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Developmental Macroeconomics

Historically, macroeconomic policies have both stabilization and development roles. However, since the 1980s the focus of macroeconomic policies shifted to stabilization alone. It is assumed that low single digit inflation and low or no budget deficits are both necessary and sufficient conditions for growth and development.

But many developing countries, especially those under the structural adjustment program of the International Monetary Fund (IMF) have achieved these targets at the cost of development, for example, by cutting public investment in key areas and expenditures on education and health. As can be seen from Figure 1, public investment has fallen in Latin America and Sub-Saharan African countries since the 1980s and 1990s. The picture is not different in the Asia-Pacific region; there have been drastic declines in public infrastructure investment, especially in agriculture.

Restrictive macroeconomic policies aimed at stabilization in a very narrow sense often caused a vicious circle of low productivity, low tax revenue and higher deficits and inflation, leading to further cuts in productive public investment. Infrastructure deficits also hampered productive and export capacity leading to larger current account deficits. In fact, one study attributed the root cause of the 1997-98 Asian financial crisis in the origin country, Thailand, to infrastructure deficits caused by cuts in public investment in the 1980s when Thailand was under the IMF's structural adjustment program. [1] As it is well known, when the countries were hit by the worst financial crisis in 1997, they had reasonable macroeconomic stability.

Against the backdrop of declining public investment, the Fiscal Affairs Department of the IMF raised a question "about the widely used approach to fiscal analysis and policy, which focuses on the overall fiscal balance and gross public debt. A concern is that this approach may unduly constrain the ability of countries to take advantage of increased opportunities to finance high-quality infrastructure projects".[2]

Therefore, it is not a surprise when the World Bank observed: "Macroeconomic policies improved in a majority of developing countries in the 1990s, but the expected growth benefits failed to materialize, at least to the extent that many observers had forecast."[3]

In light of large development gaps, significant infrastructure shortages and unsustainable environmental impacts, there is, thus, clearly a need to balance stabilization and developmental roles of macroeconomic policies.

Such a balance could entail changing the way fiscal and monetary policies are designed and implemented and how issues of public debt or inflation are viewed.

Fiscal policy

It would be most pertinent here to refer to the work of the IMF, especially when fiscal balance or debt ceiling remains one of the fundamental aspects of the IMF's support program.

For example, the IMF's Fiscal Affairs Department has argued that "increased priority should be given to spending on needed and well-designed infrastructure projects in budget allocations; room should be created, at least beyond the very short term, to protect high-priority projects when fiscal adjustment is required; and the scope for increased financing of new public investment that is consistent with short-term macroeconomic stability and longer-term debt sustainability should be fully utilized".[4]

The joint Development Committee of the World Bank and IMF has laid down some guidelines for designing fiscal policy that balances stabilization and developmental roles. It notes: "The fiscal deficit is a useful indicator for purposes of stabilization and for controlling the growth of government liabilities, but it offers little indication of longer term effects on government assets or on economic growth."[5]

Therefore, there is a need to identify and incorporate the transmission channels through which fiscal policy influences long-term growth. This requires that "attention be focused on the likely growth effects of the level, composition and efficiency of public spending and taxation." The Development Committee warns: "Fiscal policy that neglects these effects runs the risk of achieving stability while potentially undermining long-term growth and poverty reduction."

Monetary policy

The preamble of the IMF's Article of Agreement IV states that "each member shall ... endeavor to direct its economic and financial policies toward the objective of fostering orderly economic growth with reasonable price stability, with due regard to its circumstances" (Article IV.1.i).

The key here is "reasonable" price stability and due regard for country specific circumstances. Therefore, monetary authorities should not excessively focus on a pre-determined inflation target without any regard for growth or causes of inflation. This means due attention to the supply side factors. Monetary tightening or raising interest rates in response to supply shock inflation is a blunt tool that hurts growth and employment.

Historically, central banks have played an important role in development by easing the constraint of access to credit for firms through credit allocation policies. For example, subsidized bank loans (known as "policy loans") were a vital instrument for the implementation of the strategy of the Republic of Korea for promoting heavy and chemical industries. In India, a decisive shift in credit deployment in favour of the agricultural sector took place in the 1970s and 1980s. From an extremely low level at the time of bank nationalization, the credit share of the sector had moved to nearly 11% in the mid-1970s and to a peak of about 18% at the end of the 1980s, which was the official target. This change played an important role in the increase of agricultural output in India.

Therefore, monetary and credit policies should ensure financial inclusion and adequate supply of credit to productive sectors, especially agriculture and SMEs. The monetary authority should also ensure that credit does not fuel speculative activities, especially in the capital market and does not create property bubble.

Exchange rate policy

Exchange rates have both microeconomic and macroeconomic roles. As a relative price,[6] exchange rates play an important microeconomic function in terms of structural change between tradable and non-tradable sectors of an economy and in maintaining international competitiveness. Owing to the close association between balance of payments outcomes and budget deficits and monetary policy stance, exchange rates can also function as an important macroeconomic policy tool.

Many observers have attributed the 1997-98 Asian financial and currency crises to their pegged exchange rates, and suggested a more flexible exchange rate regime. But a greater flexible exchange rate is not always an optimum policy for the developing world.

At the 2001 Kobe meeting of Asia-Europe Finance Ministers, the Chairman's concluding statement noted: "there is a spectrum of possible exchange rate arrangements, depending on various aspects such as the size of the economy, trade and investment structure, the sequencing of capital account liberalization and the level of economic development. No single arrangement is necessarily right for all countries all the time."[7]

Given the role of exports and FDI and the need to stabilize the economy, a developing country should follow an exchange rate stability approach. However, this may mean some loss of monetary independence. This will not matter when the economy is doing well as exports grow and FDI flows in. Furthermore, a country following this approach does not necessarily lose monetary independence. It can retain monetary independence with some control on short-term capital mobility or if capital flows are not significant. An important lesson of the Asian financial crisis is that nominal stability must not end up in real appreciation.

When there is a negative shock or a boom ends, a country should have the ability to adjust its exchange rate downward, that is, it should adopt the real target approach. When the exchange rate is allowed to depreciate, a country also gains the ability to use fiscal-monetary policy to stabilize the economy and minimize the adverse effects on poverty. The cautionary note here is that Governments may delay depreciation for political reasons, which can throw the economy into deeper recession.

Managing capital flows

The opening of the capital account is seen as essential for encouraging capital flows and the development of the domestic capital market. These are expected to enhance both the volume and efficiency of investment and hence, economic growth. However, empirical evidence of the growth-enhancing effect of capital account liberalization (CAL) is mixed.

For example, Eichengreen et al, (2009) found that "the positive effects of capital account liberalization are limited to countries with relatively well-developed financial systems, good accounting standards, strong creditor rights and rule of law. It suggests that countries must reach a certain threshold in terms of institutional and economic development before they can expect to benefit from capital account liberalization".[8] Similar findings are also reported in Kelin et al (2008).[9]

Capital flows management is a sovereign right of a country under the IMF's Article of Agreement (Article VI). Therefore, countries should have active capital flows management in place in view of the risk of large capital inflows and their sudden withdrawals to macroeconomic management and financial sector fragility. Both the IMF and World Bank have now recognized capital flow management as an essential macroeconomic policy tool.[10] The IMF has suggested a range of tools for managing capital flows.[11]

However, the IMF's recommendations remain partial and omit some key types of beneficial actions. Specifically, regulations are recommended to be implemented as a last resort after the acquisition of sufficient foreign exchange reserves and other actions, and should be temporary and market-based. But research and experiences of countries show that regulations to restrict capital outflows should be an important part of the toolkit, along with regulations for managing inflows.[12] Capital account openness should not be viewed as an all-or-nothing proposition. Capital account can be open to equity flows – both portfolio and FDI, even when money and bond flows are managed.

In sum, a judicious use of macroeconomic policies can enhance their developmental role without compromising macroeconomic stability.

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[1] Chowdhury, Anis (1999), "Villain of the Asian Crisis - Thailand or the IMF?", *ASEAN Economic Bulletin*, Vol. 16 No. 2 pp 168-177

[2] IMF (2004), "Public Investment and Fiscal Policy", Fiscal Affairs Department, p. 3

[3] World Bank (2005), *Economic Growth in the 1990s: Learning from a Decade of Reform*, Washington, DC. p. 95

[4] IMF, op cit, p. 3

[5] IMF-World Bank Development Committee (2006), 'Fiscal Policy for Growth and Development: An Interim Report', April 6 (p. i)

[6] The ratio of two prices between tradable and non-tradable products or between domestic and foreign goods.

[7] Available on www.mof.go.jp

[8] Eichengreen, Barry, Rachita Gullapalli and Ugo Panizza (2009), "Capital Account Liberalization, Financial Development and Industry Growth: A Synthetic View" , http://emlab.berkeley.edu/~eichengr/capital_account_2-10-09.pdf

[9] Klein, Michael W. and Giovanni P. Olivei (2008), "Capital account liberalization, financial depth, and economic growth", *Journal of International Money and Finance*, Volume 27, Issue 6, pp. 861–875

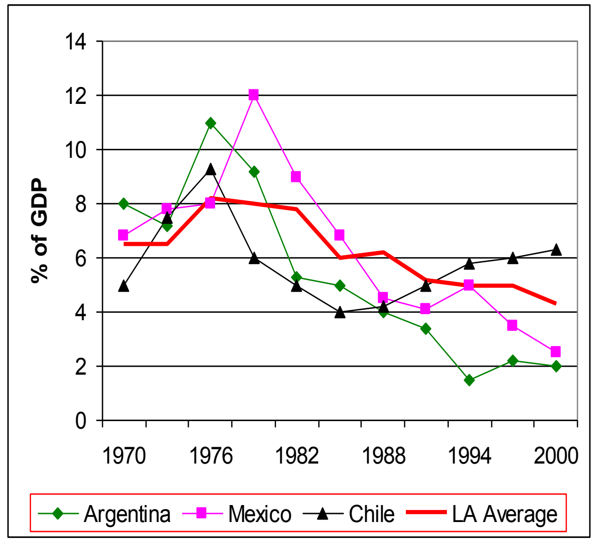
[10] IMF (2012). 'The Liberalization and Management of Capital Flows: An Institutional View', November 14. World Bank (2010). *Global Economic Prospects Crisis, Finance, and Growth*. Washington DC

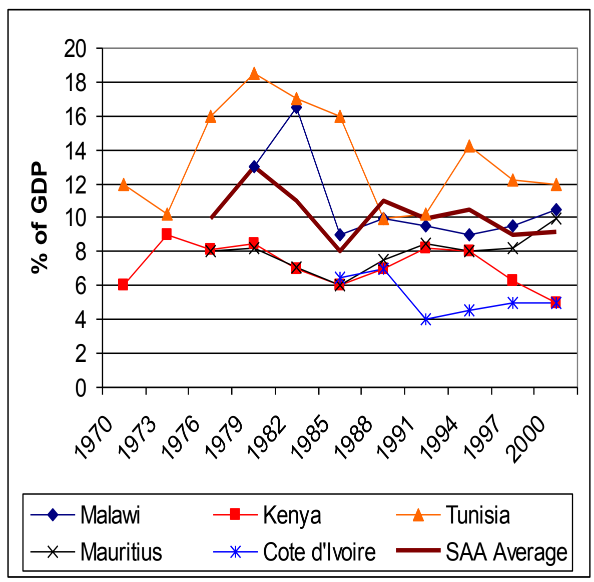
[11] Ostry, J. D., A. R. Ghosh, K. Habermeier, M. Chamon, M. S. Qureshi, L. Laeven, and A. Kokenyne (2011). 'Managing Capital Inflows: What Tools to Use?'. IMF Staff Discussion Note 11/06. See ESCAP/MPDD

Policy Brief # for a discussion of pros and cons of various techniques.

[12] See, for example, Kevin Gallagher, Stephany Griffith-Jones, and Jose Antonio Ocampo, 2012, Regulating Global Capital Flows for Long-run Development, Pardee Center Task Force Report. Boston, MA: Fredrick S. Pardee Center for the Study of the Longer Range Future, March.

Figure 1: Public investment in Latin America and Africa





Source: IMF (2004), "Public Investment and Fiscal Policy", Fiscal Affairs Department