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## Introduction:

# Economic Policies in Support of MDGs and Poverty Reduction

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In 2000 189 countries committed to the Millennium Development Goals, which called for cutting world poverty in half by 2015. With business as usual, however, we have little hope of achieving most of the Millennium goals, no matter how much money rich countries contribute to poor ones.

(Polak 2005, p. 64)

The purpose of the RBA Regional Project on Economic Policies in Support of MDGs and Poverty Reduction is to develop a coherent set of analytically sound policies, based in country experience, which would make the achievement of the Millennium Development Goals a realistic probability in most, if not all, countries of the sub-Saharan region. The focus of this book is macroeconomic and adjustment policies. The identification of such policies builds on a large body of research arising from the UNDP's Asia-Pacific Regional Programme on the Macroeconomics of Poverty Reduction, and seeks to combine what is relevant from that programme with the research arising from the programme on Africa.

While poverty reducing policies must have a sound theoretic basis, ensuring this is of little help if the policies cannot be effectively implemented, and have the intended effect. Evaluating the feasibility of implementation and likelihood of a successful impact requires detailed knowledge of each country, for the economies of the region are far from homogeneous. Not only does one size not fit all, it may be that even specifying a set of generic sizes would not be sufficient. It may be that in important aspects the macroeconomic framework and the structural policies that would make the MDGs achievable vary for each country. If this is the case, and it probably is, this book can do no more than identify a broad framework which provides a guide to a set of effective pro-poor policies. The generic chapters identify a broad framework which provides guides to a set of effective pro-poor policies, while the country chapters identify specific pro-poor policy choices.

Expansionary macroeconomic policies can be used to achieve an economy's sustainable growth rate. But this would be a necessary, but not a sufficient condition for achieving the MDGs for most sub-Saharan countries. First, slow growth over the last two decades suggests that for perhaps a majority of the countries the sustainable growth rate is relatively low. Second, growth has been slow or negative, with little or no progress made since the MDGs were announced. The key to achieving the international development targets is a growth path characterized by distributional equality. Orthodox policies over the last two decades have relied on deregulation and non-intervention to achieve growth rates. The growth increment, within this

framework, has been considered costless. Raising the sustainable rate of growth is not, however, without tradeoffs. It emanates from increased investment, which implies a relative reduction in consumption in any time period.

Chapter 2 presents the theoretical framework which is the technical basis for analyzing pro-poor policies. The Chapter begins by defining pro-poor growth: growth is pro-poor when the poor, however defined, receive a larger portion of the annual growth increment than their initial income share. Conventionally when growth raises the income of the poor it is said 'growth is good for the poor.' Our definition, however, implies that growth must directly improve the distribution of income, which is not encapsulated in the trickle-down approach to growth and development.

### **1.1 Macroeconomic Policies for Poverty Reduction**

A macro policy is pro-poor when it also raises the growth rate well above the rate of population increase; substantially reduce the variability of growth; and foster a more equitable growth path. These have not been achieved in the last two decades mainly because macro policy relied too much on restrictive fiscal policy and contractionary monetary policy. However, as Chapter 3 rigorously demonstrates, restrictive fiscal policy can be converted to an expansionary one through an employment-intensive public investment programme, financed by increased resources mobilization both domestic and international.

During the stabilization and structural adjustment periods too much emphasis has been placed on deficit reduction. This has necessitated stringent fiscal policy, which had typically a pro-cyclical impact. It is surprising to note that, in the least developed countries, there is evidence that moderate deficits are not closely correlated with inflation. Numerous studies have also found that the impact of inflation on growth is not conclusive. It has always been assumed that inflation is equal to the rate of monetary expansion. Yet, if income is increasing and the demand to hold money is rising concurrently, a portion of the money supply will be non-inflationary (Thirlwall 1974). Empirically, negative impact of inflation only sets in above inflation rate of 15 percent and some cases the threshold reaches 40 percent (Bruno and Easterly 1996). Stiglitz (1998) also stresses that it is hyperinflation that policy makers should worry about. In fact, an inflation rate of 40 percent can be taken as a norm. Financial conservatism should not be the same as 'anti-deficit and anti-inflation radicalism' and balanced budget does not mean zero inflation (Sen 1998). The absolute inflation figure tells not much and the Non-Accelerating Inflationary Rate of Unemployment (NAIRU), even in the developed economies, was not achieved (Phelps 1993 and Bruno 1995).

In addition to deflationary policies, a practical constraint to counter-cyclical fiscal policy has been balance of payments pressure. However, there is a room for expansionary fiscal policy if policy makers maintain control over the currency conversion of development assistance. Currency reserves can be used to support the balance of payments in contractionary periods, while fiscal policy is used for counter-cyclical purposes in the Keynesian sense. What we have seen in the last decades is pro-cyclical-cum-contractionary fiscal policy to the detriment of the growth potential in many countries of the sub-Saharan region. As Chapter 3 shows, using fiscal policy for fostering growth goes beyond simply increasing expenditure. A growth-fostering

*pro-poor* fiscal policy package requires a particular type of public expenditure: public investment, which is aimed at demand expansion, supply enhancement, and redistribution.

If inflationary pressures are weak and the relationship between growth and inflation is not certain, low interest rate and an expanding monetary supply are not radical suggestions. When inflationary pressures are paramount, then it should be monetary policy that must be used to counter them. In both cases, inflation targeting has a limited applicability for the sub-Saharan region mainly because it is contractionary and anti-poor. The structural characteristics of sub-Saharan countries make targeting of a monetary variable a complex policy objective. Real targeting makes much more sense where macroeconomic policies are judged against their poverty impact. Hence a pro-poor monetary policy requires low real interest rates, a tolerance for moderate inflation rates, and an expansion of the money supply that accommodates growth and financial deepening. To achieve these outcomes, it is probably the case that it would be more pro-poor to finance prudent fiscal deficits by monetization than by bond sales, which redistributes income to high-income groups.

The appropriate pro-poor exchange rate regime is the 'crawling peg'. Under this regime policy makers pursue managed nominal devaluations. This regime is more realistic compared to the flexible exchange rate based on the view that economies have a unique, market-determined exchange rate which strikes the correct balance between tradables and non-tradables. A substantial portion of a country's foreign exchange flows may not be market related (development assistance and debt service, for instance), so that the so-called market rate would not reflect the appropriate relative price of tradables even in theory.

The practical purpose of devaluation is to lower the foreign currency price of a country's exports. If the inflationary effect of the devaluation is contained, the purpose should be achieved in the short run. However, if the trading regime is a liberal one, as in most sub-Saharan countries, the domestic currency price of exportables will slowly approach the international price. Because of the lag in the price adjustment, periodic nominal devaluations can maintain a wedge between the export price and the world price. In the current imperfect world, governments in sub-Saharan countries have little choice but to pursue an exchange rate policy that fundamentally represents a regime of under-cutting its regional neighbours, who export many of the same commodities. In the long term this problem may be reduced by export diversification. In the short and medium term one must frankly concede the likelihood of 'fallacy of composition' effects from any exchange rate policy, even one that is part of a pro-poor macro policy.

The analytical work on pro-poor growth leads us to identifying a 'Fiscal space'. It is the potential for expenditure expansion through fiscal and monetary policies, which recognizes the constraint on a pro-poor macro policy. There are four ways to generate fiscal space: raising the revenue share in GDP; increasing the fiscal deficit; benefiting from debt relief; and receiving a higher level of development assistance. Domestic resource mobilization is perhaps the most difficult in the short to medium term, which often requires institutional reforms and implementation of new tax regimes. Deficits can be increased in countries where they are below a certain threshold that is not detrimental to growth. In the SSA region, average debt service

across countries was 4.5 percent of GDP in 2001. If debt relief reduced this by half, 2.4 percentage points could be gained for fiscal space. Development assistance at the 1990 level would add another 2.4 percentage points. The assistance could come on concessionary basis and with long grace periods to avoid the debt trap.

## **1.2 Adjustment Policies for Poverty Reduction**

The multilateral organizations and bilateral donors have since the early 1980s fostered and funded a specific set of policies that, in their view, would transform sub-Saharan economies to a sustainable growth path. In essence, these policies, called ‘structural adjustment’, aim to restore prices to an imaginary general equilibrium. As pointed out, this price set would eliminate putative ‘distortions’, primarily through reducing state intervention. In the financial sector interest rates must be allowed to reach ‘market clearing’ level. In the trade sector barriers must be removed to exploit comparative advantage. In the public sector enterprises need to be divested to increase efficiency and lessen the burden on public finances. However, the virtuous effects of these policies are not supported by the empirical and historical literature. Instead, a demand-driven interventionist strategy is necessary to disburse credit to poverty-sensitive sectors, target the poor through policy lending, protect local industry for employment generation and guarantee basic-services that are provided on the principle of social provision. Most relevant to an ‘unpacking’ of the ‘structural adjustment’ framework, emanating from the discussion in Chapter 4, are:

1. Targeted credit to manufacturing, export and agricultural sectors – reversing recent declines;
2. Protection of local markets and particularly manufacturing industry through careful selection, mainly to stimulate more labour-intensive growth;
3. Using restructured development banks to lend for social policy, targeting particularly the rural poor; and
4. Maintaining provision of basic services under public ownership, until minimum access to social and utility services is guaranteed.

### **1.2.1 Investment-Focused Financial Policies**

Raising interest rates to their ‘market clearing level’ may, in some cases, mobilize savings by increasing the opportunity cost of holding real assets. However, such an approach rooted in the idea of a price-constrained economy, ignores the impact of high interest rates on reducing availability of credit. In SSA, credit provided to the private sector has been falling and it is well below that achieved by other successful regions, notably East Asia. High interest rates are not necessarily market rates given that the industry is characterized by oligopolistic structures. The impact of financial liberalization is to choke off demand by reducing the amount of credit available. The region has seen declining savings and gross capital formation throughout the last two decades. Agriculture and manufacturing often receive lesser proportion of credit, while loan advances are predominantly for short-term financing of working capital in the urban sector rather than for long-term financing of investment or gross capital formation.

A policy focused on expanding micro-finance institutions to reach the poor is a commendable objective; not least because these institutions pool resources, enhance networking, recognize traditional arrangements, and target the poor, particularly

women. However, the growth and coverage of micro-finance institutions is terribly low. There is also no hard evidence on the success of micro-finance institutions in actually facilitating access to financial services. The available evidence indicates that those who have access are not the rural poor (Mosley 1999). Micro-finance alone does not make sustainable contributions to improving equitable access to financial services nor to long-term productive lending.

Although under constant threat from restructuring, liquidation and privatization; development banks can successfully carry out lending for social policy purposes. The principle of domestic policy lending has its equivalent in international policy lending practiced by the multilateral development agencies. There is no reason why the same principle should not apply within countries as it does within international development finance. The successful transition economies in Asia are moving towards the separation of policy lending from commercial lending. While the transition is country-specific, we can outline some policy choices. Learning from China, Indonesia and Vietnam, commercial banks make lending decisions based on collateral and there is only limited demand satisfied through such requirements. The unsatisfied demand is what policy should focus on. The commercial banks could use differential interest rates to channel credit for long-term private investment. The development banks could focus on special sectors and lending for social policies. Where they are successful, micro-finance institutions (MFI's) could be linked to the formal banking sector to ensure equitable access to financial services.

There is ample evidence from late industrializers that controlled financial markets proved to be developmental and redistributive (Chang 2000). Such a strategy is not anti-private sector, but recognizes the segmented nature of financial markets. Private financial institutions serve particular clients, mainly those with collateral and concentrated in industrial zones. Policy lending could target those who do not belong to these groups. Whatever revision there is of financial liberalization, it should be focused on building institutions and regulatory frameworks to avoid future crisis as those seen in Latin America and Asia. When building institutional capacity, the appropriate speed and sequencing of reforms is important; however, poverty-focused interventions, as validated by historical evidence, need to consider using interest rate ceilings to provide targeted and selective investment finance.

### **1.2.2 Economic Policies to Generate Productive Employment**

Trade liberalization is based on the idea that developing economies need imported goods and services for structural transformation. Since they possess a comparative advantage in labour-intensive production, trade barriers mean high cost of local capital inputs and resources are diverted away from labour-intensive areas. However, restrictive import licensing and exchange controls also raise unofficial trade. At the same time, bureaucrats designated to allocate foreign exchange and import licenses are prone to corruption and rent-seeking. Under this framework, liberalization benefits the poor through more competitive exports and international knowledge spill-over.

In practice, however, more than trade duties, relative price changes and world income growth are significant determinants for most of the primary commodities poor countries export. Although export duty reductions bring about increases in exports, the effect is much less than the impact of removing tariffs and other import

regulations. Trade liberalization increases the income elasticities of demand for both imports and exports, but increases the price elasticity of demand for imports more than the price elasticity of exports. Import duty reductions worsen the balance of payments; more than reduction in export duties improve it.

There is also another aspect of trade barriers that is often neglected. We find that import barriers protect the poor whereas export duties have redistributive effect. Given that dependence on primary commodity exports is associated with inequality, selective export duties and other progressive taxes, such as corporate and income taxes, may be alternative sources for financing pro-poor public investments. The impact of increased import flows has also been that manufacturing growth and employment significantly stagnated throughout the last two decades. Liberalization hurts previously protected industries resulting in deindustrialization, as imports satisfy local consumer demand. Employment creation in the sub-Saharan Region has been sluggish, with output losses in the manufacturing sector most evident.

Countries that experienced high growth, mainly ascribed to ‘openness’ did not do so through dismantling trade barriers but through harmonizing niches in international markets with domestic industrial policy. In such cases, defining property rights and clear distinctions between trade liberalization and outward-orientation have been instrumental (Rodrik 2002). Liberalization focused on simply replacing Quantitative Restrictions (QRs) with tariffs is not synonymous with outward-orientation. The latter is a strategy that exploits international market signals with the necessary complementary policies in place.

The goal of trade liberalization or export promotion must primarily be to generate earnings from the export sector to finance industrial policy for the domestic market. The findings that emerge are that African farmers and entrepreneurs are under threat both from not being able to penetrate agricultural markets in the developed world as well as severe competition from imports. Adjustment policies, mainly financial liberalization curtailed institutional credit to vital sectors – agriculture and export. Austere macroeconomic policies on the other hand, constrain expansion of public investment. The lesson is a review of wholesale liberalization and pursuing careful harmonization of trade and financial policies within a country-specific condition.

### **1.2.3 Strengthening Public Sector Provision**

Donors have made privatization one of the conditionalities for further development assistance on the basis that state ownership has severely limited output responses and public enterprises became a burden on public finances. Not only did donors impose conditionalities on privatization but demand that the process be a signal to commitment to reform – ‘lock in’ in the language of the World Bank. Thus far, thirty-seven countries in the region have divested 3,494 enterprises, which is about 40 percent of the total public enterprises. Faster and bigger privatizations are expected in the future. Fundamentally, the mainstream approach to privatization has not changed - without ownership transformation there will not be efficiency gains because governments are not able to introduce reforms that expose state enterprises to competition; they cannot access private capital markets; they are unable to attract the best managers; and they cannot protect enterprises from political interference.

Privatized firms, on the other hand, lead to efficiency measured by changes in financial viability, output, prices, quality and choice of products.

However, it is not always the case that privatization, just by change of ownership, leads to efficiency. In many reported cases, privatization was followed by high closure rates in the privatized entities, low productivity, indebtedness, loan defaults, and poor quality of services. Hasty and ill-prepared privatizations resulted in employment reduction, worsening of working conditions, bad governance, increased burden on tax payers, and high prices to consumers. The 'success' very much depends on how the post-privatization market structure unfolds. Often, privatization unfolds concentrated market structures under which pricing policies transfer income away from the poor. This is confirmed by previous privatizations of enterprises in sectors with less competition and those which are highly profitable (Campbell-White and Bhatia 1998 and Bayliss 2002a and 2002b). Today, it is common place that governments announce a bid where no bidders come forward precisely because they are left with a concentration of loss-making enterprises. In some cases, therefore, privatization results in net fiscal loss. If privatization improves the efficiency or profitability of enterprises then the share of tax on income, profits and capital gains must be higher reflecting both changes in the structure of taxes and its progressiveness. As discussed in Chapter 5, evidence for this effect is hard to come by. The contribution of privatization to public finances was not markedly different compared to the pre-privatization period.

The argument here is not whether privatization is good or bad, but inevitably the process involves transfer of property rights and wealth. This transfer must be based on guarantees that the process is transparent and most of all the poor are not excluded. The preoccupation with efficiency, the fiscal impact and governance issues, has left little room for impact assessment of the privatization process on poverty reduction. What is often forgotten is state intervention and ownership often have 'offensive' character in fulfilling development objectives through ownership of large utilities and heavy industries (Castel-Branco, Cramer and Hailu 2003). Neglecting these aspects of state-owned enterprises, particularly utility privatization has been disastrous. It is common to witness various protests and public outrage following privatization in the water and energy sectors.

The most important aspect of public sector provision is working out who the consumers are, the nature of the service, who will cover the costs and how prices are determined. In countries with low access to utilities and social services, the challenge is financing initial up-front investment costs as in setting up electric grids or building dams. Proponents of privatization argue that a universal provision of public services through subsidies does not discriminate among those who deserve free access on the point of use and those who can afford to pay for the services. But privatization is hardly a solution. Ability and willingness to pay are important issues to consider. Based on individual cases and country-specific situations, universal access to basic services must be the principle to reduce poverty levels. A case by case study goes beyond the assumption of reproducibility – if the feasibility of replicating one successful privatization in one sector to another or from one country to another is not taken to be definite. Since the fiscal impact of privatization is at best neutral, where divestitures are unavoidable, earmarking privatization proceeds to poverty reduction is one possibility.

Ultimately then two important issues must be addressed. First is to determine the spatial, sectoral and other characteristics of poor households. This is mainly because designing pro-poor adjustment policies requires perceptive knowledge of who the poor are, where they are located, which sector they work in and which productive assets they own. This list can be expanded according to gender, disability and general vulnerability. Determining the state of poverty before recommending adjustment policies is paramount as the characteristics of the poor mentioned above are fundamentally country-specific. Second, liberalization sets free dynamic forces often associated with deterioration in poverty, predominantly leading to slow employment expansion and unequal distribution of income. These outcomes can be countered through public policies. Instilling the political will and strengthening the capacity of states to introduce countervailing policies are necessary preconditions for implementing poverty reducing measures.

#### **1.2.4 The New Context for the Africa Regional Programme**

As the discussion in Chapter 6 shows, the challenge facing the Africa Regional Programme on Economic Policies in Support of MDGs and Poverty Reduction is the imperative to “‘operationalize’ the MDG framework, and, more specifically, to determine the policy implications of this framework for National Poverty Reduction Strategies.”

The first generation of Poverty Reduction Strategy Papers (PRSPs) must now incorporate MDG-based Poverty Reduction Strategies. The new strategies in turn need to be more striving towards meeting the MDGs. The policies of most ‘first-generation’ PRSPs have unduly focused on macroeconomic stabilization, rarely providing pro-poor growth strategies. The focus must now turn to scaling up of public investment. The financing of such investment must also be ambitious than the most current PRSPs argue for. Financing is likely to be forthcoming and substantial public investment programmes can be implemented as a ‘big push’. But the question remains as to how most countries improve the mobilization of domestic resources as an exit strategy from a more aid dependence trajectory.

### **1.3 Country Experiences in Poverty Reduction: Lessons for Policy**

Rwanda has implemented various macroeconomic and adjustment policies both as a recovery programme and liberalization of the economy. However, the challenge remains in designing policies which promote sustainable growth with greater equity and impact upon poverty directly. Despite relative stability compared to the decade of conflict, post 1994 fluctuations in growth rates and rising prices of food have negatively affected the poor. A commitment to reduce poverty requires the integration of a macroeconomic framework that focuses on public investment on a scale large enough to address current infrastructure limitations. Expansionary fiscal policy is a key to employment generation, mobilization of resources, and achieving macroeconomic stabilization without inhibiting growth and poverty reduction.

Monetary policy in Rwanda focused on inflation targeting and has not paid any attention to stabilizing output. The financial systems need to address serious lack of formal credit available to rural and agricultural borrowers. The highest impact on

poverty reduction necessitates directing credit to projects with the highest ‘social’ returns in terms of employment and asset expansion for the poor. As **Chapter X** shows since there are “limited levels of institutional credit available through the financial sector it is imperative that credit gets channelled into long-term employment intensive projects. The ultimate goal being an increase in rural sector, high value added and employment generating activities”.

Tanzania has undergone a number of stabilization and adjustment programmes under the auspices of the International Monetary Fund and the World Bank. These programmes aimed at macroeconomic stability, including liberalization of internal and external trade, privatization of state-owned enterprises, abolition of subsidies on industry and agriculture and fiscal tightening (including introduction of user fees for health and education), and currency devaluation. However, economic growth has not been impressive and the provision of social services has, in some cases, fallen drastically. The policy priority for Tanzania is to incorporate the MDG’s in the second-generation PRSP, which is to be implemented in the near future. As discussed in **Chapter X**, to realize many of the MDGs “it will be important to design a pro-poor strategy that includes growth with redistribution, expansion in public investment, financial policies focused on facilitating access by the poor and policies to generate long-term productive employment”.

The story in Sierra Leone is that of post-conflict reconstruction at the same time focusing on the MDG targets. In January 2005 the Poverty Reduction Strategy Paper was launched. However, the new strategy fell short of setting out a macroeconomic and adjustment framework, which promotes pro-poor growth in the sense elucidated in this book. Therefore, **Chapter X** points the possible policies that are relevant for designing a recovery programme as well as for the objective of growth that is equitable. The PRSP revolves around macroeconomic stabilization and structural adjustment with growth and poverty reduction being derived by implication and not directly through sustained pro-poor growth. What is required is a framework for poverty reduction and policies to stimulate pro-poor growth in securing the MDGs. These policies necessitate increased public investment, possibly funded out of domestic sources including increased rates and collection enforcement of urban property taxes; increased taxation and targeting of luxury goods; taxes on tourist activities; widening the tax base by identifying indirect evidence on income.

Increased public investment in turn can be focused on public works projects that directly hire the poor; increases in the wages of the poor; and creation of infrastructure assets that give the poor access to markets and lower their production costs. Financial system in Sierra Leone, as is the case in other countries in the SSA region, lack to sectoral or geographical coverage for reaching the poor. Credit disbursement is highly concentrated in rural areas and away from agriculture. Still a higher proportion of credit emanates from family members, while high interest spreads discourage small and medium enterprises (SMEs).

As **Chapter X** shows, South Africa, although classified as a middle income country, faces the challenge of reducing the level of poverty, income inequality and unemployment. To address these challenges policy shifted from ‘growth through development’ to the ‘development through growth’ and now to the present policy debate where greater emphasis is placed on intervention and redistribution. The first

approach heavily relied on infrastructural development and provision of basic services. This was considered ambitious as income of the bottom deciles needed to grow at more than seven percent annually, and the incomes of the top deciles to grow at about 3.5 percent. At the same time major tax reforms and shift in investment were required to achieve the objectives set out in the initial policy documents.

Actual policy focused on reducing inflation and trade liberalization. Orthodox policies replaced the more Keynesian approaches contained in the original post-*apartheid* policy documents. Around 1996 government policy reiterated development through growth, with private sector investment being the major driver. Public investment did not take the central policy in policy dialogue. Instead tight monetary and fiscal policies were pursued for economic stability. High interest rates, low inflation, and low fiscal deficits became the cornerstone of policy. Post-2001 the emphasis became expansion and broadening of employment opportunities through intensive investment in skills, explicit focus on small business development and increased investment in social and economic infrastructure.

However, there is little departure from orthodox prescriptions. Macroeconomic and structural policies are “negotiated by big (White-owned) business and the ANC from as early as 1990 in which the ANC committed to promoting macroeconomic stability and opening up the economy in return for big business’s agreement to participate in ‘capital reform’ in which black economic empowerment could alter the ownership structures prevalent in the South African economy”. The question is will South Africa reduce poverty and inequality with its current policy stance? High and sustained levels of economic growth have not been forthcoming. However, households have gained through reoriented government spending on social grants, education, health and housing – all aimed at eroding entitlement deprivation amongst the poor. While the growth of expenditure of the poor in nominal terms had been growing over the 1995-2000 period, the increase has been significantly lower than for high-income groups. In addition the racial bias against traditionally disadvantaged communities presents a policy challenge. Whatever gain is there from social grants, it risks being eroded through rising levels of inequality.

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## 2

# Macroeconomic and Adjustment Policies for Pro-Poor Growth

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### 2.1 Analytical Framework: Price and Demand Determined Economies

There are two broad theoretical approaches to macroeconomic analysis, demand determined and price determined frameworks. A *price determined economy* is either in a unique full employment general equilibrium, or prevented from achieving that general equilibrium by private or public price ‘distortions’. An *economy is demand determined* when its level of output is limited by one or all of the components of aggregate demand: consumption, private investment, government expenditure, or exports.

The theoretical differences between the two frameworks imply fundamental policy differences. Consider the simple case of a closed economy with no public sector that produces only one product (see Weeks 1989). In the price determined framework, all markets clear in an instantaneous process, in which no exchanges occur at prices other than those in the price set which would prevail at full employment general equilibrium (no ‘false trading’). In this theoretical circumstance, consumers and producers take prices as ‘signals’ to determine the quantities they buy and sell. If all markets clear automatically at the unique full employment price set, then it follows that any action by private or public agents to inhibit market adjustment in prices will result in an outcome below full employment. Assuming there to be no private constraints to *instantaneous* price adjustment (e.g., no market power by private agents), the full employment equilibrium price set is unique, and all markets are fully developed, it follows that the role for public policy is extremely limited. The price determined framework implies that fiscal and monetary policies should be ‘neutral’ and ‘passive’.

‘Neutral’ fiscal policy should not alter the incentives of private agents from making the choices that would yield the general equilibrium price set: 1) taxes should not affect private agents’ decisions between income and ‘leisure’ (e.g., no income tax); 2) neither taxes nor expenditures should affect the relative profitability of commodities (no tariffs, export levies or subsidies); 3) expenditures should not impact on the consumption allocation decisions of households (no sales taxes that discriminate among commodities and no subsidies to commodities); and 4) government should not ‘distort’ capital markets by competing with private agents for funds (no funding of the fiscal deficit through bond sales). As a practical matter, governments must tax, spend, and sometimes run deficits. The price determined framework accepts this and counsels that the inherently distorting operations of the public sector should be minimized: levy taxes on a uniform basis (a single tariff rate for all imports, for example); minimize fiscal deficits; and restrict government operations to national security, social services, and general administration.

It should be noted that an active monetary policy, that involves inflation targeting, for example, is inconsistent with the fundamental neoclassical macro framework. In this framework, inflation should be zero, so that nominal and real interest rates are equal to each other and to what is required for the general equilibrium price set.<sup>1</sup> Inflation targeting is discussed below.

The theoretical basis for the price determined framework is quite weak. It cannot be demonstrated that there is a real world process that ensures the realization of the full employment price set. Nor can it be demonstrated that the full employment price set is unique. The latter is a quite serious problem, because if the price set is not unique, the concept of 'distortions' is called into question. A distorted outcome is defined in relation to a non-distorted one. If there is more than one non-distorted outcome, one cannot be sure that the prices in an economy with public sector interventions are substantially different from some non-distorted outcomes.<sup>2</sup>

While price determined systems may seem abstract curiosities, they are the basis for any statement that governments 'distort' the economy. One cannot allege the existence of distortions without simultaneously asserting the existence of a unique non-distorted economy. Consider the apparently simple statement, 'tariffs distort profitability between importables and exportables'. The validity of this statement requires the prior demonstration of the existence of a unique full employment general equilibrium. Since this cannot be demonstrated generally, even in theory, the correct statement would be, 'tariffs alter profitability between importables and exportables'. The practical difference between using the two words, distort or alter, is the core of policy debate. If public sector actions distort the economy, which results in inefficiency, they should be avoided or minimized. If the actions alter the economy, then a subjective policy assessment is required to determine whether the alteration is a net benefit to society.<sup>3</sup>

If one moves from the ethereal world of the abstract to the characteristics of African economies, it should be obvious that the price determined framework is not applicable.<sup>4</sup> First, during two decades of stabilization and structural adjustment, most of these economies have been demand determined by high real interest rates, fiscal austerity, or heavy debt burdens, and in some cases all three. Second, many of the economies have suffered from declining terms of trade, which have had a net contractionary effect on external demand. Third, and frequently ignored, major prices in many African economies are not primarily market determined. It is obvious that the nominal interest rate is an administered price if the monetary authorities practice inflation targeting. In addition, in almost every sub-Saharan country official aid flows and debt servicing represent a substantial portion of the balance of payments, and neither is directly sensitive to the exchange rate. As a result, the value of a 'floating' exchange rate is determined to a great extent by non-market flows.

If economies are demand determined, then the existence of a general equilibrium price set becomes a moot point, because relative prices change as the level of aggregate demand rises and falls. Therefore, relative prices are not 'signals' to producers and consumers, but result from their production and consumption decisions. Since prices do not determine quantity choices by consumers and producers, they are derivative *from* them; they are not signals of efficient allocation. That is, producers and consumers are not price-takers. This implies that public sector

interventions should be judged on a pragmatic basis in terms of social cost and social benefit. In the case of fiscal policy, active macroeconomic interventions are justified to move the economy towards full employment and to foster growth. Taxes and expenditures should be similarly judged, and not by whether they violate non-relevant abstract principles of efficient allocation. The criterion for judgement should be whether taxes and expenditures achieve the goals set by society, and when those goals conflict, an empirical analysis of trade-offs is required.

The demand determined framework predicts and accounts for unemployment, concludes some inequalities to be inefficient, and calls for effective public sector intervention to achieve social objectives. The demand determined framework considers the social objective of sustained growth to be one in which the public sector provides the residual stimulus to maintain the economy at its productive potential. In the short and medium run this involves counter-cyclical policies, and in the long run investment that increases aggregate supply. Thus, a growth fostering policy package that recognizes economies to be demand determined would have the following components:

1. an expansionary fiscal budget, consistent with the rule that the overall deficit not exceed public investment;
2. an accommodating monetary policy that tolerates moderate inflation to achieve higher growth, by a) targeting the 'Golden Rule' real interest rate (equal to the sustainable growth rate of per capita income), b) allowing the money supply to expand to accommodate growth and monetary deepening, and c) providing subsidized credit for poverty reduction programmes; and
3. a managed exchange rate regime that seeks to maintain a rate is expansionary by promoting tradeables.

How these are designed for implemented in sub-Saharan countries is discussed in subsequent sections.

## 2.2 Pro-poor Growth

The Chapter presents a general theoretical framework which is the technical basis for the policy discussion in this book. Then, general characteristics of the sub-Saharan region are identified, because the discussion of macro policies must be grounded in the basic economic characteristics of the many countries of the region. This is done before turning to specific aspects of macro policy.

At the outset of the discussion we define what we mean by pro-poor growth. Growth is pro-poor when the poor, however defined, receive a larger portion of the annual growth increment than their initial income share. This implies that growth should lead directly to improvements in income distribution and social welfare; i.e., that they are not left to contingent trickle-down effects (see Saad Filho 2005). The definition can be elaborated by comparing different patterns of growth. Empirical evidence shows that in the vast majority of cases, economic growth raises the incomes of those households at the bottom of the distribution. In this sense 'growth is good for the poor' (Dollar and Kraay 2000). Our definition of 'pro-poor growth' is more specific, and seeks to differentiate among periods of growth, sometimes called 'growth episodes', in which growth is more and less advantageous to those below the poverty line.

In the case of an absolute poverty line, pro-poor growth implies that, for households below the poverty line before the growth episode, incomes increase at a rate greater than the rate for the set above the poverty line. This can be elaborated algebraically. At any point in time, the growth rate of household incomes is the weighted average of the rate for the poor and the non-poor. If the head count poverty ratio<sup>5</sup> is  $H$  and the growth rates for the poor and non-poor are  $g_p$  and  $g_{np}$ , then:

$$g = Hg_p + (1 - H)g_{np}$$

The extent to which growth is pro-poor over any time period can be measured by the following ratio:

$$\text{Index of pro-poor growth} = \text{IPPG} = g_p/g_{np}$$

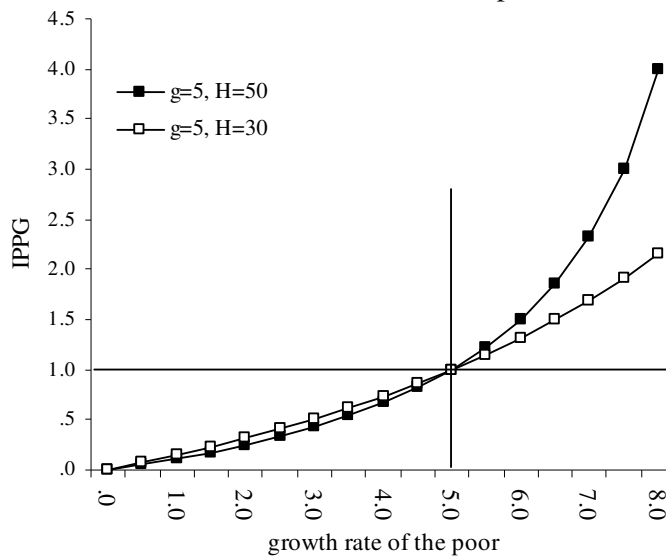
For any rate of growth of aggregate household income, this index is a function of the head count poverty ratio. If the aggregate rate is  $g^*$ , then:

$$g_p = (g^* - [1 - H] g_{np})/H$$

Figure 2.1 shows the index of pro-poor growth for a five percent overall rate of growth and head count ratios of thirty and fifty percent. Below an index of unity (neutral distribution growth between the poor and non-poor), a higher head count ratio results in a lower measure of pro-poor growth, and above unity a higher measure. This measure of pro-poor growth has the advantage of being easily measured from household surveys, assuming they are consistent in design, and allowing a cardinal measure of the degree to which growth is pro-poor. Its disadvantage is that the index is defined for positive values of the growth rates for each group.

Figure 2.1:

Indices of Pro-poor Growth for 5 percent Growth and Head Count Ratios of 30 & 50 percent



### 2.3 Growth and Distribution

Using macro instruments in a purposefully expansionary package to achieve an economy’s sustainable growth rate would be a necessary, but not a sufficient condition for achieving the MDGs for most sub-Saharan countries. This is because: 1) slow growth over the last two decades suggests that for perhaps a majority of the countries the foreseeable, sustainable growth rate is relatively low (two to three percent per capita); and 2) during the years since the MDGs were proclaimed, growth has been slow or negative, with little or no progress made. However, one can make a virtue of necessity. A growth path characterized by greater distributional equality would make the MDGs feasible, as well as achieving the socially desirable goal of greater equity.

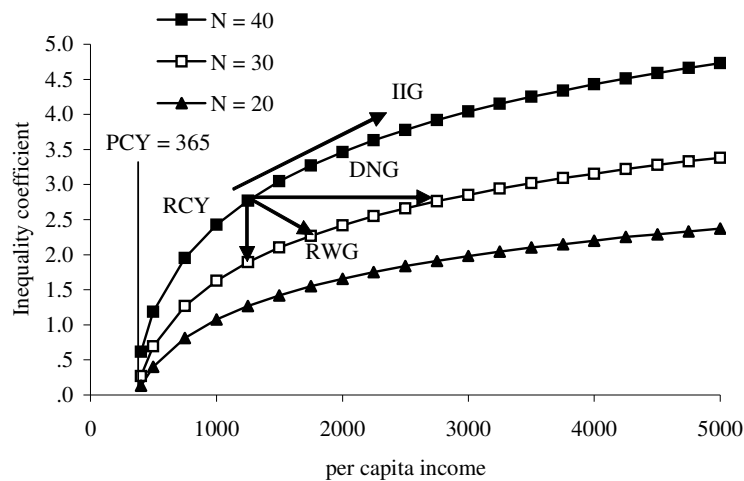
Further, even if it were the case that most sub-Saharan countries could achieve the MDGs through growth alone (which most cannot), there is the issue of opportunity cost. The orthodox tendency over the last two decades has been to treat increasing the growth rate implicitly as a ‘free good’ achieved through deregulation and non-intervention in general. Raising the sustainable rate of growth is not costless within any policy regime. It requires increased investment, which implies a relative reduction in consumption in any time period.<sup>6</sup> Specifically, the investment cost of a one percentage point increase in the sustainable rate of growth is equal to  $n$  percentage points of national income, where  $n$  is the capital-output ratio. For example, if the capital-output ratio were four, a government would have the option of applying four percent of GDP to raise the growth rate by one percentage point, or to apply some or all of that four percent directly to fund MDG goals.

The inter-relationship between growth and distribution can be demonstrated with a simple model, which assumes that taxation and public expenditure are used to create a growth increment that is more equally distributed than initial income. For simplicity, we assume that the growth increment is equally distributed across all

income deciles, which we call the redistribution with growth path (RWG), and contrast this to a growth path in which distribution is unchanged (Distribution Neutral Growth, DNG). Using a Pareto distribution for personal income, we can generate a set of constant poverty curves for different degrees of inequality and levels of per capita income, shown in Figure 2.2.<sup>7</sup> For generality, Figure 2.2 also includes the two other possibilities: redistribution of current income growth (RYG), and increasing inequality growth.<sup>8</sup> The diagram uses the international standard poverty line of one US dollar a day.

Figure 2.2:

Relationship between Inequality and Per Capita Income for Constant Levels of Headcount Poverty

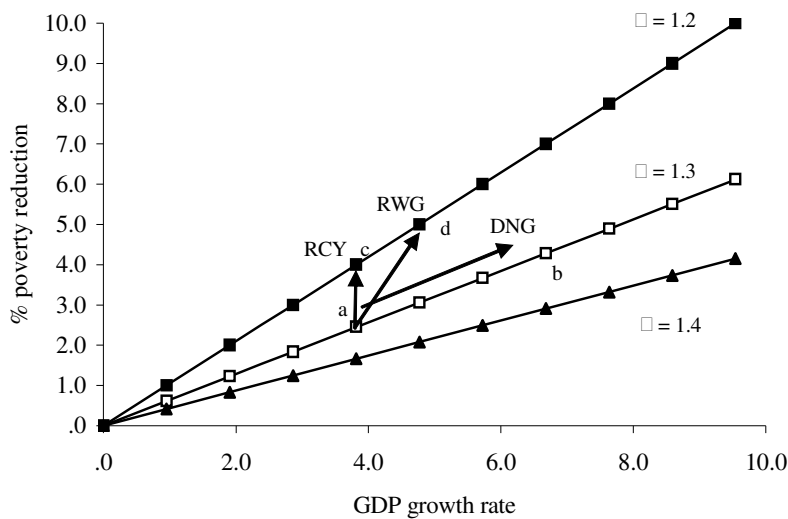


The diagram implies generalizations that we can apply in our subsequent analysis of pro-poor macro policy. First, because the schedules converge to the left, the impact of redistribution on poverty, of current income or of the increment, *declines* as per capita income declines. At low incomes, both redistribution and redistribution with growth are less effective, relatively to distribution neutral growth. Second, for a given per capita income, the lower the level of inequality, the greater is the impact of redistribution on poverty reduction.<sup>9</sup> In other words, when the poor are clustered close to the poverty line, the income transfer necessary to raise them out of poverty is less than if the same number of households were unequally distributed.

The growth-distribution interaction on poverty reduction can also be shown for growth rates. In Figure 2.3, the percentage reduction in poverty is on the vertical axis and growth rates on the horizontal. Three lines are shown, for increasing degrees of inequality as they rotate clockwise (with  $\alpha$  the index of inequality from the Pareto equation). The figure shows that for any initial per capita income, growth reduces poverty more, the less the inequality of initial income distribution. From the initial position at point a, distribution neutral growth increases the rate of poverty reduction along the schedule  $\alpha = 1.3$  to point b (an increase in the growth rate with distribution unchanged), redistribution of current income involves a vertical movement to point c, and a shift from 'a' to 'd' is a case of redistribution with growth.

In Figure 2.3, the proposed marginal redistribution has characteristics that derive automatically from the nature of income distributions. First, and most obvious, the relative benefits of the equal absolute additions to each income percentile increase as one moves down the income distribution. Second, and as a result of the first, for any per capita income, the lower the poverty line, the greater will be the poverty reduction. As a corollary, when a policy distinction is made between degrees of poverty, with different poverty lines, the marginal redistribution will reduce 'severe' poverty more than it reduces less 'severe' poverty. Third, the more unequal the distribution of income below the poverty line, the less is the reduction in poverty for any increase in per capita income, or redistribution of that increase. Thus, a pro-poor macro policy has two elements: use of demand-expanding policy instruments to promote an economy's full growth potential; and use of taxation and expenditure to make the growth path more equitable.

Figure 2.3:  
Poverty Reduction and GDP Growth  
for Degrees of Inequality



#### 2.4 Characteristics of sub-Saharan Countries<sup>10</sup>

The sub-Saharan countries have several characteristics relevant to macro policy, which differentiate them from countries in other regions:

1. Low-income status almost without exception, including a majority of the Least Developed Countries (using World Bank and UN definitions);
2. Economies that are overwhelmingly agricultural, with output extremely weather-sensitive;
3. Inefficient domestic commodity markets in part due to poor and deteriorating infrastructure;
4. Dependence on concessional development assistance (especially from the World Bank), that is heavily conditional;

5. Heavy debt burdens; and
6. Underdeveloped financial sector with limited access to formal banking services;
7. Little diversification of exports and reliance on primary commodity exports;
8. A growing labour force, particularly among the youth and women
9. Inadequate capacity to compete in international markets;
10. Limited access to basic social services;
11. A near-catastrophic incidence of HIV-AIDS.

While in other regions there are countries with these characteristics, in no other region are all of the above so generalized. Taken together, these characteristics produce what is of central importance to the design of a pro-poor macro policy: a high level of growth instability. Figure 2.4 shows a scatter diagram of the average growth rate of thirty-nine sub-Saharan countries, and the standard deviation of that rate, using four-year moving periods, 1961-1999.<sup>11</sup> Visual inspection of the diagram suggests a negative relationship over much of the thirty-nine years. During 1969-1981, the adjusted correlation coefficient is 0.32, with an elasticity between the variables of minus 0.72; and for 1982-1999, the statistics are 0.48 and minus 0.88, respectively. These statistics suggest that for most of the four decades, the hypothesis that instability impacted negatively on the regional growth rate cannot be rejected.<sup>12</sup>

Figure 2.4:  
Scatter Diagram of the GDP Growth Rate and its Standard  
Deviation, 39 sub-Saharan Countries 1961-1999  
(four year moving averages)

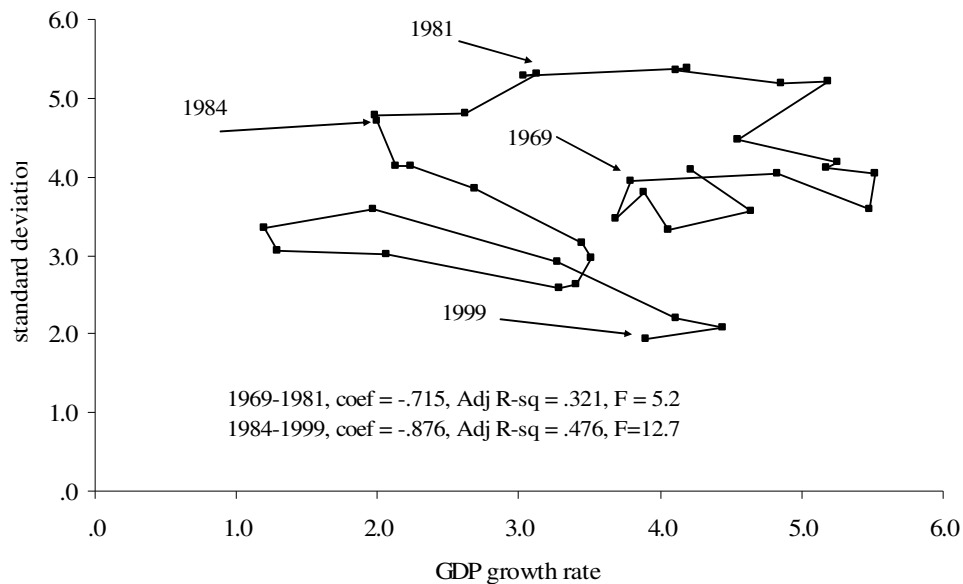
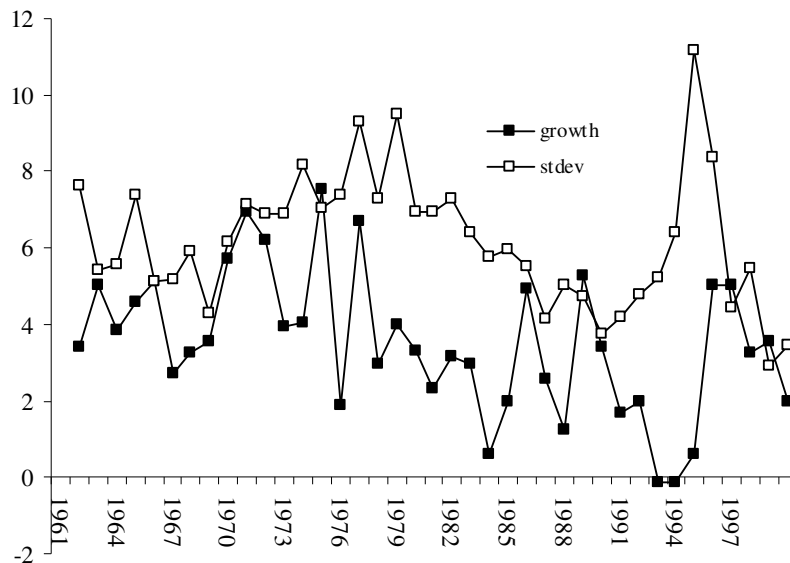


Figure 2.5 displays the average growth rate and standard deviation of growth rates across countries. In only six of the thirty-nine years was the standard deviation lower than the cross-country growth rate, and these occur with apparent randomness.<sup>13</sup>

Figure 2.5:  
 Cross-Country Growth Rates & Standard Deviation,  
 Sub-Saharan Countries, 1961-1999



To show how severe has been growth instability in Africa, Table 2.1 provides several complementary indicators. The first column gives the number of years for which there are GDP growth statistics for each country, and, whatever the start date, each series is continuous through 1999. The second column gives the percent of years for which the growth rate of the country was above the average for the region, which is followed by the growth rate itself, the standard deviation, and the coefficient of variation. To these basic growth statistics are added the relative growth rate, which is the country average divided by the regional average (with the latter calculated for the years for which there are data for the country). Columns eight and nine report the number of times each country was among the ten fastest and ten slowest growers in the region, by decade (1960s, 1970s, etc.). The final three columns report extreme shifts in growth rates, arbitrarily defined as a year-to-year change in the absolute value of the growth rate equal to or greater than ten percentage points; the percentage of years when this occurred follows, and, finally, the number of these shifts that were consecutive. Fluctuations in growth rates were greater for the sub-Saharan countries compared to other regions, even greater than for North Africa and Western Asia, despite the large petroleum price shocks that have destabilized growth in those countries (see Table 2.2).

Column three of Table 2.1 reports for each country the number of years that growth was above the regional average, as a percentage of all years. The percentage of years above the average compared to relative growth suggests that country growth rates were skewed.

Table 2.1: Indicators of Growth and Instability, Sub-Saharan Countries, 1961-1999

Country	data years	% > aver	Grw rate	Stdev	Relative growth rate	League by highest 10	Table decade lowest 10	Growth Reversals		
								Years > 10	% of years	No. +/- Consecutive
Botswana	39	92	9.7	5.7	2.76	4		1	3	0
Uganda	17	82	5.3	3.7	1.50	1		0	0	0
Guinea	13	77	4.1	1.0	1.17	1		0	0	0
Gabon	39	67	5.2	11.1	1.47	2		8	22	8
Eq Guin	15	67	5.9	5.5	1.68	1	1	1	8	0
Mauritius	39	62	5.1	6.4	1.45	3		10	27	6
Swazild	29	62	5.3	4.5	1.50	1		1	4	0
Malawi	39	62	4.4	5.6	1.24	3		7	19	6
Cote d'Iv	39	59	4.6	5.7	1.31	2	1	12	32	7
Moz'que	19	58	3.2	7.9	0.90	1	1	4	24	2
Lesotho	39	56	5.8	7.8	1.65	3		12	32	7
Ethiopia	18	56	2.8	7.8	0.80			5	14	3
Gambia	33	55	4.0	3.4	1.15			1	3	0
Kenya	39	54	4.8	5.3	1.36	3		6	16	4
Seychelles	39	54	4.6	6.4	1.30	1		4	11	3
Rwanda	39	54	3.3	12.1	0.94		1	10	27	7
Togo	39	51	4.0	6.7	1.14	1		7	19	6
Congo, Rp	39	51	4.3	6.4	1.21	1	1	2	5	0
Benin	39	51	3.3	3.4	0.92	1	1	1	3	0
Mauritania	39	51	3.6	6.5	1.04	1	2	11	30	9
Guinea-B	29	48	2.4	8.5	0.68		1	9	33	6
Angola	19	47	1.8	7.7	0.51		1	2	12	2
Zimbabwe	39	46	4.1	5.8	1.18	2		6	16	4
Nigeria	39	46	3.5	7.9	0.99	1	1	13	35	8
Ghana	39	46	2.5	4.5	0.71	1	2	3	8	0
Burk Faso	39	46	3.5	3.4	0.99			2	5	0
Senegal	39	46	2.5	4.5	0.72		1	8	22	6
Sudan	39	44	3.4	6.3	0.96	1	1	6	16	4
Cameroon	39	44	3.5	6.6	0.99	2	2	6	16	4
Eritrea	7	43	4.1	4.3	1.16			1	20	0
So Africa	39	41	3.2	3.9	0.91	1	1	3	8	2
Burundi	39	41	2.6	6.6	0.74	1	2	9	24	4
Mali*	32	41	3.0	5.1	0.84		2	5	17	4
Niger	39	38	1.7	6.4	0.47		2	6	16	6
Tanzania	11	36	3.4	4.9	0.97			3	33	3
Chad	39	33	1.9	7.8	0.55	1	2	11	30	10
Congo DR	39	32	.2	6.3	0.06		2	2	5	2
CAR	39	31	1.5	4.1	0.43		4	3	8	2
Namibia	18	26	2.2	3.3	0.61		1	1	6	2
Zambia	39	26	1.9	4.8	0.54		2	6	16	4
Mad'car	39	26	1.5	3.5	0.44		3	2	5	0
Srr Leone	39	21	.7	5.6	0.20		2	4	11	4
	1391	na	3.5	6.5	1.00	40	40	214	15.4	145

Percent of years &gt;|10| = 68.0

Notes:

1. 'data years' refers to those years with GDP growth statistics.
2. '%>aver' is the number of years the country's growth rate was greater than the average for the years covered by its data (to one percentage point).
3. 'Grw rate' is the average for the years covered.

4. 'Stdev' is the standard deviation of the growth rate for the years covered.
5. 'Relative growth rate' is the country average divided by the cross-country mean for the years covered for that country.
6. 'League Table' gives the number of times a country was among ten highest or lowest growers by decade.
7. 'Growth reversals, years >|10|' gives the number of years for which the country's growth rate increased or decreased by ten or more percentage points compared to the previous year, followed by the percentage of years in which this occurred ('% of years'), and the number of years for which they were consecutive with opposite signs.

Table 2.2: Summary of Instability Measures by Region, 1961-1999

Region	Number of countries	Growth		Reversals > 10 ,		gdp grw: stdev
		Growth rate	Countries with 0 or 1	% of all years	percent consecutive	
Sub-Sahara	42	3.5	21.4	15.3	68	7.2
LA & Carib	28	3.8	39.3	7.7	66.3	6.3
Asia	20	5.7	40	6.3	22.2	4.8
NA&WA	16	3.6	31.3	19.6	68.2	5.5
Totals	106	napp	31.1	12.2	60.1	6.2

Notes:

Except for the sub-Sahara growth reversals of 10 percent or more were concentrated in a few countries: Latin America and the Caribbean (21% in the Bahamas and Trinidad & Tobago); Asia (31 percent in Bangladesh and Myanmar); and North Africa & Western Asia (31 percent in Syria). The last column gives the standard deviation of the growth rate.

For the region as a whole, the skew is negative, as Figures 2.6 and 2.7 show, the former for growth rates themselves and the latter for the absolute first difference.<sup>14</sup> The mean growth rate across countries for all years was 3.5, compared to the median value of 3.1. About sixty percent of the growth rates lay below the average. For first differences, by definition there is a mean of zero, but a median of 0.1, again with a negative skew.

Figure 2.6:

Distribution of Growth Rates in the Sub-Sahara,  
1961-1999 (1357 of 1390 shown)

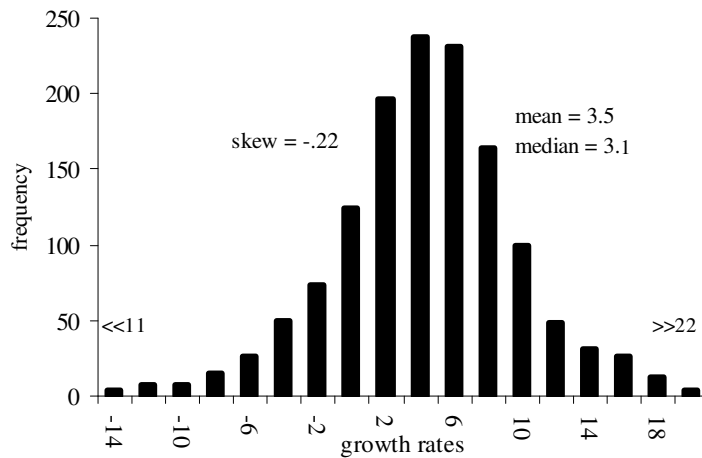
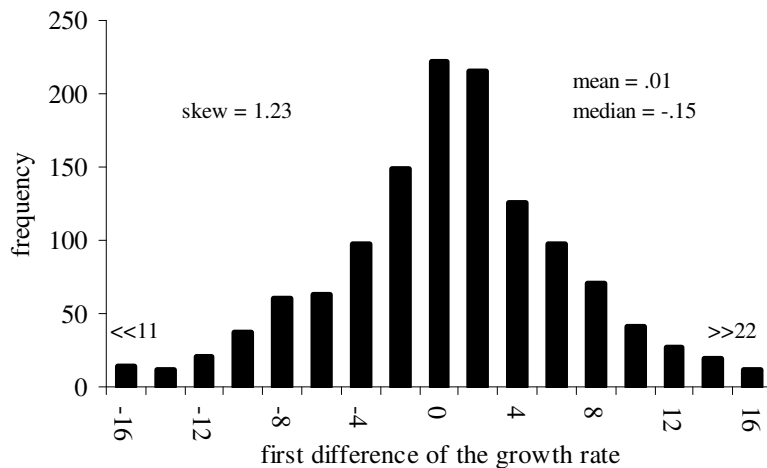


Figure 2.7:

Distribution of the Annual First Difference in Growth  
Rates in the Sub-Sahara, 1961-1999  
(1282 of 1347 shown)



Associated with the instability is the lack of sustainable growth. During the four decades, 1960-2000, countries migrated in and out of a 'league table' of the ten fastest and slowest growers, such that there were few cases of persistent high performers. Five countries appear in the top ten growers in three of the four decades, Botswana (the only one with the maximum of four), Mauritius, Malawi, Lesotho and Kenya. Three of these five are small countries and contiguous to South Africa (members of the South African Customs Union, SACU), and a fourth, Mauritius, is an island with few structural similarities to the continental countries. At the other extreme, there were two consistently low growth countries, the Central African Republic and Madagascar, both in the bottom ten for all decades.

More striking than the persistently fast and slow growers are the nine countries that could be found in the top ten in one decade *and* the bottom ten in another. Perhaps the most extraordinary case is Cameroon, in an elite group every decade: twice among the ten fastest, twice among the ten slowest. Such reversals might be attributed to being conflict affected or a petroleum exporter, but neither characteristic applies to Cote d'Ivoire or Benin; which also switch between the top and bottom. While in every decade the Sub-Saharan region had countries with outstanding growth rates, even ones in the range of the so-called High Performing Asian Economies,<sup>15</sup> few of the forty-three could sustain such rates over the long run.

Perhaps the starkest indicator of instability is extreme growth reversals. Of the country-years summarized in the table, in fifteen percent of the cases the growth rate changed by more than ten percentage points. Sixty-eight percent of these large shifts came as consecutive growth reversals; i.e., a change of ten percent or more was followed by a greater than ten percent change of the opposite sign. Malawi, with a four-decade growth rate of 4.4, experienced during 1992-1995 consecutive growth reversals of -16, 17, -20, and 26 percentage points. The high frequency of consecutive growth reversals for the thirty-eight countries suggests that large shifts were not random, but concentrated in seizures of instability. Inspection of the clustering of reversals shows no obvious general cause, such as changes in the terms of trade, drought, conflict, changes in government, or major policy shifts, though all these appear as influences during one period or another.

Table 2.2 shows that the growth variability for the Sub-Saharan countries was considerably greater than for other regions. Only twenty-one percent of the Sub-Saharan countries had either no episode of a ten percent year-to-year shift in growth or only one. For Latin American and the Caribbean and Asia the percentages were almost double that number. The North Africa and West Asian region had a higher percentage of years with such large growth shifts, but almost a third were for one country, Syria. Coefficients of variation of the growth rate show a similar difference between the Sub-Sahara and the other regions. Though the Sub-Saharan, Latin America and the Caribbean, and North Africa and West Asian regions had similar average rates of growth, the coefficient of variation for the first was substantially above those for the other two regions. The Asian group had the lowest coefficient of variation, and the lowest standard error.

Whether growth instability in the sub-Saharan countries resulted in a lower average growth rate is of secondary importance. Of primary importance is that the instability meant that in many countries a large proportion of the population plunged into poverty in years of negative growth. A central goal of a pro-poor macro policy package must be to minimize this effect, so that the ascent out of poverty becomes permanent, not transitory. In more developed countries, fiscal and monetary policies are used to reduce cyclical fluctuations in growth. However, the clustering of large growth reversals suggests that the problem in the sub-Saharan region is more structural than cyclical. The usual fiscal and monetary instruments would not be effective. This seemingly intractable problem can be greatly reduced were donors and lenders flexible in their aid conditionality, more often than not, imposed as a part of adjustment policies.

## 2.5 Summary

The orthodox approach to the economic problems of sub-Saharan countries uses a general equilibrium price determined framework. At the theoretical level, this framework has serious limitations arising from the restrictive nature of its assumptions. Its application to the sub-Saharan region is singularly inappropriate because in as far as it has practical relevance it requires developed and efficient markets that are far from the regional reality. Its emphasis on minimal public sector activity leaves fostering pro-poor growth to 'market forces', and the empirical evidence suggests that these forces systematically generate anti-poor growth. More appropriate is a demand determined framework, in which the underdeveloped nature of markets can be accommodated. Within this framework, the role of public sector action to foster growth and reduce poverty is central. This discussion has set the stage for the following chapters in which the concept of pro-poor growth is rendered concrete through a presentation of specific policies.

## Macroeconomic Policies for Poverty Reduction in Africa

JOHN WEEKS

...[I]nstitutional mechanisms for policy implementation are critical; that poverty reduction issues must be integral to the macroeconomic regime...

(Ohiorhenuan, Wayem & Barungi 2004)

### 3.1 Fiscal Policy

A pro-poor macro framework for the sub-Saharan region must have three goals. It should: 1) raise the growth rate well above the rate of population increase, achieved by less than ten of the countries over four decades; 2) substantially reduce the variability of growth; and 3) foster a more equitable growth path.

The simplest element to specify is how to raise the growth rate. Setting aside exogenous factors such as weather effects, the major limitations to faster growth are 1) restrictive fiscal policy, 2) contractionary monetary policy, and, in most countries, 3) a balance of payments constraint. Converting a restrictive fiscal policy to an expansionary one would be achieved through an employment-intensive public investment programme, financed by borrowing or, one might hope, increased development assistance and debt relief. A growth-accommodating monetary policy requires using the interest rate as a long-term investment instrument rather than for short term stabilization; i.e., an end to inflation targeting. The balance of payments constraint could be relieved by interventions to establish a stable and moderately undervalued real exchange rate. Development assistance would provide support during the transition towards a stronger export performance. Each of these familiar tactics is discussed in detail below.

The major causes of growth instability for the sub-Saharan countries are: 1) fluctuations in the terms of trade, which impact directly on aggregate demand via export and import prices, affect the fiscal balance through trade taxes, and tighten or loosen the balance of payments constraint; and 2) variations in weather that largely determine the performance of rain-fed agriculture in a region where irrigation is limited. Both of these factors are beyond the direct management of sub-Saharan governments in the short and medium term, though the effect of the latter could be reduced in the long run by structural changes in the agricultural sector.

With few exceptions, African governments suffer from the ineffectiveness of policy instruments that might be used to counter growth instability. In more developed countries, fluctuations in foreign exchange flows can be partially absorbed through open market operations by the central bank. Few African countries have bond markets sufficiently developed to use this instrument effectively. The absence of bond and equity markets also means that so-called market based capital controls are unlikely to be effective (e.g., taxes on private in-flows and out-flows). None-the-less, there exist policies that even low-income countries with underdeveloped financial markets can implement to reduce the impact of fluctuations in the terms of trade and weather.

At least three policy options are available. The first derives in part from changes emerging in the management of development assistance. As a condition for concessional lending from the World Bank and the International Monetary Fund, almost all sub-Saharan countries must prepare Poverty Reduction Strategy Papers.<sup>16</sup> One aspect of the process associated with these documents is that donors and lenders should simplify and coordinate their loans and grants, in part through moving from funding projects to budget support. Within this process, African governments could negotiate for longer-term commitments from donors and lenders, with a more predictable flow of funds. In some countries, with specific donors and lenders, this has occurred.<sup>17</sup> If assistance flows were predictable, they could be dispersed by governments in a manner to counter the domestic impact of changes in the terms of trade and unfavourable weather, as an alternative to the ineffective open market operations. Perhaps the most important function of ODA funds would be to manage the nominal exchange rate to reduce its fluctuations, a source of instability identified in numerous studies.<sup>18</sup>

Second, even in low-income countries fiscal policy can be used as a counter-cyclical instrument. However, in stabilization and structural adjustment programmes throughout the sub-Sahara, emphasis has been placed on deficit reduction, and fiscal policy has typically had a pro-cyclical impact. To the extent that this approach has any theoretical basis, it derives from a price determined in which the general price level automatically adjusts to maintain full employment. In addition to the real world improbability of the effectiveness of this adjustment mechanism, its theoretical validity requires the operation of the so-called real wealth effect, which can be shown to be logically faulted.<sup>19</sup>

Given the weakness of the underlying theory, it should come as no surprise that empirical evidence indicates that moderate deficits are not closely correlated with inflation, and that the impact of inflation on growth is ambiguous (discussed further below).<sup>20</sup> In addition to policy conditionalities, a practical constraint to counter-cyclical fiscal policy has been balance of payments pressure. By maintaining control over the currency conversion of development assistance, and using currency reserves to support the balance of payments in contractionary periods, governments could return fiscal policy to the counter-cyclical purpose recommended by generations of Keynesians.<sup>21</sup>

Third, ODA funds could also be used to support programmes that reduce the impact of changes of international prices on importers and exporters. For a small country price stabilization schemes for exports would reduce the volatility of production levels. However, attempts to compensate producers for the full effect of international price changes, for example via a fixed producer price, often prove to be too expensive to maintain in the long run. More modest price stabilization rules, supported by development assistance, could have a substantial impact on terms of trade fluctuations.

Use of ODA in the manner suggested above would require donors and lenders to allow recipient governments to have control over the conversion of grants and loans into national currency, which is not the case in many African countries.<sup>22</sup> In effect, donors and lenders would have to accept exchange controls as a legitimate instrument

of economic policy, as advocated by Lim (1999) for East Asian countries. At no resource cost to themselves, development agencies could make a major contribution to poverty reduction by allowing sub-Saharan governments to decide the most effective manner in which to manage their aid flows. As well as contributing to pro-poor growth, doing so would practice the principles of the PRS process, that recipient governments should have ownership of their policies.

Of the three goals, increasing the growth rate, reducing growth instability, and fostering a pro-poor growth pattern, the last is the most difficult given the structural characteristics of sub-Saharan countries. The fiscal policy in almost all stabilization and structural adjustment programmes is pro-cyclical, when it is not continuously contractionary, constraining growth below potential. Reversing this policy is not a simple matter of increasing expenditure. A growth-fostering *pro-poor* fiscal policy package requires more public expenditure of a particular type: public investment, which can achieve the three necessary elements of such a package, demand expansion, supply enhancement, and redistribution.

In the absence of a robust public investment programme, the pro-poor element in fiscal policy would consist of social expenditure, counter-cyclical measures, and progressive taxation. While each of these is important, in many developing countries the capacity to intervene counter-cyclically is limited, and progressive taxation non-feasible for most of the population. The progressiveness of the tax system is determined in the sub-Saharan region by the relative low contribution of the 'formal' sector to income generation, and redistributive current expenditure may be beyond the administrative capacity of the public sector.

Even more important, basing redistribution on the current budget is not a growth strategy. If sustained, it may create a new, more equal distribution which the economy will approach. However, except for a possible one-off impetus resulting from the positive incentives to the poor of the redistribution, it has little impact on the sustainable growth rate. For this reason, public investment is the *sine qua non* of a pro-poor growth strategy, and the reduction of public investment undermines that strategy.

The emphasis placed on public investment requires consideration of one of the major arguments against it, so-called crowding out.<sup>23</sup> The argument that public investment in Africa would crowd out private investment is somewhat surprising. It is typically the case that those who make this argument also urge governments to undertake major policy changes to encourage inflows of foreign investment, usually without expressing strong concern that the latter might crowd out private domestic investment.

In general, 'crowding out' occurs when an economy is near full employment. When there are unutilized resources, there is economic space for an increase in all types of expenditure, both public and private. Even if 'crowding out' occurs in under these circumstances, it is unlikely to be complete. That is, the elasticity of private investment with respect to government expenditure of any type will be less than minus one. As a consequence, public investment would be growth-inducing both in its demand and capacity effects unless the return on the marginal private component were sufficiently higher than on the public component such that the growth impact

were negative. This can be shown formally using the simple Harrod-Domar model, where  $y$  is the rate of growth,  $v$  is the incremental capital-output ratio, and  $i$  is the share of investment in output. Let the subscripts  $pr$  and  $pu$  be private and public investment, respectively, and 0 and 1 be two time periods. Without public investment, the warranted (potential) rate of the economy is:

$$y_0 = [v_{pr}] [i_{pr0}]$$

Let the 'crowding out' ratio be  $\alpha$  (the fraction by which public investment reduces private investment), and the private output-capita ratio be the same in both time periods. Then, the new growth rate with public investment is:

$$y_1 = [v_{pr}] [i_{pr0} - \alpha i_{pu1}] + [v_{pu}] [i_{pu1}]$$

We can compare the two scenarios by subtracting  $y_0$  from  $y_1$ :

$$y_1 - y_0 = i_{pu1} [v_{pu} - \alpha v_{pr}]$$

Crowding due to the introduction of public investment will reduce the rate of growth if and only if,  $v_{pu} > \alpha v_{pr}$ ; in other words, only if public investment is more capital using than private investment by the ratio of crowding out. If the capital-output ratio for public investment is smaller than for private investment, public investment never reduces the growth rate, no matter what the value of  $\alpha$ , assuming its upper limit to be unity ('total crowding out', one hundred percent). If crowding out is total, the growth rate falls only if public investments are more capital-using than private ones. Thus, public investment having a negative impact on the capacity-creating source of growth occurs only under the very restrictive conditions in which crowding out is total and private investments use less capital per unit of output. The former is unlikely and the latter can be avoided by public choice of investment projects. The considerable work that has been done on employment intensive public works can provide practical guidelines to ensure that public investments are not excessively capital using. Theory and practice suggest that 'crowding out' is unlikely to have a negative impact on growth.

As a final observation on crowding-out in the sub-Saharan region, a substantial part of private sector investment either does not borrow for investment, or does not do so in the financial markets that would be affected by government borrowing. Investment by small producers, rural and urban, is often self-financed, or financed from indigenous lenders with little connection to the formal banking system. In addition, foreign investment, to the extent it is important, is not typically financed from domestic financial markets.

## 3.2 Monetary Policy

### 3.2.1 Orthodox 'Inflation Targeting'

Perhaps the most concrete (and pernicious) application of the price determined framework manifests itself in the policy of 'inflation targeting'. Within this framework, every economy is presumed to be in or moving toward general equilibrium and inflation is the result of expectations and 'random shocks'. In other words, inflation has no structural cause; it follows from people's anticipation of it, and these anticipation are primarily the result of government behaviour. In its most inflexible form, inflation targeting involves assigning to the central bank the mandate to use its policy instruments to realize an inflation rate within a specific range, or,

more extreme, below a specific rate.<sup>24</sup> The instrument to ‘hit’ the target is almost always the nominal interest rate. In practice, attempting to fulfil such a mandate overrides all other policy objectives, be they short, medium or long run; i.e., achieving a competitive exchange rate, stimulating investment, and managing the budgetary cost of the government’s debt.

The major argument in favour of inflation targeting is that its success, a low inflation rate with a small variation, would foster growth by providing a stable macro environment for private investment. There are two issues here: the effect and wisdom of targeting as such; and the inflation rate to be targeted. These issues have been addressed comprehensively by Saad Filho (2005) in a training module for this project, and are not repeated here. For purposes of this paper, it can be pointed out that consideration of the alleged positive benefits of inflation targeting requires a prior acceptance that the policy is feasible; i.e., that most central banks in the sub-Saharan region could by use of the monetary instruments available to them realize a pre-determined rate of inflation and maintain it with small variability.

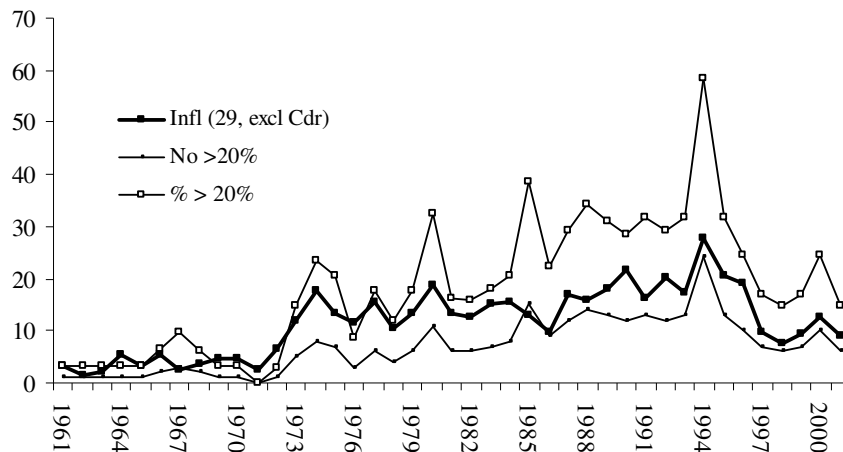
This proposition is not credible, because of the large and unavoidable stochastic (random ‘shock’) element in policy outcomes. For example, during 1980-1999, the average annual terms of trade shock across forty-two sub-Saharan countries equalled 4.5 percent of GDP, with a standard deviation of 5.4.<sup>25</sup> For the average regional economy with a trade sector of one-third of GDP (average of the export and import shares), this would imply an annual average price ‘shock’ of 1.5 percent. However, since the standard deviation is so large, there would be a thirty-three percent probability of a positive shock up to three percent in any year. In other words, an inflation target of five percent, for example, would exceed half the time (by the definition of randomness), and be double rate ten percent of the time. Should the mandate demand five percent or less in most years, the *de facto* target would have to be well below the mandated target. This implies an institutionalization of high nominal interest rates, which would translate into demand-compressing real interest rates.

In the context of such large and persistent terms of trade shocks, not to mention weather-related shocks, it would be impossible for the central bank to achieve the basic goal of a stable and predictable rate of inflation. But, could it be argued that inflation has been so serious in the sub-Saharan countries that targeting it is required to bring the rate down, even if stability is beyond policy?

Despite the recessionary consequence of choosing a low numerical target and attempting to achieve it in the context of severe and systematic random shocks, many external assistance agencies vigorously defend the policy for inflation reduction as such. What might be called the ‘bottom line’ defence is that ‘inflation is bad for the poor’; therefore, inflation targeting is ‘good for the poor’. This allegation appears repeatedly in IMF and World Bank documents. There is little evidence to support it. In one of the few empirical studies of the distributional impact of inflation, Galli and van der Hoeven found that ‘[t]hough in high inflation countries restrictive monetary policy is often beneficial for inequality, reducing inflation in economies with initially low inflation might increase inequality’ (Galli and van der Hoeven 2001).

If practical knowledge of sub-Saharan economies leads one to the conclusion that inflation targeting is doomed to fail by its own criterion because of random shocks, inspection of economic performance reveals that if the goal is to reduce the average rate of inflation, targeting is not necessary. Figure 3.1 shows inflation rates for twenty-nine sub-Saharan countries over forty years, 1961-2001.<sup>26</sup> At first inspection, it would appear that after a period of very low inflation into the early 1970s, the countries of the region began to display strong inflationary pressures, with a notable reduction in the second half of the 1990s.

Figure 3.1:  
Inflation over 40 Years in the Sub-Saharan Region, 1961-2001



Source: *World Development Indicators 2003*, 'GDP Price Deflator'.

Notes:

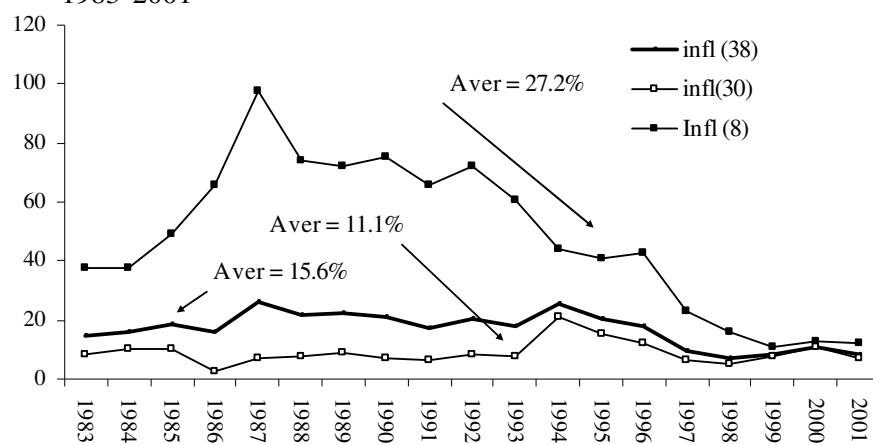
Infl (29, excl Cdr) = average annual inflation for all the countries with continuous data, 1961-2001, excluding the Democratic Republic of Congo.

No>20% = number of countries with inflation rates over twenty percent, for all countries with data in a given year (maximum of 42).

%> 20% = percent of countries with inflation rates over twenty percent, for all countries with data in a given year.

However, expanding the number of countries and disaggregation yields a quite different conclusion, as Figure 3.2 shows. In practice, the sub-Saharan countries were divided into three groups for inflation performance: two hyper-inflation countries (Angola and the Democratic Republic of Congo, not shown in the chart), eight inflation-prone countries, and thirty moderately low-inflation countries (see notes to the chart, where the countries of the second third categories are listed).<sup>27</sup> An inflation rate of less than ten percent two-thirds of the time, the experience of the moderately low inflation countries of the region, would not seem to justify shackling monetary policy to so-called price stability. This judgment is reinforced by the convergence of the high inflation countries to the level of the low inflation countries. This convergence across countries of different sizes, economic structures, and past performance, suggests inflationary pressures have declined for the entire region, perhaps due to a less inflationary external environment.

Figure 3.2:  
Convergence of Low and High Inflation Sub-Saharan Countries,  
1983-2001



Source: *World Development Indicators 2003*, 'GDP Price Deflator'.

Infl (38) = average annual inflation for all countries with continuous data, 1983-2001.

Infl (30) = average for Benin, Botswana, Burkina Faso, Burundi, Cameroon, Central African Republic, Chad, Republic of Congo, Cote d'Ivoire, Ethiopia, Gabon, the Gambia, Kenya, Lesotho, Liberia, Madagascar, Malawi, Mali, Mauritania, Mauritius, Namibia, Niger, Nigeria, Rwanda, Senegal, Seychelles, South Africa, Swaziland, Togo & Zimbabwe.

Infl (8) = Ghana, Guinea-Bissau, Mozambique, Sierra Leone, Somali, Sudan, Uganda & Zambia.

We can conclude that inflation targeting fails as monetary policy for the sub-Saharan region on all counts: 1) in as far as it seeks to stabilize the rate of inflation, it is not feasible; 2) if it merely seeks to lower the average rate of inflation, it is unnecessary in the vast majority of countries; and 3) by its inherently contractionary consequences, it is anti-poor.

### 3.2.2 'Real Targeting'

If inflation targeting is anti-poor, might that be other variables that if targeted would contribute to a pro-poor growth path? It is important in this context to distinguish between a commitment to an outcome, and assigning it as a mandate to an agency of government. In the latter case, if the target is binding in the sense of requiring specific policy action, the possibility arises that attempting to achieve it may be inconsistent with other policy outcomes.

While in principle 'real targeting' has its attractions for a pro-poor macro framework, it suffers from two major problems: 1) the relationship of the target to policy instruments; and 2) the feasibility of such targeting by sub-Saharan governments. The fundamental goal of a pro-poor macro strategy would be poverty reduction, but this cannot be targeted in an operational manner. It would be futile to have annual poverty targets, because the incidence of poverty fluctuates in response to

many short term changes over which the government has limited or no influence. It is generally recognized that poverty reduction is a long term process. If poverty targets are set for a longer period, the issue of short term policy priorities remain, and poverty targeting is indistinguishable from a commitment to the MDGs.

On a purely technical level, poverty targeting, as opposed to monitoring growth for its poverty impact, is not possible as a macro policy mandate. Governments, in the sub-Saharan region or elsewhere, have no macro instrument that directly acts on poverty. While the same could be said for inflation (the interest rate impacts on the cost of borrowing, not inflation itself), the links between macro instruments and poverty are many and contingent.

Superficially appealing is the suggestion that real output might be the mandated target. While some macro instruments have a direct impact on real output, for the sub-Saharan countries the stochastic component of aggregate output is so great that setting this target is non-operational. Targeting real output also suffers from the problem of conflict among policy objectives. Try as a government might, it will inevitably face circumstances in which it is necessary to constrain real output to prevent an even larger decline. This might be necessary in face of an unsustainable trade deficit or excessive inflation. In such circumstances, macro policy requires a flexible mandate, what Saad Filho calls ‘constructive ambiguity’ (Saad Filho 2005).

In summary, the structural characteristics of sub-Saharan countries make mandated targeting either infeasible or undesirable, or both. Feasible and desirable would be a political commitment to poverty reduction, such that each aspect of macro policy was assessed *ex ante* and *ex post* for its poverty impact, and these assessments be subject to public scrutiny. One manifestation of the commitment could be a poverty assessment of the annual budget.

### **3.2.3 Pro-poor Monetary Policy**

Liberated from the straight-jacket of inflation targeting, monetary policy could contribute to pro-poor growth. Used as the major instrument for macro management, monetary policy can do little to make growth pro-poor. However, in support of an expansionary fiscal policy it can indirectly foster growth that is pro-poor. As a general rule, if inflationary pressures are weak, this support would take the form of positive but low real interest rates and an expanding monetary supply.

While these seem simple guidelines, foster growth and counter inflation when necessary, their application in sub-Saharan countries is not straight-forward. In most of the countries of the region, financial markets are underdeveloped. Indeed, in a few countries, the monetization of the economy is low.<sup>28</sup> The concrete result of underdeveloped financial markets is that governments find it difficult or impossible to sell their bonds to private agents. This explains the common practice in the region of legislation that requires commercial banks to hold a portion of their reserves in government bonds. In practice this requirement has tended to have an anti-poor bias, as discussed in Section V in the context of domestic borrowing. The narrow bond market also implies that deficit spending, if financed domestically, tends to be covered by monetization (selling bonds to the central bank).

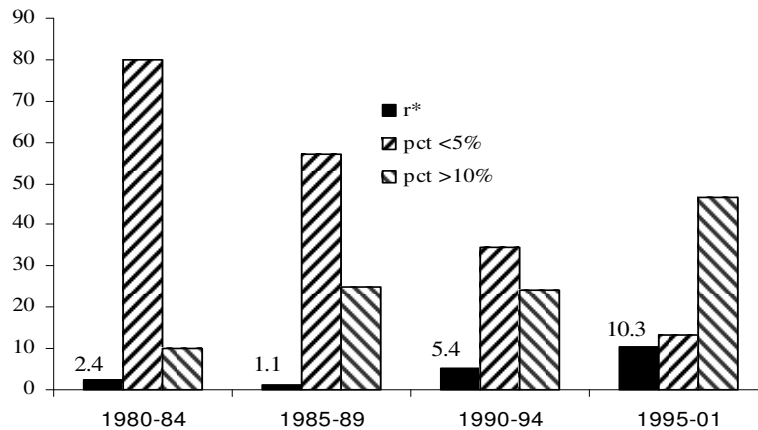
Wisely or unwisely, most sub-Saharan governments have granted autonomy for central banks to make decisions about the policy instruments which are within their mandate (Ethiopia is an exception). The most used instrument in the hands of the central bank is the rate at which it lends money to commercial banks, often loosely called 'the interest rate'. Manipulating this rate is alleged to be an effective manner in which to achieve two policy outcomes, price stability and exchange rate stability. It would achieve price stability by: 1) provoking a commensurate change in the commercial bank lending rate; 2) that this would lower or raise the cost of borrowing; 3) a change in the cost of borrowing would increase or decrease the demand for credit; and 4) then, the supply of money would adjust to the demand. The alleged mechanism for stabilizing the exchange rate is more direct: 1) provoking a commensurate change in the commercial bank deposit rate; and 2) this attracts or repels foreign capital deposits, which by definition increases or decrease foreign exchange reserves.

These mechanisms do not operate effectively in most sub-Saharan countries. The amount of commercial lending for fixed investment is typically low, allegedly for risk reasons. More often the lack of interest in lending for productive investment is because the high returns on government paper (due in great part to inflation targeting), and the faster turnover of loans to finance imports and exports. Therefore, attempts to stimulate private investment by lower interest rates are unlikely to have a substantial impact. Further, many countries are characterized by enormous spreads between the central bank rate and the commercial lending rate (and between lending and deposit rates. As a result, to induce commercial lending rates down to a level to stimulate investment is not feasible, perhaps requiring negative *nominal* central bank rates. Finally, most private productive investment is not financed through the commercial banking system either because it is by small operators, both rural and urban, or because foreign investors raise their funds abroad where interest rates are lower.

Notwithstanding the limited role played by interest rates in most sub-Saharan countries, their levels since the mid-1990s have represented a massive price misalignment ('distortion' to use the neoclassical term). This is shown in Figure 3.3. Because data on interest rates are incomplete, averaging across countries can be misleading on its own. Thus, the chart shows the cross-country average real commercial lending rate for countries with data ( $r^*$  in the chart). It also gives two other statistics: the percentage of countries covered in which the rate exceeded ten percent and the percent in which it was below five percent. Five percent can be taken as an estimate of a standard rule of growth theory, that the long term real interest rate should not exceed the maximum sustainable rate of growth of per capita income. If we divide the 1980s into two halves, eighty and sixty percent of countries, respectively, had real rates below the growth-constraining maximum, and only ten and twenty percent above it.

Figure 3.3:

Real Commercial Lending Rates for Sub-Saharan Countries,  
and Percentage of Countries in Ranges, 1980-2201



Source: *World Development Indicators 2003*. Variable is defined as ‘the lending rate adjusted for inflation measured by the GDP deflator’. Thirty countries, with numbers in parenthesis noting periods for no data (periods numbered 1 to 4): Botswana, Burundi, Cameroon, Cape Verde (1), Central African Republic, Chad, Rep of Congo, Eq Guinea (1), Ethiopia (1), Gabon, Gambia, Guinea (1), Kenya, Lesotho, Liberia, Madagascar (1), Malawi, Mauritius, Mozambique (1-3), Namibia (1&2), Nigeria, Sao Tome & Principe (1), Seychelles (1), Sierra Leone, South Africa, Swaziland, Tanzania (1), Uganda, Zambia & Zimbabwe. The two hyper-inflation countries, Angola and Congo DR, omitted.

Subsequently the average rate rose dramatically, to over five percent in the first half of the 1990s, and over ten percent for 1995-2001, with almost half of the thirty countries suffering from real lending rates in double figures. Were private sector wage rates misaligned to this degree, by one hundred percent, it would be judged as a severe obstacle to employment growth. It is surprising, therefore, that development assistance agencies have not criticized the misalignment of interest rates; on the contrary, some have sought to defend it, on a ‘risk’ argument. If it is the case that commercial lenders are so risk averse in sub-Saharan countries that they can only be induced to loan by charging punitive interest rates, the prospects for increasing domestic lending for private capital accumulation are bleak.

Returning to the earlier discussion of interest rates and private investment, the limited ability of the central bank to stimulate investment does not imply there is no pro-poor role for the central bank rate. Lower central bank rates would have two pro-poor effects: 1) government bonds are held by the wealthy, or the institutions of the wealthy, so lowering rates has a positive impact on income distribution; and 2) lower rates imply a smaller domestic debt service in the public budget, producing ‘fiscal space’ for pro-poor government expenditure.

Allowing the money supply to expand faster than real output can also have a pro-poor impact, by increasing access to credit in ‘informal’ financial markets.<sup>29</sup> It also encourages financial ‘deepening’; i.e., the ratio of the money supply to aggregate

output, which is typically low in sub-Saharan countries. Money supply management raises the question of what instruments would be used to counter inflationary pressures, if these became a serious policy concern. The key policy issue is what constitutes 'a serious concern'. Cross-country regressions suggest that inflation is uncorrelated with growth for the rates that characterize sub-Saharan countries (Easterly & Bruno 1998); i.e., rates below forty percent. Therefore, if growth and poverty reduction are the goals, a tolerance for moderate inflation is required. This is especially the case because due to the weakness of financial markets, the only effective instrument for reducing inflation in most countries would be fiscal contraction.

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

### 3.3 Exchange Rate Policy

The current orthodoxy that exchange rates should be determined in an unregulated foreign exchange market, that they should 'float', is a marked reversal of the previous orthodoxy for twenty-five years. During 1945-1970, all members of the IMF were signatories to an agreement that governments would maintain a fixed rate, usually to the US dollar, and inform the IMF of intentions to devalue or revalue.<sup>30</sup> The system of fixed exchange rates broke down not because of a change in judgement about its effectiveness; on the contrary, attempts were made to extend its life when its imminent demise was obvious. Given the strength of the fixed exchange rate orthodoxy had before the early 1970s, it is difficult to avoid the conclusion that the acceptance of the theoretical arguments for 'flexible' rates represented making a virtue of necessity.

The orthodox arguments for fiscal austerity (balanced budgets) and tight monetary policy allege that these indirectly benefit the poor, by fostering macroeconomic stability. In as far as this might be true, one would conclude that the poor would benefit no more than the population as a whole, so strictly speaking these policies would not be pro-poor. In the case of flexible exchange rates, the orthodox argument is that they benefit the poor directly, and more than the non-poor. The argument, which is made for underdeveloped countries in general and especially the sub-Saharan region, goes as follows: 1) the majority of poor households are rural, deriving their livelihoods directly or indirectly from agriculture; 2) agricultural commodities are tradables; 3) real currency depreciation raises the prices of tradables relatively to non-tradables; and 4) flexible exchange rates result in real currency depreciation.<sup>31</sup>

For sub-Saharan countries the first and last steps in the argument are generally valid. In only a few of the countries is a majority of the population urban, and in none is a majority of the poor. Almost all the countries suffer from balance of payments pressures, and opening the capital accounts has not, and is unlikely to, result in capital inflows that prompt appreciation (as has occurred in Latin American countries). However, the second and third are of dubious validity. Tradability is not determined

simply, by international markets for similar products. As Liang (1992) argued, a commodity is a tradable only if it is a close substitute in the international market, and if transport costs are not prohibitive. Many of the major products of small farmers in the sub-Saharan region are not close substitutes to international products,<sup>32</sup> and the producers are so far from transport and marketing challenges that even close substitutes cannot in practice be traded internationally.

While in theory a real devaluation should increase the price of tradables, if domestic markets are inefficient, the relative price change can be slight. Even more important, in many sub-Saharan countries a large portion of the poor, both urban and rural, may be net food buyers, in the latter case because they are agricultural day labourers. The net impact of a rise in the relative price of tradables on poverty cannot be determined *a priori*. None-the-less, the export promotion effect of a real devaluation would be a key part of a pro-poor exchange rate policy. In other words, the possible negative impact on poverty due to higher food prices in the short term is of secondary importance to the medium and long term need to relieve the balance of payments constraint. To reduce that negative effect, devaluation could be combined with food subsidies, which are consistent with WTO rules. This combination of policies would require the fiscal space to fund the subsidies, an issue treated in the next section.

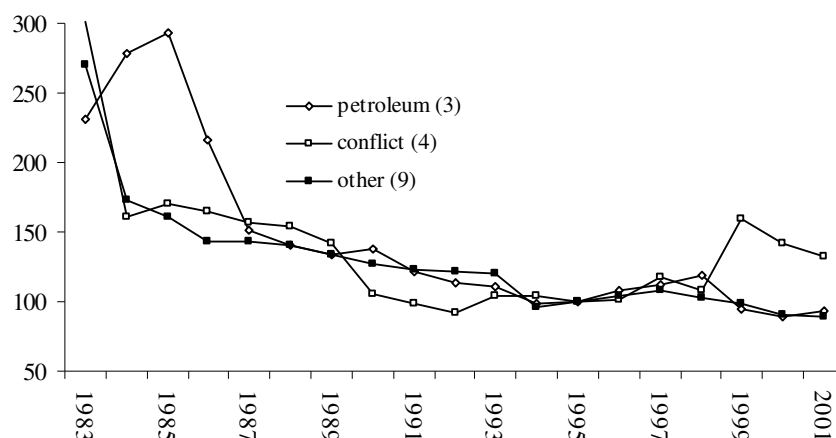
The appropriate exchange rate regime for promoting exports would be the well-known 'crawling peg', in which the government pursues managed nominal devaluations. There are several advantages of this regime over a one-off devaluation followed by non-intervention, which seeks to jump to some unique 'equilibrium' exchange rate. First, the view that economies have a unique, market-determined exchange rate which strikes the correct balance between tradables and non-tradables is incorrect in practice. As discussed above, a substantial portion of a country's foreign exchange flows may not be market related (development assistance and debt service), so that the so-called market rate would not reflect the appropriate relative price of tradables even in theory. Second, the practical purpose of devaluation is to lower the foreign currency price of a country's exports. If the inflationary effect of the devaluation is contained, the purpose should be achieved in the short run. However, if the trading regime is a liberal one, as in most sub-Saharan countries, the domestic currency price of exportables will slowly approach the international price (the so-called Law of One Price). Because of the lag in the price adjustment, periodic nominal devaluations can maintain a wedge between the export price in domestic currency and the world price.

Statistics from a few countries suggest that real exchange rates have not been seriously misaligned in the sub-Saharan region since the early 1980s (see Figure 3.4, where the countries are divided into three groups). From 1983 through 1993, the measure in the charts showed a continuous devaluation, quite large for all three groups, petroleum exporters, conflict affected, and the others. During the ten years that followed real exchange rates were virtually stable for all sixteen countries. One can draw only tentative conclusions from statistics covering less than half the countries of the region, but it is suggestive to compare exchange rate movements to export performance. In Table 11 growth rates of constant price exports are shown for the same three country groups. Perhaps the most surprising result of the table is the discovery that export growth over the nineteen years was almost identical across the

groups, and low compared to the growth of world trade for the same period.<sup>33</sup> In other words, for this incomplete coverage, it made no difference on average if a country was a petroleum producer, conflict affected, or neither of these. One major difference across the groups was the variation in export growth. For the petroleum exporters and conflict affected countries, the coefficient of variation was over two (approaching three for the latter), and only slightly over unity for the other countries.

Comparison of Figures 3.4 and 3.5, especially for the ‘other’ countries, suggests that a depreciating exchange rate was insufficient to foster a rate of export growth that could support GDP growth rates that would reduce poverty. An exchange rate that would make exports competitive should be combined with public investment to reduce transport and other costs, and a purposeful industrial policy. Industrial policy lies beyond the scope of this paper on macro policy. However, we can suggest that achieving satisfactory export growth rates requires such a policy in all sub-Saharan countries.

Figure 3.4  
Real Effective Exchange Rates, 16 sub-Saharan Countries  
by Group, 1983-2001



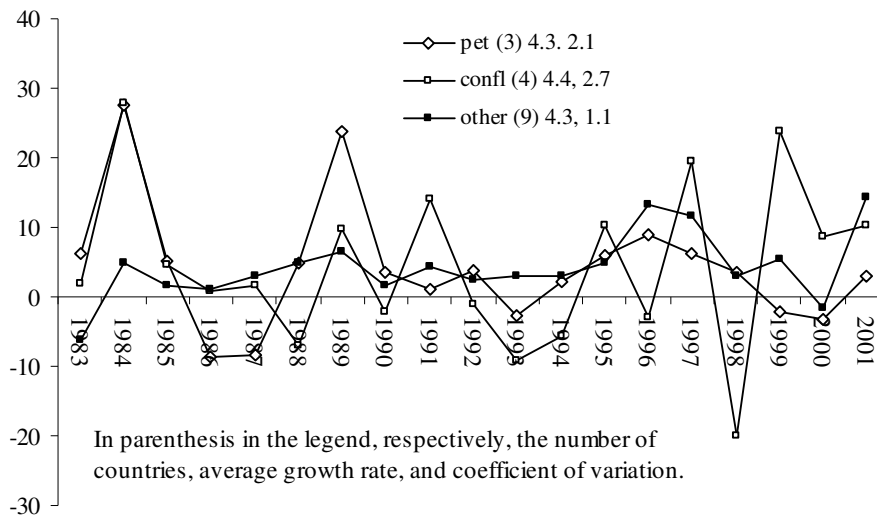
Source: *World Development Indicators 2003*. Variable is ‘the nominal effective exchange rate (a measure of the value of a currency against a weighted average of several foreign currencies) divided by a price deflator or index of costs’.

Petroleum: Cameroon, Gabon, Nigeria;

Conflict: Burundi, Congo DR, Sierra Leone, Uganda

Other: Central African Republic, Cote d’Ivoire, the Gambia, Ghana, Lesotho, Mali, South Africa, Togo, Zambia.

Figure 3.5:  
Rates of Export Growth, Categories of sub-Saharan Countries,  
1983-2001



A final, extremely important comment is required on exchange rates. At the beginning of this section we pointed out that the IMF was created to oversee a system of fixed exchange rates. The principal purpose of the system was to prevent the recurrence of the competitive devaluations of the 1930s that had destabilized international trade. In the current imperfect world, governments in sub-Saharan countries have little choice but to pursue an exchange rate policy that fundamentally represents a regime of under-cutting its regional neighbours, who export many of the same commodities. In the long term this fallacy of composition problem may be reduced by export diversification.<sup>34</sup> In the short and medium term one must frankly concede the likelihood of fallacy of composition effects from any exchange rate policy, even one that is part of a pro-poor macro policy.

### 3.4 The Key: Fiscal Space

While not quite as futile as shifting the deck chairs on the Titanic in preparation for sinking, expenditure reallocation within a given budget alone is not a serious approach to poverty reduction. On the contrary, the most important constraint on a pro-poor macro policy is the expenditure constraint. To consider this, we define 'fiscal space' as the potential for expenditure expansion consistent with macro stability. The creation of fiscal space is the essence of a pro-poor framework, and all other macro policies derive from it. There are four ways to generate fiscal space: raising the revenue share in GDP; increasing the fiscal deficit; benefiting from debt relief; and receiving a higher level of development assistance. Each of these is considered below, from a pro-poor perspective.

Increasing the share of public revenue in GDP is the most effective way to create fiscal space, especially when combined with a prudent deficit. Increasing revenue has the potential to be pro-poor both on the revenue and expenditure sides, the former through progressive taxation and the latter through social programmes and

public investment. Raising tax rates and extending coverage are the obvious methods for increasing revenue. However, there is limited scope to do either of these in sub-Saharan countries. Because the vast majority of the labour force is not in wage employment, collecting income taxes is difficult to the point of impossible, and is restricted to the so-called formal sector. In some of the countries there may be scope for increasing taxation from companies. Substantial revenue gains may be possible by reducing tax ‘holidays’ and other *ad hoc* exemptions.

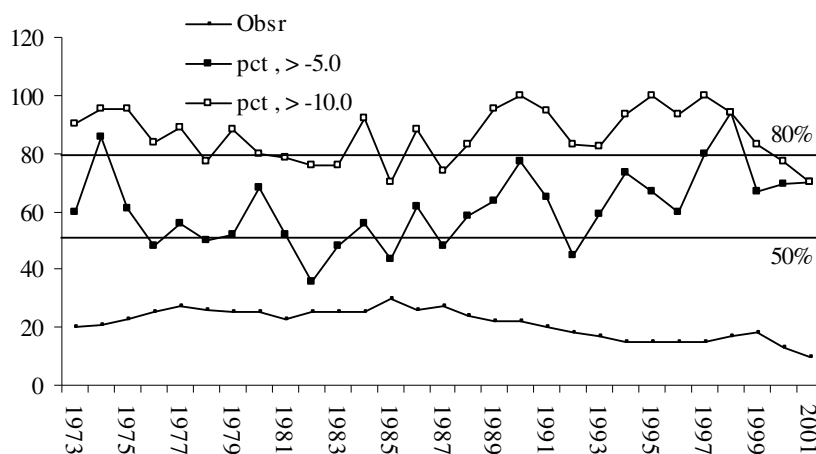
The potential for broadening the coverage of sales taxes is also limited, because a large portion of sales in rural and urban areas are by small and micro operators. Assessing the level of turnover of these operators involves the same problems as estimating incomes. Thus, it is not surprising that the bulk of public revenue arises from taxes on external trade, which as a result of trade liberalization has declined. The attempt to replace these by so-called value added taxes has not in general proved successful, in the sub-Saharan countries or elsewhere (Roy & Weeks 2004). The collection of VAT suffers from the same problems as for sales taxes in general. Given that tax systems in sub-Saharan countries are not progressive for reasons explained above, raising the tax share in GDP may be necessary, but is not a pro-poor way to create fiscal space.

For forty years, economists in developed countries viewed deficit spending as a mainstream policy, requiring no special justification. Indeed, it was balanced budgets that required defending, since they were pro-cyclical and seen to have no virtue in and of themselves. Some felt it necessary to qualify their support with the caveat that the budget should be balanced ‘over the cycle’ (for example, Gardner Ackley). Others rejected even this, maintaining that it was bad economics to fund investment from current income; governments, like businesses, should borrow to invest. For developing countries, it was argued that structural factors, such as supply inelasticity in agriculture and imports constraints, tended to limit the real value of the government expenditure multiplier, causing deficits to have an inflationary impact. This implied that counter-cyclical use of fiscal policy would not be effective, but did not affect the argument that investments could be funded by borrowing.

In the 1980s, a different mainstream orthodoxy emerged, harking back to the pre-Keynesian 1920s, that deficits, whether inflationary or not, were undesirable. As for other policy conclusions of the current orthodoxy, this one is based on a price-determined analysis. If an economy is price determined, there can be no real output increase resulting from demand stimulation. Therefore, the excess demand created by an increase in the fiscal deficit is eliminated either through the reduction in other categories of expenditure (‘crowding out’), an increase in net imports, or inflation. As a theoretical proposition, this argument is of limited interest. Since by definition real output effects of demand expansion are zero in a price determined system, the theory assumes its conclusions. The practical question is, does it appear that in sub-Saharan countries deficits stimulate the negative effects that the orthodoxy predicts? Below we argue that governments should be pragmatic about monetizing deficits. Therefore, it is important to provide an analytical basis for the proposition that monetization does not necessarily provoke a destabilizing rate of inflation, or an unmanageable trade balance.

It is beyond the scope of this draft of the paper formally to model deficit effects (see Weeks 2001 where this is done), so the discussion takes an *ad hoc* approach. First, it was shown in Section III that inflation rates have been low to moderate in most sub-Saharan countries. In the hyper-inflation countries, Angola and Congo DR, large deficits and high inflation went together, but they were the result of a common cause, persistent internal conflict. Second, the limited cross country information available suggests that fiscal deficits have not been excessive in most sub-Saharan countries. Using statistics from *World Development Indicators 2003*, Figure 3.6 shows the cross country statistics for the overall fiscal deficit including external grants; that is, current and capital expenditure on the debit side, and revenue and development assistance on the credit side. Because of the ‘patchiness’ of the coverage, if only countries with near-continuous statistics were included, it would have resulted in fewer than ten observations. Therefore, all countries with a statistic for a given year are included, and less exact indicators are used, the proportion of countries with deficits from zero to minus five percent of GDP, and zero to minus ten percent. The number of observations for each year is also shown, with the country details below the chart.

Figure 3.6:  
Fiscal Deficits as Share of GDP, in Sub-Saharan Countries:  
Percentage of Countries in Ranges, 1973-2001



Source: *WDI 2003*. Variable is ‘current and capital revenue and official grants received, less total expenditure and lending minus repayments. Data are shown for central government only.’

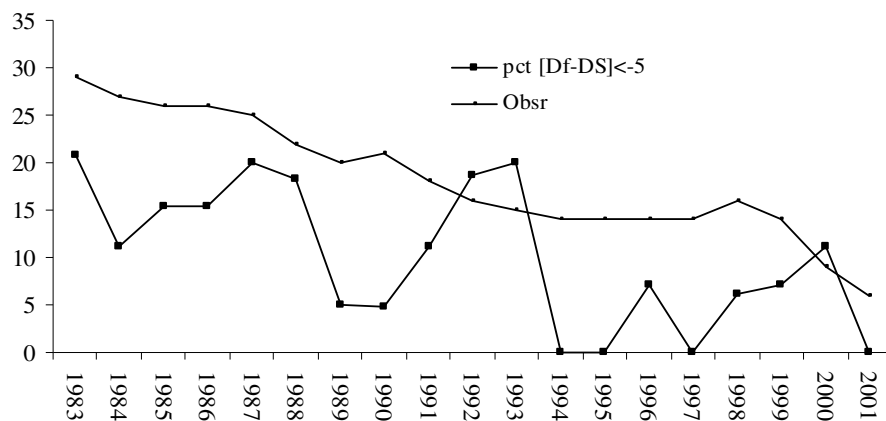
Notes: ‘Obsr’ is the number of countries, ‘pct’ is percent of countries, and ‘>’ is greater than (the deficit is negative, so  $-4 > -5$ ).

Countries (number of years with data in parenthesis): Botswana (24), Burkina Faso (21), Burundi (23), Cameroon (23), Chad (10), Comoros (6), Congo DR (29), Rep Congo (14), Cote d’Ivoire (17), Ethiopia (14), Gabon (16), the Gambia (11), Ghana (21), Guinea-Bissau (7), Kenya (29), Lesotho (22), Liberia (15), Madagascar (17), Malawi (18), Mali (13), Mauritania (6), Mauritius (25), Namibia (16), Niger (6), Nigeria (10), Rwanda (16), Senegal (17), Seychelles (16), Sierra Leone (26), Somalia (6), South Africa (29), Swaziland (21), Togo (11), Uganda (18), Zambia (16), Zimbabwe (22).

It can be noted that in twenty-one of the twenty-eight years, over eighty percent of countries had deficits less than minus ten percent, and in twenty-two of the years fifty percent ran deficits less than five percent. While it is difficult to judge appropriate deficit levels without reference to the economic circumstances of a country, one can conclude that available statistics suggest that perhaps half of the countries of the region for three decades had levels that would allow for a prudent increase to generate fiscal space. Given the limited policy options of governments of the sub-Sahara, if inflationary pressures are low, monetization is probably the least anti-poor method of financing deficits. As discussed above, bond sales redistribute public revenue from the population as a whole to the wealthy.

Lenders have it in their power and discretion to increase fiscal space dramatically through debt relief. It is to the credit of several bilateral lenders that they have cancelled debts completely. Much more important in the sub-Saharan region are the debts owed to the IMF and the World Bank. Relief for these debts has proceeded at a pre-global warming glacial pace due to onerous conditionalities.<sup>35</sup> Figure 3.7 uses the fiscal deficit minus official debt service as the indicator for the impact of an accelerated multilateral debt relief process. As was the case for Figure 3.6, there are few countries with continuous statistics. Again, the percentage of countries is used as the indicator. Servicing official debt of the government requires a domestic currency entry in the fiscal budget, equal to the foreign currency debt payments converted at the official exchange rate. Therefore, the variable, the fiscal deficit net of debt service (DnDS), indicates the fiscal space that would be created by full debt relief. In only one of the nineteen years, the first 1983, did more than twenty percent of countries covered have a deficit net of debt service more than five percent of GDP. To put it positively, in almost all years, well over eighty percent of countries had a deficit net of debt service less than five percent. At strict comparison can not be made between Figures 3.6 and 3.7, because coverage of countries and years is different. However, at the very least Figure 3.7 suggests that substantial external debt relief would substantially liberate fiscal space.

Figure 3.7:  
Fiscal Deficit minus Debt Service as Share of GDP, Percentage of  
Countries, 1983-2001



Source: *WDI 2003*. Variable is 'the sum of principal repayments and interest actually paid in foreign currency, goods, or services on long-

term debt, interest paid on short-term debt, and repayments (repurchases and charges) to the IMF [as portion of gross national income]’.

Notes: ‘Obsr’ is the number of countries; Pct [Df-DS]< -5 = percentage of countries whose ratio of (fiscal deficit minus debt service payments)/(Gross National Income) is greater than minus five percent (the deficit is negative, so  $-4 > -5$ ).

Countries (number of years with data in parenthesis): Botswana (14), Burkina Faso (10), Burundi (16), Cameroon (15), Chad (9), Comoros (5), Congo DR (19), Rep Congo (11), Cote d’Ivoire (16), Ethiopia (13), Gabon (6), the Gambia (2), Ghana (11), Guinea-Bissau (7), Kenya (16), Lesotho (13), Liberia (6), Madagascar (17), Malawi (8), Mali (6), Mauritania (1), Mauritius (19), Nigeria (4), Rwanda (7), Senegal (8), Seychelles (16), Sierra Leone (17), South Africa (8), Sudan (2), Swaziland (12), Togo (5), Uganda (5), Zambia (6), Zimbabwe (15).

Figure 3.7 shows that multilateral debt relief is all the more appropriate, because fiscal constraints in the region are in part the direct result of multilateral lending that created no income generating asset. Whatever other problems may have been associated with adjustment and stabilization problems, they violated the basic rule of prudent budgeting, that borrowing should not be for the purpose of current expenditure.

The final source of fiscal space, additional development assistance, has been plagued with controversy and inconsistency on the part of the international development agencies. On the one hand, the development community has pledged itself to provide increased assistance (MDG 8). On the other hand, most agencies, bilateral and multilateral present arguments against doing this in practice. The most ubiquitous argument, which has replaced the earlier ‘absorptive capacity’, is that development assistance (and public expenditure in general) is determined by rent-seeking in the recipient countries; that is, corruption, including theft.

Several considerations undermine the force of this argument against increasing development assistance. First, it provides donors and lenders with a convenient explanation when development assistance is judged to be unsuccessful. Second, the governments of the developed countries committed themselves politically to MDG 8, which calls for major increase in development assistance. One presumes this commitment referred to the disbursement of that assistance, as well as its budgeting. To make the commitment for developing countries in general, then, to postpone its disbursement in specific cases suggests that either the commitment had a strong rhetorical component, or donors or lenders were unaware of country circumstances. Neither would release development agencies from the commitment they made.

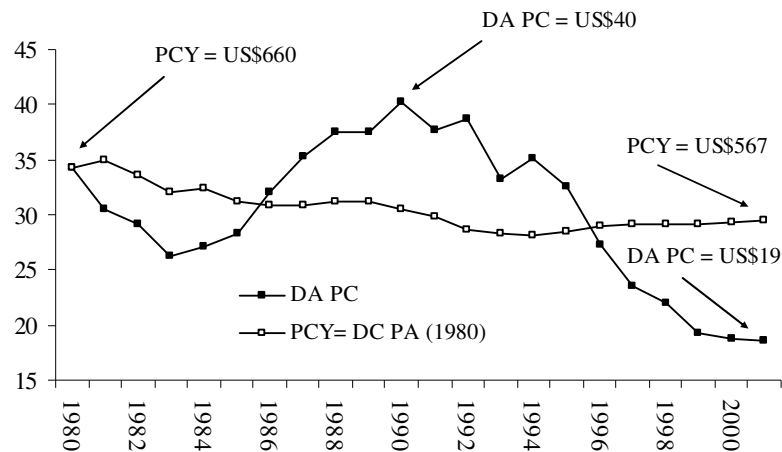
Second, for at least a decade bilateral and multilateral agencies have funded projects for improving ‘governance’, a broad category that includes reducing corruption. The continuation of these projects by the same agencies suggests that some success has been achieved, since it would not be in an agency’s interest to fund

failure repeatedly. Therefore, the amount of corruption must have declined in many countries of the sub-Sahara.

The actual performance by donors and lenders in the sub-Saharan region has not been consistent with the commitment to poverty reduction and achieving the MDGs,<sup>36</sup> as shown in Figure 3.8. In the chart, development assistance per capita (DA PC) has been deflated by the price index for US GDP. For presentational purposes, regional income per capita (PCY) set equal to the development assistance per capita for the initial year (with actual levels indicated with arrows). After reaching a per capita high of forty US dollars in 1990, price deflated development assistance declined to less than half of that level, nineteen dollars per capita in 2001. Over the same period, per capita income for the region declined by about five percent.

Figure 3.8:

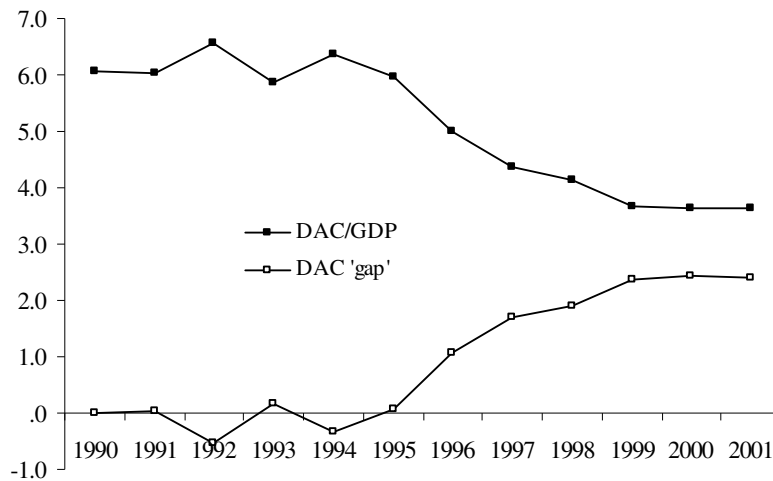
Constant Price Development Assistance per Capita & Per Capita Income (indexed), Sub-Saharan Countries, 1980-2001



Had development assistance to the region remained steady at its per capita level of 1990, in 2001 its share of an unchanged regional GDP would have been 2.4 percentage points higher than the actual level.<sup>37</sup> This is shown in Figure 3.9, and it should be stressed that this higher share in GDP would result not from an increase on the development assistance level of 1990, *only from no reduction in that level*. A return to the relative generosity of 1990 would substantially increase fiscal space.

Figure 3.9:

Development Assistance as % of GDP and the DA 'Gap',\*  
1990-2001



\*The DAP 'Gap' is the share of development assistance in GDP in 1990 minus that for each subsequent year.

Having discussed the four routes to greater fiscal space, we can now summarize the potential for increasing it. The difficulties to raise revenue dictate modest potential for this method, perhaps one percent of GDP. While deficits in most countries are not excessive, increasing them on average across countries should probably be avoided, though this could be done in countries with deficits below five percent. Average debt service across countries was 4.5 percent of GDP in 2001. If debt relief reduced this by half, hardly a radical proposal, 2.3 percentage points could be gained for fiscal space. Finally, a return to the assistance levels of 1990 would add another 2.4 percentage points. To prevent development assistance generating a new debt burden, it would be all provided as grants, or the concession loan component given a grace period until after the MDG deadline.

Thus, a small increase in public revenue, no increase in fiscal deficits, incomplete debt relief, and reversing the reductions in real development assistance would create the potential to expand fiscal space by almost six percentage points of GDP. *This would be sufficient to achieve the MDGs by 2015 in most countries.* Because of administrative capacity constraints and the time needed to design effective programmes, it would be necessary to phase such an increase over several years. The resulting share of government expenditure in GDP would not be excessive, around twenty-five percent on average for the region. These calculations show that the problem of finding the resources, fiscal space, to achieve the MDGs is not primarily technical. The primary difficulty is political will of the governments of the development assistance agencies, who formally committed themselves to the MDGs.

This increase in fiscal space and its effective application for pro-poor growth would require a macro framework described earlier in this: growth-fostering public expenditure based on public investment, a monetary policy that accommodates that expenditure, and a purposeful exchange rate policy to promote exports.<sup>38</sup>

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<sup>1</sup> Since the general equilibrium price set is unique, there is only one real interest rate that is not distortionary, which we can call  $r^*$ . Equally important in terms of formal logic (though of little practical significance), a nominal interest rate above  $r^*$  would distort the transactions demand for money from its general equilibrium value (it would be ‘too low’). As a result, at full employment output, the price level would be ‘too high’. As a result, real balances (or real ‘outside’ wealth) would be ‘too low’.

<sup>2</sup> If the general equilibrium price set is unique, it is not necessary to know what it is, since by definition any price intervention prevents it from being realized.

<sup>3</sup> ‘Subjective assessment’ is used in the sense that the economics profession defines ‘positive’ and ‘normative’ statements.

<sup>4</sup> ‘In our view, the slow progress of [structural adjustment programmes] in reviving the HIPC [countries] ...is related more to the fundamental problem of the theoretical construct than to the weak capacity of African states and institutions in implanting and carrying through structural adjustment to completion’ (Nissanke and Ferrarini 2004, 47).

<sup>5</sup> The ‘head count ratio’ is the proportion of the population below a given poverty line.

<sup>6</sup> If there is excess capacity, implied if the economy is demand determined, growth can occur in the short term without net investment, but not in the long term.

<sup>7</sup> The Pareto distribution takes the following form, with households or people numbered in ascending order of income ( $h$  being the number assigned to each), and  $Y$  is the income of that household or person;  $A$  is a scalar determined by per capita income, and  $a$  is the distributional coefficient (and summary measure of inequality):

$$Y_i = Ah_i^{-a}$$

As  $a$  increases, the gap between the income of household  $i$  and  $i+1$  increases

<sup>8</sup> The algebra of the model is explained in Dagdeviren, Weeks and van der Hoeven (2002).

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<sup>9</sup> Our model specifies the slope of the distribution function near the poverty line with the parameter  $\square$ , along with it being an index of overall inequality.

<sup>10</sup> See Geda and Weeks (2004).

<sup>11</sup> The diagram shows the four-year standard deviation of the cross country average, not the standard deviation among countries. In the second draft of this paper, the coverage will be extended to 2002.

<sup>12</sup> This hypothesis has been tested econometrically and confirmed by Lensink and Morrissey (2000). The conclusion of that study is indirectly supported by the results in a paper by Fosu (2001) linking growth to instability in imports, exports and investment.

<sup>13</sup> While there are thirty-nine countries with time series, only thirty-one have data for all thirty-nine years. However, the cross-country averages for 1961-1999 are almost the same for both sets of countries. Figure 2 uses the average for thirty-nine.

<sup>14</sup> The absolute first difference is the difference between the growth rate in one period and the previous period; in symbols,  $g(t+1) - g(t)$ , where  $g$  is the grow rate and  $t$  the time period.

<sup>15</sup> That is, Indonesia, Korea, Malaysia, Taiwan and Thailand. This term for these countries (along with the city states of Singapore and Hong Kong) was coined by the World Bank.

<sup>16</sup> See the World Bank website (<http://www.worldbank.org/poverty/strategies/index.htm>), where the PRSP process is described.

<sup>17</sup> For example, an agreement was signed between the UK Department of International Development (DFID) and the government of Rwanda establishing a medium term commitment by DFID and scheduling of assistance flows (see DFID 1999).

<sup>18</sup> In the approach of the international financial agencies, nominal exchange rate fluctuations are viewed as a buffer to external shocks. A recent study concludes, 'the big selling points of floating exchange rates – monetary independence and accommodation of terms of trade shocks – have not lived up to their promise' (Frankel 2003).

<sup>19</sup> A falling price level cannot in itself bring the economy to full employment even in a Neoclassical model. Since incomes in a market economy derive from prices, a falling price level in itself results in a downward spiral of incomes and prices. To resolve this problem and maintain the argument that a competitive economy continuously seeks full employment equilibrium, in the 1930s Pigou introduced the 'real balance effect'. He argued that falling prices increase the purchasing power of money, which would lower the saving rate and raise demand to clear the goods market at a full employment level. However, the real balance effect requires that money be an asset but not a liability. If it is also a liability, then a fall in prices has no wealth effect, with the increase in the value of the asset exactly off-set by the increase in the value of the liability. Since most money in a market economy is bank money, the real balance effect would be small even in theory. The same argument applies to all other forms of wealth-holding (see Weeks 1981, chapter 4).

<sup>20</sup> From a cross-country econometric study, Bruno and Easterly conclude, 'Our findings do not support the view that reduction of high inflation carries heavy short-to-medium run output costs' (Bruno & Easterly 1995).

<sup>21</sup> See Weeks (2001) and Geda (2002) for further discussion of counter-cyclical policies in the African context.

<sup>22</sup> For example, in Mozambique the World Bank deposits its loans directly into government accounts in private banks, and the latter are free to convert the foreign exchange when they wish.

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<sup>23</sup> The crowding out phenomenon applies to all expenditure, but here we consider only the case of investment.

<sup>24</sup> For a more detailed discussion, see Saad Filho (2005).

<sup>25</sup> The calculation is from *World Development Indicators*, ‘Terms of Trade Adjustment’, and the average is of the absolute value, which reduces the standard deviation by half.

<sup>26</sup> These are the countries with data for all years.

<sup>27</sup> The distribution of inflation rates were as follows (low inflation countries first, high second, with the number of annual observations 570 and 152, respectively): percentage of years greater than ten percent (thirty-four and eighty percent); greater than twenty percent (eleven and seventy); and, greater than thirty percent (five and fifty-six). Twenty-nine of the sixty-two values over twenty percent for the low inflation countries occurred in Malawi, Nigeria and Zimbabwe, but these averages were not significantly different from those of the other twenty-seven countries in the group.

<sup>28</sup> In Ethiopia the proportion of the population with little or no use of money was estimated in the early 2000s to be over fifty percent (Geda, Shimeles & Weeks 2004).

<sup>29</sup> While the term ‘informal’ is almost invariably used to refer to all borrowing and lending activities outside the commercial financial system, it is a misnomer, because these activities are quite formalized in terms of behaviour. More accurate would be the dichotomy ‘regulated’ and ‘unregulated’.

<sup>30</sup> Needless to say, this commitment was rarely kept, since it involved inviting currency speculation.

<sup>31</sup> It would be more precise to say that orthodox theory concludes that a floating regime would produce a nominal exchange rate that continually adjusted to the optimum for the relative price of tradables and non-tradables.

<sup>32</sup> Examples are white maize as opposed to yellow maize, and *teff*, the grain staple in Ethiopia.

<sup>33</sup> World trade grew at seven percent per annum, 1983-2001, according to *World Development Indicators 2003*.

<sup>34</sup> Fallacy of composition refers to the possibility that what seems true for one producer (a lower price increases sales) may not be true if all producers take the same measure.

<sup>35</sup> In their study of HIPC, Nissanke and Ferrarini conclude ‘unless genuine debate can be extended to...policy conditionality – i.e. the design of [structural adjustment programmes] – real ownership of policy reform programmes will not be in the hands of recipient countries’ (2004, 47).

<sup>36</sup> The MDGs were officially endorsed by heads of state in 2000 (the Millennium Declaration), though ‘[m]any of the targets of the MDGs were first set out by international conferences and summits held in the 1990s’ (World Bank MDG website, [http://www.developmentgoals.org/About\\_the\\_goals.htm](http://www.developmentgoals.org/About_the_goals.htm)).

<sup>37</sup> Had the additional ODA been used effectively, GDP would have been larger, thus reducing the ratio.

<sup>38</sup> A similar macro programme is proposed by Bradford (2005).