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# 1

## Potential and Limitations of Pro-Poor Macroeconomics: An Overview

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### **Introduction**

Since the mid-1990s, poverty reduction and the achievement of better living conditions in poor countries have slowly gained a place on the national policy agenda of developing countries, while, following the adoption of the Millennium Development Goals, the achievement of quantitative targets in these areas has become the main goal of international development.

The ability to achieve such goals, and in particular the goal of halving the incidence of income poverty by 2015, critically depends on how much pro-poor growth (PPG) will be realized. In this regard, a huge literature has developed on the factors that lead to PPG, including initial conditions, factors endowment, comparative advantages, exogenous shocks, external financing and public policies. Simplifying a little, the latter can be divided into macroeconomic, development and social policies. A key issue of PPG is the extent to which these three sets of policies accelerate growth and improve the distribution of income. In this regard, the theoretical debate of the last two decades has led to an important convergence among different schools of thought about the development and social policies that reduce poverty.<sup>2</sup>

A similar convergence has not yet been reached for macroeconomic policies. While there is also agreement in this area about the need for avoiding the excesses of macroeconomic populism, viewpoints still differ on how ambitious stabilization targets should be, the choice of the exchange rate, the effectiveness of devaluation, the appropriate level of taxation, the extent of deregulation, the opening of the capital account, the effectiveness of capital controls, the speed of adjustment to shocks, and so on. This disagreement has become even more acute in the wake of a string of macroeconomic crises and of the growing need to orient public policy toward poverty reduction.

In the past, macroeconomic policies were traditionally assigned the tasks of reducing the twin deficits, containing public debt and inflation, liberalizing product and factors markets, privatizing state assets and liberalizing external trade and capital flows. Their success or failure was assessed in terms of the extent of reforms implementation in these areas and not of their poverty impact, as it was felt that

their main task was to re-establish the preconditions for growth, and that growth itself, along with safety nets, would have taken care of poverty. In most developing and transitional countries, the implementation of such an approach has reduced inflation and, to a lesser extent, current account deficits. Yet, the growth performance and poverty reduction were unsatisfactory. With rare exceptions, in the 1980s and 1990s, growth remained elusive in Latin America, sub-Saharan Africa, the Middle East and North Africa and, until the late 1990s, in most transition economies. In these regions, between 1987 and 2000, poverty declined less rapidly than required to halve poverty by 2015. Where growth accelerated and poverty declined, as in China, India and Viet Nam (see Chapter 11), macroeconomic and development policies differed markedly from those promoted by the liberal approach. While the above disappointing outcomes might have been caused by inappropriate development and social policies, unexpected shocks or unfavourable initial conditions, this volume argues that they were due to an important extent to unexpected problems caused by liberal macroeconomic policies.

Thus, the nature of a pro-poor macroeconomic (PPM) policy remains controversial, and the controversy has intensified with the liberalization of the capital account and rapid all around liberalization. In this regard, this volume briefly reviews the problems of unsustainable packages, macroeconomic populism and liberal policies, and then proposes the elements of an intermediate approach that – after adaptation to local circumstances – can achieve the objective of promoting growth and poverty alleviation in a sustainable way. The search for an innovative PPM is made even more pressing because of two considerations. First, several macroeconomic problems, such as high levels of inflation, that led to the implementation of stringent fiscal and monetary policies are no longer present. The main macro imbalances are caused now by the policies followed in the major industrialized countries, the United States *in primis*, and the development of international financial markets that have drastically narrowed the policy space of national governments. Between 1992 and 2001, the daily turnover in the foreign exchange market increased from a daily average of \$0.7 trillion to \$1.2 trillion, which is more than 50 times the daily trade in goods and services and 10 times that in securities. As a result, the combined official reserves of all central banks have fallen from about 15 days of private turnover in the foreign exchange market in 1977 to about one day in 1995 (Bhaduri 2005). Because of these trends, national governments are now compelled to follow policies aligned to the expectations of financial markets.

## **Unsustainable, populist and intermediate macroeconomic regimes**

### **Unsustainable and populist macroeconomic policy regimes**

There are many examples of unsustainable macroeconomic policies that are sanctioned by the International Monetary Fund (IMF). These policies are only briefly mentioned here, as their problems are well understood; rather, the main

focus of this volume is on the limitations of liberal macroeconomics and the search for a PPM.

While the research evidence shows that budgetary stability is a necessary – though not sufficient – precondition for PPG (Klasen 2004), several countries are characterized by a weak fiscal policy. This is most often due to the inability or unwillingness to raise an adequate amount of tax revenue – as often observed in highly informal or unequal economies – with the result that even moderate levels of public expenditures lead to persistent deficits that are financed with monetary emissions, state bonds carrying high interest rates or external borrowing. While there is nothing wrong with budget deficits per se if they are financed with domestic bonds, the level of debt is non-explosive, the level of output is well within the production possibility frontier and public expenditure creates productive infrastructure, this is not so when the deficit is financed with excessive seignorage or foreign borrowing contracted under a fixed peg. The Russian Federation in 1996–1998 and Argentina in 1996–2001 are just two examples of how a weak fiscal policy leads to crises and poverty rises.

A second unsustainable policy concerns the adoption of a fixed nominal exchange rate. Such a regime is unable to cope with external shocks, is prone to speculative attacks and unavoidably leads to an appreciation of the real exchange rate. In turn, this provokes balance-of-payments difficulties, large sudden devaluations and growing dollarization that, as shown in Chapter 13 on Bolivia, significantly limits the possibility of conducting an independent monetary and exchange rate policy. A third, related, unsustainable policy concerns the adoption of multiple exchange rates. As noted in Chapter 4, if applied temporarily and with reduced spreads in countries where the poor are employed in the non-traded sector, then such a policy might serve some purpose, though it leads to a misallocation of resources and a fall in exports over the medium term. The impact is much worse if most of the poor work in the export sector. As shown in Chapter 12 of this volume, in 1999, the application of such a policy in Uzbekistan transferred 16 per cent of gross domestic product (GDP) from agriculture to the manufacturing sector, massively raising in this way rural poverty and overall inequality.

Fourthly, financial repression – entailing the administrative setting of interest rates and credit allocation, public control of the main banks and the ability of the government to unload on the commercial banks and the central bank the budget deficit – is another example of unsustainable policy that favours state parastatals and penalizes small and medium-sized enterprises (SMEs). It also causes financial disintermediation and – if real interest rates are negative – transfers large amounts of resources from depositors to borrowers. Fifthly, for some economies in transition, price liberalization remains incomplete and relative prices distorted. While countries can deliberately distort relative prices for social purposes, as lump sum taxes and subsidies might not be technically feasible, a generalized policy of this type generates a contraction in aggregate supply and can be practised only in countries – such as Turkmenistan – where the government can count on the distribution of mineral rents. Finally, illiberal policy regimes tend to feature also excessive trade protection and, especially, a considerable anti-export bias taking

the form of low procurement prices paid by state marketing boards, export taxes and overvalued exchange rates.

More nuanced is the evaluation of those policy regimes that Dornbusch and Edwards (1991) labelled 'macroeconomic populism', that is, policy regimes that emphasize economic reactivation in depressed economies with large unused capacity, and pay less attention to the problems posed by inflation, deficit finance and the reaction of economic agents to administrative interventions. In this approach, the inflationary and balance-of-payments pressures that might have otherwise resulted from this fiscal stimulus are restricted by a drop in average and marginal cost of production induced by the output expansion and the drop in profit rate per unit of value added. Inflation reduction might be possible because of the excess capacity available in the economy and the concurrent freeze of prices, tariffs and wages, the stability of the nominal exchange rate, a swift reduction in interest rates and high initial currency reserves. Though this approach emphasizes little direct redistribution, the poor ought to benefit from lower inflation and the jobs, higher wages and greater demand for goods produced in the informal sector or by small farmers induced by the reactivation of the economy.

While the Keynesian and structuralist theories supporting such an approach indicate that it works only under specific conditions, the policies followed in practice often deviated from the theory and, for instance, adopted an expansionary stance even when the level of output had neared full capacity and inflation, supply and balance-of-payments problems had started to emerge. However, such choices were the result of political economic considerations, such as imminent elections or the search for short-term consensus, rather than of any theoretical recommendation. The evidence on the impact of heterodox adjustment shows positive initial results followed by a macro crisis in some cases, while in others the short-term gains were permanent but did not improve long-term performance. The Austral, Cruzado and Inti Plans introduced in 1985–1986 in Argentina, Brazil and Peru led to an improvement in growth, inflation and poverty performance over the first two years, but to a worsening situation over the medium term. Perhaps the most serious criticism concerns the fleeting nature of the redistributive gains in favour of the poor. While increases in wages and agricultural prices boosted real incomes among the low- and middle-income groups over the short run, a weak fiscal and monetary policy massively eroded the real value of wages, incomes and social expenditures over the medium run.

### **Intermediate macroeconomic regimes**

Intermediate macroeconomic regimes accept the broad logic that guides the liberal approach, but apply it selectively and after adaptation to local institutions and conditions. As noted by Rodrik (2003), while some basic principles – such as protection of property rights, contract enforcement, market-based competition, appropriate incentives, responsible monetary and fiscal policy and debt sustainability – are universally valid, they do not map into unique policy packages and need to be applied in different ways under different institutions and conditions. Thus, reformers have substantial 'policy space' to transform some general

principles into concrete packages sensitive to local conditions. From the perspective of this volume, successful countries are those that have effectively exploited this 'policy space' for growth and poverty alleviation purposes.

A first group of positive experiences in this camp refers to several cases of successful unorthodox stabilization programmes. Two famous cases in the 1980s are Israel and Turkey. Unorthodox stabilization was also pursued with success in Uzbekistan in 1991–1995 (see Chapter 12), thanks to the gradual liberalization of prices, the maintenance of industrial subsidies, trade and foreign exchange controls and the launch of a successful import-substitution programme for oil and wheat. The adoption of these 'best second-best policies' allowed the containment of the transitional recession in relation to the Central Asian Republics that followed a liberal approach.

A second group of intermediate regimes concerns countries that followed a different approach to macroeconomics. As noted by Chandrasekhar and Ghosh in Chapter 11, though it broadly and gradually adhered to the principles of protection of property rights, market competition, sound money and so on, macroeconomic policy in China followed a trial-and-error reform path in consonance with local conditions that differed drastically from the liberal approach. China liberalized prices in steps using a dual-track pricing system, redistributed commune land without granting the right to sell it due to the incompleteness of credit markets, created township and village enterprises owned by local authorities, used public banks to foster capital accumulation, controlled the capital account and managed the exchange rate. In addition, macroeconomic stabilization was based on administrative measures that restrained investments by regional governments and public corporations. In turn, a large share of foreign trade remained under administrative control, either through quotas and fairly high tariffs or because state-owned enterprises accounted for more than half of all trade.

A third group of countries liberalized according to the liberal wish list, but did so gradually, often following a two-track system including a liberalized sector and a protected sector, and after having strengthened their domestic institutions and creating greater regulatory capacity to withstand the shocks caused by the external liberalization. As noted by Bundoo in Chapter 8, what initially put Mauritius on a successful track was the creation in 1970 of an export processing zone that generated a boom in garment exports. However, while export processing zone firms were granted tax holidays, free repatriation of profits and finance at preferential interest rates, the traditional sectors remained protected until the mid-1980s. Imports were fully liberalized and restrictions on current payments were removed only in the early 1990s when the foreign exchange reserves had reached a safe level. Similarly, minimum interest rates on deposits and the ceiling on bank credit to priority sectors were abolished in steps, and the financial sector was liberalized only after strong regulatory institutions were developed. In general terms, the state strongly guided the restructuring of the economy that gradually evolved from sugar, to textile and tourism, and then to financial, transport and information and telecommunication technology services.

A fourth group of countries followed a basically orthodox approach, but adopted – if at times temporarily – policies that deviated from the standard blueprint. In

Chile, for instance, from 1992 to 1999, measures were introduced to discourage short-term portfolio inflows, while the exchange rate was managed (see Chapter 4). In a different way, Malaysia successfully managed its macroeconomy from the real side. In Chapter 9, Jomo and Wee note that the main macroeconomic objective was sustained growth of the tradable sector, rather than price stability or external balance. This was achieved by raising the rate of investment financed by high public and private savings and foreign direct investment (FDI) attracted by generous incentives and guarantees and a liberal trading and capital account regime. Monetary policy was accommodating and allowed for some inflation, while fiscal policy was used to influence the level and allocation of public investment. Problems of overheating were treated as structural problems requiring long-term measures to raise supply rather than short-term demand management measures.

### **Liberal macroeconomics and its problems**

As noted in the introduction, during the last 20 years, liberal policies succeeded in opening up the economy, devaluing the real exchange rate and achieving greater commercial and financial integration. Even in the difficult context of sub-Saharan Africa, real exchange rates fell on average by 30 per cent in the period 1980–1998, inflation declined and the trade/GDP ratio rose from 51 per cent to 62 per cent (Kayizzi-Mugerwa 2000). In Latin America, such reforms were implemented to an even greater extent, as confirmed in Chapters 10, 13 and 14. However, the growth, inequality and poverty alleviation results were disappointing in most cases because of the problems discussed hereafter.

### **Stabilization overkill**

As noted by Chand in Chapter 3, the standard monetarist approach to stabilization typically leads to larger-than-expected improvements in the balance of payments and inflation and greater-than-expected declines in GDP, investment and employment. A possible explanation of this ‘overkill’ is that expenditure-reducing monetary and fiscal policies take effect more quickly and generate a bigger depressive effect than the supposedly expansionary exchange rate policies. Second, large and rapid deficit reductions entail a fall in revenue that requires more fiscal cuts. Third, capital markets tend to exacerbate the problem as they behave pro-cyclically due to the ‘flight to security’ and falling ‘appetite for risk’. Fourth, improvements in the external balance and inflation do not, by themselves, restore credibility and trigger a recovery of domestic and foreign investments in severely depressed economies with sky-high interest rates. Finally, and most importantly, credit restraint results in reductions in expenditure, especially for private investment, far greater than projected by the IMF’s financial programming model.

IMF-type stabilization induces recessions that affect long-term growth and poverty alleviation. As just noted, investment demand falls two to three times faster than GDP due to steep rises in interest rates, the working of the flexible accelerator mechanism, the worsening of expectations and greater risk aversion in periods of mounting uncertainty. Secondly, recessions may cause a fall in enrolments as children are pulled out of school, with the effect of abandoning for

good the educational system (World Bank 2000). Thirdly, in poor countries, inequality worsens during recessionary periods as flexible labour markets allow enterprises to shed labour and cut wages, while weak safety nets do not compensate for the loss of labour income. If the deterioration in inequality is large, then incentive problems may arise. Finally, severe cuts in public expenditure may affect the functioning of essential state services, raising in this way inefficiency over the long term. In brief, the view that the orthodox approach causes 'short-term pain but long-term gains' is misplaced. A botched stabilization can – and indeed often does – affect growth and poverty for several years.

### **Sequencing problems**

Domestic financial liberalization in the presence of large deficits tends to generate sharp rises in interest rates, as governments can no longer force the central bank or the commercial banks to buy government debt at artificially low interest rates. To finance their deficit, they are obliged to create domestic bond markets in order to sell large amounts of treasury bills. Because of a lack of credibility and the size of the bonds issue, governments have to raise interest rates on their bonds. Such a rise spreads quickly to the banks' lending rates, causing a contraction in credit demand and levels of activity and attracting speculative capital, the inflow of which raises the real exchange rate, and thereby shifts relative prices against the traded sector, with possible destabilizing effects on the current account balance. In Chapter 14, Arbache illustrates other examples of sequencing mistakes characteristic of the liberal approach.

### **Liberalization with incomplete institutions**

Domestic financial liberalization was expected to lead to financial deepening, greater competition in banking, private credit expansion and the creation of bonds and stocks markets. In other words, measures that, by increasing financial intermediation, were expected to raise the saving, investment and employment rates and to reduce poverty incidence. However, the empirical evidence points to disappointing results in many cases. With financial de-repression, the banking sector was often transformed from a public into a private oligopoly, as signalled by sharp rises in real interest rates and spreads. Even the entry of foreign banks did not raise competition, as these concentrated on a small number of low-risk customers. As a result, the credit expansion was lower than expected, market competition did not improve and the poor continued to be excluded from formal credit. In addition, financial liberalization was not preceded by a prior strengthening of the regulatory capacity of the central banks. In sum, financial deregulation in the absence of institutions ensuring market competition and prudential regulation led, in most cases, to oligopolistic markets characterized by little competition and high instability, as signalled by the recent rise in the frequency and severity of banking crises.

### **Loss of domestic policy making in economies with an open capital account**

Capital account liberalization imposes severe restrictions on monetary, exchange rate and fiscal policies. Much depends, of course, on the extent of liberalization and the composition of the inflows. As noted in Chapter 6 by Bonassi *et al.*, FDI in

labour-intensive manufacturing can generate favourable effects by transferring capital, technology and managerial skills to the host country, though, as mentioned in Chapter 14, the level of FDI depends to a considerable extent on privatization policies. In Brazil, for instance, privatization generated revenues equal to 25 per cent of the current account deficit in 1997–2000, but once most assets were sold, the country had to rely on less stable portfolio flows.

Likewise, if accompanied by the ability to impose controls on inflows and outflows and restrictions on bank lending to the non-tradable sector, the selective opening of capital inflows can secure precious resources for the tradable sector without causing instability. According to the ‘impossible trinity debate’, in the absence of interventions by the central bank, a country that opens up its capital account loses its monetary independence but enjoys considerable benefits, including lower domestic interest rates. Yet the literature shows that domestic interest rates seldom converge towards the US rate as a result of several factors that are ignored by standard analysis (Ticci 2004). In addition, the opening of the capital account prevents the adoption of policies of ‘financial restraint’<sup>3</sup> that would lead to an outflow of domestic capitals. Finally, in some countries – Brazil being one of them – domestic interest rates are indexed to the nominal exchange rate and thus move upwards any time the exchange rate falls.

Secondly, the opening of the capital account narrows the range of exchange rate choices. As noted in Chapter 4, intermediate exchange rate regimes are difficult to implement in the presence of an open capital account. Under these circumstances, a country is unable to target a competitive exchange rate, as this can easily become the target of speculative attacks. Even assuming a country has the ability to do so, strong financial integration may lead to large dollar-denominated indebtedness that discourages the recourse to devaluation. Third, in a world of mobile capital and immobile labour, globalization can make the conduit of an independent fiscal policy and tax-financed redistribution problematic. Developing countries aiming to attract FDI and other foreign capital are under pressure to reduce the rates of corporate income tax and to grant tax holidays and industrial subsidies that – altogether – reduce the level of public revenue. Finally, as noted by Klasen in Chapter 13, the opening of the capital account can increase the dollarization of the economy, thus preventing the introduction of an active monetary and exchange rate policy and the recourse to devaluation to kick-start export-based growth. Therefore, a complete opening of the capital account may lead to a ‘worst-case’ policy scenario characterized by high interest rates, a high exchange rate and low tax revenue, that is, macro signals that impede long-term development and poverty alleviation (Taylor 2004).

### **Perverse interactions between policy instruments and policy reversals**

Trade liberalization entailing sharp cuts in import duties worsens the fiscal deficit, as the decline in easy-to-collect trade taxes is not offset by a revenue rise from other taxes. The ensuing rise in the budget deficit may call for deflationary policies.

Secondly, in most of the countries that have received large amounts of portfolio flows, overall savings and capital accumulation have not generally increased or have even fallen, as domestic savings decline or stagnate, giving rise in this way to a kind of investment substitution. Indeed, domestic savers seize the opportunity offered by financial opening to diversify their portfolios by investing abroad, institutions lessen their effort at mobilizing domestic resources and public savings fall in an attempt to achieve the lower budget deficit required to attract foreign funds, while the capital inflows may be used to finance current consumption rather than investment. A third perverse interaction is observed on the occasion of import liberalization intended to expose domestic producers to foreign competition and induce gains in microeconomic efficiency. However, a simultaneous liberalization of the capital account can offset the intended effects of this measure, as the appreciation of the real exchange rate leads to import booms and a deterioration of the current account, as frequently observed in Latin America during the 1990s.

### **Asymmetric distribution of the benefits and costs of trade and financial globalization**

Capital account liberalization could benefit the poor, because of the increase in output and employment that it makes possible. Such effects, however, are not automatic. Greenfield FDI in manufacturing favourably affects employment and wages, but the impact of mergers and acquisitions is mixed. And finally, as shown by Bonassi *et al.* in Chapter 6, greenfield FDI can generate positive growth and distributive effects if they are directed to labour-intensive manufacturing, but are less successful in this respect when they are directed to capital- and skill-intensive mining.

Even when the poor benefit from greater employment opportunities linked to capital inflows, they are unlikely to benefit from them directly, as capital inflows generally fund an expansion of consumer credit of the middle-upper class or are invested in high-return and high-risk short-term activities in finance, insurance and real estate that employ few unskilled workers. In turn, any expansion in bank credit is unlikely to benefit SMEs, as a lack of collateral and high transaction costs reduce their access to formal credit. For these reasons, foreign resources are channelled to clients who were already well served, such as multinational corporations and high net worth individuals. As small firms are more labour intensive than big firms, a continued segmentation of the credit market in spite of a credit expansion has a high social opportunity cost. Finally, purchases of shares in the domestic stock market benefit the large quoted companies, but not the SMEs and small rural and informal sector producers with high rates of return.

Employment may also fall due to the appreciation of the real exchange rate that accompanies a surge in inflows. Indeed, while the credit boom induced by the capital inflows increases demand, the appreciation of the exchange rate increases the share of the latter satisfied with imports. Meanwhile, the loss of a competitive hedge by traded sector firms, following the appreciation of the real exchange rate, pushes domestic enterprises to restructure, adopt more flexible contracts or sub-contract work to informal sector firms. While raising labour productivity, such measures swell informal employment and cut wages even during growth spells. In

Brazil, for example, informal employment rose from 37 per cent to 50 per cent of the total between 1990 and 2002.

### **Financial liberalization and antirural bias**

As noted by Klasen (2004), any kind of growth – whether labour intensive or not – could be made pro-poor if it involved a policy of progressive taxation and transfers. However, much more preferable is a growth that occurs in sectors where most of the poor are employed and that makes use of the factors of production that they own. In most developing countries, the majority of the poor are employed in agriculture and SMEs, and PPG ought to be focused on these sectors. As noted by Chandrasekhar and Ghosh in Chapter 11, the poverty alleviation elasticity of agricultural growth is, in fact, higher than that of non-agricultural growth.<sup>4</sup> This confirms findings by Ravallion and Datt (2000), who showed that rural growth reduces poverty faster than urban growth and that it also diminishes poverty in urban areas, as an increase in agricultural wages raises the reservation wage of unskilled workers in cities. Similar consideration can be made for SMEs and labour-intensive manufacturing. Their growth improves the situation of the urban poor and migrating rural poor and – via remittances and rises in rural wages – that of the rural poor left behind.

Given all this, macroeconomic policy must avoid an antirural bias and stimulate economic activity in labour-intensive agriculture, SMEs and the informal sector. In this regard, a main problem of the dominant approach is that it tends to distort the macroeconomic signals against the traded sector, and agriculture in particular. Fixed pegs tend to appreciate the real exchange rate, discourage exports and facilitate the imports of agricultural and manufactured goods. The liberalization of the capital inflows generates similar effects. In addition, financial liberalization tends to reduce access to credit for the small-scale agricultural, manufacturing and services sector due to problems of asymmetric information, collateralization and high transaction costs and also because of the removal of directed credit allocation to these sectors (see Chapter 11 on India), while the additional credit booms favours the non-poor and sectors where production is little labour intensive.

### **Growth and consumption instability**

Since the mid-1980s, growth instability has increased perceptibly in many developing countries in parallel with a greater international integration (Caprio and Klingebiel 1996). Focusing on the industrialized countries, Lucas argued that what matters for welfare is mean income growth over a given period and not its variance around the mean, as credit markets can move resources backwards and forward. But, where credit markets are incomplete, the time horizon short and information problems severe, higher growth volatility raises uncertainty, lowers investment and, if income per capita is close to subsistence level, augments transitory and permanent poverty. In addition, as noted by Prasad *et al.* (2003), greater financial integration has also led to increasing consumption volatility, as highly financially integrated countries followed a cycle of consumption boom–panic–crisis–collapse. A main factor behind this trend is the pro-cyclical nature of interest rates and spreads that reduces the ability to borrow abroad in crisis periods.

### More frequent crises with real effects

In an increasingly integrated world economy, emerging economies directly affected by sudden shifts in capital flows as well as those ‘innocent bystanders’ with connections to them are more easily hit by financial, banking and currency crises and new forms of contagion than in the pre-globalized world. Such crises have long-lasting real effects. Stiglitz (1998) shows that countries that suffered banking and financial crises in 1975–94 saw their GDP growth decline on average by 1.3 per cent over the subsequent five years compared to countries that did not experience such crises. The impact of such crises is also asymmetric, particularly in countries with weak labour institutions and safety nets. Székely (2003), for instance, found that the liberalization of the capital account in Latin America generated a strong rise in wage inequality. In turn, the World Bank (2000) showed that poverty rises due to financial liberalization persisted after returning to full-capacity growth, as large income falls forced the poor to adopt unsustainable survival strategies.

### Elements of pro-poor macroeconomics

It is difficult to determine *ex ante* which macroeconomic policies are most suitable for the poor or for society as a whole, as these will depend on a long list of local conditions, including whether the poor work in the traded or non-traded sector, the country has a rigid or elastic supply of wage goods, the government plays an important role in the economy, the size of the foreign debt, the nature of domestic institutions, the efficiency of markets, and so on. Thus, the best solutions can only be country specific. Yet some broad principles apply fairly generally. At a general level, a PPM policy is characterized by policies of crisis avoidance and maintenance of a reasonable macroeconomic balance. However, macro stability appears increasingly insufficient to ensure long-term growth, let alone long-term PPG. The experience of the 1990s shows that growth will not materialize if macro stability is not accompanied by: (i) a competitive and stable real exchange rate encouraging investments in the labour-intensive tradable sector; (ii) low-to-moderate real interest rates; (iii) strong institutions for the regulation of the financial and banking sector; (iv) measures to speed up the accumulation of capital by linking, as in Malaysia, the macroeconomic policy to development policy; (v) trade liberalization that avoids a collapse of the import-competing sectors, while quickly removing any anti-export sector bias; and (vi) preservation of adequate pro-poor and pro-growth public expenditure during stabilization.

### Measures to prevent macroeconomic crises

In an increasingly unstable world economy, the first task of PPM is to adopt measures that reduce the risk of macro shocks. Key choices in this regard include the following measures.

#### *Limit foreign indebtedness and mobilize domestic savings*

The liberalization of the current account offers an opportunity to access a global pool of savings. However, as noted earlier, this entails several risks. Thus, the

recourse to foreign resources should be selective – for example, for the traded sector – while countries with large foreign debt should aim at gradually reducing it, as done for instance in Chile, where the stock of foreign public debt fell from 39 per cent to 13 per cent of GDP between 1990 and 2004 (see Chapter 10).

In Chapter 5, Weller argues that capital accumulation should be funded through a mobilization of domestic resources to be achieved through the strengthening of indigenous financial institutions. This can be achieved by providing them with infrastructural support, tax-free status and public guarantees for loans, or by relying on existing postal office networks. Or, as argued in Chapter 9 by Jomo and Wee in the case of Malaysia, by ensuring a low level of inflation, imposing mandatory savings through the Employee Provident Fund and tightening consumption credit. Following a mixture of such policies, China was able to raise its investment rate to 32–44 per cent of GDP, with FDI accounting for only 5 per cent and domestic savings for the rest. In recent years, Chile was also able to increase its national savings and investment rate (see Chapter 10). In the same vein, the empirical evidence shows that open economies with larger domestic banking systems have smaller portfolio inflows than those with smaller domestic banking systems. A policy of moderate financial restraint (see above) could also be used to raise domestic savings. And, finally, public savings can be raised to finance infrastructural development and safety nets by increasing tax pressure as done in China in 2000–04, where revenue rose from 15 per cent to 20 per cent of GDP. This approach is recommended in particular in the 60 or so developing countries with tax/GDP ratios below 10–12 per cent.

#### *Controlling capital inflows and harnessing their sectoral allocation*

PPM should delay capital account liberalization in countries with large budget deficits and weak regulatory capacity. Once these conditions are met, the policy maker ought to treat different types of inflows differently. In countries with a large labour supply, an opening to FDI in manufacturing is likely to be favourable to the poor. In Malaysia, for instance, the government succeeded in attracting FDI to priority manufacturing sectors, while, as argued by Bundoo in Chapter 8, Mauritius attracted significant levels of FDI to the export processing zone, a sector that became critical in terms of employment and export earnings. The benefits to the host country increase further if national regulations make the FDI inflow conditional to the establishment of joint ventures that facilitate technology transfers, require the hiring of national engineers and managers and require a minimum local content of intermediate inputs.

Even when stable macroeconomic conditions and appropriate regulatory institutions are in place, a country should be free to impose controls on capital flows if they become a danger to economic stability. As noted by Weller in Chapter 5, countries can impose minimum stay requirements or impose international capital transactions taxes on inflows varying with the asset maturity, as was done in Chile between June 1991 and March 2000. In turn, the central bank can limit the foreign exchange exposure of domestic banks, forbid them to borrow internationally to extend loans to the non-tradable sector and introduce temporary or permanent

administrative controls on inflows and outflows, as done in Colombia, India, Malaysia, Singapore and Taiwan. As noted by Jomo and Wee in Chapter 9, between January and August 1994, the Malaysian authorities subjected bank funds to stricter reserve and liquidity requirements, imposed limits on non-trade-related foreign indebtedness of domestic banks and restricted the sale of short-term monetary instruments to non-residents. In turn, following the exodus of funds during the East Asian financial crisis, strict controls were imposed on short-term outflows by banning offshore ringgit trading, restricting ringgit exports and imports, limiting ringgit loans to non-residents and compelling non-residents to retain their investments in Malaysia for at least 12 months.

A key issue in this regard is the duration of the controls. The IMF supports the introduction of temporary controls during crisis periods, but countries may consider extending such measures as long as they are needed, as in the case of China. The example of India also illustrates the possibility for an emerging economy to attract foreign capital amid continued, if slowly declining, capital controls, without being subject to sharp and potentially destabilizing capital inflows.

Capital controls are not easily implemented, especially in countries with limited administrative capacity. Helleiner (1997) and Chapter 5 of this volume suggest that their effectiveness is influenced by the administrative capacity of the country, that controls cannot replace sound macroeconomic policies, that no single measure can be effective everywhere, that controls slow down the flow of capitals but do not eliminate it completely and that controls can be circumvented. Others underscore that countries that adopted controls, such as Chile and India, abandoned them at a later stage. Altogether, it would appear that while capital controls are unable to stop all inflows and outflows, they could – in conjunction with other measures – constitute a deterrent against massive shifts in financial assets. A related key issue is to understand what domestic institutions and regulations permit channelling financial flows to the traded sector. The experience of Malaysia and Mauritius shows that appropriate incentives can attract FDI toward labour-intensive manufacturing. In turn, the central bank can forbid domestic banks to borrow abroad to invest in the non-traded sector, limit foreign ownership in sectors such as real estate, require commercial banks to allocate a share of their lending to the agricultural sector and SMEs (see Chapters 9 and 11) and set up loan guarantees to these sectors.

Policy makers can also apply measures to offset the monetary effects of the inflows. Such measures include asking state-controlled financial institutions to switch their deposits from the commercial banks to the central bank, sterilizing the capital inflows, increasing the reserve ratio of commercial banks with large foreign deposits, substituting foreign with domestic borrowing whenever the interest differential is not excessive and encouraging domestic institutions such as pension funds to invest part of their assets abroad.

#### *Choosing a pro-poor exchange rate regime*

Such a regime should minimize the risk of currency crises, and at the same time provide adequate incentives to the expansion of the traded sector where the

majority of the poor is often employed. This means rejecting the view about the superiority of two 'corner solutions' over intermediate regimes. Indeed, in theory and practice, neither of these two approaches performs better in terms of growth and crises avoidance than the intermediate regimes. Though it is difficult to generalize, particularly in developing countries that need to grow to reduce poverty but can count only on narrow domestic markets to sell their output, an intermediate regime aiming at credibly stabilizing the real exchange rate and its expectations is the best option. For example, it is possible to adopt an intermediate exchange rate of the BBC (basket, band and crawl) type, fix its central parity at a competitive level – equal, say, to 70 per cent of the purchasing power parity exchange rate – allow it to fluctuate within a given band to neutralize small shocks and devalue the central parity in case of large inflation differentials with the basket reference countries, so as to leave the real exchange rate unaltered. Empirical research has shown that a competitive exchange rate has been a key factor to kick-start growth (Rodrik 2003) and improve long-term performance.

However, this approach leads to a slower decline of inflation, and needs to be supported by moderately expansionary fiscal and monetary policies and measures that limit capital inflows. In addition, this approach may not fit the needs of countries where the poor are located in the non-traded sector, where the traded sector is skilled labour intensive – as in most mining economies and industrialized countries – or where the poor are located in the traded sector, but structural factors reduce the pass-through of the benefits of devaluation. Also, in very small economies with highly volatile terms of trade and difficulties in diversifying their exports, dollarization may be an option. Finally, in large developing economies with comparatively low trade/GDP ratios, a competitive exchange rate is less important for growth and poverty alleviation. These objectives can be better pursued through an expansion of the domestic components of aggregate demand driven by fiscal policy (Bhaduri 2005).

#### *Stabilization funds and contingency rules*

In many developing countries, government revenues oscillate widely because of large fluctuations in the demand and prices of the commodities they export and climatic shocks. Capital markets behave pro-cyclically and so reduce the possibility of stabilizing consumption in bad years. All this leads to large public expenditure cuts that exacerbate the impact of the shocks on poverty, investments and growth through Keynesian multiplier effects.

In this type of country, PPM can try to limit the impact of shocks by creating stabilization funds that set aside resources during periods of high demand and prices of the exported commodities and release them in crisis years. During the boom years, such a policy helps to reduce the inflationary pressures arising from the non-traded sector, while in case of crisis the release of funds to the state budget sustains aggregate consumption. As discussed in Chapters 2 and 10, stabilization funds have helped to smooth public expenditure fluctuations in Chile, Norway and Venezuela.

An essential requirement for the smooth functioning of stabilization funds is that the rules that regulate their functioning – how much and when it needs to be

set aside, in which assets to invest the fund's resources, under what circumstances to release such funds, and so on – are set *ex ante* by law and are not left to the discretionary decisions of policy makers. A second requirement is that the price of the commodity does not follow a random walk without mean reversion, as this would exhaust the fund resources in just a few years. Thirdly, to have an impact, the funds must count on large endowments generated by a commodity for which there is substantial demand in world markets during normal times, as in the case of copper and petroleum. For developing countries that export less valuable commodities, stabilization funds are out of reach. Fourthly, the rainy days must come late and not early. Finally, as argued by Reddy in Chapter 7, in order for stabilization funds to be protected from risks and be readily available for use they have to be kept in a safe and liquid form, yielding in this way limited returns. For this reason, a diversion of resources from the satisfaction of present needs to the fund is likely to be suboptimal in poor countries with a high social discount rate.

Another solution to the problems posed by the instability of public revenue is the adoption *ex ante* of contingency rules that establish, in case of unanticipated shocks, that governments are not bound by the usual fiscal targets and are free to increase public expenditure, raise taxes or allow for a widening of the deficit. Such measures provide credibility and transparency to an expansionary fiscal stance in countries where automatic stabilizers are weak and discretionary anti-cyclical fiscal policies are often looked upon with suspicion by the markets and the IMF.

#### *International safety nets*

As noted by Reddy in Chapter 7, in recent decades, a few international mechanisms were created to deal with exogenous shocks affecting developing countries. The IMF used the Compensatory Financing Facility to offer financing in case of declines in export earnings or rises in cereal import costs. This facility was replaced at a later stage by the Poverty Reduction and Growth Facility (IMF 2003). A second market-based approach, which was later abandoned, was based on international buffer stocks aiming at stabilizing commodity prices. In addition, the Lome Convention established aid-based mechanisms, including the STABEX and FLEX funds, to stabilize the export earnings for certain commodities and countries. Yet these mechanisms offer limited protection against global shocks and are mostly loan based.

New approaches to be explored by PPM include insurance-based, aid-based and international tax-based global mechanisms. Included among the first group are catastrophe bonds, weather derivatives, commodity-indexed bonds or other derivatives contracts that transfer a given risk to others in exchange for an initial payment. In principle, these contracts could be extended to cover the risk of financial shocks. Yet such contracts are costly, carry a high default risk and create moral hazard in case of external shock due to the improper behaviour of international economic agents. Yet in Chapter 7 Reddy notes that this problem could be solved if an international public intermediary financed the derivative contracts covering against the risk of external shocks.

A second approach emphasizes the possibility that insurance against global risks is built into systems of aid provision that explicitly counteract adverse cyclical

shocks of international origin. One example could be a global contingency fund, financed in advance by donors, providing additional resources to countries affected by severe shocks. Present proposals in this area cover natural disasters, but could be extended to macro shocks. A third mechanism could be based on the institution of earmarked international taxes on activities that cause global negative externalities, such as short-term portfolio flows and carbon emissions. Such taxes would generate the double benefit of reducing the activities that cause the externalities, while at the same time making resources available to deal with their consequences (Atkinson 2005). Such an approach has the advantage of recognizing the causal role played by countries in creating adverse shocks that are experienced by other countries.

### **Managing macroeconomic crises in a pro-poor mode**

If successfully implemented, the measures discussed above should reduce the frequency of macroeconomic crises, but will not be able to eliminate them entirely. Thus, PPM must also develop broad principles to manage crises in ways that control macro imbalances, while avoiding surges in poverty. A first step in this regard is to formally introduce a poverty target into macroeconomic stabilization models along the lines suggested by Chand in Chapter 3. Setting an explicit poverty target helps identify trade-offs between stabilization and poverty targets, measure the 'sacrifice ratio' of alternative approaches and determine the amount of international assistance or the nature of alternative policies that could ensure consistency between stabilization and poverty objectives.

#### *Exchange rate-based versus money-based adjustment*

This choice depends on a host of factors, and clearly there is no 'one-size-fits-all' solution. However, as argued in Chapter 4, in economies with a price-elastic supply of tradable goods, a moderate foreign debt and rigid wages and utility rates, a controlled devaluation of the exchange rate, accompanied by fiscal expansion, low interest rates, a rapid reorganization of banks in the wake of the shock and, if needed, capital and import controls may help re-establish balance-of-payments equilibrium more quickly and with smaller output and employment losses than following a monetarist approach that causes a contraction in the domestic components of aggregate demand, while being unable to raise exports. As noted by Jomo and Wee in Chapter 9, Malaysia initially responded to the financial crisis of 1997–1998 by adopting a contractionary approach, but then opted to increase spending and pegged its devalued currency to the US dollar, containing in this way the rise of unemployment and poverty. However, conscious of the possible short-term contractionary and inflationary effects of devaluation, governments ought to set up employment-based safety nets and subsidize key consumption items.

Such an approach may be less likely to succeed in economies where the traditional export is capital intensive and the new exports are more land intensive than labour intensive, or where labour demand is biased towards skilled labour. Problems can also arise in countries with an inelastic supply of exports, a high share of imports on exports and rigidities that make devaluation contractionary

(Krugman and Taylor 1978). Devaluation may also be resisted in countries where banks, firms and governments have large unhedged short-term foreign currency exposures.

It is also likely that the devaluation raises inflation-induced poverty, especially among the low-income net food buyers in the urban and rural sector. This conclusion, however, needs to be juxtaposed with the costs of an output contraction induced by the monetarist approach. While devaluation-induced inflation affects the poor disproportionately, they might be hit even harder by a fall in GDP and employment induced by the adoption of a monetarist adjustment. In both approaches, the rise in poverty will also depend on the safety nets in place. Their extent may be more limited, however, in the case of the fiscal retrenchment typical of the monetary approach.

#### *Fiscal policy, deficit size and pace of deficit reduction*

As noted by Jha in Chapter 2, in many developing countries, budget deficits result not so much from excessive expenditures, as from extremely low and falling tax/GDP ratios.<sup>5</sup> In such countries, a strengthening of the tax/GDP ratios and the retrenchment of non-productive expenditures during normal times would widen the scope for conducting a counter-cyclical fiscal policy in crisis years.

During crisis periods, the fiscal policy of industrialized countries allows an expansion of the deficit. This occurs automatically owing to the working of the automatic stabilizers and through a discretionary fiscal expansion. In developing countries, the widening of the deficit is not generally due to an increase of public expenditure – as automatic stabilizers are weak or non-existent – but to sharp falls in revenue due to high tax buoyancy.<sup>6</sup> Countries endowed with stabilization funds can moderate this impact but, as noted, this option is not available to all. Under such circumstances, a temporary rise in the deficit maintains aggregate demand at an acceptable level and limits the impact of shocks on output and poverty. However, until recently, the IMF has demanded crisis-affected countries to quickly reduce the deficit, with yearly cuts of 3–4 per cent of GDP. Such a policy generates several negative effects. The most obvious is a fall in aggregate demand, output and employment and a rise in poverty and inequality. In addition, large cuts affect the deficit itself, as tax revenue is endogenously determined by the level of output. Hence, an attempt at rapidly reducing the budget deficit could lead to its increase, demanding in this way the imposition of further restrictive measures. This partly explains the disappointing performance of IMF programmes in reducing fiscal deficits and the persistence of fiscal stress in countries undergoing adjustment.

As mentioned, contingency rules can establish that, in the case of external shocks, governments are not bound by the usual fiscal targets and are free to sustain spending levels, increase taxes or allow a widening of the deficit. A key issue is the choice of a sustainable deficit under crisis situations and of its subsequent pace of reduction. In this regard, the IMF argues that an optimal fiscal deficit should be sustainable over the next five to 10 years, but in determining this it assumes the rate of growth, fiscal revenue and interest rates as exogenous, while – as shown above – such variables and the deficit are jointly determined. Nor can

the case for quick deficit reductions be argued on the basis that temporary deficits are costly, as there is no convincing evidence in this regard (see above). In contrast, there is evidence that large and rapid fiscal cuts reduce growth over the short and long term and can cause irreversible declines in the well-being of the poor. So, while large deficits certainly need to be reduced over time, this should be done gradually. As suggested by Adam and Bevan (2001), deficit reductions of up to 1.5 per cent of GDP per year help to re-establish fiscal balance with a minimal impact on growth, but larger reductions actually hurt growth.

*How to achieve a given target deficit?*

Relation (1.1) below suggests that there are several strategies to reduce the budget deficit ( $BD$ ) as a percentage of GDP ( $Y$ ). It is possible to act alternatively on the primary public expenditure ( $PPE$ ), taxes ( $T$ ), non-tax revenue ( $NTR$ ), foreign aid ( $FA$ ), interest rate on the domestic debt ( $r$ ) and foreign debt ( $r'$ ), national and foreign public debt ( $NPD$  and  $FPD$ ), exchange rate ( $E$ ) and expansion of the monetary base ( $\Delta H$ ). Each of these strategies affects the deficit and poverty both directly and indirectly via the relations linking the variables on the right hand side of equation (1.1)

$$BD_t/Y_t = PPE_t/Y_t - (T_t + NTR_t + FA_t)/Y_t + (r - g)NPD_{t-1}/Y_t + (r' - g)E_t FPD_{t-1}/Y_t - \Delta H/P_t Y_t \quad (1.1)$$

In Chapter 2 Jha notes that the IMF deficit reduction strategies generally focus on reducing  $PPE$ . While cutting unproductive expenditures is certainly desirable, if the cuts are marked, aggregate demand and GDP will fall, and public opposition may derail the entire stabilization effort. Secondly, if the cuts affect pro-growth expenditure,  $g$  (the growth rate of GDP) may fall and the long-term deficit rise. Thirdly, given the asymmetric distribution of lobbying power, large spending cuts hurt the poor more than the rich.

The fiscal deficit can also be reduced by raising  $T$  and  $NTR$ , a policy seldom implemented in IMF-supported programmes, even in countries with low initial tax/GDP ratios. The macroeconomic impact of rising taxation is less contractionary than that of cutting public expenditure, as governments have a lower propensity to save than households or enterprises. Taxation may also help redistribution, especially in countries with low tax/GDP ratios. Foreign aid ( $FA$ ) in the form of international safety nets, such as those discussed above, can also help stabilize the budget and the balance of payments and, if well targeted on pro-poor programmes, reduce the social impact of the initial shock. Yet, so far donors' discretion continues to dominate aid granting. Perhaps greater trade and financial liberalization – a frequent source of exogenous shocks – should be made conditional on the creation of international safety nets.

In addition to stimulating growth, a lowering of the domestic interest rate ( $r$ ) would also diminish the cost of servicing the public debt, thus reducing the need to cut pro-poor and pro-growth expenditures. In view of the high level of nominal

and real interest rates in many countries (see, for instance, Chapter 14 on Brazil), such a measure would generate considerable 'fiscal space'. Yet to be effective, such a measure needs to be accompanied by the imposition of controls on capital outflows as, in the absence of such a measure, the domestic asset holders might move their funds abroad, thus weakening the exchange rate ( $E$ ) and so raising the international interest rates ( $r'$ ) with the result of raising the domestic currency cost of servicing the foreign debt ( $FPD$ ).

A controlled expansion of the monetary base ( $\Delta H$ ), leading to a less than proportional increase in prices ( $P$ ), can also create fiscal space and help reduce the deficit, though this is more likely to occur if a country has considerable unutilized capacity. As argued in Agénor and Montiel (1999), resources equal to 2–3 per cent of GDP were created in this way in countries with moderate initial inflation and a controlled monetary expansion. Finally, in crisis situations, countries may be unable to service their debt. This is particularly the case for countries hit by large external shocks or facing enduring crises such as the heavily indebted poor countries. Thus, a given target deficit might be achieved through measures that reduce the stock of domestic debt ( $NPD$ ) or foreign debt ( $FPD$ ). Measures here could reduce or cancel part of the interest payment on the foreign debt ( $r'FPD$ ) or the stock of debt itself ( $FPD$ ) – along the lines of the measures cited in Chapter 7 – or introduce costless debt standstills by which the payment of principal and interests is suspended in cases of *force majeure*.

Which route to take to reach a given target deficit depends upon the initial conditions and thus varies from country to country, but there are certainly options available other than cutting public expenditure. With a low tax/GDP ratio, Bolivia and India (see Chapters 13 and 11 respectively) should raise more tax revenue. Chile, on the other hand, already has a high tax/GDP and expenditure/GDP ratio and adjustments might concentrate on the expenditure side or the lowering of interest rates.

#### *Composition of expenditure cuts and domestic safety nets*

PPM requires that under crisis situations, pro-poor and pro-growth public spending on health, education, public works, basic income support, infrastructure and key productive investments be protected or even expanded. The impact on the poor can be reduced further by focusing a growing share of public expenditure within each of the above sectors on programmes with low administrative costs and high intrinsic efficiency, such as child immunization, elementary education and the rehabilitation of transport infrastructure. In the budget process, such objectives can be promoted by earmarking the revenue of certain taxes to essential programmes or by establishing by law transparent priorities. Such an approach has been applied in 1990–1992 in Chile when an expansion of social programmes focused almost exclusively on services for the poor. In addition, as argued by Solimano and Pollack in Chapter 10, monetary transfers targeted at the bottom 40 per cent of the Chilean population dampened the effects of crises on the poor, as their share in total transfers rose from 56 per cent to 73 per cent between 1987 and 2000. The cost of such safety nets need not be large. For instance, the Mexican programme *Progres*a, which

targets a whole range of interventions and benefits to about two million households, costs only 0.2 per cent of GDP and one per cent of the federal budget.

A particularly effective way to focus public subsidies on the poor are conditional transfers – that is, transfers that affect poor families if their children attend school regularly or are taken for periodic checkups at health centres. This approach provides an incentive to the poor to uptake essential services, while improving their consumption capacity. Another specific measure needed to contain the rise in poverty during crisis and adjustment periods consists of ensuring that food prices, which constitute the main component of the poverty line, do not rise unduly. This objective can be achieved by setting up public distribution networks, adopting anti-speculation measures or introducing food subsidies financed by taxing windfall earnings on foreign exchange assets during adjustment periods.

#### *Pace of stabilization and optimal adjustment path of the poor*

The case for adopting a gradual adjustment programme and/or instituting compensatory safety nets for the poor acquires particular relevance when taking into account the differences in social discount rates of the main social groups. Indeed, the poor have a higher social discount rate than the middle class or the rich, and therefore prefer an adjustment path that scatters the adjustment burden over a longer period of time, even if this entails greater inter-temporal welfare costs both for themselves and for society as a whole. For them, an approach – such as that entailed by a successful hard peg – that entails a less pronounced initial contraction and larger distant losses, to which they attach lower values due to their higher discount rate, may be preferable to the smaller but frontloaded losses associated to real devaluation (Lustig 2000).<sup>7</sup> Thus, a more gradual approach maximizes the net present value of the income streams of the poor over the entire adjustment period, making use of their specific social discount rate. A PPM would thus choose a slower approach, even if this is suboptimal from an aggregate perspective. The best solution, however, consists of adopting the overall optimal adjustment path, while compensating the poor with transfers equal to the drop in their income caused by the choice of a devaluation-based adjustment approach.

#### *Inflation targeting and monetary policy*

The orthodox view is that inflation is costly as it changes relative prices – and so reduces the informational power of the price system, erodes profits and wages, raises uncertainty and discourages investments, and has the greatest impact on the poor. Secondly, high inflation can have perverse monetary effects: it reduces real money supply and raises the interest rate, induces a contraction of output and a fall in tax revenue and, in extreme cases, leads to currency substitution and dollarization. Thirdly, if the capital account is open, even comparatively small inflation differentials may cause capital flights. For all of these reasons, the standard prescription is to aim at single-digit rates of inflation through raises in interest rates and credit restrictions.

Yet a PPM focusing on reducing inflation must also take into account other considerations. To start with, Bruno and Easterly (1998) and Stiglitz (1998) show

that driving inflation below 40 per cent per year produces no discernible economic benefits, though it might affect poverty favourably. Secondly, as argued above, a rapid reduction of inflation is likely to cause a contraction in GDP and – because of the endogeneity of tax revenue to GDP – a widening of the fiscal deficit. In addition, as noted in Chapter 10 on Chile, a policy of high interest rates increases the concentration of financial wealth in the hands of the holders of financial assets. Furthermore, given the limited internal cashflow of firms in developing countries, the low elasticity of their demand for money in relation to the interest rate and the mark-up price formation mechanism dominant in these countries, a rise in interest rates has the effect of raising production costs and prices. Thirdly, reducing inflation to single digits requires sharp recessions that disproportionately affect the poor. These points are now recognized by the IMF Institute, which argues that while the optimal inflation is 2 per cent to 3 per cent per year in industrialized countries, it is 10 per cent to 15 per cent in developing countries.

A PPM will thus adopt less ambitious inflation targets, and aim at their gradual reduction over time. This means that while real interest rates will aim at the 3 to 5 per cent range, the nominal rates ought to increase less markedly than in the standard approach. This policy should help to contain cost-push inflation, and at the same time avoid a contraction in investment and growth that would negatively affect employment and poverty. While the money supply compatible with this approach needs to be accommodating, the policy maker should simultaneously introduce microeconomic reforms to reduce other components of cost-push inflation. Finally, credit policy should aim at eliminating the segmentation of the credit market that reduces access to credit by SMEs.

## **Conclusions and limitations of pro-poor macroeconomics**

A first finding of this study is that the World Bank (1990) poverty alleviation strategy based on growth, investments in the human capital of the poor and safety nets for those left behind has failed to ensure a rapid decline in poverty. As noted in the case studies on Bolivia, Chile and India, this approach did not explicitly promote the productive activities of the poor or address the large inequality problems permeating these countries at the beginning of the reforms. For instance, the *Concertación* governments in power in Chile since 1990 focused on poverty reduction, but did not set any target for the redistribution of income and assets, despite a wealth of evidence that high levels of inequality negatively affects growth and poverty alleviation. The neglect of high levels of inequality possibly explains the suboptimal results obtained in this country in terms of poverty alleviation and worsening of the distribution of market income during the 1990s. In contrast, the highly egalitarian conditions prevailing at the beginning of the reforms in China facilitated growth and poverty reduction.

A second finding is that while some basic economic principles – incentives, certainty of property rights, reasonable macro balances, and so on – were followed in all successful countries analysed in this volume, the way these objectives were

pursued by national macroeconomic policies varied substantially depending on the structural and institutional conditions of each country. In China and Malaysia, for instance, rapid poverty alleviation, moderate inequality, market competition and secure property rights were achieved under conditions of strong state presence in manufacturing, state control over financial institutions, a managed exchange rate and a controlled capital account.

Thirdly, this volume shows that several obstacles to PPG cannot be removed by macroeconomic policy. To start with, PPM cannot produce all of its beneficial effects if deep-seated inequalities in the distribution of asset, credit, opportunities and human capital are not removed or, as argued in Chapter 12 on Uzbekistan, if inequality rises because of the development approach that is followed. Chapter 14 shows that in highly unequal Brazil, poverty is more responsive to a fall in inequality than to an acceleration in growth induced by good macroeconomic policies, as the poverty reduction effect of growth is much lower when the initial inequality is high. Thus, PPM cannot wait for poverty to be reduced by the positive distributional consequences of better macro policies that might take time to materialize.

The impact of PPM is also limited in economies with a large subsistence and informal sector that is only loosely integrated in the economic mainstream and is located in rural and mountainous areas, marginal urban areas, small towns and remote regions. In Brazil and Chile, the main problems faced by the poor in the informal sector are a lack of education and poor integration with modern sector activities; in Bolivia, geographical isolation is an additional factor. Indeed, such a subsistence or informal sector is weakly influenced by changes in macro signals. There is a need, therefore, to better integrate such sectors into the overall economy, while avoiding the instability that could be associated with growing economic integration. Public expenditure policies can do a lot to achieve this goal by developing public infrastructure in the fields of transport, communications and energy, although this effort will take several years and considerable resources to bear fruit. A proactive tax and incentive policy is obviously needed to improve such integration and – as in the case of Malaysia and Mauritius – to mobilize investments for absorbing the migrants from the subsistence sector to the modern sector.

PPM is also much more difficult to implement in small, dependent and undifferentiated developing economies with exogenous terms of trade and a high reliance on the exports of few primary commodities. As seen in Chapter 13 on Bolivia, such structural weaknesses and the limited scope for diversifying the export basket severely limit the scope for conducting PPM. To become more effective, PPM requires microeconomic changes in the goods, labour, credit and insurance markets that permit a diversification of the production structure, as observed in Mauritius. In economies with deeply segmented credit and goods markets, for instance, the poor do not benefit from lowering interest rates or devaluation to start new activities. Under such circumstances, sound macroeconomic policies alone are not enough. A promising approach – which could not be explored in detail in this volume – would be co-ordinating macro with micro policies that simultaneously

attack the structural determinants of poverty, combining, for instance, a removal of market imperfections with pro-poor macro policies such as those illustrated above. Finally, PPM would benefit from strengthening institutions, governance and administrative capacity. Problems in these areas often reduce the impact of potentially useful pro-poor policies aiming at the mobilization of domestic resources, capital controls, decentralization, and so on.

## Notes

- 1 The author would like to thank Yilmaz Akyuz, Stephan Klasen, Gerry Helleiner and José Antonio Ocampo for discussions and comments on earlier drafts of this chapter. The usual disclaimers apply.
- 2 There is broad agreement that investments in health, education, child nutrition, gender balance and empowerment of the poor improve well-being, generate high returns, reduce inequality and contribute to macroeconomic stability. The main elements of pro-poor structural policies such as human and physical capital accumulation, technology transfer, land reform, agricultural growth, microcredit and insurance are also agreed by scholars of different schools of thought. Thus, *ex ante* interventions that improve the functioning of markets and public institutions are likely to enhance the poverty impact of macro policies. For instance, devaluation has a greater impact on poverty in a country with more egalitarian agrarian structures and flexible labour markets than in the case of *latifundia* and rigid labour markets. Differences persist in other areas – such as the extent of industrial policy – and, within some of these areas, on the way in which the agreed policy objectives should be pursued. For instance, some authors suggest that the threat of expropriation is an unavoidable component of a land reform, while others favour an approach based on the willing-buyer-willing-seller basis. For a review of the main areas of agreement and disagreement, see Klasen (2004).
- 3 Where asymmetric information prevails and the level of domestic savings is suboptimal – as in many developing countries – maintaining real interest rates on deposits at positive but below the market-clearing level and limiting entry by the domestic and foreign banks generates a moderate amount of rents for banks that are encouraged to expand efforts at mobilizing deposits and monitoring their borrowers. Such a policy was widely pursued in East Asian countries in the earlier phase of their development.
- 4 All countries that achieved rapid growth and poverty reduction over the long term experienced an increase in land yields, agricultural growth and farm and rural non-farm incomes during the take-off phase of their growth. The experience of China in 1978–84 and India in the 1980s confirms this rule, which was verified in the East Asian Tigers and elsewhere.
- 5 Chapter 2 demonstrates that unweighted average tax/GDP ratios of 13 emerging economies shows a downward trend between 1985 and 1999, while a recent panel study by Chu *et al.* (2004) points to an average drop of one percentage point in the tax/GDP ratio during the 1980s–1990s period, as opposed to a rise of 1.6 points between the 1970s and 1980s.
- 6 Lustig (2000) indicates that a one per cent drop in GDP causes a revenue decline of 1.8 per cent in the Organization for Economic Co-operation and Development countries, but of 5.8 per cent in Latin American countries.
- 7 This conclusion may change, however, if the discount rate is lowered by the development of credit and insurance markets, which allow them to sustain their consumption during a sharp adjustment spell.

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