ECO 403 – L0301
Developmental Macroeconomics

Lecture 1
The Theoretical and Methodological Framework

Economic Models and the Great Recession

- We failed to ***prevent*** and ***forecast*** the downturn and to ***respond*** to it
  - Due to unhelpful ***models*** based on wrong ***assumptions***

- ***Unfettered markets*** are ***not efficient*** when there exists market failure

- ***Macroeconomic models*** before the crisis underestimated market instability
  - They focused on ***exogenous shocks*** but many shocks are ***endogenous***

- We need ***new models*** to understand the ***real world*** and design appropriate ***economic policy***

The Theoretical Framework of Developmental Macroeconomics

- ***Macroeconomics*** and ***Development Economics*** are usually studied separately
  - This course integrates both perspectives
- The approach is associated with ***Keynesia***n and ***structuralist development*** macroeconomics
  - It combines the working of markets with government intervention
- ***Developmental Macroeconomics*** applies mainly to middle-income developing countries
  - But also to small, ***resource-rich***, developed countries such as ***Canada***

The Market vs. the Public Sector

- Should we use the ***market*** or the ***public sector*** — i.e., the *state* — to solve socio-economic problems?

- According to market-advocates, the market makes the "best" allocation of resources
  - The market outcome is an ***equilibrium*** (i.e., it cannot be improved by the action of market forces)
  - But is this equilibrium an ***optimum***?
  - Can state intervention improve this market outcome?

- What is the ***role of the state*** in the determination of economic outcomes?

The Market vs. the Public Sector (cont'd)

- The ***state*** has always been at the centre of the study of economic ***development***

- For ***modernization theory***, the state is ***benevolent*** and ***pluralistic***
  - The ***state*** complements and promotes ***markets*** for the benefit of society

- For ***Marxism***, the state is a reflection of ***class*** conflict
  - The state complements and promotes markets according to the interests of the ***ruling classes***
  - The state acts as the ***collective*** capitalist

An Extreme Pro-Market View

- The view of the role of the state in economic development changed with the emergence of ***neoliberalism*** (i.e., of the ***Washington Consensus***)

- Neoliberals see the state as being based on the pursuit of individual self-interest through ***political*** as opposed to ***market*** means
  - Source of ***rent-seeking*** and ***corruption***

- Two ***propositions*** followed:
  - The ***state*** should be confined to a ***minimal*** level of activity
  - Economic ***development*** is an inevitable consequence of the reliance on ***market forces***

A More Moderate Pro-Market View

- A less extreme pro-market position accepts that government intervention ***may*** improve outcomes when there is ***market failure***

- ***Market failure*** refers to two possible situations:
  - Something prevents the emergence of a market
  - For some reason (e.g., externalities), markets do not produce an optimum

- Existence of market failure is viewed as a ***necessary*** but not ***sufficient*** condition for government intervention

- ***Developmental Macroeconomics*** takes a moderate pro-market view

Theoretical Method of Analysis

- ***Developmental Macroeconomics*** and ***Neoclassical Macroeconomics*** adopt different ***methods***

- ***Developmental Macroeconomics*** follows the ***historical tradition*** and uses the ***empirical*** or ***historical-deductive*** method
  - ➢ It makes generalization from ***observed regularities***
  - ➢ It takes into account behaviour of real ***economic agents*** and ***policymakers***

- ***Neoclassical Macroeconomics*** follows the ***hypothetical-deductive tradition*** and uses the ***hypothetical-deductive*** method
  - ➢ It makes generalization from ***axioms***
  - ➢ It takes into account the behaviour of ***"homo economicus"***

Assumptions of the Developmental Macroeconomics Model

- Markets are unable to keep macroeconomic balances due to insufficient ***demand*** and insufficient ***access to demand***

- Insufficient demand and access to demand keeps the ***rate of profit*** low and thus ***investment*** expenditure is also low
  - Thus the economy does not produce at full employment

- Imports, exports, investment, savings, and inflation all depend on the ***exchange rate***

- The ***exchange rate*** connects or disconnects the ***efficient firms*** from ***domestic*** and ***international markets***

Overvaluation of the Currency

- Tendency in developing countries towards a cyclical and chronic ***overvaluation*** of the domestic ***currency***
  - If not neutralized, macro prices will be out of equilibrium

- If the ***currency*** is overvalued,
  - The ***real wage rate*** will be artificially high
  - The ***expected rate of profit*** will be low

- Overvalued currencies are associated with high ***rates of interest*** and low ***rates of inflation***
  - Overvalued currencies are associated with ***recessions***
  - Overvalued currencies benefit the ***rentier*** capitalist at the cost of the ***productive*** capitalist

Balance of Payments Crises

- ***Developing countries*** tendency to the ***overvaluation*** of the exchange rate is due to:
  - ***Dutch disease***
  - ***Foreign credit*** being used to finance domestic expenditure

- ***Developed countries***' debt is denominated in its ***own currency***
  - Thus typical ***financial crises*** in developed countries are ***banking crises***

- ***Developing countries***' debt is denominated in ***foreign currency***
  - Thus typical ***financial crises*** in developing countries are ***currency*** or ***balance-of-payments crises***

Developmental Macroeconomics vs. Keynesian Macroeconomics

- In addition to insufficiency of ***demand***, there is insufficiency of ***access to demand***
- Rather than the ***budget deficit*** and the ***rate of interest***, the key variables are the ***current account*** deficit/surplus and the ***exchange rate***
- Not only the ***real rate of interest*** is too high during recessions, the ***currency*** is also ***overvalued*** and the ***expected rate of profit*** is ***depressed***
- Rather than current account ***deficits***, developing countries should aim at current account ***surpluses*** when facing ***Dutch disease***

Developmental Macroeconomics vs. Structuralism

- Middle-income developing countries are not characterized by having ***"dual"*** economies, but rather by being indebted in ***foreign*** currency
- Emphasis on ***industrialization*** is downplayed since it is already assumed
- The need for ***capital account*** surpluses is replaced by the need for ***current account*** surpluses
- While ***industrial*** policy is important, the key is ***exchange rate*** policy

The Process of Economic Development

- Economic ***development*** implies increasing ***productivit***y and improvement in ***standards*** of living

- Productivity increase could take place in the same product or in transferring labour to technologically more sophisticated goods

- ***Wages*** are determined in the long run by ***costs of production*** of wage goods and by ***social*** and ***historical*** conditions

- For ***Developmental Macroeconomics***, in the long run the ***rate of profit*** is constant and ***wages*** are the residual
  - ***Wages*** rise proportionately with ***productivity***
  - Since mid-1970s, ***wages*** are growing more slowly than ***productivity***