Preface

It has been a long and strenuous journey since the time I submitted my M.Phil. dissertation in 1991. That was the year, India plunged into a severe balance of payments crisis. A series of reform measures were adopted at the behest of the IMF to retrieve the economy from the crisis and put it on a path of growth on a sustainable basis. It was argued that fiscal reform should target the fiscal deficit as a proportion of GDP to restore macroeconomic balance. This was associated with a series of measures (the Structural Adjustment Programme) with the objective of infusing market principles in the functioning of the different areas of our economy.

After I did my M.Phil. on the determinants of private corporate investment in India, I was looking for a theme for my research in Ph.D. The search was guided by my objective to find out the applicability of the standard conventional macro-theories in case of India as it was in my M.Phil dissertation. I started reading the slender book by W. M. Corden, titled ‘Inflation, Exchange Rates and the World Economy’. I thoroughly enjoyed reading the book. The basic argument of the monetary approach to the balance of payment was explained in simple terms. The recommendation was clear and bold enough ‘..stop creating credit’, as the excess supply of money leaks out of the economy leading to a decline in the foreign exchange reserves under typical monetarist assumptions. The argument was impressive and convincing. I started wondering, does the economy behave in a way as envisaged by the monetarists? To put it differently, what is the underlying transmission mechanism? Linked with it was the question, how rational and justified it was to target the fiscal deficit to restore balance in the external account. Are the underlying assumptions behind such policy decision valid for India? During that period, a new concept of deficit, the fiscal deficit, was being widely used in the economic circle. I started reasoning it out what determines the degree of correspondence between the fiscal deficit and the trade deficit. The Fund prescription of targeting the fiscal deficit is, after all, based on ‘financial programming’ developed at the Fund, which is essentially a different version of the monetary approach to the balance of payment.

After listening to Prof. Lance Taylor, I was impressed. I have always felt that there is a need to base economic analysis on the institutional and structural characteristics of an economy. Straight-jacketing of any policy derived from a model blindly to apply in case of India is a gross violation of economics since the assumptions of the model must correspond to that of India. Economics is a science conditioned by time and space.
In my M.A., I opted for a special paper in Public Finance, taught by Dr. Arun Kumar. The treatment differed markedly from the conventional approach with special emphasis on the black economy. I approached Dr. Kumar to do my thesis on the aspect of stabilization policy in India. I gradually started realising that there is more to it. It is not only the characteristics of an underdeveloped country one should be paying attention to, but also the black economy, an integral part of our economy as several studies indicated from time to time. Corresponding to the generation of black incomes, there are black consumption and black investment. Mis-invoicing of trade transactions facilitate capital flight. All these are hard facts of life. Therefore, there is a need to marry these two, to try and understand how the economy functions in the background of the dominant doctrines and to incorporate the black economy into the macro analysis.

Dr. Kumar devoted himself to build up a macro model taking into account the black economy as an integral part and specific to the Indian context. His preliminary thinking on this came out as a Working Paper of the Centre in 1993, which contained the skeleton of the model. He dubbed the failure to include the black economy as a 'missing dimension' in the Indian policy making. But the model needed to be fleshed out in terms of the functional specification of its major constituents.

To begin with, understanding of the various aspects, institutional and functional, of the black economy was a difficult proposition for me, who was little exposed to the outside world where the black economy thrives. It was similar to the experience of a blind man trying to guess the shape of an elephant. I am indebted to Dr. Kumar for his patience and continuous support in trying to understand the black economy, integrating the various aspects of the black economy in a coherent framework. My endeavour was badly hampered by vicissitudes throughout. I left JNU and joined National Institute of Public Finance and Policy (NIPFP) in 1995 after resorting to de-registration. The set-up at NIPFP was conducive for research but office work, along with the tours were indeed demanding.

I have made a modest attempt to develop the model suggested by Dr. Kumar (1993, 1999) in this thesis. After the introduction, I have tried to highlight the missing elements in the analysis of ‘twin deficit’ and monetary dynamics in India. On the basis of the findings, I arrived at the conclusion that inclusion of the black economy is essential for a fuller understanding of the economy. After laying out the model, I hypothesise the functional specifications of consumption and investment and proceed from there.

In my endeavour to write my thesis, I have been helped and encouraged by many people. I am indeed extremely grateful to my supervisor, Dr. Kumar, for guiding me through the tortuous path to the submission of my thesis. It is because of his patience, moral support and advice in the event of crisis that the thesis could be produced. My father stood behind me
like a rock lest I deviate from my pursuit till very recently. I wish he were alive today to see
the thesis taking its final shape, which was his only demand from me. I lost my mother soon
after my father's demise. I am still unable to cope with the very big loss I had to suffer. The
thesis could not have been produced today but may be some years later had Dr. Ashok Lahiri
not been persuasive and considerate enough. His reminding me almost every alternate day
was embarrassing enough for me but ultimately credit goes to him. He was helpful and
understanding. I owe to the teachers of my college, Dr. Gopal Trivedi and Mr. Pronab Basu
for arousing interest in Economics. At the Centre during my M.A., attending the classes of
Late Prof. Krishna Bharadwaj and Prof. Prabhat Patnaik used to be a wonderful experience for
me. Among my colleagues, I would like to mention Dr. Hiranya Mukhopadhyay and Dr.
Kavita Rao for their help and encouragement. It was Dr. Mukhopadhyay who introduced me
to the latest techniques of time series applications. Among my senior colleagues, I would like
to thank Prof. D.K. Srivastava, Prof. Indira Rajaraman, Prof. J.V.M. Sarma and others who
were concerned and helpful. Among my well-wisher, I would like to thank Dr. Dev Raj Singh,
Dr. Bibekananda Ray Chaudhuri, Dr. Kaushik Chaudhuri, Dr. Gautam Naresh, Mr. T.S.
Rangamannar, and Late Dr. Subrata Sengupta for their help and encouragement. The endless
list of friends includes Pratap, Gautam Naresh, Partha Guha, Pradipda, Subrata, Dipayan,
Sagar, Pinaki, Lekha, and many others. Sunil was highly co-operative in reading the draft of
my thesis. Among my family members, my daughter, Chandrima, and my wife, Somdatta had
to bear the brunt of adjustment over the last eight years. My gratitude to my elder brother,
Arun cannot be simply put in words. I can never repay my debt to them. It was my 'dada' who
persuaded me to opt for Economics after my school. He would indeed be very happy today. I
highly appreciate the concern of my other family members, in particular, my father-in-law,
Mr. J.B. Chattopadhyay.

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April 2002