

THE MACROECONOMICS OF IMBALANCE AND ADJUSTMENT

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In macroeconomics textbooks, the term 'adjustment' merely describes the diverse, autonomous mechanisms through which macroeconomic equilibrium could be restored when a system is in disequilibrium. But the form in which the term has come to dominate the development economics vocabulary in recent years refers essentially to the policy changes considered necessary to correct for balance of payments disequilibria, defined as arising from inflationary causes.

In fact, the literature often uses the term without discrimination to refer to two separate processes. First, policy realignments within a given trade regime warranted by developments in the international or domestic economy that are not 'temporary', such as a secular shift in the terms of trade or an "excessive" accumulation of internal debt over time.¹ Second, changes in internal policy necessitated by an autonomous shift to a more open trade regime consequent to the removal of quantitative restrictions on imports, a reduction in tariffs, and the adoption of a liberalised exchange rate system. Since the early 1970s most developing countries have faced external or internal "shocks" of the kind necessitating the first of these processes of adjustment. Forced, at that point, to turn to the International Monetary Fund for interim financing, they have had to accept policy advice that recommends a more open trade regime, which, in turn, warrants adjustment of the second kind.

¹ "Structural adjustment policies may be defined as policy responses to external shocks, carried out with the objective of regaining the pre-shock growth path of the national economy. Regaining the growth path, in turn, will necessitate improvements in the balance of payments following the adverse effects of external shocks, since a country's balance-of-payments position constrains its economic growth. ... A broader definition will also include adjustments to internal shocks which may find their origin in inappropriate policies, such as the excessively expansionary fiscal measures taken in Mexico after 1972, or in political events, such as the April 1974 revolution in Portugal." (Balassa 1982: 23).

Adjustment in either of these forms involves correcting for external imbalance without reference to the maintenance of 'internal balance', defined in conventional open economy macroeconomics as the achievement of full employment. Within that framework, an economy afflicted by both unemployment and a balance of payments deficit, would worsen the external deficit by increasing domestic absorption, when it uses fiscal policy to correct for internal imbalance. However, external balance, it was argued, could simultaneously be achieved by resorting to devaluation.² This presumes that the post-devaluation impact of the multiplier, determined by the effects of devaluation on the trade balance, on the one hand, and on the value of the multiplier, on the other, is unambiguously positive in the wake of currency depreciation. But devaluation, if it is to be 'effective' in a situation of cost-plus pricing (with fixed mark-ups when there is excess capacity) in the manufacturing sector, must involve distributional shifts. Either wages or domestically produced inputs must fall in real value, in the wake of an increase in the cost of imported intermediates, to prevent domestic inflation from neutralising the effects of the devaluation on relative prices. Such distributional shifts are likely to result in a fall in the value of the Keynesian multiplier, just as much as the devaluation would result in an increase in net exports. And in a situation where the export response is weak and the share of imports in variable costs is high, a devaluation could result in a domestic recession if the decline in the value of the Keynesian multiplier is greater than the increase in the value of the multiplicand $(I+X-M)$, due to the beneficial trade balance effects of the devaluation. [Kaldor 1978; Krugman and Taylor 1978; Taylor 1983; Patnaik 1991].

Balance of Payments Sustainability

If both internal and external balance are difficult to ensure simultaneously, any model of adjustment must target one of them on a priority basis. In the post-War period stretching till the early 1970s, persistent external imbalances were rare. This was not because there was no material basis for such imbalances. Underdeveloped nations were at the bottom of the international industrialisation league table and therefore externally vulnerable. Their dependence on imports of manufactures and exports of primary commodities often resulted

² See for example Rivera-Batiz and Rivera-Batiz (1989), pp.166-175.

in trade and current account imbalances when growth was sought to be accelerated within an open trade regime. But current account deficits in the balance of payments were restricted, since they could only be financed with controlled, 'official', bilateral and multilateral flows that fell within the broadly defined category of foreign aid. The development problem consisted in ensuring a semblance of internal balance at the exogenously given level of access to foreign aid, which defined the current account deficit that could be sustained. Hence, a degree of protection and a less import intensive growth strategy were seen as necessary to preempt any unacceptable deceleration in growth. That is, countries adopted an interventionist trade and industrial policy regime to ensure that 'enforced' external balance did not lead to persistent internal imbalance reflected in unemployed resources. The premise of policy was that any level of the current account deficit had alternative trajectories in terms of growth and employment associated with it. Development strategies attempted to maximise employment of domestic resources, including labour, given the level of access to foreign savings.

In recent years, however, capital flows other than those through official bilateral and multilateral channels have accounted for a growing share of total flows to developing countries. Commercial loans and autonomous flows of foreign direct and portfolio investment are now the main mechanisms for recycling funds from surplus to deficit countries. The sustainable deficit on the current account of the balance of payments, defined as that which can be financed by autonomous (as opposed to exceptional) flows, becomes difficult to define in this context. The factors influencing the volume of such financial flows to any particular developing country are nebulous. These autonomous flows are far more volatile than flows of development aid were in the past. And given the uncertainty surrounding a country's export performance, the extent of financing consistent with a country's future debt-servicing capacity is a matter for speculation as well.

That is, while at any given point in time developing countries are in a position to finance a much higher current account deficit than they could in the past, there is no **a priori** definition of the current account deficit that is 'sustainable' over time. If in the effort to approximate internal balance the current account deficit widens to a degree which

undermines 'investor confidence', financial flows diminish or dry up, necessitating exceptional financing and a process of adjustment. Further, the capricious nature of 'investor confidence' implies that even a relatively innocuous level of the current account deficit relative to GDP often proves unsustainable.

Once established as 'unsustainable', it is the deficit that must adjust to the uncertain, but 'autonomously' given, level of foreign exchange access. This reduction of the current account deficit could be effected through a curtailment of investment and growth, and therefore the demand for foreign exchange, or through direct curbs on imports into the system, aimed at regulating the trade and current account deficit to levels that are strategically acceptable.

The IMF's perception

However, IMF-type adjustment is far more specific. In its framework, a sustainable current account is defined to include a trade regime that is 'liberal' or 'open'. "A viable balance of payments has two aspects. **First, it implies that balance of payments problems will not be merely suppressed but eradicated**, and second, that the improvement in the country's external position will be durable." (Emphasis added. Khan and Knight 1985: 2). This definition of viability forecloses a protectionist response to balance of payments difficulties and is based on the presumption that the failure to transit to a non-interventionist and open policy regime only suppresses balance of payments difficulties, rendering even a comfortable balance of payments position unsustainable.

Implicit in the IMF's reasoning is, of course, the notion that trade liberalisation is a means for enhancing the supply of foreign exchange as well. This increased access to foreign exchange is attributed partly to an increase in exports stimulated by enhanced international competitiveness in the wake of liberalisation, and partly to increased access to capital from the international financial system. The problem is that while the evidence for a direct relationship between liberalisation and export expansion is spotty, that for a definitive causal link between liberalisation and capital inflow is scant. And even the meagre

evidence for such relationships suggests that they are significant at all only in the medium or long run.

Despite the lack of theoretical and empirical grounds for such associations, the IMF's prescription merges the stabilisation and long run adjustment components of the balance of payments problem in developing countries. Most of those economies were till recently characterised by an industrial and trade policy regime fashioned to partially insulate the system from the ravages of international inequality and stimulate growth based on the domestic market. Whenever external shocks or the process of accelerating domestic growth resulted in an unsustainable balance of payments, stabilisation in the short run involved a reduction in absorption. However the process of growth itself was not premised on access to foreign markets or foreign savings.

As opposed to this, in the prevalent IMF-Bank perception, when faced with 'shocks', external or internal, these economies have to both stabilise immediately as well as quickly transit to an open economic regime that precludes a strategy that attempts to dilute the linkage between the rate of growth output and imports. This has two implications. First, at the prevalent level of production, imports tend to be higher than before liberalisation, i.e., there is a tendency for the import intensity of domestic production to rise. Second, any attempt to raise the rate of growth of output translates into an increase in the rate of growth of imports. This implies that, given exports, associated with each level of the sustainable level of the current account is a sustainable level of output.

Not surprisingly, IMF-type adjustment in developing countries carrying the vestiges of interventionist regimes to different degrees, calls for a combination of trade liberalisation and rather stringent "demand-side" policies that correct for macroeconomic imbalances reflected in an unsustainable current account deficit. To the extent that trade liberalisation does not enhance foreign exchange access in the short run, demand management must cope with the needs of stabilisation as well as those created by the enhanced imports that liberalisation results in.

In other words, the IMF's definition of sustainability limits the notion of 'adjustment' in a double sense. First, it makes external balance, or the equation of the demand for foreign exchange to its exogenously given supply the dominant target of the adjustment effort. And, second, it forces changes in trade policy that render the process of adjustment dependent largely on a direct reduction in domestic absorption. This differentiating feature of an IMF-type package is missed in descriptions of its framework as one in which an 'unsustainable' current account deficit is treated as symptomatic of an overheated economy where aggregate demand has been allowed to exceed supply. To quote an IMF study (Khan and Knight 1985: 2): "Typically the need for a stabilisation programme, whether supported by the Fund or otherwise, arises when a country experiences an imbalance between aggregate domestic demand (absorption) and aggregate supply, which is reflected in a worsening of its external payments position." In actual fact, stabilisation through an IMF-type strategy involves a reduction in absorption to a far greater degree than typically needed in less developed countries faced with internal or external shocks.

Reading the Identity

How is this reduction in absorption to be ensured? Total domestic absorption consists of the sum of consumption, investment and government expenditure and identically equals national income **minus** the current account surplus (or, if we ignore other current account flows, the trade surplus). Reduced absorption therefore would imply reduced national income, a higher current account surplus (or lower deficit) or both.³ IMF-type stabilisation

³ Nominal domestic absorption is given by

$$A = C + I + G$$

Defining national income as

$$Y = C + I + G + X - M$$

we have

$$A = Y - [X - M] = Y - CAB$$

See for example Dornbusch (1980).

theory obviously reads this identity from left to right, "explaining" the deterioration or improvement in the current account balance (CAB) in terms of autonomous changes in domestic absorption. But there are three issues that need to be clarified here. First, which of the components of domestic absorption can be treated as being independent of income and therefore exogenously given? Second, what are the instruments that the government can use to ensure a reduction in these exogenous variables? And, finally what is the mechanism through which the reduction in absorption affects current account flows on the balance of payments?

As a first case, we can reasonably assume that consumption cannot be treated as an autonomous component of domestic absorption. This implies that it should be investment or government expenditure that generates an imbalance or restores balance. Accounting for taxes to finance government expenditure and rearranging terms in the national income identity, the current account deficit can be read as being equal to the sum of the deficit on the government's budget and the excess of private investment over savings.⁴ That is, given the level of consumption associated with any level of disposable income, domestic absorption exceeds domestic supply when the government's budget is in deficit or private investment exceeds savings or both, necessitating a current account deficit to close the

⁴ Subtracting taxes from both sides of the identity

$$A = Y - [X - M] = Y - CAB$$

we have

$$C + I + [G - T] = [Y - T] - CAB$$

or

$$CAB = [Y - T - C] - I + [T - G]$$

Since $Y - T$ equals disposable income and $T - G$ the budget surplus

$$CAB = [S - I] + \text{Budget surplus}$$

or the current account deficit

$$CAD = [I - S] + \text{Budget deficit}$$

demand-supply gap. On the other hand, if foreign savings serve as a substitute for domestic savings, an increase in the current account deficit is accompanied by a widening of the domestic investment-savings gap.

Consider now an economy which is running a current account deficit of a magnitude which it can finance with its prevalent degree of access to foreign finance. If in such an economy there is an autonomous increase in private investment or government expenditure or both, the current account deficit would remain unchanged only if there is an equivalent increase in private savings or tax receipts or the two in combination. And if there are any constraints to an increase in domestic supply, the current account deficit would remain unchanged only if price increases ensure distributional changes that "force out" savings or tax revenues from the economy.⁵ This, of course, would happen only if the government prevents access to foreign supplies, which in the IMF's view amounts to "suppressing" balance of payments difficulties. If they are not suppressed, the increase in absorption would result in an increase in the current account deficit rather than inflation. Allowing the macroeconomic imbalance to spill-over onto the balance of payments provides, according to the IMF, a clear indication of the extent of adjustment required by the system, given its capacity to "earn" foreign exchange.

The Mechanism

But what is the mechanism which ensures the reduction in 'autonomous' government expenditures or private investment required by the adjustment effort? And how would the

⁵. In fact, the issue is more complex because the price level has a logic of its own, independent of the relation between aggregate demand and supply. Few can deny that the prices of most commodities are not determined purely by demand and supply interactions, but on a cost-plus basis in which margins above costs are determined by a host of factors. While the reasonable and convenient assumptions of prime cost-plus pricing and constancy of prime costs till some level of capacity, allows for quantity adjustments to dominate so long as the degree of monopoly remains constant, there is nothing to prevent an increase in the degree of monopoly in contexts where demand is buoyant and expectations are that demand would exceed capacity constraints in the future (Kalecki 1971: 43-61; Bhaduri 1986: 62-85). That is, well before supply constraints are realized, the multiplier could operate through both quantity and price adjustments. The imbalance which determines the rate of inflation is not necessarily, and definitely not only, excess aggregate demand, but also the contested terrain of production and pricing, where distributive shares are determined.

effects of this reduction transmit themselves onto current account flows on the balance of payments? In the theory which underlies IMF adjustment strategies, the decision variable which influences the deficit on the government's budget or the excess of investment over savings in the system is credit creation by the central bank. But identifying the credit creating role of the central bank as the instrument of intervention does not simplify matters altogether. An essential feature of an open economy is that money supply depends not only on the policies of the central bank and the behaviour of domestic residents and financial intermediaries, but also on trends in the balance of payments. Defined in terms of the assets side of the central bank's balance sheet, high powered money consists of net foreign assets (NFA) and central bank credit (CBC).

With high-powered money (H) defined as

$$H = NFA + CBC$$

the change in high-powered money

$$H = NFA + CBC \quad \dots\dots \quad (1).$$

Hence, the change in money supply (M_s) is given by

$$M_s = (H) = (NFA + CBC) \dots \quad (2)$$

where is the money supply multiplier.

Thus, if an improvement in the current account balance, that is, an increase in net foreign assets held by the central bank, is to accompany a reduction in central bank credit, these changes should either not affect the supply of money or do so in a fashion that does not neutralise the expected effect of the change in central bank credit on net foreign assets.

The simplest version of the orthodox monetarist position overcomes this difficulty by considering an economy in full employment that satisfies the small country assumption and is therefore a price taker in international commodity and capital markets. With real income given at full employment and interest rates given from international markets, the demand for money in such a system is given and stable. Now, assuming $\alpha = 1$ we have

$$NFA = M_s - CBC \quad \dots\dots \quad (3).$$

Since money market equilibrium requires that the supply of money is equal to the given demand for money,

$$NFA = M_d - CBC.$$

That is, net foreign assets register a decline whenever credit creation by the central bank increases relative to money demand. This is a situation where the public finds itself loaded with excess money balances. Since prices in the domestic market are determined by international prices, this implies an increase in net real wealth or the real value of money balances held with the public. The monetary approach to the balance of payments argues that this has a "real balance effect", or spurs an increase in expenditure. And given full employment of domestic resources, increased expenditure results in increased consumption of foreign goods and a consequent balance of trade deficit. Since that deficit results from an excess of credit creation relative to money demand, it is assumed that it can be corrected through some sort of domestic credit ceiling.

The Fiscal Deficit

The inadequacy of this simple framework should be clear. It is based on the simplifying, but far too stringent, assumptions that countries are at full employment and function as price takers in international markets. Yet the idea that curbs on credit provide a mechanism to correct for balance of payments disequilibria has persisted, and has even been elaborated. In IMF-type adjustment strategies, the warranted curbs on credit take the form of a simultaneous restriction of the fiscal deficit of the government and the credit drawn by it from the central bank to finance that deficit.

The emphasis on the fiscal deficit is not without design. In terms of the conventional national income identity, it reflects one of the two components into which any excess of ex

ante investment over ex ante savings can be decomposed, with the total excess of investment over savings equal to the deficit on the current account or the decline in net foreign assets, given by

$$NFA = M_s - CBC.$$

Now, assuming the government's budget deficit is financed by central bank credit (CBC_g) and other forms of domestic borrowing (DC_g):

$$G - T = CBC_g + DC_g \dots\dots (4)$$

ie.,
$$NFA = M_s - [G - T - DC_g] - CBC_{ng} \dots (5)$$

where
$$CBC = CBC_g + CBC_{ng}.$$

That is, a decline in the central bank's foreign assets position occurs when the sum of the government's deficit financed by the central bank and additional central bank credit to the private sector is greater than the increase in money stock. Assume that the adjustment programme emphasises a reduction in the deficit of the government financed by the central bank. If the size of the fiscal deficit remains the same, this would involve an increase in the government's borrowing from the open market, which could 'crowd out' lending to the private sector. To foreclose that possibility, IMF adjustment strategies target a reduction in the fiscal deficit of the government.

But the argument still requires that the either the supply or demand for money is fixed in some fashion, allowing equilibrium in the money market equilibrium to determine the other. If the full employment and small country assumptions do not hold, the demand for money is not a given. If we assume that M_s is given from 'outside' and willingly held by the population at the prevailing interest rate and real income configuration, and that central bank credit to the private sector either remains unaffected or decreases, then the reduction in the fiscal deficit implies an unambiguous improvement in the balance of payments. The

problem is that in a world far more complex than the simple monetarist model, no such assumption is valid. In which case, equilibria which suggest an inverse relation between the fiscal deficit and the change in net external assets of the central bank are not the only ones compatible with money market equilibrium. No more can purely monetarist explanations like the "real balance effect" prove adequate.

To illustrate this we can better use the identity depicting the balance sheet of the consolidated banking system rather than the central bank alone, viz.,

$$NFA_b + DC = M_s \dots (6).$$

Now since the government's fiscal deficit is financed either by domestic or external borrowing

$$G - T = DC_g + EC_g \dots (7)$$

$$\text{Hence } NFA_b = (T - G + EC_g) + (M_s - DC_p) \dots (8).$$

It should be clear that a reduction in the fiscal deficit would be accompanied by a reduction in the borrowing of the government either from the central bank or from the public. If the assumptions of textbook monetarism with regard to full employment output and prices do not hold, this could affect the demand for money in two ways: first, the reduction in government expenditure could adversely affect the level of real income in the system; and, second, to the extent that any reduction in expenditure results from a cut in the government's borrowing from the public, it could reduce the rate of interest. These two mechanisms have contrary effects on the demand for money, with the former reducing it and the latter tending to increase it. If the interest elasticity of demand for money is low, the net effect would be a decline in the demand for money. This implies that, if money market equilibrium holds, money supply would be lower than it would have been without the cut in the fiscal deficit. In addition, lower interest rates would raise domestic credit to the public. Both these effects, by reducing the second term on the R.H.S. of (8), viz., $(M_s -$

DC_p), could more than neutralise the increase in the first term, viz., $(T - G + EC_g)$, consequent to the fiscal deficit cut, and therefore result in a decline in net foreign assets with the banking system.

This illustration merely suggests that even assuming that the money market is in equilibrium, we have multiple equilibria involving alternative values for the different terms of the identity. That is, the monetarist effort to focus on one among many possible equilibria, read the monetary identity from right to left and have the budget deficit determine the change in net foreign exchange assets of the banking system is fraught with problems.

Modified approach

It is possibly for this reason that actual policy-oriented discussion within the IMF initially adopted a modified version of the monetarist argument when discussing the adjustment mechanism. In Polak's celebrated defence of monetary stringency (Polak 1957) as a mechanism for balance of payments adjustment, he defines macroeconomic imbalance as an increase in income that raises induced imports while leaving autonomous exports untouched, making adjustment a process of aligning growth rates to levels 'warranted' by the rate of growth of exports. That adjustment is ensured through a sharp reduction in credit creation by the banking system. In Polak's original model, the process of adjustment was rather straightforward, being based on the simple quantity theory of money notion that the ratio of money to income is constant. Any explanation of the changes in the quantity of money is also, therefore, an explanation of changes in income.

As before, taking 'money' to be nothing more than the formal liabilities of the banking system, changes in the quantity of money can be equated to changes in the (net) foreign assets of the banking system plus changes in domestic credits by the banking system. Of these two, only the latter is treated as an autonomous 'decision variable'⁶, making income

⁶ "Credit expansion is a function of the banking system. It may be difficult, perhaps in some circumstances humanly impossible, for the system to withstand demands for credit from the government or other insistent borrowers; and in such circumstances the

dependent on the extent of credit creation. Changes in foreign assets, on the other hand, are seen to be the result of an exogenously given level of exports, and a level of imports determined by the level of income. This essentially means that to reduce the current account deficit, the system would have to reduce the level of income without reducing exports, which it can do only if it reduced new income resulting from internal credit creation.⁷ The assumption here is of course that the supply of credit (and therefore the level of nominal income) is fully controlled through controls on expansion of credit by the banking system. Implicit in that assumption is a definition of money that arbitrarily restricts it to the debt obligations of the central bank and the formal liabilities of the commercial banking system, and excludes all forms of 'near-money'. Not only have financial instruments that play such a role been important in the financial system of the less developed countries, but

desire to make public development expenditure, or to construct private factories, may be considered from many points of view, the cause of the expansion of the economy. But for purposes of monetary analysis and monetary policy there is a clear gain in clarity if the responsibility is pinpointed on the credit expansion. The economic development could also have been financed by higher taxes or a foreign loan. The factories may have been built by restriction of consumption or by the repatriation of capital. In all these situations, the desire to spend for a particular purpose would not have led to a payments problem. In a real sense, the credit expansion is the cause of the payments problem." (Polak, 1957: 13).

⁷ The equations in the original Polak model read as follows:

$$Y(t) = Y(t-1) + DC(t) + X(t) - M(t)$$

$$M(t) = mY(t-1)$$

where Y is the money value of national income; DC is the increase in credit by the banking system; X and M stand for exports and imports; and m the propensity to import at the margin.

The first of these equations is based on the assumption of an income velocity of circulation of money equal to 1, which gives

$$M_i(t) = Y(t) - Y(t-1)$$

where M_i is the increase in the quantity of money. That combined with the balance sheet identity

$$DC(t) + X(t) - M(t) = M_i(t)$$

yields the first equation.

their presence has increased with the process of 'financial liberalisation' that accompanies IMF-type adjustment packages.

Their exclusion, implying the lack of financial assets that can be held as an alternative to money and goods, is however in keeping with the implicit notion that money is kept almost exclusively for transactions purposes in developing countries. The latter in turn provides the basis for the assumption that people adjust their holdings of money in proportion to changes in monetary transactions, resulting in a constant ratio of money to income, needed for the relationship between changes in money supply and nominal income.⁸

There is one other serious difficulty with Polak's formulation of the problem. Since the relationship specified is between money supply and nominal income, the model is unclear on the extent to which the process of adjustment is mediated by a decrease in prices as opposed to a decrease in real output. For, unlike conventional monetarist models, it does not assume full employment, allowing for Keynesian-type adjustments in response to a curtailment of credit expansion. And since simultaneous price adjustments are not ruled out, restrictions on credit creation affect the level of nominal income via both output and prices. This implies that the import equation in the model has to relate imports to the nominal value of income and the import propensity 'm' captures both the increase in imports due to an increase in real income and the increase in imports resulting from the substitution away from domestic goods because of a price increase. The fallacy of treating the effects of substitution away from domestic goods in favour of imports because of an increase in domestic prices on par with and equivalent to an increase in import demand due to an increase in real incomes should have been obvious even to Polak. But having chosen to retain the monetarist framework (and conclusions) while giving up its unrealistic assumptions, he could not make the requisite distinction between two qualitatively and quantitatively diverse processes.

⁸ "The assumption of a constant velocity of circulation eliminates another complication, viz., the extension of credit or the purchase by the banking system of existing domestic assets which does not lead to expenditures on goods and services by the borrower or seller of the assets. An operation of this nature would be equivalent to an increase in the quantity of money without an increase in income." (Polak 1957:16).

However, some noteworthy features of this early formulation of the IMF's position on adjustment are that: (i) it relies explicitly on a transmission mechanism that involves a fall in nominal income and therefore imports; and (ii) it does not explicitly distinguish between regimes which are interventionist and those which are not or make the case that a shift in policy in one direction or another would change the pace of expansion of exports or the volume of capital inflow. It merely states that for any level of exports generated within any trade regime, there exists a level of credit creation and income growth that is compatible with a sustainable balance of payments position.

Demand Management

This is significant because, as noted above, a defining feature of more recent IMF writing (Khan and Knight 1985) is that it treats trade liberalisation as a part of stabilisation on the one hand, and a mechanism which ostensibly partially endogenises foreign exchange access, on the other. This implies that in the course of the traverse to the 'appropriate' policy regime, adjustment would involve both trade reform and demand management.⁹ Once the economy was on the growth path characteristic of the appropriate regime, adjustment to specific shocks would be based on demand-side policies similar to those suggested by Polak.

However, a more open trade regime aimed at shifting production in favour of tradables or enhancing the international competitiveness of domestic firms, results in higher imports in the short run, while promising returns in terms of higher exports, if any, only in the medium term. This perverse effect of a change in the trade regime in the short run, introduces an

⁹ "In the context of developing countries, economic stabilisation usually refers to a programme of comprehensive economic measures designed to achieve broad macroeconomic goals such as a sustained improvement in the balance of payments, a reduction in domestic inflation, or some combination of the two. Naturally the implementation of such a programme presupposes the existence of serious economic problems which necessitate a basic redirection of economic policy. In general terms, the fundamental objective of a stabilisation programme is to achieve 'a suitable relationship between resource availabilities and needs that causes minimum strain on the internal price level and produces a desired balance of payments result'." (Khan and Knight 1982: 709).

obvious bias in favour of demand-management policies in all adjustment packages recommended by institutions like the World Bank and the IMF, to which developing countries turn when strapped for balance of payments finance.

As a result, in the more recent analytical support for IMF-type adjustment strategies, demand management is even more central, since it is needed to neutralise the perverse effects of 'structural reform' as well. And, as indicated earlier, within demand management, the focus has shifted from credit creation in general to the fiscal deficit on the government's budget financed with credit from the central bank or the banking system.

In practice, that reduction has both direct and indirect effects on demand: direct, because of the decline in government expenditure on private sector goods and services; and indirect, because of the multiplier effects on income of government expenditure reduction. In most developing country environments where government expenditure significantly influences the expansion of the home market, this is likely to have an adverse effect on private investment as well. That is, there is a strong likelihood that an increase government investment and borrowing normally "crowds in" private investment and borrowing and that a reduction in the former would reduce private investment as well.

As a result, the overall deflationary impact of a fiscal deficit reduction is substantial. The curtailment of demand consequent to such deflation would in turn affect the volume of imports into the system, permitting a reduction in the current account deficit, for any exogenously given rate of increase in exports. To the extent that there is any autonomous increase in imports in the short run, either because of a change in the trade regime accompanying stabilisation, or because of income distributional factors that transfer incomes away from income groups whose import intensity of consumption is far less than average, the extent of the recession needed to ensure a given increase in net foreign assets would be greater.

This, of course, is the real side of the picture, where the transmission mechanism is a fall in output consequent to fiscal adjustment. However, the monetary identity we have at hand

suggests an alternative scenario. Assume, for example, that for 'extraneous reasons' autonomous flows of portfolio and credit capital to the private sector increase sharply or that public sector assets are sold to foreign investors as part of a privatisation programme. If these foreign exchange receipts do not get spent on imports, but are 'sold' to the domestic banking system, they would increase the net foreign assets with the banking sector, which would release an equivalent volume of rupee resources to the agency acquiring the foreign assets in the first place. This implies an increase in money supply or a positive M_s on the right hand side of identity (8) relating to the consolidated banking system, equal to the increase in net foreign assets on the left hand side. But here of course the direction of the causality is reversed, inasmuch as it is the inflow of foreign capital and the consequent increase in net foreign assets with the banking system that is resulting in the increase in money supply.

To the extent that the accretion of rupee resources with the private or public sector results in an increase in domestic expenditure, the inflow of foreign resources results in an increase in domestic income as well. That is, when the identity is read from left to right, the narrative could be one in which an autonomous increase in foreign capital inflows raises money supply and domestic income.

This suggests that any increase in net foreign assets can **a priori** involve both processes: a deflation that reduces import demand and an inflow of foreign capital that raises domestic income. The causality can run from the RHS to the LHS when adjustment is ensured through a recession, or from the LHS to the RHS when adjustment is supported by a large inflow of foreign capital. If the latter tendency dominates, the process of 'adjustment' appears benign from the point of view of economic activity. That is, if at all a process of adjustment based on a reduction in the fiscal deficit is to prove non-recessionary, it can happen only if there is an inflow of foreign resources either because of privatisation of government assets through sale to foreigners, or because of other developments that encourage foreign capital inflow when fiscal adjustment is in progress. It is for this reason that the IMF has made the sale of public assets to foreigners and financial liberalisation important elements of a "macroeconomic adjustment" package. It is this autonomous, foreign capital inflow

requirement that is underplayed in the argument that 'adjustment' need not have recessionary consequences because "supply-side policies" spur private investment.

Devaluation

It is, of course, true that in a typical IMF-type package, fiscal adjustment is combined with a devaluation that is directly aimed at the current account deficit. Operating with the conventional small country assumption and taking the tariff structure as given, the textbook neoclassical framework implicitly treats the real exchange rate as "the relative price variable in a simple supply-and-demand analysis in which the quantity of real dollars demanded and supplied is expressed as a function of its real price"¹⁰ (Helmert 1988). If at the prevailing exchange rate there is demand-supply gap, it is because capital inflows are ensuring balance of payments equilibrium and equating aggregate spending to total income and the net inflow of funds from abroad. The balance of payments disequilibrium resulting from any reduction in access to foreign exchange can be corrected through devaluation because (i) it stimulates an expansion in the supply of tradables by rendering the production of both importables and exportables more profitable, while reducing demand for them through a rise in relative domestic prices; and (ii) it reduces the supply and stimulates the demand for non-tradables and eliminates any excess supply that arises because of reduced spending consequent to reduced access to foreign exchange. Thus, in this framework, a devaluation is essentially an expenditure-switching policy that operates on both the demand and supply sides.

There are of course 'exceptions' where expenditure-reduction is also inevitable. The most obvious is when it is the government which was the recipient of foreign capital inflow and is forced to cutback expenditures to ensure equilibrium at the new exchange rate. But as discussed at the beginning of this essay, even when such a cutback is not warranted, a devaluation tends to be contractionary if the decline in the value of the Keynesian multiplier resulting from distributional changes is greater than the increase in income resulting from the rise in the trade balance associated with the devaluation. Assessing these

¹⁰ The demand and supply curves reflect alternative equilibrium situations in the foreign exchange market.

factors in the light of the possibility that the supply responses expected to be stimulated by the devaluation may be slow in coming, a policy of currency depreciation could also largely be seen as an effort at demand management aimed at deflating a system to correct for balance of payments disequilibrium, however generated.

Besides the difficulties inherent in the small-country assumption, there is an additional problem with this approach. Balance of payments deficits only partly reflect differences in flows of imports and exports (or income and expenditure). Increasingly, such deficits may become expressions of a stock-flow disequilibrium between total foreign debt and current income. The significance of this is that exchange rate movements designed to affect flow variables are limited in their impact depending on the weight of inelastic elements such as amortization of and interest payments on external debt. At the same time, if the exchange rate is market determined, then the very nature of the stock-flow disequilibrium itself affects expectations and thus also impinges on the currency market and consequent changes in the exchange rate (Chandrasekhar & Ghosh 1993). In sum, though the overall strategy of IMF-type adjustment involves expenditure-reduction through fiscal and monetary contraction, expenditure-switching brought about by exchange rate devaluation, and trade liberalisation measures with longer run efficiency aims, contraction is at the core of the program. And unlike the approach embodied in the Polak model, the currently dominant strategy is doubly contractionary, inasmuch as it has to neutralise the perverse effects of liberalisation on the current account in the short, and possibly medium, term. The approach is one of deflating the system to a degree where, at the prevailing import intensity of production, the demand for foreign exchange is in keeping with the access to foreign exchange within an unequal world order. However, the perception appears to be that openness, which provides international agents greater freedom to produce for domestic markets and own domestic assets, would substantially increase that access.

Models of Adjustment With Growth

In fact, to meet the criticism that the IMF's package is extremely adverse from a growth point of view, two kinds of arguments have been put forward by supporters of conventional

adjustment programmes. The first is that it is possible conceptually to design "growth-oriented adjustment programmes" (Khan and Montiel 1989), which "simultaneously eliminate the macroeconomic imbalances in the economy **and** raise the growth rate", by combining the monetary approach to the balance of payments with a simple version of the open economy neoclassical growth model. The link between these two apparently conflicting models, one of which uses contractionary policies to correct balance of payments disequilibria and another which relates the rate of growth to the rate of investment,¹¹ is ensured by taking the rate of growth in capacity output in the former as determining the rate of growth of output in latter. For a given rate of growth of output delivered by the growth module, there exists a rate of price increase compatible with money market equilibrium, since both increases in real output and an increase in prices raise the demand for money in flow terms. With exchange rate changes taken as exogenously given,¹² the rate of price increase influences the relative profitability of exports and the relative costs of imports, and thereby the trade deficit. And that deficit in turn determines the quantum of foreign savings available to the system and therefore the level of investment and growth. This implies that one can read both positive and negative relationships between the rate of growth of real output and the rate of price increase. In the monetary model, increases in prices and in real output are negatively associated because both increase the flow excess demand for money. And in the growth model increases in the domestic price level, which increase the trade deficit and the corresponding foreign savings, are associated with increases in real output. Thus the rate of growth and rate of price increase are simultaneously determined in an equilibrium which tallies with the identities and the relationships characterising conventional models.

¹¹ Since the rate of investment is assumed to be equal to the rate of saving, "an increase in the private savings rate, government savings, or in the exogenous component of the current account deficit would increase real output growth, in each case by increasing aggregate saving and, therefore, investment" (Kahn and Knight 1989).

¹² The effects of a devaluation on growth, working through its effects on foreign savings, is ambiguous. "Devaluation simultaneously increases the real value of the initial level of savings and by, discouraging imports and encouraging exports, reduces that level. The first effect increases real investment, whereas the second decreases it." (Kahn and Knight 1989: 288).

There are a number of obvious inadequacies in this conceptual union, the most striking being that it treats the flow of foreign savings as endogenously determined. By doing so, the model implicitly assumes that if a system chooses to realise a rate of growth which requires a level of foreign exchange access greater than currently available, prices fall through monetary adjustments to ensure the realisation of that rate of growth. That is, the model assumes that the burden of adjustment falls only on prices - a proposition that it implicitly sets out to establish.

In practice, the problem of adjustment arises because exogenously determined flows of foreign capital are inadequate to finance the current account deficit. As Polak puts it, the merged model is not needed to show that "if a country can afford an increased current account deficit, it can use the resulting resources to raise its rate of growth" (Polak 1990). If at all the model has any usefulness, it is to solve, under rather stringent restrictions on the 'exogenous' variables, for the growth in capacity output associated with each level of external financing. That is, it is not so much a model of adjustment with growth as one defining the prospects for growth given the adjustment requirement set by the access to international finance.

The Alternative Perspective

In contrast, the second defence of IMF-type adjustment theory against the criticism that it is unduly contractionary is more sophisticated. It sets out to argue that given the changes in international financial markets, an appropriate adjustment package that includes major reforms in the financial sector, can ensure external financing of a magnitude that either minimises the extent of adjustment through growth reduction or even overwhelms that reduction with parallel growth-inducing effects. Adjustment policies that correct for balance of payments disequilibria also create an appropriate macroeconomic environment that contributes to enhancing foreign financial inflows.

That is, efforts at reducing the deficit in the government's budget or liberalising trade policies have an indirect effect on the net foreign assets of the central bank. By spurring

investor confidence they result in inflows of direct and portfolio investment that amount to an accumulation of such assets. And to the extent they do, they are reflected, on the liabilities side of the central bank's balance sheet identity, in an increase in currency with the public or deposits of the commercial banking system with the central bank, that imply an increase in high powered money and therefore in money supply. In terms of the identity relating to the consolidated banking system, net foreign assets increase on the left hand side and money supply on the right hand side. And in terms of the reduced form of the national income identity, the argument reverses the causality that adjustment conventionally implies in a developing country. It moves from an increase in the net foreign assets of a country to a higher excess of **ex ante** investment over domestic savings, which implies a rise in the real output.

As argued earlier, it is with this implicit reasoning in mind that recent versions of the IMF adjustment package have emphasised the role of financial liberalisation. In practice, there are two aspects to such liberalisation. The first involves "a substantial reduction of government intervention in setting interest rates and allocating credit" (Cho and Khatkhate 1989). The second involves "policy actions that increase the degree of financial openness, i.e. the ease with which residents can acquire assets and liabilities denominated in foreign currencies and non-residents can operate in national financial markets (including the enjoyment of market access by foreign banks)" (Akyüz 1993). Such openness is often accompanied by a gradual shift to convertible currency regimes. Clearly the two forms of liberalisation are related. Foreign banks and institutional investors, which are to be encouraged to undertake investment, would prefer an environment in which regulation of their activity by domestic governments is minimal.

In fact, while there are adequate grounds to argue that financial liberalisation is no route to efficiency in resource allocation in developing countries (Stiglitz 1993), from the point of view of external financial agents, liberalisation is a major opportunity for profit in the developing countries. First, emerging financial markets in those countries, though volatile, offer extremely high returns in a period when the debt overhang and slow growth in the developed countries has affected financial interests adversely. That makes risk-discounted

returns in the developing countries much better than in the developed. Second, privatisation programmes have put up for sale resources of substantial value that can be acquired relatively cheap in a context of currency depreciation. Third, these are markets in which the pent up demand for credit is substantial and innovative financial instruments have not been experimented with in the past. Fourth, real interest rates tend to be relatively high in developing countries undertaking adjustment programmes involving monetary stringency. And finally, the sharp increase in the external debt of most developing countries since the mid-1970s has created new market opportunities for swaps and other such mechanisms aimed at dealing with that debt.

The Case for Financial Liberalisation

In the event, there has been a sharp increase in the volume of transborder financial flows to developing countries in recent years.¹³ Capital today is not just fluid, but is also drawn from across the globe to be invested in a few selected areas deemed fit or creditworthy by a handful of transnational financial institutions (Patnaik 1993). It is not just corporations but nations that are now routinely "rated" for their creditworthiness, based on a host of nebulous economic and political criteria. And even though multinational commercial or merchant banks do not exert exclusive control over financial flows, the lead given by them is followed by a host of individual rentiers. Liberalisation, including financial liberalisation, becomes a necessary (but not sufficient) condition for attracting such flows reflective of a new feature of the international environment, viz., the centralisation of finance.

There are however a number of problems here. To start with, foreign capital flows are of three kinds: direct investment aimed at productive capacity creation; portfolio flows which

¹³ Between 1989 and 1992, while global flows of foreign direct investment (FDI) declined from \$234 billion to \$150 billion, those to the developing countries rose from \$29 billion to \$40 billion, fuelled by a \$50 billion-privatisation drive in these countries. Second, portfolio flows in the form of investments in bonds, equities, certificates of deposit and commercial paper, rose from less than \$10 billion in 1990 to \$37 billion in 1992. All told, flows of this kind have risen from around \$35 billion to more than \$75 billion in the first three years of the 1990s.

enter under conditions of easy repatriability and are therefore extremely unstable; and commercial credit from foreign institutions and non-residents. If the first of these flows is realised within a relatively open trade regime, the capacity created tends to be neutral between production for the domestic and external market, and therefore tends to enhance exports as well.¹⁴ On the other hand, flows of purely "financial capital" have little impact on real output and tend to be more speculative, responding adversely to any instability either of the real economy or financial variables like the rate of inflation and the exchange rate. "Capital flows exert a considerable influence on exchange rates and financial asset prices, and are themselves influenced by expectations regarding rates of return on financial assets denominated in different currencies. This means not only that domestic policies have a new channel of influence on exchange rates, trade, balance of payments and, hence, the level of economic activity (namely, through their effects on capital flows), but also that these will all be influenced by financial policy abroad and by events at home and abroad that alter expectations" (Akyüz 1993). In such a world, the "national space" available to the State as its area of control, within which it acts to promote development, is substantially

¹⁴ The rise to dominance of finance capital has been accompanied by substantial changes in the nature of foreign investment, especially in terms of its relationship with trade. In colonial times foreign direct investment in the colonies was closely linked with the needs of colonial trade, and was directed in the main into areas such as plantations, the extractive industries, shipping and insurance. Such investment only strengthened the "enforced bilateralism" in trade that colonialism implied. With the onset of decolonization and the adoption of protective, import-substituting strategies by independent post-colonial states aiming to industrialize rapidly, foreign investment often became a substitute for trade. With tariff and non-tariff barriers foreclosing the developing country markets of leading international firms, they found the need to jump those barriers, by establishing production facilities that could service local markets. More recently, not only has the revolution in transport and communications and the changes in technology, that have segmented production processes, expanded world trade and capital flows over time, but over the last two decades or more there has been a rapid dismantling of protective regimes and relaxation of regulations on foreign investors across the globe. This has affected the character of foreign investment as well, since after allowing for national peculiarities and variations in political structures, any production site worldwide is becoming a potential site for production for world markets. For the transnational firm, which over the years has increasingly detached itself from dependence on home country resources, it offers the opportunity of locating itself in environments where it can overcome the disadvantages that specific macroeconomic developments such as inflation or microeconomic features like high wage levels create, and substantially enhance its international competitiveness (Refer ESCAP 1993).

eroded. For, the entire range of fiscal, monetary or external policies have to be adjusted keeping in mind the implicit requirements set by the fluidity of finance, subordinating national requirement to the caprices of international capital.

Dependence on fluid finance also implies that to keep financial stocks within the country and maintain consistent flows over time, countries have to encourage within the reformed financial sector a relatively high interest rate by opting for a tight money policy. High interest rates are not only a prerequisite for capital inflows that ensure balance of payments viability and exchange rate stability, but also keep inflation down and dampen disincentives for financial asset holders.

To meet this danger of the loss of national space inherent in the conventional adjustment package it is often argued that current account liberalisation is safe (and indeed necessary) as long as controls on capital flows remain. The literature thus advises developing countries not to lift controls on capital flows, or at least to delay lifting controls until current account balances or surpluses are assured. However, such advice is likely to have no real relevance given de facto openness to capital flows. Indeed, the argument that opening of only the external current account is a low risk strategy is based on a rather specious distinction between current and capital accounts that has very little meaning in practice. As long as there is no way of ensuring that exporters repatriate their earnings, and no other incentives are provided for them to do so, then "capital flight" could simply take the form of exporters keeping their money abroad in anticipation of future devaluations. To the extent that structural trade imbalances persist, this will also depress expectations about the value of the currency and act as a barrier to capital inflow. These in turn imply that expectations become self-fulfilling in the absence of large-scale intervention by the central bank which would involve depletion of foreign reserves.

The Political Economy of Adjustment

Adjustment packages involving reduced government expenditure, high interest rates and convertible currencies, while in the interests of metropolitan financial capital, are

obviously inimical to both metropolitan and developing country industrial capital. Reduced government expenditure while imparting a degree of stability to financial markets, slows the rate of expansion of the home market in developing countries, which provides the base for productive investment. High interest rates are a disincentive for productive investment, aggravating the recession associated with adjustment. And volatile exchange rates that cannot be directly controlled substantially increase uncertainty, while yielding little additional benefit relative to well defined dividend and capital repatriation laws.

The background to this bias in favour of financial interests of the adjustment strategies being adopted by developing countries needs elaboration. Consider, for example the evidence on "acceptable" inflation rates and targets, on the one hand, and "acceptable" levels of the current account deficit, on the other. While the rate of inflation deemed acceptable varies across countries, the 3-4 per cent target set for Germany by the Bundesbank has gradually caught the imagination of policy-makers in the developed industrial nations and, more recently, in the developing countries. That figure is, of course, remarkably low when compared to the rate of inflation which prevailed in most countries during the post-War years. Over the period 1965-80, World Bank figures indicate that inflation averaged 19.2 per cent per annum in 'low-income countries excluding China and India', 20.9 per cent in middle income countries and 7.6 per cent in high income economies.

The resistance to inflation in most countries comes mainly from two sources, though all sections are concerned about the uncertainties that episodes of hyperinflation involve. First it comes from those, like wage workers, peasants and the salariat, who are unable to adjust their incomes fast enough to keep pace with inflation. Second, it comes from financial interests, who are concerned about the effects of inflation on the value of financial assets and on the real rate of interest.

There is reason to believe that till recently the influence of international and domestic financial interests on policy in the developing world was limited. In fact, in many developing countries, control over financial institutions rested directly or implicitly with

the State. What determined the limit to profit inflation then was the political feasibility of eroding real incomes beyond a point, which defined the "inflation barrier" faced by those governments. Depending on the play of autonomous forces influencing the rate of price increase and the relative weight in influencing policy of those whose incomes were eroded by inflation, the government's manoeuvrability in terms of deficit financed expenditure was circumscribed by that barrier. In periods when the threat of 'excessive' inflation was low the government stepped up its expenditure, only to retreat when that threat became real. But given the correlation of political forces in these countries during those years, the acceptable rate of inflation was much higher than the targets commonly associated with 'structural adjustment' packages today.

Acceptable Deficits

Changes with regard to what is acceptable have been true of the current account deficit as well. In fact, till the early 1970s the limits to the deficit on the current account that developing countries could incur were set by their limited access to international finance. When they exceeded those limits, and were forced to turn to the IMF for balance of payments finance, it was not the deficit on the government's budget which was the focus of IMF attention (for that was largely kept in course by the inflation barrier), but the controls and regulations characteristic of import substituting regimes, and of course what were considered their 'overvalued' exchange rates. Besides deregulation in the industrial sector, trade liberalization and devaluation (not convertibility) were the main elements of stabilization packages, ostensibly aimed at improving the export competitiveness of these economies, so that they could earn the foreign exchange needed to finance their imports.

The emphasis on these elements of the package also served the interests of metropolitan industrial capital, which dominated policy-making in the developed world during the post-War boom. Liberalization opened up markets, which earlier could be accessed only by jumping tariff barriers and establishing capacity in the domestic tariff area of the developing countries. With foreign investment rules being uncomfortably stringent, this was

hardly the best option. Further, devaluation, by reducing the foreign exchange value of domestic assets, permitted cheap access to crucial resources in countries that were prepared to allow foreign investment in areas like the extractive industries and agricultural production.

The period immediately after the first oil shock saw a dramatic change in this scenario. The international payments system now reflected huge current account surpluses with the oil producers, relatively small surpluses with the developed countries as a group and massive deficits in the developing world. Since oil surpluses were held in the main as deposits with the international banking system controlled in the developed world, the private financial system there became the powerful agent for recycling surpluses. This power was indeed immense. Expenditure fuelled by credit in the developed and developing world generated surpluses with the oil producers, who then deposited these surpluses with the transnational banks, who could offer further doses of credit. This power to the finance elbow was all the more significant because a slow down in productivity growth in metropolitan industry had already been bringing the post-War industrial boom to a close - a process that was hastened by the contractionary response to the oil shocks.

From the point of view of the developing countries, these developments in the wake of the oil shocks appeared positive. Needing liquidity to finance their post-shock deficits, they found it easier to negotiate with a relatively atomistic banking system that could impose no conditions rather than the centralized multilateral financial institutions like the IMF. Banks flush with funds were keen to lend, and the possibility that the rather high current account deficits they were financing were unsustainable was not considered. No level of the current account deficit was unacceptably high. What mattered was that the nature of the international financial system hitherto had kept the volume of commercial borrowing by these countries relatively low.

Thus, this congruence of interests - of the developing countries to borrow and the banks to lend - resulted in the fact that the current account deficit was for almost a decade and a half no constraint on growth in the underdeveloped world. This had two implications. To start

with, it appeared to render import-substitution as a strategy meaningless, since that strategy was prompted in the first instance by the external vulnerability that underdeveloped countries faced ever since the Great Depression. In a world awash with liquidity which could be easily accessed, that vulnerability hardly seemed to a problem, let alone a factor that should be the prime determinant of the nature of growth strategies. Secondly, it appeared to remove all constraints on the manoeuvrability of the State in developing countries. Government's could incur massive deficits on their budget, since imports financed with international borrowing could ensure that any excess demand would not spill-over in the form of inflation. That is, so long as there are no limits on the current account deficit, the inflation barrier is inoperative as well.

The fall-out of this scenario is now history. Right through the 1970s and 1980s governments in one developing country after another combined more liberal growth strategies with huge budget deficits financed with on international borrowing, since that partly neutralized the adverse effects on domestic growth that liberalization had. In fact, during those years many developing countries actually recorded rather creditable rates of growth, which were often attributed to liberalization rather than the irresponsible pump-priming by domestic governments, which the irresponsible lending practices of the international banking system encouraged.

But the boom obviously could not last, as it became clear that none of these borrowers were in a position to meet their debt service payments, without resorting to further borrowing. This together with the evidence of the colossal overexposure of the international banking system in many developing countries set afoot the deceleration in the flow of liquidity that came to be called the 'debt crisis'. The banks of course could not pull out, because that would have spelt closure for many of them, as much of developing country debt would have had to be written off rather than rescheduled. But they needed an agent to discipline governments whom they had in part tutored to be undisciplined. And the hitherto neglected policeman, the IMF, came in handy.

For the developing countries involved the situation was a virtual trap. The current account deficit on the balance of payments which was hardly an indicator of the health of borrowers in the past was now found "excessive". It was no more just a constraint on growth, but a problem in itself, since it could not be financed. And given the context in which it took the place of inflation as the binding barrier on growth, it could easily be identified as the result of profligacy rather than of external vulnerability.

This changed attitude, which was in keeping with the IMF's perspective on the matter was strengthened by the fact that an attempt to reduce the deficit by a retreat to a more insular regime was found near-impossible. To start with, the borrowing splurge had meant that the interest payment component had risen to be such a large share of outflows that the curb on imports had to be massive to ensure the necessary correction on the current account, which leaves amortisation uncovered. Secondly, the period of liberalization had created powerful lobbies interested in the government persisting with that policy, which rendered a retreat "politically infeasible".

The Interests of Finance

In the event, most governments turned to the IMF for balance of payments finance, and had to accept in return a package that involved curtailing central bank credit to the government, intensifying trade reform, dismantling regulations on national **and foreign** firms and agents, devaluing and moving towards a convertible currency, privatizing the public sector, and in the new phase, reforming the financial sector. All of these were in keeping with the requirements set by the rise to dominance of international finance. Trade liberalisation and deregulation are inevitable elements of a strategy that provides the basis for international investments aimed at world-market oriented production that can be 'facilitated' with finance. Crucial resources in the hands of the State or the domestic private sector, like for example hydrocarbon resources, are rendered eligible for acquisition by foreign interests, so that real assets can serve as collateral for the financial transactions of foreign firms. And business conditions are made acceptable to financial agents through a liberalisation of

the financial sector and a gradual shift towards convertibility for capital account transactions.

In sum, the current IMF-type adjustment package is wide in scope and targeted towards the requirements of finance capital. As a result neither fiscal nor monetary policy can be controlled in keeping with domestic objectives. And real growth in the developing world has to be curtailed substantially. But that is immaterial so long as the objective of a larger share of a smaller cake being diverted to international financial interests is realised. It is in this sense that adjustment in its present form is nothing more than the macroeconomics of the international financial oligarchy.

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