THE MACROECONOMIC REASONING IN THE *TDR*

Introductory remarks

by

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TDR and the Originality of UNCTAD

UNCTAD's work was initially based on a centre-periphery view of the world in which there were rich, technologically advanced industrial countries and poor technologically backward developing countries, and the basic pattern of international trade was the exchange of the manufactures produced in the former for the commodities produced in the latter. Steady economic growth was assumed to be inevitable in the advanced industrial countries and the problem of development in the peripheral countries was seen as a question of how to integrate them into the growth dynamic of the centre in a way in which there were mutual benefits for both the centre and the periphery. It was argued that this would not happen automatically because of the balance of payments constraints facing developing countries given the structure of international trade. In this situation, the free play of market forces could not guarantee fast enough growth rates in developing countries to address the pressing social problems of poverty, malnutrition and accelerating jobless urbanization. There was therefore a need for development planning to help developing countries to accelerate the process of development and such disciplined effort should be supported by international cooperation.

The content of development policies and international cooperation was derived from the analysis of the constraints from the centre-periphery pattern of global interdependence. These were synthesized in Raul Prebisch's Report of the Secretary-General to UNCTAD I, "Towards a New Trade Policy for Development". At the national level, the policy focus should be promoting industrialization, and in particular turning away from "inward-looking industrialization", by getting rid of excessive protectionism and by promoting exports of manufactures, which in a rational policy would be combined judiciously with import substitution. At the international level, this policy should be supported by measures to ensure higher prices for commodities for producing countries, to reduce commodity price instability, to provide compensatory financing, to provide trade preferences for selected manufactures exports and to use aid to build up trade capacities. Most fundamentally, the application of the principle of reciprocity in trade liberalization *before peripheral countries industrialized* should be rejected because it would lead to unequal outcomes and would not maximize international trade. Special measures were also recognized as being necessary for the "least developed" amongst the developing countries.

This initial UNCTAD synthesis is rightly recognized as brilliant. It provided the intellectual foundation for the so-called golden years of the organization, from 1964, through the period when attempts were made to promote a New International Economic Order, to the end of the 1970s. As such, these ideas have often been associated with UNCTAD's originality.

However, intellectual histories make clear that these ideas were actually hatched in Latin America, and particularly in ECLAC, and projected to a global scale through the vision of Raul Prebisch. I would like to argue here, therefore, that one should not look for the originality of UNCTAD in this first synthesis. Rather it lies in the analytical and policy work of UNCTAD which began in the 1980s, particularly, though not exclusively, through the vehicle of the *Trade and Development Report* (*TDR*).

The first Trade and Development Report was published in 1981 and it states quite clearly that "The present situation appears to require a new development paradigm". This was, of course, a moment in which development thinking and practice was turning decisively away from planning. But more fundamentally, the initial *TDR*s identified real structural changes in the global economy which, quite apart from the swinging of the ideological pendulum, were rendering the old paradigm obsolete.

One element of this changed situation was the deep economic recession in advanced economies. A second was the breakdown of the international development consensus between developed and developing countries which UNCTAD had been promoting. This was based on the idea that accelerated economic development in developing countries would increase their purchasing power, and if their import capacity increased this would promote economic growth in developed countries and contribute to full employment. Once controlling inflation replaced full employment as the central axis of economic policy in developed countries, this rationale for an international development consensus was sidelined. But third, and perhaps most important, was that a new form of global interdependence was emerging which was rendering obsolete the centre-periphery pattern which had underpinned UNCTAD's work in the 1960s and 1970s.

The *TDR*'s of the early 1980s grapple to formulate a new language to grasp this new reality. They speak of "the internationalization of output and trade"; the emergence of a new international division of labour, with the industrialization occurring in the periphery in a very uneven way; an increase in the effective control of resources by transnational corporations and their dominant market power influencing the distribution of the benefits of trade; "the growing privatization of the international monetary system", as private capital flows became more and more important; a growing tendency in which "national money and capital markets have increasingly become integrated into a world money and capital market"; and the emergence of new international regimes governing economic and financial relations. What was being addressed was, of course, the multiple-stranded phenomenon which later came to be labelled "globalization".

I would argue that since the early 1980s, the *TDR* has sought to construct a new synthesis to grasp the new realities following the breakdown of the centre-periphery model on which UNCTAD was founded. Moreover, it is in this, and related work such as the Least Developed Countries Report, that the originality of UNCTAD lies.

In seeking to reconstruct a new synthesis, there was continuity with the past in the sense that, as in the Prebisch paradigm, the focus was on the interaction between global interdependence and national processes. Moreover, as in the past, analytical work sought to blend macroeconomic and financial analysis with developmental and trade analysis. The basic object of study remained the analysis of the ways in which macroeconomic balances, particularly the investment-savings nexus and the balance of payments constraint, interacted with structural change, the working of capital and labour markets, and the dynamics of distribution, in the context of global interdependence, to generate virtuous circles of sustained growth, vicious cycles of economic stagnation and periodic economic crises and growth collapse. However, there were important new contributions.

Three contributions stand out. Firstly, there was enhanced understanding of successful development experiences, following an intense effort to decode the role of government in East Asian development and to work out how that could be applied in Africa (see, in particular, *TDR* 1994, 1996, 1998). Secondly, there was deep understanding of the nature of financial crises and debt dynamics. This strand of work began with warnings in the late 1980s, continued with prescient analyses and policy proposals in the 1990s, particularly in the light of the East Asian financial crisis, and continued through the 2000s, with increased understanding of the financialization of international commodity markets and the effects of the nature of the international monetary system on development prospects. Thirdly, there was an

important intervention on the relationship between globalization, growth and distribution (*TDR* 1997), which remains, 15 years on, one of the most insightful and fresh studies on the subject.

In general, UNCTAD's work in the *Trade and Development Report* has been of the utmost significance. As I have argued elsewhere (Gore, 2000), whereas UNDP provided a moral critique of the Washington Consensus policies, focusing on their objectives, UNCTAD provided an economic critique based on a more realistic understanding of how capitalist economies grow and develop than that provided by market fundamentalism. These analyses were founded on a deep understanding of, and belief in, the dynamic benefits of capitalism, married with recognition of its proneness to instability, its radical inequalities and the ever-present processes of creative destruction through which success always carried the seeds of future failure.

The analytical insights of the *TDR* were critically important in the 1990s when the Washington Consensus was at its peak. But they have remained important up until today because, although pronounced dead on many occasions, the Consensus still enjoys a lively afterlife. But was a new synthesis, comparable to the Prebisch's centre-periphery model, actually formulated?

Overall, I think it was not. One close shot was the *TDR* 1999 which argued that trade liberalization was associated with faster import growth than export growth and this was leading to increased reliance on external finance and increased vulnerability to financial crises. In the early 2000s, some effort was also made to refine the picture with a deeper understanding of different forms of industrialization in developing countries and integration into global value-chains. But in general I think that too much attention was paid to how new forms of global interdependence were associated with instability and financial crises, and too little attention was paid to how new forms of global interdependence were associated with rising inequality.

In some sense, the frequent recurrence of actual and ever-larger financial crises crowded out the slow and sustained study of the silent and slower crisis of persistent and rising inequality at a global scale. This tendency was further reinforced by a continuing fracture between the macroeconomic and financial analysis and expertise on the one hand, and the developmental and trade analysis and expertise on the other hand, with the former always perceived as superior. Marrying these two strands in the work of the *TDR* has always been difficult.

The failure to do more work on inequality and follow up on the *TDR* 1997 was, I believe, a major strategic error. A new international development consensus centred on MDGs and a so-called people-centred approach to development actually did emerge in 2000 after the Millennium Declaration. With a focus on global inequality, UNCTAD could have warned against much of the romantic violence which has come with this approach. But without sustained work of this type, UNCTAD has not had a significant voice in these debates.

So where should we go from here? Fortunately there will be renewed attention to inequality in the *TDR* 2012. Moreover, it is possible for UNCTAD now to engage pro-actively with the post-2015 development policy framework. But the deeper challenge now is that, as *TDR* 1981 put it, "The present situation appears to require a new development paradigm". Put simply, as many recognize, the global financial crisis marks the end of an era. But the problem is, as it was for those writing the *TDRs* of the early 1980s, to discern what the emerging tendencies are.

There are many possibilities. But I have argued elsewhere (Gore, 2010) that we have come to the end of the period where globalization can serve as a useful organizing principle for development thinking and practice, and we must now focus on global sustainable development. This implies a major shift in vision from viewing the economy as an isolated system to viewing the economic system as a subsystem of the ecological system, drawing material resources from the ecological systems and in turn affecting those systems through waste and pollution, including carbon emissions. This paradigm shift offers new ways of looking at international trade, development and global inequality in a world where my carbon footprint affects everyone everywhere, and so does yours, and where the richest 15 per cent of the world population are responsible for 75 per cent of total carbon emissions. This is now the most existentially important new form of global interdependence.

This shift in vision is going to be vital for thinking about, and negotiating consensus on, a sustainable

future of prosperity for all. But realizing this shift in vision requires a new mix of skills amongst professionals and deeper inter-disciplinarity, merging the macroeconomic, the developmental and the ecological. Do we have the imagination? Will we be able to change again? Once again we face a test of the originality of UNCTAD.

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Statement

by

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Reflections on some of the macroeconomic issues raised by UNCTAD's *Trade and Development Report* over three decades

Introduction

First of all, I congratulate the *Trade and Development Report* on its 30th birthday; oh that we were all so young! I have only been a regular recipient of the *Report* for the last eight years or so, and have never read it from cover to cover. But I always look for interesting charts and tables, and I read the *Overview* containing the main arguments. It has always had a Keynesian, non-orthodox (although not too non-orthodox) flavour about it, which distinguishes it from publications emanating from other international institutions concerned with economic development such as the World Bank, International Monetary Fund and the World Trade Organization. In particular, it has always advocated and promoted policies of international Keynesianism, stressing the importance for all countries in the world of maintaining global aggregate demand so that trade can be kept on an even keel and not suffer extreme ups and downs as it did in the 1930s and 1980s, and again today (UNCTAD, 1987, 1996, 2002, 2009, 2011). It has always been cautious about symmetrical trade liberalization, which can cause balance of payments problems for weak countries if imports grow faster than exports (UNCTAD, 1992, 1993), and cautious over the liberalization of international capital flows which can lead to severe short-term macroeconomic instability, especially in the presence of large global payments imbalances (UNCTAD, 1999, 2006, 2007, 2009). It has also pointed to the damage done to countries by the uncontrolled movement of primary commodity prices and the long-term deterioration of terms of trade of many primary commodities (UNCTAD, 2008, 2011). Interestingly, these are all issues that preoccupied Keynes in the 1930s and at Bretton Woods in the 1940s, and were central to the criticisms of orthodox trade theory made by UNCTAD's first Secretary-General, Raul Prebisch, in the 1950s and 1960s. I will take up some of these issues in what I have to say below.

Firstly, I discuss the role of exports in economic growth, and why the structure of trade matters for economic performance (UNCTAD, 1996, 2003, 2006, 2010). Secondly, I refer to Prebisch's concern over the balance of payments consequences of the freeing of trade. Thirdly, I refer to my own research (with others) of the effects of trade liberalization on export growth, import growth, the balance of payments and the trade-off between growth and the balance of payments. Finally, I end with discussion of Keynes's solutions to global imbalances and the

instability of primary product prices which plague the world economy today more seriously than they did when Keynes was writing his plans for a new international economic order to be implemented after the Second World War.

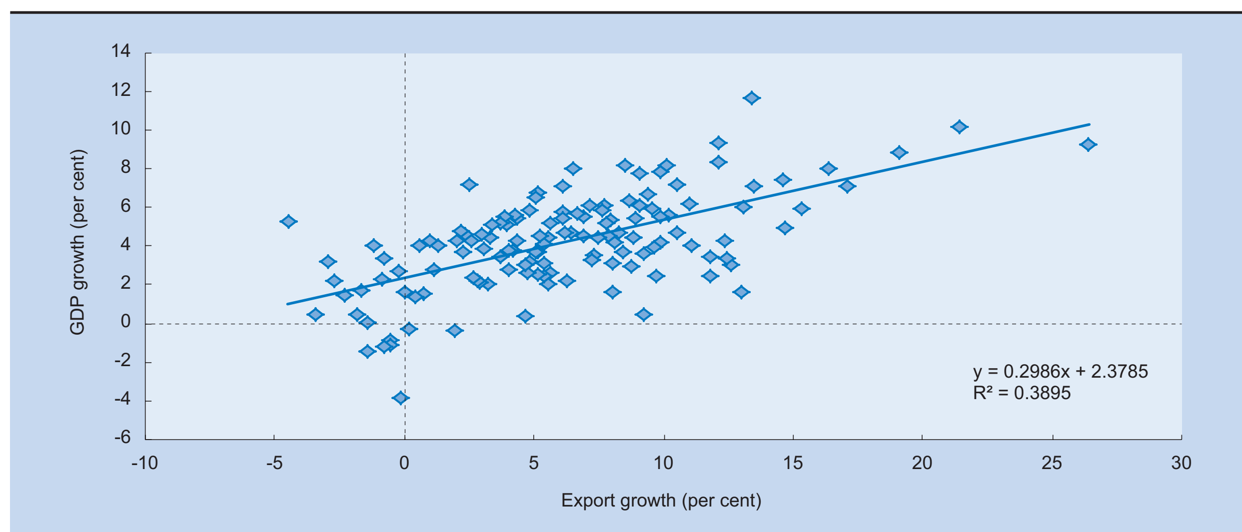
Exports and growth

It was the great 19th century economist, Alfred Marshall, who wrote 'the causes which determine the economic progress of nations belong to the study of international trade' (Marshall, 1890). He was right. There is a stronger correlation between GDP growth and export growth than between GDP growth and almost any other single variable. Figure 1 gives the correlation across 133 countries over the period 1995–2006.

In discussing the relation between exports and growth, however, it is useful to distinguish at least three different models with different emphases. First, there is the orthodox supply-side model (see Feder, 1983) which assumes that the export sector, because of its exposure to foreign competition, has a higher level of productivity than the non-export sector and confers externalities on the non-export sector. Thus the share of exports in GDP, and the growth of exports, both matter for overall growth performance. I have no quibble with this, but the orthodoxy neglects the demand side, which may be even more important. Exports are not only a direct source of demand, but also an indirect source because they pay for the import content of other components of demand, allowing these other components to grow faster than otherwise would be the case. This is the open economy analogue of the Hicks super-multiplier (see McCombie, 1985).[1] Thirdly, export growth can set up a virtuous circle of growth whereby export growth leads to fast GDP growth; fast GDP growth leads to greater competitiveness through static and dynamic returns to scale, and improved competitiveness leads to faster export growth (see Dixon and Thirlwall, 1975, UNCTAD, 1996). In such a cumulative model, it is differences in the income elasticities of demand for exports (and imports, if balance of payments equilibrium on current account is a requirement – see below) between countries which is the essence of divergence between industrial and agricultural economies, or between 'centre' and 'periphery' to use the terminology coined by Prebisch (1950, 1959). It makes a difference to countries whether they produce and export cabbages or computers. Structure, and the supply and demand characteristics of goods, matter for economic performance. As early as the mid-19th century, in the debates over free trade, John Stuart Mill (1848) recognized that the growth effects of

Figure 1

ASSOCIATION BETWEEN GDP GROWTH AND EXPORT GROWTH



trade depend on what a country specializes in – whether natural resource activities or manufacturing activity; and most recently Stiglitz (2006) has written:

> A country whose static comparative advantage lies in, say, agriculture, risks stagnation; [without protection]its comparative advantage will remain in agriculture, with limited growth prospects. Broad based industrial protection can lead to an increase in the size of the industrial sector which is, almost everywhere, the source of innovation; many of these advances spill over into the rest of the economy, as do the benefits from the development of institutions, like financial markets, that accompany the growth of the industrial sector.

'What you export matters' has been formally modelled by Hausmann, Hwang and Rodrik (2007) who show a strong relation across countries between the structure of exports, export growth and GDP growth (where structure is measured by a country's share of 'high income' goods associated with rich countries).

One country's exports, however, are another country's imports. Imports can also be growth-promoting in a number of ways. Imports of capital goods, particularly into developing countries without their own capital goods sector, are important for investment and structural change. Capital imports embody knowledge and technical progress which can be mimicked. Imports of consumption goods increase choice and consumer welfare. The real problem arises, however, when the growth of imports exceeds the growth of exports which causes balance of payments deficits. If deficits cannot be financed, and real exchange rate changes are not an efficient balance of payments adjustment mechanism, economic growth may have to be sacrificed, and the static and dynamic welfare gains from trade may be offset by real income losses from unemployment.

This was one of the major grounds on which Prebisch (1950, 1959) questioned the mutual profitability of free trade between 'centre' and 'periphery' with the latter exporting primary commodities with a low income elasticity of demand and importing manufactured goods with a higher income elasticity of demand. The orthodoxy still ignores the monetary or balance of payments effects of trade in the discussion of the welfare benefits of trade. This neglect has a long ancestry which stretches from the price-specie flow mechanism of David Hume (1752) (the old gold standard adjustment mechanism) to the modern view that current account deficits do not matter because they simply represent consumption smoothing (Obstfeld and Rogoff, 1997). Free trade orthodoxy assumes balanced trade and the full employment of resources which in the real world may not apply to many developing countries. This leads me to the discussion of trade liberalization and the impact that liberalization has had on export growth, import growth and the balance of payments, and whether trade liberalization has improved the trade-off between growth and the balance of payments.

Impact of trade liberalization in developing countries

The first point to make is that export growth and trade liberalization are not the same. As Stiglitz (2006) remarks:

> Advocates of liberalisation - - - - cite statistical studies claiming that trade liberalisation enhances growth. But a careful look at the evidence shows something quite different - - - it is exports –not the removal of trade barriers- that is the driving force of growth. Studies that focus directly on the removal of trade barriers show little relationship between liberalisation and growth. The advocates of quick liberalisation tired an intellectual sleight of hand, hoping that the broad brush discussion of the benefits of globalisation would suffice to make their case.

Advocates of liberalization always stress the beneficial impact of trade liberalization on exports, but rarely focus on the other side of the coin which is the surge of imports that may result, and the negative effects that trade liberalization can have on the balance of payments.[2] It is this neglect, combined with my interest in balance of payments constrained growth models (see McCombie and Thirlwall, 1994, 2002, and Thirlwall, 2011), that led me in the early 2000s to embark on a major research programme (with collaborators) on the impact of trade liberalization on trade performance in developing countries in general, and Latin American economies in particular.

The first study to emerge from the research programme was Santos-Paulino and Thirlwall (2004) which takes a panel of 22 developing countries from the four 'regions' of Africa, Latin America, East Asia and South Asia that undertook significant trade

liberalization during the period 1972–1997. Trade restrictions are measured by export and import duties, and liberalization is captured by a dummy variable in the year in which significant liberalization took place (and continued). What we found (taking an average of results from different statistical methods of estimation using panel and time series/cross section data) was that export growth accelerated by about 2 percentage points; import growth jumped by 6 percentage points, and the trade balance/GDP ratio deteriorated by 2 percentage points.[3]

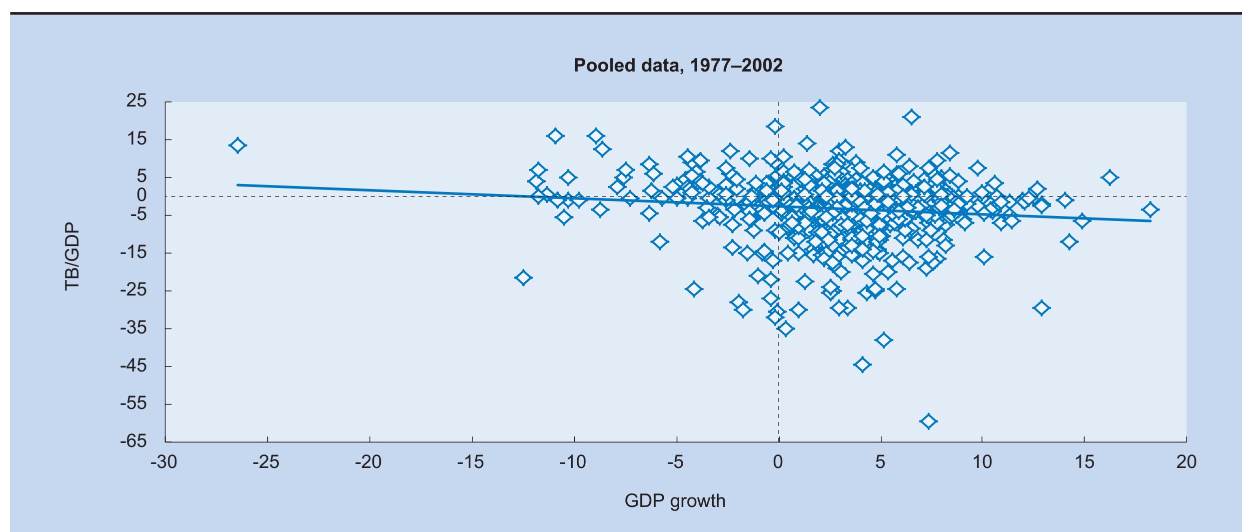
A second study (Pacheco-Lopez and Thirlwall, 2006) estimates the direct effect of trade liberalization on the income elasticity of demand for imports for 17 Latin American countries over the period 1977–2002 using a slope dummy variable to capture the income elasticity pre- and post-liberalization. The estimated elasticity for the pre-liberalization period is 2.08, and 2.63 for the post-liberalization period. This result is confirmed using the technique of rolling regressions taking 13 overlapping periods starting from 1977–1990 and ending in 1989–2002. The estimated income elasticity starts at 2.04 and ends at 2.82 giving an annual trend rate of increase of approximately 0.04 percentage points. This increase in the income elasticity of imports more or less offsets the increase in export growth post-liberalization, leaving the GDP growth rate consistent with balance of payments equilibrium broadly unchanged. This was also the conclusion of Parikh (2002) taking 64 countries:

> The exports of most of the liberalising countries have not grown fast enough after trade liberalisation to compensate for the rapid growth of imports during the years immediately following trade liberalisation. The evidence suggests that trade liberalisation in developing countries has tended to lead to a deterioration in the trade account.

The ultimate test of successful trade liberalization, at least at the macro level, is whether it lifts a country on to a higher growth path consistent with external balance; in other words, if it improves the trade-off between growth and the balance of payments. In a third study (Pacheco-Lopez and Thirlwall, 2007) this issue is examined for the same 17 Latin American countries as discussed above taking the trade balance/GDP ratio as the dependent variable and income growth (y) as the independent variable. The technique is first to estimate the trade-off curve for the whole time period and then to include a shift dummy into the regression equation for the year in which each country undertook trade liberalization in a significant way to see whether the shift dummy is positive or negative. Using pooled data (giving 425 observations) shown in figure 2, and fitting a linear regression gives the simple trade-off curve as (t statistics in brackets):

Figure 2

THE RELATION BETWEEN GDP GROWTH AND THE TRADE BALANCE TO GDP RATIO



$$TB/GDP = -3.203 - 0.315\,(y) \quad (1)$$
$$\qquad (6.3) \quad (3.3)$$

Adding the shift dummy variable (lib) gives:

$$TB/GDP = -1.387 - 0.258\,(y) - 3.610\,(lib) \quad (2)$$
$$\qquad (2.1) \quad (2.7) \quad (4.2)$$

The shift dummy turns out to be *negative.* Trade liberalization has apparently worsened the trade-off by 3.61 percentage points. When the model is extended to allow for real exchange rate changes and the growth of world income the coefficient on the lib dummy falls to -2.0, but is still significantly negative. All this has implications for the sequencing of liberalization (UNCTAD, 1992, 1993).

Global imbalances

The consequences of trade, and trade liberalization, for the balance of payments of countries, have implications for global imbalances and the optimal functioning of the world economy. Global imbalances are bad for the health of the world economy. They give rise to huge, volatile and speculative capital flows, they contribute to currency instability and the need for countries to hold large foreign exchange reserves to intervene in currency markets when necessary, and they lead to an arbitrary reallocation of resources between surplus and deficit countries, often from poor to rich countries (UNCTAD, 1985, 2000). Today, for example, there is something perverse about poor Chinese transferring resources to Americans twenty times richer than themselves.

Global imbalances can cause severe difficulties for individual countries, particularly those in deficit, and they exert deflationary bias on the whole world economy. Of course, the world as a whole cannot be balance of payments constrained, but it only requires one country or a small group of countries not to be constrained for all the rest to be so. There is a limit to which deficit countries are willing to finance deficits. And that limit may constrain growth considerably below the rate that would achieve the full employment of resources. That is the surest sign of balance of payments constrained growth: deficits on current account and unemployed domestic resources. Commentators make the obvious point that not all countries can have export-led growth – some countries have to import – but export-led growth from deficit countries is not a zero-sum game if surplus countries allow their surpluses to diminish. The world as a whole would be better off.

The world economy need not be in this situation of serious global imbalances if it instituted institutional mechanisms to penalize surplus countries that are reluctant, or unable for some reason, to spend more or reduce their surpluses in some other way[4] (I am dubious about the role of currency appreciation). The IMF could declare, for example, if the decision-making bodies agreed, that it will not tolerate members' surpluses exceeding a certain percentage of GDP – say 2 per cent, which is a sustainable deficit for most countries. In the old days of the Bretton Woods system, this magnitude of deficit would have put countries on the margin of fundamental balance of payments disequilibrium. Countries with surpluses above 2 per cent of GDP could be fined at progressively higher rates. The proceeds from fines could be given as aid to the poorest countries in deficit. Indeed, Keynes had a similar plan in mind at the Bretton Woods conference in 1944 in his proposals for an International Clearing Union[5] which would have been like a world central bank, issuing its own international money (bancor) which countries would have used for payments to each other. Each country would have had a quota with the Union (as countries do now with the IMF which determines borrowing limits). Keynes's proposal was that if a country had a credit (or debit) balance in excess of one-quarter of its quota, it would pay a charge of one per cent of the excess balance, and another one per cent if its credit (or debit) exceeded one-half of its quota. If credit balances exceeded 50 per cent of quota on the average for at least one year, the country would have to discuss with the Governing Board appropriate measures to restore equilibrium. Keynes writes : 'these charges - - - - would be valuable and important inducements towards keeping a level balance, and a significant indication that the system looks on excessive credit balances with as critical an eye as on excessive debit balances, each one, indeed, the inevitable concomitant of the other'. As is well known, however, Keynes's proposal for an International Clearing Union was rejected by the Americans at Bretton Woods. Keynes used to joke that his proposal for a bank had become a fund (the IMF), and his proposal for a fund had been named a bank (the World Bank)!

Keynes's other proposal for a 'scarce currency' clause, which would have given the right to deficit countries to discriminate against the import of goods from surplus countries (expected to be the United States of America), was accepted, but the clause was never implemented because the United States of America soon became a debtor country.

The idea of a scarce currency clause could, however, be resurrected to be used against persistent surplus countries in the way originally envisaged. Both ideas of trade discrimination (notwithstanding the rules of the WTO, which has never shown interest in the balance of payments consequences of free trade), and the penalization of surplus countries, are ripe for consideration for a more stable international economic order, and to reduce deflationary bias in the world economy arising from balance of payments constraints on demand and growth in perpetual deficit countries.

The instability of primary product prices

Another destabilizing feature of the world economy that preoccupied Keynes both before and during the Second World War was instability of primary product prices. In a Memorandum in 1942 on the 'International Regulation of Primary Products', he remarked : "one of the greatest evils in international trade before the war was the wide and rapid fluctuations in the world price of primary commodities - - - - it must be the primary purpose of control to prevent these wide fluctuations" (Moggridge, 1980).

The developing countries in particular, and the world economy in general, suffer several problems from the uncontrolled movement of primary product prices. Firstly, it leads to a great deal of instability in the foreign exchange earnings and balance of payments position of developing countries which makes investment planning and economic management much more difficult than would otherwise be the case. Secondly, price volatility of primary products leads to volatility in the terms of trade, which may not reflect movements in the equilibrium terms of trade between primary products and industrial goods. In these circumstances, world economic growth becomes supply constrained if the prices of primary products are 'too high', or demand constrained if they are 'too low'. Thirdly, because of asymmetries in the economic system, volatility imparts inflationary bias combined with tendencies towards depression in the world economy at large. When the prices of primary products fall, the demand for industrial goods falls but their prices are sticky downwards. When the prices of primary products rise, prices of industrial goods are quick to follow suit and governments depress demand to control inflation. The result is stagflation (UNCTAD, 1990, 2008, 2010, 2011). As Keynes put it in his Memorandum:

> At present, a falling off in effective demand in the industrial consuming countries cause a price collapse which means a corresponding break in the levels of incomes and effective demand in the raw material producing countries, with a further adverse reaction, by repercussion, on effective demand in the industrial centres; and so, in the familiar way, the slump goes from bad to worse. And when the recovery comes, the rebound of excessive demands through the stimulus of inflated price promotes, in the same evil manner, the excesses of the boom (Moggridge, 1980: 121).

There is explicit recognition here of the mutual interdependence of primary producing developing countries and richer developed countries, which has been a central theme running through UNCTAD's *Trade and Development Reports*, and was dramatically highlighted by the Brandt Commission Report published in 1980.

The instability of primary product prices that Keynes observed has not gone away (UNCTAD, 2005). A major study by Cashin and McDermot (2002) at the IMF looks at trends and cycles in both the nominal and real prices of 17 non-food primary commodities over the period 1862–1999 and conclude:

> Although there is a downward trend in real commodity prices [the terms of trade] - - - it is small compared with the variability of prices. In contrast, rapid, unexpected and often large movements in commodity prices are an important feature of their behaviour. Such movements can have serious consequences for the terms of trade, real incomes, and fiscal positions of commodity dependent countries, and have profound implications for the achievement of macroeconomic stabilisation.

They find 13 occasions since 1913 when the annual price change was more than 20 per cent. They also find average price slumps last longer than price

booms (4.2 years compared to 3.6 years). Kanbur and Vines (1986) demonstrate large macro gains from the stabilization of primary product prices.

Keynes's solution to primary product price instability was his proposal for what he called 'commod control', an international body representing leading producers and consumers that would stand ready to buy 'commods' (Keynes's name for typical commodities), and store them at a price (say) 10 per cent below the fixed basic price and sell them at 10 per cent above. Commodities should be stored as widely as possible across producing and consuming countries. The latter idea has some contemporary relevance as a means of responding quickly to conditions of famine. The finance for the holding and storage of 'commods' in Keynes's scheme would have been provided through his proposal for an International Clearing Union acting like a world central bank with the power to create money for international collectively agreed purposes. Keynes was convinced that such a 'commod control' scheme would make a major contribution to curing the international trade cycle and would operate much more immediately and effectively than public works. But Keynes's proposal never even got to Bretton Woods because of opposition in the United Kingdom from both the Bank of England and the Ministry of Agriculture (see, Thirlwall, 1987).

Today, the finance for storage and holdings of stocks could be provided by the issue of Special Drawing Rights (SDRs) by the IMF. The world has created a new international money, but fails to use it for socially useful purposes. Seventy years have passed since Keynes's war-time proposal, but primary product price fluctuations still plague the world economy. The world still lacks the requisite international mechanisms to rectify what is a major source of instability for the world economy.

Conclusions

What I have tried to do in this brief paper is to take up some of the macroeconomic themes that UNCTAD's *Trade and Development Report* has focused on over the last thirty years, and to give my own perspective on their importance. I believe that some of the issues have not been given as much attention as they deserve, particularly the balance of payments consequences of the freeing of trade. But I endorse the emphasis on the importance of trade for growth, the highlighting of the importance of the role of structure in the determination of macroeconomic performance, the importance of avoiding deflationary bias in the world economy and maintaining global demand, and the serious problems posed by commodity price fluctuations. What the world now needs are appropriate institutional structures and rules of the game to achieve the outcomes that the *Trade and Development Report* has championed over the years.

Notes

1. I am hoping that the *Trade and Development Report* never uses the term 'net exports' and asserts that if 'net exports' are zero (trade is balanced) that exports make no contribution to growth. They do, by paying for consumption good imports, investment good imports, and imports that go into exports.
2. One notable exception is the work of Parikh in the UNCTAD *Trade and Development Report, 1999*.
3. Parikh's study for UNCTAD (1999) of 16 countries over the period 1970–1995 found a deterioration in the trade balance of 2.7 per cent of GDP.
4. UNCTAD (1990) addresses the issue of sharing adjustment between surplus and deficit countries.
5. Command Paper 6437, April 1943. Reprinted in Thirlwall (1987).

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Statement

by

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Keynes, Schumpeter and the Macroeconomics of the *TDR*

The section on macroeconomics and finance in the excellent paper prepared for this panel by the UNCTAD secretariat opens with a clear statement of the intellectual roots of the analytical approach of the *Trade and Development Report*. It links it essentially to the contribution of the two economics giants of the 20th Century, John Maynard Keynes and Joseph Alois Schumpeter (with a reference also to the work of Michal Kalecki and Nicholas Kaldor). This intellectual lineage is important to understand the macroeconomic reasoning of the *TDR* and its relationship with the so-called "mainstream" macroeconomic analysis as exemplified by the World Bank, the International Monetary Fund, the GATT/WTO and the OECD, to which UNCTAD and the *TDR* have often been perceived as an alternative.

The *TDR* has in effect consistently proposed alternative views to those of the mainstream on the analysis of the global economy, on developed countries' macroeconomic management policies and on national development policies for developing countries. This has at times been characterized as involving an anti-market stance. The truth is, of course, quite different. As the Secretariat paper succinctly puts it, the *TDR* "aimed at promoting well-targeted pragmatism in policy making. The concern of the *TDR* was not 'state vs. market', but effective policy vs. 'market fundamentalism'".

And this is entirely in line with the views of Keynes and Schumpeter. As is well-known, both were sharp critics of orthodox market economics, albeit for different reasons. Keynes' critique centred on the challenge to the assumption that free markets would by themselves achieve full employment equilibrium, on the need for state intervention to expand effective demand and on the crucial role of investment in determining the level of spending in the economy; Schumpeter's critique focused on the neglect of innovation and entrepreneurship in orthodox theorizing and the need to introduce a dynamic approach. Schumpeter, furthermore, was convinced that capitalism had a tendency to disintegration, and that there was a corresponding tendency for socialism to prevail.

The emphasis on the critical elements in Keynes' and Schumpeter's analyses of capitalism has tended to obscure the fact that neither was against the market or private enterprise. Keynes in particular was a fairly strong advocate of free markets. In the *General Theory* he wrote:

> If we believe the volume of output to be given, *i.e.* to be determined by forces outside the classical scheme of thought, then there is no objection to be raised against the classical analysis of the manner in which private self-interest will determine what in particular is produced, in what proportions the factors of production will be combined to produce it, and how the value of the final product will be distributed between them."[1]

He was also totally opposed to socialism and the command economy and particularly critical – indeed,

scornful – of Marxian socialism. "Marxian socialism", he wrote in 1924, "must always remain a portent to the historians of opinion – how a doctrine so illogical and so dull can have exercised so powerful and enduring influence over the minds of men and, through them, the course of history."[2]

As an aside, it is interesting to note that another distinguished Cambridge economist and Keynes associate, Joan Robinson, thought this dismissive attitude was a disservice to Keynes himself. "Kalecki" – she wrote – "had one great advantage over Keynes – he never learnt orthodox economics … The only economics he had studied was Marx's. Keynes could never make head or tails of Marx … But starting from Marx would have saved him a lot of trouble".[3]

Schumpeter's position on free market capitalism was more ambivalent. While in his early writings – notably his 1911 *Theory of Economic Development*[4] – he took the view that small firm competition was best for innovation, in his main work of 1942 *Capitalism, Socialism and Democracy* he argues that monopoly, particularly of the enlightened sort exemplified by the Aluminum Company of America, is the most innovative system:

> … because perfect competition is impossible under modern industrial conditions—or because it always has been impossible—the large-scale establishment or unit of control must be accepted as a necessary evil inseparable from … economic progress … What we have got to accept is that it has come to be the most powerful engine of that progress and in particular of the long-run expansion of total output … In this respect, perfect competition is not only impossible but inferior, and has no title to being set up as a model of ideal efficiency.[5]

And, as already indicated, in the last analysis he thought capitalism could not survive and that socialism was its heir apparent. This statement, however, has two major caveats. Firstly, it does not entail a preference for socialism: "prognosis does not imply anything about the desirability of the course of events that one predicts. If a doctor predicts that his patient will die presently, this does not mean that he desires it. One may hate socialism or at least look upon it with cool criticism, and yet foresee its advent."[6]

Secondly, and more importantly, Schumpeter believes that capitalism will break down not under the weight of economic failure but because of its spectacular success, at the heart of which is the figure of the innovative entrepreneur and the quintessentially capitalist process of creative destruction that innovation entails. His view is that this very success is undermining the social institutions that protect it, and a main criticism of orthodox market economists is their inability or unwillingness to recognize this process and to address the need for action to rescue capitalism from the threat of its own success.[7]

There is therefore some significant common ground in the fundamental approaches of Keynes and Schumpeter to the analysis of capitalism, and yet the two – despite furthermore being exact contemporaries and knowing each other for over two decades – had little time for each other. Harvard Professor Arthur Smithies refers to "Keynes' indifference to Schumpeter and Schumpeter's hostility to Keynes", both of which he attributes to the fact that "Keynes was a lineal descendant of the English Utilitarians while Schumpeter had no Utilitarian blood in his veins".[8]

There is, of course, a more specific theoretical reason for this distancing, and one that poses a difficult challenge to any effort at building a macroeconomic analytical framework that aims at incorporating both contributions. In one crucial respect, the basic parameters of Keynes' and Schumpeter's models are different. Keynes' model assumes constant production functions; technological change is exogenous and the issue is how to maintain full employment in the short run ("in the long run we're all dead"). By contrast, for Schumpeter "the outstanding feature of capitalism" is that production functions "are being incessantly revolutionized. The capitalist process is essentially a process of change of the type that is being assumed away [in the *General Theory*]".[9] In his review of the *General Theory* Schumpeter writes: "Since Mr. Keynes eliminates the most powerful propeller of investment, the financing of changes in production functions, the investment process in his theoretical world has hardly anything to do with the investment process in the actual world …"[10]

The *TDR* approach addresses this predicament by placing emphasis on capital accumulation, redefining the savings-investment relationship and introducing the notion of the profit-investment nexus. In a Keynesian departure from neoclassical growth models according to which investment is financed by

household savings, the *TDR* model posits, to quote the Secretariat's paper, that "growth is a condition for increasing domestic savings rather than its effect and that an increase in real investment is possible without a prior cut in consumption, since the investment itself will create the required savings by generating additional income. What is needed to raise output and incomes and to accelerate structural change are not savings but financing of investment. This leads to the conclusion that it is more pertinent to focus on the factors constraining investment and pushing up interest rates." Attracting foreign investment is still necessary, but not to replace domestic savings, rather to finance trade and the foreign exchange cost of investment when export earnings are insufficient.

Schumpeter on the other hand is very much present in the notion of the investment-profit nexus and particularly in its policy implications. The nexus is defined as "the dynamic interactions between profits and investment which arise because profits are simultaneously an incentive for investment, a source of investment and an outcome of investment."[11] As applied to the East Asian industrialization process, this analysis leads to three basic propositions:

> First, high rates of investment played a major role in the exceptionally rapid growth of successful East Asian economies and this investment was, after an initial period, supported by high rates of domestic savings. Second, profits increasingly became the main source of savings and capital accumulation. Third, government policy accelerated the process of capital accumulation by creating rents and pushing profits over and above those that could be attained under free market policies.[12]

It was the accelerated pace of capital accumulation that made it possible to improve rapidly the methods of production and quality of output, to diversify the range of goods and services produced and to compete successfully in world markets for manufactured goods.[13] The policy lesson, in the words of the Secretariat paper, is that "strong enterprise profits simultaneously increase the incentive for firms to invest and their capacity to finance new investments from retained earnings, and to the extent that investment can be financed by the banking system, which has the power to create credit depending on the amount of liquidity provided by the central bank, the prior existence of savings balances in the financial system is not a prerequisite for investment."

There is a second major area in the *TDR* analysis where the influence of Keynes and Schumpeter is apparent. It is the introduction of a political economy approach whereby economic processes and outcomes are not simply the play of abstract variables but reflect the social and political interaction and indeed struggles of different groups with different, and often opposed, interests and with varying power and influence.

Here the main inspiration is Schumpeter. Keynes was, of course, fully aware of the political economy of economic processes, but as somebody possessing himself an extraordinarily intelligent mind he was sometimes reluctant to admit that other intelligent individuals could fail to respond to a logical and structured argument solely because it did not serve their interests. In the introduction to his *Essays in Persuasion*, published in November 1931 as the global capitalist economy was plunging into the Great Depression, Keynes explained that his central thesis was "the profound conviction that the Economic Problem, as one may call it for short, the problem of want and poverty and the economic struggle between classes and nations, is nothing but a frightful muddle, a transitory and *unnecessary* muddle. For the Western World already has the resources and the technique, if we could create the organization to use them, capable of reducing the Economic Problem, which now absorbs our moral and material energies, to a position of secondary importance."

Schumpeter takes an entirely different view: economic processes and policies do not essentially have to do with persuasion and rational discourse, but with interests and power:

> There is no scientific sense whatever in creating for one's self some metaphysical entity to be called "The Common Good" and a not less metaphysical "State", that, sailing high in the clouds and exempt from and above human struggles and group interests, worships at the shrine of that Common Good. But the economists of all times have done precisely this. While perfectly aware, of course, of the fact that the business process must be understood from the businessman's interest, most of them have been blind to the no less obvious fact that the political process and hence political measures that affect economic life must be understood from the politician's interest ... And political science itself was in general as little concerned about the facts of its subject

> matter and as prone to philosophize on this very same common good and popular will. It was, therefore, a major scientific merit of Marx that he hauled down the state from the clouds and into the sphere of realistic analysis.[14]

And it is this notion that economic processes and policies always have winners and losers that is at the heart of the political economy approach of the *TDR*. A good example of this kind of analysis was the 1997 *TDR* whose Part II was on Globalization, Distribution and Growth. It is appropriate to conclude these remarks by quoting at some length its main conclusions, since today, fifteen years later, they retain full validity as the kinds of issues that the debate on globalization and development should be addressing seriously:

- Taken as a whole, the world economy is growing too slowly to generate sufficient employment with adequate pay or to alleviate poverty;
- This has accentuated longstanding tendencies for divergence between developed and developing countries. Moreover, greater gaps between them have been accompanied by widening gaps within the South as a handful of newly industrialized economies have pushed ahead of other developing countries;
- Finance has been gaining an upper hand over industry and rentiers over investors. Trading in existing assets is often a much more lucrative business than creating wealth through new investment;
- Capital has gained in comparison with labour, and profit shares have risen in developed and developing countries alike;
- Growing wage inequality between skilled and unskilled labour is becoming a global problem;
- The hollowing out of the middle class has become a prominent feature of income distribution in many countries; and
- There is almost everywhere increased job and income insecurity.[15]

Notes

1. John Maynard Keynes, *The General Theory of Employment, Interest and Money*, New Delhi, Atlantic, 2008: 347 (first published in 1936).
2. John Maynard Keynes, *The End of Laissez Faire. The Economic Consequences of the Peace*, Prometheus Books, 2004: 33(first published in 1926 and 1919, respectively).
3. Joan Robinson, *Collected Economic Papers*, Vol. III, Cambridge, MA, MIT Press, 1980: 95–96.
4. Joseph A. Schumpeter, The Theory of Economic Development. *An inquiry into profits, capital, credit, interest, and the business cycle*, Cambridge, Mass., Harvard University Press, 1934.
5. Joseph A. Schumpeter, *Capitalism, Socialism and Democracy,* Taylor and Francis e-library, 2003: 106.
6. Schumpeter, *Capitalism, Socialism and Democracy*, op.cit.: 61.
7. In an address to the American Economic Association in 1949 Schumpeter lists the developments that, in his view, reflect the process of disintegration of capitalism and the rise of socialist tendencies, and then adds this gently ironic comment: "I believe that there is a mountain in Switzerland on which congresses of economists have been held which have expressed disapproval of all or most of these things. But these anathemata have not even provoked attack." The reference is, of course, to the meetings of the Mont Pelerin Society organized in 1947 by Friedrich Hayek and attended by, among others, Karl Popper, Ludwig von Mises and Milton Friedman. Joseph A. Schumpeter ("The March into Socialism", *American Economic Review*, 40(2), Papers and Proceedings of the Sixty Second Annual Meeting of the American Economic Association, May, 1950: 449).
8. Arthur Smithies, "Schumpeter and Keynes", *The Review of Economics and Statistics*, May 1951, 33(2):164.
9. Joseph A. Schumpeter, Review of Keynes General Theory. *Journal of American Statistic Association*, December 1936: 794.
10. Ibid.
11. Yilmaz Akyuz and Charles Gore, The Investment-Profits Nexus in East Asian Industrialization, *World Development**, 1996,* 24(3): 461.
12. Ibid.
13. Ibid: 468
14. Joseph A. Schumpeter, "The Communist Manifesto," *Journal of Political Economy*, June I949: 199.
15. UNCTAD, *Trade and Development Report 1997*: 63

Statement

by

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What I am going to discuss, in line with what Carlos said, is the theoretical background of the *TDR* in the last ten years. For the 20 preceding years Yilmaz is much more competent to speak, so let me stay with the more recent past. I'll try to put the *TDR* in perspective to some big ideas in economics, on which we are all building our analysis. Unfortunately, I must say, although I am German, I never found a way into Marx's theories, though I tried several times but always stopped reading after ten pages or so. But indeed, I will try to answer this session's question, concerning the essence of the macroeconomic reasoning in the *TDR*.

Before that, I want to comment on one point that was discussed extensively this morning, namely why the *TDR* has so often not received the attention and recognition it deserves? My answer would be that insufficient recognition being received by your work can be a positive indicator about the significance of what you are saying. There is one form of obliviousness that is not a good indicator, namely, if you are totally boring or you are totally besides the point, if you are not questioning and challenging anything. Well then, if you are not paid attention to, then it is ok and you need not complain about it. But that is truly not the case of the *TDR*.

The *TDR* has always been provocative, always willing to challenge mainstream ideas and in this case insufficient recognition from the other side of the debate may signal that you are doing exactly the right thing. This is because your challenge has hit the core of the matter and endangers the credibility of the other side of the debate. If your whole theoretical edifice is being critically assessed by a certain person or publication, and not only by way of theorizing but most critically, through empirical evidence, then it is usually the best strategy to simply dismiss what this person or this publication says as being irrelevant. Engaging with such criticism may undermine your methodology and put at risk the credibility of your work in the broader public eye. Being sidelined for this reason, and I will give some examples later on, is in fact the best indicator of successful critical and forward-looking research.

So what is the essence of macroeconomic reasoning in the *TDR*? To put it in a nutshell: markets do not get the macroeconomic prices right. Do not misunderstand: Carlos Fortin said correctly that we are in favour of the market economy in principle. But although we are in favour of a market economy we have to take note of the fact that there are many markets in this world that do not get the prices right, indeed, that never get the prices right. And if you have major markets, and it is indeed the macroeconomic markets that I am talking about, that never get the prices right then you have a major problem in the global economy.

If, for example, currency speculation drives the currency valuation systematically away from equilibrium, even in the wrong direction given the values of the fundamentals, the huge destabilizing effects marginalize many other questions including those about the right structure of trade or the role of tariffs and protection in general.

Then the priority question for the global economy is how do we get the prices for international trade right? How do we get currencies that are following

the fundamentals? Take the wonderful case of Brazil: The country has experienced an enormous real appreciation in the last 5 years. The real exchange rate of the Brazilian Real appreciated, mainly due to carry trade speculation between Japan and Brazil, by around 60 per cent. India is another example. We have many examples in the recent past where countries are flooded by short-term capital and the prices go exactly in the wrong direction.

Now, if you show that simple fact, as we did in the G-20 deliberations (UNCTAD has observer status since 2010 due to the advocacy of some developing country G-20 members) to those delegations who are strongly advising to leave the currency valuation exclusively to the market because only the market can get the price right, what do you expect? What would be the reaction of the United States delegate in the G-20 to the presentation of this fact? His whole argument, in particular his complaint about China that has to liberate its capital account and has to leave its currency to the market so that the market can find the fundamental valuation, is based on the belief that the markets are always right. If you show that the market price is most of the time going in the wrong direction, if you demonstrate that the markets never find the fundamentals, what would he say? The answer is: Nothing. Silence. He just ignores you. And the reaction of IMF, World Bank, OECD, Bank for International Settlements and most of those sitting around in these meetings, is similar.

Silence is the only way out for them, because they have no argument at all! And if they talk about commodity prices as if commodity prices are always reflecting just supply and demand and you show that is not true because commodity prices are highly correlated with other financial market prices, what are they going to say? Again, no reaction at all is the most probable outcome because they have no argument at all and because you have challenged the keystone of their argument.

The same is true for the other macroeconomic prices. As I said, exchange rates are never right if you leave them to the market. Commodity prices are rarely right if you leave them to the market. But we have another important price that is hardly ever determined by the market – that is the interest rate. Interest rates are determined by central banks. To be sure, monetarism got it wrong, no central bank in the world steers money supply and the point of intersection of that supply with money demand determines interest rates. Central banks directly fix interest rates and provide as much money as necessary to keep the rate at the targeted level.

That is why, in the past ten years, we have criticized the traditional assignment of policies, which was driven by monetarism, where central banks try to bring down inflation even at the price of extremely high interest rates. We have argued consistently and constantly in the *TDR* that it is better to look out for other instruments to stabilize prices and use monetary policies to stimulate investment, real investment obviously, not gambling in international casinos.

That instrument is wages. But if you demonstrate empirically that inflation is mainly determined by the price of labour, by wages, salaries and productivity, namely unit labour costs, then you are again in danger of being ignored, because the most important of all dogmas is the one about the "flexible labour market". Every well-trained traditional economist strongly believes that the flexible labour market is, as Rolph Van der Hoeven has shown in the morning, the only way to overcome unemployment.

But if it is not true, and indeed, in *TDR 2010* we have argued that it is not true, then you are the odd guy out and you will be met with stony silence. But there are very good arguments to make the case that flexible wages do not clear the labour market because, as Joseph Schumpeter and Alfred Marshall knew very well, for the labour market as a whole supply and demand are not independent. However, to argue with normal supply and demand curves only makes sense if both are independent. For such a big factor as labour as a whole this is not true. So forget about neoclassical economics as far as the wage level and the labour market as a whole is concerned.

This simple analysis provides us with good arguments to hold that in the four extremely important macro-markets the normal market mechanism does not work – the currency market, commodity markets, the money market and the labour market. The "Washington Consensus" was about getting the prices right. But how can we get the prices right in the economy as a whole if in all these important markets the prices are hardly ever right and never clear the market?

In light of this, the essence of the macroeconomic reasoning of the *TDR* is that you need a state, a

government to do most of the work. You need a government with a clear idea about the functioning of the economy, about the development potential of the economy and about the external constraints the economy faces and, in light of these ideas, a government that is able to design an economic policy strategy. That, in essence, is the main policy thrust of the *TDR* in the last ten years.

Charles Gore asked: why it is important? Well, because all the other things are nitty-gritty compared to that big idea. There is not much that can move the world in the right direction if the four big prices that I mentioned are most of the time wrong. Governments have to intervene in the commodity market to get it right in light of an idea about the degree of financialization and based on its correlation with other financial market prices. To get the currency market right you need an idea about the fundamental and fair valuation of currencies and governments have to design a scheme, which allows currencies to follow the fundamentals. And to get the interest rate right, you have to follow an idea about the interest rates that is conducive to development and will help your investment in fixed capital to flourish and to help you catch up.

The fourth and maybe the most important idea you need is about the functioning of the labour market and about the conditions people need to invest so much of their lives in a system that is characterized by a growing division of labour. I think, we will be able to argue the case for a fair share of labour in *TDR 2012* because the division of labour has to bear fruit for all and not only for few. Many examples show already that this is not possible without intervention of governments and they also show that this is not only necessary for social reasons but mainly for economic reasons because without that no country is able to generate the domestic demand to generate a sustainable growth path and to respect all the other targets that we have as human beings.

Let me put the core of the message in a bit more abstract terms: A neoclassical economist would argue that a functioning market economy is about flexible prices and rather fixed quantities. We are arguing just the other way round: a functioning market economy, a developmental economy, an economy with the potential to develop works well with rather fixed macroeconomic prices and flexible quantities. If these prices are fixed at a pro-growth level and quantities are flexible growing income will be the result. That is exactly what you expect from a functioning economy for development.

Now, please allow me to give you a last example of why it is so difficult to overcome ignorance. Berthold Brecht in his play about the life of Galileo Galilei describes what happens if you are questioning, based on empirical evidence, the whole edifice of a science. At a certain point of the debate some mainstream scientists visit Galileo and ask him to enter into a formal dispute about his thesis. Galileo responds that he is not asking for a formal dispute but only a check of the facts. There is my telescope, he says; just look through it and you see what I am saying. But the philosophers and the mathematicians, who came to discuss with him, refuse to look through the telescope. Instead, they argue that it is useless for them to look through it as they know for a priori reasons that Galileo must be wrong. That is exactly the point of ignorance the *TDR* often touches; the better the argument and the stronger the evidence the more likely the analysis is to be ignored.