Secular stagnation, the exchange rate and cheap labor

An exchange between Paul Davidson and Luiz Carlos Bresser-Pereira

From Luiz Carlos Bresser-Pereira 27.11.2013

Dear Paul

What do you think of Krugman's comments on Larry Summers' secular stagnation hypothesis? I don't have Summers' presentation, but Krugman's article is attached.

Warm regards,

Luiz Carlos

From Paul Davidson, December 1, 2013

In response to your query on Krugman's comments on Summers and secular stagnation I think both Summers and Krugman are myopic for they are basically arguing what causes a lack of effective demand in a CLOSED economy.

The answer to today's national shortage of effective demand in many nations is that most economies are OPEN and therefore at the mercy of international trade imbalances-- and the desire to maintain stimulate effective demand through export led growth. Little was made of this problem when Hansen wrote his secular stagnation thesis in the 1930s -- but Keynes was worried about this problem lowering effective demand in the UK as early as the 1920s.

In the 1920s the UK had double-digit unemployment in every year except one. The US , on the other hand , had prosperity ("The Roaring Twenties") until 1929 and then the Great Depression. The Roaring Twenties was fed by a real estate bubble and a stock market bubble both of which burst at the end of the 1920s.-- So this may seem to support Summers! But I think the problem is deeper -- as in open economies when much of the labor force is employed in mass production industries -- foreign "competition can lead to falling or at least a lack of effective demand. Yet free trade is supported by almost all economists based on universality of the law of comparative advantage!

As I point out in chapter 7 of my book THE KEYNES SOLUTION:

In mass production industries..." differences in production costs are less likely to reflect differences due to nature's climatic or mineral endowment associated with any particular nation, as the same technology is used in production of any specific product in any nation.

Keynes [1933 p. 238] recognized this possibility when he wrote

> “A considerable degree of international specialization is necessary in a rational world in all cases where it is indicated by wide differences in climate, natural resources.... But over an increasingly wide range of industrial products... I become doubtful whether the economic costs of self-sufficiency is great enough to outweigh the other advantage of gradually bringing the producer and the consumer within the same ambit of the same national economic and financial organisations [to assure full employment]. Experience accumulates to prove that most modern mass production processes can be performed in most countries and climates with equal efficiency.”

In other words, Keynes was arguing for more domestic effective demand from domestic income earners, Keynes was also arguing, and today’s facts tend to demonstrate that, given the existence of multinational firms and the ease with which they can transfer technology internationally, any differences in relative costs of production in most industries is more likely to reflect national differences in money wages (per same hour of “real” human labor) plus the costs of providing "civilized" working conditions such as limiting the use of child labor, plus the costs to the enterprise of workers’s fringe benefits such as providing health insurance and pension benefits for employees, etc. In other words, in today’s free trade system the global location of industrial export factories are more likely to reflect differences in hourly money wages, occupational safety and other labor expenses that the enterprise must bear, than real costs associated with either national differences in climate or difference in the availability of natural resources.

In the 21st century, low transportation and/or communication costs make it possible to delivery many goods and services cheaply to distant foreign markets. Consequently, mass production industries that use low skilled workers , semi-skilled workers, or even high skilled workers are likely to locate factories in those nations where the economic system values human life the lowest, at least as measured by the wage paid per hour of labor and the work environment provided by entrepreneurs. Most developed nations long ago, passed legislation that made "sweatshop" production and the use of child labor illegal. Yet such conditions typically still exist in the "competitive" export industries of most less developed nations. Consequently, free trade competition usually implies that in developed nations there will be a loss of jobs to workers in nations that have large populations of cheap available labor, working in "sweatshops", with little legislation requiring safe and healthy working conditions. The result of such free trade competitive forces must inevitably lower the standard of living of the workers in the developed nations towards the wages paid in low wage countries such as China. Do we really want to reduce American workers to a wage of perhaps something less than a dollar per hour and simultaneously permit American children to work in the factories so that the family can earn enough to avoid starvation?

If we permitted China to build a factory in California and operate it as the factory would be operated in China with

(1) children under 14 years old working in the factory,

(2) no occupational safety conditions,

(3) workers on the job for 55to 60 or more hours a week, at a money wage rate significantly less than the government mandated minimum hourly wage in the United States, and

(4) the factory polluting the environment,

then the civilized laws of the United States would not permit any resident of the United States to buy any products from this California based Chinese factory. Nevertheless, under the banner of free trade, we permit Americans to buy products from such an uncivilized and unhealthy factory environment just because the factory is located in China.

Why should we abandon our belief in the social desirability of a factory system that treats workers in a humane and civilized manner? Obviously if we permitted American entrepreneurs to hire workers under the same conditions that Chinese workers are employed, then the resulting American factories could undersell the factories located in China if only because the cost of transportation from the factory to the American market would be lower for such American sweatshops.

Under current conditions, free trade with low wage nations such as China is not free competitive trade at all since American law ties the American entrepreneurs's hands behind their back by preventing them to match Chinese labor hiring conditions.

The Keynes Solution to outsourcing jobs to such unfair competitive factories would be to prohibit imports being brought in from any factory that did not, at least, meet the conditions of our labor laws and produce goods that would pass government inspection under the Pure Food and Drug Act and any other consumer protection laws.

.... If, however, we continue to permit, under the banner of free trade, the outsourcing of mass production jobs then there is bound to be a growing number of displaced workers from previously high paying mass production industries in developed nations, looking for employment opportunities. Consequently there will be increased competition for the existing service jobs in nontradeable production industries by these displaced workers The result will be to depress wages in these nontradeable American production activities [See Uchitelle, 2006], or at least prevent the wage of employed workers from rising significantly over time. Given the large volume of outsourcing that has occurred in recent years, it is, therefore , no wonder that the share of wages in U.S. GDP was, by 2005, at its lowest level in decades.

As we crossed the threshold into the twenty-first century, Keynes's analytical framework indicated that the argument for free international trade as a means of promoting the wealth of all nations and their inhabitants can not be rationalized on the basis of Ricardo's law of comparative advantage -- except perhaps for minerals, agriculture and other industries where productivity is related to climatic conditions or mineral availability. Production in these climate and natural resource related industries, however, is typically controlled by the market power of cartels and/or producer nations's governmental policies designed to prevent market prices from falling sufficiently to reflect the "real" costs of production. In other words, industries for which the law of comparative advantage might still be applicable are often largely sheltered from international competitive forces by the exercise of cartel power (e.g., the Organization of Petroleum Exporting Countries [OPEC]) or government power to control supplies sold on international markets.

The growth of multinational corporations in mass production industries and the movement towards a more liberalized free trade in the final decades of the twentieth century encouraged business enterprises to "outsource" production, i.e., to search for the lowest wage foreign workers available in order to reduce production costs. The availability of "outsourcing" also acted as a countervailing power to high cost labor union organized domestic workers in developed countries. Indeed in the early years of the 21st century, the rapidly developing industrial structure of many nations (e.g., China, India, Southeast Asia) can be largely attributed to the competitive search by multinational firms to rid themselves of union problems by utilizing low wage foreign workers to compete with organized high wage workers in developed nations to produce the identical goods and services under the same technological production processes.....

In the early decades after the second world war when transportation and communication costs between nations was large and there were significant restrictions on trade, high domestic unit labor costs acted as a spur to encourage entrepreneurs in mass production industries to search for innovative ways to improve domestic productivity and thereby reduce labor costs per unit of output. With the growth of multinationals and the removal of many restrictions on the international trading of mass produced manufactured goods, high domestic labor costs now encourages practices such as outsourcing, rather than productivity enhancing investments to lower unit production costs. Under current conditions, it is cheaper to outsource using existing technical production processes then incur the higher cost of searching for technological improvements in production process to reduce unit production costs domestically. Accordingly the higher profits from outsourcing have not been plowed back into research and technological development of domestic production techniques . Nevertheless in the past, it has been technological innovations by entrepreneurs looking to increase output and profitable sales while lowering the unit labor costs that has`raised living standards for all members of the capitalist economy.

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Thus: Capitalist animal spirits for investment domestically in most developed economies are reduced so much that even at a zero interest rate there is very little investment!! So much for Krugman's liquidity trap -- it has been caused by outsourcing in my view..

Keyes was well aware of this problem as he indicates in his last chapter of the General Theory where he notes that international trade has become a tool to become more competitive at the cost of your trading partner. And in his Keynes Plan at Bretton Woods, he also recognized this trade problem. I have revised the Keynes Plan for the 21 century with my INTERNATIONAL MONETARY CLEARING UNION proposal but no government has taken it very seriously as yet. [Although China is beginning to see the problem with relying on exports for growth and is beginning to worry about how to expand domestic demand instead of export demand! In October 2013 I was invited by Beijing University to give a series of lectures on this problem -- and at least I got academics there interested.

Under the rules of free trade today, there is less of an incentive for managers to pursue innovations to improve domestic labor productivity in any industrial sectors where inexpensive foreign labor can "do the job" and transportation and/or communication costs are small relative to production costs. The decline in the rate of growth of domestic labor productivity in many developed nations since the 1970's can be, at least partly, related to this phenomena of emphasizing the use of cheap foreign labor vis-a-vis the search for domestic production process improvements by the private sector.

Thus we have growing inequality as well!!: with the hollowing out of the middle class causing a further lack of effective demand.

I hope this make some sense and I would be very interested in your reaction to my comments

Paul

From Luiz Carlos Bresser-Pereira, December 2

Dear Paul,

Thanks for your response. I have the same opinion that free trade and globalization eventually benefited countries like China that were able to keep their exchange rates competitive, and counted with low paid and low protected workers. Latin American countries, like Brazil, were unable to keep their exchange rates competitive, were unable to neutralize the tendency to the cyclical and chronic over-valuation of the exchange rate that exists in developing countries. This is my central thesis in the book "Globalization and Competition". Now I am finishing, with the cooperation of José Luis Oreiro and Nelson Marconi, a book that will be called "Developmental Macroeconomics", where we make more systematic these ideas and some new ones, particularly the one on the value of the exchange rate and its relation with the Dutch disease.

What I really don't know is how rich countries like the US can overcome the competition coming from cheap labor. For long economists and policymakers thought that the superior productivity of the US would cope with the problem, but this is not true. The only solution that I can devise is a combination of Keynesian and developmental strategies, which stimulate demand and productivity. But I know that this is a half solution.

I attach my recent paper on the value of the exchange rate and the Dutch disease.

Warm regards,

Luiz Carlos