

# **MACROECONOMIC AND GROWTH POLICIES**

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## **Acronyms**

FDI	Foreign Direct Investment
GDP	Gross Domestic Product
IMF	International Monetary Fund
ODA	Overseas Development Aid
VAT	Value-Added Tax
WTO	World Trade Organization

## I. INTRODUCTION\*

Macroeconomic stability is a necessary condition for development and for growth. However, the record of the past two decades shows that recently fashionable ideas, and policy recommendations, of what makes for good macroeconomic management and for such stability have been overly narrow. Indeed, in many countries they have wrought the opposite of what was intended.

Developments over the past decade have changed perceptions across the world about the nature of desirable macroeconomic policies. The Asian financial crisis of the late 1990s and the meltdown in Argentina at the turn of the decade showed the possibility of apparently “prudent” fiscal strategies still being associated with unsustainable macroeconomic processes that created the possibilities of crises. The emphasis placed explicitly by the UN and the international community on achieving the Millennium Development Goals and the need to ensure finance for development have indicated the need for changing the emphasis of economic strategies. All these and related factors have produced a broad understanding that macroeconomic management in open developing economies should be guided by the following framework:

- Macroeconomic policy needs to be developed within a co-ordinated framework, so that fiscal, monetary, exchange rate and capital management policies are consistent.
- The time horizon should be medium term, set within a systematic framework that provides the contours within which macroeconomic and public expenditure strategies are organised.
- Economic growth, livelihood stability and employment generation must be given significance, and should not be “crowded out” by an *overly narrow* focus on macroeconomic stability and inflation control.
- It is not just the aggregate rate of economic growth, but also the pattern of that growth, which is crucial. Indeed, a moderate but sustainable rate of growth, which involves employment generation and poverty reduction, is preferable to a higher rate of growth that is based on greater income inequalities and has more potential for volatility and crisis.
- For most countries, the primary goal should be productive employment generation providing “decent work”. This requires more than macroeconomic policy alone; in particular, industrial policies providing carefully considered incentives to promote desired investment and financial policies including directed credit will play a role.
- The significance of public expenditure in sustaining and expanding the productive human resource base of the country through social spending must be recognised. Macroeconomic policies must ensure that public expenditure in the social sectors is maintained at adequate levels.

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- Developing country governments need to be more confident of the positive effects of *appropriate* expansionary fiscal policy and, in particular, of the critical role of public investment.
- There needs to be more emphasis on raising public resources in ways that do not adversely affect the poor, for example through effective implementation of progressive direct taxation, (flexible) trade taxes and taxes on capital movements.
- Monetary policy should accommodate fiscal policy, not the other way around, and both should be targeted to real economic goals such as employment generation, livelihood protection and expansion and poverty reduction. This has implications for the kind of independence to be given to central banks. It also means that inflation targeting, *in itself*, cannot be the central goal of monetary policy.
- Exchange rates should be flexibly managed, even to the point of creating a band within which market forces are allowed to work. This requires some control over capital account movements, preferably through a range of flexible instruments.
- Last, but not least, all macroeconomic policies must take full account of equity considerations and impacts.

In short, pragmatism, within a growth-enhancing framework, and flexibility, guided by the specific requirements of each country's context, should be the guiding principles, rather than a dogmatic "one size fits all" approach.

The following material expands on the above points. We do not propose any specific policies as it would be impossible to do so given the differences between developing countries. Instead, we raise some major issues for consideration and suggest the policy space that is available to address them. We begin with placing macroeconomic policy in context in the following section, and then consider fiscal policy, monetary policy, managing economic cycles, and exchange rate policy in the next four sections.

## **II. WHAT IS MACROECONOMIC POLICY?**

Macroeconomic policy addresses the overall aggregates of the economy: prices, output, employment, investment and savings, government balances, and balances on the external account.

The goals of macroeconomic policy can and do vary. They include creating conditions for sustained growth; price stabilisation or inflation control; reducing unemployment; smoothing economic cycles and volatility in output and employment; correcting aggregate and sectoral imbalances; reducing poverty, and providing greater equity for all, especially the marginalised.

There are three major policy instruments to manage these macroeconomic aggregates, namely,

- (a) fiscal policy;
- (b) monetary policy, and
- (c) exchange rate policy.

Fiscal policy covers matters such as taxation and other methods of resource mobilisation, and levels and patterns of expenditure, that is, the aggregate fiscal stance. Monetary policy centrally addresses the base interest rate and levels of credit in the economy. Exchange rate policy, in contemporary open economies, is largely related to monetary policy.

Macroeconomic policy involves trade-offs between its conventionally accepted goals. Thus, a quest for macroeconomic stability focusing on inflation control may imply sacrificing employment, and counter-cyclical measures may worsen sectoral imbalances.

These short run goals in turn have a bearing on development policies. The quest for macroeconomic stability may lead to insufficient emphasis, or worse, on strategies for sustainable and more inclusive development, or improving human development and meeting broader social objectives. In particular, the goals of price stability and employment generation can be in conflict. Unfortunately, the pursuit of price stability or the correction of external imbalances has too often become so dominant as to lead to the neglect of pervasive and persistent unemployment and underemployment. However, a shift in focus making productive employment generation the most important goal need not generate imbalances or instability.

### **Short-term and long-term linkages**

Economic policy makers have often assumed that macroeconomic policies are short run measures to address current problems, most importantly stabilisation and correcting aggregate imbalances, and that they can be treated separately from measures to promote economic growth and development. However, short-term measures can determine the contours of future growth and affect possible future economic strategies. For example, a non-judicious reduction in public expenditure to correct a fiscal deficit, resulting in a reduction in important infrastructure investment, directly affects future growth prospects. Conversely, policies such as development plans or economic adjustment exercises designed for the medium or longer term directly impact upon current conditions and affect short run movements. Policies of trade liberalisation designed to reduce external deficits by bringing domestic relative prices closer in line with world trade prices may create incentives to reduce investment and increase consumption, thereby creating imbalances within the economy; or they may reduce trade tax revenue, creating pressure on the public deficit.

Short run macroeconomic policy and longer term growth strategies are inextricably linked, not separate and independent. In particular, public investment affects growth directly, by improving the supply conditions of infrastructure, etc., thereby expanding the capital base of the economy and the potential for further accumulation, and indirectly, through its positive linkage effects with private investment. For developing countries, the paramount concern is to access a more growth-oriented, employment-generating macroeconomic stance, and public investment is a critical factor in achieving this. However, it should also be recognised that macroeconomic policies are not the only factor determining the rate and pattern of growth, and that the investment climate in general (including for both public and private investment) has a significant role to play. Microeconomic interventions and other policies can influence the incentives to invest and the distribution of investment in important ways.

In addition to growth associated with productive employment generation, a major concern of macroeconomic policy is the reduction of economic volatility. Economic instability is undesirable for many reasons. There are direct costs of income variability in the presence of imperfect capital and insurance markets, so that income smoothing over the economic cycle is imperfect and downswings are associated with consumption falls especially among the poor. In general, in all countries, the poor bear the brunt of economic fluctuations: they suffer most in slumps, through higher unemployment and lower real wages; and they tend to gain relatively less from booms which, especially in recent times, have been more associated with higher returns to capital and not necessarily with higher employment generation.

### **Politics of policy choices**

Given the potential conflicts between goals and across instruments, the choice of policy mix is not a purely technocratic exercise, but reflects political choices and has social implications. Aggregate policies carry strong distributional implications, especially with respect to asset and income distribution and the differential provision of public goods and services across groups in the population. These implications relate not only to differences across economic classes and social groups, but also gender differences.

Some examples may help to clarify this point. Controlling inflation can be seen as a goal in itself, because it hurts bondholders and those who receive interest income, or because it hurts those whose wage incomes are not indexed. But it may also be seen as a means to faster growth (on the grounds that inflation creates uncertainties about the future and therefore depresses investment) or more equitable distribution (because inflation adversely affects the non-indexed and poorer wage earners). However, in some cases an excessive focus on inflation control may be worse for the poor than moderate inflation, if the inflation control measures create higher unemployment and therefore directly causes poverty. It could also weaken workers' bargaining position, depress wages and therefore indirectly increase poverty.

Similarly, cutting government expenditure and raising the price of public services in order to reduce the fiscal deficit may be preferred by those holding financial assets, but would operate against those who rely on the multiplier effects of government spending for their incomes, and add to the burden of unpaid household labour thereby disproportionately hurting women. Monetary policies can have different effects upon groups who can access credit markets easily, and those (such as the poor and women) who have less control over assets and therefore collateral, and so cannot access credit on equal terms. In all these cases, the growth and distributional effects will vary depending upon the characteristics of the country concerned, such as the degree of indexation of wage incomes, how investors respond, the particular activities in which employment is generated or lost, and so on.

Therefore policy-makers and the general public need to be aware of the trade-offs and the distributional consequences of particular policies, so that informed political choices shape the development strategies and the macroeconomic policies chosen in particular contexts.

In brief, economic policy making – especially macroeconomic policy – is not only about the total aggregates in the economy. It is also about income distribution, and the gains and losses by gender as well as to different classes and groups in society.



Another important point to bear in mind is the importance of microeconomic instruments for meeting macroeconomic objectives. Macroeconomic processes are *not* entirely the consequences of what are seen conventionally as the basic macroeconomic instruments. Particular micro interventions can have important macroeconomic and developmental effects, both positive and negative. Bank regulations can have macroeconomic consequences for domestic financial and business cycles as well as for the balance of payments. Directed credit can change sectoral balances and thereby affect aggregate growth and its pattern. Tax and other policies that discourage destabilising and speculative capital flows can prevent macroeconomic volatility. Competition policies that affect domestic investors and their interaction with foreign competition can affect the level of investment and the balance of payments.

### **III. FISCAL POLICIES**

Fiscal policies relate to the set of government strategies for revenue collection and expenditure, and they play a critical role in determining both the level and the pattern of economic activity. They affect growth prospects as well as income distribution in important ways. The means by which public resources are mobilised, and the extent to which they are increased, affects the incomes of different sections of the society and the ability of the government to spend. The pattern of government expenditure directly affects the potential for future economic expansion because of the critical role of public investment in infrastructure, for example, but it also affects the material and social conditions of society. The overall fiscal stance can determine the level of activity and employment and the degree of vulnerability to economic cycles.

It is important for any fiscal strategy to be sustainable over the medium term, which means that it should not involve explosive accrual of public debt or lead to excessive public deficits that generate major aggregate imbalances over time. Therefore, there is clearly a need for fiscal discipline to be exercised within a medium term time horizon. However, in the short term and in each and every period, this is not always required. Indeed, an obsession with meeting rigid fiscal targets in each period may be counter-productive if it implies lowering the growth and employment generation potential of the economy and not utilising domestic resources effectively. This is discussed in more detail below. The feasible and desirable extent of flexibility in fiscal stance will depend on the specific context of the developing country, bearing in mind the broader necessity of fiscal discipline over a specified time period.

#### **Public resource mobilisation**

The importance of increasing public revenues in most developing countries cannot be stressed too much. Given the significance of public investment in enhancing economic growth and meeting other social goals, and the need for fiscal sustainability, it is absolutely critical for governments to focus on methods of raising revenues. International evidence suggests that those states with some degree of success in economic development are also those that have been able to increase or maintain high rates of public resource mobilisation.

In many developing countries, the need to increase public resources is especially marked at present, because government revenues have been under pressure, and have even decreased as a proportion of national income. This is not only because of the decline in ODA and the uncertain and often volatile nature of external capital flows,

but because macroeconomic and trade policies of the recent past have tended to reduce revenue from taxation in many low-income countries.

Some of the ways in which recent policies have reduced public tax revenues in relation to national incomes are as follows. Many countries offer incentives to foreign investors in the form of tax breaks and explicit or implicit subsidies, in order to attract foreign capital into the economy. When there is a demand for a “level playing field” for domestic investors, they are forced to reduce taxes on domestic profits as well, and both of these reduce tax revenues. Trade liberalization has tended to involve extensive cuts in import tariffs as well as export taxes, thereby reducing an important source of indirect taxation. Once again, for reasons of symmetry, domestic excise duties cannot be raised in consequence. The shift to a VAT regime in many countries has been accompanied by the reduction or elimination of other indirect taxes, with a net reduction of tax revenues. In addition, cuts in government expenditure as part of fiscal restraint packages tend to make output growth more sluggish, which in turn tends to negatively affect tax collections even at given tax rates. For all these reasons, tax revenues as a share of GDP have been on the decline in developing countries as a group.

Globalisation has undoubtedly played a role in this, through both trade and financial liberalization. Greater openness to capital flows and concern with attracting such inflows and avoiding capital flight have entailed major tax concessions to both foreign and domestic investors. This has been compounded by the presence of international tax havens and the flexibilities allowed by double taxation treaties and other loopholes in tax systems, which effectively allow for large scale tax evasion. As a result, the tax losses of developing countries, because of assets held offshore and the shifting of corporate profits between jurisdictions, have been estimated to be as much as \$100 billion per annum (Cobham, 2005).

Obviously, only co-ordinated international action can plug such tax loopholes for capital. This should be a priority on the international policy agenda, but it is not yet so, even though it would provide much greater revenue raising capacity to developing countries as well as have positive income distribution effects. However, there are other possible instruments that can be used by individual countries, many of them with the advantage of relative ease of collection.

### ***Box 1***

#### ***The advantages and disadvantages of VAT***

Many countries have recently shifted from sales taxes to VAT (Value Added Tax) systems. Despite its name, the VAT is not generally a tax on value added as such; rather, it is usually a tax on consumption. In essence, VAT is charged at all stages of production or sale, but with some mechanism for firms to offset the tax they paid on their purchases of goods and services against the tax they charge on their sales of goods and services.

The arguments in favour of VAT relate to the perception that it leads to greater harmonisation and creates more incentives to pay the taxes. It is also argued that VAT is a non-distorting tax.

VAT systems can have different rates, but they are often harmonised and may even carry a single rate. This can make it more regressive than pure sales taxes. A uniform VAT is regressive as it increases the cost of goods consumed by the poor. However, exemptions increase cascading effects and break the VAT chain, making enforcement more difficult (Bird and Gendron, 2006). Differential rates also create administrative problems.

Over 120 countries currently use some form of VAT system. The evidence on its fiscal and distributive implications is very mixed. As VAT is supposed to be a tax to end all taxes, many countries that have adopted VAT do not levy excise duty, entry tax or luxury tax. This can lead to a decline in tax revenue if VAT receipts do not offset the loss of other tax revenues. An IMF study found that in low income countries, VAT has replaced less than 30 per cent of the revenues lost through the elimination of trade taxes (Baunsgaard and Keen, 2005).

There are other problems with implementing VAT in developing countries, especially those with a large informal sector or “black economy” (Stiglitz and Emran, 2004). VAT is essentially a tax on the formal sector. It cannot cover informal activities, such as small-scale farming and household enterprises, small vendors and petty traders or service providers. In a perverse way, VAT can impede development by encouraging such activities to stay informal, rather than enter the formal sector where there is more value addition. In response, governments may try to increase taxation of the formal sector, which in turn can drive more activity into the informal sector. This is all the more likely as, in many developing countries, individuals and enterprises at all income levels are in the informal sector to varying extents.

Thus, in developing countries, VAT may not be as “non-distorting” as claimed. If the informal sector is large, it is more distorting, as it creates a disincentive to transit to formal or registered economic activities, despite the desire of governments to expand the latter.

In any case, it is practically impossible in almost all developing countries to impose a tax on all commodities and services. For even partial coverage, VAT requires substantial administrative capacity and has relatively high costs of enforcement. VAT refunds are often cumbersome and expensive to administer. This is why moving from other taxes to VAT typically reduces tax revenues for small open developing countries, in particular. In large developing countries with federal systems of government and taxation, there are other issues, such as the sharing of powers of taxation on consumption between regional and central government, which can create complex issues for the management of tax policy.

#### ***Strengthening domestic tax policy***

Domestic tax policies can clearly be strengthened in most developing countries, in terms of direct taxation as well as certain types of transactions taxes that do not fall disproportionately upon the poor.

Tax policies have direct income distribution implications – across classes, regions, social groups and gender – and these implications must be borne in mind while formulating appropriate policies. In particular, the gender effects of tax policies are often ignored, even as there is greater recognition of the gender-differentiated effects of public expenditure policies. Barnett and Grown (2003) have provided indications

of the many ways in which different tax policies can have differential impacts on men and women, and also therefore also have different revenue implications.

The desirable tax regimes for developing countries, that would provide increased collection without disproportionately harming the poor or women and having regressive effects, would imply:

- Improving tax administration and enforcement by making available more public resources for such activities, and by reducing or eliminating exemptions and loopholes.
- Diversifying sources of tax revenue instead of relying on a single indirect tax such as VAT.
- Relying as far as possible on rule-based and non-discretionary tax instruments which are corruption-resistant and have lower transaction costs.
- Increasing personal income tax collection from the rich.
- Targeting luxury consumption in raising taxes.
- Taxing capital more effectively without affecting investment.
- Using trade taxes creatively and flexibly.

How to go about each of these is discussed in more detail below.

There is a strong case for increasing the share of personal income tax in total revenue – not necessarily by raising marginal tax rates but by stepping up enforcement and eliminating loopholes.

Improving tax policy and tax collection should entail diversifying sources of revenue and moving beyond heavy reliance on the value-added tax. Governments, even in poor countries, have to be willing to spend more on tax administration and come down more clearly for enforcement and against evasion.

Taxes on capital and foreign trade are not only easier to collect, they are also less regressive than indirect taxes that affect the incomes of the poor. The increasing reliance on domestic indirect taxes of various kinds in budgets of developing country governments generally adds to income inequalities. Even payroll taxes have been found to be regressive in many developing countries. Therefore a shift to higher collection of direct taxes on corporate profits and individuals should be considered.

It has been noted that personal income taxes in developing countries rates are often not progressive in practice (Birdsall and Torre, 2001). Even when the statutory tax rates are high and seem to be progressive, multiple exemptions and other loopholes combined with lax tax administration and enforcement make the actual taxes paid by richer groups effectively much lower.

In addition to improving tax collection and getting rid of loopholes, there is a case for expenditure taxes that target the rich. This can be done by increasing rates or levying new taxes on certain types of luxury expenditure, relating to both goods and services, such as taxes on foreign travel, on consumption in luxury hotels, on purchases made in high-end shopping malls, on imports of non-necessities, or on purchase of luxury vehicles. This can also serve the function of stabilising consumption over economic cycles, by reducing the extent of speculation-driven consumption booms.

Given the high costs of efficient tax administration and the problems associated with enforcement, developing countries need to think of corruption-resistant tax structures (Stiglitz and Emran, 2004) that are more automatic and rule-based rather than involving individual discretion. This is a consideration that makes instruments like trade taxes and turnover taxes on financial transactions especially attractive, since they can be levied mechanically and therefore even-handedly. Expenditure taxes on luxury consumption also share this advantage.

### ***Selective taxes on capital***

A strong case can be made for certain types of taxes on capital that can be imposed in developing countries without damaging prospects of more investment. Moreover, direct taxes on capital are relatively easier to collect than a range of indirect taxes, which are also usually more regressive. Some options include:

- Taxes on foreign exchange transactions. These can curb potentially destabilising speculative behaviour to some extent, and can also provide significant resources to the public exchequer. They are easy to collect, and where turnover taxes on foreign exchange transactions have been imposed (a “Tobin tax”), they have had no apparent adverse impact upon aggregate rates of investment domestically. The turnover tax rate should be so low, say, less than 0.1 per cent, that it would hardly affect real transactions, such as export and import payments, or remittances by workers abroad, but would still operate as a disincentive for purely speculative currency flows.
- Taxes on all financial transactions, at a very low rate that does not affect transactions of a productive intent. These can be useful in raising resources in periods of financial sector boom, and at the same time dampen unsustainable asset price increases often associated with such booms. They are also among the most easily enforceable of all taxes, which is a major point in their favour.
- Capital gains taxes. These can and should be used more widely but with some creativity, especially upon financial assets. Not only would this provide more revenue, but differential tax rates on different kinds of financial assets and their transfer can prevent excessive speculative activity in domestic financial markets. Obviously, they must be used flexibly and constantly monitored so that they do not add to pressures for capital flight in periods of financial stress.
- Taxes on income from assets held abroad. These may require international agreements, but they are especially worth pursuing where a substantial proportion of domestic residents’ wealth is held in foreign assets.
- Wealth taxes. Although the role of such taxes has been much reduced in recent times, wealth taxes transfer resources from richer groups to government and can be very effective in raising national savings rates. This is because a lot of consumption by the rich in developing countries leaks out in the form of import-intensive consumption or direct consumption abroad, while financial liberalisation allows wealth holders in developing countries to shift some of their savings abroad. A tax on gross assets can be used, as in Mexico, as a minimum corporate tax deductible on corporate income tax.
- Differential taxes to promote “more desirable” types of FDI, in particular “green field” FDI. This is important because the rush to attract foreign capital inflows in general has led many developing countries to promise or create

conditions for untenably high rates of return on such investment, which become hard to maintain and are easily reversed with the slightest perception of domestic instability of any kind.<sup>1</sup> In order to be able to impose such taxes with confidence, developing countries need to be sure of which forms of foreign investment they welcome and which are less likely to contribute to the economy. Moreover, it must be borne in mind that there are likely to be difficulties in collecting such taxes in practice, and that there may be administrative costs in trying to prevent or minimise such tax avoidance.

### ***Trade taxes***

Another set of options centres on trade taxes. Easier collection is also an attribute of trade taxes, but their role has been greatly reduced in the recent past as reductions in import tariffs and removal of export taxes have been part of the global process of trade liberalisation. Such reduction of trade taxes has obviously had some impact on domestic incentives and production structures. But it has also substantially reduced revenues available to developing country governments. While WTO obligations and other constraints have significantly reduced available options for imposing trade taxes for most developing countries, there is still some scope for using these creatively to generate more public revenues and dampen cyclical fluctuations emanating from international economic conditions.

A number of trade taxes are WTO-compatible and would also provide more revenue. Some examples are:

- Taxes on imported luxury goods.
- Export taxes on certain important export commodities. These can play a very useful role in generating more public revenue in periods of export price boom, as they have in Argentina in the recent past. However, their imposition should be responsive to changing international market conditions.
- A system of variable tariffs on a range of agricultural and industrial goods, operating in a band within the WTO tariff bindings, such that international price volatility is not immediately translated into domestic relative price volatility.<sup>2</sup> This is especially important for primary commodities whose world trade prices have fluctuated greatly in the past decade. But it is also likely to

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<sup>1</sup> The developing countries that have been most successful in attracting FDI, such as the People's Republic of China and Taiwan Province of China, have maintained a wide range of regulations governing such investment, including not only differential taxes but also enforced technology transfer. In contrast, many countries that have provided huge tax concessions to foreign capital, or offered guaranteed rates of return on utilities that ultimately imply large losses for the state exchequer, have still not been favoured as destinations for FDI. Often, this is because such countries have low rates of public investment, implying relatively poor infrastructure and lower domestic rates of economic growth, hence are less attractive to foreign investment. In such circumstances, tax policies that generate more revenue for public investment in infrastructure are more likely to have positive effects in attracting desired FDI in the medium term than all the possible fiscal incentives.

<sup>2</sup> For example, a country that regularly or periodically imports a good that substitutes a good which is also domestically produced can choose to ensure that the post-tariff price of the imported good remains within a certain range even if there are fluctuations in the international price, because the tariff adjusts to ensure stability. This means that the import prices do not have a destabilising effect on either domestic production or consumption.

be significant for some manufacturing goods in future, given the current evidence of substantial increases in manufacturing production capacity especially in large developing countries. For some commodities, variable tariffs may conflict with WTO rules for member countries.

Trade-related issues are discussed in greater depth in the *Trade Policy* guidance note.

### ***Managing the public provision of services***

Sometimes returns from publicly held assets can provide resources for the government, in particular the revenues from public holding of natural resource corporations, utilities and other service providers. Prices of such goods and services are administered prices, and can be sources of either public revenues or losses. However, as noted in the series guidance notes on *Public Investment Management*, such administered prices are not primarily to be seen as sources of public revenue.

Publicly provided goods and services fulfil important social goals, indeed basic needs, and it is not usually appropriate to price them according to purely commercial criteria, although the fiscal implications of the pricing strategy must be managed. The distributive implications, and the structure of incentives generated in the economy, are critical in assessing particular pricing strategies for such administered prices.

For example, an across-the-board increase in some administered prices and user costs (such as basic water rates, public health services and so on) will directly affect the poor in an adverse way. On the other hand, graduated and progressively increasing tariffs on some public services and utilities is usually a good idea, requiring larger, usually richer, users to pay more towards their provision, and going some way towards a user-payment principle. Thus, graduated, and sharply increasing, tariffs on electricity and water use beyond a basic minimum, can generate revenues to cross-subsidise smaller, usually poorer, consumers and to extend service provision to the poor.

It can be argued that such pricing strategies need not be confined only to public sector activities, since it is theoretically possible for a well-designed privatisation to include the possibility of continued cross-subsidisation. Similarly, it is also possible to think in principle of a progressive consumption tax on utilities that could still make it possible for the government to access revenues from such services.

However, in practice these goals have proved hard to achieve. Private investors in utilities have tended to resist, and have often been successful in avoiding, extensive cross-subsidisation that would ensure universal access to all citizens, including the poor, at reasonable rates. The experience of water privatisation in countries as different as Bolivia and South Africa confirms this. Similarly, governments have found that transaction costs of progressively taxing the consumption of utilities has been very high, and governments in most countries have typically not been able to raise much revenue from this source. This makes it harder – and more expensive – to provide such facilities and services to the whole population, including the poor.

There can be other purely fiscal reasons for continued public ownership of productive assets. Obviously, public ownership, or some form of subsidy to private investors, is required whenever social returns are higher than private returns to any investment. But public ownership is also worthwhile in other cases, as long as the returns from such assets are higher than the prevailing rate of interest on government debt, as this then provides a cheaper means of financing necessary public expenditure than more

government borrowing. The question of ensuring that such returns are actually achieved then becomes one of proper management.

These are important considerations in any discussion of the privatisation of state assets. While this is covered in detail in the *Public Investment Management* guidance note, some points need to be stated here as they are of direct relevance to fiscal policy.

First, as has been noted, in all cases of economic activities with positive externalities, there is some role for government intervention, and the only question is what that role should be. It should not be assumed that regulation of private activity is costless; rather, it is often costly, and can be difficult because of information asymmetries. This means that regulation of private activity may actually be more distorting and less desirable than direct government ownership under certain conditions.

The second point relates to government revenues. In most privatization cases, governments typically receive less than the “true” value of the assets they sell. This is not only because of corruption, which often arises in the privatization process, but also because of the very nature of the transaction. Whenever a government chooses to sell off an asset, it thereby foregoes the associated income. If the future income flow from this asset is equal to or more than the prevailing interest rate on government securities, then the government would be a net loser of future income by selling it. However, a private buyer will only purchase the asset if it provides at least a rate of return equal to the rate of interest on government securities, because that is where the private investor could otherwise put the money. This means that for such sales to occur, either (a) the private investor must believe that it is capable of generating more profits than the public sector, or (b) the asset must be undervalued so that the actual rate of return for the private buyer turns out to be higher. This is why most such privatizations involve the undervaluation of public assets, although the degree of undervaluation can depend upon specific features of each case, including cronyism and corruption. Therefore, since such deals really involve the loss of a stream of income to a government that is usually already short of resources, it cannot be good for either the government fiscal position or the economy as a whole.

The case for privatization then depends critically on the assumption that private ownership and management will ensure more efficiency and profitability than public. This argument is discussed in the *Public Investment Management* guidance note. Here, it need only be noted that there is neither compelling theory nor convincing empirical evidence that public enterprises are *necessarily* less efficient than private ones. There are of course numerous examples in developing countries of state owned enterprises that neither generate positive social returns nor public revenue, but instead are inefficient vehicles of state patronage. But this is not inevitably the case – some state-owned enterprises in developing countries, including China, India, Singapore and others, rank among the most profitable and efficient enterprises in the world. The issue is therefore one of ensuring proper management of such enterprises, and allowing them enough autonomy to make them effective without sacrificing the emphasis on social goals.

### ***Using ODA effectively***

Foreign aid has come down substantially in the past two decades, both as a proportion of richer countries' GDP, and in proportion to the GDP and investment of developing countries. Nevertheless, ODA still helps to finance a significant proportion of the government deficit or even the balance of payments deficit of some countries.



It is now recognised that such aid has mixed effects on growth prospects, largely depending on how it is utilised. There has been much discussion in recent times of the role that ODA can have in creating “Dutch disease” effects by causing an appreciation of the exchange rate (Gupta et al., 2005; McKinley, 2005). Section VI provides a more extended discussion of “Dutch disease” issues; here we consider the macroeconomic effects of ODA and how to ensure that positive effects dominate.

The positive macroeconomic and growth effects of ODA are obvious, especially for poor, foreign exchange-constrained developing countries. ODA can reduce three gaps that keep domestic investment and growth below potential: the savings gap, the foreign exchange gap and the fiscal gap. It is sometimes argued that thinking in terms of these gaps is no longer relevant for developing countries, given international capital mobility. However, a large number of developing countries cannot access international capital markets as much as they would like, and continue to experience actual or implicit foreign exchange shortages. Therefore, foreign aid that fills the gaps mentioned above can be very important for small developing countries, especially those that are keen to use public investment to generate higher aggregate economic growth in a stable way; otherwise, such investment could lead to balance of payments problems or cause domestic inflation where there are domestic supply constraints. It effectively amounts to an addition to domestic savings and allows governments to spend more than the revenues raised through taxation and other means. It can therefore allow for more accumulation through public investment in critical areas, including infrastructure and critical social spending with future social productivity implications, such as in health and education.

However, aid inflows can have negative effects. The most widely recognised of these is that such inflows, like other forms of capital inflow, put upward pressure on exchange rates which can then shift domestic incentives away from tradeables to non-tradeables, if domestic relative prices move in response. The consequent changes are likely to be sharper where there has already been extensive trade liberalisation, involving a move away from quantitative restrictions on imports. Foreign aid can also cause higher inflation when it is spent not on imports but on government spending on non-tradeables or domestic activities in which there are supply constraints preventing output from expanding to meet the enhanced demand. A deeper critique relates to the potential negative effect of foreign aid on domestic savings, and the possible substitution of foreign savings for domestic savings. However, if the two are not perfect substitutes, aid will imply an increase in investible resources in the aggregate.

Under certain conditions, foreign aid can act as a constraint on autonomous growth. In economies that have already opened up the external trade account and do not have specific measures to control imports other than flat rate tariffs, any upward tendency of the currency resulting from aid inflows can result in cheaper, and therefore increased, imports and more expensive exports. When aid inflows push up exchange rates in countries with open trade and tight government fiscal stances, some economic activities become uncompetitive, leading to losses of potential income and employment in return for relatively little per capita aid. Cambodia, a small country where foreign aid is a significant proportion of the government budget and of national income, has experienced such problems.

So, how can ODA be used to maximise its positive effects, and minimise the negative ones? If ODA is used to increase public investment in important areas to ease supply constraints and improve aggregate productivity, it will not be inflationary and can

have expansionary effects. These effects could spill over into positive balance of payments effects through more exports or reduced imports. So it is important to ensure that ODA translates into higher public investment, preferably in areas where there are shortages or which form bottlenecks for production, or in areas where existing levels of provision are socially sub-optimal.

The problem in many developing countries today is that the fear of the adverse effects of currency appreciation is so great, and the need to keep higher levels of foreign exchange reserves to guard against potential financial crises is so acutely felt, that aid inflows are not put to good use (McKinley, 2005). Instead, a common tendency is to combine such inflows of foreign exchange with deflationary domestic policies to ensure rising levels of foreign exchange reserves – both as insurance against future instability and to prevent upward movements of the currency which could damage external competitiveness and reduce the viability of domestic enterprises. In some cases in recent years, this tendency has gone so far that ODA is effectively not used at all to reduce the three gaps mentioned above, and therefore cannot play a positive role. However, if recipient governments can avoid this trap and use ODA for productive public investment that contributes to current and future growth, its macroeconomic effects will be positive (Reddy and Minoiu, 2006)

## **Government spending**

### ***Patterns of government expenditure***

Public expenditure is absolutely crucial to both stability and growth in developing economies. However, the direction of public investment is important. Most developing countries do not have the luxury of increasing public investment in all areas in which it is needed; prioritisation is unavoidable.

Previously, there tended to be greater emphasis on public investments with higher growth implications, for example, in infrastructure and capital goods industries. This followed from the perception that most developing economies are constrained by supply bottlenecks in critical areas, usually infrastructure.

A counter-position now emphasises public expenditure in activities that generate more employment and demand, to kick-start macroeconomic processes that will create enhanced output through supply responses.

In most developing countries, the goal of full employment is made more complex by the prevalence of two distinct forms of excess labour relative to demand due to:

- (a) structural factors – such as inadequate aggregate capital, choice of technology, asset inequalities and institutional forms that inhibit greater investment – that lead to the persistence of open unemployment or high underemployment, and
- (b) cyclical or more short-term factors that lead to unemployment levels that can be corrected by more expansionary fiscal and monetary policies.

Public investment is a key that can open both doors, by increasing demand in the short run and also enlarging the capital base of the economy. The nature, direction and efficacy of such investment are important as the multiplier effects and long-term growth implications will differ accordingly.

However, public investment is not a strategy to be employed in isolation. It is important to be attentive to other structural features such as technology choice, asset

inequalities and institutional conditions. Nevertheless, within the scope of short run macro policies, public investment is the most potent instrument for generating both growth and employment.

In brief, there is no “one size fits all” approach to the ordering of public investment priorities. They must differ according to the particular circumstances of each economy. But, public investment requires at the very least a medium term time horizon, possibly longer, if it is to be effective. Therefore it must occur within a systematic framework that involves some overall strategy for the future. Putting priorities to government expenditure is a political task, but its strategic aspects should not be ignored, and governments must be conscious of the longer-term growth implications of public spending.

In recent times, such a positive attitude towards public investment has given way to a more hesitant approach, one that reduces the proposed arenas of action to allegedly desired or proper areas of public expenditure. It is argued that the government should stay out of those areas that the private sector is willing and able to invest in, and limit itself to providing an appropriate mix of fiscal and other incentives and regulation to ensure that the private provision is socially optimal.

According to this view, instead of focussing on economic activities (in what were earlier seen as natural monopolies and now appear to be contestable markets), developing country governments should focus on social sector expenditures alone, where it is almost universally accepted that there will be private under-provision. The focus of public expenditure is supposed to be confined to primary education and public health, and away from physical infrastructure and actual production of capital goods and intermediates.

In practice, many shortcomings and difficulties have emerged, as many developing countries have found out to their cost. Often, when governments have reduced investment in certain areas, private agents have not been forthcoming in sufficient measure, despite the very large concessions provided which in turn often place a great burden on the exchequer.

**Box 2**

***Should public sector employment be downsized?***

There is a widespread perception that fiscal restraint should be associated with downsizing of public employment. Besides the benefit of reduced government expenditure, this is justified on the grounds that less employment in any enterprise or public activity proves that the enterprise is more efficient, a sign of good health, good economics and good sense. But this can have adverse results, in its impact on society and even on the overall fiscal stance.

International experience suggests that obsessive downsizing of the workforce can be socially damaging. For example, in Britain, the reduction of staff strength in the privatised railway system has been associated with a deterioration of service, with many more accidents, inordinate delays, frequent unannounced changes of schedule and a much more surly workforce which has to work longer hours and more intensely without security of contract. Some Latin American privatisations of important public utilities have resulted in not just job losses, but also declining safety precautions and reduced service effectiveness. Cost-cutting pressures have prevented attainment of required levels of employment, while the remaining workers are unable to match delivery levels associated with the previous larger workforce.

Undoubtedly, there are situations of over-manning in government departments and public enterprises. In general, however, aggregate public sector employment in most developing countries is not excessive. The ratio of public sector workers to total population is 5 per 100 in OECD countries; the international average is 3. But, for developing countries it is 2, and for Sub-Saharan Africa it is only 1 per 100.<sup>3</sup> This translates to less public services provided per capita of population. Whether in basic transport and infrastructure, adequate housing or sanitation, or universal access to minimum decent health facilities and educational opportunities, the gap between social need and actual availability is huge. Downsizing public sector employment may also lead to a transfer of some public services (such as health, education, etc.) to the household, using unpaid labour, resulting in additional burdens on women.

This suggests that in most circumstances the government should spend more on such areas and employ more people, not less. If public sector workers are underemployed, the solution is to use their services more effectively and productively, through retraining and redeployment.

Many developing countries put more emphasis on military and policing functions, rather than public services. The focus should be new public employment in areas of clear social need such as health, sanitation and education. However, necessary administrative functions should not be understaffed.

Many socially necessary or desirable investments involve large initial outlays and long gestation periods. Given the various uncertainties involved, many factors inhibit private, including multinational, investment, even if numerous incentives are provided. This is particularly the case in small countries that are prone to political upheavals or economic instability for reasons outside the government's control.

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<sup>3</sup> Calculated from ILO Yearbook of International Labour Statistics, 2003.

### ***Box 3***

#### ***Macro policies and growth: The Indian case***

It is now accepted that the shift to a higher economic growth trajectory in India came about not in the 1990s, after neo-liberal economic reforms, but a decade earlier, from the early 1980s. This is a useful example of how various factors contributed to a changed investment climate thereby generating higher growth.

According to Chandrasekhar and Ghosh (2004), the 1980s escape from economic stagnation and the shift to a more rapid growth trajectory was enabled by three major factors:

1. a big increase in the fiscal stimulus provided by government spending directed to rural areas to a greater extent than before, with positive multiplier effects. It was associated with growing fiscal deficits, as government revenues did not increase in proportion.
2. substantial import liberalization, especially of capital goods and components for manufacturing. This import liberalization for inputs and intermediate goods created an impetus for private investment to enter a range of consumer durable goods production.
3. associated with both was a shift to external commercial borrowing by the state to finance the increase in the fiscal and current account deficits.

The model of public sector-led expansion could continue a decade without generating higher inflation because of import liberalization, financed by government external borrowing exploiting the “new” access to foreign exchange afforded by changes in international finance.

Rodrik and Subramanian (2004) pointed to the “attitudinal shift” in the government in the early 1980s, which was pro-business (rather than pro-market as subsequently) and favoured the interests of existing businesses rather than new entrants or consumers. According to them, such a small attitudinal shift elicited a large productivity response. In fact, not only existing businesses benefited; the period saw the rise of many new businesses that eventually became significant regionally and globally, e.g., Reliance Industries, which became one of the top five global petrochemical producers by 2000. But government’s attitudinal shift, also expressed in micro policies favouring large capital, influenced the rate and pattern of private investment.

This combination of forces led to higher growth rates in the 1980s, but it culminated in the economic crisis of 1990-91. The build-up of external debt and continued large government deficits created an unsustainable growth process after a decade. However, even in the subsequent period, fiscal stimulus remained important for aggregate growth in India.

So private investment in important areas “freed” for private players is usually not enough to meet the requirements of the economy, and turns out to be even more expensive for the taxpayer than public investment because of the fiscal costs of meeting various incentives such as guaranteed rates of return on investment. In the case of the energy producer Enron and the state government of Maharashtra in India, for example, the government ended up paying much more for power that still has not been produced and distributed than it would have if it had simply set up a plant itself.

In short, governments need to take a more holistic approach towards determining the areas to be covered by public investment and provision, rather than automatically excluding areas where it is assumed that private players may be interested.

#### ***The implications of government deficits***

Public expenditure and taxation have distributive implications. It is generally assumed that the aggregate fiscal stance is relevant only for aggregate growth patterns. However, whether this stance results in greater or less employment generation has distributive implications, increasingly seen as very important in most countries today.

This is also the case with fiscal deficits, which have both overall effects and differential impacts upon particular social groups. While rentier groups may oppose larger fiscal deficits under all conditions, workers and citizens availing of public services may welcome deficits if they are associated with public expenditure that leads to more employment or increased provision of public services or act in a countercyclical way. An obsession with controlling fiscal deficits according to some arbitrary norm, as is usual in a lot of recent legislation around such deficits, adversely affects the possibilities for countercyclical macroeconomic stances and reduces the developmental or growth-oriented activities of the government.

Even when fiscal deficits are to be reduced, there is a basic problem with making expenditure cuts the essential means of doing so. A reduction in the revenue, or the fiscal, deficit can be effected in a number of ways besides expenditure cuts. The most obvious is an increase in direct tax revenues, which are typically more desirable in developing economies with high levels of income and asset inequality; this can occur along the lines discussed above. Also, trade taxes can be seriously considered as a means of public resource mobilisation, again along the lines mentioned above.

A more recent argument is that fiscal deficits are destabilizing because of its impact on the expectations of investors who can move their capital out of the country. In an economy that is liberalised with respect to the capital account of the balance of payments, hence open to speculative capital flows, it may be the case that speculators look at the size of the fiscal deficit, which thus becomes a determinant of their state of confidence. In such cases, policy makers need to be aware that increases in fiscal deficits seen as necessary for counter-cyclical purposes or for future growth may need to be accompanied by measures to prevent capital from flowing out because of adverse investor expectations. Such measures can include lock-in periods for foreign investors, constraints on capital export by domestic residents, and the like; these are covered more comprehensively in the *Financing Development* guidance note.

It is also important to note the negative role that can be played by poor accounting frameworks, which include certain items as part of the deficit without considering the overall context (Stiglitz et al., 2006). For example, IMF accounting practice of including foreign aid in the expenditure budgets (and therefore deficits) has led to excessive fiscal stringency in the case of several African governments, even in situations where more expansionary policies would have been more appropriate.

Obviously, this does not mean that running fiscal deficits is always desirable, or that governments can adopt a “spend now, repent later” mode in choosing the fiscal stance. Rather, it points to the need for greater flexibility with respect to fiscal targets, especially when the deficits are the result of productive public expenditure, and during economic downswings.

Fiscal sustainability is a crucial medium term issue. However, it can be made compatible with increased public productive investment especially when combined with higher tax revenues from those who can afford to pay and some controls on capital movements to prevent destabilising flows of resources; rigid rules on fiscal deficits in the short run reduce the possibility of effective countercyclical policies by governments, including in open developing economies. For example, the ability of countries like Malaysia and the Republic of Korea to recover relatively rapidly from the debt crisis of the late 1990s was directly related to the expansionary fiscal stance adopted by their governments after the sharp downturn of 1998.

### ***Are fiscal deficits always bad?***

The conventional view that fiscal deficits are always “bad” is based on three arguments. First, it is argued that a fiscal deficit can be inflationary, or that it will cause external deficits, and is therefore destabilising. Second, it is suggested that large fiscal deficits will “crowd out” more desirable private investment by reducing the investible resources available to the private sector and raising the interest rate on borrowing. Third, it is argued that, even if fiscal deficits do not cause inflation, they lead to the accumulation of public debt and mounting future interest obligations of the government, and therefore are not sustainable.

None of these are necessarily true. Their validity depend upon specific conditions which may not hold in practice, so that the advantages of fiscal deficits – more output and employment – may outweigh the disadvantages.

Consider the first argument, that fiscal deficits are inflationary or lead to balance of trade deficits. Both of these outcomes – inflation or external deficit – emerge from an excess of aggregate demand *ex ante* over aggregate supply. But the size of the fiscal deficit, which shows only the net demand from the government sector, does not necessarily tell us anything about aggregate excess demand. It is possible to have any combination of public or private surplus or deficit, which would lead to very different outcomes with respect to both inflation and external deficits.

The standard identity for an open economy:

Private Investment - Private Savings + Government Deficit = Current Account Deficit

allows for a government deficit which does not involve a current account deficit if the private sector saves more than it invests by the same amount. It can similarly allow for the opposite situation in which a surplus on the government account is associated with a current account deficit if the private sector account is in deficit, i.e. private investment is greater than private savings by more than the amount of the government surplus.

So it is quite possible for a large public deficit to be entirely financed by a voluntary private sector savings surplus. This was the case in Italy for more than a decade from the mid-1980s, when fiscal deficits of as much as 9 per cent of GDP were met by positive private savings-investment balances of equal proportions.

Similarly, there can be large balance of payments deficits or higher inflation in countries with low, zero or positive fiscal accounts, when the private sector spends more than it earns. This was the case in many Southeast Asian economies before the crisis of the late 1990s, and is currently true of the United States economy.

One of the more interesting features of some “emerging economies” in the developing world from the 1990s onwards has been that strict fiscal discipline and low public deficits or government budget surpluses have been associated with large external deficits resulting from private profligacy permitted by economic liberalisation.

It is obvious that fiscal deficits will lead to inflation only if public expenditure does not create multiplier effects that cause output to expand, because of supply bottlenecks. Such supply constraints do exist in many developing countries, but they are less evident in a world where imports can be used to bridge the gap temporarily. It is certainly possible for developing countries to use the fiscal stance to address situations of excess capacity or cyclical downswing, without such adverse effects. Obviously, this is not an argument for continued or larger fiscal deficits over time –

there should be attention directed towards ensuring fiscal balance over the medium term, which would be possible if the deficits are pre-dominantly financing public productive expenditure.

The second argument that public investment will “crowd out” private investment is based on two assumptions: that government demand for borrowed funds will cause a rise in prevailing market interest rates, and that a rise in such rates will in turn depress private investment.

Both assumptions are problematic. The government administers interest rates through the central bank. Insofar as they rise, this reflects policy choices made by the government, such as when such a move is seen as required for attracting foreign savings. In financially liberalised economies interest rates tend to rise not because of demand for credit from the government but because of the need to attract and maintain investor confidence. In open developing countries they are therefore crucially affected by international interest rates, in particular in the developed world. Higher interest rates can be compatible with substantially lower levels of the fiscal deficit as a share of GDP. Also, when investors' expectations about future profitability are bullish – for example because of substantial infrastructure investment by the state which would give rise to positive demand and supply linkages with private industry – investment will increase despite higher interest rates. Further, crowding out is unlikely to be a problem when there is excess capacity in the economy, since public spending in such cases will lead to higher output.

The third argument against fiscal deficits is the possibility of the undesirable build up of public debt. An important distinction should be made between the revenue deficit (that is, the difference between current expenditures over revenues) and the fiscal deficit as a whole, which includes this revenue deficit as well as public productive investment. In general debt-financed revenue deficits, that is borrowing to meet current expenditures, should be controlled. However, even for revenue deficits, there are certain cases, such as a slump, when government tax revenues may fall but revenue spending should not always be cut simply to balance the books, since debt financed public expenditure may even be necessary to lift the economy out of the slump. Obviously, this should not be the practice in “normal” times.

The case of fiscal deficits is more complex. There is nothing necessarily wrong with borrowing to meet investment requirements. Indeed, there is a case for a fiscal deficit composed entirely of public capital investment, *as long as the social rate of return from such investment exceeds the rate of interest*. There are many crucial areas, for example in physical and social infrastructure, where public investment is essential since the presence of externalities means that the private sector is not likely to invest at socially optimal levels. Thus, there is a crucial role for the government as an investor, and the government can and should borrow to invest in socially necessary areas, whether infrastructure or public services. Other public investments that add to the deficit can be considered as long as the projected social returns are higher than the projected interest rate. If these investments are socially productive, they will result in higher government revenues in future, because of the growth generated over time. If such investments involve social returns lower than the projected interest rate, they should be financed out of government revenues rather than through borrowing.



### ***Managing public debt***

Developing countries need to work out the appropriate level of public debt and then to achieve that norm. There is a basic rule of thumb: rates of return on debt-financed investment should not be lower than rates of interest, to avoid a debt spiral. But there are other issues as well. There are many views on what should be the ratio of public debt to national income. Many developing countries currently look to the European Union's criterion for the Growth and Stability Pact, of not allowing the ratio to cross 60 per cent, but this is also no more than an arbitrary rule of thumb, not backed by solid economic reasoning.

For developing countries, the issue is further complicated by the fact that external public debt has very different implications from internal debt, and can expose developing economies to financial crises that undermine the internal financial system as well.

Financial liberalisation measures usually operate to increase interest rates on public debt, by forcing governments to enter the open market for debt and removing interest ceilings which used to operate in most developing countries. As a result, public debt piles up faster than before if tax revenues do not increase at the same rate as interest rate increases. For many developing countries, this process alone has generated a “debt trap” in which a large proportion of government current expenditure, sometimes as much as the entire fiscal deficit, go towards interest payments and, even then, are not sufficient to cover them. Therefore, since the interest rate on government borrowing can be managed (see below), and governments generally remain preferred borrowers for financial markets, it is desirable to use interest rate policy to keep the accrual of public debt within limits and prevent exploding levels of debt.

If a country is already in what may be perceived as an unsustainable debt situation, different issues are involved in trying to get out of it. The accumulated experience of financial and debt crises in developing countries has provided some insights into how to go about the process of restructuring public debt when the debt burden becomes excessive or simply impossible to service.

**Box 4**  
***Desirable levels of public debt***

It is very hard to set strict norms about the desirable level of public debt as it depends on many conditions other than the rate of growth of GDP. Usually, some ratio of debt to GDP is taken as the relevant indicator, for example, the European Union's 60 per cent of GDP norm for the maximum public debt. This is of course quite arbitrary, since lower or higher levels could be sustainable depending upon the rate of growth of GDP over the relevant period. Further, it does not make a distinction between internal and external public debt, which can be a very important consideration for low-income developing countries in particular.

Instead of looking only at absolute levels of debt in relation to GDP, the flow payments associated with stocks of debt should also be noted. Some basic rules to be borne in mind are:

- (a) There must be medium term stability of debt levels, that is, countries must locate themselves within debt cycles that involve periods of net inflow or debt accrual followed by periods of net outflow or debt repayment. The length of these periods depends upon the nature of the debt-financed investment and its effects.
- (b) Countries should avoid exploding aggregate levels of public debt, that is, levels of debt that increase progressively each year, as it will become unsustainable in the medium term.
- (c) Public external debt in particular should be biased as far as possible towards bonds and longer maturity loans bearing lower interest rates. An important issue for many developing countries is the maturity structure of public debt. As Stiglitz et al. (2006) pointed out, most long-term debt is generally denominated in foreign currencies (which involves exchange rate risk) while domestic debt is generally short term. Yet most public investment involves long-term returns, which can create a mismatch between repayment schedules and the ability to repay.
- (d) Public debt for purely consumption purposes should be avoided unless much higher future tax revenues are anticipated for other reasons (such as demographic changes).
- (e) The distribution of public debt between internal and external sources should be such as to prevent the country from excessive dependence upon foreign creditors. Ideally, most public debt should be internal.
- (f) For external debt, a relation of equality in the medium term (not necessarily in each period) should be maintained between the rate of interest and the rate of increase in foreign exchange earnings, whether through exports or labour remittances.

If these conditions are not met, it is important to think of alternative means of raising public resources, such as domestic resource mobilisation, instead of relying on additional external borrowing, which can lead to an unsustainable debt situation and even crisis. Such a crisis can occur even with relatively low ratios of public debt to GDP, if most of the debt is external. It is necessary to take note of these conditions rather than the conventional stock-flow measure.

Debt restructuring can play a very useful role by getting rid of the debt overhang, allowing public resources that were tied up in debt servicing to be put to productive use and generally allowing policy makers to get on with the process of growth and development. The conditions under which debt is restructured can range from very easy or preferred options for debtors, with some implicit debt write-off and low interest rates on rolled over debt, to very painful options involving much higher interest on debt which has multiplied because all unpaid interest has been added to the principal. But the extent to which restructuring is possible, or involves less painful policy conditions than imposing "austerity" upon the poor, depends upon the ability of the government concerned to bargain with creditors and hold out for the best deal without agreeing to potentially very damaging conditions. It is wrong to assume that debtor countries have few options but to accept very adverse conditions for debt restructuring. The recent experience of Argentina's successful restructuring of a

significant part of its external debt suggests this can be achieved with adequate political will, even under conditions of prolonged and intense crisis.

## **IV. MONETARY POLICIES**

### **Expanding the policy space**

It was once held that the basic goal of macroeconomic policy was to achieve internal balance, defined as full employment, and external balance, defined as balance on the external account. If there was unemployment and excess capacity in the economy, the aim of fiscal and monetary policies would be to generate sufficient economic expansion to reach the full employment target; going beyond that target would generate inflation because of supply bottlenecks. Openness complicates the picture not only because of the effect of domestic expansion upon the current account of the balance of payments, but also because of the possible effect upon capital flows. In the basic Keynesian framework, achieving both internal and external balance requires the use of not only the domestic levers of policy but also the exchange rate.

Monetary policy was seen as part of this overall strategy of aggregate demand management combined with exchange rate management. In this strategy, inflation control was only one of its several simultaneous aims. In developing countries, the monetary policy was directed not only to the broad level of economic activity and employment, but also to specific aims such as ensuring investment, including in particular areas, or even poverty reduction.

Monetary policy was therefore an integral part of macroeconomic and overall development strategies, and not only about price stabilisation and inflation control, much less inflation targeting. It aimed at expanding supply in strategic sectors, improving livelihood conditions in sectors employing a large proportion of the labour force such as agriculture, generating more productive employment by providing institutional credit to small scale producers in all sectors, and so on. These remain critical features of monetary and financial policy, but they have been progressively submerged by the obsession with price stability as the basic remit of monetary policy.

These broader concerns, and the focus on development banking, need to be revived for developing economies to achieve sustained and employment-generating growth. As the re-emergence of these broader concerns in monetary policy is contingent upon a more critical stance towards the narrow remit of inflation targeting, we examine some of the basic underpinnings of this narrow remit en route to re-establishing the validity of the broader, more flexible approach.

**Box 5**  
**Monetary Policy in the West Asia Region**

Liberated from the straitjacket of tight inflation targeting, monetary policy could contribute to pro-equity growth. Used as the major instrument for macroeconomic management, monetary policy can do little to make growth pro-poor. However, in support of an expansionary fiscal policy it can indirectly foster growth that is pro-poor. As a general rule, if inflationary pressures are weak, this support would take the form of positive but low real interest rates and an expanding monetary supply. However, interest rates should not be so low as to induce high capital-intensity in future output.

While these guidelines appear simple, their application in Western Asian countries is not straightforward. In all the countries in the region, financial markets are underdeveloped, though some exhibit certain forms of financial intermediation. The concrete result of underdeveloped financial markets and conditions of regional instability is that Governments find it difficult to sell their bonds to private agents. This explains the common practice in the region of legislation that requires commercial banks to hold a portion of their reserves in government bonds. In practice, this requirement has tended to have an anti-poor bias, because it redistributes general revenue to the wealthy as interest payments.

Narrow financial markets imply that the effectiveness of monetary policy to pool savings, stimulate private investment and influence/guide its allocation patterns is low. However, the limited ability of the central bank to stimulate investment does not imply that there is no pro-equity role for the central bank rate. Lower central bank rates would have two pro-equity effects: (a) government bonds are held by the wealthy, or the institutions of the wealthy, so lowering rates would have a positive impact on income distribution; and (b) lower rates imply a smaller domestic debt service in the public budget, producing “fiscal space” for pro-equity government expenditure.

Allowing the money supply to expand moderately faster than real output can also have a pro-equity impact, by increasing access to credit in “informal” financial markets. It also encourages financial “deepening”, that is, the ratio of the money supply to aggregate output, which is typically low in the ESCWA region. Money supply management raises the question of what instruments would be used to counter inflationary pressures if these became a serious policy concern. The key policy issue is what constitutes a “serious concern”. Cross-country regressions suggest that inflation is uncorrelated with growth for the rates that characterize the ESCWA region. Therefore, if growth and poverty reduction are the goals, a tolerance for moderate inflation is required. This is especially the case because, owing to the weakness of financial markets, the only effective instrument for reducing inflation in most countries would be fiscal contraction.

In summary, a pro-equity monetary policy requires low real interest rates, a tolerance for moderate inflation rates, and an expansion of the money supply that accommodates growth and financial deepening. To achieve these outcomes when private banks set exorbitant interest rates, it probably would be more pro-equity to finance prudent fiscal deficits by monetization rather than by bond sales, which redistribute income to the wealthy.

Source: Excerpt from ESCWA, Summary of the survey of economic and social developments in the Economic and Social Commission for Western Asia region, 2005-2006, (E/2006/20), para. 52-56.

## **Can money supply be controlled by policy?**

It is said that governments can control the money supply, and the desirability of such control is based on the belief that the money supply is responsible for inflation, a condition allegedly caused by too much money chasing too few goods.

The reality is that as economies grow more sophisticated, it is always possible for new types of liquidity, or “quasi-money” to emerge. In a world of financial innovation where quasi-money can be created, the overall liquidity in the system cannot be rigidly controlled by the monetary authorities, as was recognised by Nicholas Kaldor in 1982. Rather, the actual liquidity in the system is endogenously determined. Financial innovation creates new possibilities for liquidity. Thus, credit card transactions, bills of exchange, IOUs, hire purchase agreements, all involve the creation of liquidity. There have been situations in which share certificates have been treated as liquidity. The emergence of futures trading and derivatives has created very complex webs of liquidity creation.

With money taking so many complex forms, many of them near impossible to calculate much less regulate, it is impossible for governments to control the actual money supply. Rather, the money supply is determined by the workings of the system, by the level of economic activity, and the prices at which goods and services are traded. This is one clear case where demand creates supply.

Further, there is no convincing case that increasing money supply causes inflation, since it is more likely that the causation is the other way around. Empirically, there is no easily discernible relationship between the rates of growth of money supply and of inflation on the one hand, and real output growth on the other. The theoretical argument is based on the twin assumptions of full employment (or exogenously given aggregate supply conditions) and aggregate money supply determined exogenously by macro policy. Neither assumption is valid; in particular, the latter assumption of money supply being susceptible to control by policy makers is not justified. In addition, the notion of a stable “real demand for money” function (where the demand for money is determined by the level of real economic activity) is demolished by the possibility of speculative demand for money, a feature that is enhanced by financial sophistication and the greater uncertainties of operating in today's economies. This means that instead of increasing money supply causing inflation, it is more likely the case that higher inflation rates generate changes in money supply broadly defined.

The critical feature of the demand for money and financial assets, since it is based on expectations in uncertain conditions, is that it is inherently volatile, unpredictable, and prone to sharp swings. This implies that monetary policy must be associated with sufficient regulatory power on the part of the government and the central banks to minimise such volatility, as it can have very unfortunate implications for the real economy.

What is evident from this is that the real monetary variable in the hands of the government is the interest rate. Thus, attempts to control the money supply typically translate into interest rate policy instead. Interest rate management in developing countries has to be focused not only on stability but also on growth, that is, interest rates should be kept at levels that encourage more investment. This is also where the advantages of some amount of directed credit, towards strategic or priority sectors, are significant. Of course, interest rates and monetary policy alone cannot work to create domestic expansion; they must be accompanied by expansionary fiscal policy.

The critical point is that as far as possible monetary policy should accommodate fiscal policy and the overall goals of society, such as growth and employment generation. This does not mean that monetary policy should encourage instability in the name of growth; rather, it should be part of the broad set of policies which aim to reduce volatility and increase economic activity in a balanced and sustainable way. Excessive inflation is damaging for equity, stability and growth, but what is perceived as “excessive” varies widely across countries. In countries where most incomes, including wage incomes, are indexed, there may be social tolerance for inflation levels that are internationally high, in the region of 15-20 per cent per annum or more, which will also not adversely affect investment. But in countries where the majority of the population receives incomes that are not automatically indexed, even inflation rates of 10 per cent per annum can be perceived as damaging and destabilising.

It is important to remember that macroeconomic instability can kill growth, but macroeconomic stability (when it is broadly defined so that it is not focussed on a narrow target such as inflation) is only a necessary condition for growth, **not** a sufficient one.

### **Targeting inflation or targeting growth, employment and well-being?**

As noted, in recent years, the focus of monetary policy in many countries across the world has changed. Central banks are increasingly oriented to fixing a particular target for the inflation rate, and adjusting the interest rate and other banking policies accordingly. Other objectives are ignored or become secondary, while the monetary authority focuses upon achieving the desired rate of inflation. The extreme case of this is found with “independent” central banks (see the Annex for an extended discussion of central bank “independence”), which publicly declare a certain desired rate of inflation and then adjust monetary levers accordingly. This was first attempted in developed countries, but a large number of developing countries have also adopted this practice, explicitly or implicitly. It has also been given a seal of approval by the multilateral financing institutions as well as organisations of private international investors.

This strategy has been criticised on a number of grounds (Epstein, 2002, 2005; Stiglitz et al., 2006). The most common criticisms are:

4. This strategy carries high economic, social and political costs, as high real interest rates inhibit economic expansion and employment generation; in practice, such high real interest rates have been adhered to even in contexts of substantial unemployment and persistent poverty.
5. It is unnecessary, as there is no convincing evidence that moderate inflation has any effect upon real macro variables, and its impact upon income distribution depends upon institutional conditions in an economy. Of course very high rates of inflation are undesirable and damaging, for both growth and income distribution impacts, and there is a lot of empirical literature to support this.<sup>4</sup> However, cross-country evidence now suggests that some inflation has

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<sup>4</sup> Easterly (2005:31) notes that cross-country time series regressions for developing countries suggest that very high inflation and chronically high budget deficits are destructive of growth prospects because of the macroeconomic instability they generate, but “it doesn’t follow that one can create growth with relative macroeconomic stability.”

negligible impact on growth possibilities, as relatively “high growth” countries such as China and India have shown over the past two decades.

6. The negative income distribution effects can be managed by appropriate social protection policies to ensure access to basic goods to the poor and to workers, or to provide consumption buffers that protect them to some extent from the erosion of real income through inflation. Such social protection policies can also play an important role as automatic stabilizers in recessions, a point which is developed in the next section on managing cycles.

There are other problems with the strategy of inflation targeting. It does not distinguish between cases where there may be inflation inertia (that is, where expectations create continuously high inflation rates) and where there may not be, for example where the increase in prices is due to some specific factor such as an import price shock or an increase in the VAT tax rate.

Further, inflation targeting does not necessarily generate either internal or external balance, much less achieve both simultaneously. If, for example, fiscal policy is oriented towards exchange rate targeting (which is now common in many emerging market economies), there can be quite severe problems of co-ordination between the two. Thus, a devaluation can have expansionary effects upon export production and import-substituting production, but only if the central bank does not immediately hike interest rates to prevent the devaluation from having inflationary consequences in excess of its own target rate of inflation. If there is a shock to exports, it may make sense (if one wants to restore quickly both internal and external balance) to take actions to directly undo the shock, such as through fiscal policy, rather than tightening monetary policy, which can lead to other imbalances. Conversely, focusing on low inflation targets may cause the government to become excessively contractionary, with implications for exchange rate management as well.

Indeed, in developing countries it is quite likely that periods of accelerated growth will be associated with moderate inflation because supply constraints are encountered. In such cases, the focus of policy makers must be

- to prevent inflation from becoming excessive by addressing actual and potential supply bottlenecks, and correcting sectoral imbalances that may add to inflationary pressure, for example in agricultural production;
- to ensure the growth process is not adversely affected by policies to control inflation;
- to counter possible regressive effects of inflation through specific measures directed at the poor, such as public provision of certain basic needs; and
- to ensure that inflationary expectations are not built up in the system thereby causing higher rates of inflation over time.

An alternative to inflation targeting is a macroeconomic strategy that targets those real variables that are important for a particular country (Epstein, 2005). These targets need not, indeed should not, be the same over all periods. The standard targets would obviously be aggregate economic growth, employment and investment. In addition, the targets could relate to adequate livelihood for the people, which would mean concern for ensuring the viability of economic activities that sustain most of the workforce, such as agriculture and small enterprises in manufacturing and services. They could relate to poverty reduction, which would imply concern for increasing the

availability of more productive and higher paid work for less skilled workers, or reducing prices of basic needs, such as food, water, health services and basic housing. They could be concerned with reducing sectoral or regional imbalances, which could involve special packages for sectors or regions that are lagging behind or policies to increase inter-sectoral linkages.

This kind of strategy obviously has direct relevance for the fiscal policies adopted. But it also means that monetary policy would have to be different from that envisaged in an inflation-targeting paradigm. In particular, the central bank will have to consider the use of other instruments, apart from the interest rate, to achieve the various goals, and these instruments will have to be used in consonance with the overall fiscal policy in terms of level and direction of public expenditure. The basic elements of such an alternative strategy are:

- Policy makers and the central bank need to identify the set of targets in a measurable fashion. Some, such as aggregate growth or investment, are relatively easy to measure. Others, such as employment generation or poverty reduction, may pose problems in countries where the statistical system is not equipped to calculate some variables in a systematic and periodic way. In such cases, reliable proxies should be found. For example, if poverty reduction is the target but large consumption surveys occur only every five or ten years, then those factors directly affecting the poor – such as agricultural and unskilled workers' wages compared to prices of necessities – could be monitored. If productive employment generation is the target, employment in small-scale enterprises could be monitored as a proxy for the broader process of employment growth.
- Monetary policy must be part of the overall macroeconomic policy directed towards these targets, rather than operating on a separate track of addressing monetary variables only. It should be aligned to and accommodate fiscal and exchange rate policies.
- Since the chosen target must be met within other constraints, interest rate management will not suffice and other instruments must be used by the central bank. These can include directed credit and other ways of encouraging banks to lend to, say, more employment generating borrowers; guarantees for specific kinds of desired investment; some controls on capital flows to reduce the possibility of balance of payments problems associated with the strategy; creation of specific packages for sectors or regions identified as priority areas.
- Policy makers should avoid excessive rigidity over any one target and be prepared to be flexible in adjusting targets and instruments depending upon the requirements of changing situations.

## **V. MANAGING ECONOMIC CYCLES**

Economic volatility has become one of the most pressing problems for macroeconomic policy in most developing countries. The critical questions for policy makers attempting to manage economic cycles from the point of view of both short-run economic management and longer-term growth strategy are:

- how to reduce the tendency to economic cycles originating not only from domestic tendencies, but also from international product and capital markets;



- how to reduce vulnerability to external shocks facing the economy that give rise to volatility;
- how to improve the economy's automatic response to such shocks;
- how to expand the scope for discretionary responses;
- how to design discretionary responses;
- how to design "built-in stabilizers" which automatically reduce the adverse effects of shocks;
- how to manage economic cycles, especially so that downswings can be reduced in both severity and duration;
- how the worst effects of a crisis and the subsequent adjustment can be reduced, with minimal adverse effects upon the poor and low income;
- how to help the poor and disadvantaged groups in particular to cope with the effects of shock and subsequent adjustment; and
- how maximum growth and longer term stability benefits can be derived from booms which are anticipated to be relatively short-lived.

The management of economic cycles has been a standard goal of macroeconomic policy since the Keynesian revolution, when it became accepted that the government's fiscal and monetary stances could reduce the length and intensity of slumps in particular. For a long time, it was assumed that countercyclical policies predominantly related to managing slumps and crises of different dimensions. This was because of the potential adverse impact of shocks, whether they were external, such as terms of trade shocks, exogenous to the economic system, such as harvest failures, or related to the impact of policy interventions. The management of these shocks to prevent or reduce the severity of a downturn, or measures to bring the economy out of a trough, were the most important forms of managing economic cycles. In the recent past, however, other issues relating to cyclical patterns have emerged, for example, how to benefit in the medium term from temporary externally generated booms, such as sudden improvements in the terms of trade.

Keynesian demand management remains an important approach to deal with economic cycles. But such demand management is often inadequate in reducing economic volatility or preventing crises for small low income economies in particular, because of the deep-seated structural reasons for such volatility, associated with various supply bottlenecks, the dominance of low productivity activities and the nature of international trade in major items of export and import.

Most developing countries face both internally and externally generated economic volatility. Internal cycles can come from collapses in output, such as crop failures in small economies with heavy reliance on some important agricultural commodities, or manufacturing cycles related to sectoral imbalances or policy interventions. External volatility emanates from the greater vulnerability of emerging markets to financial crises, or the impact of sudden negative terms of trade shocks in small open developing economies. The distinction between the two types of cycles is increasingly hard to draw as they tend to merge given the greater mobility of capital. Thus, capital flight can result from exogenous factors, such as changes in interest rates in the United States or problems in a neighbouring country causing "contagion" in financial markets, but also from changes in domestic policies, processes or even politics.

So how do developing country policy makers in a world of highly mobile capital and open trade accounts engage in counter-cyclical policies to avoid or mitigate depressions and slumps?

***Box 6***

***Changes in the nature of economic cycles in developing countries***

Historically, many small developing countries faced problems of growth instability due to their dependence on agriculture and a few commodities as major sources of foreign exchange earnings. In recent times, these problems have been compounded because many of the economic policies urged upon them are in fact pro-cyclical or tend to encourage greater volatility. Macroeconomic policies conventionally associated with dampening cycles increasingly worked in the opposite way; other policies such as those associated with tightening prudential norms in financial systems also act pro-cyclically. In these situations, even in open developing economies, it was still possible to devise counter-cyclical macroeconomic policies to reduce or minimise the adverse effects of slumps. However, open capital accounts and new forms of capital mobility significantly constrain such possibilities for most developing countries, even those with relatively small volumes of capital inflows.

Policies of trade and financial openness have been associated with scenarios in which macroeconomic policies have acted in a pro-cyclical fashion. The effects of external shocks are magnified or downswings are sharper because fiscal and monetary policies do not respond with expansion but further contraction. A major reason for this is the perceived need to maintain or revive “investor confidence”. This leads to policy responses such as raising interest rates or maintaining a very high rate, or cutting public expenditure to reduce the fiscal deficit, during periods of financial crisis, asset deflation and domestic downswing. Instead, in such circumstances, the effective counter-cyclical measures would be the opposite: reduce interest rates and increase public expenditure.

In addition, various other economic policy measures or regimes have pro-cyclical properties. For example, rigid prudential norms, such as capital adequacy ratios that impede the ability of banks to lend more when their own capital is reduced, essentially stem credit flow during economic slumps, aggravating the slump. Similarly, public guarantees on private investment, such as governments underwriting risks or guaranteeing rates of return on private investment in what are now known as “public-private partnerships”, tend to encourage more profligate or over-ambitious private behaviour during a boom, and even more reticent private behaviour during a slump than would otherwise have occurred. Since pro-cyclicality adversely affects long run growth, these issues cannot be ignored by economic strategists.

Further, economic volatility has much worse effects on the poor, who typically do not benefit so much from booms but bear the brunt of the downswing and subsequent adjustment. Many studies show that workers have to face unemployment and/or take wage cuts in periods of downswing. Also, in most developing countries, credit and insurance markets usually do not work in ways that would allow the bulk of households to reduce the adverse effect of the “bad times” by smoothing consumption over time in the face of fluctuating income.

Domestically, the basic instruments remain the same, but they now have to be combined with measures to regulate or minimise capital flight. This means that some form of capital controls may be indispensable to enable governments to engage in strategies to counter slumps. They need not, indeed should not, be heavy handed administrative controls: a range of market-based and non-market measures are available to developing countries, to be used flexibly and judiciously in combination with domestic macroeconomic policies. Thus, market-based measures such as reserve requirements for portfolio inflows can be combined with fiscal measures such as differential tax rates for different kinds of capital income and administrative measures

such as minimum lock-in periods for capital. These need not be “permanent” but should be flexibly used in changing situations.

There are several ways of trying to achieve the goals listed above in terms of managing cycles, and many have been tried in the developing world recently.

### **“Automatic stabilizers”**

While fiscal and monetary policies remain the basic levers to ensure changes in aggregate economic activity over the course of a cycle, there are other measures that can be quite effective. In particular there are some “automatic stabilizers” that developing countries can and should use, such as:

- Progressive taxation, which reduces the negative fiscal impact on the poor. (It should be noted that some economic reforms that move away from progressive tax systems, including moving to a VAT system, can weaken such an automatic stabilizer.)
- Welfare programmes and social protection policies, including unemployment insurance schemes, worker protection, special access to non-collateral based credit, public distribution systems for food and other necessities, income support for female-headed worker households, and so on. All these operate to ensure that consumption does not fall as much as it otherwise would during a downswing.
- Automatic adjustments of tariffs to external prices, such as the variable tariff scheme discussed above in Section III.
- Pension plans that do not involve defined contribution, since such programmes may lead to more volatility in consumption in response to a shock to the stock markets.

### **Discretionary stabilizers**

In addition to automatic stabilizers that are particularly important in times of downswing, there are ways of responding to booms that could dampen cyclical processes. Some of these include:

- A counter-cyclical tax such as an export tax that allows the government to generate more revenue during periods of an export boom, to be set aside for a price stabilisation fund for future exports.
- A tax on capital inflows, limited to, say, equity and portfolio capital as opposed to “green field” investment, in periods when such inflows are high.
- In situations of clear overheating and build-up of speculative bubbles, restricting activities that are likely to be associated with boom/bust, e.g. speculative real estate, through measures such as imposition of higher capital gains taxes and bank regulations that restrict the extent of lending to the real estate sector.

## **VI. EXCHANGE RATE POLICIES IN OPEN DEVELOPING ECONOMIES**

Managing exchange rates to ensure growth and stability has become one of the most significant requirements of macroeconomic policy. This is especially so after trade liberalisation reduced the ability of governments to manage the balance of payments by other means and to ensure that higher levels of the exchange rate are not associated with lower levels of activity and employment. With trade liberalisation, even prior to the liberalisation of capital flows, a significantly overvalued domestic currency is likely to generate unemployment, and an undervalued one, to generate inflation.

The problem is how to achieve a desirable value of the exchange rate, to encourage investment in tradeables yet provide price stability, and to avoid sharp destabilising changes. Developing countries have been through a gamut of strategies, from strongly fixed exchange rate systems to completely flexible “floating” regimes. Both extremes have shown their disadvantages. Fixed exchange rate regimes are too rigid and delay eventually necessary movements of the exchange rate, which then become subject to very sharp shifts with associated crises. Completely flexible rates are usually too volatile and can depress longer-term investment because of the considerable uncertainty thereby generated.

In general, exchange rates are managed directly or indirectly by governments, and not left solely to the determination of market forces. For developing countries, intermediate regimes, such as managed floats or crawling pegs, work best. They allow governments to adjust the level of the exchange rate to external conditions as well as to the current policy priorities for the domestic economy. These managed floats are best maintained through a combination of capital account and banking policy measures, along with the more usual open market operations of the central bank purchasing or selling currency in the foreign exchange market.

The argument for keeping the exchange rate low is usually presented in terms of promoting the export sectors. This is not only for purely trade reasons, but also because it is felt that the traded goods sectors thereby encouraged are more dynamic compared to non-traded sectors, and that the higher rates of technical progress will spill over to other sectors. Thus, it is argued that the expansion of traded goods sectors is more likely to enhance growth than, say, the expansion of the construction sector. A second argument focuses on poverty. A high level of the exchange rate could lead to lower domestic prices for sectors such as agriculture, which in turn would adversely affect peasant cultivators. In countries where peasant cultivators form an important segment of the population and economy, this would directly affect rural poverty. In such cases, the government may prefer to maintain a low exchange rate and combine it with some export taxes: external balance can then be achieved along with protecting agriculturalists and generating revenues for development expenditures.

However, all these possibilities are available mainly when there is some possibility of containing very volatile flows of mobile capital. When capital flows are liberalised, exchange rates become exceedingly difficult to manage. This can lead to unintended and undesirable processes and outcomes.

For example, the evidence on capital inflows and subsequent crises suggests that once an emerging market is “chosen” by financial markets as an attractive destination, processes are set in motion which are likely to eventually culminate in crisis. This works through the effects of a surge of capital inflows on exchange rates in the

following way. An appreciating real exchange rate encourages investment in non-tradeable sectors, the most obvious being real estate, and in domestic asset markets generally. At the same time, this upward movement of the currency discourages investment in tradeables and therefore contributes to a process of relative decline in real economic sectors, and even deindustrialisation in developing countries. Given the interest rate differentials between domestic and international markets and the lack of prudence on the part of international lenders and investors, local agents borrow heavily abroad to directly or indirectly invest in the property and stock markets.

It is important to remember that high real rates of interest tend to be associated with appreciating exchange rates, which in turn has the negative consequences already described. The two conditions – high interest rate and high exchange rate – therefore go together, with adverse effects on investment and the level of economic activity.

One important conclusion is that, as far as possible, exchange rates in open developing countries still need to be “managed”, preferably within a band, along the lines of a crawling peg which can adjust to changing internal and external economic circumstances. A related conclusion is that capital flows need to be “managed”, in terms of both inflows and outflows, to prevent excessive volatility and possible crisis.

### ***Box 7***

#### ***Exchange rate appreciation and emerging market “crises”***

It is no accident that emerging market economies that have experienced substantial financial capital inflows simultaneously experienced property, real estate and stock market booms, even as the real economy may have been stagnating or even declining. These booms generated the incomes to keep domestic demand and growth in certain sectors growing at relatively high rates. This often created a dualism of rapid income expansion in some sectors and stagnation or decline of many productive activities and aggregate employment. Sooner or later, this resulted in signs of macroeconomic imbalance, not necessarily in the form of rising fiscal deficits of the government, but as a current account deficit reflecting the consequences of debt-financed private profligacy. In the light of recent experience, these booms based on capital inflows can even be described as “pre-crisis” booms, as occurred in Mexico before the “tequila crisis”, Turkey, Russia, Argentina at various points in the 1990s, and the East and Southeast Asian economies that experienced financial crisis in the late 1990s.

It has been suggested that many emerging economies faced these problems because they allowed their current account deficits to become too large, reflecting too great an excess of private domestic investment over private savings. This is a change from the earlier obsession with government fiscal deficits as the main macroeconomic imbalance worth caring about. But it still misses the basic point. This is that, with completely unbridled capital flows, it is no longer possible for a country to control the amount of capital inflow or outflow, and both movements can create undesirable consequences, especially upon the level of the exchange rate, which in turn can shift domestic incentives in undesired ways.

If, for example, a country is chosen as a preferred site for foreign portfolio investment, it can lead to huge inflows, causing the currency to appreciate, thus encouraging investment in non-tradeables rather than tradeables, and altering domestic relative prices and therefore incentives. Simultaneously, unless the capital inflows are simply (and wastefully) stored as accumulated foreign exchange reserves, they must necessarily be associated with current account deficits. This is true even of small countries that receive relatively little in the form of foreign private capital inflows, as even small inflows or outflows affect market-determined exchange rates at the margin. Thus, “sound” economic policies are themselves undermined by the pattern of capital flows which cannot be determined by domestic policy makers.

Without these in place, the likelihood is that attempts to keep fiscal and external deficits within “prudent” limits and not allow the exchange rate to appreciate will mean simply saving the resource inflows rather than using them for increased investment or consumption in the economy.

In fact, that is precisely what is happening in much of the developing world at the moment. In most developing countries, the recent increase in net savings has not come from higher household or private corporate savings, but from reduced deficits or larger surpluses of the public sector, mainly due to public spending cuts. This is deflationary on the part of developing country governments, and suppresses domestic consumption and investment, with obvious effects on current levels of economic activity and employment. But it also negatively affects future growth prospects because of the long-term potential losses of inadequate infrastructure investment, etc.

Capital account convertibility accompanied by domestic prudential regulation cannot guard against such boom-bust volatility in capital markets. With completely unbridled capital flows, it is no longer possible for a country to control the amount of capital inflow or outflow, and both movements can create hugely undesirable consequences. Financial liberalisation and the behaviour of fluid finance have therefore created a problem analogous to the old “Dutch disease”, with capital inflows causing an

appreciation of the real exchange rate, in turn resulting in changes in the real economy, all within a process that is inherently unsustainable over time.

However, capital inflows – whether of foreign aid or private investors – are not necessarily macroeconomically adverse. Such inflows can obviously fill one or more of the development “gaps” and can contribute to reducing the savings gap by providing investible resources. If they are effectively utilised as productive investment that operates to increase both demand and supply, they lead to more growth and employment generation. If they enhance productivity conditions, this can encourage more exports or import-substituting domestic production, reducing the foreign exchange gap.

Some controls on external flows of capital and goods will help in achieving these desirable outcomes faster and in a sustainable way. Co-ordinated macroeconomic policies can prevent the “Dutch disease” consequences of unfettered capital account liberalisation and allow foreign capital inflows to be effectively utilised for the purposes for which they are intended.

## VII. ANNEX

### Should the central bank be “independent”?

Central bank “independence” is sometimes believed to be an essential economic reform, but what does it mean?

The argument for central bank “independence” depends upon the following three monetarist postulates:

- Real growth is determined by the available supply of factors of production such as capital and labour, and the rate of productivity growth; changes in monetary variables do not have any impact on real economic activity and output growth.
- Money supply is exogenous to the system and can be controlled by the monetary authorities pursuing well defined targets for monetary growth.
- Inflation is due to an excessive growth of money supply relative to an exogenously given “real rate of growth of output” and can be moderated by reducing the rate of growth of money supply.

These postulates lead to arguments for an “independent” central bank whose essential job would be to control inflation by using money market levers to control money supply and therefore the price line. This is usually referred to as “independence” from the political process, and therefore from the government. Paradoxically, this is an “independence” conferred by the government, as when the government of Britain passed legislation to give such “independence” to the Bank of England.

We have already indicated that the first proposition is not valid in the short term or even in the medium term, since interest rates affect investment as well as consumption. We have also shown that aggregate money supply cannot be controlled by the monetary authorities; rather, the interest rate is the real policy variable. Similarly, inflation reflects the excess of expenditure over output, and the associated increase in money supply is part of the same process. So it is the excess of expenditure over output that needs to be managed, rather than the money supply. So the postulates which are used to argue for central bank independence are themselves flawed.

Central banks do need some degree of insulation from the day-to-day ebb and flow of politics and should be able to focus on medium term objectives of the economy and society. However, the “independence” intended by the drive for “central bank independence” is to have central banks focus almost exclusively on one aspect of economic policy – the control of inflation and price stability.

Such a single-minded focus may not just ignore, but even be detrimental to, other objectives so crucial to developing countries, such as growth and employment generation, since the central bank will tend to have a deflationary bias. Under such an understanding of “independence”, central bankers can ignore pressures to relax monetary policy, even to the point of sacrificing economic activity and employment. In effect, it means removing monetary policy from any political and democratic accountability.

Nor does such “independence” mean that the central bank therefore becomes apolitical. Rather, such “independence” represents, wittingly or unwittingly, a



political choice by policy makers: some interests, e.g. rentiers, are elevated over others, such as unemployed or underemployed workers, or small scale industrialists and agriculturalists, who would be interested in a higher level of economic activity.

The motivation for such a measure in many developing countries is the desire to attract international investors who want some signal that the government is serious about inflation control, or so it is perceived. However, there is really no trade-off between giving up control of monetary policy and attracting capital inflows. Instead, since such a strategy usually means higher real interest rates, whatever the requirements of the domestic economy, it tends to depress domestic economic activity. Furthermore, such central bank “independence” constrains fiscal policy as well, limiting the government's recourse to deficit financing by raising the cost of government borrowing, inadvertently putting the economy on a deflationary course even when that is not desirable. While there is no necessary relation between central bank independence, capital inflows and domestic economic growth, the first is generally associated with lower rates of economic activity, investment and therefore future growth, than would otherwise have been the case. Low or stable inflation is certainly one of the factors that can promote a healthy “investment climate” in a country, but there are several other factors that are also important. And if the low inflation results from very tight monetary policy that restricts investment, then the net impact upon investment will not be positive.

In summary, central bank independence focussed primarily on inflation control can be adverse to promoting the growth prospects of the economy. Instead, monetary policy should accommodate fiscal policy, which itself should be directed towards expanding growth, employment and better human development. Rather than “independence”, the central bank should be an arm of government, its activities forming part of a co-ordinated macroeconomic strategy.

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