NEW PATTERNS OF MACRO-ECONOMIC GOVERNANCE

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THE KEYNESIAN VISION

Never Again

When Keynes set to work in 1940/41, at the time of a desperate fight for survival of democracy, to draft the documents which would become basic inputs to the Bretton Woods Conference held in 1944, his objectives can best be understood as negative - in the sense of negating the experience of the Great Depression of the 1930s. The overarching principle was: 'Never again!' - never again anything like the 1930s. Then there was heavy unemployment - so the new objective must be full employment as a top priority (and Keynes had shown in 1936 in his famous General Theory of Employment, Interest and Money what the instruments of a full employment strategy should be). In the 1930s there had been a breakdown of internationally agreed trade and investment rules - so the new objective was to prevent beggar-my-neighbour policies and manage the world economy according to agreed rules. The 1930s had seen first futile attempts to maintain the gold standard, then its collapse and competitive currency devaluations - so the new objective was to have stable currencies with agreed adjustment procedures. The 1930s had been a period of deflation - so the new objective was expansionary macro-economic policies. The 1930s had seen a collapse in commodity prices - the new objective was to stabilise and maintain commodity prices. The 1930s had been a period of rising protectionism, and narrowly national scrambles to achieve self-sufficiency and balance of payments surpluses - so the new objective was to move towards liberal and agreed rules for expanding world trade and to support countries in balance of payments deficit. Above all, the 1930s had seen the withering away of the League of Nations - so the need was to build a new and stronger United Nations to provide the political and social security indispensable for an expanding world economy.

All these objectives were interrelated in Keynes' coherent vision of a better and sustainable world system. For example, the provision of adequate liquidity and the discouragement of trade surpluses also served the objective of full employment: a country in balance of trade deficit helps to produce the public good of full employment since it creates excess demand for goods from the rest of the world. By the same token, the surplus country is the enemy of the world economy in that its failure to import sufficiently reduces employment in the rest of the world; hence, the importance of proper liquidity in the world system and an appropriate recycling of surpluses.

However, of all these objectives that of full employment was the top priority. An expanding economy with full employment of productive resources, especially human resources, would be the rising tide which would 'lift all boats'. Anticipating some of the following discussion, we may at this point reflect that the objective of full employment has certainly a more human face and a more direct relation to human security than control of inflation which was to take its place as a top priority in later years. This connection was clearly in the minds of the founders of the United Nations: the US Secretary of State, in his Report to the President on the 1945 San Francisco Conference stated: 'No provisions that can be written into the Charter will enable the Security Council to make the world secure from war if men and women have no security in their homes and their jobs.'

Keynes was deeply influenced by the Beveridge Report which was published in the same year, 1942, as his own 'Memoranda' crystallizing his thinking and basic proposals for Bretton Woods. The Beveridge Report embodied the objective of a social welfare state on a national basis (for the UK), but the principle of social security, with safety nets, protection of vulnerable groups on and income transfers to the poor, was readily transferable to an international dimension. Keynes had collaborated in the preparation of the Beveridge Report and was an enthusiastic supporter.

Thus the key elements of the Keynesian vision were: global macro-economic management by established and agreed institutions with growth, full employment and avoidance of deflation as top priorities; prevention of beggar-my-neighbour policies and encouragement of international co-operation to the common advantage; achievement of greater equality, social security and protection of vulnerable groups, both within countries and internationally across countries.

It is a matter of historical significance that the new post-war international order was established not as a unified process but in two separate steps. The first step was the creation of the Bretton Woods system, with the Bretton Woods Conference of 1944 as its landmark. The second step, a year or so later, was the creation of the United Nations, with the 1945 San Francisco Conference as the landmark. Both the fact that the two systems were created by separate processes, and also the fact that the Bretton Woods system preceded the UN system, are important and created a number of subsequent problems. [1]

The Bretton Woods Tripod

Taking the Bretton Woods system first, the structure envisioned was that of a tripod resting on three legs. In 1942, still at a critical stage in the war, Keynes had produced three famous memoranda respectively on an International Clearing Union, an International Investment Fund and on International Buffer Stocks for Commodities. These three sets of proposals ultimately crystallised in three institutions: the IMF, the IBRD or World Bank and GATT (replacing the stillborn ITO). However, in this process of institutionalisation the original proposals were heavily watered down and in some respects distorted.

(a) The IMF

The IMF was initially envisaged by Keynes as a world central bank, issuing its own reserve currency, or 'bancors'. (The World Bank was envisaged as an investment fund - hence the statement that the Fund should have been a bank and the Bank should have been a fund.) It was to be a powerful institution with resources equal to one half of world imports - under present circumstances this would have meant a Fund of $2 trillion (2 million million dollars!). The Fund was supposed to put strong adjustment pressures on the surplus countries which threatened the rest of the world with deflation and unemployment and shift general liquidity to the deficit countries which helped to maintain full employment and expansion in the rest of the world. For this purpose Keynes proposed penal action against surplus countries in the form of a tax (negative rate of interest) of 1% a month on outstanding trade surpluses. One need only list these elements of the original vision to see to what extent reality has diverged from it. Some of these divergences, e.g. the failure to create sufficient liquidity in the form of SDRs or the asymmetrical pressure on deficit countries rather than on surplus countries are now the starting point of reform proposals. Above all, the objective of fixed exchange rates which was at the heart of the original proposals was abandoned in 1971 and we now have a regime of effectively floating exchange rates and widespread currency instability.

In the process of shifting the weight of its pressures to the poorer deficit countries depending on its support, the IMF also became an influence in the direction of monetarist, deflationary and restrictive policies with control of inflation, expansion of exports and debt servicing as primary objectives, rather than the full employment maintenance of import capacity and avoidance of debt burdens in the original vision.

(b) The World Bank

The investment fund - which became the World Bank - was supposed to do the major recycling of capital from capital-surplus countries to poorer capital-deficit countries. This was based on the optimistic assumption that the marginal efficiency of capital in capital-scarce countries must be very high compared with the capital-rich countries; hence there would be a large reservoir of highly profitable projects in what we now call the developing countries and a natural incentive for capital to flow in their direction. It was only a question of identifying and designing these projects and creating the institutional framework for organising the flow by borrowing in the rich countries and lending to the poor. Repayment would be assured by the high profitability of the projects. This would be sufficient to reduce poverty and implement the international aspect of the Beveridge concept of social security.

The role of the World Bank was to be clearly distinct from that of the IMF. The IMF was a monetary institution with an emphasis on short-term equilibrium, the demand side of the economy, and programme lending; by contrast the World Bank was to be a development institution with emphasis on the long-term, the supply side of the economy, and project lending. While this distinction seemed clear-cut in the initial conception, subsequent developments have eroded it. In the case of the World Bank, the limitation to project lending proved to be difficult to reconcile with its envisioned big role in development. This was partly because of the labour-intensive and time-intensive process of identifying, designing, implementing and monitoring of projects, and partly because it became increasingly clear that the success of projects depended not so much on the quality of the project as on the economic policy environment in which the project had to operate (which was supposed to be the sphere of operations of the IMF). Moreover, contrary to the initial optimistic assumptions, it turned out that in the poorer countries there were not sufficient projects which were profitable at non-concessional rates of interest and generated resources sufficient to service the loans. Hence the World Bank (like the IMF) was driven towards offering concessional facilities and beginning to operate as an aid organisation.

As a result of having to deal with the debt crisis and other harmful external impacts on developing countries during the 'lost decade', the World Bank in its structural adjustment programmes was also moving from long-term lending to medium-term lending, while the Fund with its own structural facilities was moving from short-term lending to medium-term lending. Thus there was an increasing `grey area' of medium-term policy-based programme lending in which the division of functions between the Bank and the Fund was far from clear.

The debt crisis and its move into structural adjustment lending also meant that the Bank (as well as the Fund) took on the role of debt custodian. The original intention, by contrast, had been that the Bank (and Fund) should be the custodians of an international order in which the debt crisis would not have arisen in the first place.

(c) The ITO/GATT

The third leg of the tripod of the Bretton Woods system was supposed to be the International Trade Organisation. Although this was not negotiated at Bretton Woods but three years later at Havana (1947-48), its establishment was already confidently anticipated at Bretton Woods and the Terms of Agreement of the IMF and World Bank were drafted on this assumption. In Keynes's vision, the ITO was an essential part of the Bretton Woods system. Among its essential features was included the negotiation of commodity agreements - Keynes for many years had been a strong believer in the need for stabilisation of commodity prices. As negotiated in Havana, the charter of the ITO included chapters on: Purposes and Objectives, Employment and Economic Activity, Economic Development and Reconstruction, Commercial Policy, Restrictive Business Practices, Intergovernmental Commodity Agreements, Institutional Aspects of an ITO, the Settlement of Differences and General Provisions. The far-reaching scope of the ITO - much beyond the scope of the present GATT - will be evident from this list. Apart from commodity agreements, it included employment, restrictive business practices, economic development, and it also provided for a close relationship with the United Nations (which by that time had been established). Among its purposes was also 'to encourage the international flow of capital for productive investment' and improvement of labour standards where the ITO was expected to work closely with the ILO. In commodity agreements, the ITO was to secure 'such prices as are fair to consumer and provide a reasonable return to producers'. It is clear that the ITO, if established, would have been a very powerful organisation, even overshadowing the IMF and World Bank.

In the event, the ITO was never established. It lapsed in 1951 when it became clear to the US administration that the US Congress would not ratify the Charter as negotiated in Havana. Here is a clear gap in the system as envisaged at Bretton Woods. By the time that it was clear that there would be no ITO Keynes was dead. He had left Bretton Woods - like everybody else - in the firm belief that the ITO would be established. It is an open question whether he would have been satisfied with the outcome of Bretton Woods if he had known that there would be no ITO.

Pending the ratification of the ITO, in 1947 a `Protocol of Provisional Application' was adopted - the present General Agreement on Tariffs and Trade (GATT). This provisional arrangement has now lasted for 46 years - rien ne dure que le provisoir! GATT clearly covers only a part of the functions of the ITO. Moreover it is not an institution like the IMF or World Bank defining and implementing precise norms, but it is in the nature of a negotiating or consulting mechanism engaging in a number of 'rounds' of negotiations aiming at trade liberalisation. There is however a proposal now on the table in the Draft Final Act of the current Uruguay Round to establish a full organisation (a Multilateral Trade Organisation or MTO). This proposal, like the Uruguay Round itself, is however still in the balance at the time of writing. Even if the MTO is successfully established, it would have much narrower functions than the ITO. Moreover, in a significant shift illustrating the difference between 1947 and 1993, the MTO would not be linked with the UN as the ITO was supposed to be but with the Bank and the Fund.

Apart from filling part of the gap created by the non-ratification of the ITO with GATT, in 1964 UNCTAD was established which also took up some of the ideas behind the original ITO Charter, i.e. in its integrated programme for commodities. But UNCTAD remained a forum for discussion and formulation of new ideas. It remained an integral part of the UN and was not a separate institution. The present situation can only be understood against the background of history, with the rest of the ITO agenda - insofar as it did not go to GATT - scattered over the rest of the UN system. The subsequent discussion of restructuring the system will have to concentrate on GATT and the proposed MTO.

(d) The United Nations: Global Governance

The ITO is not the only gap compared with the original vision. Although at the time of Bretton Woods the United Nations did not yet formally exist, it was already on the horizon and it was clearly envisioned as being the locus of global macroeconomic governance. The need for such a locus was inherent in the 'never again' approach to avoid the unemployment and other disasters of the 1930s. The UN was considered the obvious place for global governance because avoidance of the events of the 1930s was seen by everybody concerned at the time as crucial for the maintenance of peace and avoidance of war. The organs for global economic governance were defined the year after Bretton Woods - in 1945 - when the UN Charter was agreed as being the UN General Assembly and the Economic and Social Council (ECOSOC). The UN was also to be equipped with a fund for aid to developing countries - a little later the Marshall Plan served as a precedent.

In the event, this did not materialise for reasons discussed in the section on The Bretton Woods Institutions and the UN. The UN was limited to technical assistance and food aid, while multilateral financial aid was allocated to the World Bank (and to a minor extent the IMF). The function of global governance went partly to the Bretton Woods institutions and partly outside the UN system altogether to the G-5 or G-7 and the OECD. Thus the Bretton Woods system - apart from being incomplete due to the lack of the ITO - also in the event lacked the envisioned essential fourth leg of global governance in the UN. In addition to being incomplete, the system also operated in a way quite unforeseen in the original vision and in some ways heavily distorted away from it. Today we are seeing a need to restructure the system. The original vision is still valid in indicating to us directions which restructuring should take.

Did the Keynesian Vision have a Human Face?

The answer to this question - comparing the Keynesian vision with the present reality - is yes and no. Let us take the 'yes' first.

As emphasised in the preceding part of this paper, the guiding star of the Keynesian vision was: 'Never again!', i.e. by all means avoid the miseries of the Great Depression of the 1930s. These miseries were not only economic but human miseries, in the form of heavy unemployment, social insecurity, starvation wages and a heavy incidence of poverty. Avoiding a repetition of this traumatic experience was therefore conceived as a humanitarian as much as an economic necessity.

The establishment of full employment - abolition of unemployment except for an inevitable minimum - as a dominant objective was in itself a human and social orientation, relating to job security as well as participation and avoidance of social marginalisation. The objective of full employment is certainly more closely directed towards human resource-oriented development than the objective of control of inflation and avoiding balance-of-payments deficits which has presently largely replaced it.

The expansion of productive employment which was the main Keynesian objective is today recognised as one of the three core themes of the World Social Summit, in addition to poverty reduction and enhancement of social integration. Full employment is also closely interrelated with these other two objectives. The unemployed and their families are being integrated into the social fabric. Moreover, as the 25 years of full employment Keynesianism 1946-1971 have demonstrated, full employment makes foreign immigrants welcome as an essential addition to the labour force and prevents the rise of xenophobia and racialism. With full employment, the new immigrants are quickly integrated into the economic and social life. In more recent years, with the abandonment of full employment strategies, we have seen all this happening in reverse.

The link of full employment with poverty reduction is equally clear: the unemployed will normally be among the poorest families and their poverty is alleviated by obtaining employment. There may be a certain reduction in real wage rates for those already in previous employment, but if this occurs it would be amply compensated by increased opportunities for upgrading, promotion and overtime earnings. Moreover, government revenue would be increased by high taxable profits and incomes from employment which would help to support social services and the financing of social safety nets. All in all, although full employment would bring cross-currents of redistribution among as well as between social groups, it is a positive sum-game. With proper social arrangements the losers could be compensated leaving the rest better off than before. The high rate of investment and pressure on available resources would also stimulate technological innovation and thus contribute to higher future growth rates.

Keynes was also deeply involved with the Beveridge Report of Social Security For All, establishing the framework of a Social Welfare State, which appeared in 1942, the same year as Keynes's three original memoranda for the Bretton Woods triad of IMF/WB/ITO. While the Beveridge Report was not formally part of the Bretton Woods agenda, Keynes was an enthusiastic supporter, having closely collaborated with Beveridge in its formulation. Thus the idea of a social safety net with universal coverage and protection for the most vulnerable groups - the young, the old, the ill and all other groups outside the labour market as well as the chronically unemployed - was fully embraced by Keynes. It is true that this was on a national basis, more directly for the UK. It is also true that Keynes's initial interest in development problems was weak - too weak to embrace the idea of an international welfare state. But he held that the principles of the Beveridge Report were moral principles which should apply even - or perhaps especially - in the reduced economic circumstances of the UK during and immediately after the war.

In his essay: 'The Economics of our Grandchildren' Keynes had approached the idea of an international welfare state indirectly and implicitly, but nonetheless unmistakeably. He argued there that as the richer countries became richer and richer, very little value would be attached to further wealth accumulation; instead, additional resources provided by technical progress would be devoted to charity as well as increased leisure-time spent on cultivating the arts. Although he did not mention this explicitly he would readily have agreed that while the charity he had in mind might begin at home it need not and should not end at home.

It was well-known to Keynes and his circle that the Western concept of unemployment, based on full-time public sector jobs, would not be directly applicable without modification to, for example, rural people in marginal environments or more generally to developing countries with large informal sectors. Indeed, conditions resembling the informal sector of developing countries were recognised to exist even in advanced industrial countries and were covered by the concept of 'hidden unemployment' (developed by Joan Robinson) or 'underemployment'. In the 1970s it became the standard view that the real problem of developing countries was poverty rather than unemployment. This was particularly strongly argued by the ILO Employment Mission to Kenya[2] which established the concepts of the informal sector and of the 'working poor'. Since then, there has been a synthesis of the specifications of poverty and unemployment respectively as the chief problem, embodied in the policy objective of increasing 'productive employment'. In this qualified form, employment has been re-established as a key objective, with the further proviso that it has to be supplemented by social safety nets for groups not capable of employment. The qualified objective of productive employment makes the human-oriented character of the objective even more explicit by linking it with the objectives of poverty reduction and increase in human welfare. [3]

Having said all this, in support of the thesis that the Keynesian vision of an expanding full employment world economy was essentially human-centred, we now enter into a more doubtful area. In the first place, it is certainly true that Keynes and the Keynesian consensus treated unemployment more as an economic waste and economic folly than as an offence against human-centred development. He used the language of a professional economist, not of a social reformer. The latter role he left to his involvement in the Beveridge Report and to his more peripheral writings. However, since the economic waste and the human waste of unemployment coincide, perhaps not too much need be made of this particular distinction.

More serious is another divergence of the Keynesian vision from our present emphasis on human-centred development. The Keynesian vision of full employment growth was in terms of full-time paid jobs, leaving little room for preferred part-time employment ("disguised unemployment"), flexible employment arrangements, working from home nor indeed was women's work at home or in raising children recognised as productive employment. In all these respects, the Keynesian approach is at odds with current emphasis on flexible labour markets and, in particular, the notion that only paid work has value.

Thirdly, the Keynesian picture of full employment neglected the rural-urban relationship crucial in developing countries. If employment in the urban/formal sector increases, there is intensified migration from the low-income rural areas. If the income gap between rural and urban incomes is high, it becomes rational for rural workers to run the risk of unemployment in the town for the sake of a chance of a well-paid urban job. Thus for every new job created in the urban sector, there may be several new migrants and unemployment may actually increase (Harris-Todaro model). Thus a full employment policy may have to be concentrated on rural employment opportunities and the reduction of the rural-urban income gap.

The main instrument in the Keynesian system for achieving and maintaining full employment was demand management by active macroeconomic government intervention; and the main objective of this active government intervention was the maintenance of a high level of investment, both private and public. This is most clearly expressed in the Harrod-Domar formula which links the Keynesian system with development economics, by defining the conditions for sustained and sustainable full-employment growth. The H-D formula analyses this growth as a function of the rate of investment (or saving) divided by the capital/output ratio. Thus stated, this is a simple tautology - telling us that if the rate of investment is for example 15 per cent and the capital/output ratio is 3:1 (indicating an efficiency of investment of 33.3 per cent), then the rate of growth will be 5 per cent. In this formulation, the approach could appear mechanistic and abstract, since the 'investment' is clearly perceived as physical investment, in terms of 'bricks and mortar'. There is no indication here of the concept of human investment or human capital formation which today is universally accepted as an important element in total investment.

The H-D formula can easily be interpreted - or misinterpreted - as a form of 'capital fundamentalism'. 4 When linked with models like that of Arthur Lewis embodying the concept of surplus labour, it easily leads to the notion that capital is the only scarce factor and sets the limit to development. Even when 'human capital' is added it may lead to a limited view of human capital, limited that is to what promotes the more efficient use of the ultimately decisive factor of physical capital. In education, this could lead to stress on high-level skills needed to operate modern technology, with insufficient concern for the primary and secondary educational infrastructure. Even though this would not have reflected the views of Keynes or H-D, it is undeniable that it influenced development practitioners of 'capital fundamentalism' during the period of the Keynesian consensus.

Capital fundamentalism or investment fundamentalism had implications for income distribution not conducive to a 'human face', once a state of full employment was approached. If the key to growth lies in investment, savings must be increased. This puts a premium on shifting income to richer groups with a higher capacity and propensity to save. (Indeed, the fashionable Kuznets curve indicated that this was a normal process in the earlier stages of development). This view not only run counter to objectives of poverty reduction, it specifically neglected the importance of asset acquisition by poorer people as a means of increasing economic (and human) security.

However, there are two qualifying factors which make the H-D formula approach appear more human and less mechanistic that it might appear at first sight.

(a) The all-important capital/output ratio in the denominator of the simple H-D equation measures the efficiency or rate of return of investment. It is perfectly compatible with the Keynesian system to argue that the capital/output ratio is partly, mainly, or almost wholly determined by labour productivity which in turn is the result of human investment in health, education, training, etc. It is perhaps a pity that these factors were not specifically identified but instead tucked away in the denominator under such a neutral term as 'capital/output ratio'. 5 But at least a proper interpretation of the H-D formula shows that the human factor has not been eliminated from the picture.

(b) The H-D formula identified per capita growth rather than aggregate growth as the objective; hence the rate of population growth was introduced as a negative factor, deducted from the rate of investment (or saving) divided by the capital/output ratio. 6 The population factor clearly introduces an element of human development. The H-D formula opens up the possibility that the desired objective of higher per capita growth can be achieved by slowing down the rate of population growth. This is particularly relevant for developing countries and forms an integral part of a human-centred view of development. The consensus today is that human investment particularly improved literacy and education for women, can be an important factor in reducing the rate of population growth.

(c) Within the context of keynesian full-employment macroeconomics, investment (or saving) is achieved, not by cutting consumption - which would reduce human welfare and could reduce human capital formation - but by increasing total resource utilization. Investment and consumption increase together, by way of increases in total income. It is only when the condition of full employment and full resource utilisation is reached that choices between investment or consumption have to be made.

Summing up, we can say that the Keynesian growth system, while it certainly was mechanistic, and did not explicitly mention the human driving forces, yet it is capable of incorporating the present view of human-centred development without forcing us to abandon the system. There are however new elements other than people and population which are missing from the Keynesian vision. Social integration may perhaps be considered as at least partially taken into account through full employment. However such elements as the environment, the role of women, and the question of human rights, which now form an integral of our concept of development, were clearly not represented in the Keynesian vision (nor in the neo-liberal counter-vision which displaced the Keynesian consensus in more recent years). Thus we may say that the Keynesian vision is still valid, with the addition of some new issues such as the ones just mentioned.

1. See the subsequent section on 'The Bretton Woods System and the UN System'

2 . Employment, Incomes and Equality in Kenya - a strategy for increasing productive employment in Kenya, International Labour Ofice, Geneva, 1972. The reference to 'productive employment' in the sub-title already foreshadowed the 'synthesis' mentioned in the text.

3. There is a parallel between the qualification of the full employment objective as 'productive employment' and the qualification of the growth objective as 'labour-intensive growth' or an 'appropriate pattern of growth'. In the qualified forms of 'productive employment' and 'labour-intensive growth', the growth and employment objectives clearly come close together.

4. Yotopoulos and Nugent: Economics of Development - Empirical Investigations, Harper and Row, New York, 1976, p12.

5. The 'residual factor' of increasing total factor productivity (TFP) through technical progress is also not specifically identified in the H-D formula.

6. G = I(S) -p, where ICOR is the Incremental Capital/Output ratio. ICOR