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# The Relevance of Keynesian Economics to Developing Countries: Traditional and Modern View

Keynesian theory was mainly concerned with cyclical unemployment which arose in industrialised capitalist countries especially in times of depression. During the period of Greet Depression (1929-33), the developed capitalist countries faced a drastic fall in GNP resulting in severe unemployment.

J.M. Keynes explained that it was fall in aggregate effective demand for goods and services that was responsible for depression and huge unemployment that arose during the period of depression. Keynes put forward a theory of income and employment which explained the determination of income and employment through aggregate demand and aggregate supply.

In the early fifties although few economists caused doubts on the validity of the Keynesian theory as applied to the advanced developed countries of the West, a number of eminent Indian economists cast doubts on the applicability of Keynesian economics to the developing countries like India.

Prominent among those who held that Keynesian theory was not relevant in the context of the underdeveloped economies, mention may be made of Dr. V.K.R.V. Rao and Dr. A.K. Dass Gupta who pointed out that the nature of the economic problems of the developing countries was quite different from the problems that arose during the Great Depression in the developed countries of the West and therefore the Keynesian theory of income and employment and the policy recommendations were not very helpful in the context of the then under-developed countries.

In what follows we first explain this traditional view regarding the inapplicability and irrelevance of Keynesian economics to the developing countries like India. However, in recent years, in my view, after five decades of economic growth and development in the developing economies like the Indian many principles and postulates of Keynesian theory have become quite relevant to the problems of the present day developing countries. We discuss below these traditional and modern views about the relevance of Keynesian economics to the developing countries.

## <u>Traditional View: Irrelevance of Keynesian Economics:</u>

### The Demand-Deficiency Problem:

The principle of deficiency of effective demand is perhaps the most important proposition put forward by J.M. Keynes. It was pointed out that Keynes explained that drastic decline in GNP and increase in involuntary unemployment that occurred during the period of depression was due to deficiency of aggregate demand caused by decrease in investment demand, but the problems of lack of economic growth, poverty and unemployment were due to entirely different reasons. Poverty and unemployment in developing countries, it was pointed out, was caused by more fundamental and structural factors such as lack of capital stock relative to labour force of these economies.

Thus, Dr. A.K. Das Gupta wrote, "Indeed whatever be the generality of the General Theory may be in the sense in which the term 'general' was used by Keynes the applicability of the propositions of the General theory to conditions of an underdeveloped economy is at best limited".

Therefore, it was explained that Keynesian policy prescriptions to raise aggregate demand such as increase in Government expenditure by deficit financing cannot be adopted to accelerate the growth of income and employment.

It was emphasized that the nature of unemployment prevailing in the developing countries was different in that it was of the type of chronic disguised unemployment caused by deficiency of physical capital and lack of wage goods rather than decline in effective demand which was stressed by Keynes to be responsible for the rise in cyclical, involuntary and open unemployment.

### Keynes' Policy Prescriptions are not Relevant:

It was emphasised by Dr. V.K.R.V. Rao that Keynesian policy prescription of deficit financing to overcome depression, if adopted in the developing countries to finance increase in investment expenditure by the Government was likely to generate inflationary pressures in the developing countries rather than increasing real income, output and employment.

In fact, Dr. V.K.R.V. Rao, among others, contended that in the developing countries it was classical economics which laid stress on increasing the rate of saving for accelerating rate of growth of income and employment was applicable and relevant rather than Keynesian economics which emphasised deficiency of effective demand. Thus, Dr. Rao ends his article, already quoted, "It is the classical thesis which is operative for the other category (meaning, the underdeveloped countries) where you move from one level of development to a higher level of development."

He adds further, "old-fashioned prescription of 'work harder and save more still holds good as the medicine for economic progress, at any rate as far as the underdeveloped countries are concerned." While Dr. V.K.R.V. Rao, Dr. A.K. Das Gupta and their followers laid stress on classical policy prescription of rapid accumulation of physical capital to accelerate economic growth and generate employment opportunities, Professor, Vakil and Brahmananda emphasised the rapid expansion of wage goods (i.e. essential consumer goods of which most important are food-grains) as the remedy for accelerating growth and removing poverty and unemployment.

**Keynesian Multiplier is Inapplicable to Underdeveloped Countries:**

In his well known paper quoted above, Dr. V.K.R.V. Rao emphasised that Keynesian investment multiplier is not applicable to underdeveloped economies. He showed that in underdeveloped countries the operation of multiplier leads to the increase in prices rather than output and employment. Therefore, according to him, in under-developed countries multiplier works in money terms and not in real terms.

The reason is that there are essential conditions for the operation of Keynesian multiplier in real terms. One important condition is that the supply curve of output should be elastic so that when aggregate demand for goods increases as a result of the working of multiplier process, output should be adequately increased without bringing about rise in the price level. But it was asserted that since in underdeveloped countries there was little excess production capacity in consumer goods industries, the supply of goods could not be increased due to the desired extent.

The second condition for the working of multiplier in real terms without causing inflation is that the supply of working capital, raw materials, power can be easily increased to meet the increases in their demand as a result of the working of multiplier. This condition too was also not fulfilled in case of the underdeveloped countries like India.

The third condition for the working of multiplier in real terms was that there should be involuntary open unemployment. That is, there are a large number of workers who are without work and would like to work if they find employment at the prevailing wage rates. However, as mentioned above, the nature of unemployment in developing countries is different. Instead of open involuntary unemployment there is disguised unemployment.

These disguisedly unemployed workers do not realise that they are unemployed. They are supported by joint family system and they would like to remain in agriculture though their services are not actually required and in fact their marginal productivity in agriculture is zero or negligible. It was argued that they are not really involuntarily unemployed in the Keynesian sense and would not be readily coming to supply their labour services in expanding industries as a result of the operation of investment multiplier.

Thus, Dr. V.K.R.V. Rao argued that the particular form which unemployment in an underdeveloped country like India takes are for Keynesian purposes practically analogous with one of full employment and to that extent prevents the working of multiplier for increasing employment and output.

It was further asserted by the economists in the fifties that in underdeveloped countries the principal occupation of the people was agriculture and the greater proportion of their income was spent on foodgrains as income elasticity of foodgrains was very high. On the other hand, when during the fifties, it was pointed out that supply of agricultural products was inelastic in the underdeveloped countries like India.

This is because they thought production in agriculture was subject to uncertain natural factors like climate and rainfall. The farmers also lack other inputs like fertilisers, high quality seeds, irrigation facilities. In view of these constraints of the farmers, it was difficult for them to increase agricultural production, especially of foodgrains, adequately in response to the increase in aggregate demand resulting from the operation of investment multiplier. Thus, the result was the rise in prices of foodgrains which through wage-price spiral would result in inflation in the underdeveloped countries.

## Modern View: Relevance of Keynesian Economics in Some Important Respects:

Much of the above arguments for irrelevance of Keynesian economics and instead the applicability of classical economics were advanced in the early fifties when the developing countries were industrially backward and there was a paramount need for underscoring the importance of capital accumulation through raising the rate of saving.

That the inadequate growth in aggregate demand could serve as a constraint on the process of industrial growth was totally neglected. Thus, the fashion among economists in the fifties and sixties was to lay stress on the importance of supply-side factors with which classical economics was concerned to the total neglect of the demand-side of the problem of economic growth.

However, in the beginning of the current millennium, the situation in the developing countries has vastly changed as a result of 50 years of economic development and structural transformation that has taken place in their economies. With this change in the economic conditions of the developing countries, a number of modern economists think that several crucial elements of Keynesian economics have become relevant to the present-day developing countries.

**The following elements of Keynesian economics have become relevant to the present-day developing countries:**

1. The Problem of Demand Deficiency

2. Investment Behaviour of Entrepreneurs

3. Portfolio Choice

4. Theory of Consumption Function

5. Principle of Income Multiplier

6. Government Intervention to achieve economic stability and promote economic growth.

We discuss below how the above principles of Keynesian economics have become applicable to the present-day developing countries.

**Problem of Deficiency of Effective Demand:**

Development experience of the last half a century has revealed that even in the developing countries the role of adequate growth in effective demand for achievement of sustained economic growth on which Keynes laid a great emphasis cannot be ignored. Late Prof. Sukhamoy Chakravarty rightly remarks, “So far the demand has been disregarded on the ground that we always have full utilization of capacity as capital goods will necessarily earn positive return. Empirical evidence suggests that this is not a safe assumption to make even in a developing country i.e., capital can remain under-utilised when the capital services earn a positive price".

Even in the early fifties Ragnar Nurkse in his now well-known work, "Problems of Capital Formation in Underdeveloped Countries" had emphasised that investment in the developing countries was low because of narrow size of the market. According to him, inducement to invest in modem capital equipment in the developing countries is low because the size of the market, which is needed to ensure their optimum or full use is limited. By size of the market, he means the level of aggregate demand for goods. Of course, the demand deficiency problem to accelerate investment in the developing countries is of different nature than that mentioned by Keynes.

The narrow size of the market in the developing countries is primarily due to the mass poverty prevailing in these countries. This mass poverty has been caused by lack of adequate economic growth, the existence of huge unemployment and underemployment and a highly skewed distribution of income.

Poverty of the people means that they have small purchasing power so that the level of effective demand is low which adversely affect inducement to invest in consumer goods industries. As a result, sustained rapid growth of consumer goods industries is not possible.

As a matter of fact, in certain periods of industrial development in these economies lack of effective demand has caused slowdown and deceleration of industrial growth and smaller utilisation of established capital stock. For example, in the period from mid-sixties to the late seventies (1966-1977) the Indian industrial sector witnessed a deceleration in its growth rate.

Various explanations for it have been offered but the widely accepted view has been that of decline in effective demand caused by decrease in public investment during this period. Besides, slowdown in industrial growth has also been attributed to the fall in growth of agricultural production resulting in lower incomes and demand of the rural people for the industrial products.

Apart from the above explanation of the actual slackening of demand for industrial products in certain specific periods of industrial growth, even theoretically, the emergence of slackening of effective demand causing under-utilisation of the existing capital stock in the industrial sector of the developing countries has been brought out. Thus Prof. Sukhamoy Chakravarty argues "industrial prices are usually quite sticky while agricultural prices are liable to fluctuate.

As a result when agricultural prices go up, notably the prices of food, money wage rates remaining constant, the proportion of wage income spent on food rises, leading to the erosion in the residual purchasing power." This implies the slackness of demand for the industrial products, which will cause "the emergence of excess capacity in the industrial sector."

He further adds. "If, on the other hand, money wages go up, the general price level tends to rise with a concomitant reduction in the real purchasing power of 'relatively fixed income recipients' a category which for this purpose should include even workers in the unorganised sector, beneficiaries of government transfer payments etc." This adversely affects demand for industrial products.

Prof. Chakravarty also explains that the use of imported capital-intensive technology in various sectors of the economy results in highly skewed distribution of income, which causes slackening of demand and emergence of excess capacity in the industrial sector.

He thus writes, “the importation of modern capital intensive technology frequently accentuates the problem by generating a highly skewed income distribution which restricts the market size further, making it more profitable to sell lower volumes at a higher profit margin.”

**Recent Demand Deficiency Problem in the Indian Economy:**

It may be noted that since mid 1996 till date (April 2003), that is, in the last six years the Indian economy has again witnessed a slowdown in industrial growth. There is a general consensus that this slowdown in industrial growth has been mainly caused by decline in effective demand. The demand from all important sources namely, agriculture, investment and exports have decreased. Thus, authors of Economic Survey (1998-99) write, The slowdown in industrial growth may be attributed primarily to slacking in aggregate demand.

**Among the factors causing this slackening of aggregate demand three factors have been mentioned:**

(1) Fall in demand for Indian exports,

(2) Decline in consumption demand by the rural people due to negative growth in agriculture, for example in 1997-98,1999-2000,2000-01, and 2002-03 and

(3) Slow growth of investment, both by the public and private sector.

From our above analysis of the relevance of demand deficiency as a constraint on industrial growth, it should not be understood that supply-side factors such as raising the rate of saving and capital formation to accelerate economic growth are unimportant.

What is being emphasised here is that it is not adequate to rely merely on supply-oriented growth models such as the one used by IMF and World Bank whose structural adjustment reforms seek to tackle only supply-side factors determining economic growth to the utter neglect of the fact that economic growth may also be demand- constrained.

It is clear from above that the industrial growth in the developing countries may also be demand- constrained, apart from constraints of resources such as rate of saving, stock of capital, infrastructure facilities, and raw materials availability.

**Investment Behaviour in Developing Countries:**

Keynesian economics is also relevant to the developing countries with regard to its analysis of investment behaviour as distinct from the classical analysis. Classical economists did not distinguish between decision to save and decision to invest. According to them, decisions regarding saving and investment were coterminous. Keynes distinguished between decision to invest and save and argued that it was investment that determined saving and not the other way around. According to him, when investment goes up, income will increase through the operation of multiplier and at a higher level of income more will be saved.

An important contribution made by Keynes to the theory of investment refers to the role of business expectations in determining investment. According to him, the rate of investment is determined by rate of interest on the one hand and marginal efficiency of capital on the other. Marginal efficiency of capital refers to the expected rate of return on investment. The marginal efficiency of capital depends on the state of business expectations regarding future prospective yields from the investment currently made.

When businessmen become pessimistic about future prospective yields, the marginal efficiency of capital declines which adversely affects investment. This investment behaviour as visualised by Keynes is as much relevant to the investment in the modern sector of the developing countries as to the industrialised developed economies. Given this investment behaviour, "It is then no longer sufficient that the community's propensity to save should be stimulated. We also need to ensure that investment climate is suitably improved".

In building up favourable investment climate business expectations have to be influenced through appropriate fiscal and monetary measures adopted by the Government. Writing about investment behaviour in the contemporary countries, Prof. Chakravarty further writes, "Given the present state of technical knowledge, there is much greater use of fixed capital in industrial processes. Since decisions to invest in fixed capital imply commitment of resources to a prolonged and uncertain future, the question of time and uncertainty becomes crucial. At this stage we have to introduce the problem of expectations which bring us into the domain of Keynes' theory."

It may be noted that in the current context of slowdown in private investment which is an important factor causing slowdown in industrial growth, we can explain the decline in private investment in new shares and physical capital assets in terms of 'animal spirits', a term used by Keynes to refer to the waves of pessimistic and optimistic expectations of investors.

According to them, due to political uncertainty as well as due the uncertainty about the ability of the Government to pursue certain crucial economic reforms, there is lack of investors' confidence which has prevented them from investing in new shares and physical capital assets. The above analysis clearly brings out the relevance of Keynes' investment analysis to the developing countries.

**Portfolio Choice by Investors:**

Another important element of Keynesian analysis which is relevant to the developing countries is related to portfolio choice. Since classical economists were concerned with the economy where there existed a commodity money and credit played no role in it, they were not concerned with portfolio choice. In the modern exchange economy even in developing countries like India credit plays a crucial role and portfolio choice by the investors, at least among three types of assets, namely, bonds and shares, physical capital assets and money balances (for example, in the form of bank deposits) must be made.

In the developing countries the situation may arise when due to high capital costs and low prospective yields expected from them the investors may not be induced to invest in physical assets and new bonds or shares of companies and instead opt for keeping their savings in the form of money balances (for example, in time deposits of banks).

It is important to note that in recent years (1997-2003) such a Keynesian type situation is prevailing in the Indian economy where investment in shares and physical capital assets by households have declined and instead investment in bank deposits have greatly increased.

Economic Survey of Government of India for the year 1998-99 makes a special mention of such a change in the portfolio choice by the households.

Thus, it writes, “The uncertainty combined with performance of stock markets since the boom of 1994 and lack of trust in issuing companies and market intermediaries has also led to a shift of retail investors from riskier investment into safe heavens like bank deposits and post-office savings.”

The portfolio choice has also caused stagnation of investment in the years 1996-2002, which, as seen above, cannot be explained in terms of classical economics. In fact, the followers of classical economists think that relative shortage of physical capital in the developing countries, rate of return on investment must be high, which as seen above, is contrary to what has been actually observed. This clearly brings out the correctness of Keynes’s fundamental insight into the determination of investment and portfolio choice.

To quote Prof. Chakravarty again, “We can easily imagine situations where people try to shy away from investing in physical assets, the rate of return and the rate of interest is such as to give an edge to holding savings in the form of cash balances. The resulting situation will be of Keynesian type.”

Elaborating further he writes that “Uncertainties surrounding physical investment decisions are often much larger in developing countries and the cost of making a wrong decision is often quite high in a market which is very often quite small and slowly growing”. It is clear from above that with regard to portfolio choice Keynes’s insight was quite significant and is relevant to the behaviour of investors both in the developed and developing countries.

**Keynes’ Consumption Function:**

An important contribution of Keynes was his consumption function. Classical economists thought that rate of interest were the dominant influence on decision to consume and save. However, Keynes argued that consumption is a function of current level of absolute income ($C = a + bY$) where C is the amount of consumption and Y is the current level of absolute income.

Using consumption expenditure data of the Indian economy researchers have found that in accordance with Keynes’ consumption function, disposable income is the dominant determinant of private consumption expenditure in the Indian economy and further that rate of interest does not play any significant role in determining consumption.

Besides current income, income distribution and the amount of wealth which were considered by Keynes as objective factors determining consumption have also been found to be important factors determining consumption expenditure. It is interesting to note that no empirical evidence in favour of post-Keynesian theories of consumption, namely, Modigliani’s Life Cycle theory of consumption and Friedman’s Permanent Income hypothesis of consumption have been found applicable to India. Thus, Keynes’s principle of consumption function is very relevant to the developing countries like India and accordingly it has been extensively used in various econometric models of the Indian economy.

**Keynesian Multiplier and the Present-Day Developing Countries:**

As shown above, it was explained by V.K.R.V. Rao and others that in the developing countries Keynesian multiplier does not work in raising real income or output and employment but instead it works only in money terms which gives rise to inflationary pressures in the economy.

The inapplicability of the Keynesian multiplier was based on the assumption that in the developing economies capital stock (or production capacity) tended to be fully utilised and there existed no excess capacity in consumer goods industries. Further, irrelevance of multiplier to the developing countries was based on the premise that most of the demand generated by increase in investment was directed towards foodgrains whose supply could not be easily increased.

But the situation in the present-day developing countries has substantially changed. For example, in the Indian economy today (i.e., in the year 2003) there exists a good deal of excess capacity in consumer goods industries and also during the periods of deceleration in industrial growth of 1966-1977 and 1997-2003 a lot of excess capacity existed in the consumer goods industries. Further, thanks to the green revolution even foodgrains production can be increased in response to the rise in demand for them.

Thus, in the present prevailing situation of unutilised capital stock in consumer goods industries, the increase in investment will produce a real multiplier effect on increase in output and employment, though due to some supply-side bottlenecks such as lack of infrastructure such as power, good roads, highways and ports and imperfections in the Indian economy the size of multiplier is not as high as warranted by the high marginal propensity to consume.

Even where there is no excess capacity, demand generated by stepping up of investment, private or public, leads to more investment for expansion of productive capacity which is usually termed as the acceleration effect. Indeed, the combined working of multiplier and accelerator, which is called super- multiplier, can take place as a result of increase in investment, private or public, in the present context of the developing countries.

**Role of Government Intervention:**

A fundamental departure from classical economics made by Keynes related to the intervention by the Government for regulating the economy if full employment is to be re-established. Keynes showed that if left free the market mechanism would not work to restore automatically full employment if the economy finds itself in the grip of depression caused by deficiency of effective demand arisen due to the fall in marginal efficiency of capital. The same applies to the problem of sustained economic growth in the developing countries.

If left completely free to the market mechanism there is no guarantee that sustained economic growth will be achieved in the developing countries. In the developing countries, the Government has to intervene by way of adoption of suitable fiscal and monetary policies to stimulate not only private investment to achieve rapid growth but also to ensure growth with price stability.

Besides, for achieving sustained economic growth it requires that Government should step up public investment in building up economic infrastructure such as power, telecom, irrigation, ports, roads and highways to tackle supply-side bottlenecks to economic growth but also to invest in social capital such as education, public health.

In the context of developing countries, stepping up public investment is likely to stimulate private investment rather than reducing it. Contrary to the popular perception, the analysis of empirical data of the Indian economy by Professors Pandit, Krishnamurthy, and Sharma find clear evidence for crowding-in-effect of public investment.

Public investment not only generates demand for the private sector but also improves infrastructural facilities such as power, transport, communication, which help private sector investment and stimulates overall growth of the economy.

All this is contrary to classical economics which believes in Laissez Faire policies. From the foregoing analysis we conclude that certain crucial elements of Keynesian analysis have become relevant to the present-day developing countries.