

ON THE ECONOMICS OF "OPEN ECONOMY" DE-INDUSTRIALIZATION

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It is an honour for me to have been invited to deliver the V.V.Giri Memorial Lecture this year at the Annual Conference of the Indian Society of Labour Economics. Shri Giri was not only a committed trade unionist but a social thinker of note who sought to build a bridge between his Gandhian outlook and his struggles on behalf of the working class. As Labour Minister in Pandit Jawaharlal Nehru's cabinet he adopted an approach towards the settlement of industrial disputes that was both innovative for its time and mindful of the interests of the workers in a manner befitting a country emerging into freedom after centuries of colonial oppression. Even if he had not become the President of India at a later date, Shri Giri would still have been counted among the makers of modern India. It is in the fitness of things therefore that we should honour him at the Annual Sessions of this Society.

I have chosen on this occasion to speak on a topic that is of profound importance to the working class, namely "de-industrialization", a concept which I use to refer to a situation where a section of the workers employed in the industrial sector of an economy *becomes unemployed* owing to a deficiency of demand for the products they produce. This is not the traditional definition of de-industrialization, which refers to a decline in the ratio of the work-force employed in industry¹. According to the traditional definition in other words, any structural change in the economy whereby the pattern of sectoral employment shifts away from industry, leading to a decline in the share of industry in the work-force can be called de-industrialization. *In other words, de-industrialization can occur according to the traditional definition even in an economy which is in perpetual full employment, but not so according to my definition, where the unemployment of hitherto employed industrial workers constitutes the hall-mark of de-industrialization.*

Since the output, and hence employment, of the agricultural sector is given in the short-run, and is unaffected by the demand for it (whose effect, in the absence of State support, would be on price), *any* reduction in *aggregate* demand, entails *ipso facto* a reduction in the employment in the non-agricultural sector, including in particular the industrial sector, and hence de-industrialization on my definition. My definition of de-industrialization in short is practically synonymous with an increase in unemployment through deficient aggregate demand (which is inclusive of but is not synonymous with, as we shall see, Keynesian unemployment).

In this paper however I am not concerned with *any* de-industrialization. My focus is only on those situations where de-industrialization is *directly* caused by an economy's interaction with the outside world through trade and financial flows. (I shall not even be discussing de-industrialization caused by the fact that an economy open to financial flows would have to be kept deflated in order to "retain the confidence of the investors", which is a euphemism for bowing to the caprices of global financial speculators, since such de-industrialization can be said to be *indirectly* caused by the economy's interaction with the outside world). The reason I confine myself to discussing such "open economy de-industrialization" is my belief that such de-industrialization is not fully understood. An increase in unemployment through

¹This particular criterion has been used by a host of scholars in India in their empirical investigation into the question of whether there was de-industrialization in the colonial period. See for example Daniel and Alice Thorner (1962) and A.K.Bagchi (1976).

deficiency in aggregate demand in a closed economy setting has been discussed extensively by economists, starting with Keynes and Kalecki. But the open economy setting remains to be explored at greater length.

A further preliminary point must also be made here. De-industrialization in real life may not always be observed in its pristine purity; it may be superimposed on a situation of growth, so that *an absolute decline in industrial employment may not be directly observable*. But that is a matter concerning the interpretation of data; my concern in this paper being theoretical, I shall not be discussing the statistical criteria for identifying the phenomenon.

I

Conventional neo-classical economics is incapable of recognizing de-industrialization in this sense, since it is based on the assumption that the economy always functions at full employment. The opening up of trade between two economies may well mean that one specializes in manufacturing, and hence witnesses a shift of work-force from agriculture to manufacturing, while the other specializes in agriculture and hence witnesses a work-force shift in the reverse direction. In this case there would be a decline in the proportion of the work-force in manufacturing in the second economy, and hence de-industrialization in the conventional sense, *but not de-industrialization in the sense defined by us which refers to the creation of involuntary unemployment among hitherto employed industrial workers*. Since neo-classical economics cannot recognize involuntary unemployment, it cannot *ipso facto* recognize de-industrialization as defined here. To understand the phenomenon of de-industrialization therefore we have to go beyond conventional neo-classical economics.

There are at least three different cases of "open economy" de-industrialization that we can distinguish between. The first and the most obvious of these is where, for a given stream of autonomous expenditures, the economy comes to have an import surplus. This is the case of de-industrialization recognized by Keynesianism. Imports represent a leakage of aggregate demand from the economy to the Rest of the World, just as exports represent an accretion to it. An import surplus therefore represents a net leakage of demand from the economy. It therefore entails higher Keynesian unemployment compared to a situation where, for the same stream of autonomous expenditures, no such import surplus exists, or even a situation where, for the same stream of autonomous expenditures, no trade exists at all. Putting it differently if an economy opens itself up for trade, and this trade brings in its wake an import surplus, without stimulating the stream of autonomous expenditures at all or not to an equivalent extent, then the economy would have a lower level of aggregate demand and employment than before it opened itself up. The benefits of trade claimed in the conventional neo-classical literature always presume full employment. But once this presumption is abandoned, the possible impact of trade on the level of aggregate demand has to be reckoned with and trade may turn out to cause recession and unemployment via an import surplus.

To be sure if the government in this situation enlarged the fiscal deficit then the unemployment-generating effect of an import surplus can be nullified. But then the economy's indebtedness to the outside world would be higher in the post-trade than in the pre-trade situation, even though the level of employment remains the same in the two, so that the conventional proposition of trade being unambiguously beneficial still cannot be sustained.

II

The second case is where de-industrialization can occur *even with balanced trade*, or for that matter *even with an export surplus*. This case is clearly outside the Keynes-Kalecki paradigm. It can arise only in a situation where the industrial sector's output is always wage-goods constrained, but never demand-constrained *in the sense of being below what the availability of wage-goods warrants*, owing to inadequate demand. De-industrialization in such a situation can be explained through a simple example². If real wages (reckoned in terms of, and spent only on, the wage-good which consists exclusively of the agricultural product and is agriculture's only product) are fixed at w' , all of which is consumed, if agriculture produces a surplus S over its own wage-bill and if the agricultural as well as the industrial capitalists neither consume, nor directly use for investment purposes, any wage-good, then in an economy with only these two sectors, industrial employment would be given by S/w' . Industrial output would be given by bS/w' where b is the productivity per worker in industry. Now, if a part, say e of this S is exported abroad by the agricultural capitalists (or landlords) and exchanged directly for an equivalent amount (in value terms) of imported industrial good, then the domestic industrial employment would shrink to $(1-e)S/w'$, and domestic output to $(1-e)bS/w'$.

The reason for the shrinking of industrial output in this case can be stated in two alternative but equivalent ways: either as a reduction in agricultural *supply* for domestic industry, or as a reduction in the *demand* for industrial goods which the agricultural surplus gave rise to. We therefore have de-industrialization in the sense I have defined, despite external trade being balanced. An extension of this case is when eS of wage goods is exported but an amount $a eS$ is of industrial goods is imported ($a < 1$), the remainder being net lending abroad by the agricultural capitalists or landlords (or, as happened in history, a forced extraction without any *quid pro quo* by a colonial power); then, even assuming, as before, that industry does not face any *additional* demand constraints that would push its output below what the availability of wage goods warrants, there would still be de-industrialization, since domestic industrial employment would be $(1-e)S/w'$, and output $b(1-e)S/w'$. In short, whether agricultural capitalists import the full value of their exports or only a fraction of it has *per se* no impact on domestic industrial employment and output, which would shrink if there is any export of domestic wage-goods (or of commodities whose production takes land away from wage-goods production). Such de-industrialization, it follows, is perfectly compatible with an export surplus from the economy.

Let us examine this case a little more closely. Conventional neo-classical trade theory would say that if de-industrialization occurs because domestic agricultural capitalists (or landlords) prefer imported manufactured goods to domestically produced ones, then the resources released through such de-industrialization would get absorbed in the agricultural sector (where there is comparative advantage), resulting once again in a full employment equilibrium, but one with a different output-mix. But there is an essential difference between agriculture and industry (which the neo-classical assumption of symmetry between goods obliterates): resources released by de-industrialization can be employed in agriculture only if unused land for employing these additional resources exists. Of course the effective supply of land can be increased through the provision of certain "land-augmenting" inputs, e.g. irrigation, but these typically come from the State. If the State is unwilling to provide these,

²The argument of this section has been developed more elaborately in Patnaik (1996).

or if the loss of revenue it suffers on account of de-industrialization, makes it *curtail* its investment expenditure (owing to a belief in the necessity of "balanced budgets"), then resources rendered unemployed by the shrinking of industry would not be absorbed in agriculture, and de-industrialization would continue to prevail.

This is the classic case of de-industrialization under colonial rule³. The pre-colonial economy was characterized not by autonomous investment or government expenditures, but by the fact that the surplus raised from the peasantry by the State, landlords and merchants was used to sustain a class of artisans whose products in turn were used by the surplus appropriators for various purposes. When the colonial State replaced the pre-colonial one, it laid claim to a part of the surplus which it simply expropriated and shipped abroad (the so-called "drain") without a *quid pro quo*. To be sure, the commodities which were produced earlier and the commodities which were demanded by the metropolis were not identical, so that the commodity composition of the surplus had to change, for which the production structure had to be transformed⁴. But since, with the exception of the "canal colonies" in the Punjab, no significant State investment occurred to promote "land augmentation", the siphoning off of this surplus abroad had a de-industrializing effect on the economy. (This is what was referred to above as de-industrialization in the midst of an export surplus, except that under colonialism the country built up no claims upon the colonizing country through these export surpluses which were simply appropriated without any *quid pro quo*, under the camouflage of constituting "payments for good administration"). In addition, since the landlords and the merchants who obtained the other part of the surplus switched their demands from home-produced to foreign-produced goods, there was an additional cause for de-industrialization. (The fact that wage goods were directly exported but other goods which displaced them on the available cultivated land, was, logically, of little consequence⁵).

III

It so happens that the issue of colonial de-industrialization had been a subject of debate between the two most outstanding figures of modern India, Rabindranath Tagore and Mahatma Gandhi, who had very different views on the subject. Since the debate between them has now become accessible, thanks to the labours of Professor Sabyasachi Bhattacharya of my university, a brief comment on it may not be out of place here⁶.

The disagreements between Tagore and Gandhi covered a number of themes. Some of these derived their importance from the contemporary context and hence are of secondary importance for us today, e.g. whether burning cloth, just because it was foreign-produced, in a country where large numbers of people, including even women, had barely enough cloth to cover themselves, was justified; whether, even if burning cloth belonging to oneself might be defensible, asking someone else to do so was morally justified; whether, even assuming that abhorrence of foreign cloth was defensible, every one should start spinning one's own yarn as a means of building a new order; and finally whether issues such as these should be discussed

³For a specific theoretical discussion of colonial de-industrialization, see Patnaik and Ghosh (1991).

⁴For an illuminating discussion of this point see Bagchi (1972).

⁵The effect of agricultural exports consisting of non-food crops in curtailing domestic food availability has been discussed by U.Patnaik (1996).

⁶See Bhattacharya (1997), Part I, documents 15 and 16.

at all by the use of arguments other than the cold logic of economics. On all these, needless to say, Tagore's was the sceptical voice.

But the fascinating question covered by the debate, which remains pertinent today and lies at the core of economic theory, concerns the following. While Gandhiji emphasized the de-industrializing role of imported foreign cloth (and of foreign goods in general), Tagore took the position, which was also stated eloquently in his novel *Ghare Baire*, that the superior quality and lower price of foreign cloth (of any given quantity) were of benefit to the peasantry, including even the poor peasantry. Opposition to foreign cloth therefore was against the interests of the peasantry. (He had already seen in the context of the *swadeshi movement*, the possibility of a communal division arising from such opposition, since the bulk of the peasants in Bengal of his time were Muslims while the leadership of the *swadeshi* movement which spearheaded the opposition to foreign cloth was predominantly middle-class Hindu. He gave expression to this premonition in *Ghare Baire*).

If we accept Tagore's argument, then we must conclude that the opening of trade, even while having a de-industrializing effect on the economy, also has the beneficial effect of cheapening articles of mass consumption, and therefore improving the living standards of those who are not thrown out of employment. We must also conclude that there is a conflict of interest between those who are thrown out of work because of the imports and those who are not. Can we then be justified in taking an unambiguously protectionist position? This is a question on which, with hindsight, some analytical light can be thrown.

The answer to this question hinges crucially upon whether the unemployment caused by de-industrialization has the second-round effect of weakening, *visavis* their surplus expropriators, the bargaining strength of those producers who are not the direct victims of de-industrialization and who may be expected to experience an improvement in their standard of living owing to the cheaper imports. It is reasonable to assume that it would, as indeed it did in the colonial period⁷. If the increase in unemployment has the effect of so reducing their bargaining strength that they get pushed back to the same level of living as what they had experienced before the opening of trade, then clearly the *entire benefit of cheaper imports would have accrued to the class appropriating the surplus*. In this case, since one segment of producers would have been thrown out of work as a result of the opening of trade and another segment would have experienced no improvement in its living standard, it would be perfectly legitimate to see the opening of trade as being against the direct producers as a whole, and benefiting only the class of surplus appropriators. One can in such a case quite legitimately and unambiguously argue in favour of protection against cheap imports. This argument of course would be weakened if the direct producers who continue to be employed experience some *increase* in their living standards, i.e. the increase in the rate of surplus extraction in their case is not large enough to offset the beneficial effects of cheaper imports. On the other hand, in the opposite case, where they witness a decline in their living standards compared to the pre-trade situation, the argument for protection would be strengthened.

Historical evidence, as already mentioned, argues against any improvement in the living standards of the producers who were not directly hit by de-industrialization. Even in their case, however, we have to recognize one particular fact. While the rise in the proportion of surplus extracted from them, which nullifies whatever gains they could make from cheaper imports, occurs after some time (when the impact on unemployment and hence of increased

⁷See on this Bipan Chandra (1965).

labour reserves is felt on their bargaining strength), there is some improvement in their living standards in the interim, prior to the rise in the share of surplus. In this sense one can say that Tagore's argument had some validity in the short-run, but Gandhiji's position was more valid in the long-run.

IV

I now come to the third possible case of de-industrialization, which is of special relevance in today's context. The second case related to a situation where the domestic industrial producers were incapable of standing up to import competition and needed protection. But this third case concerns a situation where even if the domestic producers *ceteris paribus* can withstand foreign competition, the absence of restrictions on capital flows may still precipitate de-industrialization. This in short has nothing to do with their relative competitive position at the base exchange rate. It arises entirely as a fall-out of the caprices of speculative finance.

Consider an economy which is completely open to capital flows in both directions and has a flexible exchange rate. It exists in a universe, like the one today, where a large body of finance capital is moving around from country to country in the quest of rentier gains. If in this situation finance suddenly flows into the country, for whatever reason, then the exchange rate would appreciate, resulting in a cheapening of foreign goods relative to the domestic goods in both domestic and foreign markets. This would lead to a closure of domestic activities, de-industrialization, and unemployment of hitherto employed workers, including industrial workers. The capital inflow, in other words, would have created room for its own absorption by giving rise to an equivalent current account deficit. And this deficit which is nothing else but the excess of domestic investment over domestic savings, would have widened not because of a rise in investment (which cannot happen since investment decisions are taken independently, and the sheer inflow of finance cannot possibly stimulate larger investment), but through a decline in savings, through a decline the level of domestic activity. *The capital account of the balance of payments in such a universe drives the current account, and not the other way round, as most open economy models with capital flows, including the celebrated Mundell-Fleming model, assume.*

Financial inflows in fact spell doom for the economy twice over. When they come in, they cause unemployment, recession and de-industrialization; and when they leave, since the entire inflow has thus got used up financing the country's ruin, they cause financial crisis and insolvency, forcing the country to go begging for funds from the IMF which in turn imposes strict "conditionalities" including the selling off of domestic assets to metropolitan buyers at throwaway prices. In other words debt-financed de-industrialization is followed by a financial crisis when the time comes for the debt to be repaid, giving rise to the phenomenon of expropriation-cum-denationalization of domestic assets.

This obvious scenario, however, despite the fact that it has worked itself out in one country after another, is scarcely understood or appreciated. Even many sensitive and progressive economists take it for granted that the level of activity in an economy is curtailed only as a response to the financial crisis when capital flows out, but that, by the same token, the level of activity is *enlarged* when capital flows in. Nothing could be further from the truth.

This belief springs from a confusion between capital-in-production and capital-as-finance.

The enormous mobility of capital that we observe in today's world relates to capital-as-finance: the fact that less than two percent of cross border capital flows is linked to trade-related transactions bears this out. The inflow of capital-as-finance does not *per se* lead to any expansion in domestic activity. True, it represents a command over resources which are *potentially usable*, but their actual use can occur only if *simultaneously* there is an expansion in the demand for such resources. Since such a miraculous coincidence never occurs, the inflow of finance typically causes an excess supply of foreign exchange, which gets eliminated through a rise in the exchange rate that has the effect of increasing the demand for foreign exchange by switching demand from home to foreign goods, i.e. by de-industrialization.

It may be thought that Central Bank intervention to maintain a stable exchange rate by holding reserves, such as is happening in India, can get rid of the problem: it would amount to holding foreign exchange resources for a while until demand for such resources gets generated, which gets around the simultaneity problem. As a matter of fact however, even though such Central Bank intervention would, quite obviously, prevent de-industrialization, it would give rise to other problems. Foreign exchange reserves with the Central Bank typically earn very little interest (no more than 1 or 2 percent for instance in the case of India)⁸; on the other hand, the finance capital which comes into the country earns rates of return (including capital gains) which are quite hefty (which after all is the reason for its flowing in). The country in other words is borrowing from abroad at high rates and using the funds to earn low rates, which is indefensible. The *maintenance* of large foreign exchange reserves therefore entails a loss for the country. On the other hand the usual avenues, which one can think of, for the using up of such reserves are either not available or are positively harmful (or both) in the context of the pursuit of neo-liberal policies. Let us see how.

The existence of foreign exchange reserves can, under certain circumstances (e.g. by removing restrictions on imports where such restrictions exist), be used to stimulate larger domestic consumption of imported goods. But then this would amount to using short-term loans to enlarge consumption (typically of the rich who are the main consumers of imported goods). But in such a case, when the funds are sought to be moved out, the country would be in the midst of a financial crisis which would reduce activity and impinge on the living standards of the poor. Not only would the funds have been frittered away with nothing to show for it, but the poor would have to bear the burden arising from the profligacy of the rich. This is scarcely defensible.

Of course it may be argued that the existence of these resources should be used to stimulate not private consumption but private investment. But private capitalists cannot be coerced into investing if they do not wish to (and there is no reason why the sheer existence of reserves should stimulate this wish). Some may think that the money created against the Central Bank's holding of reserves, would, in one way or another, ease the availability of finance for investment purposes and thereby stimulate private investment. But this would be the case only if private investment is finance-constrained, to start with. Typically however, the investment decisions of that section of capitalists (the large capitalists) for whom financial availability improves as a consequence of the Central Bank's holding of reserves, are demand-constrained rather than finance-constrained; and that section of capitalists (the small

⁸I am grateful to Professor Mihir Rakshit for providing this information at a seminar on October 24, 2003, at the Centre for Economic Studies and Planning, Jawaharlal Nehru University.

capitalists) whose investment decisions could at all be said to be finance-constrained, do not experience an improvement in the availability of finance even when the Central Bank's reserve-holding increases. It is not surprising therefore that throughout the period when foreign exchange reserves have piled up in India, gross fixed capital formation in the private sector as a proportion of GDP has shown no increase whatsoever, and has continued to remain below the figure for the mid-nineties when a burst of demand expansion had pushed it up⁹.

Moreover even if it is assumed, for argument's sake, that private investment does increase as a result of accretion of reserves, this would amount, from the country's point of view, to "borrowing short" for "investing long", and, typically, borrowing in foreign exchange for investing in non-foreign exchange earning projects, which is, as the East and South Asian experience testifies, a sure recipe for financial crisis¹⁰.

Given the autonomy of private investment, it may be thought that an expansion of public investment should be used to overcome the problem of reserve accumulation. But such an expansion is anathema in a "liberalized" economy (even in India today, where there is a palpably demand-constrained economy, the chorus from the Washington pundits, and local experts of the same persuasion, is for a *curtailment* of the fiscal deficit, and hence by implication, of government expenditure). Moreover, the problem of "borrowing short to invest long" would still remain, and even, plausibly, the problem of borrowing in foreign exchange to invest in non-exchange earning projects. It follows then that any expansion of domestic demand to alleviate reserve accumulation, even if the expansion is of a sort that can be considered socially desirable, must be accompanied by the imposition of some measures of control on capital movements.

Both the re-activation of the State as an investor and the imposition of capital controls however run completely contrary to the direction of neo-liberal policies. The pursuit of these policies, to put the matter differently, exposes the economy, in a situation of financial inflows, to de-industrialization; the only alternative to de-industrialization in such a regime is a wasteful and palpably unwise accumulation of foreign exchange reserves.

V

Even this offset however is being sought to be removed, at least from the Asian developing countries. An argument is being advanced that not only China and India but even other Asian economies are maintaining exchange rates that are undervalued, and that these countries should therefore let their exchange rates appreciate. I shall not go into this argument here, which to my mind represents an important component of a new imperialism, of the metropolis enlarging its market at the expense of the "outlying regions", much the way that Rosa Luxemburg had theorized in the context of old imperialism. I shall only discuss one implication of it which seems to me obvious from the Indian case.

If the sheer fact of an accumulation of reserves is to be treated as being symptomatic of an

9. The factors underlying the demand expansion in the mid-nineties are discussed in Chandrasekhar and Ghosh (2002)

¹⁰A number of papers on the East and South East Asian crisis, arguing along these lines, can be found in K.S.Jomo (1998). See also Ghosh and Chandrasekhar (2001).

undervalued exchange rate (for in the Indian case there can be no other basis for claiming that the rupee is undervalued), then in effect the exchange rate is being sought to be determined by demand and supply on the market without Central Bank intervention. Since the market excess demand is strongly influenced by speculative financial flows, and since exchange rate movements affect the real economy, the acceptance of this argument amounts to institutionalizing a state of affairs where the caprices of a bunch of speculators determine the lives of millions of people, *without any let or hindrance*. In particular it amounts to institutionalizing a state of affairs where a sudden bout of speculative capital inflow would perpetrate de-industrialization on an economy. Since the purpose of economics is to bring about an improvement in the lives of the people, economists must raise their voices not only against the institutionalization of such a state of affairs, but for moving further from mere Central Bank intervention for currency stabilization to a re-activation of public investment, together with capital controls.

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