

This is the Accepted Version of Toporowski, J. 'A Kalecki Fable on Debt and the Monetary Transmission Mechanism' *Review of Keynesian Economics* 4 (2), 224-228. Published by Edward Elgar. Available at: [10.4337/roke.2016.02.08](https://doi.org/10.4337/roke.2016.02.08)

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## A Kalecki Fable on Debt and the Monetary Transmission Mechanism

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### Abstract

Kalecki explained debt resolution by means of a fable about monetary circulation between mutually indebted individuals. This Note explains the context and some of theoretical implications of the fable. These point to an asymmetry in monetary policy in which excessively tight monetary policy may restrict economic activity and force resort to informal debt.

**Keywords:** Kalecki, Keynes, monetary policy, debt.

**JEL classification:** B26, E12, E52, H63, N24

Kalecki would occasionally tell stories illustrating the paradoxical, even irrational, aspects of capitalism. Perhaps best-known is his tale of two railway lines in competition with each other and suffering from excess capacity, whose only long-term solution is the construction of successively further railway lines to ensure full capacity utilisation on railway lines already built (Kalecki 1933).

In the course of an exchange of views on the Greek crisis with Kalecki's student, Kazimierz Łaski, I passed on to him a fable of private debts in a Greek village being cleared through the circulation of a €100 note brought to the village by a German tourist, and returned to him at the end of the story. Łaski pointed out that the story was much older and had in fact been originally told to him by Kalecki when the two men were working together in the 1960s. I was able to reconstruct Kalecki's story from the fragments remembered by Łaski, adding to it my own explanatory remarks, to make the story comprehensible to the twenty-first century reader. The story is presented in the next section. Its significance is then discussed in a separate section leading up to conclusions about Kalecki's monetary theory that are relevant today.

### 1. Kalecki's Fable

Following the death, in 1935, of the Polish military dictator Józef Piłsudski his regime continued under a group of his military cronies, known as the 'colonels', who increasingly modelled their regime on that of Mussolini in Italy. One of the colonels, who was responsible

for economic development, wanted to understand the economic principles behind government stabilisation<sup>1</sup>. He called in Kalecki's colleague from the Institute for the Study of Business Cycles and Prices (*Instytut Badań Konjunktur Gospodarczych i Cen*) Ludwik Landau, to explain the principles behind the 'new economics'. Landau had just been fired from the Institute and was now working then at the national statistical office, Główny Urząd Statystyczny (see Kalecki 1964, and Landau 1957).

Landau explained at length the principles of effective demand and credit cycles underlying levels of output and employment at any one time. The colonel had evident difficulty in grasping this. In a final effort to break through the colonel's incomprehension, Landau told the following story:

'In an impoverished Jewish shtetl in Eastern Poland, whose residents were mired in debt and living on credit, a wealthy and pious Jew arrived one day and checked into the local inn, taking care to pay his hotel bill in advance. On Friday, to avoid breaking the Sabbath injunction against carrying money, he handed over to the inn-keeper for safe-keeping a \$100 note<sup>2</sup>. Early on Sunday, the wealthy and pious Jew left the inn before the inn-keeper had had a chance to return the banknote.

After a few days, the inn-keeper decided that the wealthy Jew was not going to return. So he took the \$100 note and used it to clear his debt with the local butcher. The butcher was delighted and gave the note for safe-keeping to his wife. She used it to clear her debts with a local seamstress who made up dresses for her. The seamstress was delighted, and took the money to repay her rent arrears with her landlord. The landlord was pleased to get his rent at last and gave the money to pay his mistress, who had been giving him her favours without any return for far too long. The mistress was pleased because she could now use the note to clear off her debt at the local inn where she occasionally rented rooms.

So it was that the bank-note finally returned to the inn-keeper. Although no new trade or production had occurred, nor any income been created, the debts in the shtetl had been cleared, and everyone looked forward to the future with renewed optimism.

A couple of weeks later, the wealthy and pious Jew returned to the inn, and the inn-keeper was able to return to him his \$100 note. To his amazement and dismay, the wealthy Jew took the note, set fire to it at the paraffin lamp that was on the table, and used it to light his

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<sup>1</sup> Kazimierz Łaski thinks it may have been Roman Górecki (1889-1946), a lawyer who had joined Piłsudski's 'Legion', a militia formed to fight along-side the Austrian army in 1914. By 1926, just before Piłsudski's

Experiments of every kind have been avoided, particularly the experiment of artificial "manipulation of business conditions," in the belief that only by means of simple, classic, orthodox methods can positive results be achieved.' (Górecki 1935 p. 17).

Górecki was Minister of Trade and Industry in the Polish Government from October 1935 to May 1936.

<sup>2</sup> The Polish currency, the zloty, had been placed on a dollar standard in 1934 at a rate of zł.5.26 to the US\$. Efforts to maintain this parity included a restriction on the issue of banknotes. Hence the widespread use of informal credit and debt. The Polish writer Stefan Themerson related to the author how, faced with a shortage of banknotes and bank credit, Themerson's publisher in the 1930s Gebethner and Wolff had offered Themerson a wagon-load of coal in payment for royalties. Themerson refused this payment, and they finally agreed that Themerson would receive as payment a stay in a hotel in the Polish mountain resort of Zakopane, where the publisher had credit.

cigarette. On seeing the inn-keeper's dismay the wealthy Jew laughed and told him that the banknote was forged anyway.'

Landau finished his story and waited for understanding to seize the colonel. Beads of sweat appeared on the colonel's forehead, from the intellectual effort at comprehension. Finally, when he thought he had stumbled on the explanation, the colonel exclaimed: 'Ah, I knew from the very beginning that there was something wrong with that Jew. Of course, the money was forged!'

Kalecki's conclusion from this was that unfortunately too many people think like the colonel, and very few people understand the story as we do.

## 2. Kalecki and the monetary transmission mechanism

Kalecki may have been reporting a real-life incident. More likely the story was apocryphal, as indicated by the stylised characters in the story, the intellectually-challenged colonel, the wealthy and pious Jew and the philandering landlord. But Kalecki may also have been inspired by real events that happened in his lifetime. In 1925, a Portuguese adventurer, Arturo Virgilio Alves Reis (1898-1955) perpetrated one of the greatest frauds in banking history. At the time the Portuguese government and its central bank, the Banco de Portugal, were following a strictly deflationary policy in order to support the foreign exchange value of the Portuguese *escudo*. The escudo had been in difficulties for over three decades after depreciating against its gold parity in the wake of the Baring crisis of 1891. After the First World War, the Portuguese government attempted to stabilise the exchange rate by balancing its budget. The resulting parsimony in public investment depressed the economy while the central bank restricted its note issue to maintain a scarcity value of the notes. In this situation Reis placed a forged order for banknotes with the suppliers of Portuguese banknotes, the London firm Waterlow. He used the notes to establish a development bank in Angola and engineered an economic boom in Portugal, forcing down the exchange rate of the escudo. When the forgeries were uncovered, Reis was arrested amid widespread popular support for the man who was revitalising the stagnant economy. Reis was sentenced to 30 years in prison and the following year the civilian government succumbed to a military coup. Waterlow eventually lost the case brought against it in London by the Portuguese Government and was taken over by its rival De La Rue. The Portuguese economy did not recover until the Second World War<sup>3</sup>.

The inter-war period was full of frauds and dealers in debt. Kalecki was aware of them through his economic journalism in the 1920s. One of them, in particular, he commented upon. This was Ivar Krueger, whose Swedish Match Trust came to control 75% of the world's production of matches, including a monopoly position in Portugal (Kalecki 1928). Krueger also conducted a lucrative business in buying government debt. In March 1932, the London business journal *The Economist* uncovered irregularities in Krueger's accounts. He checked into a Paris hotel and shot himself through the heart. Unlike Keynes, who had lunched with Krueger and regarded him as a victim of 'beastly' American bankers and their liquidity preference, Kalecki merely observed that 'the functioning of capitalism depends not

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<sup>3</sup> I am grateful to Arturo O'Connell for referring me to the case of Reis. The story of the fraud is told in Bloom 1967.

on the nature of individual foremen who control its mechanisms but on the structure of those mechanisms' (Toporowski 2013, p.22).

Fraudulent trading in debt is also the common journalistic and literary interpretation of such operations. For example, Krueger appears as the financial manipulator Erik Krogh in Graham Greene's novel *England Made Me*, published shortly after Krueger's death. Such trading of debts appears, for example, as the periodic injection of cash by the gambling club-owner Herr Vossner to clear his member's IOUs in Anthony Trollope's 1875 novel *The Way We Live Now* (the money being returned to Vossner as his patrons settled their debts to him). But there is more to the Kalecki fable, and its real-life counterpart than mere fraud. As he pointed out, it was the stupid colonel who thought that it was just fraud. We are supposed to know better.

The context created by Kalecki is not a liquidity trap, since none of the indebted people in the story actually have or accumulate any money. Nor does it conform to the format of the standard 'monetary circuit', since no production takes place in the story. The context is perhaps closer to what Ralph Hawtrey called 'credit deadlock', or what Irving Fisher called 'debt deflation', a situation in which economic activity is frustrated by excessive debt which makes firms unwilling to borrow even at low interest rates. Hawtrey had recommended that 'a credit deadlock which is impervious to cheap money may (thus) yield to treatment of through open market purchases of securities' by the central bank. Such operations would make banks more liquid and therefore more inclined to lend.' (Hawtrey 1938, p. 256). This kind of monetary policy is what Keynes is commonly referred to as describing as 'pushing on a piece of string'.

The theoretical concept that describes the context most closely is Steindl's '*enforced indebtedness*', the indebtedness that arises when income falls short of necessary expenditure and there are no savings to fall back on (Steindl 1988). But Kalecki's point in the story is that there is debt beyond the banking system. There are no financial intermediaries in his story. He had elsewhere described informal debt as the alternative to welfare provision that prevents consumption from rising when wages or employment increase (Toporowski, 2013, p. 73). In his fable, debt needs monetary circulation through the circle of inter-locking, deadlocked, indebted balance sheets for debt to be cleared so that credit-financed activity may restart.

### 3. Conclusion

The endogeneity of the money supply is a feature of credit operations in a capitalist economy. However, Kalecki's fable indicates the limitations of such endogeneity. In the first place, while larger firms and even some households with substantial assets may have little difficulty in securing credit as required, there exist on the margins of the capitalist economy those small firms and poorer households that need monetary circulation, even fraudulent monetary circulation of whatever is accepted as means of settlement of debts, to manage their debts. Secondly, even at the level of governments and corporations with access to the full range of credit facilities, monetary circulation in the debt system is necessary to manage and refinance debt. The real target of Kalecki's ridicule are policy-makers who attribute the value of money to its scarcity. An excessively tight monetary policy can depress economic activity because such a policy may restrict debt operations. But this does not mean that a loose monetary policy can stimulate such activity.

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