

Economic integration, macroeconomic policy and micro markets*

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ABSTRACT:

The New Partnership For Africa's Development (NEPAD) has been established to provide a substantive platform for African countries to initiate a series of policy steps toward more rapid economic growth and poverty reduction. Critics have argued that some of the policies, especially regional integration, will do more harm than good, and have cast the debate as a binary choice between the open and closed economy. Neither a fully closed nor a fully open economy is likely to maximize welfare and growth. In contrast to the notion of policy autonomy in the closed economy, the closed economy requires far more stringent application of price controls, monetary, fiscal, and competition policies than do more open economies to prevent rising inflation and worsening income distribution. On balance, more open trade and capital relationships are preferred, because they help to ensure consistency between macroeconomic policy and microeconomic behaviour and are more conducive to improving income distribution.

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1 Introduction

Over the past year, NEPAD has emerged as the primary vehicle for bringing African countries into what might be described as the ‘reformist’ wing of the world’s economic and political community. I use the term reformist, because while NEPAD places much emphasis on good economic and political governance within African countries, it also urges potentially far-reaching changes to the international developmental architecture - and more laterally to aspects of the political economy interaction that have characterised North-South relationships over the past several decades. Perhaps more broadly, NEPAD provides a critical link between domestic and international economic policy by providing consistency between the two, and, by doing so, ensuring that the pre-requisites for sustained economic growth are in place for South Africa (and Africa more broadly).

Somewhat surprisingly, NEPAD has generated criticism from some quarters, which has generally consisted of the view that economic integration is welfare-decreasing, and that international economic policy (trade and capital account policy) should be set to protect domestic economic and political relationships (Bond 2002).¹

These narratives have a long pedigree, and even a cursory review of economic debate over the past century belies the notion that these are somehow progressive in the sense of having some innate logical or moral claim on promoting human development. The position, in very general terms, is that the current stance of policy in South Africa is responsible for unemployment and other ills afflicting the country. More broadly, economic integration is supposed to dramatically worsen, and in some versions cause, those afflictions in national economic systems. The recommendation made is that South Africa should withdraw from its international linkages through raising tariffs on imported goods, re-imposing and strengthening controls on the movement of capital, and using the resulting closed economy conditions to raise fiscal spending to a much higher percentage of GDP. Presumably, these moves would have to be supplemented with price and wage controls and other administrative forms of price determination.

¹I use the term ‘economic integration’ to mean low or non-existent tariff and non-tariff barriers to trade and minimal restrictions on the cross-border flow of capital. The idea can be deepened, of course, to include few restrictions on the cross-border movement of labour, removal of border controls, and cross-national infrastructure and other physical links between national economies.

More generally, the suggestion is that all developing countries should insulate themselves from the costs imposed on economies by international economic integration, not least because this enables governments and states to avoid domestic economic reform that can be politically upsetting. Moreover, the closed economy is supposed to enable governments to pursue policies that reflect some ‘true’ choice expressed by a political community. In short, the critique of NEPAD advocates protection for prevailing domestic economic and political relationships through closed international economic policies. In this view, international economic links, particularly in goods and capital markets, impose constraints on states’ abilities to achieve desired social and economic ends. We can reformulate this less philosophically - the critique says that the economic and political benefits of closed economies outweigh the benefits of more open international economic links.

This paper explores some of these issues. The following section discusses the theoretical and empirical question of how closed or open current and capital account policies affect demand management policy, and provides an historical example of how international economic integration enhances national growth and income. Subsequently, I discuss the importance of macroeconomic stabilization using South Africa as an example, and then why improving income redistribution depends in part on macroeconomic stabilization through consistent microeconomic relationships. Finally, the last section pulls the points together to show why the NEPAD critique violates perhaps one of the more important lessons of 20th century economic history and theory - that macroeconomic developments are a function of microeconomic relationships. Governments cannot avoid the welfare costs imposed by inconsistent microeconomic relationships and policies by resorting to closed economy policies. To the contrary, the closed economy only makes existing disincentives more perverse for growth, distribution and welfare by entrenching the capacity of well-organised interest groups to extract rents from the economy - and widening the exclusion of marginalized social groups.

Much of the discussion so far has been cast as a binary choice between integration and non-integration and the implications for macroeconomic policy and microeconomic and institutional relationships. In part, this is because the general debate in South Africa has been polarized along ideological lines. As I noted above, ‘perfect markets’ like ‘national autonomy’ are abstractions, which in a polemical environment make for swift denunciations of policies (and considerable efforts to portray ideas and policies in a particular light). This is unfortunate, because democratic governments and accountable states

should seek to maximize the net benefits of sets of policies reflecting in some manner a number of different social, political and economic values. That any single set of values does not overwhelm all others in plural political and economic markets is a sign of strength in democratic polities, and if reflected in balanced economic policies should be positive for growth and a more equal distribution of income.

2 Integration, growth, and public welfare

It seems necessary at the outset to deflate the notion of absolute national autonomy. It is a concept as abstract and unreal as that of ‘perfectly competitive markets.’ States exist in an environment of international and domestic constraints. Moreover, countries that seal themselves off from international linkages have worse performing economies over time (Rodríguez and Rodrik, 2000).

One reason for the worse performance is that in an environment without international linkages, coercion, public expenditure and inflation are some of the only policy tools left to the state.² These tend to be inefficient from either a political or economic sciences perspective. Indeed, one of the larger problems of economic autarky (or what the French Left in the 1980s called ‘the Albanian Option’) undermines economic efficiency and eventually accountability and democracy.³ Empirically speaking, closed economies provide little public space for civil society organizations, in particular trade unions. In summary, the alternatives suggested by the critique of NEPAD (domestic stasis and no economic integration) are either simply not attractive for pub-

²Robert Skidelsky provides a very useful discussion of this problem with reference to Haljmar Schacht’s closed economic system in 1930s Germany, in the third volume of his biography of Keynes. Three facets of the system made it sustainable for a few years. The first were forced bilateral export and import agreements with German satellites. The second was the ability of Germany to block access by the satellites to accounts set up to clear the payments for the bilateral trade arrangements. And third was massive public expenditure on rearmament which increased employment in lieu of economic activity that might have been created through a more multilateral trade regime. However, this was not a system that was sustainable without forcing the import of raw materials, forced labour, and confiscation of mark balances built up by the satellite countries.

³One suspects, furthermore, that security and stability are only experienced by governments capable of insulating themselves from any political criticism arising from the deteriorating economic conditions of the country.

lic welfare and income or illusory.⁴ Where implemented, such policies have led to stagnating growth rates, high (or repressed) inflation, growing inefficiencies in the private and public sectors, poor investment decisions, and the erosion of democracy and accountability.

One can surely agree that there are costs associated with international economic integration. But the benefits of integration for pareto improvements in welfare, expanded policy options available to governments, and rising economic growth rates outweigh the costs.

International linkages raise the number of tools available - even though there may be some threshold of international linkages over which state power is lessened.⁵ One area in which state power has probably been reduced is in instances in which developing countries have completely opened themselves up to large inflows of capital, especially where this is concentrated in debt or portfolio flows. The costs of allowing and not properly regulating large capital inflows have proven to be very large in some countries where capital has suddenly pulled out. This is not, however, an argument for imposing exchange controls to prevent any inflows and outflows of capital, but is an argument for suggesting that governments should regulate flows in a manner that maximizes the net benefits of such flows.

More generally, restrictions on capital inflows constrain the size of current account deficits that countries can run, and, in turn, on the size of sustainable fiscal deficits. As I shall discuss further below, trying to increase deficit spending in a closed economy environment is likely over time to result in a worse income distribution, lower and less efficient investment and employment. This means, contrary to the view of the critique, that if governments choose to run closed-economy policies, they are more constrained in their choice and use of demand management policies than if they run open-economy policies.

This point can also be extended to microeconomic and institutional relationships - a closed economy needs highly efficient, accountable, and rules-

⁴Garrett, Geoffrey and Lange, Peter, 'Political responses to interdependence: what's "left" for the left?' in *International Organization* 45,4, Autumn 1991. See also, Ross, George "Where Have All the Sartres Gone? The French Intelligentsia Born Again" in James F. Hollifield and George Ross, eds. *Searching for the New France* (New York and London: Routledge, 1991). And an excellent article restating an updated politics of economic policy for the Left Tony Judt, "The Social Question Redivivus," *Foreign Affairs*, September/October 1997.

⁵In other words, a non-linear relationship.

based institutions and more fully competitive markets to offset the efficiency loss from having no international competition. The catch is that in practice, such policies have never worked well in an economic sense, and never for long in a political sense - largely because they tend to require non-democratic institutions to keep them in place.

Given the increase in volatility of capital flows, and their potential effects on small economies, perhaps the most trenchant criticism of NEPAD involves the question of whether inward flows of capital assist in the growth of African economies. While it is the case that cross-border flows of capital have become more volatile in the 1990s, they are nevertheless not a new phenomenon. Governments in many countries have been trying to address them since the early 1970s (as well as prior to the 1930s), and many have done so very successfully. Those efforts have all recognized that while volatile capital flows are partly a function of the operation of international financial markets themselves (information asymmetries, herd behavior), they also have to do with the quality of domestic economic governance. Poor regulatory systems and monetary and fiscal policy management make economies much more vulnerable to volatility and contribute to it by perpetuating the shocks through the productive and employment relationships in the economy (Eichengreen and Leblang, 2002). Most of the criticism applied to open capital markets, the impact of volatility in particular, has little to do with African economies, since they in absolute terms they draw little in. The argument against open capital accounts for African economies needs to rather focus on the variability of aid flows, which has to do with donor budget cycles.

Good monetary and fiscal management, and appropriate financial regulatory systems, conversely enable countries to derive large benefits from mobile capital - particularly when they make it possible to run current account deficits. Maximizing the pace of economic growth and standards of living is easier when current account deficits are allowed - in other words, in international economic environments that allow countries to spend more than they earn (or to invest more than they save domestically) in the short-term so that they can finance greater social expenditure, physical capital, and social and economic infrastructure to produce and earn more in the medium-term. For absorption to be higher than income, some level of openness to trade and capital flows is necessary. In other words, achieving more rapid economic growth and wealth creation through intertemporal leveraging of the balances on current and capital accounts requires relatively low tariffs and some reasonable level of openness to inflows of foreign savings.

Figure 1: Current accounts, net private and official flows to Africa (source: IMF World Economic Outlook, 2002)

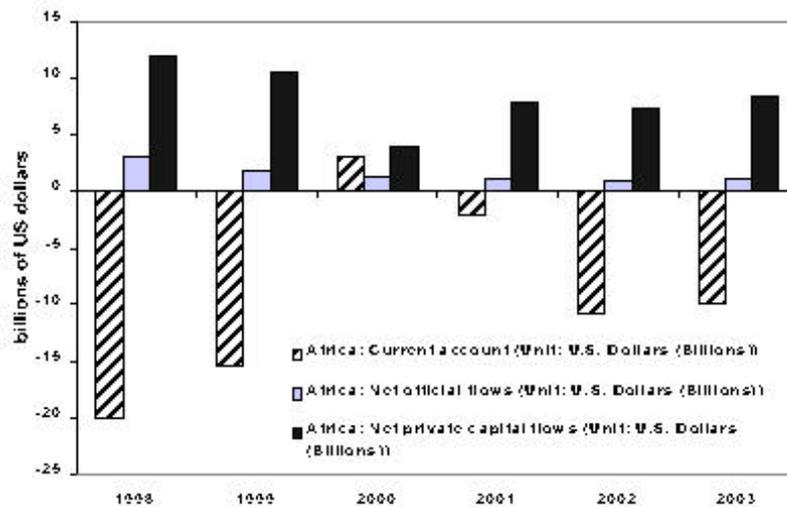


Figure 1 shows that in 1998, Africa as a whole consumed about US\$20 billion more than it produced, and attracted sufficient capital inflows to finance the high level of absorption. Would public welfare and economic growth been higher in Africa if countries had not been able to run current account deficits of this magnitude?

It is, of course, in theory possible to run a small closed economy that remains democratic, accountable, and with low inflation, but such a country cannot run current account deficits, and hence is constrained to run even more economically orthodox policies than those attributed to the ‘tyranny’ of mobile capital. The reason for this is that closed markets tend to lead to inelastic product demand and greater concentration of firms - eventually resulting in markets dominated by cartels or monopolies, rising prices, declining quality of products, and falling consumer power. Decreasing competition, in turn, retards investment, and the economy moves on to a lower equilibrium growth path - with higher inflation. In this supply constrained economic system, any fiscal or monetary expansion leads swiftly into inflation. The difficulty is that as the economy slows, the temptation to turn to nominal

demand expansion grows, and this is one reason why closed economies tend to exhibit higher rates of inflation than open economies and/or they create shortages in the production of goods (repressed inflation).⁶

Economic and political history suggest that attempts to forego international economic integration because it imposes political costs in terms of requiring good economic governance results in the ‘Albanian option’ becoming a grim reality (rather than just a bad dream). This becomes critically important in the context of NEPAD, which places a strong emphasis on good economic governance. Among other interpretations, this can mean that governance should allow more people to experience rising levels of utility (however defined) without unduly biasing the system in a way that disproportionately burdens other social groups. As I will discuss below, macroeconomic stabilization is critical to good economic governance, as is economic integration and macroeconomic coordination between countries. The theoretical underpinning here is straightforward - economic integration through enhanced economic coordination between states in turn increases the capacity of individual states to address domestic development challenges, because it makes macroeconomic coordination and the benefits of pursuing open economy policies more welfare enhancing. Closed economies are not able to draw upon the implied resource of macroeconomic stability and growth in other economies to grow themselves.

The usefulness of integration for growth and development goes back (at a minimum) to the 19th Century, with Friedrich List’s argument that in a world dominated by free trade Britain, countries like Germany and the United States needed to promote the development of an active state which looked to the creation of a strong national economy.⁷ In List’s view, however, this did not mean that Germany and the United States should not trade with Britain, but that they should seek to diversify and develop their domestic manufacturing in order to compete on the world stage. List’s was an instructive point, because he did not advocate closing off integration with the world economy, to put it in today’s parlance, but rather the reverse - embracing the task of developing the national culture, society and economy

⁶Due to the need to constrain the activities of consumers and producers, of course, the empirical evidence shows that real-world applications of these policies tend to result in, and/or are conducted by, autocratic governments with formal but not functioning democracies

⁷One can go further back of course to mercantilist economic theories of the 15th Century, which entail the accrual of gold through trade to finance the state.

in order to compete with the world more fully. Britain's trade hegemony in the late 19th Century was not upended by countries shrinking from the challenge (Kindleberger, 1987).

Keynes's arguments beginning with his *Treatise on Money* and extending through his idea of an international payments mechanism were along similar lines, and even more directly entailed integration with the world in order to create mechanisms to stabilize the potentially volatile flows of capital and goods that existed in a world of relatively free markets. There was no question, however, that growth, employment and welfare could be maximized in an environment in which countries could pursue national economic strategies and were integrated with those of their neighbors.⁸ More generally, even in relatively closed economies (such as the United States today), integration matters for income, growth and policy.⁹

The Bretton Woods Institutions were designed - in large part by Keynes - to assist countries through an international payments mechanism to use their current accounts to leverage growth through international trade and capital flows.

It is perhaps also worth noting that Keynes's intentions at Bretton Woods eclipsed in "integrationist" terms what was actually created at the time. Keynes wanted the International Monetary Fund to be a sort of super-Central Bank/payments institution (the 'International Clearing Union') that administered a new fiat money (Bancor) that would underpin settlements between countries and hence back-up the various national currencies that were subject to inflationary policies of national governments (Keynes, 1924).¹⁰ In an environment of high savings and low consumption, aggregate demand management was (and is) supportive of international integration by drawing more people into economic activity through adjustment of economies away from

⁸ Keynes's views changed over time in relation to the question of whether or not countries were in a classical (full employment) or demand-deficient situation.

⁹ Openness is defined as the ratio of exports and imports to GDP.

¹⁰ For excellent essays and letters to finance ministers by Keynes attempting to warn them away from inflationary solutions to their debt problems, see John Maynard Keynes, *Essays in Persuasion*, Keynes's basic point behind the International Clearing Union was that the international monetary system had to be sensitive to both the risks of inflation and deflation - the latter being the subject of *The General Theory*. It is also worth noting that Keynes wanted the clearing union to be run explicitly by the United Kingdom and the United States as coequal hegemony, as opposed to White's proposal for a more multilateral institution. On this latter point, see James M. Boughton, "Why White and not Keynes?," IMF Working Paper WP/02/52.

agriculture and small business to extensive modern industry.¹¹

I bring up both of these thinkers, List and Keynes, because they are germane to the idea that integration with the world economy and equitable and sustainable growth are somehow mutually exclusive. And, because List and Keynes were skeptical of the idea that free international market-places led necessarily to economically and socially efficient outcomes. Indeed this healthy skepticism lies behind the manifold activities of the modern, post-war European Left and their emphasis on social equity and equitable growth - and by extension to the development of Europe's social democracies. I discuss them here as a comparator. This is the same Left that in Europe were the primary builders of European integration, the Single Market, the European Monetary Union (and "System" before that), cross-national regulatory structures - and, somewhat earlier, harnessed the creative power of markets to social democratic and democratic socialist ideas (Katseli, 1989).

In short, international reform agendas can be supportive of domestic reform. The European Union, after all, was created in part to address international threats (a menacing Soviet presence on the one side, and a highly competitive, creditor, United States economy on the other), both of which were capable of undermining the particular christian democratic/social democratic national formulas of most West European countries. While these threats provided base realities to which the Europeans needed to respond, more proximate causes emerged in the late 1960s and 1970s under the impetus of lower barriers to trade between European economies, and the inability of these economies to continue with high rates of savings and investment. The latter had been steadily undermined from the early 1960s as the profitability of European economies declined as real wages caught up and surpassed productivity.¹²

¹¹See Shonfield, 1965 for evidence of this in postwar Europe. Keynes lamented that saving can be too high, but this complaint has to be placed in the context of alternative vehicles for saving. In the 1920s and 1930s, the problem with high saving was that the one vehicle for saving, government bonds, was in constant danger of being eroded by higher inflation, while the other, into equities, was unattractive due to slowing (and eventually negative) industrial growth rates, and poor financial regulation leading to booms and busts. In an environment of reasonably free capital flows, the fact that savings flow out to other countries reflects the same poor set of alternatives. The policy implications are clear - to keep capital within national borders means that countries subject to capital flight and inflation need to improve growth prospects.

¹²The policy response using both fiscal and monetary policy to counteract the decline in profitability made matters much worse, because these economies had already achieved

In many ways, “integration” for social democratic political parties and their working class constituencies in Europe was the means to ensure income stability and rising earnings that were initially threatened by the combination of uncontrolled inflation, real wage disequilibria, and declining profits and investment in the 1970s. A social democratic Europe, in other words, was made sustainable by integration with the world economy.¹³

The brief digression on Europe’s experiences with achieving equitable growth and integration is useful for the simple reason that it provides a concrete example of the successful interaction of the two policy aims (growth and integration) - something some critics seem to think *a priori* cannot occur. To summarise the argument, international economic integration supports macroeconomic stabilisation and rising trade, which in turn contributes to improved growth rates, more employment, and a more fair distribution of income.

Finally, the evidence on the link between openness and long run economic development is also fairly unambiguous - particularly when it comes to Africa (Sachs & Warner, 1995, Collier & Gunning, 1999). Collier and Gunning note: “By the 1980s, Africa had become less open [to trade] than other regions. On one measure, not only was Africa the area with the highest trade restrictions, but the gap between it and the next most restrictive area, the Middle East, was wider than that between the Middle East and the most liberalized region, the Far East” (Collier & Gunning, 1999).

Perhaps more pertinent for this discussion, the same authors conclude that the trade restrictions used by most African countries were even more damaging because these economies are small relative to the rest of the world. It is simply incorrect to argue that African economies are in their current condition due to open-economy policies. One is more likely to find the legacy of various colonial practices and ‘imperial preferences’ at the root of poor eco-

full capacity. Nominal expansion could no longer boost aggregate supply - in Keynes’s terms, the classical system applied as real wage disequilibrium resulted in full capacity. Hence, in Europe, the international project of the European Monetary System, the single European Market, an increase in the scope of the European Commission, and eventually the European Monetary Union, had a dual purpose - establishing economic competition between European economies on a common macroeconomic policy basis, and strengthening internal economic links to enable a better competitive position relative to major competitors in North America and Asia.

¹³It may also be worth noting that the archetypal social democratic nation-state, Sweden, was (and remains) a vigorous supporter of trade liberalisation. Sweden was a cornerstone of the British-led European Free Trade Association (EFTA).

conomic performance. This does not mean that African economies, or NEPAD, should promote radical tariff and capital account reform, but that regional economic integration that enables development of industry, agriculture and services by active, capable and accountable states in a regional economy would enable Africa to gain more than it currently does from its relatively closed trade regimes. NEPAD also encourages African governments to focus on domestic economic policies and institutional design and framework that will enable them to benefit more from economic integration.

3 South Africa's economic reform

How has South Africa faced the challenge of ensuring positive-sum outcomes from integration and domestic reform? First, the multilateral benefits from growth and openness are integral to development - more rapid growth in other economies augments demand and provides a beneficial constraint on the development of monopolistic market practices. On average, foreign demand has contributed on average 40 percent of the increase in South Africa's GDP growth rate from 1994 to 2002. Second, macroeconomic stabilisation is good for growth, because it reduces the propensity of the economy to develop an inflationary spiral, and by lowering the rate of inflation, improves the distribution of income, and raises the economic value of market signals.

Low inflation, competitive markets, and sustainable fiscal policy help to achieve three of the more critical pre-requisites for macroeconomic stabilisation and improving living standards - protecting real income against price increases, enhancing employment creation, and providing social and economic services and income support. Poor fiscal policy and inflation can work together to worsen income distribution. For example, in an environment of high inflation, the growth rate of fiscal transfers has to more than match inflation in nominal terms to generate a real increase in welfare for the recipient - providing a further impetus to higher inflation in the following time period. I address fiscal policy, inflation and market structures in turn.

South Africa has mostly completed the shift from macroeconomic instability that characterized the late 1980s and early 1990s to stability - thereby providing a floor under changes to distribution caused by variable inflation. Stabilisation has been accomplished through an inter-linked set of adjustments in fiscal, monetary and trade policies. The growth performance of the economy has improved considerably (see Table 1). Achieving more rapid

Figure 2: Growth in GDP and GFDF (Source: South African Reserve Bank, Quarterly Bulletin, various issues)

Annual average %	1970-79	1980-89	1990-99	1990-94	1996-00	2001	2002
CPI Inflation	9.9	14.6	9.9	12.5	7.0	6.6	10.0
Real gross domestic product	3.3	2.2	1.3	0.2	2.6	(CPIX) 2.8	(CPIX) 3.0
Real gross fixed formation	4.7	0.7	1.4	-1.5	4.1	3.6	6.3

economic growth to increase labour absorption entails pursuing the same goals using a different set of policies. In short, macroeconomic stabilisation and microeconomic reform both raise the potential growth rate of the economy and can increase effective demand by freeing up economic surpluses and broadening economic activity to more people.

3.1 Sustainable and pro-growth fiscal policy

Fiscal policy in previous years added to financial and real economy imbalances through skewed and largely inefficient spending on physical and human capital. High levels of dissaving added to inflationary pressures. Fiscal policy has been refocused toward resolving distributional concerns, fiscal controls have been successfully implemented, while the budget deficit has been brought to a manageable, and growth-supportive, level.

Moreover, fiscal policy has a developmental rather than welfarist cast, as exemplified by the Integrated Rural Development Programme, Working for Water, the Skills Development programme, and other programmes.¹⁴ Fiscal

¹⁴In addition to the human and poverty-reducing benefits of such a developmental approach, it also has an important short-term economic benefit - the addition of substantial numbers of the currently non-economically active population to economic activity, and hence a once off increase in the level of GDP, and growth, and a reduction in poverty. Hertz, 2001, has shown that given the distribution of employment and unemployment in South Africa, a rise in employment generates significant welfare gains for the poor even assuming that the same population groups bear the cost of financing those jobs. See Tom Hertz, "Can wage cuts reduce poverty? Simulation evidence from South Africa", Centre for Health and Well-Being, Princeton University (2001). The main reason for these results is that the wage/employment elasticity of unskilled workers is high, about .99, which means, contrary to the notion of 'unemployability' used by many analysts in South Africa, that unskilled workers would likely be able to find employment at a wage level

Figure 3: Fiscal policy trends, 1990-2001 (source: National Treasury Budget Review, 2003)

% of GDP	1990-94	1995	1996	1997	1998	1999	2000	2001	2002
Government consumption expenditure	20.0	18.3	19.4	19.2	19.0	18.6	18.7	18.9	19.2
<i>Gross fixed capital formation</i>									
General government	3.0	2.4	2.4	7.3	-4.4	-3.8	-6.2	0.1	4.6
Public corporations	2.4	1.9	1.9	9.2	52.8	29.1	-9.7	-3.6	2.5
General government saving	-5.1	-4.2	-5.0	-4.6	-2.8	-1.8	-1.9	-0.2	-0.4
Interest on public debt	4.9	5.9	6.3	6.1	6.4	6.2	5.8	5.4	4.9
General government tax revenue	24.7	24.1	24.7	25.4	26.9	27.1	26.3	27.6	28.0

policy has aggressively shifted toward redistribution of services to the lower half of the income distribution. Housing and social security spending has become strongly redistributive (Van der Berg, 2000).

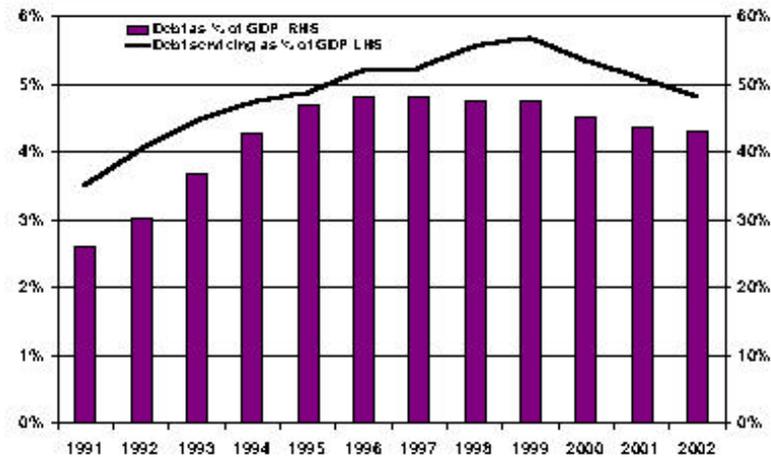
The redistributive tenor of fiscal policy has been made possible by reversal of the distorted expenditure decisions pre-1994, including the drastic reduction of major subsidies, and the control of public debt levels. In turn, interest costs have been sharply reduced, freeing up resources for consistent increases in real spending.

The decline in debt service costs as a percentage of GDP from near 6 per cent at its peak in 1999 to about 4.7 per cent in 2002, has released an amount of about R10 billion for alternative spending uses. Improved public expenditure management, moreover, has contributed to consistent revenue over-runs, allowing for a more expansionary fiscal policy.

The best redistributive strategy is one that enables people to engage in economic activity. Employment would do far more to relieve poverty than would most conceivable welfare measures. The state should eliminate market failures, provide effective services and social and economic infrastructure. The domestic development strategy should seek to raise the profitability of the domestic economy by unlocking economic opportunities and providing the sort of institutional infrastructure and quality public services that both raise the potential growth rate of the economy and raise the incomes of the poor.

commensurate with their skill.

Figure 4: Public debt and debt servicing costs as a percentage of GDP (source: National Treasury Budget Review, 2003)



The current fiscal policy tries to achieve both. It redistributes income from the tax-paying and employed population to the poor without contributing to poverty-trap behavior, and it seeks to modernize key areas where the state interacts with the private sphere - including, transport infrastructure, social and economic services, education, health, etc. On a broader level, the fiscal strategy has also provided a more appropriate balance of financing the improvements in services by bringing private finance in as a substitute for sovereign debt through public-private partnerships, thereby freeing resources for other areas of spending.

3.2 Low inflation and distribution

Monetary policy has moved from the excessively accommodating stance of the past, and government and the monetary authorities have adopted an inflation-targeting framework to replace the previous exchange rate-based and money supply framework. Inflation targeting has enabled the Reserve Bank to assess a broader range of economic indicators and their influence on inflation. At the same time, the new framework increased the transparency of monetary policy by making it clear that inflation was the primary target of the monetary authorities. By deemphasizing the inflation management

aspects of the exchange rate, the policy has expanded the tools available to the Reserve Bank, and enabled the exchange rate to act as an absorber of negative exogenous shocks. Allowing external prices (the exchange rate) to adjust also limits the quantity adjustments to output and employment that would occur in a fixed exchange rate monetary policy, and is therefore positive for the distribution of income in the face of an uncertain international economic environment and volatile capital flows.

Econometric analyses of possible configurations for Phillips Curve relationships have found little evidence since the early 1980s for stable links between the money supply, interest rates, inflation, unemployment and growth (Schaling & Fedderke 2000, Fields, Leibbrandt & Wakeford, 1999). The same studies find robust and statistically significant evidence that inflation is a function of supply side and fiscal factors - primarily mark-ups by firms and nominal unit labour costs (private and public sector). In terms of economic growth itself, studies show that relatively low inflation has been better for growth in South Africa, and that growth is primarily a function of the commodity price cycle and other real factors (Mariotti, 2001, Bell, Farrell & Cassim, 1999). While in the short-term, there is some inflation/output tradeoff, this does not hold in the medium and long run, and is dependent on the extent to which inflation expectations remain adaptive.

Some have argued that inappropriate attention to macroeconomic stability has been the main reason for slow growth and rigid poverty levels.¹⁵ That assessment is simply incorrect. Real exchange rates remained high and relatively stable from 1986 through a monetary policy that accommodated all

¹⁵Inexplicably including one of the larger foreign investment banks operating in South Africa. One reason for slower growth in South Africa has been the series of exogenous shocks hitting the economy (in 1996, 1998, and 2001) and their impact on business and consumer confidence. Reintegration with world markets has been accompanied by substantial flows of goods and capital, but has also raised concerns over the impact of these flows on growth, investment, employment, inflation and the stability of the economy. Since the early 1990s, South Africa has experienced a prolonged period in which global economic events have substantially moved the economy away from its steady-state rate of growth of about 4% per annum. This deviation was caused by the international financial turmoil that spread around the globe from roughly 1996 through the end of 1998, and again in 2001. South Africa's growth rate was seriously affected in 1998, but also in 1997 and 1999. In the absence of those disruptions, the South African economy would likely have grown at about 3.5 to 4% in each of those three years. In short, while the vicissitudes of globalisation had a negative impact on the economy from 1997 through 1999, they are unlikely to have had a major effect on the potential growth rate of the economy.

inflationary pressures. The resulting high rate of price inflation (relative to major trading partners) ensured that despite considerable nominal exchange rate depreciation, the real cost of imports remained stable.

Alongside accommodative fiscal and monetary policy, high inflation in previous years was also the result of protectionism, adaptive expectations and wage determination, and the structure of the economy - especially those aspects of the structure contributing to price formation. Tariff liberalisation has limited the potential for cost-push inflation by increasing competition in product markets, while inflation-targeting facilitates the altering of inflation expectations and wage setting patterns.¹⁶

Reducing inflation relative to that of trading partners causes real depreciation of the exchange rate and a shift in production toward traded goods. Domestic consumption shifts toward non-traded goods and domestically-produced tradeables as the real cost of imported goods rises. In short, a non-inflationary monetary policy over time does not lower aggregate demand, but increases it, changes its composition, and raises overall productivity and profitability.

For those reasons, much of the debate over monetary policy has been beside the point. Criticism has centered on monetary and fiscal policy, whereas in an integrated macroeconomic view, these have more often than not merely counter-balanced changes that have been made in trade policy - raising the proportion of exports in the structure of output and over the longer-term the profitability of non-tradeables and import-competing goods.¹⁷ South Africa's more fundamental economic problem lies elsewhere - increases in demand have little impact on aggregate supply because they provoke relatively

¹⁶The inflation targeting framework, moreover, has shifted the emphasis in monetary policy away from the exchange rate pass-through effect toward domestic sources of inflation. This has resulted in greater stability in domestic interest rates, and a greater cushion for the real economy through a more flexible real exchange rate. In terms of Australian or Scandinavian models of small open economies, internal and external balance improves as a more competitive real exchange rate raises foreign demand and increases capacity utilization even as inflation remains low. Monetary policy predicated on targeting a real exchange rate level only indirectly targets inflation. Its main focus is on maintaining a particular level of purchasing power in terms of imported goods. The improvement in the current account balance, and therefore the room for lower interest rates, can only come from an exogenous decline in domestic inflation relative to imported inflation.

¹⁷Trade liberalisation, for example, reduces the profitability of exporters in the short-term, while disinflationary monetary policy, by reducing the real exchange rate, increases the level of protection afforded to exporters.

Figure 5: Comparative growth in real GDP 1994-2000 (source: IMF World Economic Outlook, April 2003)

	South Africa	Advanced Economies	Difference (advanced growth minus SA growth)	Western Hemisphere	Sub-Saharan Africa
1984	3.2	3.4	+0.2	5.0	1.9
1995	3.1	2.7	-0.4	1.8	3.0
1996	4.3	2.9	-1.4	3.6	5.6
1997	2.6	3.5	+0.9	5.2	3.0
1998	0.8	2.7	+1.9	2.3	3.3
1999	2.1	3.4	+1.3	0.2	2.6
2000	3.4	3.8	+0.4	4.0	2.8
2001	2.6	0.9	-1.7	0.6	3.6
2002	3.0	1.8	-1.2	-0.1	3.4

small increases in investment and human capacity development at a stable level of employment. I will return to this point below.

In the context of economic integration, it is important to recognize that there is no long-run tradeoff to be exploited in the use of monetary policy. International linkages, and hence economic measures of them such as the balance of payments and exchange rates, exist irrespective of the degree to which capital controls and trade restrictions are used to seal off economic relations with other economies. The link between interest rates and inflation, and by implication, monetary policy is also evident. As Keynes' later arguments (although not those in the *General Theory*) about the International Clearing Union implied, "liquidity preferences" of one society spillover into those of others through the balance of trade and payments, thereby ensuring that the determination of interest rates in any particular economy remains affected by those in others.¹⁸ When an economy operates in what Keynes called the classical situation, then even the short-term tradeoff disappears, with uncoordinated monetary policy changes resulting in swift changes in exchange rates, foreign reserves, or both. In South Africa, the responsiveness of firms to changes in inflation expectations seems difficult to reconcile with the idea that surprise money supply increases might result in permanent increases in output.

¹⁸In more contemporary theories, this link is captured in the idea of an interest parity condition, which relates inflation, exchange rates and interest rates between economies. Different real economic conditions, including the degree of competition, within any particular economy affects the rate of inflation.

For a more balanced distribution of income, moreover, high inflation is plainly irreconcilable with democratically-expressed preferences. On the one hand, high inflation erodes investment, and eventually employment levels, and, on the other, lowers real income levels. It bears repeating that the poor are least able to protect their real income levels from high inflation, and therefore suffer disproportionately from the implied relative change in the distribution of income.

4 Linking macroeconomic performance to microeconomic constraints

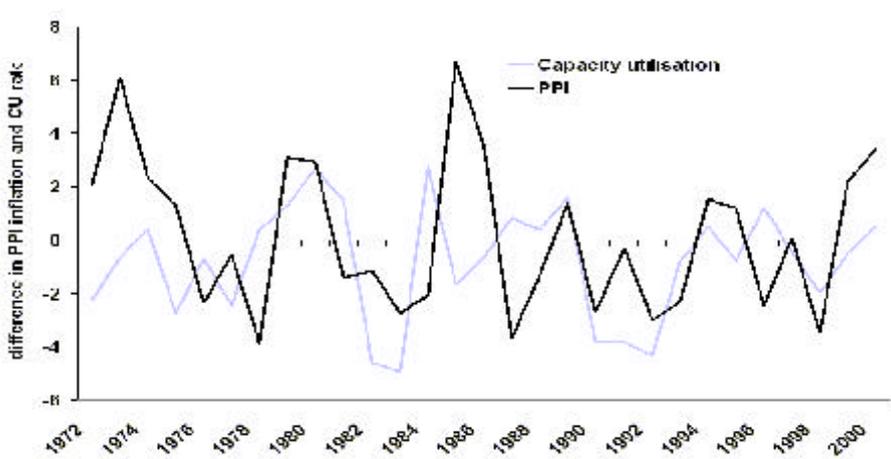
The ‘potential’ growth rate of an economy is the maximum rate at which the economy can grow without creating financial imbalances. These imbalances arise when output in the economy claims more on the resources of the economy (land, labour, capital, other factors of production), than the economy can provide without raising the prices of those factors. One of the most acute ‘factor constraints’ in South Africa is skilled workers. As the economy’s growth rate rises by more than about 3.0%, demand for skilled workers rises quickly relative to the supply of skilled workers, thereby bidding up the price of those workers.¹⁹ Generally, constraints exist for all factors of production (capacity utilisation), and GDP growth in excess of the supply of factors causes inflation to rise - eventually choking off growth.

Recent analytical work shows that the productive structure of the economy is marked by relatively non-competitive markets, which allow firms to charge high mark-ups on their costs of production (Fedderke 2001). In general, one way of looking at marginal pricing (the price of the last good produced) is to assess the difference between costs to firms and the final price they charge. The mark-ups charged by most sectors of the economy, including for sub-sectors of manufacturing are very large. The ability of firms to command such mark-ups has direct implications for investment, since non-competitive markets enable firms to charge high mark-ups, and non-competitive markets, as was discussed earlier, are bad for investment and growth.

The average mark-up in South African manufacturing lies at about 85%

¹⁹The BER’s quarterly and monthly surveys of business always show that high-skill labour is hard to find, even when the economy is running at below its potential growth rate.

Figure 6: Difference in the rate of capacity utilisation and producer prices, 1972-2000 (Source: National Treasury series)



over cost, compared to the United States, which has an equivalent mark-up of about 45%.²⁰ This mark-up becomes larger when the economy experiences a cyclical downturn, suggesting that prices play little role in helping the economy to recover from a cyclical downturn.

Trade also affects mark-ups, with increased import penetration ratios decreasing the size of the mark-up. This is an important issue in the context of overall trade policy, since (measured by effective protection rates) just over one-half of the economy has become more liberalised since 1990, and just under one-half has experienced little change or become more protected.

Finally, there is no evidence that high mark-ups over cost, nor high concentration ratios, have been beneficial for investment or growth. The econometric evidence shows that, investment and output growth do not respond much to either the ability of firms to charge large margins over the cost of production, or the lack of competition in these industries. Furthermore, higher mark-ups and more concentrated industries are negatively associated with employment. The findings for South Africa (Fedderke 2001) are reinforced by cross-country work, which finds that the intensity of competition is positively associated with more rapid growth (Dutz & Hayri 2001).

The contributions of different productive factors (labour, capital and productivity/technology) to growth in the last thirty years are shown in the following table. While the contribution of physical capital has been weak, labour usage has turned negative, and total factor productivity growth has increased - and provides most of the impetus to growth in the 1990s. While this increase in the contribution of total factor productivity is important, it is worrying that physical capital's contribution declined and labour detracts from growth.

It is worth noting that the decline in employment in the formal sector should result in a negative contribution to growth, unless the growth in productivity of labour remaining in employment is very high. The evidence suggests that this is not the case. If the marginal productivity of labour were high, the negative impact on growth from declining labour absorption would

²⁰Interestingly, high mark-ups characterise a wide range of manufacturing sub-sectors as well as other (2-digit) sectors. Within the latter category, the sectors with the highest mark-ups (over 100% of cost) include agriculture, diamond, gold and uranium mining, electricity, gas and water, wholesale and retail trade, and financial intermediation, insurance, and real estate. Coal mining, transport, storage and communication, and aggregate manufacturing exhibit mark-ups between 50 and 100% of cost. Building and construction is the only 2-digit sector with mark-ups under 50% of cost.

Figure 7: Contribution of labour, capital and technology to growth in real GDP

	Real GDP Growth	Labour	Capital	Technology
1970's	3.2	1.17	2.54	-0.49
1980's	2.2	0.62	1.24	0.34
1990's	1.4	-0.58	0.44	1.07

Source: Fedderke (1999)

have been much larger. In other words, the loss of employment would have had a larger negative impact on growth in GDP.

In terms of physical capital, weak investment growth in the early 1990s would result in a lower contribution to growth in the 1990s as a whole. Nevertheless, the returns to capital in terms of real value added are low compared to efficiency gains (captured in the total factor productivity variable).

A turnaround in employment in the formal sector would result in a positive, but weak contribution to GDP growth. Clearly, this needs to improve through higher labour productivity. In terms of physical capital investment, a lower cost of capital would result in a greater contribution from investment to GDP, but would not necessarily increase the returns to capital.

These output distortions become critically important for growth in the South African context, because they reinforced the socio-political factors that segmented the economy by race in the past. In the 1960s, 70s, and 80s the economy was dominated by extractive industries tapping into the natural resource endowment, especially mining and basic metals. Parastatals supported this development path even further by providing the basic infrastructural needs of an economy focused on commodities, and by crowding-out the development of social and human capital, non-mining based capital investment, and infrastructure development for manufacturing and other sectors. In Africa generally, public services have been seen as good vehicles for creating employment rather than actually providing services (Collier & Gunning, 1999). Critics of corporatisation, hard budget constraints and competition in public services need to explain why they prefer expensive and poor quality public services imposed by monopolies.

Relatively uncompetitive markets result in poor investment performance, because they dampen the need for firms to innovate - even though innovation itself is both a creative and destructive process. To improve growth

rates, investment should enhance productivity. As the South African economy moves away from oligopolistic markets and parastatal dominance, productivity growth rates should rise and pull up real wages.

South Africa has achieved macroeconomic stability, with reasonable economic growth rates given extant structural constraints on supply. Output to employment elasticities show, moreover, that this growth has not been 'job-less,' but that other factors have contributed to deteriorating employment levels in some industries. At the same time, trade liberalization, especially in manufacturing, has been good for employment, with liberalized sectors performing well in terms of investment and employment (Fields and Leibbrandt 1999, Fedderke 2001). A review of the series of October Household Surveys and Labour Force Surveys suggests the general comment that the economy has undergone significant adjustment as the old mining base of the economy became less important due to long-term declines in commodity prices (especially gold) and that re-integration with the world economy has favoured newer, and at this point, still small industries and services.²¹

Part of the challenge for South Africa is to move from the current 'low-level equilibrium' to a higher equilibrium point - in other words moving to higher growth in a sustainable way. Societies become accustomed to certain microeconomic relationships, and they are difficult to alter, even when the macroeconomic context changes. Such sclerosis hinders the efficiency of demand management and the speed of the supply response to an opening-up of the economy.²² The objective of microeconomic reform is to increase

²¹Moreover, regulatory structures and institutional relationships have not adjusted to allow a new definition of 'formal' economic activity, with a European definition prevailing that emphasises full-time employment, fixed places of business, registration with tax authorities, etc. The difficulty with this is that the 'definition' is as much a social one as it is economic - resulting in reticence to acknowledge the importance of 'informal' sector economic activity for general welfare. This degrades the social standing of workers in non-standard forms of employment and undermines communitarianism. The employment effect of this can be significant, because it effects the decision between work and non-work, and thus the overall supply of labour. International experience conclusively shows that temporary and part-time work has been the largest single source of job creation in many countries in the 1990s. European countries, especially Ireland, the Netherlands and France, have moved consistently toward broader definitions of work in order to provide jobs to more people. Narrowing the definition of work will only lead to greater loss of employment due to its direct cost implications, but also in terms of reducing the scope for human capital creation through employment.

²²In an environment where microeconomic relationships are characterised by widespread nominal and real rigidities, monetary and fiscal policy can negatively affect the develop-

incentives and remove blockages that prevent economic agents from responding to improvements in the macroeconomic environment - thereby releasing both demand and output (Lim, 1994; Romer, 1986; Romer, 1998; Grossman and Helpman, 1991; and Aghion and Howitt, 1992). In summary, sustained macroeconomic stabilization requires consistent microeconomic relationships - the establishment of which is supported by appropriate international economic integration.

ment of the economy and the length of the upward and downward phases of the business cycle. Monetary and fiscal policy is constrained to be incremental if changes to them perpetuate disturbance through the real economy (shortening the upward phase of the cycle and lengthening the downward phase). Nominal and real rigidities can, in this formulation, be positive for the economy to the extent that the authorities can use 'money illusion' to produce a long-lasting increase in output. This might occur because wage and price formation are relatively slow processes, such that an increase in the money supply results in the appearance of an increase in aggregate demand. In the current environment of significant information flows about economic policy, however, such attempts are most likely to create self-fulfilling dynamics which rapidly undermine any attempt to manipulate economic growth. The reason why is relatively straight-forward: market information is more highly developed in financial markets, such that money market prices, bond yields, and exchange rates react very quickly to policy change. The 'pricing-in' of new information in efficient markets, therefore, pre-empts any developments in goods markets and prevents their realisation. While these considerations suggest that too much information is bad for the efficacy of policy making, this would not be a useful conclusion. Rather, it suggests that the economic effects of nominal rigidities are created by the interaction of markets that analyse and price-in information quickly and those that work on past information, and for that reason have sticky expectations. Such 'adaptive' expectations are symptoms of the nominal rigidities that impede the adjustment of the economy to shocks and can result in poor macroeconomic outcomes. Rigidities caused by "rents" are created primarily by regulatory and institutional relationships. These are the same rigid institutional relationships which Rodrik, Stiglitz, Greenwald, Olsen and others identify as inhibiting the growth of income and reduction in poverty. Reducing rents that are created by these relationships frees surpluses for investment in other economic activities, and, by expanding economic activity to more of the population, reduce poverty. Joan Robinson defined "rents" as "the conception of a surplus earned by a particular part of a factor of production over and above the minimum earnings necessary to induce it to do its work." See Joan Robinson, *The Economics of Imperfect Competition*, (London: MacMillan 1933). Supply side and structural reforms create their own demand. Given an fixed amount of absorption, reducing costs allows for greater demand for products. Outside of consistently inflationary aggregate demand policies which depends on money illusion for any supply response, this is the only way to improve demand for SA products. What applies to domestic demand also applies to foreign demand.

5 NEPAD, South Africa and globalisation

National development strategies need support from the international economic environment to ensure that foreign demand grows in a consistent, stable manner. For South Africa, of course, Africa remains a key, and relatively under-developed source of foreign demand for South African products. But NEPAD is also about creating new relationships and fixing those that do not or have not worked.

List's notion of developing domestic industry and Keynes' notion of aggregate demand management is echoed in some of the NEPAD proposals, especially those on developing infrastructure and improving economic governance. Both envisage an unlocking of domestic demand, even if they are not as obvious in their impact on aggregate demand as is a direct increase in deficit spending. To take economic governance as an example: improving it is expected to increase domestic investment and stem capital flight. This mechanism presumably could operate through the savings channel first and then flow into investment - or through rising investment and then into saving, which in turn further fuels investment (Fedderke 2000 & 2002; Fedderke and Liu 2002; Fielding 1997 & 2000).

The point I wish to make is that the debate over economic policy in South Africa and in NEPAD needs to move beyond simplistic conceptions of what is or is not good policy driven by extreme logic. Given Africa's poor economic performance, the policy questions involved with NEPAD have little to do with marking up philosophical points, but with making decisions about realistic means of addressing economic difficulties in a welfare improving manner. Countries with precarious fiscal and debt positions and high rates of inflation can hardly be advised to press on with further increases in deficits and closed-economy policies. But at the same time, it is also not sound to open goods markets to international trade without other policies in place to support the shifting of labour and capital from one sector to another.

While appropriate macro and microeconomic relationships are critical for reducing poverty through growth, employment, low inflation and sustainable fiscal policy, the international economic environment should also be conducive to growth at the national level. It need not be, and this is where reform of the international financial and development architectures is needed. Much of the criticism of international capital and financial markets has a point, even if the critics tend to focus exclusively on the costs of global markets rather than the benefits.

The relevant question is not whether open economy policies and free-entry global capital markets are good or bad, but how the international community ensures that an appropriate international financial architecture is combined with appropriate national policies (exchange rate, monetary, competition, regulatory and labour, in particular) to maximize the benefits.

So should South Africa, and developing countries more generally, renounce NEPAD and the economic logic of national development in a conducive international environment for one of protectionism?

The most important failure of those advocating withdrawal from the world economy is the lack of anything serious on how to raise growth rates and income. Bad policies do result in lower rates of growth (Wacziarg, 2002). Rather, because closing borders place limits on economic activity in developing and poor societies, they are more likely to increase bonds of dependency that most critics of NEPAD and South African economic policies claim to deplore. Some forms of dependency are not better than others.

In addressing its stagflationary period, Europe fortunately chose neither to close the borders (the Albanian option) nor submit fully to the dictates of global capital. NEPAD and the African Union show that Africa will also not follow those roads. The focus in NEPAD on improved economic governance and policies supportive of regional economic integration and infrastructure for economic activity (market and non-market) is appropriate for fulfilling Keynesian notions of economic development.

Raising productivity and real wages should be done on Listian grounds - through national *and* international channels to raise efficiency and improve production processes and develop technologies for the sake of expanding employment and income. Following the logic (and evidence) of the Lucas critique and the work of Ball, Mankiw, Romer, and the other New Keynesian economists, this also means that macroeconomic stability and effective policies need to reflect consistent microeconomic relationships. Microeconomic reform should be designed to minimize the economic effects of institutional, structural and regulatory rigidities. In short, if macroeconomic aggregates misbehave, it is usually because sectoral and regulatory policies and institutions are not functioning well. And that, in turn, means that it is less likely that a national economy will benefit from integration.

Perhaps most critically, a domestic development strategy needs to ensure that institutions and regulations do not in themselves impede fair distributions of income, whether it is propelled by market forces or government policies. This has both macroeconomic and microeconomic/institutional impli-

cations. Closed economy policies are sure to prevent a politically-acceptable distribution of income (the apartheid system is a case in point), because they entrench inefficient microeconomic and institutional relationships that create rents (and therefore poor macroeconomic results). Moreover they weaken, not strengthen, the state. Their advocates, whether they like it or not, are trying to turn economic, social and political history back onto Hegelian feet. Further weakening the democratically-legitimated nation-state, despite its many faults and its occasional weakness in the face of global capital, is not a recipe for more rapid economic development - nor any progressive notions of human fulfillment.

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