SECOND L. K. JHA MEMORIAL LECTURE

THE STRATEGY OF ECONOMIC ADJUSTMENT

Jacob A. Frenkel

The Reserve Bank of India has instituted a lecture series in memory of late Shri L. K. Jha, who was Governor of the Bank from July 1, 1967 to May 3, 1970. The inaugural lecture was delivered by Mr. Robin Leigh-Pemberton, Governor, Bank of England on "Economic Liberalism, Central Banking and the Developing World" on October 16, 1990. The second lecture in this series on 'The Strategy of Economic Adjustment' was delivered by Professor Jacob A. Frenkel, Governor, Bank of Israel on November 30, 1992. Shri M. Narasimham, formerly Governor, Reserve Bank of India presided over the function. Shri S. Venkitaramanan, the then Governor, Reserve Bank of India welcomed the guests and Shri S. S. Tarapore, Deputy Governor proposed the vote of thanks. Professor Frenkel's lecture is reproduced below.

Mr. Governor, Members of the Presidium, distinguished audience and colleagues:

I feel extremely privileged to have been invited to present the second L. K. Jha Memorial Lecture and honoured to have the opportunity of addressing this august gathering. This being my first visit to India, I could not have expected a warmer hospitality or a more gracious reception. During the past two days, which is the amount of time I have spent here, I have already had the opportunity of making many new friends. I never realised how many old friends I have here, and I am delighted to renew acquaintances made in my past incarnations at the University of Chicago, the International Monetary Fund and, of course, the present gathering.

The subject that I will be discussing today is somewhat general : "The Strategy of Economic Adjustment." Naturally, I am aware that when one starts a title with *the* strategy, one may be misinterpreted because there is nothing like *the* strategy. I should probably have indicated "Strategies for Economic Adjustment," because there are so many peculiarities that each country and society faces, and the strategy of adjustment must be tailored, custom-made for their specific needs. Still, I do not feel apologetic for having used *the strategy* because there are some general principles that encompass many of these possibilities and should therefore be of interest.

I would like to address several topics today. First, the issue of stabilisation; second, the transition towards growth; third, liberalisation in general, which raises the question of what you should do first, namely, the sequence of economic measures, as well as how fast you should go about it. Then comes the issue of a safety net, protecting the economic programme and the society undergoing the adjustment programme, how secure it should be and why it is so important to have it. Of course, certain preconditions are needed, and I will also articulate them. Most importantly in the present context, since we are in the Central Bank, the Reserve Bank of India, I would like to pay special attention to the concept and importance of the capital market.

What does stabilisation mean? What are the lessons that I can bring from my own country in this context? I do realise that in India the issue of economic stabilisation is not the most pressing one, but should always be kept in mind. All over the world, there have been attempts at stabilisation when countries have experienced extremely high inflation. There are several lessons that can be learned from these experiments. First, it is a long journey, and there is always political pressure to declare victory prematurely and move from what might be called the stabilisation phase to the phase of growth. I still remember in my IMF days visiting a country two months after the onset of stabilisation, when the head of the State asked me:

"Is the stabilisation phase over? Is this the time to move towards growth?". And indeed, as you look at the countries that have attempted to stabilise, you see that the first phases are the easiest ones, like going on a diet; it is very easy to shed the first few kilos or so. It is sustainability, or staying power, which makes it so difficult to stay the course. Therefore, if it was up to me to decide when to declare victory, I would say that great prudence is called for and one should never declare victory, rather keep the effort up as part of one's way of life. However, as we look at various countries which have been successful in effecting stabilisation, we see that their problem has not been so much stabilisation itself as the resumption of growth. It is this notion of failure to resume growth that has so discredited the strategies of stabilisation. I would therefore like to address the question : what lessons can be learnt about stabilisation efforts with reference to the resumption of growth?

If one looks at a typical stabilisation package one sees that a great deal of emphasis is placed on economic aggregates. The budget deficit must be cut, total government spending must be reduced, monetary control must be in place, etc. etc. Yet, when "stabilisation" succeeds one sees that somehow there is no basis for takeoff. This leads to the following conclusion: growth should not be viewed as just *another stage* in the process, but should rather be built into the very design of the stabilisation programme. This means that telling governments to cut down their aggregate spending is not good enough. We should be more informative. We should be much more specific, perhaps even intrusive, pointing out that if you cut certain kinds of spending, you curtail the infrastructure for growth. The selfsame reduction in spending that is needed for the stabilisation will have a different impact on growth and investment, and attention has to be paid to this from the outset. For example, those countries that have attempted to stabilise have generally taken the politically more convenient line of saying, let us cut infrastructure investment, education and spending on health care, but not government consumption or .... public sector. Why? Because politically it is of course, less convenient and if you cut the size of the public sector, there may be repercussions from the electorate. If you cut infrastructure investment, that affects the next generation but they are not voting yet. So the victim of stabilisation is the future. It is therefore a big mistake to assess the success of stabilisation by just one number : the inflation rate.

I am all for cutting inflation, which is public enemy number one, but I think it is extremely important that the design of a stabilisation effort should incorporate a long-term perspective, which means that government should be told to cut spending, but on consumption, not on capital formation. Do not make reductions at the expense of the infrastructure, as it is so much more difficult to rebuild. As a matter of fact, studies on the factors that stimulate private-sector investment show that there is a high degree of complementarity between infrastructure investment by the government and private-sector investment. Economists, myself included, maintain that a very large public sector is something which upsets private enterprise, competing with it and creating difficulties. This does not encourage private investment. There are, however, exceptions — infrastructure investment, or activities like research and development that the private sector would not undertake on its own. It is, I think, this kind of insight that one looks for in the broad array of stabilisation programmes. Those that have succeeded to resume growth and those that have not, teach us about it.

We all talk about interest rates; we want to keep real interest rates low because we want to promote investment. In all the countries that I am familiar with, including my own, there is pressure on the monetary authorities to relax monetary policy, because that is the way to reduce interest rates, and if you lower interest rates, so the story goes, you promote investment and growth and all kinds of beautiful things. The reality is that what upsets investment are real, not nominal, interest rates. What causes high real interest is not tight or easy money per se — that is the story of inflation. What causes high real interest rates in the present conditions of capital markets, is the budget deficit. One does not need to convince professional economists like the people in this room of the obvious, and yet there are difficulties in convincing the general population of this. After all, somebody has to pay for the budget deficit,

and if the government does not have a tax system in place, a tax administration mechanism that is capable of mobilising the resources to pay for government spending, then a budget deficit follows. A deficit means that somebody has to pay. But who is this somebody? If there is a well-managed tax system we know who pays. A democratic society expresses its priorities in its choice of who pays, and if you have notions regarding the distribution of income, egalitarianism, and social objectives, you can manifest them through your tax structure — a tax structure that is voted in and legislated upon. There are also more implicit notions. If some people do not pay taxes, there is the illusion that somebody is getting something for nothing. We all know how wrong that is, because it is either paid for through the inflation tax or, if we are strong enough on the monetary side, as we ought to be, it is paid for by the crowding-out of private investment. Because when the government enters the market place and borrows, it competes with the other investors and drives up real interest rates. Activities that would have been undertaken by the investors are crowded out, and the next generation is saddled with smaller capital stock and less accumulated investment. There is also a larger public debt to service without the tax base that can be used for this. Therefore, I think that the issue of the budget deficit should be addressed on three fronts: We have to recognize that a budget deficit means that somebody pays for it explicitly or implicitly. We should be very mindful of the dangers in using the "inflation tax," which we do not want and if we want to ensure that it does not happen, we have to have a strong and independent central bank. This message comes through at every stage of the process. I have been involved with the IMF during the past few years and the Fund has looked at Eastern Europe, at the former Soviet Union and the various Republics and one lesson has been learnt: if you really want to get inflation under control you must have a strong and independent central bank. That is what has to be done on the inflation front. When it comes to the other issues, it is essential to have a tax system in place, otherwise real interest rates will remain high. And when real interest rates remain high and the budget deficit is large, the entire economic system is shattered.

There is a notion that a budget deficit is something that does not put a burden on society because after all the government is large and can accumulate more debt. But who is the government? It is the tax payers, and it is therefore very important that we measure the budget deficit correctly and do not think that if we manage to borrow and finance the budget deficit we do not have a deficit problem. By doing this we are simply shifting the burden to the future. Thus, economic stabilisation cannot be fully assessed unless you regard growth performance as part of it, and the budget deficit cannot be assessed unless the mechanism by which it is repaid is part of it.

I now turn to the issue of the sequencing of economic measures and the liberalisation of the economic system. There has been a long debate as to what should be liberalized first : the balance of trade or the capital account of the balance of payments. The debate came up most recently with the economic reforms in Eastern Europe and the former Soviet Union and the call for currency convertibility. I think that we have learnt several lessons there, the most important being that we must draw a sharp distinction between currency convertibility for the current account and currency convertibility for the capital account. When it comes to the current account, I am all for it, because that is basically where the gains from trade are to be found. After all, who could object to consumers having the opportunity to consume and import goods as cheaply as possible from the world economy, especially when new markets are opened? Furthermore, when you start with an economy that is highly monopolised, who could object to introducing greater competition into it? There is no better mechanism than introducing competition into an economy, than confronting it with international prices and norms. It also brings in the discipline of the price system, because once you are in a large market then, if you cannot make it, you should probably not be there. When it comes to capital-account convertibility, I would be much more prudent and be very sure to have my parachute with me before I jumped from the aeroplane. If I could assume that there was a safety net somewhere down there (like a large stock of international reserves) that would be a

bonus. Confidence in the financial system and a stable macroeconomic environment are essential to the introduction of capital account convertibility. But in the public debate that developed concerning 'convertibility' versus 'non-convertibility' there was some confusion and people did not distinguish sharply enough between current account convertibility and capital-account convertibility. I think that it is very difficult to find good reasons why a nation should forgo the benefits of free trade and current-account convertibility.

Permit me to make a few remarks about capital market reform. Capital markets have undergone an enormous change in the last few years, both domestically and internationally. There is a good reason for this, and I will also try to demonstrate that economic development within a nation is hampered unless there is a liberalised and well-functioning capital market. But for a well-functioning capital market not to be risky there must be additional elements. Let me start from the most trivial example. There were no car accidents 200 years ago, yet today there are a great many. Would anyone suggest returning to the days of no cars as the best way to stopping accidents? Obviously not. I think we all understand that if we really want to minimise the cost of car accidents the right strategy is to widen the roads and legislate, may be make seat-belts compulsory and introduce safety precautions. This is also the prognosis, as well as the main instrument, for capital market reform. If you liberalise the capital market you must make sure that it is accompanied by an extremely effective supervisory authority as well as a regulatory authority. Here we are in a bind. The American philosopher George Santayana once said that those who cannot remember the past are condemned to repeat it. That is right, provided tomorrow has something to do with yesterday. But when we have a fundamental change in both perceptions and technology, as is indeed the situation regarding the nature and functioning of capital markets, our tomorrow gains very little from the knowledge of yesterday. So when I say: let us design a supervisory authority with regulatory capacity and all the rest, the question is: supervising what? The unchartered territory? This is the paradox. We should be cognizant of the fact that when we invent cars we will have car accidents. We should also be cognizant of the fact that we should have as wide a road as possible, with seat-belts as effective as possible, but that still tomorrow is not like yesterday, and therefore very little can be learnt from yesterday. Therefore, driving is hazardous, but we must try to do our best, and try not to skid. Accidents come with the territory, as it were. I would also say that they illustrate the paradox of liberalisation and regulation. In a society that has no degrees of freedom, where everything is set in advance and organised from the centre, you do not need to regulate anything. You do not need to supervise anything. Everything is predetermined. So, paradoxically but logically, the more open a society is, the more free enterprise it has, the more regulation you need. Not the regulation of the way *individuals* operate, but regulation of the way in which *the markets* and society operate so that within the well-functioning regulated markets individuals can operate freely as free enterprise prevails.

This bring me to the importance of the capital market. And again, although I may draw my examples from extreme cases like the centrally planned economies of Eastern Europe and the Soviet Union, I think that some general principles emerge. At the early stage of transition towards a market system, you have an economy that is fully owned by the public sector, representing the diametrical opposite of the free enterprise, private-ownership society. Now you want to open up and to start having private ownership and free enterprise, and the question is: how do you start? In the old regime, the one in which enterprises were all run from the centre, where profit considerations were not the prime consideration, an enterprise could run losses but was in no danger of having to close, because if there was a problem then you go to the central government, or you go to a bank, and you get credit. And you get credit whether you are a good or a bad firm, because you will never go out of business, because if you get into trouble Big Daddy (the State) will be there to bail you out. So we had a system in which enterprises were run inefficiently. They never went out of business because credit was available, and if the bank did not give credit, another firm gave credit and a very intricate network system of inter-enterprise credit

developed. In deciding on credit allocations there was no need to examine whether an enterprise was viable or not. This information was useless; there was no incentive to accumulate such information since there was always somebody to bail you out. Now these economies undergo a revolution as the society decided to move to private enterprises and to adopt stringent rules and tight budget constraints, not soft budget constraints. But they have a problem, namely, that they start with extraordinary excess luggage on their back. Their balance sheets are very complicated; the assets of one enterprise include the liabilities of another; some liabilities are good and some are bad. How do we know where to start?

Introducing a fundamental reform, where tomorrow differs from yesterday, requires taking a logical step with respect to the initial balance-sheets. A *sharp cut* has to be made and this means different rules of the game, sometimes a different legal structure and "clearing the books." There is only one point of time at which it is possible to clear the books without yielding significant redistributions of wealth, i. e., when all the books are owned by the public sector. Because then clearing the books means undertaking a book-keeping exercise and shifting money from one pocket of the public sector to the other. Then it is literally a pure book-keeping exercise. But once the government sold enterprises to the private sector it is too late. So I am in favour of undertaking this financial restructuring at a very early stage. But a tax system must be in place, because if the government is about to sell enterprises to the public, by privatising the profitable enterprises, then the government loses future sources of tax revenues. Unless the government can change its spending patterns, it will produce the breeding ground for the next budget deficits. I pointed out earlier that the budget deficit involves sacrificing the future by crowding out private investment. It follows, therefore, that one needs to have a tax administration in place, with a proven capacity to raise revenue, prior to unloading those revenue-yielding enterprises. Thus, I cannot be more emphatic in saying that yes, privatisation is essential, but it is equally as urgent to have a well-developed and functioning tax system.

Even if the tax system is in place, we still need to worry about the capital market, and we need the capital market for at least two reasons. Let us take trade liberalisation. When you liberalise the economy and open it up to foreign competition, you are always subject to the pressures of those who feel that they will be displaced. Labour fears unemployment and enterprises fear they would be out of business, and so on. I think that two remedies are called for here: First, there must be a very clear recognition that the process of trade liberalisation takes time; but second, it must be realized that the process is a one-way street, with no going back. I think it makes no sense to declare from one day to the next that all tariffs are eliminated, not because I am against eliminating tariffs, but rather because I am in favour of it, and I am enough of a political realist to realise that such a declaration will not be adhered to. If a reform measure involves even a single step of retreat along the way, its credibility will be lost. So that in the liberalisation of trade, what is needed is a multi-year trajectory, preferably one that is legislated, with a very clear timetable of removal and ever-increasing reduction of protection. Nonetheless, some enterprises will have to go under because they are not viable without protection. Here the role of the capital market is central, because once the books have been cleared, the well-functioning capital market should ensure that good enterprises can sail through the storm. The capital market has the virtue of being able to separate the losers from the winners and provide credit when the economic realities warrant it. By the same token, if an enterprise is not viable, the credit markets will not support it. But for this we need to have a well-developed credit market and capital market, because if we do not, then even the good enterprises may join in lobbying against trade liberalisation.

Another example illustrating the usefulness of capital markets pertains to monetary policy. Consider for example a situation in which the monetary authorities decide to make monetary policy tighter because of various considerations, including the fight against inflation. Naturally, this will put some pressure on enterprises and by its nature, monetary policy does not work like a laser

beam; it is an aggregative policy. It affects the entire economy. However, the very existence of the capital market provides the opportunity for good firms to smooth out such adjustments and borrow in the market, thereby making the monetary policy that was adopted more effective.

With regard to exchange rates, in Israel our exchange rate is pegged to a basket of currencies, and we have used the exchange rate in our stabilisation effort. But we were very careful to do it only after our budget deficit had been checked. Otherwise you get into another fundamental difficulty, namely, if you have a large budget deficit you drive up real interest rates, and the tendency is to strengthen your currency. You find that you lose competitiveness, but this is not because you have managed your currency wrongly, interest rates are too high, or monetary policy is tight, but because of the real interest in the context of the budget deficit. The recurrent crises in the foreign exchange market of the European Exchange Rate Mechanism have demonstrated time and again that a tendency towards currency appreciation and loss of competitiveness was induced by high real interest rates in that wake of the budget deficit. Thus, drawing on our own experience, focusing on the budget deficit and the exchange rate, we see that the exchange rate can be a very powerful and useful instrument, contributing to stabilisation as well as increased competitiveness, *provided* the other fundamentals of economic policy are in place. Thus, an economy with a large budget deficit is really handicapped in making good use of its other efficient policy instruments. When we introduced stabilisation in Israel we started with triple-digit inflation in the mid-eighties and brought inflation down in a very short period to about 17 to 18 per cent and there we got stuck. Then we saw that other successful stabilisation efforts had also got stuck at exactly the same point. We looked at Chile, Mexico and Argentina, and saw a very similar situation. Hyperinflation was stabilised, the exchange-rate anchor was fine, the budget deficit reduction was successful, but we had got stuck. We then realised that one of the reasons for this was that the economy had become accustomed to living with inflation and had developed extraordinarily sophisticated instruments to cope with it, and hence had reduced the incentive to fight it. An extremely intricate mechanism of indexation evolved, resulting in a very inflexible labour market. When the wages of nurses rise, this goes through to the wages of doctors, plumbers and shoe-makers. You cannot have any flexibility in the labour market, you cannot fire or hire according to economic performance and productivity. This is the heritage of the period of high inflation. Therefore, as you stabilise, you realise that the first few kilos in the diet are the monetary phenomenon, requiring "only" a significant cut in the budget and stringent monetary policy. The rest requires a much more comprehensive approach, putting together the trade side, the labour market, and the financial market. Only when such added arms of the economic reforms are mobilized the process gains credibility, and you can continue in resuming growth and in making further gains on the inflation front. Taking the example of Israel again, as our growth resumed to the range of 6 to 7 per cent per year during the past two years, we have now cut our inflation by half, and in 1992 our inflation rate was below 10 per cent.

The exchange rate is also an instrument that can support the anti-inflation fight. Exchange-rate policy should be consistent with the inflation objective. Rather than compensating for *past* inflation, the exchange rate should be adjusted according to the feasible target inflation-rate. That is the mechanism adopted in Israel by which the anchor principle can be used, cutting loose from the past, which you want to abandon, and moving to the future in accordance with your economic objectives.

Travelling today through various countries that have undertaken reform, one cannot help but be impressed by the fundamental change that has taken place during the past ten to twenty years. At present there is much less of an ideological debate when it comes to economic policy than there used to be. In the past, the debate between fiscal austerity versus fiscal easiness or inflation versus unemployment, were debates between right and left, rich and poor. I think that there is much greater convergence of professional views. Now the issues concern the tactics of implementing an agreed strategy rather than the debate between strategies. And it is in this sense that I kept the

word *the* strategy of economic adjustment in the title of my talk, because there are general principles. These principles recognise that there are no free lunches, that when the government takes something, somebody pays for it, that in a complex economy there is no better mechanism than the private sector, that price mechanism is of the utmost importance, and that the difference between gradualism and non-gradualism is not between being careful and careless. Dogma has given way to professionalism. There are areas where once a decision has been taken it must be implemented decisively and not gradually. The analogy that comes to mind is the decision to move from driving on the left-hand side of the road to driving on the right. It would never occur to anyone to do this gradually, saving that on Monday small cars will move, and on Tuesday large cars, etc.

It is in this sense that in some areas once a decision has been taken it must be implemented in one shot. Decisions with regard to issues like opening up an economy and removing tariffs or the liberalisation of trade, are also dramatic. However, their implementation can be smooth and spread over time, provided it is credible, and credibility means a one-way road, not a stop-go approach. One of the problems one sees today in various places where economic reforms have been undertaken is the frustration of the population who is disappointed with what was promised to them. But I must be frank in saying that often the mistakes are not because of the strategy of reform but rather because of the politicians' tendency to make unrealistic promises. There is no such thing as a "velvet revolution" when it comes to economic reform. Drastic reforms are always painful, and are always at the expense of one element or another. While society may of course create appropriate safety nets, you cannot protect everyone, because if you did, the reform would not constitute a true surgery, and some surgery must be undertaken. But if there is one lesson it is — explain what is happening and mobilise political support by pointing to the alternatives. This is something that was done in the Israeli Stabilisation of 1985. We had a painful hyperinflation, enterprises stopped producing and concentrated on playing with financial instruments. Inflation destroyed the price mechanism and the economic system became completely dislocated. It was against this background that the politicians approached the public explaining that things could not go on like this, a change was essential, the alternative to stabilisation was much worse, and therefore, even though adjustment would be tough, it would still be better than the alternative. In this regard, in Eastern Europe and the former Soviet Union there was euphoria about the political change and a naive view about the economic hardships that reform entails. Of course, multilateral organisations must help, and the tax system will generate safety nets, and so on but it must be tackled in the right way. Conditionality clauses in agreements with multilateral organisations like the IMF and the World Bank must also be tackled in the right way, so that when money is borrowed it is used well, and is an investment, so that the fruits of the tree will be there to repay the loan yet the tree will still be there. All of this has to be done well, and I think, therefore, that what we have seen recently is not that the strategy of economic reform has been discredited but rather that the educational efforts that have been made in mobilising political support have been inadequate.

Let me conclude with a remark made by Lord Keynes at the closing ceremony of the Bretton Woods Conference which was held almost half a century ago. It was there that the World Bank and the IMF were created amid heated deliberations and a great deal of criticism. Lord Keynes said in his closing speech, "I am greatly encouraged, I confess, by the critical, skeptical and even scalping spirit in which our proceedings have been watched, and welcomed in the outside world; how much better that our projects should begin in disillusion than that they should end in it." Indeed, because economic reform is so essential, deliberations, public debate and free discussions are always helpful in clarifying the inevitability and usefulness of the strategy of economic adjustment.