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Institute for Policy Dialogue
Macroeconomics Task Force

Institutions of Macroeconomic Management
History, Theory, and Practice

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1. Introduction

Over the last decade or so, the idea that institutions matter has become widely accepted among economists, even including many of the orthodox ones, who used to scoff at the idea. Consequently, among those who are interested in the developing countries, the “one-size-fits-all” approach of the IMF and the World Bank has been increasingly challenged, and attempts are made to incorporate institutional factors in the design of policy programmes for developing countries.

However, studies of institutions have been mostly in microeconomics – such as the studies of property rights institutions and corporate governance institutions – and political economy – such as democracy and state bureaucracy. In contrast, macroeconomics has been almost been an “institution-free-zone”, with the wage

bargaining institutions in the developed countries being the only major exception.

In this chapter, I will try to show that institutions matter also for the macro-economy a great deal, and therefore that we need to explicitly incorporate institutional factors in macroeconomic theory. One innovative feature of the present chapter is that it draws extensively on the history of the development of institutions of macroeconomic management in today's developed countries (all historical information are from Chang, 2002, ch. 3, unless otherwise indicated). While our ultimate interest is the role of institutions in the macroeconomic management in developing countries, we believe that discussing the historical experiences of today's developed countries makes it easier for the readers to understand that better macroeconomic management requires institution building.

In the discussion, we will show that in the early days of economic development in these countries, many of institutions that contemporary orthodox macroeconomic theories take for granted – for example, the central bank, income tax, bankruptcy law – did not exist or existed only in most rudimentary forms. This made effective macroeconomic management extremely difficult, magnifying and prolonging macroeconomic problems. It took time and effort for them to construct certain institutions of macroeconomic management and thus acquire the ability to manage their

macro-economy effectively. This suggests that an improvement in the macroeconomic management of today's developing countries requires conscious efforts at institution building. Unfortunately, however, many of the changes in institutions and policies currently recommended to the developing countries by the orthodox economists are in fact likely to unwind many of the improvements in the institutions of macroeconomic management over the last couple of centuries and thus make their more unstable and unmanageable.

2. The Central Bank

These days, many people, especially the free-market economists, regard the central bank (or more precisely the politically-independent and inflation-focused central bank) as one of the foundational stones of capitalism, but it is a relatively recent invention in the history of capitalism.

Although from as early as the 18th century dominant banks (e.g., the Bank of England or the large New York banks) were forced to play the role of lender-of-last-resort in times of financial crises, the establishment of central banking was strongly resisted by free-market economists until the late 19th century and the early 20th century.

Not understanding the logic of "socialization of risk", they believed that creating a central bank would mean bailing-out imprudent borrowers in times of financial turmoil and thus encourage excessive risk-taking (or create what we these days call "moral hazard"). This sentiment is best summed up in the remark by the influential 19th-century thinker, Herbert Spencer, when he argued that "[t]he ultimate result of shielding man from the effects of folly is to people the world with fools" (quoted in Kindleberger, 1996, p. 146).[1] As a result, the development of central banking itself – never mind its political independence or quality of management – was a very slow and halting process in today's developed countries (for further details, see Kindleberger, 1984).

However, over time all countries have come to accept the need for the central bank, as people have come to realize that the benefits from its ability to stem financial panic and thus stabilize the macro-economy by preventing financial panic far outweigh the costs that it may carry in the form of "moral hazard".

The Swedish Riksbank (established in 1688) was nominally the first official central bank in the world, but it did not become a real central bank until 1904, when it gained note issue monopoly. The first "real" central bank was the Bank of England,

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[1] The original source is H. Spencer, "State Tampering with Money and Banks" in *Essays: Scientific, Political, and Speculative* (London: Williams & Northgate, 1891), vol. 3, p. 354.

which gained note issue monopoly in 1844. Other central banks were established mainly in the late 19th and the early 20th century. The Italian central bank gained note issue monopoly only in 1926. Although it was established in 1913, the Federal Reserve Board did not control 65% of the US banks that accounted for 20% of total banking assets until as late as 1929.[2] Also, until the Great Depression, the Federal Reserve Board was *de facto* controlled by Wall Street.[3]

Free market economists of today do not object to the existence of the central bank itself in the same way in which their intellectual forefathers did. However, their view of what it needs to do is very different from what had convinced people of its need in the first place. In the currently dominant view, the central bank's role is almost exclusively defined in terms of maintaining the value of the currency and thus attain *price* stability.[4] Its role as a mechanism to enhance broader *macroeconomic* (and not

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[2] This meant that in 1929 the law "still left some sixteen thousand little banks beyond its jurisdiction" (Cochran & Miller, 1942, p. 295).

[3] The most telling evidence is the story of Charles E. Mitchell, head of the National City Bank and a director of the Federal Reserve Bank of New York. Mitchell, in an attempt to minimise damage on his speculative activities in the run-up to the Great Depression, successfully put pressure on the Federal Reserve Board to reverse its policy of monetary tightening announced in early 1929.

[4] And indeed this is the line taken by Friedrich von Hayek, when he proposes the scrapping of central banks and argues for free competition among note-issue banks.

simply price, but also output and employment) stability by preventing financial panic is completely ignored.

It is well known, of course, that the IMF recommends absurdly high interest rates and the immediate closing of weak financial institutions to developing countries in a macroeconomic crisis, despite the fact that such measures actually encourage, rather than prevent, the spread of financial panic, exacerbating the crisis. It is, however, less well known that the IMF has also made the countries under its tutelage grant constitutional independence to their central banks and make them focus exclusively on price stability. Such change has entrenched a mechanism that significantly reduces the lender-of-last-resort function of the central bank.

3. Budgetary Institutions

Government taxes and spending are often inversely related to the overall level of activity in the economy. In an economy where taxes are progressive, when the economy is in boom, more people and firms go over the tax exemption thresholds or move into higher tax-rate brackets. At the same time, the number of people claiming social welfare benefits falls. Consequently, the government net spending falls in relative

terms, having a stabilizing effect on the macro-economy. When the economy slows down, the reverse is true. This is known as the "built-in stabilizer" function of government budget.

Capitalist economies did not have this built-in stabilizer from the beginning. In the early days, income taxes were considered an affront to capitalism, while social welfare spending was minimal, if not totally absent. As the construction of the tax base and the introduction of social welfare institutions took time, the establishment of the built-in stabilizer happened also took time.

Income tax was initially only used as an emergency tax intended for war financing.[5] This in part reflected the political under-representation of the poorer classes but also the limited administrative capability of the bureaucracy. This limited bureaucratic capacity was indeed one reason why tariffs (the easiest taxes to collect), were so important as a source of revenue in today's developed countries in earlier times (and are indeed for many of today's poorest developing countries).

Britain was the first country to make income tax permanent, which happened in

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[5] Britain introduced graduated income tax in 1799 to finance the war with France, but scrapped it with the end of the war in 1816. Denmark used income tax for emergency finance during the 1789 Revoutionary War and the 1809 Napoleonic War. The USA introduced a temporary income tax during the Civil War but repealed it soon after the war ended (1872).

1842. However, the tax was much opposed as an unequal and intrusive measure. John McCulloch, one of the most influential economists of the time, argued that income taxes "require a constant interference with, and inquiry into the affairs of individuals, so that, independent of their inequality, they keep up a perpetual feeling of irritation" (cited in Bonney, 1995, p. 434). As late as 1874, the abolition of income tax was a major plank of Gladstone's election platform, although he lost the election. In the USA, the income tax law of 1894 was overturned as "unconstitutional" by the Supreme Court. A subsequent bill was defeated in 1898, and the Sixteenth Amendment allowing federal income tax was only adopted in 1913. However, the tax rate was only 1% for taxable net income above $3,000, rising to 7% on incomes above $500,000 (Carson, 1991, p. 540). In Sweden, despite its later fame for the willingness to impose high rates of income tax, income tax was first introduced only in 1932 (Larsson, 1993, pp. 79-80).

Somewhat later than the introduction of progressive income tax came the other key element of the built-in stabilizer, namely, the establishment of social welfare schemes, especially the unemployment benefit.

Institutions that take some (if not very good) care of its weaker sections have always been necessary to guarantee social peace in any human society. Before industrialization, this care was provided by extended families, local communities, and

religious organizations. However, this started changing with industrialization. Industrialization led to urbanization and secularization, which led to the decline in institutions like families, communities and religious organizations. Consequently, the government began to take a more active role in the provision of social welfare.

However, before the 1870s, social welfare institutions in today's developed countries were very poor, with the English Poor Law-type legislation, which provided only meager help and stigmatized the recipients of state help, at their core.[6] The inadequate provision of social welfare in times of unprecedented social change meant that social tensions reached serious levels by the middle of the 19th century, as we can see from the constant (real and imaginary) fear of socialist revolution that gripped many of these countries around the time.

Consequently, modern social welfare institutions started to emerge in the late 19th century. This was spurred by the increasing political muscle-flexing of the popular classes after the significant extension of suffrage during this period and by union

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[6] Such attitude made many countries deprive the recipients of state help of voting rights. For example, Norway and Sweden introduced universal male suffrage respectively in 1898 and 1918, but it was not until 1918 and 1921 respectively that those who had received state assistance were allowed to vote.

activism.[7] Germany was the pioneer in this area. It was the first to introduce industrial accident insurance (1871), health insurance (1883), and state pensions (1889). Unemployment insurance, a key element in the built-in stabilizer, first emerged in France in 1905. Once in place, unemployment insurance spread quickly, with virtually all of today's developed countries (except for Spain and Portugal) establishing it by 1945.

After the Second World War, the importance of government budget started growing rapidly with the introduction of more progressive income taxes and more generous unemployment insurance. At the same time, the willingness of governments to manipulate the budgetary system for macroeconomic purposes has grown thanks to the abandonment of the old "balanced budget" doctrine and the rise of Keynesianism. While the rise of neo-liberalism since the late 1970s put enormous pressure for "small government", even countries like Britain, a leader in the neo-liberal revolution, has found it very difficult to significantly scale down the overall budget and in particular welfare spending.

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[7] Of course, there was no one-to-one relationship between the extension of suffrage and the extension of welfare institutions. While in cases like New Zealand there is a clear link between the early extension of suffrage and the development of welfare institutions, in cases like Germany welfare institutions grew quickly under relatively limited suffrage.

In today's developing countries, the orthodox recipe calls for the contraction of an "over-extended" state. Orthodox economists believe that there is a natural incentive for government bureaucrats to expand the budgets they control (the so-called "budget-maximising bureaucracy model" of Robert Niskanen). From this point of view, the government, especially in developing countries where there is little outside check on it, is almost by definition "over-extended". Naturally, the prescription is to roll back the over-extended state.

In the process of budget cut, particular emphasis has been put on the cut in "premature" welfare spending that orthodox economists see as "unaffordable" for developing countries. Fortunately, more recently even some of the orthodox economists have come to accept the role of some minimal "social safety net", acknowledging the serious social dislocation and conflict caused by their policies, such as radical trade liberalization, ill-conceived financial liberalization or premature opening of the capital market. However, this is still not a generalized tendency, and even when there is no explicit attack on it, welfare spending is often the first to get the axe, given the weak political voice of the poor. Given that welfare expenditure is the most "stabilizing" element in the budget, the relative shrinkage of its share in overall budget

disproportionately diminishes the role for government budget as an "automatic stabilizer".

The downward pressure on the size of the budget in the orthodox programme is intensified by the inevitable fall in tax revenue that result from this programme. There are two key elements. First of all, most orthodox economists believe that progressive income tax penalizes high-earners and thus work against "wealth creation". They therefore want overall income tax rates cut and their progressivity reduced. Second, trade liberalization, which always constitutes a core element in any orthodox policy package, significantly reduces tariff revenue. This is even a bigger blow than cuts in income tax, much of which is being evaded in developing countries anyway, because tariff revenue accounts for the largest single tax revenue for the poorer countries, given their weak capacity to collect other (especially income) taxes. Thus seen, the microeconomic policies of the orthodox programme create an even more contractionary bias in macroeconomic policy.

4. Institutions for Financial Regulation

Financial regulation, both domestic and international, has important

macroeconomic consequences. Institutions that regulate the kind of assets that financial firms (e.g., banks, non-bank financial institutions) can hold, the amount of lending that they can make, the extent of deposit insurance, and the rules of their liquidation in times of trouble all have great impacts on the stability and the variability of the macro-economy. They affect the amplitude of the business cycle, the likelihood of asset bubbles, the manner in which the bubbles may build up and burst, and the way in which the aftermaths of any bubble manifest themselves. For the developing countries, institutions that regulate international capital flows have particular importance in macroeconomic management, given the small sizes of their financial markets.

Until recently, the orthodox economists regarded the institutions of financial regulation simply as something that needs abolishing – they talked of financial "repression" and "liberalization", as if they were political scientists discussing the evils of some totalitarian or authoritarian regimes (no doubt some of them saw financial regulation as inevitable in such regime). However, the marked increase in the incidences of financial crises in the last two decades of financial liberalisation, especially in developing countries, has forced even many orthodox economists to accept the need for

better financial regulation, especially cross-border capital control.[8]

Of course, developing good institutions for financial regulation is not easy and takes time, as we can see from the fact that such regulation was highly inadequate in the early days of capitalism.

Banking regulation took long time to develop in today's developed countries. In the USA, "wildcat banking", which was "little different in principle from counterfeiting operations", was prevalent until throughout the 19th and the early 20th century (Atack & Passell, 1994, p. 103). Although the overall cost of failures of unregulated banks at the time is estimated to have been small, bank failures were widespread (p. 104). Even as late as 1929, the US banking system was made up of "thousands upon thousands of small, amateurishly managed, largely unsupervised banks and brokerage houses" (Broagan, 1985, p. 523). Modern banking regulation was introduced in the USA only between 1931 and 1935 (the crowning moment being the establishment of the federal deposit insurance system in 1935) in an attempt to deal with the aftermath of the Great

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[8] According to the data provided by Eichengreen and Bordo (2000, table 6), there were 17 financial crises (16 currency crises and 1 "twin crisis" that combines banking and currency crises) during the quarter century following the end of World War II (1945-71), roughly the period of financial repression in these countries. In the following quarter of a century (1973-97) that saw increasing financial liberalisation, the number of financial crises increased by 5.6 times to 95 (17 banking crises, 57 currency crises, and 21 twin crises).

Depression, and in particular of the 1933 banking crisis (Calomiris, 2000). Banking regulation was introduced only in 1934 in Germany and in 1935 in Belgium.

As for capital control, it was only after centuries of international financial turmoil that today's developed countries were convinced that they needed to establish a system of capital control after World War II. Although the spread of neo-liberalism in the last couple of decades have prompted these countries to abandon capital control once again recently, rather strict capital control was in place in all of them, except in the USA, during the post-WWII period until well into the 1980s. Even the UK, a country with history of international financial domination and an early converter to neo-liberalism, maintained capital control introduced after World War II until the end of the 1970s.

In the contemporary context, while few would dispute that a "good" set of institutions regulating the financial system is essential for macroeconomic stability and economic development, there is really no agreement on what is exactly meant by the term "good". To the orthodox economists, what is "good" in this context is determined by what (they think) is good for the financial industry. However, this is a very narrow view, as what is good for the financial industry may or may not be good for the macro-

economy or long-term economic development. Two recent institutional changes pushed by the orthodox economists are notable in relation to macroeconomic management, namely, the abolition or the scaling-down of deposit insurance and the BIS capital adequacy standard.

Many orthodox economists have attributed financial crises in developing countries to the existence of (explicit and implicit) deposit insurance, which in their view creates “moral hazard” on the part of the banks, which then lend to misconceived or speculative projects. Accordingly, the IMF has recommended that countries abolish, or at least significantly scale down, deposit insurance.

One obvious problem with this prescription is that it is not clear whether deposit insurance *per se* leads to poor lending decisions. Deposit insurance does not necessarily creates moral hazard for the bank managers who make the lending decisions. By definition, it is the depositors who are protected from this arrangement, and not the bank managers. Therefore whether deposit insurance gives the bank manager the incentive to make imprudent lending decisions will be critically determined by the degree to which his/her job security and remuneration depends on the quality of his/her decisions, and not merely by the existence of deposit insurance. In this sense, the widely-used analogy between deposit insurance and fire insurance is fundamentally

misleading, because in the latter case the insured has (some) control over the likelihood of the insurance money being paid out, while in the former case the insured (the depositor) does *not* have much meaningful control over the likelihood.

The point is that, if the bank managers know that they will lose their jobs and suffer in reputation when their banks fail, the knowledge that their banks will be bailed out by the government does not give them much comfort. In this case, deposit insurance will not create moral hazard on the part of the bank managers. Of course, in practice the bank managers do not necessarily get fully punished for their poor decisions, but this is the result of a poorly designed incentive system for the bank managers, and *not* the result of deposit insurance *per se*.

Even if we ignore the above (fundamental) problem, there cannot be a blanket case against deposit insurance even from the orthodox point of view. Even many of those who advance the deposit insurance story accept that there is a clear benefit from such insurance, which is to preserve the stability of the domestic payments system (at least McKinnon & Pill, 1998, do that unequivocally). If so, the real question here is whether the costs from moral hazard that deposit insurance creates is greater than the gains from the greater macroeconomic stability that it provides by preventing bank runs. The fact that most developed countries have deposit insurance suggests the gains have

been generally far greater. With the deposit insurance gone, the chance of financial panic has become greater, with negative implications for macroeconomic management.

The point is that what is “prudent” for the banking sector itself may not necessarily be good for the macro-economy. In times of recession, it is better for the banking sector to lend less while it may be better for the macro-economy if it did the opposite – we will get back to this issue soon when we talk about the BIS capital adequacy ratio.

Another recent change in the institutions of financial regulation that requires our attention is the BIS capital adequacy ratio standard. This standard has been promoted by the orthodox economists as preventing banks from making imprudent lending.

However, the problem with the BIS standard is that, while it is eminently sensible from the individual bank’s point view, it totally lacks any macroeconomic perspective. In times of economic recession when asset prices fall, the BIS ratio of a bank will fall even without a deterioration of the inherent quality of its lending. In this situation, the banks are forced to contract their lending. This is sensible for individual banks, but if all of them called in their loans, the economy will worsen, which will put a downward pressure on asset prices. This, in turn, will shrink the banks’ asset bases even

further, requiring even more contraction in their lending, and thus worsening the macro-economy even further. In boom times, the opposite will happen. The result is the magnification, rather than the dampening, of business cycles.

The fact that the BIS ratio magnifies, rather than dampens, the business cycle with harmful effects on the macro-economy was clearly demonstrated by the events relating to the recent economic troubles in East Asia.

First of all, take the case of Japan. The Japanese banks traditionally had lent a lot compared to their asset bases, were made to observe the BIS ratio from 1996 at a very short notice. This was a particularly unwise decision on the part of the Japanese government, as the Japanese banks were then particularly in poor financial states following the bursting of the financial and real estate bubbles in the early 1990s. This forced the Japanese banks to call in lots of their loans, thus, stamping out any shoot of recovery that was in the offing in the country (the Japanese economy grew at over 3% in 1996 after a few years of slow growth).

Particularly hard hit by the re-call of Japanese bank loans were the borrowers in other Asian countries, as the Japanese banks naturally started calling in loans from more risky borrowers from developing countries first. This contributed to the on-set of the 1997 Asian crisis. The IMF made things even worse for the crisis-hit countries by

forcing them to introduce the BIS standard. Introducing the BIS standard with a short transition period in developing countries with weak a banking sector would have been a bad move even in a favourable macroeconomic situation. Introducing it in the middle of a major financial crisis was a monumental folly. This forced the banks to stop lending and, further, to re-call existing loans, thus exacerbating the crisis. For example, in the case of Korea, bank lending in 1998 shrank to 1.6% of the pre-crisis level (259 billion won in 1998 vs. the average of 15,930 billion for 1996-7) (Shin & Chang, 2003, p. 114, table 14.3). It is difficult to imagine how this kind of fall would have been possible without the sudden introduction of the BIS ratio, even considering the magnitude of the crisis.

The problem is that the changes in the institutions of financial regulation favoured by orthodox economists, especially the decision to abolish/reduce deposit insurance and to introduce the BIS ratio, are based on a fallacy of composition. What may be good for an individual bank is not necessarily good for the banking sector as a whole, and even less for the macro-economy. The result has been the increased pro-cyclicality of the macro-economy and the increased difficulty of macroeconomic management.

5. Bankruptcy Laws

Few people would include the bankruptcy law as an institution of macroeconomic management. However, the kind of bankruptcy law a country has important implications for its ability to manage the macro-economy.

In pre-industrial Europe, bankruptcy law was mainly regarded as a means of establishing the procedures for creditors to seize the assets of and to punish the "dishonest" and "profligate" bankrupt businessmen. With industrial development, there came an increasing acceptance that business can fail due to circumstances beyond individual control, and not just as a result of individual dishonesty or profligacy. And as a result, the bankruptcy law also began to be seen as a way of providing a clean slate for the bankrupts to try for a second chance. This transformation of bankruptcy law was, together with generalised limited liability, one of the key elements in the development of mechanisms for "socialising risk" that allowed the greater risk-taking necessary for modern large-scale industries.

However, at least until the mid-19th century, the bankruptcy law in the UK, the then the most industrialized country, remained highly deficient by modern standards. Until then, bankruptcy remained the privilege of a very small class of wealthy

businessmen, the responsibility for prosecuting laid entirely with the creditors, and the system was not uniform throughout the country. There were also problems involved in the granting of "discharge", as it was granted by the creditors and not by courts, which deprived many businessmen of the opportunity to make a fresh start. There was also a lack of professionalism and corruption among bankruptcy commissioners. In the 1842 amendment, discharge became the right of courts, not creditors, making it easier for bankrupts to get their second chance. However, the coverage of the law was still limited until 1849, when it became applicable to anyone who earned their living by "the workmanship of goods or commodities".

In the USA, the early bankruptcy laws were modeled on the early (pro-creditor) English law and administered at the state level. However, until the late 19th century only few states had bankruptcy laws at all and these varied from one to another. There were a number of federal bankruptcy laws introduced during the 19th century (1800, 1841, and 1867), but they were all short-lived due to their defective nature (repealed in 1803, 1841, and 1878 respectively). It was not until in 1898 that Congress was able to adopt a lasting federal bankruptcy law.

Bankruptcy laws in developing countries have attracted an increasing amount of

attention over the last two decades or so. The large-scale corporate failures that followed various economic crises during this period have made people more aware of the need for effective mechanisms to reconcile competing claims, transfers of assets, and the preservation of employment. The industrial crises in the OECD countries in the 1970s and the 1980s, the collapse of the Communism and the miserable failure of "transition" since the late 1980s, and the 1997 Asian crisis were particularly important in this regard.

In the current debate on bankruptcy law, attention has been paid almost exclusively to the microeconomic implications (for a recent literature review in the developing country context, see Carruthers, 2000). For example, much of the debate has been on whether the bankruptcy law should be lenient or harsh on the debtors. Some argue that a harsh law is necessary, as otherwise it can lead to "moral hazard" on the part of the debtors and thus to inefficient investment. Others argue that a good bankruptcy law should be lenient on the debtors and give them time for restructuring and also a chance to "wipe the slate clean". Still others have debated whether the French bankruptcy law that protects the employees of the bankrupt firms has any merit.

However, very few people in the debate discuss the macroeconomic aspects of the bankruptcy law. From the point of view of macroeconomic management, the greater

protection of the debtors and the employees will be more beneficial than the protection of the creditors. In times of recession, a quick liquidation of enterprises in trouble may in fact magnify the recession, while the immediate sacking of workers will also deprive income from groups with higher consumption propensity. Of course, the macroeconomic cots and benefits will have be set against the microeconomic ones, but what is clear is that those who design the bankruptcy law need to take the macroeconomic factors into account.

6. Price- and Wage-Setting Institutions

In the view of most orthodox economists, prices and wages are set by competitive forces, unless there are "artificial" rigidities created by interest groups, such as industry cartels and unions. Any such rigidity, in their view, is inefficient and, more relevant for our concern in this chapter, prevents smooth macroeconomic adjustment.

However, by the late 19th century, the kind of competitive markets that the orthodox economists regard as their ideals ceased to exist. As the minimum efficient scales of production grew, firms gained some degree of price setting power, enabling them to engage in "mark-up", rather than "marginal", pricing. This increased the

possibility for "price wars" and consequently macroeconomic instability. At the same time, the increasing unionization (partly made possible by the growing size of firms) and the growing class consciousness of the workers, buttressed by the extension of suffrage, put an end to the "competitive" labour market (for a more detailed and insightful analysis of institutional evolution during this period, see Maier, 1987).

With these changes, many free-market economists wanted to return to the old world of small, price-taking firms and atomized and acquiescent workers. However, it was becoming increasingly clear that this was not possible given the technological and political changes. Therefore new institutions to manage the new price- and wage-setting process had to be created.

In terms of price setting, cartels were obvious early solutions. They became widespread in all of today's developed countries by the late 19th century. While cartels gave stability to long-term investment and increased macroeconomic stability, there were obvious problems with them, such as "unfair" competition and their undue political influence. Consequently, attempts were made to regulate them.

The pioneer in this regard was the USA. The country introduced the Sherman Antitrust Act in 1890. In this Act, unions were also treated as cartels, and in fact until 1902 when President Theodore Roosevelt used it against J.P. Morgan's railways

holding company, Northern Securities Company, it was mainly used against unions, rather than against large corporations. The Clayton Antitrust Act of 1914 banned the use of antitrust legislation against the unions.

During the 19th century, the British state neither supported nor condemned cartels and other anti-competitive arrangements. However, until the First World War, the courts were quite willing to uphold the validity of restrictive trade agreements. The Restrictive Practices Act of 1956 was the first true anti-trust legislation in the sense that it assumed for the first time that restrictive practices were against the public interest unless proven otherwise.

In other countries, cartels were even more favourably treated. For example, the German state strongly supported cartels and enforced their agreements during the late 19th century and the early 20th century – in particular the highest court making the ruling in 1897 by the highest court that cartel is legal. However, later (in 1923 and 1933 in particular), certain restraints on cartels were introduced (although not necessarily well implemented). In many other European countries, regulations of cartels did not really exist until after World War II.

In terms of wage setting, after World War I when it became clear that a return to the old world of acquiescent labour is impossible, many countries started experimenting

with “corporatist” ideas, which tried to resolve the growing social tension by organizing interest groups into “corporations” that explicitly coordinated their activities.

In some countries, such as Germany and Italy, corporatism was more of a slogan than an institutional reality exploited by rightwing dictatorships, and consequently delivered few results (Maier, 1987, ch. 2). However, some other countries built more effective collective wage bargaining institutions with lasting results. Norway and Sweden led the way by signing grand compromises between labour and capital in 1935 and 1938 respectively (the Basic Agreement and the Saltsjobaden Agreement)..

The most important element of social corporatism was the incorporation of the unions in the macroeconomic management process. The unions were given concessions in terms of full legalisation of union activities, better welfare provision, and emphasis on full employment in government macroeconomic policy management. In return, they were asked to accept private ownership and managerial prerogatives in hiring and firing. It was expected that giving the unions the power to fully exercise their collective bargaining power will make them more “responsible” and calibrate their wage demands in line with overall macroeconomic sustainability.

After World War II many other European economies also adopted “social corporatist” wage bargaining institutions. The advantages of “social corporatism” in

macroeconomic management were demonstrated during the period of “stagflation” in the 1970s and the 1980s, when countries with strong institutions of collective wage-price bargaining, especially Sweden, Norway, and Austria, had much better macroeconomic performances than other countries with “freer” or “more flexible” labour markets (Rowthorn and Glyn, 1990).

In the developing countries, product and labour markets tend to be quite differently organized from their counterparts in the developed countries.

Some of their product markets are also oligopolistically organized. The weakness, or even absence, of their competition laws means that in these markets prices may be even more rigid than their counterparts in the developed countries. On the other hand, the developing countries also have a large “informal sector”, where prices are more competitively determined and thus less sticky. They also rely heavily on primary commodity exports, whose markets are very competitive and therefore their prices subject to large price fluctuations.

In terms of wage setting, the existence of a vast pool of surplus labour means that on the whole wages in developing countries are very flexible, even in the “formal” sector. Indeed, the falls in real wages have been rather dramatic in many developing

countries during recent experiences of economic crises and stagnation. Having said that, we must point out that the picture is more complex. In many developing countries, there may be individual industries where strong unions exist. In some other countries, notably in Latin America, there have been experiments with wage indexation at least for the formal sector.

What is clear is that the institutions for price and wage setting are much more heterogeneous in the developing countries than in the developed countries. Given this, the dynamics of price- and wage-setting in the former tend to be much more complicated than in the latter.

Notwithstanding this complexity, it is fair to say that on the whole the nature of price- and wage-setting institutions in the developing countries make their prices and wages more prone to fluctuation than their counterparts in the developed countries. This, in turn, means that the macro-economy in the developing countries tend to fluctuate more than do their counterparts in the developed countries.

7. Conclusion

In this chapter, we have examined how institutions have fundamental influence

on the behaviour of the macro-economy. The institutions that affect the macro-economy include not only "obviously macroeconomic" ones like the central bank, budgetary institutions, and price- and wage-setting institutions but also "apparently microeconomic" ones, such as institutions for financial regulation and bankruptcy law.

In discussing how these institutions influence the macro-economy and therefore the scope and nature of macroeconomic policy, we used historical evidence from today's developed countries in order to show how these institutions are not "natural" but things that have to be consciously built. Then we discussed the implications of the currently orthodox (neo-libeal) position on these institutions for macroeconomic management, especially in developing countries.

We conclude that the orthodox recommendations for institutional changes are based on pre-Keynesian ideas of macroeconomics (as far as the subject can be said to have existed then). The institutions that they recommend are the ones that will weaken the macroeconomic "stabilizers" that the developing countries have built over the last few decades with great difficulty (e.g., cuts in welfare spending) and, even worse, magnify business cycles (e.g., inflation-focused central bank, the BIS ratio). Thus, in terms of macroeconomic management, these recommended institutional changes are likely to turn the clock back to the days when the failure to understand the fallacy of

composition made policy-makers so inept at macroeconomic management.

The developing countries are already prone to more cyclical behaviours of their macro-economy because of their underlying production and institutional structures. To make them adopt policies and institutions that are pro-cylical, rather than anti-cyclical, is to make their macroeconomic management even more difficult.

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