

Recent Developments in Open Economy Macroeconomics*

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The convening of this conference is a welcome sign that Indian economists, like their peers in other countries, are becoming increasingly conscious of the benefits that a country can gain by integrating itself into the global economy. These benefits are primarily microeconomic: they permit an economy to achieve output of greater value from a given set of inputs. They may also permit the inputs to grow more rapidly, if export-led growth overcomes the foreign exchange constraint. On the other hand, integration into the world economy does make an economy more exposed to global shocks, and coping with these accentuates the challenge to macroeconomic policymakers.

This paper addresses three of the important issues that arise in designing a macroeconomic policy that will permit prudent integration into the global economy.

Macroeconomic Modelling

The large macroeconometric models used for serious forecasting and policy simulations contain the distilled conventional wisdom of the profession at any point in time. Their evolution over the last decade hardly justifies the fashionable despair about the supposed collapse of macroeconomics. On the contrary, they seem to pin down tolerably well the impact of changes in most exogenous factors and policy events on critical variables like income, inflation, and the current account of the balance of payments. The main innovation in these models over the past decade has been their incorporation of rational expectations, at least as an option. Comparisons between versions of the same model and without rational expectations show quite clearly that the "policy ineffectiveness theorem" of Robert Lucas (1981) is only half right: incorporation of rational expectations *does* reduce the impact of changes in monetary policy, but it does *not* eliminate them and render policy ineffective (Bryant et. al. 1989, Helliwell 1989).

* Keynote address to the workshop on "Open Economy Macroeconomics and its Relevance to India" organized by the Gokhale Institute of Politics and Economics, Pune, 15-17 March 1990.