C. D. DESHMUKH MEMORIAL LECTURE
1992

THE WORLDWIDE ADJUSTMENT PROCESS IN THE 1980s

Jacques de Larosiére

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CHINTAMAN DESHMUKH MEMORIAL LECTURES

Chintaman Dwarakanath Deshmukh, who passed away on October 2, 1982, was the first Indian Governor of the Reserve Bank of India. He later became the Union Finance Minister. In recognition of his meritorious services to the Reserve Bank and the nation and to perpetuate his memory, the Reserve Bank of India has instituted an annual lecture series styled Chintaman Deshmukh Memorial Lectures. So far, six lectures have been delivered and published in this series, as mentioned below :

Lecture No.	Delivered by	Subject	Date
1.	Professor Nicholas Kaldor	The Failure of Monetarism	January 18, 1984
2.	Professor James Tobin	Central Banks and Government Budget	January 9, 1985
3.	Professor Janos Kornai	State-Owned Firm, Bureaucracy and Market : Hungarian Experience	February 7, 1986
4.	Dr. Lawrence Klein	Financial Innovation : Effects on Economic Performance	November 24, 1987
5.	Mr. Michel Camdessus	The Evolving International Monetary System : Some Issues	October 4, 1988
6.	Mr. E. Gerald Corrigan	Global Economic Prospects at the Turn of the Decade	January 11, 1990

The seventh lecture on "The Worldwide Adjustment Process in the 1980s" was delivered by Mr. Jacques de Larosiére, Governor, Banque de France on March 24, 1992.

Chintaman Deshmukh was born on January 14, 1896 at Nata, near Fort Raigarh, in Maharashtra, in a land-holding family with traditions of public service. Chintaman's father, Dwarakanath Ganesh Deshmukh, was a respected lawyer and his mother, Bhagirathibai was a deeply religious lady.

Chintaman had an outstanding educational career. He stood first in the Matriculation examination of the University of Bombay in 1912, also securing the first Jagannath Sankersett Scholarship in Sanskrit. At the University of Cambridge he took a first in the Natural Sciences Tripos in Botany, Chemistry and Geology in 1917 winning the Frank Smart Prize in Botany. He appeared for the Indian Civil Service Examination, then held only in London, in 1918, and topped the list of successful candidates.

For most of his 21 years with the Indian Civil Service, Chintaman Deshmukh was with the then Central Provinces and Berar Government, where among other things, he was probably the youngest among those who held the positions of Revenue Secretary and Finance Secretary. While on leave overseas in London, he worked as one of the secretaries to the Second Round Table Conference in which Mahatma Gandhi participated. The memorandum submitted by the Central Provinces and Berar Government, which Deshmukh prepared, for the purpose of the enquiry by Sir Otto Niemeyer leading to the award on the financial relations between the Centre and the Provinces under the Government of India Act, 1935, won him high acclaim.

Chintaman Deshmukh's association with the Reserve Bank of India began in July 1939, when he was appointed Liaison Officer in the Bank to keep the Government of India in touch with the Bank's affairs. Three months later he was appointed Secretary of the Central Board of the Bank and two years later in December 1941, Deputy Governor. He was Governor from August 11, 1943 to June 30, 1949.

Chintaman Deshmukh proved to be an outstanding Governor. He presided over the transformation of the Reserve Bank from a private shareholders' bank to a nationalised institution and secured the enactment of comprehensive legislation for the regulation of banking companies and the establishment of the first financial institution for the provision of long-term credit to industry, namely, the Industrial Finance Corporation of India. He also initiated a number of steps for building up an adequate machinery for rural credit. Commenting on Chintaman Deshmukh's role in regard to the provision of rural credit, a leading co-operator wrote that he "brought about a complete change in the approach from one of hesitant conservatism or laissez-faire to that of a progressive outlook and adoption of positive steps to build up an institutional machinery to provide agricultural credit and for channellig Reserve Bank funds for development of agriculture." With nearly a decade's intimate association with the Reserve Bank, Chintaman Deshmukh reviewed central banking in India in a most thought-provoking Kale Memorial Lecture in 1948.

Chintaman Deshmukh played an important role in the Bretton Woods Conference in July 1944, leading to the establishment of the International Monetary Fund and International Bank for Reconstruction and Development. In both of these institutions, Chintaman Deshmukh was a Member of the Board of Governors for ten years and was the Chairman at the Joint Annual Meeting of these two institutions held in Paris in 1950.

In September 1949, Prime Minister Jawaharlal Nehru appointed Chintaman Deshmukh India's Special Financial Ambassador to America and Europe, in which capacity he conducted the preliminary negotiations for a wheat loan from the U.S.A. Towards the end of the year, Jawaharlal Nehru asked Chintaman Deshmukh to work on the organisation of Planning Commission and appointed him member of it when it was set up on April 1, 1950. Shortly thereafter, Chintaman Deshmukh joined the Union cabinet as the Finance Minister and held that office with distinction till he resigned from it in July 1956. His stewardship of the country's finances was marked by prudence as well as humane perspective and vision, dealing imaginatively with the changing financial needs of a developing country. Financial policy was directed towards facilitating the achievement of rapid growth, social justice and economic stability. He made significant contributions to the formulation and implementation of the country's First and Second Five Year Plans. He was also primarily responsible for such important landmarks in the area of social control of the financial structure as the enactment of a new Companies Act and nationalisation of the Imperial Bank of India and life insurance companies.

The departure from the Union Cabinet marked the beginning of a different phase of public service by Chintaman Deshmukh in the realms of education and social service. He was Chairman of the University Grants Commission from 1956 to 1960, helping to lay a solid foundation for the improvement of the standards of University education in the country. He was Vice-Chancellor of the University of Delhi from March 1962 to February 1967, building it up as an outstanding institution of higher learning.

Chintaman Deshmukh also gave generously of his time and energies to the building up of other important institutions devoted to the cause of education and research. He was President of the Indian Statistical Institute (ISI) from 1945 to 1964. It was during the period when he was both the President of the ISI and the Union Finance Minister that the National Sample Survey, to be conducted by the ISI, was instituted (1951-52), and the Central Statistics Office established. He was President of the Institute of Economic Growth, New Delhi, from 1965 to 1974. He served as the honorary Chairman of the National Book Trust from 1957 to 1960. He founded the India International Centre in 1959, of which he was Life President. He headed the

Court of Governors of the Administrative Staff College of India, Hyderabad, from 1959 to 1973 and was Chairman of the Indian Institute of Public Administration, New Delhi, in 1963-64. Other bodies with which Chintaman Deshmukh was associated included the Indian Council of World Affairs (1960-67) and the United Nations Institute for Training and Research (1965-70). Along with his wife Durgabai, Chintaman Deshmukh participated in multifaceted social service work, especially in the functional literacy and family planning work undertaken by the Andhra Mahila Sabha, Madras and Hyderabad, a social organisation of which Smt. Durgabai was the Founder President. He became its President after Smt. Durgabai's death.

Chintaman Deshmukh's old college at Cambridge, Jesus College, elected him an Honorary Fellow in 1952 in recognition of his distinguished contribution in the areas of Indian and international finance and administration. He was co-recipient in 1959 of the Ramon Magsaysay Foundation's Award for distinguished Government Service. A number of prestigious universities and institutions, international as well as Indian, conferred on him doctorates honoris causa; these included the Universities of Princeton (U.S.A.), Leicester (U.K.), Pune, Delhi, Allahabad, Nagpur and Osmania (India), as also the Indian Statistical Institute.

Chintaman Deshmukh had a great love for gardening and horticulture was his special hobby. He continued to be a deep student of Sanskrit and published a volume of his poems in that language in 1969. He was proficient in a number of foreign languages also.

Chintaman Deshmukh died in his 87th year at Hyderabad where he had finally settled down. With his rare combination of qualities of head and heart, idealism and objectivity, culture and science, integrity, dedication and imagination, Chintaman Deshmukh will always rank high among the eminent sons of India.

WELCOME ADDRESS

S. Venkitaramanan
Governor, Reserve Bank of India

Mr. De Larosiére, Dr. I. G. Patel, Ladies and Gentlemen,

It is with great pleasure that I welcome you all to the Seventh Chintaman Deshmukh Memorial Lecture. Many of you are aware that this series of lectures was instituted to commemorate the late Shri Chintaman Dwarkanath Deshmukh, the first Indian Governor of the Reserve Bank of India, who passed away in October 1982.

Chintaman Deshmukh, who was born on January 14, 1896, had a brilliant academic career and an outstanding record of service as a civil servant, central banker, parliamentarian and Minister, economic policy maker and educationist. After securing a first in Natural Sciences Tripos at the University of Cambridge, he was an illustrious member of the Indian Civil Service for 21 years. He joined the Reserve Bank in 1939 and quickly rose to become its Governor in 1943, a position he held with great distinction till the middle of 1949. During the period of his stewardship of the Bank, a comprehensive legislation for the regulation of banking companies was enacted, the Industrial Finance Corporation of India for providing long-term credit to industries was set up and a sound institutional structure for rural credit was initiated. He played a crucial role as an active member of the Indian delegation to the Bretton Woods Conference of July 1944 which led to the establishment of the International Monetary Fund (IMF) and the International Bank for Reconstruction and Development (IBRD). He was a Member of the Board of Governors of both these institutions for ten years and was the Chairman of the Joint Annual Meetings of the two institutions held in Paris in 1950. He was the Finance Minister of India from 1950 to July 1956, a period during which India's planning process for economic development firmly got under way. The imprint of his vision and pragmatism is clearly seen in the economic policies that were then shaped for promoting economic growth with stability and social justice.

After leaving the Government, Chintaman Deshmukh continued to play an active role in many areas of public life, particularly in education and social service. He received several national and international honours such as election in 1952 as an Honorary Fellow by his alma mater, Jesus College, Cambridge, and the Ramon Magsaysay Foundation Award for distinguished Government service in 1959. A man of many parts and wide interests, deep culture and humanity, Chintaman Deshmukh is remembered with great respect and regard.

We have been extremely fortunate in attracting eminent persons to deliver lectures in this series, the first being Professor Nicholas Kaldor in 1984, while subsequent lectures were delivered by Professor James Tobin in 1985, Professor Janos Kornai in 1986, Professor Lawrence Klein in 1987, Mr. Michel Camdessus in 1988, and Mr. E. Gerald Corrigan in 1990.

For the Seventh lecture today, we are happy to have amongst us Mr. Jacques de Larosiére, Governor, Banque de France and Mrs. de Larosiére. We warmly welcome them to this city of Bombay and we do hope that they will have happy memories of their visit to India.

Mr. de Larosiére is an internationally well-known personality. We in India remember him fondly for his constructive contribution as Managing Director of the IMF to India's efforts at external and structural adjustment at the beginning of the 'eighties.

Born in 1929, Mr. de Larosiére had his Bachelor's degree from the University of Paris. He earned post-graduate degrees from the Paris Institute of Political Studies and the National School of Administration. Subsequently, he joined the Treasury and went on to become the Under Secretary of Treasury, a position he held during 1974-78. He was also Chairman of the Deputies of Group of Ten between 1976 and 1978, and he was appointed Managing Director of the International Monetary Fund in 1978. During his tenure as the Managing Director, the international economy was faced with many challenges. Mr. de Larosiére's leadership in addressing these issues was widely acknowledged as one that was characterised by wisdom and sympathetic understanding of the problems of developing countries. After leaving the International Monetary Fund in 1987, he became Governor of the Banque de France, a position he has been holding with great distinction. He also served as the Chairman of the Committee of Governors of the Group of Ten in 1990. He was decorated with the titles of "Officer de La Legion d'Honneur", and "Chevalier de l'Ordre Nationale du Merite".

Mr. de Larosiére has chosen to speak today on "The World wide Adjustment Process in the Eighties". There is none who is better equipped to speak on this subject than Mr. de Larosiére. For, he left a fine imprint on the adjustment process in both developed and developing countries during the most fascinating decade of the 'eighties. We look forward to hearing his reflections on this subject.

We are indeed privileged to have Dr. I. G. Patel, to preside over this function. Dr. Patel held many distinguished official and academic positions. He is an eminent economist and has been one of our leading policy makers. We are proud of the fact that Dr. Patel, as Governor of the Reserve Bank of India, played an important role in shaping adjustment policies during the early 'eighties. We are grateful to him for having agreed to be present to-day and to offer his observations on this evening's lecture. We also warmly welcome Dr. (Mrs.) Alakananda Patel.

I once again welcome all of you to this function and would now request Mr. de Larosiére to deliver the Seventh Chintaman Deshmukh Memorial Lecture.

THE WORLDWIDE ADJUSTMENT PROCESS IN THE 1980s

Jacques de Larosiere

It is a great pleasure for me to be here in Bombay with you tonight. I have worked with the authorities of your great country for more than twenty years in the various stages of my career, and have developed with them a relationship founded on confidence, respect and friendship.

So, as you can imagine, I am delighted to be seeing my Indian friends here once more. It is also a great honour for me to be invited to your prestigious annual meeting commemorating Chintaman Deshmukh. The character and rigorous intellect of the first Indian Governor of the Reserve Bank of India have left their stamp on your institution and your country.

I have chosen to speak tonight on the process of adjustment in the world over the past decade. It strikes me that the 1980s produced a rich crop of lessons in this respect, providing ample food for thought for politicians, economists and historians.

All countries are led to respond, in some way or the other, to changes in the economic and financial environment. They can do so passively, by borrowing as much as they can or by allowing inflation to surge. They can do so negatively, by refusing to open their markets to the outside world. But they can also — and that is now a general tendency — adjust actively and positively, by adapting to change, and by striving to develop their productive potential in order to generate the strongest and most sustainable economic growth possible.

The factors that have induced countries to take their adjustment into their hands over the past two decades or so are many and well-known. They include the oil shocks, technological change, the opening up and increasing globalization of markets, the emergence of new competitor nations, the savings shortfall and the resulting rise in interest rates, the demise of the money illusion and of its accompanying inflationary financing facilities, the revolution in communication techniques and the resulting ease with which people can compare living standards, etc.

Regardless of whether it flows from external shocks, financial constraints or a realization of the widening gap in economic performance between nations and different social and political systems, the need for adjustment has come to be a general phenomenon. It concerns every country — be it industrialized or not — even if the causes, nature, extent and human cost of adapting obviously vary greatly from one country to another.

Apart from countries' levels of development and degrees of integration into world trade, we may consider that the eighties witnessed an upsurge in lucidity and realism, and an increasingly shared vision of the nature of the adjustments to be made and the means by which to achieve them.

This consensus, which to a large extent grew out of the mistakes and shortcomings of the past, emerged gradually in the course of the eighties, with varying degrees of intensity, and according to different timetables from country to country.

I shall be organizing my remarks around two themes:

the eighties showed that there was no longer any alternative to active and positive adjustment;

they also showed the way and the means to achieve it.

I shall conclude with a few remarks on the need for internal coherence in the reforms to be implemented, and on the international dimension of the process.

I. THERE IS NO ALTERNATIVE TO ADJUSTMENT

First, let us analyze the sequence of events that helped throw most economies off-balance and brought home to policy-makers the need for adjustment.

1.1 **For the industrialized countries,** the oil shocks of the seventies generally amplified the consequences of earlier economic policy shortcomings, and in some cases served to reveal them. The impoverishment stemming from higher oil prices confronted oil importing countries with the dilemma of either adjusting or borrowing abroad.

Certain countries preferred to adapt swiftly to these events: that in particular was how Germany responded to both oil shocks, and how Japan reacted to the second. To do so, they allowed their economies to take the full strain of the oil price increases, containing growth in domestic demand through stringent macroeconomic policy. They gave priority to increasing corporate profit margins in preference to growth in household incomes. In so doing, they enabled their companies to invest in order to modernize and boost competitiveness, which helped them win market share, increase exports and thus offset the impact of the higher oil bill. By refusing to subsidize the cost of oil in any way, moreover, they encouraged energy conservation. The upshot was a far-reaching change in the structure of the energy content of these economies' industrial output.

Other countries were slower to admit the reality and long-term nature of the phenomenon, and for some years they were tempted to favour the growth of consumption and real wages. As a result, their trade balances deteriorated, external debt rose — with a consequential increase in their debt servicing burden — and the savings capacity of their producers was impaired. Enterprises saw their capital stock dwindle while their financial costs grew. After a while, in the early eighties, those countries too felt the need to adjust; but by then the process was more painful than for those that had decided to adapt swiftly to the altered circumstances.

But the oil price rise was not the only factor to trigger or reveal imbalances requiring corrective measures. Before that, competition in manufactured goods from low-wage developing countries had confronted the industrialized countries with the need for far-reaching industrial redeployment. Even if the developed economies' markets have not been as open as some would wish — as is the case with agriculture — the countries of the North have nevertheless had to restructure whole sectors of their industry — particularly textiles and steel-making. Those countries that recognized the need and carried out these reconversions by shifting production to industries in which they enjoy a comparative advantage, have, on the whole been better placed than those that resisted change by closing their frontiers or subsidizing now loss-making activities. In either case, the refusal to adjust has impeded these economies. Ultimately, the cost to the consumer or taxpayer is far greater than in countries whose economies have adapted to the true state of international costs.

More generally, those industrialized countries that genuinely pursue free market economics are obliged to adjust permanently. Technological breakthroughs, the liberalization of international trade and capital flows, the acceleration of information and transportation, the growth of multinational corporations etc. are all forcing companies to adapt continuously to progress and innovation. Any regulation that is protectionist in its aims — even if dressed up in some other guise — can only delay external adjustment and make it harder still.

1.2 **For the developing countries,** a great many processes and events have forced them to adjust.

We can consider a number of different cases.

One group of countries, mainly in Southeast Asia, often called the "newly-industrialized countries", was very quick to respond to the demands of world markets. From the outset of their development, these countries adopted an "open" market model. What are the chief features of their success? I would mention four main ones:

- They have given priority to domestic savings as a source of investment, and for this purpose, they have avoided excessive tax takes and fiscal deficits;

- They have maintained flexible and realistic exchange-rate policies in order to better ensure their connection with the international trade system;

- They have kept the door open to foreign investment;

- They have permitted the development of a strong private sector in their economies.

Most of these countries tackled the shocks of the seventies and eighties with relatively low levels of inflation and debt. They have achieved substantial economic growth taking advantage of expanding internatioanl trade.

Many other countries have more or less actively relied on "endogenous" growth models. The general idea behind these strategies is that, before opening up to the outside world, it is first necessary to build an economy (sheltered by a measure of protectionism) that is sufficiently diversified and resilient to be capable of withstanding external influences one day. These models seek to substitute local products for imports so as to develop domestic employment and activity. In this kind of system, industries usually need to be protected by price and exchange controls and restrictions on foreign trade. Being relatively inward-looking, these economies draw little benefit from the technological progress disseminated by world trade. Because of the protective barriers surrounding them, companies have little incentive to increase efficiency and profitability. In fact, many of these firms were notable for their high costs and losses. When some of these industries are set up for political reasons and prove unviable, costs rise and competitiveness declines, which affects the economy as a whole.

These strategies were popular in the sixties and seventies, and generally created a large expansion of the public sector. Once industrial decisions are largely determined by government, and once the financial situation of a large number of firms depends primarily on public subsidies, government decisions on prices and a system of import quotas or tariff protection, the authorities become the chief player in the economy and are tempted to intervene directly in the production process and expand the state enterprise sector.

These systems usually entail all kinds of complex regulations which distort the invisible hand of the economy. The goal then becomes less to produce on competitive terms than to take full advantage of the regulatory system. Investment choices are not always governed by economically rational considerations. In a certain number of countries, this gave rise to large scale, relatively unprofitable investment schemes weighed down by too high operating costs. Clearly, in such cases, the allocation of national savings has been skewed, to the detriment of the community.

Certain countries have witnessed the development of mixed systems, in which a regulated public sector coexists with a sometimes fairly efficient private sector. But all too often, controls on prices, foreign trade and exchange have created distortions and diminished competitiveness.

A good many countries, notably in Latin America in the seventies, failed to control their public expenditure and allowed huge deficits and a substantial external debt to build up. In many cases, they kept their exchange rate too high, which favoured imports at the expense of the competitiveness of their own productive systems. This also encouraged substantial capital outflows. Rising world interest rates — following the anti-inflationary adjustment begun in 1979 and recession in the early eighties — caught these economies in a pincer movement, and their terms of trade deteriorated just as external funds were becoming scarcer, available on shorter terms and at a higher cost. The Latin-American external debt crisis broke out in August 1982. The adjustment-borrowing dilemma was now a thing of the past: debt-ridden economies had no choice but to adjust to the external world, since the financial markets would no longer supply the means to delay the necessary corrective measures. By providing financial assistance, the International Monetary Fund and the World Bank played a crucial role in helping these countries to work out recovery plans, thus allowing them to buy the necessary time in order to adjust.

It would be a mistake to draw sweeping generalizations from these necessarily much too brief considerations. Some of the countries whose itineraries I have just described have scored undeniable successes. Brazil's industrialization is one example. Another is the development of India's infrastructure and the considerable expansion of its agricultural potential over the past two decades. Today, India has been self-sufficient in food for ten years, yet some people were predicting that it would never feed its population. India has also encouraged the growth of a modern and competitive industry.

The fact nevertheless remains that in the course of the 1980s a certain number of countries encountered growing difficulty in generating sufficient savings to meet their investment needs. Several factors contributed to this: the debt-servicing burden, deteriorating commodity prices, and adjustment "fatigue". These countries — some of which had already begun to adapt in earlier years — were faced with the need to do still more and in some cases revise those of their past strategies that had aggravated the problems to be resolved.

1.3 A third interesting category of countries from this point of view is that of the **centrally planned economies.**

These countries thought they could develop command economies in which production and investment decisions were in the hands of the planning authorities. Governments were thought to make more rational choices than actors in a free market.

Experience showed these wholly-centralized strategies to be a source of considerable waste and inefficiency, and highly debatable resource allocation. On the whole, those systems generated low productivity and a lack of any spirit of enterprise and initiative. The shock that revealed the extent of these countries' economic dilapidation and brought home to them the need to reform was that of political liberalization and, more generally, the revolution in information. As moral and political frontiers came down as a result of this opening up, comparisons were made and citizens refused to see their living standards decline merely to prop up economic systems that had demonstrably failed. This accounts for the universal wave of reform that has gathered momentum in the past few years throughout Eastern Europe and in certain collectivist economies in Africa.

Having analyzed the events that uncovered these areas of vulnerability or triggered crisis in various forms, in different types of economy, I would like to make one simple remark: adjustment often flows from an external shock, but it is never decided abroad nor carried out to please some foreign power. In each case, the decision is a national one, taken by the authorities, or which the authorities resolve to take in the interest of their people. It is a question of necessity, sometimes survival, not of choice or preference for some doctrinaire model or policy.

Let us now take a look, in the light of recent experience of a certain number of countries, at the main roads to adjustment taken since the 1980s.

II. ROADS TO ADJUSTMENT

The great wave of economic reforms that has gathered strength over the last decade or so in most countries is of considerable importance to anyone interested in economics, history and political thought.

Probably the most fascinating aspect of this trend is its universality, and the consistent, homogeneous nature of its characteristic features — regardless of the level of development or political system of the countries concerned.

I shall now try, very briefly, to point out what strikes me as being its four essential characteristics:

- seeking broad monetary and economic stability,
- opening up economies to the outside world,
- redefining the role of the state in the economy,
- deregulation.

2.1 The necessity of broad economic and monetary stability

One of the fundamental gains of the past ten years is the recognition of the benefits of monetary stability. No economist worthy of the name is any longer prepared to argue that inflation can assist, or take the place of, adjustment.

Experience has amply shown that inflation was socially unjust — it always hits the worst-off hardest — but also that it was regressive in terms of economic development. The idea — often popular fifteen or twenty years ago — that one could trade off "a little more inflation against a little less unemployment" has been shown to be mistaken. In fact, those countries that have best kept inflation in check are precisely the ones that have experienced the most sustained growth. "Stop-go" policies have exacted a heavy toll in terms of long-term growth, as witnessed by the stagflation experienced in many industrialized countries in the 1970s. As for stabilizing at an "average inflation rate", this has turned out to be most often illusory, there being a strong risk of inflation taking off and spiralling into hyperinflation, paralyzing the entire economy.

By definition, inflation destabilizes expectations, affecting investment and consumption decisions. It undermines confidence and growth in trade. It distorts asset allocation decisions, notably by enhancing the appeal of speculative assets at the expense of productive investment of savings. Generally speaking, it "blurs" market signals and distorts the relative price structure, hindering sound allocation of resources.

But above all, it leads to greater uncertainty over real returns and the authorities' reactions, fostering a wait-and-see attitude and shortening decision-makers' time frames, to the detriment of medium and long-term decisions.

Inflation is no longer even a means of collecting hidden taxes on citizens and especially on the state's creditors. For many years, what is known as the "money illusion" allowed certain governments to borrow strong money and repay in depreciated currency. With the internationalization of capital flows since the beginning of the eighties, together with improved economic information and the generalization of positive real interest rates around the world, economic agents just refuse to hold depreciating debt instruments. They are only prepared to lend against instruments that keep their value, and they have put pressure on those governments that do not curb inflation to index their debt in terms of both principal and interest. That indeed explains the soaring level of domestic national debt and the cost of servicing it in the very high inflation countries. This is forcing countries to adjust their policies in the direction of stabilizing the value of their currency.

Domestic and external currency stability naturally creates an incentive to build on comparative advantages, choose more efficiently and rationalize productive activities. The successful fight against inflation enabled the industrialized countries, after the 1982 recession, to enjoy eight years of economic expansion, the longest period of growth since the second world war. The revival of inflationary pressures observed in some industrialized countries in 1988-89, particularly the Anglo-Saxon ones has indeed contributed to the slowdown in growth over the past two years.

It follows from these considerations that any economic reform programme — and particularly any structural reforms — must be rooted in a macroeconomic policy designed to achieve stability. This implies that fiscal, monetary and incomes policy must be mutually supportive in the drive to curb rising prices. Fiscal policy has a fundamental role to play in that respect. Monetary policy — no matter how well managed — can never hope to achieve its goals effectively if the public finances are profoundly and durably in deficit. It is vital to curb the fiscal deficit in order to release savings resources, avoid crowding out private investment and help to ease pressures in the capital market.

The authorities everywhere in the world have, in consequence, adopted — or are endeavouring to adopt — a more prudent, more rigorous monetary and fiscal policy mix designed to bring their economies back into balance and restore confidence. In particular, they have followed more systematic rules of behaviour in response to cyclical trends. An example of this can be seen in policies to rehabilitate the public finances by reducing public sector deficits as a percentage of GDP over the medium term. Mexico reduced its fiscal deficit as a percentage of GDP from 17.2% in 1982 to just 1% today, while inflation dropped from 130% in 1987 to under 20% today. By the second half of the eighties, sounder financial management has significantly reduced the burden of public sector deficits and national debt on the wealth of the nation, even if much still remains to be done, particularly in the United States, where the federal deficit is still too high and represents a substantial drain on world savings.

2.2 Opening economies to the outside world

Even if the process of opening up an economy to the outside world needs to be managed gradually in certain instances, this is a key feature of present day adjustment and growth strategies. International trade is, in effect, contributing to growth in those economies that are part of the system.

In the first place, this opening up process acts as a spur to competition and emulation. Indeed protective barriers provide scant incentive to take initiatives, innovate or seek productivity gains. By contrast, in an open economy, competition provides a powerful stimulus to greater efficiency.

Opening up an economy to imports and direct foreign investment also acts as a major driving force in the dissemination of new technologies.

Foreign investment — which has frequently been restricted or barred by defensive national regulations — provides benefits not only by introducing foreign know-how, but also by creating conditions for genuine partnership between the foreign risk-taker and the local economy. These forms of commitment frequently prove more beneficial to the host country than simple financial relations. Lastly, direct investment has the advantage of supplying funds while not creating any additional debt for the beneficiary country.

Attitudes towards foreign capital have changed considerably in the past few years, notably in Latin America, where regulations used to be fairly restrictive in this respect.

This strategy of lowering barriers to the outside world is starting to bear fruit. To cite a few examples: between 1965 and 1988, East and South-East Asia's contribution to world GDP grew from 10% to 20%. Their share of the world value of exports of manufactured goods rose from 9% to 21%. South East Asia's four newly-industrialized economies alone have multiplied their share eightfold in the same period. Meanwhile, those developing countries that remained closed to trade have generally experienced falling per capita income. China's experience since 1979 in opening up its economy helped this country to double its ratio of exports to GDP in the 1980s (it is currently 12%) and enjoy surging growth. I would also like to welcome India's efforts to liberalize supply and open its economy over the past decade, which have already yielded appreciable results. Its per capita income grew by 3% annually on average during the eighties, compared with just 1% between 1960 and 1979. Following a slowdown in the process, it is worth noting that positive new measures have been taken to this end under the Indian adjustment programme, notably by opening up the country more widely to foreign goods and investment and by further liberalizing international trade (by lowering customs duties). Latin America, meanwhile, is starting to reap the benefits of its intense drive to open up its economy during the eighties. It enjoyed strong growth (averaging 3%) in 1991, achieving the first rise in per capita income since 1987, while inflation came down sharply from 1200% in 1989 to 200% in 1990. Many Latin American countries have indeed opened up their economies quite substantially : Mexico, Chile, Venezuela and, more recently Argentina, are cases in point. Opening up their economies has initially aggravated the trade balance somewhat — in Mexico, notably — but the other adjustment measures, and the return flow of capital as confidence revived, has overall served to make these countries more competitive.

To cite Mexico once more, after going into sharp recession in 1986 (with a decline of almost 4%), it has progressively returned to healthy, sustained growth (about 4% in 1990 and 1991). Chile too, after a period of recession in 1982 and 1983, has averaged better than 5% a year growth since then.

I would further point out that, despite the extent of the difficulties they are currently experiencing, certain countries in Eastern Europe (Hungary and Czechoslovakia) which have improved their year-on-year inflation performance, have managed to offset lost market share in the rest of Eastern Europe by successfully redirecting their exports towards the OECD countries.

2.3 Reducing and redefining the role of the state in the economy

Throughout the world, there has been a movement in favour of redefining the position and role of the state in the management of national economy and finances. Naturally, this trend has affected differently the Western nations and the former centrally-planned economies, or those where the public sector used to play a predominant role. But the change of direction has been comparable.

This points in the direction of greater interaction between state and market. Government must facilitate development of the market, occupying a more modest and more flexible role in it, while concentrating on a few priorities.

Whereas it was long thought that direct intervention by the state in the economy could restore balance where the private sector was incapable of doing so alone, the 1980s showed on the contrary that excessive intervention lacked efficiency and appeared as a source of distortion. Today, confidence in the market and the dynamism of private productive supply is the bedrock of successful adjustment.

From a structural standpoint, the broad wave of privatization in the second half of the decade in Latin America, as well as in Africa, Asia and Europe, is evidence of this trend. The intensive drive for financial liberalization in Asia and certain North African countries is another sign of this trend. Hong Kong and Singapore have become major international financial centres. The comprehensive tax reforms being implemented in countries such as Mexico, South Korea, Colombia and Indonesia are also highly significant of the way in which the role of the state is being rethought. In Africa, Tunisia, the Ivory Coast and Togo have begun privatizing, while Ghana has embarked on an ambitious programme to reform its public sector. One could go on citing examples.

More recently, Eastern Europe has engaged in a move towards privatization that could be of great magnitude given the collective structure of these countries. But this phenomenon is still only at its beginning given the difficulty of selling off state assets in the absence of savings, capital markets and entrepreneurs, not to mention legal security of ownership.

How are we to account for this sweeping process? First, because the active presence of the state in industry, agriculture and trade has bred distortions and inefficiencies. These are aggravated when public sector corporations enjoy monopolistic positions and are protected from external competition.

Collectivized farming in particular has been a blatant failure.

In many cases, privatization has been seen as a means to strip firms of their monopoly and thus to promote greater management flexibility and efficiency by introducing competition.

Privatization is also a means to relieve the pressure of budgetary constraints on state enterprises and attract private capital, which had frequently been shifted abroad in the absence of local outlets. Extensive privatization in Latin America in recent years has contributed powerfully to the return of capital, the reduction of national debt, an upturn in investment and a revival of initiative among local entrepreneurs.

However, the fact of putting in place a productive system designed to encourage private initiative and allow it to blossom does not signify a general and total withdrawal of the state.

The existence of a pragmatic, flexible state structure, capable of anticipating or accompanying market developments may, indeed, represent a source of strength, as was the case with the take-off of Asia's industrialized economies.

The eighties also demonstrated the importance of physical and "intellectual" investment in a country's structural adjustment process, the state being in the best position to intervene in this kind of investment, whose social returns are high. Most analysts emphasize the crucial importance, in the economic development process in all countries, of investment in their human capital, education and training, a point often overlooked in the past.

Spending on infrastructure, environmental conservation and research, which make a decisive contribution to long-term competitiveness in developing and industrialized countries alike, pertains for a large part, to the government.

The state also has a role to play in ensuring the social acceptability of adjustment measures, notably by creating a stable and structured framework of industrial relations. That is because development calls for extensive involvement by the population in decision-making. With that in view, governments should seek to promote more equitable income distribution and to cushion the impact of adjustment on the most vulnerable sections of society.

It is also up to the state to see to it that the credit risks incurred by the financial system are appreciated as accurately as possible. While the authorities neither can, nor should, substitute their judgement for that of the risk-takers, it is their job to ensure that financial institutions are sufficiently sound. More rational use of available domestic savings depends on that.

In a great many countries in Eastern Europe and the South now making the transition to a market economy, there is a need for the state to develop a full-scale legal system guaranteeing a measure of security of ownership and in transactions, and regulations concerning business start-ups and failures. For the market is not merely a mechanism, it is a whole system of institutions and specific rules designed to allow these mechanisms to flourish and function efficiently.

2.4 Deregulation

One of the lessons of the eighties was the need to go further in eliminating structural impediments to adjustment and growth. To that end, governments are increasingly tackling a whole series of distortions flowing from governmental regulation that tend to reduce and waste capital. The aim is to allow the price mechanism to operate as freely as possible, by creating a favourable environment for business and private initiative. This was the spirit in which Western countries embarked on their market liberalization and deregulation programmes. Most of the remaining price controls were discarded. Labour markets were liberalized so as to achieve greater flexibility and thus, in particular, to allow real wages to adjust more readily to productivity gains and changes in the economic environment in which businesses operate. One concern has been to prevent external shocks from squeezing companies' margins disproportionately. Those countries that have most successfully kept wages in check (Japan, Germany and the United States) were quickest to absorb the oil shocks. That accounts for the measures taken in many countries to abolish or curtail income-indexation mechanisms.

The wave of deregulation has particularly affected sectors of the economy where it was thought that greater competition would harness resources more efficiently. This has been the case in the transport and telecommunications sectors. But probably the most decisive changes have occurred in the financial systems. Prices and the conditions in which financial activities are conducted have been liberalized, while subsidized loans have been cut back sharply. Banks now operate in a far more competitive climate than beforehand. Quantitative and qualitative credit controls have progressively been replaced by more flexible monetary policies operating through interest rates. The range of financial instruments and services has been broadened. Restrictions on international financial transactions have been removed, with the virtually complete abolition of exchange controls. Transactions have become more transparent, and this in itself contributes to sound allocation of resources.

The way industrial policies have changed clearly illustrates this development. Subsidies have seen their share of GDP decline overall. Public intervention in general has become less dirigiste, more neutral, more horizontal and transparent.

Efforts have also been made to introduce a greater degree of transparency into welfare spending choices, and a greater sense of responsibility on the part of the actors concerned. Reforms affecting taxation (direct and indirect) are equally significant of the determination to encourage private productive supply, by seeking to lower the tax burden, and above all to introduce greater neutrality into tax systems and simplify them. Thus, a good many governments have lowered tax rates in the upper bands and reduced the number of marginal rates, while broadening the income tax base. Measures have been taken to rationalize and broaden the indirect tax base also. But this process is by no means complete, and the overall tax burden has continued to climb, albeit more slowly than in the seventies.

All in all, rolling back the "regulatory levy" is a source of competition and flexibility. One may even argue that economies such as that of Turkey were literally "liberated" by the reforms introduced in the early eighties. Deregulation and privatization have made a sizeable contribution to the emergence of a competition-driven "business culture."

CONCLUSION

To conclude this survey, I would like to discuss a few considerations regarding the conditions for success of economic reforms.

To begin with, the effectiveness of an adjustment programme to a large extent depends on the consistency of its various components. For example, it is vital that macroeconomic stabilisation measures dovetail with structural measures. To be successful, the lifting of price controls implies rigorous demand management. But it would be in vain if it applied to monopolies having little incentive to reduce their costs and raise their output. Similarly, to reap the full benefits of opening up the economy, the domestic environment must be competitive and domestic demand kept under control.

Second, an economic programme must set medium and long-term goals. It is indeed impossible to tackle the fundamental problems of growth by means of short-term measures.

Third, perserverance is called for. In an uncertain environment, the visible steadfastness with which policies aimed at stability are pursued is vital to credibility, and hence sustainability.

Lastly, the strategy adopted must be explained to, and understood by, public opinion, and the latter must be in a position to grasp what is at stake. For that, governments should strive to communicate and create a political and social climate conducive to a sense of involvement and commitment to the reform.

In recent years, a certain number of developing countries have successfully pursued bold, coherent and sustained strategies which have yielded far-reaching successes. That is the case with Mexico, for example, which has brought its fundamentals back into balance, started to diversify and modernize its productive industry, and has again begun to enjoy substantial growth.

But in order to yield its full benefits, the adjustment process must also coincide with similar and symmetrical efforts elsewhere on the international scene.

What I said earlier about opening up to the outside world should apply to all nations. How can one recommend to a country that it liberalize its imports if the international markets are not open to its own exports? That is why the success of the Uruguay Round negotiation is so crucial. With that in mind, the tendency for trade to polarize around a few trading areas, e.g. the EC, the North American market, etc., may represent a stage and an important step towards opening up world trade. But this must not be allowed to crystallize into relatively inward-looking blocks and should be firmly placed in a context of open multilateral relations. It is worth noting in this respect that the volume of imports by the EC from countries outside the EC has grown rapidly since the Common Market's inception, and we have every reason to believe that the single market too will see a fresh surge in extra Community imports.

In the same vein, efforts — notably by the leading industrial countries — to bring their economies back into balance, are in need of more effective international coordination.

How can we be content to observe that the industrialized countries taken as a whole became net importers of savings in the 1980s? When one considers the vast investment needs of the Third World and Eastern Europe, one cannot avoid concluding that the worldwide distribution of savings is distinctly unfavourable. To redirect financial flows towards the developing countries, the leading industrialized nations will have to generate more savings, and some will have to put their own public finances in order. One is bound to admit that the results of multilateral surveillance in this respect have been rather limited.

Beyond applying the disciplines of adjustment to the industrialized countries themselves, more needs to be done in respect of development aid. Clearly, external aid can never replace domestic savings, which remain the basic condition of any economic progress. But aid has an important rôle to play in efforts to redirect savings geographically, in financing certain projects and helping to cope with temporary payments imbalances, in particular ones arising as countries are opening up their economies.

The international financial institutions play a major role in these areas. The Bretton Woods organizations have boosted and adapted their assistance, particularly by providing financial support for debt-reduction programmes. Which is why, following the World Bank's capital increase, it is vital to complete the IMF quota replenishment.

It nevertheless remains that, whatever is done in the way of coordination and international aid, external transfers can never do more than supplement sustained and credible efforts to adjust by the countries concerned themselves.

Adjustment, based on a return to the broad equilibria and price stability, on opening up the economy to the outside world, and on curtailing regulation and the role of the state in the economy, has become a universal imperative.

On completing this panorama, one is struck by the extent and convergence of the thinking that has presided over the formulation of adjustment policies over the past ten years or so. A good many concepts have been abandoned, even if they were initially founded on generous and praiseworthy intentions. For example, it has been shown that subsidized loans aimed at priority sectors distort, and eventually diminish, the volume of funds available. Similarly, a freeze on the prices of certain goods and services for social considerations squeezes profit margins, discourages investment and thus hinders economic progress. Greater realism, acceptance of market disciplines, and the substitution of pragmatism for ideology, are the hallmarks of today's adjustment process.

The eighties showed that there was no quick fixes, but that neither was underdevelopment inevitable. The sometimes spectacular results that have been achieved in a good many Third World countries are proof of that.

Clearly, much still remains to be done. But the way forward is now more clearly marked, and the number of economies that have reached the critical threshold of modernization has grown considerably. As the number of players in the world economy increases and becomes more homogeneous, the potential for world trade growth is greatly enhanced, as are the expected economic transmission effects. Provided international trade can become more open within a multilateral framework, we may hope that, after years of illusion and often misguided policies, followed by a long period of harsh awakening and reforms, the nineties will be the decade in which past efforts will translate into more evenly-distributed, healthier and more sustainable growth.

PRESIDENTIAL REMARKS

Dr. I. G. Patel

Mr. de Larosière, Governor Venkitaramanan, Ladies and Gentlemen

I am sure I am not letting you in on any great secret if I tell you that I was immensely pleased and flattered when Governor Venkitaramanan invited my wife and myself to be present on this occasion. The last time that both of us were present in this auditorium was some ten years ago when there was a music concert to say farewell to us. No Governor ever likes to take leave of his Central Bank; and when the time comes when you must, I can assure both of you Sir, that the withdrawal symptoms are very acute indeed. One likes to return to the old haunt as often as one can; and I am indeed grateful to you, Mr. Governor, for providing me with such a splendid opportunity.

To be able to return on an occasion which marks the memory of Chintaman Deshmukh is a very special honour. This audience does not need to be reminded of his many-sided genius or of his rich contribution to the country. But I can perhaps mention some personal experience of mine which also allows me to acknowledge the deep debt of gratitude that I personally owe to him.

In 1950, when I was just beginning my professional life, I received an offer to join the staff of the International Monetary Fund. I badly needed to accept the offer. But I was under contract to serve the University of Baroda for five years as a condition of the scholarship that had sent me to Cambridge. There were difficulties about my release from the contract, and I took courage and wrote to Mr. Deshmukh about my predicament. He was then our Governor on the Board of the Fund in his capacity, I think as a kind of Economic Ambassador for Prime Minister Nehru. I knew him then only by name and reputation. But he wrote promptly to the authorities concerned urging for my release and arguing that getting trained at the I.M.F. for some years would make me more useful to the country. And that of course did the trick.

Four years later, I joined Mr. Deshmukh's Ministry as Deputy Economic Adviser. My first assignment which he personally gave me was to prepare for him an album of Indian Statistics to help him on his forthcoming visit abroad. It was amazing how quickly he absorbed all the information in four fat volumes and how cleverly he used it on so many occasions. But for me, preparing those fat volumes was the best apprenticeship I could have had for the role of an Economic Adviser.

My only regret is that I did not manage to bring him to visit this new building. I had personally gone to Hyderabad to invite him and he had graciously agreed despite his failing health. But the trip had to be called off at the last moment on doctors' advice.

To our distinguished speaker this evening, I owe a different kind of debt. As Managing Director of the I.M.F.,he made my task as Governor of the Reserve Bank a good deal easier. Most of you know that we negotiated then the largest drawing from the Fund — 5 billion SDRs. But not many persons know how smooth and courteous were the negotiations with the Fund — with none of the agonies over conditionality. Fewer still know that we obtained that drawing against the background of active opposition. But we could not have obtained the drawing without the firm and active support of the Managing Director over several difficult months; and I would like to place on record my gratitude and that of our country to Mr. de Larosiere for his courage, courtesy and persistence during those difficult days of the second oil crisis.

Much water has flown down the Ganges since then, and Mr. de Larosiére has just given us a masterly and succinct account of the experience and lessons of the 1980s. I was struck by one phrase he used to describe this experience when he said that 'the eighties witnessed an upsurge of lucidity and realism.' His lecture, if I may say so, was itself a model of lucidity and realism. It is difficult for me to comment on it – and indeed unnecessary to do so as I agree with practically everything he said. We are indeed all adjusters now and the hall-marks of the adjustment process everywhere are 'greater realism, acceptance of market disciplines, and the substitution of pragmatism for ideology.'

The question that often worries me is this: despite the growing congruity of experience and opinion, why is there still so much controversy around adjustment programmes and what can be done about this?

Part of the reason for the controversies undoubtedly is that many countries start the adjustment process too late when their back is to the wall and when a lot of accumulated debris has to be swept away - often with the help of Bank and the Fund. The remedy is, of course, what Mr. de Larosiere used to urge : go to the Fund early enough, and we did exactly that in 1980-81 when we approached the Fund for a very large drawing when our reserves, if I recall rightly, were still five or six months' imports.

Mr. de Larosiere is also right when he says that the decision to go to the Fund and the Bank is in each case a national one. The Bank and the Fund can take us to the stream, but they cannot make us drink; and the fault for not finding the stream earlier is of the country concerned.

But the involvement of the Fund and the Bank does create complications and these complications have become greater over time as there has been a tendency for conditionalities to proliferate, become more rigidly quantitative and time-bound and acquire a sudden death character. A recent World Bank agreement with an African country, I am told, had as many as 102 time-bound conditions. Is this really necessary or even wise? When we are all batting so to speak on the same wicket and are on the same side, and when the process of adjustment is so complex and prolonged and ranges over a very wide field, I doubt if sudden death conditionality of quarterly credit ceilings is any more all that crucial. I am not arguing against the idea of ceilings or against other conditions. But we do need greater flexibility and trust in the administration of conditionality and same restraint in trying to run every aspect of a country's life.

The second main reason for controversy, of course, is that in reform, the pain comes first and is unevenly distributed and the rewards come later and are also unevenly distributed. We Hindus have no difficulty in understanding this or in accepting it. When the oceans were churned at the beginning, the poison came first and the nectar afterwards. And the poison had to be drunk by only one god, Shiva, whereas the nectar was enjoyed by many.

We have something of this free-rider problem even now. The poor Finance Minister has to take all the blame for reducing subsidies, and for devaluing and for signing long letters addressed to the Bank and the Fund. Other Ministers take credit for extending the Public Distribution System and for removing industrial or import licences and the like.

But that apart, there is need to humanise the process of adjustment and that means more external resources on concessional terms with some debt reduction as well as a more hospitable foreign environment by way of freer markets, higher savings and lower interest rates. I was very happy that Mr. de Larosiere drew pointed attention to this.

But I think there are problems nearer home so to speak – nearer his earlier home – which also need to be tackled. There is need to lower Fund charges which were raised unduly in the 1980's in response to excessive subservience to market forces which can have only a limited place in a cooperative endeavour. The concessional windows in the Fund also need to be opened a bit wider and put on a more durable basis. The balance between the Bank and the IDA was also wrongly skewed – or skewed too soon – during the 1980's; and this needs to be remedied. I am sure Mr. de Larosiere will use all his authority and influence to ensure that the Bank and the Fund reflect the needs and wishes of all its members and not just of the rich and the powerful.

Ladies and Gentlemen, let me once again thank all of you for coming here, the Governor for inviting us and our distinguished guest and speaker for giving us such a rewarding time.

Thank you

VOTE OF THANKS

S. S. Tarapore
Deputy Governor, Reserve Bank of India

Mr. de Larosiére, Dr. Patel, Mr. Venkitaramanan and distinguished invitees

It is indeed a great honour to the Reserve Bank of India to have with us today Mr. de Larosiére to deliver the Seventh Chintaman Deshmukh Memorial Lecture. Mr. de Larosiére has been successively Managing Director of the International Monetary Fund and Governor of the Banque de France and as such he has had a vantage point from which to view the adjustment process in the 1980s.

Being at the helm of the central bank of a country which in the recent period has achieved the lowest inflation rate in Europe, we need to take note of his sagacious advice that inflation cannot assist or take the place of adjustment and that countries that have best kept inflation in check are precisely the ones that have experienced the most sustained growth. He has stressed that macro-economic stabilisation measures should be dovetailed with structural measures and he has also stressed the need for perseverance. With his rich experience of adjustment programmes we need to take note of his advice that it is vital that the strategy of adjustment is explained and understood by the public at large and the need to evolve a commitment to reform — this is in fact an important matter which the authorities in India have been stressing repeatedly in the context of our structural adjustment programme. Finally, Mr. de Larosiere has raised the fundamental question in international economic relations as to "how can one recommend to a country that it liberalise its imports if the international markets are not open to its own exports." On behalf of the Reserve Bank of India may I, Sir, thank you for delivering a thought provoking address on a subject of immense concern to us in India at the present time. We are also grateful to Mrs. de Larosiere for her gracious presence this evening.

We are indeed grateful to Dr. I. G. Patel for agreeing to preside over today's function and for offering his percipient views. While Dr. Patel has held many distinguished posts, I am sure Sir that you will understand that for us in the Reserve Bank you will always be exclusively our Governor. We are also grateful to Mrs. Patel for agreeing to be with us today.

To those of you who have kindly responded to our invitation, and in particular the members of the Deshmukh family, may I, on behalf of the Reserve Bank, thank you all.