Chapter 4 explored the role of debt and financial market exuberance in the business cycle. Chapter 8 extended the analysis of cycles to incorporate the idea of a financial super-cycle that operates over several business cycles. This chapter further extends the time period of analysis to the long-run growth effects of financialization, particularly increased inside (that is, private sector) debt.¹

The issue of growth is examined in a neo-Kaleckian framework. That framework connects the analysis with Chapter 3 which used a short-run neo-Kaleckian macro model. Chapter 3 explored financialization using a stages of development approach in which each stage corresponded to a short-run period with different institutional characteristics. This chapter uses a dynamic version of the neo-Kaleckian model that focuses on the rate of growth rather than the level of output.

The foundation of the neo-Kaleckian framework is the model of economic growth developed by such authors as Rowthorn (1982), Taylor (1983) and Dutt (1984, 1990). In these models growth is determined by the rate of capital accumulation which depends on the profit rate and the rate of capacity utilization. That core model is then supplemented by a model of income distribution in which the profit share and rate of profit depend on the rate of capacity utilization (Lavoie, 1995).

This chapter augments the core neo-Kaleckian growth model to incorporate the effects on growth of interest transfer payments between debtor and creditor units. This adds another dimension to the burgeoning

This chapter is a significantly revised version of an essay titled “Inside debt and economic growth: a neo-Kaleckian analysis that was published in The Alternative Handbook of Growth Economics, Mark Setterfield (ed.), Cheltenham: Edward Elgar, 2010.
literature on “financialization” that argues changes in the financial system over last 25 years may have lowered growth (Hein and Van Treeck, 2007; Skott and Ryoo, 2008; Stockhammer, 2004). The existing financialization literature tends to focus on the growth effects of an increased profit share and higher asset prices, whereas the current chapter focuses on the growth effect of higher indebtedness. The effect of debt on growth operates primarily through its impact on saving, which in turn affects capacity utilization and the profit rate. These latter two variables then impact investment and thereby affect growth.

The chapter is structured as follows. Sections 9.1 and 9.2 examine an economy with consumer debt issued through a bond market. Section 9.3 examines an economy with consumer debt financed by an endogenous money banking system. Section 9.4 examines an economy with corporate debt financed by an endogenous money banking system. Section 9.5 concludes the chapter. One major take-away is that intuitions derived from short-run macroeconomics can be misleading for growth theory. Thus, in short-run macro models higher inside debt levels lower economic activity but in a growth context higher debt can theoretically raise growth rates.

9.1 A growth model with bond market consumer debt

The first model to be considered is an economy in which there is consumer debt provided through a bond market in which debtor households borrow from creditor households. The bond market therefore transfers claims on income from creditors to debtors.

The model that is developed is related to one presented by Dutt (2006). However, Dutt’s analysis is conducted under conditions of a fixed income distribution whereas the current model has an endogenous income distribution that is affected by the level of debt. The model also includes wage bill division effects and a stock market wealth effect.

The equations of the short-run static macro model are:

\[ Y = C + I \]  \hspace{1cm} (1)
\[ C = C_D + C_C \]  \hspace{1cm} (2)
\[ C_D = z[1 - \varphi]Y - iD + B \quad 0 < \varphi < 1; 0 < z < 1 \]  \hspace{1cm} (3)
\[ C_C = \gamma_1[(1 - z)[1 - \varphi]Y + \varphi Y + iD - B] + \gamma_2 V \quad 0 < \gamma_1 < 1, 0 < \gamma_2 < 1 \]  \hspace{1cm} (4)
\[ V = qE \]  \hspace{1cm} (5)
\[ q = e\varphi Y/E \quad e > 0 \]  \hspace{1cm} (6)