MACROECONOMIC POLICY ENVIRONMENT: SOME OBITER DICTA[1]

Visiting Professor, B. N.GHOSH
Institute of Management and Technology,
Govt. of Kerala (CAPE), Alleppey (India)

Abstract: The article analyses the political economy of macroeconomic policy making, and the implications of policy conflicts, political business cycles, fiscal deficits and various types of politico-economic instability, market imperfections and inefficiency in governance. It concludes that macroeconomic policy making is the outcome of struggles among competing political forces, pressure groups and vested interest.

Keywords: Macroeconomic policy, political economy, fiscal deficits, politico-economic instability, inefficiency in governance

Özet: Bu çalışma politik ekonomi açısından makroekonomi politika oluşturma, uygulamada karşılaşılan politik ihtilafları, politik konjonktürel dalgalanmalar, mali açıklar ve çeşitli türdeki politik ekonomik istikrarsızlık, piyasa eksiklikleri ve etkin olmayan yönetimi analiz etmektedir. Çalışma makroekonomik politika oluşturmanın birbiriyle rekabet eden farklı politik güçlerin, baskı gruplarının ve görünen çıkarların bir sonucu olduğunu vurgulamaktadır.

Anahtar Kelimeler: Makroekonomik politika, politik ekonomi, mali açık, politik-ekonomi istikrarsızlık, etkin olmayan yönetim

1. INTRODUCTION

In the movie *Gone with the Wind*, Rhett's last words, "My dear, I don't give a damn" seem to be final words of a modern-day policy maker who is

[1]The present article is a modified version of a chapter in my forthcoming book (2013), *Economic Environment of Business*, Oxford University Press, New Delhi.

invariably a politician. A politician does not often bother about the fate of his country and countrymen as does a statesman. In fact, there is a fundamental difference between a politician and a statesman. Whereas a politician looks for the future election, a statesman looks for the future generation. Macro policy making in any country is often mixed with and influenced by political considerations.

Politicians generally maximize the benefits of short-term gains that can be realized through elections. They are often considered to be myopic their policy formulation and implementation. Thus, the political economy of macroeconomic policy is an interesting and realistic area of study in macroeconomics. Fortunately, most economists in the academic profession have come to realize that good economic advice needs an understanding of the political economic situation and they are now doing their analysis explicit, rather than implicitly as used to be the case a few decades ago (Rodrik, 1996: 38). Political economy argues that macroeconomic policy-making is the result of political struggle within an institutional structure and that policy making is significantly influenced by political factors (Alesina and Perotti, 1994: 351).

The basic purpose of the present paper is to pinpoint several cases by way of interpreting the areas where political rationality gets conflated with economic necessity in the shaping of macroeconomic policy in both the developed and the under-developed countries (Ghosh, 2007).

2. MEANING AND NATURE OF MACROECONOMIC POLICY

A Macroeconomic policy may be defined as a set of rules which can be utilized to achieve certain desired goals (objectives). There are two types of macroeconomic policies: monetary policies and fiscal policy. Macroeconomic policy is a type of economic policy by which the authorities try to achieve certain objectives with the help of given instruments. Macroeconomic policy is designed to modify or regulate the economic management of the country with reference to the given objectives. Any macro policy attempts to assess the behavior of an economy as a whole and tries to find out ways in which the aggregate performance of the economy may be improved.

The theory of macroeconomic policy can be regarded as a part of positive economics in the sense that it can predict certain consequences of particular policy changes in a way which can be subjected to empirical verification. Secondly, it can also predict the policy changes themselves as a function of certain economic variables. Thus, a macroeconomic policy can predict the effects of government expenditure on national income and so on. Macroeconomic policy is concerned with the analysis of the existing behavior of an economy, *i.e., with what is*. In the same way, a macroeconomic policy can also be normative in character. It may be concerned with certain propositions that if a particular type of objectives is to be attained, the policymaker should

go in a certain way. Similarly, when we say that the policy should be like this or that, we are making the policy normative in character. The normative positions are concerned with *ends* and use the word, *should.* The theory of macroeconomic policy is normative in the sense of presenting particular ends, or saying what the ends of the government should be. In a sense, macroeconomic policy, in its normative perspective, falls in the realm of welfare economics. The policy is also positive because it is empirically testable.

An administrator should be able to analyze the consequences of a policy and should also be able to formulate policies when necessary. A public policy may be micro in character. Micro policy is designed for a specific or local area, but a macro policy has far wider application. It may be employed in the whole polity or the whole economy. It is essential to know that macro political or macroeconomic policy objectives are bound to have many common grounds. Needless to say, economic policy is an important part of public policy. Thus, a public will essentially incorporate many economic issues and desiderata. By now it is clear in the minds of economists that macroeconomic policy is both necessary and feasible. In fact, a great deal of writing in the past 20 years or so has pointed out the difficulty in economic policy making, especially when the economy has a dynamic stochastic nature. In such a case, the policy making of the government may bring more harm than good. However, macroeconomic policy does not imply that a policy is always feasible.

3. WHY DO WE NEED A POLICY?

The need for a macroeconomic policy arises for a number of reasons.

First, the economic system, being free, does not automatically adjust itself in a suitable way to the different shocks which may appear in an open economy. A policy is necessary to adjust the economy to various shocks and disturbances.

Second, a policy is necessary to quicken the process by which the economy can attain the desired goals. If no policy is taken up, it may take a long time to attain the objectives. In other words, a policy is needed, when the economy is going either too slow or not in the proper direction.

Third, a policy may be needed for eradicating the unnecessary disturbances in the economy, like inflation and unemployment. A policy may be introduced to influence the working of the system which is desired or to eliminate certain undesirable situations. Such situations are very much possible in a dynamic economy where the system of information is imperfect and the situation is highly uncertain.

Fourth, macroeconomic policies are sometimes necessary to have occasional far-reaching structural changes in the economy, which can assist the automatic working of the system.

Lastly, a macroeconomic policy is essential to correct major deviations from the desired state of affairs. It may also be helpful for the fine tuning of the economy. Recently, in most of the developing countries, macroeconomic policy is mainly designed to achieve with the shortest period of time a desired pattern of economic growth.

Targets and Goals of Macroeconomic Policy

In the case of macroeconomic policies, the policy actions do not immediately affect the goals. There are various types of uncertainties and disturbances which will result in delay and distortions. Moreover, there are many types of information gaps. So it is necessary to have some types of proxies for knowing the goals. These proxies can be called targets of a macroeconomic policy. While the indicators of a monetary policy are high-powered money, bank liabilities and assets, and short-term rate of interest, the targets of a monetary policy are money supply, bank credit and long-term interest rate. It should be noted that the targets of a macro policy must be related to indicators and goals. The targets should be observable and also capable of being affected by the policy actions. It is observed that certain variables cannot immediately respond to policy changes. This is the reason why we should use *intermediate variables.*

However, in order to be operationally meaningful, Tinbergen has stated that the number of policy instruments should be the same as the number of targets; otherwise, some of the targets may not be achieved at all. Another very important implicit assumption in a macro policy is that all policy instruments are independently variable and they exercise differential impact on target variable. In other words, no two policies are supposed to have the same impact on the target variable. If this condition is not fulfilled, all targets may not be achieved, even if the number of instruments remains the same as the number of targets.

Source: Ghosh, B. N. (2012), *Modern Macroeconomics*(ch.35), Ane Books, Delhi

4. WHY DO POLICYMAKERS DIFFER?

A question is often posed: if policy making is supposed to be a science, then why do policymakers agree to differ with one another in the matter of policy? Disagreement is sometimes essential among the public policymakers;

otherwise, there would be no frontiers to their subjects of policy making. Policymakers may disagree due to the following reasons:

- Policymakers may differ on the rate at which one policy variable should be sacrificed in order to obtain more of the, other. For instance, 2% or more of inflation may be required to reduce unemployment by 1%. In such case, some amount of value judgment is also implicitly involved.
- Disagreement among the policymakers may be over the nature of positive relations between variables. For example, the exact relation between aggregate expenditure and economic growth may be subject-matter of dispute. This is so because a unique value of correlation between the two variables has not yet been arrived at.
- Policymakers may disagree over the indirect effect of some policy changes. For instance, some will consider the indirect effects of devaluation to be very serious on inflation; others will disagree.
- Policymakers can differ because they are asked questions for which the existing theory makes no clear perdition. For example, on the question of economic consequences of the Greenhouse Effect on India, there is no conclusive study available yet.

5. POSSIBILITY OF CONFLICTING POLICIES

As experience shows, it is impossible to fulfill all policy objectives simultaneously. One policy measure may take us closer to one objective, but it may at the same time take us away from another objective. In such a case, the policymakers would confront the problem of *policy conflicts*. It is, therefore, not sufficient for the administrator to decide which objectives are worth pursuing; he must also decide on some rate of substitution (trade-off) between the two objectives. In other words, he must find the permissible rate of trade-off, keeping in mind the social choice and the welfare function. It must be indicated how much of one objective is worth sacrificing in order to get how much of the other objective. As far as possible, the trade-off has to be quantified, *e.g.,* 4% inflation can be tolerated as the necessary cost of having 2% reduction in unemployment.

But why does a policy conflict arise? There are many reasons which can lead to policy conflicts. *Firstly,* the number of instruments may be insufficient as compared to the number of targets or goals, *Secondly,* it may not be known as to what values should be given to the instrument variables to achieve the targets. And *lastly,* there may be lack of reliable market information. Some of the sets of conflicting policy objects may now be briefly mentioned. *Firstly,* as has been found by A. W. Philips (1958), there is an inverse relationship

between the percentage rate of growth of price level (inflation) and the percentage rate of growth of unemployment. This implies that in order to reduce unemployment, more of inflation has to be permitted, and *vice versa.* However, the correct trade-off to eliminate this policy conflict has not yet been empirically established. *Secondly,* price stability has been found to be inconsistent with balance of payment equilibrium in many countries. *Thirdly,* price stability does not go well the objective of economic growth. *Fourthly,* at least in the short period, full employment objective and growth objective have been found to be conflicting objectives. *Fifthly,* full employment and price stability do not agree well with each other. Similarly, domestic price stability and exchange stability may be in conflict with each other. In fact, these are only a few examples of conflicting in nature. There may be many more of such conflicting objectives in the real world. However, there may also be cases where conflicting objectives are conspicuous by their absence.

6. RESOLVING CONFLICTING OBJECTIVES

As a matter of fact, different objective functions are not monolithic, but are essentially multi-dimensional in character. It is, thus, necessary to know to how the conflict between the two objectives can be resolved and coordination achieved.

Some conflicting objectives may be resolved by making a harmonious adjustment and judicious mix. For, instance, the conflict between growth and price stability can be easily removed through the determination of optimum rate of investment which should neither worsen the balance of payments position nor unduly reduce the tempo of economic development.

In order to resolve the conflict, it is necessary to properly assign the policy instruments. In this connection, Prof. Mundell has suggested that for reducing the problem of unemployment and for achieving internal balance, it is necessary to deploy the *fiscal policy.* However, for achieving the balance of payment equilibrium (external balance), it is more appropriate to deploy the monetary policy. If this not done, and the policies are assigned otherwise, the situation will worsen.

In the case of conflicting policy objectives, the administrator should assign priorities, and make a choice. He should try to have an optimal combination, depending on the socio-economic and political milieu of the country. For instance, in the case of conflicting objectives like economic growth and price stability, the administrator will have to make a choice between the high rate of growth and galloping inflation. However, an optimal combination between some rate of mild inflation and economic growth may ultimately be found out.

The policymakers must classify the objectives into short-run and long run, keeping in mind the immediate and distant socio-economic desiderata. The short-run goal should be tried to be realized first. But short-run policy objectives should not serve as constraints for the long-run objectives. For instance, price stability is a short-run objective, whereas economic growth is a long-term objective. No measure intended to achieve price stability should disturb the long-term objectives of capital formation and economic growth.

The best way to coordinate the conflicting objectives is to give priority to the solution of short-run goals, but the short-run goals must be subordinated to the long-term goal. The major conflict between short-term and long-term objectives must be removed, although at times some minor deviations may have to be permitted to continue for some time. In making a choice between conflicting objectives, the primary aim should be to attain that optimal combination of the objectives which is most likely to serve the national interest in the best possible way.

7. RULES vs. DISCRETION

Macroeconomic policy can be implemented either by following certain set rules and regulations or by the discretion of the policymakers. The rules are generally rigid and advocate a constant rate of growth. Sometimes the rules have to be modified. Prof. Milton Friedman was in favour of following a monetary rule which will equate the rate of growth of money supply with the rate of growth of output. In such cases, business cycles can be avoided by following some set rules. However, the rules cannot always be followed in every case. For some situations, the rule may not be existing at all. Some policymakers are in favour of using discretion in the matter of Macroeconomic policy. But the problem is that discretion is often arbitrary and unsuitable. If the authority is given the power of discretion, it can practically do anything it likes. In that case, the result may be more harmful than helpful.

However, it should be noted that a rule is not necessarily fixed. It may be changed according to the circumstances on the basis of discretion. The discretion may not always be *as hoc* or irrational. If discretion is used judiciously by the policymakers with respect to the changing circumstances, there cannot be any objection against discretion. In the case of rules, it is necessary to know as to where the authority to change the rules is located. After all, the rule must not be too rigid. It is also necessary to know whether the policy should be announced in advance or not. The authority which can change the rule must be accessible and amenable. However, there is always, a trade off about future policy that comes from rules and flexibility of policymakers in responding to the shocks. We may conclude this section with the statement that rules should not be followed if they are too rigid and difficult to change with

the changing circumstances. Similarly, discretion can be followed, if it is based on judicious decision and rationality. Thus, the debate between rule *vs*. discretion is not really worth its salt because it is necessary to know about the various aspects of rules an discretion with reference to particular circumstances. There should not be any blind adherence to either rule or discretion.

8. LIMITS TO MACROECONOMIC POLICY

There are many limits to macroeconomic policy both at the policy-making stage as well as in implementation. Some of those limitations can be summarized as:

- Policy making becomes very difficult in the context of unreliable data and imperfect information
- Macroeconomic policy is also limited by the ideology of the government. A particular ideology may make the policy biased. Thus, macro policy must be free from ideology.
- Macroeconomic policy making becomes very difficult in an economy which is characterized by dynamic stochastic factors.
- Most of the Macroeconomic policies are based on the concepts of welfare and optimality. It must be noted that there is no unique definition of these concepts, which are operational.
- Macroeconomic policy may not be suitable for all groups of people. All policies are not equally good for all people. Thus, its desirability may be different for different people.
- Macroeconomic policy requires frequent changes so as to make it suitable for the changing society. There cannot be anything like a permanent and once-for-all policy.

Why Monetary Policy has Limited Efficacy?

The efficacy of monetary policy is limited by the existence of long lang. Monetary policy cannot be effective in the short run. Monetary action takes a longer time to affect the price level than to affect the stock of money. Moreover, it is very difficult to predict accurately what effect a particular monetary action will have on the price level and when the effect will take place. For these reasons, money stock should be the immediate guide or criterion for monetary policy.

It is very important for the monetary policy to avoid sharp

swings in policy. Monetary fluctuations should not be very frequent and in large magnitudes. Monetary policy should try to achieve a steady rate of growth of money stock. This can more or less ensure a situation of price stability. Price stability can be ensured by a monetary rule which will more or less match the rate of growth of money supply with the rate of growth of output. For the US economy, Friedman has recommended a 3-5% rate of growth of money supply per annum. However, it is better to have a fixed and steady rate of growth of money supply than to have an erratic rate. Friedman finds that empirically, periods of relative stability in the rate of monetary growth have been associated with periods of relative stability in economic activity. Conversely, periods of erratic monetary growth have also been the periods of erratic economic activity. By following a steady course, monetary authority can make a major contribution towards promoting economic stability.

Source: Friedman, M. (adopted) (1968),"The Role of Monetary Policy", *American Economic Review,* March

9. POLITICAL BUSINESS CYCLE

The theory of political business cycles is an important area of public choice theory, and clearly shows the close interactions between macroeconomic and political analysis. Ever since the publication of a paper by William Northaus (1975), the subject has become the center of attention not only among economists but also among political scientists and political economists (*see*, for example, Berger and Woitek, 1997; Rogoff and Sibert, 1988; Treisman and Gimpelson, 1999; Hibbs, 1977; Block 2002). The basic assumption of the theory of political business cycles is that politicians are guided mainly by short-run considerations. A ruling party wants to maximize votes and win the election. Therefore, before elections, it may reduce unemployment through expansionary monetary and fiscal policies. Since politicians are myopic, they do not have the ability to appreciate the long-run implications of such a policy. However, by following the expansionary policy, the party comes into power, but experiences, after a time lag, the emergence of inflationary symptoms. Inflation after elections can occur mainly in three possible ways. First, there can be pre-electoral manipulation of monetary-fiscal policy that leads to tax cuts and monetary expansion to generate more demand. Second, the government, after coming to power, may prefer to raise the prices of products and services which are under its direct control. This may be due to many motives including the generation of budget surplus, better command over resources and the financing of desired projects at hand. Third, during elections, the government gets financial help from business people, traders and producers with the tacit

understanding that, if elected, these people can make up the loss by raising the prices of their products without any objection from the government.

In the model developed by Nordhaus, there is an implicit negative relationship between unemployment and inflation. The logic is based on the Philips curve analysis. This implies that when unemployment and inflation. The logic is based on the Philips curve analysis. This implies that when unemployment goes down, inflation has to go up. In order to control this inflation, the party in power activities tight macro-policies of less spending and budget surplus. But then, because of the negative relationship, inflation is brought down and unemployment increases. So there is a cyclical relationship between these two critical macro-variables, which gets accentuated by political factors. The cyclical ups and downs are also possible in general economic activity where upswings may be followed by downswings, and inflation may follow recession. This is found to be empirically the case in many countries.

In the generation of political business cycles, the central bank of a country may, to a great extent, be responsible, particularly when the latter is not independent of executive control (*see,* Leertouwer and Maier, 2001). It is an established empirical fact that fiscal deficit shows a general tendency to escalate in many countries during election years. The behavior of such deficits can be explained more or less satisfactorily by political economy factors.

10. POLITICAL ECONOMY OF FISCAL DEFICITS

Persistent budget deficits in many countries during the 1980s and 1990s have encouraged many researches to investigate the sources of deficit bias in fiscal policy beyond the domain of pure economics. One explanation provided by the new political economy suggests that governments are sources of enormous inefficiencies. They are engaged in rent-seeking activities, and there are obvious regulatory failures in many directions. The bureaucracy is engaged in maximizing the budget and extravagant expenditure. Therefore, high rates of inflation and persistent budget deficits are common factors in such economies. However, the bad news is that fiscal deficits often reduce economic growth (Easterly et al., 1994).

In recent years Max Weber's view about benevolent and efficient bureaucrats has been challenged by various authorities. Representative works on bureaucracy have been done by W. Niskanen (1970), among others. In fact, without understanding the influence of the bureaucracy, the genesis and implications of the political economy of macroeconomic policy cannot be properly appreciated. In the Niskanen type of model, the bureaus have the following two essential characteristics (Ghosh, 2001). First, bureaucrats maximize the total budget of their bureaus under given demand and cost

conditions, subject to the constraint that the budget must be equal to or greater than the minimum total costs at the equilibrium output. Second, bureaus exchange specific output for a specific budget. The starting point of such a model is that bureaucracy maximizes its utility function. The utility function subsumes many related variables such as salary, power, patronage, pecuniary motivation, easy management and so on. All these variables are a positive monotonic function of the total budget of the bureau. Thus, the bureaucracy maximizes its utility function by increasing the size of the budget. The second characteristic-exchanging output for a total budget - gives the bureau the same type of market power as a monopoly. This is precisely so because the bureau is often the sole producer of a particular type of product which is sheltered from market competition (e.g., defense products). Thus, as a producer, each bureau is unique in its own way and enjoys some monopoly power.

Bureaucracy expands by increasing the size of its budget every year. This is possible because the government has to depend on bureaucracy; and its information base and other details cannot be challenged by the government (minister). It should be noted that the relationship between a minister and bureaucracy is like a bilateral monopoly where settlement is to be made through compromise. The bureaucracy often enjoys a unique position as it possesses the stock of better and more up-to-date information. Because of the information asymmetry between a minister and a bureaucrat of a department, the proposed budget expansion by the bureaucrat is thus easily granted, and this results in inefficient output.

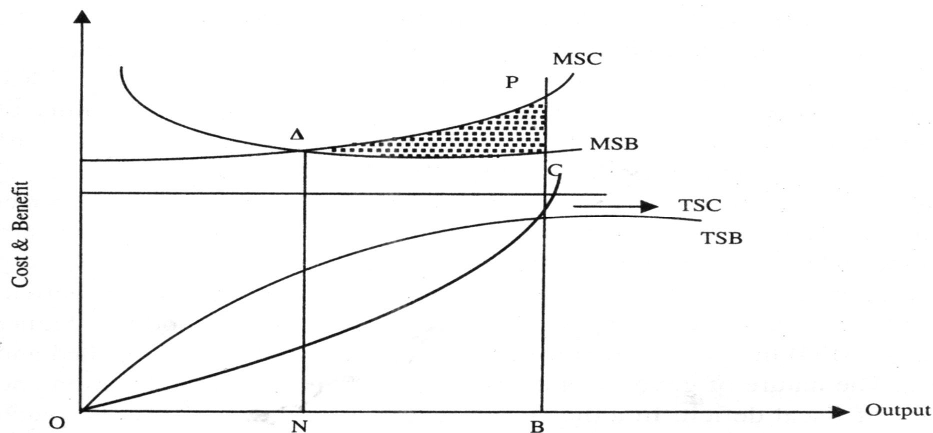

Figure 1: Market efficiency and output under bureaucracy

As the diagram above reveals, the market efficient output is ON; but output under bureaucracy is OB which shows MSC > MSB i.e., a loss of efficiency (APC area). The sponsor grants the budget because he/she believes that maximization of output is good for vote maximization in the re-election. Generally, a minister does not annoy a bureaucrat and they are in collusion on many matters. Because of their monopolistic power, it is possible for bureaucrats to pursue rent-seeking behavior. However, there are mainly two types of inefficiencies in a bureaucracy. First, there is an allocative inefficiency which arises out of output production beyond the optimum level justified by the equilibrium between MSB and MSC. The actual output production is inefficient because the cost is higher than the benefit. Second, bureaucracy involves X-inefficiency resulting from inefficient supervision, over-staffing, higher operational costs and so on. Thus, political processes in many of the developed countries (DCs) and less developed countries (LDCs) involve inherent deficit bias. Buchanan and Wagner (1977) argue that deficit bias mainly arises out of information asymmetry and misunderstanding of the actual situation. While the electors can well understand the obvious benefits of lower taxes and higher government expenditures, they are often ignorant about the implications and problems involved in expansionary fiscal policy.

In the making of fiscal policy, the interactions among the players may lead to different degrees of fiscal deficits (Table 1). These are: an elected leader may incur huge government debt to restrain his or her successor's spending. The desire to restrain future spending was an important motive for former US President late Ronald Reagan's policy of high budget deficit in the 1980s. Deficits can also be used as important signals to tell voters about the ability of the government to enhance public welfare and social benefits. This was also one of the motives for Reagan's policy of high fiscal deficits. Indeed, signaling considerations may explain why politicians often use inefficient pork-barrel expenditure (expenditure to say put in politics) rather than straightforward resource transfers to their cronies (Corate and Morris, 1995). Also, the durability of the government is a critical factor in explaining the quantum of fiscal deficit. In a constantly changing government apparatus, there is a likelihood of higher fiscal deficits (HFD) than in a government which is more secure, established and long-lasting. The nature of governments also seems to matter in the creation and management of fiscal deficit. In a 'benevolent dictatorship' things may be different. Also, the cost of running a democracy is probably higher than that of running a dictatorship.

Table 1: Determinants of Fiscal Deficits

Deterministic Factors	Alternative Components	Type of Fiscal Deficit
Durability of the Government	Temporary	HFD*
	More Durable Government	LFD**

Nature of the Government	Dictatorship	LFD
	Democracy	HFD
Party System	Single Party	LFD
	Multiparty (coalition)	HFD
Political Character of		
Government	Strong Government	LFD
	Weak Government (Noodle State)	HFD
Expenditure Policy	Too many programs	HFD
Limited Objective	Based on Political Business Cycle	LFD

Note: *HFD implies high fiscal deficits and **LFD implies low fiscal deficits

A new government may also be more of a spendthrift than an old government. This is probably due to the implementation of new policies and new action programs. Thus, a new government is likely to be involved in a high fiscal deficit, and also, the type of party in government may be decisive factor for fiscal deficits. A coalition type of government may have, more often than not, a higher fiscal deficit compared to a single party government. The nature of policy also matter in the case of fiscal deficit. A government may try to solve one problem at a time. In such case, fiscal deficits may be much lower than for a government which tries to solve many problems at the same time in order to gain public confidence and politico-economic stability. A government that has to solve many problems simultaneously is likely confront fiscal deficits. Some empirical findings are presented in more concrete terms in the discussion that follows.

Since cross-country differences in the debt/deficit ratios and fluctuations in fiscal deficits in many European countries over the years cannot be adequately explained by the known economic factors, the usual presumption is that some political economy factors must be playing a role. The Roubini and Sachs model (1989) shows that a weak and unstable government is associated with high fiscal deficits, and that a strong and stable government is associated with low fiscal deficits. Thus, political factors have a strong impact on budgetary balances. From the available empirical studies on the political economy of budget deficits, a few important lessons can be learnt (see details, Romer, 2001). A country’s political character plays a critical role in the budgetary outcome. Significant political factors are involved in the budgetary process, as well as the nature of the government coalition, or otherwise. It is necessary to understand the mechanism of how plurality of power and its dispensation leads to the creation of budget deficits. It may be true that some strong political economy elements, other than mere changes in political guards, may be at work. Formidable fiscal deficit problems which were linked to government

failure were associated with the debt crisis that affected a large number of Third World countries in the 1980s.

11. POLITICAL INSTABILITY, EXCHANGE RATE DEPRECIATION AND INFLATION

Taking a cue from the Mundell-Fleming model, one can state that for an open economy with political instability, the actual interest rate is determined by a risk premium which can be looked upon as a compensation for political uncertainty. If political policy raises the risk premium, there would be capital inflow and subsequently, a lower nominal exchange rate but no increase in the level of income (Mankiw, 2003: 329). The policy decision to counteract the falling tendency of the domestic exchange rate, if at all, is also a political matter. The fact that political instability is an important determinant of a country's risk premium and hence the accompanying high interest regime, is borne out by the experience of Mexico in 1994 and the crisis-ridden East Asian economies of 1997. In all these cases, domestic interest rate rose appreciably despite heavy capital inflow, defying the basic tenets of the Munedell-Fleming model, and the nominal exchange rate depreciated simultaneously. All these factors sped up the process of the onset of a currency crisis.

Political instability, however, is a function of many different types of factors and forces, such as, frequent changes in governments, in policies, in power relations and in future expectations about political twists and turns. Political instability can be measured by the actual frequency of transfer of political power. Political instability has been found to be positively associated with inflation, and it also sustains inflationary expectations which may be incorporated in wage bargains. Since political instability also aggravates inflation, which in turn escalates inequality, there seems to be a relationship between political instability and income inequality (see Albanesi, 2001). Income inequality may also have a positive impact on political instability.

Political instability, income inequality and economic growth are mutually correlated. Venieris and Gupta (1986) find that political instability has a negative impact on savings. This implies that political instability can reduce investment and growth. An empirical study by Ben-Habib and Spiegel (1992) substantiates that socio-political instability considerably reduces the incentive for investment. In fact, poor countries are more unstable because they cannot manage to be rich, and they cannot manage to be rich because they are not politically stable (Alesina and Perotti, 1994:359). So, for politically unstable poor countries, the vicious circle continues unabated.

A high degree of income inequality is associated with illegal activities, social instability and unrest. In a society with a significant degree of income inequality, the majority of voters will vote for higher taxation on the richer classes for many obvious reasons, and this apparently discourages both

investment and growth. The model presented by Alesina and Rodrik (1994) concludes that there is an inverse relation between income inequality and growth. Higher income inequality leads to higher taxation and more government expenditures on pro-poor programmes. Thus, income inequality seems to be an important determinant of socio-political instability, which in turn produces adverse effects on economic growth.

One of the essential tenets of the new political economy – that nothing should be left to the discretion of the government because it cannot do anything right – does not seem to be correct in light of the empirical experience of many countries in both the developing and developed world. Discretion can reduce the rate of inflation, as the evidence of central bank independence shows in a number of cases, and it is indeed possible to have a free lunch (which is usually undreamt of by economists). If macroeconomic policy making can be made free from pernicious political influences, an economy can perhaps get rid of political business cycles, if they are at all present.

But election politics is often accompanied by heavy fiscal deficits. In modern states, deficit bias is often associated with the nature, character, durability and the expenditure policy of the government. In general, coalition, democratic and unstable governments are highly deficit-prone. The question of political stability is, after all, a critical issue. The market system that generated political (and hence economic) instability in many developing countries at the initial stage of their industrialization process led many to believe that there was market failure in such countries. Thus, for bringing about development with stability, the state was given a clean mandate. But the State became an instrument in the hands of many power groups. Policies became more partisan and politically motivated, and the opposing interests of the power groups delayed the process of macroeconomic policy-making and its implementation. Excessive monetary fiscal expansion led to economic-financial instability and in many countries, the symptoms of both market and government failures became all too apparent.

In the event of government failure, some quasi-market reforms including liberalization and privatization were introduced in many developing countries. But such reforms were also not from political moorings. Whereas in some countries, privatization generated and expanded crony capitalism, in others, it did not make much headway, as there were group pressures and opposition against privatization. But in spite of privatization in East Asia, the growth of crony capitalism and macroeconomic vulnerability played a major role in generating bank failures, financial instability and the depreciation of exchange rates.

In fact, political instability is highly correlated with a number of macro variables including inflation, income inequality, fiscal deficits and exchange

rate depreciation. A higher degree of political instability increases the risk premium of a country which leads to higher domestic interest rates, less investment and so forth, so as to give rise to exchange rate depreciation with all the attending pessimism that makes a country macro economically weak and vulnerable. In the present-day world, political instability arises out of, and is often exacerbated by, not only frequent changes in the government and its policy, but also by the influence of pressure groups, uncertainties and externalities both from within and without. And in every situation, the State has to struggle hard to remain in power and to achieve its short-run objectives. Thus, it is obvious that macroeconomic policy becomes a reflection of the temper of the political will and preference at a particular point in time, and no macroeconomic policy is indeed neutral in its formulation and implementation.

12. MARKET IMPERFECTIONS VIS-À-VIS INEFFICIENT GOVERNMENT

Many Third World economies put emphasis on public sector regulations and controls. Most of these economies, which were free from foreign domination and control, wanted to have more and more government control for many obvious reasons. The evidence of market imperfections and distortions in those countries gave the impression, in the minds of policy makers, that they were vulnerable to market failure.

The macroeconomic policies of these countries consisted of large-scale public ownership, strict controls over industrial growth, over-valued exchange rates and import-substitution. Each one of these policies has a political economy counterpart. These policies were designed to give more power to the government for centralization and industrial expansion under a protected environment. In addition, many countries followed urban bias strategies of development that seemed to strengthen the industrial sector through favorable sectoral terms of trade, withdrawal of rural savings, higher relative taxation on the rural sector and so forth (*see,* Lipton, 1977). All these issues gave enormous power to the bureaucracy and led to regulatory failures on many fronts. Currency values are generally looked upon as a symbol of national power and prestige. However, the adoption of the policy of over-valued exchange rates led to trade deficits that were unsustainable large. A large deficit can be financed by either foreign borrowing or monetization but both these measures involve financial instability (Rodrik, 1996:14). Also, these decisions become, in the end, politically motivated.

In general, the fundamental problem of macroeconomic inefficiency and policy cycles in many countries arises out of distributional struggles among the contending partners or groups. The State is often an instrument in the hands of powerful groups and their possible coalition interests. Very often, the coalition

governments in these countries want to retain their power as long as possible, and in doing so, they have to satisfy all the players in the game of politics. In every case, the governments have to satisfy the powerful groups that make and unmake the government. There is often a *war of attrition* between different groups, and the group that proves to be more powerful can capture the government. Due to a high degree of market imperfections, the market mechanism does not work in many developing economies. The invisible hands do not play any role, and instead, the visible hands of the state and bureaucracy operate more successfully in sheltering the economy from macroeconomic disequilibrium. The existence of political markets in many LDCs results in misallocation of resources and is responsible for market failures (Ghosh, 1998).

The political necessity of satisfying all classes of people for vote maximization in some LDCs, and the desire to stay in power require the expansion of monetary-fiscal policy often beyond the justifiable limit. The domestic policy of monetary and fiscal expansion, even by incurring public debt to satisfy populist political motives, leads to the persistent balance of payment deficits under the regime of fixed exchange rates (Krugman, 1979), and this ultimately makes the economy vulnerable to speculative attack. Conceivably, expansionary macroeconomic policy will also mean raising wages and lowering competitiveness. Under such a situation, any attempt to defend the currency by the authorities will result in higher interest rates. High interest rates, increasing wages, deteriorating current account balances and the appreciation of real exchange rates can be taken as the leading indicators of currency crisis (Kaminsky and Reinhart, 1998: 7). The interest rates are often not market determined in LDCs and may be politically administered. While in some cases, high interest in favoured in order to benefit the unproductive *rentier class* which lives on interest earnings, in others, a regime of low interest rates may be invoked to favour the capitalist class for borrowing from banks. However, the tragedy is that very often, interest rate manipulation does not serve the purpose for which it is designed. Kindleberger seems to be right in saying that a high interest rate may attract funds or repel them depending on the expectations that a rise in interest rate generates (Kindleberger, 1996:8).

The emphasis on heavy industries, in pursuance with the Soviet model of industrialization, and in sympathy with the philosophy of import substitution, led to the genesis of government failures in many developing countries. The following are the primary reasons for government failures: government intervention sometimes leads to unpredictable and undesirable consequences. For example, an attempt to introduce rent control often leads to reduced supply of houses. Very often, the ends of government policy are not sufficiently clear and there arises an end-means conflict. The trade-off between the conflicting macro objectives is not determined on the basis of the society's preferences but by personal motives and political agenda or, there may be entirely unwanted

trade-off points. Also, there may be implementation failures due to a number of reasons including corrupt practices, favouritism, nepotism and so forth. Moreover, government intervention in many cases is very expensive, and the resultant net benefit may be much less than the cost involved. In fact, the precise relationship between the instrument variable and the policy variable may not be known to the government before policy formulation. In such a situation, there are either over-shootings or under-shootings. Under these circumstances, the introduction of government to mitigatemarket failure generally leads to the substitution of one type of inefficiency for another. The uncertainty that arises in the matter of macro policy-making during the twilight period of market and government failure is basically motivated not so much to justify the growth of the economy as to gain political mileage.

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Dr. B. N. Ghosh, PhD (India), PhD(Australia), M. CIM(UK), GFCR(Harvard), is currently Visiting Professor of Economics at the Institute of Management and Technology, Punnapra((Kerala), Govt. of Kerala, and also at Sir John Hicks College of Economics and Management, Leeds(UK). Formerly, he was the Director of IMT, Kerala. He has taught in a few universities in India and Malaysia for a long time. He has worked in Eastern Mediterranean University, North Cyprus as a Visiting Professor of Economics for many years. He had also a stint as a Visiting Professor at Zhejiang Gongshang University, China. He has written extensively in refereed professional journals. His research works have been published in India, USA, UK, Canada, Korea, Italy, Malaysia, Singapore, Bangladesh, Netherlands and Philippines. He has written, edited and co-authored a large number of books. His books have been published by, among others, Arnold-Heinemann, Longman, Macmillan, Ashgate (London), Nova Science Publishers (New York), Palgrave-Macmillan and Routledge, London and New York, Oxford University Press and Sage Publications, New Delhi, among others. Upon invitation, Prof. Ghosh has delivered special lectures/attended international conferences in Malaysia, Florence, Tunisia, Iran, India and China, among other countries. He has undertaken short-term consultancies for various organizations including the, UGC, UNDP and the Govt. of Malaysia. He is Chief Editor of Journal of Human Development. Prof. Ghosh is the recipient of the Emerald Award (UK) for the year 2006.

Dr. B. N. Ghosh, PhD (India), PhD(Australia), M. CIM(UK), GFCR(Harvard), halen Institute of Management and Technology, Punnapra (Kerala), Govt. of Kerala'da Misafir Ekonomi Profesörü olarak bulunmaktadır. Ayrıca, Sir John Hicks College of Economics and Management ve Leeds(UK) Üniversitelerinde misafir Profesör olarak bulunmuştur. B. N. Ghosh Hindistan ve Malezya'daki

bazı üniversitelerde uzun süre ders verdi. Doğu Akdeniz Üniversitesi Ekonomi Bölümünde ve Çin'de bulunan Üniversitelerde misafir öğretim elemanı olarak dersler verdi. Birçok saygın hakemli dergide yazıları yayınlandı. Hindistan, Malezya, ABD, Kanada, Kore, İtalya, Singapur, Bangladeş, Hollanda ve Filipinlerde araştırmaları yayınlandı. Birçok kitap yazdı ve bunlar:, Arnold-Heinemann, Longman, Macmillan, Ashgate (London), Nova Science Publishers (New York), Palgrave-Macmillan and Routledge, London and New York, Oxford University Press and Sage Publications, New Delhi yayınlandı. Birçok ülkede ders vererek konferanslar sundu. UGC, UNDP ve Malezya hükümetine danışmanlık yaptı. Uluslararsı dergi olan Journal of Human Development'te baş editor olarak görev yapmaktadır. Prof. Ghosh, 2006 yılında Emerald ödülünü almıştır.