p. 71):

> But after all has been said in qualification of the main proposition, it remains true that some new investment is going on with a well−advised expectation of reasonable profits on the basis of current costs, prices, and rates of interest. The rate of interest in times of depression may be unsatisfactory to

> lenders; it may be discouraging by comparison with the customary range of interest rates during better times. Still, the obstacle to business is not to be sought in an effectual discouragement of lenders, for in point of fact money is readily to be had on good security during any protracted depression.

On the contrary, lower and/or decreasing interest rates mean depression. Veblen says, “A discrepancy between accepted capitalization and current earning−capacity, similar to the discrepancy discussed above but of a progressive character, arises under modern conditions apart from a fall in the rate of interest.” (Veblen, 1904, p. 72). Veblen tells that, with high or low, or with increasing or decreasing rates of interest, there is always a possibility for the recessions or depressions; the existences of interest rates and the credits are the reasons for the depressions. This is an internal effect of how the industry goes on, so the recessions and depressions are results that come from the heart of the industry itself.

Although, through the business cycles, the level of output remains the same, the money value of the output changes due to the price changes. The depressions are results of the change in the money value of the output in this regime. The rates of profits fall, this makes businessmen suffer “emotionally”, because they lose the money value of their assets, not the real value. Also, workmen suffer because of the falling rate of prices, the unemployment and the falling rates of wages. However, workmen suffer emotionally too.

Veblen (1904, p. 75) summarizes the situation of workers under these conditions:

> For those workmen who continue to find fairly steady employment during the depression, however, even at reduced wages, the loss is more apparent than real; since the cheapening of goods offsets the decline in wages. Indeed, the cheapening of the means of living is apt to offset the fall in wages fully, for such workmen as have steady work.

The problem of falling profits in this stage “calls for a remedy” in order to increase the prices and make the capitalization possible again. The problem can be solved within either of two directions (p. 79):

- Increasing unproductive consumption of goods,
- Elimination of the "cutthroat" competition that keeps profits below the "reasonable" level.

Veblen describes how the system may work under these ways of seeking reasonable level of profits by looking at the effects of the wasteful expenditures in the economy, firstly (1904, p. 79):

> If enough of the work or of the output is turned to wasteful expenditures, so as to admit of but a relatively slight aggregate saving, as counted by weight and tale, profitable prices can be maintained on the old basis of capitalization. If the waste is sufficiently large, the current investment in additional industrial equipment will not be sufficient to lower prices appreciably through competition.

As a result, in the first remedy, private, business and government's wasteful expenditures altogether increase the productivity. On the other hand, in the second remedy for falling profits, coalitions of firms decrease the competition and cost of production, and prices will be fixed at a desirable and reasonable level. There are some branches in the industry that the coalition cannot be succeeded, so this leads to another depression at some point. This will lead a "wider coalition", and the process repeats itself.

In this separation of management and ownership after the second degree of separation, the remedy for falling rates of profits creates an economy that there is not a competition between going concerns, but between firms and workers (Veblen, 1904, p. 82):

> To this there is a broad exception, given by the circumstances of the industrial organization. This organization rests on the distinction between business management and ownership. The workmen do not and cannot own or direct the industrial equipment and processes, so long as ownership prevails and industry is to be managed on business principles. The labor supply, or the working population, can therefore not be included in the ideally complete business coalition suggested above, however consummate the machine system and the business organization built upon it may become. So that when the last step in business coalition has been taken, there remains the competitive friction between the combined business capital and the combined workmen.

3.7. Prices and Exchange Rates

There is a trade-off between prices and exchange rates. Exchange rates affect advancement in prices. Higher prices and higher efficiency, which is in not only industrial production, but also supply of precious metals, will decrease prices ultimately. Veblen says (1904, p. 74):

> As has more than once been the case, prices may be advanced through a freer supply of the precious metals, or by an inflation of the currency, or a more facile use of credit instruments as a subsidiary currency mechanism. Now, the growing efficiency of industry has an effect in lowering the (material) cost of production of the precious metals and so increasing the ease with which they are supplied, after the same manner as it affects the supply of goods for industrial or consumptive use. But the increased supply of the precious metals has, of course, an effect upon prices contrary to that exerted by the increasing supply of goods. In so far as this effect is had, it acts to correct or mitigate the trend of business toward chronic depression.

Veblen continues (1904, p. 75):

> But certain circumstances come in to qualify the salutary effect of a lowered cost of the precious metals. Improvements in the industrial processes affect the (industrial) cost of production of the precious metals in a less degree than the cost of other goods; at least, such seems to have been the case recently. But beyond this, and of graver consequence, is a peculiarity affecting the value of the money metals. The annual product of the money metals is not annually consumed, nor nearly. The use of them as money does not consume them except incidentally and very slowly. The mass of these metals in hand at any given time is very considerable and is relatively imperishable, so that the annual accretion is but a small fraction of the aggregate supply. The lowered cost of the annual supply has therefore but a relatively slight effect upon the aggregate value of the available supply.

Hence, there is no real effects due to the changes in the rate of exchanges; the only effect comes from the changes in the level of supply of precious metals is that the increase in the speculative movements and speculative inflation.

3.8. Results in the Real Sector and the Financial Sector

After the second degree of separation, speculative kinds of credits and separation of the ownership and management, in a depression, the business sector tries to sell as much as they can from the low prices. However, in the real sector, this indicates the loss of goodwill. Because of the lower profits, they need to decrease the cost in the short term, which makes them lose the quality of the products. The sales of goods decline, and there happens a loss of the goodwill and intangible property. The reputation and the perception of the reputation suffer after this point. Therefore, there is a reduction of "market value" toward the "book value". In addition, the increase in technological change slows down because the financial sector does not support the real sector with a falling market value in the real sector. As a result, the use of plant and equipment goes down, investment rates decrease, and the result is the unemployment of labor. The general welfare gets negatively affected due to results of the new regime.

On the other hand, in the financial sector, the results are worse than the real sector. There are the loss of goodwill and the liquidation of intangible value. Market value exceeds the book value mostly due to intangible property value based on the speculation due to false confidence, fraud and prevailing myths of finance. Therefore, the market value declines more in the financial sector more than it does in the real sector. This is because most of the assets are the intangible property in the financial sector, and now there is not enough intangible property in order to increase the market value. Most of the knowledge comes from the labor force, and other than buildings or computers, there is not much of tangible property in the financial sector. As a result, the market value falls greater in the

financial sector than the real sector, and the intangible property declines dramatically. This affects the real sector, so the results become much worse. Veblen summarizes this below (1904, p. 63):

> It does not commonly involve an appreciable destruction of property or a large waste of the material articles of wealth. It leaves the community at large poorer in point of market values, but not necessarily in terms of the material means of life. The shrinkage incident to a crisis is chiefly a pecuniary, not a material, shrinkage; it takes place primarily in the intangible items of wealth, secondarily in the price rating of the tangible items. Apart from such rerating of wealth, the most substantial immediate effect of a crisis is an extensive redistribution of the ownership of the industrial equipment, as noted in speaking of the use of credit.

As can be seen, high prices are indicators of good times and bring prosperity to society, but low prices make society suffer. The business cycle theories suggest that we assume there is an external shock that affects the general welfare. In reality, the shocks are not external; the recessions and depressions are internal facts, which are price disturbances and advances, come from the economy itself (Veblen, 1904, p. 61).

3.9. The Information Age

With larger amount of information available today than ever before, it is generally accepted that technology and joint stock of knowledge of the society will bring about and actually, have already raised the accessibility of the information by all classes of the society in theory. However, information is a private property and usually collected in databases that are owned by private corporations (Perelman, 1998, p. 31-32). The information is not a direct part of masses' lives, and is used for commanding and controlling them, especially in the work places. Managers, who are more "skilled" and knowledgeable compared to the

workers, control and command them. Furthermore, Perelman (1998, p. 25) discusses that the advancement in technology and stock of information might have a meaning to the society if the education system had been gotten ready for and integrated with it. The lack of an advanced education system forces people to be left away from accessing the advanced information, improving their skill, and having high-paying jobs; they have to work for lower wages in mostly service sector jobs. As a result, workers and ordinary individuals do not benefit from skyrocketing accumulation of information as it is presumed. Even though everybody can access to whole information in theory, without owning necessary tools and knowing how to access, possess and manage information, it is not realistic to expect society to benefit from it.

3.10. Back to the Modern Implications

3.10.1. Technical Analysis

An application of financial instability theorem to the foreign exchange markets is accurate, because free and unregulated markets are the reason and result of volatility at the same time in the Post-Keynesian framework. Bandwagon effect is one implication of this way of thinking and a product of heuristics and tendencies. Agents take risks when there are price movements, because everybody else seems to be doing the same (Harvey, 2009, p. 52). Technical analyses usually support the ongoing trend in the markets, and making decisions based on this seems realistic to the agents.

Although technical analyses make people feel confident about their decisions, mathematical calculations, equations, equilibrium or disequilibrium do not always represent the most reasonable choice or decision. It is hard to make scientific experiments in social sciences, because the experiments must be repeated again and again on different groups. “Analysis cannot be divided into two parts as a versus of qualitative and quantitative analysis” (Mitchell, 1925, p. 1). Data helps understand the cause and effect relationship with econometric analysis, which is an inductive analysis. On the other hand, when data changes, the cause will also change, which is a deductive process. “One of them does not dominate the other” (Mitchell, 1925, p. 1).

However, there is not a sharp distinction between inductive and deductive processes. For economic analysis, institutions standardize behavior and help to reach the gap between theory and practical subjects. The important thing is to look at the data and understand what the data says, instead of the making a model that fits to the data. Therefore, data should make the difference. “The increase of statistical data, the improvement of statistical technique, and the endowment of social research are enabling economists to make a larger use of quantitative analysis.” Wesley Clair Mitchell says (1925, p. 10). This causes that problems are formulated differently from the qualitative analysis, but economic theory needs to be changed for promoting institutional problems. The actions of individuals are not as important as the actions of people within an institutional structure, because institutions standardize behaviors. Institutional problems are preferred for quantitative analysis, because standardized behaviors are easier to be measured and analyzed; also building relationships among the variables are uncomplicated. Foreign currency market is an institution and it actions in a way that can be understood by looking at not only

individuals, quantitative outcomes, models or technical analyses without understanding what the data really suggests, but it is necessary to understand the collective action and psychology.

3.10.2. Risk and Uncertainty

Harvey (2009, p. 53) suggests, "people take more risks or choose risky options when they feel they are losing" or vice versa. Agents are willing to buy a devaluing currency more, and sell a valuing currency more. According to Harvey (2009, p. 53), trading limits and cash-in are other factors for the decision-making. Furthermore, preconceptions of agents are very important in this process: "preconceptions comprise the mental model and a social product" (Harvey, 2009, p. 54). All decisions that are made by agents are affected by from whom they learn not only while they are dealing in the market, but also during their whole lifetime.

Furthermore, the demand for the assets increases as much as people expect to get a higher yield. What Keynes suggests about the role of money fits to the exchange rates very much. More than the trade flows, portfolio flows determine the respective prices in the exchange rates market. The reason is that the demand for money never chocks off. The desires for having a higher yield, diminishing the default risk and keeping the ability of staying liquid causes the unstable exchange rate market and the portfolio movements. As a result of this, among all exchange rates, some are determined as more "valuable" for some time period. Harvey (2009, p. 41) summarizes this below:

> The greater the yield an agent expects to earn, the greater the demand for the asset; the greater the default risk, the less enthusiastic an agent is to buy;

> and the easier one suspects it will be to liquidate the asset, the more attractive it will be. Nations whose assets are perceived to be offering a higher yield, lower chance of default, and greater liquidity will experience appreciating currencies as agents rush to buy those assets, creating net capital flows.

We learn from the history that there are many attempts both for pegging the exchange rates and for floating the exchange rates (generally within a range) freely depending upon the money flows across countries. Each country or region has different economic reactions for each, and there is no single form of determining the best for them. This is because they have different economic, political and social structures, history, institutions and culture. In addition to this, humans are not rational and homo economicus. As a result, there are psychological facts that affect human behavior in various circumstances. There are tendencies, heuristics, expectations, conventions, uncertainty and others that make outcomes of markets and humans indefinite. Unstable exchange markets, letting the portfolio flows be free because of the belief that humans are rational and market conditions will determine who wins and who loses cause more uncertainty and make some stronger while making others vulnerable. Necessary regulations should be established by understanding human behavior, habits of thoughts and institutions, because an orthodox way of explanation of how foreign exchange markets work only makes the conditions worse for the most.

CHAPTER 4

MODERN MONETARY THEORY

4.1. Fixed Exchange Rates

After the discussion of how international trade finds itself a place in Keynes's original thoughts in the previous sections, it is time for the role of exchange rates derived from his implications to the Modern Monetary Theory. Currency sovereignty brings about some advantages and flexibilities with the appropriate exchange rate regime in this framework.

There are some critiques to Keynesian and Post Keynesian approaches for the adoption of fixed exchange rate systems. Claudio Sardoni and Randall L. Wray Sardoni and Wray (2007, p. 4) suggest that the Keynesians and Post Keynesians do not pay attention and give the necessary importance to the capital movements. The problem for these schools and "the reformist proposals" are only related to "the current account imbalances".

Sardoni and Wray (2007) discuss that currency sovereignty with floating exchange rates bring flexibility on economic policies for the government, but they do not find it sufficient for economic welfare and development. Also, a fixed exchange rate regime can only be effective with capital immobility. However, full control on capital and capital immobility are not very possible due to such as economic, political and ideological environment, and technological and economic difficulties. For instance, Keynes's suggestions of "Bancor" as a monetary unit and "world government" as a regulatory agency are not realistic and can create problems under today's conditions. Sardoni and Wray

(2007, p. 4) explain this by pointing out that a lack of policy independency could cause "the sort of global deflationary bias that Keynes feared-a sort of modern mercantilism based on accumulation of international reserves".

After the World War II, in the Bretton Woods, it is decided that there should be a fixed-but-adjustable exchange rate system. This is not actually what is in Keynes's mind. According to Sardoni and Wray (2007, p. 5), The Bancor Plan, which provides a unit of account for all countries around the world, is Keynes's plan.

> ... an International Clearing Union based on a Bancor unit of account; the Bancor, in turn, would be fixed in value relative to gold and then the currencies of all countries participating in the ICU would be fixed relative to the Bancor. The Bancor would be used only for clearing purposes among countries; countries could buy Bancor balances from the ICU using gold, but Bancors could not be redeemed for gold—ensuring there could be no run on Bancors. (Sardoni and Wray, 2007, p. 5)

The Bancor Plan was never adopted. Instead, countries chose "a fixed-but-adjustable system of exchange rates, with the dollar pegged to gold and serving as the international reserve currency" (Sardoni and Wray, 2007, p. 6). Until 1960s, the system worked well. However, because of various economic instabilities around the world, the pressure on the US Dollar caused the system to collapse.

Since then, most of the countries try flexible exchange rate systems. This is usually accepted as a neo-liberal version of the exchange rates regimes. In the standard theory, trade imbalances are the reasons for adjusting the exchange rates, which can cure the imbalances and create equilibriums. However, the economic system has not been working as expected. Sardoni and Wray (2007, p. 7) discuss that although most countries do not have freely floating exchange rates, the interventions are not important enough to be the only explanations of the trade imbalances. Also, the exchange rate instability around the

world is greater than what only trade imbalances could cause. The US and Japan are two examples for global economic instabilities. Sardoni and Wray (2007, p. 7) show that the US with large rising current account deficits and Japan with large current account surpluses are two instances of no equilibrium-seeking exchange rate adjustments.

4.2. Currency Sovereignty

A sovereign government has abilities to provide monetary and fiscal independence by issuing a currency that is non-convertible at a fixed rate of exchange to any other currencies. Also, a sovereign government is not revenue-constrained or reserve-constrained. In addition, the interest rate paid on sovereign securities are not subject to the market forces and they are exogenously determined.

A floating exchange rate regime gives the advantage of having policy independence to a country with a sovereign government. With a floating exchange rate system, it is likely to have internal stability while the cost is external instability. However, the policy independence gives the ability of using domestic macroeconomic policies to create internal stability. Floating rates with high capital mobility establish an economic system that can be sustained without crises caused by the fixed exchange rates.

> … a nation that adopts its own floating rate currency can always afford to put unemployed domestic resources to work. Its government will issue liabilities denominated in its own currency, and will service its debt in its own currency. Whether its debt is held internally or externally, it faces no insolvency risk. (Sardoni and Wray, p. 15)

Sardoni and Wray (2007, p. 20) discusses that a "managed money system that is closer to Keynes's fiat money system than to the commodity money system at the other

extreme" can be a better exchange rate system than a freely floating one. On the other hand, a floating exchange rate system is not a sufficient condition for full employment, higher output and welfare. In a world of high capital mobility, it is a necessary condition, only. Uncertainty and inflation can be costs of a floating exchange rate system, even though; it is still a better alternative than a pegged exchange rate regime.

4.3. Floating Exchange Rates under Unemployment or Full Employment

Under the conditions of floating rates of exchanges, unemployment might be a problem to be dealt with. Unemployment is a problem because of low budget deficits that is not enough to cover the needs of the private sector. According to William F. Mitchell (1997), private sector needs to hold money for transaction purposes, saving and fulfilling the tax obligations, and when budget deficit is not at a level that is enough to satisfy these desires, unemployment occurs. As a result, "unemployment is not a macroeconomic phenomenon and is not a real wage problem" (Mitchell, 1997). The Buffer Stock Employment Model is a policy recommendation and may be a solution for preventing unemployment under these circumstances. Mitchell tells that the BSE model is counter to the economic policies that the OECD countries held in 1970s, and the result is that in order to prevent high inflation; tight fiscal and monetary policies caused unemployment. However, the BSE model recommends an economic environment that preserves price stability while dealing with the unemployment.

In order to maintain price stability without causing high unemployment, Mitchell suggests that the BSE concept of the Non-Accelerating Inflation Buffer Employment Share

(NAIBER) (Mitchell, 1997) is the policy that governments can hold. The government can set a base level wage, so "it can absorb all the current idle workers into paid employment". Mitchell (1997) adds: "the change in the buffer employment ratio disciplines the wage-price pressures in the private sector by asserting the buffer stock wage as the numeraire". As a result, the Buffer Stock Employment Model is the one policy, which must be held by sovereign governments with a fiat currency in an open economic system for its social welfare considerations, its ability to maximize the macro benefits and its target to sustain the price stability. Additionally, in a BSE economy, floating exchange rates do not necessarily cause any problems. The reason is that, in a full-employment economy, a mechanism of controlling price stability will prevent any instability due to the exchange rate changes.

Mitchell (1997) shows that there is no relationship between changes in the Deficit/GDP ratio and the changes in the real interest rates that could be detected. What this proves is that the real interest rates are determined independently from the relative size of the deficit. As a result, in a floating exchange rate system, the long-term real interest rates are not determined by domestic economic conditions. In addition to this, some studies show that globalization has no effects on long-term real interest rates and has some effect on very-near short-term real interest rates. However, there is some causality between short-term and long-term real interest rates.

Also, there is no causality between the current account deficit and the budget deficit according to some studies. Mitchell (1997) shows that in 1979, 1980 and 1981, there is no such causality in Australian economy. This is counter to what Twin Deficit Hypothesis suggests.

The Post-Keynesian approach suggests a fixed exchange rate system and capital controls. Mainstream economics advocates a flexible exchange rate system and free capital movements. Apart from these, the combination of the BSE and flexible exchange rates assure a full employment economy. Warren Mosler (1998) says that this combination "insures not only full employment, but also favorable terms of trade".

Mosler (1998) explains that necessary policies in order to sustain full employment damage a fixed exchange rate currency, drain the country's foreign exchange reserves and cause devaluation. Also, economic weaknesses caused by holding restrictive fiscal policies to defend the currency can "reduce local tax liabilities, cause currency weaknesses and loss of reserves" (Mosler, 1998). Countries fix their currencies to the US Dollar create an advantage for the US, and allow the US to run a persistent trade deficit. On the other hand, the desire to save US Dollars keeps its value high. With a national budget surplus, the US creates a short squeeze on the US Dollars which results deflation in countries that peg their currency to the US Dollars. The only way to prevent this is devaluation.

Russia with a fixed exchange rate system before August 17, 1998, and Hong Kong with a currency board are two examples that Mosler (1998) gives. Both countries had similar economic problems due to two kinds of fixed exchange rate systems. However, if Russia had a floating exchange rate regime with a BSE full employment policy, "at least there would be a semblance of full employment with potential of real gains in needed output by the new public employees, and the possibility of the emergence of the private sector as a functioning currency is reinstated" (Mosler, 1998). The nominal wage for unskilled labor is probably the most stable price in an economy, and this supports the

argument of the BSE model, which maximizes the price stability under full employment and exogenously determined wage (Mosler, 1998).

Under a fixed exchange rate regime, this would not likely happen. Trying to sustain full employment with a fixed exchange rate regime would cause foreign exchange reserves to drain, and the interest rates to rise. Mosler says: "this could happen with either a BSE program or more traditional spending increase, and higher interest rates may accelerate the loss of foreign exchange reserves in two ways" (1998):

- Higher rates could reduce business profits and consumer spending, slowing the economy and reducing tax liabilities.
- The higher rate of interest the government must pay to borrow itself puts more of that currency into private sector hands in the form of interest income.

Additionally, "if the government attempts to tighten fiscal policy it may slow down the economy and thereby reduce tax liabilities, weaken the currency and lose foreign exchange reserves" (Mosler, 1998). In contrast, if tax liabilities exceed the government spending, this strengthens the currency. Mosler says that economic growth driven by "accelerating advance of private sector credit growth has sustained GDP growth and total employment, but it has not been sufficient to sustain corporate profit growth" (1998). As a result, "credit expansion without income expansion is a case of increasing financial leverage and Minsky bubbles" (Mosler, 1998).

To sum up, sustained full employment, favorable terms of trade, real political options and flexibility will be the outcomes of a combination of the BSE and floating exchange rates. This type of economic structure will help keep the foreign currency reserves, but the currency will depreciate.

4.4. International Trade and Flexible Exchange Rates

From the point of view of domestic industrial production, there are inputs that are used for producing outputs. This is also true for the foreign-trade industry: exports are the inputs, and they are sold to be able to import, so the imports are the outputs in the foreign-trade industry. If the difference between exports and imports is positive, this is called investment in the real sense, and it is called loss in the pecuniary sense just like it is when the difference between inputs and outputs in positive. In another case, it is called disinvestment or profit when the difference between inputs and outputs is negative.

In this sense, export surplus or capital export in one country is a loss for that particular country, and a gift to the other countries. This gift constitutes other countries' import surplus or capital import. In the contrary to this perspective, export surplus is widely accepted as a favorable balance of trade; however, it leads to the capital export as well, so there happens a lack of resources for enabling building up productive equipment without cutting their current consumption in the export surplus country (Lerner, 1951, p. 323). Lerner gives an example for unfavorable balance of trade: In 1949, most of the countries other than the United States wanted import surplus and capital import in order to create the productive equipment (Lerner, 1951, p. 323). As a result, such times, unfavorable balance of trade is preferable.

On the other hand, in case of depressions, the export surplus, capital export and favorable balance of trade are preferable, because it enables society to maintain the employment, investment, income and consumption levels (Lerner, 1951, p. 324). This leads the country in depression to restrict its imports, but this is a restriction of exports of other

countries at the same time. Because the others' foreign investment will decrease, their levels of employment and income decrease as well, so the country that had export surplus and imposed import restrictions exported some of its unemployment to the other countries (Lerner 1951, p. 324). Here, the changes in income levels depend upon the magnitudes of the multipliers.

These countries will suffer from the import restrictions imposed by the forenamed country that has export surplus. However, this may lead these countries to impose import restrictions in order to retaliate, but this only causes unemployment and poverty due to the diminished volume of international trade (Lerner, 1951, p. 325). Even though they do not impose import restrictions, they can no longer have import surpluses, because they get less from their exports and get less amount of foreign money for buying foreign goods. If each country try to export more than they import, this is going to be unsustainable, because "total exports cannot be greater than total imports", and there will be "a reduction in the volume and benefits of international division of labor" (Lerner, 1951, p. 326).

In this context, exporting more than importing seems like the necessary economic policy for a country. In the traditional Marxian trade theory, for example, this is the basis for the foreign trade, because that will bring prosperity. Lerner (1951, p. 327) says that this can be true only for "the continuance of the upside-down depression economy". However, economies do not need export surpluses or even foreign trade in order to maintain welfare; domestic investments are enough to stimuli the economy. Even domestic investments for capital goods are not necessary, domestic production of consumption goods creates the desired level of employment in an economy.

On the other hand, in order to be able to import, countries need foreign currencies and need to export as a way of collecting foreign currency. At this point, the subject matter is not the need for currency; it is the imports that the country benefits from. Lerner (1951, p. 327) rejects the slogan of "Export or die!" and suggests "Import or die!" instead, for the industrially advanced countries, because of their need for importing raw materials and food.

Without the full employment policy, free trade becomes a dangerous adventure, and imposing restrictions on imports seems reasonable. In order to sustain a high level of employment, it seems like import restrictions, tariffs or quotas are necessary. Even though these restrictions are beneficiary to the small groups of producers, others including individuals suffer from higher domestic prices due to the ineffective use of resources. Nevertheless, the interest and gains of small groups from these restrictions does not contribute to the society enough to cover the loss of others. In case of full employment, however, the insincere excuse of protecting the employment level will be invalid.

If there is full employment, capital import is not a cause for domestic depression (Lerner, 1951, p. 332-333). Investment resulting from functional finance offsets the disinvestment due to capital import. Capital import causes unemployment in export industries; displacement and replacement of the workers to prevent their unemployment might cause inefficiency. Lerner (1951, p. 333) tells that as long as other countries continue to export even though their imports are not at a high level because of the depression, the capital movement from them will prevent suffering from the depression inside. In the short run, this money can be used for paying the wages and salaries, and what is produced and consumed during this period will be the net profit (Lerner, 1951, p. 333). In the long run,

the displaced workers with inefficiency in other than export sectors will create a wealth smaller than they would work in the export sector, and this is called foreign debt. Nevertheless, the economic activity financed by capital imports brings prosperity, and it is time for giving credits rather than accumulating them. The export sector is now willing to give extended credits in a depressed market, and the depressed countries can no longer resist and maintain export surplus. Lerner (1951, p. 334) tells that functional finance eliminates their ability of maintaining export surpluses through competitive domestic producers even though these countries resist.

If the domestic import surplus cannot be financed by the exports of depressed countries, the amount of foreign currency available will diminish, so the foreign currency will appreciate while the domestic currency depreciates. This will increase exports and decrease imports, and the exchange movement will continue until the import balance disappears (Lerner, 1951, p. 335). The volume of trade will go down, because both the volumes of export and import will decrease meanwhile. The benefits of international trade will diminish, but this will not cause a depression in the economy as a whole. As long as the domestic demand for imports and foreign currency is greater than the foreign demand for that country's exports and domestic currency, currency depreciation is necessary and can prevent a domestic depression.

There are ways of preventing depreciation of currency, such as reducing money wages, prices and money incomes, imposing governmental restrictions on imports and bringing about sufficient depression to the country in order to diminish the domestic demand for imports as much as the decrease in the foreign demand for exports (Lerner, 1951, p. 335-336). However, these are either impossible or harmful ways of defensing the

currency. A reduction in money wages, money income and domestic prices is not feasible, because they are not extremely elastic, and even if they were, this would be harmful to the economic stability and can bring about some depression (Lerner, 1951, p. 336). Imposing restrictions on imports can be harmful to the international cooperation (Lerner, 1951, p. 338). As a result, the tools of preventing currency depreciation can be impossible to be used, or using them can be harmful to the prosperity or international cooperation.

Lerner says, “The basic condition for international economic cooperation is not fixed exchange rates but economic prosperity.” (1951, p. 344). The efforts of stabilizing the rates of exchanges without taking care of other issues create the same results internationally as balancing budget creates domestically. It will kill the international cooperation and domestic prosperity based on full employment policies. Lerner (1951, p. 345) tells that domestic prosperity is an outcome of four policies: removing all kinds of trade restrictions, freeing international payments from bureaucratic interference, preventing disturbances from sudden capital movements, and finally the stability of the exchange rates; and the stabilization of the exchange rates is the least important one. Nevertheless, without prefect price elasticities, fixing exchange rates can depress the economy, because capital flows do not change prices, it changes interest rates and may decrease the level of investment, employment and output. As a result, fixing the rates of exchanges and waiting for prices and money incomes to decrease cause depression and opposite to the prosperity.

To sum up, in order to disregard the balance of payments, the countries have to have a flexible exchange rate regime. Therefore, the flexible exchange rate system is a necessary condition. However, the balance of payments still have impacts on the private

sector surplus or deficit; so this regime does not bring about a sufficient condition itself alone. Private sector surplus is the sum of public sector deficit and the trade or the balance of payments surplus. If the government deficit is larger than the trade deficit, or the trade surplus is larger than the government surplus, or there are government deficit and trade surplus at the same time, then it is possible to have the private sector in the surplus. If government sector's surplus is larger than the balance of payments surplus, or the balance of payments deficit is larger than the government deficit, then the private sector is in deficit.

CHAPTER 5

FULL EMPLOYMENT MECHANISMS

After analyzing the approaches to the international exchange of the Institutional and Post-Keynesian theory and the Modern Monetary Theory, it is necessary to point out that the Institutional and Post-Keynesian theory of international exchange suggest that a fixed exchange rate regime can eliminate the weaknesses of the economies.

The Modern Monetary Theory suggest that with the full employment, a flexible exchange rate system can be beneficiary to both developed and underdeveloped countries; at least, that will not deteriorate the current level of welfare, and will add to it. In the Modern Monetary Theory, because the full employment can provide solutions to the problems occurred due to domestic and international economic policies in a capitalist society, I discuss how employment policies can be applied using the tools of functional finance and can bring full employment.

Full employment is a phenomenon, which is assumed that it exists in the ultimate equilibrium through the automatic mechanism, in the neoclassical economic theory. There is nothing to do to reach full employment, but wait. The automatic adjustment mechanism will bring full employment in the capitalist economy; so firstly, it is necessary to analyze this mechanism in the neoclassical framework. Then, I will explain how this mechanism fails to work with regard to the Keynesian perspective. Lastly, with the functional finance, how a capitalist economy can truly work will be analyzed.

5.1. The Automatic Mechanism of Full Employment

In a capitalist economy, there is a point that there may be full employment. That point is the equilibrium of three dimensions: “the rate of interest, the rate of investment and the level of consumption” (Lerner, 1970, p. 271). Before outlining how this mechanism for full employment works, there are some determinants of the level of this mechanism in the neoclassical approach.

First, an economy is assumed to be perfectly competitive. The output level is determined by the employment level with a constant level of equipment. The employment level is determined by the profitability of the employment. The profitability of employment is determined by the money demand for goods and services. As a result, the employment level is determined by the total expenditure, which is the same with the total money demand for goods and services.

Second, the level of employment is determined by total expenditure, which creates and is equal to the total income. In a capitalist economy, the total expenditure for finished goods and services of the payers are equal to the total net income of the receivers.

Third, the total consumption expenditure is less than total income, because households do not spend all of their money; they save too. Of course, this is correct for people who earn much enough to be able to save. However, there is investment, which is a result of “the purchase of goods that are kept and added to one’s wealth, and this expenditure is not for current consumption” (Lerner, 1970, p. 273). Also, Lerner (1970, p. 274) adds other non-consumption expenditure to the investment expenditure too. He gives an example for the non-consumption expenditure: “Government expenditure on relief

projects – which is regarded as income by the recipients thereof." (1970, p. 274). Therefore, the sum of consumption and investment expenditures is equal to the total income.

Fourth, even though consumption level does not change in every situation investment declines, the total income will decrease. When the total income decreases, the consumption will decline. This time the fall in consumption will cause a decline in total income. Again, this process will continue, "until income fall so low that all income earned in the society has to be consumed" (Lerner, 1970, p. 274). As a result, the consumption will reach a point that that cannot be reduced anymore, and there is a low stable level of income and consumption at that time.

Fifth, if there is no investment activity in the economy, then the total income must be coming from the consumption. This can be generalized, as every other level of investment must have a corresponding level of income. In the first case, the equilibrium consumption (with respect to the propensity to consume) is higher than total income. When the investment is higher, the total income is also higher, and the equilibrium consumption will be less than total income this time. Lerner says, "The greater level of income, the greater will be the equilibrium consumption; but as income increases equilibrium consumption increases by a smaller amount." (1970, p. 275). Therefore, the level of income depends upon the level of investment, because the difference between total income and equilibrium consumption is the level of investment.

Sixth, the distribution of income determines the propensity to consume (Lerner, 1970, p. 277). The distribution of income "in a purely capitalist society" creates rich and poor, and "this forces rich to save and prevents poor from saving." (Lerner, 1970, p. 277). The only stimuli to change the propensity to consume in a society may be the redistribution

of income. Lerner says that because such an attempt of controlling may be called as "socialism", and cannot be accepted in such a society, the propensity to consume must be taken as given. Under this condition, the level of employment is determined by investment by the private sector, and so by the interest rates.

Seventh, the level of investment depends upon the rate of interest and the estimates of the profitability of investment, which will correspond to the efficiency of investment under the conditions of the perfect competition. (Lerner, 1970, p. 277). In Chapter 17 of the General Theory, Keynes (1953, p. 222-254) describes the interest as a hurdle. Interest rate sets the standard for the discount rate, which is the marginal efficiency of capital. When the marginal efficiency of capital equals to or exceeds the rate of interest, then the investment will be made.

Lerner says, "The desire or need to hold money called liquidity preference." (1970, p. 278). There are reasons to hold money or part with money. In Chapter 13 of the General Theory, Keynes tells that the speculative motive of holding money drives the liquidity preference theory. The uncertainty pushes people to hold money instead of parting with it. Lerner says that when there is more business being done, there is more desire to hold money. The money payments are necessary to be made, and if the uncertainty increases, or if the payments and receipts become more irregular, the need and desire to hold money will rise (Lerner, 1970, p. 278). Also, if the prices are high in the economy, the liquidity preference will be higher, or vice versa. Lerner adds that when prices are "falling", the liquidity preference will be higher, and when prices are "rising", the liquidity preference will be lower. When times are bad, it will be better to hold money, and when the times are good, it is better to part with it.

However there is a cost of holding money for people in an economy. The cost is the interest rate, and Lerner indicates that the lower the rate of interest, the higher the desire for holding money, and when the rate of interest is high, the demand for money is lower (Lerner, 1970, p. 278). When the level of money supply does not change, or "money in existence" is at a constant level, all of the money available has to hold by somebody. Even though people want to decrease their money holdings when the rate of interest is low, it is not possible for all people to achieve it. This is correct for a situation that the rate of interest is high and people want to hold more money. When the money supply change, "the amount held by all members of society together will have to change in the same direction and by exactly same amount irrespective of any preferences of the individuals" (Lerner, 1970, p. 279).

As a result, the interest rate is not determined by the supply and demand in the loanable funds market like it is explained in the neoclassical framework; it is determined by through the combination of liquidity preference and the money supply.

Eighth, the two ways of parting with money are spending and lending. Because the payments and receipts are equal in an economy, the level of spending will be equal to the level of receiving. If there is no increase in the level of consumption goods, or no decrease in the inventories, then the prices will increase if the level of spending increase. Lerner says, "The flow of consumption goods must be fixed in total so that one individual could get more only the extent that other individuals could be made to take less." (1970, p. 279).

Other than spending, lending is an alternative for parting with money. Lower rate of interest for money will push people to less liquid but higher interest-yielding instruments. People will lend the surplus cash, which is "more than enough to satisfy the

need and desire for liquidity at the current cost in terms of the interest" (Lerner, 1970, p. 280).

Until this point, in order to constitute a framework for the mechanisms for full employment in a purely capitalist economy, the determinants of the level of employment were analyzed. In this framework, there are some forces and their natural tendencies that can create full employment in such a capitalist economy. Lerner establishes eight stages in an economy that will ultimately eliminate unemployment and automatically check the inflation (Lerner, p. 281-284):

1. If there is not full employment the price of labor will fall because of the competition of the unemployed for jobs.
2. The prices of all other factors of production will fall in the same proportion as wages, since any factor, which falls in a smaller proportion, will be replaced to some extent by the relatively cheaper factor labor.
3. As a result of the equal fall in the prices of all the factors, competition between the producers, at the same degree of intensity as before, will reduce the prices of the products until they too have fallen in the same proportion.
4. There is still no increase in the level of employment, because there is still profitable and unprofitable employment due to the same proportion of decrease in prices of both factors and products.
5. There then results a reduction in the demand for money to hold.
6. The decrease in the need for money to hold leads to lending on the part of all the people who now find that some of their cash holdings are not necessary and might as well be exchanged for other forms of wealth that yield an interest.
7. This has the effect of bidding up the prices of the interest-yielding forms of wealth, thus reducing their yields together with the particular yield on money loans that we call the rate of interest.
8. The reduction in the rate of interest will make it profitable to increase investment. (Increase in employment. Also, the decrease in the rate of interest will push the consumers to consume more and save less. Consumption of goods and employment increase.)
9. The increase in the income the people employed by the increase in investment will lead to more consumption and the creation of still more income and employment in accordance with the propensity to consume.

These stages can or cannot bring about full employment at the end of one cycle. There can be still unemployment, and if there is still unemployment, the whole process

repeats itself. Then, “wages will have no tendency to fall” (Lerner, 1970, p. 283). Also, the whole process can work reverse if there is an excess total demand beyond the level necessary for full employment (Lerner, 1970, p. 283 – 284).

5.2. How It Really Works

5.2.1. The Mechanism Produces Unemployment

Although the mechanism is expected to work smoothly, it is very likely to have some disruptions through the stages. Any kind of failure in the process can cause inflation or unemployment.

First, wages may not fall. There are two “guilty” sides that do not let wages fall. One side consists of the unemployed workers, which are the alternatives for the current workers; they are not willing to work for a wage less than the standard wage. The others are the worker organizations, which make an effort to prevent the wages to fall. However, Lerner (1970, p. 285) tells that, even there is a reduction in wages; this does not guarantee that the real wages will go down. This is because the prices go down accordingly.

It is also possible that there may be other reasons that cause unemployment, so wage reductions cannot be the only instruments to maintain the mechanism. Because the relative wages mean more to the workers, they tend to desire an increase in the absolute money wages. However, the effort to keep the relative wages high will cause “a resultant rigidity of wage rates” (Lerner, 1970, p. 286). Therefore, wage rigidities are obstacles on the way of seeking sustainable full employment.

Second, even if wages fall, this still does not guarantee eliminating the unemployment at all. Lerner (1970, p. 286-287) suggests that a reduction in wages can stimuli the economy only in special cases and for only the small economic units. For a firm, a reduction in wages can cause the employer to hire more workers and increase the output level; but this can be true "when everything else remaining the same" in the economy. The customers for this firm will not lose the advantage of higher wages, so the sales of products of this particular firm will not be diminished. When this is generalized to the whole economy, every wage receiver will get lower money incomes, so the total demand cannot be maintained in the same high level as it was before the wage reduction.

Third, when there is unemployment, wages must fall according to the determinants discussed before. However, the workers try to keep their wages higher for a reason. If money wages fall as expected, prices may not fall opposite to the assumed relationship between them. Lerner tells that it is possible that some monopolistic firms, which control some factor of productions, do not allow their prices to fall (1970, p. 287). Currently high prices cause "unemployment of these other factors", and the products, which are produced by using these expensive factors, will also be expensive (Lerner, 1970, p. 287). Therefore, the real wages will not decrease.

On the other hand, the labor can become a substitute factor due to the high prices of factors of production other than labor. This can increase the employment level. However, at the time when some of the factors of productions are fixed such as land, then those factors cannot stay unemployed for a long time, and prices of the some of those pieces of lands, for example, keeps getting higher (Lerner, 1970, p. 287). Lerner says that its effects on the economy will be the same with the effects of those fixed factors' absences

(1970, p. 287). Worse economic conditions can increase the level of employment under these conditions.

In contradiction, when the prices of other factors that are produced instruments of production, this will both destroy the economic conditions for the society and decrease the level of employment, Lerner says. (1970, p. 287-288). “In the manufacture of the instruments of the production that are not being used”, there will be a decrease on the level of employment, so the investment will decrease (1970, p. 288). The level of substitution of labor for other instruments of production will not be enough to cover the deficiency of employment.

Fourth, if the prices of the factors of production decrease, then the prices of products will decrease as well, as assumed before. However, monopolistic firms can keep the prices high in this situation, and can prevent a fall. Lerner suggests that monopolistic firms can and tend to prevent a fall in products when there is a depression and prices of factors decrease (1970, p. 288). In such a situation, even though output level decrease, monopolistic firms tend to increase their prices in order to get high level of profits (1970, p. 288). As a result, a fall in the prices of factors does not cause a fall in prices of products, and it is not possible to achieve a full employment level as it is assumed.

Fifth, when discussing the determinants of the automatic adjustment above, it is assumed that a fall in the prices of factors will cause a fall in the prices of products in the same proportion, and these levels of prices will be maintained for a while. Then, the need for cash will decrease. However, without a government intervention, it is likely that these prices will not decrease at the same proportion, and the need for cash will not be diminished. Even there are “no monopolistic restrictions and devices”; there will be

different patterns of the process of falling prices of factors and products (Lerner, 1970, p. 289). A little decrease in the wages due to weak bargaining power or lack of an ineffective organization will cause unemployment, at first. Then, as long as there is this persistent unemployment, the trade unions will lose strikes and lockouts because their funds run out. Also, the workers will have spent all their savings and credit, and will have had to agree on the reduction on wages. After this point, wages will fall at an increasing rate, and prices will follow them. Employers will lose, firstly, their hope to sell their stocks at a higher price if they keep their stocks for a long time, and, secondly, their financial ability to keep their stocks in the market (Lerner, 1970, p. 289).

When prices are falling, the desire for holding money will be higher. This is because "purchases made later when prices are lower and one can get more for the money" (Lerner, 1970, p. 289). The appreciation of money due to the price falls causes similar benefits with loaning money out at interest instead of keeping it idle for waiting price falls (1970, p. 289). However, they are different at the same time at some degree; "because it is uncertain how long prices will keep on falling, people prefer to have their money on hand ready to buy before prices start rising again" (Lerner, 1970, p. 289). As a result, the increased desire for holding money when prices are falling is more than sufficient to offset the decreased desire for holding money when prices are lower (Lerner, 1970, p. 289-290).

In another case, even though the prices of factors and the prices of products fall at the same proportion, it is not certain that this will be beneficial for the firms under any condition. Firms with fixed monetary obligations will have a heavy burden due to the price falls (Lerner, 1970. p. 290). Increased bad debts and bankruptcies cause creditors to hold money to protect themselves under uncertainty (Lerner, 1970, p. 290). "This contributes to

demand for cash and helps to offset the decreased need for cash on account of the lower level of prices." Lerner summarizes the situation (Lerner, 1970, p. 290).

Sixth, as a part of the mechanism, prices fall, and the desire for holding money falls, accordingly. This happens if prices are falling more and more and become very much lower than before, its effects exceed the effects of ongoing fall, the result will be that the desire for holding money decreases (Lerner, 1970, p. 290). Another reason for the lower desire for holding money can be the decreased level of uncertainty; Lerner explains such a situation by saying, "most of the bad debts have been written off and most of the bankruptcies carried through so that there is more confidence that the remaining debts will be paid when they fall due" (Lerner, 1970, p. 290). The following part of the mechanism after this is lending.

However, the level of confidence in society can be diminished after the period of falling prices. Lerner points out that lending might not have to be the next step, because "the period of falling prices, defaults and bankruptcies, many banks will close down and confidence and credit may be impaired so the supply of money contracts" (Lerner, 1970, p. 290). As a result, the amount of money in existence or money supply can "decrease as rapidly as the need for it, or even more rapidly" (Lerner, 1970, p. 290). Additionally, even there are no banks closing down, the need for less cash and lower amount of credit money will cause "businessmen to reduce their obligations to the banking system at the expense of their cash balances" (Lerner, 1970, p. 290-291). Also, the public will not lend under these conditions (Lerner, 1970, p. 291). Lerner says that the money in the bank is the most important form of money, so a decrease in the money in the bank in a highly developed credit system will cause an automatic decrease in the money supply (Lerner, 1970, p. 291).

Even though people pay their debts to the banks because of the decreased desire and decreased level of holding money, banks do not tend to and want to lend money in order to hold more cash (Lerner, 1970, p. 291). As a result, "the decrease in the liquidity preference on the part of the public may be offset or more than offset by the decrease in the amount of money available for the public to hold" (Lerner, 1970, p. 291).

Seventh, if the lending of the surplus cash increases, the rate of interest decreases according to the determinants discussed before. However, if the desire for holding money decreases, then the rate of interest decreases very little or negligibly (Lerner, 1970, p. 291). If the owners of wealth in the society think that the rate of interest is normal, then it is very unlikely that the interest rates decrease. In addition, even if the rate of interest decreases, it will come back to the "normal" rate soon (Lerner, 1970, p. 291). The owners of wealth will "sell their securities that will have appreciated because of the fall in the rate of interest" (Lerner, 1970, p. 291). This is an opportunity for the wealth owners to hold more money instead of securities. When the rate of interest rises back, it is time for them to buy the securities back at a lower price (Lerner, 1970, p. 292). Lerner says that the owners of wealth create a system that absorbs any cash that is free form the transaction processes in the economy, so they keep the rate of interest at a level that they desire (Lerner, 1970, p. 292).

Eighth, the wealth owners may be convinced that the rate of interest is definitely going to fall after a while. There may be a level for the rate of interest that it cannot fall below (Lerner, 1970, p. 292). The owner of wealth may be "willing to own securities yielding this low rate of interest or to have money yielding no interest but providing a feeling of security and liquidity instead" (Lerner, 1970, p. 292). The large volume of the

securities in a low rate of interest will keep the rate of interest at the current low rate, and a large amount of cash available does not change this situation (Lerner, 1970, p. 292).

Ninth, if the rate of interest decreases, it must cause an increase in the investment according to the determinants of the mechanism. However, there are some reasons for this not to happen. First of all, when prices fall, this will cause a decrease in the efficiency of the investment, because the products can only be sold at the lower future prices. Therefore, the investment will decrease, and the decrease in the investment may more than offset the decrease in the rate of interest (Lerner, 1970, p. 292). Secondly, the fall in the prices of factors will not be enough to induce the investment. Also, the current level of investment and future investments may decrease. The investments will be postponed due to the expectations of further falls in the prices of factors (Lerner, 1970, p. 292 - 293). Thirdly, "falling" prices will cause not only investments to be postponed, but also consumption will be postponed due to the expectations of even lower prices of products in the future. The decrease in consumption will also effect the investment in a bad way (Lerner, 1970, p. 293). In addition, the decrease in consumption and investment because of the falling prices is a consecutive process, "… The decrease in investment decreases income and consumption and prices still further, and the decrease in consumption decreases investment once more." (Lerner, 1970, p. 293)

On the other hand, there is another process that creates an environment for economic destruction, crisis and depression. The falling prices will affect the state of mind of purchasers who wait for further falling in prices; decrease in spending will cause further "decrease in prices and employment, in less consumption and less investment, in a further increase in bankruptcies and bad debts, and so in a further need for cash to hold to meet

the danger of debts being unpaid by due". (Lerner, 1970, p. 293). Also, this will cause following effects step by step: "an increase in the interest rate and decrease in investment still further, adding to the downward movement in employment and income and spending and prices and to a further increase in the need for cash and in the rate of interest" (Lerner, 1970, p. 293). Furthermore, the fundamental uncertainty has a great effect on investments. Their effects are greater then the effects of a change in the rate of interest (1970, p. 293-294).

Tenth, the last part of the mechanism is that if investments increase, this will increase the levels of income and consumption in the society. When investment increases, there will be even "greater increase in income and consumption in accordance between the propensity to consume" (Lerner, 1970, p. 294). This is the most reliable step in this mechanism according to Lerner, just because of the stability of the propensity to consume (Lerner, 1970, p. 294). As a result of this relationship, "the gap between income and equilibrium consumption is equal to the greater rate of interest" (Lerner, 1970, p. 294). The propensity to consume has a great role in this mechanism so that the increase in consumption will offset the increase in savings because of the lower rate of interest. As a result, if all parts of the mechanism works well until this point, the next step, which is the redistribution of income and automatic reestablishment of full employment will be achieved. Lerner (1970, p. 294) adds that all this mechanism can work in reverse: from full employment to inflation.

5.2.2. Implications

Lerner (1970, p. 295) says that not only are wages rigid, but also other prices might be rigid in an economy; also, there may be more than one type of employment, and the wages for these may not be the same. When other prices are rigid too, and there are several types of employments, the operation of this mechanism and fundamental determinants do not change. This is because there are relative prices. For instance, when there is a fall in a price of one factor, that factor will be used more, and will substitute other factors. When more than one factor's prices fall by the same proportion, then they will be used as alternatives for other factors. The ultimate effects will be the same in either case. Therefore, a fall in a price of a factor will result in the same way in both flexible and rigid prices cases.

The business cycles are due to the deficiency of demand, and the deficiency of demand is a result of an unequal distribution of income, Lerner says (Lerner, 1970, p. 296). Lack of income is a cause for lack of consumption in an economy. Lack of consumption causes lack of investment, and unemployment. As a result, the unequal distribution of income causes the business cycles.

Lerner shows that one of the factors of the deficiency of demand is the trade cycles (1970, p. 298). The uncertainty will affect the level of investment and the desire to take risks in an economy. The uncertainty causes higher risks on investment, and diminishes the efficiency of the investments; the level of investment in an uncontrolled economy will fall due to the uncertainty (Lerner, 1970 p. 298). The business cycles bring uncertainty whether or not the good times continue or how long the good times will continue (Lerner, 1970, p. 298).

The good times with high level of spending in a capitalist economy will increase the revenue of the government from taxes. Government borrowing based on the expectations of continually high tax revenues, and government spending on socially beneficial activities will increase. The total demand will rise in such a situation.

However, in the bad times, the incomes reduce, so the government will decrease its spending due to the fall in tax revenues; but at the same time, the government must serve the national debt. The government's attempt to raise taxes in order to serve the national debt will decrease the incomes further, because of the decreases in both government and private spending. The income, spending and investment fall, so "the depression will be deepened" (Lerner, 1970, p. 299). Lerner calls this kind of activity of government as "Sound Finance", and it creates a deflation in the economy (Lerner, 1970, p. 299 - 300). The only result of the sound finance is to make the economic conditions worse. Thus, Lerner suggests "Unsound Finance" which creates more government debt, more spending, more investment so more economic activity (Lerner, 1970, p. 300). The more government spending and debt rises, the more income raises; it creates similar results with the more investment activity.

5.3. Functional Finance

Abba Lerner (1970, p. 302-322) rebuts "some exceptionally powerful and firmly established prejudices" by showing that they are useless.

Lerner tells that the national debt is not a really important issue for a nation (1970, p. 302 - 303). The perspective that makes national debt a burden to the people has some arguments such as:

- National debt must be paid one day.
- National debt is a burden for the nation, because the interest of the debt must be paid by their taxes.
- National debt is a burden for the posterity, because it is their duty to pay debt back.
- National debt is a sign of national poverty.

Firstly, the national debt does not have to be paid unless there is a call from banks to the depositors in debts, or a call from the lenders to the corporations under obligations. Secondly, national debt is not a burden, because the payments for the debt and the revenues for the government bonds cancel the debt out. Thirdly, the posterity that pays the debt is the same posterity that receives the revenue. Lastly, because what somebody pays is what others receive, the taxes citizens pay are revenues for the citizens that have the government bondholders. Even if there is a need for higher taxes but this is not desired, then borrowing or printing money will be the solution. Lerner (1970, p. 303) says that printing or borrowing money for interest payments have similar effects with doing this for any other purposes. As a result, "The instruments are not available until it is recognized that the size of the national debt is relatively unimportant," (Lerner, 1970, p. 302), and "… that the interest on the debt is not a burden on the nation," (Lerner, 1970, p. 303). Also, unlike the firms or corporations, governments cannot bankrupt due to the internal debt. Borrowing money from the citizens or printing money is always an option for a government to meet its monetary obligations.

One person's debt is some other person's credit, and this is true for both the private sector and the government sector. Private sector's debt turns out that it is investment from some creditor, and it is widely accepted that the sum of investments creates a nation's wealth. While government sector's debt is also a credit from bond purchasers, the government debt shows a nation's poverty. However, this cannot be the case, because

government's debt might be turn out as private sector's investments and might create private sector's surplus. Lerner (1970, p. 305) tells that the corporation of "the skill and industry of its inhabitants and in the natural sources and equipment indicates the real wealth of a nation".

The external debt creates a burden for the country that borrows from another country. While borrowing, the country becomes one that consumes more than that produces; and when the time the country has to pay the debt back comes, that country has to consume less than that produces. Lerner tells that there might be some inconveniences due to these conditions when paying the debt back (Lerner, 1970, p. 305).

On the other hand, the internal debt is different from the external debt. Lerner says that the internal debt is not like an individual borrowing from another individual; it is like an individual borrows from one of her pockets and put that money into her other pocket (1970, p. 306). Furthermore, the internal borrowing indicates the private sector investments and the private property. "Government debt is opposite to government ownership of wealth" Lerner says, so the more government ownership of the wealth demonstrates the less private ownership of the wealth (Lerner, 1970, p. 306).

The issue that can arise at this point is the distribution of the private ownership of the wealth. Although the size and the changes in the size of the government debt affects the distribution of wealth and income, it affects and changes more "the fundamental objectives of maintaining full employment or with the optimum use of resources, or with the proper division of resources between producing current consumption and adding to the equipment of society" than the distribution of wealth and income (Lerner, 1970, p. 307).

In the mainstream economics literature, it is accepted that taxing is the instrument of raising money for the government, but Lerner tells that when raising money is needed, the government can raise "all the money it needs" by printing money (1970, p. 308). However, taxation arranges the distribution of the wealth and income between the government and the private sector including the households. It is an instrument that determines the level of money government keeps and controls, and determines the ability of saving and spending of the taxpayer.

The internal borrowing is not a way of creating income to the government too. Borrowing also determines the amount of money, and the amount of government bonds public have, Lerner tells (1907, p. 309). The more government borrowing means the more public holds government bonds, and the money value of the bonds decreases, so the interest rates increase; if the aim of the government is to regulate the interest rates and the level of money available to the public, then borrowing is an instrument for the government (1970, p. 309). Otherwise, printing money is the way of raising money for the government.

For instance, war bonds are also needed for only decreasing the level of spending done by the public. The money available should not be spent for civilian goods, so the government redistributes the money. Lerner tells that issuing government bonds does not decrease the demand for the civilian goods, nor provide additional income for the government; the outcome is the interest payments that the government must do in the future (1970, p. 310).

The government may increase the level of money available to the public, and may decrease the rate of interest in order to pay the national debt; or the government lends money and creates national credit, if there is no national debt (Lerner, 1970, p. 310). At

this point, it is important to mention that Lerner suggests national debt does not indicate "national insolvency or poverty", and national credit does not indicate "national prosperity and wealth" (1970, p. 310). The government can print money if there is a need for more money to spend; it can reduce taxes if it wants to increase the income, wealth or spending of particular groups or classes of people in the society; even negative taxes can help stimulate the economy when it is needed (Lerner, 1970, p. 310).

Both taxes and bonuses affect the rate of interest as well as they affect spending (Lerner, 1970, p. 311). It is a matter of fact whom is the target of the taxes and bonuses. For example, the rich and the poor will not be affected the same by a tax cut or a bonus. Lerner says that the rich tends to save more, and the poor tends to spend more by any incentive like those (1970, p. 311). The rich will use this additional money for saving, lending or adding to his stock of cash (Lerner, 1970, p. 311). As a result, this will decrease the rate of interest. Therefore, bonuses and/or government lending decrease the rate of interest while higher taxes and/or government borrowing increases the rate of interest. Lerner (1970, p. 311) tells that higher interest rates due to the government borrowing will encourage people to spend less and save more. On the contrary, lower interest rates due to the government lending will cause an economy the people save less and spend more.

In addition to taxing and spending and borrowing and lending, the government has the ability of buying and selling in order to distribute or redistribute the income in the society. Buying and selling are neither instruments using for creating income for the government; they are instruments using for taking income from one class, and giving it to another. Buying goods from an individual has similar effects with taxing the same individual, and selling goods to an individual creates the same results with giving bonuses,

Lerner says (Lerner, 1970, p. 313). When the government wants to receive foreign money, selling is an instrument that government can use.

Lerner explains the roles of taxing and spending, borrowing and lending, and buying and selling below (1970, p. 313):

> The government need merely borrow whenever it wishes to raise the rate of interest, lend (or repay debt) whenever it wishes to lower it, tax when it wishes to decrease consumption, and reduce taxes (or increase bonuses) whenever it wishes to increase consumption. This is how the instruments work.

Printing money is not an instrument such as taxing and spending, borrowing and lending, and buying and selling. It is dependent upon these instruments, and can support them when it is necessary. Lerner (1970, p. 314) shows two cases that there is and is not a need for printing money:

> If the money that comes in to the government treasury from selling, borrowing and taxes is equal to or greater than the money needed for buying, lending and bonus distribution, there is no need for any money to be printed. If the money coming in is less than the money that has to be given out and there does not happen to be enough money in stock in the government vaults, the printing press can be called upon to provide the money needed to carry out the government policies.

Lerner (1970, p. 315) describes the results of the application of the fiscal instruments as the desired levels of consumption, investment and the rate of interest. Full employment can be achieved by fully utilizing the resources, and by the resources devoted to investment at a certain rate (Lerner, 1970, p. 315). The unemployment is a result of the deficiency in total demand, so the government's duty must be stimulate the total demand. Government lending is the key for lowering the interest rates until the proper level of investment achieved; tax cuts or bonuses are the incentives to achieve the proper level of

consumption (Lerner, 1970, p. 315). The combination of these creates the full employment in the economy.

In the time of a depression, when the entrepreneurs are not willing to undertake risks and make investments, even though the rate of interest is very low or zero, what government must do is to take action, and make some investments (Lerner, 1970, p. 315). Government buying or "public works" will help the society use the resources and create additional consumption. Also, government should reduce taxes, increase bonuses, increase total income and total demand for consumption goods and services in order to increase the level of employment (Lerner, 1970, p. 315 – 316).

If there is full employment, increasing government spending can cause inflation; conversely, decreasing government spending can cause unemployment. However, Lerner (1970, p. 316) says that the government's total spending must be regulated based on the conditions in the economy. In order to increase the total demand under some unemployment, increasing "useless and even moderately harmful" public spending is a better option than taking no action. Lerner tells, "The direct marginal social benefit of the public works may be low or even negative, but the indirect marginal social benefit, through the resulting increase in income, in demand, and in employment elsewhere to satisfy this demand, must be added to the direct marginal social benefit to obtain the total marginal social benefit from the public works." (1970, p. 316). Even if there are some political reasons to force the government to fix the spending, such as preventing government deficit, the equality of the marginal social benefits of public and private must be provided by employing the optimum use of the resources.

On the contrary, in an inflationary environment, if there is full employment, it is government's job to decrease its spending, which increases the interest rates and decrease the investments and consumption.

The government's adjustment policies of the total demand are not only necessary for providing the full employment, but also necessary for maintaining the optimum use of the resources (Lerner, 1970, p. 317). Providing the perfect competition is the tool for the division of resources between "the production of different products" and "the different investments"; and maintaining government borrowing and lending, which determines the rate of interest, is the tool for the division of resources between the total consumption and total investment (Lerner, 1970, p. 317). Also, government should equalize the different classes' marginal social benefits by its allocation of public and private spending; and it should equalize the marginal social costs of different taxes by minimizing the losses of different sectors.

For the government, balancing its budget must not be its goal that determines all other economic policies. The full employment and preventing the inflation must be the government's principles (Lerner, 1970, p. 317). The government is not like any normal business, so it must not be act like it is one. Lerner tells that balancing the budget is the first principle of the government just because of the prejudices of the businessmen about the government deficits (Lerner, 1970, p. 317). However, what they think and feel is not more important than the maintaining full employment and preventing inflation.

Lerner tells that if it is possible to balance the budget when maintaining the full employment and preventing the inflation, then there is no reason not to balance the budget (1970, p. 317). Lowering the interest rates by redistributing the income will not create a

government deficit, but will increase the total demand. Increasing taxes on the rich and decreasing taxes on the poor is a way to do this (1970, p. 317 – 318). The rich will not decrease their spending much, but the poor will spend more with higher income. Furthermore, additional taxing on rich will cause that the rich will use their "money stocks or hoards in order to pay taxes, to lend the revenues on the market or repay the government debt", which will reduce the rate of interest and increase the investment and the total demand. (1970, p. 320). Lerner says that this option is more frustrating for the businessmen than the option that creates government deficit (1970, p. 320).

The redistribution of income may cause a discouragement for making investments by the businessmen (Lerner, 1970, p. 320). Also, unbalancing the budget more than necessary to provide full employment can diminish the confidence of the businessmen to the government (Lerner1970, p. 320). These can make the results worse, and create a huge deficiency of the economic activity. In this case, the government must do all the spending and must provide the full employment without upsetting the businessmen; resulting higher total demand means higher profits, so the gains will overcome the prejudices of the businessmen (1970, p. 321). Higher levels of production and investments will result in the full employment, and the objection that functional finance interferes with free choice between saving and spending is extraordinarily empty." (Lerner, 1970, p. 321). Lerner (1970, p. 322) summarizes the concept below:

> The choice between present consumption of one's income and saving it depends much more on the distribution of income than on the 'time preference' on which the controlled economy is set to trespass. But the great weakness of the objection is that the individual in the uncontrolled capitalist economy who decides to save does not shift resources from producing present goods to producing goods in the future. He merely sets them free so that they become unemployed. The decrease in demand by the men who are put out of work by this and who now have no wages to spend leads to still

further decreases in employment. In fact the amount that people save is determined in the uncontrolled economy, not by their thrift, but by the investors who raise or lower the total income of society to the level where consumers are freely willing to save exactly the amount that the investors have invested. It is only this illusion of freedom of consumers' choice that exists in the uncontrolled economy. And even this is not lost, since the individual is still free to save or spend his own income in any proportion that pleases him. What is gained is the possibility of a careful consideration of people's attitudes as between present and future by the government when it makes a democratically controlled decision as to how much of the resources of society to devote to current consumption and how much to devote to increasing and improving society's equipment for producing goods in the future. In doing this, subsidiary devices can be put into service to give the consumer a real influence over the allocation of resources between present and future consumption.

CHAPTER 6

MARXIAN APPROACH

6.1. David Ricardo's Trade Theory vs. Karl Marx's Approach

David Ricardo's theory of the comparative advantage indicates a barter economy model that includes all trade activities between the countries. This theory has been supported by many of the economists including John Stuart Mill and Alfred Marshall, and has been appreciated through centuries. What this theory suggests is that the price adjustments balance the trade in each country in a sense that these economies are pure economies and money is neutral. Ricardo (2004, p. 128-149) discusses that the free trade and the mobility of the capital flows will automatically adjust the prices and rates of profits, based on the cost differentials. Milberg (2002, p. 246) summarizes "When one country has an absolute productivity (or more generally, cost) advantage or disadvantage in all sectors, the principle of comparative advantage will determine specialization and trade patterns only if comparative cost differentials automatically become absolute money cost and price differentials."

Here is Ricardo's example of the trade of two commodities (wine and cloth) between two countries (Portugal and England). The cost differentials between two countries cause a situation that the country with the absolute cost advantage has a trade surplus (Portugal), and the one with the absolute cost disadvantage has a trade deficit (England). However, this is not permanent; Hume's price-specie-flow mechanism brings about that the capital moves from the deficit country to the surplus country, and the prices

will be adjusted through this mechanism (Milberg, 2002, p. 246). Higher prices in the surplus country and the lower prices in the deficit country will cause that at least one commodity with the smallest absolute disadvantage becomes cheaper in the deficit country than the surplus country (Milberg, 2002, p. 246-247). As a result, its export will increase and the trade will be balanced ultimately.

Karl Marx analyzes Ricardo's theory of the comparative advantage by looking at the effects of the capital movements on the prices and interest rates. Marx's says (1991, p. 685):

> It is indeed an old humbug that changes in the existing quantity of gold in a particular country must raise or lower commodity-prices within this country by increasing or decreasing the quantity of the medium of circulation. If gold is exported, then, according to this Currency Theory, commodity-prices must rise in the country importing this gold, and thereby the value of exports from the gold-exporting country on the gold-importing country's market; on the other hand, the value of the gold-importing country's exports would fall on the gold-exporting country's market while it would rise on the domestic market, i.e., the country receiving the gold. But, in fact, a decrease in the quantity of gold raises only the interest rate, whereas an increase in the quantity of gold lowers the interest rate; and if not for the fact that the fluctuations in the interest rate enter into the determination of cost-prices, or in the determination of demand and supply, commodity prices would be wholly unaffected by them.

As can be seen, Marx rejects Ricardo's price adjustment mechanism that is based on Hume's price-specie-flow theory. Also, this is a rejection of the modern variations of the Ricardian trade theory (Shaikh, 1980, p. 224-225). As a result, the assumption of the automatic price adjustment mechanism in Ricardian trade theory does not find a place for itself in the Marxian trade theory. Marx approaches to the issue by looking at the changes in the rate of interest rather than the prices. The effects of the capital movements on the interest rates are more important than the effects of the wage and exchange rates on the

relative price adjustments (Milberg, 2002, p. 248). This implication of Marx is very similar to Keynes's implications about the same adjustment mechanism.

6.2. From Competitive Capitalism to Monopoly Capitalism

Marx suggests that the capital in question in Smith and Ricardo's approaches to the foreign trade is the merchant capital, not the industrial capital. In the Capital Volume 3, Marx explains (1991, p. 441):

> The great economists, such as Smith, Ricardo, etc., are perplexed over mercantile capital being a special variety, since they consider the basic form of capital, capital as industrial capital, and circulation capital (commodity-capital and money-capital) solely because it is a phase in the reproduction process of every capital. The rules concerning the formation of value, profit, etc., immediately deduced by them from their study of industrial capital, do not extend directly to merchant's capital. For this reason, they leave merchant's capital entirely aside and mention it only as a kind of industrial capital. Wherever they make a special analysis of it, as Ricardo does in dealing with foreign trade, they seek to demonstrate that it creates no value (and consequently no surplus-value). But whatever is true of foreign trade, is also true of home trade.

It is the industrial capital that is used for the production of commodities and that creates the value and the surplus value, and it is the merchant capital that is used for the trade of the commodities and that transfers the value and the surplus value (Shaikh, 1980, p. 208). The merchant capital comes about after the industrial capital by definition, and it is the merchant capital that puts the money into the exchange. Anwar Shaikh (1980, p. 208) says, "Because the essential circuit of merchant capital involves 'buying cheap and selling dear', the question of the determination of prices is critical; and this in turn means that money – the connection between value and price, surplus value and profit – must be adequately developed prior to the analysis of merchant capital."

However, the role of prices becomes secondarily important after the time of Marx. The modes of production have evolved, and the Marxian economists analyze the national and international trade over the recognition that it is the monopoly stage of the capitalism since Lenin's explanation in Imperialism (1939) (Shaikh, 1980, p. 208). Additionally, it leads the Marxian economists to give up analyzing the price formation due to the stage of monopoly (Sweezy, 1942, p. 270-271) (Shaikh, 1980, p. 208). Nevertheless, the role of price dominates its position in the international trade through the relationships between monopolies and between monopolies and states.

6.3. Capital Movements: Developed and Under-Developed Capitalist Countries

Marx rejects the relationship between the capital flows and price adjustments (Shaikh, 1980, p. 226). The supply of gold does not affect the prices as it is explained in Ricardian framework. Thus, the outflow of capital does not decrease the prices in the deficit country; it affects the rate of interest through the decrease in the supply of loanable money-capital and the decrease in the demand for money-capital (Shaikh, 1980, p. 226). The bank reserves, the level of investment and the level of output will decrease eventually, and there will be a lower level of efficiency. There will be "a chronic trade deficit balanced by persistent outflow" (Shaikh, 1980, p. 226). The only way for such countries to have higher efficiency comes from the natural advantages such as availability of resources and climate, but they are not enough to offset the disadvantages of under-development (Shaikh, 1980, p. 228).

On the other hand, the inflow of capital (or gold) does not increase the prices in the surplus country. Opposite to the deficit country, the inflow of the capital will increase the bank reserves, so the supply of loanable money capital will increase. This will be followed by increases in the levels of investment and output and higher efficiency. As a result, there will be "a chronic trade surplus balanced by persistent inflow" (Shaikh, 1980, p. 226). Also, there are an advanced technology and a more productive workforce that conditioned to the capitalist production more than it is in the under-developed capitalist countries (Shaikh, 1980, p. 228).

The capitalists in the surplus country will lend their money in the deficit country in order to get higher profits due to the higher rate of interest. This is a reason for temporary capital inflow to the deficit country; but paying the capital back with the interest payments will increase the capital outflow even more in the long run. Therefore, the chronic trade deficit cannot be cured by short-term capital inflows. Shaikh (1980, p. 226) shows that in Ricardo's example, Portugal corresponds to the developed capitalist country, and England corresponds to the under-developed capitalist country, and says, "In free trade, the absolute disadvantage of the under-developed capitalist country will result in chronic trade deficits and mounting international borrowing. It will be chronically in deficit and chronically in debt." The absolute advantage rules the trade, not the comparative advantage (Shaikh, 1980, p. 231).

Of course, the desire for trading and the tendencies for higher profits of the merchant capital, it is possible for the underdeveloped capitalist country to switch to more advanced techniques internally; this would increase the efficiency by using domestic resources. However, Shaikh (1980, p. 228) says that the "the vastly greater cost and scale

of advanced techniques, the complex interdependence required among different techniques for anyone to be viable, and the greater socialization of the work-force" are the obstacles for a national development for such countries. It is also possible that these tendencies for modernization of the production techniques might take the form of direct investments and come from the developed capitalist country to the underdeveloped capitalist country. Shaikh (1980, p. 228) says the modernization based on direct investment does not have the same obstacles that an effort to develop internally might have been prevented by. The capitalists from the developed country have the access for a larger amount of capital, more advanced technology and skilled workers (Shaikh, 1980, p. 228). In addition to these advantages, the wages are lower in the underdeveloped countries. This is the most important factor that favors direct investment, and it is the most important difference between the commodity trade and the direct investment; still, the most significant reason for the uneven development is not the wage differences; it is the difference in the production techniques according to Shaikh (1980, p. 228). Although lower prices of raw materials, location and climate are the reasons for the attraction of the direct investment, these may be specific for some industries or some branches of industries; the lower wages and cheap wage-labor are "general social characteristic of under-developed capitalist countries" (Shaikh, 1980, p. 228). Also, the capital flows from developed capitalist countries to the underdeveloped capitalist countries are attracted by the export industries that cannot compete with the products produced with the advanced technologies in the developed countries. The export industries have advantages of the lower wages and wider access to the raw materials, so the direct investment encourages production that has no foreign counterpart (Shaikh, 1980, p. 229). This is not only correct for the sectors of export

industries, but also domestic production is also supported by the foreign investment due to the low costs and high profits. Modernization of the production techniques by the foreign capital lower the costs and raise the rates of profits, even if the profitability in the underdeveloped capitalist countries were lower than the developed capitalist countries (Shaikh, 1980, p. 229). However, the increase in the supply of the goods will decrease the prices of those goods and the profits of those sectors; eventually, these sectors will be left behind by the foreign capital, and the foreign capitalists will be looking for new sectors for investment. The industries that cannot compete with the cheap imports will not add anything to the national wealth, and the sectors that are profitable for the direct investment will be under the control of the foreign capital. Shaikh (1980, p. 229) says the only policy the underdeveloped countries are able to follow is the protectionism after then. Also, the developed countries find themselves to support protectionist policies for their countries too. This is because the lower costs in the underdeveloped countries are detrimental for the sectors in the developed capitalist countries like it is in the underdeveloped capitalist countries (Shaikh, 1980, p. 229).

6.4. Exchange Rates

In this context, the separation of the regimes of the exchange rates such as fixed and flexible is not reasonable unlike it is accepted in the neoclassical framework. The regimes of exchanges are demonstrated as the mechanisms of purely independent national currencies (Yeager, 1966, p. 104) (Shaikh, 1980, p. 225). However, in the gold standard, for example, there were national currencies that were “independent”, but they were fixed

to the gold, so they float within the strict limitations. Shaikh (1980, p. 225) says that the assumption of purely flexible exchange rates and prices that are determined by the forces of supply and demand is a neoclassical phenomenon. He adds, "Marx's method very much the intrinsic limits of these apparent variations: in the case of prices, these arose from labor-times; in the case of exchange rates, from the existence of the money commodity (as in gold-points)." (1980, p. 225).

Furthermore, Shaikh and Antonopoulos (1998, p. 8) reject the neoclassical model of the exchange rates that premises that all countries will be equally competitive through the automatic price and exchange rate adjustments in the long run. Their position is that the real exchange rates are associated with the real unit costs of tradable products depending upon the productivity real wages. Exchange rates reflect countries' relative international competitive positions measured by their relative real unit labor costs (Shaikh and Antonopoulos, 1998, p. 22). Because they change, increase or decrease over time, the real exchange rates are non-stationary in the long run, and follow the time path of the country's relative unit costs (Shaikh and Antonopoulos, 1998, p. 9).

Also, the relative unit costs change slowly over time, so "the difference between the rate of change of nominal exchange rates and relative national prices must be similarly small", and if there is high rate of inflation, the country's "nominal exchange rate must depreciate at roughly the same rate in order to make the real exchange rate track the trend rate of change in real unit costs" (Shaikh and Antonopoulos, 1998, p. 9).

In addition, according to Shaikh and Antonopoulos (1998, p. 9) balance of trade surpluses of competitively strong countries, based on their cheap exports, and balance of trade deficits of competitively weak countries, based on cheap imports, cannot be

eliminated or balanced through time and trade, because the exchange rates are pinned to the real unit costs. He says, “Any equilibrium in foreign trade will therefore come through the balance of payments, not balance of trade” (Shaikh and Antonopoulos, 1998, p. 9). This means that the trade imbalances must be eliminated and covered by capital flows or direct payments, and currency devaluation cannot offset the imbalances alone (Shaikh and Antonopoulos, 1998, p. 14).

Lastly, Shaikh and Antonopoulos (1995, p. 14 - 15) points out that a change in a country’s competitive position will change its exchange rate, on average, ceteris paribus. When relative costs of production decrease, the prices of exports will also decrease relatively, so its currency will depreciate. Either advancement in productivity (high road) or reduction in real wages (low road) is the way of improving the competitive position of a country. As a result, free trade is beneficiary only for countries that are economically strong enough to be competitive internationally.

6.5. Unemployment

In the Marxian framework, unemployment is inherent to the capitalism. No automatic adjustment can cure the problem of the unemployment. In the capitalist economic system, the capital accumulation, technological advancements, the pressure on the money wages, and the reserve army of labor are the main causes of the unemployment. As a result, unemployment is inevitable in a capitalist society.

There are ways of eliminating unemployment in the Marxian framework. Because I want to keep the scope of this thesis limited to what capitalism offers, I will not discuss Marxist employment policies in detail.

6.6. International Trade and Development Theories

In order to widen the understanding of the international trade and international division of labor theories, here is a brief discussion of four underdevelopment theories from the Marxian tradition. The first theory is the Unequal Exchange from Arghiri Emmanuel. The second is the Dependency Theory, particularly Andre Gunder Frank's approach. The third theory is the Uneven Development, which is mainly driven by Samir Amin. Finally, the last theory is the World System Analysis from Immanuel Wallerstein.

Angotti (1981, p. 126) explains that there are four main perspectives that Dependency Theorists have:

> Nevertheless, there are perhaps four main theoretical perspectives shared to some extent by most dependentistas: (1) the critique of dualism, (2) the core/periphery theory, (3) unequal exchange, and (4) the dependent bourgeoisie.

More or less, each of the four approaches from Emmanuel, Amin, Frank and Wallerstein has these perspectives. However, the weight they give to each depends on the context.

6.6.1. Unequal Exchange

Emmanuel supports the comparative advantage theory of Ricardo's by accepting that it is the relative advantage that matters in the international trade. The problem with Ricardo's theory is that Ricardo explains the nature of trade by focusing on the commodity flows. Emmanuel says that it is the capital flows in addition to the commodity flows that cause unequal exchange and imperialism (Emmanuel, 1972) (Shaikh, 1980, p. 209). The capital flows due to the differences of the rates of profitability between countries, and the profitability is determined by "the abundance of natural resources and the cheapness of wage labor" (Shaikh, 1980, p. 210). However, the main difference between the developed first world countries and underdeveloped third world countries is the wages of labor. Thus, as long as capital moves from the developed countries to the underdeveloped countries, there will be high profits; local capitalists can reinvest and governments can tax and reinvest, and these underdeveloped countries will develop rapidly. There will not be imperialism anymore (Shaikh, 1980, p. 210).

On the other hand, Emmanuel says that this is not likely the case. Capitalists from developed countries are attracted high rates of profit in developed countries; but they are ready to make investments at profit margins that are lower than what the capitalists in underdeveloped countries expect. As a result, foreign capital inflows causes that the prices and profits decrease, and profits are gained and taken by the foreign capitalists. Capital movements from developed countries are reasons for unemployment, stagnation and foreign domination in underdeveloped countries (Emmanuel, 1972, p. 265) (Shaikh, 1980, p. 210).

One of Emmanuel's solutions for the uneven development is to equalize wages between the developed and underdeveloped countries, but Shaikh says that this is not a solution (1980, p. 229). Equalizing the wages cannot solve the problem of unevenness, because this can only equalize the level of exploitation of workers, not anything else; the detrimental consequences are inherent to the capitalism (Shaikh, 1980, p. 230).

6.6.2. The Development of Underdevelopment

When social sciences are not treated as unrelated individual pieces, it affects and makes our understanding of any issue wider. What we guess from the current conditions of countries are that the development of underdeveloped countries does not depend on only policies for the current situation and the future, they also depend on the historical background of those. Andre Gunder Frank understands that economic, social and political history of developed and non-developed countries are very different. Having this perspective helps to understand the current paradigms. Frank has several theses which show that the inequality between developed and non-developed countries depend on the historical facts, monopolistic structure of the economy in the developed countries, and metropolis-satellite relations between and inside these countries.

The first thesis is very much related with the historical facts. Frank suggests that the currently developed countries have never been underdeveloped in the history. They were undeveloped, but not underdeveloped (Frank, 1994, p. 150). However, the underdeveloped countries are historically non-advanced countries and have never reached to the developed stage.

Secondly, he says that it is believed that those countries' own economic, social, political and cultural characteristics or structures produce the current underdeveloped results for them. (Frank, 1994, p. 150) However, he thinks it is important to see that the historical or current economic and political relationships cause these situations. These relationships are globally controlled and regulated. Global forces are originally from the advanced economies and they shape the underdevelopment of underdeveloped economies. Monopolistic structure in the developed countries mostly affects the economic structure of the rest of the world.

Lastly, he criticizes the mainstream recommendations, which find the solution for the progress of non-developed countries in imposing capital and globally approved institutional injections from the developed part of the world. He says that the current effort for development is independent from these genetically modified policies.

He refuses the idea that the heterogeneous income distribution and advancement in the society create a "dualism" in the society in non-developed countries (Frank, 1994, p. 150). This dualism comes about because of the relationships between the underdeveloped countries and the developed countries. The idea of dualism suggests, some part of the society transforms itself as a bourgeois class and has strong relations with the developed countries, while the other part protects its pre-capitalist features and does not transform itself. He suggests that the communication with the outside is held not only by the former, but also by the latter. Frank (1994, p. 151) explains:

> Analogously to the relations between development and underdevelopment on the international level, the contemporary underdeveloped institutions of the so-called backward or feudal domestic areas of an underdeveloped country are no less the product of the single historical process of capitalist development than are the so-called capitalist institutions of the supposedly more progressive areas.

Frank uses the terms “metropolis” and “satellite” in order to refer the two parts of the society. The “diffusion” of the institutions from the developed countries comes through the advanced areas in the non-developed country, which have strong relationships with the developed countries. These advanced areas become the “satellites” of the developed countries, while they are “metropolises” which have “satellites” in their own country. He (Frank, 1994, p.151) explains this by using the Latin American countries as an example:

> Thus these metropolis-satellite relations are not limited to the imperial or international level but penetrate and structure the very economic, political, and social life of the Latin American colonies and countries. Just as the colonial and national capital and its export sector become the satellite of the Iberian (and later of other) metropoles of the world economic system, this satellite immediately becomes a colonial and then a national metropolis with respect to the productive sectors and population of the interior. Furthermore, the provincial capitals, which thus are themselves satellites of the national metropolis -and through the latter of the world metropolis- are in turn provincial centers around which their own local satellites orbit. Thus, a whole chain of constellations of metropoles and satellites relates all pans of the whole system from its metropolitan center in Europe or the United States to the farthest outpost in the Latin American countryside.

This relationship between satellite and metropolis is not because of the desire of helping the underdeveloped countries develop. The idea behind this chain is taking the economic surplus in the former and transporting it to the latter, according to Frank. He suggests that the metropolises in the underdeveloped countries are parts of the exploitation of the ruling classes in the developed countries of the non-developed economies.

> Each national and local metropolis serves to impose and maintain the monopolistic structure and exploitative relationship of this system as long as it serves the interests of the metropoles which take advantage of this global, national, and local structure to promote their own development and the enrichment of their ruling classes. (Frank, 1994, p.152)

As a result of this exploitative chain, the national metropoles of underdeveloped countries do not have a role as the driving force for development. They are satellites of the

metropoles of the developed countries, which are not satellites of any other metropole. In addition, the underdeveloped countries are not the ones who cannot develop, they are left as non-developed by the capitalist system and its dynamics.

6.6.3. Uneven Development: The Origin and Development of Underdevelopment

Samir Amin divides the world into two parts: the core and the periphery. The unequal exchange between them depends upon mostly mobility of capital, which causes that the economy in periphery is dominated by the advanced mode of production in core. He provides nine theses in order to explain his theory of the transition of peripheral capitalist economy. The theses and problems associated with this transition are the focal points here.

For the first thesis, he says that in the periphery, the problem associated with the pre-capitalist transition is not that it is a transition from a pre-capitalist economy to a monetary economy, which is assumed widely. The problem is the difference of the process of this transition in periphery than it is in the central economies. “The economic theory interests itself occasionally in the problems of ‘transition of from a subsistence economy to a money economy.’” In reality, however, the pattern of transition to peripheral capitalism is fundamentally different from that of transition to central capitalism.” (Amin, 1976, p. 200) In peripheral countries, the destruction of the pre-capitalist formations does not bring a more advanced economic system. He says “… the ruin of the crafts without their being replaced by local industrial production” (Amin, 1976, p. 200). What can be understood from this thesis is that he sees the economic advancements in the underdeveloped countries

as the destruction of the pre-capitalist economic system. This does not give any significant results on transformation of the economy, which changes the production methods there into the existing ones in the developed countries. Non-capitalist economic structure is being destroyed by the strong competition abilities of the core.

For the second thesis, he explains three kinds of distortions, which are caused by unequal international specialization. The first distortion is about the export activities. It is suggested that the goods that are exported are not the final hi-tech goods in the periphery. Mostly, goods that are classed as the raw materials or primary goods are exported. In contrary, final hi-tech goods are purchased from central economies. According to Amin, this is not because of the "inadequacy of the home market", it is because of the "superior productivity of the center in all fields" which leads the periphery economies to become the "...complementary supplier of products for the production of which it possesses a natural advantage..." (Amin, 1976, p. 200)

The underdeveloped economies are not able to become more sophisticated or transform to major economic centers worldwide. As complementary goods and services producers, the periphery economies face with the lower wages, and for the same productivity level, the income decreases, because prices of goods that are produced and exported decrease. This is a cause for the unequal trade between the advanced and non-advanced economies.

Another distortion is "the hypertrophy of the tertiary sector in the periphery" (Amin, 1976, p. 200). Because the industrialization cannot be grown a lot, service sector grows much more rapidly. Amin says that in the central economies, this is seen in the difficulties in realizing surplus value, which is "inherent in the advanced monopoly phase".

However, in the periphery, it is the result of the peripheral capitalism and development, which have limitations and contradictions such as inadequate industrialization or increasing unemployment. It is an obstacle for the capital accumulation in the non-developed countries. This can be seen as a chicken-and-egg problem. Capital accumulation is an issue in such peripheral countries; also this itself prevents the capital accumulation there.

The last distortion of the unequal international specialization is that the modern production techniques are applied to the light branches of the activity. It is very different from many already advanced economies, because their economic structure was mostly based on heavy industries, which causes high productivity. This is very much like the previous distortion, so the causes and results are similar.

Amin claims, "The theory of multiplier effects of investment cannot be extended in a mechanical way to the periphery" (Amin, 1976, p. 201). Keynes's theory of multiplier effects is based on "the difficulties of realizing the surplus" and it is not the case in the periphery economies. Amin says that the exporting of the profits of foreign capital creates "leaks" for the multiplier effect. Foreign, multi-national or transnational companies take the surplus value away from the periphery. What is gained does not stay in the economy, so the multiplier effects should not be seen as a force of increasing investments and output.

According to Amin, "the periphery is without economic means of action in relation to the monopolies" (Amin, 1976, p. 201). The non-developed economies fail to integrate the world market because of the limitations of economic activity inside. "Underdevelopment is manifested not in level of production per head, but in certain characteristic structural features that oblige us not to confuse the underdeveloped countries

with the now-advanced countries as they were at an earlier stage of their development." Amin says (Amin, 1976, p. 201).

He explains three features that destroy the claim as the non-developed countries are at the earlier phases of the advancement. One is the distribution of income problem, which is caused by the unevenness of the distribution of the productivities and price dictations from the center. The other is the lack of the transmission of the benefits from economic progress of the advanced economies to the periphery. The last one is that the international specialization is determined and dominated by the benefits of the central economies. If there is an end for the developing progress for the peripheral countries, the nature of the international specialization cannot make the non-developed countries arrive that stage, he claims.

Amin suggests that the process of development of the periphery is not going to result with the development. Efforts to grow will prevent growing, independent from whatever the productivity per head is. "While at the center the capitalist mode of production tends to become exclusive, the same is not true of the periphery." Amin says (Amin, 1976, p. 202). In the periphery, the mode of production is based on the pre-capitalist structure and the imposed capitalist formations at the same time. The political relations and the economic structural dichotomy tend to bring state capitalism to the periphery, according to him. As a result, non-advanced countries tend to become countries that have state-capitalism, which is not the case for the current developed countries.

To sum up, according to Samir Amin, the mode of production in the periphery is in its pre-capitalist stage. Because they are agricultural, exotic, non-advanced goods and services producers, advanced capitalist mode of production in core destroys their pre-

capitalist self-sufficient techniques and structure. Meanwhile, advanced goods and production techniques are exported from the core countries. Capital mobility between core and periphery economies causes unequal exchange because of the higher prices of advanced goods and lower prices of complementary type goods. As a result, the terms of trade are always getting worse for periphery and getting better for core.

6.6.4. The World-Systems Theory

The World-Systems Analysis is more likely to be an approach than a theory. "World-systems analysis was an attempt to combine coherently concern with the unit of analysis, concern with social temporalities, and concern with the barriers that had been erected between different social science disciplines." (Wallerstein, 2004, p. 16)

The world-system is an analysis, which consists of the "world-economies" and "world-empires". It can be understood as it deals with the world as a whole; however, this analysis treats the economies, empires and systems as a world. Immanuel Wallerstein makes a connection between the origins of the social sciences and the methods that are used for understanding the world wider with this analysis. Therefore, this approach is a tool that must be used when trying to comprehend relationships between countries or economies as a global market economy.

According to Wallerstein, there have been firms, individuals and states for a long time, so these are not special institutions for the capitalist economy. What is special for capitalism is the "endless accumulation". Endless accumulation means that "people and firms are accumulating capital in order to accumulate still more capital, a process that is

continual and endless" (Wallerstein, 2004, p. 24). This major aim for individuals and the firms cause the system to be formed as much justified as for endless accumulation. As a result, the structure of the system has to be built for that. Wallerstein says that this structure "eliminates" all other motivations and only supports the major aim called endless accumulation. In order to satisfy this, the world economy has to act as a whole under capitalist structure.

As it can be analyzed by looking at the current conditions, capitalism requires a world that is not unified as a whole. Wallerstein says that the system needs a large market that comes from many smaller states instead of few "world-empires". Wallerstein (2004, p. 24) says:

> Capitalists need a large market (hence mini-systems are too narrow for them) but they also need a multiplicity of states, so that they can gain the advantages of working with states but also can circumvent states hostile to their interests in favor of states friendly to their interests. Only the existence of a multiplicity of states within the overall division of labor assures this possibility.

The world economy, according to Wallerstein, is not based on a homogenous political or cultural structure. It is based on the international division of labor. By this, the capitalist system and its desire of endless capital accumulation are able to find huge areas in order to survive. He says that the capitalist world system requires some institutions such as "markets, states within an interstate system, the households, the classes and the status groups or identities" (Wallerstein, 2004, p. 22).

He analyzes market as where the producers always want to be monopolies to make higher profits. Because the perfect monopolies are more theoretical and it is hard to make them real, Wallerstein says, the producers try to create quasi-monopolies, which can be driven by a strong state force. By inventions and patents, it is very much likely to make

higher profits by higher prices. Other products that are not covered by patents in the market will cause an oligopoly, not a perfect monopoly. Therefore, the higher rates of profits for the producers are always possible.

Other than the patents, there are some more ways to create quasi-monopolies for the developed countries. He points out five other methods (Wallerstein, 2004, p. 26):

- State restrictions on imports and exports,
- State subsidies and tax benefits,
- The ability of strong states to use their muscle to prevent weaker states from creating counter-protectionist measures,
- The role of states as large scale buyers of certain products willing to pay excessive prices,
- Regulations that cause the elimination of smaller producers and the increase the degree of oligopoly.

The quasi-monopolies lose their power and position, when other candidates of the new monopolies enter to the market. One quasi-monopoly stay in the market until the new one shows up, but the period the former one was the only quasi-monopoly gives enough time for the capital accumulation, Wallerstein says.

> When a quasi-monopoly does cease to exist, the large accumulators of capital simply move their capital to new leading products or whole new leading industries. The result is a cycle of leading products. Leading products have moderately short lives, but they are constantly succeeded by other leading industries. Thus the game continues. As for the once-leading industries past their prime, they become more and more "competitive," that is, less and less profitable. We see this pattern in action all the time. (Wallerstein, 2004, p. 27)

Wallerstein defines the world economies by dividing them into two major groups: the core and the periphery, and there is also semi-periphery as a separate group. Two groups of core-like production and periphery production are the results of the international division of labor. The core-like production is what we defined before as the production processes that are led by quasi-monopolies, and there is a high-degree of profitability. Periphery

production has a higher degree of competition and a lower degree of monopolization inherently. As a result, exchange between two sides causes capital accumulation in favor of the core-like production side, and the exchange between two sides is always unequal. He matches the core-production with high-degree of profitability and quasi-monopolies with the states that are strong, because of the patronage system of such states.

He divides the states depending on the production processes there. There are core states with high quasi-monopolistic production style, periphery states that have periphery production style, and semi-periphery states that have some from both of two production styles.

> Core-like processes tend to group themselves in a few states and to constitute the bulk of the production activity in such states. Peripheral processes tend to be scattered among a large number of states and to constitute the bulk of the production activity in these states. Thus, for shorthand purposes we can talk of core states and peripheral states, so long as we remember that we are really talking of a relationship between production processes. Some states have a near even mix of core-like and peripheral products. We may call them semi-peripheral states. They have, as we shall see, special political properties. It is however not meaningful to speak of semi-peripheral production processes. (Wallerstein, 2004, p. 30)

As a conclusion, Wallerstein's World-Systems Theory sees economies as small pieces acting together as a whole global economy. Core-like, periphery and semi-periphery states are the major players of the game instead of large empires. Quasi-monopolies and monopolies trying to be quasi-monopolies help a system that accumulate the capital in the core states uninterruptedly, and leave periphery as underdeveloped.

Both Andre Gunder Frank's The Development of Underdevelopment and Immanuel Wallerstein's The World System Theory are much more based on the monopolistic structure of the economy in the center (or metropolis) than the capital mobility. They underlie the importance of the historical background of central and

peripheral countries. Also, they both suggest that the inequalities in the income distribution or social injustices are not because of the higher classes in the society. These are the results of the economic, social and political relationships between center and periphery, and determined by center's metropolis. In addition, monopolies and quasi-monopolies determine the exploitation levels in the periphery by low wages, taking the surplus from the periphery to the core. Lastly, the stronger quasi-monopolies are causes for the existence of strong countries, so the rank of a country and its situation in the world is determined by the other countries' economic structure as much as itself, and their economic and political relations.

According to Frank, there is an exploitation-chain, which is a result of the metropolis-satellite relations. Wallerstein distinguishes periphery states from core and semi-periphery states and explains the exploitation power of core by its advancements over periphery and semi-periphery. These are results of the existence of multi-national or transnational firms.

Frank and Amin both suggest that for the periphery, it is possible to get rid of the economic dependency of core by stopping having economic, social or political relations with the core (Yarkın, 2008, p. 179-180). Wallerstein says it is not possible to be independent from the core as the periphery, and "... in the world system, there is no core without the periphera and vice versa." (Fitch, 2002, p. 66)

The third split in the development theories is the Underdevelopment theories, which includes the Dependency Theory, the Structuralist Theory and the Neo-Marxist Theories. Underdevelopment theories are lack of class and gender analysis, mobilization of capital is the major decisive factor in their analyses, and they are fetishist (Ercan, 2006, p. 16).

However, they analyze the economic relationships in a way that is different than the previous mainstream or alternative approaches: They include political, social and historical perspectives in order to understand economic conditions truly.

Emmanuel, Frank, Amin and Wallerstein's approaches are characterized under de facto rules of Underdevelopment Theories. All three approaches explain the current conditions of the underdeveloped and developed countries from a wider perspective which credits economic conditions as reasons, political power, social and institutional characters as results, and vice versa as an endless cycle.

CHAPTER 7

CONCLUSION

In the capitalist economic system, most of the countries have open economies and close economic relationships. In such a world, the movements of people, capital and goods and services have a great impact on each country's state of welfare. International exchange is inevitable under current economic conditions, because nearly all countries depend upon foreign resources from the raw materials to the advanced technical production units and from the direct investments to the short-term portfolio movements. However, the outcome of international exchange is a dependent variable; what is beneficiary and what is harmful depends upon how capitalism functions in each country.

Economies of most of the countries are currently functioning under the influence of neoliberal economic and political policies. They are vulnerable to the capital flows, as it is suggested in the Post-Keynesian approach, they are dependent to the developed capitalist economies in production and technology, as it is suggested in the Marxian approach, and there are no domestic employment policies that can protect the economic stability, as it is suggested in the Modern Monetary Theory approach under neoclassical economic attempts of providing prosperity. In addition, a fixed exchange rate system causes extra fragility, closed economic systems cause inefficiency and preserve self-interest of small groups of capitalists, and policies that produce unemployment causes economic instabilities, depressions and late recoveries from depressions.

The refugee crisis and huge human flows across developing and under-developed countries needs to be solved with some employment policies quickly without causing

additional major economic problems. There are ways to eliminate unemployment, and the outcomes of such economic policies are even not inflationary and do not bring instability or depression. Especially under current conditions of huge human flow from the under-developed world to the western countries, the job creation or buffer stock employment programs supported by Mosler (1998), Wray (1998, 1999), Forstater (1999) and Mitchell (1999) such as the Employer of Last Resort (ELR), Job Guarantee, Public Service Employment, or Buffer Stock Employment suggest methods and procedures in order to reduce and cut off the unemployment. These job creation programs are not only dedicated to economies where business cycles are caused by the internal conditions, but also they are eligible to be employed where unexpected unfavorable external economic outcomes are possible.

In the time of a huge need of new jobs, a job creation program can be the solution. It can be implemented very quickly without creating additional problems, and the fruits can be collected in a few years. Also, it is better for the governments to intervene than doing nothing and leaving the peoples escaping from wars to be obliged to scratch a living and pay. Then, open economies without strict trade restrictions and flexible exchange rate regimes can be beneficiary all around the world. A stimulus to the domestic total demand with full employment policies will help diminish the effort of the capital to find new investment opportunities abroad, and the resources can be used efficiently.

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VITA

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After working as a research assistant in the Department of Economics at Balikesir University for almost two years, she received a graduate studies scholarship from Turkish Ministry of Education, which allowed her to continue her studies in Economics in the USA. She spent 6 months at the School of Foreign Languages at Marmara University and almost a year at the ELS Language School in Boston in order to improve her English language skills for academic purposes.

In January 2014, she started her graduate education in the Department of Economics at the University of Missouri - Kansas City. She was graduated and awarded the Master of Arts degree in Economics in December, 2015.