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**FLUCTUATIONS IN GLOBAL ECONOMY : INCOME  
DEBT AND TERMS OF TRADE PROCESSES**

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## A B S T R A C T

Three processes of stimulation or contraction of the world economy have been distinguished in the paper : the Kahn-Keynes multiplier process, the Fisher-Kalecki debt process, and the Prebisch-Singer terms of trade process. The inequalities of world income distribution and the asymmetries of effects of expansion in incomes in different economic groupings foul up the expansionary potential of the multiplier process and dim the prospects of global Keynesianism. Inequalities in the distribution of assets as between different countries and within countries lie at the heart of the pulsations caused by the debt process. Finally, the great division of the world between poor, less developed countries and the affluent OECD block partly rests on and partly propels the Prebisch-Singer debt process. A synergistic interaction between the three processes pushing the world economy forward is continually impeded by the Janus-faced character of capital : as finance it demands unhindered mobility and as a productivity-raising agent it requires embedding in a country, in an organization, in a production site and in a committed managerial and entrepreneurial cadre.

Fluctuations in global economy : income  
debt and terms of trade processes

1. The need to study global processes of expansion

From the 1850s until now, the global economy has undergone several long stretches (spanning at least 7 to 8 years each, that is, the length of the so-called Juglar cycle) of expansion and contraction. In the phases of contraction or expansion, the fates of a number of countries have been exceptions to those of the majority of economies. The exceptions, especially in periods of contraction, have often been the trend-setters and have often framed new rules of the game. Thus, for example, during the so-called Great Depression starting in the 1870s, Germany and the USA began to forge ahead as the trend-setters for the whole capitalist world (see, for example, Saul, 1969). The losers were mainly highly populated, dependent or semi-dependent countries such as India and China, and many countries of Africa as well. *BUT* the losers happened to contain many more people than the exceptional trend-setters. Similarly, during the other great depression of the 1930s, Japan, the Soviet Union and many less developed countries of Latin America adopted various measures of government intervention, including central planning, and were able to escape the severe drop in employment and income that characterized the U.K. or Germany (The demand stimulation in Germany with the Nazi military programme helped her to provide jobs for the boys, but at considerably lower real wages than before, thanks to the severe suppression of workers' rights (Lurie, 1947) ).

The third great depression during the century and a half since the Crystal Palace exhibition of 1851 - the depression starting in 1981 - is still with us, and does not yet show signs of going away. Again, several economies, mainly those of East and South East Asia, including Japan and the People's Republic of China as well as the four dragons and the NICs of the ASEAN, have escaped a sustained contraction in this phase. Until 1990, India was also somewhat of an exception. However, most other countries of Latin America and Africa have experienced nothing short of ecocide - a long-drawn-out contraction in incomes, running down of the productive apparatus, and a severe deterioration of the environment - during this phase.

Throughout all these phases of contraction or expansion, forces of international competitiveness have gone on working to put some countries ahead of others, relatively speaking. Many of these forces are long-term in nature, having to do with rates of long-term investment, the discovery and use of new technologies, innovations in business organization, and new strategies of government-business interaction. I will not deal with such long-term factors except in so far as they are germane to questions of short-term movements. Relative prices and real exchange rates are also instruments in the game of international competitiveness. However, by definition, such instruments cannot be used to stimulate all economies of the world, although, as many economists have argued before (see, e.g. Robinson, 1947), the attempt by many countries to use such instruments can lead to a contraction of the real incomes of all the countries taken together. Since adjustments in real exchange rates, including measures of devaluation cannot, therefore, be

recommended as a general prescription for the world as whole, I will also largely leave aside the consideration of such issues. However, there are situations in which while the basic rules of the game provide for a global expansion, individual countries that suffer from misalignments of their exchange rates can be helped to realign their foreign exchange rates. This was in fact the arrangement that was envisaged under the Bretton Wood system.

Of the three processes I have picked out for analysis in this paper, two are assumed to work without necessitating any systematic changes in the structure of relative prices (including exchange rates). These two are (a) the Kahn - Keynes - Kalecki income multiplier process as extended to the world economy by Harrod, Metzler, Goodwin, Chipman and others, and (b) the process of credit creation and its extension to the world economy as embodied in the agreements leading to the Bretton Woods system. These two will be analysed on the assumption that the relative prices of commodities remain unchanged or change slowly and in a random manner. However, the third process involves systematic changes in terms of trade between the advanced, industrialized countries, and the less developed countries (LDCs), dependent on either primary products or crude manufactured goods for their export earnings. These systematic changes are separately analysed, for, they have a very definite bearing on the aggregate expenditures, on inflationary price rises and expectations relating to investment for the world economy as a whole and not just for the LDCs.

It is hoped that a conceptual separation of these processes will help us understand how much of their working can be taken to be 'automatic' in any useful sense and how much they are affected by various kinds of national policy and by international public intervention of different kinds. A comprehensive treatment will, of course, require a book rather than an article. But an indication of some of the important ways in which the processes are affected by policy choices will show up the role of explicit public and transnational intervention in blocking or fashioning linkages between the three processes. This will serve to emphasize the asymmetric roles played by actors with different degrees of power, and by imperfect and short-sighted cartellization of economic power by a few global leaders including the leading OECD governments, the IMF and the World Bank, and by a handful of transnational corporations (TNCs) whose interests influence the decisions of these policy leaders and finally, the relative futility of the efforts of even these policy leaders to stimulate the global economy so long as they refuse to recognize the frequency and pervasiveness of conflicts between short and long-term goals and i tween the demand of capital as finance and of capital as the controller of productivity - augmenting institutions. The special problems created by the two-way mobility of capital as between most LDCs and the OECD countries and the immobility of labour as between different countries will be treated in the final section of the paper.

## 2. The expenditure multiplier in the global context and asymmetries of economic power

The income-expenditure multiplier had a number of precursors before its canonical formulation in Kahn



(1931). Kahn (1984) has disclaimed that he could be considered to be the real begetter of Keynes' General Theory (1936). Nonetheless, Kahn's article still reads as if it was a conscious application of Keynesian macroeconomics to the discussion of the impact of an increase in expenditure on public works. The importance of the supply conditions of consumption goods, the implication of a rise in wages in response to an increase in the demand for labour, the critical importance of a banking policy -as to whether or not credit is tightened whenever prices rise (Kahn, 1931, p.3), \_the variation in impact on employment with variations in the size of the 'dole' in relation to the wage of an average worker, and the 'alleviation' to the increase in purchasing power resulting from an increased dose of investment in the presence of imports of consumption goods and raw materials (Kahn, 1931, p. 5) are all there in Kahn's analysis. Moreover, Kahn also clearly recognized that an increase in world prosperity could cause a rise in autonomous expenditure in the form of exports to other countries and th^s could have a greater impact on employment (and, according to Kahn, prices) than an isolated increase in investment in a single country (Ibid. pp. 6\_7\_)

Kahn also recognized that

A perfectly closed system ... is the world as a whole. It follows, as is indeed quite obvious, that an international policy of 'public works' would be far more efficacious from the point of each separate country than a purely local policy. (Kahn, 1931. p. 13).

In a way, the triad of institutions Keynes tried to

design in the 1940s - the International Trade Organization, the International Monetary Fund and the International Bank for Reconstruction and Development - was meant to serve the cause of international public works whenever unemployment went beyond acceptable levels, without jeopardising the prospects of growth in the world economy (cf. JMK, 1980a and 1980b; and Williamson, 1981). As we know, the Keynes Plan was only very partially realized, and the system that he designed was ultimately turned on its head : the pursuit of price stability and facilitating adjustment to the working of markets and not the pursuit of full employment and world prosperity have become the watchwords of the IMF and the World Bank.

Besides Kahn's pathbreaking article (and Meade's contribution to it) there were other early, brilliant applications of the concept of the foreign trade multiplier in Harrod's International Economics (1933). But a generalization of the concept of the foreign trade multiplier to that of an international expenditure multiplier had to wait for the work of Machlup (1943), Metzler, Goodwin and Chipman, in the decade ending in 1950. The re-interpretation of the Metzler-Goodwin-Chipman interregional or intersectoral multiplier as an international matrix multiplier is a straightforward process provided that fixed exchange rates, and accommodating monetary policy and international capital transfers can be assumed to hold (Metzler, 1942a, 1942b, 1950; Goodwin, 1949; Chipman, 1951)<sup>(1)</sup> .

In a recent exercise, Goodwin (1980) divided the world into a small number of blocks such as the USA or

North America, EEC, Japan etc. and then worked out the increases in exogenous or autonomous expenditure that would be needed so as to raise world incomes by specified percentages or amounts, calculated in a common international currency such as the still-born 'bancor' (Goodwin, 1980). Since there were unused capacities and idle hands in virtually all countries, in principle, all of them would experience increases in income and expenditure as a result of such global Keynesianism. Since the aggregate deficit of the countries suffering balance of payments deficits on current account must balance the aggregate current account surplus of the countries experiencing a balance of payments surplus, and since the latter would have experienced a net increase in their incomes, it should be possible for the surplus countries to sustain the income expansion process of the deficit countries by making transfer payments as gifts or long-term loans. But as Keynes (1980a, 1980b) had recognized in his plans for an international clearing union, there is nothing in the usual processes of balance of payments adjustment under a fixed exchange rate regime that would compel the surplus countries to make such transfer payments to deficit countries or to reflate their economies in the first place if such reflation seemed to militate against their other domestic or international policy objectives. He had sought to levy a charge or interest on the credit balances of the surplus countries with the proposed international clearing union or central bank if they exceeded certain limits. (Keynes, 1980a; Harrod, 1951, pp. 542-548). Eventually, Article VII of the articles of agreement for the International Monetary Fund embodied the so-called 'scarce currency' clause

this meant that if the IMF declared the currency of a particular country to be scarce, then all other member countries could impose limitations on the freedom of exchange operations in the "scarce" currency. This provision, however, remained a dead letter in operation: deficit countries faced penalties in various forms so that even if a currency was scarce in effect, the deficit countries as a group could never avail of the 'scarce currency' clause (Tew, 1967, p. 96). Thus the pessimism of Joan Robins<sup>(1947)</sup> regarding the possibility of avoiding beggar-my-neighbour policies and their contractionary consequences seemed to be eminently justified especially after the dollar had gone off gold and foreign exchange rates were allowed to float. The ironical fact is that it is the IMF which effectively enforces beggar-my-neighbour policies on countries plagued with chronic balance-of-payments difficulties.

The manipulation of the IMF policies for short-run advantages by the U.S.A. and some of its close allies derives its rationale from asymmetries in the impact of global Keynesianism on expenditure flows as well as from considerations of retaining the levers of power in the hands, of transnational banks and transnational corporations in a world of free capital mobility ~~and~~ restricted mobility of commodities and labour. The unequal distribution of benefits of changes in autonomous expenditures results from (a) the initial unequal distribution of incomes between different countries, (b) differences in the composition of the outputs of the different countries as regards tradables and nontradables and (c) differences in marginal propensities to save and import as between different countries. A number of simulations have been made of the effect on national expenditure and income flows of one per cent increase in government expenditures in the U.S.A. (and in Germany and

Japan). The effects naturally take time to work themselves out but the impact diminishes quickly over time. Hence the income multipliers are given as in the second year after the increase in government expenditures. In Tables 1 and 2 we reproduce the results of two sets of simulations. The asymmetrical nature of the impact is most obvious in Table 1. From Table 2 it would appear that the international repercussion effects of a fiscal expansion in the U.S.A. and the rest of the OECD (ROECD) are about the same. But we must remember that the simulations behind Table 2 are based on the assumption that the ROECD which include Japan as well as the U.K., Italy, Denmark and other Western European countries can coordinate their policies. As the recent difficulties faced in ratifying the Maastricht treaty and in keeping the lira, the pound and the franc within the limits of the ERM band have demonstrated, such coordination itself would require considerable political determination.

Table 1 International multipliers for the U.S.A., and Japan

Effect on	<u>Initiating country</u>		
	U.S.A.	Japan	Germany
U.S.A	1.7	0.1	0.1
Japan	1.3	1.3	0.1
Germany	0.4	0.2	1.3
Canada	1.0	0.1	0.0

Source : H. Edison, J. Marquez and R. Tryon, 'The structure and properties of the Federal Reserve Board multicountry model', Economic Modelling, April, 1987; as quoted in Dornbusch and Fischer, 1990, p.194.

Table 2 International multipliers for the U.S.A. and R'OECD (the rest of the OECD) (in percentages of national or regional income)

Effect on	Initiating country or region	
	U.S.A.	ROECD
U.S.A.	1.2	0.2
ROECD	0.3	1.5

Source : Fischer, 1988, p.16

We have assumed that increases in expenditure in all the economies take place through autonomous increases in government expenditure or in private investment. But different economies face different kinds of constraints in respect of fiscal expansion; and in any case autonomous increases in private investment cannot be brought about by an official fiat. Hence it must be hypothesised that some economies would be stimulated through monetary and some through fiscal expansion. However, either policy could change the relative international competitive position of different countries, bring about significant changes in exchange rates and lead to trade and investment flows tending to upset the calculations made on the basis of an initial set of exchange rates and relative international prices. For example, if the USA sought to stimulate the economy not by an increase in government expenditure but via the path of monetary expansion, that is, by lowering the rate of interest and allowing banks to extend larger amounts of credit (and thus allowing the money supply to be expanded), it would lead to a depreciation of the dollar and expand U.S. trade at the cost of competing countries which experienced an appreciation in the foreign exchange value of their currencies (Fischer, 1988, p. 16

and Dornbusch and Fischer, 1990, p. 194). if the U.S. competitors do not adopt compensatory measures to protect their net exports, then the net effect for the world economy might be contractionary rather than expansionary. Paradoxically enough, if the close competitors of the U.S.A. in foreign trade did undertake compensatory policies, then the net effect might be contractionary for all of them. For much of the 1980s, the U.S.A. in any case sought to attract capital from abroad to meet the large and generally increasing deficit in her balance of payments. Thus the policies of the U.S. government (and other governments) in respect of operation of money and capital markets might upset most of the predictions derivable from global income multiplier models.

There is one particular aspect of the lack of policy coordination for economic expansion which seems to have attracted less attention than it deserves. Because the OECD countries (with the sole exception of Taiwan) are the major generators of mobilizable capital flows in the international economy and are also the major recipients of such capital flows, and because the OECD countries as a group form the biggest market for all products - primary commodities and manufactured products alike - it is possible for them to reach agreements on international financial policies and trade policies which minimize the cost of adjustment for themselves but which impose dead-weight losses on those countries which cannot participate in these negotiations. (The meetings of the G7 countries are the most striking examples of such exclusionary coalitions). Since the levers of control and operation of the global financial system rest with banks and coalitions located in OECD countries, and most IMF - World Bank structural adjustment policies are imposed as

if they are addressed to the domestic policy delinquency of a single country, considerations of financial prudence almost always prevail over requirements of expansion. The structural adjustment policies are meant to limit the domestic absorption of the erring country and increase its exports. Since both the income and aggregate price elasticities of LDC exports are typically low, such policies give rise to an endemic contractionary tendency in the world economy. But in the meantime, some bank loans may be repaid and the exposure of OECD-based transnational banks (TNBs) to the LDCs may have come down. Thus global Keynesianism becomes a victim of the narrow financial interests of a handful of TNBs and their influential clients in OECD countries.

Of course, virtually all the major industrial countries also face severe problems in raising their rates of investment and productivity growth through either expansionary fiscal policies or expansionary monetary policies. But many of these problems - fear of rising real wages and burgeoning budget deficits - have their ultimate roots in their fear of losing in the race of international competitiveness with countries within the OECD block, and with a few countries outside the block. The fear and lack of willingness to commit themselves to a joint reflationary policy generate the kind of stagnation we have been witnessing in the global economy for more than a decade.

The question has been asked as to how, in view of all these problems of keeping up with the Joneses among the major OECD countries, the global economy could have at all expanded in, say, the nineteenth century, or in the period 1945-1970 ? The answers given to these questions have been, of course, quite varied as between different



economists. One reason why in the pre-1914 period the world economy as a whole and not just the leading industrial countries is judged to have succeeded is that insufficient account has been taken of the performance of such major areas of the world as India, China and most of Black Africa. Many of these countries experienced major famines in the last thirty years of nineteenth century. But it may also be true that the international gold standard, by providing a reasonable degree of exchange stability for the major OECD countries made economic calculation less fraught with risk and provided a secure background for investment flows, especially to the white-inhabited colonies of the western hemisphere, Australia and New Zealand (cf. Nurkse, 1961, Lecture one, and Eichengreen, 1985b, p.9). However, the stability of exchange rates of the major OECD countries had as its counterpart the exchange instability of many countries of Latin America on an inconvertible paper currency, and countries on the silver standard such as India upto 1893, and China, and many other East and South-East Asian countries upto 1914 and beyond. It may even be argued that much of the burden of adjustment in the international economy in the late nineteenth century was passed on to the non-white colonies of European countries (Bagchi, 1979).

Thus the only period that seems to have witnessed global Keynesianism on a world scale is that between the end of the Second World War and the floating of the dollar in 1971. The reasons why this was sustained over such a long period, and why the postwar boom came to an end are still matters of debate (see, for a sample of debates, Weisskopf, 1979, Armstrong, Glyn and Harrison, 1984; and Singer, 1989). It should be noted, first of all, that the stimulating impulses were very unevenly distributed across

countries at the best of times : for most LDCs, there was nothing on the scale of the Marshall Aid to western Europe, or the market-supporting strategies pursued in the case of Japan, South Korea and Taiwan by the U. S.A. and her allies. Even the spinoff effects of the U.S. involvement in the Korean and Vietnam War were confined to a few countries or city economies (such as Hong Kong, South Korea and Thailand). However, the competition between the two military and political superpowers, the USA and the USSR did provide a space for many LDCs to pursue essentially Keynesian policies, often buttressed by a large dose of protectionism. The co-operation between the major OECD countries was also made possible by the fact that up to the middle of the 1960s there was a large technological gap between the U.S.A. and her close allies in most of the dynamic sectors of the economy, and the could generate the surplus to sustain the process of transfer of technology to those allies.

However, the very universality of the use of the dollar as the currency for international transactions and asset holdings ultimately made it seriously overvalued; the U.S.A. and British concentration of resources on military-related technologies allowed the two major 'free riders', namely, Germany and Japan, to steal a decisive march in many areas of civilian technology. continued full employment without the forging of a consensus on incomes policy unleashed rates of inflation which made economic calculations increasingly risky and led to unsustainable departures of the real exchange rates from their official values, and private hot money flows made balance of payments deficits increasingly disruptive.

I am not trying to provide an exhaustive catalogue of all the factors that led to the collapse of the Bretton

Woods system and global Keynesianism, however unevenly distributed over states and regimes that system might have been (for an account of the less-than-even handed treatment of LDCs by the IMF even when the Bretton Woods system was alive and kicking, see Konig, 1973 and Gulati, 1980; for instances of the use of the World Bank as an instrument of imperial domination, see Hayter, 1971).

What I am suggesting is that the collapse of the coordinated system of economic management put in place at Bretton Woods was connected with asymmetries of economic power which changed over time and seemed to require new rules for coordination of economic policies - rules which have yet to be formulated although the earlier system collapsed more than twenty years ago.

### 3. The credit stimulation and the debt deflation process in the global economy

If Keynes is credited with the building of the edifice of the theory of aggregate output, and employment on foundations provided by Kahn, Meade and others, he also was the theorist par excellence of the complexity of money as an institution of a modern, capitalist economy. Analysis of the role credit institutions play in stimulating economic activity and correspondingly the way a disruption of credit can disturb real economic activity has a hoary history. David Hume (1752b) theorized about the way paper credit economised on metallic money. He also argued that increase of commerce and industry would tend to lower the rate of interest and hence encourage enterprise on the part of potential borrowers (Hume, 1752a). Credit institutions figured as major facilitating forces in Schumpeter's theory of economic development (see, for

example Schumpeter, 1911; Bellofiore, 1985). Keynes was by and large an advocate of cheap money most of his life.

The raising of the British bank rate from 3 to 4 per cent in 1923 provoked him to write one of his most memorable philippics against that conservative institution, the Bank of England (Keynes, 1923a as quoted by Harrod, 1951, p. 338). Keynes was an advocate of cheap money policy during the Second World War, and Harrod credits Keynes with the change in climate of opinion that allowed the Second World War to be fought with a long term rate of interest at 3 per cent as against the 5 per cent that prevailed during the First World War (Harrod, 1951, p. 492-93). Keynes was in this respect in tune with most of his academic colleagues (Sayers, 1956, pp. 153-162), but he had done much to mould the pro-cheap money opinion of the 1930s. However, in the light of Keynes' de-emphasis on monetary tinkering as a way of stimulating economic activity, it is fair to conclude that he regarded a cheap money policy as part of the environment of expectations that allowed expansionary policies to be pursued in a situation of unemployment, or resources to be mobilized and utilized in appropriate directions (war financing, for example) rather than as an instrument for economic expansion on its own. (This would be true even if a 'liquidity trap' was not encountered at a low rate of interest).

The impact of credit shock or credit stringency on macroeconomic conditions such as prices, output or employment was also known to many economists and publicists. Veblen (1904) and Hawtrey (1913, 1919, 1928) were among the first group of economists who had attributed a major role to debt deflation in causing fluctuations in aggregate activity (Bigg, 1987; Gertler, 1988). In his Tract on Monetary Reform (1923) Keynes

analysed the instability of credit in causing declines in activity and employment in postwar Europe.

In the Tract, which was mostly an updated and expanded version of Keynes<sup>1</sup> articles in the Reconstruction Supplements of the Manchester Guardian Commercial (published between April and July 1922), Keynes discussed the relation between money and real rates of interest, and eloquently described the differential effects of inflation and deflation - the former tending to impoverish the 'investors', that is, the rentiers, the latter tending to ruin the businessmen and the workers (who suffered unemployment). He also showed how the borrowers would try to beat inflation by borrowing more and more; but ultimately, if the rate of inflation went out of hand, they could end up being without any credit or wealth. (All this anticipates much of the discussion on the Phillips curve and the essence of the claims made by the rational expectations school without their absurdities). However, Keynes was concerned here and later on in the Treatise with questions of stability of the price level and the best way to regulate the supply of money and institutions of credit rather than with analysing the consequences of a collapse of credit or a process of debt deflation as such. The state of credit was an essential part of the business environment which entered into calculations of marginal efficiency of capital in the General Theory. However, in the ensuing debates, and in the neoclassical synthesis which long passed for Keynesian economics, especially among U.S. economists, the complexities of the credit market were swept under in the often sterile debate about the exact role of the stock of money, and the causal relation between money and output.

There were, of course, major exceptions, not only among the Cambridge Keynesians such as Kahn, Kaldor and Joan Robinson, and the authors of the Report of the Radcliffe Committee (1959) but also among U.S. economists such as James Tobin, and Hyman Minsky, who regarded money only as the leading asset among a number of assets, mainly differing in terms of the degree of liquidity, which itself would vary with the state of expectation. But it probably remains true that the consequences of changes in the state of credit as against those in expectations regarding fiscal policy or changes in output were not fully teased out in the literature in the major Keynesian •'tradition. This is where it seems that Irving Fisher's attempt to explain the depression of the 1930s (Fisher, 1932, 1933) has stimulated new analysis of the macroeconomic consequences of changes in the state of credit. A number of younger economists, such as Ben Bernanke, Alan Blinder, N. Gregory Mankiw, G. Rich, J.E. Stiglitz, A. Weiss, and others, working on empirical data relating to the prewar gold standard and to the experience of the 1930s in the U.S.A. and Canada, and building on insights from the literature on uncertainty and asymmetric information have striven to find out the possible influence of changes in the state of credit on aggregate economic activity. Much of this work is also highly relevant for understanding the consequences of the international debt trap most LDCs have been embroiled in since 1981.

Fisher suggested that the depression of the 1930s was exacerbated, if not caused in the first place, by the process of debt deflation. The burden of debt on firms and individuals and the effects of bank failures and bankruptcies led to decline in expenditures and contraction of the credit that might otherwise have

allowed firms and individuals to get over a temporary fall in income or cash flow. Although Friedman and Schwartz (1963) attributed a causal role to the contraction of money supply in the precipitation and prolongation of the depression of the 1930s in the U.S.A., they failed to substantiate their opinion by means of a plausible theoretical model.

The recent revival of academic interest in the market for credit and in debt or credit crisis as causal influences on the ebb and flow of real incomes is the result of a convergence of three different streams of work. The firsthand chronologically the oldest, is some new work on the functioning of the gold and gold exchange standards, and re-interpretation of older writings in the light of new theoretical (including Keynesian) insights. The second is a stream of writings on the microeconomics of credit markets and of the working of firms in the presence of asymmetric information and principal-agent problems, and extension of that work to take in the probable consequences for macroeconomic activity. The third stream is the work initiated by Mishkin (1978) and Bernanke (1983) on the interpretation of empirical data (mainly pertaining to the U.S. experience) bearing on debts of firms and individuals, bank failures, and fluctuations in aggregate national income and employment.

We shall take up the second of these three strands first. Economists have long been aware that neither the money market nor the capital market can be perfect. The reasons are basically to be found in three factors. The first is that money markets and capital markets are forward-looking in time and therefore inevitably involve risk and uncertainty. The second is that perceptions of

risk and uncertainty are generally different as between different entities and tend to vary systematically as between lenders and borrowers or as between suppliers and users of capital in general. Thirdly, there are systematic differences between economic agents as regards their ability to cope with risk and uncertainty : the value of collateral or security for a loan is one way of judging this ability. But in the case of many borrowers it is better represented by the goodwill of the firm or the individual. The imperfection in the capital market is expressed not simply by, say, a declining cost of capital for big rather than small borrowers, but more importantly, by other conditions surrounding a loan such as the frequency or stringency of monitoring by a lender, the insistence on or omission of the explicit hypothecation of the collateral, and most importantly for our purposes, the rationing of credit to different borrowers at the same nominal rate of interest.

Kalecki (1954) had already considered constraints on the entrepreneur's ability to raise outside capital or loans imposed by the value of his capital. He had also hypothesized that the individual firm or the controlling  
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group of/joint-stock company would associate an increase in the size of the loan taken by it with an increase in risk of loss of initial capital or of control over firm. But these considerations had been brought in by him only for specifying the investment function and not for analysing the money or credit markets as such. In Keynes' discussion of degrees of liquidity of different assets in Chapter 17 of the General Theory, there is an implicit recognition that the markets for different kinds of assets may be imperfect (see for a useful discussion, Minsky, 1975, Chapter 4). Imperfection of the capital market in the sense of its inability to convey full information about the relative profitability of different investment



projects and the necessity of bears and bulls to systematically differ in their perception of likely movements of bond and share prices underlie Keynes' formalisation of the speculative motive for the demand for money (Kahn, 1954). But most of this analysis was swept<sup>4</sup> under in his attempt to formalize the liquidity preference theory of the rate of interest and demonstrate the generality of underemployment equilibria in an economy in which money plays an essential role in bridging the present and the future. (We may guess that the Central role played by the Bank Rate in Britain and the success of the Bank of England as a lender of last resort made Keynes ignore the possibility of bank credit and supply of money by commercial banks putting further spokes in the wheel of the automatic stabilization mechanism favoured by the preKeynesian neoclassical theorists, but I would not go further at this stage in verifying that guess).

The new work in this area first concerned the microeconomics of the credit market. Jaffee and Russell (1976) basically took up Kalecki's argument from the point of view of the lender and showed that under a wide variety of circumstances the probability of default increases with loan size. Moreover, borrowers differ in their ability and willingness to repay. Lenders cannot sort out the good projects from bad ones and bad borrowers from good by increasing only the rate of interest. The bad borrowers would promise to repay and default and the good borrowers would have to pay a premium - a 'lemons' premium, (to borrow from the terminology used by Akerlof (1970)) to cover the greater risk of default of bad borrowers. The lenders then find it optimal to resort to credit rationing in order to screen out the really risky projects and limit the damage caused by bad borrowers. In a later paper, Stiglitz and Weiss (1981)

built on this analysis to sharpen the result that credit rationing is the natural outcome of a situation in which the lenders do not have any a priori or at least cheap method of sorting out the bad from the good borrowers, or the bad from the good projects. In Jaffee and Russell's analysis the bank could use the amount of collateral \* demanded to sort out the good from the bad borrowers. Stiglitz and Weiss (1981, p. 249) showed that

increasing the collateral requirement of lenders (beyond some point) may decrease the returns to the bank by either decreasing the average degree of risk aversion of the pool of borrowers or, in a multi-period model, including individual investors to undertake riskier projects.

Consequently, it may not be profitable to raise the interest rate or collateral repayments when a bank has an excess demand for credit. Instead, banks deny loans to borrowers who are observationally indistinguishable from those who receive loans.

Other analysts have followed the same line of reasoning and shown that in the presence of incomplete and asymmetric information and costly monitoring the market for credit can be imperfect in many different ways. For example, Mankiw (1986) showed that in the market for <sup>for</sup> student loans (or it could be the market/loans for new technology in agriculture), a rate of interest that would allow the banks to recover their outlay (with bad or dishonest students being effectively subsidized by good or honest students), might easily lead to the collapse of the market. He also showed that it might be socially beneficial then for the government to subsidize credit so

as to bring down the cost of credit to good borrowers (and also, of course, to bad borrowers).

A similar kind of reasoning can be used to demonstrate that share prices at any moment of time are at best incomplete indicators of the true worth of a firm. It would also indicate why while financial intermediaries can be used to gather and convey specialized information about the profitability of particular projects and firms, neither elaborate financial intermediation nor securitization can get rid of what has been called the problem of 'costly state verification' (Townsend, 1979).

These imperfections at the level of firms and banks, borrowers and lenders can build up into macroeconomic forces that cause disturbances to aggregate economic activity when an external shock occurs, or when there is a change in a crucial policy parameter such as the Bank rate or the stringency of selective credit control. In a model constructed by Blinder (1987), production is entirely dependent on bank credit, and a contraction in credit can lead to a larger decline in output than in aggregate demand (since the latter is smaller than total income by the fraction of the marginal propensity to save) and price rises to clear the market. Thus a stagflationary situation is brought about by credit contraction. Of course, when interest is a large element in cost, and the rate of interest rises, cost-push can cause an inflationary price rise along with a fall in output : output can fall in a competitive market where producers do not expect to pass on the increase in costs or it can fall because tighter credit means rationing out

a part of the output which is dependent on loans for working capital. Bernanke and Blinder (1988) have constructed a model in which bonds and bank loans are imperfect substitutes, and with unchanged returns on bonds, changes in the rate of interest on bank loans or in total credit extended by banks would affect aggregate output.

The analysis of Canadian data, by contrast with Bernanke's analysis (Bernanke, 1983) of US data, failed to turn up evidence of an independent influence of credit crunch or bank failures on the degree or duration of the depression in that country (Haubrich, 1990). At first sight, this is surprising because Canada's was a much weaker economy than that of the U.S.A. and Canada did not have a central bank at all until 1935. The weakness of the Canadian economy was demonstrated by the influence exerted by international factors, and especially by the U.S. depression in causing business failures and deepening the recession in Canada. But the lack of a Canadian central bank was compensated for by a strong system of branch banking and by the willingness of the government to provide virtually unlimited liquidity to banks with assets but faced with a liquidity crisis (Haubrich, 1990; Drummond, 1991). A spate of amalgamations in the 1920s left Canada with a handful of banks with branches spanning most regions of the country and with diversified portfolios. These banks were also subject to a careful system of monitoring by the government and their charters had to be renewed every ten years. Under an Act passed in August 1914, the Dominion government had to provide banks with Dominion currency notes against the pledge of virtually any assets they had to offer. Thus the Canadian government acted as an effective lender of last resort.

We will now briefly refer to that part of the working of the gold standard which throws light on the way in which the operation of the credit mechanism had, in the pre-second World War period, influenced the start or the propagation of expansionary and contractionary movements in the world economy and its constituent parts. It had been pointed out already by numerous analysts such as Keynes (1913, 1930), Whale (1937) and others that the pre-first World War gold standard was not an automatic mechanism working through inflows and outflows of specie changing price levels in countries with balance of trade surpluses and deficits; it often involved the active intervention of the monetary authorities in the major gold standard countries to sterilize the effect of gold movements or block an anticipated outflow of gold. The critical role of the credit policy of the same monetary authorities, and especially of the Bank of England, had already been stressed by these analysts. Later economists such as Ford (1960) and Triffin (1964) pointed out that as far as exporters of primary commodities were concerned, the Bank rate changes in the London money market had an opposite effect to what the specie-flow-price mechanism predicted. The loss of gold from England induced the Bank of England to raise the Bank rate; this in turn led to a stringency of credit for imports of primary commodities (London being the largest importer, entrepot or clearing centre for the international trade in such commodities) and a fall in their prices in comparison with the prices of manufactures of industrial goods. Such a development was connected with the fact that as Kalecki (1954) put it, primary commodity prices were demand-determined whereas industrial prices were cost-determined, or as Hicks (1965) put it later, the markets for primary commodities were flex-price markets

whereas the markets for manufactures were fix-price markets. Credit contraction in the major gold standard countries could then have an effect in transmitting contractionary impulses especially to those countries whose incomes were overwhelmingly derived from the production of primary commodities.

The interesting point is that not all those countries whose exports consisted mainly of primary products in the late nineteenth century derived their income mainly from agriculture. Thus while Canada and Australia were chiefly exporters of primary products, they already derived the major part of their national income from non-agricultural sectors of the economy (Kuznets, 1971, Chapter IV). Thus it is probable that the effect of the credit policy of the advanced capitalist countries was less severe in these countries than in the non-white colonies whose incomes were overwhelmingly derived from the agricultural sector. On the other hand, Rich (1988) has argued that the reserve-ratio policy of the chartered banks of Canada tended to aggravate business fluctuations, originating from external shocks : a fall in the interest rate and an expansion in export incomes would be attended by a lowering of the cash-reserve ratio and lead to an expansion of bank credit and money supply through the credit multiplier. A rise in international interest rates and contraction in exports would have the opposite effect.

As far as Canada was concerned (and this probably also applies to Australia or South Africa in the same period) international capital movements were not sensitive to interest rate differentials (Dick and Floyd, 1991;

Redish, 1991) but were determined by long-term factors such as the pulsations of European migration and preferences of the British investor (Piatt, 1985). Thus the question of impact of credit policy in the international context cannot be divorced from questions of relations of dependence or underdevelopment in the international economy (cf. Darity, Jr., 1987 and Marcel and Palma, 1988) .

The recent theoretical and empirical work on internal and international adjustments to credit shocks brings into question many of the -policies imposed on the less developed as well as developed countries in the name of sound banking or financial liberalization. Modern banks originally operated almost exclusively in what Okun (1981) called customer markets : this is how small local banks still operate in most countries. Some banks, mostly with government encouragement,- if not with explicit or implicit subsidy, entered into a long-term relationship with their customers, fostering industry, giving working capital loans for growing cash crops, tying loans to the introduction of new technology and facilitating the invasion and penetration of export markets. Countries differed systematically in the use of banks as instruments of economic development. As is well known, in Germany, Japan and eastern and central Europe, and in our own times, in South Korea and India, state-owned commercial banks played a much more actively promotional role than in Britain and the U.S.A. But even in the U.S.A., banks, often with the help of public subsidies, played a major role in the financing of agriculture.

In the crisis of the 1930s, those promotional, specialized banks which had tied themselves to the interests of particular localities, regions or industries

were severely affected by the spreading contagion of financial panic (Eichengreen and Portes, 1987). Germany, Austria and other central European countries which had practised universal banking proved to be especially vulnerable. The failure of German debtors to meet their bills issued by financial institutions based in London was one of the factors responsible for weakening the pound further in 1931 and ultimately forcing Britain off the gold standard (Sayers, 1976, Chapters 17 and 20). However, even in these crises the quality and seriousness of internal or international policy pursued by financial institutions influenced the degree of damage inflicted by credit market failures. For example, the Standstill Agreement worked out by the monetary authorities of the major European countries may have prevented the German situation from deteriorating even further than it did by 1931-33. Again, while both Austria and Hungary practised universal banking, Hungarian banks were less affected by the depression of the 1930s partly because the latter had been less saddled with unmarketable industrial securities at the start of the depression (Weber, 1991). One of the lessons of the depression of the 1930s is that while financial contagion can deepen and prolong the recession, prudent and co-ordinated management of the crisis by monetary and fiscal authorities, effective intervention by the monetary authorities as lenders of last resort, and timely dissemination of information about the real state of the economy can stop the credit crisis from turning into a melt-down of all financial institutions (Eichengreen and Portes, 1987; Park, 1991; Weber, 1991).

In the 1970s and 1980s, policies pursued by the IMF as the international lender of last resorts and timely



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^banks in the U.S.A. and other OECD countries are alleged to have moderated the possibility of financial panic and the collapse of the financial system. The World Bank (1985) had already proclaimed in 1985 that participants in financial markets 'responded positively and flexibly in coping with the debt-servicing problems of the developing (2)

countries'. The attempt to keep this 'durable structure' in place has, however, imposed burdens in terms of contracting incomes and world trade (Marcel and Palma, 1988) in virtually all countries and those burdens have been borne primarily by the poor in terms of losses in jobs and earnings. They have also been unequally distributed as between the OECD countries, the East Asian NICs on the one hand, and virtually all other LDCs and countries of Eastern Europe on the other. Moreover, several developments in the 1980s definitely tended to increase the fragility of the financial system (Rybczynski, 1987; Sen, 1991).

The first factor has been a steep rise in the real rates of interest all over the world, threatening the solvency of producing firms and credit institutions alike, and putting at risk all programmes of long-term promotional measures aimed at increasing output and productivity. These increases, in combination with the earlier low-interest saving plans of risk-averse households, have also pushed such credit institutions as the U.S. saving and loan (S & L) associations more deeply into the risky and volatile real estate markets, and caused the S & L debacle (White, 1991, Part II). Such debacles all over the world have put pressures on the domestic lenders of last resort and sometimes brought their credibility into question (as happened, for example, in case of the central bank of the Philippines under Marcos) .

It is, of course, true that in the 1930s as prices declined and nominal rates of interest did not fall proportionately or fell only with a considerable lag, real rates of interest also rose (Fisher, 1933; Tobin, 1987). But this was more an unintended consequence of deflation than a rise in real rates deliberately engineered by a major economic power to counter balance of trade deficits by inducing capital inflows.

The second factor exacerbating fragility has been an implicit or explicit cartellization of transnational banks (TNBs) and international credit institutions which have confronted a group of borrowers, overwhelmingly from LDCs, who have been unable to organize in a similar fashion. Curiously enough, such cartellization has also encouraged free riding by some creditors, thus further increasing the costs of adjustment of LDCs and putting further pressure both on the international lender of last resort and on domestic monetary and fiscal authorities of the OECD countries.

Once the process of deflation (or even sharp deceleration in the rate of inflation) starts, debtors everywhere lose out in relation to creditors. But this process, along with the collapse of smaller credit institutions, will also generally mean the concentration of banking assets in fewer hands. It is then likely that many of the smaller borrowers will be rationed out. When this is accompanied by a rise in the real rates of interest or, where TNBs are the creditors, a rise in the rate of interest as deflated by the real rate of exchange, the typical term structure of bank portfolios will shift towards short-term assets. (This kind of change was one of the driving forces behind foreign banks, followed at some distance by a few Indian public sector banks, misusing the

portfolio management scheme through placement of funds in the stock-market - a practice that eventually led to the scandal of the scam that has rocked the Indian banking scene since April 1992). A solution that has been sought by bankers and by the better-placed firms in the LDCs is to securitize the bank loans at an accelerated rate. Such securitization has in fact exaggerated the arm's length nature of the relationship between big banks and their borrowers, and has exposed an even greater share of the capital funds employed in industrial and other non-financial (and in some cases even financial) enterprises to the hazard of a speculative bubble.

From the late 1970s, the problem of credit availability to the LDCs have been compounded by the initial debt overhang of the highly indebted debtors and the snowballing of that debt burden through rises in the rates of interest, continual shortening of" the spectrum of interest rates and the costs of tying loan repayment arrangements to various projects favoured by TNBs, and their favoured clients.

The 1980s and the 1990s are also plagued by the history of the near-hegemonic presence of the U.S.A. in the financial world and her drastic loss of international competitiveness in many branches of manufacturing and agriculture. In 1987 it was estimated that more than two-thirds of 'the approximately \$2.5 trillion in international bank claims [were] denominated in dollars. Moreover about three-fourths of international bond issues [were] denominated in dollars' (Greenspan, 1988, p. 62). This means that any attempt at coordination of international economic policy will have to reckon with US

domestic economic policies and the likely impact of efforts at international cooperation on those policies. It is, of course, possible as has happened in the past, that the managers of the domestic U.S. economy would welcome international initiatives in a situation in which they otherwise fear a stalemate or being forced to take a decision which is harmful in the long run (Putnam and Henning, 1986, as cited by Fischer, 1988).

Apart from the imbroglio created by the huge U.S. debt and current account deficits, the mountainous debt overhang of the LDCs is no nearer vanishing into a molehill after the much-touted Brady and Baker initiatives. Most of the international bankers' moves in this direction have merely served to make a show of U.S. and OECD power and sometimes augment that power (Bagchi, 1992b). There is plenty of historical evidence that bankers can get together and produce coordinated policies which can aggravate the problems of fundamental imbalances in the world economy rather than moderate them. It has been recently argued that the developments leading to Britain adopting the gold standard in 1925 at a prewar parity of sterling in relation to gold and those forcing her off the gold standard in 1931 are striking evidence of the 'ordinariness' of the thinking of top bankers (Kunz, 1991), an ordinariness that served to aggravate and prolong the Great Depression of the 1930s. Keynesian macroeconomics was born in a long struggle to free economics from the 'ordinariness' of bankers' logic as well as from the Treasury view of economic policy buttressed by the theory of a barter economy (see, in this connection, Moggridge, 1980; Skidelsky, 1988 and Clarke, 1988).

We have been witnessing another long bout of 'ordinariness' or conventional wisdom of transnational bankers serving to prolong the global recession of the 1980s. Most of the structural adjustment policies forced down the threat of debtor countries in sub-Saharan Africa or Latin America by the IMF and the TNBs can only be characterized as 'beggar-my-debtor' policies - to vary a phrase used by Joan Robinson (1947) to characterize the conventional wisdom of the 1930s. The inability of the LDCs to keep to their extortionate repayment schedules and the refusal of the TNBs to lend to most LDCs on commercial terms also generated excess liquidity in the monetary system linking the OECD countries. This accelerated the securitization process and produced phenomena of stock market booms and busts without there being a quickening of growth in the real economy, as has been clearly brought about in Marcel and Palma (1988) and Sen (1991).

#### 4. Unequal exchanges and terms of trade variations

Marx (1867, Part Eight) and the Marxists (e.g. Luxemburg, 1965; Dobb, 1946) have long discussed the phenomenon and the genesis of unequal exchanges between town and country, between capitalist and pre-capitalist economies and between the metropolis and the colonies. This structural analysis has been organically linked with processes of accumulation in the metropolis and accompanying 'backwash effects', if not downright underdevelopment, in the colonies and ex-colonies (for summaries of the work by Marxists, neo-Marxists and world system or dependency theorists in this area down to the end of the 1970s, see Brewer, 1980, chapters 6 - 8). Unequal exchange has been seen as the outcome of the joint action of a number of causes : the use of force by

capitalists, especially from the metropolis, to extract surpluses from peasants and labourers who have been actual slaves or virtual serfs; the systematic denial of free access to markets to artisans and peasants by merchants and capitalists with urban and metropolitan links; the creation of incentive structures and dominance-subordination relations which have militated against productivity-raising investments and industrial transformation of the economy, and so on. Some authors, e.g. Emmanuel (1972) and Lewis (1978) have anachronistically attributed the phenomenon of unequal exchange entirely to differences in wages or productivity of labour between the colonies and the metropolis, ignoring the fact (a) that in colonies markets in labour and commodities were often neither free nor competitive (so that calculation schemes of the Marx-Sraffa prices of production are inappropriate) and (b) that the differences in productivity were often the creation of the metropolitan-colonial relationship, since while productivity-raising investment was a characteristic of metropolitan capital, colonies often suffered an erosion of resources, human, constructed or natural, rather than their augmentation (See, for critiques of the Emmanuel-Amin formulations of unequal exchange, Bharadwaj, 1986 and Chandra, 1986).

Interestingly enough, this strand of analysis has not been connected with the Prebisch-Singer propositions on long-run trends in terms of trade between primary producers and industrial economies or between advanced capitalist economies and LDCs. The proposition, put forward independently by Prebisch (1950) and Singer (1950) that the terms of trade of primary producing countries in relation to those of industrialized countries have shown a

secular decline since the 1870s, has been debated ever since. The debates have concentrated rather more on empirical evidence for the proposition than on the theoretical basis of it. In the empirical tests, the relevance of different kinds of terms of trade - whether they should be terms of trade of all primary products as against all industrial products traded internationally, or • whether they should be the terms of trade of those countries for which the overwhelming share of exports is accounted for by primary products as against those for which manufactures constitute the major share of exports, or whether they should be the terms of trade of all LDCs defined as those for which per capita incomes fall below a certain level - has been debated. Along with those, different concepts of terms of trade - gross or net barter terms of trade, single or double factorial terms of trade, terms of trade corrected for productivity changes - have been advanced as the relevant concepts by different analysts. Furthermore, the significance of breaks in terms of trade movements - as during and immediately after the Korean War, or in the aftermath of the first OPEC hiking of oil prices and primary commodities, boom in the early 1970s - has been interpreted differently by different analysts.

The Prebisch-Singer hypothesis is an inversion of the proposition derived by classical political economy from the alleged scarcity of natural resources that the prices of manufactured products will tend to decline relatively to those of agricultural products and that this mechanism would ultimately lead to a cessation of accumulation and growth. Many economists held on to the classical inference about the secular decline in the terms

of trade of manufactures as a kind of maintained hypothesis for a very long time. But there is another aspect of variations of prices of primary commodities and the resulting disturbances in the performance of the economy as a whole which had attracted the attention of many economists, including Keynes, at least since the end of the first World War. During the war Keynes, as a representative of the Treasury, was a member of the Indian Wheat Committee set up by the Secretary of State for India, which sought essentially to monopolize all wheat exports from India and keep the price of wheat low. In one of his Manchester Guardian Commercial articles (Keynes, 1922), Keynes wrote about the instability of commodity markets, and the high costs of risk-bearing on the part of producers and speculators. Commodities continued to engross a considerable part of his time as an economist and investment adviser, and his occasional writings on the subject in the eight-odd years from 1929 to 1938 alone occupy 300 pages (JMK, 1983, 255-647). By 1938, Keynes had come to consider a publicly organized scheme for holding of buffer stocks of commodities as a useful auxiliary of any programme for attaining stability of prices and employment (Keynes, 1938). He also put forward schemes for international price stabilization of commodities, with the possibility of introducing a currency which would be linked to international stocks of commodities.

The economist who has perhaps most closely followed Keynes in his concern for stabilization of the prices and production of primary commodities is Kaldor (see especially Kaldor, 1963; UNCTAD, 1964, 1976; and Thirlwall, 1987, especially chapter 11). The case for a commodity-reserve currency essentially rests on the



problem that gold or a single reserve currency (such as the dollar) as the international medium of exchange creates for the world payments system : gold is relatively inelastic in supply and its mining is restricted to just two or three countries and so it does not respond to the needs of the world payments system. The problem with a single reserve currency is that it allows the issuer of the currency to pursue policies which eventually harm every participant in the system, and at the same time it imposes a burdensome obligation on the home country which has either to go on generating balance of payments deficits (thus enabling other countries to acquire the reserve currency) or to go on investing in their economies on the basis of export surpluses. Either way the international exchange rate of the reserve currency becomes unsustainable; once the currency is devalued, further expectations of devaluation make it less and less suitable as a reserve currency. A commodity reserve currency with diverse enough composition of 'appropriate commodities might get around such problems. However, I will not discuss the merits and demerits of such a system but concentrate on those aspects of the variations of primary product prices and the changes in their terms of trade in relation to manufactured products that create special problems for the stability of the world economy as a whole.

In order to understanding peculiar problems for the world economy and the LDCs posed by large or sudden changes in primary product prices, it is necessary to recognize first, a difference between the primary products and the manufactured products in terms of flexprice and fixprice markets, and in terms of the differences in lags of adjustment of the outputs of primary products and

manufactured products. It is necessary further to recognize a difference between the organization of production of primary products in western Europe, the U.S.A., Canada, Australia and New Zealand where most of the primary products traded are highly capital and land-intensive, and where most of the GNP is derived from the secondary and tertiary sectors and countries in which the same products are produced with the help of little capital investment but a lot of labour and where the major part of the GNP and employment is still derived from the primary sector. A third distinction should also be made in respect of the marketing of primary products and manufactured output. : in a very large number of LDCs, exportable primary products are marketed by giant trading corporations based in the OECD countries such as Cargill, Louis Dreyfus and Co., and so on. Finally, for many, in fact most, LDCs, productive investment is critically dependent on imports of capital goods from more advanced economies - generally OECD countries but also from some countries of Eastern Europe, some East Asian NICs and some large LDCs such as Brazil and India. But even the latter are dependent critically on OECD countries for the supply of capital and intermediate goods for high-technology industries.

Taking the difference between flexprice and fixprice markets, and the relative salience of the primary sector in generating incomes in LDCs, it can be seen that a fall in the prices of primary products will hit the incomes of primary producers. This will depress the demand for manufactured goods from the advanced market economies. If the decline in prices is expected to be more than temporary and the consequent deflation in incomes in the LDCs is also expected to be sustained, this will have an exaggerated impact on the exports of capital

goods from the OECD economies to the LDCs. It may be asked as to why the decline in primary product prices will not lead to a corresponding decline in prices and stimulate demand through a rise in expected profits of firms and nullify the effect of a decline in the terms of trade of producers of primary products. While such a possibility cannot be entirely ruled out on a priori grounds, it is rendered unlikely by several other circumstances. By now the proportion of costs of raw materials derived from the primary sector in the total costs of manufactures is quite low; the other costs such as labour and interest costs and so on are far more important and far more sticky. Moreover, there is often an asymmetry in responses of prices of manufactured products : while increases in costs tend to be matched relatively quickly, declines are not so quickly reflected in price movements. (This is rational behaviour in an oligopolistic industry under a wide variety of anticipated reactions on the part of competitors). Lastly, if the advanced industrial countries are already in the grip of competitive deflation, with competitive tightening of monetary policies (cf. Currie, 1993, p. 179), this will lead to a regime of high and increasing interest rates. Given all these factors, it is no surprise that Beckerman and Jenkinson (1986) found that in the early 1980s, while the decline in primary product prices had a major impact in moderating inflation in the OECD countries through changes in prices of importables, such changes were not accompanied by any parallel changes in prices of manufactured products exported by OECD countries to <sup>o n e</sup> another nor by any related changes in rates of wage inflation (see also Grubb, 1986).

What happens when prices of primary products go up, and suddenly ? Suppose the particular products are sold mainly by transnational corporations (TNCs) based in the OECD countries. In that case, in the first round, the effect on demand will depend on the behaviour of such TNCs, since most of the gains from increases in prices will accrue to them. If, however, the gains from increases in prices accrue to the owners and producers in LDCs, then the effect will depend on the degree of concentration of ownership of the land and mines which produce the primary products. If the ownership is concentrated in a few hands, then the immediate effect would be to increase ex ante savings rather than demand for consumer goods or producer goods for capital formation. Thus if there is a redistribution in income in favour of the landlords and mine-owners in LDCs as a result of a rise in primary/prices, then demand for manufactured goods may go down. But if ownership of the concerned assets is diffused among actual producers, then there may be no such contractionary effect.

However, if increases in prices of primary products are speedily matched by increases in prices of manufactured products in the OECD countries and in other major producers of manufactures, then the stimulation effect on the demands for manufactures from producers of primary products will fail to materialize, and the demand in the OECD and other major producers of manufacturers will itself be dampened. This dampening effect will have longer-term implications if, because of a higher degree of concentration among producers of capital goods, their prices are raised more than proportionately.

Thus a sudden fall or a sudden rise in prices of primary products may both have a recessionary effect

on the world economy, giving' rise to the so-called 'Kaldor kink' (Thirlwall, 1987, pp. 277-8). However the longer-term fall-out of a rise or a fall in primary product prices may be very different. A rise in primary product prices is likely to be reversed through at least three different kinds of mechanism. The first is innovation and substitution of production processes requiring a lesser input (per unit value of final product) of primary raw materials. The second is increased investment for the production of primary commodities by those primary producers who use capital-intensive processes and who find their profits going up as a result of increases in their product prices. The third is an extension of production of primary products through the intensification of labour and the mining of land and natural resources by those producers who use relatively labour-intensive methods.

On the other hand, there is no reliable mechanism for re-'er'sing the fall in primary product prices in a situation of world recession and a high rate of demographic growth. When market demand for commercial products is falling, real investment has become meagre, and yet an increasing number of persons are entering the labour force, the latter will try to produce more of the same products by using more and more labour in relation to virtually unchanging supplies of land and capital. It is to prevent such generalized recession and drastic impoverishment in poor countries specializing in primary products that the commodity reserve currency of Kaldor, Hart and Tinbergen (UNCTAD, 1964) was designed. A sensible objective of a policy of stabilizing terms of trade of primary products would be to allow prices of commodities with diminishing income elasticities of demand to come down gradually, while planning for a change in the output composition of the economies towards products with high income elasticities of demand, that is, for

industrialization in short.

The secular decline in terms of trade as an empirical fact put forward in the Prebisch-Singer hypothesis referred to earlier was one of the major arguments for industrialization of the LDCs in the postwar world. There is a considerable body of work which seeks to establish that there indeed was a secular decline in net barter and net double factorial terms of trade of primary producing countries as against those of the advanced capitalist or industrialized economies up to the Second World War (Sapsford, 1985; Sarkar, 1986a and 1986b; Singer, 1987; Sapsford, Sarkar and Singer, 1992). It was also claimed that after an initial pause after the Second World War, this decline was resumed from 1960s, and after a short break in the 1970s, the decline persisted in an exaggerated form in the 1980s. It was also found that the declining terms of trade were better explained by specification of country groups than by specification in terms of commodities. Thus manufactured exports of less developed countries suffered a relative price decline when compared with the prices of manufactured imports from the advanced market economies (Singer, 1987; Sarkar and Singer, 1991). This last phenomenon can be explained by the easy contestability of markets for manufactures using older types of technology and characterised by constant, rather than increasing, returns to scale and the protectionism prevailing in advanced market economies against many of the manufactured exports from LDCs, especially textiles and garments. The prices of such exports from LDCs tend to go down when they are all competing for the same quotas restricting their import into OECD countries.

The finding of a secular decline in terms of trade as advanced by the Prebisch-Singer hypothesis has been challenged repeatedly in the literature. One of the latest such challenges was mounted by Cuddington and Urzua (1989), who claimed, after using a Bex-Jenkins approach to the analysis of time series, that no deterioration in the net barter terms of trade of primary produces could be established for the period from 1900 to 1983, apart from a one-time drop in 1921. However, using the same kinds of methods as Cuddington and Urzua (1989) but with an improved specification, and without any prior assumption of stationarity in the time series or its first differences, Ardeni and Wright (1992, p. 810) have found that 'the inference of secular deterioration in the net barter terms of trade made by Prebisch and Singer in the 1950s appears to have been correct at that time, and valid for the whole century through 1988...'

A secular decline in the terms of trade of LDCs specializing in production and export of primary products will damage the investment prospects in such economies by severely limiting the capacity of the countries concerned to invest in the agricultural and non-agricultural sectors since both the investible surplus and the capacity to import the essential capital goods and technology will be badly eroded. On the other side, the incentive to invest, especially in improved methods of producing the primary products themselves, will be badly affected. A secular decline is, of course, made up of a series of short-run declines. Even if there is no secular decline in the international prices of exportables and terms of trade of LDCs specialising in exports of primary products, if a decline in the corresponding prices and terms of trade is experienced

for a succession of years that will generate strongly contractionary impulses for those economies and those impulses will be transmitted to other economies. In the absence of an effective international lender of last resort, an inevitable result of such medium-term declines in prices of exportables of LDCs and accompanying deterioration in their terms of trade will be to damage their credit-worthiness as judged by TNBs and other sources of international credit. Once the debts of LDCs begin to mount, they will rapidly approach a situation when their credit rating falls below the level which is considered to be safe enough for renewal of commercial loans.

In the 1980s (and earlier), purely financial phenomena have in turn strongly influenced variation in terms of trade between mainly agrarian or primary exporting and mainly industrialized countries dependent chiefly on exports of manufactures and services. In particular, the mirroring of most LDCs in external debt and their desperate attempts to generate more export earnings in falling markets have led to further declines in their terms of trade than would have occurred in the absence of such compulsions (Gilbert, 1989; Sarkar, 1991). The particular history of near-hegemonic dominance of the U.S.A. has played a role here. Most debts, even when owed to countries or banks domiciled in countries other than the U.S.A. have been denominated in dollars, and repayment terms have also been set in dollars. Hence during a major part of the 1980s, when the dollar rose in relation to other major currencies such as the yen or the mark, the rates of exchange of debt-entrapped LDCs fell more steeply than if the transactions had been denominated and carried out in hard currencies in general



(Gilbert, 1989). In any case, even if the debts had been denominated in a suitably adjusted basket of hard currencies rather than in dollars, the compulsion to repay <sup>the</sup> debts with shortening maturities and rising interest rates in a situation of global recession would have imposed an 'excess transfer burden of debt' on LDCs (Sarkar, 1991).

There is evidence that in the last century the forcible integration of countries such as China and India through a basically tributary mode of exchange between such economies and the metropolitan countries of the North Atlantic seaboard not only impoverished them but also caused widespread famines since the usual survival strategies in the presence of harvest failures were greatly upset by the need to make massive transfer payments on the external account (Bagchi, 1979). A very similar phenomenon seems to be occurring in major parts of the African continent in the 1980s : many of these regions were only recently pushed or forced into the network of international payments before they were prepared for anything like equal participation in such networks through appropriate investments in infrastructure, marketing facilities, and investments that raised average productivity even to survival levels in conditions of fluctuating prices and receding customers.

In his 1976 paper, Kaldor (1976) had speculated on the implications of a sudden break in terms of trade between exporters of primary products and of manufactures. He had prophesied that such breaks would cause major upsets in the international payments mechanism and would generate unsustainable inflationary or deflationary pressures. The attempt to contain

inflationary pressure in OECD countries (which were only partially caused by rises in energy prices) proved to be ultimately successful. This was achieved in many OECD countries, as mentioned earlier, partly through a fall in the prices of primary products (as had also happened in the last thirty years of the nineteenth century) and partly through tight monetary policies and wage repression. After putting the inflationary spiral into reverse and causing massive unemployment and global impoverishment in the process (Bagchi, 1992b), policy-makers are still befogged as to exactly how to move on to an upward spiral of production and employment without again being caught up in competitive inflation.

5. Conflicts between unregulated mobility of finance, long-term investment and expansion of the world economy

In the above analysis, we have looked at those short and medium-term processes which can roll the world economy along either an expansionary or a contractionary path. However, the basic engine for locomotion of individual economies and the world economy remains long-term investment. In one of his last papers on capitalist growth, Kalecki had maintained that 'the long-run trend is but a slowly changing component of a chain of short-period situations; it has no independent entity'<sup>1</sup> (Kalecki, 1968, p. 165). We are now no nearer answering the question of exactly how investment decisions which result in brisk or slow growth are made nationally or internationally than Kalecki<sup>^</sup>as when he wrote his essay. But we have seen how wifty slowing down of investment in most OECD countries and most of the LDCs outside East Asia, the sustained long-run growth of the years 1945-1970 has become only a memory in most countries.

That a high or low rate of investment has a bearing on each of the three processes outlined earlier does not need an elaborate disquisition. Other variables and relations, remaining constant, a higher level of investment will mean a higher level of national income as the expenditure multiplier process works itself out. Credit will become more plentiful as income growth powered by a high and sustained level of investment renders loans less risky. On the other side, if a cheap money policy can be credibly sustained, it will make long-term investment more viable. A high rate of investment, if it is reasonably well allocated in an LDC starting from a position of specialization in primary exportables, will make such production more efficient with the input of better technology and better inputs. More importantly, it will allow it to shift the spectrum of outputs towards products with a high income elasticity of demand and capable of benefiting regularly from innovations at home and abroad. This will mean that even if the terms of trade of primary products in relation to manufactures were to decline, it would not hurt the typical LDCs individually or collectively so badly as to set them off on a downward spiral.

If the international co-ordination of short-run policies is difficult, the co-ordination of policies relating to long-term investment flows is even more tricky. Capital, or rather finance, has generally flowed in directions which are perceived to have been the most profitable from the investor's point of view. Such perception has in its turn been shaped by political and racial factors as well as strictly economic factors. The pre-1917 French investment in bonds of Tsarist Russia or western investment in South Africa are perhaps the best illustrations of such proclivities. There is a long

tradition claiming that British foreign investment has often taken place at the cost of the domestic economy (see, for a recent analysis, supporting such a point of view, Kennedy, 1987). In recent years, similar opinions favouring the argument that capital or finance is often transferred from the domestic economy of typical LDCs for strategic reasons or reasons of short-run expediency without considering the long-term health of such economies have been voiced in many quarters.

The convergence of such views regarding the possible effects of international mobility of capital among economists studying advanced market economies and those interested in LDCs is not accidental. There is an inescapable conflict in the heart of the process of industrial capitalism itself as both Kaldor and Myrdal (1957) had recognized a long way back. Successful investment in a particular area, through the operation of static and dynamic economies of scale, tends to raise the productivity of the agents of production in those regions.

Then capital, adult labour and entrepreneurship all tend to be concentrated in those favoured areas and the other regions acquire a deserted look. To the extent that the wages and infrastructure costs rise in the developed regions, there may be a tendency for a flow back into the underdeveloped regions, but generally that tendency works only fitfully and incompletely. Thus even developed market economies end up with advanced and backward regions. When the economies concerned are separated by the political barriers of different states and by enormous difference in language, modes of organization of business, levels of educational and infrastructural development, the problems of adjustment of the two economies to the chain of cumulative and inequalizing causation become even more difficult.

Typically, the mobility of labour as between an advanced market economy and an LDC is much more restricted than the mobility of capital. Thus large bodies of labour cannot move to take advantage of the agglomeration and productivity-raising advantages of the advanced region. Capital can and does move to take advantage of low-wage labour. But low-wage labour is also usually low-productivity labour, especially when that labour is not equipped with the capital, education and infrastructural facilities available in the advanced region. In order to raise the productivity of labour and the capital equipment, it is generally necessary to commit finance and plough back profits in the long run. But in the situation of a typical LDC, with low rates of capital formation and huge pools of unemployed labour, the owners of capital from the advanced capitalist country do not feel enough confidence to commit the finance over a long period. Thus not only the advantage from the full exploitation of economies from known technology but also the possible advantages of idiosyncratic and path-dependent technologies are lost.

Nationally guided economic policies can unduly impede the full exploitation of economies by fragmentary markets. But if the economies are large enough, and the governments are pursuing a sensible strategy of industrialization, they can provide an environment for the fructification of productivity-raising investment through commitment to a firm, an industry and a region. Such policies often involve a restriction on the international mobility of capital. But at the sacrifice of short-run profitability of finance, a higher rate of return to all the factors, not excluding capital, could

be achieved through such a short-run sacrifice. This kind of resolution of conflict is not guaranteed, but it is not unthinkable either.

Unrestricted international mobility of capital with more and more restrictions on the mobility of labour as between LDCs and advanced market economies has badly - damaged the prospects of productivity-raising investment and growth in all LDCs and all advanced market economies. There are no easy ways out of the three-way conflict between the requirements of long-term commitment of finance for productivity-raising investment policies for easing the transition of losing regions or economies to adjustment with lower population levels but at higher levels of productivity, and the demands of footloose finance in search of the highest returns at any point of time. But uncoordinated investment flows and unrestricted international mobility of capital have proved to be highly inimical to global economic growth and stability and especially to the growth and stability of LDCs.

Even many mainstream theorists (such as Dornbusch, 1990) have recognized that uncontrolled mobility of finance is a major destabilizing force in foreign exchange markets. Since variations in foreign exchange rates and sudden flights of capital have created an atmosphere of greatly enhanced uncertainty and induced speculation, the so-called securitization of investment has not at all served the cause of long-term investment. It is not accidental that the two economies of Germany and Japan with carefully segmented capital and money markets did much better in terms of economic growth throughout the 1970s and 1980s than the two countries of the U.K. and U.S.A. which put the demands of finance and

unification of capital and money markets at the top of the agenda (cf. Mullins and Wadhvani, 1989). However, even as major strands in the work of mainstream economists are pointing towards public intervention and public, internationally coordinated regulation of international trade (Bagchi, 1992a), the trend of orthodox policymakers' opinion still favours liberalization of external trade and payments, without putting in any blockages to prevent a world financial and economic meltdown. If I were to speculate about the shape of things for which policymakers should strive on a global basis, it would be to try to put finance at the service of industry rather than industry and all long-sighted productive enterprise at the service of short-sighted footloose finance. As I have argued above, a basic conflict lies at the heart of capitalist rules of the game. While profit-maximization dictates looking for the highest gain at every moment of time without looking any further, long-term productivity growth requires a commitment to a particular enterprise, location, and a particular way of organizing the firm-specific and social division of labour (including that relating to innovations and productive adaptation).

One of the worst casualties of the current ~~xkxxwcmxx~~ scenario is likely to be R & D in most countries which are not favoured by footloose finance. If the proposals mooted by Mr. Arthur Dunkel of the GATT are accepted they will sound a deathknell for R i D activities which are needed not only for innovation but also for learning (Cohen and Levinthal, 1991). It is by defying the rules of footloose finance that such countries as Japan and Germany have been able to build up their formidable competitiveness in manufacturing. It is remarkable that even while Japan's firms were thriving on

high gearing ratios, the giant Japanese banks were' much less profitable than their British and American counterparts (Corbett, 1990). It is also worth noting that Japanese TNBs have not proved particularly successful in local banking outside their home ground in Japan and East Asia. So international competitive advantage in manufacturing does not get automatically translated into competitive advantage in financial markets, even if a country succeeds in generating huge external surpluses. It is, of course, not obvious that the world can be organized as a group of Japan<sub>s</sub> Inc. without running into even greater and more difficult conflicts of interest between capitalist countries than we have witnessed. But continuing to obey the current shabby rules of the game set by transnational bankers and speculators in foreign exchange markets is no way to put the three basic processes outlined above working for global enrichment rather than global impoverishment and global disaster in the shape of famines, wars, pervasive criminality and an ecological Armageddon.



F O O T N O T E S

1. For references to the literature on the foreign trade multiplier upto 1947, see Ellis and Metzler, 1949, pp. 596-7; for a survey which takes into account most of the theoretical work on the foreign trade multiplier and its empirical implementation upto 1985, see Gandolfo, 1987, chapter 13.
  
2. For a critique of the IMF-World Bank view of international economic policy, see Bagchi, 1990.

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