Development From a Post-Keynesian and Institutionalist Perspective

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Introduction

- Objective of this lecture
  - What do Post-Keynesian and (heterodox) institutionalist approaches contribute to our understanding how the process of development occurs?
- Before we can answer this question, need to clarify
  - What is the state of affairs in development economics?
  - Why do we need PK and Institutionalist approaches?

Introduction

1. How did the discipline of development economics evolve?
   - From the birth of development economics to the Washington Consensus (WC) and Post-Washington Consensus (PWC)
   - What are we missing?
2. Post-Keynesian Alternatives
   - Post-Keynesian theory: Classes, distribution and structural change
   - Post-Keynesian theory: Finance in development
3. Heterodox Institutionalist Alternatives
   - Khan's political settlement approach: Understanding the State

Development Economics: The State of Affairs

Newer Development Economics: The Post-Washington Consensus

Development Economics – The State of Affairs

The Post-Washington Consensus (PWC)

- The PWC: From Letting Markets Work to Making Markets Work
- Recognition that markets do not work perfectly and fail:
    - Externalities (‘Self-discovery’, Hausman and Rodrik 2003)
    - Information Asymmetries (e.g. credit markets, Hoff and Stiglitz 1993)
- State intervention might be justified to correct market failures but only to the extent that the state has the capacity to improve upon market outcomes (trade-off market vs. government failure)
- New Institutional Economics: weak enforcement of property rights as explanation for underdevelopment (North 1990)
- At the policy level
    - Anti-corruption/ ‘good governance’ agenda
    - Piecemeal interventions to correct specific market failures (make individual markets work)
    - Overlap between WC and PWC (especially macro): Both highly conservative in fiscal and monetary policy, support ‘free’ trade, privatisation, liberalisation, wage moderation and (labour market) deregulation

Development Economics – The State of Affairs

- What are we missing?
  - Current mainstream based on ahistorical models without room for historical, systemic or structural specificities
    - Bias towards domestic reforms (correcting specific market failures in piecemeal way) while shying away from global or structural reforms
    - What about issues like power asymmetries in global value chains? practices like transfer pricing? International patent rights? Wealthy global elites and rising levels of inequality? Volatility of primary commodity prices or capital flows?
  - Supply-side determined framework – no role for demand
  - Models based on representative agents - no conflicts of interest
    - No reflection on why vested interest exist, what sustains them and why certain groups (the poor) have no effective voice
    - Which markets do we ‘enable’ – and is that a value neutral decision?

Post-Keynesian Alternatives

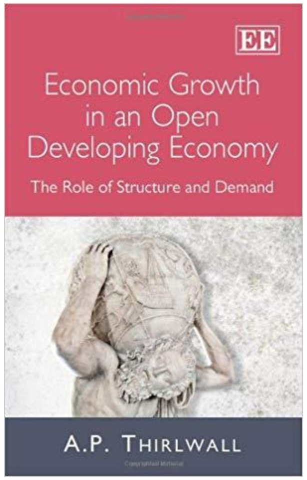
1. Post-Keynesian theory: Classes, demand and structural change
2. Post-Keynesian theory: Situating the role of finance in development

Post-Keynesian Theory and Structural Change

- Industry (manufacturing in particular) characterised by rapid productivity growth
- Stylised facts known as Kaldor's Growth Laws.
  - The First Law:
    - The faster the rate of growth of the manufacturing sector, the faster will be the rate of growth of GDP
  - The Second Law (the Kaldor-Verdoorn Law):
    - An Increase in the rate of growth of manufacturing output leads to increases in labour productivity in that sector (Circular cumulative causation)
  - The Third Law:
    - The faster the growth of manufacturing output, the faster the rate of labour transference from nonmanufacturing to manufacturing, so that overall productivity growth is positively related to the growth of output and employment in manufacturing and negatively associated with the growth of employment outside manufacturing.
- Growing recognition that manufacturing engine of growth (e.g. Lin 2012) requiring (industrial) policy support but no consideration of demand under assumption of unlimited export markets (e.g. Amsden 1990: 11; Monga 2013: 154)
- Kaldor (2007: 55): this process can be demand-constrained

Post-Keynesian Theory and Structural Change

Thirlwall's Balance of Payments Constrained Growth



- Thirlwall (1986) formalises Kaldor's two-stage two-sector model: *Balance of payments constrained growth*
  - Agricultural and export demand as the two main sources of autonomous demand
  - Early stages of industrialisation: demand agricultural sector
  - Later stages of industrialisation: export demand
- Growth of agricultural purchasing power given by the price of investment goods obtained per unit of agricultural output (i.e. terms of trade between industry and agriculture)
  - Lower industrial terms of trade, higher agricultural sector's growth rate, the higher *demand* for industrial output
  - Manufacturing *supply* positively related to industrial terms of trade: lower wages, hence increase in industrial profits that can be reinvested
- Equilibrium growth rate at which manufacturing sector growth is neither constrained by demand nor supply is given by the relative price level at which the two sectors' growth rates equalise

Post-Keynesian Theory and Structural Change

- Over time, exports will come to dominate demand from agriculture as source of autonomous demand and growth of the industrial sector becomes *balance of payments constrained,* summarised "Thirlwall's law":

$$y_{i,bop} = \frac{\hat{\varepsilon}\, y_{world}}{\hat{\pi}}$$

Income elasticity of demand for exports

Income elasticity of demand for imports

- Interpretation:
  - Export demand constrains a country's ability to pay for the imports necessary for (ongoing) production processes (especially capital goods)
    - Domestic investment demand can leak into imports for which current production capabilities have to pay in the form of exports
    - Exogenous rise in export demand might leak into disproportionate rise of imports
  - Pace of structural change constrained by world market demand for current domestic production
    - Structural policy questions: how to diversify economies
    - Systemic questions: why sluggish growth in global demand? Why volatile demand for certain products? Race to the bottom?

Post-Keynesian Theory and Structural Change

- Mobilising domestic sources of demand key challenge for late-industrialisers
- Formation of dynamic domestic markets *alongside* and *as a basis for* export growth important for successful structural transformation (Storm 2015, Storm and Capaldo 2018, Palley 2006)
- Consistent with PK theory and development experience of successful industrialisers
    - China: underpinned by an expansion of domestic-mass consumption sustained by a comparatively egalitarian income distribution (Lo and Zhang 2011)
    - South Korea: 53% of industrial output growth could be attributed to domestic demand expansion (Chenery, Robinson and Syrquin 1986)
- Anticipation of growing domestic consumer markets is also important driver of investment decisions of contemporary manufacturing businesses in Africa
    - see examples from Nigeria’s Dangote Business Conglomerate

Post-Keynesian Theory and Structural Change

Dangote's motivations to expand production: anticipation of growing domestic markets




- "Oil prices are inching up and the price of wheat is stabilizing. This should translate to increased *purchasing power* in the *local economy* and also facilitate our ability to manage our material cost better [Dangote Flour Mills Annual Report 2008]

- "NASCON Allied Industries Plc is Nigeria's leading refiner and distributor of household, food processing and industrial salt (…). We have recently expanded our product lines to include Tomato Paste, Vegetable Oil and Seasoning in a bid to *transform to a FMCG company*, ensuring that our products become staples in the homes of *millions of Nigerians*." [NASCON Annual Report 2016]

- [Dangote Tomato Paste] We entered into this product category in response to an identified supply gap within the Nigerian market where local production plus imports have been unable to effectively *meet local demand*. [NASCON Annual Report 2016]

- The influx of Nigerians to urban areas is a trend that increased the population's reliance on purchased food staples and supported the *growth in demand* of confectionaries, beverages and packaged food products, in which sugar is a major input. Yet, the anticipated effect on businesses did not materialise due to *subdued consumer spending*. [DSR Annual Report 2015]

Post-Keynesian Theory and Structural Change

Kalecki Pioneer of development thinking

- Kalecki's work little acknowledged in development circles but important contribution into factors constraining domestic demand growth
- Kalecki, Michal. 1954. 'The Problem of Financing Economic Development'. In *Collected Works of Michal Kalecki*, edited by Jerzy Osiatynski, Volume V Developing Economies:21–44. Oxford: Oxford University Press
- Kalecki's work questioned many aspects of modernisation and neoclassical development theory:

1. Questions that industrialisation impossible unless directed towards external markets
2. Questions necessity of low wages: instead rising wages stimulate domestic demand
3. Emphasises neglect of agriculture: difference between price formation in manufacturing & agriculture

Post-Keynesian Theory and Structural Change

Kalecki Pioneer of Development Economics

- Takes issue with the view that domestic markets too small
  - 3 main social classes: capitalists, workers and small proprietors
  - 2 sectors of production
    - Department I: produces investment goods
    - Department II: produces consumption goods (agricultural and non-agricultural)
  - In principle self-sustaining system: expansion of Dep I leads to increase in demand for consumer goods
- In practice no reason to assume automatic re-investment of profits:
  - Distribution between capital and labour
    - Income concentration and widespread monopolisation of economy (also Dutt 1984)
  - Class and power relationships influence formation of prices and purchasing power
    - Role of rural elites
    - Inelastic supply of food leading to fall in real wages
    - Benefits of price increases not accruing to small proprietors: no countervailing increase in demand for mass-consumption goods in countryside
- Result: “(…) increased profits will not be spent at all, or will be spent on luxuries.” (Kalecki 1954 [1993]: 29)

Post-Keynesian Theory and Structural Change

Kalecki Pioneer of Development Economics

- Solution:
  - Support the growth of effective demand
    - Limits to income redistribution through generalized rise of wages due to high degree of informality
    - Instead redistributive public spending favouring most vulnerable classes
    - State-led investment (deficit spending) to lead private sector investment
    - Financed through taxation on profits and the rich (reduce demand for imported luxuries, avoid speculative hoarding)
  - Necessity for institutional change in agricultural sector
    - cheap bank credit to peasants to improvements in the method of cultivation, small-scale irrigation, and cheap fertilizers

Post-Keynesian Theory and Structural Change

- PK theory provides a justification for why structure of production matters
  - Justification for why developing countries should attempt to promote structural change through targeted industrial and agricultural policies
- Demand growth can constrain structural change
  - Which factors constrain growth of domestic demand base?
    - Income distribution
    - Pre-capitalist class relations
    - Government spending
    - Operations of lead firms in GVCs?
  - Which factors constrain growth in export markets
    - Subdued growth in world demand: Income distribution and financialisation
    - Race to the bottom between developing countries: Fallacy of composition

Post-Keynesian Economics and the Role of Finance

- PK theory offers differentiated account of the role of finance in development differentiating functions of credit, identifying debt structures and processes by which balance sheets are kept liquid
- Unlike mainstream
  - Initially strictly positive relationship finance-growth (McKinnon 1973, Shaw 1973)
  - Market-failure approaches: Sequencing of financial liberalisation and micro-finance movement
  - After financial crisis: threshold anyalsis (Yilmazkuday, 2011; Arcand, et al., 2012)
- PK critical view on financial liberalisation
  - Minsky-type shift from hedge to speculative financing and boom bust cycles in Southeast Asia (see Kregel 1998, Dymski 1999, Arestis and Glickman 2002)
- PK scholarship on financialisation in developing countries
  - Developing economies exposed to dysfunctional forms of finance
  - Domestic institutions shape pressures towards financialisation and there are specific ‘mutations’ against pre-existing domestic context (Karwowski and Stockhammer 2017)
  - Subordinate role of developing countries in global financial hierarchy (Kaltenbrunner and Painceira 2018)

Post-Keynesian Economics and the Role of Finance

- Direct consequences of financialisation in developing countries:
  - In- and outflow of ‘hot money’: exposes them to banking and currency crises and prompting the costly accumulation of reserves (Kaltenbrunner and Painceira 2015)
- Replication of financialisation dynamics in developing economies
  - Non-financial corporations (NFCs) increasingly undertaking financial and often short-term oriented, speculative investments (Demir 2007, 2009; Kaltenbrunner and Painceira 2018; Karwowski 2018)
  - Households becoming increasingly indebted (e.g. mediated by micro-finance institutions, Bateman 2015)
- Out-sourcing of labour processes in Global Value Chains (GVCs) instrumental in setting in motion the shift in sources and uses of profits characterising financialized capitalism (Milberg 2008)
  - Hailed as a stepping stone to economic diversification and job creation (AfDB, OECD, and UNDP 2014; Staritz, Plank, and Morris 2016)
  - Yet ‘upgrading’ in GVCs difficult not least given lead firms’ logic of accumulation (Neilson 2014; Palpacuer 2008; Milberg and Winkler 2013)

Heterodox Institutionalist Alternatives

- Khan’s Political Settlement Approach: Understanding the state

Heterodox Institutionalist Alternatives

Khan's "Political Settlements" approach

- Power-based analysis of institutional creation and enforcement criticising New Institutional Economics
  1. Which institutions are really relevant?
     - Institutions that set strong incentives for firms to achieve advanced "organisational capabilities" in productive sectors
  2. Institutional enforcement depends on power-configurations in society:
     - Which individuals and groups are more likely to influence choices; how is their power distributed and organised within the state and the market
     - Need to understand history and context for that
- Distinguishes between 4 different types of political settlements based on degree of horizontal and vertical contestation of ruling party
  - Key idea: not to bring countries closer to 'ideal type' but that institutions (policies in place) have to match the political settlement (distribution of power in society)
  - What works in which context?

Heterodox Institutionalist Alternatives

The political settlements approach

From Khan (2010)		HORIZONTAL DISTRIBUTION OF POWER: EXCLUDED ELITES WEAK	STRONG
VERTICAL DISTRIBUTION OF POWER: LOWER LEVEL FACTIONS	WEAK	POTENTIALLY DEVELOPMENTAL DOMINANT COALITION RWANDA Longer-term horizons Implementation capabilities high	VULNERABLE AUTHORITARIAN COALITION
	STRONG	WEAK DOMINANT PARTY UGANDA, CAMBODIA Implementation capabilities weakened by multiple demands and 'blockers'	COMPETITIVE CLIENTELIST BANGLADESH, GHANA Shorter-term horizons: threat of powerful excluded elites Implementation capabilities weakened

Conclusions

Political Settlements Approach to institutions

- ○ What is in the interest of those who have power? How do these interests come about and change over time?

Post-Keynesian development theory

- Understanding formation of markets and demand
  - ○ Relevant for problem of structural transformation and situating past failures of ISI
- Understanding of money and finance
  - ○ Moving beyond simple finance-growth nexus or threshold analysis
  - ○ Manifestations and consequences of financialisation in developing countries

- Together useful starting points to uncover structural and systemic aspects of development