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Macroeconomic Policies for Development

After several decades of a narrow focus on controlling inflation and reducing fiscal deficits, discussions of macroeconomic policy have returned to fostering growth and development. The IMF's Chief Economist, Olivier Blanchard¹ has stated that “in the age-old discussion of the relative roles of markets and the state, the pendulum has swung—at least somewhat—toward the state”. He added: “macroeconomic policy has many targets and many instruments” and “monetary policy has to go beyond inflation stability”.² Justin Yifu Lin, Senior Vice President and Chief Economist at the World Bank, has also argued for a “New Structural Economics”, emphasizing industrial development as the way out of poverty.³

In formal terms, the pendulum is swinging from orthodox towards more heterodox macroeconomic policy. What do these terms mean? First, by “orthodox”, we mean policy derived from the theoretical framework of efficient markets and quick adjustment to full utilization of resources. If an economy has an automatic tendency to full employment within a time period acceptable to policymakers, then, by definition, macroeconomic management is unnecessary. If that full employment outcome is realized, given the parameters of the economy, then there is no justification for macroeconomic intervention. In this case, monetary and fiscal policies should be neutral, and the exchange rate should “float” without intervention.

We use the term “heterodox” to refer to macroeconomic policy derived from imperfect market clearing. The imperfection can manifest itself in several forms: persistent unemployment, rising inequality, or limited competition. At the macroeconomic level, inefficient market clearing implies that an economy does not automatically adjust to its full potential output. These inefficiencies justify public intervention, designed specifically for each country context.

Among the analytical and practical shortcomings of orthodox macroeconomic policy was its advocacy of a *de facto* neutral or contractionary fiscal and monetary policy. Equally problematic was the implicit or explicit view that this policy stance was appropriate for all countries. If we define orthodox macroeconomic policy as the “thesis”, the appropriate policy is not its “antithesis”. Instead, this policy brief presents a set of macroeconomic policies which are likely to promote growth and reduce poverty.

Policy Coordination

At the minimum, governments have four macroeconomic objectives: achieving potential growth, maintaining sustainable internal and external accounts, preventing a destabilizing rate of inflation, and poverty reduction. If, as the orthodoxy argues, an economy has an automatic tendency to full employment, then policy coordination is a trivial matter.

The generally accepted analytical framework for the coordination of macroeconomic policy in open economies – at least according to orthodox policy – is the Mundell-Fleming model (Fleming, 1962; Mundell, 1963).^{4 5} This model assumes that if a government operates a flexible exchange rate regime, then fiscal policy is ineffective in influencing the level of output. This conclusion implies that monetary policy must bear the major burden of macroeconomic management. If this conclusion was valid, there would be very little scope for macroeconomic management. This is because the first priority of monetary policy would be control of inflation.

However, the Mundell-Fleming model contains an internal contradiction in its logic, which renders the conclusion invalid.⁶ For instance, a model anchored on a flexible exchange rate regime ignores the impact of exchange rate changes on the price level. If, for example, we look at a “small country” case, the logically complete story of monetary expansion would be:⁷

- 1) An increase in the money supply, results in a trade deficit. With perfect capital flows this deficit is instantaneously eliminated by a depreciation of the currency.
- 2) Depreciation of the currency raises the price level *via* the price of imports.
- 3) Lower real money supply as a result of a price increase makes the real depreciation less than the nominal.
- 4) Therefore, monetary policy would not be completely effective because of the price effect on the real money supply and the real exchange rate.

This logical sequence implies that the effectiveness of monetary policy to manage the level of output depends on two parameters. The first is the marginal propensity to import, which determines the impact of a devaluation or depreciation on the domestic price level. The second key parameter is the sum of the elasticities of export and import volumes with respect to the real exchange rate. This combined elasticity determines the required magnitude of the real change in the exchange rate to equilibrate the current account.

The above parameters are extremely important for our analysis. For resource-rich countries, the supply of mineral or oil exports is frequently not exchange rate elastic. This is because prices are quoted in world currencies such as the dollar or euro and world demand is price-inelastic. It is also the case that resource-rich countries can have high import shares. These two characteristics tend to reduce the usefulness of monetary policy for macroeconomic management. In the case of post-conflict countries, exports may be supply-inelastic due to some disruption of markets, destruction of infrastructure, disruption in land tenure systems, and population shifts.

To summarize, economic theory does not produce a rule for the relative effectiveness of monetary and fiscal policy when the exchange rate is flexible, either in general or specifically for resource-rich and post-conflict countries. In contrast, there is no analytical controversy that fiscal policy is relatively more effective than monetary policy when the exchange rate is fixed. The fixed exchange rate consideration is important as most developing countries, especially post-conflict, adopt such a regime. Resource-rich countries actively manage their

currencies, especially the exporters of hydrocarbons.

Once the analytical inconsistency of the Mundell-Fleming model is acknowledged, we can address appropriate principles of policy coordination; where fiscal, monetary and exchange rate policies are not considered in isolation from one another. The analysis of how each of these macroeconomic instruments can be designed for strong growth needs to be preceded by a clarification of how they interact and support or undermine one another.

The minimum goal of coordination is to prevent the different policy instruments from conflicting with one another. The Tinbergen principle states that successful outcomes require the number of policy objectives to match the number of policy instruments. As noted above, a government has several simultaneous and complementary policy objectives at the macroeconomic level. These objectives require an equal number of instruments, which would be found among the fiscal, monetary, and exchange rate management tools.

Zambia provides a clear example of the contradictory use of policy instruments in a mineral-rich country. In the mid-2000s, in an attempt to prevent appreciation of the kwacha provoked by rising copper prices, the Bank of Zambia carried out foreign exchange purchases (sold kwacha). At the same time, the Bank conducted open market operations to prevent the money supply from exceeding limits set by an IMF agreement. The intention of the first instrument was to increase the availability of the domestic currency, while the second had the opposite effect (Weeks, *et al.*, 2007).⁸

Short- and Long-Term Policy Interventions

An active macroeconomic policy would have complementary short-term and medium-term components. The short-term component relies on the current fiscal budget, tax instruments, and complementary monetary and exchange rate measures for countercyclical intervention. Countercyclical intervention can be institutionalized as part of normal macroeconomic policy.

Countercyclical expenditures that can be implemented effectively are closely related to a country's level of development. The more developed a country, the more alternatives there are. Where a substantial proportion of the labour force is in wage employment, governments can implement a range of cash transfer programs, including unemployment benefits, pensions and family allowances (Weeks, *et al.*, 2004).⁹ Even faced with implementation constraints such as low population densities and weak road links, some sub-Saharan governments have successfully carried out temporary employment schemes, or “cash for work” projects. These projects involve quickly-initiated and rapidly-completed activities using employment-intensive techniques that have a large component of repair and maintenance. For instance, in response to the recent global financial and economic crisis, the wage paid to workers under Ethiopia's Productive Safety Nets Program (PSNP) was increased, benefiting 7.3 million people. In 2009, the Government of Sierra Leone implemented an employment program, which created jobs for 14,000 workers.¹⁰

The medium-term objective is to increase the productive potential of the economy and “crowd-in” private investment. This

discussion invariably provokes reference to a phenomenon and analysis named the Dutch Disease. The term is applied to large financial flows, mainly resource revenues and foreign aid. But the term is not always applied with precision of definition, nor are the associated “Dutch Disease effects” always rigorously specified. The formal analysis of the Dutch Disease has major pitfalls. First, the formal version is a general equilibrium, full-employment model, which severely limits its relevance. Second, and more analytically serious, the concept has lost its specificity due to attempts to generalize the analysis. Therefore, one needs to look at characteristics of developing countries in designing macroeconomic policies.

For example, in post-conflict and resource-rich countries, large inflows of foreign exchange are insensitive to the real exchange rate, and have a strong effect on its nominal value. For resource-rich countries, this is a result of the nature of global markets for natural resource commodities. The large development assistance and humanitarian inflows to post-conflict countries are completely insensitive to exchange rates, at least in the medium-term.

Additionally, these large inflows of foreign exchange are not associated *ex ante* with substantial employment generation. This is obvious for development assistance which, by and large, is not designed to generate significant employment. In the case of hydrocarbons and minerals, it is due to the low employment-intensity of production. The comparative experiences of Algeria and Morocco are revealing. The Algerian economy is oil-driven. Morocco is not resource dependent and has a vibrant manufacturing sector, mainly textiles and garments. In

Algeria, female employment in the non-agricultural sector is only about 12 per cent. In Morocco, the figure is 33 per cent. These disparities have been explained by capital-intensive oil production in Algeria and labour-intensive manufacturing exports in Morocco (Ross, 2008).¹¹

Another characteristic that has a direct bearing on policy design is the relative insensitivity of public revenue to national income. The scope for rapid revenue mobilization is limited in most developing countries. In some cases, the majority of the labour force may not be in wage employment. In other cases, taxes are limited by the relatively large size of the informal economy and reduced capacity to generate public revenue.

Concluding Remarks

Macroeconomic policy involves the management of priorities and trade-offs, in which policy instruments are used to seek an outcome chosen by national governments. A heterodox framework has a better chance of promoting growth and reducing poverty. As discussed above, this involves fiscal policy that focuses on mobilizing domestic revenue, scaling-up public investment and preventing over-heating. Monetary policies would revitalize the financial sector, avert inflationary hikes and stimulate private sector investment. Exchange rate policies would focus on maintaining international competitiveness. For best results, policy coordination is necessary.

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¹ <http://blog-imfdirect.imf.org/bloggers/olivier-blanchard/>.

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<http://autenticidadept.wordpress.com/2011/05/26/the-future-of-macroeconomic-policy-nine-tentative-conclusions/>.

³ http://www.wider.unu.edu/events/annual-lecture/en_GB/04-05-2012/_files/85615690402103392/default/press%20release%20for%20WIDER%20annual%20lecture%2015%20_Justin%20Lin%20Maputo_.pdf.

⁴ Fleming, Marcus (1962). 'Domestic Financial Policies under Fixed and under Floating Exchange Rates'. IMF Staff Papers 9.

⁵ Mundell, Robert (1963). Capital Mobility and Stabilization Policy under Fixed and Flexible Exchange Rates. *American Economic Review* 53, pp. 112-119.

⁶ A full technical presentation including algebraic derivation, is found in Weeks, John (2009). The Effectiveness of Monetary Policy Reconsidered. Working Paper 202, Political Economy Research Institute, Amherst, Massachusetts.

⁷ "Small country" refers to the case of a country for which changes in its exports and imports would not affect world prices. This is the case for almost all developing countries, with China being one of the rare exceptions.

⁸ Weeks, John, Shruti Patel, Allan C. K. Mukungu and Venkatesh Seshamani (2007). *Kwacha Appreciation, 2005-2006: Implications for the Zambian Economy*. Lusaka: UNDP.

⁹ Weeks, John, Nguyen Thang, Rathin Roy and Joseph Lim (2004). *Seeking Equity within Growth: The macroeconomics of poverty reduction, case study of Vietnam*. Hanoi: UNDP.

¹⁰ The International Labour Organization calls such projects as "labour-intensive public works". <http://www.ilo.org/public/english/employment/recon/eiip/index.htm>.

¹¹ Ross, Michael L. (2008). Oil, Islam, and Women. *American Political Science Review*, 102 (1), pp. 107-123.