

**ROCKY ROAD TO REFORM: LESSONS FOR INDIA
STRUCTURALIST APPROACHES TO
MACROECONOMICS AND DEVELOPMENT
ECONOMICS**

**By
DR. LANCE TAYLOR
Seminar and Discussion on 23 April 1994**

**AT
GOKHALE INSTITUTE OF POLITICS AND ECONOMICS
(DEEMED TO BE A UNIVERSITY)
PUNE 411 004**

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Thank you very much for the very kind introduction on the part of both the introducers.

I suppose , I will try to be provocative. - try to provoke some discussion about the question of economic reform in India and also elsewhere in the world. An alternative title of the talk could be economic reform in India and elsewhere or perhaps it should be elsewhere and India ; because what I want to do is try to give some background about the economic reforms debate for developing countries and then give a few country examples of how a particular kind of reform package has worked, then give some counter examples and finally make a few observations about India. I think, it is probably worthwhile to begin with some background about the discussion regarding economic reform in developing countries, especially seen from the United States and, in particular, from those institutions in the United States that dominate or play a major role in the discussion all over the world, that is, the Bretton Woods institutions like the World Bank and the International Monetary Fund. They and the

other actors in Washington DC area in the late '80s arrived at the doctrine which has come to be called the 'Washington Consensus' which sets out the rules that the developing countries are supposed to follow in terms of economic reform. I would like to begin with some observations about the forces which caused the Washington Consensus to appear. I think, the relevant background really has to do with the emergence of a general trend towards neo-liberal economic policy making worldwide that has been growing in strength over the past one or two decades. What do I mean by liberal? Usage of the word, of course, will be the European usage meaning that the State should withdraw and not be terribly active in economy. It is in part a state versus market debate with markets getting precedence in Washington Consensus. There are some reasons why this debate may turn in the other direction in the not too distant future. This liberal trend, again in the North-in the industrialised world - certainly gained strength throughout, the '80s and '90s. There are several reasons why that happened. One, quite obvious for the United States is that since the early '70s there has essentially been no per capita income growth. The income instead has basically stagnated in the United States for almost 25 years, the real wage has fallen, the income distribution has got worse and certainly there has been growth of malaise if you like, as a consequence of these economic trends. May be, this is just a Kondrateif cycle and per capita income growth will once again turn up. May be, this is not true. Secondly, even in the United States and certainly in Europe, the project of building the welfare state more or less completed itself by 1970 or 1975 so that by each country's social stand-

ards, and I must say, social standards even in the United States were lamentably low, but by each country's standards, these days there is access to health care, access to pensions. The momentum that was generated by growth of provision of these services has now disappeared and the only thing left is to deal with the bureaucracy which is not necessarily a very satisfying experience even if you get health care as a consequence.

So, slow growth and the end of the construction of the welfare state combined with the general conservatism of the economics profession. In the United States, the people who are now leaving the scene - the Samuelsons, the Solows and the Tobins - actually grew up in the depression and entered economics because they wanted to make the world a better place or at least not have depressions any more. That generation was succeeded by another generation of young Tories who seem mostly interested in arguing that market has its strengths and we should respect the market. This sort of generally conservative line of the economics profession combined with lack of growth basically, I think, underwrote the ideology of the very able conservative politicians who took power in the 1980's, i.e. Reagan and Thatcher, and sort of helped build neo-liberalism into the intellectual and institutional framework. One can think of other factors. Certainly the power of finance capital has grown substantially over the past 25 years, putting pressure on the banking systems and policy makers to respect the prerequisites by financiers as opposed to the prerequisites of people who would like to produce commodities and this has certainly contributed to the liberalisation of capital

markets. Then finally, the failure of socialist, or if you prefer, pseudo-socialist regimes in USSR and Eastern Europe have also given strength to the neo-liberal cause. All this has come to the fore as far as developing countries are concerned, in the creation and ratification of the so called "Washington Consensus", which phrase was first used by John Williamson in about 1989 or '90 and it still retains a good deal of strength in the thinking about what the developing countries should do to reform their economies. In particular, these "economic reforms" basically are supposed to have a certain structure according to the doctrines of the Washington Consensus. First, there should be stabilisation of the economy, and what is meant by stabilisation is essentially application of a policy package that was designed almost 40 years ago by the International Monetary Fund and which is still applied quite consistently by that institution when it is asked by a developing country for a line of credit in response for conditions on that country's economic policy. The typical elements of stabilisation are austerity, i.e. fiscal austerity, meaning that the public sector borrowing requirements should be reduced, often by cutting back on public investment and on social services. There has to be monitored austerity in the sense that the remaining fiscal deficit should not be monetised, interest rates should be increased, etc. There should be devaluation, the local currency should be weakened to the extent possible, which is supposed to promote export growth and cut back imports. There may well be other relative price shifts as part of the package - most typically real wage reduction, perhaps shifts in terms of trade between agriculture and industry. All these relative price

changes plus the economic contraction that the policy almost always entails, will create shifts in the income distribution. Basically, these distributional changes are thought to be a natural counterpart of the stabilisation attempt. This policy package is often successful in creating a recession. The recession may well improve balance of payments, possibly may or possibly may not affect the inflation rate. In so far as the IMF targets on supportable trade deficit, the package works. One of the problems would be the recession may prolong itself which gives rise to standard accusations that the Fund engages in something which is sometimes called overkill. The adjustment element of the policy package - the Washington Consensus package - essentially says that it is desirable to create allocative efficiency in the economy. What I mean by allocative efficiency is the removal of all wedges between prices for the same good or commodity in different markets. This will have various implications. For example, there may be a producer or consumer good subsidy and then the subsidy driving a wedge between producer price and consumer price of the good and you will not have allocative efficiency as long as that wedge persists. Or, if there are foreign trade interventions, tariffs, import quotas, they create wedges between the relative prices of these goods in the international market and relative prices of these goods in the home market and these too should be removed. If the government or nationalised banking system is in the business of providing cheap credit to certain enterprises, (certainly the case in Korea for many decades) this targetted cheap credit represents a wedge

between cost of borrowing for these enterprises and the enterprises elsewhere in the economy. That too is an example of allocative inefficiency. Suppose we get rid of these price distortions, suppose we get the prices right, what happens? There are two kinds of stories that standard economic theory has produced in this regard. One is that achieving allocative efficiency is supposed to lead to productive efficiency. If you have allocative efficiency, the standard theorems of neo-classical economics that under standard assumptions, which are rather strong, tell you that getting allocative efficiency means that since you go to the economic productive efficiency point, you will be producing as much as you possibly can. There is really no empirical evidence in favour of this proposition. It is our prior. Usually the empirical evidence provided is that if you raise a certain agricultural price against another agricultural price, then you get a switch in crop mix or something like that. But at an economy wide level, it is more of an assertion than something that can be demonstrated. Moreover, if you do the calculations, using standard neo-classical models, the gains from attaining allocative efficiency in terms of productive efficiency will be usually small and you wonder why they put so much effort into it. The other reason is essentially that although the theorems do not support it, the assertion is that achieving allocative efficiency will somehow jump the economy on the path of growth where productivity growth was substantially higher than it was before and therefore your overall growth rate will increase. But that is more an act of faith or a statement of faith than something that can easily be demonstrated. Perhaps there is some historical

evidence against this which I will discuss. Secondly, there is notion that when the government intervenes in the economy, it does create room for rents. That is, if I am speeding down the highway and the traffic policeman pulls me over, threatens to give me a ticket, that obviously creates the possibility of a rent for the traffic policeman. He is intervening in the market in a way threatening a fine. Since an import licence allows the owner of quota right to import goods through the world market cheaply and sell in the home economy at a higher price, there is rent involved for the holder of the import licence. This rent is supposed to generate activity called rent seeking and people are supposed to put a lot of efforts into rent seeking to the detriment of overall economic activity. Therefore, if the State withdraws from the economy, there will be fewer rents and economic efficiency will be heightened. Certainly, there is an element of rent creation in any state activity. On the other hand, there is also rent creation amply generated by the private sector through monopoly positions and divide and rule tactics, applied in the labour markets by firms, and dumping. So, the private sector also obviously generates its own rents but somehow these are neglected in the standard discussion. In any case, either because of the alleged gains in allocative and productive efficiency and/or because withdrawal of state will reduce rents, then the Washington Consensus argues very strongly in favour of market liberalisation which has a number of aspects. One is financial market liberalisation, i.e. rates of returns across different financial activities should be equalised subject to risk. That means,

basically no more subsidised credit. Taxes should be reduced and rationalised. There should be trade liberalisation. Quotas should be replaced by tariffs, tariffs should then be reduced. May be there should be capital account liberalisation to facilitate flows of portfolio and direct foreign investment. Liberalisation of foreign trade should ideally take place, - liberalisation of both foreign trade and foreign capital movement should take place in a regime of weak exchange rates. The labour market should be deregulated. There should be privatisation, the notion being that public enterprises are intrinsically less efficient than private enterprises and therefore if we privatise public enterprises, once again we will get efficiency gain. More often than not, privatisation may bring stabilisation as I will discuss in a minute. Privatisation may also essentially be a fiscal exercise, i.e. if you cut taxes, often there are problems of interest rate on public debt and privatisation is often a recourse to make your fiscal accounts better, at least for a couple of years.

There are at least two questions that one can ask about the effects for the results of this kind of intervention, application of this kind of package. The first question is : Has something like a market friendly adjustment - a stabilisation cum adjustment package-been characteristic of "successful economies"? That is, you can go around the world and point to certain countries and say, on an average, these guys have been doing pretty well. Have they applied the Washington Consensus package? The other question is that where it has been applied, has the Washington Consensus package been successful? That is, there are many economies these days, in which some elements or elements of this

package have been imposed and one can then ask, how well they are doing. What I would first like to do is to try to address the second question, that is, illustrate briefly for a few economies, what results the Washington Consensus package has generated and try to draw a few lessons from their experiences. In this basically I am drawing on the work of a number of country scholars in the network that has been organised during the last ten years with the World Institute of Development Economic Research in Helsinki and is not my judgement so much as judgement of the people of the countries involved. On the whole, what I will do is give you a mix of favourable and unfavourable and unexpected consequences of the Washington Consensus package for at least a few countries - Chile, Argentina, Mexico, Turkey, economies of sub-Saharan Africa and post socialist economies. It is important to recognise that at the level of debate that even if these things have not gone absolutely or perfectly well, the Washington Consensus people have generally a standard counter argument which one always has to bear in mind. That counter argument simply says, "you did not do enough". Any policy package applied anywhere in the world, is not going to work the way its designers thought it would. They will not achieve all the things they attempted to do and there will be unpleasant surprises. We do not have perfect foresight and rational expectations and something is always going to jump up and scare us. The neo-liberal response to that is that "you did not go far enough". About the Eastern Europe and former Soviet Union, for example, since the collapse in particular in Russia in 1993 or 1994, our newspapers are

filled with people saying that we asked them to liberalise but they did not liberalise quite enough. If they had carried the whole package through, it would certainly have succeeded. It is obviously a Utopian argument and you can never refute a Utopian argument because Utopia is never achieved for one reason. But the argument really is Utopian and that explains part of its power and you always have a fall back position. It is simple. So it can appeal to politicians with the mental capacity of Ronald Reagan and then makes a powerful kind of story. All we can do when discussing this kind of story is to look at what happened. Let us talk about Chile from that point of view. Chile is treated as number one success case of this package. Just to review the history briefly, Chile is a small country, geographically complicated, which pursued import substitution and industrialisation very aggressively up until 1970 and everybody agreed that it had gone much too far. It grew slowly, has a very unequal income distribution and was essentially an oligarchic country. There was a brief period between 1970 and 1973 of Popular Front Government which failed both because it tried to be too expansionary and because it was destabilised from abroad. The Front Government was replaced by a very tough military regime under General Pinoche, which for its own reasons, chose to apply neo-liberal economic policies very consistently beginning about 1974-75. Chile thus went through a dozen years of neo-liberal adjustment. There were two big recessions, real wages were substantially cut, and there were periods of overvaluation which I will discuss in a minute. The policy "finally worked" in 1985. Since 1985, Chile has been growing very rapidly and the real wage, real level of income

finally achieved its 1970 level by about 1990-91. Just briefly, there are a few lessons that one can draw from this experience. It is certainly true that the neo-liberal policy played some role in the Chile recovery. Particularly, extreme wage cut imposed substantially helped exporters of raw materials, forestry products, fish meal and fruits which partially propelled the export boom since then. However, the State by itself also invested very heavily in copper. There was heavy public investment. Moreover, these rapidly growing exports were essentially supported by three previous decades of State intervention. There had always been heavy subsidies for afforestation. There had been public sector efforts put in for technical change, technical upgrading, new varieties, quality control, etc, of fruits. The State rationalised production of fish meal. So, the State was always there. It was not fully the invisible hand story and also the standard sequencing of the market - friendly policy package was reversed. That is, the economy did not stabilise until after adjustment. Inflation was not contained until the export boom started which provided foreign exchange and enabled stabilisation to take place. There were several aspects of Chile which differed substantially from the sort of standard Washington Consensus package. These specific aspects of Chile experience also indicate that straight liberalisation attempts without the public investment, without draconian wage control, who can say whether or not it would have worked? It is also a question of how to assess it. If you had asked the Chilean populace in 1973 and said here I have a package. It can take a dozen years. It is going to be very

painful on the way through and you talk to them in 1990 looking backward. Your dozen years were pretty painful but you are fairly prosperous now. Before - and - after evaluations will differ. I think, this is something to be borne in mind when considering these packages. More generally, the Washington Consensus package has now been applied in various countries all over the developing world for 10-12 years. We are now standing in 1994. The debt crisis, which provided an entre' to the Bretton Woods institutions to control economic policies in a number of countries, occurred in 1982. You can go around, locate countries where the package has been applied for the last 10-12 years and the results may not be terribly successful. Economic policy of Bangla Desh has been essentially under Bretton Woods control since mid-80s. They are not doing at all well. In Sub-Saharan Africa, the only success cases are Tanzania and Ghana but success in these cases boils down to 1-2 per cent positive growth with a trade deficit of 15 per cent of GDP and that scarcely has been considered to be a sustainable situation.

Then Mexico. Mexico is obviously quite central to American policy concerns for geo-political reasons, for reasons of fear of migration, etc. The Bretton Woods package has been applied consistently in Mexico for 12 years now and at the moment, the economy has 7 per cent trade deficit, negative growth and it is not entirely heartening.

Another touted success case in the last 2 - 3 years has been Argentina. Argentina has been a very difficult economy for many decades. In 1991, hyperinflation was stabilised by what can be called heterodox anti-inflation package which involved implicit

price controls by negotiation between the government and big producers, freezing nominal wages, freezing exchange rate for dollars (that was written in the Constitution with which it was going to be tricky when it was to be devalued) and by a degree of austerity and fiscal rationalisation. Why did stabilisation in Argentina stick after so many unsuccessful attempts? One reason has to go back to the question of increasing financial dominance of the world economy, which I mentioned before. Argentina opened its capital account - external capital account - exactly at a time when American interest rates were beginning to go down and after a period of about 12 years of pretty aggressive capital flight. Argentinian rich, Latin American rich, generally have got a stake in the United States. They send their kids to schools. They go to Miami for shopping. At appropriate time, one goes to Huston for triple bypass surgery. All this takes a certain amount of money. Now they are essentially going into international investment business. With liberalisation of Argentinian capital market, reduction of US interest rates, you get 3 - 4 per cent in USA, you get 15 per cent in Argentina. Certainly, it becomes quite attractive to take your money home. So, there was a strong substitution effect of the interest rates reduction, and, at the same time, there was a strong income effect because the government had rationalised debt, and government fiscal accounts were substantially better, when interest rates had gone down and they had fewer foreign payment obligations. So the money comes home, it is invested in real estate, various kinds of financial instruments. Pretty good capital gains are made. Part of it goes into

consumption. Since 1991, Argentina has been enjoying consumption led boom. However, with high interest rates and strongly appreciating currency, because there is some residual inflation and the nominal exchange rate has been pegged to the dollar very solidly, no investment, it will only be a matter of time. Also, no public assets are now left to sell. Government sold off the oil company in August to pay off some unfunded pension obligations. So, sooner or later, they are going to have to raise taxes. It is not a very viable situation it would not last. It was very much successful in the short run. But it was a situation provoked or resulting naturally from the class structure of Argentine economy and the Argentine social structure and the particular aspects of the Bretton Woods package.

I would like to draw that same lesson very briefly from the experiences of Mexico and Turkey and then go on to say a little bit about the first question that I posed - how these policies have been applied in developing countries, and then I will come back and say a few words about the case of India.

Mexico looks like Argentina in most respects except it is not growing. Moreover, income distribution has become strikingly worse. Rents, in fact, were created by Mexican privatisation. If you sell off public enterprises, you certainly create possibilities for insiders to be the purchasers or to make substantial amount of money out of the sale of activity. The brother of the President and some of his friends were prominent in privatisation, for example, the telephone company, TelMex. It is also said that telephones did not work any better after privatisation took place.

Turkey was considered to be another success case in the early '80s and it is a very interesting one because the success after ten years completely fell apart. Turkey's package in the '80s was based on substantial real wage reductions, a shift in agricultural terms of trade against peasant farmers and a lot of directed subsidies plus devaluation aimed at stimulating exports. Internal aggregate demand was cut very sharply by income distribution and at the same time export markets were opened up. There was second oil shock in 1979 and the Iran-Iraq war which created local markets in steel, cement and the kinds of things which Turkey could produce rather well after 20 years of industrialisation. So, they had export led boom till 1986-87. However, the thing was distributionally unsustainable for two reasons. First, this wage explosion and shift in the terms of trade have now made Turkish products very costly. It is not at all clear that the Turkish producers can participate in international markets. Secondly, in what was allegedly a liberal regime in mid to late 80s, corruption got very substantially worse in Turkey, for social reasons. Thus, they had a degree of liberalisation but in the previous Turkish organisation, the bureaucracy, perhaps like Indian bureaucracy, which was essentially in charge of, among other things, passing of rents. There was plenty of intervention in the economy but that intervention went through the hands of the bureaucracy. The whole import substitution industrialisation strategy involves creation of rents. The real question is how the rents are to be used, what further actions they will produce. In the Turkish case, there was some success in industrialisation .

What happened under liberalisation is that another political layer was inserted in charge essentially, of allocation of rents and distribution of public funds. It came out of the Prime Minister's office. It was very corrupt. There is now in Turkish press lot more discussion of corruption than there was before and allegedly the liberal regime essentially succeeded in making the situation perhaps a good deal worse.

The counter argument from the neo-classical side would be that they did not go far enough. As I said before, it is a Utopian argument but you know we live in real world and they chose to do this. And the repercussions that occurred were fairly natural. Finally, they also opened up the capital markets so that there is lot of money going back between Istanbul and the financial centres in Europe. At the moment, they are going through a lively or exciting financial crisis and it is not clear what the outcome will be.

Having said this, it is a mixed record, there are some successes, some failures. Liberalisation certainly did help in Chile. Other things helped in Chile as well. Argentina and Mexico have problems resulting explicitly from liberalisation in that benefits of liberalisation seem to last in some sense for a while. In Turkey, there is some contradiction. Much depends on the initial conditions, both political and economic. Hence, I do not think, you can draw any terribly strong lessons. In terms of the other question, if you look at the successful economies, what conclusions can you draw? Let me talk very briefly about the East Asian success cases of South Korea and Taiwan and, may be, for a few seconds about the Indian case by way of conclusions.

What characteristics of economic policy formation appear central to the sort of four decades of very rapid growth in Korea and Taiwan. It seems to me that one can point to several aspects. One is that these countries engaged in very aggressive macroeconomic policy aimed at, in particular, promoting capital formation. They also did that under fairly prudent fiscal policy. What do I mean by that? It is useful to distinguish between government savings and public sector savings which is the difference between current revenue and current expenditure. On the whole, public sector savings was kept positive in these economies. On the other hand, public sector borrowing requirement, which is investment minus savings, was always substantially greater than zero. So they did engage in inflationary finance in the sense that the public sector borrowing requirement was substantially high and that was targeted, as I mentioned, at capital formation. It is also fair to say that this aggressive macro economic policy was pursued in a generally favourable foreign exchange environment. That is, Korea and Taiwan never really had to worry about the balance of payments deficit in a serious way. Korea almost went under in 1982, when the debt crisis hit, but did not and that was about the scariest episode. But generally both before and after that episode and certainly in other stabilisation episodes, they kept investment up. How in spite of this, did they keep investment up? One aspect is that basically the organisation of the Korean bureaucracy is powerful, widely supported within the economy and society and autonomous. Essentially the bureaucracy offered the firms a deal. We will give you cheap credit, ample

protection in the internal market, access to intermediate imports if you need them, assistance in technology, if you open up your books to us so that we know what is going on at enterprise level, so that we target all these interventions. If you perform, this package will continue. If you do not perform, we will cut it off. We may merge you with your competitor as the Japanese do. That was basically the deal. This kind of institutional deal is not dissimilar in practice from the close linkages that existed between German banks and German enterprises which organised in cartels around the banks. It certainly is not too different from the structure in Japan before the war and from the reorganisation of Japan's industry after the war. I am not talking here about an Anglo-Saxon kind of capital market where rates of returns are equilibrated across assets due to the strength of transactions between participants in the capital market. You know, it is insider kind of finance. There should be risks in insider finance also. This insider finance was characteristic certainly of Korea and Taiwan and, in different forms, Japan and many European countries. It is not a part of the package of recommendations made by Washington Consensus. There was also plenty of local protection. There was a limited variety of consumer goods available in the Korean market. This had the implication, if you do not have very much to buy, you might as well save money; no chance of putting it abroad certainly. Also, protection of internal market gave Korean enterprises some areas of learning in terms of new products and new processes. This import protection was coupled with export protection, export subsidy, cheap credit etc. and, as said, two policies are involved here, orchestrated

by the bureaucracy - import protection policy and export promotion policy. They were used specifically as two instruments in different combinations for different sectors and different firms at different times. The neo-classical Washington Consensus counter argument to that essentially says that it has cancelled - import protection was offset by export promotion and yet they went through all these motions. They should have just let the market rule. They created a non level playing field with import protection and levelled it off with export promotion. But that is a real dumb argument. It does not recognise the complexities and interaction of the two kinds of policies. In fact, nor was competition promoted within the internal market. Under certain circumstances, competition is a good thing. But what was interesting in Japan and Korea, they had a doctrine of excessive competition, particularly in sectors subject to economies of scale where very often you get over-building of capacity. Everybody says, we have excess capacity now. Then they had to engage in price wars and cut-backs; somebody creates a big mess and they have another capacity cycle. Japanese bureaucracy did not just permit this to happen. They gave different groups of enterprises in sequence the possibility of heavy investment. This kind of regulation of market was certainly characteristic, all the way through, of interventions in the East Asian economies. They are not invisible hand stories. They are not liberal stories. They were very effective stories, certainly capitalist stories. We are not talking about socialism in any sense of the word but managed capitalist market and it was managed very successfully.

I am no expert on India. I am sure, around this room, everybody can say more intelligent things than I can about Indian economy but let me spend, may be five minutes, pointing out some of the dangers that may arise from liberalised Washington Consensus type economic policies in the Indian context. I think, it is quite important, there is lot to be said for aggressive macro economic policy. That is, if you grow fairly steadily and fairly rapidly for a fairly long period of time, particularly if investment share of GDP is relatively high, this has all kinds of positive feedbacks. One is Kaldor sort of feedback of growth in technical progress which has been picked up by the neo-classical economics in the late '80s under the rubric of the new theory of growth. It certainly recognises the importance of rapid steady growth in scale and things like that. Investment is important because new high-productivity technology is certainly embodied in the new plants. Well, you can think in terms of ratios, for example, that of debt to exports. Suppose your aggressive macro policy, in fact, involves increase in debt, in effect, that is okay as long as you raise denominator along with numerator. Debt over GDP is stable because both numerator and denominator go up; debt over export is stable because both numerator and denominator go up. Obviously, it is easier to raise numerator than the denominator and you have to think in terms of how to achieve the latter. Nonetheless aggressive policy is important and on the basis of the inadequate information and knowledge, I suppose that aggressive macro policy with fairly high level of public investment probably had fairly good deal to do with India's rapid growth during '80s as compared to the previous period. Of course,

India went into trouble in 1991 and that illustrates the problems that appeared as a consequence of rapid growth policy, particularly rapid growth policy which requires foreign inflows. If you rely on portfolio investment, in particular, Argentine and Mexican stories quite clearly illustrate the problems that are involved in that kind of policy package; that is, you have to maintain high interest rates internally to bring money from abroad, which is not necessarily good for investment. And you may be driven in the direction of appreciating the exchange rate to accommodate trade deficit, which is necessary to bring in capital inflow, which has been the case in Argentina and Mexico. This has not happened in India so far. I do not usually have observations very much in favour of central bankers but I must say that the enthusiasm for printing rupees to buy capital inflows which the central bank had demonstrated over the last couple of years is altogether a heartening policy and I hope they will keep it up. Nonetheless, there are inflationary risks also in that, something else to be considered. Another risk, there is the question of how viable in the world international economy, how sensible is the policy predicted on large private capital inflows over a period of 5 - 10 years. Also large private inflows are now coming in. Portfolio investment has to be accommodated and it poses the risk that I have just indicated. Direct foreign investment has to be used. It is striking in the Korean case. For example, Korea and Taiwan tried to avoid direct foreign investment. They were after technology and did a lot of reverse engineering, allowed lot of royalty payments to achieve technology. But they allowed a fairy

limited role for entry of trans-national corporations. Brazil, during its rapid growth period, say between 1940 or 1950 to 1980, allowed in large direct foreign investment opening up technology through joint ventures, essentially unpackaging the mix of attributes that trans-national corporations possess. The unpackaging operations are not easy but it is something which Brazil did very successfully. In so far as India opens its economy to direct foreign investment, the decision will have to be made : What is the world financial market going to be like from five to ten years down the road? At the moment, there is lot of capital floating around. There is no question whatsoever about that in the world market. A lot of it is somewhat speculative. Certainly in the long sweep of time, there will be another period of great financial liberalisation in the world economy which will have treaded financial collapse worldwide followed by deregulation of capital market. I am not saying that there is going to be the world financial crash. Certainly, there will be fluctuations and how one gears one's domestic prices to those fluctuations is a very open question. Certainly, keeping money in the form of reserves which can be monetised is not the best way to do that. It will be nice if they are invested. That is something to be considered. On the whole, the Indian macro policy has been quite conservative and prudent and I expect probably it will be continued to be so in future, perhaps for good reason. Finally, just a word, well two words, one about coming back to the question of capital formation and achieving productivity growth. I think, probably public capital formation is likely to be a fairly big component of a high investment package because public sector is

better equipped to provide some kind of capital than private sector. Also it appears, depending upon which econometrics which you look at, probably, public investment will have crowding in or at worse a small crowding out effect on private investment so that even if there is weak crowding out effect, the overall investment is likely to increase as a consequence of appropriate public capital formation in infra-structure and so can certainly add to productivity growth. Finally, there is the question of overall strategy of growth and the question about political coalitions. If you look at the political coalitions, for example, in Mexico or in Turkey that supported the market friendly Washington Consensus type policies, the guys that you see as elements of this political coalition, first of all, certainly not all but certainly many firms, in particular more aggressive and technologically adept firms which in fact are in a position to benefit from liberalisation. That is, if you have grown up as a dinosaur under the import substituting industrialisation, you are not going to be very much in favour of liberalisation. On the other hand, if you are quick on your feet and likely to make some money, then certainly you are going to be partisan of Washington Consensus type package. Certainly, the financial community tends to be in favour of Washington Consensus type of package because they are in a position to make money on transactions on the kind of growth in inside financial assets that accompany the external liberalisation. You are likely to get good deal of support from consumers in the top two or three deciles of income distribution since they are the ones who are in a position to benefit from the

wider variety of consumer goods in the market, better availability of, essentially access to - the kind of consumption basket that is characteristic of industrialised economies. This kind of coalition can be a very powerful one. There is no question about that. One has to ask about people who are being left out and certainly about working class, traditional proletarianised - unionised working class. Of course, peasantry was left out of the Turkish liberalisation. Political consensus, ultimately collapsed, they came back and caused wage explosion and reverse shift in agricultural terms of trade which had substantially destabilised their economy. Mexico is a fairly large country of about 90 million people, the size of the biggest Indian State. Mexican population is certainly divided on ethnic and class lines. Ethnically, you can distinguish European emigrants on the one hand and the Indian population on the other. Geographically, it is a diverse country. The Mexican revolution, for example, never really arrived in the South, in the States of Mohacca and Choapas. What happens in Mexico after 12 years of Bretton Woods policies? As I indicated, there is overall slow growth but certainly the essentially white upper one or two deciles of income distribution, essentially in Mexico city, had benefitted very substantially from the kind of policies that have been pursued and they were looking to make quite a lot of money out of NAFTA. The Zapatist Army in Choapas has obviously been forming itself for a long time and we are talking about deep social movement with deep historical roots and I have no idea about what is going to happen. It is striking that the Zapatist Army appears just when the NAFTA gets signed. It is the culmination of liber-

alisation policies combined with the emergence of broad-based revolt on the part of underclass and, I think, in terms of the political economy of economic reforms, Mexico and Turkey should give one pause about pushing too heavily into market friendly policies.

During the discussion, following points were raised and clarified by Dr.Taylor :

Points raised

My first question is about State versus market aspect that Dr.Taylor raised. We have to distinguish between a well planned and a well guided State intervention that occurs in a mature democracy and the kind of State intervention occurring in a fragile multi-party democracy like India where several measures are adopted for purely vote catching and populist reasons like writing off of loans, etc. In such cases, market is possibly the best safeguard against ad-hoc populist State intervention.

If the demand and supply based exchange rate is much higher than the purchasing power parity based exchange rate notwithstanding the differences between tradeables and non-tradeables, do we say that there is an element of rent in the foreign exchange deals?

Consider the package of structural adjustment measures and stabilisation measures as between two different economies. It is quite possible that in the case of one, balance of payments mal-adjustment may flow from current account side, for example is India. But there may be another economy where mal-adjustment

followed from opening up of capital accounts. So, we can say that the same type of stabilisation adjustment programmes may not work in the case of both these economies because the origin of trouble is different. In the case of one economy, it is current account. So, commodity market adjustment may be more important. In the case of another, financial reforms or capital market adjustment may be more important. But why is it that Washington Consensus package gives us a uniform package? It is because of the IMF's preoccupation with monetary approach to balance of payments, because monetary theory of balance of payments integrates current account with capital account of balance of payments. It does not distinguish between these two things and any mal-adjustment in the balance of payments is traced to monetary disturbances. What is your opinion about it?

You have made a reference to rents that arise as a result of bureaucratic power but, I think, you did not go into the whole question of the extent of rent though, of course, you opposed Washington Consensus package. Still, there would be a role for the State in your kind of things. Would you then say that there are certain types of things which the State can perform without this kind of rent seeking arising to any alarming extent and there are certain other types of functions which if the State takes over then there is greater possibility of rent seeking, so that in that case, we may have some kind of a judgement of the right kind of intervention which the State may make.

Reply by Dr. Taylor

There are two questions about the State and two questions related to balance of payments and exchange rate concerns. With regard to the State, I think, that the debate is obviously not State versus market; the debate is what should the State be doing and what the State should not be doing. To be fair, the Washington Consensus itself envisages some role for the State. Certainly, the State is a night watchman to see that laws will be enforced, criminals will be apprehended, the army will be paid for, etc. Moreover, the Washington Consensus is basically a supply side story for what is going on in the economy. The neo-classical theory is basically a supply side story which says that there is something the State can do to stimulate supply. In particular, under some circumstances, it is probably okay for the State to invest in infrastructure and to promote education although in other circumstances the private sector could do that better. Finally, if you read the World Bank Development Report, 1992, as opposed to 1991, they have also said that the State should do something but not too much about the environment. The only point that I would like to make is that in the whole history of capitalism, and in particular, of the countries which have had relatively rapid, and may be even relatively equitable, growth, the State has historically done a lot more. There is, in the case of Korea, as I discussed, strong State intervention. US, the bastion of neo-liberal rhetoric, was the most protectionist country in the world until the Second World War and even gave away millions of acres to the Western Railroads. The Western Railroads

do not do much railroading any more but successor ownership is still living off oil revenues or cutting off the virgin forests on those millions of acres of land so that rents were created by all this State intervention. However, through the whole political economy of these "successful economies" these rents got transmitted into capital formation and into productivity advance. And in a way, the question is not so much getting away from rent creation, though obviously one can do that excessively certainly in populist or quasi-populist contexts, perhaps in India and certainly in Turkey since the mid 1980's. There are no historical cases, if you like, of non-rent-based industrialisation. It seems to me that what we should be thinking about is not this utopian ideal positions where rents were not created but rather positions where rents are created and turned into effective capital formation and into effective productivity growth. In the particular Indian context, what one has to do in this complex environment, in so far as the State has any freedom to act, the State has to think about what kinds of rents have to be created and also think to withdraw or cut them off if rents are created excessively. For example, in the case of Chile, they went heavily into import substitution in a small country where they would never have got economies of scale in any of the things they were doing in import substitution and it did not work. Part of the neo-liberal success case of Chile has to do with recognition that intervention was pursued inappropriately in some sensitive form. And there are major dangers.

With regard to monetary approach to balance of payments and the conflicts between current and capital accounts. Fundamental-

ly, as I mentioned, the IMF is in the business of running recessions and if you get into external trouble from current account, if the terms of trade go against you, or if export market falls apart, or if you get into trouble because of capital account which was the case of the debt crisis, in either case, these problems reflect themselves into unfinancial current account. And the time-proven way to get the trade deficit down is to run a recession. With regard to exchange rate, I would like to go more macro in terms of macro economic balance, internal and external balance. I suppose, I have never thought about it. There is some kind of rent implicit between PPP and some other exchange rate but how that rent gets realised is what I would have to think about a bit more. In terms of macro economic programming, having a fairly stable and may be fairly weak, though not necessarily terribly weak, exchange rate, - stability matters more than weakness - and getting over-valued exchange rate is a sort of trap which one does not want to stumble into.

Points raised

A classical question in liberalisation discussions you talked of seems to be - how to minimise the discrepancies between political decision time and economic decision time. By this, what I mean is that the horizon that the entrepreneur producer has in mind seems to be always greater than the time horizon the politician or the ruler governing the economy seems to have. In this case, it appears that neo-classical economists, whatever they talk of, have at the heart that hypothesis, namely, how to mini-

mise the discrepancy between these two decisions? Either you minimise these by creating certain institutional structures for better functioning of financial and labour markets or you reduce, you make passive the role of political decision - making process in influencing the economic activity. Examples that you have given, particularly of Korea, show that the government is starting some kind of delinking process by minimising this gap. Now, my question is that when you talk of structuralism in general, as a critique of neo-classical economics, when you talk of trade unions, power struggles and political structure, how are we going to tackle the discrepancies between these two crucial decision times?

Most of the developing countries take to trade liberalisation after excessively devaluing their currencies. There are several cases like that. Devaluation itself is really across the board subsidy to exports, across the board tax on imports. So already you have, through the devalued exchange rate, considerably increased the degree of protection to the developing countries and then they are advised to reduce the tariffs and quotas. This itself means that the effective degree of trade liberalisation is illusory. It is very small. Therefore, the purpose of this particular thing when tariffs are reduced, actually tariffs are reduced only on capital goods, machinery, spares and intermediates. They are never reduced so far as consumer goods are concerned because most of them are under banned items, with the result, it is really an attempt to increase corporate profitability. Second thing, the devalued exchange rate attained is to make this market attractive for foreign direct capital inflows because

all non-tradeables like services, raw materials, land are made excessively cheap so far as foreign investors are concerned and so they come here, set up production facilities, bring capital from outside. Sometimes, they borrow at 5 to 6 per cent. So, the thrust of the whole trade liberalisation process is really to create an environment for industrial growth. If the industrial growth is really one of the items on national agenda, why should we be so much against the Washington Consensus?

Given the poor infrastructure and soaring fiscal deficit in India, how do you expect public capital formation becoming main component of investment?

From the lecture, I gathered that if the Washington policy package is to succeed in the country like India, three conditions have to be met. None of these three conditions are met. One condition is that the level of public investment should be high. For example, if you see our budget, we have a deficit on the revenue account. That is, revenue expenditure is much greater than revenue account receipts and this is being financed by surplus from capital account. So, our Central Government is not a creator of capital. It is destroyer of capital. People are saving but they are spending this money on revenue account expenditure. So, there is no likelihood that public investment will pick up on any big scale. Second thing, as regards income distribution, there was a chance during the last year that interest rates would have fallen, but in fact what happened was that due to very large fiscal deficit, rates of interest on government securities were kept very high. In fact, banks were flush with funds. One bank officer

said that banks are not doing banking any more. They are not lending. They are only placing the funds in government securities. Due to high fiscal deficit, the interest rates have been kept at a high level. And thirdly, in the Washington policy package, response of portfolio investment has been much greater. It is three times that of direct foreign investment. Given this background, what would you say, how will you prognosticate success of Washington policy package in India?

You have described a number of success stories and perhaps one of the elements that contributed to the success is the policy prescription package from Washington. But I have my own doubts about the effectiveness of the package or how properly that package has been packed. But apart from that, one important thing that we are forgetting which, in my view, has contributed to the success of this kind of liberalisation policies in other countries is that up to the '80s, the global capital market was flush with funds. What I mean to say is that global rate of savings was very high whereas when you make the projection into next decade, the first decade of the 21st century, the trend indicates that there is going to be a global shortage of savings. Under these circumstances, if the policy prescriptions are applied in some of these countries, specially opening of capital account and all that, and given that many of these Asian and African countries are having their own problems of credit worthiness, to what extent these policy packages are going to help many of these developing countries in the next decade?

Reply by Dr. Taylor

The question about different time horizons in economic and political decision making is a very good one, to which I have no coherent answer in that this problem plagues any democracy and in one way or another has to be circumvented. The resolution of this difficulty essentially has to take the form of some appropriate kind of institution, some type of economic institution which can take the long view. This institution will have to take various forms in various places and will have to be - the economic sociologists have developed a nice notion of embeddedness or a nice phrase of embeddedness which essentially says that workable institutions are embedded in the society - in some sense rooted in, arising from, the society and unless such institutions are embedded in that sense, they are likely to be transitory, peripheral and not likely to work. There are two forms of embedding long - term institutional decision making. One is through an appropriate set of private institutions and certainly in the German and Japanese cases, probably Japan mixes the two examples, but certainly in Germany, banks do take a long view. Historically, they have taken a long view. They were big institutions; we are not talking about small actors here. They have significant economic power as did the firms in debate with the banks. They use their information about the enterprises and their economic power to take a fairly long - term view about providing credit for investment. So, that is one kind of possible institution. And notice it is not the State. I tend to be a partisan of the State, but one should recognise that the private sector in some cases

can also do these kinds of things perfectly well. The other would be an appropriate Weberian kind of bureaucracy which also has support built into the system in some ways. No matter which political masters come and go, the bureaucracy is willing to undertake these tasks. Now, that is no prescription. It is an observation about the kind of entities that are involved.

Devaluation versus liberalisation. The only thing I will add is that in Washington Consensus standard sequence of policy is that first you should liberalise with a closed capital account. That is, first turn your quotas into tariffs and as you are reducing protection, and you probably want to be devaluing, and then after you have straightened your current account in this way, then you should think of opening your capital account with an appropriate sort of exchange rate. That is the standard policy package. If you are really doing this and trying to get all the prices right in the sense that you are really solving a complicated computational general equilibrium model and at the end of the day, you have to come out with the right exchange rate, it is not easy to solve these kinds of models in the real time. It is in fact, impossible. So, you are putting in tremendous computational and allocational burden on the price system, particularly on interest rates and exchange rate. And it is not clear that an unencumbered market will arrive at the appropriate solution nor that the planner - liberalisers ex ante will arrive at the appropriate solution and that is one reason why you really want to go relatively slowly.

Indian fiscal position. I do not want to go into details

about the Indian fiscal position because I do not know the details. I will say, however, that in so far as opening of capital markets requires you to run high local interest rates that already is one risk to the fiscal position simply because of the interest obligation of public debt and open capital market together with money flowing in and out necessarily gives rise to that risk. Moreover, the distinction between portfolio and direct investment is likely to remain an acute one until India, if it follows through this kind of policy, becomes a thoroughly acceptable country to the world capitalist community and I do not know how long that will take. The portfolio investment is relatively hot money going around the world looking for relatively high returns and if you play that game, you have to play it very carefully and it is pretty risky. The direct foreign investment will take longer term, build longer-term alliances and friendships between Indian and foreign firms and it is not necessarily something to be expected immediately. Moreover, what do you want to use it for? Thailand and Malaysia are essentially been turned into export platforms by the Japanese and the Koreans to assemble commodities and sell them into American market. That appears to be a perfectly viable strategy at least in the short run for those countries. What strategy India wants to follow is another question. Certainly, public investment is likely to play an important role in any successful kind of package. That will require fiscal discipline. Whether or not this fiscal discipline will appear is an open question. The package does require not only ample savings flows world - wide. It also requires fairly

stable capital markets world-wide. Again one can not make predictions. In the US, in the last 2-3 years there has been a big growth of "hedge funds" which engage in various kinds of arbitrage operations, some of which are very risky and the money one makes from such successful arbitrage is in billions of dollars. The latest kind of arbitrage, which is a good thing from the Keynesian point of view, has been between low short-term interest rates and high long - term interest rates. Essentially, short - term interest rates were cut in the US economy. There is an arbitrage opportunity. You can borrow short essentially to buy up long - term bonds. That is perfectly fine. There is an arbitrage opportunity there. The whole interest rate structure is going to come down. That will be pretty nice. On the other hand, these kinds of operations are down on margin. When short-term interest rates in US economy have recently risen by 0.75 of a per cent, lot of hedge funds are now looking very shaky because they are borrowing on margins on these kinds of financial manoeuvres. Maybe this is just a bubble and this will go down. That will be very fine. Maybe, there will be major losses. It is not a prediction but it is a possibility. If that happens, we have a big financial crash. It is not a question of savings. It is the question of financial intermediation across the globe and if that breaks down, you can be in a very risky position.

Points raised

We seem to have left out agriculture in the discussion. I would like to ask a question. If I am not mistaken, the initial reforms even in China were really in agriculture and these led to

very high increases in productivity which were wide spread and these did create a wide - based support for reforms even in China. Now, in India if we want to expect a continuing support for economic reforms, then the gains of reforms will have to be more widely distributed which will not happen unless agriculture shares the gains of productivity increases if they take place. I would like to know your reaction to this aspect of the problem.

You mentioned in your presentation that the Korean bureaucracy is collaborating closely with the Korean equivalent of the Zaibatsu on the condition that the assistance given to them will be resulting in investment, competitiveness and greater exports, etc. If they do not perform, they will be ruthlessly merged with somebody or the other who is performing. My question is, how are they able to do this? It is really a question in the realm of political economy. Because in India we have tried several such schemes where you are offered assistance on the basis of certain terms and conditions and the man does not perform but he has 100 ways of continuing with it without performing. Is it something in Korean character or is it something else? And a related question is, how is it that in such a situation, the administration is uncorrupt because in other countries in that region the whole economy is destroyed by corruption by those in power.

Accepting your criticisms of the Washington Consensus, could you advocate that we go back to the original control regime that we had for 45 years or do you basically agree with Washington Consensus that the market should be allowed to work. Or do you just disagree with certain components of that package?

We have been using words like reforms, liberalisation, allocative efficiency, rationalisation, sensible policy. These are all words. When it comes to implementation, I have certain fundamental questions to ask about that. The speaker said that what the government should do and what the government should not do has to be decided. Whether Washington Consensus has to decide this or the people of the country should decide this?

From 1991 onwards, there has been good amount of capital inflow to many of the Latin American countries. Now that the capital inflow is also coming to countries like India, in Latin American countries like Mexico and Argentina, this has created exchange rate appreciation and therefore subsequently their export sector has suffered. In Chile, they have overcome this problem through sterilised intervention, the central bank's intervention and therefore the exchange rate did not appreciate. In India, we have now, more or less, the same problem. That is, lot of capital is coming in, our reserves have soared up. Our authorities do not want the exchange rate to appreciate. Therefore, the Reserve Bank has intervened in the market and the appreciation of rupee has been prevented. But this intervention is of a non-sterilised nature and therefore our money supply has gone up. Liquidity has increased and subsequently the real exchange rate may appreciate and therefore under the circumstances, what is your advice to the Reserve Bank on a combination of exchange rate and monetary policy? Some people argue : Let the exchange rate appreciate. Why do you worry? We can avoid inflation. We can import things cheaply.

Dr. Taylor's reply

It is not my place to advise the Reserve Bank of India but the question is very rightly raised about the sort of macroeconomic programming problems that are implicit in the new access to portfolio investment. I guess, the only observation I would add is that unless we have a fairly deep market domestically in terms of government paper or something like that, it is very hard to sterilise only by market type of interventions and this kind of sterilisation is not readily available in the Indian context. Basically, it is a question of trying to use the reserves in a way that will contribute to the growth process. One possibility that some countries have availed themselves of is to create some sort of longer term holdings abroad which will not be in the hands of the central bank, which would not get monetised. One could create a State Investment Corporation or something like that to have assets abroad, and transfer assets between that and the RBI. If you do it that way, you have access to the money. If you just pre-pay debt - that is what the current Minister of Finance is thinking of doing - that is fine. It gets rid of the reserves and is a form of sterilisation. The only thing is, one will not be able to borrow when there is a rainy day, which there certainly will be.

Appreciation versus inflation issue is crucial. Certainly, in the Argentinian case, the appreciation which they have there is intimately involved in inflation stabilisation. It has also tied interest rates, as I was indicating. It involves a lot of balls to juggle with only one hand.

The question about who decides what to do, it is a question of political economy. Certainly, the Bretton Woods institutions in any developing country emerge as one more major political actor. There is no question about that. That political actor's presence will simply not be permitted in a country like, say, USA. That simply will not be permitted. The US has financial resources to avoid that kind of pressure. IMF certainly will not do so. But in a country like India, particularly when India has to avail itself of IMF credit, they essentially become internal political players. they become part of the internal set of political alliances. In this kind of coalition in support of market friendly policy that I was discussing earlier, one of the major players in the coalition is obviously the Bretton Woods institutions combined with the embassies of the market friendly economies. Who decides what to do? Well, they are one of the players but the ultimate decision is arrived at by the political process and they are overwhelmingly powerful players; but certainly players they are.

Should India go back to the control regime? I guess, not. Probably, getting rid of licensing was not such a bad idea. Again, it is not State versus market debate. There are States and there are markets. And in so far as most people these days, grudgingly or not, have said that they will have to live in a capitalist system, then it is a question of how to make that capitalist system work in the political situation of the country at hand. There are different kinds of capitalisms, some better, some worse, in a variety of dimensions, and the question is, in the Indian context, if socialism, whatever that means, is not

available, then you do have a capitalist economy. How is the State, among other actors, supposed to behave in that economy to make it work in a sensible fashion? There will certainly be market intervention. That is everywhere. The question is - how is it to be made effective?

Korean bureaucracy. First thing, in the light of the previous comment that, in fact, Korea was an autocracy and that it is now breaking down to certain extent, democracy is beginning to raise its head. This idealised bureaucracy was operating under fairly strong military regime and it is interesting to know that before that regime came in early '50s, Korea was rent seekers' heaven. It was pure rents, pure corruption. One of the first things that the new government did was to throw all businessmen in jail and then let them out if they promised to cooperate with the bureaucracy. Moreover, the discovery of miracles of export led growth was made very gradually. If you see the President's annual address, exports started growing and after a couple of years, he says, "yes, exports have been pretty good" and then next year he says "you are doing pretty well, exports are growing at 40 per cent". Then next year, "the Korean economy is powered by exports and we should do everything we can to push them". So, the bureaucracy stumbled into its role. It was not an invented role. There is considerable power of bureaucracy over the enterprises and they have power to control firms which depended on the overall political situation. This may not be possible in India. But then one has to arrive at some other sort of situation. Corruption, certainly they are corrupt. However, both Japan's and

Korea's bureaucracies are guaranteed their ascent into heaven. They retire at fairly early age and go to a nice job in an enterprise. So, they are well taken care of in their old age. Certainly, they get money and power. There is corruption. There is no question about it. But the rents and rent seeking do not take away the whole system when rents are translated into productive performance. That is, I think, in a way, the lesson from these economies.

China story is again extremely complicated and I am no expert. So, let me make a couple of observations. One is that when the commune system was broken down and price freedom was given to the agriculturists, there was very large supply response. There is no question whatsoever about that. Price signals do matter. I am not saying that market does not matter. I am saying that market has to be managed and that was a very intelligent piece of market management which made the Chinese agricultural sector buy into reforms. Second observation is that the big rapid expansion of exports out of South China has fairly deep historical roots. After all, Hongkong made its fortune as a low wage garment exporter and what is going on in South China now is what could be interpreted as next chapter of Hongkong's economic history. There is also State intervention along with lot of infrastructure, lot of pressure on firms to perform, lots of subsidies, lots of interventions with the price system and lot of corruption. They are working so far. Projecting for the next five years, Chinese export growth can not possibly persist at its current rate. How that particular bubble will deflate has to be seen.

Points raised

You said that Washington Consensus package came into existence in the late '70s and '80s to help the developing countries. With Bretton Woods institutions, we have fairly good assessment of the results of the package that had worked in several developing countries, especially in Latin American and South American countries and also in the East Asian countries. On the basis of that, is there thinking in Washington package to modify or change because a number of new variables are coming into the picture? The reason why I am saying this is that when it comes to India, we are told that Washington package requirement is liberalisation of economy in various sectors and we are also told that during the liberalisation process, i.e. transitional process, there should be some safety net taking into account certain bad effects of liberalisation process. When it comes to Washington package, through conditionalities of multi-lateral trade agreement, the same safety net conditions are played down and it becomes very difficult to proceed with the liberalisation process during the transition process period if the same safety nets in terms of providing subsidies, in terms of employment problems, in terms retrenchment of labour, are played down and the country is faced with greatly difficult problems in the transitional liberalisation process. Is there a thinking of re-evaluating Washington package in terms of new information, new variables coming into the picture ?

My question relates to the problem of poverty and unemployment in the context of economic reforms which you unfortunately did not mention . There is already a great deal of poverty and unemployment in the country. It looks likely that with liberalisation and the reform processes being set into motion, a given amount of investment will go on absorbing less and less labour. This would really mean that poverty, rather than going down, might increase at least in the short run and one does not know how long this short run will last. This problem of poverty and unemployment is extremely vital in the context of economic reforms. Is it not true that the successful cases you quoted, say China, had tackled the problem of poverty and unemployment to a certain extent prior to liberalisation and reforms, something which has not happened here ?

My question is precisely about technology. Washington Consensus policies really try to integrate domestic economy with the world market economy. Here, international competence is very important and there precisely technology advancement is very necessary. In this context, I am afraid, with recent liberalisation, India is not sufficiently competent technologically. That is one of the reasons some section of Indian industry expressed fear that multi-nationals will take over industrial activity of India and India will lose economically. Also technologically, the small sector is not strong in India. What is the experience of South Korean and Taiwanese economies in this connection and what do you think, will happen to India in the near future ?

Dr. Taylor's reply

Is the Washington Consensus going to change? Yes, almost certainly. I think, the more basic question is, is a sort of neo-liberal world-view likely to continue to be dominant and, particularly in the North? We have no answer. But it is important to recognise that both in the Southern countries and in Northern countries, the free market package has not delivered all that it promised. Certainly, things that Thatcher and Reagan promised have not materialised. One expects, sooner or later, that this will provoke some kind of a political reaction and that will give rise to some kind of non-neo-liberal synthesis. How that will affect the developing countries? I think, it is likely to be strongly affected by the recognition that the successful countries have not fully adopted Washington Consensus and in countries where Washington Consensus has been largely adopted, there were significant failures and then the question is - how does one learn from that?

The safety net question is one that again depends very strongly on local circumstances. People in the IMF talk lots about safety nets in places like Columbia and Ghana which have allegedly shielded the population from the worst effects of stabilisation and adjustment. Critics argue that these have been essentially cosmetic operations and although the Washington Consensus package talks about safety nets, in fact, they simply are not applied and the losers have to face the consequences as best as they can.

With regard to the question of poverty and unemployment,

there are probably two observations that I will want to make. Ultimately, over a period of decades, the way that capitalism delivers goods is that there is on going productivity increase, which, sooner or later, gets realised in the form of higher real wages. And the higher real wages support the demand to keep the economy at a full employment level. In a poor country, this delivery of goods is likely to be a very complicated process. It is hard to argue directly against productivity increasing investment because that is ultimately where growth has got to come from. At the same time, one has to recognise that in the short run people will be put out of jobs. They will have to be assisted. We come back to the safety net question. Moreover, sources of demand have to appear for new commodities with which to enable the growth process to proceed. This is where exports become important and capital formation becomes important. Reducing poverty, as the China question illustrated, also depends very much on advances in agriculture, increasing of incomes in agriculture. The traditional recommendations for agricultural led growth in India, which may or may not be institutionally feasible, recognise this necessity.

With regard to technology and absorption, in dealing with multi-nationals, I think, it is important to recognise that there are really two kinds of theories about the role of economic policy and how one thinks about the economy in a particular trade liberalisation. The neo-classical argument looks at it from the consumer angle essentially saying that if new goods come into the market, perhaps more cheaply produced outside than they are in the economy, then the consumers benefit and it is certainly true.

The American consumers benefitted greatly when the Japanese cars came in. That was the case of liberalisation forced upon the United States which provided considerable benefits to the consumers and consumers are quite conscious of that. On the other hand, from the production point of view, what the invasion of the Japanese car industry into the United States did was that it threatened the established industry, certainly put a lot of people out of jobs and perhaps had a possibility of substantially destabilising the macro economic system since the car industry is so essential to the west. Thus, the production point of view is not recognised by the Washington Consensus. It is not recognised by the neo-classical theory. It comes from other theoretical strand that goes back to Alexander Hamilton in the U.S. and Friedrich List in Germany and certainly influenced the Japanese. From the production point of view, then, do we want more finances coming in? The real issue, it seems to me, is what do they offer us, how can we unpackage the package of multinational advantage, how can we get access to technology? If we choose not to go the multinational route, then how can we help the small enterprise sector and how can they be induced to push the exports in world market? If you think in these terms, you will necessarily be driven in the direction of the actions by a fairly big actor, may be the Central State, may be local State Government, may be private banks who are willing to take a long view and think about how production can be stimulated and that is really the riddle that the Washington Consensus basically does not address.

Professor V.M. Dandekar

It is not possible for me to make any concluding remarks on what Dr.Taylor has said so well though some of the questions probably have been not completely answered. But on this whole theme, Dr.Taylor would not mind my stating very briefly my own position.

I know much less about Chile and Argentina and what not than possibly you know about India.

My own view is, and you said it well, that what is appropriate policy, what will succeed, very much depends upon the initial conditions, economic and political. I may be too confident about this matter. But I do not think, we are being dictated by whatever is called the Washington Consensus. A consensus emerged in India. We were in deepest trouble. Our domestic public debt was sizeable - somebody mentioned about revenue not being balanced for the simple reason that 50 per cent of the revenue receipts were going into interest payment. Government was borrowing without bothering how much interest they have to pay. We had fine smooth sailing for two decades so long as international aid was pouring in. Therefore, a stage was reached that something had to be done, and I repeat, a consensus, political consensus, emerged. Before this government came to power, we were fortunate to have in a few months, 4 - 5 governments of all shades of public opinion. The present Finance Minister in his first budget said that I am here and he pointed out to four ex-Finance Ministers sitting in the Parliament saying : 'Tell me what you would do in this position. I am willing to sit with you'. And that I think is the

political consensus that has emerged. I don't care, what they talk about Washington. We are deciding on our own matters.

My second observation is, I do not believe in stability. Every system creates a vested interest. The present system or whichever was in position in the last four decades has created a vested interest of not only the bureaucracy but unionised labour and everything else. The new system will create another vested interest and another upheaval will take place. I think, that is what happens all over the world and we should not expect it is going to be different. Like success depends on initial conditions, it also depends upon our capacity to fight for survival. If we have the grip, we shall succeed. Otherwise, we shall go underway.

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Macroeconomics and Development Economics
by Dr. Lance Taylor**

**Seminar and discussion on April 23, 1994, at
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What I would like to do is to take 45 minutes or an hour to try to sketch and give you the diagrams of a few simple models, to try and illustrate how simple notions of economic structure tell us about how the same policy can have different implications in different countries, different kinds of economies, or how different economies would require different policy interventions to try to achieve the same goals. Basically, what I want to do is to illustrate what I have in mind with three simple diagrams.

The first story that I want to discuss is implications of how income distribution affects macro economic adjustment and how different kinds of changes can in one set of circumstances be favourable while in another set of distributional circumstances, be unfavourable. The story I have in mind is absorption of productivity growth. That is, we were discussing in this morning, how essentially to support long-term growth in per capita income, there has to be some productivity growth in the system, ideally accompanied by higher standards of living. Now,

what I would like to do with this simple set of diagrams is to illustrate how the productivity growth rate is absorbed in two different kinds of macro economic systems. By way of background, it is important to recognise that great economists over the decades have had a somewhat ambivalent attitude towards productivity growth. The neo-classical theory says in general that productivity growth is unambiguously a good thing but if we think about the structure of neo-classical models, the reasons are fairly obvious. Most neo-classical macro models postulate Say's law in one form or the other. So, all factors of production are fully employed. If one factor of production automatically becomes more productive, somehow the system will adjust nicely and automatically to absorb that increase in productivity growth, created essentially from labour productivity that had increased, by spreading jobs around throughout the system. There will be overall income gain and so there is really no question of absorbing productivity growth or change. Same is true of Kaldor, who was the first person after the Second World War to talk extensively and sensibly about productivity growth. Kaldor also assumed the full employment model. He did not assume marginal productivity conditions as are characteristic of a lot of neo-classical theory. Once again, absorbing productivity growth is no problem as long as one assumes full employment. If you do not assume full employment, then the story becomes a little bit more complicated. Among the opponents of productivity growth were Ricardo to an extent and Marx to a certain extent. Ricardo was writing at the time when the Luddites were quite active in the England environment. Luddites smashed machines in England around 1810. They were

basically weavers who had been put out of their jobs by some of the technological advances in the first phase of the industrial revolution. Ned Lud was a feeble minded person, who lived sometime in 1770s and 1780s, smashed a loom and was properly dealt with. This movement took its name from Lud and, between 1810 and 1820, the Luddites roamed around England and smashed machinery, particularly textile machinery. Ricardo, responding to this issue of his day, added a chapter called "On machinery" to the third edition of his Principles, which was published around 1821. In effect, Ricardo said that the Luddites were right which made rest of the economics profession doubt his sanity. The argument he made was the same that the Luddites were making, that essentially if you have a technical advance which displaces workers, if you have labour saving technical change, certainly jobs will be destroyed. The question is : how does the macro system adjust, does the macro system adjust to prevent these people from being kicked out, letting them to be picked up in other employments?

One way of answering that question in terms of neo-classical theory that has appeared over the last 10-12 years is illustrated in the diagram on the first page of the Annexure to this lecture. I have got unit labour cost on the vertical axis. Unit labour cost in a simple macro model is just the real wage times labour-output ratio and if you think about that purely macro-economically, then the real wage times the labour output ratio is going to be equivalent to wage share if you talk about unit labour cost economy-wide. So, I have got either unit labour cost or wage share on the vertical axis and on the horizontal axis, I have got

output. The first question I want to ask is what happens to aggregate demand or macro economic balance conditions - the IS (investment = saving) condition as a function of the real wage. There are a couple of papers that came out in early '80s which basically asked this question. One was written by Bob Rowthorn at Cambridge University and another by Amitava Dutt in his Ph.D. thesis at M.I.T. Suppose, we have a progressive redistribution of income. They ask, what is going to happen to the level of output or to the level of aggregate demand after this progressive redistribution, say, after the real wage increases. Now, the orthodox theory, you recall, tells you that aggregate demand or output has to go down. If workers become more expensive, then firms are supposed to lay off the workers and output is supposed to decline. That is, there is supposed to be an inverse correlation between the real wage and level of output which is very strongly built into neo-classical theory. That happens to be untrue, incidentally, by and large. If one observes anything, it is a positive correlation between real wages and output. A classic example has been experience in the post socialist economies since the early '90s when they tried their orthodox reforms and quite strikingly there are positive correlations between the real wages and output. Unfortunately, both of them went straight down. So, it is a positive correlation in downward direction. The elasticity is about equal to one between real wage reduction and output losses under the post socialist transition. May be, it makes you think once or twice but that never deters the people who believe in neo-classical theory. What these guys, Rowthorn

and Dutt, did was not to worry about the supply side story but to worry about the demand side story. Presumably, progressive income redistribution, increase in real wage will, if savings propensities differ across classes, which they probably do, almost certainly do, then progressive income redistribution is likely to raise consumption and thereby stimulate aggregate demand. However, the progressive redistribution will also be associated with less profitability for investment and therefore investment demand might be expected to decline. All this happens in an economy, let us say, which is closed to foreign trade. In an economy open to foreign trade, progressive redistribution presumably will also be associated with higher export costs and exports also may go down. So, it can go either way : the real wage increase can be associated with higher aggregate demand in which case, we may call the economy wage-led. Or progressive redistribution could be associated with fall in aggregate demand in which case the economy will be profit-led since regressive redistribution will increase profit, will increase demand. So, we have a choice between wage-led and profit-led macro economic adjustment. Some of the econometrics is beginning to come in. The general lesson from the econometrics seems to be that industrialised economies tend to behave as if they were profit-led, developing economies tend to behave as if they were wage-led. One reason for that, which I will explain in a minute, is that devaluation which cuts the real wage often tends to be contractionary in developing economies and that is a thought which I want to develop a bit further on. Now a question : What happens when there is technical advance in a profit-led or a wage-led economy? What I have here is these two

diagrams on the first page of the Annexure where the upward sloping curve in the wage-led story of the upper diagram is the IS curve - aggregate demand curve. The aggregate demand rises as a function of the real wage or the labour share. In profit-led economy, the IS curve slopes the other way.

I have also stuck on some schedules which I label 'cost' and basically what I have in mind is a simple differential equation describing the evolution of the real wage over time. The change in real wage, w , I am assuming (since I can put it on the same diagram) is the same function of real wage itself and of capacity utilisation or u or output for that matter. So, in terms of this particular model, that is the simplest kind of description of the wage adjustment that one can come up with and typically the real wage tends to rise with the level of output. So, you would get a positive sign there. When I was taking first year university physics, a common argument was to say that the world is stable. Economists also like to make the same argument. If the world is stable, an increase in real wage will lead real wage to fall, you get a negative sign. If that is the case, then the locus of points along which the change in real wage is zero will be positively sloping curve and that is what I mean by cost schedule in these two diagrams, roughly speaking. I think, I have to extend that to talk about changes in labour-output ratio. But let me not bother to do that.

Then, what happens when costs fall? Suppose, you are in a wage-led economy, as in the top diagram; the cost schedule slides

downward because there is an increase in the rate of growth of productivity. If we believe in the Washington Consensus, when we liberalise prices, productivity growth automatically speeds up and the cost schedule slides downward. What happens in effect at the initial real wage? Is it, people are thrown out of jobs? What happens is that there is no automatic job creation that accompanies productivity increase. In the wage-led economy, you essentially get an immediate drop in aggregate demand and then you will converge to a new equilibrium at a lower level of output and at a lower level of real wage. Productivity increase will not have been absorbed. Moreover, here I want to add something to the diagram which I may use in another diagram a bit later on. One can also think of an investment function which also depends on the real wage and the level of capacity utilisation and, in particular, one may typically assume some kinds of signs of the investment function like that. That is, the increase in capacity utilisation through standard accelerator kinds of arguments will tend to increase investment demand, and an increase in real wage, increase in wage share, will be accompanied by profit squeeze and that will tend to reduce investment demand. One can then think on the basis of this investment function. On that particular diagram, one could think of imposing, given the investment function, that I just had written up there, one can easily draw a family of iso-investment loci i.e. schedules of points or loci of points along which investment stays constant. If investment is more responsive in this kind of economy to changes in output than it is to changes in distribution, you can verify fairly easily that these loci will be steep. You are talking about higher

investment levels as you move outwards and as a consequence not only is the shift downward in the cost schedule associated with a reduction in the level of output and a lower real wage, it is associated unambiguously with a reduction in the level of investment and thereby in the long run with a reduction in the rate of growth. So, unambiguously in this particular set up, technological change does not look like such a good thing. The Luddite argument extends to the long run. Whether or not the Luddites were right is something that we can possibly take up but which I do not want to address at the moment. The only thing I want to stress is that there are certain aspects of the structure of the economy which can make it difficult to absorb technical change and may be one ought to worry about these aspects of the economic structure. Notice that, in profit-led economy this is no particular problem. In a profit-led economy, that is, in the lower part of the diagram, the cost schedule shifts downward, that is associated with reduction in labour cost, but also associated with an increase in output and moreover it could be associated with an increase in growth by the same kind of argument that I made here. What makes the economy wage-led? One thing is the buoyant investment function and another thing is the exports which are responsive to unit cost. One part of the Korean miracle, of course, was selection of an export bundle which was highly responsive to reduction in Korean unit cost as a consequence of the rapid pace of investment that was being undertaken in that country. So, in that sense, although superficially a wage-led economy looks like a better place to live in, a profit-led economy may be easier to

run. So, this is just one aspect of structure which I think is of interest or one kind of macro economic structure that we can formalise very easily which may be of interest in terms of the on-going policy debate. Let me just sketch another picture which is not very much of interest with the ongoing policy debate in India but may be we can talk about it also as it may be in the US or other industrialised nations. Suppose, we assume that the US, in fact, is profit-led. I will just redraw a diagram here. The way this diagram differs from the diagram that is shown in the Annexure on the pages that I have passed on is that the cost curve is non-linear and becomes pretty steep at a high level of capacity utilisation. Among the radical economists in the US, this steepening of and the non-linearity of the cost curve is sometimes called the full employment profit squeeze or something like that. It essentially says that when you get to high levels of economic activity, the bargaining power of unions increases, people are more willing to be fired because alternative jobs are available. So, the alternative cost of job loss goes down which means the firms have to pay more. This kind of argument is, basically if you believe in this and there is some econometrics in support of it, that expansionary policy which outwardly shifts the IS curve is not going to do very much good. It is mostly going to spill over into real wage increases. There would not be much increase in output. Moreover, if we go back to the investment function where the arguments were essentially the level of capacity utilisation and the real wage before profitability. Suppose that investment function is highly sensitive to profitability considerations. That is the globalisation story basically.

If I assume that investment function is highly sensitive to this profit differential or to the profitability in this country versus its profitability outside this economy, then instead of being steep as in the previous diagram that I sketched out, the iso-investment loci will be shallow. In fact, it will be true that if they are shallow enough the expansionary policy will be associated with reduction in the rate of growth so that you essentially get a little short-term benefit from the expansion that will come about initially. Then you go back to the new equilibrium point. The new equilibrium iso - investment locus can, in fact, lead to a lower rate of output growth. It is tricky. In both these cases, the attempt at market friendly policy in the wage-led case, the attempt for faster productivity growth in the profit-led case, the attempt for expansion are going to backfire and they are going to backfire depending on the structure of the economy at hand.

If you turn to the second page of the Annexure, you will get the story about devaluation. You will recall that devaluation tends to be contractionary and, in advanced countries, devaluation for another reason may not be very helpful for the trade deficit. What I have done in these diagrams is to put the trade deficit on the vertical axis versus output on the horizontal axis. External balance is essentially measured by the trade deficit. It is often measured the other way round but let me measure it by the trade deficit. What I am saying is that the trade deficit - external balance schedule essentially says that the trade deficit increases as a function of output, which is

more or less what you expect - start bringing in imports and you stop exporting. Internal balance in this particular diagram is essentially the excess of investment over savings. The standard Keynesian stability condition, that we all learn the first time when we take macro economics, says that both investment and saving are likely to rise as functions of the level of output but saving will rise more strongly. That says that $I - S$ is going to be a downward sloping function of the level of output. So, that is what the internal balance schedule tells you. Suppose that the economy is profit-led and suppose we do a devaluation, essentially, devaluation is a cut in real wage so that aggregate demand is likely to increase in the profit-led system. So, internal balance shifts upward. On the other hand, in terms of external balance, presumably, the trade deficit declines in response to devaluation. So, you get a picture something like the upper diagram. External balance shifts down, internal balance shifts up. You go to an equilibrium where output increases but the trade deficit does not get a lot better. And that essentially comes out of profit-led nature of economy. Then you get a story which looks like the story of US, let us say, in the late '80s. In the first part of the '80s, America was appreciating and everybody was telling that exchange rate was going very badly out of line. Then, they always have accords. There were some accords of mid-'80s and of '85. The dollar started to devalue. It did not do much with trade balance but output continued to boom. More or less, an explanation is that output was booming in early part of '80s because of fiscal deficit. In the second half of '80s, the

fiscal deficit was cut somewhat but output continued to boom because of devaluation, as shown in this diagram. The economy finally ran into problems of that nature but they did not materialise until the unfortunate Presidency of George Bush.

Now, suppose you look at the lower part of the diagram, may be the developing economy is wage-led so that devaluation shifts the internal balance schedule downwards and in that case one could go to an equilibrium where the trade deficit definitely improves but level of output goes down. I thought through another story about the wage-led economy, - how you will think of combining fiscal policy and devaluation. If the economy is wage-led and you do devaluation, you might argue that devaluation should be combined with expansionary fiscal policy, the argument being that devaluation will help external account but will also reduce the level of output. So, may be, we should offset the reduction in the level of output with expansionary fiscal policy. Of course, when IMF comes to town, it tells you just the opposite. That is, you should combine devaluation with contractionary fiscal policy which in effect shifts IS curve still further downward and this kind of combination, devaluation with contractionary fiscal policy is what gives rise to the standard accusations that IMF is engaging in over-kill. On the other hand, it is hard to believe that IMF will ever come to town and say : 'Why don't you devalue and by the way increase public sector borrowing requirement by 2 per cent of GDP?' That, I think, is not likely to be on the cards. Then try to make sure that the recession is run by combining all possible recessionary tools.

Then, let me take just a few minutes to illustrate the last model which became fairly popular in the late '80s to illustrate what happens to developing countries when they were subjected to adverse external shocks but also helps to think about how developing countries might adjust to favourable external shock, that is, recommended that fairly high capital inflows. This particular version of the three gap model essentially combines the familiar Keynesian cross diagram with the foreign exchange constraint. That is, again the first time you take macro economics, you learn to draw a simple diagram with investment or the rate of growth on the vertical axis, level of output on horizontal axis. The saving function is steeper than the investment function, as I was discussing a while ago, and the cross between the savings and the investment functions gets you to macro economic equilibrium. The third schedule that I have imposed on the diagram essentially is foreign exchange constraint and it is drawn with a negative slope essentially to reflect the nature of imports in most developing economies. That is, after any pursuits of import substituting industrialisation, you will typically find that the economy has become dependent on intermediate imports. That is, essentially what import substituting industrialisation does is to replace imports in its production phases, it replaces imports of final goods by import of intermediate goods which basically means that if you want to keep up production within the country, you need a certain availability of foreign exchange. On the other hand, even in places like India, import substitution of capital goods is never complete. So, you are also dependent on

imports of some kinds of machinery and equipment and if you are going in for capital goods import liberalisation the coefficient for imports of machinery and equipment will, of course, go up. May be it is more efficient but that is the trade off that you confront. So, a given amount of foreign exchange can either be allocated to imports of capital goods which means that you can keep a high level of investment, or it could be allocated to imports of intermediate goods which means that you can keep high level of current output. But with a given availability of foreign exchange, you can not do both. And when the countries became foreign exchange constrained in the '80s, they responded in various ways. In Zimbabwe, in Africa, because they were not getting along terribly well with the Bretton Woods institutions, they essentially inherited a complex system of import licensing from the old Rhodesian government and they essentially used that system of import licensing to regulate imports of intermediate goods and keep out import of capital goods. So, basically they had low investment with high capacity utilisation in Zimbabwe throughout the '80s. They were, in fact, trying to combine that with some degree of export subsidy and it was looking pretty good. Then, in around 1990, they decided to liberalise anyway for reasons which are not altogether clear. It is not going very well really but that is another story. Tanzania, by contrast, was heavily infested with foreign donors who insisted that their favourite investment projects should be completed. That means, most of the foreign investment, foreign exchange coming in went into investment projects, very little in to intermediate imports. The economy became highly import compressed and capacity utilisation fell

down to about 70 per cent. Thereafter, to finish up this story, when Tanzania did a deal with IMF and the World Bank, they got in foreign exchange and devalued. The foreign exchange allowed them to get rid of import compression and output went up. In that case, you got devaluation which superficially at least was expansionary although it was certainly associated with lot of capital inflow. So, you have this downward sloping foreign locus. The way I have drawn the solid lines in the diagram, they all three cross in one point which, in terms of high school geometry, means that I have to be slightly clever when I draw the lines. Normally it takes two lines to determine a point, but I managed to get away with three here. How did I do that? There are couple of stories one can tell. One is that the savings function, in fact, depends on the rate of inflation and the story would be basically that a higher rate of inflation is associated with a reduction in aggregate demand (household demand) and thereby an increase in savings. There are couple of stories that one can tell. One is that when price inflation speeds up, typically the wage lags behind. So, money wage rises less rapidly than the price level. That means that the real wage declines if the economy is wage-led. That therefore means that aggregate demand will decline. This kind of adjustment is typically called forced savings in the literature. It is not the best label. Savings go up because the poor people whose wages go down are forced to consume less. This kind of adjustment is also obviously associated with Kaldor in the post-World War II macro economic literature. It was really characteristic of all macro economic literature before the publi-

cation of General Theory. These ideas come and go depending on theoretical whims and what seems relevant at some point of time. But certainly forced savings was a major aspect in adjustments in the developing economies in the '80s. There is something else called the inflation tax which basically says that if I hold certain amount of cash Rupees and if the rate of inflation speeds up, then the value of my cash Rupees is going to erode more rapidly. If I am a rational person, what I will do? As the value of my wealth is eroding and therefore to restore my wealth, I should save more. So that in effect inflation tax is also associated with an increase in savings or a reduction in aggregate demand which, of course, is what any tax should do. Now, one piece of evidence in favour of the relevance of these particular linkages is that in Latin America and elsewhere in the '80s, when they had so called heterodox shock and inflation stabilisation, some - of which worked, some of which did not, essentially, they resorted to economy wide price freezes imposed by decree. These price freezes when inflation was 300 to 500 or a 1000 per cent per year one day and the next day, resulted in inflation reduction. An effect of the rapid inflation reductions was a big surge in consumption demand. That was essentially, one could interpret it to be, inflation tax - forced saving working backwards. So, what I could do is to sketch a number of savings-loci in the diagram which are associated with changes in different levels of the rates of inflation and as you go in the North-West direction in the diagram, you are talking about different inflation rates - higher inflation rates going North-West. So, the story would be then that macro equilibrium really is determined by the intersec-

tion of the I and F loci. That is what is determining macroeconomic equilibrium and then the inflation rate is adjusting to generate the rate of saving that would ratify that kind of equilibrium. That is, if you think about it, fundamentally the kind of monetarist story. Inflation tax is a fairly monetarist way of looking at the economy and saying that suppose I were to shift the investment function upward in this diagram, given the position of the foreign exchange locus, that means I would have to go in the direction of higher 'G', and lower level of output. The way that lower level of output would be ratified would be by a faster inflation rate which would squeeze people out of the market. The monetarist dimension of that story is that if I shift the investment function up, if I shift the government spending up, then to pay for that upward shift in investment, or upward shift in government spending, I would have to go to the banking system to get additional credit. The additional credit either to firms or to the government would give rise to expansion in money supply and expansion of money supply would be associated with a faster rate of inflation. That is the monetarist dimension of the story which is hidden behind the diagram. Note incidentally that I am assuming basically that banks either finance investment or they finance the government. And an increase in investment can be inflationary just as much as an increase in government spending. This sort of more or less even - handed treatment of demand injections is, in fact, characteristic of the kind of monetary economics that was done by people like Knut Wicksell in the '20s and '30s of this century. The notion that government only is to

blame for inflation by printing money is one that became more popular in the last few decades. So, I think, saying that any injection which is financed can be inflationary is a more sensible way to view it. One can also think of equilibrium being determined by intersection of I curve and S curve for given rate of inflation. That is, I can say that there is a given rate of inflation which is being determined from the side of cost which is, more or less, the structuralist view of inflation. Basically there are two inflation theories that we have inherited for 200 years of economic thought. The structuralists say that it comes from cost and class conflict and that kind of things. The monetarists say that it basically comes from spending too much money, too much aggregate demand. I think, both are right, more or less right, depending on circumstances. However, if you had a purely structural inflation, then you would peg the rate of increase in prices, that would peg the position of the savings locus. Savings and investment will give standard kind of Keynesian cross and then you can assume that F was adjusting up and down through capital inflows and capital outflows to ratify the equilibrium. So, there are two possible kinds of equilibrium stories.

Now, the last thing I would like to talk about, which you see in the diagram on the next page of the Annexure, is what is going to happen if suppose money starts coming into the economy - foreign exchange starts coming into the economy - so that there is an upward shift of the F function, say, from the solid line to the more wavy line. How is the economy going to adjust? And there are various stories that one can tell. If the saving function

does not shift, you see that F function shifts up and there will be wavy line intersection with the unshifted saving function. What that, is basically saying is that you have got more foreign exchange available in the system and the available savings schedule will enable us to go to a point like 'A'. In fact, that point is associated, as you can see, with some increase in both output and some increase in investment. But how could you get to a better position? And there you have to think about the other schedules which might be shifting. One story is that maybe the inflation rate will go down. You do not need the forced savings any more because you are no longer bound, i.e. if you think in terms of the Latin American debt crisis, for example, the F schedule shifted downward, you were stuck in a supply constrained equilibrium. Aggregate demand initially exceeded aggregate supply. Initially, you are running 3 per cent trade deficit and then the banks say 'we will stop lending you money and, by the way, please pay the interest on the outstanding'. What that means is that you shift the 3 per cent trade deficit, let us say, to a 3 per cent trade surplus to pay the interest. In effect, that is a very strong supply shock because the foreign exchange is necessary to keep up production for the reasons that I have been indicating. Therefore, demand has to fall back down to supply and one way to do that is to run an inflation and to cut real wages, which is, in fact, what countries did when subject to the debt crisis. Now, it is a kind of the other story. Maybe inflation can go down, meaning that saving schedule can shift downward, meaning that consumption can go up. So, one way of accommodating to the increased availability of foreign capital would be to

shift up consumption function via a reduction in inflation. This looks like the Argentina story or the Mexican story that I was talking about this morning. The adjustment takes place on the side of reducing saving rates. Output certainly goes up. But you are still crawling down the foreign exchange schedule which means that you are not going to be growing very fast. Alternatively, you can try to shift up the investment function by one means or another. That means basically that the increase in available foreign exchange is going to be associated with higher capital formation; financial capital inflow is associated with higher physical capital formation. That lets you go to a higher rate of growth. But it does not happen automatically and either the private sector picks up on the capital inflow and actually turns it into investment or else the public sector intervenes in one way or another to facilitate the new investment. Now, lot of things are going on behind the scene in this diagram, as is true of many other diagrams. That is, you have got changes in the rate of inflation. You probably are going to see shifts in relative prices between traded goods and non-traded goods. You are going to see, more or less, appreciation of the currency, you are going to see changes in interest rates. It is not too hard to write down the full macro system around all these changes and even to think about that macro system at least algebraically. But it becomes a bit too complicated to put on simple diagrams. So, I guess, with that particular observation, may be, we break off here.

Points raised and replies given by Dr. Taylor :

Point

Coming back to the first diagram in the Annexure for the wage-led economy, the conclusions will change if relative slopes change. Do these relative slopes have something to do with stability conditions ?

Reply

The way I drew it, it is stable. That is, you can think of some little arrows pointing up and down - above the cost schedule pointing down, below the cost schedule pointing up - which would tell you that this is stable adjustment. The unstable case has a steep cost schedule and, if you do not mind, there is another observation which can be based on this particular diagram - suppose the cost schedule is steep so that it cuts IS curve from below. Suppose that the IS curve shifts outward. It could shift outward either because of expansionary policy or, more interestingly, it might shift outward because you do one of these heterodox shocks, anti inflation packages and aggregate demand goes up because you get rid of the forced saving and inflation tax. I would not bother to draw the diagram but what you see of course is that the cost schedule cuts IS schedule from below. If I shift the IS schedule upward, you will get instability with every increasing levels of real wage and aggregate demand and, in fact, this instability is one of the things that destabilised the heterodox shocks.

Point

If you make normal assumptions, we must have IS curve downward sloping. If the wage share goes up and propensity to consume of the workers is greater than that from profit, if the wage share goes up, naturally the total amount of saving in the economy is going to come down and with that also investment in the economy. So, you should have IS curve sloping downwards. Increase in the wage share in national income means a larger share of consumption in national income and lower share of savings.

Reply

So, the IS curve it goes up. Basically, this is the aggregate demand locus that is called IS and the condition for it is $I - S = 0$. So, as you say, an increase in the wage increases wage share, savings goes down. Ex ante $I - S$ is greater than 0. The way you get profit-led story is to say that I depends on real wages. So, real wage goes up. There is profit squeeze, investment function shifts downward and that gives you the downward sloping case.

Point

How is it different from the kind of macroeconomics we learnt in the Mundell - Fleming model and its other versions? Does it also suffer from stock-flow complications?

Reply

Most but not all. I have a recent book. I suppose I can bring out copies and circulate. Unfortunately, I do not have it. I have a recent book called "Income Distribution, Inflation and

Growth". If you want to see the formal analysis, that underlies most of what I am talking about to you, it is available there. How does it differ from the orthodox macroeconomics? In some ways, not very much, but let me make a couple of observations. One is that the kind of things that I do and the sort that other people do is more or less consciously based on the kind of economics that was done by Keynes, Kalecki, Keynes' predecessors, Kaldor. And we can essentially talk about the methodology for a long time. It treats macro system essentially as a macro system and reasons in terms of aggregate distributional categories like wages, profits. I have not done any sectoral stuff here, but one can also think of agriculture versus industry models and that kind of thing. It is explicitly macroeconomic, founded on structure somehow described, which will typically take class, sector dimensions in the formal models that one can work with. It asks about stabilities and instabilities that may occur in the system. I might also add that some people extend this kind of analysis to the financial side of the system. So, there is another body of thought out there, relatively coherent relatively recent, mindful of the past, mostly produced by people who think of themselves as being leftist or progressive, whatever that means. How it differs from the main stream stuff is that the main stream economics in the US at least has gone through a number of cycles over the last few decades. You had the neo-classical synthesis which I would interpret as a kind of bastardised version of what is going on here. That was followed by rational expectations which turned out to be uninteresting, essentially trying to say that the supply

side is what really matters under the kind of peculiar rationality assumptions that neo-classical economics entails. So, you have neo-classical synthesis, you have the rational expectations monetarist explosion. That begins to run out of gas. Somewhere along the line, however, the notion appears that the macro economy really is described by some kind of optimisation model over time. And finally in the last 5 or 10 years you have appearance of the so-called New Keynesians and the Blanchard-Fischer text book which is the most recent codification of macro, essentially based on the Ramsey models and the post-Keynesian stuff. From my point of view, most of the post-Keynesian stuff could have been written in quite coherent English and, in fact, was prior to 1939. There is really very little that is new in that literature aside from lot of mathematisation which is not particularly helpful. There are certainly some overlaps between post-Keynesian stuff and the kind of stuff we do, but the motivation is rather different.

Point

You have spoken about the changes in the price level. Suppose we have sectoral price level changes like when we have agriculture and industry, then how does that work? In your model, agricultural sector depends on demand and supply but about industry, then, we ought to have some mark up or something like that.

Reply

I do not have time enough but I will sketch the whole thing. I can work with different methods of price adjustment depending

on the sector. Let us say that agricultural prices respond more to excess demand for products of the sector depending upon the elasticities and it may well be that industrial prices are fixed by mark up. So, then one has a supply limited price flexible sector, a demand limited mark up price sector, it is easy enough to put together the so called fixed price flex price models with distributional changes built into them which deal with that kind of an issue. If one is thinking seriously of modelling the Indian economy in this framework, you will essentially have to combine these three gaps with that kind of story. Equally, with that kind of story you can talk about traded goods versus non-traded goods, one which is market clearing, one which is fix - price. Traded goods price in this case is fixed from the world market and that leads to some overlap between the kind of models I am talking about to you and the Dutch Disease literature which appeared in the orthodox literature some 10 - 12 years ago.

Point

When you were arguing in terms of inflow of capital, you did not refer to exchange rate movement even once. The whole argument was in terms of trade deficit and domestic output. What I feel, when you are talking about internal balance and external balance, some reference to exchange rate movement would have cleared the process of analysis, process of adjustment more fully because if capital inflow is there, exchange rate appreciation takes place or naturally then, in order to preserve internal balance, which way does it have to be shifted?

Reply

In terms of diagram on page 2 of the Annexure, essentially, I assume, the thinking is about fixed exchange rate system and I am assuming that capital movements are not responsive to changes in the exchange rates, which is not true. So, in the fixed exchange rate system, what I am doing is considering the implications of re-pegging the exchange rate. And the story I was telling in the fixed rate system, if you adjust the exchange rate, make a stepped devaluation, you are likely to get an improvement in the trade deficit, which is standard. It would also change absorption and the way absorption changes is basically what is going to determine whether devaluation is going to be expansionary or contractionary. The issue whether it is expansionary or contractionary is pretty practical in the developing countries and it has been fairly widely discussed.

Point

I would like to draw your attention to the diagram on page 3 of the Annexure where you have drawn the three-gap figure. As far as this particular diagram is concerned, we have the saving constraint, we have foreign exchange constraint as well as you have investment schedule. But what I am surprised to find is that there is no mention of the fiscal gap which is indeed the third gap. According to me, if I compare this figure with the literature, this looks similar to two gap analysis. In what way is your treatment of the three gap model different from the earlier two gap analysis?

Reply

The way these three gap models were first put together, the reason why people wrote down three gap models was intimately tied up obviously with the so called double transfer problems that appeared in Latin America after the debt shock. That is, basically you have to grant a trade surplus to pay the interest obligations. However, the debt had largely been nationalised. Therefore, the government had to run a primary fiscal surplus apart from the debt obligation to be able to repay the debt. There was a further notion that private investment is crowded in or at least not strongly crowded out by public investment so that if you are fiscally constrained, then, you are likely to cut back on public investment even if there is weak crowding in. Therefore, the original two gap literature had said that investment is likely to be constrained by available foreign exchange through the trade gap, by saving through the saving gap and by these two things - savings and the available foreign exchange. The three gap literature says that there is also likely to be a fiscal constraint on investment because of the reasons I was discussing - you have to send money abroad, that means you have to cut back public investment, cut back capital formation. That is the way some people, myself included, set up three gap models and quite a few other people, before I did, set up three gap models in the late '80s. Now, what you have here is essentially a restatement of the model in terms of another set of constraints. What I have done is keep the foreign constraint. I have written separately

the investment function and in the saving constraint, I have essentially built in the fiscal gap in a monetarist way saying that if you invest more, if the fiscal deficit goes up, then you have to borrow from the banking system and this will create inflation and that inflation is essentially what parameterises the saving function. So, it really is the same model thought in a monetarist version, although it is set up somewhat differently from the other three gap presentations.

Point

For the series of models that you have given us, can you quickly summarise the macro economic equilibrium conditions only? I am not asking for all the equations. Only the equilibrium conditions of each.

Reply

It is really the same in all the models. i.e. $I - S = 0$ and then you tell different stories about how to get them.

Professor V.M.Dandekar

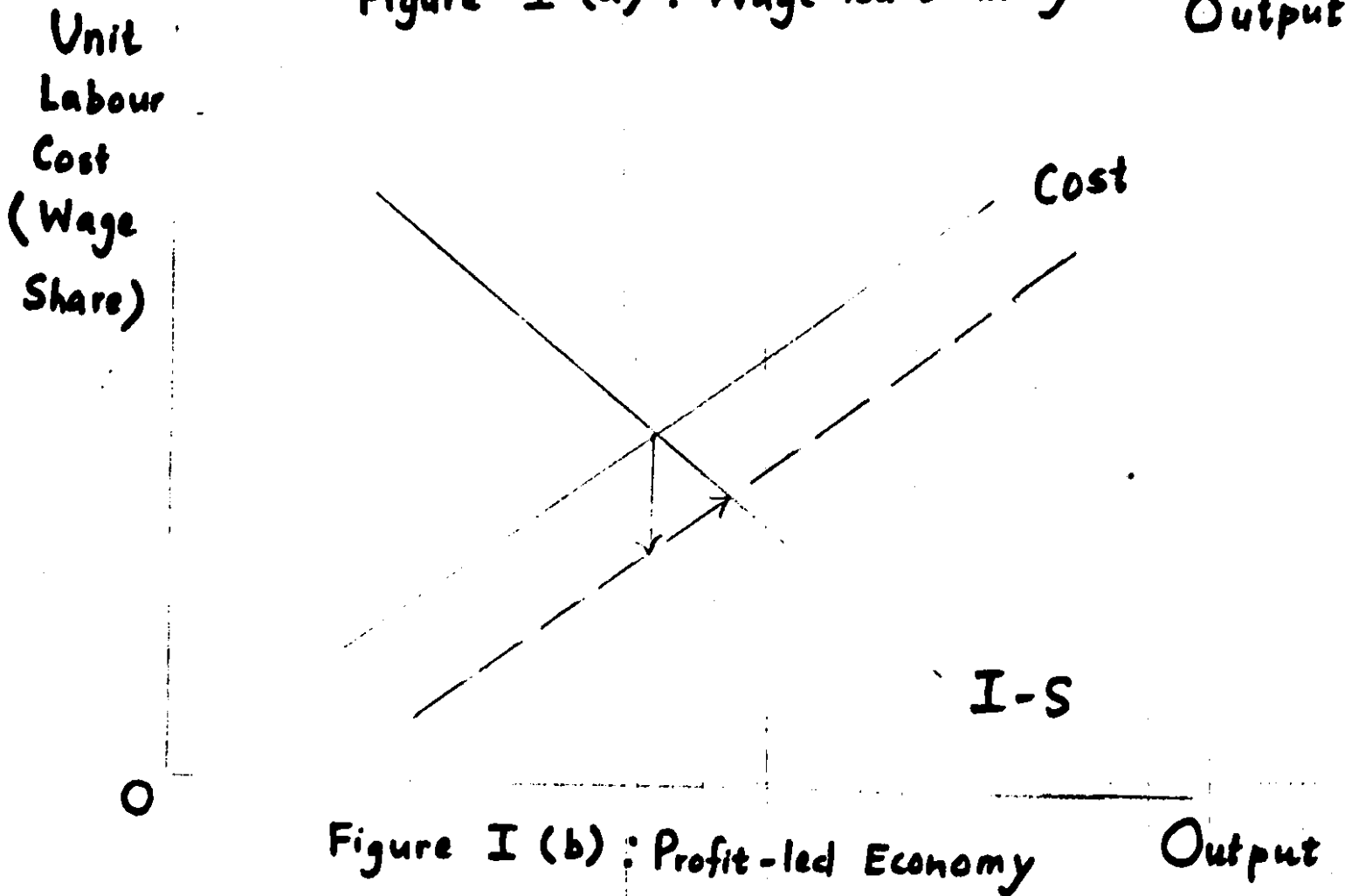
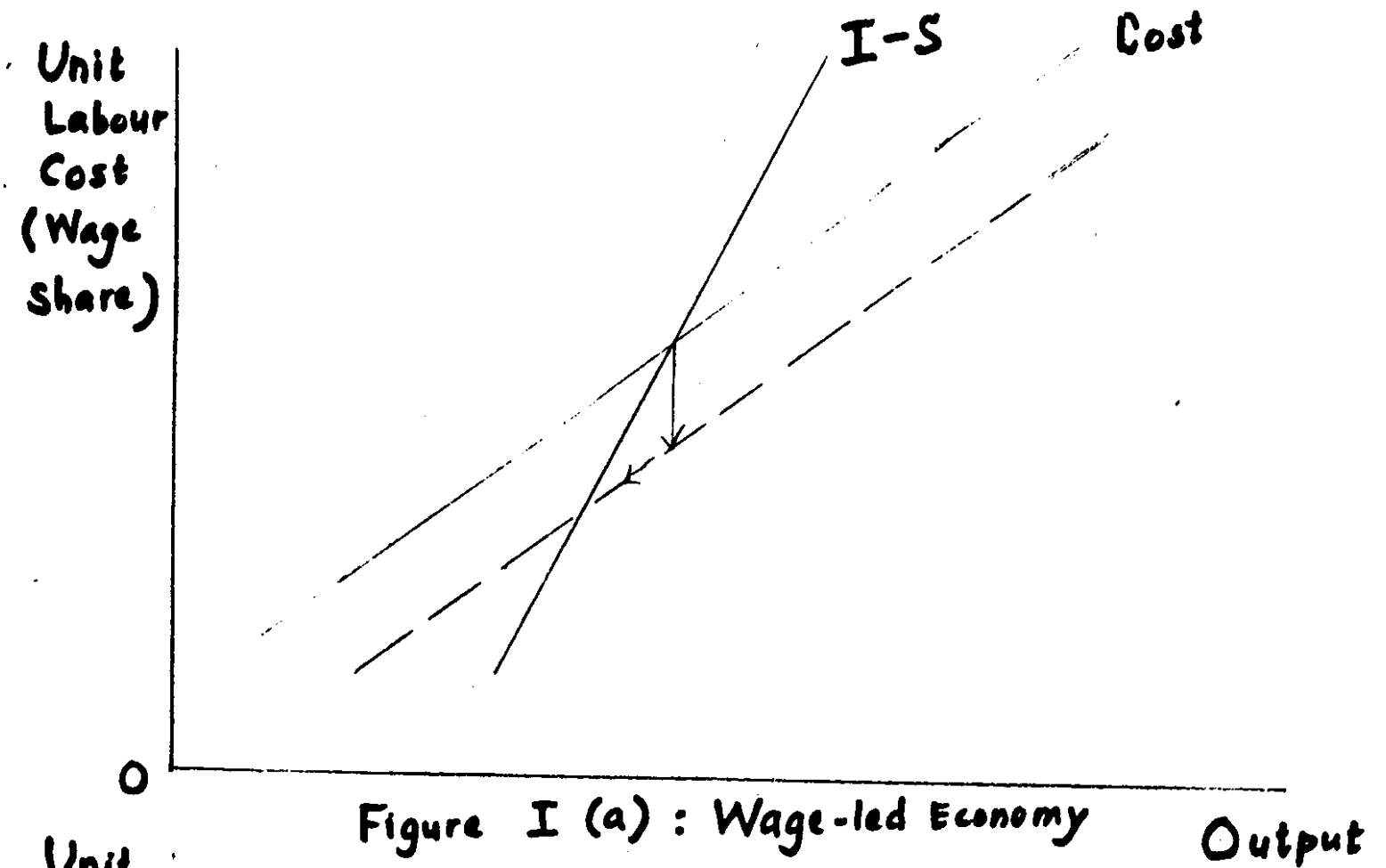
If I have understood the questions from the audience, I think, most of them are puzzled as to what is the structuralist that you want to say. Your methods, your diagrams is something which is in the familiar Keynesian tradition and what is structuralist about it? That is the kind of doubt which some of the questions have raised and I am emphasising this because there is a feeling that some people say that they are structuralists or institutionalists or something else but when it comes down to

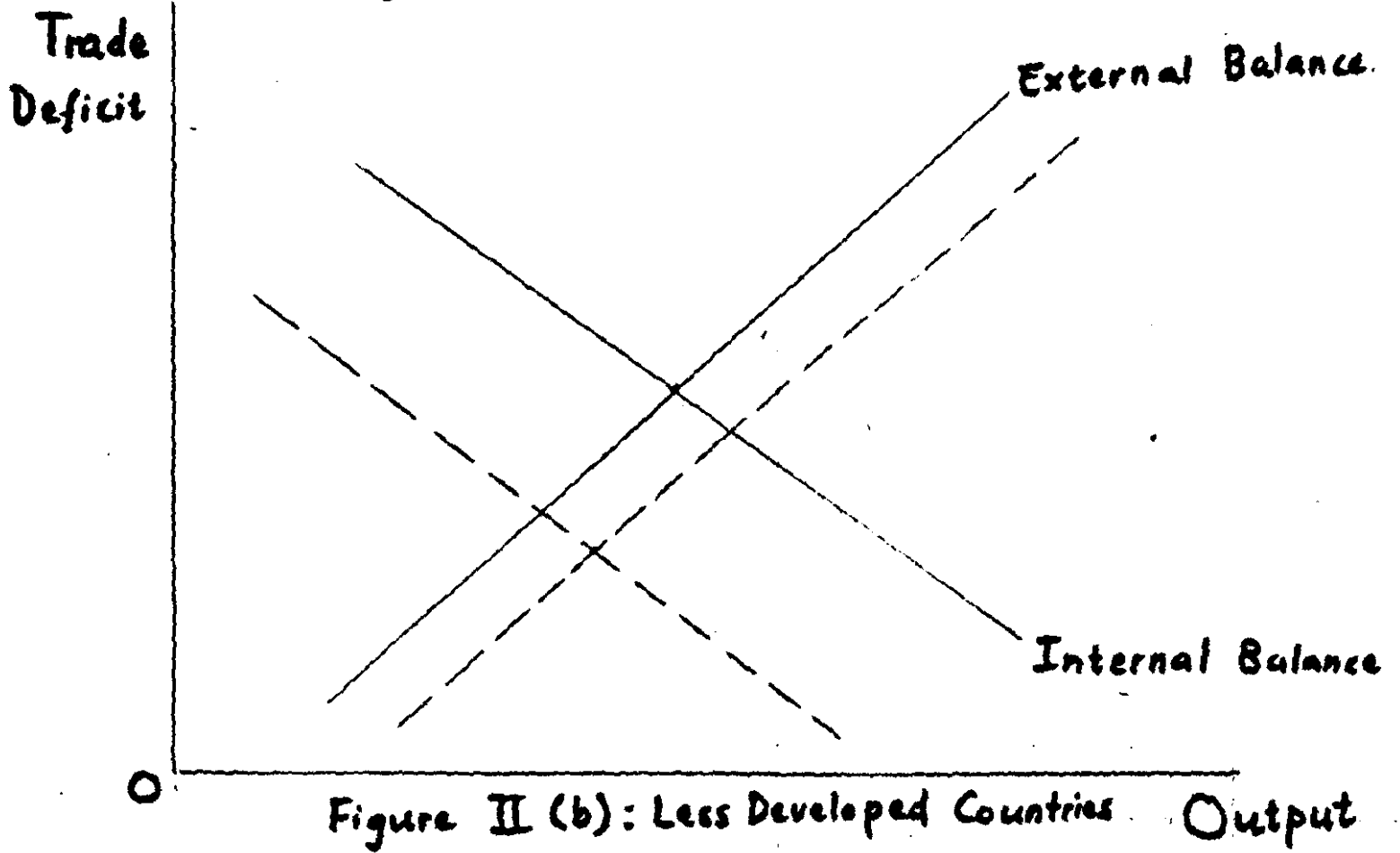
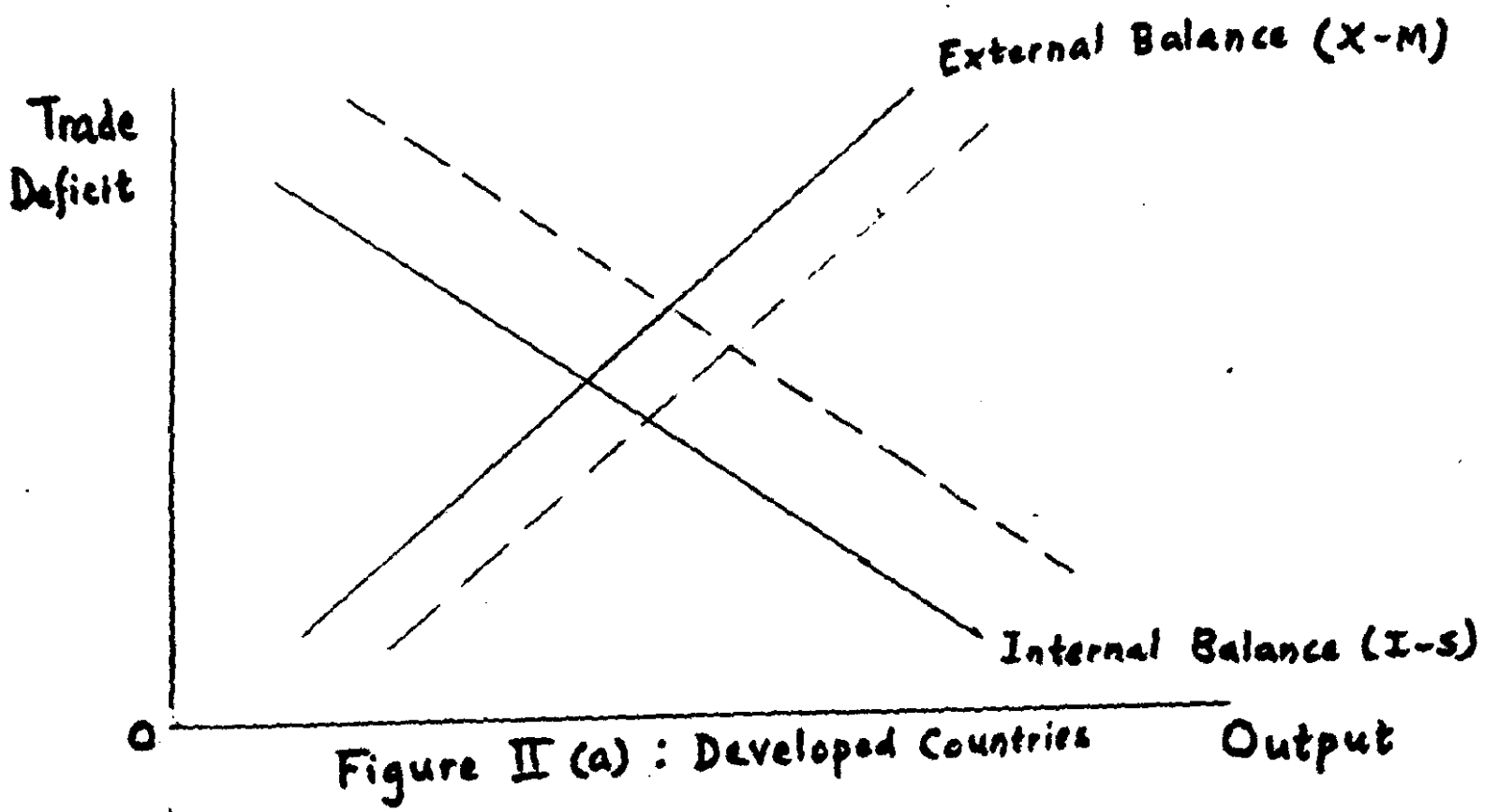
brass tacks, they come back to the neo-classical economics. In my feeling, I think, we have lost a chance if we were discussing the general equilibrium - that is what the last question was "what is the equilibrium that we are talking about" - then I think, we have lost the chance when von Neumann put forward a certain, and that is what I call really a structure of the economy and a major role that he made - there are some missing links because he never claimed to be an economist and he was too busy a scientist to pursue this little thing further - but what he emphasised was that the technology creates a surplus and a technology that means certain amount of input creating certain amount of outputs, if it does not create surplus, it will not survive. That is point No.1. What we did not pursue, it was pursued up to a point, but it ended up by saying that the economy may not be integrated by economy we mean the input-output matrix may be decomposable. But, then the rates of surpluses will be different but what the consequences of that are have not been really pursued. I will give you a very simple point. I happen to be travelling around and stay in the metropolis and so called five star hotels but I like to walk out in the morning and have a cup of tea at the corner shop. I have always wondered how come the same cup of tea costs Rs.50 at the hotel and Re.1 at the corner shop. My feeling is that the economy is really disaggregated and the classical, neo-classical, whatever that is, assumption that there is a uniform rate of profit and there is a uniform rate of wages and all wages are consumed and profits are all invested - I think, we are not able to get out of this. Profits are not all invested, lots of luxury

consumption is going on and so far as organised labour is concerned, 90 per cent of the organised labour today in India is income tax payer. So, do not suppose that all wages are consumed. These are some of the points which I presume or at least expect, should be addressed to by a school which thinks it wants to break through the standard dogma that has come down. It was good for school teaching, but when it comes to analysis of the real economy, when we discuss, there was some question he was asking "what do you do in Indian situation to agriculture". What he really was talking is that agriculture is a different economy, as different as two different economies; they don't meet, their input-outputs do not inter cross. They are decomposable matrices.

I do not want to expand on this. Sraffa came in between. He created a lot of dust. It did not settle down with any meaningful conclusions. This is not my theme and I should not be talking more.

ANNEXURE





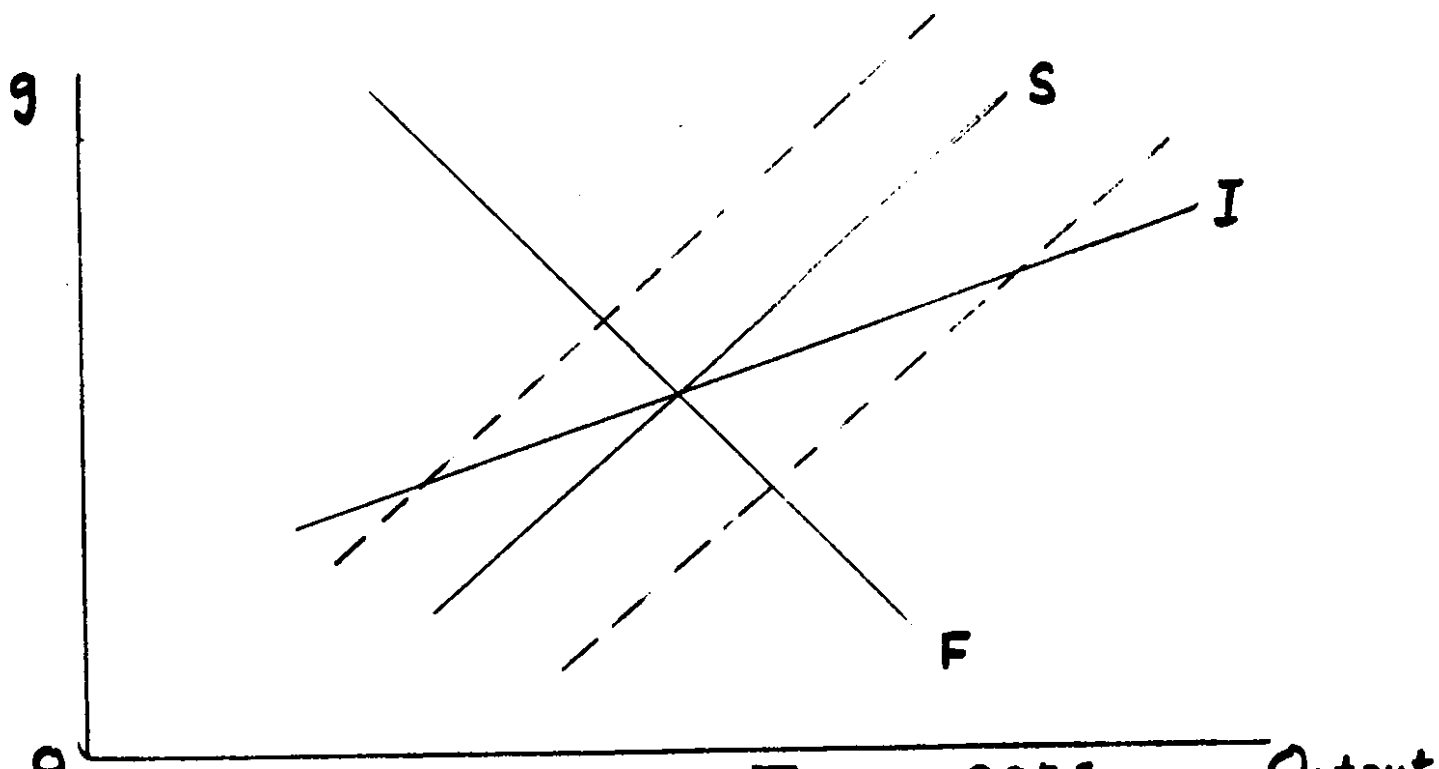


Figure III (a) : Three-gaps

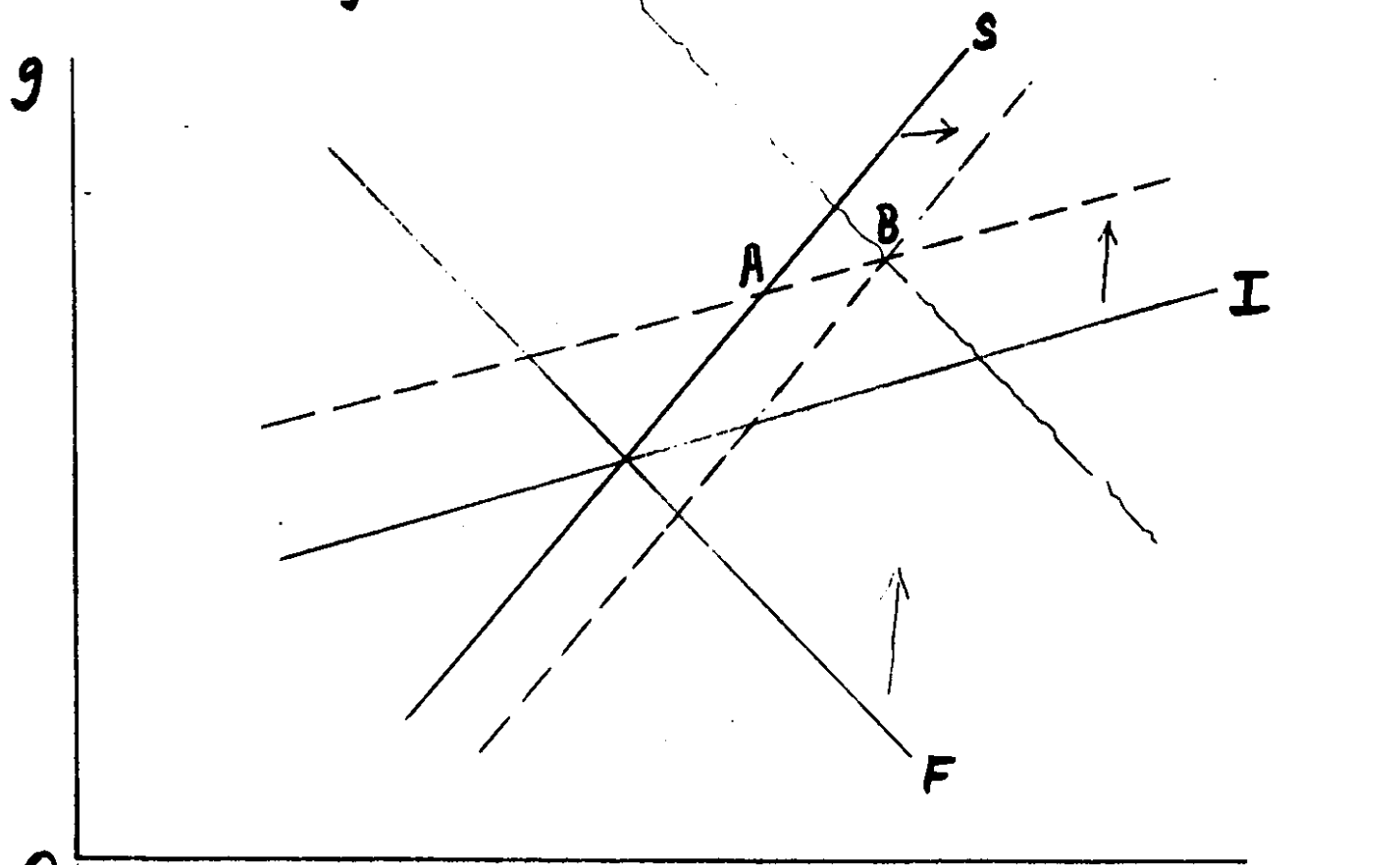


Figure III (b) : Capital Inflow