IDEAs Conference on 'Reforming the Financial System: Proposals, Constraints and New Directions', Muttukadu, Chennai, India, 25-27 January 2010

Conference report

Day 1: 25 January 2010

Session 1: Is it possible to regulate finance now?

The first day of the conference started with a welcome address by **C.P. Chandrasekhar** (Jawaharlal Nehru University), the chair of the first session. Elucidating on the theme of the conference, **C.P. Chandrasekhar** said that there has been very little debate in the countries in the South about the need to re-regulate the financial system. Although these countries have been configuring their financial structure to resemble the Anglo-Saxon model as it evolved since the 1980s, debates regarding re-regulation of finance have remained confined mainly to countries like the US and the UK. Besides, given the development context of the developing countries and the regulatory framework in these countries, their requirements could be very different, thus necessitating post-crisis reform substantially different from that required or feasible in the developed countries. Therefore it is necessary to discuss these issues keeping in mind the peculiarities of the emerging markets. In this context, he emphasized that the purpose of the conference was to develop a holistic and heterodox approach to regulate the present financial architecture as well as develop a developing country perspective.

In the first presentation of the session, **Jan Kregel** (The Levy Economics Institute of Bard College) focused on issues regarding the viability of implementing bank regulations similar to the Glass-Steagall Act, alternative approaches to regulate the financial system and the reasons why a Glass-Steagall kind of approach is unlikely to succeed. In this context he argued that to be able to regulate effectively it is essential to understand the functions of a financial system. According to him, the main function of a financial system, as understood under the Keynes-Kahn-Schumpeter approach, is to create liquidity. Elaborating on this point he said that banks, for example, have two functions: storage and transfer function; and liquidity function. Under the second function, which Minsky calls the 'acceptance function' of banks, banks by making loans create deposits and thereby provide liquidity to individuals who receive these loans. While this relates mainly to commercial banks, other financial institutions also create liquidity. Stock markets, for instance, convert long-life physical capital assets into financial assets which are liquid as they can be traded day to day. Thus, there are a range of financial institutions that also create liquidity, although the way they create liquidity is different. It is this aspect of the financial system that went out of control and is one of the reasons for the current crisis. The regulation of the financial system should focus on regulating the financial institutions in accordance with their methods of creating liquidity. In other words, rather than adopting traditional approaches of regulating either the financial institutions, their functions or particular instruments, regulating the liquidity function could be an effective alternative.

Regarding the feasibility of returning to the Glass-Steagall kind of regulation, Jan Kregel argued that among other things, this Act had failed earlier. This was because the Act by regulating one set of institutions (commercial banks) while leaving the unregulated financial institutions free to develop new means of liquidity, created a situation whereby the latter turned out be more profitable alternatives. That is, they began competing with the acceptance functions of banks, thereby eroding the ability of commercial banks to survive as

viable institutions. To go back to Glass-Steagall would therefore require ensuring that the banks subject to these regulations are able to make sufficiently high rate of return to survive the competition. Secondly, this would also require an iron-clad definition of the functions of banks for regulation to be effective. It is, however, nearly impossible to do so. Thirdly, he said, going back to Glass-Steagall kind of regulation would also require regulating the regulators themselves. He concluded by asserting that as long as we continue to regulate the financial system by regulating institutions, functions and instruments, we will end up with a situation which is bound to collapse. Therefore there is a need to think beyond the traditional methods of regulating the financial system.

In the second presentation, **Abhijit Sen** (Member, Planning Commission) focused on the changes that the current crisis has brought about in the overall policy environment. He began by arguing that the current situation is very different from what it was a year ago. Thus while the need for regulation has been recognized all over the world in major international forums like the G20 and the Basel, there is now a feeling in some sections that everything is coming back to normalcy (popularly termed as pushing the reset button), which could not have been imagined a year back. As a result, in contrast to the earlier general consensus about the need for regulations even when there were differences on the appropriate policies, today there is a swing backward in regulation. In India, for example, there is almost a consensus in official circles to welcome the recent surge in the inflow of capital – i.e. "riding with the wave". In this context, he pointed out that the emerging market economies would be the targets of the future speculative attacks and therefore there is a need to define the targets and the triggers. He argued that only limited regulation and intervention by government could be expected unless these targets and triggers are clearly specified.

Pointing out that all speculation needed credible stories that can build up expectations, he said that in the recent past the issue of decoupling and low agricultural growth have been the major credible stories. The belief held by many economists that globalization has been really working had led to high future valuations; but these valuations have now been moderated due to the crisis. Now, it is widely perceived that the US consumer demand is unlikely to revive, and therefore speculation needs new stories. According to him, a new and likely story would be to capitalise on the current disequilibrium caused by the crisis. He felt that food, fuel and commodities can be the drivers of future speculative bubble. However, only limited regulation can be expected and it would not come as a matter of overall policy change. Therefore he argued that there is a need to link those parts of the financial system which are to be regulated to the commonly perceived potential imbalances in future. He concluded on the note that the pressure for regulation had to come from the real sector and that too with political pressure.

Seeraj Mohamed (University of the Witwatersrand, Johannesburg) in his presentation focused on the social and economic impact of financial liberalization on South Africa. He argued that the new democratic government not only continued with policies similar to those adopted during the apartheid regime, but in addition resorted to widespread dismantling of regulations and controls on the financial sector and cross-border flows of capital, thereby opening the economy to speculative attacks. As a result of inadequate regulation of finance, the government's attempts to redress socio-economic problems inherited from the earlier apartheid had not worked. It also led to massive misallocation of capital, and deindustrialisation of the economy making it more dependent on mining and minerals. Thus this amounted to supporting the 'wrong' type of growth based on speculation and debt-driven consumption, and increased financial fragility and dependence on short-term capital flows. Inadequate control of cross-border flows and the surge in net portfolio investment increased the liquidity in the economy, resulting in a massive surge in credit

extension to the private sector without commensurate rise in private business investment over 2000-08. While a large part of the increased liquidity went to financing the growing household consumption, the other part went in for acquisition of financial assets, much larger than net capital formation in the private sector. There has, therefore, been an increase in the process of financialisation and greater dependence on short-term speculative activities even within corporate business enterprises.

He also drew attention to the increased use of financial instruments which had increased systemic risk. Regarding investment, he said that it was not only small but was also misallocated with most of the money being invested in credit cards, car finance and short-term debt. Apart from this, a large part of the fixed investment was channelled into real estate and transportation. This had led to a decline in capital formation in manufacturing, resulting in the reduced share of manufacturing in output. So when the crisis came, the already bad employment situation worsened, even as the services sector which employed the majority of casual workers, shrunk. This led to a situation where official unemployment figures rocketed to 23% in 2009 - increasing the hardship of majority of the population. He concluded by reiterating the importance of controls on capital and its allocation in the financial sector in a developing economy like South Africa.

Leonardo Burlamaqui (Ford Foundation) focused on the political economy dimension of the crisis and possibilities of regulation. Arguing that for a long time an ideology that favoured private sector over the public sector had dominated, he emphasized the need for public institutions to take care of public interests, as markets have proved to be ineffective in this regard, especially in finance. Further, he pointed out that it would be difficult to expect good regulation under the current ideology, and at best, only poor regulation could be expected. Thus there was a need to develop and disseminate an alternative to the current prevailing ideology.

Looking at the political economy dimension of the current crisis, he felt that what the world was facing was not just a financial crisis but a trade-off between corporate sponsored globalization and democracy. Speaking about the financial system, he said what reigned in financial system today can be called ‘destructive entrepreneurship’. This was very different from Schumpeter’s creative destruction kind of entrepreneurship; instead, what we have since the Reagan Washington Consensus is a Sorosian kind of profiteering based on speculation, ability to structure debts in future markets etc.

With regard to regulation, Leonardo Burlamaqui argued for the need to restore the Schumpeterian-Keynesian functions of the financial system and set in motion some sort of a broad re-regulation process. In this context he pointed out that the global financial system is much broader than the banking system, and included all kinds of institutions, even the so-called global governance institutions. Therefore, re-regulation of that requires much more than re-regulation of the banking system; also, since these are all highly interconnected it requires a concerted global approach rather than a national one. Over the last one year, many international bodies like Basel, IOSCO, IASB and Financial Stability Board (FSB) which were hitherto dominated by developed nations had witnessed inclusion of many developing nations belonging to the G20. Even as the G20 has been upgraded it is still to be seen if it wields enough power.

In conclusion, he outlined an international reform agenda which placed emphasis on a new version of Glass-Steagall for the 21st century; limiting leverage and raising capital requirements; subjecting over the counter (OTC) derivatives to prior approval; utilizing the best practices available outside the US and UK; creating an adequate incentive system for regulators; making rating agency public utilities; and reforming international institutions like

BIS/BCBS as well as the GATS agreement at the WTO. He further argued that there is a need to develop global financial governance based on regional financial cooperation and enhanced representation by G20 as well as non-G20 nations. In this context, he felt that certain new institutions like "global financial governance body" (GFSB) could be created, where national regulation would be supplemented by international supervision, regulatory coordination and enforcement power. GFSB should also have coordinated capital account control mechanisms.

The presentations were followed by an invigorating discussion on a variety of issues ranging from regulation of the financial system, possibilities of having international bodies for regulation and so on. **Luiz Carlos Bresser-Pereira** (Getulio Vargas Foundation) observed that the ability of developing countries to regulate international finance was limited, and hence there was a need to distinguish between domestic finance and international finance when talking of regulation. Given the limited ability of developing countries to regulate international finance, he queried about the ways by which they could avert pressures on the balance of payments and their currency and reduce their indebtedness**. Jayati Ghosh** (IDEAs Secretariat and JNU) asked whether the argument put forward by Jan Kregel implied that the purpose of financial regulation should be to control all liquidity (something akin to monetarism) or control the specific institutions and the kinds of liquidity they create and the channels they can go into. She also wondered why it would not be possible to have an "iron clad" definition of banking for effective regulation, since any regulation would need some strict definition. With reference to Leonardo Burlamaqui's argument of international mechanism for coordinated capital account control, she wondered about the feasibility of such an arrangement to work in a democratic manner given the dominance of the developed nation in international relations, and instead proposed going back to IMF Article 5, which allows all countries to have capital controls. **Arturo O' Connell** (Central Bank of the Argentine Republic) cautioned about the over-optimism about the G20, even with the newly included developing countries, since experience has shown that G20 has been working to co-opt the developing countries into the regulations that the developed countries have now accepted. He also expressed concern about the role of an international body in ensuring capital controls as he felt that it would be better to leave this matter in the hands of the national authorities. He also criticized the governance structure of G20 which he said is just a meeting of the state and bank chiefs/ officials of the member countries. **Ratan Khasnabis** (University of Calcutta) raised the question regarding the possibility of regulating the banking sector. He pointed out that there was a need to regulate the inter-country movement of capital, as well as a need to stop the movement towards full capital account convertibility. Moreover, multifunctional banking needed to be stopped. He emphasized the need for proper information management through a regulatory body, to minimize the information asymmetry present in capital markets. **Jomo K. Sundaram** (UN DESA) expressed doubts about an international organisation protecting the interests of the developing countries, especially at a time when the interests of the 'epistemic community (of finance)', are so hegemonic. He also took the position that G20 has essentially become G7 as developing countries in G20 have not been able to assert their interests effectively, and have not taken into account the interest of other developing countries. He also pointed out that while there is great deal of optimism that now the real economy will prevail, it needs to be remembered that for many countries, the real economy is to a great extent foreign dominated; this is one reason why the resistance to the ascendancy of finance has been so weak and this also poses a serious problem in terms of defining and articulating what the real economy is about. In this context he queried whether it was meaningful for developing nations to rely on functional finance. **Ilene Grabel** (University of Denver) opined that looking at the current scenario of G20 it is difficult to determine its future. A lot depends on whether the smaller countries are allowed to participate in its meetings. She was hopeful about the future of global finance as well as optimistic about the possibilities of

progressive reforms and heterogeneity under the new G20. **Gerald Epstein** (University of Massachusetts, Amherst) commented that there are enough reasons to feel that the battle regarding regulation of the financial system in a progressive manner is not over yet, at least in the US. For that, the key aspect is that the power and size of finance should be reduced and the real sector should dominate finance and not the other way round. He also suggested certain key pointers for regulating the system, namely, changing compensation policy to prevent banks from taking undue risks during boom times; a resolution mechanism that do not continue to create moral hazards; and finally given that there has been a transformation in the ownership of financial assets around the world, the government and the tax payers should be able to use these financial institutions for public purposes. Commenting on the argument made by Abhijit Sen, **Rizal Ramli (**Komite Bangkit Indonesia) said that it is difficult to know from where and when the wave is going to come since they are not periodic in nature. **Sushil Khanna** (IIM, Kolkata) enquired about the possible changes in the proposals put forth by Jan Kregel given that only a few advanced countries have large global banking and most developing countries do not have well-known international banks. **Carlo Panico** (University of Naples) drew attention to the increased dominance of finance relative to the real sector and the attendant change in the distribution of income. This, he argued, was due to change in the approach from one based on discretionary powers of the authority vis-à-vis the financial firms to one based on rules. This change in approach had increased the ability of the financial sector to evade rules and engage in speculation. The power relations between the authorities and the financial sector had changed leading to policies which favour financial liberalization. This he argued had led to distribution of conflict in society. He suggested that the new strategy should restore the abilities of the authorities to control the financial sector.

Responding to the comments and queries, **Jan Kregel** said that the observed increase in the share of value added in the financial sector is largely fictitious, as it is not because of a predatory increase in the size of the financial sector but is a result of change in policy, namely that of transferring public provisioning to private provisioning, which has increased the profitability and size of the financial sector. In other words, legislative actions had contributed more to such redistribution than the financial sector's own actions. On the issue of capital controls and stand of the US, he argued that the US was not a supporter of free international capital movements. Rather, it was a supporter of free entry, right of establishment and national treatment for US capital in other countries. Since the US banks have been active as global banks for a long time, the idea of global competitiveness is extremely important, and unless countries have domestic financial institutions it would be difficult to regulate them. In response to the question by Jayati Ghosh, Jan Kregel said that it was old Chicago school (Henry Simon) version of monetarism which favoured narrow banking i.e. banks acting mainly as depositories. However, since there are alternative sources of liquidity (e.g. commercial papers), all such instruments should be regulated by the same set of regulations. On the issue of the real sector versus the financial sector, he said that it was the 'real' sector which encouraged creation of alternative sources of liquidity as it provided them with cheaper finance; so, the issue was never about the 'real' sector fighting the financial sector but about both contributing to the breakdown of the system.

Abhijit Sen's response to comments on the current international scenario was that the G20, as it stands today, would involve trying to get the bigger developing countries to agree to a common set of regulations for everyone rather than give individual countries the right to regulate independently. On the issue of capital controls, he argued that India still had a fair amount of capital control, which perhaps gives it enough confidence to be able to ride the bubble.

Seeraj Muhammad responded that a part of his pessimism comes from the fact that in South Africa and many developing countries, banks have been partly taken over by foreign banks which make the process of reforming the financial system that much harder. As his last point he mentioned that financialization of non-financial operations has meant that the distinction between the real sector and the financial sector is less clear, making it all the more difficult to regulate.

Leonardo Burlamaqui in response to the question on the future course of G20 felt that it was a new potential source of power and it was still evolving. What is important is to come up with clear alternatives. While he agreed that certain countries, especially the US, were dominant in international policy making, it still provides an opportunity as the entry of new players could alter the power balance giving way for larger policy space for many others. On the issue of national versus international regulation, he clarified that what he meant by international mechanism for regulation was not a new global financial authority but coordination among the domestic authorities on the lines of G7, so that while national authority prevails, there is better coordination with international regulations supplementing national efforts.

Session 2: Banking regulation: Glass-Steagall vs. Basel norms

Y.V. Reddy (Emeritus Professor, University of Hyderabad) started by focusing on ownership issues in the financial structure and the nature of the financial reforms under discussion. He argued that both public and private banks can co-exist and even compete as each helps in serving different sections of the society and hence has different strengths and weaknesses. A lot of criticisms are directed at private banks on the basis of their ownership. However, it is often unrecognised that even private banks are under the control of the regulating authorities who have a say in the nature of ownership. For example, in India there were several restrictions on the voting rights, proximity of business houses to banks, appointment of board of directors etc., which watered down the differences between public and private banks and promoted healthy practices.

The key issue in the wake of the crisis is not ownership but governance and regulation, he pointed out. It is the failure of the regulating authorities to ensure proper governance and to restrict the expansion of weak banks, which is the cause of concern in recent times. Financial regulations are subverted to broader public policies, and financial stability, capital buffer, macro-prudential counter-cyclical policy, liquidity etc., are issues that affect the decisions of the authorities. To understand the current scenario, each of these issues and the policy decisions pertaining to them need to be analyzed, to understand why the banking structure is facing this crisis today. In his opinion, the most important lesson is that there are limits to competition in the financial system. The emphasis on level playing field for finance of different countries can be problematic given the inequalities between the economies. He also made it clear that the large size of financial institutions is not a guarantee against risks; in fact, it often makes them more prone to failure.

He argued that countries and institutions cannot be looked at through the same prism. He pointed out that, given inequalities in nature and strength of the different players in the financial market, any regulation must be local in nature; also, financial regulations need to be more national and less global. Countries such as the USA and UK, which have multinational banks, have realised this problem and are going for national regulations. Developing countries like India should also look for domestic solutions to the problem, and devise regulation to best serve its national interests. He thus called for better and more efficient regulation in the financial sector today, one which would cover both financial infrastructure and financial instruments.

Arturo O'Connell (Central Bank of the Argentine Republic) pointed out that financial crises are not an exception but rather a norm, occurring in cycles. However, every time a new crisis occurs, we revisit the same debates all over again: greater governmental support or stringent regulations. In a real world scenario, government support is given which rides on certain regulatory reforms. This time, however, the crisis is different in terms of size and complexity, given the much riskier banking system—a result of bigger size and greater concentration in the banking sector.

This is a result of erroneous government support in the face of earlier crises. Government support to the financial system has increased dramatically in the form of liquidity support, deposit insurance etc. Such measures were supposed to be used only in specific situations and with preconditions placed on financial institutions. But governments have always rushed, to support the financial system. This behaviour encouraged dilution of the self-insurance system in banks, and led to their involvement in riskier activities.
Finance today is governed by a 'shadow regulatory' system, which has emerged of late, where unelected officials and narrow-based committees at the international level have started deciding the contours of the regulatory framework. Their decisions become 'norms', and eventually some sort of international treaty is accepted across the world despite it being undemocratic and based on problematic assumptions of the self-regulating market mechanism.
One problematic feature of such norms is the whole exercise of risk estimations and extreme dependency on these estimations. To build and apply models that estimate risk by closely following market events are bound to be erroneous as the markets themselves are highly imperfect and prone to crises. Furthermore, each entity operates on its unique risk estimation model, which is a problematic operating framework by itself. The risk in the system is endogenous, and risk estimations which may be correct from the individual's point of view may be problematic from the systemic point of view. He thus called for regulations based on 'unlevel' playing fields and greater diversification of financial agencies, contrary to the current practice of unifying them into one big global sector. The Chinese wall between banking and non-banking sector must be rebuilt to dampen the effect of cycles of booms and bust in the financial system. Developing countries have their own set of financial concerns like BoP problems, capital flights, need for long term finance etc., and should design domestic regulation policies accordingly. He called for a narrow banking system which will remove the securitization of their deposits and use of deposits for speculative activities. He also slammed the "too-big-to-fail" notion, saying that it encourages risk-taking by big financial institutions as they are assured of government bail-outs.

The core problem pertained to the debate about using public money for fuelling speculative bubbles instead of spending on developmental projects. Unless this problem is addressed, we will soon have a greater financial crisis in the coming days. To avoid such a calamity, the government might need to indulge in greater intervention and control over the banking sector. Publicly-elected democratic body should be in charge of the financial system. Also, there is an urgent need for publicly-owned development banking in third world countries. Unless accountability can be ensured in the financial system, the problem of cyclical crises will continue.

C.P. Chandrasekhar (JNU), in his presentation focused on the issue of using finance as an instrumentality to generate growth that is broad-based and equitable as well as ensures stability of the system. For ensuring this, he argued, a set of issues need to be addressed. The first of such issues is that of differential regulation of banks given that they are the principal depository institutions, and play a special role in terms of being the core of payment settlement system. Another set of issues concerns the kind of regulations to be

adopted. In particular, the concern is whether regulation should be such that the system is allowed to structurally self-organize around a certain set of rules like disclosure norms, capital adequacy requirements etc., rather than try to shape the system according to the nature and size of the institutions. Also, an issue is whether, in the absence of structural regulations, the system develops a tendency to increase and proliferate the level of risks, thereby creating inherent systemic difficulties. Then there are issues pertaining to the possibility of credit assets becoming tradable assets, which could impact the real as well as the financial sector much more substantially than what would be the case if assets like equities are traded. Finally, the question is whether financial innovations, even though they help deal with situations of extreme liquidity mismatch, actually improve efficiency of intermediation and not increase risks. The financial entanglement along with increasing risk propensity in the system can actually raise costs and have serious consequences for the whole economy if a crisis comes to pass.

In effect then, banks should be regulated differently from the rest of the financial sector, as its role and centrality in the economic system is very different. This, however, does not imply that there should be little regulation of the non-bank segment, like under the Basel-type Anglo-Saxon regulatory model. Besides, there is a strong case for using finance as an instrumentality, especially for developing countries, and regulate the kind of instruments that are to be allowed. In case this is not done and the financial system is allowed to self-regulate, there is likely to be a tendency towards securitization, thereby increasing risks, and lead to inevitable crisis-like situations.

The issue of differential returns between banks and the non-banking sectors, created by differential regulation, can be justified in a market economy if the crucial parts of the financial system are in the public sector. Therefore, the need of the hour is to have a financial system where the logic of being driven by profit is not the main motive of finance.

During the discussion, **Parthapratim Pal** (IIM, Kolkata) questioned whether the main problem of the financial system is that of uncertainty, and if it is at all possible to have controls or effective regulations in an environment of total uncertainty. He also wondered about the feasibility of national-level regulation given that reintroduction of capital controls has not worked well. Raising a similar point, **Leonardo Burlamaqui** enquired about the problems that are likely to arise in managing global banks if regulations were to be mainly national. He pointed out that while “shadow regulatory management” is problematic it is not wise to trust the elected representatives as is clear from the experiences in the developing and the developed world alike. **Jayati Ghosh** linked the arguments put forth by C.P. Chandrasekhar and Jan Kregel, and wondered whether financial inclusion is not possible with a purely private system, and whether it is technically possible to ban financial innovations in order to ensure that public banks survive. **Jan Kregel** responded saying that securitisation is not inevitable as its proliferation was possible because of regulatory failure, or rather because the regulatory structure was set up to allow it to make sufficient profits. Further, securitisation by itself is neither good nor bad; what made the present ones bad was the wrong belief that it is possible to price risk efficiently. He added that the issue of the need to limit the process by which public deposits are used to fund these sorts of activities is misleading. It is not public deposits that are being used to fund these activities but the ability of the banks to create liquidity that allows them to fund them. And therefore, there should be a different set of regulations for banks.

Filomeno III Sta. Ana (Action for Economic Reforms) wondered whether central bank independence is possible or it’s just a country specific issue. **Abhijit Sen** commented that current discussions at official levels about regulations and controls lack honesty and seriousness. **Prabhat Patnaik** noted that since all capitalist booms are based on some

degree of irrational exuberance, some undervaluation of risk is always present in any capitalist endeavour. In these circumstances, all financial innovations that contribute to the undervaluation of risk also prolong the boom. And hence any financial regulation will also truncate the boom. Thus without bringing in the issue of an alternative stimulus for a boom, which could very well involve the state and therefore is likely to be opposed by finance, it is not enough to talk about financial regulation. There is, therefore, a need for a larger political attack on finance capital to bring about a meaningful change. **Vineet Kohli** (TISS, Mumbai) queried about the need for NBFCs, for if we have to regulate them then the differences between them and banks will be reduced to insignificance. **Gerald Epstein** suggested that taxation can be used as a measure to reduce the size of the excessively large and systemically dangerous financial system as well as address the issue of differential profitability in a world of differential regulations. **Gabriel Palma** (University of Cambridge) questioned the logic of having flexible exchange rate or rapidly changing interest rates which only further undermine stability and raise uncertainty in an already uncertain world. Besides, the lack of coordination in the working of central banks also adds to the uncertainty. **Carlo Panico** remarked that financial innovations can have positive effects if properly regulated, and therefore rather than abolishing them altogether, the focus ought to be on regulating them effectively.

In response, **Y.V. Reddy** reiterated that independence of a central bank is desirable for stability but its policy will remain subordinated to broader public policies. He added that both banks and non-banks can co-exist with different sets of regulations but there is a need for a clearly-defined relationship between them. On the issue of national versus international regulation, he said that in today's context, national controls and authorities have to play a greater role in regulating finance even though some international co-ordination will always be required. **Arturo O'Connell** replied that a world with too many unknowns is what is meant by uncertainty. A world of uncertainty requires stricter regulations; however, that by itself can only give a range of directions the economy can take and not exact directions. While agreeing with the need for international regulations, provided the wrongs of the present system (like shadow banking, banking secrecy, credit rating etc.) are corrected, he pointed out that national regulations, suited to the situation of each country, are equally, if not more, important. Addressing the issue of shadow regulation and democratic bodies, he argued that having democratically elected representatives in charge will at least bring the issues to public notice if nothing else. Agreeing that financial innovations have acted as a substitute for directed credit, **C.P. Chandrasekhar** argued that instead of banning them, the need is to regulate the kind of instruments and institutions that would be allowed to do this with the proviso that they fulfil the larger aims. He also added that differences between banks and NBFCs have anyways been reduced in the era of liberalization, but there is no reason why NBFCs should not exist and do what they are supposed to do. However, each of these segments should be under regulations, so as to avoid another crisis.

Session 3: Finance and the real economy - 1

Prabhat Patnaik (JNU & Kerala State Planning Board), in his presentation, outlined the fundamental flaw in the theory of the global savings glut propagated by Fed Chairman Ben Bernanke to explain the increase in the current account surplus (CAS) of the emerging market economies (EMEs); the current account deficit (CAD) of the US; and the general lowering of the long-term real interest rate in the post-1996 world economy. He noted that this theory has also been related to the financial crisis by some IMF economists who claim that the low long-term real interest rates caused by the "savings glut" gave rise to the asset price inflation whose inevitable collapse has precipitated the current crisis.

Expounding on the theory, he pointed out that it is fundamentally incorrect since it assumes there is no income adjustment following the outward shift in savings curve in the EMEs. In fact, the impact of an outward shift of the savings curve would be first on the income of the EMEs. With income adjustment, a rise in the level of desired savings at any given level of income, interest rate and exchange rate (such as is supposed to have occurred in the "emerging market economies"), will reduce aggregate demand in the domestic economy, which will lower income not only in the domestic economy, but globally. In short, a global "savings glut" will produce a global recession, where there is no necessary reason for any change in the long-term interest rate, or in the current surpluses and deficits relative to GDP, in the manner suggested by the "glut" theorists.

The "savings glut" theory, however, is erroneous even when there is no actual fall in income either in the EMEs or in the "rest of the world" (in effect the US). A rise in *ex ante* private savings in the EMEs, at the base values of the three variables—income, interest rate and exchange rate—will leave the level of income in the EMEs unchanged if countervailing fiscal measures are undertaken in the domestic economy, which keep the *ex ante* overall savings unchanged. But in such a case, there will be no change in the current account surplus. According to Prabhat Patnaik, the idea that increase in savings in EMEs has caused larger finance capital that has gone sloshing around the world causing the crisis is the result of the confusion between *ex ante* and *ex post*. The set of factors responsible for the *ex ante* shift and what actually occurs *ex post* are determined by independent factors. The very process that gives rise to a larger supply of finance capital also gives rise to a larger demand for it. Putting it differently, he said that a "savings glut", which is necessarily an *ex ante* concept, either does not get realized at all, because it causes income in the EMEs to shrink; or if it (or a part of it) gets realized as higher *ex post* savings in the EMEs, then it does so precisely because conditions have been created elsewhere such that it gets demanded at the base levels of income, interest rate and exchange rate, ensuring that there is no "glut".

According to Prabhat Patnaik, Bernanke's theory is similar to the one put forward by the British Treasury during the Great Depression, which was dubbed by Joan Robinson as the 'humbug of finance'. He emphasized that if an enlarged current account surplus is accompanied with a situation of booming employment and income in the US, then it signifies the presence of excess demand in the US economy. Thus the cause for an expansion in the level of activity in the US occurring at the same time as an increase in *ex ante* savings in the EMEs, must lie in some independent factor. The idea of larger *ex ante* savings in the EMEs themselves causing an increase in the level of activity in the US, which is presumed by all those who attribute the world financial crisis experienced above all in the US, to the "savings glut" in the EMEs, lacks any theoretical basis. Expansion of activity in US is more a reflection of excess demand in US rather than excess savings in EMEs.

However, the rejection of the global saving glut argument does not mean a rejection of the problem of world economic imbalances. The logic of export-led growth had induced EMEs to compete to keep their market share intact in the world market. However, the accumulating reserves prevented them from improving the lives of their people and had forced a reduced domestic absorption. The reason for these imbalances, however, does not arise from a savings glut.

Saul Keifman (University of Buenos Aires), in his presentation, contended that the present financial crisis which caused this recession is symptomatic of much deeper problems that go beyond the failure of inadequate (or missing) financial regulations. In his view, while the ongoing discussion on reforming the micro- and macro-prudential financial regulation is a

very important and welcome development, the task of stabilizing financial markets, let alone the overall economy, will take much more than new financial regulations.

In this context he pointed out that the Turner Review (2009), released by UK's Financial Services Authority (FSA), though a remarkable document, providing a critical insider's view of what went wrong with global finance, offers very little in terms of regulation. The report, after recognizing the importance of market failures, irrational behavior, financial liberalization and securitization in determining asset price bubbles, only recommends finding ways to prevent or mitigate excessive credit supply as a method of regulation. This, in Saul Keifman's opinion, was a contradiction and the emphasis on excessive credit supply reveals a misinterpretation of bubbles as asset price inflation. In short, the report doesn't seem such a radical departure from conventional wisdom. In contrast, the Stiglitz Commission Report (Commission of Experts, 2009) takes a broader view of the genesis of the crisis and does not limit crisis prevention only to new financial regulations. Instead, it points out the key role played by deregulation not only in the financial sector but in the overall economy. In this context, Saul Keifman asserted that the increased frequency of financial crises and macro instability noticed in the last three decades is the consequence of the neoliberal programme which resulted in the currently hegemonic variety of capitalism known as finance-led capitalism or *financialization.*

Regarding regulation in the developing countries, his argument was that the main challenge faced by the developing countries was how to design financial and non-financial regulations that would prevent capital flight and drastically reduce capital flow volatility and mobilize and allocate domestic savings for productive investment. Not only would capital controls reduce the amount of foreign exchange reserves, they would also provide more policy space in terms of monetary and exchange rate policies that are conducive to developmental goals.

However, he pointed towards major obstacles to this in terms of WTO commitments, bilateral preferential trade agreements and clauses on financial services, apart from the unwillingness on behalf of American and European countries in terms of giving up their seignorage powers, and committing themselves to give substantial resources to multilateral banks. This situation necessitates South-South monetary clearing arrangement to save international reserves and/or funds to help during country-specific crises. Given that there is an increasing recognition not only of the public utility nature of banking but also of the advantages of departing from private corporate model of banking, the need of the hour is to close down tax and regulatory havens, end bank secrecy and implement global taxation in order to prevent capital flight. He concluded by underscoring the importance of seriously pursuing monetary and fiscal policies to bring about stability.

Rainer Kattel (Tallinn University of Technology) focused on the financial and economic crisis in Eastern European (EE) countries. He opined that while the EE countries are often touted as examples of successful integration into the world economy, it is these countries that have ended up being hit the most by the meltdown. The foreign savings-led growth strategy characterised by massive inflow of FDI; huge cross-border lending (in foreign currency) by newly foreign-owned financial sector; and growing dependence of exports (up to 80% of GDP) lie at the root of the crisis faced by these economies. Together with neoliberal macro-economic policies, the aspiration to become a eurozone member brought about an environment of procyclicality, averse to any kind of government intervention in these economies.

This particular growth strategy had led to transformation of the banking sector, with the ownership largely going over to foreign-owned banks, usually unwilling to lend to the productive sector. At the same time, the massive inflow of FDI drove industrial restructuring

with large parts of the restructured industries being oriented towards low value added activities with low domestic linkages. The loss of competitiveness due to the perverse industrial restructuring was further fuelled by the rapid currency appreciations. Moreover, a very fast rise in domestic household borrowing fuelled by cross-border loans occurred, so that on the eve of the crisis, EE countries, especially Baltic States were reeling under a massive foreign financing gap. The imbalances that have cumulated over the years are being transformed into other forms of imbalances, mainly increasing public debt or unemployment or both. The Baltic economies are facing correction almost entirely through the labour market, experiencing thus both a rise in unemployment rates and a sharp fall in real wages. With accession to EU and the eurozone, he opined that almost no policy options are left for EE countries. He emphasized the urgent need to reform and to generate industrial and innovation polices. Even more urgent, he pointed out, was the need to re-establish the link between the productive and the financial sector. But the capability to do it, he cautioned, had shrunk tremendously owing to the narrow policy space left with these countries.

Gabriel Palma (University of Cambridge) began by highlighting the fact of increasing income inequality in the US since the period of neoliberal counter revolution. He pointed out that in the period preceding the Reagan regime, the growth of average income of the bottom 90 per cent in the US was two to three times the average income of the top one per cent. After the late 1970s, on the other hand, the average income of the bottom 90 per cent remained stagnant for nearly 30 years. Moreover, during the Clinton regime, 45 per cent of the additional income was appropriated by the top one per cent, while later during the Bush administration 74 per cent of the additional income was appropriated by the top one per cent. In this context he pointed out that there seemed to be a high level of correlation between rising income inequality and rising share of financial assets in GDP.

Speaking about the essence of neoliberalism, reflected in the income share of the top 10 per cent as a multiple of private investment in GDP, he argued that in the post-Reagan period, capitalists have been appropriating much more than what they have been giving back to the society. In his opinion, historically, capitalism has asserted its legitimacy even when appropriating a large share of the social product by giving back to the society saving, investment, technological change or in short improving the productive forces of the society. But, neoliberalism has created new forms of appropriation and accumulation (via rent seeking) as well as an extreme and strategic distribution, such that although the average income of the bottom 90 per cent had stagnated for roughly 30 years, they do not challenge this situation within a democracy.

With respect to recovery from the crisis, he said that the vital issue for recovery is of reconciling high inequality with effective demand. In the pre-crisis period the problem of effective demand was overcome through debt-financed consumption, which necessitated easy access to credit, reduction in transaction costs and an injection of optimism or animal spirit in the economy. And the economy was able to sustain same rate of personal consumption expenditure as in the period over 1950-80.

But this time it wouldn't be possible to depend on debt-financed consumption as there is a limit to financing it endlessly. And given that wages are not likely to rise, the US economy is likely to face even worse problems of lack of effective demand. What is even more frightening is the complete absence of an alternative discourse, and in this context, he wondered how long debt-financed consumption would continue and what would make capitalist accumulation sustainable at least at a mediocre pace.

Initiating the discussion **Luiz Bresser-Pereira** commented that developing countries getting indebted in foreign currency is an important reason for increasing financial fragility in these countries, and therefore rather than asking for regulation the aim should be to avoid getting indebted in foreign currency. **Terry McKinley** (SOAS) highlighted the possibility of a third variable which probably made it possible for the US to run up huge Current Account Deficits. He also asked whether it was internal factors such as the divergence between income and debt as well as the fact that the dollar was the reserve currency which drove the deficits. **Andrew Fischer** (Erasmus University, Rotterdam), also felt that an alternative explanation rather than China's obsession with retaining world market shares in exports for explaining China's rising current account surpluses would be more helpful. **Ilene Grabel** queried as to what made policy makers in Eastern Europe tie their hands—whether this was just neoliberal policy of trying to attract foreign investment for distancing themselves from the rouble zone and in the process accept a bad bargain for getting a permanent place in Europe. She wondered if this was motivated by a need to attract higher foreign investment or the need to get away from the rouble zone and into the eurozone. **Pranab Mukopadhyay** (Goa University) queried as to how long the US can continue to have domestic injection in the form of increasing government expenditure such that it helps to maintain current account deficit in the US while raising either current account surplus or excess savings in the emergent economies, given that faith in the dollar has been declining.

Surajit Das (NIPFP) pointed out that it is possible to argue that the pegged exchange rate maintained by China is an exogenous factor that helps explain China's competitiveness vis-à-vis the US, which wouldn't have been possible under a flexible exchange rate policy with free flow of capital. He enquired about the impact of allowing capital flows from US to China, which under a floating exchange regime would result in appreciation of the Chinese currency and fall in the Current account Surplus.

Jomo K. Sundaram pointed out that Bernanke was talking more about reserves and current account surplus rather than savings per se, and queried as to how this would change Prabhat Patnaik's analysis. Regarding the analysis on Eastern European countries, he queried if the greater depth of Eastern European crises was partly owing to the rapidity of transition in these countries. He also pointed that the distinction between finance and the real economy is problematic if one thinks that the real economy will favour reforms to rein in finance. In fact, absence of any strong lobby makes the feasibility of the kind of reforms suggested by Saul Keifman extremely tenuous. Commenting on Gabriel Palma's presentation, he contended that more than the problem of lack of consumer demand, what the US is going to face is lack of enough investment avenues due to overhang of overcapacity following access to cheap credit in the pre-crisis period. The real problem was about which sectors the private sector would invest in. He pointed out that two sectors where this could happen were the food and renewable energy sector. However, this would involve distortion and would go against neoliberal ethos as it would involve substantial amount of cross subsidies, making it infeasible.

S.K. Rao (Administrative Staff College of India, Hyderabad) queried how it was possible that the share of income of the top 10 per cent had increased sharply up to 1992 and stagnated thereafter given that income distribution had become more unequal especially after 1992. **Gerald Epstein** commented that one way of bringing back a greater connect between non-financial capital and labour and reducing hegemony of finance could be through pushing for private-public partnerships, green transition, infrastructure and restriction of financial gambling and financial profit. **Abhijit Sen** questioned whether it would be possible for finance to create another bubble and push an agenda for revival on its own terms. **Ratan Khasnabis** asked whether it would be possible to link the recessions in

the US (like the dotcom bubble of 1999-2001 and the recent sub-prime crisis of 2008) with the trend of stagnating wage earnings of the bottom 90 per cent of the US population. **Rohit** (IIT, Delhi) asked whether it is likely that China also opts for something similar to the Plaza Accord that US forged with Japan in the 1980s, when the US was facing similar problems vis-à-vis Japan as it is doing with China today. In this context, he queried about the possible options that China had, given that corporations like Wal-Mart had a direct interest in non appreciation of the Chinese currency and may be a powerful lobby against any such move.

Satyaki Roy (ISID) pointed out that Gabriel Palma's argument that the recovery has to be based on rentier capital implies capitalism is heading towards a conjecture where it is going to be more and more dependent on technological innovations followed by a series of financial bubbles, with shrinkage in the phase of deployment and therefore drastic fall in the rate of profit. In this context, he queried whether the situation implies that production relations of capitalism are genuinely confronting the development of technology and productive forces. **Bhumika Muchala** (TWN) queried about the prospects of BRIC countries and other developing countries pushing for a global reserve system reform at this particular juncture. **Arindam Banerjee** (RIS) commented that since it is neoliberal policies that are responsible for the financial crisis, there is a need to look at the crisis of neoliberal growth models rather than merely restricting to reforming finance.

Responding to the queries raised, **Prabhat Patnaik** clarified said that he did not agree with the view that, in the recent period, there has been a differentiated impact on different countries with some doing well and others faring badly. In his opinion, the supposed gainers like China and India are as much caught in the spontaneity of the system, particularly the neoliberal system in which they function, as Estonia is. In the case of China and India, these countries have been holding on to the reserves but at the cost of holding down domestic consumption and curtailing wages. This is therefore as much a part of being caught in the neoliberal regime and not the result of invidiousness on part of the particular governments. That is, it is a result of the objective pressures created by the capitalist system, because in the game of increasing exports there is always the threat of someone else taking over your market share in the world economy. These are therefore various manifestations of the crisis, in which some countries hold on to large reserves but are unable to improve the lives of their people even when they do not face any balance of payments problem, while the other extreme is that of Estonia. In this context, he pointed out, Bernanke's arguments of invidiousness on China's part of not consuming and throwing excess saving at the world is wrong because if US decided not to boost domestic demand, in a regime of no protectionism, greater competitiveness of Chinese products would lead to greater unemployment in the US. So US resorting to debt-financed spending is a way to avoid increase in unemployment in the US rather than doing favour to any other country.

As far as the specifics of the arguments regarding savings glut goes, he said the issues are interrelated; none are manufactured by anyone but are part of the spontaneity of the system and the imbalances generated are likely to get worse. Therefore, financial de-linking was not enough; what was needed was overall de-linking from the neoliberal growth strategy.

In his response **Saul Keifman** agreed that simply regulating the financial sector was not sufficient, and for developing countries the main issue was to control capital flight for which capital controls are necessary. He also emphasized the importance of fiscal policy tools to smoothen the volatility brought about by capital flight. He stressed that the distinction between the real sector and finance was more in terms of distinction between activities

rather than the actors, and that there were enough distinctions between the two sectors. About the need for new mission of SDRs and the political will of BRIC countries, he opined that this kind of initiative wouldn't work unless northern countries such as Europe and Japan support them.

Rainer Kattel said that the reasons for Eastern European countries hanging on to the currency peg is the belief that tight macroeconomic environment is good for attracting FDI and the attempt to get into the eurozone. The two issues are now seen as being interconnected such that being in the eurozone is seen as a guarantee of FDI.

Gabriel Palma contended that blaming the Asian savings glut for the excess liquidity in the world system is incorrect as Asian forex reserves constitute a miniscule portion (1 per cent) of stock of global financial assets. In his opinion, this is more a reflection of the fact that in mainstream economics, the blame for failure is always put on some exogenous factors.

Regarding the issue of the US discontinuing public expenditure expansion, Gabriel Palma pointed to the insufficiency of the US recovery saying that the stimulus package has not really been spent in sectors that would matter for the real economy. As regards the need for subsidies in food and green sectors to boost the economy, he felt that it will not be sufficient to boost consumption power. Without the sufficient boost to effective demand, which is completely lacking given the stagnancy in real wages for the last thirty years, and with the household sector, corporate sector and public sector being neck deep in debt, the US economy cannot be revived. Meddling with relative prices in the right direction alone cannot be the engine of growth.

Delineating the link between financial bubble and income stagnation, he remarked that rising inequality resulting from rapid surge in the income of a small fraction of people in a very short period and much of it being thrown into the financial market was what fed the bubble.

On the question about what lessons China should learn from the global experience in the last thirty years, he explained that following the Plaza Accord and Japan's experience, China should be wary of allowing exchange rate corrections led by the financial market. Further, China should desist from opening up of capital accounts.

Day 2: 26 January 2010

Session 1: Finance and the Real Economy - 2

The first speaker of the session **Terry McKinley** (Centre for Development Policy and Research, SOAS) initiated the discussion by highlighting the fact that financial liberalization that led to globalization of finance, capital and trade, also globalised inflation. Thus inflation had become an international phenomenon. Increased volatility of food and oil prices and their persistently high levels even after attaining a peak were the two resultant problems. Basing his argument on the case of Brazil, he underscored that the speculative flows of capital became a persistent source of price instability especially over the past decade. In the current economic scenario, capital was being increasingly channelled into financial assets, away from productive investments. Asset bubble in equities and real estate had become well recognized among the mainstream economists, but presently the asset bubble in commodity posed a prominent problem. The hot money inflows could have an inflationary impact either directly through a rise in the ratio of domestic prices relative to international prices, or indirectly through appreciation of nominal exchange rate due to rapid overvaluation of currency. This eventually led to a sharp depreciation with an inflationary

impact transmitted through imports. This was illustrated by the 2008 crisis experience of Brazil, with important lessons to be noted. It showed that efficient co-ordination of macroeconomic policies was necessary. Also, these policies had to be designed in accordance with exchange rate and capital account considerations, and financial co-integration needed financial reforms.

Referring to the protracted period of high inflation i.e. 2000-08, Terry McKinley signalled towards the limited prospects for developing economies to counter the rate of inflation in the medium term, even though public sector deficits had replaced private sector borrowing. Assessing the ways out of this trap, he saw international commodity speculation, general commodity index as well as oil price index as the wild cards in this situation.

Tracing the growth of world financial assets, he said that the value of the world financial assets nearly quadrupled relative to the global income in the period 1980-2000. Most of this rapid growth was driven by increases in equities and private debt in developed countries. In the present situation, these assets are likely to grow more slowly in line with lower GDP growth rate. Equities, for instance, took the biggest hit and dropped by 50 per cent globally during 2008-09. The total value of financial assets as well as capital flows fell in the same period.

According to Terry McKinley, there would be an increase in global assets growth in future in emerging economies mainly because the international investors expected faster growth and more expansion in financial assets in these countries. These countries were much more likely to face inflation in the medium term. Also, the US sub-prime crisis was still a problem in the case of some emerging economies, where lack of corrective mechanisms in real estate prices led to the real estate boom previously.

Concluding his discussion, Terry McKinley said that the nations having high savings rate, high current account surplus and pro-active economic management (e.g. China) were in the strongest positions to monitor the rising inflation. But in emerging economies without such strong structural fundamentals there was a continuing threat of financial instability due to rising speculative investment which was always tied to the possibility of capital outflows, leading to depreciation and likely inflation in future. Therefore, there was a need for reforms in macroeconomic management, especially in exchange rate and current account, in such vulnerable economies.

Illustrating Indonesia's case, the next speaker, **Rizal Ramli** (Komite Bangkit Indonesia), emphasized the necessity of addressing the speculative source of inflation. He argued that speculative transactions were much higher than real transactions in the world economy, and the associated leverage was not sufficient to minimize the negative impact of speculation on the real economy. Since the effect of speculative transactions on food price and the poor remained highly significant, he argued that it was necessary to regulate such transactions. Further, speaking about the segmentation of the domestic economy with respect to inflation in Indonesia, he pointed out that for policy making it was important to address the impact of inflation on lower-middle class segment of the society. As Indonesia had to import the basic food items (rice, sugar, flour etc.) consumed by the lower-middle class, the rise in food prices brought on by speculative dynamics hurt this segment the most.

He further argued that factors such as the dominance of finance under the neoliberal economic policy, the strong *Rupiah* and the country's free trade agreements (with China, Australia) led to significant shifts in the industrial structure of Indonesia. In the process, Indonesia has become a major source of raw materials, plastic products, fuel, gas and mining, while importing labour-intensive products and food from China. The result of this

trade pattern was a jobless growth since 2001. This kind of growth strategy, Rizal Ramli underscored, could not be sustained in the long run; sooner or later, the economy would run out of its resources and at stake would be welfare. Thus, in light of the set of issues confronting the Indonesian economy at present, monitoring speculation rather than general financial regulation seemed to be a preferred approach. Since a further fall in the US dollar was likely, a rise in speculative activity on commodity prices such as food and energy was highly probable. Therefore, there was a need to analyze the question of how to regulate and reduce the impact of this rise in speculative dynamics.

This was followed by the presentation of **Anisuzzaman Chowdhury** (UN DESA), who mainly focused on two crucial issues: demystifying 'financial regulation', and 'debt-inflation-growth' in the post-crisis scenario. Quoting the Growth Commission Report, December 2009, he stated that as far as strengthening the financial system was concerned in the modern economic scenario, when the financial models of the advanced countries were under question, the future path of developing countries also seemed vague. He highlighted that even after the financial crisis there was a consensus on the financial deregulation theme, albeit at a slower rate. Nonetheless, the ultimate destination for all economies seemed to be the adoption of the Anglo-Saxon model. He added that in the haste towards deregulation, along with overlooking the fact that market failures were pervasive in the financial sector, the distinction between economic and prudential regulation—the two distinct categories of financial regulation—were also ignored. Contrary to arguments that financial deregulation would increase savings and improve efficiency of investment, in reality the world economy had witnessed a rise in indebtedness, overinvestment in speculative avenues, with little positive impact on the real sector, and increasing fragility of the financial sector. Pointing to the concerns present in the Glass-Steagall Act of the 1930s, such as the excessive rate of interest on demand deposits threatening liquidity of banks, high competition among banks squeezing their profit margins and also stock gambling, he argued that each of these elements were present in the Asian financial crisis.

Regarding the situation of the developing economies, he emphasized that these economies were less sophisticated, faced regulatory constraints and had no resources for large bail-outs. Therefore, preventing a system-wide failure seemed to be the only defense strategy for these countries. Segregation of a part of the banking system that would provide a limited range of services, a restraint on excessive bank competition and entry, and tightening of prudential regulation should be the main elements of such a strategy. An appropriate control over both deposit and lending rates to prevent excessive risk-taking and encouragement of long-term investment was required as well. He identified the need for major domestic players in an economy which could participate in implementing a crisis response. Moreover, he emphasized that domestically-owned banks should dominate the financial sector as foreign banks tended to have divided loyalties. The large state-owned banks provided a layer of reassurance in crucial situations. Specialised banks for sectors such as agriculture and SMEs could serve to meet the development needs. The growth experience of Japan and other East Asian countries, he argued, pointed to the fact that financial restraint serves both stability and development needs. He therefore suggested improving the legal systems and information disclosure, imposing rate ceilings on bank deposits, limiting credit expansion and exposure levels to risky sectors, etc. to reduce the likelihood of banking crisis.

Responding to the call for sound finance and stopping fiscal stimulus to deal with the fear of debt and inflation, he stressed that rather than the size it was the composition of the debt that mattered. Therefore, he argued, there is a need for abandonment of the narrow concept of 'sound finance' as measured by debt-to-GDP ratio and adoption of the concept of 'functional' finance which evaluated government finance on the basis of its impact. He

concluded saying that research has shown that inflation need not necessarily hamper growth.

In her presentation, **Jayati Ghosh** focused on the possibility of the world economy suffering another stagflation similar, to some extent, to that of the 1970s. Citing the case of the dramatic volatility in commodity (food, metals and oil) prices witnessed since 2007, she pointed out that the sharp fall in prices immediately after the crisis was followed by even sharper increases since early 2009. She argued that this volatility was caused not by changes in real supply and demand but by increased financial activity in these markets. Beginning from 2003, commodities have emerged as an attractive alternative investment avenue, and this trend has accelerated since 2006 when the housing market in the US became a less profitable investment avenue. In addition, the financial deregulation policies, by dismantling the earlier restrictions on financial agents from entering such markets, largely aided the process. As a result, a bubble was generated in the futures markets and was transmitted to the spot markets as well.

While not disputing the longer-term supply issues for food and agricultural commodities arising out of the agrarian crisis in the developing countries and the policy neglect of agriculture, she argued that the recent surge in international prices had nothing to do with the real economy. The fact that the recent prices changes are finance-driven is evident in the fact that the new OTC futures contract synchronise perfectly with the movement of commodities prices.

However, even when not driven by the real economy, the price rise had tremendous negative implications on the real economy, especially that of the developing economies, and direct producers. This was because the global price rise, a result of financial activity, mainly increased the margins between farm gate and global prices. Rise in the prices of necessities along with stagnating income and employment worsens the distribution of income. In addition, this can also generate cost-push inflation even in a context of low economic activity.

The threat of inflation comes from the fact that the involvement of financial speculators in the commodity market raises the possibility of persistent rise in prices, as commodities are seen as safe havens and inflationary expectations in a significant number of commodities, if not all, are likely to persist. This generates cost-push pressure even when there is large excess capacity in manufacturing. In addition, the policy response across the world of encouraging renewed bubbles would add to the problem. At the same time, the relatively weak and volatile global output recovery because of the failure to redress the problems in the financial sector along with continuing collapse of the real estate prices and growing sovereign debt issues in many countries, weak employment recovery and pro-cyclical policies imposed by IMF in countries facing BoP problems, show that sources of new demand are considerably constrained and would add to the recessionary tendencies. That in turn implies that future inflation, driven by cost-push factors, will be associated with relatively weak and volatile output recovery, and the world is likely to face a new form of stagflation.

Since this is a different kind of stagflation, Jayati Ghosh argued that broad macroeconomic policies like the interest rate would be counterproductive and only dampen the recovery. Evaluating the possible methods to deal with this new stagflation, she asserted that the most immediate action to control commodity prices called for specific actions to control the sources of the cost-push inflation and regulation of finance with respect to commodity markets. She proposed, as a prospective strategy, the banning of financial players from involvement in commodity futures markets, re-instating commodity bonds and buffer

holdings, and working out different means for ensuring cheaper access of these commodities for developing countries.

Jayati Ghosh concluded on the point that inflation was still about income distribution and the projected stagflation reflects the attempt of the global financial class to continue to increase its share of global income. Thus the class struggle continues and, even in the wake of financial crisis, the global financial class continues to win against the wage-earning class. The attempt to resolve this requires not just a reduction in political powers of finance but also, perhaps, a more extensive crisis—a possibility, which cannot be ruled out.

In the ensuing discussion **Pranab Mukhopadhyay** (Goa University) wanted to know from Terry McKinley whether other factors such as the term structure of lending rate and periods of investment were also affecting the fragility of the economies. He asked Anisuzzaman Chowdhury whether the rise in rural savings in Bangladesh and Nepal reflected the high level of remittances being channelled through domestic banking. The question addressed to Jayati Ghosh was regarding the change in the period of stock-holding of agricultural products and its impact on volatility of agricultural prices. Commenting that inflation is inimical to interests of finance, **Roshan Kishore** (Research Scholar, JNU) queried about the contradictions in the present phase where inflation was not only being driven by activities of finance but finance was also benefiting from inflation. **Vamsicharan Vakulabharanam** (University of Hyderabad) wanted to know why restructuring of the real economy had not been emphasised upon and global financial restructuring mainly focused on the regulation of finance. He also queried whether one can talk of transitional institutions out of capitalism. **Parthapratim Pal** (IIM, Kolkata) wanted to know whether the huge expansion of palm oil production during the period of rise in prices of commodities was eating into the food production and causing food insecurity in Indonesia. He further queried whether this sudden rise in commodity prices influenced cash crop cultivation in Indonesia. He also enquired whether the 'ratchet effect' that seemed to operate in the case of domestic and international prices was due to the dominance of major retail players or because of local-level speculative activity and the ways to regulate commodity prices domestically in an integrated world. **Shouvik Chakraborty** (Research Scholar, JNU) wondered whether the choice of the time period of Jayati Ghosh's study was amplifying the scenario of her analysis, as there were limited instances in the last century when primary prices had shown high volatility. He wanted to know whether, besides speculation, other real factors such as increasing demand for bio-fuels, increasing input prices, climate change and neglect of agricultural policies also contributed in the price rise. **C.P. Chandrasekhar** (JNU) raised the issue of Baltic countries, South Africa, Indonesia and Brazil that seemed to replicate the growth strategy of the USA, whereby the rise in debt-financed consumption, replacing public expenditure, became the driver of growth. He wondered whether house price inflation with banks providing easy liquidity explains this tendency getting replicated in the developing economies. He also queried whether China's strong growth, increased consumption of fuel and massive fiscal stimulus package contributed towards commodity price inflation. Regarding the prospect of a new form of stagflation, **Gabriel Palma** (University of Cambridge, UK) opined that commodity prices at the moment were behaving completely in an old-fashioned manner. The price of copper which had historically remained at $1 per pound increased to $4 per pound, and then had not fallen below $3 per pound. China's consumption was too small to act as an influential factor here. He further stated that the financial fragility of Latin America coming into the crisis was slightly different from that of other East Asian examples. Specifically referring to the current account adjustment in most of the Latin American countries just before the boom in commodity prices, he pointed out that, had such a step not been taken, Latin America would have found itself in a similar situation of facing another asset bubble. Commenting on Jayati Ghosh's arguments, **Ilene Grabel** (University of Denver) said that many countries had faced massive de-

industrialisation and financial speculation was the only source of economic activity, which was affecting the real sector adversely. She wondered whether the current bubble had any real sector roots. She wanted to know from Terry McKinley whether taxes could be used as a tool to monitor these asset bubbles. **Filomeno III Sta. Ana** (Action for Economic Reforms, Philippines) wanted to know whether the rise in deficit financing expenditure could co-exist with low taxes on the poor. **Andrew Fischer** (Erasmus University) queried how stagflation would work in the case of stagnant wages. **Prabhat Patnaik** (CESP, JNU) asked about the basis of the increase in demand for food grains, essential for driving speculation, given that global cereal consumption had actually fallen in the world. He also asserted that unless excess demand curves were absolutely vertical, speculation-driven inflation would be associated with some increase in stock. Further, he mentioned that stagflation gave rise to conflicts without anybody gaining. If, however, wages are not rising, then it is more of a standard kind of inflation where the poor gets squeezed out, rather than stagflation. He also queried about the possible responses on the supply side to her idea of stagflation.

In response, **Terry McKinley** argued that for dealing with fragility of the economy, some management of the financial system was needed. He referred to China as a good example, which had been able to follow its rapidly changed policies successfully. He added that the factors that raised the asset prices had only a shallow impact on emerging economies and hence, such factors could not provide any measure of fragility of an economy. As to why real economic restructuring was not talked about, he mentioned that such a discussion called for separating commercial banks from investment banks, and emphasized restructuring banking sector as a whole and its role in the economy. Regarding the question of income distribution, Terry McKinley underlined that it needed to be looked at both nationally and internationally. In this context, he pointed out that although China and India were held responsible for global inflation, because of their marginal impact, they have very little role to play in it. In reply to the question on taxes as a tool, he said that the depreciation of US dollar has been driving lot of financial inflows into the emerging economies. As the dollar depreciates, portfolio investors would continue to sell dollars and buy assets and currencies. Therefore, a modest experimental tax (as proposed in Brazil) to hold the appreciation of US dollar could be imposed. But he felt that this would be successful only in short term and suggested detail discussion about the management of the capital account.

Anisuzzaman Chowdhury, in his response, agreed to the fact that there had been an impact of remittances on the rural savings in Bangladesh, Nepal and other countries. With the rise in rural savings, deposit taking by the banks rose while that of certain other banks remained stagnant. Hence, the overall savings of the banking system had not risen.

Responding to the questions, **Rizal Ramli** argued that one needs to differentiate between externally-driven and internally-driven strength of a currency. In the case of Indonesia, the *Rupiah* gained strength largely due to external factors such as increase in hot money inflows and debt. In the case of other East Asian economies, such as the Philippines, the increase in the strength of the currency was largely internally driven, based on rise in competitiveness and productivity. Replying to the question about palm oil eating into the food production of Indonesia, **Rizal Ramli** said that Indonesia was the largest producer of CPO (palm oil) worldwide. Malaysian companies had expanded palm oil production into Indonesia recently. As Indonesia followed a liberal policy, domestic prices followed the rise in international prices. As a result, a large proportion of the population was unable to access CPO and suffered badly. In order to disengage domestic prices from international prices, good governance was needed; only then could such a speculative play on prices be stabilized. Regarding deficit financing, his argument was that countries with highly skewed income distribution like the Philippines needed a good taxation system that taxed the higher

income class and not necessarily resort to deficit financing. But these nations had opted for the easy way out—borrowing. To this, **Anisuzzaman Chowdhury** added that printing money could be sought in the case of any emergency or crisis, but otherwise if deficit financing was pursued, the composition and not the size of expenses had to be thought about.

Jayati Ghosh, in her response, argued that that there had been no remarkable changes in private stock holding pattern in the recent period. While private stock holding went up, public stock holding fell by a greater measure, such that the proportion of the latter to the former fell. But these changes could not be related to volatility in agricultural prices. She further argued that there were a lot of reasons for the fall in agricultural growth rate, but there had been no instances of global demand imbalances in the last ten years. The consumption data from FAO showed that every year there had been monthly rises in demand of particular commodities, but, overall rise had been very little and the demand remained below supply over the period. While acknowledging the role of certain real economic forces, in particular that of price of oil, she asserted that inflationary expectations also had a major role to play. With respect to China's role in driving global agricultural prices, she said that, barring metals, China does not have much impact on prices of most agricultural commodities. Regarding the 'ratchet effect' she mentioned that such an effect was quite complicated either for identification or interpretation and the results might vary for different countries. But a major factor working in that case might be the fall of the public distribution system, which could possibly account for the inability of countries to check prices, and for the resulting vulnerability. Responding to Roshan Kishore, she said that the aversion of finance to inflation was based on the assumption that fall in real interest rates was closely followed by fall in real value of assets. But the finance being discussed in the current scenario was quite different in the sense that it was mainly driven by differential returns and motivated by capital gains. She emphasized the point that commodities had started behaving like financial assets now with all associated market imperfections. Agreeing with the issue of the effect of bio-fuel prices on food prices, **Jayati Ghosh** added that maize prices had not increased after an initial change in 2008. Also, subsidies played no role in the recent price rise. Other animal feed prices might have risen due to the knock-on effect of the change in the use of maize. Agreeing with Ilene Grabel, she said that there was a need to create another credit financial bubble to finance the real economy.

Agreeing with the observation that in the absence of a completely vertical excess demand curve, speculative price increases would increase stock, **Jayati Ghosh** said that there has been some increase in stocks, but lesser than expected as a large part of the activity are in the future contracts. In response to the question about the process of stagflation she argued that one can think of a situation (like the present) where the only way a government can induce a recovery is through creating another credit bubble. This credit bubble in turn keeps the wage incomes broadly unchanged even though real wages fall. But because of some access to credit consumption levels are maintained. Finance which is looking for ways to revert back to the earlier income shares or even increase it, sees commodities, fed by inflationary expectations, as an easy alternative. Therefore it enters the commodity markets and causes speculative price increase which translates into much higher price increases in developing economies. The rise in prices then leads to a fight back to maintain real income through using increased access to credit. This then leads to the situation where no one is able to increase their share of income, but nonetheless there is a generalised inflation which results from the initial cost push.

Session 2: The Proliferation of Finance

The second session was chaired by **S.K. Rao** (Director General, Administrative Staff College of India, Hyderabad).

In his presentation, **Gerald Epstein** (University of Massachusetts and Co-Director, PERI, USA), put forward the idea of 'financial pre-cautionary principle' for regulating finance. The principle is based on the idea that risky and opaque financial innovations be tested and forbidden if they are found to be unsafe, and that the burden of proof of the safety of the innovations should lie with the seller of these instruments. As an example of the implementation of this principle, he pointed out that RBI (Reserve Bank of India) used its discretionary powers successfully. By disallowing financial products it deemed unsafe, mandating the need of prior approval for certain products, monitoring the performance of newly-introduced instruments it considered potentially risky, disallowing of naked swaps and tightening of the norms when required, India was able to deal with the crisis relatively unscathed. He proposed an agency namely 'Financial Stability and Product Safety Administration (FSPSA) on the lines of Food and Drug Administration (FDA) in the USA. The proposed FSPSA would work on the principle that financial products can be introduced only with the prior approval of FSPSA, and only those products that have some usage and were proven safe would be approved. In this context, he pointed out that since 'regulatory capture' limits the effectiveness of any regulatory agency including the proposed FSPSA, the only way to deal with it is through increased democratic accountability and transparency.

Mario Tonveronachi (University of Siena, Italy), the next speaker of the session, criticised the prevalent notion among policy makers that financial fragility was more a result of certain market excesses that the regulators overlooked or failed to keep up with, and not so much a result of financial innovation. According to him, the transformation of the financial system that resulted in its fragility came about with the tacit consent and knowledge of regulatory authorities and policy makers. Their ideological belief in the self-regulating financial markets led them to be complacent about the new originate-to-distribute model of the banking sector which included, among other things, tendency towards large size in banking and increased interconnection not only within the banking sector but also increased capital contiguity between the real and the financial sector.

He argued that financial innovations based on fine measurement of risk, instead of improving the management of systemic risk worsens the fragility of the financial system as measurement of risk based on expectations of future prices is highly uncertain. Questioning the rationality of self-correcting markets, he pointed to the sub-prime crisis where a generalised mis-pricing of various instruments, especially CDOs and guarantees, could survive and inflate for a long time without any correction and eventually led to the crisis. The so-called excesses of the financial sector that resulted in the crisis, according to him, “are in effect part of the physiology and not of the pathology of the wanted financial morphology”. Asserting that any rethink of the system should aim at the ‘end of Financial Laissez Faire’, he put forward certain proposals to this end. In this regard, he said that regulation based on the ability for fine measurement of a wide array of risks and prudential approach should be replaced with systemic containment of risk. Further, he added that while new financial innovations and instruments need not necessarily be banned, they should not be allowed to operate when their threat to systemic stability cannot be contained, and regulation should be such that systemically important institutions simply should not exist. He also proposed to seek a ban on trading by leveraged institutions and operation of non-financial firms either directly or indirectly as financial intermediaries.

Talking about the challenges faced by emerging economies in the context of global crisis,

Dilip Nachane (Director, IGIDR, Mumbai), the last speaker of the session, proposed certain measures to reduce the costs of financial failure of the economy. Noting that minimising systemic risk poses a major challenge for the emerging economies, he said that although there is a wide array of traditional measures to deal with systemic risk they often suffer from certain limitations and perform poorly in practice. He asserted that excessive reliance on market discipline as a regulatory mechanism would prove counterproductive. Talking about the Raghuram Rajan Committee in the context of financial sector reforms in India, he said that though the committee came up with a set of positive recommendations, it also made some ambiguous and several unpalatable recommendations, like inflation targeting, allowing takeovers by and mergers with foreign banks. Before concluding, he put forward an alternative agenda for reforms in India that focused on credit delivery to micro, small and medium enterprises (MSMEs), capital controls, independence of central bank and various other such measures.

The session was then opened for discussion by the Chair, who noted that there was a need to look in depth the nexus between central bankers and various vested interests. **Amiya Bagchi** (Director, IDS, Kolkata) commented that the discussions in the conference had ignored the embedded nature of the financial system within the imperial system. The present day imperial hegemon, USA, has been creating huge liquidity in the system through large deficits, which in the hand of the rich is feeding the commodity and asset bubbles. He asserted that any reform within the financial system is ineffective as long as the inequalities underlying an imperialist system persist. **Ilene Grabel** (Josef Korbel School of International Studies, University of Denver) hoped that securitisation would be slower in developing countries as a result of the crisis. Addressing Dilip Nachane, she enquired about the code of conduct that should be implemented for the credit rating agencies (CRAs). **Gabriel Palma** (University of Cambridge) expressed scepticism of the supposed effectiveness of Gerald Epstein's proposal of 'FSPSA', since regulatory capture, which was also ideological, would be a big hurdle. According to him, the only way to deal with ideological capture was to link originators of the innovations to the performance of those instruments. Addressing Gerald Epstein, **Rizal Ramli** (Komite Bangkit Indonesia) said that an extensive definition of systemic risk would create a moral hazard among the banks, and they would use this to get expensive bail-outs for themselves as Indonesia's experience showed. **Jan Kregel** also expressed scepticism over Epstein's proposal for a regulatory body along the lines of FDA, saying that Glass-Steagall Act, which was on similar lines, had not fared so well.

In his response, **Mario Tonveronachi** said that to take care of the problems mentioned by Amiya Bagchi it was imperative that international financial flows be controlled, and that this was difficult in the short run as the reform of the financial system was mainly a political problem. He did not expect any policy changes at the international level that would remove the basic fragility of the system. **Dilip Nachane** responded by clarifying that his view of containing systemic risk had more to do with prevention rather than cure. Answering Ilene Grabel, he remarked that though the Indian experience with CRAs was not bad, bankers seems to have better information about their borrowers than these agencies. Regarding the code of conduct for CRAs, there should be a clear separation of investing agencies from CRAs in terms of overlapping board membership, and consultants and members of credit rating agencies should not be part of official committees and bodies. While agreeing with Amiya Bagchi, **Gerald Epstein**, opined that getting finance under control was necessary to address the inequalities and for the initiation of structural reforms. He also concurred with Gabriel Palma, by saying that in the present context, there was a serious ideological capture along with regulatory capture. Responding to Jan Kregel, he agreed that there were mechanisms in his proposal that were similar to Glass-Steagall in certain ways. He opined that Glass-Steagall Act did work well for a very long period of time during the 'golden age' of capitalism, until it got weakened eventually. Responding to Ilene Grabel on credit rating

agencies, he said that the official role of credit rating agencies in the regulatory mechanism should be eliminated as these agencies were saddled with conflict of interest.

Session 3: Global Imbalances, Role of Finance, Exchange Rates and the Mercantilist Structure

Dimitri B. Papadimitriou (Levy Economics Institute, Bard College) argued that over the past decade a combination of diverse forces has created a significant increase in the global supply of saving—a global savings glut—which helps to explain both the increase in the US current account deficit and the relatively low level of long-term real interest rates in the world today.

Many developing and emerging-market countries, especially oil-exporting countries, turned their current accounts into surplus in order to reduce their foreign debts, stabilize their currencies, and reduce the risk of financial crisis. China, for instance, through its export-led growth model has created a large current account surplus, while developing a strong industrial structure, accumulating huge dollar reserves. Such kind of trading relations resembled neo-mercantilism where the US treasury took the place of gold.

The US had been able to sustain debt-financed spending and its net foreign assets (NFAs) had been increasing at market prices, though since 2006 they had started declining. This may lead to decreased US domestic sector spending or, if the current account deficits persists leading to a reduction in NFAs, might force a catastrophic depreciation in dollar. In such a situation, there exist three possible scenarios.

Firstly, considering the simulations based on the baseline scenario and medium-term projections by the Congressional Budget Office, growth will resume but would remain sluggish and would not be enough to reduce unemployment. Alternately, if deficit reduction is postponed and the current fiscal policies are continued, there might be a reduction in the unemployment rate but it would worsen the current account imbalances. However, in a scenario where dollar is allowed to be devalued moderately (by around 11.9%) there might be an improvement in the current account imbalances in the medium term, and it might also allow for a tighter fiscal policy, which in turn would lead to an improvement of government finances.

Thus, there is a need to revalue the currencies of those countries running surpluses to counter current global imbalance which in turn would require concerted action of Central Banks. However, if these policies fail, then unpopular “protectionist type” measures like import certificates and non-selective import tariff might become necessary.

The second speaker, **Andrew Fischer** (Erasmus University, Rotterdam), argued that the discourse in savings glut is an ideological reformulation, and a lot of this discourse is a camouflage for global restructuring of Transnational Corporations, in particular, that of TNCs based in the US, Japan and the EU. Besides, the role of finance as a lubricant for consolidation of this process is another aspect that the global savings glut argument camouflages. Seen from China’s perspective, its surpluses are a sign of vulnerability in as much as they are a sign of power. Contrary to mainstream perceptions that it was Chinese economic policies that repressed consumption thereby creating savings which led to bubble in the US, since the late 1990s, Chinese consumption has been on the increase. In reality, it was the US’s high debt-financed consumption spending that drove export and investment demand of its trading partners and led to the adjustments in the savings rates to investment.

Pointing to the problem of increasing savings/ declining consumption in the 1990s, he said that the Chinese government took steps to manage it and since the early 2000s, household savings have fallen, in particular rural savings. Therefore the increase in Chinese savings is due to increase in national savings, with the main source of such increase being reinvested earnings of the corporations. Coming to the exchange rate question, he argued that it is not obvious that the Chinese currency is undervalued, or that revaluation of Chinese currency would lead to a correction either in the global imbalances or the Chinese current account. Given the high import content of Chinese exports, exports might become expensive due to Yuan revaluation, while imports would also become cheaper thus neutralizing the impact.

Analysing China's pattern of growth, he argued that till the 1990s it was similar to that of a typical peripheral late industrialiser. Since the East Asian crisis there had been some dramatic changes with the realignment in East Asian production networks. In the process, China increased its trade surplus with the US and the EU but its trade balance within East Asia worsened. However, China's rising trade surplus has been accompanied by increased volatility in the current account. Besides, unlike the trade surpluses of European nations, a major portion of the Chinese surpluses was earned by foreign funded-private firms. When converted into Chinese currency these export earnings create huge amounts of foreign claims on domestic financial assets. This then forces the government to sterilise the currency by issuing bonds. However, since the interest rates on these bonds are higher than the low interest-yielding US treasury bills securities, China is not only funding the US current account deficit but also subsidising it as well as the TNCs. Therefore, China's situation continues to be vulnerable and it might soon face a balance of payments problems or a major financial crisis in the next five to ten years, particularly if it are not careful about the increasing influence of mainstream economics in its universities.

Rohit (IIT, New Delhi), in his presentation, dealt with the implications of rising inequality and the declining share of wages in gross domestic product all over the world including China and the US since the 1980s. He contended that because of declining wage share and rising share of profit, consumption as a proportion of output would have a declining tendency. In addition, declining government expenditure under neoliberal policies and increasing financialisation has led to a tendency towards under-investment. This is explained by the fact that increasing financialisation under neoliberalism led to an increase in the rate of profits on financial assets, thereby resulting in sharp decline in real capital expenditure. As a result, the only sources of growth remaining under capitalism in the neoliberal era are net exports (like in China) and the wealth effect arising from increased rate of profit on financial assets (as in the US).

He argued that both these trajectories are ridden with inherent instability. In the case of the US, the rise in consumption owing to wealth effect is unlikely to be sustained as consumption based on wealth effect is prone to be volatile and would in turn lead to instability in the growth of the system. In the case of the export-led strategy of growth, as in China, the instability of the system, even though not apparent, remains a problem. In order to remain competitive, Chinese prices had to remain relatively low. Given that it was politically difficult to sustain undervalued exchange rate and the mark-up could not go below a certain level, competitive prices could only be maintained either by reducing real wages or increasing labour productivity. And both of these have the effect of reducing the share of wages in total output (unless real wage increases are exactly matched by productivity increases), hence reducing the share of consumption in output. Thus, such a growth path means that increase in net exports can come only at the cost of decline in wage share; therefore, even this strategy has instability inbuilt in the system.

Comparing the USA and China, he argued that while in China consumption had declined but investment increased, in the US the reverse happened. Therefore in the US the base of growth was small (since the wealth effect was only applicable for the upper income section of society) but the multiplier was large, while in China the base was larger but the multiplier was smaller. He concluded on the note that the way to get out of both these unstable strategies of growth was to increase both the multiplier and the base.

Jomo K. Sundaram (Department of Economic and Social Affairs, United Nations) made the point that the global imbalances was not just a bilateral affair between China and USA, but also included a third angle, whereby, on the one hand China was running a current account surplus with US and, on the other, it was incurring deficits with many third world nations. Besides, the imbalances were not simply of trade but were also reflected in broad military and political hegemony of the US. The root cause of the crisis lay with the design of the Bretton Woods system. This was evident from the dollar-gold parity which helped the US to run sustained current account deficits as well as run several wars. These imbalances are therefore not new to the system, but have surfaced repeatedly in form of the "Cross Atlantic challenge" between the US and the EU and later between the US and Japan. The current debate between the US and China is almost a repetition of the US Japan Debate.

During the East Asian Crisis, although all countries devalued exchange rates to promote exports, the North East Asian (NEA) countries effectively linked export promotion to import substitution while the South East Asian (SEA) economies only concentrated on export promotion without linking it to import substitution. The SEA economies relied on foreign investments in their industrial strategy, leading to the domination of financial interests which opposed dollar appreciation; with the end of *endaka,* East Asia slipped into financial crisis.

China, post-1994 devaluation, relied on contract manufacturing and in the process learnt a lot via "learning by doing". After the end of the boom of Township and Village Enterprises (TVEs), firms achieved economies of scale. This helped China reach the position it is today. The devaluation of its currency would lead it to a crisis similar to that of Japan. Drawing lessons from the East Asian and Latin American crises, China must stick to accumulated reserves for self protection as there is no lender of last resort, and the IMF conditionalities are onerous. However, there is also a need to revisit the political equations—and not just rely on exchange rate changes—for solving the imbalances.

In the discussion following the presentations, **Gerald Epstein** enquired whether the US can continue to run deficits if China keeps on accumulating reserves. **Vamsicharan Vakulabharanam** (University of Hyderabad) wanted to know whether the global imbalances were indicative of any kind of structural shift from the US towards China. **Amiya Bagchi** pointed out that since Transnational Corporations can own assets internationally across borders they can increase inequality and fuel inflation at global level. In this context he queried about the possibilities of China nationalizing their TNCs. **Anisuzzaman Chowdhury** (UN DESA) added to Rohit's point saying that along with de-unionization and financialisation, the simultaneous deregulation of the labour market in the name of flexibility of labour has added to the fall in wage shares. **Terry Mckinley** pointed out that the US and China are locked in a relationship of convenience, and depreciation by the US would adversely affect other nations. At the same time the problem could not be solved by persistent US fiscal deficits. **Jayati Ghosh** argued that more problems would arise when the US tries to adjust compared to the situation if the US did not adjust. In the scenario where the US adjusted she wondered about the options that were available for China. Given the fact that China had been a major production platform in the world with a majority of its exports being processed ones, she asked whether there would be transition issues involved

since China would have to go for substantial production restructuring. She also noted that imperialism had been remarkably resilient. In the 1970s the US has been the hegemon and despite claims of other countries (like Japan and Germany) taking over, the hegemony of the US was back and this needs to be considered. **C.P. Chandrasekhar** stated that rather than a global imbalance, the current crisis seems more like a general crisis of US capitalism. And despite this long crisis the US has managed to remain the home of the reserve currency because of which it has been able to violate domestic and external financial constraints. Given that 70 per cent of exports from China come from FDI firms, **Surajit Mazumdar** wanted to know how much of China's retained earnings comprised of FDI. He also queried as to what explains the large retained earnings in the case of domestic firms**. S.K. Rao** raised the issue of the role of US military expenditures in demand generation at this particular juncture. In the context of China's unwillingness to appreciate its currency, **Y.V. Reddy** pointed out that devaluation of the dollar would amount to the rupee getting appreciated vis-à-vis the dollar. Thus, post-crisis, countries who did not contribute to the crisis might be severely affected by adjustments either by USA or China. **Jan Kregel** argued that the current problem of imbalance was a conflict of development and structural adjustment. It was more like a two-country model where one country relied on industrialization for development and the other had to go for structural adjustment. The US had been able to export the structural adjustment to others nations till date. Now the US should make way for other developing nations undergoing certain adjustments themselves. **Chang Kyung-Sup**, pointing out that the Chinese growth had been built up upon TVEs, said it was important to realize the potential of domestic enterprises. He further emphasized the retaining of autonomy during policy making.

In response to the issue raised by Gerald Epstein, **Dimitri Papadimitriou** argued that the US adjustment process, although not successful, had nonetheless begun. In this context he pointed out that certain proposals like import tariff on China and grant of import certificates are being considered at various policy circles. He further pointed out that the US could not continue to run deficits if it did not depreciate its dollar. He felt that the US might appear hegemonic and might look like a political power but it had lost its financial clout.

In his response, **Andrew Fischer** said that the classic dilemma for developing countries had been how to industrialize without getting into the balance of payment deficits. Trade surplus in China today is related to an austerity drive that led to under-consumption. But when growth took off from the early 1990s, trade deficit soared. Therefore, the FDI norms were relaxed and the currency was devalued. He pointed out that the big challenge for China and for a developing country like India was to create MNCs which were profitable enough to feed their export earnings.

Rohit responded saying that unless there was break from neoliberalism it would not be possible for the growth path to create redistribution. China today has replaced Japan of the 1980s in terms of importance, but whether it too will face a similar fate will depend on the fate of its currency. Given that external factors are responsible for the recent recovery of China, its sustainability is disputable because of the persistence of the crisis and the impact it had had globally.

Jomo K. Sundaram said Japan was the single largest buyer of the US treasury because it was a kind of payment for political and military security. The issue of low interest rates was more prevalent in the 1970s than in the 1980s in the case of Japan. However, savings rate could be high even with small positive real rate of interest. He also stated that major contributors to the US foreign earnings had been financial services and manufacturing services. Earnings in the manufacturing services were based on the intellectual property

rights which had been pushed strongly in the Uruguay Round. Thus, there had been increase in rental income in the US which again provided it a major source of domination.

Day 3: 27 January 2010

Session 1 - Restructuring Finance for Development

In the session chaired by **Rolph van der Hoeven** (ILO, Geneva), the first speaker **Ilene Grabel** (University of Denver) focussed on the effect of the global crisis on governance and policies of the IMF, the prospects of regional alternatives to the Fund, and the policy space available to developing and transitional countries. The crisis, she contended, does not appear to be inducing epochal, universal changes in financial governance. Instead, a "productive incoherence" is beginning to take the place of neo-liberal coherence that characterized financial governance over the past decades. Along with the neoliberal prescription to financial crises for national governments and IFIs, there is a proliferation of responses to the crisis that have not congealed into a coherent strategy or regime. This may signal a new openness to policy and institutional innovation, and may ultimately prove to be productive of development and supportive of policy and institutional diversity.

Both the East Asian crisis of 1997-98 and the Great Depression induced coherent institutional and policy responses. The response to the East Asian crisis cohered around neoliberalism, with developing countries increasingly facing a contraction of policy space. The Great Depression, on the other hand, marked a radical turning point in financial governance with enhanced role for the state.

The current crisis rescued IMF from growing irrelevance, and critics believe the modest adjustment of voting shares will not help the developing world much. Ilene Grabel, however, argued that this could reinforce other changes in the governance of the Bretton Woods institutions.

Asia progressed towards the creation of facilities that might over time reduce or even obviate the role of the IMF in its economic and financial governance. In May 2009, the Chiang Mai Initiative gave way to Chiang Mai Initiative Multilateralization (CMIM), a $120-billion regional currency reserve pool from which member countries can borrow in times of crisis.

While mostly sticking to neoliberal strategies, the IMF's response also demonstrated some flexibility. The current IMF assistance programmes have narrower scope of conditionality and emphasis on social protection for the poor and the vulnerable. However, the Fund's greater flexibility for countries failing to meet their fiscal targets has been offset by a stringent monetary policy. The result of these conflicting interventions is Stackelberg Warfare that renders some of the IMF's programmes incoherent. For example, the SBA for Iceland included stringent capital controls provisions, but the Fund reacted only mildly to the capital controls imposed by Brazil.

The current crisis holds promise of the creation of more space for development, policy and institutional experimentation and heterogeneity as well as greater degree of pluralism in the governance of the world economy. It may even wean developing countries away from the neoliberal model towards national economic policies and enhanced policy space.

The second speaker **Filomeno III Sta. Ana** (Action for Economic Reforms), analyzing the relationship between exchange rates and institutions in the context of the Philippines, said institutions affect economic growth. Although some economists doubt the role of certain policies in affecting economic growth, he felt that it can help shape or transform institutions.

In the case of exchange rate policy, incentives arising from competitive or undervalued currency could encourage entrepreneurship, productivity, innovation, and social cohesion.

He argued that undervaluation is required if developing countries are to grow fast: undervalued currency translates into higher long-term growth and enhanced relative profitability of tradable goods. It can help developing countries face constraints such as market failures in the transition period. However, a strategy of undervaluation is not easy since sterilizing capital inflows is costly and involves high opportunity costs, and inflation has to be tamed.

Undervaluation is not just about exports as what matters is not export output but the output of tradables. Although the global imbalances contributing to global recession makes undervaluation undesirable from the perspective of macroeconomic stability, very few options are available to developing countries. It is a form of industrial policy, and is the first option for many developing countries because of the constricted space for a wide range of industrial policy tools.

Neoliberals argue that the cost of managing the exchange rate and having industrial policy for developing countries are very high and that there is regulatory capture by vested interests, especially in weak states. But the gains from output, incomes and employment arising from capital/ financial regulation far outweigh the costs of corruption and rent-seeking and the inferior gains from the status quo. A level of predictable corruption and rent-seeking can be tolerated; however, transaction costs need to be strategically addressed and the state's capacity as enabler and regulator has to be strengthened. This is mainly a political, institutional agenda, best achieved by winning political power.

The final speaker **Sudip Chaudhuri** (IIM, Kolkata), dwelt on the issue of long-term viability of India's balance of payments and competitiveness of Indian industries following the adoption of neoliberal polices in response to the 1991 BoP crisis of 1991. He argued that, contrary to the claim that structural and industrial reforms would positively impact long-term viability of BoP, trade deficit had increased tremendously since 2003-04. While the current account deficit (CAD) performed better, that too has increased substantially, reaching 2.5% of GDP in 2008-09. The relatively better performance of the CAD was more on account of software exports and private remittances. But given that private remittances and foreign institutional investments are highly volatile, even this remains a case for concern.

A look at the composition of trade deficit shows that it was primarily due to fuels deficit, while the manufacturing trade balance showed a surplus with the deterioration beginning in 2001 and turning into deficit since 2006. The question is, if this shows that neoliberal policies helped the performance, what explains the deterioration witnessed since 2001. A close examination, however, reveals that the breaks occurred in the mid-1980s and the early 2000s, and not in 1991, implying that the manufacturing trade surplus cannot be attributed as success of neoliberal policies. In fact, while manufacturing exports grew faster than manufacturing imports over the period 1985-2001, since the early 2000s—although both exports and imports accelerated—the latter grew much faster than the former.

Regarding the role of early industrial policy and the sectors explaining the increases in manufacturing exports, he argued that in the period under consideration, export growth was contributed by a small number of traditional industries such as textiles, gems & jewellery. Apart from these, pharmaceuticals, automobile parts, iron and steel were the other main sources of export growth. Since these were precisely the industries that the erstwhile planning strategy had sought to develop, rather than reforms, it is industrial policies that lie

at the root of the success of these industries. That is, export success has been mainly on account of industries (pharmaceuticals, motor vehicles parts etc) that had already been developed through conscious strategy in the earlier period and not because of new industries. Thus, even though the growth in exports occurred after 1991 it was due to pre-1991 policies. Similarly, in the case of imports, the moderate rate of growth in the 1990s and the sharp increase thereafter reflect the success of past industrial policies and the failure to develop new industries.

The fact that imports were under control in the 1990s reflects that Indian industry was competitive. However, with the surge in GDP growth (and service sector growth) in the early 2000s and rise of telecommunication and software services, demand for and imports of many Advanced Technology Products (ATP) have increased phenomenally. This again is a result of complete withdrawal of the State from Industrial Policy in India, particularly after 1991. The lack of industrial policy has resulted in imports going up sharply in developed industries such as machinery, drug intermediates and motor vehicle parts, despite India being a competitive manufacturer of machinery. For example, while the tariff for the import of manufactured goods were mostly in the range of 7.5-10%, duty-free imports were allowed in vital sectors such as computers, telecommunication equipment, etc. Further, even existing industries are being negatively impacted because convoluted policies like the inverted duty structure and the relatively high indirect tax rates amount to a negative protection.

Therefore, unless steps are taken to prevent the damage to existing industries and to promote new ones, the manufacturing trade deficit is likely to worsen. For, the claim that the abolition of Industrial Policy as a part of structural reforms has had a positive long-term impact on BoP is questionable. In fact, lessons in the importance of industrial policy for India could be had from the experience of China and US, both of which pursued their national interest aggressively. It is therefore important to have the policy space that the developed countries had and do away with the WTO or Washington Consensus.

During the discussion, **Luis Bresser-Pereira,** commenting on Ilene Grabel's assertion about productive incoherence, felt there was a coherent response to what is happening. He gave the example of a new alternative development strategy being developed in Latin America: the school of new developmentalism. The tripod upon which new developmentalism rests, he said, were a) growth with domestic savings, avoiding current account deficits; b) fiscal responsibility, i.e. no budget deficit; and (3) a strategic role for the state, but not state-led development.

Regarding the issues of informal governance and the powers of the IMF's officials, **Arturo O'Connell** said the IMF is run by the US Treasury-Wall Street combine. Real power lies with the US Treasury, and the issue of 'ideological capture' is a serious one. Some changes in voting shares at the IMF would not change its policies. He noted East Asia's reasonable success with regard to regional alternatives to the IMF, and attributed it to the presence of "wealthy uncles" in the region. A year after the crisis, an enormous finance made available to the developing countries came with conditionalities. Taking the example of Argentina, he said countries often accumulate substantial forex reserves as a symbol of strength, and authorities are reluctant to use it for that very reason. He said that forex reserves should be used in times of crisis instead of relying on foreign aid. Referring to the issue of corruption raised by Filomeno III Sta. Ana, since capital controls are non-discriminatory, he did not see the problem of corruption and rent-seeking.

Disagreeing with the view presented by Sudip Chaudhuri, **Jomo K. Sundaram** said there still are a whole range of industrial policy instruments in India, and the main problem is the

incoherence of policy. The same problem exists in China, where inter-state competition to attract private capital is resulting in a race to the bottom. Regarding the view on 'productive incoherence', he felt that although an opportunity did present itself but the global community failed to seize it. The important thing to do is to identify where things went wrong. According to him Latin American economists exaggerate the importance of regional alternatives. As far as the Chiang Mai Initiative is concerned, nothing has happened to date. The Latin American Reserve Fund performed better. It has no conditionalities, but is not big enough to help current account problems of big countries like Brazil. He added that productive incoherence in response to the crisis allows for the possibility of contradiction and of bringing about change. But a 5 per cent change in quota shares is not significant, and far more changes are needed. Moreover, neoliberals are trying to put capital account liberalization back on the agenda.

Sushil Khanna queried about the ways of measuring overvaluation or undervaluation of a currency and aligning the nominal and real exchange rates, since the real exchange rate can only be found out ex-post after taking into account the rate of inflation at the end of the year. Commenting on Ilene Grabel's paper, he said that the "Big uncles" of Asia get scolded by the US whenever they pose a challenge. Citing the example of Japan, which was criticised by the US when it tried to set up a regional fund, he felt pessimistic about any regional alternatives emerging in Asia.

Saul Keifman disagreed with the notion of productive incoherence and changes in the IMF, saying that the Latin American debt crises of the 1980s and the adjustment process pushed by the IMF had turned the 1980s into a "lost decade" for the region. The fiscal and monetary targets imposed by the IMF were unrealistic and impossible to meet. The frequent negotiations with the IMF, where targets were renegotiated every three months, were not signs of IMF's flexibility but showed that targets were impossible. He felt that there is no policy incoherence between the fiscal and monetary policy advocated by the IMF, as whenever fiscal policy is not contractionary enough, monetary policy has to be tight. He also queried if in Sudip Chaudhuri's analysis the inputs for services that are exported are included in services.

On the issue of undervaluation, **Andrew Fischer** commented that it was not clear whether China's currency was undervalued. Depending on one's assumptions, China's currency undervaluation could be shown to be anywhere from 0% to 70%. He felt that revaluation of the currency will have an impact on agricultural prices in the country, with 40% of the population being exclusively consumers of agricultural products. He said the electric and machinery success of China was due to the economies of scale in the processing of imported goods and its export, and not necessarily due to any industrial policy. **Rohit** (IIT, New Delhi) expressed doubt whether the Chinese currency is undervalued, since the country's low costs could be due to its technological advantage. **Venkatesh Athreya** (Bharathidasan University) said that at any given point of time, there is no way to determine what the 'correct' equilibrium rate of any currency is, and therefore whether it is overvalued or undervalued. He noted that many heterodox economists are unwilling to make a clean break with the epistemology of the neoclassical equilibrium models. Besides revisiting Keynes, there is a need to go back to Marx to change the system. Devaluation means a cheapening of labour as it was a strategy carried out to weaken labour unions as well as lower the real wage by increasing inflation.

Referring to Ilene Grabel's comparison of the present financial crisis with the Great Depression, when with the withdrawal of the New Deal there was a bigger slump, **Rohit** asked whether there is a similar possibility now, given that the Republicans continue to

demand the withdrawal of the stimulus package. With no Glass-Steagall or New Deal now, what were the avenues that could revive a depressed US economy?

Referring to Ilene Grabel's presentation, **Nirmal Chandra** said that unless regional groupings had flexibility and did not impinge on economic sovereignty, they could become like the IMF itself. Commenting on Sudip Chaudhuri, he said that the old idea of import-substituting industrialisation is perfectly valid, and it was criticized by the neoliberals to make space for the Washington Consensus. However, only a few developing countries could pursue it successfully, as sufficiently large domestic markets are needed for it. Given the WTO rules there is no space for these countries to develop. In fact, the very success of China and India might block the industrial development of such countries unless there are countervailing measures.

Atulan Guha (IRM, Anand) asked whether the success of industrial policy should be discussed only in terms of export-import performance. The industry is important for ensuring a stable growth and this is what industrial policy should work towards, since the sustainability of development resting only on agriculture and services is doubtful. **Kasturi Das** (RIS, New Delhi) commented that the changes in quota shares at the IMF would not be enough to ensure the needed policy space. Furthermore, regional alternatives were difficult to take off and are time-consuming. On India's exports and imports in the post liberalisation era, she queried about the extent to which changes in exports and imports can be explained by industrial policy alone, positing that demand-side issues and changes in the national system of innovation could also have important roles to play. On the issue of WTO and policy space, she felt that restoration of the policy space would be possible only if the WTO was abolished. **Jayati Ghosh** pointed out that the obsession with exchange rate was the result of giving up the idea of multiple exchange rates, which was the basis of South East Asian industrialization. Commenting on Ilene Grabel's paper, she said optimism should not be in terms of these institutions undergoing change of heart but from changes in international power balances. Hence, according to her, the real source of optimism is the evident unravelling of the US economy, and the fact that many US quotas are today WTO compatible is a heartening development. **Bhumika Muchala** (Third World Network) raised the issue of the condition of the farm and non-farm rural sector of India, and solicited Sudip Chaudhuri's views on how an ideal strategy could be developed to include the rural sector in the growth strategy. Further, she commented that the issue of the G-20 exacerbating and perpetuating the accountability problem in the IMF by augmenting the Fund's lending resources without demanding any changes in governance needs to be looked into. The Flexible Credit Line, though without conditionalities, is provided only to countries with supposed macro-stability.

In her response, **Ilene Grabel** said that a careful examination reveals that there are nuanced differences as well as some continuity in the IMF responses to the East Asian crisis and to the current financial crisis. It is too early to say that the opportunity has been lost and that neoliberalism would continue. It is important to look at where the cracks are developing in the IMF policies as well as where new initiatives are coming from. The changes in voting shares at the IMF may be modest, but there are other changes happening: neoclassical theory, for example, is losing credibility. This could create space for more heterogeneity. After all, the IMF had to join hands with China, India and Brazil in handling the crisis. What Argentina did with regard to bond holders was in spite of Wall Street. IMF had to revise its guidelines for exchange rate surveillance, when China reacted strongly to IMF's criticism of unfair exchange rate management.

Thus, according to her, spaces may be opening up for an alternative, domestic demand-led growth. Regarding regionalism, she argued that CMIM was a possible alternative mechanism

to assist developing countries if they could figure out regional surveillance mechanisms different from the IMF. And as the US recession gets deeper, it could have the effect of creating more space for alternative mechanisms. Her reference to IMF's talk of social protection was simply to highlight the contradictions in the Fund's approach. The Fund imposes fiscal restrictions even as it talks about social protection. It is a different kind of IMF, though it might still not be good enough.

Filomeno III Sta. Ana, in his response, agreed on the need to stop obsessing with undervaluation and overvaluation of currencies. But there are ways by which undervaluation or overvaluation could be estimated, and one of them is the Big Mac index published by the *Economist*. Inflation across countries, especially across major trading partners and similarly-placed countries could be compared to estimate the extent of undervaluation or overvaluation. For example, if India has 10% inflation and Philippines 0% inflation, the Indian currency should depreciate to equalise prices. On the issue of China's undervalued currency, he said that he had referred to Rodrik's study. On corruption and rent-seeking, he said there would be no problem if discretion was absent. But in the case of financial and capital controls, some discretion might still be there, and in such cases rent-seeking could occur.

Sudip Chaudhuri agreed with Jomo K. Sundaram's observation that India still has an industrial policy. But the point, he argued, is how they are used. Agreeing with the comment that industrial policy is not the only factor, he pointed out that this was mainly looked at since it is impossible to look at all the factors. Besides, it explains the observed trend in the economy.

Session 2 - Freedom from Finance: Rethinking development strategy

The chair of the session **Nirmal Chandra** (IIM, Kolkata) noted that whenever finance has dominated, there has been very little development (like in the Soviet Union in the 1920s and in Japan later), which reinforces the point that freedom from finance is essential for proper development.

The first speaker of the session, **Luis Bresser Pereira** (Getulio Vargas Foundation) focused on the importance of competitive exchange rates for growth and development in the developing countries. He argued that because of two structural reasons, namely the Dutch disease and the interest rate differential, exchange rate in the developing countries show a tendency to appreciate. And it is not the market but crisis or the threat of crisis that equilibrates the exchange rate, because only a currency crisis forces governments to depreciate. And this occurs in cycles, with the exchange rate depreciating sharply because of a crisis. In the absence of a policy to manage the exchange rate, this leads to a current account deficit. The ensuing increase in debt results in creditors losing confidence and withdrawing assets, thereby leading to a new currency crisis.

Regarding the tendency of currency over-appreciation in the developing countries, he argued that the strategy of growth with foreign savings, inflation targeting and exchange rate populism (lower inflation and increase in wage improves politicians' electoral prospects provided the crisis does not overtake them) are some of the causes.

Rather than increasing investment, growth with foreign savings policy results in a high rate of substitution of foreign for domestic savings. The result is high current account deficit leading to exchange rate appreciation. Thus a competitive exchange rate is fundamental for developing countries' growth as it opens up various avenues of foreign demand.

The other important factor which causes chronic appreciation of the national currency is the Dutch disease, caused by a Ricardian rent originating in abundant and cheap resources. Because of this, the exchange rate tends to be much higher than is necessary to make industries that rely on state-of-the-art technologies economically competitive. Essentially a demand side obstacle, the Dutch disease model is based on two exaggerated equilibria: a) the current rate equilibrium and, b) the industrial rate equilibrium. Unlike in the developed countries, in developing economies these two rates differ from each other, showing the existence of the Dutch disease. Thus a competitive exchange rate is the industrial equilibrium exchange rate and not the equilibrium current account exchange rate.

While the Dutch disease, he argued, tends to be most severe in low-cost oil-producing countries, it can also be caused by abundance of cheap labour, such as in countries like China and India.

Imposing tax on goods that generate the Dutch disease is an effective method that governments in developing countries can adopt to neutralize the disease. Import tariffs is another alternative. Both these can cause the exchange rate to shift from current to industrial and thus make it competitive.

He concluded by noting that the global imbalance may have originated from the fact that developing countries are beginning to learn the key role of exchange rate in economic development. Developing countries have begun to understand the fundamental problem affecting them, i.e. the structural tendencies of overvaluation of the exchange rate, and this may also perhaps explain the large increase in reserves in some of the developing countries.

The second speaker **Amiya Bagchi** (IDS, Kolkata), focused on the issue of whether it is viable to expect those in power—that is those who had benefited most from neoliberal policies—to support radical financial reforms. In this context he pointed out that one of the major impacts of neoliberal policies has been the enormous increase in inequality in the world.

However, there is very little work being done on the routes through which inequality increases, even though there exist numerous works on rising inequality in the distribution of income and wealth.

In the literature, there are two broad views regarding the genesis of increasing inequality leading to oligarchic formations. One view, taking off from the work of Pareto, Mosca and of McAlister (1879), says that the transitional probabilities of changes in income or wealth are proportional to the initial values, and that generates a chain process which leads to various kinds of skewed distributions of income—Pareto distribution, lognormal distribution etc. The other view centres on Marx's definitions of increasing inequality namely, centralisation and concentration of economic power. However, existing literature on the latter tradition is not yet well developed.

Closely linked to rising economic inequality is the issue of rising oligarchy in the political sphere, both being responsible for the 'ideological capture'. The kind of democracy that is prevalent all over the world since World War II in the advanced countries and other countries, including India later on, is based on Schumpeter's notion of democracy. Democracy thus is seen as competition for political power such that it may also be an oligarchic democracy, characterised even by fraudulent elections.

Elaborating on the broad routes along which inequality had grown in India, he said that barring the states of Jammu & Kashmir, Kerala, West Bengal and Tripura, the initial condition of high levels of inequality in the distribution of land ownership have remained, while major private sector firms continue to be tightly controlled by particular families. The giving away of public resources by politicians to favoured firms and individuals in the name of promoting development including infrastructure and systematic manipulation of government regulations have increased in the neoliberal era. Thus there is a growing nexus of those in power, economic and political, and rising trend of corruption in India.

This growing nexus between money, criminality and corruption is evident not only in India but in other countries as well. And this is making it even more difficult to get a popularly elected government and not just the best government money can buy. In this context, he argued, it becomes pertinent to ask whether it is practical to expect those in power at the present juncture to be in favour of and hence carry out the needed reforms in the financial system.

The third speaker of the session **Chang Kyung-Sup** (Seoul National University) dwelt on jobless industrial restructuring and financialization of poverty in post-crisis South Korea. He argued that behind the rosy picture of the prompt recovery of the South Korean economy from the recent financial crisis, lie the financial crises being faced by those at the grassroots level. Post the 1997-98 crisis, two fundamentally risky phenomena had made the South Korean economy structurally vulnerable – abandoning of labour-intensive industries and annulling stable employment conditions, and dependence on global financiers for corporate financing and stock value sustenance. The loss of stable and decent jobs among ever increasing population has led to a situation of declining wage income across society, resulting in increased poverty in both absolute and relative terms. This poverty is increasingly manifested in terms of financial entrapment ensuing from heavy personal indebtedness to the state, banks, kin members and private insurers. From being the world's highest savers until the 1997-98 crisis, in a decade, South Koreans became one of the world's lowest savers, thereby calling for a different approach to national economic development.

Yearning for a globally competitive financial industry after the tormenting experience of the 1997 financial crisis, South Korea made the swift establishment of globally viable consumer and investment banks its new industrial policy. Most of the financial firms capitalised on the relaxed regulatory environment by approaching wage-deprived and socially unprotected segments of South Korean. South Korea is facing developmental failure even when the economy is doing well.

The issue of financial regulation and control is especially difficult and complex for South Korea. Its approach to finance is not just of regulation but of developing a strong domestic financial industry.

The South Korean economy today is powered by global financial capital with the largest banks being 80 per cent foreign owned. The most profitable firms have a large share of foreigners. This global financial engagement in the South Korean economy, especially since the IMF crisis, has led to this generous tolerance on the part of the global financial community towards Koreans continuing developmental state policy. They now want the Korean economy to prosper and Korean industries to export more. Thus, the attitude of IMF and global financial community towards Korea is changing dramatically.

He concluded by looking at China's interesting institutional arrangements in its economy. Although China has local groups, who behave like international financiers, but overall there

is state ownership and little market speculations. Therefore, the success of China in fending off the negative impacts of global finance capital is, to a large extent, due to its political and institutional uniqueness.

The last speaker **Surajit Mazumdar** (ISID, New Delhi) highlighted the need to develop more concrete contours of an alternative development strategy in order to be able to take development strategy beyond finance. This, he contended, requires recovering the heterodox tradition of development economics that has been nearly obliterated because of the dominance of neoliberal ideology. That in turn requires recognising the changed context in which the developing economies operate today. Partly because of their own attempts at development and partly because of financial liberalisation and globalisation in these economies, it is no longer possible to go back to old ideas of development economics. At the same time, there are limits to the changes and certain conditions like inequality between different set of countries continue to persist, thereby demarcating the developing from the developed countries. All these make the discussion of development issues and the need to recover development economics pertinent.

Regarding the aspects that development economics needs to consider, he argued that many developing economies today no longer fit the old criteria used for characterising a developing economy. They have all moved away, although in an uneven manner, from those initial conditions. In many developing countries, for instance, there has been substantial increase in per capita income. Some have per capita income higher than what the US had in the 1950s, which was not considered an underdeveloped economy then. At the same time, a large number of countries continue to remain way below the US 1950 levels implying that there is great divergence between developing countries. The same is true if one looks at the production structure or the structure of exports. In most countries the share of agriculture in total production has come down, even though they continue to be largely agrarian. Seen in terms of share of manufacturing, the least and the most industrialising countries of the world are both developing countries. Although, many developing countries rely on primary commodities for exports, a few of them export mainly manufactured commodities. Investment levels on the whole today are higher in the developing world than in the developed world, reflecting that even savings and investment rates no longer match with the old criteria of underdevelopment. Therefore it is no longer feasible to identify a developing economy on the basis of the criteria of level of income, structure of production, structure of workforce etc. Also, given that there are huge variations within the developing world itself, the ‘one-size-fits-all’ approach to development strategy is no longer feasible.

In addition, in the light of experience and changes in the context of many developing countries, there is also a need to rethink the excessive emphasis put on capital accumulation in the classical development model. In particular, there is the need to move away from the old tradition of emphasising the importance of capital accumulation without bringing in the question of techniques of production, employment generation and income distribution, and of sustainability.

Similarly, there is a need to consider closely the idea that, in the current scenario, developing countries need to move away from export-led growth in favour of domestic demand-led strategy of growth. While the same choice was available even in the 1940s and 1950s, the context has changed today such that the trade-offs are different for different countries and involve potential conflicts of interest between developing countries. This was not the case earlier as then protection of the domestic market meant protection from the industries of the developed world. Today, that protection could also mean protection from another developing country.

Therefore, all these as well as the possibility and scope of developing countries to be able to meet many of the requirements, need to be incorporated for reconstructing development economics. Along with this, there is need to re-establish the development agenda as the core of any strategy of growth.

During the **discussion**, **Rolph van der Hoeven**, citing the example of Argentina's attempt to impose a limited export taxes running into political difficulties, queried about the feasibility of export taxes in Luis Bresser Pereira's analysis.

Andrew Fischer commented that rather than the Dutch disease and the interest rate, overvaluation was more due to internal-external disequilibrium for peripheral late industrializing countries, particularly Latin American countries. **Rizal Ramli** commented that increased external borrowing like inflow of hot money played a role in overvaluation of currency. He also enquired about the notion of the industrial exchange rate, arguing that the convention to use the weights of trading basket of the partner does not work in the case of Dutch disease. Instead what is more appropriate is to use the competitor's market basket and not that of the trading partners. On Amiya Bagchi's presentation, he said oligarchs benefited most from liberalization because they are already well-entrenched in the closely-regulated economy. The crisis in Latin America and Asia have shown that the top 1% always does better because they can protect themselves. It is the middle class that is most affected and they are the ones who would push for economic and political changes.

Venkatesh Athreya pointed out that even today imperialism and the nature of domestic ruling classes remain the central concerns inhibiting development and possibilities of social transformation even in the better-off developing countries. **Ilene Grabel** pointed out that when characterizing Keynesian approach to exchange rate theory it would be important to emphasize the role of expectations and not just that of fluctuations of exchange rates around a certain fundamental like current account performance. **Gabriel Palma** said that the most significant stylized fact in Latin America since the beginning of economic reform is the slowdown of economic growth and productivity growth owing to increasing deindustrialization. He added that along with the causes mentioned by Luis Bresser-Pereira, lack of industrial policy vis-à-vis competitors, is another factor that explains increasing of deindustrialisation witnessed in Latin American countries. **Saul Keifman** commented that while he agreed with the need for a differential exchange rate for avoiding the Dutch disease, the export tax is a case for differential exchange rate rather than for current account surplus. He also pointed out that differential exchange rate is necessary but not sufficient since that would not bring about the required technological innovation necessary for development. Commenting on Surajit Mazumdar's presentation, he said even though many developing countries are industrialising and exporting manufactures, certain fundamentals have not changed. Unlike in the past, today, owing to the global production system, manufacturers are no longer innovators. The developed countries continue to be the innovators and hence the technological rent continues to be captured by these countries.

Roshan Kishore (Research Scholar, JNU) wanted to know about the primary contradictions that needed to be dealt with to take the developmental agenda forward; whether to go back to the previous system of welfare economy or to protect the petty production system which will prevent bubble and increase agriculture terms of trade. **Satyaki Roy** queried whether increasing heterogeneity within the developing countries implies that capitalism, instead of being looked at as a binary structure, with a sharp divide between the developed and the developing world, should be seen as an integrated system. **Santosh Kumar** queried about the routes through which even the poor had access to finance in South Korea, given that in

other countries increasing financialization has resulted in exclusion of those segments of the population. **Shipra Nigam** (Research Scholar, JNU) wondered about the speaker's lack of optimism regarding the rise of financial citizenship in South Korea, which aims at providing legal-economic recourse to victims of indebtedness. **Vibha Iyer** (Research Scholar, JNU) asserted that too much emphasis was being laid on international finance capital and avoiding international indebtedness given that domestic financial interests have no conflict of interest with their international counterpart.

In response, **Luis Bresser-Pereira** said there was a need for a rethink of most of development economics, as many development models (like the two-gap model) depends on foreign finance. Critiquing the growth with foreign savings model, he pointed out that the effect of foreign finance on the economy is uncertain. An increased inflow may not lead to increase in investment or growth rate of the economy. With respect to imposition of taxes to nullify the problem of the Dutch disease, he said that while it is difficult it is not impossible.

Chang Kyung-Sup said that prior to the crisis the relationship between the state and the people was developmental, enabling a full employment regime for decades. Social policies became weak and with the crisis and declining employment, the state became quite irrelevant. The microfinance scheme, which became popular in Korea, was sought to be increased with the help of major corporations.

Amiya Bagchi responded by saying that oligopoly always existed, and increased with neoliberalism. The Schumpeterian democracy has become the best democracy that money can buy because of the growing inequality in wealth distribution. He also pointed out that what is good for the Indian bourgeoisie is not necessarily good for the common people and disagreed with the assertion that it is the middle class that suffers.

Agreeing with the comments made, **Surajit Mazumdar** added that any instability in the given unequal relation with a dominant core should be utilised to nudge the system to a better one.