Struggling to keep economics relevant

Economic Theory and Policy amidst Global Discontent: Essays in Honour of Deepak Nayyar

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A hundred years ago, 'Political Economy' died and 'Economics' was born. This purported to be a 'pure' science purged of all those irrational sentiments that make human beings so irritatingly unpredictable. Above all it was purged of politics. Its self-appointed goal was to frame economic laws that would have the same timeless validity as the laws of the natural sciences.

Out of this was born 'classical', and, more recently, 'neo-classical economics'. This is what students of economics study first when they enter a university. Pride of place in these studies goes to the study of competition. Competition breeds efficiency and innovation. The inefficient get weeded out and only the strongest and the most innovative prosper.

Consumers benefit from this struggle because it constantly improves products and widens their range of choice. Over decades the 'laws of the market' have been turned by ever more sophisticated mathematics into a set of universal principles. The most important of these is that markets stabilise and regulate themselves so they should be allowed to recover from external shocks with a minimum of human intervention. In its extreme form, its devotees regularly invoke Adam Smith, the "invisible hand" and God to justify non-intervention.

All this has been made possible by introducing one premise — that of absolute rationality. Since human behaviour is often irrational and seldom predictable Economics makes a second assumption: that while individual behaviour aberrations can be random, these tend to cancel each other out when we study the behaviour of large groups. This assumption breaks down when the aberration is systemic and affects the behaviour of all members of a group in the same way. Human sentiments then must be factored into the model. When this is done the laws lose their universality.

The Great Depression of the 1930s was one such occasion. The onset of globalisation in the 1970s was a second. The financial crash of 2008 and the prolonged depression that has followed is the third. We are suffering from the impact of the second and third "market failures" and neo-classical economics has no panacea to offer but ask the world to grin and bear it.

The 21 essays in *Economic Theory and Policy amidst Global Discontent* by some of India's and the world's best economists analyse where neo-classical economics has failed and suggest where and how human beings can be brought back to the centre of economic policymaking. The leitmotif running through all the essays is that the market economy has not only ceased to be self-regulating, if it ever was, but has become positively disequilibrating

Economic Theory and Policy amidst Global Discontent is a collection of 21 essays by some of India's and the world's best economists that analyse where neo-classical economics has failed and suggest where and how human beings can be brought back to the centre of economic policymaking.

The collection is a festschrift in honour of Deepak Nayyar who turned 70 in 2016. In an extraordinary career that has spanned research, teaching and advising the Government of India, Nayyar has been the Vice Chancellor of Delhi University, Chief Economic Adviser to the Indian government, Professor at Jawaharlal Nehru University,

New Delhi, at the New School for Social Research, New York, at Oxford and Sussex Universities in the UK and at the Indian Institute of Management, Calcutta. His seminal research has been in the areas of foreign trade, economic development, globalisation and the inequalities it has created.

The leitmotif running through all the essays is that the market economy has not only ceased to be self regulating, if it ever was, but has become positively disequilibrating. Since the current phase of globalisation began – broadly speaking in the 1970s – the trans-nationalisation of industry, trade and finance has progressively worsened income inequalities, replaced cyclical with chronic unemployment in the industrialised countries, halted industrialisation (measured by the growth in the share of industry in the GDP and employment) and even triggered a premature de-industrialisation in the developing countries, and greatly increased insecurity, whether of jobs, livelihoods or health. In the industrialised countries the middle class is being squeezed out of existence; crime and extremism are on the rise. Developing countries are suffering from all these in an aggravated form. The youth increasingly face no future and see hope only in migrating to the still-rich industrialised world.

In his essay "Capitalism, Consciousness and Development", Akmal Husain traces the origins of all the evils described above, the Crash of 2008 and the prolonged recession that has followed, to the parking of global wealth in financial assets instead of in real investment in industry, agriculture, better social services, and foreign direct investment in the less developed countries — the situation the world reached in the early 2000s when banks ran out of profitable investment opportunities and began creating pyramids of phantom assets that yielded phantom profits till the entire edifice crashed in 2008.

Financial deregulation and a simultaneous sharp cutback in taxation of the rich and the middle class, added to the imbalance. As a result, between 1964 and 2013, while world GDP grew by 49 times, and world trade by 133 times at current prices and exchange rates, financial assets held by the banking system grew by more than 6,000 times!

Had the governments of the world continued to tax their citizens at the rates of the 1960s and 1970s; had trade unions remained strong and continued to extract their earlier share of the rise in productivity for their workers; had the hours of work shortened further in response to increases in labour productivity, had foreign aid remained at the same proportion of GDP as it had been during the Kennedy era; had international capital movements not been freed of all curbs and the growth of offshore banking been restricted; had the Glass-Steagall Act not been rescinded, the Crash of 2008 and the global recession that followed, might never have happened. For these were the regulatory barriers that had maintained parity between labour and capital, and created the economic and social security that had given moral legitimacy to capitalism during the "thirty glorious years" that succeeded the end of the Cold War. But all these controls and regulations were products of nation-state capitalism, and by the beginning of the 1980s the destruction of its institutions, which had become obstacles to the spread of Global Capitalism was in full swing. Since economic theory has always run a laggard's race to explain and legitimise every change in the way people make money, it is not surprising that all the institutions created during nation-state capitalism became anathema to the neo-classical economists of the 1980s.

One area in which the resurgence of neo-classical dogma has done irreparable damage is the understanding of development economics. Neo-classical economists have consistently insisted that there are no separate policy requirements for late starters in industrialisation to follow if they want to catch up with the industrialised countries. All they have to do is keep an open economy, exploit their natural advantages and remove hurdles to investment and trade, and industrialisation would automatically follow. This view was sold by the World Bank to the developing countries. But as the 30 glorious years ended in the late 1970s, de-industrialisation set in among the highly industrialised countries and protectionism reared its head within them — the export-led model faltered. It is in countries that have been forced, by the IMF or World Bank, for example, or have slavishly followed the dictates of neo-classical economists, as India has done under the sway of the Reserve Bank of India, that development has failed and de-industrialisation has set in

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This view was, in a sense, sold by the World Bank to the developing countries through a series of studies that pointed out the failings of the closed economy model of growth, notably in India and Egypt, and the success of open economy models in Hong Kong, Singapore, South Korea, Taiwan and elsewhere in East Asia. But as the 30 glorious years ended in the late 1970s, de-industrialisation set in among the highly industrialised countries and protectionism reared its head within them — the export-led model faltered. The East Asian initial successes became the only countries, along with China, to burst through the protectionist barriers that the rich nations had begun to erect under a variety of environmental and other pretexts. They did so by flouting each and every tenet of neo-classical prescriptions for growth. This prompted a fresh study of how Korea and Taiwan had broken through earlier and these studies found that their success stemmed from the adoption of carefully framed policies to subsidise export growth by transferring the burden of doing so onto their domestic markets.

In virtually all the remaining developing countries, attempts to follow the open economy model has led to a halt of industrialisation, measured as a share of GDP or employment, and in several, like Mexico, Argentina, Turkey, Russia and the South-east Asian 'Tiger' economies it has precipitated economic crises. Despite this, neo-classical economists have kept searching for explanations other than their faulty policy prescriptions to explain these failures.

In an incisive and sometimes mordantly humorous essay titled "The Rise and Fall (?) of the ABP (Anything But Policy) Discourse in Development Economics", Cambridge economist Ha Joon Chang discusses the six causes to which the neo-classical economists have ascribed the failure of the rest of the 'Third World' to industrialise. These are: Geography; Climate; Natural Resources; Ethnic diversity; Culture; and Institutions. Chang correctly points out that while barriers arising from these do exist, they have been overcome by selective policy interventions in the successful developing countries. It is in countries that have been forced, by the IMF or World Bank, for example, or have slavishly followed the dictates of neo-classical economists, (as India has done under the sway of the Reserve Bank of India) that development has failed and de-industrialisation has set in.

Lack of space prevents me from discussing all the 21 essays in this book. It prevents me from even outlining their principal theses. So I will mention those I found particularly relevant and useful in understanding the current global disorder and discontent.

Frances Stewart's essay titled "Inequality and Conflict: Global Drivers and Interventions", in which she distinguishes vertical inequality, that is inequality between individuals within a nation, from horizontal inequality, that is inequality between religious, racial or ethnic groups within a nation and between nations and points out that while the former has not necessarily led to conflict, the latter has been the prime driver of conflict both within and now increasingly between nations.

Joseph Stiglitz's 60-page essay on "The Theory of Credit and Macro-Economic Stability" summarises his seminal research into why the overwhelming dependence on monetary policy to revive the global economy after the Crash of 2008 has been a failure. He points out that while monetary measures that increase money supply stimulate spending and growth in normal times, in a severe crisis, such as the world entered in 2008, this does not happen because people refuse to borrow. Stiglitz lays out with precision the many reasons why the money supply-credit link can get broken and argues that restoring borrowing requires a prior revival of demand — in sum, a return to Keynes.

The last four essays in the book are on the Indian economy post the 2008 crash. To me they are the most important, but with the exception of the essay by Nagesh Kumar, former Director General of the Delhi-based Research and Information System for Developing Countries (RIS), the remaining three – "Major policy debates in the Indian economy" by YV Reddy; "Globalisation and the slowdown in the Indian economy: A demand-side view" by Mritunjoy Mohanty; "Is land a bottleneck for economic development in India" by Ram Singh – while making valuable observations, left key questions in my mind unanswered.

YV Reddy, who was the Governor of the Reserve Bank of India from September 2003 till September 2008, has described the various ideological battles, such as between the Nehru-Mahalonobis strategy and Vakil-Brahmananda approach in the 1950s, the battle over devaluation in 1966, the controversy over the nationalisation of commercial banks in 1969, and over the IMF structural adjustment loan India took in the early 1980s. He also makes a point of mentioning the tussle over whether or not to open up India's capital account, as recommended by two committees, both headed by RBI Deputy Governor Tarapore, in 1997 and 2006 in response to strong pressures exerted on India by international banks and the IMF. The fact that Reddy commissioned a second report in 2006 when he himself was the RBI governor, even after seeing how the lack of capital account convertibility had saved India and China from the Asian financial crash in 1997 shows that Reddy himself was in favour of the move.

It also explains his haste in raising interest rates from January to October 2007 by more than 3 per cent because inflation had, in his words, "breached the 5 per cent barrier" in the summer of 2006, for both reports had laid down that India's inflation rate had first to be brought down to between 3 and 5 per cent before it could consider opening up its capital account.

This was the single catastrophic move, taken without any regard to whether the rise in inflation had been caused by excess demand, shortages of supply, or simply global increases in commodity prices on which India had little control, that killed the growth spurt that had begun in 2003. As Nagesh Kumar has shown in his essay "Reversing Premature De-industrialisation for Job Creation", 2007 was when the share of Industry in the GDP stopped growing and, after two years, began to fall. Wisely for himself, but not for his readers, Reddy ends his reflections in 2006. ■