

## Chapter V

# Macroeconomic policies and poverty reduction

Poverty, in all its complex dimensions, is a condition with a social and economic context and poverty reduction (or the lack thereof) always occurs within a macroeconomic context. History shows that high rates of economic growth sustained over a period of time are necessary for poverty reduction, while the distribution of the benefits of growth determines the impact on poverty. The macroeconomic policy framework often sets the parameters for social policies by defining the policy and fiscal space for government action. The following analysis focuses on macroeconomic policies and how they influenced poverty reduction in the past.

For two and a half decades starting from the end of the Second World War, Governments of the industrialized countries, through active reflationary macroeconomic management, achieved rapid reconstruction and prosperity underpinned by full employment and low inflation. Governments in developing countries also played a very active role in promoting economic growth and structural change after independence from colonial powers was gained. Developing countries as a group experienced impressive economic growth and structural change within their economies. Industry was the fastest-growing sector, resulting in a rapid rise in industry's share of gross domestic product (GDP) in "virtually all the developing economies" (World Bank, 1978).<sup>1</sup> However, there were variations among developing countries; growth and structural

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<sup>1</sup> In recognition of this achievement, the General Assembly designated the 1960s as the First United Nations Development Decade (see Assembly resolution 1710 (XVI) of 19 December 1961). Reviewing the performance of the developing countries over 25 years (1950-1975), the *World Development Report 1978* (World Bank, 1978) noted:

The developing countries have grown impressively over the past 25 years: income per person has increased by almost 3 per cent a year, with the annual growth rate accelerating from about 2 per cent in the 1950s to 3.4 per cent in the 1960s ... Moreover, it compared extremely favourably with growth rates achieved by the now developed countries over the period of their industrialization: income per person grew less than 2 per cent a year in most of the industrialized nations of the West over the 100 years of industrialization (p. 3).

The *Report* also noted:

The Progress made by developing countries is more impressive considering that their populations have been growing at historically unprecedented rates. During 1950-1975, their total population increased at 2.4 per cent a year. This is substantially faster than the population growth rates—typically about 1 per cent a year—that the now developed countries had to contend with during the period of their industrialization (pp. 4-5).

change in most low-income countries in Africa and Asia, where the majority of the world's poor live, were slow.

Despite impressive economic growth, progress in the quality of life was slow. About 40 per cent of the population in developing countries—or nearly 800 million people—remained in absolute poverty. The situation had become difficult in the 1970s for most developing countries with the breakdown of the Bretton Woods system of fixed exchange rates and the oil price shocks. Industrialized countries faced stagflation caused mainly by those shocks. The countries that borrowed recycled petrodollars<sup>2</sup> from commercial banks faced debt crises in the 1980s when interest rates were raised sharply in the United States of America and the United Kingdom of Great Britain and Northern Ireland to control inflation. Only a few economies withstood the rigours of the difficult international economic environment and continued to grow rapidly.

These developments in the 1970s and 1980s served as a catalyst for an ideological shift in terms of macroeconomic policy and the role of the State, which meant the retreat of the Keynesian compact whereby Governments played a significant role in economic stabilization. The hallmark of this shift has been smaller government, its functions confined to the realm of property rights, law and order and maintenance of macroeconomic stability, identified with low inflation and balanced government budgets.

The contrasting experiences of Latin America and East Asia in the 1980s provided the context within which the dominating macroeconomic policy prescriptions evolved. Many key Latin American countries experienced high inflation, recession or slow growth, and unsustainable fiscal deficits with money creation. They suffered from the inefficient and protectionist policy of import substituting industrialization and ultimately failed to reduce poverty. In contrast, fiscally prudent East Asian countries experienced low inflation, outward-oriented industrialization, robust growth and sustained declines in poverty. This experience combined with the demise of the Soviet Union and the embracing by Eastern Europe of the market economy reinforced the ideological supremacy of neoclassical economics.

It was in this atmosphere that a series of economic policies were formulated by several Washington, D.C.-based institutions such as the World Bank, the International Monetary Fund (IMF) and the United States Department of the Treasury. This so-called Washington Consensus promoted the idea of sound monetary policy and fiscal prudence as the pillars of macroeconomic policy and argued the case for privatization and limited government, extolling as well the virtues of globalization, epitomized by free trade and unrestricted capital movements (Williamson, 1990). Achievement of low inflation and balanced budgets (and, later, opening of the capital account) became the core

<sup>2</sup> Deposits in Western banks by oil exporting countries, which enjoyed revenue windfalls from the oil price hikes.

conditionalities in the IMF rescue packages as the World Bank pursued structural adjustment (trade liberalization, financial deregulation and privatization) through loan agreements.

The present chapter offers a critical evaluation of the impact of the macroeconomic policy framework of the Washington Consensus on growth and poverty reduction. The evaluation of structural adjustment programmes (economic liberalization) is the theme of chapter VI. After assessing the impacts of macroeconomic policies on economic growth, poverty and inequality, the chapter will review the underlying reasons for the outcomes and then offer an alternative framework for pro-poor macroeconomic policies aimed at achieving employment creation with price stability.

## Growth performance

If growth was undermined by the high inflation generated by macroeconomic instability and the protectionism driven by statism, the elimination of these obstacles should have unleashed the energies of the private sector in full force and economic growth should have accelerated. However, that has not happened: “Economic growth rates in those countries that adopted the ‘stabilize, liberalize, and privatize’ agenda has turned out to be low not only in absolute terms, but also relative to other countries that were reluctant reformers and relative to the reforming countries’ own historical experience” (Rodrik, 2004, pp. 1-2). The World Bank (2005, p. 95) notes:

Macroeconomic policies improved in a majority of developing countries in the 1990s, but the expected growth benefits failed to materialize, at least to the extent that many observers had forecast. In addition, a series of financial crises severely depressed growth and worsened poverty ... [B]oth slow growth and multiple crises were symptoms of deficiencies in the design and execution of the pro-growth reform strategies that were adopted in the 1990s with macroeconomic stability as their centrepiece.

In Latin America, after radical reforms had been pursued, mostly under IMF/World Bank stabilization and structural adjustment programmes, growth performance did not even begin to match the performance achieved when Governments exerted tight control over the economy (table V.1).<sup>3</sup> Most of the transition economies of Eastern Europe experienced modest or negative growth rates following the Washington Consensus-inspired reforms and macroeconomic policies.

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<sup>3</sup> In the 1990s, Argentina pursued International Monetary Fund (IMF) and World Bank programmes strictly. However, the unemployment rate soared from 6.5 per cent in 1991 to over 17 per cent in 1995 and the number of people living in poverty increased from 22 per cent in 1993 to over 27 per cent in 1995, as the Gini coefficient (a conventional measure of inequality) rose from 0.45 in 1992 to 0.47 in 1995.

Table V.1

**Decadal GDP growth performance of developing regions,  
1960-2000 (percentage)**

Region	1960-1970	1970-1980	1980-1990	1990-2000
East Asia <i>minus</i> China	6.4	7.6	7.2	5.7
South Asia	4.2	3.0	5.8	5.3
Latin America	5.5	6.0	1.1	3.3
Africa	5.2	3.6	1.7	2.3

Source: Bosworth and Collins (2003).

South Asia's performance appears respectable owing mainly to growth acceleration in India beginning in the 1980s. Despite the general belief that its growth acceleration could be attributed to the liberalization of 1991, India's take-off actually began a decade earlier, during the early 1980s and under heavy protectionism (Rodrik, 2004). The stellar performance of East Asia cannot be attributed to the conventional policies. Instead, its varied policies can best be described as reflecting market pragmatist heterodoxy (see Chang, 2006, chaps. 1-3).

Private investment has also been adversely affected by the orthodox macroeconomic policy framework of the past three decades geared, among other things, to achieving low single-digit inflation rates. This policy priority typically required a high-interest-rate regime. Furthermore, financial sector deregulation and the opening of the capital account of the balance of payments usually involved high real interest rates (see chap. VI). Hence, such macroeconomic policy and economic liberalization have constrained domestic private investment (United Nations Conference on Trade and Development, 2006).

### What role did the macroeconomic policy mix play in a disappointing growth performance?

A number of growth-retarding factors which resulted from the macroeconomic policy mix can be identified, including (a) declines in public investment and (b) growth volatility.

There have been precipitous declines in public investment since the early 1980s in both Latin America and Africa, the two regions which experienced growth slowdowns. Public investments have generally declined in Latin America since the debt crisis starting from around 1982, while the collapse in sub-Saharan Africa during the early and mid-1980s was reversed slightly before the decline continued, more gradually, in the 1990s (International Monetary Fund, 2004). The declines in public investment were the direct

result of excessive emphasis on the attainment of balanced budgets with little regard for the composition of government expenditure. In most cases, the budget was brought to a balance or surplus by cutting public investment rather than by raising taxes. Cuts in non-discretionary expenditure, such as public sector salaries or subsidies, were also avoided because of the political sensitivity involved.

The countries of those regions did not opt to raise taxes, as many faced significant problems with regard to tax administration. The IMF/World Bank programmes and policy advice improved the efficiency of tax administration but have done little to help raise tax revenues and have tended to result in the reduction of direct taxation in favour of indirect taxation. The removal of trade-related taxes with trade liberalization and various tax incentives to attract foreign investors have seriously eroded the fiscal space for many developing countries, as the declines in revenue were not compensated for by the expected increases in indirect consumption-based taxes, such as the value-added tax (VAT) (see chap. VI). Thus, developing countries were faced with the difficult task of improving their fiscal balances while their revenues were falling. The situation was made worse by the fact that declines in public investment were not matched by increases in private investment, as had been hoped.

Reviewing the situation, an IMF report (International Monetary Fund, 2004, p. 3), prepared in consultation with the World Bank and the Inter-American Development Bank, noted:

The share of public investment in GDP, and especially the share of infrastructure investment, has declined during the last three decades in a number of countries, particularly in Latin America. Since the private sector has not increased infrastructure investment as hoped for, significant infrastructure gaps have emerged in several countries. These gaps may adversely affect the growth potential of the affected countries and limit targeted improvements in social indicators.

The report also acknowledges that fiscal analysis and policy, which focus on overall fiscal balance and gross public debt, may have unduly constrained the ability of countries to take advantage of increased opportunities to finance high-quality infrastructure projects. Research at the Inter-American Development Bank found that public investment in infrastructure in the period 1987-2001 was negatively affected by IMF adjustment loans, while debt increases were associated with higher public infrastructure investment (Lora, 2007).

The agricultural sector has suffered most from declines in public investment, as public spending in agriculture plummeted across developing countries in recent years (Akroyd and Smith, 2007). In Africa, public spending on agriculture fell from 6.4 per cent of total public spending in 1980 to 5 per cent in 2004; in Asia, total public spending in agriculture fell from 14.8 to 7.4 per

cent, while Latin America witnessed a decline from 8 to 2.7 per cent over the same period (International Labour Organization, 2008, p. 22).

### Growth volatility

A growing body of empirical research finds a robust negative cross-country relationship between growth and volatility and a significant negative correlation between growth and medium-term business cycle fluctuations (Kroft and Lloyd-Ellis, 2002; Aysan, 2007). One of the causes of increased output growth volatility has been pro-cyclical macroeconomic policy aimed at price stability and fiscal balance. It is well known that macroeconomic policies targeting price stability cause excessive fluctuations in output as the burden of adjustment falls on only one variable (output). Most developing countries are prone to supply shocks owing to their high dependence on agriculture and imported energy; and output fluctuations are greater when macroeconomic policies remain focused on price stability in the face of such shocks (Walsh, 2000).

Focusing on price stability is supposed to create favourable conditions for private investment, capital inflows and exports, which should spur growth. Thus, the decline in output and employment is supposed to be short-lived. This belief was behind the advice of IMF given to Indonesia to raise interest rates and restrain Government expenditure at the height of the 1997-1998 crisis. As was the case for many other developing countries, Indonesia remained faithful to this policy framework even after it had left the IMF programme, and has continued to pursue contractionary monetary policy to contain inflation due to recent hikes in food and energy prices in international markets.<sup>4</sup>

Also, many developing countries do not have the policy space within which to implement counter-cyclical macroeconomic policies in response to shocks for two reasons. First, the requirement to keep budgets in balance forces them to cut expenditure during downturns as revenue falls. Second, countries with open capital accounts are not supposed to be able to simultaneously pursue an autonomous monetary policy and control the exchange rate while maintaining an open capital account. While all three actions are potentially feasible, only two are supposed to be possible at any point in time, though in practice, many countries pursue supposedly suboptimal combinations of the three policy objectives after being encouraged or forced to open their capital accounts.

Additionally, most developing countries do not have the resources or fiscal space within which to undertake large-scale counter-cyclical measures. As noted earlier, there have been significant reductions in trade-related revenues

<sup>4</sup> In contrast, Bangladesh refused to follow the advice of IMF and other multilateral financial institutions to pursue contractionary monetary policy in order to rein in food and energy price-induced inflation, exacerbated by cyclone Sidr.

following trade liberalization in many developing countries in recent decades. Various incentives including tax exemptions and cuts aimed at attracting private investment have also reduced fiscal space by reducing government revenue.

Many low-income countries, especially in Africa, found their external indebtedness rising following trade liberalization. Their imports rose at a much faster rate than their exports; as a result, they faced serious balance-of-payments problems (see chap. VI). These countries were forced to borrow, either from international capital markets at high interest rates owing to their low credit rating, or from IMF with conditionalities attached. While the rising external debt seriously constrained their ability to pursue poverty-reducing developmental activities, the conditionalities of adjustment loans forced them to continue with the very policies that had led to their predicament in the first place.

In sum, declines in public investment and excessive growth volatility, which have had adverse impacts on the overall growth performance of many developing countries, especially in Latin America and Africa, and the transition economies of Eastern Europe and the Commonwealth of Independent States, were due to macroeconomic policy reforms. They have not only reduced both policy and fiscal space for the adoption of counter-cyclical policy measures designed to reduce output volatility, but also contributed to greater volatility, thus retarding growth. The stability of nominal macroeconomic variables, such as consumer price levels and the fiscal balance, has failed to generate the much-hoped-for private investment.

## Impact on poverty and inequality

The disappointing growth performance obviously slowed poverty reduction. The rise in inequality further diminished the impact of growth on poverty reduction. There is a large body of literature that attributes this rise to globalization and structural adjustment programmes (see Goldberg and Pavcnik, 2007, for a survey). Other policies have also contributed to increased inequality.

Conservative monetary policy aimed at lowering inflation is supposed to be good for the poor. Since wage adjustments typically fall behind price rises, inflation reduces the real wage. Since most of the poor are wage earners, the income share of the poor in national income declines vis-à-vis that of profit earners. If there are any savings to be had, the poor mostly hold them in cash; but inflation reduces the real value of money holdings and if inflation is unanticipated, the poor will be harmed even more disproportionately, as they have weaker bargaining power and are generally less able to hedge against inflation.

However, there are a number of counter-arguments with respect to conservative monetary policy. If inflation reduces real wages, then employment should rise, creating more income-earning opportunities for workers. Therefore, the employment effect of inflation (creating more jobs because of lower

labour costs) can outweigh the real-wage effect (lower income) on poverty. This is likely to be the case, as the inflation (real wage) elasticity of poverty is found to be significantly less than the output (employment) elasticity of poverty. For example, one IMF study using pooled data from a cross section of 85 countries found the inflation (real wage) elasticity of the income of the poor to be 0.03 compared with an output (employment) elasticity of 0.94 (Ghura, Leite and Tsangarides, 2002).

Furthermore, most of the poor are net debtors and inflation reduces the real value of their debt. Finally, as highlighted above, mainstream macroeconomic policy frameworks have increased the volatility of output and employment. Output variability has a negative impact on both poverty and inequality (see box V.1); poor, unskilled workers are the first to lose jobs and it takes much longer for the job market to recover than for output to increase.<sup>5</sup> Reductions in public expenditure on health, education and other social programmes that

#### Box V.1

#### Income instability and the people living in poverty

People living in poverty are more vulnerable to income swings; there is also an asymmetry between the poor and the non-poor in responding to positive and negative shocks. Empirical studies find that the bottom two income quintiles experience disproportionately greater suffering from volatile income swings (Breen and Garcia-Penalosa, 2005; Laursen and Mahajan, 2005). People living in poverty do not have diversified income sources, are less skilled and are less mobile both between sectors and spatially. Moreover, they have less access to credit and insurance markets, and depend more on public transfers and social services (Guillaumont Jeanneney and Kpodar, 2005).

The inability of people living in poverty to cope with negative shocks can result in a loss of human capabilities, which is difficult to reverse. Thomas and others (2004) have shown that poor families remove their children from school when family incomes fall suddenly. Income instability also impacts negatively on nutritional status, as necessary consumption cutbacks are made (Dercon, 2006). For a cross-section of Asian and non-Asian countries, greater income volatility, measured as the standard deviation of the growth rate of gross domestic product (GDP) per capita, had negative effects on health outcomes (Rahman and Aradhyula, 2007).

Furthermore, in many developing countries, even when official poverty rates are low, a large number of people remain vulnerable. They are often just above the poverty line, or “in absolute terms, on the edge of the poverty line, using the World Bank standard of \$2 per day” (Birdsall, 2002, p. 8). A small shock to the economy, or mishaps such as adverse weather, illness in the family or the sudden death or incapacity of earning members of the family, can therefore push a significant number of people into poverty. Various estimates show that recent food and energy price hikes pushed over 100 million people into poverty (Islam and Buckley, 2009).

<sup>5</sup> It is crucial to make a distinction between “output recession” (based on quarterly declines in GDP) and “labour market recession” (based on the evolution of real wages and employment). The latter usually takes much longer to recover from than the former. Historical evidence culled by Reinhart and Rogoff (2009), based on 14 cases, suggests that it took 4.8 years on average for the unemployment rate to revert to its pre-crisis level, though GDP returned to its pre-crisis level in 1.9 years.



are carried out in order to maintain fiscal balance also disproportionately affect the poor. This is especially true during economic downturns.

What concerns the poor is not the overall price level that the conservative monetary policy aims to control, but the prices of particular commodities or services that dominate their consumption basket. Thus, stabilization of prices of food and basic services such as health care, education and public transportation has much greater impacts on poverty reduction than the stabilization of overall inflation. Monetary policy, however, is not well suited for the task of stabilizing prices of goods and services in the poor's consumption basket. Instead, fiscal measures such as subsidies are needed.

### The way forward

The way forward requires a fundamental shift away from the paradigm of the Washington-based institutions, or even the so-called post-Washington Consensus, to the kind of thinking that produced full employment with price stability following the Second World War. While policies will vary depending on particular country situations, some broad guidance from the experiences based on that thinking can be useful today.

Macroeconomic policies should strive for both short-run stability and long-term development. Therefore, public investment for building up infrastructure, technological capabilities and human resources is critical for growth and productive employment generation and, hence, for poverty reduction.

Public expenditure must also give priority to primary health care, universal basic education and human security—all of which are pro-poor. There is a substantial body of research on pro-poor budgets and the poverty alleviating effects of fiscal policy (Roy and Weeks, 2004; McKinley, 2004, 2008). Such an approach does not focus on government spending per se, but on whether government expenditure reduces poverty by disproportionately benefiting the poor relative to the non-poor (Osmani, 2005), explicitly linking macroeconomic policy with poverty reduction and human development.

Focusing on inflation and fiscal deficits alone reflects too narrow a view of stabilization. Therefore, stabilization needs to be defined more broadly to include stability of the real economy, with smoothened business cycles and reduced fluctuations of output, investment, employment and incomes. Achieving such stability of the real economy may require larger fiscal deficits and higher rates of inflation than prescribed by the conventional macroeconomic policy mix, especially in the face of economic shocks or natural calamities.

Much of the importance placed on fighting inflation today stems from the hyperinflation prevailing in several Latin American countries in the wake of the debt crises of the 1980s. Yet episodes of hyperinflation are historically rare and occur only in extreme economic and political circumstances. At the same time, there is no evidence that moderate inflation in the range of 10-15 per cent

harms growth. Nor is there any convincing evidence that inflation necessarily accelerates to hyperinflation even if it exceeds 20 per cent.<sup>6</sup> Stabilization of the prices of food and other products that weigh heavily in the poor's consumption basket has a more favourable effect on poverty reduction than the stabilization of the overall price level or the consumer price index (CPI).

Broad-based stabilization policies that focus on the real economy can boost economic growth in several ways. They can respond better to sudden contractions in investment and output due to either external shocks or natural calamity-related supply shocks, which can have negative dynamic effects on a country's growth path. For example, a prolonged output decline in an emerging manufacturing sector will deter new investment and technological change and thereby seriously erode productive capacity and future efficiency. Labour-intensive small and medium-sized enterprises are the most adversely affected by such a prolonged and deep recession, as they depend mostly on internal finance and operate on very thin cash-flow margins. Broad-based stabilization policies can thus stop unemployment from rising sharply and persisting, thereby preventing deskilling and demoralization of the labour force.

In many developing countries, a large number of (middle-income) people remain vulnerable to poverty, as they live at the edge of the poverty line. A small shock can therefore push them into poverty. This can be prevented through broad-based stabilization policies which recognize the right to decent employment of every willing and able citizen, as well as the direct link between decent jobs and poverty. We hardly need a more poignant reminder than the current global financial and economic crisis to illustrate this point. Thus, the government must assume responsibility as an "employer of last resort",<sup>7</sup> through, *inter alia*, various job guarantee schemes, ranging from those keeping more employees than necessary in State-run enterprises to such programmes as provide (as in the United States) federal funding for employment in state and local governments. Finally, by reducing the variability of income and employment, broad-based stabilization policies also prevent inequality from rising and thus enhance the poverty-reducing effect of growth.

Therefore, broad-based stabilization policies that boost economic growth and increase per capita incomes can lead to faster poverty reduction. The poverty reduction impact of growth will be enhanced if growth can be made more equitable or pro-poor through careful design of public expenditure.

6 Studies find inflation could accelerate if it exceeds 35-40 per cent (see Bruno and Easterly, 1998; and Dornbusch and Fischer, 1993).

7 According to Beveridge (1944, p. 18), full employment "means having always more vacant jobs than unemployed (people), not slightly fewer jobs" and "that the jobs are at fair wages, of such a kind, and so located that the unemployed (people) can reasonably be expected to take them; it means, by consequence, that the normal lag between losing a job and finding another will be very short". For an analysis of the definition's applicability in developing countries, see Wray (2007).

This means *fiscal policy* must be dominant at *all* times, not just when monetary policy loses its effectiveness.<sup>8</sup> Recognizing that both the level and composition of government expenditure can have significant impacts on growth, poverty and inequality<sup>9</sup> means abandoning the narrow concept of “sound” finance measured by the debt/gross domestic product (GDP) ratio. Instead, the concept of “functional” finance, which evaluates government finance based on its impact, should be adopted.<sup>10</sup> From this perspective, a better measure of fiscal sustainability is the debt-servicing ratio ( $[\text{principal} + \text{interest payments}] / \text{GDP}$ ), that is to say, debt will be sustainable if government expenditure is both productivity- and growth-enhancing. In other words, Governments still need to guard against unproductive expenditures.

*Fiscal space:* Owing to the volatile nature of aid (see box V.2) and the increased vulnerability to shocks, there has to be a renewed commitment to domestic resource mobilization in developing countries, which should also be seriously counter-cyclical by accumulating fiscal resources during boom periods and using such resources to finance expansionary policies or targeted interventions during downturns. The goal of a “stabilization fund” is to create the necessary fiscal space within which to sustain investments in human capital and basic infrastructure across business cycles and to scale up passive and active labour-market policies (such as job guarantee schemes) as well as social protection so as to minimize the impact of external shocks on poverty.

*Monetary and exchange-rate policies* should play a supportive role and accommodate the Government’s need for development activities and counter-cyclical measures. This means more active coordination between fiscal and monetary authorities and a limiting of central bank independence.<sup>11</sup> Confi-

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8 For example, in a situation like the current global crisis or the stagnation of Japan in the 1990s, many orthodox economists, including those at IMF and the World Bank, favour fiscal stimulus as the effectiveness of monetary easing hits its limit with interest rates hovering near zero (as was also the case during the stagnation of Japan in the 1990s). However, they consider this only a short-term measure until the monetary policy regains its effectiveness.

9 See Domar (1946). Domar (1944, pp. 801 and 804) notes the following:

That deficit financing may have some effect on income ... has received a different treatment. Opponents of deficit financing often disregard it completely, or imply, without any proof, that income will not rise as fast as the debt ... There is something inherently odd about any economy with a continuous stream of investment expenditures and a stationary national income.

10 Lerner (1943, p. 39) notes:

The central idea is that government fiscal policy, its spending and taxing, its borrowing and repayment of loans, its issue of new money and its withdrawal of money, shall all be undertaken with an eye only to the *results* of these actions on the economy and not to any established traditional doctrine about what is sound or unsound (italics in original).

11 Leaving aside technical arguments, a broader issue of democratic governance and technocratic insulation of institutions is at stake. Milton Friedman (1962, p. 219) noted that

## Box V.2

**Can aid ease fiscal constraints?**

One of the rationales for foreign aid has been the need to ease financial constraints on the Government. Prior to the present crisis, official development assistance (ODA) flows to developing countries had risen after 2001 and then declined after 2005. In 2008, aid flows from Development Assistance Committee (DAC) donors increased again, reaching almost \$120 billion, returning to a share of 0.3 per cent of donor countries' combined gross national income (GNI). This was still far less than the 0.7 per cent share of GNI agreed to in the 1960s and reiterated many times since, for example, at the International Conference on Financing for Development, held in Monterrey, Mexico, in March 2002.

ODA can play an important counter-cyclical role, provided such flows go up when the receiving country's economy slows and revenues decline, and thereby contribute to the country's long-term development. However, aid flows have been found to be generally pro-cyclical, and this pro-cyclicality is likely to recur during the current global crisis owing to the synchronized downturns in all economies. Even if donors maintain their aid shares of national income, the absolute amount of aid will fall owing to the decline of national incomes in most Organization for Economic Cooperation and Development (OECD) economies since late 2008.

An additional problem is the uncertainty of aid disbursement and associated volatility. Even before the current global financial and economic crisis, low-income countries, especially the least developed countries, had seen large fluctuations in annual aid flows of up to 2-3 per cent of GDP for the least developed countries as a group (see United Nations, Conference on the World Financial and Economic Crisis and Its Impact on Development, 2009, para. 23). Studies show that shortfalls in aid are frequently followed by reductions in government spending and sometimes by increases in taxes—and sometimes by both. In other words, the typical aid-receiving country is unable to offset an unexpected non-disbursement of aid by borrowing, and has to resort to costly, swift and, possibly, inefficient fiscal adjustment (see Bulíř and Hamann, 2003, for a good survey of the issue).

An IMF assessment prior to the current crisis noted that the volatility of aid flows is likely to increase in the years ahead. One reason for this has been identified as the switch from project to programme aid. Programme aid flows tend to be more volatile than project aid, usually committed upfront and disbursed on a multi-year basis. Thus, it warns that:

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“money is too important to be left to the central bankers”. Friedman (1985, p. 8) elaborated his concerns as follows:

Is it really tolerable in a democracy to have so much power concentrated in a body free from any direct political control? ... One economic defect of an independent central bank ... is that it almost invariably involves dispersal of responsibility ... Another defect ... is the extent to which policy is ... made highly dependent on personalities ... A third technical defect is that an independent central bank will almost invariably give undue emphasis to the point of view bankers ... The defects I have outlined constitute a strong technical argument against an independent central bank.

Stern and Stiglitz (1996, p. 18) have made the point more succinctly:

The degree of independence of the central bank is an issue of the balance of power in a democratic society. The variables controlled by the central bank are of great importance and thus require democratic accountability. At the same time, the central bank can act as a check on government irresponsibility. The most successful economies have developed institutional arrangements that afford the central bank considerable autonomy; but in which there is a check provided by public oversight, an oversight that ensures the broader national interest is taken into account in the final decisions.

The development community runs the risk of slipping into a low-level equilibrium—that is, countries that budget prudently over the medium term would discount pledges of assistance; donors would then see fewer funding gaps, in turn causing aid commitments to fall behind intended increases or even in absolute terms. Signs of this happening are already evident, with many low-income countries discounting aid commitments in their plans (Eifert and Gelb, 2005, p. 1).

Therefore, to reduce volatility in official financing and to allow developing countries to sustain long-term investments, the predictability of such financing should be enhanced through multi-annual agreements between donors and recipient countries, in line with the 2005 Paris Declaration on Aid Effectiveness and the 2008 Accra Agenda for Action on improving aid effectiveness.<sup>a</sup>

There is a fierce debate about the effectiveness of aid in promoting growth and poverty reduction. Recent research has found a large positive effect of “developmental” aid on economic growth, but also arrived at contrary conclusions with regard to the importance of policy environment for diminishing returns to aid. Development aid yields positive impacts only in the long run, highlighting the importance of long-term commitment of donors (Minoiu and Reddy, 2007). From this perspective, donors’ preference for programme aid over project aid in recent years has been detrimental, a conclusion similar to that of the IMF study cited above. Not only is the disbursement of programme aid less predictable, but it also comes with conditionalities which undermine national ownership of the development agenda.

<sup>a</sup> The Paris Declaration on Aid Effectiveness, endorsed on 2 March 2005, is an international agreement to which over 100 ministers, heads of agencies and other senior officials adhered and through which they committed their countries and organizations to continue to increase efforts in harmonization, alignment and managing aid for results with a set of monitorable actions and indicators. The Accra Agenda for Action (document A/63/539, annex) was agreed in 2008 and builds on the commitments agreed in the Paris Declaration (see [www.oecd.org/dac/effectiveness/parisdeclaration](http://www.oecd.org/dac/effectiveness/parisdeclaration)).

dence of the private sector in macroeconomic policies rests more on the credibility of the Government’s commitment to counter-cyclical measures and long-term development than on having a fixed low inflation target, as the former reduces uncertainty about future profit expectations. While central banks can use the traditional instrument of interest rates (or instruments such as reserve requirements) to keep inflation moderate, specialized credit regulation can be a second instrument for effecting employment creation and poverty reduction.

Fully flexible or fixed exchange-rate regimes are inherently inferior, as they simply give up major macroeconomic policy objectives. In an open developing economy, the exchange-rate regime has to be both stable and flexible. The stability of exchange rates is needed to support growth-promoting and poverty-reducing trade and structural change. A stable exchange-rate regime is also needed for domestic price stability and to avert the wealth effects of exchange-rate fluctuations in the face of currency mismatches in portfolios. The demand for flexibility comes from the need to have some degree of freedom to manage trade and capital account shocks in order to minimize their adverse impacts on income, employment and poverty.

*Policy space:* In addition to managing exchange rates, monetary authorities should also actively manage the capital account in order to enhance the

Government's policy space. This will allow depreciation of the exchange rate and expansionary policies in response to external shocks, and thereby mitigate adverse impacts on poverty.<sup>12</sup> Capital account openness should not be viewed as entailing an all-or-nothing proposition. The increased importance of equity flows has widened the effective scope for capital account management. A capital account may be open to equity flows, especially for foreign direct investment (FDI), but closed to volatile short-term flows or to excessive external borrowings by the private sector.

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12 Even the Bretton Woods institutions do not now look at capital account restrictions so unfavourably as they used to a decade or so ago. For example, on capital account liberalization, the World Bank (2009d, pp. 47-48) notes:

Capital restrictions might be unavoidable as a last resort to prevent or mitigate the crisis effects. A few emerging countries have introduced capital controls and other measures to better monitor and, in some cases, limit the conversion of domestic currency into foreign exchange ... capital controls might need to be imposed as a last resort to help mitigate a financial crisis and stabilize macroeconomic developments.